Suite 1, 20 Bundaroo St
Bowral NSW 2576

Tel (02) 4862 3724
Fax (02) 4862 3735

PO Box 1668
Bowral NSW 2576

QUARTERLY REVIEW – SEPTEMBER 2012

Over the last few months global equity markets have moved higher in light of generally positive steps taken towards stabilisation of the situation in Europe and in anticipation of more supportive monetary policy by central banking authorities. Markets in the US and Europe (Germany) are actually up by 12% and 23% respectively, whilst here in Australia the ASX200 has risen by less than 8%, held back by softer commodity prices, concerns over growth in China, inappropriately high interest rates and a stubbornly high Australian dollar.

Thankfully, monetary regulators around the world stopped jawboning and actually put their money where their mouth was this month. In the last few weeks we have seen coordinated action around the globe underpinned by the ethos of "doing whatever it takes".

Much of the uncertainty that has gripped equity markets for some time has now been removed – Greece is staying in the EU, the European Central Bank (ECB) will start buying the bonds of peripheral sovereign nations, the German constitutional court has sanctioned the ECB's response and Ben Bernanke has now confirmed QE3 (efforts designed to further stimulate the US economy and reduce unemployment). For holders of Australian equities, however, these are all "hygiene factors" – that is, they will probably **stop the market from falling**, but they won't of themselves push our market higher.

Europe – Decisive action buys significant time

Mario Draghi (President of the ECB) declared in July that he would "do whatever it takes" to preserve the Euro, but the lingering concern was that the Germans may not let him. The programme subsequently announced by Draghi in early September had much to like about it as it managed to provide definitive action to lower sovereign bond rates, yet at the same time it sort to keep a lid on the inflationary implications of such action and reiterated the need for continued fiscal reform amongst struggling nations.

The ECB will engage in "Outright Monetary Transactions" (OMT) – put simply, they will buy European sovereign bonds (with maturities of 1 to 3 years) in the secondary market with a view to putting downward pressure on that countries bond rates. Importantly there was no timeframe or cap placed on the amount of bond buying that will take place. Also, to appease the Germans, the programme will be "fully sterilised", which means the extent to which the ECB buys one countries bonds (eg Spain) it will sell an equivalent amount of another countries bonds (eg Germany). This means the ECB will not be increasing its balance sheet and will not be adding to the money supply in the EU. Critically, this will limit any potential inflationary impacts – a key prerequisite for German approval. The other important aspect of the ECB's intervention is that it will not seek to subordinate the priority ranking of private bondholders – in other words, it will stand in line with other creditors to get its money back and will not seek to jump to the head of the queue.

Any nation can apply for support under the OMT and the ECB will undertake some due diligence of its finances and, if necessary, look to apply greater fiscal controls. Adherence to any existing austerity measures will be mandatory.

Prior to the announcement in July, Draghi had observed that "the size of the sovereign premia (borrowing costs) were hampering the functioning of monetary policy". The reality is that the fiscal health of nations (like companies) is usually expressed in terms of their ability to meet their borrowing or interest costs. Clearly, the higher the interest rate applied to their loans, the higher the budgetary cost for the sovereigns concerned.

True to his word Draghi appears to have engineered a practical solution that has delivered on his promise to reduce the "sovereign premia". If we look at Spanish bonds, the 2 year rate has fallen from around 7% pa in July to currently sit at just on 3% pa. Likewise, the 10-year Spanish bond rate has fallen from 7.6% pa in July to about 5.7% pa. Draghi 1, skeptics nil.

US – Bernanke once again delivers but at what potential cost

September has been a busy month for Central Bank intervention with Ben Bernanke at the US Federal Reserve (the Fed) also announcing the much anticipated QE3 (Quantitative Easing or money printing as most of us know it). Whilst the third tranche of easing was telegraphed to the market some time in advance, what was unexpected was the potential magnitude of the programme. The initiative aims to buy-back up to USD 40 billion **per month** in mortgage-backed securities which are currently held by US Banks – this puts cash into the hands of banks (which hopefully they will lend-out) and it provides more liquidity into mortgage markets (hopefully stimulating growth in the housing sector). Somewhat surprisingly QE3 is **not capped** either in terms of volume or timeframe – the Fed will keep buying securities until it sees growth pick up and unemployment come down. Bernanke has also indicated that he is even happy to see inflation move towards the top of the Fed's target band as a necessary consequence of this action.

The Fed also announced a continuation of "operation twist" – operations designed to keep longer term borrowing rates (eg mortgage rates) at unprecedentedly low levels.

