

Fear, Greed and Lack of Trust Revisited or 'Fat-fingers, Greece and Tax'?

Market Update by Frank Uhlenbruch and Brian Thomas, Perennial Investment Partners

- What has happened?
- Why has this happened?
- What does this mean for investors?
- Putting the last few weeks into a longer term perspective
- Appendix: Chronology of events, carry trade explained

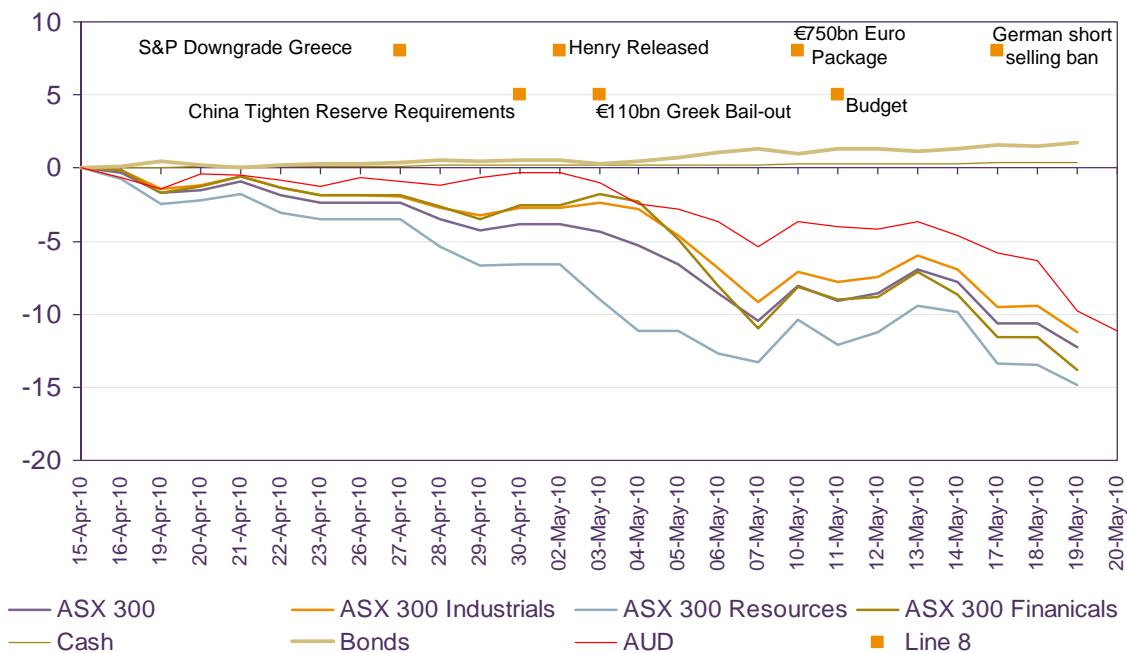
What has happened?

Prior to 15 April 2010 (co-incidentally the 98th anniversary of the sinking of the Titanic) all looked reasonably calm in the investment world. The Australian sharemarket (S&P/ASX 200 Index) had just hit the 5,000 mark and the market had rallied over 65% (including dividends) since the GFC induced low on 6 March 2009.

However, since mid-April there has been a remarkable change in sentiment. The Australian sharemarket recovery has stalled, with the market falling over 10% and major gyrations in currencies (see the appendix for a chart of currency movements). The dramatic riots in Greece, the apparent 'fat-fingered' data entry error that caused the US stockmarket (Dow Jones Index) to plunge nearly 1000 points before the 'error' was discovered and the new Resources Super-Profits Tax led the headlines. This brief paper gives an overview of recent events and what it could mean for investment portfolios going forward.

The following chart shows the dramatic falls in growth assets and the Australian Dollar (AUD), which has fallen from 93 US cents on 9 April 2010 to 81 US cents on 21 May 2010. Australian Resources have been hit particularly hard, over doubts about China's growth prospects and the negativity and uncertainty surrounding the proposed Resources Super-Profits Tax. As expected in these periods, government bonds have once again exhibited their defensive qualities.

