

Quarterly Review & Outlook

OCTOBER 2011

Sense of déjà vu?

Yes we started our last Quarterly Review with the same heading and unfortunately it is still just as relevant today.

Thankfully, the US avoided default during the quarter as their politicians agreed to increase the debt ceiling. This was overshadowed however by Standard and Poor's downgrading the US from AAA to AA+. The downgrade was triggered by the lack of guidance and planning on future debt reduction.

The US Congress established a bipartisan committee to identify a further US\$1.2 trillion in budget cuts. The committee must reach agreement by 23 November 2011 and have the cuts enacted by the end of December 2011 or face automatic spending cuts in 2013.

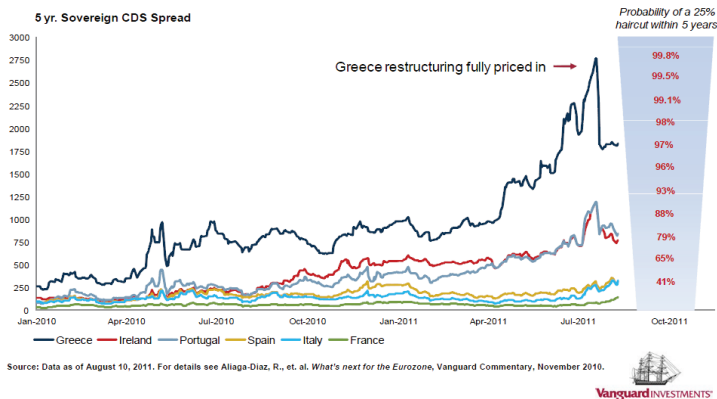
The risk of a European sovereign default continues to roil global markets as sentiment drives investment decisions. The fear, at present, is that any default will trigger another liquidity squeeze similar to the Lehman's event that triggered the Global Financial Crisis.

Any significant default will have an immediate impact on European banks as they are the largest holders (outside of the European Central Bank) of sovereign debt. Default would trigger an urgent need to recapitalise the banks and therefore a reduction in the amount of capital available to the broader economy.

Chart 1 provides the current market estimates of the chances of a default by some of the European nations, with Greece leading the pack at 97%. It seems a foregone conclusion that Greece will default, it is just a matter of timing.

The ultimate risk of a European default is another global recession, however this time with no government bailouts.

Chart 1: Probability of a 25% default within 5 years



Global pressure is mounting on the Europeans to take decisive action and non-European governments are demanding a solution be put in place by the next G20 meeting in Cannes on 3-4 November 2011.

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Spain has announced that it has consolidated its savings banks from 45 to 15 and has spent €4.75 billion nationalising the banking operations of its three largest savings banks. Another two savings banks have been given a further 25 days to find additional capital or face the prospect of being nationalised. Such measures are a positive for the banking sector in general and should provide a degree of comfort should there be a sovereign default.

Global Recession

Markets seem to be pricing in a global recession. Global growth has indeed slowed and forecasts for future growth continue to be scaled back as outlined in Table 1, however a global recession is not inevitable.

