Australia Outlook 2016: Déjà Vu All Over Again . . .

Investors should be prepared for 2016 to look similar to 2015, with high volatility and poor returns for risk assets

- Risks to the global economy are rising. We continue to be skeptical that the Australian non-mining economy can offset weakness in the mining economy, especially with a housing market that seems to be peaking. We remain structurally bearish on the Australian dollar.
- Australian equities are fairly valued but not attractive given macro headwinds and slightly negative forecasts for earnings. Neutral positioning is appropriate; active managers should be able to add value given the top-heavy nature of the market. Outside of Australia, we retain our preference for emerging markets, Eurozone, and Japanese equities versus expensive US equivalents.
- Continuing to hold some Australian government bonds makes sense, despite concerns about overvaluation, as domestic macro risks remain and Australian bond yields are more attractive than most other developed markets.

Markets were volatile in 2015, dominated by themes of a strong US dollar, weak commodity prices, nervousness over China, and anxiety over when the US Federal Reserve would raise rates. This year seems to be more of the same: the market action in the first few weeks of January is eerily similar to that of last August when weakness in Chinese equities and the renminbi shook global markets, and the price of oil continues to plummet. Indeed, in re-reading our outlook from last year[1] we are struck with a sense of déjà vu, as many of our macro concerns and market views remain the same.

At the risk of repeating ourselves, we continue to see headwinds for the Australian economy, as the recovery in the non-mining economy will not be strong enough to offset weakness in the mining sector amid a less benign external environment. Thus, we expect bond and cash yields to move lower in Australia and the Australian dollar to remain weak in light of heightened

C|A research publications aim to present you with insights from a variety of different viewpoints. The views of our Chief Investment Strategist can be found each quarter in VantagePoint.

[1] See Jason Widjaja and Aaron Costello, "Australia Outlook 2015: Still Cautious," Cambridge Associates Research Note, February 2015.

volatility in global markets. Australian equities will also stay under pressure and will likely continue to underperform non-Australian equities. Yet, given that our base case is not for a full-fledged crisis in China or a recession in the United States, we do not think investors should drastically de-risk portfolios. Instead, investors should remain levelheaded, as 2016 may play out largely the same as 2015, or even 2011, with macro concerns ultimately blowing over, but with risk assets producing lackluster returns as global growth and corporate profits remain weak.

For now, markets are still in flux, and depending on how sharp drawdowns are in the interim, 2016 may represent an attractive buying opportunity for Australian equities, and perhaps distressed assets in the global energy and commodity space. Until more attractive opportunities present themselves, investors should hold steady and be prepared for a ride that is similar to last year, albeit already noticeably more volatile.

Macro: Risks Are Rising

The current bout of risk aversion has hit just when many economists had become relatively bullish on the Australian economy. While the economy slowed modestly over the course of 2015, the fourth quarter saw a rash of indicators surprise to the upside. The net result is that consensus forecasts in early January expected GDP growth to accelerate from 2.3% to 2.6% in 2016, with inflation also expected to rise modestly from 1.5% to 2.2%. The consensus also expected the Reserve Bank of Australia (RBA) to remain on hold and bond yields to tick up a bit to 3.1% (Figure 1). January's market events mean all of these forecasts are being revised. But even before markets took a dive in January, we were skeptical of the view that growth and inflation would accelerate, given our concerns over the headwinds Australia's economy faces.

Figure 1. Australian Economic Indicators
As of 21 January 2016

	2014	2015	2016 (F)
Real GDP Growth (YoY %)*	2.6	2.3	2.6
Inflation (YoY %)*	2.5	1.5	2.2
RBA Cash Rate (%)	2.5	2.0	1.9
10-Year Australian Govt Bond Yield (%)	2.7	2.9	3.1
AUD/USD	0.82	0.73	0.69

* Figures for 2015 are forecasts.

Much of the resilience in the Australian economy over the past few years has been due to the ongoing housing boom, which has helped offset the drag from falling mining investment. A weak Australian dollar has also contributed, with non-commodity exports and services (such as tourism and education) doing well. Yet the construction industry and residential real estate market have reached a critical turning point. Multi-year highs in new dwelling approvals point to a housing supply that is starting to outweigh demand (Figure 2). House prices seem to be peaking at the same time that new loans to property investors have been curbed to only 35% of total new loans, a two-year low. It is unclear who will take up the new housing supply, as trends in migration are also slowing.

