

Investment Market + Portfolio 6 September 2011

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Where are we now?

Table 1: Market movements over the 2011/2012 financial year to date

MARKET INDICATOR	LEVEL AT 30 JUNE 2011	LEVEL AT 31 JULY 2011	LEVEL AT 31 AUGUST 2011	MOVEMENT IN LOCAL CURRENCY OVER THE COURSE OF THE FINANCIAL YEAR	MOVEMENT IN AUD TERMS OVER THE COURSE OF THE FINANCIAL YEAR
S&P ASX 200	4607	4425	4296	-6.8%	-6.8%
S&P ASX RESOURCES	5584	5464	5177	-7.3%	-7.3%
S&P ASX AREIT	843	791	800	-5.1%	-5.1%
USA: S&P 500	1307	1290	1218	-6.8%	-6.3%
UK: FTSE 100	5855	5815	5394	-7.9%	-5.9%
GERMANY: DAX	7294	7158	5784	-20.7%	-20.4%
JAPAN: NIKKEI 225	9816	9833	8955	-8.8%	-3.2%
CHINA: HANG SENG	22398	22440	20534	-8.3%	-7.8%
USD/AUD	1.0718	1.0935	1.0667		+0.5%
YEN/AUD	86.32	84.90	81.72		+5.6%
EUR/AUD	0.7390	0.7677	0.7388		+0.3%
GBP/AUD	0.6677	0.6610	0.6544		+2.0%
AUS: 90 DAY BANK BILL % P.A.	4.96	5.01	4.81	-0.15	
AUS: 10 YEAR GOVT BOND % P.A.	5.21	4.80	4.37	-0.84	
US: FED FUNDS RATE % P.A.	0.09	0.11	0.12	+0.03	
US: 10 YEAR GOVT BOND % P.A.	3.09	2.80	2.23	-0.86	
GOLD USD/OUNCE	1501	1627	1825	+10.4%	+10.9%
OIL USD/BARREL (WTI)	95	96	88	-7.3%	-6.8%
COPPER US CENTS PER LB	467	445	420	-10.1%	-9.6%

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- Share markets have weakened significantly over the course of the financial year to date, due to market concerns about:
 - The difficulty of the US reaching a resolution of its budgetary problems without further exacerbating the slowdown in its recovery;
 - Signs that growth in the services sector of the US economy is close to stalling;
 - Dissension within the US central bank over the course that monetary policy should take next;
 - The lack of a final resolution of European sovereign debt problems and the risks that this poses to the major European banks which have not yet written down by much the values of the European sovereign bonds that they hold; and
 - Possible slowdowns in Chinese growth as the authorities there try to constrain inflation.
- Offsetting these concerns there have been some good corporate profit reports in the US as well as elsewhere, including Australia. There have also been some episodes of optimism fuelled by statements by central bankers regarding their readiness to do all that they can to avoid a slide back into recession.
- Global share markets fell sharply from the end of July to about the middle of August, and then rallied somewhat by the end of August following a well received speech by Ben Bernanke, Chairman of the US Federal Reserve Board. Since the turn of the month they have started to weaken again as fears of a double dip recession in the USA returned with poor unemployment figures, slumping consumer confidence indicators and continued weakness in the US housing market.
- Short term interest rates have remained at or near record lows in much of the developed world and the Reserve Bank of Australia decided last month to keep its key cash rate at 4.75% p.a. instead of raising it to combat the risk of rising inflation. It is now more likely that the RBA will keep interest rates on hold for longer and possibly cut them if the international economic outlook worsens.
- Long term bond yields have moved significantly lower as investors worldwide bid up the prices of long term government bonds as they shifted assets from shares to perceived safer alternatives. This illustrates clearly the strength of fear as a driving emotion, with investors clearly choosing the lesser of two risks. At the time of writing, US 10 year bonds had fallen in yield to 1.99% p.a.
- The events of the last five weeks have shown the fragility of consumer confidence in the USA, Australia and elsewhere. They have also impacted on fragile investment market confidence, turning a slow growth scenario into a fear of impending return to recession.
- In summary, the month of August has been momentous and may yet prove to be a major turning point towards the start of a protracted final leg of the Global Financial Crisis which started in mid 2007.
- As we have said before, the fragmented nature of the US government has now precluded it from being able to prevent a slide into recession by means of another fiscal stimulus package, similar to that used in 2008 and 2009. It is in fact more likely that the withdrawal of fiscal stimulus already under way will reduce US GDP growth in 2012 by around 2% p.a. without any further cuts to expenditure which may be recommended to Congress before the end of this year.
- Share markets are adjusting prices to reflect the increased risk of recession. The key question is whether this process of adjustment is near its end and share markets now offer good value to long term investors. They may well overshoot and the momentum may be negative for some months to come. Patience will be needed to take best advantage of renewed buying opportunities.
- In order to provide sound basis for long term decisions, we make assessments of the relative valuation of the major world share markets in terms of their current prices versus long term Fair Value. Fair Value is the price that a share market should trade at in order to achieve the long term Fair Value Return. The assessed Fair Value Return is the current long term government bond yield in the investor's home country plus a margin or Risk Premium which is sufficient to justify the additional risk of investing in the market. We have used the Australian 10 year bond yield as the basis for assessing Fair Value together with long term estimates of growth in earnings per share which are linked to projected growth in nominal GDP for each country. This in turn is the sum of the rate of inflation and real GDP growth.
- The lower the ratio of Current Market Price to Fair Value, the more attractive the particular share market appears. The higher ratio of Current Market Price to Fair Value, the less attractive or expensive the share market appears. We have made assessments under three different scenarios to provide an indication of the sensitivity of the results to the assumptions made. The various scenarios of what may happen in financial markets are set out in more detail later in this report, but the key assumptions are noted in Table 2 on page 3.

