MARKET COMMENTARY: JULY 2015

EXECUTIVE SUMMARY

- The negative June quarter took away 65% of first quarter returns, but annual returns of 5.7% still acceptable
- Banks fell heavily with lesser falls in consumer stocks, healthcare and REITS
- Notwithstanding Greek uncertainties, growth in Europe, US & Japan look to be stronger in 2015
- Views on China remain mixed, with short term equities sell off affecting the Australian market
- Australian economy challenged between declining business investment and strong building approvals
- Rising US bond yields to act as headwind but should herald re-emergence of growth
- Equities still offer attractive dividend yield particularly with franking credits
- Post correction, Australian PER valuations returned to 15x, but earnings growth in 2016 looks challenging
- Better earnings growth prospects overseas – we highlight global thematic Exchange Traded Funds ("ETF's")
- Income yield stocks continue to outperform, but the declining A$ will help our exporters

What the ASX 200 Accumulation index "gaveth" in Q1 (ie a 10.3% gain), it took much of it away in Q2 with a 6.6% loss. Financials - that account for 30% of the ASX 200-declined by 9% with Banks alone being down 12%. Consumer Stable stocks declined almost 10%, Healthcare down 6.5% and REITs down 5%. Global markets have experienced similar trends generally with the US and China being at the more extreme ends - ie US down less than 5% and China more than 20%, reflecting their different growth and risk profiles. Key factors leading to weakness include Greece, China and expectations of rising interest rates.

Observations from Overseas

During May, we were fortunate to meet a number of professional investors in London and Hong Kong. Some of the more interesting points coming out of the meetings included:

- Consistent view that growth in the US, Europe and Japan will be stronger in 2016
- Markets do not have cheap valuations and are at risk when the US Federal Reserve commences it's phase of increasing rates
- Views on China, as usual, are mixed. The Asian view tends to be more positive. Significantly, China is moving towards a far more prominent position in the global village as its financial markets open up to foreigners
- Not withstanding Greece, recovery in Europe including the periphery continues to gather pace. Reforms in Spain and even Italy and France are underway to varying degrees
- Greece is expected to be resolved in the near term via a debt restructuring or a Grexit
- The subject of "disruptive technologies" (new technology based business models threatening incumbents) came up. Key issues raised included climate change, e-commerce, the "internet of things", new business models operating at the regulation periphery such as Uber and FinTech.

China

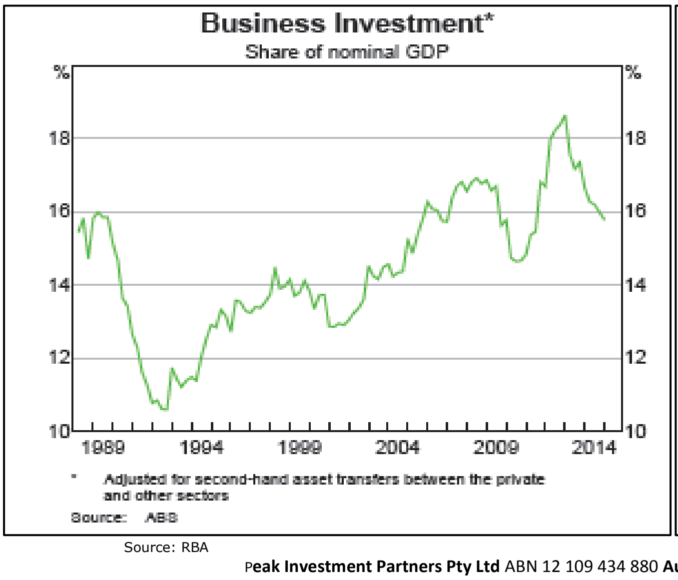
Of greater significance to Australia is the recent sell off in Chinese equities and the heightened level of market turbulence with much of the market suspended from trading. This has had a negative impact on commodity prices, especially iron ore.

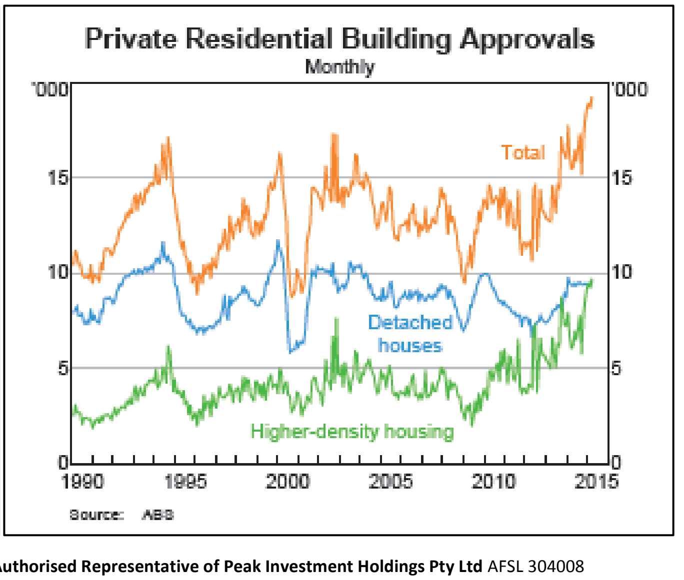
The China CSI 300 index increased 140% from its 12 month low, and has recently corrected more than 40%. Unless this volatility settles down, there is a risk that the real economy begins to suffer disruption and lower growth. For Australia, this could mean lower commodity prices and also a lower $A.

