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Investment Strategy | Australia

Market Update: Do we need to reassess?

Global uncertainty and growth conditions

The disorderly effort to stabilise European sovereign debt has resulted in a full blown crisis of confidence in financial markets. Secondary features such as the rate and nature of growth in China, topping out of commodity prices and moderating leading indicators would typically be part of shorter term market movements, but in the heat of these times, they are additional issues for risk adverse investors and encourage traders into short positions.

It would be remiss to suggest that this is a passing phase. The difficulty in dealing with the consequences of unsustainably high levels of government debt, which has been in the making for some time, is going to take years to resolve and invariably results in lower global economic growth, political instability and periods of uncertainty.

The imminent question is whether a vote in Germany overnight (21 May) approves the €750bn EU Stabilisation package. Even though this may provide a temporary relief to sentiment, it is unlikely to signal the fundamental end of the issue. The size of the package is not the question – it should be able to adequately cover the refinancing requirements of the indebted nations of Europe. However, over the coming months, government budgets will remain under intense scrutiny by the financial market for any inconsistency in assumptions to rebalance the deficits. Spending cuts, in some cases dramatic, are inevitable and the socio-political consequences will weigh on elected governments.

It would therefore be reasonable to suggest that the emerging signs of economic recovery in Europe will at least hit a temporary air pocket and probably only re-emerge in a patchy fashion. Globally, Europe is a meaningful region, but the world has been able to achieve reasonable economic growth even with slow momentum in Europe. The critical issues are global financial stability, the potential growth from the US and the momentum in emerging markets.

In brief we have seen a cyclical improvement in economic data, ahead of expectations, out of the US. However this is likely to fade as the year progresses as we move past annualising against the plunge of 2009, due to high unemployment and reduced fiscal support. Unfortunately, the financial instability we are currently experiencing is also likely to cut off the improvement in business and consumer confidence, both key to changing spending and investment behaviour.

In summary, while the European debt crisis is likely to pass, the real cost and growth implications for global economies are becoming more obvious. On the other hand, we do believe the risk of a major meltdown is low as governments have clearly signalled their willingness to mortgage the future to support the present. Major policy mistakes are hard to point to, even if the execution has been patchy. Indeed by and large, governments have and probably will continue to achieve their aims.

Australian economic conditions appear to remain in sharp contrast to these issues, as well as the moderate level of government debt. While this augurs well for the longer term outlook, we are reminded by the heightened sensitivity to China, commodities and global interest rates. The apparent resilience could prove fragile if the developed world's economic conditions impacts on Asia.

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Investment returns and allocations

The investment implications of these comments are to temper expectations (if there are any!) of a return to normal investment conditions and 'fair value' market for some time. But they do not either suggest that portfolios should retreat and take all risk off the table.

We have commented in recent notes on the financial strength of the corporate sector. Companies have historically low levels of debt and are operating on a low cost model. Cash flow has been good and profit results have tended to be positive on balance. Companies have significant capacity to pay dividends, undertake buybacks and invest capital with an emerging acquisition cycle demonstrating that corporations and private investors see value in businesses. In addition, corporate lending and the corporate credit markets are relatively liquid with apparent negative change in credit availability, albeit largely to highly rates entities.

We stress the importance of asset allocation, especially to fixed interest markets, where we recommend a 30% portfolio weighting for low risk and 25% for medium and high risk investors. The construct of the fixed interest component is also critical, that is to provide stability and income, not with the intent of capital gain. And we encourage investors to re-consider global investing to reduce the sensitivity to the Australian market on the investment portfolio. Global markets have held up better than the local market due to our link to commodity markets and the risk trade. Unhedged exposure would have served to dampen the impact of equity volatility.

What to consider now?

Investors should re-assess their portfolios in this environment. The purpose is to get the investments ready to participate in any recovery in equities rather than waiting for a recovery.

For direct holdings, we believe larger blue chip companies should be emphasised. Mid to small capitalisation stocks are best off in the hands of bespoke fund managers. Not all stocks can be winners, and a balance in industry segments, risk and themes is appropriate. It is the overall portfolio that matters rather than focusing purely on outliers.

We believe bank stocks are oversold, if only for the 6%+ fully franked yield on offer, with very low risk in that yield. Solid industrial companies such as CPU, ORI, UGL, RHC, AMC and NWS also make the grade and we firmly believe these can be exceptional buying opportunities as all stocks get indiscriminately caught in the downdraft. We remain cautious on resources companies given uncertainty in the RSPT outcome and lack of any global interest in this theme at present. However adding NCM will dampen the volatility from holding the major resource stocks and provide exposure to gold. Finally adding lower risk companies such as AGK, APA, QBE and WDC will aid the defensive nature of portfolios.

In managed funds the Wavestone Long /Short and AR Capital fund are structured to make the most of volatility. Denning Pryce is another way to participate as well as the potential for relatively high income. Globally Platinum International can take contrarian views and active currency management.

In Fixed Interest, an appropriate hybrid portfolio alongside a manager such as Pimco or Vianova will be a redeeming feature if the current environment persists.

Finally on currency. The rapid slide in the Australian dollar is largely reflecting the sell down by investors out of our equity market and the uncertain commodity outlook. It also coincided with the view that the RBA may pause on interest rates until later in the year, removing the interest rate opportunity for the A\$. We also remind investors that the classic risk adverse currencies of the US\$ and the Yen have been the beneficiary of current circumstances. We would caution against over reacting to the currency now, indeed it would be inconsistent to suggest anything positive for equities without implying that the currency should at least stabilise. At this point we would look to the potential for a broad trading range of 75c-90c/US\$ and shift our bias to hedged and unhedged accordingly. To date we have suggested a 50/50 hedged/unhedged allocation. However we are strongly of the view that investors hold some unhedged foreign currency exposure as it will once again limit some volatility in the portfolios. Australian investors are implicitly in the currency trade simply through our weighting towards Australian equities and specifically resources.

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