

Global economic outlook

Gradual recovery with developing economies leading the world out of recession

The IMF has upgraded its outlook for global growth with activity expected to expand by 4.0% over 2010. The IMF expects a weak recovery in developed economies and a moderate recovery in developing economies. Developed economies (which represent about 60% of global GDP) are expected to grow by 2.0% over 2010, while developing economies (40% of global GDP) are expected to grow by 7.0%.

The US economy (23% of Global GDP at market exchange rates)

Economic data flow has improved in the US, although the recovery still looks fragile. Much of the improvement to date relates to a rebuild in inventories and government spending rather than an increase in consumption or investment. Although an improvement in the labour market, with payrolls increasing by 162,000 in March 2010 and the unemployment rate falling to 9.7%, is a positive sign that a broader recovery may be starting to take hold.

Fiscal and monetary policy is still quite expansionary with the 2010 Federal budget deficit forecast to hit US\$1.6 trillion or 11% of GDP while the US Federal Reserve (the Fed) maintains the cash rate will remain at zero "for an extended period". The Fed is expected to withdraw from its quantitative easing program (the buying of government and mortgage securities with printed money to keep loan rates low) in the June quarter but this has not been confirmed, at the time of writing.

The S&P 500 has recovered 70% since the March 2009 low and the housing market looks to have found a base and is improving, albeit slowly. Nevertheless, the big picture remains that the US economy is heavily indebted, with US\$42 trillion in debt across the private sector and US\$10 trillion in debt across the public sector, against an economy worth US\$14 trillion. The US has many years of low growth ahead as consumers reduce spending to pay down debt, and the government will eventually have to reduce spending and/or increase taxes to do the same. The IMF expects the US economy to grow by 2.7% over 2010.

The European economy including the UK (21% of Global GDP)

Europe looks decidedly weaker than the US with growth expected to be minimal over 2010. The ECB seems reluctant to offer the scale of monetary stimulus of the Fed while Germany is reducing Government spending rather than increasing it. There has been considerable market focus on the Greek budget deficit blowout with Greek 10 year bond yields spiking to over 7.0% despite measures to reduce the budget deficit and a statement that the European member states and the IMF would bail out Greece if required. There is a real risk that contagion sets in and market concerns spread to other fiscally stretched states like Portugal, Spain and Italy. Indeed, there seems a much greater risk that the post-GFC deleveraging cycle will lead to more insipid growth and deflation in Europe than in the US.

The UK seems to be acting more decisively than Europe and has seen a more rapid recovery. The BOE has slashed the cash rate to 0.5% and has been engaging in quantitative easing, while the government has been busy providing support for the real economy with a major fiscal stimulus package. The government's budget deficit is set to rise to £167bn (12% of GDP) over the year and with an election in May, the next government has some hard decisions to make to cut the deficit. The IMF expects the European economy to grow by 1.0% and the UK economy to grow 1.3%, over 2010.

The Asian economy (21% of Global GDP)

After a dismal 2009, the Japanese economy is showing some signs of recovery. Improved consumer confidence, a rebuild of inventories and a strong turnaround in net exports are expected to lift growth in coming quarters. The Nikkei has recovered 54% from its March 09 low and the recent Tankan survey reported that business confidence is at two year highs but this has not led to any major increase in business investment as yet. The Bank of Japan has cut interest rates to 0.1% from 0.3% and the government is mulling over a new stimulus plan, although with a public debt to GDP ratio of 220%, its options are limited. Deflation will probably remain as a problem for the Japanese economy during 2010.

China moved decisively to head off the GFC-induced collapse in global trade that harshly affected similar export-dependent economies like Japan, Korea and Germany. The Chinese government released a 4 trillion yuan (US\$585bn) stimulus package focused on stimulating internal consumption and investment. At the same time, Chinese State-owned banks lent 9 trillion yuan (US\$1,353bn) in new loans over 2009, nearly double the 2008 amount. As a result, China's economy continues to grow at a rapid 8-9% pa but there are increasing concerns that the stimulus has led to a property bubble in China's major cities. This may be true but Chinese authorities have greater direct control over the banks and the economy and should be able to manage the situation. The IMF expects the Japanese economy to grow 1.7% and China's economy to grow 10.0% over 2010.

