

January 2010

AUSTRALIAN & GLOBAL MARKET WRAP

Australian Economic Review

Australia has weathered the global financial crisis storm better than most developed countries.

The Australia Government has adopted a proactive approach through stimulus packages and monetary policy to ensure that the future economic environment will be positive. 2010 will be the 19th consecutive year of positive growth for Australia. Only two countries can match this claim, none other than our increasingly important trading partners, China and India.

Here we consider the big picture themes that point to Australia's run of growth continuing for another year, with a pace in the 3% to 3.5% range looking readily achievable. Central to our analysis is the recognition that various investment cycles and exports will be supportive of growth in the near-term, as well as the medium-term.

For 2010 a sharp housing investment upswing and a burst of public investment will be key growth engines. This is typical in the initial period following a downturn. In the housing sector, pent-up demand emerged over recent years, with the RBA tightening monetary policy for the six years to 2008. Dwelling approvals slumped to 132,000 in 2008/09, some 30% below estimates of requirements. Owner-occupiers responded in large numbers to a 41 year low in interest rates and additional Government incentives. Finance commitments to owner-occupiers for new dwelling construction are up 80% from the low of a year ago. Moreover, investors are beginning to return to the housing sector – a necessary development for a sustained upswing. Housing investment is forecast to add almost 1ppt to growth over the year to June 2010, a turnaround from a subtraction of around 0.7ppts over the previous year. This positive sentiment has been reflected in the upward movement in the commercial property sector.

Australian Commercial Market in Review

While Australian commercial property markets have experienced recent volatility like the rest of the world, Australia has now enjoyed over 19 years of stable, positive economic growth while commercial property returns have been remarkably consistent. Data from The Property Council of Australia/Investment Property Databank indicates annualised standard deviation of the Australian composite property index was just 4.0% per annum over the last 10 years. Total commercial real estate investment transactions continued their upswing in the fourth quarter 2009 rising to \$2.7bn, a 20% increase on the proceeding quarter. This increase shows a continuing improvement in commercial property activity across Australia, following a volatile 2008. This quarter has marked the return of CBD office activity with significant deals occurring in Brisbane, Sydney and Perth.

A number of large office deals are also due for completion early in 2010. The office sector attracted the most amount of activity in 2009 with over \$1bn worth of buildings transacted in the fourth quarter.

Retail assets continue to attract the interest of investors as better than forecast economic conditions continue to provide support to retail spending.

Transactions in hotels, leisure facilities and healthcare (other) formed the second largest segment of activity in the quarter.

Listed trusts have re-emerged as purchasers with the Commonwealth Property Office Fund purchasing buildings in Brisbane (\$208mn) and Perth (\$95mn). There has been a return to larger lot sizes during the quarter as transactional evidence emerges of stability in pricing especially for premium and A grade assets.

Australia's commercial property markets have had to withstand the toughest economic environment presented since the early 1990s recession. So far, the sector as a whole has escaped major bloodletting, although there have been some casualties in the listed sector, emanating not so much from property market weakness itself but from business models reliant upon excessive gearing. There has been some contagion stemming from such entities having to adjust balance sheets but by and large, commercial property has insulated itself relatively well in this environment, even though activity centres linked to commodities markets have displayed greater volatility.

Office Snapshot 2010

Sydney's office market fundamentals are weakening but are not expected to deteriorate significantly as new supply remains subdued. This should avert more considerable dislocation given there has already been surprising weakness in rentals recently (primarily via higher incentives). Prices have fallen by around the national average.

