

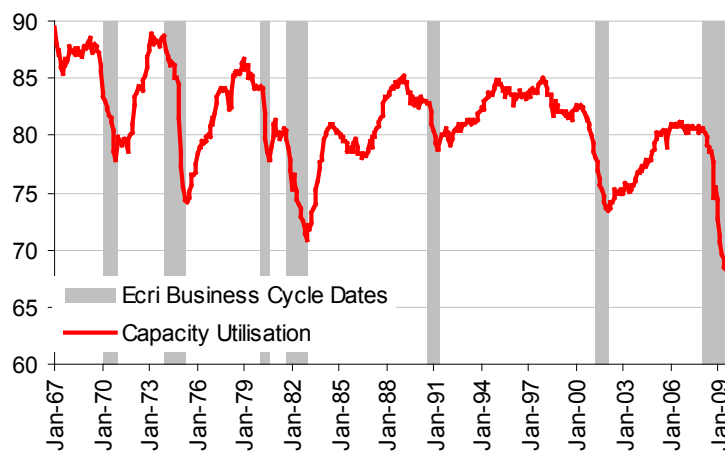


Key Points:

- The Global Recession is ending and a recovery is underway.
- Financial conditions are slowly improving. However credit supply remains relatively tight.
- What lies ahead? In our view the recovery will be slow due to a de-leveraging consumer and slow employment growth, despite continued hopes on China.
- Stock markets have rebounded strongly, driven by increasing risk appetite

Figure 1. US Capacity Utilization

Source: FactSet



The Global Recession is ending

The Global Recession is ending and a recovery is underway (see chart 1 above). However, in our view the recovery is likely to be a slower recovery than the market is currently anticipating. From an economic perspective GDP growth (in developed countries) is made up of around two thirds consumer demand, with the remainder split fairly evenly between government spending and private domestic investment. What has occurred (and typically occurs following a credit episode) is that consumer spending slows considerably – in fact in the three to four years following a credit episode the consumer generally contributes nothing to GDP growth. This leaves the slack to be picked up by businesses and the government.

What lies ahead: de-leveraging and slow employment growth

Over the past thirty years credit growth has grown at a significantly faster rate than nominal GDP. Or, in other words, consumers have grown their debt levels significantly faster than their incomes. Specifically, consumer credit has grown at between 10 and 15% pa whilst household disposable income has grown at around 4% pa. This wasn't a problem in the eighties and nineties as the consumer had a relatively low debt level to begin with and interest rates were high. As interest rates fell consumers were able to take on more debt and in the early nineties, with the introduction of inflation-targeting by central banks, interest rates remained low. By the late nineties debt-to-household disposable income levels reached around 100%. This is the uppermost level that central banks regard as sustainable.

Of course the introduction of securitised mortgage debt meant that banks could lend as much as they liked as long as they were able to on-sell the risk to someone else. As a consequence debt-to-household disposable income levels increased to around 140% in the US and 159% in Australia.

The consumer is now in the process of de-leveraging (whether by default or by paying down debt). In the US (where much of the lending is non-recourse) this process occurs very rapidly. In fact the estimate is that the US is now roughly half-way through the process after two years. This implies that in around two to three years time the US consumer will be in a position to at least maintain their credit growth at the same level as their income growth. In Australia, thanks to the increased first home-buyers grant, we have not yet truly begun this process.

Why does this matter?

As we mentioned before the consumer makes up around two thirds of GDP in developed countries. Over the past thirty years consumer credit growth has grown at between 10 and 15% pa. Now in order to maintain that level of gearing consumer credit can only grow at the same rate as disposable income growth, that is around four percent per annum. Clearly, this is a far cry from the historic 10 to 15% pa. With consumer credit growth being less than half what it was we should expect the consumer to contribute less to growth in GDP.

A tepid recovery

This is the primary reason that, in our view, the recovery is going to be very tepid, particularly compared to previous recoveries. Of course slower consumer credit growth has other implications. Consumer demand is largely responsible for corporate profits. With consumer demand subdued, it is unlikely that businesses will expand and as a result employment is likely to be slow to pick up.

The other driver of slow employment growth is the availability and cost of credit, in particular to small businesses. Whilst there appears to be no sign of improvement in end demand in the economy, small businesses typically do not put in place any expansion plans. However, even those that would like to expand are constrained by the lack of availability and cost of credit (see Figure 2 below). The reason for this is that banks themselves are only half way through their de-leveraging process and as a consequence their lending capacity is still contracting (see Figure 3 below).

