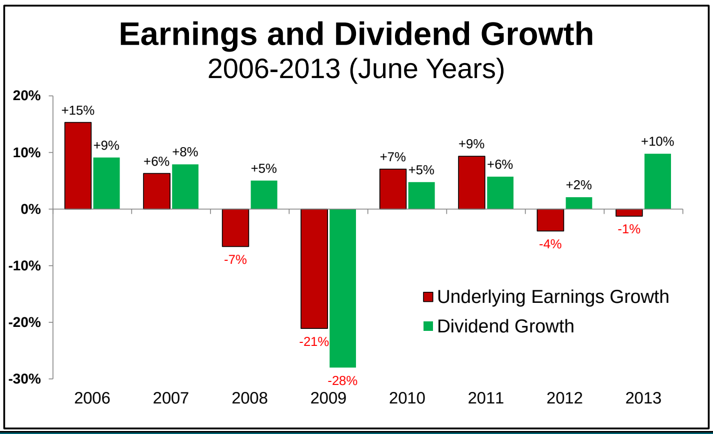
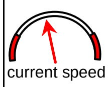
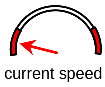
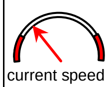
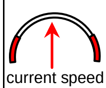
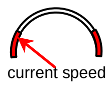


Australian Reporting Season

The annual reporting season for Australian listed companies was reasonably benign on the whole, and a slight improvement on the small earnings decline in the prior year. Earnings ended up flat for the year with slowdowns in both the local economy and in China. Weak top line revenue growth was offset by lower interest expenses and cost cutting.

Strong earnings gains in the healthcare, telco, utilities sectors and the banks were offset by big earnings declines in mining, retailing and energy sectors. On the other hand cash dividends rose by a better than expected 10% across the market, with big dividend growth from the energy and healthcare sectors, the banks and even from the miners.

All of this made for a good year for shares. The overall market (measured by the All Ordinaries index) rose by 16%, or 21% including dividends in the year to June, plus another 7% to the end of August.

