

SEPTEMBER 2011 - OUTLOOK SUMMARY

- Weak economic data has led to financial markets factoring in a greater risk of a 'double dip' recession in developed economies. In combination with fears of possible debt contagion spreading from Europe into the US financial system, equity market volatility remains at high levels and over the quarter resulted in a rally to safe haven investments, such as US Government Treasury securities which have traded below equity market dividend yields.

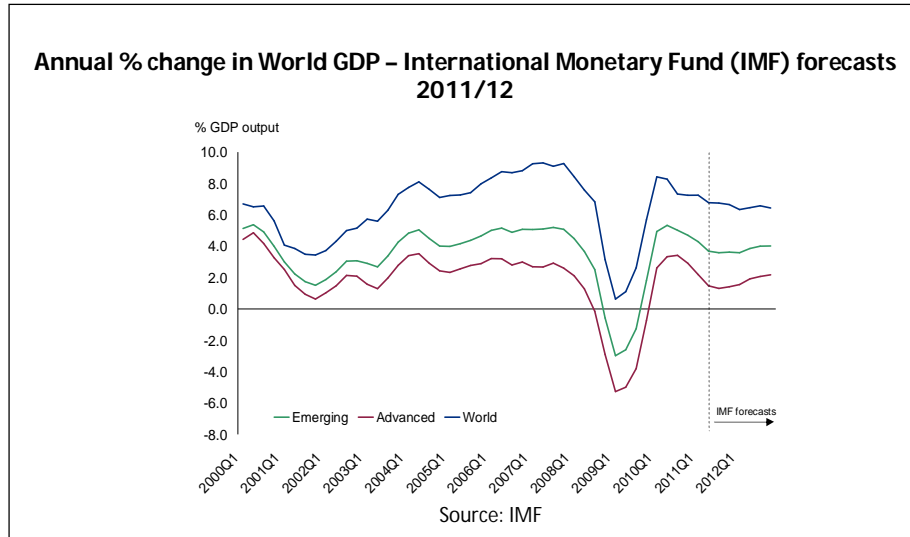
- Looking forward we believe a 'muddle-through' scenario is most likely, where global growth continues at sub-trend pace and the European sovereign debt crisis is contained, with minimal long term impact on the global financial system. This would be sufficient to keep commodities at relatively high levels. Markets may continue to price in dysfunctional outcomes at times which could lead to ongoing volatility. In this scenario the Australian economy is well placed to grow at around 3% in 2012. Given that inflation prospects have improved, the RBA still has room to cut the cash rate moderately if warranted.

- There is no change to our view that the Australian sharemarket will be 'range bound' in the near term. While we have stated previously that the market could move higher based on valuation fundamentals, clearly sentiment is on a knife edge and this could push out the timing of an earnings based recovery. The most likely scenario, at present, is that the market grinds higher over several years. We place a very low probability of the market sinking to index levels seen during the financial crisis of 2008/09. Recent weak global economic data and equity market performance is expected to be reversed somewhat in the next six months but major structural issues such as European government debt remain a source of volatility.

