



Business Outlook

CEDA's Economic & Political Overview 2006

Perth
16 February 2006





**Prepare
for boom
to end:
Treasury**



BHP Billiton sees no end to China's boom

Economic overview: this time last year

- China's insatiable demand for raw materials had led to a favourable commodity supply/demand dynamic causing a significant appreciation in most commodities.
- This fuelled strong growth in the Australian economy and stock market.
 - The Australian stock market had risen 55% in Australian Dollar terms and over 100% in US dollar terms from 2003-2005.
 - WA in particular was highly leveraged to the Chinese boom.
- Robust balance sheets led to corporate activity, particularly in the resource sector.
 - The biggest of which was BHP's circa A\$9b takeover of WMC.
- However, we did warn of certain storm clouds emerging...
 - Economy was approaching full capacity.
 - Input costs were rising, impacting margins.
 - Interest rates were poised to rise.

Global growth has been strong, largely fuelled by the US and China.

US & China

- US
 - Housing Bubble
 - Wealth effect consumption
 - Inflationary concerns
 - High energy prices
- China
 - Strong performance but:
 - Growth slowing
 - Overcapacity
 - Non performing loans
 - Political dissent

Rest of the world

- Japan
 - Recovering strongly
- Rest of Asia
 - Buoyant
- Europe
 - Continues to disappoint
- South America
 - Signs of recovery although underinvestment is a concern
- Africa
 - Good growth potential but relies on political stability

Globally

- Clash of ideologies and the risk of a pandemic are a threat to global stability

Buoyant commodity and energy prices have driven much of Australia's recent strong economic performance. However, Australia can be seen as two distinct economies:

WA & QLD

- Strong commodity demand has led to forecasted GSP growth rates of 5% in WA and 4.5% in QLD for 2006.
- Strong balance sheets have enabled increased business investment, with dramatic investment in the resource sector and allied support industries.
- High demand for new dwellings is persisting, increasing consumption but distorting resources.
- Economies are at full capacity with constraints starting to bite:
 - Public sector capital works are competing for labour
 - Other input costs are rising

Rest of Australia

- Forecasted growth rates in GSP are 2.5% in SA, 1.5% in ACT, 2.75% in NSW and 3% in Vic.
- Housing markets in NSW and Victoria are well off their peak, reducing debt based consumption.
- Moderation in growth of household spending.

Australia wide

- Signs that Australia's long expansionary period is vulnerable to external shocks.

Recent housing boom significantly contributed to solid economic performance.

- US has defied many critics with strong economic growth.
- Economic growth has been largely driven by consumer spending. However, a large proportion of this spending has been financed from borrowing against capital gains on homes.
- Chief Economist at Merrill Lynch, David Rosenberg, believes that housing accounted for 50% of US GDP growth in the first half of 2005.
- However, continued high energy prices are likely to undermine consumer confidence as inflationary concerns lead to fears that interest rates will rise.
- Not only is the US economy exposed if housing prices cool off, but housing booms negatively affect productivity by diverting resources into consumer spending, away from more productive uses.
- Hope is that business investment will take up the slack.

US housing market has soared

The share price of the US's largest home builder reflects the recent housing boom.

Pulte Homes Share Price

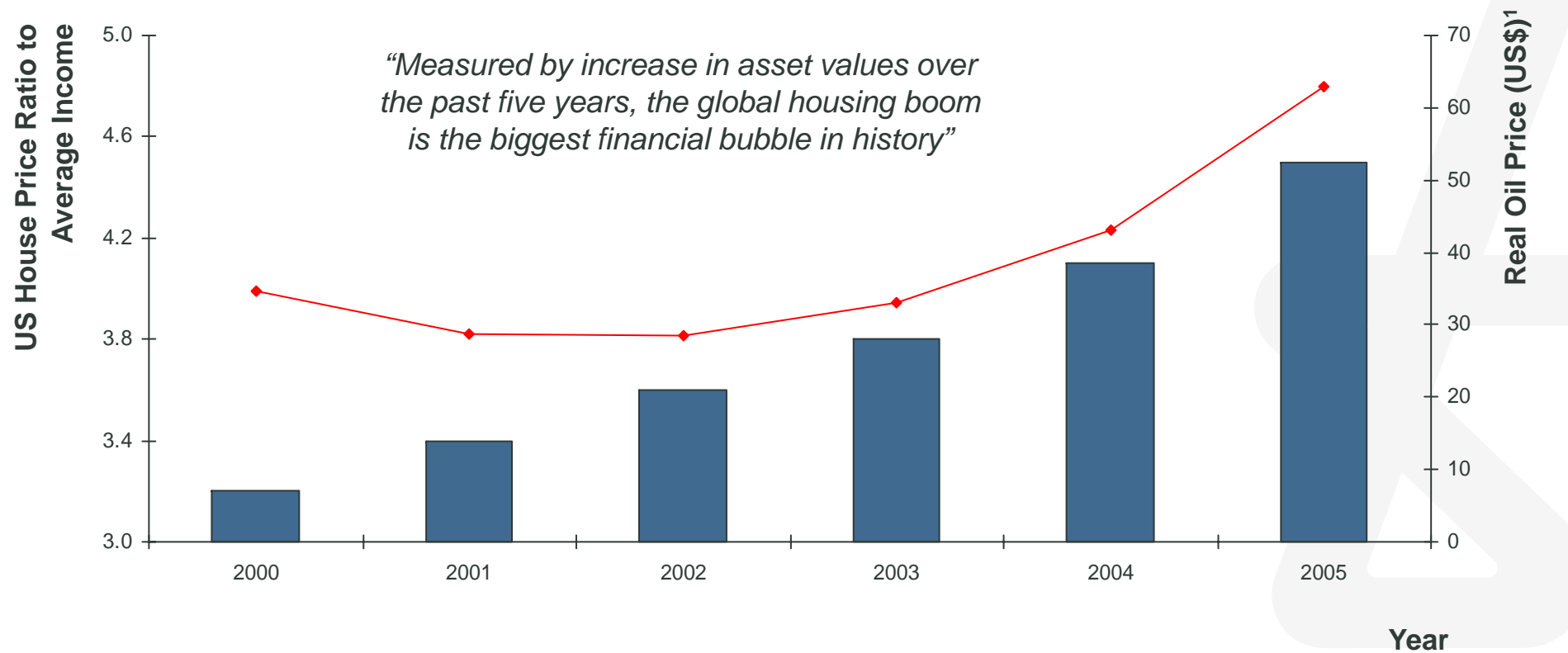


Source: Bloomberg

High oil prices are balanced by soaring housing prices

But how long can the housing bubble last?

Housing price ratio to average income vs real oil prices



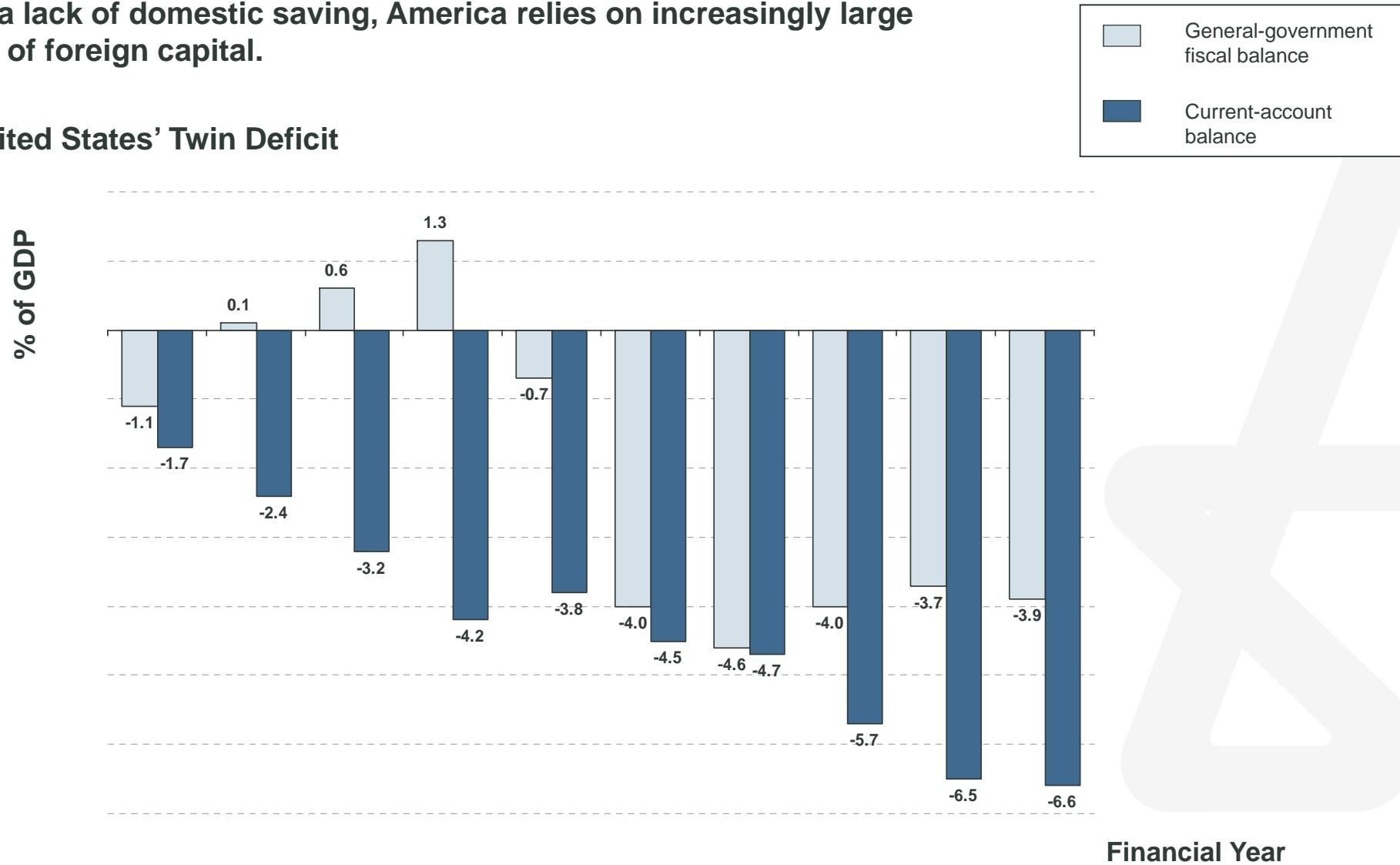
¹ Adjusted to 2005 Prices

Source: The Economist

US twin deficit

Due to a lack of domestic saving, America relies on increasingly large inflows of foreign capital.

United States' Twin Deficit



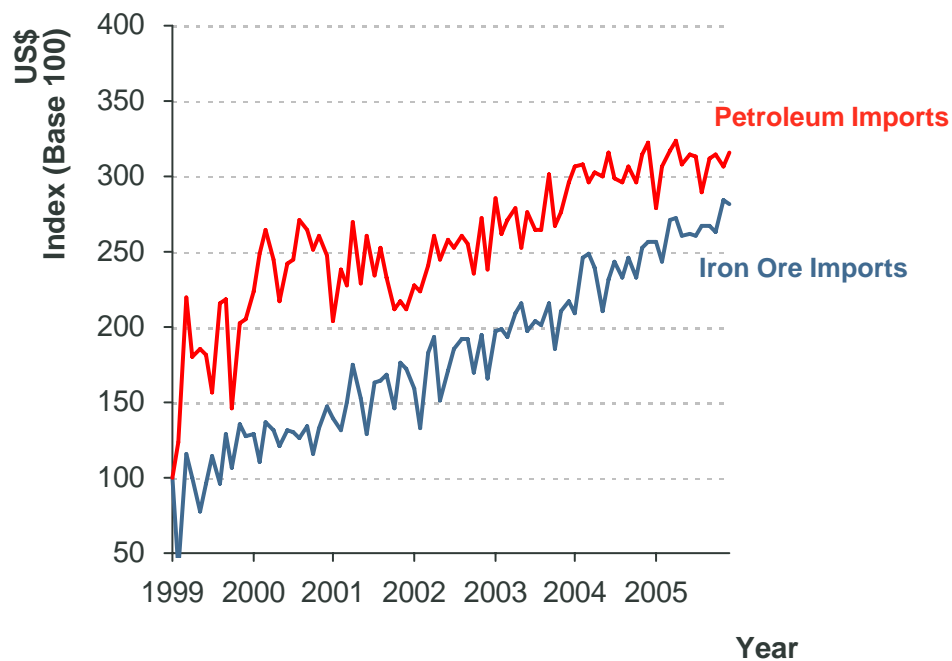
China's economy has been the driver of the world economy.

- The World Bank has forecast China's economy to grow by 9.2% in 2006.
- By some measures China's economic expansion has contributed fully a third of global economic growth in recent years.
- This "China Boom" is responsible for much of the Australian share market's amazing run. This is due to Australia's leverage to the mining sector.
- The effect on growth has been particularly pronounced in WA and QLD, causing full employment and fuelling rising housing prices.

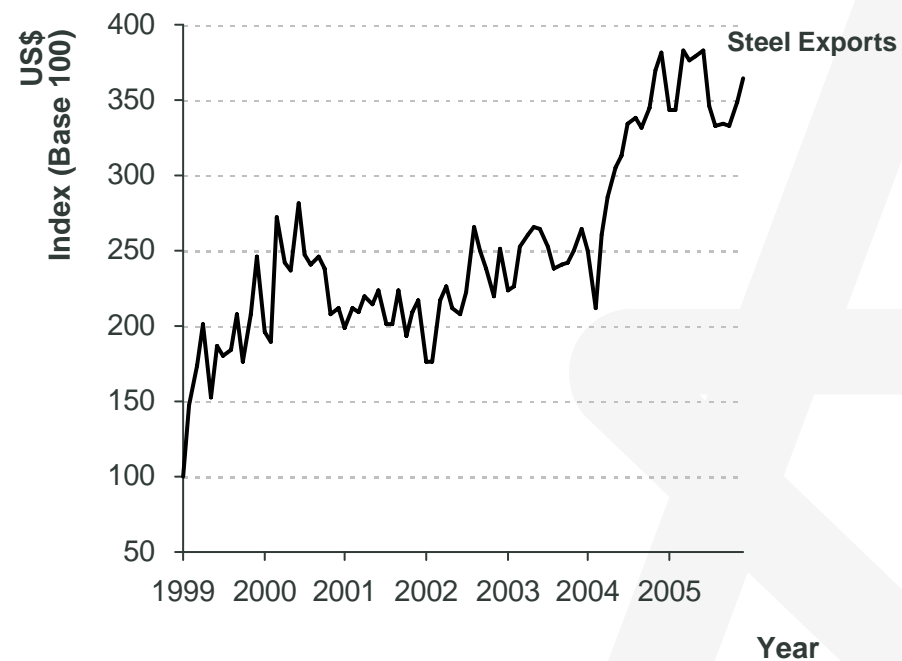
Chinese commodity imports and exports

China's imports and exports of commodities has exploded since 1999.

Chinese Imports



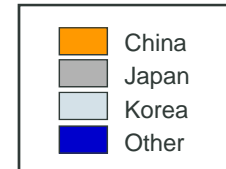
Chinese Exports



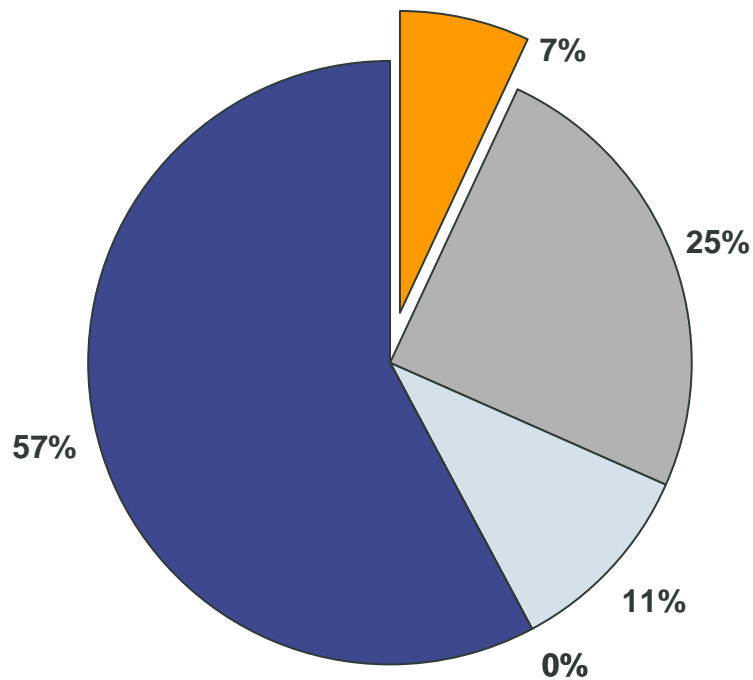
Source : Bloomberg

China's importance to WA exports

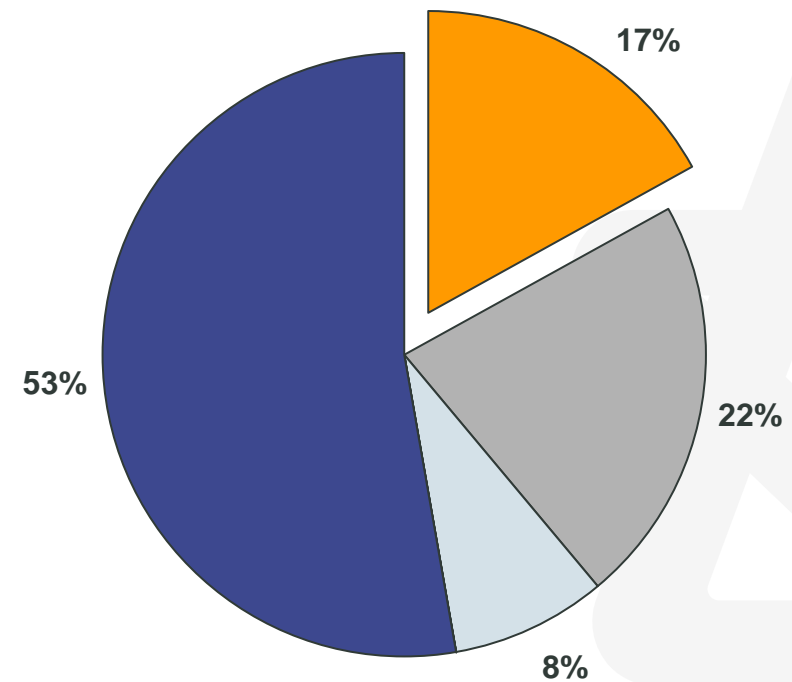
China's share of WA exports has increased since 1997.



