McGregor Asset Consulting

Economic and Market Commentary
September 2012

Financial markets continue to deal with a high level of uncertainty as the Europeans seek solutions to the high debt levels that continue to grow, high unemployment levels and recession across many of the member countries.
The ECB has announced a further support mechanism to the region of a bond purchase program that allows member countries to off load distressed bonds to the ECB. This is seen as a good step forward in seeking to stabilize the financial crisis in Europe. Equities and other risk assets have responded positively over the past two weeks.
In addition the US Fed has also reacted in providing further stimulus via QE 3 which is aimed at buying mortgage backed securities over an unlimited period and has received mixed response although equities markets have been positive. US short term interest rates are now anticipated to be pegged at close to zero out to 2015. The US is awash with cheap funds and should be positive for the housing market which is showing good signs of recovery and the flow on affects across the economy. The US election is now in full swing with the result in November expected to be close. It is becoming evident that the divide between the Republicans and Democrats has become extremely polarized which should make it more difficult for compromise in Congress as they have to deal with debt issues in early 2013. While we would expect to see the focus remain on jobs in the US the unemployment rate has not dropped and remains worryingly above 8%.

Uncertainty still dominates in Europe as a long period of recession and low growth appear to dominate sentiment and decision making. The 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. While Germany has been pushing for spending constraints in the region it is now starting to suffer declining GDP growth which may well add to a further year of difficulty for the Eurozone. It appears that the probability of Greece remaining in the Euro has increased at least until 2013.

A further 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. 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. The Euro currency is likely to remain under pressure as the market forces impact and sentiment remains uncertain.

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. 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 1.8% producing a negative real return which cannot be maintained]

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 significant slowing in growth. Exports are showing clear signs of being impacted by the slowdown in Europe. Commodities have taken a substantial slump with iron ore now at $100 per tonne off from the high of $180 per tonne. This is likely to have a significant impact on the Australian economy over the coming year as it impacts the budget and spending programs of the government. The Chinese leadership which is going through a process of change and transition appears to be encountering a much more difficult path than previous leaders as it seeks to reign in the imbalances of a country that has had 10%pa growth for a decade and is faced with managing a country that is adjusting to the huge urbanisation that has taken place. China is well placed to adjust from the infrastructure focus to a more consumption led transition. This is likely to create a slowing in export trade from Australia so an adjustment is likely to be required in Australia. 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 - 7% GDP which should still provide an underpinning for 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 higher labour costs. Political uncertainty is also making business decisions more difficult.

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 cash rate remains at 3.5% but may be eased should the outlook for commodity prices drop further. 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. Bank shares are currently offering in the region of 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. Overall the environment calls for a well-diversified investment portfolio of both risk assets and defensive assets.

- **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: [Neutral] Global Listed Property: [Neutral]** Quality listed property securities delivering solid yields are likely to benefit from the focus on yield and suggest a neutral weighting to this sector. Quality direct property is also showing signs of recovery although likely to be slow as access to funding remains difficult.
- **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: [Neutral]** 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.
- Social unrest in Europe the Middle East, especially Syria, Iran and Egypt is becoming an increasing concern for governments.
- 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.

- 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 Australian 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

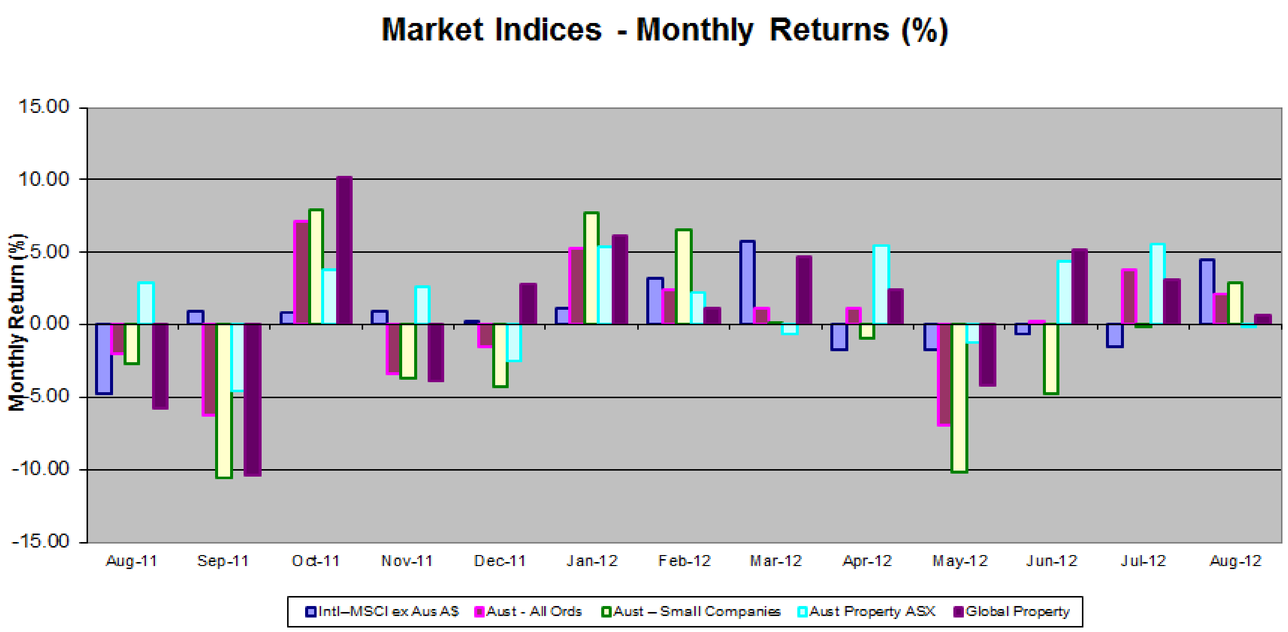
Market Indices	Aug-11	Sep-11	Oct-11	Nov-11	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12
Intl–MSCI ex A A$	-4.77	0.95	0.85	0.93	0.21	1.17	3.24	5.80	-1.73	-1.76	-0.62	-1.56	4.50
Aust - All Ords	-2.00	-6.27	7.17	-3.43	-1.57	5.23	2.41	1.15	1.10	-6.90	0.25	3.74	2.12
Aust – Small Coy	-2.69	-10.61	7.87	-3.71	-4.30	7.75	6.51	0.19	-0.92	-10.22	-4.78	-0.19	2.95
Aust Property ASX	2.89	-4.58	3.78	2.65	-2.55	5.40	2.25	-0.59	5.42	-1.24	4.34	5.55	-0.13
Global Property	-5.72	-10.41	10.22	-3.90	2.77	6.17	1.11	4.63	2.45	-4.22	5.15	3.08	0.60

Annual Share Market Performance

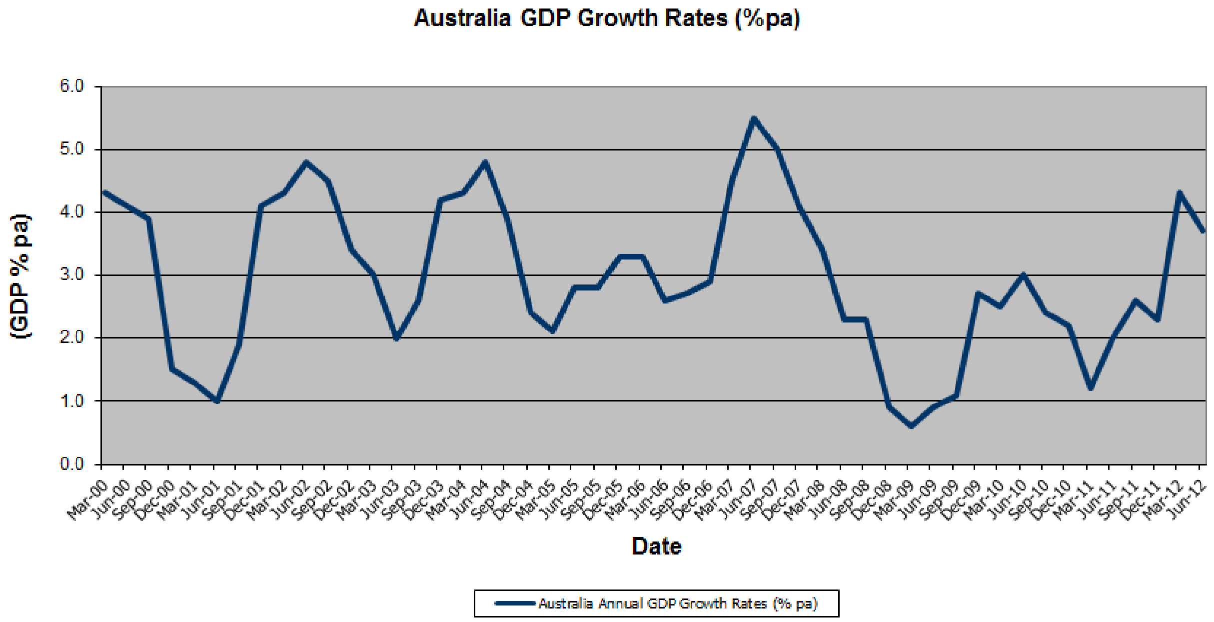
Markets Index	1 Year to 30 Jun 10 %	1 Year to 30 Sep 10 %	1 Year to 31 Dec 10 %	1 Year to 31 Mar 11 %	1 Year to 30 Jun 11 %	1 Year to 30 Sep 11 %	1 Year to 31 Dec 11 %	1 Year to 31 Mar 12 %	1 Year to 30 Jun 12 %	1 Year to 31 Aug 12 %
Intl–MSCI ex A A$	5.22	-2.79	-2.40	0.64	2.66	-4.52	-5.34	0.69	-0.50	12.29
Aust – All Ords	13.78	1.73	3.31	4.80	12.17	-8.43	-11.43	-6.27	-7.04	4.04
Aust – Small Coy	11.18	6.63	13.05	13.49	16.41	-12.11	-21.43	-8.57	-14.61	-11.08
Aust Prop – ASX	20.34	-4.52	-0.68	4.74	5.87	-6.29	-1.56	1.67	10.98	21.54
Global Property	43.86	24.88	26.15	24.78	36.60	1.06	1.94	8.40	6.93	17.20

