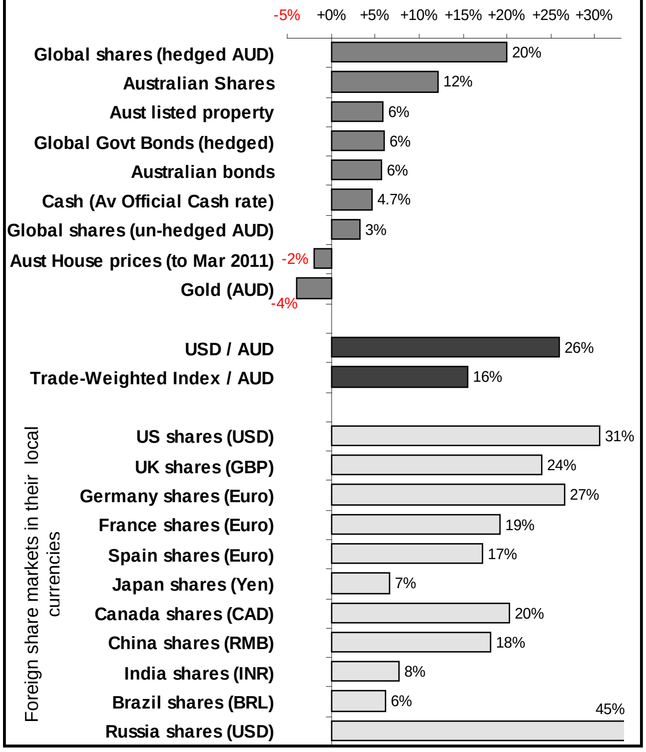
MONTHLY MARKET MONITOR – End Jun 2011

Chart of the Month: A pretty good year for investors

Returns: 12 months to June 2011



One year ago, if somebody had suggested that within 12 months the world would suffer a litany of catastrophes including:-

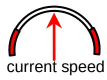
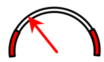
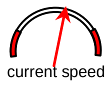
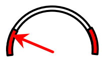
- civil wars and revolutions across the Middle East,
- a flare-up in military tensions between the Koreas,
- a massive earthquake, tsunami and nuclear melt-down in Japan,
- oil prices jumping 25% and gold prices jumping 21%,
- bailouts of Greek, Irish and Portuguese government debts,
- the US government coming close to breaching its debt ceiling,
- a huge local government debt bail-out in China,
- escalating violent riots across Europe, and
- devastating once-in-a-century flooding across Australia

– many people would have panicked and been tempted to put their money in the bank, or retreat to the so-called "safety" of gold or bricks & mortar.

Despite these tumultuous events, it turned out to be a good year for Australian investors in all the main asset class - except for gold and housing.

The broad Australian share market generated total returns of 12% for the year, or 9% above inflation, which is a little higher than the long term historical average, and volatility was much lower than in recent years. Australian bonds and global bonds both returned 6%, which is also very close to their long term expected averages, despite the escalating global debt problems. Although the gold price jumped 21% in US dollar terms, the gold price in Australian dollars fell 4%, meaning it lost 7% in real terms after inflation, and median Australian house prices also lost ground.

Shares in most of the major international markets did very well again (bottom bars), with many countries achieving 20+% returns in their local currencies. Our process prefers that new investments are hedged (where possible) when the AUD is rising strongly (as it was during 2009 & 2010), and un-hedged when the dollar is substantially over-valued and prone to weaken, as it has been in recent months.

		Economies – June 2011	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The local economy continues to be pressured by the over-valued dollar, high household savings rates, rising wages bills (with minimum wages increased 3.4% recently), the new floods tax and the prospects of a new carbon tax and higher superannuation contributions. Despite these pressures, business confidence remains relatively strong, and companies are going ahead with some $120b in capital investment projects (including $80b in mining projects). Consumers are sensibly opting to save money and pay off debts rather than buy even more stuff they don't need.	Average growth rate	Growth flattening	
	US	The US economy continues to grow very slowly. There are early signs of recovery, but just as many signs that point to a "slower for longer" scenario. The completion of "QE2" (the 2nd round of "quantitative easing") at the end of June will reveal just how reliant the economy, share prices and commodities prices have been on artificial money-printing. Despite the high unemployment rate, rising inflation (mainly in food and fuel prices) will probably prevent a "QE3" round of money printing at least for a while. House prices are still falling, and this is affecting consumer confidence and spending, but the recent minor fall in oil prices may provide some relief. The dangerous game of Russian roulette is still being played in Washington over who can hold out for the longest, before the US Treasury runs out of money in early August. Even if the Treasury does default on its interest payments (as it did at the end of 1979), it will probably be rectified in a day or so (making it a mere "technical" default).	Below average growth rate	Recovery remaining slow	
	China	The primary issue in China remains inflation and whether the policy measures to fight it will result in a hard or soft landing. Consumer price inflation edged above 5%, which is well below crisis levels, and still below the 8% level reached before the GFC. The recent interest rate rises and credit restrictions have now slowed lending growth. The currency has been allowed to rise by 5% over the past year and the government will come under more pressure over its currency policy from the US with the ending of "QE2" there.	Strong growth	Growth slowing	
	Japan	Japan continues to re-build infrastructure and manufacturing capacity following the tsunami and nuclear crisis in March. Prime Minister Naoto Kan has agreed to resign over government mismanagement of the crisis, leaving the political leadership in chaos once again. The outlook for manufacturing and export activity remains subdued, with the slow-downs in China, Europe and stagnant growth in the US.	Chronic recession, deflation	Remainin g weak	

