Is the next global recession heading our way?

Presented by:

Matthew Sherwood
Head of Investment Markets Research
Perpetual Investments

June 2011

Points for discussion

- Global economic data has softened
- Are investors on a road to nowhere?
- The new return dynamics in the post-GFC world
- Australia – mid-cycle slowdown or worse?
- Australian shares – will the underperformance continue?

The market bears believe we are heading for a global recession

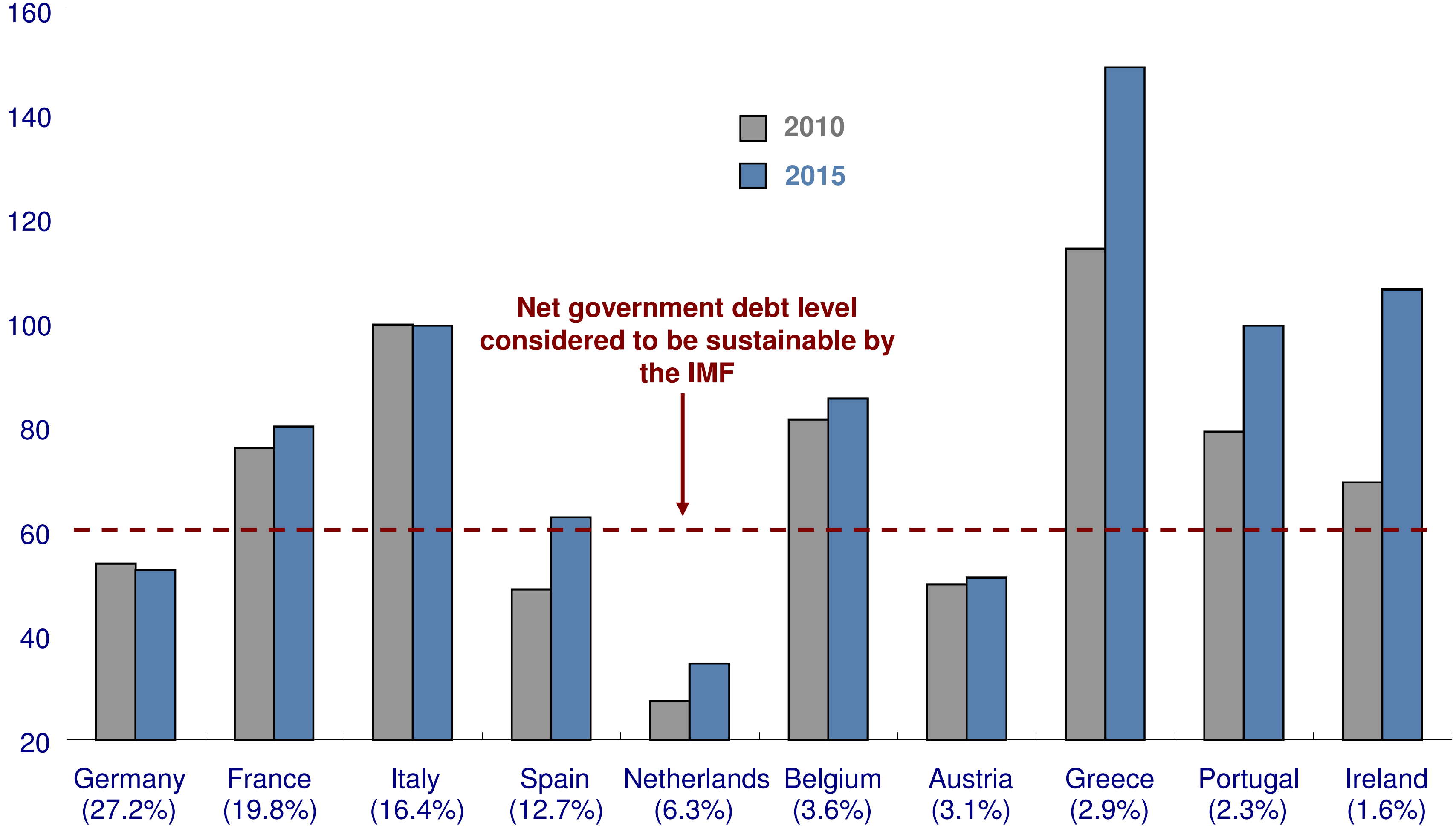
What are the pessimists thinking?

- European debt is increasing and funding and rollover has become an issue
  - smaller countries are more vulnerable
  - banks are the primary concern
- US growth appears to have hit a wall in H1 2011
  - manufacturing activity is slowing and the labour market's growth has declined
  - Auto production has declined
- Japanese earthquakes will send their economy into recession
- Asian growth is moderating in most countries
  - the impact of Japan
  - higher interest rates

The bulls and the bears are right some of the time, but not all of the time

European debt – a case of the tail wagging the dog

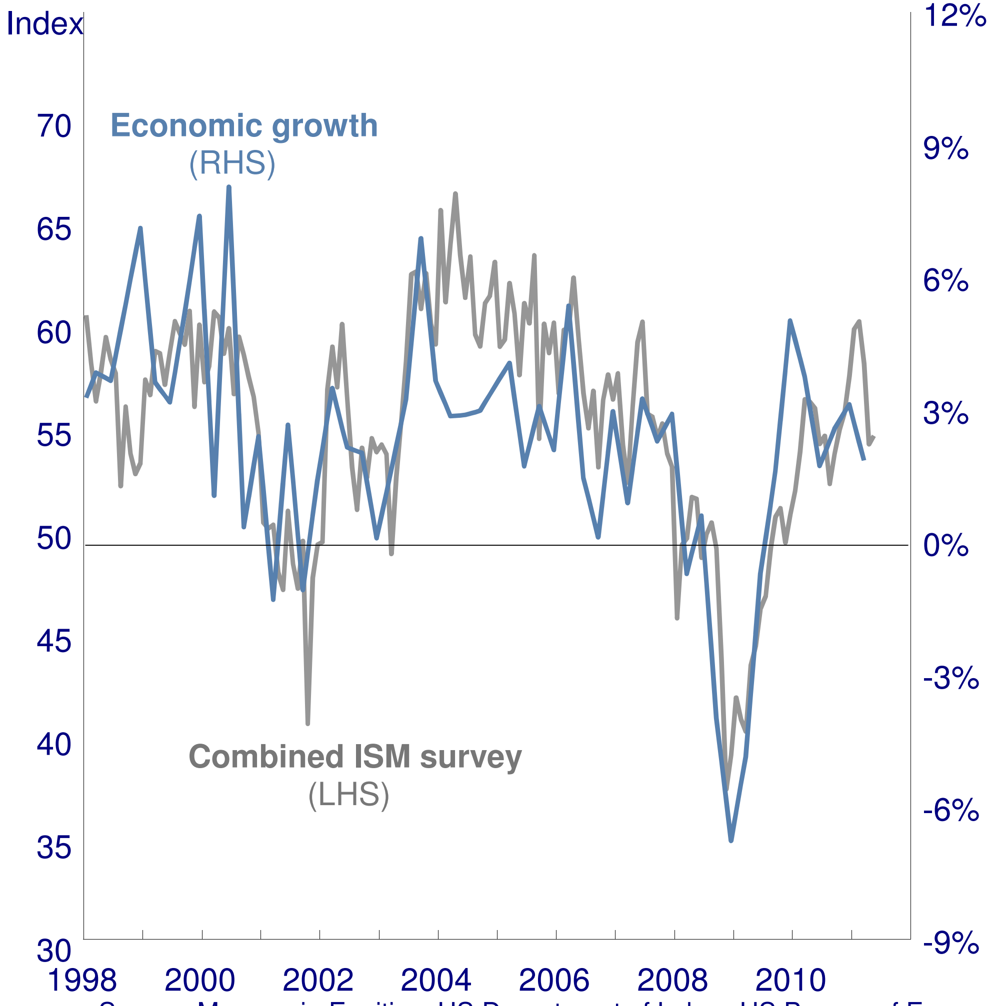
European Net Government Debt (% economic activity)

