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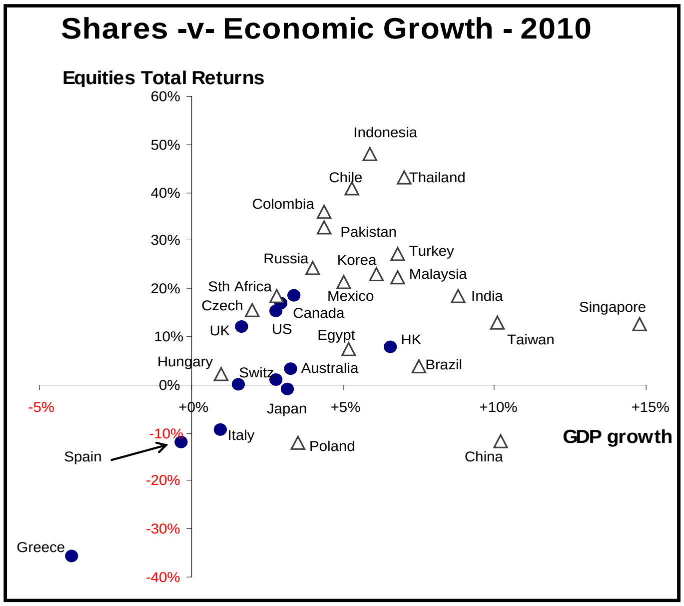
MONTHLY MARKET MONITOR – End December 2010

Chart of the month: Shares -v- Economic growth



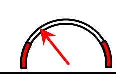
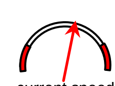
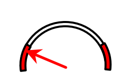
2010 provided another reminder that the relationship between economic growth and stock market performance is weak. While almost all commentators, bank economists, think tanks, policy makers, government finance departments, treasuries and central banks focus on the economy and economic factors like inflation, interest rates and unemployment, we don't invest in economies, we invest in asset markets – like shares, bonds, property & commodities, etc. Since asset markets don't follow economic growth, it pays to focus primarily on asset markets rather than on economic debates.

Despite Australia technically avoiding the global recession, and despite record mining export prices and volumes, the Australian stock market performed worse than almost every other developed market in 2010. The only worse stock markets were those of Greece, Spain, Italy & Poland, which all collapsed in the midst of the European debt crisis. (Returns in Japan, Switzerland, Hungary and France were similar to Australia)

Several stock markets provided 20%+ returns despite only modest economic growth – including Indonesia, Chile, Colombia, Russia, South Korea, Mexico and even Pakistan, despite widespread devastation by war and floods there.

Several countries had lower economic growth than Australia but generated higher stock market returns – including the Czech Republic, South Africa, US & UK. The US, UK and Germany are struggling with slow growth and fears of double-dip recessions but they all enjoyed good stock market returns in 2010, after even higher returns in 2009..

Other countries enjoyed rapid economic growth but weak stock markets – including Brazil, China and Hong Kong. China takes the cake – with 10+ economic growth, but -12% stock market returns – demonstrating that growth engineered by massive government-directed investment using government directed debt, and government/political domination of company boards doesn't necessarily translate into stock market returns for investors. Both Canada and Germany enjoyed similar economic growth to Australia in 2010 (and both were led by export booms like Australia) but stocks returned +17% in Canada and +19% in Germany in 2010 (following returns in 2009 of +33% returns for Canada and +27% for Germany), compared to our 3% returns in 2010 for Australia. Australia needs to do more than rely on booming commodity prices, which are always only temporary.

		Economies – December 2010	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The local economy grew by 3% in 2010, following less than 1% growth in 2009. Over 2010 the government had its foot on the accelerator with stimulus spending, but at the same time the central bank had to apply the brakes by raising interest rates several times. Our high interest rates and high structural current account deficits meant we were unable to play ball in the global competitive money-printing and currency devaluations, so our soaring dollar has hurt exporters and kept tourists away. Over 2011 we can expect more rising prices and wage break-outs as employment remains tight and the government cuts immigration in response to anti-immigration populism.	Average growth rate	Improving	 current speed
	US	The US economy grew by around 2.8% for the year, after contracting by 2.5% in 2009. Fears of a double-dip recession have receded in recent months, but it is still highly likely, given the tentative recovery is based on extremely loose fiscal and monetary policies, which cannot last forever. Unemployment remains at around 10%, and even those in jobs are crippled by mountainous household debts and negative equity. Somehow consumers kept spending and US stocks continued to rebound, returning a healthy 15% for the year.	Below average growth rate	Recovery remaining slow	 current speed
	China	The Chinese economy grew by 10% in 2010, up from 8% in 2009, but the growth was driven by government directed lending & investment, much of it unproductive and ill-directed. A key question for global markets for 2011 is whether China can engineer a soft landing or suffer a hard landing as it battles inflationary forces and rising unrest from workers. The government has taken a range of measures to restrict lending, increase interest rates, boost farm production and increase wages. 2011 will not be a dull year.	Strong growth	Growth slowing	 current speed
	Japan	Following a 5% economic contraction in 2009, the Japanese economy grew by around 3% in 2010, despite the high yen, falling prices, a paralysed government, non-existent reform agenda and falling population. Despite all of this, economic growth and stock market returns were the same as for Australia in 2010.	Chronic recession, deflation	Remaining weak	 current speed

