

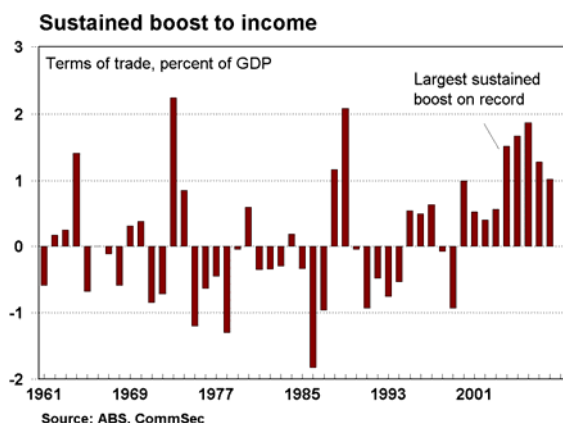
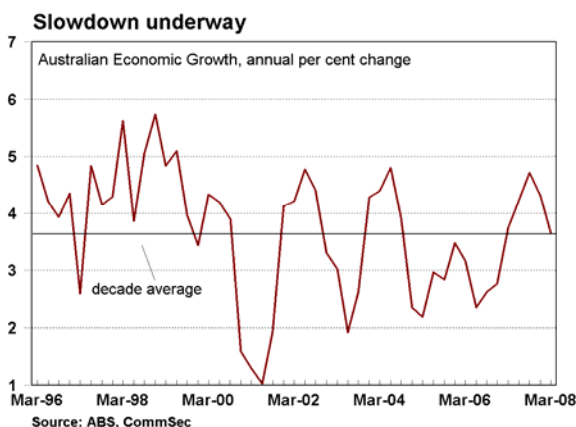
Year in review: Oil and financial jitters dominate

Review of financial markets

- **Soaring commodity prices – especially oil – and the US sub-prime crisis were the two key influences on financial markets over 2007/08. Major bourses fell across the globe but sharemarkets of energy-dependent nations posted strong gains.**
- **The Australian sharemarket recorded its biggest annual decline in 26 years. But in each of the previous four years the sharemarket posted gains of more than 20 per cent – the strongest sustained period of gains in 20 years. The sharemarket falls on average once every four years.**
- **The resources sector became the largest sharemarket sector, passing financials for the first time in 21 years.**
- **Residential property was the best performing asset class in 2007/08, ahead of cash and bonds.**
- **The Reserve Bank lifted rates on four occasions in 2007/08 and there is clear evidence that the economy has slowed in response. The RBA continues to fret about the boost provided by the terms of trade.**

Big Picture

- How times have changed. In July 2007, the global sub-prime crisis was just bubbling to the surface, the Australian sharemarket was sitting around 6,300 points and the oil price was around US\$70 a barrel. A year later and the effects of the US sub-prime crisis continue to reverberate, oil has doubled in price to US\$140 a barrel and the Australian sharemarket has slumped almost 1,000 points.
- The Australian sharemarket recorded its biggest fall in 26 years in 2007/08, but the performance needs to be put in context. The 15.5 per cent decline for the All Ordinaries follows four years of 20 per cent plus returns – the strongest period in 20 years. And the majority of global bourses – with the exception of Middle Eastern oil nations – have recorded sharp declines over the past year.
- In Australia, soaring commodity prices also resulted in the resources sector taking over as the largest sharemarket grouping from financials for the first time in 21 years. The S&P Resources 300 index has a market capitalisation of \$385 billion, ahead of the S&P Financials 300 with \$350 billion.
- On the economic front, the US economy has markedly slowed – it may be actually in recession, but that's still an



Craig James – Chief Equities Economist (Author)
(612) 9312 0265 (work) | craig.james@cba.com.au

Produced by Commonwealth Research based on information available at the time of publishing. We believe that the information in this report is correct and any opinions, conclusions or recommendations are reasonably held or made as at the time of its compilation, but no warranty is made as to accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Bank of Australia ABN 48 123 123 124 nor any of its subsidiaries accept liability to any person for loss or damage arising from the use of this report.