Australia "Challenged"

The transition from an economy driven by record high commodity prices and related investment, to one where consumption and services take over has proven challenging (see business investment chart below). Housing has recovered strongly and seems set to continue into 2016, given a record high level of housing approvals as shown below. Consumption is growing modestly, full time job creation is minimal (though part time is growing), wages growth is historically low and public sector investment (ie infrastructure) is declining.

There are a couple of "greenshoots" amid the gloom. Business and Consumer Confidence have both increased over the last quarter. Lending to businesses by Banks has been strengthening. The most populous states of NSW and Victoria are now growing much faster than WA and Queensland. Infrastructure spending in NSW is to strengthen from 2016 onwards. These trends would be well supported if the $A was closer to 70c against the $US.





Source: RBA

Investment Strategy

In recent years, the May to July period has been the low point in the equity market seasonal calendar. The recent correction in 2015 of circa 10% in most markets including Australia has been seasonally consistent. Significantly, it has discounted the inflection point in interest rate trends after several years of zero interest rates in the US and a 30 year old bull market in bonds.

While rising bond yields are providing a headwind, we see a number of positives that should support equity markets over the next quarter or two. These include:

- Strengthening economic activity in the US, Eurozone (Greece aside), Japan and stabilization in China. Recent leading indicators appear supportive.
- Earnings growth momentum industrials in housing, media, healthcare and telecom are expected to improve into 2016
- Equities continue to offer attractive dividend yield compared to other asset classes

Valuations now more attractive

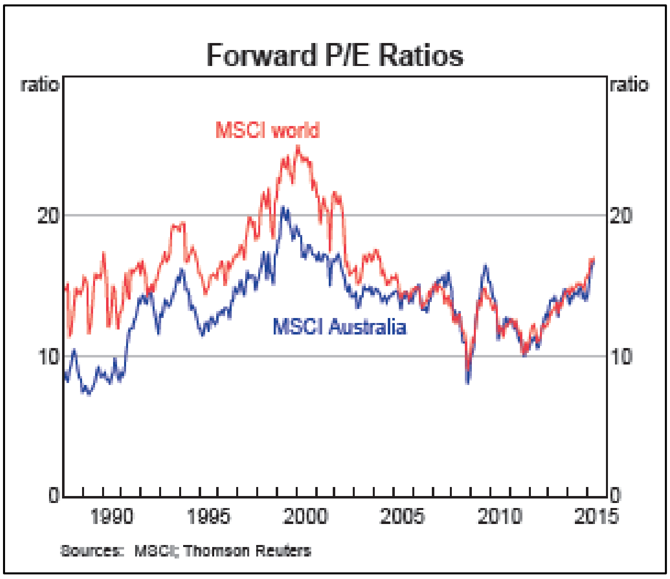
Following the recent correction, the PE for 2016 has got back to 15x earnings according to Macquarie Research, with Industrials (ex Financials) at 15.9x and Banks at 13.3x. While overall earnings growth looks anaemic at -2.4% in FY 15 and 6.4% in FY16, Industrials ex Financials is 8.6% in FY 15 and 11.6% in FY 16. The laggards for FY 16 include Banks at 3.9% and Resources at -1.4%.

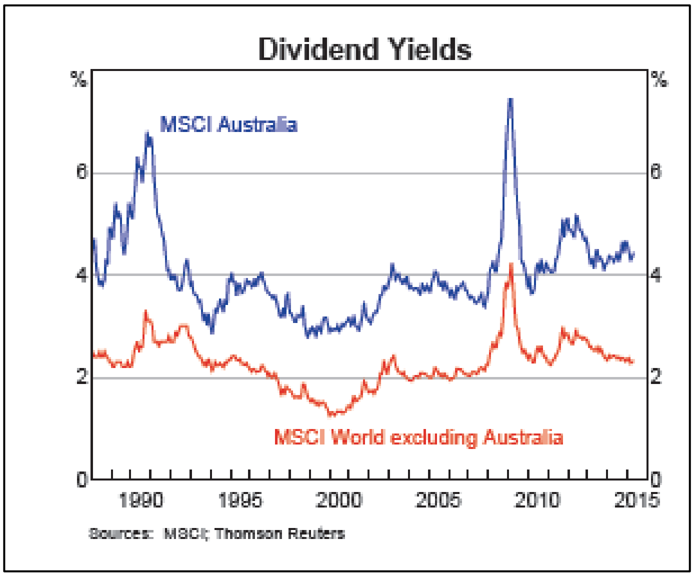
We continue to favour the combination of yield plus growth. Australian interest rates are not expected to rise in the short to medium term, making fully franked dividend yields of circa 5% very attractive – grossed up to >7%

We also continue to be very selective on sector exposure. Healthcare, Infrastructure, Financials, telecoms, select Industrials and Energy. Several smaller companies are also attractive - where we suggest you speak to us re the Peak Smaller Company SMA offering where returns were circa 15% p.a. over 3 years to 30 June 2015 (Source: Praemium, Peak).

Offshore we continue to find investment opportunities. Given our general cautiousness on Australia's growth prospects, we see Exchange Traded Funds ("ETF's") investing in Europe and Asia as being relatively attractive. We also continue to see thematic funds in areas such as renewable energy, global healthcare, cyber security, technology as being attractive for Australian investors.

Consistent with recent history, "growth" stocks has continued to struggle and disappoint, while "yield" has outperformed. Portfolios structured towards growth stocks such as Qube, Flight Centre, Seek, Ramsay have struggled, especially with the Banks also significantly underperforming. Infrastructure stocks outperformed - despite delivering negative returns - as did Telstra, Ardent Leisure along with a number of Resource stocks such as BHP, Oil Search, and internationally exposed companies such as James Hardie and Macquarie Bank.





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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