



Caravel Consulting Services

Independent advice for institutional investors

WHERE TO INVEST IN THE NEXT TWO YEARS?



AIOFP GOLD COAST CONFERENCE

21 October 2011

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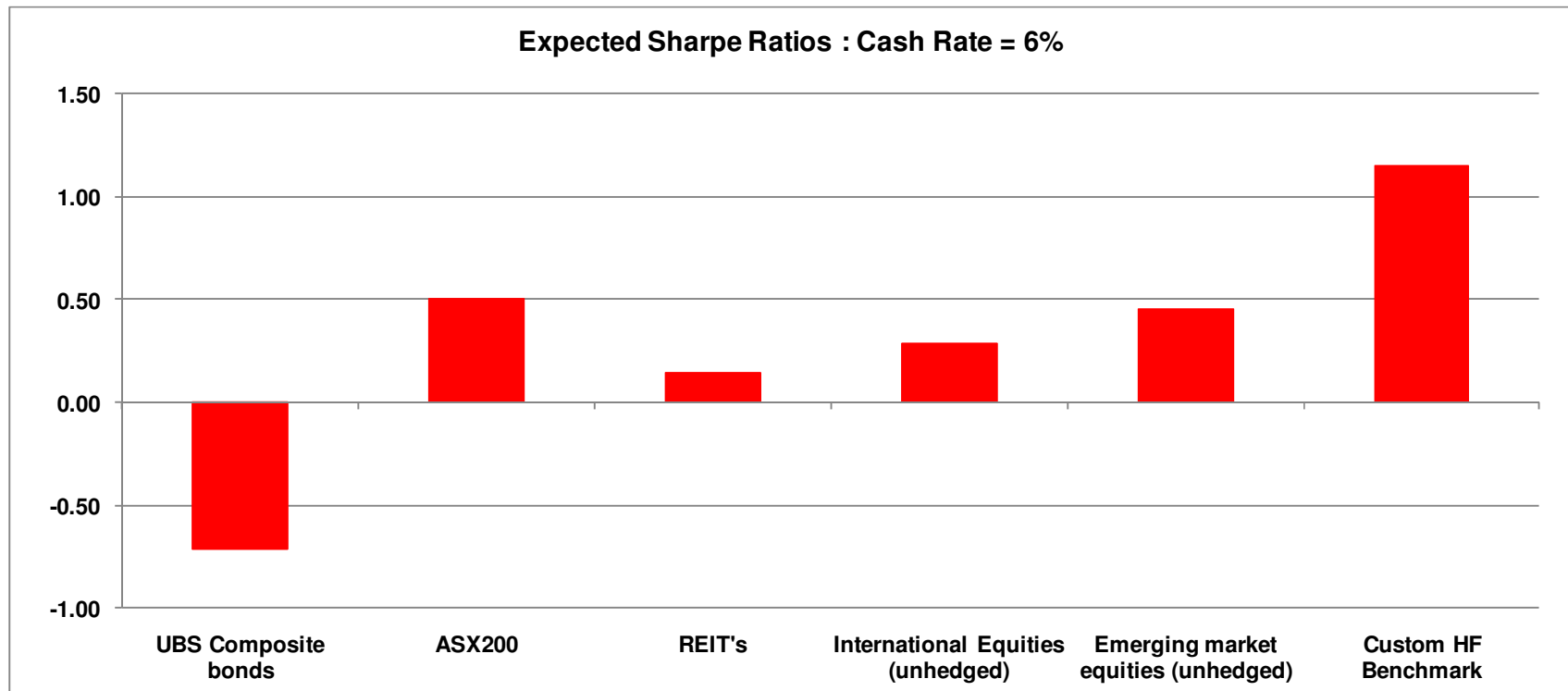
Key messages from last year - 1

- The future pace of economic growth is the key - sustainable growth is how policy makers redress the big imbalances of unemployment and budget deficits ✓
- Markets are heavily driven by what happens in the US - as long as growth concerns persist, bonds will do better than equities and the US\$ will be weak ✓ X
- The shape and timing of the transition path between bonds and equities is unclear, but the policy imperative skews the probability of the eventual outcome (Quantitative Easing announced in Oct 2010) ✓ ?

Key messages from last year - 2

- Official forecasts say emerging economies will continue to outperform ✓ X
- Tighter monetary policy here than in the US will help keep upward pressure on the \$A for a while longer - hold foreign currency hedges ✓
- The \$A could easily test parity with the US\$ in coming months, but by 2012 we expect Fed tightening to help the US\$ start clawing back some ground ✓ X

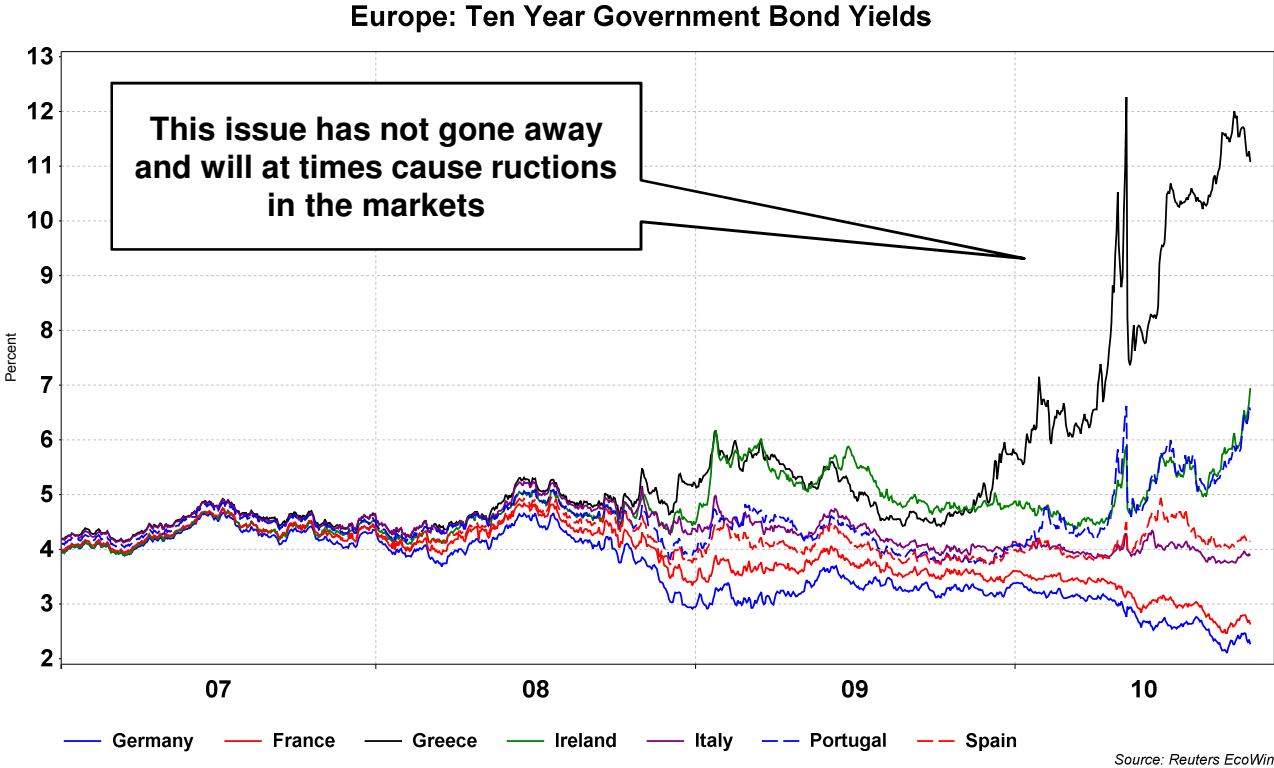
Summary of expected risk adjusted returns – October 2010



