

Summary of Key Views:

A month of positive developments on the surface is facing considerable short-term headwinds. Valuations for equities appear attractive based on the consensus earnings outlook. However, there are emerging downside risks to corporate earnings, given a growing decline in economic activity from the US to China. Bond yields are low by historical levels, but are consistent with the recent downward revisions in inflation expectations. Spread assets such as corporate debt remain attractive on a medium term outlook.

Improvements in corporate earnings in the US have been heavily overshadowed by growing uncertainty over the broader macroeconomic outlook. Economic data releases over the past month have mostly surprised on the downside, including key growth and employment indicators. Investors now widely anticipate a slowdown in the US in the second half of 2010 and extended period of sub standard growth in Europe. The sustainability of economic recovery continues to depend on an economic expansion in emerging markets and accommodative policy settings, which is arguably at odds of the various austerity measures proposed for the coming year.

Despite the fear of growing supply in the medium term, safe haven assets such as global government bonds have continued to perform well on rising risk aversion and a more subdued outlook on inflation. However, the downside for sovereign bonds at this point appears much higher than for stocks. US Treasury bonds are trading at much-appreciated levels, without inflation protection. Because of the asymmetric price profile of bonds, an increase in expected rates or an increase in inflation could cause prices to fall rapidly. The conflicting views between the corporate and macroeconomic outlook are best viewed through the movements of gold prices, which have trended lower in July despite supportive demand for defensive assets.

Current gloom about deflation in economies such as the US, however, appears overdone, even though there is anecdotal evidence of wages falling in some service and public sector industries there. In a deflationary world, many things would be different, and both domestic demand and world trade might come to a grinding halt. This is a very unlikely scenario. We would expect government policy everywhere to vigorously combat such a trend. Also, the US has little risk of slipping into a Japan-like deflationary state. As a consumption-led economy, the US consumer has little chance of permanently increasing its personal savings to much above 3-4%. We see no immediate end to this consumption-led economy, particularly as it continues to be supplied by willing suppliers like China.

If fear of deflation subsides, then consumer spending may resume, and it is important to be positioned for a further equity market recovery. The suddenness of equity market rallies makes it important not to be underweight this asset class. Developed markets worldwide still face significant headwinds, including deep-rooted housing market problems, high structural unemployment, and a current credit/liquidity scarcity. But if they can overcome these, equity market growth in these markets will be sustainable.

Capital expenditure from corporate sector has so far been tentative. Other than refinance existing debt facilities, the

corporate sector has generally maintained a conservative balance sheet and is reluctant to increase new production capacity. Although corporate earnings in 2009 and the first half of 2010 have modestly surprised on the upside, many large economies such as the US was indirectly financed through government fiscal aid (increasing consumer demand) and much of the earning improvements came from assertive cost cuttings, neither of which may not be repeated in the same magnitude. Banks have larger amounts of capital, but don't want to lend – this is occurring in Australia as well as in other developed countries. Banks won't finance non-bank lenders – so someone else (i.e. governments) may have to do so. The US government indirectly did so through its TALF program (which has wound down), and so may need a substitute for this.

Among other things, central banks might be able to provide collateral and/or facilities to the shadow banking system of non-bank financials, which at this point needs to continue to play a part in financial and economic recovery due to lack of viable alternatives (policy-based lending such as the US' Fannie Mae and Freddie Mac housing finance providers is tapped out, and addresses only one sector, mortgage finance). Precisely because the structure of financial system is now too weighted towards large international banks, all of which act slowly, only with government approval and all at the same time, non-bank financials are still needed as a source of diversity in the developed world, as much as they may be reviled by their retail clients.

In China, we expect that currency appreciation will be managed, that wages will increase to maintain political stability, but that export prices may be managed in order to maintain the country's trade surplus. In this sense, we see little likelihood of something analogous to the oil price shocks that occurred in the 1970's (i.e. a sudden repricing of exports upwards) that would contribute to high inflation.