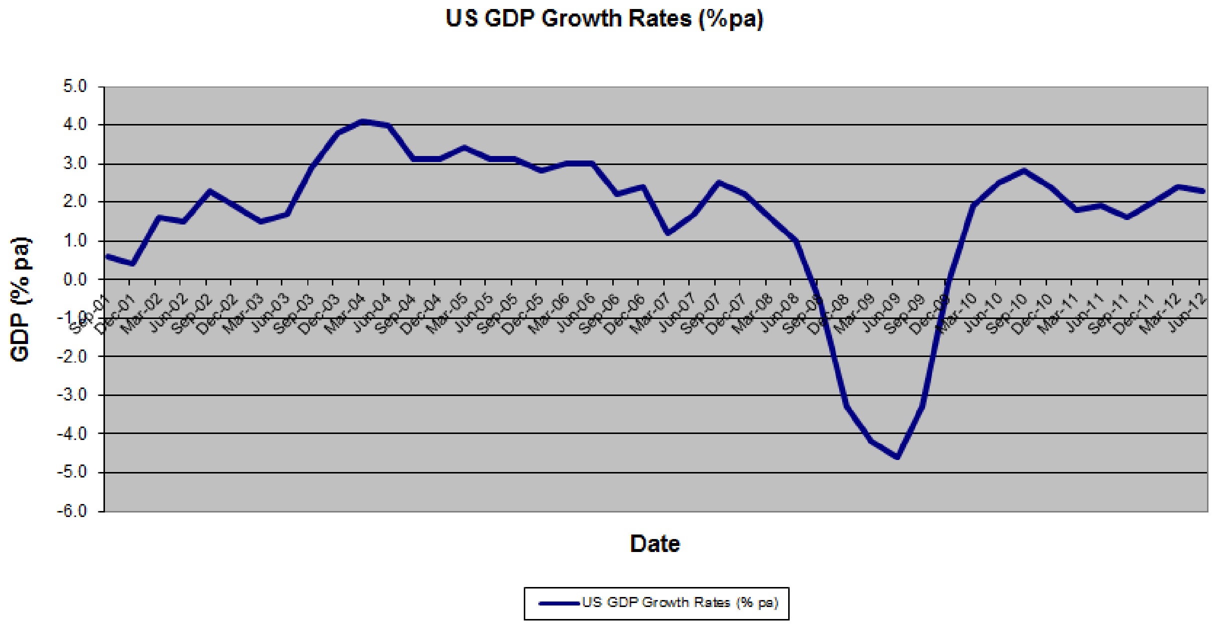
Best Performing Asset Sectors for twelve months ended 31 August 2012

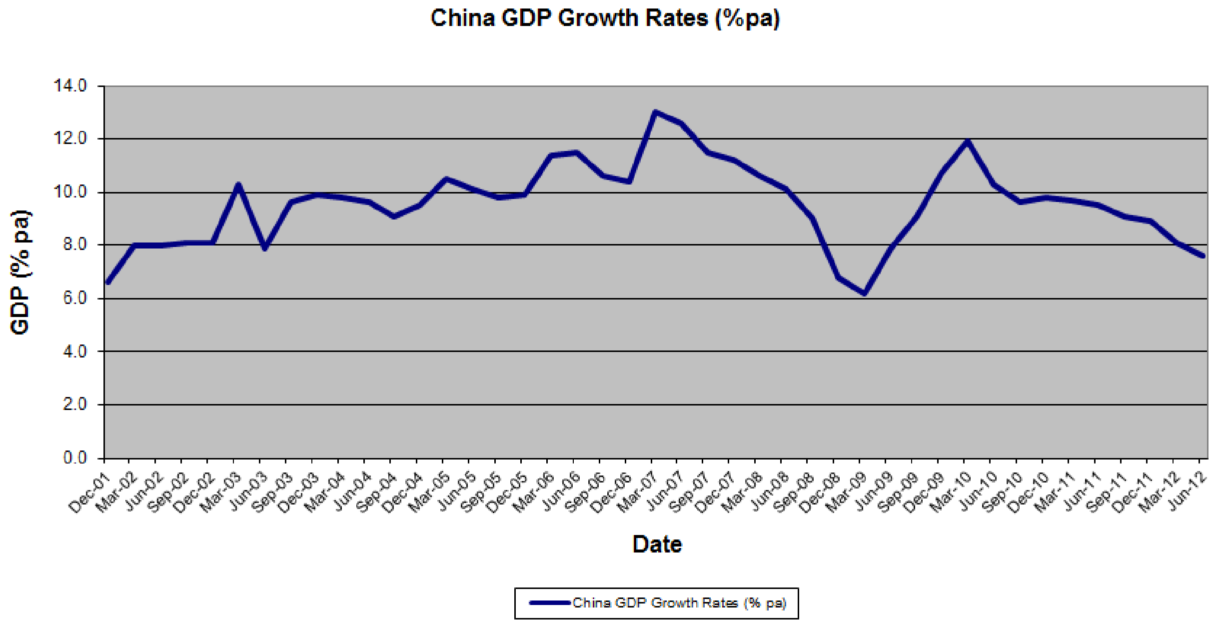
Sector	Market Index	Return
Aust Listed Property	S&P/ASX Property Trusts Accum Index	21.54
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge $A	17.20
International Equities Unhedged	MSCI World Ex Aust Accum Index A$	12.29
International Equities Hedged	MSCI World Accum Index Hedged A$	11.31
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged $A	9.85
Australian Fixed Interest	UBS Warburg Composite 0 + Years	9.49
Cash	Australian 90 Day Bank Accepted Bill	4.44
Australian Shares	S&P/ASX All Ords Accum Index	4.04
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	-11.08



