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QUARTERLY REVIEW – MARCH 2009

A TALE OF THREE CITIES

When you ask a market practitioner at the moment "how's business" you may find that you end up with at least three different answers to what appears to be a fairly straight forward question. The problem is that peoples' view of the current state of the "down turn" and the prospects for recovery very much depend upon the prism they are using to look at the world. In this quarter's outlook, we thought we'd try and piece together a picture of where we are in the cycle based on the view through three different prisms (ie Economic, Credit & Equity), with an obvious focus on the implications for equity markets.

1. Economy

Most economic commentators are of the view that we are past the half way mark in the global recession. Whilst we talk about a global recession, it is fair to say that the impact on the economies of individual countries has varied significantly – all have been impacted but the depth and duration of any recession impacting them will vary.

In the first part of any recession/economic down turn we see a marked deterioration in business and consumer confidence, inventories blow out and manufacturing output drops into a black hole. We can put a tick against all these things. These are the **leading indicators** of economic activity – they are the first to suffer, but also the first to recover.

We recently attended a presentation by the Head of Global Asset Allocation at Barclays Capital and he made a compelling case that we passed the nadir of global economic contraction in November'08 – January'09. He supports this view by reference to a number of leading economic indicators:

- Global inventory data is pointing to a paring of the overhang that has built up over the past 6 months and we are seeing growth in global new orders.
- Business confidence (across the globe) is actually improving
- Real consumption in the US is no longer in decline and whilst manufacturing output has fallen away significantly, this gap between supply and demand is not sustainable – output must rise in the short term.

- Whilst unemployment will get worse (as a lagging indicator) the increasing gap between manufacturing output and demand indicates that unemployment may not get as bad as some are speculating.
- The Chinese economy has responded very quickly to the Government stimulus. Whilst the first quarter GDP figure was slightly below expectations, this aggregate number masks the significant improvement during the month of March.
- Output in South Korea, Taiwan and Thailand has bounced. Together with Sweden, these are considered to be the "bell-weather" economies of the globe.

In Australia, we are well placed to weather the remainder of the global down turn. We have a stable financial system, we have seen expansionary fiscal policy, house prices have remained resilient, the currency has depreciated and there has been sizable cuts to monetary policy with more room to move if required. With regard to the latter, the flow on affects of official cash rate cuts here in Australia are amongst the most direct in the developed world given the level of household borrowing and the prevalence of variable rate lending.

The key risks to a rosier economic outlook include:

- Falling levels of global trade – global trade will provide the biggest stimulus to economic growth, but despite the rhetoric, protectionism is looming as a threat to increased levels of trade
- US Housing market – there are tentative signs of recovery, but some of the foreclosure statistics and loan-to-valuation ratios are hideous
- A slump in the Australian housing market – our market has largely been immune from the disasters that have struck other developed housing markets. If our market were to head down the slippery slope, the knock on affects (given housings central positioning in the economy) could be material
- Bank credit – bank lending generally underpins economic growth. Margins are still high (specifically for corporates) and lending volumes remain low.

2. Credit Markets

The picture is certainly less clear for credit markets:

- We're only just at the beginning of the bad debts and defaults cycle
- We are moving into a situation of over-supply of government bonds/treasuries.
- Historically low interest rates (next move likely to be up, putting pressure on bond prices)
- There is still further (potentially significant) deleveraging to come
- As noted above, credit is still not flowing into the corporate sector – banks are hoarding cash and credit spreads remain very high.
- Sovereign risk, particularly in Eastern Europe and some emerging market countries, is likely to become an issue

Fixed interest and bond managers are still very much "down in the mouth". Traditionally the problems in credit markets lag the position in the real economy and equity markets. They know only too well that things in their part of the world will get worse, before they get better.

3. Equity Markets

Equity markets have begun to look through the malaise associated with the global economy and credit markets, and now have their sights fixed on longer term fundamentals. This has only been a recent phenomena – up to a month or two ago in equity markets, there was a dearth of confidence and economic and business data was greeted with large doses of negative sentiment. There are now tentative signs that the worst may be behind us. Since the low in early March'09, the S&P (ASX) 200 is up around 18% (as at 24 April) and Australian bank stocks have risen on average by almost 30% in the same period.