Major Markets		Current position	Direction / Trend	Pace of growth
Australia	In August the Reserve Bank cut its target cash rate for the 8th time in the current cycle that started in November 2011. It said it was trying to encourage people to spend more money, but people's interest income is now lower, leaving them with less money to spend, not more. Instead the lower interest rates have encouraged people to borrow and speculate, which is helping drive up share prices. It has also fuelled a minor boom in flats sold off the plan by aggressive property marketers to investors with borrowed money. The August company reporting season revealed a trend toward higher dividend payout ratios from listed companies. While this may appear to be good for shareholders in the short term, it leaves companies with less money to reinvest for future growth. This in part reflects the decline in mining investment, low consumer confidence levels, and sluggish construction markets. It also may reflect the low levels of business confidence experienced this year, despite encouraging developments in the US, Europe and Japan. An unambiguous result in the upcoming federal elections would hopefully lift consumer and business confidence and encourage investment for future growth.	Below average growth rate	Growth slowing	
Europe	The next big milestone for Europe is the German Bundestag (lower house) elections on 22 September. In the middle of last year Germany started to shift from insisting on harsh austerity for the PIIGS and more toward a softer line allowing more time for reforms, less severe cuts to pensions and benefits, more tolerance of the inflationary effects of money-printing, and more money for bail-outs. This softer line boosted stock markets and bond markets but it angered German voters and Chancellor Angela Merkel's ruling Christian Democrat party lost a string of local elections. Merkel has had to walk a tightrope between the Bundesbank's hard line stance and the IMF's and EU's pro-growth, pro-inflation program. Thus far she has walked this tightrope rather well and she looks like pulling off a Christian Democrat victory, but perhaps with a larger say for the emerging minor parties. A clear Merkel win would most likely bolster confidence and stock markets across Europe.	Contracting	Remaining very weak	
US	The unemployment rate in the US continues to fall steadily. It has been pretty much a straight line decline from the peak level of 10% in October 2009 down to 7.4% now. CPI inflation is still low at 2% but it is on the rise again from a post-GFC low of 1.1% in April of this year. Thus far the recovery is proceeding along similar lines to many prior recessions, albeit more prolonged on this occasion due to the unusual severity of the 2008-9 contraction. The housing market recovery is continuing to broaden beyond just the most beaten down markets and also beyond the investor market to ordinary home buyers. The Fed will need to ensure its withdrawal from the artificial bond buying program does not lift interest rates too quickly, as most home mortgage interest rates are tied to 30 year treasury yields. The Fed has allowed 30 year yields to rise from below 3% at the start of the year to near 4% now, causing rates on conventional 30 year mortgages to shoot up from 3.4% to 4.4%. Although still low compared to their pre-GFC average of around 6-6.5%, rising mortgage interest rates will put a dampener on the demand for housing loans and, in turn, on employment and production in downstream industries. Much will depend on the handover of the Fed reins from Ben Bernanke to either Larry Summers or Janet Yellen, as we discussed in last month's report.	Below average growth rate	Recovery remaining slow	
Asia	Despite the slowdown in the overall Chinese economy, China's real estate construction industry remains robust, with an annual growth rate of 20%, an increase on the 16% growth rate last year. Housing prices and construction activity have been rising steadily since the middle of last year. It seems local governments have not been enforcing the central government's widely trumpeted restrictive measures to dampen the market, including increases in down payment requirements for buyers, higher interest rates on loans for second and subsequent houses, and tax increases on profits from sales of properties. These are having little impact but the central government appears happy to let the housing construction boom soften any potential hard landing for the economy. We are reasonably confident China's construction boom will continue for some time, as new premier Li Keqiang's main claim to fame has been his championing of rapid urbanisation as the key to economic growth. Construction requires rocks and Australia does rocks. However, the middle man is the Chinese steel mills and they have a habit of over-producing. As a result steel prices undergo major swings from time to time and these in turn impact prices of iron ore and coking coal. Even with the massive over-production of steel this year, steel prices and commodities prices have been rising in the lead up to the peak construction season coming up, and the benefits should flow through to Australian miners.	China: Cyclical slowdown Japan: Early recovery	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	The local stock market was up a little in August during reporting season following strong gains in July. Miners were the main winners for the month as positive developments in China caused metal prices to recover a little, ending a six month slide in metals prices since February of this year. BHP's new CEO Andrew Mackenzie seems determined to spend more money on Canadian potash mines after his pet project failed to get up in 2010 (BHP's hostile $40b bid for PotashCorp in 2010 was thankfully blocked by the Canadian government). RIO shareholders are still wishing RIO's aggressive purchase of Alcan at the top of the market for $38b (100% financed by debt) had been similarly blocked by politicians. On that occasion the Canadians gratefully pocketed the windfall $38b in cash. RIO has been writing it off ever since, and it still can't find a buyer for it at a fraction of the price it paid. BHP and RIO were both up a little in August, and are in our portfolios. Other strong performers in our portfolios were Westpac (up 11%), Origin Energy (up 10%), AGL (up 8%), Sonic Healthcare and Woolworths (both up 6%).	Around fair value	Around average long run returns
	Developed markets shares	The major developed country stock markets had a flat month in August, with most holding onto their 10-15% gains for the year to date. Add to this the currency gains of around 13% from our un-hedged stance, and total returns are nearing 30% year to date. The Japanese market also took a breather and ended August flat, holding onto its 30% gains for the year to date. US shares had recovered strongly in July from the May-June QE taper scare, but paused in August as positive economic news heightened investors' fears that the Fed would press on with scaling back its $85b in monthly bond purchases. Microsoft surged on the news of CEO Steve Ballmer's exit. Bill Gates handed over the reins to Ballmer at the start of 2000 at the peak of the dot com boom. The share price promptly crashed 65% within a year and 12 years later is still well below its peak level even after jumping 35% this year. Apple on the other hand is up 1,800% over the same period.	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)
	Emerging markets shares	Shares in most emerging markets have fallen as global investors pulled money out of emerging markets and back to the US and Europe. Nearly all Asian markets were down significantly but, because the Australian dollar has fallen by more than nearly all emerging markets currencies in the flight to safety, there has been very little net impact for Australian shareholders. The only Asian market up in August was China, spurred by announcements of new infrastructure projects designed to support the soft landing. The stand-out emerging market in August was Argentina (up more than 15% in August and 35% for the year to date) as it braces for yet another default on government debt that remains outstanding after the $100b IMF bailout in 2001.	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	The global flight of capital saw Australian bond prices fall across the board in August. Yields rose across all maturities and in all segments of the market. Inflation linked bonds fared worst and are down around 4% this year as future inflation expectations have fallen with the prospect of a local economic slowdown ahead. This follows the solid 8% returns from inflation linked bonds in 2012 when future inflation expectations were rising. We have been under-weight Australian bonds in portfolios all year, with only small holdings retained mainly for liquidity purposes.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Rates on bank TDs remain low and are still declining in many cases, even though the underlying treasury yield curve has been rising since May. This is continuing to drive the shift of money out of TDs and into other assets like investment properties and shares. For fixed income exposure we still prefer TDs over bond funds on a risk-reward basis.	Rates around long run average	Around average long run returns
	Global Bonds	Emerging markets bonds and high yield bonds suffered most in the global capital flight in August. We have none of these in portfolios. Among the big government debt markets, yields on long term bonds rose a little in the US, Germany, France and especially the UK, but continued to fall in Japan and Spain. We remain under-weight in portfolios as we see yields rising further in the medium term driven primarily by the scaling back of the US Fed's bond buying programs.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	With inflation remaining low and the jobs market remaining weak, the much hoped for housing construction recovery's failure to arrive may tempt the RBA to cut rates further in the coming months. The likelihood of further rate cuts further is enhanced by the recent pause in the dollar's fall since May. The lower dollar has not resulted in imported inflation. On the contrary, prices of imports continue to collapse, and the resultant negative inflation in traded goods imports would seem to provide added support for more rate cuts.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property sector had its third flat month in a row in August. The market had run up strongly last year and this year up until May, driven mainly by foreign investors. Many of the foreign buyers have fled since the Fed QE taper fears began in May. Year to date returns are still a healthy 7% including distributions and we still have neutral weighting for the sector in portfolios. The underlying commercial property markets remain rather weak, but continued foreign interest is keeping asset prices relatively firm to date.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	Recent house price rises have triggered media talk of a housing "bubble". Prices have risen meekly this year but Sydney median prices have only just clawed their way back up to where they were in 2004 in today's dollars after CPI inflation. Low interest rates, government subsidies and hand-outs have yet to translate into a consistent rise in housing construction activity as hoped by the government and RBA. Far from gearing up for an impending housing boom, construction firms and building products companies are laying off workers across the country.	Varies by market and by property	Varies by market and by property
	Australian dollar	The Australian dollar was a little lower against the major currencies in August, especially the stronger UK pound. The AUD is a "risk" currency and sells off more than most emerging markets currencies in global crises. In did so in the 2008 credit crisis, in the 2011 debt crisis and again in the QE taper scare this year. For all the recent media talk of recent currency "collapses" across Asia, the AUD has sold off more than any other Asian currency except India's rupee since the start of May (and for similar reasons: current account deficit and heavy reliance on foreign debt). We remain un-hedged in portfolios and this has significantly boosted returns this year.	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