Financial Markets Update

June 2013

In April 2013 the date of our last update, the financial world was swimming in a pool of optimism. The Australian All Ords was at 5,200 and the $A bought $US1.05. Defying gravity, markets were propelled forward by positive sentiment and the wall of money created by global bankers flooding the planet with liquidity. At that time, we expressed concern that such buoyant conditions were unlikely to continue. Client portfolios were repositioned to lock in a portion of the substantial gains made since July 2012. Much has changed since then.

If The Boom is Over, Where to now for Australia?

Understanding Australia's mining boom

So much has been said and written about the benefits of Australia's mining boom that messages become blurred as conditions change. Debate runs hot as to whether Australia's mining boom (particularly in iron ore) is over and will turn into a bust, or whether we are just going through a soft patch in a boom that will go on for decades, with China at its heart.

Politicians of both major parties have laid claim to their economic management abilities during the course of Australia's biggest ever mining boom since the 1850's gold rush. On the one hand the Liberals took credit for balancing the budget and on the other the ALP took credit for avoiding a GFC induced recession.

In reality, both parties failed the country by being unable to harness any enduring benefits of the boom. Personal tax cuts, the baby bonus, free insulation, $950 cash hand outs, and a botched resource tax did nothing to improve our productivity and infrastructure base, or sever welfare dependence. The latter are long-term problems which we now face, and the burden has become more onerous considering our mining windfall gains are ending.

Every Australian should be broadly aware of how our mining industry operates. Their financial future or that of their children rests on it. This brief article is intended to assist Zanacorp clients' understanding of the nature & direction of Australia's single most important global industry.

Mining Boom or Mining Bust or Something Else?

To appreciate Australia's current position it is important to have a basic understanding of how mining booms unfold. The media will have us believe that we are either in a boom or a bust. But as is usually the case, truncated and simplified messages for mass consumption lose much in translation leaving people more confused than illuminated.

Understanding that mining booms follow predictable stages from beginning to end will help us assess Australia's current position because one thing that we all think to be true, is true……without China's continued strong growth, the Australian economy is cactus.

Some Simple Facts

- In early 2003 Australia's most prolific natural resource, iron ore, was trading at $US12 per tonne. Today it is trading at $US116 per tonne peaking at over $US160 per tonne.
- In 2009-10 China accounted for 72% of all Australia's ore exports
- Mining makes up >9% of GDP but employs <2% of the workforce
- 83% of Australian mining is foreign owned, Australia benefits principally from the income generated from royalties, company/payroll taxes, mining services and employment
- Australia's Terms of Trade (buying power) is currently 65% above our 20th Century average
- Past mining booms have lasted approx. 15 years before resource depletion or economic events acted to slow growth and bring an end to the boom. We are currently 12 years into this boom.

THE THREE STAGES OF A MINING BOOM

Commodity booms, like most other booms, are unique and complex but usually have three stages. Each stage is distinct and offers particular sets of benefits and payoffs to the economy that hosts it.

STAGE I - THE PRICE SPIKE

All mining booms begin with unexpected demand exceeding available supply thereby resulting in a spike in the price of commodities. China's resurgence since 2001 was one such event. As mining is very capital intensive, with long lead times it is unable to quickly respond to unexpected demand. The resulting demand/supply mismatch forces the prices of various commodities to spiral upwards in order to ration the scarce commodity being sought.

The impact of China's demand for raw materials at the turn of the century, saw the prices of iron ore, coking coal, copper, nickel and zinc reach all-time highs sending mining company profits and more particularly their share prices through the roof.

Stage 1 ends with miners revisiting feasibility studies and seeking regulatory approvals to identify prospects for future mining developments.

STAGE 2 - MINING INVESTMENT, CONSTRUCTION & DEVELOPMENT

In the early phases of a mining boom, miners are generally sceptical of the sustainability of demand and move only slowly to expand supply.