Key global issues to watch	Lonsec view
G7 economic growth	Gradual recovery over 2010, Europe and Japan still fragile
Asian economic growth	China to maintain an 8%+ growth rate but will come under increasing pressure to appreciate its currency
Inflation/Deflation	Deflation a risk in the short term due to excess capacity but government and central bank liquidity should lead to inflation emerging later
Bond yields	Likely to rise due to deteriorating fiscal positions of the G7 and the threat of inflation returning
Commodity prices	Will remain firm if the global recovery becomes self sustaining

Domestic economic outlook

Australia economic recovery to gather steam over 2010 and 2011

The Australian economy grew by 0.9% in the Dec quarter and 2.7% over 2009. Economic data suggests the economy is gathering momentum with the RBA expecting growth to pick up to between 3.0-3.5% pa over 2010 and 2011. This would be the 19th consecutive year of growth for Australia, cementing it as the best performing economy in the OECD and the third best performing globally, after China and India.

With the economy clearly 'out of the woods', the RBA has begun the process of increasing the cash rate to more 'neutral' levels, thought to be in the range of 4.5-5.0%. At the same time, the Federal government is winding down its fiscal stimulus programs. Australia seems to be well positioned relative to most OECD countries. Australia's strong fundamentals include:

- The economy is in its 19th consecutive year of growth;
- The financial system is in good health;
- A superannuation savings pool worth over \$1.2 trillion;
- The government is in a relatively strong fiscal position;
- Population growth of 2.1% over 2009;
- The unemployment rate remains relatively low at 5.3%;
- An estimated \$110bn in public and private investment earmarked over the short to medium term;
- The housing market has proven resilient;
- Asia, Australia's major export partner, has been less affected by the GFC than Europe and the US; and
- A rising terms of trade with prices for iron ore and coal rising once again.

The combination of Australia's relative economic strength and rising interest rates has led to the AUD strengthening to US\$0.93, at the date of this report. While a rising currency hurts our export competitiveness, it isn't all bad news as imports become cheaper and the interest on our \$680bn in foreign debt becomes easier to service, in AUD terms. It is probably a net positive in the short term but will tend to lead to long-term problems if the current account deficit continues to expand.

The main risks to the positive outlook are:

- Inflation re-emerging leading to rising interest rates;
- Any major increase in the cost of foreign capital due to rising bond yields in Europe and the US;
- a persistently rising currency;
- regulatory change; and
- any faltering of global growth, particularly in China.

While headline inflation has fallen to 2.1%, the underlying rate has remained stubborn at 3.2%. Given the economy is gaining momentum and there is little spare capacity, inflation could easily start to rise again. Already, we are seeing asset price inflation in the housing market. This could drive interest rates higher and lend further strength to the AUD. Rising interest rates would dent consumption and investment, while a rising AUD hurts Australia's export competitiveness. Other risks include any major increase in the cost of foreign capital which would force the major banks to increase loan rates regardless of the official cash rate. Any faltering in global growth, particularly in China, would hurt commodity prices and hence export income.

Overall, the economy should continue to recover over 2010 and 2011. China and broader Asia will become increasingly important to the Australian economy, in terms of trade and capital flows. The RBA will increase rates but will need to be mindful that rising bank credit spreads have already significantly increased loan rates and the private sector is still carrying a large debt burden. Lonsec expects the cash rate to reach 4.5% in mid 2010 and then remain steady for an extended period.

Key local issues	Lonsec view
Cash rate	Cash rate to reach 4.5% by mid 2010 and then remain on hold for some time
Inflation	Underlying inflation still remains a threat with the economy having little spare capacity
AUD/USD	Probably more upside in the short term while the RBA keeps hiking rates and commodity prices remain firm but risk to the downside over the medium term as the US starts to increase cash rates
Commodity Prices	Likely to remain buoyant if the global recovery gains momentum
House Prices	Higher rates should cool down the market but prices more likely to plateau than fall
Bond yields	Australian bond yields to creep higher as global bond yields rise - there is a risk that global bond yields rise significantly if markets start to lose confidence in the fiscal positions of the European, UK and US Governments

Recommended Tactical Asset Allocation

Lonsec has made no changes to its TAA this quarter. Cash remains attractive as banks fight for deposits and the RBA gradually increases the cash rate back to neutral levels. We remain concerned that US and European government and central bank stimulus will eventually stoke inflation, which will be bad news for bonds, i.e. bond yields will rise and hence prices will fall. Accordingly, Lonsec remains underweight bonds, although we acknowledge that Australian bonds offer better relative value to international bonds. Finally, we seek exposure to inflation hedges in equities, infrastructure and property. We are slightly overweight Australian equities and are considering increasing our Australian property and international equity allocation. However, we await a correction to make our move.