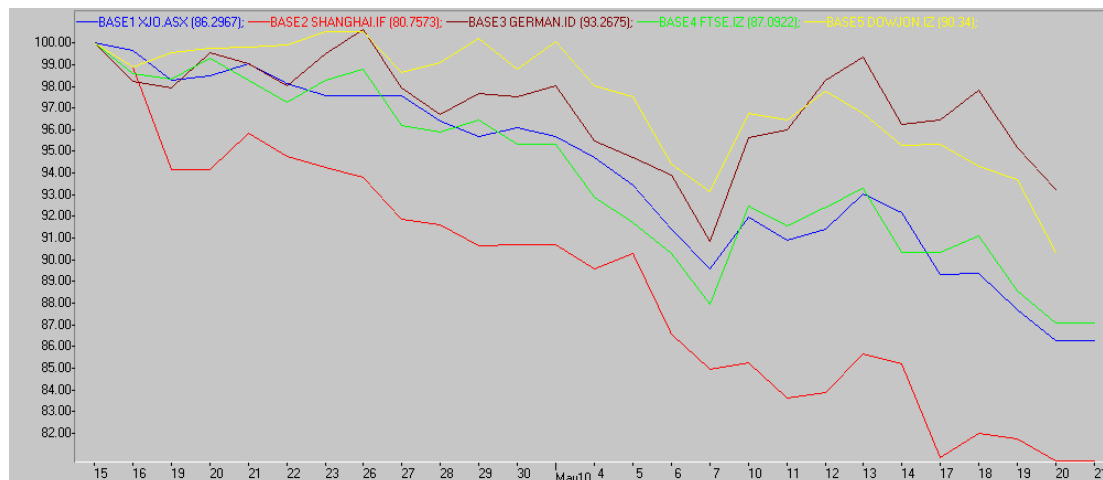
CHART 1: Performance of Local Asset Classes since 15 April 2010



Source: Bloomberg, Perennial Investment Partners Limited, end point 19 May 2010

This short-term equity sell-off has been particularly savage for Australia, with the Australian sharemarket underperforming most major stockmarkets, with the exception of the Shanghai Composite. This can be seen below in a comparison of the major economies.

CHART 2: Comparison of Global Stock Market Performance From 15 April 2010 (rebased to 100)



Source: Bloomberg

Note: German Dax- brown, US Dow Jones- yellow, UK FTSE- green, Australian ASX200- blue, Shanghai Composite- red.

Why has this happened?

Like most sudden global market events, the true causes are in no way clear-cut. However, I believe that the following are some of the likely causes.

Cause 1: Fear and lack of Trust. Global investors are still nervous after the GFC and any event that could lead to possible contagion effects is viewed with enhanced suspicion. You may recall that the initial problems with sub-prime loans in the US in the first half of 2007 were dismissed by the market but then became the major catalyst for the resulting market calamity.

Cause 2: The US share market had a good run through to mid-April and was due for a breather. The Greek debt crisis was a trigger to lock in profits.

Cause 3: China announced measures to slow the rate of expansion. This interacted with **Cause 2** and triggered a sell-off.

Cause 4: Repaying the stimulus. The massive global stimulus program (estimated by the Bank of International Settlements to be 5% of Global GDP) that saved the world from the brink of collapse has to be paid back and has created massive indebtedness in many developed nations. When you tighten fiscal policy, lost stimulus it is a drag on growth. Fiscal withdrawal and its impact on advanced economies has been on the markets' mind since the start of the year. The IMF had forecast a two speed global recovery, with advanced economy growth slower; a reflection of fiscal tightening amongst other things. It appears as though markets had their thoughts confirmed when Spain, Portugal and Greece announced fiscal austerity steps. Normally, credible fiscal cuts are rewarded by markets with lower yields.

Cause 5: Greece and the PIGS (Portugal, Ireland, Greece and Spain). The response to the Greek Government debt crisis was not decisive enough to keep investors satisfied, despite a massive €750 billion rescue package announced on 10 May 2010.

Cause 6: Currencies and the carry trade. When the above factors came into play, the Euro and AUD fell sharply, as investors sought the perceived safe haven of the USD. A falling currency is not favourable for

international investors holding Australian assets and this factor, plus the unwinding of the so-called carry trade (see Appendix), caused overseas investors to sell Australian shares and the AUD.

Cause 7: Australia shot itself in the foot with the announcement of the Resources Super-Profits Tax, which, while fine in theory, lacks consultation and transitional detail. This policy mis-step has reintroduced political risk into offshore consideration of Australia. It is not sovereign risk per se, with public sector net debt set to fall back to zero before the end of 2010.

What does this mean for investors?

