QUARTERLY REVIEW – April 2016

The 2016 calendar year got off to a very shaky start with plunging commodity prices (particularly iron ore and oil) and concerns about Australian banks. The ASX 200 stood at 5,285 on 1 January, but fell to an intra-day low of 4,706 on 10 February – thats a drop of 11% in the space of 30 working days.

At the time of writing, the market has since recovered these early year losses (now sitting around 5,300). Not surprisingly, resource stocks and banks have led the market back into positive territory (ie the sectors that were largely responsible for the earlier sell-off)

The US market has mirrored this dip and recovery, driven by similar concerns, but with an overlay of uncertainty around interest rate increases (which have now been pushed back further into the year).

After professing our concern over many months that the RBA was too far behind the monetary policy curve, Governor Glen Stevens has recently delivered a 25 bps cut to official interest rates. Based on historical interventions, the RBA has rarely made just a single rate cut (when moving from a neutral policy setting) and we anticipate at least one more cut during the year.

This quarter we'll spend a little time looking at the forces that have shaped our market over recent times and what the future might hold. We held off going to print for a little while as we awaited the 2016 Federal Budget and we'll devote some column space to its disappointingly "retrospective" superannuation proposals.

Where to for Commodities

Over recent years trading & speculative activity around commodities has increased exponentially. According to a recent report in the AFR (Lisa Murray 11 May'16), the worlds annual supply of iron ore changed hands four times in the month of April. This speculative activity invariably results in commodity prices over shooting at the top and bottom of any price cycle – plus it generates significant volatility along the way.

We believe that a floor has now been put in place for Iron Ore – at US$40 a tonne. More optimistically, Treasury has suggested in the recent budget

papers that the price might average US$55 over 2017 which would be good news for our big miners

Likewise for oil a floor at around US$40 per barrel also seems to be holding. In the case of Oil, the supply/demand dynamic is a little more sensitive to price given the distribution of production. Most of the production capacity in recent years has been added by non-OPEC nations. The reality is that at $40 per barrel, the only ones who can make a profit are Kuwait, Saudi Arabia, Iraq and Iran. The break-even point for Russia/Venezuela sits at around $55 per barrel, whilst the shale oil producers in the US need a price of almost $70 to keep them profitable.

Whilst we have previously extolled the virtues of a lower oil price for global growth prospects, the recent prolonged fall in the price of oil had some unintended consequences that spooked equity investors. The profit dynamic above indicates that many producers are underwater at extremely low prices and there was concern that some producers could default on their debt obligations. The other significant factor that caused equity prices to track down with the oil price was the selling activity of the Sovereign Funds. With a shrinking revenue base driven by falling oil profits, many sovereign governments raided their Sovereign Funds to prop up their flagging fiscal prospects. This saw these Funds sell an estimated $550 billion in stocks and bonds in the first few months of this year.

The other issue created by a prolonged fall in oil prices is the likely deflationary impact. With deflation already a significant concern for central banks around the globe, the plunging oil price created further angst for equity investors.

Is there a problem with our Banks?

By way of context, banking and financial service companies represent just over 46% of the ASX 200. With the demise in resource stocks over recent years, the Australian market has become significantly concentrated, particularly around the major banks. It was hardly surprising then, that when the banks sold off heavily from Jan'16 through to March'16, the broader market fell along with them. The pressures on banks at this time were seemingly many:

- Slowing housing market – some heat has come out of the housing market, but further reductions to official interest rates will see this sector remain well supported.
- Rise in offshore funding costs – with relative calm now having descended over debt markets and with the US Fed taking a more dovish approach to rate rises, longer term funding costs have fallen back.
- A cyclical low in bad debts and related provisioning – as part of their recent profit announcements, most banks have increased their bad debt provisioning but not by as much as was anticipated (we have seen only small pockets of problem loans). Further reductions in interest rates will ease the interest servicing impost on businesses and households.
- The authorities had forced the major banks to raise additional capital and the extent of any further capital requirements were unclear. The banks

(and indeed APRA) now seem comfortable that additional capital requirements can be met organically rather than through any large equity issuance (which have the effect of diluting earnings).

