## 2009 Review

**Obama's tough introduction**

We began the year with a newly elected US President, US interest rates at near zero and US banks and companies failing at an unprecedented rate. The GFC was at its peak. More than US$8 trillion had been wiped off the US stock market and companies as big as General Motors were in deep trouble.

The US Federal Reserve's plan included deploying its balance sheet by printing money, and lots of it.

New Treasury Secretary, Timothy Geithner's initial plan lacked enough detail, but the subsequent plan to 'stress test' 19 of the country's largest banks to see if they had enough capital looked more promising.

At this point in February, the US reported that its economy had shrunk by 6.2% in the final three months of 2008. US stocks slid to a 12-year low.

Just as things looked at their worst, a flurry of economic reports emerged showing surprising signs of stability in home sales, retail spending, factory orders and consumer confidence. Mr Geithner's extra homework revealed greater detail about the administration's asset-purchase program and stock markets breathed a huge sigh of relief. The worst seemed over.

The banks that were stress tested showed that about US$75 billion of additional capital was needed. Investors quickly stumped up the capital as several banks were eagerly reporting that they had returned to profitability in the first three months of 2009.

General Motors did eventually enter bankruptcy but most of the big banks survived and quickly repaid the large amounts of bailout money that had tided them over.

It appeared that stability had returned to financial markets as credit began to flow again. Confidence surged, companies began reporting profits that were 'less bad' than expected and by September, Mr Bernanke, the Chairman of the Federal Reserve and principal architect of the recovery plan, declared the recession was "very likely over".

Overall, according to the IMF, governments have spent about US$12 trillion propping up economies around the world. Ratings agency Standard & Poors says banks have written down about US$1.7 trillion in asset values and raised about US$1.5 trillion in new equity to meet capital adequacy levels, although this still is not enough in their opinion.

**The lucky country**

Here in Australia, we were mere observers to the shambles that was unfolding in the US, UK and elsewhere across the globe. To a large extent, our stock market volatility and government stimulus response was a mirror image of the playbook in the US. The government handed out lots of cash to keep retail tills ringing and promised loads of extra money for school halls, roads, bridges and all manner of projects designed to keep people in jobs.

Corporate Australia reacted quickly to the renewed confidence and raised almost $100 billion of fresh capital in the 2009 financial year to rejuvenate balance sheets. Much of the equity raised went to repaying bank debt.

In particular, our key banks raised so much capital that they maintained their exemplary credit ratings and became the touchstone for Australia’s seemingly miraculous avoidance of the worst effects of the GFC.

It also helped that the Australian banks experienced almost none of the large company failures that the US, UK and European banks were crumpling under. Even towards the latter part of the year, concern about the banks’ exposure to the small and medium enterprise sector was diminishing.

The government and other commentators variously attributed Australia’s unblemished banking sector as the consequence of rigorous corporate governance and regulation. The ‘four pillars’ policy had paid off handsomely, hailed the plaudits.

The Australian government had followed the lead of other countries by offering guaranteed deposits. Unsurprisingly, this sparked a rush of redemptions from institutions outside the tent to those within the comforting arms of the guarantee. This would ultimately boost the local banks’ share of deposits to over 70% of total deposits, further underpinning their capital adequacy ratios. It also led to a similar growth in their dominance of the residential mortgage market with the big four banks owning more than 70% of that market.

Far fewer people lost their jobs than was initially feared. House prices did not collapse (in fact, they went up) and the rapid reduction in interest rates (425 basis points) freed up large dollops of mortgage payments for other expenditure. Even oil prices helped out by lowering the cost of fuel. Little wonder that consumer confidence barely flinched throughout the year and surged instead to a 2-year high in October.

The resilience of the Australian economy was encapsulated throughout the year by various comments made by the Reserve Bank in its monthly policy notes.

**Chinese Takeaways**

It’s hard to ignore the part that resource-hungry China has played in Australia’s great escape. The massive stimulus that China’s government enacted only served to pour petrol on the fire in terms of their need for basic commodities like iron ore and coal – commodities that Australia has in abundance.

