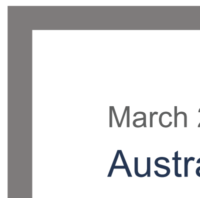

March 2013

Australian Market Commentary

Australia: Steady as She Goes

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Australia: Steady as She Goes

For 2013, Australian equities look vulnerable in the near term, but still appear attractive relative to fixed income. While we are more cautious than the consensus, we suggest investors maintain neutral allocations to risk assets and keep the ship "steady as she goes."

Despite macro worries and slowing global growth, 2012 was a positive year for investors. Global equities returned 14.1%, with Australia's 20.5% return making it one of the best-performing markets.[1] Even bonds managed to post solid returns. This year has gotten off to a brisk start as well, with Australian equities up 11.2% through 28 February, although bonds have suffered a bit as investor demand for safety has waned (Figure 1).

Last year, the "big three" global risks of a Eurozone breakup, Chinese hard landing, and U.S. fiscal cliff all bubbled to the surface, but simmered down with little impact on performance. While markets wobbled, they did not tumble, supported in part by global monetary easing. Whether it was the European Central Bank's pledge to defend the euro, the Federal Reserve's pledge of open-ended bond buying until U.S. employment improves, or the 125 basis points (bps) of cuts by the Reserve Bank of Australia (RBA), central banks went on the offensive. Today, both stock prices and investor optimism are rising, and investors seem to feel there is not much that can rock the boat in the near term (Italian elections aside).

Yet there remains a slight disconnect between the markets and the macro reality. Markets have rallied as perceptions of risk have fallen and on expectations that growth and earnings will improve. However, the expected pickup in growth is tepid and big questions remain for the longer term as to what will happen if and when central banks begin to withdraw stimulus. For Australia in particular, there are home-grown challenges, including elevated housing prices, a weakening labour market, the fading impact from the mining boom, and a strong Australian dollar. Elections in 2013 are another issue for Australian investors to grapple with.

Below we review recent asset class performance and give our thoughts on the outlook for Australian equities, fixed income, and the Australian dollar. Heading into 2012 amid the macro uncertainty, we suggested that investors "hang on for the ride" as equity valuations offered upside potential, especially if policymakers stepped on the reflation pedal.[2] We were neutral on bonds and nervous about the Australian dollar. Today is much the same, with the difference that equities look a bit more vulnerable in the short term, but still appear attractive relative to fixed income. While we are more cautious than the consensus, it still seems investors should maintain neutral allocations to risk assets and keep the ship "steady as she goes."

Australian Equities

As noted above, 2012 was a good year for Australian equities, which outperformed most other global markets.[3] However, the 20.3% return of the S&P/ASX 200 Index masked some wide divergences at home. Namely, while financials and broad-based industrials returned 29.6% and 28.0%, respectively, natural resources and small

[1] All returns are total returns in unhedged AUD terms, unless otherwise noted.

[2] Please see our 2012 Outlook Market Commentary *Australia: Hang on for the Ride*.

[3] Australia's strong total return was due in part to a hefty 5% dividend return. Dividend returns for Australian investors are higher once franking credits are included.

caps returned only 1.3% and 6.6%.[4] Last year also saw the outperformance of traditional "defensive" sectors such as health care, telecoms, and consumer staples. The outperformance of high-dividend-paying stocks, especially financials and cash-rich companies, was also a theme in 2012, both in Australia and globally (Figures 2 and 3).

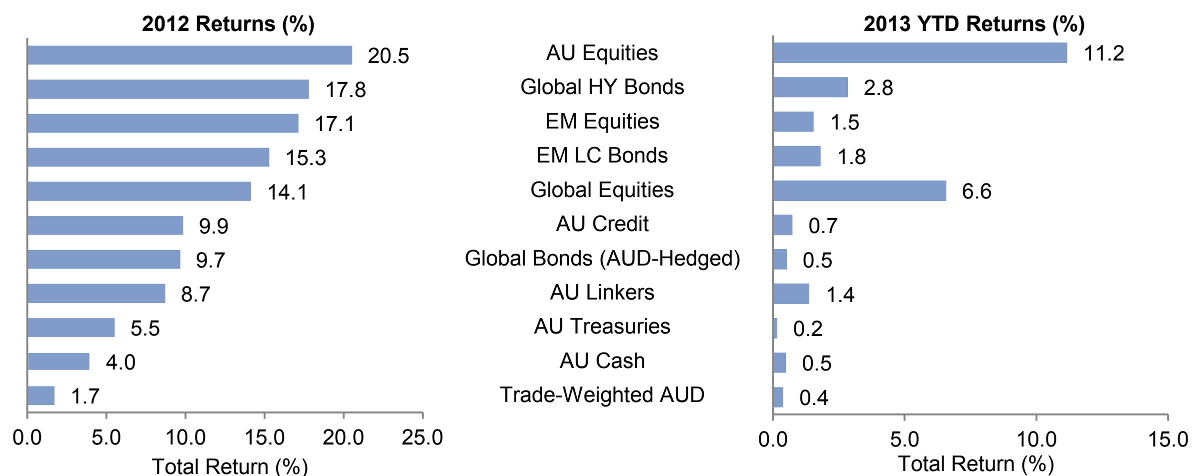
Some of these trends have persisted thus far in 2013, with financials outperforming and resources and small caps lagging behind. Globally, we have seen a tentative reversal in overall leadership, with defensive sectors underperforming more cyclical sectors over the past few months. The underperformance of mining-related companies and small caps in Australia is bucking this nascent global trend. Despite the rebound in commodity prices, investors have expressed concern over rising cost pressures and overcapacity, with Rio Tinto's 50% fall in operating earnings and $3.0 billion annual net loss the most glaring example.

