Providence

Independent Investment Advisory

Global Outlook & Strategy

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1. Key Points

- Global aggregate debt levels remain elevated
- Global growth will likely remain subpar
- Deflationary forces imposing themselves
- Valuations are more reasonable although not compelling
- Future returns are likely to be structurally lower
- Alternatives and cash remain important until clear value presents itself

Debt, Deflation and Deleveraging

There has been significant technical damage inflicted on world equity markets breaking the bull trend since 2009 where global equity markets have risen some 86% or 12% p.a. We have also witnessed a rise in credit spreads (the yield above the risk free bond rate) reflecting the concerns regarding emerging market and global energy related debt. Junk bond yields have now risen to their highest levels since the GFC and are reflecting concerns of likely higher defaults.

Official global cash rates remain at record lows and in some cases offering negative real interest rates (interest rate after inflation).

Global aggregate debt levels remain at record levels. Of most concern is the build-up of USD debt within Emerging Economies. This now threatens stability within the financial system as the USD strengthens and a deflationary environment sees this debt balloon. Asia and Emerging Markets are becoming the engine of global deflationary trends with markets beginning to reflect this view.

We expect a long period of muted investment returns with bouts of volatility intermingled with declining asset prices. This is due to the record levels of aggregate global debt. Global debt is too high and unsustainable without a strong recovery in global economies. A long period of deleveraging will see little aggregate global growth despite efforts of central banks to inflate the economies. Combined with those deflationary forces we also have a headwind of ageing demographics in the developed world.

We are maintaining an overweight holding in cash and increasing our alternatives exposure. Our preference for international equities unhedged over Australian equities is waning after the past few years of outperformance in AUD terms. We are cautious on Australian residential and A-grade commercial property due to strong rises in valuations, high cash weightings and anticipated lower Chinese investor interest.

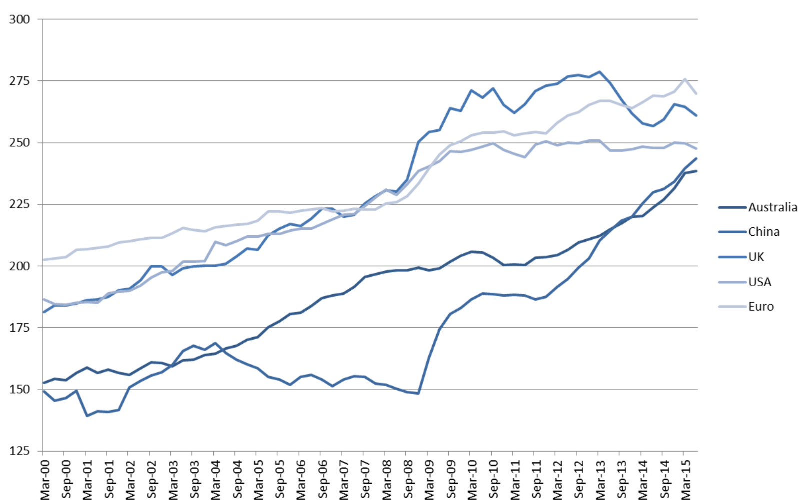
2. Investment Overview

Global growth remains sub-par at around 2.7% with little likelihood of a pickup in 2016 despite the unprecedented policies of global central banks. Coupled with a low inflation environment, these subdued economic growth levels continue to add to our concerns regarding global indebtedness.

Although the growth rate of debt has slowed significantly, it remains above the level of nominal GDP growth suggesting an ongoing deterioration in the debt to GDP ratio (Figure 1). Fortunately, current low global interest rates keep the serviceability of this debt at fairly manageable levels, however the Japan experience suggests that ongoing low serviceability costs allows extreme levels of debt to be sustained for an extended period of time. A prolonged environment of rising rates coupled with low levels of growth and inflation would certainly be cause for concern, as a result we watch the efforts of the FOMC and the rising interest rate environment in the US closely.

