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What could the outlook hold?



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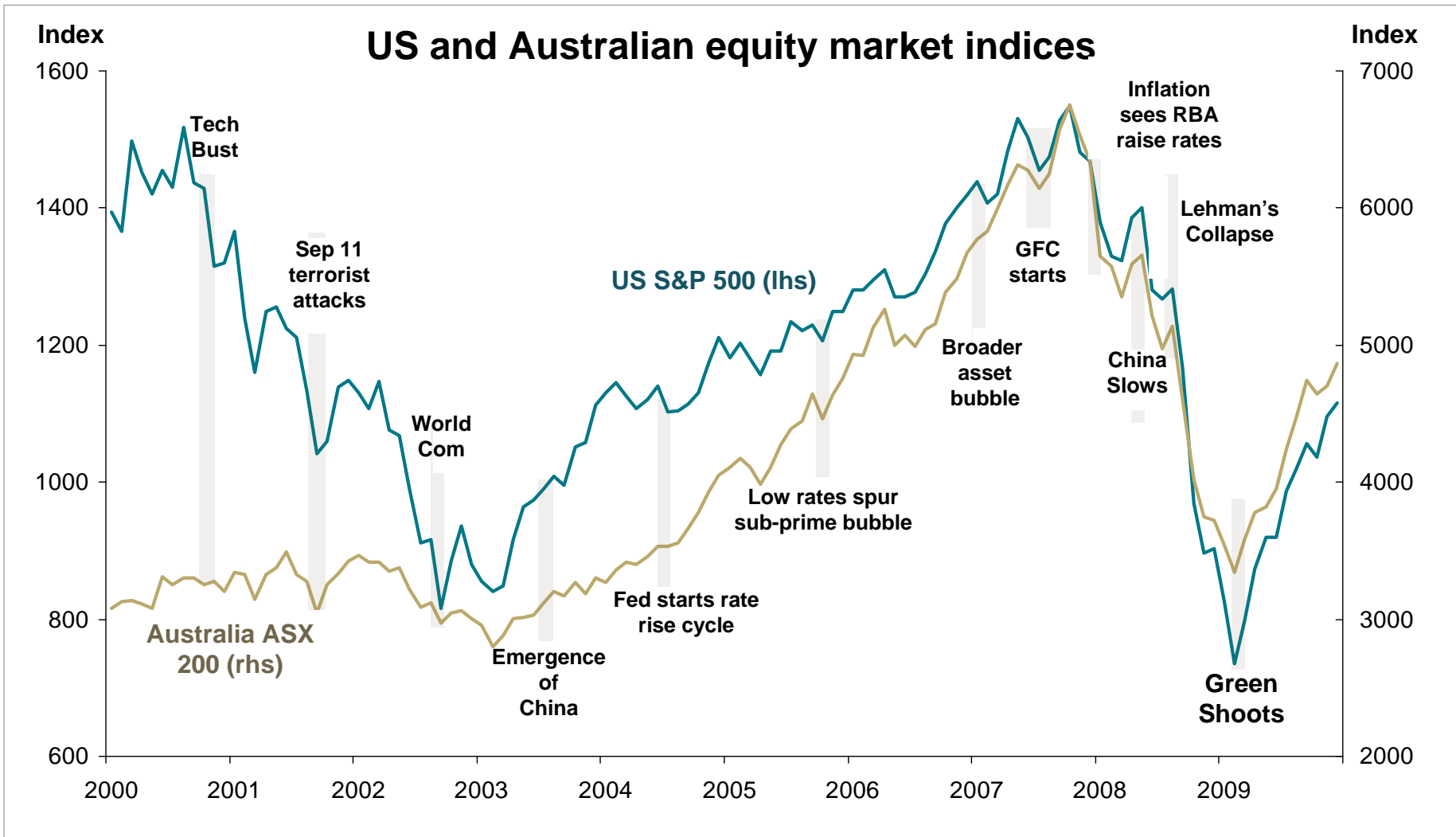
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Last decade in review – a wild ride



Bubble & Bust

Scenario 2

Scenario 3

Scenario 4

Bubble & Bust

Advocate:
Marc Faber

Scenario 1

Goldilocks

Scenario 3

Scenario 4

Goldilocks

Advocate:
RBA

Scenario 1

Scenario 2

Forgotten Years

Scenario 4

Forgotten Years

Advocate:

Nouriel Roubini (Dr Doom)

Scenario 1

Scenario 2

Scenario 3

Muddle Through

Muddle Through

**Advocate:
Paul Krugman**

Scenario 1 – Bubble & Bust



Bubble & Bust

Goldilocks

Forgotten Years

Muddle Through

Driver:

- > Policy remains stimulatory for too long
- > Eventually policy makers forced to slam on brakes

Economic backdrop:

- > Growth accelerates sharply to well above trend
- > Inflation spikes as bottlenecks emerge
- > Deep recession follows as boom proves unsustainable

Expected Market Performance:

- > Significant volatility in all markets
- > Cash rates fluctuate between very low to very high
- > Equity markets follow boom bust cycle

