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QUARTERLY REVIEW – DECEMBER 2012

The ASX200 rose by around 14.5% over the 2013 calendar year, though this point-to-point increase shrouds the volatility that characterised the Australian share market for most of the year. The turmoil that beset Greece and Europe, which paralysed global stock markets in May'12 and June'12, seems like a distant memory. The reality is that jitters over Europe and concerns over a hard landing in China wiped close to 10% off our share market in the space of about three weeks in middle of the 2012 year.

Since the European Central Bank announced its prospective intervention in EU bond markets, and Chinese authorities began applying stimulus to their slowing economy, our market has risen 19% from its intra-day low on 4 June'12 to finish the year at 4,723 – a level we haven't seen since May 2011. Not even the political shenanigans in the US late in the year around the so-called "fiscal cliff" were enough to derail the momentum of equity markets.

As we had hoped, the Reserve Bank lowered official cash rates on two occasions in the final quarter of 2012 providing further stimulus to the local equity market. Interest rates are likely to decline further over the 2013 calendar year and this will be constructive for Australian equities on a number of different fronts.

The US Fiscal Crisis – Kicking the can down the Road.

How quickly the pendulum swings! For the better part of the 2012 year, financial markets were fixated with the situation in Europe and (in the case of the Australian market) slowing growth in China. Then in the latter part of December, the US Fiscal Cliff became all the rage. As we have come to expect, the issue was eventually resolved but only after significant political brinkmanship. The so-called "fiscal cliff" saw the expiration of a raft of legislation (tax relief, welfare payments, etc) that was providing stimulus to the broader US economy. Their automatic removal on or about 31 December would have reduced US GDP by as mush as 4.7%. The package of arrangements that were subsequently put in place involved only a moderate fiscal tightening with the key items being the expiration of payroll tax relief and an increase in the tax rate for those earning more than USD $400,000 pa.

Early in the negotiation process there was hope that the fiscal cliff and debt ceiling would be dealt with as part of a "grand plan" around fiscal reform as the two issue are inextricability linked. However, partisan politics again came to the fore and the US only managed to eke out a half-baked solution to the fiscal cliff at the 11th hour.

You might recall that in August 2011 the political standoff around the renegotiation of the debt ceiling saw Standard and Poor's reduce the US credit rating. In the lead up to this time, the Australian market (ASX 200) was trading as high as 4,971 before dropping to as low as 3,766 in early August 2011. At the time of Standard and Poor's announcement, the US market dropped close to 6% in a single day.

There was an enormous backlash against politicians in the US at this time and you would like to think that lessons have been learned. This is what the market has certainly surmised and there is certainly nothing priced in to equity prices at present to account for a protracted negotiation around a new debt ceiling. In the normal course, agreement on the US debt ceiling will need to be concluded by mid to late February'13.

Europe – No News is Good News

Importantly, the measures announced by the European Central Bank (ECB) in September 2012 have resulted in significantly lower yields in peripheral EU debt. As an example of the success of "Outright Monetary Transactions", Spanish two year Government Bond rates have fallen from 6.64% in August'12 to currently stand at 2.10% in early January'13 – this is **not** a typographical error, borrowing costs for Spain have actually fallen close to 70%.

At the ECB's most recent policy meeting, Mario Draghi (the ECB President) provided a useful synopsis of the state of affairs in Europe, noting that:

- Bond rates are much lower,
- European stock markets are higher and with reduced volatility,
- There has been a cessation in the flight of bank deposits from peripheral countries,
- There have been strong capital flows back into the Euro zone, and
- The size of the ECB's balance sheet has been reduced

All in all a very positive finish to the year from a region that during 2012 threatened to plunge stock markets back below their GFC lows.

China – Moving up the U-shaped Recovery Path

Lingering concerns about the health of the Chinese economy (not shared by us) were well and truly dispelled with the release of Chinese trade figures for December – exports jumped 14% and imports were up 6%. Growth is now on track to hit at least 8.6% in 2013 (HSBC forecast) having fallen to "only" 7.8% in 2012. In good news for Australian resource companies, Chinese steel inventories have now been reduced and iron-ore prices have moved up to a 15 month high of $US150 a tone, having fallen to a low of $US86 a tonne in September 2012.