Melbourne's CBD office market is in a relatively strong position. The vacancy rate has lifted only slightly to mid-2009 and is set to rise further but will be kept in check as new office supply is projected to remain moderate. Absorption, while negative will be minimised on the back of a relatively robust economic performance. Importantly, Melbourne's rental market peaked at \$310/sqm in September quarter 2008 and has come off 15% (this is market rentals, not average rentals on lease) which is around the same level as reported in 1988 (\$300/sqm)! Rentals in Brisbane and Perth, on the other hand, peaked at \$744/sqm and \$831/sqm respectively last year. As a consequence, rental affordability in Melbourne remains very favourable, suggesting the Melbourne market will remain an attractive option for relocation. This also implies limited downside risks to rents and prices compared to most other, but especially 'commodity' capitals

Brisbane has an unprecedented supply line to digest over 2009 that will send vacancies from record lows in 2008 to record highs in 2009.

Perth is in a very similar position. Given the very rapid growth in Brisbane's prime rents (trebled in three years to June 2008), there is every prospect of a sharp and severe reversal over 2009/10. This has already translated into markedly lower market rentals which had been partly pre-empted by early decompression of income yields. Adelaide's office market is in reasonable balance and is expected to remain so through the cycle. The moderate run-up in market values and rentals (while others were booming) in recent years, together with solid fundamentals suggest good protection for values and rentals compared to other centres in the years ahead.

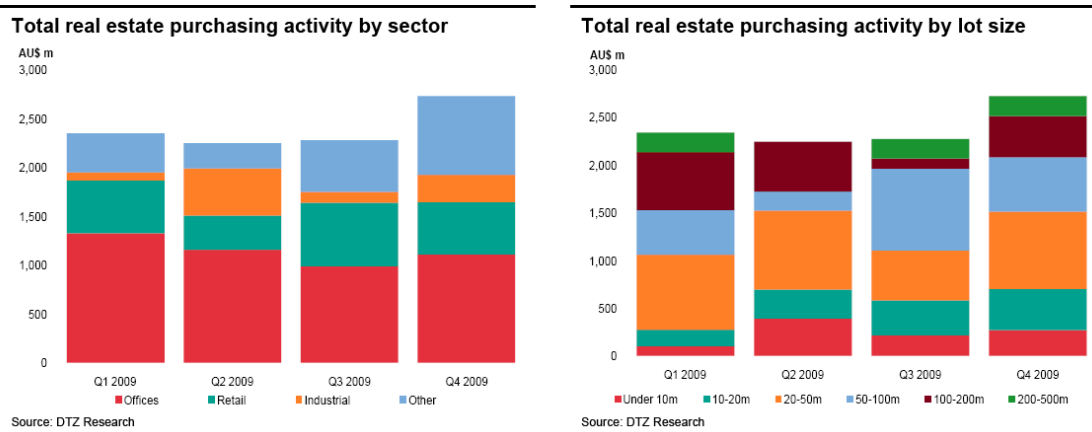


Figure 1

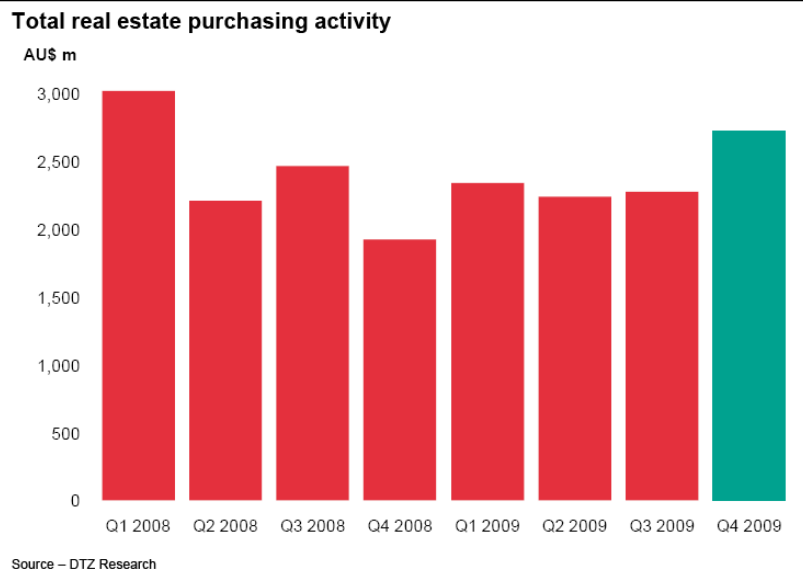


Figure 2

Although the GFC has had a significant impact on the Australia economy it has rebounded quite quickly.

