ZANACORP

Financial Markets Update

June 2010

Successful investing demands optimism in the long run, in order to enjoy the superior financial rewards offered by capital growth assets like shares or property, over cash. However, there are some periods of time where caution is called for. We believe we are in such a period.

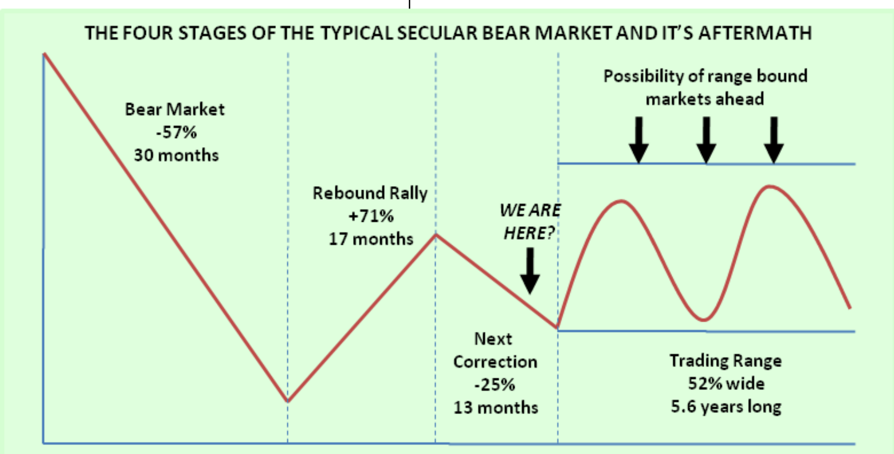
A World Unprepared For What Lies Ahead

The digital life of the 21st century is lived at a frenetic pace. The younger you are, the greater the demands. People interact with each other via instant SMS, email, social networking and telephony services available anywhere, anytime. The world is now delivered "on demand" and users have become accustomed to being in control of their "experience". A walk down any street will find someone listening to their favourite MP3 seemingly oblivious to the outside world. They turn their experiences on and off at will with a button.

We have observed the availability of instant information (not to be confused with knowledge) on any subject has led to an expectation of instant response, instant outcomes and instant solutions. The key element in this observation is "expectation". In investment, as in life, the point of satisfaction is usually measured by one's level of expectation. If we expect a 7% return and obtain 9%, investors are generally satisfied. But had the expectation been 14%, a 9% return would be a poor outcome.

Similarly, expectations of a problem being painlessly fixed in 12 months can lead to extreme discontent if it takes 3 – 5 years.

The GFC is that problem and its impact on the global economy is far from fixed. It seems inevitable there will be more pain. Unexpected pain.



Source: Teun Draaisma, The Aftermath of Secular Bear Markets, 10 August 2009

The Consumer King

Over time, consumerism has elevated people's expectations of life & shortened the time allocated to reach those lofty expectations. Debt (credit) has been the driver of this trend putting unlimited buying power in the hands of the individual. Economies are now dependant on consumer spending & credit to function "normally". The GFC showed the effects of what happens when credit is suddenly frozen.

For the western world, decades of relative peace and prosperity have increasingly led to an appetite for the good life and less tolerance of the toils of life. Worryingly, the availability of instant credit and debt funding to finance lifestyle and asset purchases has been woven into our current way of life. Patience (for anything) is no longer a virtue but rather a remnant of an earlier era, and "saving for a rainy day" just sounds silly.

Although unspoken, nearly all investors really want to believe THEIR investments can generate consistently strong returns and be insulated from the volatility that concerns EVERYONE ELSE. Put another way, people hope to ***beat the market***. The bad news is that we are all in this together, enjoying the good times & dealing with the bad.

Despite simplistic TV ads, investment returns alone won't provide a comfortable retirement or make up for years of low savings & over spending. This is epitomised by the current economic malaise faced by Greece and the other "Club Med " nations.

Closer to home, the "borrow and buy" mentality drives people on modest incomes who don't own the house they live in, to borrow aggressively to buy another. It is a "sure thing". This high risk strategy is supposed to be the "fast track" to create wealth, but is it? Leveraging has been used for centuries and created both wealth and poverty. More recently in the world, it is poverty. Heard the one about the hare & the tortoise?

We suspect the frustrating highs and lows in economic conditions over the next 2-3 years will test views of people who believe they are in control of their lives and demand far more patience from investors, both young & old alike.

