Dynamic Investment Solutions

QIC

déjà vu, all over again

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November 2011

Conclusions (November 2010)

- Global recession was caused by a justifiable collapse in household confidence – the recession we chose to have
- But as labour markets stabilised household confidence returned and resulted in V-shaped recession, with the resumption of normal growth
- To get a "W", what would precipitate a second collapse in confidence?
- There are risks, of course
- Household de-leveraging is not one
- Rising interest rates will emerge with stronger growth
- Two significant medium terms risks are
  - Inflation is a significant medium term risk
  - Falling commodity prices
- Risk is over-priced and, therefore, risk assets are underpriced

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Setting the scene

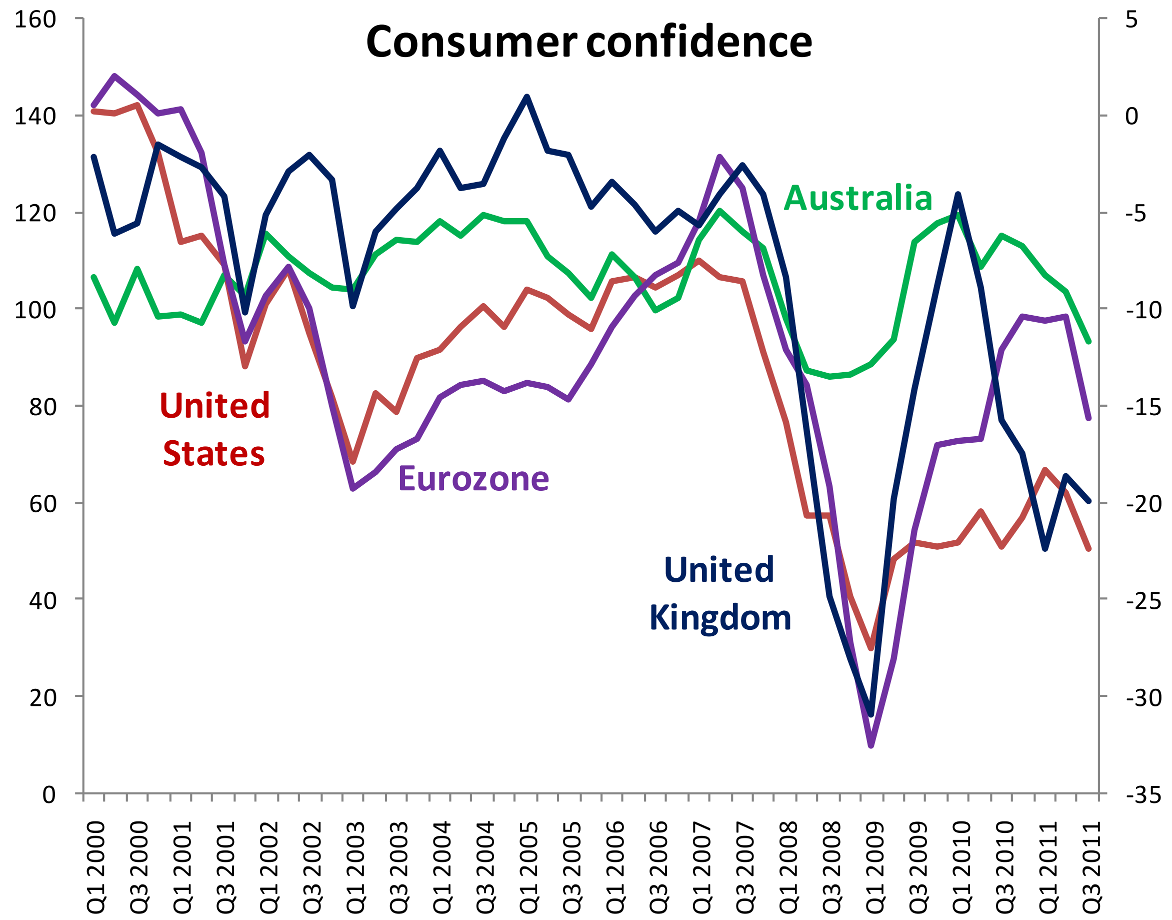
- Since this time last year:
  - Global growth has slowed, prompting renewed concerns of a double dip recession (W)
  - Australian growth has slowed
  - Growth in China has become more suspect
  - The US has postponed reckoning with its debt ceiling
  - European sovereign debt concerns have intensified – Greece has been on the problem list for two years
  - Interest rates have fallen globally, except for those countries in danger of defaulting

- These are many of the concerns we were dealing with last year
- As a result, US and Australian equity markets have gone sideways – rising then falling to post no gain
- Both bond and equity markets are pricing recession, even as company earnings contimue to increase

The problem is that consumer confidence remains fragile

Consumer confidence remains weak because consumers have much to worry about:

- Low growth
- Unemployment
- Debt
- Sovereign defaults
- Uncertain policy
- Weak governments
- Two-speed economies
- Volatile markets
- LGFVs
- ……



What do uncertain households do? They hoard cash

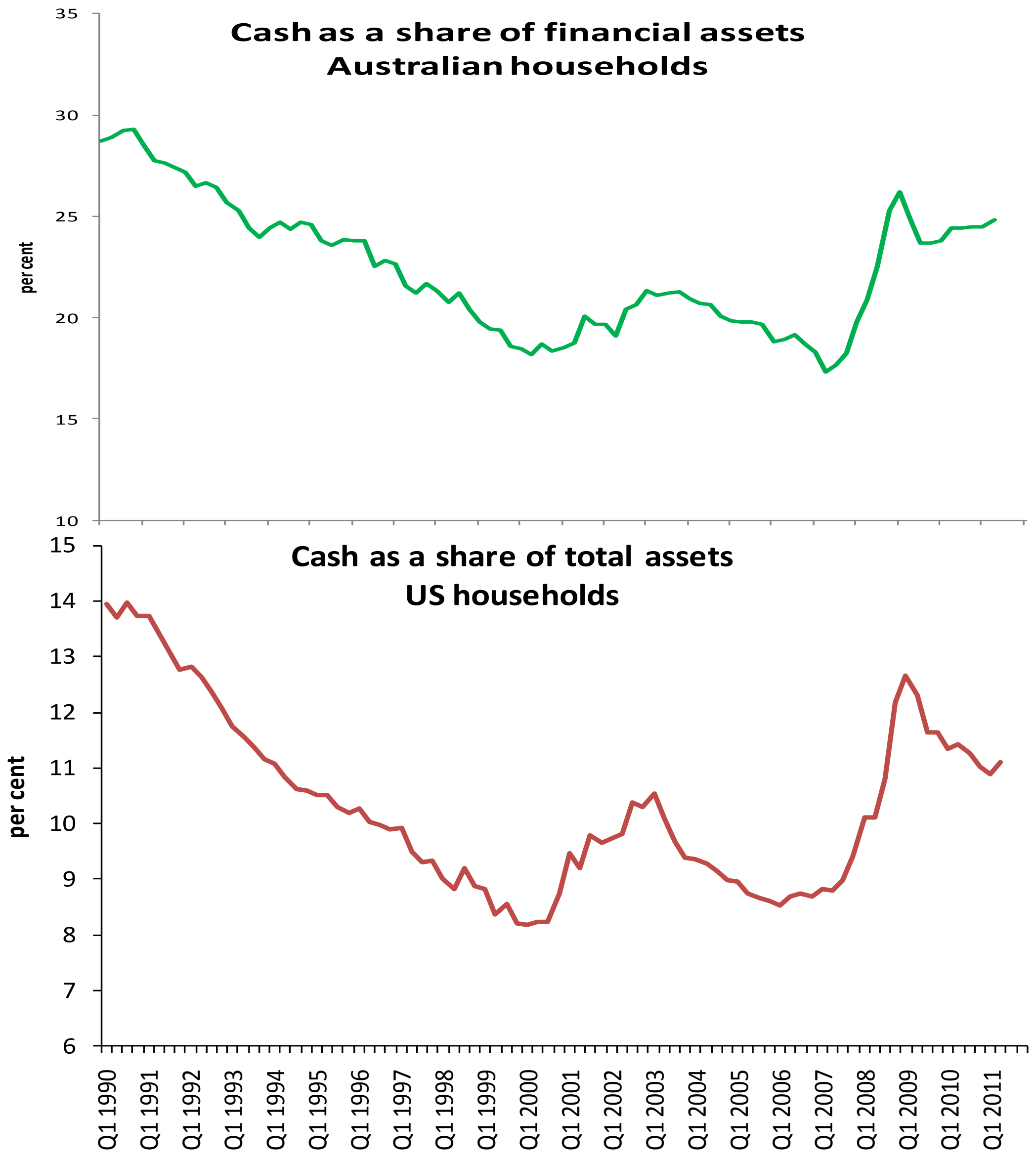
Instead of spending, at previous levels, households are accumulating cash balances, with a sharp increase since early 2008

The big question is whether or not this represents a permanent change in behaviour to a more frugal future world.

If households maintaining retail spending and hoarding cash, what are they not buying – growth assets:

housing and equities

So, what will happen to all this cash?



