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In this Ibbotson Insight, we focus on what we believe are the fundamental drivers that have helped Australia stand apart from the other developed world economies.

The key question we ask is why the Australian economy and Australian company earnings continue to hold up so well relative to other developed economies and sharemarkets. We attribute this principally to Australia's leading position as a commodities exporter; our geography, and in particular proximity to the fast-growing Asian region; and the strength of the Australian banking system.

Rather than focusing on factors helping the Australian economy which have been shared by all the major developed economies (principally stimulus packages), we ask what are the key factors which have made Australia uniquely-placed – in effect, are we deserving of that well-known tag, 'the Lucky Country'?

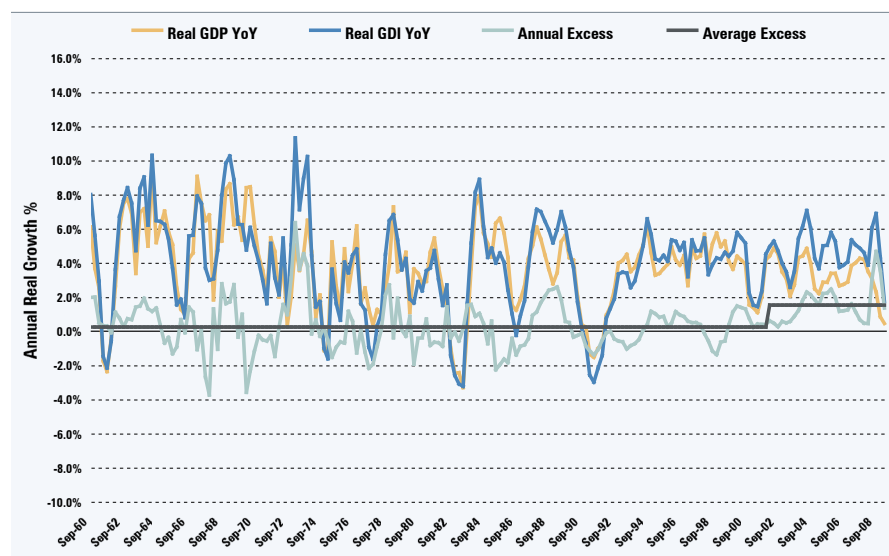
Robust Economic Growth

Australia's economic growth in the current decade, as measured by increase in real gross domestic product, has been robust, boosted in part by a dramatic improvement in our terms of trade.

The relationship between volume-based GDP measures and changes in the terms of trade is a complex one, but one that has translated into positive gains for the Australian economy and sharemarket.

Australia – The Lucky Country?

Figure 1. Real Gross Domestic Product Versus Real Gross Domestic Income, 1960–2009



Source: Australian Bureau of Statistics.

The GDP measure normally quoted and analysed is Gross Domestic Product, a volume-based measure that excludes the impact of changes in relative prices. However, it's not only the *volumes* of exports over imports that matters – arguably even more important are the relative *prices* of exports over imports. This relative pricing effect, known as the 'terms of trade', is captured in the statistic referred to as Real Gross Domestic Income (GDI).

Figure 1 tracks the differences between these GDP and GDI measures over the 49 years from 1960 to 2009. The graph shows that the average excess of GDI over GDP attributable to the terms of trade effect since 2001 has

been approximately 1.40 percent per annum, a substantial increase on previous decades when the average excess was closer to 0.20 percent per annum.

This increase in export prices relative to import prices means that a larger volume of imports can be purchased with a given volume of exports. The implied increase in the real purchasing power of domestic production is equivalent to a transfer of income to Australia from the rest of the world, and the income boost to Australia from the dramatic increase in the terms of trade over the past seven years has been significant. This increase has been one of the greatest in the world, leading to a corresponding increase in

domestic income that has been a huge boost to Australian company profits.

Terms of Trade and Commodities

Figure 2 shows that the substantial increase in Australia's terms of trade over the past seven years in particular has been attributable in large part to rising commodity prices. This strength in commodity prices reflects the strong growth in demand from the world economy and in particular China. Underinvestment in commodity productive capacity in the 1990s has caused supply problems, and with the strong demand that has followed, capacity has not been brought on stream swiftly enough.

