Investment Market Update
Issue 38 - Autumn 2010

Welcome...

This is the 38th edition of CIPL's investment Market Update. The first couple of months in 2010 were subdued, but March and April saw a convincing resumption of the market's upward trend. There have been other positive signs for client portfolios. In particular we note that over the half year reporting period, most companies held or increased dividends. This is very pleasing news and suggests that the dividend downgrade cycle has passed. Higher interest rates and narrowing credit spreads will assist hybrid and fixed interest valuations, and the level of takeover activity is encouraging.

We hope you are using our website to your advantage. All clients are provided with a log-in, and if you don't have one, or can't find it, please contact us so we can re-issue it. Not only can you view your portfolio, you can also receive recommendations by email, and accept or reject recommendations on-line...not to mention a "swag" of interesting articles on finance related topics.

Welcome to Iain Wilkinson who joined us from Suncorp Business Banking as a trainee advisor in Rockhampton.

Read on...we hope you enjoy it.

Regards
David French
Managing Director
Senior Investment Advisor

A SOLID START TO 2010

Continued economic improvement bodes well for Australian investors...

One of the perils of modern day life is the constant deluge of information – television, radio, newspapers, the internet, now even emails and video on your telephone – it can sometimes be difficult to filter out the 'noise', to try and form some perspective on what is truly happening in the world around us.

Take the daily movement of the stock market. Every evening, at 5:30, 6:30 and again at 7:30, we get to hear about the performance of the market index and the individual changes for a handful of specific companies. Up today, down tomorrow, flat yesterday…it's sometimes hard to gain a sense of the overall picture, the well-known saying "can't see the wood for the trees" immediately springs to mind.

So let's step back a bit and look at the broader picture. How are we travelling?

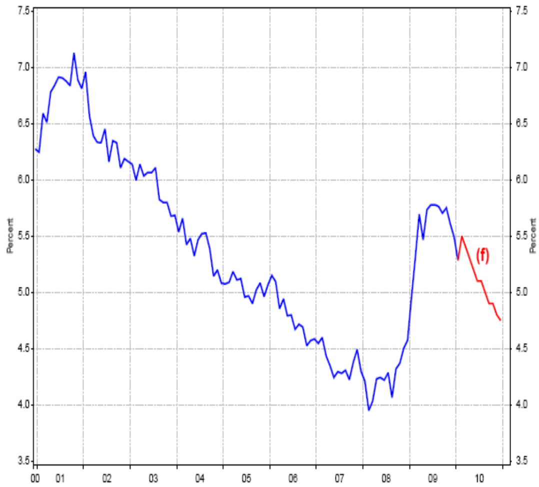
The clearest sign of an improvement in the financial world has been the performance of the stock market over the past 12 months. From the end of March 2009 to the end of March 2010, the ASX 200 index has increased by 40.67%, albeit measured against a prior period of very poor returns.

However, by its very nature the stock market is a useful forward-looking indicator - we invest in companies in the expectation of future returns, not on the basis of past returns. A rising market is usually an indication that economic conditions are improving, with expectations of increased company earnings. Already we have seen several companies increase dividend payments to shareholders.

A wide range of macroeconomic indicators confirm what the stock market is telling us:

- GDP growth is accelerating – Australia was the only developed nation not to enter into a recession during the 2008/09 period and the Reserve Bank (RBA) expects GDP growth to be around 3½% for 2010/11, an exceptional outcome given the global situation just 12 months ago (source:http://www.rba.gov.au/publications/smp/2010/feb/html/eco-outlook.html).

- Unemployment, also closely watched by the politicians in Canberra, is falling fairly rapidly as employers hire new staff to expand their businesses and operations (see chart below).



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In fact, unemployment is one area in which the economy might be doing just too well – a continued fall in the unemployment rate usually results in upward pressure on inflation, which is an unwanted by-product of healthy economic growth.

