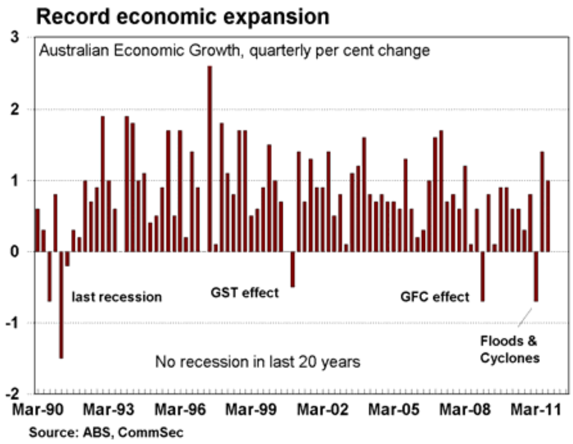
__Updated Report:__
__(Prelim report was issued Friday December 30 2011)__

Year in review 2011:
Europe, politics & natural disasters
Economic & financial issues

- **The year 2011 will be remembered for the European Debt Crisis and a spate of natural disasters. Asian economies generally held firm but so-called "advanced nations" continued to struggle.**
- **In Australia, the cash rate fell twice in 2011 – down by 25 basis points, or a quarter of a percent in both November and December.**
- **Global sharemarkets generally fell over 2012. In fact only eight of 73 sharemarkets tracked by CommSec have managed to post gains. Overall the Australian All Ordinaries index fell by 15.2 per cent in 2011 after edging 0.1 per cent higher in 2010. The ASX 200 fell by 14.5 per cent.**
- **Bonds outperformed shares for another year. Ten-year bond yields fell to 3.74 per cent in December 2011 – the lowest result in 60 years (since 1951).**
- **The Aussie dollar hit a 29½ -year high of US110.8c in late July but ended the year little changed against the greenback.**

Key developments over the past year

- **__Overview:__** There is little debate about the stand-out influences on economies and financial markets in 2011 – the European Debt Crisis and a spate of natural disasters are at the top on most analyst lists. The European Debt Crisis started with countries like Ireland, Greece and Portugal but spread to Spain and Italy and now rating agencies have the entire euro region on credit watch. In terms of natural disasters there were floods across eastern Australia, cyclones in northern Australia, earthquakes in Christchurch and an earthquake, tsunami and nuclear accident in Japan.
- But there was also a third factor – politics. Certainly the European Debt Crisis has been as much about the politics as it has been about the economics. And in US, the failure of the main political parties to agree on quick,



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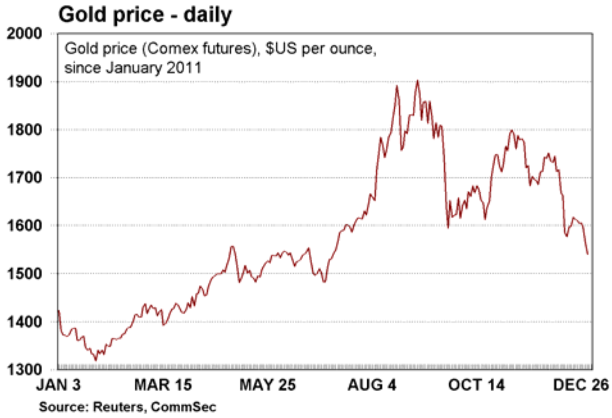
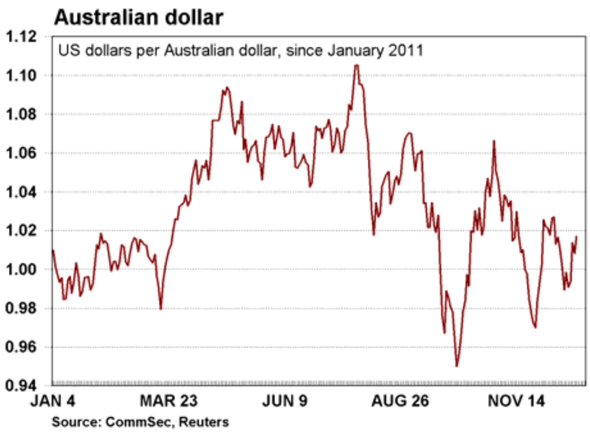
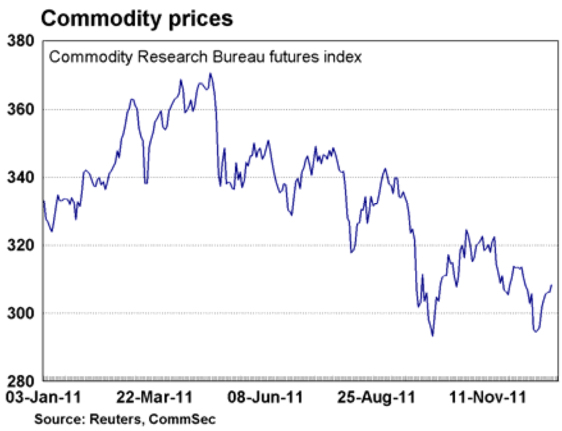
decisive action to deal with budget and debt problems added to the instability that reigned over 2011.

