

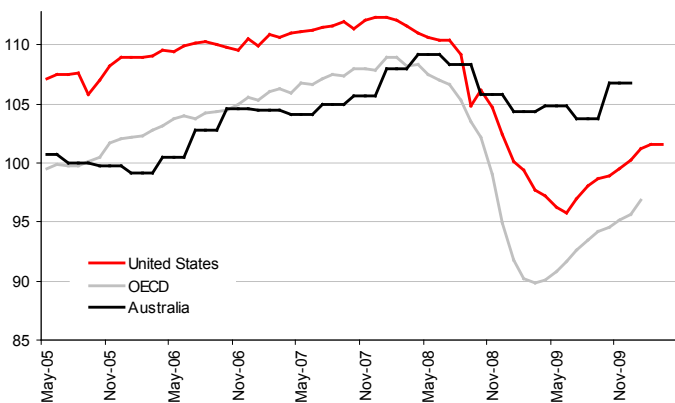
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Recovery on track, but not without risks

The global recovery is gaining strength and the worst recession since the early thirties looks to be behind us. However whilst the long, slow recovery is certainly underway and is gaining in strength it is uneven both regionally as well as across sectors. The key themes behind the slow recovery remain: slow credit growth and the delevering consumer. The key risks to the recovery are potential weakness in the housing market, tight credit, and the increasing risk of ever expanding sovereign debt. Across the emerging markets, in particular South East Asia, growth has rebounded strongly thanks to unprecedented fiscal and monetary stimulus. As a result the Australian economy has fared well.

Chart 1. Industrial Production shows the extent of the recovery Source: Factset



Global recovery gaining strength

The massive injection of fiscal and monetary stimulus globally has had the desired effect and as a result the global recovery is gaining traction. However the pace of the recovery varies across regions. The emerging markets are growing strongly in particular in South East Asia and the United States is picking up meaningfully but Europe and Japan remain in the doldrums.

While the initial recovery was driven by fiscal and monetary stimulus, the more recent pick-up has come as a result of a restocking of the supply chain. This has driven the recovery in the first half of the year.

The next stage of the recovery will be the moment of truth. As fiscal stimulus fades in the second half of the year we will discover the true level of end demand. Right now consumption has increased and is running at around 3.5%. However consumption needs to be backed by incomes which have grown at only 2% per annum. We have seen a small increase in hours worked but unemployment remains stubbornly high.

However our concerns surrounding a two-tiered economy are being fulfilled with resources and mining related sectors doing well whilst domestic industries and tourism are facing a more prolonged recovery.

Overall though, we are pleased that the global recovery is gaining traction. But given the prospect of slow credit growth and a delevering consumer we believe that total returns for the stock market will be below average and volatility will be higher. In this environment active management is likely to fare significantly better than passive. Also, we believe that good quality, small cap, value companies with solid dividend yields will outperform the market over the next three to five year period.

Key Points

- *Global recovery is gaining strength*
- *Financial conditions are improving but are doing so unevenly*
- *Slow credit growth and the delevering consumer remain major headwinds*
- *Risks remain: soft house prices, tight credit and sovereign debt*
- *Australian outlook is good, but not without risk*

In assessing the speed of the recovery we need to understand the pace of the pickup in employment. In the US economy employment grows at around 1.8% per annum with existing business subtracting 1.2% from employment and new startups adding around 3.0%. Unfortunately, due to the lack of credit available to new businesses, jobs growth is likely to remain slow.

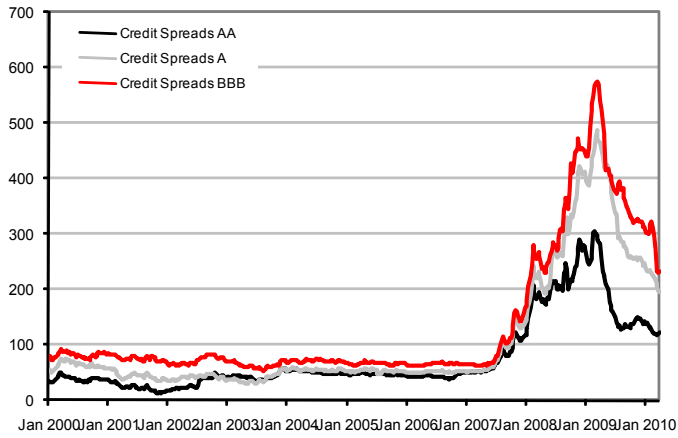
Ultimately any pick up in consumption that is not backed by incomes is bound to disappoint. As a result we continue to watch consumption, income and employment numbers in order to gain an understanding of the level of growth going forward.

