QUARTERLY REVIEW – FEBRUARY 2015

Once again investing in equities over recent times proved nothing short of bewildering. Over the 2014 calendar year, Australian equities delivered basically no capital growth whatsoever. The ASX 200 started the year on 1 January'14 at 5,350 and just over twelve months later on 20 January'15 it stood at 5,307.

In the following 40 days, the market put on almost 12% to finish the month of February'15 within a whisker of 6,000 points. Investor appetites have been fuelled by low oil prices, an RBA reduction in interest rates (hooray at last) a low Australian dollar, a solid (albeit unspectacular) profit reporting season and some short covering, just to put some extra froth on the market.

For a change, the US market has only pushed up around 6% since we began 2015 with investors pondering what higher interest rates and a stronger currency might mean for the US economy and the profitability of US companies more generally.

Australian Equity Market

The Australian share market has endured a significant period of relative under-performance compared with most advanced equity markets (particularly the US). In large part this was due to higher interest rates (relative to other advanced economies) and a higher currency.

The Reserve Bank has now finally moved to lower domestic interest rates (something we've been advocating that they should have done 6-9 months ago) and the market expectation is that there will be another fall before June'15. In theory, lower interest rates mean higher comparable price earnings ratios, in large part by "increasing" the present value of future discounted cashflows. So with a 1.0% reduction to the risk free rate (eg RBA cash rate) an Australian market which historically trades at a fair value PE of around 14 times should trade at almost 17 times, all other things being equal. Lower interest rates should also flow through into lower hurdle rates for business investment, as well as the obvious reduction in borrowing costs.

In the same way that loose monetary policy has driven up equity prices in other parts of the globe we anticipate that lower cash rates here in Australia should lead to a period of relative out-performance on the ASX 200 (indeed we have already seen the first instalment of this over the first 2 months of 2015)

The lower Australian dollar will also have a significant positive impact for Australian companies. The currency benefits are not only experienced by Australian exporters, but the lower dollar also has upside for domestic producers competing against imported goods here in Australia (as the imported goods become relatively more expensive) and also a translational uplift for Australian companies who generate some portion of their earnings in USD (eg QBE, Macquarie, CSL, Amcor, Brambles, Resmed, etc)

The US – Don't hold your Breath Waiting for an Interest Rate Rise

Data out of the US continues to confirm a strengthening economy – unemployment, consumer spending, housing, business investment, manufacturing etc are all robust. In the normal course, this would be a recipe for a tightening of monetary policy and the Federal Reserve has signalled its intention to raise rates at some point in the near future

However, we don't believe that this will be any time soon.

The expectation of a Federal Reserve rate rise has already pushed market yields higher in the US. In turn, the US dollar has also appreciated by around 25% over the past 6 months. At the same time, we have seen Canada, Australia & China all **reduce rates** and Europe has kicked off its own QE programme that will be much larger than first anticipated. Against a backdrop of a further easing in monetary conditions in most advanced nations, together with already higher US term rates and a strong currency, the Fed will be reluctant to move rates up in the short term for fear of derailing the economic recovery or spiking unemployment. The Fed will sit on its hands for as long as practical and you can rest assured that any rate increase in the current year will be measured and prudent.

Europe – QE Announced & Greek "Bluff" Called

On 22 January'15, the European Central Bank announced its own quantitative easing programme. The move was long anticipated and in the normal course we probably would have seen equity markets retreat on the news (buying the "rumour" and selling the "fact"). The saving grace, however, was that the programme was bigger than expected and will run for longer than anticipated. The ECB will purchase €60 billion of bonds & other paper each month for at least the next 18 months, injecting liquidity of over €1.1 trillion into financial markets. They have indicated that they will extend the programme if inflation remains too low. Whilst this measure will undoubtedly ward off any spectre of deflation and provide liquidity that will improve the price of financial assets (including equities) in that part of the world, there is still a need for the EU to contemplate structural and policy reforms to boost growth over the longer term.

Speaking of anti-reformists, the new Greek government has attempted (largely unsuccessfully) to blackmail the EU into significant concessions around the conditions attaching to its GFC bailout package (principally debt forgiveness and watering down of austerity measures). What Alex Tsipras and his Syriza party failed to realise is that the threat represented by a Greek exit ("Grexit") from the Eurozone is now significantly less than it was during the height of the GFC. The other peripheral nations such as

Portugal, Ireland & Spain (the other "PIGS") are in much better shape and (as Shane Oliver from AMP notes) the "defence mechanisms in Europe are now far stronger with a strong bailout fund, a banking union and a far more aggressive ECB."

Oil – The Economic Lubricant

One of the biggest tailwinds as we move into 2015 is a significantly lower oil price. The price of a barrel of oil fell by over 50% during the latter part of 2014 and, over time, this will have a **significant stimulatory** effect on most advanced and developing economies. In short, lower oil prices materially reduce business operating costs and raise the disposable income of consumers.

