

## ***Current Financial Conditions and Economic Outlook***

Poor & indecisive political leadership in Europe & United States are the key ingredients causing current extreme volatility in financial markets.

The comparative recent slowdown in economic growth in the developed world reflects the continued unwinding of high levels of private and government debt. It is however, being greatly exacerbated by a drop in business & consumer confidence, largely reflecting inadequate political leadership. This is especially so in Europe, where there is a mismatch between those who want a united Europe and the policy actions required for it to become a sustainable reality. Individual voters in Germany, France and the Netherlands, in particular, need to understand that unless real power to intervene and manage with meaningful financial capital is given to the European central authorities, nothing can be permanently fixed.

The last six months have been long on rhetoric and short on meaningful actions, resulting in more and more uncertainty as financial markets question whether the problems in Greece will ultimately spread to other countries, such as Spain and Italy (very large economies), which would bring the European banking industry to its knees.

If effective centralised solutions cannot be found in the very near term, there will have to be a drastic reorganisation of the European Union with a number of the debtor countries having to be cut loose and their currencies allowed to fall. Whilst this will cause major economic pain, it would be the only way countries such as Greece could achieve future economic growth.

Whilst the political leadership situation in the US is not as dire as in Europe, financial markets are also hoping that politicians can agree on budget management policies which will achieve a balance between improved short term growth and reduced long term government debt.

The political uncertainty is negatively impacting economic growth prospects in the developed world. Having said that, the economic outlook for 2012 is not as poor as the media would have us believe. More of that later.

Nevertheless, there is no doubt that further inadequate political responses over the next months, will not only put at risk the economic growth forecast outlined below, but the consequential breakdown in confidence could well lead to further major short term declines in share prices. The developed world is standing on the precipice. If the right decisions are made stock markets look cheap and could rise significantly, but if the wrong decisions are made, further significant falls are possible. Let's be optimistic that politicians have got the message and act accordingly.

On all the latest forecasts from the IMF and other august economic forecasters, the current economic growth outlook is not yet so low that it justifies current stock market levels. A lot of misery has already been discounted. Financial markets look at least eighteen months into the future to make company earnings forecasts. Surprisingly, the company earnings outlook in most countries is still reasonable.

We have taken the liberty to extract some economic forecasts from the latest editions of the Economist Magazine (refer to Figures 1 & 2). They highlight the growing importance to world economic growth of the emerging economies and the fact that at this stage, the world is not as yet in a

double dip recession. The inflation forecast numbers are also positive for share markets. The importance of emerging economies and markets is still not appreciated. The number of companies from Brazil, India, China and Russia on the Financial Times 500 list has quadrupled over the last five years, from 20 to 80. Emerging market businesses are stamping their names on almost every area of business. For instance, who in Australia knows that the Indian company, Tata, is now Britain's biggest industrial employer, and is in everything from cars, chemicals, consumer products and IT?

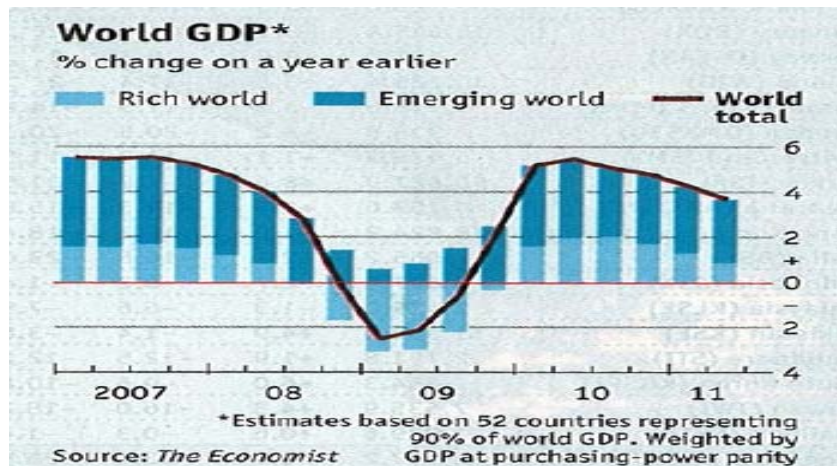
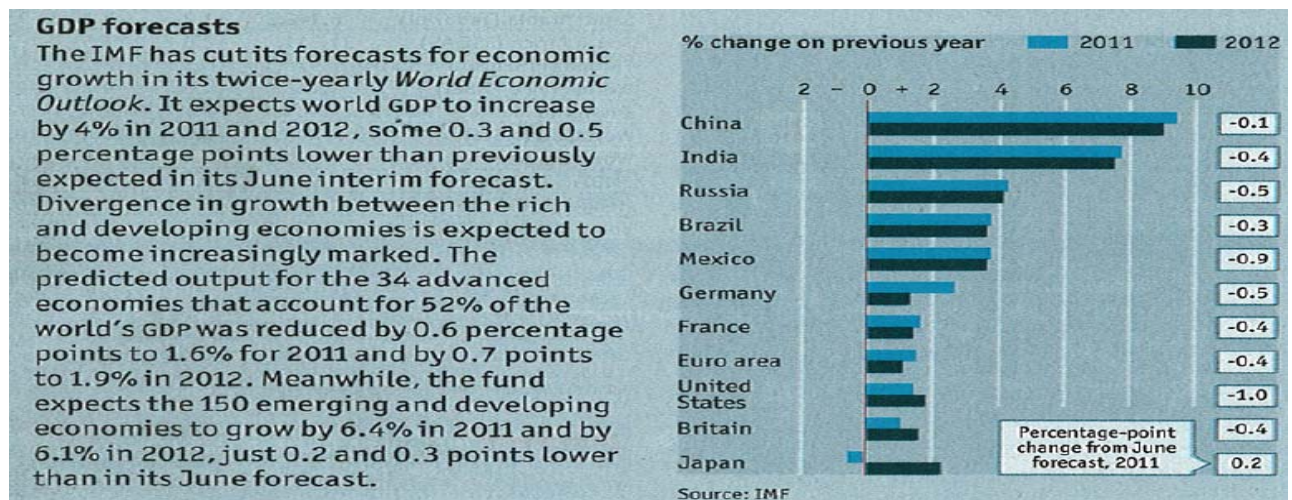


