2010 Review

The effects of the GFC continued to linger into 2010 and politics dominated financial markets.

The European debt crises in consecutive countries created the most concern for global investment markets. Greece, Spain, Ireland and Portugal all required close scrutiny and support from the European Union and the IMF.

Britain’s new coalition government instigated a severe austerity program to reduce its financial burden.

The US economy struggled to gain any momentum and will end the year with unemployment still perilously close to 10% and consumers reluctant to spend. The Federal Reserve instigated a US$600 billion quantitative easing program that will drip feed the economy with more stimulus as long as it is needed. Late in the year, the US Senate passed an US$858 billion tax-cut plan that extended Bush-era reductions for all income levels. The rising budget deficit problem will hamper the world’s biggest economy for years, but not halt it.

China, the world’s second largest economy, continued its inexorable march to economic superpower status courtesy of an artificially low currency and a massive lift in living standards for its huge population.

Australians thanked their good fortune for the plentiful and valuable bulk commodities that disappear northward in ever increasing amounts to China and Asia. The banking system easily recovered from the GFC, boosting profits substantially as bad debts dwindled.

Although the Australian stock market has underperformed the US market, as shown in the table below, the Australian dollar rose over 10% against the US dollar and the price of gold also reached new highs as the value of the US dollar continued to decline.

Market Indicators	31-Dec-09	21-Dec-10	%chg
S&P/ASX 200 Index	4,870.64	4,777.00	-1.9%
Dow Jones Industrial Average	10,428.05	11,478.13	10.1%
A$:US$	0.8972	0.9963	11.0%
Australian 10 year bond rate	5.73	5.59	-2.4%
US 10 year bond rate	3.84	3.35	-12.8%
Gold (US$/oz)	1095.7	1,386.64	26.6%
Oil (US$/bbl)	79.60	89.56	12.5%

A week is a long time in politics

Politics dominated the Australian market in 2010, domestically and internationally.

In Australia, the abandoned ETS (Emissions Trading Scheme) was followed by the Henry Tax Review which brought us the ill-advised Resources Super Profits Tax (RSPT). Sovereign risk suddenly became a massive issue for the country's booming mining industry and nearly halted many billions of dollars of investment. Mr Rudd and the unilaterally vilified RSPT duly departed to be replaced by the Minerals Resource Rent Tax (MRRT) and Ms Gillard as PM.

The government predicted the MRRT would raise $10.5 billion in 2012-14 - $1.5 billion less than the RSPT. This figure was based on the lower tax rate of 22.5% instead of 40% and the doubling of the threshold at which it kicked in. But it was also based on much higher iron ore and coal prices. If the original RSPT assumptions had been used, the MRRT would have raised just $4.5 billion, providing the mining industry with a $7.5 billion concession.

With the mining companies subdued, new Prime Minister Julia Gillard headed to an August poll confident of victory but devoid of meaningful policies. A disgruntled electorate instead delivered a hung parliament in which two independent regional MPs extracted some substantial concessions in return for supporting a minority Labor government.

The MRRT issue is clearly not over. The government is wavering over the possibility that future state royalty increases would not be creditable against the mining companies' MRRT liabilities. The companies are adamant that this is the case. The implications for the federal budget could be politically significant if the envisaged tax revenue from the MRRT falls well short.

This issue will be a tricky one for the government to resolve in 2011.

European contagion

As the European economies had followed the US into the GFC, it was to be expected that 2010 would reveal the extent of the damage to the weaker economies within the union. A new acronym PIIGS – Portugal, Ireland, Italy, Greece and Spain – became a popular reference to the trouble spots. Being part of the euro zone meant that none of these countries was able to devalue its currency in response.

Greece began proceedings with a €110 billion aid package that was conditional on severe austerity measures being imposed on the economy. The Greeks reacted with violent protests but could not avoid the inevitable reforms.

By April, Standard & Poor's (S&P) had downgraded Greek government debt to junk status, cut Portugal's credit rating by two notches and downgraded Spain's outlook. The world was focused on the contagion spreading from the smaller European nations to the larger countries.

The pressure mounted on Germany to introduce budget cuts that would bring its economy within EU limits by 2013. The country obliged with €80 billion of cuts spread over a three year period. Germany surprised the world with strong GDP gains by mid-year, lifting the pall of gloom over Europe.

