



August was definitely a volatile month, dominated by macro events such as the US debt downgrade and further concerns about European sovereign debts. September has begun where August left off – with extreme volatility and daily reactions to macro-economic news.

During August, the **ASX200 Index fell 2.9%**, although the index moved across a **17.5% range** during the period. Although we recorded the 5<sup>th</sup> month in a row of negative closes, the ASX200 finished August **14% above the low**.

By comparison, the Australian market began to outperform other markets. In the US, the S&P500 closed 5.7% lower; the FTSE100 (UK) fell 7.2%; Nikkei (Japan) was down 8.9% and the German DAX fell 19.2% for the month.

#### AUSTRALIA

The August reporting season delivered solid **earnings growth of 19.9% for the Australian market**.

On the face of it, this seems a solid economy wide story however the bulk of the growth has been seen in the **Resource, Banking and REIT sectors** while the broader Industrials sector posted marginal growth. This earnings story is a reflection of the two speed (or multi-speed) economy.

Companies that delivered significant (+5%) underlying NPAT growth compared to consensus forecasts included **Telstra, Ansell, Woodside Petroleum, Qantas, Seven West Media, Downer EDI, Sims Metal, QR National and Suncorp**. Many companies, including **Amtcor, Seek, Mirvac, Flight Centre, Qantas, BHP Billiton, Ramsay Healthcare** and **Sims Metal** produced in excess of 20% NPAT growth over the year to 30 June.

Disappointments compared to consensus forecasts came from **Billabong, Primary Healthcare, Transfield Services, IOOF, Tatts Group, Lend Lease** and **Goodman Fielder**. However most of these reports – except for Primary Healthcare – were between 5-6% below forecasts.

On a sectoral basis, those sectors that reported earnings above market expectations were:

- ◆ Resources;
- ◆ Energy;
- ◆ Transport;
- ◆ Media; and
- ◆ Banks.

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Sectors that reported below expectations, or announced major downgrades, were:

- ◆ Steel;
- ◆ Building Materials;
- ◆ Discretionary Retailers;
- ◆ Food and Beverage; and
- ◆ General Insurers.

One of the positive signs to come from the recent reporting season was the generally healthy outlook for the 2012 financial year. Miners were **positive on the outlook for commodity prices and volumes**, with many **planning significant capital expansion**.

There were, however, many headwinds that impacted on results and outlooks. The **effect of the natural disasters** in the first quarter of 2011 weakened the Contractors, Food and Beverage companies, General Insurers and Building Materials. The Queensland floods also had a **negative impact on the volumes of mining companies**.

The health of Australian corporate balance sheets was also a positive feature. A number of major equity buy-backs were announced by companies such as **Ancor, Ansell, Charter Hall Retail, Crown, Fosters, News Corp, Pacific Brands, Perpetual** and **Stockland**. **Rio Tinto** increased the company's ongoing buy-back of the UK listed shares to **\$7 billion**.

The capital management initiatives reflect the large gap between equity yields and bond yields, making the purchase of a company's own equity an attractive proposition. Buy-backs support EPS, due to the cancellation of the shares purchased.

#### FORECAST EARNINGS GROWTH

	FY11	FY12
<b>Market</b>	19.9%	16.1%
<b>Resources</b>	43.9%	23.5%
<b>Industrials</b>	0.7%	12.2%
<b>Banks</b>	11.6%	9.5%

Source: Deutsche Bank

The **high Australian dollar** has impacted many elements of the economy, especially exporters and retailers and is partly to blame for the rising job losses being experienced. To date there have been **9,000 job losses across the country announced** however there have no doubt been many more that were simply not reflected in the media. The official unemployment figure has risen to **5.3%**.

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The **RBA has left interest rates on hold** for the past few meetings and we suspect that they will continue to hold this line through the end of the year barring any dramatic international events such as a sovereign default. A recent speech by Governor Stevens indicated that the Reserve Bank is *still focussed on inflation* and the large capex plans of the resource sector.

At the moment we are not experiencing demand pull inflation due to the increased savings rate and the higher incidence of offshore purchasing, however we are seeing **increased cost push inflation** spreading throughout the economy. The cost push inflation is spreading due to the higher commodity prices and increased wages emanating from the resource sectors. *At this point the RBA would be happy to see minor rises in the unemployment rate and as such will maintain its inflation focus, keeping rates on hold.*

There has been significant market speculation that interest rates will decrease in Australia with the forward interest rate curves indicating a fall of 1.00% - 1.25% over the next year. The yield on the 10 year government bonds has indeed been falling; however this appears to be a symptom of offshore buying rather than our debt markets indicating that a rate cut is needed due to economic softness.

At this point *our economy is not weak enough to justify interest rate cuts*, unless an external event triggers a global recession. Approximately 85% of all Australian government bonds on issue are owned by foreign investors and it is this increased demand for an AAA sovereign with a sound economy that has forced the yields lower. The Russian Central Bank has recently indicated that they intend to purchase Australian bonds on a monthly basis.

## UNITED STATES

Most market pundits place the chance of a recession in the US as anywhere between 30% and 100%, in other words no one has a clear idea. We believe, barring any external shock, that the US may avoid another recession. However growth will be subdued for an extended period.

There is a growing awareness in the US that the deficit situation needs to be dealt with, although there has been a distinct lack of consensus as to how to deal with it. Unfortunately, this is likely to continue until after the general election on November 6 next year. Each party will attempt to score points off the other and there will be a lack of economic guidance.

