The Big Issues for 2012

BIG ISSUES FOR 2012

What will be the end game in Europe?
How real and sustainable is the US recovery?
Is there some 'X-factor' that will derail China?
What will be the impact of the carbon & mining taxes?
How long will it take for investors to return to shares?
How strong will be the lift in home prices?
Will inflation remain contained?
Will natural disasters be as prevalent as 2011?
Will higher oil prices derail the global recovery?
How important will politics be for economies?

Tumultuous Times

- Murphy's Law states: Whatever can go wrong, will go wrong. And clearly 2011 could be best described as the year when Murphy's Law reigned.
- First there were significant floods across eastern Australia as well as disruptive cyclones across northern Australia. Coal production in mid-north Queensland was hampered over much of the year while banana production was decimated again in north Queensland.
- There were earthquakes in Japan and Christchurch, New Zealand. And it wasn't just an earthquake in Japan, but it precipitated a tsunami and nuclear disaster. Japanese production of cars and car parts was severely disrupted, only getting back to near normal late in 2011.

FORECASTS

	2011/12	*2012*
Economic Growth	3.2%	3.6%
Underlying inflation	2.6%	2.9%
Unemployment	5.3%	5.2%
	mid 2012	***end 2012***
Cash rate	4.25%	4.25%
Sharemarket (All Ords)	4,450	4,650
Australian dollar	US95c	US100c

- There were also volcanic eruptions in Chile that resulted in ash clouds moving across Australia, disrupting air traffic.
- And it wasn't just natural disasters that dominated but fresh economic crises. The European Debt Crisis reigned over the second half of the year and political wrangling was also able to precipitate fresh problems for the US economy over the year, prompting one rating agency to downgrade the US credit rating.
- Not only did Australian businesses, investors and consumers have to contend with overseas issues, there was also the uncertainty caused by proposed carbon and mining taxes. Is it any wonder then that Australian consumers refused to spend, that economic growth proved sub-standard, that the sharemarket failed to fire and that the Reserve Bank switched its focus from rate hikes to rate cuts?

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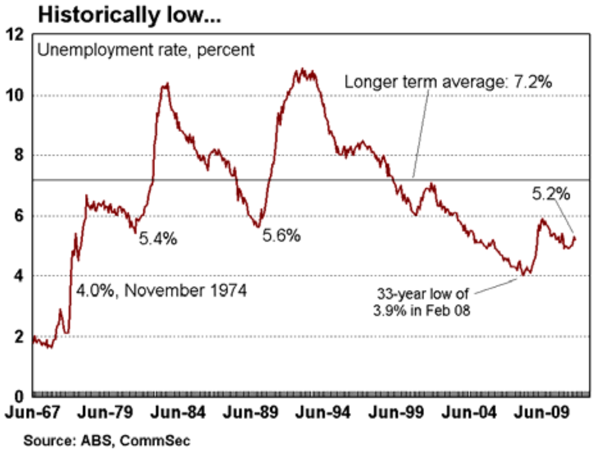
Economic and financial forecasts miss targets

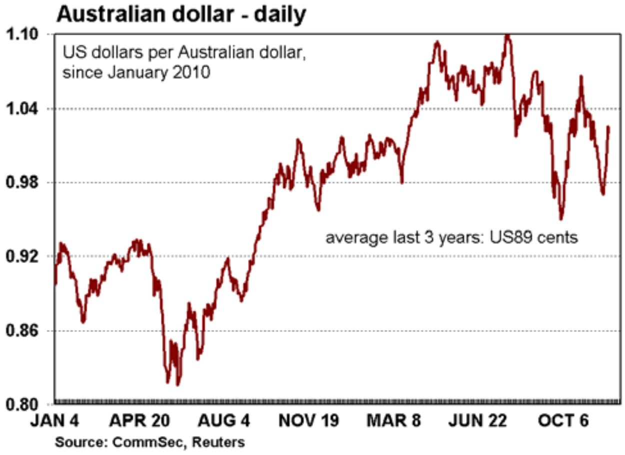
- With the benefit of hindsight it is clear that our economic and financial forecasts were overly optimistic.
- Economic growth was tipped at 3.5 per cent in 2011, with unemployment seen at 4.5 per cent by the end of 2011 with the cash rate at 5.5 per cent and sharemarket at 5,400. In a 'normal' year without the European Debt Crisis and natural disasters these forecasts would have stood a good chance of success. In fact around mid year they were still largely on track.
- The economy may have expanded 2.75 per cent in 2011 while unemployment will be nearer to 5.25 percent, the cash rate will be 4.25-4.50 per cent and the sharemarket will be closer to 4,400 points.
- The good news is that inflation will probably end 2011 near the forecast of 2.75 per cent. But the Aussie dollar forecast of US92c will be exceeded with the currency near US102c. We had expected the US recovery to be underway with investors looking to higher US interest rates and thus underpinning a stronger greenback. Still it's worth noting that just a few days ago the Aussie was below US97c, and seemingly headed lower.



