

21 August 2009

PERIODICAL REVIEW AUGUST 09

This Periodical draws on and summarizes a lot of the detailed information and data contained in the two accompanying Attachments which are labelled as follows:

1. Key Economic Data Aug 09
2. JB Donovan Aug 09

The Key Economic Data Aug 09 Attachment contains

- U.S. Economic Data which provides in chart and graph form a detailed analysis of the components of U.S. GDP, updated for the most recent Quarter, as well as some comparative employment data.
- An update on U.S. Housing Data
- A chart from the Conference Board showing the most recent update of the Composite Coincident and Leading Economic Indices for the United States and
- A current valuation of the Australian Equities Market based on relative yields.

The JB Donovan Aug 09 Attachment contains a considerable amount of detail on the long term and recent relationship between Company Earnings and Yield data and stock market prices, as well as some data on individual Country and World Economic Activity.

In this document, we will briefly summarize some key aspects of importance that arise from the data, but for those who are so inclined the Attachments will provide more detail. In particular, we commend John Donovan's paper to you, especially the early parts of the paper and Charts 1, 2 and 3 which represent original work by John. We, at least, found this work most interesting and trust that you will as well. It explains much of the behaviour in our markets in recent times, especially through the latter part of 2008 and early 2009.

Points to note are as follows:

Economic Activity

United States

1. The United States economy and its health remains the key to World economic growth. As Charts 1 – 7 in the Key Economic Data attachment show, the United States economy contracted in the 2nd Quarter of 2009 for the fourth consecutive Quarter. The contraction was both less than that for the three previous Quarters and was also less than anticipated by most commentators.
2. Private consumption remains weak, as does investment by the non bank private sector, although the level of decline of investment was considerably less than for the preceding Quarter. No doubt rising unemployment, as well as the wealth effect of falling house prices, have tempered U.S. private consumption. Of course, as we have noted more than once in our



Periodicals, from the perspective of a stock market investor, by the time unemployment shows signs of improving we will almost certainly be 6 to 9 months into the next Bull market in Equities.

3. The very substantial contraction in real private inventories via both a reduction in domestic manufactures and a fall in imports, has the American economy spring loaded for a rapid recoil should private demand show signs of sustainable strength. Having analysed Real Inventories, Sales and Inventory-Sales Ratios, we are surprised at the extent to which inventories have shrunk in the private sector. In the 2nd Quarter of 2009, U.S. private businesses decreased inventory by \$US141.1 billion, after decreases of \$US113.9 billion and \$US37.4 billion in the 1st Quarter 09 and 4th Quarter 08 respectively.
4. Net exports and government spending and consumption have been a source of net strength in the United States economy in recent times.
5. Encouragingly, real final sales of domestic product (which adjusts for changes in inventories) decreased by only 0.2% in the second Quarter of 2009, compared to a decrease of 4.1% in the first Quarter.
6. Americans will undoubtedly have spending power when confidence returns. Personal disposable income increased by \$US121.1 billion (4.6%) in the 2nd Quarter 09, while real disposable personal income increased by 3.2% following an increase of 1.1% in the 1st Quarter of 2009. But, for the moment at least, they continue to save – personal saving was \$US566 billion in the 2nd Quarter, following personal saving of \$US426.9 billion in the 1st Quarter. This represented a personal savings rate of 5.2% in the 2nd Quarter compared with 4% in the 1st Quarter.

Elsewhere

1. At the beginning of this year, the outlook for growth in the Chinese economy in calendar 2009 was downgraded to 6% from a previous forecast of approximately 8% (see Table 3 in John Donovan's paper). Recently, it has since been upgraded to 8% again. On a very recent trip to China I had the chance to look at some half year economic data on a Province by Province basis, which has made the Chinese Authorities confident that they will achieve their 8% growth target for 2009. There well may be other matters of concern, both economic and social, that China will have to address in the near term, but meeting their projected growth targets does not appear to be one of them, at least at the moment.
2. Australia appears to be in a favoured space, in part driven by continued growth in developing countries with whom we have strong trading relationships and in part driven by our strong financial institutions and structures. We also entered this period of World economic turbulence with a Budget in considerably better shape than most other Countries. A review of Chart 7 in our Key Economic Data Attachment also highlights the fact that, since the last Quarter of calendar 2007 and, despite the difficult Global circumstances, Australia still has managed to generate a net increase in jobs, albeit that a considerable number of these jobs are part time.