Bubble & Bust – The Last Decade



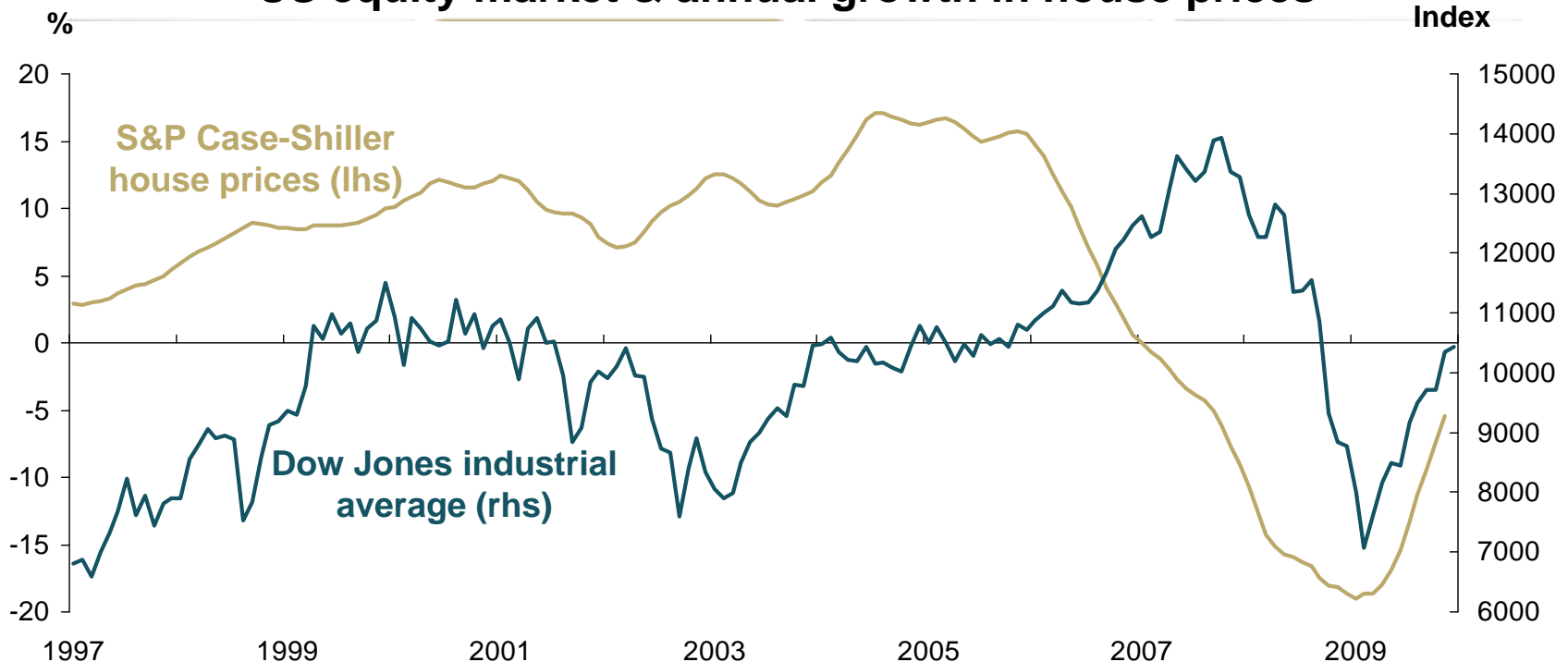
Bubble & Bust

Goldilocks

Forgotten Years

Muddle Through

US equity market & annual growth in house prices



Some are concerned about Chinese bubbles



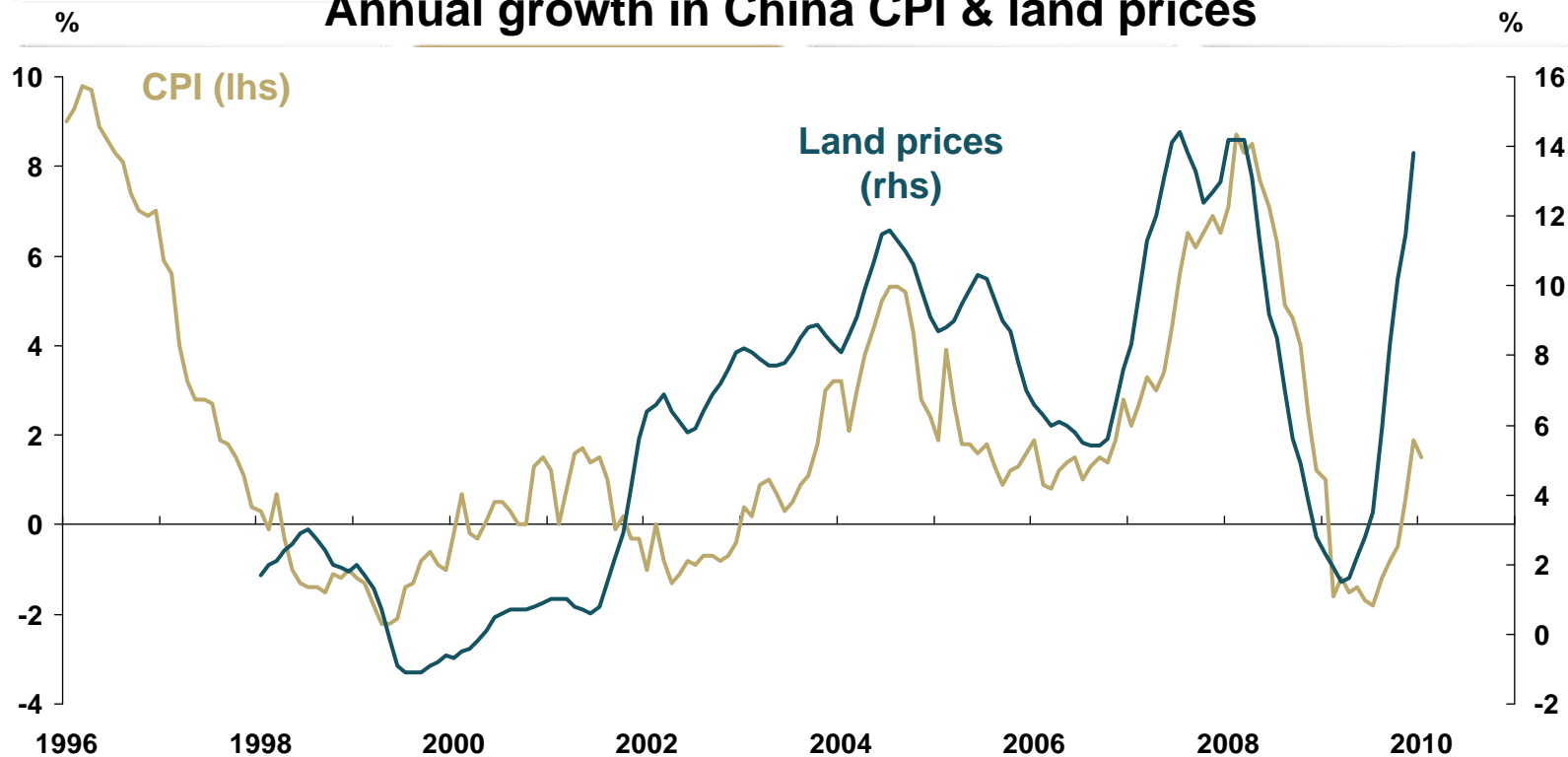
Bubble & Bust

Goldilocks

Forgotten Years

Muddle Through

Annual growth in China CPI & land prices



Scenario 2 – Goldilocks



Bubble & Bust

Goldilocks

Forgotten Years

Muddle Through

Driver:

- > No residual effects of GFC, China manages expansion cleanly
- > Policy authorities successfully manage removal of stimulus

Economic backdrop:

- > Growth moderately above trend, gradual reduction in excess capacity
- > Inflation remains in acceptable range

Expected Market Performance:

- > Cash rates rise steadily to neutral
- > Equity markets perform in line with long run average

