QUARTERLY REVIEW – August 2016

In this last quarter global markets were rocked by the news that the UK had voted to leave the European Union (the so called "Brexit"). UK equities went into free fall and there was panicked selling across Europe, Asia and to a lesser extent the US. Here in Australia, the ASX fell almost 5% in the 4 days following the vote (23 June'16) – then after analysts concluded that the impact of the exit wouldn't be felt outside of the UK, markets promptly recovered all their losses in the following 4 days.

Buoyed by solid economic data, the Fed's continued procrastination on (US) interest rate rises and ample liquidity (globally low interest rates and central bank quantitative measures), equity markets pushed up to reach 12 month highs in early August. Here in Oz, the ASX 200 touched 5,600 points at this time.

This quarter we examine the Brexit vote, update the situation in China and assess the key take-outs from the recent company reporting season.

Brexit …… Much ado about Nothing

When the good folk of the UK voted to leave the European Union (EU), it was initially characterised as a "Lehman moment" for equity markets (the collapse of Lehman Brothers in 2008 was widely viewed as the catalyst for the GFC crash in global equity markets). Shares plunged in England and around the globe and there were dire predictions about UK (and global) recession, together with the imminent demise of the EU itself. However, in the days and weeks after the vote, economists concluded that there weren't any direct transmission mechanisms that could link the rest of the globe to the fate of the UK and here in Australia, we quickly worked out that our trade exposure to the UK was limited to less than 3% of our total exports. At worst, commentators saw the risk of some indirect impacts via financial market volatility and a deterioration in business & consumer confidence. Both of which materialised; but both of which were equally short-lived. It was even subsequently postulated that Brexit may have a positive impact on Australia and its Asian neighbours, to the extent that it could throw up increased trade opportunities within the broader EU.

The other realisation in the immediate aftermath of the vote was that, notwithstanding the desire of the majority of UK voters to leave the EU, the process for achieving same would take well over two years to negotiate. And it's the shape of this exit agreement that will ultimately determine the economic impact on the UK; specifically the extent to which it will be able to retain or be forced to forego preferential trade access.

The UK is hoping that it can retain most of its trade benefits yet at the same time, curtail the free movement of persons (and ameliorate its EU funding obligations). The bad news for the UK is that the EU is likely to want to overlay a Norway-style arrangement (Norway is not a member of the EU but has trade ties). The Norwegians do enjoy most of the free trade benefits, but this comes at the cost of them having to fully adopt the free movement rules (people & capital) plus they also pay into the EU at the same per capita rate as the UK. To top it off, they "enjoy" these arrangements without any EU voting rights – go figure!

Pundits see no middle ground on China

China is one of those topics that seems to polarise economists and investors alike. Its either doom & gloom or an untapped silver lining. In economic terms, there is no doubt that China continues to deliver solid results (Q2 real GDP was bang-on consensus at 6.7% pa); the much vaunted property market continues to slow (alleviating concerns about a bubble) and authorities are making a good fist of managing the transition from an export-led economy to a consumer orientated economy. There is also still plenty of scope for authorities to provide stimulus (both monetary and fiscal) should growth ease back too far.

So from a quantitative perspective, its difficult to argue with the numbers. Where the report cards do differ, however, is around the quality of the result and, in particular, the magnitude and credit-worthiness of the debt that has to a large extent funded the growth to date. In the last few months we have seen the privatisation of some Chinese instrumentalities, government-directed restructuring of large provincially-owned companies and some bond "defaults" – all of which have un-nerved investors, but which on the whole are actually positive steps.

We've also seen tighter scrutiny of the Chinese funds management industry (many thousands of licences were revoked last month) and increased regulation of wealth management products that have been used to provide funding in the so-called shadow banking system. Again, these are initiatives designed to directly address concerns about the debt problem, but the extent of this "problem" also needs to be kept in perspective. Whilst corporate debt levels are undisputedly high in China (a little like household debt levels here in Australia), personal and government debt levels on the other hand are very low. Most importantly, around 97% of Chinese debt is actually held domestically (Hiroshi Yoh, Janus Capital) which provides greater surety over continued funding.

The view from Deutsche Bank (CIO Insight Note August'16) is that the "debt problem" can be satisfactorily managed through a combination of (prudent levels of) debt write-off & re-structuring, enhanced regulation of problematic sectors and, as necessary, fiscal policy stimulus (which effectively transfers debt from corporate balance sheets to the Government – with public debt being very low).

Reporting Season – Groundhog Day

Every six months we tell ourselves that an improvement in company earnings is just around the corner. This time, although the corner is potentially a lot closer, we're not quite there yet. The rate of decline in average earnings has certainly slowed, but we also saw continued caution around growth and market conditions (outlook statements were generally benign at best).

The one thing that reporting season does without fail is it provides a diversion from the macro. Over the past few weeks we've heard less about GDP, interest rates, inflation, etc and more about earnings expectations, sales growth, bad debts, margin pressure and the like.

A focus on company fundamentals, however, is not always a universally pleasant prospect and once again, those companies that were able to meet or exceed market expectations were richly rewarded and those that disappointed (particularly in the absence of any pre-season confessions) were hammered. The final scorecard saw 45% of profit results in line, 28% beat and 27% underperformed (Morgan Stanley). Somewhat concerningly, only about half of companies provided guidance and of these, only around net 10% were positively biased.