What we are witnessing in China is a U-shaped recovery that is being carefully stage-managed by the Chinese Government – they are keen not to repeat the heightened levels of inflation that accompanied the V-shaped recover we saw coming out of the GFC

Domestic Interest rates – Lower for Longer

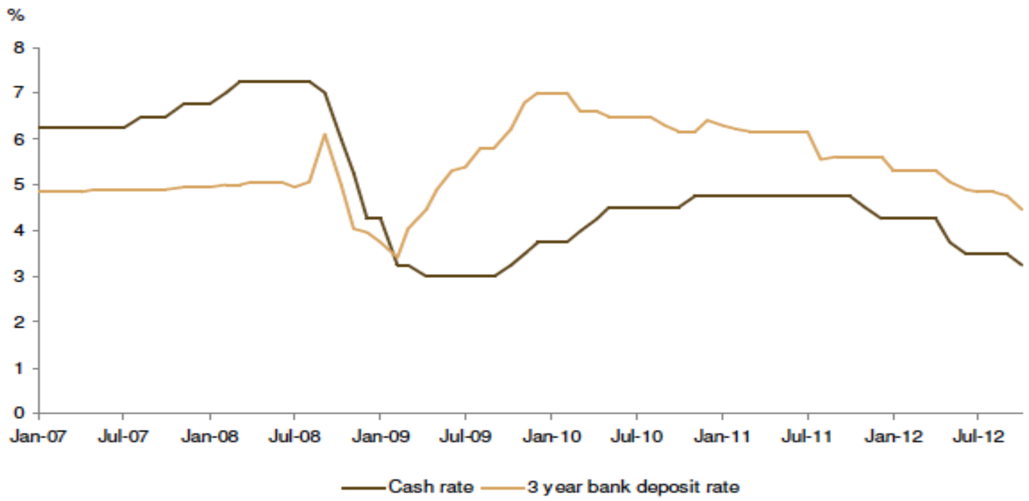
The RBA is now concerned about Australia's growth trajectory. Its economic thesis involves a slowing of mining sector investment over the next year or so – which it assumes will be "replaced" by non-mining sectors. If the contemplated business investment hole does emerge over 2013 as a result of capital spending slowing in the mining sector (and we doubt that it will to the extent intimated due to continued significant LNG project investment) there will need to be **significant** compensating investment and this is unlikely to materialise without further reductions in business lending rates. The other potential impact that lower interest rates have is that they stimulate consumer spending – people have more money left over in household budgets after making mortgage repayments.

The problem the RBA is now facing, however, is that consumers are much more conservative – they are still deferring consumption and de-leveraging their personal balance sheets (ie paying back borrowing). This situation is further exacerbated as we have moved into a period where Government fiscal policy is being engineered to **remove** stimulus from the domestic economy (ie targeting budget surpluses).

All this means that the RBA will need to contemplate greater levels of interest rate reductions (than has historically been the case) to achieve a specified increase in economic activity. The other point to bear in mind is that banks have now "decoupled" their mortgage and business lending rates from the RBA's official interest rate and the full amount of official rate reductions is no longer flowing through to mortgage rates - this situation is likely to continue into 2013. The other place banks will continue to squeeze margin is from term deposits.

Term Deposits – A Hollow Log to prop-up Bank Margins

Since the RBA moved to a loosening bias on monetary policy, official interest rates have been reduced by 1.75% in total. For those relying on the interest payments from term deposits, this of itself would represent a significant reduction in income. However, the actual reduction in bank term deposit rates has been far greater than the nominal reduction in official cash rates.



As the graph above demonstrates (Source, RBA), during the GFC, term deposit pricing became much more aggressive. In the period leading up to 2007, term deposits were typically priced at margins **below** the cash (or official) rate. As offshore funding costs increased significantly for domestic banks subsequent to the GFC, the pricing of term deposit rates became much sharper – subsequent to January 2009, term deposits were priced at a margin **above** the cash rate. At one point during the latter part of 2009, term deposits were priced at a 3.5% margin above the cash rate. This margin has now fallen to just over 1%.