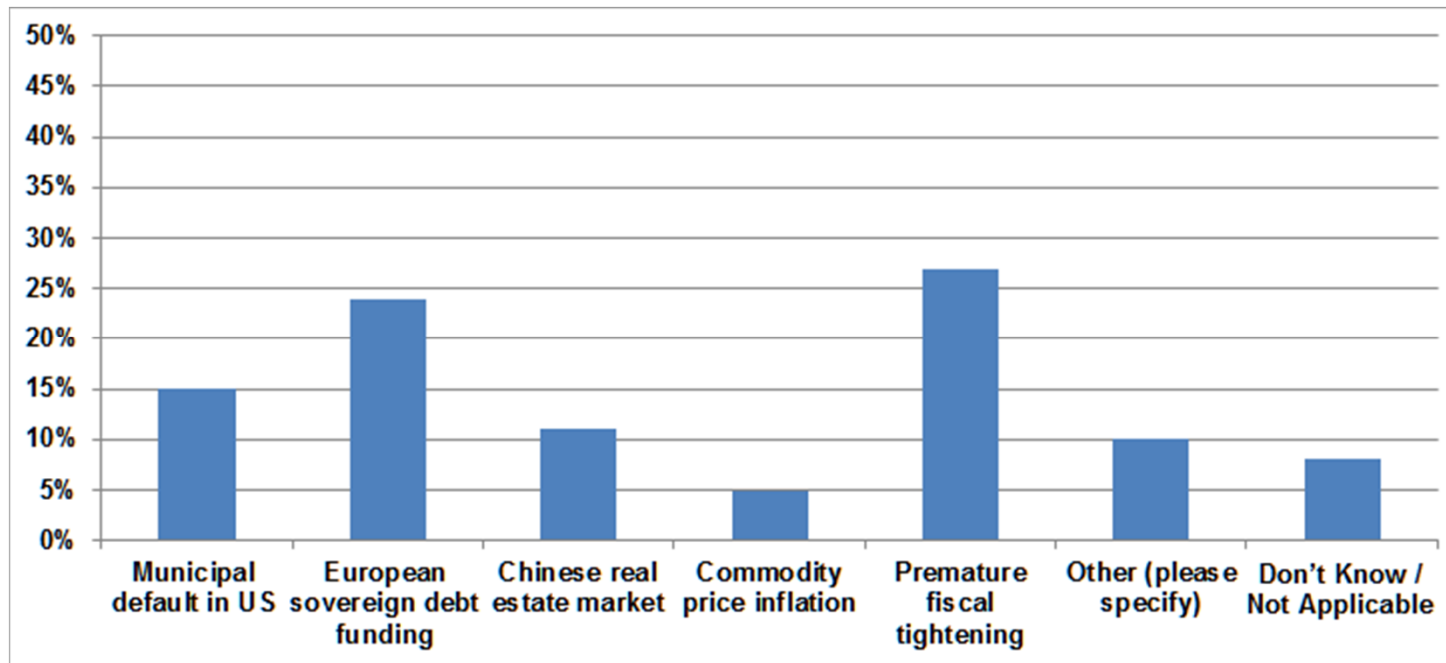
What could go wrong - October 2010

- The biggest global macro risks to our outlook are that the US economy rolls over into another recession or has another systemic meltdown: ✓**X**
- We cannot quantify these risks, but if they come to pass our ranking of expected returns allocations will be wrong ✓
- We think this is more a risk in 2010-11 than in 2011-12 ✓
- We also think the policy response would be swift and aggressive to counter such a development **X**
- Investors phasing into allocations consistent with our outlook should be able to exploit any short run contrary market movements **(!!!)**

Understatement of the year!