- Despite the issues in Europe and the US, the global economy continued to expand in 2011. At first glance that may appear surprising, that is until you work through the numbers. Because the health of the global economy is now dependent on the performance of "emerging nations" rather than regions such as Europe or North America.
- In its last update in September, the International Monetary Fund (IMF) tipped the global economy to grow by 4.0 per cent in 2011 after 5.1 per cent growth in 2010. The IMF predicted another year of 4.0 per cent growth for the global economy in 2012. But while "advanced economies" were tipped to grow by 1.6 per cent in 2011, "emerging and developing nations" were expected to expand by 6.4 per cent.

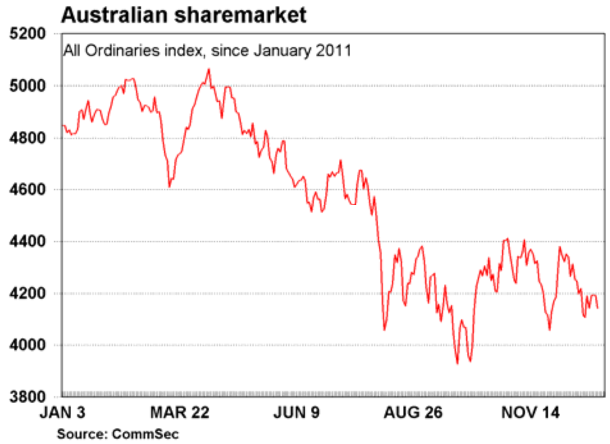


- While the global economy is less dependent on "advanced nations" it is still encouraging that there has recently been more positive news on the US economy. In November the unemployment rate hit a 2½ year low of 8.6 per cent with private payrolls up 140,000 in the month.
- **Australian economy:** There is a debt crisis in Europe. The US economy is still struggling. There were major floods and cyclones at the start of 2011. And still the Australian economy continues to expand – in fact notching up its 20th consecutive year of growth.
- Certainly the economy failed to live up to expectations over the year, with growth still well below "normal". The Reserve Bank had expected the economy to be growing at a 4 per cent annualised rate by now. But when you consider the challenges the economy had to face, the performance is laudable.
- The economy grew by 1.0 per cent in the September economy after 1.4 per cent growth in the June quarter. Annual economic growth stands at 2.5 per cent, down from the long-term average of 3.25 per cent.
- **Interest rates:** At the end of 2010 year we thought that interest rates were more likely to rise over 2011 but noted "the risk is that "new conservatism" results in rates remaining stable for longer." Well this "new conservatism" did serve to constrain spending and inflation, thus delivering the Reserve Bank the opportunity to cut interest rates and support the economic expansion. The Reserve Bank cut rates by 25 basis points on November 1 and followed it up with another rate cut on December 6.
- Earlier in the year the Reserve Bank had considered hiking rates – in fact it was a "live" option at the August Reserve Bank Board meeting. Fortunately the RBA decided against it.
- Ninety-day bill yields fell from 5.07 per cent to 4.42 per cent over 2011 and ended the year near 4.48 per cent. And 10-year bond yields fell from highs of 5.72 per cent to 3.74 per cent, ending 2011 near 3.80 per cent.
- Despite the decline in yields over 2011, Australian interest rates remain the highest in the advanced world. Three-month rates are well above the US (0.11 per cent), Japan (0.15 per cent), UK (1.05 per cent) and Europe (1.40 per cent). Australia has the 19th highest interest rates of 58 countries tracked by *The Economist*.
- **Aussie dollar:** When you consider the challenges posed to the global economy over 2011, the Aussie dollar has remained resilient against major currencies. Usually the Aussie dollar is regarded as a "fair weather" friend – tracking in line with the relative confidence level about the global economy. And certainly the Aussie dollar did lose support when the European Debt Crisis was in full flight. But the Aussie didn't fall as sharply as it did in the Global Financial Crisis over 2008-2010.