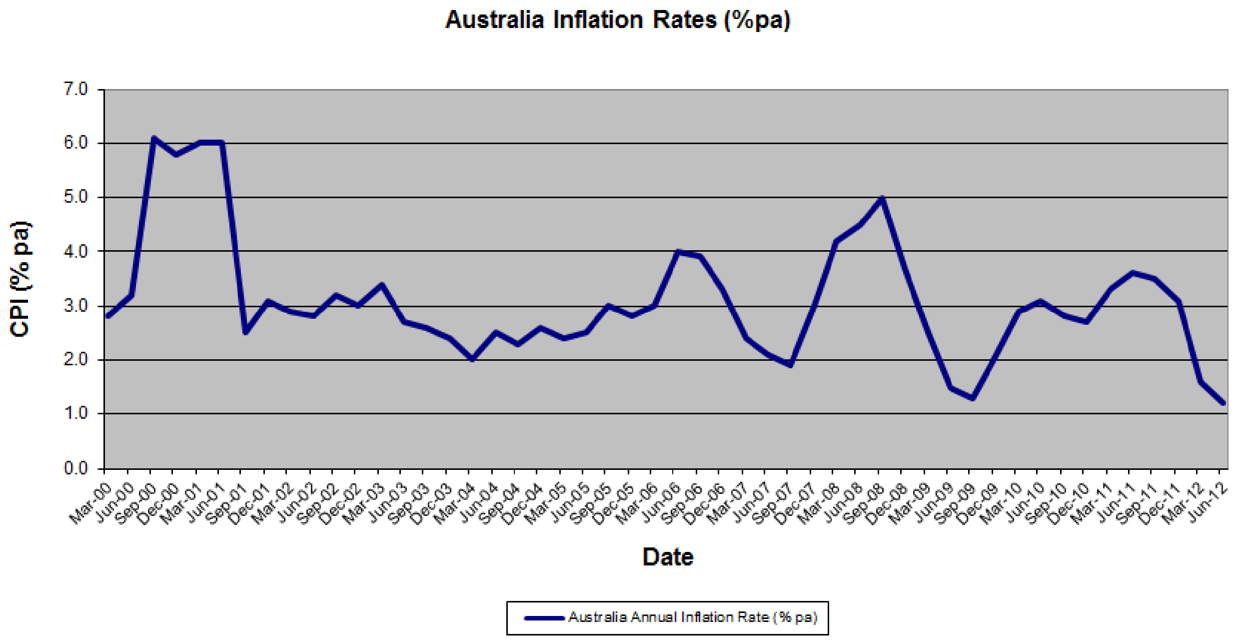
Major Economic Indicators



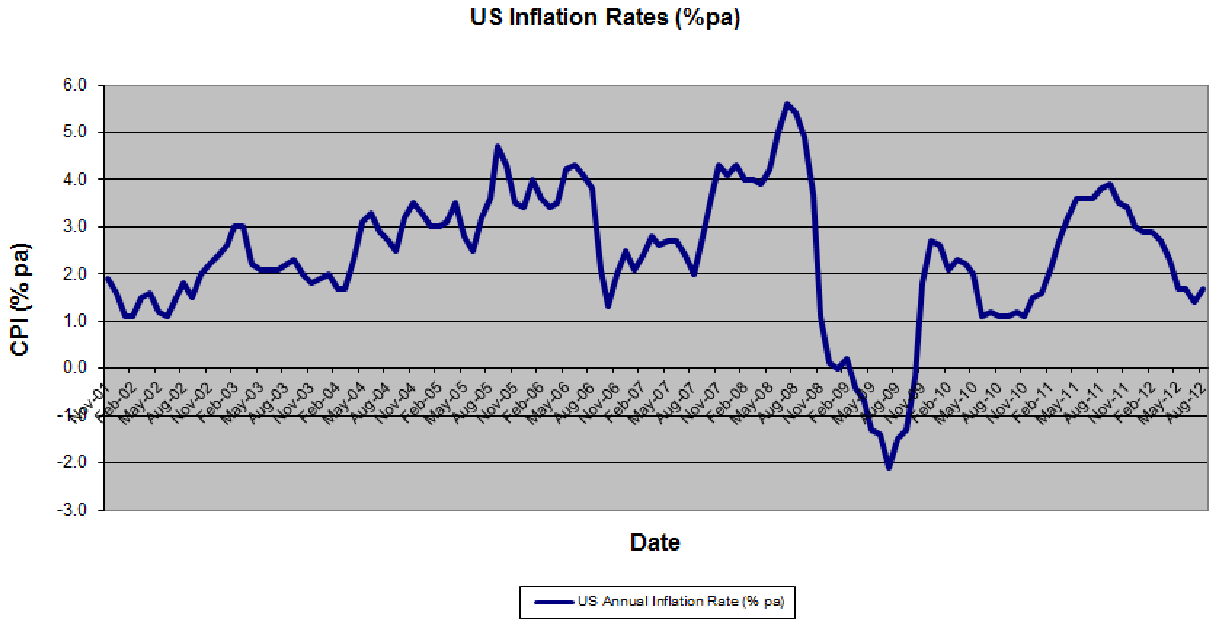




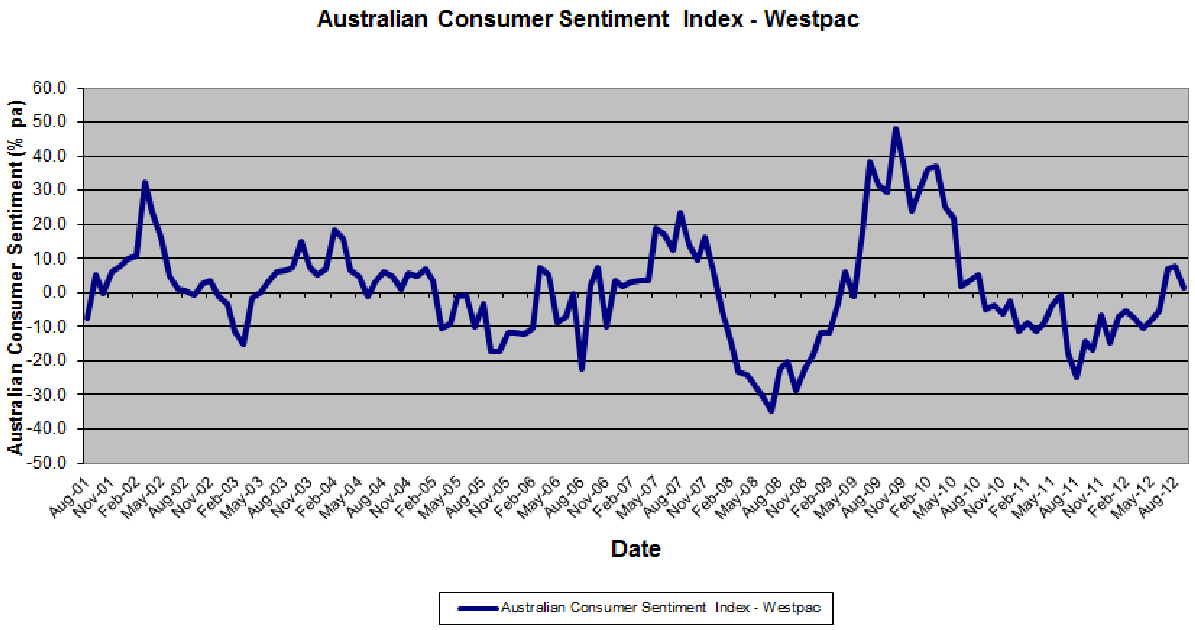
China GDP Growth Rates (%pa)
GDP (% pa)
Date
China GDP Growth Rates (% pa)

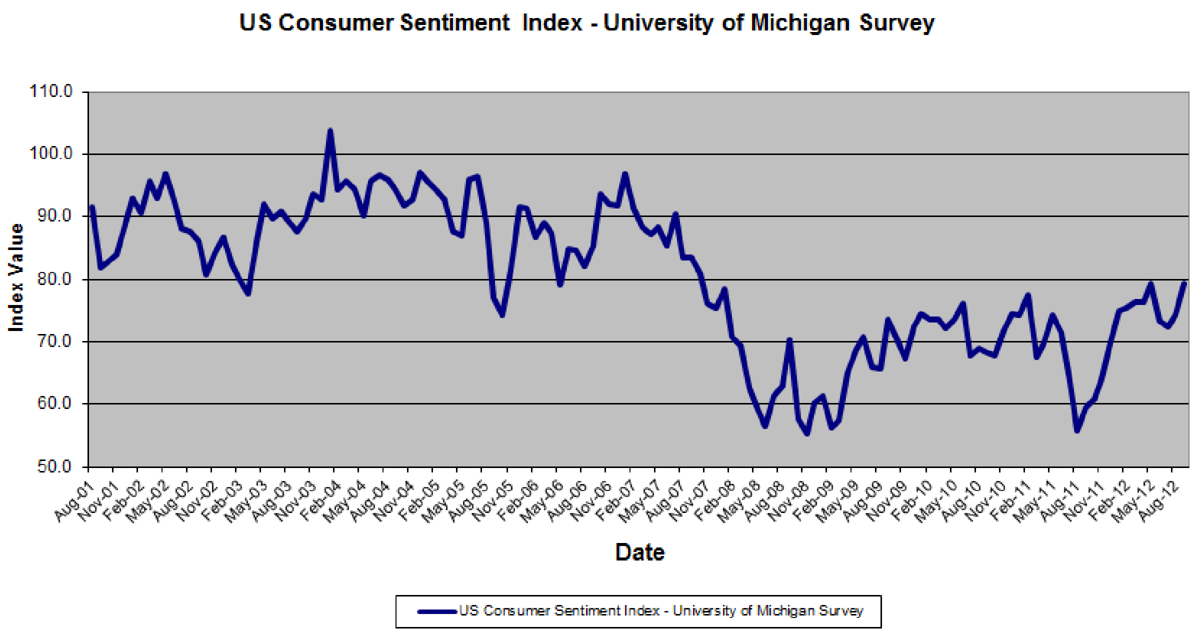


Australia Inflation Rates (%pa)
CPI (% pa)
Date
Australia Annual Inflation Rate (% pa)

