Providence Wealth Advisory Group

Global Outlook & Strategy

4th Quarter 2012

Investment Overview

We are becoming increasingly concerned regarding the outlook for the Australian economy as the moderation of the mining boom exposes the imbalances that exist within Australia. The combination of a high currency, years of negative productivity growth, high labor costs, an inflexible labor force and reliance on the booming mining sector is likely to see the Australian economy weaken over the next couple of years. This may put undue pressure on households given that debt to disposable income is still high at 150% (although lower interest costs will assist debt repayments). Additionally, Australia has become a very expensive place to live with many international visitors astounded at the high cost of living.

The world is still facing the harsh reality of a protracted deleveraging cycle ensuring that global growth, particularly in the indebted developed economies, will remain anemic. Deleveraging cycles which usually only appears once in a lifetime, can last for decades with the average deleveraging cycle around 15 years; so there is still a decade to go if we have an average cycle!

The International Monetary Fund (IMF) has recently downgraded their global growth forecasts to 3.3%. Therefore earnings growth of companies in general will be modest and mining investment is likely to be scaled back.

Meeting this deleveraging cycle is the unprecedented global quantitative easing (printing of money). This is an attempt to debase currencies or monetise debt, keep interest rates extremely low and spur investment. This will at some stage create new headaches as excess money will form new investment bubbles. However, at this stage we believe a lot of systemic risk in the financial system has been taken off the table by the central banks.

Total Assets ECB and Federal Reserve (USD) versus Gold (USD)

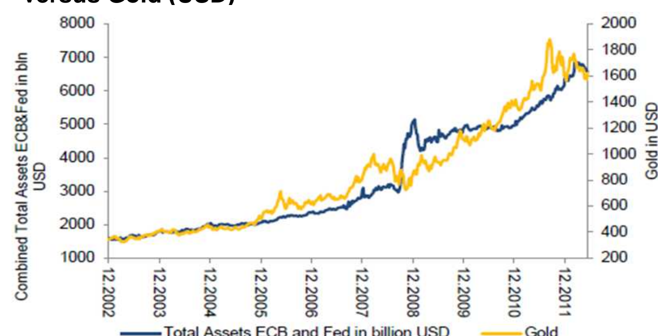

Figure 1 Although inflation is not currently in the spotlight the enormous increase in the global money supply (M1) is expected to remain supportive for gold.

US M1 & Gold

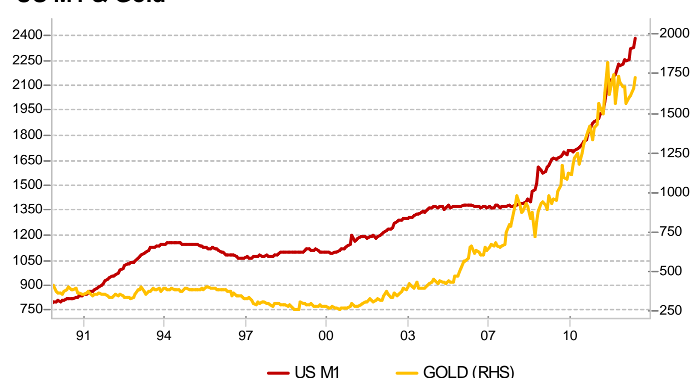

Figure 2 There is a high correlation between M1 and the gold price.

Additionally there are still legitimate concerns regarding the size of developed economies government debt and fiscal deficits. If markets lose faith in governments' ability/commitment to reduce these imbalances gold is likely to be one of the preferred "safe havens'. ***It is for this reason, the protection and preservation of capital in real dollars***, that we are investigating an allocation to gold for clients' portfolios and undertaking significant research.

We expect China to continue to grow albeit at lower levels than in the past. Once the new leadership is entrenched, and inventory overhangs overcome (housing, steel) we believe that impressive, yet sustainable, demand led growth can resume.

Although many European economies are likely to remain in recession the announcement by Mario Draghi that he will use the full force of the European Central Bank's (ECB) balance sheet to supress peripheral bond yields has taken some of the potential systemic failure off the table. There is a long road ahead for the Euro and social consequences of the austerity programs cannot be dismissed.

There are some positive signs coming out from the US. These include a pickup in US housing starts which have rebounded strongly over the past few months providing support to retail spending. There has also been evidence of an increase in the manufacturing base in the Mid-West as companies bring back onshore manufacturing capability given lower labor costs. The US could surprise on the upside regarding growth although the "fiscal cliff" (end of tax cuts) could provide a further drag to growth and uncertainty in markets.

Overall we face a low global growth environment, extremely low interest rates, substantial printing of money and the potential of further Euro shocks although a number of the systemic risks have been deferred. Investors will continue to be dragged back into risk assets (equities and property) as income assets (government bonds and cash) will not be able to provide the income required for living needs of an ageing population.