- The Aussie dollar hit 29½ year highs against the US dollar of US110.12 cents on May 2. The Aussie weakened from these highs over May and June when the Greek debt crisis flared again, serving to reduce the attraction of riskier assets such as commodity currencies and equities.
- The Aussie dollar returned to its historic highs against the US dollar in July, hitting US110.8 cents on July 27 before again retreating. The Aussie also hit historic levels against other currencies such as the Euro and the UK pound sterling. On December 30, the Aussie hit a 22-year high against the Euro at 78.52 euro cents and hit a fresh 26½ -year high against pound sterling on July 28 at 67.74 pence.
- **Global currencies:** The US dollar was generally firmer against other currencies over the past year. Of the 118 currencies tracked, 74 currencies eased against the greenback with 25 currencies broadly unchanged while 19 currencies were stronger. The strongest currency was the Mozambique metical (up 17.1 per cent) followed by the Japanese yen (up 5.2 per cent), the Chinese yuan (up 4.5 per cent) and the Paraguan guarani (up 4.3 per cent) and). At the other end of the scale, the currencies of Turkey (down 22.6 per cent), South Africa (down 22.2 per cent) and India (down 18.6 per cent) were amongst the weakest against the US dollar. The Euro was in 74th spot of the 118 currencies, down 3.4 per cent against the greenback in 2011.
- The Australian dollar was top-ranked against the US dollar in the global ranking of currencies in 2011. The Aussie dollar rose 0.6 per cent against the greenback over 2011, putting it in 16th spot of 118 currencies monitored.
- **Commodities:** Commodities put in a mixed performance over 2011. The CRB futures index fell by 8.3 per cent after a 17.4 per cent lift in 2009. Commodity prices rose until the second round of the Greek debt crisis began in late April and then trended lower over the remainder of 2011.
- The Commodity Research Bureau (CRB) index began the calendar year at 333.02 and hit highs of 370.56 on April 29. The Greek debt crisis and concerns about the health of the US economy then combined to drag the CRB lower to lows of 293.28 on October 4 and the index ended the year close to 305 points.
- Amongst the strongest commodities were wool, up 15.3 per cent, gold up 10.2 per cent, beef up 8.9 per cent and oil up 8.2 per cent. At the other end of the scale cotton prices fell by 42.8 per cent, base metals generally fell by 20-25 per cent with sugar down 26.5 per cent, spot iron ore down 18.6 per cent, wheat down 16.5 per cent and spot thermal coal down 13.9 per cent.
- **Australian sharemarket:** The All Ordinaries index began 2011 at 4,846.9 with the ASX 200 at 4,745.2. The All Ords hit highs of 5,026.1 on February 18 and then sold off over 400 points over the following month. The All Ords index then rebounded to hit the year's peak of 5,064.9 before a revival of the Greek debt crisis dragged the market lower again. The All Ords hit lows of 3,927.6 on September 26 with the ASX 200 at 3,863.9 before consolidating in a broad 3,900-4,440 range through to end year.
- The All Ords closed the year at 4,111.0, down 15.2 per cent. The ASX 200 fell by 14.5 per cent to 4,056.6.
- After edging 3.3 per cent higher over 2010, the All Ordinaries Accumulation index (measuring total sharemarket returns) again retreated in 2011, losing 11.4 per cent
- Returns have been erratic in recent years – averaging 23 per cent per annum from 2004-2007, dropping 40.3 per cent in 2008 and lifting 39.6 per cent in 2009.
- Over the past decade, total returns on shares have averaged 9.1 per cent a year – slightly down on the longer-term 25-year average performance.
- **Sharemarket sectors:** It's clear that a defensive strategy won out over 2011. Only three of 21 industry groups posted gains over of the year – Telecom (up 18.3 per cent), Food, beverages and tobacco (up 3.9 per cent) and Utilities (up 3.1 per cent). Biggest decline was by Consumer durables & apparel, down



