

## Economic and Market Commentary January 2013

We enter 2013 with a more stable investment market and improved Investor sentiment. The concerns of a major correction caused by the US deficit and fiscal issues has been diminished and deferred until March with market concerns dissipating. The US is undergoing a broadening economic recovery although from a low base fuelled by cheap funds (cash rates close to 0% and 10 year bonds 1.8%), improving consumer sentiment, improving property market and access to affordable energy all providing a lift in confidence. The US fiscal issues remain a hurdle to be overcome with politicians being required to address the significant debt issues within coming months.

Deleveraging over the past five years and an aggressive US Fed Reserve (quantitative easing) programme has contributed significantly to the change in sentiment. The US unemployment rate is a major focus for the Fed and has remained stubbornly high around the 8% region but with the housing sector starting to recover this should provide a welcome boost to employment. The Fed is targeting a 6.5% unemployment rate before reducing its stimulatory stance.

The European Central Bank has been proactive in providing a support mechanism to the region in the form of a bond purchase program, Outright Monetary Transactions (OTM) that allows member countries to off load distressed bonds to the ECB. This action has improved investor sentiment and confidence in the short term. This is assisting in the management of the Greek crisis and avoiding a calamity although the Greek austerity measures imposed by the ECB and IMF is creating social unrest. Greece's high debt levels and economy in recession continues to add to the uncertainty. Spain, Portugal, Italy and UK continue to deal with weakening economies, high debt burdens and high unemployment levels. These uncertain conditions are all leading to a long period of recession and low growth for the region and dominates decision making. The Euro currency is likely to remain under pressure as the market forces impact and sentiment remains uncertain.

Despite the US fiscal issues 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. A potential positive "game changer" for the US is the strong state of the energy market which is adding 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. It is anticipated that the US will overtake Saudi Arabia as the world's leading oil producer by 2017 and become a net oil exporter by 2030.

The emerging world is in better shape and is likely to account for much of the global growth in the year ahead. China remains key to world growth. The Chinese leadership change and transition appears to be proceeding better than expected with the corruption issues now being dealt with. Xi Jinping, President elect, is already implementing structural change, prioritising the urbanisation process and seeking to balance an infrastructure investment spending focus with consumption spending led transition. Growth has now stabilised around 7.5% and there is greater confidence in the reacceleration of the economy. This is likely to have a significant positive impact on the Australian economy in the medium term as it should provide a base for our exports. Social unrest is identified as a major issue confronting China over the coming years.

The Japanese have elected a new Prime Minister Shinzo Abe who is embarking on a strong growth strategy. He has formally adopted a 2% inflation target in conjunction with the Bank of Japan and is implementing a monetary easing stimulus of ¥10.3 trillion Yen (US\$116 billion) aimed at driving up economic growth. Forecast growth for 2013 has been increased to 2.3%. The aim is to drive down the currency and boost export earnings which should also be supportive for the equities market.

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 as the election approaches 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\$ has been supported by strong Australian bond purchasers by foreign investors seeking AAA government credit ratings. With close to zero interest rates in the US, Europe and Japan large capital flows have entered Australia chasing higher yields. This action has supported the A\$ as commodity prices have fallen which in the past would have been a major disconnect. With the high A\$ and

resulting lower cost of overseas travel Australian tourism industry is now suffering a net outflow in tourism dollars.

The RBA's action in cutting interest rates in December to 3.0% has provided a catalyst for the equities market which has responded to a more confident world environment. Volatility in markets has reduced recently and is providing greater confidence to investors. The lower short term interest rates is reducing the attractiveness of term deposits and is starting to stimulate flows into higher yielding equities with sustainable or growing dividends. Bank shares are currently offering in the region of 6% yields before franking.

Commercial and retail property valuations are now offering better value and long term investors are re-entering the market. More interest is emerging in the listed REIT space as investors seek higher yielding investments although the outlook for the housing market remains uncertain. Overall the environment calls for a well-diversified investment portfolio of both risk assets and defensive assets.

- **International shares: [Overweight]** Sentiment in global equities markets is improving which provides opportunities for international shares to outperform over the coming year. An overweight position is appropriate for the sector with the US, Asia and emerging markets being the preferred regions.
- **Australian shares: [Overweight] Australian Small Caps: [Neutral]** Opportunities are likely to arise from a stronger investment climate in Asia and the US. Investors who have been holding cash are likely to consider equities during the year as the return profile has become more attractive.  
**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 investors need to be selective in this sector.
- **Fixed Interest: [Underweight]** With interest rates at historically low levels both 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: [Underweight]** The risk return profile of Cash and Term Deposits is becoming less attractive.

## Risks

- The risk of sovereign debt defaults continues to remain 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 continues to face major challenges in managing member countries, especially Greece in near collapse, also Spain, Portugal, Italy and UK with large debt issues and the lack of discipline to control the predicament.
- Social unrest in Europe, Africa and the Middle East is becoming an increasing concern for governments.
- With large US debt levels (US\$16 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 politicians continue to defer making tough decisions.
- Increased social unrest within China maybe an issue with the large urbanisation of the country.
- Poor policy decisions by the Australian Federal government in the lead up to the election may result in lower growth for the Australian economy.

## Global Opportunities

- The Asian region continues to generate satisfactory GDP growth 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.
- The rise of the US energy industry to a point of becoming an exporter of energy (gas) within 3-4 years and oil by 2030 provides a platform for optimism.

## Australia

- Opportunities should continue as China and India evolve into stronger economies over the coming decade and demand for resources should be underpinned 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. Increased opportunities may arise in the lower grade credit markets although caution in this sector is required.
- The listed property trust sector is in better shape to participate in an improving property cycle.

### Monthly Share Market Performance over the last Thirteen Months

Market Indices	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12
Intl-MSCI ex A A\$	0.21	1.17	3.24	5.80	-1.73	-1.76	-0.62	-1.56	4.50	2.11	-0.52	0.67	2.34
Aust - All Ords	-1.57	5.23	2.41	1.15	1.10	-6.90	0.25	3.74	2.12	2.13	2.97	0.27	3.43
Aust – Small Coy	-4.30	7.75	6.51	0.19	-0.92	-10.22	-4.78	-0.19	2.95	4.37	1.31	-2.43	3.23
Aust Property ASX	-2.55	5.40	2.25	-0.59	5.42	-1.24	4.34	5.55	-0.13	1.20	5.32	-1.28	2.86
Global Property	2.77	6.17	1.11	4.63	2.45	-4.22	5.15	3.08	0.60	-0.21	1.11	1.03	3.09

