Quarterly Review – September, 2014

Market conditions

In what has become a consistent theme in recent times, macro-economic concerns overshadowed the fundamental strength of both company balance sheets and their earnings prospects this quarter. Specifically, in the September quarter, the market wrestled with the mixed implications of a strengthening US economy and a slowing China.

Despite trending upwards through July and August, the S&P/ASX All Ordinaries Index fell 1.6% in the September quarter as the imminent end of the US Federal Reserve's bond-buying program (QE3) weighed on markets through the last month of the quarter. Concern over military action in Iraq and Syria, the Ukraine conflict, and the Ebola crisis in West Africa further tested investor confidence. In reality, QE3 has already been tapered to a point where to continue would largely be a symbolic gesture and perversely, the end of QE3 signals a belief that policy makers see a strengthening US economy. Indeed, at the end of October, an advance release by the US Department of Commerce estimated that real Gross Domestic Product (GDP) increased at an annualised rate of 3.5% in the third quarter of calendar 2014. This is a slight slowing from the 4.6% rate for the second quarter, but recent early estimates have tended to be revised upwards as further source data is received.

Of greater importance to markets now is what the FOMC (Federal Open Market Committee) of the Federal Reserve says about the next phase of monetary policy: increasing the benchmark interest rate, which has been held at close to zero since the end of 2008. For the Federal Reserve, an increase will signal the beginning of policy "normalization" after six years' of a crisis stance. With deflation concerns appearing in Europe and a slowing economy in China, it's possible that US interest rates won't rise rapidly, as policy makers remain concerned about heavy handedness derailing a global economic recovery. Minutes of the last FOMC (Federal Open Market Committee) meeting in mid-September suggest that, even if US employment strengthens and inflation rises, interest rates could be kept on hold in order to bolster the economic recovery. That said, the US Dollar has been strengthening since July and commodity prices have recently fallen sharply – both are indicators that the market still expects US interest rates to rise. Admittedly, commodity prices could be seen to be sliding in the wake of weaker Chinese industrial production and a stronger US Dollar could also be said to reflect weakness in economies elsewhere. But, 10-year US treasury yields recently touched an eighteen month low which suggests that, for the short-term at least, US interest rates are unlikely to move. From a medium-term perspective, money markets are currently pricing in US interest rates of 1.50% to 1.75% by the end of 2016 which is much lower than the levels that had been forecast (2.25% to 2.50%) at the end of September.

As we've already noted, the Chinese economy continues to slow. The mini-stimulus discussed in our last quarterly (looser monetary policy and increased government spending) has faded and the impact has been quite severe: growth in industrial production fell to 6.9% in the twelve months to August, according to data released by the Chinese National Bureau of Statistics – the lowest level of growth since the Global Financial Crisis. PBOC (Peoples Bank of China) GDP data released in the quarter also revealed that GDP was growing at an annualised rate of 7.3%, suggesting that the 7.5% growth target for calendar year 2015 could be missed. Expectations of lower growth have been reflected in commodity prices and this has weighed on the share prices of Australia's resources companies in particular.

However, it is important to put the slowing of the Chinese economy into context. The IMF recently noted that the Chinese economy has recently overtaken the US to become the largest in the world *in Purchasing Power Parity (PPP) terms*. In other words, using a common currency, the value of China's economic output equates to a greater value of goods and services than that of the US.

Australia remains well positioned to benefit from China's growth, particularly given our abundance of natural resources and our proximity to this economic behemoth. Of course, the US remains the "richer" country based on more traditional measures, including GDP per capita. Nevertheless, the meteoric rise of China's economy has been amazing and the IMF estimates that China's output could soon be 20% greater than that of the US. To highlight the pace of change, consider this: in 1980, China's output was just a tenth of the size of that of America.

