



The Highs and the Lows

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As a new year kicks off, opportunities seem endless and bright and a small percentage of us have implemented our New Year's resolutions and actually stuck with them (so far). It does not take long to forget the Christmas break and remember that we are living in a world in crisis. There has been a lot of bad news to reflect upon from tsunamis to civil wars and from stock market floors to debt ceilings, 2011 was a really tough year and we have all paid a little for our participation in a global economy with lightning fast information at our fingertips.

Having survived a tumultuous 2011 with a large portion of our wealth and sanity intact, it is time to look forward to 2012 and measure up the glimmers of hope against the tail risks to which our portfolios will be exposed.

The positives:

Interest Rates

Expansionary (i.e. low) interest rates in the US and Europe (EU), with expected further easing in the EU. Expected further interest rate cuts in Australia in 2012.

Defensive Assets are over-subscribed

Investor safe havens such as bonds and gold are at critical mass. Gold has recently suffered from widespread profit taking, indicating that over-investment created a bubble resulting in a sell-off. Further evidence of over-subscription can be seen in the recent purchase of German Sovereign 6 month Bonds at negative yields. Although this shows extreme risk aversion and lack of confidence in EU banks, much of this type of investment, along with unprecedented cash holdings, will at some stage move back into risk assets, detracting from defensive asset values and contributing to the recovery rally of risk assets.

Nowhere left to run

Safe havens such as the Swiss Franc and the Japanese Yen, have seen intervention by their central banks, reducing the number of investment options for risk-averse investors.

The vultures are circling

Private equity firms are long cash. Activity in private equity transactions appears to be increasing which is a classic indicator that equities are cheap with all eyes on publicly-listed companies.

It is a global Boxing Day sale

Equity valuations are cheap relative to historic prices and compared to other asset classes. The extreme volatility in markets may indicate that investors can see value in risk assets but a series of negative events has stymied any sustained return to risk assets in 2011.

China getting footloose

After China's successful tightening campaign, in the second half of 2011, to dampen the property market and rein in inflation (which has fallen for five consecutive months to 4.1 per cent in December), it looks like 2012 will see some expansionary policy with expected growth of over 8%.

Commodity prices have fallen

Although not ideal for our miners at home on a dollars-per-tonne basis, cheaper commodity prices will tend to support demand for our exports.

Although the above suggests we are in for a positive year, we are not out of the woods yet. There remain a number of very real risks in the marketplace that threaten the attractiveness of sharemarkets and other risk assets.

Political issues

In particular, North Korea and the Middle East remain melting pots. Iran is playing cat and mouse with the US regarding the Strait of Hormuz and threatening to choke world oil supplies. Although Iran appears to be playing a game of bluff and diversion, the risk remains.

Austerity

The very measures being enforced by the EU to reduce the Sovereign debt of its constituents threaten to push these countries further into recession. Austerity measures are contractionary by nature and unfortunately this has come at a time when expansionary policy is desirable to stimulate a languishing region.

Ratings Agencies

Further sovereign downgrades by ratings agencies such as Moody's and Standard and Poor's risk a number of flow-on effects including increasing the borrowing costs for those countries and damaging investor confidence in sharemarkets.

Deflation

Although we may view some deflation as a positive, it is risky business and can spiral out of control and result in a contraction of the money supply. You may recall there was fear of deflation breaking out in the US during the GFC. However, this was managed through aggressive expansionary fiscal policy (Quantitative Easing) which tends to be inflationary.

So where do I see things going from here?

I see some significant downside risks somewhat balanced by some potentially attractive upside. We are at yet another inflection point (or possibly the same one that we have been waiting for since July 2011 as the ASX continues to trade between 4,000 and 4,500 points). The good news is that there are still two forces driving the market; but if we do experience another significant shock to the market, then there is the possibility of a 10%-15% drop in equities this year (guesstimate). Some may suggest a greater "worst case scenario" but it would appear most downside has been priced in at current levels. What has been missing in markets is a lack of sustained momentum, although the trend appears to have been overall negative since the end of the 2009 rally.

My thoughts are to remain cautiously optimistic.

Financial advice

For any further information or to discuss your financial situation, please don't hesitate to contact me on **0413 244 733** or email **simon.whiteley@eqtsuper.com**. I look forward to hearing from you.

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