What is the biggest “tail” risk – 2010

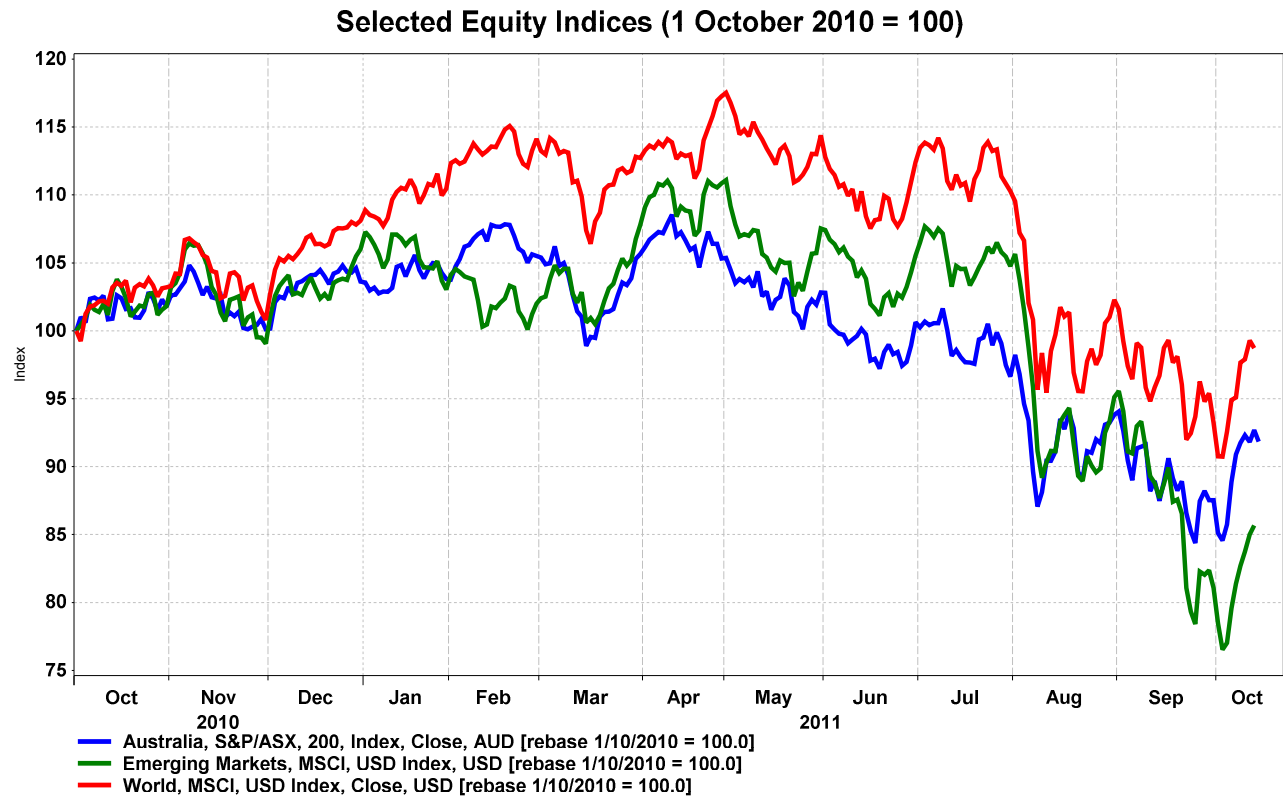


Source : Merrill Lynch/Bank of America Global Investor Survey September 2010

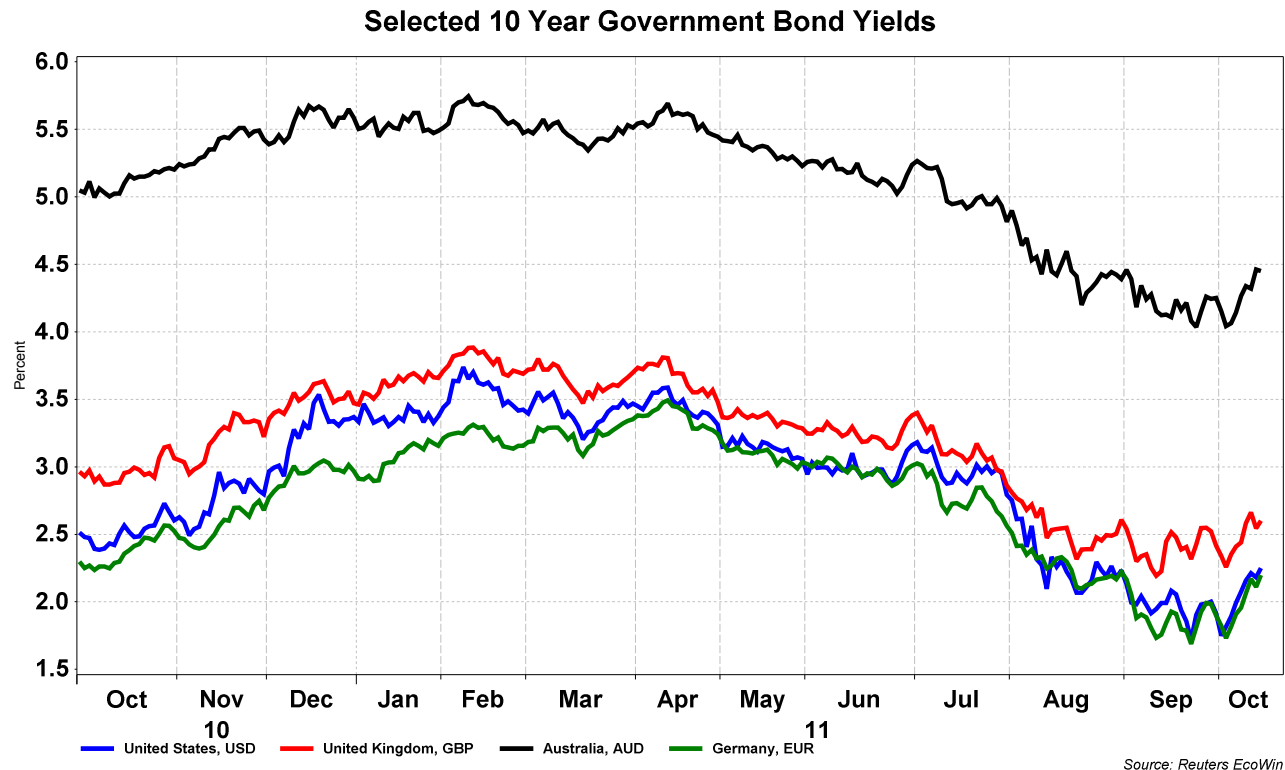
What has actually happened in the past year?

- Despite the Japan earthquake, up to around May this year the broad story was unfolding as described:
 - Equities rallied, bond yields rose and the \$A went through parity
- Since then things have fallen apart – why?
 - The US debt ceiling debacle
 - The extraordinary intransigence of European policy makers
 - The negative impact of these events on global sentiment and spending
- What did we miss a year ago?
 - We put too much faith in policy makers' willingness to do the right thing
 - We underestimated the viciousness and extremism of US politics
 - We underestimated the deep-seated nationalistic sentiments in Europe
 - The supply shocks driving up food prices and inflation and higher interest rates in the emerging economies => slowed a significant source of world demand

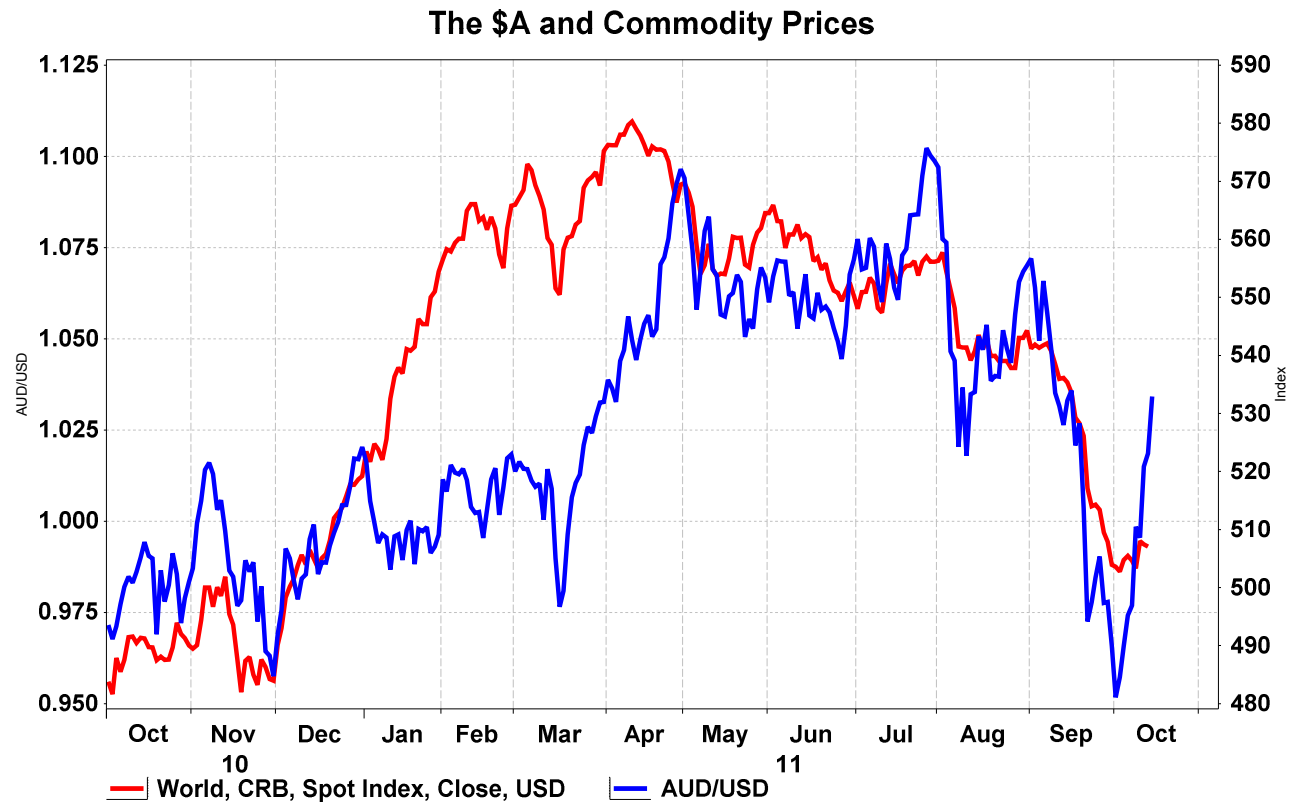
Sell in May and go away.....