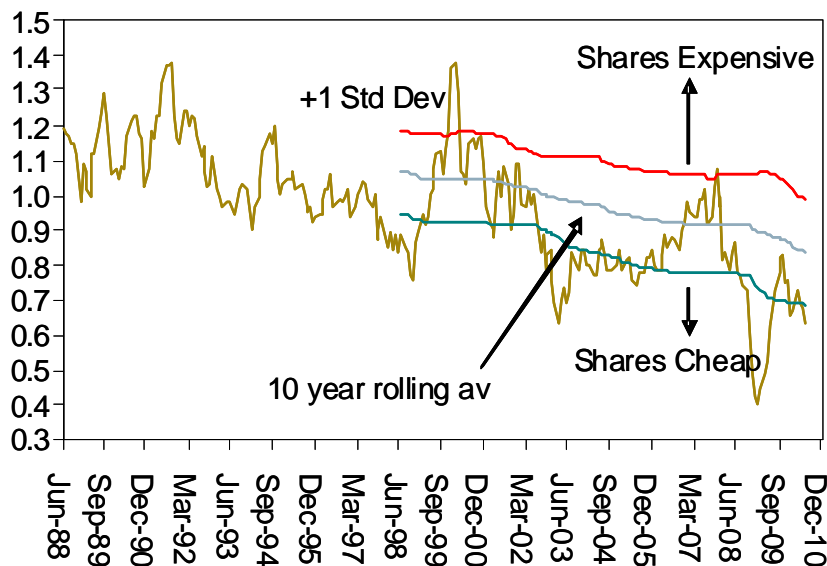
Whilst fear, uncertainty and lack of trust is driving markets, it is hard to predict exactly when normality will return. Certainly I believe, as do many commentators, that the indiscriminate selling of the AUD and Australian shares (predominantly by overseas investors) has been overdone and that the Australian sharemarket represents very good value.

A sell-off sows the seeds of the next recovery and for Europe it is the fall in the real Euro effective exchange rate. In Australia, fall in the AUD is helping Australian exporters, with the RBA of the view that the income gains from the recent rise in commodity prices outweigh the fiscal and monetary tightening to date.

Against that backdrop, Australian shares have gotten significantly cheaper and on a range of top down measures look to be great value. If you believe that European problems will eventually be solved, that China will not have to go as hard on cooling growth and that the RBA will pause interest rate rises for a while, then Australian GDP growth can run at trend rates of growth and deliver the earnings that go with that.

The following chart shows that, measured on a dividend yield versus government bonds basis, the Australian sharemarket looks cheap at the moment. In addition, forward PE ratios are now down to around 12 times for Australian shares, representing good value if the economy continues to grow and earnings are delivered.

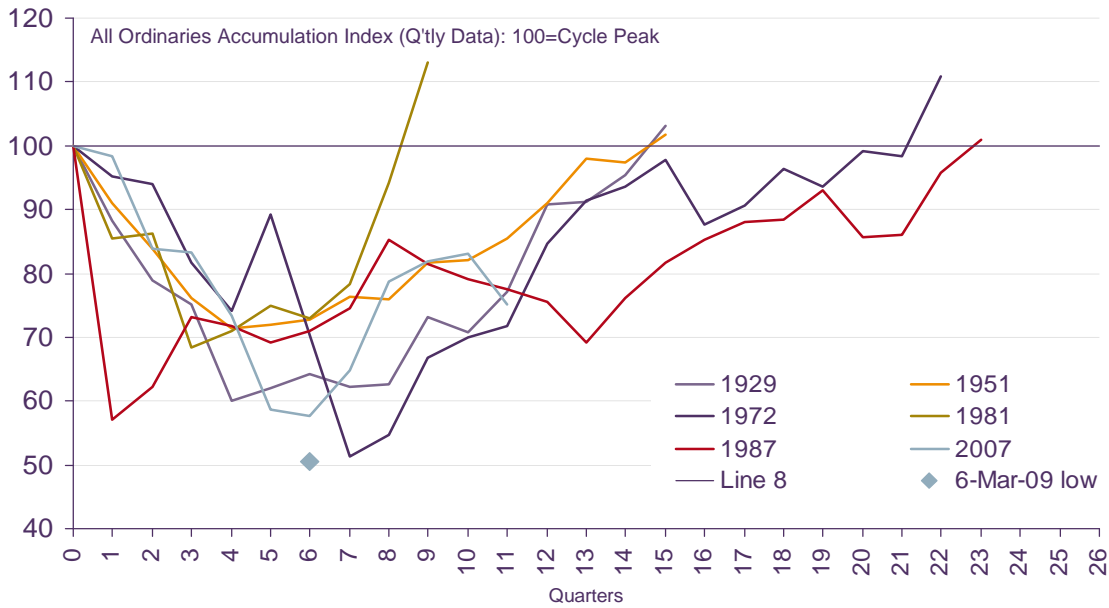
CHART 3: Long Bond/12m forward Industrials Yield



Source: Perennial Investment Partners

CHART 4 looks at the last six extreme bear markets, with the low point shown as "0" in the chart. The scale shows the quarters from the market high. As you can see, most sharemarket recoveries do not occur in a straight trajectory, even when measured on a quarterly basis. However, they do typically recover to reach new highs.