But the wall of worry returned when Ireland's long-term rating was cut by S&P who duly slapped on a negative outlook for good measure. Ireland's government unveiled a €15 billion (10% of GDP) four-year austerity plan of spending cuts and tax increases in return for €85 billion of bailout money from the EU and the IMF. Ireland's budget deficit took a huge hit in 2010 as a one-off bill to bail out its banks took the deficit from 11.7% to 32% of GDP. The austerity plan is expected to reduce the deficit (excluding the bank bailout) to 2.4% of GDP by 2014.

Spain soon followed, losing its AAA status with similar problems requiring large scale budget cuts. The fourth largest economy in the euro zone, Spain has yet to ask for a bailout but the probability remains high. The government has reacted quickly to cut spending and debt, raising taxes and selling state assets to reduce its budget deficit from 11.1% of GDP in 2009 to 6% next year.

The European Union leaders recently agreed to transform the temporary €750 billion safety net into a permanent fixture from 2013 to defend the euro. The European Safety Mechanism (ESM) will be able to grant loans to distressed member states but must first attain agreement from all member states, including Germany which will retain a veto.

France, Germany and Italy have escaped relatively unscathed. France raised its retirement age and boosted public sector contributions to private sector levels – both very unpopular measures. Italy mirrored France's moves even though its budget deficit was not as high. Germany also took steps to reduce its deficit by €80 billion to reach European Union limits by 2014.

US market

Treasury Secretary Timothy Geithner was a principal architect at the centre of the US government bailout during the peak of the GFC. He had inherited former Treasury Secretary Henry Paulson's Troubled Asset Relief Program (TARP) that pledged US$700 million of funds to bail out failing companies. Big corporate such as General Motors, Citigroup, and AIG lined up for help which was duly despatched.

Last week, Mr Geithner was able to tell a US congressional panel that the final cost of the TARP fund would come to less than US$25 billion as many of the funds had been repaid (banks) or investments made by taxpayers sold at a profit (GM, Citigroup). Remarkably, the net cost to the economy would be less than 1% of GDP compared to more than 2.4% due to the savings and loan crisis of the 1980s.

The Dow Jones Industrial Index climbed a respectable 10.3% (at the time of writing) in 2010, but was 75% above the low point of 9 March 2009.

US companies enjoyed a bumper year for profits approaching US$19 billion according to the New York State Comptroller's Office. Having reduced their costs, companies were sitting on more than US$436 billion of cash at the end of the third quarter of the calendar year.

Easy monetary policy settings were sustained throughout the year as the Federal Reserve kept interest rates at record lows. "The economic recovery is continuing, though at a rate that has been insufficient to bring down unemployment," the Fed said after its December policy meeting.

Unemployment remains stubbornly high at 9.8% and has been above 9.5% for the last 16 months, the longest stretch since records began in 1948.

In addition to keeping interest rates near zero for an extended period of time, the central bank pledged to buy US$75 billion worth of Treasury bonds each month to help keep interest rates down. The eight month program will buy up to US$600 billion of bonds. This was the much-touted QE2 (quantitative easing) policy announced in November.

Up to that date, the Federal Reserve had already expanded its balance sheet by about US$1.7 trillion in longer term assets.

The November mid-term elections also signalled a change in direction for US economic policy as the Republicans regained control of the Congress. When President Obama tried to roll over the Bush-era tax cuts, he was forced to compromise to allow tax cuts for the wealthy to be maintained. The huge and growing US budget deficit dominated financial headlines in 2010 and is likely to be a central issue through to the next Presidential election in 2012.

But the US will end 2010 in a slightly more confident mood as retail sales start to tick up and GDP growth looks to be improving. Momentum that was lacking in 2010 may return in 2011.

China

China's economy eclipsed Japan to become the second largest in the world during 2010. It was really just a question of when, not if, considering the country's huge population and rapid modernisation. GDP will probably have grown by around 10% in 2010 to approximately US$5.87 trillion. China's foreign exchange reserves will total around US$2.75 trillion, excluding its gold holdings.

The Chinese central bank has had to play the exact opposite game of its US counterpart by tightening credit to prevent a housing bubble and to control inflation which now sits just above 5%. Instead of significantly raising interest rates, however, the People's Bank of China (PBOC) has imposed greater restrictions on its banks by raising their reserve requirement, to slow down the rate of credit growth.

