



Australian Share Market Fall

Financial Spectrum give an review of the recent drop in the Australian Share Market

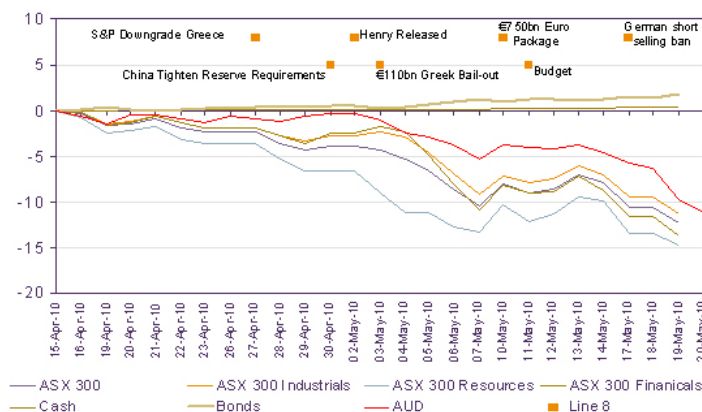
12 JUN 2010

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 6th 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 article 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 again exhibited their defensive qualities.

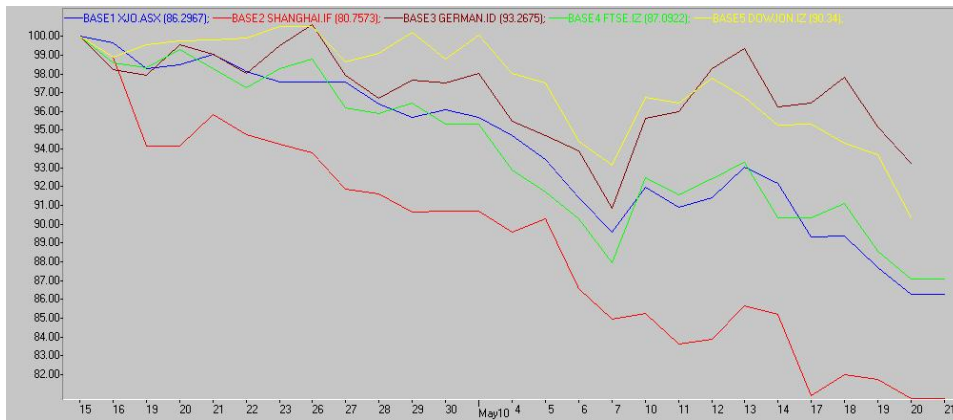
CHART 1: Performance of Local Asset Classes since 15 April 2010



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 countries.

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 the share market experienced this sudden decline?

Like most sudden global market events, the true causes are in no way clear-cut. However, we 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 (estimated by the Bank of International Settlements to be 5% of Global GDP) global stimulus program 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 it mean for investors?

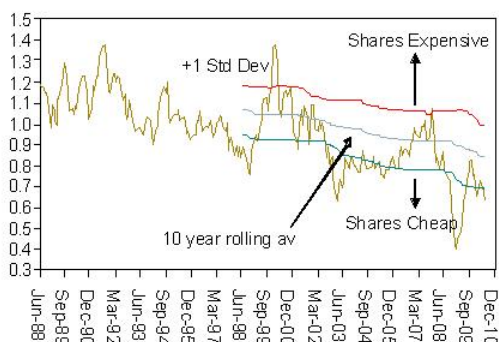
Whilst fear, uncertainty and lack of trust is driving markets, it is hard to predict exactly when normality will return. Certainly I believe, as do many commentators, that the indiscriminate selling of the AUD and Australian shares (predominantly by overseas investors) has been overdone and that the 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, falls in the AUD are help Australian exporters, with the RBA of the view that the income gains from the recent rise in commodity prices outweighing 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.

