Providence
Independent Investment Advisory

Global Outlook & Strategy

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Central Banks are furiously blowing but there is still no wind in the sails

1. Key Points

- We expect modest global economic growth for the remainder of 2016
- The potential exists for further interest rates rises in the US
- The Australian economy is expected to slow from current strong levels
- An uneasy balance exists within the Australian residential property sector
- Credit looks attractive as an asset class, along with Australian mid cap equities
- Valuations in risk assets are still elevated
- We maintain an overweight to cash
- Long term asset class returns are expected to trend lower

Central Banks are furiously blowing but there is still no wind in the sails.

We subscribe to the consensus view of a slow growth world in aggregate although strong US growth and rising inflation expectations may see The Fed increase interest rates further if markets settle. The Fed seems hostage now to financial market volatility. China is likely to manage the current slowdown in our view with stimulus forthcoming from authorities to maintain a growth rate of around 5%.

We expect the Australian economy to slow from current strong growth with the AUD to trade in a 65-75c range and the potential for an interest rate cut towards the end of the year. House prices are expected to decline gradually given overvalued levels and indebted household sector.

Credit looks attractive as an asset class with credit spreads already pricing in a rise in default rates and providing equity like returns for lower risk. We believe that mid cap companies in Australia look attractive and therefore we are likely to bring back some funds from our tactical overweight in International Equities.

Within property, listed REIT's look reasonably priced although direct property looks expensive after cap rate compression.

Volatility, uncertainty and low interest rates are likely to remain a feature for the foreseeable future.

2. Investment Overview

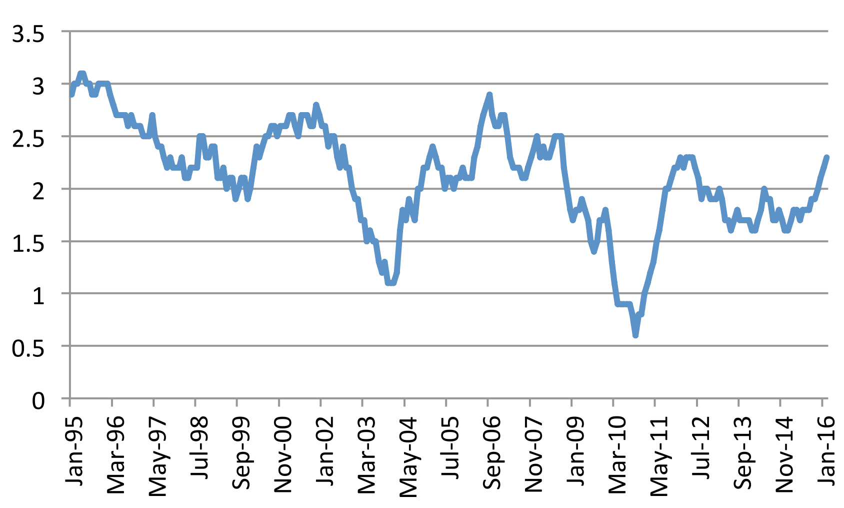
Global central bank policy remains the focus for global markets; however it appears that the firepower of extraordinary monetary policy settings is waning. Markets are beginning to look through the excess liquidity and have begun to focus on some of the longer term outcomes that monetary policy has perpetuated. Below is a good summary provided by Evans and Partners:

- Extreme levels of inequality with the asset rich thriving relative to the asset poor who have the compounding impact of exposure to low interest rates and weak labor markets.
- Sub-par growth is entrenched with the path of least resistance to share price growth now related to using cheap debt to buy-back funds and lifting payout ratios to attract yield hungry investors, rather than investing to generate earnings growth.
- Risk has been mispriced. Generally speaking, the "risk free" rate has been the government bond yield with investments priced off or relative to this rate. Having a "risk free" rate that is at or below zero has pushed investors into higher risk investments in order to generate an adequate return.
- Low levels of interest rates have left little monetary ammunition in the event of any further economic deterioration.

With these issues now at the front of mind, we believe the markets will begin to focus more on economic and business fundamentals when allocating assets. **With low economic growth entrenched, we generally expect lower long term returns from asset classes.**

The US economy is performing relatively well with the unemployment rate at 2007 levels of 4.9%, evidence of stronger consumer spending, strong private credit growth and an expanding service sector. The recent economic strength has also seen a rise in inflation (figure 1). These factors do raise the potential for further gradual increase in the cash rate over 2016.

