MARKET COMMENTARY JULY 2014

EXECUTIVE SUMMARY

- Global markets performed strongly for a second year in a row, despite weak earnings growth. Valuations such as price earnings multiples moved from cheap in 2011 to somewhat expensive.
- Very low interest rates and inflation have produced something of a disconnect between equity markets and the real economy. Without stronger earnings, equity markets appear somewhat vulnerable to rising interest rates.
- Economic recovery needs to gather momentum. Global growth is forecast to increase from less than 3% in 2014 to over 3.5% in 2015.
- Australia has been lacklustre over the last quarter as a combination of political issues, weak consumer confidence, high $A, weak commodity prices have negatively impacted. At best, we see a marginal improvement in the months ahead.
- Our investment strategy is concentrated on sustainable, predictable yield with some growth, overseas earners, revenue streams linked to inflation and limited resources exposure biased to energy.

Another strong year for equities

For the 12 months to 30 June 2014, a very strong 19.3% return in the MSCI World Index, the broad measure of global sharemarket performance would infer that economic conditions and companies were in good shape. The two regions most severely affected by the GFC-USA and Eurozone-provided the strongest performances (up around 20%), while markets less impacted such as Japan and Australia were amongst the weaker performers (up 10.9% and 12.4% respectively). The only major market to lose ground in the year to June was China which declined 7.3%.

Over the last year, there has been a disconnect between euphoric asset markets (shares and property) and sluggish rates of economic recovery with weak corporate earnings growth. In contrast to the strong performance from share markets, current year earnings trends in the US and Europe are forecast to grow in 5-10% range. How can this be?

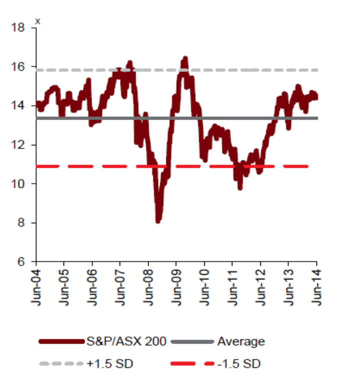
Following the GFC, aggressive monetary policy by major central banks was first designed to stabilize the financial system, secondly prevent a dangerous deflation spiral first and then support recovery in the real economy. While successfully achieving the first objective, the second remains work in progress some five years on. In the absence of a recovery in the real economy, an unintended consequence of 'cheap money' has been liquidity driven increases in asset prices and a mispricing of risk.

In a ZIRP (zero interest rate policy) world, investors have been encouraged to redeploy funds from traditional low risk investments such as money market funds to, higher yielding equities, particularly with franking and corporate bonds.

Higher multiples drive equity returns

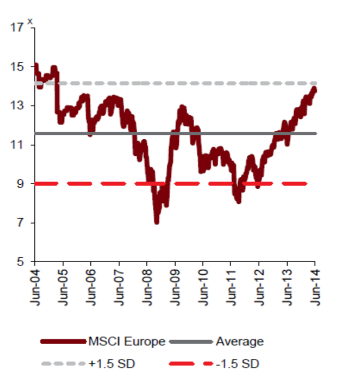
Forward Price Earnings (PE) multiples have risen significantly as a result. As seen below the forward PE of the S&P500 in the US has increased from 14x one year ago to near 16x currently on forward earnings. In Europe, the increase has been even more dramatic, rising from 11.5x to near 14x. In Australia, the PE expansion has been less pronounced, partly due to a stronger than expected rate of earnings growth from major banks, and a lacklustre market performance during the 6 months to June. The simple conclusion is that equity valuations have deteriorated over the last year, with the possible exception of Australia.

Figure 6: S&P/ASX 200 fwd PE (14.4x)



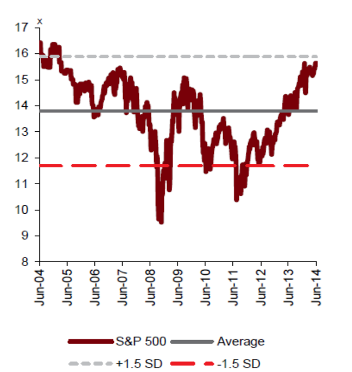
SOURCES: CIMB, COMPANY REPORTS

Figure 7: MSCI Europe fwd PE (13.8x)



SOURCES: CIMB, COMPANY REPORTS

Figure 8: S&P 500 fwd PE (15.6x)



SOURCES: CIMB, COMPANY REPORTS

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Liquidity driven markets often don't end well. The best case outcome is that recent trends of improving global growth continue over the year ahead, consensus forecasts of 3% global GDP growth are realized, central banks start to withdraw stimulus, corporate earnings growth rates strengthen and interest rates and inflation drift up modestly. This appears to be what equity valuations are factoring in at the moment.

Stronger growth, higher rates

In the months ahead, markets will most likely have to adjust to the perception that rates will trend higher in 2015 in the US and the UK. After such an extended period of artificially low rates, how markets react to this change is far from clear. However it seems fair to conclude that at a minimum, volatility will increase and it would not surprise if equities went through a 'reaction' phase. Over the last six months, markets generally have not corrected by more than 5%. According to Longview Research from the UK, the only year when there was not a 5% or more correction in the S&P500 since 1970 was in 1995. We are therefore due.

In Australia, the lack of consumer confidence post the budget is the biggest challenge. Away from the discretionary retail sector which remains challenged, housing related activity remains strong, providing banks with reasonable credit growth. The labour market is stable, savings remain historically elevated and overall wealth continues to grow. These positive outcomes are being offset by declining resources investment, declining terms of trade from falling iron ore and coal prices, a stubbornly strong $A and a declining manufacturing sector.

In many respects, the increasingly closer economic ties between Australia and China are delivering some of the same consequences. The new leadership regime in China has embarked on a major reform program affecting everything from political administration to financial markets, urbanization and supply side reform. The Abbott government has embarked on a program of economic and social reforms that are proving very unpopular. This, in part, explains why China and Australia have been amongst the worlds more poorly performing sharemarkets over the last 12 months.

Investment strategy defensive

In summary, while markets may continue higher in the near term, driven by low rates and a thirst for yield, there is an increasing risk of a market reaction given the prospects of weak growth in corporate earnings, higher interest rates and a modest uptick in inflation. This suggests to us the need for a relatively defensive portfolio structure with some liquidity in income hybrid securities and cash available for lower prices. Key features of our current thinking are:

- The duration of this asset inflationary period is impossible to call. This will become clearer when interest rates perceptions start to rise. The risk:reward is becoming unattractive.
- Portfolios remain biased towards stocks with a blend of sustainable yield plus some growth. This implies exposure to defensive, predictable earnings such as healthcare, consumer staples, infrastructure, telecoms and selected financials
- We hold some exposure to companies with the bulk of earnings in currencies other than the $A - US, Europe, and Emerging markets where growth prospects seem superior to those in Australia. These include selective industrial stocks.
- We retain exposure to companies that have revenue models that are linked to the CPI as a hedge against the prospect of rising inflation such as infrastructure and property management companies
- We see some opportunities in fragmented industries such as aged care, insurance brokers, vets and child care where successful "roll up" strategies are providing earnings growth
- We are limiting our exposure in Resources to diversified majors where volume growth is offsetting subdued prices. We favour the energy sector where volume growth is locked in and very selective gold exposure where mandates allow.

We look forward to catching up with you soon to discuss your portfolio and address any change of circumstances or issues that we might be able to help you with.

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