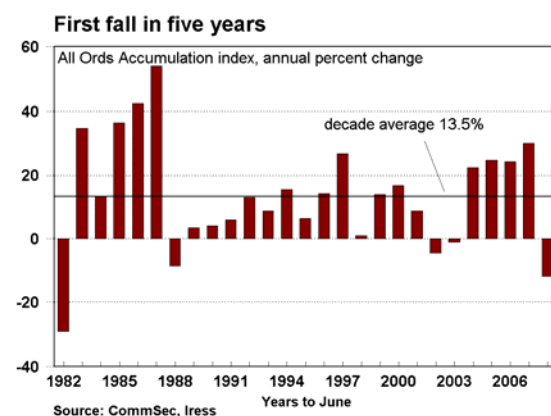
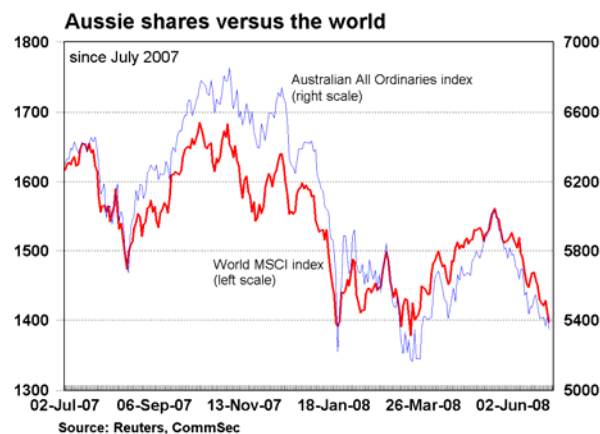
The report has been prepared without taking account of the objectives, financial situation or needs of any particular individual. For this reason, any individual should, before acting on the information in this report, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice. In the case of certain securities Commonwealth Bank of Australia is or may be the only market maker.

This report is approved and distributed in Australia by Commonwealth Securities Limited ABN 60 067 254 399 a wholly owned but not guaranteed subsidiary of Commonwealth Bank of Australia. This report is approved and distributed in the UK by Commonwealth Bank of Australia incorporated in Australia with limited liability. Registered in England No. BR250 and regulated in the UK by the Financial Services Authority (FSA). This report does not purport to be a complete statement or summary. For the purpose of the FSA rules, this report and related services are not intended for private customers and are not available to them.

Commonwealth Bank of Australia and its subsidiaries have effected or may effect transactions for their own account in any investments or related investments referred to in this report.

open question. However Australia is now linked to the fortunes of China, not the US, and the Chinese economy has continued to boom. In fact the Chinese economy is doing a little too well – and the world is struggling to keep up with its resource needs – whether it be grains, oil, coal or metals.

- The Australian economy was doing well up until the start of the 2008 but interest rate hikes, higher living costs and a weaker sharemarket have taken their toll on consumers. While budgets remain in good shape, consumers have elected to cut back on spending and borrowing – precisely the response sought by the Reserve Bank to keep inflationary pressures under control.
- Certainly the overall economy has slowed – the 0.6 per cent growth in the March quarter was the weakest outcome in two years. But annual growth of 3.6 per cent is broadly in line with longer-term averages. The job market remains tight with unemployment near 34-year lows at 4.3 per cent. And while employment fell in May for the first time in 19 months, job vacancies are at record highs. Vacancies currently top 180,000 people - equivalent to 10 months of “normal” monthly employment gains.
- The Reserve Bank lifted interest rates four times in the past year – the most significant tightening cycle in eight years. But after the last move in March, the Reserve Bank has remained on the interest rate sidelines, content that the extent of tightening has been sufficient – so far at least – to restrain inflationary pressures.
- With food and energy prices soaring, central banks across the globe are on high alert for inflation. And that’s especially the case in Australia with both headline and underlying measures of inflation just over 4 per cent.