Easing some of our concerns is the pickup in growth and lower unemployment rate in the US. The US currently has an annualised growth rate of 2.8% due mainly from a build-up in inventories. Final domestic demand however, has fallen from 3% to 2.7%. Although the unemployment headline rate has fallen from a peak of 10% in October 2009 to 5.5% at the most recent reading, the participation rate has fallen with many opting out of the workforce. This is evident if you look at US employment as the hours worked instead of the number of jobs it removes the distortion of making a part time job equivalent to a full time job. The result is that there has been virtually no growth in employment so far this century (Figure 2).

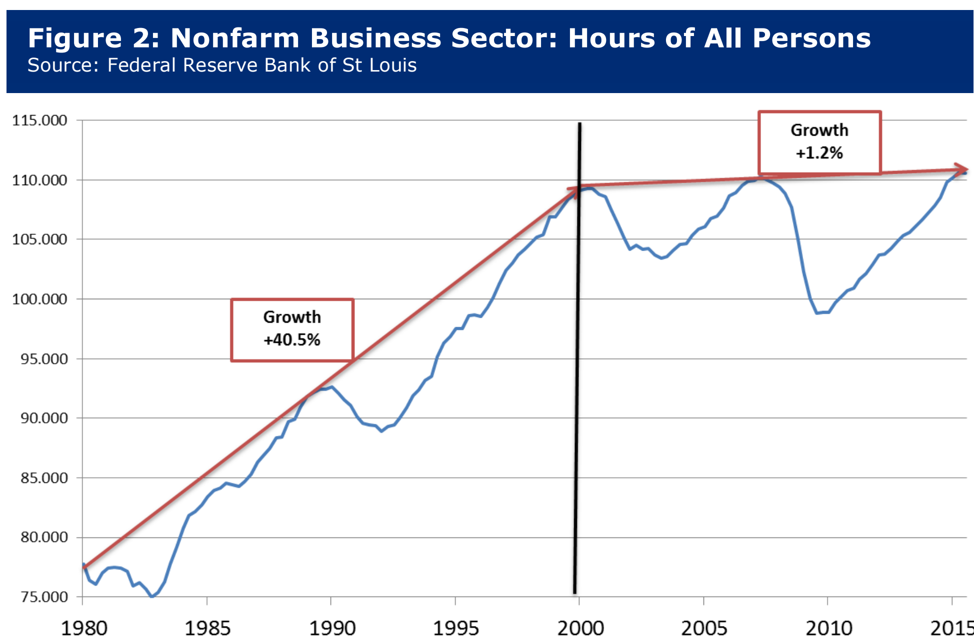
Figure 1: Non-Financial Sector Debt to GDP
Source: Bank for International Settlements (BIS)



Inflation in the US still remains subdued; in the current environment we are likely to see a very gradual rise in US interest rates, unless the pace of wages growth increases significantly and therefore improves the inflationary prospects.

The risks in the US remain the strengthening USD and the impact on economic growth, the impact of lower oil prices on the shale gas industry and the potential for a further deterioration in inflation at a time where debt levels remain high.

Figure 2: Nonfarm Business Sector: Hours of All Persons
Source: Federal Reserve Bank of St Louis



China, despite the recent slowdown remains a good long term story as the economy successfully rebalances from capital spending to consumer spending, although the economic growth rate is likely to decline to 5-6% from the current headline rate of 7%. Recent import data shows a 15-20% decline, Industrial production posted its weakest reading since 2008 of 5.6% and fixed asset investment growth is at 10.2% continuing its downtrend since its peaks in 2009. These readings, while negative for commodity markets, suggest the rebalance is occurring at a faster rate than most expected. The transition is a resounding positive for the Chinese economy and gives credit to the environmental reforms that Xi Jinping outlined.

Counter to this positive view, we hold concerns regarding the deflationary trend within China as core PPI declined 5.9% from a year ago in December. This combined with the high levels of corporate and state debt is certainly something of concern although China still has monetary and fiscal tools at its disposal to combat any significant slowing in the economy.

