

## **MARKET COMMENTARY: October 2013**

### **EXECUTIVE SUMMARY**

- Europe, Japan, China and US to deliver stronger growth in 2014
- Unconventional monetary policy elevates political risk, as individual and corporate sector risk declines
- Australia set to navigate between mining investment boom and more conventional economic cycle
- New government expected to lead a stronger non-mining economy, better corporate earnings in 2014
- Market to push towards 6,000 in 2014 but portfolio strategy to be maintained towards defensives; infrastructure; overseas earners, fully franked dividends with more neutral positions in Resources, Energy and Cyclical

### **Global Trends**

Boosted by increasing confidence that the global economy is experiencing a synchronised recovery as we head towards 2014, financial markets have experienced a good year and a strong quarter.

During the course of 2013, the US economy has continued to see modest growth (notwithstanding politicians best efforts to derail the recovery), Europe has stabilised with embryonic signs of improvement. Abenomics in Japan has improved confidence and the new leadership regime in China appears to have successfully put a floor under growth at around 7.5%pa. While markets are aware of these improving trends, ample liquidity should support rising markets through 2014, giving confidence to a 'buy on weakness' strategy.

### **Political Risk**

What is concerning us is increasing political risk. Since the GFC, we have observed reduced levels of risk in the private sector as individuals have de-gearred and de-risked personal activities and balance sheets. We also observe lower levels of corporate risk, as companies have strengthened balance sheets, through increased cash. Regulators have forced financial institutions to increase capital reserves and adopt more conservative lending practices.

### **Government Balance Sheets**

Conversely, government related balance sheets globally have deteriorated. Policy settings have become higher risk and in several cases, have taken activities into uncharted waters with respect to the consequences. We would cite the US, the Eurozone (broadly), Japan and to some extent China as examples of this trend. Clearly this represents a significant part of the global economy and financial markets. The current situation in the US is a live example of this elevated level of political risk.

### **Relevance to Your Portfolio**

To the extent that "an event" emerges out of the political realm that impacts financial markets, we intend to continue running defensive portfolio structures that are capable of withstanding some market volatility. By nature share prices and portfolios are always vulnerable to short term falls, but as we saw in the post GFC era, good companies and well-constructed portfolios do recover.

### **Australia under a Liberal Coalition**

While the Australian market has given a very hearty endorsement to a change of government courtesy of a 10% gain in the September quarter in the ASX200 index, we do see the Australian economy at something of an inflection point. The mining investment boom that has underpinned economic growth in recent years has peaked. As its contribution declines in the years ahead, it will need to be replaced by more domestically focussed sectors such as retail, housing, infrastructure and the like. While there have been some early signs of a housing recovery with stronger consumer and business confidence, we are yet to see sufficient strength to offset the declining level of mining investment.

## Australian Earnings Prospects

The ASX200 Index has moved from 4,500 to 5,200 since June. This increase has been entirely driven by higher PE ratings (from under 12x earnings to more than 14x currently). We believe that we will start to see upgrades to earnings to justify the 5,200 level. If not, this level is vulnerable. Some of the factors that we are looking for to provide a boost to corporate earnings growth are:

- Continued momentum in the global economy, raising GDP growth towards 4% in CY14 from near 3% currently
- The conversion of better consumer and business confidence into stronger domestic economic activity
- A lower \$A, preferably somewhere in the 80's against the \$US
- A recovery in non mining investment spending, including public sector infrastructure

## Market Strategy

Should the majority of these events come to pass, and in the absence of a "political accident", the ASX 200 index should push towards 6,000 points during the course of 2014. Lending support to the achievement of this level will be historically low and benign interest rates in Australia. Cash levels remain at high levels for many individual investors, and we anticipate an asset reallocation to continue from cash into higher yielding securities – floating rate securities and equities.

## Investment Strategy

In the context of our earlier comments regarding defensive portfolio structures, our key investment themes currently are:

- Maintain a bias to defensive industries such as Healthcare (Ramsay), Consumer Staple (Wesfarmers), Infrastructure (Transurban, APA) Telecoms (Telstra, IINet), Banks
- Overweight companies with overseas earnings, particularly those with global franchises such as CSL, Fox, Brambles
- Overweight companies with a relatively high, fully franked yield that has good prospects for growing the dividend over time (Banks, Telstra, Wesfarmers)
- Maintain a neutral position on Resources, with a bias to energy (BHP, Santos) and away from base metals and iron ore (RIO).
- Maintain limited cyclical exposure, with emphasis on yield (Adelaide Brighton, Stockland, Asciano, Perpetual)

## New Investment Themes Under Review

The first is the emergence of the Chinese consumer. We recently attended an investment conference sponsored by Credit Suisse on the dairy industry in Australia and New Zealand. The Asian markets and China in particular are showing strong appetite for protein including milk. We are currently evaluating investment opportunities in the sector.

The second is a substantial increase in infrastructure spending in Australia. It seems clear that Liberal Coalition governments are committed to a broader range of long term funding alternatives. We see this as very positive, and will create a range of attractive investment opportunities.

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.

**Ian Wenham**  
Director  
02 8274 5808

**Richard Nicholas**  
Director  
02 8274 5809

**Andrew Martin**  
Director  
02 8274 5801

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