
Morgan Wealth Management group



Economic & Market Commentary

January 2012

Overview

European sovereign debt issues continued to be the main driver of overall market performance over the December quarter. Most equity markets in developed economies rebounded, after falling sharply in the third quarter. Locally, the S&P ASX200 Index increased 1.2% for the quarter, but was down 14.5% for the year.

In Europe, volatility in financial markets persisted as yields on Italian and Spanish bonds remained at elevated levels. European banks were effectively cut off from new lending prompting the European Central Bank (ECB) and other central banks to intervene and provide liquidity. The ECB cut interest rates by 50 basis points over the quarter and made changes to its two longer-term refinancing operations increasing the maturity of loans to 36 months and relaxing collateral rules. The refinancing operations will provide some relief to funding pressures faced by European banks. They could also allow the banks to take advantage of the cheaper funding using the funds to purchase sovereign bonds, effectively an indirect way of the ECB providing support to the sovereign bond market. However, given that European banks are required to achieve core capital ratios of 9% by mid-2012, the banks may remain cautious in purchasing sovereign bonds, limiting the effectiveness of the plan. In our view, Europe is likely to experience a recession in the year ahead as further austerity measures are introduced and banks continue to deleverage to meet capital ratio requirements.

In the US, the economy showed some slight improvement over the quarter. Retail sales trended higher in the lead up to the Christmas season and consumer confidence improved. The number of jobs created in the quarter improved from previous quarters and average weekly hours worked increased marginally. Although the economic data has been positive, we question whether the current rate of expansion is sustainable in the year ahead. The US government continues to run large budget deficits, but this will be difficult to maintain as government debt levels are already excessively high. We expect this issue will be highly debated in the run-up to the presidential election in November.

In China, economic data released during the quarter indicated a broad slowdown. Inflationary pressures eased over recent months as policy tightening started to take effect. Export growth slowed markedly due to the slowdown in developed economies. Of particular concern was the continued weakness in the property and construction sectors, with reported falls in house prices, sales volumes and private housing construction. If conditions continue to deteriorate and inflationary pressures recede, we think policymakers will ease monetary policy to provide some support to the property and construction sectors.

Ultimately, economic growth in Australia will depend upon an orderly resolution of the European sovereign debt issues and continued growth of our major trading partners, particularly China and to a lesser extent, the US. Economic growth is expected to pick up over the next few years with an increase in planned mining capital expenditure. However, weakness in sectors other than the mining and energy sectors is likely to persist. We expect that consumers in the face of global uncertainty will continue to save more and pay down debt, weighing particularly heavily on our retail and tourism sectors. However, unlike most other developed economies, our relatively low levels of government debt and more neutral interest rates provide some scope for fiscal stimulus and further easing of monetary policy.

Global Economic and Financial Conditions

Global economic data released in the quarter were mixed, with slightly more positive data from the US. However, data also showed that the weakness in Europe had spread to other regions with export growth deteriorating in emerging economies. The sovereign debt crisis in Europe weighed heavily on financial markets with European banks finding it difficult to raise funds, prompting central banks globally to intervene and provide liquidity.

United States

Economic growth in the third quarter expanded at faster pace than previous quarters. GDP increased at an annual

rate of 1.8% in the third quarter, after increasing 1.3% in the second quarter. Personal consumption, non-residential fixed investment and exports contributed strongly.

Retail sales trended higher over recent months. Consumer confidence also improved, although it remained at a subdued level. Activity in the housing sector remained weak and the S&P/Case-Shiller Home Prices Indices indicated that home prices continued to move down further in October.

Manufacturing activity improved over recent months. The ISM manufacturing index rose to 53.9 in December from 52.7 in November. The new orders, production, employment and new export orders components all recorded higher readings. Activity in the non-manufacturing sectors continued to expand, albeit at a

more modest pace. The ISM non-manufacturing index recorded a reading of 52.6 in December, with most components stable to marginally higher over the month.

On average, 137,000 jobs were created per month in the final quarter, an improvement from previous quarters. Job creation continued to be concentrated in the private sector, as the public sector continued to shed jobs. Average weekly hours worked increased to 34.4 hours in December. However, high levels of long-duration unemployment persisted, making up over 40% of total unemployment. Overall, the unemployment rate fell to 8.5% reflecting both gains in employment numbers and declines in labour force participation.

