



Economic and markets update

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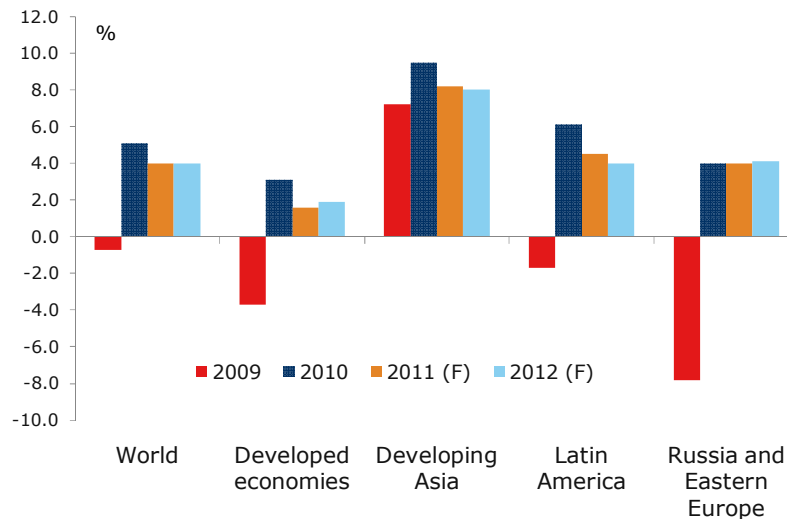
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Multi speed global economy

Global economic recovery is uneven



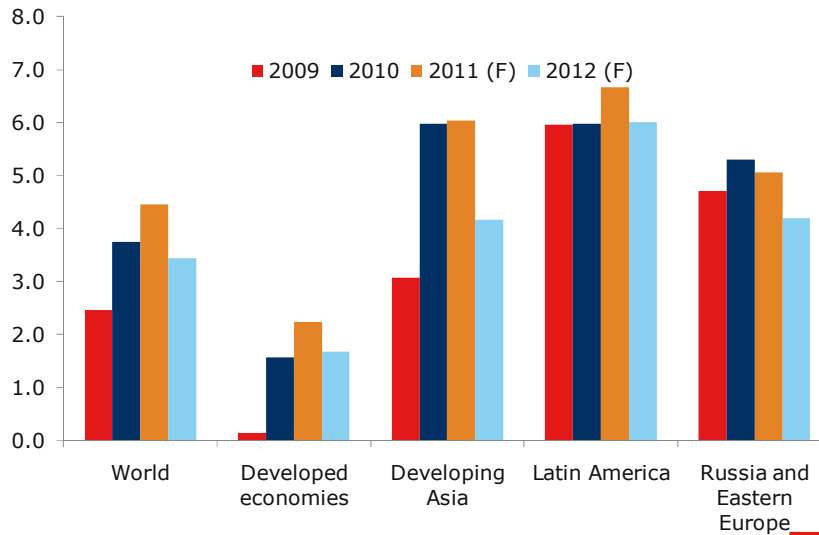
Source: IMF World Economic Outlook September 2011.

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- Strongest economic growth coming from emerging markets, but recent policy tightening now clearly having an impact on emerging economic growth.
- Brazil has slowed from 9% growth in March 2010 to 5% now. Interest rates have been tightened due to growth and inflation. More rate rises are expected.
- Korea has slowed from 8% in March 2010 to just under 5% now. Inflation has also been an issue and official interest rates have been lifted from 2% to 2.75% over the past 12 months. More rate rises are expected.
- India growth has slowed, albeit more moderately than Brazil and Korea. Reserve Bank of India has been lifting interest rates to counteract inflation.
- China still growing around 10%. Target is 8% and now will move to 7% in next 5 year plan starting this year. Can't keep growing at 10% given capacity constraints. Undertaking a number of measures to slow growth – increasing bank capital requirements, lifting interest rates and cracking down on property speculation by increasing deposit required and banning second homes.
- Growth in the developed world modest, soft patch evident in first half 2011. US economy leading the charge despite current soft patch.
- Japan re-entered recession due to natural disasters, starting to show signs of recovery in late June as production levels recover to more normal levels.
- No doubt that the Japan disaster did have an impact on manufacturing levels globally, especially in car production and electrical component production.
- Power outages continue in Japan and factories are now being asked to lower power production
- Given the monetary policy being undertaken in emerging markets, and more needed given real interest rates are in negative territory, growth is expected to slow further.
- Could see more convergence in global economic growth.
- Although all depends on what developed economies have to do to control inflation as well.
- Each country is taking a different approach. US and UK are happy to have higher inflation by keeping interest rates near zero perfect, while EU have begun to lift interest rates to control inflation

Inflation a rising concern

Inflation pressures are uneven



Source: IMF World Economic Outlook September 2011

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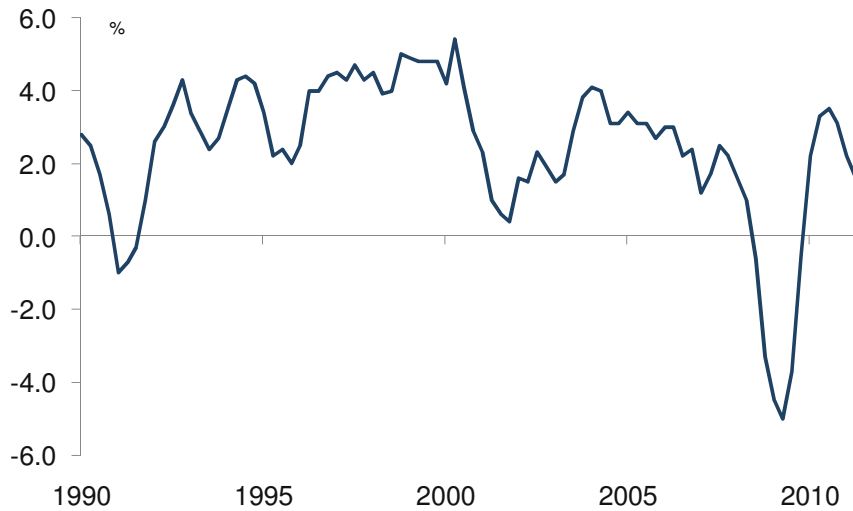
- Global inflation trends are moving higher
- This has to do with higher oil and food prices.
- Emerging economies spend a higher proportion of income on food. Around 45% in the Middle East, 30% in China, compared to 15% in Australia.
- Led to mass protests in the Middle East
- Core inflation pressures remain very relatively low in developed world with significant spare capacity, especially the labour market. Historically 70% of inflation comes from wages.
- Increased risk that developing nation inflation pressures could spill into developed world.

