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PERIODICAL REVIEW FEBRUARY 2010

The Australian Stock Market has started calendar 2010 in much the same way as it started 2009, although, in our view, much has happened in the intervening 12 months to make the circumstances considerably different. Correspondingly, nothing should be read into the likely outcome for the market this year from either ancient or recent history.

As usual, there are any number of pundits trying to predict the future and, as usual, successful investors will almost certainly be those who maintain constancy in their approach and who only give credence to hard data and facts and not market opinion.

The attachments to this periodical are as follows:

1. U.S. Economic Data updating U.S. GDP figures for the most recent quarter (the fourth quarter of calendar 2009)
2. An update of U.S. Housing Data
3. A chart from the Conference Board showing the most recent update of the composite Leading and Coincident Economic Indices for the United States
4. A graph showing World Gross Domestic Product and the contribution made by a number of selected Economies to World GDP.

Some points to note that arise from the data are:

Economic Activity

United States

The attachment shown as Attachment 1 contains two tables. Table 1 analyses economic growth showing percentage movements within sectors, while Table 2 takes into account the relative importance of each component of the Economy in terms of its contribution to overall activity, and weights movements accordingly to show their actual contribution to the overall change in economic activity. Both tables are important, but Table 2 gives a clearer, single Table view of economic activity within various subsectors of the Economy and their relative contribution to overall growth. The fourth quarter data is the advance (first) estimate of activity and we always add the caveat that such data will almost certainly be subject to some revision, as may earlier quarters. However, broad trends are emerging.

Some points to note on the U.S. Economy are as follows:

1. The Economy grew at 5.7%, seasonally adjusted at annual rates, in the fourth quarter of 2009, compared to growth of 2.2% in the third quarter of 2009. The Economy has expanded for the last two quarters after four quarters of continuous contraction.
2. For full year 2009, the Economy contracted 2.4%, the worst performance since 1946. However, it was a year of two halves, with the first half of the year showing strong contraction and the second half showing strong growth. The fourth quarter of 2009 recorded the best growth since 2003 and indicated a rate of annual growth better than that generally anticipated by analysts.
3. Personal consumption was solid, if not spectacular, while investment by the non bank private sector showed a strong rebound and, in our view, is one of the key things to concentrate on in this latest set of figures. Gross private investment contributed 0.54% to the 2.2% growth in the third quarter of 2009 and a very respectable 3.82% to the 5.7% growth recorded in the most recent quarter. These two quarters of accelerating investment growth follow seven consecutive quarters of contraction in investment by the private sector. It would appear that the bulk of the increase in investments was in equipment & software, suggesting an Economy that is aggressively looking for efficiency & productivity gains. But it is an Economy that is now net investing after a long period of contraction in investment activity by the private sector. Today's investment, assuming it is sound, is tomorrow's growth and any investment at all suggests that business confidence is rising, and a number of surveys & indicators have been underscoring this in recent times.
4. Real residential fixed investment increased 5.7% for the quarter compared with an increase of 18.9% in the prior quarter. These two consecutive quarters of expansion follow a very long period of consecutive quarter on quarter reductions in this area and suggests a sector of the Economy which is starting to stabilize and look at steady expansion. While there will continue to be a long "tail" on repossessions/forced sales to purge the excesses of 2003-2006, absent any major interest rate shocks in the U.S. Economy which affect mortgage rates, we maintain the view that we have now held for the last few months that this market is either at or very near its bottom.
5. The strong growth achieved in the fourth quarter has been achieved with no real stimulus from the Government sector, with total U.S. Government consumption & investment contributing -0.02% to the fourth quarter growth of 5.7%. In contrast, the Government sector contributed 0.55% to the 2.2% GDP growth recorded in the third quarter of 2009.
6. Real final sales of domestic product (arrived at after stripping out inventory adjustments from overall growth data) in our view gives a good proxy for potential sustainable growth in the Economy and was 2.3% in the fourth quarter and represents the fifth consecutive quarter where there has been a steady improvement in this area – a most pleasing development. We would also like to see steady and sustainable growth in this area, rather than quick & overly vigorous growth spurts that may induce fiscal & monetary responses that we would not wish to see at this stage of economic recovery.
7. Current dollar GDP – the market value of the nation's goods and services – increased 6.4%, or $221.3 billion in the fourth quarter to a level of $14,463.4 billion. In the third quarter the increase was 2.63% or $90.9 billion.
8. Current dollar personal income increased $190.2 billion (4%) in the fourth quarter compared with an increase of $35.1 billion (1.2%) in the third quarter. Disposable personal income increased $130.8 billion (4.8%) in the fourth quarter, while real disposable personal income increased 2.1%.
9. Personal saving in the quarter was $516.9 billion compared with $495 billion in the third quarter, and further lifted the personal savings rate to 4.6%.

