

Cautious optimism for year ahead

As the green shoots of recovery start to appear, investors are advised not to wait until the global economy is in full bloom before they get themselves set. Krystine Lumanta reports.

Market experts are optimistic about a return to form by Australian equities in the coming financial year, but recommend that investors and advisers continue to exercise caution in the current climate of uncertainty.

As valuation levels become more attractive, a mix of positive and negative influences is creating opportunities in specific sectors and stocks.

This contrasts with the beginning of 2010, when the Australian equities market struggled against the slowdown of investment amid tense fears of a double-dip recession, due to the financial strife in Ireland, Portugal, Greece and Spain.

Back then, financial markets were clearly alarmed. Today's economic situation is not so different, yet there appears to be a change of attitude among investors, and a focus on how performance can be maximised, rather than a meek acceptance that returns will be murky.

Riccardo Briganti, head of research at Macquarie Private Wealth, says he believes that the global economy is going to pick up after experiencing a "period of weakness that we've been through mid-year", allowing investors to get set for a move back into equities.

"That's the starting point, and that's a positive for equities in general," he says.

"You've sort of seen it [recently] as some of the risks of the Greek debt crisis have eased and that's led to a higher level of confidence.

"We need to watch the economic indicators, but our feeling is the weakness we've been

through over the last month or so is not a fundamental problem, and so the global economy [will start] to recover through the second half of this year."

Even if a recovery is not yet fully apparent, it should not be dismissed as an unattractive period as "the uncertainty will present opportunities for long-term investors to accumulate some solid companies over the next 12 months", according to Robert Penaloza, head of equities at Aberdeen.

"If we're looking forward over the next 12 months, [we] are quite cautious; but having done the homework for quite a long time already, we have identified companies that will withstand the headwinds, both external and domestically," Penaloza says.

"So what will probably happen is that valuations will get cheaper.

"But when you do invest, you're obviously looking out towards the longer term."

The table on the following page shows the latest performance data conducted by Morningstar, current to 30 June, with figures for large-cap domestic share funds ranked by their five-year rate of return. Interestingly, the best performers over five years weren't necessarily those with the largest net assets.

Paul Taylor, head of Australian Equities at Fidelity and portfolio manager of the Fidelity Australian Equities Fund, says that "the ideal situation" is to be able to "buy at this point in

time when the fears are quite great, and buy good quality companies at a great price".

"The Aussie market would be below 12 times earnings and under 5 per cent dividend yields," he says.

"Historically we trade on 15 times earnings."

MACRO FEARS

Three key macro-economic "fears" have been identified as the top influences on the financial markets - particularly equity markets - and do not look likely to go away anytime soon.

According to Macquarie's Briganti, the possibility of a China slowdown is the most important concern for Australia.

"The data coming out of China shows that they are going through this mid-year slowdown, but it also shows that inflation has seemed to have peaked out at about five-and-a-half per cent," he says.

"So the Chinese government don't have to tighten monetary policies further and that's what gives us confidence - that you'll see a pick-up in the second half of the year."

Taylor says that China's growth is slowing and will slow down even more.

"I think that's the interesting one that could change in this environment...because that's not an external influence, that's the Chinese authorities saying, 'we need to slow down; inflation's too high'.

"In a historical perspective, China has acted

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fairly counter-cyclical through the whole period," Taylor says.

"When things were tough they went for growth and when things kicked off, they pulled back progressively.

"So there's probably a reasonable argument to be made that if global growth, which is one of the fears at the moment, becomes weaker and becomes tougher, the [outcome] is that China will probably reverse its economic undertakings."

China is currently slowing economic growth by raising interest rates and making it harder to borrow money, Taylor says.

"If global growth becomes weaker, what's likely to happen is that China will reverse those decisions and metaphorically take their foot off the brake and maybe put their foot back on the accelerator.

"That's actually a [situation] that I think could change this year. If that happens, the markets could turn around very, very quickly.

