



Quarterly Market Outlook – September 2011

The Global Economy



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Introduction

The global economy grew at an annualised rate of 4.3% in the first quarter of 2011, but growth has slowed in the second quarter and downside risks seem to be increasing. Financial markets continue to debate whether the slowdown is temporary or marks the start of a deeper global economic downturn. The key risks markets have been focussed on remain the potential expansion of the sovereign debt crisis in Europe and a prolonged weakness in the US economy.

In Australia, economic growth was much weaker than expected in the first half of 2011 due to the earlier flooding and cyclones and a more general weakness outside of the resources sector. Growth is expected to accelerate in the second half of 2011 as Queensland recovers and global growth rebounds. The downside risks for Australia are weaker than expected global growth, particularly in Asia, and continued weakness in the broader economy due to cautious consumers concerned about rising costs, new taxes and the outlook for the global economy.

Australia

Australian economic growth was much weaker than expected in the first half of 2011 due to disruptions caused by flooding and cyclones in the first quarter and the effect of global uncertainty on consumer and business sentiment. Australia's economy recorded its quarterly largest decline in 20 years, shrinking 1.2% in the first quarter of 2011. This was primarily as a result of the toll extensive flooding took on coal exports. Annual growth fell to 1.0%, but expectations are for a recovery later in the year due to the ongoing mining boom.

Setting aside the impact of flooding, Australia's resource exports remain the key strength in the economy. Commodity prices rose to yet another new high in June, with the Reserve Bank of Australia's (RBA) index of commodity prices rising 1.3% in June in SDR terms (the basket of currencies in which it is measured) as per the RBA's preliminary estimates. The largest contributors to the rise were estimated export prices of coking and thermal coal, with iron ore also making a contribution. Rising commodity prices have resulted in a significant increase in planned capital investment in mining and energy projects. According to the Australian Bureau of Agricultural and Resource Economics and Sciences' (ABARES) most recent data, the combined capital expenditure of Australia's minerals and energy projects were a record \$173.5 billion in April 2011, 31% higher than in October 2010. "The significant increase in planned capital expenditure reflects the mining industry's confidence in the medium and long-term outlook for Australia's mineral and energy commodities," ABARES acting Deputy Executive Director Terry Sheales claimed.

Australia's economy is frequently referred to as a "two speed economy" with the key weaknesses lying in household spending and housing activity. Household spending and housing activity over the first half of the year were soft, with little to indicate the situation will change over the remainder of 2011. This is highly apparent in retail sales growth, which currently stands at around 2%-3% per annum, well below the 6% per annum average rate prior to the global financial crisis.

September 2011 Quarterly Market Outlook as at 30 June 2011

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The Australian household savings ratio also highlights consumers' preference not to spend. The ratio has increased to 11.5% from zero or less just six years ago.

Despite an economy in the midst of a mining boom, a very low unemployment rate of 4.9% and strong wage growth, Australian consumer confidence has become progressively weaker. The Westpac–Melbourne Institute Index of Consumer Sentiment fell sharply by 8.3% in July from 101.2 in June to 92.8, with a reading under 100 indicating there are more pessimists than optimists. Australians are showing heightened concerns regarding the European financial crisis; the ongoing impact of the seven interest rate hikes between October 2009 and November 2010 and the possibility of more to come; and more recent uncertainty about the introduction of a price on carbon.

Within the data, the largest fall in confidence (–11.1%), was in the highest income group, of whom receive the least generous government compensation in relation to the proposed carbon tax. Confidence in mortgage holders dived by 16.5%, despite the Reserve Bank keeping rates on hold following the Board meeting in July. Household debt relative to household income remains extremely high, which means greater interest rate sensitivity for households already dealing with rising expenses such as utility costs, which are up nearly 50% over the last four years alone. While these fears are likely to remain, Count's Research House, Lonsec, expects the RBA will keep the cash rate on hold for 2011, given growth is likely to fall short of expectations and monetary policy is already "mildly restrictive" according to the RBA's own view.