As Australian equities have rallied, valuations remain reasonable (Figures 4 and 5). Both forward price-earnings (P/E) ratios and our composite normalized P/E metrics are near historical averages. Our normalized P/E ratio of 17.2 is modestly above (0.3 standard deviation) the historical average of 15.6, while price-to-book (P/B) ratios are a bit more elevated. Both metrics are within our fair value range and below the levels reached in 2011.

Relative to global equities as a whole, Australia also appears fairly valued, trading within historical norms on a comparative P/E and P/B basis (although again a

[4] Based on S&P/ASX 200 sector indices. The resources index includes mining and energy-related companies and accounts for 23% of the overall market, while industrials contains the rest of the ASX 200, including financials, which alone account for 43% of the market. MSCI sector indices divide the market into ten sectors, and industrials account for only 5% of the market.

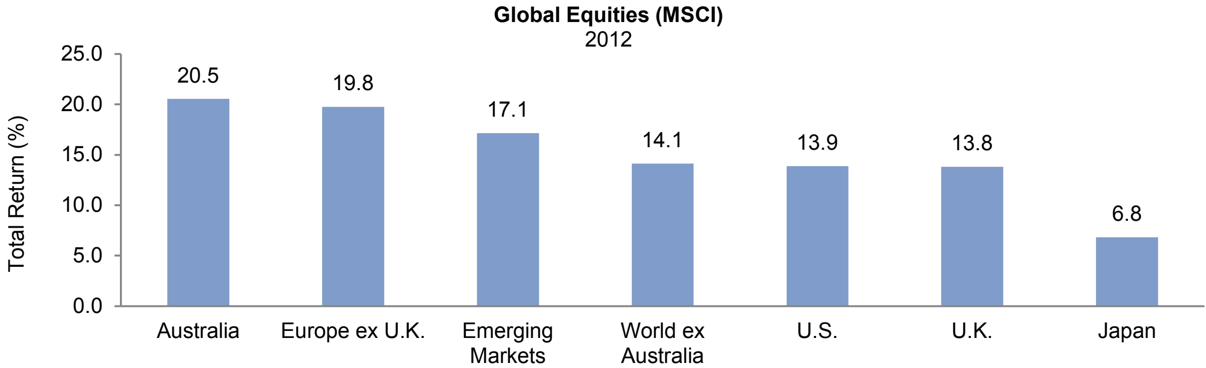
Figure 1. Asset Class Performance
As of 28 February 2013 • Australian Dollar

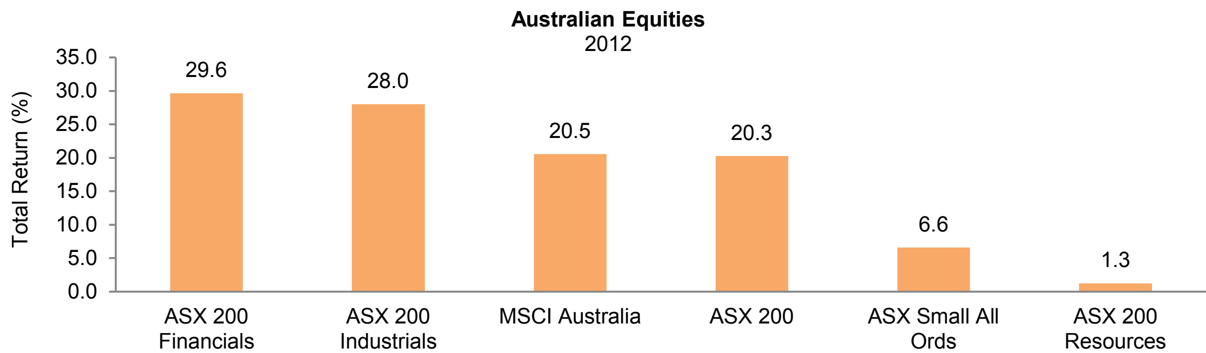


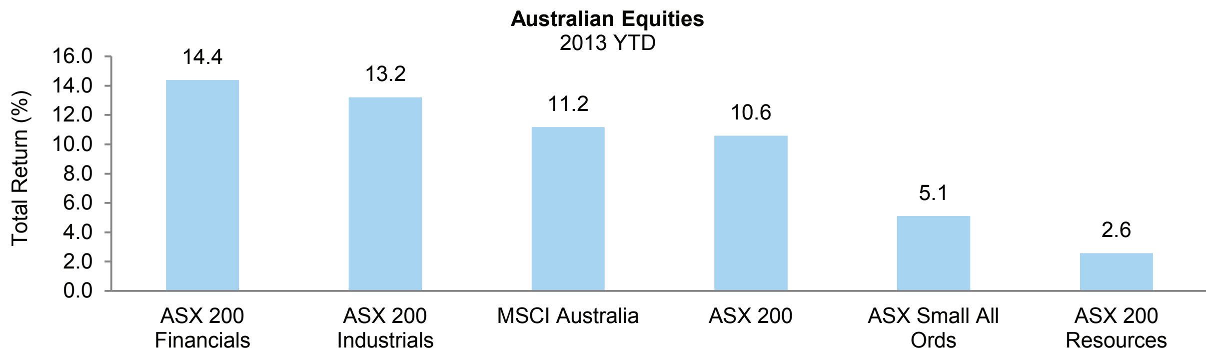
Sources: Barclays, BofA Merrill Lynch, J.P. Morgan Securities, Inc., MSCI Inc., Reserve Bank of Australia, Thomson Reuters Datastream, and UBS. MSCI data provided "as is" without any express or implied warranties.
Notes: Returns represented by: MSCI Australia Index ("AU Equities"), BofA Merrill Lynch Global High Yield Bond Index ("Global HY Bonds"), MSCI Emerging Markets Equity Index ("EM Equities"), J.P. Morgan Government Bond Index Emerging Markets Global Diversified ("EM LC Bonds"), MSCI World ex Australia Index ("Global Equities"), UBS Australia Credit Index ("AU Credit"), Barclays Global Aggregate (AUD-hedged) Index ("Global Bonds [AUD-Hedged]"), UBS Australia Inflation-Linked Bond Index ("AU Linkers"), UBS Australia Treasuries Index ("AU Treasuries"), UBS Australia Bank Bill Index ("AU Cash"), and Reserve Bank of Australia AUD Index ("Trade-Weighted AUD").