Furthermore, the consolidation in the resources sector in recent years coupled with the global contraction in available capital means that overinvestment is not likely to be a significant factor in the near future, either. For example, the joint venture between Rio Tinto and BHP Billiton in the Pilbara is likely to create reduced supply responses and higher prices for iron ore (Australia's largest mineral export).

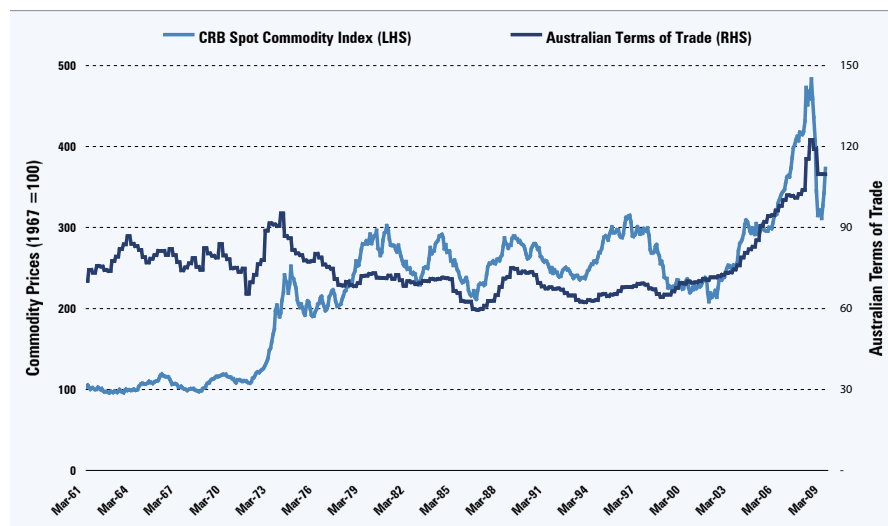
We do not see enough capacity coming on stream to exert significant downside pressure on commodities prices, and we expect the tight supply situation to persist for some time yet. Additionally, much of future world economic growth is expected to come from emerging Asia, and growth in these developing economies has a much greater resource commodity intensity than in the developed world. This is likely to provide further support for commodity prices, specifically for those that Australia exports.

Favourable Geographical Position

As we've noted already, the strongest demand for commodities is coming from the Asian region, particularly China and India. Figure 3 shows that Asia has appreciably higher growth rates than the world in general and developed markets in particular. Although Japan is still Australia's largest trading partner, China and India are some of our fastest-growing trading partners (Figure 4). (China accounted for 24.60 percent of Australia's exports at 30 June 2009.)

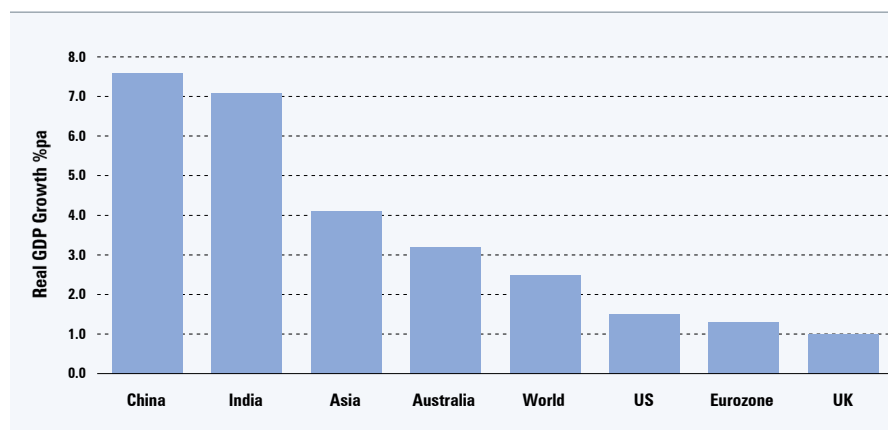
Australia is uniquely-positioned to sell goods, services, and commodities into these key world