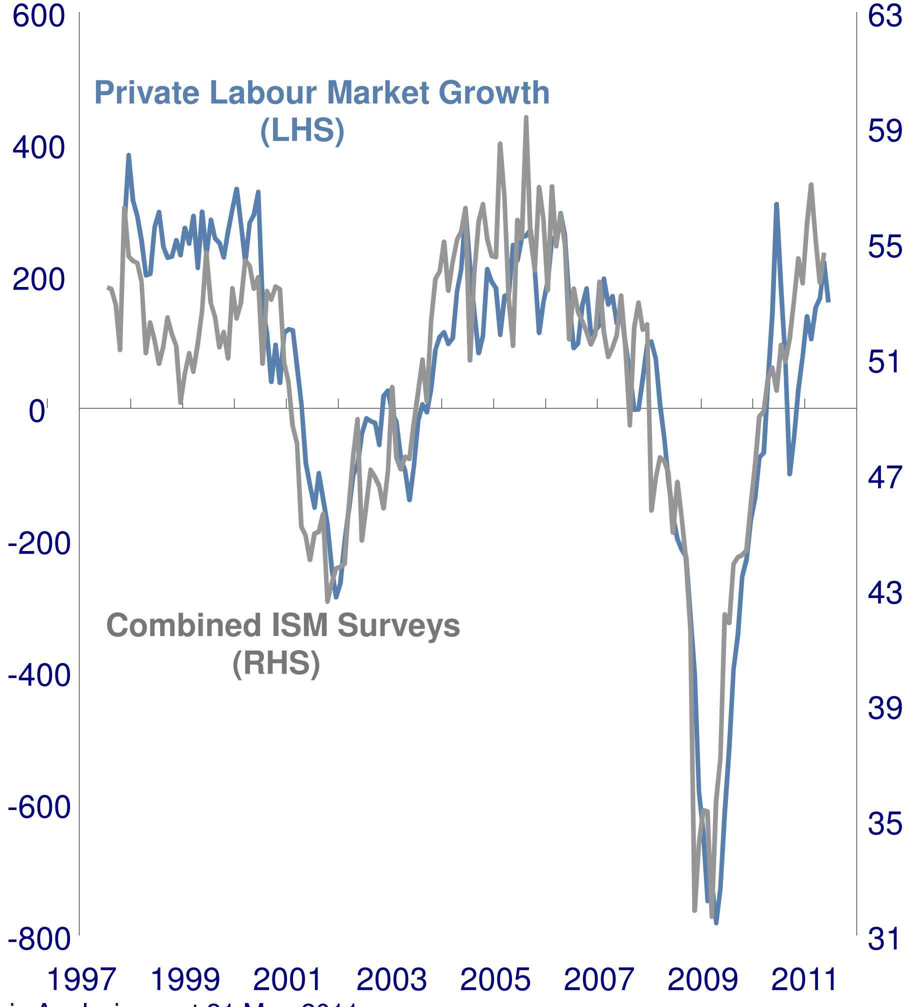


Source: Macquarie Equities, OECD and www.economywatch.com.au ,as at 5 June 2011

The US recovery is solid and sustainable, but not spectacular

US economic growth and combined ISM surveys and Employment growth (%)

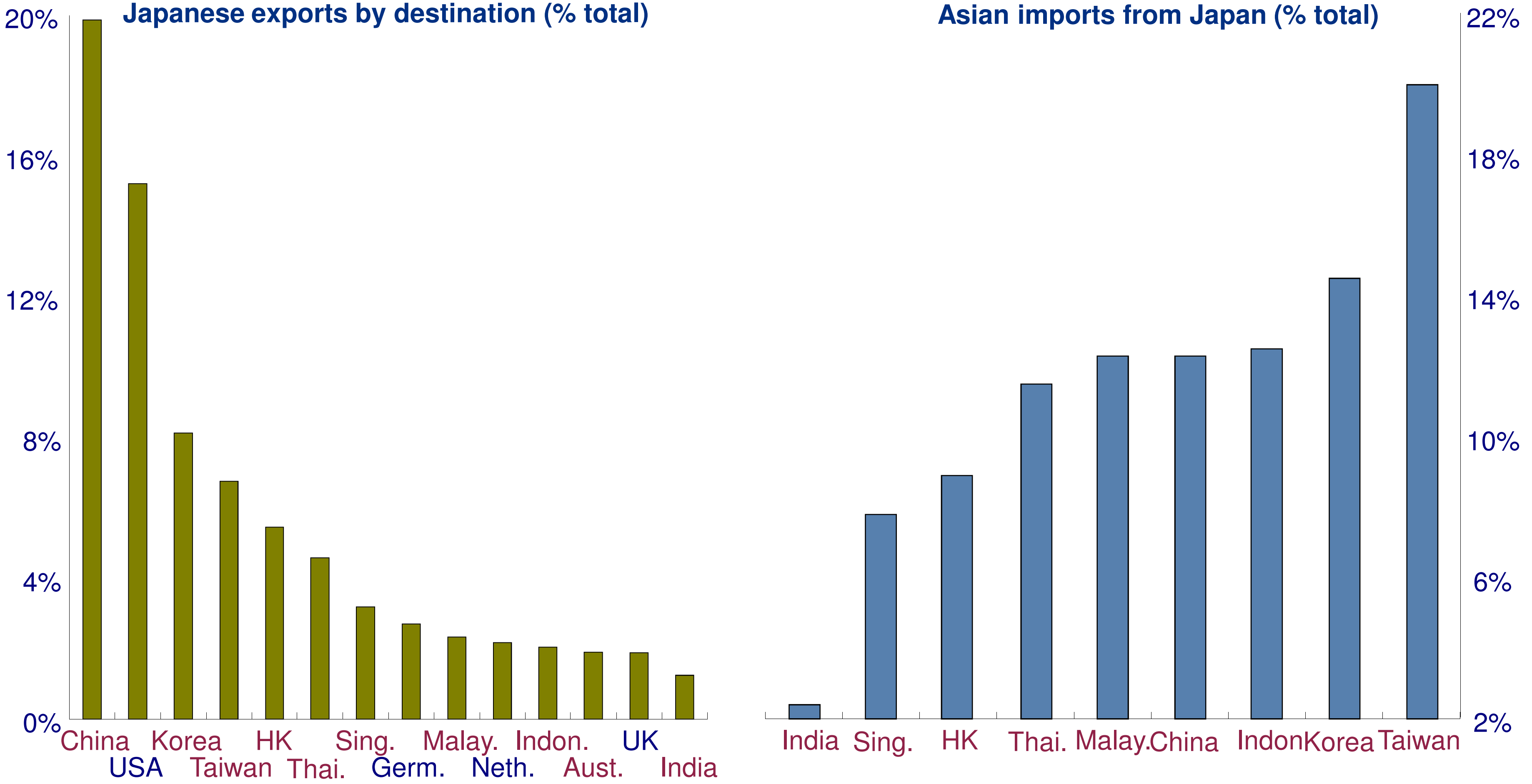




Source: Macquarie Equities, US Department of Labor, US Bureau of Economic Analysis as at 31 May 2011.