All Zanacorp clients will know that we value patience as one of the cornerstones of successful investing. Our great challenge today will be to assist people to continue to value, understand and have confidence in this investment principle in a world that has forgotten it.

Life's pace may have increased, but the path to investment success remains unchanged. There is no short cut to creating wealth and no website with a 10 minute video condensing the collective knowledge of the ages into a YouTube presentation. It takes time, discipline and patience, which is increasingly difficult to ask of people.

Most of us have lived through challenging times like this before. Remember the 1970's stagflation era, 1980's stock market crash, the 1990's "recession we had to have", the 2000's dot com bubble, the post 9/11 and Iraq invasion? These were troubling economic periods with the wounds now healed by time. People panicked during these events, but have forgotten. As we go forward, keep in mind the measured approach we took with your investment portfolios and the investment success we later enjoyed. Events this time will be different, and yet the same. We would ask clients to resist the urge to "dash for cash" because the fear created by the media, the internet and the plethora of "noise" overwhelms you.

We suggest you go about your life as normal managing your income and being sensible with your spending. Treat the path ahead as just another chapter in history. We'll have a wall chart for this "blip" in 5 years time which will put the turbulence in it's correct perspective.

Each day we are typically asked for our forecasts of investment markets (aka "what return will I get this year?") as if this is a simple question with a simple answer. After all, investment advisers are supposed to have all the answers and Alan Kohler can do it on TV in 2 minutes. Unfortunately, it is not that simple.

With the global economy shrouded by uncertainty, all investors will need to endure an extended period of anxiety. Are you prepared?

The share market is one of the few places where you can have a fire sale and expect no-one to turn up

The Global Financial Crisis - Act Two

As we have consistently stated over the past 12 months, we believe the economic and investment world will traverse a somewhat "W" shaped recovery. That said, our expectations 2-3 years out are for stronger, more sustainable markets supported by real economic growth and sounder economic fundamentals than exist today.

The diagram on our front page illustrates a simplified pattern of human (market) behaviour following periods of economic shock. It is based on actual data over 19 episodes and serves as a sample guide of what may come. A picture paints a thousand words.

After a temporary time of euphoria, markets have once again turned their gaze to the scattered underlying problems of the global economy. With little forward visibility markets are naturally volatile and investors scared. This is a necessary and unavoidable part of fixing the problem and may last for 12-24 months.

Make no mistake, the 2008/09 GFC and its aftermath is not an ordinary cyclical recession to be followed by the usual cyclical recovery. It would be foolish for investors to optimistically believe we are out of the woods.

Over the past 18 months, the world has experienced a once in a lifetime economic event. In the developed world, including Australia, private debt has been swapped for public debt in order to avert a global depression.

This is not an overstatement of the facts. Interest rates were slashed to ensure over geared home owners and speculators were not destroyed along with the banking system that provided the debt. Although we genuinely believe the worst is behind us, the path to a sustained recovery is only just beginning and will cause some financial discomfort for everyone.

In hindsight, the response to the ***GFC - Act One*** was straight forward. Engage a co-ordinated effort by all sovereign nations to spend.

GFC - Act Two is not quite so simple. Credit markets have repriced risk and rationed credit. This has led to some nations being forced to balance budgets and introduce austerity measures (echoing the 1930's) whilst others continue to spend and support their fragile economies to avoid a "double dip" recession. Mmmm, can both approaches be right? So much for us all learning lessons from the Great Depression!

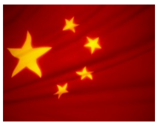
The situation is best explained by a brief economic overview of the various global centres. What follows may seem daunting and fearful but we believe the new reality facing the world has both the sickness diagnosed and the cure in development. It will just take time.

Our views should be contrasted with those of many reputable advisers who are far more optimistic and aggressive when allocating their clients' funds. At present in deeply uncertain times, we prefer to tread a safer path for you, our client.

European Credit Crisis & Austerity

The widely reported severe sovereign debt woes of the PIIGS (Portugal, Italy, Ireland, Greece and Spain) are a direct consequence of weak governments bailing out their hopelessly indebted citizens. The Eurozone and its unified currency has for the first time been tested, with Germany and its taxpayers being asked to shoulder most of the burden for its profligate neighbours, by providing more loans.