The BIG apparent threats to markets

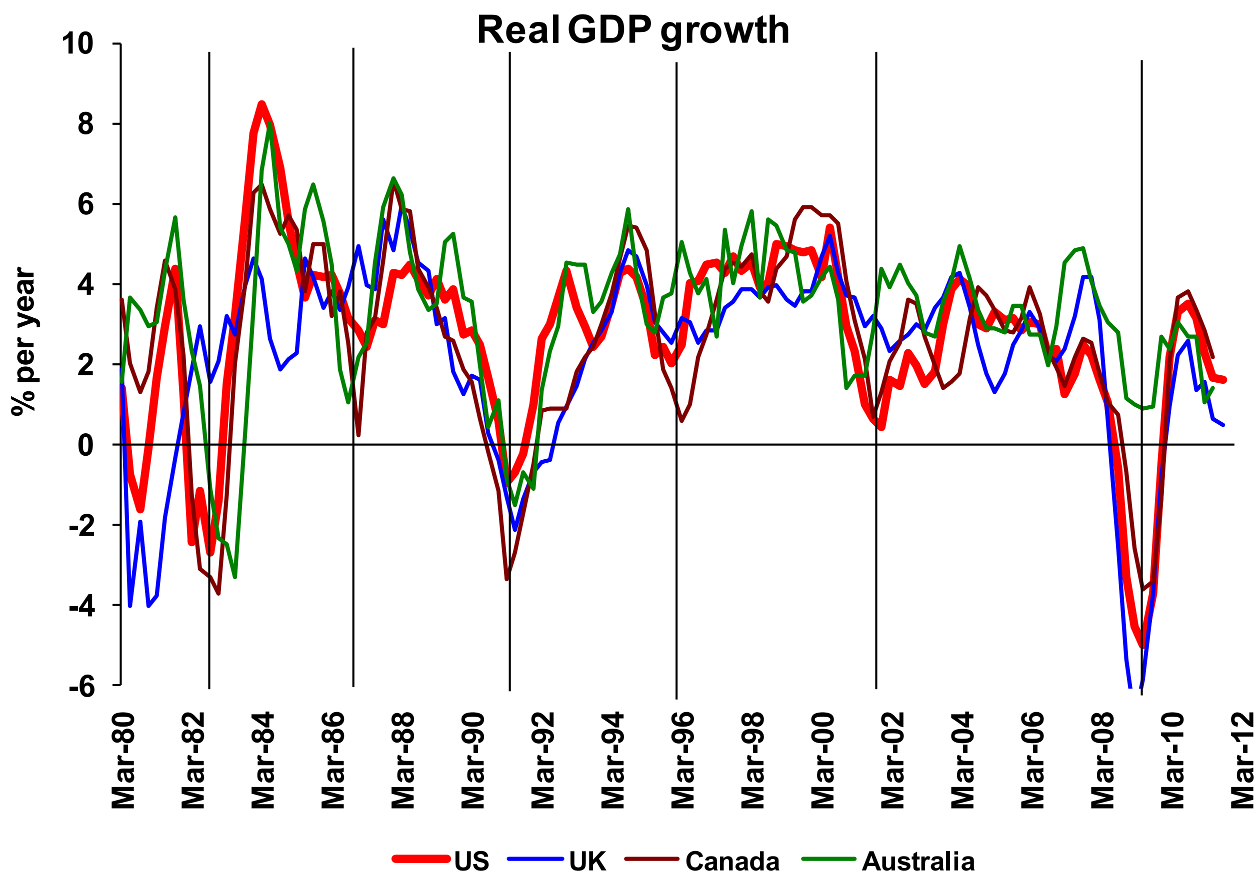
- No/low, weakening growth in US and Eurozone
  - Earnings collapse
- Sovereign debt defaults in Europe
  - Second financial crisis
- China recession
  - Collapse in global demand
- The new thrift
  - A fundamental change in consumer attitudes
- Inflation
  - Not on anyone's horizon yet

Is growth collapsing again, giving us a “W” ?

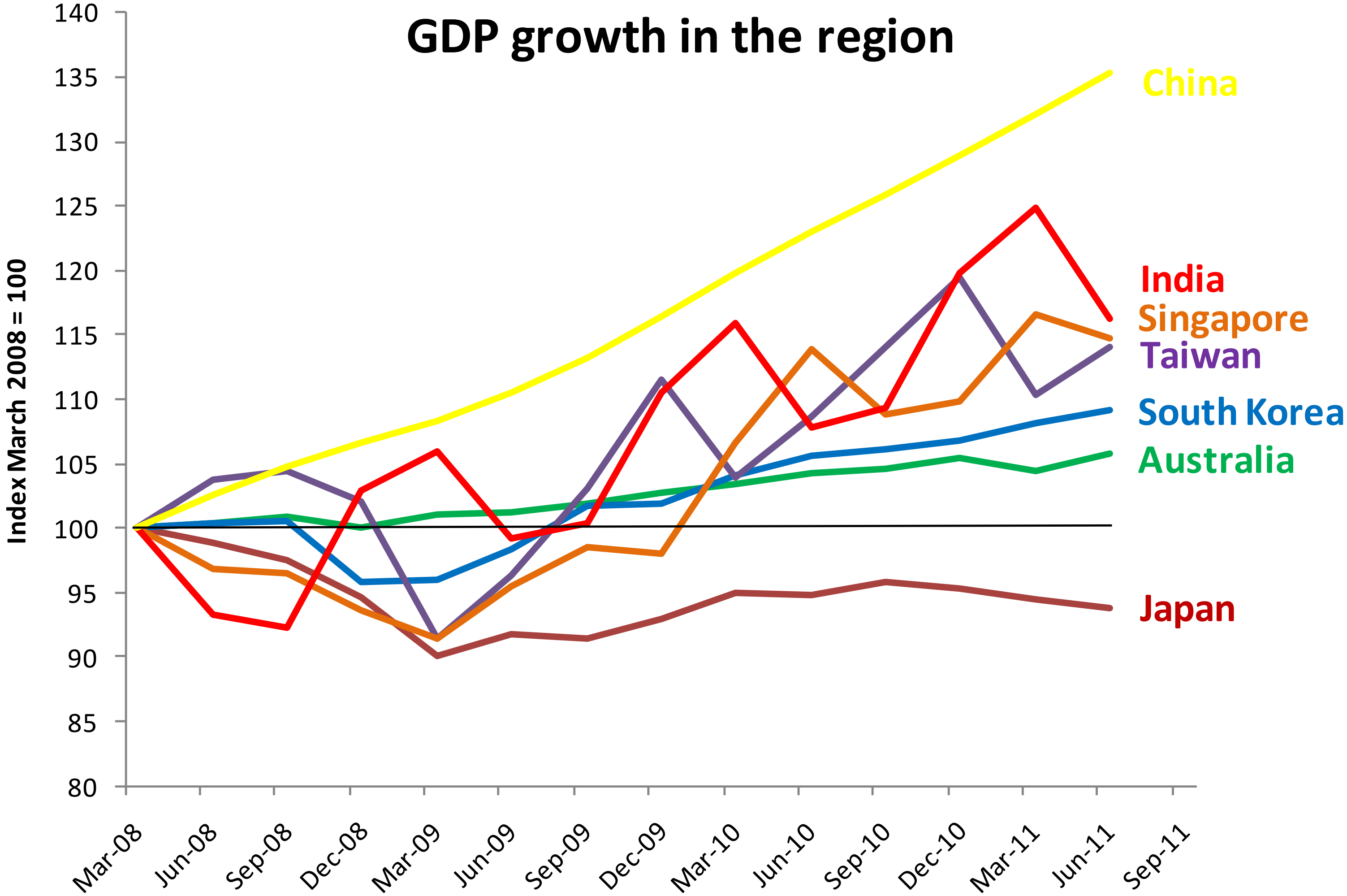
Recovery from the Great Recession was swift and V-shaped

But, was it just the first half of a “W”

Current views are mixed with respect to a slide back into recession



Asian economies mostly prosper

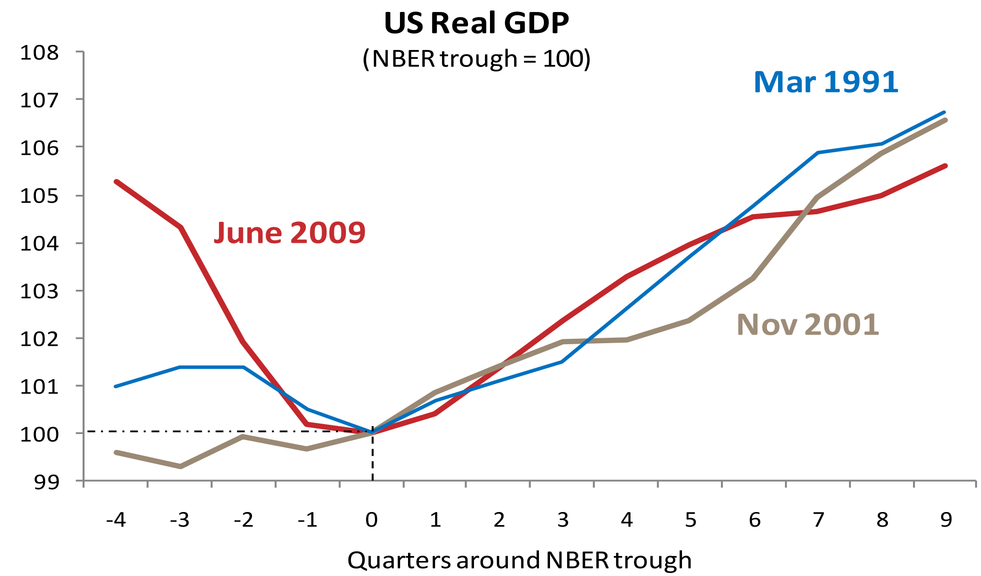


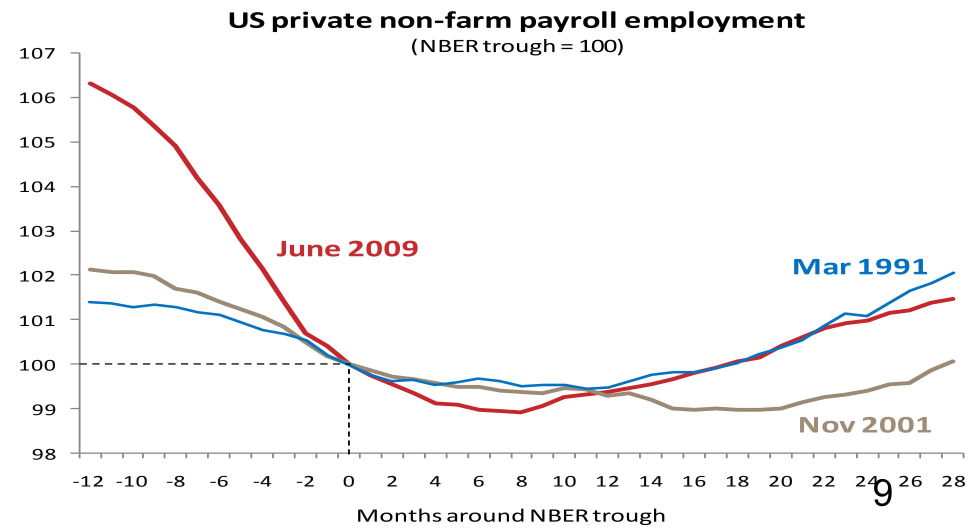
The US recovery still isn't bad!

