

create, accumulate, protect

Economic Review
3rd Quarter 2011

- 1. Why China is so Important to Australia & Our Stockmarket 2**
- 2. Are the Big 4 Banks a Guaranteed Great Investment..... 5**
- 3. How the Icelandic People have Boldly Tackled the Legacy of the GFC 7**

This material is provided for information only. No account has been taken of the objectives, financial situation or needs of any particular person or entity. Accordingly, to the extent that this material may constitute general financial product advice, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to the investor's objectives, financial situation and needs. This is not an offer or recommendation to buy or sell securities or other financial products, nor a solicitation for deposits or other business, whether directly or indirectly.

1. Why China is so Important to Australia & Our Stockmarket

In recent times, countless articles have been written on the growth of China. We too have written several papers on China:

- China's Growth Trajectory & Implications for the United States
- Why One Boatload of Iron Ore Now Buys Us More Flat Screen TVs
- Why Invest Beyond Australia?

China deserves our attention given its emergence as an important factor in our domestic prosperity. The more we learn about China, the greater our understanding of what our relationship may mean for our future.

Some facts on our current relationship with China¹:

- 4.6% of Australia's Gross Domestic Product² is generated by exports to China.
- Over the past 10 years, the percentage of our exports that flow to China has increased from 5% to 25%. Consequently resources now account for 58% of our total exports, up from 35% a decade ago.
- Of the \$58 billion of goods shipped to China last year, \$34 billion was loaded onto iron ore ships in the Pilbara region of Western Australia.
- Australian businesses plan to invest \$140 billion on capital expenditure in 2011-12, with \$83 billion in the mining sector.
- Demand for our resources is one factor that contributed to Treasury's recent budget assumptions that the Australian dollar will hold at US107c for two years, and then decline by US0.9c a year.

The factors above will result in higher government revenue from taxation, but not for a few years yet. By 2014-15, the Government projects that revenue from income taxes will exceed \$300 billion, up from \$240 billion today.

As much as we stand to benefit from China's growth, the flipside is that a significant slowdown in China is likely to have an adverse impact on our economy.

As the Reserve Bank of Australia (RBA) and Treasury have stated, there is always a risk of short term volatility in China's economic growth. However, they still view a rapidly expanding Chinese middle class as a game changer that will keep economic growth strong. Nevertheless, it is widely expected that Chinese growth will moderate in coming years.

The biggest risk to China's economy is that it grows too fast and inflation becomes an issue. When a country has high inflation, businesses struggle to commit to new expenditure as the expected rate of return is much harder to gauge compared to times of stable inflationary growth. Foreign companies are also more reluctant to invest into a country with high inflation for the same reason. The net effect is that economic growth slows.

In Australia, the RBA uses interest rates to control inflation. In China, there are more novel ways of approaching this problem. Chinese authorities simply order companies not to

¹ *China Investors Need Nerves of Steel*, SMH, John Garnaut, 28 May 2011

² GDP is the market value of all goods and services produced by our economy.

increase prices, and fine those that don't comply. They also order banks to ration new loans.

The current strength of commodity prices is in large part due to Chinese demand. Whilst it costs BHP US\$40 to produce a tonne of iron ore in the Pilbara³, the current selling price is around US\$170 per tonne. In 2007, the price was closer to US\$70 per tonne.

China currently accounts for 60% of global iron ore consumption and 52% of coking coal consumption⁴. Iron ore is BHP's greatest source of profits, and coking coal, which is needed to make steel, is second. So BHP's success is closely aligned with China's demand for steel.

BHP CEO Marius Kloppers notes that new mines are under development by BHP and other companies, but most will take at least two years to become operational. This curb on supply should help keep prices high in the meantime. When the new supply is available, prices are expected to fall, but volumes will also rise. The net effect may actually be negligible. Time will tell.

Some are concerned that the resources boom is forcing a major restructuring of the Australian economy, and if the boom passes, our economy's output potential will be permanently lowered. This is known as the "Dutch Disease". However, many national economies have demonstrated how quickly they can adapt to new market conditions and thus prosper.

The latest national accounts show mining represents just over 9% of our GDP, down from the 10% averaged through the latter half of the 1990s. Surging iron ore and coal exports have been offset by declining oil sales, whilst liquefied natural gas production is yet to commence.

However, as the capital expenditure plans of the mining sector illustrate, our economy continues to direct resources towards the long term opportunities that mining and China offer our economy.

What are some lessons for investors?