U.S. Housing

1. Those who follow this Periodical series will know the importance that we attach to U.S. Housing Data and, in particular, the importance we attach to the trend in prices for single family homes. The huge excesses in the U.S. Housing market which peaked in 2006, led the U.S., and then the World, into its current situation and its recovery will be pivotal in leading us out.
2. U.S. residential construction has now made a negative contribution to U.S. GDP for 14 consecutive Quarters. Whilst residential construction is a relatively small part of the economy (about 5%) its psychological effects on perceived wealth and consumption can be considerable.



3. We believe that there are strong signs that the worst in the U.S. Housing market is over, although there will doubtless be some geographic areas and segments in the market which will continue to experience some pain for a little while yet.
4. Examination of Charts 8 – 12 in our Key Data Attachment reveals as follows:
 - A drop in inventories of available houses for sale of almost 700,000 houses between June 2008 and June 2009.
 - The median house price appears to have bottomed in January 2009 with reasonably strong growth evident in median house prices in all 4 major sub sectors of the U.S. market in recent times (in the South the median house price has gone up for each of the last 5 months, while in the West, the Midwest and the North East, median house prices have increased for each of the last 3 months).
 - Housing affordability remains at historically high levels since the current Composite Affordability Index has been kept by the National Association of Realtors, although it has decreased a little recently as house prices have increased and the 30 year mortgage rate has increased slightly. The 30 year mortgage rate, which takes its lead from other paper of an equivalent tenor, remains a key to continued momentum in this market.
 - There appears to be a continued uptrend in pending home sales which is a good forward indicator of housing activity. The National Association of Realtors recently reported that pending home sales were up for 5 consecutive months until the end of June 2009, the longest continual uptrend in this indicator for 6 years. It should be noted the United States has a first home buyer's tax credit program which is due to expire later this year. However, it is our belief that a number of key indicators suggest that both construction activity and house prices either are already at, or are rapidly approaching, long term cyclical lows.

U.S. Leading Indicators Index

1. Attached as Chart 13 of the Key Economic Data Attachment is a chart showing both the Coincident and Leading Economic Indices for the United States, as produced by the Conference Board.
2. In our March edition, we cautioned that our experience, as well as available Research, told us that we needed to see at least 3 consecutive months of strong growth in the Leading Indicator Index before we would impute any importance to it.
3. The most recent publication of this Index put out by the Conference Board (August 20, 2009) shows that the Composite Leading Economic Index for the U.S. Economy rose for the fourth consecutive month to the end of July. The Coincident Economic Index was flat in July, the first time it did not register a decline since October 2008. The Conference Board has concluded that the U.S. Economy will turn positive soon.
4. Since the Index began to be compiled in 1959, three consecutive months of an upturn in the Leading Index of the strength seen in the current upturn, has always marked the end of a contraction in the Economy. While the Indicator has an unblemished record in calling a turning point, it is not a particularly good guide to the strength of an upturn, nor its duration. Still, by any account, the state of the U.S. Economy is considerably better at the moment than it has been in the recent past.

Predictions and Equity Markets

1. There has been much talk recently of green shoots, yellow shoots, weeds, and V, W and, until very recently, U shaped recoveries, most of it imprecise to the point of being useless. Every commentator has a view of when markets will turn and the likely strength, or lack of it, in any recovery. Even the "experts" in this area have, at best, a spotty record in accurately predicting economic growth rates for relatively near dated periods. See for instance, Table 3 in John Donovan's paper on the predictions made in the Economist Magazine (an acknowledged international benchmark) for growth in both the U.S. and World Economies for 2009 made at three different periods over the last year or so.



**Predicted GDP Growth for Calendar 2009
(Economist Magazine at indicated dates)**

% Change on Year Ago	12-Jul-2008	31-Jan-09	13-Aug-09
USA	1.3%	-1.2%	-2.6%
The World	2.76%	0.01%	-2.34%

2. The real point to be taken from the amount of electronic and printed media space and time currently being devoted to the debate on the above issues, is not whether or not any of the points of view expressed have validity, but rather that Economic growth is now front and centre as the topic of debate, rather than the viability or stability of the Western World's financial systems. The post Lehmann Brothers debate on issues such as bank nationalisation and the survival of current financial structures in developed western democracies now appears to have passed. Consequently, the element of the most recent market downturn which can be attributed to concerns about the future viability of our Financial System has now been discounted. Market prices that obtained prior to that now become our benchmark, with future growth in Equity Markets once again dependant upon perceptions of future growth in earnings and dividends.
3. Chart 3 in John Donovan's paper and Chart 14 in the Key Economic Data Attachment both indicate that, while the stock market is no longer pricing equities as if they were expecting a negative real rate of growth in dividends in perpetuity (always an absurd proposition) our Equity Markets still remain undervalued on even modest assumptions of growth if you are a long term investor.

Regards,
Peter Harper