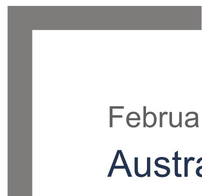


February 2014

Australian Market Commentary

Australia Outlook 2014: Watch Out for That Transition

Jason Widjaja | Aaron Costello

CAMBRIDGE ASSOCIATES LIMITED

Copyright © 2014 by Cambridge Associates Limited LLC. All rights reserved. Confidential.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates Limited LLC ("CA"). Copying of this publication is a violation of U.S. and global copyright laws (e.g., 17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. Therefore, recipients may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that may be described in the report. No part of this report is intended as a recommendation of any firm or any security, unless expressly stated otherwise. Nothing contained in this report should be construed as the provision of tax or legal advice. Past performance is not indicative of future performance. Any information or opinions provided in this report are as of the date of the report and CA is under no obligation to update the information or communicate that any updates have been made. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results made by a manager that are delivered to CA electronically, by wire, or through the mail. Managers may report returns to CA gross (before the deduction of management fees), net (after the deduction of management fees), or both.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Fiduciary Trust, LLC is a New Hampshire limited liability company chartered to serve as a non-depository trust company, and is a wholly-owned subsidiary of Cambridge Associates, LLC. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorised and regulated by the Financial Conduct Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G). Cambridge Associates Investment Consultancy (Beijing) Ltd is a wholly owned subsidiary of Cambridge Associates, LLC and is registered with the Beijing Administration for Industry and Commerce (Registration No. 110000450174972).

CAMBRIDGE ASSOCIATES LIMITED

Australia Outlook 2014: Watch Out for That Transition

In 2014, we expect a rougher road for Australia, which is currently in a transition phase that has been quite benign so far, but may not remain so.

For investors, 2013 was a year of contradictions. If you knew in late 2012 that the year ahead would see escalating fears over a Chinese hard landing, commodity prices (including gold) tumble, emerging markets equities stumble, and high-yield asset classes like REITs fumble, you might have concluded that 2013 would be a poor year for Australia. However, while the Australian dollar did suffer a near 15% drawdown, Australian equities returned 20.9% and house prices continued to rise. Angst over the end of the commodity boom? You couldn't tell from looking at the stock market (Figure 1).

Luckily we did not have perfect foresight, and for 2013 we suggested investors keep the ship steady by holding equity allocations neutral, underweighting fixed income (and favoring cash over bonds), remaining bearish on the Australian dollar, and leaving non-Australian equity allocations unhedged. However, we did miss the mark with our suggestion to modestly overweight EM equities.[1]

What do we (imperfectly) see for 2014? First, we expect much more muted global equity returns. We still view markets as having outpaced fundamentals, and a period of consolidation is needed. Stress in emerging markets and uncertainty over how bond markets and the US economy will react to Federal Reserve tapering will drive volatility higher. In Australia, we are concerned that markets are underappreciating the impact of the end of the mining boom as the non-mining side of the economy does not look particularly robust. Australia is in a transition phase that, so far, has been quite benign, but may not remain so.

[1] Please see our March 2013 Market Commentary *Australia: Steady as She Goes.*

While we do not expect any sort of doomsday in 2014, the road will get rougher, especially if China really begins to rebalance its economy. For Australian investors, some defensive squaring of the portfolio may be in order, such as rebalancing equities and bonds, especially if bond yields rise further, and adding more diversifying, low-beta assets. Reassessing emerging markets equity exposure and implementation is also in order. Finally, the Australian dollar still seems vulnerable on a long-term basis, although last year's sell-off has made the dollar less stretched in the near term.

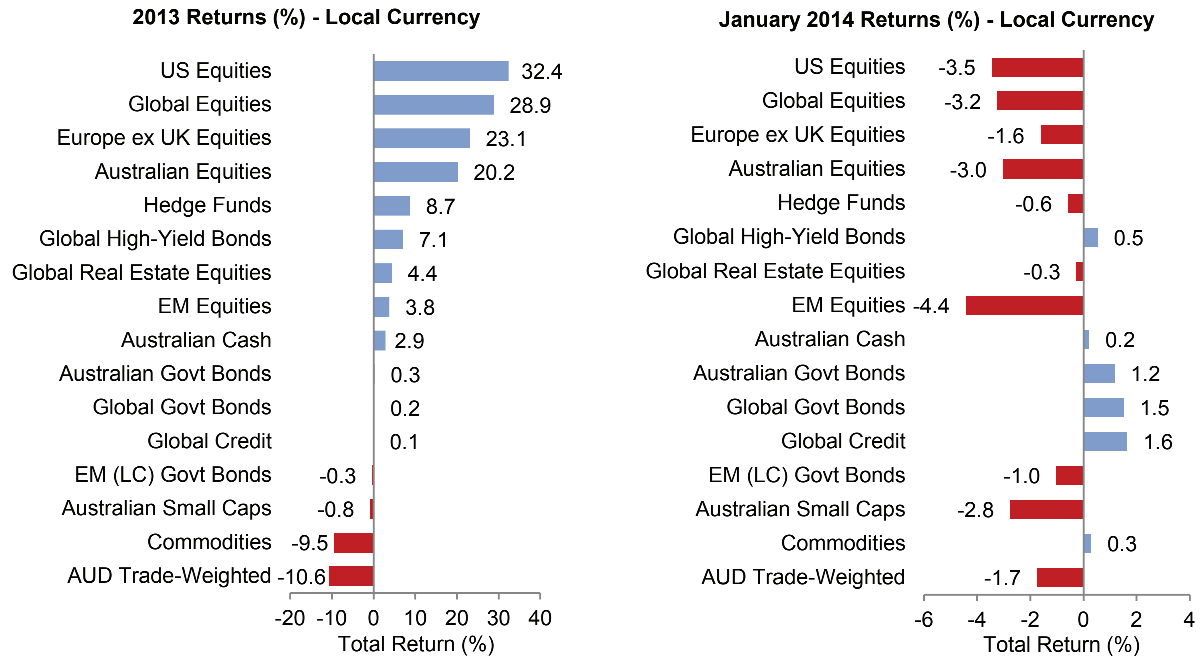
Australian Economy: Still the Lucky Country

