QUARTERLY REVIEW – October 2015

Australian equity markets took another leg down at the start of this quarter, pushed lower by the banking sector (with concerns around capital adequacy and interest margin pressures) and resources (where already low iron ore prices drifted lower still with smouldering concerns around the Chinese economy). Given the dominance of resource and banking stocks within our bourse, it was hardly surprising then to see our market breach the 5,000 point level briefly at the end of September; before bouncing back in October aided by unilateral action by the banks to raise mortgage interest rates. The ASX 200 closed at the end of October at 5,239.

The US market struggled early in the quarter, held back by continued uncertainty around when exactly the Fed will raise rates, before responding more positively to the continuing stream of good economic data that saw very positive unemployment and housing start numbers. It now appears inevitable that the Fed will raise cash rates by 0.25% in the US at its meeting on 16 December. As we've indicated previously, it will be the timing and magnitude of future rate increases that will dictate the shape of equity markets; however, Janet Yellen has gone out of her way to signal to markets that rates will remain lower for longer (thinking that is broadly factored into US futures).

This quarter we reflect on the changing mood in the investment community around dividends, we look at where we might currently be in the broader equity cycle and examine some of the potential superannuation changes that the new Government might contemplate.

Reporting Season – Dividend versus Capital Reinvestment

Our reporting season, which wound-up in September, was again highlighted by negligible earnings growth. Many large-cap companies continue to leverage cost-out strategies as a means of delivering on profit expectations. Whilst actual results were generally in line or a little better than expected, outlook commentary and guidance were soft. In today's continuous disclosure environment, it is quite rare for a company to report profits that are materially at variance with expectations – this is what confession season is all about (ie the period immediately preceding the reporting season). So if the hard numbers are already baked in to analyst's models, the only "surprise" will come from guidance that is either better or worse than expected.

The other continuing theme was an almost dogmatic support for the maintenance of dividends. In keeping with the "dividend is sacrosanct" theme of recent years, many companies have continued to reiterate payout ratios or DPS levels at the potential expense of longer term growth.

Company CEOs and Boards now have their eye's fixed firmly in the rear vision mirror – they saw how investors historically "rewarded" yield stocks and now seem hell bent on maintaining unrealistically high dividends. As Macquarie Research note (Equity Strategy Face Off – 31 August 2015) cash payouts are now growing faster than earnings, whilst at the same time, long term earnings growth expectations are falling. Something has to give!

The reality however, is that defensive yield plays have moved out of favour and investors are increasingly placing a premium on growth. There is now an increasing expectation that companies should retain a reasonable level of earnings to re-invest in the existing business (organic growth) or to assist with acquisitions. Returning capital to investors over an extended period of time ignores the business maxim that "you can't shrink your way to greatness".

In a period where earnings growth is hard to come by and with investors now rewarding companies who have a credible growth story (not to mention regulator and rating agency expectations around capital management), there are a number of large-caps who will need to take a long hard look at their current dividend policies.

Overly Pessimistic Views about China already Baked In

It's hard to let a quarter go by without observing something about China. Our thesis about the Chinese economy hasn't changed (ie it will continue to be a global growth powerhouse) despite what some of the doomsday sayers have been writing in recent times.

More recently, there have been some concerns about the general slide in the Chinese PMI (Purchasing Managers Index). The measure, however, is survey based (which means it is subject to sentiment vagaries and the like) and it has a manufacturing focus. However, as the authorities have been telling us for some time, the Chinese economy is transitioning towards "domestic consumption" - consumerism is the new mantra. Hence, whilst the headline PMI has contracted further this quarter, measures of domestic consumption have been quite robust - petrol consumption grew by 13%, domestic travel was up 46%, movie receipts increased 48%, etc (Macquarie Research, China Macro September'15). In fact the services sector is now larger than the manufacturing sector in China and its still expanding at around 8% pa.

