



Market update

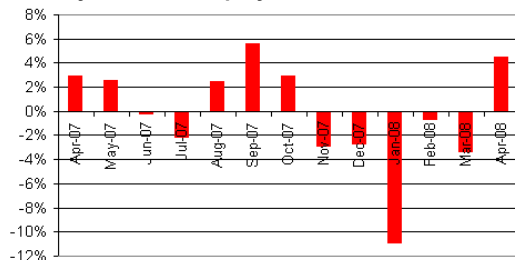
The table below provides details of the movement in average investment returns from various asset classes for the period up to **April 30 2008**.

Asset class * (% change)	One month	3 months	One year	3 years (pa)
Australian shares	+4.5	+0.4	-5.6	+16.7
Smaller companies	+3.5	+2.4	-9.0	+19.5
International shares (hedged)	+6.0	+2.1	-7.4	+10.2
International shares (unhedged)	+1.9	-1.9	-14.1	+5.3
Emerging markets	+4.7	+4.1	+10.7	+25.8
Property – Australian listed	+4.3	-0.5	-22.3	+6.8
Property – global listed	+0.7	-0.1	-24.8	+5.5
Australian fixed interest	+0.0	+1.0	+3.4	+4.4
International fixed interest	-0.7	+0.6	+7.6	+5.9
Australian cash	+0.7	+1.9	+7.1	+6.4

Australian shares

After 5 months of negative returns, the Australian share market bounced back strongly over April, finishing the month 4.5% higher. Over the past 12 months, however, the average market return is still negative by 5.6%.

Monthly Australian equity market returns



Source: van Eyk

Resource companies reversed the sharp declines of the previous month, with the sector's 9% rise the main contributor to the market's overall growth. Higher commodity and energy prices buoyed support for the miners, with the results of recent price negotiations on iron ore contracts being particularly positive. BHP Billiton was a standout during the month, rising by 18%.

Banking stocks were also generally firmer, although the sector lagged the market with an average 2.3% gain. Sentiment around finance sector stocks around the globe showed some improvement over April. This was improvement was thanks largely to the efforts of the United States (US) Federal Reserve Bank, which continues to provide liquidity and support to the embattled banking system.

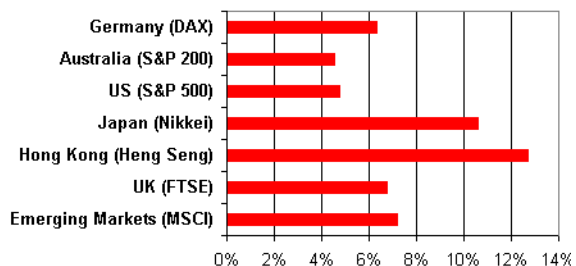
Not all sectors showed positive movements during April, however. With further evidence of a downturn in consumer spending by Australian households, consumer sector stocks generally moved lower over the month. Harvey Norman was typical of the consumer discretionary sector with a 6% fall.

Smaller companies performed well during April, albeit with a slightly lower rate of growth than the general market. The 3.5% rise in smaller company stocks last month was assisted significantly by a strong performance from the small resources sector, which like the larger resource companies, benefited from strengthening commodity prices.

International shares

Major overseas share markets also recovered during April. The majority of overseas markets increased by more than the Australian market, with the MSCI World Index rising 6.0%. Markets took some comfort from a further lowering of interest rates in the US and the United Kingdom (UK). For Australian investors with unhedged currency positions, the gains weren't as great due to the Australian dollar's appreciation – but still positive at 1.9%.

World equity market returns April 2008



Source: van Eyk. Returns in local currency.

* Asset class returns based on the following accumulation indexes: S&P ASX 200, S&P ASX Small Cap Ords, MSCI World index (AUD - Hedged), MSCI World Index (AUD), MSCI Emerging Markets (AUD), ASX 200 Props Trusts, S&P/Citigroup Global REIT, UBS Warburg Composite All Maturities, JP Morgan Broad WGFI (AUD Hedged), UBS Warburg Bank Bill.

It was a particularly strong month for the major Asian markets, with the Hang Seng Index (in Hong Kong) and Nikkei Index (in Japan) rising 12.7% and 10.6% respectively. Improved confidence in the outlook for the Japanese banking system was a significant contributor to the gains in that market.

Movements in the share prices in Europe and the US were also positive but not as strong as the recovery on Asian markets. The UK and German markets rose by just over 6%, whilst the S&P 500 Index in the US was 4.8% higher.

