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QUARTERLY REVIEW – FEBRUARY 2012

The 2012 calendar year has certainly started in a positive way for equity markets. Most markets have risen in the past two months and the US (Dow Jones) is heading back towards pre-GFC highs. Sentiment in risk markets has been much more positive, with investors looking for reasons to buy the market rather than sell.

Despite the positive start to the year, the experts are not talking up the prospects for 2012. In many respects we have started the year with similar concerns to those that we carried through most of 2011 – a slowing US economy, a flawed Chinese growth story and a sovereign debt crisis in Europe. This year, the former issues are likely to wane in significance (albeit they will bubble up from time to time), whilst the problems in Europe will remain front and centre. This year, we also get a political overlay with presidential/parliamentary elections scheduled in Greece, France, and, later in the year, the US.

So the consensus view for 2012 is for another difficult year with markets forecast to struggle to make positive returns.

The Consensus View about the Year Ahead will no Doubt Miss the Mark …… Again!

At the start of each year, brokers and analysts give their predictions as to where they think the share market is going to finish the year. There are generally two things that these forecasts have in common – they all generally see the market heading in similar directions (to that extent, we suppose there is merit in calling them a consensus); the other thing about them is that they are invariably wrong! Take a look at the chart below sourced from Goldman Sachs representing the consensus market forecast over the past 7 years, compared to the return actually generated:

Year	**ASX 200 (Yr End Target)**	**Consensus Return**	**Actual Return**	**Variance (% Points)**
2005	4258	+5%	+16%	+11%
2006	4798	+2%	+20%	+18%
2007	5910	+5%	+14%	+9%
2008	6812	+6%	-43%	-49%
2009	4367	+19%	+33%	+14%
2010	5316	+9%	-1%	-10%
2011	5301	+9%	-14%	-33%

The consensus view is usually off target – and by a considerable margin. There has not been a time where the margin of error has been inside 100% - in other words, actual returns have always been around 2 times, 3 times up to 7 times greater or less then the consensus view. To make matters worse, the consensus view for the past two years was for positive returns, when in fact the ASX 200 ended up moving backwards.
And yet this should not be a surprise – in fact statistically, it is what we should expect. This is because, as we have said on many previous occasions, markets are **anticipatory**. They are forward

looking and trying to build into today's share prices, future views about the direction of economies and company earnings. It stands to reason then that if brokers and analysts are expecting a "good year" that share prices at the beginning of the year should already have this view "baked-in".

On the flip side, if the consensus view is for markets to "struggle", face another "difficult year", or again be subject to "macro headwinds" (as the pundits are telling us will be the case for 2012), then it stands to reason that a struggling US economy, significantly slowing Chinese demand and an untidy Greek default are already reflected in share prices as we sit here today.

Our view has become more optimistic over recent months, and our research suggests all but the very worst case is probably already factored into current share prices. We now think that the risk in equity markets is actually to the upside over 2012 (albeit the first part of the year may continue to be choppy).

Bond Yields are the Barometer for Europe's Health

At the heart of the sovereign debt crisis in Europe is the concern that interest payments on borrowed monies are becoming unsustainable. In this regard, the amount of interest that European nations are being asked to pay on their debt is a direct proxy for the level of nervousness (or otherwise) that markets are experiencing around countries like Greece et al. The good news on this front is that interest rates (or yields) on the bonds of most of the European "problem children" have been falling over the past couple of months and bond auctions (across all maturities) have been well bid. This is due in large part to the European Central Bank's ("**ECB"**) Long Term Refinancing Operations ("**LTRO**") programme.

In December the ECB announced that it would lend around €490 billion to European banks at an interest rate of 1% to assist with their liquidity requirements. The ECB took the view that it would not directly prop-up sovereign governments, but that instead it would effectively flood European Banks with liquidity so they could, if they chose, buy sovereign bonds. The good news is that a meaningful portion of these funds have actually ended up supporting demand for sovereign bonds. We have seen European banks once again buying bonds and this has had the effect of reducing yields on the debt in question. Below we've included a table that evidences a fall in bond yields over recent times, which largely coincides with the injection of liquidity by the ECB.

	Recent High	**Current Yield**	**% Reduction**
Portugal	17.39%	11.93%	-31%
Spain	6.70%	5.15%	-23%
Italy	7.25%	5.47%	-25%
France	3.72%	2.99%	-20%
Ireland	14.08%	7.74%	-45%

(NB – Greece has not been included in the table as its bond yields still sit fixed at over 30% as negotiations continue over the level of write-down current bond holders will incur)

Most encouragingly, the ECB is about to undertake a second tranche of LTRO on 28 February 2012 – rumoured to be of the order of €1 trillion dollars. The first round of LTRO funding to banks resulted in government bond yields falling by around one quarter and also caused equity markets to rally. One can only imagine what the second round might do given that it will be twice the size. Importantly, the (circa) €1.5 trillion that LTRO will represent by the end of this month will <u>cover 75% of all European bank bond maturities in the next 3 years</u>. The liquidity buffer that LTRO will provide the European financial system will be huge.
It is hoped that over time, the LTRO will also slow the deleveraging of European banks (yet to be seen at this point) and thus kick-start new lending to private enterprises and households – with a view to stimulating growth and employment.

The Tragedy that is Greece

It is near on impossible to give a sensible view about global equity markets without addressing the continuing saga in Greece. It has become to be seen as a microcosm of the issues confronting the EU more generally. The success (or otherwise) that the EU achieves in supporting and reforming Greece will set the tone for its dealings with other debtor nations. Get the framework right and it can be replicated across the EU – get it wrong (and this would include precipitously causing social dislocation in Greece – read "a people's revolt") and we could see Europe spend the better part of the current decade mired in a protracted recession.

