

Quarterly Market Outlook December 2011



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The Global Economy

Introduction

The International Monetary Fund (IMF) recently downgraded its global growth forecast to 4.0% for both 2011 and 2012 (from 4.3% and 4.5%, respectively). Developed economies (which represent about 55% of global GDP) are expected to grow by 1.6% while developing economies (45% of global GDP) are expected to grow by 6.4%. The IMF also noted that the risks to its forecasts were mostly to the downside. For investment markets, the quarter was marked by “flight to safety” behaviour, with growth asset markets falling heavily and bond markets rallying.

Australia

The Australian economy grew by 1.2% in the second quarter of 2011, following a 0.9% contraction in the first quarter due to extreme weather. Household spending

remains weak as Australians continue to save more and borrow less post the Global Financial Crisis. It is this trend that has led to Australia’s “two-speed economy” tag, with a strong export sector being offset by a weak household sector. Other areas of weakness include patchy retail trade, slowing housing activity and flat credit growth. The key areas of strength have been rising business investment, for the mining and energy sectors in particular, as well as a rebound in net exports following the extreme weather interruptions in the first quarter of 2011. August saw the second highest trade surplus on record, coming in at \$3.1 billion.

Australia’s unemployment rate has steadily increased to 5.3% over the quarter, up from 4.9% earlier in the year. These figures suggest the Australian economy is weaker than the Reserve Bank of Australia (RBA) has been forecasting. This comes at a time when global growth forecasts are being revised down and commodity prices and equity markets are slumping on fears Europe’s debt crisis will not be contained. The minority Labor government continues to push ahead with a range of sweeping reforms, such as the proposed carbon tax. Whether or not these reforms are implemented is creating significant uncertainties for Australia businesses, particular given the possibility that these could be repealed should the Coalition government win the next election.

Though not without its issues, the Australian economy is healthy and its outlook strong. Should the global economy move into a period of contraction in the short term, Australia is able to cut interest rates, where most other developed economies are not afforded this luxury. Australia remains highly leveraged to the rapidly growing emerging Asian economies whose economic cycle now represents the key risk to Australia’s economic growth.

Count’s Research House, Lonsec, note that “the Australian economy has strong fundamentals relative

to most other developed economies, in terms of low public debt and a relatively strong banking sector. The Reserve Bank of Australia (RBA) has room to cut interest rates if required, which should keep the economy growing, albeit at a below-trend pace. Over the medium term, Asian growth is likely to rebound and minority government issues should be resolved.” The IMF forecasts the Australian economy to grow by 1.8% in 2011 and 3.3% in 2012.”

United States

US Gross Domestic Production (GDP) grew at an annual rate of 1.3% in the June 2011 quarter. Over the September quarter, US economic indicators have generally weakened. New payrolls have fallen from over 200,000 in April to around 100,000 by September and the unemployment rate remains stubbornly fixed at 9.1%. Manufacturing surveys, while still indicating expansion, continue to drift lower, consumer confidence has fallen to levels not seen since the 2009 recession and retail sales growth remains flat. Building and construction activity is low and housing prices remain heavily depressed. The only real positive indicators have been the recent strength in car sales, business investment and exports.

Both the US government and the US Federal Reserve (the Fed) expressed concerns over the September quarter that the US economy is faltering. This saw the announcement of a raft of fiscal and monetary policy initiatives including a US \$447 billion job stimulus bill, a promise to maintain the cash rate near zero until at least mid-2013, a new asset purchasing program dubbed “Operation Twist” and the introduction of specific support for the mortgage market.

One of the key themes playing out early in the quarter was uncertainty as to whether US Congress could agree on a way to raise its debt ceiling and reduce its budget deficit over the coming years. The decision came down to the wire and was finally struck on 2 August, the date at which the US would have needed to begin prioritising its debt in a technical default. A compromise was reached between the Democrats and the Republicans to increase the debt ceiling by US \$2.1 trillion, in return for US \$2.4 trillion in spending cuts. While this was widely expected, the subsequent US long term credit rating downgrade from AAA to AA+ by S&P created a significant shock to investment markets.

The US \$447 billion jobs package announced by President Obama in September included an extension to the payroll tax holiday, extension of unemployment benefits, aid for state and local governments and infrastructure spending. This package has been hotly debated by Democrats and Republicans and the bill

seems unlikely to pass the hostile, Republican-controlled lower house. The partisan dysfunction in US politics seen here and in the debt ceiling debate which almost shut down the US government is becoming an increasing concern and triggered S&P’s downgrade of US debt. The worry is that it will prevent effective response to the current slowdown and future fiscal restructuring.