The US Federal Reserve maintained its stance on monetary policy leaving the federal funds rate at 0 to 0.25%. It also continued with the maturity extension program that began in September and its existing program of rolling over maturing Treasury securities into new issues and reinvesting principal payments on all agency debt and agency mortgage-backed securities. The Federal Reserve released new economic projections and lowered its GDP forecast for 2012 from 3.3% - 3.7% to 2.5% - 2.9% and forecasted a higher unemployment rate of 8.5% - 8.7%.

Europe

In Europe, volatility in financial markets remained elevated as a number of banks were effectively cut off from new funding. In response, six major central banks extended existing temporary US dollar liquidity swap arrangements and lowered the cost by 50 basis points. The ECB also cut interest rates by 50 basis points during the quarter and made changes to its two longer-term refinancing operations increasing the maturity of loans to 36 months and relaxing collateral rules. The first such operation in late December attracted borrowings of €489 billion.

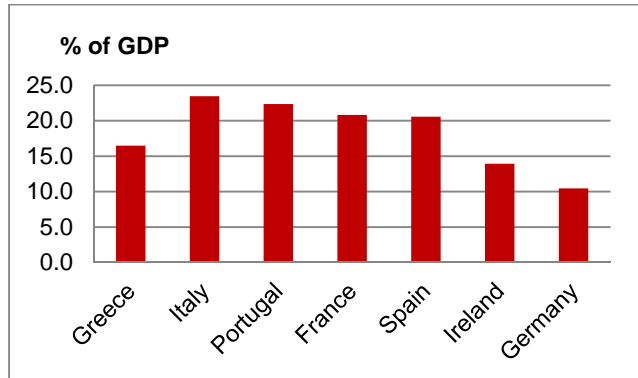
In December, European leaders held a further summit meeting and agreed on some measures which included greater fiscal cooperation, budgets deficits to not exceed 0.5% of nominal GDP and bringing forward the European Stability Mechanism (ESM) to June 2012.

Economic data released over the quarter indicated conditions continued to weaken. Euro area GDP increased by only 0.2% in the third quarter. On a yearly basis, GDP expanded by 1.4%. The unemployment rate continued to trend up, reaching a 13-year high of 10.3% in November. Consumer and business confidence also declined further.

Industrial production declined for three consecutive months to November. The Markit Eurozone Composite Purchasing Managers Index (PMI) recorded a reading of 48.3 in December, up from 47.0 in November. However, it was the fourth consecutive month that the index remained below the 50 level, signalling that business activity continued to contract. Of particular concern was the sharp fall in the new orders for goods and services.

In September, the International Monetary Fund (IMF) released a research note that analysed the fiscal challenges ahead. We have included the following graph

to highlight the significant gross funding needs of various EU countries as a percentage of their forecast 2012 GDP.



Source: IMF Fiscal Monitor

China and India

Lagging effects of policy tightening in China started to work their way through the economy as inflationary pressures eased over the quarter. The consumer price index reached a peak in July at 6.5%, but has since fallen to 4.1% in December. Producer prices also fell over recent months due to lower raw material prices.

Weakness in the property and construction related sectors persisted in the quarter with reported falls in house prices, sales volumes and private housing construction, consistent with the slowdown in credit growth.

Export growth slowed markedly over recent months as external demand remained weak, with exports growing by only 13.8% in November. The HSBC Manufacturing PMI recorded a reading of 48.7 in December reflecting continued deterioration of manufacturing conditions. New orders recorded falls while stocks of finished goods increased.

In December, the People's Bank of China (PBC) cut the reserve requirement ratio for deposit taking institutions by 50 basis points to 21%, the first cut in three years.

In India, GDP expanded at an annual rate of 6.9% in the third quarter, after increasing by 7.7% annually in the second quarter. Services sector growth was quite strong, however the mining and manufacturing sectors were weaker. Inflationary pressures decreased over recent months as food inflation decelerated. The HSBC India Composite Index, which covers both manufacturing and services sectors, increased to 54.2 in December, with the new business component rising markedly.

Calendar year 2010 growth in GDP and forecasts for 2011 and 2012 (Dec 11 Forecast) for Australia and other major regions are shown in the following table.

