Welcome to the Xmas 2012 edition of the Martin Bros. Monitior.

In this edition of the Martin Bros. Monitor:

The Buyers Are Back and The RBA Has Listened

Our last two quarterly Martin Bros Monitor's (MBM's) were titled "A buyers strike" and "Thank you, RBA" respectively. Well, the buyers have just started to re-enter our equity market and the Reserve Bank of Australia (RBA) have continued to cut interest rates to help stimulate a very weak east coast Australian economy in the face of a now peaking resources investment boom. Note – we are referring to a "peak" in resources investment, not a crash. Resource investment will continue to be very strong for many years to come. China is also not falling over, but more on that later.

As we wrote in the September MBM edition, the Europe financial crisis is over. This has been further confirmed by the lack of market volatility to every negative European headline over the past few months. Previously, any negative announcement resulted in wild swings in both bond and equity markets.

We have had a further two interest rate cuts in the last few months, taking our cash rate to 3.0%. The market is pricing in a further two more cuts next calendar year. Term deposit rates are now generally under 4.5% and heading lower, most likely to under the 4% level in the near future. Bank deposits rates in Australia are now playing catch up to our Bond rates, leading to generational low yields on “safe haven” investments. As history tells us, no party lasts forever. We have been talking about the bond market bubble for several years now, and whilst we do not want to start singing before the music starts, we get the feeling that the orchestra is well into their warm up.

In our September edition of MBM we wrote:

“Now we have the RBA to thank too. With interest rate cuts of 1.5% over the past twelve months and the promise (based on market pricing) of more to come, safe haven investors in Australia are now seeing new term deposits rates at under 5% for the first time in many years. These rates look like they are going under 4% at some stage too. Most retirees cannot afford to live on 3-4% interest income with no prospect for growth in income or capital. Eventually the cash flow doesn’t add up and Australians will be forced to take on more risk, as others have around the globe.”

In the short term, investing is all about alternatives. The trillions of dollars of global investing money chases risk adjusted return. When returns of 4, 5 or 6% can be achieved in a traditional low risk investment, there is little incentive for the “swing” money (like a swing voter) to move further up the risk spectrum chasing return, even if the potential return is higher. But when low risk investments like cash and bonds start to yield 1, 2 and 3%, such as they are in most of the developed world, investors are forced to move up the risk spectrum. This is what we are seeing in it’s infancy in Australia, right now. The rest of the world has been experiencing this for the last couple of years.

Global equity markets, specifically Europe and the US, have outperformed the Australian equity market over the past couple of years (in local currency terms before taking into the effect of our dollar appreciating). This has been at a time when people feared the US was slipping back into a double dip recession and the European financial crisis was gaining momentum. Compare this to the low unemployment and stable growth rates in Australia and you would have expected our sharemarket to be the one outperforming over the past couple of years. But economic uncertainty around the globe has resulted in ultra low interest rates globally and money printing by central banks. This, as we highlight above, has forced money into “risk assets” globally to chase a half decent return. Australia is now finally joining the party. The difference between cash/bond rates and sustainable dividend yields is now so **extreme** that money is moving off the sidelines and into the equity market to chase yield. This chasing yield results in rising share prices.

Now, back to China. For the past year the global short term money has been negative all things China. Since Australia is seen as a direct derivative of China by many global money managers, they have also been negative on Australia. These are the same people who told us that our property market was going to crash and that our banks were going to fail. For quite some time they shorted (sold stock in the hope it would fall and they could buy it back cheaper) Australian banks. Eventually they gave up on this as the dooms day scenarios they had pushed through the press did not play out. They then moved onto China and our large resource companies.

Over the past year China’s economic growth has slowed, as expected by most. But over the past few months, ahead of the leadership changeover in China, the economic data started to stabilise. Then in the past month or so since the leadership changeover, the economic data from China has been good, suggesting that their slowdown has bottomed and they will in fact grow at the 8% per annum they forecast/manufacture. Now, large cap resource stocks are benefiting from shorters starting to scramble to cover their positions, much as they did in Australian banks six months ago. This is occurring at a time when rather than a “buyers strike”, such that we had six months ago, we are now starting to see a “sellers strike.”

This “sellers strike” is caused by a few different classes of investors. Firstly, there is the yield / risk adjusted investor. They no longer want to sell equities as they offer the best growing income stream currently available. Secondly, there are the shorters. But they are no longer selling, but starting to buy back their positions, thus creating more buying pressure than selling pressure. Thirdly, there are momentum investors, who seek to trade the trend. These investors can see that we have likely moved into a higher trading range, and as such, are unlikely to be sellers below the 4,400 point level.

In last quarters MBM we included a chart showing the ASX200 price action over the past two years. This is what we wrote:

“As we write the ASX200 is trading just below the 4,500 point level. This index has now broken through the top end of its trading range that it has been stuck in for the past 16 months. This is good news, even if it were to drop back below the upper band over the next few weeks, which is entirely possible after bouncing 4% in the past month. The other bullish sign on this chart is the “higher highs” that have occurred since the July 2011 sell off.”

The market did drop back below the top end of the band at 4,450 points in the past few months. However, it has quickly recovered and is currently pushing to new 18 month highs. The same chart has been re-produced below, updated to include the last few months (see below).

As you can see, when the market dropped below the upper band it has quickly recovered into the higher territory. This is another bullish sign and has also added to the “higher lows” over the past six months. With little on the world news front to concern markets over the next couple of months, we could see it continue to push higher into the year end and start of the new year. A resolution (which is a certainty) to the US Fiscal Cliff will be a catalyst for this to occur. The idea that the US can re-write their own borrowing limits and then expect that they will not at least “kick the can down the road” is highly unlikely. Seasonally world equity markets perform well over the Christmas period. Let’s hope Santa Claus does not leave Australia off his present list this year. We suspect he won’t. Merry Christmas.