Global sharemarket performance

- Middle Eastern and African nations have been the stand-out winners on global sharemarkets over the past year, especially mining and energy-producers. Countries such as Qatar, Saudi Arabia and Lebanon dominate the winners list after sitting at the bottom of the leader-board in 2006/07. Ghana’s sharemarket has been the best, up 95.4 per cent over the past year. Next best has been Oman with gains of 79.3 per cent followed by Lebanon, up 72.8 per cent on a year ago.
- At the bottom end of the leader-board in 2007/08 were the high-flyers from a year ago – Vietnam, China and the Philippines. The weakest market has been Vietnam, down 61 per cent, after largely doubling the year before. Ireland is next, down 44 per cent, with Cyprus down 40.4 per cent.

GLOBAL SHAREMARKETS

2007/08, pct change*

Ghana	95.4
Oman	79.3
Lebanon	72.8
Qatar	59.6
West Africa	42.3

Australia (40)	-15.5

Portugal	-33.5
Estonia	-39.3
Cyprus	-40.4
Ireland	-44.0
Vietnam	-61.0

Source: CommSec, Reuters

* to June 30, 72 markets covered

GLOBAL CURRENCIES

2007/08, pct change*

Czech koruna	28.6
Poland zloty	23.6
Paraguay guarani	22.8
Slovakia koruna	22.7
Israel shekel	21.4

Australia dollar (22)	11.7

Pakistan rupee	-12.8
Solomon Island dollar	-12.9
South Korea won	-13.8
Seychelles rupee	-26.4
Iceland krona	-26.9

Source: CommSec, Reuters

* to June 30, 120 currencies

GLOBAL INTEREST RATES

2007/08, percent*

Turkey	19.17
Venezuela	17.18
Argentina	16.50
Iceland	15.82
Pakistan	13.57

Australia (15)	7.82

Canada	2.62
Hong Kong	2.33
United States	2.29
Singapore	1.25
Japan	0.75

Source: The Economist, CommSec

*3-mth rates at June 27, 55 countries

- Of the major bourses over the past year, the energy-focused Canadian sharemarket did best (up 4 per cent) followed by Hong Kong (up 1.5 per cent). Next best was the UK, losing 14.9 per cent, and strangely the US Dow Jones index held up reasonably well, falling 15.4 per cent despite the economy skirting with recession. The Australian sharemarket lost 15.5 per cent while the German Dax lost 19.8 per cent and both the Japanese and Swiss sharemarket fell by around 25 per cent.
- The New Zealand sharemarket has been one of the world's worst performers over the past year, with the NZ50 index down 24.6 per cent the NZ10 index down 30.9 per cent.
- Overall, the world index (Morgan Stanley Capital International index) fell by 2.3 per cent over the last three months to stand down 12.3 per cent over the past year.
- Finally spare a thought for what has to be the best performing sharemarket in recent years. Over the past four years Egypt's benchmark CASE 30 index has risen from just above 1,400 points to around 10,000 points – a gain of around 600 per cent.

