A dark cloud ....

Australasian Equities Monthly Commentary

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- Investors showed fear and panic in August as global growth expectations fell in the wake of squabbling in both Europe and the US that led to intensification of credit concerns and collapses in both business and consumer confidence. Global equity markets fell sharply in early August before partly recovering, ending the month down some 6% in US dollars.
- The Australian economy continued to disappoint and aside from the resource stocks, many companies reported lower than expected profits. The Australian market fell 2.2% in New Zealand dollars with the retail and media sectors showing the most weakness.
- In contrast New Zealand data remained relatively strong, earnings results were generally better (on a 3:1 ratio) and as a result the equity market out-performed global markets, declining by around 2%. The best New Zealand company reports came from Mainfreight (although the share fell). The most disappointing results came from Australian focussed companies like APN News and Goodman Fielder and exporters especially Rakon and F&P Appliances.
- Telecom showed a better than expected earnings result which initially helped the share price, but partial separation documents released at the end of the month saw expected valuations for the proposed two entities fall somewhat. As a result Telecom returned only +1.8% in the month having at one stage been up 10%.
- The portfolio returned a disappointing –3.8%, some 2.7% less than the Index. Key negatives were exposures to Australian resource, energy and healthcare stocks, which lagged the New Zealand market as "risk-off" behaviour continued. We explore in this month's strategy the outlook for resource and energy stocks, while continuing to emphasise our stronger New Zealand exposures in stocks like Fletcher Building, Mainfreight and Sky Network TV.

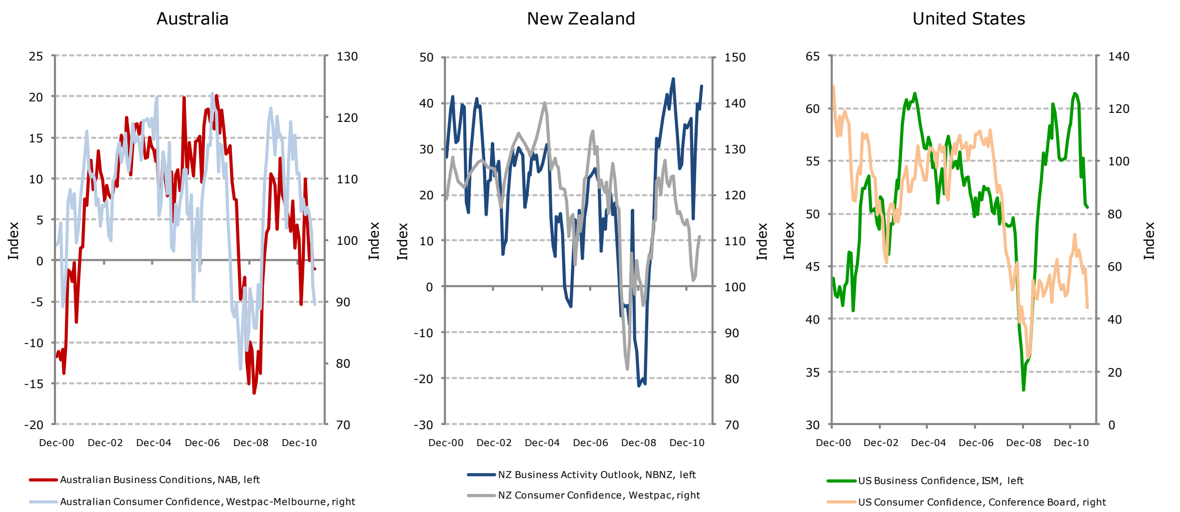
To August 2011	***Month***	***3 months***	***1 year***
Portfolio	(3.76%)	(8.02%)	9.21%
Benchmark*	(1.07%)	(3.71%)	15.29%
Relative Performance	(2.69%)	(4.32%)	(6.08%)

* Benchmark is the Russell JB Were Tradeable Index including imputation credits. Returns are before fees and taxes. Investor returns may differ. Numbers may not add due to rounding.

Strategy: A dark cloud...

Global seizures, but New Zealand a bright spot

It is extra-ordinary. New Zealand is the only OECD economy to register sequential upgrades to growth forecasts in recent months. Our business and consumer confidence stand strong, when those in most countries show shades of panic or trouble ahead. And on the whole, our companies are reporting better than expected earnings.



In this strategy note we consider:

- the latest company reporting season – a good one
- our key portfolio themes – namely New Zealand recovery, resource and energy exposures
- how we view global structural issues – positive for commodities, negative for financials
- the Australian bank, retail and media sectors – too early to buy?

Reporting Season

The New Zealand company reporting season was the most solid for over 5 years. On a three to one ratio New Zealand companies reported better than expected earnings and had upgrades to the outlook for earnings. Domestic sales and margins were highlights and a number of companies specifically mentioned expectations to benefit from either the Rugby World Cup or the Christchurch rebuild – the two key catalysts for New Zealand economic growth.

However a number of companies also showed economic stress in their exposures in Australia or in global markets and in the translation of US dollar and Euro earnings to the New Zealand dollar.

