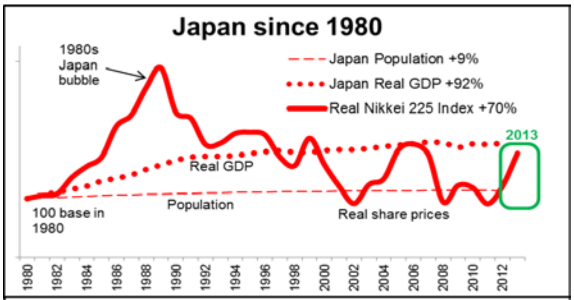
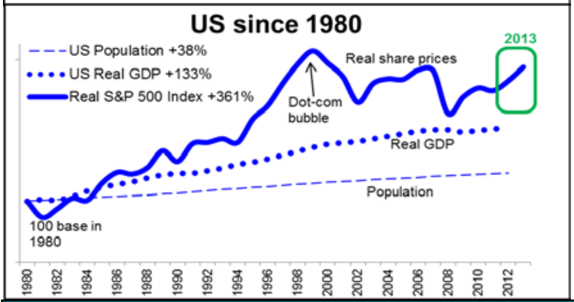




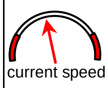
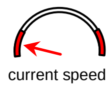
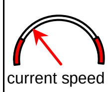
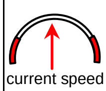
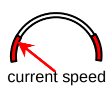
USA -v- Japan

Shares in Japan and the US have surged this year despite their sluggish economies. So far in 2013 the Nikkei 225 index is up by 30% and the US S&P500 index is up by 15% (after gaining 23% & 13% respectively last year). Both markets are being driven by extraordinarily loose fiscal and monetary policies including radical money printing.

Japanese shares peaked at the end of the great 1980s bubble when the Japanese stock market overtook the US and was briefly the largest stock market in the world. Despite the recent rebound, the broad Japanese index is still 60% below its 1989 peak (in real terms). Japan's population has grown by just 9% since 1980 but is now declining as it ages rapidly. Real GDP doubled over the period but most of that was in the 1980s boom, and the economy has been limping toward decay ever since. Japan is dying - literally, but there is life in the old warrior yet, jolted into action by the recent threatening rise of China.

In contrast the US population has grown by nearly 40% since 1980 (it has grown by the current population of Germany) and is still growing steadily. Real GDP has grown by nearly three times the rate of population growth. US share price growth has been well ahead of GDP growth, whereas in Japan share prices have lagged behind even its anaemic GDP growth. The broad US stock market index is up by 360% over the period in real terms. The US remains the global engine of growth, innovation and creativity (but also of financial engineering and asset bubbles).

