Suite 1, 20 Bundaroo St
Bowral NSW 2576

Tel (02) 4862 3724
Fax (02) 4862 3735

PO Box 1668
Bowral NSW 2576

QUARTERLY REVIEW – NOVEMBER 2011

Since writing last quarter, markets have continued to grind lower under the weight of concerns about Europe. As we feared, policy makers in Europe remain behind the curve and the tardy and iterative nature of responses is continuing to disappoint markets.

From an Australian perspective the news hasn't been all bad with commodity prices having softened, the dollar falling back to around parity and the Reserve Bank cutting official interest rates. In China the authorities have once again done a remarkable job in gradually slowing growth to rein-in inflation – of course, with a bearish equity market lacking in confidence, this was interpreted as China heading for a "hard landing".

A number of commentators are now indicating that a global recession has already been priced into markets; concluding that equities are over-sold. On a fundamental basis, there is clear empirical evidence to support this proposition, however, with the situation in European taking unwanted twists day by day, one could imagine a scenario that saw stocks fall further.

There has obviously been a lot of talk about Europe in the media, so we thought we'd devote some time in this quarter's review to look at some of the structural underpinnings of the Eurozone and the implications that this has for possible solutions.

What is the Eurozone and why is it Broken?

A few quick bullet points about the European Union and the Eurozone:

- The European Union (EU) is an economic and political union involving 27 European countries. It has its own Parliament, Commissions, Courts and Central Bank. Its hard enough getting the political parties of a single country to agree on policies – imagine what it takes to get a 73.9% qualified majority amongst 27 nations.
- The EU seeks to provide economic benefits to its members arising from a single market with the free movement of people, capital, goods and service amongst member states.
- A sub-set of the EU nations (17 in all) have formed a monetary union known as the Eurozone and these countries share a single currency – the Euro. It was intended that all members of the EU join the Eurozone once certain fiscal criteria were met.
- In joining the Eurozone, members effectively hand over control of monetary policy to the European Central Bank (see below).

The issue in Europe is primarily a sovereign debt crisis amongst Eurozone members. Certain members have significant amounts of government debt that needs to be re-financed periodically in the bond markets. The bond markets aren't keen to re-new the debt and where they do, they are demanding a significant premium (ie the countries are paying much higher interest rates). Whilst the current rates can be tolerated for a few bond tenders, they are not sustainable over the medium term as more and more government revenue is eaten-up by increasing interest payments.

We've outlined below a few bullet points that hopefully provide an explanation of why the Eurozone nations are not well placed to deal with the financial problems they now confront:

- In a sovereign country like Australia, there are a number of policy instruments available to authorities to manage an economy, including:
  - ✓ Money Supply
  - ✓ Interest Rates
  - ✓ Fiscal Policy (Government budgets)
  - ✓ Currency Value
- The problem with the Eurozone nations is that they individually only retain control over fiscal policy (ie their budgets) – they have handed over control of money supply, interest rates and currency value to the European Central Bank (ECB).
- This would not have been a problem if all nations were closely correlated in terms of their economic position (which is what they tried to achieve when admitting EU nations into the Eurozone in the first instance). However, Germany (and to a lesser extent the French) have very strong economic positions, whilst nearly every other country (as history has now revealed) is in much poorer economic shape.
- Herein lies the rub – the Germans don't need or want the same type of policy settings as the rest of Europe at this point in time. The Greeks (for example) would love to be able to print some Euro's and lower interest rates, but the ECB (which incidentally is head-quartered in Frankfurt – say no more) is disinclined to drop rates or print money. Consequently, the weaker European nations have only one lever that they can use – the fiscal one – and they are being forced to implement some very tough austerity measures. They are, of course, able to fund their budget deficits by selling sovereign bonds (denominated in Euros) but as mentioned above, interest rates being demanded by the market to hold sovereign bonds are untenable.
- So in short, we have integration within the Eurozone where its probably least helpful in the present environment (currency value, interest rates and money supply) and separation around fiscal issues (budgets, bond funding, etc) which would benefit from being more integrated at the present time.

The Solution to Europe lies in 3 Simple Words ……..

The European Central Bank (ECB) has the power to provide and immediate solution to current uncertainty in Europe. Longer term, of course, there needs to be closer fiscal and economic integration (Germany, to their credit is looking to develop solutions in this time-frame), but in the short term, markets need a circuit breaker to restore confidence.

The ECB has scope to use monetary policy (ie lower interest rates) undertake quantitative easing (printing money) and to support the financial position of struggling European countries by actively buying their bonds on a much larger scale than they have done so to date – they need to play the role of a buyer of last resort. Its not about writing the likes of Greece and Italy a blank cheque, but it is about being a lot more supportive than they are currently.

In terms of other options, the European Financial Stability Facility has been "seeded" with around 440 billion Euros with the option of guaranteeing commitments up to a total of 780 billion Euro. The constraining factor here is that around 120 billion has already been committed to Portugal, Ireland & Spain; with a further 50 billion recently being ear-marked for the re-capitalisation of European banks – that's around 40% of the core funding already allocated. There has been talk about gearing the EFSF (some say up to 2 trillion Euro), but a good deal of the equity has already been committed and somehow borrowing more money to solve the problem of countries that have themselves borrowed too much money, seems intellectually flawed.