In terms of Australia's economic outlook, Lonsec have provided the following guidance: "Despite the expected short term dip in growth, the fundamentals of the Australian economy remain sound and the medium to long term outlook remains strong. If there are any short term hiccups in the global growth story, Australia has room to cut interest rates, which is a luxury that many developed economies no longer have. Australia's economic growth is now highly leveraged to growth in emerging Asia and hence the economic cycle in these countries is now the key risk for the Australian economy. Lonsec expects Australia's annual growth rate to dip to 2.3%-2.5% in 2011. Growth should rebound to around 3.0% in 2012, assuming the Asian growth story continues and interest rates remain on hold in 2011."

United States

The US economy slowed in the second quarter, with annualised GDP growth slowing to around 2%. While

previous economic data was suggesting that US economy growth was gaining momentum into the June quarter, severe winter weather, a spike in oil prices in the first quarter of 2011 as well as supply chain disruptions stemming from the Japanese natural disaster have seen hopes for an accelerated recovery pushed out to later in the year.

Several lead indicators suggest the US economy has been experiencing a soft patch over the first half of 2011. Employment data has weakened, with the US unemployment rate drifting back up to 9.1% from its April low of 8.8%. The rate of new job creation has also fallen, with new payrolls down from around 200,000 per month earlier in the first quarter of the year to around 50,000 per month by mid-year. The US housing market remains extremely weak, with house prices down around 30% since 2007 and no signs of any pickup in housing activity. Manufacturing surveys indicate that US manufacturing is still expanding, although the rate of expansion has fallen in recent months.

The most pressing issue faced by the Obama administration is negotiating an agreement with the Republicans to raise the nation's debt ceiling from US \$14.3 trillion, which US Treasury predicts it will hit on August 2. Failing to reach an agreement would result in a US default, the US not being able to run a government in the short-term and US debt being downgraded by ratings agencies. Bondholders such as the Chinese government would be hit hard, the developed world would plunge into recession and the global financial crisis would climb to new heights. While equity and commodity market pricing suggests it is inconceivable that US Congress would intentionally default on debt and shut down the government, this risk remains a possibility in the near-term, albeit highly unlikely.

The positive news is that US growth is expected to rebound in the second half of 2011, led by rising exports, investment and retail sales. The US Fed has presented a more sombre view of the US economy, downgrading its economic growth forecasts to 2.7% - 2.9% in 2011, while acknowledging that this is at least in part due to "factors that are likely to be temporary". The IMF is slightly more pessimistic, forecasting the US economy to grow by 2.5% in 2011, down from 2.9% in 2010.

Europe

Greece was firmly in the global spotlight over June quarter, with the country having to implement fairly extreme austerity measures to receive funding from the European Union and IMF, while simultaneously averting a political crisis. The direct risk Greece's debt



problems present to the global economy are low, with Greece accounting for less than 0.5% of global GDP. However, despite Greece's size, it still owes around €340 billion to various European banks and other financial institutions, which poses potential problems for financial stability.

During the quarter, Greece's finance minister was replaced following a loss in confidence in Greece's tough budget measures. In an effort to boost market confidence, a vote of confidence in the current government and a subsequent vote on €28 billion budget savings package were conducted, both of which passed. This has secured Greece's next tranche of funding from the EU and IMF.

While Greece has met its requirement to receive additional funding, some form of default appears inevitable. Despite four years of austerity measures, the IMF has projected Greece's public debt to GDP ratio to be 152.5% in 2014, well above the 127% it was at when its troubles began in 2009. The additional funding at the very least allows Europe to delay any partial default until Spain and Italy are in stronger shape and the European banking system is better placed to withstand the impact.

An uncontrolled Greek default could lead to a sharp rise in funding costs for other heavily indebted countries like Ireland, Portugal, Spain and Italy, making it harder for them to reduce their debts. The other potential implication could be a rush to withdraw funds and reduce exposure to the most exposed banks. Banks may then stop lending to each other, as occurred in the global financial crisis and cause disruptions to global economic activity. The primary concern here would be French banks' US \$590 billion German banks' US \$499 billion exposure to Ireland, Portugal, Spain and Italy's debt.