Whilst the skeptics can point to the unlikely propensity of banks to lend (or indeed individuals & corporates to borrow) in the current environment, the extra liquidity will undoubtedly support equity markets; the housing sector will receive some type of boost and, in due course, consumer sentiment and spending will rise (if only as a result of the "wealth affect" that Bernanke himself exampled).

The other unresolved cloud on the US horizon is the so-called "Fiscal Cliff". At the end of this year there are a number of tax hikes and spending cuts that are scheduled to hit simultaneously, which in total will remove around $600 billion from the US economy (equivalent to around 4% of GDP). In its current shape, the economy could not withstand this type of shock so it is widely anticipated that some type of political compromise will prevail - albeit any compromise will be subject to significant political partisanship in the run-up to the November presidential elections. If there are political stumbling blocks in mitigating the magnitude of the "cliff" it is likely that Bernanke will have the Fed step into the breach and "do whatever is necessary" to ensure continued US economic growth and stability in markets.

The measures announced by the Fed will continue the exodus of funds out of bonds and into US equities.

China – All going to plan; just a little slower than expected

As we have been talking about for some time, Chinese authorities have been slowing their economy to rein-in the impact of inflation. Inflation was running at over 6.5% pa just twelve months ago – most recently, the CPI was sitting at just on 2.0% pa. In this same period, growth has slowed from around 9.5% pa to just over 7.5% pa. This slowing has come at a price for Australian Resource companies and commodity prices more generally. Softening Chinese demand has been further undermined over recent months by de-stocking of iron ore and coal reserves (further lowering demand). In addition, the Chinese Government has also been subsidising uneconomical Chinese miners (who have amongst the highest unit production costs globally). In the normal course, these producers would be amongst the first to down tools with a consequential reduction in supply. However, because the Chinese Government chose to subsidise these providers, supply remained solid. The resultant impact on commodity prices (ably assisted by traders) was significant.

With the inflation genie seemingly back in the bottle, the Central Bank has begun lowering interest rates (and relaxing reserve requirements) and the Government has just announced a $150 billion infrastructure package involving the construction of various new train lines, highways, airports, harbors and utility plants. Chinese provincial governments have also committed further monies to support local projects. Most recently, the Government also announced a series of measures to help stabilise export growth, including faster payment of export tax rebates and boosting loans to exporters.

It is anticipated that the benefits of this extra spending will start feeding through the economy during the fourth quarter 2012. This should see a move back up both in commodity prices and the share values of Australian mining companies.

Australian resources – Boom or bust?

There have been many ill-considered statements about resources over recent times, starting with the pronouncement by the Federal Minister for Resources (Martin Ferguson) in August that “the resources boom was over”. He tried to retrospectively qualify his statement by inferring he actually meant that “the commodity price boom was over”, but he had already set the dogs running in the streets.

In the intervening time, the big miners and the RBA have all provided clarity around exactly what the resource investment pipeline will look like over coming years. Yes, BHP has **deferred** development of the Olympic Dam project (copper, gold, silver & uranium), largely as a result of falling commodity prices and rising cost pressures. If you have a finite resource, why mine it and sell it when prices are artificially depressed. However at the same time, BHP reiterated that their total investment spend in 2012/13 will in fact be $22bn – that is, $2bn or 10% higher than the $20bn they spent in 2011/12. Hardly a developing black hole (if you’ll pardon the pun)

The RBA has likewise confirmed that it is anticipating a peak in mining investment expenditure some time in 2013/2014.

But even this is nothing to get particularly concerned about from a share valuation perspective. Put simply, miners spend money (ie cap-ex) developing tenements with a view to delivering increased production volume down the track. We might see commodity prices settle at lower levels than was the case in 2011/12, however, volumes over ensuing years are expected to be significantly higher and many informed commentators see the volume increase more than offsetting any earnings impact arising from lower commodity prices.

The other thing hurting our miners at present is the artificially high Australian dollar. The dollar normally acts as an automatic stabilising mechanism for resource company profits. As commodity prices fall, usually the value of the Australian dollar also drops. This hasn’t happened on this occasion so the profits of the miners have taken a double hit.

Respected equities analyst Charlie Aiken (Director at Bell Potter) recently interviewed BHP CEO Marius Kloppers who reaffirmed the company's strategy of owning and operating low cost, long life, expandable, upstream assets in low risk jurisdictions. They are exiting non-core assets (witness the recent sale of Richards Bay Minerals - a mineral sand operation located in Kwazulu Natal for $1.9b). The vast bulk of BHP's assets are located in Australia and the USA, with some copper assets in mining friendly Chile. BHP is significantly underexposed to politically unstable geographies.

