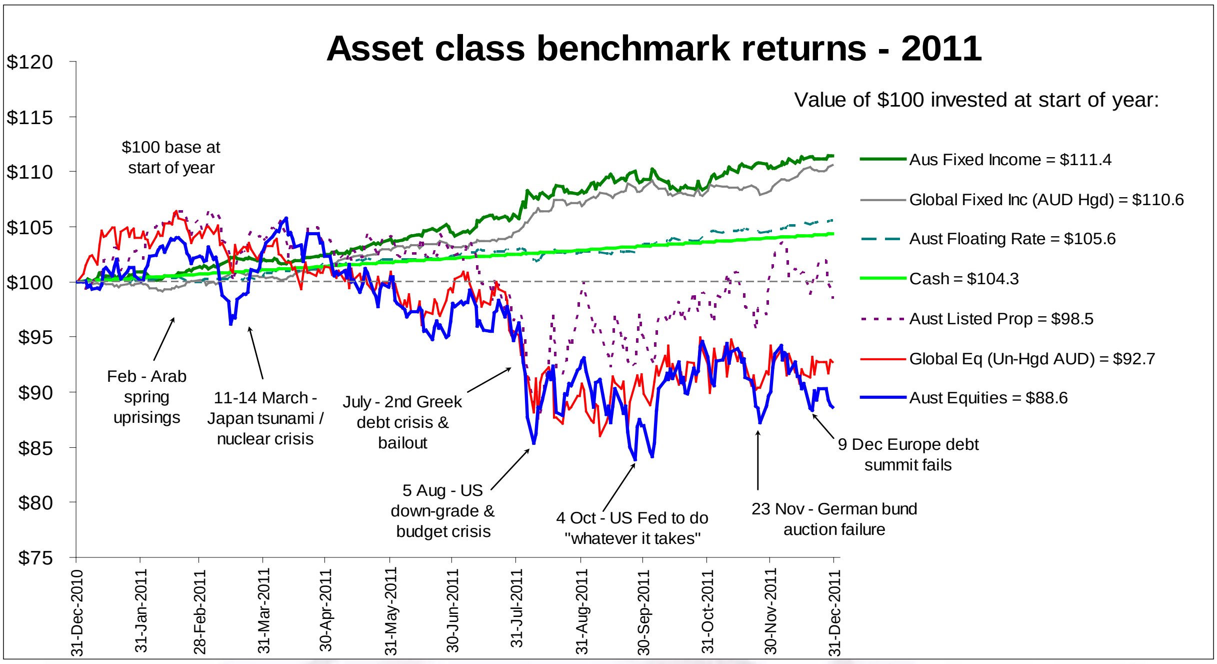
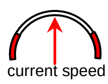
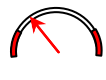
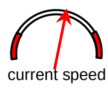
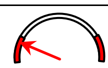
MONTHLY MARKET MONITOR –End December 2011

Chart of the month: Bonds the winners in 2011



In 2011, bonds beat shares in Australia and around the world. 2011 was a little like 2008 only less severe. In 2008, shares in most countries lost 30-40% as earnings and dividends collapsed in the "global financial crisis", while Australian and global bonds returned 15-20% as interest rates fell. The tentative recoveries of 2009 and 2010 faltered in 2011, and shares fell in nearly all countries (except the US) while bonds gained around 10%. In 2011 our portfolios were under-weight shares (particularly in the 2nd half), and over-weight bonds.

Over 2012 this situation may reverse once again. Although investors have made good returns from riding bond yields down over 2011, these ultra-low yields cannot continue to fall much further. As growth returns, and as developed country governments desperately try to inflate their way out of their debts and out of their un-affordable and un-funded pension promises, inflationary expectations may return in 2012, bringing the 30 year bull run in bonds to an end. Shares would also recover when growth returns, especially in the US.

