Financial Planning

Quarterly Market Review – December 2014

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Please Note: Past performance is not a reliable indicator of future performance.

Overview

Volatility has returned to the financial markets over the last half of 2014 which has been primarily driven by the rapid fall in key commodity prices, especially oil and iron ore. For oil, the driver appears to be the increased production of global markets such as Libya and the shale oil deposits in the US. These factors coupled with the falling demand from key consumers, such as China, have led to falling oil prices that ended the half year at US$53 a barrel and recently hit US$50 a barrel in early 2015. This is equivalent to a fall of just under 50% for the second half 0f 2014. There was a similar pattern for spot iron ore prices which fell to around the US$70 per tonne at the end of December 2014 having lost close to 25% for the half year.

For Australia this has been an unwelcome development for the resources sector significantly impacting our two major exports. The falls were severe and largely unexpected. A background factor that has cushioned these dramatic falls has been the weakening Australian dollar (A$). The A$/US$ has fallen from 0.8752 in September to close the quarter at 0.8202 (-6.3%).

The global financial markets have largely been caught up with the falling commodity prices and the impact that this will have on company revenue longer term. Analysts are busy trying to factor in the latest moves to give some guidance on what are the likely financial impacts of these developments. Resource related companies have been harshly treated as investors tried to make sense of the price movements and ultimately retreated. This action is typical of short term investors who are influenced by unruly price movement and market volatility. For longer term investors, this price action is potentially a buying opportunity however, getting the entry level right is challenging.

Global economic developments are subdued but remain optimistic for 2015:

- **The US** is still improving: Index of consumer sentiment is at an 8 year high at 93.6 in December 2014, from 88.8 in November 2014 largely attributed to lower gasoline prices;
- **China** is marking time: The Gross Domestic Product (GDP) in China expanded 7.3% in the third quarter of 2014 over the same quarter of the previous year;
- **Europe** is trailing the recovery path: December GDP up 0.3% from previous year; and
- **Australia** is stuck in neutral: The Westpac-Melbourne Institute Consumer Sentiment Index fell 5.7% to 91.1 in December 2014 from 96.6 in November 2014.

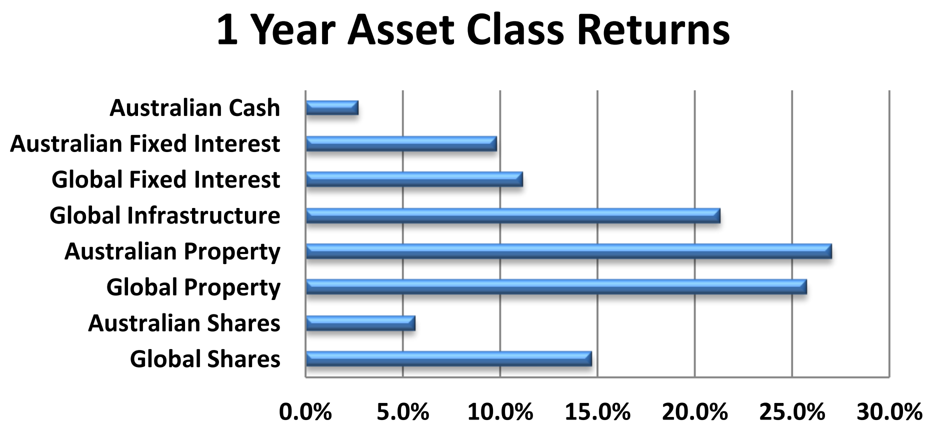
The recent commodity related activity has shifted the economic focus to the deflationary impact that diminishing commodity prices is likely to have on global economies. This is a sharp turnaround from the inflationary concerns post the pullback of the quantitative easing measures that have supported share prices generally over the last 5 years.

Asset Class Review

With global economic conditions being overshadowed with the activity in the commodity markets, returns for the broader market were sound over last year.

The asset class returns achieved were as follows:

Table 1



Source data: Morningstar, 31 December 2014

Growth Markets

The property markets have been the beneficiary of the recent share market volatility as investors chose to invest in an asset class that has been primarily driven by real property asset prices. This asset allocation change is still being driven by ‘yield chasing’ investors who are able to achieve reasonable levels of income from contracted rental leases. There has also been switching evident from Australian shares to US shares over the quarter. There is a growing interest in alternative growth investments where the underlying investment strategies are able to benefit from the volatility experienced by the broader markets.

