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Dear Client,

QUARTERLY REVIEW – MAY 2012

After a positive start to the 2012 year for global equity markets, concerns in Europe have again bubbled to the surface and with the inconclusive elections in Greece earlier in May and the prospect of peripheral nations seeking to renegotiate previously agreed austerity packages, investors of all persuasions have headed for the exists.

We flagged in our last quarterly review that whilst the market may move higher in the short term, "some type of technical correction in late Q1 or Q2 would be on the cards". The extent of this actual correction has been more significant than expected with selling being fueled by concerns over Greece's continued survival in the Euro. Markets hate uncertainty with a passion – it equates to risk, and risk aversion is currently the dominant theme in markets.

It is only fitting therefore that we again spend time examining issues in Europe. We'll also look at Australian resource stocks and offer a brief comment on the Federal Budget 2012/13.

Greece – to exit or not to exit, that is the question

In Greek elections on 6 May'12, radical parties from the left and right (campaigning on a platform of opposition to the EU austerity measures) polled in line with the established political parties. However, none of the parties were able to form a coalition government so now the Greeks will have to go back to the polls on 17 June in an election that is being portrayed as a vote about Greece's future in the Eurozone.

The issues related to Greece are many and varied, but when you strip it all away the problem now is not so much an economic or financial one – it is largely political in nature. What we are seeing in Europe at the present time is a very dangerous game of political chicken. All parties involved in the stand-off (the Greek parliament, the minority and majority Greek political parties, the Greek people, Angela Merkel, the German government, the EU leaders, the European Central Bank (ECB) etc) know that everyone is better off with Greece in the Eurozone. You would think then that if this were the case, that a solution could be quickly agreed. But the political stakes are very high.

Syriza (the left wing Greek political party) has campaigned on a platform of anti-austerity and have threatened to take Greece out of the Eurozone if the previously agreed measures can't be renegotiated. The reality is that the impact on the Greek people arising from an exit from the Eurozone would be many times greater than that which will be inflicted via the proposed austerity measures. The IMF has estimated that if Greece left the Eurozone its GDP would immediately drop 10%, the new drachma would devalue in relative terms by around 50% and

inflation would jump to around 40%. This is not too mention the cost that would then be inflicted upon the EU as it would be forced to take action to quarantine the effects of the reverberations of an exit.

As we highlighted last quarter, the Germans/EU know only too well that at some point the peripheral EU nations will need to be provided with economic stimulus to ensure their survival. They are simply intent on getting as much structural/fiscal reform out of these nations before putting any sweeteners on the table. The inescapable reality is that the better performing economies need to provide financial support for the poorer performing peripheral nations. It is understandable that German tax payers are reluctant to dig further into their pockets to bail out a series of smaller nations who have for too long resisted the need to reform their own fiscal situations (ie living beyond their means). However, the Germans also need to acknowledge that since the formation of the EU and the floating of the Euro, their economy has benefited from an artificially low currency that has had the effect of delivering economic growth over and above that which the Germans themselves would have been capable of delivering in their own right under the auspices of the deutschmark.

The Greeks (and other peripherals) have to start living within their means (hence the austerity measures), and the Germans have to start paying back a few of their free lunches (stimulating growth and funding support for the EU banking system and debt markets).

Proponents of a Greek exit from the Eurozone rightfully point out that Greece is only a very small part of the Eurozone (less than 3%) and an even smaller proportion of the global economy – in fact, in economic (GDP) terms, China produces a "Greece" every 3 weeks. However, it is not the immediate effects of a Greek exit that we should be worried about, it's the fear of the unknown – who might be next and how would other individuals, companies and Governments in the EU behave in that situation?

Whilst the direct costs to the Eurozone of a Greek exit are not significant in the broader scheme of things, the **indirect (or flow-on) costs** to the EU banking sector and sovereign bond markets could be breathtakingly large. As markets have consistently evidenced over recent years, they do not like uncertainty – lack of confidence has a huge cost. If Greece were to exit the EU, the question then arises, who might be next? Confidence in other peripheral Eurozone nations would be undermined and there would probably be an immediate run on the banks of nations such as Spain, Italy Portugal and Ireland. The ECBs LTRO programme (already funded to USD 1.8trillion), which has done so much to support the liquidity positions of European banks, has been designed to cover-off only the banks known wholesale funding requirements – not replace most of their retail and commercial deposit base. In addition, the price that these countries would then pay for their debt at government bond auctions would jump significantly. This flight to quality is already happening now with Germans being the beneficiaries – German 3 year bond rates have actually fallen to (or below) zero over recent weeks. If a rate of 6% is currently considered high for Italian or Spanish bonds, interest rates on these bonds could double should Greece exit the Eurozone.