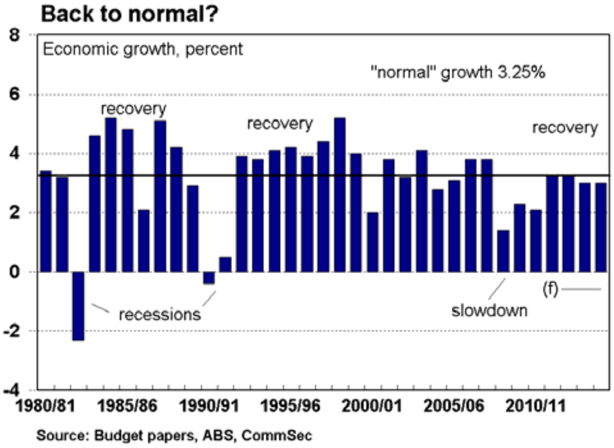
Source: ABS, CommSec

Forecasts for 2012

- As always, it is not the numerical forecasts that matter most. Rather the importance lies in the assumptions taken, the likely direction for the variables and the risks.
- We assume that the European Debt Crisis will still dominate over the first few months of 2012. Clearly the 'end game' could take a number of forms include the collapse of the euro zone. We assume that self interest will predominate and that the euro zone will remain intact. Countries will set about the task for reining in deficits and stabilising debt levels as a proportion of GDP.
- We also expect that the US economic recovery will continue and China will ease monetary policy, thus boosting growth prospects. The Australian economy should remain in balance with strong investment spending weighed against "average" growth in consumer spending and housing activity.
- Risks abound – and mostly to the downside. Political wrangling could lead to the collapse of the euro zone while politics may also stifle the US economic recovery. In Australia, there are also some upside risks. Rate cuts could cause Aussies to spend again and buy and build homes. As a result stronger consumer and housing activity may coincide with strong business investment, especially in mining regions.
- We tip 3.6 per cent economic growth over 2012 – above the norm of around 3.0-3.25 per cent, but from a low base. Underlying inflation should drift up over the year but remain below 3.0 per cent, thus allowing interest rates to remain low. Unemployment should hold in a 4.5-5.5 per cent range over the year.
- The Aussie dollar is expected to drift lower to around US95c in the first half of 2012 as weak European economic growth restrains global economic growth. But the Aussie is expected to again be near parity with the greenback in late 2012.
- While we would like to be more positive about sharemarket prospects, we retain a "soft" target for the All Ordinaries of 4,650 at the end of 2012. Aussie investors are expected to only slowly embrace stocks again over 2012 while global economic uncertainty and a firmer Aussie dollar will also restrain enthusiasm of foreign



Source: CommSec, Reuters



Source: Budget papers, ABS, CommSec

investors for Australian stocks.

The Big Issues for 2012

What will be "end game" in Europe?