Growth in GDP (Dec 11 Forecast)

Region	2010	2011f	2012f
US	2.8	1.8	2.1
EU	1.7	1.6	0.4
UK	1.4	1.0	1.1
Japan	4.2	-0.4	2.1
China	10.4	9.1	8.5
India	8.6	7.4	7.7
Australia	2.6	1.9	3.5

Sources: Consensus Economics, Macquarie Research

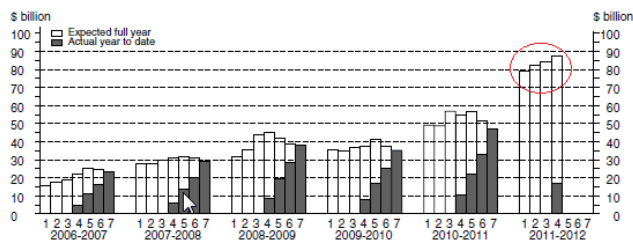
Domestic Economy and Financial Conditions

In Australia, economic data released during the quarter continued to highlight the strength of the mining sector while growth remained sluggish outside this sector, especially retail.

In Australia, GDP rose by 1.0% over the third quarter, following an upwardly revised increase of 1.4% in the second quarter. On an annual basis, GDP increased by 2.5%. Growth was strongest in the mining states of Western Australia and Queensland. Business investment relating to the mining sector was the major driver of growth with non-dwelling construction, and machinery and equipment contributing strongly. Household consumption was surprisingly strong despite the reported softness in retail sales data. The main contributors to growth were the purchase of vehicles, recreation and culture, hotels and restaurants.

The terms of trade increased 2.7% in the quarter, after increasing 5.8% in the previous quarter. This is probably the peak given the recent fall in commodity prices. Total capital expenditure rose by 12.3% in the third quarter, primarily driven by the mining sector. The fourth estimate of the expected capital expenditure for financial year 2012 increased to \$158 billion, an increase of around 6.2% from the previous estimate.

The following graph shows the expected full year and actual year to date capital expenditure for mining.



Source: ABS

Base metal prices recovered some of their losses in the third quarter with copper up 8.9%. Iron ore prices fell from

record levels to around US\$140 per tonne on the spot market.

The recent NAB monthly business surveys suggested that business confidence had improved slightly over the quarter, though still well below the long-term average. Business conditions remained strongest in mining, recreation and personal services, and transport and utilities, while weakest were in manufacturing and construction.

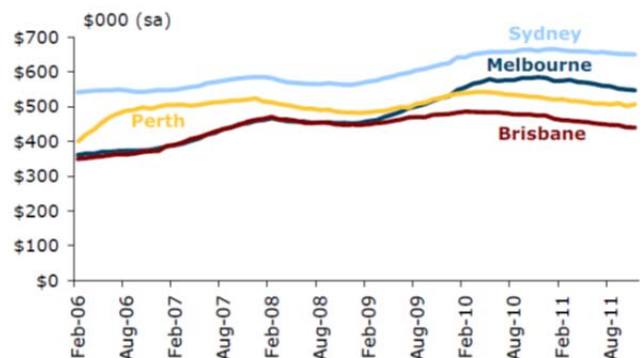
The latest Westpac Melbourne Institute Index of Consumer Sentiment survey released in January showed that consumer sentiment remained weak despite the RBA reducing the cash rate by a total of 50 basis points over November and December. The components of the index suggested that families remained concerned with their debt levels and overall financial position.

Retail sales leading up to the Christmas trading period were weak. Retail sales were flat in November, after increasing 0.2% in October. On a yearly basis, retail sales rose by 3.1%. This was consistent with continued weakness in trading conditions reported by JB Hi-Fi, Billabong and Kathmandu recently.

Credit growth over recent months has remained subdued. Total private sector credit increased by 0.3% in November, after increasing 0.2% in October. On a yearly basis, total private sector credit increased by 3.5%. Business credit outstanding increased marginally over recent months, after trending down since the global financial crisis. Subdued credit growth in the housing sector persisted through the quarter.

House prices in Australian capital cities stabilised over recent months. The latest data released by RP-Data Rismark showed that prices increased marginally by 0.1% in November. On a yearly basis, prices fell by 3.5%. However, the gains were predominantly in prices of units. Over the past year, house prices in Sydney have remained broadly flat while prices in Brisbane, Melbourne and Adelaide fell the most.

