

IML: Equity market outlook

May 2009

Key factors that will drive our equity market in the period ahead:

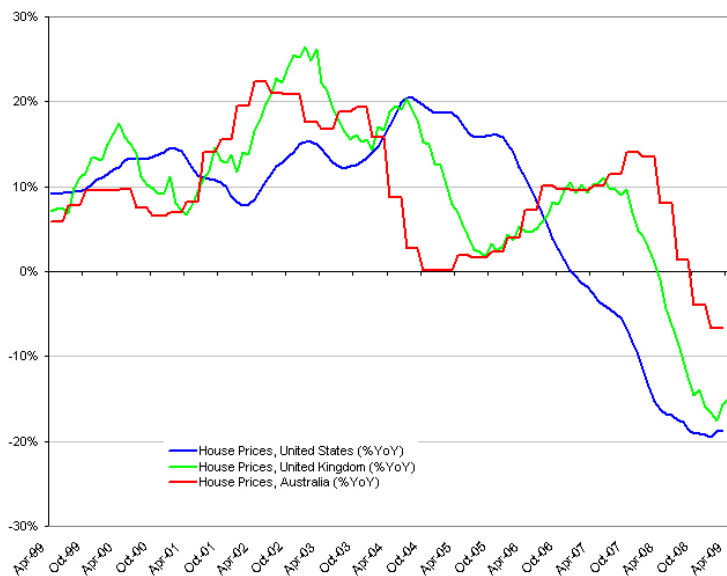
- * Globally while economies around the world remain fairly weak, we expect growth to stabilise over the next six months, however, we expect any recovery thereafter to be slow.
- * Australia is better positioned than other developed economies. Our national balance sheet is stronger, and our economy is likely to reap the benefits of a recovery in the developing nations of SE Asia and China in particular.
- * Implied volatilities and equity risk premia have contracted significantly since the collapse of Lehman Brothers in September of last year, however, they remain at levels commensurate with a significant recession.
- * Equity valuations look attractive with the Australian market trading on a PE of 14.3x 2009 earnings with a dividend yield of 6.2%.

Emerging signs of global economies stabilising:

Central banks and governments around the world have taken enormous steps in implementing both monetary and fiscal policy measures which are starting to help stabilise many global economies. Whilst economic data continues to point to a contraction over the coming quarters, the rate of decline has slowed down and in some cases has begun to improve. In particular, housing markets in both the US and the UK are showing clear signs of progress with mortgage applications and sales both increasing, albeit from very low levels. While excess housing inventories in the US will take time to clear, consumer confidence is likely to improve as house prices find a floor although higher unemployment will slow any improvement. The combined effect of fiscal and monetary stimulus supporting real disposable income and an improvement in consumer confidence is likely to translate into an improvement in aggregate demand at some stage.

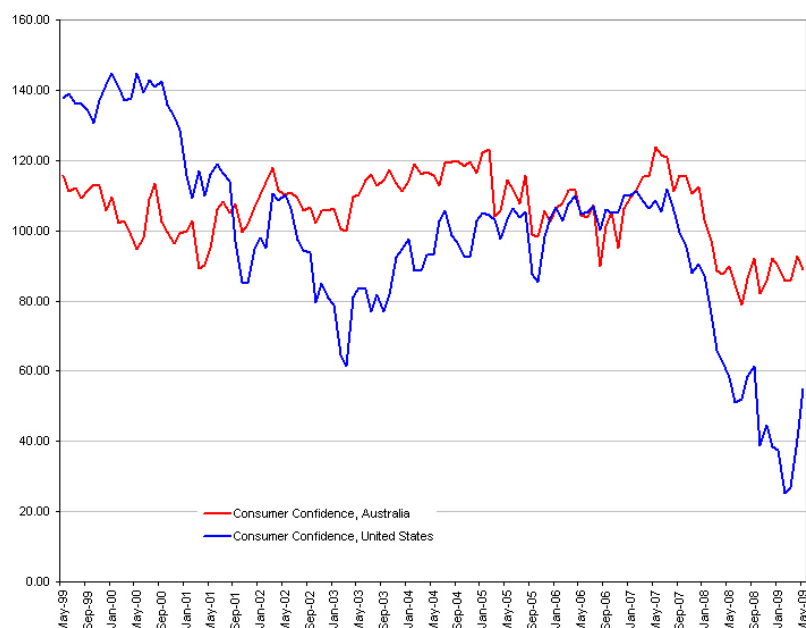
In the short-term, however, as unemployment increases, personal savings rates increase and the appetite for credit decreases, we are unlikely to see a return to the level of demand seen in the recent past. As a result, the recovery is likely to be slow with sub par growth over the short to medium term.

