

# Ausbil Dexia Limited Investment Markets

## November 2011

*Ausbil, a partnership of investment experience and financial strength*

AUSBIL DEXIA LIMITED

AFSL 229722

ABN 26 076 316 473

ACN 076 316 473

A Member of the Dexia Group

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Money does not perform. People do.



**Ausbil Dexia Limited**  
Australia

# International Economic Overview

## Overview

In terms of global growth, we expect that 2012 will see a slowdown, but no rerun of the sharp recession of 2009. However, within this aggregate, there will be wide divergences.

Our base case is that the EMU sovereign crisis will escalate, provoking a sufficiently strong policy response from the ECB and creditor governments to prevent EMU disintegration and a string of disorderly sovereign debt defaults. Even so, we expect that sovereign spreads will remain unusually wide. The euro area is already falling back into recession, with negative growth in the December quarter 2011 which is likely to carry over into 2012. Real GDP may fall by around 1.5% in 2012. This compares to a forecast expansion of over 1% just four months ago.

By contrast, the US is showing a modest but sustained growth in 2012 and beyond. Emerging Asia is showing still relatively strong – albeit slowing – growth in 2012.

The extent to which global growth is China-dependent will increase. The lagged effect of past domestic tightening and slowing export growth are likely to cool China's growth below 8% for the year in the December quarter 2011 and into early 2012. Nevertheless, China will continue to account for a huge share of global growth. Over 2012-16, China may directly account for roughly one third of global GDP growth, roughly twice the direct contribution from US GDP growth.

There are sizeable risks in the outlook. The forecast that the Euro crisis escalates and then is contained and mitigated somewhat by policy responses is subject to considerable risks – most of them on the downside.

In terms of the data, the manufacturing Performance of Manufacturing Index (PMI's) for November were weak, with the indices for Europe, UK, China and Japan all deteriorating in the month, and index levels now below 50. The notable exception was the US, where the ISM manufacturing index rose in November, to 52.7 (median 51.8) from 50.8 in October. Now at 5-month high, it suggests that the US economy is on track to grow by around 2½% (annual rate) in the current quarter.

# International Economic Overview

## United States

Despite the weakening global economy, the US economic data continues to steadily improve, albeit from a low level, and remains consistent with modest positive growth in the economy.

In addition to the resilient ISM manufacturing index, consumer confidence has improved, while private sector jobs growth continues and there has been a surprising fall in the unemployment rate. US non-farm payrolls rose 120,000 in November with private payrolls improving by 140,000. This was the fifth consecutive reading for payrolls above 100,000. The unemployment rate fell to 8.6% from 9.0%, reflecting a large gain in household employment; up 278,000. This suggests that bigger payroll gains are on the horizon.

US Consumer Confidence rose to 56.0 in November (median 44.0) from 40.9 in October, the biggest one-month jump in eight years and now at a 4-month high. It gave markets a boost when it was released but the index is still well below the 100-type levels that are consistent with strong economic conditions.

Positive, but uneven expansion in the U.S. economy is expected to continue over the next couple of years. Both the breadth and strength of the rebound is being held back by lingering imbalances in key sectors, threatened financial instability and unresolved policy questions. Since growth in income and employment resumed two years ago, recovery has managed to overcome downside risks but not without timely policy help, the scope for which is diminishing.

Despite the uncertainties, growth has picked up recently. The underlying cyclical momentum of pent-up demand has been reinforced by the unwinding of temporary drags. Car production and sales have rebounded as Japanese supply lines have reopened and production increased. Earlier weather disruptions have eased and the partial reversal of oil price spikes has buoyed discretionary income. Consumer spending is rising at the fastest rate in a year and business spending on equipment is growing at a double-digit rate. The financial support for growth is improving slowly. Bank credit is rising again, led by near 10% growth in business lending. However, financial stress indicators are elevated and contagion from the European sovereign debt crisis could feed through the banking sector.

The lack of any revival in housing remains the key shortfall in the broader recovery. The prospects favour very modest gains in homebuilding, mostly in lesser value added apartment building. Although home prices have steadied in many parts of the country, vacancies and visible inventories are high, while more than a quarter of mortgages are operating at a loss to the owner. Traffic of prospective homebuyers is still deeply depressed.