The big picture issue for Australia is the transition to the post–commodity boom era. The Australian economy has benefitted from China's economic growth over the past decade, with growth boosted by mining investments and commodity exports. However, as China is expected to move to more sustainable but slower growth, its demand for Australia's commodities will be materially impacted. To some extent this story is well known—Australian real GDP growth peaked at over 4.5% in early 2012 and has since slowed to about 2.3% in third quarter 2013, with reductions in mining investments expected going forward (Figure 2).

Yet the consensus seems to have high hopes of a recovery this year in Australia. This optimism is driven by the belief that housing construction, boosted in part by 225 bps of rate cuts by the Reserve Bank of Australia (RBA) since late 2011, and increased exports will help offset the fall in mining investment, with expectations for real GDP

Figure 1. Asset Class Performance

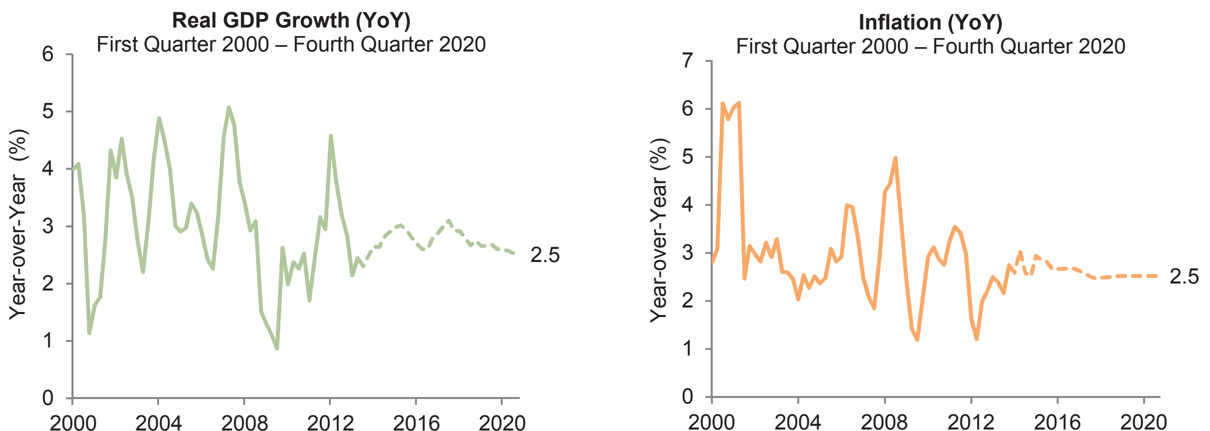
As of 31 January 2014



Sources: Barclays, BofA Merrill Lynch, Citigroup Global Markets, Dow Jones & Company, Inc., FTSE International Limited, Hedge Fund Research, Inc., J.P. Morgan Securities, Inc., MSCI Inc., Reserve Bank of Australia, Standard & Poor's, Thomson Reuters Datastream, and UBS. MSCI data provided "as is" without any express or implied warranties.

Notes: All returns are local currency except for commodities, global real estate equities, and hedge funds, which are in US dollars. Returns represented by: S&P 500 ("US Equities"), MSCI World Equity Index ("Global Equities"), MSCI Europe ex UK Index ("Europe ex UK Equities"), S&P/ASX 200 ("Australian Equities"), Hedge Fund Research Fund of Funds Composite Index ("Hedge Funds"), BofA Merrill Lynch Global High Yield Bond Index ("Global High-Yield Bonds"), FTSE® EPRA/NAREIT Developed Index ("Global Real Estate Equities"), MSCI Emerging Markets Equity Index ("EM Equities"), UBS AU Bank Bills All Maturities Index ("Australian Cash"), UBS AU Treasury All Maturities Index ("Australian Govt Bonds"), Citigroup World Government Bond Index ("Global Govt Bonds"), BofA Merrill Lynch Global Broad Corporate Bond Index ("Global Credit"), J.P. Morgan Government Bond Index Emerging Markets Global Diversified ("EM LC Govt Bonds"), S&P/ASX Small Ordinaries ("Australian Small Caps"), Dow Jones UBS Commodity Index ("Commodities"), and RBA AUD Trade Weighted Index ("AUD Trade-Weighted").

