QUARTERLY REVIEW – SEPTEMBER 2013

We finished the June quarter on a down leg in the Australian equity market – the talk was about the imminent introduction of QE tapering in the US, the Chinese banking system was in trouble and the Australian dollar was falling like a stone. Since the end of July, however, the ASX200 has risen around 10%, finishing on 5,307 as at 30 September'13. Over this same period, the performance of the US share market has actually under-performed the ASX and, over more recent times, as markets softened with concerns over the US budget and debt ceiling, the US has pulled-back in excess of 6% whilst in Australia we only lost around 2.8%, with the pull back in equity prices being met by eager buyers.

As we suspected, tapering has been put on hold in the US and we are unlikely to see any action in this regard until 2014. Bernanke will be aware that the recent Government shutdown will have an impact on GDP and he will also be reluctant to act until there is a longer term resolution to the debt ceiling issue. On the other side of the globe, Europe now has an economic pulse (lead by encouraging data out of Germany, France and Italy) and China's growth is continuing at a handsome clip.

Markets themselves, however, are now once more gripped with "fear" – not the fear and loathing kind of fear that saw equity markets plummet to historic lows during the GFC; but the "fear of missing out" (FOMO) kind of fear. As noted on many occasions previously, there is a significant volume of cash sitting on the sidelines both here in Australia (largely in term deposits) and in the US (largely in bonds & treasuries). The movement of liquidity out of equities during 2007 and 2008 that saw markets move heavily into over-sold territory, now looks poised to flood back into markets potentially pushing them into over-bought territory.

The Mad Hatter's Tea Party – US Politics at its Worst

We often lament the parlous state of Australian politics and indeed the recent election has thrown up a new band of misfits (including Clive Palmer) who will hold the balance of power in the Senate. However, the US political system, combined with that nations more right-leaning conservative views, seems to breed a more subtly belligerent (and by all accounts) more dangerous form of politician.

Would it surprise you to learn that the US government hasn't passed a budget since April 2009? Clearly the government (or president) of the day can avail themselves of various stop-gap measures but there is a broader theme at play in the US that warrants some examination. People quite rightfully ask how can a parliament not pass a budget or agree to raise a debt ceiling? How can they be so fiscally irresponsible? The answer, quite simply, is that because there is presently "no cost" to their fiscal mismanagement. US government debt has blown out significantly since the GFC – it was this explosion of debt that pushed the US towards the current debt ceiling in the first place. In any other circumstance (eg Europe, UK, etc) this huge increase in debt would have been accompanied by a higher cost of borrowing and a significant jump in the government's interest expense (ie, a direct hip-pocket cost). However, the extensive use of QE by the Federal Reserve, together with the maintenance of absurdly low interest rates has meant that there has been no political or economic cost and, therefore, no imperative to solve the fiscal imbalances. Most sides of US politics accept that the deficit needs to be reined-in by a combination of tax increases (democrats) and spending reductions (republicans) – but the political will for a compromise is lacking. Meanwhile, monetary policy continues to do all the "heavy lifting" in support of the US economy – its hard to run out of money when you are only printing it.

The current objection of the US republicans (lead most vocally by the right-wing Tea Party) revolves around the democrat's health care reforms – or "Obamacare" as its often referenced. The republicans claim that the economy simply cannot afford such reforms. However, as John Abernethy (Executive Director of Clime Asset Management) wrote in a recent thought piece … "the Republicans were all too willing to underwrite the socialisation of investment banking in 2008, but the proposed socialisation of healthcare is not seen to be as virtuous."

The recent 13th hour agreement in the US to increase the debt ceiling only sees the "can kicked down the road" and we may need to go through the whole pantomime again before 15 January 2014 (when the US government will again run out of cash) and the debt ceiling will need to be renegotiated before 7 February 2014. However, things might **not** be as bad as they first seem - as noted by Shane Oliver (Chief Economist at AMP Capital) there are a few reasons why the next budget/debt ceiling negotiations may be less traumatic. Oliver points to the fact that:

- there is a growing number of US politicians on both sides of the divide that want to solve this thing;
- the recent agreement around the temporary fix appears to include the "McConnell Rule" that would allow the president to increase the debt ceiling, unless congress voted against it with a 2/3 majority (the republicans could therefore still vote against it, but be unable to stop it); and
- finally, and most importantly, the republicans seem to have come out of the whole budget/debt ceiling debacle badly burned. Their popularity has dropped to all time lows (just 28% accordingly to a recent Gallop poll) and mid-term congressional elections are coming up in 2014. They can't afford a re-run of the recent shenanigans, otherwise they run the very real risk of losing control of the house of representatives (the democrats already hold the senate).

