

are markets back to ‘normal’?

What a difference a year can make. Twelve months ago the world was in the grip of the Global Financial Crisis. Credit markets were effectively closed, sharemarkets had halved in value, economic activity had come to a sudden halt, and investors saw only darkness ahead. Few were prepared to forecast that, 12 months on, investors would have a far more constructive view of the world.

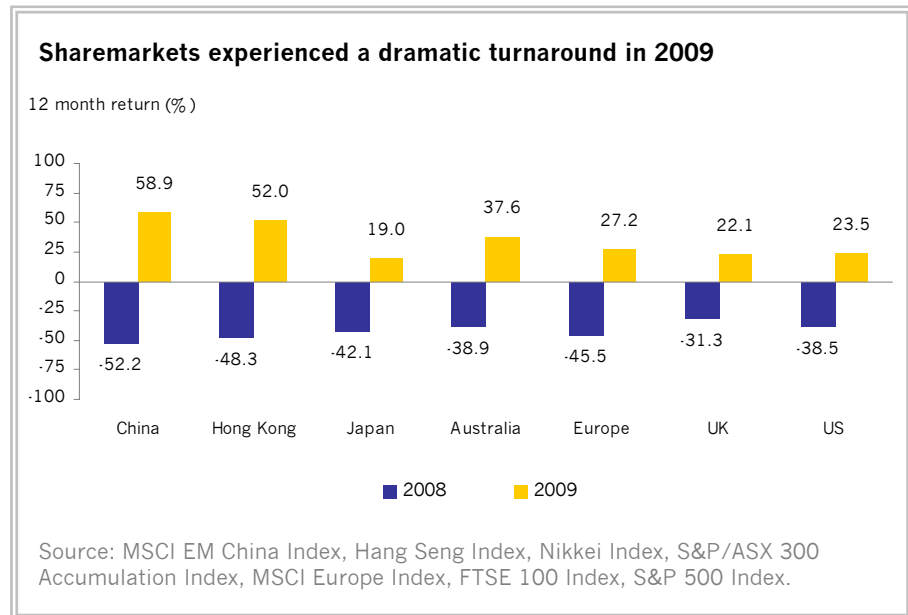
Sharemarkets were the stand-out performers through 2009 as liquidity returned to capital markets and investors became increasingly optimistic about

corporate earnings prospects. In fact, 2009 was the fifth best calendar year for international sharemarkets in the last 40 years. In Asia, some sharemarkets were up more than 50%. There was also a sharp turn of fortune in the US with its market rising 23.5% across the year. Having been at the epicentre of the crisis in 2008, the past year has seen the US market benefit from unprecedented government stimulus, aggressive corporate cost cutting and an increasingly competitive exchange rate.

The Australian sharemarket performed strongly, up 37.6% for the year. It is noteworthy that, given the appreciation of the Australian Dollar in 2009, offshore investors in the Australian market were particularly well-rewarded. The domestic economy has not only been underpinned by its economic ties to Asia, but it has also benefited from significant policy stimulus and a well regulated financial system. The strength of the domestic economy and the outperformance of the sharemarket mean that Australia now has the sixth largest sharemarket capitalisation in the world. While this is good news, it should not distract us from the need to maintain and enhance global diversification in our portfolios.

We believe the Global Financial Crisis – in particular the risk of collapse in the financial system – has passed and economies are currently in transition to more ‘normal’ conditions. Precisely how this transition unfolds and what the meaning of ‘normal’ is in a post-crisis world is the subject of considerable debate in the market. However, this type of market uncertainty is in itself quite normal, and indeed healthy, and is largely the reason that sharemarkets deliver a higher long term return than cash or government bonds. Consequently, as we head into 2010, we believe that clients should be confident that by embracing the long term investment strategies agreed with their advisers, they are well positioned to achieve their investment objectives.

Jeff Rogers
ipac Chief Investment Officer



why does ipac believe the GFC is over?

For the past two years, ipac has been following a number of financial market indicators to track the path and intensity of the GFC. Evidence from these indicators gives us comfort that the GFC has passed.