Curiously, despite some companies beating earnings-expectations they under-performed. And while other companies reported earnings in-line or worse than expected – some out-performed. This August reporting round was the first in over 10 years that our portfolio has under-performed the index. We expect some strong mean reversion in returns in the months ahead as investors focus on the quality of earnings and recognize the strength of the New Zealand economy.

To give an example, Mainfreight reported earnings some 15% ahead of market expectations and then saw earnings expectations for 2012 and beyond rise by a further 20% on average. That is a big jump by any standards, yet Mainfreight fell almost 6% in August. Sky Network TV surprised the market with a 25 cent special dividend, and still fell almost 1%. New Zealand companies that reported earnings in August, had higher earnings than last year. Overall we estimate that core earnings were up 4.5% amongst non property companies. Moreover these earnings were roughly 3% ahead of expectations. This was a good earnings round for most companies.

However there were exceptions to the good earnings announcements. Most companies exposed to the Australian consumer reported poor earnings – Goodman Fielder, APN News and Media, Fisher & Paykel Appliances and Pumpkin Patch all under-performed. New Zealand exporters also generally reported worse earnings as the strong currency hit.

In Australia companies that reported poor earnings were punished. Billabong (-42%) and Bluescope Steel (-28%) typified rough market reactions. However even stronger results were not generally rewarded as investors fretted about financial sectors risks, global growth or the outlook for demand in Australia. For example Australia's largest stock, BHP reported cash earnings ahead of expectations, lifted dividends significantly and saw its key commodity – iron ore – rise in price by 6% in the month. BHP returned -4.1%% in August.

Key Portfolio Themes

We continue to **lift exposures to New Zealand names and hold an overweight in resources and energy**.

In August we bought further shares in Fletcher Building, Sky Network TV, and Mainfreight. In part these increases reflected the fact that strong upgrades to New Zealand GDP are likely to see further upgrades to earnings for these companies. For instance, in August, consensus forecasts for the NZ economy for the calendar 2011 year showed that annual average growth expectations moved up sharply by 0.7% points to 2.1%. Expectations for growth in New Zealand next year remain close to 4%, one of the highest growth rates in the developed world. The key risk to this outlook is the sharp deterioration in global prospects.

Against that background Fletcher Building looks well set to benefit from the rebuilding of Christchurch and a more gradual lift in New Zealand residential building activity. The Government has revised up sharply the residential rebuilding costs – and overall some estimates of the total rebuilding costs have lifted from $15bn to over $20bn. Fletchers and other companies will benefit, while in addition their recent purchase of Crane Group in Australia appears to be getting some early wins.

Other stocks geared to the New Zealand recovery include Sky Network TV, Sky City Entertainment, Mainfreight and NZX. Broadly speaking we were happy with their earnings announcements and their outlook statements were also relatively strong.

Turning to the portfolios resource positions, we note that China's demand for commodities has remained resilient in the past 6 months. And despite uncertainty over growth in Europe and the US, **iron ore prices have actually risen in the past 3 months**. Against that background our portfolio has continued to hold positions in diversified commodity behemoth BHP and LNG energy focused companies like Oil Search, Santos and Origin Energy. In recent weeks as resource share prices weakened **we have lifted further commodity exposure** by buying a new position in Rio Tinto.

BHP has just delivered a record profit – above expectations, and increased it's dividend (by 22%). Yet it's share price has languished below $40 for the past month after nearing $50 in April. A similar story plays out with Rio Tinto and other major commodity companies that now trade on forward looking multiples less than 9 times next year's earnings (the New Zealand market trades at about 13 times).

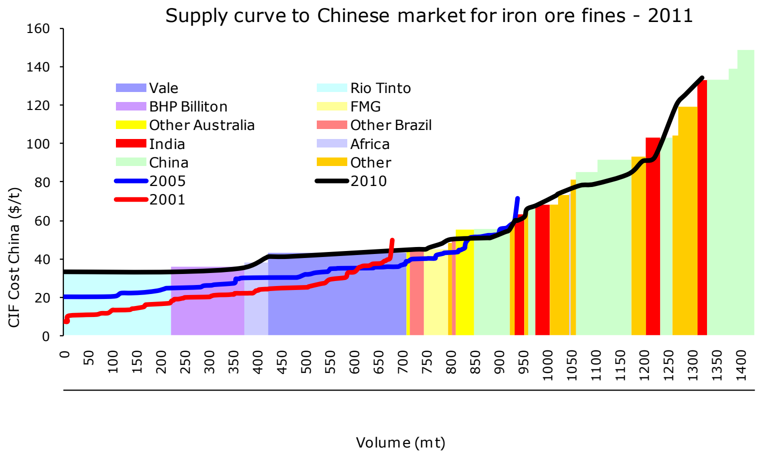
So why are investors so concerned? The current consensus has BHP earning 24% more this year than last – and if commodity prices stayed at current levels, earnings would be about 40% higher. However, that consensus hides a very wide disparity in expectations. Some expect a fall of almost 10% in BHP's earnings - others have a rise in excess of 50%. The range according to some is as wide as ever seen for such a large diversified company.