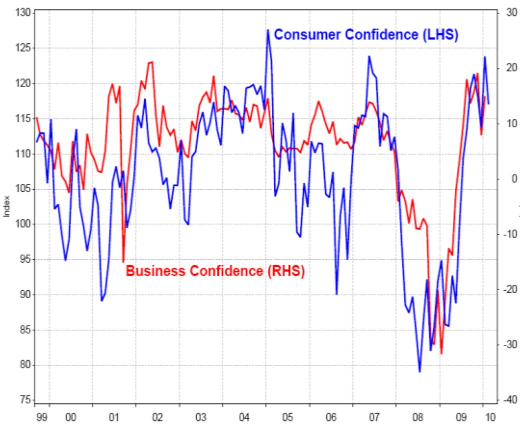
Interest rates too are headed in the right direction – upwards. Don't be fooled by politicians who promise to keep interest rates lower than the other party. The only way you could keep interest rates permanently low is to ensure that we are in a permanent recession.

The Reserve Bank generally increases interest rates when the economy is growing strongly and higher inflation could become a problem at some point in the future. Recently the RBA has changed tack slightly and is attempting to take some of the wind out of the residential property market, but this is really only a sideshow to its ongoing goal of keeping inflation within the target range of 2 to 3% per annum on average over the course of the business cycle. We are carefully monitoring the effect of interest rate increases on client portfolios, and expect to start repositioning portfolios once official rates reach about 5 per cent.

A further indication of a general improvement in the overall economic situation is the rapid rebound in consumer and business confidence (see chart below).

AU Consumer/Business Confidence

Back to pre-crisis levels



You may recognise the confidence chart, as it is one we often show and discuss in newsletters and client presentations. This is no accident – consumer and business confidence levels are critical components of a modern-day economy.

Low consumer confidence levels translate directly into fewer economic transactions such as travel, shopping, eating out, and building or buying a house. And every one of these foregone transactions is less money in the hands of a business, which then results in the business laying off staff, reducing opening hours, cancelling expansion plans or any one of a range of tough decisions.

High levels of consumer and business confidence are essential if we are to see sustained economic growth.

So from a broader perspective, the Australian economy is in good shape and few major concerns exist. Solid financial regulation, prompt government action to boost economic growth and our highly-desired resource wealth, have all worked together to underpin Australia's economic position.

…But problems in Europe remain a real concern

As we have alluded to in recent newsletters, client meetings and presentations, the primary risks to the global economy emanate from significant government debt levels in Europe, and the United States to a lesser extent.

Recent news has been dominated by the problems in Greece in particular, with extensive discussion over whether Greece would default…would the Euro survive…will there be a bailout? Greece's position is not unique – to some extent the same problem exists in Ireland, Italy, Portugal and Spain.

An understanding of the problem requires a brief summary of the sequence of events that have led to Greece's dilemma.

Starting back in 1999, the establishment of the Euro allowed countries such as Greece to swap their relatively weak currencies for a more stable and stronger currency (which was largely backed by Germany and France).

This allowed Greece to generally embark on a spending spree, pushing the government into a very high level of debt - a 2009 budget deficit of 12.7% of GDP, with total debt of 113% of GDP (though it must be said that some of this spending were stimulus measures to reduce the effect of the global financial crisis).

This poor financial management was exacerbated by revelations regarding Greece's use of complex financial instruments to hide the true extent of its rapidly deteriorating debt position from European Union regulators.

Fodder for cartoonists as Greek government debt reaches record levels

As it became apparent that Greece would be unlikely to be able to repay its mounting debt levels, global bond markets reacted by demanding impossibly high interest rates for any further lending to Greece.

The problem Greece faced was that it couldn't simply print money to repay its debts (as has been done many times in history, most recently for example in Zimbabwe), as it is tied to the Euro and Greece does not have the ability to just print more Euro's (the supply of Euro's is controlled by the European Central Bank).