Figure 2. Australian Real GDP Growth and Inflation



Sources: Oxford Economics, Reserve Bank of Australia, and Thomson Reuters Datastream.

Notes: GDP data are forecasts for fourth quarter 2013 onwards. Inflation data are forecasts for first quarter 2014 onwards.

growth to rise to 2.9% by the end of the year. Some economists are even forecasting a rate hike in the second half of 2014.

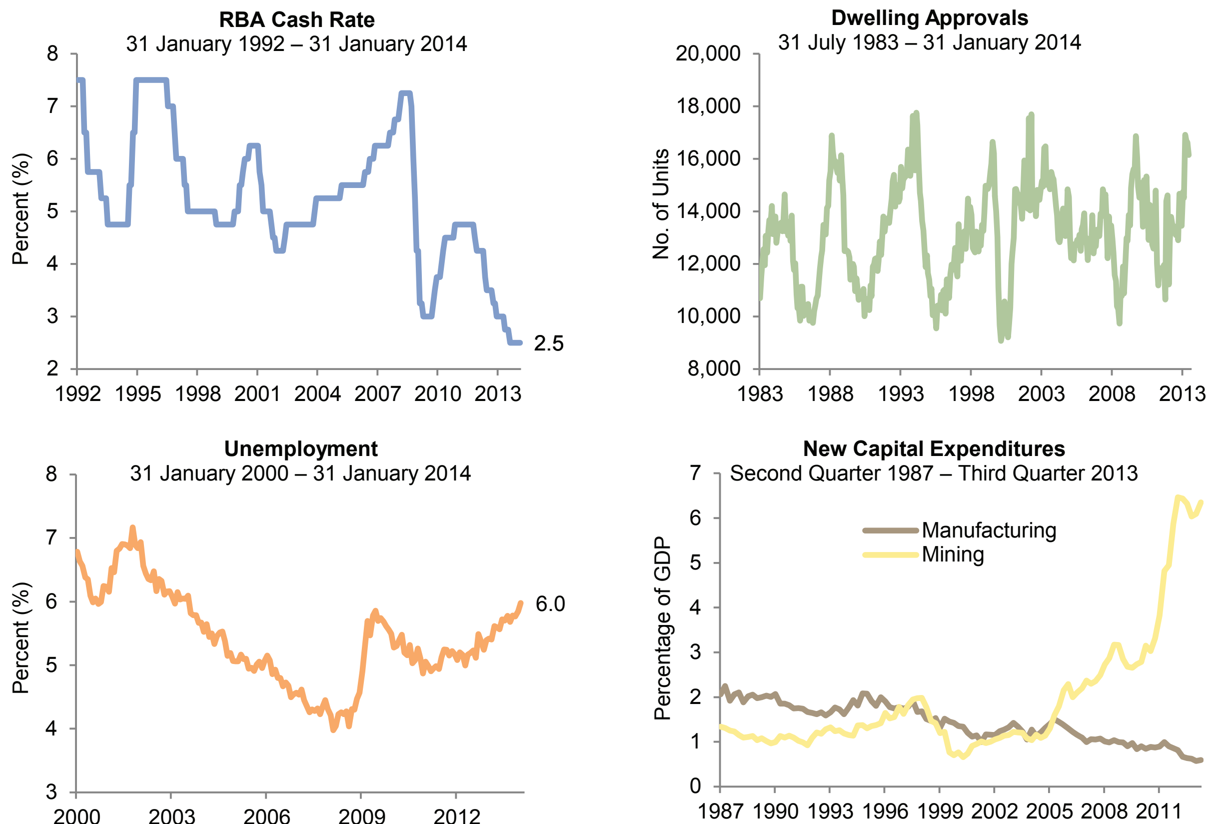
However, we are concerned that there is growing complacency given the low interest rate environment. We are also skeptical that the non-mining economy will be able to offset the fall in mining investments, especially in the near term (Figure 3). This is especially the case given our bearish views on the outlook for Chinese investment demand—we have a hunch it will slow more sharply than the consensus expects, even if a hard landing is avoided.

The big picture is that if growth averaged between 3% and 4% over the past decade or so, going forward growth will be in the 2% to 3% range at best, with downside risk given the uncertainty in emerging markets and China.

Inflation, which is expected to rise in the near term before cooling over the course of the year, picked up toward the end of 2013 to 2.7% as the Australian dollar's tumble contributed to rising import prices. The consensus expects inflation to ease to 2.5% by the end of 2014. Further declines in the Australian dollar could certainly nudge inflation upwards, but with the economy facing the aforementioned headwinds and unemployment on the rise, we believe that inflation will not be a problem in Australia.

With regard to monetary policy, the consensus is that the RBA's easing cycle has ended. However, we don't expect the RBA to be in a hurry to tighten, given uncertainties as to whether the economy can successfully transition from the expected slowdown in mining investments. Disappointing employ-

Figure 3. Australian Economic Indicators



Sources: Oxford Economics, Reserve Bank of Australia, and Thomson Reuters Datastream.

ment and wage figures in early February underscore the difficulties in the domestic economy. Moreover, inflation is still within the RBA's target range of 2% to 3%. The central bank should keep rates on hold unless there is further weakness in the economy.