While the banking system of these larger countries maintain significant exposure to the problem countries, the positive news is that the core European countries: Germany; France; the Netherlands and the UK are all experiencing strong growth. So much so that the ECB has commenced raising interest rates, with the ECB cash rate now standing at 1.50%. The IMF forecasts growth of 2.0% in the European economy and 1.5% in the UK over 2011.

Japan

Earthquake, tsunami and the nuclear disaster saw the Japanese economy return to recession in the first half of 2011. Japan's economy shrank 0.9% in the first quarter of 2011, the third consecutive quarterly decline. While these events have created significant

uncertainties surrounding Japan's medium term economic outlook there are signs of hope emerging.

The key positive sign is that supply chains, particularly in the auto sector, have been resolved much faster than companies previously expected. Manufacturers are making progress in restoring production facilities and mending supply chains after Japan's devastating March earthquake, fuelling hopes for an early rebound in output and exports. Toyota for example, expects domestic auto production will return to normal in July. Many economists expect GDP to resume expanding in July-September, reducing the need for additional easing by the Bank of Japan.

On the negative side, nuclear power plants which have temporarily shut down for regular inspection may not be able to restart for an extended period due to safety concerns following the Fukushima tragedy. If all nuclear reactors which will be shut down for regular inspection remain that way, Japan will lose 47.7mKW in power supply. This uncertainty could see manufacturers move their product offshore and will significantly increase the cost of electricity. The other factor likely to weigh on Japanese recovery is the possibility of income tax hikes intended to finance reconstruction and higher electricity charges in 2012, placing additional pressures on consumers.

Despite these difficulties, a \$200-300 billion rebuilding program is expected to provide a strong boost to growth throughout the remainder of the year. The Japanese economy is still the third world's third largest economy behind China and the US with strong links around the globe in terms of trade and capital. As a result, investors will be monitoring the progress of Japanese recovery closely. The IMF forecasts Japan to shrink by 0.7% over 2011.

Asia (ex-Japan)

Asia (ex-Japan) continues to expand at a rapid pace, but rising inflation has prompted tighter monetary policy in China, India and across emerging Asia more generally. China's bustling economy slowed slightly to 9.5% in the June quarter, down from 9.7% in the March quarter. The result has eased fears of an abrupt slowdown in economic activity and provides Chinese officials with additional scope to tighten policy to combat surging inflation.

The Chinese Government seeks to reduce economic expansion to more manageable levels and reduce inflation, which soared to a three-year high of 6.4% in June and has resulted in a series of interest rate rises over the first half of 2011. Inflation is politically difficult for China as it offsets the transfer of economic benefit



to the public and has the potential to fuel civil unrest. While many analysts expect inflation to subside later in the year, a sharp rise in prices driven by a 14.4% jump in food costs in June, has increased expectations that China will proceed with additional rate rises or other tightening measures later in the year.

Despite the additional tightening applied by the Chinese Government, factory output was 15.1% higher in June over the previous 12 months, while growth in retail sales rose to 17.7%, up from 16.3% in the first quarter. These figures would be welcomed by Chinese officials, whose other objective is to shift the growth focus to domestic consumption and move away from reliance on exports and investment.

The situation is much the same throughout the rest of Asia (ex-Japan), but to varying degrees. Economic expansion is slowing as a result of monetary policy tightening and reduced government spending. The IMF forecasts the Chinese economy to grow by 9.6% and India to grow by 8.2% over 2011.

INVESTMENT SECTORS

Australian Shares

Australian equities underperformed global equity market in the final 3 months of the financial year. The All Ordinaries Accumulation Index (including dividends) fell 4.8% over the June quarter, returning 12.2% over the 2010/11 financial year. This result reflects ongoing risk aversion as a result of ongoing uncertainty concerning global markets, the sovereign debt situation in the peripheral European countries and the risk of contagion to larger economies, as well as the recent softness in US economic data. In terms of relative performance, a high Australian dollar makes Australian shares more expensive for international investors and the prospect of new government taxes has created additional uncertainty.