CHART 4: Various Bear Market Cycles

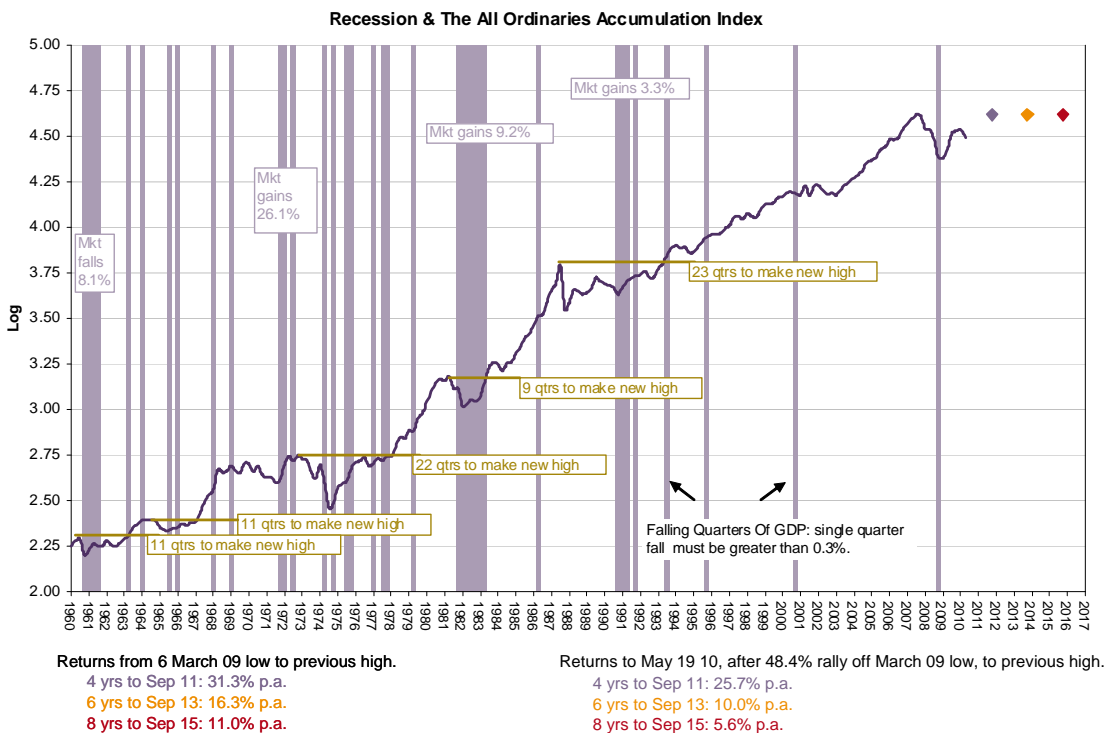


Source: Perennial, ASX, end point May 19, 2010 for 2007 cycle

Putting the Last Few Weeks into a Longer Term Perspective

In a vibrant economy like Australia, with natural resources and a well developed government and financial system, the sharemarket is likely to bounce back to new highs. The big question is how long will this take? Lets assume the recovery takes four years to bounce back to the high point reached on 1 November 2007 (ie the sharemarket bounces back to its previous high on 1 November 2011). In this scenario investors would be rewarded with returns of over 25% p.a. from 19 May 2010 by sticking with their share investments. If you push the sharemarket recovery out a further two years to 1 November 2013, this would still produce returns of 10% p.a. from 19 May 2010. A respectable return in an environment of relatively low interest rates.

CHART 5: A Solid Rebound Followed By Doubt



Source: Bloomberg, All Ords Accum, ABS, Perennial Investment Partners, end point 19 May 2010.

