



Market update

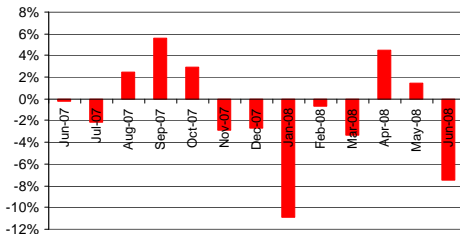
The table below provides details of the movement in average investment returns from various asset classes for the period up to **June 30 2008**.

Asset Class * (% Change)	1 Month	3 Months	1 Year	3 Years (pa)
Australian Shares	-7.5	-1.8	-13.4	+11.4
Smaller Companies	-11.3	-4.6	-20.5	+13.0
International Shares (Hedged)	-8.0	-1.0	-15.4	+5.9
International Shares (Unhedged)	-8.6	-6.6	-21.3	+0.6
Emerging Markets	-10.5	-5.7	-7.5	+17.8
Property – Australian Listed	-10.9	-15.5	-36.4	-1.8
Property – Global Listed	-11.1	-13.2	-28.8	-2.6
Australian Fixed Interest	+0.3	+0.4	+4.4	+3.9
International Fixed Interest	+0.3	-1.3	+8.0	+4.9
Australian Cash	+0.6	+2.0	+7.3	+6.5

Australian shares

The fall in share prices that begun in mid-May gathered momentum over June, with the ASX S&P 200 index dropping 7.5% over the month. With this being the third significant decline in prices since January, annual returns to investors are now well into negative territory with the 2008 financial year producing an average fall of 13.4%.

Monthly Australian equity market returns



Source: van Eyk.

Factors driving the market lower were of a similar theme to previous months, with the health of lending books of the financial sector and the inflationary impact of higher oil prices, dominating negative sentiment.

Once again the energy sector stood out in June, advancing 1.6%, to be 49.8% higher for the financial year as a whole. At the other end of the scale, consumer discretionary stocks suffered with a 14.5% decline as evidence of weaker consumer confidence mounted. The finance sector was also particularly weak, in line with overseas valuations, with a 12.1% fall.

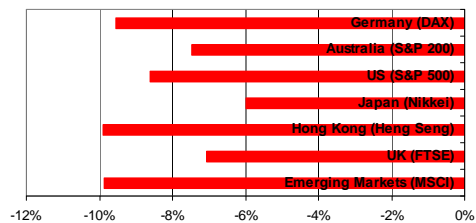
The gap between the recent performance of larger and smaller companies widened last month. The smaller companies index fell by 11.3% over June, as companies considered "lower quality" were shunned. Over 2007/08 as a whole, smaller company share prices have declined 20.5%.

The market is now awaiting the profit reporting season in August. Confirmation of profit results through this period may help restore market confidence. However, given the prevailing negative mood, any profit downgrades are likely to be harshly dealt with by the market.

International shares

All major international markets recorded significant falls last month. The overall MSCI World Index dropped by a similar magnitude as the Australian market. For investors with their currency position hedged, the MSCI Index was 8% lower, with unhedged investors averaging an 8.6% decline

World Equity Market Returns June 2008



Source: van Eyk Returns in local currency

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Themes were similar across all global markets over June as sentiment was again gripped by evidence of weakening economic growth, higher inflation led by oil prices and the ongoing fallout from losses being disclosed by major financial institutions. Despite the weakening global economy, there has been a growing realisation that central banks will be restricted in their response due to the inflationary pressures created by oil prices.

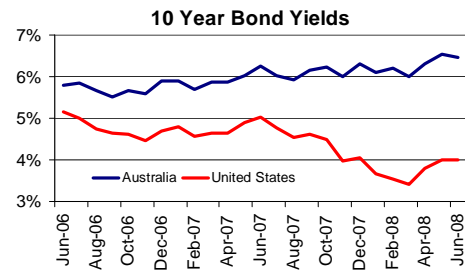
The Japanese market has been one of the better performing markets over the past 6 months. With its level of economic activity already relatively subdued, Japanese companies may have less to lose from the global downturn. None-the-less, share price movements have still been negative, with the Nikkei Index falling 6% last month and 12% since January.

Other developed economy markets all fell by similar magnitudes in June. In the United States (US), the S&P 500 was 8.6% lower, whilst in the Europe the German DAX dropped 9.6% and the British FTSE was 7.1% lower.

Emerging markets didn't escape the downward trend in prices, with significant price declines being recorded in China and other developing markets. Despite last month's 10% fall, emerging markets remain the best performing sub-segment within the international equity asset class on an annual basis.