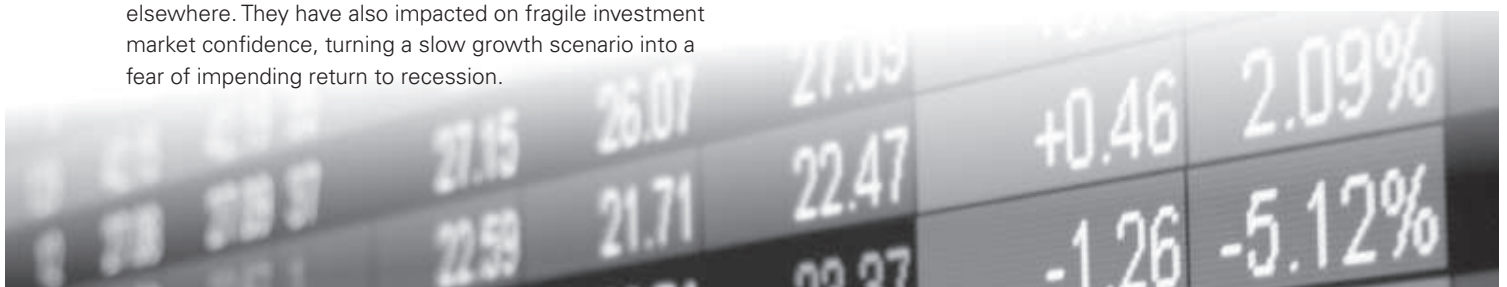


Table 2: Share market valuation indicators

SCENARIO	ONE		TWO		THREE	
CURRENT PROBABILITY ASSESSMENT FOR THIS SCENARIO	30%		15%		30%	
ASSUMPTIONS						
CURRENT BOND YIELD MULTIPLIED BY	1.15		1.20		0.90	
CURRENT EPS CHANGED BY	0.0%		5.0%		-10.0%	
EPS GROWTH RATE CHANGED BY	0.0%		0.2%		-1.5%	
COUNTRY	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %	REQUIRED LONG TERM RETURN FROM STOCKS IF PRICED AT FAIR VALUE % P.A.	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %	REQUIRED LONG TERM RETURN FROM STOCKS IF PRICED AT FAIR VALUE % P.A.	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %	REQUIRED LONG TERM RETURN FROM STOCKS IF PRICED AT FAIR VALUE % P.A.
USA	95%	9.9%	91%	10.1%	112%	8.8%
CANADA	104%	9.9%	100%	10.1%	124%	8.8%
JAPAN	167%	9.9%	160%	10.1%	194%	8.8%
BRITAIN	75%	9.9%	71%	10.1%	88%	8.8%
GERMANY	78%	9.9%	75%	10.1%	92%	8.8%
FRANCE	70%	9.9%	66%	10.1%	82%	8.8%
ITALY	85%	9.9%	81%	10.1%	99%	8.8%
AUSTRALIA	84%	9.9%	80%	10.1%	100%	8.8%
BRAZIL	73%	12.9%	70%	13.1%	85%	11.8%
RUSSIA	35%	12.9%	33%	13.1%	41%	11.8%
INDIA	108%	12.9%	103%	13.1%	127%	11.8%
CHINA	56%	12.9%	53%	13.1%	67%	11.8%