1997 – Exports by destination



2005 – Exports by destination



Source : Australian Bureau of Statistics, WA Department of Treasury and Finance

There are signs that this “China Boom” may be slowing...

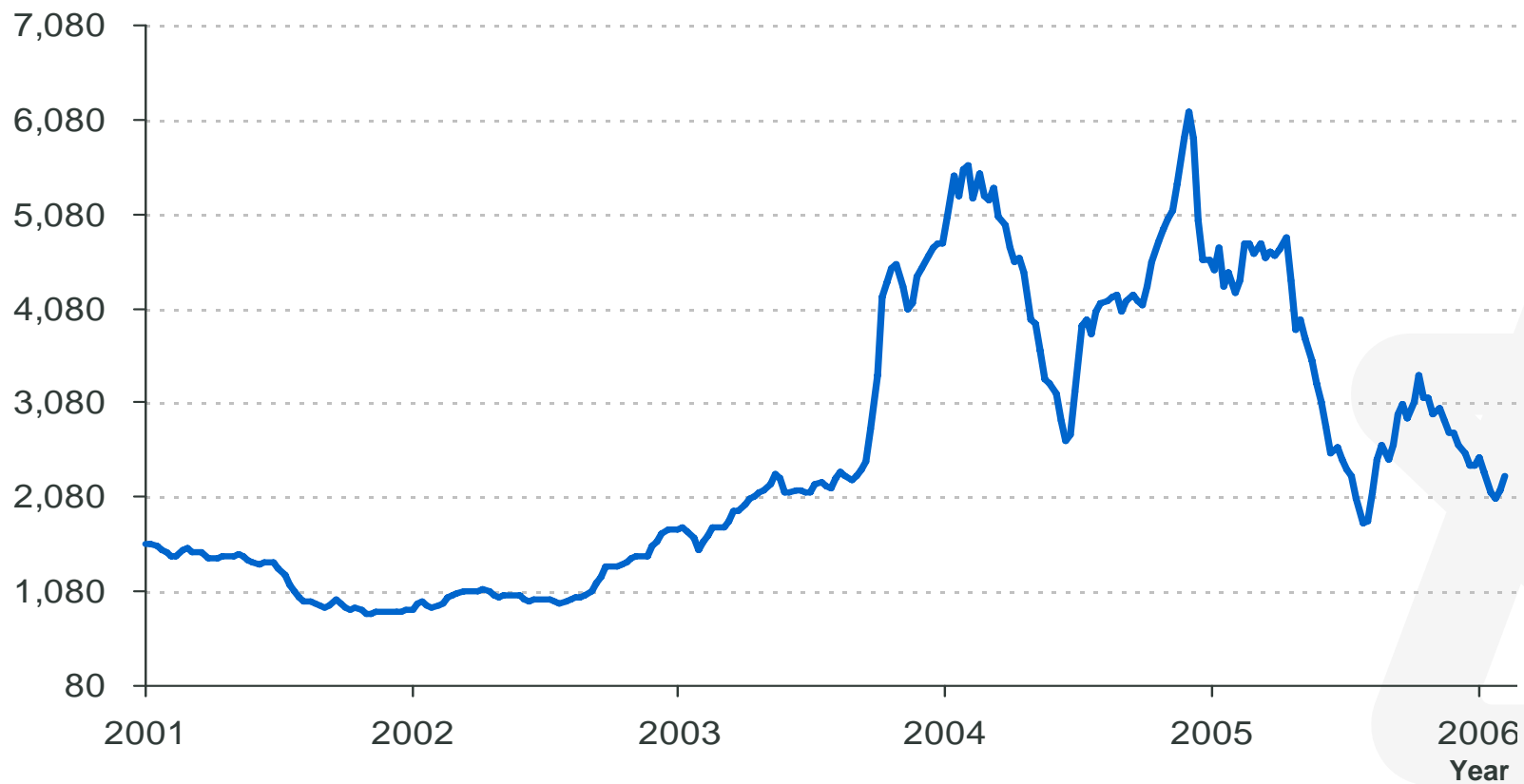
- In only 3 years, Chinese steel production has increased 3 fold to 360 million tonnes per annum. This is significantly larger than either the US or EU production of 93 and 186 million tonnes respectively.
- This phenomenal growth has flowed into the development of iron ore and coal mines as well as a plethora of related infrastructure.
- However, as capacity has increased, Chinese steel prices have fallen.

HRC Steel Prices
China



Shipping rates, which are another leading indicator of the Chinese economy, have also slumped over the last year.

Baltic Dry Index of Shipping Rates

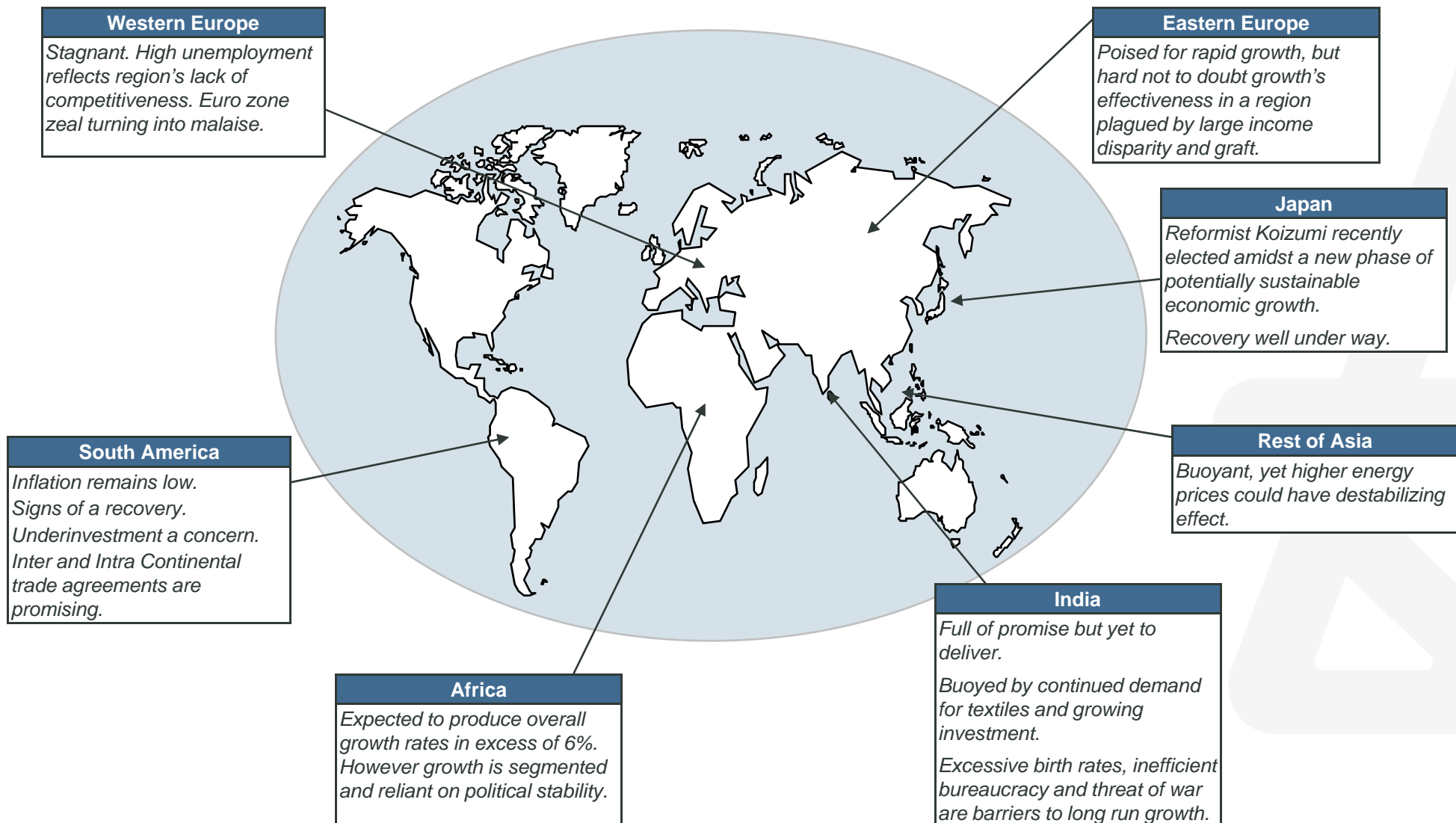


Source: Bloomberg

Other indicators that the Chinese dragon is slowing include:

- Year-on-year growth in China's crude oil imports dropped from over 35% in 2003-2004 to just 3.5% in 2004-2005.
- Property prices in some of the big Chinese cities have fallen.
- What does this mean?
 - Chinese companies continue to target output over profit.
 - Expansion has been funded through the availability of cheap money.
 - Has led to problems in the banking sector, with some estimates of underperforming loans at 40%.
- Oversupply!
 - It is likely that when the boom in China subsides, there will be serious excess supply in the economy.
 - This does not bode well for the rest of the world, as China's dominance in the manufacture of electrical and textile goods, coupled with its excess supply, could see cheap Chinese goods flooding the international markets...trade wars?

If China and the US begin to slow we must look elsewhere for increased aggregate demand.

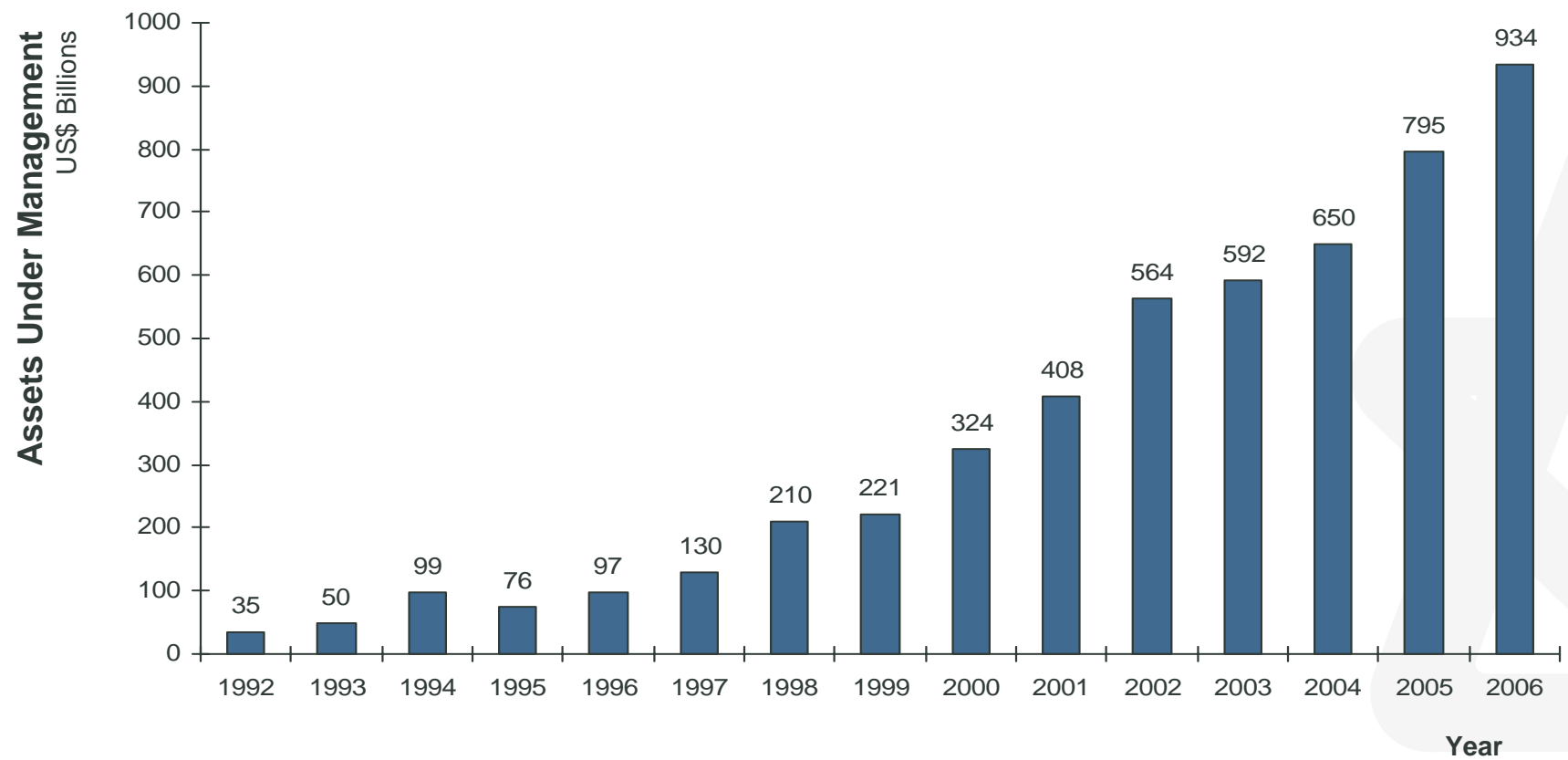


Energy prices are crucial to Australia's economic performance.

- Current supply and demand equation is being driven by low supply of Sweet Light Oil, and high demand.
- Large investment being made to develop capacity to refine Heavy Crude Oil.
- As increased supply kicks in and growth in demand from China falls prices should begin to fall: China accounted for 38% of the growth in world oil demand over the past four years.
- But we can be very optimistic that there will continue to be strong demand for natural gas as a cleaner and more environmentally friendly alternative.
- Uranium could emerge as a major new source of export revenue if the State Government changes its stance.
- So far higher energy prices haven't lead to higher inflation and interest rates, but have:
 - Dampened consumer sentiment and changed US car buying habits
 - Led to policy changes relating to renewable energy sources

A key factor affecting commodity prices is the substantial growth in hedge funds ...

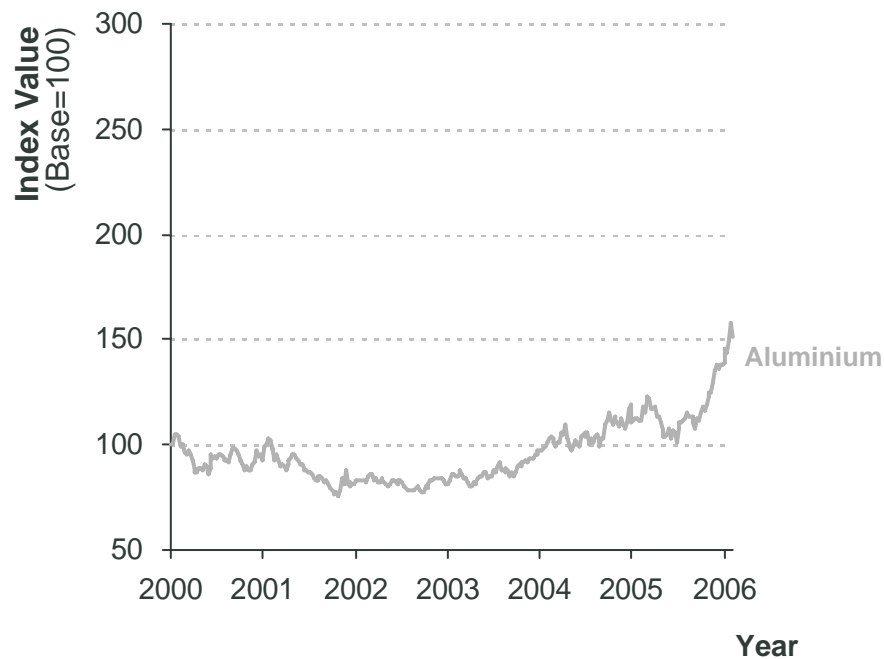
Hedge Fund Assets



... this has led to a marked increase in hedge fund speculation in commodities, 'artificially' pushing prices higher, even as fundamentals start to weaken.