		Economies	Current position	Current Direction/ Trend	Current pace of growth
Economies	Australia	After a poor start to the year, when exports and spending was affected by floods, the local economy ended up with a moderate growth rate for 2011 in line with its long term historical average. The low unemployment rate added to inflationary pressures on wages and prices, keeping interest rates and the Australian dollar relatively high for most of the year. Deteriorating global conditions finally allowed the Reserve Bank to cut interest rates in November and December. Money markets are factoring in a severe recession in 2012, which is unlikely to occur, in light of the strength in mining exports and mining investments.	Average growth rate	Growth flattening	
	US	The US economy remains tepid, but not contracting. The unemployment rate is falling slowly and levels of jobless claims are declining. Consumer confidence and spending are slowly improving, with new housing starts and new mortgage loans on the rise, and retail spending is still growing. Business confidence and investment levels also remain weak but not recessionary. 2012 is a Presidential election year and so any prospects for rational, logical debate over how to solve the deficit/debt crisis will no doubt descend into a cascade of unaffordable, populist promises to win votes. Meanwhile numerous cities and states teeter on the edge of bankruptcy, and will need to be bailed out by the Federal government, adding to the already high mountain of US Federal debt. There is a good chance that the economy may pick up during 2012, and interest rates may need to be raised sooner than expected.	Below average growth rate	Recovery remaining slow	
	China	2011 saw China switch from trying to slow the economy in order to prevent consumer price inflation and housing bubbles from getting out of control, to trying to revive growth in order to prevent a "hard landing". The adoption of a new "5 year plan" also saw the policy focus switch from export led growth to domestic demand. Economic growth is slowing but so far it is looking like 8% growth instead of the 10% average over the past decade. The currency has been allowed to rise slowly against the US dollar and so far the occasional trade spat has not been allowed to escalate into an all-out currency and trade war with the US, which would decimate world growth. Even in the event of a "hard landing" in China, China's best defence would be to boost infrastructure spending, and this would benefit Australian miners.	Strong growth still	Growth slowing	
	Japan	The two major events for Japan in 2011 were the tsunami/nuclear crisis in March, and yet another new Prime Minister in August (Yoshihiko Noda replacing Naoto Kan). The economy continues to stall, with a declining population, declining work force, weak spending, a high yen hurting exports, and a huge and still growing mountain of government debt.	Chronic recession, deflation	Remaining weak	