Once convinced that commodity demand is sustainable and prices will be supported over the medium to long term, miners begin to invest heavily in new supply in pursuit of greater profits. This stage of the cycle is typically where vast capital is required to find, evaluate, plan, develop and build new mines. Capital raisings become the order of the day as mining companies and investors alike, salivate at the prospect of potential future income, profits and capital growth.

It is during this stage that employment peaks and obtaining and retaining skilled employees is most difficult. For this reason, the wages paid to mining industry engineers, surveyors, geologists, miners, drivers and all related service providers reaches dizzying but unsustainable levels. During this stage spending reaches its peak attracting a disproportionate share of an economy's skilled labour and capital resources. It is also at this stage that mine capacity expands significantly in anticipation of the future production levels required to satisfy the unmet demand.

STAGE 3 – OPERATION, PRODUCTION, EXPORT & INCOME

Once a mining project is completed it begins producing minerals for extraction, processing and export. For mining companies, this stage is the ultimate goal as it is the point where they commence to earn revenue and generate a financial return on their invested capital. The operational stage of mining produces significant economic benefits however the distribution of those benefits changes considerably.

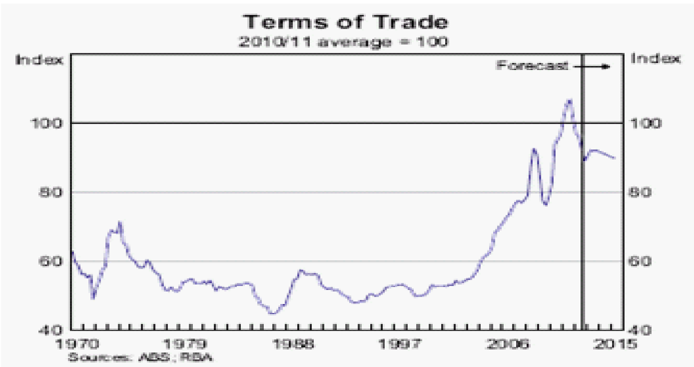
As one would expect, fewer workers are needed to operate a mine than to construct it. Thus the number of employees falls which can pose major difficulties for both the workers themselves and the regional communities that expanded rapidly in population during the mining development stage. For the people and communities directly impacted by the transition to Stage 3, managing their financial affairs and finding employment can be problematic as their circumstances will have gone from feast to famine. Unemployment will tend to rise as workers experience, pay rates & skills are not easily adapted to non mining roles.

On the other hand, the broader community begins to share in the longer term benefits of the resource boom. Investors earn dividends, State governments collect royalties, and the Commonwealth collects company taxes from the miners. Rail, road, shipping and port operators prosper. These benefits are then able to be recycled through the economy and used by the governments of the day, to distribute goods and services to the wider community.

So Where Are We Now?

At any point of time, there will be projects in each of the 3 mining stages. However the consensus view is that **many projects are approaching the end of the mining investment stage** of the boom and the Stage 2 project pipeline looking forward has suddenly evaporated**.** This has fuelled concerns about the boom becoming a bust.

With each completed project, the intensity of capital investment and employment diminishes. Fortunately, existing committed Stage 2 projects should ensure elevated mining activity continues for the next 18-24 months. There remains a massive amount of future investment yet to be spent. So the boom is not yet over, but it is moderating.



Meanwhile in the real world, with industrial shares satisfying investors' hunt for yield, mining company shareholders have become impatient as their investments stagnate and the prospect of rich dividends from the resource boom fade. Facing capital management criticism, many miners are now scaling back their expansion plans.

Over the past 12 months over $148bn in resource projects have been cancelled including BHP's Outer Harbour & Olympic Dam expansion ($50bn) and Woodside's Browse and Sunrise LNG projects ($48bn).

This has come as a shock as many of these projects were simply expected to proceed and continue to generate for years, the level of capital investment, employment and growth in Australia to which we have become accustomed and on which we rely.

Governments, mining service entities & workers are now re-evaluating the longevity and level of their future income. All downwards.

