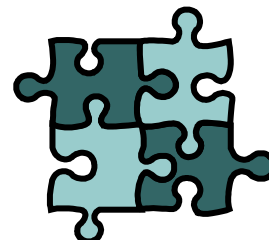


Puzzle Pieces

Let us help you solve the puzzle



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Market Update—Interest in Interest

Erina Officer



The positive economic news that we began to see last quarter has continued into this quarter. So much so that the Reserve Bank has thought that the economy may be in danger of overheating and therefore felt the need to start tightening interest rates with an increase of 0.25% in October. It is widely felt that this will be followed by increases in November and December.

This rise represent a significant development not just for Australia, but globally as it represents official recognition that the Global Financial Crisis (GFC) is over.

Now that we have found ourselves navigating a safer path around the abyss it is perhaps time we paused to look at the effect the GFC had upon us.

In the 1990's recession Paul Keating said of the downturn that it was "the recession we had to have", perhaps the GFC is the crisis we needed to face up to the reality of overspending by consumers and the relentless appetite for credit?

The negatives of the GFC for the most part were the free fall in equity markets and negative returns that portfolio's produced, for others less fortunate it was job losses or a reduction in working hours.

The positives are that markets can and do recover (remember 1987, it seems a distant memory). Almost 95% of the workforce have kept their jobs and enjoyed lower petrol prices and interest rates. Inflation to date has been under control. Another positive has been that the bad

and the ugly have been exposed. Fraudsters such as Bernie Madoff have been ousted and companies with faulty business models have been revealed which is beneficial to markets in general.

In essence what the crisis has reminded us is that greed is not always good and the economic cycle continues after cleansing.

Now that it has been accepted that we are in a period of recovery, what next?

It is widely expected that our economic output while remaining positive will be significantly lower than it has been in recent history – back to the "new" normal, where profits will be solid rather than the super profits experienced by many businesses prior to the GFC.

While interest rates are rising they still remain close to fifty year lows and below the range of 5% that is regarded as "neutral" interest rate setting. Many commentators included the respected Rory Robertson from Macquarie Bank are of the opinion that in this cycle rates will peak at around 4%. If we have an extended period of recovery this may rise to 5%.

What does this mean for portfolio construction moving forward?

Van Eyk have put together three models for interest rates. The models are based on the scenarios at 3%, 5% & 7%.

A 3% cash rate is typified by low to negative inflation, low to negative growth, poor equity markets and low bond yields. Similar conditions to what we have been ex-

periencing of late.

The most attractive scenario, the one we are yet to reach, is a cash rate of 5%. Low to moderate inflation, moderate to high growth, strong equity market fundamentals and moderate to high bond yield.

The last scenario at a cash rate of 7% would be represented by moderate to high inflation, low to moderate growth, moderate equity fundamentals and high bond yields.

So how does this play out in our portfolios?

When cash rates are low investors should reduce both cash and listed property/infrastructure and assume an overweight position in alternative assets in order to derive other sources of yield.

When rates begin to rise, cash allocations should be lifted to a more moderately underweighted position. Exposure to alternative investments and fixed income should be reduced and listed equity holdings substantially increased. As rates peak listed equity allocations should be brought back to neutral and fixed income and cash increased.

This means that we need to carefully monitor market expectations for cash rates and ensure that they are realistic and to make sure those expectations are priced into asset class values.

Investors should continually be looking for high quality investments that can survive and thrive in our "new normal" economy.

Solid Gold Baby

Following on from our information on Alternative investments in last quarters Puzzle Pieces we thought some information on GOLD would be of interest.

Gold has attracted investors for centuries, protecting wealth and providing a safe option during times of uncertainty. This remains the case today with Gold. As Gold is not reliant on an issuers promise to pay it is one of the few investments that offers a refuge from default.

Market cycles may come and go, but over the long term Gold keeps its purchasing power. Its value has remained remarkably stable, as opposed to many currencies, and as a result Gold is often bought to counter the effects of inflation and currency fluctuations.

Sounds good doesn't it but how to invest?

GOLD shares offer investors a means of participating in the gold bullion market without the necessity of taking physical delivery of gold, through the trading of a security on the ASX.

The Gold purchased by way of GOLD shares is held in allocated form, meaning that the physical metal is held on your behalf by a custodian (HSBC Bank USA N.A.), the shares are issued by EFTS Metal Securities Australia Ltd which is regulated by ASIC. Part of the attraction of investing in Gold via ASX is the ease with which you can buy and indeed sell this product.

The face value of the shares is roughly \$100 each and the return aims to be the equivalent to movements on the gold spot price less fees. The spot price for gold is based on LBMA's specification for Good Delivery (loco London), which is an internationally recognised and transparent benchmark for pricing physical gold.

Other options for purchasing Gold are to buy bullion direct from the Perth Mint or investing in listed Gold mining companies such as Newcrest Mining Ltd or Lihir Gold Ltd.

If the idea of the shiny metal stuff appeals to you please give us a call to discuss.

Australian Equity Outlook

By Anthony Hartman of Macquarie Portfolio Broking

The Australian equity market (S&P/ASX300 Accum Index) performed strongly again in September, gaining 6.24% over the month and 54.8% from its' low. Strong economic data and positive earnings momentum following the strong August reporting season helped push equity markets higher for the seventh consecutive month from the market low in early March. The Australian housing sector continued to benefit from low mortgage rates and the boost to the first home owners' grant, which is beginning to roll off on 30 September. Private sector building approvals rose by 3.1% and house prices increased by 1.9% in August

and are 7.9% higher over the CYTD. This highlights the shortage of supply and strong demand for housing. However, we would remove any exposure to local residential construction at this point in time, with the multiples in this sector fully reflecting earnings growth expected in the coming three years.

