



## Stakes Remain High in Europe

- Stock markets globally weakened during November, largely on fears that Europe is yet to contain the debt crisis. The S&P/ASX 300 Accumulation Index underperformed other major markets declining 3.4% during November, whilst the EuroStoxx 50 declined 2.3% and the US S&P 500 was only down slightly.
- Confidence in the capacity of European leaders to advance policies to contain the regional debt crisis ebbed and flowed across November, and efforts included the imposition of “technocrat” leaders for Italy and Greece. Also, during the month, the RBA reduced rates by 25bps, as expectations rose that the turmoil in Europe will have an impact on already weak parts of the Australian economy.
- Large gains made by the Energy and Materials sectors in October were reversed in November, with both sectors underperforming the market. The Property Trust and Telecommunications sectors were the best performing for the month and both provided a positive return.
- This month we provide an update on the ongoing formulation of plans to try and resolve the European crisis. We also consider how the RBA may move interest rates given the European issues and domestic outlook, and how this may impact the market.

### Market Update

% Returns to 30 Nov	Index	1M	1YR
Australian Shares	S&P/ASX 300	-3.4	-6.3
ASX Small Companies	S&P/ASX Small Ords	-3.7	-12.1
US Shares (USD)	US S&P 500	-0.5	5.6

Global equity markets were again dominated by events in the Euro zone and they finished in negative territory for the month. Whilst the domestic market continues to look cheap on a number of metrics, it is going to struggle to sustain a rally until we see a more comprehensive solution (i.e. acceptable to the markets) for the European sovereign and banking debt issues.

As we noted above, our market was down 3.4% (S&P/ASX 300 Accumulation Index) for the month. Whilst the US market had performed much the same for most of the month, it finished broadly flat (S&P 500 -0.5%) after rallying on 30<sup>th</sup> November due to the actions of central banks including the US Fed. After Asian markets had closed, six major central banks agreed to lower the cost of funding for European banks accessing US dollars (known as US dollar swaps), helping to allay fears that Europe was approaching an imminent credit crunch. This was an important, but only an incremental step in resolving the issues in Europe.

During November a number of companies held Annual General Meetings (AGM) with many highlighting the challenging nature of the current economic climate and the impact on trading conditions. The ‘mixed trading’ conditions for the non-resource segment of the East Coast no doubt contributed to the RBA’s decision to lower interest rates during November.

Mining service companies stood out during the AGM season with positive commentary from a number we own, including Monadelphous (MND), Ausdrill (ASL) and Fleetwood (FWD). These companies are benefitting from the stable demand in mining production and the next wave of new projects now being commenced.

Finally, in corporate news, Computershare (CPU) received United States regulatory approval for the acquisition of BNY Mellon’s US based share registry business. Bluescope (BSL) continues to struggle, raising \$600m in a rights issue - the third time BSL has raised equity in the last 3 years.

### Sector Returns

% Returns to 30 Nov 11	Weight	1 Month	1 Year
Consumer Staples	8.9%	-1.9	+1.7
Telecommunications	4.2%	+1.8	+22.1
Health Care	3.4%	+1.8	-7.7
Consumer Discretionary	3.9%	-3.6	-13.3
Utilities	1.5%	+1.3	+7.7
Property Trusts	5.9%	+2.7	-2.2
Financials ex-Property	31.7%	-4.9	-2.3
Information Technology	0.6%	-0.1	-20.1
Industrials	6.9%	+0.4	-4.8
Energy	7.4%	-4.3	-12.7
Materials	26.1%	-6.2	-15.5

### The Best of the Month

Several of the more defensive sectors delivered a positive return across November. The Property Trust sector was the strongest sector delivering a gain of 2.7%. Of note from our perspective, Westfield (WDC, +6.4%) made strong gains, likely buoyed by the reasonable strength in US retail sales data and the weakening of the Australian dollar. Lend Lease (LLC) lost 6.1%, whilst Charter Hall Office (CQO, +1.5%) and Mirvac (MGR, 0%) largely held their ground.



The other strong performing sector was Telecommunications which delivered a 1.8% return for the month. Of note from our perspective, was the impressive performance of iiNet (IIN, +6.3%) after it announced the acquisition of Canberra based TransACT for \$60m - a move which consolidates iiNet's position as Australia's No 3 Internet Service Provider (ISP). We also continue to see TPG Telecom (TPM) increase its holding in iiNet. Telstra again outperformed the market adding 1.6%.

### The Worst of the Month

The Materials sector was the worst performer across November, owing to general concerns around the level of commodity prices and industrial production growth in 2012. BHP Billiton (BHP, -5.0%) and Rio Tinto (RIO, -6.3%) performed broadly in line with the sector's 6.2% fall.