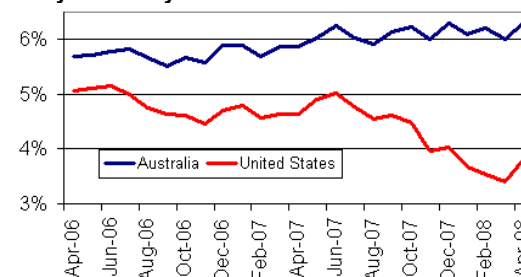
On an annual basis, the best performing sub sector within international equities continues to be the emerging markets. Last month's 7.2% gain in Emerging Market share prices (in local currency terms) brought the annual rate of growth to 20%. Investors in these markets continue to show confidence that the developing economies will continue to progress, despite the weakening in the global economic growth outlook as a whole.

Interest rates

With the domestic economy now clearly showing signs of weakening, the Reserve Bank has not seen cause to change interest rate settings since the last tightening of rates in early March.

However, with recent inflation results worse than expected, markets may be preparing for a more sustained period of high interest rates. Longer-term bond yields were pushed higher over April, with the 10-year Government bond rising from 6.0% to 6.3%. The subsequent fall in bond prices meant that fixed interest investors experienced flat returns over the month.

Ten-year bond yields



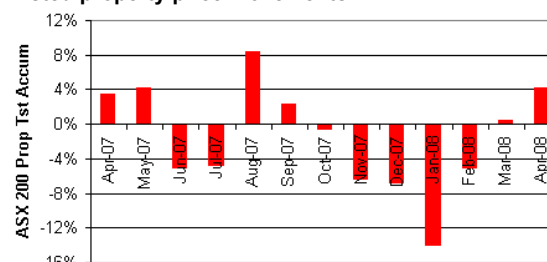
Source: Reserve Bank of Australia

There was also some increase in longer-term yields on international markets last month, despite falling short-term interest rates in the US and the UK. In the US, the 10-year Government bond yield jumped from 3.4% to 3.8%, creating negative price movements for fixed interest investors.

Property

Australian listed property markets recorded their second consecutive month of positive movement, with April's gain being a healthy 4.3%. Although the sector's running yield of 7.4% remains attractive, there may be some pressure placed on the earnings of the retail shopping centre trusts (which form the largest component of the sector) as domestic consumer spending growth weakens.

Listed property price movements



Source: ASX / S&P

Global listed property also had another positive month over April, with a small gain of 0.7%.

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The Hillross tactical view

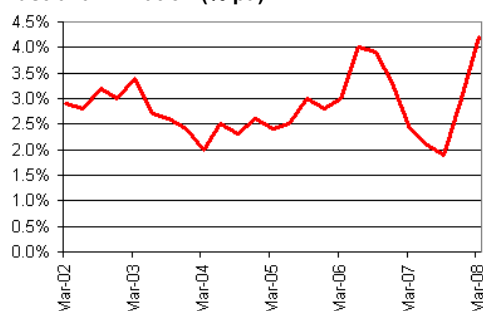
Asset class	Tactical view	Rationale
Australian Equities	Neutral	Although share valuations still appear cheap relative to the levels reached in 2007, higher interest rates and a weakening economy have worsened the earnings outlook for many companies. There remains a risk that the current recovery will push prices to a level where they are vulnerable to another correction, as earnings results soften.
International Equities	Overweight	On a relative valuation basis, international equities are still cheaper than domestic equities. The international interest rate environment is also supportive of a more sustained recovery in prices. Europe remains our favoured market.
Australian Listed Property	Neutral	The listed property sector remains in the fair value range, with the yields on offer being just over 1% above longer-term bond yields. There is some risk that concerns over the earnings outlook of shopping centre managers could detract from the sector in coming months.
Australian Fixed Interest	Neutral	Risks of further increases in domestic bond yields have been dampened by the evidence of a slowing domestic economy. Although current high inflation may persist for some time, yields may not be forced any higher if the economy remains weak.
International Fixed Interest	Underweight	The increase in longer-term interest rates recorded over April should have further to run. Existing longer-term interest rates are too low to cater for an extended period of higher global inflation.
Australian Cash	Overweight	The margin between cash interest rates and long-term yields makes cash attractive on a relative basis.

The economy this month

Inflation moves beyond target

Australia's annual inflation rate now stands at 4.2% following a higher than expected increase of 1.3% in prices over the 3 months to March. This rate of inflation is now well outside the Reserve Bank's target 2% to 3% range. The 1.3% rise in the Consumer Price Index (CPI) for the March quarter followed the 0.9% increase in the 3 months to December and is the highest quarterly increase since June 2006.

Australian inflation (% pa)



Source: Australian Bureau of Statistics 6401

The March quarter saw rising food prices continue to be a significant contributor to inflation. Food prices have been increasing around the globe due to rising demand from developing nations such as China and India. In addition,

drought in key agricultural producing regions coupled with the emerging use of arable land for bio-fuel production, is restricting the extent to which food supply can rise in line with demand. During the March quarter, the food component of the CPI rose by 2.1%, with the annual rate of growth now 5.7%.