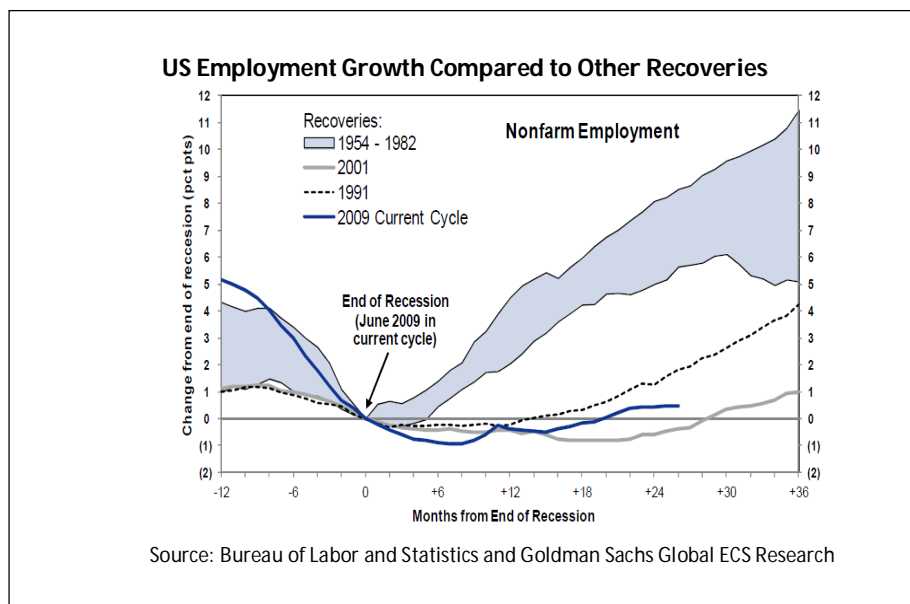
ECONOMIC DEVELOPMENTS

Global

Economic data weakened markedly in the September quarter and raised fears of a new global recession ('double dip'). The trigger was seen to be debt contagion spreading from Europe into the US banking system. Nonetheless, the IMF has only modestly revised down its global forecasts (see chart below) though also highlighting the risk of a global recession. Private sector economists are more bearish on the base case outlook (eg Citi project global growth of 3.8% this year and 3.6% in 2012).



By the end of the September quarter, pessimism was setting in among forecasters. The recovery from the 2008-09 GFC (global financial crisis) has petered out and the so-called 'Reinhart-Rogoff' thesis, which is built from a comprehensive historical analysis of financial crises, appeared valid. That is, as summarised by Citi economists, 'systemic financial crises in advanced economies and emerging markets are usually followed by deep recessions, slow recoveries and an extended rise in unemployment as [sovereign] balance sheet repair dominates'.



The US economy continues to struggle at a sub-2% growth rate as employment growth lags previous recoveries. It appears likely that the unemployment rate will stay above 9% during the 2012 presidential election year. The President has announced a US\$450 billion 'jobs plan' but this still requires legislation through Congress, and if passed will not benefit the economy materially until 2012.

However, best estimates still put the probability of a meaningful US recession at 40%. The main reason for this, according to Goldman Sachs, is that 'the most cyclical sectors of the economy, such as homebuilding, durable consumption, business investment and inventories—which typically account for all of the decline in overall real GDP in recessions—are already at very low levels of activity and are unlikely to decline dramatically further unless there is another very large shock.'

In Europe the debt crisis has worsened significantly with concerns that Greece may default being priced into financial stocks. The consequent adverse impact on consumer and business confidence with a self-perpetuating weak global economic outlook means that a shallow recession is now likely in the next two quarters, and subdued output growth in 2012. The increase in financial risk is likely to lead the European Central Bank (ECB) to ease its liquidity policies further. Indeed, the ECB announced in early October that it would resume buying covered bank bonds in November and would hold two separate tenders of year-long refinancing to eurozone banks.

In addition, markets expect that the ECB will eventually be forced to cut the repo rate from the current 1.50% level. In the UK, policy makers have already announced another round of quantitative easing - the Bank of England (BOE) surprised the market by raising its asset-purchase scheme from £200 billion to £275 billion.

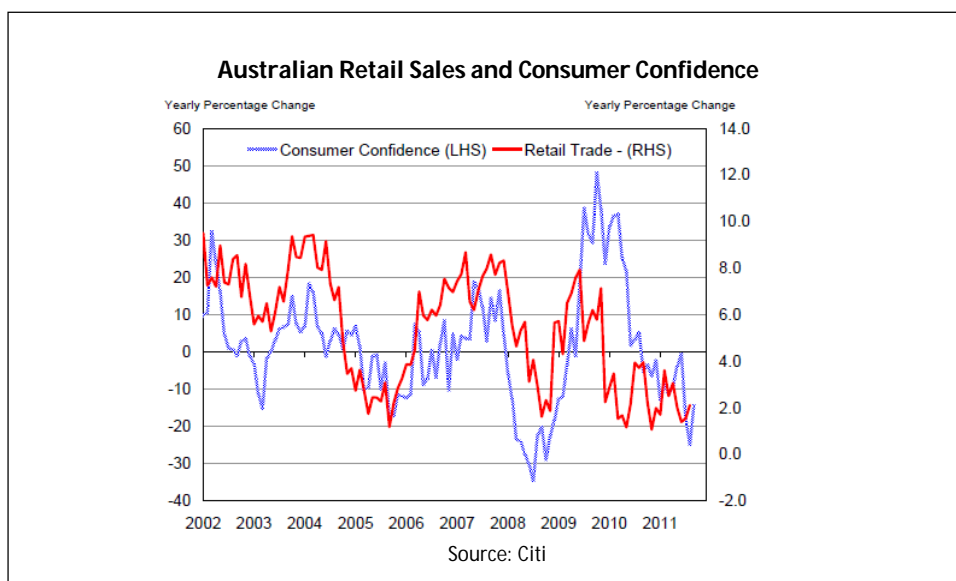
The Chinese economy continues to slow but a 'soft landing' (to a still healthy GDP growth in the 8% to 9% range) remains widely expected and this is supported by a range of economic data – the purchasing managers index (PMI) is holding around 50 and money supply growth around 15% (still the slowest rate in 5 years). Positively, inflation pressures appear to be abating with the annual CPI rate easing to 6.2% in August (from 6.5% the previous month).