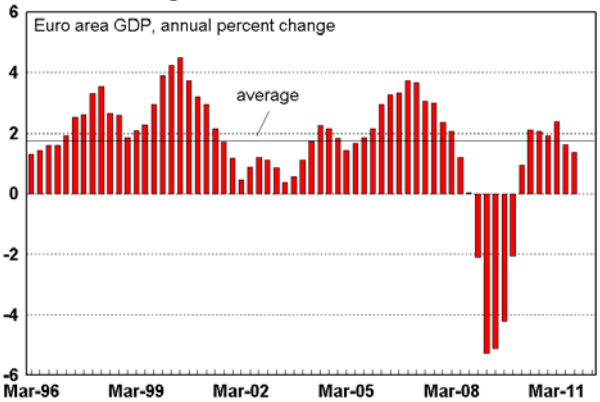
- Clearly if investors wanted an answer to one question, this would probably be it – the likely "end game" in Europe. If you had utmost confidence that the euro zone would break up in the next few months, then no doubt you would be positioned for sharp falls in Australian interest rates, the Aussie dollar and the sharemarket.
- But clearly it is possible that European nations would elect for closer fiscal integration and a more active role for the European Central Bank. In the US and Australia there are significant differences in economic conditions and incomes across states, territories and regions. But there is still a common federal tax base in both countries together with a federal budget and debt position. A United States of Europe clearly needs to move to the next step of a more centralised fiscal position while the European Central Bank needs to have similar powers to the Reserve Bank or US Federal Reserve.
- If the European Central Bank had a stated determination to buy Euro debt in unlimited quantities, then the crisis of confidence would end. Investors would have confidence that they would get their money back. But that ECB commitment would require individual countries to deal with deficit and debt problems, and presumably would need some central enforcement to ensure countries were meeting their commitments.
- Self interest will play a strong role in keeping the euro zone together. Germans may decry the lack of fiscal discipline in southern Europe but if Germany left the euro and adopted the Deutschemark, exporters would no doubt have to contend with a far stronger currency.
- And countries like Greece and Italy would clearly face far more difficult economic problems if they left the euro zone and didn't have access to the wider group's resources and support mechanisms.
- But while the "end game" in Europe is the number one issue moving into 2012, we also need to keep it in perspective. The fundamental worry is one of contagion. That is, if Greece or another country defaults on its financial obligations then banks and other investors lose money and are forced to call in loans, liquidate assets and withdraw from financial markets. The knock-on effects will be felt across the globe.
- But in terms of economic growth, China, India and other countries in Asia and the emerging nation grouping, still hold the whip hand. While on-going problems in Europe could restrain global economic growth, emerging nations would respond by stimulating activity. A raft of countries survived Global Financial Crisis Mark I and there's no reason why they can't deal with GFC II.

So What? Arguably this is the biggest issue for investors in the early months of 2012. Of course the seemingly impossible could happen and European nations could fundamentally deal with the issues over the next few weeks. But the European "end game" will affect the trajectory of the global economy and may ultimately decide if investors stay in cash-based assets or move back into shares.

How real and sustainable is the US economic recovery?

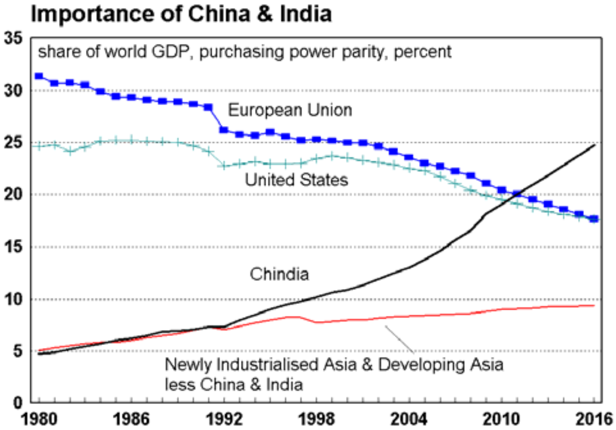
- Recent economic data has proved encouraging. Consumers are spending, jobs are being created, companies are still making money and are well cashed-up and housing markets appeared to have stabilised. The sharp fall in the unemployment rate from 9 per cent to a 2½ year low of 8.6 per cent is certainly encouraging.
- Still, on the other hand there is still an over-supply of US homes, more foreclosed housing stock could be pushed onto the market as prices stabilise, the budget deficit remains high and 2012 is an election year – adding more