AUSTRALIAN INDUSTRY GROUPS

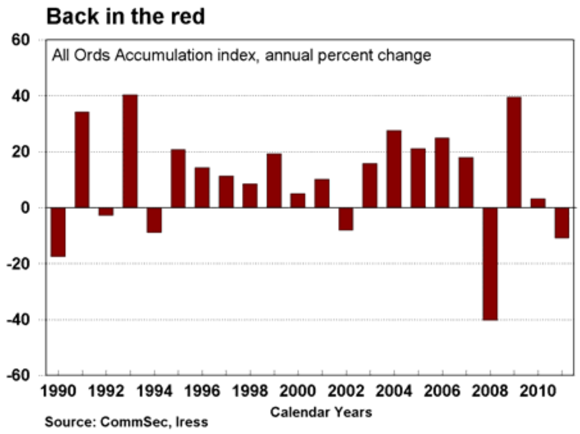
percent change 2011

Telecommunication services	18.3
Food beverage & tobacco	3.9
Utilities	3.1
Transportation	-4.7
Commercial & profess. services	-6.9
Banks	-7.0
Food & drug retailing	-7.2
Auto & components	-7.7
Health Care	-7.8
Real Estate	-8.3
Consumer services	-10.8
Pharmaceuticals & biotech	-13.2
S&P/ASX 200	***-14.5***
Media	-16.2
Energy	-20.9
Insurance	-20.9
Software & services	-22.7
Materials	-25.5
Capital goods	-26.8
Diversified financials	-29.1
Retailing	-40.8
Consumer durables & apparel	-64.2

Source: CommSec, Iress

64.2 per cent, and led lower by Billabong. Next worst was Retailing (down 40.8 per cent), Diversified Financials (down 28.9 per cent), Capital goods (down 26.8 per cent) and Materials (down 25.5 per cent).

- Small companies (or the small caps) fared worst over the year, down by 23.6 per cent, followed by Mid caps (down 19.9 per cent), the ASX 100 index (down 13.9 per cent) and the ASX 50 (down 13.1 per cent).
- **Global sharemarkets:** The bad news was that the Aussie sharemarket fell again in 2011, but there is comfort in the fact that we weren't alone. In fact only eight of 73 global sharemarkets ended the year higher.
- The All Ordinaries index fell by 15.2 per cent over 2011, putting it in 34th position. In 2010 the Australian sharemarket was in 55th position with a slight gain of 0.1 per cent.

