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QUARTERLY REVIEW – MARCH 2013

In early January when we last put pen to paper the ASX 200 stood at around 4,700, having just rallied over 8% in the preceding two months. We spoke optimistically about the potential to break through 5,000 points at some point during 2013 founded, in part, on our belief that lower interest rates would induce investors back into equity markets as they chased higher yields. To everyone's surprise, the Australian market pushed through 5,000 points in early February and it now appears that every man (and/or woman) and their dog is bullish the Australian share market.

The global economic position was summarised quite nicely by Glenn Stevens (Governor of the Reserve Bank) in his recent statement that accompanied the RBA's decision on interest rates, wherein he noted "Europe remains in recession, the United States is experiencing moderate expansion and growth in China has stabilised at a fairly robust pace". The important overlay, and the thing that is driving global equity markets higher, is accommodative (some might even argue lax) monetary policy – the markets are thriving on liquidity. The relative outperformance of the US equity market has had a lot to do with quantitative easing and we'll spend a little time this quarter looking at some of the differences between the Australian and US situations.

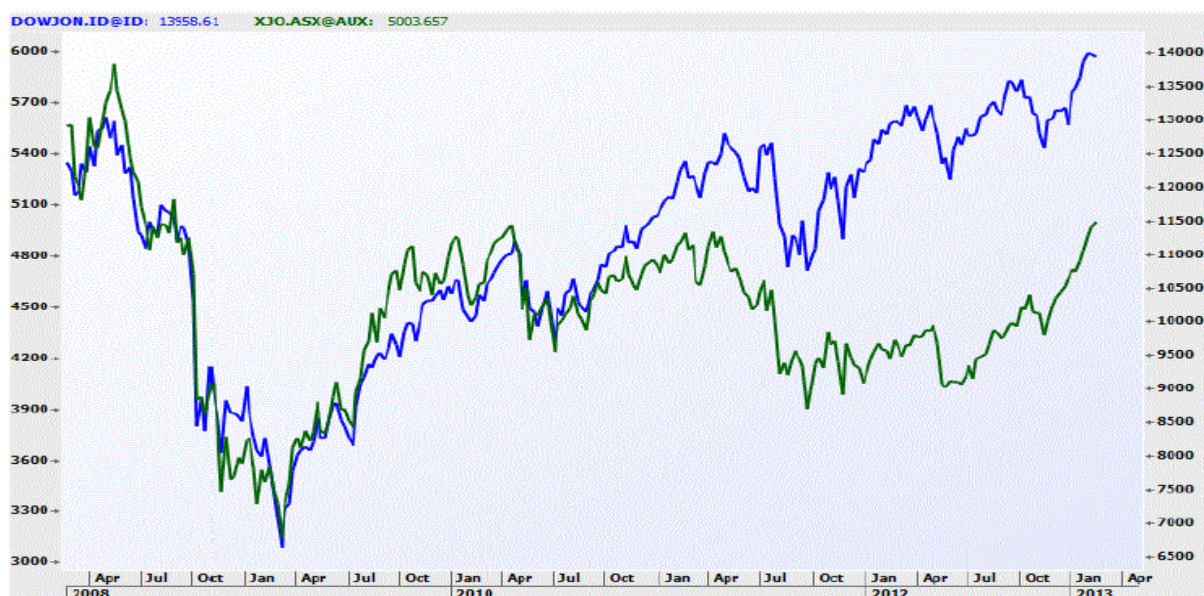
Is the ASX Dragging the Chain?

There has been a lot of talk over the last year or so about how the US equity market (Dow Jones/S&P 500) has outperformed the Australian equity market subsequent to the GFC. Some investors find it rather puzzling that if the Australian economy is in such a good place relative to the rest of the world, then how is it that our share market has conceivably under-performed the US?