China’s economic growth did slow over the course of 2008 but has regathered pace as the Chinese government brought in a massive fiscal stimulus package and kept interest rates low. GDP growth was running at an annualised 8.9% in the third quarter, well above the government’s target of 8% for the full year.

China’s energy sector has underpinned demand for Australian coal. Three quarters of China’s power generation is coal-fired and on average, two new coal-fired power plants are being built each week in China to meet demand for electricity. Even though China is the world’s largest producer of coal and has its own massive resources, it has imported coal in record tonnages from Australia in 2009, placing a major strain on Australia's port and rail infrastructure.

Australian metallurgical coal (coking coal), used in steel-making, has also been highly sought after by Chinese manufacturers. China has lifted its steel production to 617 million tonnes per annum (mtpa) in September from 423mtpa as at October last year. Total steel production for 2009 will be close to 575mt, up from 500mt in 2008, and heading for 650mt in 2010.

Although prices for iron ore and coking coal have retreated from record highs in 2007/8, the increased volumes being exported are helping to offset this factor. In addition, even if Chinese demand does taper as stockpiling slows, mothballed capacity is restarted and credit is tightened, then the recovery in other markets such as Europe and the US could support demand. Steel manufacturing capacity utilisation in these other markets declined around 50% in 2009.

Demand for the bulk commodities has been sufficiently strong to ensure that spot prices have increased to levels well above the contract prices. Indeed, RIO and BHP have yet to conclude negotiations with Chinese buyers for contract iron ore prices, placing more pressure on China to settle.

A side effect of this has been a large number of potential and actual acquisitions of Australian resource companies, or stakes in them, by Chinese companies.

**Iron Ore Triangle**

The largest of these by far was the $19.5 billion deal that RIO initiated with Chinalco in February. In an attempt to shore up its balance sheet, and avoid BHP's predatory overtures, RIO held talks with the Chinese state company to sell stakes in some of its mining operations in return for a heavy investment in the company. RIO's shareholders did not like the deal and it was eventually canned in favour of a huge $15.2 billion rights issue and an equally gigantic iron ore joint venture with BHP in the Pilbara region of Western Australia.

That deal has just been consummated in December. It certainly did nothing to foster Australia's relationship with China having led Chinalco up the aisle only to elope into the WA sunset with childhood nemesis, BHP.

Of course they would deny it, but the detention and arrest of RIO's executive, Stern Hu, by the Chinese government during the whole process may be seen by some as retribution for the deal debacle.

**Gorgon and other LNG**

Australia's resource riches do not start and finish with BHP and RIO, however. For many years, the North West Shelf was Australia's single largest resources project and export earner. Also for many years, the giant Gorgon hydrocarbon fields were lying in waiting as the heir apparent to that title.

Finally, the huge liquefied natural gas project has ticked all the necessary boxes for investors and governments alike. The investors are three of the world's biggest oil companies – Chevron (50%), Exxon Mobil (25%) and Royal Dutch Shell (25%). Chevron has since sold down a small proportion of its stake to various customers in conjunction with supply contracts.

The 30-year plus project is expected to start production in 2014. It will produce 15 million tonnes of LNG each year, which will earn export sales of approximately $300 billion over the first 20 years.

To build the project will require an investment of about $43 billion – roughly twice that of the North West Shelf project - and will generate around 6,000 jobs. A vast array of contracts is rapidly being deployed to cover the engineering and construction of the plants and offshore infrastructure. The ancillary projects such as housing, marine services and general construction and engineering work will also provide an enormous boost to the Western Australian economy. Although most of the larger contracts are likely to be won by international companies, there is still a substantial benefit to be gained for many Australian businesses.

The good news on LNG doesn't end with Gorgon either. The first phase of Woodside Petroleum's $12 billion Pluto LNG project is nearly complete and the company is close to securing an expansion of the facility. Woodside has to other substantial potential LNG projects at Browse and Sunrise that would come on-stream shortly after the Pluto expansion project begins delivering its first gas around 2013.