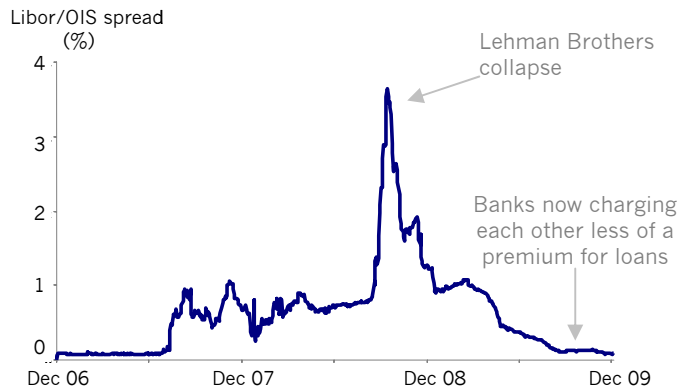
The first chart on the right shows how inter-bank markets have returned to normal. It displays the Libor/OIS spread which reflects the risk premium major banks charge each other for overnight loans. We can see how high this premium rose in September 2008 following the collapse of Lehman Brothers. Since then, as a consequence of government policy aimed at underpinning the financial system, confidence has been restored. The Libor/OIS spread is back to pre-GFC levels.

The second chart shows how the improved sentiment in financial markets has been transmitted to rising economic growth expectations. This chart shows expected growth in the US where, similar to most other regions, analysts are anticipating a rebound in economic activity in coming years. ipac's central scenario is for economic recovery in 2010, with a rise in global activity of around 3%. The bulk of global growth is expected to come from developing nations, with Australia's ties to Asia supporting growth domestically.

Finally, the third chart shows the CBOE Volatility Index which reflects sharemarket investors' forecasts of the size of future market risk. As we can see, this measure has returned to pre-GFC levels, having blown out to an all-time high in September 2008.

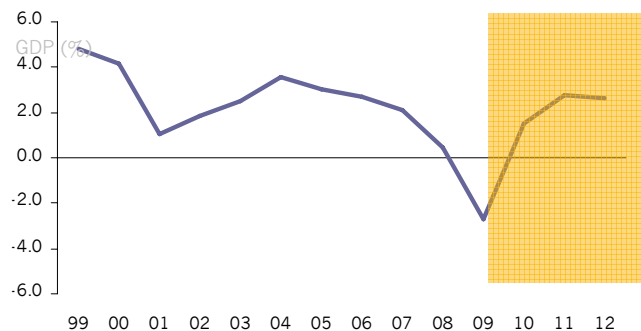
These indicators give us confidence that the risk of financial collapse has passed, and that all clients should be fully invested in their long term investment strategies.

confidence in the financial system has been restored



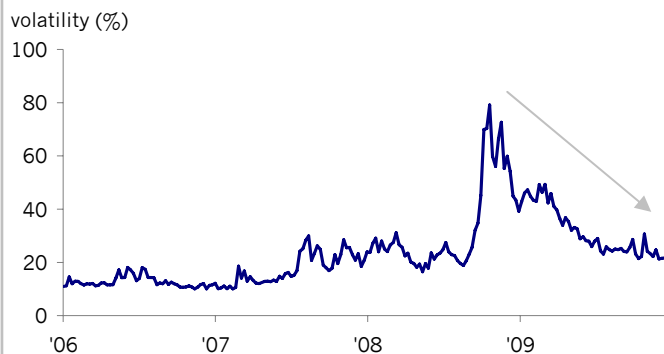
Source: Bloomberg. Data as of 31 December 2009.

there are signs of a recovery in growth



Source: IMF and ipac. Shows realised US GDP growth, and forecast US GDP growth in shaded box.

markets are showing that fear has subsided



Source: Bloomberg. CBOE Volatility Index. Data as of 31 December 2009.

what are the key issues likely to influence markets from here?

~ how emergency government policy responses are unwound

Given the huge amount of government stimulus we have seen over the past 18 months, the market is naturally paying close attention to how these emergency actions will be unwound and what this means for growth and inflation. If fiscal and monetary policy measures are unwound too quickly, this may lead to deflationary forces and growth set-backs. On the other hand, if policies are unwound too slowly, we run the risk of inflationary pressures emerging, and large budget deficits undermining government fiscal positions for a number of years. While we take comfort from the fact that central banks have demonstrated a willingness to act aggressively when it comes to implementing monetary policy, there is as yet little evidence that governments will have the political courage to implement sustainable fiscal strategies.

~ how corporate earnings recover over the short term

Last year's recovery in sharemarkets was driven by a recovery in valuations. In the period ahead, the focus will be on earnings growth. Optimists expect that corporate profits will beat expectations and quickly surpass previous highs due to a combination of aggressive expense control and a pick-up in revenues. If this scenario plays out, we can expect sharemarkets to advance sharply. This optimism stands in contrast to the view of those who think that earnings will be driven on a one-off basis by reduced costs, and that the delivery of revenue growth will be challenging in a slow grow environment. Given the divergence of opinion regarding the pathway for earnings, the market will be paying particularly close attention to any commentary around prevailing trading conditions when companies report outcomes to shareholders over the next six months.