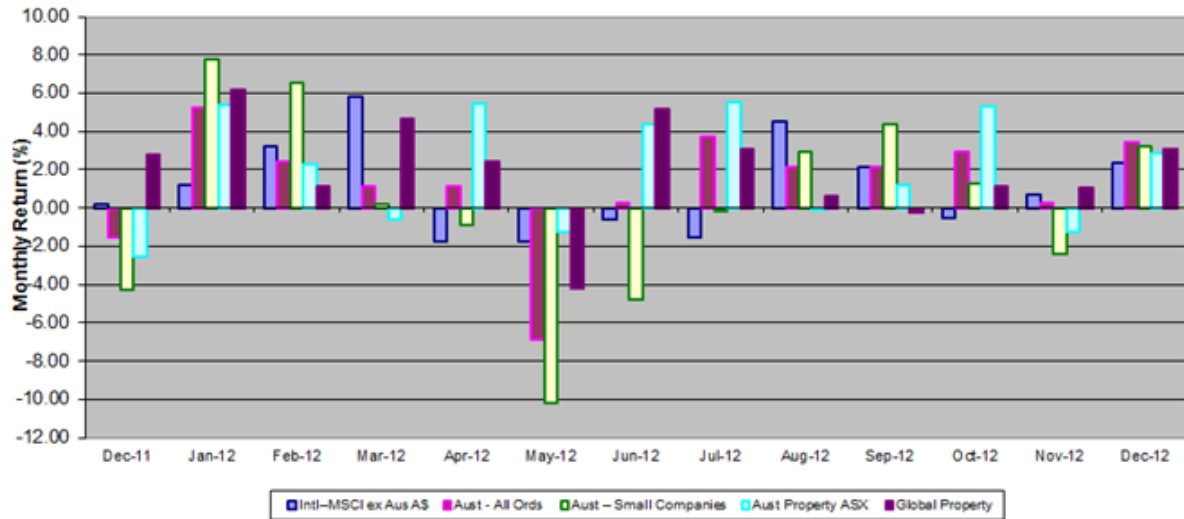
### Annual Share Market Performance

Markets Index	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 30 Sep 12 %	1 Year to 31 Dec 12 %
Intl-MSCI ex A A\$	-2.79	-2.40	0.64	2.66	-4.52	-5.34	0.69	-0.50	13.59	14.14
Aust – All Ords	1.73	3.31	4.80	12.17	-8.43	-11.43	-6.27	-7.04	13.36	18.84
Aust – Small Coy	6.63	13.05	13.49	16.41	-12.11	-21.43	-8.57	-14.61	3.83	6.58
Aust Prop – ASX	-4.52	-0.68	4.74	5.87	-6.29	-1.56	1.67	10.98	28.90	32.79
Global Property	24.88	26.15	24.78	36.60	1.06	1.94	8.40	6.93	30.54	26.29

### Best Performing Asset Sectors for twelve months ended 31 December 2012

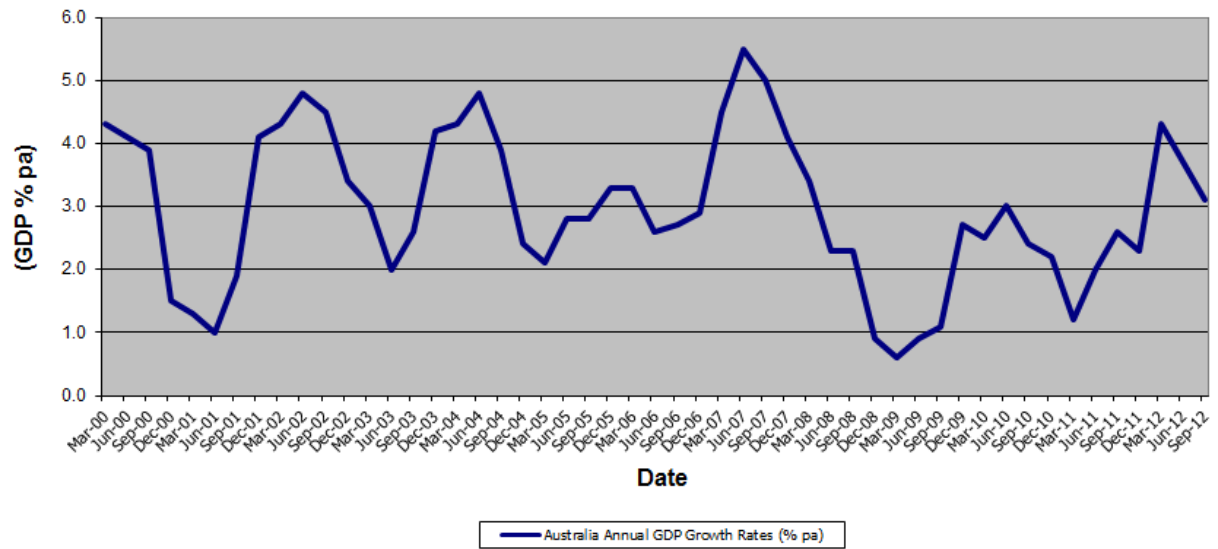
Sector	Market Index	Return
Aust Listed Property	S&P/ASX Property Trusts Accum Index	32.79
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge \$A	26.29
Australian Shares	S&P/ASX All Ords Accum Index	18.84
International Equities Hedged	MSCI World Accum Index Hedged A\$	16.05
International Equities Unhedged	MSCI World Ex Aust Accum Index A\$	14.14
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged \$A	8.02
Australian Fixed Interest	UBS Warburg Composite 0 + Years	7.70
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	6.58
Cash	Australian 90 Day Bank Accepted Bill	3.97

### Market Indices - Monthly Returns (%)

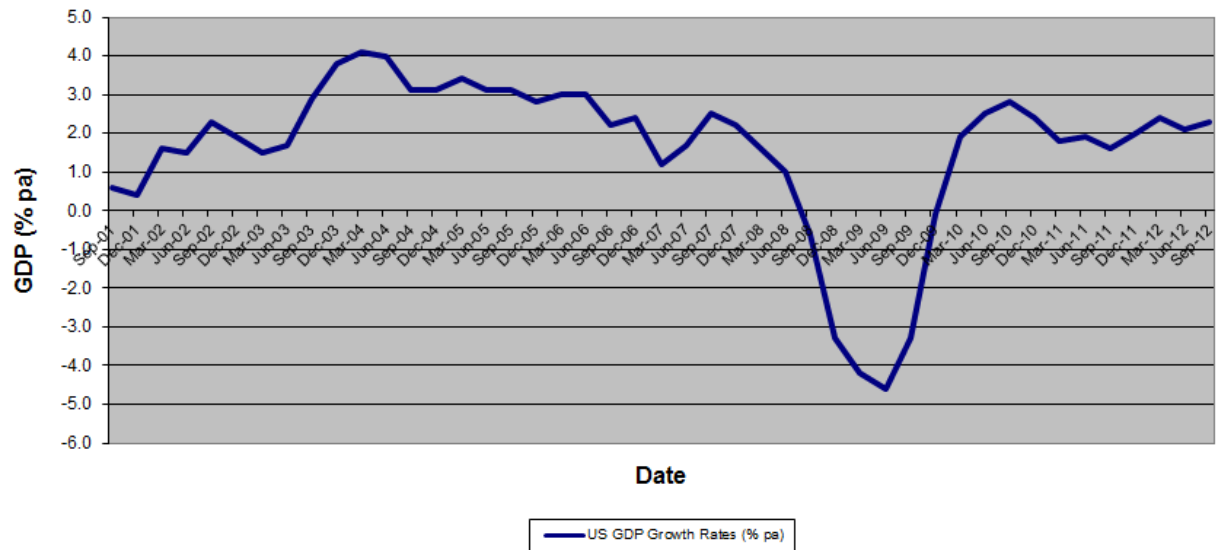


## Major Economic Indicators

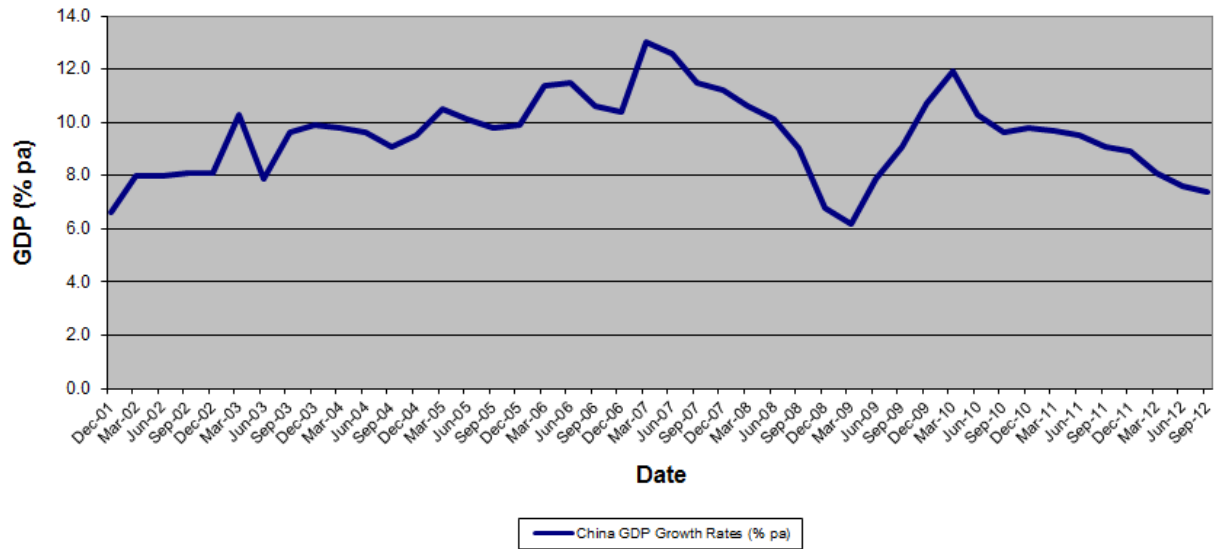
Australia GDP Growth Rates (%pa)