World Market Wrap

Australia: 2010 will be the 19th consecutive year of positive growth for Australia. A growth pace in the 3% to 3.5% range looks readily achievable. Various investment cycles and exports will be supportive of growth in the near-term and beyond. For 2010 a sharp housing investment upswing and a burst of public investment will be key growth engines. This is typical in the initial period following a downturn. The policy rate will have to rise. Our expected peak rate of 4½% remains well below market pricing.

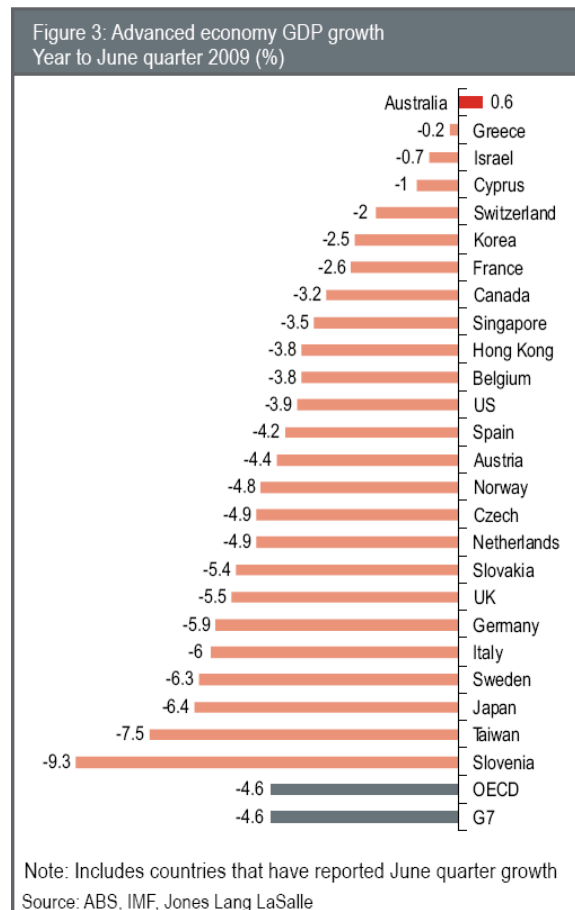
United States: The economy returned to expansion in Q3, but the recovery remains brittle. One by one, the drags on the US economy through the protracted downturn are moving to a neutral footing. That is a reliable formula for stabilisation. The next step is to find the path to a durable recovery. With household incomes in decline and credit availability tight, the consumer seems an unlikely candidate to spur the rebound. Against that backdrop, the Fed will be very patient.

Europe: Fiscal tightening, impaired banks and an uncompetitive currency will be key features of the European growth story in 2010. The Euroland economy expanded 0.4% in Q3 this year, following five quarters of decline. But as the impact of stimulus fades, the underlying weakness of the ageing, rigid and unmotivated European economy will once more show through. We expect growth to stall again in either Q4 or Q1, and then to recover only slowly as modest export growth takes hold, driven by expanding global activity but constrained by an uncompetitive euro.

Japan: The Japanese economy has re-entered the deflationary twilight zone. One contributor to this development has been the striking appreciation of the yen against both the US dollar and on a trade weighted basis. The thesis of our year ending article is that the Bank of Japan's timid approach to monetary policy not only helped allow deflation expectations become entrenched again, it is sponsoring yen strength at a time when the economy sorely needs a large and sustained real depreciation.

China: The most crucial input to our medium range forecasts is a view on the development of policy settings. On this front the administration has made it abundantly clear that they have no plans to alter the aggregate policy stance. Moreover, as we have been expecting, the administration has announced that the next fiscal cycle of five years will be initiated with an expansionary stance. Unless inflation begins to rise alarmingly (and there are no indications that it will) we will see no more than some modest tinkering around the edges on policy. By tinkering, we mean policy innovations designed to influence activity in individual sectors, clusters or asset markets, rather than to put the brakes on aggregate demand.

