MONTHLY MARKET MONITOR – End March 2011

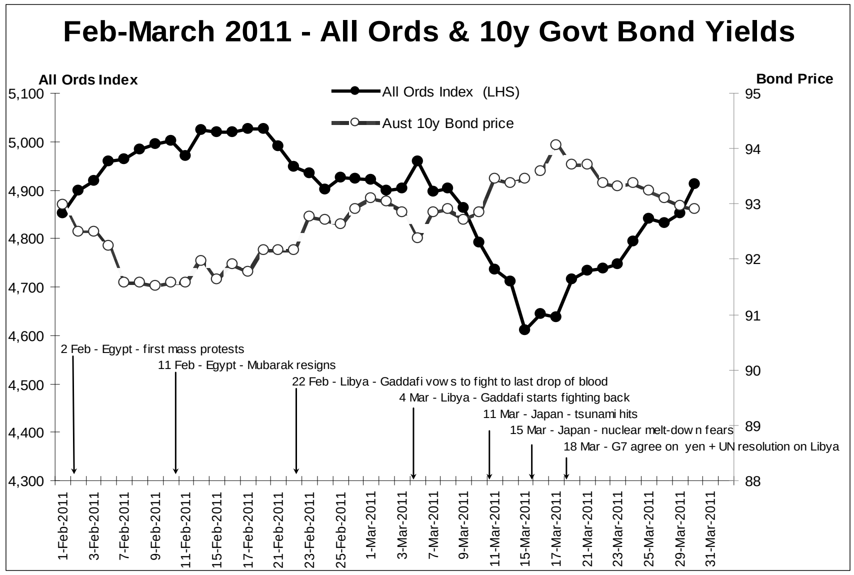
Chart of the Month: Libya/Japan crisis: impact on prices of shares & bonds

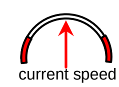
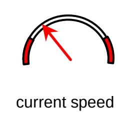
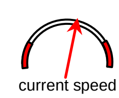
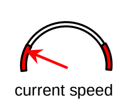
The recent traumatic events in the Middle East and in Japan provided a prime example of the value of holding bonds in a portfolio along with shares. In times of crisis, bond prices often follow the opposite path to share prices.

Optimism peaked when President Mubarak resigned in Egypt on 11th Feb, but investors soon turned pessimistic when Gaddafi vowed to '"fight to the last drop of blood" in Libya on 22nd Feb. Doom & gloom was at its worst in the week following the 11th March tsunami in Japan, when nuclear meltdown fears spread.

As the crisis unfolded investors panicked and dumped all "risk" assets everywhere – shares, industrial metals, farm commodities, "risk" currencies like the Australian dollar, and even gold. Investors moved the money into the "safety" of government bonds, pushing up bond prices.

In Australia, the rise in prices for government bonds offset about half of the falls in share prices. This also happened in 2008, when shares fell 40% but long term government bonds gained 20%. This is a prime reason for including bonds in long term portfolios.



		Economies – March 2011	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The ultra-high Australian dollar continues to put a brake on the local economy – via lower export revenues for mining companies (commodities are priced in USD, but the high exchange rate results in lower AUD revenues and lower margins since most costs are paid in AUD). It also results in lower competitiveness for non-mining exports (especially manufacturing, education and tourism). Lost production due to the January floods continues to hamper mining and agriculture, especially in Qld. However, the economy is being driven by huge planned increases in mining investments in the next few years, which remain on track as long as the global economy continues to edge toward recovery.	Average growth rate	Improving	
	US	US Congress managed to pass yet another budget band-aid which expires in early April, at which time the Republicans will need to decide whether to risk a voter backlash by shutting down the federal government (literally closing government departments and sending staff home), or to vote to lift the federal government debt ceiling so that the government can keep spending money it doesn't have. The unemployment rate seems to be stabilising around 9%, as companies slowly re-hire but governments lay off staff. Rising oil prices (petrol prices at the pump are now $4 per gallon instead of $3 last year), rising food prices (from strong emerging market demand and numerous supply disruptions), and rising mortgage repayments (as long term bond yields creep up), are squeezing household budgets and cutting spending on other household items. But how many cars, electronic gadgets and buckets of junk-food do Americans really need anyway? Like Australian households, Americans are opting to pay off debt (at last!), which makes sense, but it makes economic growth numbers look sick.	Below average growth rate	Recovery remaining slow	
	China	China continues to battle inflation (it again raised bank reserve requirements to slow lending growth) and battle against allowing its citizens' access to public information that the rest of us take for granted. Authorities quickly put down protests inspired by the popular uprisings in the Arab world, and also struggled to contain the spread of "salt riots" – panic buying of salt as an alleged cure for radiation fallout from the stricken reactors in Japan.	Strong growth	Growth slowing	
	Japan	On 11th March a massive earthquake off the coast of north-eastern main island of Honshu caused a devastating tsunami that swept away vast areas of territory around Sendai, and damaged three nuclear reactors 250 km north of Tokyo. At least 30,000 people were killed and the damage bill is likely to be in the order of $200-300b. This is a direct and permanent loss of wealth. Power cuts across the country caused numerous companies to suspend production – not just in Japan, but in other parts of the production chain across Asia. Japanese production, exports and economic growth will be lower in 2011.	Chronic recession, deflation	Remaining weak	