- Turning our attention to the Scenario One results first and given recent falls in share markets, the long term valuation indicators for the USA and Canada are close to Fair Value.
- The analysis suggests that among the G7 major economies, the share markets of Britain, Germany, France and Italy are now trading below long term fair value. On valuation grounds alone they are attractive.
- The Australian share market is also cheap relative to long term Fair Value.
- The result for the Japanese share market indicates that it would be wise to hold investment in this market at well below benchmark levels or zero.
- In emerging markets, among the rest of the so called BRIC countries China, Brazil and Russia are trading well below long term fair value.
- The analysis in Scenario Two, which is an optimistic case (although less likely in our view), does not essentially change the relative rankings of the share markets.
- Scenario Three is a pessimistic case, involving a slide into global recession. We think it is just as likely as Scenario One, which is based on slow growth but no world-wide recession. Scenario Three clearly indicates that the USA and Canada are more risky, while Australia is less compelling and is trading at Fair Value under this scenario.
- Momentum or sentiment is also very important to consider. There may well be additional significant falls of 10% to 15% over the three to six months as the accumulating bad news keeps on coming. From a longer term valuation perspective, this would offer a longer term accumulation opportunity to go above benchmark weight in Australian and International equities.
- Within the fixed interest markets the course of long term interest rates is driven mainly by inflation expectations here and internationally and the expected worldwide trend is towards an eventual increase rather than a decrease in inflation, given the amount of monetary stimulus already in place. Yields on long term sovereign debt issued by some governments such as the USA, Germany, Canada, Britain and Australia have actually declined in recent months as a result of a flight to safer issuers. In general bank term deposits still offer better value for money than government or corporate bonds, even though they have started to decline.
- Short term interest rates on cash are driven mostly by the official RBA cash rate. As this is the main policy instrument that the RBA has to control inflation, we should expect it to eventually rise rather than fall but perhaps not for another two years. The extent of any rise will be tempered by the anti-inflationary effects of the higher Australian dollar exchange rate and concerns about the risk of a global recession.

Comments on particular countries

THE UNITED STATES OF AMERICA

- The financial markets in the United States of America are now highly attuned to speculation about what may or may not flow from changes in either fiscal policy or monetary policy. They are also being impacted by day to day fluctuations in response to emerging news such as reports on consumer confidence indicators and unemployment statistics.
- With regard to fiscal policy, the recent impasse between various parts of the Congress and the President over the Federal Budget and the limit on Federal borrowing was resolved by appointing a finely balanced so called Super Committee of Senators and Representatives. This Committee has to report back by 23 November 2011 with a recommendation on how to address the US Budget deficit over the short, medium and longer terms. It is likely that even if any agreement at all is reached it will involve further spending cuts but no tax increases. Such additional spending cuts would add to the impact of expiring provisions on unemployment benefits and the Bush tax cuts, which already amount to a fiscal tightening which will reduce US GDP by 2% p.a. in 2012. This would be sufficient to tip the US economy back into recession.
- The financial markets will be relying on further stimulus from monetary policy to offset this fiscal tightening. With short term interest rates already at near zero levels and ten year bond yields down to 2.0% p.a., further stimulus would need to involve a third round of quantitative easing (QE3). The Federal Reserve has a two day meeting in mid September at which it is due to discuss all of the options (which appear to be few in number). They will need the full two days, instead of the original one day scheduled for this meeting; if they are to overcome publicly announced dissenting positions within the FOMC, which effectively sets monetary policy. If QE3 is announced and implemented on a sufficient scale, we should expect the US equities market to have a pre Christmas rally, perhaps of the order of 20% or more. (It rallied 28% in response to \$600 billion worth of QE2 in 2010–2011).
- If the Fed disappoints the share market or if the Super Committee continues the rancour of recent months, any rally will be blunted or may even go into reverse. It's a very uncertain time. What is certain is that any mis-steps by the policy makers will push the US back into recession and this will be well anticipated by a weaker share market.

