QUARTERLY REVIEW – JUNE 2013

As global equity markets cruised towards the end of the financial year with significant wind in their sails, a nasty change (which took the form of concerns about tapering of QE in the US and questions over the robustness of China's banking system) sent investors heading for cover. In the space of around a month, the Australian share market lost over 8% of its value, finishing 30 June'13 at 4,802. Notwithstanding the last minute stumble, the Australian market (represented by the ASX 200) still managed to rise by just over 15% during 2012/13. Performance was again polarised with some health care stocks posting gains over 50%, whilst at the other end of the spectrum, the mining and resources sector struggled, with some mining stocks falling by over 50%.

Most markets, particularly the US, exhibited reduced volatility over the year to 30 June'13 – the only real exception being the Asian region, where markets such as Australian and especially China struggled to post gains in the second part of the year.

Equity markets have basically been "hostage" to liquidity over recent times – historically low interest rates and money printing (and/or Quantitative Easing – QE) has provided plenty of support for equities. Relative currency levels are also playing an important role in influencing global liquidity flows. Over the second part of the financial year we have witnessed an appreciation of the USD, which when combined with anemic bond rates has seen:

- A continued switching of funds out of bonds and into equities in the US
- A repatriation (ie outflow) of funds from the Australian share market back into US cash/ US equities

In the US, there is clearly a surplus of liquidity and the question on everyone's lips is when will the Federal Reserve start its tapering of QE - or to use the oft quoted analogy "when will they remove the punch from the party". On the other side of the globe, however, the Chinese authorities are trying to further restrict liquidity in their economy to cool a potentially over-heated investment property market.

To Tapper or not to Tapper – that is the Question

Markets have been underwritten by the liquidity that QE has provided in the US. Hence, when talk of tapering QE arises, equity markets get rather nervous, albeit largely unfounded on what we know to date. The simple fact is that the party can't go on forever and Ben Bernanke (Chairman of the Federal Reserve) rightfully started the conversation about gradually removing stimulus (or to use his analogy "taking the foot off the accelerator").

But the market, in typical fashion, has over-reacted to this inevitable prospect. Nothing has been done yet and it is probable that nothing will be done in the immediate short term – the quantum and timing of any tapering is yet to be nailed down. However, that didn't stop the S&P 500 shedding 5% in quick time following Bernanke's initial statements.

The US market became a little volatile as it attempted to anticipate the timing and magnitude of tapering. However, Bernanke has always been very clear that QE was a transitional policy and, most importantly, that tapering of same will be **data dependent**. If the economy continues to grow and (most importantly) unemployment continues to fall, QE will be progressively wound back (as it should be). In other words, when the economy is robust enough to stand on its own two feet, QE will be gradually phased-out – no ones talking about stopping it al la cold turkey.

Bernanke has noted that **unemployment is still well above the Fed's target** and he has flagged the participation rate and under-employment rate (ie, people who currently have part-time work but are actually after full time work) as factors that are likely to contribute to a slowly recovering employment market. The other thing that Bernanke is only too well aware of (and something that seems to have fallen off everybody else's radar screen) is that monetary policy will have to continue to do some heavy lifting to counter-act the recent changes to fiscal policy. The sequestration imposed budget cuts (ie automatic reductions in government spending and higher income taxes), triggered to avoid the fiscal cliff in the US, are **taking an estimated 1.5%pa off US GDP**. When you take this impact into consideration, you begin to realise how much underlying strength there actually is in the US economy.

The health of the US economy was nicely summed up by Dion Hershan of Goldman Sachs wherein he commented recently that "the sheer flexibility of the US economy is striking. It has adjusted to a more difficult environment by having very low interest rates, a weakening currency, cheap & abundant labour and infinite amounts of energy; all of these points put together have really set the foundations for an improved outlook."

In terms of the timing of any actual tapering of QE, a recent Equities Research Review from Macquarie Bank opined that the current consensus view on the timetable for tapering is overly optimistic. They noted that "we anticipate QE3 will end in the first quarter of 2015 and we continue to believe that rate hikes won't occur before fourth quarter 2016."

China's Credit Squeeze

Whilst in the US credit is being given away at historically low prices (ie interest rates), the Chinese authorities, concerned about potential asset price bubbles (particularly in housing) have allowed short term interest rates to rise quite significantly over recent months – the one day interbank re-purchase rate touched 12.85% in mid-June.