Japan is a key component manufacturer for Asian & US IP

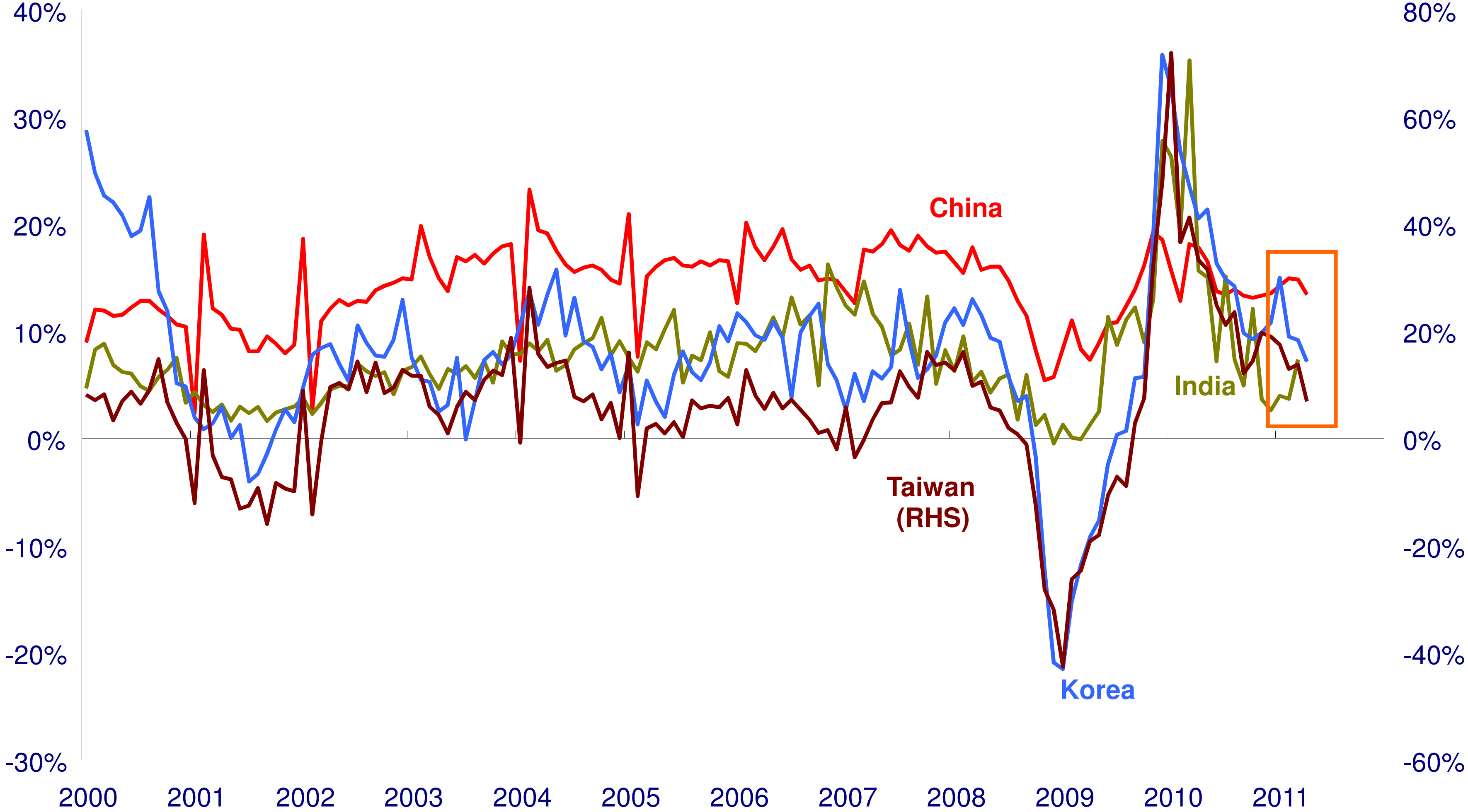
Japanese exports by destination and Asian imports from Japan (% total)



Source: Macquarie Equities as at 7 June 2011.

Chinese and Asian industrial production has slowed to ‘average’

Asian industrial production: Annual growth (%)



Source: Credit Suisse as at 30 April 2011.

What is the data truly telling us?

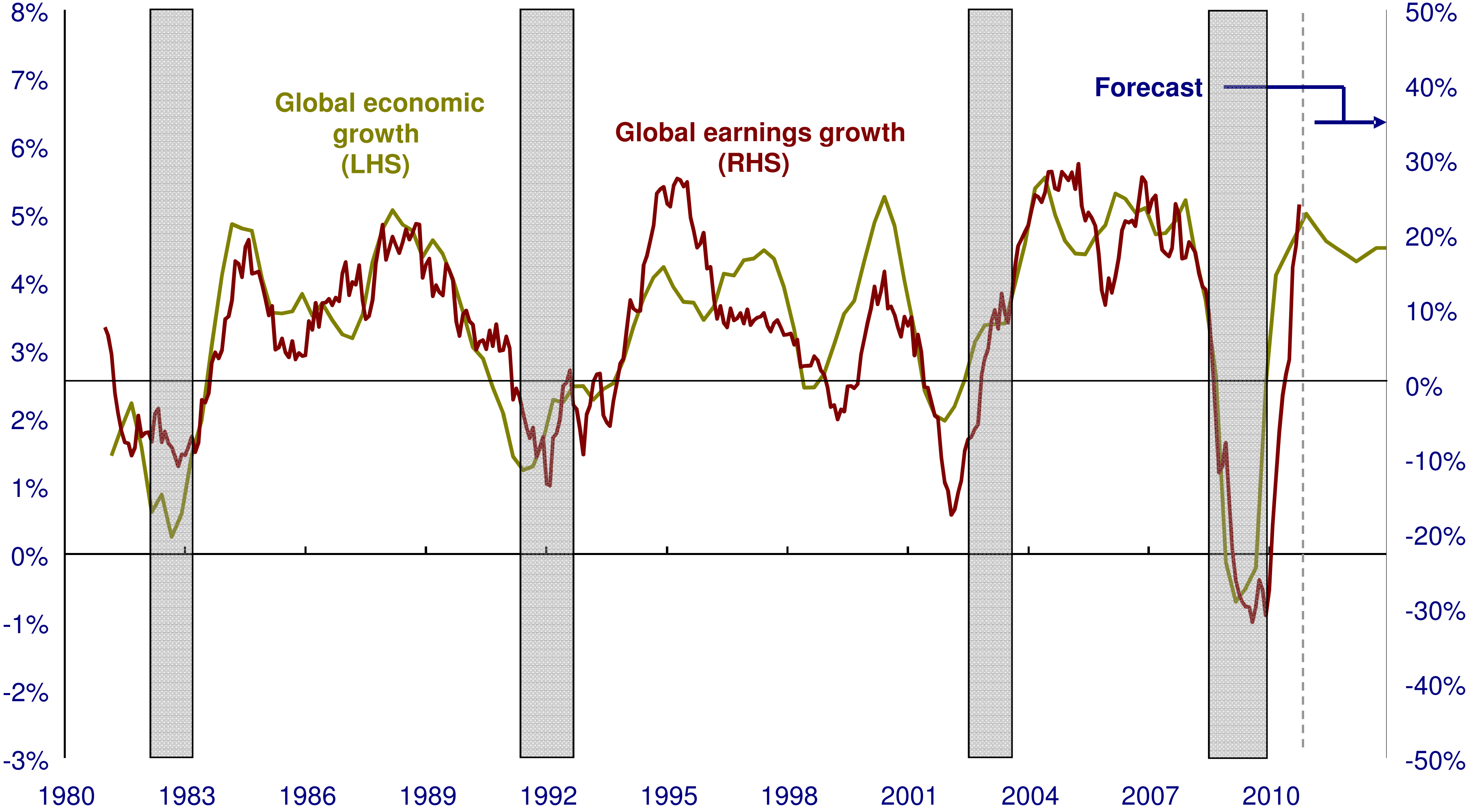
What are the risks and where?

- European debt is a significant problem
  - economic growth and inflation usually resolve government balance sheet stress
  - … but some government are undertaking reforms at too slow a pace
  - next step: highly indebted governments to sell assets
  - banks exit strategy is key for financial system health - need to diversify their European exposure
- US growth is likely to be better in H2 2011
  - Japanese recovery to spark increased auto sales
  - exports to rise reflecting depreciating US Dollar – recovery to remain sub-3% for a while
- Japanese earthquakes - short recession and then recovery
- China/Asian growth to moderate further and then recover in late 2011
  - growth remains above-average
  - inventory cycle run down to be short-lived. Housing construction to life growth in H2 2011

The key market issue is not growth or recession - it is rising growth or moderating growth and the outlook for H2 2011 is better than for H1 2011