Figure 1: World GDP



**The Economist poll of forecasters, September averages** (previous month's, if changed)

	Real GDP, % change				Consumer prices % change	
	Low/high range		average		2011	2012
	2011	2012	2011	2012		
Australia	1.4/3.4	3.0/4.4	2.1 (2.3)	3.8 (3.9)	3.3	2.9 (3.1)
Belgium	2.2/2.6	1.0/2.2	2.4	1.6 (1.9)	3.1	2.4 (2.2)
Britain	1.0/1.4	0.9/2.3	1.2 (1.3)	1.6 (1.9)	4.3 (4.4)	2.7
Canada	2.1/2.9	2.1/3.0	2.5 (2.9)	2.4 (2.7)	2.8	2.0 (2.2)
France	1.5/2.1	0.9/1.8	1.7 (2.0)	1.3 (1.7)	2.1 (2.2)	1.7
Germany	2.7/3.8	0.7/2.5	3.0 (3.3)	1.6 (2.1)	2.4 (2.5)	1.9
Italy	0.5/0.9	-0.3/1.1	0.7 (0.8)	0.4 (1.0)	2.6 (2.5)	2.0 (2.1)
Japan	-1.1/0.3	1.2/3.5	-0.4 (-0.6)	2.5 (2.8)	nil (0.3)	0.1 (0.4)
Netherlands	1.5/2.2	0.6/1.8	1.9 (2.2)	1.3 (1.8)	2.2 (2.1)	2.0 (1.9)
Spain	0.4/1.0	-0.3/1.7	0.7	0.6 (1.2)	3.0	1.7
Sweden	3.7/4.7	1.5/3.2	4.4	2.3 (2.7)	2.8 (2.9)	2.3 (2.5)
Switzerland	1.6/2.3	0.6/2.2	2.0 (2.2)	1.5 (2.1)	0.7 (0.9)	1.0 (1.3)
United States	1.2/1.8	1.0/2.5	1.6 (2.3)	2.0 (2.9)	2.9	1.8 (2.0)
Euro area	1.4/1.8	0.6/1.4	1.7 (1.9)	1.0 (1.6)	2.6 (2.7)	1.9

Sources: Bank of America, BNP Paribas, Citigroup, Commerzbank, Decision Economics, Deutsche Bank, Economist Intelligence Unit, Goldman Sachs, HSBC Securities, ING, JPMorgan Chase, KBC Bank, Morgan Stanley, RBC, RBS, Schroders, Scotiabank, Société Générale, Standard Chartered, UBS

Figure 2: GDP Forecasts

The following extract, again from the Economist Magazine (see: Figure 3 below), highlights that there is long term value in share markets which are exposed to emerging economies.



Figure 3: Economies' share of world GDP (%)

For the positives to be recognised and reflected in financial markets, European politicians must do 4 things within weeks:

1. They must make clear which of Europe's governments are deemed illiquid, and which are insolvent, giving unlimited backing to the solvent governments, but restructuring the debt of those that can never repay it.
2. They have to shore up Europe's banks to ensure they can withstand a sovereign default.
3. They need to shift the Euro zone's macro economics policy from its obsession with budget cutting towards an agenda for growth.
4. They must start the process of designing a new European system of government to stop this disastrous mess ever being created again.

As stated before, if politicians do these things, share prices will rise in most countries. If they do not, the short term consequences could be disastrous. In my forty two years in the business, I have not seen the developed world at such a critical stage. Short term timing aside, it is comforting to know that ultimately, the emerging world will save the day.

