Suite 1, 20 Bundaroo St
Bowral NSW 2576
Tel (02) 4862 3724
Fax (02) 4862 3735
PO Box 1668
Bowral NSW 2576

QUARTERLY REVIEW – DECEMBER 2010

The Year 2010

In economic terms, 2010 was a very successful year with the global economy rebounding from the depths of the GFC to grow by around 4.5%. It is fair to say that most of the expansion in economic activity was posted by developing & emerging nations - key amongst these being China, which moved up another peg during the year to be the second largest economy on the planet.

In Australia, annual growth looks like finishing at around 2.7% pa (just under "normal" levels), inflation is low (courtesy of rising interest rates) and unemployment remains at historically low levels.

Unfortunately, the improving economic circumstances did not translate directly into the local share market, with the S&P ASX200 actually falling by 2.6% (before dividends) over the calendar year - admittedly, this was after posting a 30.8% rise in 2009. Investors were spooked by talk of a double dip recession in the US, concerns over the European debt crisis and the prospect of an overheated Chinese economy. The strengthening Australian dollar was also a deterrent to foreign investors who account for over 40% of the local share market and are a key source of new liquidity.

Recovery in the US – a Precursor to Improved Equity Returns

The uncertainty surrounding the macro economic elements referenced above creates correlated uncertainty in equity markets. There were synchronised "legs down" in global equity markets in late April when Greece was bailed out by the European Union and again later in the year when Ireland was forced to accept a restructuring package. Similarly, in June when there was talk about the US falling back into recession, global markets headed south. These risk-led corrections were hardest felt here in Australian where our market is more leveraged to growth – meaning that we bounce higher as sentiment improves but fall further when risk appetite dries up.

The Chinese authorities have proven time and time again that they have the political intelligence and foresight to subtly manoeuvre the Chinese economy in order to achieve the right balance between growth needs of the broader economy and the prospect of rising inflation. In terms of Europe, commentators now correctly refer to the PIGS as a "political issue" which is at the "periphery" of economic concern in that part of the world. When you examine the economic contribution of the European nations experiencing difficulties, the magnitude of any debt problem is put into its proper context. The only legitimate "drag" on global growth/equity markets is therefore the state of the US economy, and a contemporary analysis of key data confirms that this patient too is well and truly on the mend.

Recent Goldman Sachs research into the US economy concluded that:

- Manufacturing showed a clear and broad-based acceleration in activity
- The decline in USD GDP had been well and truly arrested
- Lending standards (ie the measure of the ability for businesses to access credit) continue to ease

- Private payrolls/employment are rising
- There is clear evidence that the savings rate has stabilised giving consumers the capacity to spend – aided by the recent decision of the Congress to extend tax cuts
- US corporate cash holdings are at historic highs – companies will either need to hire, make capital investment or return to shareholders (all positive for equity markets)
- Spending on Cappex (investment in equipment and software) is at levels not seen since the late-seventies and early eighties.

At the time of writing, the latest private sector employment figures have just been released and these indicate jobs growth of 297,000 positions in the month of December, which was **three times** higher than consensus forecasts and represented the biggest monthly increase in history. Further, a report on the non-manufacturing sector (ie services) turned in its highest reading since 2006.

In concert with the broad-based recovery now underway in the US, both fiscal policy and monetary policy (including the recent second tranche of quantitative easing – QE2) remains very accommodative.

India – the next China

The factors that we expect to support solid growth in Australian equities in 2011 continue to be those that have provided assistance in the last couple of years. The domestic economic outlook is very sound, our financial and banking systems are robust and demand from China, and increasingly India, is providing above average stimulus to our economy.

We believe the China story still has a long way to run and that authorities there will continue to strike the right balance between growth and inflation. The other emerging factor over the next few years will be India. In a recent Barclay's Capital report it was projected that over the next 4-5 years India's primary energy demand will increase 50% and its metals demand by over 80%. According to forecasts by McKinsey Global Institute, to cope with rising demand, India will have to build 700-900 million square metres of residential and commercial space each year up to 2030 – the equivalent of adding one Chicago every year; and build 350-400km of metros and subways every year over the same period. The world will need a strong supply response in the next few years to satisfy this expected increase in demand.