The PIIGS together with the UK and Japan, are dealing with the compound difficulties of burgeoning government debt, falling government revenues, rising health and welfare costs and ageing populations. Each is introducing austerity measures to deal with these issues, however the impact of these policies will create serious headwinds for future economic and employment growth. In other words, the "medicine" needed to restore balance will tend to make things worse before they make things better.



China - Growth, Spending & Lending

The world is looking to China to lead the way forward to global stability and growth as it once looked to the US. We believe this will happen but not in the way it is expected. China is a growth story of the future with an ever rising level of income being distributed to a massive population that has been denied prosperity for centuries. In time, China will provide the world with many affluent consumers of global goods and services, but not just yet. China will endure growing pains on its path to power and we feel these pains are close at hand and may disrupt confidence for a short period of time.

The European slowdown is having a considerable impact on the Chinese balance of trade since the EU is China's biggest customer. A protracted European downturn will ultimately affect China's production levels and together with the US slowdown, impair China's trade surplus, income and growth. Given our reliance on a growing China, we should hope Europe's difficulties are short lived.

To offset the GFC, China (not the US) embarked on the world's biggest economic stimulus package incorporating both fiscal and monetary policies to support all sectors of their economy. These measures have proved to be very successful in maintaining Chinese growth but have contributed to overcapacity, inefficient capital allocation and a US $1.7 trillion lending boom in 2009 increasing fears of a Chinese property bubble, not unlike that in the Western world in 2007. Views differ widely on whether there is a Chinese "bubble" or just rising incomes leading to rising house prices. Clearly, a lot depends on the answer to this.

The excess liquidity in China was made available at the same time as Australia relaxed (abandoned) the regulations governing overseas buyers of Australian residential property. This has led to a flood of overseas, particularly Asian, buyers of our properties crowding out local investors and raising prices. With Australian property "cheap" compared to China/Asia this meant that our pricing metrics have been distorted by the "hot" money from overseas. Any reversal in this trend or repatriation of profits will lead to a quick and severe correction to the Australian residential property market.

Eerily, the spill over effect of the Chinese boom strongly resembles the 1980's Japanese property boom. For those clients old enough to remember, the 1980's was Japan's zenith of economic might resulting in massive trade surpluses and domestic savings matching the China of today. In the 1980's Japanese companies led a global splurge of property buying. Large tracts of Queensland real estate and luxury resorts were purchased by the Japanese because they were cheap relative to Japanese assets. Of course the bursting of Japan's property bubble in the early 1990's led to fire sales of their global property holdings and prices collapsed both in Japan and globally. It is widely held that Japan's "lost decades" between 1990 and 2005 were seeded in the environment when they appeared invincible and money was freely available for domestic and global investment.

Quite correctly we should distinguish 2010 China as different from the Japan of 1980's. But by the same measure, Japan's greatest explosion of debt fuelled growth happened after the 1987 stock market crash, just as China's has begun after the 2008 crash. Weak global growth has rarely provided export led economies with high levels of sustainable income. Anecdotally, there are literally millions of vacant debt financed apartments in China, fuelling the speculation of an overheated property market or even a bubble. Time will tell.

US Economy - Drawing From Past Strength

Much is written of the dire position of the US economy, the biggest in the world. Whilst we could focus on the familiar government debt, soft housing market, healthcare and demographic problems, we prefer to focus on the flip side of that coin.

The US is now well advanced down the path of deleveraging, moderating consumption and downward asset valuation adjustments at the household level. Unemployment, whilst high, has most likely peaked and hours worked/income generated is on the rise again. Corporate America is in sound condition with profits having recovered strongly as a result of swift cost control and severe shedding of labour.

We do not underestimate the commitment of the US administration to re-engineer the economy into one that is more export oriented, less dependent on fossil fuels and importantly driven by commercially successful innovation.

Twelve years ago, Google was a word few people had heard of, today it is a US based global titan turnover of over AUD$30 billion and after tax profits of over AUD$10 billion.

Nine years ago, unless you were a computer geek or graphic designer, an Apple was something you ate. The computer company was barely known and nearly worthless. Today an Apple is what over 150 million people live with and use every day. From the first iPod in October 2001, the company now generates annual global sales in excess of AUD$50 billion (equalling that of BHP).

In addition to these relative newcomers, of Fortune 500's 2009 listings, 32% of the biggest 50 companies in the world are US based and they account for over 50% of revenue. This is a powerful pool of resources from which the US can launch a recovery.

