

Don't Take a Big Position Before Jackson Hole!



The disconnection between robust corporate earnings, strong balance sheets and sovereign debt issues continues to grow. The negative sovereign debt issues are the only thing being aired in the press and the resulting bearishness offers numerous opportunities.

While economic predictions (particularly when used to look forward*) offer little as a guide to investment strategy.

With the recent volatility and focus on the market expectations it's worth stepping back a little and looking at the bigger picture. The title above was a trader's comment quoted in the *Financial Times*; we think it

encapsulates beautifully a flawed approach which focuses on the short-term and announcement driven market.

For the long-term investor, the current volatility throws up many opportunities. One of the reasons we are optimistic is company earnings have continued to grow steadily over an extremely long period. Certainly they decline at times of economic stress, but go on to higher levels relatively quickly.

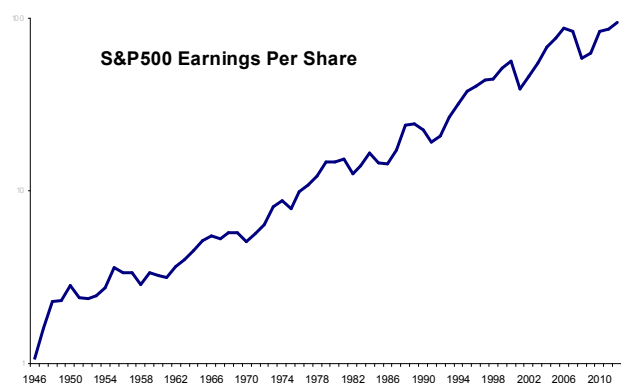
Further, the earnings among different industries can behave very differently to economic trends. For instance, earnings of online based companies (eg Realestate.com.au or Rightmove) did not decline during the GFC; rather they continued to grow strongly.

The graph shows the growth in earnings per share of the S&P 500 over the last 65 years. One could look at this figure as if all the companies were a giant conglomerate and reported a single earnings per share figure.

The point we'd make is that while the S&P 500 is pretty much where it was 10 years ago the earnings of the S&P 500 have gone from \$47 per share to \$92 per share. There is real value in stocks, particularly when compared to government bonds.

At current prices, stocks are trading at below 13 times earnings and one is not paying for upside. We don't like trying to predict the direction of the market but we do like buying when stocks are cheap.

* The economist J.K. Galbraith said that he'd predicted 9 of the last 5 recessions.



- Hugh MacNally, Director

Woolworths Debt Issue

Woolworths \$500 million floating rate notes have traded well since listing on ASX. The issue still looks attractive for investors with balanced portfolios and those looking to enhance yields above prevailing cash rates.

A quick comparison of rates shows the attraction. The benchmark cash rate set by the RBA currently stands at

4.25% and this is around the level offered on standard deposit accounts. Term deposits can enhance earnings to around 5.5% for a 12 month deposit. Against this, the Woolworths notes offer a yield benchmarked against the 90 day bank bill rate plus 3.25% so the current yield is nearly 8%.

Woolworths offered these attractive rates for two reasons: First, bank funding costs have continued to rise post GFC with wholesale markets linked to international credit markets. This has seen a dramatic blowout post the GFC as rates have adjusted to what is perceived to be a riskier environment to borrow and lend money.

The CBA recently pointed out that the pre GFC margin over the market swap rate to borrow money for 5 years was 0.17% where as now it is in the order of 1.44%. Therefore, even highly rated companies like Woolworths are required to pay high rates to raise bank debt.

The second and more important reason is a deal Woolworths has worked with the ratings agencies which will allow it to count 50% of the issue as part of its equity capital. In looking at this issue, the rating agencies would consider both the interest rate and the 5 year call terms.

For Woolworths, having the issue considered 50% equity for the first 5 years means that its overall cost of funds, which includes debt as well as equity, can be lowered - the end result is a win for Woolworths, but also for investors.

- Peter Reed, Portfolio Manager

RBA Points to a Changing Household

In a recent report the Reserve Bank of Australia (RBA) highlighted the changing behaviour of households. Australians are now spending more on housing and services, saving more and spending less on goods.

Assistant RBA governor Philip Lowe said the rise in household savings has been widespread across the population, with higher housing prices and debt levels, and cautious sentiment triggering the increase. According to the report, housing costs are continuing to increase, with expenditure on housing rising from 13% to 18% between 1984 and 2010.

Lowe also highlighted a change in purchasing behaviours away from goods and toward services. Lowe says the figures "suggest that although households are saving a higher share of their income than in the past couple of decades, they have also been prepared to increase their spending on services quite significantly."

In the early 1980's Australians were spending 14% of their income on clothing, household goods, and furniture, while today these goods make up just above 8% of spending. Lowe points to a general household shift towards "experiences", an increasingly mobile and Internet enabled society and an increasingly affluent population as contributors to the shift.

"There are significant changes in saving and spending patterns taking place in Australia. The effects of these changes are probably most pronounced in the retail sector, with both increased saving and the switch towards services lessening growth in spending on goods."

Sectors enjoying strong growth included educational services, up by 5% during the past year, recreation and culture, up by 6% year on year, hotels, cafes, and restaurants up by more than 7 per cent, and transport (in particular air) up by over 10%.

A 7.5% increase in household income last year helped buoy growth in these sectors.

- Kris Vogelsong, Corporate Development

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