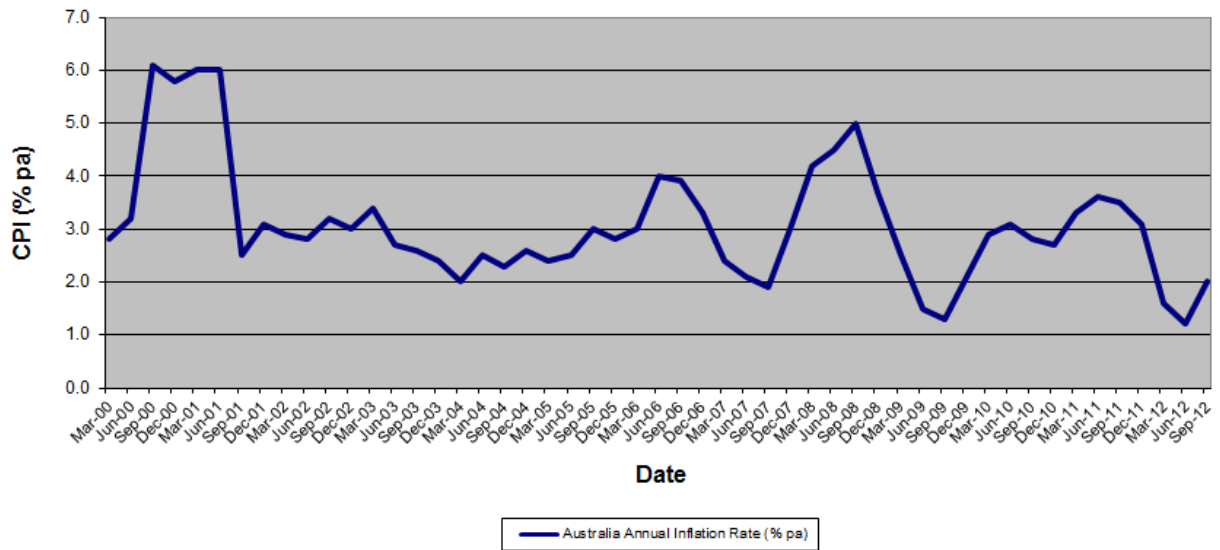
US GDP Growth Rates (%pa)

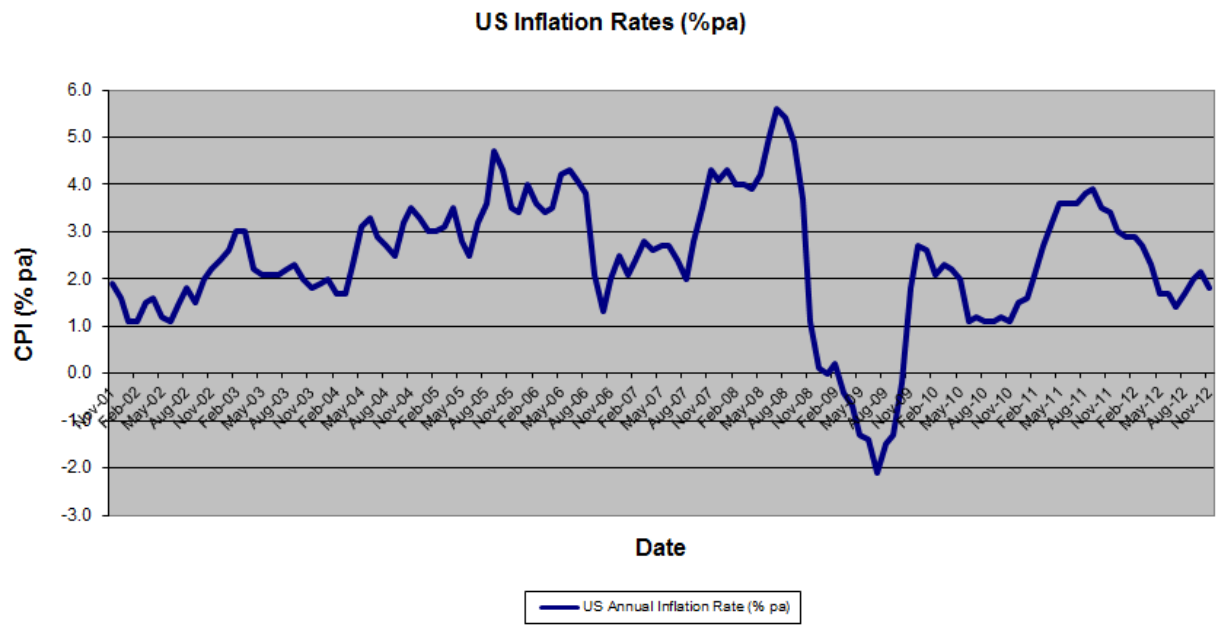


China GDP Growth Rates (%pa)

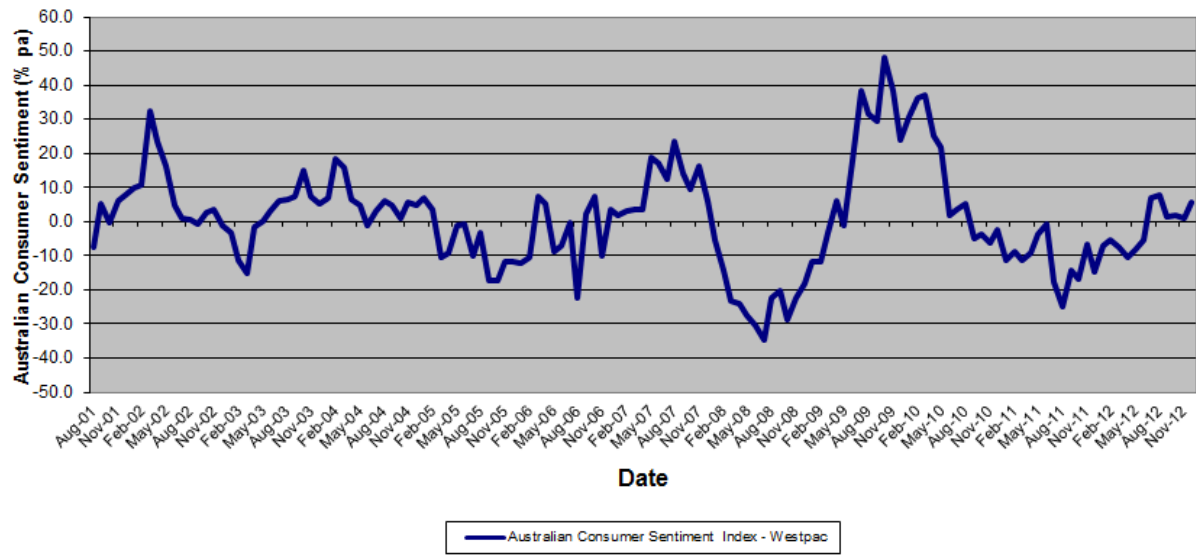


Australia Inflation Rates (%pa)

