QUARTERLY REVIEW – APRIL 2014

After a very solid first half to the financial year, equity markets exhibited increased volatility as we moved into 2014 off the back of some weak manufacturing data out of both the US & China, together with some softer than expected company earnings. The ASX 200 has proved somewhat resilient since the beginning of the calendar year, outperforming the Dow Jones subsequent to the equity market low on 5 February'14.

In the US, the Federal Reserve has continued with its tapering programme and whilst some recent economic data has been below expectations, this has largely been attributed to the unseasonably cold weather in the US. China is continuing to re-focus its economy & further de-regulate its financial system which is causing some knock-on affects for Australia, however, growth of at least 7% will be under-written by further fiscal stimulus if necessary.

Whilst over more recent times, Australian and US shares have moved higher, this has been on quite low volumes (ie not a lot of buying conviction) and the charts are indicating that markets are losing momentum. We are now staring at a likely "sell in May and go away" effect, however, in the absence of a significant fundamental catalyst, the impact may be less in 2014 that it has been in more recent years.

US Economy

Growth in the US economy continues to pick-up pace. Bank lending growth is trending higher, consumer spending is picking up, house prices are recovering, business investment is stronger and the level of unemployment has now fallen to 6.3% (back to where it was in early 2008). All this has lead the Federal Reserve to continue tapering Quantitative Easing (QE) at a steady pace, reducing the stimulus programme by around $10bn a month since December 2013. QE (V3) commenced with the re-purchasing of bonds & securities at the rate of $US85bn per month in late 2012, and this has now almost halved to $US45bn per month – importantly, without unduly spooking markets. The Fed is on track to cease the purchases entirely later this year.

Provided economic activity and unemployment continue to recover (and that will be an unequivocal caveat), the Fed may even look to begin increasing US cash rates in the first half of 2015. We doubt whether Janet Yellen will be in any hurry to tighten the reins to fast or too quickly – any move up in US rates will inevitably cause some short term volatility in equity markets and put upward pressure on the USD (the latter may be a saving grace for Australia as the AUD should depreciate commensurately at this time).

However, history tells us that the impact of a rate rise on equities will be short-lived. Recent data produced by AMP Capital (looking at US share market moves over the last 35 years in response to the first rate rise of a tightening cycle) indicates that the initial rate rise usually takes around 3-4 months for the equity market to comfortably digest; and that after 12 and certainly 24 months, markets are overwhelmingly back into positive territory.

The problem for equity markets comes much later in the interest rate cycle when rates rise to onerous levels to quell inflation. Its at this point in time that the yield curve usually inverts (ie short term rates push above long term bond yields) and equity markets pull-back – but we are a long way from that happening.

The Dow Jones has now risen over 35% in the last 2 years without really stopping to draw breath. Yes, easy money has played its part in propping up markets, however the Dow Jones has ostensibly moved up on significant improvements in underlying company earnings – something that has **not** been a feature of the Australian economic landscape to date (see Business Cycle commentary below).

China – Shadow Banking and a Perspective on Growth

We spoke last quarter about the so-called "shadow banking" system in China and we note that it continues to get bad press from a number of quarters. We indicated in our last update that we expected that at some point during 2014 that we may see some failures – which would be a good thing for the longer-term health of the Chinese financial system. As it turned out, earlier this calendar year Jilin Province Trust and China Credit Trust both defaulted on interest payments. There were no systemic ructions but it has made investors more aware of the risk return dynamic in this part of the market.

The RBA's assistant Governor Guy Debelle made some interesting observations about shadow banking at a finance luncheon last week. He noted that the situation in China was very similar to what occurred in Australia during the 1970's when quantitative controls on banks were at their peak. He indicated that the size of the non-regulated finance sector in Australia in the 1970's was (in relative terms) about the same size as the current shadow banking system in China. "It is a situation that a lot of advanced countries have found themselves in over the years" he said. He went on to add that China has carefully examined what went wrong in other countries and has tried to learn from that and avoid making similar mistakes.

Also speaking at the same conference was Joshua Chua (MD of Citi Research Asia Pacific) who made a very interesting observation about the apparent fall off in Chinese growth. Over much of the past decade, Chinese growth has typically been in double figures and some observers have lamented that, with the reduction in Chinese growth, there has been a disproportionately negative impact on the Australian economy. Chua observed that in absolute terms, the economic impact of the current 7% pa Chinese growth is exactly the same as the 10% pa growth that was delivered 5 years ago. Clearly, seven percent is indeed the new ten percent.

Where are we in the Business Cycle?

Economies, like most things in life, tend to move in cycles. Typical business cycles involve early, mid, late & recession phases. The chart below, sourced from Fidelity Asset Research, describes the characteristics of each phase of the cycle.

