bdhSterling Quarterly Economic Update

May – August 2016

Global Economics

The most noteworthy event of the last three months was the 'Brexit' referendum result from 23 June.

The 'non-consensus' outcome saw general panic in risk markets as analysts grappled with what it meant for the UK and the broader world economy. On the day of the referendum the FTSE traded 7% lower and the Pound fell 12% against the US dollar.

The period of uncertainty and buying opportunity for equities lasted a whole three days before the Brexit became a 'positive outcome' ending with a 15% rally for British stocks. The enthusiasm for equities was a global affair with markets from Europe, Australia and the United States rallying over 10% from Brexit lows.

The performance of the Pound has been less ebullient - reaching a 30-year low of £1.32 against the dollar at the end of July.

The weakness of the currency has only been exacerbated by the Bank of England cutting rates a further 25 basis points and embarking on a further round of Quantitative Easing (QE). As would be expected, UK economic data (particularly relating to confidence) for the month after the referendum has been appalling. The BOE has simply reacted with the most popular modern tool of Central Bankers globally – crushing the currency and making debt cheaper.

Unscrambling the omelette of EU regulation and establishing new trading agreements with the rest of the world is going to be an unwieldy process. In the short term there is going to be friction and the world awaits a definitive plan for the actual separation. The IMF calculates a 1%-5% hit to potential GDP by 2018.

In the medium to long term the move could well be positive for the UK. The EU has significant problems and looking forward appears to have a limited lifespan in its current make up.

New trading deals will be established with the rest of the world. Importantly, the EU still needs the UK as a market for their exported goods. Germany exports 800,000 cars per annum to the UK – its largest customer – hard to see this being upset by the introduction of tariffs or other barriers.

Barely a week passed after the referendum before the focus was again on the solvency of the European banking sector.

Italian Banks this time took the limelight, proposing a 'bailout' which was subsequently rebuffed by the German leadership by way of highlighting the EU rules stating that shareholders and bond holders of failing banks must be 'bailed in' before ECB funds become available.

This staunch attachment to the 'bail in' rules from Germany may come under question as Deutsche Bank (DB) is under extreme pressure. Its share price is now down over 70% in two years. At current prices DB has an equity valuation of US$20 billion supporting a balance sheet of $1.6 trillion.

Recent stress tests show equity shortfalls that could require DB to raise equity equivalent to the total market cap. Nationalisation may well be required. The EU periphery will no doubt enjoy the 'schadenfreude' of watching the Germans deal with this looming backflip.

The British Pound may well look like a decent position to hold against the Euro for the coming year.

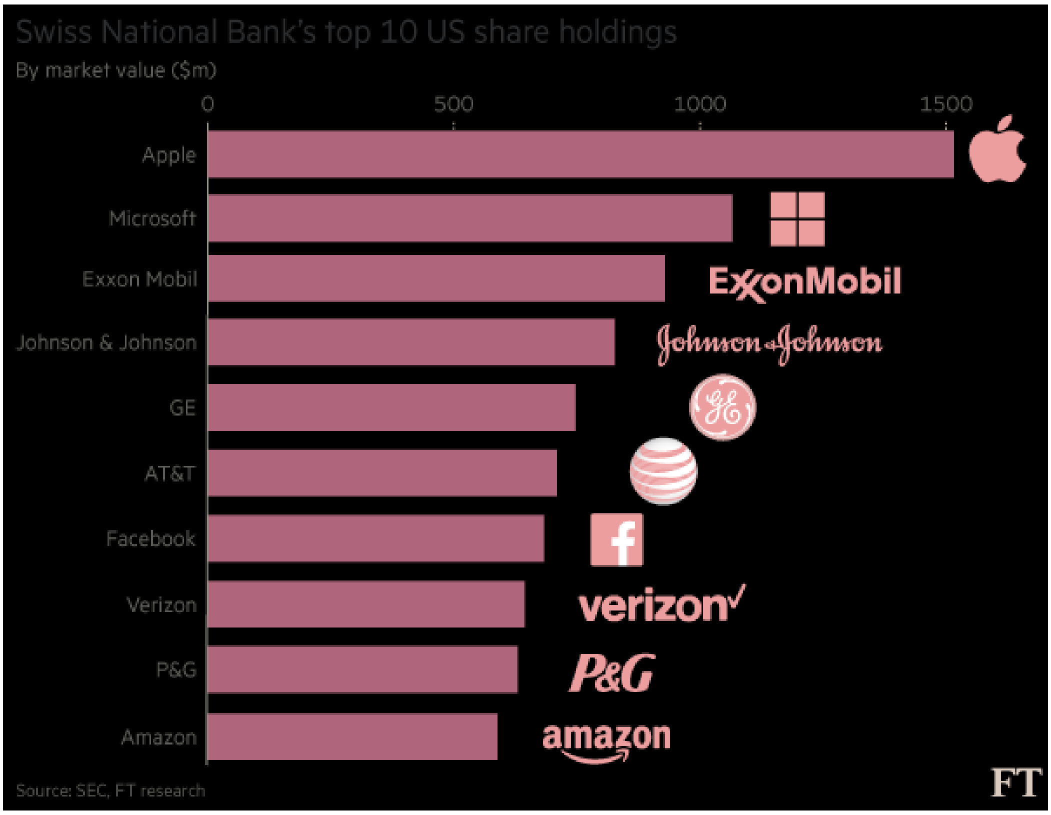
The prospect of low interest rates, a sustained current account deficit and potential for higher rates in the USA may see prolonged weakness for the Pound against the dollar, though it may be oversold somewhat in the short term.