Term deposit rates have now **fallen by close to 3%** since their post GFC peak (compared to cash rate reductions of 1.75%) and futures markets are forecasting at least a further 0.5% reduction in cash rates during 2013.

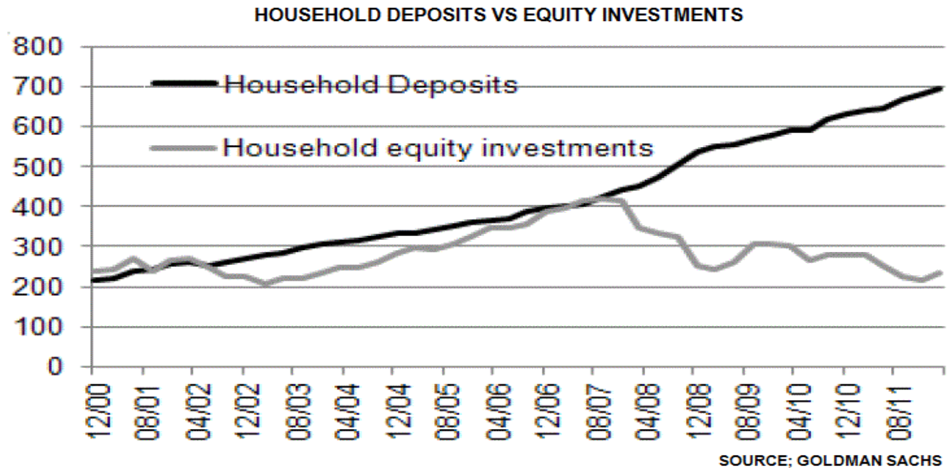
The Wall of Cash - Liquidity Support for Equity Markets

Both here and in the US, significant flows of funds have been diverted into "fixed interest" investments rather than equities over recent years. In the US, investors are being paid close to 0% to invest in short term US treasuries, yet the price of such investments has continued to climb. Some suspect that the next asset bubble to burst will be that of US Treasuries.

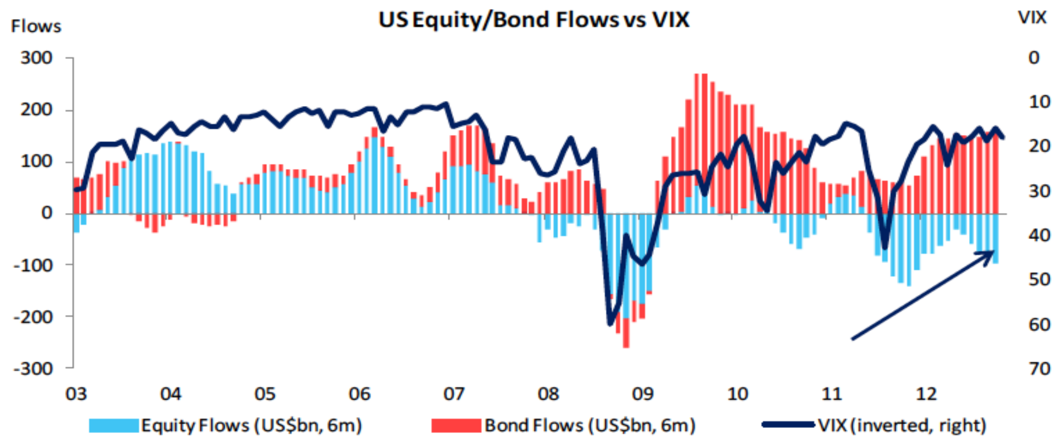
Here in Australia, many investors have found sanctuary in term deposits; but as we have indicated above, the party for this investment class is nearing an end. Official rates will, in all likelihood, continue to fall and banks will reduce term deposit rates at a faster rate than reductions in cash rates.

