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MARCH RESEARCH

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Current Themes

- Money printing around the world continues to drive risky assets (Shares, Commodities, Credit investments) higher in price…be careful of holding too much credit risk (or shares) when central banks wind back their printing programs

- European woes far from over…austerity to drag and as evidenced by recent events of Cyprus, fundamental problems of the euro remain… worsening social unrest is possible and increased market volatility will probably continue for some time

Views

Interest Rates

- RBA to stay on hold…easing bias still present but stronger than expected economic data (e.g. unemployment) reduces likelihood of easing rates in the short term
- Longer duration strategies may be somewhat volatile but there will be no bursting of the “so-called” bubble…low interest rates are here to stay for some time

Credit Spreads

- Tightening spreads may continue whilst quantitative easing continues around the world and the chase for yield continues
- Because this is an artificial stimulus, the risks are high when the printing press stops

Australian dollar

- The RBA is surprised by the high levels of the Australian dollar and as a commodity currency its high levels have been aided by quantitative easing
- Correlation with risky assets has been relatively high and there is little reason why it won’t continue

Volatility

- QE has significantly reduced sharemarket volatility since the middle of 2012. As valuations move away from fundamentals (and increasing European risks continue), volatility in sharemarkets and credit markets is expected to increase.

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Macroeconomic Risks

Europe

- The structural problems of a shared currency without a banking or fiscal union is likely to continue to threaten the global economy for years to come…the latest being the collapse of the Cyprus banking system
- Euro breakup continues as a possibility. Obviously any countries that do exit (e.g. Greece as a most likely) must do so in an orderly fashion

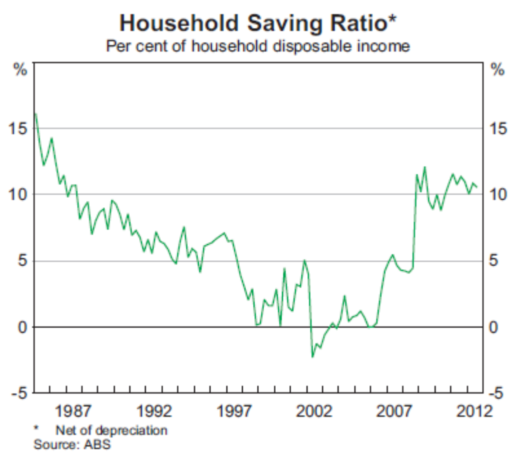
Low interest rates to continue

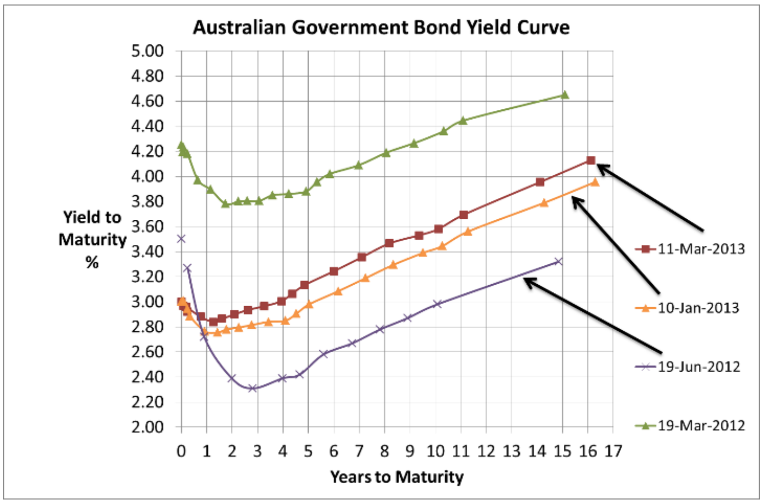
There are numerous factors that should contribute to downward pressure on interest rates in Australia. In the short term…

- Low inflation expectations...global and local deleveraging is not over and sustained higher savings should result in little demand-pull inflation.
- End of the resources boom and question marks around future growth prospects…we've had the housing boom of the 90s, the resources boom of the 00s, and they're both pretty much over…What will drive our future economic growth? The answer is not clear
- Higher than expected Australian dollar…RBA rate cuts have contributed to a slight lower dollar but QE has aided higher commodity prices and support for AUD…RBA expects a lower dollar to counter the end of the resources boom…hence a continued bias towards easing at this point in time
- Australia's AAA rating and higher interest rates compared to other countries…Australian government is one of the few AAA rated countries in the world and also amongst the lowest Debt to GDP levels…throw in the fact our interest rates are higher than other developed countries and if there's a belief the Australian dollar will be fairly stable, Australian bonds should be attractive to foreign investors.

And in the longer term…

- The retiring baby boomer…for the next 20 years they will be de-risking their portfolios to provide a steady and secure income in retirement. That is, fewer shares and property and more fixed interest
- Continued deleveraging and higher savings rates from the broader population…it's a combination of retiring baby boomers, tighter lending conditions, weaker economic growth and the continued risk aversion of households and business





Source: Reserve Bank of Australia

The above yield curve shows rates are still well below levels from around 12 months ago and they are around 3% out to terms of 3 to 4 years…therefore the market is expecting low rates to continue.