APPENDIX

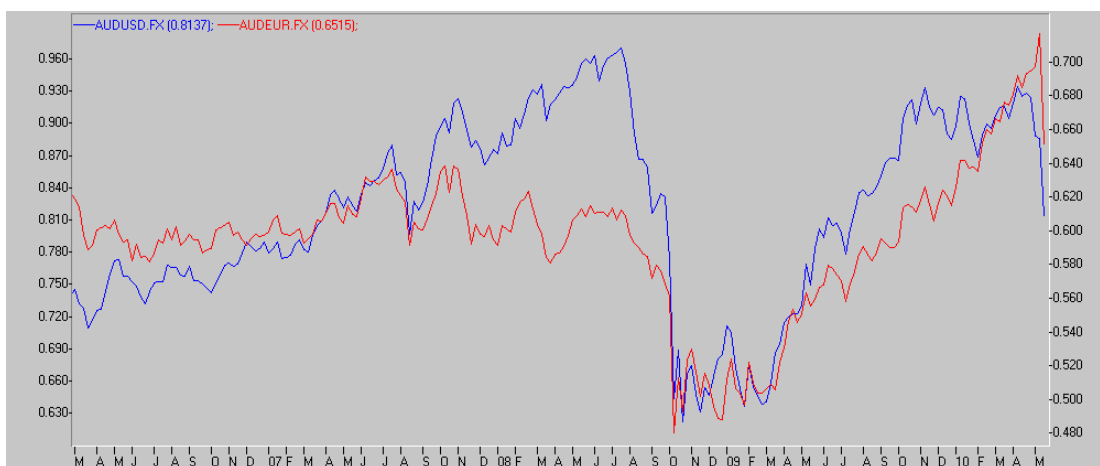
CHRONOLOGY OF EVENTS

- 9/4/10:** Ratings agent Fitch downgraded Greek Government debt to BBB with a negative outlook.
- 11/4/10:** Eurozone countries commit to a €30 billion funding package to help Greece.
- 13/4/10:** Lending by Chinese Banks fell by 43% in the first quarter, as China winds down its stimulus plans in an attempt to cool its credit boom.
- 15/4/10:** Chinese GDP 11.9% in Q1 2010 (the fastest pace in three years) and new measures are introduced to cool China's developing property bubble (i.e. 50% deposit needed for anyone buying a second home).
- 15/4/10:** Greek Government Bonds start trading at record yields.
- 21/4/10:** Greek Government Bonds hit again, as concerns develop over the funding package.
- 22/4/10:** Greek budget deficit worse than reported at 13.6% of GDP.
- 23/4/10:** Greece asks for activation of the €30 billion funding package.
- 27/4/10:** Greek Government Bonds rated 'junk' (S&P BB+) and Greece's two year bonds rise to almost 15% p.a.
- 27/4/10:** Portugal's debt downgraded to A-.
- 28/4/10:** Spain's debt downgraded to AA+.
- 29/4/10:** Greece agrees to rescue package, including increased taxes and a wage freeze for public servants.
- 2/5/10:** Australian Government responds to Henry Review, with announcements including a new Resources Super-Profits Tax.
- 8/5/10:** Greece's parliament passes the rescue package agreed with EU and the IMF, amid further unrest. Equity markets continue to fall on contagion fears. EUR/USD drops to a fresh 14 month low of 1.26. The ECB leaves rates on-hold at 1%, as expected. Trichet comments that the level 'remains appropriate'.
- 9/5/10:** The IMF unanimously approved its part of the rescue loans, with €5.5 billion provided immediately.
- 10/5/10:** Global policymakers install an emergency financial safety net worth about US\$1 trillion to bolster financial markets and prevent the Greek crisis from destroying the Euro. The massive package consists of €440 billion in guarantees from euro zone states, plus €60 billion in a European debt instrument. The IMF will contribute €250 billion, taking the total to €750 billion. Greek stocks rise by more than 7.5%.
- 17/5/10:** The German financial markets regulator announces a ban on naked short selling of all eurozone bonds and related CDS, as well as stocks of 10 financial companies until 31 March 2011. It cited 'extraordinary volatility' in the eurozone bond market. This triggers another round of equity market sell-off.
- 18/5/10:** Greece receives a €14.5 billion loan from the EU and can now repay its immediate debt, a development that helped to steady global investor's jitters. With €5.5 billion already delivered by the IMF, Greece has received the first €20 billion tranche of the loans.
- 20/5/10:** Some 25,000 people march peacefully to parliament protesting against government austerity measures.

Currency Movements: The “Carry Trade” Explained

Simply, the carry trade is an attempt by investors to borrow money in a currency which is perceived to be weak, with very low interest rates, and invest the proceeds in another perceived stronger currency, with far higher interest rates. Even if currencies do not move, the investor benefits from borrowing at a low rate and investing at a higher interest rate. If the currencies do move in the direction anticipated, the investor also gains. However, it is a high risk strategy as currencies can move in the opposite direction. The big currency movements experienced recently have resulted in many of these investors exiting the AUD to cover positions in other currencies, particularly the USD.

This five year chart of our AUS/USD and AUD/EURO really shows the dramatic fall of the AUD, as compared to these currencies.



Source: Bloomberg

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