The relative weakness in construction and finance along with ongoing retrenchment in the state and local sector has contributed to slow employment gains and the jobless rate is expected to decline slowly in 2012. Despite strong profits and historically-wide margins that typically have signalled strong labour markets, policy uncertainties are exacerbating firms' reluctance to expand.

Monetary policy is expected to remain focused on supporting financial conditions throughout the two-year horizon. With inflation within desired ranges and unemployment stubbornly high, overnight rates are not expected to rise until sometime beyond 2013.

# International Economic Overview

## United Kingdom

The Chancellor stuck to his plan of proceeding with the fiscal austerity package put in place after last year's elections. The autumn statement announced measures that were fiscally neutral for the coming years, with some extra tightening projected from 2015 to show that the government's fiscal rules will be met.

The recent data indicated that retail spending is still falling. The November manufacturing PMI remained at a similarly weak level of 47.6. The survey appears consistent with a contraction in output within the sector but, there was not a strong message that the drag on manufacturing is intensifying. Overall GDP is likely to be flat on average in the December quarter 2011 and March quarter 2012.

The Office of Budget Responsibility (OBR) reported significant downgrades to its forecasts for both growth (expected at 0.7% for 2012) and the economy's supply potential. Overall borrowing from the period of 2010/11 to 2015/16 is now expected by the OBR to be £105 billion higher than before. The deficit for 2012/13 is now forecast to come in at 7.6% of GDP, which is 1.4%ppt higher than before.

## Japan

While the downside risk from external factors remains high, after some slowing this quarter the overall economy can grow at an above-trend pace through next year with the lift from public spending for the reconstruction of the Tohoku area. The government passed the third supplementary budget for this fiscal year of ¥12 trillion (of which ¥9 trillion will be used for the reconstruction), so that public investment will likely increase in earnest from next quarter. This boost from public spending will likely continue until the end of next year.

Industrial production rose 2.4% in October, stronger than the market forecast of 1.1%. While the projection for November was revised down to -0.1% from +1.8% in the previous report (probably reflecting the adverse effect from the Thai floods), IP was projected to rebound 2.7% in December, yielding a 4.9% December quarter (annualized) increase. This would be a sharp slowdown from the 18.1% jump in the September quarter (due to resumed car production)

Finally, the November PMI fell to 49.1 from 50.6 in October with decisive 5pt and 3pt falls in output and new orders, respectively.

# International Economic Overview

## Europe

The uncertainty in Europe continues. There is still plenty of talk for a greater role for the ECB and IMF to bail out troubled nations, and/or for the issuance of joint Euro bonds and/or for increased fiscal integration. But there are no firm decisions yet. There has been some positive sentiment in markets after the central banks of the US, Europe, UK, Switzerland, Canada and Japan cut the existing temporary USD liquidity swap rates by 50 bps. This action reduced the premium that banks pay to access overnight USD. The central banks are continuing to improve short term liquidity and funding markets and ease tensions in financial markets. Equity markets rose 3 to 5% across Europe and the US following the announcement.

Whist improved liquidity provided a fillip for the markets; it does not resolve the fundamental Sovereign debt and bank capital problems. Other events, however, have been market positive. Bond auctions in France and Spain were seen as a success, due to the strong investor demand. France sold €4.3bn of debt, including 10-year bonds at 3.18%, lower than at the 3rd November sale. Spain sold €3.75bn of bonds, but still had to pay the highest yields in 6 years, with 2015, 2016 and 2017 bonds yielding 5.19%, 5.28% and 5.54% respectively. But Italy's latest bond auctions again yielded over 7%.

Meanwhile the EU finance ministers have cleared the €5.8bn bailout payment for Greece in December. The IMF however, is yet to approve its €2.2bn share of the next tranche, but it seems to be a formality from here.

The Monti-led Italian government has approved a new €30bn austerity/ growth-boosting package. The extra austerity is required for Italy to keep its pledge to balance its budget by 2013.

