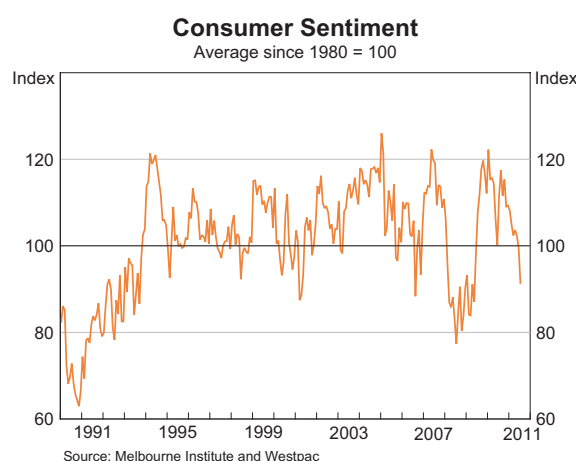
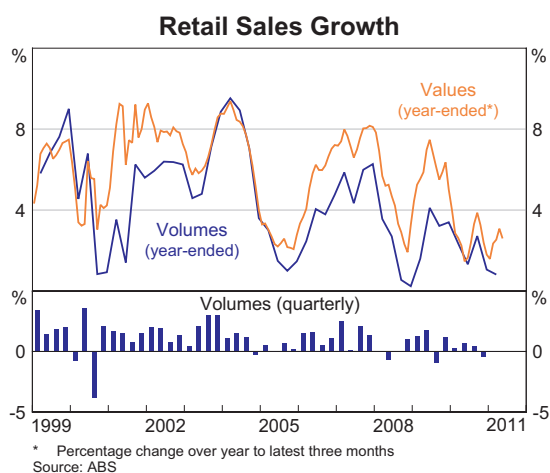


The impact of a weak consumer

As recent data points have indicated, headline inflation is rising in Australia and is testing the RBA's tolerance band of 3%. As recently mentioned by an RBA board member, "10% of the Australian economy is growing at 15% and 90% of the economy is growing at 2%"; making the setting of interest rates a particular challenge. Whilst the quantum of these growth rates may be subject to debate, what isn't, is the significant contraction in consumer sentiment generally and tourism, retailing and some housing markets specifically. This is highlighted below in both the decline in the Sentiment index and retail sales growth.



These flow not only into the fortunes of the retail sector, but Industrial cyclical's generally (goods transport, expenditure on entertainment and advertising to name a few). The question facing investment managers is the extent to which this uncertainty is already priced into the Industrials segment of the market.

The weakness of the domestic consumer is no secret however, as at 31st July 2011, consensus still appears to expect the Industrials (as measured by the market ex Financials and Resources) to experience EPS growth of 15.8% in the 2012 Financial Year. Some of the key subsectors within this number are shown below:

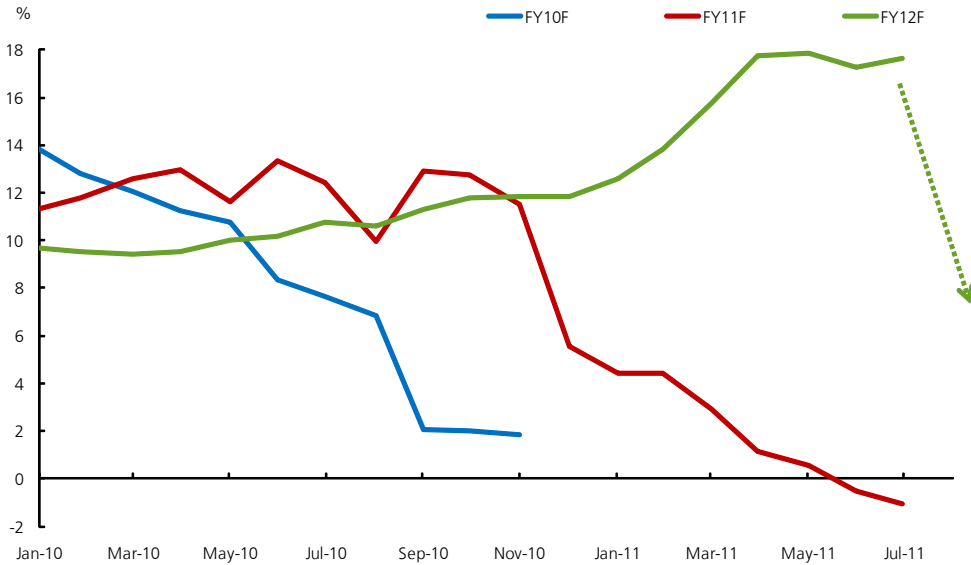
GICS Group	EPS Growth FY12 (%)	PE FY12 (X)
Transport	38.7	12.9
Infrastructure Trusts	8.1	18.1
Consumer Durables & Apparel	8.8	10.6
Hotels Restaurants & Leisure	8.4	11.7
Diversified Consumer Services	13.2	16.6
Media	12.6	10.6
Retailing	4.7	9.6
Food & Drug Retailing	18.9	13.9
Food Beverage & Tobacco	-0.1	15.8
Health Care Equipment & Services	17.2	15.8
Pharmaceuticals & Biotechnology	11.7	18.2
Telecommunication Services	8.9	11.0
Utilities	10.2	14.8
INDUSTRIALS	15.8	13.3
MARKET	17.3	11.5

Granted, the sector is trading on 13.3x FY12 earnings, which isn't excessive, and some of these sectors are more defensive in nature and/or not as influenced by movements in consumer spending such as healthcare and telecommunications. However the question remains as to whether the lower P/E's in the 'consumer sectors' represent a short term value trap whereby further earnings downgrades will precipitate further price falls (and relative underperformance).

In addition to a consumer which is saving more due to the economic pressures of higher interest rates, a high Australian dollar and an avalanche of negative news flow, businesses are also facing the prospects of rising costs associated with higher commodity prices and higher wage pressures. The impact of these combined factors will be highlighted in the August reporting season and in the outlook statements provided by companies.

Given this backdrop, and the fact that – as highlighted below - FY10 and FY11 Industrials earnings were progressively downgraded as domestic growth remained subdued, in the environment of an uncertain outlook it appears market consensus expectations in the 2012 financial year remains too optimistic.

INDUSTRIAL EARNINGS FORECASTS



Source: IBES, Datastream, Deutsche Bank

As such, we remain cautious towards the Industrials sector and expect to see further downgrades during the August reporting season. As mentioned in prior Economic Observers, we continue to see attractive opportunities for Industrials exposed to the resources industry, selective high yielding defensives, companies with overseas earnings and those with strong balance sheets. There are also various company specific opportunities such as companies delivering synergies through acquisition, business turnarounds or delivering strong organic growth by virtue of market position.