Major Markets

		Current position	Direction / Trend	Pace of growth
Australia	As the local economy inches toward the election, inflation (at 2.5% pa) and unemployment (at 5.5%) are moderate, wages are rising and interest rates have never been lower. On 7th May the RBA made its 7th rate cut for this cycle. The aim was to bring down the dollar, and it then fell 6% by month end. The Federal budget contained few surprises as almost everything had been leaked beforehand. The main losers are the taxpayers (only 55% of Australian adults actually pay income tax). Most tax-payers will be hit by the 0.5% increase in the Medicare levy, and this increase will also flow on to increase a raft of other taxes besides income tax rates. The fanciful "surplus" for 2012-3 has turned into a $19b deficit as expected. 2013-4 will be the 6th consecutive year of deficits, making it a clean sweep of deficits during Labor's term in office. Mind you, Liberal PMs Menzies, Holt, Gorton, McMahon and Fraser did not produce a single budget surplus during their combined 30 years in power either. Post war Labor governments have achieved five surpluses: 1948-9 (Chifley), and 1987-8 to 1990-1 (Hawke), compared to the Liberals' ten: 1997-8 to 2000-1, and 2002-3 to 2007-8 (Howard). With the budget out of the way it's now back to serious electioneering - buying votes in marginal seats and buying the support of the independents.	Below average growth rate	Growth flattening	
Europe	The Eurozone remains in recession, with big contractions in the southern countries, France still going backwards and Germany barely treading water. The ECB cut interest rates on the 2nd May and ECB President Mario Draghi even threatened to start charging banks interest on their excess reserve deposits to force them to increase lending to boost the real economy. The problem is that there are few willing borrowers. Unemployment rates remain high and spending is in the doldrums. At their 10th May meeting the G7 finance ministers pledged their support for even more QE and rate cuts.	Contracting	Remaining very weak	
US	Fed Chairman Bernanke changed tack a little in his 1st May "QE-flex" statement. The Fed would henceforth be more flexible in adjusting the level of bond buying depending on how the economy was tracking, rather than stick to a fixed $85b per month under QE 3-4. He probably intended the statement to soften up the market for QE to be cut back when the economy improves. But the market saw it as an indication that bond buying may actually increase instead - as the unemployment rate is still stubbornly high at 7.5% and core inflation showing only 1.7%. Consequently, markets jumped during May on what was probably a misinterpretation of this ambiguous statement. When the inevitable "QE-exit" starts (as Bernanke hinted on the 22nd) it will be a shock to bond markets and stock markets. The federal deficit is reducing rapidly with the automatic sequester cuts necessitating partial government shutdowns via mass furloughs involving enforced leave without pay for hundreds of thousands of workers at a time. The government is now heading for a deficit of around $700b (4% of GDP) after four years of trillion dollar deficits. On the housing front the picture is still improving. It has been a year since the housing market hit bottom and started its long recovery. To date the recovery has been driven mainly by investors and the largest rises have been in the markets that had collapsed the most in the crash (eg Florida), so the price rises are starting from a very low base.	Below average growth rate	Recovery remaining slow	
Asia	In China housing prices are still rising and causing headaches for the government. Inflation is picking up, but still well below 3%. With the longer term slowdown in the pace of growth, together with the weakening of construction, investment and manufacturing, metals prices continue to slide from their February mini-peaks. Most metals prices are back down near their lows of six months ago. Coal prices also remain weak. Newcastle coal sells for a third less than it did five years ago, and at only half of the price it fetched 30 years ago (in real terms after inflation). In Japan the ambitious "Abenomics" experiment is starting to show up some flaws. The yen is down while production, exports, consumer confidence, spending and profits are all up. Even Sony has managed to post a profit for the first time this decade. The Bank of Japan's new pro-inflation boss Haruhiko Kuroda was hired specifically to create inflation and to build expectations of future inflation (in order to stimulate spending, borrowing and investment). But as soon as he mentions the prospect of future inflation, bonds sell off sharply and the stock market plunges 7%, as it did on the 23rd.	China: Cyclical slowdown Japan: Very slow	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 

