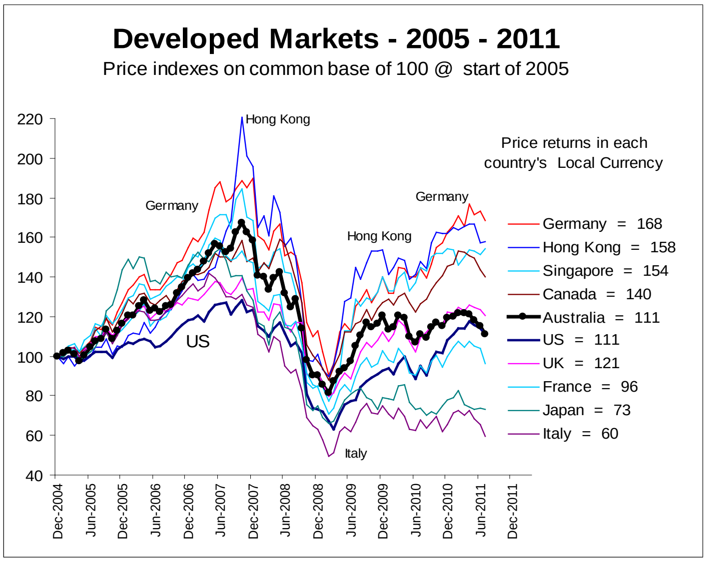
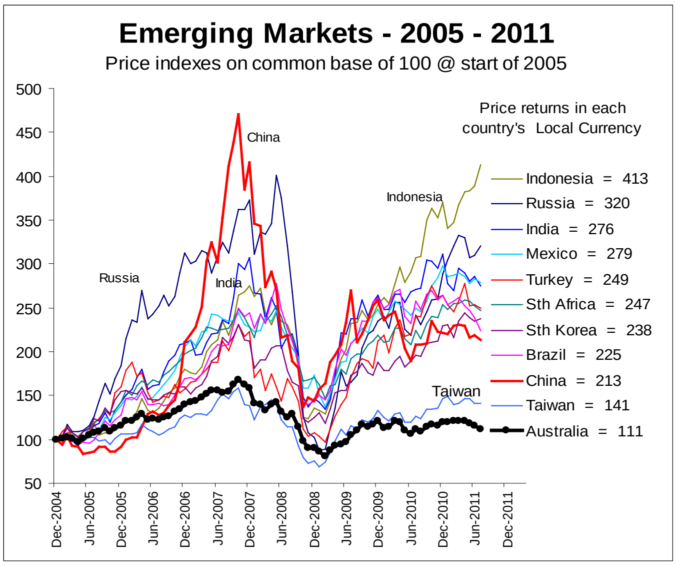
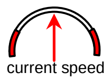
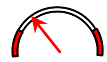
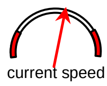
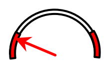
MONTHLY MARKET MONITOR – End July 2011

Chart of the Month: Australian -v- Global Stock Markets





This month's charts show the benchmark index prices for major developed and emerging country stock markets, with a common base at the start of 2005. The Australian market is placed mid-field among the developed markets, beating the UK, France, Japan and Italy, but below Germany, Hong Kong, Singapore and Canada. However, all of the main emerging markets (apart from Taiwan) have beaten the Australian market by very big margins over the period (even after currency effects). Most emerging markets ran up faster and higher in the boom (especially China, Russia & India), fell heavily in the GFC (but remained higher than Australia), and then recovered much more strongly since early 2009. Note the different scale on the right chart that enables the much higher returns from emerging markets to be shown clearly. Emerging markets shares are more volatile but they offer higher potential returns in a "low return" world.

		Economies – July 2011	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	A strong inflation outcome for the June quarter has renewed fears of interest rate rises later in the year and dampened both consumer and business confidence. The CPI inflation rate for the June quarter was 3.6% pa, well above the RBA's 2-3% target range, and "core" inflation was up from 2.2% to 2.7% pa. Price rises were not only in food (largely due to supply disruptions from the floods), but there were also relatively large price rises in other areas of cost of living including education, household items, transport, health, alcohol & tobacco and fuel. Retail spending and lending growth continue to be weak as consumers opt to save money and pay down debts rather than spend and borrow more.	Average growth rate	Growth flattening	 current speed
	US	The last-minute deal to raise the Federal government debt ceiling did nothing to restore confidence in the President or members of Congress. It was quick-fix band-aid that failed to recognize or address the long term structural fiscal problem – for decades the government has spent around 25% of GDP, but collects less than 20% of GDP in taxes, with the difference funded by a growing mountain of debt. This problem has merely been delayed for the next President to tackle. Meanwhile, corporate profit margins are benefiting from a weak US dollar, strong (but slowing) demand from emerging markets, and productivity improvements. But local consumer confidence is still low, with house prices still falling and unemployment remaining high as state and municipal governments lay off workers in the race to balance their budgets in the face of falling tax revenues.	Below average growth rate	Recovery remaining slow	 current speed
	China	So far it looks like a hard landing will be avoided this year as authorities apply various blunt instruments to try to control inflation in consumer prices and housing prices. Consumer inflation rates are now above 6%, driven primarily by rising food and fuel prices and fuelled by rapid rises in wages. Housing price growth has slowed and there are signs of slowing manufacturing production, coming on top of softer demand from the US and Europe. The high-speed train crash in Wenzhou triggered public outcries over government corruption, incompetence, cover-ups and safety compromises on rushed infrastructure projects in China's "growth at all costs" strategy. The government continues to allow the currency to rise slowly but it will come under renewed pressure from the US now that the "QE2" round has ended and the US is running out of options to revive its economy.	Strong growth	Growth slowing	 current speed
	Japan	The Japanese economy continues to recover slowly from the earth-quake, tsunami and nuclear crises in March. Bank profits are recovering well, and manufacturers are also recovering with strong sales to China and the rest of Asia, despite weaker demand from the US and Europe, and despite a strengthening yen as a "safe haven" currency against a weaker US dollar. Japanese stock markets were the only developed market to rise in July.	Chronic recession, deflation	Remaining weak	 current speed

