QUARTERLY REVIEW – SEPTEMBER 2014

The ASX 200 rose by around 14.5% over the 2013/14 financial year to close at 5,395. Once again, the move up was punctuated by concerns about the softening Chinese economy (November'13) and speculation about the impact that US tapering would have on investment flows, particularly in developing markets (January'14).

In more recent times, the index pushed to a post-GFC high of 5,679 on 3 September, before succumbing to a currency-lead repatriation of funds by US investors. This pullback of over 7% has potentially been overdone and whilst the Australian market may have a little further to fall, we see this as an opportunity to top-up positions ahead of a bullish run into Christmas.

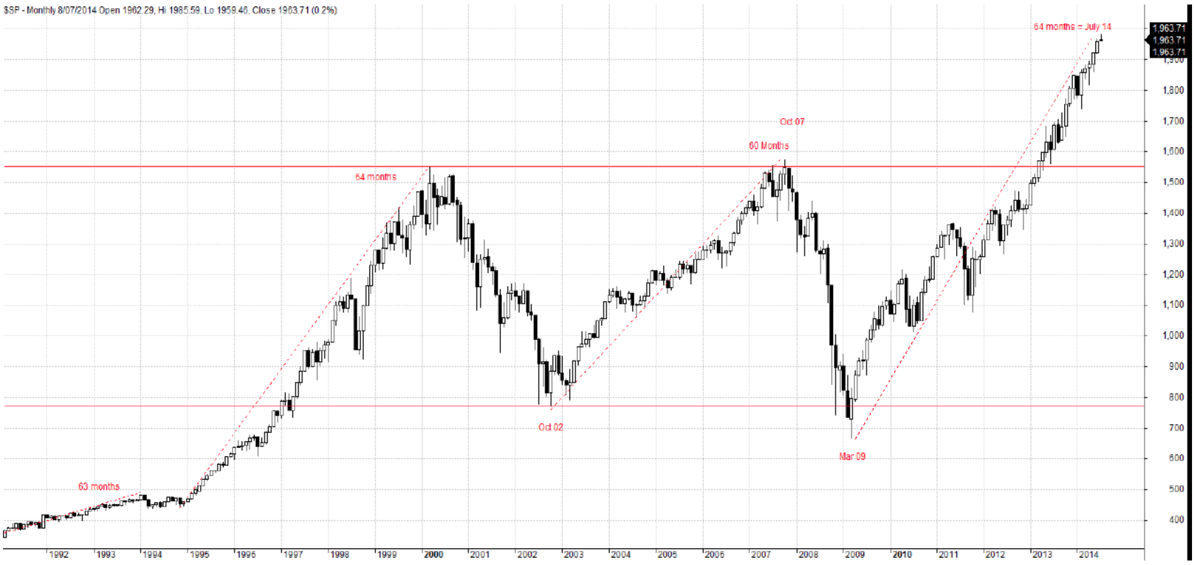
The US market has continued to defy gravity, supported by better than expected economic data, record low interest rates and liquidity. Whilst some are now concerned about the prospect of rising US interest rates, history has shown that it may be some time before rates adversely effect equity market returns.

US Equity Market

The US equity market (S&P 500) now sits around 20% **above** its pre-GFC highs. However, we don't see this as being representing a "bubble", as the move up has largely been supported by a rise in underlying company earnings. Aside from fundamentals, the other factor that determines whether or not US equities are an attractive investment is the alternative rate of return offered by "bonds" (treasuries or fixed interest) and, as we are all well aware, US interest rates currently provide very little incentive for investment in bonds.

In the absence of financially plausible alternatives, the US equity market has moved upward over the past 6-9 months without the type of volatility that has historically characterised its trading movements.

The chart over the page examples the significant recovery in the US equity market. The other point it seeks to make is to document the average length of US bull market runs – traditionally around 60 months.



Technically, we would expect to see some type of pull-back from these levels. Given underlying economic and business strength, however, this will likely not be a significant retracement, but rather a consolidation (both in terms of price and time) that should underpin further moves up in US equities.

Inflation – The Canary in the Coal Mine

The key for the US market (and indeed many equity markets around the globe) is when and by how much **interest rates will start to rise**. There has been much speculation about when rate rises in the US will commence, but the consensus seems to be next year (ie 2015) at the earliest. We feel that the Federal Reserve will want to be very sure about the health of the US economy before moving on rates and one of the key metrics (both in the US and globally), will be inflation.

If the genie stays in the bottle, then we expect that many central banks will be happy to maintain lower interest rates for longer. If inflationary expectations start to rise, and this will likely be lead by demands for **increased wages**; bond yields will move up and central banks will be forced into action. US bond yields, as a proxy for inflation, will be the canary in the coal mine.

However, speculation alone about interest rate rises (or any other aspect of macro-economic policy) does not of itself have any lasting effect on markets. Sure, it will create short term volatility and we saw this most recently with talk about QE tapering. When there was speculation back in November'13 about the Federal Reserve starting to tapper its QE programme, equity markets fell into retreat. Again, lead by a repatriation of funds by US investors, the AUD dropped around 8% and the ASX 200 fell by over 7%.