Global growth remains above-trend and will support markets

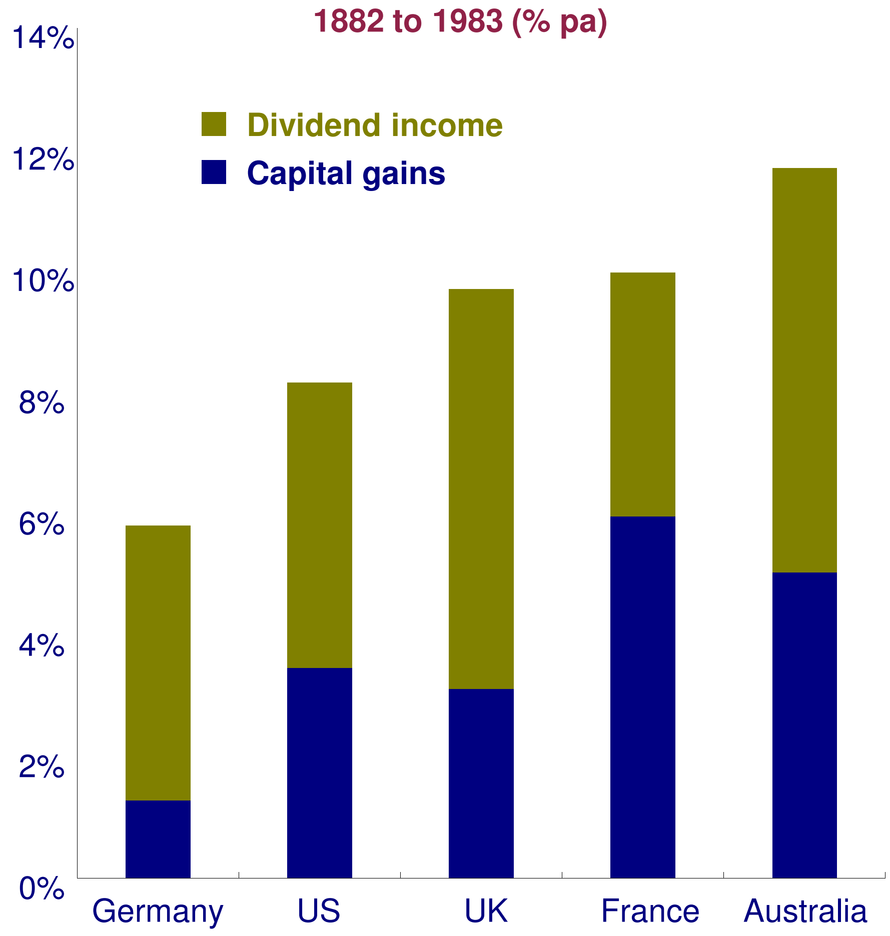
Annual global economic and earnings growth (%)

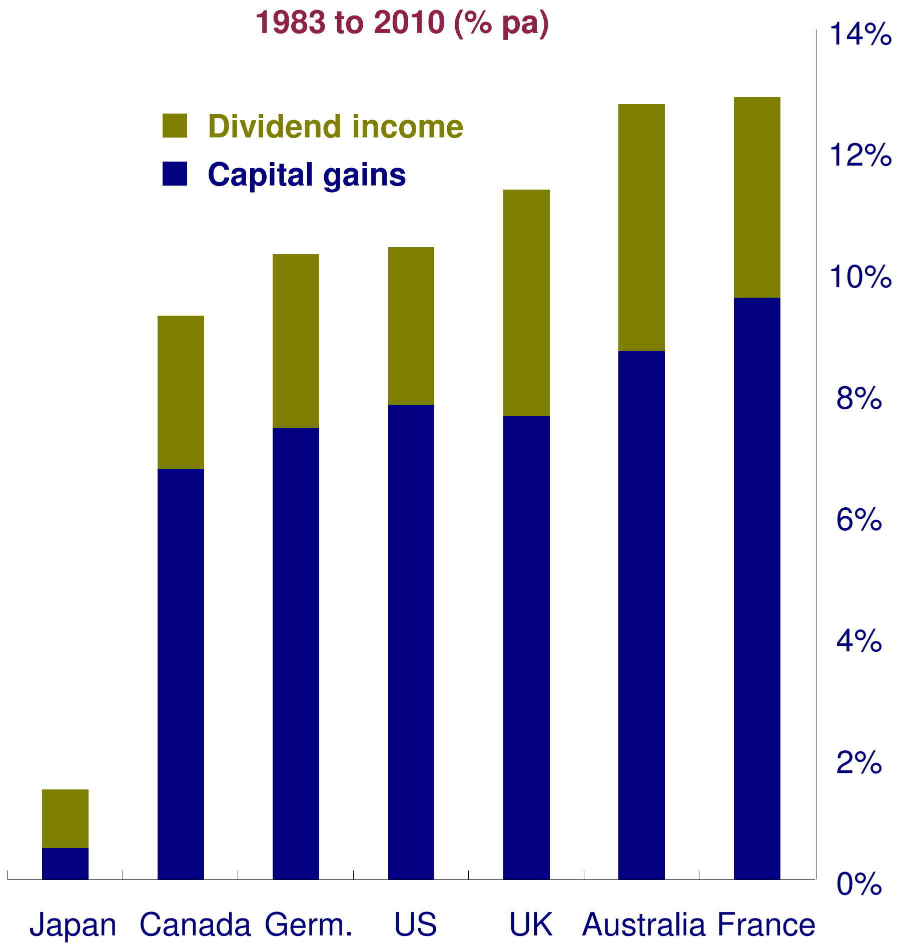


Source: UBS Limited and the International Monetary Fund as at 19 January 2011.

The composition of total returns – capital gains or income?

Composition of investment returns since 1882 (% pa)

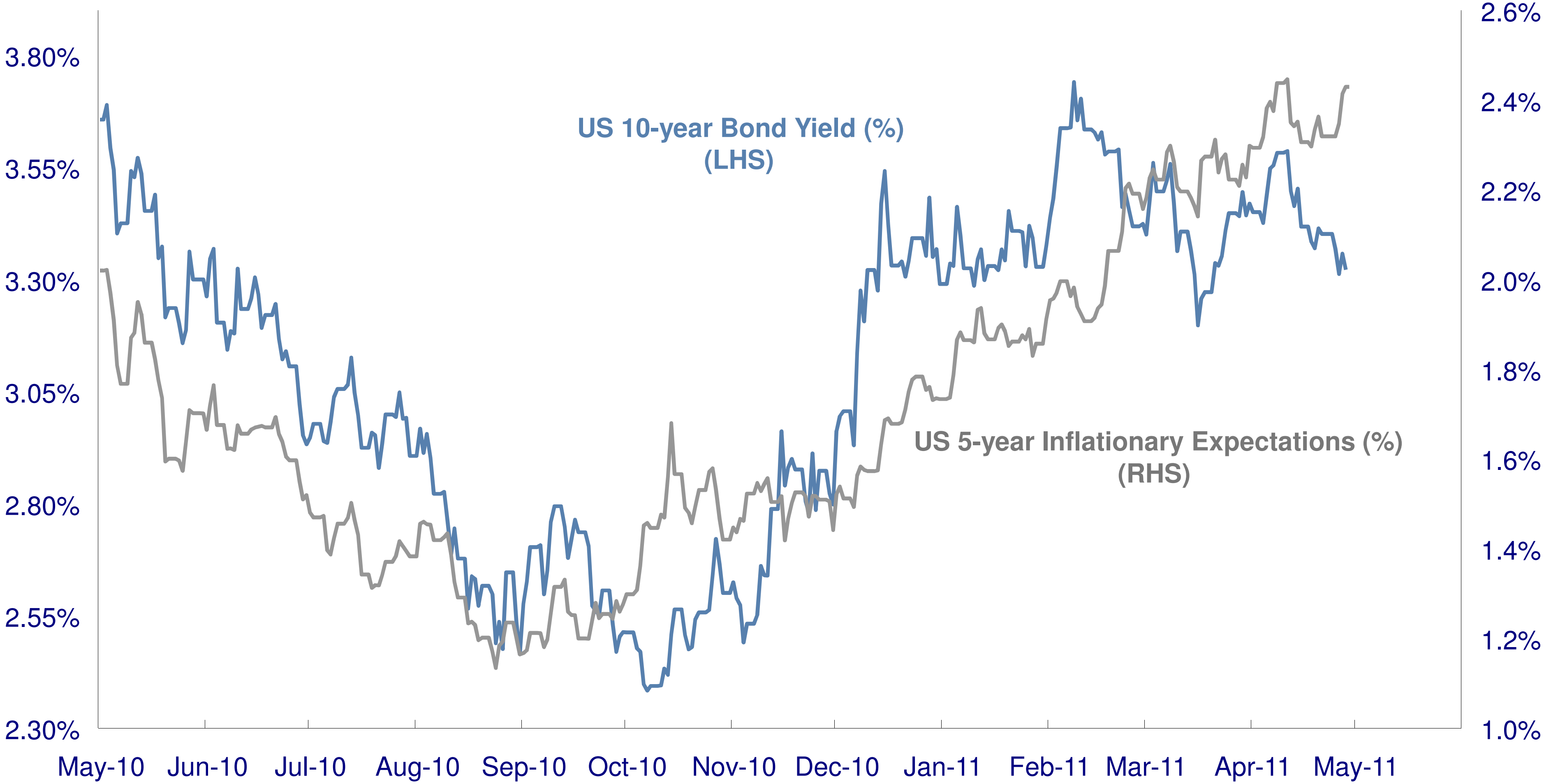




Source: Australian Stock Exchange, Reserve Bank of Australia and DataStream as at 30 June 2010.