More recently (in late October), the Chinese authorities moved to provide further monetary stimulus by:

- Reducing the 1 year lending rate by 25 bps
- Dropping the deposit rate by 25 bps (to 1.5%, the lowest ever recorded)
- Completely removing the ceiling on all bank deposit rates (this type of de-regulation is a pre-requisite to trade and currency liberalisation contemplated by the IMF and others).
- Relaxing the reserve requirement ratio by 50 bps for large banks and a further 50 bps for second tier banks that support agriculture and small business.

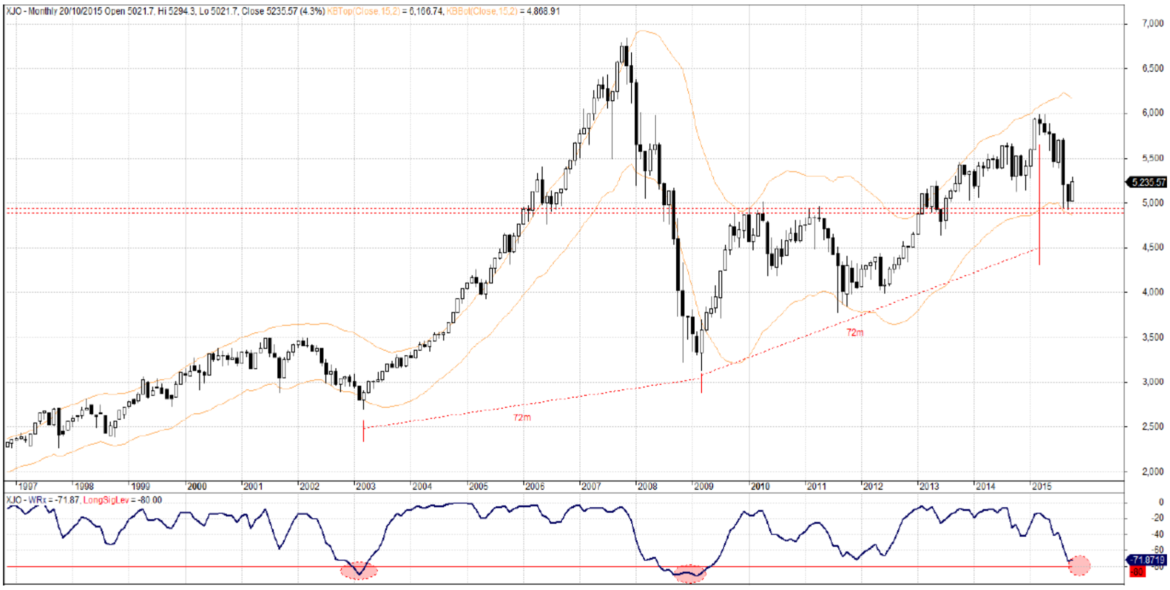
On the fiscal front, policy makers have provided tax cuts for SMEs and have accelerated spending – general budget expenditure growth (which includes infrastructure spending and social welfare) picked up 25% year on year in the September quarter (Morgan Stanley, China Economics October 2015).

In some respects, the Chinese economy is facing a similar challenge to the Australian economy – both are moving away from an investment led to a consumption led growth bias. As Nikko Asset Management point out ("China's March towards Global Acceptance" November 2015), China's current reforms echo the same efforts made by the Japanese, Korean and Taiwanese regimes in the late 20th century as they opened up their economies and markets.

Bull or Bear

One question that investors often ask themselves when markets are volatile and trending lower is – "is this just a correction or are we entering a bear market?" There is specific contextual data that we can observe that (in the current circumstances) indicates that we are merely experiencing a "healthy" correction in a bull market.