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The broad stock market index was down 15% for the year, or down 11% including dividends. Miners (-20%) were hit by the slowdowns in China & India which triggered falls in commodities prices. Retailers and consumer discretionary (-15%) suffered as consumers put their money in the bank rather than spend it. Banks almost held their ground, posting record profits despite rising funding costs and slow growth prospects. Defensive stocks did best:- Telstra up 20% (30% including dividends) and utilities (+10%). Our portfolios were under-weight shares in the 2nd half of 2011, which is when the market weakened. We are expecting earnings outlooks to be downgraded further in the new year, but there are several signs pointing to a recovery in prices from 2012.	Around fair value	Average long run returns
	Developed markets shares	The US stock market was the only developed market not to fall in 2011. US companies cut costs, paid off debt, raised capital, lifted productivity levels and boosted earnings despite slowing growth in developed and emerging markets. In contrast, UK, European and Japanese stock markets are weighed down by banking stocks, which were marked down heavily in 2011 as investors priced in a large scale collapse and/or nationalization of the European banking system due to their holdings of "PIIGS" government debt. The UK market fell 5%, but Euro-zone and Japanese markets lost 15-20% for the year. If the Euro-zone debt crisis can be contained and if China avoids a hard landing, developed market stocks are likely to recover in 2012.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	Emerging markets suffered in 2011 as "hot money" from developed markets was pulled out to cover losses elsewhere and/or to pay off debts. North Asian markets suffered from production disruptions in the wake of the tsunami/nuclear crisis in Japan, and then by the slowdown in Chinese and European demand later in the year. South East Asian markets further from China/Japan did much better, with Indonesia, Philippines, Malaysia and Thailand finishing flat for the year. Indian, Brazilian and Russian markets were also down, with corruption scandals featuring prominently in all three markets. Long term prospects for emerging markets remain favourable as they contribute the vast bulk of global economic growth. Also in their favour are rapidly expanding middle class & wealthy populations, and relatively low levels of government & household debts.	Around fair value	Above average long run returns (2)
Fixed Income	Australian Gov't bonds	Australian bonds finished the year as the best asset class for Australian investors. The benchmark composite bond index ended up 11% for the year. During the year, bond yields fell dramatically as the outlook for local economic growth deteriorated and foreign investors bought up bonds to diversify away from European bonds. Yields on 10 year commonwealth government bonds started the year at 5.5% but fell to 3.7%, and 5 year bonds fell from 5.37% to 3.3%. Bond markets are now pricing in a severe recession in Australia next year, as yields have not been this low since the 1930s depression and the 1890s depression. Over the course of 2012 we expect local bond yields to rise again as prospects for economic growth revive and more money is shifted into shares.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Australian banks have been paying extraordinarily high interest rates on term deposits over 2011 as they scramble to reduce their reliance on foreign debt markets to fund their lending. TD rates were reduced late in the year but they still offer attractive "safe haven" returns. Even if interest rates fall further, banks will probably continue to offer good rates as their foreign funding sources dry up with the escalating crisis in Europe. Early in 2012 the ceiling for the federal government guarantee on deposits will reduce from $1 million to $250k per depositor, so large investors will need to talk to their advisers about diversifying their deposits between banks.	Yields above long run average	Above av. long run returns
	Global Bonds	2011 was a great year for the global government bond market, with the benchmark global government bond index returning 10% for hedged Australian investors. Bond yields fell (and returns rose) in the big developed countries - the US, UK, Japan & Germany - as their economies slowed. Positive returns from falling yields more than offset losses from rising yields and rising default fears in the PIIGS countries (Portugal, Ireland, Italy, Greece, Spain). Government austerity measures are likely to keep European growth rates and bond yields low for some time, but US yields may kick up in 2012, caused either by a revival of growth or further rounds of money printing by the Fed.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	Australia had the highest interest rates in the developed world before the GFC, it was last to cut rates in the GFC, the first to raise them after the crisis, and it had the highest rates during the 2009-2010 recovery. These high interest rates hurt businesses and households, and attracted foreign capital which boosted the dollar, making exports uncompetitive. The resultant business slowdown forced the Reserve Bank to cut rates in November and December. Money markets are pricing in a major recession here in 2012, and are factoring in several more rate cuts over the coming months.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market ended flat for the year, beating shares by 10%. The sector regained its defensive reputation it had built up in the decades prior to the 2000s boom and disastrous 2008-9 bust. Listed trusts now have relatively low debt levels, stable cash flows, relatively high yields, boosted in 2011 by buy-backs and take-over activity. The office sector recovered first as rents and capital values stabilized during the year, with most large transactions driven by an influx of foreign buyers, despite the high dollar. Retail, industrial, and tourist sectors remain weak with subdued consumer spending and the high dollar; and the residential sector also remains weakened by high levels of household debt and the withdrawal of stimulus measures.	Around long run fair value	Around average long run returns
	Australian residential property	House prices fell in 2011, with the top end market being hit the hardest (although it rose the most in the pre-GFC boom). It has been our contention for several years that housing in Australia is still too expensive on a range of measures, and prices are likely to continue to fall in real terms (after inflation) as bank lending is restricted by new capital controls and lending margins remain high.	Varies by market, but over-valued overall	Average long run returns
Australian Dollar		The Australian dollar started and finished the year at around $1.01 USD, but it was a wild ride as the dollar reacted to the ups and downs of the US and European debt crises. The dollar peaked at $1.10 in early May and again at the end of July, and fell to 0.95 in early October and again in late November. The dollar is also been kept high by foreign buying of local deposits and bonds, which are still paying some of the highest interest rates in the world. If China can avoid a "hard landing" and Europe can avoid a full-scale melt-down, the AUD may remain high in 2012.	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