



INSIDE THIS ISSUE

Welcome to 2010

Earnings Season

Currencies

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There is little doubt that historians will record the 2008/early 2009 stockmarket meltdown in similar terms with the 1929 Wall Street crash. Subsequently, the global recovery has been no less historic. The rise for the Australian stockmarket over the last three-quarters of 2009 provided the best performance for domestic equities since the recovery from the Great Depression. Considering the rarity of such events, it is highly unlikely that 2010 returns will even come close to last year. However, in addition to the weight of history, we believe there are a number of other factors that suggest the 2010 stockmarket performance will be significantly tougher than “the rising tide lifts all boats” scenario of 2009.

Firstly, in the March quarter last year, world equity markets were priced for total financial system Armageddon. Therefore, it is not surprising that in the aftermath, the global relief rally has been very powerful. It is worth remembering however, that the subsequent rise in domestic equities from the March lows was purely driven by price to earnings expansion. As a result, the ASX 200 is currently at a 15% premium to the long term average. Consequently, financial year 2010 equity valuations are currently implying a very strong recovery in earnings. Therefore as the Australian economic recovery unfolds, we believe the equity market will become a very harsh critic if expectations are not met. 2010 earnings results will have to significantly surprise on the upside for stocks to gen-

erate sustained short-term performance. There is currently a huge leap of earnings growth faith in financial year 2011 estimates over 2010 which would want to be right. For example, Bluescope Steel goes from a consensus P/E of 32 times in 2010 to 10 times in 2011 on consensus expectations of +200% EPS growth. Good luck with that forecast, the stock is a straight up sell.

Secondly, the strong performance of the Australian economy has driven domestic equities to a premium over the global peer group. This premium will be difficult to maintain unless both first half earnings significantly surprise on the upside, and the domestic economy exceeds the current 2010 forecast of 3.5% growth in Gross Domestic Product. To achieve a surprise outcome on economic growth, China remains the key. It does appear however from the recent increase in interest rates that the Reserve Bank of Australia is committed to slowing the economy. Similarly, you will also get some stimulus fade in the local economy making previous corresponding period growth comparisons tougher. Therefore once again such an outcome would remain dependant on a positive surprise to consensus forecasts.

Thirdly, the stellar gains of the Australian dollar are extremely unlikely to be repeated this year. The local currency gained over 60% relative to the US dollar from the 2009 lows. There is no doubt that the Australian dollar has been supported by a stronger relative growth outlook with Australia the only Western country to escape a technical recession.

This economic outperformance has undoubtedly attracted significant currency-driven equity inflows. However, there is a negative flipside. The AUD and the domestic equity market have been supported by a massive increase in global carry trade positions. The risk/reward of short US dollar positions will begin to become less attractive as the Fed moves close to a tightening cycle in rates later this year. Don't underestimate how supportive global macro trades have been of leading Australian equities over the past 6-9 months.

Finally, interest rates are expected to rise significantly over the course of this year. At the height of the global financial crisis (GFC), the cash rate was slashed to a 50-year low of 3%. Subsequently, given the strength of the domestic economic recovery, the Reserve Bank has stated its intention to return interest rate settings to more neutral levels. As a result, economic strategists and bill futures are forecasting a 1% rise in the cash rate to 4.75% by the end of the year. However, given the pressure on wholesale funding costs, the margin between the official and commercial lending rates is roughly 2-3%.

Variable mortgage rates are currently between 5.75% to 6.75%. Consequently, by the end of the year, the effective cash rate to domestic households could be closer to 8%. Therefore we expect significant interest rate headwinds for consumers, home buyers, corporates and equities this year.

Make no mistake, there are plenty of investment clouds on the horizon, whilst valuations have been pushed to full levels. It is very difficult to find any value in the markets right now.

Sovereign debt could prove to be a significant issue during 2010.