We don't expect any further significant falls in bank share prices albeit they will continue to ebb and flow with changing views around the health of the Australian economy. With yields currently running at up to 7% pa (plus franking credits) and with some pressure on loan growth and margins, it is likely that we will see some trimming of payouts over the next 6-12 months, but nothing too serious. Bank share prices are likely to be "range bound" over the next year or two, so whilst we won't see double digit capital appreciation, a solid dividend yield combined with the prospect of a modicum of price growth will see bank stocks remain a core part of investor portfolios.

OUTLOOK

Our short-term view of markets is dominated by technical factors that point to a near term correction in equities. The charts for the 6th year of any decade reveal the strongest correlation to the "sell in May and go away" adage. The graphs below chart the ASX 200 in 2006, 1996 & 1986.

The movements in the index from May through to December are almost identical. In 1986 the May correction commenced on the 7th and ran for around 80 days; in 1996 the correction commenced on the 2nd and ran for about 70 days; and in 2006 the correction commenced on the 10th and ran for 30 days.

In terms of the daily charts, key resistance for the ASX 200 sits at around 5,350/5,380 (more or less the current value). We have bumped up against this level on 3 occasions in the last 6 months and in each instance the index has failed to deliver a new high. Moreover, the Relative Strength Indicator

(RSI – a technical measure used by momentum traders) is at overbought levels not seen for almost 15 months.

Technically, the US market is also looking vulnerable. Since putting in place a mid-April high, the S&P 500 has moved down in what appears to be the first leg of a 3-wave (or ABC) correction. The chart below from Market Matters forecasts a 5% correction in the short term before a bounce back above current levels.

Fundamentally, markets are also a little over valued based on forward estimates of earnings. The US reporting season is likely to do little to change this situation and if anything, there is the prospect for earnings down grades in the short term, which are likely to be the catalyst for any anticipated correction. However, the growth prospects for the US economy are still robust and interest rates there are likely to rise at a reduced pace. In terms of other significant US economic metrics, there has been a significant deleveraging of households and corporates over recent years, household wealth is approaching record levels and the breadth of economic recovery has broadened (Ron Temple, Lazard Asset Management NY).

Here in Australia, the lower dollar together with further falls in interest rates will be good for company bottom lines and equity markets more generally. Economic growth is likely to exceed forecasts driven by continued momentum in housing construction and by significant infrastructure spending, particularly in NSW. After a near term correction, we expect the ASX 200 to potentially outperform the US market over the second half of the calendar year, with the prospect for the Aussie market to finish the year as high as 5,800 points (a level suggested by Shane Oliver, Chief Economist, AMP).

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Underweight):** Whilst we remain constructive on Australian stocks in the medium term, particularly as we move into the latter part of the year, we do anticipate a short-term pull-back.
- **Global Equities (Slightly Underweight):** The US market is looking vulnerable at this point, with the potential for a correction driven by any earnings "misses" in the current profit reporting season.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and reductions to interest rates). In the very short term the sector is likely to be buoyed by further M&A activity, but this will then likely signal a period of under-performance.
- **Fixed Interest (Slightly Overweight):** Given the level of interest rates, it is preferable to hold a little less in cash and a little more in fixed interest instruments (such as income securities).
- **Cash (Slightly Underweight):** As a result of our positions in other asset classes, together with historically low interest rates, cash is presently a little underweight.

FEDERAL BUDGET – PROPOSED SUPERANNUATION CHANGES

Before we pass comment on the super changes included in the 2016 budget there are some very important caveats to get onto the table:

- Budget papers are simply a collection of "statements of intent".
- The mooted superannuation changes are scant on operational detail – having read many reviews and participated in numerous webinars, there are significantly more questions than answers at this point.
- All the budget measures are subject to the outcome of the election
- All will be the subject of industry consultation post the election
- All require the passage of legislation through both houses of a new parliament.

In short, **nothing** should be done precipitously at this point in anticipation of the Government's 3 May announcements. There is a lot of water that needs to go under the bridge.