There has also been talk about the International Monetary Fund (IMF) becoming involved; but the IMF itself is significantly under-funded and there is no way the US (as the major contributor to the IMF) is going to stump-up lots of cash to bail out struggling European countries when it only just has its head above water. Any involvement by the IMF will need to be targeted and not require further member funding.

Some Better news out of the US

Underlying economic trends are very much on the improve in the United States. Granted, unemployment is still high and a lingering threat to economic prosperity; but the bulk of economic indicators are trending in a much healthier direction. For example

- Retail sales are approaching record levels
- Corporate profits have fully recovered from the GFC
- Housing prices have stabilized
- Non-farm private payrolls have jumped up, albeit government continues to shed jobs

(See attached graphs - the trends that are evident are really quite reassuring.)

The issue confronting the US, and indeed one that plagues nearly all modern democracies, is minority government. Globally, we have made our governments hostage to political compromise as we have installed hostile houses of review (senates) or forced them into minority alliances with third parties to form government. Now is a time for strong political leadership but outside of reforming communist economies, there are few who have a clear mandate to make the tough decisions.

An Optimistic Word or Two about Markets

For those of you who follow markets closely, you may be familiar with Charlie Aitken (formerly of Southern Cross Equities, now Managing Director of Bell Potter). With all the doom and gloom being written in the media about shares, we thought we would share with you Charlie's most recent views about the Australian Market:

I can never remember more bearish sentiment and market conditions, but conversely, I can never remember cheaper valuations and sustainable dividend yields in Australian equities, particularly in the top 20 where the vast bulk of high barrier to entry, high margin, high ROE businesses reside.

The reason I remain unflinchingly bullish, as we have been from the October lows @ 3850, is because of the ultra low valuations and ultra high sustainable dividend yields. The equity risk premium and the grossed up dividend yield being paid by leading equities is the highest in our lifetime, and I don't believe that is either rational or sustainable over the medium-term.

But there is no doubt all investors need to make a choice. Clearly, many Australian's have decided the volatility in equities is "too hard" and have sold their equity portfolios to move into the unfranked safety of fixed interest. Flows into term deposits remain 4x the average of the last decade, while inflows into equities have all but stopped. Discretionary outflows from equities continue. However, it needs to be remembered that the vast bulk of retail investors chase performance and have moved out of equities AFTER a 20% correction, at record low valuations and record high fully franked dividend yields, into unfranked fixed interest right as the RBA starts a substantial rate cut cycle and Australian government bonds attract generational low yields right across the curve.

"De-equitisation" is an economically sophisticated description created to make all those selling equities at the bottom, and buying fixed interest at the top, feel good about their decision. Yes, it certainly is happening, but the decision to sell equities is more about psychology and the safe feeling of avoiding further losses, than it is about fundamentals, true investing, or anything structural. Nothing driven by psychology is EVER structural.

Head Office GPO Box 502, Sydney NSW 2001 **Telephone** (02) 9279 2444 **Fax** (02) 9279 2555 www.axiomwealth.com.au
Axiom Wealth Pty Ltd ABN 59 123 597 115. Australian Financial Services License 313422

(Charlie Aitken "Ringing the Bell" - Bell Potter - Monday 28th November 2011)

The other positive piece of news to come out of markets in the last quarter has been that **Warren Buffett** (Berkshire Hathaway) has been buying shares. Not just a few shares but $23bn in US shares, which is the most invested by Buffett in at least 15 years. In a recent CNN interview he opined that the market sell-off "didn't make sense". He urged investors to forget about headlines and the day-to-day machinations of the market and instead focus on the long-term value that is currently evident in equities. (Just as a reminder, Buffett's investment credo is "sell when others are greedy, and buy when they're fearful".)

OUTLOOK

The direction of markets in the next few months will be determined by the arm wrestle between fundamentals and the unfolding woes in Europe. The market looks oversold and is likely to bounce on any positive news out of Europe. If (for example) the ECB does take a more active role in Europe's monetary affairs, we could see a significant relief rally. The chartists (independent of the broader macro picture) are offering a technical view that sees equities leg-up in December to finish the year on an upward trend. Again, we have intuitive sympathy for this position provided we get some "crumbs" of good news out of Europe.

If the ECB's pronouncements around Europe are substantial and if there is commitment amongst EU member nations to work towards broader fiscal integration, we could see positive momentum continue for markets into the first part of 2012. However, if solutions in Europe continue to be piecemeal, and if on the other side of the Atlantic the US President continues to struggle to make progress on budgetary/fiscal reform, we could be in for a tough start to the new calendar year.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral/Slightly Underweight):** Whilst valuations appear compelling, we still see potential for further volatility.
- **Global Equities (Slightly Underweight):** Benchmark unaware and Asian focused exposures are our preference.
- **Property (Underweight):** Property is still clouded by uncertainty and typically will hold more attraction as a late-cycle play.
- **Fixed Interest (Neutral):** The RBA has now lowered cash rates and market rates continue to soften. There may be some merit at this point in extending the duration (ie, average term) of fixed interest portfolios
- **Cash (Slightly Overweight):** As a result of our positions in other asset class's cash remains slightly overweight to target.

Regards

Andrew & Stephen