Australia

While the 1.2% rebound in June quarter GDP growth data surprised the market, the composition was deemed weak given a sizeable contribution from inventory rebuilding. Although household spending has recovered somewhat, cautious consumers and a weakening employment market have boosted savings. The main impetus for growth is likely to come from the flow on effects of the mining boom to business investment. Overall, economic growth is likely to be around 1.5% to 2% this calendar year and a respectable 3% (with upside risk) next year, subject to a greater degree of uncertainty than usual.

There have been some positive indicators but consumer activity remains relatively subdued as reflected in the correlation with consumer confidence (see chart below). Retail sales increased by 0.6% in August - well ahead of the consensus estimate of 0.2%. The yearly growth rate rose to 2.1% from a depressed 1.5% in July and stabilised the trend growth rate from falling further.

According to the RBA, the inflation outlook in Australia is now benign: 'the path for inflation may now be more consistent with the 2–3 per cent target in 2012 and 2013, abstracting from the impact of the carbon pricing scheme'.



Interest rate outlook

At the October meeting, the Reserve Bank of Australia (RBA) Board decided to leave the cash rate at 4.75%, where it has been since November 2010.

However, forward interest rate markets have been factoring in sizeable rate cuts for sometime. This is reflected by physical bond yields that are below the cash rate ('inverted yield curve') and is unsustainable in the medium term unless the cash rate is cut.

While the RBA argues that it is still too early to gauge what impact European and US financial market turmoil will have on growth in other regions, they have certainly become more cautious about whether the Australian economy can remain insulated from these developments.

In the Statement released after the October Board meeting, the RBA has finally signalled that an easing in monetary policy is feasible. The RBA noted that the inflation outlook had improved and that if the September data (released Wednesday 26 October) is benign then this 'would increase the scope for monetary policy to provide some support to demand, should that prove necessary'. Thus, a rate cut as soon as November is now seen by market analysts as a distinct possibility though we place more weight on a worsening in the global economy as a trigger.

INVESTMENT OUTLOOK AND ASSET SECTOR REVIEW

The September quarter ended with a massive slump in risk assets (such as equities and industrial commodities) as investors began to factor in the risk of a renewed global recession and disorderly resolution to European sovereign debt issues. Global equities fell around 15%, in local currency terms, and commodities fell sharply from historically high levels – copper, which is a barometer for the global economic activity, plunged 23%.

Volatility has also been a feature of the quarter with the VIX index (which measures option implied US stock market volatility) trading at the highest levels since the peak of the 2008-09 global financial crisis. Gold traded over US\$1,900/oz before correcting rapidly to around US\$1,600/oz as investors raised liquidity. Some consolidation was not unexpected given gold's rapid appreciation in previous months due to its safe haven status.

Investors switched to core bond markets, driving US and German 10 year government bond yields below 2%, which is less than the dividend yield in the relevant sharemarkets. European debt fears also saw the Japanese yen and US dollar benefit after the Swiss curbed inflows to the Swiss franc by linking their currency to the Euro.

There are two main scenarios that can be identified:

- Firstly, a **'muddle-through' scenario** where global growth continues at sub-trend pace and the European sovereign debt crisis is contained with limited damage to the global financial system. Government intervention has already occurred in one case (Dexia) and policy makers are studying how to limit the impact of any default by Greece. There is a risk that eventually too much liquidity is added to the global economy triggering another round of commodity price inflation and eventually consumer price inflation in advanced economies.
- Secondly, a **'bear' scenario** where sovereign bond defaults in Europe spread beyond Greece to larger European economies and eventually into the US banking system. This would likely lead to a global recession that would include emerging market economies, negatively impacting on commodities. Policy makers are working frantically to avoid this outcome and there are a number of major international meetings (led by the G20, IMF, US and EU) in coming months endeavouring to resolve the competing political agendas.

Given the unstable investment environment and wide range of possible economic scenarios around the 'muddle-through' and 'bear' scenarios, it remains appropriate to focus on quality 'all-weather' investments, diversification and value opportunities when they arise.