The US – stall speed and debt concerns



US economic recovery slows

US annual % GDP growth



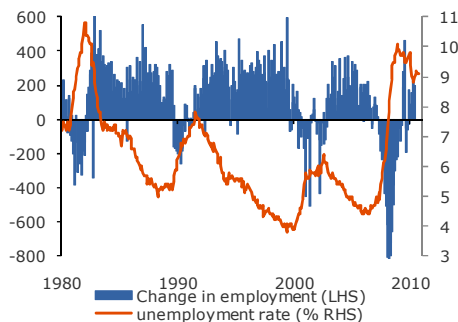
Source: Bloomberg. Data to 30 June 2011.

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- **US** economy has hit a soft patch in 2011, driven by natural disasters in Japan, weather and high oil prices.
- Growth at 1.8% annualised rate in Q1.
- Have seen downgrades for US growth forecasts for 2011, at one stage early in 2011 the market was expecting 4%, expectations are now closer to 2.5%

US employment market still soft

Jobs growth and unemployment (%)



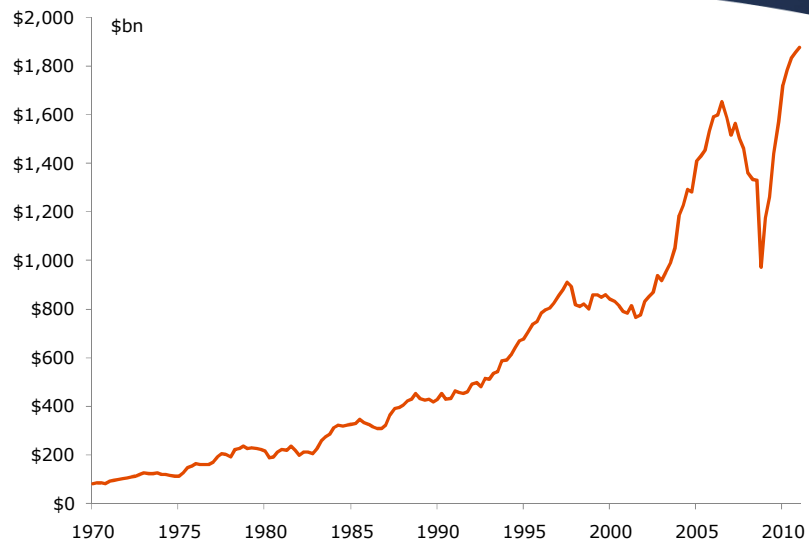
- Unemployment rate has fallen, but still high at 9.1%
- Expected to return to 6%+....but:
- Requires a number of years of above-trend economic growth
- The main political focus in the lead up to 2012 Presidential election



Source: Bloomberg. Data to 31 August 2011.

- Labour market improvement has stalled with the unemployment rate now back above 9%. Although still lower than 10% when QE3 was announced.
- At the same time inflation has accelerated. Headline inflation is 3.6%, compared to 1.1% when Qe2 was announced. Core inflation was 0.6% and falling, now at 1.6% and rising. This has been the main impediment to more stimulus.
- Although given the US economy has stalled and payrolls has been flat, the Fed now more likely to assume that inflation has peaked and could fall from here.
- Further opens the door to more monetary stimulus.
- Private companies are lacking confidence given global issues and political, gridlock to hire workers.
- Unemployment rate clearly the focus of policy makers and need to see continual reduction in unemployment rate.
- Businesses have the capacity to hire through better profits, but choosing not to hire. Instead focusing on cost reduction and productivity improvements.
- At the August FOMC meeting, a decision was made to strengthen the level of forward guidance on the Fed Funds rate, with expectations that given the current growth and inflation outlook, exceptionally low levels of interest rates would likely be warranted at least through to mid 2013.
- Further stimulus options remain on the agenda. Fed Chairman Bernanke highlighted at the annual Jackson Hole summit that "most of the economic policies that support robust economic growth in the long run are outside the province of the central bank".
- It is worth noting, however that the September FOMC will now be a two-day meeting (20th-21st) "to allow a fuller discussion.
- In this regard, the option of further monetary policy easing does look to be a "live" debate for the two-day September meeting – given that no further policy change would likely have taken only one day (as originally scheduled) to discuss. The longer meeting should allow Bernanke time to debate the economic outlook with the three dissenters on the FOMC, who did not vote for the specific interest rate timeframe.
- While the Fed Chairman did not discuss them in detail, some of the other policy "tools" open to the FOMC include increasing the maturity of their existing bond holdings, embarking on a third round of quantitative easing (QE3) and increasing the already substantial size of the Fed's balance sheet or lowering the interest rate on excess reserves.

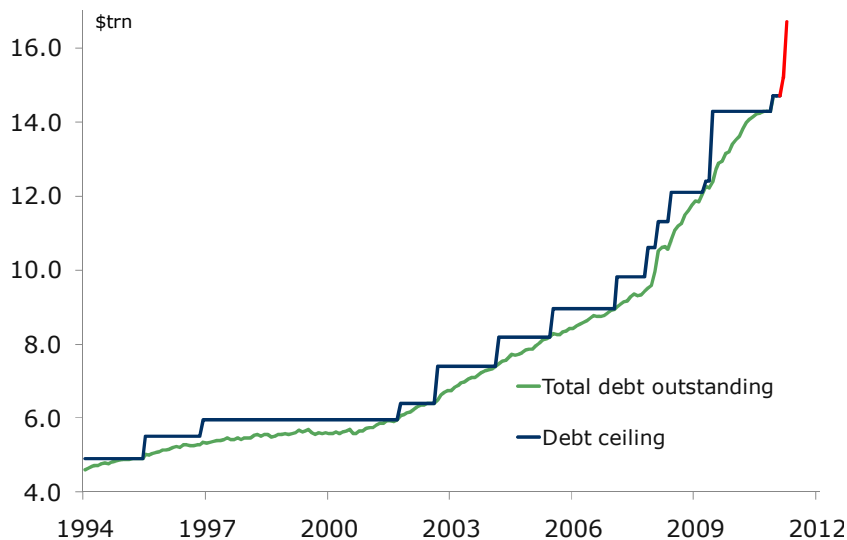
US company profits back to record high



Source: Bloomberg, Bureau of Economic Analysis. Data to 30 June 2011

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US debt ceiling increased but political uncertainty continues on