Heightened uncertainty regarding the outlook for the global economy saw industrials outperform resources by nearly 5% over the June quarter. The S&P/ASX 300 Industrials Accumulation Index fell 2.6% for the quarter compared to a 7.5% fall in the S&P/ASX 300 Resources Accumulation Index. Annually resources doubled the returns of industrials, up 18.3% versus 9.2% for industrials.

Sectoral performance also confirmed a clear flight to safety, with the Telcos (3.0% QoQ, -9.5% YoY), Utilities (3.0% QoQ, 7.3% YoY) and Consumer Staples (1.9% QoQ, 6.7% YoY) sectors being the only sectors

to record quarterly gains. The Energy (-11.5% QoQ, 7.0% YoY), Information Technology (-8.9% QoQ, -16.6% YoY), Consumer Discretionary (-8.1% QoQ, -4.4% YoY) and Materials (-6.0% QoQ, 18.1% YoY) sectors were the worst performing sectors over the quarter.

The top performing stocks for the quarter were Sigma Pharmaceutical (58.2% QoQ, 82.7% YoY), Iluka Resources (37.2% QoQ, 260.1% YoY), Telecom Corporation (27.0% QoQ, 22.9% YoY) and Foster's Group (22.7% QoQ, 24.9% YoY). Sigma's share price reflects a perceived turnaround in the business, after addressing a number of woes facing the business as well as reducing its heavy debt load through the sale of its pharmaceutical business. Iluka continues its impressive run following strong price rises in Zircon, improved production and further potential exploration upside. Foster's price was boosted by a takeover offer from SAB Miller, the world's second largest brewer, which Fosters rejected as being too low, just two months after the Foster's de-merger.

The worst performing stocks for the June quarter were Gunns Limited (-55.7% QoQ, -55.7% YoY), Energy Resources (-48.8% QoQ, -69.2% YoY) and BlueScope Steel (-39.0% QoQ, -42.6% YoY). Gunns has been mired by ongoing difficulties in the performance of its woodchip export business and continues to defend a shareholder class action in relation to whether these difficulties have been appropriately disclosed to investors. Energy Resources share price was hit hard as a result of investor aversion to the uranium industry following the Fukushima nuclear disaster in Japan. BlueScope faces the same headwinds as global steel makers in terms of excess capacity and strong raw materials supplier pricing power. For BlueScope, this has been exacerbated by a strong Australian dollar and pending government tax changes.

For the remainder of 2011, the Australian equity market will continue to follow international equity markets as they respond to the various issues unfolding around the globe. While volatility is expected to continue, Lonsec believe "the market looks attractively valued, particularly if the global recovery continues and the domestic economy gains momentum throughout the year. New government taxes remain a key risk, but are not expected to adversely impact overall economic growth - although some industries may be impacted more harshly than others."

International Shares

After a notably volatile quarter, global equities rallied strongly in the final week of June following the successful vote on Greek austerity measures.



However, this was not enough to push global equities into positive territory over the quarter, in Australian dollar terms. The MSCI World Index (ex-Australia) USD returned 0.5% over the quarter and an impressive 30.1% for the financial year. The surging Australian dollar (3.8% QoQ, 27.5% YoY) saw negative quarterly returns of -3.2% and eroded the annual gain back to just 2.1% for unhedged Australian investors. The Australian dollar concluded June buying \$1.07 US dollars.

Internationally, financials was one of the worst performing sectors amid concerns further escalation in the European sovereign debt saga will spill over into financial stability issues. Energy stocks were also sold off, but this was more likely the result of profit-taking after the strong returns generated earlier this year. Healthcare and consumer staples were the best performing international sectors, although the market was not representative of a complete cycle back to defensive sectors, with utilities and telcos recording more subdued results.