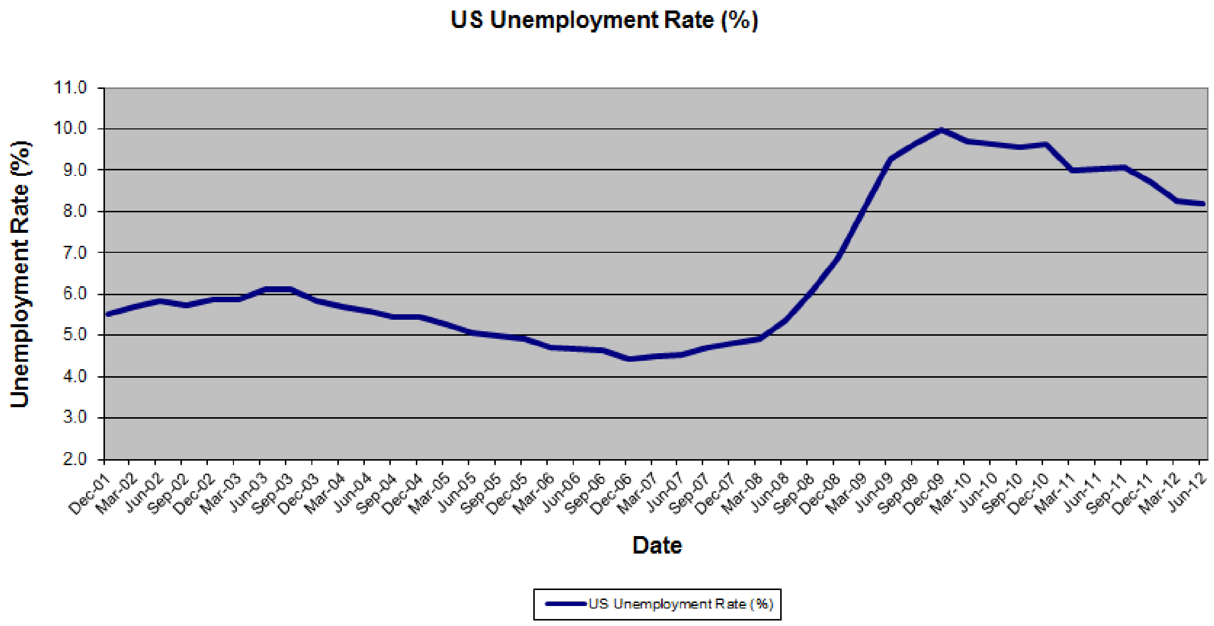

US Inflation Rates (%pa)
CPI (% pa)
Date
US Annual Inflation Rate (% pa)

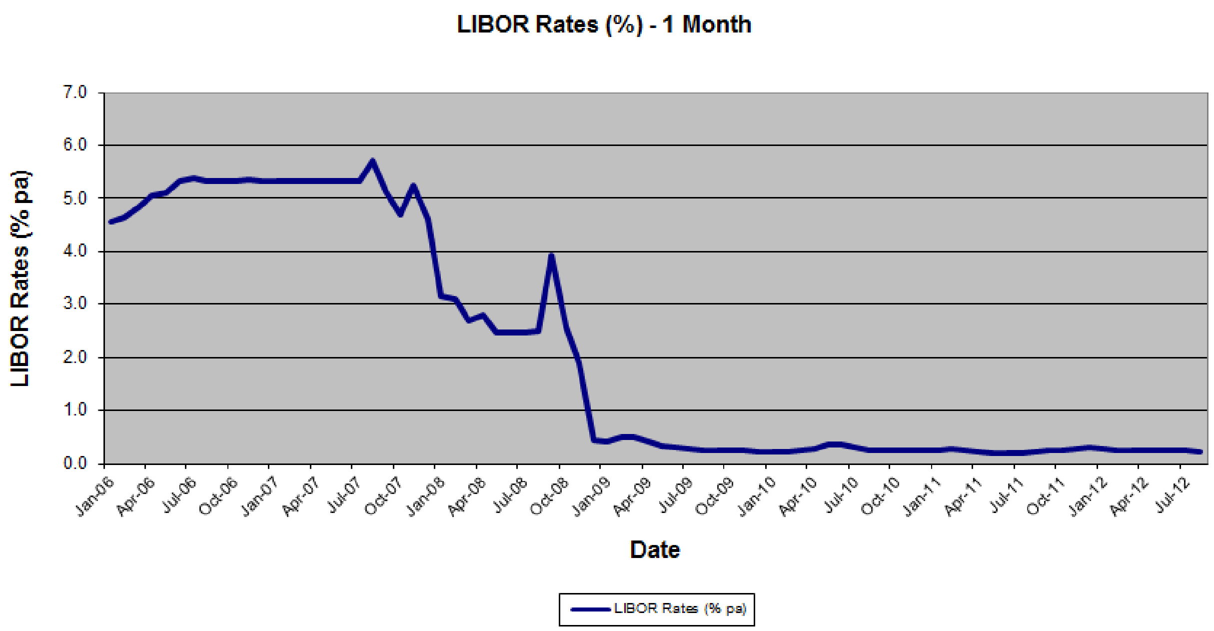

China Inflation Rates (%pa)
CPI (% pa)
Date
China Annual Inflation Rate (% pa)

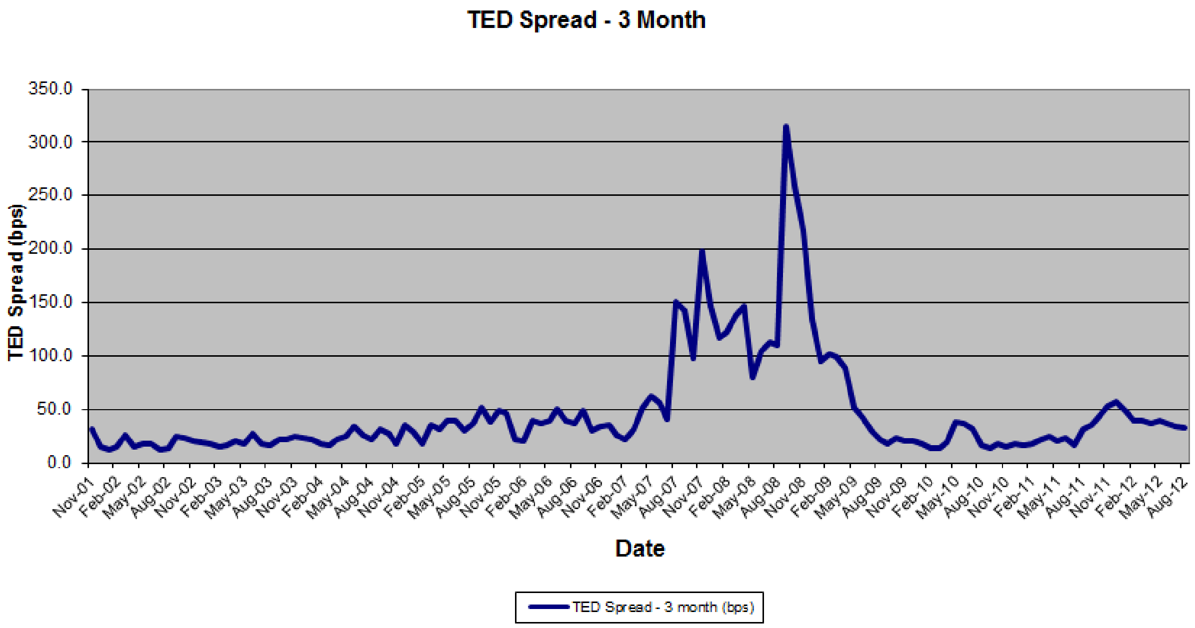

Australian Consumer Sentiment Index - Westpac
Australian Consumer Sentiment (% pa)
60.0
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
-30.0
-40.0
-50.0
Aug-01 Nov-01 Feb-02 May-02 Aug-02 Nov-02 Feb-03 May-03 Aug-03 Nov-03 Feb-04 May-04 Aug-04 Nov-04 Feb-05 May-05 Aug-05 Nov-05 Feb-06 May-06 Aug-06 Nov-06 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 Aug-12
Date
Australian Consumer Sentiment Index - Westpac

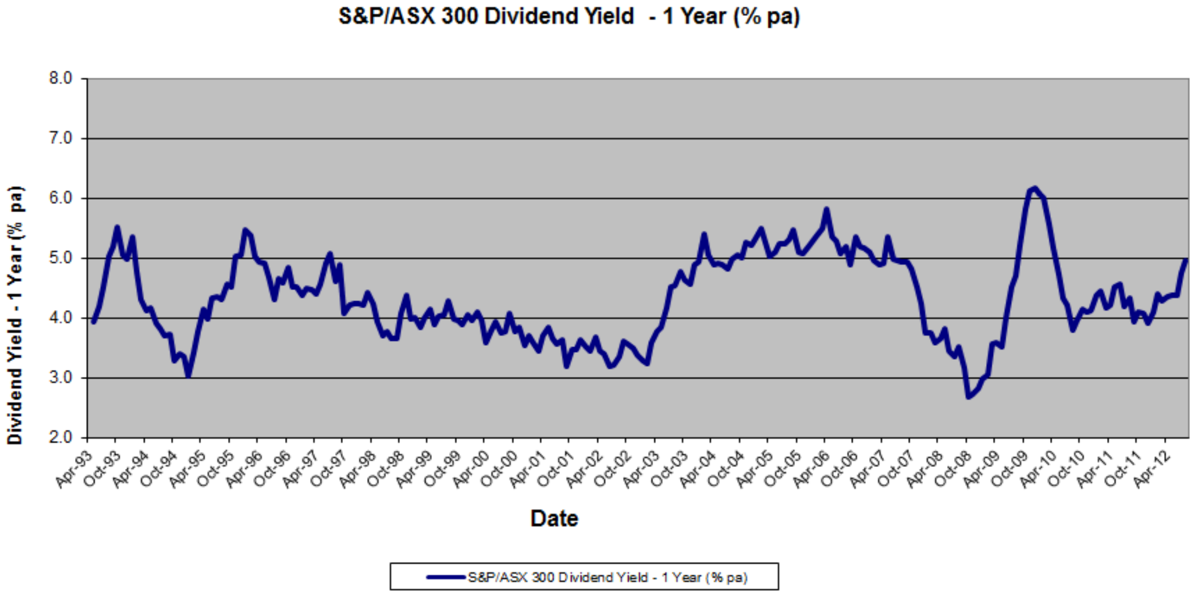

US Consumer Sentiment Index - University of Michigan Survey
Index Value
110.0
100.0
90.0
80.0
70.0
60.0
50.0
Aug-01 Nov-01 Feb-02 May-02 Aug-02 Nov-02 Feb-03 May-03 Aug-03 Nov-03 Feb-04 May-04 Aug-04 Nov-04 Feb-05 May-05 Aug-05 Nov-05 Feb-06 May-06 Aug-06 Nov-06 Feb-07 May-07 Aug-07 Nov-07 Feb-08 May-08 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 Aug-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
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
Date
US Unemployment Rate (%)