Greece was thus faced with a number of very limited options:
1 – default on its existing debts, with catastrophic consequences for its debt rating and future ability to borrow;
2 – exit the Euro and go back to a heavily devalued drachma (the Greek currency prior to the Euro); or
3 – slash spending and unveil a range of severe austerity measures to get the budget back into the black (political suicide for any government, in addition to a likely prolonged recession)

As Greece seemed unwilling to wholeheartedly embrace either Option 1 or 3, for a while it looked like exiting the Euro might be the final outcome.

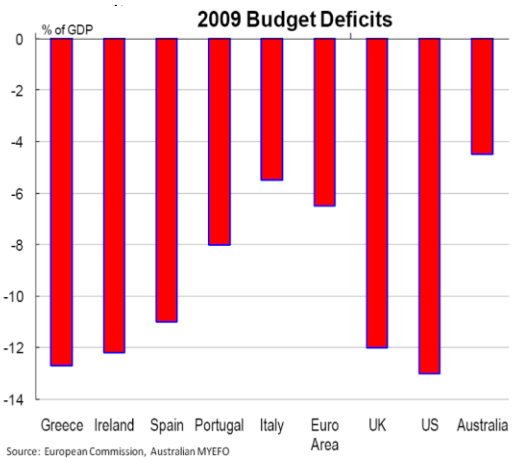
As it turns out, the potential for the destruction of the Euro became too high for Germany and France (the principal architects of the Euro and the EU) to contemplate, and an EU-led bailout of Greece was cobbled together. Greece would be able to access low interest loans of up to $65 billion through the EU and the IMF, averting the need to default or exit the Euro.

Credit and stock markets around the world reacted positively to the news that an agreement was reached, though the challenge facing policy makers is that the Greek solution is only a temporary one – what will happen when the bailout package runs out? What about Italy, Portugal or Spain?

In the end sustainable solutions to high government debt levels in Europe must be found, and the only long-term solution is most likely Option 3 – an option however which few elected politicians have the courage to accept.

Australia, on the other hand, has little in common with the experience of much of Europe. Despite media commentary and political sniping, debt levels of the Australian government are not a cause for concern.

The chart below shows the relatively strong position of the Australian economy with respect to government budget deficits. While the chart covers only the 2009 period, we expect that the 2010 figures would show a similar, if not better, relative position for



Australian government debt is expected to peak at around 10% of GDP, and even that figure may be too pessimistic. The government budget deficit for 2009/10 of around 4.5% is also manageable, and expectations are that we might even see a return to a budget surplus by 2011/12.

DUTCH DISEASE

Not what you get from too much time in an Amsterdam cafe

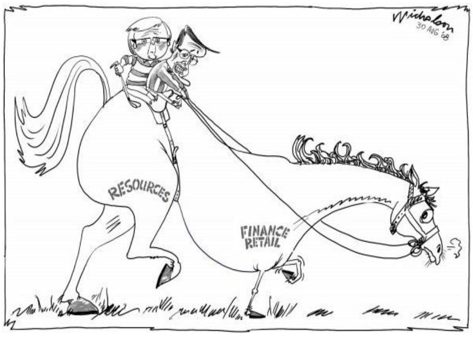
A long term risk which many commentators claim that Australia will need to deal with over the coming years, is a nice but serious problem to have – 'Dutch Disease'. Coined by The Economist journal in 1977, 'Dutch Disease' describes the apparent link between a nation's extensive natural resources and the decline in the manufacturing sector.

The theory implies that a booming resource sector (much like Australia has experienced over the past decade) will inevitably lead to the 'de-industrialisation' of the economy as the domestic manufacturing sector collapses. The theory is based on the massive natural gas discoveries which were made off the coast of the Netherlands in the 1960's. The rapid growth of the natural gas industry was viewed as responsible for a significant rise in the value of the Dutch currency, which caused its local manufacturing sector to become uncompetitive and effectively collapse.

The parallels with Australia are apparent – a booming mining sector which draws in labour and pushes up wages, which is accompanied by large inflows of foreign capital, which in turn causes an appreciation of the Australian dollar.