Defensive Markets

The fixed interest markets produced solid returns as investors rushed back into the debt instruments given the implied change in direction for inflation. Many market analysts are now thinking that Central Banks may have to provide the market with lower interest rates for longer to counter the deflationary impact that lower prices may have on their economy. The problem is interest rates globally are already at record lows.

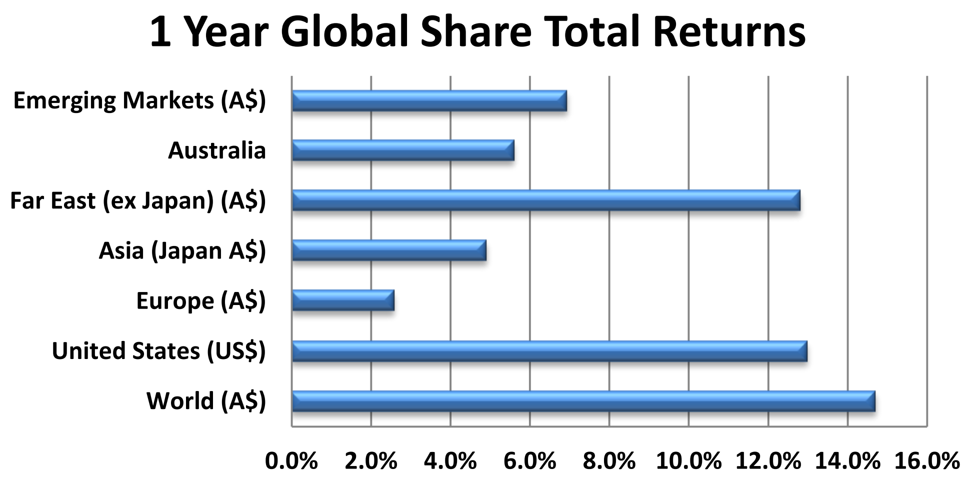
Investors have become less wary of the expected ‘normalisation’ of interest rates as expectations for economic growth stall along with consumer confidence.

Global Share Markets

The global share markets posted solid returns over the last 12 months of 14.71% helped by the ongoing economic recovery in US and the Far East. Recent oil and iron ore price falls continued to impact the returns of companies and countries exposed to natural resources.

Europe is still showing signs of benign growth with Gross Domestic Product (GDP) expanding 0.30% in the third quarter of 2014 over the previous quarter. This equates to an annual GDP of just 1.3%. Consumer confidence is improving but still a negative bias overall.

Chart 1



Source data: Morningstar, 31 December 2014

The main influences currently of investor investment preference include the following:

- The deflationary impact that the lower commodity prices infer on both interest rates and company revenue, profits and valuations;
- The overall volatility of markets and the sharpness of recent falls in the resource sector of share markets; and
- Yields and how to achieve returns above domestic cash rates plus inflation.

It is likely that the share market volatility will take another 6 months to settle and the next round of corporate results will be closely monitored to gauge the impact of the recent price activity on underlying profits.

The cheaper commodity prices will of course also benefit many companies and countries that have a heavy reliance on manufacturing and energy usage.