		Asset Classes – March 2011	Current position	Long term returns (1)
Shares	Australian Shares	Australian share prices dived mid-month (as did all other risk asset classes globally) due to the combined Libya/Japan crisis, but markets quickly recovered by month-end. The global shift away from nuclear power toward oil/gas and coal was reflected in local stocks, with oil/gas and most coal stocks up, but uranium stocks were hit hard. Also hit where stocks sensitive to rising oil prices – including Qantas and Toll. Consumer stocks continued to suffer from slow retail spending, with Wesfarmers, CC-Amatil, Billabong, Myer, Harvey Norman and even Goodman Fielder down (the exceptions were JB Hi-Fi & David Jones), and all gambling stocks were also weaker. Gold stocks continued to do well with the surging USD gold price, and the AMP/AXA deal was finally completed.	Around fair value	Average long run returns
	US shares	US shares recovered from the mid-March dip to be flat for the month but are still up 5% so far in 2011. The pattern was similar to Australia:- consumer sectors were down – including technology (Apple, Microsoft, Google, Intel, Cisco, HP, Qualcomm), as was retail (Home Depot, Target, Walgreen, Costco, eBay), and media (Disney, Time Warner, Comcast). However, oil & gas stocks were mostly stronger (Chevron, ConocoPhillips, Occidental, Apache, Halliburton). Current levels of pricing assume corporate profits will rise by at least 10% in 2011, and recent earnings results have been very strong. Even if a slower economy, due to higher oil prices and further fall-out from the Japanese crisis, results in downgrades, earnings are still likely to be higher in 2011 than in 2010.	Above long run fair value	Below average long run returns (2)
	Emerging markets	Despite the dip mid-month with the Japan/Libya crises, virtually all emerging markets did well in March, with Asian markets up the most, despite the impact of Japanese production disruptions (only North African markets were down). Despite the stronger AUD, the emerging markets as a whole still gained 4% in Australian dollar terms in March. The main game this year in most emerging markets continues to be how to combat inflation without risking hard landings. Governments continue to take measures to tighten monetary policy and lending growth, preferably without raising interest rates because that attracts hot money and makes their currencies less competitive for exporters. Russia will probably be the biggest beneficiary from the higher reliance on oil and gas while a cloud hangs over nuclear power following the crisis in Japan.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Prices jumped (causing yields to spike downward) in mid March as investors panic-sold "risk" assets like shares and commodities, but this reversed by month-end and bond prices and yields are back to where they were at the start of the month, across all maturities. We expect yields in Australia to continue to rise over the medium term, so investors would generally remain at the short end of the yield curve.	Yields below (prices above) long run av level	Below average long run returns
	Bank Term Deposits	The extra-ordinary push by local banks to increase deposits in Australia and reduce their reliance on fickle foreign debt markets since the Lehman crisis in Sept 2008 has resulted in bank deposits now making up 50% of total bank funding. The rates on term deposit may continue for some time, but the bank funding crisis is now easing, so we may soon see deposit rates return to more normal levels. This will be good news for borrowers, retailers and share prices.	Yields above long run average	Above average long run returns
	Global Bonds	Yields on all government bonds fell as investors everywhere raced to the "safety" of government bonds (even Greek bonds!), but by month-end yields were back above their end-Feb levels in the US, Germany, France & Switzerland. Yields are flat in UK (due to recession fears with rate rises there soon), and also flat in Spain & Italy (despite increasing fears of default), and in Japan (despite the massive financing task to re-build). We remain bearish on bonds over the coming years.	Yields below long run average level	Below average long run returns (2)
	Credit Spreads	Corporate spreads are still wide in Australia, despite the strong state of corporate balance sheets and profitability. However, spreads may be narrowing, evidenced by Woolworth's issue of local bonds during the month at better rates than the big-4 banks. Local banks are also gearing up for covered bond issues, which could see good opportunities to ride spreads down in this new market.	Spreads above average	Above average long run returns in Australia
Cash	Australian target cash rate	The official target cash rate remains at 4.75% and was looking to rise further before the Qld floods and Japanese disaster struck. However, local prices are still rising (with rapidly rising food and fuel prices), unemployment is still low (with skilled immigration numbers down), and demand for labour is still very tight. So far, bank margin gouging has been keeping loan interest rates relatively high so the RBA has not had to hike rates for several months. We expect rates to rise further this year.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property was weaker in March, but was still ahead 4% for the March quarter. The listed sector continues to consolidate in the wake of the GFC. ING's exit from listed funds is wrapping up, with Goodman taking over ING Industrial and Investa talking over ING Office. Centro is also trying to off-load its US assets in order to focus more on the Australian market. The outlook for this year remains positive, with rents and capital values slowly edging up, especially in the office sector.	Around long run fair value	Around average long run returns
	Australian residential	Large increases in stock for sale in the mid-market and top end, and especially in holiday markets, are keeping prices low. Also, the high Australian dollar is keeping foreign buyers and ex-pats away.	Varies by market	Average long run returns
Australian Dollar		The AUD dollar is substantially above its fundamental value since bouncing back strongly in 2009 and 2010, and it has been vulnerable to fall suddenly on any negative news affecting the outlooks for global growth and commodities prices. The crisis in Libya and Japan was just such an event. The AUD dropped 4% fall in 3 days, but it quickly recovered to 1.03 USD by the end of March as the crisis passed. The AUD remains over-valued and vulnerable to future more serious crises.	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