The era of '*cheap money*' is over

Five-year US inflationary expectations and 10-year government bond yields (%)

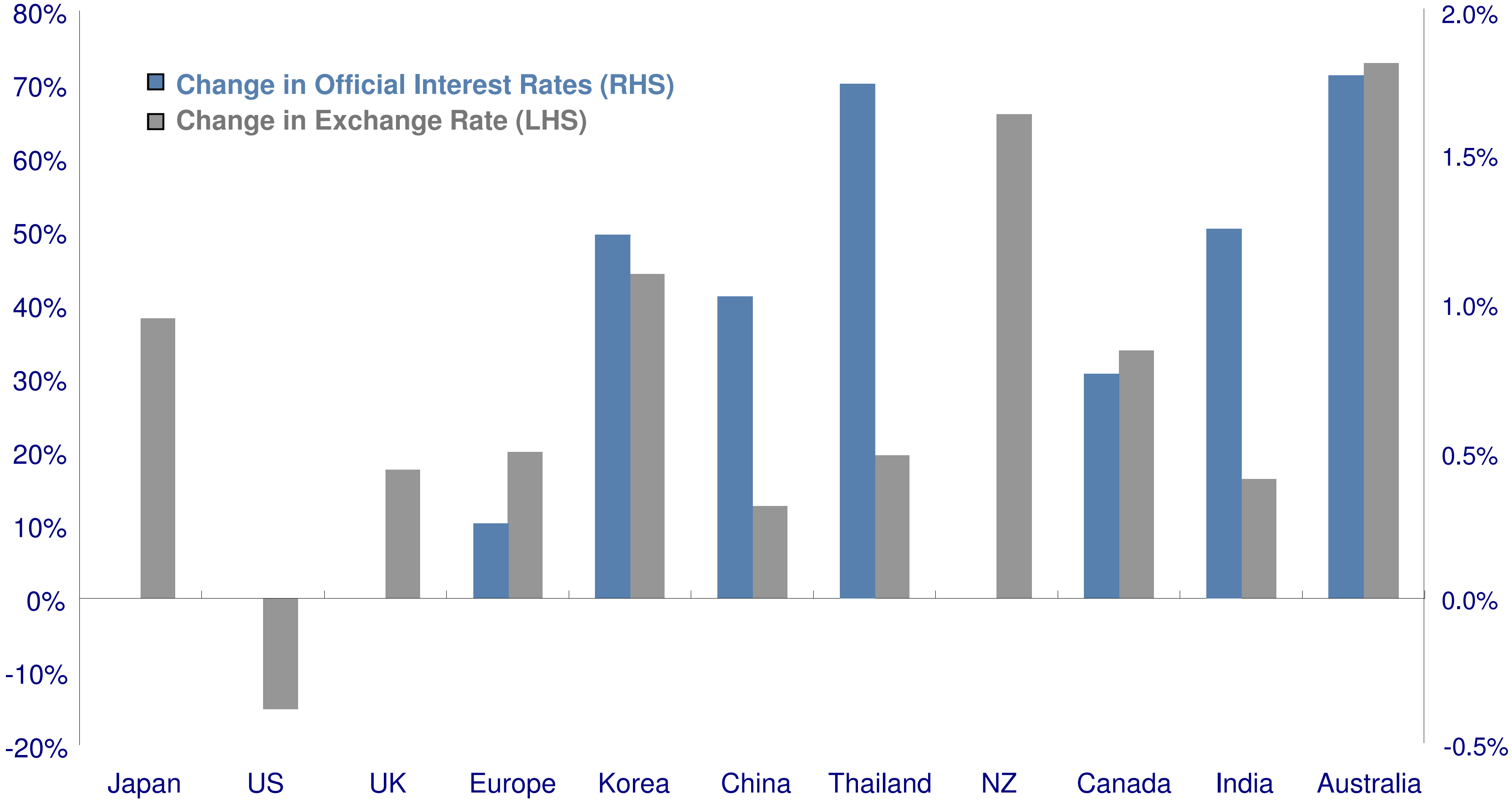


Source: ICAP Australia Limited as at 1 May 2011.The break even inflation rate is the rate of inflation that equates an investment in an inflation protected security to a nominal bond of similar duration. So if inflation averages more than the break-even, an inflation linked investment will outperform the nominal fixed rate investment.

Perpetual

Australia has experienced more policy headwinds

Change in official central bank interest rates and currency relative to USD (%)

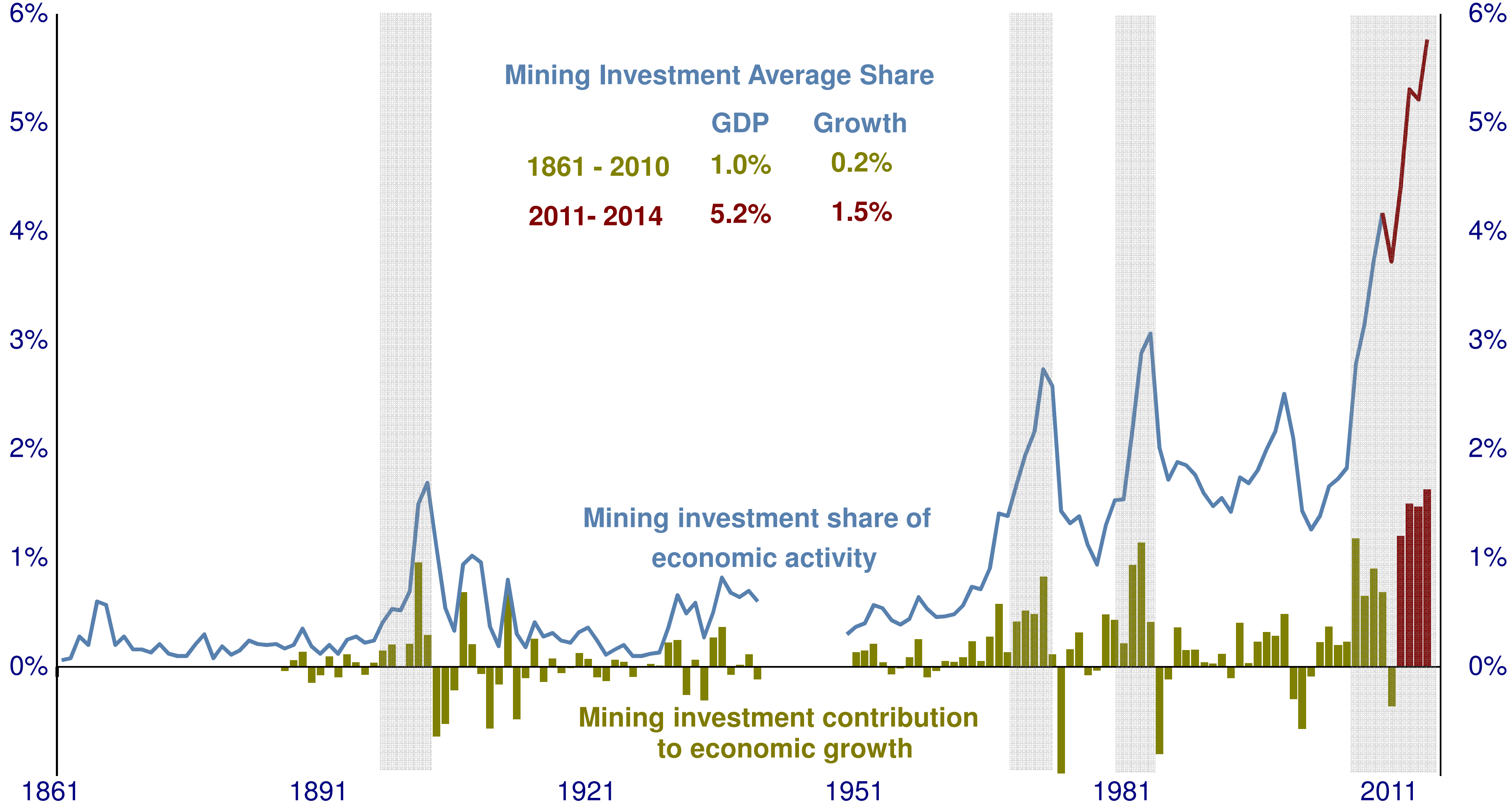


Source: DataStream and Macquarie Equities as at 7 April 2011. Change in USD is calculated using its trade-weighted index.

