

May 24, 2013

Dear clients and colleagues,

May is a very important month for Australia. Three releases are closely watched: The Reserve Bank of Australia (RBA)'s Statement of Monetary Policy; the federal government budget; and Q1 private sector capex. The first two have already been released, and reflected a challenging situation and dovish tone.

The Reserve Bank of Australia (RBA) slashed interest rates to a record low 2.75%, citing sluggish growth and rising unemployment as well as the protracted strength of Australian dollar. It expects GDP growth of 2.5% and inflation of 2.25% for 2013, both lower than the February forecast.

The government announced a budget deficit of A\$19.4 billion for the 2013-2014 fiscal year due to a slowdown in the mining boom. It predicted a smaller deficit next year and a surplus in 2015. As a point of reference, in the period from 2005-2011, terms of trade and capital investment (whose growth came mainly from the resource sector) explain more than 90% of Gross Domestic Income growth.

Recently we spent a week in Australia visiting companies, doing site visits and attending the Macquarie Australian equities conference. This year's conference was the largest ever for Macquarie, bringing over 100 companies and 1000 investors. We had the opportunity to meet about 30 companies in different sectors.

The tone from the conference was cautiously optimistic, compared with last year's "very optimistic". The most cited reasons?

- China's growth is slowing down, but urbanization is ongoing.
- Mining investment is expected to peak at the end of this year.
- Consumer spending and home building have been slow to respond to a more than yearlong string of interest rate cuts.
- Unemployment remains at 5.6%, well below other developed countries, but looks to be on its way up.

Coming up on May 30th, the release of Q1 private sector capex data is expected to confirm the peaking mining investment.

Looking ahead, the RBA forecasts GDP growth to accelerate to 3.5% next year and 4% in 2015. However, there remain considerable uncertainties on how Australia will proceed with the structural change from investment-export model to domestic-consumption and non-mining model. More interest rate cuts may be necessary.

On the political front, the September 14th national election this year also creates complexity. The opposition party is widely expected to win.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

What do we think about the Australian market?

- It is a well-developed market. The pool of investment funds is very large and dominated by institutions. There is about A\$2 trillion of institutional money in Australia, including A\$1.3 trillion in Superannuation (pension) funds. In searching for diversification, these funds are actively investing overseas. Their investment style is very similar to western peers; i.e. long-term horizon and conservative, vs. more aggressive style of other Asian peers.
- Most stocks are small caps. Over 2,000 companies are listed on the ASX, and only 50 have market capitalization above U\$5 billion.
- There are selective opportunities beyond the resource sector. We favor niche leaders with overseas sales focus because the domestic market is quite small.

During this trip we met four of five Australian companies in the portfolio. They are Panoramic Resources (nickel producer), Atlas Iron (iron ore producer), Cardno (Engineering firm), and Slater & Gordon (law firm). We came away with several new ideas. It is likely that a few will be added to the portfolio in the coming months.

Have a good weekend.

The Global Alpha team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.