



Investment Newsletter

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From the Editor....

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Market Update

Will the current market rally continue or are we in for a sell off in the short term?

It appears that from our research, many of the fund managers have missed much of the current rally and are now frustrated by having too much cash. One large investment bank reported in Australia recently that supply of large lines of stock had dried up, and that a shortage of supply had largely been brought on by an absence of sellers. Holding too much cash has become a consensus trade and during a rising market this delivers negative returns relative to benchmark indices for fund managers. It has been reported that the amount of cash presently sidelined in America is around \$8 trillion. This is within close proximity to the entire market capitalisation of US equities. It is therefore no surprise that some of this cash is finding its way back into the market.

Economic Professor, Nouriel Roubini made some interesting comments recently concerning the US deficits, which are now 3 times larger than the cost of WWII and twelve times the Government spend (relative to GDP) during the Great Depression. Roubini is supportive of the deficits because if the US did not open the purse strings, "the recession would become a depression". The deficits are the lesser of two evils, with the higher levels of inflation ultimately being the cost of Government policy, but preferable to a global depression, unemployment at 20% and widespread global unrest.

Roubini commented "there is no such thing as a free lunch. We are going to add trillions of dollars to our public debt, which is going to go from 40 to 80 per cent of the GDP. There are only a few ways in which you can finance that extra public debt. If you rule out default and a capital levy on wealth, you either have inflation tax or you have to painfully cut spending or raise taxes, and either one is not going to be politically palatable."

The other interesting comment made by Roubini was about the next growth cycle for the US and what was going to drive it.

"Periods of high growth in the United States in the last 25 years have been characterised by an asset and credit bubble. Whatever the future growth is going to be, this time around it needs to be sustainable and not bubble-prone because we are running out of bubbles to create. We had the real-estate bubble, tech bubble, housing bubble, hedge-fund bubble, private equity bubble, commodities bubble, even the art bubble—and they are all bursting."

We believe the US economy will take a number of years to fully recover from 2008, not least being a long overdue need for a pronounced shift away from such a heavy reliance on debt.

One remaining "bubble" that will at some point have to be forcibly addressed by financial markets is the extremely high historical valuation for bonds. This is an accident waiting to happen. At some point bonds will be shunned by investors worldwide. We believe this will mark the begin-

ning of a new era of inflation which has really been absent in large doses since the 1970's. The US is going to have to move back to basics and address the issue of economic growth in such a way that the economy moves forward in a sustainable way. The debt bubble that the world has just witnessed implode, is not going to be a viable catalyst for future growth.

Labelled Dr Doom, Roubini has pertinently become less bearish than he was a year ago, remarking that we "may be closer to a level of the market that is fundamentally right. A year ago we were not as close to a true bottom. Today we are closer to it. As we become closer to the bottom of the economy, the stock market looks ahead and sees the light at the end of the tunnel and rallies. In spite of these caveats, I would argue that even the latest market rally is a bear-market rally."

While we agree with Roubini that the bear market still has some time to go in terms of volatility, we may have seen that the March lows will ultimately prove to be the lowest point in the markets we will see for this cycle.

However, given the recent rapid rise in markets, albeit from a relatively low base, we believe that a correction is due in the coming weeks ahead.

Gold Update

Ongoing market volatility and mixed news on the international economic front continue to reinforce our long-term positive view on gold. Whilst some economists are becoming more bullish with respect to the global financial outlook, we believe that gold will continue to increase in value. The primary factors here are the huge inflationary side effects of the stimulus packages being implemented worldwide, which will erode the purchasing power of paper currencies.

Whilst some market participants are beginning to question the value of gold given the recent recovery in world equity markets and more promising economic data in some quarters, we believe this is no time to lose

focus. Gold's value does not diminish because the worst of the economic chaos might seemingly be behind us. Rather, we feel that the next major event that will drive the next leg-up in the price of gold bullion will be an outbreak of inflation.