There appears to be a good deal of concern that the recovery this time is different

It is not, except for the fact it is off a lower than usual base

Following the 1982/83 recession, it took ten years for the unemployment rate to fall from over 10% to 5%, even as growth remained strong





The US is looking.....................................OK

- Household confidence still weak
- House sales weak but stable
- Nominal retail sales stronger
- Car sales stronger
- Industrial production and employment growth holding at current levels
- Job vacancies rising and new applications for social security falling
- Supply disruptions from Japan earthquake past
- 3rd quarter GDP likely to be marginally stronger than 2nd quarter and close to average
- Bankruptcies are now below trend
- Corporate profitability and margins remain very strong
- Share buybacks are very strong
- Private sector balance sheets remain very strong

UK / Eurozone prospects are not as strong

- UK confidence is low but rising
- UK is choosing austerity as current policy and not expansionary monetary policy
- The peripheral Eurozone countries have solvency problems
- France and Germany are relatively strong
- The weak Euro is giving German exports a huge boost
- Euro confidence is softening

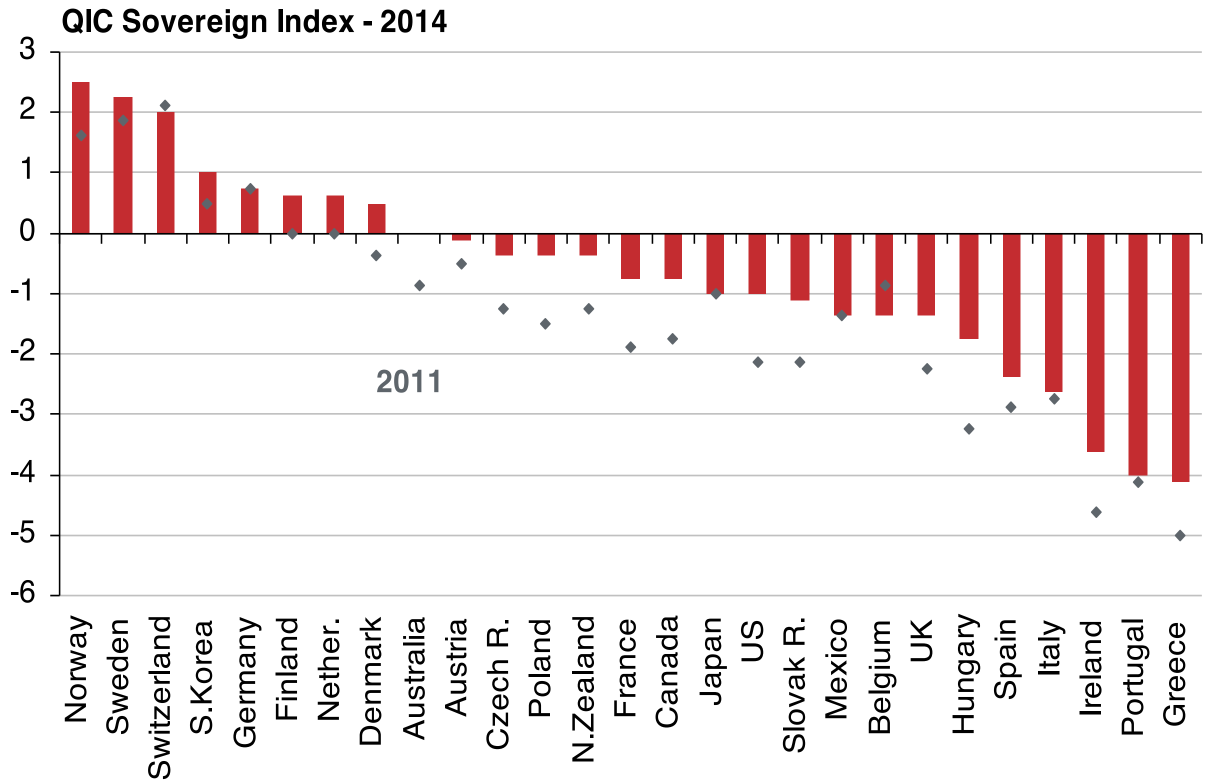
- As Germany goes so does Europe

Sovereign debt : most fiscal positions are improving

While the fiscal positions of most countries is improving, the challenges rest with those banks exposed to those economies likely to default – Greece and Portugal

But markets know where the debt is, who holds it and by how much.

This is in stark contrast to 2008



Who benefits from Euro doubts?

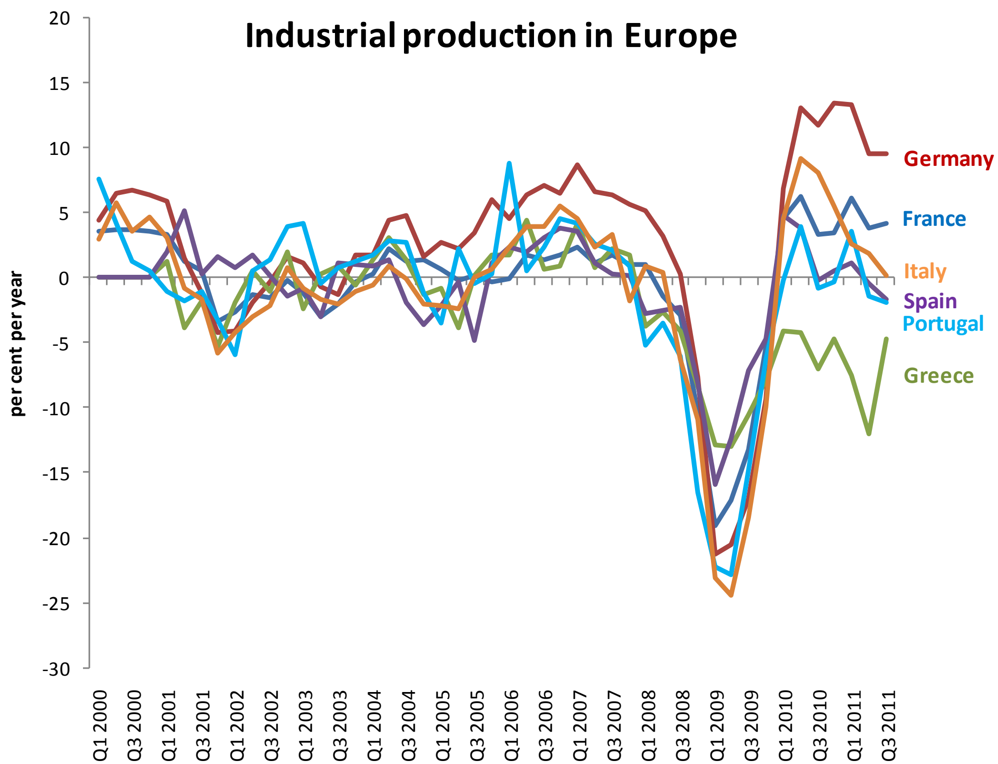
The Eurozone is not a natural currency union

Germany is doing well from an undervalued Euro, exports 50% of GDP and strong

Greece is doing very poorly from an overvalued Euro, and struggling

Austerity measures also hit unequally – as is warranted

Greeks will have to pay up to 14% of their gross disposable income, German less than 1%



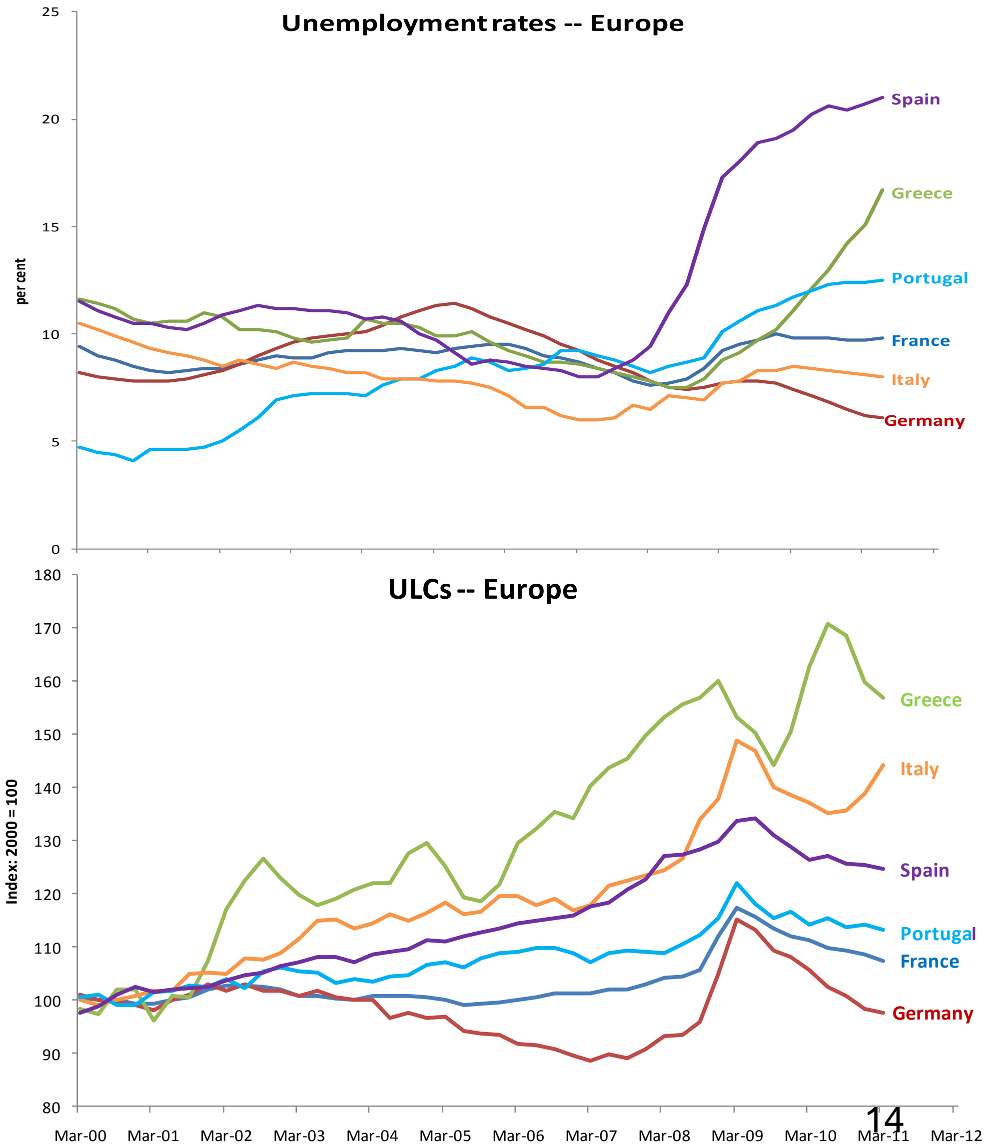
The underlying problem is productivity

Flexible currencies work to balance underlying real or nominal shocks through appreciation or depreciation

