

Period: 1<sup>st</sup> to 31<sup>st</sup> January 2007

### **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 January was 39.5% as we have taken the opportunity to sell stocks at favourable prices. The actual returns in January for the Retail and Wholesale funds were both +1.49% compared to the +1.83% 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 The ANZ Bank (ANZ), Boral (BLD), Bluescope Steel (BSL), Coca-Cola Amatil (CCL), Futuris (FCL), Macquarie Bank (MBL), National Australia Bank (NAB), Origin Energy (ORG), Orica (ORI), OneSteel (OST), Tabcorp (TAH), Toll Holdings (TOL), Westpac Bank (WBC), Westfield (WDC), Wesfarmers (WES) and Woolworths (WOW).

The stocks that performed well this month and generated unrealized capital gains include The ANZ Bank (ANZ), BHP Billiton (BHP), Boral (BLD), Coca-Cola Amatil (CCL), Fairfax (FXJ), Lion Nathan (LNN), Macquarie Bank (MBL) and Westpac Bank (WBC).

During the month, the shares that detracted from performance either due to low volatility or because they were displaying unrealized losses were Great Southern Plantations (GTP), Publishing & Broadcasting (PBL), Santos (STO) and Woodside (WPL).

Iluka Resources (ILU) was added to the portfolio while Origin Energy (ORG) was excluded.

The NavTraDE system resulted in increased weightings in: Publishing & Broadcasting (PBL), Woolworths (WOW), National Australia Bank (NAB) and Iluka Resources (ILU).

The NavTraDE system also resulted in decreased weightings in: The ANZ Bank (ANZ), BHP Billiton (BHP), Origin Energy (ORG), Westpac Bank (WBC), Toll Holdings (TOL) and Wesfarmers (WES).

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

### **The Australian Share Market**

***The Australian stock market rose 1.8% in January.***

***The unemployment rate fell to a 32-year low of 4.5%. 300,000 jobs were created in 2006.***

***Retail sales improved in December and January, and the housing market recovered as investors returned to the market in response to the record low vacancies rate.***

The Australian economy continues to grow. The Australian equity market rose 1.83% in January (S&P/ASX200 Index), the sixth monthly rise since July. The unemployment rate fell to a thirty-two-year low of 4.5% in January due to a small fall in the participation rate. The growth in jobs is about 2.8% p.a. with the resources sector leading the way with a growth rate of 3.8% p.a. Net employment gain in 2006 was around 300,000.

The Reserve Bank has maintained benchmark interest rates steady at 6.25%. Australia's CPI dropped 0.1% in the fourth quarter after gaining 0.9% in the previous three months, for an annual increase of 3.3%. The three modest interest rate rises in 2006 has had no significant impact on the housing market. In December the number of loans to owner-occupiers edged up 0.1% from November while the value of loans jumped 1.1% in the month. However, the value of loans to investors surged 4% as total lending rose 1.9%.

The interest rate rises have had some dampening effect on household spending which accounts for about two-thirds of GDP. The Bureau of Statistics data showed retail sales rose 0.3% in December following November's 0.2% rise. Household spending edged up only 0.3% in the September quarter, the slowest in more than three years. Retail sales as measured by the Cashcard index increased a seasonally adjusted 0.9% in January. Overall, spending was 5.6% higher than in the corresponding period last year. The average household's debt-to-income ratio has more than doubled in the past decade, reaching a record 158% in the September

*The trade deficit widened due to military and consumer spending. Rural exports fell sharply and dampened export performance.*

quarter. Total lending to consumers and businesses rose at the slowest pace in 17 months.

Australia's trade position recorded its 57<sup>th</sup> consecutive deficit, widening from \$897 million in November to \$1.34 billion in December. Exports slipped 1% while imports grew 2%. Rural exports fell 4%. Most of the increase in imports were due to military spending and consumer goods.

In summary, the Australian real economy remains sound although clearly driven by the resources boom. Retail spending is slowing while the housing market is resilient. Employment is strong, interest rates are still relatively low despite the 0.75% increase in 2006, and demand for Australian minerals exports remains unabated. Export growth is almost entirely in minerals. In the six months to December, gold exports surged 63%, processed minerals rose 45% and unprocessed ores 33%.