Asia: The region's economies have all returned to growth. In most economies the contraction lasted for two quarters. The better performers – the large, populous, relatively closed countries – saw one negative quarter only. While Korea has shown the most elastic bounce out of recession, India and Indonesia have been the best performers in absolute terms.



Summary of world GDP growth

Real GDP %ann	2005	2006	2007	2008	2009e	2010f	2011f
United States	3.1	2.7	2.1	0.4	-2.5	1.5	3.1
China	10.4	11.6	13.0	9.0	8.5	9.4	9.0
Japan	1.9	2.0	2.2	-0.9	-5.8	1.6	1.8
East Asia ex -China	5.1	5.7	6.0	3.1	-0.9	4.8	4.7
Europe	1.7	2.9	2.7	0.6	-4.0	0.6	1.2
Emerging ex-East Asia	6.0	6.8	6.7	5.0	-1.2	3.7	5.0
Australia	2.8	2.8	4.0	2.4	1.0	3.0	3.2
New Zealand	2.8	2.0	3.2	0.0	-1.3	3.5	3.8
World	4.5	5.1	5.2	3.0	-0.8	3.0	4.3

Sources: IMF, Westpac Economics. Aggregates weighted at purchasing power parity exchange rates from ICP 2005. See notes to detailed table on page 38.

Australian Property Predictions for 2010

The current cycle begins with housing in even shorter supply and the situation set to worsen. Australia is in the midst of a population boom, with the strongest growth since 1969. Meanwhile, despite a recent recovery, dwelling construction remains well short of the levels required to meet new demand for housing let alone already unmet needs.

Nationally, we are barely building one new dwelling for every three new people. In Sydney, we are barely building one for every five.

With credit constraints likely to remain a severe limiting factor on building there is little prospect of improvement any time soon.

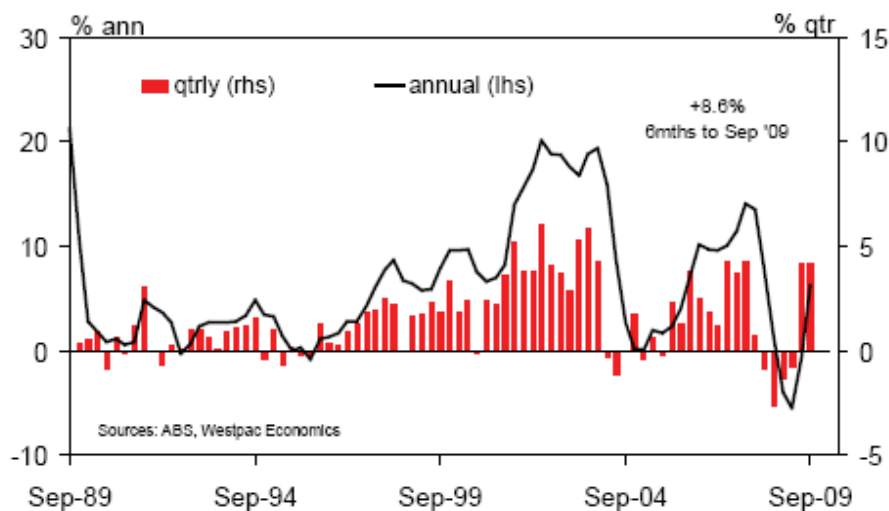
Credit issues will also constrain the extent to which buyers can bid up house prices, making it unclear exactly how these forces will resolve. And there are many other pieces to the puzzle including house price expectations and investor activity, but the situation in terms of supply and demand fundamentals, suggests the current housing upturn may again be surprisingly resilient to rate rises.