Figure 1: House Prices



Source: Factset, Investors Mutual Limited

Figure 2: Consumer confidence



Source: Factset, Investors Mutual Limited

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Australia's strong fundamentals ensure we are better placed than many other developed nations:

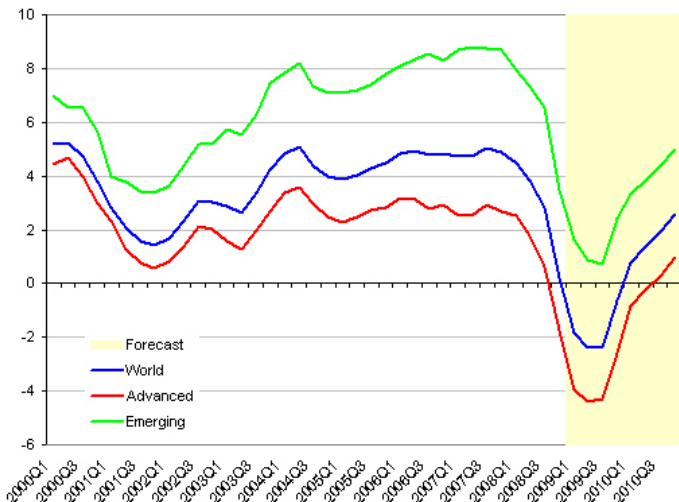
Australia remains relatively well positioned compared to other developed nations. Firstly, our national balance sheet is significantly stronger than that of other developed nations with a public debt level of 14.3% of GDP compared to the OECD average of 79.7%, allowing us significant scope for further fiscal stimulus.

Secondly, the depreciation of the Australian dollar from a peak of 97 cents to the USD to 78 cents to the USD today has cushioned our economy's exporters and increased the price of imports. The result of this is that net exports will continue to drive GDP as the weakness in imports outstrips the slowing in exports.

Thirdly, domestic consumer spending has remained relatively resilient, supported by policy stimulus. We expect this trend to continue as the Authorities maintain a stimulatory monetary and fiscal stance. Having said this we would expect a slowing in spending in Australia as unemployment increases.

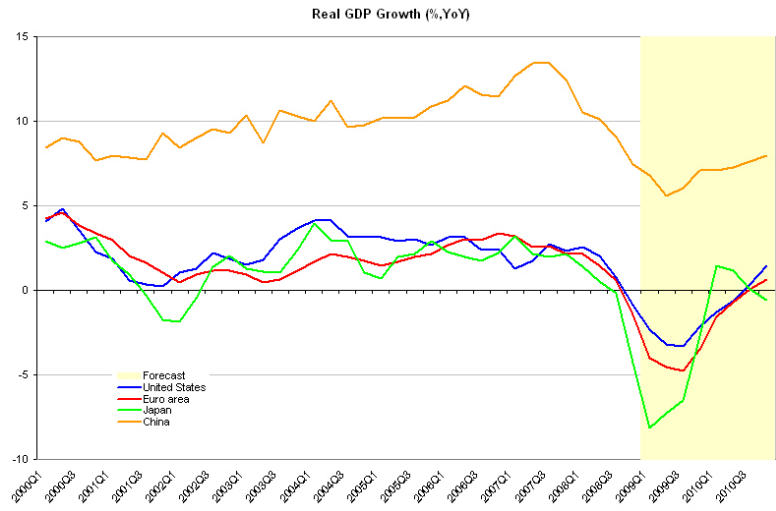
Finally, the recovery is likely to be led by emerging markets, with the International Monetary Fund forecasting emerging markets growth to rebound to around 5% p.a. and developed nations to around 1% in 2010. Given Australia's exposure to the Asian emerging markets, in particular China (expected to grow at 6.5% in 2009, 7.5% in 2010), the IMF expects Australia to contract by 1.44% in 2009 and resume growth of 0.65% in 2010, 1.9% in 2011 and 2.8% in 2012.

Figure 3: Real GDP Growth (% YoY)



Source: IMF, Investors Mutual

Figure 4: Real GDP Growth (% YoY)



Source: IMF, Investors Mutual

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Outlook for the Australian Equity market:

Equity market sentiment has improved significantly since early March with implied volatilities and equity risk premia now pricing in a recession of the magnitude of 1973, 1981 or 1991, but not nearly as severe as the Great Depression. Australian equities are trading on reasonable valuations with the broad market priced at 14.3x PE FY1 and a dividend yield of 6.2%.

Looking at Resources vs Industrials we note that the expected earnings growth rate for Resources has collapsed from 35% p.a. in September 2008 to -9% p.a. at the end of April, whilst Industrials have slowed from 10% to 2% over the same period. Partly as a result of this we continue to prefer good quality industrial companies over resource companies.

Within the banking sector we believe that whilst Australian banks remain relatively well capitalised compared with their international peers, the bad debt cycle is likely to constrain the banks' performance in the medium term particularly given the very high level of gearing amongst Australian households.

An appropriate investment strategy for today's environment:

Given low interest rates, value as a style should outperform growth going forward and small caps should outperform large caps. With a bottoming of the earnings decline in sight and a slow recovery on the way, the conditions are well suited to our stock picking style. However, given the fragility of the global economy and the advent of a slow and tepid recovery, we continue to favor good quality companies with pricing power and sustainable dividends.

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