Figure 2. Australian Commodity Prices and Terms of Trade, 1961–2009



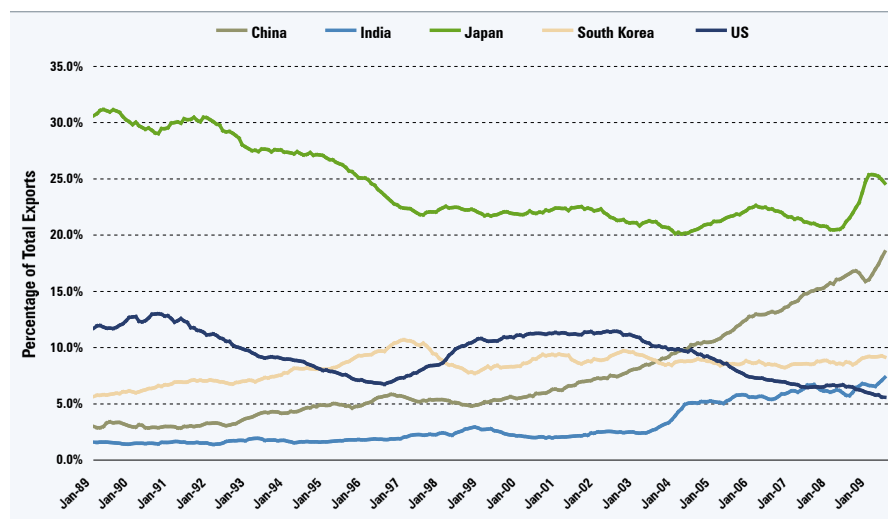
Sources: Australian Bureau of Statistics, CRB, Thomson Financial Datastream.

Figure 3. Expected Growth of Real Gross Domestic Product – Next Three to Five Years



Sources: Institute for Economic Research (Ifo) World Economic Survey, Thomson Financial Datastream.

Figure 4. Changes in Australia's Five Largest Export Destinations, 1989–2009



Source: Australian Bureau of Statistics.

growth engines. This will boost Australian GDP and GDI, driving the higher employment and consumption growth that ultimately leads to earnings growth for Australian companies. Relatively speaking, the outlook for Australia's revenue growth looks solid.

Strong Banking System

As well as enviable access to commodities and a favourable geographical location, the third aspect that fundamentally differentiates Australia is the strength of our financial system. Australian banks are well-capitalised, operate within a strong monetary policy framework, and have been the recipients of both direct and indirect government stimuli.

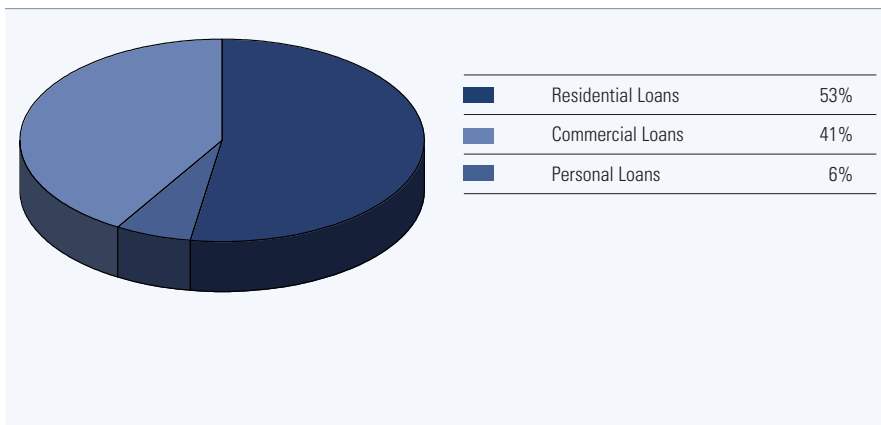
One of the key drivers of Australia's current account deficit is the need for foreign capital, and more specifically foreign debt, to finance our bank balance sheets. The Reserve Bank government guarantee program implemented in October 2008 enabled the banks to maintain their financing. Furthermore, the predominance of floating rate mortgages in Australia provided an effective mechanism for easing monetary policy, while the banks' experience during Australia's significant recession and property crisis in the early 1990s prevented excessive risk-taking on balance sheets over the past decade.

Figure 5 shows the loans and advances in the Australian banking system at 30 June 2009, and Figure 6 the relative trends in the growth of Australian and US housing prices over the past decade. The first graph shows that over half of Australian bank balance sheets are exposed to residential property.

Australian house prices held up extremely well during the global financial crisis for a number of reasons, but the imbalance between supply and demand is arguably the most important. There is fundamentally stronger demand in Australia for housing, and secondly but just as importantly, a lack of supply. Australia therefore did not experience the same housing oversupply as the United States. Given their substantial exposure to residential loans, this has been a key source of strength for the Australian banking system.