As Winston Churchill once said "You can always rely on the Americans to do the right thing – but only after they've tried everything else."

A Woman likely to take charge at the US Fed – Will we notice the Difference?

When Ben Bernanke retires as chairman of the US Federal Reserve Bank in February 2014, his place is likely to be taken by Janet Yellen, one of the current vice-chairs of the Fed. At age 66 years, Yellen is considered to be one of the chief architects of the quantitative easing programmes and her views are considered to be more "dovish" (ie favouring lower interest rates). More astute observers argue, however, that she is neither "hawkish" nor "dovish" but that she is an activist prepared to wield the Fed's powers either way depending upon circumstances at the time.

In the short term, this probably means that interest rates will probably stay lower for longer and QE tapering is likely to start later (and with less venom) than might have been the case had the current man remained at the wheel. Equity markets will likely react positively to Yellen's elevation to chairman.

What a difference a Year or Two Makes

When initial concerns about the US fiscal position first surfaced in July 2011 and it became apparent that there was a significant deadlock developing between the house of representatives and senate, global equity markets plunged by around 25% – this situation wasn't helped by Standard & Poors downgrading the US credit rating at this time. Intra-day volatility was extra-ordinarily high and sell offs in the US market were replicated, and indeed magnified, around the globe.

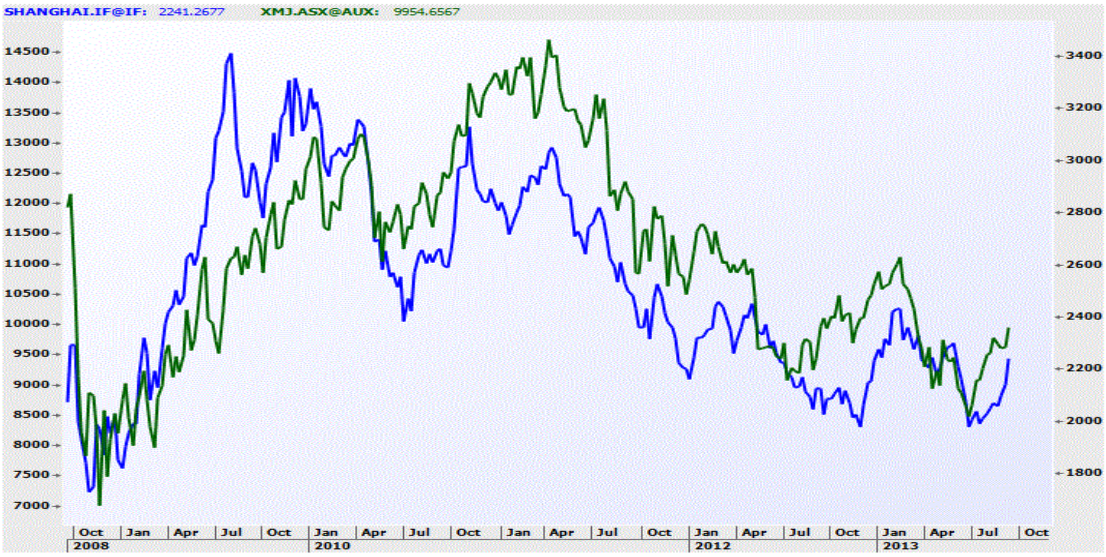
Similarly, in October & November 2012 as debate raged about the impending US fiscal cliff, markets gyrated from day to day and significant value was written off the value of Australian and global equities.