Figure 2. Equity Performance

As of 28 February 2013 • Australian Dollar

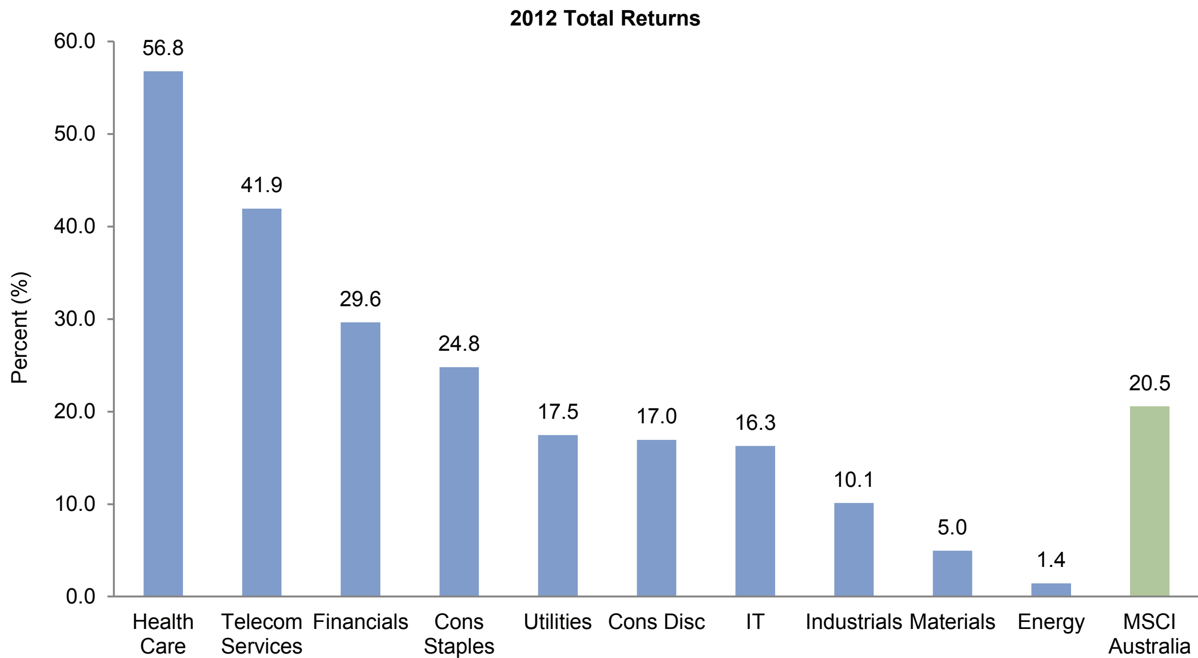






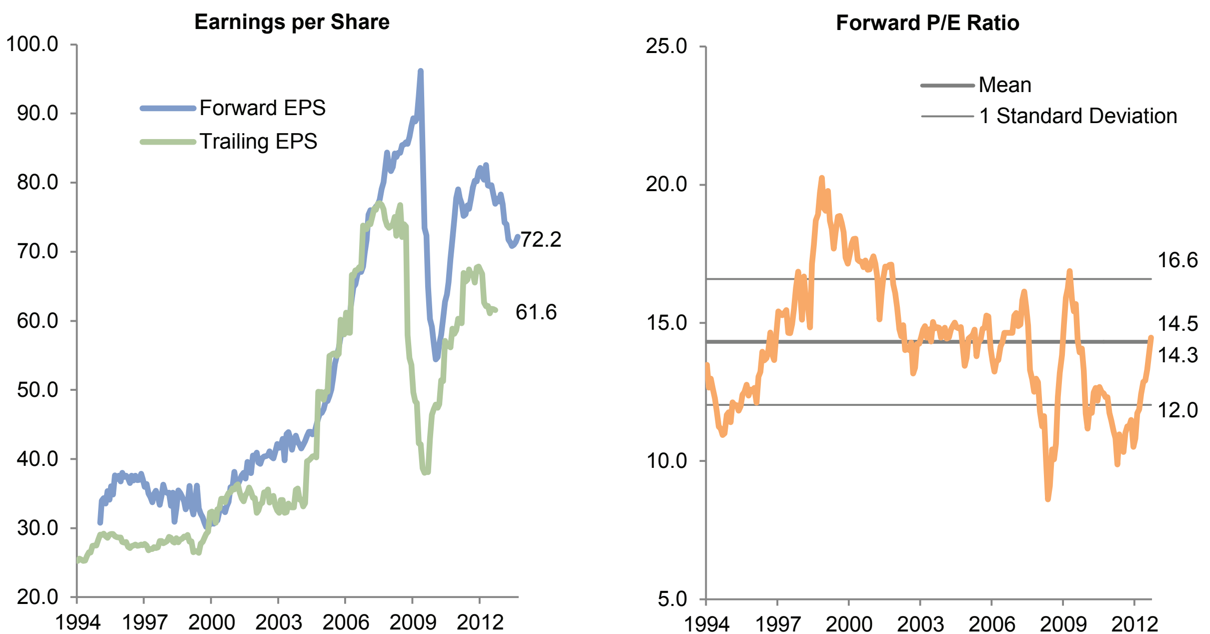
Sources: Barclays, MSCI, Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Figure 3. MSCI Australia Sector Performance
As of 31 December 2012 • Australian Dollar