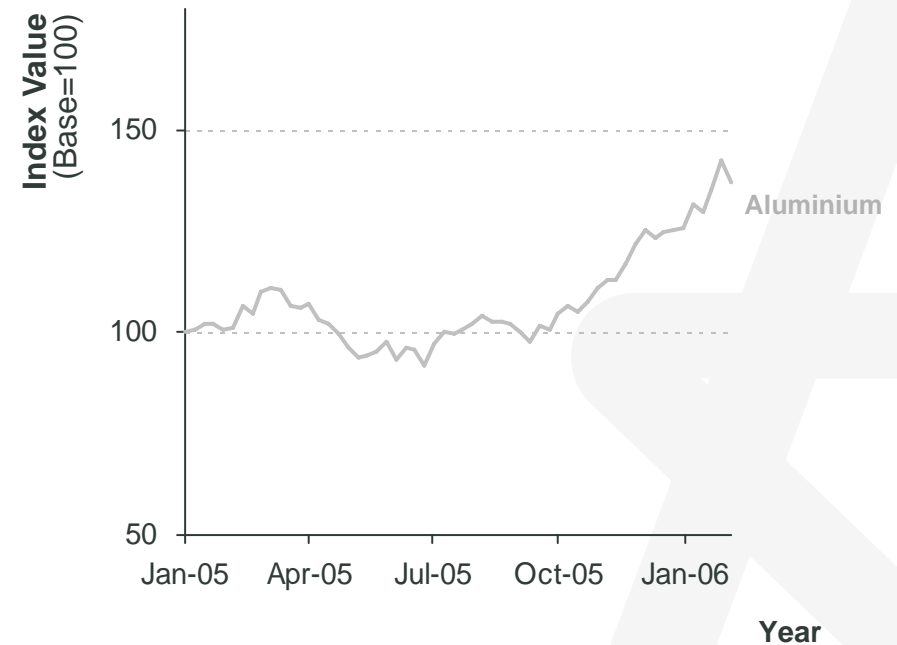
USD Prices of Key Global Commodities

6 Years



USD Prices of Key Global Commodities

1 Year

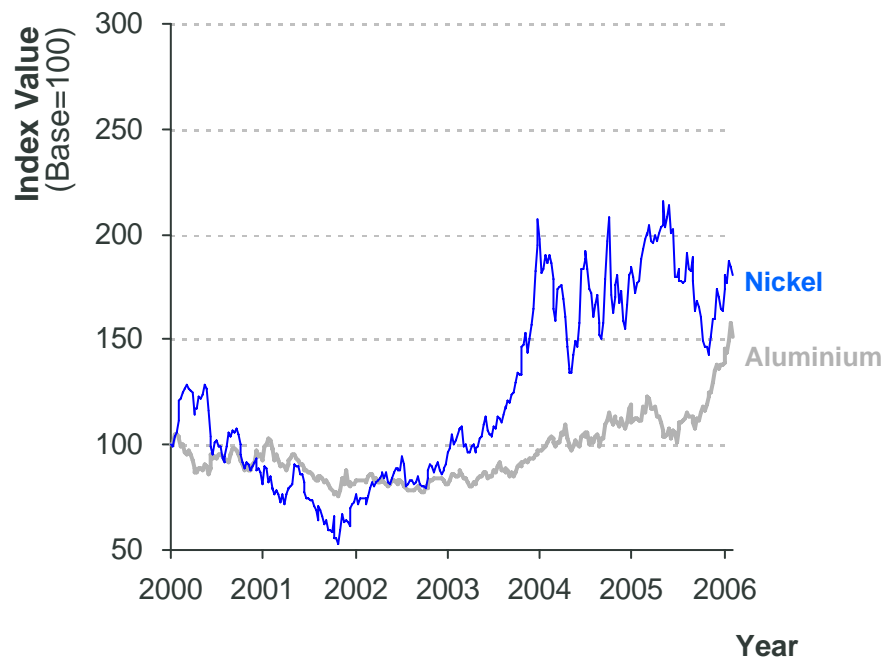


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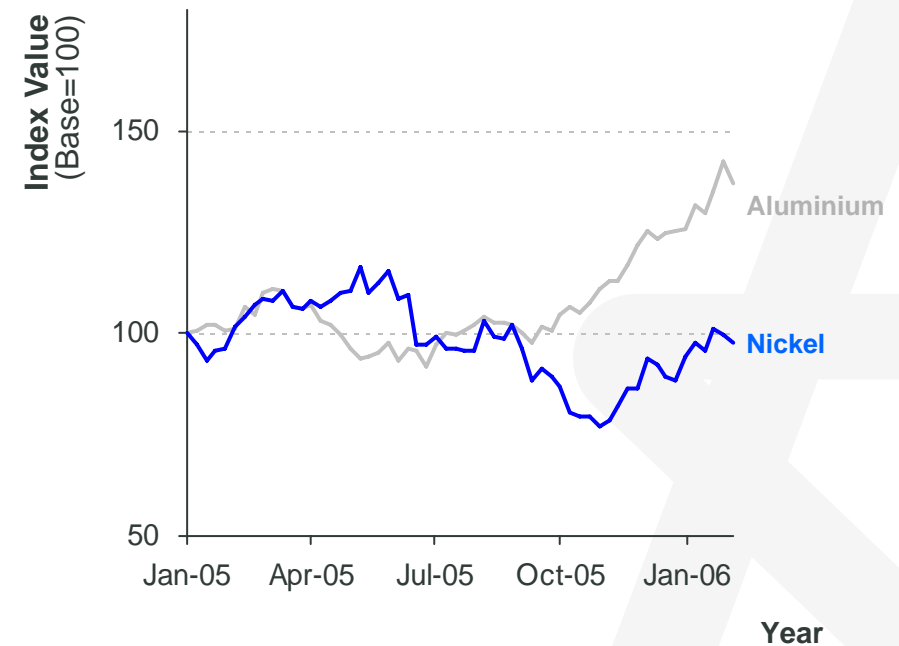
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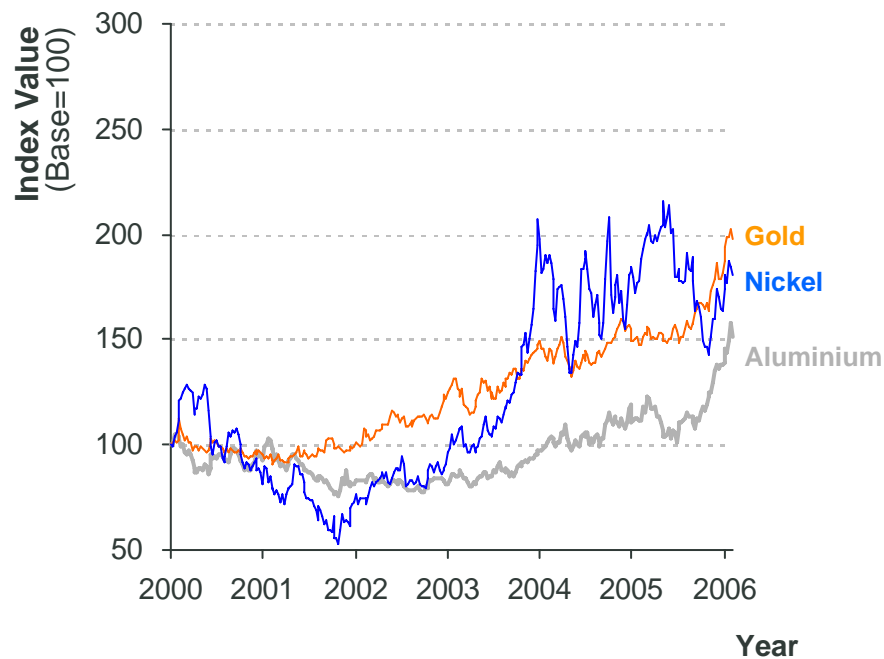


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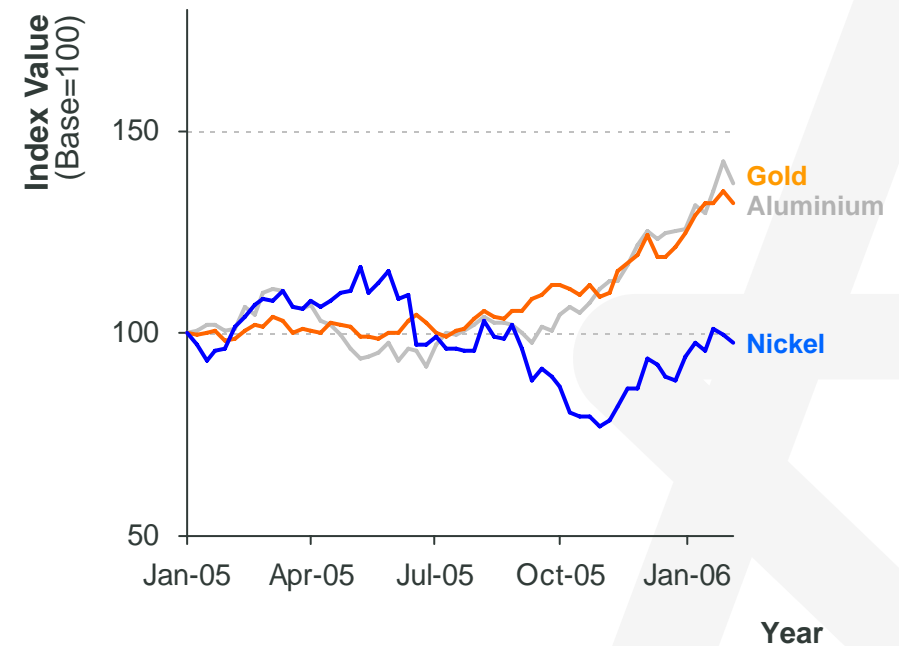
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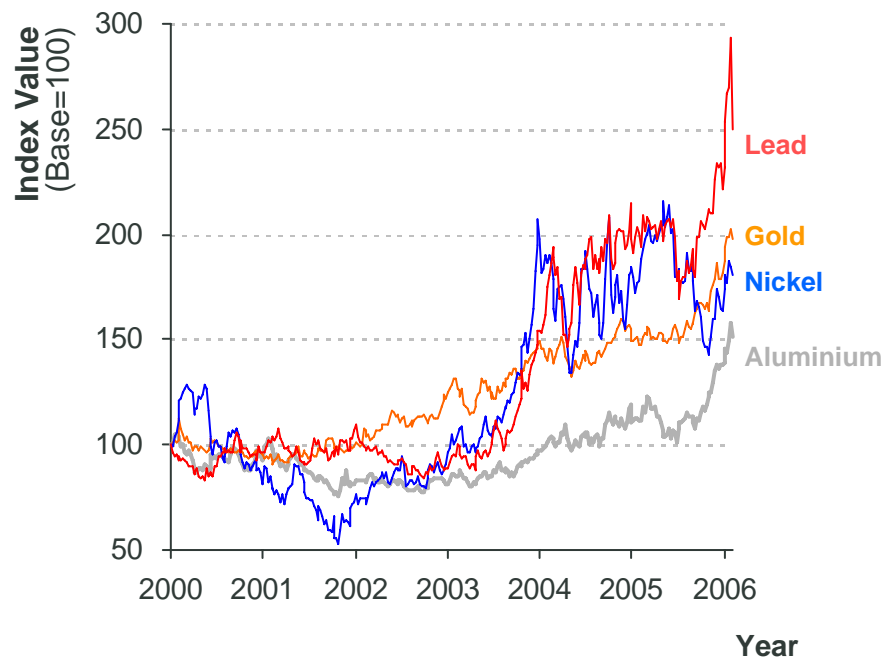


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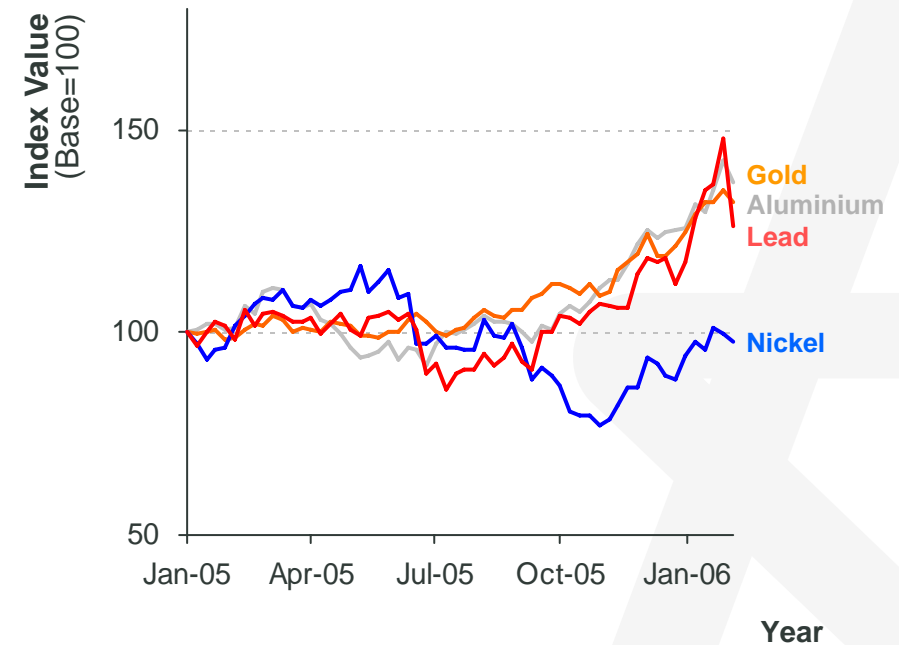
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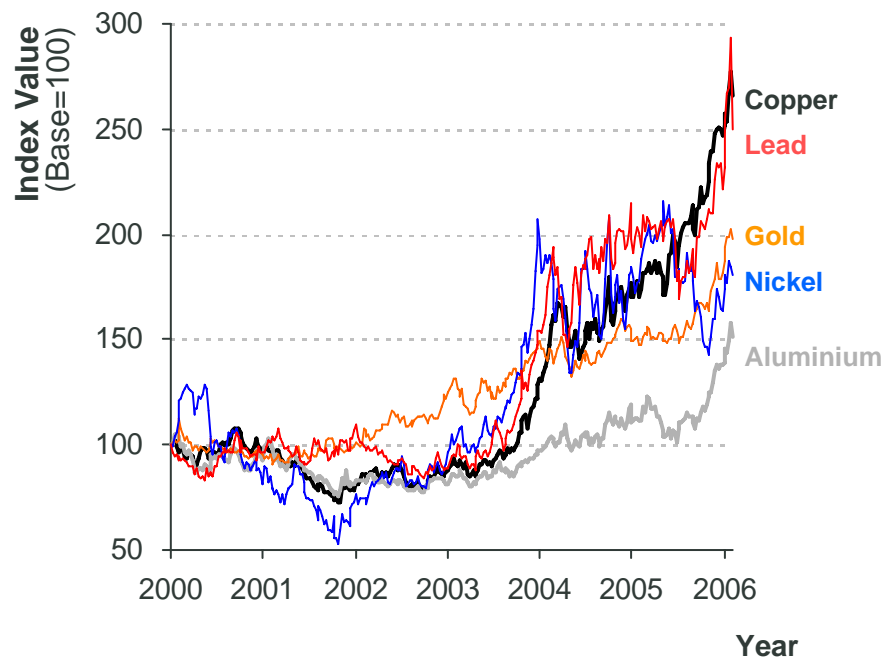


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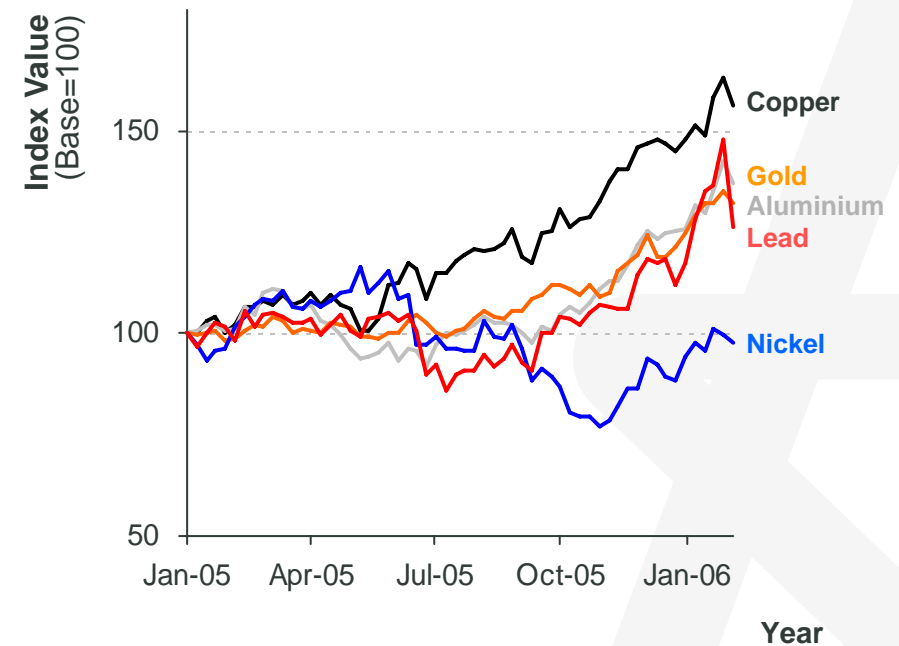
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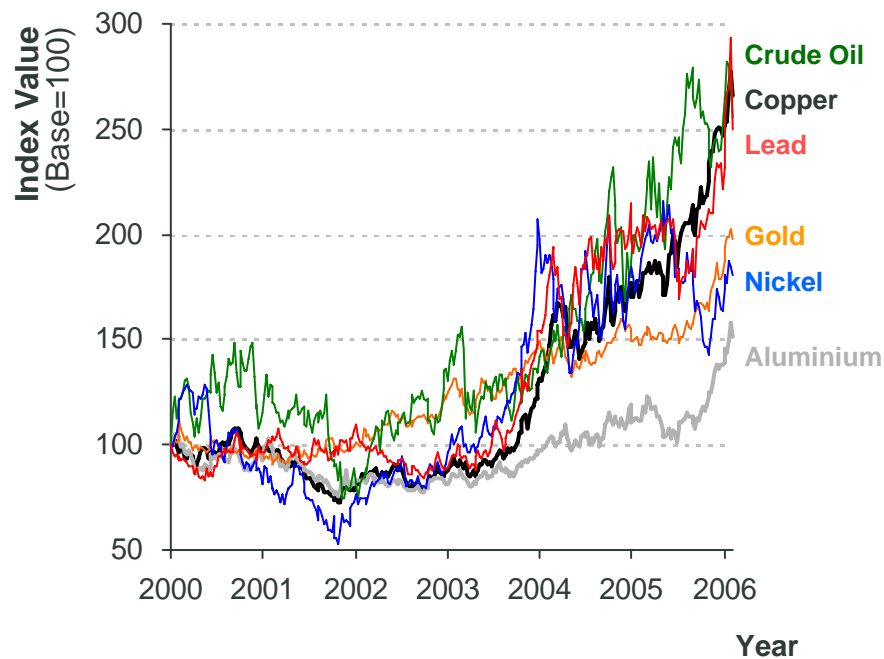


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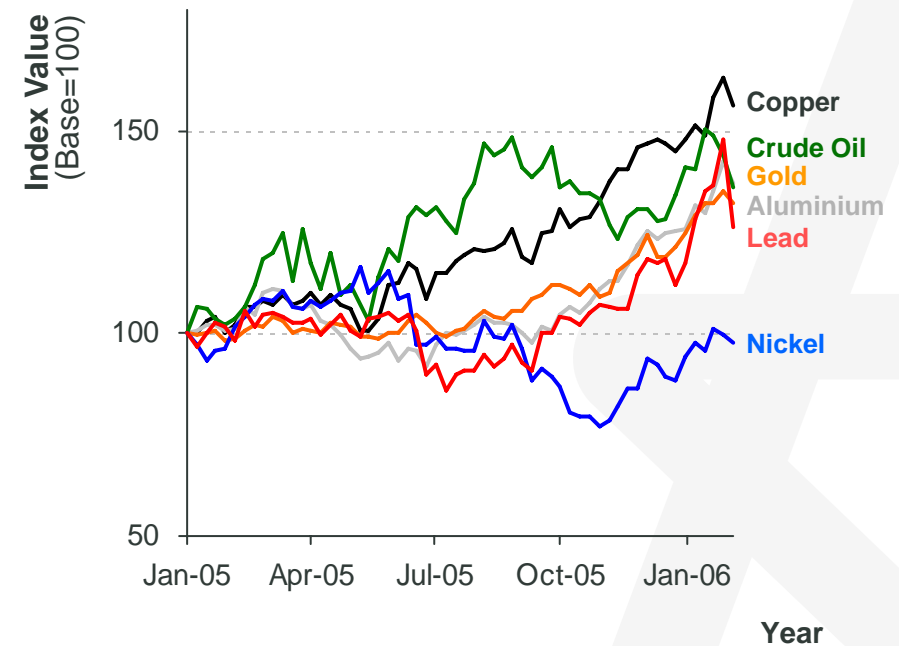
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Economic Overview

- Australia's current run of economic growth has been impressive, surpassing any previous run since federation.
- Improved terms of trade has translated to gains of over \$2,000pa per Australian since 1999.
- With the exception of WA and QLD the housing boom appears to be over.
- The end of the housing boom has substantially lowered borrowing against actual/expected increases in housing prices. As a result consumer spending is slowing.
- Commodity demand from China is partially offsetting the slowing consumer demand especially in WA and QLD.
- Costs are experiencing upward pressure as the economy continues to operate near full capacity.
- Inflationary concerns may lead the RBA to raise the cash rate further.
- Narrow interest rate spreads and weakening commodity prices could see the A\$ fall further in 2006.