Investment Category	Asset Class	Mar 10 Quarter	Jun 10 Quarter
Income	Cash	Overweight	Overweight
Income	Australian Fixed Interest	Slightly Underweight	Slightly Underweight
Income	International Fixed Interest	Underweight	Underweight
Growth	Australian Property (LPT)	Neutral	Neutral
Growth	Australian Equities	Slightly Overweight	Slightly Overweight
Growth	International Equities (Unhedged)	Neutral	Neutral

Cash – Overweight

The Australian economy has avoided recession and indeed has outperformed most OECD countries. The RBA has begun the process of lifting the cash rate from its historic low of 3.0% to more 'neutral' levels - commonly estimated to be between 4.5-5.0%. Lonsec expects the peak in the cash rate to be lower than in the past because home and business loan rates have increased, post the GFC, and high private sector debt levels make the economy highly sensitive to interest rates. Cash rate to reach 4.5% in 2010 and remain on hold for an extended period.

Australian fixed interest – Slightly Underweight

Australian Government bond yields are not overly attractive versus cash and fixed term deposit rates. If the official cash rate reverts to around 4.5% there will be a narrow spread between cash rates and 10-year bonds at 5.85%, i.e. the yield curve is expected to flatten. Lonsec is not as concerned about increased bond issuance as it once was as the budget deficit looks to be more modest than previous estimates. Public (Federal and State) debt levels look set to peak at around \$150bn rather than \$250bn in 2012/13 forecast by economists. Lonsec acknowledges that Australian bond yields offer better value than major international issues but we remain concerned that they could still move higher yet, as international bond yields rise. Based on this view, Lonsec is slightly underweight Australian bonds.

International fixed interest – Underweight

Lonsec finds the investment case for global bonds to be unattractive as yields range from 3.5% to 4.0% on most major global 10-year bond issues. The return seems inadequate given the supply of most issues will increase dramatically as G20 governments issue debt to finance ballooning budget deficits. You would only find global bonds attractive if you believe the global economy is in for a lengthy period (5 years+) of deflation, which is not Lonsec's base case scenario. Lonsec believes that at some point in the future, central banks and governments will be successful in jump-starting inflation either by conventional or non-conventional means, i.e. money printing.

Australian property (LPT or A-REIT) – Neutral

The LPT sector is dominated by the top ten stocks which have all recapitalised and are now stable. From here, the focus will be on where capitalisation rates settle for each sector and future distribution growth. Lonsec believes the LPT sector will be more 'vanilla' from now on, meaning trusts will revert back to offering good yield with only modest capital growth, over the long term.

The major risks facing the sector are continued access to capital and the risk of rising bond yields. With the 10 year bond yield approaching 6.0% the running yield on the LPT sector does not look compelling at around 5.8-6.0%. The trusts will need to generate distribution growth to offer relative value. That's not likely in the short term but if the economy continues to recover and inflation starts to appear, commercial property could make a comeback as an inflation hedge once again. After retaining a neutral weight on the LPT sector for over a year now, Lonsec is getting closer to moving overweight but we are reluctant to move until we see the effect of higher bond yields.

Australian equities – Slightly Overweight

The Australian market has rallied 60% since the March 2009 low, although the All Ordinaries Index is still 27% below the 2007 peak of 6,850. The easy money has already been made from PE expansion after the cyclical low and now most sectors are beginning to look fully valued, in the short term. The market will require solid earnings growth to keep moving higher from here.

Sector	Market weight	FY10 PER*	FY11 PER*
Resources & Energy	33%	19.4x	13.2x
Industrials	29%	15.4x	13.4x
Banking	25%	14.6x	12.2x

*broker consensus estimates

The good news is the top-down outlook for the Australian economy is quite positive and so earnings growth should be quite strong for most sectors over the short to medium term. The Australian economy is expected to grow by 3.5% over 2010 and 2011 as business and consumer confidence recovers, public and private investment booms and Asian exports continue to grow at a solid pace. Judging by current pricing, the market is expecting company earnings to rebound by at least 20% in FY11.

The main risks to keep an eye out for are: renewed weakness in the US economy leading to a fall in the S&P500; continued AUD strength and its impact on export competitiveness; rising domestic interest rates and the impact on domestic demand; and any hiccups in Asia, particularly China and India, affecting our exports. Regulatory risk is another risk that is on the increase of late. The Labor Government is reviewing regulation and licences in a number of industries including Banking, Wealth Management, Healthcare, Telecommunications, Gaming and Media, as well as taxation of the Mining sector. The outcomes may have an adverse impact on certain sectors and need to be watched closely.