The political interference in the equity markets is also damaging to sentiment and counter to the governments free-market reform agenda. Continued meddling in the equity markets could see further capital flight from the region and encourage a faster than expected depreciation in the Yuan.

Within Europe there is a slight uptick of growth to 1.6% year on year with the peripheral economies, specifically Spain, showing the strongest levels of growth at 2.4%. It is likely that there will be an ongoing and/or widening in divergence between economic performances of the various economies that make up the Eurozone. This divergence is likely to create ongoing questions around the benefits of the Eurozone and as a result creates political uncertainty in the region.

Much like the rest of the world, Europe is struggling with low inflation in the face of a burgeoning debt load. Coupled with a stubbornly high unemployment rate at 10.7% (however the lowest levels since 2012) we expect quantitative easing to remain firmly in place for 2016 with the risk skewed to an increase in the pace of bond purchases rather than any reduction.

There are certainly pockets of heightened risk within emerging markets, specifically those with current account deficits, high levels of USD denominated debt and strongly depreciating currencies. Specifically, a number of economic indicators suggest that an easing bias to monetary policy is required however the significant capital outflows has created major weakness in exchange rates thus increasing the cost of foreign denominated debt. To be sure, this has resulted in a number of countries being forced to tighten monetary policy (raise interest rates) to help stem the currency weakness.

Within Australia, the recent headline GDP OF 2.5% year on year overstates the health of the economy. After adjusting for net exports domestic demand actually contracted by 0.6% in the quarter in real terms which is at recessionary levels. Real disposable income is also weaker down 1% annualised which is worse than levels seen in the 1990s recessionary period. The terms of trade continue to impact on income levels down some 10% year on year. This comes at a time when commodity prices continue to fall, household debt is a record levels with house prices and housing starts at record highs. We are attracted to the themes within Australia of domestic tourism growth, agricultural exposure, exposure to ageing population and selected infrastructure assets. We are cautious regarding property, resources, and banks.

Overall, it is difficult to build an overly bullish case on the global economy. We do not expect any significant deterioration although the risks are certainly skewed to the downside.

Investment returns will be below long term trends, asset prices will struggle to gain from currently inflated levels and cash rates will remain low for the foreseeable future.

Being nimble, trading the ranges, retaining an overweight position to cash, seeking alpha managers and alternative strategies will be the key for acceptable investment returns in such a difficult environment.

Despite the best efforts of central bankers there will be no free ride this time around.

3. Asset Class Review

3.1 Equities – *Prefer International unhedged and mid to small cap managers domestically.*

Our preference for international equities remains in place although the valuation differences between domestic and international equities now favour domestic equities (Figures 3 and 4). We continue to prefer international equities for the diversification benefits away from the Financial and Resource dominated Australian index.

Figure 3: Aust. Trailing PE (Real 10yr mav EPS)
Source: IBES, ABS, HIS est., using proxy updates