THE EUROPEAN UNION & BRITAIN

- As we have said before, the scare driven sell offs in financial markets as Europe stumbles through the sovereign debt crisis will continue. They have already shifted the valuations of major European companies from somewhat over priced, to under price. The question is whether enough of the bad news is factored into the share prices. The answer is probably not yet. The time for increased allocation to European equities is approaching, but it should not be rushed.
- Britain is further along the path to fiscal austerity, which may have been a contributing factor in the recent riots and looting in its major cities. Therefore the prognosis for reducing its government deficit is better than in the EU or the USA but this may come at significant social and economic cost.
- Britain's banking sector has also probably recognised more of its problem assets than its counterparts in Europe. As mentioned previously, Britain's particular problem is its high reliance on the financial services sector as a result of London being a prime financial centre. This leaves Britain exposed to a loss by emigration of financial services businesses and their more highly paid staff, if taxes (or regulations affecting profit) are increased beyond what is acceptable to these participants in the economy. They can move to lower taxed and lesser regulated jurisdictions in ways that manufacturers and miners cannot.
- As we have said before the British and European economies, which are experiencing very slow growth, are not necessarily the same as their major stock markets. The major British and European multinationals have global revenues and profits, they have also cut costs during the GFC and they also have access to very cheap finance in a time of low interest rates. Their capacity to protect their revenues and profits is arguably better than that of their host governments. The key question will be whether or not the share prices fully reflect the bad news that will affect their earnings.



Comments on particular countries

PEOPLES REPUBLIC OF CHINA

- The rate at which housing and infrastructure is being built in Chinese cities is very high, but also needs to persist for years to come, in order to keep social unrest under control. The consequent demand for steel and concrete is both high and continuing. These in turn require large imports of iron ore and coal, much of it sourced from Australian based companies.
- Therefore, the positive impact of China on the Australian economy looks set to continue for the next 10 to 15 years. As we have said before, falls in mining share prices due to periodic bearishness on China look like opportunities to buy or accumulate the shares of major iron ore and coal miners.
- While the Chinese stock markets (Shanghai and Hong Kong) are likely to be both volatile and at times over priced, investment in companies listed elsewhere, which export to China, such as Siemens, Nestle and BHP, makes a lot of sense from a medium to longer term point of view.

AUSTRALIA

- The Australian economy is now more clearly than ever operating on a multi speed basis. The resources sector including both minerals and energy companies has its earnings growth underpinned by demand in the Peoples' Republic of China (PRC) and other industrialising and urbanising countries. This is expected to continue for some years.
- Within the financial sector the four major banks have oligopoly pricing and distribution power which has underpinned their ability to earn profits at or near record levels notwithstanding slower credit growth. In practice their profit growth will vary between about 4% p.a. in the bad years and over 12% p.a. in the best years. Overall their earnings per share growth and hence their share price growth should be less volatile than that of the mining and energy companies but will be significantly better than that of most other listed companies.
- Given the high combined weight of the mining, energy and banking sectors in the overall stock market index, investment via broadly based or passive funds should benefit from their earnings resilience even if many sectors of the economy experience slowdowns in the face of the higher exchange rate or consumer conservatism.

What may happen next? Possible scenarios

Given the extreme level of volatility in both the equity and fixed interest markets we need to consider 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.

SCENARIO ONE (30% PROBABILITY)

- The USA avoids a return to recession but has slower than normal economic growth (sub 4% p.a.) during the recovery over the next five years. This means that unemployment will reduce slowly and stay higher than in most previous recoveries.
- Japan achieves low real growth but with deflation continuing well into 2012.
- Europe achieves low growth with very low inflation. Inflation in developed countries picks up only slightly into the 3% p.a. to 4% p.a. range from 2013 onwards and does not get out of control. This has the beneficial effect of slightly reducing real interest rates and the real burden of debt.
- Australian cash and short term interest rates increase modestly with the RBA cash rate rising to above 5% p.a. by the end of the first quarter of 2013.
- Bond yields have a capacity to rise by between +0.5% p.a. and +1.0% p.a. by the end of FY 2012/2013.
- Commercial property values remain fairly static in 2011/ 2012.
- Earnings per share for the ASX 200 grow moderately over the next 5 years with the exception of the major resource companies which achieve more rapid growth in the next two years and beyond.
- The Australian share market is prone to falls of between 10% and 15% during the course of the next two financial years but has a reasonable prospect of being some 10% to 15% above its current level by 30 June 2012.
- International share markets, led by the US, show some moderate weakness over the next six months (10% to 15%) before resuming their recovering, underpinned by some earnings growth.
- The Australian dollar continues to swing in a wider than normal range of between USD 0.90 and USD 1.20, adding more short term volatility to returns on international assets.