Australian equities

Despite a sharp rally in the last trading days of the June quarter this was not sustained in the September quarter. Global issues relating to sovereign debt management (US and Europe) escalated in August with investor concerns carrying through into September. As a result the Australian equity market exhibited extreme volatility and finished the quarter lower with the S&P/ASX200 index declining 13.0%, or 11.6% including dividends (total return basis). After slipping from the 4600 index level to below 4000 (around -15%), the market continued to trade in a wide range of 400 points settling back near the 4000 level by the end of September.

We attribute the sell-off to ongoing and escalating global macro-economic issues. Namely equity investors continue to focus on the global debt legacy that remains post the 2008 financial crisis. Investors' risk appetite weakened and stock volatility spiked as US politicians struggled to reach an agreement on raising its US\$14.3 trillion debt ceiling. This then fuelled concerns over the risk of a default event and possible downgrade of the US AAA sovereign credit rating, which became reality when Standard & Poor's downgraded its rating from AAA to AA.

Renewed eurozone debt contagion fears subsequently embedded this air of uncertainty. Politicians across 17 Euro country members continue to struggle in bringing about coordinated action which would ease negative market sentiment. Locally, the Reserve Bank of Australia (RBA) is slowly yielding to the what markets have been factoring in for several months – that the next required move in short term cash rates is down in order to protect the Australian economy from global events. Helping our export focused, manufacturing and consumer discretionary sectors was a swift fall in the Australian dollar versus the US dollar, below parity for the first time since March, in the last week of the September quarter.

There is no change to our view that the Australian sharemarket will be 'range bound' in the near term. While we have stated previously that the market could move higher based on valuation fundamentals, clearly sentiment is on a knife edge and this could push out the timing of an earnings based recovery. The most likely scenario, at present, is that the market grinds higher over several years. We place a very low probability of the market sinking to the index levels seen during the financial crisis of 2008/09.

With recent macro uncertainty and negative consumer and business sentiment instilling a more prolonged economic recovery, the most important attribute we continue to assess, for all stocks, is earnings (and dividend) sustainability. We view the following stocks and sectors as meeting the balance of these attributes:

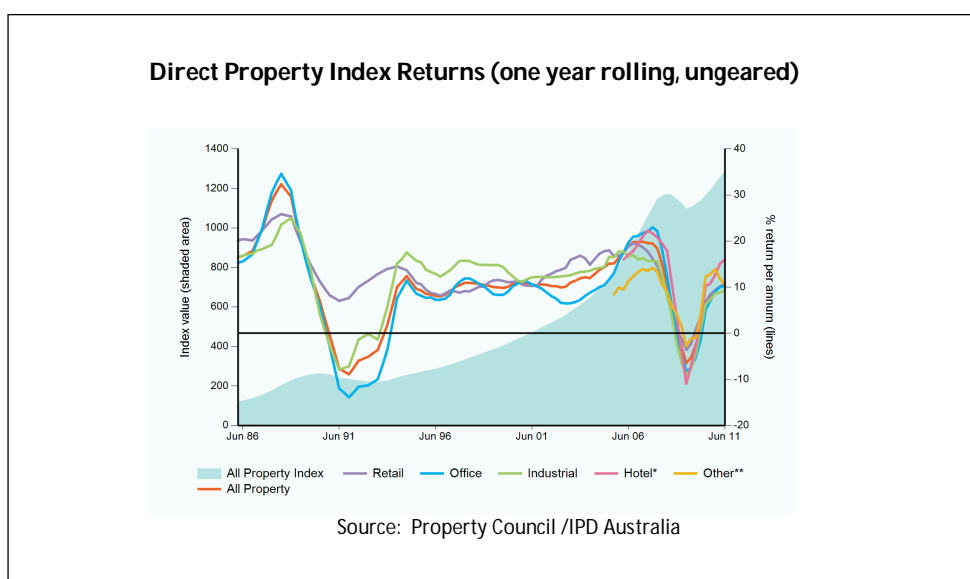
- Banking sector - the most liquid sector in the Australian market and most closely linked to global financial stress; but oversold. The major Australian banks are better capitalised than in 2009 and have recovered interest margins despite higher wholesale funding costs. While loan growth is subdued, we believe there are many others levers for management to use to maintain profit growth including cost containment. Dividends have rebounded after being cut in 2009, and are back on a path of progressive growth. We believe it is highly unlikely that dividends are cut once again. Dividend yields for the major banks average 7%-8% (FY12) or 10%-11% including a tax franking benefit.
- Consumer staples sector - traditionally a safe haven in times of economic stress, the consumer staples sector offers earnings sustainability. Woolworths (WOW) and Wesfarmers (WES) remain in our model portfolio.
- Stock specific defensives - other stocks which we believe should demonstrate a high degree of earnings certainty and have sound business structures include Orica and Sonic Healthcare.
- Cyclical upside - global economic recovery, even if prolonged and staggered, should not be completely ignored. Stocks we recommend as a hedge to cyclical recovery include QBE and CSL.

