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QUARTERLY REVIEW – A YEAR TO FORGET - 2008

It goes without saying that 2008 was the worst ever post-war year on equity markets. The Australian share market fell around 39% in the calendar year, or around 51% from its highs in November'07 to its (recent) trough in November'08.

On reflection, it was certainly a year of two halves. In the first six months of 2008 the initial drop in equity markets was followed by a reasonable rally which saw around 70% of value clawed back, before the bourse fell away again around the middle of the year. As we moved into the second six months, there were technical signs that a bottom may be forming, however, on 16th Sept'08, in what proved to be a pivotal moment for financial and equity markets, US Authorities allowed Lehman Brothers Investment Bank to fail. Financial markets froze and equity markets went into a tail spin with the falls over the following months of October and November surpassing those that had occurred earlier in the year.

The global financial system teetered on the brink of collapse during the latter part of 2008 with a number of well-known financial brands disappearing in the process. Interest rates have tumbled – in the US they are sitting at close to 0% and central governments around the world have taken unprecedented action to pump trillions of dollars into their economies and taken steps to sure up their financial institutions.

So the inevitable question begs – "whats in store for 2009"

A YEAR OF CONSOLIDATION (AND HOPE) – 2009

As we indicated last quarter, it is folly to try and predict exactly what equity markets will do in 2009. It is likely that there is still some short term volatility to be navigated but there is also some degree of optimism about how the full year will play out, with forecasts ranging from around +13% to +40% (remember that we are coming off a rather low base).

Fundamentals versus Fear

We quite rightfully spend a good deal of time looking at fundamentals in the market (earnings growth, PE ratios and the like). These are extremely important in determining relative value and hence guiding investment decision making. But there is one other important ingredient when it comes to investing – and that is **confidence**.

Obviously confidence is in reasonably short supply at the moment, however, we think that sentiment may turn over the next few months based on some emerging positives – and we think the positives are starting to outweigh the negatives:

The Positives

- **Equity yield** versus cash rates – The yield from Australian stocks is currently running at round 6% to 7% (some further discounting of dividends is on the cards as we move through the reporting season). Cash and term deposit rates are at 3% to 4% and falling. For investors with a longer term investment horizon, this differential is becoming increasingly compelling.
- **Bad news already factored into prices** – A recession and poor company profits/losses have already been factored into current share prices.
- **China** – There has been a lot speculated about the imminent demise of China. The reality is that China is not going anywhere. A few quick points
  - Over 90% of Chinese growth is fueled from internal demand (ie the consumer and the government) with only around 10% driven by exports
  - The Chinese authorities have a long way to move on interest rates – they have only recently started relaxing monetary policy amid previous concerns about inflation. Monetary authorities can also improve liquidity by lowering the bank reserve deposit ratio (a policy lever not available to other developed economies)
  - The Chinese government has recently announced an AUD 800 billion stimulus package, most of which will be deployed within the next 12 months
  - The Chinese banking system is very stable/conservative and has been immune from much of the direct impact of the sub-prime crisis
- **Liquidity** has returned to the global **financial system** – Following government intervention, interbank lending rates have now fallen significantly and funds are again flowing between global banks and other financial intermediaries
- **Equity market liquidity** – There is a lot of cash sitting on the sidelines waiting for equity markets to show some signs of improvement
- **VIX continues to fall** – The generally accepted barometer of "fear" in equity markets is proxied by the Chicago Board of Options Exchange Volatility index which has fallen into the low forties after peaking at around 89 in November'08. Prior to 2008 the VIX averaged around 15 to 20.
- Equity markets are **anticipatory mechanisms** – The real economy is likely to struggle for the better part of 2009, indeed the US is expected to remain in recession until at least the 3rd quarter of calendar 2009. Equity markets typically turn approximately 9 months prior to the bottoming of the real economy.
- **Fiscal and monetary policy stimulus** – Around the globe interest rates have been slashed and trillions of dollars have been committed to supporting economies. More action has been pledged, including a package from the new Obama administration which is rumoured to see anything up to another trillion dollars set aside to stimulate growth.
- **Oil prices** – the price of oil has fallen by over 60% which will flow through into lower costs for consumers and businesses.

The Negatives

- **Recessionary** environment – all eyes are on the US to see how long and deep the recession will be. Without some signs of improvement in the US (particularly the ailing housing market), other global economies and markets will struggle to post positive growth.

- The **global financial system** – there are a rump of significant issues which are related to the health of our financial systems:
    - **Credit Squeeze** – whilst banks are now lending amongst themselves, they are reluctant to lend businesses and this is likely to slow any recovery
    - **Re-capitalisation** of banks (bad debts) – the write-off of bank capital further reduces their ability to lend and their attempts to re-capitalise themselves is putting further downward pressure on markets
    - **Deleveraging** on the part of consumers and businesses – the continuing reduction in current levels of gearing (accompanied in some instances by further security and asset sales), together with a resistance to undertake new borrowings will slow the turnaround.

WHERE TO FROM HERE

The short term outlook for equity markets is mixed. There will be further poor economic news to come and this may well spook the markets. Of importance will be the up-coming profit reporting period – late January/February. The focus will be on the **hard data** (profit levels, capital management and dividend policy) but also the **qualitative** views contained in company guidance (eg the direction of sales, forecast manufacturing and output levels, etc).

The news is likely to be mixed (we still think that on average the data will be better than expected; that is, better than whats already factored into share prices), however, some companies will take the opportunity to "clear the decks" and with additional write-offs and proposed capital raisings, the immediate effect on the broader may well be dilutive.

Consequently, as we move through the next month, there is a risk that we may re-test the market lows established in late November '08. However, based on the "positives" espoused above, as we move further through the first quarter, buying support may begin to return to the market with the prospect of sustainable gains as we head further into the year.

We see the bigger risk for investors over the next 6 months being that they refrain from re-entering equity markets (or worse still, withdraw further) because of a (albeit somewhat understandable) desire to see clear-cut signs of a recovery in equity markets. Our experience has been that as markets improve (and they will), clients often lament their reluctance to invest earlier.

In terms of any incremental move back into equity markets over the next few months, we prefer:

Large cap rather than small cap (S&P 200 stocks) – pricing and market power
Australian & Asia regions rather than the US & Europe
Balance sheets with less gearing
Businesses with solid free cashflow levels
Companies with higher (and sustainable) dividend payouts

In terms of sectors, we like energy/resources, consumer staples, selected industrials, telecommunications and soft commodities – as opposed to financials (in immediate the short term), consumer discretionaries and listed property.

A final word about our banks

Our banks have suffered from many of the same problems that have beset (and indeed crippled) banks around the globe. In terms of equity market performance, they have been tarred with the same brush as, for example, the US investment banks, albeit not quite marked-down to the same extent. The share prices of our major banks have fallen between 50% and 60% over the past twelve months.

However, it important to understand that our major commercial banks are fundamentally different beasts from their US or European counterparts:

- Australia's four majors are all ranked amongst the top 25 safest banks in the world (S&P, Moody's & Fitch)
- They are well diversified in terms of line of business and (to a lesser extent) geography
- They enjoy relatively high levels of funding from a retail deposit base
- They are subject to the most comprehensive prudential regulation of any banks in the world and their capital ratios are high
- Their lending policies have been reasonably sound ensuring higher credit quality
- They have historically been amongst the most profitable banks (based on ROE) in the world

There may well be a need for further capital raisings amongst the banks and dividends will need to be trimmed but we will soon get to the point where the performance of bank stocks will outstrip that of other stocks. This relative outperformance will provide confirmation of a broader recovery in equity markets.

Regards

Andrew & Stephen