MONTHLY MARKET MONITOR – End January 2011

Quick Up-date: US Housing & Economic crisis

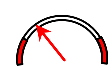
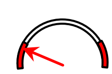
The US Federal Government has released its *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, which was the official government enquiry into the causes of the crisis. The report is a depressing insight into the sorry state of the US financial system and US economic policy making. The scale of the crisis is mind-boggling: 26 million Americans are out of work, 4 million families lost their homes through foreclosures (plus 4.5 million more are currently in the process of foreclosure), and 10.8 million home-owners now owe more than their homes are worth (which is a quarter of all mortgage holders across the entire US).

The 10 Commissioners comprised 6 Democrat and 4 Republican appointees and the outcomes reflect this partisan split. The majority report (written by the Democrat appointees) blames the crisis on a failure to regulate the evils of free market capitalism. It singles out the Federal Reserve for the most criticism – for failing to monitor, supervise or regulate credit in the financial system. Other culprits were the SEC, the banks and investment banks, excessive leverage, heavy reliance on short term funding, flawed risk models, skewed remuneration policies, the credit ratings agencies, fraudulent and predatory lending by mortgage brokers and originators, and de-regulation of derivatives markets.

The Republican Commissioners produced two separate minority reports, with very different findings. The first dissenting report (Hennessey, Holtz-Eakin & Thomas) found the number one cause of the credit bubble and the crisis that followed its collapse was trade surpluses primarily from China (!). They listed 9 other causes, including the rise of sub-prime lending, the credit ratings agencies, investment banks, increased leverage, and failure to manage liquidity risk. They also attributed some accountability to the millions of mortgage borrowers who signed up to loans they must have known they had no chance of ever repaying ("predatory borrowing" was as rife as "predatory lending").

The third report (Wallison, Republican) found the main cause was the fact that 27 million out of the total of 55 million mortgages in the US were sub-prime or otherwise high risk loans – as a direct result of the US government's social policy of forcing lenders to lower lending standards to lend to low and moderate income families (under the 1977 Community Reinvestment Act, the 1992 Housing & Community Development Act, and the 1994 Department of Housing & Urban Development initiatives), with Fannie Mae and Freddie Mac as the main conduits. These 27 million weak mortgages totalled $4.2 trillion, and were bound to lead to disaster as soon as the housing bubble burst.

Meanwhile the Dodd-Frank Reform Act was passed (before they lost control of the House), so the government had already accepted the "lax regulation" argument before the report was even published. The problem is that neither the reforms already passed, nor the proposed further reforms, address some of the real issues. Monetary policy is now looser than ever, the social housing policy that directs lenders to lend to the poor and un-creditworthy is still as entrenched as ever, universal deposit insurance has been extended even further, the financial system is even more concentrated than ever into a small number of huge "too-big-to-fail" behemoths, and the same bankers are still in place – with their bonuses being paid by tax-payers! On top of all that, house prices in the US are still unsustainably high (despite falling 30% already) and mortgage default rates are sure to rise as interest rates (and loan repayments) rise. The full report is at: www.fcic.gov/report

		Economies	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The Qld floods dominated the news here in January (although floods in Brazil, Philippines, Colombia, Sri Lanka & Saudi Arabia in January did more damage to life & property). The floods here hurt sales volumes for miners, farmers and manufacturers, but also caused spikes in commodities prices which will be good news for producers that were unaffected by the floods. The Federal Government announced a tax hike to pay for reconstruction, which will presumably be spent just as efficiently and effectively as the government's recent roof insulation program and school tuck shop program. Bureaucrats, consultants, tradies & back-packers are in for another bonanza. The victims deserve better.	Average growth rate	Improving	 current speed
	US	Despite early signs of recovery in the US (Dec qtr GPD up 3.2% pa and consumer spending up 4.4% pa) and inflation in food & energy prices, "helicopter" Ben Bernanke is pressing on with "QE2" – printing money to buy treasury bonds to try to keep bond yields artificially low. But bond yields are still rising and the monetary stimulus is fuelling asset price bubbles – notably in commodities and shares. The US budget is heading for a $1.5 trillion deficit, which is 10% of US GDP, fuelling even more anger across the US.	Below average growth rate	Recovery remaining slow	 current speed
	China	The government is trying to slow inflation and property bubbles without letting the currency rise and without causing a hard landing. It has lifted interest rates, lifted housing deposit levels, lifted bank reserve requirements, cut lending budgets, and now is introducing property taxes. Banks are disobeying orders from Beijing and have lent one sixth of their total 2011 lending budgets in the first weeks of January alone. If these reports are true, we can expect to see some reprisals and demotions. Regardless, Chinese steel mills will still need Australian iron ore and coal, and prices are still soaring.	Strong growth	Growth slowing	 current speed
	Japan	Japan suffered a downgrade to its credit rating, from AA to AA-, as the public debt to GDP ratio nears 200%, which is the highest in the world, double the levels in the PIGS and triple the rest of Europe and the US. Incredibly, proceeds from new bond issues now exceed total government tax revenues for the first time since 1946. It is hard to see how Japan can ever break out of this downward spiral, at least while the government is still in denial. Hopefully the worsening debt situation will weaken the yen, assisting exporters.	Chronic recession, deflation	Remaining weak	 current speed