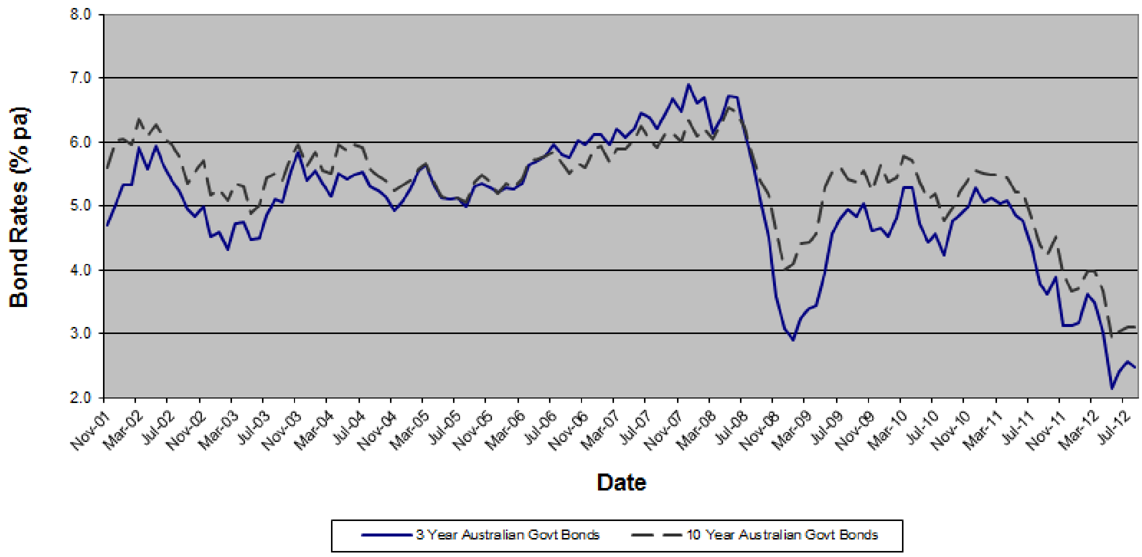

LIBOR Rates (%) - 1 Month
LIBOR Rates (% pa)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Jan-06 Apr-06 Jul-06 Oct-06 Jan-07 Apr-07 Jul-07 Oct-07 Jan-08 Apr-08 Jul-08 Oct-08 Jan-09 Apr-09 Jul-09 Oct-09 Jan-10 Apr-10 Jul-10 Oct-10 Jan-11 Apr-11 Jul-11 Oct-11 Jan-12 Apr-12 Jul-12
Date
LIBOR Rates (% pa)


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 Aug-12
Date
TED Spread - 3 month (bps)

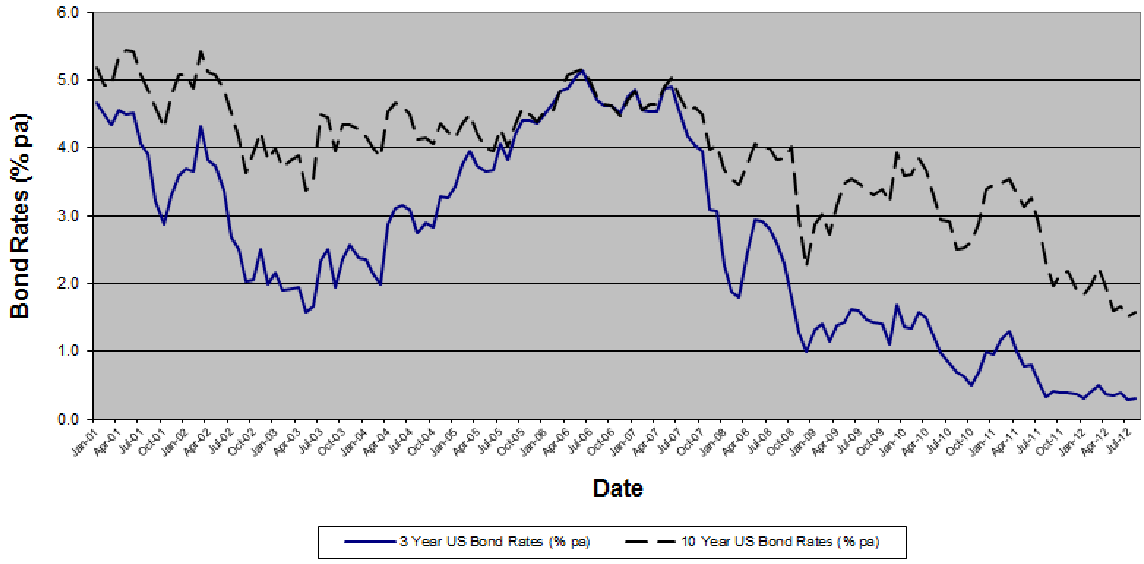


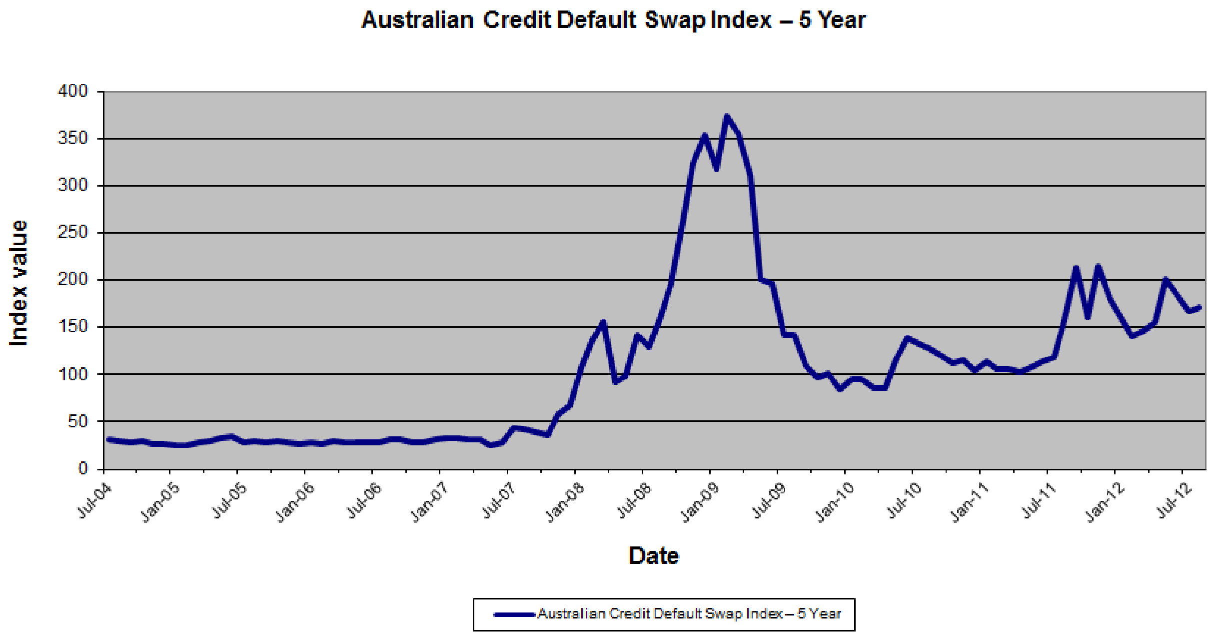
Source: Credit Suisse and Reserve Bank of Australia as at 13 August 2012.