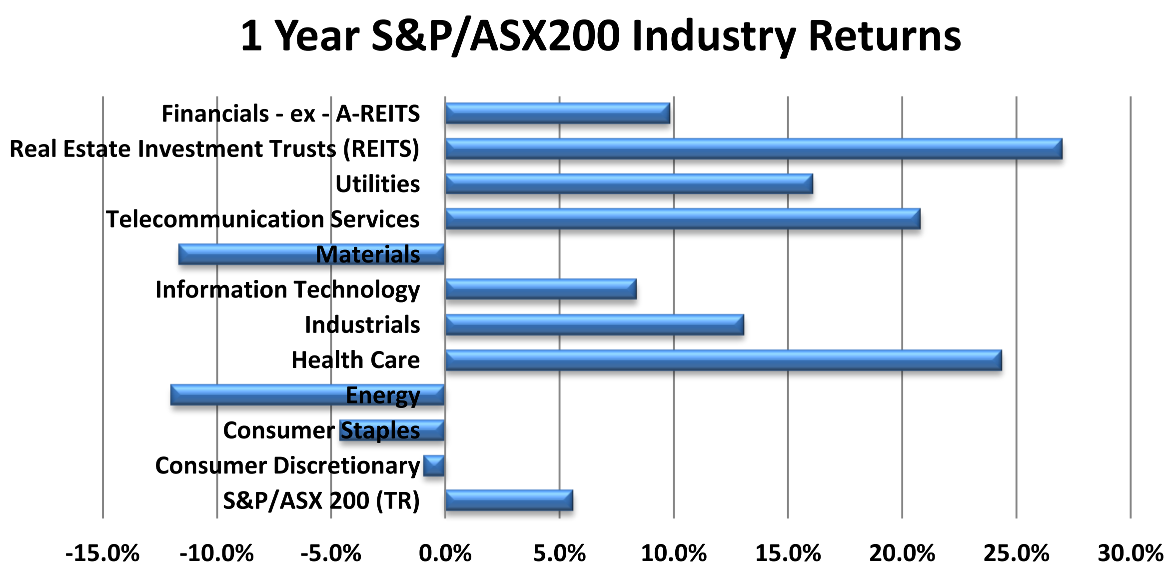
Domestic Share Market

The Australian share market was heavily impacted by the falling commodity prices, especially iron ore and oil, with the materials and energy sectors suffering most. The best performing sector was healthcare with investors still favouring companies that pay steady dividends that are fully franked.

Given the market capitalisation (size) of the companies in both the materials and energy sectors, investors are reluctant to shift holdings given the combined index weight is 20%. It is difficult to gain diversification within the Australian market given that banks, financial services and resource companies make up some 70% of the market.

The economy appears to be stalled with the latest data from the Australian Bureau of Statistics (ABS) revealed that unemployment is sitting around 6.3% in November 2014 and is expected to increase towards 6.5% as the workforce adjusts to the slowdown in demand for natural resources. The following table provides an industry breakdown of the composition of the S&P/ASX200 share market returns over the last 12 months:

Table 1



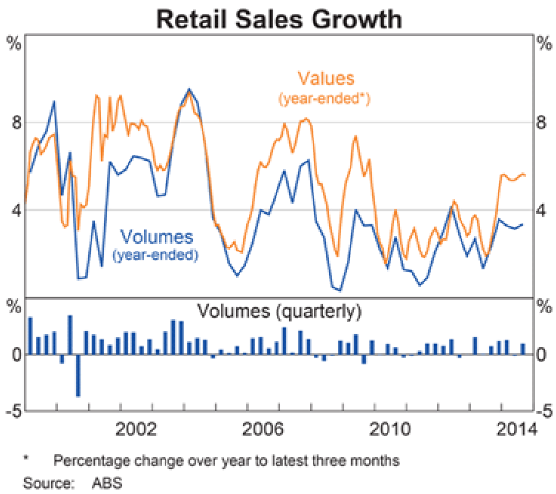
Source data: Morningstar, 31 December 2014

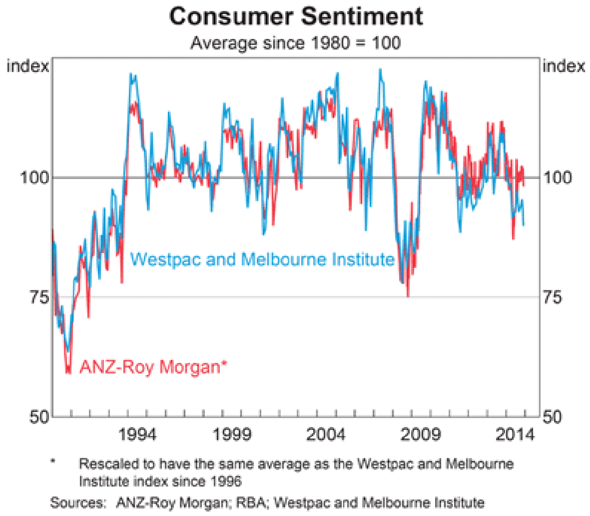
Where to from here?

Growth is slowing but not dramatically with Australian GDP increasing 0.3% in the third quarter of 2014, down 0.2% from 0.5% expansion reported in the previous three month period which was below market expectations. Net exports and consumption contributed the most to the growth while investment dragged the expansion down.

On the bright side, ABS reports corporate profits in Australia were $65,105 million in the third quarter of 2014 up from $64,798 million in the second quarter of 2014.