Lonsec is generally positive on the fundamentals of the Australian economy and its increasing links to Asia. The US economy is now less relevant to Australia than in the past but investor sentiment is still driven by the US lead. It seems that if Australia's future is increasingly tied to the developing economies of Asia then the US lead should become less relevant. Indeed, one would expect the correlation of the All Ordinaries Index with the S&P 500 to fall over time.

Lonsec expects the local market to keep pushing higher over 2010 with a target of 5,500 by year end. Lonsec recommends that investors use any correction to move to Slightly Overweight.

International equities (unhedged) – Neutral

The US market has rallied over 70% since the March 2009 low with the S&P500 approaching the 1,200 level, at the time of writing. The S&P500 is currently trading on a 2010 PER of 15.5x and 2011 PER of 12.8x which is not onerous. However, the risk to the US market is not so much valuation but earnings. The market is looking for 20% earnings growth over the next year which might be a stretch given the slow pace of recovery in the US economy.

Lonsec still has concerns about the high debt levels across the private and public sectors of the US, Europe and Japan, but believes these issues will be addressed over the medium to long term. While the yield curve in the US remains relatively low, equities are likely to outperform most asset classes.

Overall, Lonsec is more positive on the outlook for Australia and Asia than the US and Europe (which dominate the MSCI World Index) and accordingly we are Overweight Australian equities and Neutral on International Equities. Our recommendation is to tilt International weightings to Asia.