With the withdrawal of QE3 and with US interest rate rises on the horizon, it was, perhaps, unsurprising that market volatility spiked in the September quarter. The market was particularly weak in the month of September, falling around 7%, principally driven by the major banks and big miners, which together constitute 36% of the index. The banks were susceptible to offshore selling, as they are widely held by overseas investors who, with exposure to the weaker Australian dollar, reduced their holdings. The mining sector slide was driven by the aforementioned fall in commodity prices, which is consistent with a rising US dollar. Although these commodity price falls may appear severe, they are simply reverting to analysts' forecasts of long-run prices which is to be expected as the mining boom dissipates. Market volatility has been absent in recent months but it is not a new phenomenon, as can be seen in the chart below, which also shows the Australian Dollar/US Dollar exchange rate largely moving in tandem with the S&P/ASX All Ordinaries index. In January, 2014, the market fell in line with movements in the currency, before recovering in February. At the time of writing (late October) conditions have improved and the market is back to where it was in February.

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From a long term investment perspective, we see market volatility as an opportunity to selectively increase exposure to high quality companies at attractive prices.

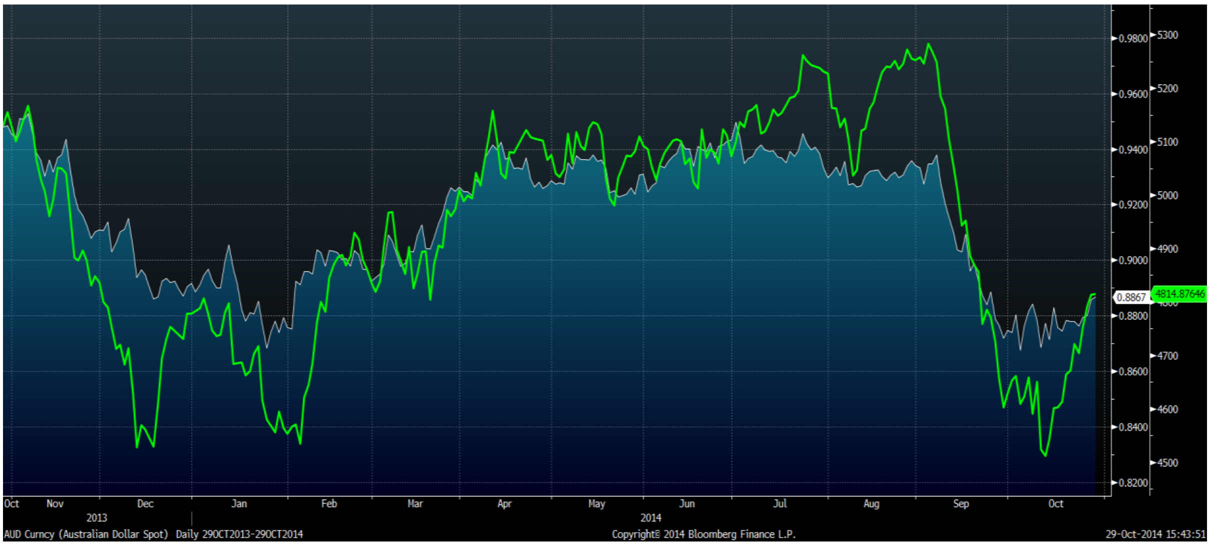

Chart 1: S&P/ASX All Ordinaries price chart versus Australian/US Dollar spot rate.

Australian share index performance and sector analysis

As the September quarter straddles company reporting season, index performance was also influenced by companies' financial results and outlook statements for the coming year. With a volatile quarter for markets it was no surprise to see the defensive sectors (Telco, Healthcare and Insurance) performing well during the period:

Sub-index	September Quarter Performance
Healthcare	8.23%
Insurance Index	5.40%
Telecom	2.82%
Australian Real Estate Investment Trust	1.13%
Industrials	-0.63%
Consumer Discretionary	-1.04%
Utilities	-1.27%
Energy	-1.45%
Consumer Staples	-1.51%
S&P/ASX All Ordinaries Index	-1.58%
Financials	-2.94%
Materials	-4.36%
Metals and Mining	-5.25%
Banks	-5.30%
Media	-6.99%

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The standout sector was healthcare, rising by more than 8% during the quarter with a particularly strong result from CSL, which saw earnings per share jump 14% in its 2014 financial year. Telecom was up a healthy 2.8% with strong results posted by Telstra, which announced an off-market buy-back and an increased dividend.

