A Few Set-Backs

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In June, Australian equities were unnerved by - 1) US Federal Reserve comments on the winding down Quantitative Easing (QE); 2) A spike in money market interest rates in China; and 3) Concerns over a domestic downturn.

Talk of a downturn in Australia intensified, as the local manufacturing sector continued to downsize (Ford the latest to announce plans of a local exit), analysts pulled back forecasts on China's growth, sluggish commodity prices saw mining companies cut spending further, while companies across a range of industries issued profit warnings. Coupled with waning foreign interest as the AUD fell, local equities lost ground.

Nevertheless, an imminent resources *production* boom, the lagged impact of stimulative monetary policy, and even a change in Government, are some tailwinds that should mitigate the downside (in our firm's view).

Furthermore, while Australian profit growth has stalled for the last 2 years, fiscal year 2014 offers positive prospects given the lower AUD and interest rates, and heightened focus on cost-cutting.

This month we discuss:

- Australian market update
- Discussion on current asset class volatility
- Equity specific reviews
- International equities strategy
- Financial Planning action points

David Leon, CPM®
First Vice President
08 8468 6129
david.leon@morganstanleyy.com

David is a Certified Portfolio Manager and advises Family Offices, Medical Professionals and Corporate Boards in the Aged Care sector.

Geoff Smith, CFP®
Vice President
08 8468 6130
geoff.smith@morganstanley.com

Geoff is a Strategic Financial Planner with extensive experience in financial planning, investment markets and insurance solutions.

Jawad Ahmad, CFP®
Financial Planner
08 8468 6127
jawad.ahmad@morganstanley.com

Jawad is a Financial Planner with the technical proficiency in developing comprehensive strategies and providing holistic Financial Planning.

Market Performance

	Jun-13	May-13	1 MTH	YEAR TO DATE
ASX20	3,014	3,059	-1.5%	5.2%
ASX200	4,803	4,927	-2.5%	3.3%
ASX200 Accum	39,163	40,094	-2.3%	5.5%
S&P500	1,606	1,631	-1.5%	12.6%
MSCI World - ex Aus	1,444	1,500	-3.8%	7.7%
AUDUSD	0.914	0.958	-4.6%	-12.0%
Oil (WTI)	96.42	91.61	5.3%	5.1%
Spot Gold	1,234.16	1,387.10	-11.0%	-26.3%
AUS CASH RATE (%)	2.75	2.75	0bp	-25bp
AUS 10Y BOND YLD (%)	3.76	3.36	41bp	49bp
US 10Y BOND YLD (%)	2.49	2.13	36bp	73bp

Source: IRESS, MSWM Research. Closing prices as at 31 May and 30 June 2013

ASX20 Stock Performance – Top 5 and Bottom 5

		Close Price	Return (mth)			Close Price	Return (mth)
Top 5				**Bottom 5**			
ANZ	$	28.58	3.8%	NCM	$	9.87	-32.0%
CBA	$	69.18	3.5%	AMP	$	4.25	-18.0%
CSL	$	61.58	3.3%	BHP	$	31.37	-10.1%
NAB	$	29.68	2.3%	ORG	$	12.57	-6.7%
BXB	$	9.34	2.0%	QBE	$	15.09	-5.7%

Source: IRESS, MSWM Research. Prices as at 30 June 2013

Australian Market Update

The last six weeks have changed everything…

What's happened?

1. **The RBA declares war on the AUD.** This prompts a selloff by foreign investors of our Australian Government Bonds and Equities. Ladies and gentlemen, the "FX carry trade is over".
2. **The US Federal Reserve signals** that the 'printing presses' or bond buying is coming to an end. This sparks a selloff in emerging market currencies (and reserve currencies like the AUD) with flows back into the USD or…the largest economy in the world.
3. **China back in the spotlight** but this time about their banking sector experiencing a Liquidity Crunch Crisis (does that sound like Credit Crisis?). For years, people have been talking about a 'shadow banking system' that could unravel the whole China financial system and strangle liquidity between banks. We hope this is only a rumour.
4. **China also continues to show signs of an economic slowdown** prompting continued selloffs of commodities (gold, copper, etc.). This is having huge implications for Australia.