Source: Bloomberg, Colonial First State

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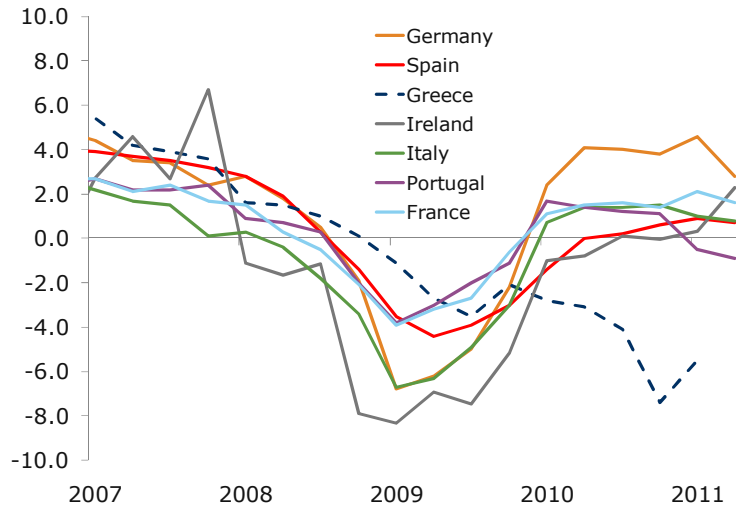
- After months of negotiations a last minute deal was struck to lift the US statutory debt ceiling by \$US2.1tr on 2 August. In return for the debt limit increase, the budget deficit path over the next decade will be cut by \$US2.4tr.
- Initially the debt ceiling will be lifted by \$US900bn, with the further \$US1.5tr to be decided upon by a bipartisan committee that is due to report by 23 November.
- In November the super committee, compiling 6 republicans and 6 democrats are due to report on the next round of budget cuts, to support the further increase in debt ceiling.
- Continuation of political posturing not good for risk markets.
- The initial increase in the debt ceiling removed the immediate risk of default, but the limited size of the increase and the political debate and process surrounding the negotiations saw Standard and Poor's downgrade the US long-term sovereign credit rating from AAA to AA+, with a negative outlook.
- The long-term trajectory of US public debt against AAA sovereign peers also prompted the downgrade.
- Post the US debt downgrade and market volatility, attention turned to the Federal Reserve for renewed monetary policy easing.
- Bond yields in the US fell sharply, already jaded by the US debt ceiling brinkmanship in Washington, market participants became increasingly concerned about sovereign and financial system risks in Europe and the deteriorating global economic outlook.
- As a result, any possible negative impact on the US bond market from Standard and Poor's (S&P) downgrading of the US sovereign credit rating were swamped as fears over possible contagion into the US and European banking systems, and speculation over a French sovereign downgrade, contributed to 'safe haven' demand for US Treasury bonds.
- In response, the 10-year US Treasury bond yield plunged through 2% to 1.97% mid-month, its lowest level since 1950, before finishing the month at 2.18%.
- Overall, 10-year Treasury yields declined by 62 bps from 2.80% at the end of July, the largest monthly drop since December 2008.
- Now all eyes turn to President Obama who is expected to announce a \$US300bn stimulus package on 8th September, although he will find it very hard to get this passed through Congress with the Republican party against any new measures.

Europe – growth upside surprise,
but debt crisis a major risk

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Diverging EU economic growth

Germany doing the heavy lifting



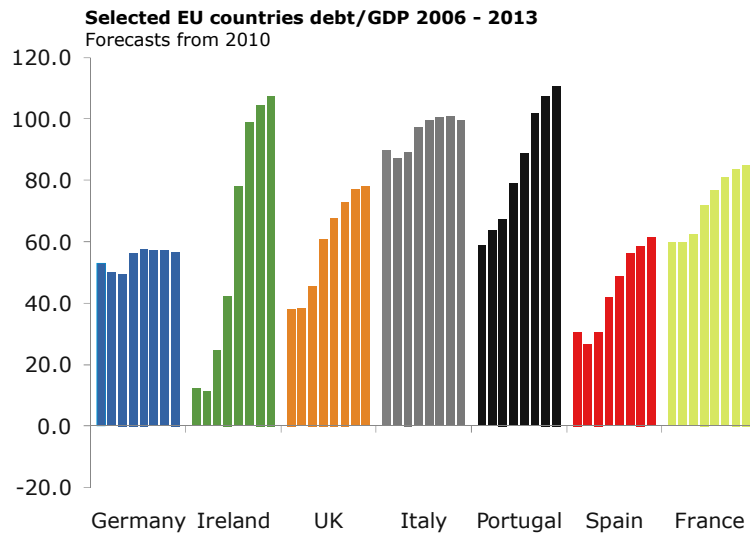
Source: Bloomberg. Data to 31 March 2011 for Greece. All others to 30 June 2011

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- European economic growth diverging according to government debt levels. Those countries implement harsh austerity packages are experiencing weak if not negative economic growth.
- Germany also performing the best it has since reunification two decades ago. This is due to large productivity improvements, good infrastructure and exports to China.

Sovereign debt a major concern

Peripheral EU debt levels are unsustainable

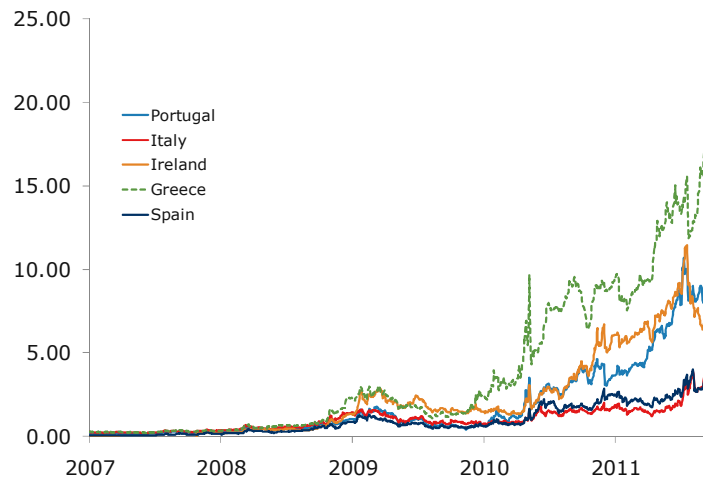


Source: IMF Fiscal Monitor September 2011.