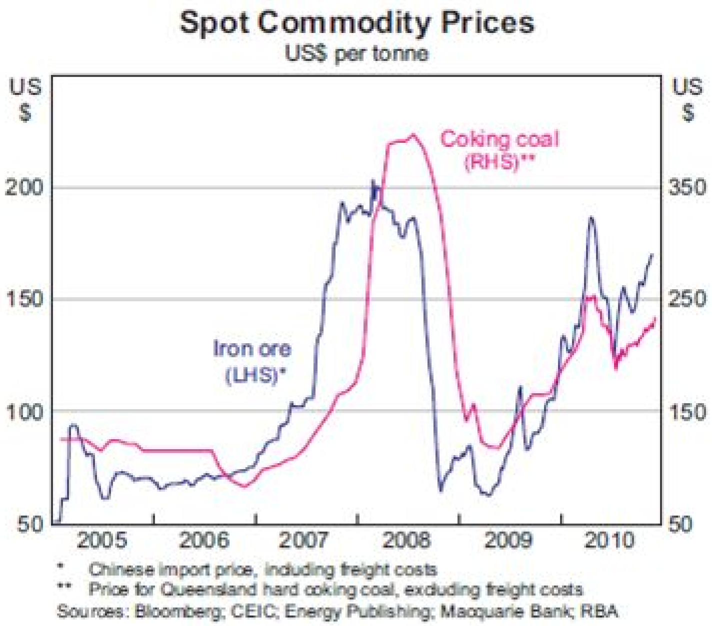
The PBOC will need to do more if it is to contain the surging housing market. Deposit rates around 2.5% and inflation above 5% is a disincentive to save and has fed the housing market and the stock market in China.

The Chinese government has come under sustained attack from the US for its artificially low currency that has been a central topic of discussion between the two countries in 2010. But Beijing has been in no hurry to lift the value of its currency, preferring to instigate minor rises in interest rates.

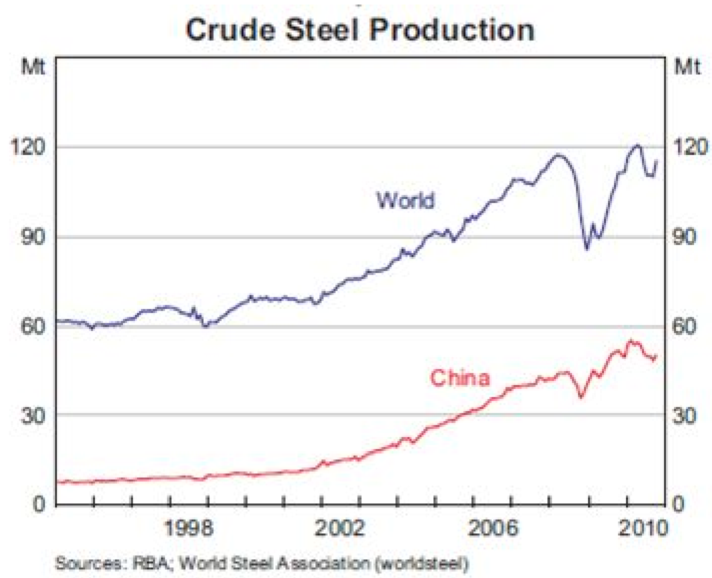
The trade deficit with the US for 2010 will likely end around US$249 billion and US lawmakers are unhappy that the yuan is, by some measures, undervalued by 25-40%. Trade tensions between the two countries will spill over into 2011.

The growth in China's infrastructure continues to absorb much of the world's raw materials. The country's energy supply plans for 2020 include big increases in renewable resources such as hydro, wind and solar energy, but these pale into comparison with the continuing demand for thermal energy. Coal is expected to increase from 1.7 billion tonnes in 2009 to 3.4 billion tonnes in 2020, lifting capacity from 652 gigawatts in 2009 to 1,000 gigawatts by 2020 - still two-thirds of the country's needs.

The China Iron and Steel Association said total imports of iron ore for 2010 would be unlikely to exceed last year's 627.8 million tonnes but stockpiles were at low levels. The big change for 2010, however, was the shift from annual to quarterly pricing of contracts which has enabled BHP, Rio Tinto and Vale to price iron ore more closely to demand. Iron ore prices almost tripled this year to US$185 per tonne in April and although prices declined 10% in the fourth quarter, tight supplies should see prices up again in 2011.



China now accounts for 45% of the world's steel production, underlining its importance to Australia as a major customer for iron ore and coking coal. In recent years, more than 80% of China's iron imports have come from Australia, India and Brazil.