Figure 1: US CPI – All Items ex Food and Energy
Source: Bloomberg



Despite this, the Federal Reserve (Fed) Chair Janet Yellen has reiterated her views that it is appropriate for the Fed to "proceed cautiously" in raising interest rates given the current uncertain global economic and financial environment.

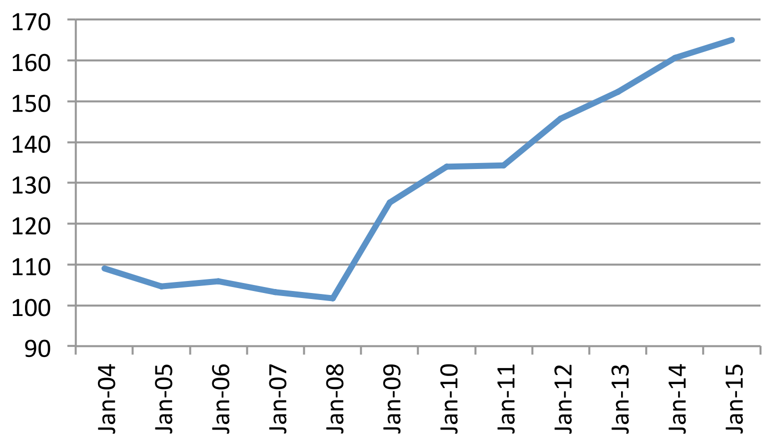
In a speech to the economic club of New York, Yellen argued that the need for caution was "especially warranted because, with the federal funds rate so low, the FOMC's ability to use conventional monetary policy to respond to economic disturbances is asymmetric."

Yellen, also said that the Fed needed to take into account the "the potential fallout from recent global economic and financial developments, which have been marked by bouts of turbulence since the turn of the year". On this point she noted that the recent decline in market expectations for interest rate increases effectively worked as an "automatic stabilizer", cushioning the US economy from these turbulences. As for risks to the outlook, the Fed Chair highlighted China's slowing growth and commodity prices, particularly oil. Noting that further declines in oil could have "adverse" effects on the global economy.

Yellen's cautious approach has practically dwarfed the recent hawkish message from other Fed speakers. The Fed Chair has now made it clear that she is happy to take the risk of higher inflation in exchange for a more certain growth outlook.

The US Central Bank has become hostage to financial markets and seems market dependent rather than data dependent

Figure 2: China Debt to GDP
Source: Bloomberg



With the slowing Chinese economy, albeit from an official 6.9% GDP growth figure, the authorities have increased stimulus with a reduction in the reserve ratio and an increase in money supply in an attempt to underpin the stated target GDP growth range of 6.5 to 7% growth. Although it is too early to determine whether these efforts will have the desired impact, early indications are positive with a resurgence of strength in the property market and an increase in new capital projects.

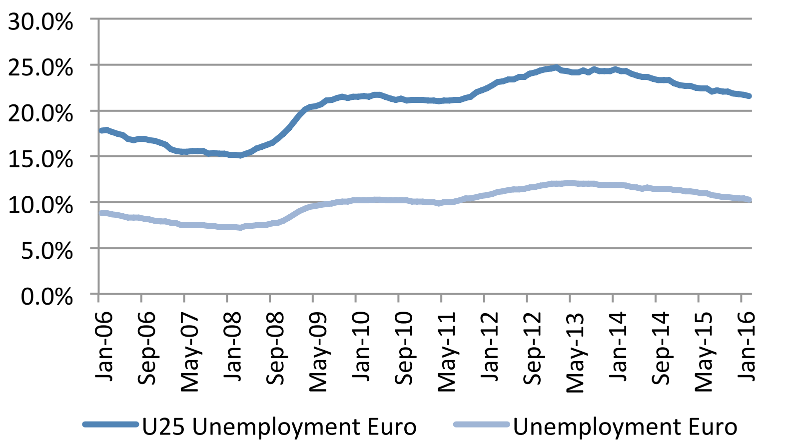
The significant risk for China remains the high levels of corporate debt to GDP (figure 2) although ongoing stimulus and high levels of government ownership of banks should suggest these levels will ease.