Charts 2 and 3





The final quarter of 2014 is showing a mild increase in retail sales however, this is generally a seasonal trend as Christmas and associated Boxing Day sales tend to boost spending.

Consumer sentiment is still a concern for the overall economic recovery as households remain cautious about the future. The Australian Westpac-Melbourne Institute Consumer Sentiment Index fell 5.7% to 91.1 in December from 96.6 in November. It is its lowest level since August 2011. Housing demand in the domestic retail housing market is stabilising at the higher levels however, prices remain firm and the likelihood of further gains is buoyed by the potential for interest rates to fall further.

For 2014 the S&P/ASX200 Index price range was 5,658 (2nd Sept) to 5,070 (4th Feb). This equates to a price movement of 588 points or 11.6%. Analysts expect a similar trading range for 2015. The index finished the year at 5,411 and the average price for the year was $5,414.

The 12 month volatility (annualised standard deviation) of the index was 17.78% compared with the 5 year volatility of 18.63%. For investors, if history repeats itself, the trading range from the closing level on December 31 of 5,411 and assuming a 50% equal split(up and down), the index price movement, would equate to a high of 5,707 and a low point of 5,114 (11.6%).

A company example is BHP where the price range for the last 12 months has been:

BHP	12 mths	Date
Maximum price	$39.68	19/08/2014
Minimum price	$27.42	16/12/2014
Price change	$12.26	
Percentage change	44.71%	
Standard deviation daily prices	2.72	
Annual volatility	16.48%	

Remember, share investing is generally for the longer term (5 to 10 years).

Global and Domestic Property

Property investors remain positive about the current activity in the sector. As previously discussed, much of the demand for property is based around yield. With interest rates globally remaining low the incentive to invest in property is strong. The drawback to property investment is picking the right sector at the right time.

Residential property is remains the favourite for retail investors who are enjoying the availability of credit but not so the high prices being demanded by sellers.

Table 2

PROPERTY SECTOR	3 mths	6 mths	12 mths	24 mths	36 mths
Global Property	15.36%	18.72%	25.74%	14.34%	9.34%
Australian Listed Property	11.51%	12.69%	27.03%	16.64%	21.85%

Source data: Morningstar, 31 December 2014

The returns are inclusive of dividends paid and reflect a total return to investors post fees.

The listed property market more recently has been the beneficiary of the volatility experienced in other sectors of the market. Generally speaking, listed property does inherit a degree of equity like volatility due to the listed nature of the shares. As with other yield based investments, property stocks have benefitted from the falling interest rates and risen strongly.

A potential drawback for the listed property market is the direct linkage to interest rates. Most listed property funds carry a level of debt which in most cases is less than 50% of their net tangible assets.

The problems with investing in this sector include the following:

- Rising interest rates will put pressure on property valuations due to the increase in servicing costs of the debt;
- Inherited equity market volatility;
- Capital volatility due to market valuations throughout the economic cycle; and
- Vacancy rates will impact cash flows and hence dividends.

The benefits gained from exposure to the sector include:

- Dividend yields are attractive;
- Lease agreements are usually CPI linked and reset annually; and
- Internally leveraged to growth in the property market.

With domestic interest rates remaining near all-time lows, distributions (rental yield) and potential for capital growth in the sector, are attracting plenty of investors.

Property plays an important long-term strategic role in a diversified portfolio.

Global and Domestic Debt Markets

Fixed Interest markets have benefitted from the latest developments in the commodity markets as fears of inflation reversed and deflationary scenarios emerged. Investors rushed back into low yielding Government bonds. The 10 year US Bonds rallied over the quarter from 2.49% to 2.17%. With core inflation running at 1.7% then investors are ahead 0.47%.

In Australia, the latest ABS data shows 10 year Government bonds closed at 2.83% for the December quarter down from 3.48% in September. The latest ABS CPI data reported annual inflation of 2.3% in September 2014. This indicates that Australian bond investors would receive a return of just 0.53% in real terms. Term deposits sit between 3.25% and 3.45% for the 1 year. The following chart shows the returns achieved from cash and fixed interest markets over the last year:

Chart 4

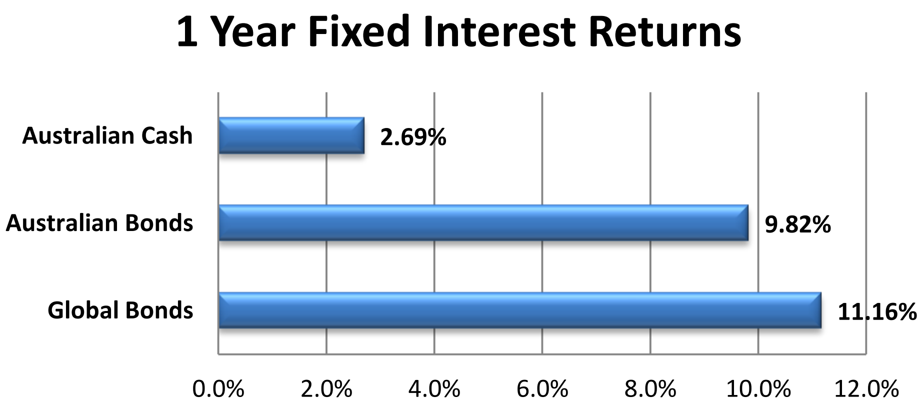


Table 3

DEBT SECTOR	3 mths	6 mths	1 year	2 years
Global Bonds	3.40%	5.63%	11.16%	6.50%
Australian Bonds	3.97%	4.98%	9.82%	5.83%
Australian Cash	0.68%	1.36%	2.69%	2.77%

Source data: Morningstar, 31 December 2014

What lies ahead for interest rates?

With the latest developments in the commodity markets, especially oil, the focus is now on deflation and the potential to derail the growth prospects that have been emerging post the GFC and Sovereign Debt crisis. Central Bank's respond to inflation by raising interest rates which indirectly tempers demand. The reverse action is applied for deflation.

With interest rates at historic lows, it will take further efforts by Governments to rekindle growth and therefore monetary policy should remain accommodative in the short term. It would appear that the inflation genie remains contained for the moment however it is expected that interest rates will normalise (rise) over the medium term.

Summary

Short Term

In the short term, volatility is a concern for the global economy however investors have had plenty of practice in dealing with such market conditions. Historically investors have initially shied away from riskier investments when volatility emerges. This will mean that short term, cash and fixed interest and, to a degree, property assets will benefit under this scenario. In the absence of a clear disaster scenario, the real danger here for investor's is to act in haste and reposition share exposures across other asset sectors. As previously experienced, this can be problematic as investors then attempt to pick the re-entry price level.

Medium Term

In the medium term, experienced investors will focus on looking for opportunities that will emerge post the stabilisation of commodity prices. Cheaper share prices will mean that companies with strong balance sheets will be on the lookout for cheap assets in order to expand their business models. Mergers and acquisitions are on the table. The old adage: buy when prices are low and sell when prices are high still works in any asset class.

Opportunities will arise as countries and companies benefit from lower energy and natural resource costs. Manufacturers will be able to potentially produce goods at cheaper prices. For countries that are major consumers of energy, such as China and Japan, this development is likely to have a positive impact in the medium term as not only are they able to source cheaper energy to produce their products, they will also be able to import natural resources such as iron ore at significantly lower prices. The question will be: do they increase profits or reduce product prices? Lower prices are deflationary.

Longer Term

Just as the global economy was showing positive signs, an 'X' factor has emerged. The speed and the degree of magnitude in which this has happened shocked most analysts. The falls have been sharp and extreme in some cases. The share price falls associated with the falling commodity prices are most likely overdone but may be pre-empting further falls.