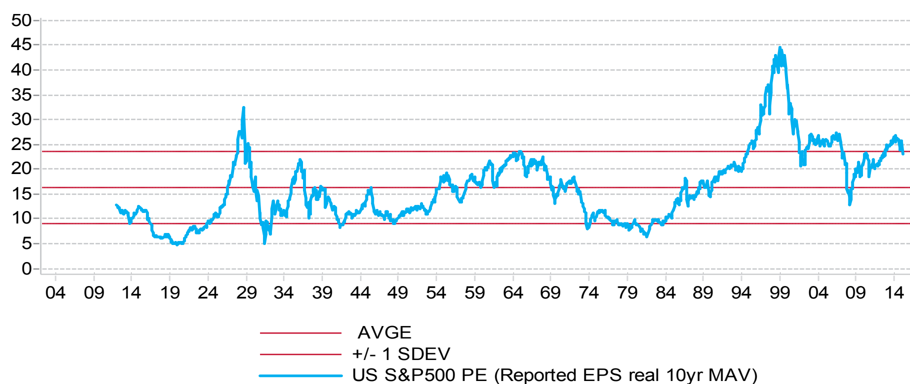
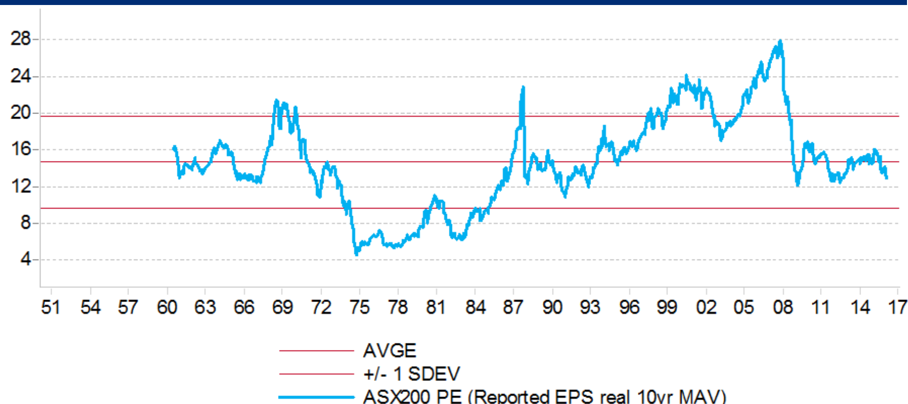


Figure 4: US PE (real reported 10yr mav EPS)
Source: IBES, Shiller, using proxy updates

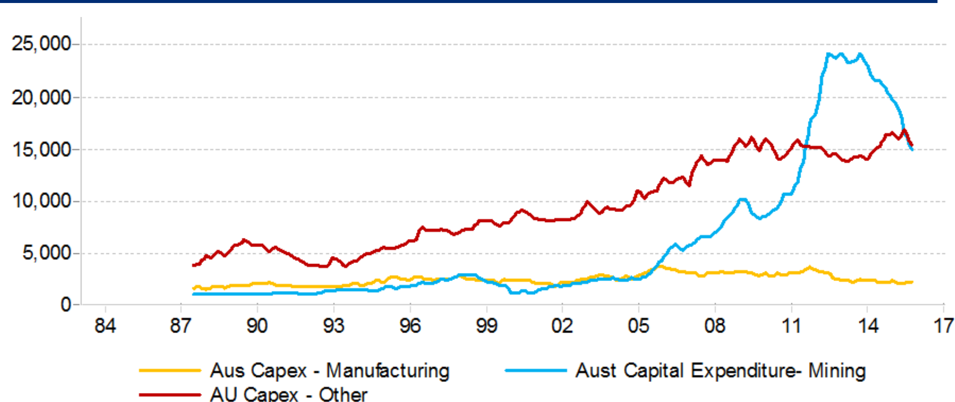


With regard to Domestic equities, as mining/energy investment in Australia cycles off peak expenditure and many projects come on line (granted with dramatically reduced commodity price headwinds), we struggle to identify many companies across all industries investing in future growth via committed capital to new projects.

Resources expenditure, as an example is now ~40% off its mid-2012 peak (Figure 5) and the flow on effect to many industries and sectors in the Australian economy is now being felt via a lack of earnings growth.

The exception to the above has been the theme in recent years by boards to gear up balance sheets to buy-back stock or companies prepared to forego growth investment in favour of returning capital to investors via yield. With that in mind, we note that out of the ASX/S&P200 index, there are 120 companies (including infrastructure and utilities) who have a forecast FY15/16 payout ratio >60% as well as fairly significant earnings assumptions (11.2%). We question the long term sustainability of some of these payouts as well as the earnings growth given the limited capital expenditure.