It is these continued drops in interest rates that are likely to drive more investors into the equity market. The "equity risk premium" (ie the difference between yields on shares and interest paid on bank deposits) is moving to an all time high. One of the reasons why "yield stocks" (such as Telstra and the major banks) have been so well supported over recent months is due to the migration of funds from disgruntled term deposit investors into shares.

The extent of the potential "wall of cash" sitting in bank deposits is highlighted in the graph below from Goldman Sachs that shows the rate of domestic household investment ($bn) in shares versus deposits.



The US experience is just as stark with significant flows of funds into bonds at the expense of equities – the recent Macquarie Research chart below tracks flows into bonds (red bar) and equities (light blue bar) over the last 9 years. It also adds a measure of volatility (VIX – dark blue line) to make the point that historically, when volatility has been low (between 10 and 20 on the VIX scale – as it is now) flows into equities have been strong. (Note that the VIX scale on the RHS of the graph is inverted.)



Source: Macquarie Research, FactSet, ICI, January 2013

Outlook for 2013 – Reasons to be Bullish

As we indicated last quarter, amongst the pre-requisites for a rise in Australian Equities were a lowering of official interest rates and better economic news out of China and a down payment has been duly made on both fronts.

We have outlined above our thinking around why the "equity risk premium" will play a significant role in providing (further) support to Australian shares over 2013. This liquidity certainly has the potential to drive the PE expansion that started over the latter part of 2012 - that is, price earning multiples have firmed without any reported increase in earnings to this point. Most bull phases in equity markets actually start in this fashion, with prices moving ahead of earnings in an anticipatory fashion (a situation made easier both here and overseas where PEs have been travelling at below their historical averages).

However, at some point markets need fundamental support to move up and stay up. In other words, (actual/forecast) company earnings will need to start increasing. As we move through the next few reporting periods (February, April and July), Australian companies will need to put some "profit runs on the board" – for the better part of 2012, each profit reporting period heralded downgrades to average company earnings. Earnings and guidance will now need to be positive to justify a further significant run-up in share prices. More so than at any other time in recent history, those companies that disappoint will be hammered.

From a technical point of view (ie those fixated by charts and historical trends) the Australian market is strongly positioned as we enter 2013. Most technical pundits expect the Australian bourse to push through 5,000 at some point in 2013. Some note that the market is tracing out a correction similar in many respects to that which emerged after the 1970's bear market.

In the immediate short term, however, given that the market has rallied strongly over recent months, it is expected that it will need a period of consolidation or potential pull-back during January to lay a platform for the next up-leg - momentum indicators (such as the RSI) ticked up into "over-bought" territory as we entered January'13.

March/April loom as a period of potential technical instability – if this coincides with a protracted debate in the US around the debt ceiling, one could easily conceive of a material correction around this time.

The top performing shares and sectors in 2012 may not finish top of the leader board again in 2013. Many of the defensives (eg health care, utilities, consumer staples etc) are looking rather expensive. Companies like Telstra and the banks might also sit in this category, however, in the absence of any negative news, they are likely to continue to be supported by the more conservative investors moving funds back into the market – as a theme, "yield" is likely to continue to be well supported in the Australian market in the short to medium term. On the flip side, some of the "uglies" from 2012 are likely to have much better years – industrials, selected discretionary retailers and resources are all looking cheap.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Overweight):** We are constructive on Australian stocks, with further reductions anticipated to official interest rates and above-average growth expected out of China. Any near-term dip in the Australian market should be seen as an opportunity to accumulate quality stocks.
- **Global Equities (Neutral):** The US market may soften in the next month or so, but increasing global liquidity levels will be supportive of equity markets over the medium term.
- **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 and we expect reductions of the order of 0.5% in official cash rates over 2013. There may be merit in accessing duration (ie, longer term securities) and limited credit risk via suitable managed funds. Listed income securities continue to be an attractive investment, albeit prices are firmer.
- **Cash (Slightly Underweight):** As a result of our positions in other asset classes, cash is moving toward a slightly underweight position.

Regards

Andrew & Stephen
10 January 2013