Overall, we expect the Australian economy to remain soft and inflation to moderately ease. Falling mining investments will be a major headwind, but a weak Australian dollar and the RBA's accommodative monetary policy should provide some counterweight. We do not expect the sudden bursting of elevated housing prices on the horizon. However, we are concerned that the housing market, driven more and more by overseas buyers, looks increasingly toppy given weak labor dynamics. Moreover, recent purchases have been for investments rather than primary dwelling purposes, with buying concentrated in Sydney, Perth, and Melbourne.

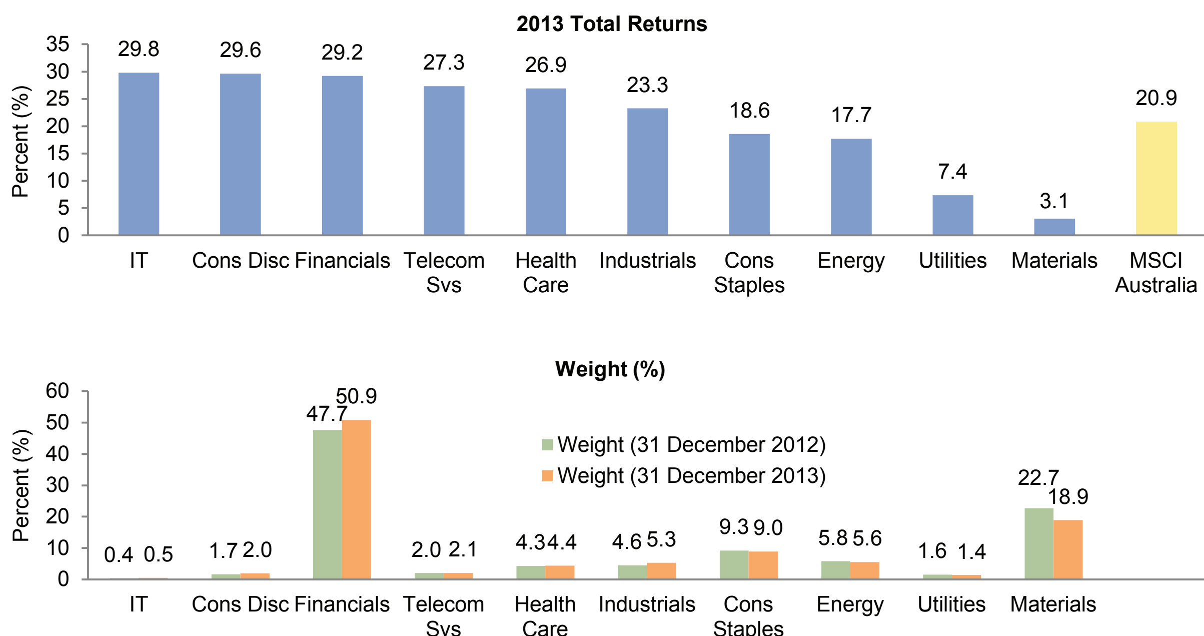
Australian Equities

Australian equities returned 20.9% in 2013, adding to a similar performance in 2012. While Australian equities underperformed the broad MSCI World Index return of 28.9% (in local currency terms), a 21% return was pretty good given the circumstances.

Given its near 20% weight in the MSCI Australia Index, the poor return for the materials sector (3.1%) was the key drag on the Australian market relative to developed markets (Figure 4). Most other sectors, including the heavily weighted financial sector, posted near 30% returns for the year, although utilities was another underperforming sector. Australian small caps were also weighed by the mining sector and continued to perform poorly, returning -0.8% in 2013. Non-mining sectors posted

Figure 4. MSCI Australia: Sector Performance Attribution

31 December 2012 – 31 December 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Percentages may not total due to rounding.