		Asset Classes	Current position	Long term returns (1)
Shares	Australian Shares	Australian shares edged up slightly in January. Banks were up strongly (especially Macquarie & NAB), and the biggest falls were in gold stocks (with the lower USD gold price). Most miners were down, on concerns over the impact of the floods (especially coal miners with Qld operations) and possible hard landing in China. However the unfolding crisis in Egypt has pushed oil to over $100 per barrel for the first time in 2 years, and this should be positive for energy and gold stocks. The overall market is not expensive, at around 12 to 13 times expected next year's earnings, with earnings set to rise by at least 15% in the coming year if all goes well.	Around fair value	Average long run returns
	US shares	US shares had a great month in January, bolstered by rebounding consumer spending and surging energy prices. Oil & Gas stocks were up strongly (Exxon, Chevron, Conoco Phillips, and also mining services stocks like Halliburton and Schlumberger). Also up strongly were IT stocks like Apple (despite another health scare for Steve Jobs, they keep posting record sales of iPhones and iPads), Oracle, IBM, Cisco, HP, Honeywell & TI, reflecting rebounds in consumer and business confidence. Retailers are also doing well – including Wal-Mart, Home Depot, Walgreen and eBay. Corporate earnings are growing strongly, but are well above their long term average.	Above long run fair value	Below average long run returns (2)
	Emerging markets	Latin American and Asian markets were mostly down for the month (with Hong Kong and Taiwan being the exceptions), while Russian and other Eastern European markets were stronger. India fared the worst of the BRICs – down 10% (with banks, software firms, steel makers all down), led by India's largest stock, Reliance Industries, despite its 28% rise in profits. Chinese markets were flat overall after a bad year last year, as the market is unsure about how the government's efforts to deflate the housing bubbles will affect local stock markets, which are dominated by banks and property companies. The Egyptian market fell 20% in late January with the civil unrest there.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Yields on Australian long term government bonds fell slightly, after strong rises over the past 4 months. The bond market is now factoring in the prospect of slower local economic growth due to the impact of rate rises last year, higher bank lending margins and the flow-on impacts of the high dollar. We expect yields in Australia to continue to rise over the medium term, so investors would generally stay at the short end of the yield curve.	Yields below (prices above) long run avg level	Below average long run returns
	Bank Term Deposits	Bank TDs remain attractive as the big banks continue to exit jittery foreign debt markets and try to 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
	Global Bonds	Global bond yields continued to rise in January. In Europe, bond yields in the stronger countries (Germany, France, UK) rose as their recovery outlooks improved, while in the weaker countries (Greece, Ireland, Spain, Italy) yields fell as default fears receded. In Japan, yields rose with the credit downgrade, reflecting heightened fears of eventual default, restructure or monetary policy induced inflation. Despite continued efforts of the US Fed to drive bond yields down via its "quantitative easing" programs, yields on US 30 year bonds continued to rise, and have how risen by a total of 1% since August of last year. As this directly feeds into mortgage payments on most US mortgages, these rises will put further pressure on mortgage default rates and foreclosures this year. We continue to be under-weight global government bonds as yields are expected to continue to rise over the medium term as economies recover and inflation returns over the coming years.	Yields below long run average level	Below average long run returns (2)
	Credit Spreads	Corporate credit spreads are continuing to improve as confidence returns and fears of global 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. For example, it is quite possible that the severe austerity programs in Europe will tip a number of countries back into recession, as the UK is looking like doing.	Spreads above average	Above average long run returns in Australia
Cash	Australian target cash rate	Cash rates in Australia remain at 4.75%, which is still below their expected long term "neutral" setting – ie still a loose (expansionary) policy setting. We expect rates to rise further in the coming year as inflationary pressures filter though into the economy – both from the domestic economy (rising food, energy, utility prices, and wage rises) and from the loose monetary policies globally.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Australian listed property trusts got off to a good start in January. Office markets continue to show signs of improvement, led by the Melbourne market, but retail sales and rents remain weak. We are expecting reasonable returns over the coming year, supplemented by some additional capital returns and special dividends as trusts look to raise their distributions to get rid of excess cash on their balance sheets, plus also the possibility of some merger and acquisition activity.	Around long run fair value	Around average long run returns
	Australian residential	The residential property market remains subdued in most centres. Recent distress sales and mortgagee auctions on the Gold Coast confirm that there is still a long way to go before the market recovers. Reduced bank competition will keep lending margins and interest rates high, and this will dampen property price rises.	Varies by market	Average long run returns
Australian Dollar		The AUD fell by around 2% against most major currencies during January, and it fell by a little more against the tentatively recovering Pound and Euro. If the crisis in Egypt broadens further across the Middle East (especially to Saudi Arabia) we could see a resurgence in the USD as a safe haven currency, and a lower AUD should relieve some of the pressures on Australian businesses.	AUD 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