Interest rates

Australian shorter-term interest rates were again steady over June, with the Reserve Bank leaving monetary policy unchanged. As evidence mounts of a weakening in economic activity, the prospect of a further increase in short-term interest rates has dwindled. Reflecting the lower likelihood of additional interest rate rises, there was a small fall in longer-term yields as well last month, which generated slightly positive returns for Australian fixed interest investors.



Source: Reserve Bank of Australia

Interest rates were also relatively steady on global markets, with the US 10-year Government bond remaining at 4.0%.

Property

Following a 9.0% fall in May, the Australian listed property sector recorded another significant decline of 10.9% during June. Concerns over the ability of the property trusts to re-finance debt positions at reasonable interest rates have plagued the sector; whilst there are growing expectations of falling valuations for underlying property assets. For the financial year as a whole, listed property trusts have fallen in price by 36.4%. Given this price weakness, yields available have risen to 8.4%.



Source: ASX / S&P

Similar declines were recorded on global listed property markets last month. The S&P Citigroup Global REIT Index was 11.1% lower over the month. Global listed property trusts have performed slightly better than their Australian counterparts over the past year, with the sector recording a 28.8% decline.

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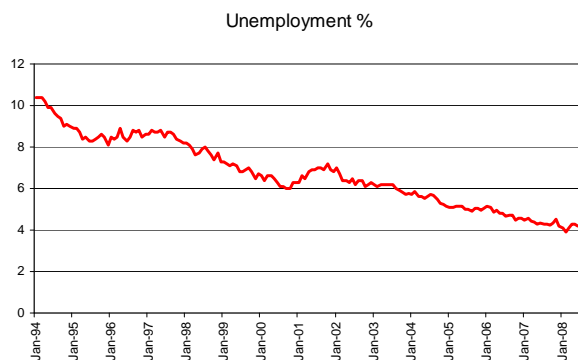
The Hillross tactical view

Asset Class	Tactical view	Rationale
Australian Equities	Overweight	With the exception of the resource and energy sectors, the Australian share market is now under valued both in terms of fundamentals and relative to global market valuations.
International Equities	Overweight	Further equity market weakness has pushed share values further into the undervalued range. With the exception of the US, which may have to experience more protracted economic weakness, markets should strengthen once there is confidence that the bottom of the economic down turn is approaching.
Australian Listed Property	Neutral	There would appear to be good value in the non retail sub segments of the listed property sector. However some softening in the price of retail property over the next 6 months could delay a price recovery in the overall sector.
Australian Fixed Interest	Neutral	Australian bonds now appear fair value given the weakening economy and the lower probability of further tightening in monetary policy.
International Fixed Interest	Underweight	Current U.S. bond yields and interest rate settings are unsustainable in an environment of rising global inflation. An upward adjustment in U.S. bond yields is still anticipated.
Australian Cash	Neutral	Whilst cash remains attractive relative to longer term fixed interest yields, the running yields now available on property and equities justify a neutral allocation to cash.

The economy this month

Labour market remains strong

Despite dwindling consumer and business confidence, the Australian labour market has remained solid with ongoing strong demand for workers. In June, there were an additional 30,000 jobs created, more than reversing the unexpected 26,000 decline in May.



Source: Australian Bureau of Statistics 6202

The increase in the number of workers employed over June allowed the unemployment rate to decline by 0.1% to 4.2%.

A strong labour market with low unemployment, if maintained, will be an important factor in providing some support to consumer spending and bank loan quality as the economy slows over the remainder of 2008.

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Exports rise sharply

Showing the strongest increase in 8 years, Australian exports surged 11.6% over April and May. At least some of the large increase in exports were attributable to an increase in the price that has been recently negotiated for iron ore sales. In addition to the rise in mining related export revenues, rural exports have also strengthened, rising by 6.2% over the past 2 months.

Bank lending on the decline

Contributing to the more negative outlook for the banking sector has been weakness in the value of new residential home loans. In a sign that higher interest rates have clearly started to impact, the value of loans approved by financial institutions for residential housing purchases declined in each of the 4 months leading up to May. Loans approved dropped by 7.9% during May, to bring the annual decline to 21.5%.

However, the news for banks is not all bad. The loan approval data confirms some significant improvements in market share for banks, with the non-bank sector experiencing a 50% fall in lending over the past 6 months. This compares to a 12% decline for banks.