The high value of the dollar then causes problems for Australian manufacturers, which struggle to compete against now-cheap overseas imports and at the same time they find that their products are too expensive to compete in their existing export markets. This is coupled with increasing difficulties in competing with the resources sector for skilled labour and for capital to invest in their operations.

The Two-Speed Economy
A challenge for policymakers



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While it is likely that a number of approaches will be used, there are only two general ways to deal with the threat posed by 'Dutch Disease'.

One of these is to attempt to slow the appreciation of the dollar, without actually intervening in foreign exchange markets. Steps include encouraging increased savings within Australia; running a budget surplus; and saving the proceeds from the boom in a sovereign wealth fund. These steps would help to reduce the need for foreign capital to fund the expansion of the resources industry.

Another approach is to increase the competitiveness of the manufacturing sector by increasing investment in productivity-boosting sectors such as education and infrastructure. These would be long-term measures however, requiring significant (and some would say unusual) foresight from our political leaders.

Nonetheless, the threat posed by 'Dutch Disease' is a serious one, with important ramifications for how we structure client portfolios to best withstand any major structural changes in the Australian economy.

BUSINESS UPDATE

More progress

The Migration of Tamworth clients to CIPL's portfolio administration system is almost complete, done with few hiccups. Thank you to all Tamworth clients for their part in making the transition much smoother than originally hoped.

Early in the new financial year we will hold some free seminars to assist Tamworth Clients to make the best use of the Portfolio System. These seminars were well received when we ran them in Rockhampton a year or so ago.

As indicated in the last edition of this newsletter, CIPL has been putting a lot of effort into improving client affairs. Apart from ongoing portfolio reviews, we have completed the change of Rockhampton client cash accounts, to a new higher interest account with The Rock, and begun managing term deposits directly, resulting in significantly improved interest rates for clients.

The next step is the production of a new financial services guide which we hope will improve awareness of the services we offer to clients. As part of this we will be instigating formal face to face reviews for most clients. This way of working has been successfully in place in the Tamworth office for some time, while the Rockhampton office has relied on more of an open door policy. While we won't be closing the door, it's clear that formal face to face meetings help form strong professional relationships and enable us to be better prepared ahead of time. We are expecting that this will further improve client outcomes, which is after all, what we are here for.

As always, we have a team of dedicated and competent staff working very hard for you. If you have any problems or concerns, call one of us, so we can get on top of it.

INSURANCE MATTERS

Jason explains why...

In my first 4 years as a financial planner I received the dreaded phone call from a client informing me that her husband had passed away.

It was my first ever application for an insurance policy, taken out when the couple purchased their first home. The wife needed to know about the insurance policy they had put in place a couple of years ago.

Calls like this really hit home the realities of life. As a life insurance expert it always makes me wonder if there was anything further I could have done or whether the level of cover was enough to adequately ease the financial burden for the family.

I immediately checked the file to see what cover had been taken. We had recommended comprehensive life insurance but the clients had decided to take only Income Protection. There was no Life or Trauma cover to provide a lump sum to the family to pay off debts, provide an income stream to his wife and children or even cover his medical & funeral bills.

In the period leading up to the client's death, there were significant changes to their circumstances. They had taken out a large mortgage, had another child and had changed jobs. Despite lots of contact to update details, they had not told me about these changes, not their insurer. They were "happy with the insurance as it is." The income protection did not cover even half the client's new salary.

Sound familiar?

It wasn't all bad news. Negotiating with the insurer, I was able to make a claim for the family after all.

The client had been off work for 12 months prior to his death, and we managed to make an income protection claim for the time off. The family received a cheque for **$79,140**.

While the family was grateful, it is obvious that the amount of cover was totally inadequate for their needs. This has caused a major reduction in the family's lifestyle - clearly the last thing the husband would have wanted to happen upon his death.

Let's face it, death, total and permanent disability and cancer aren't pleasant topics to discuss. However, you have most to gain by knowing whether your insurance policies provide you with an adequate level of cover for your current situation. We can assist by reviewing them..