Australia's relative stock market performance

The Australian stock market has performed exceptionally well against its peers over the last 2 years.

Global Indices

3 Years



Global Indices

1 Year



Source : Bloomberg

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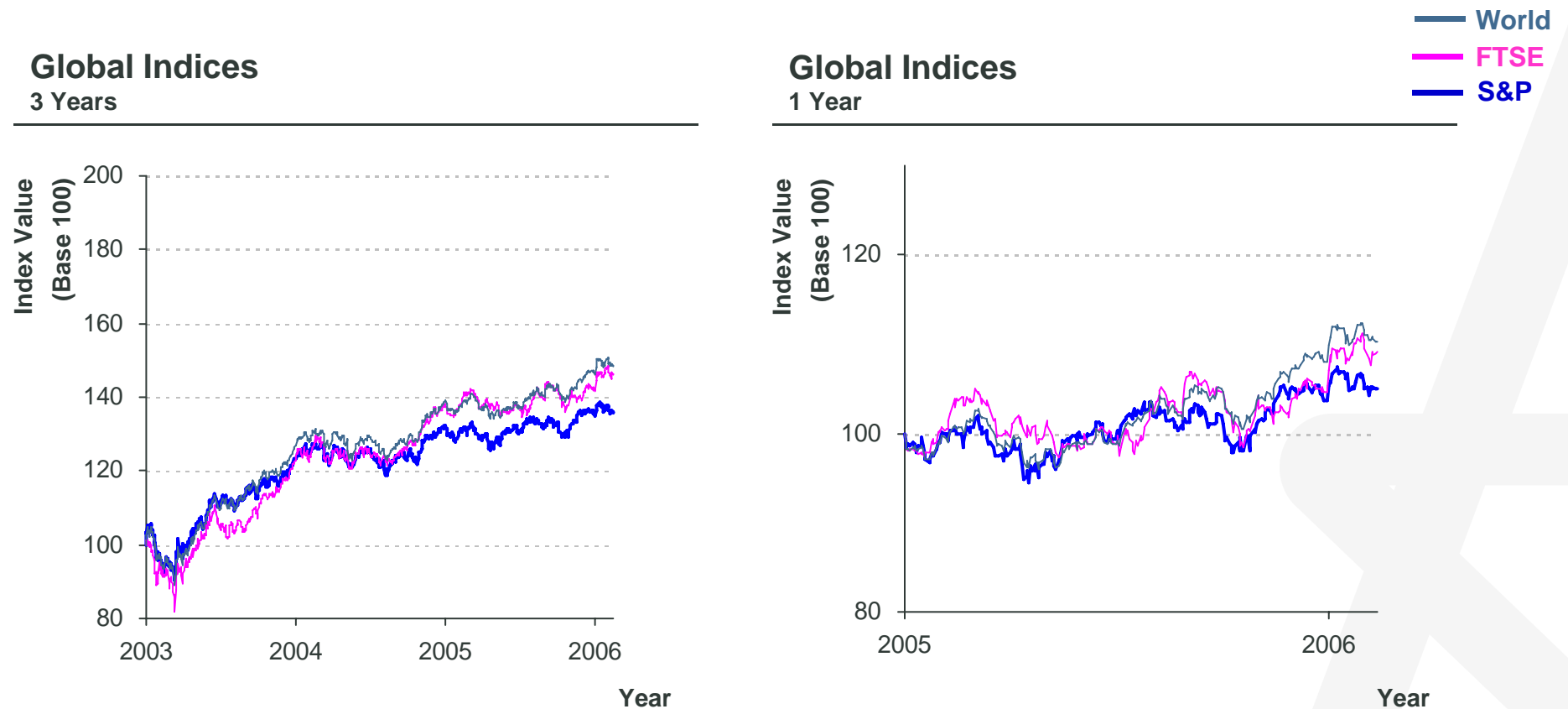
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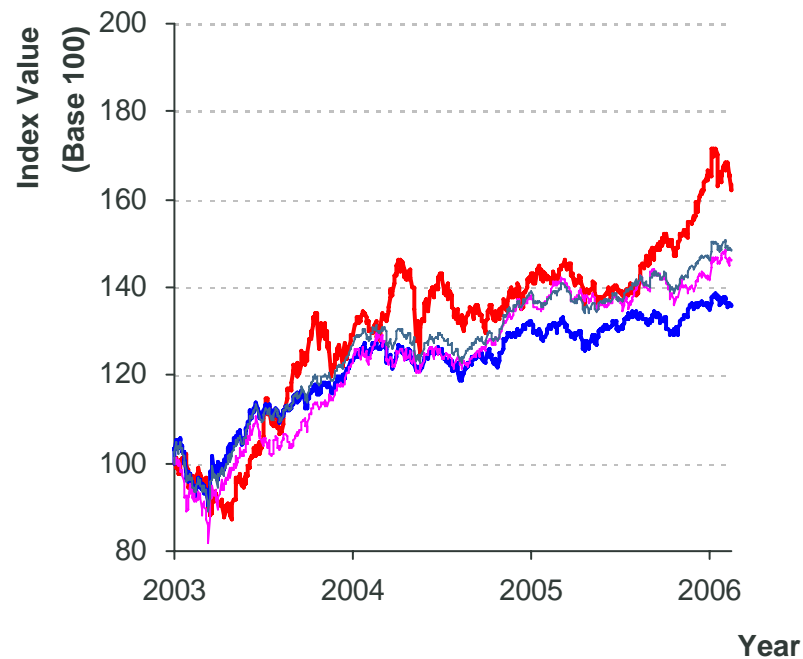
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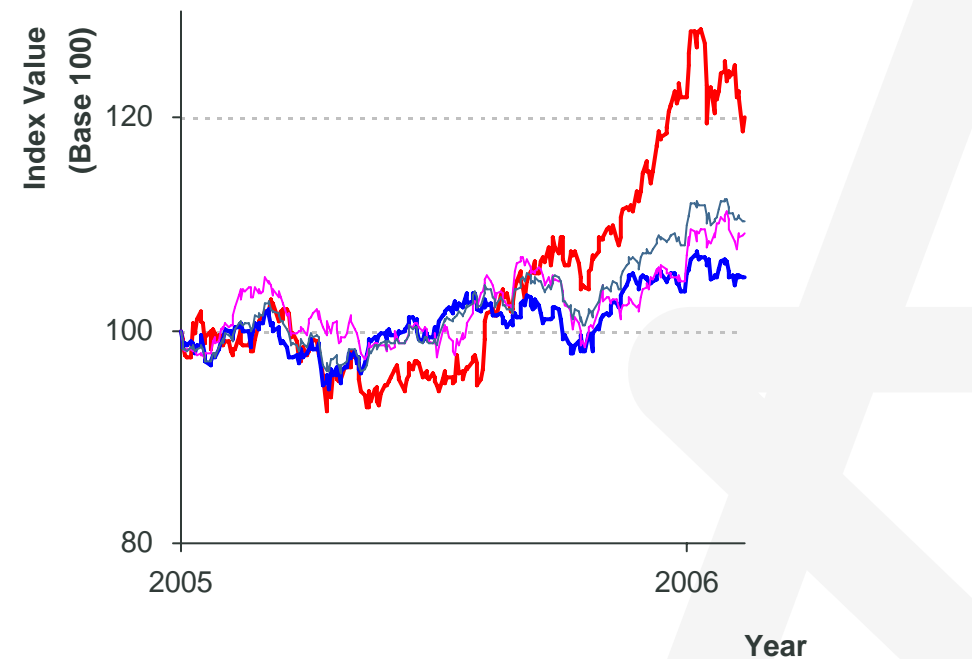
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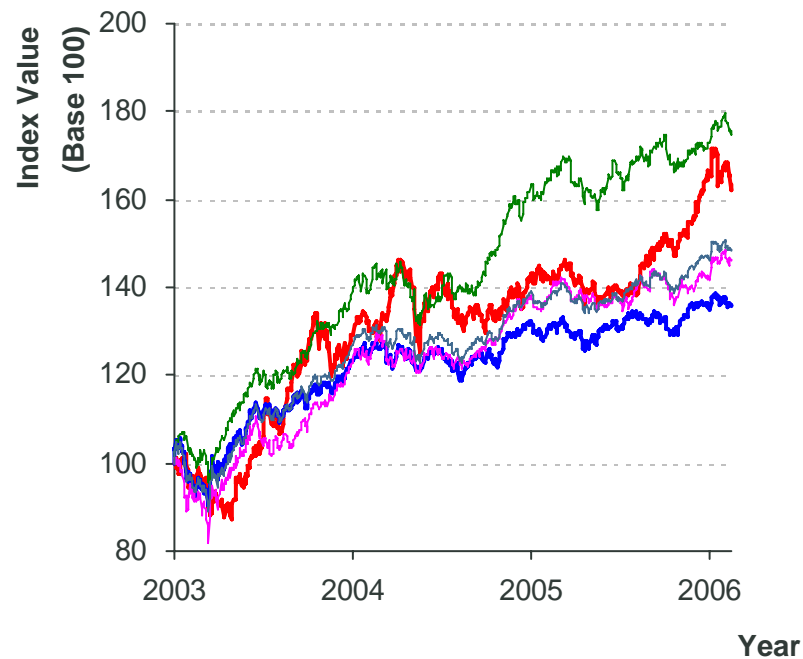
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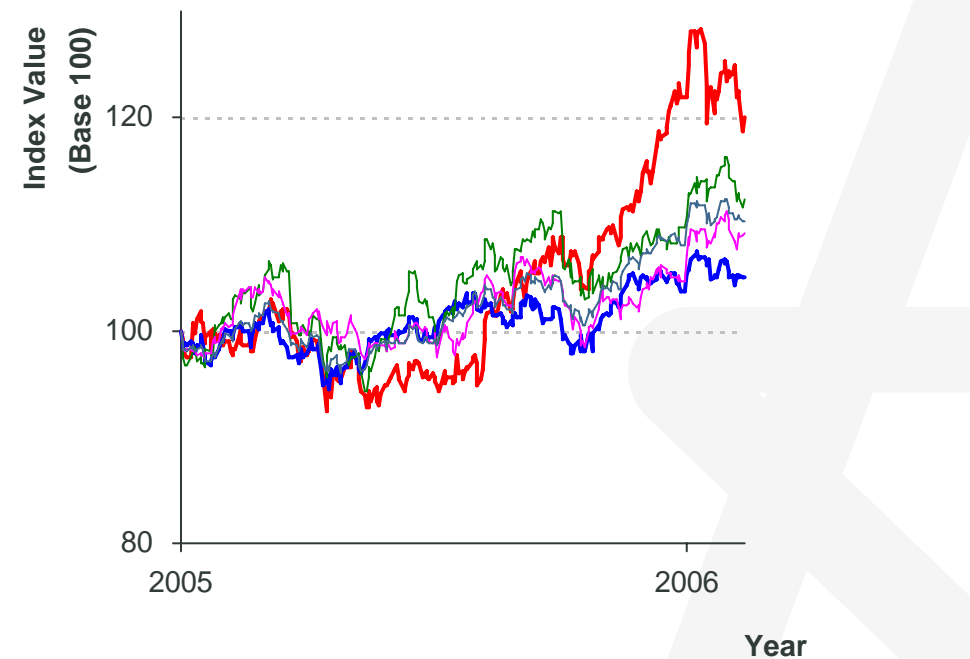
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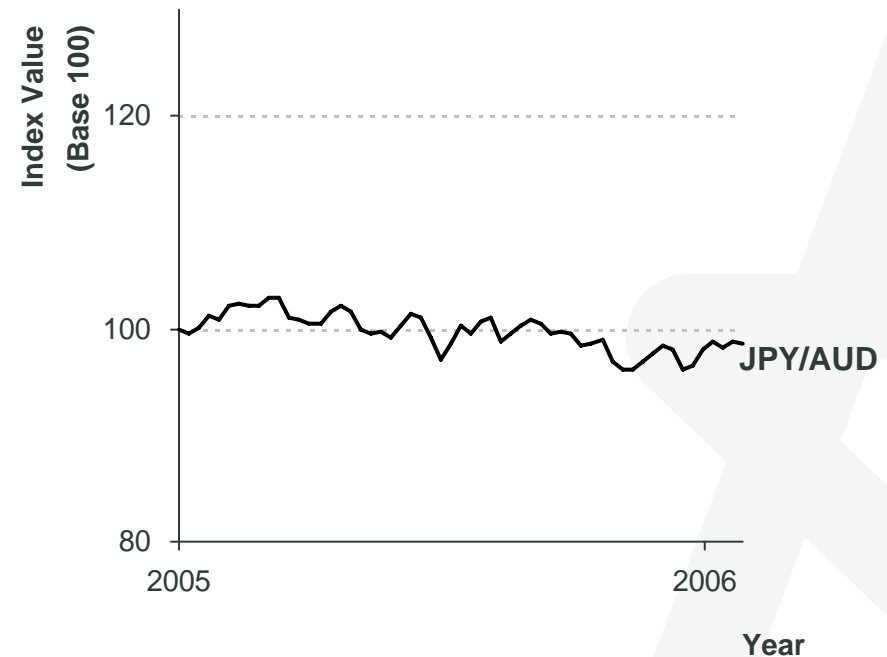


Strong commodity prices and a positive interest rate differential led to a marked appreciation of the Australian dollar against the US\$ and Japanese Yen over the last 6 years. However, this trend has slowed over the past year.