The reality was that the Federal Reserve began tapering in Jan'14 and has been steadily winding back the monthly allocation to the point where the QE programme will officially end in October'14. Over this period the US market has risen 12%.

We are now seeing an almost identical set of circumstances playing out again, this time with speculation about interest rate increases (rather than QE tapering). Our market has fallen back with the combined impact of US investor selling (particularly of yield stocks and bank income securities) and a falling AUD. We expect to see a bottom in markets early to mid October and again, the ASX 200 is likely to fall further than the Dow Jones during this current pullback.

It Will Take a Few Rate Hikes Before Equity Markets Flinch

Even when rates start to rise it will **not** spell immediate doom and gloom for equities. In this regard, Macquarie Research produced a report last month that examined the 18 Federal Reserve easing and tightening cycles since 1954. The results confirmed that equity returns are usually strong in the lead-up to the first rate increase (assumedly some time next calendar year). But, even when the first rate rise has been announced, the US market still returned an average of around 14% in the following twelve months.

Shares typically remain attractive until **at least after the 3rd or 4th rate hike** and, even then, there is not an absolute fall in returns, merely that a lower rate of return is likely relative to bonds.

Here in Australia the key for our equity prosperity over the coming twelve to eighteen months will be company earnings growth. From a Price Earnings (PE) perspective, our market is around fair value so the only meaningful way it can rise is through improved company profits.

In this regard, we have argued for some time that the RBA has been tardy, in the face of a softening domestic economy and a stubborn Australian dollar, to lower interest rates further. The RBA should bite the bullet now and implement some type of macro prudential controls to restrain investment housing growth (eg require higher levels of capital support for new investment mortgages, thereby pushing up investment home loan rates) and at the same time, move to further lower the general cash rate. This approach is probably not favoured by the majority (including the RBA themselves), but we feel that the Australian economy would benefit from some type of additional stimulus and concerns about a potentially over-heated housing sector should not preclude such action. At the very least we should not see our interest rates moving up until 2016 (unless inflationary pressures forced the RBA's hand).

Currency – the Vicious Cycle

As indicated, the other factor impacting the Australian share market presently is the **value of the AUD**, which has been falling against the USD on the back of talk of higher US interest rates. The immediate effect of this is for US investors to sell Australian assets (shares and securities) and repatriate funds to the US. This selling pushes our share market lower and forces the AUD lower – it operates as a vicious cycle in the short term forcing both the Australian share market and AUD into oversold territory. In the medium to longer term, however, a lower AUD is beneficial for Australian companies and the economy more generally.

Financial Systems Inquiry (FSI) & Parliamentary Review

During the past quarter, David Murray released the interim report of the FSI. There has been much speculation about what has been proposed, but the truth is that David Murray has done nothing more at this point in time than lay out the potential "book ends" around key issues (including proposals to maintain the status quo).

Murray and his panel have advocated a principles-based approach to nine priority issues. Key amongst these from our perspective are the issues of superannuation efficiency, retirement incomes and regulatory architecture. There will be further rounds of hearings and submissions with the final set of recommendations due some time in November'14. For those finding it a little difficult to sleep at night, we have included a link on our Axiom Wealth website to the FSI Executive Summary.

Earlier this month we also made a submission to the Parliamentary Joint Committee on Financial services. We took the opportunity to call for a more measured approach to adviser qualifications, continuing education and professional standards. With recent scandals involving some large planning businesses (eg CBA & Macquarie Wealth), there has been a lot of knee jerk reactions on both sides of the fence which will do very little to improve the quality of financial advice provided to Australians. We have also included a link to a copy of our submission on the Axiom Wealth website.

OUTLOOK

Our view about equity markets has remained relatively consistent over the past twelve months – we remain constructive on the medium term outlook for Australian and International equities, albeit with the likelihood of some type of short term retracement, which now appears to be underway. Continued volatility in the AUD is likely to exacerbate the extent and duration of any pullback here in Australia.

The Australian market currently sits around "fair value" (as measured by the PE ratio) and the same can be said about the US market. With the prospect of lower interest rates into 2015 and improved company earnings, we believe the current pullback is one to be bought with the prospect of a further rally into, and beyond, Christmas.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Overweight):** We remain constructive on Australian stocks, particularly as we move into the latter part of 2014. If the currency remains at or below current levels and the RBA delivers a further rate cut, the next 12-18 months could be very profitable for Australian equities.
- **Global Equities (Neutral):** The US market has had a very strong recovery over the last 5 years, aided by low rates and liquidity. The US economy is further along the business cycle and may be subject to less relative growth over the medium term. Asian equity markets (particularly China) are looking quite bullish.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield, but now appears to be in a correction phase. Higher relative gearing levels together with the prospect of rising longer term rates necessitates some caution in this market.
- **Fixed Interest (Overweight):** Listed income securities continue to be an attractive fixed interest investment, particularly when compared to term deposits. Given the level of interest rates, it is preferable to hold a little less cash and a little more in income securities as part of any defensive allocation in portfolios.
- **Cash (Neutral):** As a result of our positions in other asset classes, cash is presently around a neutral level.

Regards

Andrew & Stephen
30 September 2014