Occasionally, the cover can be reduced and we're happy to obtain lower premiums whenever it is appropriate.

- Have you taken out a loan?
- Got married?
- Been divorced?
- Had children?
- Have your kids started school?
- Has your salary increased by 10% or more?
- Have you changed jobs?

If you answered yes to any of these questions, you need to have your insurance policies reviewed.

If that dreaded phone call comes about you, we'd like to be able to assist your family recover and then move on with dignity and with minimal other interruption in their lives.

INVESTMENT BRIEFS

Here are some ideas for our trading clients:

ADELAIDE BRIGHTON LIMITED (ABC)

The company is a major participant in the Australian cement and lime markets and operates high capacity plants at Birkenhead and Angaston in SA and Munster in WA. It has terminals in all other states. The potential for concrete, and therefore cement, fluctuates with economic conditions and usage in both private and public sectors is recovering from the downturn.

ABC has benefited from public sector spending under the BER program, while civil engineering construction has grown at nearly 13% compound.

Increased expenditure in the rail, iron ore, coal, LNG and water sectors seems likely and ABC is seen as a strong participant in this growth.

The stock carries yield of 4.66% FF and a price target of $3.10. The present market price is $2.88.

ASCIANO LIMITED (AIO)

Asciano is Australia's largest diversified ports and rail operator with four key divisions:

- Container ports
- Coal rail
- Intermodal rail
- Auto, bulk and general

Volume indicators grew sharply through February and showed up strongly against the corresponding period 09. All cyclical indicators accelerated and coal exports were stronger.

In brief:

- International container throughput in the four major ports was up 21%.
- Car imports were up 90%
- Australian steel product was up 90%
- East coast coal exports were up 13%

Given reasonable economic conditions and a continuation of the strong overseas demand for Australian raw materials, volumes and AIO profits should be maintained well into the future.

The stock currently trades at $1.86 and has a target price of $2.00.

iiNET LIMITED (IIN)

The company was established in 1993 to deliver internet to West Australia. It now provides broadband internet, dialup internet, phone and VOIP services to 700,000 customers across Australia, NZ and SA. Complementing earnings guidance of $75m-$80m for the full year 2010 iiNet has announced the acquisition of ISP Netspace for $40m.

This is in line with the company's strategy to grow through consolidation and extends its presence in Victoria and Tasmania.

Netspace has a customer base of 97k including 70k broadband subscribers and the merger places iiNet at No.3 in the fixed broadband market. The company has strong fundamentals and an attractive growth profile. The company has a target price of $3.14 and is presently trading at $2.85. It carries a 'buy' recommendation.

INCITEC PIVOT LIMITED (IPL)

Incitec Pivot was created through a merger of Incited Fertilizer and Pivot Ltd in 2003 and listed in that year. It is the largest manufacturer and distributor of fertilizer in Australia with annual revenues of around $1bn and sales volumes of around 3mt. The scale of its operations enables it to be very competitive on the east coast where it holds market share of 70%.

Good rains in eastern Australia in the first quarter 2010 have raised the prospects of a good winter planting season and have helped drive a lift in fertilizer demand. This has also seen the domestic DAP price rise to $775t from $500-$600t in January-February.

It is expected that Incitec will sell 60% of DAP produced into the domestic market in full year 2010 against 40% in 2009.

As a consequence, net profit forecasts are being raised by 5% to $450m in full year 2010 and 10% to $500m in full year 2011.

Incitec currently trades at $3.30 and has a target price of $4.00. It carries a 'buy' recommendation.

The content of the newsletter constitutes general advice and does not take into account your particular needs. Please seek appropriate advice before acting on anything contained herein.

