QUARTERLY REVIEW – JUNE 2015

Global equity markets ended the 2014/15 financial year in retreat, off the back of concerns about a Greek exit from the Eurozone (a so called "Grexit") and volatility in the Chinese (A-Shares) stock market.

Here in Australia, the month of June saw the ASX post its worst monthly result (-5.5%) in over 3 years, driven by a further softening in commodity prices and a sell-off in bank stocks. During March and April the index made a number of assaults on the 6,000 level, only to fall away during May and June to finish the financial year at 5,459 – which represented a meagre 84 point or 1.5% advance on where it began the year on 1 July'14. We were not alone when it came to modest returns from equities, with the MSCI World Index actually falling -0.4% over the financial year (note that when global returns are translated into AUD the returns on international equities appear quite healthy due to the depreciating Australian dollar).

The consternation in markets was once again driven by concerns about a slowing Chinese economy and possible spillover effects from a "plummeting" Shanghai share market. Add to this the prospect of Greece being booted out of the Eurozone and its hardly surprising equities retreated. Accordingly, we spend some time this quarter better understanding whats actually gone on in these geographies and the likelihood (if any) that related events represent a risk to equity markets.

It's not a political, economic or fiscal problem that Greece faces …… it's cultural

At the eleventh hour we once again saw the proverbial "can kicked down the road". After securing a supposed mandate from his people by way of referendum (a move that clearly annoyed EU leaders), Alex Tsipras subsequently agreed to a raft of austerity measures and economic reforms in order to secure an additional €86 bn rescue package for Greece.

However, Tsipras has used-up a lot of his political capital (particularly within in his own Syriza party) getting a deal agreed with the EU. Some of the minor parties in his political coalition have now walked away from his government with around one quarter of his coalition voting against the austerity measures on the floor of the parliament – the measures are only being carried with the support of opposition parties.

Despite the bailout agreement, we have not heard the end of this saga and there will, unfortunately, be more pain for the Greek People. In a nutshell:

Head Office GPO Box 502, Sydney NSW 2001 Telephone (02) 9279 2444 Fax (02) 9279 2555
www.axiomwealth.com.au
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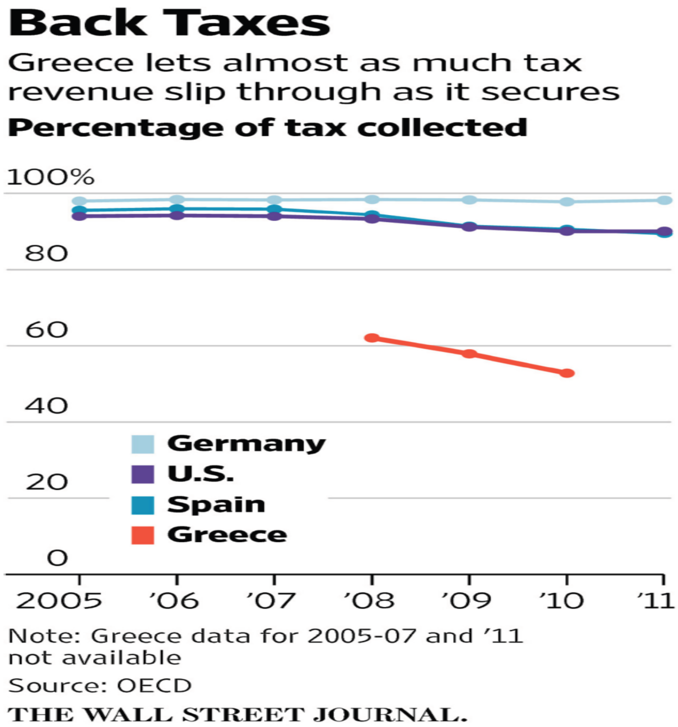
1. Greece's revenue (tax) base is shrinking – driven primarily by the fact that they don't pay their taxes
2. Greek government authorities are ineffective and inefficient – they waste money administering taxes and distributing poorly targeted welfare
3. Greece spends too much of its (shrinking) revenue on middle class welfare

The following OECD graph was sourced from a Wall Street Journal article from 25 Feb'15 and it probably represents the best single distillation of the problem in Greece. Most countries (Australia included) boast a tax collection rate ranging between 95% to 98% - in Greece, this figure is currently **below 50% and falling.**



So even if agreements are reached to raise income taxes and broaden/ increase the rate of indirect taxation, the sad reality is that the fiscal outcome of such measures is likely to fall well short of what's expected, simply because there will be a lack of compliance.

In 2013, the OECD undertook a study into Greece's Social Welfare Programmes. In a lengthy report the OECD found the Greek welfare system to be very poorly targeted (ineffective) and administered by multiple layers of overlapping bureaucracy (inefficient).

Aside from age pensions, the level of other types of social welfare (eg unemployment payments, family benefits, etc) are quite modest by European standards. However, where they are paid, they are not paid to the most needy. The young and long-term unemployed don't receive benefits (you need to have been employed for a period of time to be eligible for the dole) and Family benefits only kick in once you have 3-4 kids (single parent families and those with only 1 or 2 children largely miss out).