Goldilocks – Australia 2002-07



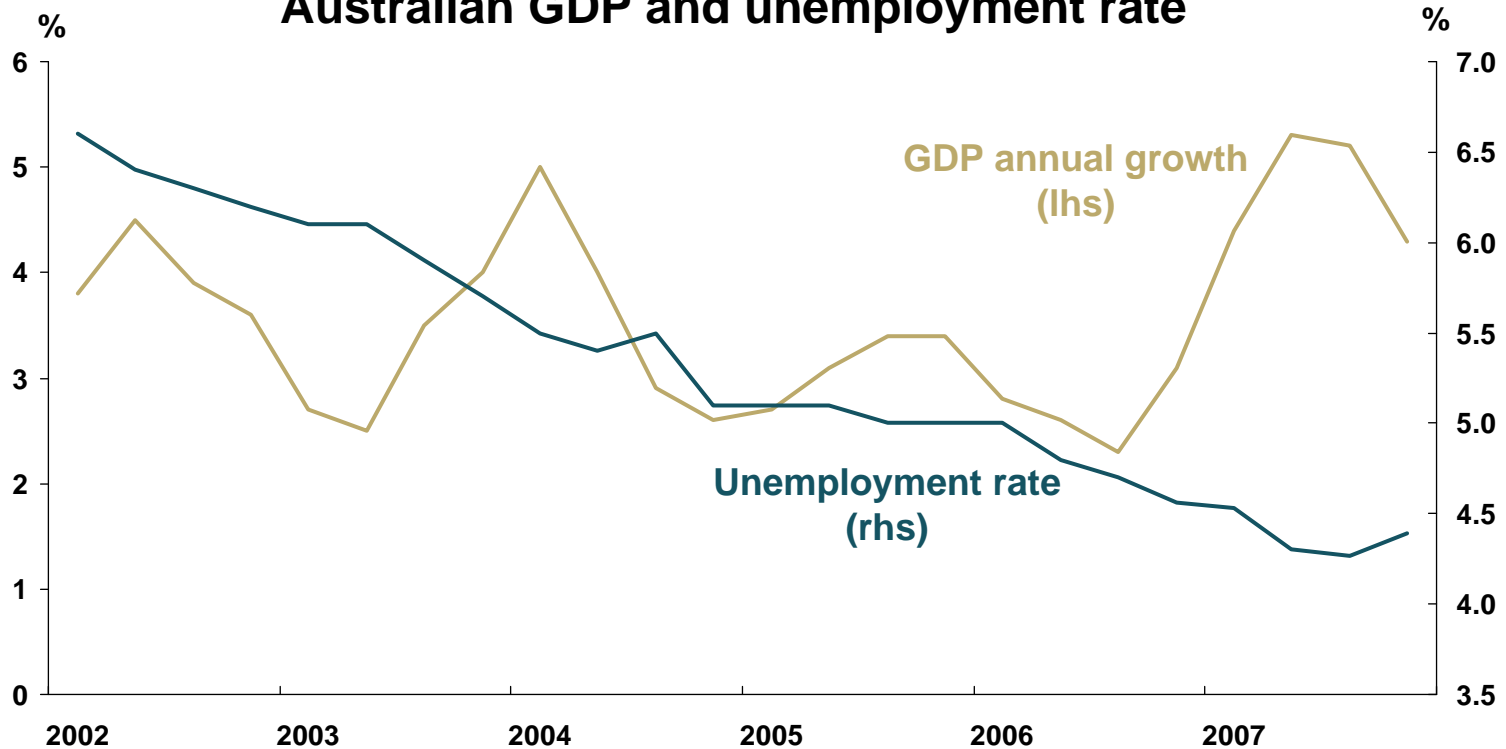
Bubble & Bust

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Muddle Through

Australian GDP and unemployment rate



Australian market outperformed US during this period



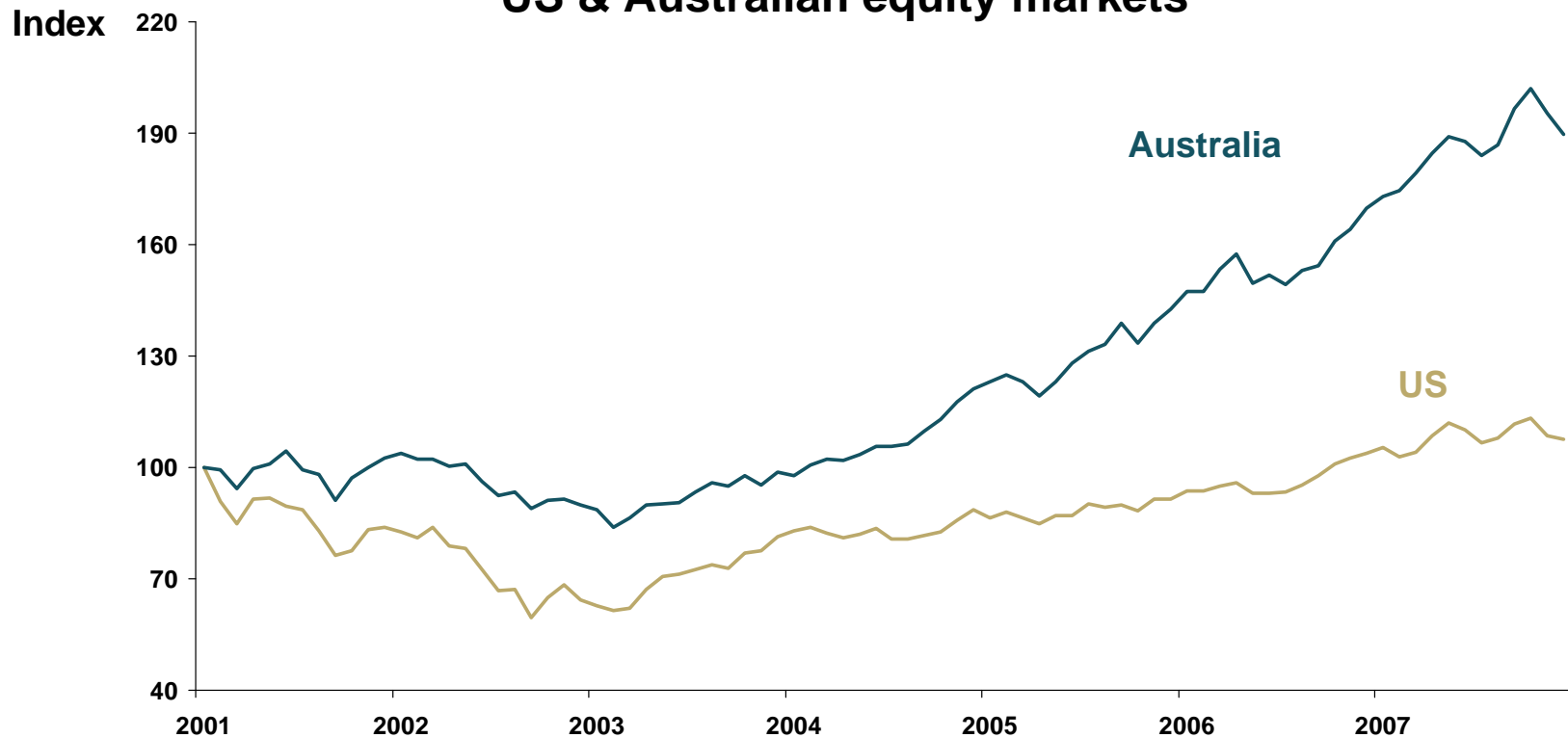
Bubble & Bust

Goldilocks

Forgotten Years

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US & Australian equity markets*