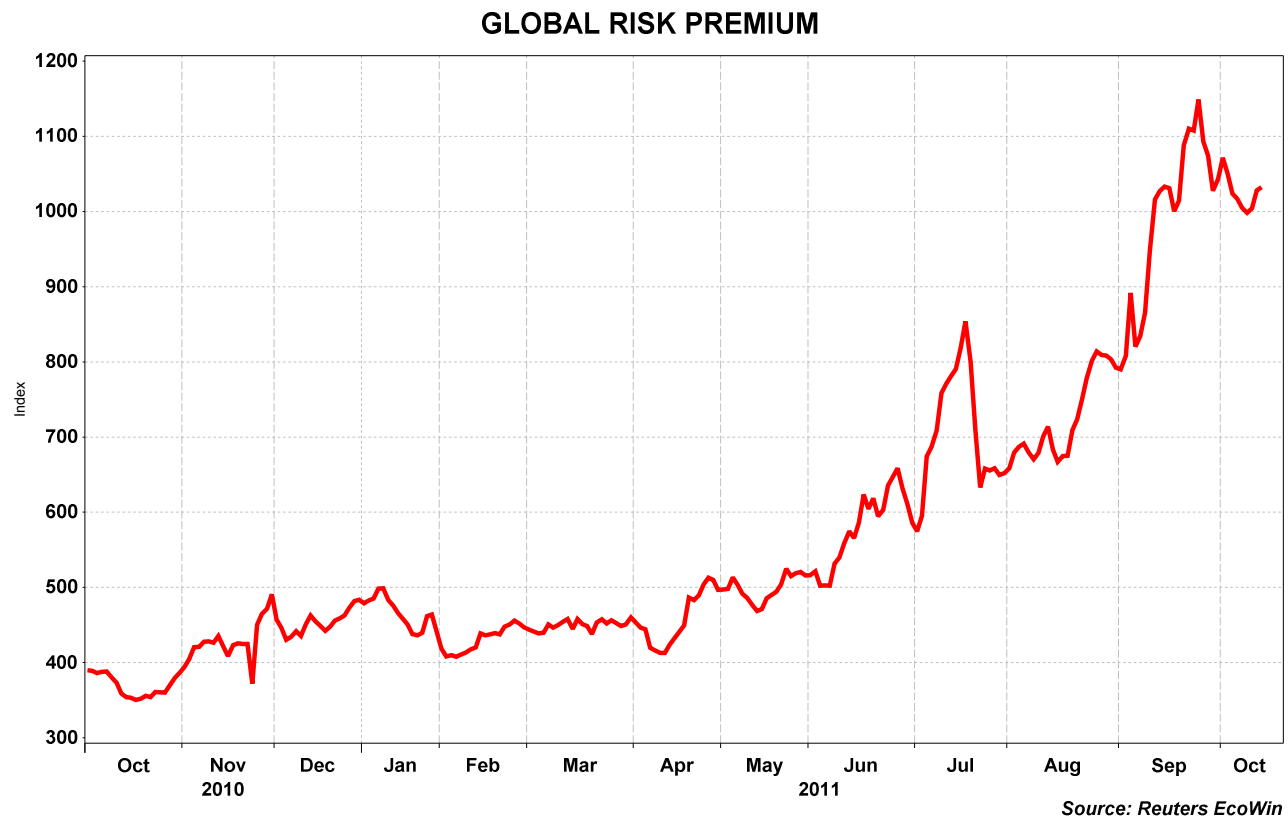
Massive rally in bonds – but look at the speed of the backup



