

## Investment Market &amp; Portfolio Update 30 June 2010

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**Where are we now?****Market movements over the 2009/2010 financial year**

| Market indicator               | Level at 30 June 2009 | Level at 28 April 2010 | Level at 30 June 2010 | Movement over the course of the financial year |
|--------------------------------|-----------------------|------------------------|-----------------------|--|
| S&P ASX 200                    | 3955                  | 4822                   | 4301                  | +9%  |
| Industrials 200                | 5330                  | 6604                   | 5824                  | +9%  |
| Resources 200                  | 4492                  | 5277                   | 4836                  | +8%  |
| AREIT 200                      | 747                   | 883                    | 843                   | +13%   |
| USA: S&P 500                   | 919                   | 1191                   | 1030                  | +12%   |
| UK: FTSE 100                   | 4249                  | 5586                   | 4916                  | +16%   |
| Germany: DAX                   | 4809                  | 6084                   | 5965                  | +24%   |
| Japan: Nikkei 225              | 9958                  | 10924                  | 9382                  | -6%  |
| China: Hang Seng               | 18378                 | 20949                  | 20129                 | +10%   |
| USD/AUD                        | 0.8130                | 0.9209                 | 0.8533                | +5%  |
| YEN/AUD                        | 78.01                 | 86.31                  | 75.71                 | -3%  |
| EUR/AUD                        | 0.5757                | 0.6978                 | 0.6944                | +21%   |
| Aus: 90 day bank bill          | 3.19                  | 4.62                   | 4.87                  | +1.68  |
| Aus: 10 year govt bond         | 5.52                  | 5.72                   | 5.09                  | -0.43  |
| US: Federal Reserve funds rate | 0.31                  | 0.21                   | 0.04                  | -0.27  |
| US: 10 year govt bond          | 3.53                  | 3.76                   | 2.93                  | -0.60  |
| Gold USD/ounce                 | 927                   | 1165                   | 1256                  | +35%   |
| Oil USD/barrel (WTI)           | 70                    | 83                     | 76                    | +9%  |

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|                           |     |      |     |      |
|---------------------------|-----|------|-----|------|
| Copper US cents per lb    | 225 | 333  | 293 | +30% |
| Nickel US cents per lb    | 694 | 1160 | 892 | +29% |
| Aluminium US cents per lb | 72  | 98   | 88  | +22% |

## ❖ Over the last month:

- The Australian share market, as measured by the ASX 200 index, has moved slightly lower, with Resources showing gains (notwithstanding the prospect of 'a great big new tax'), while Industrials lost ground and more than offset those gains.
- The US, British and Japanese share markets are down significantly, while the German and Chinese markets were stronger.
- The Australian dollar has moved higher against the US, the Yen and the Euro and is now at an historically high level versus the Euro.
- Australian short interest rates are up but long bond rates have fallen reflecting a change in sentiment worldwide about the prospect of inflation versus deflation.
- More importantly, US long bond rates are down significantly, reflecting more than the flight to US Treasuries as a safe haven. Deflation is being factored in as a real possibility.
- Short term interest rates remain as low as they can go in most developed countries. The world's major central banks have no more ability to add further stimulus through interest rate cuts. If there is a relapse into recession they will have to resort to extraordinary measures like printing a lot of money in order to provide stimulus. Even this may not work unless banks and consumers want to resume lending and borrowing at a greater pace. Over the last two years the US Federal Reserve injected \$US 1 trillion into the US banking system, but over the last 12 months bank loan volumes have fallen \$US200 billion.
- In recent days the US Consumer Confidence index for June was published showing a fall of 16% over the course of the last month.
- Commodity price movements were mixed with oil and copper up but aluminium and nickel down. This reflects the degree of confusion in markets about the likely path of inflation versus deflation as well as the rate of real GDP growth worldwide.
- There has been a potential slowdown in China and a more likely renewed slowdown in the US and Europe. Meanwhile Gold continued to rise in price reflecting the rising tide of anxiety everywhere.
- In summary, the belief in a synchronised global recovery, that was widespread in the middle of April, has now disappeared.