IMF forecasts would seem to suggest this is a reasonable forecast for Australia

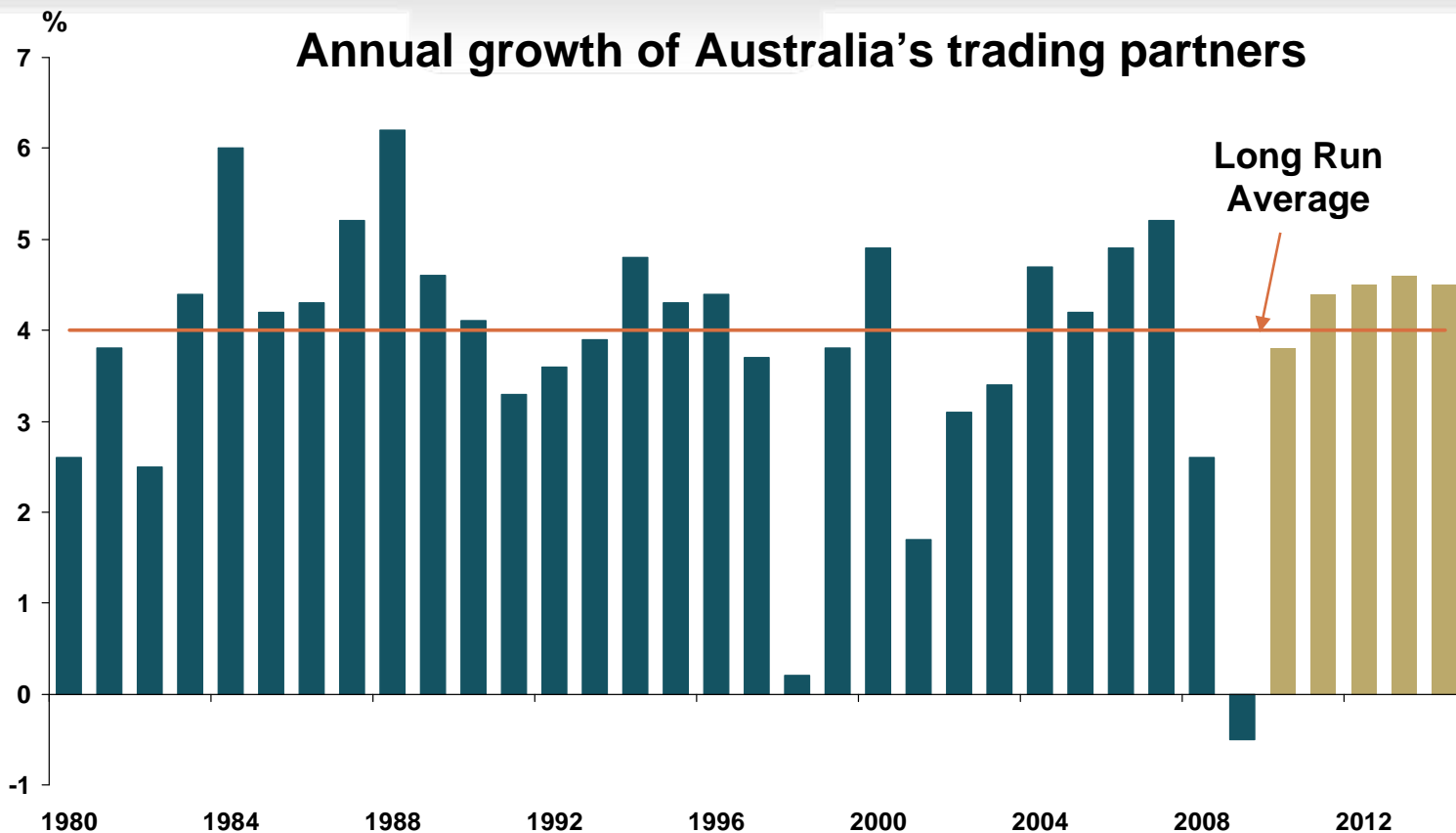


Bubble & Bust

Goldilocks

Forgotten Years

Muddle Through



Scenario 3 – The Forgotten years



Goldilocks

Bubble & Bust

Forgotten Years

Muddle Through

Driver:

- > Policy makers take away stimulus too quickly
- > Authorities either misread economy (Japan 1996) or are forced to tighten earlier than desired (sovereign debt concerns)

Economic backdrop:

- > Growth well below trend for an extended period
- > Concerns over deflation dominate

Expected Market Performance:

- > Cash rates remain near zero
- > Equity markets fall back towards GFC lows or lower

