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Investment Market + Portfolio UPDATE

26 October 2015

Summary of key points

- There is a global shortage of inflation and consumer spending. China, Japan and Europe are competing to export deflation and import inflation via looser monetary policy and falling exchange rates.
- This global shortage of inflation has caused the US Federal Reserve to defer an increase in short-term interest rates off the floor where they have been since 2008.
- This has caused a significant shift in financial market conditions over the last month or so. There is now an increased flight to safety in the form of higher allocations to long-term bonds by major institutional investors worldwide. This is offsetting risks of an increase in bond yields that had been identified previously.
- Bond yields are now more likely to stay low or even fall slightly, rather than increase over the next three years. This makes equities, particularly in the USA and Australia, more attractive than we had previously assessed.
- The patient accumulation of cash in recent times of falling and unstable equity markets is now likely to be rewarded by increasing the allocation to equities, which, most of the time, in the longer run, provide superior returns compared with cash or fixed interest.
- Over the next year, caution is still needed because no major developed equity market is particularly cheap on a scenario-weighted basis, although the Australian and US equity markets are less expensive than other markets.
- There is still the prospect of volatility in major stock markets in the months ahead, so it would be prudent not to be overweight in equities yet. Such a move to overweight could be considered if equities prices pull back by 10% or more below the current level. Given the continued volatility of markets and the fragility of the economic recovery, such a pull back in equity markets is quite possible over the course of the next year.

What to do next with Investment Portfolio Strategy

A sensible strategy to adopt is to move from a slightly underweight equities and re-invest in equities from a much longer-term point of view, particularly if financial markets weaken significantly as they often do. In summary:

- The allocation to Australian and international equities should be cautiously increased back up to benchmark levels over the next three to six months.
- Keep an overweight allocation to alternative equities, which are focussed on making absolute or positive returns in turbulent market conditions.
- Maintain a neutral weighting to property and infrastructure.
- While the risk of a rise in long bond yields over the coming year has receded, it is still sensible to keep fixed interest assets short dated and flexible.

Recommended asset allocation positioning for a three-year horizon

RECOMMENDED ASSET ALLOCATION RELATIVE TO BENCHMARK OR NEUTRAL	ZERO	MAJOR UNDER WEIGHT	UNDER WEIGHT	NEUTRAL OR BENCHMARK WEIGHT	OVER WEIGHT	MAJOR OVER WEIGHT
ASSET CLASS						
Cash				✓		
Fixed interest			✓			
Property & infrastructure				✓		
Australian equities				✓		
International equities				✓		
Alternative equities					✓	

Where are we now?

Since the end of August:

- Major equity markets fell sharply towards the end of September amidst great uncertainty about the likely path of US interest rates. This was brought on by the Federal Reserve failing to lift its short term Federal Funds rate as markets had expected. It was exacerbated by continuing concerns that growth of the economy in China may be slowing more quickly than previously expected.
- Commodity prices also fell sharply. There is clearly a continuing oversupply of many commodities, including oil, natural gas, coal and iron ore. Gold, which behaves like a currency is slightly stronger versus the USD as a result of the deferral of interest rate rises.
- Global short-term and long-term interest rates have been relatively stable over the course of the last two months and remain at record low levels.
- These very low interest rates provide continued support for financial asset prices. Since the end of September major equity markets in the USA, Europe (other than Germany) and Australia, have all risen and are now higher than they were at the end of August before the sell off.
- While there is still some potential for increases in longer-term yields which would have the potential to further undermine bond and equity market prices, the prospect for this has receded over the last month.
- Since the end of August, the Australian dollar has risen against all major currencies, driven by a perception that a rise in US interest rates has been deferred.

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Where are we now? cont.

