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Market conditions

Domestic market watchers remain pre-occupied with news from overseas, in particular from the US and China. In the United States, Janet Yellen was appointed head of the Federal Reserve. Her term, which began on the 1st of February, coincided with an important shift in policy: the winding back of the past five years' of unconventional monetary policy, which saw the Fed pour ~$4.0 trillion into the US economy over that period. The new head of the US central bank has also foresworn giving guidance based on a target unemployment rate of 7% which some analysts took to be a negative – a sign that the rate of US economic growth was still fairly sluggish. Our view is that it allows the Fed greater flexibility to slow, or quicken, the pace of stimulus and that not too much should be read into it – the US economy is continuing to recover strongly from the aftermath of the Global Financial Crisis.

China's March quarter GDP grew by 7.4% year-on-year, which was slightly ahead of consensus expectations. China's industrial production, fixed asset investment (FAI) and retail sales figures were also released. Of the three major indicators of economic activity, industrial production and FAI missed expectations. Industrial production is widely regarded as best correlated of the three with the rate of GDP growth. It decelerated to 8.7% year-on-year growth in the first quarter of 2014, from 9.7% in the fourth quarter of 2013, consistent with slowing GDP growth. However, monthly data suggested that March industrial production improved ever so slightly on the first two months of the year.

Despite FAI being below expectations, China announced a 'mini-stimulus' program during the quarter which includes plans for substantial investment in infrastructure. This has prompted analysts to forecast stronger GDP growth in coming months.

Retail spending continues to grow strongly in China – March sales grew 12.2% versus the prior corresponding period underpinning expectations that the country's growth is increasingly leveraged to domestic consumption and less on FAI.

Here in Australia, the RBA maintained the cash rate at 2.50% with no change anticipated in coming months. The Australian dollar remains stubbornly high, finishing the March quarter at 92.66 US cents and rising as high as 94.63 US cents since. RBA commentary suggests that it sees a lower Australian dollar as desirable, thus monetary policy is likely to remain accommodative, particularly in anticipation of what is expected to be a tough Federal budget in May.

Index performance and sector analysis

The S&P/ASX All Ordinaries Index gained 0.93% in the March quarter, with 'Real Estate Investment Trusts (REITs)', 'Telecommunications' and 'Financials' the top three performing sectors. The weakest performers were: 'Media', 'Healthcare' and 'Metals and Mining'.

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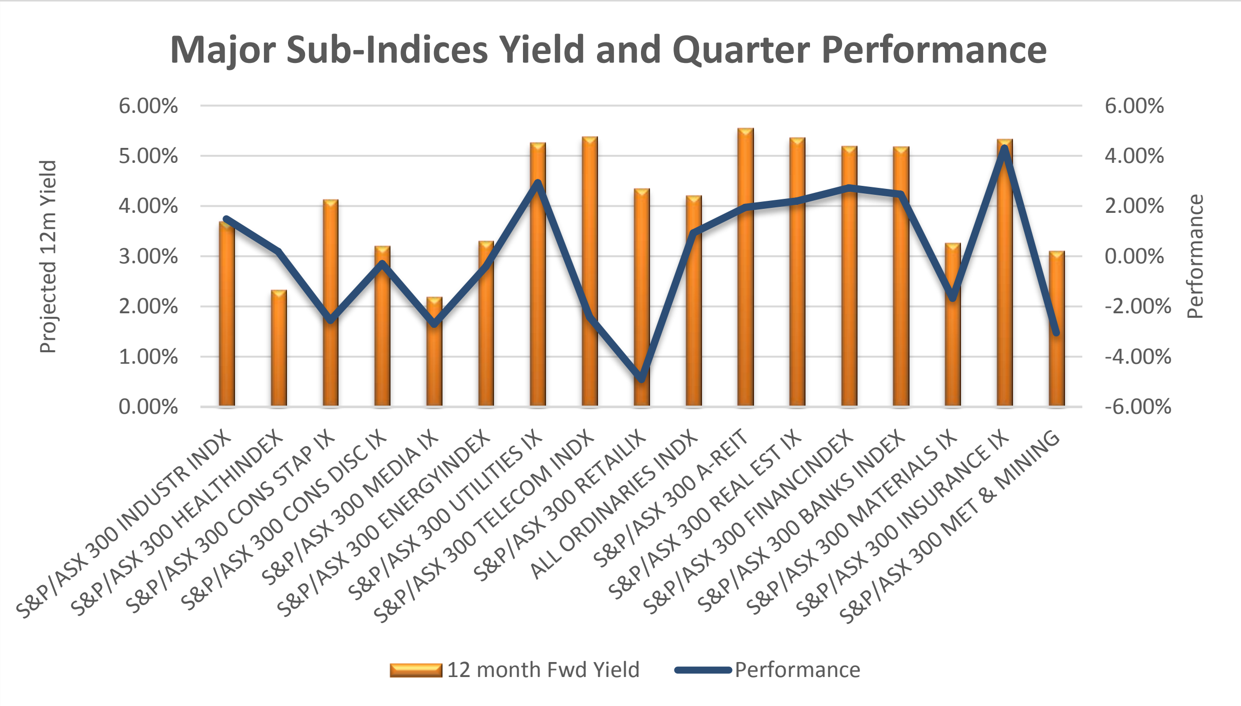
The chart below shows sub-indices performance over the quarter (RHS) versus the projected yield for the sub-indices (LHS):