Elsewhere

1. Growth in China, which remains the main driver for much of the World's growth, and particularly for resource based Economies like Australia, exceeded expectations in calendar 2009. It grew at 10.7% annualised in the last quarter of 2009. Growth will continue, and at, by western standards, a considerable pace in the near term, although the Government may well tighten credit to ensure that it keeps a lid on both price and asset inflation. The big issues for China in the medium term are social not economic, and the balancing of increasing prosperity and personal freedoms in a one party, command Economy. Growth prospects in a number of other emerging Economies vary from moderate to good and these should also provide some impetus to medium term World growth.
2. Australia, relative to the rest of the world, still appears to be in a favoured space and, while there might be short term shocks to our Economy from time to time, we can see no macro issues on the horizon that might change this.
3. Much is being said at the moment about sovereign debt for a number of Economies inside the European Union whose currency is the European Monetary Unit (the "Euro"). We will have more to say about this later in this paper. However, we have not for some years factored Europe into our equations as a strong growth engine for the World Economy and we cannot see ourselves changing that view any time soon. Growth there will at best be modest, and we are not sure that keying in the range of possibilities currently being touted for European growth will greatly change our outlook for the Australian Economy in the near term. Market sentiment, is of course, another thing and to the extent that these things disproportionately weigh on market prices, they may present a long term buying opportunity.

U.S. Housing

1. Attachment 2 shows a range of data for single family homes in the United States. House sales rose in calendar 2009 compared to 2008 although they have not yet attained the peak levels of earlier years. It perhaps might be advantageous that they not do so, or at least not too quickly. Housing supply, measured in months of available stock, is at its lowest level in over 3 years and the National Accounts indicate that building activity is starting to rise to compensate for this.
2. House prices appear to have stabilized and the Housing Affordability Index finished the year at very high levels historically, although below the all time peak in this Index experienced in early/mid 2009, as prices started to show some recovery. The Affordability Index indicates a very attractive market for buyers, subject of course to being able to obtain finance. Availability of credit and mortgage rates remain key to the continued recovery of a market that, albeit that there is still considerable activity in foreclosures, is showing signs of steady recovery and rising building activity.
3. Interestingly, as a side note, data just released from the MIT Centre for Real Estate indicates that, from the peak in 2007, commercial real estate values have fallen 40% - compared to 25 to 33% in residential home prices. Activity in commercial deals was essentially halted for most of 2009 as a result of the credit crunch and we see 2010 for commercial real estate being the year for an upturn in activity equivalent to the evening out and beginnings of recovery that we saw in residential real estate in 2009. That is, we believe that the trends in commercial real estate are lagging the trends in residential real estate by about a year.

U.S. Leading Indicators Index

1. Attachment 3 contains the most recent data from the Conference Board for the Leading and Coincident Indicators for the U.S. Economy. This data shows a continuing strong upturn in the Leading Indicators and a trend in the Coincident Indicators that suggest an Economy that has turned.

2. As we have indicated in earlier Periodicals, our experience and analysis of the data suggest that you needed at least 3 continuous months of upturn in the Leading Indicators Composite Index before you could safely call an impending upturn in the Economy. The turn has happened, but we must caution that, while the Indicators have been accurate again, the degree of movement in the Indicators can not be taken to indicate either the strength or the length of any subsequent recovery. The Indicators however should still make us sanguine that a recovery is upon us, albeit of indeterminate length & strength.

Sovereign Debt

1. Much has been said in recent times about the sovereign debt of Greece and some other European Economies. These have given the World its latest "wall of worry" and have become the focus of the Press at a time when they have largely obscured the recent round of (mostly favourable) corporate earnings reports in the U.S. and elsewhere and any real attention being given to current economic growth data.
2. Attached to this Periodical as Attachment 4 is a chart showing World GDP and the GDP of a number of countries of interest. World GDP is currently approximately $US60 trillion, of which the U.S. Economy is just under $US14.5 trillion. China's GDP at the end of 2009 was approximately $US4.9 trillion ($US4,910 billion from latest Chinese sources). Greece's Economy is approximately $US330 billion (about a third of Australia's). Greece and some other Economies that have been mentioned within the EU as potentially needing support, are regionally important, but globally are not of great consequence, even if the contagion effect is taken into account. Perspective is needed when dealing with these issues and all eyes should remain keenly focused on the larger Economies, especially the United States and China, when assessing global prospects. This is especially the case when assessing Australia's prospects.
3. Greece will be "rescued" if that is necessary, as will other countries within the Euro zone which are currently indicated, at least by the Press, as having problems that will require a "rescue". One can argue as to whether or not these countries should be inside the EMU (European Monetary Unit) but that is a pointless discussion at this stage. The fact is that they are, the stability and strength of the Euro is at stake and an accommodation will be found, with the stronger economies in the EU almost certainly bearing the brunt of it. Doubtless, economies such as Greece and Portugal will have to contract, as a price for greater fiscal rectitude. Such events are unremarkable, and we have already taken this into account in our forecasts. It is our view that the net affects on our Economy in the medium term will be, at worst, very small.
4. To the extent that equity markets overreact to these issues they may well signal the best buying opportunity that has existed since late 2008/early 2009.

As always, should you have any queries on issues raised in this Periodical, or indeed on any matter at all, please feel free to give me a call.

Welcome to 2010.

Regards
Peter Harper