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

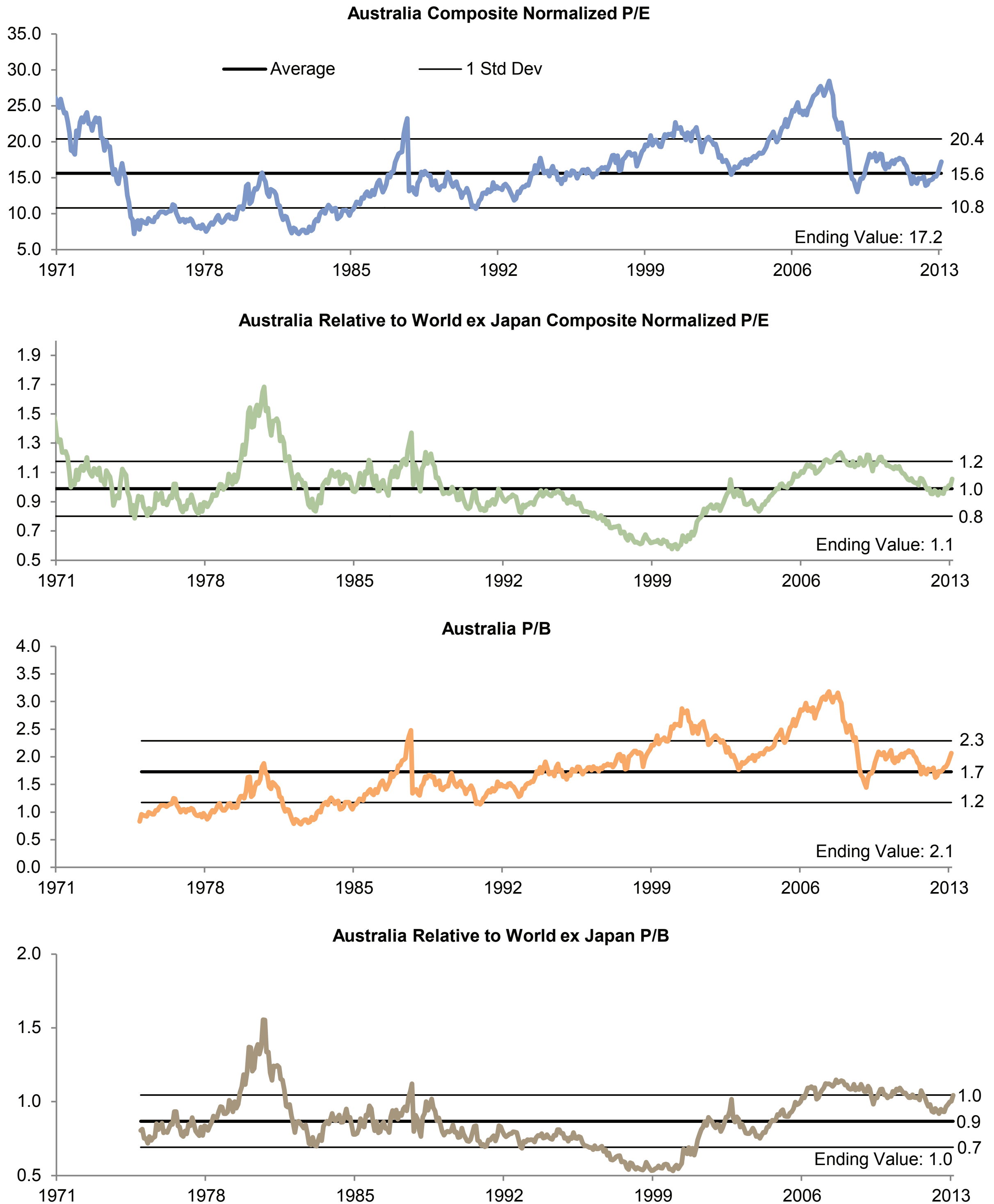
Figure 4. MSCI Australia Forward Earnings Estimates and Price-Earnings Ratios
30 June 1994 – 28 February 2013 • Australian Dollar



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Forward earnings per share are graphed leading by 12 months.

Figure 5. MSCI Australia Valuations

31 January 1971 – 28 February 2013 • Local Currency



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings.

bit pricier on relative P/B). Furthermore, Australian equities still offer a decent dividend yield advantage over global equities at 4.2% versus 2.7%.

While valuations are not yet giving a strong warning signal, we are concerned that Australian equities are running a bit hot and are due for a correction. Figure 6 shows how two momentum measures we track reached 1 standard deviation overbought at the end of February. While this alone does not guarantee a market sell-off, and markets have been even more overbought in the past, it does point to a moderation in gains and vulnerability to disappointment.