Following unification of Germany in 1989, Germany spent the next 20 years driving down costs and increasing productivity in the unified country

They now expect other countries to undertake the same medicine

Given their commitment to a unified Europe, expect the “pound of flesh” to be paid



China?

- Growth slowing
- Inflation holding
- Credit conditions tightening
- Land prices falling putting banks and shadow lending at risk
- LGFV = SOE + SPV = bad debts as land values (collateral) fall
- But even modest growth will support bulk commodity exports

The new frugal?

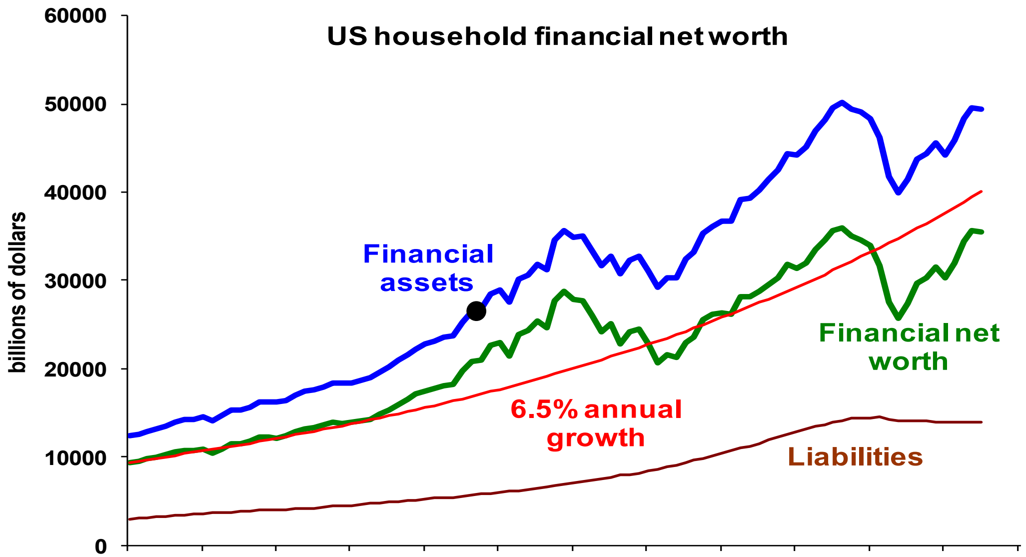
Much has been made of household's being over-leveraged and therefore curtailing consumption to rid themselves of debt

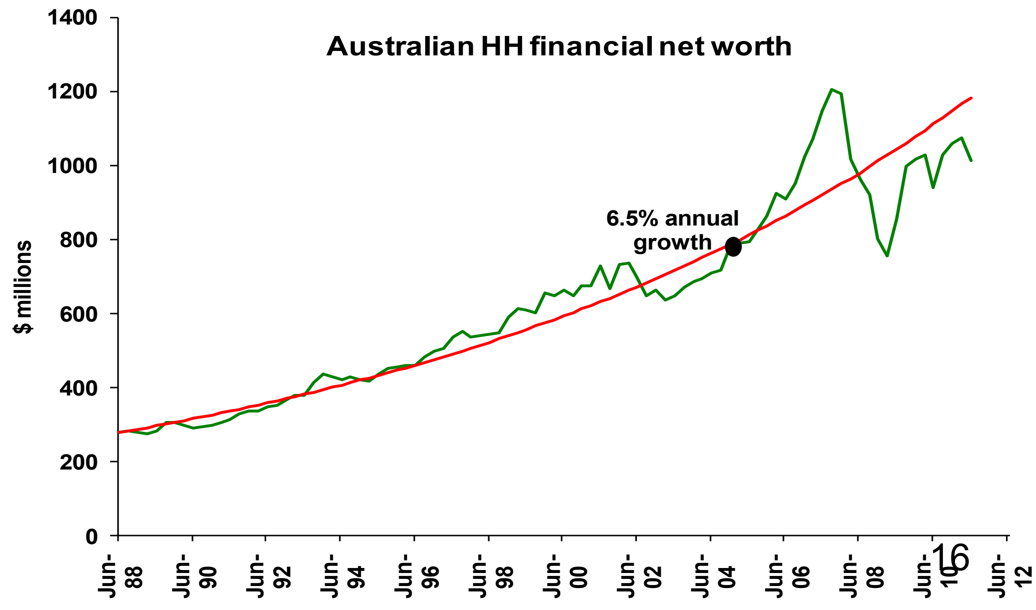
But, HH balance sheets are in good shape. They are not over-leveraged

HH savings has risen a lot recently because households are withholding discretionary spending

In the US, note gross financial assets are roughly double the 1998 level, even though equity markets have gone sideways since 1998

Cash balance are rising. Debt is roughly stable





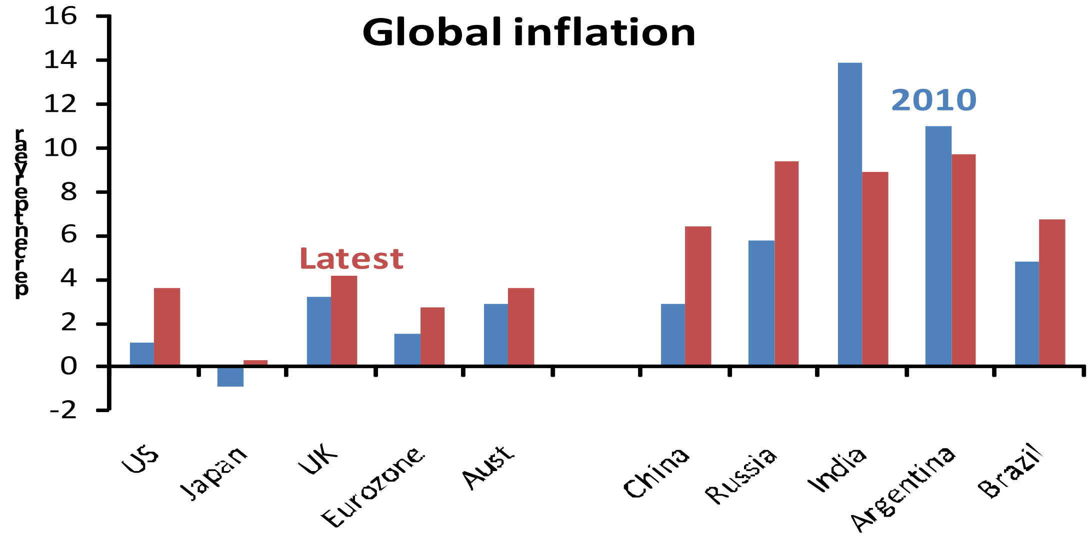
Is inflation a risk?

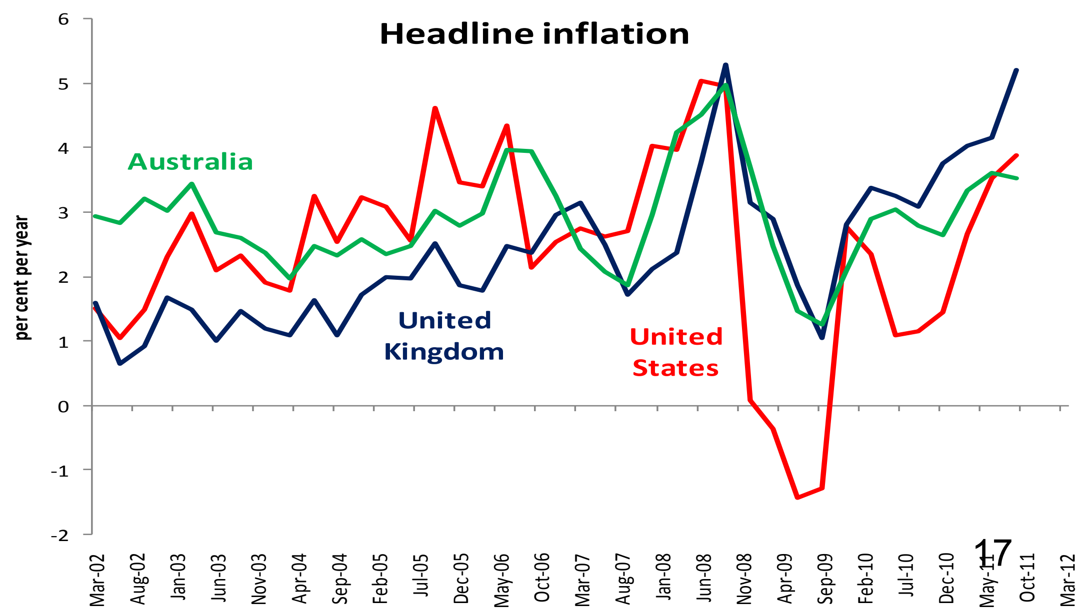
Inflation is relatively low in developed countries, relatively high in developing countries, but rising in both