Sovereign / banking risks in the EU

Bond yield spread above Germany



Source: Bloomberg. Data to 23 September 2011

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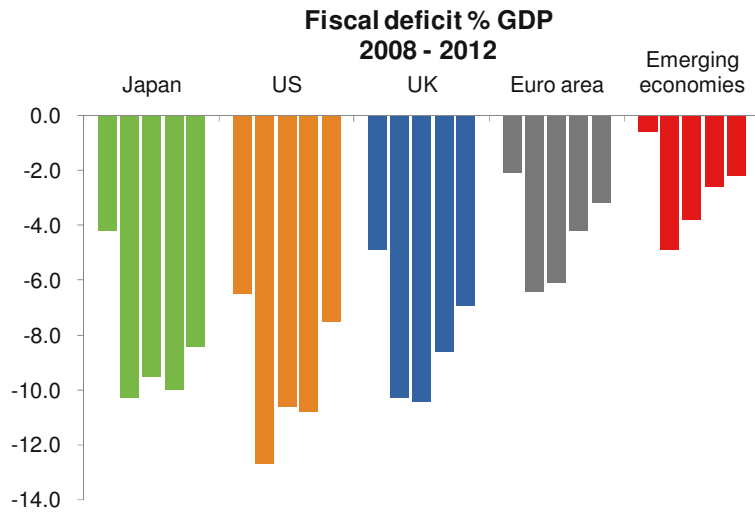
- In Europe, the focus was on liquidity issues surrounding Italian and Spanish government bonds. Economic data also weakened and political uncertainty remains high.
- 10 year government bond yields rose as high as 6.20% in Italy and 6.28% in Spain.
- Further austerity packages were announced in these two countries to help bring down absolute bond yields. Italy now expects to have a balanced budget in 2013, one year earlier than previous announcements.
- The sharp increase in yields prompted the European Central Bank (ECB) to restart its Securities Markets Program, buying Spanish and Italian debt in the secondary market for the first time to improve liquidity.
- Previously this program had been restricted to the bail-out countries; Greece, Portugal and Ireland.
- The announcement saw bond yields fall, finishing the month at 5.14% for Italian bonds and 5.04% for Spanish bonds.
- Greece is waiting on its next tranche payment, but has been delayed after IMF inspectors audited the country and discovered budget measures had not been put in place and the budget deficit was much higher than planned.

Also political posturing in Europe over the expansion of the European Financial Stability Fund. Slovakia talking about voting against the proposal. Finland continuing to demand collateral for Greek debt. Political situation in Europe very fragile, as well as concerns over bank capital. Europe still the big risk factor.

- Three outcomes from here: muddle through, which is an extension of what is happening now. Euro breakup, or fiscal union.

Europe better than others

Europe combined is a different story



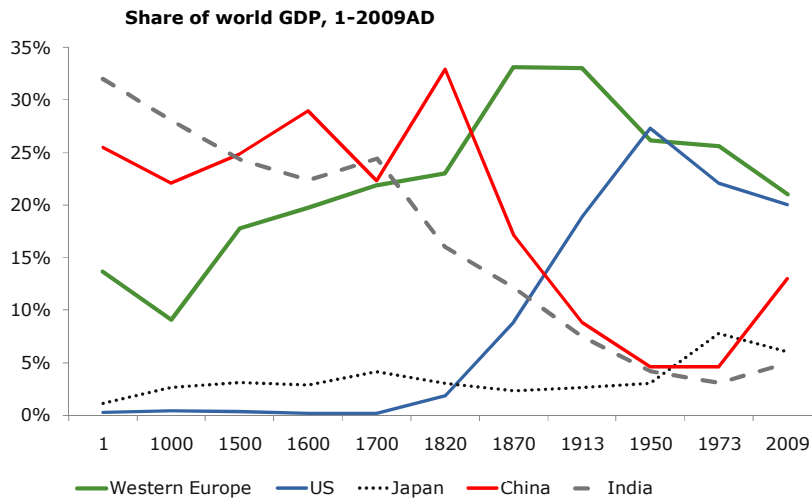
Source: IMF Fiscal Monitor September 2011.



China – structural growth driver,
but there will be a cycle

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The big picture; the re-emergence of China and India

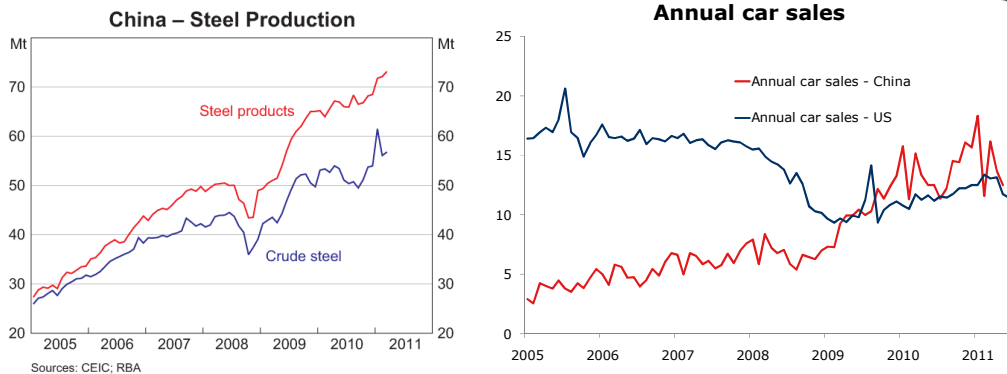


Source: Commonwealth Treasury (Maddison A, 2007, Contours of the World Economy 1-2030AD, Oxford University Press).



China and India not emerging, they are re-emerging. Knowing how the global economy has changed over time makes us more comfortable that China and India will growth for a long period of time as they catch up on what they missed out on.

China demand for resources and consumer goods



- BMW sales +60% in six-months to June 2011
- Tiffany's sales +23% gain in Asia Pacific
- Zara located in 42 cities in China – only 2 stores in Australia!

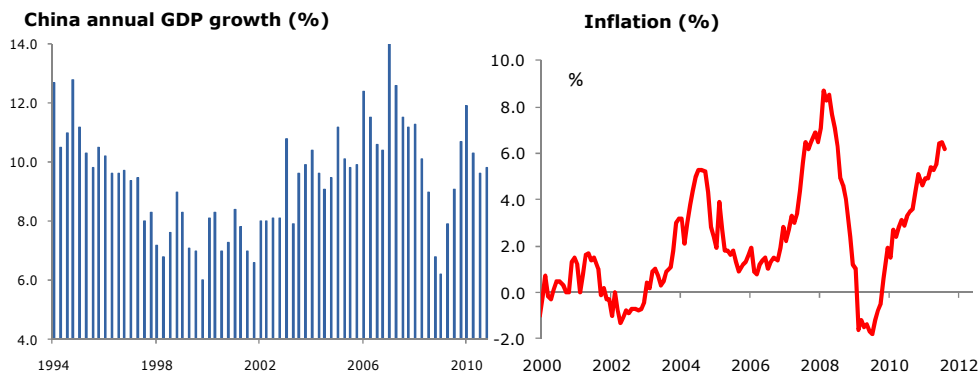
Source: RBA, Bloomberg, Colonial First State.