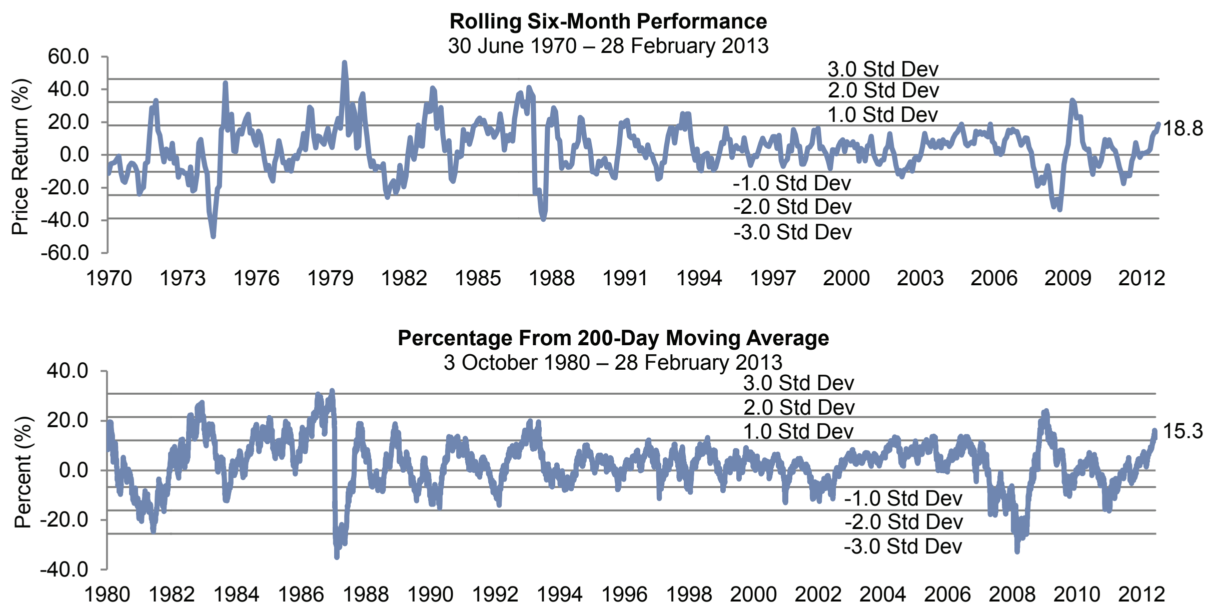
Specifically, multiple expansion drove the rally over 2012, as both trailing earnings and forward expectations declined over the year. For 2013, the consensus expects earnings to rise 5% before jumping 15% in 2014, as the mining sector is expected to return to profitability. Any disappointment in the earnings outlook could easily take the steam out of the current rally. While 5% earnings per share growth seems reasonable following last year's declines, it also depends on the financial sector achieving near 10% growth to offset weakness in the miners.

Consensus GDP forecasts pencil in a slowdown from 3.6% growth in 2012 to 2.6% growth in 2013, which seems reasonable to us. While there is debate about whether a tentative rebound in the housing market and construction can offset weakness in the mining sector and boost employment, expectations for slower growth seem appropriate. Both Chinese economic growth and demand for raw materials seem to be stabilizing at a lower level; thus, we do not see much upside surprise from mining to the growth outlook.

Overall, much like last year, we remain neutral on Australian equities. Valuations are not particularly stretched (yet), and

Figure 6. MSCI Australia Index Momentum

Australian Dollar



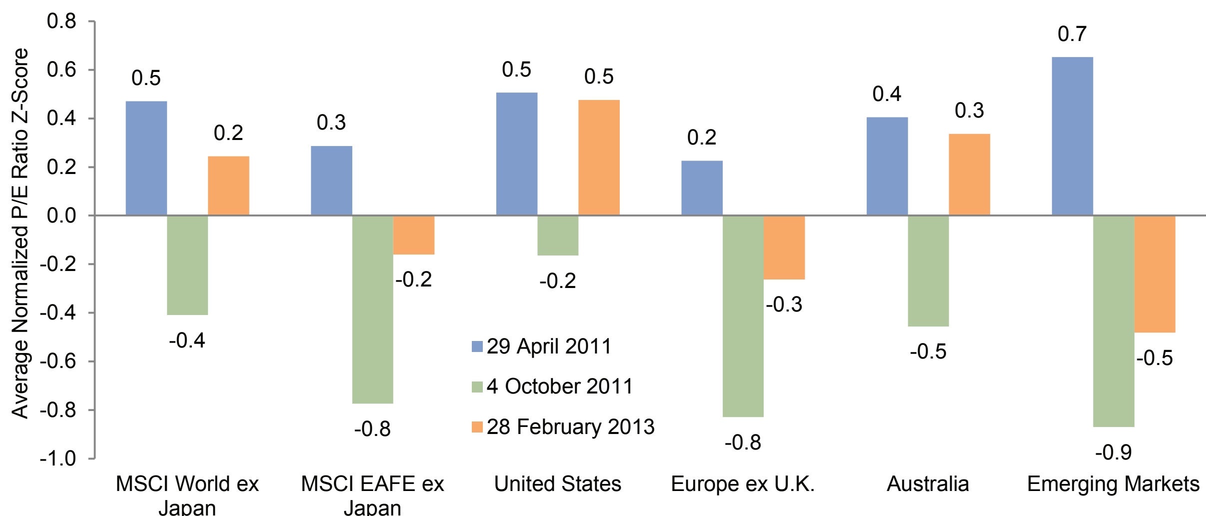
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The top graph uses monthly data. The bottom graph uses daily data.

earnings expectations are modest. A bout of market consolidation is likely on the horizon, which keeps us from being aggressive in chasing this rally. At the same time, the valuation case for non-Australian equities is not particularly compelling, especially taking dividends into consideration. However, as Figure 7 shows, U.S. equity overvaluation is impacting developed markets valuations as non-U.S. developed equities still sport below average valuations. There is an even wider valuation gap between Australian and emerging markets equities, which remain at below average valuations, despite both Australian and emerging markets sharing a common risk factor (China). Today, we would advocate roughly neutral allocations to non-Australian equities, and tilting such allocations away from U.S. equities and toward emerging markets.