"And if I look at the markets, they're factoring [in] a lot of negativity right at the moment. They really are at fairly depressed levels but reflecting quite a weak global economic outlook."

The biggest "fear" that has grabbed the most attention worldwide is the European sovereign debt levels - in Greece, in particular - but also "debt levels generally around the world", according to Taylor.

He says the market is undeniably "caught in a storm of macro-economic fears"; and sovereign debt as it currently stands is "an overhang on not only the Australian market but markets around the world".

"If I look forward, that's probably not going to be cleared up anytime soon; [it's] probably going to be with us for a while.

"In fact, if you look throughout history, this is part of the cycle.

"History tells us [that] when you have a banking crisis, the next thing that follows is a sovereign debt crisis; then following that you get

defaults, printing money and inflation.

"These always follow one another [although] it's not a short-term fix."

Shining a spotlight specifically on Greece, Briganti says it's anyone's guess as to how it will really play out.

"But what we know from what happened last year with the sovereign debt issue and from what happened in the 80s with some of the Latin American sovereign debt issues, is that there's likely to be a resolution," he says.

"It's going to be a combination of a political resolution and a financial resolution.

"So far, we've had a positive vote on austerity measures in the Greek parliament and that's sort of a tick to move in the right direction.

"There's probably a number of hurdles that still have to be faced, but despite all the press, you actually can't see a big impact of European sovereign debt issues on financial markets."

The last key macro concern is the uncertainty of the US economy and the challenges the country has yet to face.

Briganti says the main issues are around ending the second round of quantitative easing (QE2), the prospective debt ceiling vote and discussions about the high unemployment rate in the US.

"A part of that's political and we think there will be a political resolution," he says.

"In the end, the republican party will likely pass some sort of increase in the debt ceiling. The QE2 issue has spooked some investors.

"What they believe will happen is that QE2 will end, bond yields will increase significantly and that will derail the US economy where in fact, what we've seen is that bond yields have fallen even further and even if QE2 ends and bond yields rise, they're not going to rise to a level that's going to derail the US economy."

Taylor says looking forward, "the US is definitely on a recovery path, but it's certainly not a straight-line recovery path".

"You're going to have ups and downs and continued fears about a double-dip recession," he says.

"I think the likelihood of the US going back into a recession is pretty low.

"But once again, you're going to have ups and downs, and that's going to knock the market around."

MICRO FEARS

Fears are also being felt from a domestic economy perspective.

The controversial carbon tax scheme has "thrown a spanner in the works", according to Andrew San, investment analyst, equities, at Aberdeen.

"It's still unknown as to what impact there will be for the end consumers," he says.

"On top of that you've got the possible interest rate rises as well as the higher cost of living for mums and dads."

Briganti says there are "still strong headwinds coming from the strong Australian dollar and reluctant consumers" to look out for.

"What that means is that we've got this interesting situation within the Australian equities market where you're likely to see the most cyclical part of the market - that being the resource sector - do well because it's linked to global economic growth; but there's going to be a group of sectors that are going to struggle because of the strong Australian dollar and the reluctant consumer.

"So the other end of the spectrum, which is the very safe defensive sectors like consumer staples and healthcare, is going to be sought after within the domestic market," he says.

"It's almost the extremes. The most cyclical and the least cyclical are the areas that we believe are going to do well within the next 12 months."

Aberdeen's Penaloza says both micro and macro trends are not helping business confidence in Australia.

