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QUARTERLY REVIEW – SEPTEMBER 2009

The last quarter in local and global equity markets has continued to confirm that the recovery is now well underway. Economic indicators have further improved and corporate profit reports both here and in the US exceeded expectations. The net result was that the S&P 200 rose by around 18% over the past 3 months. With a rally of such a magnitude the inevitable "consolidation" (lead by profit taking) will no doubt occur and we are in the midst of a small correction at the time of writing (late October). However, it is our view that fundamentals are still supportive and we expect equity markets to continue on their upward trajectory in 2010.

So we remain reasonably bullish on equities in the medium term and we think the validation of this view can be seen in a number of areas:

This time last year

Somewhat ironically, as we moved through September '08 and into October '08, the Australian equity market stood at around 4,600 points. At that time, the world was about to fall into a huge economic recession, credit markets had frozen, banks were collapsing, short selling was banned and unprecedented central bank and government intervention was being contemplated – and the Australian market stood at 4,600.

Today, as we approach the end of October'09 the market again stands at around 4,600. However, the Australia's economic outlook is particularly rosy – leading indicators are improving at rates not seen for over 5 years and unemployment has all but peaked at levels well short of the 10% envisaged twelve months ago.

Granted, the market did subsequently push lower during the latter part of 2008, but that was against an almost Armageddon like backdrop and a complete absence of risk appetite. We contend now that equity markets are being too pessimistic in their interpretation of economic and company data and that based on more realistic corporate and economic forecasts (ie fundamentals), the market could deservedly be trading at much higher levels.

But is it a sustainable recovery

So if the market has got it wrong, what will it take for it to see the error of its ways. In short, the single factor that is holding back market valuations at present is overly conservative earnings forecasts. We talk a lot about PE (Price Earnings) ratios, primarily because this is one of our best indicators of relative value – that is, are we paying too much or too little for a given share. At any point in time, the price of the share is irrefutable – its what it trades for in

the market on any given day. Its the “E” or earnings where all the conjecture lies and where **recency bias** comes to the fore. In November 2007, broker and market earnings forecasts were (with hindsight) clearly too optimistic. However, the times leading up to this point were exceedingly prosperous and this euphoria was reflected in the earnings forecasts of the time. Now we are emerging from a period of depressed earnings and significant economic uncertainty. We are also living in a period where increasingly, company Boards and CEOs can be legally held to account for the views they provide of their company’s prospects. Faced with the recency of depressed earnings and the prospect of a jail term if forward estimates contain anything more than a mere smattering of optimism, its not surprising that near term earnings forecasts are (we think) too conservative.

The Missing Ingredient

So we would argue that a material part of what will sustain equity markets in the short term is a simple re-rating of company earnings prospects. However, there will need to be a little more than this over the medium term to support equity markets. When we look around the globe, most of the pieces in the recovery jig saw puzzle are falling into place. The one missing ingredient is the **US consumer**.

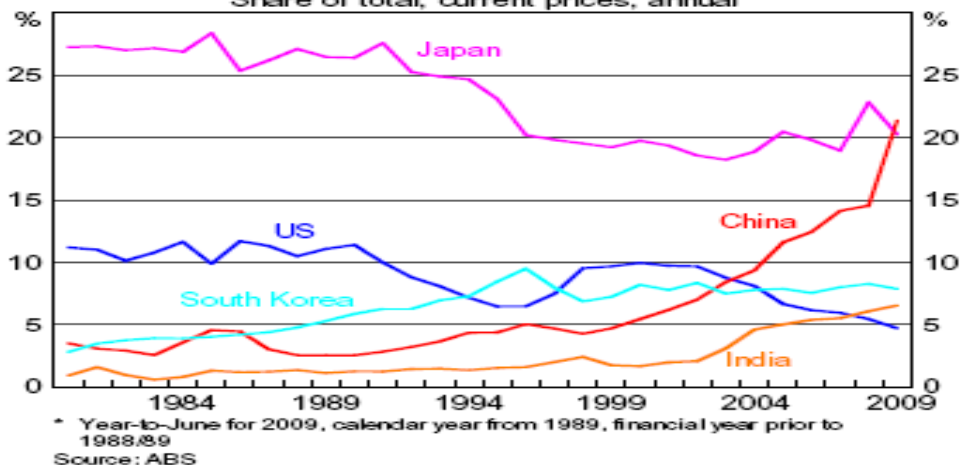
The resilience of the Australian consumer has helped, and will continue to support, Australian equity prices. Similarly, the resumption of China’s insatiable appetite for our natural resources will give us an enormous boost. However, the final and potentially biggest piece of the global jigsaw is the US consumer. US unemployment levels (whilst showing some signs of slowing) are still at significant levels and will continue to increase in the short term. US consumer confidence is still at 30 to 40 year lows. For global growth to get a much needed leg-up in 2010, the US consumer has to come out of hibernation.