BHP's four most important commodities are iron ore, copper, coal and petroleum-related products. With iron ore and coking coal prices up, and copper prices well above June lows, only oil prices are showing weakness. Yet both Rio Tinto (which is iron ore, coal and copper focused) and BHP's share prices are down over 20% in recent months.

We know that investors are worried about two things. First that much lower growth in Europe and the US will impact on commodity demand, and second that the Chinese private property market appears stretched and may demand significantly less raw materials next year.

These worries are not new, and are not being reflected in key commodity prices. The way we think is that commodity prices are likely to be held at current prices for longer than expected as the prospect of low interest rates, further US policy easing and continued developing economy demand maintains strong margins for the low cost commodity producers.

Specifically we expect investors to gradually upgrade earnings expectations for iron ore in particular – that is why we have added Rio Tinto to the portfolio (over 75% of Rio's earnings come from iron ore). BHP and Rio Tinto remain the lowest cost producers of iron ore.



Slower global GDP growth has also eased an otherwise tight global oil market. OPEC spare capacity is very constrained according to Goldman Sachs, while non-OPEC supply has been disappointing.

China again is the power behind global energy demand growth – consuming over 500,000 barrels per day more in the last June quarter than a year ago.

Global oil inventory levels of oil products are well below seasonal averages and as winter approaches in the Northern Hemisphere energy demand is expected to again lift.

We expect that higher oil prices will lead to tighter pricing for alternative energies – specifically shale gas – BHP has just completed a major purchase – and LNG. Both Japan and Korea have substantial un-contracted demand for LNG according to CLSA. We think that Oil Search, Santos and Origin Energy are well placed.

Global Structural Issues – leadership needed

Global developments in August were partly political, with a display of divisive leadership in both Europe and the US. Some commentators say that political brinkmanship highlighted the potential for America's governance and policymaking to become less stable, less effective and less predictable. The way forward ought to entail tax reform and getting cashed-up corporate balance sheets investing in jobs growth – the market remains skeptical on these fronts. Meanwhile, monetary policy is left again to do the heavy lifting. The Federal Reserve Chairman re-committed at Jackson Hole to maintain the current low level of interest rates until mid-2013 and to a special session of the Fed in September to examine the need for further measures. We think that whilst US monetary policy is being asked to lift growth, commodities generally will have tailwinds that support demand from China. A commodity biased portfolio provides some protection for the tail risks of a further significant expansion of the Federal Reserve's balance sheet. **As a result, the positive risks to oil, copper, iron ore, and coking coal prices, at a time when many commodity companies are being**

priced a very low multiples, suggests maintaining a strong diversified resource and energy weighting.

In Europe there had been some calming of Eurozone credit markets, but in reality Europe is still struggling to implement fiscal responsibility. Some commentators say that September will provide several further tests to see whether countries can get more fiscally aligned. Whilst the European Central Bank could monetize some debt, it is clear that several European states strongly oppose this. The alterative is that many bond holders are likely to see default in one guise or another. The key question is the extent to which tax payers in the relatively rich nations share that loss. **In our view the tail risks of further European bank sector stress remain, and coupled with slow Australian credit growth and falling Australian house prices, the headwinds for Australian financial shares remain. That isn't to say that Australian banks look expensive – they probably don't – but the risks still seem biased on the downside.**

For both the US and Europe, growth has been revised down to stall speed. At one stage in August – investors started to discount a significant recession. This panic stemmed from the release of the Philly Fed business confidence index which did point to a negative rate of growth in the year ahead. But a range of other indicators started to portray a less dramatic slowing in growth. In fact US industrial production, durable and factory orders, retail sales, together with broader indicators of business confidence were better than expected. However, consumer confidence and employment data remained poor – and markets continued to be very volatile swinging between each day's data outcomes as the fear of recession with no appropriate policy response gripped markets.

Australian Banks, Media and Retail – too early to invest?

Australian bank, media and retail credit default spreads have widened significantly in August. The bond market is telling us that they see a rise in risks in these sectors. Historically this has been associated with a period of relative under-performance by shares in these sectors. And indeed the media and retail sectors were particularly weak in August with few exceptions. But bank shares performed relatively in line with the market.

Normally when the market perceives the potential for an interest rate cut, the best sectors to perform are domestic cyclicals. Despite the Reserve Bank of Australia ruling it out, the market in Australia is pricing-in interest rate cuts of around 1.25% in the next year. So isn't it time to buy these domestic cyclicals? In this debt deleveraging cycle the outlook for domestic demand remains uncertain. For the media companies, new technology is a significant drag. For the retail companies, consumer preferences to shopping on-line and spending whilst travelling abroad are key factors. For the banks a flat credit growth, falling building approvals, lower house prices and global banking credit stress all combine to provide limited growth options.

Clearly banks look cheap on fundamentals. High dividend yields, benign profit results and most likely stronger asset bases, given the cumulative rise in house prices since the GFC, are all positives. However, the near term upside to profitable balance sheet growth is hard to see for the Australian banks. It may be that for the time being they just offer a good dividend yield, with the risk that they trade back towards GFC valuations.

We are visiting several banks, retail and media companies in the month of September to test our thinking on these Australian sectors and we look forward to reporting further portfolio matters in October.