Federal Reserve Chairman, Ben Bernanke, advised last Friday at the Jackson Hole meeting that the **US economy was not yet in a position of requiring additional assistance**. He did say they were monitoring the situation closely and they had additional measures at their disposal to combat any economic softness. The speech also indicated that the Federal Reserve had fired its heavy weapons

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and that it was now over to the government to implement sound policies that would provide a lift to the economy.

The markets have been focused on the President's Labour Day speech. In the televised address, Barack Obama outlined a **US\$447 billion package** of spending and tax-cuts, designed to stimulate economic growth and generate jobs. The package was larger than the market had speculated, both in the overall size and in the severity of the tax cuts. The tax cuts were predominantly payroll tax, to encourage small business to begin hiring again.

The stimulus is approximately 3% of GDP, although approximately **\$400 billion is expected to reach the economy in 2012**. Early forecasts from economists are for **US GDP growth of around 2 – 2.5% in 2012**.

Given that the general election is to be held next year it is hard to see either party not forming some level of consensus on stimulating growth as neither wants the many millions of unemployed to vote against them.

On the positive side, US corporates are cashed up and have very strong balance sheets with significantly lower gearing levels. There have already been some significant mergers and acquisitions announced, and it is likely that there will be many more over the coming months.

## EUROPE

Obviously the **largest risk facing Europe is a sovereign default** and we believe that such a default is a foregone conclusion ... *it is merely a matter of who defaults and when*. The prime candidate at the moment is Greece and the yield of over 50% on the Greek 2 year government bonds indicates that the market believes it is likely to default within the next two years.

A Greek default will rattle the markets for a couple of weeks however it *should not have a long term impact due to the insignificance of their economy on a global scale*. The larger concern is the impact it would have on the banking sector and the flow on effect to other economies.

The hope is that any default will be implemented after European banks have recapitalised and other nations such as Italy and Spain have implemented their respective austerity packages. European banks have been reticent to increase their capital positions and the IMF has called for the immediate recapitalisation of European banks. We have recently seen the agreement to merge the number 2 and 3 banks in Greece. We will probably see further banking amalgamations and recapitalisation programs as central governments force the issue so that they can avoid any future bailouts.

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From a longer term perspective we are **likely to see at least one nation removed from the common European Currency Union (Euro)** either by choice or force, which may lead to the launch of European Bonds.

Another potential outcome – at the extreme – is the abandonment of the Euro as a central currency altogether.

The austerity measures and regional politics at play in Europe are **likely to force an extended period of low growth across the region**. While Europe in general is not an investment play that we are focused on there will be pockets that will provide solid growth opportunities. Many exporters in Germany have a growing share of their revenues emanating from the emerging global markets and the current low Euro values are a boon to their exporters.

## CHINA

China's economy has been slowing, however, it **is likely to achieve a soft landing rather than the hard landing that some economists are predicting**. Most economic indicators are pointing to a soft landing and expected **growth rate of approximately 9.00% per annum this year**. This level of growth will provide a floor below commodity prices and as such should provide a floor to our resource companies share prices.

**Inflation is a key risk** to China purely due to the social unrest that it can trigger. Soft commodity prices have been rising around the world and China is facing similar issues with the price of pork, the main protein intake, rising considerably. The rise in pork is primarily due to an increased cull brought on by disease that occurred earlier in the year. Supplies of pork have increased and the central government has implemented other subsidies and strategies aimed at reducing food costs. It now appears that inflation has peaked in China and barring any natural disasters it should start reducing over the balance of the year.

China remains on track for its **economic and infrastructure expansion** with increased focus now on social housing programs. The government is also now focusing on the growing middle class as more and more university students graduate and look for appropriate jobs. The new **5 Year Plan** has set a goal of restructuring the economy away from being a low cost factory to the world to now focussing on higher end products. As an example, *China is now the world leader in solar power generation and wind turbines* and is keen to move into other higher end technologies and production.

It appears that China's growth will continue for at least the next 5 years and as such the **commodity super cycle will remain intact**. **India** is also expanding and looks set to tack over the commodity demand once China slows its infrastructure spend.

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## AUSTRALIAN DOLLAR

Given the demand for commodities, weak developed world economies and low global interest rates the **AUD is likely to see increased demand and should hold between \$1.00 and \$1.10** against the USD for the foreseeable future. Foreign central banks have been diversifying their foreign reserve holdings away from the US and Europe into currencies like the AUD and the Swiss Franc.

Such demand will continue the strain being placed on certain elements of the Australian economy and as such any investments need to be considered carefully in this context. The high AUD provides *a sound platform to instigate offshore investments* however we need further clarity on developed economies before implementing investments in these areas. The ***preferred offshore investments are equities and bonds in the emerging markets.***

## GOLD

The rise of the gold price has been spectacular and many are now questioning how far gold can go from these levels. Global inaction by governments is feeding fear and the threat of rising inflation brought on by incredibly low interest rates should provide some level of support. Gold is a very **speculative** play at present and the **volatility in price movements has increased in recent months.** However, while the global uncertainty continues, **gold will remain a hedge against this fear.**

## RUGBY

One final prediction – **Australia to win the Rugby World Cup 2011!**

Should you wish to discuss any of these points, or how the macro environment may impact on your personal circumstances, please do not hesitate to contact me.

Regards



**David Lane | Director | JR Wealth Management**

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