A decade ago, China accounted for 5.1% of Australia's exports (Japan 19.3%, USA 9.9%). In 2010, China became Australia's largest trading partner taking 23.2% of its exports, surpassing Japan (18.5%) and the USA (4.8%).

Resources rollercoaster

Australia's two biggest miners epitomised what was to be a roller coaster year for resources companies. BHP Billiton and Rio Tinto had begun 2010 with an agreement to create a US$116 billion iron ore joint venture in the Pilbara, knowing that various regulators and the global steelmaking industry would scrutinise the deal closely.

But the real issue for 2010 turned up unexpectedly in early May. The Henry Tax Review included the government's revelation that it would introduce a new tax on the resources industry intended to fund lower corporate tax rates and return the budget to surplus by 2013.

With the revised MRRT in place, the resources industry went back to planning for new growth. According to the Australian Bureau of Agricultural and Resource Economics, by the end of October there were 72 projects at an advanced stage of development in Australia with a record $132.9 billion of capital expenditure – a 21% increase from April. In the six months to October, 25 projects worth $8.2 billion had been completed.

For 2011, ABARE estimates that new capital expenditure of $54.8 billion is likely.

BHP Billiton's US$38.6 billion bid for Potash Corporation was deemed "grossly inadequate" by that company's board. In any event, the Canadian government blocked the takeover and BHP's chief executive Marius Kloppers was left with another uncompleted deal. Worse was to come.

Though both big miners tried earnestly to join forces in the Pilbara, eventually the regulatory opposition scuttled the deal and it was terminated in October. Rio Tinto immediately set out its $13 billion plans to expand its iron ore output to 333 million tonnes per annum by 2014.

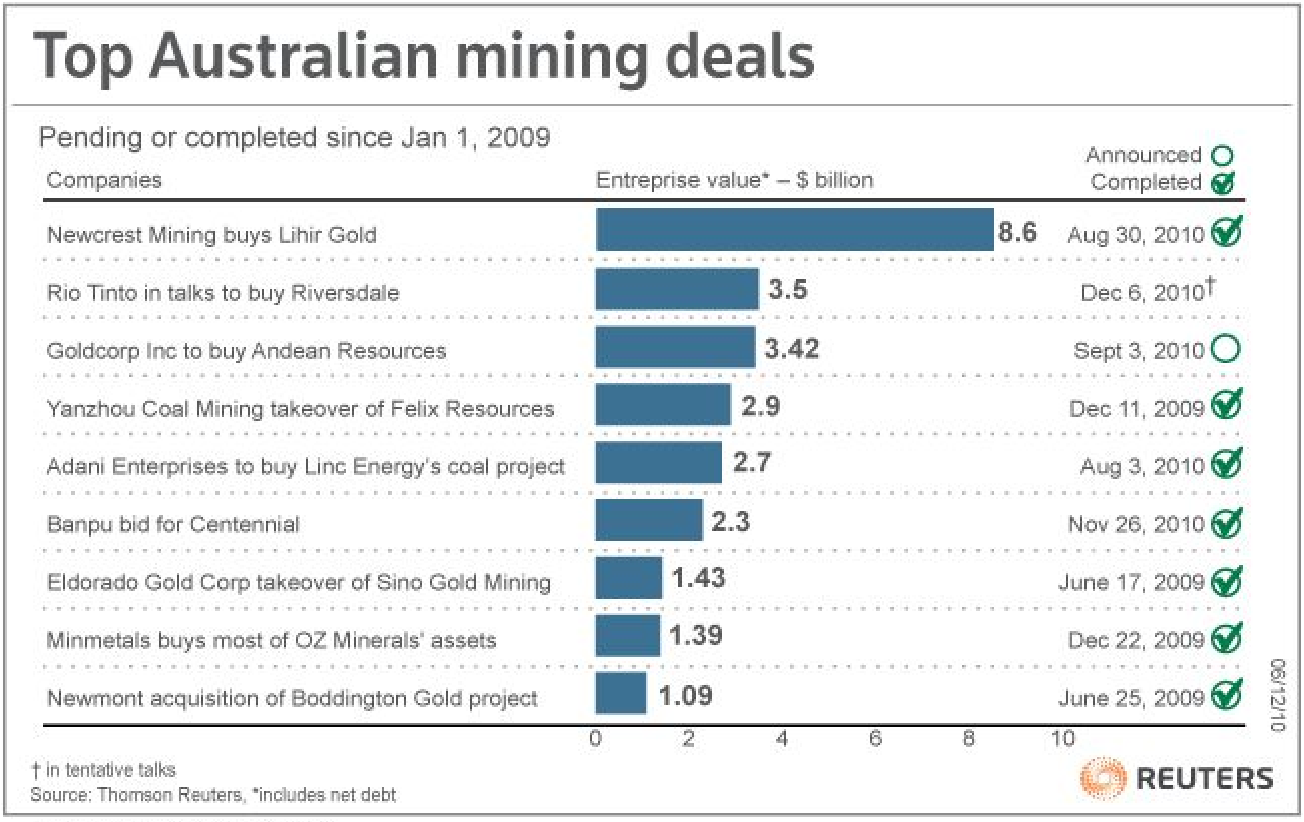
Both BHP and Rio are sitting on very conservative balance sheets and therefore have considerable scope to make further investments. But pressure is growing for greater returns to shareholders. A capital return of some size could be possible for either company in 2011.