Near normal growth



Source: European Central Bank, CommSec

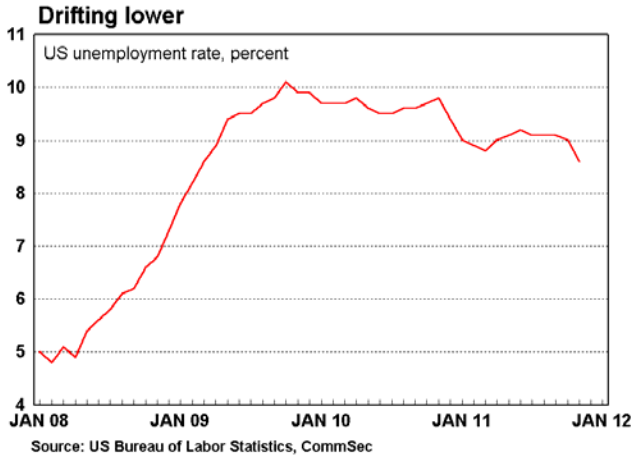
Importance of China & India



Source: IMF, CommSec

uncertainty to financial markets, especially in the latter half of the year.

- Economies are influenced by "fundamentals" like population growth, productivity and the supply-demand balance in markets, such as labour and housing markets. But economies are also influenced by "animal spirits" or confidence. If the European Debt Crisis is resolved, China continues on the path of industrialisation and there are no new "crises" in the US, businesses and consumers will get greater confidence to spend, employ and invest again.



So What? If the US economic recovery proves sustainable and actually gathers pace, this may lead to a stronger US dollar and that would provide headwinds for the Aussie dollar. A pick-up in the US would also be positive for US-reliant stocks like Westfield, News Corp, James Hardie, Billabong and CSL.

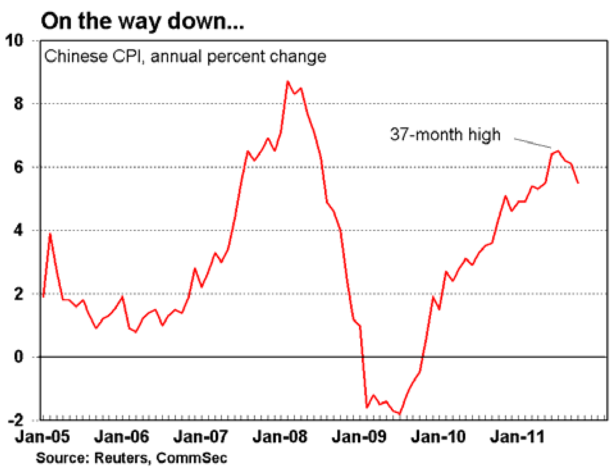
Is there some 'X-factor' that will derail China?

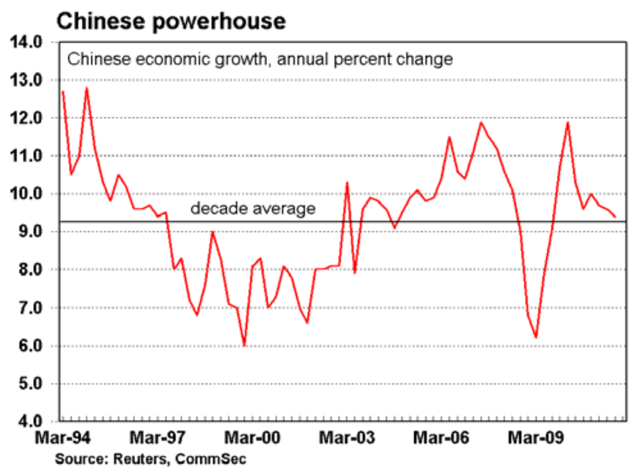
- When it comes to China, investors can't seem to win. If the Chinese economy is growing strongly then there are fears of 'bubbles' developing, such as in property markets, as well as fears that the economy will 'overheat', leading to higher inflation.
- And when authorities take the necessary steps to slow the pace of the economy, the concern is that they end up being too successful, causing momentum to stall. So investors can't win – either the economy is growing too quickly or too slowly.
- However even excluding the polarisation of views on the economy, there are still other concerns. Some worry about social and political stability. And indeed authorities are mindful that they do need to keep the Chinese people happy in an economic sense, otherwise they will start to compare personal and social liberties with those of other countries. Authorities need to ensure that people have jobs, incomes are rising, and quality of life continues to improve.
- Apart from social stability, other 'X factors' include banking sector failures, failure of local or regional governments or other bodies due to scandal or financial crisis, ethnic violence or uprising or geopolitical disputes with foreign powers.

So What? China is the second largest global economy. It is also the biggest driver of the global economy and Australia's largest trading partner. Arguably a crisis in China that serves to derail economic momentum would prove more damaging for Australia that a break up of the euro zone.

