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Update on the European Debt crisis

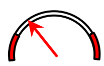
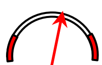
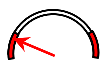
European leaders continue to edge slowly and painfully toward action on the government deficit/debt problem. Last week the German parliament approved the latest €440billion rescue package. The problem is that €440b looks woefully inadequate, even if it is passed by the other Euro-zone members. Something more like €2 trillion may be needed, which is unlikely to be approved by tax-payers and voters across Europe. German tax-payers & voters are unlikely to allow their legislators to force them to work longer and harder in order for their hard-earned savings to be skimmed off to let the citizens of the "PIIGs" avoid paying their debts. Angela Merkel's Christian Democrats are steadily losing power by supporting the bailout plans. It is highly unlikely that a unified Europe-wide plan will be approved that is large enough to contain the problem. September saw further signs of dissent:- Merkel's party lost yet another state election (Berlin) in protest over the bailouts; Germany's Jurgen Stark, the ECB's chief economist and board member, resigned in protest over the plan; and UBS announced that yet another "rogue trader" had lost $2.3b, demonstrating once again that banks have inadequate internal controls.

European banks are sitting on several hundred billion Euros of losses on PIIGS government debt, which is being carried at artificially high prices on their books. For example, Greek government debt is trading as low as 30 cents in the dollar, but is held on the books of many banks at par value. Many large European banks (and several US banks) would be insolvent if the true market value of the bonds were recognized in their accounts. Once Greece and other PIGS default (the 21st July deal to restructure Greek debt locks in a 21% default on interest payments, which constitutes default), large proportions of the debts will need to be written off and this is likely to wipe out shareholders' capital in many banks. With no Europe-wide plan, each country's government will probably inject capital into its local banks to cover the losses and, in the process, partially or fully nationalise them (much like in the UK in 2008-9). Like US and UK banks in 2008, shareholders will probably be totally or almost totally wiped out, and many banks will become government departments for several years.

The problem is not the existence of the Euro (which after all didn't exist before 1999 and Europe worked well without it). The problem is the unsustainable levels of government debts. But the existence of the Euro made the problem worse, because interest rates for the whole Euro-zone were set in Frankfurt based on German productivity levels and German thrift, and this encouraged borrowing in the PIIGS at artificially low rates. The existence of the Euro also make solutions more difficult, because the PIIGs no longer have their own currencies they can devalue, and they no longer have control over their own interest rate policies. All they can do now is raise taxes and cut spending, which virtually assures a debt spiral of slower growth, lower tax collection, and more job losses, fuelling more civil unrest.

European stock markets were hit hard over the past month as investors realised that most of the large European banks are effectively insolvent without massive capital injections to replace losses on PIIGS bonds. Although European bank stocks are down heavily, they are still probably over-priced, but the general fear has also dragged down the prices of many good companies, which are now looking cheap.

For example in Germany the big banks (Deutsche, Commerzbank) are down 30% for the quarter, but German car-makers like VW, Daimler-Benz and BMW are also down 30% and are trading at around 5 times earnings, which is even cheaper than the banks! Likewise in France, the big banks (BNP Paribas, Societe Generale, Credit Agricole) are down around 50% in the quarter and trading at around 4 times earnings, with dividend yields of 7-8%, but they are still probably over-priced. However Renault and Peugot-Citreon are also down 40% and trading at 5 times earnings. Similarly, shares in Paris-listed global brand companies like LVMH, L'Oreal and Pernod Ricard are also down 20% in the quarter but, as with the car makers, sales and earnings are being driven strong consumer spending growth in Asia.

		Economies – September 2011	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	The local economy is slowing, with consumer & business confidence remaining weak. The unemployment rate edged up slightly but the jobs market remains tight, and skilled workers are hard to find. Prices of industrial commodities including metals and oil continued to fall with the deteriorating outlooks for US, Europe and China, but prices of iron ore, coal and agricultural produce (which are Australia's main exports) remained relatively strong. The big move for the month was the fall in the Australian dollar with weaker commodities prices and slowing China. The AUD fell back below $1USD, below 80 yen, below 65 UK pence, and below 0.75 euro, which should provide relief for exporters and import replacement industries.	Average growth rate	Growth flattening	 current speed
	US	The unemployment rate in the US remains at 9% and the economy is growing at only around 1% this year, well below the rate required to create jobs. The Fed has put off a 3rd round of "quantitative easing" (QE3) for the time being and instead announced "Operation Twist" – selling $400b of short term treasuries to buy long term treasuries to bring down longer term interest rates further. The aim is to further reduce mortgage interest rates (most of which are tied to the 30 year treasury bond yields), to encourage consumers to spend and borrow. The whole sorry mess in the US was caused by artificially low rates that enticed consumers to spend and borrow too much, so the apparently the solution is to create even lower artificial rates to entice them to spend and borrow even more! Americans won't buy it – instead they are spending less on stuff they don't need and paying off debt – just like Australians.	Below average growth rate	Recovery remaining slow	 current speed
	China	The Chinese economy continues to slow as a result of interest rate hikes and credit restrictions aimed at curbing inflation, combined with the slowing US/European demand for Chinese exports. Chinese industrial production, retail sales, steel production, new construction, housing prices and fixed investment levels are all growing at slower rates compared to earlier this year, and the inflation rate is also down a little over previous months. However, Chinese demand for Australian exports is still holding up so far.	Strong growth	Growth slowing	 current speed
	Japan	The Japanese economy is finally showing signs of picking up, with increases in industrial production and construction in the re-building effort in the wake of the tsunami in March, but economic activity is still lower than pre-tsunami levels. New Prime Minister Yoshihiko Noda is already planning a new stimulus package of 12 trillion yen ($160b).	Chronic recession, deflation	Remaining weak	 current speed