How will it re-emerge? Not necessarily home grown because of the output gaps

But exported from developing countries creating margin headroom in developed economies

Already, US and UK inflation is looking ominous





Major threats – a summary

- Economic growth
  - US looking OK
- Germany and France will pay to resolve European debt crisis
  - It is only a question of who
    - Greece and Portugal to avoid a default
    - European banks if they do default
- China is shakier but robust enough to keep going for now
- Households spending is still weak
  - But household balances keep getting stronger – no household de-leveraging
- Future inflation is looming, but not on the radar for now

Australia has weakened in recent quarters, will bounce

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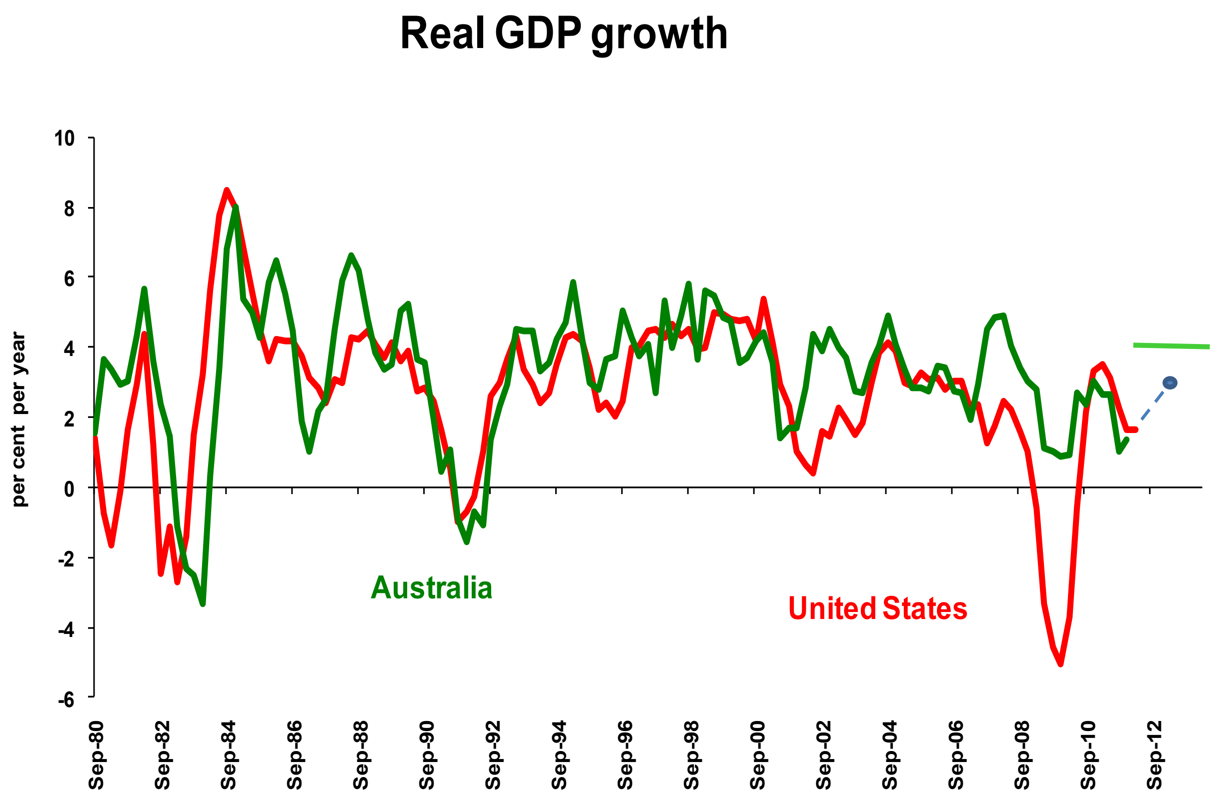
While prospects are mixed for different sectors with different exposures, supportive factors are:

- US to avoid recession and continue to grow
- Asia/China growth moderate but remain robust
- Investment to remain focussed but strong



Responding to the commodity price boom

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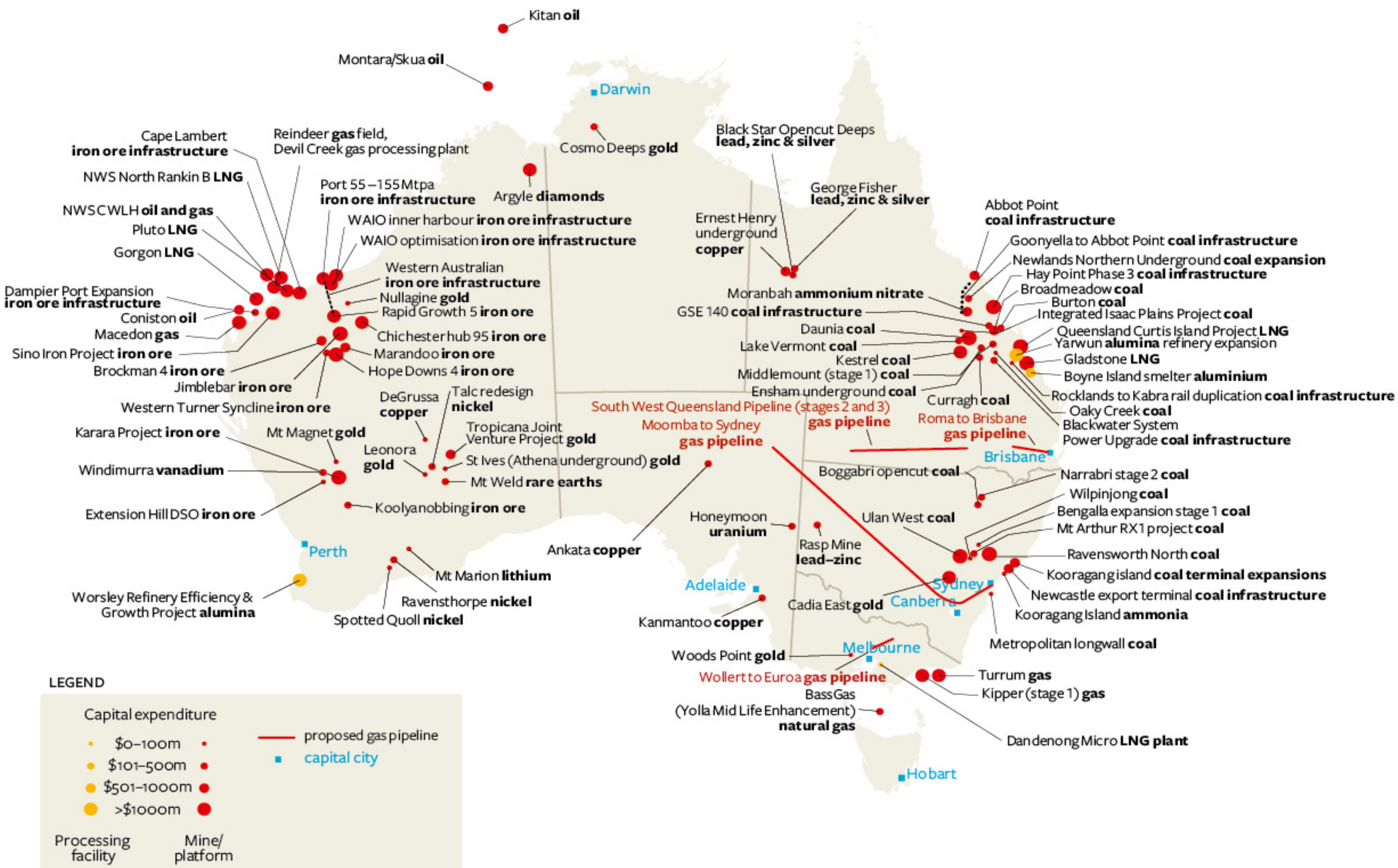
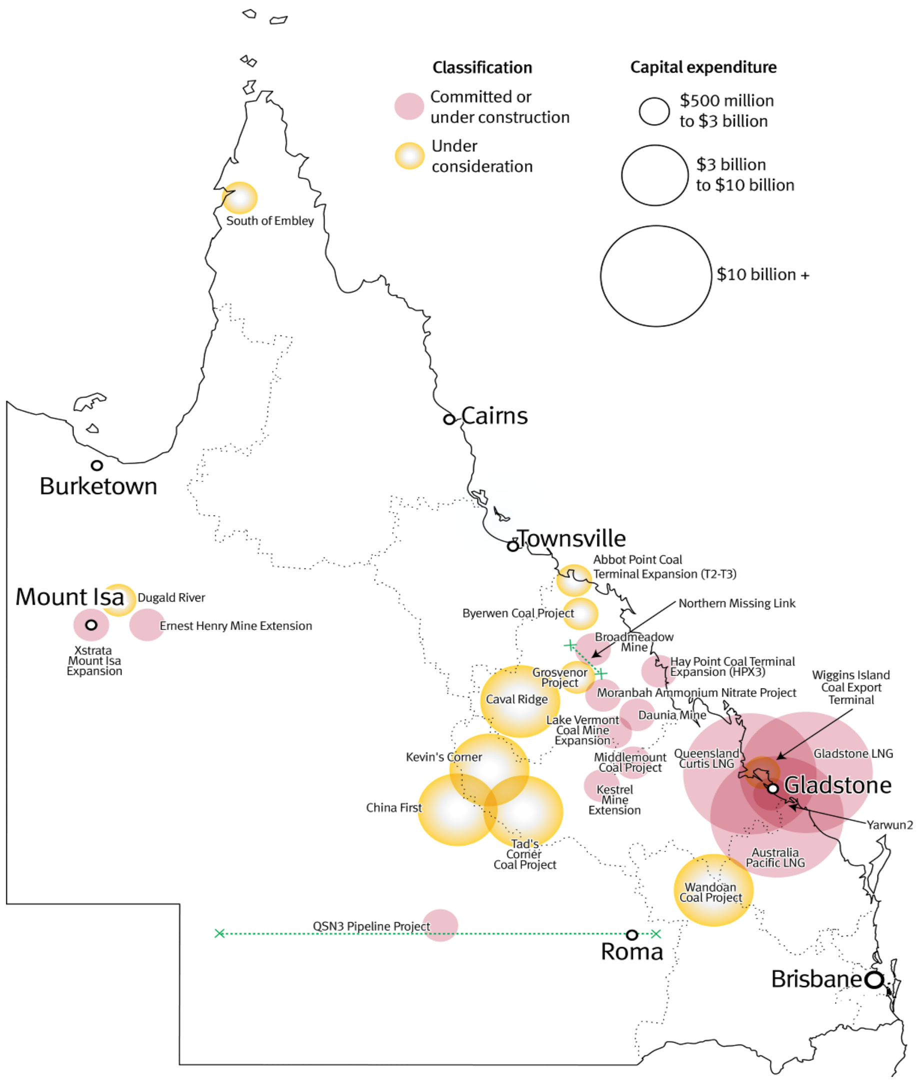
1 Advanced minerals and energy projects

