McGregor Asset Consulting

Economic and Market Commentary
August 2012

Financial markets continue to behave erratically as European uncertainty and low growth in the US dominate decision making. European focus has shifted to the ECB and how Spain's deteriorating financial position is best rectified. Spain's banking sector has deteriorated markedly with around 50% of the sector in a severe state of impairment requiring urgent recapitalising. Europe is likely to move into a long period of recession and low growth which could take many years to work through. Pressure is likely to come onto the ECB to lower interest rates further and seek more stimulus solutions from the Euro zone leaders and politicians. Germany is becoming alone voice in pushing for spending constraints in the region while other Euro zone countries push for more stimulus. It appears that the probability of Greece remaining in the Euro has increased at least until 2013. Risk assets remain volatile in the short term.

The next concern within the Euro zone is how Spain, Italy and France deal with their economies. It may well evolve that the Spanish government has to nationalise the banks to protect them from a run on the banks deposits. It is also becoming more likely that the ECB may well implement a US style rescue with banks being provided with billions of Euros of preference capital in order to stabilise the region. Labour costs in the Southern European region remain a concern being around 30% higher than the North. The Spanish housing price crash has resulted in around a million houses remaining vacant. Of significant concern is whether the politicians and bureaucrats can maintain the discipline to deliver an orderly restructure across the euro zone. To date this has been a weakness. European Union leaders have a significant challenge as the region moves into lower growth and recession and the general public (voters) vote out governments. Social unrest is also likely to be a significant issue as 2012 unfolds with confidence remaining uncertain. The Euro currency is likely to remain under pressure as the market forces impact. Spanish and Italian bond rates remain volatile while sentiment is uncertain.

The US is now well into the election process with the Republican Party announcing Paul Ryan as Mitt Romney's vice presidential candidate to take on Barrack Obama and Joe Biden. The election process appears to be deflecting major issues around the US economy and should see a focus on job creation to lower the unemployment rate which is holding around 8.2%. The underlying US economy continues to produce positive growth although at low levels (in the region of 2%) and a more upbeat corporate and banking sector. Positives for the US has been the strong state of the energy market which has added the equivalent of 1.4 billion barrels of oil to the economy and the gas sector moving to an exporter (currently an importer) of gas by 2015. This is expected to add significant jobs to the economy.

US consumer confidence is improving from a low base while US corporates are the bright spot for the economy, delivering solid earnings. They are generally well cashed up and have access to funding at very low rates (1-2%) and a weak US$. The US housing market is beginning to show positive signs of bottoming and that the worst may be over but the road to recovery is likely to be slow and long. Inflation in the US is not an issue at this stage [although with inflation now below 2% and 10 year bonds around 1.6% producing a negative real return which cannot be maintained] Bond markets appear to be signalling a move to protracted low world economic growth environment. The looming head wind for the US is the prolonged drought now severely impacting the agricultural sector with corn and wheat projections being revised down markedly. The IMF has lowered the global growth forecast to 3.5% (from 3.6%) for this year and 3.9% (from 4.1%) for next year.

The emerging world is in better shape and is likely to account for most of the global growth in the year ahead. China remains key to world growth and is presently undergoing a slowing in growth (now below 8%). Exports are showing clear signs of being impacted by the slowdown in Europe. The slowing is also a result of the Chinese leadership policies to restrain lending and reduce inflationary pressures in both goods and services, and property. This has worked with inflation now below 2% and now interest rates are being cut to provide a stimulus. The Chinese Yuan has slowly been allowed to appreciate against the US$ and this is assisting in controlling the inflation level. There appears strong consensus that the new Chinese leadership which will take control towards the end of the year are focussed on delivering in the region of 6 - 8% GDP which should provide the stimulus to underpin world growth.

The Australian economy is currently dealing with the uncertainty created by a slowing in the resources sector with major cut backs in a wide range of large resource projects due largely to the lower commodity prices and

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higher labour costs. Political uncertainty is also making business decisions more difficult.

The positive for Australia is that it is now linked more and more into China and the greater Asian economies. This should provide opportunities in our financial markets over the medium to long term. China is not immune from the problems of the western world and is also being impacted by the slow-down which is having flow on implications for Australia in the short term, especially for commodity prices which are likely to fall further in the short term. China is likely to be confronted with more and more imbalances as the surge of urbanisation continues. There is now over 50% of the Chinese population urbanised and this is likely to create greater pressures for the leadership as the wealth of the population increases.

A major headwind for the Australian market is the strong A$ making it difficult for manufacturers, exporters, retailers and tourism. The A$ is being rerated as a safe haven currency which has under pinned its strength. At the beginning of the year a major Australian bank had 30 global central banks inquire into arrangements for accounts in Australian dollars. This action has supported the A$ as commodity prices fall, which in the past would have been a major disconnect. The company reporting period has overall generated a mix of strong profit results with the exception being the materials and mining sectors led by BHP and RIO being down in the region of 30% and slashing project spending over the coming years by $50 billion in BHP's case. Substantial investment continues to be made into the gas and energy sector which should underpin the growth rate. The resource sector is undergoing a commodity price readjustment from the high levels of a year ago.

The RBA has signalled a neutral stance on cash rates which are being held at 3.5%. The lower short term interest rates is likely to reduce the attractiveness of term deposits and stimulate flows into high yielding equities with sustainable or growing dividends. The banks are currently offering 6% yields before franking. With the strong rally in Australian bonds, valuations for equities are becoming increasingly attractive. Managers with good stock picking skills should outperform in this environment. The focus on quality stocks along with dividends and high yield should ultimately reward equities investors over the medium term.

Commercial and retail property valuations are starting to offer better value and long term investors are re-entering the market. More interest is emerging in the listed REIT space as companies repair their balance sheets.

- **International shares: [Overweight]** A strong Aust$ v US$ provides opportunities for international shares (unhedged) and an overweight position is appropriate for the sector. Asia and emerging markets remain long term growth regions. Stock and country selection is going to be much more important over the coming year as volatility remains high. Europe is likely to remain subdued, while the US offers opportunities.
- **Australian shares: [Neutral] Australian Small Caps: [Neutral]** Valuations are becoming more compelling. The focus should be on quality large cap companies with strong income streams in this environment. Consider a benchmark weighting appropriate on a three-year outlook.
- **Australian Listed Property: [Underweight] Global Listed Property: [Underweight]** Property securities are likely to underperform equities on a three year outlook and suggest under weighting the sector. Quality direct property is showing signs of recovery although likely to be slow as access to funding remains difficult. The listed property sector provides limited opportunities.
- **Fixed Interest: [Underweight]** With interest rates at low levels globally and in Australia, opportunities for fixed interest are likely to be limited over the coming year. An underweight for the sector is appropriate. A cautious approach to global sovereign debt is required with opportunities for corporate bonds preferred.
- **Cash: [Overweight]** The risk return profile of Cash and Term Deposits is becoming less attractive. Use for defensive purposes in this volatile environment.

Risks

- The risk of sovereign debt defaults remains high with the large deficits being run by many countries. They now need to manage carefully the wind back. Investors need to be selective.
- The European Union faces major challenges in managing member countries, especially Greece in near collapse, also Spain, Portugal, Italy and Ireland with large debt issues and the lack of discipline to control the predicament.
- Growing tensions in the Middle East, especially Syria, Iran and Egypt may lead to an escalation in hostilities in the region.

- With large US debt levels ($15 trillion), strong political will is required to enact the necessary measures to reduce the debt levels. This is likely to be difficult as the US fiscal stimulus winds down at the end of the year with the Bush tax cuts ending.
- China's policies, (especially in relation to currency management) and actions in doing business with the US and other major trade partners is likely to be a major influence on world markets.
- Increased social unrest within China maybe an issue with the large urbanisation of the country.
- Poor policy decisions around the Federal budget target of a surplus in the coming financial year may be detrimental to growth in the economy.

Global Opportunities

- The Asian region continues to generate satisfactory GDP growth, although slowing and should continue to be a major driver of world growth. Asia should continue to create opportunities for Australian investors although with periods of volatility like we have been experiencing.
- A key factor for continued Asian growth is the increasing demand by China's consumers as they develop greater wealth and require ever increasing volumes of commodities and agricultural products, which should underpin the Australian resources and agricultural sectors over the longer term.

Australia

- Resources and energy remain key to the strength of the economy and should continue to play a leading role in the market direction during 2012 although currently experiencing a decline . Significant capital expenditure is being committed to the energy (gas) and resources sector over the coming years.
- Opportunities should continue as China and India evolve into stronger economies over the coming decade and demand for quality Australian resource companies exporting to China and India should be under pinned over the longer term.

Fixed Interest and Property

- Opportunities for higher returns from traditional fixed interest have been reduced with interest rates at low levels. The market has already factored in lower rates. Limited opportunities prevail in the lower grade credit markets.
- The listed property trust sector is now in better shape to participate in a stronger property cycle.