What will be the impact of carbon and mining taxes?

- Certainly across Australia there is much trepidation about the forthcoming carbon and mining taxes. And even before the taxes are formally introduced, they are already having an impact, weighing on consumer and business confidence levels, and thus impacting spending and investment decisions.
- But it may end up that the biggest impact of the taxes is the 'fear' element, rather than implementation. The





Government estimates that nine out of every 10 families will get some of financial assistance. And four million families (out of Australia's estimated eight million families) are claimed to get "120 per cent of their expected average price impact". Some families will actually be better off as a result of the carbon tax.

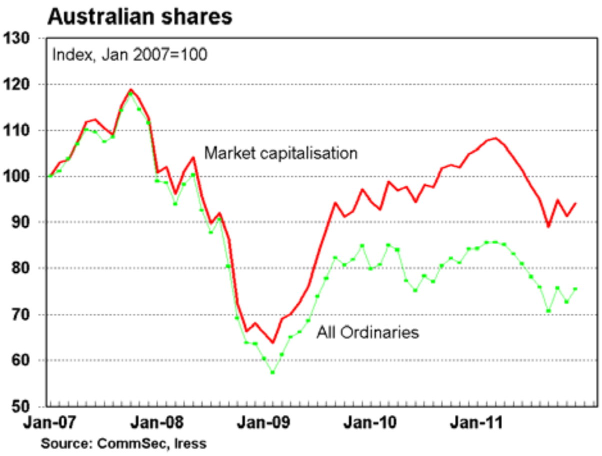
- The carbon tax will only apply to 500 businesses – especially in energy producing, waste disposal and some manufacturing areas like cement, chemicals and metal processing. At the same time assistance plans are in place to support the coal sector, manufacturing and the steel sector.
- Rather than adversely affecting the economy, the actual impact may prove far more modest. So rather than slowing down the economy, the risk is that the level of super-compensation results in little change of behaviour by consumers or businesses. That is, the goal of reducing carbon emissions may not be achieved.
- While politically the Government was forced to agree to the carbon tax to maintain support from the Greens, the watering down of the tax through compensation has ensured that it is less damaging for the economy but at the expense of environmental goals.
- The mining tax has also been watered down from the original proposals to the extent that major miners believe it will have a negligible impact on their operations. In response to demands by one of the independent members of Parliament – Andrew Wilkie – the profit threshold of the tax was raised from $50 million to $75 million. The mining tax will actually be a net cost to the Budget of $1.7 billion in the 2012/13 year. State-based royalties can be deducted from the tax and state governments have been active in lifting royalties in the past year (and probably will lift them further in coming years).
- The most efficient outcome – and one supported by mining groups – was removal of state production-based royalties and replacement by a revenue or dollar-based model. But the most efficient outcome wasn't pursued.

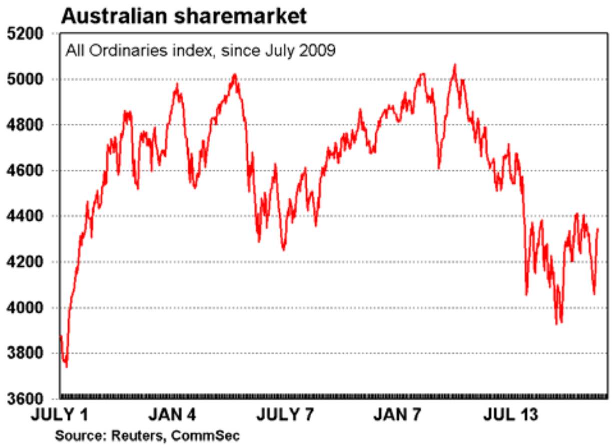
So What? In a year's time we may look back and wonder why we were so worried about the carbon and mining taxes. But once implemented, the risk is that they will be tinkered with over time, increasing the impact on the most affected businesses and industries and the economy as a whole.

How long will it take for investors to return to shares?