There are things that the EU could do to mitigate concerns in these circumstances, but the cost would be enormous. The ECB would need to step in and provide an EU wide bank deposit guarantee and they would also need to underwrite EU sovereign debt markets (ie quasi Euro bonds). If the Germans think the cost of keeping the Greeks in the EU is unpalatably high, wait until they have to make a down-payment on the costs that they would bear should Greece leave.

Spain – a slightly different set of issues

Whilst the problem that Greece confronts is largely one of Sovereign debt (ie the government being unable to pay its bills) the source of the potential problem in Spain is somewhat different. The government-debt to GDP ratio in Spain is only around 70% (actually less than

that of Germany) – whilst for Greece, the ratio sits at 132% (see table below). Moreover, the Spanish economy is actually the 12th largest in the world and around 5 times larger than Greece. Spain's problem is not so much to do with a lack of economic activity or the level of its sovereign debt, but a potential excess of corporate debt; which simply translated means that the risk in Spain lies within their banking system.

OECD GVERNMANT, CORPORATE & HOUSEHOLD DEBT TO GDP - 2010

% GDP	Government	Corporate	Household	Total
US	97	76	95	268
Japan	213	161	82	456
Germany	77	100	64	241
UK	89	126	106	321
France	97	155	69	321
Italy	129	128	53	310
Canada	113	107	94	314
Australia	41	80	113	234
Austria	82	99	57	238
Belgium	115	185	56	356
Denmark	65	119	152	336
Finland	57	145	67	269
Greece	**132**	**65**	**65**	**262**
Netherlands	76	121	130	327
Norway	65	174	94	333
Portugal	107	153	106	366
Spain	**72**	**193**	**91**	**356**
Sweeden	58	196	87	341

Bad and doubtful debts already account for over 8% of the loan portfolios of Spanish banks (in Australia, they are around 1-2%). As these debts are written off, this reduces capital levels. Global prudential requirements for banks usually specify a minimum amount of capital to support their loans and related risk exposures (typically 8%). Short of trying to reduce their level of lending, Spanish banks may well require more capital in the short to medium term.

In more recent times the Government has been forced to step into the breach and provide further capital for the 4th largest Spanish bank, Bankia, after it revealed further significant write-offs associated with its bad debts. In actual fact, Bankia was always going to require further propping up after it was created as part of a "shot-gun wedding" between several troubled regional saving banks during the aftermath of the GFC. This was only ever an exercise of kicking the can further down the road and now the Government has been forced to partially nationalise Bankia.

Whilst the other major Spanish banks have said that they will not need more capital (of course assuming that their bad debt position does not deteriorate further), if more capital is required, the trick will be for it to be provided from a source other than the Spanish government. If it is the government that funds the support, all that will happen is that the Government debt to GDP number above (72%) will increase materially. Assuming that private capital might be hard to come by, the next best solution for the Spanish bank situation would be for the ECB to cover any capital shortfall for the Spanish (or other EU) banks. This is consistent with the ECB charter, which does not allow it to directly support EU sovereigns (governments) but does allow it to take action to ensure the stability of the Eurozone banking system.

axiom

A few words about Australian Resources Companies and China

Buy, buy, buy…..

Whilst not wanting to appear too glib about the current depressed prices of Australian mining companies, their current levels represent some of the best buying opportunities we've seen for almost 25 years. Both BHP and RIO are trading on price earnings (PE) ratios of around 7x to 8x and are trading at discounts of up to 50% to their net present values.

Clearly, their share prices have fallen in conjunction with the "risk-off" trade griping global markets and also in sympathy with falling commodity prices. Underpinning these falls has been the fear of a significant falling away in Chinese demand. Again, we think the impact of the managed slow down of the Chinese economy has been over-estimated. Finally, the market also has concerns about the proposed magnitude of capital spend on projects over the next 5 years and the impact that this has on cashflow, particularly when it occurs in preference to more active capital management (eg increased or special dividends).

Whilst resource prices may fall further over the next month or so, we are reasonably assured that investors will look back on this time in twelve or eighteen months time and opine the fact that they should have bought more Australian mining stocks at current prices.

In terms of China, Glenn Stevens (the Governor of the RBA), in a recent address, took the opportunity to subtly remind us all about the longer term growth story for China, stating ".. *the Chinese economy will grow pretty strongly on average for a while yet. It will be a very large economy. Even at the new growth target of 7.5% (targets which the Chinese have consistently bettered over the last 5 yeas), Chinese GDP will equal that of the US in purchasing power parity terms within the decade. It will exceed that of the Euro area within the next 5 years*.