		Asset Classes – December 2010	Current position	Long term returns (1)
Shares	Australian Shares	The All Ords index ended the year down a fraction (-0.7%), but up 3.3% including dividends. The major indexes are still some 30% below their pre-GFC peaks. The best sectors for the year were Mining +18% (with virtually every major stock rising). Also up were the gold sector +39%, Utilities +9% (led by AGL & APA), Healthcare +5% (led by Ramsay, CSL, Resmed and Cochlear), Consumer Staples +3% (led by Fosters) and Energy +2% (led by the coal miners). All other sectors were down for the year: – industrials, consumer discretionary, IT, financials and telcos all down. The winners for 2010 were the sectors leveraged to the global recovery, while domestic sectors went backwards, as the domestic economy was mainly reliant on artificial stimulus and not real demand. The overall market is not expensive, at around 12 to 13 times expected next year's earnings, with earnings set be rise by at least 15% in the coming year if all goes well.	Around fair value	Average long run returns
Shares	US shares	US stocks had a good year in 2010 – up 13%, and up 15% including dividends. All sectors were up except healthcare. Apart from mining & energy, the strongest sectors were industrials and consumer products, reflecting strengthening revenues & earnings in the recovery, despite 10% unemployment and a slow economy. IT stocks were stars: Apple (+53%), Amazon (+34%), Oracle (+ 28%), Honeywell (+36%), Texas Instruments (+25%), & IBM (+12%). Consumer products were very strong - Nike (+29%), Kraft (+16%), Coca-Cola (+15%), Philip Morris (+22%), McDonalds (+23%), Altria (Marlboro cigarettes, +25%), and even Carnival cruises of all things (+45%). Retailers were also up: Home Depot (+21%), Target (+24%), Costco (+22%), although Wal-Mart was flat. Earnings still look on track to rise by at least 15% during the current year, so current prices are reasonable if things stay on track. Confidence is growing, production and exports are rising.	Above fair value	Below average long run returns (2)
Shares	Emerging markets	Despite having the strongest economic growth in 2010, the stock market prices in China (Shanghai Composite), fell 14% for the year, or down 12% including dividends, due to rising inflation and fears of a hard landing. The senior "tigers" most reliant on China (Hong Kong Taiwan, Korea & Singapore) were up only modestly for the year, but the junior tigers were up strongly (Malaysia, Thailand, Indonesia & Philippines). In South Asia, India and Pakistan were both up strongly, and in Sri Lanka the index doubled. In Latin America, Brazil was flat but the other major markets were all up very strongly for the year. Overall, emerging markets still have stronger fundamentals over the medium term than the debt-burdened, slow-growth, aging, "developed" markets.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Yields on long term Australian government bonds continued to rise toward the end of 2010, as fears of rising inflation abound. Despite the rises since August 2010, yields are still lower than they were in March/April 2010 when the outlook for global economic growth and equities markets were most optimistic. We expect yields in Australia to continue to rise over the medium term.	Yields below (prices above) long run av level	Below average long run returns
Fixed Income	Bank Term Deposits	Bank TDs remain attractive as the big banks continue to exit jittery foreign debt markets and raise more money at home instead. Yields remain very attractive relative to traditional bonds, and TDs remain our preferred way of investing in the domestic fixed income sector.	Yields above long run average	Above average long run returns
Fixed Income	Global Bonds	Yields on long government bonds continued to rise in all major markets – except in Spain (after the big credit spread blow-out there in November) and in Japan. Despite the recent rises, yields are still around 0.20% to 0.50% lower than at the start of 2010 for most countries, and lower yields over 2010 resulted in good returns from most markets. We are under-weight global bonds as yields are expected to continue to rise as economies improve and inflation returns over the coming years.	Yields below long run average level	Below average long run returns (2)
Fixed Income	Credit Spreads	Corporate credit spreads are continuing to improve as confidence returns and fears of double-dip recessions fade. Spreads on Australian listed bank hybrids continue to offer good value, and still offer an opportunity to profit as fears recede from global credit markets, but they remain vulnerable to any new outbreak of fear in credit markets.	Spreads above average	Above average long run returns
Cash	Australian target cash rate	We expect the target cash rate to continue to rise in Australia as the economy has low unemployment, rising prices & wages and little spare capacity. Bank bill rates are pricing in an expected 0.25% rise over the next few months. All banks offer cash accounts that pay more than 1% above the target cash rate, and this remains a very attractive place to park spare money.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts ended the year flat (after including distributions), following returns of +8% in 2009, and their disastrous -54% return in 2008. Prices in most markets have now stabilized, vacancy rates are low, new supply is limited and debt levels are low. In these conditions, we don't expect major falls in value in the coming year, but can look forward to strengthening markets, with office markets being strongest. 2011 should see a return to positive returns from the sector.	Below long run fair value	Above average long run returns
Real Estate	Australian residential	Interest rate rises should keep property prices subdued in 2011. Decreasing bank competition will keep margins and interest rates high, and this will dampen property price rises. At the top end the high dollar is also keeping buyers away.	Varies by market	Average long run returns
Australian Dollar		The currency wars of 2010 left the AUD high and dry, rising against every currency except the Yen Over 2010 the AUD was up 7% against the USD, 11% against the pound, 22% against the Euro, 10% against the Chinese RMB and Korean Won, and 3% against the Swiss Franc, Singapore dollar and Taiwan dollar. As long as commodity prices and local interest rates keep rising, more pain for exporters is in store for the coming year.	Above fair value	Below average long run returns

(1) Expected "long term" returns refers to periods of 10+ years (looking through economic cycles) starting from the current position
(2) Returns for non-Australian assets are in local (foreign) currency – hedged to AUD