REITs performed well, with valuations well-ahead of traditional discount to NTA (Net Tangible Asset) multiples, as high yields were sought by investors and Stockland Group built a strategic stake in Australand Property Group, prompting speculation that a wave of mergers and acquisition (M&A) activity might sweep the sector. Speculation that M&A activity might be a feature of the telecommunications landscape also helped to lift that sector. 'Financials' performed well given their high dividend payouts and after IAG bid for Wesfarmers' Coles insurance operations.

The 'Media' sector was weaker after a key index constituent, 21st Century Fox (FOX), announced its intention to delist from the Australian Securities Exchange in early January. The FOX share price subsequently trended down for the remainder of the quarter. There was also weakness in the share prices of companies which might take advantage of changes to media laws that may see the 'reach' rule abandoned: allowing a single company to own assets across multiple regions and across radio, TV, and print. Companies likely to launch takeover offers under any such change were sold down during the quarter. The 'Metals and Mining' sector continued to struggle as key Australian export commodity prices fell. In particular, very short vessel queues at the port of Newcastle continue to indicate a lack of demand for coal.

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Currency movements

As shown in the table below, the Australian Dollar appreciated against key foreign currencies during the March quarter as domestic macroeconomic data releases painted a slightly better picture of the strength of the Australian economy and China announced a stimulus package aimed at boosting growth. Lower interest rates overseas and reduced expectations of further easing of rates in Australia also kept the Australian dollar strong.

31/03/2014	AUD	USD	GBP	EUR	JPY	Currency Pair	Quarter Change AUD
AUD	1.0000	1.0834	1.8030	1.4948	0.0105		
USD (US$)	0.9230	1.0000	1.6642	1.3798	0.0097	AUD/USD	3.45%
GBP (pound)	0.5547	0.6009	1.0000	0.8291	0.0058	AUD/GBP	2.59%
EUR (euro)	0.6691	0.7248	1.2063	1.0000	0.0070	AUD/EUR	3.24%
JPY (yen)	95.2	103.2	171.75	142.40	1.0000	AUD/JPY	1.79%

The Australian dollar actually fell early in the March quarter, dipping below 87 US cents in late January. But, it rallied strongly through February and March. The Governor of the Reserve Bank of Australia (RBA), Glenn Stevens, had previously said that the Bank would intervene in currency markets to lower the Australian dollar exchange rate if market conditions were "appropriate," i.e. if inflation remained within the RBA's 2-3% target range. The inflation rate climbed to 2.9% for the first quarter of 2014, up from 2.7% in the previous quarter which suggests that central bank intervention is unlikely as long as the rate of inflation remains elevated.

Historically, as commodity prices have trended down, so has the Australian dollar. Thus, it is not unreasonable to expect that, if commodity prices continue to slide, the Australian dollar will trend back towards 85 US cents over the remainder of 2014.

Commodity markets

As set out in the table below, prices for two of Australia’s key commodities fell sharply in the March quarter. Thermal coal prices slipped below US$80 per tonne and iron ore fell to its lowest level in four years on the 10th of March.