More substantial ECB support will be needed to avoid disorderly default of globally/systemically significant countries like Italy and Spain. We expect such ECB support to be forthcoming. Faced with the choice between financial stability – avoiding disorderly sovereign defaults that would bring down much of the European and American banking system – and strict adherence to its purported principle of not providing either quasi-fiscal or liquidity support to sovereigns, the ECB is likely to choose financial stability, as it did in May 2010. But, as in the past, the ECB is likely to insist on and to succeed in obtaining reciprocal actions by the beneficiary countries (through greater fiscal austerity and structural reform) and by the EU member states collectively, through enhanced joint fiscal support facilities and through commitments to greater fiscal integration in the future.

# International Economic Overview

## China

Economic data released over the month is consistent with China's soft landing outlook. Chinese exports have been adversely affected by the slowdown in Europe. Headline inflation was coming down due to a good grain harvest and maturing pig cycle, with substantial reductions in pork prices. October CPI inflation came in at an annual rate of 5.5%, lower than 6.1% from previous month. The purchasing price inflation for industry also reduced to 8% from 10%. Together with the base effect, the headline inflation outlook is lower for the first half of 2012.

On the growth side, the retail sales growth eased to 17.2% from 17.7% and industrial production fell to 13.2% from 13.8%. Both were below market forecasts. On the other hand, the fixed assets investment was steady at 24.9%. Export activity slowed to 15.9% year on year growth, from 17.1%. Import activity was well supported by strong domestic demand, up by an annual rate of 28.7% from 20.9%.

The banks' reserve requirement ratio was cut by 50 basis points to 21% for large banks and 19% for small listed banks. It is the first cut since December 2008, following six increases during the year. The action came in earlier than expected and signalled a shift in China's policy stance from fighting inflation to now supporting growth. The authorities have rapidly reversed part of their tight policy in an effort to ease up tight credit supply and weaker external demand. There is unlikely to be any easing of administrative constraints on the property market.

The Eurozone is China's single largest export market with 17% of Chinese exports, which in turn accounts for about 5% of Chinese GDP. Given the European economy continues to deteriorate and is expected to enter recession in 2012, Chinese exports to the EU as a whole have already started slowing. This has reflected in recent softer production data and weaker export growth.

2012 is a transitional year for the Chinese central government and the changeover will be completed by early 2013. During this time, the central policies will be likely to focus on social stability and growth. Fixed asset investment will be supported by the policy easing. Social housing construction will continue to support economic growth into 2012, and investment will go to infrastructure projects such as irrigation systems, environmental projects and schools. As weak global demand negatively impact production growth, the domestic growth and consumer demand will be supported by various government policies and subsidies.

# International Economic Overview

## Australia

Australia has experienced a similar degree of private sector deleveraging to that of major economies. Nevertheless, the Australian experience has also differed in some important respects. In particular, non-financial companies mainly paid down debt by aggressively issuing equity and banks have maintained strong profitability despite low credit growth. Households have increased savings, but firm income growth has kept spending from falling too much below trend. It therefore seems likely that Australia's potential growth rate is largely undamaged.

The latest phase of the crisis has seen a fall in commodity prices, but companies continue to report a commitment to aggressive investment in mining and energy projects. Growth should also be boosted by an expected rebound in exports following extreme weather earlier this year. However, given that global growth is now expected to be well below trend next year - and with downside risk - the RBA has eased monetary policy, with a further move likely in the New Year, particularly if further offshore shocks disrupt global financial markets.

The interest rate outlook is modest relative to the aggressive rate cuts in 2008-09, when the RBA took the cash rate down by more than 400bp to a record low of 3%. The Bank has significant interest rate ammunition available, a luxury not shared by many other central banks, and their actions show they are prepared to use it, even if local activity continues to grow. Officials increasingly seem prepared to move on a "balance of risks" basis, and that balance is shifting to the downside. The local fallout from the turmoil in Europe is growing. Australia sends less than 10% of its exports to Europe, so the direct impact of a European recession is modest. The sovereign troubles in Europe, though, clearly are having a serious and lasting impact on global financial markets. The growing risk now is that dislocation in financial markets could put even more stress on funding markets in Australia, which would be a serious new transmission mechanism, via the banks, of the troubles in Europe to economic activity in Australia.

Government revenue collections are falling short of target, so the announced spending cuts will be an additional drag on growth. Both the growth and inflation outlook have been revised down in the Mid-Year Economic Review. This means the pressure on the economy's resources will be less intense, in the context of continued strong resource based investment.