There is an understandable, but obsessive, preoccupation with economic growth forecasts in China. The media forgets that the latest five year plan for China is predicated on 7% growth per annum. Current growth rates are still above 8%. The Chinese are currently slowing their economy a bit, to keep inflation under control. Too much growth above 7% per annum would be a bad thing.

The recent dramatic drop in some commodity prices will also help China's inflation rate, and maybe perversely, enhance the longevity of the Australian resources boom. Commodity prices are now searching for a new equilibrium level. The bellwether copper price is down almost 30% from its all time high price, reached seven months ago. It is difficult to know how much further commodity prices will fall, but they are in a process of adjusting to the current global economic climate and uncertainties. The downgrade trigger has not just been the European crisis and the downgrade of growth forecasts in the developed countries. Commodity prices are reducing because direct investors in commodities (mainly hedge fund managers) have been irrationally exuberant. The outlook for Australian resource stocks remains outstanding and any further short term price declines will provide a major buying opportunity.

Unemployment rates in significant sections and sectors of developed countries remain stubbornly high. Whilst they are a vital ingredient to confidence recovery in some countries, it is not realistic to expect quick improvements or to believe that improvements are needed for share prices to rise. Companies' management will have to be more confident of the future, for employment levels to rise dramatically. It is interesting to note that the impact of the Japanese disasters through its consequential impact on the car industry has had a greater impact on US personal consumption expenditure than the high unemployment rates.

The unemployment rate is not just about demand. It cannot be solved with more stimulus alone. There is plenty of evidence, from declining employment rates for less skilled men to rising disability roles, to suggest that western economies had a brewing jobs problem long before the financial crisis hit. The combination of new technology and globalisation has reduced the demand for the less skilled and many workers have failed to respond. The shift in demand for skills has a long way to go. In summary, developed countries have to re-educate their work forces and mobility of workforces has to be encouraged. This is a major issue for Australia.

The net consequence of some of the issues discussed above will be a continued significant change in investment trends and patterns. Growth oriented investments will have to be directed more towards emerging economies and markets. The investment basics will not change. Finding values will still come down to finding investments with higher and predictable income (yield) projections and attractive value comparators, such as P.E. relativities. In most developed countries, forward looking price earnings ratios, are between 10 and 12. Australia's ratio is about 10.5 with dividend yields at nearly 5%. This makes some Australian equities very attractively valued. Again we should state, if the politicians do not take the right decisions, these ratios could become a lot more attractive in the short term.

In the immediate future, the income derived from investments, will become even more important and the importance of income (yields) from shares, compared to other investments, will become more appreciated by unsophisticated investors. It is our job to keep repeating that mantra, though we

appreciate it is exhausting. Australia's current inverse yield curve cannot last, and all short term interest rates will fall.

The investment return from shares (price appreciation and income combined), will always return to long term averages.

The table below, which some of you have seen before, highlights the returns achieved in recent years and decades. Depending on the underlying risk, Australian shares over time normally provide an investment return of approximately 5% over the inflation rate. It is worth noting that an All Ords index level of around 5500 equates to this long term trend. In other words, an approximate 40% rise from the 4000 All Ords index level. This is achievable. We believe the returns in some emerging markets (riskier) could well be significantly higher than this over the next 5 years.

Percentage Returns at 30 <sup>th</sup> June 2011					
	1 Year	5 Year	10 Year	20 Year	30 Year
Australian Shares	12.2%	2.6%	7.4%	10.0%	11.0%
International Shares	2.7%	-5.1%	-3.7%	5.1%	9.7%
US Shares	3.7%	-4.4%	-4.7%	6.9%	11.2%
Australian Bonds	5.5%	6.5%	6.2%	8.0%	10.3%
Listed Property	5.8%	-10.0%	2.2%	7.0%	9.6%
Cash	5.0%	5.6%	5.4%	5.9%	9.0%
CPI	3.3%	3.1%	2.9%	2.6%	4.3%

Source: Vanguard; Andex Charts

Table 1: Percentage returns of asset classes

Share markets in developed economies in 2006 and 2007 went too high on the back of excessive gearing, debt levels and confidence. But they are now too low (on a medium term basis) as we deal with ongoing deleveraging and political incompetence.

Whilst we are concerned about further volatility of share prices in the short term, for the reasons outlined above, we remain selectively optimistic in the medium term. We spent a lot of time in 2006 and 2007 stating that the high levels of debt and gearing would bring the rally to an end. We are not smart enough to know when share markets will now start rising, but they will in the future. The emerging economies and markets will be the key factor, and the so called developed world, whilst remaining important, will become relatively less so. India and China will be especially vital and will have to be monitored closely. If you had to choose between putting money into select sections of the US economy, as opposed to Europe, we have a sneaking suspicion that the US could surprise on the up side. It is interesting to note, as labour costs rise in China, how many larger companies are returning their factories from China to the poorer and depressed (low wage) areas of the US.

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