The following graph shows the movement of house prices in the major Australian capital cities over the past 6 years.



Source: ANZ, RP Data-Rismark

Recent monthly employment data suggested that conditions remained relatively weak, especially full-time employment. The latest data showed that 6,300 jobs were

lost in November, after the addition of 16,800 jobs in October. The fall in full-time employment was offset by an increase in part-time jobs. This resulted in falls in both aggregate hours worked and average hours worked. Employment increased the most in mining and healthcare but fell in retail, construction, hospitality and financial services.

Core inflation for the third quarter was 0.3% and 2.5% for the year. Headline inflation rose 0.6% for the quarter and 3.3% for the year. Overall, inflation was moderate across most categories.

Global Equities

European sovereign debt issues were again the driver of overall market performance in the final quarter, as markets fluctuated with news headlines. Overall, most equity markets in developed economies rebounded, having fallen sharply in the previous quarter. Energy and industrial sectors performed strongly, while utilities and financials lagged.

For the past 12 months, most equity markets have recorded falls as a result of the steep broad-based sell off in July/August. Few sectors were spared, with healthcare, consumer staples and telecommunications the only sectors to report positive results. In contrast, materials and financials sectors were the worst performers.

Movements in major global indices as at 31 December 2011 ranked in order of quarterly performance are listed in the table below.

Index	Qtr % Change	12 Mth % Change
S&P 500 Index (United States)	11.2	0.0
FTSE 100 Index (UK)	8.7	-5.6
DAX 30 Index (Germany)	7.2	-14.7
CAC 40 Index (France)	6.0	-17.0
Hang Seng Index (Hong Kong)	4.8	-20.0
KOSPI (South Korea)	3.2	-11.0
Straits Times (Singapore)	-1.1	-17.0
Nikkei 225 Index (Japan)	-2.8	-17.3
SENSEX (India)	-6.1	-24.6
Shanghai Composite (China)	-6.8	-21.7

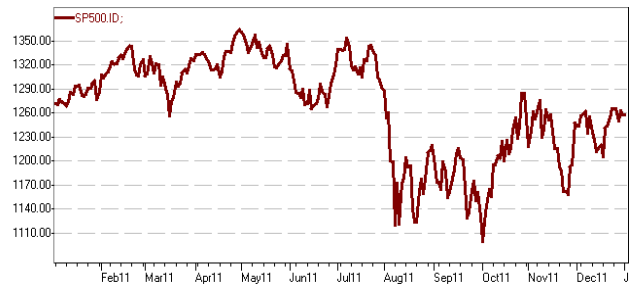
Despite the recent slowdown of growth in the US over recent quarters, companies continued to report relatively strong results. Most companies reported results for the third quarter that beat analysts' estimates. The industrials sector contributed strongly while the mining and insurance sectors produced disappointing results. The earnings results were primarily driven by stronger than expected revenue growth.

Equity indices in the Euro area recovered part of the steep losses experienced in the third quarter with Germany's DAX 30 Index and France's CAC 40 Index up 7.2% and 6.0% respectively. However, financial stocks did not participate in the rebound due to concerns over capital raisings required to increase core capital ratios by mid-2012.

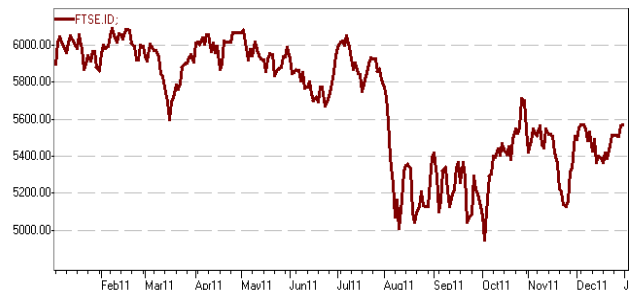
In Asia, most equity indices extended losses from the previous quarter. The Shanghai Composite Index performed poorly in the quarter, falling to levels last experienced in March 2009. Property developers remained under pressure due to a fall in property sales and tight credit conditions.

The following graphs show the movements in major regional indices over the past 12 months.