Australian Sovereign Bonds

Returns on Australian fixed income were quite strong in 2012, with the UBS Australian Credit Bond Index returning 9.9% and inflation-linked bonds 8.7%, while Treasuries and bank bills returned 5.5% and 4.0%, respectively (Figure 1). The global slowdown over 2012 saw yields on Australian government bonds tumble, with UBS Australia Treasuries Index yields hitting 2.49%, only to back up to 2.97% by February 2013. The rise in yields has only modestly impacted bond returns so far. While bond yields remain at 50-year lows, Australian investors are fortunate to still enjoy positive real interest rates, with inflation currently running around 2% and expected to remain below 3% for 2013. Linkers are yielding 0.68%, with breakeven inflation of 2.7% priced in over the next decade. This compares favorably to U.S. Treasury Inflation-Protected Securities,

Figure 7. MSCI P/E Ratio Deviation From Historical Avg Based on Composite Normalized Earnings



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations for the first four regions. For Australia, our distribution is based on the post-1970 data set. No adjustments have been made for emerging markets equities. Z-scores represent the number of standard deviations away from the historical mean.

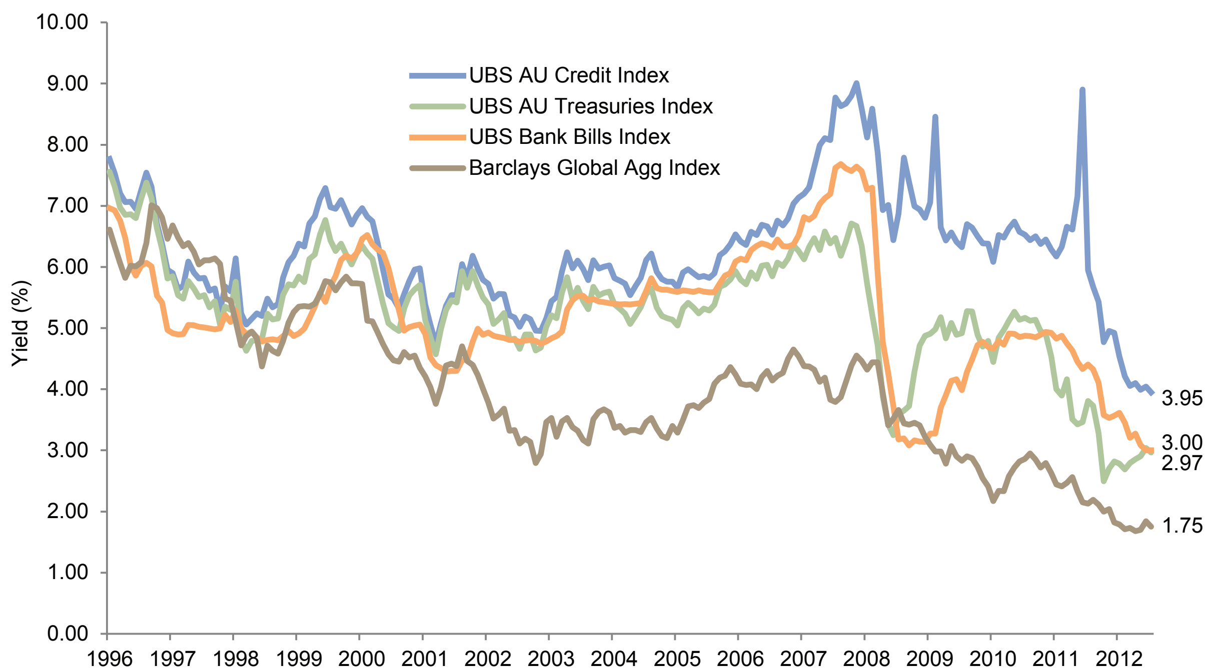
which offer negative yields for the same inflation profile (Figures 8 and 9). Given the gradual slowing of the economy and still-strong Australian dollar, the RBA—which slashed policy rates by 150 bps over the past year or so to 3.0%—does not view inflation as a concern. Consensus expectations suggest further rate cuts to 2.5% this year, although the RBA cautioned at its early February meeting that it is waiting to assess the impact of previous rate cuts on the economy, particularly the housing sector.

Australia's relatively high yields are a double-edged sword. On the one hand, Australian bonds are attractive to foreign investors, including central banks in search of reserve diversification. Thus, if the zero-rate environment in much of the developed world persists, money will continue to flow into Australia, helping to keep bond yields low. However, foreigners have come to own a very large percentage of Australian government bonds (roughly 70% or so), meaning that if and when the fund flows stop, there could be a sharp, rapid sell-off.

This dilemma around Australian sovereign bonds seems to suggest favoring cash over bonds until yields rise enough to offer a more substantial term premium versus today's flat yield curve. Higher bond yields are needed to justify neutral allocations to sovereign bonds. However, given positive real yields, we would not suggest investors be drastically underweight deflation hedge allocations, especially with lingering macro risks. Though it remains to be seen how foreign investors would respond amid a crisis, especially if the crisis involves a hard landing in China or a domestic macro accident, Australian government bond yields have scope to fall.

Our view is that at current levels, Australian government bonds are overvalued relative to fair value yields in the range of 5% to 6% for nominal bonds and 2.5% to 3%