The answer can be found in 3 simple factors:

- Monetary policy – Equity markets love liquidity and with interest rates sitting at next to zero in the United States and with huge quantitative easing programmes being implemented (QE1, QE2 & QE3), a lot of this cash has ended up in equities.
- Currency – The AUD has actually increased in value over recent years and is currently sitting at an all time high; whilst the USD on the other hand has fallen significantly in value over the same period. In USD terms, the US market has rallied over 120% from its GFC low – however, if converted into Australian dollars, its only up around 40%.

- Commodities – Depending on how you measure it, anything up to one third of our share market is represented by resources & energy stocks. Commodity prices have fallen materially over the last year or two, a fall that has been magnified in the share prices of our mining and energy stocks.



(Dow Jones (Blue) RHS. ASX 200 (Green) LHS)

The flip side of this situation of course is that if the RBA continues to lower interest rates, the currency (AUD) falls and resources continue to recover, there is potential for a significant outperformance of the Australian share market over coming years.

Europe – Why Cyprus is indeed a Special Case

Whilst the ECB has previously indicated that it will "do whatever it takes" to preserve the EU, the situation in Cyprus probably shows that in practice it will actually only do "**as much as it takes**" – not any more and not any less. We're clearly seeing that "what it takes" in the case of Cyprus is not as much as was deemed necessary for (say) Greece. This purely reflects the relative size of the respective nations within the EU and (importantly) the likely level of knock-on affects for the broader EU of any implemented solutions.

The revised bailout deal for Cyprus (which saw bank deposits less than 100,000 Euro guaranteed by the ECB) was a reasonable compromise given the circumstances. The primary economic activity in Cyprus was "banking" – its banking sector had swelled to eight times the size of its real economy courtesy of a flood of deposits from other parts of Europe, particularly from Russia. With the significant increase in the size of the liability side of their balance sheets, Cypriot banks had to go looking for assets into which they could invest and a lot of the funds subsequently found their way into (amongst other things) Greek businesses (in the form of loans) and Greek bonds. When the write-downs of Greek sovereign bonds was negotiated as part of the 2011 package of measures to save Greece, the writing was on the wall for the Cypriot banks.

Depositors with balances above 100,000 Euro (a great majority of whom are Russians) will probably lose around 30% to 40% of the value of their deposits. When banks go belly up, there are only usually a couple of options. Shareholders and debt holders usually get crunched pretty quickly. The question then remains how much pain does the depositor wear and how much does the Government attempt to inhale. In the case of the Cypriot banks, the government was in no position to take on the bad debts, so large depositors will bear the cost. In many other situations (for example in Ireland during the early stages of the GFC) the larger Irish banks were nationalised (ie the Government stepped up to the plate and put themselves further into debt).

To put some economic context around the size of Cyprus, its GDP represents just 0.2 of 1% of EU GDP – basically a rounding error in the bigger scheme of things. However, its all about contagion. How the EU/ECB deals with Cyprus sends a very strong message to the residents of other peripheral European nations. There were some concerns that the impact on larger deposits would cause a flight of deposits from (say) Spanish or Italian banks but, to date, this has not been the case and the message that "Cyprus is a special case" seems to be getting some traction within the EU.

Japan – Maybe this Time?

Historically, we haven't devoted too much column space to Japan – the economy has been suffering chronic deflation, it consumers aren't spending and its equity market has been drifting backwards since 1990. However, in the past quarter there have been some notable changes of personnel and a renewed commitment to monetary policy and reflation.

In December'12, Shinzo Abe was appointed the new Prime Minister of Japan and in March'13 Governor Kuroda took the helm at the Bank of Japan. The country has now adopted an inflation target of 2% - nothing special in that we hear you say, however, the previous target was only 1% and for some years now, Japan has suffered deflation.

The Japanese are effectively looking to launch their own version of quantitative easing (asset purchases) to double their money base over the next two years. Just to put some perspective around the size of the Japanese programme, when you rate the proposed increase in the monetary base as a percentage of GDP, the Japanese programme is over twice the size of the QE programmes implemented by the Federal Reserve in the US and just over three times the size of the programme implemented by the European Central Bank.

The share market has reacted positively to the change of leadership and the talk of reflation, with the Nikkei up almost 40% since December'12.

