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QUARTERLY REVIEW – AUGUST 2011

Over the 2010/11 financial year the Australian equity market (ASX 200) rose from 4,285 from the open on 1 July'10 to close at 4,608 on 30 June'11 – a point to point increase of around 7.5%. By contrast, the US market (Dow Jones) rose by around 20% over the same period. The US market was coming off a lower base, but it was also aided by a very low US dollar and the most accommodating monetary policy that the world has ever seen (ie official rates of between 0.00% and 0.25%) – with a couple of bouts of quantitative easing thrown in for good measure. US company profits have risen by almost 95% since December 2009. Here in Australia, the strong Aussie dollar, high interest rates, a cautious consumer and the Gillard-labor government's predilection for intervention (eg mining tax, rejection of ASX take-over, carbon tax, etc) created headwinds for our domestic companies.

The chart below (sourced from a recent Ausbil Dexia presentation) highlights the surprising under performance of Australian equities relative to other key markets over the past 12mths:

US Economy

For the major part of the last year or more, economic data coming out of the US has been overwhelmingly positive. Economic growth, lending, retail spending, housing, capital investment and the like have all turned to the positive. However, some of the most recent data (combined with other macro issues) has worried markets. We have seen a softening in some indicators and, most recently, the manufacturing and consumer sentiment surveys have been rather negative.

Most commentators (ourselves included), see the US as going through a slowing in economic activity, **not** another recession. In this regard we would observe that the recent manufacturing and consumer results were based on surveys and, hence, they are heavily influenced by sentiment. Against a backdrop of the uncertainty created by the debt ceiling debate in the US, the subsequent down-grading of the US credit rating by Standard & Poors and the "weeping sore" that is the European sovereign debt crisis, it is somewhat understandable that when asked about their likely future

intentions, companies and consumers alike would have been apprehensive. Over more recent days we have seen some more positive reads on “hard data” such as retail sales and employment.

We probably can’t go to print without a word about the Standard & Poors credit rating down grade of the US – without doubt, the single biggest impact on market confidence since the failure of Lehman Brothers during the height of the Global Financial Crisis. Whilst the financial implications for the US are not material, the symbolism (at a number of levels) has been enormous. The reality is though that the US remains the most secure “investment” around the globe – in the days/weeks after the down-grade, US bond rates **actually fell** (if something is genuinely more risky, the price of its debt (eg bonds) should have gone up). So fixed interest markets have snubbed their noses at S&P’s assessment of US risk. The other irony is that S&P has a pretty poor track record of calling risk - along with the other ratings agencies, S&P rated the collateral debt obligations (CDOs), that were at the epi-centre of the Global Financial Crisis, as triple A risk, right up to the time CDOs disappeared into a very large black hole.

European & US Debt

It would appear that a more sustainable solution to the debt problems in Europe is being eked out – albeit iteratively. The heavy lifting will continue to be done by Germany and France, and it is likely that solutions will be reactively proposed to the changing fiscal position of one European nation or another. Nirvana for the European Union would likely involve fiscal integration (including a single bond issuance programme), but there will need to be a lot more political pain to draw them into a solution of this type.

In the US, budget cuts of around 2.7 trillion dollars over 10 years have been flagged and more can be expected to appease the ratings agencies and Capital Hill conservatives. The trick will be, however, to achieve a “goldilocks” outcome. They want to reduce government spending somewhat to ally “political” concerns over the budget, but they don’t want to remove too much fiscal stimulus for fear of shifting the economy into reverse. The book ends here leave a fair bit of room to maneuver and following the public outcry over the debt ceiling, the democrats and republicans should be able to find a solution that is “not too hard and not too soft”.

An important point of context when talking about sovereign debt is that the Global Financial Crisis was all about over-borrowing by companies from banks. The way that this problem was eventually rectified was by Governments effectively “swallowing” the debt. The issue migrated from the private sector to the public sector (where no doubt it could be better dealt with), but adjusting to the new debt paradigm is certainly causing more than a little indigestion for some governments.

OUTLOOK

No one foresaw the turbulence we have seen in markets over the past few weeks – the sequence of events was unprecedented and the response from markets was (as is usually the case) a knee-jerk sell off.

Risks still abound at present, but we believe that the upside risks outweigh those on the downside – you probably won’t get this sense by reading tabloid newspapers and watching news bulletins on TV. What needs to understand is that the media’s job is to lift ratings and sell newspapers, so you probably don’t need us to tell you that fear & panic sells more newspapers than cautious optimism.