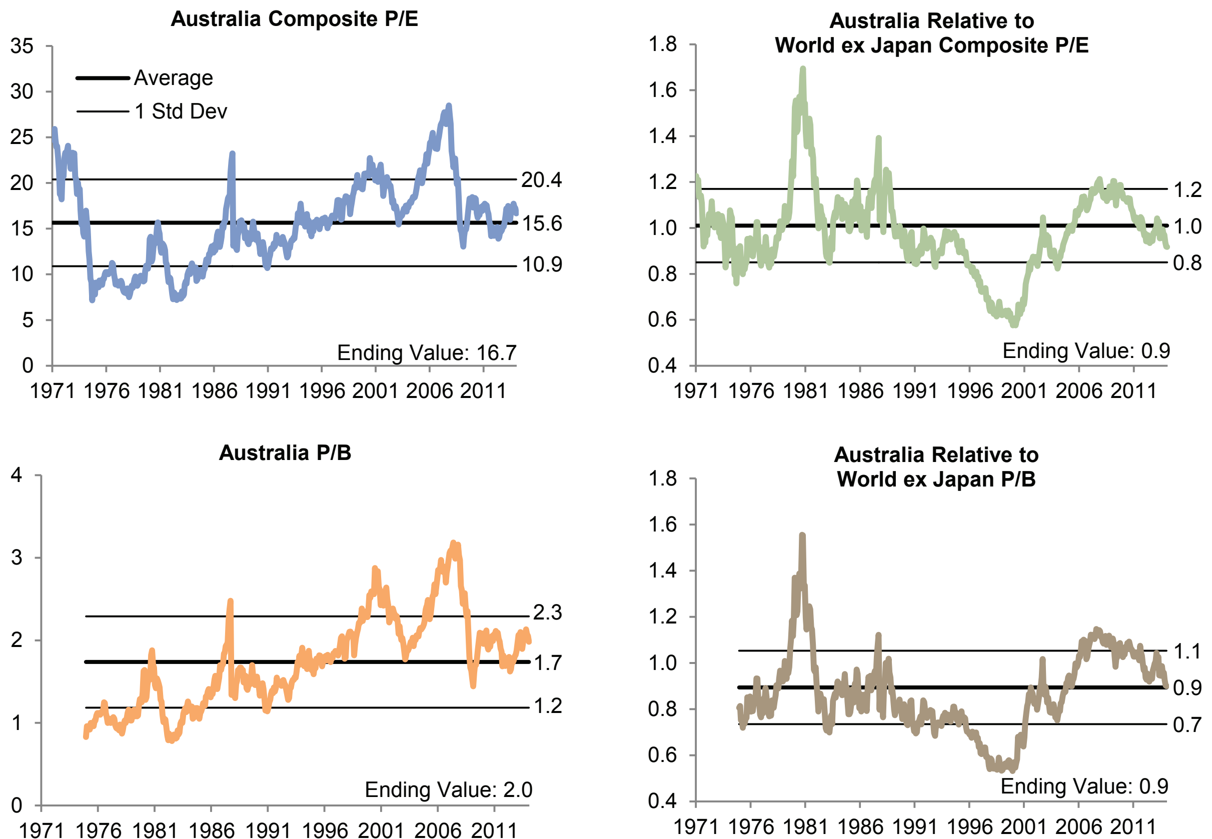
decent returns but still underperformed their large-cap counterparts. In comparison, global small caps had a tremendous 2013, returning 35.3% for the year.

After two years of strong performance, Australian equity valuations are above historical averages, but remain within our fair value range. At the end of January 2014, Australian equities traded at a normalized price-earnings (P/E) ratio of 16.7, 6.6% or 0.2 standard deviation above their post-1970 average of 15.6. However, Australian equities look more expensive on a price-to-book (P/B) basis at 14% or 0.4 standard deviation above average. On a forward P/E basis, Australia is trading slightly below its average. Overall, we view Australia as fairly valued. While valuations are not extreme on any measure, they are only modestly below the levels reached in 2010–11 that preceded the most recent sell-off (Figure 5).

Earnings will be of key importance in 2014. Last year's performance was driven by multiple expansion rather than actual earnings, which were only up 1% over 2013. For 2014, the consensus estimates earnings will grow by 10%, driven by a rebound in the resources sector (18%) and moderate growth in the financial (10%) and remaining sectors (3%).

Current expectations seem reasonable to us. An earnings rebound in the resources

Figure 5. MSCI Australia Valuations (Relative to MSCI World ex Japan)
31 January 1971 – 31 January 2014 • Local Currency



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

sector does not seem farfetched following last year's double-digit decline amid falling commodity prices. With large write-downs taken and various cost-cutting initiatives announced, any stabilization in commodity prices or volumes could boost bottom lines. However, we are not overly optimistic on the prospects for the mining/resources sectors as the risk for the earnings outlook is skewed to the downside given bearish views on the Chinese economy and commodity prices.

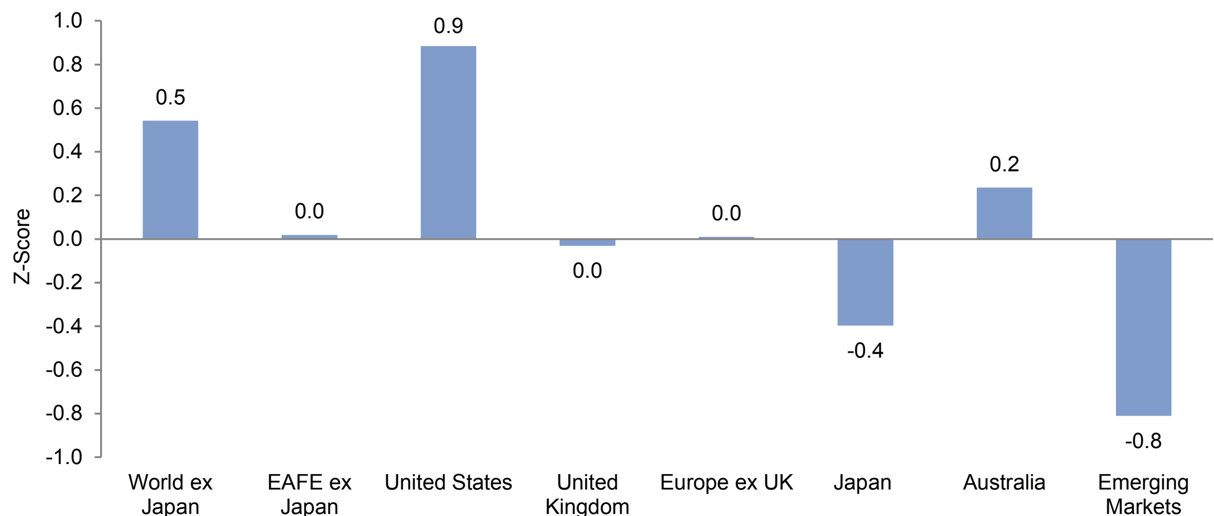
The outlook for the financial sector is arguably of more importance than the resources sector. Earnings for banks have exceeded their pre-crisis levels, unlike for the broader market, as low rates and a strong housing market have boosted bank profits. While the housing market in Australia looks toppy, with rates set to remain low, we don't foresee a housing crash in 2014. Of more concern is the slowing momentum in the non-mining recovery and labor markets, which seems to point to only modest earnings growth.

