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QUARTERLY REVIEW – JULY 2010

Over the 2009/2010 financial year the Australian share market returned around 13% (including dividends) – this was the first "up year" in the past three. Equity and risk markets more generally have taken a hammering over the last few years, however, if you average the return from Australian shares for the past six years (including the impact of the GFC) it has been 11.6% per annum.

At present, the Australian market is fundamentally cheap as it sits on a price/earnings ratio (PE) of around 11X (compared to an historical average of about 15X). The market has more or less priced in a double dip recession which we think is not a serious possibility. So, whilst there is still likely to be some volatility over the next month or so, as we move through October'10 we see some excellent value developing in the Australian market.

In terms of the macro-economic environment, the global economy is experiencing somewhat of a hiatus – which is nothing unusual at this point in the recovery. Domestically we're "changing gears" which in large part will see the government lead stimulus being withdrawn, to be substituted by private sector investment and, in due course, consumer spending.

The US Economy – A Pause in the Recovery not a Double Dip

There has been increasing talk over recent months about the potential for a double dip recession – in fact a number of commentators have made the case that equity markets have more or less fully factored the likelihood of this into its pricing.

We are not advocates of a double dip (specifically in the US) but rather we argue we are seeing an inevitable slowing in the rate of recovery. There are a number of observations we would make to support our "no double dip" thinking:

- **US housing** – The US government has now withdrawn its homebuyer tax incentives. When this stimulus measure was implemented, it had the affect of pulling construction and sales forward. With its withdrawal, the current data looks weaker than it might otherwise be. Interestingly, US housing construction is now only quite a small part of the economy – a 10% drop in home construction has about one third the impact on GDP that it had back in 2006 (ie unlike Australia, it is not a material driver of economic growth).
- Yes, **unemployment** is still high and the last set of "top line" employment numbers were far from comforting. But take a look at the "working week hours" which increased, along with the increase in weekly earnings. Combine this with the better than expected corporate profit results and you have a recipe for further economic growth. US corporates are not currently

prepared to put more bums on seats but they are at the point where they're looking to work their current employees a little harder and pay them a little more. Historically, unemployment does not peak until 15-19 months after the end of the recession, so we may continue to get patchy employment numbers out of the states for another 6 months.

- Importantly, double dip recessions have historically only occurred when authorities have made a "**policy stuff up**". Specifically, if they precipitously move interest rate up ahead of signs of sustained economic growth. In the US, authorities have been at pains to stress that they anticipate that interest rates will remain at their current levels for the foreseeable future. Real interest rates in the states are **actually negative**.

- The world has **China** to help with a lot of the heavy lifting this time around. If we took China out of the equation, the risk of another recession would be significantly higher. But at present, China is more than filling the gap that has been caused by the deleveraging of national and private company balance sheets.

- There were concerns earlier in the year about the **European sovereign debt crisis** and how this issue had the potential to push the world economy back into recession. On this point, it is worthwhile noting that 80% of European debt is owned by Europe – it is a local issue just like the Asian financial crisis of 1997. The recent European bank stress test results were positive and government bond tenders are now more or less fully subscribed (bond spreads have once again narrowed). The austerity measures currently being undertaken in Europe are estimated by the OECD to have a near term impact of only around 0.5% on global growth, but surprisingly a medium term positive impact of GDP of around 0.2% to 0.3% (via lower interest rates and improved business & consumer confidence). GSJBW recently put Europe into perspective as a "credit event that is being addressed".

- As discussed in a little more detail later, **corporate balance sheets** are in good shape – companies are deleveraging (ie paying down of debt) where appropriate and have selectively undertaken equity raisings.

Most interestingly were the words of Alan Greenspan (former US Federal reserve Chairman) who last month declared (with little media coverage) "What we are looking at currently is an invisible wall, which we've run into here. Which essentially, as far as I can see, is a **typical pause** that occurs in an economic recovery". And when you go back and look at the last nine US recessions, that is exactly what has happened – namely, the economy slows after an initial sharp rebound from the low point of the recession. Also of interest is the fact that when you look at what Wall Street did after rebounding strongly from the recessionary induced lows of 1990 and 2001, US equities drifted sideways for around 6 months before resuming their upward trend.

It's Still All About China – the Goldilocks Economy

As indicated above, one of the key reasons we believe that there will not be a second global recession is because of the growth of China. I know we keep banging on about China, but its one of the key differences this time around (compared to previous slow-downs/recessions).

For those of you who missed the news last month, China has now moved past Japan to claim second spot on the ranking of global economies (behind the US), with its June quarter GDP moving up to $1.335 trillion – it is already the world's largest exporter, overtaking Germany last year. By way of historical comparison, about five years ago the Chinese economy was about one third the size of Japan. Depending on who you believe, within around 10-15 years it will have overtaken the US as the largest economy in the world.

As you will see in the following example, the Chinese authorities have great capacity to dampen down growth if required and on the flip side, the Government has enormous fiscal reserves to stimulate growth if it begins to dip below their preferred levels. Its no wonder then that the Chinese economy is known as the "Goldilocks" economy – growth will always be not too high and not too low, but "just right".