Monthly Share Market Performance over the last Thirteen Months

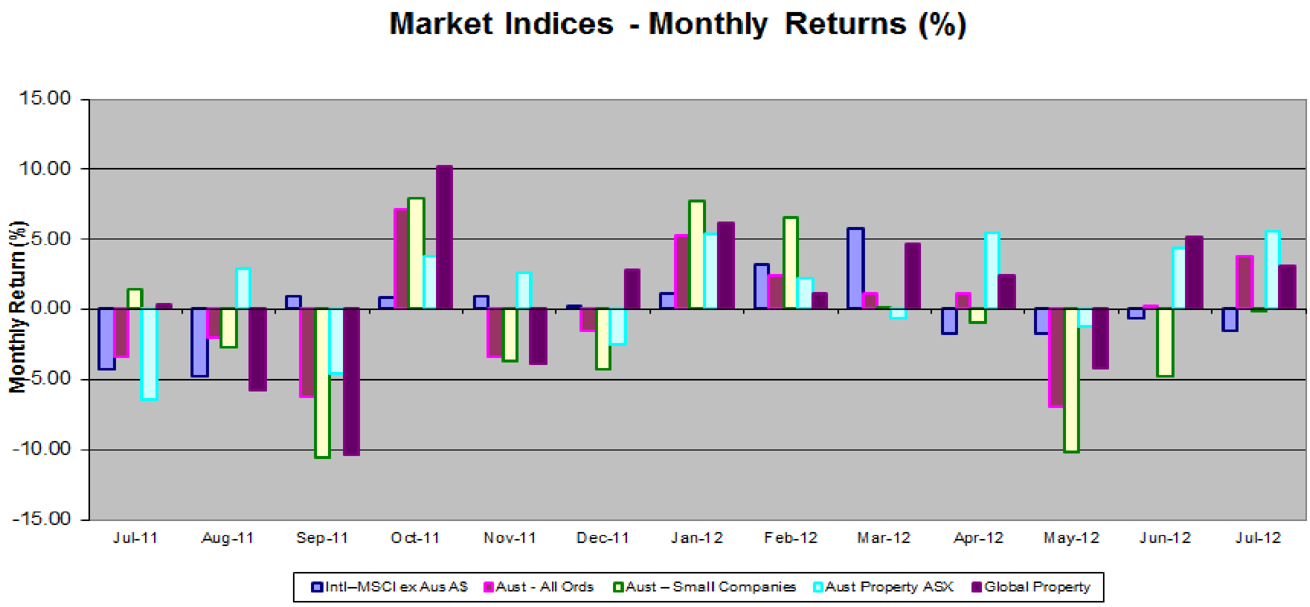
Market Indices	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12
Intl–MSCI ex A A$	-4.29	-4.77	0.95	0.85	0.93	0.21	1.17	3.24	5.80	-1.73	-1.76	-0.62	-1.56
Aust - All Ords	-3.40	-2.00	-6.27	7.17	-3.43	-1.57	5.23	2.41	1.15	1.10	-6.90	0.25	3.74
Aust – Small Coy	1.40	-2.69	-10.61	7.87	-3.71	-4.30	7.75	6.51	0.19	-0.92	-10.22	-4.78	-0.19
Aust Property ASX	-6.45	2.89	-4.58	3.78	2.65	-2.55	5.40	2.25	-0.59	5.42	-1.24	4.34	5.55
Global Property	0.35	-5.72	-10.41	10.22	-3.90	2.77	6.17	1.11	4.63	2.45	-4.22	5.15	3.08

Annual Share Market Performance

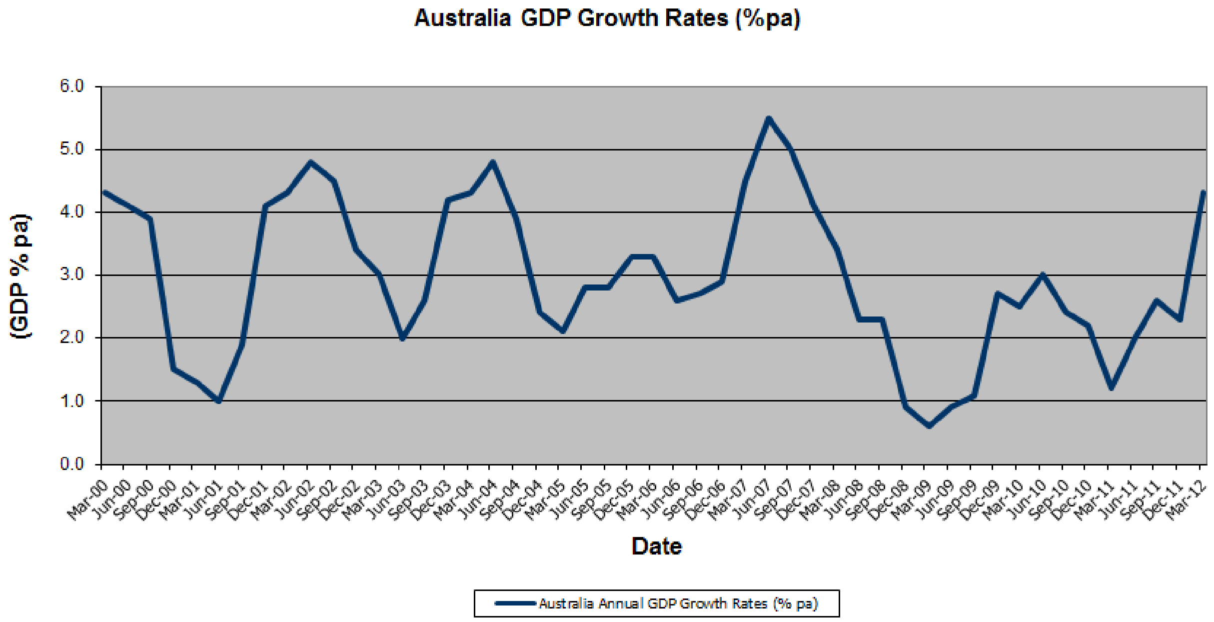
Markets Index	1 Year to 30 Jun 10 %	1 Year to 30 Sep 10 %	1 Year to 31 Dec 10 %	1 Year to 31 Mar 11 %	1 Year to 30 Jun 11 %	1 Year to 30 Sep 11 %	1 Year to 31 Dec 11 %	1 Year to 31 Mar 12 %	1 Year to 30 Jun 12 %	1 Year to 31 Jul 12 %
Intl–MSCI ex A A$	5.22	-2.79	-2.40	0.64	2.66	-4.52	-5.34	0.69	-0.50	2.33
Aust – All Ords	13.78	1.73	3.31	4.80	12.17	-8.43	-11.43	-6.27	-7.04	-0.17
Aust – Small Coy	11.18	6.63	13.05	13.49	16.41	-12.11	-21.43	-8.57	-14.61	-15.94
Aust Prop – ASX	20.34	-4.52	-0.68	4.74	5.87	-6.29	-1.56	1.67	10.98	25.21
Global Property	43.86	24.88	26.15	24.78	36.60	1.06	1.94	8.40	6.93	9.83

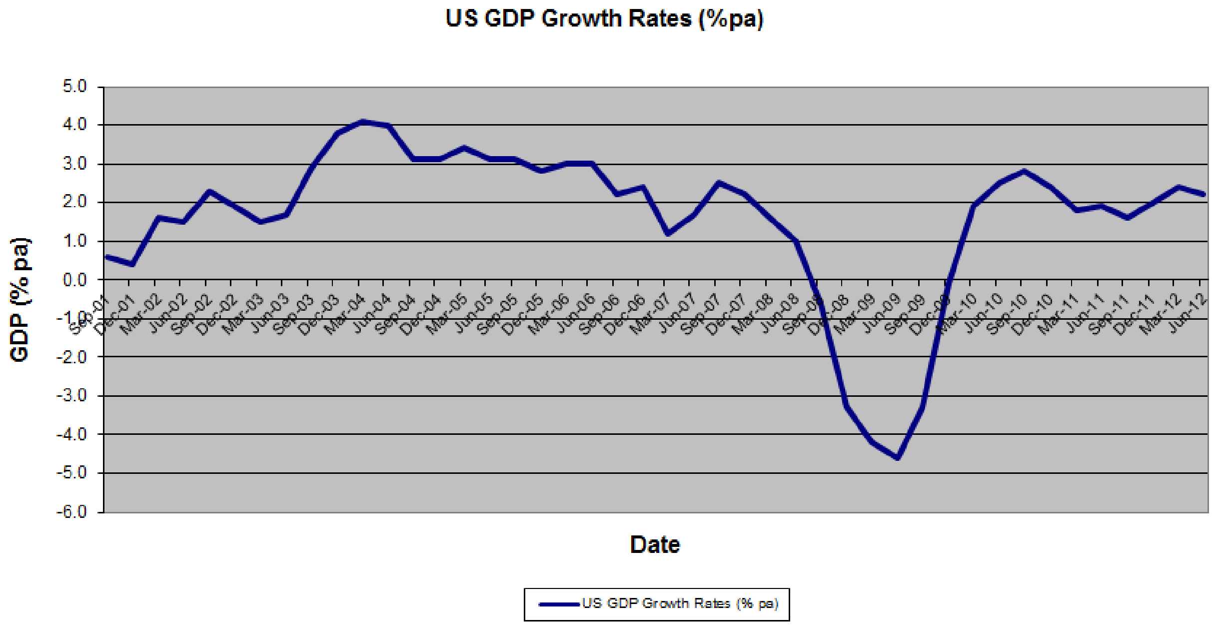
Best Performing Asset Sectors for twelve months ended 31 July 2012

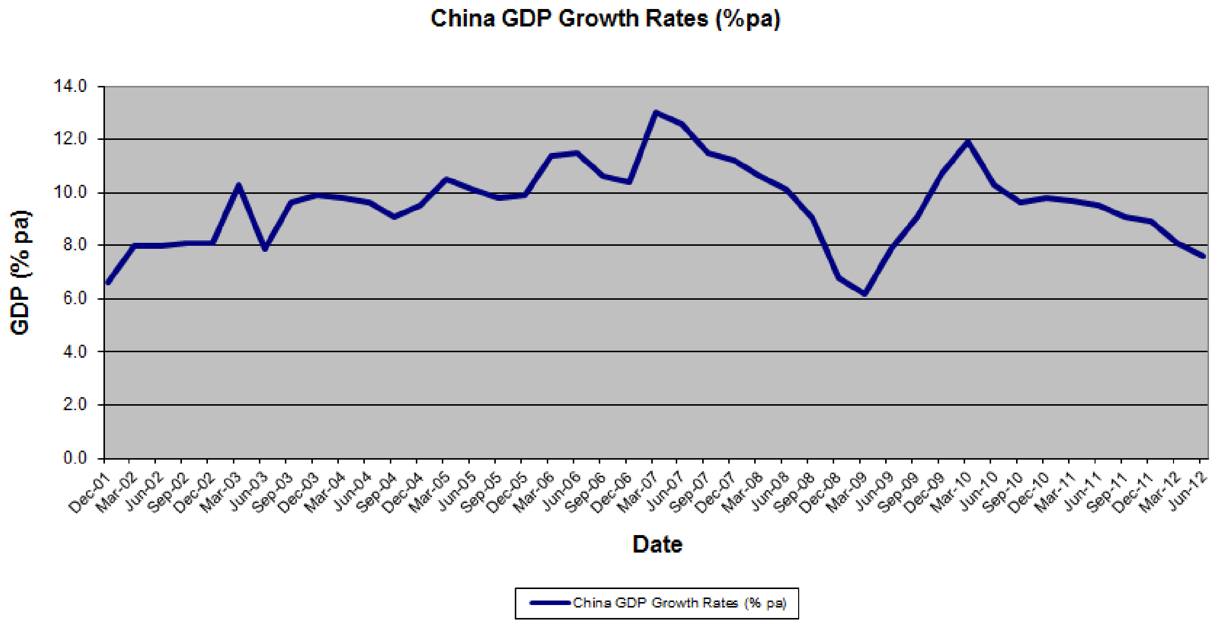
Sector	Market Index	Return
Australian Listed Property	S&P/ASX Property Trusts Accum Index	25.21
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged $A	11.98
Australian Fixed Interest	UBS Warburg Composite 0 + Years	10.97
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge $A	9.83
Cash	Australian 90 Day Bank Accepted Bill	4.57
International Equities Unhedged	MSCI World Ex Aust Accum Index A$	2.33
International Equities Hedged	MSCI World Accum Index Hedged A$	1.63
Australian Shares	S&P/ASX All Ords Accum Index	-0.17
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	-15.94