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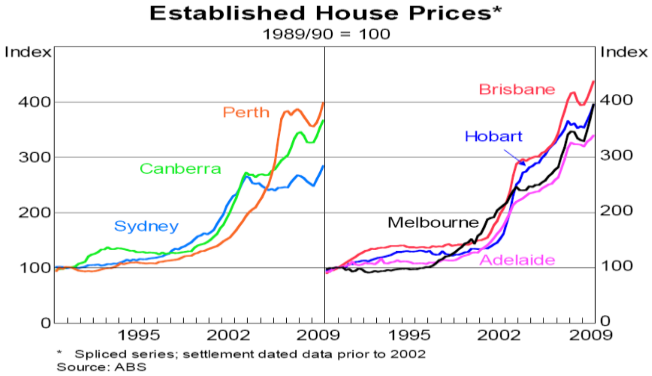
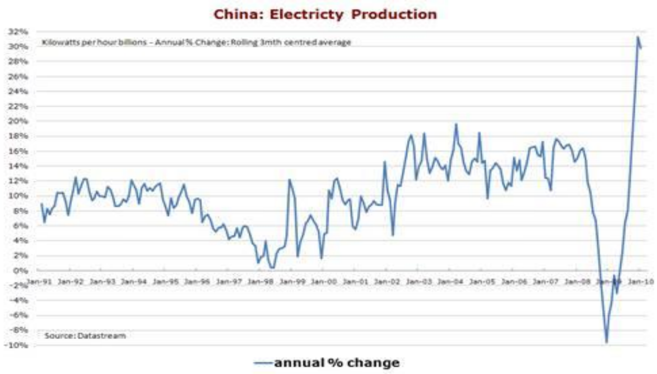
CHART PACK

Information at a glance (sources: RBA, Evans & Partners)

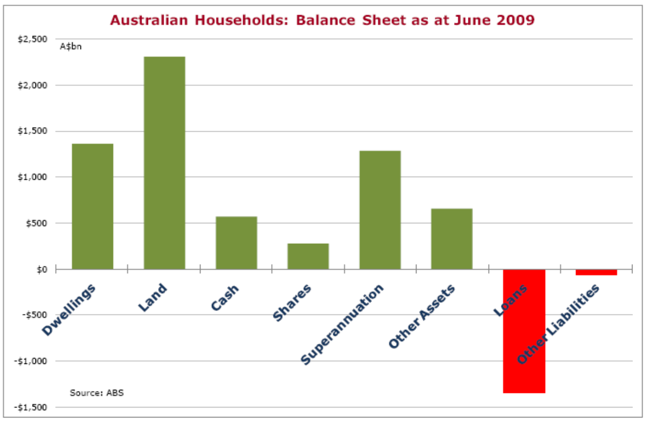
Australian House Prices - concerns of a property bubble once again surface as property prices continue to rise



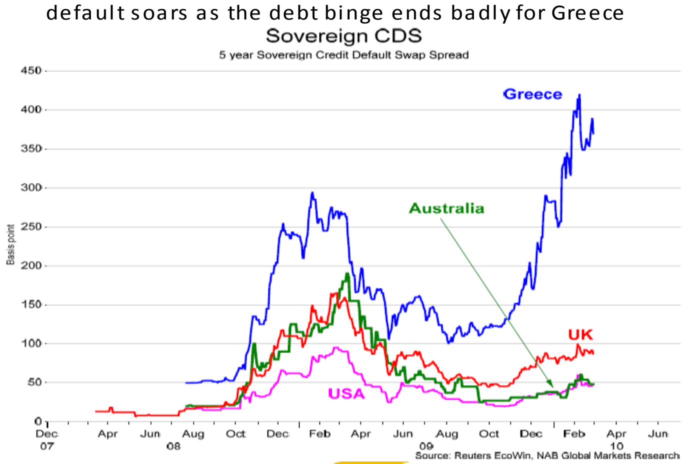
Chinese Electricity Production - a booming economy drives annual electricity production growth to record levels



Australian Household Wealth - land and housing continue to make up the bulk of Australian household wealth



Greek Tragedy - the cost of insuring against a Greek debt default soars as the debt binge ends badly for Greece



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