The big LNG projects announced in 2009 worked towards financial and regulatory completion during the year. The giant Gorgon project in WA is due for completion in 2015 and will cost $43 billion. Woodside Petroleum's Pluto LNG project and the various Queensland coal seam gas LNG projects are all at various stages of development.

Coal mining projects also continue apace, particularly in Queensland and NSW where Xstrata and Rio completed significant projects. There was plenty of takeover activity in the sector too, with Macarthur Coal and Centennial Coal among the companies of interest.

Newcrest's $8.5 billion takeover of Lihir Gold has boosted the former into the big league of global gold producers. Newcrest will lift its gold production to 3.75 million ounces in 2014 from 2.74 million ounces in 2010.

The mining industry saw several big takeovers as shown in the chart below:



Reuters graphic/Catherine Trevethan

In other important corporate events in 2010:

· Telstra continued to negotiate its way through the separation of it wholesale and retail businesses to make way for the National Broadband Network.

· QR National was the year's largest float. The Queensland government raised $4.6 billion and still owns 34% of the company.

· AMP successfully waited out NAB to claim AXA Asia Pacific for $4.15 billion.

· Foster's decided to split its beer and wine businesses in 2011.

· Tabcorp decided to demerge its casino business from its wagering and gaming business in 2011.

· Westfield separated its Australasian shopping centres into the Westfield Retail Trust.

· Shell sold about 10% of Woodside Petroleum for $3.3 billion but retains 24%.

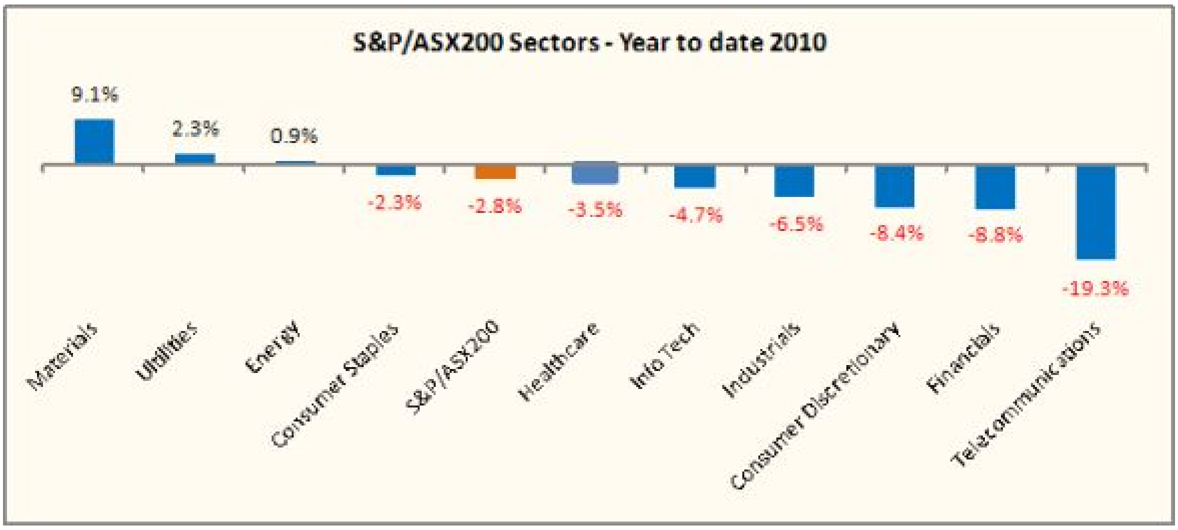
Australian economy in good shape

Interest rates were on the rise as the year began. Unemployment at 5.7% was still declining and consumers were feeling 'OK' about life as the economy had apparently escaped the worst of the GFC. The official cash rate began 2010 at 3.75% but was progressively increased to 4.75%.

