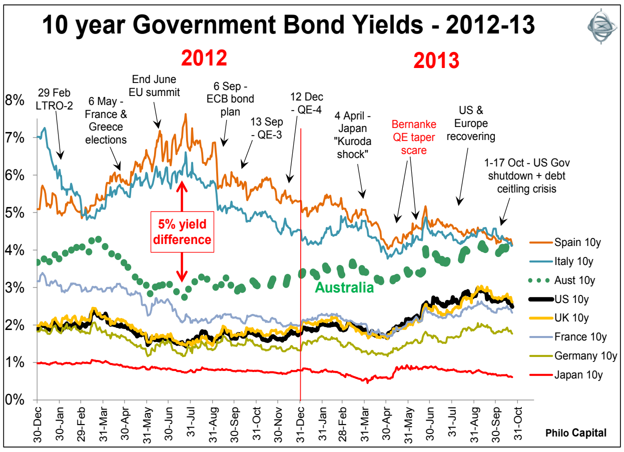


AUSTRALIA JOINS THE PIIGS

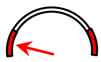
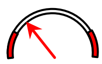
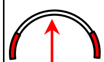
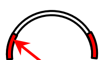
Yields on Australian 10 year government bonds are now as high as yields on 10 year government bonds of Italy and Spain, the largest of the European "PIIGS", with their crippling debts and lower credit ratings. How can this be?

Yields required by bond investors reflect perceived credit risk (expected loss through default or restructure of principal and/or interest); inflation risk (expected loss of real value through inflation); and expectations of future interest rates (which largely reflect expectations of future inflation and future monetary policy shifts that may be made to counter inflation). Yields are also being depressed by the flood of cheap central bank money, but that is a common factor affecting all assets globally, including Australian bonds.

Aside from credit risk, bond yields should rise as economic growth and inflation rates rise, and yields should fall as economic growth and inflation rates fall. But Australian yields have been rising over the past year while the local economy slows, and PIIGS yields have been falling while Europe slowly recovers. PIIGS yields are declining mainly because the perceived risk of default has declined due to progress on bank bailout and support mechanisms since the 2012 Greek crisis. In the absence of inflationary pressures, yields have little or no inflation premium built into them.

The Australian government is very unlikely to default on its bonds any time soon (it has in the past), but yields are still relatively high in order to compensate investors for potential losses. For local bondholders it is the loss of real value through domestic inflation, and for foreigners it is compensation for future currency losses through likely declines in the Australian dollar over time due to our higher relative inflation.