ENERGY	31/03/2014	31/12/2013	% Change 3 M
West Texas Intermediate (Oil)	$101.58	$98.42	3.2%
McCloskey Newcastle 6000 kc NA (Coal)	$73.05	$84.60	-13.7%
China import Iron Ore Fines 62 (Iron ore)	$116.80	$134.20	-13.0%
METALS			
Gold spot $/oz	$1,284.01	$1,205.65	6.5%
Silver spot $/oz	$19.77	$19.47	1.6%

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Platinum spot $/oz	$1,418.13	$1,369.45	3.6%
Palladium spot $/oz	$776.15	$716.45	8.3%
LME Aluminium spot ($)	$1,744.25	$1,754.75	-0.6%
LME zinc spot ($)	$1,970.25	$2,053.00	-4.0%
LME lead spot ($)	$2,041.00	$2,190.50	-6.8%
LME copper spot ($)	$6,650.00	$7,375.75	-9.8%
LME tin spot ($)	$22,844.00	$22,335.00	2.3%
LME nickel spot ($)	$15,860.50	$13,832.00	14.7%
LME cobalt spot ($)	$31,373.00	$28,950.00	8.4%
AGRICULTURE			
Green Market Fertiliser Ammonia Tampa	$580.00	$450.00	28.9%
Fertiliser (DAP) Tampa	$454.00	$410.00	10.7%

Source: Deutschebank.

Gold bucked the trend, with prices increasing more than 6% over the quarter as geopolitical instability saw investor appetite for the asset class increase. In the long-term, we expect gold prices to exhibit an inverse correlation with the US dollar, i.e. as the US economy improves and the greenback strengthens, the gold price is likely to fall.

Price strength was also evident in palladium and nickel during the quarter. Palladium, used in catalytic converters, was up on supply concerns as sanctions against Russia, the world's largest producer of the metal, could hamper exports from the country. Any restrictions on Russian palladium exports will exacerbate what is already expected to be a large supply deficit in 2014.

Restrictions on Russia also saw ammonia prices spike in the March quarter. Ukraine is a major ammonia producer and it relies on Russian gas for its manufacture. Increases in the price of gas generally feed through to ammonia prices. However, rising ammonia prices are good for Australian explosive manufacturers with a largely fixed cost supply of gas and/or ammonia – imports of explosives become more expensive.

Fertiliser (Di-ammonium Phosphate) prices also increased on the back of the ammonia price spike and were also helped along by increased US plantings following extreme winter weather in the US.

Nickel prices spiked after Indonesia banned exports in mid-January.

Summary

Overall, we think it unlikely that the RBA will raise interest rates in the short term. With reduced hard commodity demand from China, as it shifts to a consumer driven economy, commodity prices will probably fall further and this will create a drag on Australian economic growth. The Australian dollar will likely weaken in line with commodity price falls, but the pace and extent of the fall will also be driven by the velocity of the US economic recovery and associated US dollar strength. However, we are confident that portfolios are well positioned to benefit from these shifts in the Australian economic landscape.

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In our December, 2013, Quarterly Review, our research - The End of Debt Crises Should Unleash a Tide of Mergers & Acquisitions Activity Globally - set out an expectation that the time was now right for mergers and acquisitions activity on global equities markets to significantly increase. The trigger, we believed, was the end of a series of international debt crises, in particular the 'sovereign debt crisis'. The research set out here – When National Debt Turned Nasty – is a shorter companion piece which delves into the evolution of those crises, which reached a climax in mid-October 2013. It illustrates how business confidence remained stymied after the Global Financial Crisis (GFC) because just when fears about the level of private company indebtedness started to abate, even greater fear of national governments' fiscal deficits took its place.

In the second half of last year, Harper Bernays started to position portfolios in anticipation of greater M&A activity. We were therefore encouraged by this recent comment from an Australian institutional stockbroker: "… According to International Strategy & Investment Group, there have been 131 M&A deals totalling US$1.2 trn ytd [trillions of US dollars, calendar year-to-date] through last week. That includes 11 deals worth US$243bn announced last week. Last week also saw the biggest ever junk bond offering, with Numericable offering US$10.9bn to fund acquisition of Vivendi's mobile phone unit. And then overnight we can add [the] Pfizer bid for AstraZeneca, the largest takeover bid ever in [the pharmaceutical] sector…"[1]

Harper Bernays' research: When National Debt Turned Nasty

In our last piece of published research, *'The End of Debt Crises Should Unleash a Tide of Mergers & Acquisitions Activity Globally'*, we argued that the end of the US debt ceiling crisis was the trigger to unleashing a wave of mergers and acquisitions (M&A) activity globally.