S&P 500 Index (United States)



FTSE 100 (United Kingdom)



DAX 30 (Germany)



CAC 40 (France)



Shanghai Composite (China)



Sensex (India)



Australian Equities

The Australian equity market remained largely unchanged over the December quarter, after performing poorly the previous quarter. The S&P ASX 200 Index increased by 1.2% for the quarter but was down 14.5% for the calendar year.

The following graph shows the movement in the S&P ASX 200 Index over the past 12 months.



As with global equity markets, the Australian equity market's valuation declined significantly over the year. At the end of the year, the S&P ASX200 price-to-earnings ratio was around 10.5 times forward earnings, significantly below the long-term average of around 14 times forward earnings.

The defensive sectors generally outperformed the broader market as investors sought for earnings certainty and strong dividend yields.

In contrast, the cyclical sectors were the worst performing sectors, especially the Australian retail sector. Downgrades to guidance from JB Hi-Fi, Billabong and Kathmandu resulted in a large selloff across the sector. All three companies noted that trading conditions had been weak in the lead up to the critical Christmas period, which resulted in an increase in promotional activity.

Concerns of a slowdown in global growth and weakening commodity demand from China weighed on the materials sector. After performing quite strongly in the first half of the year, the sector has deteriorated significantly in the second half to finish down 25.5% for the year.

The financial sector outperformed the broader market only marginally. Globally, wholesale debt markets deteriorated over the quarter as European financial institutions found it difficult to raise debt. ANZ, Westpac and Commonwealth Bank successfully raised debt through the issue of covered bonds, albeit at a relatively expensive cost. Going forward, this is likely to impact net interest margins. Following a revision of ratings for the 37 largest banks globally, S&P downgraded the ratings of the Australian major banks by one notch from 'AA' to 'AA-'.

Corporate activity in the coal sector included two merger proposals, Whitehaven Coal and Aston Resources, and Yanzhou Coal and Gloucester Coal.

Industry sector performances for the quarter and year ended 31 December 2011 ranked in order of quarterly performance are tabled below.

Index	Qtr % Change	12 Mth % Change
Telecommunications	6.8	18.3
Utilities	6.5	3.0
Industrials	6.1	-10.7
Health Care	5.0	-10.6
Information Technology	3.6	-22.7
Financial (ex Property)	3.5	-11.0
Energy	2.1	-20.9
Property	1.9	-7.4
Consumer Discretionary	-0.7	-21.9
Consumer Staples	-3.0	-4.9
Materials	-3.2	-25.5

Listed Australian Property

The Australian Real Estate Investment Trust (A-REIT) index outperformed the S&P ASX 200 Index slightly over the quarter. The property index was up 1.9% for the quarter but down 7.4% for the year.

Charter Hall Group and Stockland were the best performing stocks in the quarter while Ardent Leisure and CFS Retail Property performed worst.

Currency

The Australian dollar appreciated against most currencies with the trade-weighted index (TWI) increasing by 7.1% over the quarter, after falling 6.7% in the previous quarter. However, the Australian dollar fluctuated wildly. The euro was particularly weak and depreciated against most currencies over the quarter due to growing concerns over the sovereign debt crisis.

The following graph shows the movement of the AUD/USD over the past 12 months.



Cash

During the quarter, the Board of the Reserve Bank of Australia (RBA) reduced the cash rate by 25 basis points in both November and December, bringing the cash rate to 4.25%. Previously, the Board had left the cash rate unchanged at 4.75% for a year. On both occasions, the Board noted that the sovereign debt and banking problems of Europe would weigh heavily on economic activity over the period ahead. Global financial markets had deteriorated where financing conditions for banks had become more difficult.

Despite the expected pickup in investment over the next few years and the fact that Australia's major trading partners' economies were recording strong growth, the Board remained concerned that the sovereign debt problems emanating from Europe may spill into other regions. It was against this backdrop and the Board's expectation that inflation would be within its target range

over the next couple of years, that the Board decided to decrease the cash rate on each occasion.

Most economists now expect that the RBA will deliver another rate cut of 25 basis points in February to bring the cash rate down to 4.00%.

90 day and 180 day bank bill yields fell in the quarter to 4.48% and 4.43% respectively.

Fixed Interest

Government bond yields in developed economies other than Europe fell to historically low levels. Yields on Australian 10 year Government Bonds decreased by about 60 basis points to 3.67%.

