Returning to Normal?

30 September 2016

September 2016 Quarter

The September quarter saw a broad based recovery in global equity markets due to improved economic conditions and a recovery in commodity prices.

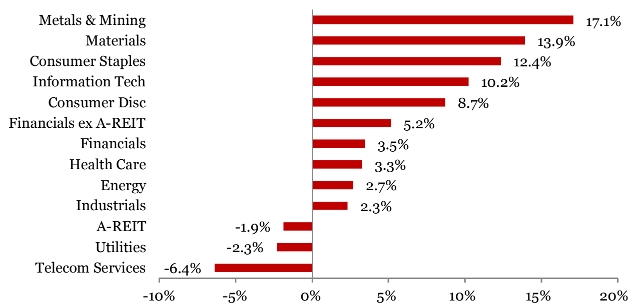
The median untaxed growth fund returned 3.2% and the median untaxed conservative fund returned 1.4% for the quarter, according to Morningstar data.

Australian shares returned 5.2% over the quarter. Within the Australian shares market, the Metals & Mining (+17.1%) and Materials (+13.9%) sectors delivered strong returns, reversing the underperformance from resources in 2015. The Consumer Staples (+12.4%) and Information Technology (+10.2%) sectors also performed well over the quarter. The Telecommunication Services (-6.4%) sector trailed the market due to lower growth expectations for internet providers.

The sectors that performed well benefitted from increasing commodity prices (resources) and from a reversal, and maybe the end of the run, for 'yield plays' - stocks that have been overvalued because investors were chasing income. Hence, sectors like A-REITS, Utilities, Healthcare and some financials underperformed this quarter. A-REITS returned -1.9% over the September quarter, after a few years of strong outperformance of the rest of the market.

The 'Value' style also performed well over the quarter as the markets started to focus again on valuation. Some market participants are seeing the falls in 'yield' stocks, the rebound in resources, and the return of investment fundamentals, as a return to a more 'normal' investment environment.

ASX Sector Returns – September quarter



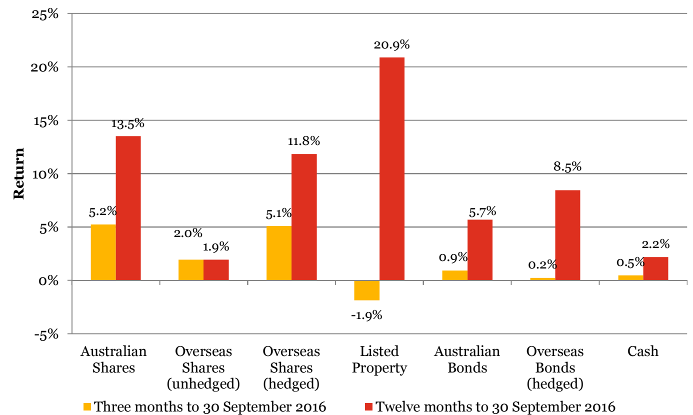
Internationally, shares recovered from falls at the end of June following Britain's decision to leave the European Union. Overseas shares returned 5.1% for the quarter on a hedged basis, but the rising Australian dollar reduced this to 2.0% for unhedged investors.

Investors initially panicked after 'Brexit' based on fears of a recession in the UK and a downgrade to the UK's credit rating, which have so far been unrealised. The pound sterling, which fell as a result of Brexit, and a rate cut in the UK have helped the UK market perform better than expected, returning 7.0% for the quarter.

US shares gained 3.9% over the quarter in the lead up to the presidential elections in November. At this point Hillary Clinton is ahead of Donald Trump as the preferred candidate, which is positive for markets, but neither candidate is generating a lot of enthusiasm. Economic data released during the quarter indicated that income and consumption was rising in line with expectations.

Investors were also optimistic about reports that Deutsche Bank was close to settling with the US government over an investigation into residential mortgage-backed securities sold in the lead-up to the financial crisis.