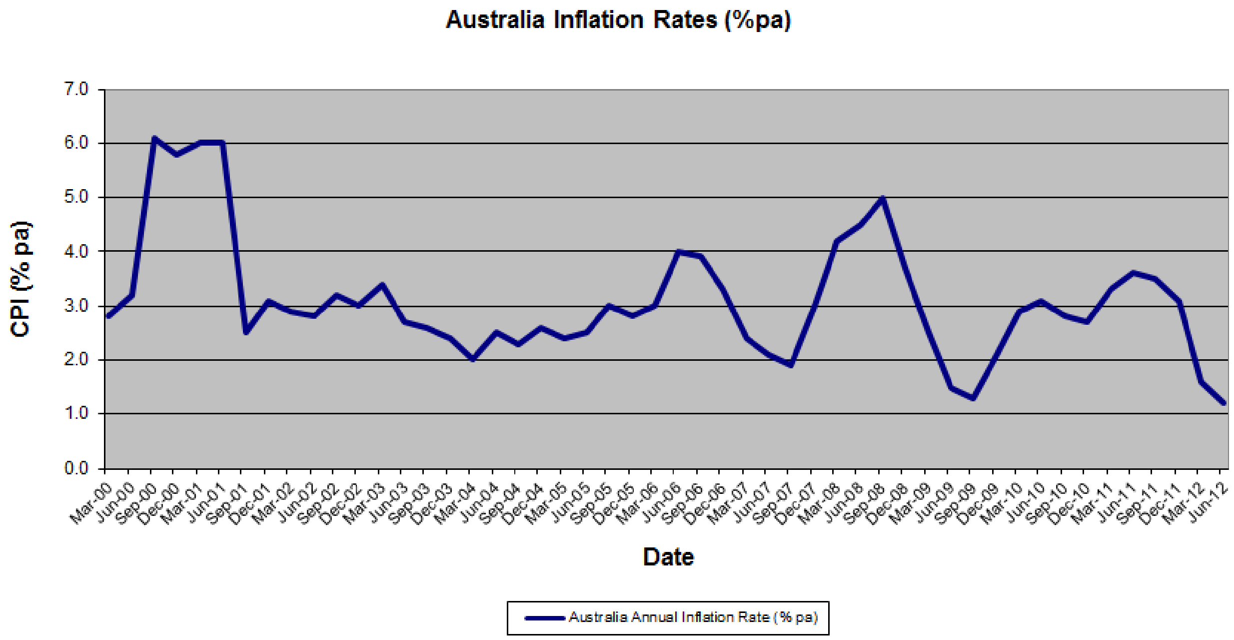


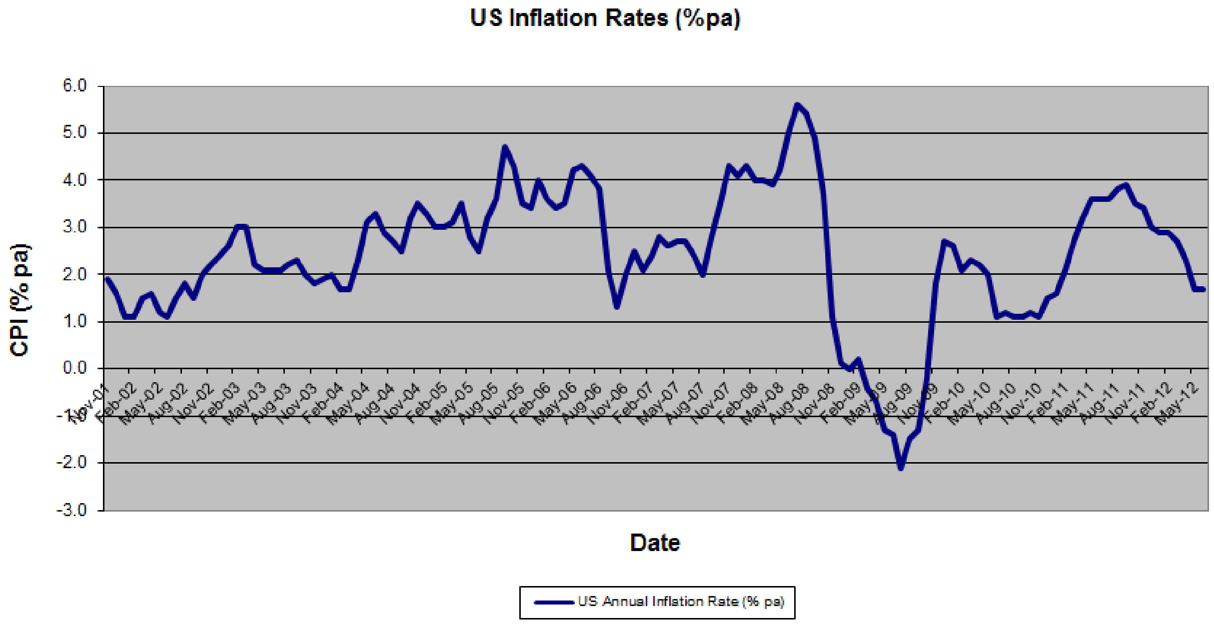
Major Economic Indicators



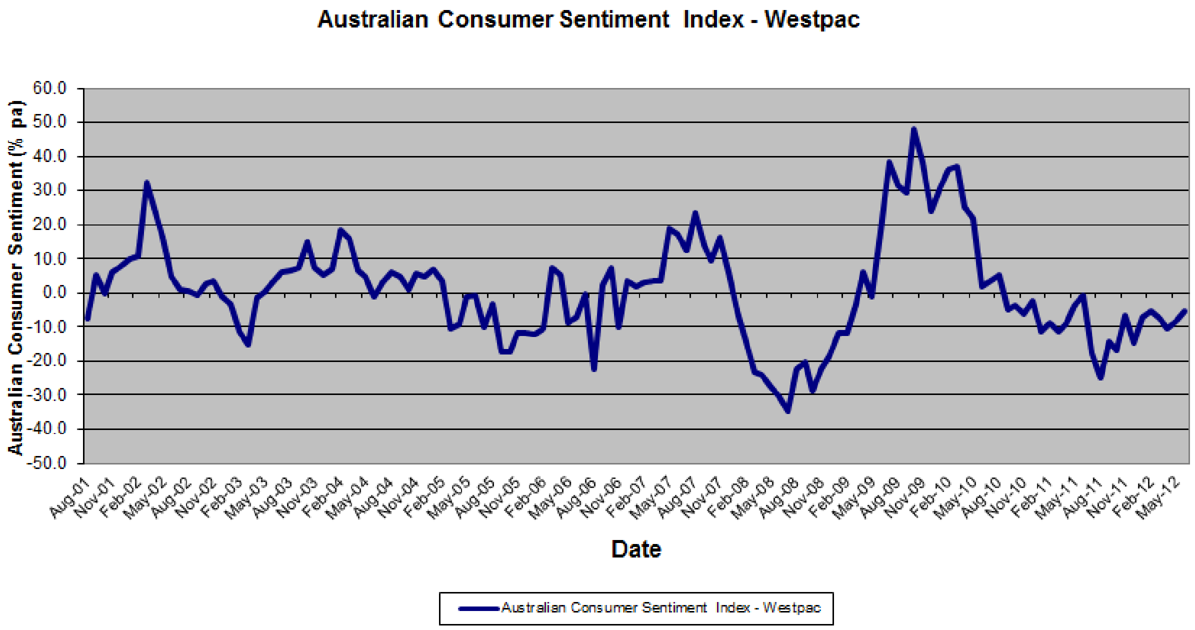



China GDP Growth Rates (%pa)
GDP (% pa)
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
Date
China GDP Growth Rates (% pa)


Australia Inflation Rates (%pa)
CPI (% pa)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Date
Australia Annual Inflation Rate (% pa)


US Inflation Rates (%pa)
CPI (% pa)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-2.0
-3.0
Date
US Annual Inflation Rate (% pa)


China Inflation Rates (%pa)
CPI (% pa)
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
Date
China Annual Inflation Rate (% pa)