There is a raft of other LNG projects based around coal seam gas located in Queensland that are progressing to various stages of readiness.

US oil giant, ExxonMobil, has also recently given final approval to its $15 billion LNG project in Papua New Guinea. Exxon's Australian partners are Santos and Oil Search.

In all, the growth of LNG as an industry will catapult Australia into the world's second largest LNG producer in time.

The Reserve Bank of Australia has estimated that investment in the LNG sector would rise from around 0.5% of GDP to about 2.5% of GDP in the next four or five years.

**Currency bungy**

The Australian dollar has been led on a merry dance over the last 18 months. From a high of almost US98 cents in July 2008, to a low point of around US60 cents in October 2008, the Aussie dollar has since lifted steadily throughout 2009 to its current level around US88 cents.

Most of this year's increase can be attributed to the huge drop in US interest rates to near zero, while Australian interest rates dropped no lower than 3% during the global easing of monetary policy. That difference in rate, together with rising commodity prices, has put the Australian dollar on an upward trajectory that some commentators believe will result in parity with the US dollar sometime in 2010.

The decline in the US dollar is likely to persist as the Federal Reserve remains committed to lower rates for longer while the US economy limps towards recovery.

As the Reserve Bank of Australia has already begun increasing interest rates towards more normal levels, the attraction for foreign investment will support that trend.

**We've golden soil...**

The demise of the US dollar has led to a scramble into gold as a genuine hard currency alternative.

Gold began the year at US$875 per ounce and has risen steadily throughout to reach current levels around US$1,100 per ounce after peaking just above US$1,200 per ounce late in the year.

A notable aspect of the gold market this year was the emergence of central bank buying of gold from the International Monetary Fund. In particular, the Indian central bank bought 200 tonnes of IMF gold putting a large dent in the 400 tonnes of gold the IMF has for sale. Mauritius, Russia and Sri Lanka have since bought gold from the IMF and other Asian countries are expected to pick up on the trend to diversify foreign exchange reserves away from US dollars.

Australia's listed gold sector has benefitted from the rising gold price, particularly stocks without significant hedging.

**... and wealth for toil**

Company earnings in Australia were nonetheless hit fairly hard in the financial year ending 30 June 2009. Many companies reported significant impairment losses on assets and intangibles, together with the effects of grimly lower operating earnings.

Most companies invoked austerity programs aimed at lowering cost bases to align with lower expected levels of activity. In some cases, this ran into the hundreds of millions of dollars of cost savings as plant capacity was shut, capital expenditure programs deferred or cancelled and workers either made redundant or put on reduced hours and pay.

No industry in particular was spared from the gloom but there were some standout examples such as the ANZ Bank's 800 people shown the door early in the year and Pacific Brands' 1,850 workers told of the shuttering of manufacturing plants in Australia and New Zealand. The latter earned the direct ire of the Prime Minister in the depths of the gloom.