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Fund Name	APIR Code	Net Assets \$m	Return 5 yr %pa
SGH20	ETL0042AU	216.46	9.07
ING Wholesale Select Leaders Trust	ANZ0216AU	3.44	7.34
OnePath OA IP-ING Select Leaders EF/S	MMF0592AU	7.86	6.37
Macquarie High Conviction Fund	MAQ0443AU	30.66	6.27
Perpetual Wholesale Ethical SRI Fund	PER0116AU	344.83	6.12
Aviva Investors Prof Elite Opportunities	PPL0115AU	59.81	5.78
OnePath OA IP-ING Select Leaders NE	MMF0593AU	6.87	5.54
ANZ OA IP ING Sel Ldrs - NE	ANZ0235AU	17.66	5.51
Aviva Investors Pers Elite Opportunities Shares	PPL0116AU	2.50	5.48
Prime Value Growth Fund	PVA0001AU	124.01	5.14
Aviva Investors Prof High Growth Shares	PPL0106AU	1,279.10	5.09
Fidelity Australian Equities Fund	FID0008AU	2,125.96	5.08
UCA Australian Equities Portfolio	—	224.42	4.99
Denning Pryce Equity Income Fund	DPR0001AU	45.30	4.98
Perpetual WFIF Perpetual Ethical SRI	PER0243AU	10.33	4.95
Perpetual Wholesale Concentrated Equity Fund	PER0102AU	906.50	4.94
Celeste Australian Equity Fund	VIM0001AU	4.60	4.85
Commonwealth - Australian Share Fund	COM0022AU	45.08	4.78
Schroder Australian Equity Fund S	SCH0002AU	1,385.08	4.64
Prime Value Growth Fund - Class B	PVA0011AU	146.46	4.62

Source: Morninstar

"I think certainly we haven't seen any domestic catalyst that's going to underpin domestic sentiment here, and certainly what's happening outside of Australia, what's happening in Europe, what's happening in China is slowing down as well," he says.

"For the rest of the year, we would say there is an element of cautiousness across businesses and across consumers.

"Looking into next year, what we would like to see really is a bit more clarity with regards to taxation, government policies, housing affordability et cetera in Australia.

"At the moment investors are just sitting on the sidelines and just waiting to see how much more expensive is it going to be to live."

MARKET OPPORTUNITIES

Despite the less than desirable global state of affairs, the uncertain market still presents opportunities to maximise investment performance.

Briganti says that the opportunities can be found "from where you see the most earnings

certainty".

"So I believe that earnings certainty exists with the resource companies because we believe the world is going to pick up," he says.

"Earnings certainty is more problematic with some of the more domestically-focused companies.

"So where else can you get earnings certainty? You get it from the stocks that pay relatively good dividends, from the defensive sectors. Consumer staples won't give you a fantastic return but they will give you a nice safe return - Woolworths and Coca-Cola."

He says it's vital to get a mix of resource companies when holding a portfolio of stocks.

Fidelity's Taylor says not only is the market overall attractive, "but the sort of difference in valuation is actually quite compressed".

"So whether it's a high growth company, low growth company, high quality company, low quality company, they're all trading on very similar multiples, which is also the market saying we're going into a low growth environment and

everything's going to grow slowly; everything's going to have very weak growth," he says.

"Now that's actually a really interesting market when you're taking a bottom-up stock specific perspective, because it allows you then to really identify great quality companies at great prices.

"If I can find a good quality company, [with a] strong balance sheet that has good growth prospects that is valued like the rest of the market on a cheap valuation, it presents really good opportunities.

"So I think that's where we are at the moment."

SECTOR PERFORMANCE

During June, Aberdeen's San visited Western Australia to gain real insights into the mining sector's condition.

"They're supposedly in the midst of a commodity boom, but when you talk to the miners [and] when you talk to the mining contractors, they're actually facing a lot of constraints either on the infrastructure side, on the labour side, equipment or even tyres," San says.

"We think that with the different sectors, [they each] face specific challenges. I feel that the opportunity is more at a stock level.

"The risks in the next 12 months are largely macro-driven with the international events and the domestic conditions. But from a stock point of view, much of the risks can be mitigated if we actually look at quality companies that have strong management and strong balance sheets.

"We're looking to top up in companies that provide sustainable cash flows and dividend yields and actually provide us with earnings growth. We're looking to do that when valuations become attractive in this kind of cautious and uncertain market."

