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QUARTERLY REVIEW – DECEMBER 2009

The 2009 calendar year closed with the All Ordinaries posting its strongest yearly increase for 16 years, rising by just on 33%. The market gain since the low in early March'09 was even more impressive with the index rebounding by around 50%.

The Australian economy avoided recession thanks largely to Chinese demand for our resources, together with very accommodating fiscal and monetary policy. Indeed the shallowness of the local downturn will throw up some unique challengers for the domestic economy as we move into 2010 – see "Victims of our own Success".

Political Expediency Becomes Fashionable in the US

Banks have long been an easy political target here in Australia – a situation that has been reasonably unique to this country. However, with the GFC and the virtual collapse of the banking system in the US, the US voter now has a potential scapegoat for their economic woes. It has, however, taken the recent loss of the safe senate seat in Massachusetts (Ted Kennedy's former seat) for Barack Obama to realise this same "truth". The voter reaction in Massachusetts has been portrayed as a backlash (by main street) against Wall St. Its hardly surprising then, that hot on the heels of the Democrats Senate loss, Obama has recently announced his intention to consider a raft of new legislation including disaggregating wholesale and retail banking operations, capping deposits and new taxes on banks. The market reacted very swiftly (and negatively) to these potential initiatives. This is a worrying turn of events and as investors interested in the efficient functioning of equity and financial markets we can only hope that this is largely political rhetoric on Obama's behalf and that much of the legislation doesn't make it off the drawing board.

Alignment of Australian and US Markets

We continue to talk about the potential for the fracturing of the nexus between Australian and US equity markets and there is now emerging statistical evidence to support this thinking. Whilst the Australian Market rose by 33% in 2009, the US share market (Dow Jones) rose by only 19%. A further interesting statistic comes from CommSec regarding market correlation – over the last quarter of 2009, market correlation between the Australian and US markets stood at only 0.32 whereas historically it has been around 0.96 (a reading of 1.0 means the markets are perfectly positively correctly). Clearly investors in the Australian market (note we are not just talking about Australian investors) have made separate judgements about the prospects of the economy and companies here versus (say) the US. We flagged this last quarter and we see this as a good thing over the longer term, however from time to time, this may lead to added volatility in the Australian market.

Its Still About China

With each quarter that goes by we find it necessary to revisit some aspect of the Chinese growth story. Last quarter we took the opportunity to talk about the breath taking rebound in Chinese final demand in part fuelled by the significant Government stimulus. Most recently, there has been talk about the potential slowing of demand brought about by the Chinese Government's increase to bank reserve requirements and related qualitative measures designed to slow bank lending. The market has reacted (unjustifiably) very negatively to these measures. This is not a bad news story; it is in fact reassuring news and reflects action that is supportive of ensuring sustainable growth. The Chinese authorities appear to be doing a surprisingly good job in finessing the economy.

Fundamental versus Technical Forces

You will often here us talk about "fundamentals" – as investors it is the longer term elements of economic performance and company earnings that shape the price (or return) we can expect to receive from investing in a particular market or stock. In this regard, macro-economic measures (eg GDP) and company specific metrics (such as earnings growth and price/earnings) will ultimately determine the price at which a stock should trade.

However, in the short term, there are a lot of additional factors that can influence the direction of a market or a specific stock and sometimes in a way that may be contrary to its longer term value drivers. These shorter term influences are known as technical factors and can relate to the volume and direction (ie short or long) of futures/options trading in the markets, together with consideration of the patterns in which markets have historically moved (referred to as charting). The interesting thing is that the technical view of a market can literally change within the space of 48 hours, depending upon the momentum in the market. What may be called as a bullish pattern on Monday, may develop into a bear pattern or down leg by Thursday.

As investors (with a longer term focus), we are primarily motivated by the fundamental aspects of markets and stocks. However, in the short term, particularly if we are looking to move cash into or out of the market (or potentially if we are trading options as part of a client portfolio) we will be interested in what technical forces may be impacting the market.

Victims of our Own Success

As noted in the introduction, Australia faces a number of unique challenges as we move into 2010. The first and most obvious fact is that interest rates here in Australia have commenced their march back up – the emergency settings put in place by the RBA in response to the GFC are being steadily (and quickly) backed-out. In the US and Europe it is anticipated that monetary policy (ie interest rates) will remain unchanged for the better part of the year.