Barclay's analysis concludes that India is around 10-15 years behind China in its urbanisation process and the expansion set to occur over the next decade will be without precedence.

The Challenge of Managing a Two-Speed Economy

Here in Australia, there has been much talk about the "two speed" economy. In short, mining and resource companies (together with those enterprises directly linked to these sectors) are driving much of Australia's growth.

In this context it is relevant to note that the Reserve Bank manages inflationary expectations with a "one size fits all" approach to monetary policy (if we were being disingenuous we could opine the use of the interest rate "sledgehammer" to crack the inflationary "walnut"). The fact that it might be only one area of the economy or one or two states that are experiencing above average growth is not a concern for the RBA. As inflation moves outside their preferred range, the RBA jacks up the official cash rate. This is how their role in moderating economic growth and keeping the inflationary genie in its bottle has historically been defined.

The fact that growth in the majority of states might actually be negative, or that consumer confidence has fallen off a cliff, is not within the scope of the RBA charter. A more holistic or pragmatic approach to monetary policy is likely to be required, but we doubt the RBA will chance its hand. This then means that it is up to fiscal policy (ie the Federal Government) to manage the distributional shortcomings of the myopic impacts of monetary policy.

We would also note that at this point in time, there are some rather unusual forces at play:

- Significant government fiscal (GFC) stimulus is being rapidly withdrawn

- Commercial interest rates have and may well continue to rise at a rate greater than the RBA cash rate (the GFC has fundamentally impacted bank funding costs)
- There are no further reductions to income tax rates/thresholds in the pipeline (these have had the effect of significantly cushioning the impact of tighter monetary policy over the last decade)
- Consumer savings levels have actually jumped materially
- Both the private and corporate sectors continue to deleverage

These trends are largely unprecedented in nature – they present a fundamentally different landscape in which monetary and fiscal policy will need to function. Our concern is that, to this point, neither Glenn Stevens (RBA Governor) nor Julia Gillard/Wayne Swan have acknowledged the challenge of our current circumstances.

Increased corporate tax receipts will naturally flow from the profits of the large resource and mining companies (assisted to some extent by the proposed mining tax) and GST receipts will also increase. However, what the Gillard Labor government will need to come to grips with sooner rather than later is the budgetary/fiscal framework by which they will transfer wealth, **in a timely and non-inflationary fashion**, from the high-speed sectors/regions in the economy to the low speed areas. The emerging gap is looking to be ominously large and they will need to turn their minds to options for stimulating the consumer and non-resource business sectors sooner rather than later.

Looking Forward – the Crystal Ball for 2011

Without exception, the major investment banks and research houses see 2011 as being a much more profitable period for the Australian share market. Based on a combination of an expansion in PE plus reasonable earnings growth, the crystal ball gazers see the following potential in the Australian market ((before dividends):

- UBS - 5,600 Dec'11 (18% annualised)
- CitiGroup - 5,300 Dec'11 (12% annualised)
- Macquarie - 5,387 Sept'11 (18% annualised)
- Deutsche Bank - 5,400 June'11 (26% annualised)
- Commsec - 5,400 Dec'11 (14% annualised)

The resource sector and related engineering/services areas are likely to continue to be direct beneficiaries of the type of growth foreshadowed above. However, the share prices of the big miners (ie BHP & RIO) now incorporate much of the upside in commodity prices and anticipated supply side responses.

This "beta", or market related return, has largely been factored-in; so the question (particularly in the mining & resources sector) is how best to access the alpha that might arise from the development and production growth opportunities in the mid-cap mining sector. We are in the process of finalising our research on how best we might be able to bring this potential "alpha" to bear in client portfolios; so stay tuned.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Overweight):** We are at a point where we are looking to opportunistically edge-up allocations to Australian equities
- **Global Equities (Slightly Underweight):** We continue to prefer benchmark unaware and Asian-focused funds.
- **Property (Underweight):** Still too much uncertainty around this sector and the risk remains to the downside.
- **Fixed Interest (Neutral):** We continue to favour bank debt (preference securities) which offer guaranteed margins above floating market rates (eg 90 day bank bill), together with some bank term deposit exposure.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes cash remains slightly overweight to target.

Regards

Andrew & Stephen