Figure 5: Aust. Capital Expenditure by Sector qtly (million)
Source: ABS, RBA



At some point in the future, the market needs to refocus its attention on those companies who are re-investing shareholder capital for future growth versus those companies whom are merely paying out capital in the form of dividends to appease shareholders and to prop of the “hunt for yield” thematic. That motive is clearly unsustainable.

It therefore remains difficult to find compelling value in the top 100 stocks in Australia. We see opportunities in the Australian ex-top 100 market, where there remains nimble management and industries that continue to grow and prosper in a sluggish Australian economy. It is therefore in this space (Ex-Top 100) where we will look to seek value for some of our Australian equities exposure.

3.2 Property

Foreigners now account for 50% of all transactions in direct property and 20-30% of residential transactions. With record house prices, record high debt to income ratios, record housing starts and foreign demand any slowdown in the economy and a drop off in Chinese purchasers would have a major impact on house prices and caution is therefore warranted despite record low interest rates. Furthermore, Australian debt levels are now at historical highs from a debt to income perspective which also creates vulnerability in house prices should we see a weakening in the domestic economy.

REIT's are trading at a 12.2% premium to underlying net asset value although there could be some upgrades to valuations given tighter cap rates in the direct sector. The cap rate compression for Prime and Secondary office and Industrial property are all well below their long term average (Figure 6).

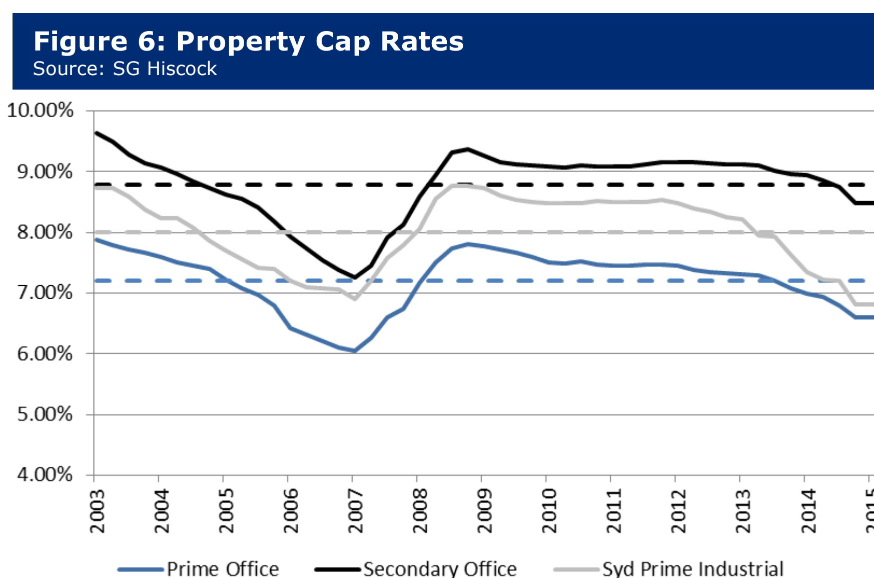


Figure 6: Property Cap Rates
Source: SG Hiscock

Implied cap rates are calculated to be 6.2% with gearing around 30% and distribution yields around 5-6%. Given the very strong performance over the past few years and cap rate compression we find it difficult to find much value in the sector although merger and acquisition activity could support the sector. SG Hiscock, one of our preferred fund managers in the sector, forecast a total return of 7.7% p.a. over the next five years.

It is very difficult to find much value in the direct property sector given tight pricing due to offshore demand and given our cautious view regarding the Australian economy. We look for value added plays (distressed property) or demographic trends i.e. aged care and child care in the direct space.

3.3 Fixed Income

Fuelled by excessive liquidity from global central banks and the search for a yield above inflation, high yield credit markets have started to exhibit some stress. Credit spreads have widened throughout most of the year (lower prices, higher yield) (Figure 7), defaults have started to rise and we are concerned that some global credit funds have been unable to provide sufficient liquidity to fund redemptions.