Europe is seeing pockets of strong growth; however the large economies are still struggling under a low inflation environment. While this dichotomy continues we expect stimulative monetary policy to remain firmly in place.

Positively, unemployment has seen a slight improvement across the Eurozone from 11% to 10.3%, however, levels of unemployment for both males and females under 25 are still elevated (figure 3). Fortunately, the trend for all levels of unemployment is downward which is supportive for future inflation.

Despite the positive progress, at best we could say that GDP growth is stabilizing at around 1.5% for the Euro zone.

Figure 3: Euro Unemployment
Source: Bloomberg



Similarly to the Eurozone, Japan is suffering from ongoing low inflation despite extensive monetary stimulus. Unfortunately for Japan, the demographic headwinds in the form of an aging population coupled with a deeply entrenched deflationary mindset are reducing the impact of this stimulus. It has been suggested that the final monetary weapon to spur inflation is full debt monetization. This is an extreme measure that would be difficult to execute politically and therefore would require a further deterioration in the economic environment.

Australia’s surprising strength places it as one of the fastest growing economies in the developed world with a real GDP growth number of 3% led by strong household consumption despite weak wages growth. This is likely to change. Household consumption has been buoyed by growth in household wealth (property led), job security (unemployment 5.8%) and lower petrol prices. This has seen the overall savings rate decline from 11.7% to 7.6%. These tailwinds are likely to abate going forward. Therefore, we believe that growth will taper off as 2016 progresses.

Household debt to income ratio, one the highest in the world along with the recent surge in property prices leaves the housing sector with an uneasy balance. The decline in house prices in mining towns and the outskirts of Sydney, Melbourne and Perth along with potential changes to negative gearing , higher interest rates charged by banks and settlement risk from some recent purchases off the plan by Chinese investors facing credit controls, could fuel a significant decline in house prices. However collectively we believe the currently low debt servicing costs and unemployment rate, declines are likely to be gradual notwithstanding a very negative view by one of our investment committee members.

Any sustained strength in the Australian dollar whilst the economy is slowing will put pressure on the Reserve Bank to cut interest rates.

There are certainly a number of concerning geopolitical issues present at the moment specifically, the European refugee crisis, Britain's potential exit from the European Union and the ongoing conflict in Syria and beyond. These are difficult to foresee and manage from an investment perspective, although we are keenly aware of the disruption to financial markets any significant deterioration in these issues would have.

Overall, we expect a slowing Australian economy from current levels and a long slow growth world. Limited top line revenue growth is expected for company earnings with interest rates remaining low for some time.

Our base case is for longer term returns from growth assets to be lower than was experienced over the past 20 years with downward pressure on asset prices. This is due to a number of factors including record global debt levels, a deflating credit cycle, negative demographics associated with an ageing population in developed economies, excess global capacity and a widening of income inequality.

We will be producing a research paper on our long term return assumptions and the impact on asset allocation before the end of the financial year.

3. Asset Class Review

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

We believe global equity markets are likely to remain volatile and range bound with valuations placing a cap on the upside and explosive global liquidity a floor on the downside.

It is difficult to mount a case for strong returns at an aggregate level. The low global economic growth environment does not bode well for top-line revenue growth and the currently elevated operating margins are under pressure from excess capacity. These combined factors suggest any further price appreciation will likely be driven by further multiple expansion which is difficult to justify outside of an improved economic and operating outlook.

Valuations of Australian equities are around longer term averages (figure 4) with value evident in the mid cap space. US PE's on a 10 year moving average basis for earnings are still elevated and at the upper end of long term trends (figure 5). Given our negative view on the AUD from the current 75c level we would remain overweight international equities but look to reduce this overweight to fund an allocation to mid-cap Australian equities on a valuation basis.