Typical business cycle

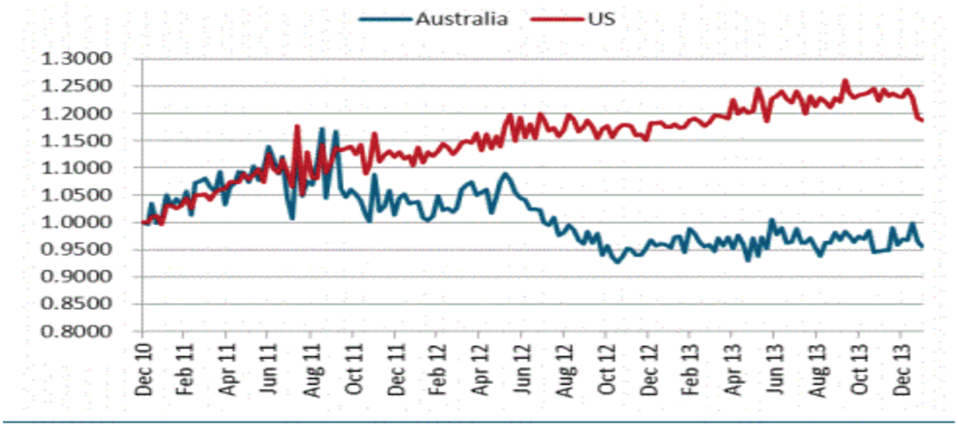
Source : Fidelity Asset Research

It is generally accepted that the US economy is now well progressed into the "mid" stage cycle, whilst Australia is still languishing in the "early" stage cycle as we struggle with the transition from mining lead-growth to broader-based economic growth. This positioning in the business cycle is also reflected in the relative performance of the respective share markets, with US equities having now **exceeded** pre-GFC levels by some 17%, whilst the Australian share market still needs to rise by a further 25% to reach levels attained prior to the GFC.

After recent company profit reporting here in Australia, Goldman Sachs noted that cost reductions have played a big part in the earnings growth achieved and forecast by many companies. They note that "in most cycles, cost reductions are typically the first variable to cause earnings upgrades ….. but the improved cost performance can be a precursor to companies reinvesting in growth (and generating increased revenue)". They go on to note that US companies were in a similar situation 4 years ago, from which point the US equity market went on to rise by close to 70%.

The graph below (sourced from Thomson Datastream, Shaw Stock Broking) shows the relative change in earnings per share from 1 December 2010 for US companies, versus Australian companies.

Chart 3: Australian EPS v US EPS (12m Fwd Estimates, Indexed to 1.00 at 31 December 2010)



Source: Thomson Datastream, Shaw Stockbroking

Australia - Mixed Signals & a big Gap to Fill

The Australian economy still continues to grow at "below trend pace" (RBA Governor Glenn Stevens) as it grapples to transition from mining lead growth. The reality is however, that mining sector investment spending is relatively high and is not due to fall in earnest until next year. Housing construction has picked up and consumer spending is on the rise. Add a likely fiscally restrictive budget into the mix and the best adjective we could come up with to describe the Australian economy at present is "patchy". The medium term positive appears to be that federal and state governments are looking to invest into (and stimulate) infrastructure. However, we also need to see an increase in non-mining business investment if we are going to see a sustainable pick-up in Australia's economic growth. We remain of the (minority) view that the RBA may well need to reduce rates one more time to kick-start business investment. At the very least, monetary policy is likely to stay at current settings over the next 12 months.

Based on fundamentals, the Australian share market (ASX200) is considered "fair value" at present, trading at a 12 month forward price/earnings (PE) ratio of 14.5 times (consistent with the 20 year average). However, this is being held down by resource stocks and when they are excluded from the metric, the core markets PE rises to about 17 times, making it look quite expensive based on current company earnings forecasts.

OUTLOOK

Our view on equities has not changed – we are constructive on shares for 2014 but we are increasingly nervous about a short-term correction in global and Australian equity values. We were expecting some type of pull-back a little earlier in the year but momentum has carried most markets higher. The problem with the recent "rally" however, is that it has been driven on markedly reduced volumes and we failed to hold the recent new high (false breaks are often a pre-cursor to a fall in share prices – see chart below):

ASX 200 – July'10 to April'14

From a technical point of view, the old adage "sell in May and go away" could yet again prove to be a truism. Overlay the adjusted PE data above and consider the gains that many share traders are currently sitting on, some profit taking (at the very least) is likely to be a feature of markets in the short term. Our view is that we may see a pull-back of between 5% - 7% in equities over the next month or two.

The second half of 2014 still looks positive with the potential for increases to company earnings here in Australia. Based on a cross-section of economists, the consensus view for the ASX200 is that it could finish the calendar year in the range 5,700 to 5,800 (a rise of around 5% from current levels). We would expect much of this increase to be accounted for in the value of resource companies, industrials and cyclicals – with less uplift for the banks and other defensive stocks more generally.

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 second half of 2014. However, in the short term, we see the potential for some level of retracement.
- **Global Equities (Neutral):** The US market is looking somewhat over-valued and ripe for some profit taking. Europe and Asia look to represent better value over the medium term.
- **Property (Underweight):** Listed Property has benefited from the flight to yield, but now appears to be in a correction phase as investors consider higher growth sectors.
- **Fixed Interest (Neutral):** Listed income securities continue to be our preferred fixed interest investment. Major bank securities are generating an equivalent pre-tax return of up to 5.8%pa.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes and the risk of some short-term softness in equity markets, cash is presently slightly overweight.

Regards

Andrew & Stephen
12 May 2014