The Fed also announced its “Operation Twist” strategy in September, which is effectively an extension of the average maturity of its holdings. The strategy involves purchasing US \$400 billion of long-dated treasury securities of up to 30-year maturity, while selling short-dated treasuries. The objective is to drive the rates of longer term securities lower in order to promote capital inflows and strengthen the dollar. It appears to have been successful thus far, resulting in record low 10 and 30 year bond yields although fund flows out of Europe and into these “safe haven” US bonds are likely to have played a part as well. This strategy was on top of a commitment to keep the cash rate at its current record low level through to at least mid-2013. Despite these initiatives, markets were generally disappointed by the announcement, expecting larger and more immediate liquidity support.

The US economy certainly appears headed for a weak patch, with the IMF is sharply downgrading its outlook for the US economy through 2012, citing weak growth and concerns that Europe won’t appropriately deal with its debt crisis. The IMF expects the US economy to grow just 1.5% this year and 1.8% in 2012. The previous June forecast was 2.5% in 2011 and 2.7% next year.

Europe

Europe’s sovereign debt issues dominated the headlines over the September quarter while economic indicators suggest the region is in recession once again. Economic growth is close to zero, retail sales growth is negative, manufacturing surveys are pointing to contraction, unemployment is averaging 10% and consumer and business confidence has plummeted back down to 2008/09 recession levels. Meanwhile, most European nations are busily enacting fiscal austerity measures to repair their budget deficits creating additional barriers to economic growth.

European banks struggled to attract US dollar financing and the European Central Bank (ECB) continues with its unconventional Securities Market Program as a result. The ECB now owns €160 billion of Greek, Italian, Irish, Portuguese and Spanish government bonds in an effort to restore liquidity in government bond markets. This has not been sufficient to alleviate concerns regarding Italian government debt, with yields

steadily rising and both Moody's and S&P downgrading Italy's sovereign credit rating.

Greece remains in the spotlight, with its next tranche of bailout funds being delayed until November to ensure it can meet the requirements set out by the IMF and EU. Greece confessed it would not be able to meet its budget deficit targets for 2011 and 2012. The Greek government has announced further austerity measures including public sector job cuts, pension reforms and new taxes on property. Financial markets are now expecting an orderly Greek default given this inability to effectively implement austerity measures in a deteriorating economic environment.

The key issues with potential sovereign defaults and debt write-downs in the weaker European nations is the effect it will have on the European and US banks holding these debts and their subsequent need to recapitalise. It is apparent that the €440 billion European Financial Stability Facility is insufficient to rescue these nations and European banks. The positive news is that EU leaders are finally turning their attentions to the real problem and have commenced work on a "comprehensive package" targeted at recapitalising European banks. The IMF expects the European economy to grow by 1.6% in 2011 and 1.1% in 2012.

Japan

Japan continues to recover after the tsunami and nuclear disaster in the first half of the year. The government's rebuilding program and a rebound in industrial production is fuelling the recovery. A period of strong growth, driven by normalisation in supply chains is expected for the September quarter economy, which will slow to a more modest pace as a result of the strong yen and export weakness. Meanwhile, reconstruction demand from the earthquake in both public and private sectors will provide ongoing support to economic activity over the coming quarters. The Japanese Administration is currently finalising a third supplementary budget, which is reported to reach 12 trillion Yen.

Under the assumption that the European sovereign debt and banking crisis will intensify to the point of a Euro area recession, Japan's exports to both Europe and other regions will likely slow. Slowing global growth combined with a rising yen will create additional headwinds for the export-oriented economy, with the IMF forecasting Japan to contract by 0.5% in 2011 and grow by 2.3% in 2012.

Asia (ex-Japan)

Economic activity in Asia (ex-Japan) remained solid but growth has been moderating in the latter half of the year. Some emerging Asian economies have experienced a slowdown in export growth but this has largely been offset by strong domestic demand supported by relatively accommodative monetary and fiscal policies, positive consumer and business sentiment as well as strong labour markets.