Opportunities

Income

- Global corporate bonds/syndicated loans
- Selected equity hybrids
- Australian bank shares

Income and Growth

- Australian REIT's and selected commercial property syndicates.
- Large cap multinational companies with scale and brand leverage

Security

- Australian term deposits/cash
- Gold
- Equity market protection through put options

Risks

- Long term fiscal outlook of a number of developed economies and lack of political will to address
- The looming "fiscal cliff" in the US
- Geopolitical risk: China / Japan island dispute, Israel/Iran
- A significant slowdown in China
- Longer term inflation

Implications

- Lower cash rate (positive for debt, non-residential property, high yielding equities, negative for income returns)
- Potentially lower AUD (positive for offshore investments and restoring competitiveness)
- Lower profit growth for domestic companies (negative Australian cyclical equities)
- Retain an above benchmark weighting to cash given the low interest rates on Government bonds
- Focus on income producing assets in a low return environment
- Offshore equity investments not hedged back into AUD
- Review gold as part of asset allocation

Asset Class Review

Equities - *Prefer International unhedged*

We prefer international equities over Australian equities at this stage of the cycle. This is a combination of an expensive currency, slowing economic growth and limited earnings growth options. Dividend yields however are attractive in such a low cash rate environment and should be supportive of valuations around current levels.

We feel that resource stocks have probably discounted the slowdown in China and may provide some value. Our preferred resource exposures are Copper, Gold, Oil and Gas. Our least preferred commodity is Iron Ore.

Australian banks look expensive from an earnings perspective but attractive from an income perspective. We expect dividends to be maintained despite a slowing economy and therefore a gross yield of 8-9% should support current share prices. Small resource stocks look incredibly cheap (those who are already in production) and will be subject to further approaches from cashed up corporates or sovereign funds.

The impact of technology is continuing to have a profound impact on traditional business models. The sectors which are sure to benefit from the interconnected mobile world are likely to include the medical field, data mining, marketing and banking. We prefer international fund managers who are not following an index benchmark but are searching the globe for those companies best positioned to benefit from a growing Chinese middle class and the new technologies available. We do not hedge back into the Australian dollar given its current levels.

Property - *REIT's Fair Value*

Australian Real Estate Investment Trusts (REIT's) are no longer cheap and are trading around fair value at a 3% discount to Net Asset Value. Cap rates have remained fairly stable with an implied cap rate of around 7.2% for the sector. Some concerns are being expressed regarding future vacancy rates given the slowdown in the mining and financial sectors. Despite our concerns of a slowing Australian economy we feel that the combination of lower funding costs, the yield premium of 300 basis points (3%) above the Government bond rate, forecast distribution growth of 3-4% and low gearing, the Australian REIT sector provides an attractive risk return for investors. We would revisit (reduce) our allocation if the sector traded at a 10% premium to net asset values.

Direct Property - *Some opportunities*

We continue to review opportunities in the direct property sector and spend many hours reviewing potential assets. Although close on a number of opportunities we are remaining disciplined in ensuring as much as possible risks have been mitigated.

Residential Property - *Finding a floor*

The reduction in interest rates and the weakness over the past few years has probably meant that residential property has found a floor. Although not expecting adequate returns from an investment sense we do not foresee any major collapse in values although a significant slowdown in the economy would caution our view.

Fixed Income – *Credit spreads contracting*

There has been a contraction in credit spreads recently which has seen credit perform well during the period. The Bentham Global Income Fund is up 5.64% for the recent September quarter. Investment grade credit spreads look quite tight and we would be cautious adding to this security. However we still prefer credit over Government bonds and utilise cash for our safety buffer in times of volatility.

Although hybrids are included in this asset class it is important to realize they also carry some "equity type" risk. As a result of increasing our exposure to these securities we have reduced our Australian equity exposure to compensate somewhat in order to manage risk within the portfolios. In

an environment where Government bonds are providing negative real returns (after inflation) and corporate balance sheets are strong (low debt) credit is likely to provide solid risk adjusted returns and we therefore expect further contraction in credit spreads and low default rates.

Alternatives – *Reviewing Gold*

As a skeptic of many hedge funds and alternative strategies we have a light weighting to this asset class. However we are forming the view that gold, as a protector of portfolios, should be included. This is centered around the potential for further currency devaluations as a means to pay down sovereign debt along with the potential of inflation as a result of the unprecedented printing of money.

Summary

Some of the systemic risk in Europe has been addressed by the ECB although global growth is likely to remain below trend. The great deleveraging cycle is set to continue placing pressure on world growth and company earnings. The Australian economy is likely to see a slower growth profile as the mining sector moderates its growth and households remain cautious. Focus is therefore on income generation within portfolios and protection of capital via cash weightings and potentially gold.

Conclusion

- Preferred assets: Credit (corporate bonds, syndicated loans), Australian REIT's and selected direct property investments, high yielding domestic equities, global equities unhedged.
- Avoid: Government bonds.
- Income generation will be harder to achieve due to lower cash rates but will still form a larger part of total returns.
- Investors will be "forced" back into risk assets (equities) as income returns from cash and Government bonds are unable to provide living requirements in an ageing population.

Asset Class	Strategic	Range	Tactical	Overweight/ Underweight
Australian Shares	35%	25% - 50%	20%	Underweight
International Shares	25%	10% - 35%	25%	Market weight
Property	10%	0% - 15%	13%	Overweight
Infrastructure	n/a	0% - 20%	0%	Not applicable
Govt Bonds	25%	0% - 50%	0%	Underweight
Corporate Bonds	0%	0% - 50%	23%	Overweight
Cash(term deposits)	5%	2% - 50%	15%	Overweight
Hedge Funds	n/a	n/a	4%	Not applicable
	100%		100%	

The above table illustrates the Strategic Asset Allocation of a balanced portfolio (Van Eyk, 2013) against an active Providence Tactical Asset Allocation. The objective of tactical asset allocation is to move among various asset classes within a risk-controlled framework to create an additional source of return. An attempt is made to take advantage of short and intermediate term market inefficiencies as a means of managing investors' exposure to market risk.

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