Australian Equity Market Performance

The Australian market has clearly benefited from lower interest rates over the last 6 months. If rates were to move lower (and we think they will) the ASX should push higher. Support for this thesis can be seen in the very recent performance of the Australia share market. With the release of better economic data, the prospect of further interest rates cuts subsides, the dollar moves higher and Australian shares are sold off. On days when economic data has been soft (eg business confidence) the market has moved higher as the chance of further rate cuts increases.

Whilst the Australian share market has (on average) moved higher, there have been two notable exceptions – resources (or materials) and small companies.

Over the 12 months to 31 March'13, the materials index (XMJ) had **fallen** by around 15%, whilst the ASX200 had **risen by around 15%.** Resources have been adversely affected by softening commodity prices (particularly iron ore) and concerns about the health of the Chinese economy (with inflation becoming a potential factor for authorities to deal with). Some brokers have plugged significantly lower commodity prices into their earnings models and (understandably) the resultant impact on the valuation of our resource and energy companies is not pretty. However, some of the commodity price numbers are "worst case" and we are some way above these levels at present. Secondly (and more importantly) many of Australia's largest mining companies have invested significantly over recent years in developing additional capacity which is due to come on line over the next year or two which, when combined with current cost cutting measures, will drive earnings higher. As we have stated previously, some of our quality mining companies have been oversold and as we move into a seasonally high period of Chinese demand for resources, we expect their shares to reclaim some lost ground.

The other sector that has been without much love to this point has been the small companies sector. The **small ordinaries index has fallen by over 10%** over the last year. This lack of growth in the smalls reflects (to a large extent) the focus that the market has had on yield to this point (small cap dividend yields are generally low). Usually when markets shift into "risk on" mode, small caps outperform large caps, however, we have not seen evidence of this trend to this point in the cycle. We think that as company earnings improve and interest rates are lowered further (which we think will be the case in the next few months), the gap between small and large caps will close.

On the subject of interest rates, many economists have now formed the view that we are at the bottom of the cycle. However, we think the RBA will still need to cut rates on at least one, possibly two occasions before the end of 2013. Unfortunately, the RBA does not appear inclined to be pre-emptive in its reading of economic weakness and it remains on the sidelines waiting for the impact of previous rate cuts to work their way through the economy. The reality is that the economy has now well and truly excreted the influence of prior rate cuts and most economic indicators are trending in the wrong direction. For the RBA, the key indicators now appear to be those around **business** investment (eg sentiment, manufacturing, business lending, hiring intentions, etc) not necessarily those relating to the consumer (eg spending, home lending, etc). The RBA is looking for signs that the non-mining sector is starting to pick up some of the slack that will be left by forecast reductions in investment by resource companies. However, business will need further interest rate cuts to encourage them to borrow and invest (which in turn should put downward pressure on the Aussie dollar).

Outlook – A Period of Consolidation is a Good Thing for all Concerned

In a fundamental sense, global economic data is certainly on the improve and whilst the issues surrounding peripheral European nations will continue to bubble up, the EU and ECB have clearly demonstrated their commitment to keeping the monetary union in tact and providing funding to struggling governments. Importantly, we are continuing to see liquidity being pumped into economies/markets by global authorities and this has been (and will continue to be) supportive of equities.

Over the past few weeks, the market (ASX200) has corrected – not sharply, but it has fallen back below 5,000 points. From a technical perspective, the thinking is that it may drift back towards 4,850 points, chew up a little more time, before moving back up towards 5,200 points in the next month or so. The guys reading the charts remain quite bullish, but again, they continue to spruik the well-worn adage to "sell and go away in May".

The US profit reporting season will shortly commence and earnings expectations aren't particularly high so if we get some half reasonable numbers from US companies, the risk is probably to the upside. Here in Australia, most brokers are now talking about Australian company earnings having bottomed so as we move further through the year, we should start to see earnings growth being factored into valuation models (at this point in time for the past few years, earnings forecasts have been negative).