Trends of Key Global Currencies
6 Years



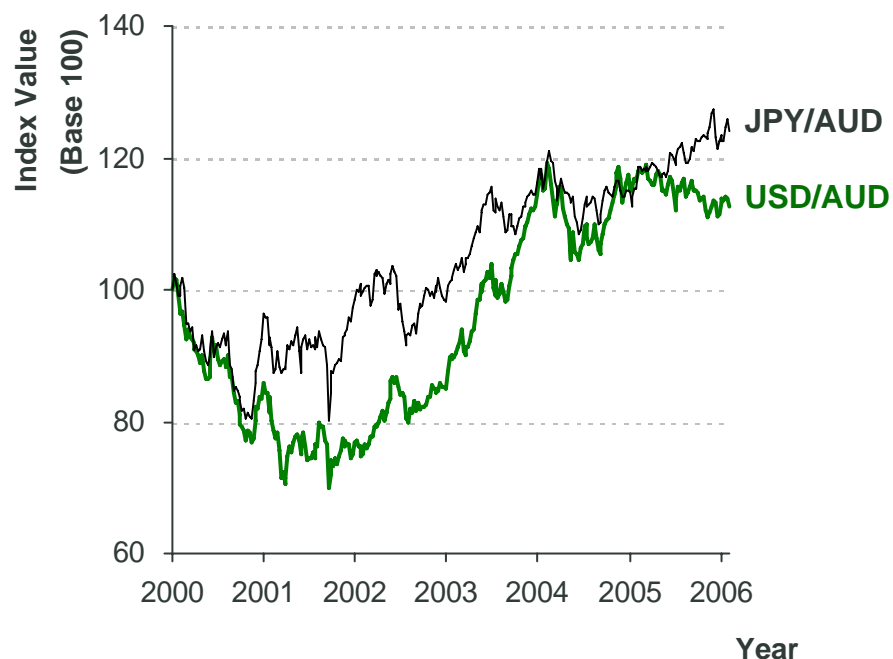
Trends of Key Global Currencies
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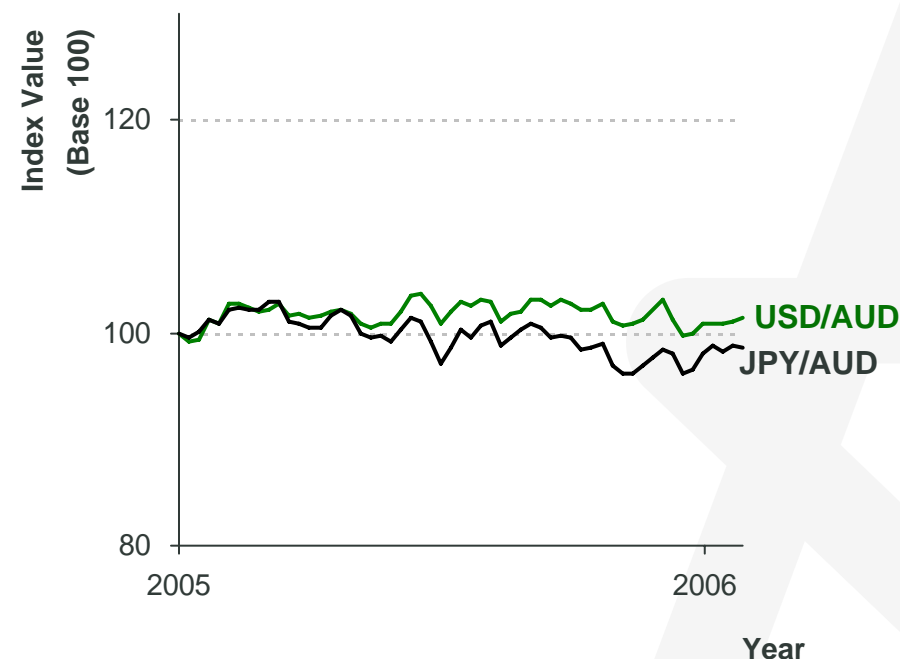
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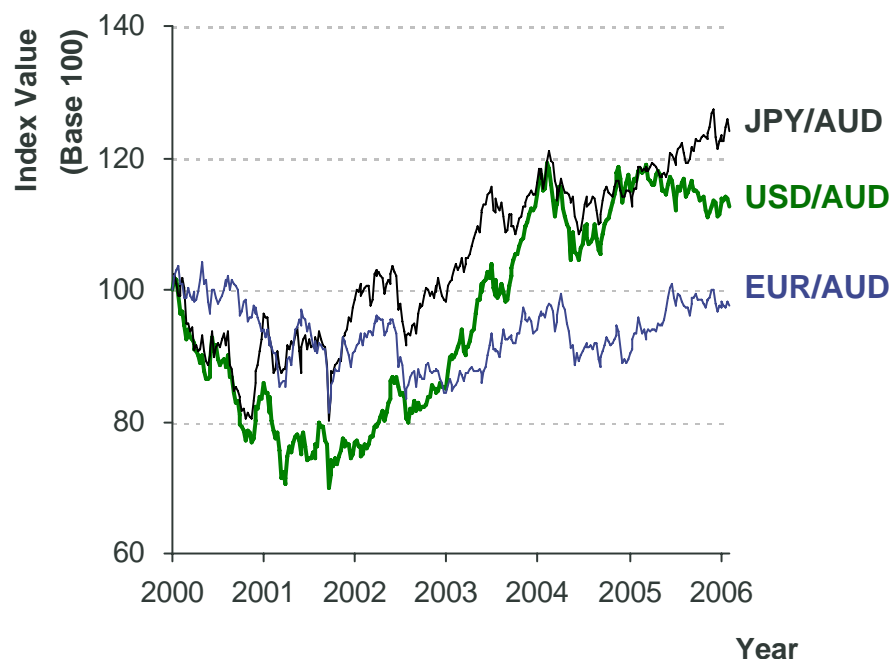
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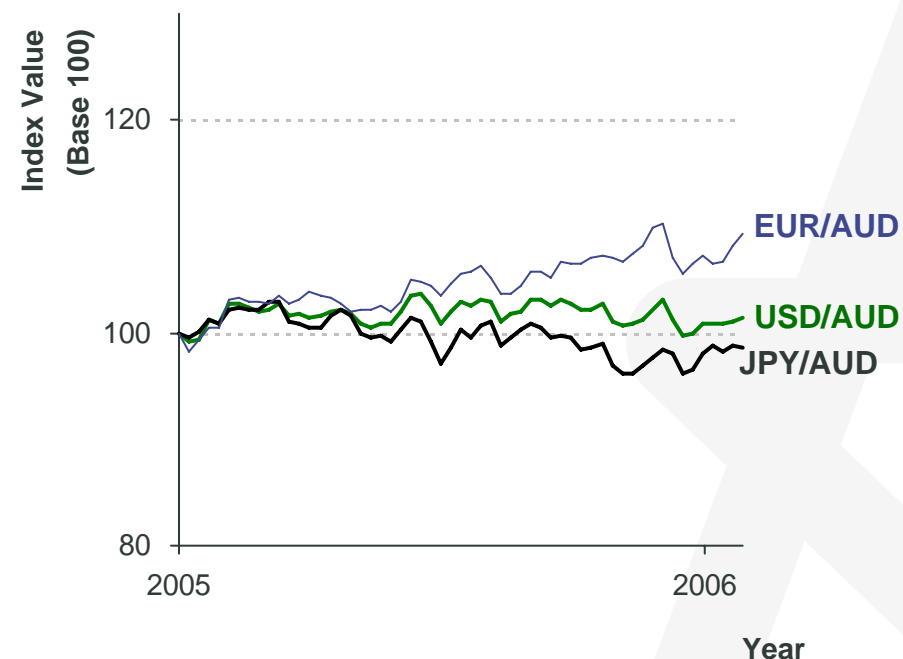
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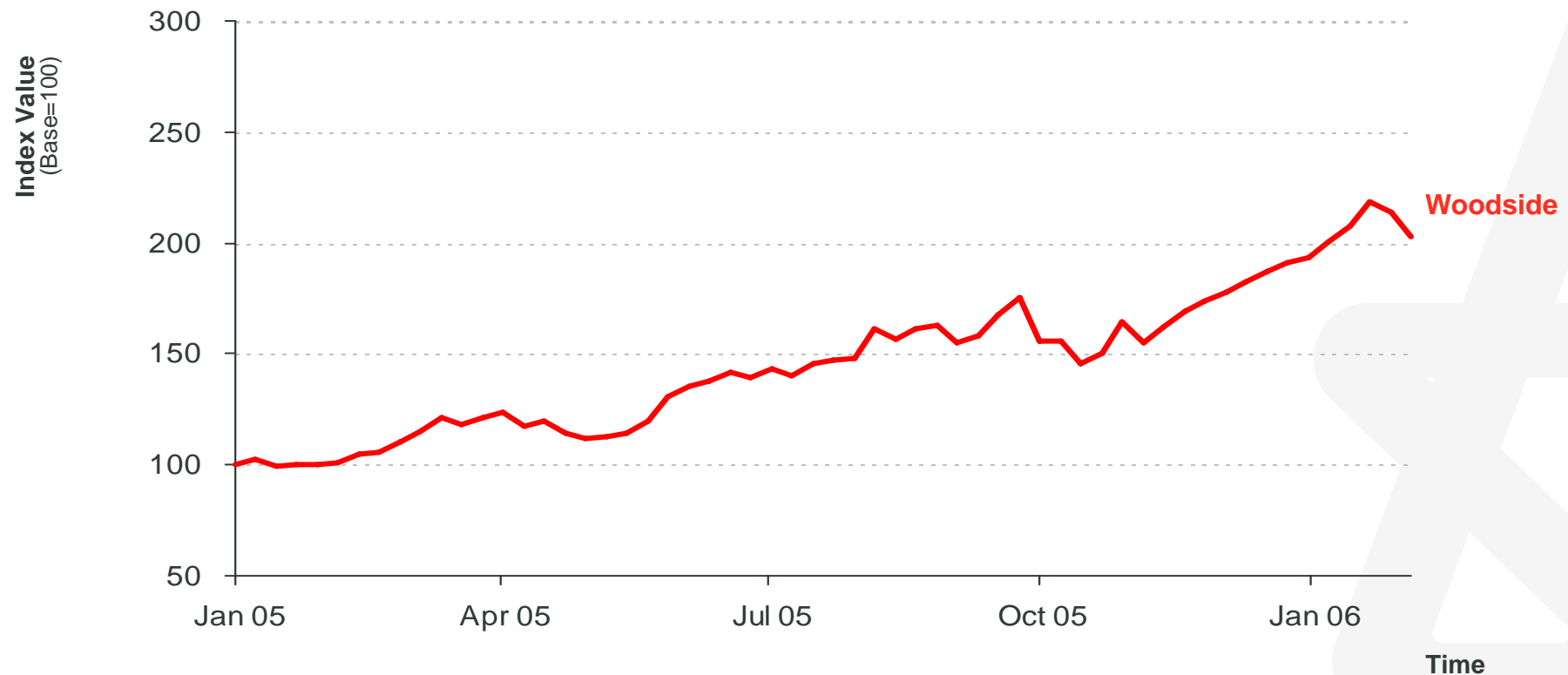
Trends of Key Global Currencies
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In particular, the share price performance of Australia's commodity and energy players has been strong, but experienced recent buffeting.

Australian resource and energy company share prices

Index

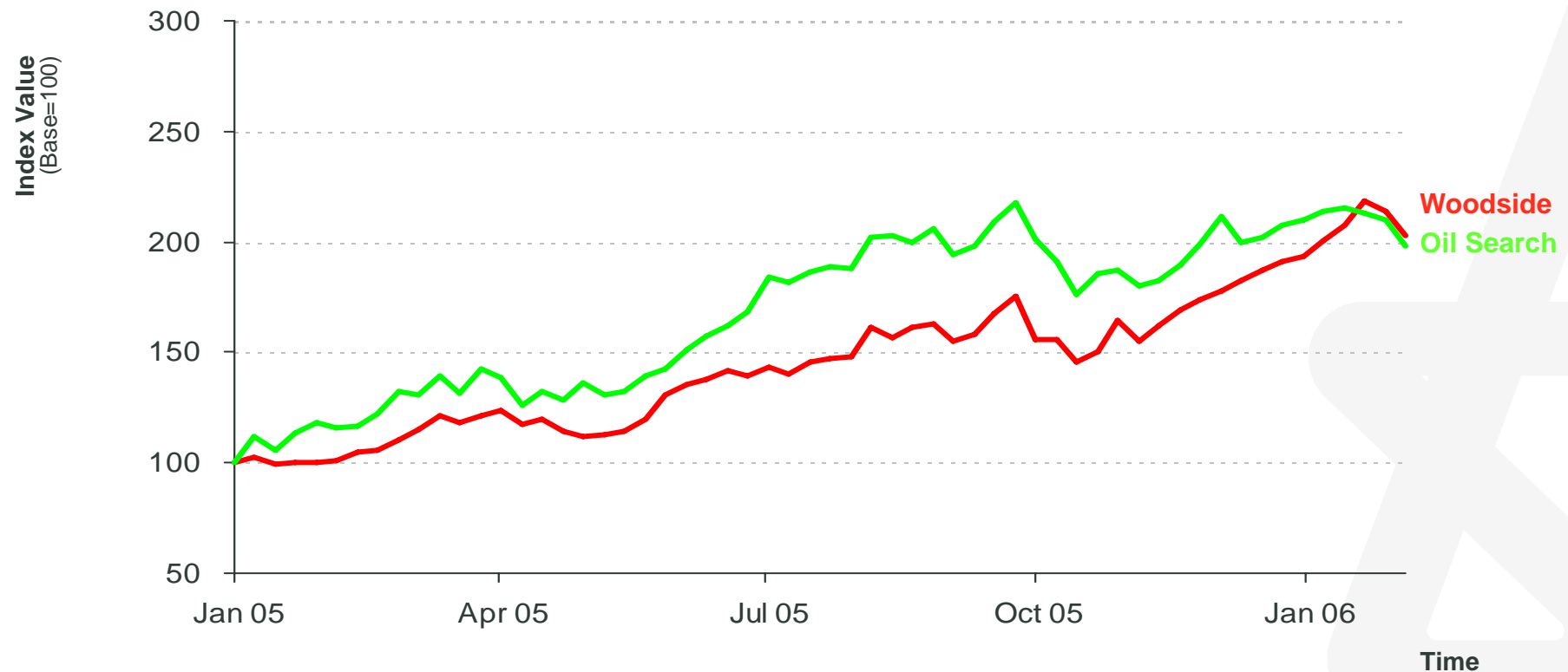


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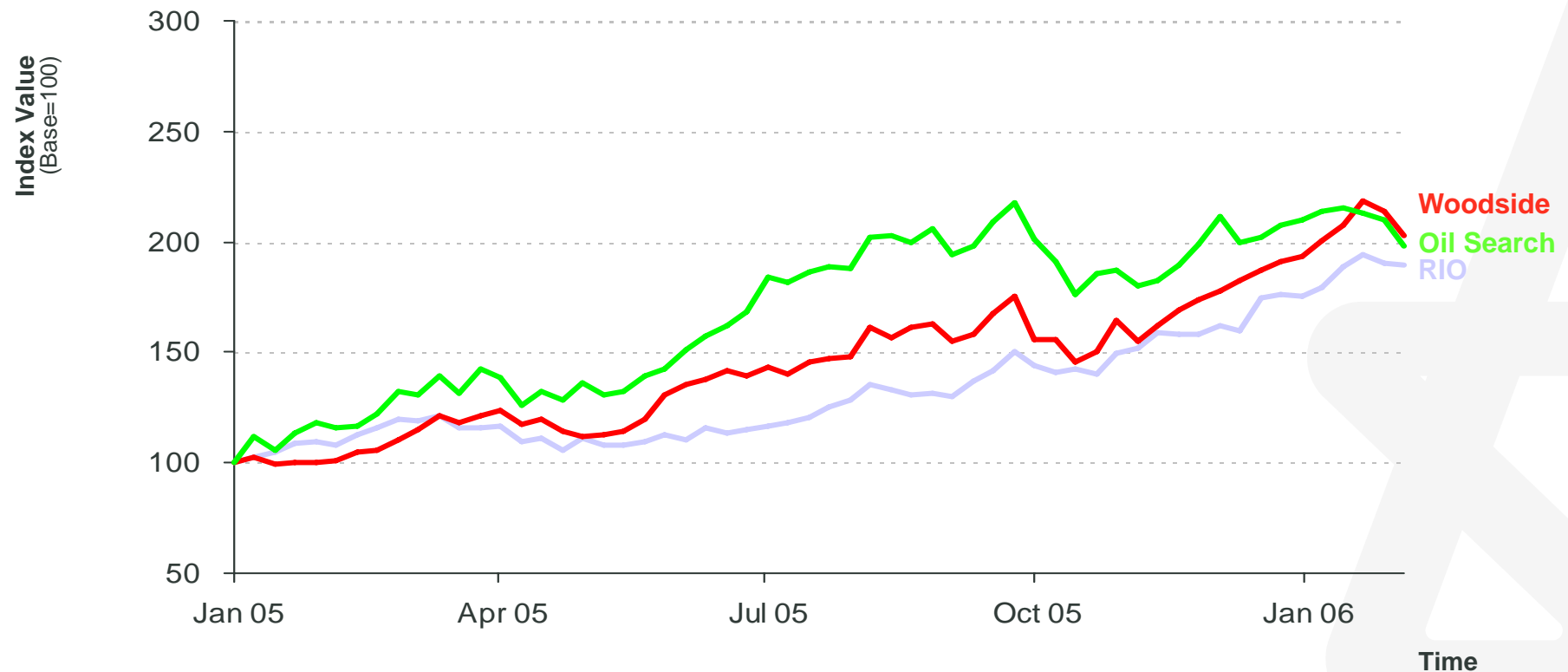


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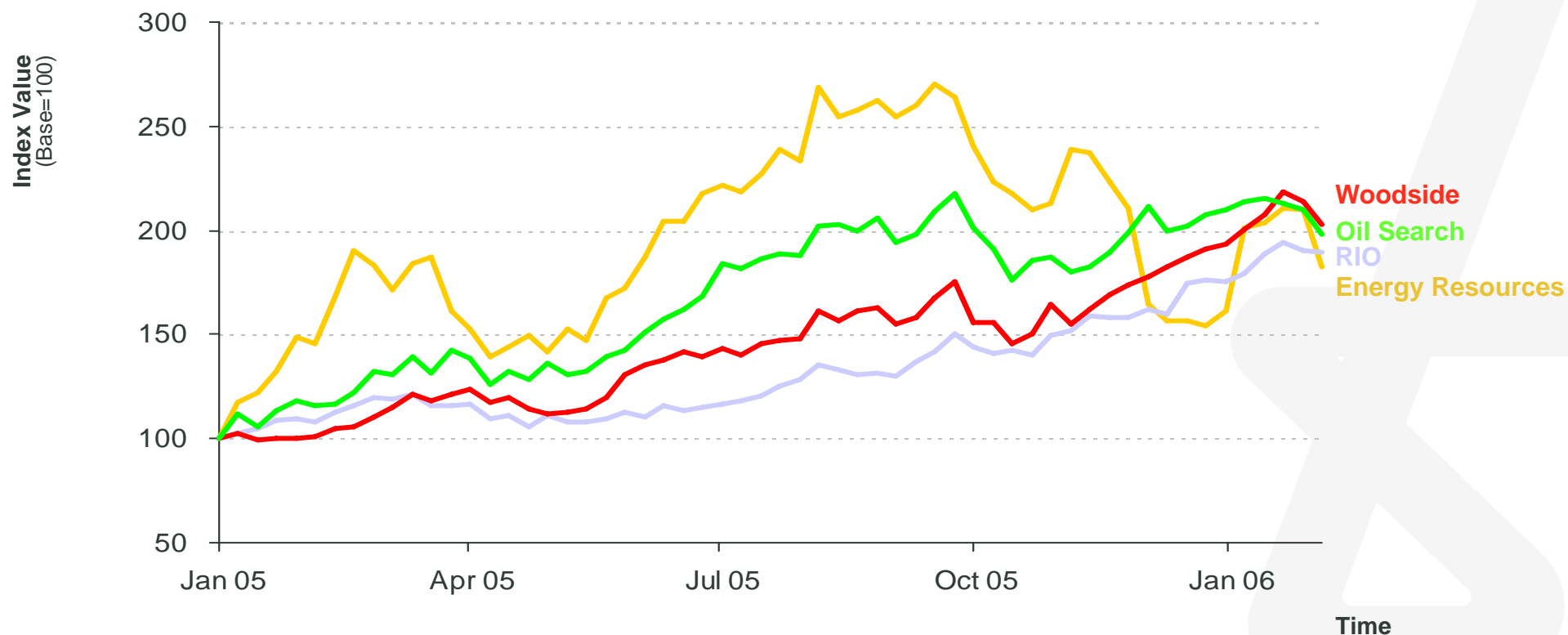


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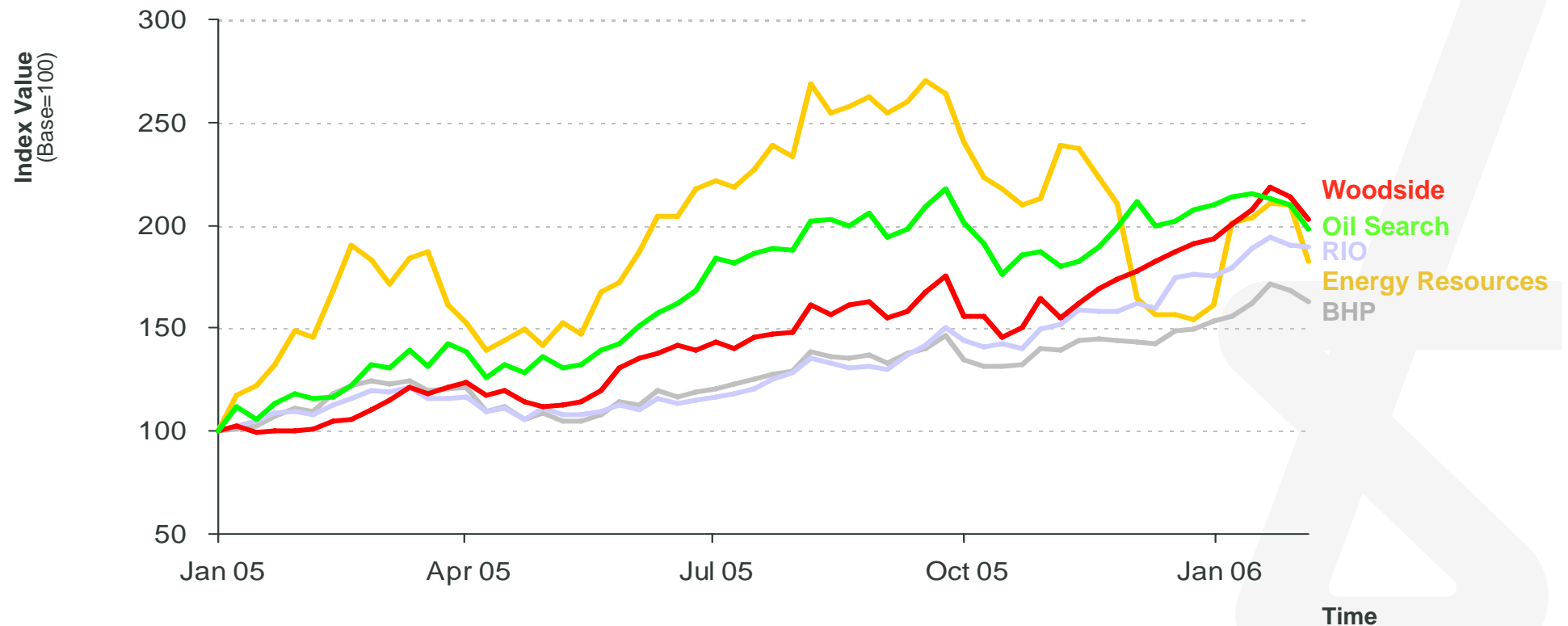