Financial conditions are improving but are doing so unevenly

Financial conditions have improved considerably since March 2009. However the improvement has not been consistent across sectors. Whilst large companies seem to have little trouble raising credit (albeit this is more expensive than pre-crisis – see chart 2), the consumer sector and small-to-medium sized enterprises remain credit constrained

Chart 2. Australian Credit Spread

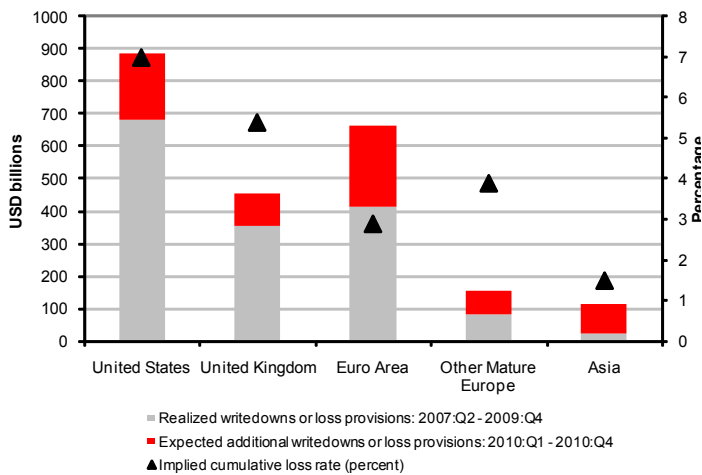
Source: Reserve Bank of Australia



In order to improve the flow of credit to the consumer sector and to small-to-medium sized enterprises we need to repair the damage done to the banking system. This entails banks being fully recapitalised and/or restructured in order to absorb the deterioration in credit quality and to support credit growth in a world of tighter regulatory standards. At the end of 2009 only about two thirds of the estimated \$2.3 trillion USD in write-downs had actually been completed (chart 3). Consequently non-financial private sector credit growth continues to contract (chart 4).

Chart 3. Realised and Expected Write downs or Loss Provisions for Banks by Region

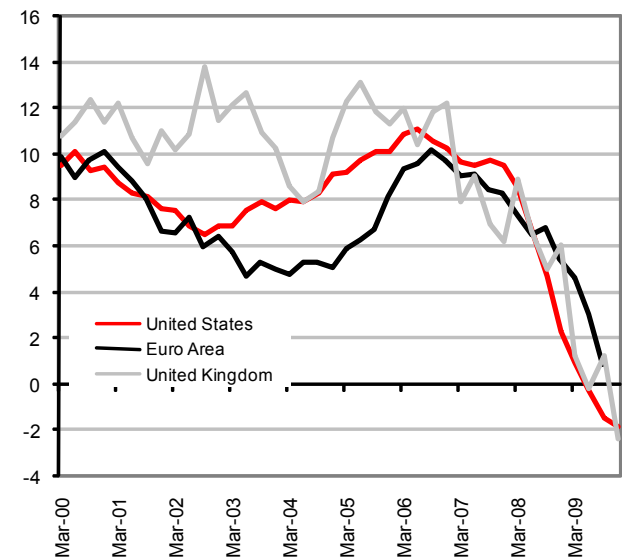
Source: IMF



The next step in improving credit growth is to revive the securitisation markets. These markets which before the financial crisis had become an integral part of the bank lending process collapsed during the downturn and have not as yet recovered. Once banks are recapitalised and/or restructured and securitisation markets have recovered, lending capacity should once again start to expand.

