Providence Wealth Advisory Group

Global Outlook & Strategy

2nd Quarter 2012

A platform for a strong rally in risk assets is in place:

- US Fed's promise to keep interest rates at zero until 2014
- European Central Bank's offer of unlimited funding for European banks for the next three years at negative real rates
- Japanese Central Bank's targeting of 1% inflation and additional printing of money
- Chinese Government's 7.5% growth target averting a hard landing

Despite the positive medium term outlook significant structural concerns remain.

Bernanke, Draghi, King and Shirakawa (Central Bankers of US, Europe, UK and Japan respectively) are basically buying time, printing huge amounts of money in order to recapitalise the banking system, debase their currency and hoping for economic growth to return.

Public sector debt in Western economies is unsustainable and without a clear path to reducing these levels, markets and economies will be subject to nasty shocks.

In addition, the deleveraging cycle will continue to place a drag on economic growth which is likely to remain below trend in most Western economies. This will place pressure on corporate earnings which are already at all time highs in the US.

At the opposite side of the spectrum are the emerging economies that have high savings rates, low Government debt and strong GDP growth.

Australia is caught somewhat in between.

Australian Government Debt as a percentage of GDP is one of the lowest in the developed economies and we did not face the "Great Recession" of 2008.

However, corporate earnings are still below the levels of 2007. This is in part due to;

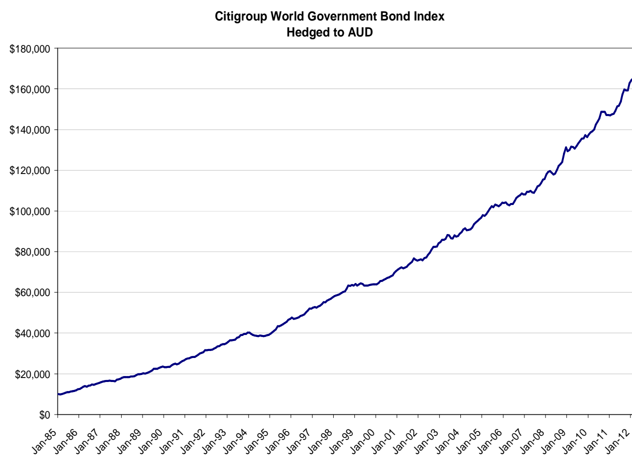
- Escalating wage costs
- High AUD
- Policy uncertainty
- High interest rates

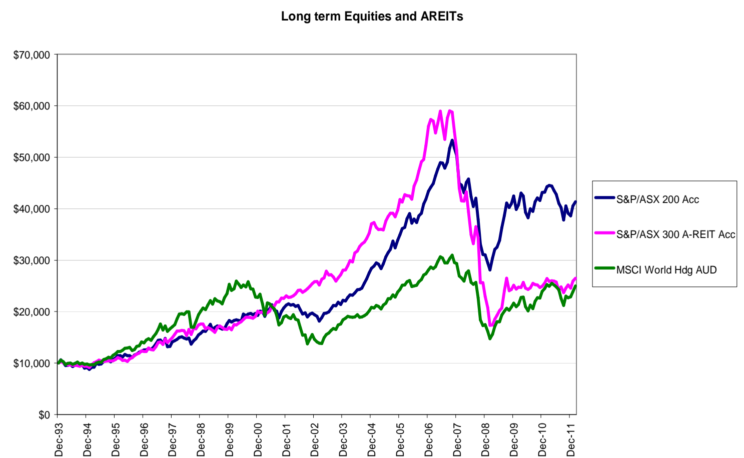
One sector of our economy, mining, is the major beneficiary of the growth in the emerging economies and our proximity to Asia and in particular China.

Government Bonds versus Equities

Another topic gaining increased press coverage is the Equities vs. Government Bond weightings within Super Funds. A number of commentators, including the past treasury Secretary Ken Henry, are calling for higher weightings to Government bonds at the expense of equities.

Whilst we tend to agree that equity weightings have been too high for some members of Superannuation funds, now is NOT the time to move to Government Bonds in our view.