Australian Consumer Sentiment Index - Westpac
Australian Consumer Sentiment (% pa)
60.0
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
-30.0
-40.0
-50.0
Aug-01
Nov-01
Feb-02
May-02
Aug-02
Nov-02
Feb-03
May-03
Aug-03
Nov-03
Feb-04
May-04
Aug-04
Nov-04
Feb-05
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Aug-09
Nov-09
Feb-10
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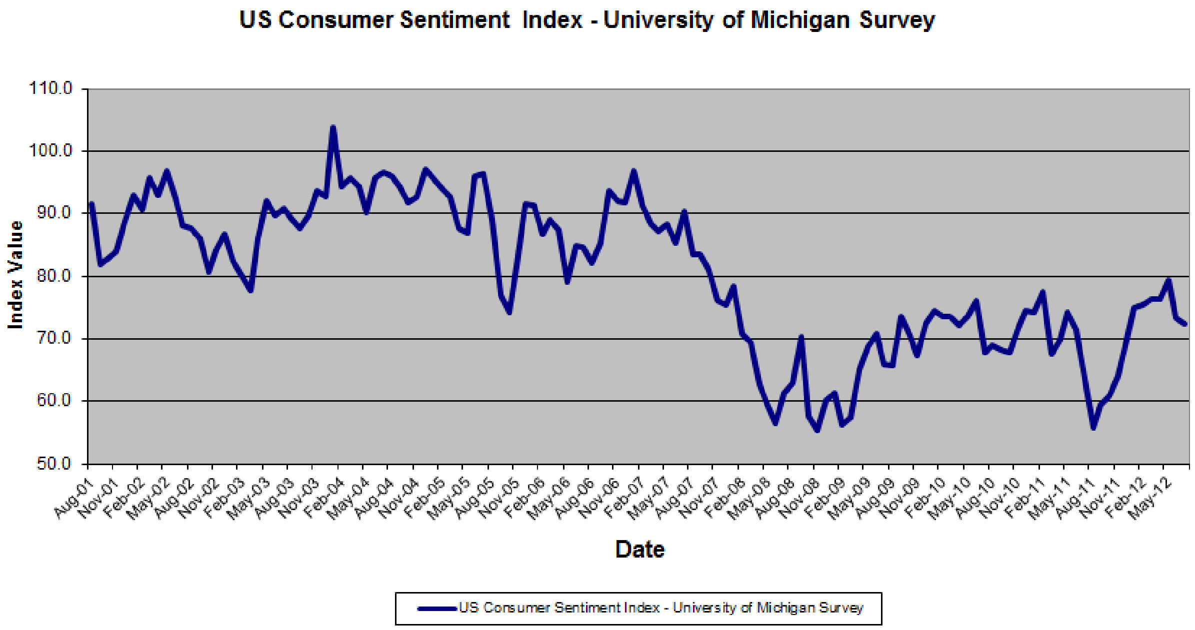
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Date
Australian Consumer Sentiment Index - Westpac


US Consumer Sentiment Index - University of Michigan Survey
Index Value
110.0
100.0
90.0
80.0
70.0
60.0
50.0
Aug-01
Nov-01
Feb-02
May-02
Aug-02
Nov-02
Feb-03
May-03
Aug-03
Nov-03
Feb-04
May-04
Aug-04
Nov-04
Feb-05
May-05
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Feb-08
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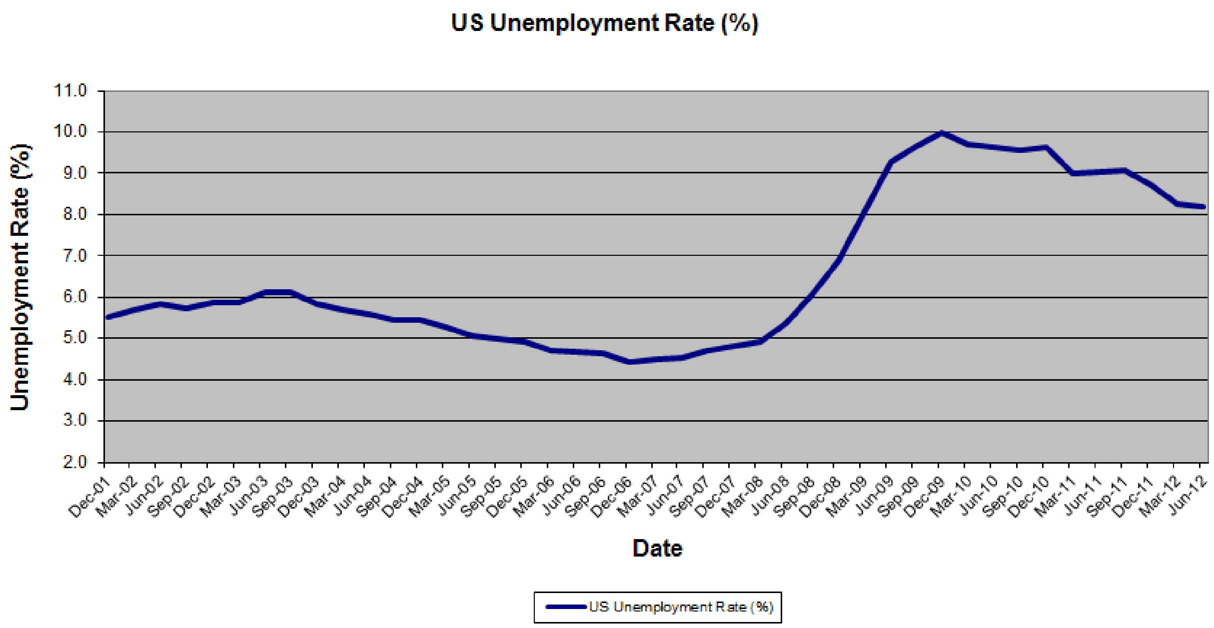
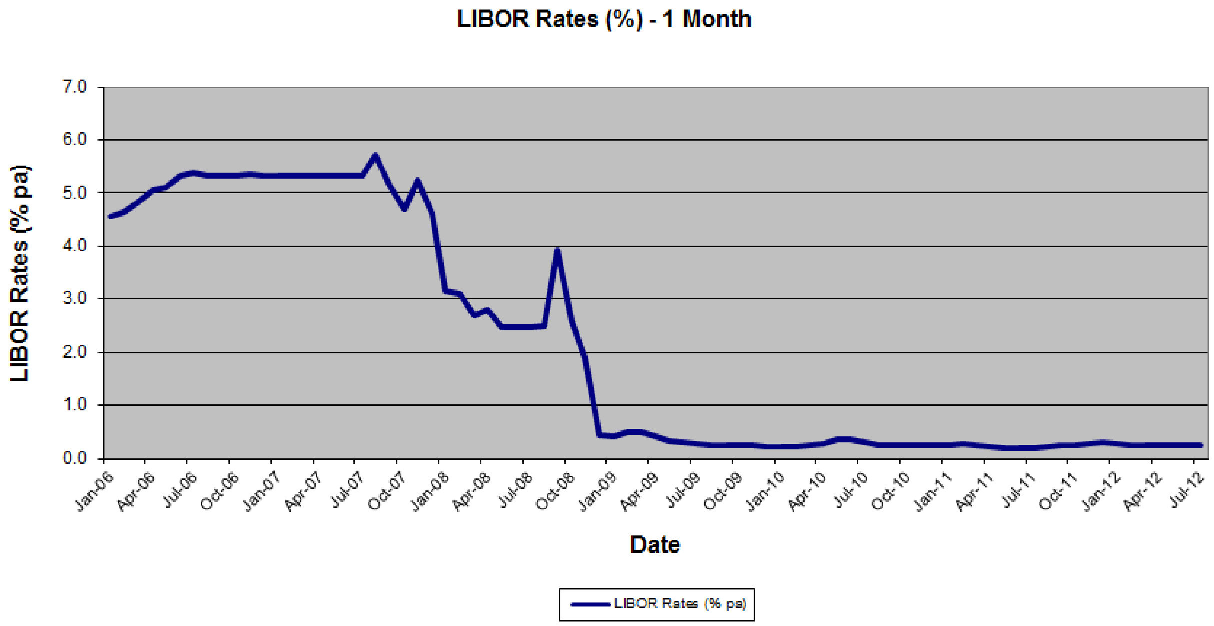
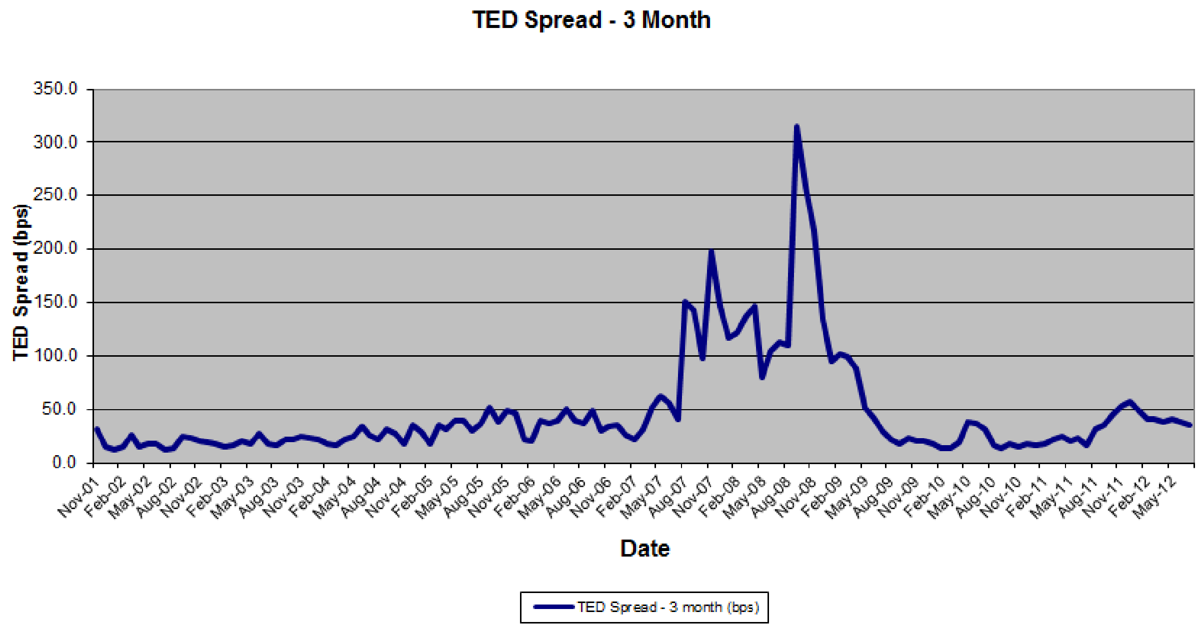
Nov-08
Feb-09
May-09
Aug-09
Nov-09
Feb-10
May-10
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Date
US Consumer Sentiment Index - University of Michigan Survey