Like all booms, expectations of big profits have lead to poor decision making and poor cost control. Project delays, cost blow outs and signs that the Chinese economy is slowing down, have changed the mining industry outlook. China has suddenly changed its steel consumption pattern from a growth rate of 8 to 10% p.a. down to just 2 to 3% p.a. Only 12 months ago such a turn of events was simply unimaginable.

Darwin's Theory To Be Tested Again

As we transition from Stage 2 to Stage 3 all commodity countries and producers face a new challenge. Resembling every prior mining boom, the painfully long lead time between feasibility and production most often coincides with adverse changes in demand. Put simply, Australia and the world have increased capacity to meet all of China's (& Asia's) demands just at the time when their needs are no longer growing.

The pre-destined consequence of this timing catastrophe is that commodity prices fall steeply and quickly just as supply increases. Many miners will find themselves with total costs of production exceeding realisable prices resulting in negative cash flows. Typically, only the most efficient or most mature miners are able to keep operating costs down and extract long term mining profits (e.g. BHP and Rio iron ore cash costs are approx. $US40 per tonne, considerably below Fortescue's costs). We expect this to be the case in this cycle with China.

Perversely the very conditions that seed a boom reverse themselves to end a boom and only the most efficient or financially strong at the beginning end up profiting at the end. On a variation of Darwin's theory of evolution, we expect many inefficient high cost Chinese and smaller mining companies both in Australia and around the world will be uneconomic and will close down their operations. Over time with fewer producers, the natural equilibrium of demand and supply will be restored and prices will be at neither boom nor bust levels.

Global production volumes will increase significantly but will yield lower prices, meaning ceteris paribus (all things being equal) annual profits will not have changed greatly. Recent weakness in the $A is a welcome boost to all exporters (including our surviving miners) but more on that later.

What Are The Benefits For The Australian economy?

Stage 1 of the boom created strong profits for existing listed miners like BHP, Rio and Woodside. It catapulted the private wealth of Clive Palmer & Gina Rinhart. It produced windfall tax receipts for governments since the early 2000's and spawned a crop of new miners.

Stage 2 of the boom produced spectacular profits, wages, and other benefits to governments, companies, workers and those communities local to and directly involved in mining development. This maintained Australia's growth and stability throughout the period from 2007 to 2013 including the GFC.

Australia's mining boom is the single greatest factor that has increased our standard of living and saved us from the GFC and global recession.

The only question remaining unanswered is whether the benefits of **Stage 3** of the mining boom will continue to support Australia's economic growth into the future.

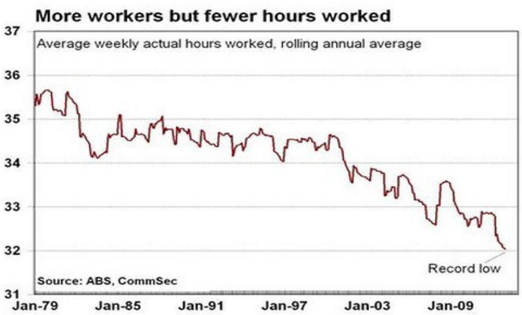
Just to be crystal clear, we do not believe the mining boom to be a mining bust. Instead, we are transitioning to Stage 3 of the mining cycle replacing blockbuster investment led growth with an annual bounty of export income and profits. This was inevitable and is good for all of us. But will it be enough?

The main difficulty we see for Australia is not the transitioning of the mining boom but rather, that much of the rest of our economy that employs the bulk of our workforce is in a poor and neglected state.

Dutch Disease

Over the last 10 years or so, there has been some serious and unintended consequences of the mining boom. Ones we cannot ignore. Australian industry, manufacturing in particular, has been "hollowed out", possibly succumbing to Dutch disease so named after the 1960's Dutch natural gas boom that decimated the country's manufacturing sector. High wages, declining productivity, high debt levels and a strong currency led to rising living standards and stimulated massive imports of goods whilst leaving local manufacturers uncompetitive.