Current Median Values Around Australia

Composition Adjusted Median House Prices (quarterly)						
HOUSES	Sep-09	Jun-09	Mar-09	Sep-08	QoQ % Δ	YoY % Δ
Sydney	\$569,061	\$549,213	\$531,380	\$531,274	3.6%	7.1%
Melbourne	\$487,246	\$459,194	\$433,802	\$437,560	6.1%	11.4%
Brisbane	\$430,868	\$426,403	\$413,771	\$423,770	1.0%	1.7%
Adelaide	\$421,765	\$408,132	\$400,426	\$411,180	3.3%	2.6%
Canberra	\$511,820	\$488,293	\$482,265	\$481,691	4.8%	6.3%
Perth	\$494,409	\$485,933	\$479,381	\$484,263	1.7%	2.1%
Hobart	\$311,366	\$295,534	\$279,980	\$279,987	5.4%	11.2%
Darwin	\$528,650	\$528,650	\$500,056	\$478,496	0.0%	10.5%
National	\$502,492	\$484,577	\$467,979	\$471,656	3.7%	6.5%

Composition Adjusted Median Unit Prices (quarterly)						
UNITS	Sep-09	Jun-09	Mar-09	Sep-08	QoQ % Δ	YoY % Δ
Sydney	\$400,819	\$386,755	\$376,426	\$365,121	3.6%	9.8%
Melbourne	\$368,138	\$352,231	\$337,242	\$338,133	4.5%	8.9%
Brisbane	\$351,253	\$350,500	\$348,491	\$343,364	0.2%	2.3%
Adelaide	\$271,464	\$269,845	\$263,712	\$261,339	0.6%	3.9%
Canberra	\$381,345	\$376,578	\$361,140	\$359,287	1.3%	6.1%
Perth	\$361,810	\$344,706	\$339,235	\$343,707	5.0%	5.3%
Hobart	\$215,251	\$212,985	\$236,021	\$231,397	1.1%	-7.0%
Darwin	\$410,085	\$366,521	\$368,901	\$326,445	11.9%	25.6%
National	\$367,727	\$355,614	\$346,458	\$342,336	3.4%	7.4%

Established house prices jump



Australian Dollar

After the beginning of December hovering around 91¢ and briefly touching both 93½¢ and 90¢ the AUD has returned to its original starting point. We had been of the view that the momentum the Australian dollar had accumulated in October was likely to spur the AUD towards 96¢ by Christmas. That task now looks a little steep but we are maintaining our view that the currency can reach 96¢ by the end of March.

Recall that we have expected that the yield differential story was likely to spur the AUD over coming months. That view remains although we recognise a number of set backs in the last few weeks. Of most significance has been the support for the USD following the release of the extraordinary US payroll data for November. The unemployment rate fell from 10.2% to 10.0% and the number of jobs lost plus revisions to earlier months showed the US jobs picture nearly 300,000 jobs better than had been anticipated.

Markets accordingly brought forward the timing of the first Fed rate hike from August to April and assessed that rates will have been increased by nearly 1% by the end of 2010 compared to previous expectations of only 50bps.

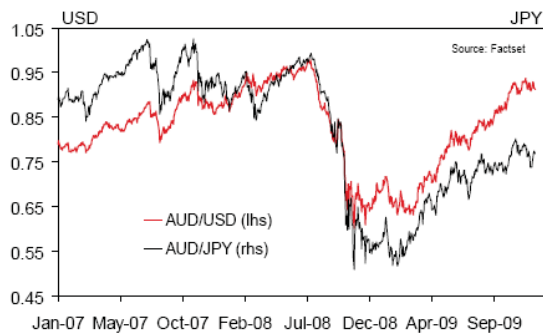
By the same token Australian markets have revised back the peak in Australian rates in 2010 from 5.5% to around 5%. That downward revision includes assessing the probability of a 25bp rate hike in February at less than 50%. This reassessment of likely short term rate profiles explains much of the lacklustre performance of the AUD in the last two weeks.