Table 1: September 2011 IMF World Economic Outlook Projections

	Year over Year					
			Projections		Difference from June 2011 WEO Projections	
	2009	2010	2011	2012	2011	2012
World Output¹	-0.7	5.1	4.0	4.0	-0.3	-0.5
Advanced Economies	-3.7	3.1	1.6	1.9	-0.6	-0.7
United States	-3.5	3.0	1.5	1.8	-1.0	-0.9
Euro Area	-4.3	1.8	1.6	1.1	-0.4	-0.6
Germany	-5.1	3.6	2.7	1.3	-0.5	-0.7
France	-2.6	1.4	1.7	1.4	-0.4	-0.5
Italy	-5.2	1.3	0.6	0.3	-0.4	-1.0
Spain	-3.7	-0.1	0.8	1.1	0.0	-0.5
Japan	-6.3	4.0	-0.5	2.3	0.2	-0.6
United Kingdom	-4.9	1.4	1.1	1.6	-0.4	-0.7
Canada	-2.8	3.2	2.1	1.9	-0.8	-0.7
Other Advanced Economies ²	-1.1	5.8	3.6	3.7	-0.4	-0.1
Newly Industrialized Asian Economies	-0.7	8.4	4.7	4.5	-0.4	0.0
Emerging and Developing Economies³	2.8	7.3	6.4	6.1	-0.2	-0.3
Central and Eastern Europe	-3.6	4.5	4.3	2.7	-1.0	-0.5
Commonwealth of Independent States	-6.4	4.6	4.6	4.4	-0.5	-0.3
Russia	-7.8	4.0	4.3	4.1	-0.5	-0.4
Excluding Russia	-3.0	6.0	5.3	5.1	-0.3	0.0
Developing Asia	7.2	9.5	8.2	8.0	-0.2	-0.4
China	9.2	10.3	9.5	9.0	-0.1	-0.5
India	6.8	10.1	7.8	7.5	-0.4	-0.3
ASEAN-5 ⁴	1.7	6.9	5.3	5.6	-0.1	-0.1
Latin America and the Caribbean	-1.7	6.1	4.5	4.0	-0.1	-0.1
Brazil	-0.6	7.5	3.8	3.6	-0.3	0.0
Mexico	-6.2	5.4	3.8	3.6	-0.9	-0.4
Middle East and North Africa	2.6	4.4	4.0	3.6	-0.2	-0.8
Sub-Saharan Africa	2.8	5.4	5.2	5.8	-0.3	-0.1
<i>Memorandum</i>						
European Union	-4.2	1.8	1.7	1.4	-0.3	-0.7
World Growth Based on Market Exchange Rates	-2.3	4.0	3.0	3.2	-0.4	-0.5

Growth in the emerging and developing economies is still expected to be robust from which Australia should benefit. The possibility of a recession in the US is still 50/50 depending on which economic data you consider, however, the chances of a recession in Europe are growing daily. Europe is likely to face a recession thanks to the extreme austerity measures that are being implemented. It is hard to envisage strong growth when governments are scaling back spending dramatically.

US Job Creation Package

On 8 September US President Obama outlined a US\$450 billion packaged aimed at creating new jobs. The "American Jobs Act" included employer incentives, new infrastructure spending and tax cuts all aimed at reducing the level of unemployment in the US. This act has been put to the US Congress for a vote later this month, though it appears that the Act is doomed in its current form, as Washington is too divided to take any significant steps before the 2012 congressional and presidential elections. This political environment is likely to result in market volatility for an extended period.

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Dutch Disease in Australia

Dutch Disease occurs when a commodity boom underpins an appreciation of the exchange rate that squeezes both the import-competing sector and the export industry. The phenomenon arose from the gas boom in the Netherlands in the 1970s and 1980s.

The Australian economy has certainly been feeling the impact of this 'disease' over the last six months as we have seen the Australian dollar climb to \$1.10 against the US dollar.

The higher exchange rate saw the Dutch manufacturing sector shrink by 18% and the lost output was never regained. Australian manufacturing is yet to fall to the same levels however we have seen highly publicised steel closures and numerous jobs lost. The AIG Performance of Manufacturing Index continues to slide showing that manufacturing remains in a contractionary environment.

Foreign Currency

With the risk aversion high and concerns about global growth there has been a wave of Australian dollar selling. As at the end of the quarter the AUD had fallen to \$0.96 against the USD and subsequent to this it has fallen to below \$0.95. We have been recommending an unhedged position for global equities for an extended period on the basis that the AUD could fall quickly.

While there remains uncertainty about a sovereign default we continue to recommend maintaining the unhedged positions.

Table 2: Currency movement as at 30 September 2011

Foreign Exchange Rates	Level	Quarterly	Yearly
AUD/USD	0.9664	-9.84%	-0.09%
AUD/EUR	0.7216	-2.39%	1.72%
AUD/JPY	74.4235	-13.82%	-7.86%
AUD/GBP	0.6200	-7.14%	0.76%

Source: IRESS Market Technology, Bloomberg

Commodities

Over the quarter all commodities (except Gold) fell and most managed to wipe out any residual yearly gains as can be seen in Table 3. The dramatic falls were the result of the overall 'risk off' trades emanating from the fear of a sovereign default.