The EU is looking to apply the blowtorch to Greece and secure as much fiscal reform via austerity measures as is possible. The reality is that austerity measures in and of themselves will not solve the problem – the country will need economic growth (ie significant stimulus) at some point in time (this is why the US & UK are printing money at the moment and not getting too concerned about budget deficits just yet). A country, like a good company, cannot shrink its way to greatness. Under the weight of significant and continued austerity measures, Greece's domestic output will continue to contract (as it has done so over the past 5 years) and its budget deficit will likely increase, if for no other reason that there will be fewer people paying taxes because they are out of work and more people will be looking for welfare handouts. Hence, the EU fiscal metrics (that seek to have government debt as a proportion of GDP fall to around 120%) will deteriorate simply by dint of a shrinking denominator – even if the level of Greek debt remains unchanged, Greece will still be in breach of key covenants within 1 or 2 years. Having laid the foundation for fiscal reform, by virtue of a very large stick, the EU, IMF and ECB will need to develop stimulatory measures to kick start Greek growth.

The current bailout negotiations involve the EU providing a funding package of around €140 billion, with a further €100 billion being sourced via a write-down in the value of bonds held by private bondholders. The immediate funding requirement is to have €14 billion cash available by 20 March when Greece's next bond payment is due. Elections are imminent in Greece (due April'12) and whilst both major political parties have indicated a preparedness to sign-up to the austerity package now on the table, if the election is seen as a referendum on these measures and the more radical minor parties campaign (and are elected) on an anti-austerity platform, the EU may find itself with a new government, not specifically bound by the covenants of the package. It would make sense then for the EU to hold over as much of the funding as possible until after the Greek elections are run and won.

OUTLOOK

Equity markets will find it difficult to rally in a significant and sustained way until there is some confidence that smaller European nations can restructure their budgets and service their debt (ie the solutions being put forward by the EU will need to be seen to be working). Many fund managers and institutional investors have remarked that they will remain out of the market until the situation in Greece (and assumedly other insolvent European nations) is "resolved". The problem is that there will not be a "green light" that comes on to signify that it is safe to go back into risk markets. The process will continue to be frustratingly iterative (remember also that we have Spain, Portugal and even Italy to deal with); however, the important take-out for from what we have seen in Europe over recent times is that global monetary authorities and Governments are committed to action. It might take a little time and it is not going to be without hiccups, but over the next 3, 6 or 12 months, we believe the situation will be "improved". If investors wait until they are able to put ticks in all the "boxes" the market may have gapped-up twenty percent.

We feel that the **US** will continue to recover with interest rates staying at close to zero and the Federal Reserve ready to pull the trigger on QE3 (ie printing money again). Aside from the currency impact, it is the huge amounts of liquidity and the equity risk premium (ie the difference between equity dividends and fixed interest rates), that is supporting the outperformance of the US share market (Dow Jones) relative to Australia.

The **Chinese** authorities have engineered a slowing of inflation and the decks are now clear for further stimulus measures to be applied to the domestic economy. By contrast, the authorities were tightening monetary conditions during 2011, with the reserve ratio for Chinese banks being increased on no less than nine separate occasions over the year. As authorities move to a loosening bias, this will have a positive impact on commodity prices, resource stocks and Australian equities more generally. Despite Chinese authorities consistently doing what they say they will do (eg drive growth, reduce inflation, curb investment housing, etc) it is fair to say that equity markets (particularly here in Australia) still remain skeptical about the Chinese growth story.

Here in **Australia**, we have witnessed disappointing equity returns. There is certainly no doubt that we have seen a de-coupling of the performance of the ASX200 and the Dow Jones – our fate seems more inextricably linked to the ebbs and flows of the Chinese, whose market was down over 25% in 2011. The domestic profit reporting period is nearing its conclusion and results have generally been "on par"; but again, outlook statements have been soft. The trend that has emerged to date is that sales of goods and services are generally up, but so too are the costs associated with producing and distributing same, which is placing pressure on margins. Even the big resource companies are struggling to keep the costs of their mega projects in check.   Consequently, earnings forecasts are being chipped back.

The Australian market is approaching a key resistance area (ASX200 ~ 4330). From a technical perspective, a break above this level would be quite positive in the short term. The catalyst for this might be further policy easings in China, the ECB's next round of LTRO or the RBA easing domestic cash rates. The reality is that we still have a way to go in resolving the issues in Europe, although we can certainly see the light at the end of the tunnel from where we are now. It probably won't happen inside the next month or two, but we believe there will be enough pieces of the jigsaw in place to enable equity markets to bounce significantly later this calendar year. In the meantime, we may well move higher in the short term, before potentially some type of technical correction in late Q1 or Q2 – this may present a good buying opportunity before a longer term bull run.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral/Slightly Underweight):** Whilst valuations appear compelling, we still see potential for further volatility. Linked to (unwarranted) concerns about China in the short term.
- **Global Equities (Slightly Underweight):** Benchmark-unaware international funds, preferably with currency hedging for more risk averse clients, remain the best way of securing global exposure.
- **Property (Underweight):** Property is still clouded by uncertainty and typically will hold more attraction as a late-cycle play.
- **Fixed Interest (Neutral):** Market rates continue to soften – the RBA is likely to move official rates down again in the next month or two. There may be merit in extending the duration (ie, average term) of fixed interest portfolios
- **Cash (Slightly Overweight):** As a result of our positions in other asset class's cash remains slightly overweight to target.

Regards

Andrew & Stephen