

Overview

- In May, the Australian sharemarket recorded its heaviest monthly fall since October 2008, with all sectors ending the month in negative territory.
- Key factors affecting the Australian sharemarket over the month were sovereign debt concerns in Europe (and risk of further contagion in the region), the Federal Government's proposed mining tax, China's monetary tightening measures and overall risk aversion by global investors.
- Nevertheless, the Australian economic environment remains broadly positive. We continue to have a favourable view of companies with offshore earnings, particularly those with significant revenue coming from the US.

May 2010

FOR PROFESSIONAL INVESTORS ONLY

ING INVESTMENT MANAGEMENT

Australian Equities Update



MARKET REVIEW

Australian Equities Index Returns as at 31 May 2010

| Indices | 1 Month Return | 3 Month Return | 12 Month Return |
|--------------------|----------------|----------------|-----------------|
| S&P/ASX 300 | -7.5% | -3.6% | 20.7% |
| S&P/ASX 200 | -7.5% | -3.5% | 20.8% |
| S&P/ASX 100 | -7.5% | -3.7% | 20.9% |
| S&P/ASX Small Ords | -8.2% | -1.9% | 19.0% |

S&P/ASX Accumulation Indices rounded to one decimal point.

Source: Datastream

The Australian sharemarket, as measured by the S&P/ASX 200 Accumulation Index, declined by 7.5 per cent in May. This was the market's worst monthly performance since October 2008, when it dropped by 12.6 per cent. On a sectoral level, the heaviest falls were recorded by industrials (-11.3%) and financials ex-REITs (-10.6%). These were followed by the utilities (-7.4%) and telecommunications (-7.2%) sectors, which are normally immune to heavy selling due to their defensive nature.

ASX200 Sector Performance as at 31 May 2010

| Sectors | Monthly Return |
|------------------------|----------------|
| Consumer Staples | -1.1% |
| Healthcare | -4.1% |
| REITs | -4.1% |
| Materials | -5.9% |
| Energy | -6.9% |
| Consumer Discretionary | -6.9% |
| Telecommunications | -7.2% |
| Utilities | -7.4% |
| Financials (ex-REITS) | -10.6% |
| Industrials | -11.3% |

Refers to sector returns from the S&P/ASX 200 Index

Source: IRESS, Datastream

Proposed tax changes weigh on Australian mining sector

In Australia, the long awaited Henry Tax Review was released early in the month. Disappointingly only a few of the recommended measures were adopted by the Federal Government. The key change affecting investors was the reduction in the company tax rate from 30% to 29% by July 2013 and then down to 28% by July 2014.

The key item that remained the subject of significant comment and speculation was the Federal Government's proposed Resource Super Profits Tax (RSPT). This new tax aims to profit from mining activity undertaken on domestic soil.

The RSPT is effectively a 40% nationalisation of Australian resource assets and this has significant implications for the resources sector. The proposed tax has cut the potential long term earnings of Australian commodity assets by over 10%.

Not surprisingly Australia's largest mining companies were seeking to engage the government on further discussion and debate on the mechanics of this tax. The uncertainty and the potential financial impact on the mining sector led to a significant sell-off of mining stocks during the month. Commodity prices also fell, with the exception of gold, which bucked the trend and rose by \$37.04 over the month to close at \$1215.97 an ounce.

The risk aversion that permeated markets also eroded the value of the Australian dollar against the greenback – falling from US\$0.90 to US\$0.81 within the space of a week.

Healthcare affected by budget cuts and deregulation

During the month it became evident that the Federal Budget Pathology funding cuts which came into effect in November 2009 and the deregulation of collection centre licences (commencing from July 2010) would impact the revenue stream of a number of healthcare companies. This led to a downgrade in earnings guidance from Primary Health Care (PRY) and Sonic Health Care (SHL).

PRY shares fell 4.3% on the day that the company announced a profit guidance of around \$330-\$340m for the 2010 financial year, compared to consensus expectations of \$356m. SHL also suffered a large price fall (of 20%) when it announced profit expectations of around \$290-\$295m in comparison to consensus forecasts of \$334m.

