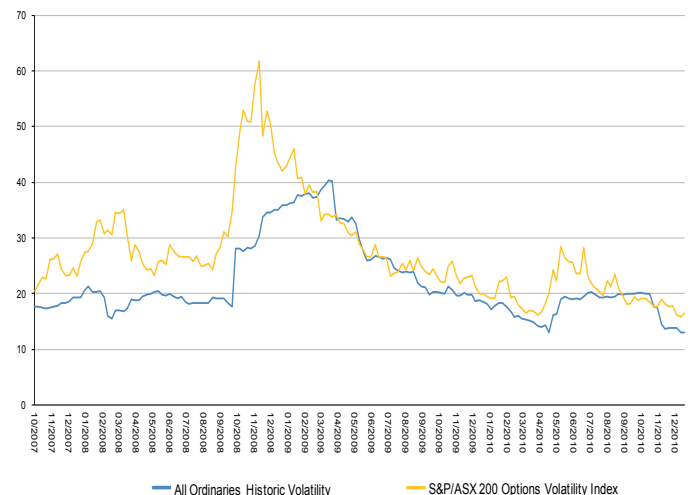
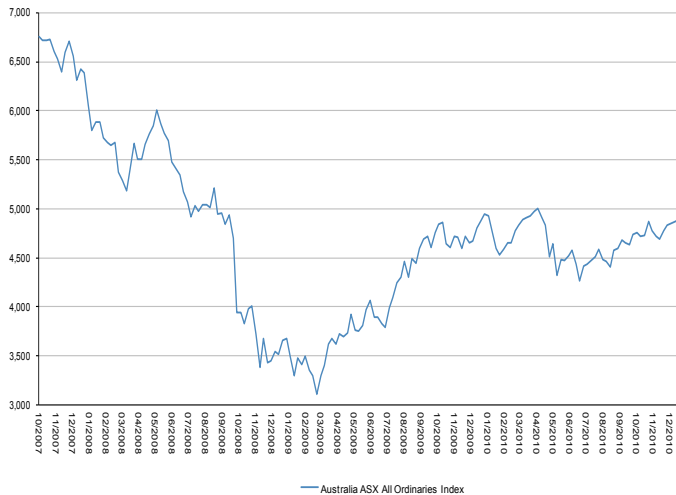


January 2011

The Past: What happened in 2010?

Last year we predicted a bear market correction of about 20% in the All Ordinaries Index after a near 60% rally from the index low point in March 2009. By early July this prediction was looking on track with a correction of about 13% from the end of 2009 index level, but with more monetary [i.e. US\$600b from the Fed's QE2 programme] and fiscal [i.e. more than US\$500b in 2011 and 2012 from extending the Bush-era tax cuts, unemployment benefits, and other new initiatives] policy stimulus in the US in the 2nd half of 2010, most developed equity markets staged a recovery, with the Australian index up nearly 15% from its July low point. Over 2010 this resulted in essentially no change to the level of the index.

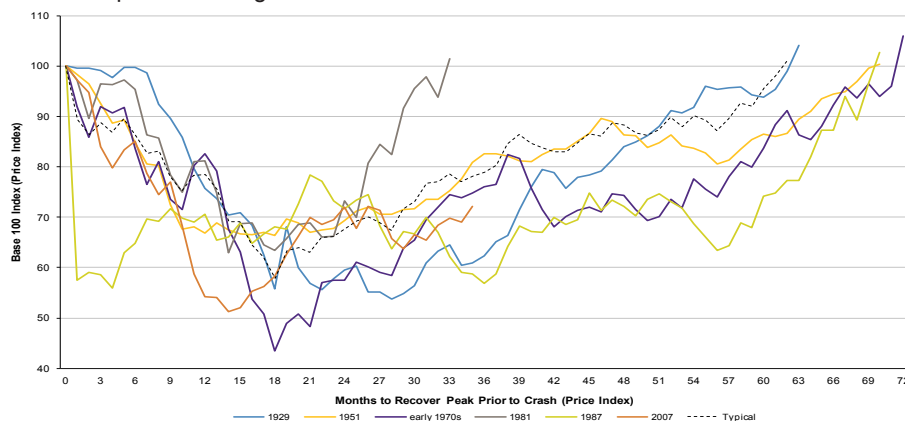


The rally in the Australian index also coincided with a fall in both implied and historic volatility levels. Implied volatility fell from a high of 32% [at the end of May] to 16% by the end of 2010. The historic volatility [26 week] fell from around 20% mid-year to 13% by year end, tapering-off over the last couple of months. The fall in volatility is perhaps the result of the market's belief that governments and central banks will do whatever it takes to avoid further sharp falls in asset values, or perhaps it's just the calm before a future market storm driven by sharply higher inflation [especially in China and other emerging economies] and the greater economic uncertainty that this brings.

The Present: Where are we now versus previous bear market cycles?

Prior to the 2007 market crash, there were previously five other market crashes [defined as more than a 30% decline from the previous high point] in Australia over the last 100 years: 1929, 1951, early 1970s, 1981 and 1987. The average severity of these crashes was a market decline of 44%. By comparison, the 2007 crash saw a decline of 49%, second only to the early 1970s crash which saw a decline of 57%.

The average number of months to return to pre-crash index levels for Australia's five previous crashes was 62 months [roughly five years], but this average was somewhat distorted by the 1981 crash which recovered in only 33 months, so the median recovery has taken 70 months [nearly six years]. Note that we are now 35 months into the current bear market, so there is potentially still some way to go before we recover to the prior index highs seen in 2007.