While we accept that markets have been correct in revising down the peak of the Australian rates in 2010 (in fact we see the peak rate for next year at “only”

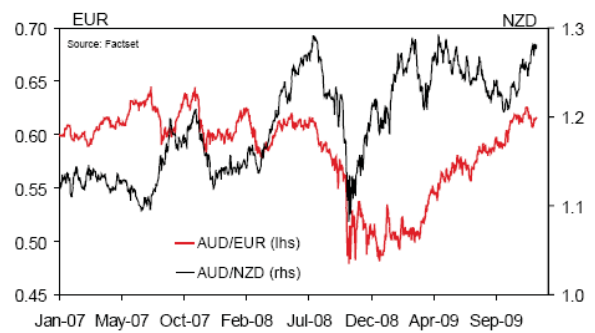
4.50%) we cannot buy the urgency on the Fed or, paradoxically, the doubt about a February rate hike by the RBA.

Over the next few weeks we expect that markets will firm up their views on the RBA continuing to raise rates steadily in the first half of 2010 while views on the Fed's timing will be pushed back to at least the pre payroll levels - if not further - towards our own view of the first half of 2011.

AUD/USD & AUD/JPY



AUD/EUR & AUD/NZD



Australian Interest Rates

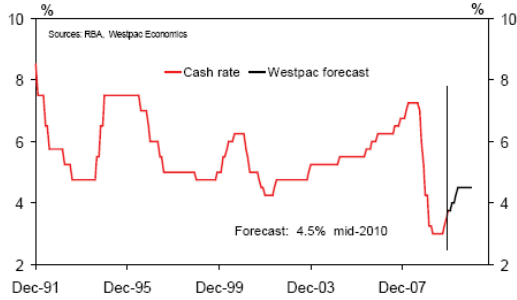
The RBA board decided to raise the overnight cash rate by a further 25bps following its December meeting. The markets were not convinced about the likelihood of that move with only around a 50% probability of a 25 bp rate hike being priced into the curve at that time.

The Statement released with the decision included a slightly more positive assessment of the economic outlook than had been the case at the time of the previous rate hike in November (house prices; government spending; household wealth). However our assessment of the tone of the Statement, including the reference to “material adjustments” (three consecutive rate hikes) indicated that if there had been a Board meeting in January the Bank probably would have paused at that meeting. With no meeting actually scheduled for January, debt holders will enjoy a reprieve regardless.

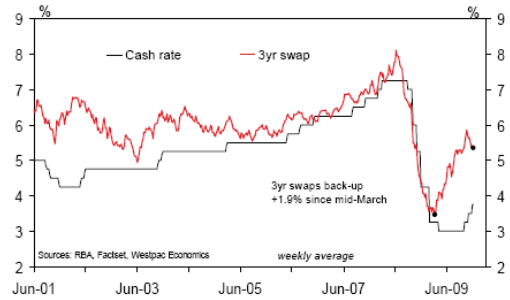
Markets have moved quickly to price in a profile for rates in 2010 much closer to our view than had been the case over the last few months. We have consistently argued that ongoing uncertainties in the global capital markets; disappointments in the pace of recovery in the major economies (Europe; US and Japan); some difficulties with the availability of credit in the domestic market; and sensitivity of the household sector to a variable mortgage rate around 7% would move the RBA into a holding pattern for much of 2010.

We have assessed that the peak in the cash rate - 4.5% - would be reached by the middle of 2010. In contrast, markets had been consistently pricing in a peak in the cash rate of 5.25% to 5.50% through to end 2010. Markets have now scaled back the likely peak to around 4.9% –still, in our view, too high.