What goes up, goes down....and back up again



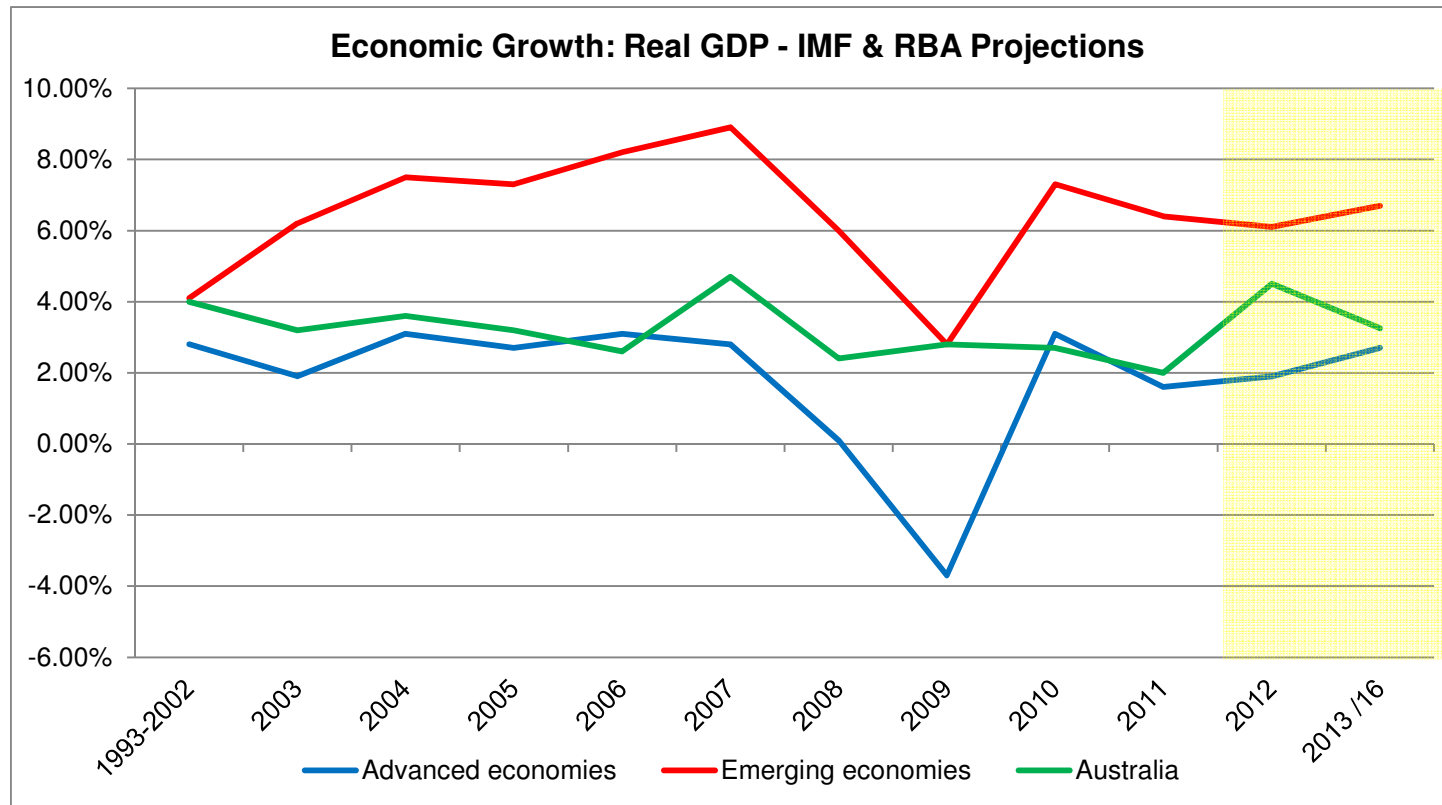
Global risk premia through the roof



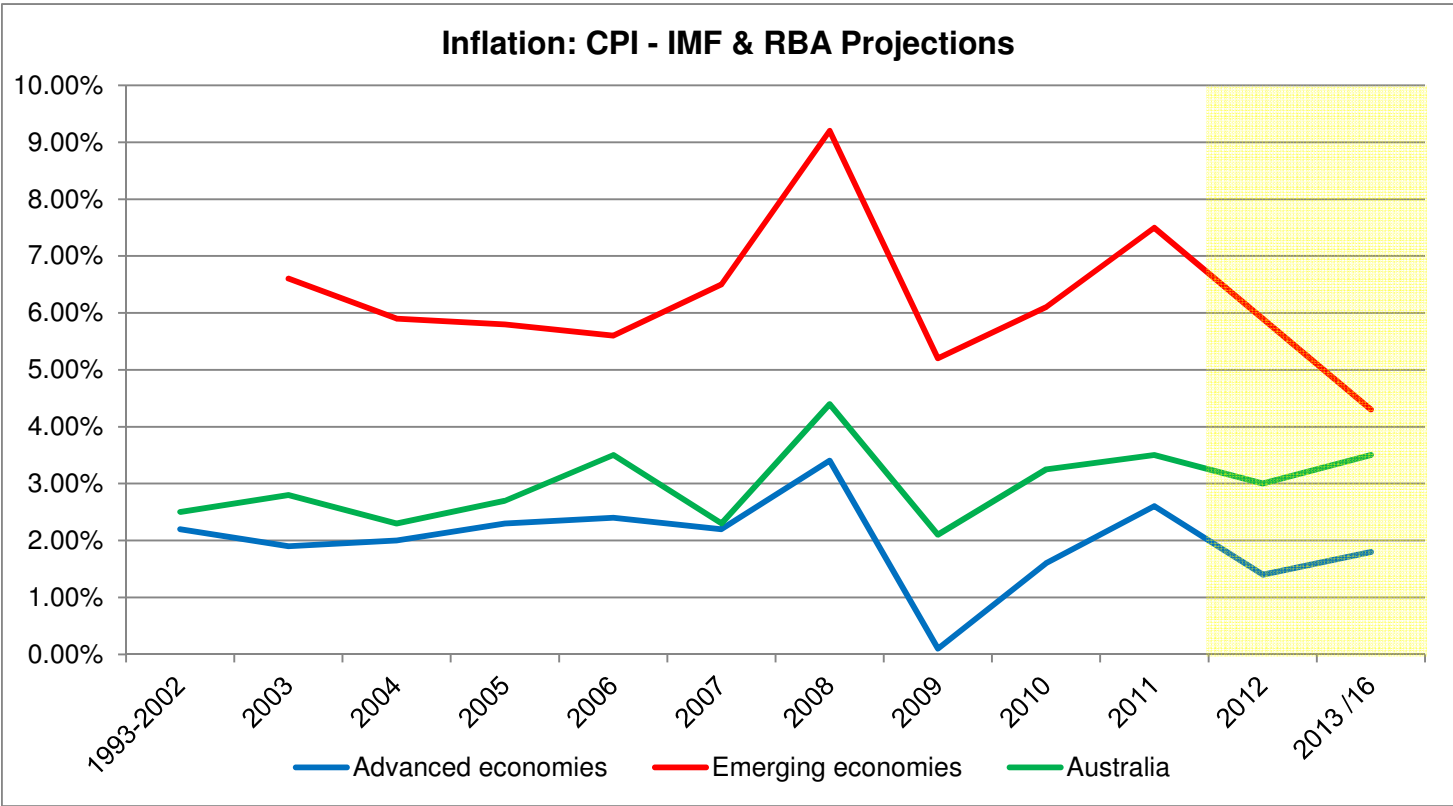
Where to from here?

- The policy imperative remains the same:
 - Growth is still the solution the world needs
 - Clear choice in forecasts – will there be (expectations of) growth or not?
- What about inflation – is it going to be an issue?
 - Australia vs. rest of world
 - Food prices & the emerging economies
- What are the central banks going to do?
 - Who has room to ease?
- What does it all mean for asset allocation:
 - Public sector vs. private sector liabilities
 - Regional & country themes within equities
 - To hedge or not to hedge?

Growth outlook – IMF & RBA



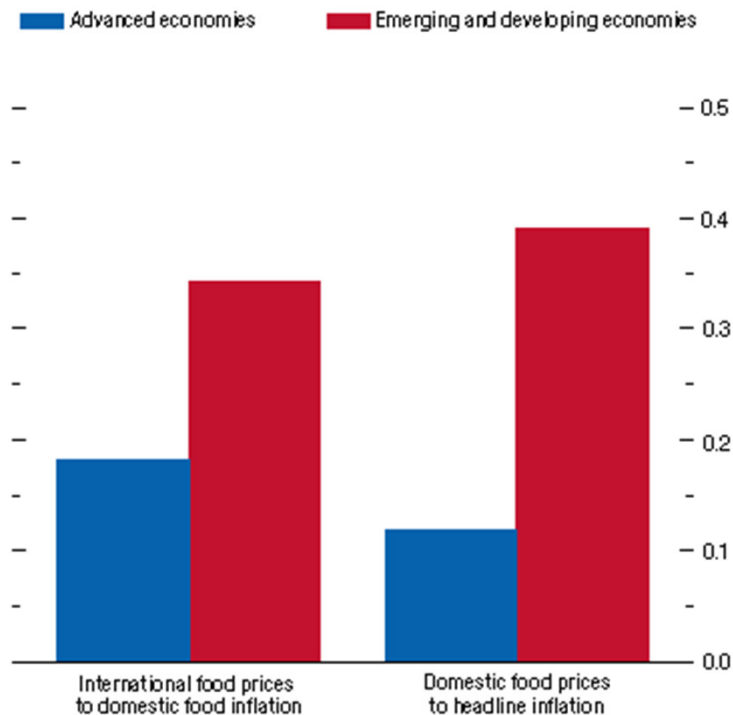
Inflation outlook – IMF & RBA



The impact of food price inflation – IMF (WEO Sept 2011)

Figure 3.9. Pass-through from International to Domestic Food Price Inflation

The pass-through from international food price inflation to domestic food price inflation and from domestic food price inflation to headline inflation is higher in emerging and developing economies than in advanced economies.

