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The economic recovery... really?

Australian investors could be forgiven for feeling bewildered. This time last year, there was confidence we had weathered the global economic storm better than most. That turned out to be right, but where is the big lift in prosperity – and share prices?

Table 1: June 2010 to June 2011

Australian Key Indices		Sharemarket (% Change)	
GDP	1.20%	US (Dow)	24.70%
Inflation	3.30%	China (Shanghai Comp)	12.42%
Consumer confidence	-2.60%	Euro area (FTSE Euro 300)	10.33%
RBA interest rate (30/6/11)	4.75%	Australia (All Ords)	8.12%
Unemployment (30/6/11)	4.90%	Japan (Nikkei 225)	2.37%

Source: www.nyt.com, sourced from Thomson Reuters

Consumer sentiment is at its lowest ebb in two years, according to the Westpac–Melbourne Institute Index. And it's not hard to work out what has brought us to this pass.

Major issues in the US and Europe; local price pressures at the checkout and petrol pump; natural disasters; confusion around the carbon tax debate — all have shaken confidence in the economic recovery and shifted our focus to protecting the family finances.

Under water

Australia's buoyant economy lost momentum earlier this year when floods and Cyclone Yasi caused the biggest quarterly decline in economic activity in 20 years.



From page 1...

In the March quarter gross domestic product (GDP) fell 1.2 per cent with floodwaters halting coal exports and wiping out summer crops. The Reserve Bank's governor, Glenn Stevens, remarked in June that the resumption of coal production in flooded mines was taking longer than expected but production levels were increasing.

He also expects a boost to demand later in 2011 from the rebuilding work in Queensland. Without the flood impact the local economy was on track to grow at more than 3 per cent.



In a turbulent world

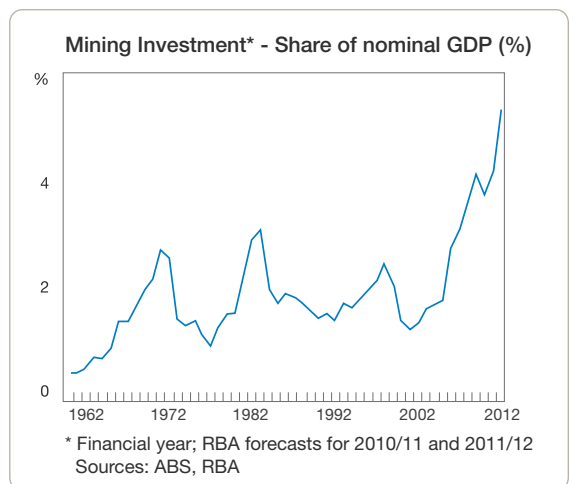
In the past twelve months the global economy has remained unsettled. Sovereign debt issues still weigh heavily on Europe, political turmoil in the Middle East hit oil prices, Japan is rebuilding after their devastating tsunami, and US recovery is stuck in first gear.

The US economy began to pick up speed late in 2010 but stalled in the March quarter. The US Federal Reserve now expects a still-respectable annual growth rate of 2.7–2.9 per cent, trending higher in 2012. The US policy of buying their own government bonds ('quantitative easing') is coming to an end after US\$2.3 trillion

has been pumped into the economy. Still, large numbers of foreclosed properties remain to suppress housing prices, and unemployment is stubbornly high at around 9 per cent.

And then there's China. Australia's prosperity depends on China continuing its rapid development without becoming a victim of its own growth. China's annual inflation hit a three-year high of 5.5 per cent in April (year on year), slightly less than expected, and real estate prices are coming off the boil, down 5 per cent in April after a 22 per cent gain in 2010.

Graph 1: Mining as part of GDP (1962 - projected 2012)



So far it seems China is staying on top of inflationary pressures. That is most important when you consider the impact of China's growth spurt on local mining investment, as shown in recent Reserve Bank (RBA) projections (above).

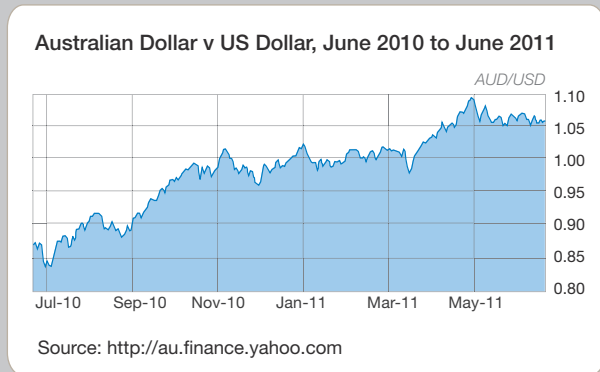
The mighty dollar

The big news over the past year was the rise and rise of the Aussie dollar. Not only was it one of the strongest and most-traded currencies in the world, but our dollar jumped about 24 per cent against the US dollar, reaching a record high of US\$1.10. It is finishing the year around US\$1.05 and is likely to remain at these higher levels until the US economy gathers steam.

While this is great news for people planning an overseas trip or contemplating the purchase of an imported car or television, the strong currency is a

negative for many equities, and bad news for local exporters, manufacturers, tourism and education, and people employed in these sectors.

Graph 2: AUD/USD (2010 - 2011)



Inflation's ups and downs

Consumers felt the full impact of the summer's natural disasters in the hip pocket. Fruit prices rose 25 per cent in the March quarter and vegetables by 19 per cent. These price hikes were partially offset by the supermarket milk wars which wiped 6 per cent off milk prices.

Consumers were also hit as civil unrest spread across oil-producing nations. Local petrol prices peaked on May 9 but have fallen up to 10 cents a litre since then, depending where you live.

