

Magellan Asset Management

Insights from Hamish Douglass, Portfolio Manager of the Magellan Global Fund

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Hamish, the fiscal dramas in Europe just don't seem to be going away. What are your latest observations?

Well, my first observation would be that these issues just aren't going to go away in the short term. Greece is going to remain in the headlines at least until the end of the Greek election on June 17th. Assuming we get an outcome the Greek situation may settle down for a period after that. We're then likely to go to Portugal later in the year, where Portugal may require another bail out and we will get the interaction between France and Germany trying to settle what the terms of that next bail out of Portugal would be. We are likely to have more volatility in the period ahead; it's very likely that Portugal will get a bail out in our view. Then Spain. Spain is a much larger country, fourth largest economy in Europe. Its banking system is in trouble. Bond yields are again rising and there is going to be increasing focus... There is a lot of focus but it is going to be an increasing focus and I think Spain is going to be the name of the game for the next 12 months and there is likely to be more volatility.

Although what I would say is that the issues are well understood. The regulators and politicians understand the issues. It is not like we have got a black swan event we are dealing with here. They're complex issues that are going to take a long time to resolve. The Central Bank, the ECB, has made substantial moves in the last six months particularly with the Long Term Refinancing Operation, the LTRO as it has become known as. When they injected over a trillion Euros at 1% interest rate for the next three years into the European banking system in December last year and February this year, that has really changed the stress of liquidity in the European banking system and you see that in key stress indicators that we look at every day. So, notwithstanding this heightened volatility, there has been some progress that has been made. The issues as I said are well understood. There is likely to be more volatility in the next 12 months and in the longer term... this is going to take a long time to resolve. You know, governments are indebted, the debts are going up, austerity is kicking in, economies are going backwards and these deleveraging processes take years. It could take another five to seven years before Europe really comes out of the back end of this and starts growing again.

You touched on Greece, how do you think the Greek issues will pan out?

Well we think in the short term, the probability of Greece exiting the Euro in a spectacular fashion, we think the probability of that event is very low. In the longer term, Greece may exit the Euro but in the short term, that it could result in an Armageddon event, we think that is of very low probability. And the reason we hold that view is because the private sector holds very little Greek government debt at the moment. When they rescheduled their debt at the end of last year and they effectively... they issued new bonds in exchange for €200 billion worth of Greek government bonds at 0.50 cents in the dollar, but of course they issued those bonds at much lower interest rates so the economic loss to the investors was over 70% of the money. But importantly those bonds are not due to mature, the new bonds, for a decade or more. That means there is not practically any debt that is held by external investors, outside of the European Central Bank and the IMF and the European Union, that can effectively default.

So the risk of Greece defaulting in the short term is relatively low. And really this has put an enormous amount of power in the hands of countries like Germany in negotiating with Greece.

The Greeks could choose to commit suicide if they wished and they could choose to exit the Euro at the moment. It would be a spectacular disaster for the Greek citizens. It's likely to be very painful for Europe if that happens but the chance of that choice being made, we think, is very low. The opinion polls for the June 17 elections are actually pretty favourable at the moment for quite a speedy resolution to this. It appears that New Democracy is out in front and New Democracy of course is the party who is pro-austerity and pro the Euro and they are likely to form if they are out in front and the party who gets the highest level of votes gets an extra 50 seats allocated to them. If the opinion polls are right, it looks like they could form a government and Syriza, which is the party who wants to have this game of brinkmanship with the Germans, appears to be in second place at the moment. But as we know in politics there's a long time to go between now and June 17th. These things can change and we will see what happens. But even if Syriza gets up and they want to have this game of brinkmanship with the Germans; we don't think they hold many cards in that debate. Their ultimate card is choosing to commit suicide to prove a point. We doubt they will make that choice at the end of the day. So, from Greece's point of view, we understand the volatility. We understand the uncertainty that the last failed elections had put on Greece and put on markets. We ultimately think the probability of a disaster in Greece is pretty low and they have made a lot of progress so far and let's see how the water continues to flow under this bridge.

There is more talk of Spain's woes worsening, particularly with the banking system being under pressure, how are you viewing the latest issues?