Of course small businesses are the biggest employer in the economy. Therefore without any expansion plans it is unlikely that unemployment will decrease in a hurry.

Figure 2. Credit Spreads (Australia)

Source: RBA

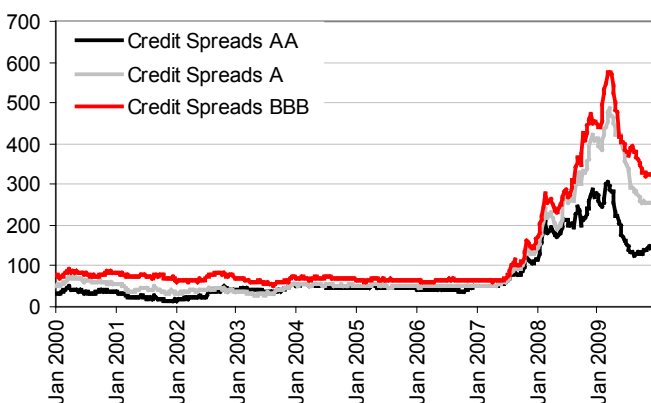
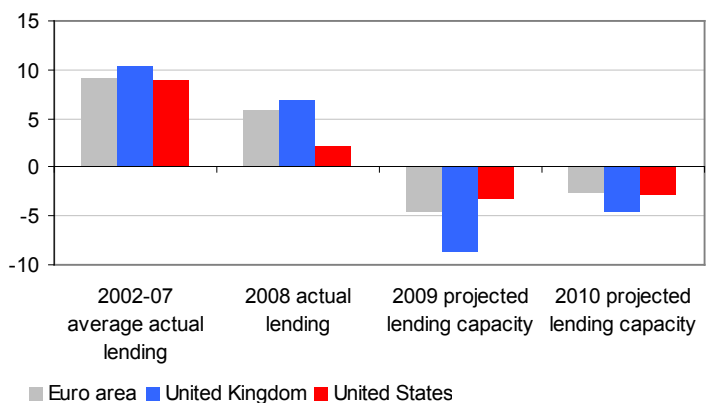


Figure 3. Bank Lending Capacity Growth (%)

Source: IML



Fiscal and monetary stimulus



With no end in sight for improvement in demand from consumers or businesses, it has been up to governments globally to step up to the mark with massive co-ordinated monetary and fiscal packages. The last time the world saw fiscal packages of this magnitude was during World War II. In order to put the packages into context, we assess them as a percentage of GDP. Of the advanced nations, Japan stands out with a debt-to-GDP ratio of around 200%, whilst the United States has increased from 62% in 2007 to a forecast 100% in 2011. By comparison Australia is forecast to have 23% debt-to-GDP, the lowest of any of the OECD nations.

Figure 4.

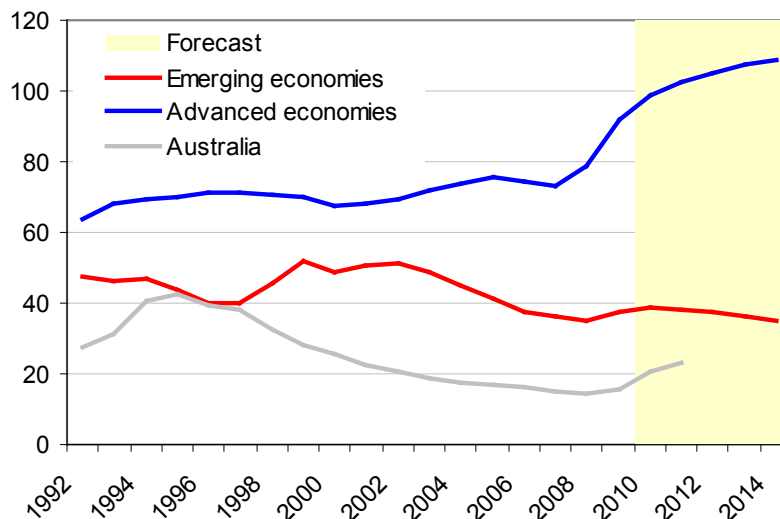
Source: IMF

	2007	2011
Australia	15	23
France	70	99
Germany	65	85
Italy	112	130
Japan	167	204
United Kingdom	47	94
United States	62	100
Euro area	71	93
Total OECD	73	104

The question remains: when does debt become a problem? In an interesting piece of research Rogoff and Reinhart (2009) estimate that higher levels of debt (over 90% debt-to-GDP in advanced economies and 60% in emerging) are associated with lower GDP growth rates. In advanced economies high debt countries have an average growth rate 4% less than those with low debt burdens. Rogoff and Reinhart also note that the GFC has been very similar to the post WWII crisis in terms of the increase in debt levels across the developed nations and note there is a risk of higher inflation as a result. (See figure 5 below.)