We do not wish to appear light handed with the current US economic problems, but it requires little imagination to envisage the US will continue to develop higher level intellectual property assets in the areas of their natural competitive advantage of software, IT, pharmaceuticals, entertainment, food and beverages.

These potentially new assets create new income and generate new taxes. The US has dedicated vast sums to the development of efficient fuel cell technology in the pursuit of their holy grail, a commercially viable electronic/hybrid vehicle. Successful development of such a technology would be a game changer in the path of the world's future and is not beyond the capacity of America. On the 29th June, 2010 Tesla Motors conducted its IPO. This is the 1st of any commercial "electric only" motor vehicle manufacturers with more to come.

In an effort not to repeat the failure of the 1930's, the US continues to adopt its "spend to grow" fiscal strategy. To date, the result has been a jobless recovery and a US $12trillon debt. Eventually it will be critical for the US economy and growth to create new long term jobs and grow income in order to address public debt issues.

Australia—Riding on the Dragon's Back

We believe Australia to be one of the more robust economies in the world. Although we display many of the "bad" habits of the fallen Western economies (too much debt, not enough savings) we earn our income from the growing Asian region. Notwithstanding the fact that Asia/China will experience problems from time to time, possibly severe ones, there is no doubt in our mind that in the longer run our geographic location and abundant natural resources will assist Australia to prosper for decades.

We currently see 3 major short term risks which may derail the Australian economy and/or compromise Australian investors.

Firstly, no matter what the state of our economy, our financial markets will follow overseas markets particularly the US. Weakness overseas will lead to weakness here. It is basic market psychology that fear and optimism are contagious and indiscriminate.

If the Dow should fall 10%-15% from current levels, it is very likely so will our markets. Under such circumstances, rational investors must determine whether prices reflect values. If prices fall below value (as in 2009) astute investors will be able to discretely acquire quality assets at discounted prices. As always, we would aim to advise clients to "buy in gloom", difficult as that may be. Falling prices though, will bring will create anxiety and remind all investors how little control we have of prices and yet how much we rely on prices for comfort and security.

Secondly, but more importantly, we are vulnerable to a residential property market correction. We do not presently see a trigger to prick the bubble as interest rates are still very low and employment is strong. These two factors critically underpin current Australian property prices as does the unabated supply of easy bank credit.

More likely, we see the threat coming from overseas either by way of a bursting of the Chinese/Asian bubble (?), which would cascade into a series of severe economic shocks for Australia. Should China "catch a cold", Australia would quickly suffer from falling commodity prices and taxes, lower income and employment and a credit/currency crisis all at the same time. Considering this actually happened, albeit briefly, only 15 months ago, people should not consider this risk to be improbable although we consider it unlikely.

Alternatively, Australians could just wake up one day and simply come to the realisation that housing debt and home prices at nearly 7 times household income are too high. The US subprime debt was recognised as problematic for years before it became the detonator of the Western world property crash that led to near meltdown of the global financial system.

Jeremy Grantham, co-founder of GMO and a global market observer who has correctly identified asset bubbles as far back as the 1970s made the following comment on the Australian property market:

> ***"Bubbles have quite a few things in common, but housing bubbles have a spectacular thing in common, and that is every one of them is considered unique and different" (Housing Market a 'Time Bomb', says Investment Legend, The Australian, 16 June 2010)***

For the record, in 1990 there was a severe land shortage in Tokyo, just before prices plummeted by well over 50%.

We would not anticipate anything like the 30%- 50% price falls in the US, UK, Spain etc to occur in Australia. There are genuine complex structural imbalances here that cause price distortions. Nevertheless, a return to levels of 2008 would imply a 15% - 20% decline. If this were to occur, every new home buyer in the last 2 years would have seen their equity evaporate and home loans might finally be a little harder to get.

Falling house prices and tighter lending would undoubtedly impact consumer spending patterns and employment & voila, Australia will join its Western counterparts wondering how this could ever have happened because "property prices don't fall" and we are different.

To ease concerns, homeowners with little or no debt should not be worried as their house is not an investment it is simply the place they live in. Homeowners with unmanageable debts should be considering strategies to reduce their debt in order to ride out any storm. But after all, we all have to live somewhere.

Our Message - Be Alert Not Alarmed

Asset prices & investment returns are beyond the control of any individual. None of us determine the price of BHP or for that matter the price of our house. These are set by markets made up of many forces and many people, some informed and some not.