Chart 4. Nonfinancial Private Sector Credit Growth

Source: IMF

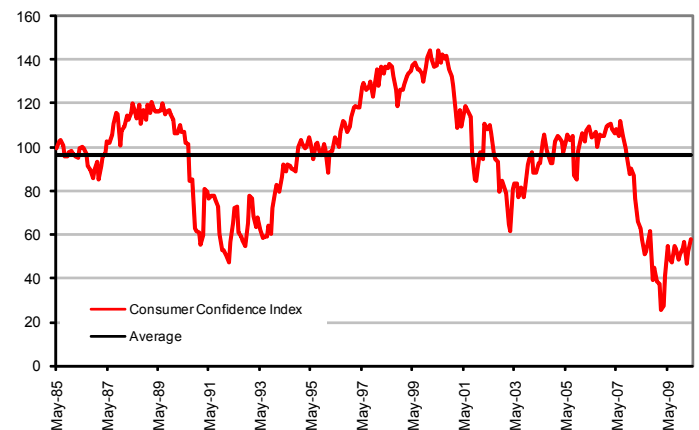


Slow credit growth and the delevering consumer remain major drivers

As noted previously the lack of bank lending capacity is a major constraint on credit growth. The other side to this equation is the demand for credit. Whilst banks may not be able to or want to lend, in the consumer sector there is little demand for credit. The reality for the US consumer is that housing has collapsed and an estimated 23.3% of mortgages are now under water, whilst 14.25% of mortgages are in some state of foreclosure or default. It comes as no surprise therefore that consumer confidence has not picked up since its collapse during the financial crisis. Note that the long term average for consumer confidence is 96.8 and it is currently measuring 57.9. As a result the US consumer is likely to continue to delever and is unlikely to start borrowing again in the near term especially whilst there are still signs of weakness in US housing.

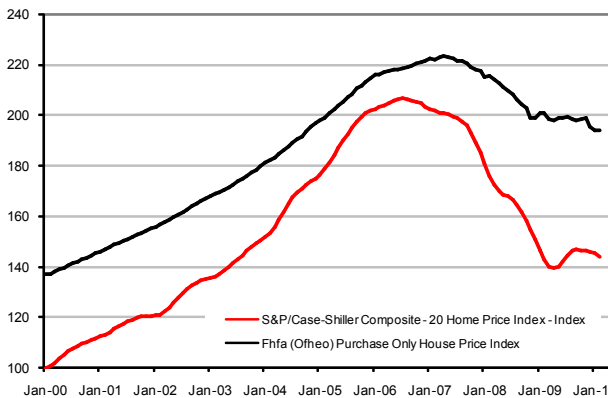
Chart 5. United States consumer confidence

Source: Factset



**Chart 6. United States house prices:
S&P Case-Shiller and FHFA house price**

Source: Factset



Risks remain: soft house prices, slow jobs growth, tight credit, and sovereign debt

There are two main risks to the recovery. The first and most obvious risk is that the recovery remains fragile. As a result any weakness in house prices or jobs growth could lead to a further contraction in the credit markets as well as a deterioration in consumer confidence. This would potentially lead to a ‘double-dip’ recession and would have significant ramifications for emerging economies through both capital flows and trade channels.

The second major risk is that of sovereign debt. With the rapid expansion of public balance sheets as governments around the world have stepped up spending in an effort to restart their economies, government debt levels have ballooned to unsustainable levels. The concern we have here is that there is little evidence to illustrate how much debt is sustainable. Clearly there needs to be a balance between economic growth (and hence tax revenues) and the cost of debt (or yield on government bonds). This will be examined in greater detail in our next note but we wish to draw attention to the fact that with interest rates at record lows and government balance sheets stretched to capacity, governments in many advanced nations are left with little room to manoeuvre.

Australian outlook is good, but not without risks

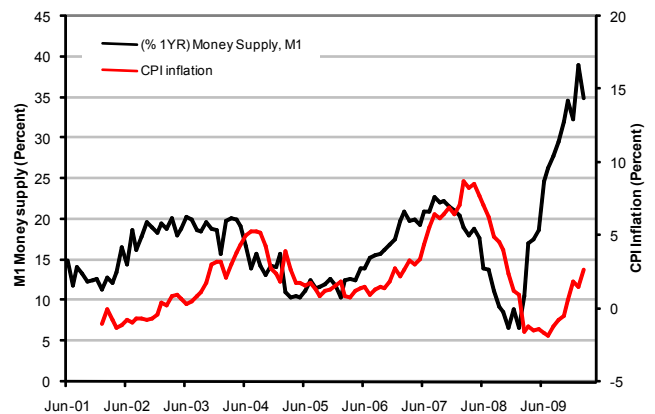
On a more positive note the outlook in Australia is more robust. Retail sales are strong and are reinforced by gains in both income and employment. Whilst the cost of credit has increased particularly amongst small-to-medium sized enterprises, this has been partially offset by demand for resources from SE Asia. Though this demand is driving a robust recovery it will ultimately continue to drive a two-tier economy with resources and related sectors doing relatively well whilst domestic industries and tourism recover more slowly