Table 1: Financial market movements

MARKET INDICATOR	LEVEL AT 30 JUN 14	LEVEL AT 30 JUN 15	LEVEL AT 21 OCT 15	CHANGE 2014/2015 FINANCIAL YEAR		MOVEMENT SINCE START OF 2015/2016 FINANCIAL YEAR	
				IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD
EQUITY MARKETS							
S&P ASX 200	5394	5515	5246	2.2%	2.2%	-4.9%	-4.9%
USA: S&P 500	1960	2057	2030	4.9%	28.9%	-1.3%	4.2%
UK: FTSE 100	6743	6620	6345	-1.8%	10.8%	-4.2%	-0.7%
GERMANY: DAX	9833	11083	10147	12.7%	13.0%	-8.4%	-1.8%
FRANCE: CAC	4422	4869	4673	10.1%	10.4%	-4.0%	3.0%
JAPAN: NIKKEI 225	15162	20235	18523	33.5%	35.6%	-8.5%	-1.5%
CHINA: HANG SENG	23200	26250	22989	13.1%	38.9%	-12.4%	-7.5%
CURRENCIES							
USD/AUD	0.943	0.7679	0.727		22.8%		5.6%
GBP/AUD	0.5511	0.4881	0.4709		12.9%		3.7%
YEN/AUD	95.32	93.81	87.2		1.6%		7.6%
EUR/AUD	0.6886	0.6866	0.64		0.3%		7.3%
INTEREST RATES							
AUS: 90 DAY BANK BILL % P.A.	2.68	2.19	2.15	-0.49		-0.04	
AUS: 10 YEAR GOVT BOND % P.A.	3.54	3.01	2.61	-0.53		-0.40	
US: FED FUNDS RATE % P.A.	0.09	0.13	0.11	0.04		-0.02	
US10 YEAR GOVT BOND % P.A.	2.53	2.32	2.07	-0.21		-0.25	
COMMODITIES							
COPPER US $ PER TONNE	7035	5767	5201	-18.0%	0.7%	-9.8%	-4.7%
GOLD USD/OUNCE	1326	1175	1171	-11.4%	8.8%	-0.3%	5.3%
OIL USD/BARREL (WTI)	105	58.29	46.03	-44.5%	-31.8%	-21.0%	-16.6%

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Assessment of equity markets

The assessment of equity markets is essential to setting overall portfolio strategy and how much to hold in growth assets.

We have revised our assessment of equity markets in Australia and elsewhere based on a significant re-evaluation of the likely path of long-term bond yields over the next three years.

Valuation is the most important part of our assessment. Essentially we compare the current pricing of equities in world share markets with an estimate of the longer-term Fair Price of each market.

The key assumptions in the assessment of the long-term Fair Price are long-term bond yields and long run earnings per share growth. A lower expected long-term bond yield implies a higher Fair Price for equities.

While we have not changed our assessment of expected earnings per share growth in major equity markets, we have shifted our expectations about the path of long-term bond yields in the USA and in Australia.

We had previously factored in events in China, which have led to a reduction in holdings of US Treasury bonds by the institutions, which manage Chinese foreign currency reserves. This puts upward pressure on US ten year Treasury bond yields which flows through to Australian ten year bond yields, which are closely correlated with their US counterparts.

Offsetting this effect on bond yields, institutional investors worldwide are now seeking the comparative safety of holding more bonds when equity markets are unstable or weak. Together with continuing evidence of slow growth worldwide and disinflationary or deflationary pressures, this has led us to reassess long term bond yields with the assistance of key input from BCA, a major North American investment research house.

Bond yields are now expected to stay lower for longer. US ten year Treasury bond yields may well decline by 0.5% p.a. or more in the course of the next one to three years. This will provide continued support for equity prices, particularly in interest rate sensitive sectors such as real estate trusts. As a result our long-term fair price assessment of equities has been upgraded, making the current market prices more attractive, especially in the USA and Australia.

Our assessment of the long-term rate of growth in earnings per share depends on assumptions about the long-term rates of inflation and real economic growth, as well as the rate of issuance of new equity or buy backs of equity. These are unchanged and are set out in table two below.

Table 2: Earnings per share growth rates for equity markets
EPS Growth Assumptions over 10 years
Date: 21 October 2015
No changes to assumptions since last analysis.

		REAL GDP GROWTH % P.A.	INFLATION % P.A.	EPS GROWTH % P.A.
AUSTRALIAN EQUITY MARKET				
ASX S&P 200		2.25%	2.00%	2.25%
ASX AREITS		2.25%	2.00%	1.25%
ASX FINVANCIAL EX AREITS		2.00%	2.00%	0.50%
ASX MATERIALS		2.25%	1.00%	1.25%
ASX ENERGY		2.00%	1.00%	1.00%
ASX INDUSTRIALS		2.25%	2.00%	2.25%
INTERNATIONAL EQUITY MARKETS				
USA	S&P 500	2.50%	1.50%	2.50%
CANADA	S&PTSX	2.50%	1.50%	2.00%
JAPAN	Nikkei 225	1.00%	1.00%	0.50%
BRITAIN	FTSE 100	2.50%	1.50%	2.00%
GERMANY	DAX	2.25%	1.25%	1.50%
FRANCE	CAC	1.75%	1.25%	1.00%
ITALY	FTSE MIB	1.25%	1.25%	0.50%
BRAZIL	Bovespa	2.00%	6.00%	4.00%
RUSSIA	MICEX	1.50%	5.00%	2.50%
INDIA	BSE SENS	4.00%	5.50%	5.50%
CHINA	Hang Seng	4.00%	2.50%	2.50%

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Assessment of equity markets cont.