If we get one or two further rate cuts out of the RBA in 2013, the Australian share market could move well above 5,500 points before the end of the year – a level that could be comfortably supported by a recovery in resource/material stock prices alone.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Overweight):** We are constructive on Australian stocks, particularly if the RBA delivers further rate cuts. Resource stocks and small caps have been oversold and represent good buying opportunities. We will continue to buy the dips.
- **Global Equities (Neutral):** The US market may soften in the next month or so, but increasing global liquidity levels will be supportive of equity markets over the medium term.

- **Property (Slightly Underweight):** Property has started to benefit from reduced vacancy rates (commercial), falling interest rates and steady payout ratios (yield).
- **Fixed Interest (Neutral):** Market rates have actually firmed a little in recent weeks in the belief that the RBA has completed its easing cycle. We expect at least one and probably two more rate cuts during 2013. Listed income securities continue to be an attractive investment, albeit their prices are firmer.
- **Cash (Slightly Underweight):** As a result of our positions in other asset classes, cash is moving toward a slightly underweight position.

STOP PRESS – Governments Proposed Superannuation Changes

The ALP Government has seen fit to, once more, fiddle with the superannuation system to help plug emerging holes in its fiscal position. Whether or not you agree with the proposed changes (discussed below) is largely immaterial. The thing that this Government **doesn't** seem to understand is that constant tinkering with the system (like they did last budget and now again this budget) creates **uncertainty** in the minds of superannuants and it **undermines people confidence** in the superannuation system. In repeated submissions to, and discussions with, Government over many years we have stressed first and foremost the need for stability in superannuation policy.

A series of superannuation changes were announced by the Treasurer on 5 April'13, key amongst these being:

- Capping tax-exempt earnings (at $100,000) on assets supporting pension income streams.
- Increases to the concessional contribution cap – from $25,000 to $35,000 (which is largely transitional in nature as the new cap is not indexed)

Its like a bad dose of "back to the future". Last budget this Government effectively re-introduced the superannuation surcharge (applying increased tax to the contributions of higher income earners) and this year we have effectively had RBLs (Reasonable Benefit Limits) foisted back on us. RBLs were an extremely complex system of calculations designed to limit peoples entitlement to concessionally taxed income in retirement. As part of the simpler superannuation reforms, implemented by the Howard/Costello Government in 2007, RBLs (amongst other things) were abolished and the whole system was made much simpler.

Wayne Swan has now announced that tax-exempt earnings on assets supporting pension incomes will be capped at $100,000 for an individual - thereafter, tax at 15% will be payable. The cap will be indexed, but in $10,000 increments, which means the figure won't be increased for around 4-5 years. (Note that withdrawals from super will still remain tax-free for those over 60 years). Despite what the Government may say, this policy **change is retrospective.** Last financial year if your pension account earned more than $100,000, the excess earning were tax-free. From 1 July 2014, the excess earnings will be taxed at 15%. There are a number of administrative issues that arise with this arrangement – dealing with multiple super accounts, pooled versus segregated assets in self managed super funds, treatment of capital gains, etc. In the case of capital gains (which form part of the assessable earnings of a super fund) the government is now proposing to establish three new classes of assets – those held prior to 5 April'13 (which will supposedly be free of CGT until July 2024), those purchased before 30 June 2014 and those purchased after 30 June 2014.

There are various contribution splitting, re-cycling and withdrawal strategies that could be employed to optimise a client's overall tax position under these policies, **however**, there needs to be a lot more detail provided about how the particular changes will be applied and, most importantly, these are **only proposals** and may not pass through the current parliament and may not be supported by an alternative coalition government after September'13.

The change to concessional contributions caps was the "sweetener" in the announcement, designed to cushion any negativity around the earnings tax. Whilst an increase in the cap

from $25,000 pa to $35,000 pa is, on the surface, an admirable concession, the sting in the tail is that this cap **will not be indexed** (unlike existing arrangements) which means that by 1 July 2018 we will be back to where we started from in terms of the nominal value of the cap.

Regards

Andrew & Stephen
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