Source: vanEyk Quant Analysis (2012)

It's amazing how people chase past performance. This is no different from chasing REIT's in 2006 after strong performances in the preceding years or Equities in 2007. The ASX is only now making available listed Exchange Traded Funds (ETF's) in Government Bonds for retail investors after a 30 year bull market.

Government bonds are no longer risk free and we believe that now is not the time to be investing in them.

Economic and Investment Market Overview

Recent GDP data in Australia confirms that outside the mining sector the economy is facing some strong headwinds. These include a high currency, negative productivity growth, increased labour unrest and an inflexible workforce.

Within the mining sector increased labour costs are putting huge pressures on costs and capex budgets.

The US has been showing some signs of positive growth posting a 3% growth rate for 2011. There are mixed views amongst economists regarding the sustainability of this rate given recent inventory rebuild and fiscal restraints expected, along with a deleveraging financial sector.

We are cautiously optimistic regarding the US economy looking out to 2013. Although some short term weakness may eventuate we believe that as the year rolls on employment growth and a stabilising of the housing market along with a potential new dose of Quantitative Easing (QE) and low interest rates will support growth.

China also attracts a lot of commentary regarding the depth of the current slowdown. We are of the view that a 7.5-8.0% growth rate will be recorded which will assist in producing a 4% global growth rate.

Emerging economies now account for over 70 % of world growth.

Japan, remembering that it is the third largest global economy, is forecast to grow by 2.4%.

Europe on the other hand is the laggard. Parts of the economy are already in recession and are struggling under severe fiscal restraint and austerity measures. Not so in Germany where the lower Euro has assisted manufacturing and exports.

Government Bond markets have shown some signs of a correction, higher interest rate equals lower price. This is a leading indicator and if it continues could mark the beginning of an equity bull market.

Previous secular bull markets in equities after WW1, WW11 and in the early 80's all coincided with an inflection point in long term bond yields. As long as we don't have an implosion in the bond market, a bear market in bonds will see a new secular bull market in equities.

Valuations are attractive in risk assets, Equities/REIT's versus Bonds/Cash. However structural concerns and low corporate earnings will likely suppress absolute performance in the years ahead.

We are concerned regarding the diplomatic language surrounding Israel and Iran. A surprise strike by Israel cannot be ruled out in 2012.

The two biggest risks in 2012 are a conflict in the Persian Gulf and a break-up of the Eurozone.

Opportunities

Income

- Australian REIT's and selected commercial property syndicates - good yield, distribution growth, discounts to NTA, conservatively geared, lower interest rates, inflation protected.
- Corporate bonds and syndicated loans - strong balance sheets, low default rates.

Income and growth

- Fully franked dividends within Australian equities, particularly banks with a 9.5% gross yield
- Large cap multi national companies with scale and brand leveraged to developing economies - conservative balance sheets, growth opportunities, low PE's, historically low Price to book ratios
- Utilities, toll roads, telecoms paying high dividend yields with growth

Security

- Australian term deposits - security with reasonable yield, tail risk protection

Risks

- Long term fiscal profile of the US/Europe combined with ongoing political gridlock
- Unravelling of the Euro zone and subsequent financial crisis (Spain next)
- A significant slowdown in China due to a collapsing of its property market
- Policy uncertainty
- Iran/Israel conflict
- Inflation – Longer term issue

Implications

- Retain high cash buffer and then look for opportunities
- Focus on income producing investments
- A flexible tactical stance will be required for asset allocation
- Risk assets are preferred over Government bonds
- Ongoing volatility and uncertainty remain in investment markets
- A lower long term real return from portfolios than was the case in the 80's and 90's
- Potential for surprise on the upside given all the bad news in markets and high cash weightings

Asset Class Review

Domestic Equities

The Australian equity market has been underperforming its international counterparts recently for good reason.

The headwinds of a high currency, an inflexible workforce and declining productivity, Government policy uncertainty and rising labour costs are putting pressure on earnings.

With over 60% of the equity market weighted towards financials and resources the performance of these sectors will dictate the majority of the index performance.

Resource stocks have been weak for the past 12 months reflecting concerns of a slowdown in China and increasing capex costs. We believe that more optimism regarding a sustained (although subdued) growth outlook for the US and fears abating of a hard landing in China will see resources find support at current levels. Labour unrest and increasing wage costs are still a major issue however which will restrain performance.