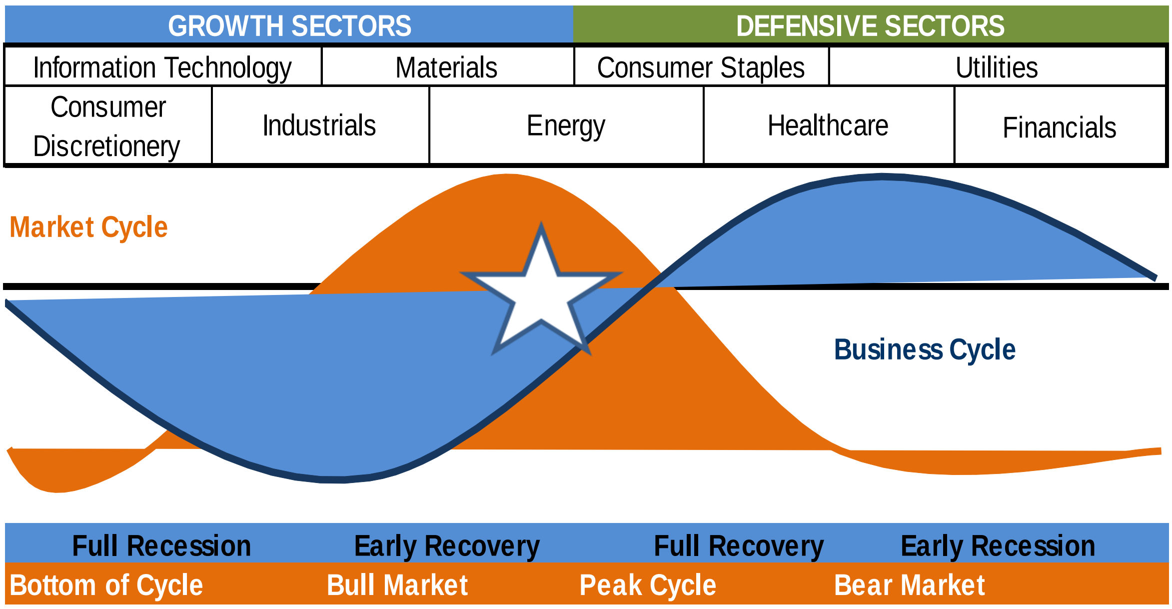
The economic activity in China has taken a back seat during this period of volatility but remains in reasonable shape. GDP in China expanded 7.3% in the third quarter of 2014 over the same quarter of the previous year. The GDP growth target for 2015 is set at 7.1%. Fiscal policy settings are likely to remain expansive for 2015 and monetary policy is positioned to help the economy continue to grow at a preferred pace.

For the moment, the global economic conditions are revealing pockets of fragmented regional recovery. The US appears to have weathered the storm better than others due to its globally diversified industry and capital structures while Europe is still proving hard to start the recovery process. Markets remain cautious but optimistic about the longer term global recovery. The big question is how quickly will economies recover from this latest distraction.

Key Message

Don't panic. Most analysts agree that the market is a zero sum game so for every winner there is a looser. The temptation to make short term changes to your investment portfolio is reactive and should be avoided without due cause. Substantial reshuffling of assets away from your preferred risk profile may significantly change your investment outcomes in the longer term. If your investment goals and objectives are still valid; you do not need the capital; your personal situation is the same, then nothing has fundamentally changed.

Remember the market cycle does tend to lead the business cycle. If the fundamentals of recovery are still in place then it is likely that this is a pullback but not a derailment.



For Australia, RBA targeted cash rates of 2.5% look like staying lower for longer. Broader issues such as the unemployment rate which hit 6.3% in November 2014, continue to keep a lid on consumer sentiment and household spending patterns.

When the dust settles, our economy will continue to make the transition from the mining sector to the services sector which hopefully will involve creating more employment opportunities. Much will depend on the level of skill required to fill these roles.

A background factor that will offset, to a degree, the commodity price fall is the value of the Australian Dollar. The lower A$ improves the pricing of our exports. Unfortunately this also increases the cost of our imports.

The market will recover from the latest bout of volatility but it may take some time to work through and unearth what are the real revenue impacts of the commodity price changes for companies and who will benefit most from them in the longer term.

Diversification throughout the cycle expands the source of your returns.

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Data Sources

Where indicated in this review, the underlying data was sourced from Morningstar on the 8th January 2015.

Benchmark	Country/Asset Class
MSCI World ex Australia (Net TR) AUD	Global Shares
MSCI Europe NR AUD (AUD)	European Shares
S&P 500 (TR) USD	United States Shares
MSCI JAPAN (Net TR) AUD	Japan Shares
S&P/ASX 200 TR AUD (AUD)	Australian Shares
S&P ASX Small Ordinaries AUD (TG) AUD	Australian Small Companies
FTSE EPRA/NAREIT Developed NR AUD (AUD)	Global Property
S&P/ASX 200 Property Trusts Accum Index (AUD)	Australian Listed Property
S&P Global Infrastructure NR Hdg AUD (AUD)	Global Infrastructure
Citi WGBI Hdg AUD (AUD)	Global Bonds
Bloomberg AusBond Composite 0+Y TR AUD (AUD)	Australian Bonds
Bloomberg AusBond Bank 0+Y TR AUD (AUD)	Australian Cash
MSCI EM NR AUD (AUD)	Emerging Markets