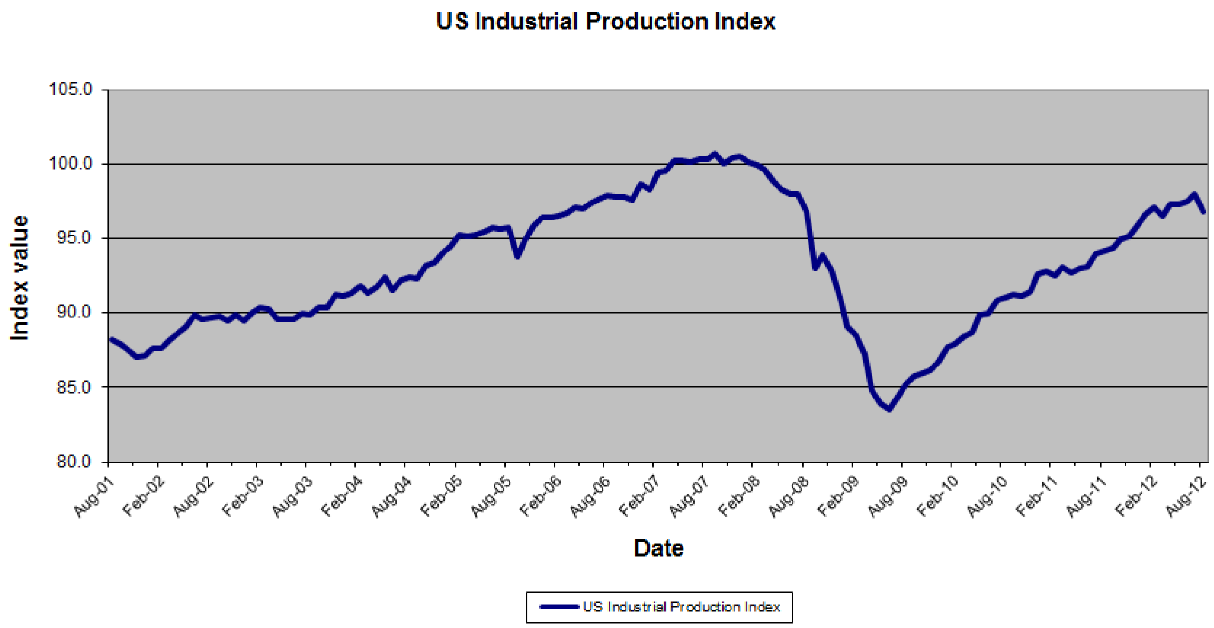
3y and 10y Australian Bond Rates (%)



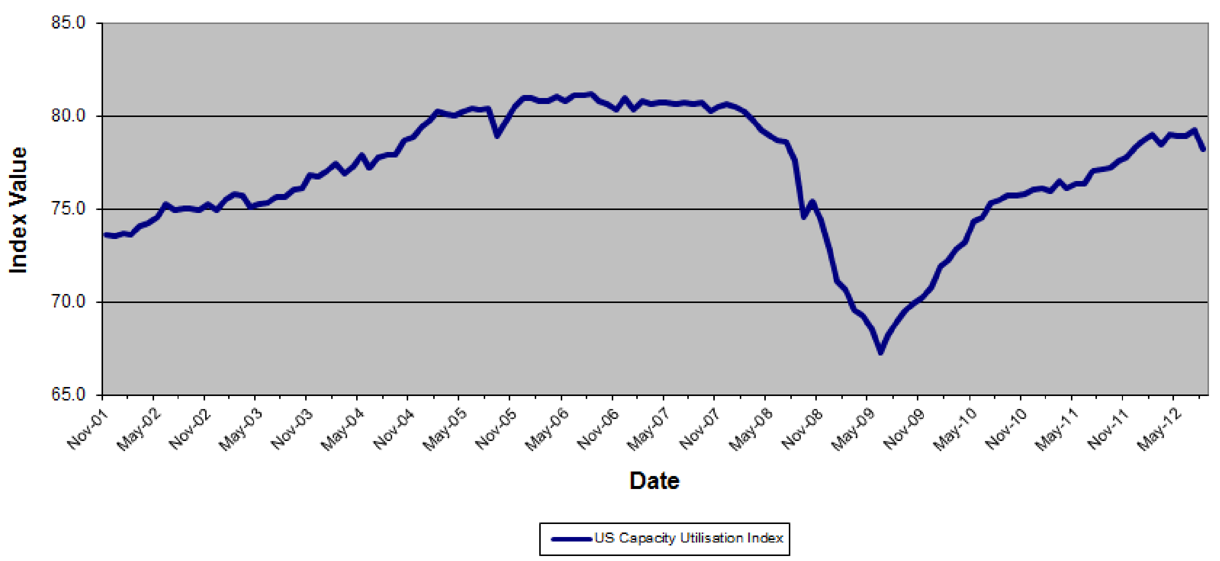
3y and 10y US Bond Rates (%)



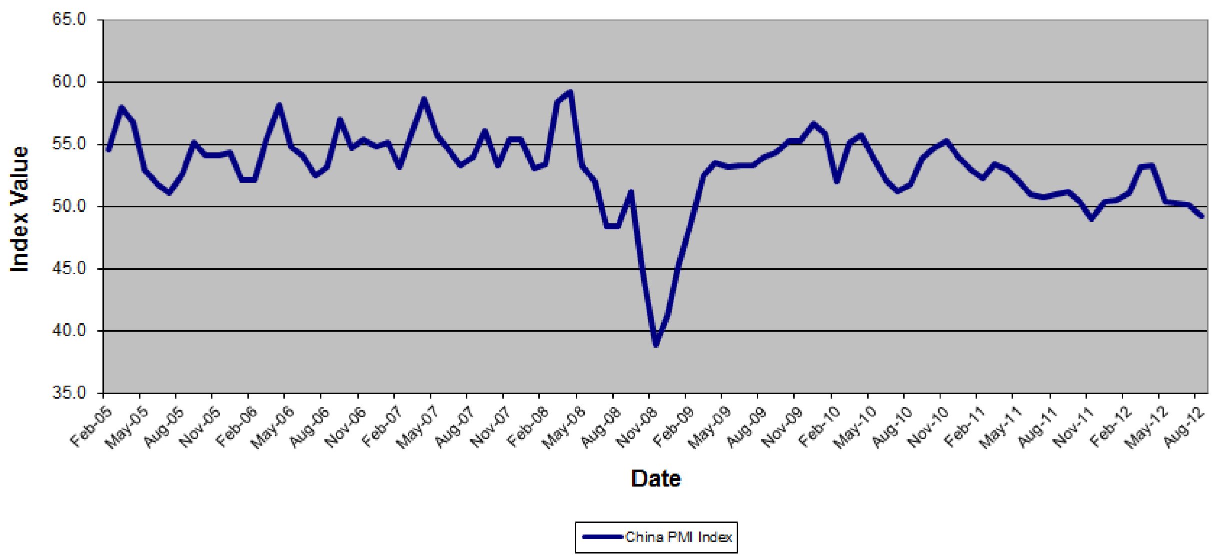

Australian Credit Default Swap Index – 5 Year
Index value
400
350
300
250
200
150
100
50
0
Jul-04
Jan-05
Jul-05
Jan-06
Jul-06
Jan-07
Jul-07
Jan-08
Jul-08
Jan-09
Jul-09
Jan-10
Jul-10
Jan-11
Jul-11
Jan-12
Jul-12
Date
Australian Credit Default Swap Index – 5 Year

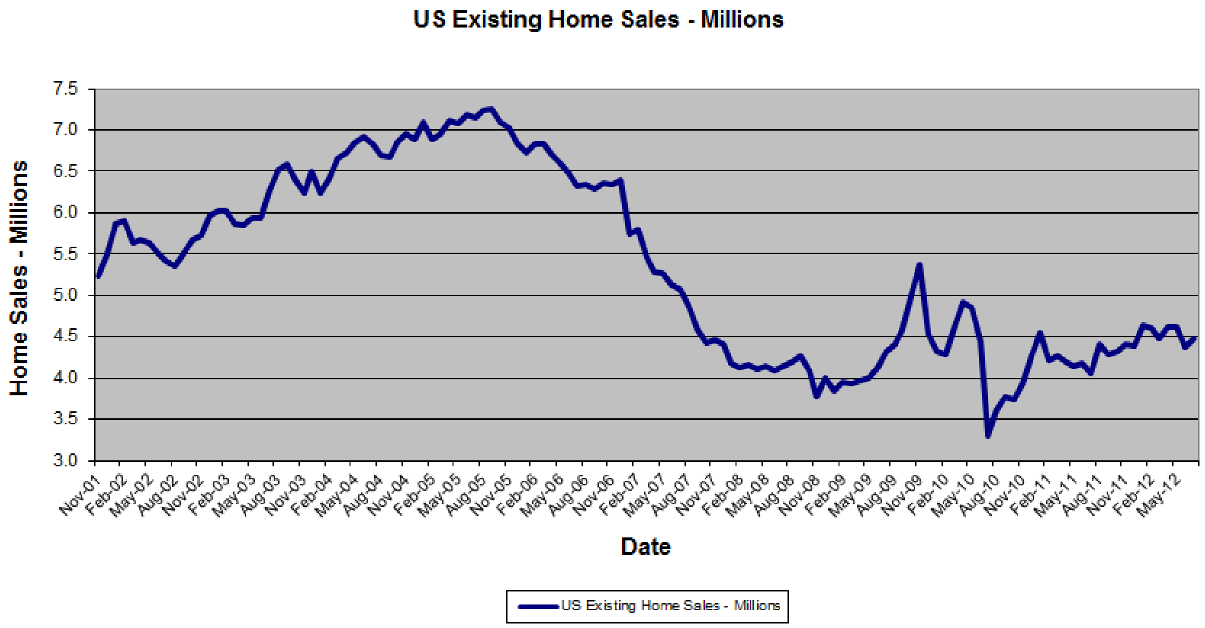

US Industrial Production Index
Index value
105.0
100.0
95.0
90.0
85.0
80.0
Aug-01
Feb-02
Aug-02
Feb-03
Aug-03
Feb-04
Aug-04
Feb-05
Aug-05
Feb-06
Aug-06
Feb-07
Aug-07
Feb-08
Aug-08
Feb-09
Aug-09
Feb-10
Aug-10
Feb-11
Aug-11
Feb-12
Aug-12
Date
US Industrial Production Index