The Wall Street Journal recently published this;

“Sovereign risk: The Dubai debt default and Greek fiscal crisis were reminders that vast amounts of debt remain outstanding, with implicit or explicit guarantees from friendly sovereign nations. Will those nations be

willing to stand behind the debt? The market is betting Abu Dhabi will bail out Dubai and the euro zone won't allow any of its members to default, even if the pain spreads to highly indebted states such as Ireland and Spain. A more pressing case may be the U.K., whose fiscal position is the worst in the industrialized world and which enjoys implicit guarantee.”

We would agree that Sovereign risk is one of the biggest out there. This risk drives bond and currency market volatility. We have already had a taste of this in terms of Dubai and Greece, but what would be more serious would be a downgrading of the UK's credit rating.

We think that equity market sentiment will be held hostage to currency and bond market sentiment and we should all be watching developments in the currency and bond markets very closely particularly given so many hedge funds are using low U.S interest rates to fund carry trades in just about anything outside of the US . A rise in US interest rates in terms of rising bond yields will see profits taken in the carry trade as the cost of funding is increasing. While you would usually buy cyclical stocks as bond yields rose, this year you will see cyclical stocks fall if US bond yields rise because the US dollar will rally on that development and carry traders will head for the exit.

We also believe that the collapse in the Volatility Index (VIX) shows you genuine investor complacency and that is despite a series of potential macro events that could upset that consensus view. Similarly, equity prices are discounting great earnings expectations and are vulnerable to disappointment.

Earnings

Given the vast amount of data and news items that we must absorb on a daily basis, it's easy to lose sight of what really matters with regards to share prices. The bottom line is that earnings and earnings expectations drive share prices and day to day volatility. Results season is therefore a critical period for the market, allowing the

calibration of valuations to reality, not withstanding any accounting shenanigans that takes place.

The current US earnings season therefore has the potential to determine whether equities continue as they have done, with corrections swiftly cut short as buyers step in. Alternatively, if earnings and importantly, outlook statements, fail to live up to the heady expectations, less enthusiastic buying support could see equity markets undergo a more meaningful correction than that which we have experienced to date.

Results so far have not contained any major bombs. Alcoa did however get the ball rolling with a disappointment. The company delivered a slim 1 cent per share fourth quarter profit, compared to a loss of 28 cents in the 2008 fourth quarter. Given that 2008 fourth quarter earnings were diabolical to say the least, improving from that low base is to be expected. Alcoa's improvement wasn't enough though, with market expectations centered on a more significant recovery to around 6 cents per share.

Intel recently provided the type of result that the market is looking for from earnings season overall. The chip-maker's fourth quarter earnings benefited from a 28% leap in sales revenue, with the bottom line lifting 10% from the same period in 2009. The company's profitability also improved, with the gross margin hitting an all-time high of 65% for the company.

Of course, last year's earnings were predominantly supported by cost cutting, which saw margins expand but not necessarily a commensurate sales recovery.

Let's not forget though, the GFC was first and foremost a *financial crisis* with its origins in Wall Streets big names. A return to profitability for Wall Street is required to give the view that the worst is in fact behind us.

We are not so sure it is though... JP Morgan had earnings of 74c per share which was above analysts expectations. The bottom line couldn't mask a couple of less encouraging facts though.

The banks top line sales were not as buoyant as expected and bad debts remain an issue with management forced to increase provisions.

JP Morgan's CEO Jamie Dimon summed it up by saying; "while we are seeing some stability in delinquencies, consumer credit costs remain high and weak employment and home prices persist."

It is for these very reasons that the recovery process in the US is going to be drawn out over a longer period than what the equity market has already priced in.

Currencies

The US dollar is currently rebounding quite strongly and it appears that higher levels for the greenback are on the cards. The strength in the US dollar has hit the commodity and emerging markets very hard, so it looks as though these markets could be in for a decent sized correction. The turnaround in the dollar is bearish for gold and we could see a correction happen in the price of gold also.

Crude oil's recent breakout has failed and we believe prices could be heading back to the US\$60 a barrel range (currently US\$77.60).

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

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