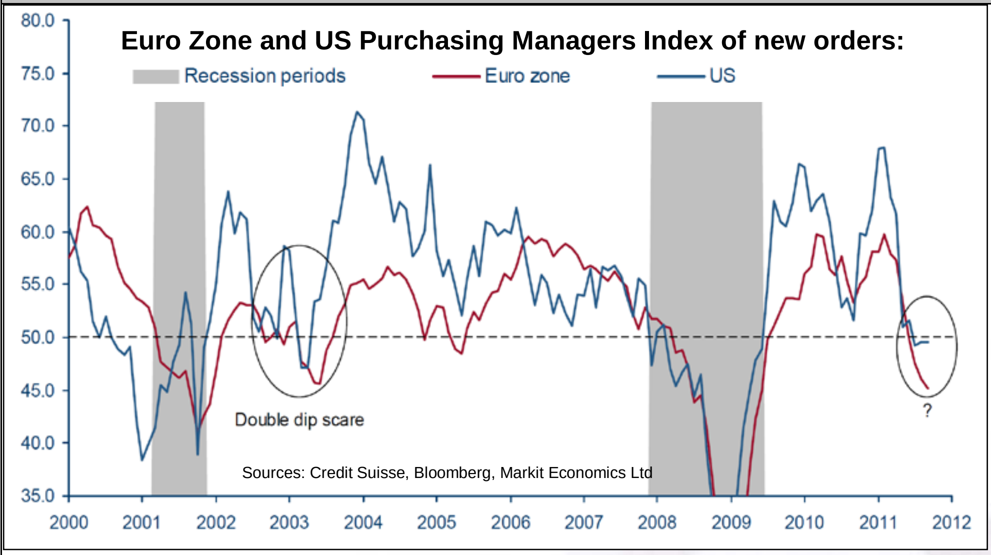
MONTHLY MARKET MONITOR – End October 2011

“Double-Dip” or the start of the next boom?



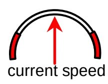
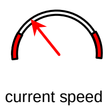
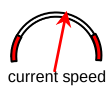
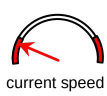
Investors will recall that early 2003 was the start of the great bull market that followed the global “tech-wreck” recession in 2001-2 that resulted from the bursting of the “dot-com” bubble of the late 1990s. Although the 2003 start of the boom is easy to see in hindsight, at the time 2003 was a very nervous period for investors.

The Purchasing Managers Index is a widely used forward indicator of future manufacturing and economic growth and it was looking very bearish in 2003, fuelling fears of a “double-dip” recession at the time. It turned out to be a false alarm as economies quickly recovered and share prices, corporate earnings, consumer spending and employment all boomed between 2003 and 2007.

The situation today looks quite similar to 2003. Over 2010-11, economies around the world have recovered from the sub-prime recession of 2008-9 but the recoveries have now faltered and manufacturing orders have fallen, giving rise to fears of double dip recessions once again.

There are some differences this time. All developed markets (including Australia) are now suffering the effects of consumer debt over-hang, resulting in depressed consumer confidence, subdued retail spending, and slow employment growth. On top of the household debt burden, the US, Europe and Japan (but not Australia) are also trying to rein in ballooning government debts using various combinations of government spending cuts (including cuts to staffing, wages, services and pensions) together with tax hikes – all of which are affecting consumer and business confidence further.

There is some good news in all of this:– while consumers and governments grapple with the effects of excess debt, companies by and large have reduced debt levels, cut costs, increased margins and increased profitability. Share prices have fallen over the past few months as economic conditions have deteriorated, but share prices generally recover well before economic growth numbers are published. Booms generally start when fear is at its greatest, as it was in 2003. However, we remain cautious and we factor in a relatively high likelihood that the pain will continue for some time yet before markets recover fully.

		Economies	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	Australia’s economic recovery since the depths of the sub-prime crisis has been relatively narrow, driven primarily by the mining sector. Although mining employs less than 2% of the workforce, mining companies are generating virtually all of the growth in corporate profits, with the rest of the economy remaining weak. Now mining profits are under pressure as commodities prices fall in the wake of the slow-downs in Europe and China, adding to the negative impact of rising wages and input costs in the mining sector. Conditions continue to weaken, with rising household savings rates, slow consumer spending and retail sales.	Average growth rate	Growth flattening	
	US	The US economy continues its tentative recovery and the most likely outlook is that it will avoid a double-dip recession. Growth rates for industrial production and consumer spending remain positive but still below the levels required to make significant inroads toward reducing unemployment, which remains stubbornly high. Total output is now edging back up to pre-crash levels. The “occupy Wall Street” protests gathered pace and spread to similar movements around the world. Citigroup was the latest bank to pay penalties ($285m) for selling sub-prime mortgage products to investors while at the same time betting they would fail, profiting while investors lost money. Inflation crept up to 3.9% for the September quarter, and this reduces the likelihood of another round of “quantitative easing” in the near future.	Below average growth rate	Recovery remaining slow	
	China	The Chinese economy continues to slow gradually rather than collapse in a “hard landing”. Property sales volumes have fallen sharply as a result of the numerous policy measures to tighten credit. This has the potential to flow through to falls in prices, which may trigger a wave of foreclosures from the already high levels of bad debts held by banks. One of the many inconsistencies in the numbers coming out of China is the contrast between the surging levels of business bankruptcies being reported, while at the same time official reports claim that corporate earnings are up 27% so far this year. The rate of growth in industrial production is also slowing due to the slowdown of export orders from Europe.	Strong growth	Growth slowing	
	Japan	The post-tsunami recovery is still gathering pace slowly, but retail sales remain weak. New Prime Minister Yoshihiko Noda is pressing ahead in his plans for higher taxes and this is eroding confidence further, but it is a necessary step in tackling the huge pile of government debt as a result of 20 years of failed government stimulus programs.	Chronic recession, deflation	Remaining weak	