ASSET CLASSES

			Current position	Long term returns (1)
Shares	Australian shares	In May the local stock market lost April's gains but has still returned 8% for the year to date. Banks were up strongly early in the month driven by dividend rises, but soon fell when investors realised something's not right when a country in the middle of nowhere with just 0.3% of the world's population can have 4 banks in the list of 11 largest banks in the world by market value. We hold the better quality banks (CBA, WBC, ANZ) but are under-weight the sector. Our portfolios are well positioned to benefit from the falling Aussie dollar, with holdings skewed toward companies with sizeable foreign revenues - eg. QBE (up 19% for the month), News (up 11%), Sonic (up 9%) and BHP (up 7%). We have been overweight Australian shares since early last year and have benefited from the overall market returning 25% over the past 12 months, plus our internal and externally run portfolios have added value on top of this.	Around fair value	Around average long run returns
	Developed markets shares	Global stock markets had another good month in May. The global index in local currencies was up 2%, plus the falling AUD added a further 6% to returns as our portfolios are un-hedged. Japan's stellar run slowed but it is still up 30% for the year to date (despite falling 7% on the 23rd). The UK market is about to join the exclusive club of countries that are back above their pre-GFC highs. The only other "developed" markets in the club are Denmark and the US (Australia is well back in the field, still 25% below its pre-GFC high, behind Norway, Sweden, Canada and even NZ). We have been over-weight global equities since early 2012 and un-hedged on the currency, so have benefited from good share price growth and from the AUD fall.	Mixed – US moderately is 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)
	Emerging markets shares	The global rally dragged up even the big emerging markets (led by China) in May for the first time since January. Smaller emerging markets are doing much better than the BRIC countries, and plenty of smaller markets are in the "back above their pre-GFC high" club - including Venezuela (up 10-fold since 2007), the Philippines, Indonesia, Sri Lanka, Argentina, Turkey, Chile, Mexico, Pakistan, South Africa, Malaysia, and Colombia.	Extremely hard to value. Many appear inexpensive to fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Australian bonds had a flat month as the yield curve continued to twist anti-clockwise (short yields falling, long yields rising), while credit spreads narrowed. Those who follow the financial media would be forgiven for believing that the trading of government bonds on the stock exchange this month was a "new" development. This is nothing new of course. Government bonds traded bigger volumes than shares on Australian stock exchanges (and were highly popular with individual investors) from the 1920s to the 1960s. Then the late 1960s mining boom and the removal of the 10% tax rebate on bond interest income saw shares overtake bond trading on the stock exchanges. We are watching the "new" listed bond market with great interest, but we remain under-weight as we see poor returns continuing over the medium term.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Interest rates on bank TDs remain low in historical terms, but high relative to underlying money market yields. We are staying at the short end rather than lock in for long terms now at low rates, and we are also using "breakable" longer term TDs. These products provide the best of both worlds (high rates plus the ability to switch to higher rates if rates subsequently rise) although these are unlikely to be as favourable when the new bank capital rules come into force.	Rates around long run average	Around average long run returns
	Global Bonds	Yields spiked upward during May, especially in the "safe havens" (the big debtor countries), as stimulus measures started to gain traction in the form of expectations of economic recoveries and future inflation. We pointed out last month that Japanese bonds were ludicrously expensive at yields of 0.6% on 10y bonds compared to 6% at the top of the 1989 Japan bubble when inflation was 2%, the Bank of Japan's current target. During May Japanese yields shot up by 0.3%, and yields rose also in the US and Germany, generating a 1% loss for the month in the global bond index. We remain under-weight as we see yields rising further in the medium term.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA cut its target cash rate for the 7th time in the current cycle that started on 1 November 2011. Curiously the RBA also warned people they should not see it as a reason to go out and borrow more money and take risks - which is the whole point of cutting interest rates!	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Foreigners have been the main buyers in the listed and unlisted commercial property markets since the GFC, and the listed market fell 4% in May as foreign interest waned. Last year trusts were trading at discounts to NTA so they undertook buy-backs to close the gap. After the price surges in the past 18 months LPTs are now trading above NTA and are raising capital. There are also signs of boom-time silliness returning, eg. Stockland borrowing to pay distributions once again (but that's what you get when you put investment bankers in charge!). We hold neutral weights on the sector, having been over-weight during much of last year's strong rise.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	As in the US, much of the housing activity here is being driven by investors taking advantage of the ultra-low interest rates on loans and by the declining yields from other asset classes. Broad-based rises in house prices are driven by surges in credit expansion, and banks are not about to embark on another wild lending spree. Nor is there any competition from non-banks or foreign lenders that might trigger another credit boom soon. On the other hand the falling dollar makes top end properties better value for foreigners and expats and this should boost local prices.	Varies by market, but over-valued overall	Below average to average long run returns
Australian dollar		The AUD finally has had its first decent fall since May of last year (when it also fell from 1.04 to 0.97 USD). This time the decline was triggered largely by the 7th rate cut, together with the falls in commodities prices and mining investment. The US dollar strengthened by another 2% as its economy continues on its recovery path. The AUD remains over-valued and our portfolios are benefiting from being un-hedged on foreign equities exposures.	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