		Asset Classes – July 2011	Current position	Long term returns (1)
Shares	Australian Shares	The local stock market continued down 3% in July, (joining all other developed markets which were also down, except Japan). Most sectors were down in the local market – banks (due to lower lending growth), insurers, oil & gas, steel makers, building materials and retailers (led by Davis Jones down 26% after its profit shock, plus Myer, JB Hi-Fi and Harvey Norman also down more than 10%). Healthcare stocks were also down, with the strong dollar hitting foreign earnings. Even defensive utilities were down, with Telstra being the only bright spot (+3%). The big miners were down a little but most of the action was in coal (with Macarthur in play), and gold miners (with the soaring USD gold price). We remain under-weight local equities.	Around fair value	Average long run returns
	US shares	As expected the end of the "QE2" bond-buying program led to lower share prices. Despite 75% of US listed companies beating earnings expectations for the June quarter, the overall market was down around 2% in July over concerns over a slowing US economy and failure to solve the US budget deficit/debt crisis. The IT sector led the way again with strong rises in Apple, Google, Microsoft and IBM. The stand-out stock continues to be Apple, which reported record sales of i-phones and i-pads, even though new versions are due in the next couple of months. But manufacturers, transport stocks and retailers (apart from eBay & Amazon) were down across the board as the US economy slowed, and media stocks were led down by the troubles at News Corp. Consumer stocks were flat, as were oil & gas stocks with energy prices remaining flat. Even defensive stocks in the healthcare and utilities sectors were weaker, July was the 3rd negative month in a row for the US market, but the overall market is still ahead for 2011 year to date. With QE2 program over, house prices still falling and unemployment still high, there is not much joy for companies exposed to local markets.	Above long run fair value	Below average long run returns (2)
	Emerging markets	Emerging stock markets were flat overall in July. Asian markets were generally up, with South East Asian markets the strongest, while Latin American markets were weakest. North Asian markets were flat, due to knock-on effects of a slowing China and slowly recovering Japan. Russian stocks continued to power ahead, despite flat oil prices. Emerging markets as a whole are not over-priced at current levels, but may suffer with the withdrawal of stimulus in the US and economic slowdowns in the US and Europe, on top of rising domestic interest rates.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	As foreshadowed last month, yields on Australian government bonds continued to fall due to the negative effects of the high dollar, higher wages and new taxes in Australia, plus heavy foreign buying triggered by fears economic slowdown in Europe and the US. Yields on bonds of all maturities continued to fall significantly, generating strong returns. Our portfolios should benefit in the short to medium from this as they are over-weight this asset class.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Although bond yields fell further over the month, interest rates on bank term deposits remain at very high levels. Rates have remained high at the short end and only dropped around 0.10% over 5 year TDs, which is still very attractive. These high deposit rates are hurting bank profits as banks are finding it hard to find borrowers willing and able to pay the resultant high interest rates on loans once the banks' fat margins are added.	Yields above long run average	Above av. long run returns
	Global Bonds	The global government bond market had a good month in July as yields on most bonds fell further and returns increased. The biggest falls in yields were on US treasuries, despite the close shave in Washington and despite the likelihood of credit rating downgrades. As government debts continue to pile up around the world, only the "PIGS" debts (Portugal, Ireland, Italy, Greece & Spain) are priced to include any risk of default. Yields on Italian and Spanish government bonds soared and are now higher than yields on Australian bonds. At these levels, we are underweight global bonds in our portfolios.	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 up to their neutral level for fear of pushing the non-mining economy back into recession as rising costs of wages and inputs and the high dollar continue to slow the local economy. We are still likely to see rates rise in the months ahead. Meanwhile most banks offer cash accounts that pay well in excess of the official target cash rate.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	All listed trusts were down except Commonwealth Office. Retail & industrial markets were hit by weak retail sales in Australia, with the high dollar hitting foreign earnings. We are slightly under-weight in the model portfolios, as a weaker local economy and strong dollar are depressing revenues. The office market is the bright spot and unit trust prices are still well below market valuations of the underlying properties.	Around long run fair value	Around average long run returns
	Australian residential	House prices continue to slide across the country, especially in real terms after inflation. Fire sales continued to depress prices, particularly in discretionary markets like beach houses/flats and rural retreats. Buyer sentiment will not be helped by renewed fears of interest rate rises following the recent inflation results. Although Australian housing in general remains heavily over-priced we don't see the market collapsing suddenly, as supply remains tight and demand from population growth remains reasonably strong. 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 July the Australian dollar was up a fraction against its trading partner currencies. Once again it was a case of a weakening USD and Euro due to their continuing debt crises, rather than a strong Australian dollar. The AUD was stronger against the USD (+2%) Euro (+3.5%), and up a little against most Asian currencies. But the AUD was weaker against the "safe haven" Swiss Franc (-2%) and Yen (-1.6%), and even weaker against a stronger NZ dollar. With European interest rates on the rise, QE2 ended in the US, slowdowns in China, Japan, US and Europe, the AUD 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