

**Period: 1<sup>st</sup> to 31<sup>st</sup> August 2006**

### **Fund Performance**

The volatility in the Australian equity market presented us with buying opportunities. The NavTraDE system buys shares as share prices depreciate. Our cash holding at the end of August was 19.6% as we have taken the opportunity to sell stocks at favourable prices. The actual returns in August for the Retail and Wholesale funds were both +1.94% compared to the +2.60% return of the S&P/ASX200.

The NavTraDE system takes advantage of irrational investor behaviour to buy quality companies as their share prices are falling and to sell them as they are rising. Consequently, the system can realize capital gains from dealing in shares with volatile price movements, irrespective of the net price movement from the beginning to the end of the period. It takes time for shares to move through price cycles and therefore for the potential of the NavTraDE system to be fully realized.

The stocks that performed well this month and generated realized capital gains through trading include BHP Billiton (BHP), Lion Nathan (LNN), Macquarie Bank (MBL), National Australia Bank (NAB), OneSteel (OST), Publishing & Broadcasting (PBL), Toll Holdings (TOL), Westpac Bank (WBC), Westfield (WDC), and Woolworths (WOW).

The stocks that performed well this month and generated unrealized capital gains include The ANZ Bank (ANZ), Bluescope Steel (BSL), Futuris (FCL), Lion Nathan (LNN), Macquarie Bank (MBL), OneSteel (OST), Westpac Bank (WBC), Westfield (WDC), and Woolworths (WOW).

During the month, the shares that detracted from performance either due to low volatility or because they were displaying unrealized losses were Coca-Cola Amatil (CCL), Origin Energy (ORG), Orica (ORI), Santos (STO), Tabcorp (TAH), Toll Holdings (TOL), Wesfarmers (WES), and Woodside (WPL).

The NavTraDE system resulted in increased weightings in: Origin Energy (ORG), Boral (BLD), and Westfield (WDC).

The NavTraDE system also resulted in decreased weightings in: Woolworths (WOW), The ANZ Bank (ANZ), and Macquarie Bank (MBL).

To view our current portfolio, please [click here](#).

### **The Australian Share Market**

The Australian equity market bounced back by 2.60% in August after falling 1.73% in July (S&P/ASX200 Index).

***The Australian stock market rose by 2.60% in August after falling 1.73% in July.***

***The job market remained strong while the housing market continued to recover as investors showed renewed confidence.***

***Retail sales also climbed despite high petrol prices and inflationary pressures.***

***The RBA raised the official interest rate by 0.25% in early August.***

The strength in the domestic economy was unabated in August, especially as world oil prices moderated. The RBA maintained official interest rates for the month, after raising it by 0.25% to 6.0% on 1 August, citing the rise in core inflation from 2.7% p.a. to 2.9%. Labour force data shows continued jobs growth. While the unemployment rate edged up 0.1% to 4.9%, the participation rate rose to a new record high of 65.1%, keeping the lid on wages pressure. Most of the jobs growth were full-time and has been a major factor in maintaining consumer confidence in the face of rising interest rates and higher oil prices (which had also moderated during the month).

Retail sales rose 0.6% in July to be 6.2% higher than last year. The major beneficiary of strong consumer confidence seemed to be department stores which showed a monthly rise of 7.0%, as discretionary spending has outpaced essentials purchases for almost the past year. The housing market continued to grow, with the number of residential approvals up by 8.3% in July to be 9.1% up on the past year. However, the value of building approvals fell 6.3% in the month or 4.8% up on the past year.

On the trade front, the news appears positive. The trade deficit narrowed from \$2.2b in May to only \$0.7% in June, led by an 8.0% jump in exports on the back of a 15% surge in minerals exports and a modest rise in manufactured goods. Encouragingly capital imports have risen 19% over the year, suggesting strong business investment. As mineral prices have risen, the current account deficit narrowed by \$0.6b to \$13.2b.

Overall, the Australian economy remains relatively strong. Some inflationary pressures are becoming apparent, particularly with the flow-on effects of high petrol prices. Consumer confidence has rebounded, despite high petrol prices and the rise in interest rates. The employment market is strong as is the housing market.

***The best performing sectors were Food & Drug Retailing; Food, Beverage & Tobacco; and Retailing.***

The best performing sectors in August were Food & Drug Retailing (+12.9%); Food Beverage & Tobacco (+6.2%); and Retailing (+5.2%).

The worst performing sectors were Energy (-4.4%); Telecommunication Services (-3.9%); and Capital Goods (-3.5%).

***World markets were up in August as oil prices fell and slightly more positive news emerged on the US economy.***

Global stock markets recovered for the second month in a row, with the MSCI index rising 2.4% after edging up 0.6% in July. The S&P500 index rose 2.1%, the Nasdaq was up 4.4%, the Nikkei 225 rose 4.4% and the HangSeng rose 2.5%. The only major stockmarket that fell was the FTSE, by 0.4%, in contrast to other European stockmarkets which all rose in August. The MSCI has now risen 2.8% for the quarter or 13.7% for the past twelve months.

***US economic data were mixed. The jobs market was strong, consumer spending was patchy, while the housing market cools.***

The prices of major commodities mostly fell in the month, except for nickel (+15.8%), lead (+1.0%), and tin (+3.5%). Crude oil prices fell 5.6% while gold was steady.

Revised US economic data was welcomed by the market, with GDP seen growing at 2.9% p.a. in the June quarter instead of 2.5% p.a. in the last release. This is slower than the 5.6% p.a. rate in the previous quarter. The falling growth rate has been linked to growing inventories and falling consumer buying of cars and houses.