The story is much the same outside of Australia. The rally last year in most developed markets was driven by valuations expansion, not earnings. On a relative valuation basis, Australia is now trading in line with global equities on both our normalised P/E and P/B metrics, although this is mostly due to overvaluation in the United States. Australia is relatively expensive versus European, Japanese, and emerging markets equities (Figure 6). As for dividend yields, Australian equities continue to be attractive with a yield of 4.4% versus 2.5% for global equities, further enhanced by franking credits.

Overall, we are neutral on Australian equities. While earnings expectations appear reasonable, uncertainty over the global and domestic economic recovery could easily see earnings downgrades and valuation compression. This year may be one of flat markets, with dividends providing most of the return.

Figure 6. Equity Valuations

As of 31 January 2014



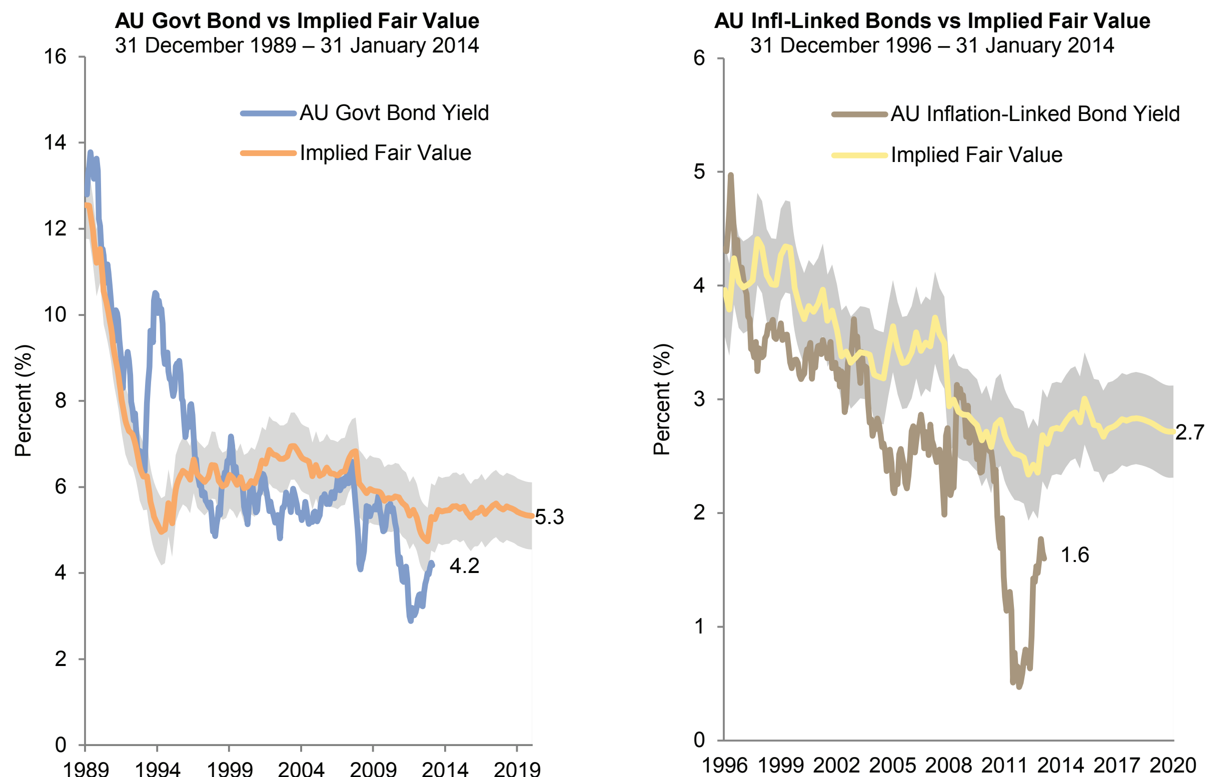
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalised price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalised earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity (ROE)–adjusted earnings. We have removed the bubble years 1998–2000 from our mean and standard deviation calculations. All data are monthly. Japan is calculated based on the ROE-adjusted P/E. Z-score represents the number of standard deviations above or below the historical average valuation.

