ARMYTAGE

# Markets Lift But Remain Cautious

- Stock Markets broke a five month losing streak in October with solid gains achieved around the globe. The S&P/ASX 300 Accumulation Index added 7.2% with the US (S&P 500) up 10.8% and Europe (EuroStoxx 50) adding 9.4%.
- Once more Europe was at the centre of global headlines, with markets reacting favourably to the latest initiatives from the European Leaders Summit. Although much work appears necessary to secure financial stability across Europe, markets rallied in relief as politicians took some steps toward solving the crisis.
- Recent Economic Data from the US confirms that economic activity has picked up in recent months and that at this stage, the US is not due for a double-dip recession.
- Large gains from both the Financial and Energy Sectors led the market higher in October, with Consumer Staples and Telecommunications largely flat in absolute terms and hence underperforming the overall market.
- This month we discuss our current portfolio positioning and why we maintain a cautious outlook given the many uncertainties facing Europe, the US and China.

## Market Update

| % Returns to 31-10-11 | *Index* | 1M | 1YR |
|---|---|---|---|
| Australian Shares | *S&P/ASX 300* | +7.2 | -3.9 |
| ASX Small Companies | *Small Ordinaries* | +7.9 | -9.1 |
| US Shares *(USD)* | *US S&P 500* | +10.8 | +5.9 |
| Global Shares | *MSCI World ex Aust* | +0.9 | -6.1 |
| Global Shares *(Hedged)* | *MSCI World (Hgd)* | +8.6 | +3.9 |

Events in Europe through October culminated in the latest series of financial measures announced at the European Leaders Summit in Brussels. This was the 14th financial summit held across Europe in the last 21 months. Global equity markets performed very strongly ahead of, and in response to, the European Leader's Meeting, and were also buoyed by the improvement in economic data in the United States over recent months. Bond investors, in contrast, remain sceptical as demonstrated by the continued high yields on offer for Italian bonds.

Commodity prices, particularly Copper and Oil, rallied across October. The exception was iron-ore — the spot price fell some 35% across the month, largely reflecting concerns about demand for steel making from both Europe and China. We do remain concerned about the tight availability of finance in China and the rising stock of houses built in the last 2 years. With China consuming more than 50% of the world's iron ore, any slowdown in China's property sector will impact not only the iron-ore price but also the Federal Government's plan for an imminent budget surplus.

Company boards were fairly active in October, with share buy-back announcements from Transfield Holdings (TSE) and Sims Metal Management (SGM). Qantas' board and management were also in the news as they took the highly controversial decision to ground their entire fleet in an attempt to bring industrial relations issues to a head. We note the rise of industrial relations unrest and in particular the ongoing industrial disputes across the port, coal and public sectors.

## Sector Returns

| % Returns to 31-10-11 | *Index Weight* | 1 Month | 1 Year |
|---|---|---|---|
| Energy | *7.40%* | +12.2 | -7.3 |
| Financials ex-Property | *31.70%* | +10.3 | +0.1 |
| Materials | *26.10%* | +7.9 | -9.1 |
| Consumer Discretionary | *3.90%* | +7.3 | -13.5 |
| Industrials | *6.90%* | +7.0 | -6.5 |
| Property Trusts | *5.90%* | +3.8 | -2.4 |
| Utilities | *1.50%* | +3.0 | +3.2 |
| Information Technology | *0.60%* | +1.9 | -21.8 |
| Health Care | *3.40%* | +1.5 | -4.3 |
| Consumer Staples | *8.70%* | +0.3 | -1.7 |
| Telecommunications | *3.90%* | -0.1 | +26.0 |

### The Best of the Month

With a strong rebound in market sentiment, the **Energy** sector was the best performing for the month, providing a 12.2% positive return. In our portfolios, Woodside Petroleum (WPL, +12.5%) performed in line with the sector, however Coal and Allied (CNA, 0.3%), currently under a takeover offer, was largely unchanged for the month.

**Financials** were also strong, gaining 10.3% in October. Amongst our holdings, the banks were universally strong with ANZ Bank (ANZ, +11.1%) and National Australia Bank (NAB, +14.9%) the top performers.