US equity indices finished the quarter relatively unchanged, as a result of a rally in the last week of June. The Dow Jones was the only major US index to end the quarter in positive territory, up 0.8% for a 27.0% annual return. The S&P 500 (-0.4% QoQ, 28.1% YoY) and the NASDAQ (-0.3% QoQ, 31.5% YoY) both fell over the quarter but enjoyed strong performance on an annual basis. The key factor influencing US stock prices over the September quarter will be the results of the reporting season and at the time of writing, the figures reported by Google, Apple and IBM have set a very positive tone.

While markets in the European periphery struggled through the first half of the year, the core European markets, continued to perform strongly, as has been the case for most of 2011. German DAX index rose 4.9% over the June quarter and 23.6% over the past 12 months. The French CAC40 Index (-0.2% QoQ, 15.7% YoY) and UK FTSE (0.6% QoQ, 20.9% YoY) are trailing the German market on an annual basis but still held up well given the difficulties experienced by their neighbours.

Asian markets were generally weaker over the June quarter. Asian equity markets were plagued by the same worries over the European debt crisis, the global growth outlook, the US economic recovery and with additional lingering concerns over inflation and policy responses in the region. China's Shanghai B index (-5.7% QoQ, 15.2% YoY) and India's SENSEX index (-3.1% QoQ, 6.5% YoY) were amongst the worst in the region. The Japanese Nikkei index (0.6% QoQ, 4.6% YoY) managed to etch out a gain as the recovery process gathers momentum after the tragic disasters

experienced earlier in the year.

According to Lonsec, "international shares (ex-US) appear reasonably priced at around 12.4x 2011 forecast earnings and 10.9x 2012 forecast earnings. However, supportive valuations and an underlying trend of improving global growth have been partly overshadowed by an increase in shorter term risks. These include ongoing uncertainty concerning global markets, particularly the situation in the peripheral European countries and the risk of contagion to larger economies, such as Germany and France, as well as ongoing softness in US economic data.

The AUD/USD is currently trading at around 1.07 and it is difficult to see a catalyst for the AUD rallying in FY12, to the extent that it did in FY11. With monetary policy seemingly on hold in Australia, it is likely the currency will be more contained in the short term."

Property Securities

The S&P/ASX 300 A-REIT Accumulation Index fell slightly over the June quarter, down 0.5%, for a modest 5.9% annual gain. The UBS Global Property Investors' Index AUD rose 4.9% over the quarter and 37.8% over the past 12 months.

The retail AREIT sector (-3.0% QoQ, 0.0% YoY) has faced considerable negative sentiment since Australia's last interest rate hike. A strong AUD has also driven an increase in online shopping and seen retail tenant demand fall, with some large name occupants such as Borders and Angus & Robertson going into administration. This has resulted in weakness in stocks such as Westfield Group (-7.9% QoQ, -9.0% YoY), Westfield Retail Trust (2.7% QoQ, 2.7% YoY) and CFS Retail (-1.4% QoQ, -4.0% YoY). The significant proportion of the local A-REITs market made up by Westfield has led to the overall decline in the index, with all sectors outside the retail sector recording relatively strong annual returns.

Other local pressures facing the sector include the possibility of further interest rate rises and the effect this will have on an already expensive domestic residential property market. The high Australian dollar is placing additional pressure on the local A-REIT market, by increasing the cost of accessing the sector for international investors. The Australian property securities sector is also feeling the pressures of the same previously mentioned global macroeconomic issues facing growth asset markets more generally.

There is little stock specific news to report, with the only key focus being tension between activist shareholders of Charter Hall Office, who seek to



change the trust's property manager. Around 50% of the sector announced their half yearly distributions, with very few surprises observed.

The relative instability of listed property trust prices over the last 2 years has resulted in subdued investor interest in the sector. This is despite several improvements within the sector, not limited to more prudent payout ratios, reduced leverage, and renewed management focus on the core business of managing property portfolios and attractive sustainable yields of around 6%. In a market dominated by a defensive mindset, yields drifting above long-term government bond yields should see investors beginning to pay more attention to the sector. Lonsec "continues to prefer domestic REITs over global REITs, due to the better economic fundamentals of Australia, the more advanced recapitalisation process and the relatively more defensive characteristics of the domestic market. The A-REIT sector has recently moved down to the lower bound of its two year 840-900 trading range and looks to offer reasonable value."