***Inflationary pressures have moderated slightly despite strong wages growth.***

Consumer spending rose 1.4% in July, after dropping 0.4% in June, led by purchases of cars, electronics and building materials. Retail sales account for almost half of all consumer spending, which in turn represents about 70% of the economy. However, overall spending has slowed since January 2003. The latest August departmental stores estimates show a 2.5% sales decline in August.

Labour costs in the June quarter rose 4.%, the most since the end of 2004. Hourly wages rose 0.4% in July and were up 3.8% from the same time last year. With rising wage pressures and high employment, inflationary pressures are unabated. Employment growth continued into August, with the unemployment rate dropping 0.1% to 4.7%, close to the five year low of 4.6% in June.

The US Federal Reserve held official interest rates steady at 5.25% after 17 consecutive rate increases since June 2004. CPI increased 0.4% in July, while core CPI rose less than expected at 0.2%.

***Chinas economic growth rate is now the fastest in more than a decade with yet another record trade surplus.***

The cooling in the housing market continues. House prices grew at 4.7% in the June quarter (+8.8% in the previous quarter), the slowest rate since late 1999. New homes sales fell 4.3% in July while the median home price rose 0.3%, the smallest rise since December 2003.

Chinas economic data continues to show an impressive growth story. GDP growth reached 10.3% p.a. in the March quarter and accelerated to 11.3% in the June quarter, the fast rate in more than a decade. China had a record trade surplus for the third month in a row, rising by US\$0.1b to US\$14.6b in July. Exports surged 22.6% and imports rose 19.7%. CPI growth slowed to 1.0% p.a. from 1.5% p.a. in July and 1.4% p.a. in June.

## **Share Market Outlook**

***Australian economic fundamentals remain sound. Inflationary pressures are slowly increasing. Economic growth is likely to remain around 3% due to healthy domestic fundamentals and the continuing strengths in the Chinese economy.***

The slowdown in the US economy has not been as severe as some have anticipated, while oil prices have eased. World inflationary pressures are still of concern. However, China's economic growth continues to fuel world growth. Some concerns are being raised on the quality of Chinese fixed assets investments and the burgeoning trade surplus.

The Australian economy is expected to continue growing, largely driven by the strong resources sector. Unemployment is at record lows, the housing market continues to grow. A further interest rate rise later in the year is likely. Business investment remains strong particularly in mining, transport and construction. Consumer confidence appears to have overcome fears of higher oil prices and interest rates due to a resurgent housing market and high employment.

***Consumer confidence appears to have overcome high oil prices due to the wealth effects of the housing boom and high employment.***

The US economy's slowdown continues, although jobs growth and utilization capacities are still high. Inflationary pressures are strong despite tight monetary policy. Further interest rate rises are likely through year's end. Corporate profits are expected to rise 30% in 2006, supportive of strong jobs growth. After rising for the past three years, corporate profits as a percentage of GDP should decline for the next 10 years, declining from about 13% of GDP to the long-term average of 9%. Economic profits, at more than 12% of GDP in the March quarter, are at their highest level in 40 years and significantly above the long-term average of 9.4% of GDP. Post 2006, unemployment may rise as consumer spending moderates and the housing market cools. Manufacturing is likely to see further cost pressures if world oil prices continue to remain high.

***Global stock markets are entering a period of increased volatility as the US economy slows and global inflation is on the rise.***

The impact of a slowing US economy is beginning to impact the global real economy, although this has seen increased volatility in world stock markets. Europe's growth is slow but relatively steady. GDP growth should be around 2% in 2006. Japan's growth is now at its strongest in years.

The outlook for the Australian equity market is positive in the short term as the resources and consumer sectors continue to support the rest of the economy. However, we may be entering a period of uncertainty and hence more marked stock market volatility. Present weaknesses in the stock market are driven mainly by concerns over global stock over-valuations and fears of global inflation and should present buying opportunities. The interest rate outlook is still relatively benign although on a mild tightening bias. Further rate rises are possible due to the expansionary effects of the budget and a resurgent housing sector.

***The key drivers of global growth remain the US and China. While the US economy cools, the Chinese economy continues to drive the world economy.***

It is probable that China's growth will continue for the foreseeable future, despite increasing fears of a fixed asset bubble and a burgeoning trade surplus. China's demand for world commodities and consumer goods is driving growth in other global regions, stimulating turnarounds in Japan and Europe. Concerns about the sustainability of US economic growth and inflationary pressures are beginning to flow through to global stock markets. Although any real economic flow-through of weaker US demand will take place in the medium term, we expect to see further stock market volatility.

The risks to the world economy in the short to medium term have increased slightly. The likelihood of a significant downturn in the world economy is still low. The outlook continues to be positive in the short to medium term.

***Resources companies may benefit from rising production and prices. Banks should benefit from continued economic growth.***

With export performance now an even greater driver of the Australian economy, export-oriented sectors, in particular Resources and Energy, should see further share price rises. Sectors able to harness general economic activity such as Banks and Infrastructure should also benefit, however Banks may be negatively impacted by rising interest rates. The wealth effects of buoyant housing and equity markets should support Materials companies, and the resurgent consumer confidence is likely to

*Ongoing problems are expected in the telco sector and industries affected by high fuel costs.*

boost retail companies.

Manufacturing and telecommunication should remain relatively weak. Airlines, transportation companies and tourism related industries could face cost pressures from high oil prices. The rural sector remains unappealing.