The second issue that will confront the Australian economy, again unlike other developing countries, is a relatively quick turn-around in unemployment, which contrary to early forecasts appears to have peaked at just under 6%. Whilst this is generally seen as being a good thing, it does point to a short to medium term lack of capacity – unlike after other recessions where there have been queues of unemployed that could be brought on-line to meet rising demand, we are likely to face labour constraints sooner rather than later. Broader supply side constraints will also become evident in the resource sector as the large miners struggle to meet rising demand from China, India and in due course, the US. Similarly, our housing market has not been as adversely affected by the GFC and again, supply is a key issue. These developing supply side or capacity constraints will put upward pressure on prices (across the board) which may flow through into inflation and, in turn, interest rates. Australia will be in a relatively unique position amongst developed and developing nations in having to confront these supply problems so early in the recovery.

PROSPECTS FOR 2010

The first part of 2010 is likely to see momentum growth in equities driven by earnings upgrades, continuing improvement in economic indicators (particularly out of the US), liquidity and M&A activity. A few quick points of elaboration:

- Broader macro economic trends are likely to remain accommodative. The thing that will make the recovery sustainable is translating these green shoots into **demand growth**, specifically in the US.
- Volatility is likely to remain a feature for the medium term as the market remains sensitive to evidence that growth is not accelerating – this will be the case particularly for the Australian market and (by inference) the Australian dollar which are seen as part of the global "risk trade" (ie when global risk appetite increases, so to do our equity markets and currency; when risk appetite falls, so to do our markets and currency). Whilst some are calling a reduction in share market volatility over 2010, we think we are likely to witness more **"volatility spikes"** as investors and traders rotate between countries, sectors and stocks based on relative valuations.
- Whilst we remain essentially positive for the Australian equities market in 2010, an increase in size, speed and duration of the aforementioned volatility spikes is cause for some concern, particularly in instances where gearing or mark- to-market analyses is taking place each day.
- The US Profit reporting season is underway and, to this point, 75% of results have been on the positive side of expectations. The Australian **profit reporting season** commences in a week or two and we expect a moderate pick up in earnings - current margin and earnings forecasts look conservative across most industries. The so-called "confessional period", the weeks preceding the quarterly profit reporting period, has been relatively quiet, with most of the announcements involving upgraded earnings or upbeat sales guidance.

The second part of 2010 is likely to contain a little more "risk" and continued growth in equities will be a function of sustainable US demand, an orderly and measured unwinding of stimulus and (particularly for we here in Australia) continued demand for commodities from growth orientated countries. We expect to see a recovery in the USD late in 2010 as economic momentum builds and as the prospect of rising US interest rates draws nearer.

The risks to our relatively positive view about equity markets in 2010 remain the US economy (potential for double dip if final demand does not pick up or if authorities miss-time the removal of stimulus); or a worsening in the sovereign debt circumstances of the so-called PIGS (Portugal, Ireland, Greece and Spain).

A number of brokers have documented forecasts about where they see the Australian market (S&P/ASX 200) finishing at the conclusion of calendar year 2010 (see over):

	ASX 200	Implied Growth
Deutsche Bank	6,000	28%
Goldman Sachs JBWere	5,700	21%
CommSec	5,600	19%
Macquarie	5,576	19%
UBS	5,300	13%
RBS (ABN Amro)	5,300	13%
Morgan Stanley	5,165	10%
JP Morgan	5,000	6%
Average	**5,455**	**16%**

NB : These growth levels **exclude** dividend benefits, which may average around 3 to 4%

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Overweight):** Australian PEs are looking a little tight at present, however we continue to look to opportunistically add to client portfolios (ie buy the dips). Thematically we have a continued preference for large cap stocks, and a bias towards cyclical stocks (including banks, financials, resources, consumer discretionary and energy)
- **Global Equities (Slightly Underweight):** Relative to last quarter we're looking at a slight rotation back towards international equities (based on valuations). We continue to prefer benchmark unaware and Asian-focused funds, with potentially some developing market exposure where appropriate.
- **Property (Underweight):** There are still many question marks hanging over this sector and the risk remains to the downside. Broader equities continue to represent better value (growth and yield). Historically, listed property has been more appropriately placed as a later cycle play.
- **Fixed Interest (Neutral):** We continue to favour bank debt (preference securities) which offer guaranteed margins above floating market rates (eg 90 day bank bill). With interest rates likely to rise, bond funds should be avoided.
- **Cash (Slightly Overweight):** As a result of underweight positions in global equities and property, cash remains slightly overweight to target.

Regards

Andrew & Stephen