*The best performing sectors were Utilities (+8.1%); Software & Services (+6.2%); Commercial Services & Supplies (+6.3%); and Pharmaceuticals & Biotechnology (+5.8%).*

Most sectors performed well in January with only 5 out of 22 sectors in negative territory. The best performing sectors in the month Utilities (+8.08%); Software & Services (+6.35%); Commercial Services & Supplies (+6.31%); and Pharmaceuticals & Biotechnology (+5.76%).

The worst performing sectors in the month were Technology Hardware & Equipment (-9.01%); Consumer Durables & Apparel (-6.60%); Media (-1.33%); and Energy (-1.20%).

*World markets were mostly strong in January.*

The global stock markets were mostly strong in January: the S&P 500 index rose 1.4%, the Nasdaq rose 2.0%, the FTSE slipped 0.3%, the Nikkei 225 rose 0.9% and the Hang Seng edged up 0.7%. The MSCI world index grew 1.1% in January with all the major European bourses recording gains. This bodes well for the Australian economy as global growth will be driven by commodity demand. The performance of the commodity prices were mixed in January, with crude oil and most base metals retreating in price, particularly zinc and copper due to concerns about the solvency of a hedge fund, while gold and nickel increased in price.

*The price performances of major commodities were mixed: gold and nickel increased while crude oil, zinc and copper declined.*

After signs of slowing in the previous quarter, the US economy recovered in the December quarter. GDP growth is estimated at a healthy 3.5% p.a. as consumer spending grew and inflation slowed in spite of a major decline in housing activity. In 2006 GDP grew by 3.4% compared to 3.2% in 2005.

*The US economy may be recovering slightly from the September quarter weakness. While the housing market remains weak, the jobs market is very strong and consumer confidence is returning, supported by cheaper gasoline prices and above-inflation wages growth.*

The CPI grew at 1.5% p.a., the slowest in more than three years, compared to 1.9% in the September quarter, due mainly to a decline in energy prices. Consumer spending, which accounts for 70% of the economy, rose at 4.4% p.a. during the quarter, compared with 2.8% p.a. in the third quarter. In 2006, consumer spending was down 4.2%, the largest fall since 1991.

The US unemployment rate grew 0.1% to 4.6% p.a. in January, the highest in the last four months, due to weaker jobs growth. Companies put on about half the number of jobs in January as in December. At the same time employment costs have been muted, rising only 0.8% during the December quarter compared to 1.0% the previous three months.

The Federal Reserve has kept the benchmark interest rate steady at 5.25% p.a. since June 2006. While it has cautioned that some inflation risks remain, the likelihood is that inflationary pressures have moderated, taking the heat of further interest rate rises in the near future.

*The Eurozone economies are showing strong economic growth, offsetting weakness in the US economy.*

The eurozone economies have also continued strong growth with the consequence of achieving record trade deficits. Britain's trade deficit for January was the highest on record. As a proportion of GDP, the trade gap is now running at 4.3% and is fast approaching the 4.9% peak reached in the mid-1970s. However, the trade gap is sustainable as it has been financed by long-term investment inflows. On the negative side, the trade deficit with the US also increased as did the gap with China. Over the channel, France also achieved a record trade deficit due to high energy prices and falling exports. In contrast, Germany achieved a record trade surplus due to its strong export performance to other European countries.

On the positive side, the UK employment market is strong, with the unemployment rate falling 0.1% to 5.5% for the December quarter, although

***China is still the engine of world economic growth. Fundamentals look sound and bode well for continued GDP growth and demand for Western goods and Australian mineral imports.***

up 0.4% for the year. Inflation is around 3% p.a., above the Bank of England's target of 2% p.a.

China's economy grew at 10.4% p.a. in the December quarter. Despite governmental curbs on money supply the economy grew by 10.7% in 2006, the fastest in 11 years, due to the flood of cash from exports with the trade surplus reaching US\$177.5 billion. Fixed assets investment growth slowed to 24.5% in 2006 from 27.2% the previous year, still a very strong expansion rate.

However, economic growth has seen a rise in inflation, with consumer prices climbing 2.8% in December, the fastest in almost 2 years. Retail sales leapt 14.6% in December after rising 14.1% in November, however the boost in consumer has not kept pace with exports due to its relatively low base.