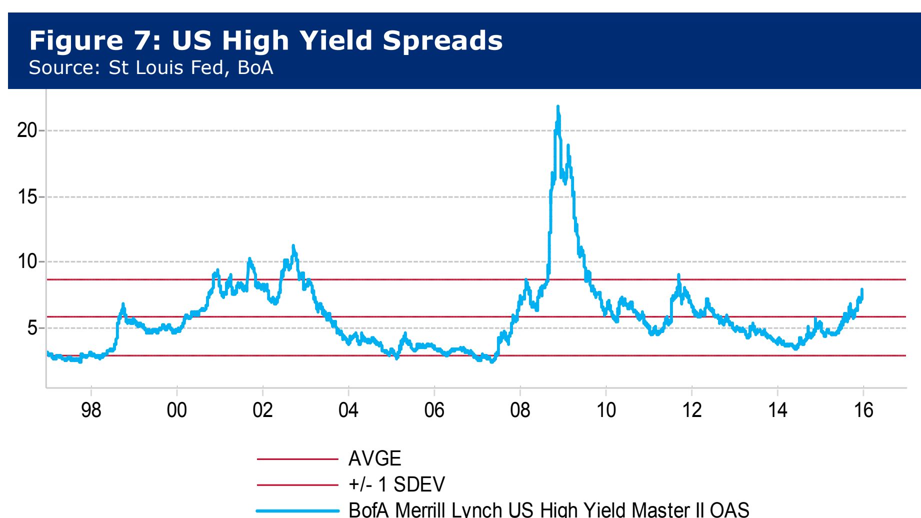


Figure 7: US High Yield Spreads
Source: St Louis Fed, BoA

As discussed earlier, global aggregate debt is at record levels which are particularly concerning in emerging markets. Excessive credit growth tends to lead to a credit crisis after artificially inflating economic activity. There seems to be a major credit cycle in the US approximately every six to seven years. In China there has been excessive credit expansion from 2008 to about 2013 with total debt to GDP now at 282%, we wonder whether China is due for a contractionary phase in credit markets.

A credit crisis in China along with rising defaults in the US combined with slow global growth would create a major dislocation in credit markets and undermine valuations in risk assets. This is not our core view at this stage but is on our watch list.

Official Government interest rates and bonds are likely to remain low in the current environment for the foreseeable future. Disinflation is firmly entrenched with concerns that deflation out of China will become ingrained globally.

The rise in credit spreads and the subsequent higher interest rate will provide some opportunities as investors are rewarded for the risk being undertaken. This is evident in our view in some recent Australian Hybrid issues which are now paying a spread 5% above cash.

3.4 Alternatives

We continue our search for non-correlated investments that provide reasonable risk adjusted returns irrespective of movements in markets. Although capturing volatility has proved elusive these funds should provide a modest return above cash without the volatility currently evident in credit and equity markets.