Introduction of a $1.6m Pension Transfer Cap

We were anticipating a policy move in this area, but **not** one that was effectively retrospective. Applying the cap against existing balances that have already been transferred into pension phase is in complete contrast to the reassurances made late last year by the Treasurer. At this time (AFR 28 Oct'15) Scott Morrison confirmed the emphasis of superannuation tax changes would be on the **accumulation phase**, rather than at retirement. "When you get to the retirement phase, that is, when you are actually needing to draw down on that income, I think that period is a very sensitive area for how people look at the stability of superannuation," he said. Mr Morrison said

introducing any changes retrospectively would **damage certainty and confidence in the system**.

There has been some speculation that this proposed change (along with certain others) are designed purely for the election campaign and that if re-elected, the Turnbull government would look to water-down some of these more contentious changes – particularly as the revenue implications associated with grandfathering existing arrangements is not significant.

If (and as we say such a change is far from certain) a cap were to be legislated, there are various strategies that could be considered. This might include segregating assets such that growth assets are allocated to pension phase (as subsequent growth beyond the $1.6m cap is allowed) and more defensive assets are placed in accumulation mode – there is no requirement to remove any cap excess from superannuation. However, one needs to remember that every dollar of earnings in superannuation is taxed at 15%, whilst the tax free (personal income) threshold is around $18,000 pa and with the overlay of Seniors & Low Income Tax Offsets, this figure can exceed $30,000. In other words, you could have $1m in a term deposit in your personal name earning 3% on which you would pay no tax. Hence, under a lifetime cap arrangement, retirement wealth can be optimised between pension, accumulation and personal income tax regimes.

Concessional Contribution Cap reduced to $25,000 pa

The concessional cap has been reduced progressively over time. However, the cap's operation has historically recognised peoples desire to increase contributions as they approach retirement and for those above 50 years of age, a larger cap has been allowed. This opportunity is now proposed to be removed. The one upside in this regard is that it is now proposed to allow individuals to **carry forward** their unused concessional cap on a 5 year rolling basis (provided super balances are below $500,000).

Lifetime Non-Concessional Contributions Cap of $500,000

This change makes little sense when viewed alongside the proposed lifetime pension cap of $1.6m. It shouldn't matter whether someone achieves the pension cap balance via non-concessional or concessional contributions – in fact one could argue that the lifetime cap should be placed on concessional contributions as these enjoy quite attractive tax concessions. By definition, non-concessional contributions are made from after-tax income and might represent the sale proceeds from (say) a property or share portfolio that may already be the subject of CGT.

Removal of Work Test for those aged 65 years to 74 years

Presently, contributions into superannuation by those aged 65 years or over can only be made if an individual satisfies a work test. This requirement has now been removed allowing contributions to age 74 years.

Effective Abolition of Transition to Retirement Pensions (TTRPs)

It has been proposed that from 1 July'17 the earnings tax exemption applying to all transition to retirement pensions will be removed – that is, the balances will effectively be treated as if they remained in accumulation phase, rather than in pension phase where no earnings tax is payable. There was some talk in the lead-up to the budget that new transition to retirement pensions might be curtailed, however, this proposal retrospectively impacts existing TTRPs.

Reduction to Excess Contributions Tax Threshold

Presently, an additional 15% contributions tax (ie 30% in total) is payable by those with an income exceeding $300,000. The government is now proposing the income threshold be reduced to include those earning more than $250,000.

Allowing PAYG earners Tax Deductions on Personal Contributions

Currently only the self-employed are able to claim an income tax deduction for personal super contributions (typically made in June of each year). It is proposed to allow all individuals under the age of 75 years to now claim similar tax deductions.

We are clearly concerned about a number of aspects of the proposed changes, particularly the absence of any grandfathering of existing arrangements, which has always been a feature of previous superannuation changes. Even Bill Shorten has signalled that the ALP will not be supporting any retrospective superannuation measures. Subject to the election outcome, we intend making submissions and representations to the Coalition, the ALP, Greens and cross-benches.

Regards

Andrew & Stephen
10 May 2016