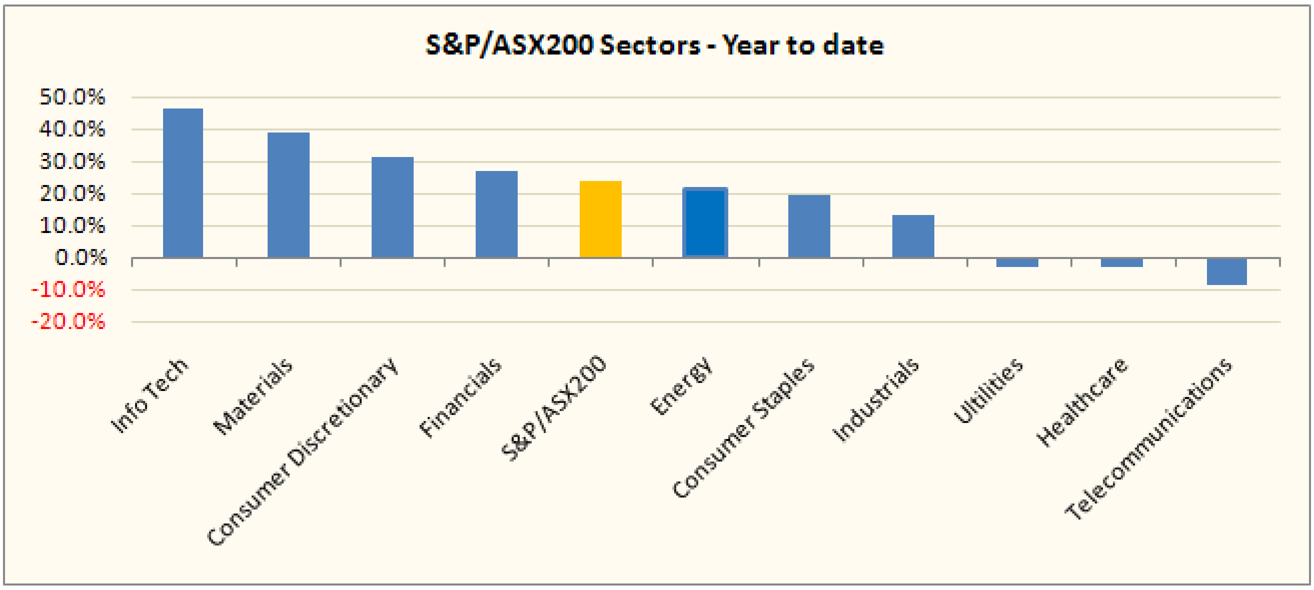
But the mood of the country's consumers and businesses has lifted substantially throughout the year as measured by various indexes. This was largely attributed to the feeling that Australia had escaped relatively unscathed from the global turmoil.

As a consequence of the rapidly improving stock market and house prices in 2009, the recovery in household wealth (and some government lolly) has sustained the retail sector in particular.

Many companies remained cautious with regard to outlook statements during the recent annual meeting season, but most were optimistic at the same time.

**Rising tide, but not for all boats**

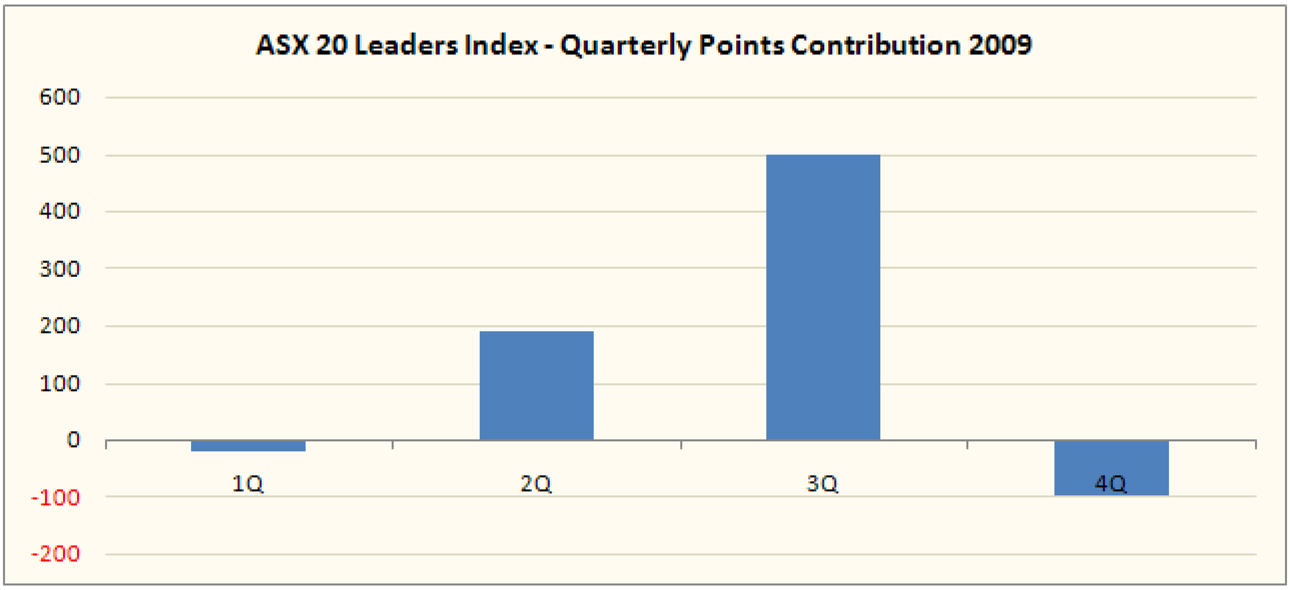
Within the Australian stock market in 2009, the performance between different sectors of the market was not even. The standout sectors were the banks, consumer discretionary stocks and the major mining and energy sectors. The biggest underperformance came from the telecommunications and healthcare sectors.