Consumer confidence is now exceedingly strong, rising to a level of 119.3, the highest level since July 2007. In contrast, retail sales data was mixed, falling by 1% in July and rising by 0.9% in August as the positive impact of Fed-

eral government stimulus packages roll off. Despite this being expected to remain the case, we are not increasing our exposure to the Consumer Discretionary Index.

The OECD+6 Leading Indicator (LI) has risen in line with its previous 1975 high (+15% 6m annualised growth) as the inventory cycle is driving demand through aggressive restocking. While China (+34.2%) is a major driver of the OECD+6 LI, the developed country OECD LI (+9.3%) is at its highest level since



1983, highlighting the improvement in the US and Europe. The Australian equity market outperformed the rest of the world (+3.0%), as the Australian consumer discretionary (+10.6%) and financials (+9.9%) sectors outperformed global peers (+2.8% and 2.1% respectively). OECD+6 Leading Indicator has risen at the rate of the mid 70s, driven by China, which has risen by 34.2% on a six month annualised basis.

We believe this data, most significantly improved by China's rising contribution since July, justifies our decision to leave the Resources exposure we have unchanged.

A major reversal is now commencing in the inventory cycle, which will lift manufacturing production significantly over the coming months. With encouraging leading indicators working to drive up risk appetite, the prospects for economic recovery are further improving and this is working in turn to push down risk premiums and give the outlook increasing support. The strong US reporting season has been characterised by underestimated operating margins, which has led to most companies exceeding analyst forecasts. Australian

investors must now focus on the underlying operating margin assumptions underpinning the FY10 and FY11 EPSg forecasts. This focus is no longer for the downside risks posed by operative leverage. Rather, investors need to assess whether the current EPSg forecasts in FY10 (for some stocks) and FY11 are factoring in sufficient operating margin recovery. As the recovery progresses, margin forecasts will be upgraded, resulting in a very large impact to earnings.

The market is likely to see considerable upgrades to forecasts running out as far as FY12, as even small changes to operating margins, via operating leverage, will produce disproportionately large increases to NPAT across the board. It is at this point, however, that we depart from consensus. The positive influences on the market we think will be:

1. The entire world is relying on the usual multiplier effect from fiscal stimulus to continue to be shown;
2. OECD & Chinese data are supportive of the case for the Resources sector and the inventory cycle argument;
3. Rising interest rates are a positive signal for banks' earnings for the year following the

beginning of the tightening cycle;

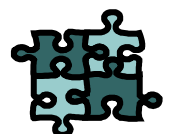
4. Margin expansion appears to be the common reason across the world for rising EPS forecasts.

Regarding points 2. & 3., we are leaving untouched our exposure to Banks & Resources this month. These sectors together comprise the biggest part of the market. We have an overweight exposure to both sectors and there we will remain until further notice. The last point is relevant to our work done earlier in the year stressing the difference between 'Top Down' and 'Bottom Up' forecasts. The 'rate of change of the rate of change' in EPS forecasts reached its' low in March, coincident with a rebound in the market, but almost an historic low in sentiment and business & consumer confidence. These measure now, however, are in different shape; as we are unclear as to the proximity of the next 'rate of change in the rate of change' we are not going to reduce such stocks as WOW, TTS, or QBE, which are perceived to be too defensive in nature to participate in the current inventory related rally. We are not inclined to increase our exposure to the US with the \$A at 90c.

Superannuation Reminders:

Just a quick reminder that the limits for the current year concessional superannuation contributions for those over 50yrs have been cut to \$50,000.

The minimum pension payment amounts for 2010 remain at the reduced rates as applied in 2009.



Stock Recommendations

By Anthony Hartman of Macquarie Portfolio Broking



Sector	Stock	Update
Resources	BHP	Low gearing, among the strongest balance sheets and cashflows around, oligopoly in Bulk Materials continues despite recent concerns about demand and inventory.
	Rio Tinto	Recovery in balance sheet strength will be the clear outcome of recent developments.
Financials	Westpac	Recent results confirm lower cost of funding and superior asset quality relative to peers. WBC remains the best provisioned and positioned of the Big 4. Forecast upgrades are expected of the Banks owing to lower bad debt charges and rising credit activity as is evident from low and stable spreads.
	Platinum	We expect significant fund under management growth in line with earnings upgrades to Financials due to lower bad debt charges and rising credit activity.
Healthcare	CSL	Best defensible position in global market. Industry has defensive characteristics yet CSL's earnings are growing . Maturing competition and new products.
Insurance	QBE	This stock has been hit by currency. We recommend adding in the short because it is a beneficiary of rising interest rates.
Transportation	Toll Holdings	Domestic logistics are expected to benefit from a domestic recovery. Low gearing, increasing market share, high ROE. Resilience in freight rates over the last six months is an encouraging sign of pricing and margins.
Consumer Discretionary	Tattersalls	Defensive earnings, best performer in this space. High sustainable yield, strong balance sheet. Several options for earnings growth are available including NSW lotteries privatisation.

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