18TH AUGUST 2011

Lifestyle Newsflash

www.lifestyle.au.com

Lifestyle Financial Services Pty Ltd
Authorised Representative of
Sentry Financial Planning Pty Ltd
ABN 74 099 029 526
Australian Financial Services Licence No 247105

Lifestyle

Suite 9 Level 10, 809 Pacific Highway
PO Box 5245 Chatswood West NSW 1515
t 02 9410 6000 f 02 9410 6010 invest@lifestyle.au.com

Volatile August 2011

In the past 2 weeks we have seen remarkable volatility which brought back dark memories of 2008. In fact, if we look at the 10 most volatile weeks of the last 31 years, last week ranked number 8. It is no surprise that 7 out of the 10 most volatile weeks belonged to 2008.

ASX200 Most Volatile Weeks in Last 31 years

Date	Close	High	Low	Volatility
23-Oct-87	1561	2129	1561	25.7%
10-Oct-08	3969	3698	3939	16.1%
21-Nov-08	3387	3710	3202	13.6%
31-Oct-97	2430	2514	2187	13.0%
17-Oct-08	3945	4404	3937	11.9%
24-Oct-08	3832	4251	3800	11.5%
25-Jan-08	5886	5886	5222	11.5%
14-Nov-08	3276	4111	3672	11.0%
12-Aug-11	4266	4281	3829	10.8%
28-Nov-08	3673	3673	3337	9.9%

Source: Goldman Sachs, Minchim Moore Private Wealth

Fear and Greed - Is this 2008 all over again?

There is no doubt that markets have again been gripped by the competing emotions of fear and greed. For many, the fear is simply an ongoing emotion that has never been fully overcome since the GFC. On the flip side, while greed has driven short term investors to try and profit from the volatility, there is also a fear from many that if they don't get back into the market now, they will miss out on any long term sustained rally to follow.

As opposed to a GFC, some have coined this period as a GSC, **Global Sovereign Crisis**. While personal and corporate balance sheets have been repairing themselves over the last 3 years, Government balance sheets have steadily been getting worse as they try to kick start economies out of recession through increased Government spending. Some economic commentators are even suggesting that what is going on now is fairly typical of this type of boom/bust/boom economic cycle. Governments have simply bailed out the public and corporates and effectively taken over their problems in the form of public debt

The Era of Deleveraging

As recent history has unfolded we have seen Western households over-leverage into housing to such an extent that they couldn't withstand the inevitable housing correction that began in 2007.

Losses have been so immense that the banking system itself faced systemic collapse under the tremendous burden. Leverage had reached breaking point and the banks simply didn't have the capital reserves to cope.

The fabric of the Western financial system faced disintegration and governments had little choice but to bail out the banks, print money and inject enormous stimulus into their economies to ward off deep recession. This has resulted in the transfer of the burden from individuals and banks to sovereign states.

Many governments were ill-equipped for these events as they were already well leveraged themselves. The stimulatory policy response drove these governments deeper into debt.

Today we find ourselves in a predicament where most Western governments have debts that are approaching or are already beyond 100% of GDP. As a rule of thumb, debts of around 100% of GDP are seen as dangerous and debts of 150% of GDP catastrophic.

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International Monetary Fund estimates at the end of 2010 tell the tale: US, Portuguese, Irish, Greek, French and UK gross public debt as a percentage of GDP stood at 92.7%, 83.1%, 93.6%, 130.2%, 84.2% and 76.7% respectively.

Perhaps even more alarming is the baseline forecast of growth in public sector borrowings in these nations. At current trend, all the economies aforementioned will reach public debts of 150% of GDP within ten years.

This simply can't be allowed to happen and governments are slowly waking up to this reality. No matter what way you look at it all roads point to more austerity. That is, less government spending and more taxing in the years ahead. This is not an ideal backdrop for equities.

To date, markets have been less than impressed with US and Euro Zone debt-reducing programs. Political will has not been strong enough to drive this point home to the electorate.

This failure of diplomacy to make the tough decisions is a central driver behind the current volatility - the market can see the problem, but policy makers haven't been forthcoming with the solution. History is a source of both sobriety and guarded optimism. Investors need to be aware that the deleveraging cycle following a credit crisis is usually a lengthy one.

On a more positive note, though, emerging economies are moving forward at an impressive clip and becoming an ever-larger part of global GDP. Their strength compensates, somewhat, for developed world fragility. Undoubtedly, there will be occasional bumps as they progress up the global economic ladder; however, the history of industrialisation in other countries suggests that they have many years of rapid growth ahead of them. China, which has emerged as a great force for growth over the past decade, appears to be on track for a soft landing. Investors are likely to take heart from this realisation.

Corporate Balance Sheets are Strong

As discussed earlier, corporate and personal balance sheets have been in a process of repair.

Eventually, company executives as well as their shareholders will become dissatisfied with meagre cash-related returns and deploy the funds to potentially higher-returning uses. In time, cash will fund organic growth; be employed in mergers and takeovers; and finally but not least, applied to capital management initiatives such as higher dividends and share buybacks.

Similarly, while individuals are saving at a record rate (the current savings rate of 11.5% of disposable income represents a 25-year high), this must change at some point as households are forced to upgrade cars, furniture, clothes and other necessities of life. At this point the cycle turns and businesses have the confidence to rebuild inventories and employ more resources which ultimately leads to higher employment and, importantly, growing tax revenues for Governments eager to repair their own balance sheets.

Australia Well Positioned

As we discussed in our April 2011 Newsletter, Australia is in strong corporate health. Profits are strong, balance sheet gearing levels are low and…we will be beneficiaries of China's future growth.

Despite the China factor, both the Government and the RBA are aware that not all parts of the Australian economy will benefit from any future resources boom. While we have witnessed seven official interest rate rises in the last two years, the Reserve Bank of Australia (RBA) has tremendous ammunition at its disposal in event of a worst-case global scenario. Official interest rates can be significantly loosened to deliver a powerful stimulus to households and businesses, if required.

These are interesting times…