According to Macquarie's Briganti, several sectors will begin to struggle, such as industrials.

"And then consumer discretionary is likely to

We see more.



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come under pressure because consumers are not spending to the extent that they had been previously - that partly reflects relatively high interest rates and partly reflects consumers just being a little bit more cautious. And their savings have increased, rather than putting their money into the equity market," he says.

Taylor says the Australian market is providing "good value".

"You've got some great companies at great prices so I think the likelihood of getting good returns over the next 12 months is much better," he says.

"I think you're going to get reasonable performance from the Australian market.

"If I look at sectors... I'm overweight in industrials and particularly mining service companies, overweight diversified resources, overweight energy and overweight healthcare.

"But I would stress that we tend to build a portfolio from the bottom up and look at individual companies rather than have sectoral themes."

AUSTRALIAN MARKET PAST PERFORMANCE

Taylor says the historical performance of the Australian market, compared to the rest of the world, should comfort investors and bring back some confidence.

"Australia has been the best-performing market in the world long term," he says.

"The London Business School looked at stockmarket performance around the world for the last 110 years, so from 1900 to 2010, and that identified Australia as the best performing market over the long term.

"Australia generated a real rate of return, so inflation-adjusted, of about seven-and-a-half per cent.

"On a nominal basis, that's about 12 per cent - so the Australian market has delivered nominally 12 per cent return per year for 110

years, which is quite a phenomenal return."

The study found five underlying reasons for Australia's leading performance: population growth, our natural resource base, corporate governance, high dividend yield and high real dividend growth.

"So if you go through all of these different areas, all of them are still very much in place and will be at least in the next decade," Taylor says.

"That's why Australia has been a good performing market. The fact that they are in place is an indication of why Australia is well positioned relative to other markets."

Nevertheless, Briganti says that over the last year, "the rest of the world and particularly emerging markets have outperformed the Australian market".

"This really goes to the crux of why you need to have a diversified equities portfolio, including international exposure, because sometimes when you look at the long-term numbers, it's going to hide specific conditions that currently exist, and vice versa," he says.

"So rather than saying that in the long term Australia had a better return than the US, which it has, [ask] why was that the case?

"It was the case because over the last 10 years, the US has suffered a head crash and a global financial crisis that hit them harder than it hit Australia. And at the moment, the Australian market is under a little more pressure because of these specific domestic conditions.

"In a way, looking over the returns over a long-term period, you have to be really cautious."

MARKET RISKS

One would assume the market is swarming with more risks, given the additional pressure from the three macro-economic fears. However, Taylor says they are all priced into the market.

"There's always more risk than you're aware of, but part of the reason why I think the Aussie market is [as] an attractive investment opportu-

nity as it is today, is because a lot of those risks are right in front of us and screaming at us," he says.

"The sovereign debt crisis [is] a real risk that could well hamper global growth, but that's well and truly priced into the market.

"The US economy; people are fearful of another recession, so that's well known in the market. People are then very worried of a hard economic landing in China, but they're all priced into the market.

"In Australia, we do have that two-speed economy, so the fear of higher interest rates [and] a relatively low unemployment rate could lead to inflation and higher interest rates. Industrial relations I guess is an issue as well, around those sorts of topics.

"All of those would be risk points," Taylor says.

It will be a while before any mass movement into the Australian equities market occurs among retail investors. Having been spooked during the GFC and pulling back from equities, investors remain cashed up and don't look like budging in the short term.

Briganti says this is truly reflective of where the comfort levels are in certain asset classes.

"Retail investors are holding relatively high levels of cash, and once there's a resumption of confidence that the global economy's on track, some of that may move out of cash and back into equities," he says.