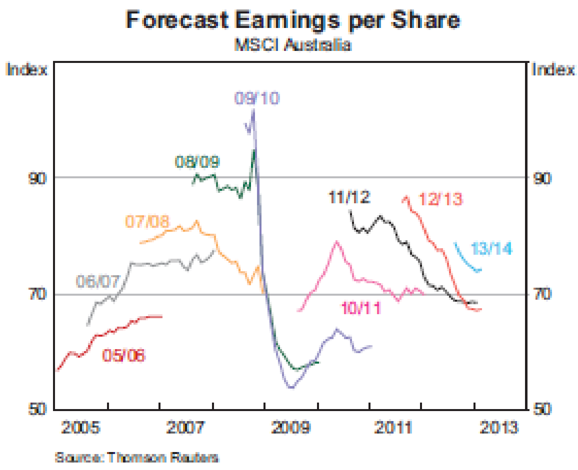
Printing Money

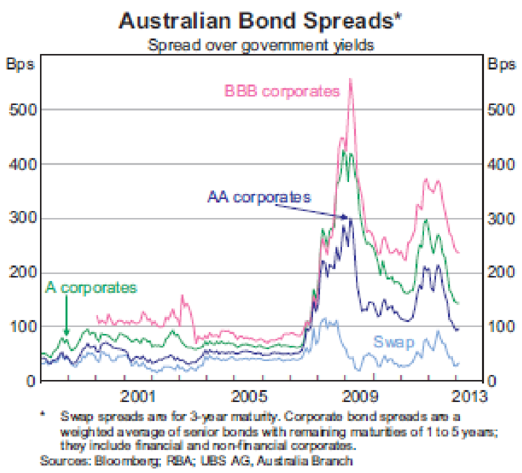
Quantitative easing is occurring in the US, UK (biggest QE per capita), Europe, and was most recently announced in Japan. So, every major economy is printing money and it needs to find a home…and its gone to risky assets, such as sharemarkets, credit markets, and commodities…as it did for previous quantitative easing programs.

Whilst there has been a lot of newspaper talk of a switch from bonds to equities there isn't a great deal of evidence supporting a switch at all…sure bond yields have increased across numerous markets but at this stage its really no more than noise and interest rates are still very, very low in all major economies.

The money printing programs have been quite unconventional….in fact part of what central banks have been doing is purchasing their own bonds. In the US the Federal Reserve Bank is printing $85bn per month (until the unemployment level gets low), so US bond yields will be low (prices high) and the increased liquidity made available to banks and investment banks should continue to flow into risky assets. Whilst commodity prices have not accelerated to the same level as following QE1 and QE2 (the first two printing programs), the argument that Commodities would be much lower without QE3 is still fair given the significantly lower growth expectations in China compared to over a year ago.

So, the big question is…do you jump on the risky asset momentum train? Obviously Europe's woes has slowed the train for the moment but with central banks more transparent than they used to be it appears the printing press will continue so funds should still flow into credit investments and shares. So, this leads to the next question? Do you want to be in risk assets when they announce the cessation of money printing? …no way!





Source: Reserve Bank of Australia

A final point regarding a lack of fundamentals supporting risky market behaviour can be seen in the above two charts…The left hand chart shows Australian sharemarket Earnings forecasts for 2012/13 and 2013/14 decreasing sharply in recent times and yet credit risk for corporates have decreased (Right Hand Chart)???...definitely a contradiction.

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> **Europe Situation—** The bottom line with the euro-crisis is that it is far from over, structural problems remains and there is bound to be further "Cyprus-like" events in the coming years.

Europe Situation

The fundamental problem in Europe is the single currency regime and some of the bad policy it has created. When economies crashed during the Global Financial Crisis, high levels of government debt created to replace lost capital and higher than it may have needed to be because the Euro did not help many economies when it was needed to. For example, it has been too strong for suffering economies such as Spain, Italy, and Portugal, and too weak for stronger economies like Germany. With a currency that doesn't help when it should, Europe has turned to tighter fiscal policy (i.e. austerity) in an attempt to reduce high levels of government debt. Unfortunately, austerity has resulted in lower revenues as well as expenses so it is also failing economies and unemployment continues to increase and economic growth continues to flounder.

The most recent event involves the collapse of the Cyprus banking system. Whilst the cost of a bailout (~$20bn) is not significant by European standards, the increased volatility in markets is due to the proposed solution which involved taxing all depositors, including small ones. The big concern here is that it could result in a bank run (massive cash withdrawals) in Spain, Portugal, Italy, and others as depositors seek to ensure their funds are protected. Bank runs ultimately result in insolvent banks because at some stage their liquidity will run out as the bulk of their assets are held in loans with much longer maturities which are not easily sold.

Until the Cyprus banking crisis appeared, European central bank action helped to calm bond markets in peripheral countries and yields are well below the peaks experienced in mid-2012. See Chart below. With the latest Cyprus situation it is still possible that peripheral countries (Spain, Italy, Portugal etc) could come under renewed pressure and there is more talk of a euro zone breakup.

The bottom line with the euro-crisis is that it is far from over, structural problems remain and there is bound to be further "Cyprus-like" events in the coming years until steps are closer to a banking and fiscal union. These issues will also contribute to lower interest rates in Australia.

Spanish 10 Year Government Bond Yield

Source: Bloomberg

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