Authorities in China have been concerned about the surge in credit growth that has been building since the beginning of the year – this at a time when the Chinese economy has been slowing down. This situation has not been helped by the emergence of the so-called shadow banking system, that involves a web of private and corporate investors, pooling funds in "wealth management products" (that are sponsored by banks and local finance arms – that carry implicit national government guarantees). In order to encourage banks themselves to be more prudent with their risk control and liquidity management, the Authorities are happy to see a rise in short term interest rates. This will also serve to curtail the operations of the shadow banking system and take pressure off potentially inflated property prices.

Again, this spike in short term interest rates spooked equity markets, with the Shanghai index falling around 15% in mid-June – a fall that had repercussions for both the Australian & US markets which fell by around 5% at this same time (with a lot of this pain reflected in the share prices of China facing businesses, such as resource stocks).

The positive out of this is that the Chinese Authorities are clearly targeting **sustainable** growth, keen to avoid price bubbles and reducing corruption along the way.

Are we there yet ………. How low might the AUD go?

Its been a long held view that the Australian dollar has become "over-valued" pushed upward by commodity prices and higher domestic interest rates (particularly when compared to global interest rates running at or close to zero). No one however, knew exactly when and by how much the dollar would eventually retreat.

The rot probably started when George Soros and Stanley Druckenmiller (renowned hedge fund manager) purportedly made comments in early May'13 that the AUD was one of the most over valued currencies around the globe. A campaign of shorting the AUD quickly ramped up and in the space of just over a month the currency lost over 12% of its value – falling from around $1.03 to just under $0.91.

The immediate affect of this drop in the currency was that the ASX 200 also fell sharply. This was a simple function of liquidity – initial falls in the AUD drove foreign investors (particularly US investors) to sell Australian shares and repatriate cash. They had done very well out of holding our yield stocks (such as the banks) and it was timely to take some profits. Its important to realise that **around 45% of the value of the ASX 200 is held by foreign investors** – so when they do decide to sell, they inevitably move the market down. Not only were they selling their existing shares, but they were not prepared to provide fresh liquidity to the market (ie buy new shares) until the dollar reached some type of floor.

The AUD currently sits at just over 90 cents and its probably reasonable to conclude that its over-shot to the downside in the short term. However, the expectation is that **it will move lower over time**. Even the Reserve Bank sits in this camp, with Glen Stevens noting in his July'13 statement on monetary policy that "the Australian dollar has depreciated by around 10 per cent since early April, although it remains at a high level. It is possible that the exchange rate will depreciate further over time." The reality is that the reserve bank would prefer to see an exchange rate that starts with an "8" rather than a "9".

Whilst in the short term, the currency has created a bit of headwind for the equity market, over the medium term, a **lower AUD is unquestionably a good thing** for the Australian economy and, in turn, the equity market. Goldman Sachs Research indicates that every 4% decline in the value of the AUD is equivalent (in GDP uplift terms) to a 0.25% reduction in cash rates. So far as the Australian equity market is concerned, analysis recently conducted by Ausbil Dexia suggests that for the 2014 financial year, Australian listed company earnings will increase by 5% to 9% for an AUD/USD exchange rate of $0.95 and $0.90 respectively.

Australian Equity Market Performance

The defensive and yield plays that have dominated our market over the past year or more are looking a little long in the tooth. Whilst you don't want to be pushing too hard against the tide, the one thing that has always bemused us somewhat with the yield trade is that investors are actually paying a premium for something that they already own – dividends are simply payments to shareholders of the cash/profits previously generated by a company. A number of brokers have moved to adopt "hold" or even "reduce" recommendations on some popular names (eg Telstra) so, depending on ones risk profile, it may potentially be timely to look at trimming up some holdings. However, the reality is that these companies will continue to be supported by retail investors, particularly as interest rates fall.

On the flip side of the coin, we have recently seen a number of articles suggesting that with prudent capital management (basically putting less free-cashflow into the ground and more into shareholder pockets) resource and energy companies could well become the "new defensives" inside the next 2-3 years. With its recent project deferrals and increased dividend payout ratio, Woodside Petroleum (WPL) now has a dividend yield of almost 5% and as companies such as

RIO and BHP wind-down capital expenditure (which will increase free-cashflow) there are prospects that their yields will move significantly above their circa 3% current levels.