April 2011



Resource projects are driving new investment



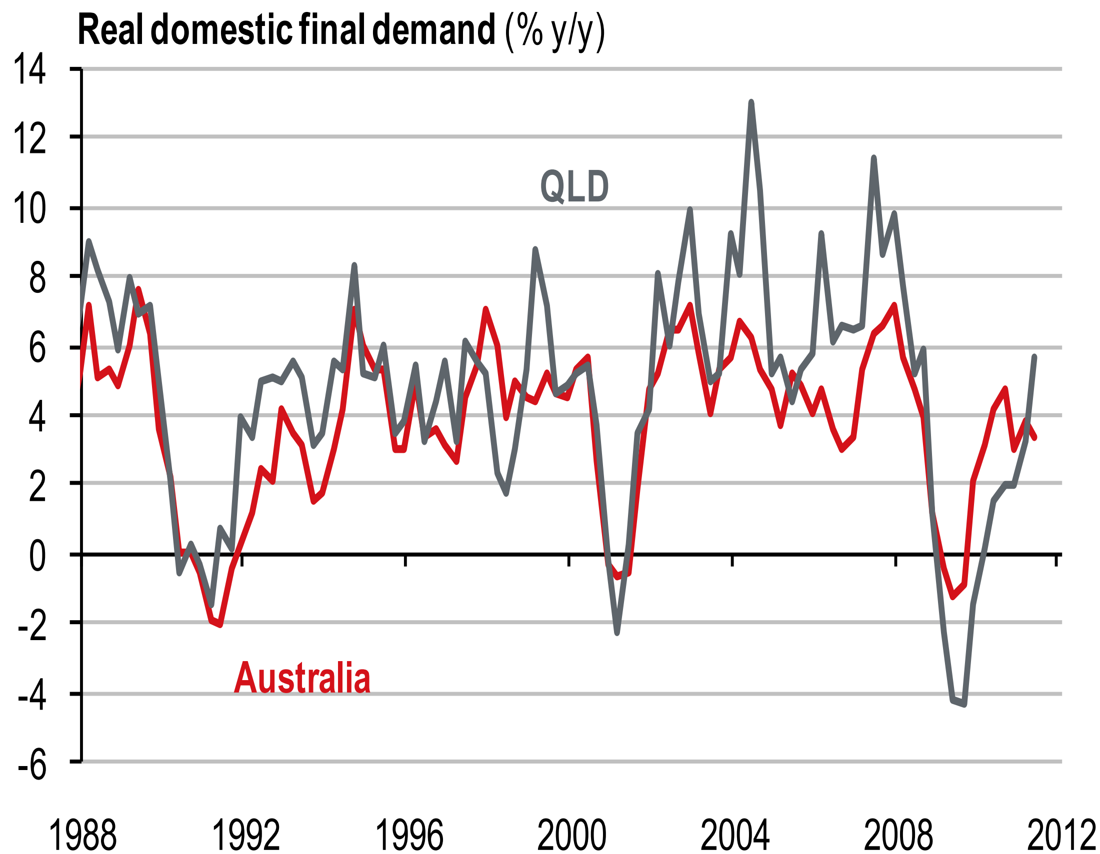
Source: State Budget 2011-12

Queensland coming back

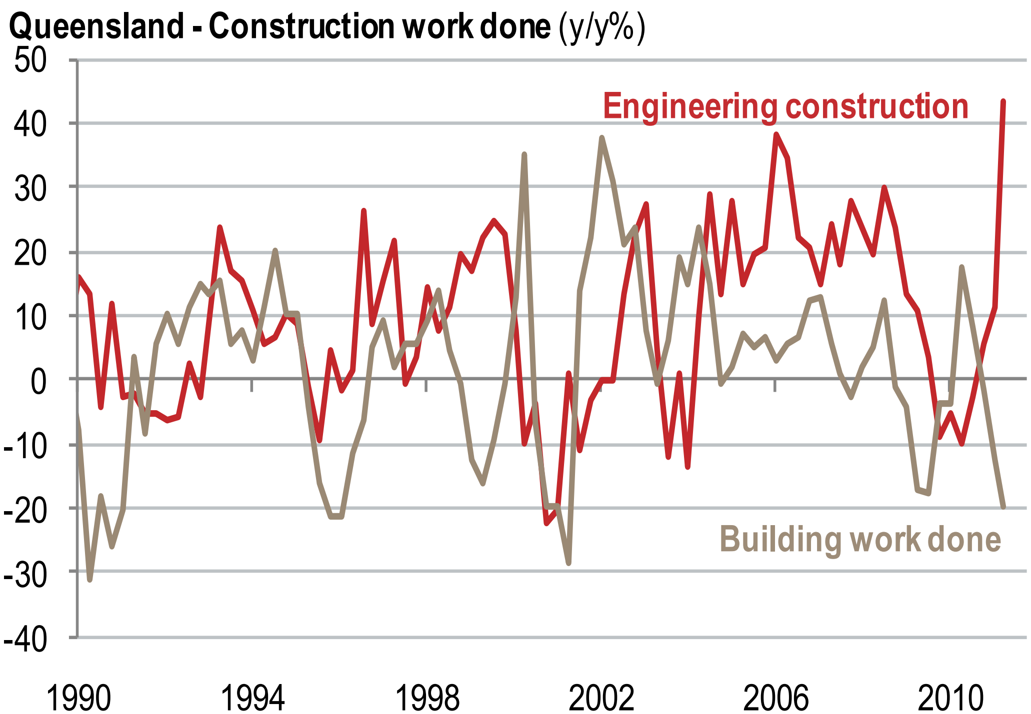
Strong recovery in Q2

QLD's SFD rose 3.5% in Q2 compared to a 0.7% rise in national final demand;

Household and government consumption both rose 0.7%, while private business investment surged nearly 20% due to mining investment and the rebuilding effort;



Queensland: construction work done



Strong rise in construction work done in flood aftermath

Construction work done rose 14.9% in Q2 after the floods and cyclones weighed on activity in Q1;

Engineering construction drove the gain, rising 25.7% over the quarter, while building work done dipped 0.2%. Investment within the mining sector likely contributed to the strong rise in engineering construction.

Within building work done, total residential work fell 4.6% but alterations rose 7.7% due to property repairs. Non-residential building increased 4.8%.

Source: ABS, QIC calculations

A negative: Population growth is a concern

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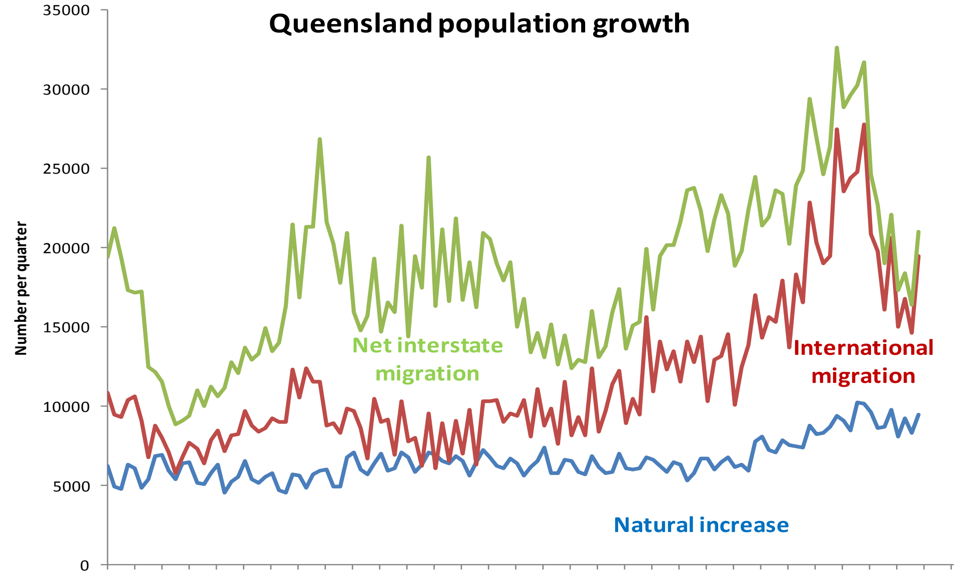
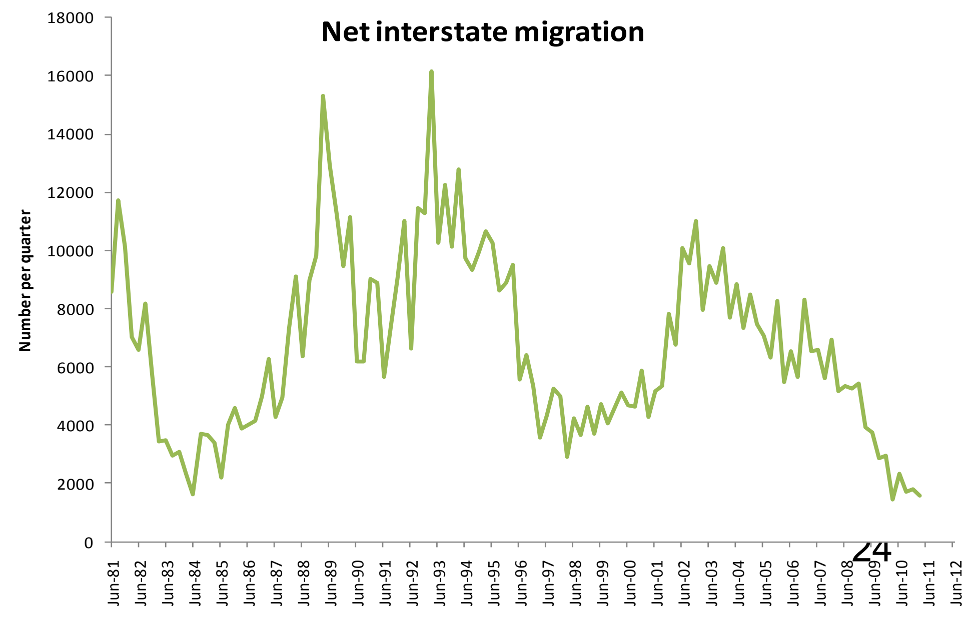
The Queensland population growth rate is high because of the high natural growth rate and high international migration.