Whilst the future is bright for BHP and its contemporaries, there are always risks.

Today, BHP comprises almost 13% of the Australian stockmarket capitalisation, with Rio Tinto at 3% and Newcrest Mining and Woodside around 2.5% each. So a well-diversified market portfolio still provides you with significant exposure to the resources sector and, consequently, China's economic expansion.

But uncertainty necessitates you maintain exposure to other sectors of the domestic and global economy as well. China still has a communist government that exercises great control over the economy. We don't want our clients to position their portfolios so that their retirement income is overly dependent on a small number of Chinese politicians.

And resources haven't been the only way to generate strong investment returns in recent times.

³ *Iron ore price train is coming to a stop*, SMH, Barry FitzGerald 14 March 2011

⁴ SMH, 4 June 2011

The following table details the actual performance of the ASX 300 Resources Accumulation Index (a proxy for a portfolio of resource stocks) compared to our Australian Value stock strategy between June 1992 and May 2011 (which is all data available), a period when resource stock prices have comfortably outperformed the wider market. Our Australian Value stock strategy usually comprises 40% of our client's Australian equity portfolios and would typically have a below market weighting to resource stocks. The results are:

	ASX Resources Index	Aus Value Strategy	Variance
Annual Return	13.73%	14.59%	+0.86%
Growth of \$1M	\$11.52M	\$13.30M	+15%
Standard Deviation	21.1	15.3	-5.8

Source: Returns Program

The data demonstrates that our Value strategy outperformed the resources portfolio, yet volatility or risk as measured by standard deviation was lower.

So whilst resource stocks have performed exceptionally well over the past 20 years, the risk/return trade off means there is no compelling argument to be substantially overweight your portfolio to this sector.

2. Are the Big 4 Banks a Guaranteed Great Investment?

Does a good company make a good investment?

Many Australian investors feel comfortable having the Big 4 Australian banks – ANZ, Commonwealth Bank, NAB & Westpac – as a cornerstone of their Australian share portfolio given that they are generally regarded as good companies. Collectively, the Big 4 banks account for around 22% of Australia's stockmarket capitalisation.

As Ric Battellino, Deputy Governor of the Reserve Bank of Australia (RBA), recently noted, the Australian financial sector benefited greatly from the credit boom that began in the mid-1990s and ended with the GFC⁵. The good work of regulators and the Federal Government over this period helped ensure that our financial system weathered the GFC better than most countries.

In recent times, the pace of credit growth has been much slower. Ric noted that although history tells us that periods of weak credit growth such as the present one are relatively short-lived in a growing economy, it would be wrong to think that this guarantees a return to the growth experienced in bank balance sheets since the mid-1990s.

The past 15 years was an extraordinary period for the Big 4 banks driven by what was largely a one-off adjustment to household gearing following financial deregulation and the sustained fall in inflation (as the RBA formally adopted an interest rate policy to maintain an annual inflation rate between 2% and 3%).

In the economic climate likely to be faced by banks over the next few years – solid economic growth but with cautious behaviour by households and relatively low inflation – the RBA anticipates that the rate of growth in credit will remain somewhere in the single-digit range.

Competition for new credit lending should be strong, which can often coincide with a relaxation of borrowing standards.

Some research suggests that lenders are already cutting standards, for example increasing loan to value ratios⁶. These practices expose the lender to greater loss if they need to foreclose on a loan.

The number of loans in arrears – particularly those 90 days past due – is now at the highest level in 15 years⁷. Most of this troubled crop of loans was written in 2008 and 2009 – when government stimulus packages and interest rates falling from 7.25% to 3% fuelled vigorous property market activity.

The low doc loans that were prevalent during 2008 and 2009 make up a higher proportion of those that are not meeting interest payments.

There are other challenges the Big 4 banks may face in the near future, which include:

⁵ Address to Annual Stockbrokers Conference, Sydney, 26 May 2011. GFC: Global Financial Crisis.

⁶ Herald Sun, Peter Taylor, 7 June 2011

⁷ *Vintage housing bubble may give us trouble*, SMH, Elizabeth Knight, 1 June 2011

- Uncertain impact of the Basel III reforms⁸. A report released in early June by the Australian Centre for Financial Studies says the new rules could affect Aussie banks by requiring them to hold larger reserves of liquid assets for each dollar they lend.
- Legislative issues, with the Greens (who now control the Senate) proposing a tax on banking profits.
- A report was released in May 2011 by a Senate Economics Committee into competition in the banking sector recommended initiatives to ease concentration in the industry and make banks more accountable for their margins and return on equity. That could lead to greater competition for the Big 4 banks.