Inflation may not be as dramatic or sudden as a headline grabbing default, but it is just as damaging to real returns for investors.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	The local unemployment rate fell a little from 5.7% to 5.6%, but it is still trending upward slowly from 4.9% in April 2011. Participation rates are declining and companies are still reducing staff and off-shoring operations. Confidence levels with consumers and business are at relatively high levels, buoyed by low interest rates, rising house prices, the end of the gruelling election campaign, and renewed growth in China, US and even in Europe. However this optimism has yet to translate into higher levels of spending and investment by consumers or businesses. Good Chinese growth numbers lifted the prices of metals in October. Even coal prices rose, ending their three months in the basement at the bottom of a long, steady 45% decline in coal prices that started in early 2011 before the tsunami/nuclear crisis hit Japan.	Below average growth rate	Growth slowing	 current speed
Europe	European economies edged forward a little in October, although the Euro is drifting higher and has gained 5% since early July. Following Angela Merkel's Christian Democrat win in Germany in September the final composition and terms for a new coalition government are yet to be settled. Coalition terms will probably limit the hard line austerity plans favoured by the CDU and the Bundesbank. It will probably mean the softer line of the SPD and the Greens, allowing the PIIGS more time and lighter conditions for compliance with budget targets and debt limits. This should be positive for markets, at least until the next crisis erupts. Spain may be turning the corner toward recovery. Exports are growing and unemployment now appears to be finally receding, having peaked at 27% (compared to a rather high 8% even at the top of the boom in 2007). The other big risk is Italy, where Enrico Letta survived another attempt by Silvio Berlusconi to destabilise the government. It may not be the end of Berlusconi as a political force, as he has come back many times in the past.	Still virtually Stagnant	Recovering very slowly	 current speed
US	The US fiscal crisis dominated news and financial markets in October. With no agreement on the new fiscal year's budget by the 30 September deadline, the partial government shut-down commenced on 1st October. On the debt ceiling issue the bitter bipartisan brinkmanship went right down to the wire once again before another last minute deal was done to avoid the government running out of money and having to stop paying its bills. The mid-October compromise deal appears to offer no long term or even medium term solutions, but merely postpones the budget crisis until 15 January, and postpones the debt ceiling crisis until 7 February, when the White House and Congress will probably go through it all again. Between now and then the budget position will probably improve a little as the recovering economy is generating more tax revenues, while the sequester cuts and furloughs are reducing outlays. Meanwhile rising mortgage interest rates threaten to dampen the housing recovery. On 9th October Janet Yellen was nominated to chair the Federal Reserve Board from next year and this gave the market some confidence that the withdrawal of the quantitative easing program will be drawn out for longer than expected. This was echoed by out-going chairman Ben Bernanke on the 30th.	Below average growth rate	Recovery remaining slow	 current speed
Asia	The Chinese economy is looking like it is strengthening further from its 2012 slowdown. Output accelerated slightly from 7.5% to 7.8% per year on the latest numbers, driven mainly by strong government-directed infrastructure and property construction. Inflation is also edging upward steadily from its lows of a year ago, and the government may need to start thinking about applying the brakes a little harder to the property market, perhaps at the Third Plenum meeting next week. Renewed confidence in the "soft landing" scenario, instead of a "hard landing" is driving metals prices higher and in turn the share prices of miners and industrial companies in Australia and around the world. The Japanese economy continues to improve, thanks to the government's renewed commitment to stimulus spending and structural reforms. The Tankan survey of business confidence shows confidence at its highest levels since the 2007 boom. Manufacturing activity and exports are improving thanks to higher demand from the US, Europe and China, and the lower yen. The "Abenomics" policies brought about a 25% collapse in the yen from late year to May of this year, bringing it back to 100 yen/USD, where it had been in mid-2008 before the GFC. The yen has been kept reasonably stable at around 100 yen/USD since May and this stability at lower levels has been positive for exporters.	China: Cyclical slowdown Japan: Early recovery	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 current speed  current speed