Overall, the reassessment of bond yields and EPS growth rates has led to most major equity markets becoming more attractive at current prices as shown in table three below which sets out the assessments of current market prices relative to long-term assessed fair price, under three different scenarios.

Table 3: Fair Price assessments for the Australian and International equity markets.

Date: 21 October 2015
Risk Free Rate = 2.61%
Equity Risk Premium = 5.00%

Red = Expensive (Above 120%)
Black = More or less Fair Value (80% To 120%)
Green = Cheap (Below 80%)

Changed assumptions since last analysis highlighted in blue.

SCENARIO	ONE: MODEST EARNINGS GROWTH	TWO: FASTER EARNINGS GROWTH	THREE: RELAPSE INTO RECESSION	AVERAGE OF SCENARIOS ONE – THREE
PROBABILITY OF SCENARIO	30%	15%	40%	
EPS GROWTH ASSUMPTIONS				
CURRENT EPS CHANGED BY	0.0%	5.0%	-15.0%	
LONG TERM EPS GROWTH RATE CHANGED BY	0.0%	0.2%	-1.0%	
RISK FREE RATE = CURRENT 10 YEAR BOND YIELD TO CURRENT YIELD MULTIPLIED BY	0.90	1.30	0.70	
COUNTRY	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %			SCENARIO WEIGHTED AVERAGE %
USA	88%	98%	113%	101%
CANADA	107%	118%	138%	124%
JAPAN	130%	139%	164%	147%
BRITAIN	123%	135%	157%	141%
GERMANY	94%	102%	119%	107%
FRANCE	130%	140%	165%	148%
ITALY	151%	161%	190%	171%
AUSTRALIA	81%	90%	104%	93%
BRAZIL	177%	191%	224%	201%
RUSSIA	78%	83%	98%	88%
INDIA	104%	116%	134%	121%
CHINA	77%	81%	96%	87%
MSCI	101%	112%	130%	117%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	64%	69%	81%	73%
ASX FINANCIALS	89%	95%	112%	101%
ASX MATERIALS	177%	188%	222%	200%
ASX ENERGY	92%	98%	116%	104%
ASX INDUSTRIALS	78%	86%	100%	90%

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Assessment of equity markets cont.

Following the reassessment of the key factors:

1. The US equity market is now fair value on a scenario weighted basis;
2. The European, British and Japanese equity markets are still expensive;
3. Diversified international portfolios, as represented by the MSCI international index, are still expensive;
4. The Australian equity market is slightly cheap on a scenario weighted basis;
5. Within the Australian equity market, AREITs and Industrials look cheap, while the Materials sector (BHP, RIO) is expensive. Financials including the banks look slightly expensive if we are headed into a recession scenario but otherwise look fairly priced to slightly cheap.

MOMENTUM

Our momentum assessments analyse the pattern of the change in equity markets over the preceding six months. These patterns have some correlation with market returns over subsequent twelve-month periods, although the correlation is relatively weak. The rise in month-to-month volatility in recent times has rendered the momentum indicators neutral and somewhat unstable, month to month.

QUALITATIVE FACTORS

Looking forward, we summarise the status of key qualitative factors influencing financial markets as set out in table 4 below:

Table 4: The Global Scorecard: Qualitative factors affecting financial markets

REGION	PLUSES	MINUSES
USA	- Monetary policy is still supportive of asset prices with both short and long term interest rates at historically low levels. - The real Federal Funds rate has been negative since 2008 and is likely to continue to be negative and therefore supportive for some time. - Chairman Yellen of the US Federal Reserve has made clear that interest rate increases will be gradual and will be linked to the maintenance of full employment and in addition, the improvement in the labour market reducing the degree of underemployment. It is more likely that there will be a deferral of rate increases into 2016. - There is still a sizeable volume of stock buy-backs, which is providing support for both earnings per share and stock prices over the next 6 to 12 months, but this factor is diminishing. - The US economy has continued to grow at a reasonable rate of 2.5% p.a. in real terms, sufficient to support some continued growth in corporate earnings per share albeit at a slower rate than has been the case in previous recoveries. - Fiscal policy is still stimulatory with the federal deficit at 2.6% of GDP. This is not likely to change much before the 2016 election. - The fall in the oil price has been a net positive for the USA as it adds to a consumers' ability to spend and consumer spending makes up 70% of the economy.	- The rising US dollar continues to make international earnings of major companies less valuable and this adversely affects the EPS growth of most major listed companies. The USD is likely to continue to be strong even though interest rate increases may be deferred. - The US equity market is overpriced on a number of historical measures such as the Cyclically Adjusted Price Earnings (CAPE) ratio, so caution is needed. The CAPE is currently at 25x versus a long-term historical average of 15x. While the CAPE indicator is a blunt instrument of uncertain timing value, it indicates a propensity for a decline in equity prices at various times in the next one to five years. - Consumers appear to be saving more and paying down debt, constraining growth in consumer spending, which makes up about 70% of the US economy. - Inflation continues to surprise on the low side, particularly as oil prices fall. This has the effect of increasing real interest rates and discouraging investment. - There is the prospect of disruption to the economy around Christmas and New Year if Congress fails to pass key funding bills. The removal of the Speaker of the House has made a shutdown of parts of the Federal Government somewhat more likely.

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Assessment of equity markets cont.

Region		
JAPAN	- Monetary policy is more supportive of both the economy and asset prices than it is in the USA. - Fiscal policy is highly stimulative with the government deficit running at 6.8% of GDP. - Japan is a major importer of oil and gas and will benefit greatly from lower prices of these commodities. The key question is whether the savings will flow into consumer spending. - The weakening of the Yen over the last two years has provided support to the export sectors of the Japanese economy and stock market, but this effect is weakening and may even reverse. - If it did, we expect the Bank of Japan to increase its monetary stimulus via more quantitative easing (buying bonds and equities).	- Real GDP growth has slowed to 0.7% p.a. and inflation is undershooting the 2% p.a. target set two years ago by the Bank of Japan by a long way. Overall nominal GDP growth, which creates scope for earnings per share growth, is much slower than expected at around 1.4% p.a. - A rising yen, as a result of competing devaluations by China and other countries, would be a serious headwind for corporate earnings growth. We expect that the BOJ would intervene to push the yen down. A lot of countries are competing to export deflation and import inflation, which is in short supply globally.
CHINA	- Reported Real GDP Growth is holding at around 6.9% p.a. - Fiscal policy is supportive, with the government running a deficit of 2.7% of GDP. - Monetary policy is more supportive than it has been.	- We expect Real GDP growth to fall to 5% p.a. or below within the next two to three years. - The recent stock market and currency events cast doubt on the surefootedness of the Chinese authorities and calls into question their ability to use a command and control approach to avoiding a hard landing.
EUROPE	- Fiscal policy is still broadly supportive of economic activity, with EU governments on average running a deficit of 2.1% of GDP. - Monetary policy is now much more helpful for both the economy but more importantly the financial markets due to the large scale Quantitative Easing program now being implemented. There is also a preparedness to expand this further if growth and inflation do not recover. - The relatively weaker Euro will assist earnings growth of many Eurozone companies. - The influx of refugees is quite sizeable and will create extra demand in the European economy.	- There is still a risk of persistent recession and deflation in Europe. - Forecast real GDP growth for the Eurozone is low at 1.5% p.a. - Notwithstanding the slow growth prospects, most European equity markets are highly priced as if growth were going to pick up soon.
GREAT BRITAIN	- Real GDP growth continues to be better than expected and is running ahead of the EU at 2.5% p.a. (versus 1.5% p.a.). - Monetary policy is quite stimulatory with interest rates at a 300 year low. - Fiscal policy is still very stimulatory with a deficit of 4.4% of GDP notwithstanding the government's rhetoric about austerity and small government.	- There may still be significant disruption of the EU banking system due to an eventual default by Greece and whether or not it exits from the Euro. This would have a knock on effect for the UK, which is heavily dependent on London's role as a financial centre.
AUSTRALIA	- The Federal deficit will remain higher for longer helping support economic growth. - The weaker AUD (versus the USD) will assist growth in some industries and the falling terms of trade will sustainably push it below USD 0.70. - The RBA has kept its key rate on hold at 2.0% p.a. It has scope to cut further. A rate of 1.5% p.a. in the next 6 months in two steps of 0.25% would not surprise.	- The possibility of a hard landing in China means there is still further risk to the Australian terms of trade and budget positions of the Federal government. - Iron ore prices could well fall towards $40 per tonne or below. - The banking sector share prices have come under pressure as regulators mandate higher capital ratios leading to major capital raisings. There may be more to come. - Bank payout ratios are very high with dividends at more than 75% of earnings. - Bank and resource company dividend growth will be constrained and may even reverse.