Globally, however, the reaction from Central Banks has been for more of the same medicine.

Australian rates were cut in August. The EU is expected to announce more Quantitative Easing in coming weeks and the Japanese announced more measures including the ongoing buying of Japanese equities with newly issued Yen.

The Japanese monetary experiment reaches new levels on a regular basis. The Bank of Japan is now a Top 10 shareholder in 90% of issues on the Nikkei 225 index and owns over 50% of the exchange traded funds.

Not to be outdone, the Swiss Central Bank has printed enough Francs to accumulate a US$125bn portfolio of global equities, including a US$1.50bn position in Apple Computer.



The effect on GDP growth globally remains muted despite all of this monetary experimentation.

US GDP growth remains stagnant with the June Qtr. reading of 1.5% annualised.

The US employment market is reasonable with consumption and residential construction a bright point. Investment is still very poor. With consumption and construction the driver of the US economy at the moment – it is easy to see why the Federal Reserve has been 'stuck on the runway' after raising interest rates by 25bps.

The markets are backing the next move from the Fed to be no sooner than July next year. If they continue to take cues from Europe, Japan and Chinese numbers – July may be too soon.

Australian Shares

Australia was again one of the best performing global markets during the quarter.

Up over 6%, the broader index almost made up its losses from 12 months ago. Though investors should be mindful that during this period they would have achieved a strong dividend from their holdings.

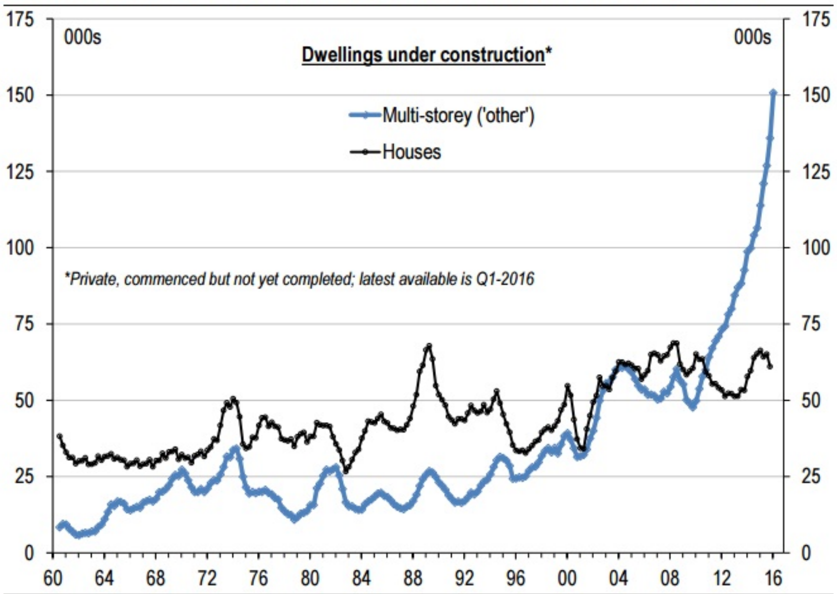
Half yearly profit reporting has begun post the quarter end. The all-important banking sector appears to be delivering as expected with low profit growth, lower margins and slowly increasing bad debt levels.