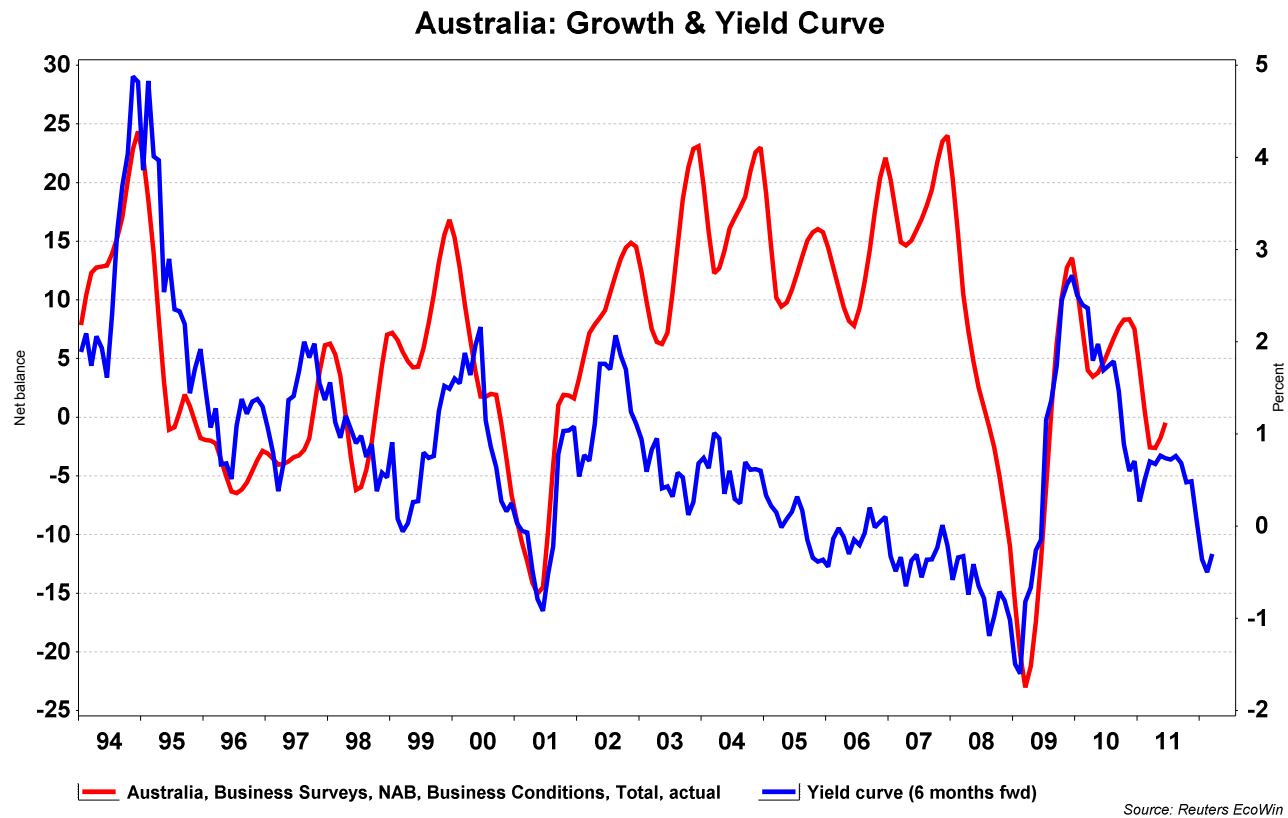


“Food prices should decline modestly but remain high in real terms through 2012, assuming a return to more normal weather conditions and stable energy prices, which affect food prices through biofuel and production costs”

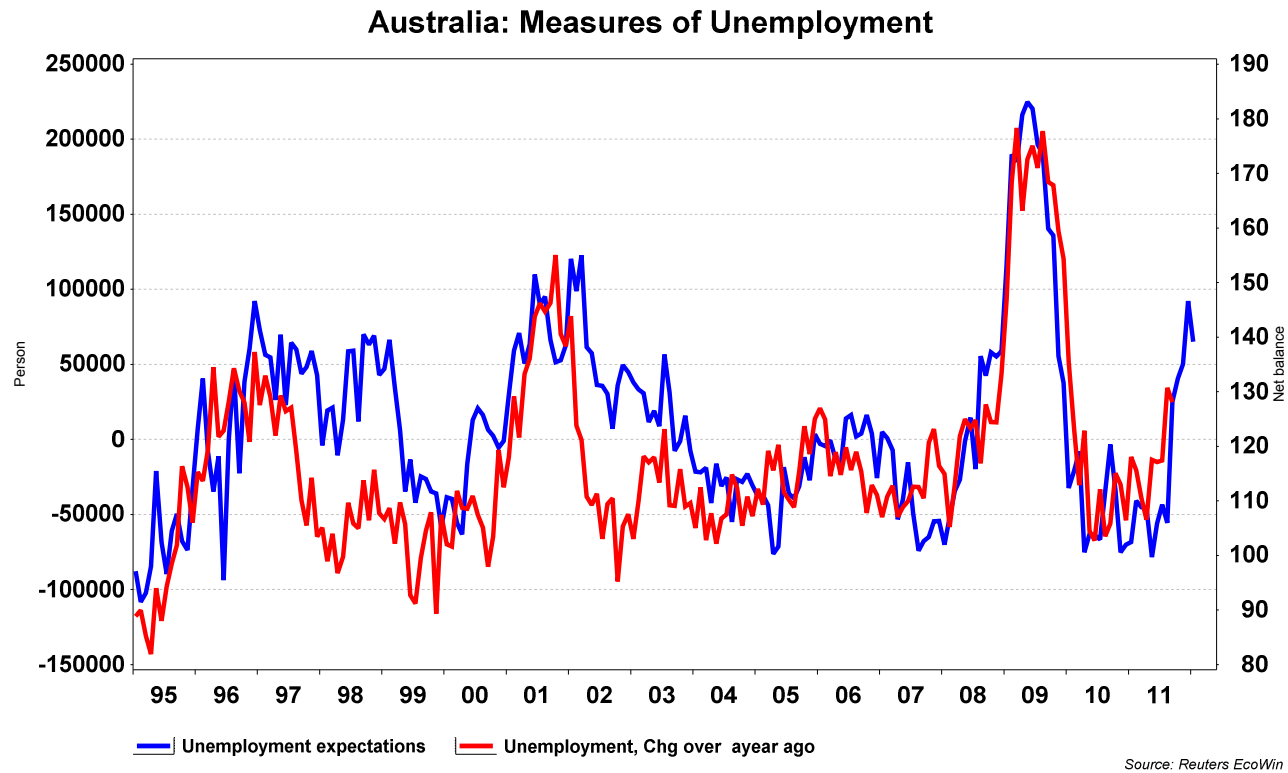
What will the central banks do?