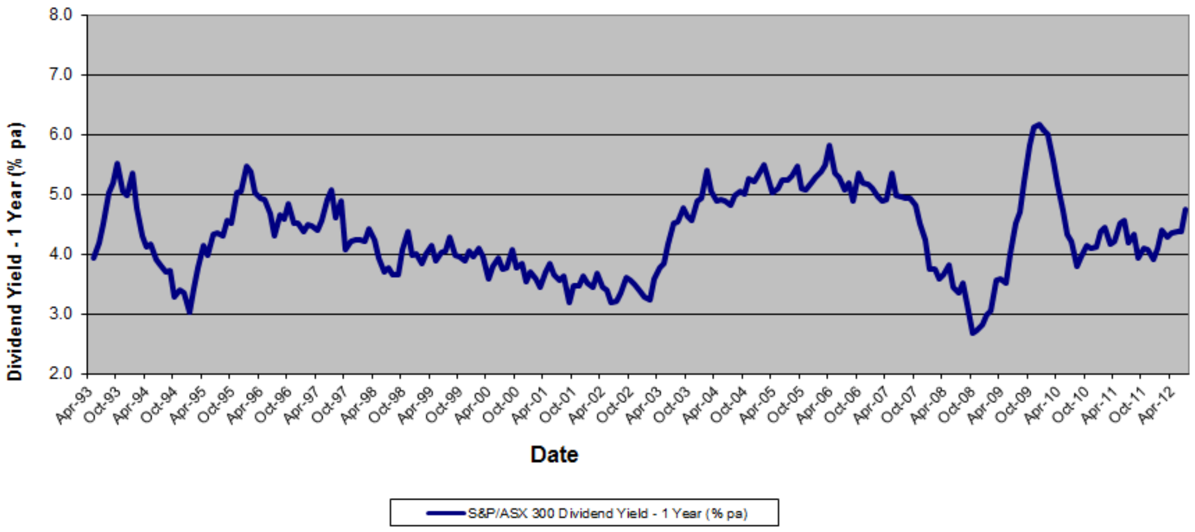

China Retail Sales Value (%pa)
Retail Sales (% pa)
25.0
20.0
15.0
10.0
5.0
0.0
Sep-01 Dec-01 Mar-02 Jun-02 Sep-02 Dec-02 Mar-03 Jun-03 Sep-03 Dec-03 Mar-04 Jun-04 Sep-04 Dec-04 Mar-05 Jun-05 Sep-05 Dec-05 Mar-06 Jun-06 Sep-06 Dec-06 Mar-07 Jun-07 Sep-07 Dec-07 Mar-08 Jun-08 Sep-08 Dec-08 Mar-09 Jun-09 Sep-09 Dec-09 Mar-10 Jun-10 Sep-10 Dec-10 Mar-11 Jun-11 Sep-11 Dec-11 Mar-12 Jun-12
Date
China Retail Sales Value (% pa)


US Unemployment Rate (%)
Unemployment Rate (%)
11.0
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
Dec-01 Mar-02 Jun-02 Sep-02 Dec-02 Mar-03 Jun-03 Sep-03 Dec-03 Mar-04 Jun-04 Sep-04 Dec-04 Mar-05 Jun-05 Sep-05 Dec-05 Mar-06 Jun-06 Sep-06 Dec-06 Mar-07 Jun-07 Sep-07 Dec-07 Mar-08 Jun-08 Sep-08 Dec-08 Mar-09 Jun-09 Sep-09 Dec-09 Mar-10 Jun-10 Sep-10 Dec-10 Mar-11 Jun-11 Sep-11 Dec-11 Mar-12 Jun-12
Date
US Unemployment Rate (%)


LIBOR Rates (%) - 1 Month
LIBOR Rates (% pa)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Jan-06 Apr-06 Jul-06 Oct-06 Jan-07 Apr-07 Jul-07 Oct-07 Jan-08 Apr-08 Jul-08 Oct-08 Jan-09 Apr-09 Jul-09 Oct-09 Jan-10 Apr-10 Jul-10 Oct-10 Jan-11 Apr-11 Jul-11 Oct-11 Jan-12 Apr-12 Jul-12
Date
LIBOR Rates (% pa)

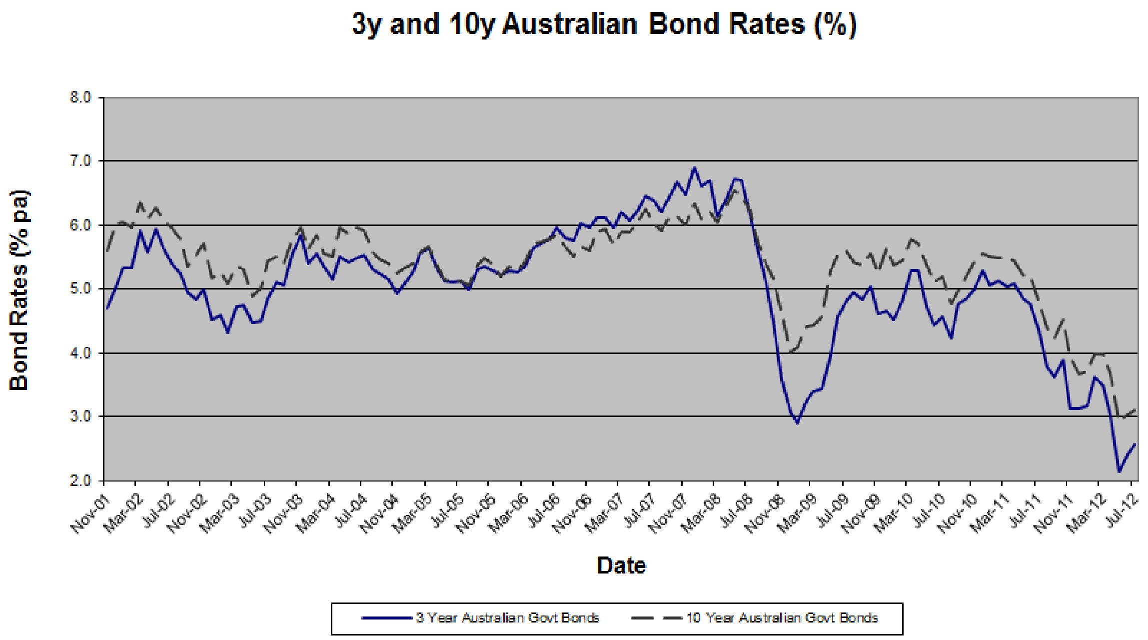

TED Spread - 3 Month
TED Spread (bps)
350.0
300.0
250.0
200.0
150.0
100.0
50.0
0.0
Nov-01 Feb-02 May-02 Aug-02 Nov-02 Feb-03 May-03 Aug-03 Nov-03 Feb-04 May-04 Aug-04 Nov-04 Feb-05 May-05 Aug-05 Nov-05 Feb-06 May-06 Aug-06 Nov-06 Feb-07 May-07 Aug-07 Nov-07 Feb-08 May-08 Aug-08 Nov-08 Feb-09 May-09 Aug-09 Nov-09 Feb-10 May-10 Aug-10 Nov-10 Feb-11 May-11 Aug-11 Nov-11 Feb-12 May-12
Date
TED Spread - 3 month (bps)

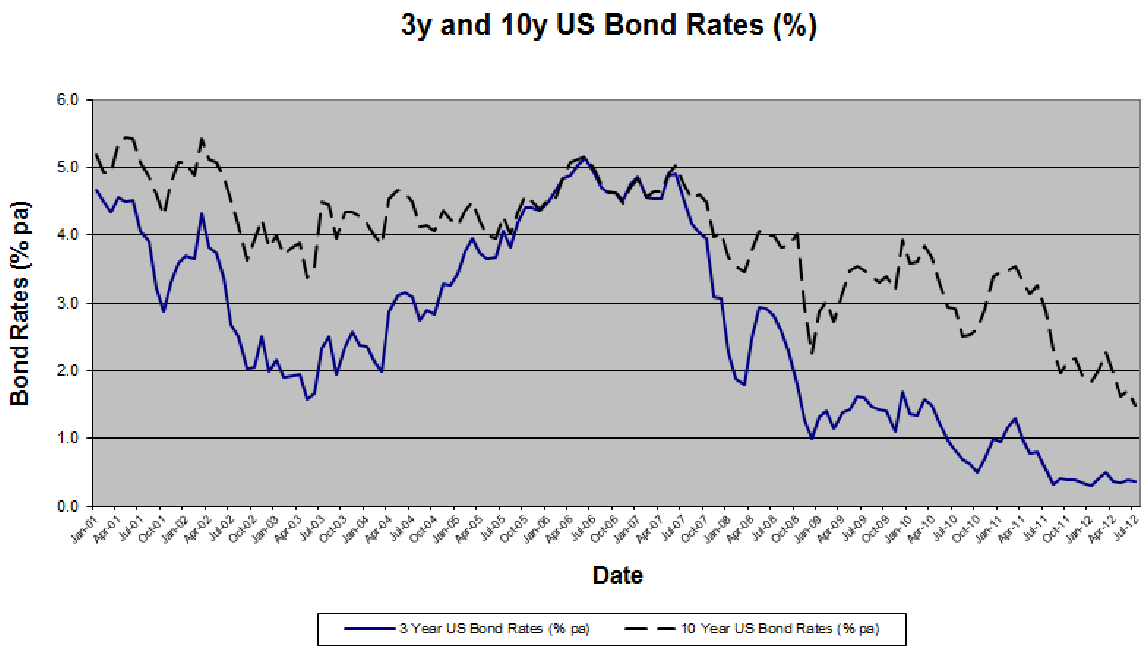
S&P/ASX 300 Dividend Yield - 1 Year (% pa)