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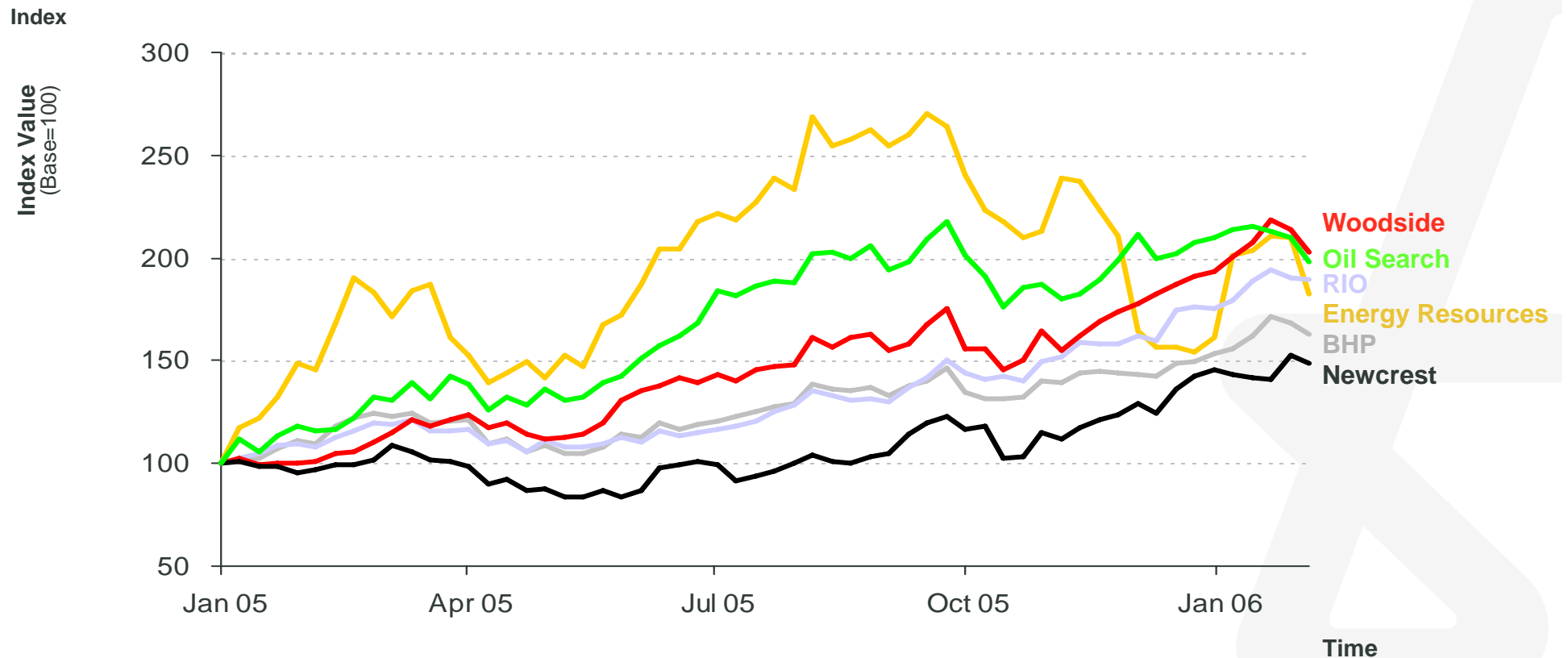


Source : Bloomberg

Company profits

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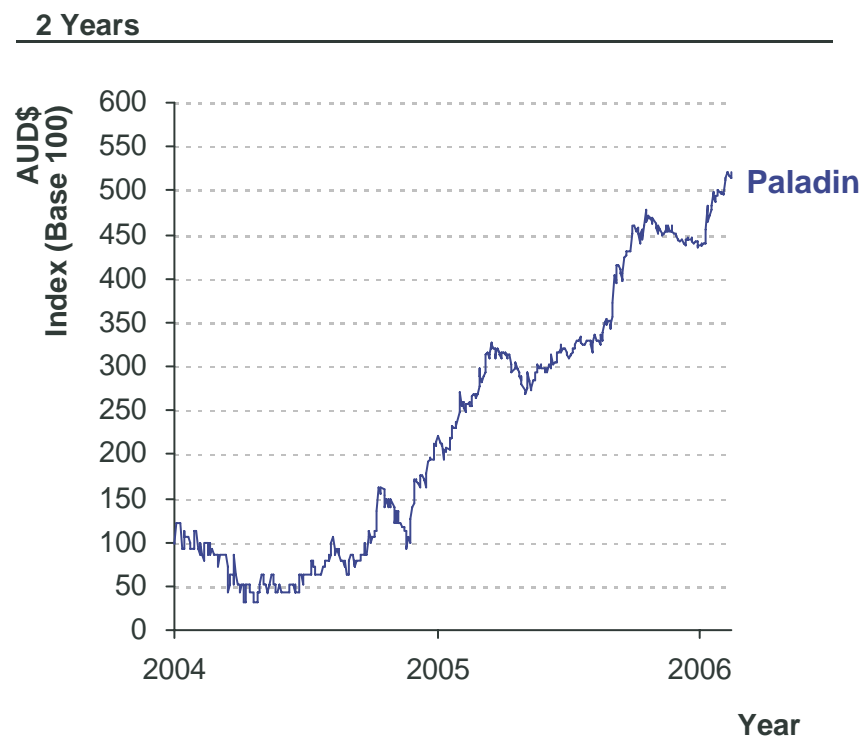
Australian resource and energy company share prices



Source : Bloomberg

Individual company performances

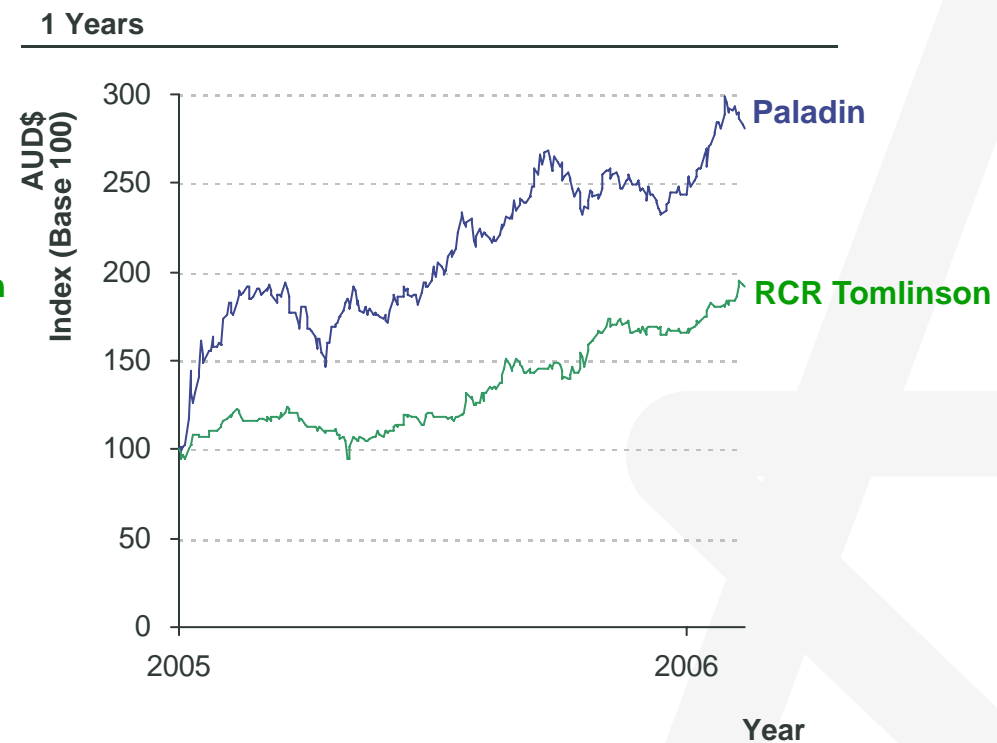
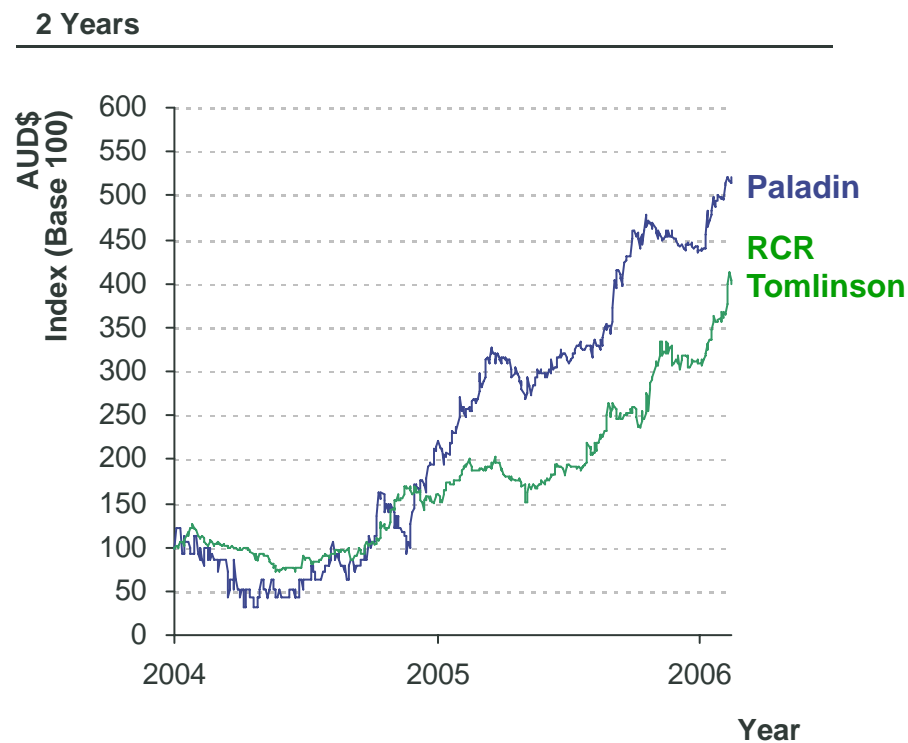
WA's most significant energy/resource players have experienced a similar trend.