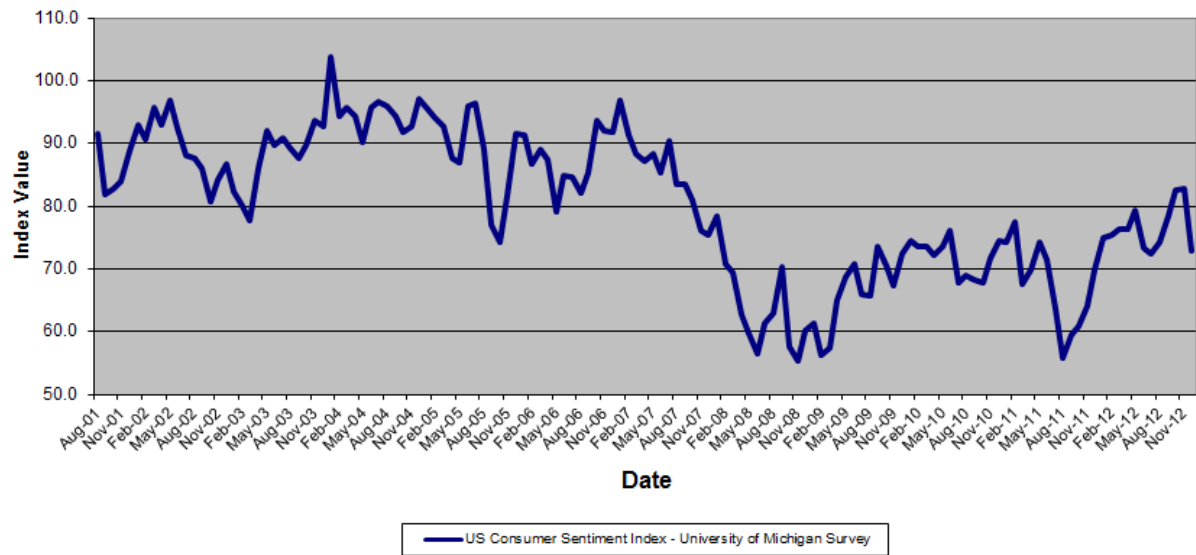




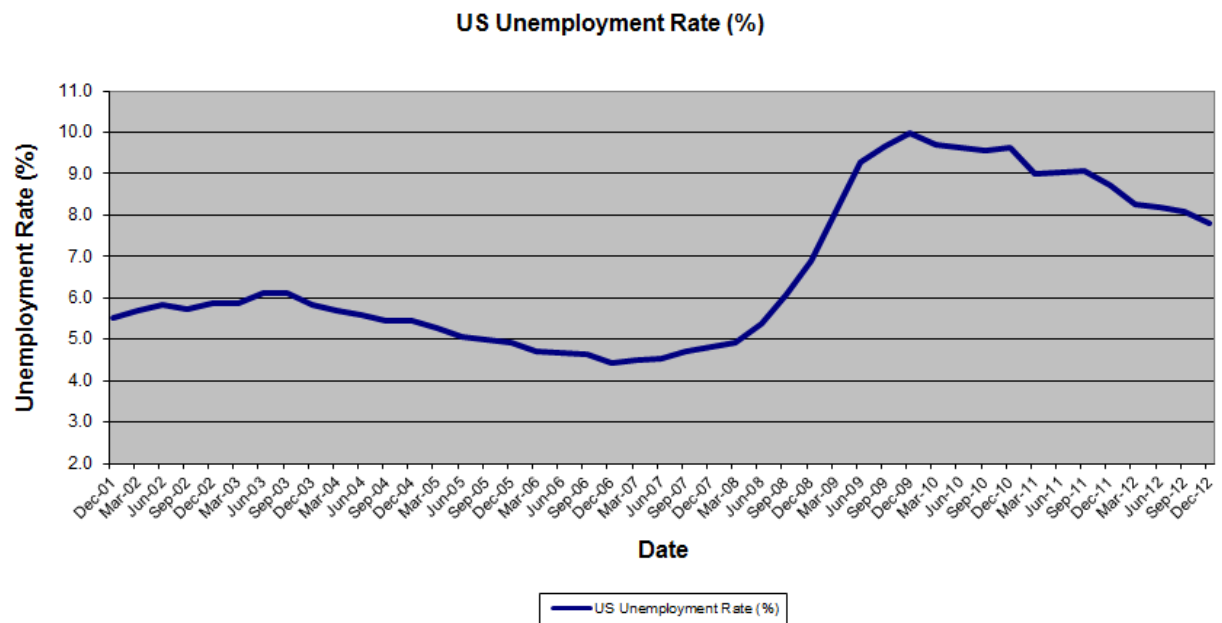
**Australian Consumer Sentiment Index - Westpac**

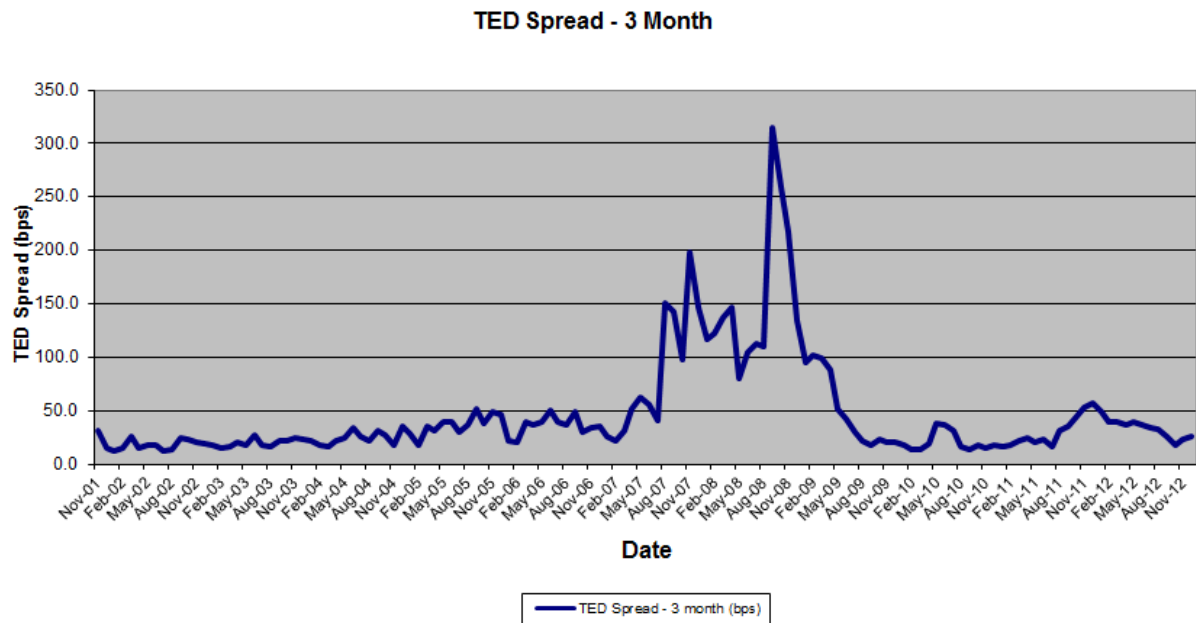
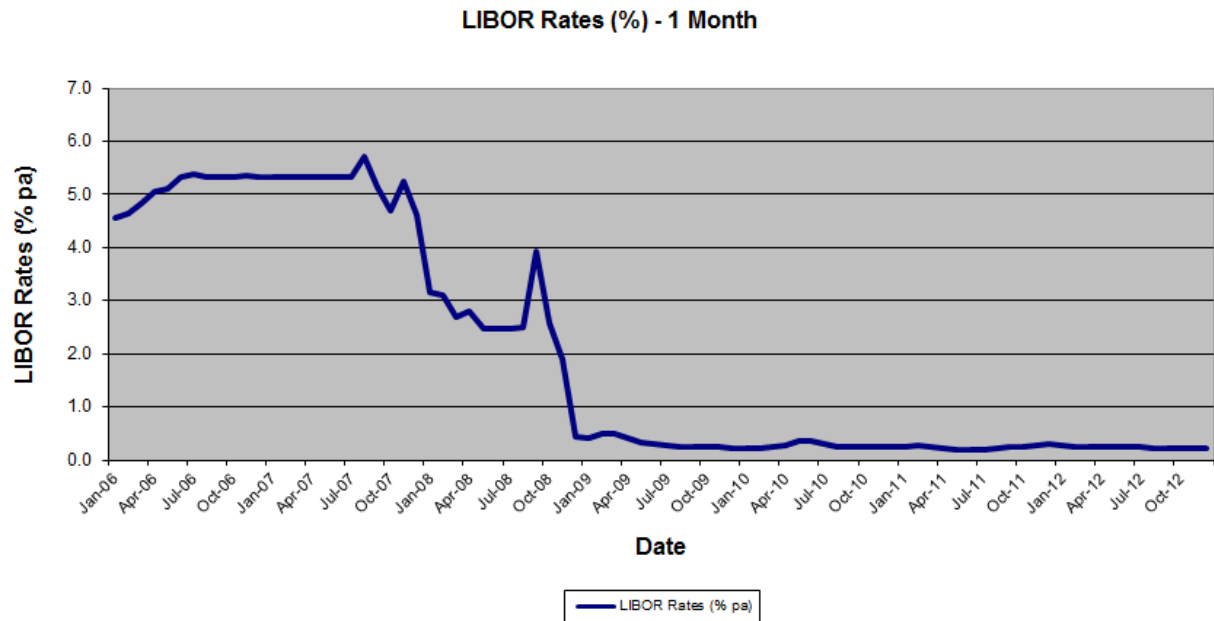