### The Worst of the Month

Almost all sectors delivered a positive return in October with only **Telecommunications** earning a negative result, down 0.1%. Amongst our holdings, Telstra (TLS, +0.0%) was unchanged for the month, however iiNet (IIN, +18.8%) made strong gains. The stock had underperformed of late, but recovered following the move by rival TPG Telecom to acquire shares in iiNet. TPG moved above 5% on iiNet's company register.

**Consumer Staples** was also a poor performing sector relative to the market adding only 0.3% for the month. Core portfolio holding Wesfarmers (WESN, +2.8%) made reasonable gains for the month as their major Coles supermarket chain continues to outperform their key competitor Woolworths (WOW, -4.2%) which is not currently held in the portfolio. Interestingly, WOW has just appointed a new CEO whose task is no doubt to improve Woolworth's performance in the supermarket segment against Coles.

# Economic News & Portfolio Positioning

| Key Indicators | 30 Sept 11 | 31 Oct 11 | Change |
|---|---|---|---|
| $AUD | US$0.97 | US$1.05 | ↑ |
| Oil (crude) | US$79/bl | US$93/bl | ↑ |
| Gold | US$1623/oz | US$1715/oz | ↑ |
| RBA Cash Rate* | 4.75% | 4.75% | ↔ |
| Aust 10yr bond | 4.22% | 4.52% | ↑ |
| US T-bills | 0.14% | 0.14% | ↔ |
| US 10yr bond | 1.92% | 2.11% | ↑ |

** The RBA lowered the Cash Rate by 0.25% on 1 November 2011*

Over the past few months, Armytage has made a series of portfolio changes to deal with the period of significant market instability we are currently going through. We have sought to "de-risk" the portfolios by re-positioning into larger and more liquid positions with solid sustainable yields, providing the greatest expected return at the lowest level of expected risk. We have done this as the outlook for the US and Europe remains poor and continues to weaken, and European debt issues remain largely unresolved. Further, the extent of the slowdown in China's growth remains unclear.

In an environment of slowing global growth expectations, the ongoing downgrade cycle for domestic companies is likely to continue, and until we see some improvement in the global macro backdrop, investors in the market are likely to remain wary. That said, how do we see this fitting with current market moves and macro level news?

October's positive market performance reflected a rebound in heavily oversold positions driven by the *fear* a disorderly unwind of the Greek situation and its potential impact on Eurozone economies (the contagion effect). As Eurozone authorities announced some measures to deal with the regions problems and some of the economic data from the US turned out to be better than expected, the markets breathed a collective sigh of relief. However, the Fixed Income markets are clearly indicating continued deep concern (and fear) about the outlook for Europe. Below, we consider some of the key events from Europe, the US and China over the past month, highlighting some of the risks that we are monitoring.

## Europe – Sovereign & Banking Crises

During October much of the world's attention was focused on Europe where a number of key meetings were held in an attempt to resolve short term issues for Greece and to create a framework for dealing with broader Eurozone issues. Some of the key announcements, as well as several problems that we foresee for Europe are as follows:

*Establishment of a Support Fund (EFSF)*

The European Financial Stability Facility is similar to the US TARP fund which was established at the height of problems in the US to assist with the recapitalisation of US banks. The EFSF is now to be leveraged to provide as much as €1trn of capacity and is designed to assist the sovereign bond markets of troubled Eurozone nations and the European banking system. However, the Fixed Income markets have already concluded the EFSF is too small to achieve its objectives. In fact, when the fund recently sought to issue bonds to fulfil its mandate, there were few buyers – not a good start for the bailout fund.