Australian sharemarket

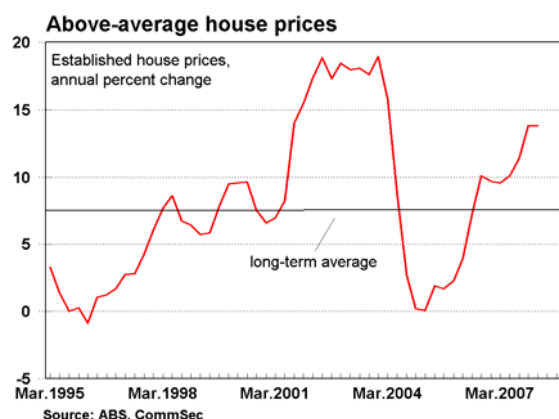
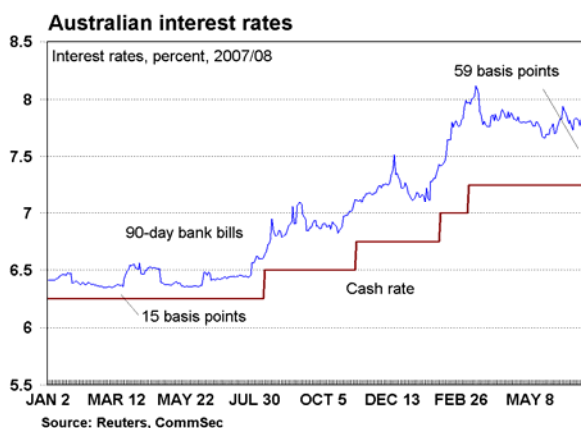
- The Australian sharemarket finished in 40th place of 72 global bourses in 2007/08, with the All Ordinaries losing 15.5 per cent. This was the biggest fall for the sharemarket in 26 years – that is, since 1981/82 when the All Ordinaries fell by 32.4 per cent. The ASX 200 fell by 16.9 per cent over 2007/08 to 5215.3.
- Over the past quarter, the All Ordinaries fell by 1.4 per cent to 5332.9 while the ASX 200 lost 2.1 per cent.
- In terms of total returns (growth in share prices and dividends), the All Ordinaries Accumulation index was down just 0.6 per cent in the June quarter to be down 12.1 per cent over the 2007/08 financial year. Still, the result needs to be kept in context. Over the previous four years, total returns on shares grew on average by 25 per cent a year – the strongest period of gains in 20 years.
- The only solace for investors is that almost all sectors lost ground in 2007/08 – so there have been few places to hide. In fact, only three of the 20 industry groupings rose over 2007/08.
- Leading the pack has been the energy sector with gains of 35.0 per cent, followed by the CSL-dominated pharmaceutical & biotechnology sector, up 21.7 per cent. The materials (mining) sector was the other gainer, up 18.1 per cent.
- One of the key developments on the sharemarket over 2007/08 has been the fact that the market capitalisation of the resources sector passed financials for the first time since the late 1980s.
- Weakest sectors over the year have been diversified financials, down 51.1 per cent, followed by consumer services, down 50.5 per cent largely reflecting the slide in the share price of ABC Learning. Transportation lost 48.9 per cent in 2007/08 after gaining 48.3 per cent the previous year.
- Given the soaring price of oil, the strength of the energy sector and sharp decline in transportation hardly come as

AUSTRALIAN INDUSTRY GROUPS

percent change 2007/08

Energy	35.0
Pharmaceuticals & Biotech	21.7
Materials	18.1
Food & Drug Retailing	-6.3
Telecommunication services	-11.1
All Ordinaries	-15.5
Software & Services	-20.4
Capital goods	-21.3
Health care	-21.4
Food Beverage & Tobacco	-26.3
Banks	-29.7
Commercial Services	-30.1
Utilities	-31.6
Insurance	-32.8
Consumer durables & apparel	-36.4
Media	-37.5
Retailing	-39.7
Real Estate	-40.7
Transportation	-48.9
Consumer services	-50.5
Diversified financials	-51.1

Source: CommSec, Iress



a surprise. And the US sub-prime crisis caused financial and property stocks to fall across the globe. Property trusts fell by 40.3 per cent in 2007/08 with banks and insurance sectors not far behind.

- Large companies (large caps) generally out-performed their smaller counterparts over the last financial year. The ASX 50 index fell by 15.4 per cent, compared with a 21.4 per cent decline in the Mid-Cap 50 index and 23.3 per cent decline in the Small Ordinaries index.

Interest rates

- For the first time in five years, returns on bonds have outperformed shares. The UBS bond accumulation index rose by 5.4 per cent in 2007/08 – the best year since the 8.5 per cent growth in returns in 2004/05. As noted above, the All Ordinaries accumulation index fell by 12.1 per cent over 2007/08.
- Ninety-day bills rose from 6.44 per cent to 7.83 per cent over 2007/08, reflecting the four rate hikes over the year. The Reserve Bank lifted official rates by a quarter of a percent in August, November, February and March, and the cash rate now stands at 7.25 per cent.
- Ten-year bond yields traded over a wide range of 5.80-6.80 per cent over the past financial year, ending the period at 6.45 per cent.