		Asset Classes – September 2011	Current position	Long term returns (1)
Shares	Australian Shares	The local share market continued to weaken in September, despite the strong profit growth, dividend increases, high cash levels and low debt levels recently reported for the June year. The market as a whole lost 6% for the month, down 11% for the quarter and down 13% for 2011 to date (including dividends). September was the worst month since May 2010, when the first Greek default crisis struck. Worst hit were the miners, especially iron ore, copper/gold and uranium (with lower industrial commodities and a 10% fall in the USD gold price), but coal miners fared better as coal prices remain relatively strong. Also hit hard were banks, due to the escalating European banking crisis. The rest of the market reflected a reasonably sound local economy. Industrials held up well (eg Orica, Amcor), and even discretionary retailers held up (eg. Harvey Norman, JB Hi-Fi, David Jones), and cyclical transport stocks also held up. Defensive sectors remained in favour, with Telstra (up 2%), healthcare (most were up except Cochlear which was hammered by a global product recall), and utilities held up, while gambling stocks were down on uncertainties regarding the poker machine reforms. The overall market is now entering cheap territory, with prices less than 12 times 2010-11 earnings and dividend yields at 5%, or nearly 7% including franking credits. But prices will probably weaken further in the coming months as earnings outlooks are downgraded with lower local and global growth, lower export commodities prices (even after the effects of the falling dollar) and rising wages & costs.	Around fair value	Average long run returns
	US shares	The broad US stock market was down 7% in September, but this meant 2% gains for un-hedged Australian investors after the currency gain with the falling Australian dollar. The falls in stock prices were mainly in banks (with fears over the European crisis), miners (with lower commodities prices), and oil/gas (with lower oil prices). Other stocks held up well - including retailers, consumer and IT stocks. IT stocks like IBM, Oracle, Intel, Amazon & Apple held up well, as did US-listed global consumer stocks like McDonalds, Nike, Colgate-Palmolive, and Proctor & Gamble, driven primarily by Asian growth, despite the weakening local US economy.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	Almost all emerging markets fell in September (Turkey being the main exception) despite strong fundamentals – ie strong economic growth, current account surpluses, low government debt levels, and strong corporate balance sheets. However, most falls in many market indexes were more than offset by falls in the Australian dollar. Among the major markets, the biggest falls were in China (led lower by banks on concerns over bad debts) and Russia (with the big falls in oil prices). Meanwhile underlying earnings in many leading stocks remained strong – typified by the Hong Kong listed Prada, which is enjoying booming sales and earnings (up 70%), especially in Asian emerging markets	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Bond yields fell dramatically again in September as the outlook for growth slowed and investors shifted from shares to the safety of bonds. Yields on 10 year bonds sank to 4% late in the month, near the GFC lows at the end of 2088, so bond markets are pricing in a GFC-like slowdown again. Yields on all maturities over a year were down around 0.15% for the month and down around 1% for the quarter, producing strong returns of around 1% for the month and nearly 5% for the quarter.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Banks have been cutting term deposit rates as bond yields have fallen in recent months, but bank TDs are still attractive relative to government and semi-government bonds of similar terms. There are still opportunities to lock in relatively good interest rates as banks are slow to reduce rates, and remain vulnerable to credit market shocks emanating from Europe, so they are still chasing investors.	Yields above long run average	Above av. long run returns
	Global Bonds	September saw another month of strong returns as yields fell in most countries. These falling yields generated returns of 1% for the month across the global government bond index, and 5% for the quarter, the same as for Australian bonds. US and German 10y yields are back down below 2%, UK yields are below 2.5%, and Japanese & Swiss yields down to 1%. European Central Bank buying has been keeping Italian and Spanish yields artificially low below 6% and this is likely to continue as there are not many other courses of action that can prevent Italy and Spain from descending into a Greek-like debt/deficit spiral.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	After seven interest rate rises between October 2009 and November 2010, the target cash rate has remained at 4.75% for nearly a year. The falling dollar has taken some pressure off the Reserve Bank to cut rates, as it is still concerned about rising local prices and wages. Cash rates may even fall in the coming months if the local economy slows further as global and Chinese growth deteriorate.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Unit prices of listed trusts fell less than for shares in September, but were still down 5%, or down 10% for the quarter. Prices were underpinned by relatively high distributions and the prospect of rising pay-out ratios, and foreign buyers sniffing around for bargains, and the lower dollar will help. Most trusts still trade at big discounts to their alleged market valuations, but investors are understandably sceptical about the valuations. With distribution yields now above 7% and rising, and term deposit rates falling, more investors may be enticed back into property trusts as prices fall further.	Around long run fair value	Around average long run returns
	Australian residential	Prices continue to fall in most markets, especially in Perth and in holiday markets, where thousands of flats are still sitting empty from the over-building during the boom years. The upcoming spring season will see more supply hit the market but demand remain weak, with buyers reluctant to borrow and banks reluctant to lend. Added to this are rising fears that property taxes may return as part of the government's broad tax review.	Varies by market	Average long run returns
Australian Dollar		The Australian dollar fell significantly in September as the outlook for global growth deteriorated. The AUD fell 8.5% against the US dollar over the month but it fell less against the Euro, Sterling and Asian currencies, which weakened against the USD. If the European debt crisis continues to worsen and domestic Chinese economy continues to slow, the AUD is likely to fall further in the coming months. We continue to recommend against hedging of foreign equities exposures, to cushion further falls in foreign share prices, but recommend foreign bonds be hedged at all times.	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