By historical standards, the current PE (price to earnings ratio) for the ASX 200 is around long term average levels (ie fair value), however, the alternative to equities (namely bonds and fixed interest) are yielding reducing rates of return and there is the prospect for EPS upgrades as we move into upcoming reporting seasons.

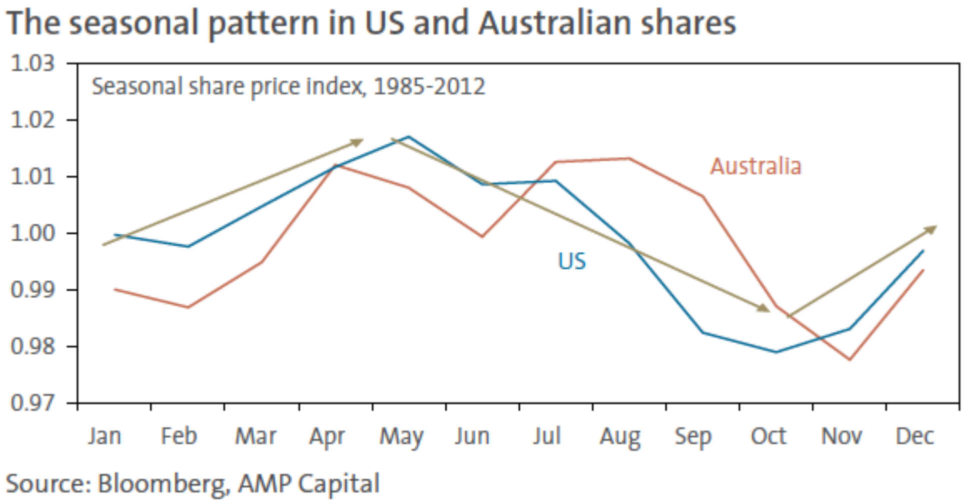
Outlook

The S&P 500 has recently posted another all time high and US equities appear primed for a correction of up to 10%. From a technical perspective, the US market is currently in an "over-balanced" pattern. You will see from the graph below that on the three previous occasions where the price action has fallen below the (red) trend line, that we have seen pull-backs of between 10% and 15%. The momentum indicators (eg relative strength indicator) are also in over-bought territory.

US Share Market – S&P 500

The Australian market will probably also pull-back but we don't expect to the same extent. We have not run up as high and have been subject to additional "Chinese" shocks (which have dampened our market) over the last 6 months. Technically, the ASX 200 appears to be in the midst of a 3-wave pull-back. We have had an A-leg down that started in late May and currently the market is grinding higher in a B-leg up, which may last another few weeks, before an anticipated C-Leg down. Any correction should not be too savage, potentially seeing the ASX 200 fall to around 4,750.

Seasonally, we are moving into a period that is not a particularly strong time for equities (see graph below) and markets may remain choppy through until October.



We anticipate that whilst the currency may consolidate at current levels for a period, that it will fall further in the ensuing twelve months. With the recovery in the non-mining sector continuing to be patchy (and with inflation under control), we expect the Reserve Bank to lower interest rates by at least a further 0.25%, potentially 0.50% by the end of the 2013 calendar year. Combined with improving economic fortunes in the US and Chinese growth under-written at a minimum of 7.5% p.a, we believe company earnings growth will provide the catalyst for sustained equity market gains as we move into 2014.

Asset Allocations

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** We remain cautiously constructive on Australian stocks, particularly as we move into the latter part of 2013. If the currency remains at or below current levels and the RBA delivers further rate cuts, the next 9-12 months could be very profitable for Australian equities. Resource stocks and small caps have been oversold and represent a longer-term buying opportunity.
- **Global Equities (Neutral):** The US market is expected to pull back over the next couple of months, but global liquidity and improving economic data should support company earnings and in turn, equity prices over the medium term.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield, but now appears to be in a correction phase. In due course, falling interest rates should flow through into firmer prices.
- **Fixed Interest (Slightly Overweight):** We expect at least one and potentially two more rate cuts during 2013. Listed income securities continue to be an attractive fixed interest investment.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes, cash is moving toward a slightly overweight position in the short term.

Regards

Andrew & Stephen
19 July 2013