It should be made clear to the community that further interest rate cuts from the Reserve Bank cannot be passed on automatically to borrowers, lest they reduce the net interest margins earnt by the banks to provide their service to the community.

Lower RBA rates or less profitable banks is now the trade-off. Retirees would be happy to see strong profit margins for the banks retained - particularly considering the lack of investable interest rates in the deposit markets.

The success of the banks navigating the treacherous political climate, as much as the looming slowdown in construction activity in the Eastern States is probably going to guide much of the performance of the Australian economy and stock market over the coming 12-18 months.

Figure 2: Dwellings under construction 'super-boomed' in Q1 to a record high 216k (as commencements spiked)



Source: ABS, UBS

The incredible expansion of construction in Australia is obviously not sustainable and will have to unwind over time, as has the mining engineering expansion of the previous decade.

The RBA will be doing their best to lower the Australian dollar to assist export industry; but would also appear the governments should be planning massive infrastructure spending to soak up the excess supply in construction as the boom slows.

We remain invested at the low end of our allocation to Australian shares.

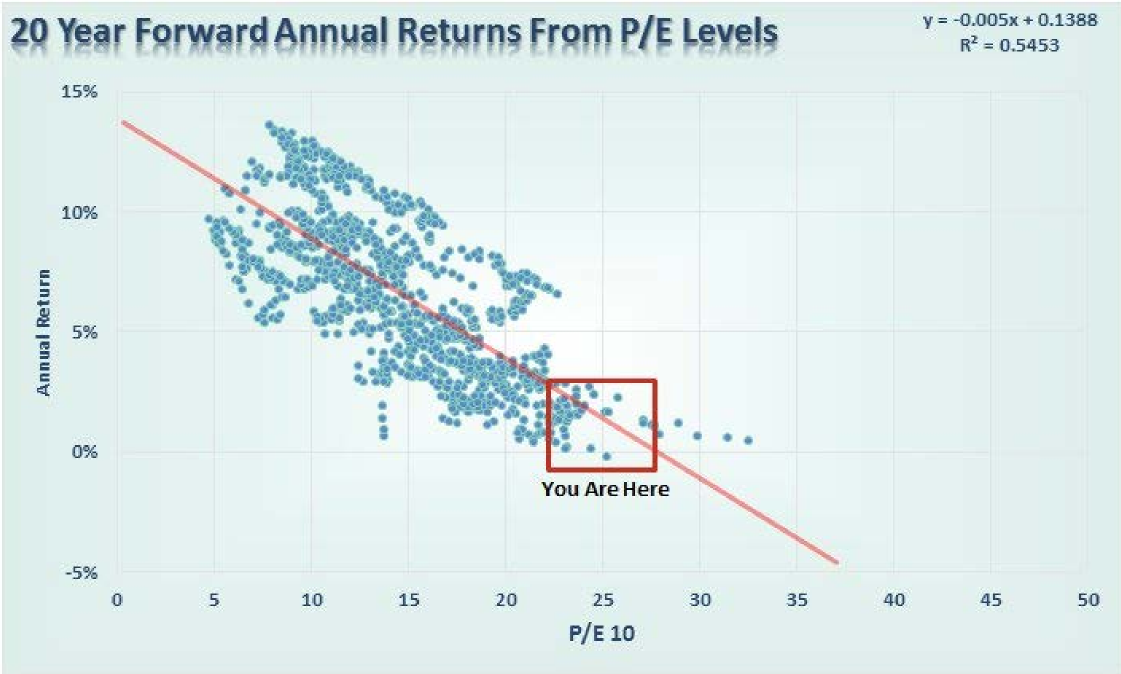
International Shares

The global share allocations grew by over 3% after the large rally post Brexit.

The S&P500 made new all-time highs with an 8% rally post Brexit. The collapse in global bond yields again lead to the rallying cry of “there is no alternative” or TINA and equities were bought globally for their yields.