In China, growth has been slowing due to tightening monetary policy and as a result of lower global growth more generally. Manufacturing surveys have tipped just into contraction territory and concerns are emerging that China's property and infrastructure investment boom may result in bad debt issues for the financial system in the medium term. These risks appear overstated at present, with a well-capitalised Chinese banking sector, majority-owned by the central government who have the resources to provide support if needed. Fiscal and monetary policy levels are both at the disposal of Chinese officials to ease inflation down from its elevated 6.2%. The IMF forecasts the Chinese economy to grow by 9.5% in 2011 and 9.0% in 2012.

Indian policy makers also face the challenge of bringing down inflation, with the inflation rate moving beyond the Reserve Bank of India's level of comfort, reaching a yearly high of 9.8% in August. Real interest rates are still much lower than pre-crisis averages, despite recent policy tightening, while credit growth remains strong. The IMF forecasts the Indian economy to grow by 7.8% in 2011 and 7.5% in 2012.

Broadly speaking, economic growth in the Asia (ex- Japan) region has been highly resilient to the weakness in Western economies, but inflationary pressures remain at the forefront of concerns. More recently, growth expectations have moderated under recessionary fears in developed economies. Growth is now expected to decelerate while remaining strong and being sustained by domestic demand. This view is under the assumption that global financial tensions do not escalate. A deep slowdown in the United States and Europe would clearly dampen external demand in Asia but domestic demand will continue to support growth.

Investment Sectors

Australian Shares

The Australian sharemarket had a difficult quarter, with the All Ordinaries Accumulation Index (including dividends) fell 11.3% over the September quarter, for a negative 8.4% return over the last 12 months. Globally, investors were consumed by the sovereign debt saga playing out in Europe as well as weakening US economic data and at one point, the unthinkable possibility of a debt default in the US. Australia was far from immune, despite our increasing dependence on Asian economic growth.

Resources had a particularly bad quarter, reversing the strong gains recorded over the first half of the year. The S&P/ASX 300 Resources Accumulation Index fell 18.8% over the quarter while the S&P/ASX 300 Industrials Accumulation Index fell 8.2% over the quarter for a 6.7% annual loss.

Sectoral performance presented a clear picture of risk aversion with the Telcos (6.9% QoQ, 17.2% YoY) sector being the only sector to rise over the September quarter, followed by Utilities (-2.7% QoQ, -5.2% YoY) and Consumer Staples (-4.2% QoQ, -7.0% YoY) in terms of best relative performance. Sectors more leveraged to the economic cycle were sold off heavily, led by Materials, (-19.2% QoQ, -12.8% YoY), Energy (-17.8% QoQ, -17.8% YoY), Consumer Discretionary (-13.9% QoQ, -22.2% YoY) and Information Technology (-13.1% QoQ, -23.6% YoY).

At the stock specific level, Bow Energy Limited (64.1%), MacArthur Coal (45.4%), Resolute Mining (29.5%), Alacer Gold Corp. (29.2%) and Eastern Star Gas (28.1%) enjoyed the strongest performance over the quarter. On the negative end of the spectrum, the greatest quarterly price declines were experienced by Murchison Metals (-56.2%), Paladin Energy (-51.8%), Goodman Fielder (-51.3%), Karoon Gas (-45.5%) and Lynas Corporation (-44.9%).

The major corporate news over the quarter was Fosters (2.5%) acceptance of a takeover offer from SAB Miller. The \$12.3 billion offer was accepted for \$5.53 per share, including a 13.25c dividend and a 30c capital return after Fosters had previously rejected an offer of \$4.90 per share from the same company. BHP (-20.0%) was on the acquisition path again snapping up US company Petrohawk Energy in a US\$12.1 billion transaction, increasing shale natural gas resources.

In assessing the outlook for Australian equities, Lonsec have provided guidance that “economic fundamentals remain strong, but a relatively weak reporting season,

offshore macro issues and a lack of political cohesion domestically continues to hurt markets. The AUD is expected to come off should the RBA start to cut rates. The local market continues to take the lead from overseas markets, and has been negatively affected by continued weakness in global markets. A more defensive stance is warranted given short term headwinds, and a neutral stance allows for a more bullish position if these headwinds weaken in coming months.”

International Shares

Global share markets experienced a horror quarter after the pessimism building through the first half of 2011 reached new heights. All global markets experienced heavy sell offs over a particularly volatile September quarter. The MSCI World Index (ex-Australia) USD fell 16.5% over the quarter for a 4.2% annual fall. A falling Australian dollar improved the result for unhedged Australian investors, with the index falling 7.4% for the quarter and 4.1% annually in Australian dollars. The Australian dollar fell 9.8% over the quarter to US \$0.97.