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- ❖ Since the most recent peak in April, the fall in global share markets has been significant, erasing much of the gain accumulated over the course of the financial year just ended. The Australian ASX 200 index is down 14% from the level of 5001 reached on 15 April 2010. The retreat from risky assets has also significantly weakened the Australian dollar against the US dollar and the Yen (but not the Euro which has had its own particular problems during the sovereign debt crisis that flared up in May in Europe). The flight from risk has also pushed metal commodity prices down by around 20% and the gold price up to a record level of \$US1256.

Looking at the movements over the whole of the financial year just ended:

- The recovery in equity markets has faded towards the end to become a fairly modest one in most markets local currency terms except for Germany.
  - The significant rise in the AUD versus the Euro (+22%) reduces the gains in German shares to +2% in AUD terms. This is a reminder that there are times when hedging international investment matters a lot.
  - Long term interest rates are lower especially in the US, reflecting the re-emergence of concerns about deflation already noted as well as a shift by investors worldwide into US Treasury bonds as a safe haven
  - Commodities are still generally stronger even after some recent falls, with Gold consistently strong
- 
- ❖ Commentary on the major economies
    - USA. The recent signs of stronger recovery in economic growth have petered out with concerns rising about weaker than expected jobs growth and housing starts. Comments from the Federal Reserve highlighting the link between the US economy and those of Europe where renewed fiscal austerity threaten to push it back into recession. Meanwhile the threat of a double dip recession in 2011 induced by a new wave of mortgage defaults remains. As we commented last month the high level of the US Federal deficit makes it more difficult for the Obama administration to contemplate another major fiscal stimulus, especially given its more tenuous support base in the US Senate. Moreover it would be difficult for the Federal Government to mount a rescue mission for any of the several large states which are now have their finances in a very difficult position due to constitutional limits on taxes and budget deficits. In the absence of Federal assistance, this implies further cuts in public services and an overall fall in demand in the US economy. The rest of the world will not escape the effects if (or when) this happens.
    - Japan. While there is a continued risk of deflation and it is likely that profit growth will moderate over the next few years, there is some prospect that the recently installed latest Prime Minister, who was a strong finance minister, may actually do something that his four predecessors in the last five years have

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not been able to achieve. The new government will be worth watching for any signs that Japan has reached the bottom of its protracted economic stagnation.

- Europe. The fiscal austerity that we said was needed to bring government deficits and debt under control and threatened slowdown throughout Europe has started and threatens to move Europe back into recession, acting as a major drag on the world economy. Major fiscal restraint packages have already been introduced in Germany, Britain, Italy and Spain. More action is likely in these major economies as well as elsewhere in Europe.
- China. As we commented last month, there is a risk of a slowdown in steel production and manufacturing in the light of a slowdown in the EU, which is now China's biggest export market. This will be exacerbated to some degree by the recent Chinese policy shift to allow an increase in Yuan exchange rate, albeit a tightly controlled one.
- Australia. Following a series of interest rate rises, the RBA has now acknowledged that there is some cause for concern from a potential slowdown in Europe as well as in the US and China. Politics has started to dominate the news with the apparently sudden demise of Prime Minister Rudd's career and the rise of his successor. The shock and awe professed by the media and political pundits (whose job it is to pick these vents in advance) reminds us that politicians are just like everyone else in the world. Fickle. The speed with which the opinion polls (and the ALP) shifted against Rudd merely mimics the shifts in sentiment in financial markets over the last three years. In each case we are witnessing the behaviour en masse of a crowd of people who are alternately frightened (of losing money, losing office, being swamped by asylum seekers, paying more taxes etc) or greedy (for capital gains, higher office or more handouts). Meanwhile consumer confidence is starting to wane and it is usual that the onset of elections weakens it further.
- The G20. This is now the dominant discussion group for the world's leaders. It met on the last weekend in June and put out a statement of its collective views on a range of matters including the continuation or withdrawal of economic stimulus. Among the 48 points in its communiqué, the G20 endorsed the goal of cutting government deficits in half by 2013 and stabilising the ratio of public debt to GDP by 2016. These targets were proposed by Canada and supported by Germany and Britain. The USA argued for more flexibility and the targets were expressed as a guideline rather than a deadline. Nonetheless the pressure is for a worldwide cut back in government stimulus, if only to keep the bond markets happy. Writing in the New York Times, the next day, Paul Krugman, winner of the Nobel Prize for Economics in 2008, heavily criticised the G20. He said that he "fears we are in the early stages of depression" which will be "primarily a failure of policy". He found the G20 meeting "deeply discouraging" with governments "obsessing about inflation when the real threat is deflation" and "pressing the need for belt tightening when the real problem is inadequate spending". We tend to agree with Krugman, even though he is a Nobel Prize winner (remember that the now defunct Long