"I think there's more bigger trends at play within direct equities, like the emergence of ETFs [exchange traded funds], which could see Australian investors take a more active interest in international investing because it's been made easier for them to do that." ■

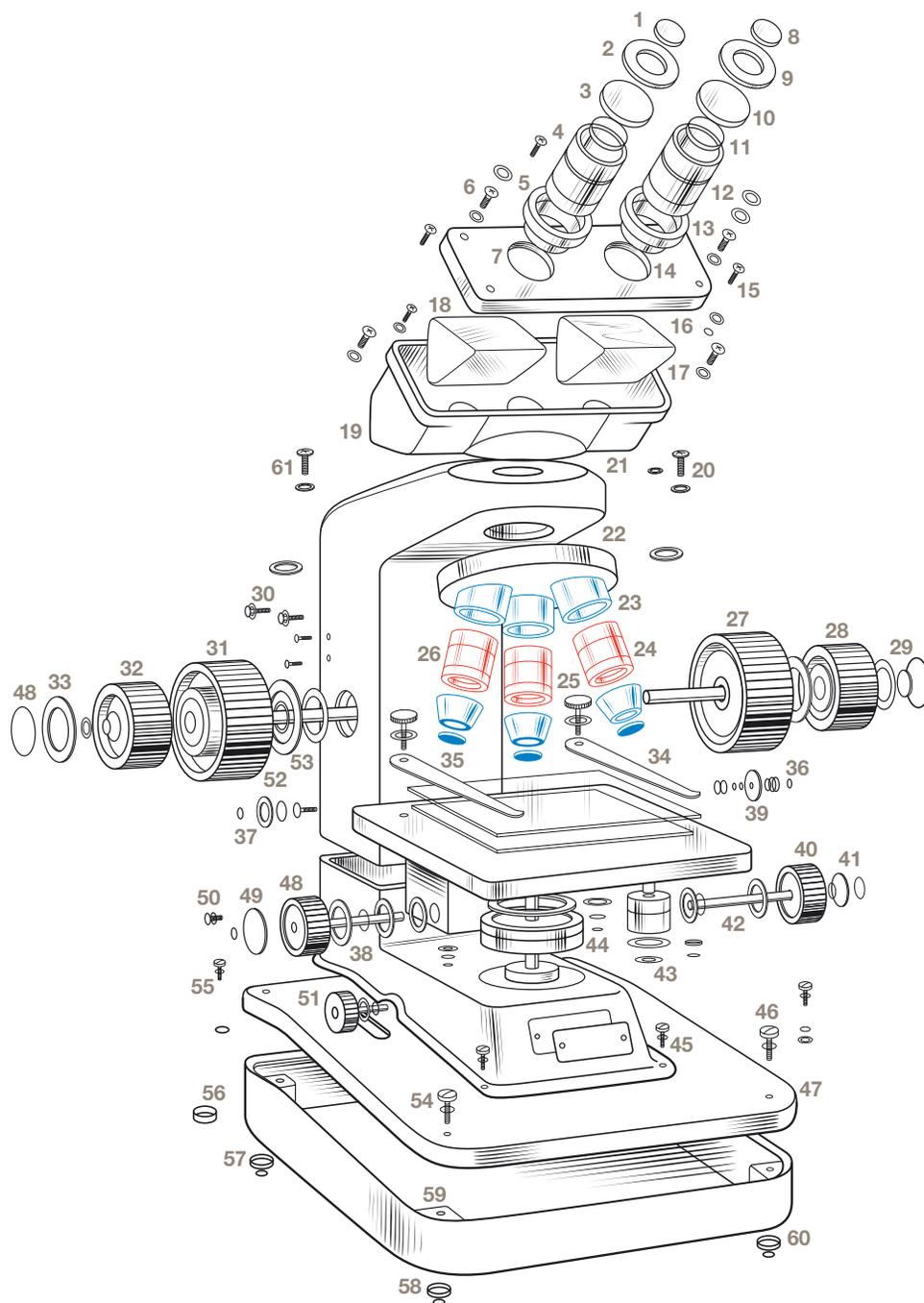
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