The 1970's saw Great Britain move from being an oil importer to an oil exporter as a result of the OPEC oil shock which sent oil prices soaring. For Britain this unexpectedly made her expansive North Sea Oil field reserves commercially lucrative. This new found income and prosperity saw wages increase markedly, along with the British pound, and led to British exports becoming uncompetitive until the country fell into a recession. *Is any of this sounding familiar?*



Dutch disease does not have to end in tears. Norway, also sharing in the North Sea Oil riches managed their income boom differently from Holland and Britain (using far better planning & fiscal discipline) and today enjoys the 3rd highest per capita income in the world. *(World Bank 2008-2012 GDP per capita).*

Brazil, Canada, South Africa and Australia have all bathed in the Chinese trough. Each country has symptoms of Dutch disease.

We hope that Australia's economic decision-makers will have done their homework. We fear that the disciplines applied by Norway and its people, like Germany in Europe, will be a challenge for Australia. In those countries, industry and skilled work was and is considered a privilege and individual achievement an aspiration. Welfare is not a major cost to their nations' purse. The same cannot be said for Australia where welfare is somewhat of an albatross around our necks.

The Grattan Institute study of combined government expenditures for 2012-13 shows that in total, 22% of our entire nation's income pool is spent on welfare. Welfare spending, which continues to grow, exceeds spending on health (19%) & education (14%). It seems to be an intractable cost that no Australian government has successfully dealt with.

2013 ABS statistics reveal **around 250,000 Australians are currently turning 65 each year** increasing at the rate of 37,500 p.a. The majority of those will quite reasonably move from being contributors to our public coffers to dependants of it. They have made their contribution. But the dependence ratio, that is the number of workers to retirees, continues to decline.

We remain ever disturbed that manufacturing companies like CSR, Heinz, and Ford (to name just a few) are deciding to close their factories and export our jobs as are many service providers like QBE, AGL and our major banks. This does not augur well to replace mining jobs.

Lessons From History

History teaches us that the natural order of things is that all booms will end. That does not mean our country's prospects are poor as much as it means that as a nation, we will need to work much harder to maintain our current standard of living. We need to refocus on those industries where we can successfully compete in the global economy. Outside of long term mining interests, traditional industries like agriculture, tourism and education capture Australia's best prospects. Although health services is our fastest growing industry, it is not one we want to be. Put delicately, caring for our sick & aged is the least we can do as a society, but it will not maintain future living standards.

The mining boom stirred by China's urbanisation has successfully taken us to where we are, but that is more a function of good luck than good management. We have enjoyed our share of "free kicks". After all, it was not man that put minerals on our continent, and your writer will admit to having never dug an ounce of ore in his lifetime or known anyone who has. Do you?

Our take on Australia's economy generally is that investors should remain attentive and mindful of the winds of change. Be prudent in your borrowing and frugal in your spending over the next 12 months until our economic path is more visible. Do not anticipate massive investment market returns.

Unemployment Rising

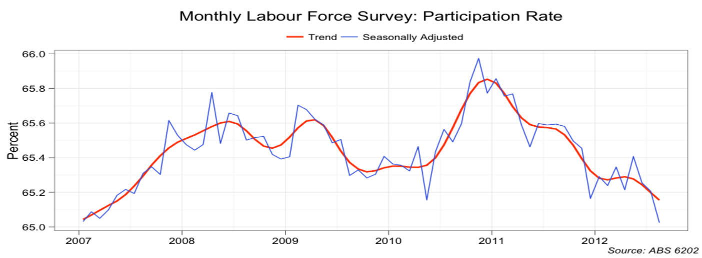
For the 1st time since the GFC, unemployment poses a real threat to our economic well being and any breach above 6% will signal a serious softening in all sectors of the economy including all non-mining sectors of lending, spending and housing. There will be few safe havens.