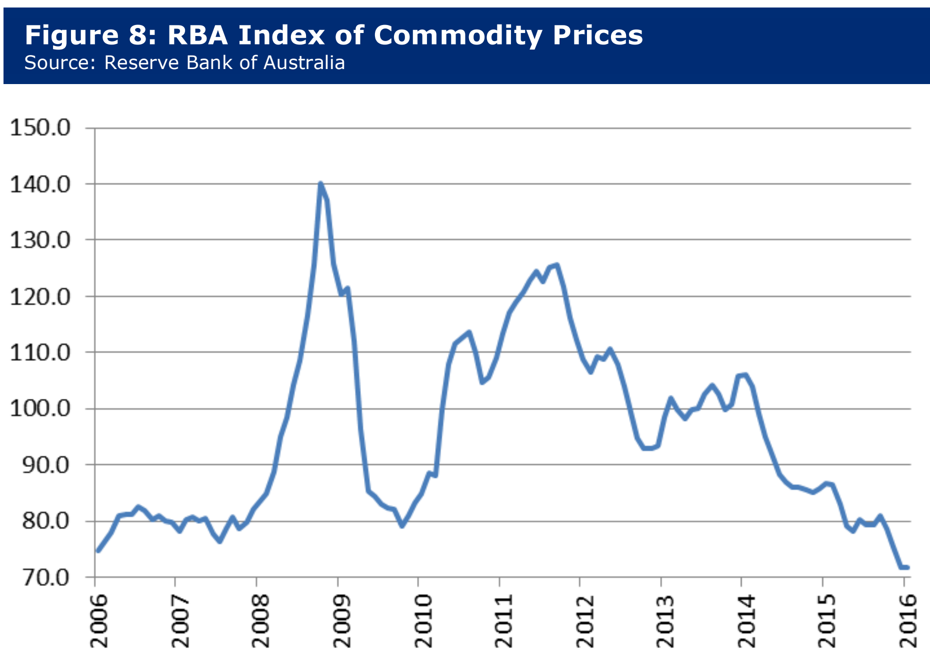


Figure 8: RBA Index of Commodity Prices
Source: Reserve Bank of Australia

Commodities have been in a severe bear market for the past four years due to a slowing China and oversupply (Figure 8). Although higher cost producers will eventually be squeezed out of the market cheap low interest rates are delaying the inevitable defaults. It's hard to build a bull case for commodity prices given our expectations of low global growth.

Providence Investment Committee

Steven Crane
Steven has over forty years of investment experience having started in financial markets in the early 1970's. He has held such positions as Senior Portfolio Manager and member of the Asset Allocation Committee at AMP. For seven years he was the Chief Executive of ABN Amro. His current Directorships include among others: Chair of NIB Holdings limited, APA Group, Bank of Queensland and Transfield Services.

Chris Grubb
Chris has held senior Fund Management and Broking positions within the Jardine Fleming Group in Japan, Hong Kong and Singapore. He was also a Director of Jardine Fleming Ord Minnett and Chairman of Investor's Mutual and Investor Web and is currently a Director of several Asian focused investment funds. He also Chairs Boardroom Australia and is a Director of Boardroom Limited in Singapore. Chris also acts an Executive Coach.

Stephen Roberts
Stephen has over forty years of experience as an economist and financial markets strategist in banking, broking, and funds management. He has worked as Chief Economist with Equitilink and UBS. He worked on the Secretariat of the Australian Financial System Inquiry (Campbell Committee) in 1980, helping draft recommendations that led to the deregulation of the Australian financial system. He is an honours graduate in Monetary Economics from the London School of Economics.

Peter Hooker
Peter has held such positions as an Industrial Analyst at BZW Australia (now ABN Amro), Director reporting to Head of Research, was on the Equities Executive Committee, and Director and Head of Industrial Research. He has a B.Sc. in Chemistry, B.E. in Chemical and Materials Engineering, and Graduate Diploma in Finance and Investment. He has over 25 years of experience in investment markets.

Jonathan Pain
Jonathan has thirty years of international investment experience. He has held such positions as Chief Investment Strategist of HFA Asset Management, Chief Investment Officer of Rothschild Australia Asset Management, Head of Investments at Gulf International Bank in Bahrain, and Chair of the International Asset Allocation Committee at Paribas Asset Management in London. He holds a joint honours degree in Economics and Politics from Keele University, and a Masters degree in the Economics of Finance and Investment from Exeter University.

Ian Wenham
Ian has over thirty years of experience in equity research, investment strategy, and portfolio management. He has held such positions as Equity Analyst with Meares and Philips, Research Director of BZW Australia: covering equity strategy and industrial research. He was also Regional Research Director with BZW Asia, and Director of Asian Research at Lehman Brothers Asia: where he chaired the Investment Policy Committee and was the firm's supervisory Analyst for the Asia Pacific Region. He has also managed the strategic global equity investments for the Lowy Family Private Fund. He currently heads his own investment firm.