- Oil price – GaveKal Global Research have pointed to the predictive significance of oil, concluding from historic analysis that falling oil prices have **never** preceded a global recession. On all occasions in the last fifty years when oil prices have halved, faster global growth followed.
- Bull Markets Pop – From a technical perspective, bull markets don't just fizzle out, they go "pop". Mature bull markets rise exponentially before they peak (usually in 3 distinct waves) and they accelerate into a top before exhausting.
- Morgan Stanley "Full House" - Morgan Stanley has issued a "Full House Buy" following the recent pull-back in equity markets. Most international research houses use a combination of metrics and timing signals to determine whether they should be buying, selling or holding equities. Morgan Stanley focus on 5 such measures and for the first time in 6 years, all have confirmed a "buy" signal on global equities. Early 2009 was the last time such a call was made by Morgan Stanley. The only other time the measures have coincided was when Morgan Stanley called a "Full House Sell" in July 2007
- Fundamentals – The Price Earnings (PE) for the ASX is currently around historical averages, dividend yields are high, corporate balance sheets are (by and large) very healthy and the equity premium (the incremental benefit received for holding equities rather than bonds) is very high.
- Technical Analysis – The market found good price support at the 5,000 point level (see graph below). This has been a significant level over many years, providing resistance in the aftermath of the GFC and then as a support level from late 2012. (In terms of bull markets "popping", note the accelerating 3 thrust high in the lead up to the GFC.)



Dr Robert Gay from Fenwick Advisers penned an article recently for the Portfolio Construction Forum ("What do 1987, 1998, 2005 and 2015 have in Common", October'15) in which he compared historically similar periods of time based on positioning in economic and equity cycles.

In each of the nominated years:

- The US economy was close to full employment
- Inflation was benign
- Commodity prices were very low
- Emerging markets were under financial strain
- Volatility was a feature of financial markets
- The USD was strong
- US monetary policy was excessively generous

The following year (ie 1988, 1999 & 2006) proved to be the strongest year for global growth during the respective expansions and over the next two years, equity markets rose to cyclical highs. So in 2016, Gay sees economic growth increasing, credit expanding rapidly off the back of low rates, the Fed procrastinating on interest rates (in light of low inflation) and emerging market currencies recovering. This will be a positive time for equities, before a cycle high some time during 2017.

Citigroup equity strategist Robert Buckland also suggests that equities have a while to run yet. He concludes that global equity markets have now moved into "Phase 3" of a bull market, when equities continue to perform despite rising credit spreads. This period is characterised by increased volatility and lasts for up to 3 years. His message at an investment bank conference in Sydney when asked about the recent market stresses was quite blunt – "Don't hang around in our asset class if you can't handle losing money. Corrections happen; get over it. This is a dip that should be bought, it's not the beginning of the next bear market".

OUTLOOK

We are now entering a seasonally strong period for equities – both Australian and US shares usually exhibit strong growth from thanksgiving (late November) through to the new year. Having put in place a low during September, we are expecting the market to move back to 5,450 before years end. This will be aided by the anticipated "Santa Clause" rally and will represent a 50% retracement of the 5,996 March'15 high.

This move up is likely to be lead by the banks with investor concerns around interest margins and bad debts now largely placated. Resource companies are likely to continue to struggle in the short term with residual uncertainty over Chinese growth and consequential implications for commodity prices. That said, we note with some interest that just about every broking house/investment bank now has BHP on a buy with a target price ranging from $25 to $31 (analysts forecast a 12 month target for stock prices).

Our thinking is that as we move into the new year, the ASX is likely to consolidate around the 5,500 mark, whilst the Dow Jones may suffer a slightly larger "C leg down" (as part of a typical 3-wave or ABC pull back). Again, we don't see this as being anything other than a "healthy" correction.

We note that Citigroup came out recently and claimed that they expect the ASX to rise to 6,200 during 2016 (or close to 20% above its current levels). Maybe this is something we can all wish for if we find ourselves on Santa's lap at some point during the festive season.

Financial System Inquiry (FSI) - Superannuation

During the past quarter the new Turnbull government has moved quickly to accept most of the recommendations from the Murray FSI. One of the key areas where policy development is still on-going is in relation to retirement incomes & superannuation – this is being progressed with the broader work on tax reform.