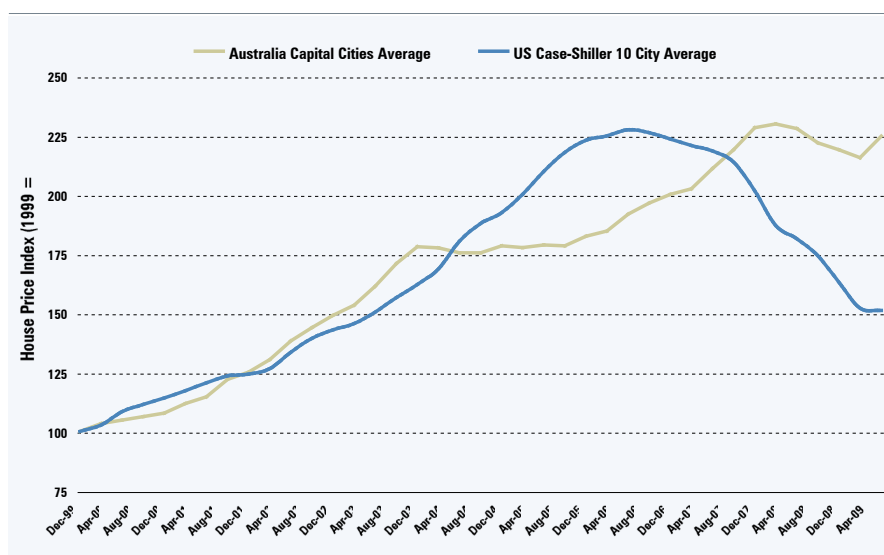
Statistics from the Department of Immigration & Citizenship indicate that more than 158,000 new migrants came to Australia in 2007/08.

Figure 5. Breakdown of Australian Bank Loans and Advances at 30 June 2009



Sources: Reserve Bank of Australia, Australian Prudential Regulatory Authority.

Figure 6. Growth of Australian and US Housing Prices, 1999–2009



Sources: Australian Bureau of Statistics, Case-Shiller Home Price Indices.

The estimated Australian resident population at 31 December 2008 was 21.6 million, an increase of 406,100 people (or 1.90 percent) since 31 December 2007. Australia's population growth rate was higher than the world population growth rate of 1.20 percent over the same period. Australia is ranked at the top of the OECD for population growth. On the basis of Australian Bureau of Statistics medium-term assumptions about Australia's future fertility, life expectancy, and net overseas migration, Australia's population is projected to grow to 35.50 million in 2056. This will provide a fundamental underpinning to the demand for housing.

From a supply perspective, the National Housing Supply Council State of Supply Report 2008 conservatively estimated the gap between total underlying demand and total supply of housing to be approximately 85,000 dwellings at 30 June 2008. On the basis of assumptions of medium-term growth in supply and underlying demand, this overall gap is projected to grow to 203,000 dwellings over the five years to 2013. While these projections are sensitive to changes in underlying assumptions, this certainly suggests a limit to the downside risk to Australian house prices. A precipitous fall is unlikely given this supply/demand imbalance, providing further strong support for the Australian banks.

Conclusion

Australia's economic performance has been strong over the past decade, and this has underpinned the strong performance from the Australian sharemarket relative to the other developed world markets.

We believe Australia is uniquely-positioned to extend this period of good fortune for three key reasons: the supply of commodities is likely to remain tight, and demand is expected to hold up; Australia is well-positioned to leverage off Asian growth, particularly in India and China; and Australia's banking system remains adequately-capitalised, and residential loans are very well-supported by underlying supply and demand dynamics.

Australia has harnessed these competitive advantages over the past seven years through profit margin expansion. Given the continuing expansion of global trade and the progressive shift of economic power from the West to the East, Australia is extremely well-positioned to capitalise further on these trends.

The US, UK, Japanese, and European economies remain heavily-mired in public and private debt, and household balance sheets will take more time to repair. The normal processes of the capital cycle are unlikely to lead to a genuine expansion in profit margins and a demand-led recovery in revenue growth for some time. With this backdrop in mind, Australia is indeed the 'Lucky Country' well-positioned relative to other developed nations to deliver solid economic and earnings growth. ■■

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