Stock Review - Seven Group Pref. Shares (SVWPA)

Seven Group (SVW) is a diversified investment house with ownership and interests in several different businesses. Included in its stable of investments is the exclusive licensing rights to sell Caterpillar equipment (including mining, agricultural, infrastructure etc) in NSW, Western Australia and North Eastern China. SVW also hold approx. 35% of Seven West Media listed shares, a 45% interest in Coates Hire, approx. $400m in other listed shares (widely reported as Telstra) and circa $500m in cash from their recent sale of shares in Consolidated Media (Foxtel).

Seven Group is therefore very well capitalised with a large amount of liquid assets and growth opportunities. It is RBS’s number one pick in the mining service sector (although not just a mining services company as outlined above).

The SVWPA's are a preference share issued by Seven Group in 2005 and which became a perpetual security in April 2010, at which time the distribution margin was stepped up and now pays an annual gross (incl franking credits) floating rate distribution of 4.75% plus the 180 day bank bill swap rate, based on a face value of $100 per security. As the security is currently trading at $84.50, the current gross floating annual distribution rate is circa 9.03%.

This income yield is still very healthy, particularly in a market that is focusing more and more on sustainable income as term deposit rates continue to fall. Given the diversified earnings of the parent company, SVW, and its strong liquidity position, we are very confident of the company's ability to continue to meet the distributions on an ongoing basis (which is the real risk to these types of securities). Beyond the ability of the parent company to pay the distributions, the only other notable risk with securities such as these is the interest rate margin. This is different to official interest rates and is the interest rate demanded by the market (through supply and demand) for securities such as this that fall into the income securities / hybrid asset class.

Interest rate margin risk is affected by general market sentiment and in an ordinary market or global environment is relatively stable. In a GFC type of event then the interest rate margin demanded by the market will increase. Since these securities pay a fixed rate margin above the 180 day (or 90 day) BBSW, then if the interest margin demanded by the market increases, then the security price of existing securities will fall so that the yield matches the increased interest margin demanded by the market.

In the GFC we saw the interest rate margins expand on heightened fear for all income securities including the big four banks. The security prices did fall, not by nearly as much as the equity market, however, when common sense prevailed and the fear had subsided, most securities recovered to where they were trading prior to the GFC. Except those that were issued by underlying companies that did not recover (these were few).

In a world that is now chasing yield because of globally very low interest rates, many of the income securities have appreciated in price (which is not the main reason for buying these types of securities) due to the interest margin demanded by the market falling.

SVWPA's are currently yielding 9.03% and the distributions are supported by a well funded, diversified and liquid parent company. We are very comfortable holding these as within a diversified income securities allocation (of a portfolio).

Technical Update

BEWARE of super contribution limit changes for 2012/13

This is a reminder for all people who are over 50 and were in prior years contributing over $25,000 per annum to superannuation in concessional contributions (tax deductible contributions such as SGC, salary sacrifice), that the limit is now $25,000 for all persons.

Therefore, if you were previously contributing more than $25,000, you may like to check your total contributions year to date now that we are half way through the financial year. If you are in any doubt feel free to contact us for assistance or to confirm your position.

Contributions Schedule for 2012/13 Financial Year

Concessional Contributions (deductible)

- Up to age 75 - $25,000 p.a. per person
- If over 65, must meet work test
- Excess tax rate on contributions over Concessional Cap (in addition to standard 15% contributions) - 31.5%

Non-Concessional Contributions (non-deductible)

- Up to age 75 - $150,000 p.a. per person;
- Or $450,000 per person (over 3 year period), up to age 65 (incl. turning 65 in that financial year as long as contribution is made on or before 30 June of that year) - Please note: if $450,000 non-concessional contribution is made after turning 65 in that financial year, it must be made in 3 parcels of $150,000 each on different days
- If over 65, must meet work test

Excess tax rate on contributions over Non-Concessional Cap - 46.5%

Christmas Hamper Competition

It's that time of year, our traditional Christmas Hamper competition returns for 2012.

For those not familiar with this competition, you must ‘qualify’ to enter the draw by answering each of the questions below. Each question must be answered correctly before your name will be entered into the draw for the hamper.

Please email Cheyne at cheyne.peat@rbsmorgans.com or call him on (03) 9947 4137 with your answers.

The competition closing date is Tuesday the 18th December at 4:30pm AEDST. The winner will be drawn the following morning and notified by phone, with delivery of the gift basket on Wednesday or Thursday of that week.

This year's hamper is called "Premium Selection" and is valued at over $300. It includes various goodies including an assortment of wine, shortbread, nuts, chocolate, biscuits and much more......

Questions

1. What is the current official cash rate that is set by the Reserve Bank of Australia (RBA)?

2. What colour original Wiggle is staying with the group next year?

3. How old was Dame Elisabeth Murdoch when she passed away recently?

4. Which male singer sang and wrote the famous Christmas song "Last Christmas"?

5. How many Australian drivers started in the 2012 Australian Formula 1 Grand Prix at Albert Park?

GOOD LUCK!

ASX Market Hours - Festive Season

Please note the amended ASX trading hours below over the upcoming Christmas and New Year period. Members of the Martin Bros. Team will be available each day the market is open.

- Monday 24th December - Reduced Trading (10am to 2pm)
- Tuesday 25th December - Market & Office closed (Christmas Day)
- Wednesday 26th December - Market & Office closed (Boxing Day)
- Thursday 27th December - Normal Trading
- Friday 28th December - Normal Trading
- Monday 31st December - Reduced Trading (10am to 2pm)
- Tuesday 1st January - Market & Office closed (New Years Day)
- Wednesday 2nd January - Market returns to normal trading hours