In terms of inefficiencies, there are presently 40 different authorities overseeing the delivery of social security benefits and more than 100 different authorities paying age pensions. These number are further exacerbated by cronyism & corruption in most levels of Greek Government and bureaucracy, the extent of which was probably best exampled by the Greek Finance Minister (Yanis Varoufakis) himself who earlier this year opined "it costs three times as much to build a mile of freeway where we are (Greece) than it does in Germany".

Some commentators will point to the fact that since 2007, Greece has progressively raised its retirement age from 58 years to 67 years – in line with that of most EU nations. Sounds great in theory, but the reality is, however, that there are exceptions and "carve outs" to the laws which currently see **75% of Greek public servants** retiring before the legal age and a whopping **90% of private sector workers ceasing work before the national retirement age** (these figures were tabled in Parliament late last year by the former Greek Labour Minister, Tiannis Vroutsis).

Debt Restructuring – The Elephant in the Room

Whilst the EU has so far refused to make any public comment about debt restructuring (ie writing off loans) it goes without saying that behind the scenes, certain promises have been made. It is inconceivable that Tsipras has agreed to a raft of austerity measures without some specific or implied debt relief.

The EU has obviously asked Tsipras to put "runs on the board" before they show their hand with respect to any debt re-structuring. No doubt Greece will be looking for a simple "haircut" – ie a write-off of debt. However, the EU will be keen to make any debt concessions look anything but – there will be consolidation of debts, a lowering of interest rates, possible interest holidays and term extensions – but there is likely to be little in the way of debt write-downs. The net result will be the same (and even possibly more costly for the EU) however, by avoiding the term debt write-off they will mitigate (but not avoid) the negative reaction that is likely to come from the other PIGS (ie Portugal, Ireland & Spain) who took their austerity medicine with little in the way of material debt restructuring.

If we were the cynical types we might argue that Tsipras has been happy to sign-up and legislate all manner of measures in order to get access to additional funding & re-structuring, knowing full well that at the end of the day, Greece will again fall well short of the EU's fiscal targets. In the words of Martin Luther King (and we're paraphrasing here) ….. "you can't legislate cultural change".

As we noted last quarter, the contagion risk of a Greek "failure" is limited (eg 0.25% of global GDP, improved health of EU economies post GFC, reduced exposure of banks to Greek debt, etc). We saw in June after Tsipras called his austerity referendum and urged a no vote (which many saw as an entrée to an inevitable Grexit), equity markets experienced some short term noise, but only ended up retreating around 3% - 5%.

China – "whatever it takes"

On the other hand, ructions in China do have the potential to represent a far greater threat to the Australian economy and share market. The reality is, however, that Chinese authorities continue to selectively intervene in the economy and financial markets to reduce the economic and investment amplitude of any adversity and/or exuberance.

Mario Draghi (President of the European Central Bank) once famously said that he would "do whatever it takes" to avert a crisis in the Eurozone. Coming from a man who overseas an institution that has a convoluted governance structure and diluted accountability, he ended up doing quite a remarkable job of steering the EU out of the depths of the sovereign debt crisis. So it should hardly come as a surprise that in a socialist market economy, Chinese authorities are more often than not able to deliver a near "goldilocks solution" to the most vexing of issues. At first it was concerns about faltering growth rates; then the property market was thundering out of control; and next it was the so-called shadow-banking system that threatened to bring the economy down. This time, the concern is over a burgeoning share market that, according to some, threatens to derail the broader economy.

Its important in the first instance to understand the unique character of the Chinese share exchanges. It has been estimated by Reuters that over 85% of share trades in China are made by individuals, around two thirds of whom have not graduated high school. Institutional ownership (ie banks, fund managers & companies) is limited and because foreign ownership is specifically restricted, it amounts to less than 2% (with most foreign investors trading via the Hong Kong market).

Twelve months ago the Chinese (Shanghai) market was trading on single digit PEs. Since that time it has risen over 120% (a fact which many commentators have neglected to mention) and it has now subsequently fallen back by around 30% (something that has reverberated in headlines around the world). The reality is, however, that the Shanghai index is still some 60% above its June'14 level and currently trades on a PE of less than 17 times – broadly in line with the Australian market.

As noted above, the Chinese share market is dominated by individual investors and the Chinese are a nation of gamblers. This leads them to "trade the trend", riding the upward momentum of markets in good times and selling out when things turn down – they are traders not investors. When you overlay liquidity displaced from property investment and sprinkle over a large serving of margin lending, the recent trends in the market are hardly surprising. Below is a list of interventions that have been used by the Chinese authorities to "normalise" markets:

- Allowed direct investment in the stock market by Chinese pension & sovereign funds (previously these entities were only allowed to invest in treasuries and bonds)
- Reduced limits on margin loans and allowed investors to add property as security to avoid forced selling

- Banned short-selling of shares
- Suspended new initial public offerings (IPOs)
- Allowed a majority of companies to suspend trade in their shares
- Ordered large shareholders (with more than 5% stakes in companies) not to sell shares for up to 6 months

It is anticipated that many of these measures will be rolled back over coming months.

