MARKET COMMENTARY APRIL 2015

Executive Summary

- Global growth outlook remains mixed. While US growth continues and Emerging Asia improves, China faces headwinds and Europe & Japan are in the midst of Quantitative Easing programs. Deflation concerns have eased, but not abated.
- Over 20 Central Banks are cutting interest rates fuelling a global search for yield, Australia included. Asset markets such as equities and property continue to inflate.
- Deterioration in Australia's prospects amid political challenges favour International sector thematic opportunities through ETF's and overseas earnings
- Oversupply of most commodities, slowing demand in China and a strong $US sees commodity prices weaker along with commodity based currencies such as the $A.
- Valuation levels, neither cheap nor expensive in a low rate, low inflation environment. Skeptical of resources and energy rebounding in 2016. The lack of momentum in corporate earnings growth stands as the biggest single risk to equities.
- May to October remains weakest period for markets after a historically strong March quarter. Our investment strategy continues to be focused on companies offering a balance between yield and growth.

Review of the March Quarter

- Australia, like other markets that are engaged in policy easing mode such as the European markets, Japan and China, have all enjoyed strong first quarter gains. Germany has been the standout, rising 22%.
- Commodity prices have continued to weaken with oil down more than 10% over the quarter, iron ore down 28% and coal prices down 15%.
- Despite the weakness in commodity prices, as well as a meaningful decline in interest rate spreads with the US, the $A has only declined 7% against the $US and less than 5% against the Euro.
- Stocks and sectors performing strongly during the quarter have continued to be those offering a combination of yield plus growth (financials, infrastructure, property, telecom), and companies with the majority of earnings coming from outside Australia (healthcare, selected industrials).

The reporting season in February highlighted the following continuing trends:

- A distinct lack of growth in revenue
- Continued management emphasis on cost cutting to protect margins
- Benefits from lower funding costs
- An increased emphasis on capital management, including special dividends and share buybacks
- Substantial cuts to resources related investment, and limited evidence of new non mining investment outside housing

Deterioration in Australia's Prospects Favours International Opportunities

From an Australian investors' perspective, arguably the most significant event during the opening quarter has been the deterioration in the short to medium term outlook. Several factors have emerged-some international, some domestic-that warrant a review of current investment strategy. Of significance:

Recent election results-other than NSW-highlight the political challenges associated with embarking upon structural reform programs, even of a longer term nature. With the Murray Review, the Tax White Paper, the Inter-Generational Review among others all in the "melting pot", it is hard to see how business and consumer confidence have much chance of recovery.

So our conclusions are that over time, we are likely to see the rate of growth in Australia under pressure relative to a number of other markets and that the $A still has downside risk as we go through the adjustment phase. As a consequence, where mandates allow, portfolios should hold an increasing proportion of exposure to international markets, either directly or through the overseas earnings of Australian companies.

In view of slower growth in demand for commodities by China, and producers willingness to increase supply (iron ore, LNG, oil), the outlook for price recovery in the near term looks challenged.

Review of Investment Strategy

For the sake of consistency, but also because it has continued to deliver results, we repeat the opening para from our October and December 2014 Market Commentary:

"…we remained positive towards Healthcare, Infrastructure, Financials and companies with significant overseas earnings…Those key metrics of metrics of predictable yield with growth, companies earning revenues in non $A, and limiting resource companies contributed positively to performance." This still seems appropriate.

- Our expectation is that outlook for Australia will lead to further cuts in interest rates and a lower $A. While key sectors domestically will generate top line growth due to sector specific factors, others will struggle (ie retailing, mining & mining services, engineering).
- As a way of increasing International exposure, we have primarily used Exchange Traded Funds ('ETF's). Conceptually, ETF is a Fund listed on the Australian or US Exchanges that invests into an index of market shares or sector shares according to their index weighting and is benchmarked against that underlying Index.
- The advantage of the ETF is that we can buy or sell the ETF on the relevant market, with 3 day settlement and pay a lower management fee. Managed Funds don't necessarily provide the same access and settlement and will likely charge a higher fee.
- From our perspective, the development of ETF's offers us the ability to utilize our international experience to make informed investment decisions on sectors, markets and thematics, through a basket of stocks to spread the risk.

To be specific, here are some examples of our current thinking on ETF's:

- Global Technology: Holds Apple, Google, Microsoft, Samsung Electronics
- Global Healthcare: Holds Johnson and Johnson, Pfizer, Novartis, Bayer
- WisdomTree European: Holds Anheuser-Busch, Daimler, Unilever, Siemens
- WisdomTree Japan: Holds Toyota, Mitsubishi Finance, Canon, Takeda, Nissan
- Chinese & India: High growth Emerging economies
- Global Clean Energy: Vesta Wind, First Solar, Sun City

Outlook

While April has historically been the strongest month for equity returns, May through to October tend to deliver lackluster performance. Following the strong performance year to date, and with a soft quarterly reporting season expected in the US during April and May, a period of consolidation would not surprise.

From a global perspective, valuations, while not cheap, are not extreme. PE ratios in most developed markets have converged around 17x for 2015 and 15.5x for 2016. While earnings growth numbers have been revised down significantly for 2015 on the back of lower oil and other commodity prices, double digit growth is forecast for 2016 (in part driven by some recovery in Energy prices). Interest rate trends remain supportive, including the US, where higher rates continue to be delayed. Benign trends in inflation are also supportive of equities.

Australia has similar investment metrics. For the ASX300 index, Goldman Sachs have valuations at 17.4x (2015) and 15.6x (2016) and forecast earnings respectively. Overall earnings growth numbers are -2.8% in 2015 and +12% in 2016. For Industrials, earnings growth is forecast to be +9% in both 2015 and 2016. Resources are -43% in 2015 and +30% in 2016.

In a continuing low interest rate and inflation environment, a future 2016 PER of 15.5x is not expensive with grossed up dividend yields of over 6% relative to cash rates. At 5,891 (8/4/15), a rebound in earnings growth provides the basis of a further 10% total return from Australian equities over the next 12 months, made up of a 4% dividend yield (plus franking) and 6% capital gains; taking the ASX200 index to 6250.

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

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