Fortunately, average full-time earnings are up by more than 4 per cent while household disposable incomes improved by more than 7 per cent over the year.



Holding rates

For all the talk about interest rate rises the RBA has lifted the official cash rate just once in the last 12 months, by 0.25 per cent to the current rate of 4.75 per cent. At the same

time, the banks moved away from a lock-step link to the official rate, lifting rates more than once while citing the rising cost of local and overseas funds. Though there has been a pause, most economists believe the rate cycle remains on an upward trend.

Australian interest rates remain among the highest in the developed world. The benchmark rate on 90-day bank bills is around 5 per cent, well above the weaker economies of the US (0.12 per cent), Japan (0.16 per cent), UK (0.83 per cent) and Europe (1.43 per cent).

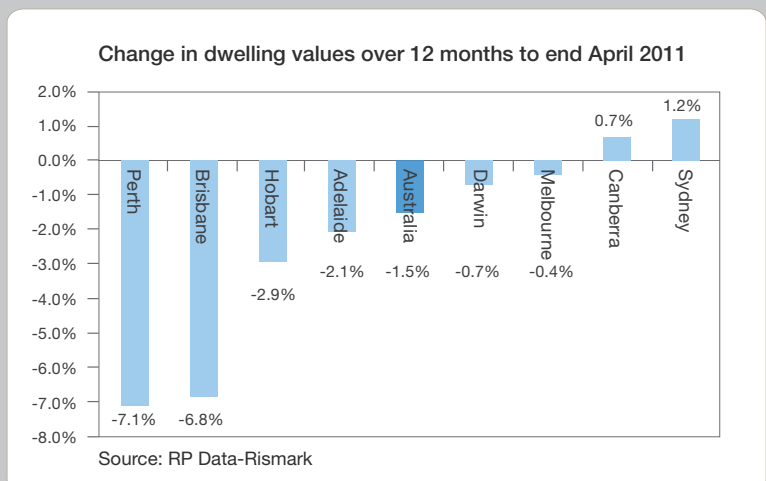
Housing price dips

'Safe as houses' sums up the attitude of Australian investors towards property. But the last 12 months has shown that not even houses are safe when the banks stop lending cheap money and prices have grown out of reach for people on average incomes.

According to the RP Data-Rismark home value index, Australia's capital city home prices fell 1.5 per cent in the year to April 30. The falls were not uniform across the country or within markets. Perth and Brisbane fell hardest while Sydney and Canberra rose slightly. Even so, Sydney remains the country's most expensive and least affordable city with a median house price of \$515,000 - more than 10 times average incomes.

Vacancy rates remain tight but rental yields have barely moved, at 4.2 per cent for houses and 4.9 per cent for units, well below their 2009 peaks. The sluggish market is reflected in the latest housing finance figures. The value of residential housing investment loans fell almost 16 per cent in the year to April.

Graph 3: Australian property prices





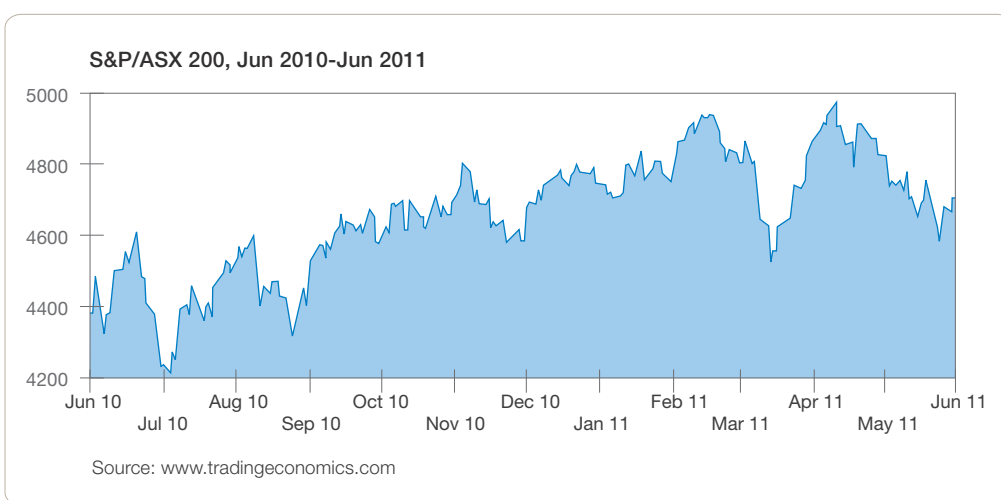
Markets moving sideways

Australian share investors continued to recoup some of the losses made during the Global Financial Crisis (GFC), but the champagne corks are not popping.

While June figures remained volatile, local share prices rose just over 8 per cent for the financial year, well down the international pecking order. The US* (up 24 per cent), UK* (up 19 per cent), Germany* (up 22 per cent) and Canada* (up 17 per cent) all outshone the local market, whilst Greece* recorded a -15 per cent return. Total returns from local shares, once you include dividends, were around 12 per cent, making it the second year of positive returns since the GFC.

Resources stocks led the way but banks, retailers, manufacturers and exporters were squeezed by rising interest rates, the strong dollar, and consumers opting to save their cash.

Graph 4: The Australian sharemarket



The road ahead

Australia's report card at 30 June 2011 might read 'doing well; but could do better.' By most measures, our economy is still the envy of many but the riches from the mining boom are not trickling down evenly.

Households are worried about the rising cost of living and will continue to fear the impact of a carbon tax until the details are revealed. But wages are outpacing inflation, unemployment is low, and the dollar buys more than ever before.

The global investment environment is more volatile than anyone would like, but the ongoing mining boom, falling house prices and rising interest rates present opportunities for astute investors.

* These figures are at market close, 29 June 2011



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