- After the 1987 sharemarket crash it took seven years for the sharemarket to return to peak levels. In response to a financial shock, clearly it took some time for investors to again embrace shares. And a similar situation is occurring now.
- However after the 1987 sharemarket crash, investors quickly embraced residential property. However in the current environment, not only are share prices under downward pressure, but home prices are also correcting lower after solid growth over 2009/10. Now cash-based assets such as term deposits are the investment of choice.
- However, it is important to consider the different relativities currently in place. The All Ordinaries index is almost 37 per cent below the peak level of 6,853 points set on November 1 2007. That is, the market would have to grow by almost 60 per cent from current levels to return to record highs.
- Interestingly the total capitalisation of the sharemarket is just over 20 per cent down from peak levels, meaning that the market needs to grow by 26 per cent to reach record highs.
- Similarly the All Ordinaries Accumulation index (includes share prices and dividends) is 23 per cent down from record highs, meaning that it needs to grow by just over 30 per cent to reach record levels.

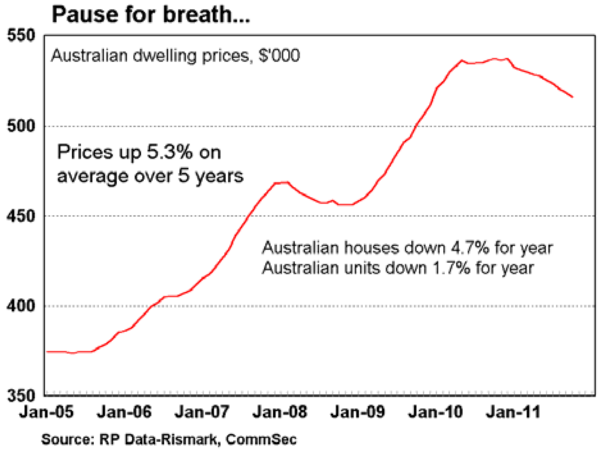
So What? Investors need to focus on total shareholder return (TSR) not just share prices to determine the value of their investments. While returns on shares fell 40 per cent in 2008, they rose by almost the same margin in 2009. It would only take a more stable period for European and US economies for equities to be back in favour.





How strong will be the lift in home prices?

- In 2009 Australian home prices rose by 12.1 per cent – well above long-term averages. In 2010 home prices grew by a further 5.1 per cent, while in 2011 it is likely that home prices will fall by around 4.5 per cent.
- Over the past six years home prices have grown by around 6 per cent a year – largely in line with growth of household incomes.
- Clearly home prices will vary across the country in line with the fundamentals of demand and supply. Melbourne home prices have posted stronger gains than many other markets in recent years, supported by strong population growth. But home construction has also been far stronger than many other states, suggesting less upside potential for prices in 2012.
- A common factor across capital city housing markets is tight rental markets and rising total property market returns. Unemployment also remains historically low across the country.



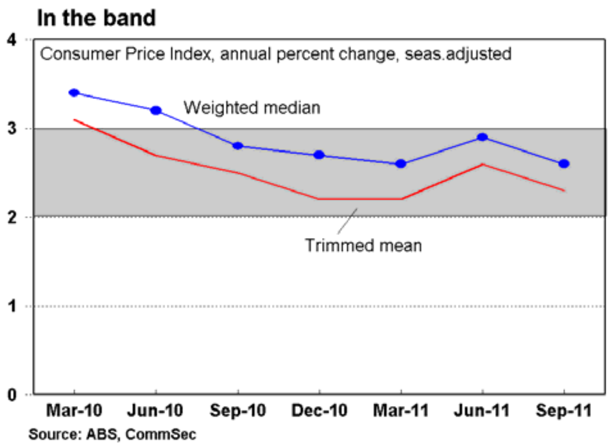
- Overall home prices are likely to grow between 0-3 per cent in 2012 with the Melbourne market likely to record flat price growth while Sydney should record above-average gains.

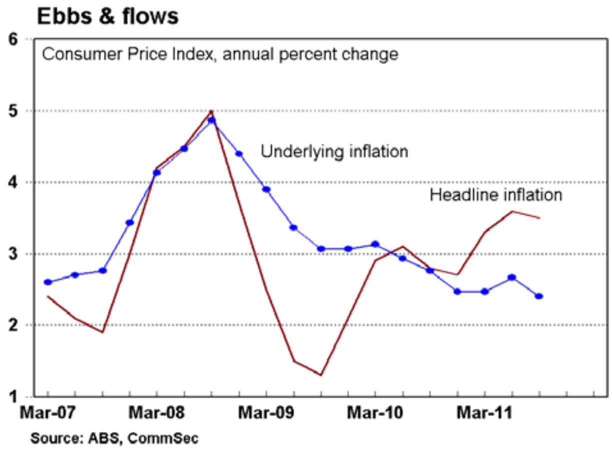
So What? As is the case with the sharemarket, property investors need to focus just as much on potential price growth as on the sustainability of the tenancy, current rents and future rental growth.