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- China slowing due to recent tightening measures. Inflation is high at over 5% (target is 4%) and getting harder to control due to food prices and also large wage gains.
- Still trying to slow the economy through higher bank capital requirements and official interest rate rises.
- The other way of course is through letting the currency appreciate more rapidly. Appears no support for doing this until change in leadership in 2012.

China – still a cycle in the structural story

Inflation leading to policy tightening and slower growth



Source: Bloomberg, GDP growth to 30 June 2011. Inflation to 31 August 2011.

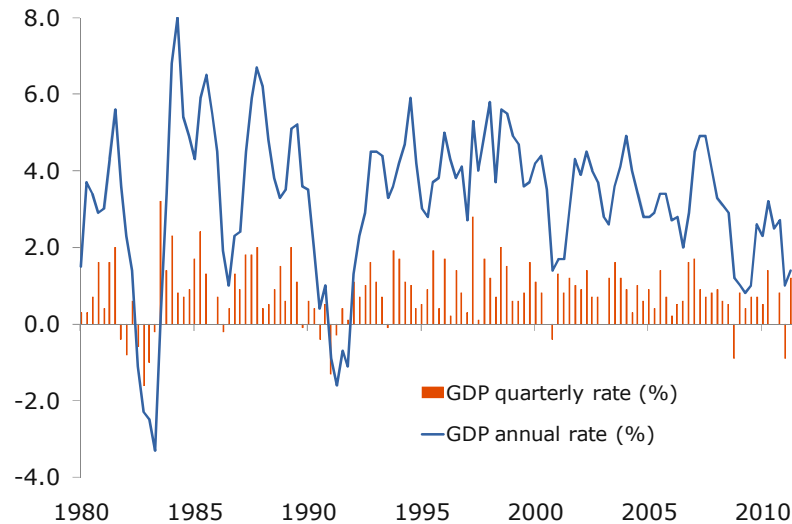
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Australia

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Australian economy is recovering

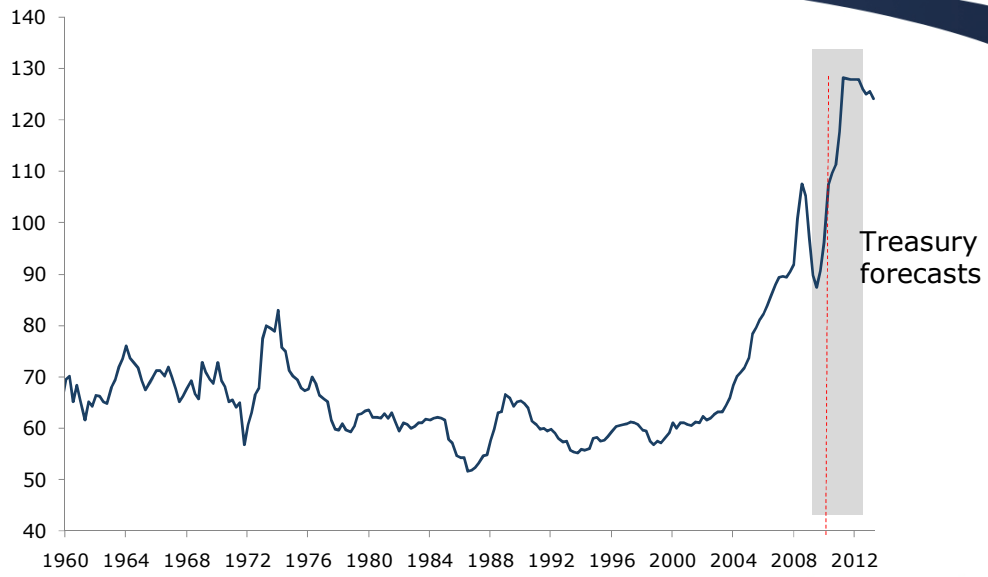


Source: ABS. Data to 30 June 2011

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- The Australian economy rebounded in Q2 2011 by 1.2%/qtr after falling by a revised 0.9%/qtr (was -1.2%/qtr) in Q1 2011 post the natural disasters. The annual pace of growth also rebounded, to 1.4%/yr from 1.0%/yr in Q1. The pace of growth still looks unusually low following a very strong +1.4%/qtr in Q2 2010 and masks some of the underlying strength seen in today's data.
- The mix of economic growth in the quarter was interesting with household final consumption spending up 1.0%/qtr (contributing 0.5% points to growth), contrary to expectations and read through from retail sales data. Private sector capital spending was up 1.3%/qtr (+0.1% points contribution), driven by a 4.9%/qtr increase in machinery and equipment, no surprise given mining and gas projects progressing over the quarter.
- Public sector capital spending fell 3.8%/qtr as federal stimulus measures were unwound as expected. In addition, changes to inventories contributed to growth by a very large 0.8% points on the quarter.
- The household savings rate fell to 10.5% from a flood payment impacted 11.7% in the previous quarter, still a high savings rate and indicating the cautious consumer remains despite some underlying signs of consumer demand.
- On a state level, the strongest growth was in Queensland up 3.5% for the quarter, which mostly reflects the delayed recovery from the floods earlier in the year. South Australia was also surprisingly strong, up 2% for the quarter.
- Western Australia grew by 1.0%/qtr and the Northern territory grew by 1.1%/qtr. Tasmania and ACT both had negative growth, down -0.5%/qtr and -0.7%/qtr respectively. Victoria and New South Wales both experienced weaker growth than the key mining states, signs that a two-speed economy may still exist.
- Growth still below expectations of RBA due to weaker consumer and slower recovery in coal exports. This should not impact the interest rate outlook, unless growth weakens from here.