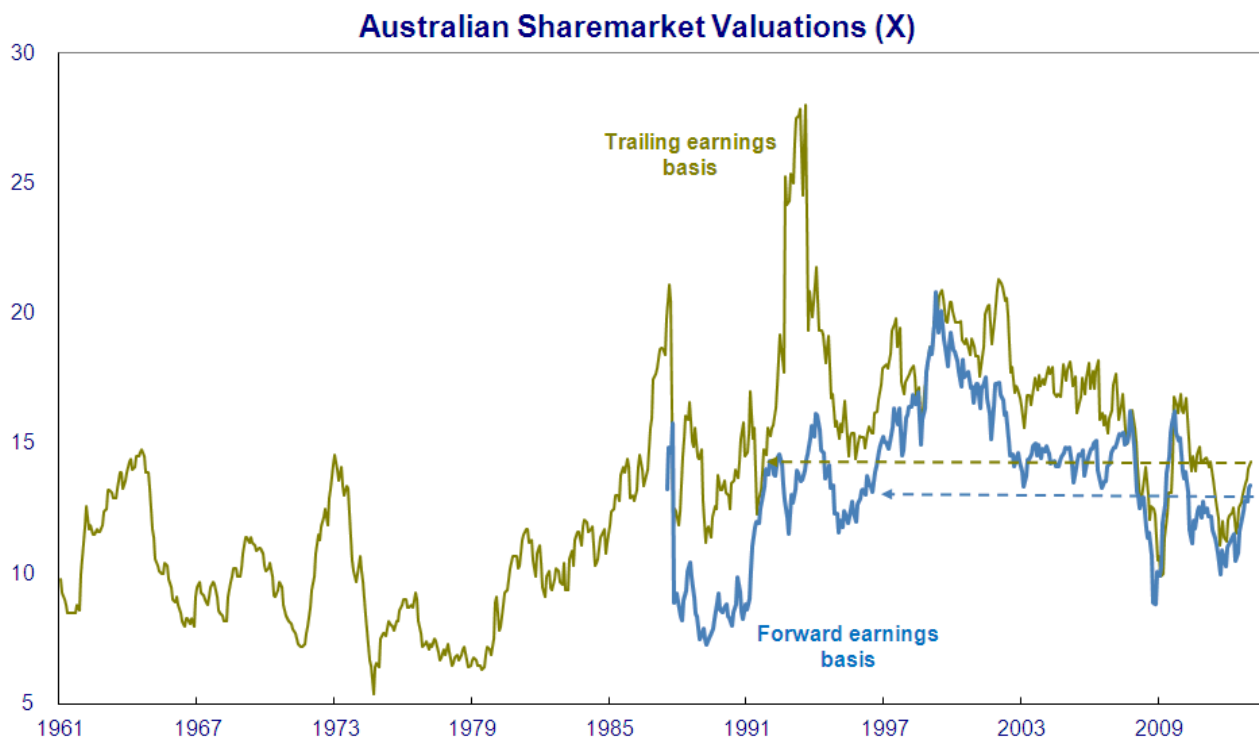
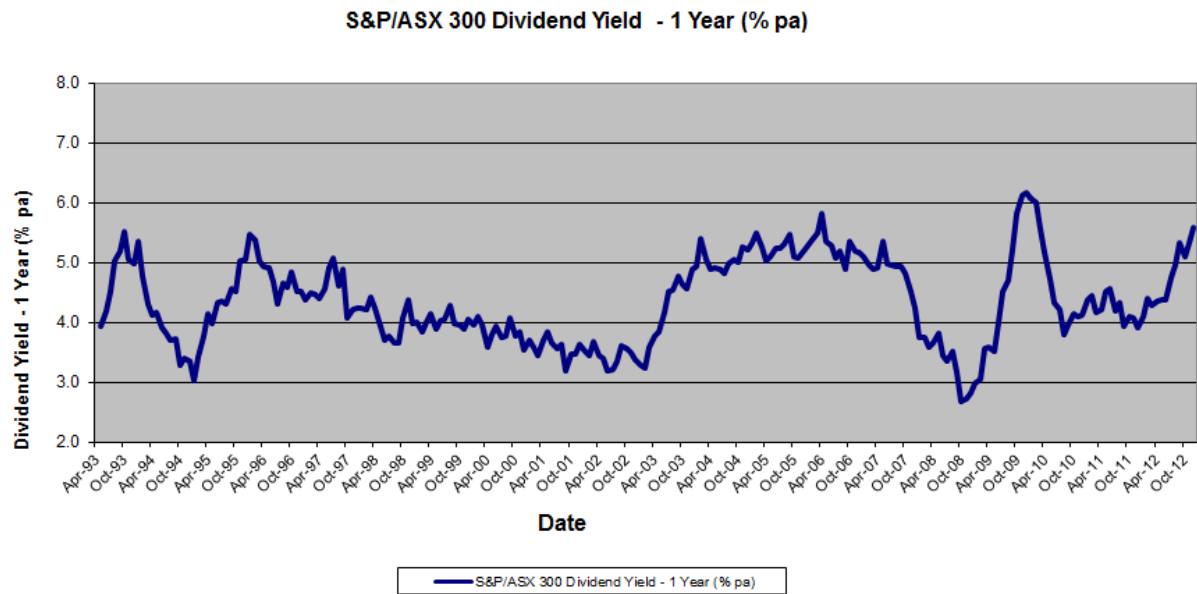
**US Consumer Sentiment Index - University of Michigan Survey**