		Asset Classes – June 2011	Current position	Long term returns (1)
Shares	Australian Shares	As outlined in the last two months' reports, we were expecting poor returns for mid-late this year, (we heavily discounted earnings outlooks due to likely flow-on effects of the high dollar and household de-leveraging) and this eventuated in the share price falls during May and June. Despite the recent dip, the overall market had a good year in the 12 months to June, with total returns of 12%, which is 9% above inflation - better than the long term average. Miners and mining services stocks were the main gainers with few exceptions. Oil & gas stocks were mostly up, despite falls in the recent quarter. Despite weakening in recent months, industrials also had a good year. The main weakness was in retail, consumer and media sectors due to weak consumer spending. The small cap sector had another tremendous year following the strong bounce out of the GFC last year.	Around fair value	Average long run returns
	US shares	US shares returned 30% for the 12 months to June, (following 20% in the previous year). As in most other countries, most of the gains were in the first half, with 2011 being slower. For the year to June, the vast majority of stocks enjoyed double digit returns. Technology stocks were very strong again, with Apple, IBM, Oracle, Honeywell & Dell up more than 30%. Online retailers also did well, with Amazon and eBay up more than 60%. Manufacturers were up strongly, with virtually all major stocks up by 30-50%. The consumer sector was also very strong, with stocks like Coca-Cola, McDonalds, Kraft, Nike, Yum Brands, Philip Morris up more than 20%. Even retailers, media and transport stocks did well. The weakest sector was banks, with concerns about bad debts and law suits over sub-prime losses (like the recent $8b ruling against Bank of America). The good times may not continue, with the end of QE2 in the US, and with interest rates rising in Europe & most emerging markets to slow consumer spending.	Above long run fair value	Below average long run returns (2)
	Emerging markets	Emerging markets as a whole had another stellar 12 months to June 2011. China and other North Asian markets remained weaker in June due to supply problems in Japan, but South East Asian markets, India and Pakistan remained strong. Brazil had a poor year (but still positive) as inflation and rising interest rates combined to slow credit growth and economic activity. The Indian experience was very similar. Russia was the stand-out market among the BRIC countries, with returns of more than 40% for the 12 months. Despite strong returns from China, we expect higher volatility as more hedge funds start shorting and "rumour-traging" Chinese stocks to exploit fears over accounting fraud and bad debts in Chinese companies.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Yields on Australian government bonds fell in June, but ended the June year a little higher than a year ago, resulting in returns for the 12 months in line with our long term expectations. The pattern over the past couple of months has been very similar to last year, when yields fell on news of the first Greek bail-out. This time around, yields have been kept low due to fears of slowdown in Europe, plus the high dollar and new taxes in Australia, and also by strong foreign buying of local bonds. We expect these forces to continue in the coming months.	Yields below (prices above) long run av level	Below average long run returns
	Bank Term Deposits	Even though interest rates on government securities fell in June, banks have retained their very high term deposit rates. The recent credit ratings downgrades of the banks renewed the pressure on them to raise local deposits, and they are paying through the nose – which is bad for borrowers but a bonus for investors. Despite the very flat yield curve (where interest rates are very similar across short and long terms), the longer terms offer the most attractive returns.	Yields above long run average	Above av. long run returns
	Global Bonds	Despite the escalating debt crises in Europe, Japan and the US, the global bond market had a good year as yields continued to fall. This shows that the market is expecting slow growth and deflation in the major markets, rather than inflation and widespread defaults. There is still scope for yields to fall further but we continue to under-weight the sector. The global bond market is prone to a large correction one day, but not just yet it seems.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA remains reluctant to raise interest rates back to their neutral level for fear of pushing the non-mining economy back into recession, but it is faced with continued loose fiscal policy, tight labour market 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	Unit prices were down a little in June, but finished flat overall for the financial year to June. Total returns from the sector were 6% for the year, including distributions. Most of the small trusts posted good gains, with most of the larger trusts slightly weaker. Rents, capital values and distributions stabilised during the year, but there was much corporate activity and restructuring in virtually all sectors. Westfield restructured yet again, most trusts shed excess stock, some managers exited altogether (eg ING) and there are on-going battles for control of others (eg Charter Hall). There has been increased activity by hedge funds trying to exploit the discounts to NTA. We expect modest returns and more corporate action in the coming months.	Around long run fair value	Around average long run returns
	Australian residential	House prices remain weak in most segments of most markets. There are still many more sellers than buyers, with lingering concerns over likely further interest rate rises. The weakest cities are Brisbane (following the floods) and Perth (over-hang from the pre-GFC mining boom). Although housing in general remains heavily over-priced (as it is propped up by a mountain of foreign debt), we don't see the market collapsing suddenly. The more likely outcome is for more weak growth (failing to keep pace with inflation) for the next few years.	Varies by market	Average long run returns
Australian Dollar		In June the AUD gained against the USD and sterling, but fell against the stronger Yen, Euro and Swiss franc. As we have reported here in previous months, the AUD remains highly over-valued and vulnerable to slowing economic growth rates in China and the developed markets, which are now evident. With European interest rates on the rise, QE2 ending, slowdowns in China, Japan and the US economy remaining weak, the dollar is more likely to fall than rise significantly, and we recommend that global equities be un-hedged for new investments.	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