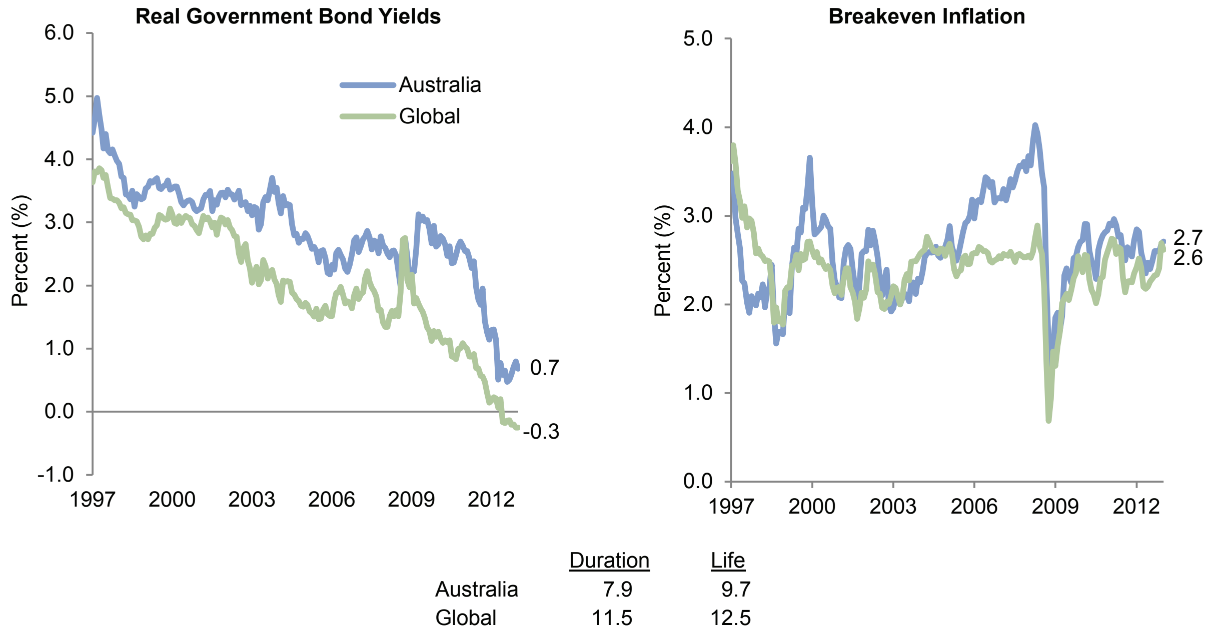
Figure 8. Australian Bond Index Yields
31 August 1996 – 28 February 2013



Sources: Barclays, Thomson Reuters Datastream, and UBS.

Figure 9. Global Inflation-Linked Government Bond Yields

28 February 1997 – 28 February 2013



	Duration	Life
Australia	7.9	9.7
Global	11.5	12.5

Sources: Barclays and Thomson Reuters Datastream.

Note: Data are based on the Barclays Inflation-Linked Bond and Breakeven series.

for linkers. While we do not expect mean reversion to such levels in the near term, government bonds are unattractively priced. Given that inflation is unlikely to be a near-term issue, yields could remain at relatively low levels for some time, although they may rise amid an increase in growth and inflation expectations. Thus, for bond mandates designed as a hedge against deflation, we advocate being slightly underweight sovereign bonds and holding some cash in its place (cash serves a similar role in the portfolio, has less interest rate risk, and comes without a significant opportunity cost today given the somewhat flat yield curve). The bottom line is that investors need to hold some high-quality fixed income as dry powder and protection from additional deflationary shocks; Australian investors are lucky enough to get paid something to do so.

Diversifiers[5]

Equity-oriented portfolios should include a range of investments designed to diversify equity exposures and lower overall portfolio volatility. Such investments include low-beta hedge fund strategies and credit-related opportunities, among others. Our view to maintain roughly neutral risk exposure, while also slightly underweighting relatively expensive defensive bond allocations, places increased importance on diversifying assets. Indeed, investors have piled into high yield and other fixed income strategies over the past few years specifically for equity-like returns with lower volatility.

Today, we are not excited about the outlook for credit. While such exposure can dampen overall portfolio volatility and equity beta, the upside seems quite limited. The UBS

[5] Please see our 2013 Outlook Market Commentary *The Tug of War Continues* for additional views on various diversifier and credit strategies.

Australian Credit Bond Index currently yields 3.95%, or 99 bps over the sovereign bond index—a wide spread historically, but not particularly compelling versus Australian equity dividend yields. Foreign bonds seem unappealing, with the Barclays Global Aggregate Bond Index yielding only 1.75% (although hedged fixed income would generate an additional 2% to 3% in yield pickup) (Figure 8). Global investment-grade corporate bond yields are also quite low and entail duration risk despite offering "normal" spreads over sovereigns. Global high-yield bonds have limited upside from current levels (given most bonds trade near their call prices), and while yields of 6% may be more attractive than sovereign bonds amid a risk-on environment, they are also less compelling against equities. The same could be said for emerging markets debt, which offers similar yields to high yield, with added emerging markets currency exposure.

Thus, we find ourselves advocating more exposure to low-beta hedge fund strategies (including long/short funds) and funds with flexible mandates and an absolute return focus (e.g., global tactical asset allocation, global macro, and broad mandate multi–asset class managers). The market backdrop continues to be difficult for many hedge fund managers, with long/short funds in particular pressured by continued high correlations and low dispersion, although these factors have improved somewhat in recent months. Low interest rates also remain a significant headwind for most hedge fund strategies. These challenges cannot persist indefinitely, and given the lack of return left in credit markets and credit strategies, we find the characteristics of these lower-beta funds attractive today.