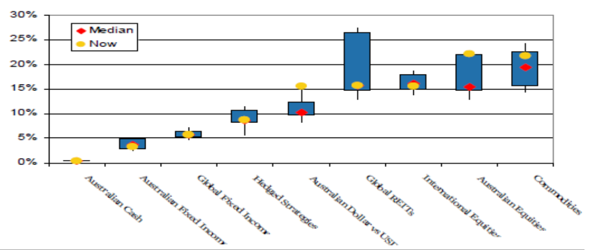
Asset Class Volatily

Have you thought that things appear to be really volatile here in Australia lately? You'd be right. Things are actually more volatile now than they were during the GFC! If you're an investor in Australia, it's been a really bumpy ride compared to our peers overseas who are experiencing calm conditions.

- Australian Cash & Fixed Income: normal
- Global Fixed Income & Equities: normal to low volatility
- Australian Dollar (AUD): above crisis level volatility
- Australian Shares: above crisis level volatility
- Australian Direct Property: above crisis level volatility

Please see an interesting piece that our research team did on the topic (Private Wealth Manager, Long Term Volatility for Asset Allocation – 21 June, 2013).

Figure 1: Distribution of Realized Volatility for Major Asset Classes over a 7-Year Investment Cycle



Source: Morgan Stanley Wealth Management Research

Equity Specific Reviews

This month we'd like to give investors an update on a sampling of compaies we follow for our clients. This sampling we believe gives investors an insight as to what sectors are doing well…and which aren't.

We start with **AMP Limited (Overweight, Morgan Stanley)** because recent events for them we believe highlight the coming years of economic challenge Australia faces. AMP recently surprised the market with a unscheduled profit warning. Downgrades of earnings were on the back of a spiked increase in Income protection policy claims (i.e. unemployment and injury) and Life (i.e. deaths). We believe this could be a leading (predictive) indicator for the challenges we may be facing here at home with unemployment and stressful business conditions on the rise. (This equally does not bode well for the banking sector).

This leads us into the **mining sector** here in Australia. Their weakness comes on the back of a acute and unforecasted halt in the mining sector which has caught economists and politicians by surprise. The resources sector in itself has underperformed the broader market by almost -27%.

Newcrest (Equal weight, Morgan Stanley) on the back of falling Gold pricing and production delays at Lihir Island (located in PNG; A volcanic island), NCM recently surprised the market with a multi-billion dollar write down of its valuation of the recent purchase. We are of the view that even with this write down, the company's balance sheet (e.g. gearing level) is strong and that an equity raising to strengthen their balance sheet will not be required (for now…). Upside exists still for the company but volatility is likely to persist until the market is informed on the companies new five year plan given the new commodities environment.

BHP & PanAust (Overweight, Morgan Stanley) and Rio Tinto & Iluka (Equal weight, Morgan Stanley) all signaling to the market that conditions are too uncertain to push forward with certain projects and that the outlook for commodities pricing remains soft impacting their profit outlooks.

By guilt through association the mining services sector has performed almost as poorly with the average major service provider down by -14%. Why? With fears of a longer recovery anticipated in Europe and a possible (still hypothetical) slow down in China taking place, it appears the extreme demand for commodities over the last 10 years is over and things are reverting back to long term averages.

Quality names like **ALS, Mineral Resourses (both Overweight, Morgan Stanley),** and **Bradken (Equal Weight, Morgan Stanley)** are indicating their businesses remain strong but that the outlook continues to deteriorate. **Mermaid Marine (Overweight, Morgan Stanley)** on the other hand has been the star performer (relatively speaking) on the back of current expectations that LNG or liquefied natural gas projects will continue to progress (could this reverse too?). We have seen profit taking here lately given even the LNG sector may face headwinds if things slow down in the Energy sector too.

NRW (Nuetral, CITI) has been hit the hardest with expectations that most new projects (of which they are heavily leveraged too) will be moth balled. For those investors who have not sold the stock already to offset gains within their portfolio, there could be a potential share price recovery if there is progress on the Roy Hill project in WA (Gina Reinhart) which could be another Pilbara! NRW should be one of the first in line to win tenders.

Strength within our domestic Australian portfolios continues to be found in companies who's earnings are less susceptible to economic shocks and in many cases are beneficiaries of the **falling AUD**.