Inflation was pretty much under control at 2.4% annualised and house prices had risen by 13.6% in the fourth quarter of 2009 and by 20% year on year in the first quarter, according to the Australian Bureau of Statistics.

Business and consumer confidence fluctuated but ended the year solidly in positive territory.

Within the stock market, the materials sector was the best performing sector gaining over 9% compared to the S&P/ASX200 Index decline of 2.8%. Telstra was largely responsible for the telecommunications sector's underperformance to be the worst sector for 2010. The financial sector also underperformed faring only slightly worse than the retailers in the consumer discretionary sector. The chart below shows the sector performances:



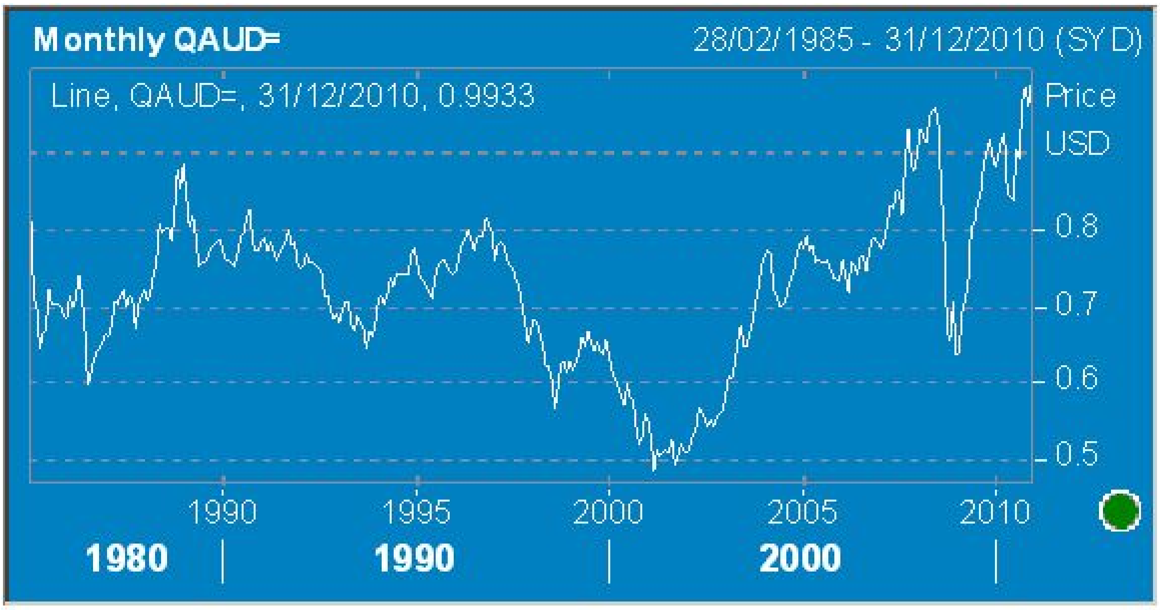
The banking sector was under pressure towards the end of the year with the threat of regulatory reform both domestically (from the Treasurer) and internationally (from the new Basel 3 reforms). In the end, neither was particularly onerous.

The real problem for the banks stemmed from pressure on their net interest margins as cheap pre-GFC funding continues to be refinanced at more expensive rates.

This funding conundrum led the banks to raise mortgage interest rates above the central bank increases, attracting plenty of unfavourable criticism.

Despite this, the banks collectively produced a record $22 billion profit during 2010, partly due to much lower bad debt charges.

The Australian dollar was a standout feature for 2010, reaching parity with the US dollar for the first time since it was floated in 1985. The chart below shows the range it has traded in since 1985:



The higher Australian dollar was a double-edged sword helping to contain inflation by making imported goods such as flat panel televisions cheaper. But it also hurt exporters and companies whose main earnings are sourced in US dollars, such as mining companies, or those who translate their earnings from the US into Australian dollars.

The Australian equity market is currently valued on a price to earnings ratio for 2011 of 14.0 times with a prospective dividend yield of 4.5%. That is nicely in line with the market's long term average suggesting it is fairly valued. The prospect for another reasonable year of earnings is good.