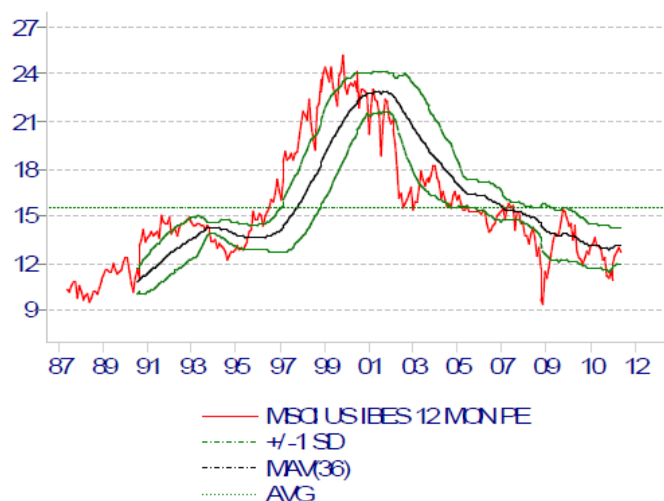
The energy sector looks well supported with higher oil prices expected to remain.

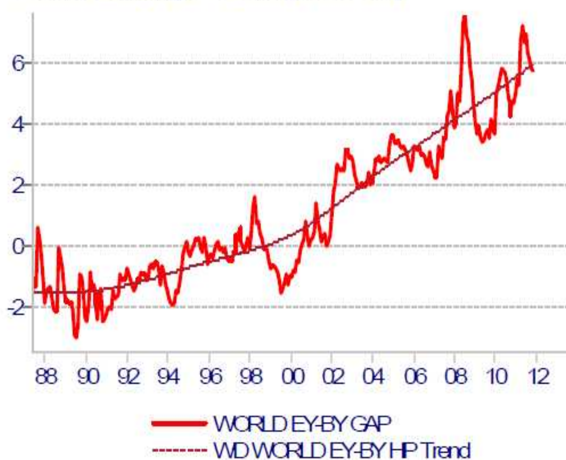
Within the financials the major banks will probably be supported in short term running into their dividend period. However, after that little capital appreciation is expected due to low credit growth, weakening economy and increased capital requirements. Gross yields of 9.85% which we believe are maintainable, despite softening residential markets, should support current prices and look attractive versus Government bonds and cash.

Better earnings growth can be found in companies outside Australia although the 6% yield for the domestic market has some attraction.

International Equities

Valuations of Global equities versus Government bonds are the cheapest they have been in a generation.





Source: Heuristic (2012)

Additionally, the corporate sector is in the best financial shape it has been for decades. With the cost of capital now significantly below a company's earnings yield, further share buybacks can be expected to underpin share prices.

On a longer term view there is great value.

We favour those fund managers who are targeting global companies that have sales exposure to emerging markets and are not constrained by index weightings. The cheapest equity markets are often those which are most feared and that can provide opportunities. For example, you can buy a stock like BMW, which has huge sales potential in the Asian market, trading on a sub 10x PE. Should it be trading as a domestic German stock or a multi national brand?

Quality fund managers can exploit these valuation discrepancies.

Emerging Markets

Once again developing economies led by China, India, Brazil and Russia are likely to provide over 70% of world growth. Having exposure to those companies that supply to the consumer in the economies should see strong revenue growth.

We tend to invest in companies that sell into those economies whether they are through our international fund managers or Australian resource companies.

Fixed Income

We have a zero weighting to Government bonds believing that there is a high likelihood of capital loss over the next few years. We do not believe this to be the risk free asset class that many believed it was (certainly Greek Government bonds weren't!!). Any whiff of inflation will see these long duration assets suffer after a 30 year bull market.

Strong corporate balance sheets, low default rates and elevated credit margins provide an attractive investment opportunity in corporate bonds/credit.

We prefer Australian term deposits, corporate bonds and loans.

There has been a stampede of new Hybrid issues coming to market over the past quarter which have proved popular with retail investors. Securities yielding between 7.25-8.00% in high quality corporate names have attracted funds sitting in cash. It is imperative to understand that these securities rank behind corporate loans and bonds. Additionally, there are significant differences in the maturity terms. These need to be clearly understood as some issues are poorly structured for the investor. However some issues have attracted our attention and, when combined with the rebate (0.5%-1.00%) we have negotiated for clients, the 12 month return looks attractive.