The S&P/ASX 200 Index reached a low point of 3,145.5 on 6 March after starting the year at 3,722.3. As at the time of writing, the index had risen around 24% for the year to date and about 47% from the lowest level in March.

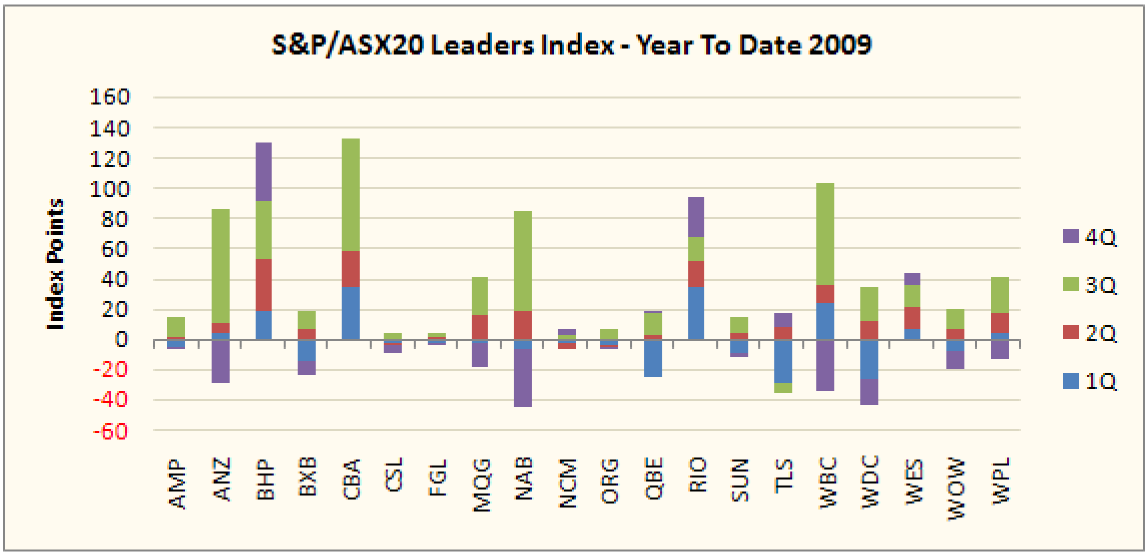
But that compared to the peak level, pre the GFC crisis, of 6,828.7 reached in November 2007. The market is still some 32% below that level.

Illustrating the recovery during the year is the following chart of the 20 Leaders Index by quarter. It clearly shows the market surged in the second and third quarters and has consolidated in the fourth quarter.




The telecommunications sector underperformed the market by almost 28% for the year. This was mainly due to the specific situation enveloping Telstra concerning the impending split of its network and retail assets.

Using the Twenty Leaders Index as a proxy for the wider market, it becomes even more apparent that the best stocks to have owned in 2009 were the banks, BHP and RIO. In aggregate, the four banks (not including Macquarie Bank) contributed just over half the 26% gain in the 20 Leaders index in 2009, while BHP and RIO combined contributed 39% of the gain.

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