- Australia:
 - Will the RBA cut or not – short run vs. medium term views
 - Even if they do our rates will be higher than the rest of the world for some time
- USA:
 - The Fed has told us what they are going to do – refining the message
- Europe:
 - Expect rate cuts by early 2012 as growth and inflation roll over
 - Europe is entering an extended slow growth phase which suggests the need for relatively low interest rates for some time
- Emerging economies:
 - If inflation moderates there is room for rate cuts – growth is suffering under the tightening regime
 - An important source of potentially good growth news for the markets

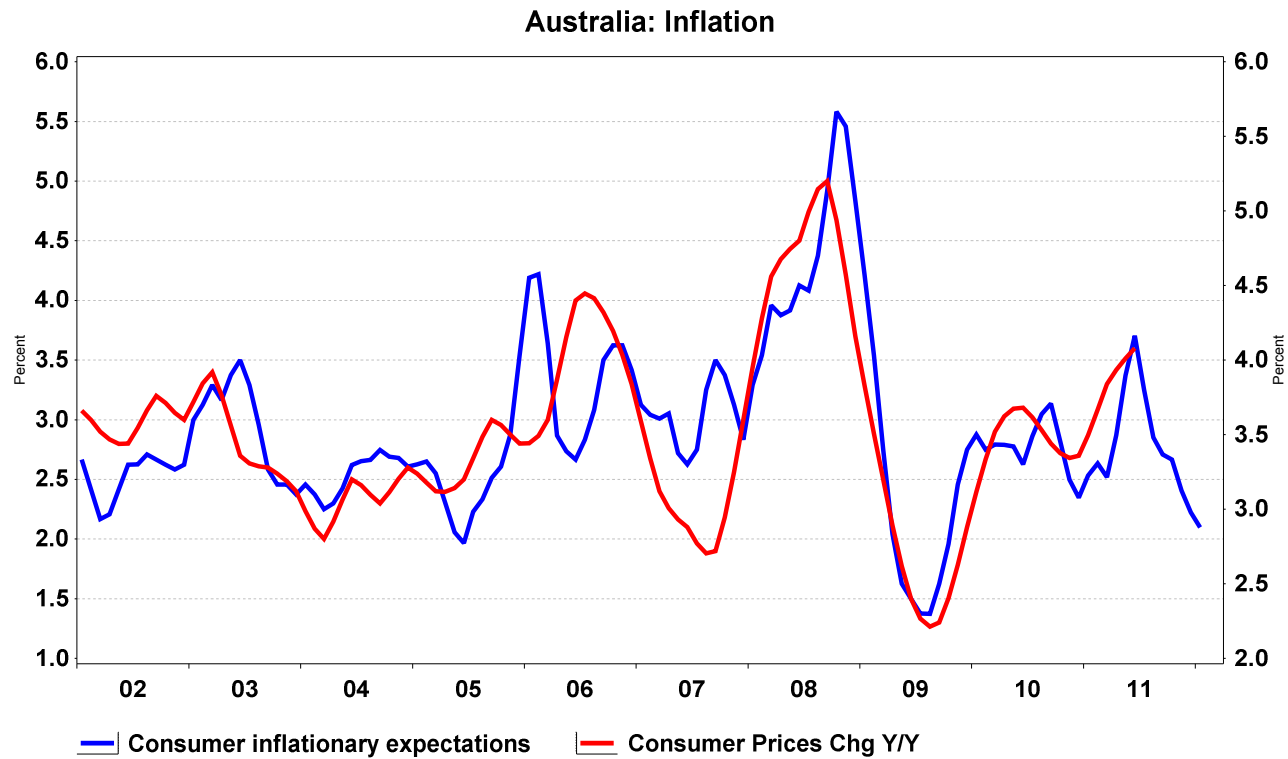
Australia: growth and the bond market



Australia: unemployment rate heading to 5.5%



Australia: inflation to ease?



Equities vs. bonds

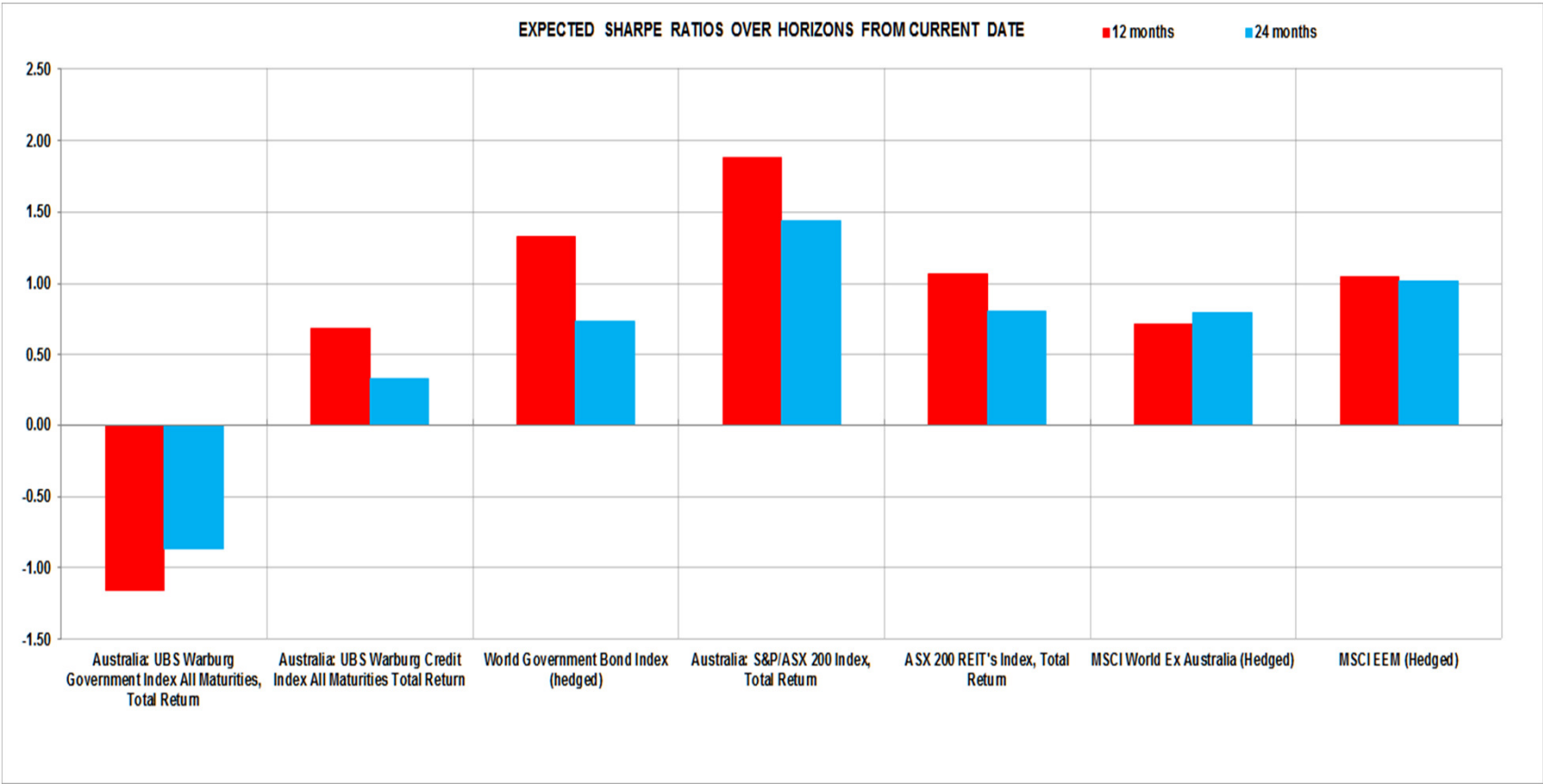
- Still depends on what you think of growth
 - Our growth outlook above suggests rotating into equities and corporate bonds and out of government bonds
 - Extended period of zero cash in the US combined with Operation Twist may limit degree of backup in government bonds but returns will be weak and capital losses should be expected in 2012
 - Expected Sharpe ratio for government bonds is very poor
- Equities very cheap at the moment
 - Better news on growth needed to unlock the value
 - Expect that to happen by mid-2012
 - Significant potential short run gains in equities
 - Favour Australian equities, especially small caps, and emerging markets