Australian Fixed Income

In 2013, the prospect of Fed "tapering" heavily impacted Australian fixed income and its global counterparts. Ten-year Australian government bond yields rose 102 bps to 4.2%, while inflation-linked real yields rose 94 bps to 1.7%, despite the RBA cutting the cash rate by 50 bps to record lows of 2.5%. Australian treasuries returned 0.3%; inflation-linked bonds, -1.6%; and bank bills, 2.9% (based on UBS indices). Australian credit performed well, returning 4.3%, as spreads tightened.

Given the rise in yields, both nominal and inflation-linked Australian government bonds are moving toward our fair value range. While yields appear low compared to the past decade or so, we feel fair value for bonds has also shifted lower as the Australian economy transitions to a lower growth rate. In determining an appropriate fair value range, we analyzed current and forecasted growth and inflation trends in Australia. Our fair value estimate is around 5% for long-term Australian government bonds and around 2.5% for inflation-linked bonds. At current ten-year yields, both nominal and inflation-linked Australian government yields are still outside our fair value range but close to crossing over, especially nominal bonds (Figure 7).

Figure 7. Australian Government and Inflation-Linked Bonds Versus Implied Fair Value



Sources: Barclays, Oxford Economics, Reserve Bank of Australia, and Thomson Reuters Datastream.
Notes: Implied fair value for nominal bonds is calculated by adding rolling five-year real GDP and rolling five-year inflation. Implied fair value for inflation-linked bonds is the rolling five-year real GDP. Australian government bond yields are represented by yields on ten-year Australian Commonwealth Government Bonds while Australian inflation-linked bond yields are represented by yields on the Barclays Australian Inflation-Linked Bond Index.

High foreign ownership of Australian government bonds continues to worry us. In investors' search for yield, Australian government bonds have been popular given their relatively high yields and AAA rating. As of last September, foreigners owned roughly 68% of these bonds, down from around 75% in early 2012. We view it as a positive that foreign investors did not drastically reduce holdings during last year's turbulence (despite both rising yields and a falling Australian dollar). While the risk of foreign selling remains should fears of a crisis in Australia or hard landing in China worsen, domestic institutions could step in and provide some support, as they did in 2008–09.

Given the recent back up in yields and steepening of the domestic yield curve, we are less inclined to advise holding cash instead of bonds in defensive fixed income portfolios. In general we don't find bond yields so attractive as to overweight fixed income, though being drastically underweight sovereign bonds is less compelling, especially since we don't believe the RBA will need to hike. While the yield curve may flatten if the RBA begins to hike rates, we are not quite convinced domestic economic conditions justify rate hikes in the near term. At the same time, yields certainly have scope to fall amid a global deflation scare (perhaps triggered by China).

The Australian Dollar

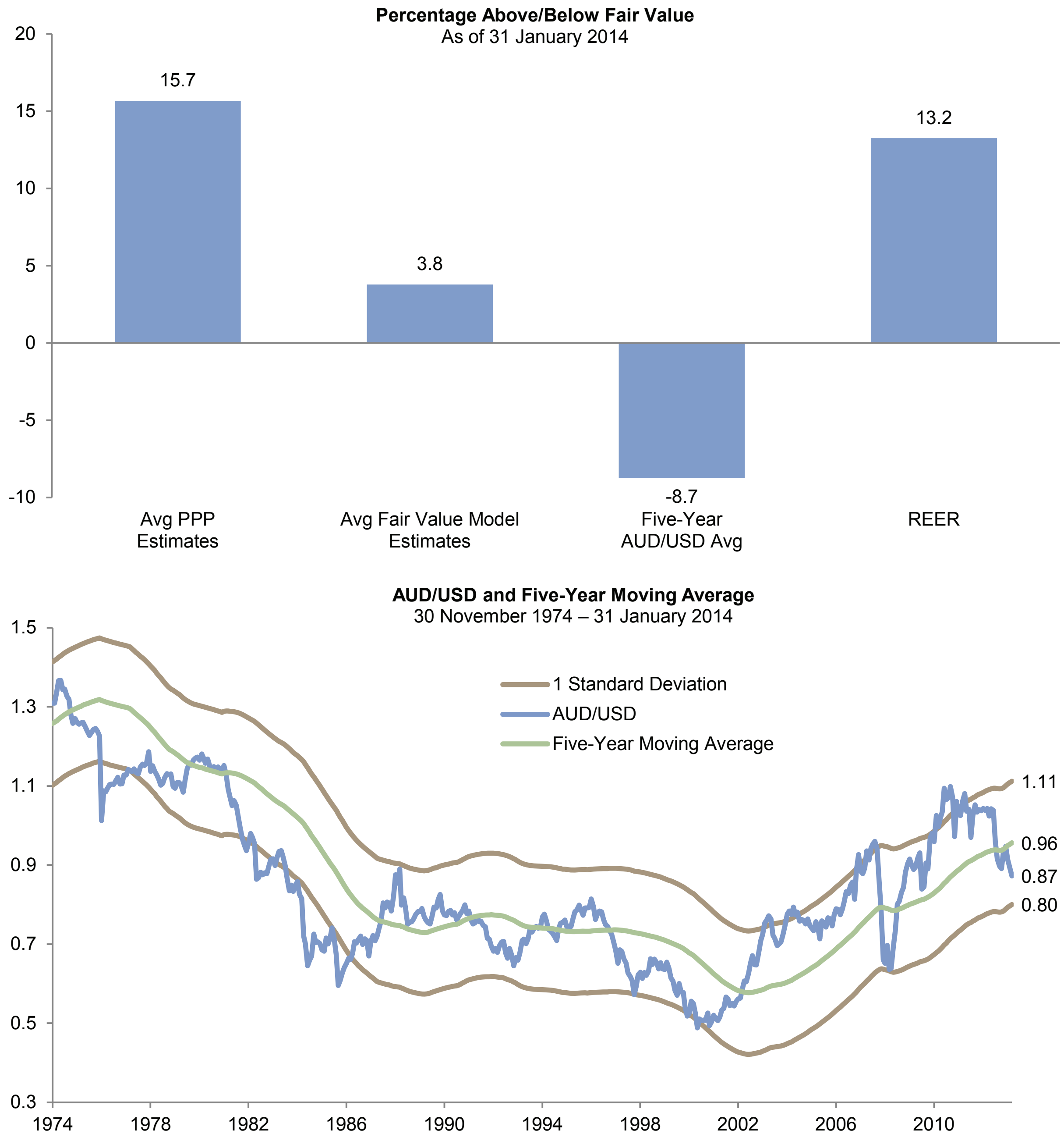
The Australian dollar was down 13.8% against the US dollar and 10.6% on a trade-weighted basis last year, making it one of the worst-performing currencies in 2013. This downtrend has continued in 2014 with the currency falling 2.5% in January 2014 versus the US dollar.