Floating rate securities including bank hybrids and notes performed strongly in the quarter as retail investors sought for higher yielding securities in a falling interest rate environment. As a result, yields dropped markedly.

Both Woolworths and Origin Energy undertook capital raisings during the quarter. Woolworths raised approximately \$700 million through the issue of Woolworths Notes II (WOWHC). The interest rate is calculated on a quarterly basis as the sum of the 90 Bank Bill Rate plus a margin of 3.25%. Similarly, Origin raised \$900 million through the issue of Origin Energy Subordinated Notes (ORGHA), but the margin was set at 4.00% above the 90 Day Bank Bill Rate. Both securities are listed and were trading at a premium to their face value of \$100 at the end of the quarter.

Investment Outlook

The global economy faces significant challenges in the year ahead. Political issues and the European sovereign debt crisis are likely to continue to weigh heavily on financial markets. With both public and private sectors in developed economies continuing on the path of deleveraging, economic growth is likely to remain subdued. In this environment, consumer and business confidence will remain weak.

In Europe, it is clear that the sovereign debt crisis will drag on for some considerable time. It seems to us that the series of summit meetings held over recent months have focused on greater fiscal cooperation and fiscal austerity, without any measures to support growth. At the time, the general view of market participants was that the European Central Bank (ECB) would view these agreements positively and increase its direct government bond purchases in the secondary market to drive yields down to a tenable level. However, at its press conference in December, the ECB restated its position that it would not support such actions. Instead, it announced that it would conduct two longer-term refinancing operations, increasing the maturity of the operations to 36 months and allowing for a wider range of assets used as collateral. The first operation in late December was well received, attracting

borrowings of €489 billion. The second operation is expected in March 2012. The operations will provide some relief to the funding pressures faced by European banks and could also allow them to take advantage of the cheap funding and use the proceeds to purchase sovereign bonds. The impact of these operations on sovereign bond yields remains unknown since European banks are unlikely to increase holdings of sovereign bonds significantly given that they are under pressure to achieve core capital ratios of 9% by mid-2012. We are unsure how things will ultimately unfold, but with further austerity measures to be implemented and banks continuing to deleverage to meet capital ratio requirements, it looks increasingly likely that Europe will enter a recession in 2012.

The US economy faces significant challenges in the year ahead. Although the recent economic data has been slightly positive, it is questionable whether this is sustainable given the consumer remains debt constrained. To date, both monetary and fiscal policies have been supportive of private sector demand. Going forward, we expect monetary policy to remain stimulative, but fiscal policy to be less supportive. The US government continues to run large budget deficits, but this will be difficult to maintain as government debt levels are excessively high. We expect this issue will be highly debated in the run-up to the presidential election in November. In an environment where both private and public sectors are deleveraging, we expect economic growth will be relatively weak.

In China, economic data released over recent months indicate the emergence of a broad slowdown. Exports are being impacted by the slowdown in developed economies, especially Europe. On the domestic front, there has been a slowdown in the property and construction sectors due to policy tightening. If conditions continue to deteriorate and inflationary pressures recede, we think Chinese policymakers will ease monetary policy to provide some support to the property and construction sectors.

In Australia, economic growth is expected to pick up over the next few years due to an increase in planned mining capital expenditure. As had been reported in our previous quarterly reports, weakness in sectors other than the mining sector is likely to persist. We expect that consumers in the face of global uncertainty will continue to save more and pay down debt weighing particularly heavily on our retail and tourism sectors.

Unlike other central banks in developed economies, the RBA has greater flexibility to reduce the cash rate to support the economy if conditions deteriorate. However, we expect that banks will only pass on part any RBA rate cut given the escalation in wholesale funding costs over recent months.

We still maintain our positive view on the outlook for the resources and energy sectors. However, we recognise that China will need to rebalance the economy over the medium term, allowing fixed asset investment to slow and consumption to play a bigger part of GDP. As a result, the Chinese economy could slow as it makes this transition and commodity demand, especially iron ore, could weaken. We will continue to monitor this development closely.

Given the risk that European sovereign debt crisis could deteriorate further, we think equity markets will remain volatile for some time. With this in mind, we think it is prudent to continue to take a conservative approach and maintain relatively high allocations of cash and fixed interest.

Disclaimers

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