Table 3: Commodity prices as at 30 September 2011

Commodities	Level	Quarterly	Yearly
Gold - Spot (\$US/oz)	1,624	8.25%	24.14%
Oil - WTI Spot (\$US/bbl)	79	-17.41%	-1.55%
Copper - Grade A	7,132	-23.33%	-11.45%
CRB Index	298	-11.80%	3.94%
Aluminium - High Grade	2,207.00	-12.04%	-4.62%
Lead	2,060.50	-21.43%	-8.91%
Nickel	18,305.00	-20.84%	-21.74%
Tin	20,850.00	-19.50%	-15.42%
Zinc	1,905.00	-17.71%	-12.45%
Cotton	112.65	-17.38%	-0.68%
Wool	1,193.00	-15.33%	36.34%
Wheat (Futures)	6.09	-0.81%	-9.61%

Source: IRESS Market Technology, Bloomberg

The supply/demand fundamentals are still in place for most commodities and as such we should see a return to price strength, however, this is predicated on the world not slipping into another recession.

The continued strength of China (expected GDP growth rate next year of 9.0%) will see demand continue to outstrip supply. For those brave enough to withstand the volatility and with a long enough time horizon, the current equity prices allow strategic buying of household resource names.

Australian Equities

As was the case with commodities, all sectors (except Telecommunications) fell dramatically over the past quarter as outlined in Table 4.

Table 4: Australian equity sector returns as at 30 September 2011

Industry Groups	Quarterly	Yearly
Banks	-11.32%	-13.18%
Capital goods	-17.22%	-26.92%
Commercial Services & Supplies	-14.93%	-12.60%
Consumer Durables & Apparel	-37.26%	-49.45%
Diversified Financials	-17.58%	-24.74%
Energy	-17.27%	-16.75%
Food & Staples Retailing	-5.21%	-8.52%
Food Beverage & Tobacco	-0.64%	-1.38%
Health Care Equipment & Services	-11.82%	-5.69%
Hotels Restaurants & Leisure	-12.24%	-11.55%
Insurance	-16.79%	-18.23%
Materials	-19.30%	-12.79%
Media	-12.33%	-21.33%
Pharmaceuticals & Biotechnology	-10.53%	-9.83%
Real Estate	-10.46%	-11.67%
Retailing	-17.22%	-38.12%
Software & Services	-13.99%	-19.37%
Telecommunication Services	7.07%	17.51%
Transportation	-5.65%	-10.98%
Utilities	-2.74%	-4.61%

Source: IRESS Market Technology, Bloomberg

The reluctance of the consumer to spend has encouraged the selling of consumer stocks and the durables sector fell 37.26% over the quarter.

The defensive sectors of food, telecommunications and utilities all held up reasonably well while the growth orientated sectors were sold off indiscriminately.

The Australian reporting season has finished without too many surprises. Chart 2 shows that weakness was evident in the consumer orientated and manufacturing sectors however banks, property trusts and resource companies showed continued strength.

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Chart 2: Australian reporting season to 30 September 2011

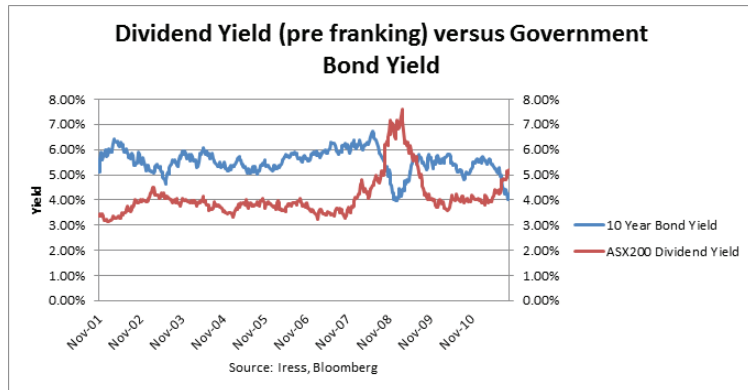
SUMMARY OF REPORTING SEASON TO DATE						
AGGREGATE NET PROFIT COMPARED TO GS&PA EXPECTATIONS AND PCP						
Market Segment	Actual Net Profit \$M	GS&PA Expectation \$M	% Diff. b/w Act. & Expect.	No of Cos. reported	PCP \$M	% Increase on PCP
Total	71,782	72,065	-0.4%	145	62,514	13.2%
Industrials	36,828	36,139	1.9%	116	35,578	0.7%
Industrials ex Prop. Tr.	32,009	31,389	2.0%	97	32,306	-0.9%
Total Ind ex Financials	22,637	22,297	1.5%	90	23,998	-5.7%
Total Ind ex Financials, TLS	19,393	19,167	1.2%	89	20,113	-3.6%
Large Ind ex Financials	19,469	19,086	2.0%	35	20,888	-6.8%
Large Ind ex Financials, NWS	16,676	16,481	1.2%	34	17,843	-6.5%
Smaller Ind ex Financials	3,169	3,211	-1.3%	55	3,110	1.9%
Banks	7,129	7,053	1.1%	2	6,355	12.2%
Property Trusts	4,818	4,750	1.4%	19	3,272	16.4%
Resources	34,954	35,926	-2.7%	29	26,936	29.8%
Resources ex BHP, RIO	7,464	7,545	-1.1%	27	5,529	35.0%