Residential property

- Residential property was the best performing asset class in 2007/08. According to the Real Estate Institute, the best returns on 2 bedroom apartments in the year to March were achieved in Brisbane and Adelaide (both up 25.3 per cent), followed by Canberra (19.5 per cent) and Melbourne (up 19.2 per cent). The lowest return occurred in Perth (up 7.8 per cent), but that still exceeded returns on bonds, cash and shares.
- Supporting the returns on property have been strong fundamentals – namely rising population growth and patchy building activity. As a consequence of both supply and demand-side factors, rental vacancy rates are hovering at generational lows with all vacancy rates remain below the “equilibrium rate” of 3.0 per cent.
- On the supply side, investors have preferred the sharemarket in recent years due to the superior returns achieved compared with property. And in the more recent period, investors have been reluctant to embrace property with interest rates rising. At the same time, population growth lifted to the fastest rate in 18 years, underpinned by record migration.
- The Bureau of Statistics measure of house prices rose by 1.1 per cent in the March quarter to stand 13.8 per cent higher than a year ago. Over the past 20 years, house prices have grown just over 8 per cent per annum.

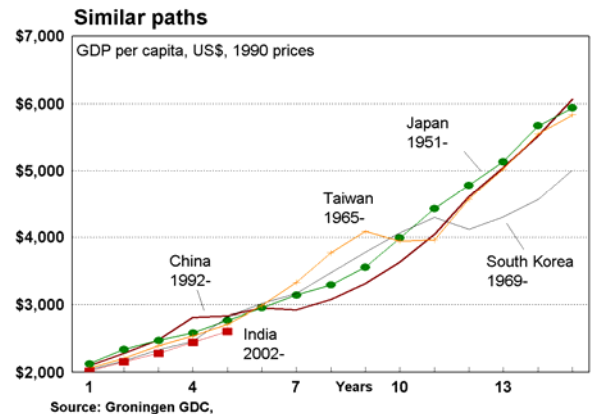
Currencies & commodities

- The Australian dollar appreciated 11.7 per cent against the US dollar over the past year, putting it in 22nd spot of 120 currencies monitored by CommSec. Only 25 currencies fell against the greenback over the past year while 30 held steady and 65 currencies appreciated in value.
- The strongest currencies were located in eastern Europe with the Czech koruna up 28.6 per cent. The currencies of Poland, Slovakia and Hungary were also near the top of the list. Weakest currency was the Iceland krona, down 26.9 per cent.
- Of the majors, the safe-haven Swiss franc was the strongest (up 16.4 per cent) with the Japanese yen and Euro



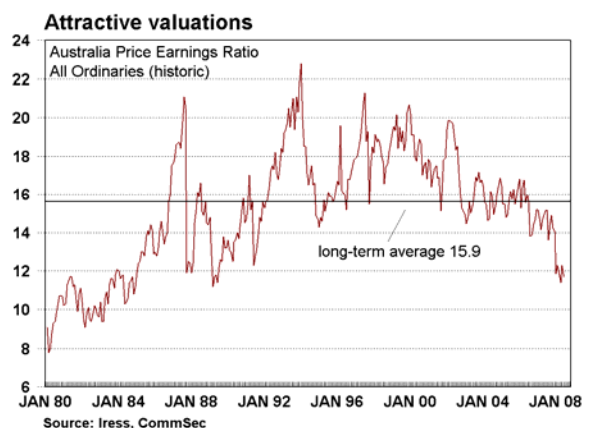
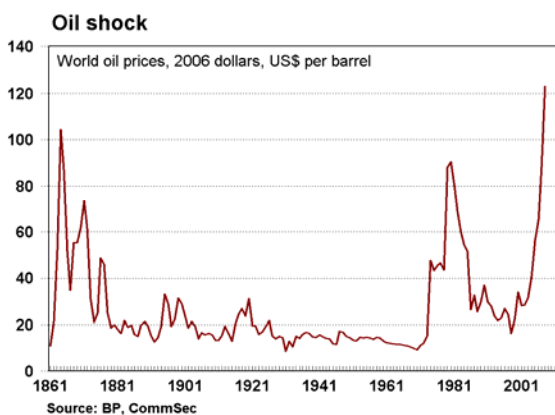
both up around 14 per cent. Even the Chinese Yuan appreciated by 10 per cent against the US dollar over 2007/08.