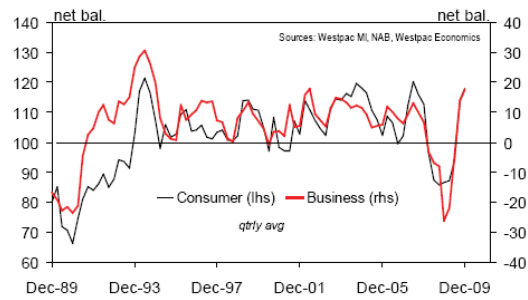
RBA: begins gradual tightening



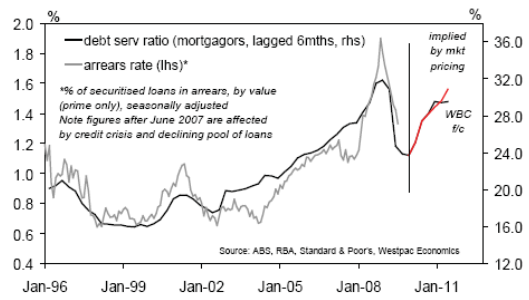
Market rates up, a step ahead



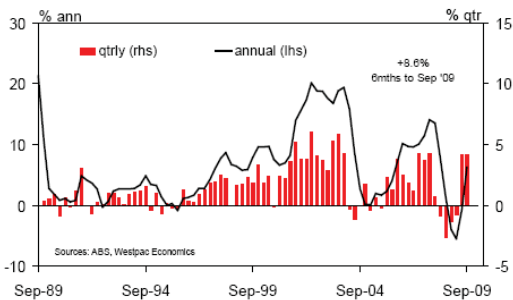
Confidence climbs



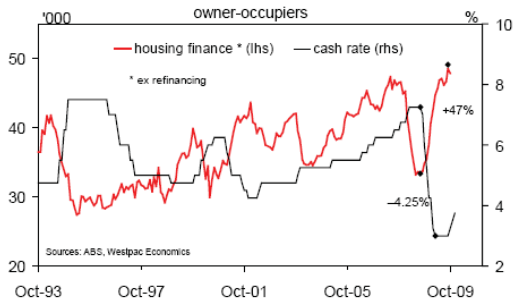
Debt burden vs mortgage arrears



Established house prices jump



Housing finance at historic high



State Analysis

New South Wales and Victoria

NSW and Victoria had more exposure to the sectors most affected by the GFC – the white collar jobs in finance, stockbroking, property and business services, and parts of retail. So their economies suffered initially in the 2008 downturn. While the white collar employment appears to have turned for the better there are still clear problems with weakening manufacturing and commercial and industrial construction activity.

Queensland, Western Australia and Northern Territory

But the second wave of the GFC dragged down the mining regions as mines were closed and projects cancelled or delayed. The result was that Queensland, WA and NT will have a modest fall in mining construction and operations to contend with until mid 2010. But its duration looks to be short because of the mineral commodity price resurgence. China's favourable growth projections are now the major influence on Australia's export volumes and prices over the next few years

South Australia & Tasmania

South Australia and Tasmania do not have high exposures to those sectors worst affected by the GFC. That limits the job and income loss that could have occurred. They will benefit from the lift in residential construction activity that we expect from the combination of very low mortgage rates and relatively high First Home Owners grants and related concessions.

SFD Forecasts* (%pa)	NSW	Vic	Qld	SA	WA	Tas	NT	ACT	Aust.
2007/8a	3.9	6.1	4.0	2.3	6.2	6.8	8.4	2.2	4.7
2008/9a	-0.4	0.3	-2.3	0.1	2.0	-2.2	-1.2	-0.5	-0.4
2009/10	2.7	3.2	4.1	2.2	4.5	2.5	5	3.0	3.2
2010/11	3.3	3.5	4.5	3.0	5.0	2.5	5	3.0	4.0

*Real State Final Demand. Australian figure is real gross national expenditure. See forecast pages for more details.

