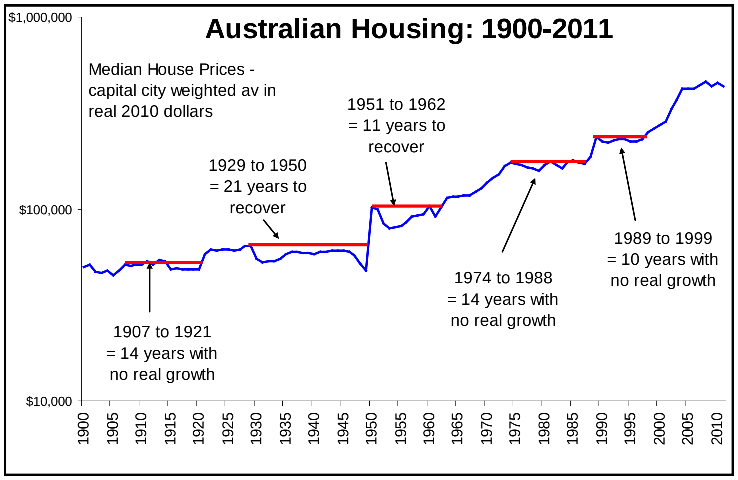
MONTHLY MARKET MONITOR – End May 2011

Chart of the Month: Australian House Prices



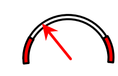
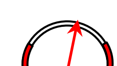
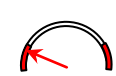
This month's chart shows real median house prices in Australia (the weighted average of median prices in the 8 capital cities, adjusted for inflation). This price series is not adjusted for quality improvements so it over-states actual returns. Most of the increase in house prices has been due to improvements in quality over time: - the median house in 1900 had 2 bedrooms, 1 toilet out the back, no garage, and no hot water, but the median house today has 3-4 bedrooms, 2 bathrooms, a garage, running hot & cold water, electricity and a host of gadgets – so the growth in prices largely reflects improvements in quality and higher construction costs, not returns on investment.

Real growth in non-quality-adjusted house prices has been 2% pa since 1900, but when adjusted for quality improvements (so we compare like with like) real prices have grown by less than 1% pa, which is lower than the rate of growth in real household incomes.

Real house price growth over the past century has not been steady. It has come in just a few short price booms, separated by long periods of zero or negative real growth. These price booms were: the 1920-1 post-war boom (re-settling of returning soldiers), the early 1950s boom (after war-time price and rent controls were lifted), the early 1970s boom (driven by rapid growth in building society and finance company lending), the late 1980s boom (driven by bank deregulation, competition and lax credit standards), and the early 2000s boom (driven by non-bank competition, loose credit standards and a massive build up in foreign debt-funded household borrowing levels).

Median house prices have been virtually flat in real terms since the market peaked in 2004-5, and there will probably be no real price growth for several more years in this current phase. This is due to several factors including: lower population growth rates, less bank competition, increasing bank margins, the absence of non-bank securitized funding sources, a reversal of the falling inflation cycle which lowered interest rates during the 1990s and 2000s, tighter bank capital requirements, and household de-leveraging as people pay off debts.

These are median price figures only, so there is still money to be made by picking the right properties in the right locations (eg in growing cities, close to employment, beaches, parks, etc), which requires careful analysis. Although it is true that Australian house prices are among the most over-valued in the world, and Australian households are still among the most indebted in the world, there is no immediate catalyst for a sudden bursting of the bubble. While this is good news, it is also likely that there will be no general rise in real prices for some time yet.

		Economies – May 2011	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	In May the Federal government outlined the budget for the 2011-2 year. It was based on flimsy assumptions and forecast another $20+billion deficit for next year. It failed to cut spending (spending will increase by 4%), but it assumes a 29% increase in company taxes and a 10% increase in personal taxes, and it relies on high commodities prices continuing for several years, which is highly unlikely. The overall economy is still growing (after contracting in the March qtr due to disruptions in Qld mine and farm production), but the growth is all in the mining sector, while other sectors continue to be subdued.	Average growth rate	Growth flattening	
	US	While the weaker US dollar is assisting manufacturers and exporters, the domestic economy is still very weak. House prices are stilling falling and there is still a huge over-hang of housing stock from over-building in the boom. Unemployment rates remain high as federal, state and city governments frantically lay off staff and cut programs to stave off bankruptcy. The current round of government bond-buying ("QE2") is due to end in June, and the Feds may well have to continue to buy government bonds to try to depress long interest rates and depreciate the US dollar further. There are still no long term solutions to the budget crisis – the Democrats will not allow cuts to "entitlements" and the Republicans will not allow tax rises. The outcome is likely to be lower spending by governments and households, plus higher taxes – which would slow growth further. One piece of good news for the whole world is that Donald Trump has pulled out of the Presidential race for 2012!	Below average growth rate	Recovery remaining slow	
	China	The economy continues to slow gradually. Trade surpluses are still growing, with a surge in exports but slower growth in imports, renewing US calls for faster currency appreciation. The central bank lifted bank reserve ratios for the 5th time, and bank lending is now slowing (lending is down around 15% from last year), which is welcome news. So far the government has nipped all efforts to stage a local "jasmine revolution" in the bud.	Strong growth	Growth slowing	
	Japan	Production disruptions resulting from the tsunami-related power cuts pushed Japan's economy back into recession in the March quarter, but growth is expected to resume in the 2nd half of this year. The reconstruction effort is now well under-way and consumer spending and tourism revenues are surprisingly strong.	Chronic recession, deflation	Remaining weak	