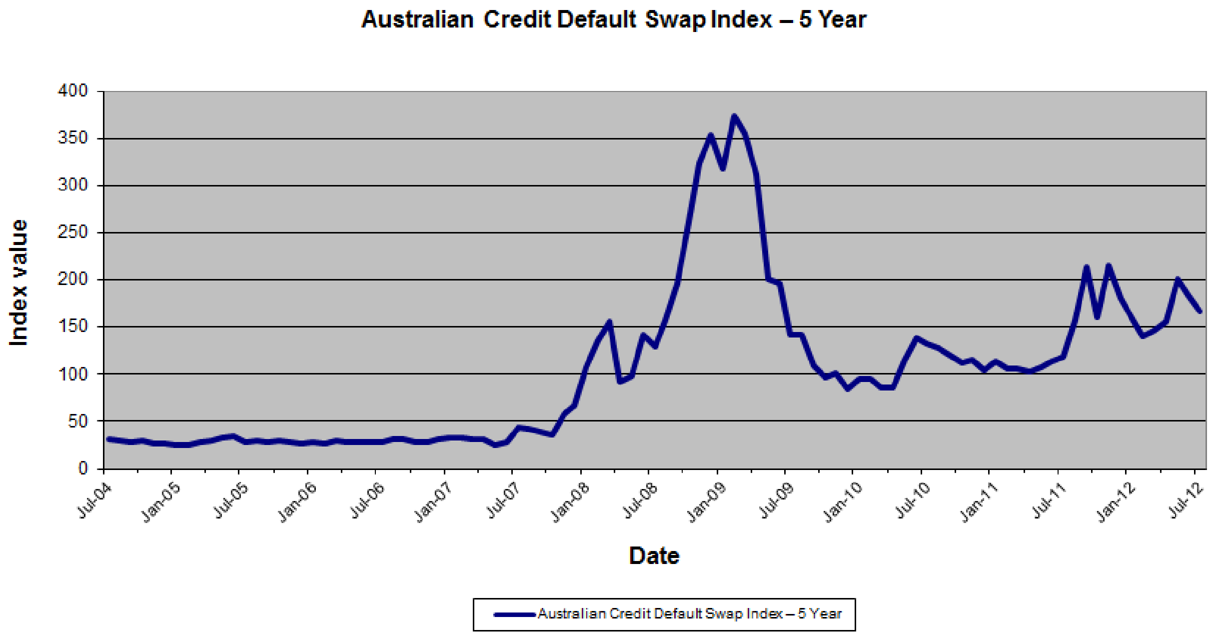


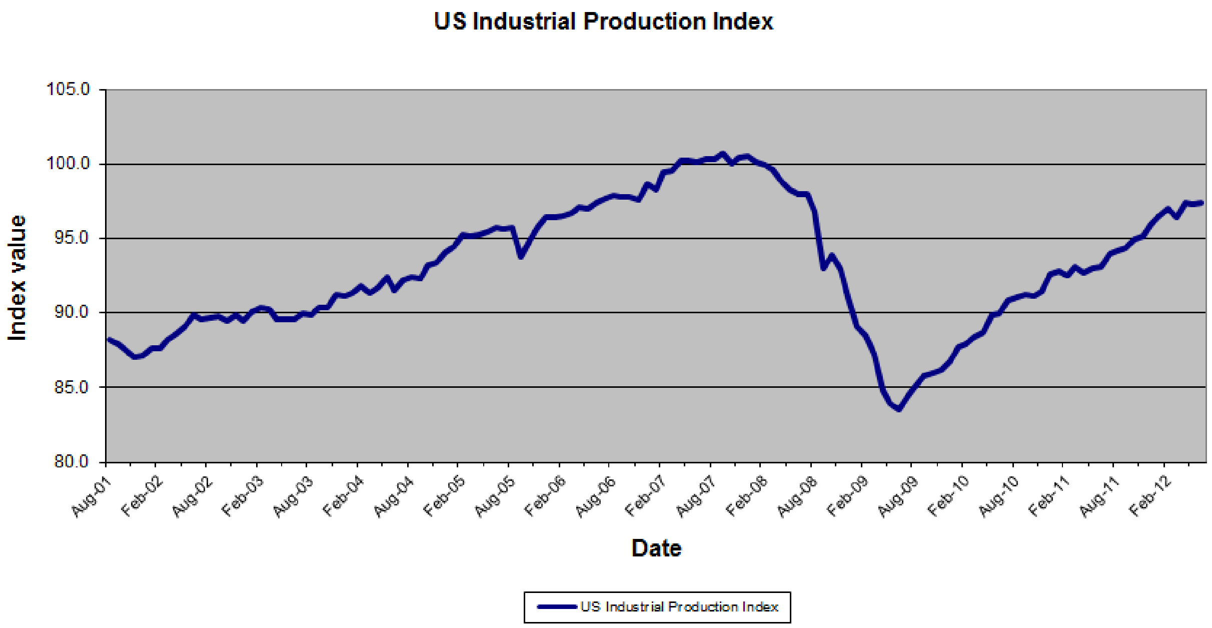
Australian Sharemarket Valuations (X)

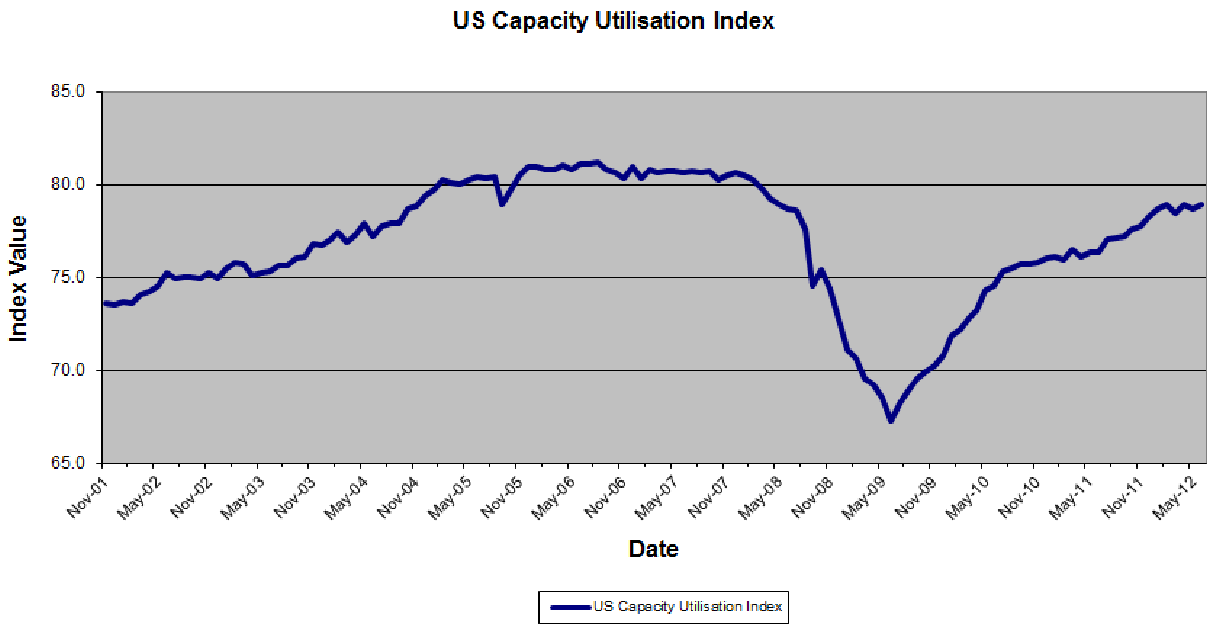
Source: Credit Suisse and Reserve Bank of Australia as at 13 August 2012.


3y and 10y Australian Bond Rates (%)
Bond Rates (% pa)
Date
3 Year Australian Govt Bonds
10 Year Australian Govt Bonds


3y and 10y US Bond Rates (%)
Bond Rates (% pa)
Date
3 Year US Bond Rates (% pa)
10 Year US Bond Rates (% pa)


Australian Credit Default Swap Index – 5 Year
Index value
400
350
300
250
200
150
100
50
0
Jul-04
Jan-05
Jul-05
Jan-06
Jul-06
Jan-07
Jul-07
Jan-08
Jul-08
Jan-09
Jul-09
Jan-10
Jul-10
Jan-11
Jul-11
Jan-12
Jul-12
Date
Australian Credit Default Swap Index – 5 Year


US Industrial Production Index
Index value
105.0
100.0
95.0
90.0
85.0
80.0
Aug-01
Feb-02
Aug-02
Feb-03
Aug-03
Feb-04
Aug-04
Feb-05
Aug-05
Feb-06
Aug-06
Feb-07
Aug-07
Feb-08
Aug-08
Feb-09
Aug-09
Feb-10
Aug-10
Feb-11
Aug-11
Feb-12
Date
US Industrial Production Index


US Capacity Utilisation Index
85.0
80.0
75.0
70.0
65.0
Index Value
Nov-01
May-02
Nov-02
May-03
Nov-03
May-04
Nov-04
May-05
Nov-05
May-06
Nov-06
May-07
Nov-07
May-08
Nov-08
May-09
Nov-09
May-10
Nov-10
May-11
Nov-11
May-12
Date
US Capacity Utilisation Index