The ongoing oil price increases has also impacted inflation. Average fuel prices reached new highs in the March quarter, with a 5.4% jump bringing the annual growth in fuel prices to a very significant 18.9%.

Retail sales

Recent data has provided further evidence that the Australian economy has commenced on a path of slower growth. Following earlier indications of declining consumer confidence, the March quarter retail sales data confirmed that there has been a definite decline in the growth rate of spending by consumers.

In the 3 months to March, the quarterly adjusted volume of retail sales fell by 0.1%. This follows a particularly strong rate of growth in sales in the second half of 2007. A lower level of spending on food, as well as hospitality and service items, were the main contributors to the fall in the volume of retail sales in the March quarter.

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From speculation to starvation

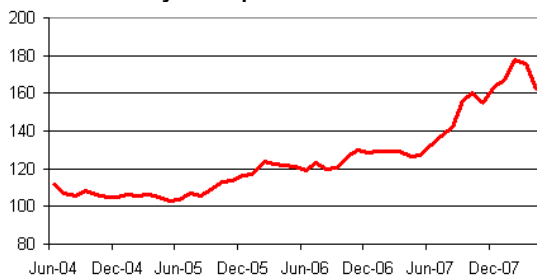
Rising food prices have been a feature of recent inflation numbers in Australia, with the food component of the Consumer Price Index (CPI) rising by nearly 6% over the past year. With food representing just under 20% of the expenditure base on which the CPI inflation measure is calculated, the higher cost of food has been a significant contributor to the rise in inflation; and subsequent lifting of interest rates designed to control this inflation.

Supermarket shelves don't tell the full story

However, the 6% rise in food prices experienced by Australian consumers is only a very small part of the story being told on global food markets today. A large proportion of what Australians end up paying for food items is really a reflection of the costs of getting food items to the supermarket shelves, rather than the underlying cost of the actual food produce itself. Costs such as packaging, transport, wholesaling and retailing will often dwarf the physical cost of the food being purchased. As a result, when the underlying cost food raw materials increases, there will normally only be a muted percentage rise in the price paid for food items by the end Australian consumer.

In reality, the global price for many food-based agricultural commodities has escalated to extraordinary new heights over the past year. The chart below traces the movement in the Reserve Bank's Commodity Price Index for rural items. This Index measures prices for various rural commodities and weights these prices based on the rural item's importance to Australia's export revenue. It can be seen from the chart below that rural items measured by this Index have jumped in price by nearly 30% over the past year. Rising wheat prices have been a major contributor to this increase.

Rural commodity index price



Source: Reserve Bank of Australia (SDR currency mix. 2001/02 = 100 on index scale).

The rise in price for some specific rural commodities has been even more spectacular than that shown by the above Index series. From a global perspective, the most significant change in food prices has been that relating to rice. In just the last 6 months, the price of rice on global markets has more than doubled. With rice a staple food for such a large proportion of the world's population, the impact of the sudden price boom is far reaching.

Supply, demand and speculation

A rise in the price of agricultural commodities had been expected by many observers for some time (see Feature Article of View from the Hill in February 2007). The economic development of China and India was always expected to lead to the generation of greater demand for agricultural items (in a similar fashion to what has happened with mineral and energy based commodities). As consumers become wealthier, they will increase their consumption across a wide range of categories of goods and services, including food.

On the supply side, economic development and wealth generation is also normally associated with a shift from a subsistence agricultural society to a more urbanised society where individuals are less like to produce their own food. There has also been the increasing use, or planned use, of agricultural land for the production of bio fuels, which has threatened the capacity of the world to generate additional supplies of rural commodities.

However, as seems to be the way these days on global markets, the extent and speed of the upward movement in price for many items has been significantly greater than what could be explained by fundamental supply and demand forces. It would appear that speculators have become more heavily involved in the futures markets where contracts over agricultural commodities are traded. As prices have increased, it is likely that more and more speculators have been attracted to these markets, possibly exacerbating (or at the very least speeding up) the extent of price change.

Implications of higher food prices

Whilst there may be some element of recent food price rises that could be associated with a "speculative bubble", there is little doubt that much of the increase is likely to have some permanency due to the demand and supply balance described above. The change in the level of food prices will lead to a change in the distribution of wealth from food consumers to food producers.

The impact on those in developing nations, who are unfortunate enough not to produce their own food and typically devote large proportions of income to food purchase, has been particularly severe. Unaffordable food and concerns over starvation has led to riots in several countries (eg Haiti) and the hoarding of whatever food is available. There has been a significant decline in the effective relative income of these nations and no doubt a growing risk of political unrest as effective living standards decline.

Far more fortunate, Australia, as a net food exporter, is expected to be a beneficiary of the upward shift in food prices – albeit with a temporary increase in inflationary pressures as a result. The contribution to economic growth from the rural sector can be expected to increase with increased profits from those involved in the production of food.

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