Figure 4: Ausrtalia PE (real trend EPS)
Source: Heuristic, IBES, Shiller,

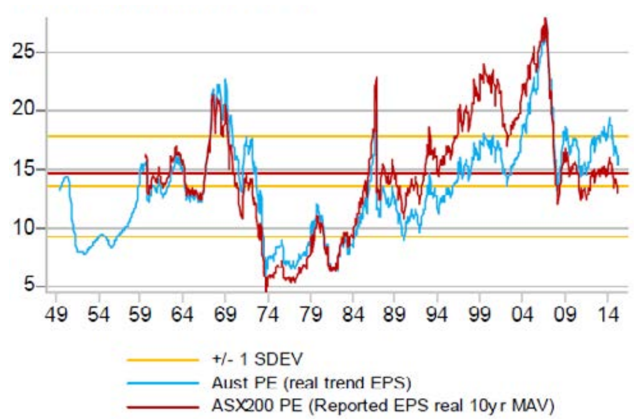
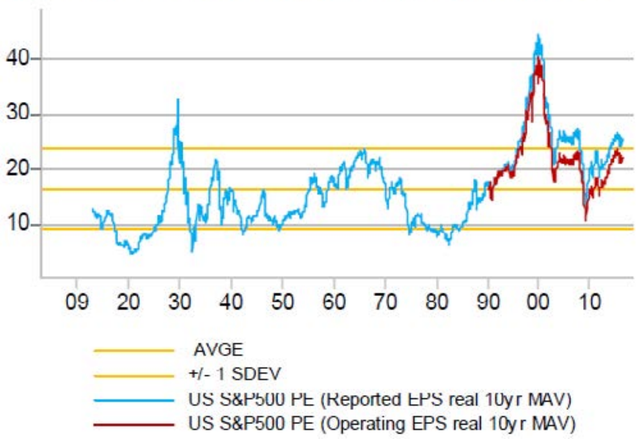


Figure 5: US PE (real reported & operating 10yr MAV EPS)
Source: Heuristic, IBES, Shiller

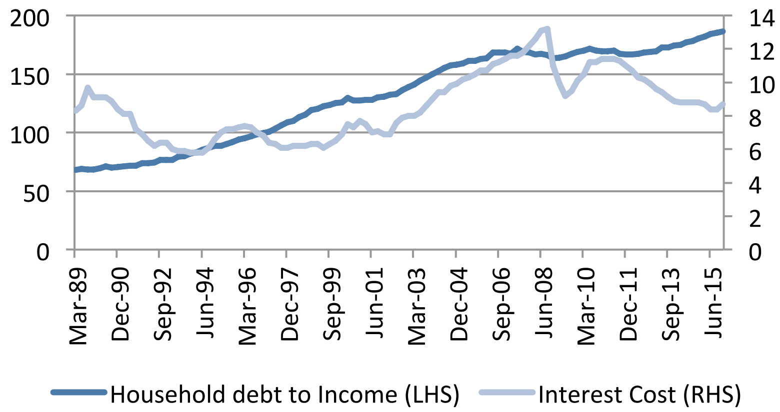


We have previously commented on the recent lack of capital investment from the largest companies listed on the ASX. Any excess cash has primarily been distributed to shareholders through dividends or buybacks which has been supportive of share prices in the short term. It is now difficult to see how dividend growth can continue given this lack of investment over the recent history. With this in mind, we see far greater 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.

3.2 Property

Although the serviceability of household debt is comfortable given the current low level of interest rates, we are concerned regarding the high level of household debt to income for Australian households (figure 6).

Figure 6: Australian Household Debt to Income and Serviceability
Source: Bloomberg



We expect very little price appreciation from residential property in the years ahead and are very wary of the potential over supply in the apartment market. Some of the seasoned large players in this space are reducing their assets.

Within the listed sector gearing remains modest, funding costs are low and valuations are lagging current transactions in the direct property market. 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.

Nonetheless the sector is trading on a 11.5% premium to net asset value. With a distribution yield of 5.5% maintainable and a growth in operational income of 4.6% a year and adjusting for the premium to NAV over a 5 year period, a return of 7.8% is achievable.