We thus continue to live in a bipolar world characterized by volatility in which the public world of macroeconomics and the private world of corporations – which intersect in the capital markets – are still at odds with other. While most developed countries are doing what they have to politically in order to remain functioning economically, many developing countries are doing what they have to economically in order to remain functioning politically. Tactically, we are still in a holding pattern.

Market developments during July 2010 included:**Equities**

Equity markets traded markedly higher for the month on declining risk aversion, with investors gained comfort from the results of the stress test of European banks. Positive quarterly earnings reports from the US corporate were generally supportive of equity markets. For the month, defensives have generally underperformed relative to cyclicals and the financial sector.

The S&P/ASX 300 index returned 4.5% in July. Global developments were again a key driver of the local market in spite of investor focus on the reporting of half yearly earnings results by domestic companies.

At the start of the month, economic data released in the US confirmed earlier signals that the labour market recovery had stalled. Despite this uncertainty over the economic outlook, robust earnings results and positive earnings guidance from US companies shows corporate earnings continued to be improving and has underpinned much of the market rally in July. Locally, earnings results were broadly in line with market expectations.

During the month, the Committee of European Banking Supervisors revealed that seven out of 91 European banks failed their stress tests with an overall capital shortfall of EUR 3.5 billion, including one German, one Greek and five Spanish banks. Questions still remain surrounding the 'stress level' of these tests and the severity of the sovereign shocks.

Global equities rose 0.7% in July in Australian dollar terms; with the appreciation of Australian dollar against the major currencies offset a large proportion of the monthly positive gain. In local currency terms, developed market equities (as measure by the MSCI World ex-Australia Index) rose 5.8%. Emerging market equities gained 6.2% while global small cap equities returned 5.7%.

Fixed Interest

Domestic and global fixed interest returned positively for the month, gaining 0.3% and 0.9% respectively as measured by the broader composite indices. The US 10-year bond yield were mostly range trading during the month as market zigzag between falling risk aversion and weakening economic data before finished the month 2 bps lower at 2.91%. In comparison, Australian bond yields rose 12 bps for the month in spite of a softening in the core inflation indicator.

Corporate bonds recorded positive monthly return on tightening spreads and a return in demand for spread the high yield added 3.8% for a cumulative three month return of 1.4%.

Property and Infrastructure

Global listed property and infrastructure markets rebounded strongly in July, with the UBS Global Real Estate and UBS Global infrastructure and Utilities Index up 8.6% and 5.2% respectively. The S&P A-REIT index posted a relatively modest increase of 1.1% and underperformed the broader equity market. Among domestic REITs, selective names posted strong gains (CNP +43%, IIF +18%) on favourable development on corporate restructuring or speculation of potential takeover activity.

Alternatives

Hedge funds posted positive returns in July, with most sub strategies benefited from the strength of the equity markets and spread assets rallies. Equity hedge strategies recorded the strongest gains, returning 2.88%. Event Driven and Relative Value strategies both benefited from improvement in demand to risk assets, returning 2.2% and 1.6% respectively. Macro strategies delivered a modest gain for the month (0.3%). The breakdown of market trends (particularly in commodities market) and sharp market movements have heavily impeded the performance of trend following strategies.

Commodity prices have finished the month mostly firmer in spite of moderation in growth in China. Soft commodities were the best performers with wheat gaining 40%, sugar 22% and soybeans 15%. Metals gained appreciably with Copper, Zinc and Aluminium all recorded double digit gains. Energy have lagged other commodities but managed to post solid gains (crude oil was up 4.2%). Only precious metals have recorded negative return for the month.

Gold weakened in July after posting strong performance in the past 2 months and breaking above US\$1200. A breakdown in the relation between gold and treasury bonds saw gold trading modestly lower while 2 and 10-year yields increasing in price over concerns of another economic contraction in the second half of 2010.

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