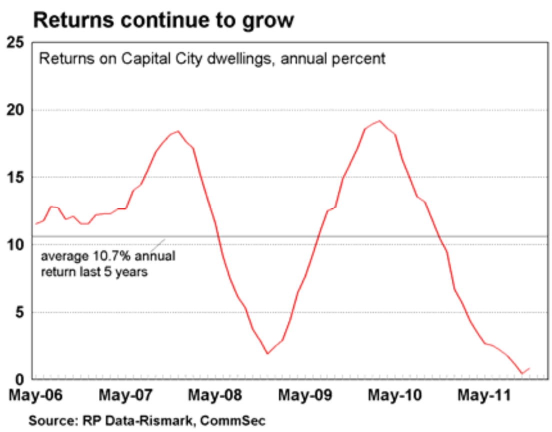


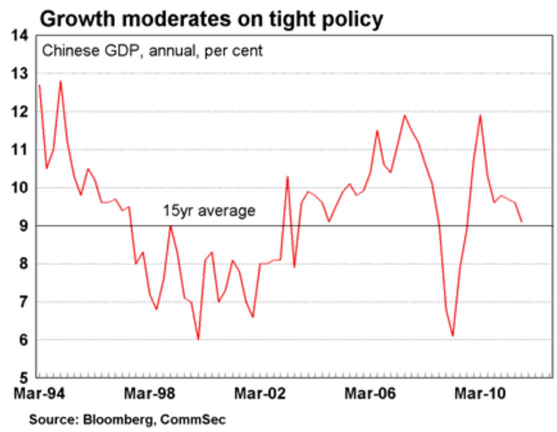
- At the top of the global rankings in 2011 was Venezuela, up 79.1 per cent, followed by the US Dow Jones with a gain of 5.5 per cent. Yes, that's right – the US sharemarket was the second strongest in 2011 ahead of the Philippines (up 4.1 per cent), Indonesia (up 3.2 per cent), Ecuador (up 1.5 per cent), Qatar (up 1.1 per cent), Malaysia (up 0.8 per cent) and Ireland (up 0.6 per cent). At the other end of the scale, Cyprus (-70.7 per cent), Greece (-51.9 per cent), Ukraine (-45.2 per cent) and Egypt (-42.5 per cent) recorded the largest declines.
- While the US Dow Jones rose over 2011, other US sharemarkets were mixed with the S&P 500 index largely flat with the Nasdaq down 1.8 per cent.
- In Europe the UK FTSE fell by 5.6 per cent while the German Dax lost 14.7 per cent. In Asia the Japanese Nikkei fell by 17.8 per cent in 2011 but the NZ 50 index fell by only 1.0 per cent (10th best market in 2011).
- **Other asset classes:** For the second straight year returns on government bonds exceeded returns on shares. The UBS government bond index rose by 13.4 per cent in 2011 after lifting 4.8 per cent in the previous year. Still, over the past decade, returns on bonds have averaged 6.5 per cent per annum, short of the 9.1 per cent average return on shares.
- Final figures on returns on Australian residential property won't be available for another month. But the RP Data/Rismark capital city accumulation index indicates that returns on Australian dwellings grew by 0.8 per cent in the year to November 2011 after lifting by 9.5 per cent in calendar 2010.
- Over the past five years residential property returns averaged 10.7 per cent per annum, versus 2 per cent returns for shares, 7.7 per cent for bonds and 5.1 per cent for cash.

Outlook for 2012

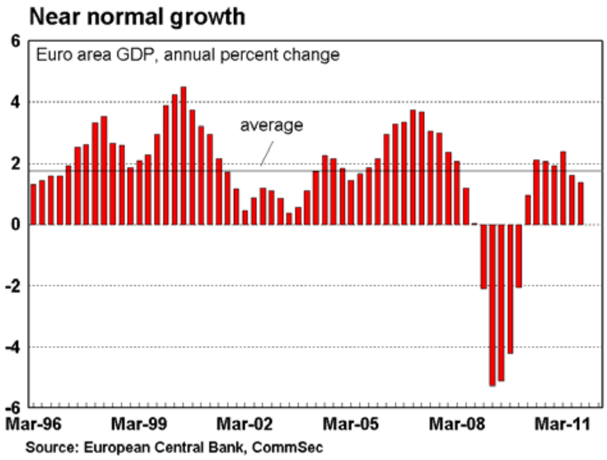
Domestic & Global Economies

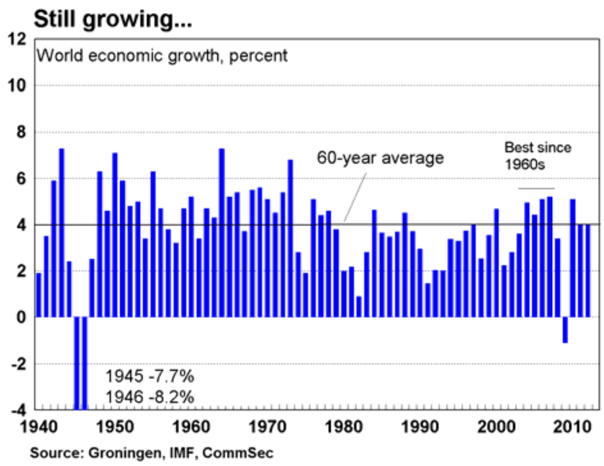
- It took some time in coming, but European leaders now appeared focussed on doing what it takes to work their way out of a crisis situation. But a solution to the crisis won't happen overnight. The crisis has all been about a loss of confidence in the ability of European countries to deal with high debts and deficits. Confidence is lost quickly but regained only slowly.
- But there is a raft of new governments across Europe. And all know what is expected of them. Governments need to show discipline in cutting spending but they also need plans to grow their economies, thus lifting consumer and business spending and budget revenues.