Reserve Bank of Australia – Current Rates & Statistics

Policy Target for the (effective 24 January 2010)	Interest the Cash	Rate Rate	3.75%
Inflation CPI Year to December 2008		Rate	1.3%
Exchange A\$ / 4pm AEDT 4 February 2009		Rate US\$	0.9136

Growth, Interest Rate & AUD Forecasts

March Quarter 2010

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
	(a)	(a)	(a)	(a)	(f)	(f)
Economic activity %pa						
Private final demand	4.4	4.6	5.9	1.8	1.6	4.5
Household spending	2.8	4.2	4.0	1.3	2.4	3.4
Dwelling investment	-4.3	1.9	1.3	-1.9	2.9	12.6
Business investment	16.1	8.3	15.3	6.7	-2.6	6.1
Public final demand	3.7	4.2	4.2	4.2	5.8	1.0
Domestic final demand	4.2	4.5	5.5	2.4	2.5	3.7
Inventories (contrib. to GDP)	-0.3	0.3	0.2	-0.9	0.7	0.3
GNE	3.9	4.8	5.6	1.4	3.2	4.0
Exports	2.3	4.0	3.9	2.3	2.0	8.4
Imports	7.3	9.2	14.1	-2.5	7.1	13.1
Net exports (contrib. to GDP)	-0.9	-0.9	-2.0	1.0	-1.1	-1.2
GDP	3.1	3.8	3.7	1.1	2.1	3.1
Prices and wages %pa						
CPI	4.0	2.1	4.5	1.5	2.9	3.1
Underlying CPI	2.9	2.8	4.4	4.0	2.7	2.8
AWOTE	3.2	5.0	4.0	0.0	3.0	4.1
Wages Price Index	4.1	4.0	4.2	3.8	3.2	4.0
Real h/hold disposable income	4.7	6.0	2.4	4.2	2.7	3.6
Terms of trade 2007/8=100	88.9	94.7	99.8	107.5	102.8	109.8
Labour market						
Employment %pa	2.9	2.9	2.6	1.1	0.8	2.1
Unemployment rate %	5.0	4.5	4.2	4.9	5.8	6.0
External accounts						
Current account: \$bn	-54.3	-59.4	-73.2	-37.7	-62.0	-64.6
Current account: % of GDP	-5.4	-5.4	-6.2	-3.0	-4.9	-4.7
CBA Commodity Index USDs						
Metals Index	179	239	183	258	251	263
Energy Index	235	225	311	399	283	350
Rural Index	128	140	183	145	163	167
Total Index	184	212	258	266	241	267
Interest rates (end period)	Cash Rate	90 Day Bank Bill	3 Year Swap	5 Year Swap	10 Year Swap	10 Year Bond
Mar-09	3.25	3.14	3.91	4.51	5.03	4.42
Jun-09	3.00	3.19	4.84	5.54	5.99	5.52
Sep-09	3.00	3.38	5.40	5.83	6.02	5.36
Dec-09	3.75	4.14	5.41	5.85	6.25	6.25
Mar 10(f)	4.25	4.50	5.95	6.10	6.50	5.80
Jun 10(f)	4.50	5.00	6.25	6.30	6.60	5.90
Sep 10(f)	4.75	5.30	6.40	6.40	6.70	6.00
Dec 10(f)	5.00	5.50	6.50	6.50	6.75	6.10
Mar 11(f)	5.00	5.60	6.55	6.55	6.75	6.10
Exchange rates (end period)	AUD/USD	AUD/JPY	AUD/EUR	AUD/GBP	AUD/NZD	AUD/CHF
Mar-09	0.69	68	0.52	0.48	1.24	0.79
Jun-09	0.81	78	0.58	0.49	1.25	0.88
Sep-09	0.88	79	0.60	0.55	1.22	0.91
Dec-09	0.90	83	0.62	0.55	1.23	0.94
Mar 10(f)	0.95	86	0.63	0.55	1.20	0.94
Jun 10(f)	0.98	93	0.63	0.54	1.20	0.96
Sep 10(f)	0.95	91	0.63	0.51	1.19	0.98
Dec 10(f)	0.90	88	0.61	0.50	1.18	0.97
Mar 11(f)	0.88	88	0.61	0.49	1.17	0.97

We trust that we have provided an insight into the Australian financial market and are more than happy to discuss any queries you may have.

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Sources

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