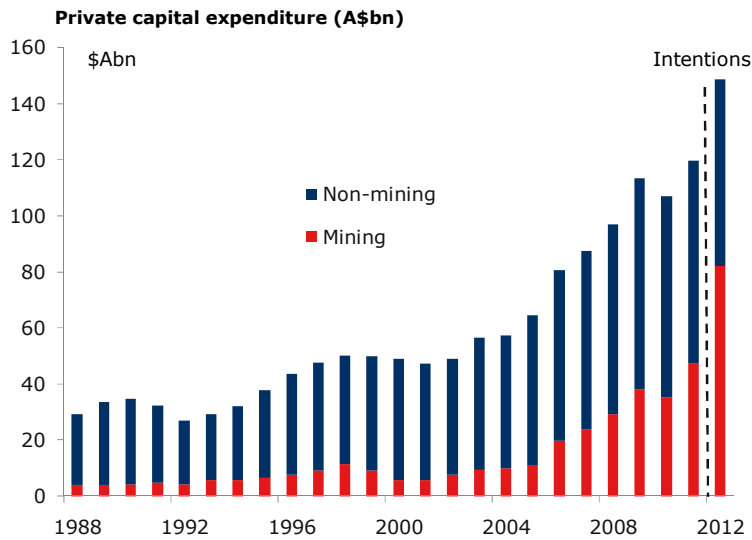
Terms of trade to drive growth



Source: ABS; Treasury estimates for 2012 and 2013.

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Leading to lots of capital investment



Source: ABS. Data as at August 2011

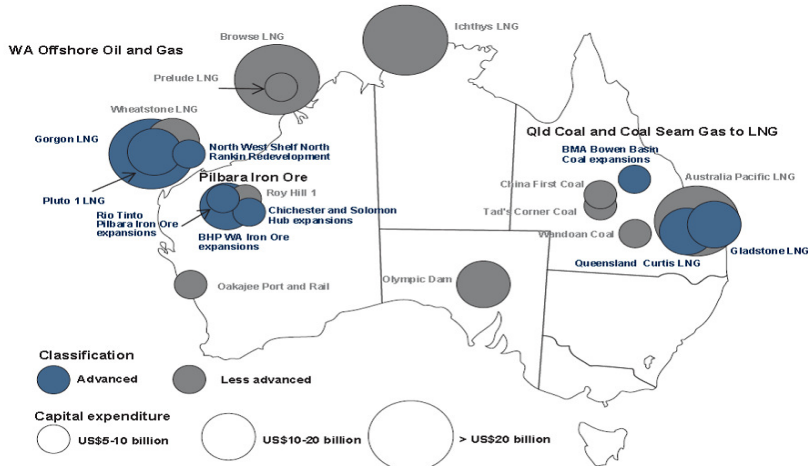
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-Also confirming the strength in the mining sector was revised capital expenditure intentions. These were upgraded for 2012 to \$A149bn (was \$A140bn), with the mining sector accounting for \$A82bn of the total.

-Already feeling wages pressure come through in the mining industry

-This is expected to put pressure on Australia's already low spare capacity and lead to inflationary pressures.

Where are the projects

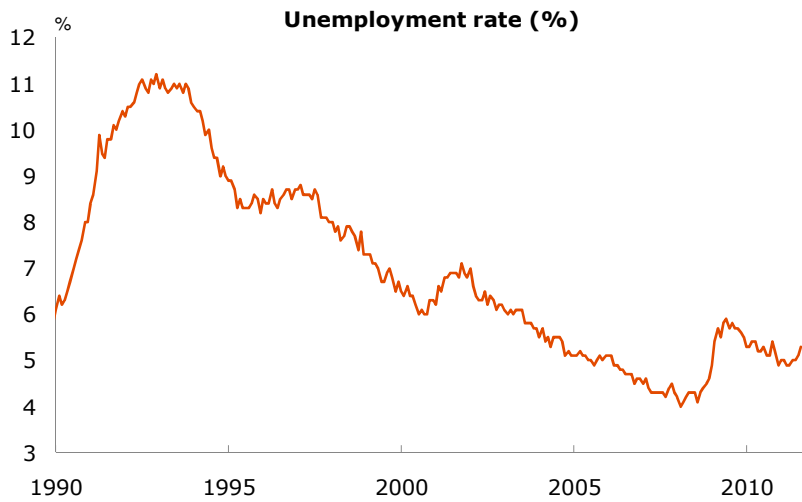


Note: ABARES defines advanced projects as either 'committed' or 'under construction' and less advanced projects as those undergoing a feasibility (in some cases, pre-feasibility) study, or that have not yet been subject to a final investment decision since the completion of a feasibility study.
 Source: Indicative estimates based on ABARES, company reports and other publicly available information.

Source: 2011/12 Budget.



Labour market stalls



Source: ABS. Employment data to 31 August 2011.

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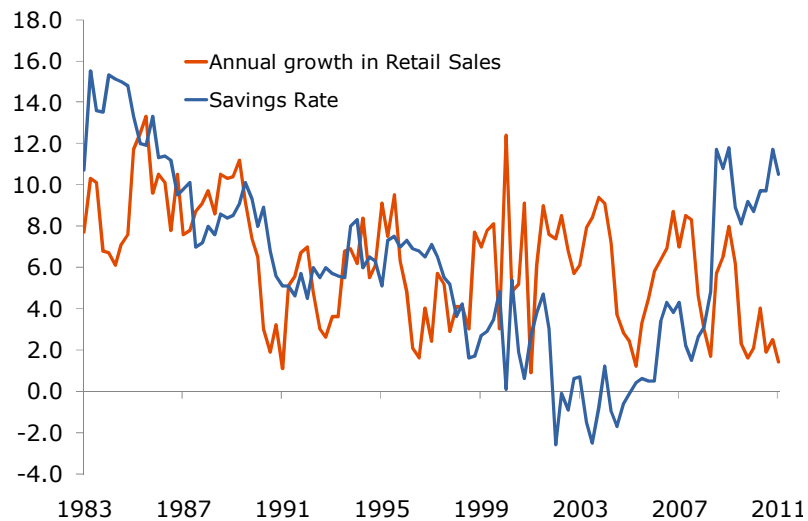
Unemployment rate back up to 5.3%, up from 4.9% in April.

Queensland really moving around the figures, could still be issues with coal mines and weakness in SE Queensland.

Still shows a waning of labour market strength.

Issue for RBA now will be how this impacts on wages pressure and inflation outlook.

Savings rate remains high



Source: ABS> Data to 30 June 2011

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-The household savings rate retreated to 10.5% from a revised 11.7% in Q1 2011 (was 11.5%). This is at odds with recent thinking about ongoing household caution given global events, but a move higher in Q3 2011 cannot be ruled out in light of recent market volatility.