- Turning to commodities, at least half a dozen times over the past year key gauges of commodity prices appeared to reach a peak, and on each occasion new highs were set. Energy commodities certainly have led the way with the price of oil doubling and the spot thermal coal price lifting 140 per cent. But the steel commodities have soared with coking coal price tripling for the year starting April 2008 and iron ore price lifting 85 per cent.
- Base metal prices have generally softened from highs set a year ago although copper is up 13.2 per cent and aluminium has gained 14.5 per cent. Of other commodities, gold has risen 36 per cent, rice has lifted 160 per cent and wheat is up 48 per cent.
- The Commodity Research Bureau futures index rose by 47 per cent over the past year, hitting record highs on June 27.



Outlook

- Fear has been a big driver of global sharemarkets over the past year. Initially it was the fear of the unknown on financial markets – the uncertainty about just how badly US banks were affected by the sub-prime crisis, and how far those effects spread to other financial institutions and economies. Then there was the fear about soaring commodity prices – especially oil. The uncertainties centred on just how badly businesses and consumers were affected by soaring energy prices. Unfortunately, both these fears continue to affect investor behaviour.
- While some highly-indebted companies in Australia were caught up in the global financial crisis, such as Centro and ABC Learning, Australian banks were relatively immune. However Australian banks were certainly not immune from the selling of financial stocks across the globe, with the sector sliding almost 30 per cent last financial year.
- While we expect confidence to gradually be restored, it will take time. Not only in terms of confidence about the health of the US financial system but also about the ability of businesses and consumers to deal with rising energy and food prices.
- Fundamentally there is a 10-month inventory of unsold homes to be worked through in the US. And financial firms are still reticent about lending, despite repeated efforts by central banks to boost liquidity.
- And then there is China. The world has never witnessed industrialisation and urbanisation of the scale of China. The Chinese population of 1.3 billion people dwarfs the 100 million population of Japan when it similarly moved down the industrialisation path back in 1970.
- In this sort of environment the Australian sharemarket will remain at the mercy of global forces. And the coming profit-reporting season will also be a testing time as investors brace for bad news. However if Australian companies have weathered the global storm as well as we expect, the sharemarket could again start to drift higher through August and September.
- Certainly valuations on the sharemarket are supportive. The current historic price-earnings ratio of 11.7 is hovering near 19-year lows, and well below the long-term average of 15.9.
- We expect the All Ordinaries to reach 6,100 by end year with the ASX 200 closer to 6,000. We continue to favour



domestic defensives such as telecommunications, health care and food & drug retailing as well as the globally-driven mining (materials) sector. The energy sector has posted solid gains in recent years, and with the oil market tight, is poised to make further gains. However the sector also carries substantial risks with valuations well above long-term averages.

- Over 2007/08, the value of portfolio diversification was clearly demonstrated - across stocks and asset classes. While shares are well positioned for growth in 2008/09, it will be a bumpy ride, especially in the next few months. Bonds and cash will retain their safe-haven allure in the short-term while fundamentals remain supportive for residential property.
- Turning to interest rates, the Reserve Bank retains its bias to lift rates. While the economy has slowed in response to higher interest rates and rising living costs, the terms of trade is a constant focus of the RBA. The terms of trade equates export prices to import prices. Export prices are soaring while imported goods have become cheaper courtesy of a higher Australian dollar. The extra income from coal and iron ore prices alone equates to over \$2,000 for every Australian.
- The risk is that the Reserve Bank will lift rates again by a quarter of a per cent in the next six months.
- Turning to the currency, CBA strategists tip the Aussie to reach parity with the US dollar in the September quarter before easing later in the year in response to a strengthening greenback. High commodity prices and high interest rates support the Aussie. But improvement in the US economy later this year should cause expectations to shift to higher US interest rates, buoying the greenback. The Aussie dollar is tipped at US96 cents by end 2008 and US92 cents by June 2009.

Craig James,
Chief Equities Economist, CommSec
Work: (612) 9312 0265