Property

The outlook for office, industrial and retail is mixed depending on the sector and location. Offshore investment flows have been strong and has accounted for over 30% of the transactions undertaken in the commercial sector in 2011.

Vacancy rates in the office market are still at the lower end of equilibrium assumed to be between 7 and 9%. Supply additions are expected to fall in 2013 with the development outlook in Sydney the fourth lowest since 1970 after adjusting for the size of market. Jones Lang LaSalle is forecasting rents to grow by 5% p.a. over the 3 years on top of prime yields of 7.4%.

Although new industrial supply in 2011 was the lowest in a decade leasing activity has been subdued given the uncertain macro environment and volatile demand environment within Australia.

The retail sector has seen enormous stress for tenants at the discretionary retail level. Whether this is structural or cyclical remains to be seen however higher incentives are required to attract/retain tenants.

We are attracted to the office sector in Sydney, WA and Adelaide and Government leased office in Canberra for direct property exposure.

In the listed property sector, REIT's have gone back to being a more defensive, cash flow yield driven investment. We believe 10% total returns are available in this sector and are particularly attractive versus bonds.

Despite a severe shortage of affordable housing it is our view that the Australian residential property market is expensive but is more likely to stagnate rather than fall suddenly.

Infrastructure

We are attracted to the thought of secure income from this asset class with CPI increases built into the rental income stream. However, it is difficult to find appropriate vehicles to invest. We have some exposure through the equity market but will search for other opportunities in order to provide solid inflation protected income.

Hedge Funds/Absolute Return Funds/Alternatives etc

With some leading Australian equity fund managers struggling to add much Alpha (additional performance over a benchmark) we have been reviewing alternative strategies for some time. Although we are sensitive to the fee structure embedded in some funds we believe there is merit to include a low correlated, market neutral hedge fund in portfolios.

Private Equity

We have little exposure at this stage, although there may be some attractive opportunities arising in the future as available credit will be scarce for those companies looking to expand. There may be a case for switching some funds from equities to private equity managers over the coming 18 months.

Summary

A platform for a strong rally in risk assets is in place however significant structural challenges remain. World growth will once again be dominated by the developing economies with Europe, UK and the US struggling under the deleveraging cycle. Australia has its own challenges on the growth front with earnings under pressure. Overall valuations of risk assets are attractive particularly when compared to bonds. We would be avoiding Government bonds at these levels whilst still retaining a healthy cash buffer. Geopolitical issues surrounding Iran and Israel do concern us as do ongoing uncertainty regarding the Euro.

Our stance is to protect portfolios (cash) from short term volatility and look for longer term investment opportunities (equities, credit and property) whilst avoiding the current bubble (Government Bonds).

Conclusion

- Preferred assets; Credit (corporate bonds), Commercial property/REIT's, high yielding Australian Equities, global equities leveraged to emerging economies and Cash
- We expect long term returns from a balanced portfolio to be in the order of 8% pa amongst a "Wall of Worry" backdrop
- Our approach is to remain defensive over the longer term with higher cash levels and a focus on yield/income.

Asset Class	Strategic	Range	Tactical	Overweight/ Underweight
Australian Shares	35%	25% - 50%	25%	Underweight
International Shares	25%	10% - 35%	23%	Underweight
Property	10%	0% - 15%	10%	Market weight
Infrastructure	n/a	0% - 20%	0%	Not applicable
Govt Bonds	25%	0% - 50%	0%	Underweight
Corporate Bonds	0%	0% - 50%	21%	Overweight
Cash(term deposits)	5%	2% - 50%	21%	Overweight
Hedge Funds	n/a	n/a	0%	Not applicable
	100%		100%	

The above table illustrates the Strategic Asset Allocation of a balanced portfolio (Van Eyk, 2012) against an active Providence Tactical Asset Allocation. The objective of tactical asset allocation is to move among various asset classes within a risk-controlled framework to create an additional source of return. An attempt is made to take advantage of short and intermediate term market inefficiencies as a means of managing investors' exposure to market risk.

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