Some critics have recently been bandying around statistics that supposedly highlight the cost of superannuation to the federal budget and they have been using them as a justification for making significant change to superannuation laws (ie impose significant tax imposts). Key amongst these is the $32 billion cost quoted in the Federal budget papers. However, this is acknowledged by Treasury, the Government, accounting groups and industry bodies as being a gross overstatement as it only considers the short term costs. When you overlay the savings the Government makes on paying out less in the way of age pensions (as a result of people having their own super) and the certain impact that would arise with people changing their behaviour (ie shifting from one tax effective vehicle to another – eg moving into negative gearing, income streaming via trusts, etc) the estimated cost more than halves.

Critics also point to the fact that superannuation benefits accrue predominantly to the wealthy. However, according to a recent Association of Superannuation Funds of Australia (ASFA) report, about 75% of the tax concessions applied to contributions are actually enjoyed by middle income earners (those paying marginal tax rates between 30% and 38%). Allied to this, over 85% of salary-sacrificed contributions are made by middle income earners.

The reality is that Australians receive financial support for their retirement from the government through either the age pension, tax concessions on their superannuation or some combination of the two. When both forms of assistance are added up across a lifetime, the average taxpayer benefit is around $300,000 across all tax brackets as a contribution by the Government.

The moral here is never let the facts get in the way of a good story!

The other important point is that over the past decade there has already been a significant winding back in the ability of individuals to make concessional superannuation contributions. Contribution thresholds, which previously were un-capped, have been progressively wound back to $100,000, to $50,000 and now to $25,000 per annum. It is no longer possible for individuals to tax effectively dump large sums of money into super – those often quoted individuals who have in excess of $10m in super achieved these balances prior to the introduction of the current contribution caps. To the extent that this is seen as a problem, then it should be recognised as an historical anomaly and not one that can be repeated under current laws.

Having now vented our spleens about ill-informed calls for superannuation reforms, we do acknowledge that there is probably room for some sensible change:

- To placate the concern that superannuation should not be an inheritence planning tool, there is scope to consider some form of **lifetime cap** on super contributions.
- The review of the superannuation system must be **de-coupled from the budget process and contemplated (say) only once each parliamentary term**. Typically Governments have announced changes to superannuation as part of bi-annual fiscal reviews (ie the budget and MYEFO). In order to maintain investor confidence, superannuation reform needs to be seen as considered and measured, not some short term cash grab to alleviate an emerging budget deficit.
- Application of a **"tax rebate" to concessional contributions**, rather than a flat tax rate. For example, a concessional contribution might attract a 20% tax rebate, rather than a flat 15% rate of tax. This means that someone on a marginal tax rate of 47% would pay contributions tax of 27%, rather than the current 15%.

Thankfully, the noises coming out of Canberra (at least on the Government side) are quite positive. The Treasurer (Scott Morrison) has made it clear that any changes to superannuation cannot be **retrospective** and hence will likely focus on the accumulation phase (including contributions) rather than on retirement or pension phase (and the tax rates applied thereto).

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 the year. We still believe the RBA will deliver at least one more rate cut in this cycle which, combined with lower oil prices and a softer currency, could see an extended period of outperformance by Australian equities.
- **Global Equities (Neutral):** Whilst the US market has pulled back this quarter (and subsequently clawed back some of the losses) it is potentially still over-priced and in the new year we would not be surprised to see a "C-leg" down. We continue to see good value in Asian equities.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and more recent reductions to interest rates). In the very short term the sector is likely to be buoyed by further M&A activity, but this will then likely signal a period of under-performance.
- **Fixed Interest (Slightly Overweight):** Given the level of interest rates, it is preferable to hold a little less in cash and a little more in fixed interest instruments (such as income securities).
- **Cash (Slightly Underweight):** As a result of our positions in other asset classes, together with historically low interest rates, cash is presently a little underweight.

Regards

Andrew & Stephen
23 November 2015