



Market Moves Reviewed

Volatility in global markets has once again emerged with the dramatic sell off in equity markets over the last week. Last night the Dow Jones index fell 512 points or 4.3% due to the fear that the US is heading towards a double dip recession. The trigger for the sell off originated in Europe as sovereign debt fears pushed Italian and Spanish 10 year government bond yields higher and traders took into account the Bank of Japan entering the foreign currency markets to push down the value of the Yen against the US dollar.

Over the last week the markets have had an incredible number of events to grapple with:

- ❖ **Fear that the US debt ceiling would not be raised** – now rectified however the process in which a solution was found was extremely convoluted and highlighted the lack of unity in leadership and bipartisan support. While political point scoring is a global phenomenon it is disappointing to see that such a gulf exists in the US as to how to tackle their debt problems. It is not too dissimilar to the approach that the Europeans have taken and this has kept the issues at the forefront of markets concerns;
- ❖ **US Gross Domestic Product growth weakness** – the June 2011 quarter growth rate was a softer than expected, coming in at 1.3% however the larger concern was the downward revision of the previous quarters growth rate from 1.9% to 0.4%;
- ❖ **Global manufacturing weakness** – we have started to see softness in global manufacturing data with the Australian data recording a reading of 43.4, the US recording 50.9 and the Chinese recording 50.7 in June. Any reading over 50 indicates that manufacturing is still expanding, while a reading below 50 indicates a contraction. Australian manufacturing is suffering at the hands of a stronger currency and is also reflective of the two speed economy;
- ❖ **Strong savings rates** – globally the consumer is still deleveraging and therefore saving more. This increased saving and consumer caution is impacting retailers and creating a slowdown in domestic economies. The silver lining of this approach is a far stronger consumer balance sheet and once consumer sentiment turns we would expect to see retail sales rebounding strongly;
- ❖ **Increasing inflation concerns** – both domestically and internationally inflation is causing central banks some concern however we are yet to see spiralling prices. This concern has placed central banks in a hawkish stance, however, should the global economy start slowing dramatically the inflation concerns will also dissipate. The Reserve Bank of Australia has indicated that it still believes the recent spike in inflation is being caused by the impacts of floods earlier in the year

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and they expect inflation to reduce over the rest of the year to levels that are within their targets;

- ❖ **Weakness in US unemployment** – US unemployment data for the month of July will be released tonight our time and the market is expecting this release to again show softness and potentially a lift in the unemployment number. The lack of employment growth in the US is a concern however they have been adding new jobs each month which is a positive start. In order for the US economy to gain significant traction we need to see a dramatic turnaround in the unemployment data.

The previous **Global Financial Crises (GFC)** was centred on **corporate concerns** and queries over balance sheet strength however *this time around the concern is focused squarely on government balance sheets and their ability to reduce debt loads*. We have been highlighting for some time that the austerity packages required will have a detrimental impact upon the local economies however the *corporate balance sheets, in general, are in a far stronger position with record levels of cash being held*.

The following chart provides an update on the progress of the US reporting season. To date approximately **67% of S&P500 companies have reported** and **approximately 43% of those have reported better than expected earnings** while only 14% have reported lower earnings.

Sector	F'cast	Actual	Diff	Diff	Number reported	Still to report	%	Earnings	
	\$USm	\$USm	\$USm	%				+ ve	-ve
Aerospace and Defense	4,894	5,141	248	5.1	11	0	100%	6	0
Auto	3,059	3,374	315	10.3	6	0	100%	4	0
Consumer Staples	16,171	16,288	117	0.7	17	8	68%	2	3
Healthcare	27,224	28,202	978	3.6	43	6	88%	14	5
Hotels, Restaurants and Leisure	2,407	2,600	193	8.0	9	0	100%	7	0
Industrials	12,224	12,575	351	2.9	37	5	88%	11	7
IT	27,477	31,598	4,121	15.0	47	7	87%	27	2
Materials	5,196	5,343	146	2.8	18	3	86%	4	1
Media	6,418	6,552	134	2.1	5	10	33%	3	1
Retail	1,719	1,805	86	5.0	10	5	67%	6	2
Telco	5,298	5,544	246	4.6	5	3	63%	2	1
Transport	3,548	3,819	271	7.6	8	1	89%	3	0
Utilities	6,524	6,696	173	2.6	14	19	42%	8	4
Marketex Financials, Resources	122,160	129,537	7,378	6.0	230	67	77%	97	26
Banks	6,644	7,226	582	8.8	14	0	100%	11	0
Diversified Financials	20,032	20,719	687	3.4	26	3	90%	10	2
Insurance	7,295	7,275	-20	-0.3	17	5	77%	5	5
REITs	854	1,036	182	21.3	10	3	77%	7	1
Financials	34,825	36,256	1,431	4.1	67	11	86%	33	8
Energy	35,372	35,187	-184	-0.5	30	11	73%	12	7
Metals and Mining	3,309	3,225	-83	-2.5	9	0	100%	2	6
Resources	38,681	38,413	-268	-0.7	39	11	78%	14	13
S&P500	195,665	204,206	8,541	4.4	336	89	79%	144	47