But both these sources of growth add less to the household formation growth rate

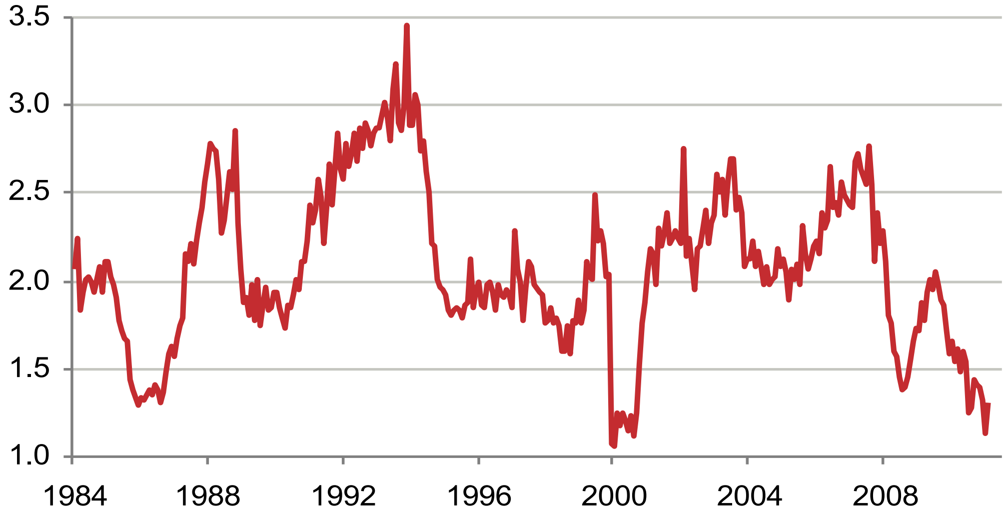
The past source of strong growth – net interstate migration – is at a very low level



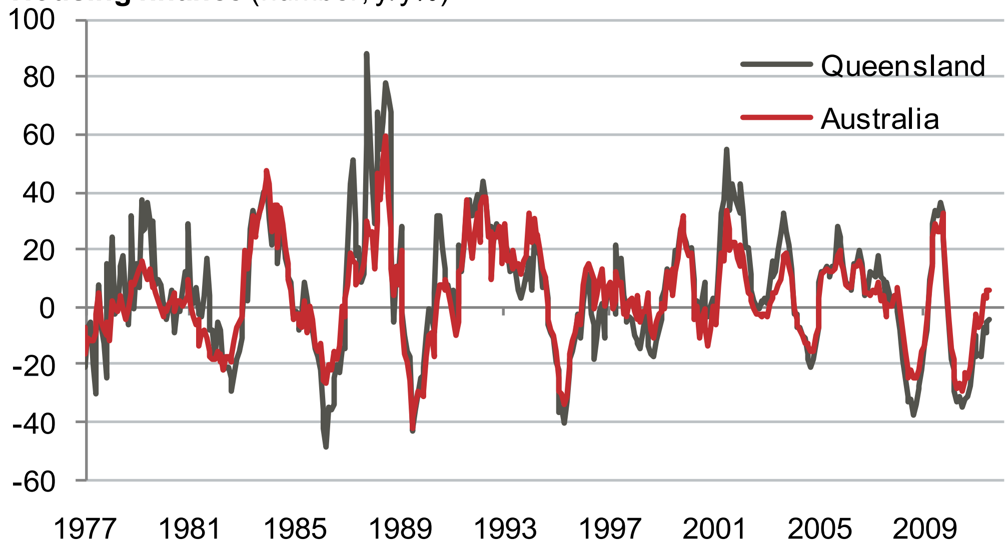


Queensland Housing Sector

Queensland - Private housing approvals (sa,000s)



Housing finance (number, y/y%)



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Dwelling approvals surge in August

- Queensland building approvals rose nearly 20% in August, with strong gain in both housing and multi-dwelling construction

But level of approvals remains close to lows of last twenty years

Solid improvement in housing finance

- as the number of housing loans rose 2.3% in July, after two months of lacklustre growth

House prices to remain subdued

The peaks in house price growth coincide with peaks in residential house approvals

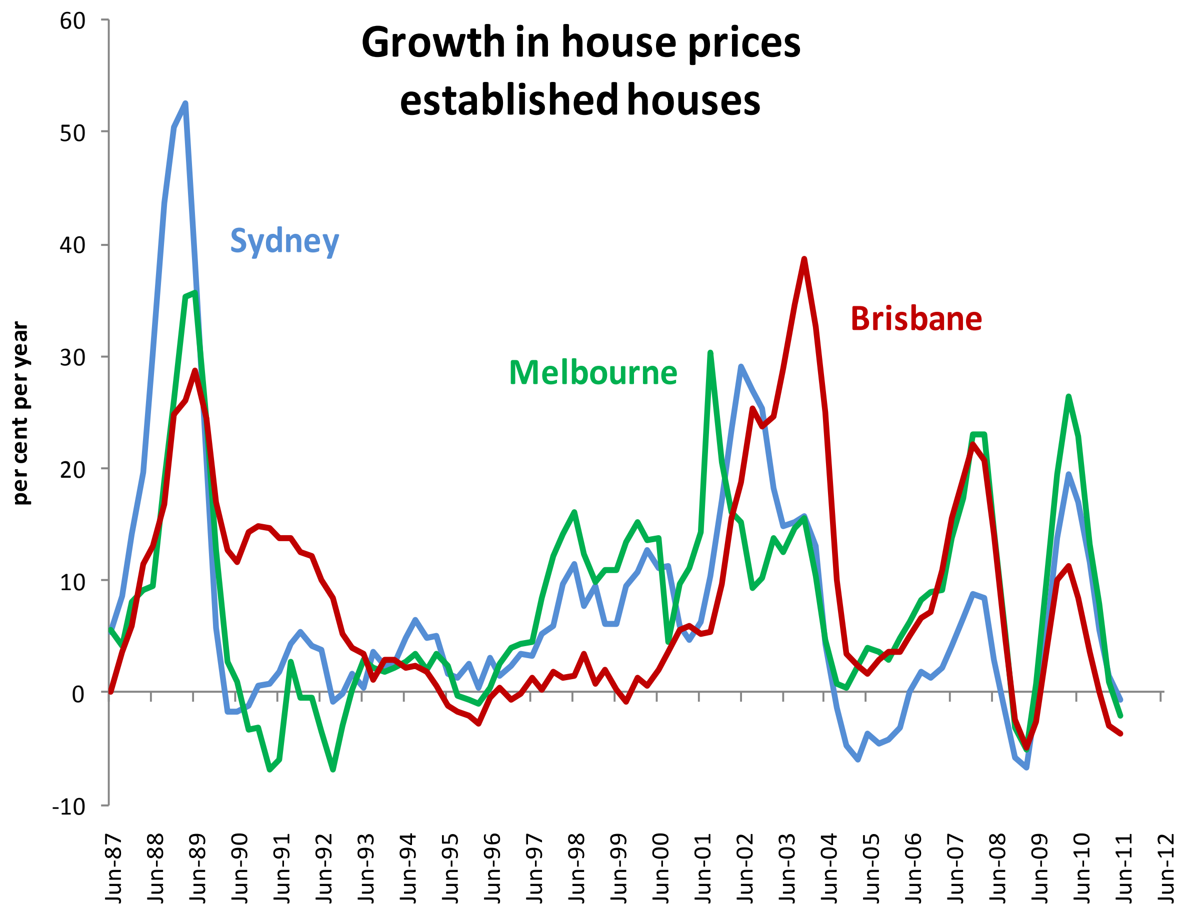
With approvals weak, house prices will also remain subdued

But there will be no collapse.