China Purchasing Managers Index (PMI)
65.0
60.0
55.0
50.0
45.0
40.0
35.0
Index Value
Feb-05
May-05
Aug-05
Nov-05
Feb-06
May-06
Aug-06
Nov-06
Feb-07
May-07
Aug-07
Nov-07
Feb-08
May-08
Aug-08
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May-09
Aug-09
Nov-09
Feb-10
May-10
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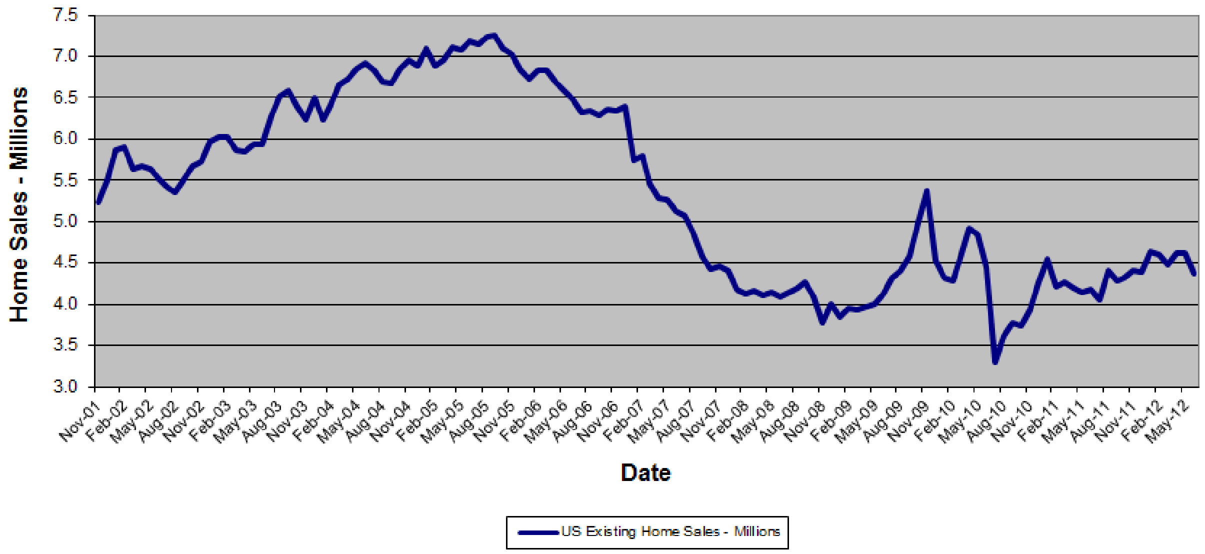
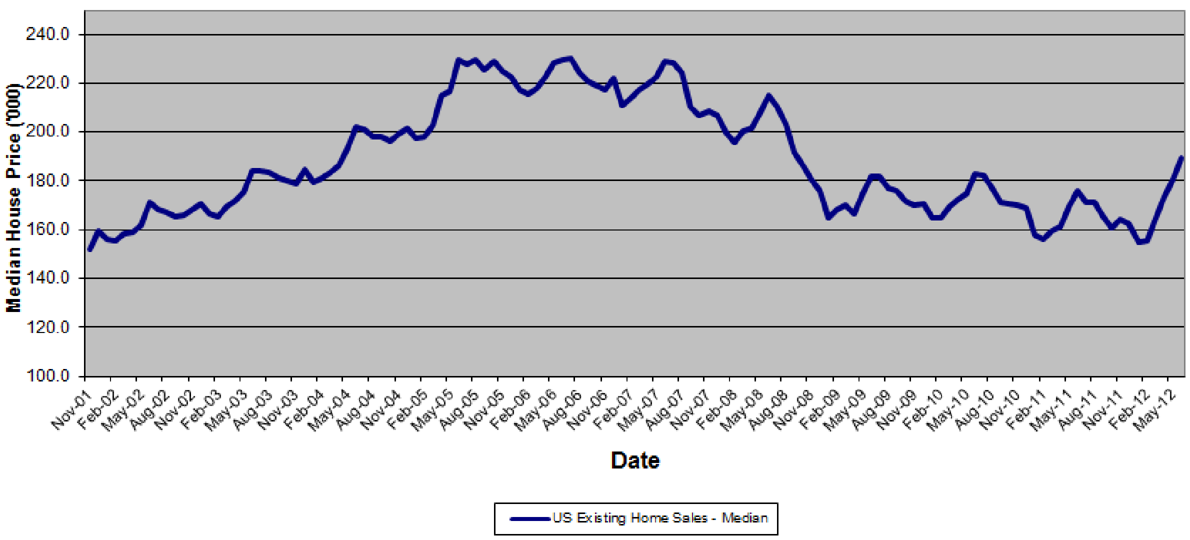
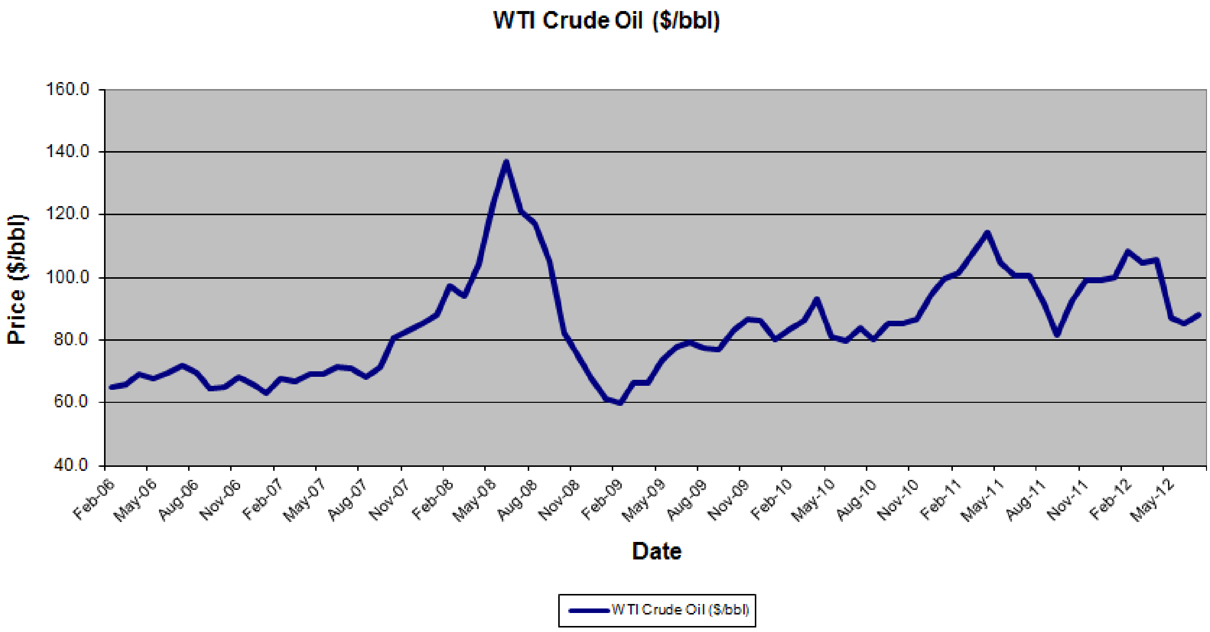
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Date
China PMI Index

US Existing Home Sales - Millions



US Existing Home Sales - Median




WTI Crude Oil ($/bbl)
Price ($/bbl)
160.0
140.0
120.0
100.0
80.0
60.0
40.0
Feb-06
May-06
Aug-06
Nov-06
Feb-07
May-07
Aug-07
Nov-07
Feb-08
May-08
Aug-08
Nov-08
Feb-09
May-09
Aug-09
Nov-09
Feb-10
May-10
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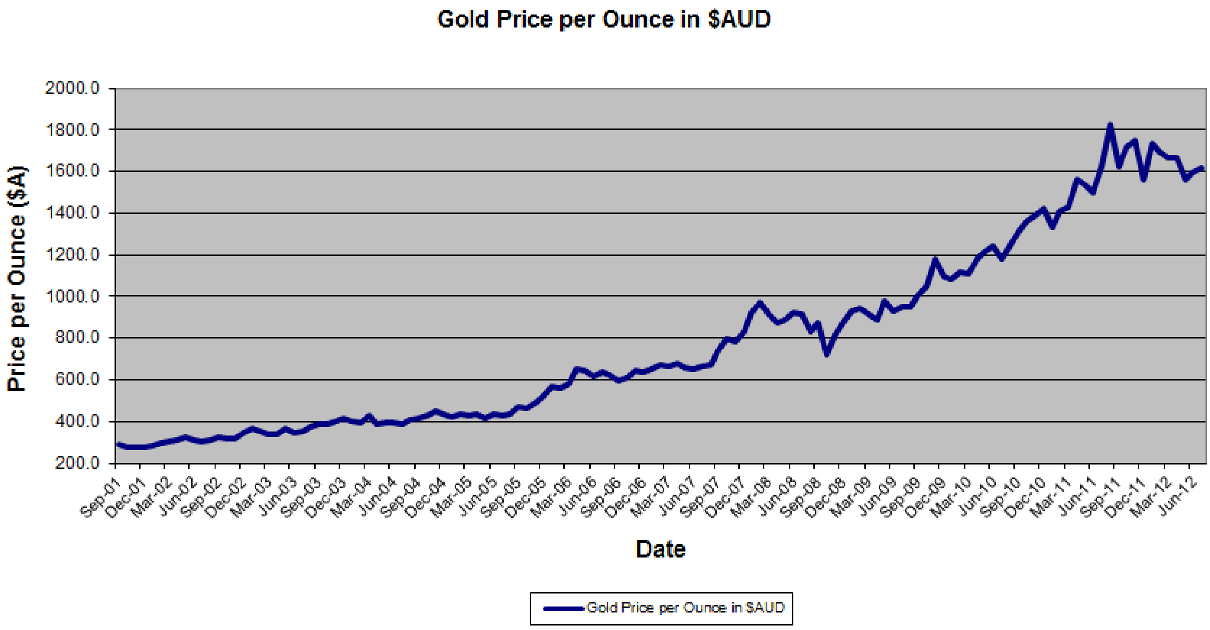
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Date
WTI Crude Oil ($/bbl)