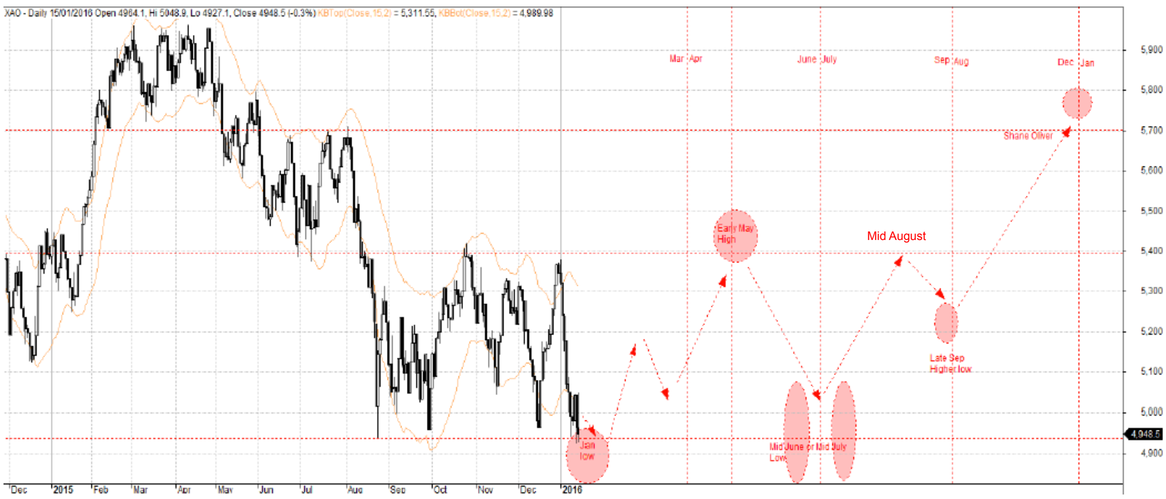
As has been the tradition in more recent reporting periods, mid-caps out-performed large caps (particularly ex 20) and globally focused companies did better that domestically linked firms.

The lacklustre EPS growth, accompanied by the market rally over July, reinforces our technical view that the ASX is looking rather tired and should pull-back over the next month or so.

OUTLOOK

Our short-term expectation is for markets to pull-back – both fundamental and technical analysis points to the market being fully-valued presently. Last quarter we were anticipating a May high, followed by a 5% correction – which played out largely to plan. However, the bounce into July (+10%) has been much stronger than expected.

The first major "support" level for the ASX 200 on the way down sits at around 5,350 - about 3% below current levels. We would expect some support at this point (albeit temporary), but based on the 60 year chart (which we've been using as a bit of a mud-map for 2016 - below) the market is likely to grind lower through until the end of September. The next major technical level for the ASX is around **5,200** and this could mark the low in this part of the cycle.



This chart has been remarkably accurate in picking the dates for market highs and lows so far this year. The recent rally extended beyond the 5,400 level projected, but the timing of the decline from mid-August appears uncannily close to the mark.

In terms of the medium term outlook, there was an interesting piece of research by Macquarie Capital Markets on US wage growth that caught our eye (16 August'16). It noted that their proprietary modelling is indicating US wage growth is on the verge of acceleration across a broad sub-section of industries. In the last two broad-based expansions, the US equity market rose by an average of over 16%. The article went on to conclude that "our assessment of the current cycle is that a US recession is unlikely until at least 2020".

This relatively positive view about US equities is consistent with longitudinal analysis of US interest rate rises (previously reported) which concluded that equities continue to outperform other asset classes until at least after the 4th interest rate hike in any cycle (so far we've seen one rate rise from the Federal Reserve).

On the point of valuations, Schroder's recently crunched some numbers looking at the relationship between interest rates and the Australian Market's price earnings ratios (PEs). We hear a lot at the moment that the market is "over-valued" because PE ratios are above historic averages. As we've pointed out in the past, however, investment returns are relative and whilst the average ASX PE since inception is around 14-15 times, it is also true that as interest rates fall, the average PE rises. Notably, the average PE when bond yields have been around 5% is 12 times. When yields have fallen to circa 3%, the PE has averaged 15.5 times. Bond yields in Australia are currently at 2% and the (trailing) PE is around 16 times. So following any short term pull-back, we believe that there is scope for developed markets to move higher into the latter part of the year.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Underweight):** Whilst we remain constructive on Australian stocks in the medium term, particularly as we move into the latter part of the year, we do anticipate a short-term pull-back.
- **Global Equities (Slightly Underweight):** The US market is looking vulnerable. Uncertainty around rates and a looming Presidential election will keep a lid on equities over the next couple of months.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and reductions to interest rates), but these macro gains are now fully baked-in. In the very short term the sector might 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 less in cash and a little more in fixed interest instruments (such as income securities).
- **Cash (Neutral):** As a result of our positions in other asset classes, our net cash position is neutral

Regards

Andrew & Stephen
30 August 2016