

In February, the S&P/ASX300 Accumulation Index was up 7.3%. Year to date, it is up 10.4%. What a remarkable start to 2015. In 2014, the total return for the year was only 5.3%¹. So why is everyone so buoyant? Reporting season, the local economy, or is it global macro?

Reporting Season

It's certainly **not** anything coming out of earnings reporting season. Key observations for the half-year earnings results were:

- Weak revenue (again);
- Cost out (sustainable?);
- Dividend surprises and buybacks;
- Capex cutting (again); and
- Payout ratios rising (sustainable?).

Local Economy

It's certainly not anything from our local macro economy. The Reserve Bank of Australia wouldn't have cut rates if they thought growth was taking off in Australia. In fact their key observations are:

- Growth below trend;
- Domestic demand weak;
- Unemployment higher;
- Output growth below trend;
- Spare capacity in the economy;
- Strong house prices; and
- Australian dollar still above fair value.

Global Macro

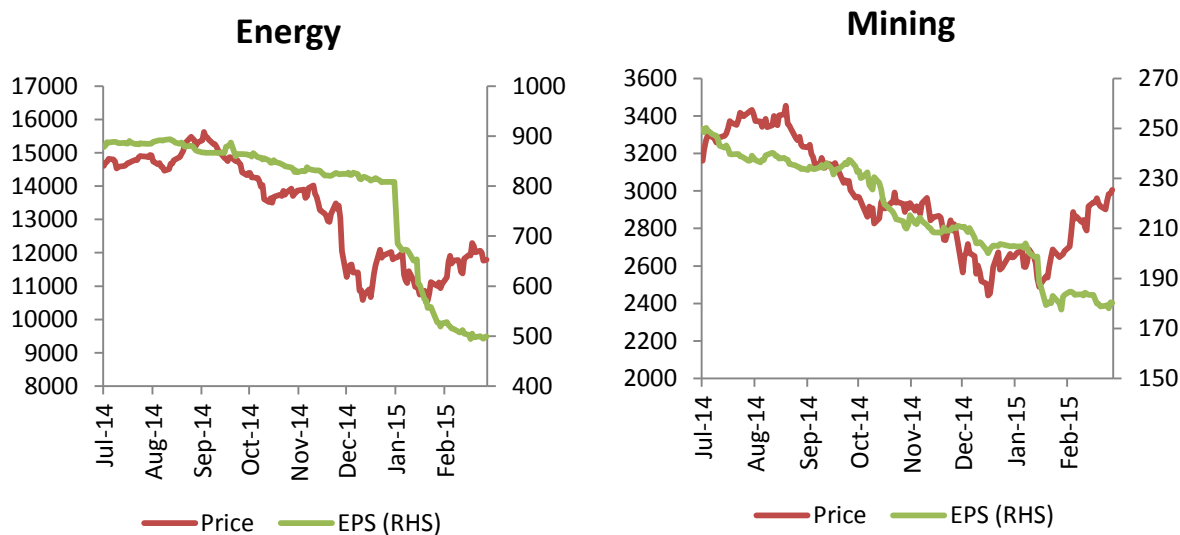
The strongest parts of the market were Resources and Materials. Oil price recovery drove energy sector stocks back up directly. The move in oil prices reflected the global investment community being less fearful of deflation, and this relief carried all risky assets up very strongly around the world. This appetite for risk was seen in equity markets everywhere, including Australia. *Therefore, it was global macro driving the thematic moves we saw in Australian equities, not issues specific to Australian stocks or the local economy.*

¹ Source: Bloomberg

Will the February Trend Continue?

The resources sector has been on a strong rebound trajectory since mid-January as part of the risk rally. How have these moves related to changes in forecast earnings? Not at all! In fact, price moves have been in the opposite direction to earnings over this period. This isn't a new phenomenon. Prices are a lot more volatile than the earnings, but earnings act as an anchor and eventually they converge. The only way for the current price recovery in resources stocks to be sustained is if there is a substantial recovery in earnings. There is no evidence of this recovery yet.

Figure 1: Price Index and 12 month Forward EPS for the S&P/ASX 300 Energy and Metals and Mining Indices - 30 September 2014 to 28 February 2015



Source: Bloomberg

The key issue is whether this short-term risk rally will continue.

Market uncertainty really started to pick up in the 4th quarter of 2014. Since 30 September, there have been three major spikes in volatility in the market along with large market drawdowns, in October, December and January.

At the end of last year, we set an expectation for 2015 of continued spikes in volatility, and stops and starts to earnings and prices. We aren't expecting a bad year, but a volatile one.

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