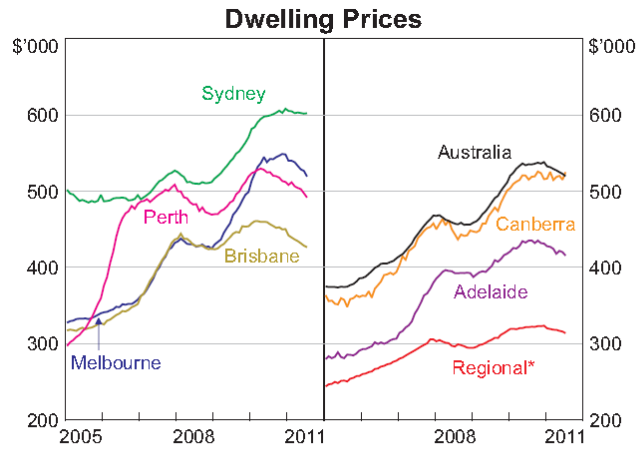
-The Q1 2011 savings measure was likely impacted by the savings of flood assistance packages which may have been unwound in Q2 2011.

-The fall in the savings rate came with a strong performance by the consumer. This is at odds with retail sales data over 2Q which showed ongoing weakness.

-It is important to remember that retail sales data only represents roughly 30% of all consumer spending. If we examine the national accounts data, it shows consumer demand rising 1% over the quarter in volume terms. This was driven by spending on transport services (+5.9%/qtr), recreation & culture (+3.1%/qtr) and hotels, cafes & restaurants (+3.0%). The consumer is willing to spend, but the composition and mechanism (through switching to online) is changing.

House prices stagnating

Annual change in house prices (%)



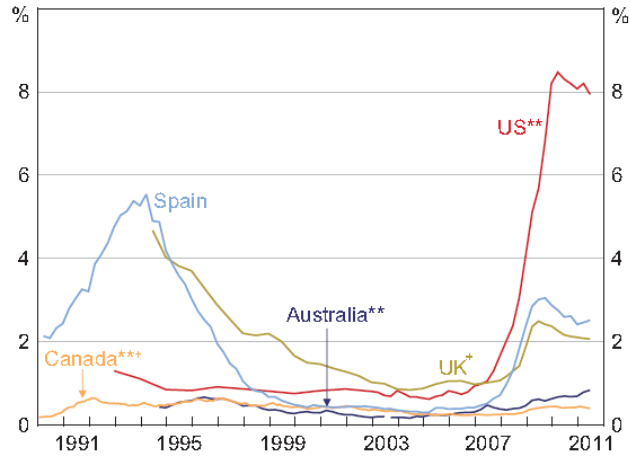
* Excluding apartments; measured as areas outside of capital cities in New South Wales, Queensland, South Australia, Victoria and Western Australia

Sources: RBA; RP Data-Rismark

Arrears up slightly, but low by comparison

Non-performing Housing Loans

Per cent of loans*



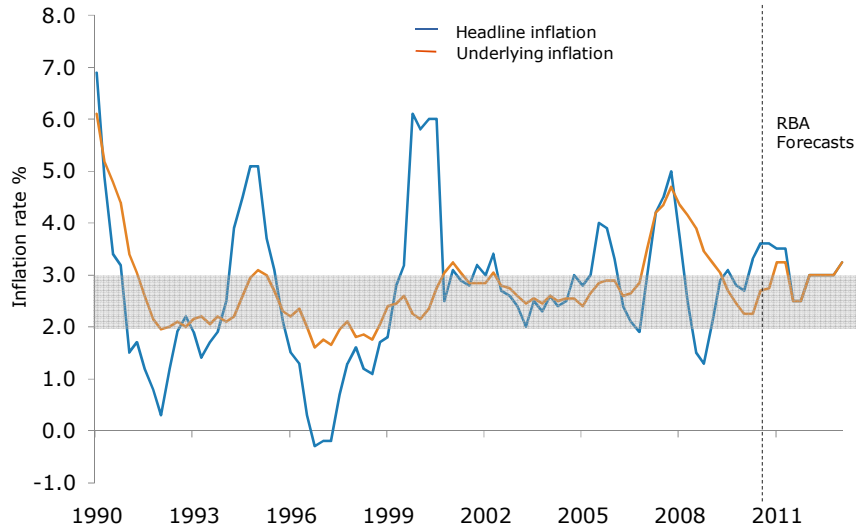
* Per cent of loans by value; includes 'impaired' loans unless otherwise stated; for Australia, only includes loans 90+ days in arrears prior to September 2003
 ** Banks only
 + Per cent of loans by number that are 90+ days in arrears
 Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

Source: RBA



Australian inflation

At the upper end of target range



Source: ABS, RBA. Data to 30 June 2011. Underlying inflation is an average of trimmed mean and weighted median. Forecasts provided in RBA statement on monetary policy, August 2011 edition.

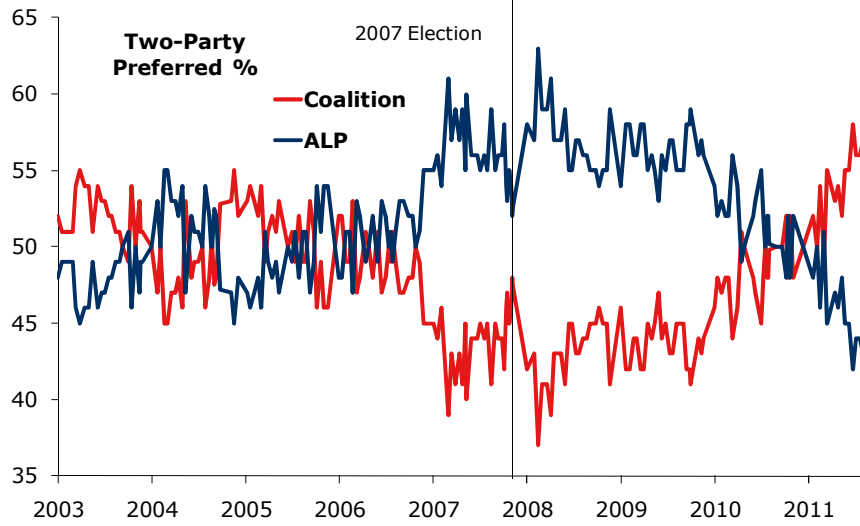
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Inflation still an issue, with headline inflation at 3.6% and underlying inflation at 2.7%. With a relatively tight labour market, and wages pressure, and weak productivity, RBA still concerned about inflation.

But:

The RBA has also acknowledged that if weaker demand eventuates it could dampen wages pressure and price setting behaviour and “curtail the upward trend in inflationary pressures that has, up to this point, appeared to be in prospect”. There is obviously a counter argument to this, being low levels of productivity, the mining and gas boom and rising administrative process, particularly electricity.