Kloppers has indicated that BHP is targeting flat cost growth in FY13 and FY14 (maybe even falling costs) and, across its suit of commodities, it will look to increase production volumes by 10% in each of FY13 and FY14. According to our maths, that means BHP will grow earnings by 20% over two years, before factoring in the inevitable recovery in commodity prices from their current levels.

BHP remains structurally bullish on China and considers that they are still in the early stages of urbanization (**iron ore and coal**). But they continue to position their portfolio for the next cycle of growth which will see significant increases in Chinese incomes which will, in due course, lead to significant demand for **potash** (fertilizer to increase protein production), **copper** for electricity, telecommunications & small devices, plus energy (**oil and gas**).

As Charlie reported "*I suspect they are trying to head for a portfolio where in a perfect world iron ore, coal, copper, potash and energy would contribute roughly 20% of earnings each. Back to the truly diversified model where they are profitable every given day due to their place on the cost curve, while the diversification also gives you less volatility of earnings*" (Charlie Aitken, Ringing the Bell, 11 September 2012)

This is a company that knows its markets, has a well-articulated strategy and has an associated roadmap for how to extract most economic value for its stakeholder along the way.

Australia Equities – a recipe for success

The prerequisites for a move higher in Australian equities are twofold:

- Firstly, Chinese stimulus – which, as indicated above, has now been announced and should start flowing through in the next month or two.
- Secondly, the RBA needs to drop official interest rates by at least 0.5%

The RBA has been an institution that has historically extolled the virtues of its forward-looking view on inflation – principally when it came time to pre-emptively moving interest rates up. It is therefore surprising (and somewhat disappointing) how fixated they have been on looking in the rear view mirror when rates need to be reduced.

- Its been painfully obvious for some time that the (non-mining) sectors of the economy have been struggling. With the slow down in mining company cap-ex and unemployment starting to tick-up, every single metric pertaining to economic growth now sits on the wrong side of the ledger.
- The Government of the day is hell bent on delivering a surplus and the deteriorating terms of trade is likely to create further pressure on the federal budget.
- Previous interest rate reductions are yet to have any material impact on consumer spending (they remain content to de-lever).
- The Australian dollar remains stubbornly high in large part because of high domestic interest rates.

The prospective plans of consumers, corporates and governments (both state & federal) are all aimed at cutting costs/lowering spending which means lower growth. Most importantly, inflation sits at the lower end of the RBA's target. There should be no further debate; the RBA needs to get off its hands and drop rates to stimulate growth and (importantly) to help lower the value of the Australian dollar.

OUTLOOK

The US market has risen strongly over the last 3 months based on speculation about QE3 – at the very least it is now due for a little profit taking ("buy the rumour and sell the fact"). Given the improving macro environment and the additional liquidity now being pushed into markets, our much feared "technical washout" in September/October looks unlikely to materialise. We still do expect some softness as we move through September and October – but not a fully-blown correction. **A leg down of around 3% to 4% seems likely at this point**.

Markets could then recover as we move towards the end of the calendar year, but the move up may not be uniform across all sectors. We think that the next bounce may be similar to that which accompanied the initial recovery of the GFC, where mining company shares began to move up in November'08, whilst most other sectors continued to drift lower until March'09.

As Chinese demand comes back online and as commodity prices improve, buyers are likely to move back into Australian resource companies. In the first instance, this may come at the expense of defensives and banks, which have been over-bought in more recent times.
If Fund Managers want to buy BHP & RIO (which are trading on PEs below 10 times) they may have to sell stocks such as Telstra, CSL, Ramsay Health Care, CBA, etc.

From a longer term technical point of view, we are just about to complete the fifth year of the bear market cycle, which began in November'07. Interestingly, the 6 bear markets since 1900 have lasted an average of 5 years. The chartists now optimistically anticipate that we are about to start a bull market super-cycle (fingers crossed).

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** We are approaching attractive buying territory for many Australian stocks. Mining stocks are very close to a re-rating rally and this may be followed by other (risk-focused) sectors shortly. Any near-term dip in the Australian market should be seen as an opportunity to accumulate quality stocks.
- **Global Equities (Neutral):** The US market may soften in the next month or so, but increasing global liquidity levels will be supportive of equity markets over the medium term.
- **Property (Underweight):** Property is still clouded by uncertainty and typically will hold more attraction as a late-cycle play.
- **Fixed Interest (Slightly Overweight):** Market rates continue to soften – the RBA should move official rates down again in the short term. There may be merit in extending the duration (ie, average term) of fixed interest investments and looking to include additional exposure to listed income securities
- **Cash (Neutral):** As a result of our positions in other asset classes, cash is moving toward a neutral position.

Regards

Andrew & Stephen
20 September 2012