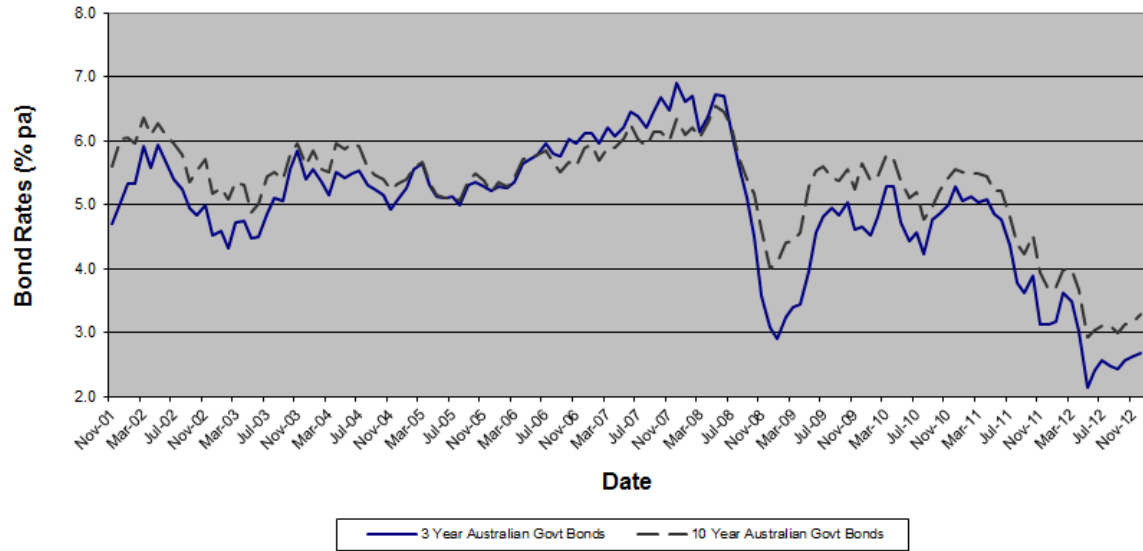




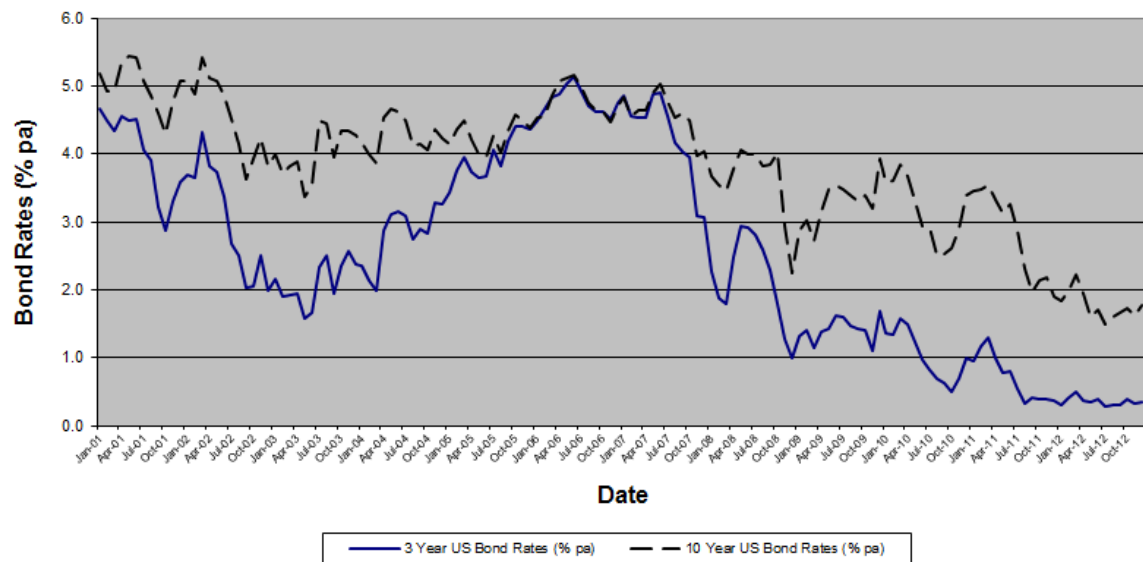


Source: UBS Australia and Reserve Bank of Australia as at 15 January 2013.

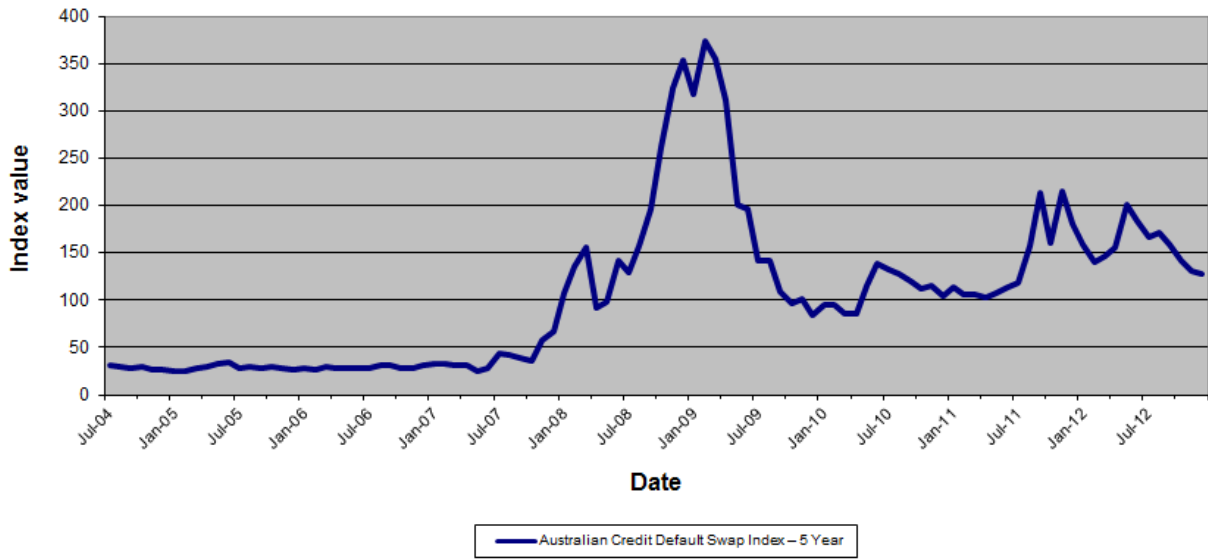
**3y and 10y Australian Bond Rates (%)**