SCENARIO TWO (15% PROBABILITY)

- Worldwide growth stronger than expected due to consumers and businesses recovering in confidence. US unemployment drops below 8% by late 2012, Europe grows real GDP by 2% p.a. or more, 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 2013 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 over the course of 2011–2012 to combat re-emerging inflation risk.
- Bond yields up by between +1.0% p.a. and +1.5% p.a. by the end of FY 2011/2012.
- Commercial property values start to recover more quickly starting in 2012.
- The Australian share market is prone to falls of between 5% and 10% during the course of the next two financial years but has a reasonable prospect of being some 15% to 20% above its current level by 30 June 2012.
- International share markets, led by the US, show some moderate weakness over the next six months (10% to 15%) before resuming their recovery, underpinned by some earnings growth.
- The Australian dollar continues to swing in a wider than normal range, adding more short term volatility to returns on international assets.

SCENARIO THREE (30% PROBABILITY)

- Recession re-emerges in the USA, Japan and Europe in late 2011 to early 2012 and proves to be a worldwide double dip event and lasts till 2013 or later, threatening a recession in Australia.
- Inflation is contained by recession and slips into deflation worldwide 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% p.a. from current levels by the end of calendar 2011 and by further 1.0% p.a. in 2012 as the world moves into recession and the RBA cuts rates to stimulate the economy.
- Australian Ten Year Bond yield down from current level by between 0.5% p.a. And 1.0% p.a. by late 2012.
- Commercial property values do not recover their 2007 level until 2016 or later.
- With the exception of major resource companies, earnings per share growth for the ASX 200 companies are negative in 2011-2012 and slower by 1% p.a. for the next 5 years.
- Australian, European and US stock markets bottom some time in 2011-12 between 20% and 30% below current levels and recover their current levels in 2013-2014.
- The Australian dollar continues to swing in a wider than normal range, adding more short term volatility to returns on international assets.
- The other 25% of possibilities we simply do not know about. They include a range of unknown unknowns. The world has become a more uncertain place in the last few weeks.

What to do next: Implications for Investment Portfolio Strategy

Taking into account the various scenarios outlined above, portfolios should:

- Maintain their current positions with heightened levels of cash;
- Be ready to increase their weighting to Australian and International equities over the next three to six months during episodes of significant market weakness i.e. 10 % or more below the current levels as set out in Table 1 above;
- Continue their significant underweight in property subject to investing in exceptional opportunities which offer returns in excess of 12% p.a.;
- Bias fixed interest to bank term deposits;
- Generally avoid investment products that are not clearly transparent in terms of how they work and what they charge such as hedge funds and structured products;

RECOMMENDED PORTFOLIO WEIGHTINGS (UNCHANGED SINCE LAST REPORT)

Table 4 below 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. In summary, the recommended portfolio strategies take account of all three scenarios outlined above. They are unchanged from last month except for an increase in the allocation to Australian equities by 10% of the relevant benchmark weight. Given the level of turmoil in the market we believe that this increase should be implemented over the next three months perhaps in two or three stages at levels below 4000 on the ASX 200 index. 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 with clients. Table 3 below sets out trigger points for buying and selling various share markets for those who wish to manage portfolios on this basis.

Table 3: Share market buy and sell ranges as at 5 September 2011

SHARE MARKET (AND INDEX)	INCREASE WEIGHTING WHEN INDEX BELOW	REDUCE WHEN WEIGHTING ABOVE
Australia (ASX 200)	4000	4800
USA (S&P 500)	1100	1440
Great Britain (FTSE 100)	5100	6200
Germany (DAX 30)	5900	7600
Japan (Nikkei 225)	8800	11000

Table 4: Madison Recommended Portfolios: asset allocation relative to long term benchmarks

ASSET CLASS	TARGET PORTFOLIO WEIGHTING AS A % OF LONG TERM STRATEGIC OR BENCHMARK WEIGHTING
RISKY ASSETS	
Australian equities	75% for portfolios 1&2; 95% for portfolio 3; 100% for portfolios 4 and 5.
International equities	65% for portfolios 1 & 2; 75% for portfolio 3; 80% for portfolio 4; 85% for portfolio 5
Property	50% with a bias to unlisted assets on a very selective basis with total returns above 12% p.a.
Fixed interest -Tier 2	30% in AA rated issuers only
DEFENSIVE ASSETS	
Fixed interest -Tier 1	50% with a bias towards bank term deposits
Cash	Balance of the portfolio

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 be worthwhile provided that (a) 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; (b) 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; and (c) 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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