Asset Class Returns – September quarter



1. *All market returns shown above are before tax and before investment costs.*
2. *Indices used are outlined in the Disclaimer section of this newsletter.*

The Japanese share market returned 7.2% this quarter, recovering some of the losses made in earlier quarters. The Bank of Japan has maintained interest rates at -0.1%. The Japanese yen finally started to weaken in response to stronger US economic data.

The European share market returned 5.1%, over the quarter. The Italian banking sector continued to weigh on European markets but markets were boosted by reports that the US government's investigation into Deutsche Bank was close to settling at a sum much lower than expected. Emerging market shares returned +7.6% (MSCI EM Index) for the quarter.

China's share market (based on the MSCI China Index) posted a +13.9% return over the quarter as the share market and industrial production start to show signs of stabilising.

Since 30 September 2016

The pound sterling continued to weaken following Prime Minister Theresa May's announcement that the UK would begin the process of exiting the European Union by March 2017 and that that the UK may introduce stricter immigration policies despite the risk of losing access to Europe's single market.

Commodity prices, particularly oil, have shown signs of stabilising following talks held by OPEC members to curb output.

Outlook

We believe that the major asset classes are broadly at fair value, but there are increasing risks as equity market gains have come from expansion of the price/earnings multiple and not rising corporate profits (see article later in this newsletter). We do not see a need for clients to deviate from their long term asset allocations at this stage, but markets may be vulnerable to shocks.

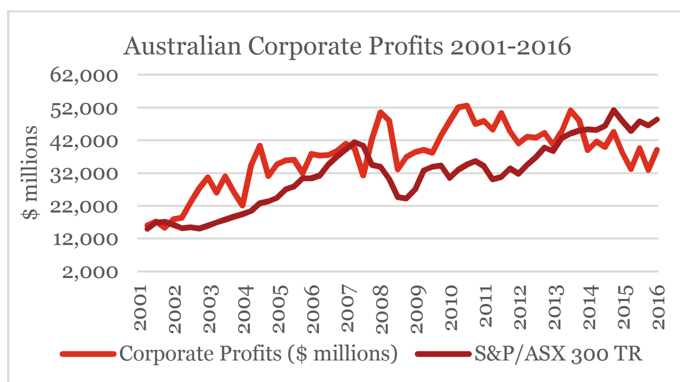
Some key issues going forward include:

- **Global Interest Rate Policy** – The US Federal Reserve (Fed) is expected to increase interest rates in the future; however, the pace of the increases is expected to be slow and subdued. At the September 2016 meeting, the Fed kept interest rates unchanged citing further evidence of economic progress is needed before increasing interest rates. The European Central Bank and the Bank of Japan have wound back their respective asset purchasing programs. Continued efforts by these central banks to stimulate the economy have not delivered the intended outcomes.
- **Commodity Prices** – The September quarter saw potentially the bottom for commodity prices. Over the quarter iron ore prices increased from $51.4 to $56.7, and coking coal prices increased from $73 in January to $187 in October. These price increases led to increases in the prices for resource stocks and some optimism that the downward trend has turned for the resources sector.
- **US Election** – The US Presidential election in November is being closely monitored by global financial markets. Both candidates have expressed disapproval of the Trans-Pacific Partnership Trade Agreement and raised dissatisfaction of a number of current trade agreements already in place, which may dampen business and consumer confidence.

Profit – Equity Market Divergence

Over the longer term, company profits and the Australian equity market have generally moved in the same direction. Higher profits translate to higher returns on equity markets. However, since 2013 profits have fallen by 24% but the S&P/ASX 300 has increased by nearly 10%. This divergence has also been observed in many other equity markets.

The S&P/ASX 300 is now 16% higher than its 2007 peak, while company profits have declined by 1% over the same period. The growth in the US S&P 500 is about three times the growth in company profits since its 2007 peak.



Source: Australia Bureau of Statistics

If profit growth is not driving equity markets, what is? Interest rates in Australia and in many other countries have fallen over the last few years. As interest rates fall, the decrease in the discount factor applying to future earnings can support an increase in equity market prices.

Also, equity prices reflect future earnings and not just current earnings, so there must be some expectation that corporate profits will recover at some point. Looking ahead, the earnings prospects across various industries is bleak.