Energy was also a poor performing sector, falling 4.3% during November, despite the rising oil price. Although geopolitical concerns provided support to the oil price, global economic concerns, together with stock specific issues drove the sector down. From our perspective, Coal and Allied (CNA, 0.7%) (Currently under takeover offer) was largely unchanged for the month as we await the finalisation of the various regulatory steps for the takeover to be completed.

Gloucester Coal (GCL, +17.8%) rebounded after recent weakness, whilst Dart Energy (DTE, -20.8%) underperformed after some short term negative news about exploration in China. Woodside Petroleum (WPL, -9.3%) underperformed after the release of a production downgrade for 2012, although management have confirmed that the long awaited Pluto project remains on track for first production early next year.

## Economic News & Portfolio Positioning

Key Indicators	31 Oct 11	30 Nov 11	Change
\$AUD	US\$1.05	US\$1.03	↓
Oil (crude)	US\$93/bl	US\$100/bl	↑
Gold	US\$1715/oz	US\$1746/oz	↑
RBA Cash Rate	4.75%	4.50%	↓
Aust 10yr bond	4.52%	3.93%	↓
US T-bills	0.14%	0.14%	↔
US 10yr bond	2.11%	2.07%	↓

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

As we discussed last month, company fundamentals are currently being trumped by the outlook for the global and domestic economy. The data from the US continues to improve, and this supports our view the US will continue to grow at a modest pace. The news from China continues to be mixed, but is partly dependent on the depth of the slowdown in Europe.

So the other issues we would like to briefly cover this month are: (a) the outlook and impact of the RBA's interest rate cuts; and (b) the next steps for Europe.

### RBA: CY 12 Interest Rate Outlook

The RBA cut its key interest rate on Melbourne Cup day, for the first time in 12 months. We have also seen a further cut in its main rate to 4.25% in early December. The events in Europe and the slowing conditions locally have provided the backdrop for these rate cuts. Whilst these cuts may only be modest, they will have an important psychological effect on households and business given it was only a few months ago we were expecting a rise in rates (i.e. the effect on people's thinking should be greater than a normal 50bp cut in interest rates given the recent rate hike expectations).

At this stage it is unclear how much further rates will be cut. In large part, it will be dependent upon the outlook for Europe and China. If China slows more than currently expected, we could see a slowdown in the rate of mining investment, which would then make room for other parts of the domestic economy to grow more rapidly. We need to remember the RBA had been hiking rates to ensure there was room in the economy for the business investment boom arising from the Mining and Oil & Gas sectors. At this stage, we view a sharp slowdown in business investment as unlikely given the major miners have indicated it was a mistake for them to slowdown expansions to the extent they did during the GFC.

In relation to Europe, it would probably require a major breakdown in the Euro zone system, such as the exit of a member country or the collapse of a bank to spur dramatic interest rate action (of the extent we saw during the GFC) by the RBA. Again, we are of the view, given the comments of European leaders, that they understand the risks around both these outcomes, and will work hard to ensure neither actually happens.

### The Euro zone Lurches toward a Resolution

Europe was once more a major focus for investors during November. As focus shifted to the details and implementation of policies announced at the European Leaders Summit in October the Eu(ro)phoria quickly faded. As we highlighted last month the key bond yields on European nations continue to flag serious risk, with the yield demanded by investors for Italian and Spanish debt rising above 7% and 6% respectively during November. At these levels, the interest burden for these countries would soon become crippling.

The stronger economies of France and Germany were not immune as French borrowing costs continued to rise and an auction of German government debt met with weak demand. It is fair to say bond investors remain sceptical about the solutions put forward to date.

These events were inextricably linked to the change in government for each of Spain, Italy and Greece. Spain's new leader resulted from a long planned election, whereas for Greece and Italy domestic and international political pressure saw the incumbent resign and replaced by a 'technocrat.' Such techno-



crats are non-elected bureaucrats and presumably have no interest in re-election – ideally they are better placed to serve bad medicine to the electorate without fear of political retribution. But, will the patient take the required medicine from such un-elected leaders!




Our view remains that the Europeans will lurch towards an acceptable policy solution (after exhausting all the other options), although political motives make the timing and structure of any ‘final’ outcome uncertain. Any concrete moves by the European Central Bank, perhaps in concert with the IMF to step in to the market to support bonds yields of struggling sovereign nations is critical to a resolution – it has been a fundamental flaw of the Euro that there has been no lender of last like the US Fed is for the US dollar.

The Germans have thus far staunchly resisted any moves to formally allow the ECB to fill the lender of last resort role. However, Germany remains keen to extricate maximum value (i.e. structural change) in return for any commitments to support sovereign debt either directly or via the ECB. As an interim step, commitments around national budgets and treaty changes to the EU voting structure may prove sufficient for the Germans to soften its stance.

Symbolism reigns supreme in the histories of Europe and the Empires past, including that of the once formidable Roman Empire. I note with interest that newly installed Italian Prime Minister, Mario Monti will share his nation’s pain and austerity and not draw any salary in his new role.

## 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

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- 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.

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

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