Australian Dollar

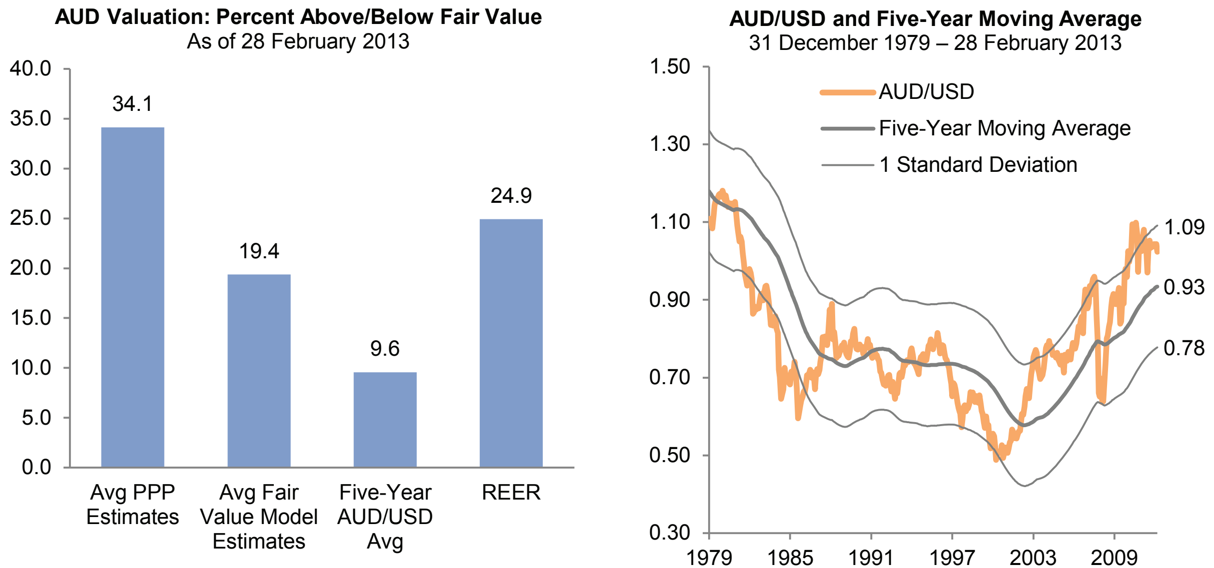
The Australian dollar remains the trickiest piece of the outlook. The Australian dollar rose 1.3% versus the U.S. dollar last year and 1.7% on a trade-weighted basis. The currency is up slightly so far this year, and is hovering around AUD/USD 1.04–1.02. The Australian dollar was relatively stable last year, despite the tumble in commodity prices *and* rate cuts by the RBA, breaking what has until now been a tight relationship over the past few years. This stability has been attributed to the surge in foreign buying, especially by central banks. At current levels, the Australian dollar is still generally regarded as overvalued, but estimates vary greatly on the level to which the dollar should revert.[6] Comparing the current level of the real effective exchange rate to its long-term average implies the Australian dollar is 25% overvalued, while some commentators argue parity is the new fair value, implying the Australian dollar is not so stretched (Figure 10).

We are agnostic on the near-term outlook for the Australian dollar, especially given recent changes in its correlations to global risk assets. However, over the long term, we remain bearish, based on our view that the positive terms-of-trade shock from the commodity boom will fade as China's demand for commodities slowly declines.

This raises the question of strategic hedging for Australian investors. Rather than try

[6] Purchasing power parity estimates from the International Monetary Fund and *The Economist* imply a fair value for AUD/USD of 0.65 and 0.93, respectively, making the Australian dollar 58% to 10% overvalued today. However, econometric fair value estimates from Goldman Sachs and J.P. Morgan (which take into account factors like terms of trade and interest rate differentials) place fair value between 0.80 and 0.92, or 30% to 11% overvalued. Over the past five years, the Australian dollar has averaged 0.93 with a +/- 1 standard deviation band of 1.09 to 0.78.

Figure 10. Australian Dollar



Sources: Bank for International Settlements, *The Economist*, Goldman, Sachs & Co., International Monetary Fund, J.P. Morgan Securities, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Real effective exchange rate (REER) is as of 31 January 2013 and expressed as percent change over long-term average. Average PPP estimates reflect a simple average using IMF and *Economist* data. Average fair value model estimates reflect a simple average using Goldman Sachs and J.P. Morgan data.

to develop an optimal hedge ratio, we feel investors should strategically hedge investments intended to play a defensive role in the portfolio. Namely, we would hedge high-quality, fixed income, and diversifying hedge fund allocations to preserve their diversifying characteristics—in other words, to not let the currency return dominate the asset class return. Today, we would support leaving global equities unhedged. While maintaining a full Australian dollar hedge during the boom years of the past decade was very beneficial, going forward we view the upside for the Australian dollar as modest. We see secular downside to the Australian dollar, but whether the currency will go back to the AUD/USD 0.50 level seen a decade ago remains to be seen. The prevailing range of 0.8 to 1.1 over the last five years could be the new norm for now.

Summary

Overall, our outlook is much the same as it was last year. It is hard to be too excited by the macro outlook, both in Australia and globally. Economic growth is expected to continue to moderate in Australia (although remain robust relative to other developed economies), and while the global economy appears to be stabilizing, it would be premature to expect a sharp acceleration in growth, especially in China.

Yet equity markets in Australia (and globally) have rallied sharply in expectation of an upturn in the earnings cycle. While valuations appear reasonable (for now), markets seem overbought and at risk of a sell-off. At a minimum, equities are overdue for a period of consolidation. Of course, there is the chance of a continued overshoot in equity markets if global growth does pick up and/or earnings exceed expectations, but this is not our base case.

For now, we would remain largely neutral on equity allocations given that valuations are not at either extreme and markets are not depressed. We would suggest titling equity allocations in favor of emerging markets equities at the expensive of U.S. or domestic equity allocations, given relative valuations.

In general, the outlook for fixed income is unappealing. Sovereign bonds have very low yields, and credit has limited upside, especially versus equities. We recommend underweighting Australian sovereign bonds in favor of cash until yields back up, while maintaining some exposure to defensive fixed income given macro risks and positive real yields in Australia. To compensate for the increased equity exposure from underweighting sovereign bonds and tilting toward emerging markets equities, we recommend increasing allocations to other low-beta strategies and hedge funds. The Australian dollar is murky to us in the near term, but we generally advise leaving global equities unhedged at this juncture.

Overall, assuming the global economy totters on, inflation remains low, and central banks stay generous with their liquidity, markets should grind higher, with equities beating bonds. We expect some bouts of market volatility as markets have outpaced fundamentals, and the potential remains for global macro concerns to flare up later in the year. But for now, investors need to maintain a steady hand on the wheel and keep portfolio allocations "steady as she goes" in what remains a challenging investment climate. ■