Across our diverse range of business clients, we have been told without exception that conditions are difficult in the non-mining goods and services and retail sectors, especially over the last 3 months.

Although our experience is only anecdotal, national accounts figures continually show that although more people are working than ever before, the participation rate and hours worked continue to trend down.

Of all things economic, the measures that we view as the barometer of a country's wellbeing are those relating to the health and productivity of the labour force. For this reason, we are more watchful than ever of the "canary in the coal mine". Labour is the lifeblood of the economy and the source of all production, income and spending. It underpins everything we take for granted from a healthy government, to a good lifestyle and even the price of our homes. Look at those countries in the world struggling and where house prices fell. There you will see high unemployment rates, especially in the 18-35 year age brackets.

We are not convinced Australia's future employment prospects are poor, but neither are they strong. A legacy of the mining boom is that Australia has become a high costs country in which to do business. Our challenge may lie in adopting & accepting structural industry change.



Our conclusion on Australia's overall growth (GDP) prospects is that with continued strong exports, we are unlikely to enter recession. We do however suspect that, domestically, it may feel like a recession. Rising unemployment, fuel & energy costs and inflationary pressures from imports will all bear down on local consumers and demand.

China's Credit Boom and Shadow Banking System

Most investors will be unaware of the recent turbulence in the Chinese interbank lending rate. In the first evidence of financial stresses in the world's second largest economy, the seven-day interbank lending rate increased from 3% to over 12% in 21 days. The cocktail of market driven hot property prices coupled with banking/credit stress is disturbing.

Many respected economists dismiss these observations as the product of Western eyes not understanding Eastern culture or a lack of appreciation of the scale of China's urbanisation program. We feel the better view may well be that ***where there is smoke there is fire.***

Extreme credit cost volatility indicates that all is not well. Reminiscent of the FED panic in the midst of the GFC crisis, the Peoples Bank of China released a mind numbing supply of liquidity in order to stabilise rates and pacify markets. Rates have since reduced to around 6%.

Supporting the more bearish view of China, Fitch recently lowered one of its key ratings on Chinese government debt with warnings about a credit build up that has ballooned at an annual rate twice that of GDP growth. They commented that "risks over China's financial stability have grown" eluding to concerns over China's shadow banking system. This is the first downgrade of Chinese debt since 1997 the period of the Asian currency crisis.

The lifeboat for both us and the rest of the world is that China has a virtually closed current account and the banking system draws its funding from domestic sources. This means that for China a global "GFC style" collapse is most unlikely. Nevertheless, we remain on notice.

What now for the Pacific peso ($AUD)?

The convergence of Chinese weakness, deteriorating sentiment & domestic conditions, political uncertainty & recovering US economy have delivered a swift vengeance to our currency and re-rating of its risk.

Only months ago, economists were expecting an above parity $A for the next decade. Yet within 6 weeks the dollar has fallen 13% causing havoc to the pricing policies of importers of all goods and services.

As described in our April newsletter, the flight of capital from our markets, high yielding equities, and our currency has occurred in a heartbeat. There is probably more downside yet. Improving data from the US has led to an $A exodus of institutional "hot money". We were a safe harbour for the vast sums of global liquidity searching for a high yield home during the GFC torrent of volatility. But not any longer.

We should not fear a lower dollar but rather we should embrace it. For the first time in years, our local manufacturers, our farmers, our miners, our tourist industry and our educational institutions will benefit from the currency rather than be its victim. These are the industries which can support the economy and create jobs in the future. If the price we must pay to retain home grown jobs is to pay more for our TVs, toys and trips then so be it. Look for the $A to have an "8" handle.

QE Tapering - It Is Actually Good News

You would think that news of a US economic recovery and falling unemployment levels would be viewed positively by markets. Not so. Paradoxically, weak data is currently being seen as favourable since it eases the fear of QE (money printing) tapering. Markets are so hooked on the cheap & plentiful supply of liquidity from years of QE that they fear even the thought of just winding down the rate of the stimulus.