There was a plethora of issues for investors to digest over the quarter, including an increasing expectation that Greece will require a “managed” default on its debts and increasing concerns that contagion to Italy and Spain cannot be avoided. This triggered a timely intervention in bond markets by the ECB, providing investors with some comfort that a large bailout of these two countries would not be required. Finding a way to ring fence any default events to Greece, Ireland and Portugal without triggering the more severe consequences of default risk spreading to Italy and Spain remains the key challenge for European leaders.

The market spent the entire quarter fluctuating wildly around each new piece of news regarding potential solutions, agreements and disagreement between the relevant parties. It is a very serious crisis and there is increasing speculation that one or more nations may need to exit the European Union. It is not surprising that European equities were amongst the worst performing market over the quarter, with the German DAX index falling 25.4% over the September quarter and 11.7% over the past 12 months. The French CAC40 Index (-25.1% QoQ, -19.7% YoY) experience a similar result for the quarter while the UK FTSE (-13.7% QoQ, -7.6% YoY) fared better.

US equities markets also tracked along a volatile downward path, with European woes combining with weaker US economic indicators and concerns that the US political system is becoming increasingly ineffective in providing real solutions to its problems. In the face of its own sovereign debt issues and the unthinkable risk

of a US technical default, US Congress's failure to negotiate a timely resolution weighed heavily on the market. An agreement was eventually reached but the relief was short-lived. Congress's apparent impasse towards allowing the US Government to run out of cash and maintain government saw S&P downgraded the US long-term credit rating to AA+ from AAA and sent market into free-fall once more. The combination of the above plus a regular stream of negative news saw US equities retreat heavily over the quarter. The S&P 500 (-14.3% QoQ, -0.1% YoY) experienced the greatest quarterly decline, followed by the NASDAQ (-12.9% QoQ, 2.0% YoY) and the Dow Jones (-12.1% QoQ, 1.2% YoY).

Asian equities markets also experienced sharp declines. Chinese officials continued with their balancing act containing inflation while sustaining economic growth against a weakening global economic outlook. Chinese equities measured by both the China's Shanghai B (-14.6% QoQ, -11.2% YoY) and Hong Kong Hang Seng (-21.5% QoQ, -21.3% YoY) indices fell sharply, as did the India SENSEX (-12.7% QoQ, -18.0% YoY) and all other major emerging Asian indices. The Japanese market provided no insulation for investors amid concerns a global economic slowdown will negatively impact Japan's manufacturing an export sectors. The Nikkei fell 11.4% over the quarter and 7.1% over the past 12 months.

In regard to the outlook for international equities, Lonsec have provided the following guidance: "Although Europe and slowing global growth remain a concern, Lonsec notes that PE levels across major equity markets are now much more modest, and many major companies have significant cash balances. There is likely to be an increase in share buy-backs and mergers & acquisitions activity in coming quarters".

Property Securities

Like all growth assets, property securities were sold off heavily over the September quarter, due to concerns surrounding the global economic outlook and risks to financial stability, although not to the same extent as equities. The S&P/ASX 300 A-REIT Accumulation Index fell 8.2% over the September quarter and 6.3% annually while the UBS Global Property Investors' Index AUD fell 15.1% over the quarter, up 2.0% over the past 12 months.

In terms of the domestic A-REITS market, Lonsec note that "At current price levels A-REITs are expected to deliver a sector yield of around 6.0% p.a. This is a significant premium above the income return being generated from global property securities, which are expected to return a weighted average yield of around 4.0% p.a. The A-REIT market is still expected to deliver

less volatile returns than Australian shares and global property securities (hedged) over the short to medium term due to the strong balance sheet position of Australian property vehicles. This factor, in combination with the current valuation discount and high yields, means that Lonsec still has a preference towards A-REITs over global property securities at this point in time."

For international listed property markets, Lonsec believe that "most global property securities markets currently appear to be less attractive from a valuation point of view, with global markets overall trading at an average discount of 11% and an implied market cap rate of 6.3% p.a. The higher implied cap rate of A-REITs versus other global markets largely reflects the interest rate differential between Australia and other markets. US REITs currently look to be reasonably fairly valued and should offer a good opportunity for long-term investors due to the premium between property securities yields and bond yields."