		Asset Classes	Current position	Long term returns (1)
Shares	Australian Shares	The local stock market followed global markets up in October (but not up as much as the US and big European markets which were hit very heavily in the September quarter), recovering September's losses. This rise in prices is despite the deteriorating local economic environment, softening earnings and a slowing China. The broad local stock market indexes are still around 10% down for the year, We still see a risk that share prices may weaken further in the coming months as earnings outlooks are downgraded with lower local and global growth, lower export commodities prices and rising wages & costs eating into profit margins. Despite the consumer slowdown in Australia, banks continue to do well, with NAB reporting reasonably good results:- revenue up 6%, lower bad debts, earnings per share up 16% and dividends increased by 5%. Many in the media are getting excited about the prospect that interest rate cuts will boost share prices. Contrary to popular myth, the reverse is usually true. Rate cuts (when rates are already below their neutral level) indicate significant economic deterioration and in the past that has in most cycles been accompanied by falling earnings and share prices. We do see a recovery in share prices next year, but there is still a risk that prices may go lower in the short term before they recover.	Around fair value	Average long run returns
	US shares	US shares were up strongly in October, due mainly to hopes that the European debt problem has been magically solved. Earnings results in the US saw a mixed bag of outcomes – exemplified by Amazon's earnings which were down heavily, contrasting UPS which were up strongly. Perhaps as an indicator of the recovery in the American consumer spending, American Express credit card revenues and earnings were up strongly, and bad debts were lower. US corporate balance sheets are in a strong position, but growth in the US market is still slow, and now China is starting to weaken.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	All stock markets across the world (except Pakistan, Sri Lanka and Turkey) had a good month in October, and even Chinese stock markets finally broke their long downward slide. It was a good illustration of how closely global markets have recently been driven by big macro news stories, rather than the merits of each company. In August it was the US Congressional budget/credit downgrade crisis, and in September and October it was the Greek debt crisis. Emerging Markets in particular are at the mercy of trillions of dollars of "hot money" that sloshes around the world triggered by the flimsiest rumour or obscure headline. Although developed and emerging markets rose by similar amounts in October, emerging markets look significantly better placed in future, with lower debt levels, stronger fiscal management, growing populations and rapidly growing middle classes.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	The dramatic collapse of bond yields in September partially reversed in October, as pessimism over Europe abated somewhat with the latest iteration of the rescue plan for Greece. Once again headlines out of Europe dominated the market and yields on Australian bonds rose despite the deteriorating outlook for the local economy, which ordinarily should have seen bond yields fall. In our model portfolios most of the allocation to Australian fixed income is in the form on bank term deposits which offer attractive rates and are unaffected by daily changes in bond yields.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	While the Australian corporate sector has de-leveraged by reducing debt levels in the wake of the 2008-9 credit crisis, Australian households are not de-leveraging, but are saving cash in the form of bank deposits, rather than reducing debt levels. It is a little strange since interest received on deposits is fully taxable but the interest they pay on household loans is not deductible. Perhaps they are just biding their time before the next big spending spree (?). Bank TD rates are falling but they still offer a very attractive place to park money in the short term while other assets become better value.	Yields above long run average	Above av. long run returns
	Global Bonds	Following the dramatic collapses in bond yields in the September quarter (which generated high returns for bond investors), yields in most markets rose in October. In the US and Germany it was due to receding fears of recession, and in Italy, France, and the PIGS it is due to heightened fears of default – especially after the 50% haircut agreed on Greek debt. The latest "grand plan" to fix the European debt problem is also likely to see the ECB continue to buy up more bonds, which should keep yields from rising to dangerous levels.	Yields below long run averag e level	Below average long run returns (2)
Cash	Australian target cash rate	After having kept short term rates at 4.75% for the last 12 months, the Reserve Bank reduced rates by one notch to 4.5%. Interest rates are still too low to contain inflation in the long run given the structure of the Australian economy (with long run real economic growth of around 3% plus long run inflationary outlook of around 2-3%, this indicates at a target cash rate of around 5% to 6% is required to keep inflation in check). However, sluggish growth at home, together with slow-downs in the US, Europe and China, have prompted the RBA to stimulate growth here, despite the tight labour market and rising wages and prices in many sectors.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Transaction activity in the commercial property sector (especially office markets) has been improving all year, but it has been driven largely by foreign buyers. Many large foreign institutions are seeing Australia as a relatively "safe haven" away from the troubles in Europe, US, and China, despite the strong Australian dollar. Local banks remain extremely reluctant to lend and this is keeping local buyers quiet. While unit prices of listed trusts rose in October, almost all still trade at large discounts to the underlying value of their properties.	Around long run fair value	Around average long run returns
	Australian residential	As expected, house prices continue to fall in most markets, especially at the top end. Housing finance volumes are at levels last seen in the middle of the sub-prime credit crisis, and similar to levels back in the mid-late 1990s. We believe that housing is still too expensive on a range of measures, and prices will continue to fall in real terms as the economy slows further and banks margins remain high.	Varies by market	Average long run returns
Australian Dollar		Since the start of the current resources boom in the 2000s, the Australian dollar, global stock markets and commodities prices have tracked each other very closely, all driven by outlooks for global growth and growth in China in particular. While commodities prices and the dollar fell significantly in September as the outlook Europe, the US and China deteriorated, the dollar recovered some ground in October as sentiment improved in the US and Europe. The AUD is still heavily over-valued against most currencies and will is expected to come down over time as Chinese growth slows.	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