		Asset Classes – May 2011	Current position	Long term returns (1)
Shares	Australian Shares	In last month's issue, we reported that we were expecting poor returns from Australian shares in mid-late 2011. We have been heavily discounting Australian corporate earnings outlooks (due to likely flow-on effects of the high dollar and household de-leveraging). In May the profit down-grades started, which rattled share prices and the overall market index was down 2% for the month. Worst hit were the big-4 banks, as their credit ratings were cut by Moody's, due to their heavy reliance on foreign debt to fund the mountain of household debt in Australia. (These are the people who issued "AAA" credit ratings to more than 45,000 mortgage backed securities issues at the top of the market before the sub-prime collapse!). Defensive stocks returned to favour, with gains in Telstra and Woolworths in particular.	Around fair value	Average long run returns
	US shares	US shares were down around 1½% in May, but were up for Australian investors since the AUD fell by more. We were expecting a strong March quarter reporting season for US companies, and it was even better than expected, with 70% of companies beating profit expectations. Revenues were up 9% (mainly in foreign revenues thanks to the weakening US dollar), and profit margins are also stronger, thanks to aggressive cost-cutting during the GFC. The highlight of the month was the float of LinkedIn (the business networking web site) on 19th May, when the $45 stock traded at up to $122 on the first day, which is more than 30 times sales and 1,800 times earnings. Dot-com fever is back! Although the overall market is over-valued on long-term measures, current earnings and share prices are being supported by strong revenues, high margins, low corporate debt levels, cheap money, and a falling US dollar that is boosting competitiveness and foreign sales.	Above long run fair value	Below average long run returns (2)
	Emerging markets	Emerging markets shares were down around 2.5% in May, but held up in Australian dollar terms due to declines in the AUD. Russia had the biggest fall (-7%), due to the 9% fall in oil prices. Lower manufacturing output in north Asian markets, due to parts supply disruptions flowing from Japan's power crisis, affected confidence and led to a flight of foreign capital, causing prices to fall. Also weighing on confidence are possible negative effects of monetary tightenings as governments battle inflation in food & fuel prices across the emerging world. Higher interest rates and tighter credit threaten to choke off growth and force currencies to rise, which would hurt competitiveness and exports. But domestic demand in most emerging markets remains strong. As a sign of the times, Prada is planning a float in Hong Kong, and is experiencing bumper profits from booming sales in the emerging markets, as is the case with many other European luxury brands.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	The big federal government budget deficit for the 2011-2 year will require a flood of new Commonwealth government bond issuance - about $53b gross, or $33b net - to be issued in the coming year alone. Ordinarily this massive increase in debt would be expected to cause yields to rise, but yields are likely to be kept low as a number of foreign governments and global bond funds are increasing their holdings of Australian bonds in order to reduce their reliance on US treasuries. This should help depress bond yields here, but also put further upward pressure on the AUD.	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 this will probably continue for some time, especially in light of the recent credit down-grades of the big-4 banks. Bank TDs remain our preferred way of holding low risk fixed income assets in Australia in the current environment.	Yields above long run average	Above av. long run returns
	Global Bonds	Yields on long term government bonds fell again for most countries, except for Ireland, Portugal, Spain and Italy, which are on the Greek path to default. Portugal finally succumbed to a €78 billion bail-out plan in May. Policy-makers have finally accepted that Greece cannot escape default, and its debt will require restructuring in the form of interest haircuts and/or extended terms. Yields on US government bonds are still falling, despite the Republicans toying with forcing a default, despite S&P's down-grade warning, and despite "QE2" due to cease in June. There is room for yields to go even lower in the short term as growth slows, but over the medium term, bonds look over-priced.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA continues to be reluctant to raise interest rates back to their neutral level for fear of pushing the non-mining economy back into recession, but is faced with continued loose fiscal policy and rising prices & wages, which will probably force it to raise rates later this year.	Cash rates below long run av. level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property sector held up in May, despite weaknesses in the retail and residential sectors. Fears over falling house prices and a dearth of new house buyers affected Stockland in particular in May. Westfield held up despite slow US retail sales, and is looking to sell down a large part of its US centres. Offsetting the softness in retail & residential, recoveries in global office rents and values should benefit other trusts eg. Dexus, GTP, Investa Office (ex-ING) & Charter Hall Office.	Around long run fair value	Around average long run returns
	Australian residential	House prices continue to fall (especially in real terms after inflation) as banks are reluctant to lend (as they hoard capital in readiness for the upcoming Basel 3 rules) and households are reluctant to borrow (preferring instead to pay off debt). Mortgage arrears rates are rising, especially in the first home borrower market, where hundreds of thousands of renters where lured into the housing market by low interest rates and tax-payer funded hand-outs in the GFC cash splash. There are still far more houses, beach houses and Gold Coast flats on the market than there are buyers.	Varies by market	Average long run returns
Australian Dollar		After hitting USD 110.1 at the start of the month, the AUD then fell 1% to 2% against all major currencies in May except the Euro, as commodities prices and mining share prices fell, and as global economic growth outlooks slowed. The AUD remains over-valued and vulnerable when growth in China slows, global growth slows, and/or when 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