We indicated last year that banks had been responsible for dragging markets down to their lows and that an early sign of equity market recovery would be an out-performance in bank stocks. It may well be the early stages of this phenomenon that we are now witnessing.

Historically, when we look back at the interplay between economic growth and inflation, we have now moved into one of the most profitable "quadrants" for equity markets – that is, when real GDP and CPI are both low, equity market performance is at its highest (contrast this with the period over the latter part of 2008, when GDP was low and inflation was high, which typically corresponds to a period of negative growth in equity markets).

There are still down-side risks associated with the potential for further earnings revisions and, in this regard, the **upcoming profit reporting season** in the US (and subsequently here in Australia) will give the market a read on whether the earnings reductions that have been baked into current share prices have been over-done or not.

Clearly, macro economic data still has the potential to push markets lower, but we would suggest that it would need to be materially bad to detract from current sentiment. The other key issue remains credit market. Whilst we have conveniently segregated the view on credit, the reality is that without continued improvement in the credit markets (ie reduced spreads and increased volumes of bank lending) the recovery in the equity markets could prove short lived. A useful signpost here will be the results of the **US bank stress testing** (expected 4 May)

Keep an eye out for the two "r's"

With any recover in equity prices will come the inevitable **retracement** – profit taking and nerves will at some point return to the market over the coming month or two and the bourse will again correct. However, we expect that (baring some type of economic or financial disaster) it is likely to hold on to a good proportion of the gains it has booked to date. Whilst many are debating whether it will be a "u-shaped" or a "v-shaped" bounce in equity markets, the reality is that it will look something more like a "w-shaped" recovery.

The other trend that will become more apparent as any recovery gathers pace is a **rotation** out of defensive stocks into more cyclical stocks. As investors' risk appetite improves, there will be a move towards acquiring higher proportions of growth orientated stocks, potentially at the expense of more defensive stocks. In the case of Fund Managers, who are more or less fully invested at any particular time, this is

achieved by selling some portion of their defensive stock holdings to make room for the cyclical (riskier) stocks.

This is not to say that defensive stock prices will plummet, but as the recovery gathers pace the relative performance of stocks like the banks, industrials and consumer discretionaries are likely to out-perform stocks like consumer staples, telecommunication and health care stocks which have suffered far less over the past 12-18 months.

ASSET ALLOCATIONS

In summary, we remain quietly optimistic that equity markets have now begun a longer term recovery. We fully expect some volatility over the next few months, but that any retracement in values will not retest the lows of March'09. Moreover, we know that there will be a further deterioration in some of the lagging economic indicators (eg unemployment), but that this is a function of where we are in the business cycle and that this trend in the data has largely been factored-in by the market.

Against this backdrop, we are looking to move towards the following allocations in client portfolios:

- **Australian Equities (Slightly Underweight) .** We continue to look to incrementally add to client portfolios, with a continued preference for large cap (neutral) over small cap (underweight) stocks, and a slight bias towards cyclical stocks (including the banks)
- **Global Equities (Underweight):** The US economy (and by inference its equity markets) is likely to struggle for a longer period of time and hence we continue to avoid benchmark aware international funds. Asia and some developing markets offer better prospects.
- **Property (Underweight):** Continued problems with managing debt and lower property prices will combine to stifle performance in the sector for some time to come
- **Fixed Interest (Neutral):** With falling interest rates, some of the gloss has gone off fixed interest, however, there are some attractive offerings in the bank debt (preference share) space.
- **Cash (Overweight):** As a result of underweight positions in global equities and property, cash remains overweight.

One final observation that is worth making at this point is in regard to "alternative asset classes". Over the past twelve months, many advisers and asset managers have extolled the virtues of private equity, infrastructure, direct property and the like – claiming that their underlying values are more stable than listed investments. The fact is that listed assets are very transparent (ie priced on a mark to market basis) and have already taken their valuation haircuts – the markets have seen to this. The alternative investments are still to confront their (significant) downward revaluations and potentially face emerging liquidity issues as investors head for the door.

Regards

Andrew & Stephen

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