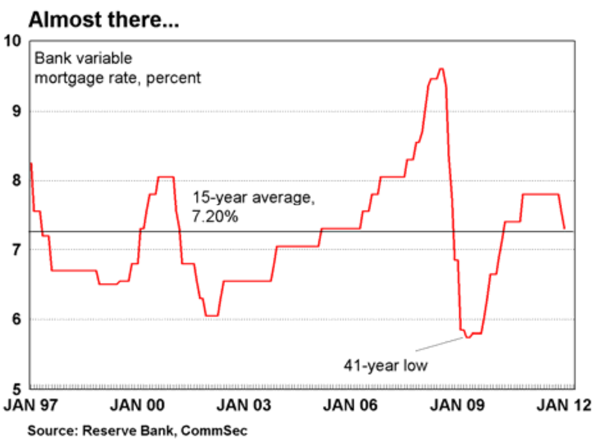


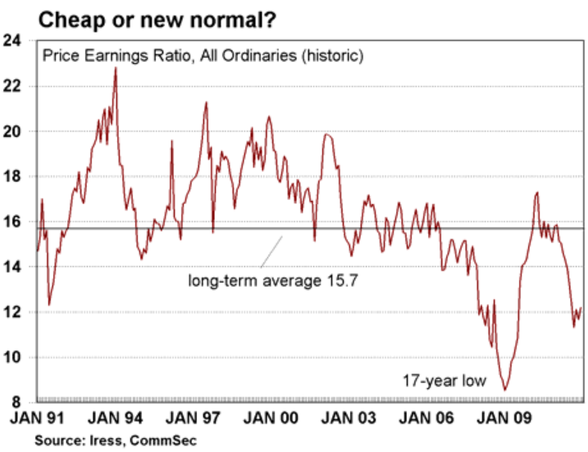


- In the US, the economy is showing more encouraging signs of improvement. But as is the situation in Europe, the turnaround will take time. An oversupply of housing stock still needs to be worked through. Job markets are still fragile and then there are the challenges posed from abroad – namely Europe.
- The other challenge for the US is politics. The past year can be best remembered for the haggling between Democrats, Republicans and the White House that led to a situation where the US lost its AAA credit rating. Perhaps politicians are learning from their experiences, but it was encouraging that the Republicans and White House were able to achieve an agreement on payroll tax just prior to Christmas. Still, 2012 is an election year, suggesting that the year will be another one of challenges.
- In China, policymakers have successfully slowed the pace of economic growth and tamed inflation. Now authorities need to reflate the economy without waking the inflation dragon.
- The rest of Asia is generally in good shape. While 2011 was a year when policy was tightened across Asia, 2012 will be a time when the shackles can be taken off to insulate economies from the risks in North America and Europe.
- The International Monetary Fund hasn't changed its forecasts since it last made them in September. As such, a number of analysts believe the estimates are too high.
- Currently the IMF expects the global economy to grow by 4 per cent in 2012 after posting similar growth in 2011. Advanced nations are tipped to grow 1.9 per cent in 2012 after estimated growth of 1.6 per cent in 2011 and a healthy 3.1 per cent expansion in 2010. Emerging nations are tipped to grow by 6.1 per cent in 2012 after 6.4 per cent growth in 2011 and 7.3 per cent in 2010.
- Analysts generally believe that global economic growth will be closer to 3.5 per cent, rather than 4.0 per cent. The long-run trend growth rate is around 3.8 per cent, so the current projections aren't desperately low – certainly not approaching the -0.7 per cent outcome in 2009.
- Chindia – China and India together – will continue to drive the global economy. We expect the Chinese economy to grow by 8.7 per cent in 2012 with the India economy to grow by 7.2 per cent.
- In Australia, the Reserve Bank estimates that the economy is growing at a 2.75 per cent annualised pace – well below "normal" or trend growth of around 3.25 per cent. The RBA expects annualised growth to be around 4.0 per cent in mid 2012 and 3.0-3.5 per cent by December 2012.