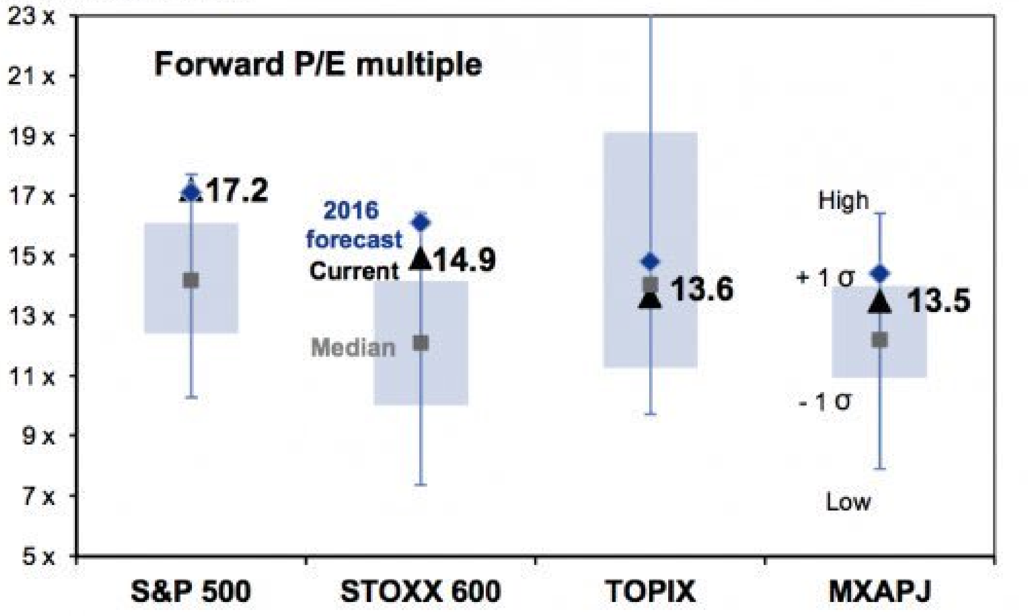
The Australian 10-year bond yield dropped from 2.5% to 1.8% over the quarter. A record breaking move matched across the globe that led to a force feeding of yield seeking money into share markets with no regard for valuation.

US reporting season has almost come to an end. Profit and revenue growth are flat again. US equity multiples are in rarefied air again and match historical levels only seen before awful events in 1929, 2000 and 2007. Historically, buying at these multiples has led to a very low performance over the longer term outlook.



The US markets have attracted capital from around the globe and are outright expensive compared to their peers in Europe and Japan. The US market is currently more expensive than 95% of previous times in history on a forward PE measure.

Exhibit 1: Global equity market valuation relative to history
as of August 3, 2016



Source: MSCI, FactSet, I/B/E/S, and Goldman Sachs Global Investment Research.

With this in mind we have been moving more funds towards European equity markets which offer lower valuations and higher dividend yields. The major scare factor of the banking sector in Europe has been somewhat mitigated by the now vastly lower participation in the broader indexes of the banks. As an example - Credit Suisse and Deutsche Bank were removed from the Euro 50 index in July.

We remain at the bottom end of our allowable allocations to equities overall; but are overweight compared to Australian shares.

Foreign Exchange and Commodities

The commodities markets broadly settled down after the mayhem of earlier this year emanating from Chinese retail futures traders speculating in everything from steel to eggs.

Table 1.1: Commodity Price Growth[(a)]
SDR, three-month-average prices, per cent

	Since previous *Statement*	Over the past year
Bulk commodities	2	–2
– Iron ore	–4	–5
– Coking coal	9	7
– Thermal coal	9	–5
Rural	4	–3
Base metals	2	–11
Gold	4	11
Brent crude oil[(b)]	20	–22
RBA ICP	4	–7
– using spot prices for bulk commodities	2	–5

(a) Prices from the RBA ICP; bulk commodities prices are spot prices
(b) In US dollars
Sources: Bloomberg; IHS; RBA

The Australian dollar was overall flat over the quarter but recovered from a 5% dip in May. The stronger Aussie (10% from January) has detracted from portfolios' performance this year.

We still maintain the Aussie will soften over coming years with the RBA left with only one tool now to spur growth in the Australian economy.

The National Australia Bank (NAB) this week proposed another 50bps of rate cuts and the advent of 'unconventional policy' which in less nuanced discussion is a reference to 'money printing'.

The expectation for a weaker A$ is also backing our long positions in gold for the portfolios. The gold price rallied another 6.4% during the quarter – trading at a new all-time high against the A$ post Brexit. The poorer precious metal cousin, Silver, rallied a full 14% during the quarter to be up over 42% for the year to date.