Despite Healthcare being one of the strongest-performing sectors for the year to 30 June 2016, the industry saw some of the largest revisions of earning projections in August. New guidelines introduced by the federal government prevent aged care providers from charging fees for certain services and the sector is also expected to suffer funding cuts and greater scrutiny in the 2016/2017 budget.

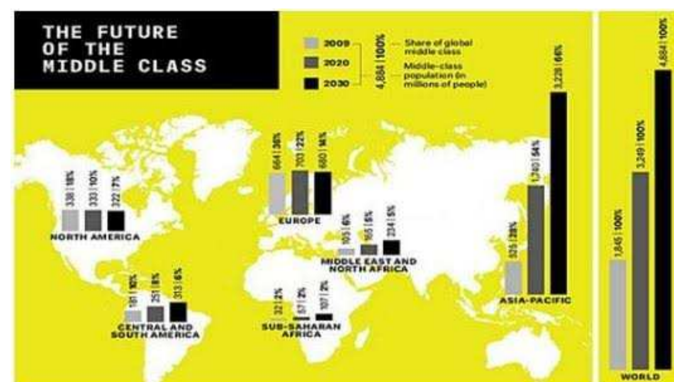
Revenue expectations were also weakened by greater regulatory and capital requirements placed on banks and the slow recovery of commodity prices.

If profits and equity market continue to diverge, the concern is that equity markets will eventually run out of steam and suffer some sort of correction. Unless profit growth improves, the current market rally is unsustainable.

Better in the Middle?

In the developing world the middle class is expanding rapidly and is seeing higher incomes, which will have a profound impact on many economies and international trade. In the developed world the middle class is being squeezed and incomes have been stagnant. The dissatisfaction of middle income voters is being felt politically in a number of countries.

The middle class population is expected to grow from 1.8 billion in 2009 to 3.2 billion people by 2020 and 4.9 billion by 2030. Most of this growth is expected to come from the developing world, where economic growth has led to higher income levels and consumer spending. By 2020, just over half the middle class population will be found in Asia, and by 2030 the Asian middle class is expected to grow to over 60% of the total middle class population.



Source: The Atlantic Magazine May 2015 issue, "The Disintegration of the World"

China and India have the largest populations in the world but a relatively small middle and upper class. As both countries develop economically, those in the lower class stand to gain the most from opportunities in employment and improving their standard of living. In addition, a significant proportion of people in the lower class are only just below the income threshold for the middle class. Hence, even a slight improvement in income levels would see a significant shift of people from lower to middle class ranks. By one estimate, China's middle class comprises some 109 million adults, five times the size of Australia's population.

While the middle class is growing rapidly in developing countries, the middle class in developed countries has stagnated and in some places, the real income of the middle class has declined. Middle class citizens in the US and Europe have taken to the streets to vent their frustrations with public systems and political parties that have proven inept at handling economic and social crises such as the loss of jobs to cheaper overseas markets and the refugee crisis in Europe.

The growing dissatisfaction of the middle class in developed countries has made many in the political class nervous. The middle class have always been counted on to support progressive political agendas, economic liberalisation, and globalisation. However, as the middle class becomes more disillusioned with their standard of living, populist political views are emerging and threaten to shake up the political and economic balance of powers.

The growing middle class population in Asia and other developing countries presents an opportunity for Australia. As incomes increase, spending obviously increases but it also changes in favour of discretionary and leisure items. These include services such as travel, health, finance and education. Blackmores is a great example of an Australian company that is capitalising on the demand from Asia's middle class for vitamins, minerals, herbal and nutritional supplements.

Demand for Australian produce, such as beef and milk, is increasingly coming from Asia, where local produce is considered inferior and not necessarily safe to consume. China recently became our largest export market for wine, after a 51% increase in the last year.

Tertiary education providers have also benefitted from expanding into Asian markets, by capitalising on their prestigious status in Asia. Many have established a considerable online business in Asia. One Australian private secondary school already has operations in eight cities in China.