Currencies

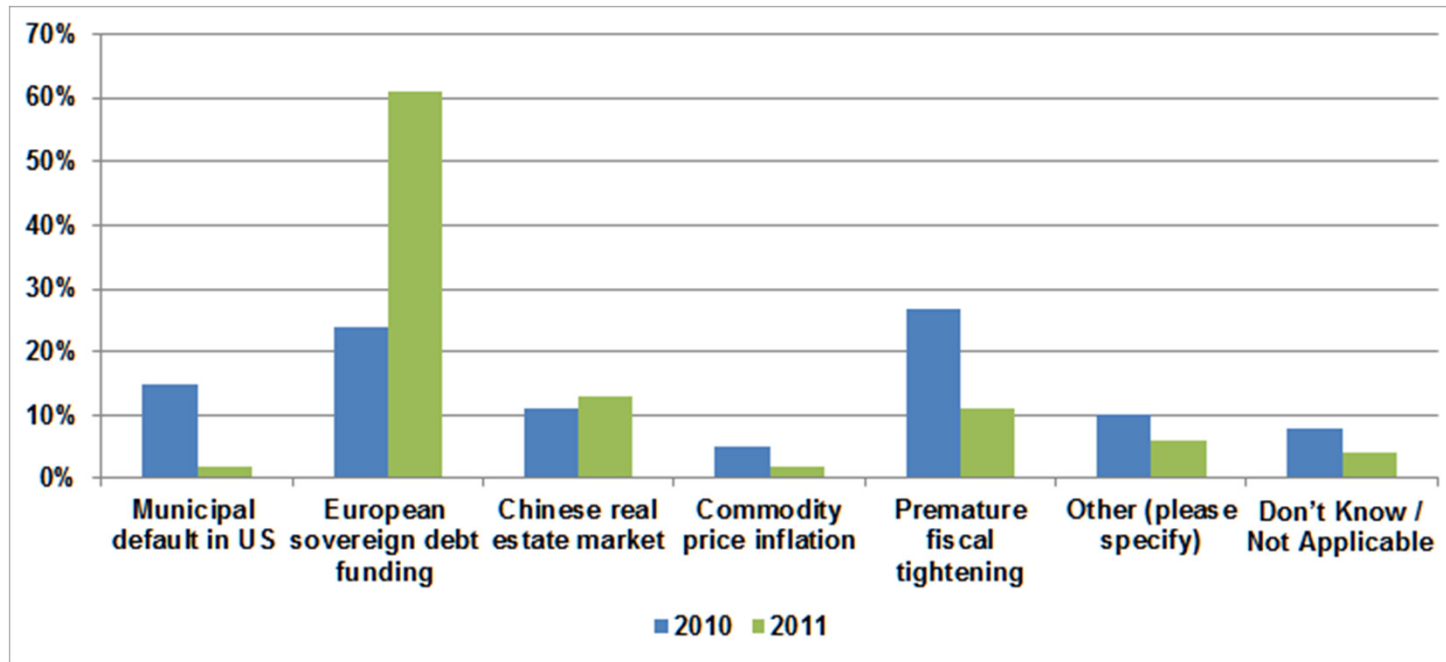
- Exchange rates will continue to be the means by which growth gets re-distributed around the world:
 - Simple rule of thumb: stronger economies have stronger currencies
 - We can divide the world up into blocs of stronger and weaker economies and currencies
 - Strong = emerging markets, Australia
 - Weak = USA, UK, Europe, Japan

- We expect the \$A to appreciate further in 2012
 - This, plus the significant advantage to be gained from the forward points, implies staying hedged in offshore assets

Summary of expected risk adjusted returns – October 2011

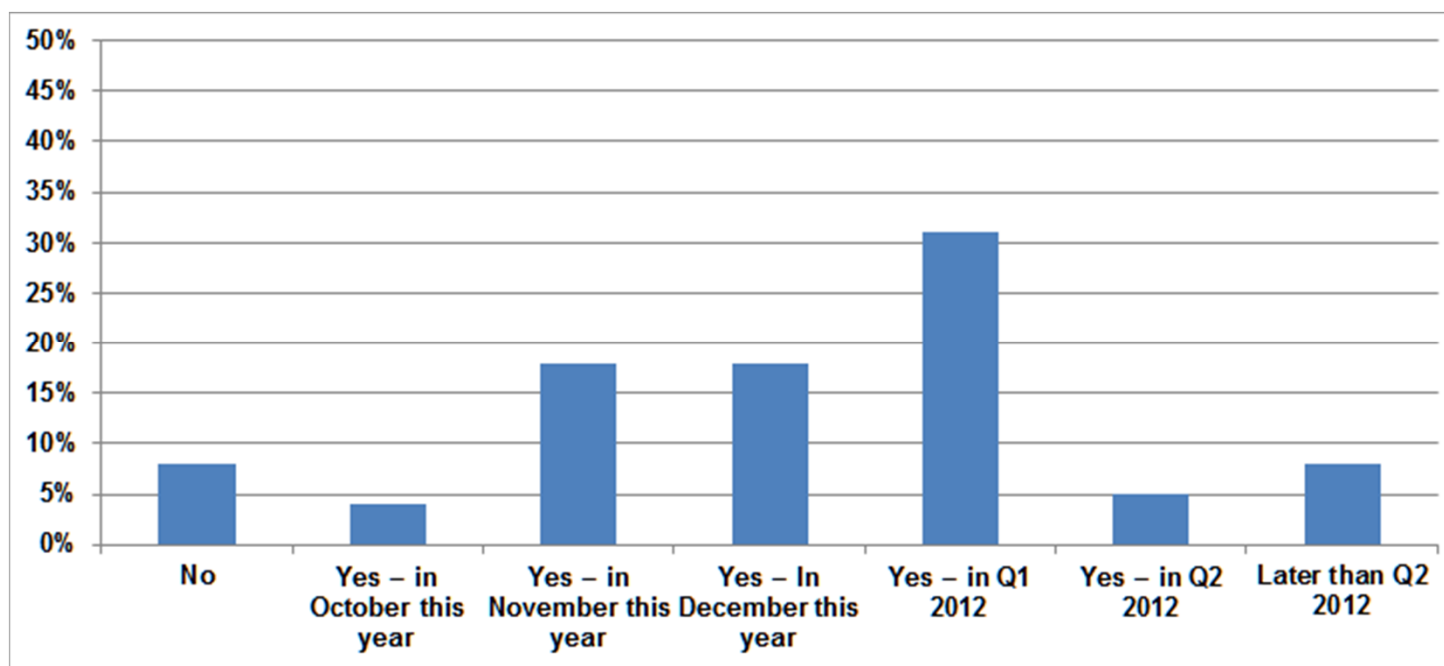


What is the biggest “tail” risk – 2010 vs. 2011



Source : Merrill Lynch/Bank of America Global Investor Survey September 2010 & October 2011

Do you believe Greece will default?



Source : Merrill Lynch/Bank of America Global Investor Survey October 2011

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