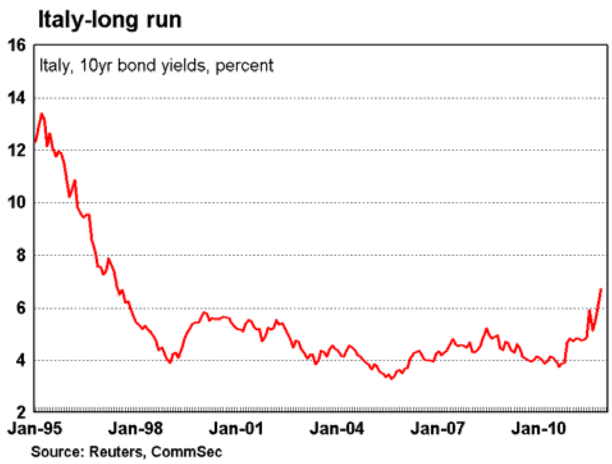




- We wouldn't significantly disagree with these forecasts and expect the Australian economy to grow by around 3.6 per cent in 2012.
- CommSec also expects the jobless rate to broadly hold between 5.0-5.5 per cent over 2012, ending the year near 5.2 per cent. Inflation is unlikely to be a problem with the underlying rate holding between 2.5-3.0 per cent over the year.

Financial markets

- Our central view is that Euro nations will do what it takes to prevent the currency region from collapsing and prevent member countries from defaulting on their obligations. The gradual recovery of the US economy is expected to continue. And Asian nations will look to insulate their economies from global risks by easing policy settings. Inflation isn't the enemy at present, rather the risk of economies stalling.



- Clearly there are a multitude of risks – mainly to the downside. European and US economies remain fragile and weighed down by large debts and budget deficits. The challenge is to grow the economies while also maintaining discipline on government spending.
- The upside risk is that advanced economies stabilise, China continues to expand strongly, commodity prices lift and inflation again becomes an issue. In that situation careful judgement is needed by central banks to ensure that fledgling recoveries aren't de-railed.
- We tip the Aussie dollar to ease from current levels near US102 cents to US95 cents by June 2012 and then rebound to US100 cents by December 2012. Clearly the downside risks for the global economy will put downward pressure on the Aussie in the first half of the year. The prospect of lower domestic interest rates will further trim support from the currency in the first half of 2012.
- But on the assumption of global healing – especially in the second half of 2012 – we expect the Aussie dollar to

WINNERS AND LOSERS

Total returns, since 1986

	Best return	*Worst return*
1986	Media	Consumer services
1987	Transport	Diversified financials
1988	Retailing	Insurance
1989	Retailing	Transport
1990	Utilities	Retailing
1991	Media	Insurance
1992	Media	Transport
1993	Transport	Commercial services
1994	Retailing	Media
1995	Banks	Transport
1996	Commercial services	Retailing
1997	Food & staples	Consumer services
1998	Telecommunications	Energy
1999	Technology hardware	Insurance
2000	Utilities	Software services
2001	Capital goods	Technology hardware
2002	Utilities	Technology hardware
2003	Software services	Insurance
2004	Consumer services	Technology hardware
2005	Energy	Telecommunications
2006	Pharmaceuticals & biotech	Health care equipment
2007	Pharmaceuticals & biotech	Consumer durables & apparel
2008	Pharmaceuticals & biotech	Diversified financials
2010	Automobiles & Components	Consumer durables & apparel
2011	Telecommunications	Consumer durables & apparel

Source: CommSec

return to around parity with the greenback.

- The relatively firm currency will continue restrain interest by foreign investors in Australian assets. This factor, together with uncertain global economic prospects and conservative Australian investors, suggest only modest upside for the Australian sharemarket over 2012.
- Certainly valuations on the Australian sharemarket remain broadly favourable. Currently share prices stand at 12.2 times historic earnings – below the long-term P/E ratio of 15. At face value the sharemarket appears cheap, but given investor preference for liquid investments such as cash and bank deposits, it may actually just be regarded as fairly valued in these more conservative times.
- CommSec expects the ASX 200/All Ordinaries to lift to around 4,450 in mid 2012 and to 4,650 points by end 2012. Total returns on shares are expected to grow by 15 per cent in 2012. This may sound high, but it must be considered that returns went backwards by 11.4 per cent in 2011.
- Shares are expected to out-perform other asset classes over 2012. Returns on residential property are expected to grow modestly by 5 per cent given that supply and demand for property has become more balanced. Cash is expected to provide returns of around 4.25 per cent over the coming year but returns on Government bonds may ease 3-5 per cent as yields lift from historic lows.
- CommSec expects at least one more rate cut by the Reserve Bank in 2012. Clearly with inflation under control and significant risks abroad, the Reserve Bank stands ready to cut rates and shore up Australia's economy. CommSec is factoring in another quarter per cent rate cut in February.
- The Reserve Bank has made it abundantly clear what it considers "normal" interest rates – the average level of rates over the past 15 years. The mortgage rate has averaged 7.20 per cent over the past 15 years. Currently the mortgage rate is 7.30 per cent – still a little on the high side.