Fixed Interest & Cash

Over the September quarter, The RBA left the official cash rate unchanged at 4.75%, where it has sat since November 2010. Futures markets have priced in a rate cut in light of the expectation for continued global economic weakness. While acknowledging this weakness, the RBA continues with a more hawkish tone than many of their central banking counterparts. So in the meantime, retail investors continue to enjoy attractive rates. The UBS Warburg Bank Bill Index rose 1.20% for the quarter and 5.0% over the past 12 months. Cash rates the major global economies remained stable.

Australian and most developed world bond markets continued to rally during the September quarter, boosted by the continued "flight to safety" from riskier assets as investors' confidence continued to be eroded by a vicious circle of declining equity markets, falling liquidity and credit availability, and a deteriorating global economic outlook. Australian 10-year Commonwealth Government Bond yields finished the quarter at 4.22% and The UBS Warburg Composite Bond Index rose 4.63% over the quarter and 9.04% over the last 12 months.

Investors and equity and bond markets maintained focus on the policy makers' responses to the European sovereign debt crisis and recessionary concerns in the US. Over the quarter European leaders ratified an increase to the European Financial Stability Fund (EFSF) to €440bn, representing the bailout fund used for Ireland and Portugal. It is becoming widely accepted that this fund will need to be lifted to €2 trillion to cope with bank recapitalisations, a managed Greek

default and to provide liquidity for Italian government bonds. However, European leader's slow response to deal with the crisis and doubts over the credibility of some policies have contributed to ongoing market disappointment, driving down 10-year US Treasury yields to a record low of 1.72% on 22 September. Eventually, yields finished the quarter at 1.92%. German 10-year bund and UK 10-year government bond yields ended the quarter at 1.89% and 2.43% respectively. The Citigroup World ex-Australia GBI (hedged) in \$A index returned 5.23% over the quarter and 7.35% over the past 12 months.

On the outlook for fixed interest and cash, Lonsec note that "term deposit rates continue to offer retail investors a particularly attractive proposition in a risk return sense. The Government announced during the quarter that the current Commonwealth Government guarantee provisions will roll off, and be capped at \$250,000 from 1 February 2012 rather than the current \$1m. Lonsec cautions against extensive use of long fixed deposits (3-5 years) as cash proxies, given the liquidity and interest rate risks. The Australian bond yield curve is inverted, with 10 year government bonds yielding just 4.3% at time of writing (versus wholesale cash rates at 4.75%). Further, global bonds are expected to remain at relatively low levels, with risks to the upside."

Investment Market Summary as at 30 September 2011

Stock Market Indices to 30 June 2011		1yr % pa	3yrs % pa	5yrs % pa	7yrs % pa
ASX All Ordinaries Accumulation Index		-8.43	0.02	-0.38	5.79
S&P/ASX 300 Industrials Accumulation Index		-6.74	-0.40	-2.54	3.69
S&P/ASX 300 Resources Accumulation Index		-12.90	0.94	5.26	13.03
S&P/ASX 300 Listed Prop. Accumulation Index		-6.29	-11.68	-13.59	-4.85
Dow Jones Industrial Index - US		1.20	0.19	-1.35	1.14
Standard & Poors 500 Index - US		-0.90	-0.96	-3.27	0.21
Nikkei Dow Index - Japan		-7.14	-8.24	-11.61	-3.07
Dax Index – Germany		-19.74	-9.57	-10.70	-2.81
FT-SE 100 Index – UK		-7.57	1.51	-2.96	1.66
Shanghai B Index - China		-11.16	0.94	6.13	7.78
MSCI World Acc Index net divs in \$A		-4.07	-6.71	-7.35	-1.47

Australian House Prices to 30 June 2011	Median Value (\$'000s)*	1yr % pa	3yrs % pa	5yrs % pa	7yrs % pa
Sydney	637.4	6.04	4.99	4.14	1.89
Melbourne	557.0	10.63	7.92	8.90	5.77
Brisbane	443.1	-1.09	2.82	6.73	5.97
Adelaide	406.7	3.01	4.75	7.77	7.48
Hobart	373.4	1.99	4.54	6.26	7.34
Perth	483.5	-0.70	1.46	6.58	10.08

* Moving annual median values based on figures supplied by the Real Estate Institute of Australia.

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