Perpetual

Our largest ever mining investment boom is coming

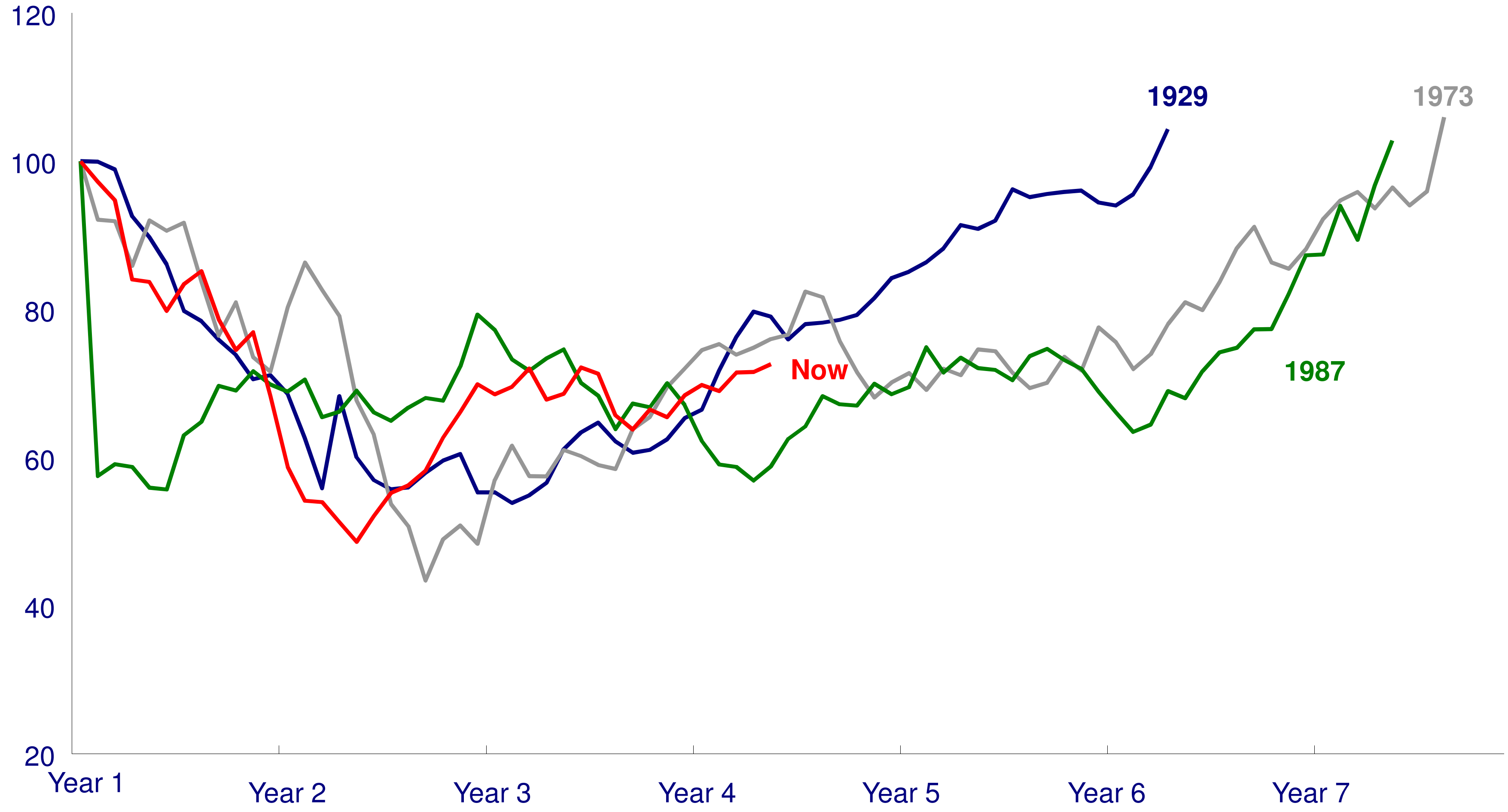
Mining investment: contribution to economic growth and nominal GDP (%)



Source: UBS Australia Limited as at 31 January 2011. Forecasts are a database of investment projects from ANZ Bank.

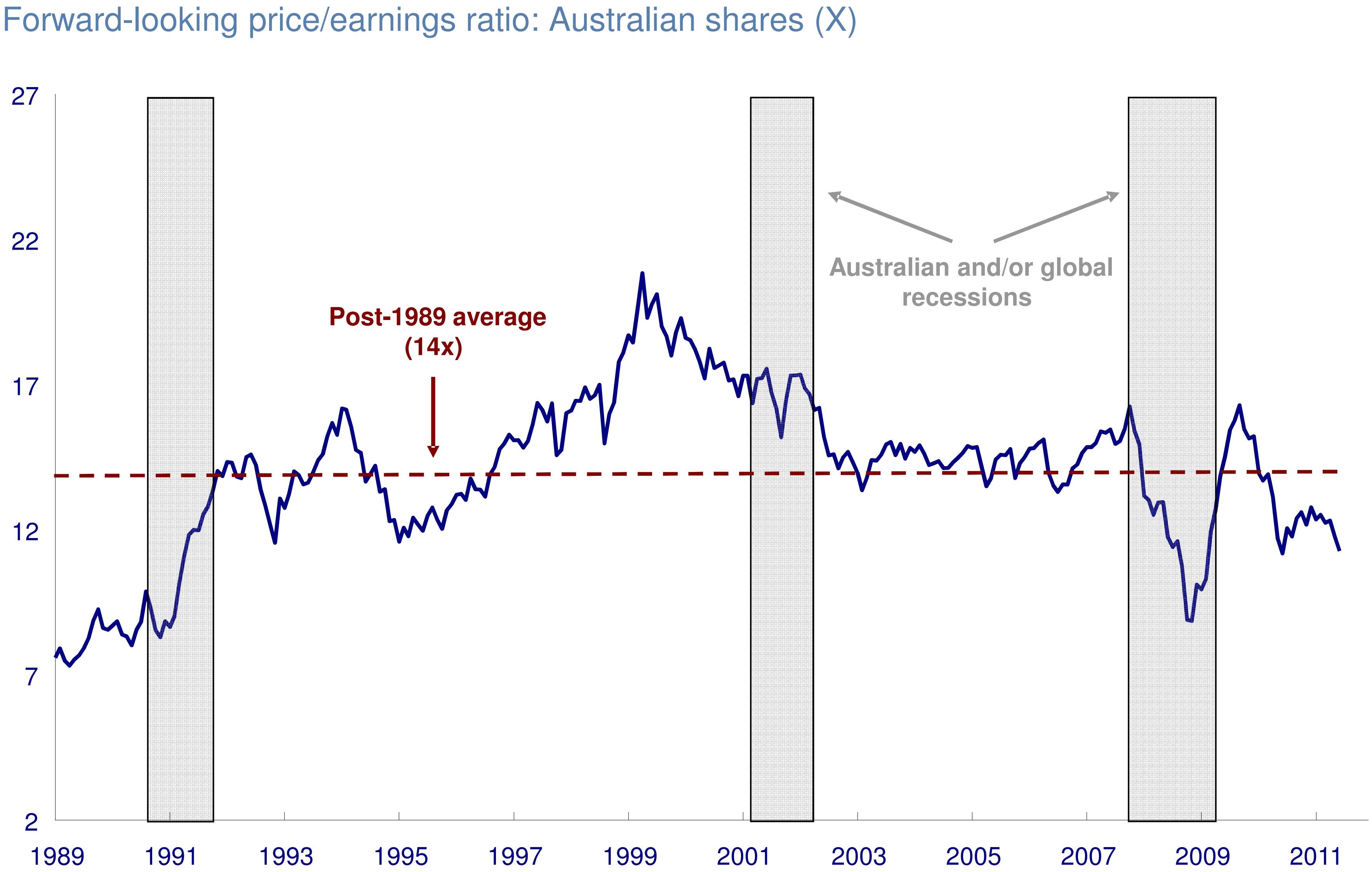
Side trending markets - quite common after large bear markets

Australian sharemarket trends after a 40%+ price decline (%): Indices rebased to 100 at trough



Source: Australian Stock Exchange as at 6 June 2011.