Prices are supported by:

• Underlying population growth
• No excessive over-building
• Low defaults and arrears
• Mortgagees hoarding interest rate cuts

Prices are held back by lack of confidence

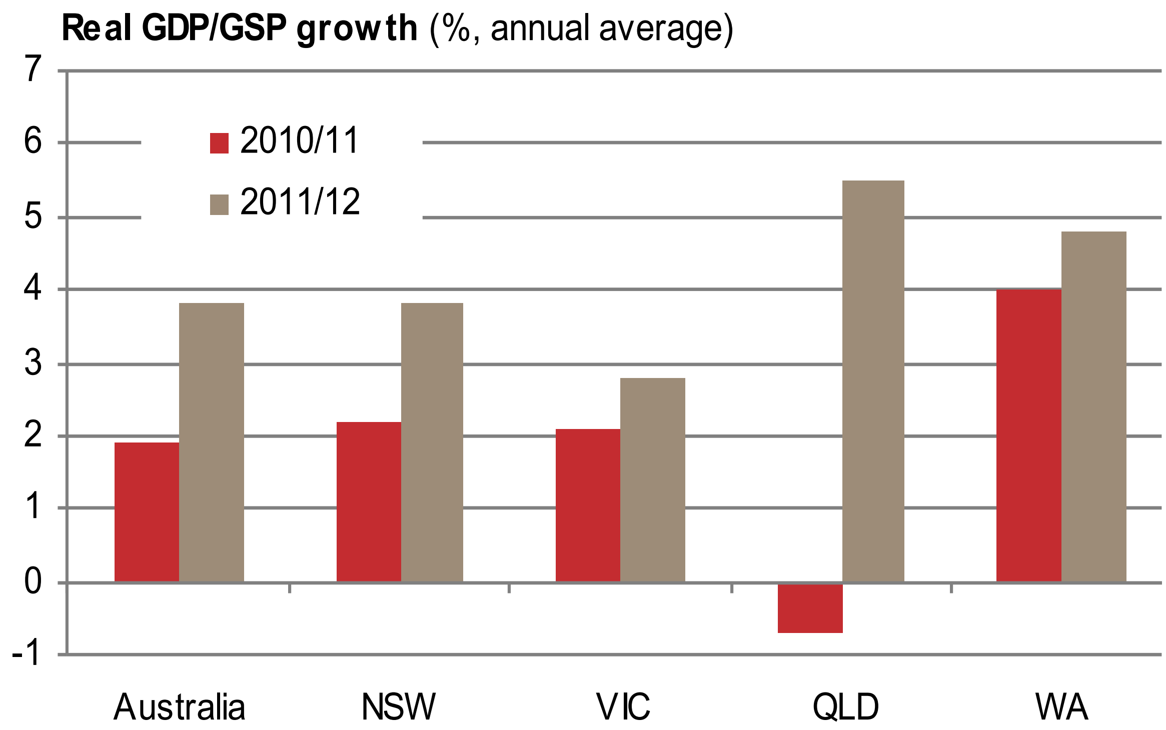


Outlook for the Qld economy

Growth in QLD depressed by floods in 2010/11, but rebounding strongly in 2011/12

Strong growth in 2011/12 as coal exports rebound and capital expenditure by the mining sector ramps up

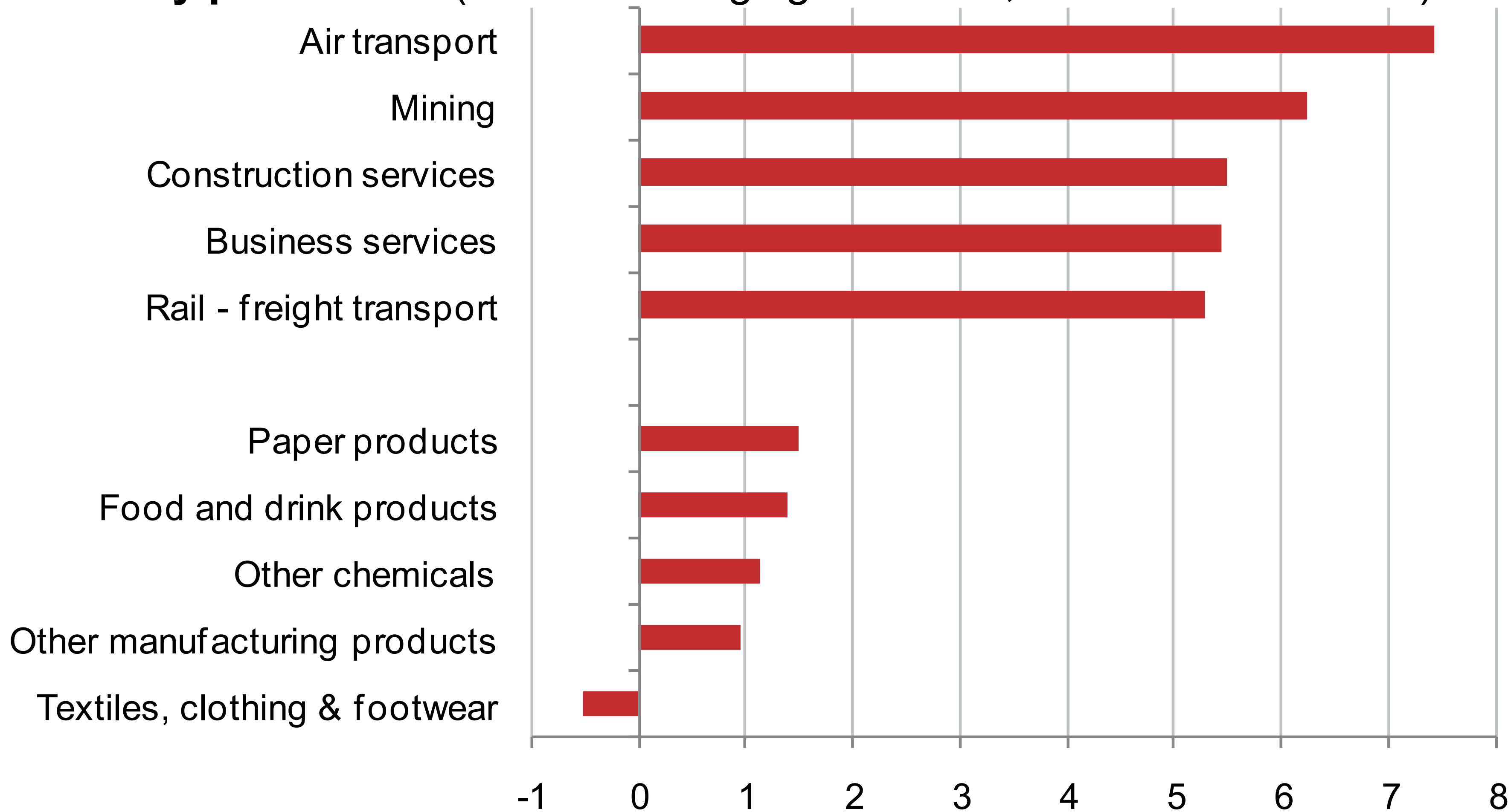
2011/12 real GSP to grow by 5.5 per cent average annual



Source: OESR; ABS; QIC; CoPS

Best and worst performing industries

Industry production (annual average growth rate, 2010-11 to 2019-20)



Source: QIC

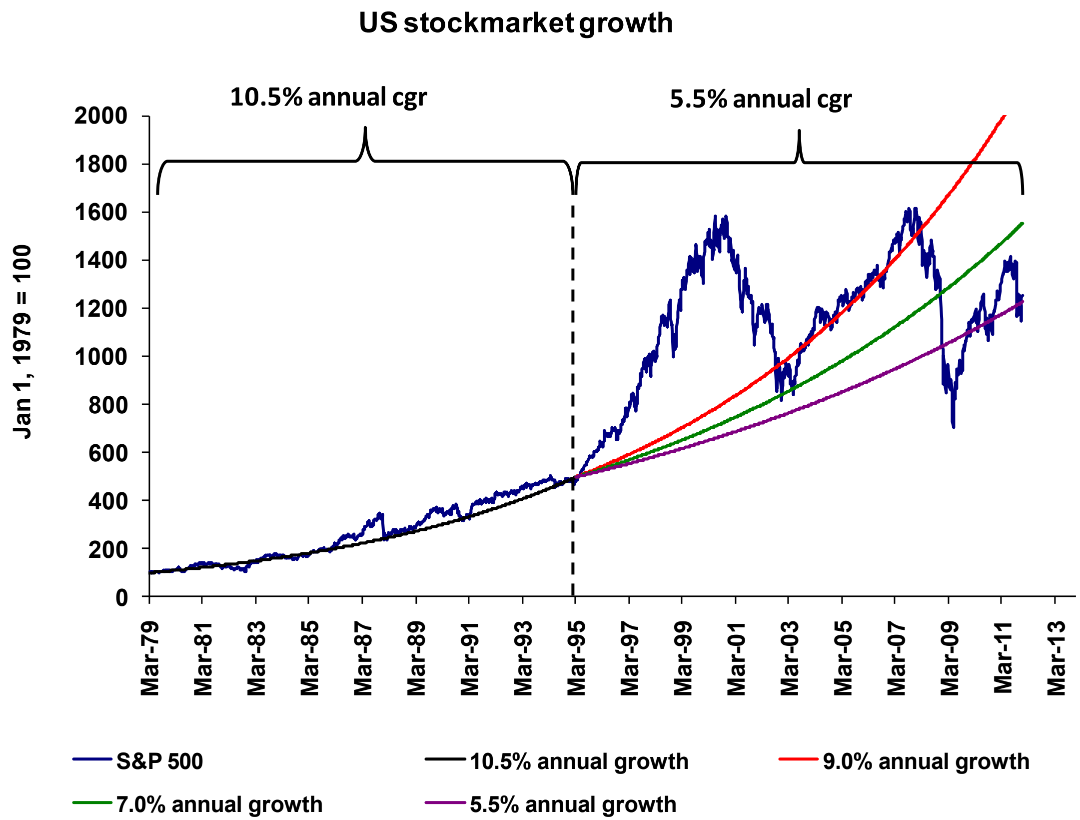
Is risk over-priced?

The comparison between the two 16 year periods – 1979 to 1995 and 1995 to 2011 is stark

Real outcomes are not significantly different but nominal outcomes and volatility are

As a consequence, attitudes towards risk are very different and now risk is not well tolerated

Given the massive build up in cash, this must change



Period	Real GDP	Inflation	Nominal Profits
Jun 79 to Jun 95 (16 years)	2.8	4.8	7.1
Jun 95 to Jun 11 (16 years)	2.4	2.5	6.8

Conclusions

- Global growth has recovered from the recession
- Consumer confidence is fragile, and currently weak, creating a soft spot for current growth
- Major global economies, ex-Japan, will continue to grow
- Labour markets have stabilised
- US and German economies look in good shape
- Global fundamentals are quite good
- Key risks to global growth are sovereign debt and future inflation
- Queensland suffered badly during GFC
- Population growth in QLD remains weak
- Global equities look cheap by historical standards