## Fixed Interest

### Performance and Outlook

The Reserve Bank of Australia (RBA) decided to cut interest rates by 25bps at its December Board meeting. While markets were almost fully priced for a rate cut, analysts were evenly divided as to whether the RBA would follow up its November easing with another rate cut in December. The rate cut became more likely following the decision of the Chinese authorities to ease monetary policy and the co-ordinated policy actions of the 6 central banks on the USD swap rate, as this highlighted that the global growth outlook had continued to deteriorate.

Further weakness in Chinese manufacturing is expected in coming months and the risk of Chinese growth temporarily slipping below 8% has increased. The RBA cites slowing growth in China, the impact of weaker European growth on Asian trade, as well as the impact of financial market volatility stemming from the European debt crisis as the key reasons for weaker global growth and hence the easing decisions.

Thus, while the RBA hasn't pre-committed itself to cutting rates further, if there is deterioration in unemployment, low inflation and/or further downgrades to the global growth outlook, the RBA will not hesitate to respond. On that basis, we still anticipate that the RBA will cut rates at its next Board meeting in February 2012. Further cuts, as priced in by the market, are less assured.

The main driver of our bond market continues to be the European political gyrations. There is an important leaders' meeting scheduled shortly and many meetings in the lead-up. Angela Merkel and Nicholas Sarkozy have been speaking publically about the need for greater fiscal unity. This is generally being interpreted as some form of oversight of European Sovereign Governments' fiscal plans. The line of reasoning suggests that once fiscal discipline is locked in it becomes easier to convince potential investors and the ECB (either directly or via the IMF) to invest money in bonds. The balance of risks may now be changing. The situation in Europe appears to be improving and Australian yields remain exceptionally low by historical standards. The central risk in Australian rates is not heavily tilted towards a rally. Any improvement in risk taking will be at the cost of bond yields, with pressure on the longer dated low bond yields.

## Foreign Exchange

The Australian dollar has plumbed the lows of 0.96 and returned to high 1.02's in recent weeks. This volatility is a product of the ongoing uncertainty in Europe and the ebb and flow of market expectations for a more permanent euro-area remedy. It weighs on the AUD due to both growth and interest rate expectations, as well as time-honoured correlation patterns with the EUR.

We expect this volatility to continue, with the AUD moving higher on any liquidity boost and affirmative policy action in Europe.

However, the AUD highs are getting lower and the broader economic data is beginning to soften. This confirms the earlier view that the AUD will not be able to sustainably return to its highs. Australia's reliance on China's growth has been an extremely strong supporter of the Australian economy and the AUD.

The relationship between the AUD and the rest of the world has changed, as this reliance on China increased. This relationship likely ensures that the AUD's long term value has risen in the last decade. But there are two way risks and the downward pressure is beginning to assert itself. The recent China manufacturing PMI recorded a sub-50 reading for the first time since the financial crisis of 2008. The underlying details were also poor. China's property prices are necessarily declining, as the authorities take the heat out of the sector in order to address affordability issues.

The recent unexpected event in China was Reserve Requirement Ratio cut (RRR). There is more than enough policy scope to ensure that the necessary policy accommodation is achieved to avoid a hard landing in China. But, it is likely that growth is slowing. This is a negative for the AUD. Also of note is the recent RBA commodity price index has pointed to this expected reduction in commodity prices which limits the AUD upside.

The RBA has eased twice in two meetings. The market has already priced in a series of easing. Hence there has been little market surprise with little reaction on the currency with the cuts. The market surprise will be evident when the RBA does not continue to cut. This will be a 2012 issue.

## Australian Equities

The Australian equity market as measured by the S&P/ASX 300 closed the month 3.4% lower. Equity markets fell in November as investors opted for a more conservative position due to ongoing concerns over a deepening sovereign debt crisis in the European Union that saw Italian bond yields climb to a historical high of more than 7.0%. The deepening crisis also led to credit downgrades to various European governments and the resignations of the leaders in Greece and Italy.

In corporate news, the Banks earnings reports were consistent with analyst forecasts; however a more difficult funding market was highlighted. Bluescope Steel launched a renounceable rights issue program to strengthen its balance sheet, thus highlighting the continuing challenges for domestic, trade exposed manufacturers. Finally the AGM Season continued to provide investors with a mixed message on current trading conditions with a majority of companies highlighting a tough operating environment.