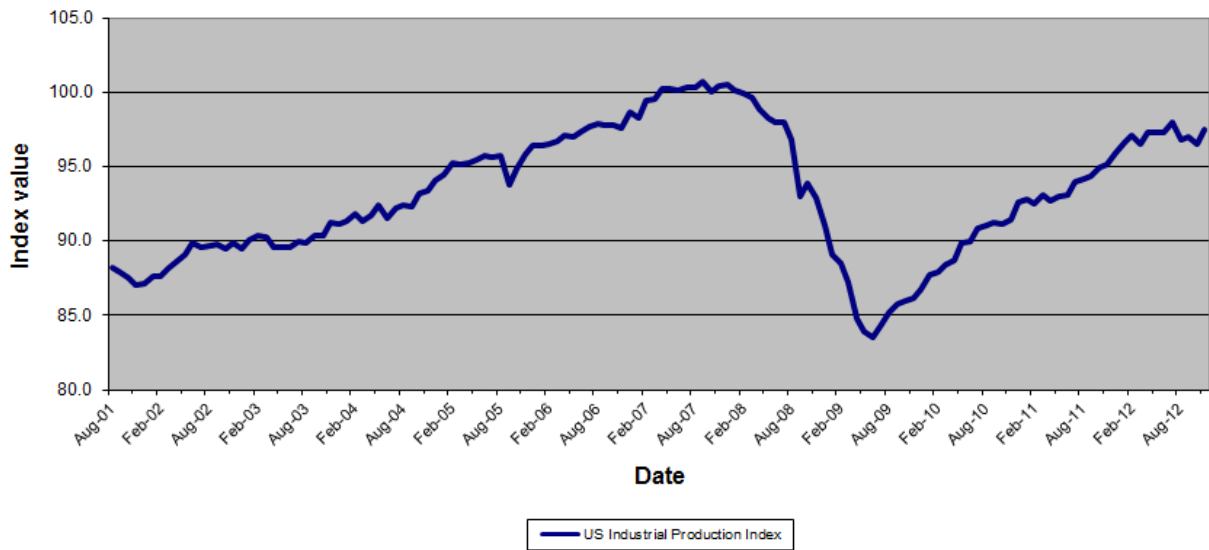
**3y and 10y US Bond Rates (%)**



**Australian Credit Default Swap Index – 5 Year**



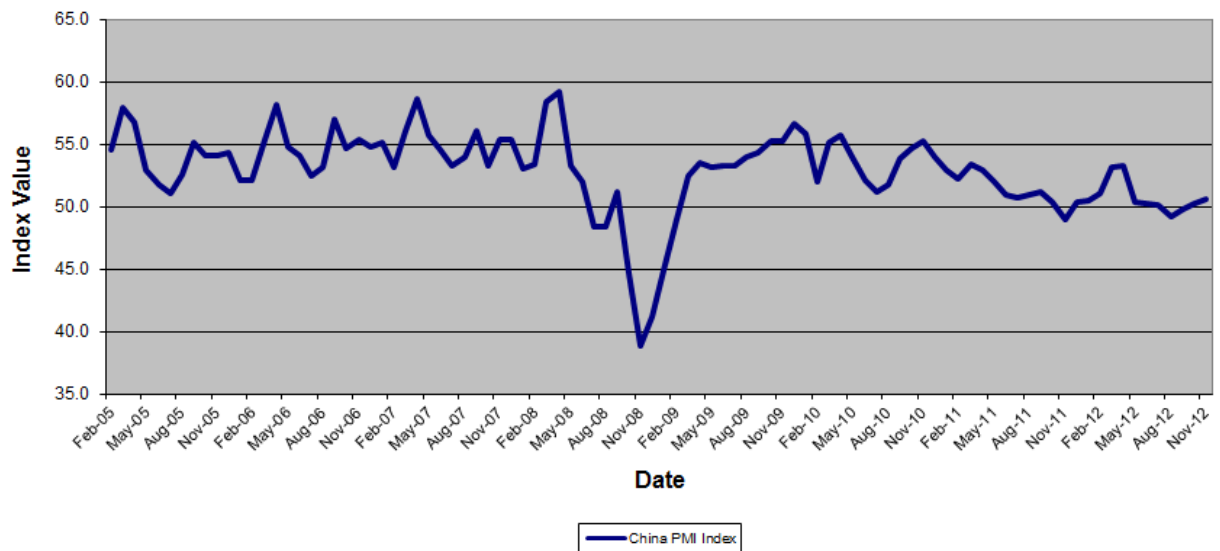
**US Industrial Production Index**



**US Capacity Utilisation Index**



**China Purchasing Managers Index (PMI)**

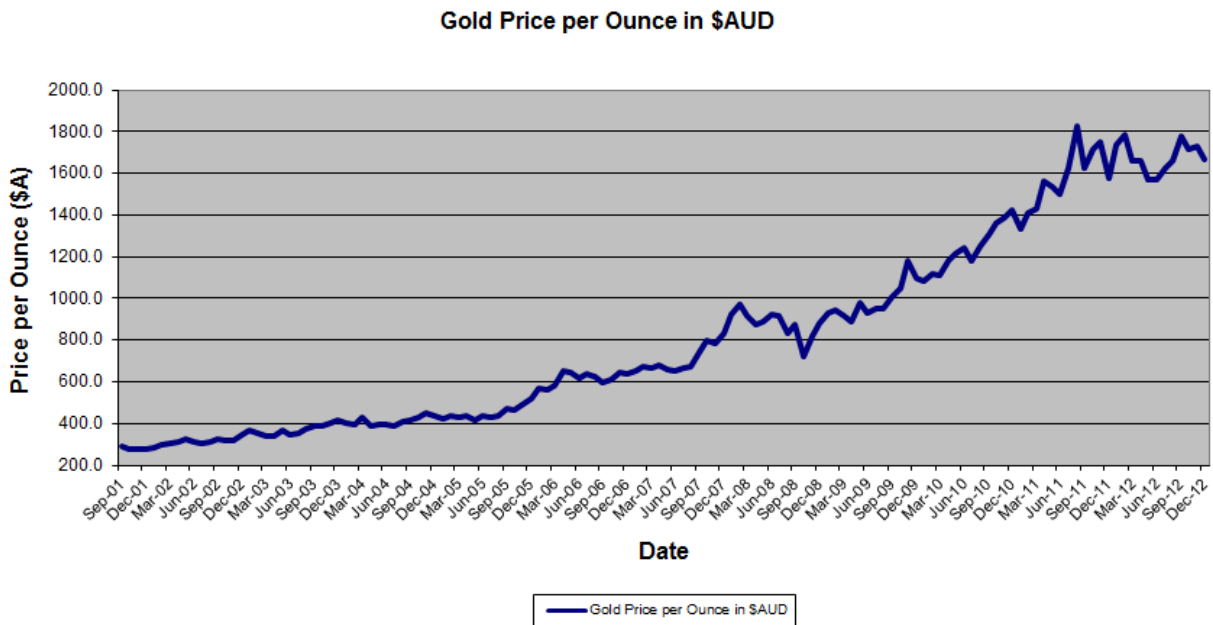
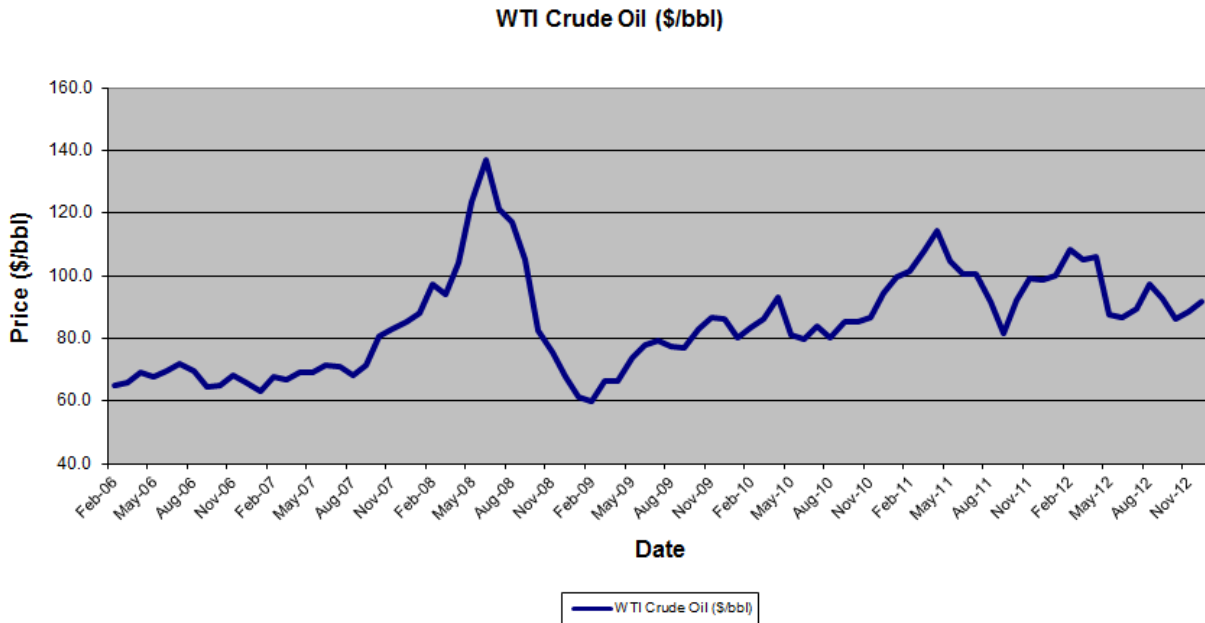