We anticipate the next 12-18 months may bring waves of fear that will grip the markets from time to time and send prices down. If this should happen, it will be important to remember the difference between "price" and "value". Good investors make their money when good assets are mispriced and poor investors lose it. In the calmness of today, keep in mind that quality assets, both shares and property retain their value over time even though their price may fluctuate.

***"Look at market fluctuations as your friend rather than your enemy, profit from folly rather than participate in it"* Warren Buffet**

Expect investors to react impulsively to volatility and uncertainty and seek the refuge of cash and term deposits, selling their growth assets at deflated prices. But don't join them. As we have said many times, this is usually a mistake as when markets recover (and they always do) they often produce returns of 25%-35% in a year, quickly overcoming the 5%-6% p.a. returns from cash. This is where patience can be converted into money.

It would be nice for investors to be able to bypass the anxiety of 2-3 years of volatile markets. Unfortunately reality is not a movie and there is no fast forward button. But the story will have a good ending.

Market Commentary

Interest Rates and the Australian Dollar

Depending on the state of China, we see two extreme possibilities with Australian interest rates & currency levels.

Should China continue to grow strongly and carry us with them, the dollar will remain firm and interest rates may rise by a further 0.5%-0.75% over the next 12 months.

On the other hand, Chinese weakness would see all bets on hold with the A$ under pressure and employment weakening. Under these conditions, interest rates would be left on hold for an extended period and possibly fall if sentiment deteriorated sufficiently. We rate the odds of the latter outcome at more than 50%, but without total conviction to that view.

Australian & International Shares

In 2010 most share markets around the world recorded their best performance in 3 years. With all markets peaking around April 2010, they settled well off their highs at 30th June having posted the following returns for the year:

Australian All Ords	8.7%
US Dow Jones	15.7%
Japanese Nikkei 225	(5.8%)
Hong Kong Hang Seng	9.5%
German Dax	24.0%
UK FTSE 100	15.7%
China Shanghai A	(18.9%)

As if markets did not have enough economic data to absorb, the environmental and financial hazard resulting from the BP oil spill in the Gulf of Mexico and the Resources Super Profits Tax (RSPT) are also weighing on the minds of investors. Markets have much to absorb.

Broadly speaking, we see the Australian share market trading in a range of 3,800 - 5,200 (+/-15%) until we see a clearer picture of global economic growth.

Overseas markets will similarly swing wildly in a +/-20% range with potential periods of panic selling on bad news.

Listed Property Trusts (AREITs)

AREITs have recovered significantly over the last 12 months with the index rising by 12% and outperforming the All Ords.

The sector is still in consolidation mode having substantially completed its capital raising cycle in 2009. The market leader, Westfield, continues to be well placed to develop its global property portfolio with the comfort of over $7billion in cash. With GPT, Goodman Group and Mirvac continuing their "back to basics" strategies, we are quite comfortable with the NTA discounts and rental income streams going forward and would accumulate holdings over the year ahead.

Residential Property

For the time being, our detailed global commentary should provide readers with our view on residential property. There are many complex demand/supply factors at work which point to conflicting conclusions.

The momentous rise in property prices over the last 12 months leads us to believe the end of the boom is sooner rather than later. Last year we warned that 2009 would be similar to 1989 and we continue to hold that view. The property market will be highly sensitive to jobs data. As long as there are jobs, people have income to spend and meet their mortgage commitments.

MARKET FACTS	**June 2010**	**June 2009**	**June 2008**	**June 2007**	**5 Years Ago 2005**	**7 Years Ago 2003**	**10 Years Ago 2000**	**15 Years Ago 1995**
Australian All Ordinaries	4,325	3,948	5,333	6,310	4,229	2,999	3,258	2,017
Dow Jones (US)	9,774	8,447	11,350	13,409	10,374	8,985	10,477	4,556
FTSE 100 (UK)	4,917	4,249	5,626	6,608	5,109	4,031	6,313	3,315
Nikkei (Japan)	9,382	9,958	13,481	18,138	11,584	9,083	17,411	14,517
Hang Seng (Hong Kong)	20,129	18,378	22,102	21,772	14,201	9,577	16,156	9,207
Dax (Germany)	5,965	4,809	6,418	8,007	4,583	3,221	6,898	2,084