Figure 5. Government Debt to GDP

Source: IMF

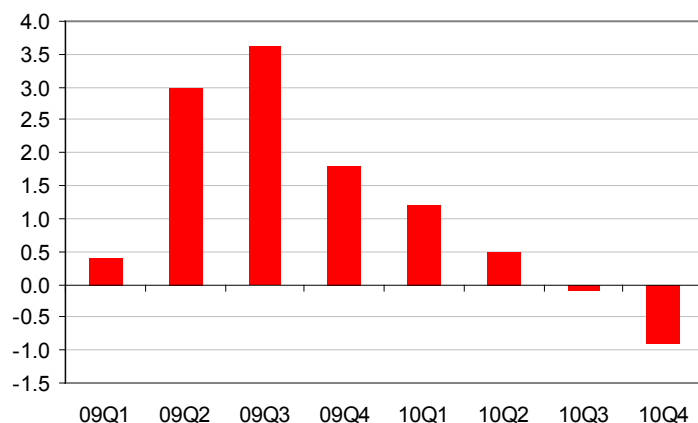


After the stimulus what has been achieved?

In the third quarter last year the US economy achieved a final GDP growth of 2.2% whilst it is estimated that stimulus added 3.6%.



Figure 6. The Moment of Truth for Stimulus
Contributions to real GDP growth, percentage points
Source: Moody's



Activity has picked up quickly in the short term. However the forces that are driving the current rebound are largely temporary in nature; that is major fiscal stimulus, central banks' support for credit markets and restocking the supply chain. These forces will diminish over the course of 2010. As a result, without a pickup in consumer demand we expect monetary and some fiscal stimulus to remain in place until such time as credit begins to flow to small enterprises and the consumer starts to spend again. We believe that fiscal stimulus will slow over the course of the year as governments fret about the sustainability of debt levels. However, we expect monetary stimulus will remain in place.

Pinning our hopes on China

With China receiving the largest stimulus package as a percentage of GDP globally and Australia the third largest, it comes as no surprise that growth domestically has remained strong. Of course pinning our economy to China comes at a price. Given the enormous stimulus package in China, demand has remained strong and resource companies in Australia have been able to maintain production levels. At the same time, massive domestic stimulus at the consumer level has seen Australia avoid a recession. This domestic strength has pushed the Australian dollar to highs not seen since the early eighties. The knock on effect is that we now have a two-tier economy with resource companies doing reasonably well whilst domestic industries and tourism are struggling.

Where do we go to from here? The likelihood is that Chinese demand will continue in the short term, but not at the same pace. Already Chinese authorities are applying the brakes by putting up interest rates and slowing the pace of credit expansion. We believe that this will mean a slowing in demand for resources over 2010 and as a result prices will come off. Of course with Resource stocks making up almost 40% of the Australian stock market, this will mean a bumpy ride.



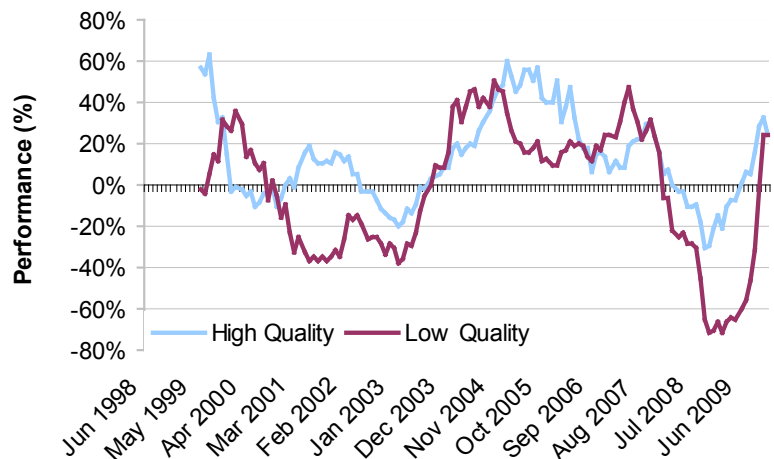
The stockmarket: Pricing in a strong recovery