In 2015, over 500,000 Chinese travelled to Australia for a holiday. These numbers are expected to grow strongly with China projected to overtake New Zealand as our largest international market by arrivals in 2019-20. Importantly, Chinese visitors spend more in Australia on average than visitors from any other country.

Asher Judah, author of The Australian Century, sums up the importance of the next decade best - "*The rise of the global middle class will pave the way for a new golden age in Australian society*".

The Rise of ETF's

Exchange Traded Funds (ETFs) are gaining rapidly in popularity and are now being used by many different types of investors, from large experienced institutional funds through to the most novice of investors. ETFs can be used to provide investors with exposure to an index e.g. the S&P/ASX 300 Accumulation Index or any group of stocks. The growth in ETFs in Australia has been rapid; between July 2004 and September 2016 the annual growth rate has been 31%, and assets currently stand at $24.1 billion (25% of which has been invested in the past twelve months). The range of different types of ETF is also expanding rapidly, giving investors cheap and easy exposure to a range of assets.

There are commonly two types of ETF:

- Physical ETFs – which buy the underlying investments on the reference index that the ETF is seeking to track; and
- Synthetic ETFs – which utilise derivatives and the underlying investments to derive the reference index.

A benefit of these investment products is that they provide access to a broad number of securities whilst having relatively low fees compared to other managed investments. ETFs are often used to achieve the benchmark return of sectors which are difficult to actively manage or outperform after fees. They are also used to apply short-term tactical tilts to portfolios as well as achieving a temporary exposure during transitions. In addition, investors often combine multiple ETFs to gain broad market exposure and diversification, for example to create a balanced portfolio. Other ETFs offer investors the ability to gain exposure to more unusual investments than they normally would; for example, emerging markets and commodities.

Another advantage of ETFs is the daily liquidity which is seen as a benefit for most investors; however, some sceptics have questioned how some ETFs can be more liquid than the underlying assets which they trade in, for example an ETF that trades throughout the day despite including some stocks that may not typically trade every day. The market price for an ETF is based on supply and demand, which during periods of volatility can create an imbalance and forces the ETF to trade at a premium or discount to the actual value of the underlying assets. In most cases arbitrage traders or the issuer will step in to ensure that the ETF trades at close to the underlying value.

One example of an ETF that has had issues maintaining its market price relative to the Net Asset Value (NAV) is AMP Capital's China Growth Fund. Recently investors in the ETF voted for the fund to be wound up, with the main reasoning being that the ETF has traded at a discount for some time, at one point the ETF traded at over a 35% discount. The wind-up will force the sale of the assets and the return of capital to investors at the full net asset value.

Some key aspects to consider when investing in ETFs are:

- Liquidity – if the underlying investments are easily bought and sold then it is likely you can buy and sell ETF units at the fair price rather than at a discount/premium;
- Check that the market price for the ETF is close to the NAV per unit of the underlying investments in the ETF, this will provide an indication as to whether the ETF is fairly valued;
- Consider the timing of buying or selling, during periods of market volatility ETFs can trade irrationally and may not offer a fair price; and
- Investing in Synthetic ETFs exposes investors to derivatives and therefore adds further risks.

ETFs seem like they are here to stay and will become an increasingly important part of investors' product mix.

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All reasonable care has been taken to provide performance and investment data that are accurate. However, we have relied on a range of external sources for data. As a result, we are unable to guarantee the accuracy of the data contained in this document.

Indices Used:

Australian Shares: S&P/ASX300 Accumulation Index

Overseas Shares (unhedged): MSCI World(Ex Australia) Index in Australian dollars

Overseas Shares (hedged): MSCI World(Ex Australia) Index (hedged)

Listed Property: S&P/ASX300 Property Trust Accumulation Index

Australian Bonds: Bloomberg AusBond Composite Bond Index (All Maturities)

Overseas Bonds (hedged): Citigroup World Government Bond (Ex-Australia) Index (Hedged)

Cash: Bloomberg AusBond Bank Bill Index

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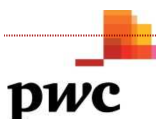

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