Chinese Policy Finesse (not a Sledgehammer to Crack a Wall Nut)

To exemplify the finesse with which the Chinese economy is being managed, we thought it would be enlightening to reflect on how the authorities there recently addressed concerns about an over-heated property market in Shanghai and Beijing. In Australia, if the RBA has concerns about property bubbles, they pull on the only policy lever that they have – they jack up interest rates. And if it doesn't work the first time, then they jack up rates again. Eventually they will take the heat out of the property market, but because interest rate policy is such a blunt instrument, they stifle consumer spending and, most distressingly, they put a lid on business investment because it costs more to fund the capital projects that business might be contemplating. In other words, there is a lot of collateral damage. In Australia, we are also seeing a geographical disparity in growth and inflationary pressures which the RBA is ill-equipped to manage (the so-called "two speed economy"). The mining-based states of WA and to a lesser extent Qld are doing very nicely thank you very much, but states such as NSW are a virtual economic basket case. The last thing we need in NSW is for someone to come along and raise interest rates - but because of inflationary and property pressures in WA, thats exactly what the RBA is likely to do.

Now let's turn to the issue that the Chinese authorities were facing earlier this year. They were seeing a speculative investment property market beginning to take shape (particularly in Beijing and Shanghai) and this was putting upward pressure on property prices. What they did **not** do was jack up interest rates; what they did do was introduce a raft of specific measures:

- They changed the quantitative controls over bank lending, introducing tighter lending controls for investment funding. These included capping the amount (via the Loan to Valuation ratios) that banks could lend to second or third home buyers, investors and those purchasing larger and more expensive homes.
- Local Government controls were implemented which meant that at least 70% of development land had to be converted into "affordable" housing.

- Developers were banned from taking deposits from buyers where a minimum amount of pre-sale activity was not evident.
- There was a suspension of residential property sales to non-residents.
- Specific caps were put on the number of properties an individual could own in Beijing and Shanghai (ie no more than 2 homes).

Low and behold, Chinese property prices fell in June for the first time in many years. The targeting of the solution to reflect the precise scale and scope of the emerging issue was simply breath taking. Glen Stevens (our RBA Governor) could only dream of having this level of policy specificity at his disposal.

Reporting Season gives us Comfort

In the recently completed US reporting season around 77% of companies beat analyst profit predictions. Here in Australia we are approaching the end of our reporting season and most companies are now well and truly back in the black. Dividends are back in vogue and the majority of companies have actually announced increases in their interim dividends (up 22% on the previous period). Some companies even managed positive outlook commentary – which in our minds is a dead give-away that they really expect things to pick up over the next twelve months.

The good news is that companies are not relying on cost cutting to meet earnings expectations this time around. Revenues and costs have surprised on the upside and whilst ordinarily, rising costs would be seen as a negative, it does suggest an increase in business spending from the "recession cautious" levels.

Not only are Australian companies deleveraging but they are building up their cash reserves – around $60 billion, which is around 30% higher than the 6 months to December'09. This can be used to fund growth or returned to shareholders (buy-backs) – either way, it is a positive for the share price.

We see the trends evident among Australian corporates as proof that they are now well placed to invest and drive economic growth.

A quick word about Bank Interest Margins

Ever since the global financial crisis began to emerge, banks have been facing significant pressure on funding costs. For the first time in history we actually saw banks moving mortgage interest rates out of synch with the cash rate movements of the RBA.

Bank interest margins (the difference between what they pay depositors and what they charge borrowers) are the most significant contributor to bank profits and the recent bank profit results indicated that interest margins were again contracting.

With the RBA now indicating that monetary policy is "neutral" (ie they have paused interest rate increases), the major banks are likely to unilaterally move up mortgage rates. Their thinking would have been to do this very soon after the federal election, to minimise the political jaw boning that they will receive from Canberra. They would have been happy to jack up rates and cop some flack no matter which political party was in power.

However, at the time of writing, we look like we're headed for a hung parliament with a lot of horse trading to occur over the next few weeks before a minority government can be formed. This will have taken some of the wind out of the sails of the banks – they do not want to pop their heads up in the current environment and run the risk of having bank re-regulation on the wish list of one or all of the country independents. They will bide their time but funding pressures are unlikely to subside in the short term and their recent profit reports indicate that they may need to tweak-up loan rates (by around 0.10% to 0.15%) to bolster their margins. Watch this space ....

2010 to finish on a high, but some turbulence in the short term

Historically, after periods of significant market correction, uncertainty levels have held back market returns as investors wait for confirmation that underlying fundamental data points on the economy and profit cycle remain solid.

The fundamental view on markets is still sound and the attractiveness of equities has only strengthened in the last few months (due to a combination of softer prices and more positive longer term earnings estimates). However, the short term is clouded with some uncertainty and the market has all but priced-in the likelihood of a "double dip". In other words, the market has done a good job of over-baking the negative sentiment and the traders will continue to ride the resultant momentum over the next month.

Since early in the year, a number of technical "houses" (read – large global investment banks) have been forecasting a material correction in late September. There are now a number of research houses and brokers with their money on this horse. The concerns about a double dip recession are also providing some fundamental impetus for this thinking. Its by no means a certainty, but when the consensus view is for the market to move down and in the absence of overwhelming positive economic or company news to the contrary, it is probable that the market will move lower over the course of September.

That said, the technical views are that we are still in the early stages of a cyclical bull market and that equity prices will recover after this correction. Provided company news continues to be supportive, we may see a rather healthy bounce in the latter part of the year (traditionally the first half of the financial year is a stronger period for equities that the second half).

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** In the immediate short term, we are happy to sit with "neutral" allocation to Australian equities, but would look to move this to overweight in the coming months. Again, we sound like a broken record but resources and energy are key themes we continue to support in our stock selections.
- **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. 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), together with some bank term deposit exposure.
- **Cash (Overweight):** As a result of our positions in other asset classes and having regard to the short term technical view of the market, cash remains slightly overweight to target.

Regards

Andrew & Stephen

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