Authorities will no doubt continue implementing their broader reform agenda and, as far as the share market is concerned, this will progressively see more institutional and foreign ownership of Chinese shares. It is also anticipated that at some point in the next 6-12 months, Chinese shares will be included in relevant MSCI global indices. These changes will see more "patient" investors involved in the market and should serve to reduce volatility.

We contend that the share market plunge represents little risk to the real economy as:

- The enormous run up in the Shanghai index (+120%) had no spill over effect (similarly, the plunge also lacks economic grounding).
- The equity market accounts for less than 2% of China's aggregate corporate financing needs.
- The so-called "wealth impact" on consumers is much less in China because households have much higher levels of savings and because most share investors are still 60% better off than they were 12 months ago (yes, those who bought on the way up may be out of pocket, but an equal number would have profited from selling).
- Chinese banking stocks have not fallen much by comparison to the broader index, which indicates that this is not a structural issue likely to spill into financial markets (recall plummeting bank stocks in the GFC).

The Chinese growth engine is still turning over nicely

Many have written that the slow down in the Chinese economy represents a significant risk to the Australian economy. In fairness, if Chinese growth had slowed to 6% pa 8 years ago (from 15% pa), we probably would have felt an impact, but not today given the sheer size of this economic juggernaut.

World Bank statistics indicate that China's level of gross domestic product (GDP) has **increased almost 10 fold** over the past 13 years, rising from around USD1.4 trillion in 2001 to around USD10.5 trillion in 2014 (www.tradingeconomics.com). Even at 6% growth, this still represents an expansion in domestic product of around USD0.6 trillion

By way of contrast, in the same 13 year period, US GDP roughly doubled and growth over the coming quarter is expected to average around 3.0% pa (or approximately USD0.5 trillion on an annualised basis).

US Interest Rates – It's not "when" that's important, but by "how much" and "how often"

The US economy is undoubtedly the best placed of developed nations - any number of economic metrics point to the health of the underlying economy; company earnings have steadily improved subsequent to the GFC and, consequentially, US equities have pushed up steadily over the past 6 years

The move up hasn't been impulsive (unlike the recent Chinese surge) and technically the uptrend is still intact and fundamentals are sound (valuations are a little above average, but nothing alarming).

The big question then becomes what impact will rising rates have on the momentum of the US equity market. The Federal Reserve Bank has **clearly signalled** to the market that it will look to begin normalising monetary policy this year. Many have pencilled in September, albeit we think it will be a little later in the year – either way, the market has already baked-in a 0.25% increase in the US cash rate. The "unknown" then becomes when will the next rate increase occur, by how much and then (going forward) how many rate increases will we see before the Fed moves to a neutral position on monetary policy (ie suspends rate increases)?

We suspect the Fed will be very reserved and transparent in implementing future rate increases. They will probably occur at a slower pace than many are predicting (due to an under utilisation of labour, an already strong USD and global growth concerns) and only after significant "jaw boning" of (or signalling to) the market – when rate rises do occur, they will not come as a surprise. As we cited last year, Macquarie Research has concluded, based on historic analysis of rate tightening cycles, that even when rates start to rise it should **not** immediately impact the upward trajectory of the US equity market. They indicated that 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.

OUTLOOK

Last quarter we were anticipating some type of correction and we suspect that this has now largely played out. We remain of the view that the US economy will continue to grow above trend and that China will achieve around 6% pa growth in the financial year ahead (even if it involves authorities deploying more stimulus). Here in Australia, the velocity of economic tailwinds is likely to increase courtesy of a low AUD (with potential to fall further), cheap fuel (which is a significant input cost for many businesses) and low interest rates (with a further cut likely later in the calendar year).

The US profit reporting season has kicked off largely in line with expectations and Australian companies will follow with their results in August. The average earnings growth forecast for the ASX 200 is actually negative (due primarily to resource companies), which leaves scope for earnings to surprise to the upside. Moreover, there wasn't much action during the recent "confession season" (the lead-up to reporting season where companies are now obliged to disclose any material deviations to forecast earnings). This also seems to point to the potential for a move up in Australian shares, albeit with the usual volatility around outlook statements, or lack thereof, for specific companies.

We are entering a seasonally positive time for equities and we suspect that after a period of consolidation (that will take us through into our profit reporting season), the ASX will likely push back towards the 5,800 mark. Many economists and brokers see this level as the likely high for the year, however, given the tailwinds noted above and the prospect of a further interest rate cut (which can now be contemplated with impunity by the RBA given the very recent move by banks to jack-up investment lending rates) we suspect we may move closer to the 6,000 mark by the end of 2015.

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. We expect one more interest rate cut from the RBA 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 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 in the short term. We 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
26 July 2015