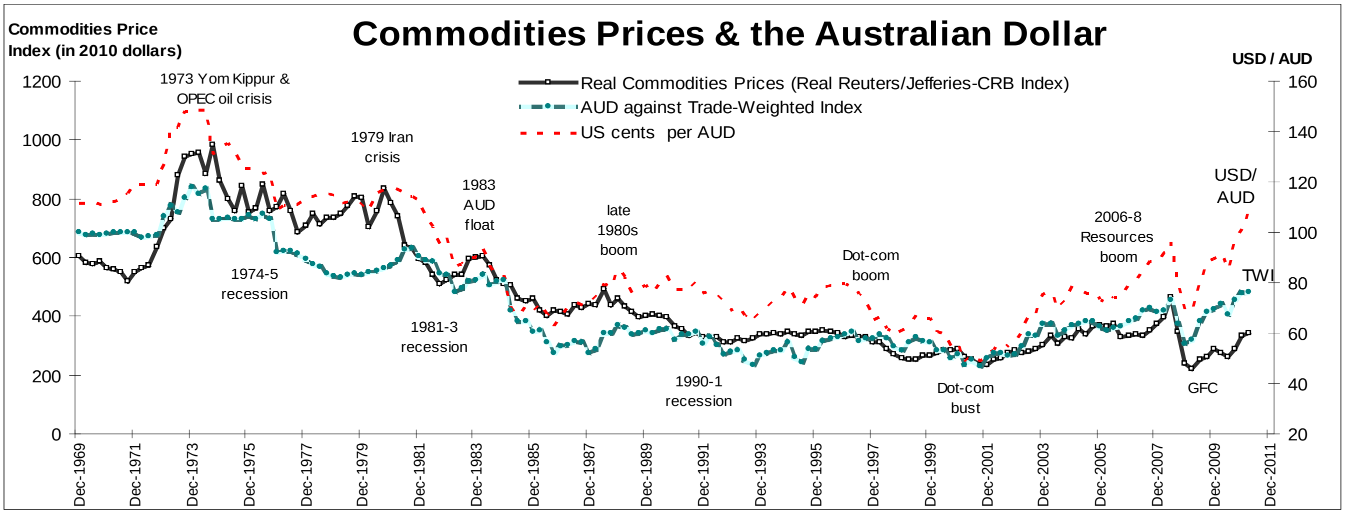
MONTHLY MARKET MONITOR – End April 2011

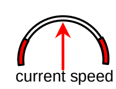
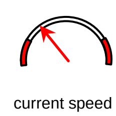
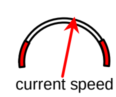
Chart of the Month: Commodities Prices and the Australian Dollar



This month's chart shows the Australian dollar compared to real commodities prices over the past 40 years. The AUD is expressed in terms of US dollars (red dashes) and also the Trade-Weighted Index of our trading partner currencies (green line). Real commodities prices are measured by the broad Reuters/Jefferies Commodities Research Bureau Index, which includes a basket of commodities, in real US dollars.

The Australian dollar is driven by several factors, including relative interest rates, inflation rates, current account and foreign reserve levels, but through the ups and downs of business cycles it tends to follow commodities prices as our exports have always been mainly raw commodities, and prices are very sensitive to business cycles. Real prices of commodities (after inflation) are still well below their 1970s levels. In real terms, the prices of almost all commodities except oil have been falling for more than a century. Over the past 10 years, demand from China and India has lifted the prices of most commodities but prices are still relatively low. Over the past decade, the AUD has risen more against the USD than against other currencies, but this reflects the depreciation of the USD, rather than AUD strength.

If the US recovery remains on track and China continues to grow strongly, commodities prices and the Australian dollar will continue to rise.

		Economies – April 2011	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The strong Australian dollar, high bank margins and re-discovered thrift by households continue to slow the local economy. At the same time, the tight employment market and wage rises are fuelling inflation. Consumer prices were up 1.6% for the March quarter and up 3.3% for the year to March, which is above the central bank's 2-3% target range. Even excluding food and fuel price rises, the underlying inflation rate is still above 3%, with healthcare, education, utilities and transportation costs rising at uncomfortably high rates. Apart from miners and banks, other sectors are generating virtually no growth. So far the Chinese growth merry-go-round continues to spin, but there are clouds on the horizon.	Average growth rate	Growth flattening	
	US	Battles continue in the US over the budget deficit and government debt crises, with no bi-partisan solution in sight. Meanwhile the extremely loose monetary and fiscal policies are forcing down the US dollar and fuelling asset price bubbles all over the world. US companies have used the recession to cut payrolls significantly and increase productivity (Australian companies have done neither), and the lower dollar has boosted exports, so US company earnings and share prices are rising. With rising food & fuel prices, house prices still falling, unemployment rates remaining high, and Congress likely to approve only limited increases in the government debt ceiling, the Fed is running out of options.	Below average growth rate	Recovery remaining slow	
	China	The main issue in China is still how to contain rising inflation and the social unrest that it fuels, without bursting the housing bubbles and/or losing the Communist Party's iron grip on power. It has raised interest rates, raised bank reserve requirements, restricted lending and has even allowed the Renmimbi to rise slowly but steadily against the US dollar – it has now risen 5% since August 2010. So far these measures have not worked. The Communist Party is not famous for soft landings – but they have plenty of experience doing hard landings, eg the 1949 revolution, the Great Leap Forward, the Cultural Revolution, and Tiananmen Square. Everyone is now hoping for an inaugural soft landing.	Strong growth	Growth slowing	
	Japan	The Japanese economy is coping with March's earthquake, tsunami & nuclear crises better than most of the doomsayers expected. More back-up power generation capacity has been found, and production in most areas has resumed. The re-building will take several years, and this will boost imports of raw materials from Australia.	Chronic recession, deflation	Remaining weak	