Source: Company data, GS&PA Research estimates

Chart 3 indicates that Australian shares are once again offering dividend yields in excess of the 10 Year Government Bond yields as they were during the Global Financial Crisis. This is generally a very good indicator that Australian equities are cheap.

The same situation is evident in US equities however the critical point of difference is that the US bonds yields are being artificially reduced by the US Federal Reserve.

Chart 3: Australian dividend yield vs 10 year government bonds



International Equities

Table 5 shows that the equity sell down has indeed been global.

Table 5: Global equity index returns as at 30 September 2011

International Indexes	Level	Quarterly	Yearly
MSCI World ex-Australia Index (Hedged)	775	-15.33%	-6.77%
MSCI World ex-Australia Index (Unhedged)	3,147	-7.99%	-4.52%
DOW JONES	10,913	-12.09%	1.16%
S&P 500	1,131	-14.33%	-0.86%
NASDAQ	2,415	-12.91%	1.97%
JAPANESE NIKKEI	8,700	-11.37%	-7.14%
UK FTSE100	5,128	-13.74%	-7.57%
GERMAN DAX	5,502	-25.41%	-11.67%
FRENCH CAC40	2,982	-25.12%	-19.74%
HONG KONG HANG SENG	17,592	-21.46%	-21.32%
SHANGHAI COMPOSITE INDEX	2,359	-14.59%	-11.16%
KOREAN COMPOSITE	1,770	-15.76%	-5.51%
NEW ZEALAND ALL INDEX	754	-3.41%	2.67%
BOMBAY SENSITIVE 30	16,454	-12.69%	-18.01%

Source: IRESS Market Technology, Bloomberg

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With the market already pricing in a global recession we could actually see the possibility of a market rally towards the end of the year if the world can garner some comfort that the Europeans will act decisively.

As we write there are still three European countries that still need to ratify the increase in the European Financial Stability Facility (bailout fund) – Malta, Netherlands and Slovakia. Slovakia are due to vote on 17 October 2011.

Slovakia have declared that they will reject the proposal. All market participants will be watching this vote closely to see how much pressure the rest of the Euro area will bring to bear.

Real Estate Investment Trusts

As mentioned previously, the Australian listed property sector (AREIT) performed relatively strongly over the quarter having increased earnings by 16.4%. Unfortunately, the market still has a perception that the sector has not changed since the Global Financial Crisis.

We believe that the sector is offering good yields on attractive net tangible asset discounts. Most players in the sector have recapitalised their balance sheets and are enjoying low vacancy rates.

International trusts continue, however, to be overvalued.

Bonds

The Australian bond market is pricing in interest rate cuts of up to 1.25% by the end of 2012. We continue to believe that this is overly optimistic and is more likely to be a symptom of foreign nationals seeking out our sovereign debt due to our high credit ratings and rates on offer.

Cash and Term Deposits

The Financial Claims Scheme (the Commonwealth Government guarantee scheme previously up to \$1 million per bank) has been amended. The new cap to be introduced from 1 February 2012 is \$250,000 per person per financial institution. Existing term deposits continue to be covered at the current level until 31 December 2012, or until the deposit matures, whichever occurs sooner.

The Reserve Bank of Australia (RBA) left rates on hold at its September meeting and is likely to do so for the rest of the year. The RBA has noted the global concerns but it also remains worried about inflationary pressures here in Australia. The next release of the inflation numbers in late October will provide clarity as to the next likely move by the RBA.