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Best & Worst Sharemarket Returns
All Ordinaries, 2011, per cent

Best	
Sigma Pharmaceuticals	99.07
Flinders Mines	90.00
Iluka Resources	69.26
Village Roadshow	63.48
Gold One International	58.46
Senex Energy	53.85
Aurora Oil & Gas	51.79
Mesoblast	47.97
Samson Oil & Gas	46.15
Beach Energy	43.35
Worst	
Hastie Group	-93.28
White Energy	-88.66
Platinum Australia	-87.09
Energy Resources	-83.51
Nyota Minerals	-80.43
Gunns	-80.00
Carnarvon Petroleum	-79.58
Berkeley Resources	-79.54
Paperlinx	-79.51
Pluton Resources	-78.64

Source: Bloomberg, CommSec

Best & Worst Sharemarket Returns
ASX 200, 2011, per cent

Best	
Sigma Pharmaceuticals	99.07
Iluka Resources	69.26
Aurora Oil & Gas	51.79
Mesoblast	47.97
Beach Energy	43.35
Regis Resources	42.50
Envestra	36.19
Telecom NZ	26.95
Silver Lake Resources	26.58
Austar	25.65
Worst	
White Energy	-88.66
Energy Resources	-83.51
Bluescope Steel	-78.49
Billabong	-78.16
OneSteel	-72.97
Paladin Energy	-72.21
Kagara	-68.52
Dart Energy	-67.94
Goodman Fielder	-64.83
APN News & Media	-63.05

Source: Bloomberg, CommSec

KEY EVENTS FOR FINANCIAL MARKETS IN 2011

10-Jan-11	Brisbane floods
03-Feb-11	Cyclone Yasi hits North Queensland
10-Feb-11	Eqyptian President resigns
22-Feb-11	Christchurch earthquake
11-Mar-11	Earthquake & tsunami in Japan
25-Mar-11	EU leaders agree on permanent €500 billion bailout fund
06-Apr-11	Portugal seeks bail-out
01-May-11	Osama bin Laden killed
16-May-11	Bail-out for Portugal of €78 billion
21-Jul-11	Second bail-out for Greece of €109 billion
27-Jul-11	Aussie dollar hits 29-year high of US110.8 cents
31-Jul-11	US budget deficit deal reached
02-Aug-11	US President Obama signs budget bill
06-Aug-11	London riots
06-Aug-11	Standard and Poor's cuts US credit rating
13-Sep-11	Moody's downgrades credit ratings of French banks
17-Sep-11	Occupy Wall St protests
20-Sep-11	Standard and Poor's cuts Italian credit rating
05-Oct-11	Steve Jobs dies
13-Oct-11	Standard and Poor's cuts Spanish credit rating
20-Oct-11	Libyan leader Moamar Gaddafi killed
27-Oct-11	Euro leaders agree on three part plan
29-Oct-11	Qantas grounds fleet
01-Nov-11	Reserve Bank cuts rates
09-Nov-11	Greek Prime Minister resigns
12-Nov-11	Italian Prime Minister resigns
20-Nov-11	New government elected in Spain
30-Nov-11	World central banks announce joint action plan
05-Dec-11	France & Germany announce fiscal pact
06-Dec-11	Reserve Bank cuts rates
09-Dec-11	EU leaders agree on stricter budget limits
21-Dec-11	Banks borrow €489 billion from European Central Bank
22-Dec-11	US bipartisan deal on payroll tax

Source: CommSec, various news agencies