		Asset Classes – April 2011	Current position	Long term returns (1)
Shares	Australian Shares	After the bounce-back from the Japan/Libya crises in March, local shares were flat in April, and are up 3% for 2011 to date. Miners were down due to continuing fears of slowdowns in developed markets and China. The main exceptions were Newcrest (gold) due to the surging USD gold price, and also Equinox (copper) thanks to the take-over battle. Global slowdown fears also hit mining services stocks (Worley Parsons, Boart Longyear, Monadelphus), steel producers (Bluescope and OneSteel both down 12%) and building materials (Boral, CSR, James Hardie, Adelaide Brighton). The local spending slump also continues to hit all retailers, with Harvey Norman, JB Hi-Fi, David Jones, Myer and Metcash down. Money shifted into defensive sectors - Telstra was up 3%, and utilities like AGL, Spark, APA and DUET were also up. The big banks were all stronger, led by NAB, as they continue to increase margins. We are expecting poor returns from the Australian share market later in the year and we may under-weight the asset class in portfolios soon.	Around fair value	Average long run returns
	US shares	Despite continuing debt problems in governments, banks and households in the US and in the rest of the developed world, revenues and profits of most US companies continue to benefit from the extremely loose fiscal and monetary policies in the US and other major developed markets. Surging oil prices are driving up earnings in the big oil companies, and earnings in the major export sectors are benefiting from productivity gains, the weakening lower US dollar, and strong in demand from emerging markets. The US market has doubled since the March 2009 lows, and is now within 10% of its pre-GFC highs. Virtually every sector was up in April except banks, which were flat. The IT sector continues to surge ahead on strong sales and earnings results. Apple was flat but IBM, Microsoft, Oracle, Intel, Cisco, Honeywell, TI, and Dell were all up strongly, despite supply chain disruptions from Japan's tsunami and nuclear power crisis. Manufacturers were very strong, with most stocks up - eg Boeing, Ford, Caterpillar, 3M, Du Pont, Dow Chemical & many others. Most consumer stocks were also up - eg Procter & Gamble, Coca Cola, McDonalds, Pepsico, Kraft, Nike, Colgate-Palmolive, Philip Morris - with strong foreign earnings due to the weak USD.	Above long run fair value	Below average long run returns (2)
	Emerging markets	In April, emerging markets were up 3% in USD terms but slightly lower in AUD terms due to the rising AUD. Most East Asian markets were stronger, but in China the market was flat, but still up 4% for the year. Nearly all Chinese banks are up despite lending restrictions, higher capital constraints and rising interest rates, which have hit property developers and manufacturing stocks. The Brazil market was down 4% on concerns over slowdowns in US, Europe and China, on top of concerns over a slowing local economy - all sectors were down except local food, beverage and tobacco stocks. The Russian market was also flat, but is still up 14% so far in 2011, as oil & gas stocks constitute 60% of the market. India was also weaker again as it battles rising inflation.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Bond yields are up slightly at the short end in anticipation of rising short term rates. Long term yields have flattened anticipating a slower growth. Yields will probably rise further, especially if the Reserve Bank is reluctant to raise interest rates for fear of pushing the non-mining economy into recession. If short term rates rise, we would start shifting to the long end of the yield curve.	Yields below (prices above) long run av level	Below average long run returns
	Bank Term Deposits	Rates on local bank term deposits continue to be higher than usual relative to government bonds of equivalent term, and they main our preferred way of holding low risk fixed income assets in Australia for the time being.	Yields above long run average	Above av. long run returns
	Global Bonds	Yields on government bonds in most developed economies fell on fears of slower growth in due to lower spending and investment as countries battle with budget deficits and debt levels. Despite short term strength we remain bearish on bonds over the coming years. US yields are also being kept low by the Fed bond buying program, which is likely to cease in June of this year.	Yields below long run average level	Below average long run returns (2)
	Credit Spreads	Corporate credit spreads are still wider than is justified by corporate balance sheet strength and should provide good returns as spreads contract as global credit markets recover from the after-effects of the GFC. Sovereign defaults and European bank bail-outs will be buying opportunities.	Spreads above average	Above av. long run returns
Cash	Australian target cash rate	The official target cash remains at 4.75% despite inflation rates drifting above the RBA's target range. Unemployment rates are still low and migration numbers are down, so demand for labour is still very tight and wages are rising. We expect rates to rise further this year.	Cash rates below long run av level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts edged up in April, bringing total returns to 4% for 2011 to date. The best sector continues to be offices, with Comm Office and Charter Hall Office generating the best gains. Most trusts are still trading below their net asset values, as investors are still wary of valuations. Retail & industrial sectors are suffering from slow consumer spending and the high dollar, but the overall outlook for this year remains positive, with rents and capital values slowly edging up.	Around long run fair value	Around average long run returns
	Australian residential	The housing market in all states continues to fall (in nominal and real terms after inflation) due to high bank margins, tight bank lending restrictions and a flood of excess stock as banks move to sell up defaulting borrowers they have been sitting on since the GFC waiting for prices to improve. Banks are now realising prices aren't going to bounce back so they are steadily releasing more forced sales, which is increasing stock for sale and depressing prices.	Varies by market	Average long run returns
Australian Dollar		The AUD was up 5% against the weakening US dollar, up 2% to 3% against other Asian currencies, but it was flat against the Swiss Franc and lost 3% against a stronger Euro. It is not so much about a strong AUD, but more a result of central banks continuing to reduce their holdings of US dollars toward other currencies, mostly Euro and Francs. The AUD remains over-valued and vulnerable when growth in China slows, global growth slows, or US interest rates rise.	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 terms – ie hedged to AUD but excluding any profits/losses from hedging