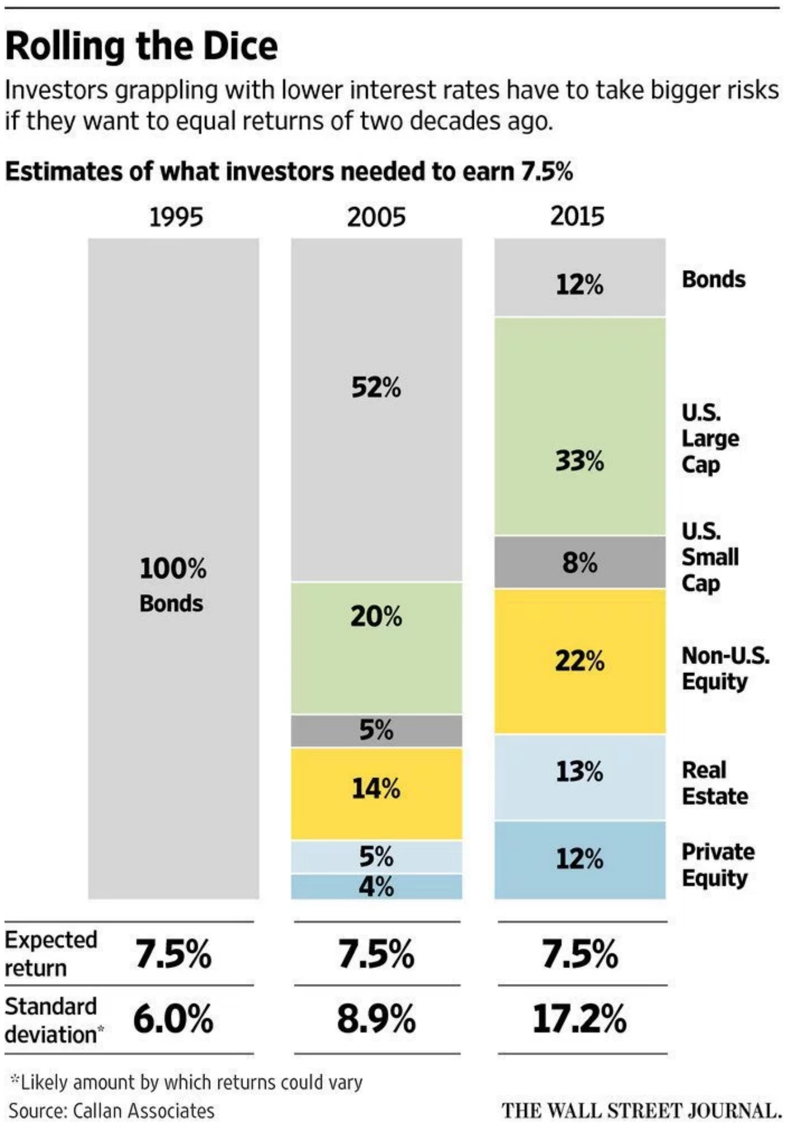
Precious metals have awoken from their four-year slumber and remain a hedge against the global monetary policy experiment.

Forward Outlook

Portfolio construction remains focussed on managing downside risks. The rebound in the last quarter from equities needs to be viewed in the context of Australian and European shares still being down on a 12-month horizon and the S&P500 breaking through a new high first established mid-2015.

During the subsequent periods, global equity markets have suffered 3 significant drawdowns over 10%. These events in hindsight were times to add to equities. It is difficult to make the same case here.

The chart below offers a sobering view of how US investors over the last 20 years have been forced to change their asset allocation in seeking a 7.5% per annum return in the United States.



The key takeaway is the move in the 'standard deviation' of the return. Standard deviation is a measure of volatility or risk – the chance you won't achieve your desired goal – under this measure it has tripled.

We remain overweight cash, bonds and gold.

Hopefully in coming months we could see an outbreak of competition in the A$ term deposit markets. If rates can get closer to 4% per annum on bank term deposits in a rate war, we could move some funds out of bonds and lock in some longer term rates.

Market Indices

	Start	End	% (QOQ)
ASX200	5245	5563	6.1
Aust. Banks	23.77	24.77	4.2
Aust. Miners	7.06	7.2	2.0
MSCI Global	1640	1707	4.1
SP500	2065	2172	5.2
NASDAQ	4341	4730	9.0
FTSE	6197	6732	8.6
DAX	10125	10301	1.7
AUD/USD	0.77	0.76	-1.3
AUD/GBP	0.52	0.57	9.6
Gold US$	1292	1349	4.4
Gold A$	1695	1773	4.6
Brent Oil	43.37	43.53	0.4
RBA Cash Rate	1.75	1.5	-14.3
Aust 10yr Bond	2.54	1.874	-26.2