Domestic economic data saw the RBA cut the cash rate by 25 basis points for the first time since April 2009 from 4.75% to 4.50% (a further 0.25% cut was announced on the 6th December) with comments on global uncertainty and European Sovereign debt stress supporting the decision. The mid-year review of the Australian Government budget confirmed the expected delivery of a budget surplus in FY 2012/2013 despite falls in projected revenues and the announcement of \$6.8bn in spending cuts. The AUD traded below parity for much of the month before recovering with a late month rally from a low US\$0.97 to close at US\$1.028.

Commodity prices had mixed results in November due to ongoing global growth concerns. Brent Crude (+2.3%) and Iron Ore (+10.6%) were both up for the month, whilst the base metals complex (LME Index -2.5%) was impacted by economic fears. Spot Gold (-0.7%) also fell during the month.

The Resources sector (-6.3%) underperformed Industrials (-2.2%) on the back of weaker investor sentiment that pushed commodity prices lower. The smaller companies, represented by the S&P/ASX Small Ordinaries (-3.7%), underperformed the large cap stocks, represented by the S&P/ASX 50 Leaders Index (-3.3%).

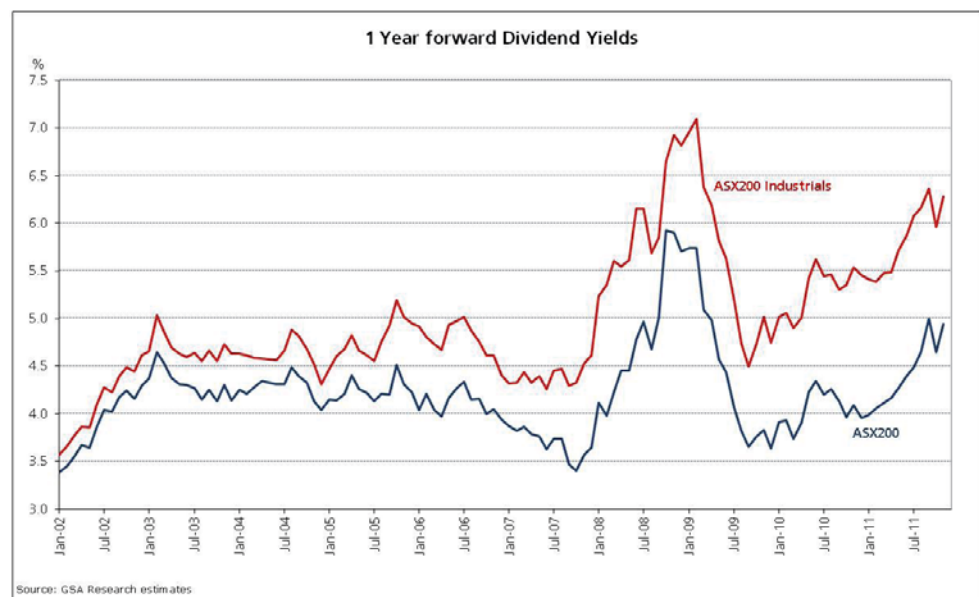
At a sector level, REITS (+2.7%), Telecommunications (+1.8%) and Healthcare (+1.8%) were the best performing sectors. Within REITS, the major stock performers were Stockland (+7.3%) and Westfield Group (+6.5%). Within Telecommunications, Telstra outperformed (+1.9%), whilst in the Healthcare sector, the best performer was CSL Limited (+8.1%).

The underperforming sectors were Materials (-6.2%), Energy (-4.3%) and Financials ex LPTs (-3.7%). Within Materials, the underperformers were OneSteel (-32.9%) and Boral Limited (-10.9%). Within Energy, the underperformers included Woodside Petroleum (-10.3%) and WorleyParsons (-8.1%). Within Financials, QBE Insurance underperformed (-8.7%).