Feature article

Extreme views capture markets

For the 3rd time this year, world share markets have been swept up in a wave of negative sentiment and prices once again have been pushed down to levels that appear too cheap to be justified based on normal fundamentals.

The Australian share market has been hit particularly hard, experiencing the most significant price falls since the 1987 crash. As at July 2nd, the overall S&P ASX 200 Index had dropped 20% from the start of the year. This number, however, is masked by the strong performance of energy and mining stocks, which if removed, mean that the remainder of the market has dived 30% over this period.

A protracted recession?

Extreme market movements like those we are currently experiencing are often driven by extreme views about the likely future state. Currently there would appear to be at least 2 “extreme” views that have permutated across financial markets and generated significant negative sentiment.

Firstly, fears have been fuelled by a view that the global economy is about to enter some form of protracted recession, where a breakdown of the financial system brings growth in the real economy to a halt.

Although somewhat isolated from the worst of the undoubted problems in the United States financial system, recent share price movements imply a belief that Australia will not be spared the full brunt of this recession. A 30% fall in industrial share prices from a “reasonable” base is only reconcilable with view that real company earnings will weaken significantly due to some form of lengthy period of economic weakness.

The facts, however, do not support such a pessimistic view. Unemployment is running close to 30-year lows; annual retail sales growth at 6% is in line with its 10-year average; export receipts are 20% higher than they were a year ago; and the Government has been able to maintain a large financial surplus largely due to the health of company profits.

Admittedly, economic data is inherently backward looking, however the above data helps highlight the extent to which conditions would have to deteriorate before the Australian economy could be described as being in poor health. The majority of economic forecasters are still predicting a slowdown in growth, rather than a contraction, in the

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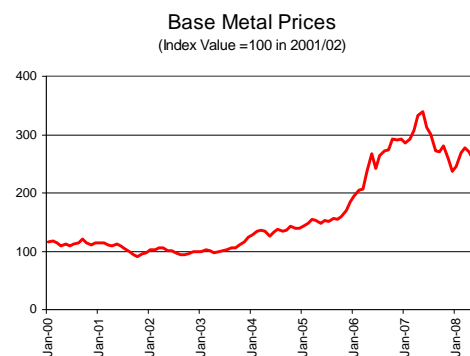
economy. For example, the Reserve Bank in its latest monetary policy statement confirmed that its “latest view assessment continues to be that demand growth will be moderate this year.”

A commodity bubble that won't burst?

A 2nd and increasingly dominant view that has been generating concern in financial markets is that commodity, and in particular, energy prices, will continue to escalate in the near future to levels well beyond even today's highs. This growth in commodity prices will lift inflation around the globe, forcing central banks in the US and Europe to abandon loose monetary policies and lift interest rates sharply. The magnitude of the higher inflation and interest rates will be such that there is considerable negative impact on corporate earnings and share prices.

There is little doubt that the commodity price growth we have already witnessed is already forcing inflation higher and placing pressure on global interest rate settings. However, economies around the globe have collectively been able to absorb the impact of substantial increases in commodity prices over the past 4 years. The likelihood of a “manageable” impact on inflation has been increased as the economic outlook has generally softened.

In addition, given slower growth in the world's largest economies, there must be some doubt over the continued upward trajectory of commodity and energy prices. It is quite easy to put forward persuasive arguments, that ignore lower demand in the developed economies, and highlight the sheer size of populations in China and India to portray an ever increasing appetite for commodities and energy. However, these arguments don't consider that price is a function of demand and supply, and ultimately heavily influenced by the cost of supply. The fact that China is becoming increasingly dominant as buyer in commodity markets will increase its bargaining power and ability to drive prices closer to marginal cost – in much the same way the Japanese did in earlier decades.



Source: Reserve Bank of Australia (in SDR currency equivalent)

We have already witnessed quite significant corrections in the price of several base metals. The chart above shows the movement in base metal prices as a group in recent years. Base metals (aluminium, nickel, copper, zinc, lead) are subject to similar demand and supply forces as other commodities and have fallen in price despite a heavy appetite from China.

Opportunities presented

Relative to expected company earnings, share prices in Australia today are the cheapest they have been for some 13 years. If negative sentiment has caused share markets to over react to various extreme or worst case scenarios, then there should be good buying opportunities for share market investors. A preparedness to focus on the long term and weather further potential bouts of market negativity is no doubt required.

Investors may also consider skewing their share investments away from resources and energy stocks. The prospect of a correction in commodity prices places a higher risk on these sectors compared with industrial shares, where the most significant price falls have already occurred.

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