Source : Bloomberg

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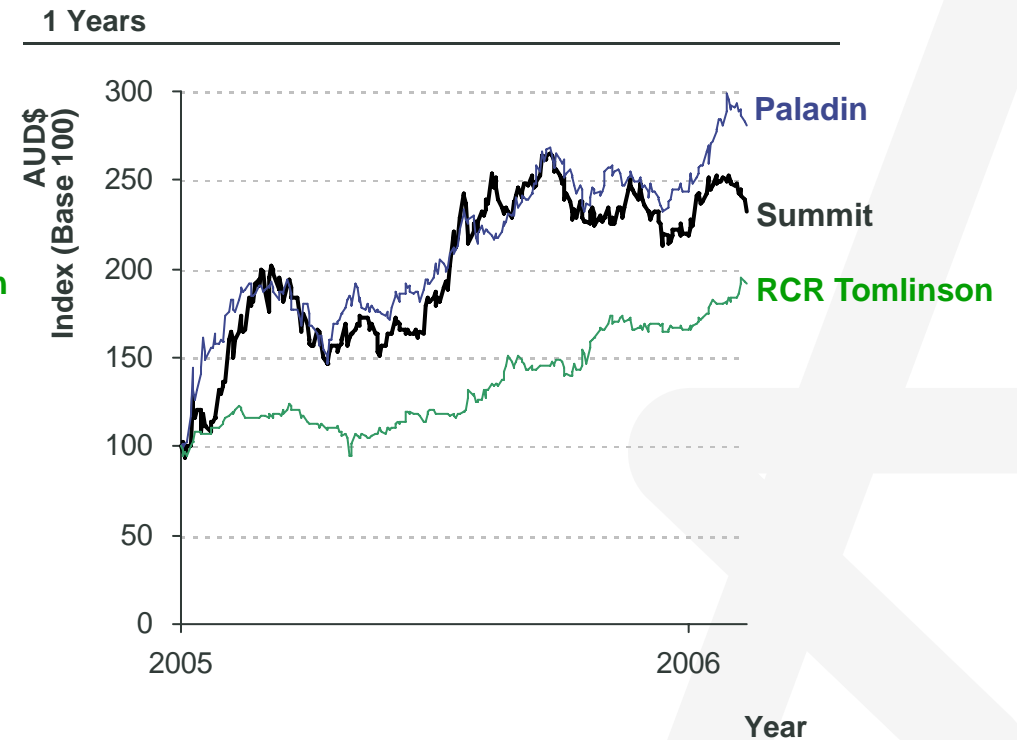
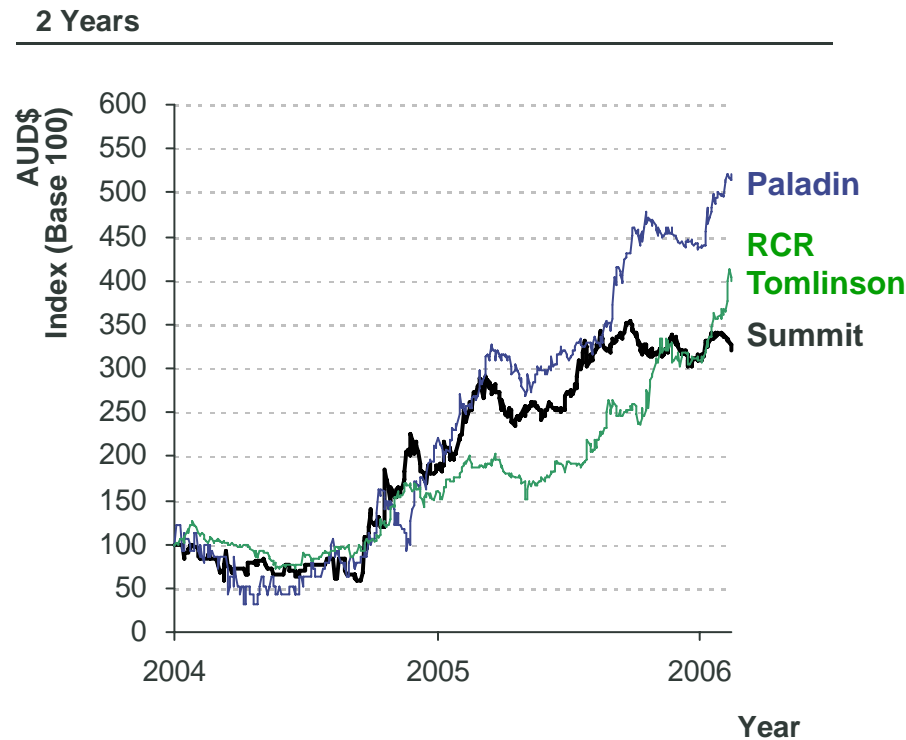
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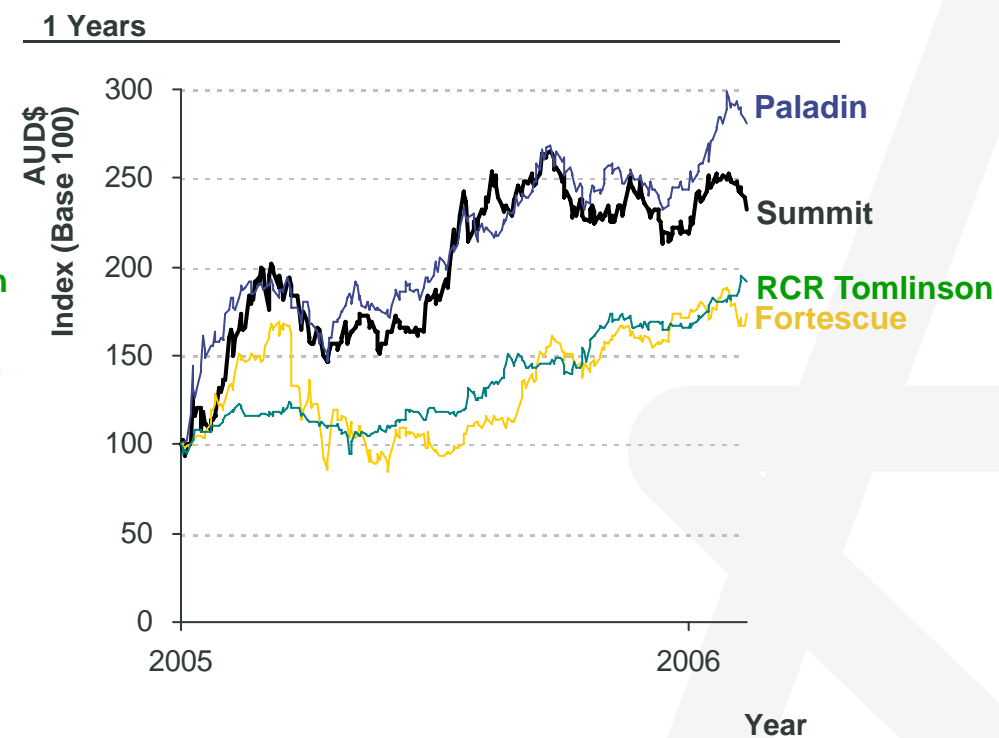
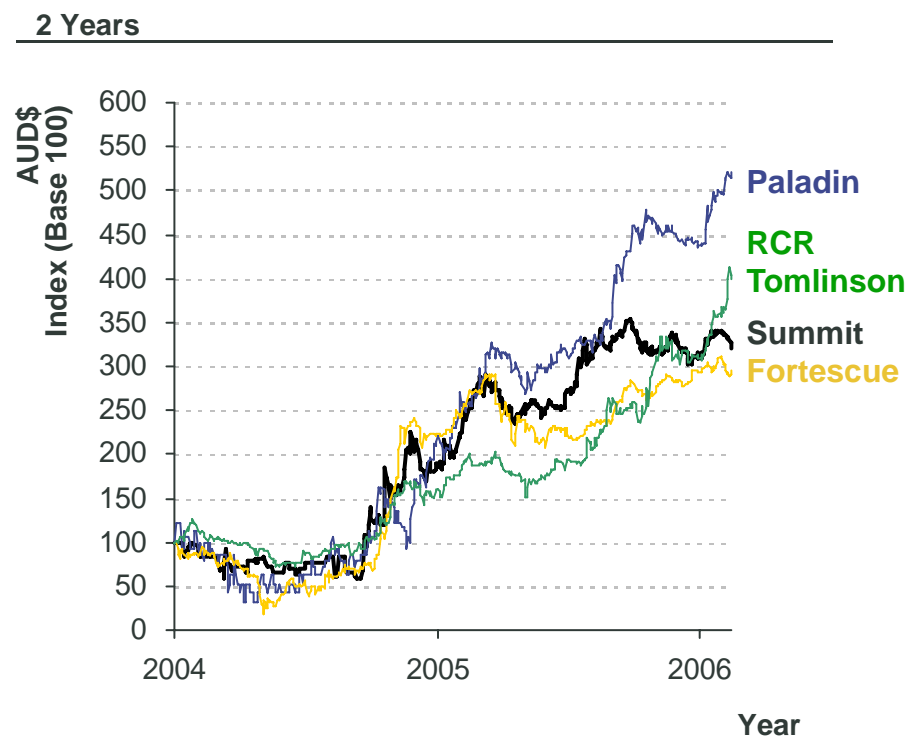
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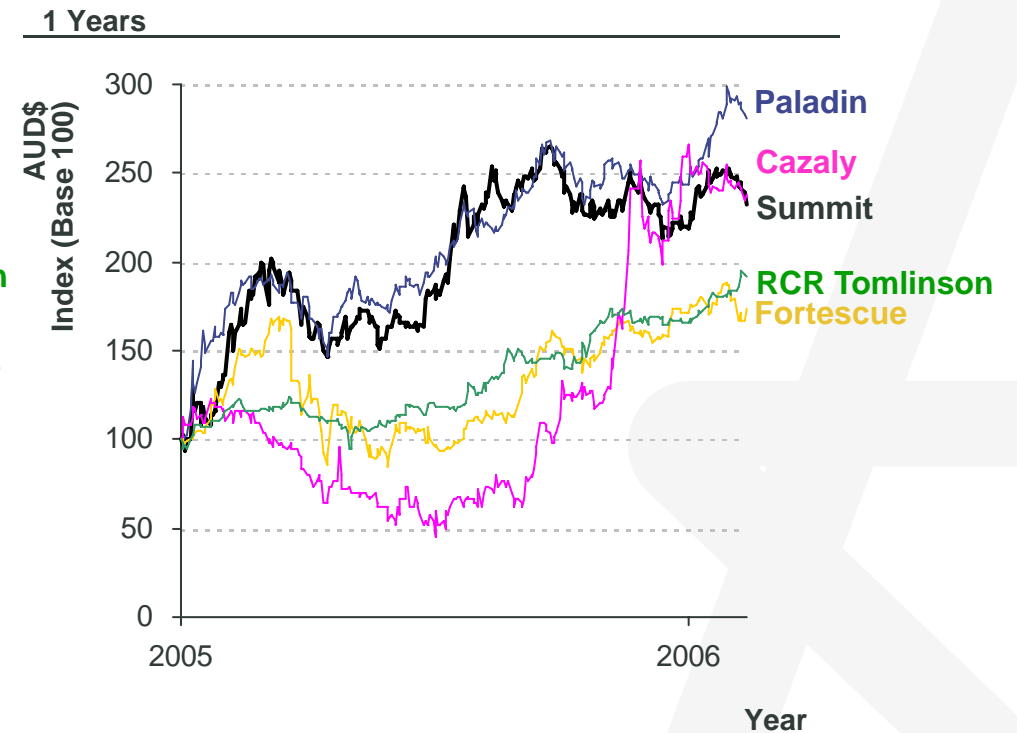
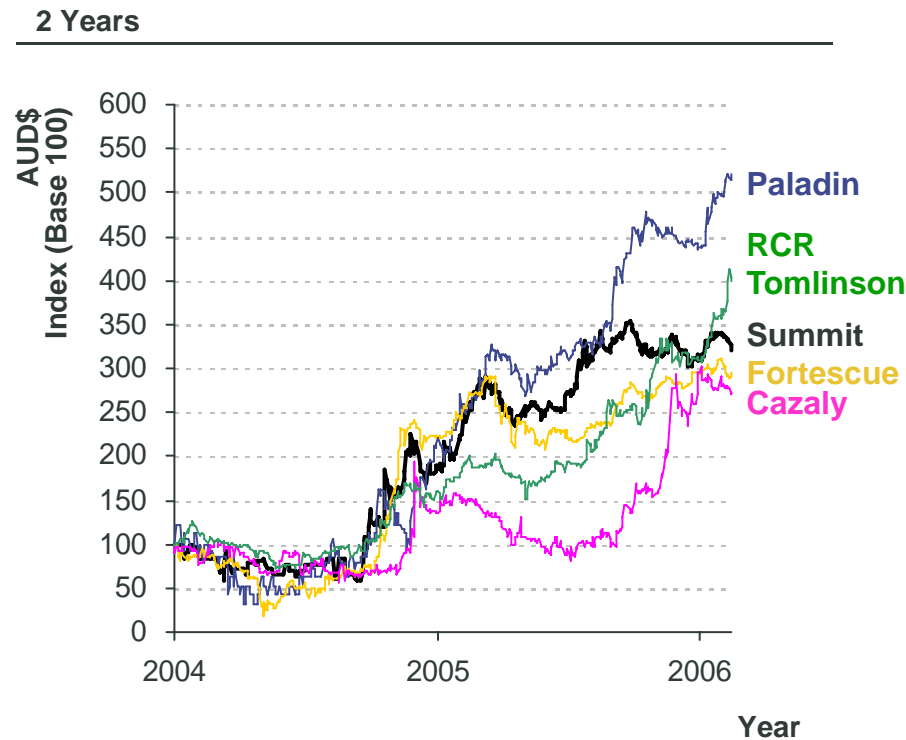
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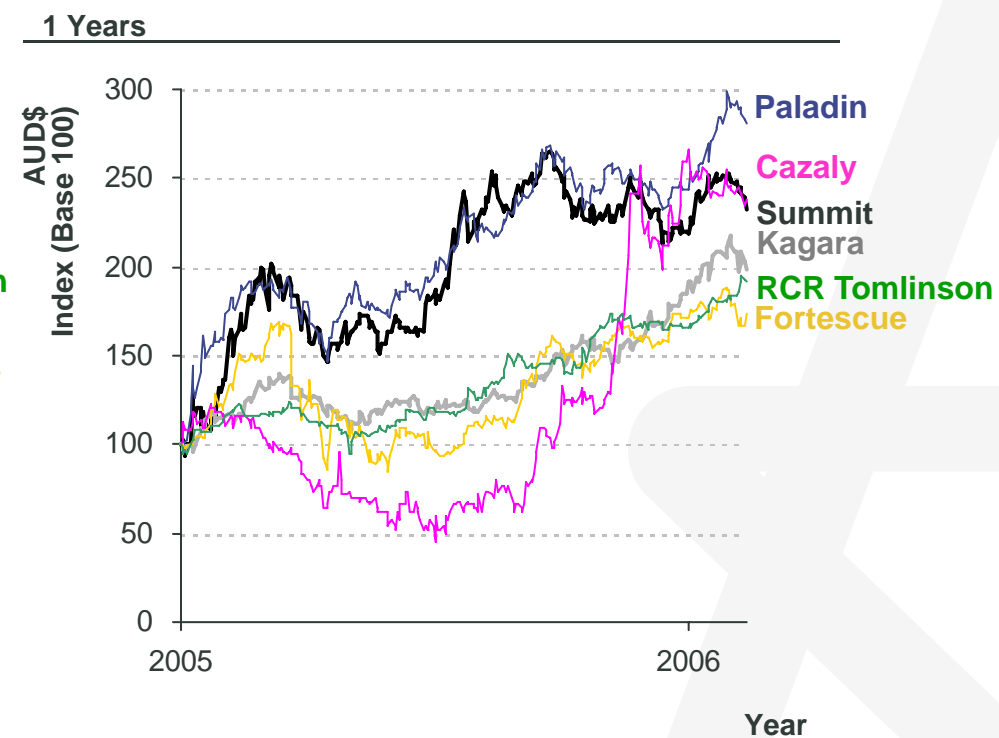
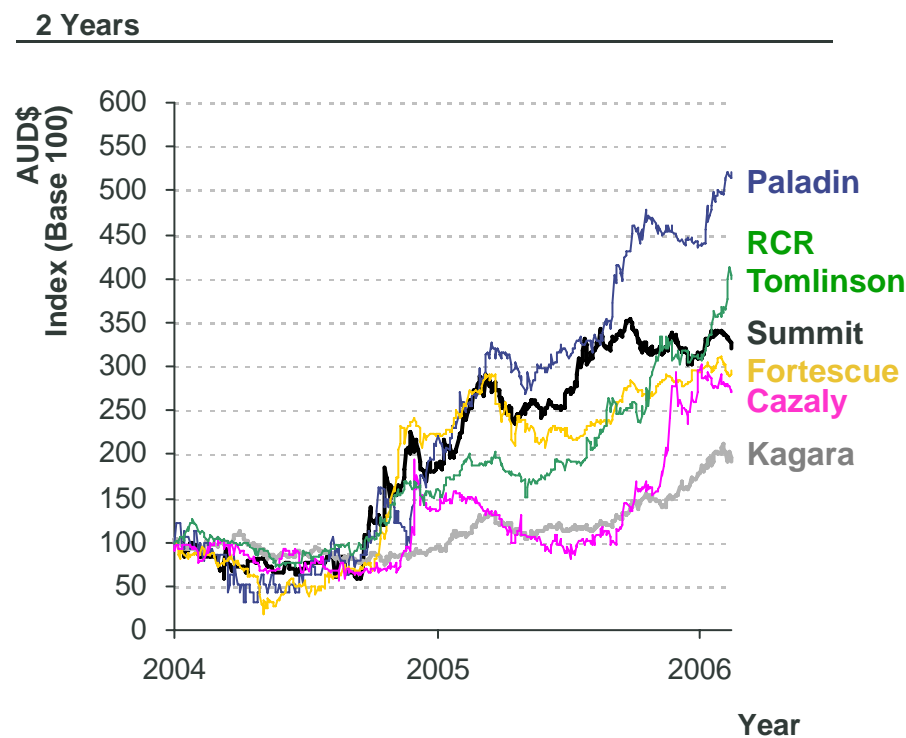
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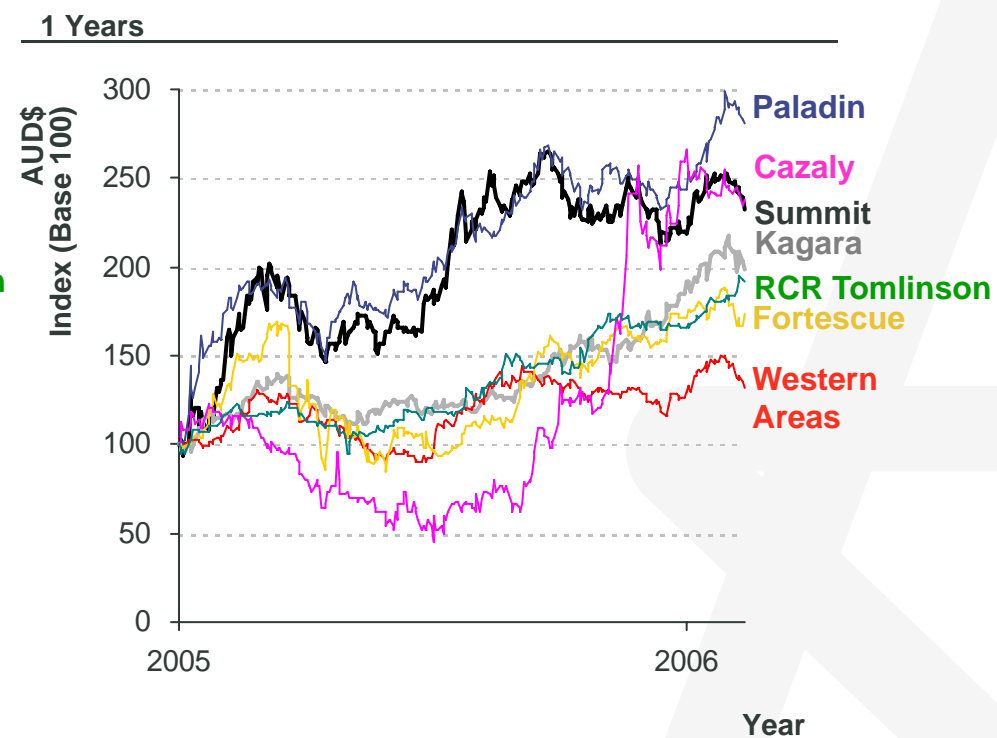
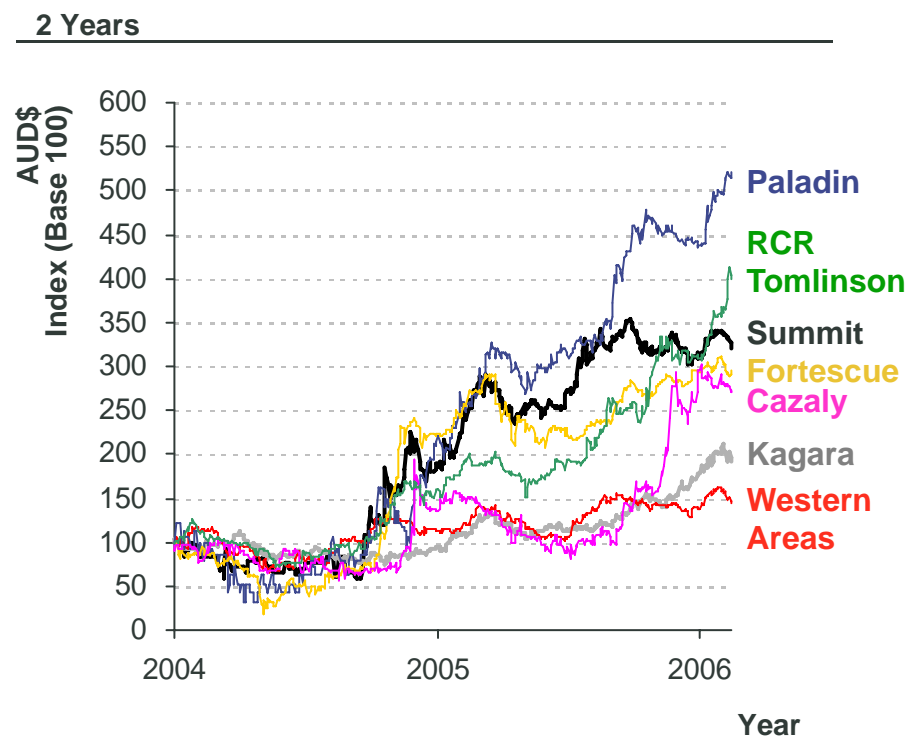
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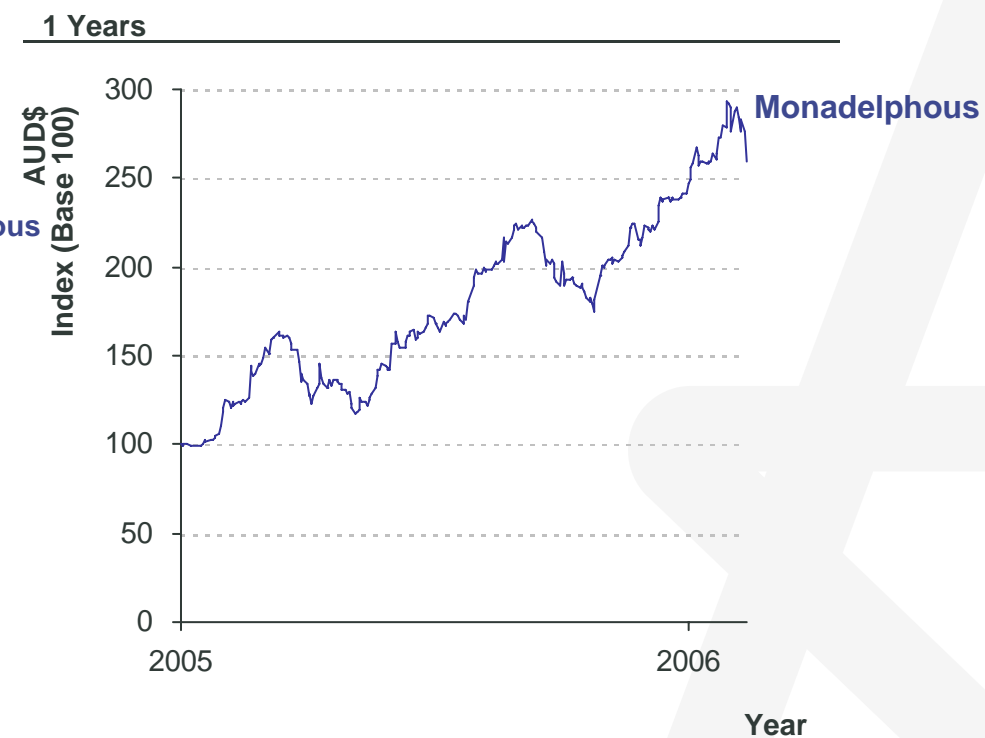
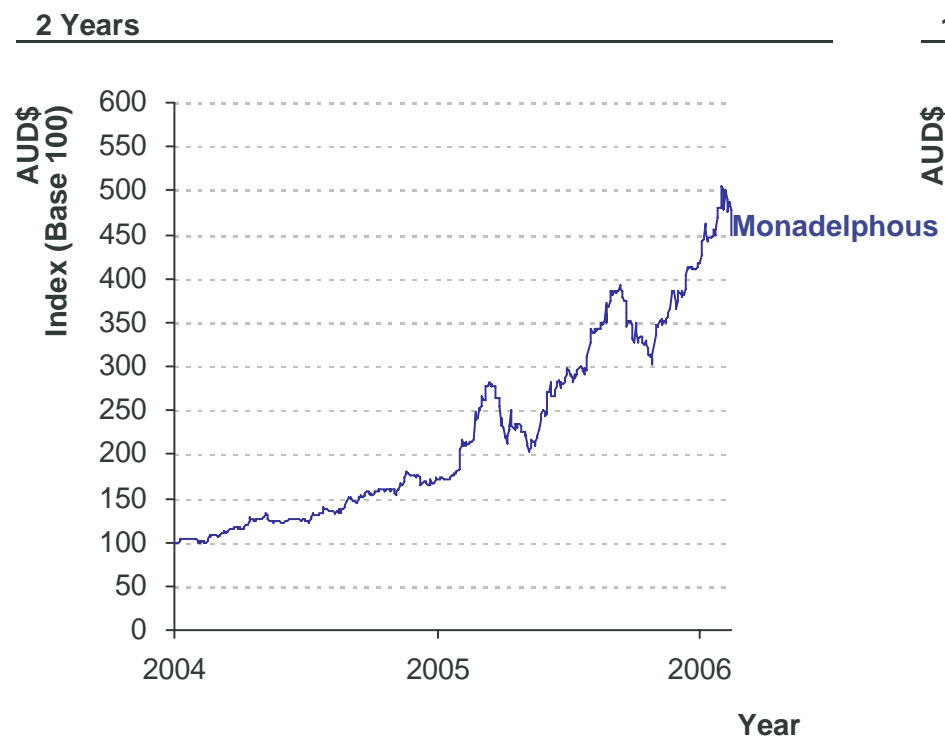
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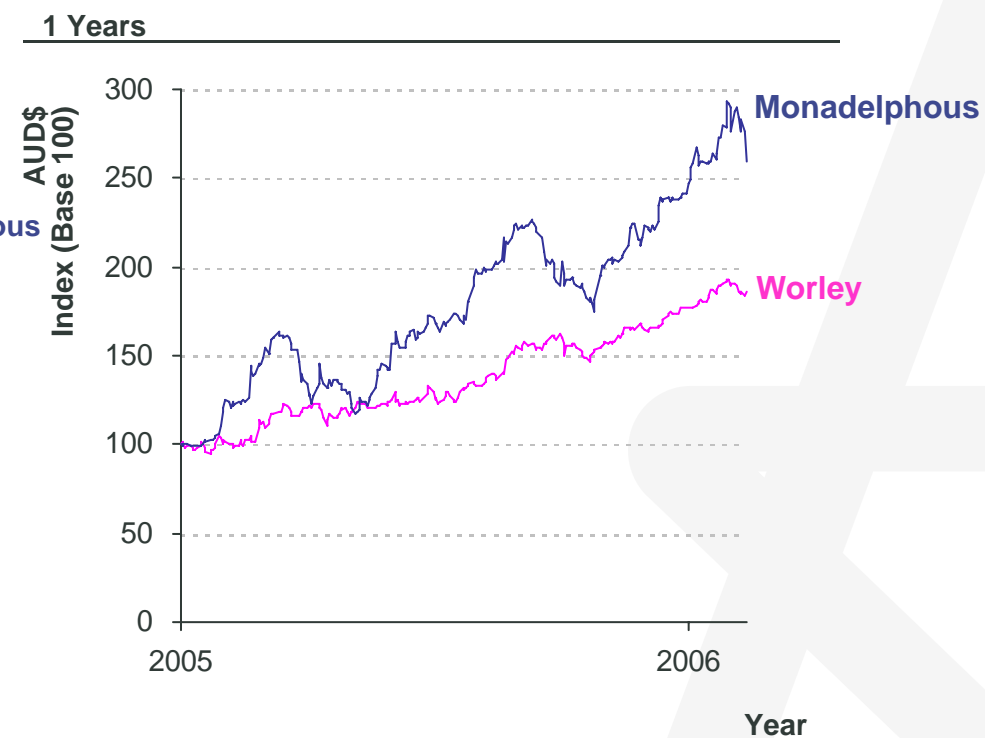
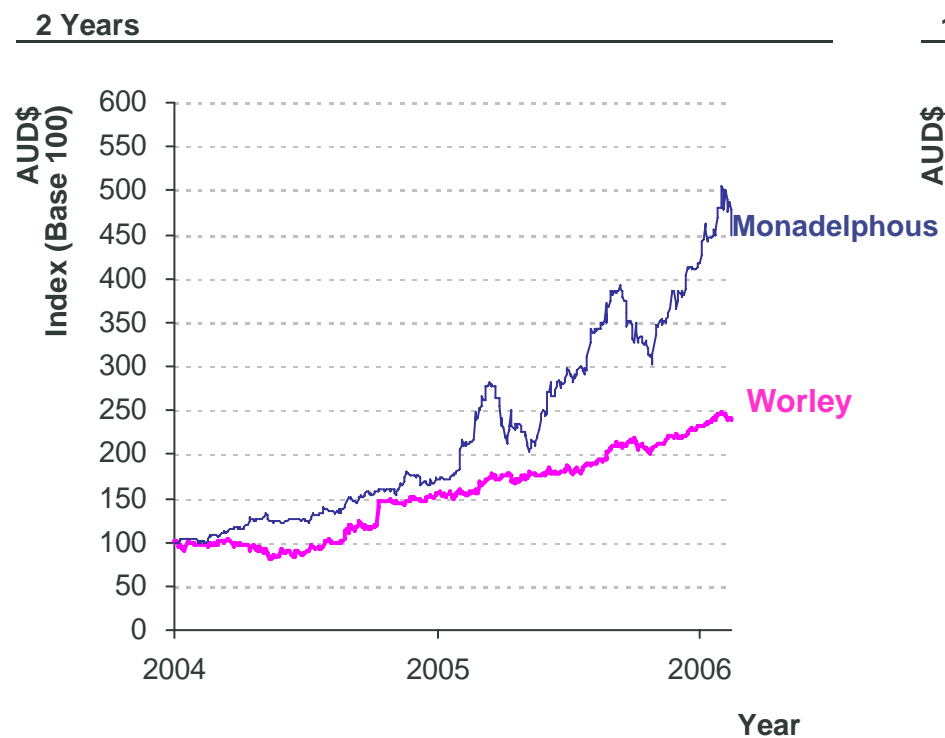
National Performers