US Capacity Utilisation Index



China Purchasing Managers Index (PMI)




US Existing Home Sales - Millions
Home Sales - Millions
7.5
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
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
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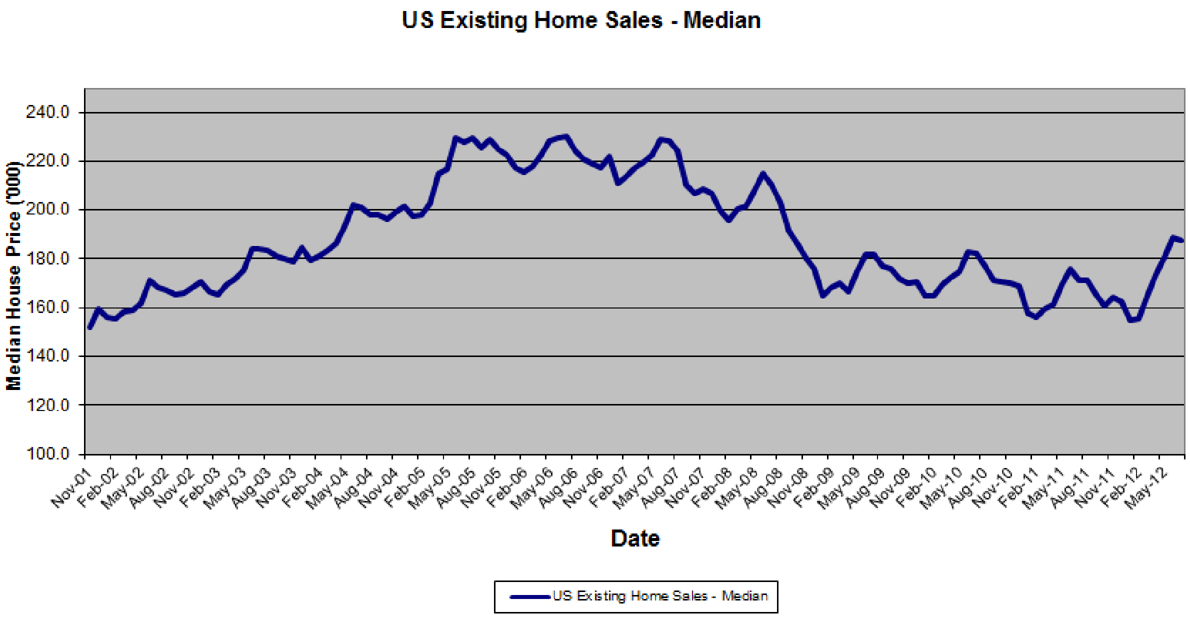
Aug-09
Nov-09
Feb-10
May-10
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Date
US Existing Home Sales - Millions


US Existing Home Sales - Median
Median House Price ('000)
240.0
220.0
200.0
180.0
160.0
140.0
120.0
100.0
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
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May-09
Aug-09
Nov-09
Feb-10
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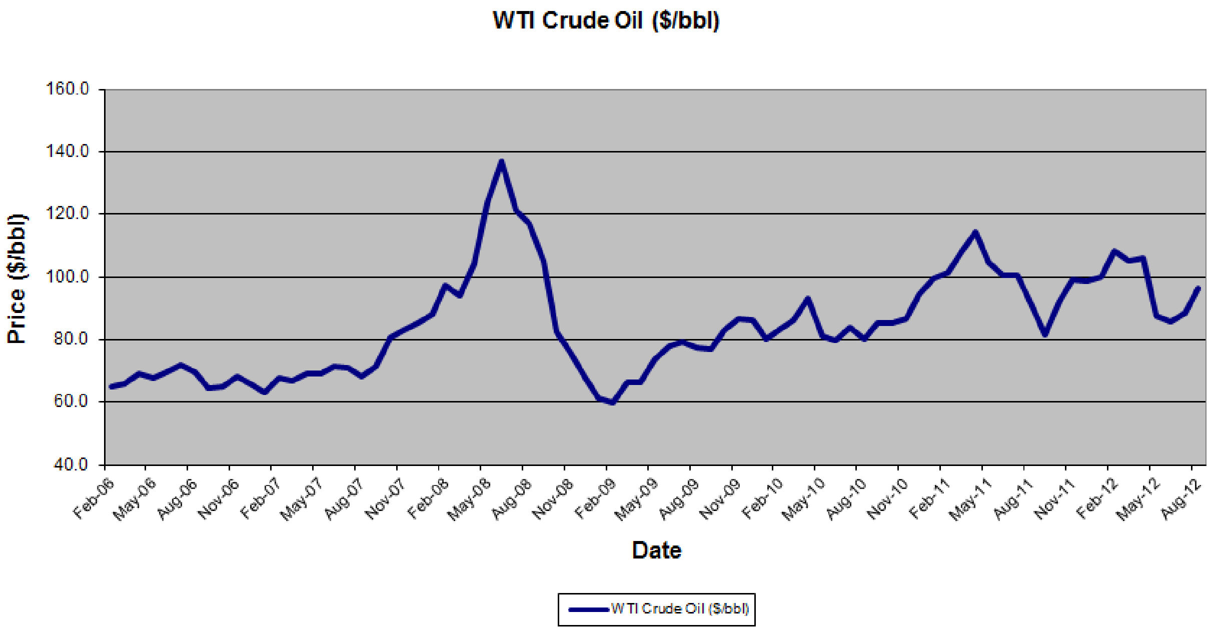
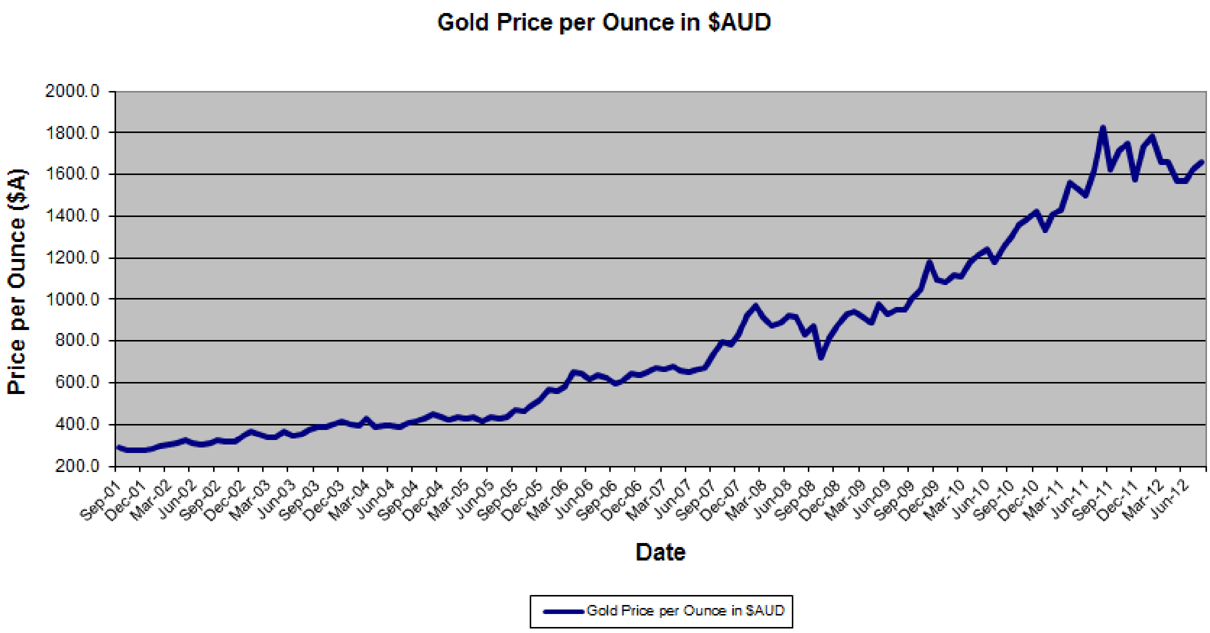
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Date
US Existing Home Sales - Median