Elsewhere in the sector M&A activity has been heating up. Sigma Pharmaceuticals announced it had received a take-over offer from Aspen Pharmacare Holdings (the largest listed pharmaceutical company in South Africa) for \$0.60 per share. Sigma shares rose by 37% on the back of this announcement. Healthscope (HSP) too received a take-over offer from a private equity consortium with HSP priced at \$5.50 per share. HSP shares rose 17.3% on the day of the announcement.

Financial bailout reinforces the fragility of the European economy

From an overseas perspective, the €750 billion financial rescue package announced by the European Union (EU) and the International Monetary Fund (IMF) for Greece and the other heavily indebted European nations served only to temporarily calm fears of renewed stress in the credit markets. Furthermore, the announcement by Germany to ban naked short-selling only added to further risk aversion in global financial markets.

Financial concerns were similarly evident in the US, where the US Senate passed a bill designed to restrict the activities of US banks, and a criminal probe was launched into the client disclosure practices at investment bank Goldman Sachs.

China tries to keep a lid on spending

On May 10, the People's Bank of China announced a 50 basis points increase in the reserve requirement ratio (RRR), which effectively reduces the amount of liquidity in the banking system. The government is keen to keep inflation under control and by increasing the RRR, this will serve to slow credit growth.

OUTLOOK

Overall, the Australian economy appears to be experiencing a rapid cyclical recovery, driven primarily by high commodity prices and increased government spending. Moreover, there is gathering evidence of a rebound in the US economy, which bodes well for domestic companies with US exposure, or whose earnings are denominated in US dollars. However, the environment is not without risk.

In terms of the major near-term drivers of the market, we note that there are a number of factors presently at play.

- The Australian dollar has weakened against the US dollar amid a renewed aversion to risk by global investors. Nevertheless, this represents a source of potential upside for domestic companies with US dollar earnings exposure. We expect that US economic recovery will take centre stage and be the biggest positive in the world this year. US productivity is improving by 4%, corporate profits have increased, industrial production is growing, US manufacturing is expanding and consumption is also strong. Restocking is beginning to take place while interest rates remain low. The stimulus packages of last year coupled with a resumption in the flow of credit has begun to translate into economic growth and the cost cutting story of 2009 is now translating into a positive earnings story for 2010. We see a great opportunity ahead for companies leveraged to a turnaround in activity and economic growth in the US, such as News Corp, James Hardie, Brambles and Computershare - to name a few.
- Investors will need to keep an eye out on what is happening in China. China is tightening and slowing their economy due to the threat of inflation and a surging property market. A slowdown in the pace of economic growth in China could have immediate and significant consequences for Australian resources producers. In addition, the ongoing debate over the potential impact of the RSPT is likely to weigh on sentiment towards local mining stocks.
- The fading impact of the Australian Government's consumer stimulus measures coupled with rising interest rates will most likely subdue consumer spending. Domestic interest rates are a potential concern, with the official cash rate having been raised six times since October last year. This will lead to further downward pressure on early cyclical stocks and a flattening of the yield curve which will put bank margins under increasing pressure.
- Sovereign debt issues in European countries and the possible contagion effect into the rest of Europe could give rise to a tightening of credit and liquidity. It could also lead to periods of ongoing volatility in global share markets.

From a technical perspective it is important to note that earnings per share (EPS) growth has increased strongly from the negatives of the past two years and is currently forecast to grow by over 25% on a one-year forward basis. This is reinforced with Industrial Production (IP) figures rising from -12% in the first half of 2009 to +12% in March 2010 and is coupled to strong commodity demand and robust liquidity conditions.

Hence, despite the pullback over the last month, the upward trajectory of the Australian equity market has remained intact, driven by fundamental value reflected in the one year forward Price/Earnings of all companies which are at 11x versus a long run average of 14x.

With such a mixed backdrop we must remain vigilant on the bottom up analysis of company earnings and valuations. It is apparent that some stocks will perform strongly over the remainder of 2010, while others will come under pressure due to regulatory changes, changing investor sentiment, and rising interest rates.

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