Our only concern surrounding Australian consumption is that whilst the rest of the developed world is delevering, Australian consumers have resumed their love affair with debt. Clearly this is a concern for the Reserve Bank of Australia and one of the key reasons for the sharp increase in interest rates. Rates have moved up from 3% to 4.5% and are likely to approach 5% (the neutral level) by year end.

What about Chinese demand?

Going into the downturn China, our largest trading partner, spent a massive 15% of GDP in an effort to ensure that their economy did not feel the effects of the slowdown. Following this extraordinary stimulus package demand for commodities has, unsurprisingly, been running strongly and prices have reacted accordingly. However, given the massive increase in money supply it is likely that we now see a significant increase in inflation. Chinese authorities have stated that they will actively target inflation, and are now beginning to slow credit growth through increasing bank reserve requirements and tighter lending practices. As a result we expect the level of demand for commodities to normalise. Note that we are not expecting an outright collapse in prices, we simply expect the prices to adjust back to fair value.

Chart 7. M1 money supply and CPI inflation in China Source: Factset



Looking to the future in China, one of the key concerns for policy makers will be the rebalancing of the economy. China’s growth story is one of urbanisation of the population. However as infrastructure spending slows it will be important for China to introduce a new driver of growth through domestic demand. Obviously this is easier said than done. By comparison across the developed world the consumer generally accounts for around two thirds of GDP whilst in China consumer demand accounts for only one third of GDP. From a global perspective the driver of the global economy remains the US consumer accounting for roughly US\$10.5 trillion per annum. The Chinese consumer accounts for US\$1.5 trillion per annum and the Indian consumer US\$750 billion.

Conclusion

Australia has largely escaped the effects of the global financial crisis and is likely to see monetary policy continue to tighten as fiscal stimulus fades in the second half of this year. Given Australia's exposure to SE Asia we expect growth to continue. However our concerns surrounding a two-tier economy with resource companies doing well whilst domestic industries and tourism face a much slower recovery remain in place.

In the United States the recovery is gaining traction. Fiscal and monetary stimulus have had the desired effect. The supply chain restocking is taking place and the first signs of the consumer recovery are showing. All indications are that the recovery will be both long and slow. In Europe, despite panic over Greek sovereign debt and the contagion, business activity indicators are pointing to a recovery being underway. However it is likely to be slower than in the US and in Japan the recovery looks to be sluggish as well.

In conclusion the recovery is fragile but is continuing to gain strength. Financial conditions are easing, and employment should pick up slowly. Delevering will remain a key theme for the foreseeable future. As a result we expect growth to slow while the world finds a sustainable level of demand as stimulus fades. The key risks are a collapse in confidence in the recovery as a result of either weaker housing, or tight credit, or panic over the sustainability of sovereign debt.

Investment strategy

Given that we are in the early stages of a long, slow recovery we believe that on a three to five year view value and small caps will outperform growth and large caps. But with the prospects of slower economic growth and greater uncertainty we are likely to face a stock market of lower total returns and higher volatility. As a result we believe that the best strategy will be to focus on high quality companies with solid dividend yields as dividends should make up a higher proportion of total returns going forward and will reduce the volatility of the portfolio.

Against the backdrop of this outlook for the global economy we remain defensively positioned. We are overweight the Consumer sectors, Health Care, Telecoms, Utilities and Industrials and are underweight Materials, Financials, Property Trusts and Energy. Whilst it may seem counterintuitive to be overweight the Consumer sectors at a time like this our overweight position is focussed on staples such as Metcash (distributors to the independent grocers - IGA), gaming stocks such as Crown and Sky City which have proven to be fairly recession proof, as well as Amalgamated Holdings which is performing exceptionally in its cinema operations.

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