Lonsec Direct Model Portfolios

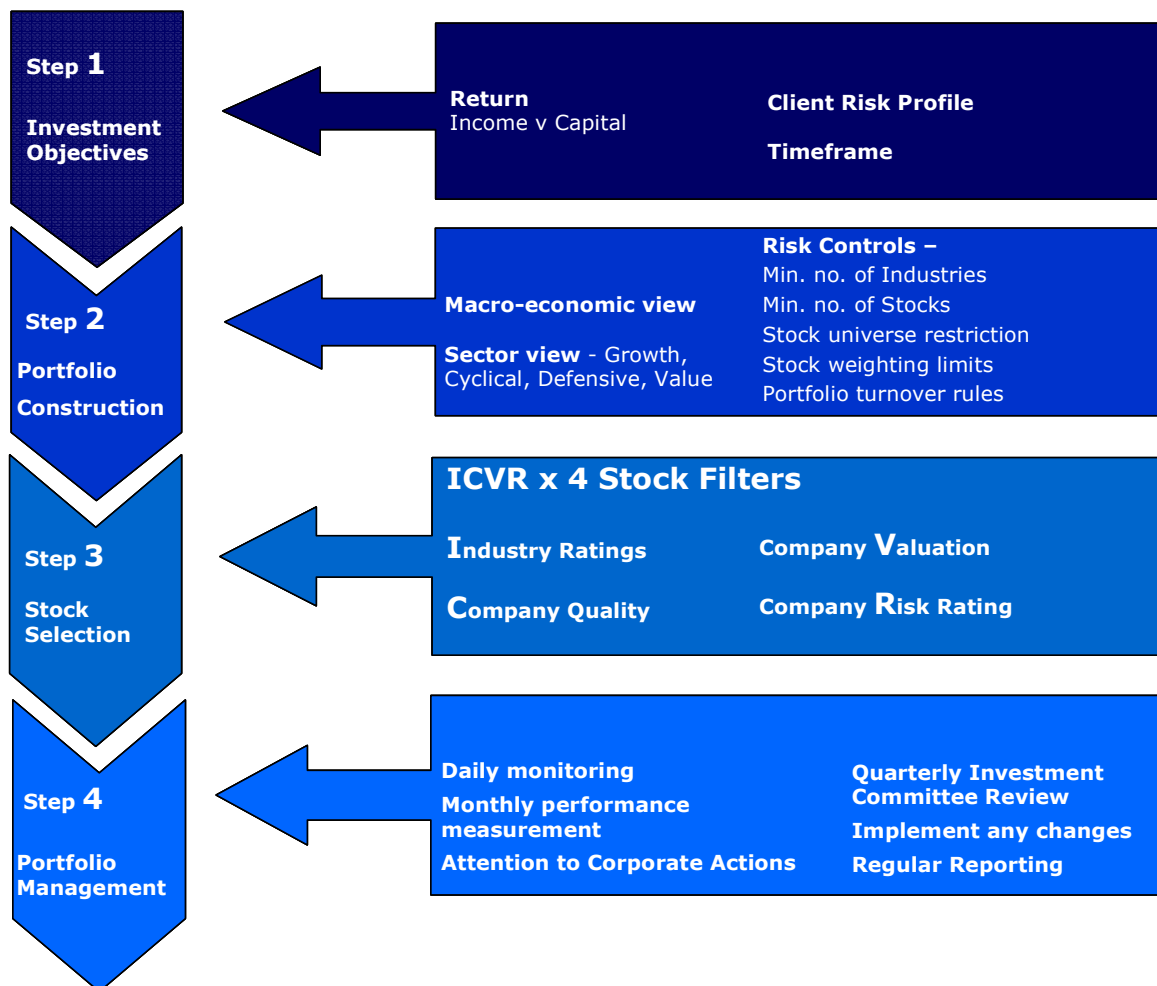
Lonsec Investment Philosophy

Lonsec takes an active approach to investing and focuses on generating absolute returns, over the medium to long term, through high conviction portfolios.

Lonsec employs a four-step investment process that has a strong focus on “top-down” macro-economic and sector themes. Risk is managed at both the portfolio and individual stock level.

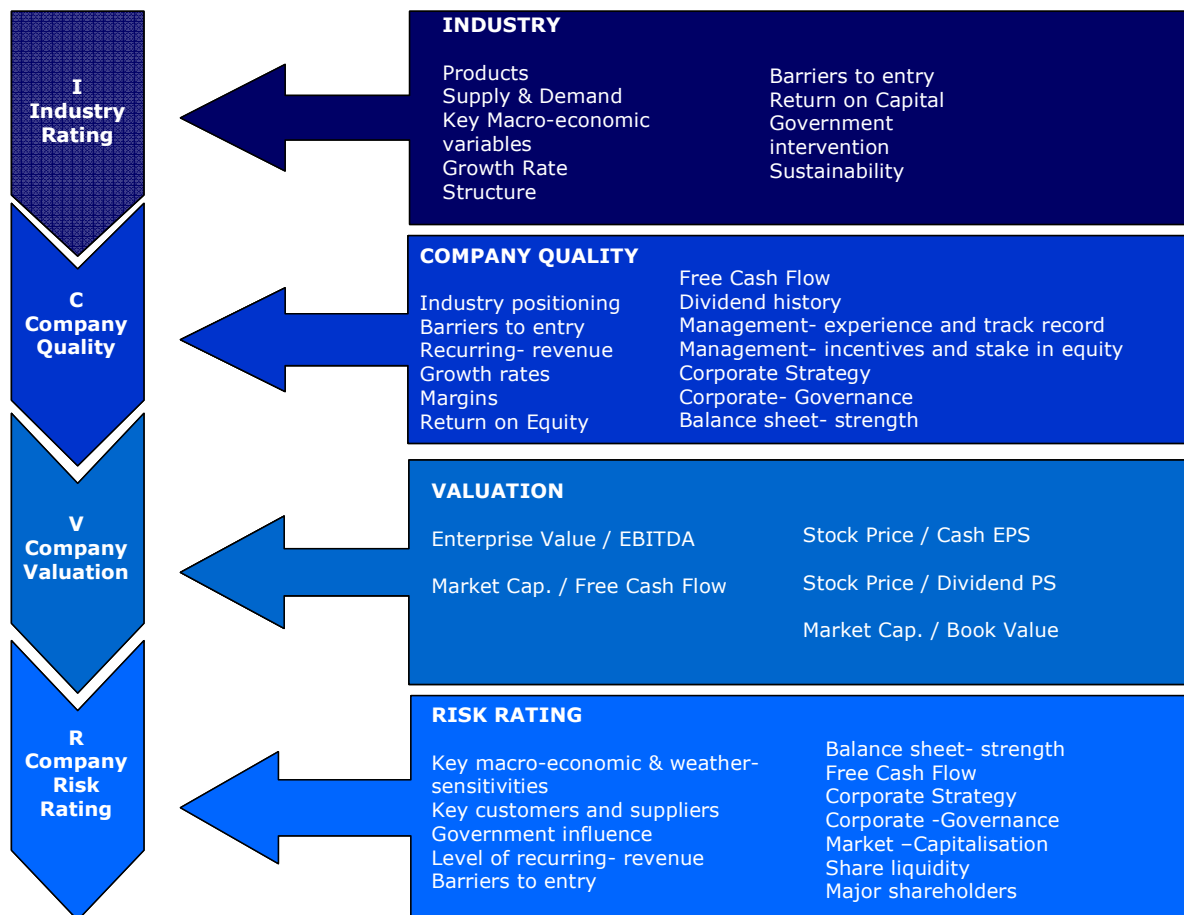
Lonsec’s Top-Down Investment Process

Lonsec employs a four-step investment process. The portfolio is heavily influenced by top-down themes at the Portfolio Construction level (Step 2). We employ four stock filters (Industry, Company quality, Valuation and Risk) to select stocks at the Stock Selection level (Step 3). Risk is managed at both the Portfolio Construction and Stock Selection levels. The final step is to manage the portfolio and regularly review our top-down themes and stock selections.