Treasury Wine Estates (Equal Weight, Morgan Stanley) has been the best performing consumer staple sector (out performing the sector by 68% over the last 2 years) beating the likes of Woolworths, Wesfarmers, CocaCola and Metcash by a substantial margin. Although the stock appears fully valued, we believe $8.00 (price target) at $0.80 (AUD) is possible and continue to back the 'China consumption/Margin Expansion' story here. **A leverage play towards the falling AUD.**

NewsCorp (Best Idea, Overweight, Morgan Stanley) recently completed a demerger of its coveted media assets (i.e. Movies, Fox News, etc.) from its paper assets (i.e. Newspapers, etc). The stock split gave investors 2 holdings: FOX = 20th Century Fox and NNC = New NewsCorp. If you noticed a price drop recently, this is because of the split, not bad performance. Again, a **huge beneficiary of the falling AUD.**

ResMed (Overweight, Morgan Stanley) continues to perform strongly even in a challenging and changing regulatory environment in the US. We believe the upside to this stock is significant (Sleep Apnea highly under diagnosed) and the **falling AUD is a huge boost to their margins.**

Dominos Pizza's (Overweight, Morgan Stanley) interim result was strong in terms of profit growth and is resilient in the face of very challenging sales comparables. And whilst there were some surprises to absorb, we see this as a function of their model changing dynamically via investment in store footprint, format, offer and efficiency. DMP is a **beneficiary (in many ways) to a falling AUD.**

The **ASX20 Yield Maximiser (YMAX)** has been performing as expected following the broader ASX20 index faily closely. If market volatility continues, it is possible the covered call strategy within the fund will generate up to 10% in yield over the next 6 months. As many of you are aware, given that a large component of the ASX20 are the big banks (of which we are bearish on – please refer to challenges faced by AMP), we are using this investment as a bearish hedge against downside risk in the banks.

QRX Pharma (Buy, CITI Research) recently announced a scheduling delay in their new drug submission to the Food & Drug Administration (FDA) as they recently discovered a time input discrepancy within their pivotal study 22. It was disclosed by the company that the data collection machines used in the study were all sent from California to multiple sites throughout the country. It so happened that the weekend of the study a few of the sites experienced daylight savings changes and the nurses used the new time. In contrast, the data collection machines used their original collective time. The company has stated this will have no impact on the quality of the data collected or their findings but 16% of the 30 million+ data points will need to be redated and this will take a few weeks. They are expecting to present to the independent advisory board and the FDA now in August and September respectively (although a date has not been formalized as of this writing). Apparently, the FDA nor the Auditors caught this oversight but QRX did in the end. Although a delay is disappointing, this should not impact the companies long term potential.

International Portfolio

Our move into this space for clients 4 years ago has proven to be very successful and the last 6 weeks (with the dramatic fall in the AUD) has been the icing on the cake! We continue to recommend the "GO INTERNATIONAL" thematic for the following reasons:

1. The AUD should continue to weaken on the back of:
   a) RBA lowering interest rates another 50bps
   b) USD strengthening, recovering economy
   c) Falling resource pricing highly correlated to falling AUD
   d) Outflows of foreign investment from the AUD (selling pressure)

2. Opportunities for less volatile equity investment because:
   a) There are more blue chip multi-national companies to choose from overseas
   b) Australian shares have become more volatile because of the volatility of the AUD (please see point on Australian volatility on page 2)
   c) Australian economy weakening on the back of a resource boom ending

The following are stock rated Overweight by Morgan Stanley that our team is currently following:

- JPMorgan
- Starbucks
- American Tower
- Amazon
- Monsanto
- Siemens
- Mazda
- Chevron
- YUM!
- Michael Kors

Key Superannuation and Tax Proposals Set to Become Law

The last few days have seen a raft of proposed superannuation and tax proposals move successfully through both houses of Parliament and are set to be enacted as law.

1. Superannuation contribution cap increase

If you're 59 years of age or older on 30 June 2013, then your concessional contribution cap will increase to $35,000 from 1 July 2013.

For certain clients this will allow you to increase the amount you direct into the tax effective environment of superannuation and could offer an immediate tax saving for those on mid-to-high marginal tax rates.

Note: If you're between age 65 and 75 you must meet a work test to contribute to superannuation.

2. 'Super Surcharge' is back for high income earners

Anyone with an adjusted taxable income (ATI) that exceeds $300,000 in any financial year from 1 July 2012 will pay 30% tax on concessional contributions paid into a super fund. The regular contributions tax is a flat rate of 15%. In instances where part of your concessional contributions 'pushes' your ATI above $300,000, only the excess contributions above $300,000 are taxable at the higher 30% rate.

Note: This change could also impact investors who have realised capital gains, significant franking credits or other one-off income transactions that may push their ATI above $300,000 in a single year. The scope goes beyond those who are working and earning/drawing income above $300,000 per annum.