We also argued that all of the traditional drivers of increased mergers and acquisitions activity – low levels of company indebtedness, low interest rates, deep and liquid credit markets, buoyant equity valuations and positive indicators of a general increase in business confidence – had been in place since late 2012. Thus, we were surprised that M&A activity didn't ignite in early 2013. We concluded that directors' fear of a return to GFC-like conditions was the most likely impediment and that that was only likely in the event of a major sovereign defaulting on debt repayments.

A series of crises following the GFC gave rise to the spectre of such an event. The 'Eurozone crisis' emerged in 2009, but had substantially diminished by late 2012. However, just as this subsided, the so-called US 'fiscal cliff' became a mounting concern on the other side of the Atlantic. This led to a debt repayment crisis for the US government in 2013, which came to a head in late 2013.

[1] Source: Peter Roberts, Managing Director – Institutional Sales, Credit Lyonnais Securities (Asia), 29th of April, 2014.

Fortunately, a repeat US debt crisis in 2014 now looks unlikely and certain European states, considered pariahs in international debt markets up until 18 months ago, have recently issued new debt at reasonable rates indicating that Eurozone governments are increasingly getting their finances in order.

But, the situation five years ago, immediately following the GFC, was markedly different. Back then, national governments, not private companies, were increasingly struggling with heavy debts. And unlike private companies, they weren't able to swap debt for equity.

The Eurozone Crisis

In some instances, private debt was simply transferred to public ownership. This was particularly true of the European banking sector where a bursting property market bubble saw numerous loan books turn sour. These losses lead governments across the continent to bail out numerous banks. The rescue packages often involved national governments taking equity in banks, partially guaranteeing deposits and/or standing behind banks' liabilities. In some cases, the results were disastrous as the debts being assumed by national governments were equivalent to a large proportion of GDP, thereby undermining governments' ability to act as lenders of last resort. Consequently, a number of sovereign governments were forced to seek their own financial bailouts.

Some national governments also had a hand in fuelling the crisis. Low interest rates from around 2002 to 2008 encouraged a number of countries to borrow heavily. When global credit markets froze in late 2008, following the collapse of Lehman Brothers, actual budget deficits were far worse than had been forecast. For instance, the United Kingdom Budget delivered in March, 2008, forecast a public sector net borrowing requirement equivalent to 2.9% of UK GDP for 2009. But, decelerating economic growth and falling tax receipts, a consequence of the GFC, saw the actual 2009 fiscal deficit come in at 12.4% of GDP – over four times more than the original forecast![2] This was not just a European problem[3], but under-reporting of fiscal deficits certainly was – Eurostat, the European Union's Statistical Office, threatened legal action against Greece for under-reporting fiscal deficits as far back as 2004[4] and the practice continued until late in the decade[5].

Ultimately, The European Commission, European Central Bank and the International Monetary Fund were all instrumental in mitigating the 'Eurozone Crisis'. In May, 2010, the 27 member states of the European Union agreed to provide financial assistance to member states requiring a financial bailout (the European Financial Stability Facility). In essence, the

[2] Source: table 2.2 'Summary of public sector finances', p.24, *Budget 2008* and table 2.6 'Summary of public sector finances', p.38, *Budget 2009*, both published by HM Treasury.
[3] In the US Budget delivered on the 4th of February, 2008, a 2009 fiscal deficit equivalent to 2.7% of GDP was forecast; the actual 2009 fiscal deficit was 9.9% of GDP. Source: Budget of the US Government 2008 and 2011, both published by the US Government Printing Office.
[4] 'EU warns Greece for under-reporting deficit', *Financial Times*, 23rd of September, 2004.
[5] 'Greece edges closer to defaulting on its debt', *The Washington Post,* 23rd of April, 2010.