The Forgotten years – Japan 1990-2006



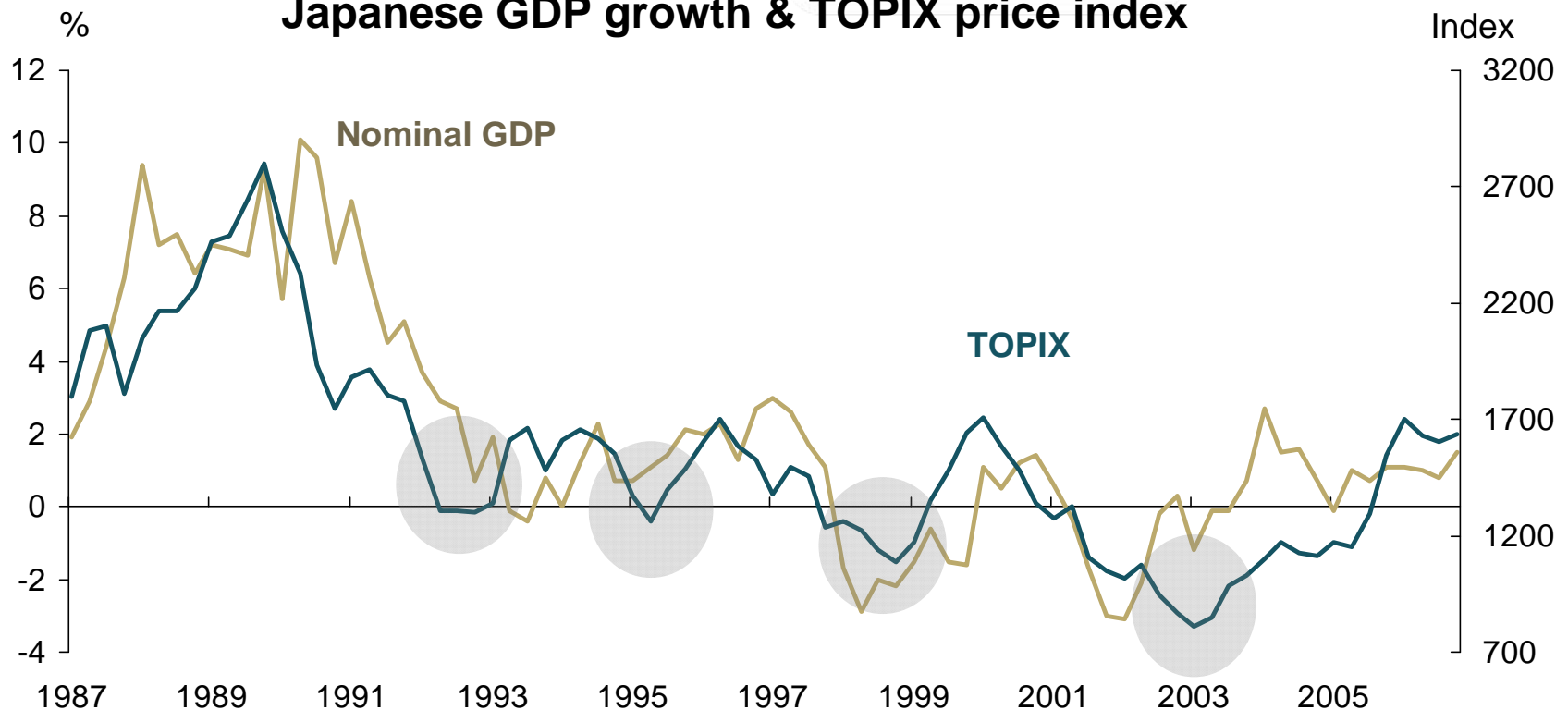
Goldilocks

Bubble & Bust

Forgotten Years

Muddle Through

Japanese GDP growth & TOPIX price index



The Forgotten years – Japan 1990-2006

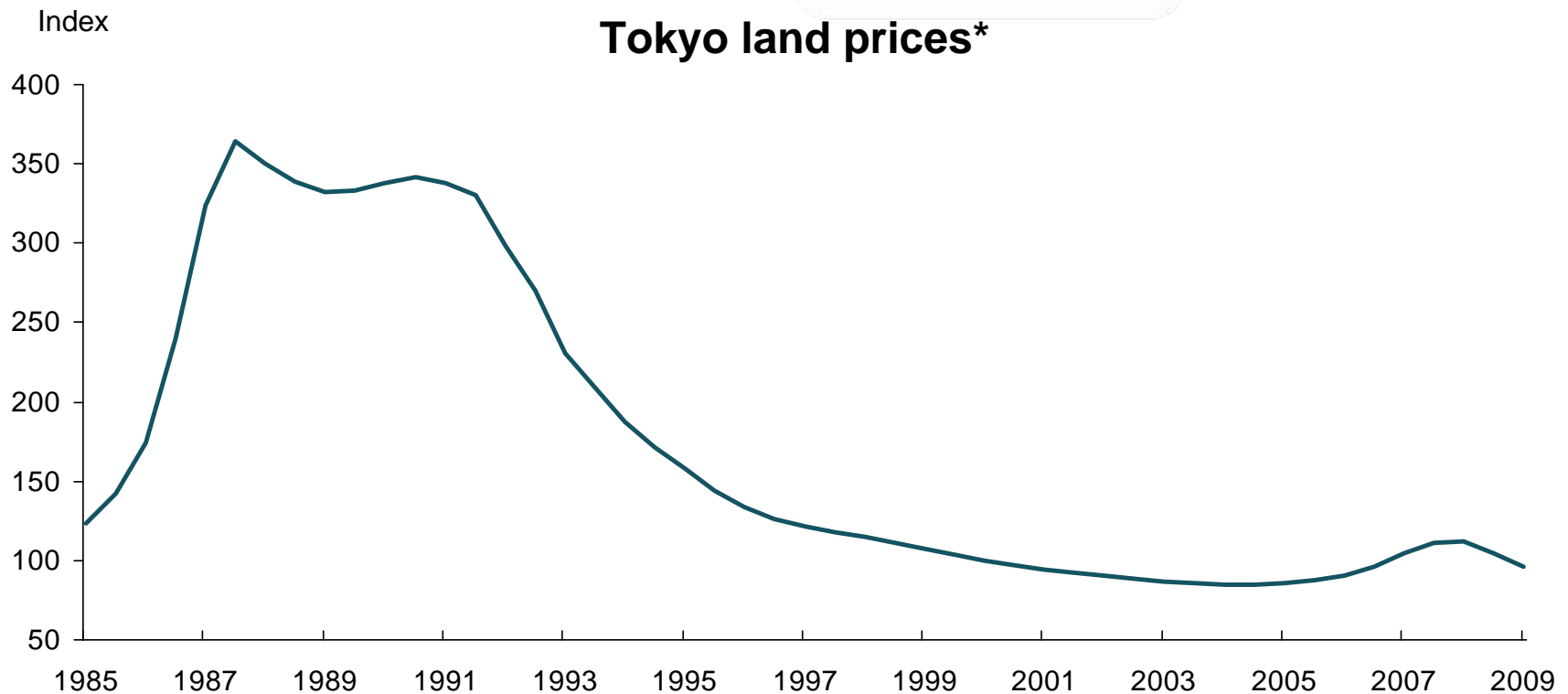


Goldilocks

Bubble & Bust

Forgotten Years

Muddle Through



Scenario 4 – Muddle through



Goldilocks

Bubble & Bust

Forgotten Years

Muddle Through

Driver:

- > After effects of GFC hold back growth
- > Sovereign debt concerns prevent further stimulus

Economic backdrop:

- > Industrial economies grow no more than trend leaving high unemployment for a protracted period
- > Deflation more a concern than inflation

Expected Market Performance:

- > Cash rates remain low
- > Equity markets broadly track sideways

Muddle through – US 1965-1973



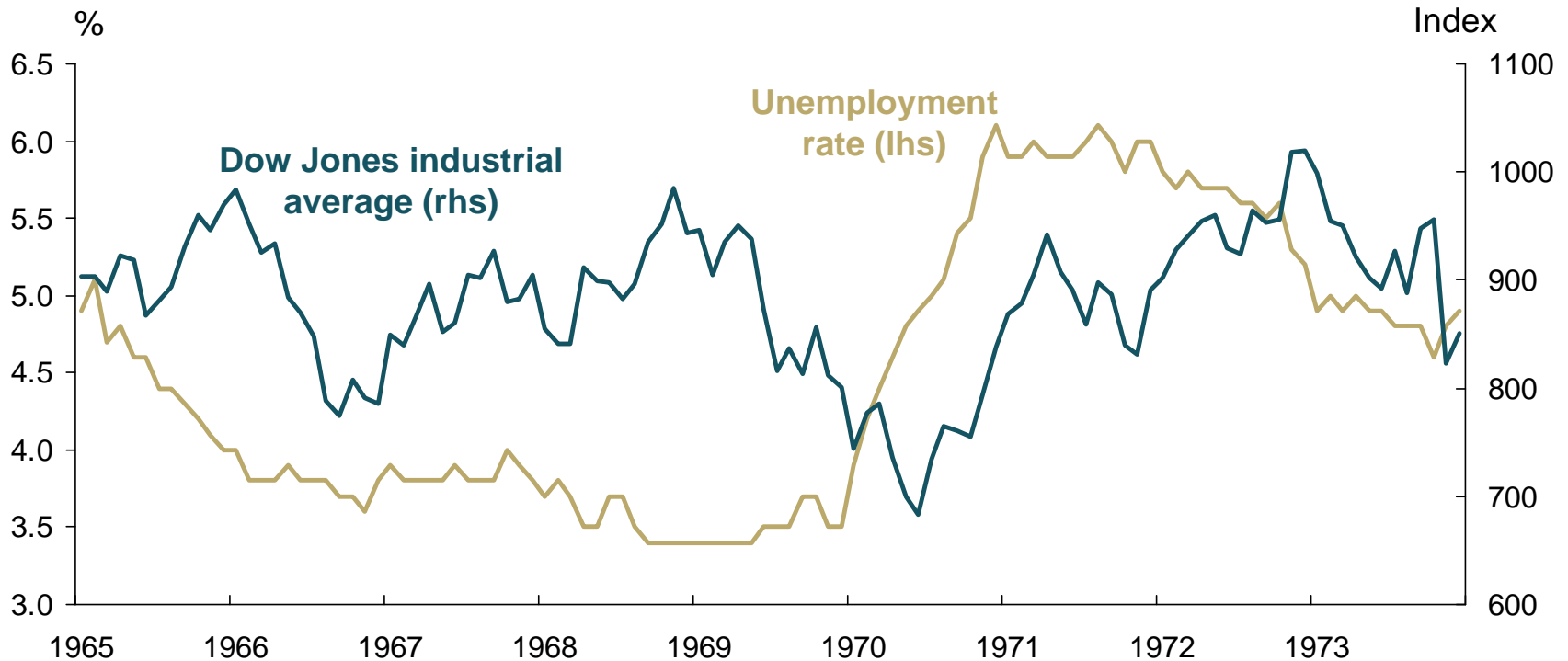
Goldilocks

Bubble & Bust

Forgotten Years

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US unemployment & Dow Jones Industrial Average



