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CHESTERFIELDS
Financial Services Pty Ltd

February 2011 - Market Update

Domestic Market

•The ASX100 accumulation index managed another positive month in February (+2.4%), with the Resource stocks back in the drivers seat.
•Banks also managed to continue their positive run after the majority of the big 4 delivered better than expected quarterly / half yearly cash profits.
•The obvious divergence of growth in our "2 speed" economy was never more prevalent than during the recent half year reporting season.
•While the Resource sector is now expecting earnings growth in excess of 40% for FY11, the Industrials will be lucky to report flat earnings, after contracting 5% last financial year. This has been driven as much as anything by an inability to control costs. The market has now pushed earnings improvements out to FY12, with an overly optimistic expectation of 15% growth.
•The Energy stocks (+3.5%) were boosted in February by the continued political unrest in the Middle East. The threat of an oil shock pushed the WTI oil price through US$100/b. Worley Parsons was a key mover, up over 10%.
•Healthcare was the main under performer in February, with negative earnings surprises from most of the index. A lot of which can be attributed to a strong Australian dollar.
•There was little in the way of rosy economic data domestically. Flat retail sales continue to be hit by the last rate rise in November, while business confidence is still sluggish at best.
•On the bright side, interest rates should be on hold for at least the next 3-4 months as the RBA watches their past work do its job!
•As stated last month, we expected more moves on the merger and acquisition front. Well we didn't have to wait long, with the Stokes backed WAN announcing a proposal to buy the Stokes backed Seven media group - who would have thought!

Resources

Oil

•Disruptions in supply from Libya's civil unrest have put the brakes on supply from the oil rich nation.
•While OPEC, mainly Saudi Arabia, has lifted supply to meet demands, we have again witnessed a shift from supply and demand trading to political speculation to determine the price.
•This has the potential to significantly hamper the global economic recovery, along with high food prices and high international unemployment.

Gold

•Has returned to many investors radars as a hedge against inflation.
•Trading at record highs over $1,400 US per ounce.
•Exchange Traded Funds (ETF's) have provided retail investors easy access to invest in bullion.
•Whilst a high gold price is good for Australian producers, it is partially negated by a high exchange rate that is fully un-hedged for the majors.

Global Market

ASIA

•Emerging markets (EM) have underperformed developed markets (DM) since late 2010.
•Over extended price rises through 2010 & higher growth in the US has seen investors switch back to DM.
•But rising inflation in most of Asia is also a factor causing concern for investors.
•In the short term we expect the out performance of DM's to continue.
•But in the medium to long term EM remain our preferred targets based on higher growth rates & lower debt levels.
•China has been one of the key factors behind the relative under performance of EM's over the past few months.
•Inflation in China is the main negative factor affecting sentiment.
•CPI remains stubbornly high @ 4.9% y/y despite 3 interest rate rises in 4 months plus a raft of other measures.
•The bank reserve ratio is 19%, the highest in 20+ years.
•There are some signs of loan growth falling. Interestingly Premier Wen has said China is setting a lower growth target of 7% over the next 5 years.
•In the context of rising inflation this can be seen as a move to reduce growth/price expectations.
•Clearly rising oil & food prices will make the task of containing more difficult.
•Sentiment towards China will remain negative at least in the short term.
•But the Chinese have proven themselves to be skillful managers of their economy (unlike many others!) As a result we remain positive on China long term & see opportunities building during this period of underperformance.
•In Asia; Thailand, Korea & Taiwan have the highest Intensity.
•An extended oil shock would hit these economies the most.
•Philippines & HK are the least oil intensive so may suffer least. Indonesia & Singapore are probably in the strongest growth position meaning they would weather a shock better than most.
•India has been sold off aggressively already, but should investors really take flight, the large current account deficit, which is financed by offshore investors would become a problem.
•Russia is one of the more interesting EM a present.
•Higher oil prices are seen as a positive.
•In addition Russia has shown a willingness to allow the ruble to appreciate as means to control inflation. This provides a secondary benefit to investors.
•Questions remain about corporate governance & political Interference. As a result we have often preferred Asia for EM Investments.
•But Russia could be an interesting "hedge" if other EM's come under pressure from rising oil.

US

•US equities continue to perform strongly.
•But prices look over extended in the short term.
•The S&P500 is up 31% since June '10.
•The fundamentals have improved but not that much.
•The spike in the oil price may be the catalyst for a correction.

•If the oil prices continue to rise then the risks of a global slow down also rise substantially.
•Many recessions have been preceded by oil prices spikes & commodity based inflation is already problem in most countries.
•While we rate this as a reasonably low probability at this stage, the risk should not be totally ignored.
•Assuming the worst case scenario is avoided then the outlook for the US in the short term is still supportive.
•Manufacturing has risen to its fastest pace since '04.
•Service industries expanded at the fastest pace since '05.
•Despite the improving outlook there is no risk of interest rates rising soon.
•Bernanke doesn't believe higher oil & commodity prices will lead to a permanent rise in broad inflation. Who is he kidding, just take a look at the rest of world & the bond market!
•Reading between the lines we can assume that the CPI will continue to be "fudged" (by stripping out everything that goes up –what consumer doesn't buy food energy & clothes!)
•That will enable interest rates to remain low & monetary policy loose -a positive for equities in the short term.

UK & EUROPE
• Germany remains in a solid upward trend.
•But it's probably over extended & due for a correction in the short term.
•The performance of the DAX is in stark contrast to the rest of Europe. Of course, this reflects the fundamentals.
•But Germany does not operate in a vacuum & most of its exports (60%) still go to other Euro nations.
•We continue to question the sustainability of the DAX performance.
•German unemployment fell to 7.3% s.a, the lowest since 1991.
•Exports were up 18.2% y/y & not surprisingly business confidence is at a 2 yr high.
•This should sustain investment which will be positive for future growth.
•But Euro zone growth is not picking up. Q4 growth was 0.3% , same as Q3 & well behind the US @ 0.8%.
•If the US Dollar bottoms & the Euro weakens then the outlook is probably ok.
•But the ECB is certain to move on interest rates before the Fed. This would be a negative for growth & positive for the Euro.
•In effect a double negative for equities.
•Euro equities are unlikely to continue to lead & the US is the preferred developed market for now.
•The Bank of England suggests inflation will peak at 4.4% in 2011 & not ease back until 2012.
•Despite this the BofE have indicated that interest rates will remain low.
•Remember when Central Banks said maintaining price stability was their most important role?
•Unemployment remains at 7.9% but youth unemployment is the highest since records began 1992.
•The UK economy is stagnant but we have a better feel for likely action by the BofE -go for growth & forget inflation.
•That reduces the risk to the economy in the short term but the UK is still likely to lag the US.

Bonds

•Domestic bond yield's remained flat over the February period.

•Weak retail sales combined with extensive damage to rural Australia from floods and storms helped interest rates stay steady; any pricing pressure on the Reserve Banks when considering interest rate rises was dampened.

•There is still medium to long term inflationary pressure building domestically and internationally, which can be seen as a risk for fixed rate investors.