Note: Only stocks reporting a June quarterly result are included in this analysis.
Source: Capital IQ, Macquarie Research, August 2011

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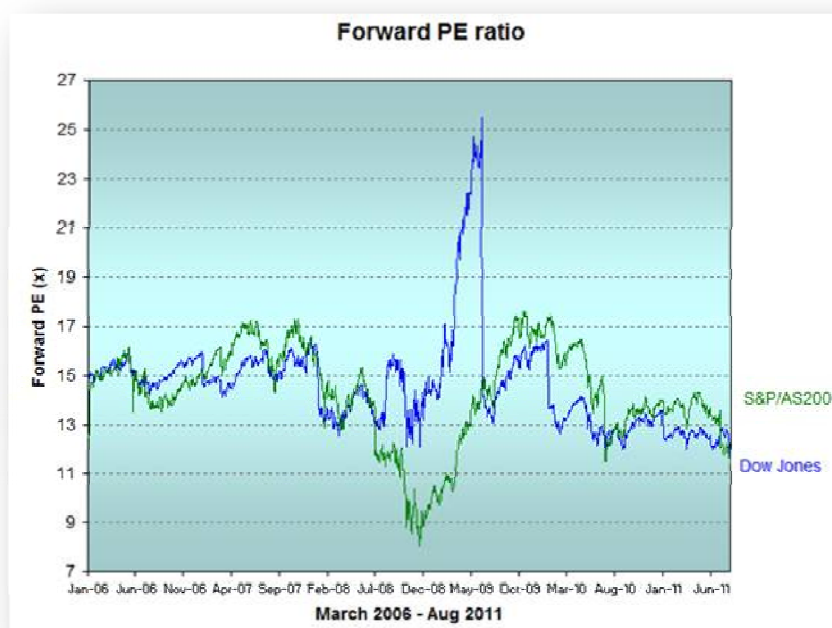
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At some stage this balance sheet strength will be deployed and as such it will stoke economic growth. To date, the problem has been that there is merely no incentive for corporations to deploy their cash. This position may now be changing as **overnight the US one month Treasury bill rates actually traded at a negative 0.0102%**. In other words, you paid the US Treasury to hold your money. The **Bank of New York Mellon**, the world's largest custody bank, also announced overnight that it would **start charging its clients for excessive cash holdings**.

These low rates, increased fees and action by central banks such as Japan and Switzerland to devalue their currencies could be the triggers that force corporates to seek better returns on lazy cash holdings. The **carry trade** - borrowing in low interest rate currencies and investing in high interest rate markets and commodities - **seems to also be unravelling**. **Commodity prices have started to taper off** which should allay inflation concerns and generally reduce costs, eventually leading to increased capital expenditure.

The following chart, sourced from Bloomberg, also shows that based on forward earnings our share market remains cheap and is priced at similar rates as it was during the GFC. The main difference, as mentioned above, is that corporates are in a far stronger position this time around.



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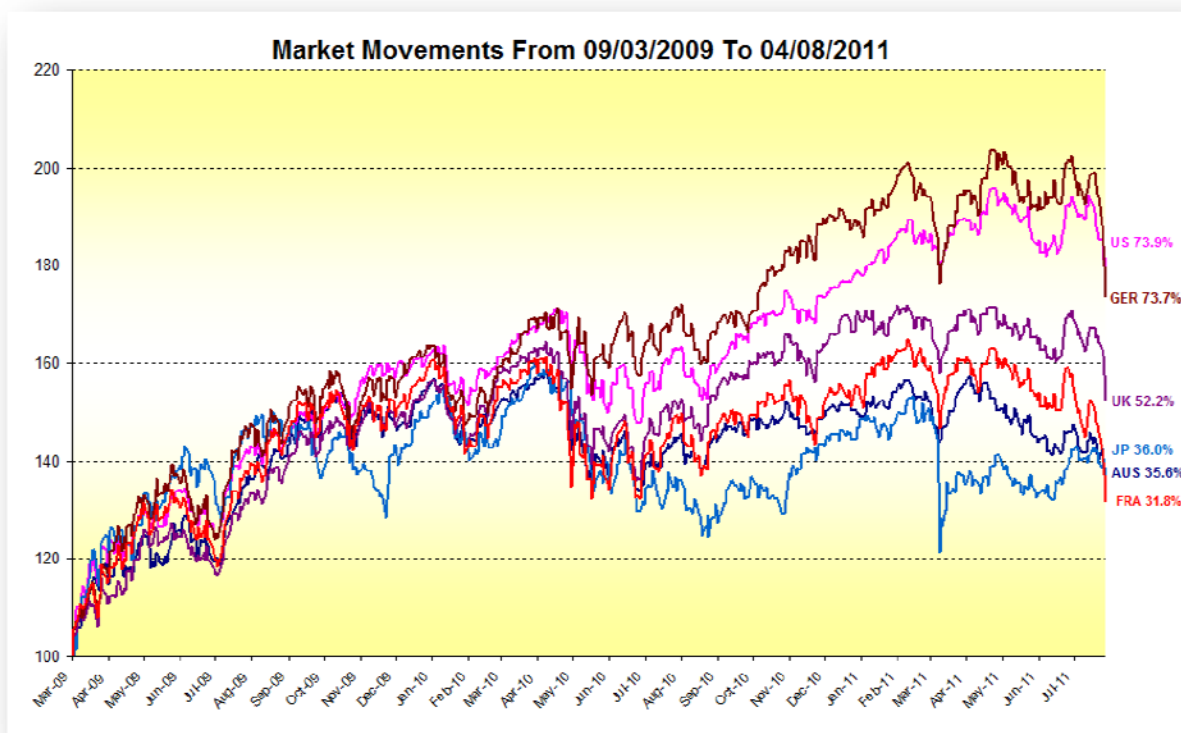
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Should the global economy *move into a new recession the impact will no doubt be felt in the equity markets* however at this stage **we continue to believe that such a recession will be avoided**. Global economies are slowing however **China appears to be managing a soft landing and inflation is abating**. The **US** is slowing however at the moment it is still managing a **long slow growth environment**.