Will inflation remain contained?

- The current "headline" rate of inflation stands at 3.5 per cent. That relatively high rate of inflation has been boosted by flood-induced increases in fruit and vegetable prices as well as utility fees (electricity, gas, water) and higher petrol prices.
- The "underlying" inflation rate is currently around 2.5 per cent. The Reserve Bank wants to keep inflation between 2-3 per cent over time, so clearly the Reserve Bank would have good reasons to be happy with the current situation. In fact the Reserve Bank expects the underlying rate of inflation to remain between 2-3 per cent through to the end of 2013.
- As always special factors could push the "headline" rate of inflation higher in 2012 such as floods, drought and cyclones and their impact on fruit and vegetable prices. Sharp changes in the value of the Australian dollar also have an influence on prices of imported goods. Then there are factors like rising utility costs and changes in petrol prices.
- But overall, provided that consumers continue to shop around – locally and offshore – this will keep price pressures under control. Also wage increases need to be restrained in line with productivity changes and general price increases of 2-3 per cent. At present there are good reasons to suspect that inflation can remain contained.

So What? If inflation is contained, then the Reserve Bank has no reason to lift interest rates. And given the current risks in the global environment, if inflation is contained, then the Reserve Bank has greater flexibility to cut rates and support economic activity.





Will natural disasters be as prevalent as 2011?

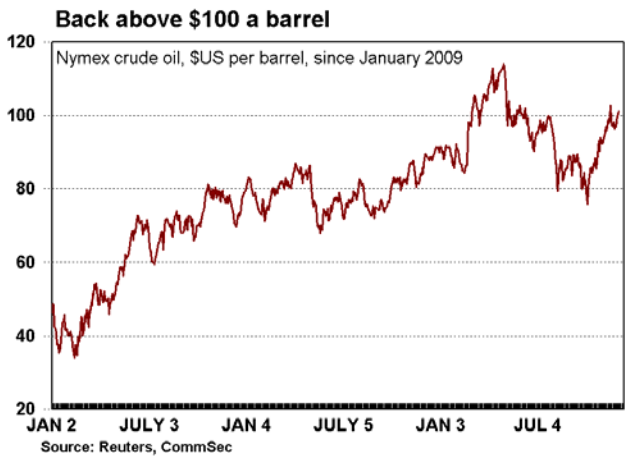
- Who wouldn't love to know about the likelihood about natural disasters before they strike? Sadly no one does, but clearly natural disasters or climate events can change the economic landscape quite markedly.
- At the start of 2011, how many people predicted that there would be an earthquake, tsunami and nuclear accident in Japan? Few hands in the air I suspect.
- The best that we can do in Australia to guard against the risk of events like floods, cyclones and droughts is to watch the traditional El Niño and La Niña indicators.
- Currently a La Niña event is developing with the Southern Oscillation index above a reading of +8-10 points. But the SOI is still well below the levels reached last year when the east coast of Australia was severely affected by floods.
- According to the Bureau of Meteorology: *"Climate models surveyed by the Bureau suggest this event is likely to peak near the end of the year and persist into early 2012. Current observations of this La Niña show that it is considerably weaker than the very strong 2010-11 event."*

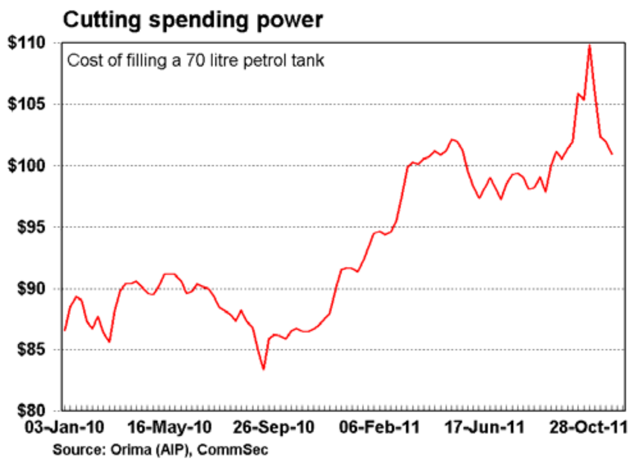
<u>So What?</u> Investors have to stay aware of weather-related events – not just floods and droughts, but also the potential for unseasonal weather, affecting construction companies, insurance companies, retailers as well as rural producers.