Lonsec’s Stock Selection Filters (ICVR)

Each stock is selected after a rigorous qualitative and quantitative analysis involving four stock filters. A Lonsec stock will have high ratings in each category based on our analysis and judgement.



Lonsec Core Model Portfolio

Objective

To deliver strong absolute returns, over the medium to long term, through a diversified “blue-chip” portfolio invested across a number of industries.

Portfolio Rules

Investment universe	ASX TOP 150
Benchmark	ASX TOP 100 Accumulation Index
Min. no. of stocks	10
Min. no. of industries*	8
Individual stock limit	12.5%
Cash weighting	0%
LPT weighting	0% (Refer to Property asset allocation)
Targeted portfolio turnover	30% pa

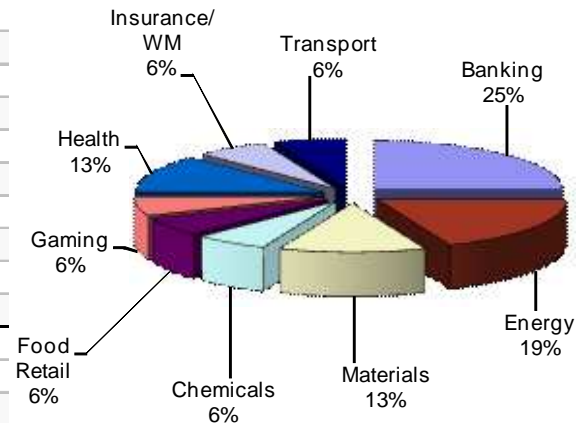
*Note: industry is a subset of the broader GICS sector.

Portfolio Profile

PORTFOLIO EXPOSURE BY INDUSTRY

		Weight
Banking	Banking	25.00%
Energy		18.75%
Materials	Materials	12.50%
Chemicals		6.25%
Food Retail	Food Retail	6.25%
Gaming		6.25%
Healthcare	Health	12.50%
Insurance/WM		6.25%
Transport	Transport	6.25%
Total		100.00%
TOP 50		87.50%
Ex-TOP 50		12.50%