Concerns over public debt limited fiscal spending



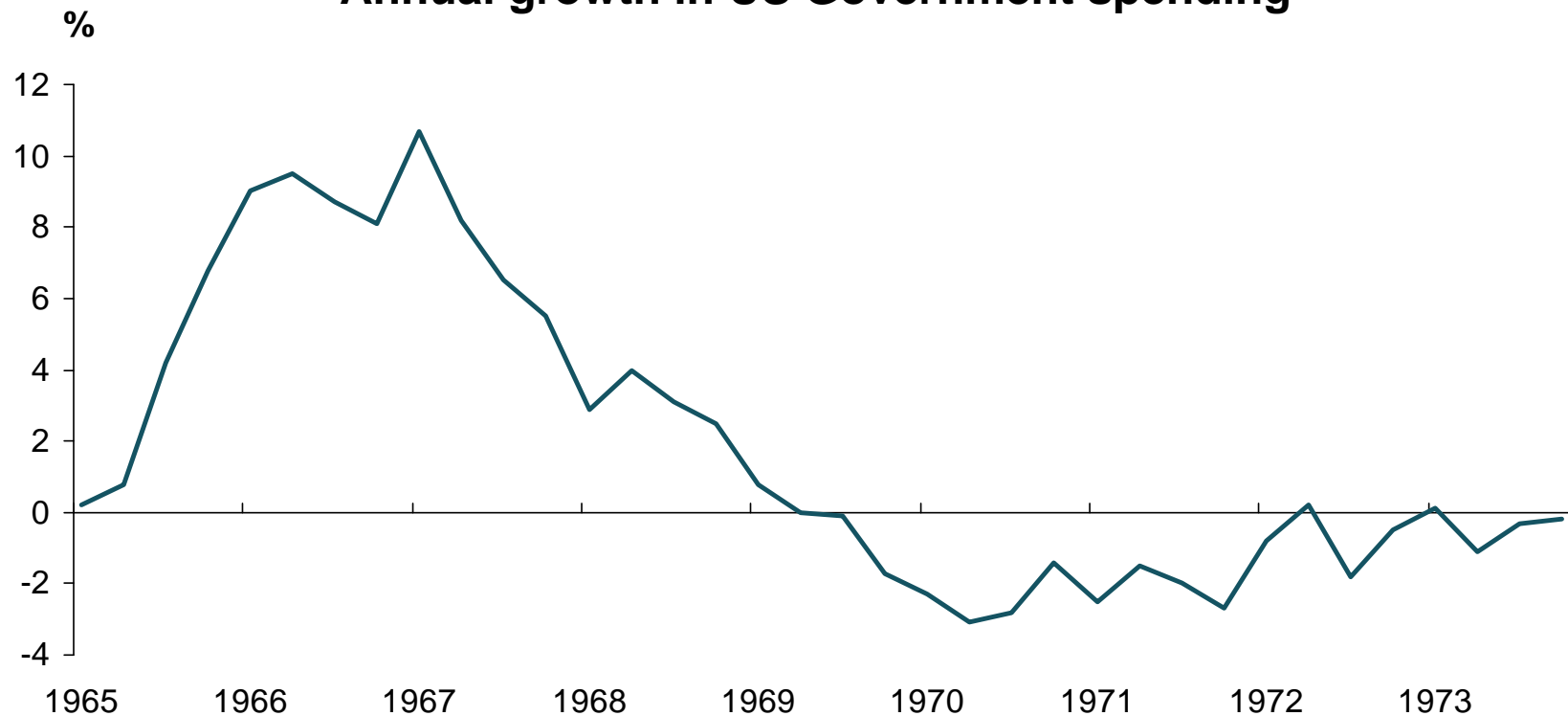
Goldilocks

Bubble & Bust

Forgotten Years

Muddle Through

Annual growth in US Government spending



Parallels with sovereign concerns in the PIGS today



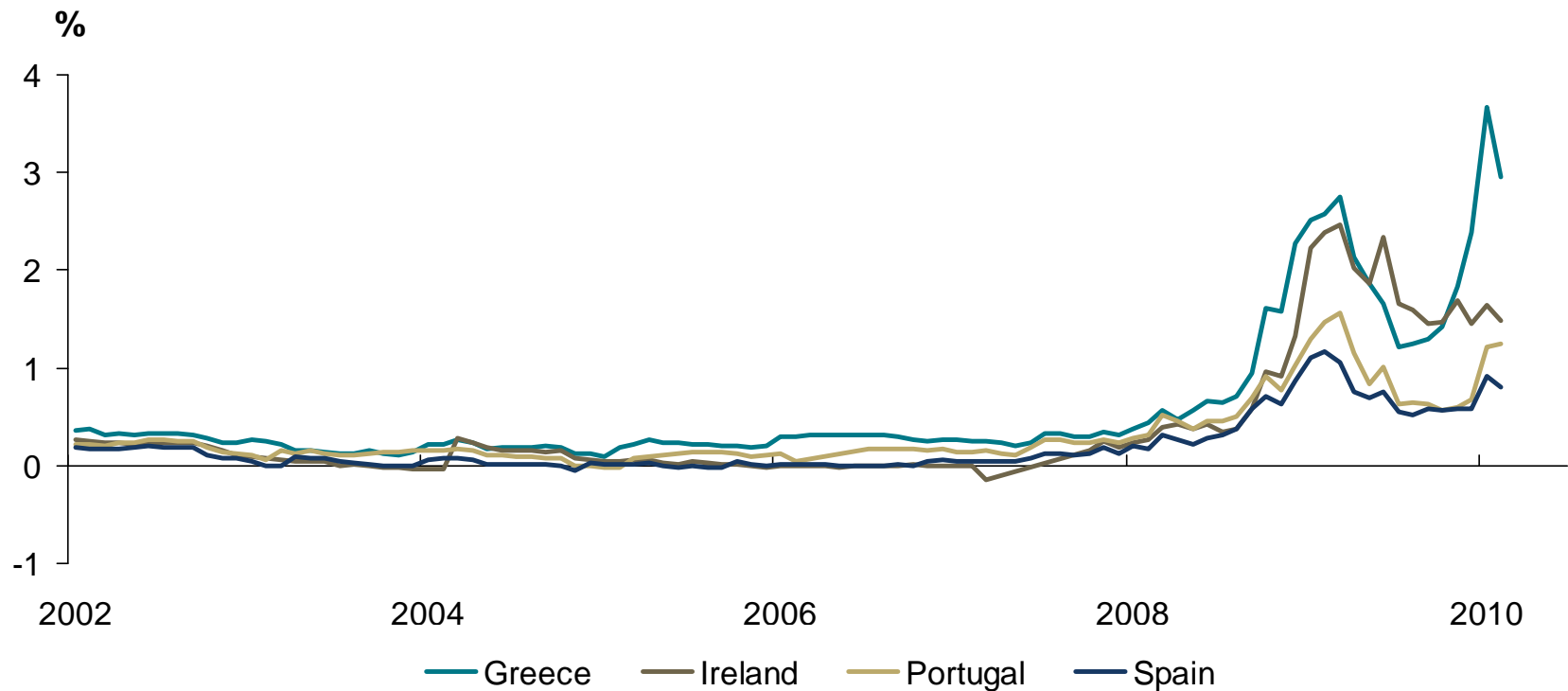
Goldilocks

Bubble & Bust

Forgotten Years

Muddle Through

10 yr Govt Bond yield spread over German Govt Bonds



Economic Scenarios – my thoughts



- > Fairly uncertain environment at present
- > Forgotten years may be unlikely, but worth protecting against
- > We are optimistic on China, though cyclical upswing fully priced
- > Cost if we are wrong on China would be large as share of global & Australian GDP has grown markedly
- > Developed economies have bigger impact on our markets than on our macro economy
- > Even if everything goes well, markets can trade on negative sentiment for a long time

Markets can diverge from fundamentals for a long time



US & Australian equity market indices (Jul 2007 = 100)

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