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Term Capital Management had the benefit of not one but two Nobel laureates on its board). Krugman thinks that both the US and Europe are “well on the way to Japan style deflationary traps”. Meanwhile the leading commentator martin Wolf said in his Financial Times column that “concerted austerity might destroy the recovery”

## ❖ Inflation versus deflation

Last month we discussed the prospects for inflation versus deflation. We said that the only real solution probably consists of reduced public spending worldwide together with some mild inflation of 3% p.a. to 5% p.a. to help bolster tax revenues and reduce the real value of sovereign (and everyone else’s) debts. But we also said that if the banks and consumers stay in their shells there may not have enough inflation to go round. We still think that the most likely scenario seems to be one of slow growth (of 0 % to 2% p.a. in the developed countries and 3% p.a. to 5% p.a. in developing or emerging countries) together with moderate inflation of 3% p.a. to 5% p.a. Alternative scenarios include a significant risk of a lapse into deflation and prolonged recession or even depression, with a lesser risk of a leap into higher inflation beyond 5% p.a. and slow real growth. Over the course of the last month the likelihood of the recession/deflation scenario has increased significantly. In the most likely scenario equities and property should offer the best returns. In the long recession / depression scenario, cash and eventually some fixed interest should fare best. In the higher inflation scenario cash will be king.

It is worth commenting separately on the possible use of gold in portfolios, in the context of inflationary versus deflationary expectations. Gold should be viewed as an alternative (if somewhat archaic) form of money or currency rather than as a commodity with any real world use (apart from jewellery and dentistry). Gold rises in price relative to paper money (such as the US Dollar) when people lose faith in the purchasing power of the paper money, either due to the risk of outright default or that of default by stealth if inflation gets out of control. The key point is that if inflation remains reasonably under control and predictable then financial contracts including financial investments can take this into account and prices adjust accordingly. It is only if inflation becomes very high and unpredictable that holding gold starts to make a lot of sense. Moreover, if there is a prospect of deflation, holding gold makes even less sense. So the decision to hold gold in a portfolio depends on the view taken on inflation versus deflation and the likely unpredictability of inflation. On balance we think that inflation will be low and predictable over the next ten years.

## ❖ The debt markets

The flight into high quality sovereign bonds issued by the USA and Germany has continued. The size of possible capital losses if yields rise is now greater than before, but the prospect of such losses is now lower in the next 12 months. We think that it is still not the time to go long in high grade fixed interest. Meanwhile the lower grade

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issuers among the governments of the world as well as corporates are not yet offering enough premiums to compensate for concerns about default.

## ❖ Foreign exchange markets

The flight from risky markets has boosted the US dollar, driven the Euro to new lows and savagely reduced the Australian dollar against the USD and the Yen (although at the time of writing it appeared to be stabilising under the influence of RBA buying).

## ❖ The equity markets: Current stock market valuations

The recent falls in most stock markets have clearly reduced the overpricing of the expensive markets (except for India) and made the cheaper ones even more attractive from a longer term perspective.

| Country          | Ratio of current market value to long term fair value | Required long term return from stocks if priced at fair value |
|------------------|---|---|
|                  | %   | % p.a.  |
| <b>USA</b>       | <b>88%</b>  | <b>8.94%</b>  |
| <b>Japan</b>     | <b>89%</b>  | <b>6.46%</b>  |
| <b>Britain</b>   | <b>66%</b>  | <b>9.24%</b>  |
| <b>Germany</b>   | <b>59%</b>  | <b>8.19%</b>  |
| <b>Australia</b> | <b>109%</b>   | <b>10.43%</b>   |
| <b>Brazil</b>    | <b>159%</b>   | <b>15.39%</b>   |
| <b>Russia</b>    | <b>104%</b>   | <b>14.91%</b>   |
| <b>India</b>     | <b>291%</b>   | <b>17.71%</b>   |
| <b>China</b>     | <b>80%</b>  | <b>11.67%</b>   |