The major banks were softer on sentiment, with only CBA reporting during the period – its result was in-line with the consensus of analysts' expectations. Media was the weakest sector with the free-to-air broadcasters reporting soft advertising markets and an ongoing challenging outlook.

Currency movements

This quarter finally saw the Australian dollar fall of its perch with the currency declining ~7% against the Greenback and ~2% against Sterling. As expected, it was not jawboning from the Reserve Bank of Australia which caused the fall, but the prospect of interest rates rises in both the US and the UK. Sterling also rebounded strongly after Scotland voted to stay part of the UK. In contrast, the Euro was weaker against the Australian Dollar, in part due to poor GDP data out of Germany and the threat of Greece exiting debt bail-out agreements earlier than anticipated.

	AUD	Change	USD	GBP	EUR
AUD	**1.0000**		**1.15**	**1.86**	**1.44**
USD	0.87	-7.18%	1.0000	1.62	1.26
GBP	0.54	-2.27%	0.62	1.0000	0.78
EUR	0.69	0.62%	0.79	1.28	1.0000
JPY	95.2630	0.45%	109.71	177.5	138.16

Commodity markets

Commodity prices were mixed with crude oil prices down 10% during the period – increased production from Libya, no fall in OPEC production and the USA becoming increasingly self-sufficient owing to unconventional oil production all contributed to the price fall.

ENERGY	**30/09/2014**	**30/06/2014**	**%Change 3M**
Crude Oil	$94.57	$105.37	-10.2%
McCloskey Newcastle 6000 kc NA (Coal)	$65.60	$70.35	-6.8%
METALS			
Iron Ore (62%) Spot	$80.90	$90.40	-10.5%
Gold spot $/oz	$1208.16	$1,327.32	-9.0%
Silver spot $/oz	$16.98	$21.03	-19.3%
Platinum spot $/oz	$1300.75	$1,486.00	-12.5%
Palladium spot $/oz	$773.10	$843.25	-8.3%

LME Aluminium spot ($)	$1928.75	$1,856.75	3.9%
LME zinc spot ($)	$2,281.75	$2,214.25	3.0%
LME lead spot ($)	$2090.50	$2,144.00	-2.5%
LME copper spot ($)	$6720.00	$7,041.00	-4.6%
LME tin spot ($)	$20,279.00	$22,540.00	-10.0%
LME nickel spot ($)	$16,241.00	$18,969.00	-14.4%
LME cobalt spot ($)	$32,162.00	$30,499.00	5.5%
AGRICULTURE			
Green Market Fertiliser Ammonia Tampa	$640.00	$520.00	23.1%
Fertiliser (DAP) Tampa	$466.00	$458.00	2.7%

Source: Bloomberg.

Of greatest relevance to Australia's economy were the lower realised prices for its two major export commodities: iron ore and coal. Iron ore production levels remain high as both Rio Tinto and BHP implement major capacity expansions. Indeed, most analysts remain of the view that iron ore is likely to stay oversupplied until at least 2016 with high-cost producing Australian and Canadian supply likely to be curtailed first, along with non-integrated Chinese production. Concern about slowing Chinese property construction led to flat to falling industrial metal prices in the quarter. Nickel, which soared in the prior quarter, fell after fears of supply discontinuity abated during the period. With the continuing strength in the US Dollar it was no surprise that gold and silver were weaker – in the long-run, prices for these two precious metails tend to be negatively correlated to the US dollar.

Summary

Our perspective on domestic interest rate policy remains unchanged from the June quarter - it's unlikely that the RBA will raise interest rates in the short term. Although, we note that the domestic economic growth baton is being well and truly handed to NSW and Victoria from the States more heavily oriented towards mining. China's economic growth rate is continuing to slow, with the intensity of metals consumption falling at an even faster rate. Despite the fall in iron ore prices, the terms of trade remain cushioned by massive supply expansions from these major producers. Perhaps the most significant change from the last quarter has been the wind up of QE3 in the US, which finishes at the end of October, and the devaluation of the Australian dollar against the Greenback.

We remain confident that portfolios are well positioned to benefit from a weaker dollar, stronger offshore economic growth and a more robust construction industry locally, as Government infrastructure projects start to move from the planning to execution phase.