However, today's market is a different beast to the one of a year or two ago. In the current environment where there is confidence around the breadth and depth of the US recovery; where the fiscal outlook in Europe is more assured; where Central banks have demonstrated a preparedness to inject liquidity and where growth in China is once more climbing back above 7.5%– investors are much better equipped to deal with any uncertainty that may come there way. The US market's worst day during the recent political stand-off saw only around 200 points taken off the value of the Dow Jones (around 1.3%) and over the 16 days of the government shutdown, the bourse actually rose by 2.4%.

You can tell a lot about a market by the way it trades down (and up). Sentiment is crucial to the success or otherwise of markets. Previously, a fall in share prices was greeted with further selling or, at the very least, a reluctance to buy. Today, however, any pullback in the market is viewed as a buying opportunity to put more cash back into equities. This positive sentiment is also being assisted by a rather unusual "no lose" conundrum linking economic date & equity markets – good economic data is seen as good for the underlying economy and therefore good for company earnings and equities. Bad economic data means that QE will continue "un-tapered" which means more liquidity, which is also good for equities. QED!

China & Australian Resource Companies – in Lockstep

The share price performance of Australian resource companies over calendar 2013 has suffered at the hands of softer than expected Chinese growth (which in turn had an impact on commodity prices) together with credit market concerns in that same country. Recent growth figures out of China indicated a tick up in economic activity with the September quarter GDP up to 7.8%pa from 7.5%pa the previous quarter. The close-knit relationship between the fortunes of the Chinese share market and our own resource companies is evidenced below:



Blue-Chinese Share Market **Green**-Australian Resources Index

Brokers and analysts alike are now "falling back in love" with the big miners. Everyone's finally starting to realise the magnitude of surplus cashflow BHP & RIO will have at their disposal over the next few years. In a recent research paper from Macquarie Equities the penny finally seems to have dropped under the heading …"After Capex comes the Production". They go on to say that "after 10 years of heavy investment and peak cycle acquisitions, the market has perhaps lost track of the diversified miners imminent jump in free cash generation. Under our forecasts, BHP generates un-allocated free cashflow (over and above dividends and spending plans) of US$38bn (or 22% of current market capitalisation) over the remainder of this decade. Similarly, RIO generates US$49bn (or 49% of its current market capitalisation)." When Macquarie run these numbers through their valuation models, they conclude that "the market is ascribing a heavy discount to the miners future free cash flow (and hence) the potential share price upside from getting capital management right is huge." Their current 12 month price targets for BHP and RIO are $43 and $81 respectively.

OUTLOOK

One thing we have noticed over recent months with the plethora of research material that crosses our desks every day is that there is an increasing propensity for analysts to be talking about medium to longer-term bull markets. There are still the usual doomsayers, but they seem to be dropping in number and (importantly) receiving less coverage in the mainstream press – again, a reflection of improving sentiment.

The market seems to have run on from the technical highs we were expecting in early October. The momentum indicators are touching over-bought levels and we may see some type of pullback over the coming weeks (or possibly just some type of consolidation). However, with sentiment and liquidity supporting equities, we expect any move down will be quite shallow. Other factors that are (or will be) supportive of equities include:

- We are moving into a seasonally positive time for equities – the calendar says "buy".
- US economic data continues its steady improvement.
- The "no taper" decision in the US will provide liquidity that will find its way in to equities.
- Whilst the AUD has moved up somewhat over the past month or so (largely on the no taper decision) we expect the AUD will drift lower over 2014, benefiting most sectors of the Australian economy.
- We believe the RBA "owes" the Australian economy one more rate cut before the end of the year.
- Commodity prices are likely to remain around current levels (supporting resource company share prices and hence the ASX200 into 2014).
- Forward Price Earnings (PE) ratios are not overly stretched
- Profit expectations for upcoming company reporting seasons (in the US and here in Australia) are only moderate, at best, with scope to surprise on the upside.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Overweight):** 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 a further rate cut, the next 9-12 months could be very profitable for Australian equities. Resource stocks and small caps represent a longer-term buying opportunity.
- **Global Equities (Slightly Overweight):** The no taper decision in the US will ensure liquidity to support global equity markets 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. Later in the cycle, falling interest rates should flow through into firmer prices.
- **Fixed Interest (Neutral):** 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 (Slightly Underweight):** As a result of our positions in other asset classes, cash is presently slightly underweight.

Regards

Andrew & Stephen
25 October 2013