Gold Price per Ounce in $AUD
Price per Ounce ($A)
2000.0
1800.0
1600.0
1400.0
1200.0
1000.0
800.0
600.0
400.0
200.0
Sep-01
Dec-01
Mar-02
Jun-02
Sep-02
Dec-02
Mar-03
Jun-03
Sep-03
Dec-03
Mar-04
Jun-04
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Dec-04
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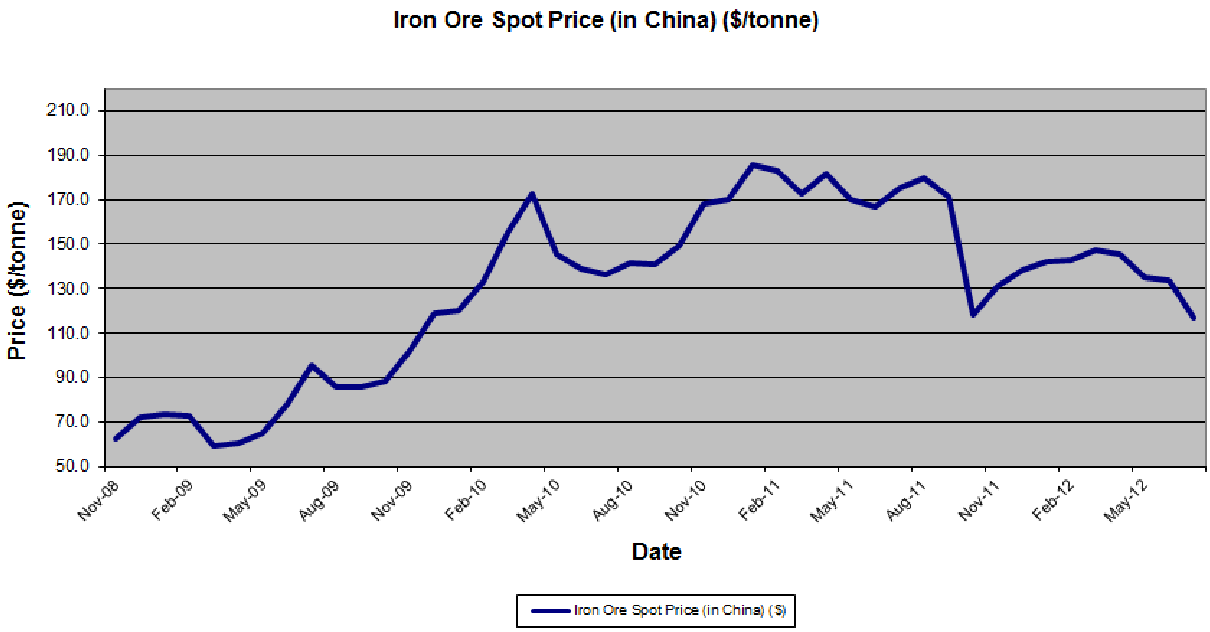
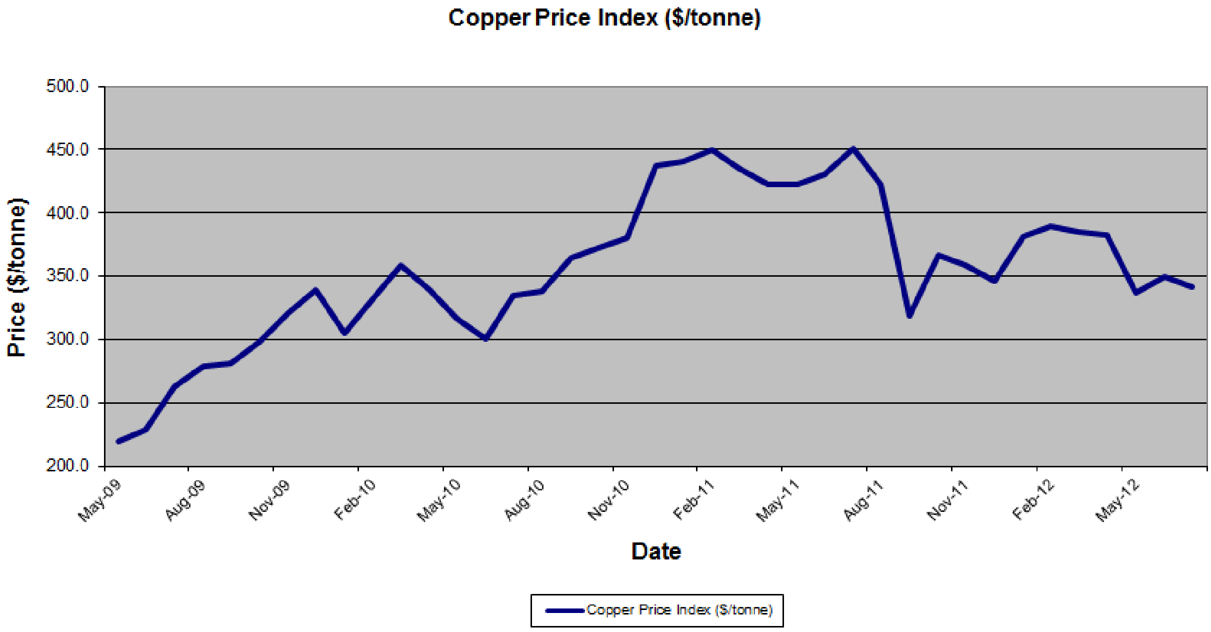
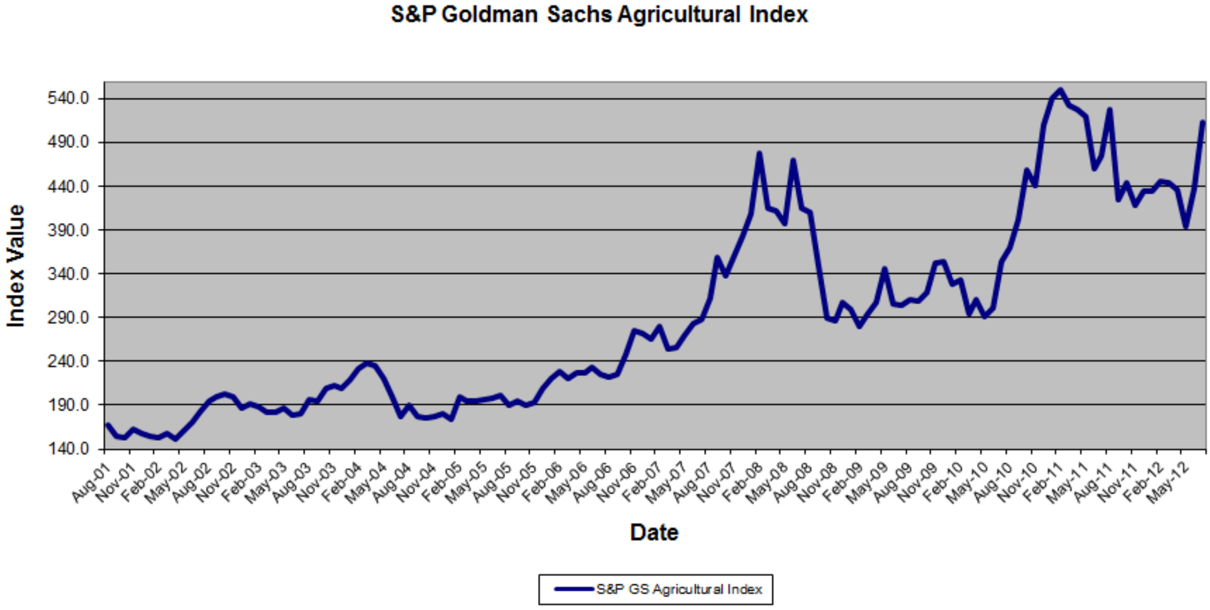
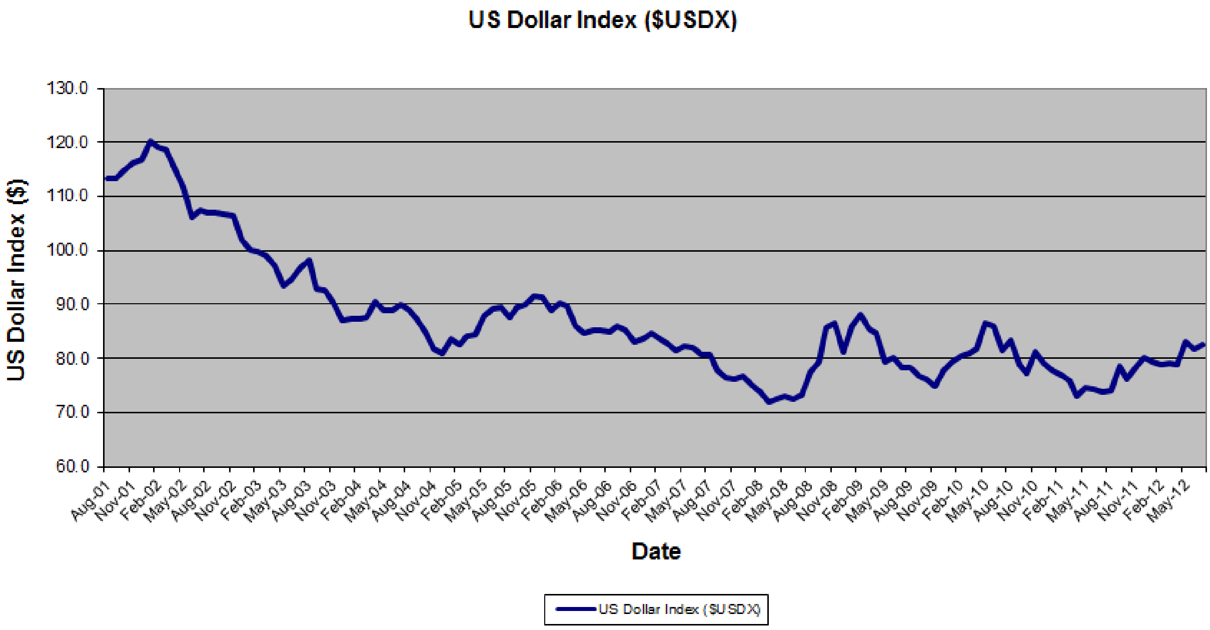
Mar-10
Jun-10
Sep-10
Dec-10
Mar-11
Jun-11
Sep-11
Dec-11
Mar-12
Jun-12
Date
Gold Price per Ounce in $AUD


Iron Ore Spot Price (in China) ($/tonne)
Price ($/tonne)
Date
Iron Ore Spot Price (in China) ($)


Copper Price Index ($/tonne)
Price ($/tonne)
Date
Copper Price Index ($/tonne)





The DXY is a weighted index of some of the major trading partners of the United States. The components of the DXY Index are (by weighting): Euro (57.6%), Japanese Yen (13.6%), Great Britain- Pounds Sterling (11.9%), Canadian Dollar (9.1%), Swedish Krona (4.2%), and Swiss Franc (3.6%).