Yes, we do have views on that issue. Spain is the elephant in the room. The austerity measures that the new centre-right government are implementing, are biting and unfortunately the unemployment rate is going up and pre-2008 there was a spectacular property bubble. On some estimates, Spain was constructing three times the amount of houses that were required to be lived in by the population each year. So there has been a massive excess supply and who financed this spectacular bubble in housing? The banking system. They financed the constructors, they financed the mortgagors, they are loaded up with loans to this property bubble in Spain and of course there are going to be massive write offs required. At the same time the unemployment rate is going up, it is now 24.4% in Spain is the latest figure and it is likely to be going up by the day.

And what is happening, a little off the back of what has happened in Greece, bond yields are again rising in Spain and there is this laser like focus on dealing with the Spanish banking system. Bankia, the third largest bank in Spain which is an amalgam of seven savings banks in Spain is being bailed out to the tune of over €16 billion. It has already received €4.5 billion in capital and there is a dispute with the ECB about exactly how that recapitalisation can occur. Of course, that is going to put further debt on the Spanish government's balance sheet as that recapitalisation happens and there are estimates out there

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and I don't think they are unrealistic, maybe there is a €100 billion of capital that has to go in to Spanish banking system. At the end of the day, if Spain gets shut out of the capital markets, ultimately we think that the European stability mechanism that comes in place on the 1st of July will provide the funds to Spain to recapitalise its banking system if they are not able to borrow those funds themselves. And if Spain totally gets shut out of funding markets, we believe in that scenario, the European Central Bank is likely to dramatically expand its balance sheet and most likely enter the secondary markets and buy Spanish bonds to drive down the yield. So, we could get a heightened level of volatility, this is a very problematic situation in Spain, but again we think it is very low probability that it's going to result in an Armageddon event for Europe and for the world as a whole.

You have spoken more recently about the economic recovery in the US over the next three years plus, given November's presidential elections, how do you think the economy will develop over time?

No, we don't think the presidential election is going to have much bearing in terms of our, you know, relatively optimistic view that in three years' time the US is going to be led into quite a sharp recovery through an increase in housing starts in the economy. We think when housing starts get back to a more normal level when this excess inventory is used up and it is our estimates about three years to utilise the inventory housing starts could well double from their present rate of 600,000 to 700,000 housing starts per annum at the moment back to about 1.4 million housing starts. That will have a massive injection into the economy in terms of the amount of money that is being invested in housing, of course it will have a big effect on the unemployment rate at that time, it will have a dramatic effect on the budgetary position of the United States driving down the budget deficit. We do not think that equation gets changed very much at all depending on who is in the White House between Obama or Romney at the end of the day. The issue at the beginning of next year of course is the fiscal cliff, where the Bush tax cuts expire and there are automatic expenditure reductions that would come into place back off the debt ceiling extension that was agreed in August next year. There is not a lot of time between the November presidential elections and February next year in order to enact something that would get through that fiscal cliff. Whilst I think we are going to have some volatility and some uncertainty around that time, ultimately, we think Congress will not allow a massive fiscal retraction to happen in a single point in time and we hold that view irrespective of whether Romney or Obama is the president post the next elections.

And Hamish, are you happy with where the Chinese economy is tracking at the moment?

The Chinese economy; we have been proponents of a soft landing scenario where China dramatically stimulated its economy in 2009 and 2010 largely through an expansion of credit through the state-owned banks (partly owned by private shareholders) lending money to local government authorities to build property and infrastructure, a highly effective program but of course with a program like that where you expand the bank's lending capacity by 80% in two and a half years, you are likely to leave the banks maybe with some problem loans and the Chinese government is dealing with the consequences of the stimulation they did to their economy and the economy is slowing down as they've slowed credit down.

In the last six weeks, it appears that the Chinese economy is slowing down faster than we have been anticipating. Still a soft landing scenario but a faster slow down than we have been anticipating. It is still only six weeks of data and I think everyone needs to be cautious

about data coming out of China, about exactly its accuracy but there is a number of data points that shows the year on year growth in certain areas of the economy has slowed very materially. It's not a recession by any stretch of the imagination, maybe China grows at 7% this year and not above 10% - so slowing down more rapidly than we thought but still a relatively soft landing scenario.



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