The real fireworks in the gold market will come when the viability of the US dollar is finally brought into question. We are not there yet, but time is approaching. Consider this. The US national debt has now topped US\$11 trillion. When Bush came into power in 2000, the US national debt was less than US\$4 trillion, which was the accumulative burden over the previous 250 years.

The latest trillion-dollar stimulus package by the Obama administration will not only increase the overall level of debt, but in actual fact is the largest peace-time US Government assistance package as a proportion of GDP. As a result, US money supply has surged by more than 20% over the past 12 months and the alarm bells are well and truly ringing.

It does get worse however! As money supply will continue to expand into the future, the US must at some point experience renewed weakness. It is our view that the US dollar's role as the world reserve currency will be challenged in coming years which will drive gold's price higher.

This process already seems to be underway with Russia's central bank announcing that it was diversifying its foreign exchange reserves (currently around US\$400 billion) and was going to buy more gold. And other central banks are following step, led by the Chinese.

We did expect that China would boost their gold holdings and that we believed that the Chinese central bank had been a steady accumulator of gold behind the scenes. Just recently this was confirmed when the head of the country's State Administration of Foreign Exchange said that China had boosted its gold reserves by 76% since 2003 and was now the world's fifth-biggest holder of gold by country.

China has the world's largest foreign exchange reserves at around US\$1.95 trillion as of March 31. The holdings have climbed about sixfold during the past 6 years as the country benefited from record trade surpluses and inflows of foreign investment. Over the same period gold prices have almost tripled to more than US\$900 an ounce from US\$337 an ounce.

Zhang Guobao, head of the country's National Energy Administration, has said that China should invest more in commodities instead of hoarding the dollar. This reflects a big change in attitude from Asian central banks and is particularly poignant given that whilst the International Monetary Fund (IMF) is selling gold, Asian central banks are diversifying into gold.

Fortescue Metals Group (FMG)

It was interesting to read a recent article quoting China's Hunan Valin Iron & Steel Group, Fortescue Metals' (FMG) new 17% shareholder, on their ability and their willingness to ensure FMG's growth ambitions.

According to Valin, FMG may need between \$3 billion and \$4 billion to expand output from 50 million tonnes to 90 million tonnes. *"We'll do whatever we can to help Fortescue to become a 100 million tonnes per year producer,"* Valin's Chairman Li Xiaowei said at a press conference in Changsha.

"We'll help co-ordinate with Chinese financial institutions to help Fortescue get the funding it needs. We'll help Fortescue to become the largest iron ore supplier to the Chinese steel industry," Valin's Li said.

At the same press conference FMG chief executive Andrew Forrest stated that Fortescue has been studying a proposal to list in Shanghai for the past 16 months and separately, Valin's Li said the steel maker is in talks with two to three domestic rivals for mergers to boost capacity and is also setting up a fund to conduct mergers and acquisitions.

They are bold comments and we think it demonstrates why FMG chose Valin as an equity partner rather than going the institutional route at a steeper discount.

The Valin investment may well ensure that FMG will never have to issue equity again and interestingly, on our analysis, everyone is short and that includes the domestic institutions. From what we can see, there is only one domestic institution on the register in any size, with only 2.1% of the company owned by local institutions in total, post the Valin transaction. Surely that makes it Australia's most institutionally under-owned stock.

Why the underperformance of FMG against other miners? Sure, they had a tough quarter (as did all of the iron ore producers in the Pilbara) and yes there is the well publicised court case involving Forrest, but maybe the latter is the only answer as to why they are trading where they are. Valin has made the investment to sure up the balance sheet and we remain confident that you will see an improving quarterly production performance moving forward as the lump circuit and desands plant are commissioned and production ramps up.

We think that if the market wants to buy risk, then what better stock to turn your attention to than FMG which is yet to really move.

Information in this Newsletter is drawn from various sources, including extensive and comprehensive research by Fat Prophets, FN Arena, Bloomberg and the local press.

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