We believe that some time during the second quarter of next calendar year the US consumer will come back online again. Inflation is likely to remain low in the US and interest rates will remain at extremely accommodating levels. The US Federal Reserve has already resisted the temptation to raise official rates from their near zero setting (0 – 0.25%). This reluctance of authorities to raise interest rates is likely to see the US consumer loosen their purse strings sooner rather than later in the year, particularly if unemployment peaks in the short term.

The Chinese Juggernaut

There has been a lot of talk about the Chinese bubble bursting but to para-phrase Mark Twain, talk of China’s demise was greatly exaggerated. Yes, there was a period of reduced growth (maybe around 6% per annum) and Chinese companies did go through a period of de-stocking (ie running down their inventories) which had a significant impact on commodity prices and demand for our resources. However, this was only a very temporary occurrence and we have now been through a significant period of re-stocking. The Chinese Government applied enormous economic stimulus to the domestic economy which more than adequately substituted for the drop-off in demand from the US. Economic growth is now back to almost 9% and the authorities are looking at ways to temper growth and reduce inflationary pressures. The chart of Purchasing Managers Index (PMI) measures likely growth or expansion in the manufacturing sector and clearly shows the dip and return to business as usual:

The Chinese stimulus and its resultant surge in **our** economic growth should not be understated. In the chart below you will see how the significance of the Chinese trade relationship has trended up over time and importantly, how it surged over the last 6 months, more than making up for downturns in US and Japanese demand – note also the recent trend up in the significance of India's trade dealings with Australia.



We have previously talked about the notion of breaking the nexus between the US and Australia – not just economically but also in terms of equity markets. Whilst for the foreseeable future we are likely to remain hostage to the directional trends set in the US market, we think increasingly it will be Australia's economic prospects (significantly linked to China) and the earnings performance of our own Australian companies that will dictate the magnitude of the rises or falls in our equity values.

The only downside to being joined at the hip to China is that it provides the RBA with a greater level of confidence to be able to raise official interest rates and the Australian dollar is likely to continue on its upward trajectory (which is likely to lead to us importing more inflation and make our (non-resource) exports less attractive on world markets).

The Hidden Head Wind

The one hidden head wind in our outlook for equity markets is the significant amount of capital raisings that have occurred in the last twelve months. In the Australian market alone, over $100bn of new capital (ie shares) have been raised. This equates to around 10% of total market capitalisation. The maths of these raising is therefore quite simple – companies need to earn at least 10% more in profits just to stand still (on a critical EPS basis). If we take the example of Wesfarmers, the dilutionary dynamics of the situation are further reinforced. Over the last 2 years, Wesfarmers has increased its number of shares on issue by around 65%. You don't create value simply by issuing shares – quite the contrary. You have to be able to grow the size of the pie (ie your company's profits) by an amount at least commensurate with the amount of new capital issued to maintain a share price.

We don't see this necessarily as a significant issue, but one which cannot be ignored when making share price comparisons to a year or two ago. It will certainly represent a speed hump for particular companies as we move into 2010.

ASSET ALLOCATIONS

As indicated last quarter, we believe that equity markets have now begun a longer term recovery, but still expect periods of volatility – specifically late October/early November. We are looking to position client portfolios as follows:

- **Australian Equities (Overweight) .** We continue to look to opportunistically add to client portfolios (ie buy the dips), with a continued preference for large cap (neutral) over small cap (underweight) stocks, and a bias towards cyclical stocks (including banks, financials, resources and energy)
- **Global Equities (Underweight):** The US economy (and by inference its equity market) is likely to underperform in a relative sense. Hence we continue to be underweight benchmark aware international funds and prefer Asian-focused funds, with potentially some developing market exposure where appropriate.
- **Property (Underweight):** Whilst there has been a rationalisation of players in the listed property market and the more significant players have reduced their gearing and re-valued their property holdings (ie written down their value), 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