These assessments have been based on current earnings per share and PE ratios as well as moderate assumptions for growth in earnings per share over the next ten years. It is important to note the divergence on opinions on earnings per share growth rate over the next few years- particularly in relation the largest share market –the US. On the one hand the analysts at the major US broking houses and investment banks are forecasting growth in 2011 for the earnings per share of companies in the S&P 500 index of more than 12%. On the other hand Andrew Smithers, head of Smithers & Co, an independent firm of analysts with a very credible

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track record, is forecasting a 20% fall in the same variable. It would be fair to say that there is more than the usual degree of uncertainty in the short to medium term outlook for share prices.

#### What may happen next? - possible scenarios

- ❖ Given the extreme level of volatility in both the equity and fixed interest markets it is worthwhile considering a number of scenarios of what may happen over the next one to three years. It is important to recognise that we need to use scenarios because even our best assessments are so uncertain and there is a significant likelihood that our recommended portfolio strategies will turn out to be wrong if left unchanged in the face of market developments.
- ❖ Base case (40% probability)
  - The USA avoids a return to recession but Japan continues in recession well into late 2010 and Europe re-enters recession in 2011.
  - Inflation in developed countries picks up into the 3% p.a. to 5% p.a. range from 2011 onwards but does not get out of control.
  - Australian cash and short term interest rates increase modestly over the course of 2010 (with the RBA cash rate rising to about 4.75% p.a. by the end of 2010).
  - Bond yields up by between +0.25% p.a. and +0.50% p.a. over the course of the rest of 2010 and up between +0.5% p.a. and +1.5% p.a. by the end of 2011.
  - Commercial property values do not recover their 2007 values till 2012 or later.
  - Earnings per share for the ASX 200 grow moderately over the next 5 years with the exception of the major miners which achieve more rapid growth in the next two years and beyond.
  - ASX and US stock markets recover their 2007 high by mid to late 2012. The markets are prone to further falls of 10% to 15% during the course of 2010.
  - The Australian dollar continues to swing in a wider than normal range of between USD0.75 and USD 0.95, adding more short term volatility to returns on international assets.
- ❖ Upside case (10% probability-previously 15%)
  - Worldwide growth stronger than expected due to consumers and businesses recovering in confidence as governments generally handle the gradual withdrawal of the stimulus exceptionally well. US unemployment drops below 9% in 2010, Europe avoids a relapse into recession, Japan recovers more quickly and Chinese growth slows only minimally.
  - Inflation in developed countries picks up into the 3% p.a. to 5% p.a. range from 2011 onwards but does not get out of control, even though it is at the higher end of the range most of the time.
  - Australian cash and short term interest rates increase more significantly over the course of 2010 and 2011 to combat re-emerging inflation risk.

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- Bond yields up by +0.5% p.a. to +1.0% p.a. in 2010 and by up to +3.0% p.a. by the end of 2011.
  - Commercial property values recover their 2007 values by late 2011.
  - Earnings per share growth for the ASX 200 are faster than expected over the next 5 years.
  - ASX and US stock markets recover their 2007 high by mid to late 2011.
  - The Australian dollar continues to swing in a wider than normal range, adding more short term volatility to returns on international assets.
- ❖ Downside case (35% probability-previously 30% )
- Recession re-emerges in the USA and Europe and proves to be a worldwide double dip event and lasts till 2012 or later, threatening a recession in Australia.
  - Inflation is contained by recession and slips into deflation for up to 5 years, ranging between -2% p.a. and +1% p.a.
  - Australian cash and short term interest rates down by 1.0% from current levels over 2010 and by further 1.0% p.a. into 2011 and 2012 as the world moves into recession and the RBA cuts rates to stimulate the economy.
  - Bond yields down by 0.5% p.a. by the end of 2009 and a further 1.0% p.a. in 2010.
  - Commercial property values recover their 2007 level in 2016 or later.
  - Earnings per share growth for the ASX 200 is negative in 2011 and slower by 1% to 2% p.a. for the next 5 years.
  - ASX and US stock markets bottom some time in 2011 between 20% and 30% below current levels and recover their 2007 high by 2015 or later.
  - The Australian dollar continues to swing in a wider than normal range, adding more short term volatility to returns on international assets.