EFSF, underwritten by Germany, became a vehicle for issuing €440 billion of bonds guaranteed by (solvent) EU member states. In January, 2011, a complementary program, the European Financial Stabilisation Mechanism (EFSM) was introduced to enable the European Commission to issue up to €60 billion of bonds to fund bailouts.

Uncertainty as to the financial stability of the Eurozone persisted until September, 2012, when the European Central Bank announced that it would begin to purchase the bonds of all Eurozone countries being bailed out. The immediate and sustained impact was to lower bond yields (the cost of borrowing) for all countries being bailed out, thereby enabling them to issue their own reasonably priced debt in global markets.

Arguably, sovereign indebtedness was largely a European problem from late 2009 until September, 2012. But, as one crisis subsided, another was building across the Atlantic.

The US Fiscal Cliff

A series of tax cuts made by an earlier presidential administration in the US were due to expire at the end of 2012. This came at exactly the same time as planned spending cuts, aimed at ensuring the US did not exceed its legislated borrowing capacity, were to take effect. The combined impact of these measures – the so-called 'fiscal cliff' – threatened to derail a US economic recovery. The US Congressional Budget Office forecast that the 'fiscal cliff' was likely to cause a mild recession, with unemployment rising in 2013.

Fortunately, the impact of tax cuts was mitigated by new legislation which simply raised taxes by a lesser amount. But, there was no solution for the spending cuts. Another stop-gap measure, introduced on the first day of 2013, simply postponed them and US politicians shifted focus to the country's legislated borrowing capacity – the so-called 'debt ceiling'. A case of 'if you can't stop spending, stop trying to limit the amount you spend', perhaps? But, failure to find a permanent solution to the 'fiscal cliff' begat another crisis in the second half of 2013: the 'Debt Ceiling' crisis. In late August, 2013, the US Treasury publicly stated that a failure to raise the debt ceiling would see the country default on its debts in mid-October.

The US Debt Ceiling Crisis

The prospect of US default raised the spectre of a new GFC: global debt markets would grind to a halt and equity markets would likely collapse. Not many company directors were comfortable contemplating takeovers against this backdrop. The severity of the crisis was underlined by a partial shutdown of the US government which saw hundreds of thousands of civil servants furloughed for a fortnight.

Another stop-gap measure, the Continuing Appropriations Act, was passed in mid-October, suspending the debt ceiling until early February, 2014. Despite being a temporary solution, it did actually lead to a longer-term solution: by mid-January, 2014, a two-year funding package for the US government had been negotiated, which calmed nerves considerably.

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As we noted in our last piece of published research, further stop-gap measures are likely to be employed, if only because US politicians will have an eye on the general ('mid-term') elections in November, 2014, when all of the seats in the House of Representatives and one third of the seats in the Senate will be contested. The partisan stoush over US debt didn't make the Republican Party popular with the electorate with one notable poll showing a marked shift in preferences for who should control Congress[6]. Thus, if only for reasons of political expediency, we do not expect a repeat debt crisis in 2014.

We also suspect that growth in the US economy will continue apace, producing, as it usually does, an increase in government revenues and a drop in recurring government expenditures. This is key to an ultimate resolution of the US debt crises and we suspect that businesses have largely made the same observation, hence the recent rush of M&A activity.

Of course, the same principle – that stronger economic growth will help to resolve debt crises – applies to the Eurozone countries. Recent indications of improving financial management, as well as stronger economic growth in the Eurozone, bode well. But, the greatest signal that confidence in Eurozone economies has been restored has been recent activity in the sovereign debt market. In early April, Greece issued its first long-term bond since March, 2010. Greece expected to be able to sell €3 billion and had priced the offering at a 5.00% to 5.25% yield. At the auction, around €20 billion of bids were received, enabling the Greek government to price the offering at a 4.95% yield. Thus, investors appear to be pricing in an end to national debt crises, even in the absence of definitive political solutions. The benefit for equity investors has been the clear surge in global M&A activity.

[6] "…American voters prefer a Democratic-controlled Congress to a Republican-controlled one by eight percentage points (47 percent to 39 percent), up from the Democrats' three-point advantage [in September, 2013] (46 percent to 43 percent)…" http://firstread.nbcnews.com/_news/2013/10/10/20903624-nbcwsj-poll-shutdown-debate-damages-gop?lite