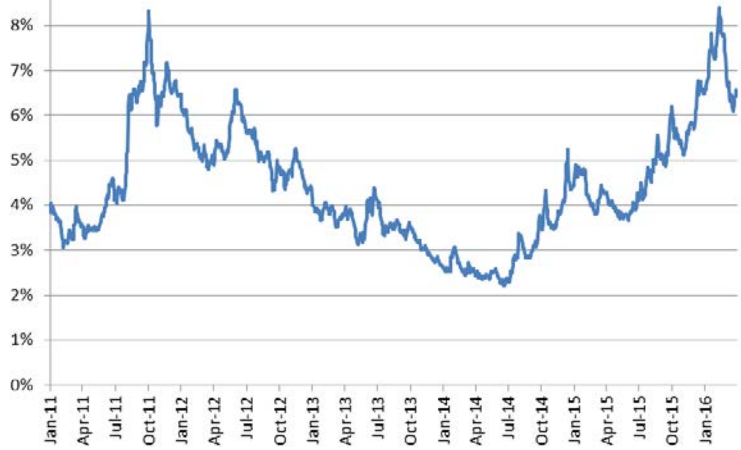
Reported cap rates of below 5% in A-grade commercial property are a red flag to valuations. This strength is due to the weight of money from offshore buyers and warrants caution in this sector.

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 have a preference for distressed properties where active management can add value and/or investments that will benefit from demographic trends including aged care and child care in the direct space.

3.3 Fixed Income

The recent widening of credit spreads has provided opportunities in this space. High Yield spreads have widened to previous highs (figure 7), excluding the GFC period. This level is factoring in an increase in defaults mainly led by the energy sector. Within credit, US senior secured loans look particularly attractive at current levels.

Figure 7: BarCap US Corporate HY 10 yr Spread
Source: Bloomberg



With the anticipated slowdown in the Australian economy and some tail risk management of a deflationary world, Australian 10 year Government bonds would interest us around the 3% level. We do not directly hold any duration or global government bonds preferring cash as our defensive allocation.

We have recently purchased some Australian Bank Hybrids after the increase in interest rate offered and a rebate of placement fees to clients available.

There is likely to be further hybrid issuance from the banking sector to bolster their capital adequacy ratios in the face of further regulatory requirements. With approximately $3bn of bank hybrids and another $2bn in other corporate convertible notes reaching their 1st call date during the remainder of 2016, we expect pricing to remain favourable for investors.

3.4 Alternatives

We have been undertaking due diligence on a Private Equity fund that will provide exposure to global private equity investments that are diversified by industry and security type.

Our attraction to the sector is predominantly due to the valuation methodology difference between private equity and listed equity products. Listed equity is generally valued on forward earnings multiples which has recently resulted in significant multiple expansion, conversely Private Equity is generally valued on a trailing multiple of earnings. The result is that the majority of the valuation uplift from a private equity investment is from growth in earnings and underlying fundamentals of the business under this form of ownership.

Although not a sector we invest in directly, it is worth commenting on the extreme volatility that the commodity space has experienced in response to the shifting Chinese economy from construction to consumption. There was a widely held view that Chinese demand for many commodities would continue into perpetuity, however, this no longer appears to be the case. Unfortunately, this has come at a time where a number of large scale, low cost producers have started producing, creating a significant oversupply in many commodities but most notably Iron Ore.

The oil and gas sector has also been one of the heaviest hit of the commodities. Much of this has been due to an oversupply as OPEC countries protect their market share from the US shale operations and Iraq lifted their output after the removal of sanctions. With the persistent low price of oil we have seen shale oil suppliers cut back their supply as production becomes unprofitable and a number of large scale developments be cancelled or deferred. Should this trend continue, the supply-demand imbalance should be rectified resulting in less volatility and a higher oil price.

Despite the doom and gloom surrounding the sector, there will certainly be some commodity prices that benefit from the emerging middle class over the medium to longer term. Specifically, those commodities that are key inputs to consumer items such as copper (electrical and white goods), potash (fertilizer) and other rare earth minerals (electronics).

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 focussed 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).
Deflation	When the inflation rate is below 0 and the general price level of goods and services decreases.
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.
Mid-Cap	Refers to the market capitalisation of a company. In this context, any company outside of the top 50 largest stocks by market capitalisation on the ASX
Multiple Expansion	An Increase in the Price/Earnings ratio
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
Reserve Ratio	The minimum fraction of deposits that a commercial bank must hold as reserves. A reduction in reserves allows the bank to lend more.
Unhedged	In the context of international investments, having full exposure to the movement in the local currencies.
USD	US (United States) dollar.

Safe Passage

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