The estimated extent of this stimulus depends on who you want to listen to, but the following is a cross-section of reported benefits:

- Deutsche Bank estimate that the drop in the oil price is **equivalent to 2 RBA interest rate cuts (50bps)**. The reality is, however, that the drop in the oil price is likely to be even more stimulatory than a rate cut, as the fall in petrol prices is leaving surplus cash in the wallets of consumers and businesses benefit from reduced input costs. Rate cuts on the other hand, don't translate into reduced loan repayments for borrowers (merely a lowering of the overall borrowing term) so there is no significant consumer cash flow benefit.
- Francis Scotland of Global Macro Research indicates that the fall in the oil price is equivalent to a "huge, globally co-ordinated tax cut" which he estimates to be worth **$400bn to $500bn** in 2015.
- Based on IMF modelling it has been estimated that a 20% reduction in the oil price results in **0.2% increase in global GDP** growth. Assuming a linear relationship, then a 50% drop in oil should add around 0.5% in GDP benefit.

Of course the joy is not evenly spread. The US is a primary beneficiary of lower oil prices. Credit Suisse estimate that the GDP benefit for the US is almost twice that of the global average (ie a 20% drop in oil could result in a 0.4% GDP improvement). For Japan, the IMF projects the GDP impact to be around 0.6%.

Developing countries (such as China & India) are also significant winners. In India, for example, crude oil accounts for 34% of their total import bill There are also enormous fiscal and economic benefits for energy subsidising nations such as India & Indonesia (where high fuel costs have had a significant drain on government finances) – the lower oil price is now allowing these nations to wind back the level of subsidies.

On the down side, oil-producing economies such as Russia and Saudi Arabia will suffer declines in GDP of up to 2.0% (based on IMF modelling). In response to this eventuality, Standard & Poors reduced Russia's credit rating to "junk status" (BB) late last month. The other potential negative in the short term is the possible liquidity impacts for equity markets. A report carried in the Australian Financial Review last month observed that ten of the worlds top twenty sovereign wealth funds (which are amongst the largest investors in the world) derive their capital from countries heavily dependent on oil and gas revenue. The concern is that these sovereign funds may be forced to liquidate significant equity positions to help keep their respective governments afloat.

The thing to note about oil (unlike other commodities such as iron ore) is that supply is already beginning to adjust to the lower prices. Most of the additional oil production capacity in recent years has been added in the US (largely by way of shale oil reserves) and recent statistics from that part of the world indicate that the number of productive oil rigs fell by almost 20% in the two months to December'14. This would indicate that oil prices are likely to rise as we move further into 2015.

OUTLOOK

In looking ahead we see a number of factors that will act to support favourable returns for Australian equities:

- Lower interest rates
- Reduced energy costs (particularly oil)
- Strength in the Australian housing market
- Lower AUD
- Continuing growth in US economy
- Inflation low globally

So whilst the tailwinds look very positive for equities (particularly here in Australia), after such a run-up in prices over the past couple of months, we would expect the market to take some type of breather. This will likely take the form of a leg-down that is not expected to be significant, with 5,680 points being a solid technical support level for the ASX 200.

Technically there is potential for a larger correction in 2nd quarter 2015.

Whilst the tailwinds are potentially significant, at some point, the fundamentals will need to improve to justify materially higher equity values. Forecast company earnings growth for 2015 has fallen from around 6% just prior to the start of the 2014 year, to sit almost flat following the completion of the recent profit reporting season (albeit resource stocks have disproportionately dragged this forecast lower). Whilst falling market interest rates might warrant a more lenient view on fair value PEs, the macro tailwinds above will need to translate into higher company earnings at some point during the next 6-12 months to warrant still higher share prices. We saw this happen in the US and we feel reasonably confident that a similar flow-through to earnings will eventuate her in Australia.

Even after a potential correction in the 2nd quarter, we think that the tailwinds here in Australia have the potential to push the ASX 200 well above 6,000 points by the end of 2105.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Overweight):** We remain constructive on Australian stocks, particularly in the second half of 2015 and beyond. We expect one more interest rate cut from the RBA before June which, combined with lower oil prices and a softer currency, could see an extended period of outperformance by Australian equities.
- **Global Equities (Neutral):** The US market has enjoyed above average returns for some time and whilst we are still generally positive on the market, the rising USD together with the prospect of rising interest rates (in the medium term) could act as a handbrake to returns. Asian equity markets (particularly China) are looking quite bullish.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and more recent reductions to interest rates). Most REITs are now not able to fund current distributions from free cashflow so it would appear that a correction is not too far away.
- **Fixed Interest (Overweight):** Given the level of interest rates, it is preferable to hold a little less cash and a little more in fixed interest instruments (such as 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 a little underweight.

Regards

Andrew & Stephen
12 March 2015