For further information please contact:



Michael Fitzsimmons
Chief Investment Officer
michael.fitzsimmons@jcpip.com.au
+61 03 9607 4101



Wes Campbell
Head of Institutional Business & Portfolio Manager
wes.campbell@jcpip.com.au
+61 03 9607 4117

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Similar to what happened in the mid-1950s, mid-1970s, and late 1980s; there is still the risk of a further sharp fall in the next couple of years, especially if inflation accelerates [which is already happening in emerging markets, and may also occur in developed markets if easy monetary policy is maintained as economic recovery accelerates]. However, if inflation can be contained to moderate levels [i.e. below 5%], then based on previous cycles the Australian market should continue to recover over the next three years, with a capital growth rate of about 12%pa [plus a dividend and franking yield of about 5%, based on 2010 figures].

Our calculation of the current fair value PER of the Australian equity market is 15.6x [this compares to the current market PER of 13.9x]. This fair value PER is based on: (1) the current 10 year Australian government bond yield of 5.5% [2.7% real]; (2) an equity risk premium of 6.4% [6.3% long term and 6.6% short term – next 2 years]; and short-term NPAT growth rate of 14% in 2012, and 9% in 2013 [consensus figures]; and long-term NPAT growth of 4.5% [consistent with Australia's long-term historic real per capita GDP growth of 1.6%pa, and our expected Australian long-term inflation rate of 2.8%pa].

These figures imply that the Australian equity market is currently modestly cheap [i.e. 10%, which is similar to our market cap. weighted bottom-up NPV analysis]. However, we would caution about the risks to higher real bond yields, equity risk premium, and/or lower NPAT growth rates that could come from: (1) further European sovereign debt issues [e.g. Portugal and Spain]; reduced confidence in the sustainability of the US fiscal position [and its implications for monetary policy and inflation expectations]; upside inflation risks [especially in emerging economies, notably China]; and the implications of the latter on short-term Chinese economic growth, commodity prices, Australia's terms of trade, employment, etc.

The Future: What do we expect in 2011?

Our most likely scenario [i.e. 50% probability] is that the Australian equity market continues to recover and generates a capital return of about 10% in 2011 [note this is similar to the 13% return shown on the dotted “typical line” on the previous chart, i.e. from month 35 to 47].

What if some of these risks eventuate in 2011? What would this mean for the Australian equity market?

Let's assume that (1) real bond yields fall by 0.5% [i.e. flight to safety as risk premiums increase]; (2) short-term equity market volatility increases to its average level since Oct 2007 of 27%, plus one standard deviation of 9%, i.e. 36% [resulting in an increase in the equity risk premium from 6.4% to 7.5%]; and short-term NPAT growth falls to 0% in 2012 and 2013 [as commodity prices tumble which in turn impacts Australia's terms of trade, employment, etc.]. Under this scenario we would expect Australia's PER to fall from 15.6x to 11.6x, resulting in a 25% fall in the equity market. [We'd put a 35% probability on this scenario.]

This market fall would be similar to those seen in: (1) the mid-1950s [10% from Jul 1955 to Jun 1956]; (2) the mid-1970s [16% from Jul 1976 to Aug 1977]; and (3) the late-1980s [27% from Aug 1989 to Dec 1990].

Alternatively, what if none of these risks eventuate? That is: European sovereign debt bail-outs do not spread from Greece and Ireland; the market sustains confidence in the US fiscal position and the Fed's willingness and ability to withdraw monetary stimulus at the appropriate time; emerging market inflation pressures are kept under control [especially China's]; and Australia easily grows its way out of its household debt problem. What would this mean for the Australian equity market?

Let's assume that real bond yields and market volatility stay at current levels, but short-term NPAT growth is about 1.5x current consensus expectations [i.e. 21% in 2012, and 14% in 2013]. Under this scenario we would expect Australia's PER to fall to 14.9x [i.e. 4%], but with NPAT growth of 21% in 2012, this would result in an 18% rise in the equity market. [We'd put a 15% probability on this scenario.]

If we probability weight the above scenarios we get an expected capital return forecast for the Australian equity market of -1%, i.e. essentially another flattish year, but this outcome belies the inherent risks and the potential negative payoff from these risks.

Conclusion

There are times when forecasting is comparatively easy and other times when it is almost impossible. Making an equity market forecast this year feels like one of those almost impossible times! In his seminal paper, “Six Rules for Effective Forecasting”, Paul Saffo says, “...it is a liability for forecasters to have too strong a proclivity to see change, for the simple fact is that even in periods of dramatic, rapid transformation, there are vastly more elements that do not change than new things that emerge.”

2011 will be extremely difficult to call from an Australian equity market perspective. There are still significant risks associated with the deleveraging process underway in many developed economies, and also more immediate inflation risks in most emerging economies. Australia is still reasonably well placed to grow its way out of its household debt problem, assuming China manages to keep inflation under control and the Reserve Bank of Australia manages to keep household spending in check given the big income boost from the stronger terms of trade in 2010. This will be a tough balancing act, made all the more difficult if China has to crunch its economy to manage inflation.

We continue to have a defensive positioning in the portfolio (since mid 2009) and in recent months have taken advantage of the strength in cyclical stocks (especially resource stocks), switching to some oversold industrial exposure. This has particularly been reinforced by our caution towards inflation risks in China.

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