~ what the medium term growth trajectory will be after we transition from the deleveraging phase

Eventually, economic conditions will normalise. However, a major debate in markets centres on the nature of the new 'normal'. Many market participants believe that the combination of reduced financial leverage, set-backs to trade globalisation, and greater government involvement in the economy will result in a lower than average rate of economic growth in the years ahead. As time progresses, if it appears that economies are more resilient than expected, then growth markets may see strong returns.

~ how the interplay between developed and emerging economies unfolds

A key structural imbalance in the global economy, that has been building over the past decade, relates to the excess savings in emerging economies and excess consumption in developed economies. From a financial markets perspective, the key expression of the tension this creates is focussed on China's exchange rate management policy. Maintenance of a structurally weak exchange rate leads to unproductive asset price speculation in China, and risks increasing geo-political tension between East and West. A key question for markets is how this tension is managed and whether the imbalance can be unwound in an orderly way.

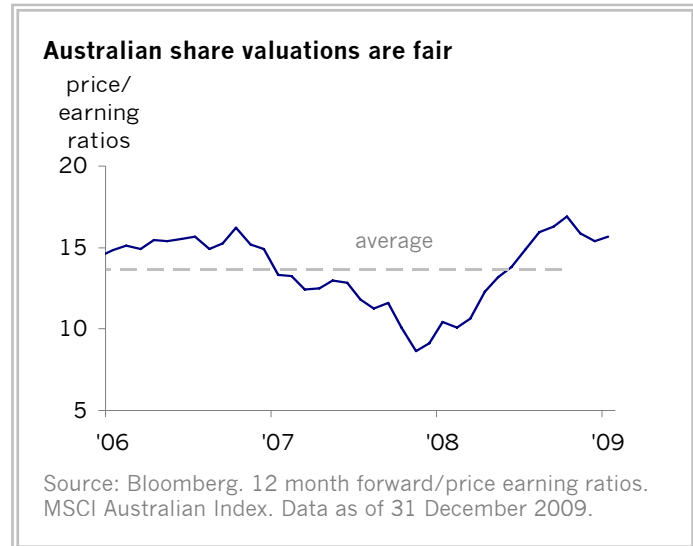
if interest rates are expected to rise, why is ipac holding bonds in client portfolios?

Cash rates are expected to continue to rise in Australia, and tightening is forecast to start in the US and Europe either later this year or next year. While rising interest rates are generally seen as bad news for bond prices, markets have already taken the prospect of rising interest rates into account. Yields in bond markets are higher than current cash rates, and in many markets the gap between bond yields and the cash rate is at an historically wide level. Providing there is no unexpected surge in inflation expectations, the bond market can handle a modest rise in bond yields, and still deliver returns in excess of cash. Critically, if economic conditions do not improve in line with our central forecasts, then bonds will do well and demonstrate their diversification benefit in diversified portfolios.

how are growth markets expected to perform over the coming year?

Within shares, valuations are in line with historical averages, so the outcome for sharemarket returns will be driven by earnings, and the extent to which they match expectations. In Australia, there is scope for corporate earnings surprise coming from robust economic activity in the region. In addition, consolidation within several industries is likely to provide support for the market.

In property, private valuations for commercial and retail property have stopped falling, and listed trusts have improved their balance sheets through capital raisings. The cost of debt also appears to be normalising, which should lead to stabilisation in this sector of the market. Providing there are no further shocks to the market, listed property should offer returns slightly above the long term average.



how will ipac respond to movements in the Australian Dollar?

At present, the Australian Dollar is above fair value. It has appreciated well above its long term average of \$US 0.72. Factors driving the relative strength of the Australian Dollar are well known to the markets. These include favourable interest rate differentials and high commodity prices. Since these factors are unlikely to remain in Australia's favour on a permanent basis, ipac's bias is to consider whether portfolios should increase exposure to foreign currency.

what does all this mean for client portfolios?

As market sentiment continues to recover, correlation between investment markets will fall back to more normal levels. In this environment, we believe there are good prospects for active managers to add significant value. As a consequence, client portfolios are expected to perform in excess of long term expectations. Indeed, should corporate earnings surprise on the upside, there is scope for client portfolios to perform particularly well over the next few years.

This publication has been prepared for distribution to professional financial advisers only and is intended to provide general information. ipac asset management limited ABN 22 003 257 225 (ipac) AFS Licence No. 234655 does not authorise the distribution of this publication to or use by existing or potential investors. Existing or potential investors should base their investment decision on the detailed information contained in the current Product Disclosure Statement (PDS) and should consult their financial adviser. While ipac has released this information for guidance purposes only and believes the information contained herein is correct, no warranty of accuracy, reliability or completeness is given and, except for liability under statute which cannot be excluded, no liability for errors or omissions is accepted.