Richard Nicholas
Richard has over thirty years of experience in private client portfolio management in London, Hong Kong, and Australia. Richard started his career with Deloittes in London, before cutting his investment teeth with The Rothschild family. He was the founding research director at S&P Fund Research UK, and Investment Director at Hill Samuel Pacific in Hong Kong. He has also held senior positions with Hambros Pacific in Hong Kong, Alliance Capital in Asia, and ANZ Private Bank. He is currently director at Peak Investment Partners.

David Croll
David has over twenty years experience in stock broking and funds management. He has held such positions as a dealer on the options trading floor, the manager of the branch office network for stockbroker Rivkin Croll Smith: based in Melbourne. Since 1998 he has managing several private companies involved in options trading and investment in listed and unlisted equities. He is currently the Managing Director of Noontide Investments Ltd. He has a Bachelor of Arts majoring in Politics from Macquarie University.

Grant Patterson
Grant has over thirty years of experience in equity markets. Prior to forming Providence he was a Director of ABN Amro, and Head of Retail Broking. He has also held other senior positions such as Senior Institutional Dealer, Head of the Sydney Institutional Dealing Desk, and also Head of Corporate Liaison.

Michael Ogg
Michael has over twenty years of experience in investments, starting his career at JPMorgan Investment Management in London in the early 90's. In Australia, Michael worked for AMP Asset Management holding senior roles in institutional equities, and for Deutsche Bank as a Client Advisor in Private Banking. Michael has an MA(Honours) Economics from Aberdeen University.

Stephen Christie
Steve has over 20 years of investment and finance experience, including as Director and Head of Private Wealth for Ord Minnett, Chairman of the Ord Minnett Investment Committee and Head of Asset Allocation for Goldman Sachs JBWere Private Wealth Management. Steve holds a PhD in Applied Finance, is an Honorary Fellow at Macquarie University, an Adjunct Professor at Notre Dame University Sydney and a Trustee Director of major industry super fund QSuper.

James Smith
James has over twenty years of investment market experience (cash equities). Prior to joining Providence, he held the position of Deputy Head of Domestic Sales at CIMB Securities (Australia) and was a member of the CIMB Equities (Australia) Management Committee. He has also held positions as Director - Sales at RBS, ABN AMRO and Sales at Deutsche Bank. James was responsible for Melbourne Sales/Account management in his previous roles over the last decade and in the last two years, was also responsible for New Zealand.

Glossary of Terms

Alternative Assets	An alternative asset is a newer type of asset that has not been traditionally considered part of an investment portfolio.
A-REIT	Australian Real Estate Investment Trusts. Listed property trusts.
AUD	Australian Dollar.
Cap Rate	The ratio between net operating income and the capital cost/market value of the asset.
Credit Spread	The margin paid over the risk-free rate (government bonds).
Current Account Deficit	Where the value of imports for a country is greater than the value of exports
Deflation	When the inflation rate is below 0 and the general price level of goods and services decreases.
Final Domestic Demand	Private consumption plus government consumption plus gross fixed investment
Foreign Denominated Debt	Debt issued in a currency other than the home company of the issuer
GDP	Gross Domestic Product - a measure of an economy's total output.
High-Yield corporate debt	Debt issued by a corporation that has a credit rating that is below investment grade.
Junk Bond	Colloquial term for a high-yield or non-investment grade security. Carry a credit rating from the rating agency Standard and Poor's of BB or lower.
Net Asset Value (NAV)	The value of an entity's assets less the value of its liabilities.
Non-Correlated	An asset class that does not move in a similar direction to another asset class.
Participation Rate	The number of people employed or actively looking for employment.
PE Ratio	Price Earnings ratio - the share price divided by the earnings per share of the company.
PPI	Producer Price Inflation
Real Interest Rate	The interest rate after inflation
Unhedged	In the context of international investments, having full exposure to the movement in the local currencies.
USD	US (United States) dollar.

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