Global Equities

There was a large sell off in the September quarter with higher beta emerging markets hit hard. Still it is important to note that, in Australian dollar terms, advanced economy markets (MSCI) outperformed Australian equities (-8.0% compared to -11.7% for the S&P/ASX 300).

International equities were helped by the sell off in Australian dollars, which fell from a quarter high of US\$1.10 to under parity against the US dollar. The Australian dollar remains well above longer term measures of value (purchasing power parity is at US\$0.66, according to OECD estimates). However, it is supported by the terms of trade at 140 year highs, wide interest rate differentials at a time when core countries are running interest rates close to zero and a sound fiscal position (Australia's AAA sovereign rating).

Australian Direct Property



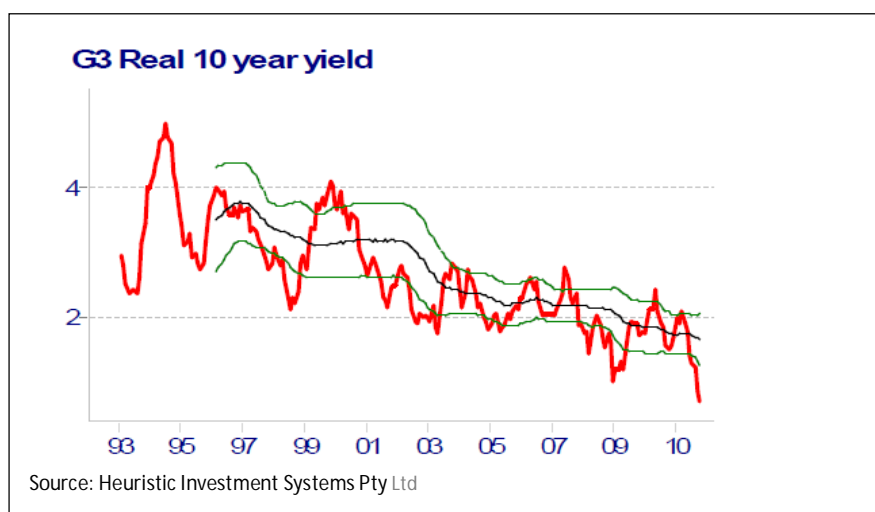
Given the nature of direct property markets, where properties are not traded regularly and sales data is not widely available and often lagging, it is difficult to give an accurate snapshot of performance over the September quarter. However, recently released data from the IPD Australian property database which includes over \$130 billion of Australian property from a wide range of participants provides a useable index of performance for the year to June 2011.

Total return for direct commercial property for the year to June 2011 was 10.6% (annualised income return of 7.5% and capital return of 2.8%) according to Property Council of Australia / IPD Index. Of the property sub-sectors within Commercial, Hotels was the leader at 16% total return, followed by Retail at 10.7%, Office at 10.4% and Industrial at 9.4%. Within the Office market, performance across CBD office markets for the year to June have varied, led by 13.4% total return in Melbourne, 11.7% in Perth, 9.2% in Sydney, 8.9% in Brisbane and 7.8% in Canberra.

Each market presents various levels of supply / demand fundamentals and over the quarter we have invested in property syndicates where we have seen opportunity to buy assets below valuation from distressed sellers (e.g. Centuria 8 Australia Ave Fund) or in markets which we believe have solid growth characteristics (e.g. Perth). We continue to see strong buying opportunities over the next year, before the property cycle moves to a more mature phase.

Cash and Fixed Interest

Term deposits have eased to around 5.70% but still remain attractive in both absolute and risk adjusted terms. The rally in government bonds, especially internationally, means that the International Fixed Interest sector appears very overvalued given our base case economic scenario. The degree of overvaluation is shown by real (inflation adjusted) 10 year bond yields which are close to zero.



Credit spreads (the difference between yields on government and corporate bonds) have widened as investors chased core market government bonds. Concerns about a global recession, rising bank funding costs and likely company defaults also emerged. However, it should be stressed that the actual level of defaults is at very low levels and balance sheets are sound. Issuance has been at high levels in recent years and corporates have raised significant equity.