Core Portfolio by Industry



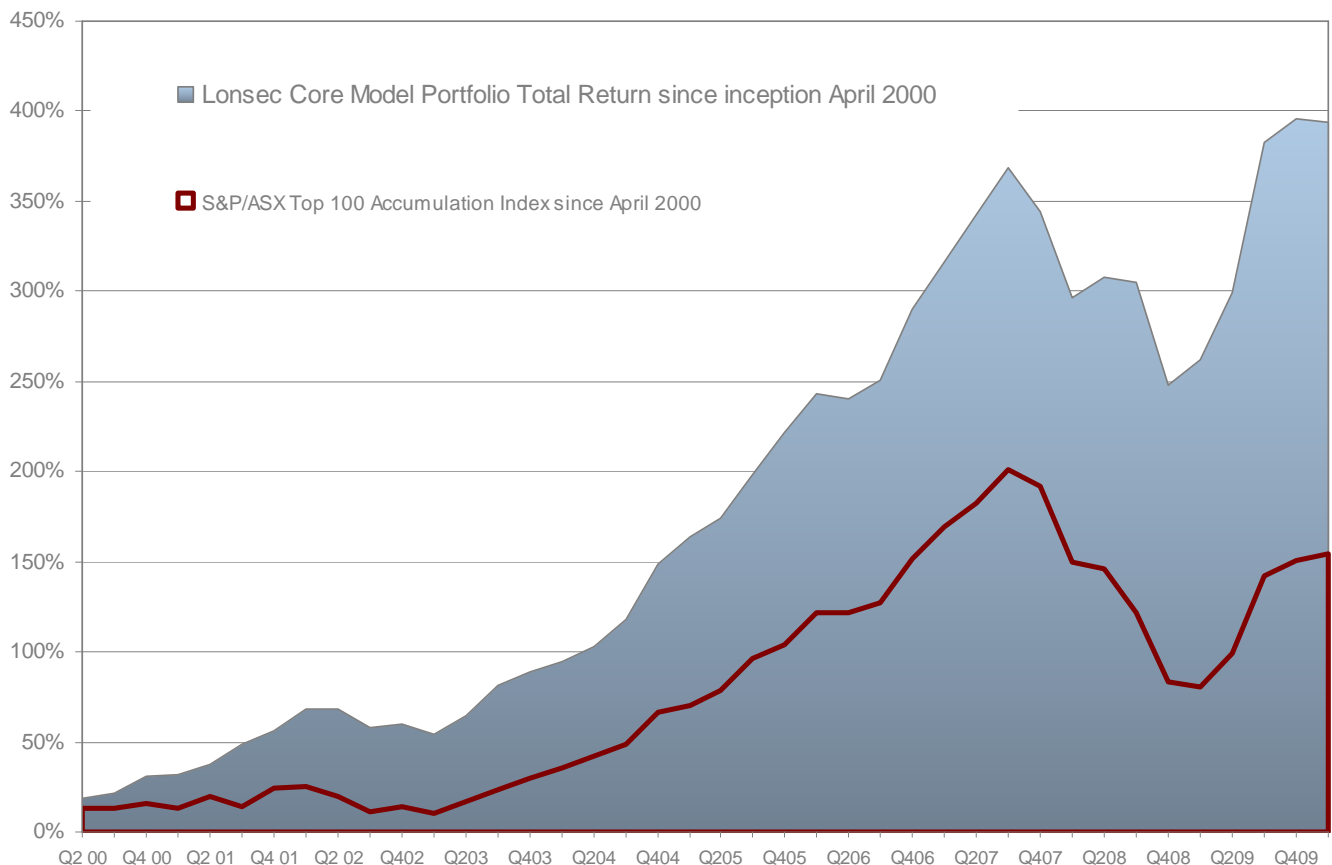
Portfolio Performance

INVESTMENT PERFORMANCE										Since	Since
Period ending	31 March 2010	Month	Qtr	Year	2 Yrs ¹	3 Yrs ¹	5 Yrs ¹	7 Yrs ¹	9 Yrs ¹	Inception ¹	Inception ²
Lonsec Core Model Total Return³ (%)		5.4	-0.6	36.2	11.5	5.8	13.4	18.1	15.8	17.4	393.6
S&P/ASX TOP 100 Accumulation Index (%)		5.7	1.5	41.1	0.9	-1.9	8.3	12.6	9.4	9.8	154.1
Out/Under Performance (%)		-0.3	-2.1	-4.9	10.6	7.7	5.0	5.5	6.4	7.6	239.5

¹ % per annum ² Total return since inception date 17 April 2000

³ Investment Performance is calculated before fees, charges, brokerage and taxes. Dividends are reinvested at the end of each month.

The portfolio is reset at the end of each month back to the model portfolio w eights. This prevents portfolio w eights from skew ing over time and ensures performance figures remain relevant. The Lonsec Core Model portfolio is a fully-invested notional portfolio w ith no cash w eighting. Physical portfolio results w ill differ depending on cash levels, start date, fees, taxes and compliance w ith model w eights. Past performance is not a reliable indicator of future performance.



Lonsec Income Model Portfolio

Objective

To deliver an attractive fully-franked income yield together with some capital growth, over the medium to long term, through a focused income portfolio.

Portfolio Rules

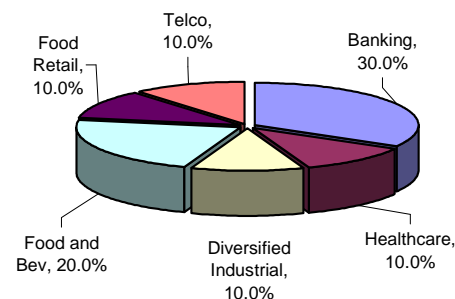
Investment universe	ASX TOP 150
Benchmark	ASX TOP 100 Industrial Accumulation Index
Min. no. of stocks	8
Min. no. of industries	4
Individual stock limit	12.5%
Minimum franking	100%
Cash weighting	0%
LPT weighting	0% (refer to Property asset allocation)
Targeted portfolio turnover	30% pa

Portfolio Profile

PORTFOLIO EXPOSURE BY INDUSTRY

	Weight
Banking	30.0%
Healthcare	10.0%
Diversified Industrial	10.0%
Food and Beverages	20.0%
Food Retail	10.0%
Telco	10.0%
Utilities	10.0%
Total	100.0%
TOP 50	80.0%
Ex-TOP 50	20.0%