Australia is facing its own challenges with a **booming resource sector, strong dollar** and a **consumer who is still deleveraging** however the Reserve Bank of Australia is by far in the strongest position to tackle any global slowdown. We are in a fortunate position where they **can cut interest rates dramatically in order to invigorate our economy** should it weaken in the future. Many of the data points that have concerned the markets this week have been short term in nature and as such we need to see more information before we can formulate a clear idea as to the degree of global economic softness. Unfortunately, the market tends not to wait for such clarity and pre-empts such confirmation. **At the moment the markets are in the process of pricing in the next global recession**.



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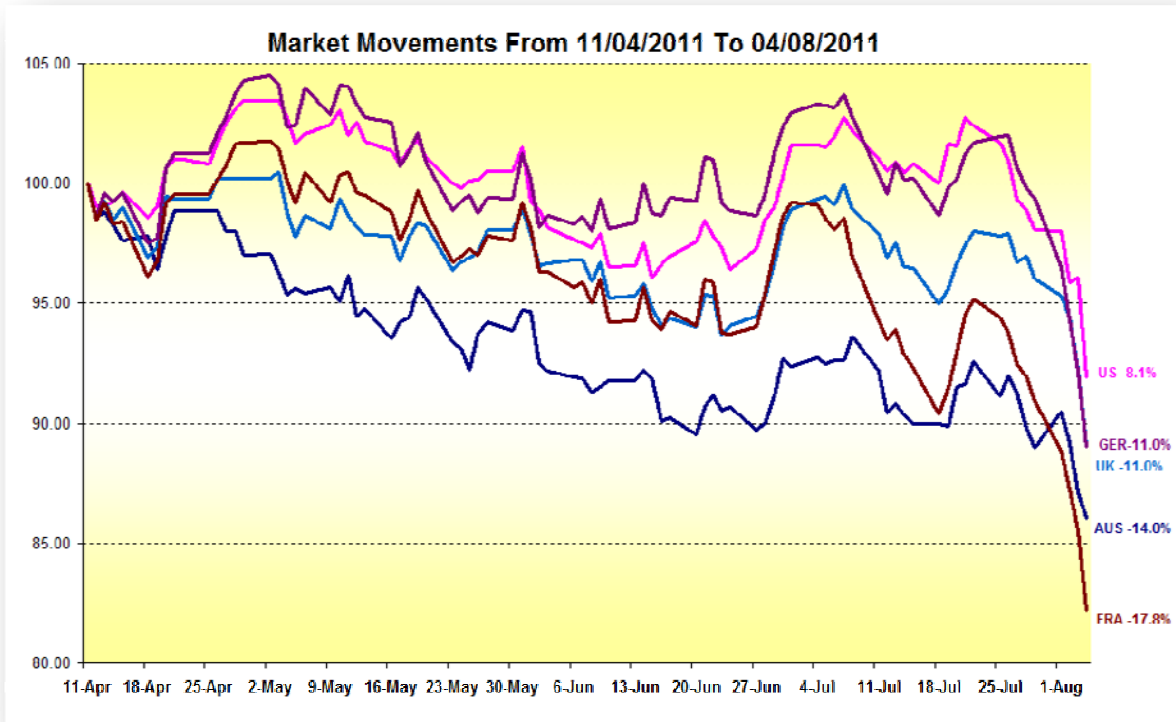
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The charts above show the performance of the markets from the low point in March 2009 and the respective market bounces. The second chart shows the moves from the recent high in April this year. As you can clearly see, the Australian market has significantly underperformed the US markets.

We have been cautious on the global outlook for some time and as such **have been recommending an overweight position in cash and Australian Fixed Interest** which we will continue to discuss with you in your portfolio reviews.

Should you wish to discuss any of these points please do not hesitate to contact me.

David Lane | Director | JR Wealth Management

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