Based on our readings and feedback from market participants, we believe that:

- The US will not fall back into recession (albeit growth is slowing).
- Germany & France will continue to support smaller ailing European nations
- China will continue to grow at close to double digit pace.

- Here in Australia, the benefits of the resources boom will (eventually) flow back into the broader economy and the Australian consumer will open his/her wallets.

Interestingly, the higher level of savings amongst Australian households at present is more to do with "choice" rather than a financially-grounded imperative based on rising interest rates. This is a message that the RBA needs to heed as it further reinforces the relatively ineffectual nature of monetary policy at present (interest rates rises or indeed falls).

These macro-hypotheses are founded upon the weight of evidence that gives us cause for optimism. We're certainly not blind to the downside risks, but we think that the probabilities attaching to the upside are materially higher than any downside risks.

Things we take comfort from:

- The underlying trend in US economic data
- Company balance sheets are in extraordinarily good shape
- Japan is getting back on its feet again after the earthquake – the supply chain implications of the earthquake were probably more far-reaching than many expected.
- The recent US profit reporting season significantly exceeded broker expectations
- The falling price of oil improves profit margins and takes pressure off inflation
- A lower AUD improves the competitiveness of industry and makes Australian equities more attractive to foreign investors (who account for 40% of market liquidity)
- Significant scope for the RBA to relax monetary policy in Australia if needs be
- Australia's economic position and robustness of our banking system
- Emerging commodity demand from India
- China buying US, Portuguese, Italian and Spanish bonds

Things that makes us a little nervous:

- The political brinkmanship evident in the US (the rise of the tea-party is not helping)
- The fiscal constraints likely to be imposed on the US
- No scope to further lower interest rates in US
- The Australian government's continued predilection for intervention
- Chinese inflation
- Falling productivity amongst Australia companies
- RBA's growth forecasts

In terms of the latter, the RBA has consistently over-estimated the impact of the mining sector on growth. Recent ABARE data has confirmed that much of the anticipated mining infrastructure spend will be "imported" (ie will flow to foreign companies) and this means that the mooted 2% uplift in growth from mining infrastructure spend could well be less than 1%.

The Australian market low of 3,766 reached briefly during the day on 8 August seems like a long time ago – at the time of writing, the Australian market (ASX 200) has just moved through 4,250, representing an increase within a week of 12.8% (which constitutes more than a mere "dead cat bounce"). Many are now confidently calling this the bottom and, based on fundamentals, its hard not agree with that view. However, fundamentals are **not** what has been driving the market over the past few weeks. Panic and fear find their own self-fulfilling rationale in times of global uncertainty and when investors step onto the sidelines (as they typically do during times of great volatility) the market only moves one way. Today's programme-based share models and momentum trading strategies only accentuate any market corrections (down or up). Those that chose to or were forced to sell have now left the markets to be replaced by exuberant buyers.

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However, any sniff of soft economic data out of the US, slower than expected growth out of China or a hint of more problems amongst European nations, could see the market jump lower again. But, based on what we can see at the moment in terms of macro economic trends, together with forecast company earnings, the fundamental position is very constructive for equities. Aside from the depths of the GFC, equities markets are now the cheapest they've been for many decades and for investors with a medium to longer-term outlook, there are some quality stocks trading at very attractive prices. On a (forward) price earnings basis, most global markets are trading at 20% to 30% below historical averages.

Another interesting data point was provided last week by Macquarie Equities when they noted in their Equity Strategy Update that "when equity markets see cyclical highs (ie we move from bull into bear markets), certain characteristics are normally evident – high gearing, excessive credit growth and high M&A activity are the normal signs of excess. While evident as we entered the GFC, these characteristics are now broadly absent from today's market."

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** Whilst valuations appear compelling, we still see some volatility on the horizon.
- **Global Equities (Neutral):** Benchmark unaware and Asian focused exposures are our preference. Where clients are comfortable with the potential risk, unhedged currency positions hold some long-term attraction.
- **Property (Underweight):** Property is still clouded by uncertainty and typically will hold more attraction as a late-cycle play.
- **Fixed Interest (Neutral):** Market rates are softening (TD rates have fallen around 0.4% in recent weeks). 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 (Slightly Overweight):** As a result of our positions in other asset class's cash remains slightly overweight to target.

Regards

Andrew & Stephen