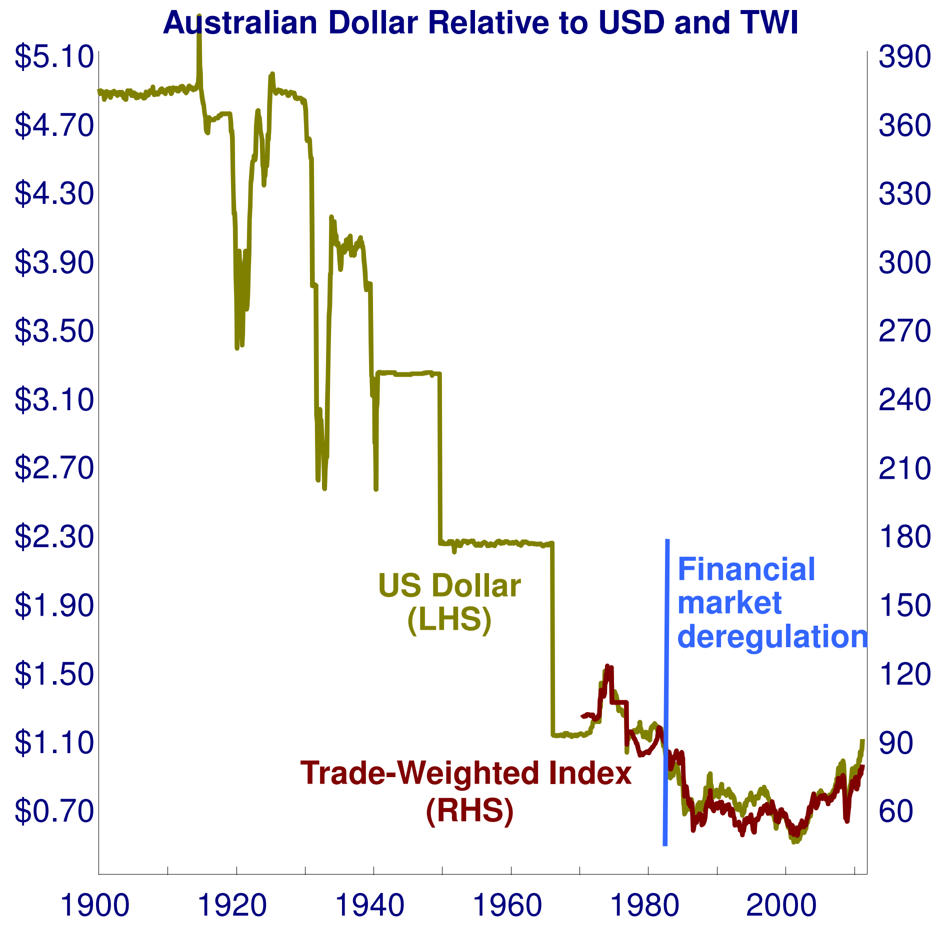
Valuations are at an historic low point



Source: UBS Australia Limited as at 9 June 2011.

Aussie dollar beyond parity – a new dawn or back to the norm?

- Why is the Australian market underperforming?
  - its not because of a weak economy
  - higher currency
  - higher interest rates
  - market composition
  - sustained earnings downgrades
  - A rise in perceived 'sovereign' risk
- What is needed to end the side-trend?
  - global economic stabilisation
  - RBA moving to 'on hold'
  - Australian dollar's ascent to stabilise
- Why would these end the side-trend?
  - risk aversion would diminish
  - domestic economic growth would rise
  - global earnings to rise in AUD terms



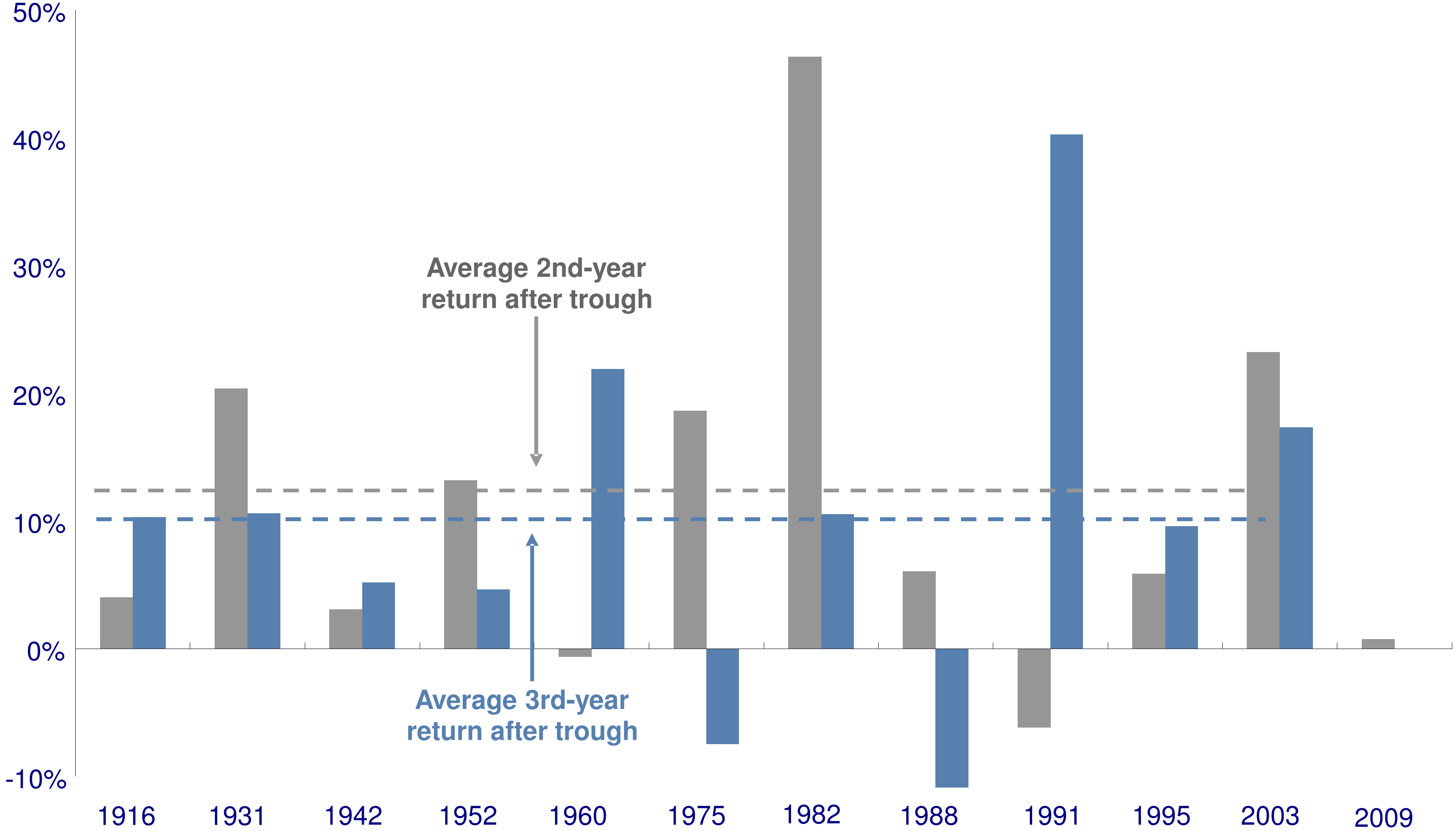
Source: RBA as at 30 September 2010.

Investors tend to see the side-trending market as an opportunity – speculators see it as a time to look elsewhere

