

MARKET UPDATE

December 2011

Australian Sharemarket

2011 was a challenging year for investors. Whilst the Australian sharemarket increased 1.20% during the December quarter, sharemarkets globally were particularly volatile throughout the year. The main cause of the heightened volatility in 2011 was the continued evolution, but no resolution, of the European debt crisis. The potential multiplier effect that a European recession could have on developed and developing markets, combined with the impact on global capital markets continues to cause investors to take a risk averse stance.

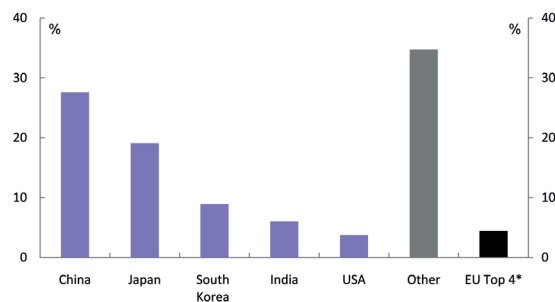
Why Europe Matters

In recent years, the prosperity of the Australian economy has been closely linked to the growth of developing markets, in particular China. In fact, Europe has continued to become a smaller direct trading partner for Australian businesses. However, this cannot be said for our other major trading partners.

Chart 1 below highlights that almost two thirds of our exports for the 12 months to October 2011 were directed to China, Japan, South Korea, India and USA. In fact, Europe's largest four economies of Germany, France, UK and Italy only make up 4.4% of our exports over this period.

However, Europe continues to be an important export destination for our major trading partners as illustrated by Chart 2 below.

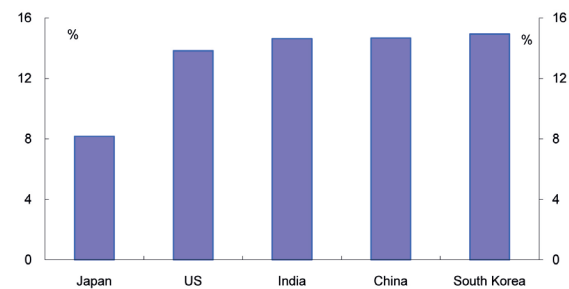
Chart 1 - Australia Merchandise Exports (12 months to 31 October 2011)



Source: ABS, The Trust Company

* EU Top 4: European Union largest 4 economies (i.e. Germany, France, United Kingdom and Italy)

Chart 2 - Share of Exports to Euro Area



Source: Haver Analytics, Datastream, Korea International Trade Association, CIRA

Given investors' current risk averse positioning, it is reasonable to expect that if some of the following scenarios transpire in the new year, they could be a catalyst for a rally in the sharemarket in 2012:

- imminent firming of a solution to the European debt crisis
- signs that Europe has avoided a recession
- continued improvement in economic data from China or the US.

In the near term, it is likely that both global and domestic economic and financial conditions will remain challenging and as such we are cautious on the outlook for the Australian sharemarket. Capital growth is likely to remain subdued and as such conditions are likely to favour investments in companies which are able to maintain and potentially increase their dividends. In line with our thinking throughout 2011, we continue to believe income will play an integral part of total return for client portfolios.

For income orientated investors, who can tolerate a degree of capital volatility, the pendulum is swinging towards the sharemarket offering attractive income relative to cash. Bank term deposit rates have been relatively attractive over the past couple of years reflecting both high official interest rates and a desire by Australian banks to diversify their funding sources. Term deposit rates are now starting to come down, and this will probably continue if the Reserve Bank of Australia (RBA) reduces official interest rates. Similarly, banks may become less aggressive in their competition for term deposits leading to further reductions in the term deposit rates.

On the other hand, the Australian sharemarket's franked dividend yield, currently around 6.5%, is already above the term deposit rate. And with the potential for further rate cuts, then Australian shares with relatively high tax-effective income distributions become even more attractive for investors.

Interest rates

Over the December quarter, the RBA cut official interest rate to 4.25%. The 0.5% cut was delivered in two 0.25% moves, the first in November, the second in December 2011.

The previous tightening RBA rhetoric arguably shifted in October as the outlook for inflation improved. This was primarily due to softening domestic demand and the major global headwinds that affected our economy throughout 2011. This translated into cautious spending behaviour from households. The RBA now sees "inflation likely to be consistent with the 2% to 3% target in 2012 and 2013" and has hence moved rates from a tightening bias to a "more neutral" stance.

The perceived risks to the domestic and international economies continue to weigh on Australian interest rate markets. China's growth is slowing as intended and European Governments are "still seeking to craft a full response" to the debt crisis. As such, markets are continuing to price in rate cuts for first half of 2012.

As both bond yields and cash rates have been falling, it is likely that over the short term, returns from fixed interest and cash-like investment will be lower than those experienced in recent periods.

What does this mean for our clients?

The Australian sharemarket was range bound throughout the last quarter of 2011 where the index fluctuated between 3950 to 4300 levels. We believe the sharemarket in near future will continue to be volatile as global sovereign debt issues and economic conditions continue to affect investor confidence and overall returns. Accordingly, investors may need to readjust their short-term return expectations.

We assume that capital growth for Australian shares is likely to be muted over the short term. Therefore, our focus remains on investing in quality securities that are likely to deliver solid tax-effective income in the current climate. We believe our diversified approach of investing in conservative securities across cash, fixed income and shares should provide investors better 'sleep at night' solutions in a low return and volatile investment environment.

Should you have any questions regarding your investment portfolio, please contact your Client Adviser or call us on 1800 662 812.



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