The Australian stock market, in line with other global markets, has run hard with investors eager to embrace the concept of a “V” shaped recovery. In fact we note that from time to time sell-side analysts have found it difficult to increase their earnings numbers to keep up with the price increases! Our analysis from a bottom up perspective of consensus earnings finds that the Australian market is pricing in a 25% increase in earnings for 2010, 22% for 2011, and 18% for 2012... The same analysis using IML estimates reveals earnings growth of 5% in 2010, 7% in 2011 and 8% in 2012. On the back of this, the market is trading on a PE multiple of 16 times 2010 earnings. In other words, our view is that many sectors of the share market are currently expensive and that many share prices, in particular for more cyclical companies, are being based on earnings that are unlikely to materialise.

Buying Quality

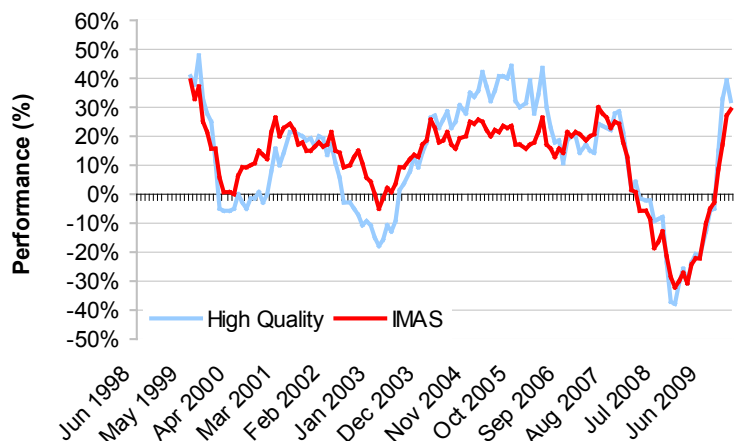
During the market downturn from October 2007 to March 2009 our Low Quality Index lost more than 70% of its value whilst our High Quality Index was down only 30% on a rolling twelve month basis. Many Low Quality companies that didn't collapse during that period have rallied very hard in the subsequent share market recovery.

Figure 7. Rolling 12m Performance of High Quality and Low Quality Portfolios
Source: FactSet/ IML



We are in the business of buying good quality companies that have a policy of paying out profits to shareholders in the form of dividends. Looking at our performance relative to our High Quality index highlights that we are performing exactly in line with where good quality companies have performed since 2007.

Figure 8. 12m Performance of IMAS vs High Quality
Source: FactSet/ IML



IML's portfolio positioning - where are we now?

We have said previously that we thought we were in the early stages of a slow recovery. We have also said that we thought this recovery would bring with it lower total returns with greater volatility as the market comes to grips with slower end demand and greater uncertainty from the macro economic environment. As a result our portfolios continue to be defensively positioned and we are currently overweight the consumer related sectors (excluding discretionary retailers – of which we own none). This is largely through our holdings in gaming and entertainment stocks, Crown casino, Sky City and Amalgamated holdings. We are also overweight Telcos, Industrials, Utilities and Health Care. We are underweight Financials, Property Trusts and Resources. However, we do have an overweight position in Origin Energy. Whilst we are not bullish on energy in the short term, Origin remains effectively debt free and derives over 50% of its profits from utility based operations. Origin has also established a joint venture with Conoco Phillips which has the potential to deliver significant earnings upside post 2015.



Risks to the recovery

The main risk to the recovery is that end demand remains weak. If so it will be a difficult choice for policymakers - either maintain fiscal stimulus which will call into question the sustainability of debt levels, or phase out the stimulus raising the danger of a double dip recession.

In reality, fiscal stimulus will become less effective as investors seek reassurance that deficits and debt will eventually be scaled back.

Conclusion


In Australia, the outlook remains reasonably positive. Unemployment remains relatively low and our exposure to South East Asia and in particular China should see us perform better than the average advanced economy, however, it will likely be a bumpy ride. Importantly, our national balance sheet (in terms of debt-to-GDP) is very strong compared to many countries and this will allow the Government to support the economy further should it be required. However, tighter credit conditions, increasing interest rates, and a heavily indebted consumer points to slower growth in the future.

Looking ahead for the US, high unemployment, poor income growth, tight credit and the need to pay down debt mean that consumption growth is likely to slow further this year especially when the boost from fiscal stimulus starts to fade. This US slowdown is unlikely to be offset by higher growth from China as the Chinese authorities are applying the brakes by putting up interest rates and slowing the pace of their credit expansion.

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