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	October was the fourth consecutive month of good returns for the local stock market, which has more than recovered from the 11% fall in the “QE taper” scare in May-June. The big banks and big miners were the main gainers for the month, driven by the prospects of rising profits and dividends. The broad market is now up 16% for the year, and 20% including dividends, exceeding the gains from the whole of 2012. We have been bullish on Australian shares since early 2012 and have been overweight in portfolios since then, benefiting from the market’s strong surge over the period. Although the market is approaching over-priced territory relative to earnings in many sectors, dividends are still relatively strong and rising.	Around fair value	Around average long run returns
Shares	Developed markets shares	US stock markets surged through the latest US government shutdown and debt ceiling crises. The S&P500 index has now risen 60% since then Treasury Secretary Tim Geithner kicked off the rebound with his “whatever it takes” speech on 4 October 2011, opening the door for QE3/4. Overall, global markets are now back to around 5% above their 22 May 2013 pre-taper scare highs. For the 2013 year to date, the global average is up 20% and all markets are up, led by cyclical rebounds in Japan, US, Germany and France. We have been over-weight global equities since early 2012 and we remain on the lookout for signs of over-pricing. Cash dividends have been rising, but earnings have yet to catch up.	Mixed – US is moderately over-priced on long term measures, but most other markets are under- priced to fairly priced	Around average long run returns, but currency gains expected (2)
Shares	Emerging markets shares	Shares in emerging markets enjoyed another strong month in October, continuing their September quarter rebound from the May-June sell-off. Markets with floating currencies benefited from currency falls in the capital flight following the May-June QE taper scare (like India, Brazil and Russia). Chinese markets were flat for the month, but all markets were up strongly in South-East Asia, South Asia, North Asia, and especially in the Middle East and Africa, as oil prices retreated back below $100 per barrel.	Difficult to value. Many appear inexpensive to fair value, but are reliant on fickle global sentiment	Above average long run returns, but high volatility (2)
Fixed Income	Australian Fixed Income	Treasury yields rose 10-15 basis points across all maturities in October as the market sensed a reduced likelihood of further RBA rate cuts, due to fears of a speculative housing boom if the ultra-low interest rates (in Australian terms) continue for too long, and rising inflation rates. Yields at the long end have now risen by around 1.2% since the all-time lows reached on 25 July last year. We have zero weighting to long duration Australian bonds in portfolios, as yields are expected to rise further in the medium term.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Rates on bank TDs remain relatively low although treasury yields have been rising over the past 15 months. Banks will need to raise deposit rates if and when the demand for credit picks up. Business lending is still dormant and housing lending has yet to rise significantly, so banks have little need to chase deposits at this stage until lending picks and/or global credit markets deteriorate. Despite the low rates on offer we prefer TDs over bond funds on a risk-reward basis.	Rates below long run average	Below average long run returns
Fixed Income	Global Bonds	Global government bond returns rose again in October as bond yields continued to fall. US 10 year treasury yields had risen to 2.98% on 5 September and then fell steadily during September as investors rushed in to buy more bonds as the deficit crisis escalated and the government shutdown and possible default loomed. Then in October after yet another last-minute deal that merely delayed the crisis for a couple of months, and rating agency Fitch downgraded US to “negative watch”, investors raced in to buy more bonds, pushing prices up and yields down further. US 10 year yields ended October at 2.57%. A similar thing happened when US debt was downgraded by S&P in the August 2011 debt ceiling crisis - prices surged and yields fell as eager investors raced in to pay more for US debt after its credit rating was lowered. Bond investors are strange animals - they race in to buy bonds at higher prices when credit ratings agencies adjudge their risk of default has increased! This is not just the case for US bonds. Yields on Japanese bonds fell as investors rushed in to buy more of them when they were downgraded in January 2011, and yields on French bonds fell as investors rushed in to buy more of them when they were downgraded in January 2012. We remain under-weight global bonds, as they have virtually no credit risk or inflation risk built into their pricing.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA is still concerned about the exchange rate and it may need to cut the target cash rate further if the dollar continues to drift upward from its recent low of 0.89 USD in early August. The unemployment rate still is a relatively low 5.6%, price inflation is still a problem, wages are still rising, and house prices are picking up, all of which limit the scope for further rate cuts.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The underlying commercial property market in Australia continues to deteriorate. Vacancy rates are rising and effective rents are falling in the major markets. The listed property market rose with shares in the general global relief rally in October, despite the sector being fully priced. This follows four relatively flat months since the May-June QE taper scare. We remain neutral on the sector and are expecting moderate returns over the coming year from current levels.	Over-valued on long run measures	Around average to below average long run returns
Real Estate	Australian residential property	Housing markets are rising, mainly driven by investor activity - both domestic and foreign. Confidence among first home buyers and upgraders improved after the federal election but seems to have been dampened somewhat by the recent RBA warnings on the dangers of gearing up at the current very low interest rates, and also by the decreasing likelihood of further rate cuts in this cycle. Housing surges are usually driven by rapid growth in credit, new types of lending competitors and/or new competitive sources of credit, but these are not present this time.	Varies by market and by property	Varies by market and by property
Australian dollar		The AUD crept up in October in the global relief rally in shares and other risk assets. It is still down around 10% from its April levels before the QE taper talk triggered a capital flight out of high risk markets, but is still over-priced on fundamentals. We are partially hedged in portfolios where variable hedging is available, otherwise un-hedged for long term global share holdings.	AUD above fair value	Currency gains for Australian investors as the AUD falls

(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 AUD terms – ie including any profits/losses from hedging or currency movements