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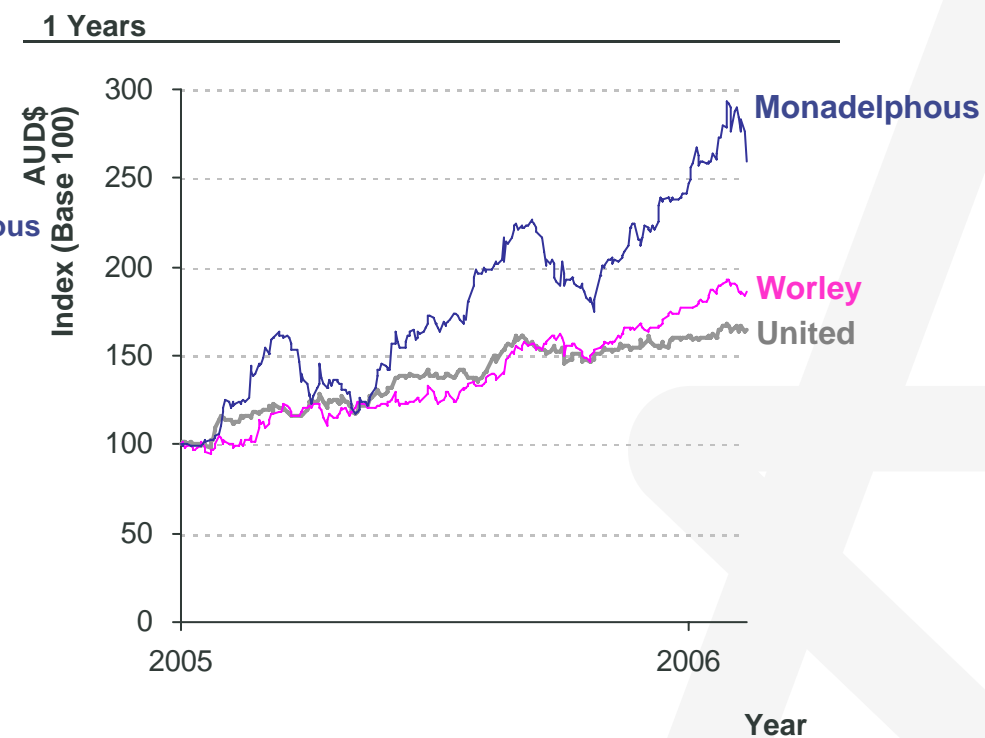
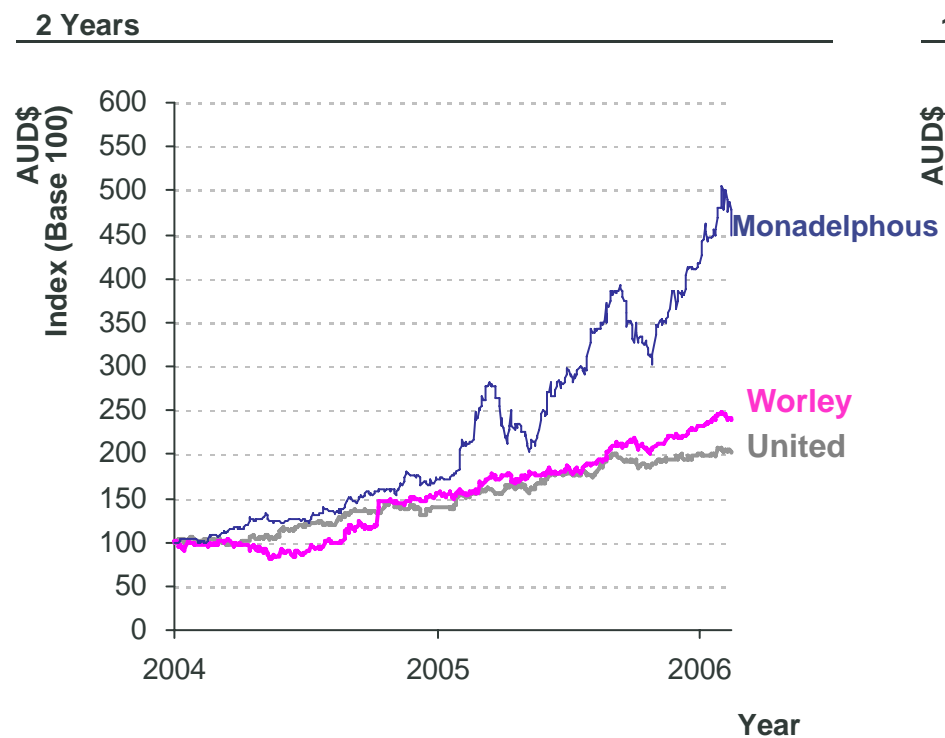
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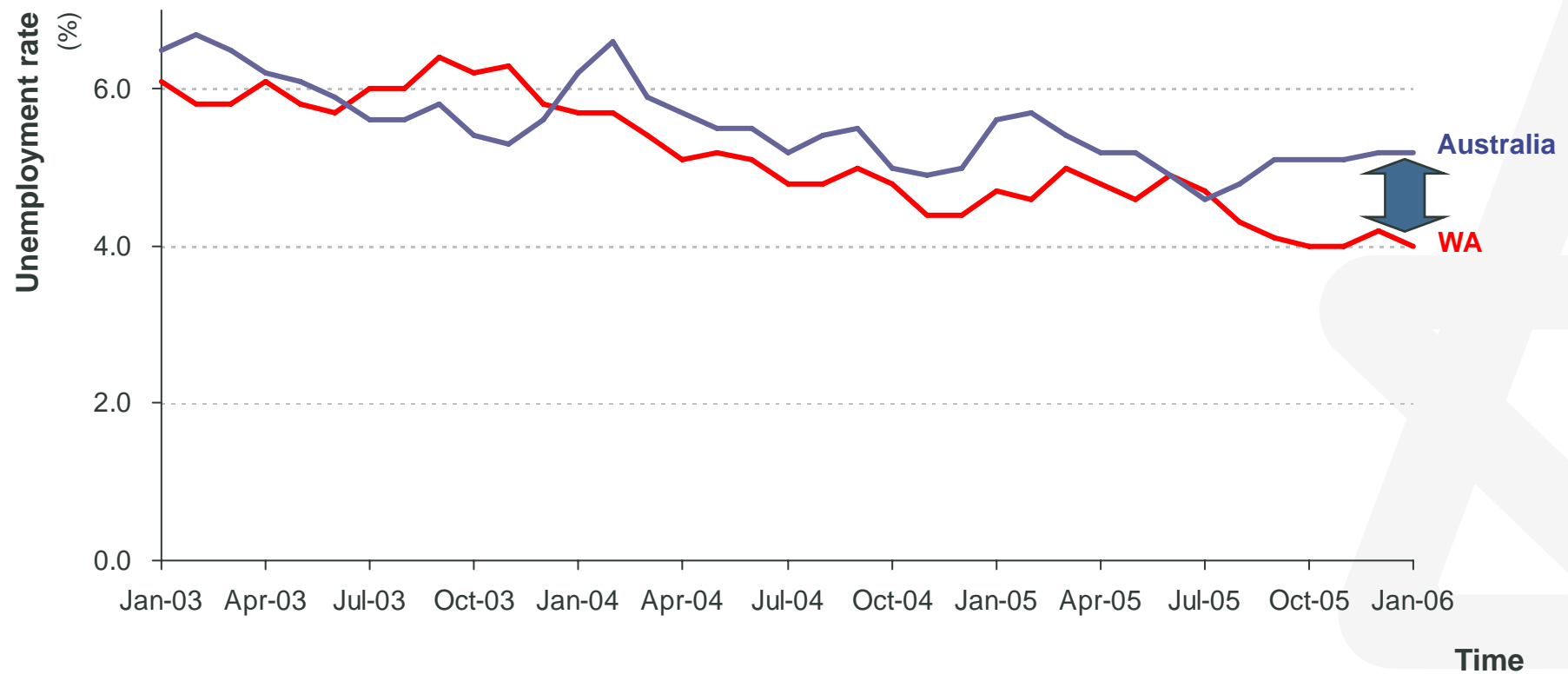


Source : Bloomberg

The unemployment rate in WA has fallen as a result and labour availability is an issue.

Unemployment rate

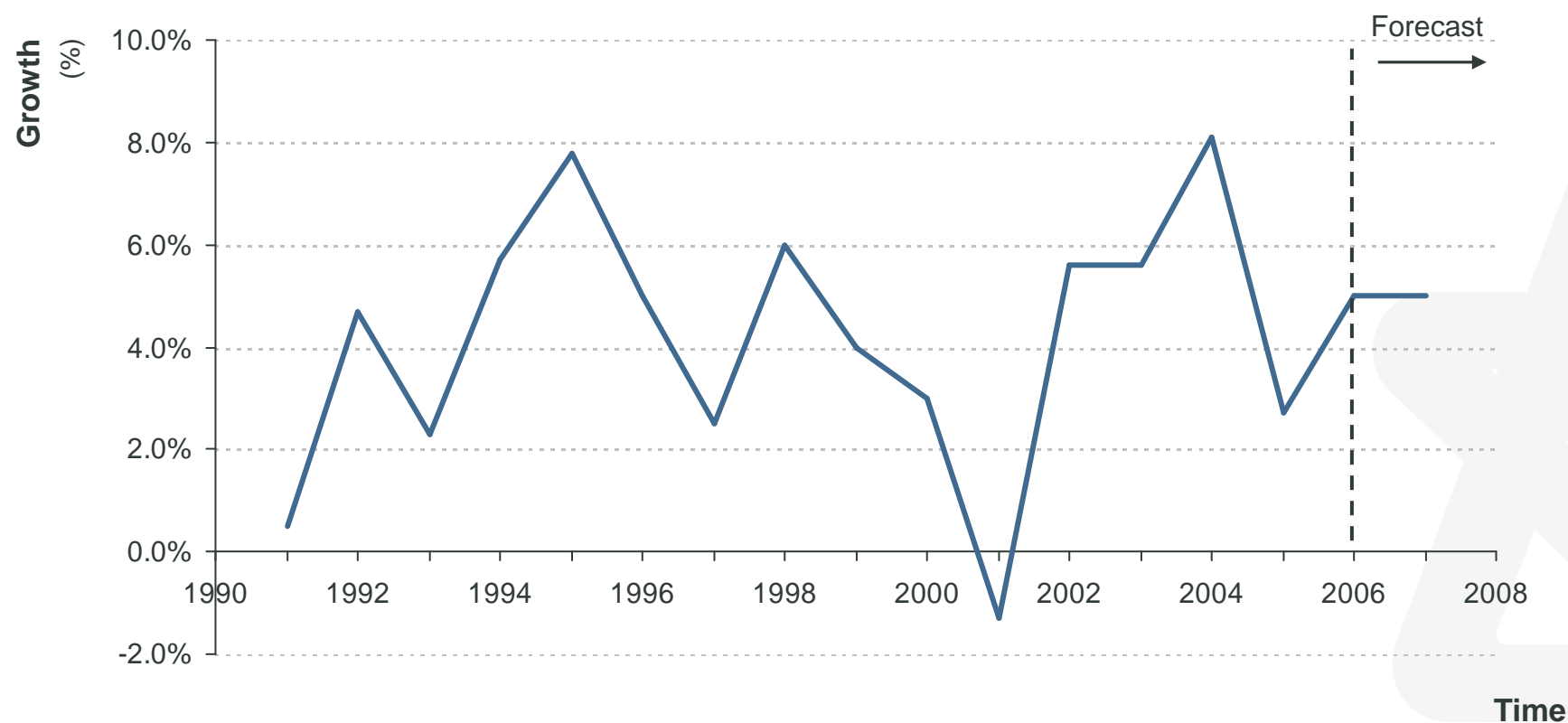
Western Australia v Australia



Source : Bloomberg, Australian Bureau of Statistics

WA's leverage to Asia provides a favourable economic growth outlook.

WA Gross State Product Growth



Source: Bloomberg, Western Australian Department of Treasury and Finance

- Australia (particularly WA) still basking in the China effect glow.
- Stock and property markets (particularly in WA) have been exceptional performers over recent months.
- Future performance will be driven by global, not domestic, factors.
- Cracks appearing in macro/global environment.
- Will see financial markets react first, then property.
- Sheer amount of real and committed money being spent in WA means time to prepare.



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