The picture emerges of an industry that has long basked in near perfect conditions – strong credit growth, shelter from competition, a stranglehold on the home loan market, fat margins – but which may now be facing the gradual erosion of these strengths.

None of this analysis suggests that the banks are in any serious trouble, and the current level of loan delinquencies does not indicate there is a major problem. The Big 4 banks remain very good companies.

However, you should not be misled to believe that a good company necessarily makes a good investment.

Over the 10 years to 31 May 2011, the average annual return of each of Big 4 stock was:

Commonwealth Bank	10.8%
Westpac	10.6%
ANZ	9.9%
NAB	3.3%
Average	8.6%

These returns are solid compared to the average annual return for the Australian stockmarket of 7.8% during the period. However, in comparison, the gross return of our Australian share strategy for the period was 10.2% pa – or 1.6% pa higher⁹.

Past performance is no guarantee of future performance, so we are not suggesting that the next decade will deliver similar results. But what we do recommend is that investors maintain an appropriate level of exposure to the Big 4 banks in their portfolios, but also ensure their portfolio is positioned to capture the higher expected returns that small and value company stocks deliver compared to large companies like the Big 4 banks.

⁸ The **Basel Committee on Banking Supervision** is an institution created by the central bank Governors of the Group of Ten nations, including Australia. The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision

⁹ Source: Returns Program. Returns are gross and do not include costs.

3. How the Icelandic People have Boldly Tackled the Legacy of the GFC

Recently, one of our colleague's clients travelled to Iceland. Part of their motivation was to visit an island of renowned beauty, but the main reason was to experience how this country of 320,000 people (which is smaller than the Australian Capital Territory) has dealt with effectively going broke during the Global Financial Crisis (GFC).

One of our colleague's clients has been the CEO of corporations and today acts as a mentor to numerous CEO's, so he was intrigued to learn what he could learn from the Icelandic experience.

The financial crisis has had serious consequences for the Icelandic economy. The national currency has fallen sharply in value, foreign currency transactions were virtually suspended for weeks, and the market capitalisation of the Icelandic stock exchange has dropped by more than 90%. As a result, Iceland is currently undergoing a severe economic recession.

When the major Icelandic banks folded during the GFC, no country was prepared to offer them financial assistance. They were on their own.

Understandably, our colleague's client had a firm expectation of discovering a country where people have lost everything and a sense of gloom and doom dominates.

The reality is quite the opposite. As our colleague's clients noted, "if this is as bad as it gets, what are the rest of us worrying about?" Here are a few of their observations of life in Iceland today:

- People have lost all their savings, but they are not depressed. They are getting on with life. There are more BMWs in Iceland than in Sydney – albeit most pre-dating the GFC – but the people are living contentedly with what they have.
- The people are in high spirits. The national currency, the Krona, has depreciated significantly, but this has made Iceland a cheap and popular holiday destination. The tourists are coming, and bringing their spending dollars with them.
- Icelandic people are a proud people. There is a real sense of camaraderie that they are facing this economic calamity together.
- This bond may best be summed up by a tee shirt for sale with the slogan: "*We Ain't Got Cash But We've Got Ash*"
- Geo-thermal energy is abundant and provides free hot water and cheap electricity. In fact, Australia ships alumina to Iceland to process into aluminium as it's cheaper than using hydroelectricity in Tasmania. Iceland is actually considering running a cable 1,600km underwater to Scotland to provide the country with electricity – they're in the process of seeking funding.

Life in Iceland today highlights that in adversity, and with a large dose of humility, people can be innovative, visionary and creative.

This has led our colleague's clients to ponder how Australia has lacked vision and wasted our recent wealth on short sighted issues rather than take on bold projects with long lasting benefits. In contrast, the Icelandic people are devoting their limited resources to building a better future.

Perhaps the explanation for this divergence is cultural. Iceland is not 'Americanised' or overtly focused on consumerism. Rather, the people see themselves as having a long and proud heritage, and in adversity, have reverted to their Viking origins.

If all you knew of Iceland came from the business pages of Australian or European newspapers, you would believe that Iceland today is an unmitigated disaster.

Financially, this is mostly true. However, socially and culturally life has gone on and, in some ways, improved. The churches are full and innovation and creativity is blossoming. Everyone is upbeat and welcoming. Perhaps it's time for a visit.