The immediate market response to QE tapering has been a lift in long term interest rates, a rise in the US dollar and falling equity prices. **Gold has retraced all the way from $1,900 to $1,225 an oz.** Ouch!

Cautiously, we believe markets will get used to the tapering of QE and recognise that a recovering US economy is fundamentally better for all asset prices than FED support. Investors simply need a bit of time to get used to the crazy notion that **a return to normal monetary conditions is good.** We see QE withdrawal if well managed, as a big positive.

2012 –13 MARKET WRAP

Australian Shares

The Aust All Ords capped off the year up 15% with the ASX 200 up over 17%. High yield and defensives like healthcare, telecoms and financials were the highlight. This year investors threw materials and resource related small cap stocks into the sin bin. We see mid-high single digit returns in the year ahead with rotation from defensives into beaten down cyclicals. $A exposed businesses will continue to be favoured.

International Shares

The standout asset class this year was international shares. Most markets delivered 12%-20% returns and the drooping $A added an extra 10% on top of that. Having consistently recommended this sector, we have enjoyed showing clients this hidden gem in their portfolios with our preferred overseas share and infrastructure funds delivering unparalleled performance. Expect 2014 unhedged returns of 6%- 10%.

Think you know Europe? Well it just got bigger! Croatia joins the EU on 1st July as the 28th member nation. Even so, the region still struggles with rising social unrest. Think volcanic eruption - things may explode.

From the Market Facts table below, you will notice Japan's Nikkei has increased by over 51% since 2012. Wow! That's Abenomics "3 Arrows" plan at work - monetary easing, govt spending & structural reform.

A-REITS

Yet again Westfield and most major diversified A-RIET funds delivered returns over 20% driven by the hunt for yield. Annual income returns of around 5% - 6% from conservative A-RIETS are attracting those retirees favouring income. Contrasted with sub 3% net income from illiquid direct residential property investments, it is easy to see why. Facing the headwind of rising bond yields look for returns of 4.5% - 6.5% in 2014.

Cash & Interest Rates

Difficult to call at the best of times, short term interest rates look likely to drift lower to support the struggling domestic economy. Pre-retirees have been single minded in their desire to reduce debt. Even maturing Gen X'ers are starting to address their much higher levels of debt.

A by-product of deleveraging is subdued consumer demand. Clients may recall our piece on the Paradox of Thrift. This phenomenon is playing out in many discretionary retail sectors which are struggling, except for cafés, restaurants and the o/s travel sectors that continue to boom.

Since we expect unemployment to rise over the coming year, we feel **the RBA will leave rates on hold with a bias to ease**. Younger home borrowers are again being afforded a leg up, while retired risk averse Term Deposit investors get used to a diet of bread and water. For now.

REVISED SUPER CONTRIBUTION CAPS & SG NOW 9.25%

Legislation passed on 25th June, 2013 provides that from 1st July 2013, the super contribution limit for total pre-tax and SG contributions is capped at $35,000 for all taxpayers over 60 years of age and $25,000 for all other taxpayers. Compulsory employer Super Guarantee increases from 9% to 9.25%.

MARKET FACTS	June 2013	June 2012	June 2011	June 2010	5 Yrs Ago 2008	7 Yrs Ago 2006	10 Yrs Ago 2003	15 Yrs Ago 1998
Australian All Ordinaries	4,775	4,135	4,660	4,325	5,333	5,034	2,999	2,688
Dow Jones (US)	14,909	12,880	12,414	9,774	11,350	11,150	8,985	8,997
FTSE 100 (UK)	6,215	5,571	5,945	4,917	5,626	5,833	4,031	5,884
Nikkei (Japan)	13,677	9,008	9,816	9,382	13,481	15,505	9,083	15,830
Hang Seng (Hong Kong)	20,803	19,441	22,398	20,129	22,102	16,627	9,577	8,543
Dax (Germany)	7,959	6,416	7,376	5,965	6,418	5,683	3,221	5,934