Fixed Interest & Cash

The RBA have left the cash rate on hold at 4.75%, since November 2010. The RBA face the difficult task of having to balance the needs of a "two speed economy", where inflationary pressures are growing in pockets of the economy, while domestic data remains soft elsewhere. Consensus interest rate expectations have shifted from interest rate rises later in the year, to interest rates remaining on hold throughout 2011. Westpac has moved against consensus, predicting the next interest rate move to be down.

Most central banks in the major developed economies continue to err on the side of caution, leaving short-term interest rates very low over the first three months of 2011. The European Central Bank was one of the exceptions and followed up its April rate rise with a further 0.25% rise in July, placing the official rate at 1.5%. The Peoples Bank of China was another exception, raising its one-year lending rate target by 0.25% to 6.56% in early July. China's battle to contain inflation has resulted in 3 interest rate rises this financial year alongside limits being placed on the amount of money banks are allowed to lend.

Both Australian and US Government bonds yields fell over the quarter following weaker economic data from the US and Europe's debt fragility. This trend was reversed late in the quarter following positive developments in Greece and some improved US economic data. June also marked the official end of the second round of quantitative easing by the Federal Reserve. The UBS Composite Bond Index returned

2.3% over the June quarter and 5.5% over the 2010/11 financial year while the Citigroup World ex Australia GBI (hedged) in \$A returned 2.7% for the quarter and 5.4% annually.

Lonsec have provided the following guidance in relation to defensive assets: "Deposit rates currently on offer to retail investors are particularly attractive in a risk return sense, while the Commonwealth Government guarantee remains in place (until October 2011). However, Lonsec cautions against extensive use of long dated fixed term deposits (3-5 years), given the liquidity and interest rate risks. The Australian bond yield curve is particularly flat, with 10 year government bonds yielding 5.23% at the time of writing (versus wholesale cash rates at 4.75%). Therefore, investors in long dated term deposits have greater exposure to interest rate risk, as a rise in rates will make current longer dated term deposits less attractive.

Furthermore, global bond yields are expected to remain at relatively low levels, although the risks are to the upside (i.e greater risk of yields rising rather than falling). A rise in bond yields will have a negative impact on the capital value of bonds. Credit markets appear to have stabilised at current levels and continue to offer reasonably attractive returns for the risk."

Investment Market Summary as at 30 June 2011



Stock Market Indices to 30 June 2011		1yr % pa	3yrs % pa	5yrs % pa	7yrs % pa
ASX All Ordinaries Accumulation Index		12.17	-0.21	2.61	8.43
S&P/ASX 300 Industrials Accumulation Index		9.22	2.26	0.30	5.51
S&P/ASX 300 Resources Accumulation Index		18.26	-3.31	8.16	18.58
S&P/ASX 300 Listed Prop. Accumulation Index		5.87	-9.65	-10.32	-2.95
Dow Jones Industrial Index - US		27.01	3.03	2.17	2.51
Standard & Poors 500 Index - US		28.13	1.05	0.78	2.11
Nikkei Dow Index - Japan		4.62	-10.04	-8.74	-2.66
Dax Index – Germany		23.65	4.75	5.35	8.93
FT-SE 100 Index – UK		20.92	1.86	0.38	4.18
Shanghai B Index - China		15.16	0.32	10.56	10.20
MSCI World Acc Index net divs in \$A		2.06	-3.09	-5.16	-1.14

Australian House Prices to 31 March 2011	Median Value (\$'000s)*	1yr % pa	3yrs % pa	5yrs % pa	7yrs % pa
Sydney	632.0	8.70	4.91	3.95	1.99
Melbourne	556.5	13.46	8.61	9.05	5.88
Brisbane	449.4	2.65	4.47	7.30	7.09
Adelaide	407.9	6.75	6.31	8.06	8.16
Hobart	372.6	3.93	4.88	6.54	8.57
Perth	487.8	8.02	1.99	9.97	11.95

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

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