Will higher oil prices derail the global recovery?

- Investors always need to keep a close watch on the oil price. Every US recession since the 1970s has been associated with a sharp run up in the price of oil. And it is important to note that, despite the ongoing turmoil in Europe and the US, the Nymex oil price has pushed above US$100 a barrel.
- Fortunately for Australian motorists the oil price has been tracking closely in line with the Australian dollar, thus dulling the impact on household budgets. Further, the Singapore gasoline price has not been tracking higher in line with Nymex or Brent prices as a result of plentiful supplies in the Singapore market.
- Clearly oil demand is also changing across the globe, especially for automotive use. Not only are more cars using more efficient diesel fuel, but there are continuing advances in hybrid car production and LNG and electric powered vehicles.
- Still, the world remains dependent on fossil fuels and the global economy is vulnerable to sharp increases in oil prices, especially at a time when other stresses are taking place such as debt problems in advanced nations such as Europe and the US. And there are always risks of geopolitical events that could serve to push oil prices higher even without normal demand influences.

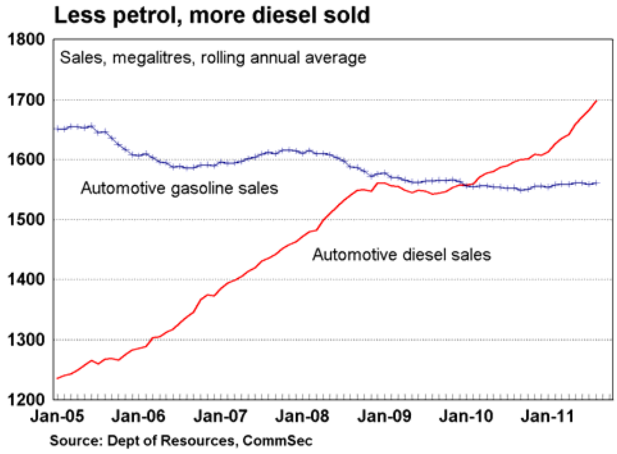
<u>So What?</u> Rising oil prices are important not just for the broader economy. Certainly filling up the car with petrol is the single biggest purchase that most Australian households make each week. So the rising cost of fuel is especially important for consumer-focussed companies such as retailers.





How important will politics be for economies?

- This could be considered somewhat of a "left field" issue. That is, it is not a traditional economic issue. But clearly economics and politics go arm in arm – much to the chagrin of traditional or textbook economists. To get agreement on economic problems, frequently compromises have to be achieved. Not only are we seeing this in Europe, but also in the US with discussions on addressing budget deficits, and here in Australia on issues such as the carbon or mining taxes.
- In the coming year, politics and economics are likely to be even more entwined. European governments must cut budget deficits despite opposition from their constituents, especially public service workers. Some governments – such as Italy – are now controlled by economic technocrats.



- And in the US, the Presidential election will be held in November. Democrats remain fundamentally opposed to spending cuts in areas like health and social security. Republicans remain opposed to higher levels of taxation to address budget shortfalls. Economists are well aware that both spending and taxing measures need to be employed to address high budget deficits.
- At the end of the day the success or otherwise achieved by economists to get US voters to understand the fundamental budget issues may affect the result of Congressional and Presidential voting results.
- Here in Australia a range of issues in 2012 could be affected by the tug-o-war between political and pure economic considerations such as immigration, the pursuit of a budget surplus as a goal in itself, balance between fiscal and monetary policies and design of taxes like carbon and mining taxes.

So What? Politics will always get in the road of efficient economic solutions. But the interplay between politics and economics will be especially prominent over 2012, ultimately affecting decisions made and thus affecting financial markets such as currencies, interest rates and sharemarkets.

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