US Existing Home Sales - Millions

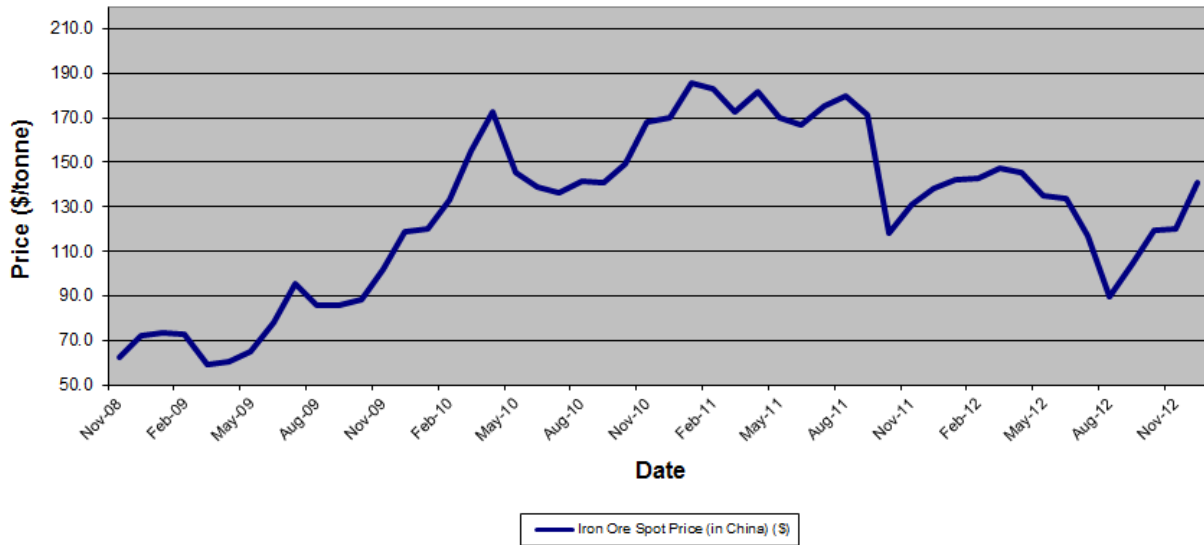
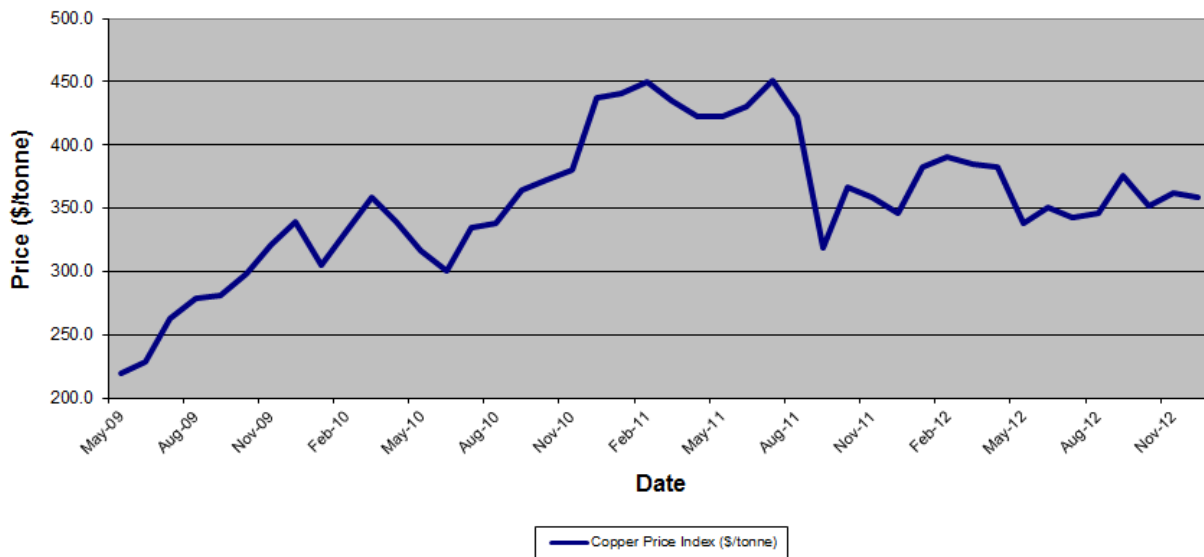


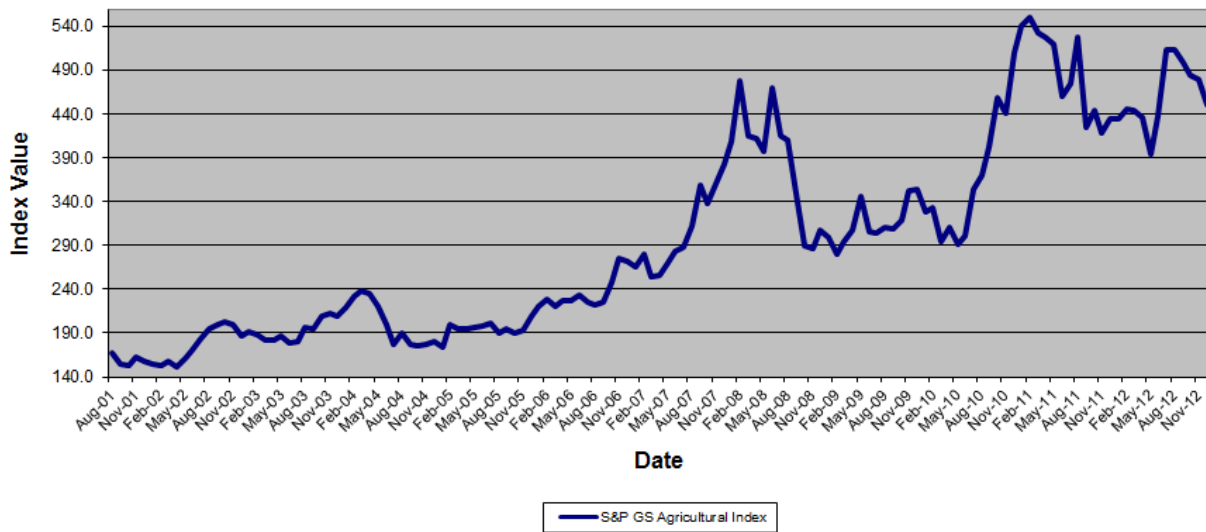
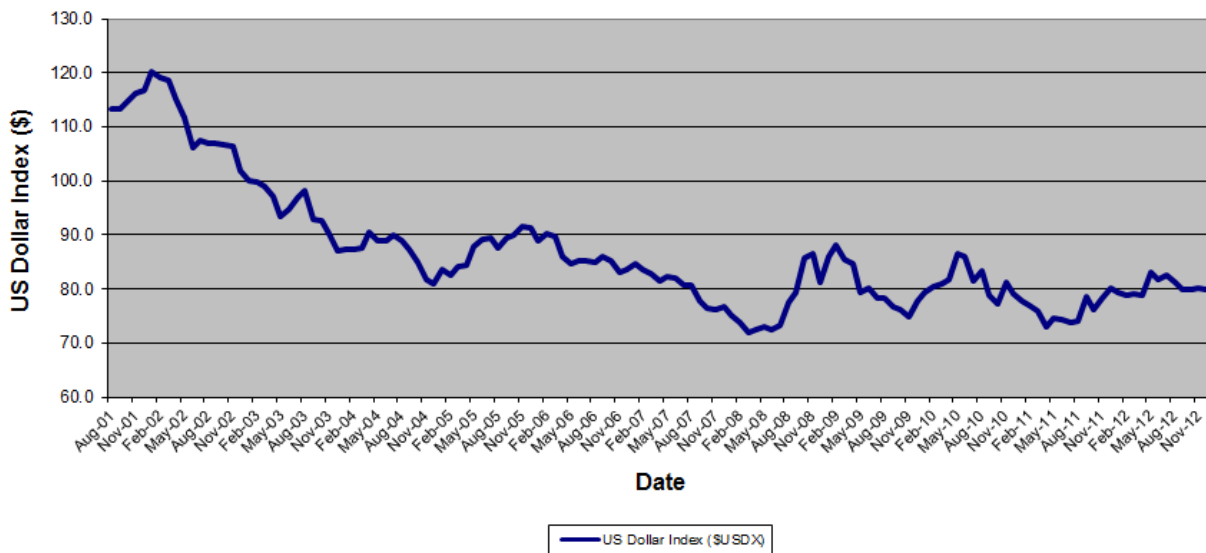
US Existing Home Sales - Median







**Iron Ore Spot Price (in China) (\$/tonne)****Copper Price Index (\$/tonne)**

**S&P Goldman Sachs Agricultural Index****US Dollar Index (\$USDX)**

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%).