### **Share Market Outlook**

***The US economy appears sound in the short term.***

The immediate prospects for the US economy appear good. The jobs market is buoyant as corporate profits remain relatively high. Inflationary pressures have eased as consumer spending moderates and the housing market cools. The US trade imbalance should not be a problem in the short term as it is a major driver of Chinese growth. The 56-month string of trade deficits is not causing undue concern so long as the other engine of world growth, China, is prepared to fund its growth through exports to the US. At present around 50% of China's exports are to the US.

***Australian economic fundamentals remain sound. Inflationary pressures are rising and leading to the possibility of interest rate rises in the first half of 2007.***

The US Federal Reserve is unlikely to raise interest rates soon as it has moderated its core CPI and GDP growth forecasts. A cut in interest rates to support the housing market is possible but unlikely as the indications are that the oversupply of housing stock should clear in the coming year or so. Core CPI is expected to advance by 2.3% in 2007 and by 2.2% in 2008. GDP growth should be in the region of 2.0 to 2.7% in 2007. The unemployment rate should rise a tad from current lows as US corporations become more cautious, pushing up the rate from 4.5% to around 4.9%. There is some risk to the financial sector due to the weak housing market, with some of the smaller riskier mortgage lenders already showing signs of distress. The larger financial institutions will be somewhat shielded by the strong corporate sector.

***Economic growth is likely to remain around 3.0% despite the severe drought due to healthy domestic fundamentals and the continuing strength of the global economy.***

While there have been recent concerns about the sustainability of the US industrial momentum and the increase in mining supply and stockpiling of base metals, commodity prices should be supported by the robustness of the European and East Asian economies. Inflationary pressures are growing, particularly in Great Britain where the Bank of England raised interest rates last month by 0.25%. British inflation accelerated to 2.7% p.a. in November, the fastest in at least a decade and to almost 3.0% p.a. in January.

***The labour market appears buoyant but may have passed its peak. Consumer confidence should improve due to the continued wealth-effects of strong stock and housing markets.***

The risks to the global economy are still low and suggest continued growth in 2007, although at a slightly lower pace than in 2006. Slowing US economic growth and increased geopolitical risks should see the US dollar weaken. A soft landing for the US economy is still anticipated while the corporate sector appears healthy, inflationary pressures have abated, and a crash in the housing market seems unlikely.

Australian economic fundamentals appear sound in the short term with continued economic growth likely in 2007. The unemployment rate is low, business profit outlook is sound, and equity markets continue to reach new records. It is likely that the risks to the housing market have moderated and may be turning around due to recent destocking of rental properties. The government has slashed its economic growth forecast to the slowest in six years, due to the worst drought in a century cutting farm output by 20%. However, the resources sector should continue to dominate while the consumer sector slows and a high A\$ impacts export manufacturing. Chinese demand for Australian minerals remains strong for the foreseeable future.

Demand from China for Australian commodities should support the A\$

particularly as the US\$ weakens. A stronger A\$ should aid importers at the expense of exporters. Revenues and profits for materials companies should continue to benefit from high commodity prices and increasing production.

*The key drivers of global growth remain the US and China.*

*European and East Asian economies should offset weakness in the US economy.*

*Resources companies should continue to benefit from strong Chinese demand for commodities. Banks and materials companies should benefit from high economic activity.*

The Chinese growth story continues to fuel economic growth in the rest of the world. Chinese inflation is remarkably low considering high credit growth and consumer spending, although recent data point to an uptrend. The risks to the world economy in the short to medium term are largely unchanged. Fears of higher oil prices have abated and the general outlook is positive.

The likelihood of a significant downturn in the world economy is low. The outlook continues to be positive in the short to medium term. The global economy grew by about 4.0 to 4.5% in 2006, and is expected to grow by 4.0% this year. China's GDP growth is now expected to be around 10%.

The banking sector should continue to benefit from high economic activity. Resources companies may benefit from further global demand and higher production but will have to contend with a stronger A\$. Materials companies should benefit from the resilience of the housing market. Infrastructure companies may benefit from higher traffic numbers associated with strong economic activity. Retail stocks should continue to be supported by strong consumer sentiments and a strong A\$.

Negatives are expected from wine stocks and companies associated with the rural sector. Industrial stocks are not particularly compelling as a sector, particularly as exporters must contend with a strong A\$.