*Haircut for Greek Private Lenders*

Private lenders to Greece are to take a 50% face value haircut on their debt. However, this is viewed as insufficient to return Greece to a sustainable level of debt. Also, other States with debt problems now know to hold out for a similar reduction. *Why would a country ever battle through years of austerity when they can force the private sector to write-off the debt?*

*Recapitalisation of the European Banks*

It was agreed that European banks needed to raise approximately €100bn of new capital. This is simply insufficient to allow these banks to write-down sovereign debt, meet new international capital standards and perform their core function of lending money to business and households to facilitate economic growth. In fact, it is more likely European banks will continue to ration credit to businesses and households with the adverse effect of constraining economic growth. We have seen reports in recent days of European banks winding back lending in Asia, Latin America and Eastern Europe to instead focus on home market lending. Although this is sensible from their perspective, it could precipitate a credit crunch in these regions and so impact global growth.

Our conclusion after these announcements? The package is unlikely to be sufficient to achieve more than just pushing matters a few months down the track. However, during November, we have already seen a dramatic rise in the funding cost for Italy to the point where Berlusconi was forced to resign, and we have now seen the installation of unelected technocrats to run Italy and Greece. More dominos will likely fall in coming months in Europe, and the market will become very risk averse at times.

## Chinese Economic Outlook

We have had concerns for some time about the outlook for Chinese GDP growth given its dependence on credit driven Fixed Asset Investment. In particular, with all of the apartment construction started in 2009 as a result of the credit binge instigated by the government after the collapse of Lehman Bros, we

have concerns that stock can be sold in a timely manner by developers (i.e. you can't start the next lot of apartments until the current batch are sold). Further, can China continue to grow the level of property starts from seemingly already high levels?

These issues are then exacerbated by the credit tightening which has been undertaking to reduce inflationary pressures in China. While inflationary pressures are easing in China, it is not clear there can be a dramatic easing in monetary policy or a loosening in policies designed to slow the property market.

We continue to monitor the situation. During October we did see the impact of tight credit on commodity traders and concerns around the property market as iron-ore prices fell to their lowest levels since November 2009. Although there may be some upside to commodity prices, the issues in China and the outlook for economic growth in the US and Europe make us very cautious at present.

### US Outlook

As many would re-call, the US came to the brink of a debt default a few months back as Republicans and Democrats fought over an increase in the debt ceiling in the US. The increase in the debt ceiling came with an agreement for a group representing both sides to identify $1.2trn in US spending cuts. Without bipartisan agreement, there would be automatic cuts to the US budget spending.

A negotiated settlement would likely see some lift in spending next year in the US to offset some of the expected fiscal drag (i.e. the impact of the natural withdrawal of spending on US economic growth as a result of the end of Federal government spending programs). The introduction of automatic spending reductions will likely lead to further downgrades to US GDP growth for CY12.

## For Further Information

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Andrew is the lead Portfolio Manager for the Ralton SMAs, part of the Armytage suite of products, responsible for the day-to-day management of the portfolios as well as the economics & thematics strategy for the Armytage investment team. He is supported by a dedicated and highly experienced team of investment professionals each with an average 14 years investment experience.

Andrew's career in funds management and investment banking spans almost 20 years including the past 5 years managing the Ralton portfolios. He previously held senior positions with major investment banks around the world, most recently as an Executive Director within the Financial Structuring Group of UBS in Hong Kong. He started his career at Arthur Andersen in Melbourne, where he spent four years as a tax adviser.

Andrew holds degrees in Economics and Law from Monash University, a Masters of Applied Finance from Macquarie University, and is a qualified Chartered Accountant.

## About Armytage

Armytage Private is a boutique investment specialist majority owned by members of its investment team and key executives. Founded in 1997, Armytage is a pioneer in Australia's investment industry, offering a suite of actively managed IMAs, SMAs and managed funds.

Armytage is a Value manager with a fundamental investment approach designed to identify quality businesses trading at a considerable discount to valuation. The process is guided by three fundamental beliefs:

- Markets are not perfectly efficient and the true value of a business is not always reflected in its share price;
- Undervalued companies can be identified through detailed and intensive research; and
- Capital preservation is critical to wealth creation.

### Products & Services

Investment strategies offered by Armytage include:

- Ralton Separately Managed Accounts
- Armytage Australian Equity Income Fund
- Armytage Asian Infrastructure & Property Fund
- Armytage Individually Managed Account Service

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