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Assessment of equity markets cont.

Our overall assessment of these qualitative factors for both the Australian and international equities markets is in the middle part of the neutral range, i.e. slightly better than previously. Taken together with the valuation and momentum indicators, our overall assessment of the key equity based asset classes is set out in Table 5 below.

Table 5: Overall assessment of equity markets

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
VALUATION INDICATOR – SCENARIO WEIGHTED (LOWER IS BETTER)	93%	117%	73%
MOMENTUM INDICATOR	Negative	Neutral	Neutral
QUALITATIVE INDICATOR	Neutral	Neutral	Neutral

IN SUMMARY

- Given that the qualitative factors and momentum are essentially neutral, more reliance should be placed on the valuation factors.
- The Australian equity market is still in the fair value range and is significantly more attractive than most international markets.
- The US equity market is still reasonably attractive compared with other international markets on a long-term valuation basis.
- There is still the prospect of instability in monetary policy and financial market reactions so caution is still warranted.
- The low level of bond yields and short term interest rates and the pursuit of yield are the key factors making Australian and the US equities markets appear to be reasonably fairly priced against other asset classes.
- Given the volatility of markets we could not rule out a further significant pull back in prices in Australia or in the US of the order of 5% or more. This would offer an attractive accumulation opportunity for investors operating on a longer-term 5 to 10 year timeframe as we see continued low bond yields being fairly supportive of equity prices in the medium to longer term.
- The period of heightened volatility in financial and investment markets that we have entered looks set to continue for many months to come. There is the prospect of wide and wild swings in short term returns.
- Our view over the medium term of three to five years, is that the most likely outcome, for both the economy and equity markets, is either a recession or a period of slow growth.
- The risk of a relapse into recession is enough to make the US Federal Reserve very cautious about when and how fast to raise interest rates in the USA. Equally the need to avoid recession and deflation will also keep the European Central Bank and the Bank of Japan dedicated to keeping short-term interest rates at historical lows while suppressing long-term interest rates via their very large quantitative easing (bond buying) programs.

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Assessment of equity markets cont.

Table 6 sets out trigger points for buying and selling various share markets, for those who wish to manage portfolios on a long term basis with reference to accumulation or reduction trigger points as an alternative to the approach of setting weightings relative to long term strategic benchmarks.

Table 6: Stock Market Investing Limits

COUNTRY	INDEX	LEVEL AT 21 OCT 2015	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2030	2002	1802	2402	Hold
CANADA	S&PTSX	13841	11199	10079	13439	Reduce
JAPAN	Nikkei 225	18531	12564	11308	15077	Reduce
BRITAIN	FTSE 100	6345	4492	4043	5390	Reduce
GERMANY	DAX	10417	9711	8740	11653	Hold
FRANCE	CAC	4673	3155	2839	3786	Reduce
ITALY	FTSE MIB	22270	13033	11730	15640	Reduce
AUSTRALIA	ASX S&P 200	5248	5625	5063	6750	Hold
BRAZIL	Bovespa	47076	23390	21051	28068	Reduce
RUSSIA	MICEX	1722	1954	1758	2344	Accumulate
INDIA	BSE SENS	27420	22746	20471	27295	Reduce
CHINA	Hang Seng	22989	26505	23855	31806	Accumulate
WORLD EX AUST	MSCI World Ex Australia	1656	1420	1278	1704	Hold
AUSTRALIAN MARKET SECTORS						
ASX AREITS	ASX AREITS	1264	1733	1559	2079	Accumulate
ASX FINANCIALS	ASX Financials ex AREITS	6928	6856	6171	8228	Hold
ASX MATERIALS	ASX Materials	8389	4193	3774	5031	Reduce
ASX ENERGY	ASX Energy	8926	8558	7702	10270	Hold
ASX INDUSTRIALS	ASX Industrials	4788	5338	4804	6405	Accumulate

These indicators are sending the same message as the valuation indicators in table 3:

1. Reduce exposure or be underweight to some of the more expensive international equity markets and the Materials sector of the Australian equity market;
2. Cautiously hold or accumulate in other sectors of the Australian equity market and in the US equity market.

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