Portfolio by Industry



Portfolio Performance

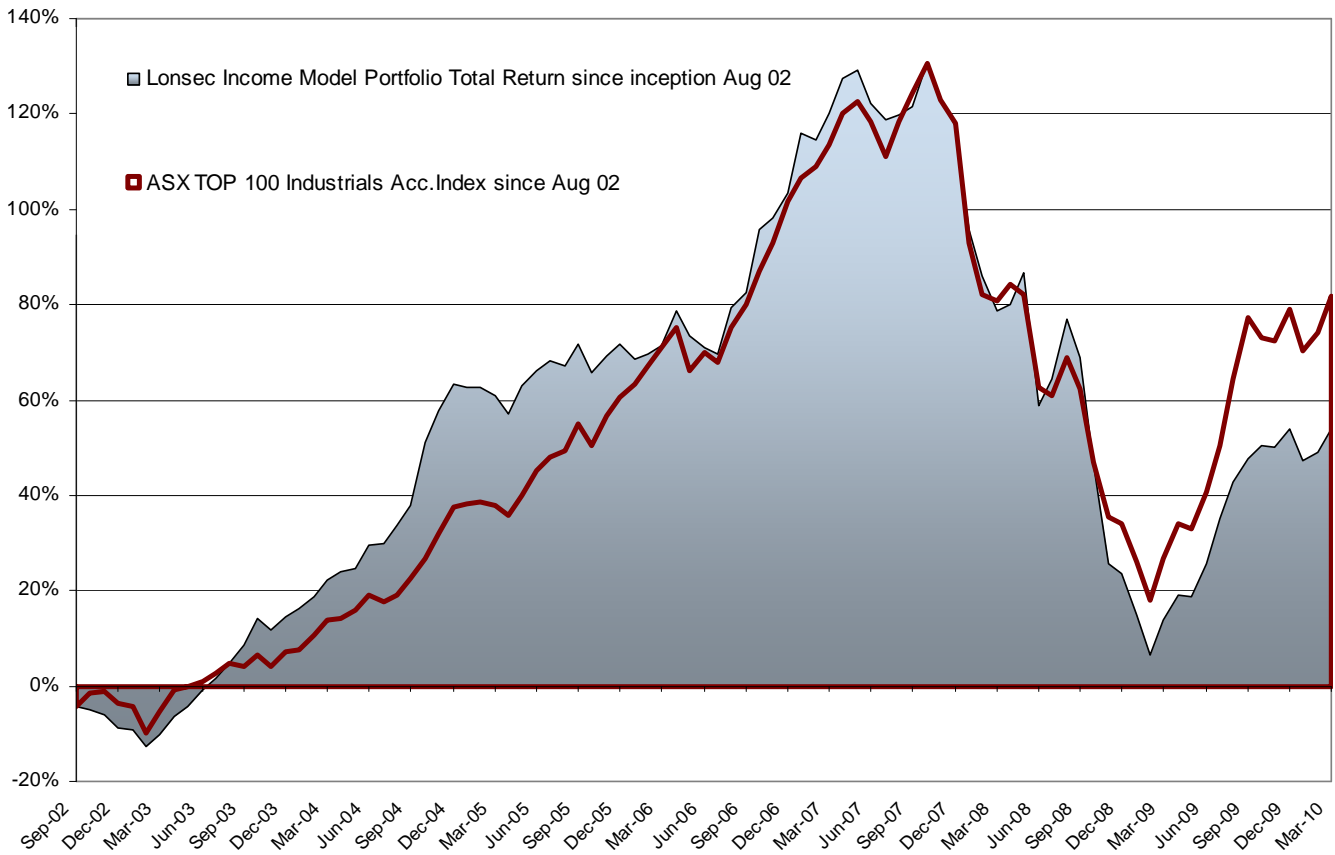
INVESTMENT PERFORMANCE									
Period ending	31 March 2010	Month	Qtr	Six Mths	Year	3 Yrs ¹	5 Yrs ¹	7 Yrs ¹	Since Inception ²
Lonsec Income Total Return³		3.3%	0.0%	4.3%	35.1%	-11.2%	-0.9%	8.0%	54.0%
ASX TOP 100 Industrial Accumulation Index		4.4%	1.5%	2.4%	43.3%	-5.2%	5.7%	9.8%	81.7%
Out/Under Performance		-1.1%	-1.5%	1.9%	-8.2%	-6.0%	-6.6%	-1.8%	-27.7%

¹ % pa ² Total return since inception 20 August 2002

³ Investment Performance is calculated before fees, charges, brokerage and taxes. Dividends are reinvested at the end of each month.

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Portfolio Performance since inception



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