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
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Aug-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
Sep-04
Dec-04
Mar-05
Jun-05
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Dec-08
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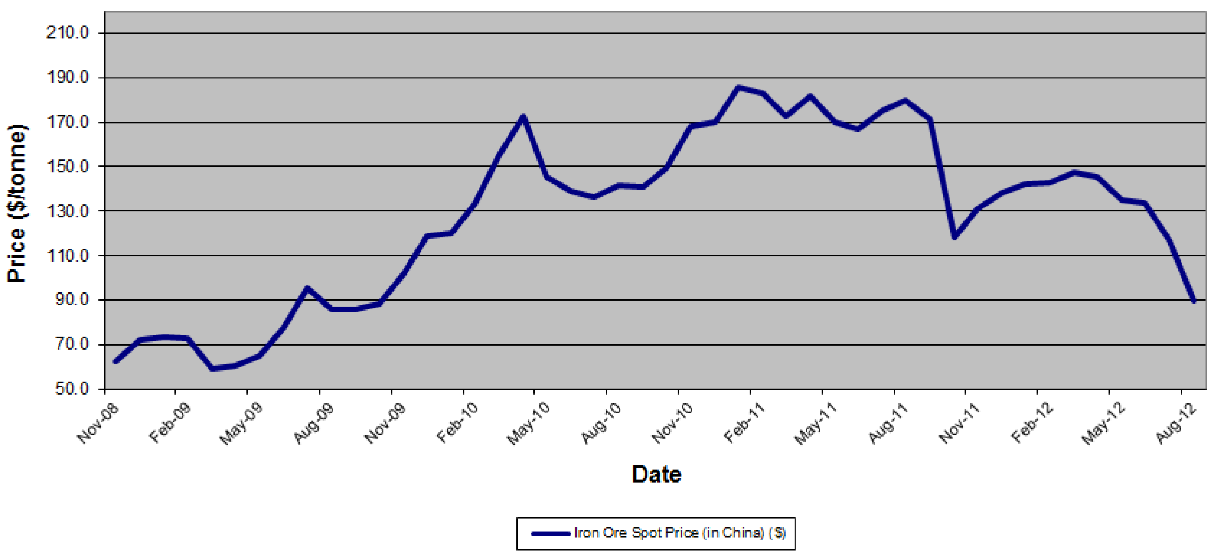
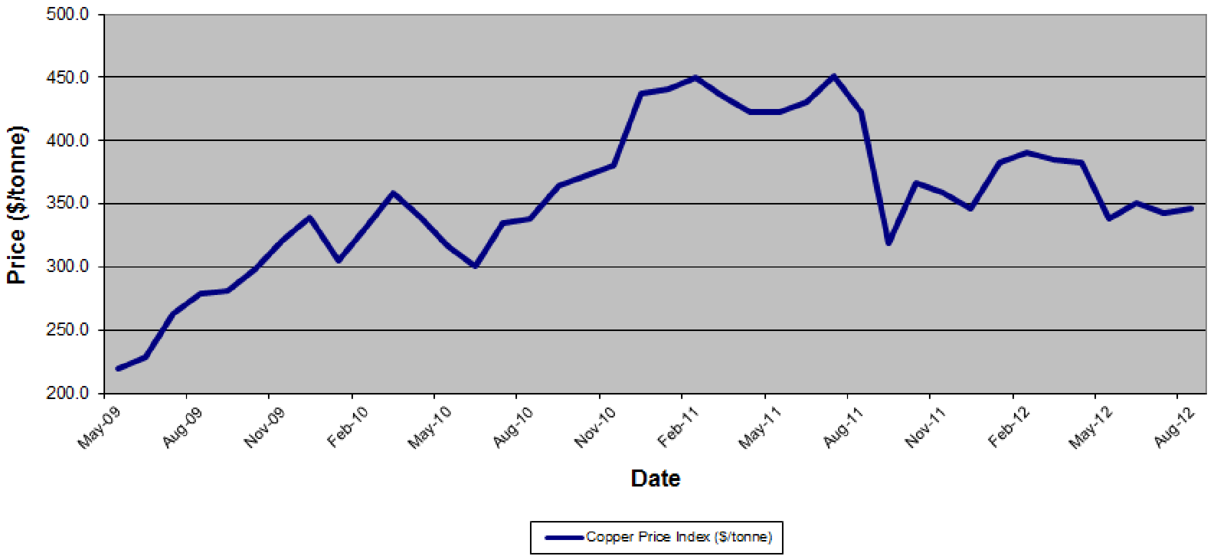
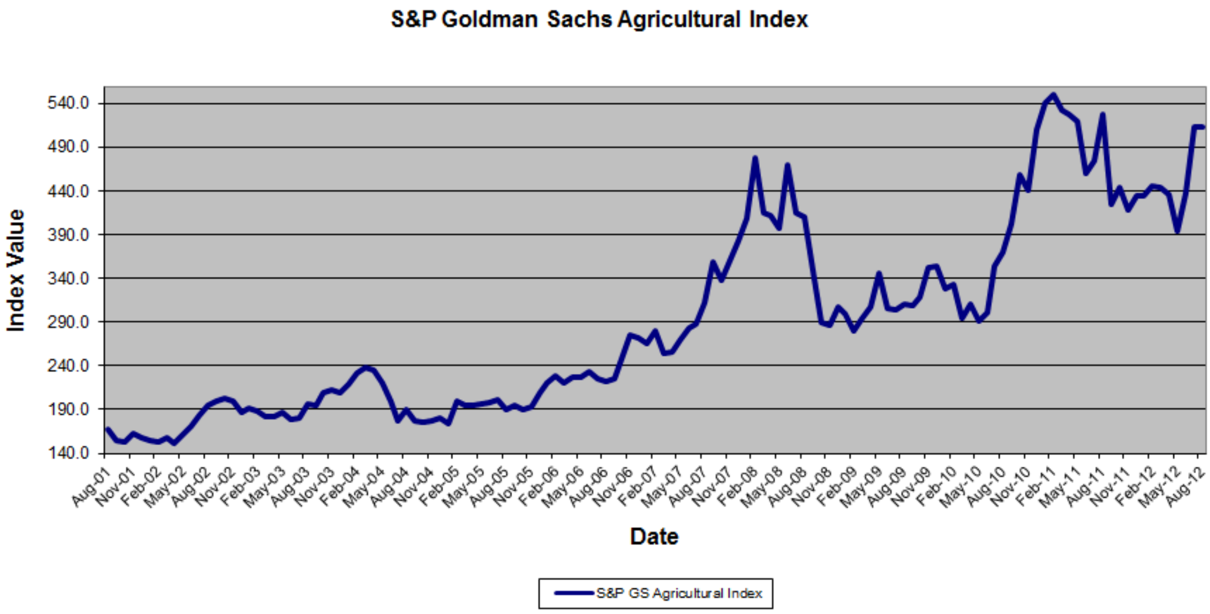
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10
Sep-10
Dec-10
Mar-11
Jun-11
Sep-11
Dec-11
Mar-12
Jun-12
Date
Gold Price per Ounce in $AUD

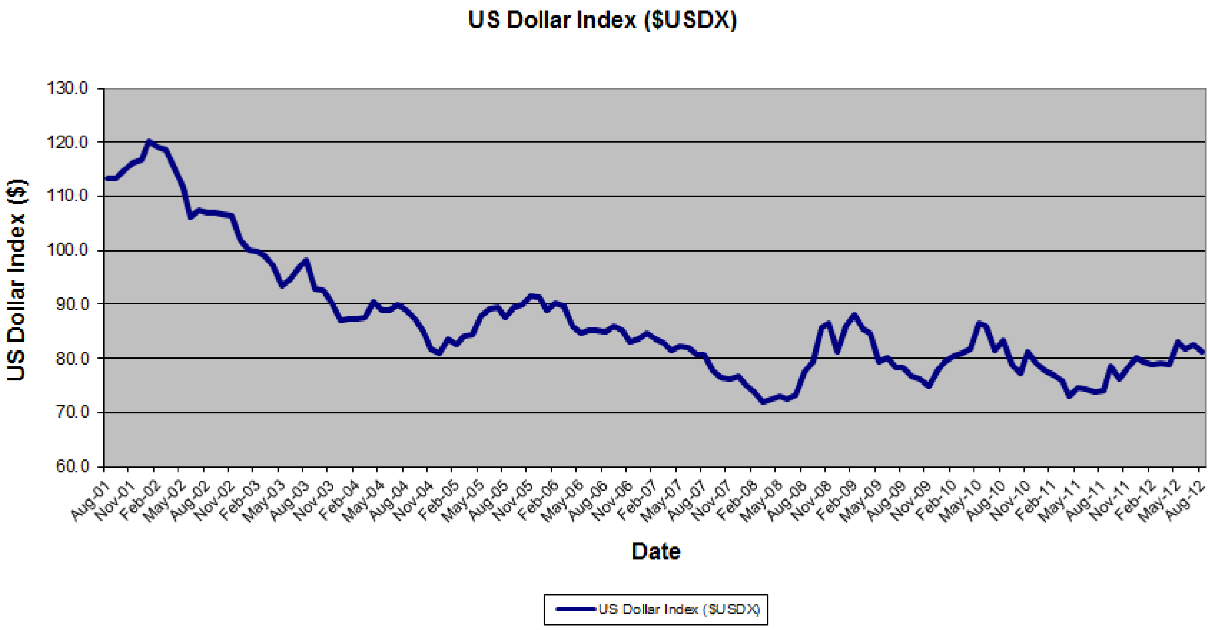
Iron Ore Spot Price (in China) ($/tonne)



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%).