3. Off market share transactions between related parties and Self Managed Superannuation Funds (SMSF)

The current rules that permit off market transfers between related parties and SMSFs will continue post 1 July 2013. Proposals to ban/restrict transactions in listed assets (such as shares) between related parties and SMSFs from 1 July 2013 were not adopted and will not become law.

4. Refund of up to $10,000 excess concessional contributions for 2012/13

Currently, excess concessional contributions are taxed at the highest marginal tax rate and are counted for non-concessional contribution purposes. This has led to adverse outcomes for some in the past, with tax penalties totaling 93%.

Where the concessional contribution cap of $25,000 is exceeded by no more than $10,000 in the 2012/13 financial year, members will have the ability to accept an offer from the Australian Taxation Office to have the excess refunded to them with that excess being treated as income in their tax return and subject to tax at their marginal tax rate.

Further changes are proposed for income years starting on 1 July 2013 but these proposed have not yet become law.

These are likely to be the only proposals to be enacted as law given Parliament rises for the final time this session. We will keep you informed of any policy changes.

STRATEGY CHANGES

COMPANY	SECTOR	REASON	ACTION
NA	NA	NA	NA

OUR SELECTION PROCESS

- The stocks selected seek to be profitable today with high Return on Invested Capital (ROIC), high gross margins and low capital intensity.
- High profitability that seeks to be sustainable for the long term, with the support of powerful intangible assets such as strong brands, products or services with high barriers to entry.
- The companies must have high quality management teams committed to maintaining the high returns through focused investment and innovation with careful stewardship of capital.

OUR BENCHMARKS

- ASX200
- Morningstar Balanced
- MSCI Global

TEAM PROFILE

David Leon (Investment Adviser) is a Certified Portfolio Manager® from the School of Engineering and Applied Science from Columbia University, New York, USA. David primarily advises Family Offices, Medical Professionals and Corporate boards within the Aged Care Sector. David began his finance career working as an analyst for a boutique investment banking firm in Chicago that executed underwritings and placements for state and local government entities. While still working in Chicago, he was invited to join UBS as a private client adviser and financial planner. In early 2007, David and his Australian wife moved closer to her family in Australia. David was recruited by Goldman Sachs where he held the title of Director. David graduated with honours from Northwestern University in Chicago, has an Advanced Diploma of Financial Planning, is an ASIC Accredited Derivatives Adviser and is licensed to trade equities, globally. David is also a Governor of the American Chamber of Commerce.

Geoff Smith (Strategic Financial Planner) is a Certified Financial Planner® with over 25 years of experience in Financial Planning and Investment Advice. Prior to joining Morgan Stanley Wealth Management, Geoff was a leading Financial Adviser and principal of Adelaide based financial advisory firm Prescott Securities. In addition to this experience Geoff holds a Diploma of Financial Planning and a Diploma with the Australian Insurance Institute. Geoff specialises in providing quality strategic and investment advice and portfolio wealth management both to individuals and to tax exempt organisations.

Jawad Ahmad (Financial Planner) is a Certified Financial Planner® and has been in the financial service industry since 2006. He has a strong technical background and has vast experience in holistic financial advice. Prior to joining Morgan Stanley Wealth Management, Jawad worked as a Financial Planner and Para planner with Godfrey Pembroke based in Adelaide. He holds a Bachelor of Finance (University of Adelaide), is an ASIC accredited Derivatives planner and has a Graduate Diploma in Global Wealth Management (University of Adelaide) for which he was awarded the most distinguished graduate award in 2007.

Please contact your financial advisers to obtain a copy of the full research reports listed or refer to our website at www.morganstanley.com.au.

Research sourced from:

1. "Treasury Wine Estates" – Morgan Stanley Research, 24 June 2013
2. "Dominos Pizza" – Morgan Stanley Research, 13 February 2013
3. "Newcrest Mining" – Morgan Stanley Research, 10 June 2013
4. "ResMed" – Morgan Stanley Research, 7 June 2013
5. "Large Cap Miners – what to watch out for" – Morgan Stanley Research, 25 June 2013
6. "NRW Holdings" – Citi Research, 11 June 2013
7. "AMP Limited" – Morgan Stanley Research, 24 June
8. "QRX Pharma" – Citi Research, 27 June 2013
9. "Private Wealth Manager: Long Term Volatility for Asset Allocation" – Morgan Stanley Research, 21 June 2013
10. "Australian Engineering/Construction: Assessing the Impact of E&Cs of the Resource Cycle Downturn" – Citi research, 6 June 2013

Important information

Please ask your financial adviser for additional details.