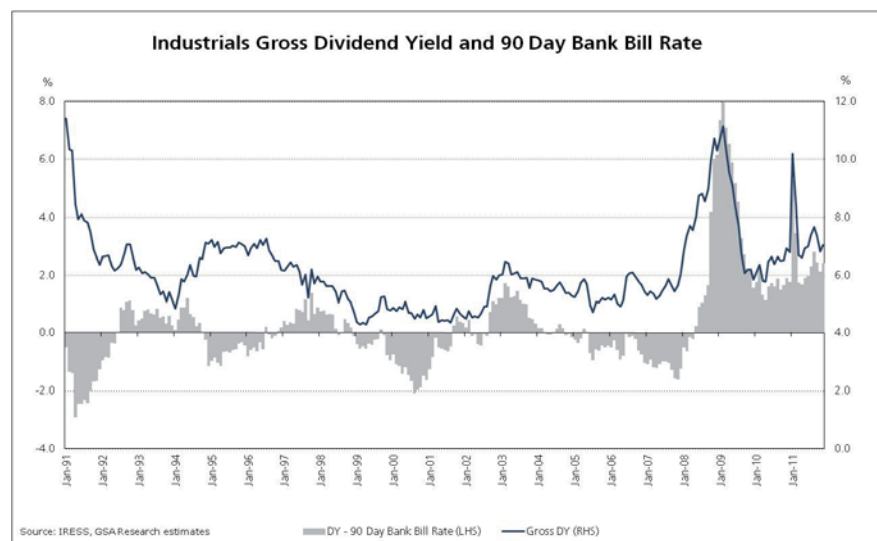
# Australian Equities

## Cash rates or equity market dividend yields?

Australian equity market investors currently enjoy a very attractive cash dividend yield of ~5%, which compares very favourably to the current cash rate. Drilling down to the industrial sector, the yield on the S&P/ASX 200 Industrials Index rises to over 6%; which - when grossed up for franking credits - is effectively equivalent to almost 7%.



The chart below illustrates the difference between the grossed-up Industrials yield less the 90 day bank bill rate (i.e. the sustainable yield spread). This spread is likely to become even more compelling if the Reserve Bank reduces the official cash rate further. Historically, Australian equity values reach an inflection point when the sustainable yield spread is greater than 130 basis points and at present the spread is greater than 200 basis points.



Data: ASX 200 Industrials Gross Dividend Yield, 90 Day Bank Bill Rate

# Australian Equities

The table below highlights the cash yield opportunities at a sector level (across non mining sectors) greater than 5%.

Sector	FY12 (f) Sector average cash dividend yield	Highest FY12 (f) cash dividend yield within the sector
Agriculture Sector	5.7%	7.5%
Banks	7.8%	8.4%
Capital Goods	5.3%	10.1%
Consumer Durable & Apparel	7.7%	9.2%
Containers & Packaging	5.8%	5.8%
Diversified Consumer Services	5.6%	6.2%
Diversified Financials	6.4%	8.6%
Food & Drug Retailing	5.5%	6.9%
General Insurance	7.9%	9.5%
Hotels Restaurants & Leisure	5.9%	10.2%
Infrastructure Trusts	5.5%	6.1%
Life Insurance	7.6%	7.7%
Real Estate & REITs	7.7%	11.1%
Retailing	6.9%	9.9%
Software & Services	6.0%	10.3%
Telecommunication Services	7.3%	8.9%
Utilities	5.3%	9.2%

Source: Ausbil broker consensus, 25 November 2011

Today, companies are less geared than prior to the GFC in 2008 as a result of the equity recapitalisations of their balance sheets. This has seen the gearing level for all listed companies fall to ~30% and the interest cover rise to ~9x earnings. In the August profit report season there was a notable increase in announced capital management initiatives such as share buy-backs and special dividends across a variety of industries. These recent announcements are supportive of the financial strength of listed businesses with strong balance sheets and solid cashflows. However, the current operating environment remains challenging for the industrials sector whereby EBITDA margins have fallen to their lowest levels in 15 years which presents both an opportunity and increased risk. Investors should be cautious about companies facing structural headwinds with weak business models, as these companies are likely to have unsustainable dividend yields regardless of how attractive they may seem at face value today.

The headline dividend yield at a stock level can be misleading and the challenge for investors is to ensure that the underlying business has a strong balance sheet, sustainable earnings and earnings growth to support the dividend into the future. In this current environment, we continue to find opportunities where earnings growth is above market growth rates and the dividend can be sustained with growth possibilities.