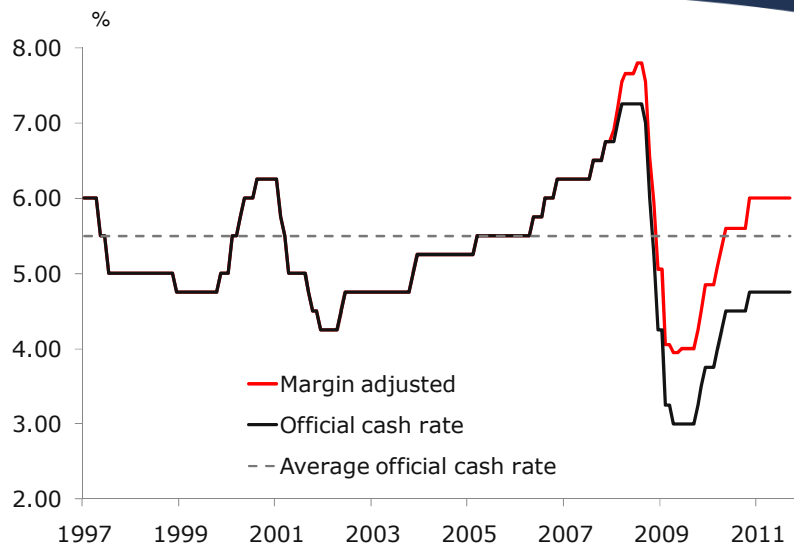
Political uncertainty



Source: Newspoll. Data to September 2011

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Interest rates into restrictive territory

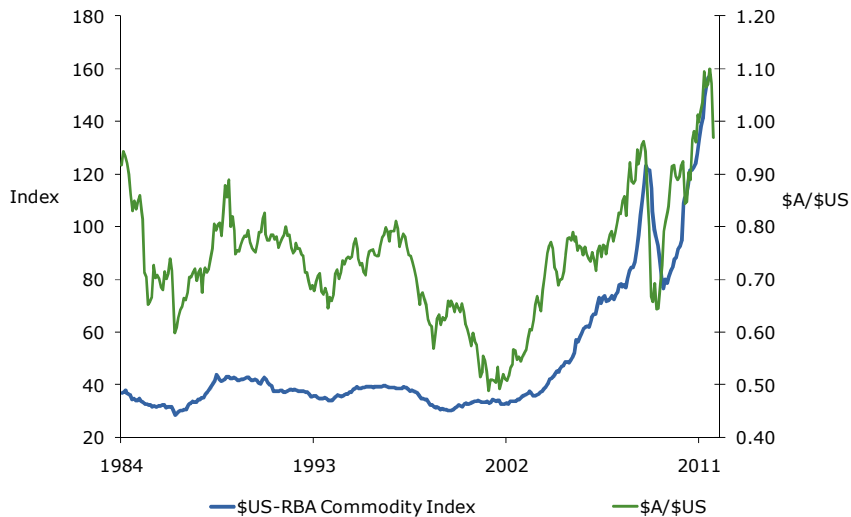


Source: RBA. Data to September 2011

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In this uncertain environment it is likely to see the RBA leave interest rates on hold well into 2012. What recent speeches and GDP data does not do is ratify market expectations of an imminent and substantial easing of monetary policy in Australia.

A\$ supported by commodity prices

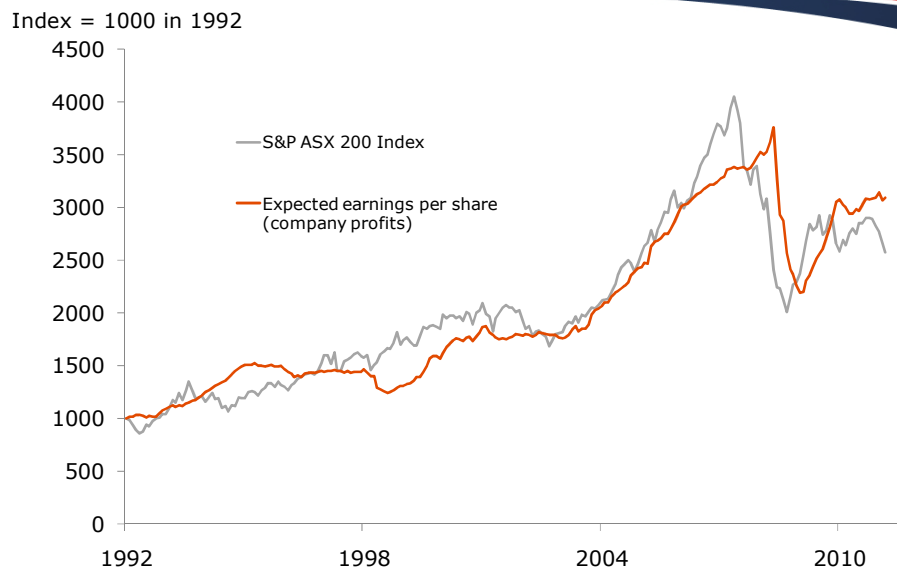


Source: RBA, Bloomberg. Data to 31 July 2011 for commodity prices and \$A to 19 September 2011.

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- The AUD is trading above parity with the USD, its highest level since the December 1983 float.
- Being driven by commodity prices, interest rate differential, confidence and structural buying of AUD by offshore investors.
- AUD now 5th most traded currency, (we are the 17th largest economy = big difference!
- AUD/USD 4th most traded currency pair.
- AUD is a way to buy the Asian growth story and China. Lots of mining work to be done with a good return, led to buying of AUD
- Strength of the AUD is well justified by terms of trade boom, rising commodity prices, strong capital inflows and higher interest rates.
- But future path could depend on further stimulus from Fed.
- Still a lot of offshore buying for Aussie govt bonds. Where as offshore investors staying away from equity market due to political overlay and AUD strength.
- Commodity prices still staying firm especially iron ore and

Australia – profits and the sharemarket



Source: Macquarie Group, Bloomberg. Data to 31 August 2011 for Forward EPS and S&P ASX 200
Past performance is no indication of future performance.

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Summary

- Daily news about US and European debt is dominating the short term investment landscape
- It is important to continue to think about the long term structural changes in the global economy
- Much of this comes from the re-emergence of China and India and other emerging economies
- This is causing unprecedented demand for resources, food, consumer goods and infrastructure
- In Australia we are seeing the benefits of this but the adjustment process to this structural change is more painful than originally estimated
- In these volatile times financial advice remains more important than ever to guide