The other 15% of possibilities we simply do not know about. They include a range of unknown unknowns.

#### **What to do next: implications for investment portfolio strategy**

Allocation to Australian and International equities should be cut back over the next few months and then subsequently rebuilt cautiously on significant weakness in markets (15% or more below current levels i.e. at or below 3800 on the ASX 200) to benchmark allocation levels over the next twelve months or beyond , depending on which scenario develops.

Cash and term deposits are becoming more appealing investments as time goes by and as the RBA lifts interest rates.

Government bond yields are more likely to rise than fall worldwide over the next 1 to 3 years. Tier 1 or government fixed interest is therefore less attractive than cash over the next twelve months.

Fixed interest with credit risk still requires caution unless it is short dated or variable rate and issued by a AA rated entity.

Commercial property in the US and Europe is still prone to major downward revaluation although in Australia we may be

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getting closer to the bottom. Unlisted property investments should be confined to brand new portfolios being built from acquisitions from distressed sellers or comprising long term leases to tenants of unquestioned quality.

In this climate of market instability generally avoid investment products that are not clearly transparent in terms of how they work and what they charge. In general avoid hedge funds and structured products and virtually everything that needs to be fed or watered.

**Recommended portfolio weightings**

The following table sets out portfolio allocation guidance in terms of positioning relative to long term benchmark or strategic asset allocations. We have expressed them in terms of percentages of the long term benchmark or strategic allocations. They assume that an active return seeking approach to portfolios management is used in each sector rather than a market matching or index approach. Where an index approach is used, a lower allocation should be made as there is no buffer provided by the value added of an active management approach. The reduction in allocation as a percentage of the benchmark allocation where a market matching approach is used should be 10% for Australian and International equities as well as property and 5% for fixed interest.

In summary, the recommended portfolio strategies take account of all three scenarios outlined above. Major economies have a significant risk of tipping into a deflationary and prolonged recession. Their share markets have realised this and are as much driven by fear of this outcome as by hope of avoiding it. The recommended portfolio weightings have a significant amount of cash which is both precautionary and available for the opportunity for deployment into growth assets depending on how the scenarios unfold. The situation requires fairly constant review and attention.

| <b>Asset class</b>     | <b>Target Portfolio weighting over the next 3 years relative to long term (5-10 year) target weight as a % of long term strategic or benchmark weighting</b> |
|------------------------|--|
| <b>Risky assets</b>    |  |
| Australian equities    | 65% (previously 80%)   |
| International equities | 65% (previously) 80% biased towards less expensive markets with 50% hedged and 50% unhedged  |

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|                         |  |
|-------------------------|--|
| Property                | 50% with a bias to unlisted assets on a very selective basis with total returns above 10% p.a. |
| Fixed interest -Tier 2  | 30% in AA rated issuers only   |
| <b>Defensive assets</b> |  |
| Fixed interest - Tier 1 | 50% with a bias towards bank term deposits   |
| Cash                    | Balance  |

## ❖ Investment of new cash flow

We recommend that new regular cash flows in or out of the portfolio are invested in order to achieve the target allocations recommended above. Large one off cash flows should be invested over a period of six months to achieve the same result.

## ❖ Gearing to invest

For some investors borrowing to invest will still be worthwhile provided that:

- There is a strong prospect the return on the investments assets bought with the borrowed funds will outperform the cost of borrowing on an after tax basis over the term of the loan (although it is increasingly difficult to find such investments given the rising costs of loan funds); and
- The investor has a very high tolerance for short term risks and fluctuations in asset prices whose effects will be magnified in any geared investment (the tolerance to such fluctuations may be enhanced by the presence of a capital guarantee or protection mechanism which ensures that the amount of the loan to be repaid is no more than the value of the assets being financed: and
- Geared investments are not made into asset classes where the recommended allocation is less than 100% of the long term benchmark, unless the individual asset offers the prospect of significantly better returns relative to the rest of the asset class.

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