Perpetual

Lower third year returns - income is more important

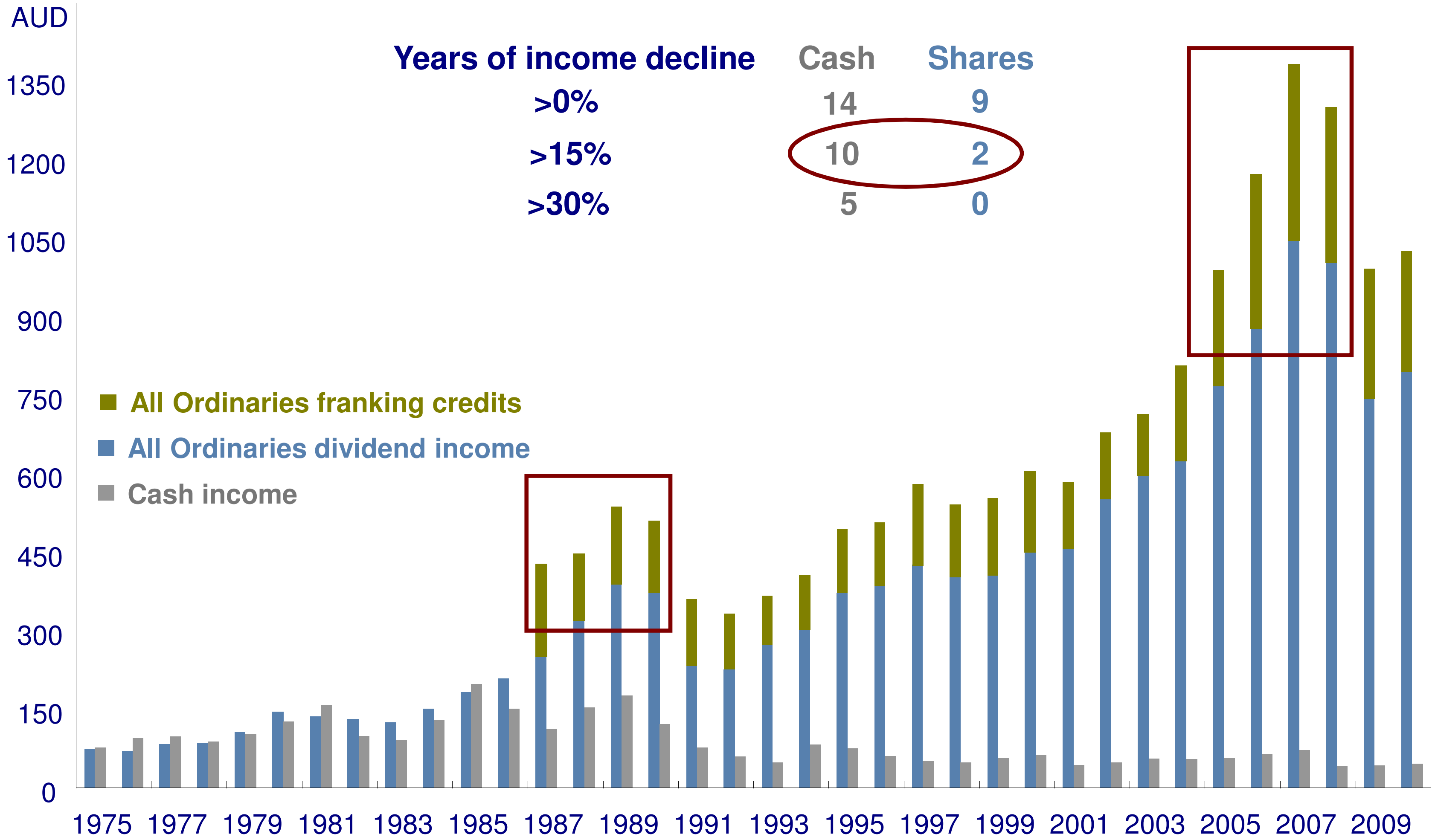
24 month and 36 month returns: Australian shares (%)



Source: Australian Stock Exchange as at 11 March 2011.

What is the most reliable source of income?

Investment income: Cash vs Australian shares (A$1,000 initial investment)

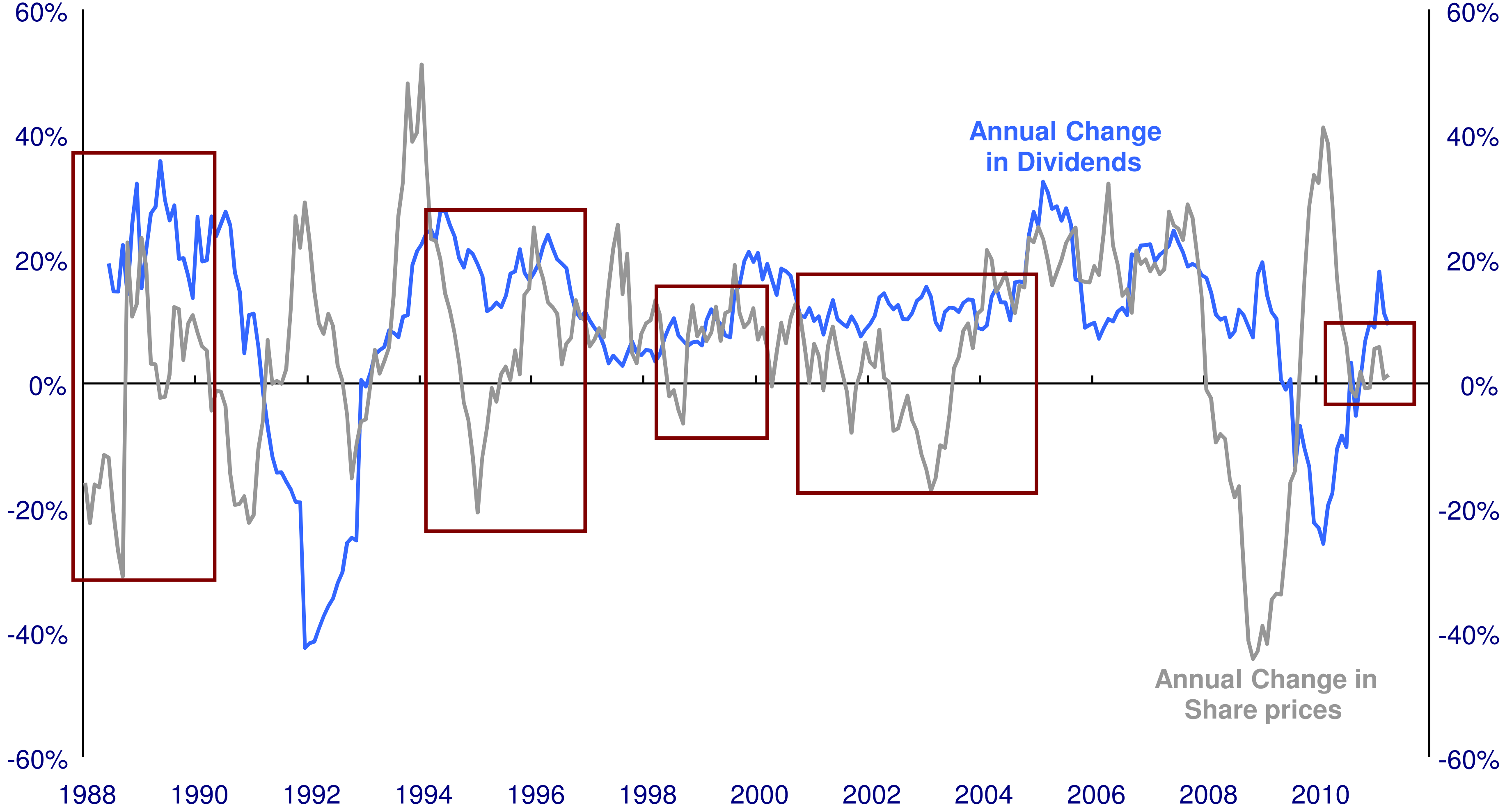


Source: DataStream as at 31 January 2011.

Perpetual

What is the most reliable part of your total return?

Annual change in dividend payments and share prices: Australian sharemarket (%)



Sources: UBS Australia Limited and DataStream as at 30 April 2011.

Global dynamics - portfolio implications

- Advanced economies - reason to be cautiously optimistic going forward:
  - US to outperform, Europe and Japan - but growth is likely to be sub-trend due to imbalances
- Industrialising Asian economies to moderate then recover
  - commodity supply/demand imbalance to ease slightly
- Investors may need to re-examine their exposure to global shares
  - corporate earnings to rise, valuations are attractive and AUD unlikely to rise much more
- Australian shares:
  - Headwinds:
    - sentiment remains very fragile and investors remain scarred by the GFC
    - a hawkish domestic central bank has produced below-recession level credit growth
  - Tailwinds for Australian shares
    - Australian economy to strengthen in 2012 and corporate balance sheets are in good shape
    - Australian dollar has had most of its rise and valuations are attractive
    - investors are cashed up

The post-GFC world is very different to what we know and trust – the key is understanding the changing world and adapting

Important note

This presentation has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426 for the use of financial advisers only, it is general information and is not intended to provide you with financial advice. The views expressed in the article are the opinions of the author at the time of writing and do not constitute a recommendation to act. Any information referenced in the presentation is believed to be accurate at the time of compilation and is provided by Perpetual in good faith. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. No company in the Perpetual Group guarantees the performance of any fund or the return of an investor's capital (Perpetual Group means Perpetual Limited ABN 86 000 431 827 and its subsidiaries). Total returns shown in the presentation/slides have been calculated using exit prices after taking into account all of Perpetual's ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.