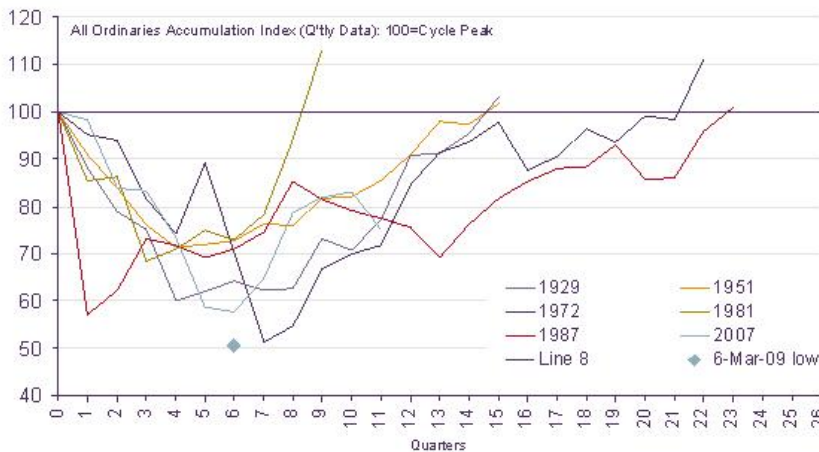
Important Information: This document has been prepared by Financial Spectrum Pty Ltd (ABN: 57 134 661 706) as is current as of February 2010 but may change without notice.

The information contained in this newsletter is of a general nature and does not take into account your personal needs and financial circumstances. Before making any decisions based on the advice contained in this booklet you should consider whether it is appropriate for your circumstances.

Financial Spectrum is the holder of an Australian Financial Services Licence (AFSL 334400).

Copyright © 2010 Financial Spectrum Pty Ltd

CHART 4: Various Bear Market Cycles

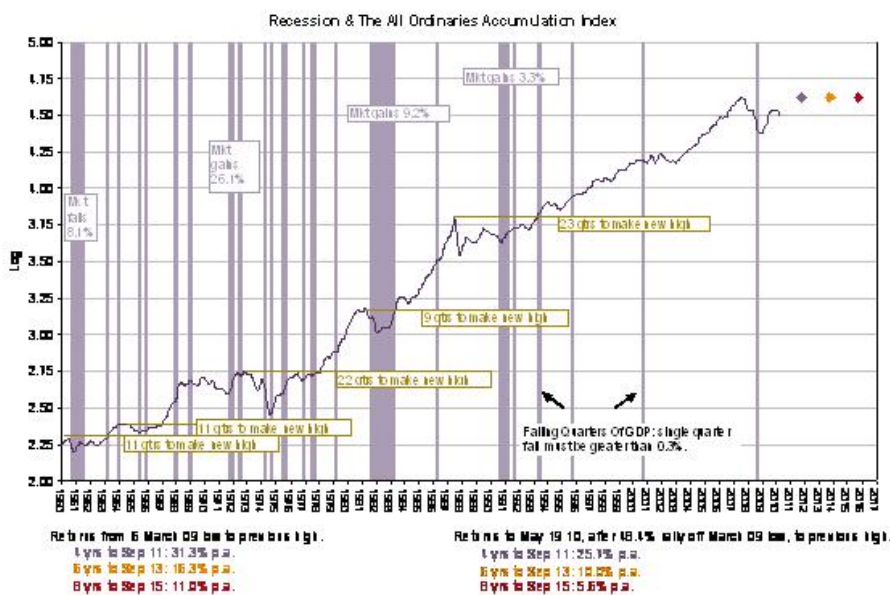


Source: Perennial, ASX, end point May 19, 2010 for 2007 cycle

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. Even if it takes another four years to bounce back to pre-GFC levels, investors should be rewarded with returns of over 25% p.a. by sticking with their share investments.

CHART 5: A Solid Rebound Followed By Doubt



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

Important Information: This document has been prepared by Financial Spectrum Pty Ltd (ABN: 57 134 661 706) as is current as of May 2010 but may change without notice.

The information contained in this newsletter is of a general nature and does not take into account your personal needs and financial circumstances. Before making any decisions based on the advice contained in this booklet you should consider whether it is appropriate for your circumstances.

Financial Spectrum is the holder of an Australian Financial Services Licence (AFSL 334400).

Copyright © 2010 Financial Spectrum Pty Ltd