The 2012/13 Budget – the surplus you have when you're not having a surplus

The ALP federal government has "manufactured" a surplus for the 2012/13 budget period – because it promised that it would. It is important to note that this is a "forecast" only and that last year, for example, the Federal Government was forecasting a $22bn deficit and ended up delivering something more of the order of a $44bn deficit. The Government has notionally declared a surplus of $1.5bn by bringing forward expenditure into the current financial year (estimated to be around $5bn) and pushing back planned expenditure from 2012/13 into 2013/14 (also estimated to be around $5bn). The key drivers of the anticipated turn around in the fiscal position are overwhelmingly tax related – increased company and personal income tax receipts, mining tax, carbon tax, and superannuation tax.

Most disappointingly, the Government chose to make a cheap grab at our superannuation savings. It deferred the introduction of the increased concessional contributions cap for 2 years (saving $1.5bn over the forward estimates) and doubled the level of contributions tax for those on higher incomes (increasing revenue by close to $1bn over the forward estimates). This latter measure is simply the old "superannuation surcharge" by another name. We've been down this path before and it was considered regressive, inequitable and too complex at the time - which is why it was abolished by the former Howard government in 2005. These proposed changes to the superannuation system are nothing whatsoever to do with sensible policy-making or enhancing retirement benefit outcomes for Australians. They will only serve to further undermine people's confidence in the superannuation system, knowing that the current government views it simply as a cash cow that can be harvested when they need to make ends meet.

OUTLOOK

It is often said that the night is darkest just before dawn and the current situation in financial markets is no different. Unfortunately, we know that dawn will not occur until after the Greeks return to the polls on 17 June'12, at the earliest. The EU is aware of what needs to be done to salvage the position of the peripheral nations but it will sit tight until at least after the outcome of the Greek elections is known (the only thing that may force the ECBs hand ahead of this time is if the run on Greek bank deposits becomes unmanageable in the short term).

In terms of the other global influences on our market, the **US** continues to deliver economic data that supports further appreciation of US equities. The recent employment numbers were below expectations, but this was only one month and the other important fact to remember about the US is that, unlike our own RBA, the US Federal Reserve has a "dual mandate", to maximize employment and to keep stable prices. If the rate of decline in unemployment rate in the US is indeed starting to plateau it will only be a mater of time before the Federal Reserve announces further measures to pump liquidity into the US economy (ie QE III).

In **China**, inflation now appears to be under control and authorities have moved to an easing bias. The Central bank has recently lowered the Reserve Ratio Requirement (a mechanism to provide liquidity to the banking system) and the Government has commenced some targeted stimulation of the economy, releasing around $6 billion in consumer spending subsidies late last month. The GDP target for China in the upcoming year is 7.5% and there is next to no chance that the authorities will deliver a number short of this mark.

At present, most equity markets (including Australia) are being sold down on the basis of fear not fundamentals. Technically, the chartists are indicating that we (ASX 200) may need to revisit lows of around 3,850 before recovering. To drop to this type of level in the short term we would need to see some type of "fundamental" catalyst - which could involve a negative outcome from the Greek elections and/or tardy stimulatory responses by European, US and Chinese authorities.

If a pro-EU party (PASOK or New Democracy) forms government after the 17 June Greek elections, then markets should settle quickly, particularly if we see a more accommodating approach from the EU on austerity measures and a heightened desire to deliver closer monetary and fiscal integration. If an anti-austerity party is returned (eg Syriza) we will then see a continuation of the game of political chicken and there will need to be further negotiations over austerity measures. There is still a possibility that even with Syriza in power, Greece may remain in the EU albeit we will have to move pretty close to the edge of the precipice before compromise is reached.

We suspect (and hope) that common sense will prevail in Europe and that Greece will remain in the Eurozone. Once this position becomes clearer and various stimulatory measures are applied both in Europe and by various central banks around the globe, the resultant liquidity is likely to jump-start equity markets. Economic conditions more generally are supportive of global growth moving back towards trend and, on this basis, equity prices will need to rise, if only to better reflect likely company earnings levels over 2013 and 2014. The sun will indeed come out again at some point soon and shine on equity markets.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral/Slightly Underweight):** From a longer term investment perspective, valuations are very attractive – the market may move a little lower in the short term, but some buying opportunities are just too hard to pass up.

- **Global Equities (Slightly Underweight):** The US market is likely to remain more resilient in the coming months. The Chinese share market also appears to have turned the corner.
- **Property (Underweight):** Property is still clouded by uncertainty and typically will hold more attraction as a late-cycle play.
- **Fixed Interest (Neutral):** Market rates continue to fall – the RBA is now in an easing bias and likely to move official rates down again in the next few months. There may be merit in extending the duration (ie, average term) of fixed interest portfolios
- **Cash (Slightly Overweight):** As a result of our positions in other asset class's cash remains slightly overweight to target.

Regards

Andrew & Stephen
4 June 2012