Despite the tumble, at the end of January the AUD/USD was 0.87, only 8.7% below its five-year average of 0.96 (Figure 8). Currency valuation metrics indicate that the currency is overvalued by roughly 16% on a purchasing power parity basis and 13% on a real effective exchange rate basis, but only 4% according to investment bank econometric fair value model estimates. Going forward, the consensus expects the Australian dollar to modestly weaken by 2.6% versus the US dollar in 2014 to 0.85. This view is supported (or perhaps influenced) by RBA Governor Glenn Stevens, who stated in December that the AUD/USD rate should be closer to 0.85.

We do not have our own target for the Australian dollar, but over the long term we remain bearish given above average valuations and structural changes in the Australian economy. We acknowledge that there is a possibility the currency will rebound following last year's sharp drop. However, we see down as the path of least resistance for the Australian dollar, especially amid renewed stress in China or if the domestic economy weakens more, forcing the RBA to further cut rates.

In terms of hedging, we feel last year's advice remain relevant today—hedge defensive investments, such as fixed income and diversifiers (hedge funds), to prevent currency movements from dominating the asset class returns and leave global equities unhedged.

Figure 8. Australian Dollar Valuations



Sources: Bank for International Settlements, *The Economist*, Goldman, Sachs & Co., International Monetary Fund (IMF), 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 December 2013 and expressed as percent change over long-term average. Purchasing power parity (PPP)–implied exchange rates are based on relative price levels between countries, with the assumption that a basket of identical goods should cost the same across countries. Average PPP estimates reflect a simple average using IMF and *The Economist* data, which are based on consumer prices. Fair value model estimates are derived from econometric models that take into account several variables such as PPP, interest rate differentials, fund flows, etc., to produce an equilibrium exchange rate. These fair value estimates differ from currency forecasts, as it is not always assumed that currencies revert to fair value over the forecast horizon. Average fair value model estimates reflect a simple average using Goldman Sachs and J.P. Morgan data.

Summary

Compared to last year, we are more cautious on Australia as the macro picture has become more concerning. China's expected slowdown will materially impact Australia's mining industry and at the same time the non-mining economy remains sluggish. There is also uncertainty as to the direction of domestic monetary policy. For now, the RBA's stance is to keep rates on hold unless there is further weakness in the economy.

The murky economic environment will put pressure on investor sentiment for Australian equities. However, we remain neutral on the asset class as valuations are still fairly valued while high dividend yields will provide some support.

Regarding offshore equity exposure, modest overweights seem in order. We would tilt such exposures in favor of non-US and emerging markets equities at the expense of the United States, given wider valuation spreads versus Australian equities.

However, we view emerging markets equities as a long-term value play, not a bet we expect to pay off in 2014. Emerging markets equities will likely remain under pressure, an outcome for which investors need to be prepared.[2] Investors unable to tolerate the volatility of such a tilt should consider reducing emerging markets overweights. In implementing emerging markets equity allocations today, Australian investors need to be aware that much of the index level undervaluation is in the energy and materials sectors. Given domestic market (and economic) exposure to the materials sector, Australian investors may want to allocate to managers or themes in emerging markets not overexposed to such stocks.

As for fixed income, given the rise in yields and our expectations of slower growth, we are less negative on government bonds, and no longer suggest large underweights in favor of cash. This is not to imply investors should overweight bonds, for yields are not overly attractive on an outright basis. However, keeping some exposure to defensive fixed income is warranted given macro risks and a steepening yield curve.

Finally, given headwinds facing the Australian dollar, we generally advocate AUD-based investors leave foreign equity holdings unhedged. ■

[2] Please see our February 2014 Market Commentary *Emerging Markets: Navigating Through Rough Waters.*