MACQUARIE INVESTMENT MANAGEMENT

MACQUARIE

Insight
November 2012

Big picture decisions for Australian equities in 2013

SUMMARY

Markets in 2011/2012 have been dominated by four big themes. In the face of GFC2 fears, investors have preferred the safety of defensives and chased dividend yield over capital growth. These big macro themes may once again dominate thinking in 2013, but how will the year ahead compare to 2012?

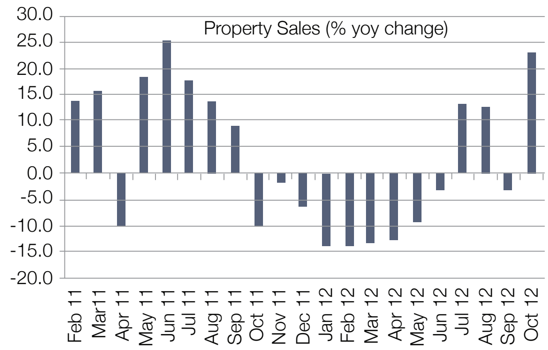
CHINA

China, the dominant driver of iron ore prices, is the most important theme for earnings of miners and mining services companies. The price of iron ore is driving Australian investors' attitudes towards resources and mining services sectors.

To date, China's GDP has slowed marginally more than expected in 2012. However, the Chinese government has been restrained in stimulating the economy, increasing infrastructure but not excessively, and exports fell more than expected. This environment was weaker than business was expecting, resulting in inventory de-stocking in mid 2012. As a result, steel mills are now carrying historically low levels of iron ore.

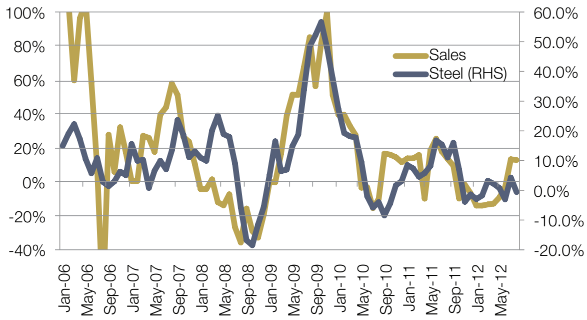
Property sales were negative from October 2011, but turned positive nationally in July 2012 after significant loosening of policy for owner occupier purchasing in March 2012 (refer to chart 1). We are expecting the positive momentum in property sales to continue, although the government remains sensitive to property prices.

Chart 1: Property Sales



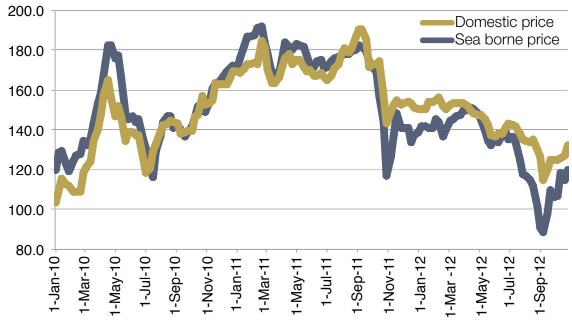
History shows that property sales and steel demand move together (refer to chart 2).

Chart 2: High correlation between property sales and steel



Finally many are unaware that a material difference emerged between the Chinese domestic and the sea borne iron ore price. Over time the prices average to similar levels, but in times of poor sentiment the sea borne price trades well below the domestic price. The dramatic fall in sea borne price led many to declare the end of the commodity boom, and also lead to many mining companies tightening budgets and cutting costs.

Chart 3: Sea borne iron ore prices fell far more than domestic prices in 2012 (US / t)



We remain positive on steel demand in China and iron ore pricing in 2013, with property construction, infrastructure demand and the end of de-stocking all contributing to growth in iron ore demand, while manufactured exports will probably remain weak but should no longer represent a drag on demand. These factors encourage us to believe the sea borne price will close the gap to a rising domestic iron ore price in 2013, surprising many in the market.

We remain overweight mining and select mining services companies as we believe the market is too pessimistic on commodity prices and is prematurely calling the end of the commodity cycle.

EUROPE

Stability in Europe is very important globally. European politicians put into place the framework of the stability regime in late 2011 but it has taken until September 2012 to ratify the European Stability Mechanism, which has allowed the European Central Bank to commit to buying sovereign bonds. The markets have loathed this policy void, with the deep negative sentiment about Euro stability spilling meaningfully into confidence, worsening the macro environment in Europe.

We do not expect 2013 to repeat 2012. The stability mechanisms are finally live and should, when implemented, assist in restoring confidence in the Euro area. Well-documented problems exist in periphery countries which will continue in 2013 but should be less negative.

We believe overall Eurozone can achieve zero to small positive GDP growth, materially better than the dramatic slowdown that occurred in 2012.

US

The US should be in a better position in 2013 as business and consumers face less uncertainty. Elections will be done, and the "fiscal cliff" should be resolved. Housing starts will continue to positively contribute and cheap gas will continue to benefit the economy, as will fewer concerns about Europe.

We remain underweight the expensive defensive and high yield/no growth stocks as we see global risk appetite returning with fading GFC2 fears.

AUSTRALIA

Sentiment is critical to how consumers and businesses are behaving. Australian sentiment is being driven by more than just domestic factors.

The non-mining economy has been weak in 2012: high Australian dollar, low housing starts, job insecurity, banks interest rate decisions and "end of commodity boom" sentiment all contributing.

The Reserve Bank of Australia (RBA) cutting interest rates has traditionally been a signal of a pending turn in the non-mining economy. We do not see the RBA as trying to stimulate the non-mining economy just yet. Rather, they are attempting to stop it getting worse as the mining/liquefied natural gas capex boom will still continue in 2013 even if iron ore prices fail to recover.

We see 2014 as more of the turning point for the non-mining economy in Australia, with a rebound in iron ore prices supporting the Australian dollar in 2013.

We are very selective in our positioning in Australian domestic exposed cyclicals. We see the cycle turning more favourable in 2014 than 2013 presently, but structural issues remain.

CONCLUSIONS

We believe 2013 offers a more optimistic environment than 2012, with the removal of a number of key uncertainties, especially in Europe and the end of de-stocking in China, allowing a modest rebound in the global economy. The Australian equity market is not positioned for such an outcome and remains very defensively focussed.

We disagree with this positioning and see enormous value opportunities in the Australian market reminiscent of the GFC-induced low in March 2009.

CONTACT DETAILS

Macquarie Investment Management Client Service on 1800 814 523
8.30 am to 6.00 pm, Monday to Friday (Sydney time)

macquarie.com.au/mim
email: mim.clientservice@macquarie.com

Macquarie Investment Management
PO Box R1723, Royal Exchange NSW 1225