Meanwhile, household debt levels climbed from 180% in 2014 to 185% in 2015. Although this has occurred amid a fall in household interest payments due to record-low interest rates in Australia, households likely cannot continue to lever up at their current pace (Figure 3). The labor market seems to be improving, but real

Figure 2. New Dwelling Approvals
31 December 1983 – 30 November 2015 • in thousand units

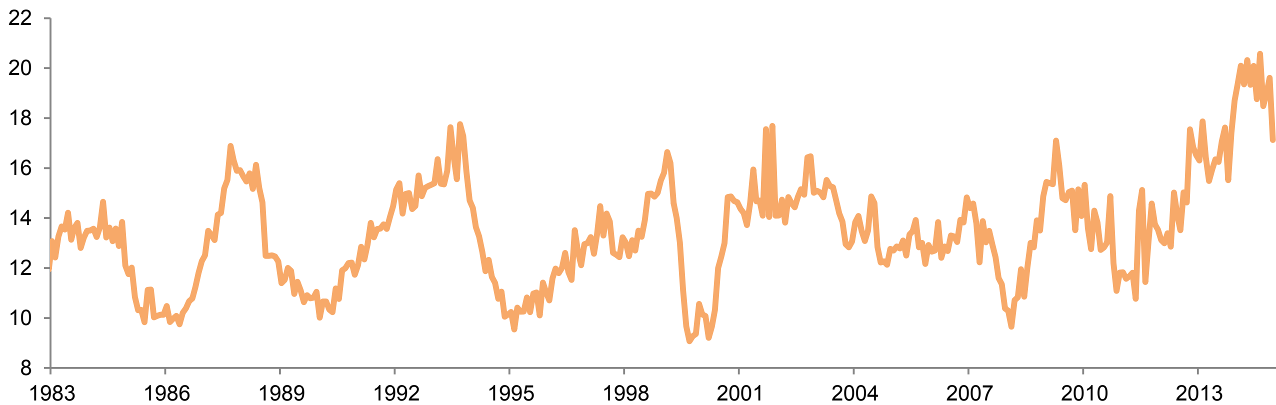
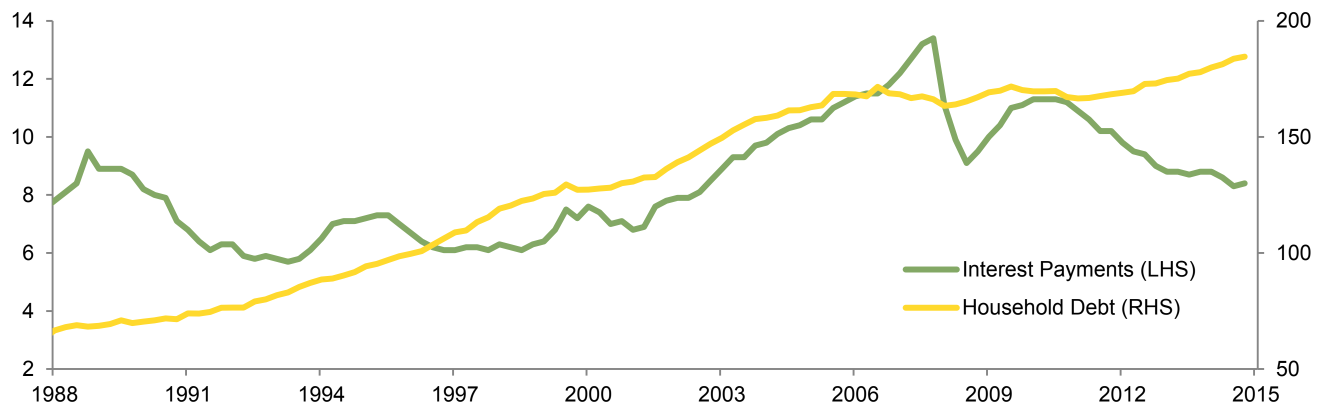


Figure 3. Interest Payments and Debt as a Percent of Household Disposable Income
Fourth Quarter 1988 – Third Quarter 2015 • Percent (%)



wage growth continues to be relatively weak at 1%. Further, the full impact from the fall in mining-related investment has yet to be felt, while non-mining, non-housing investment is flat. As such, we remain highly skeptical that the non-mining economy can continue to offset the weakness in the commodity sector, especially with the housing market rolling over.

This doesn't mean a recession is imminent, although risks are rising. Rather, this analysis shapes our view that the RBA will remain dovish, and additional rate cuts are possible to boost to the economy if needed. However, pulling that trigger might get more difficult as the RBA is wary of reigniting house price appreciation and increasing household debt levels.

Unfortunately, the global picture is also not supportive. In our view, China is already experiencing a hard landing on the industrial side of the economy, which only grew 0.9% in nominal terms in 2015, down from 20% as recently as 2011. Although the service sector is growing at a relatively robust 10%, this part of the economy will also weaken in 2016, due in part to weak corporate profits, which will feed into lower wages and ultimately lower

consumption. Thus, we continue to expect weaker economic data out of China, as well as a weaker renminbi, which may rattle markets. While we expect growth in China to continue to slow, we are not yet convinced that a financial crisis is set to occur, given the semi-closed nature of the banking system and ample room for the People's Bank of China (PBOC) to lower rates and inject liquidity. However, stemming the flow of capital flight out of China is key for the PBOC, which means increased capital controls are needed. Failure to stem the tide of outflows raises the risk of crisis in China and needs to be watched carefully. Interestingly, Australia has been a major beneficiary of Chinese capital flight, particularly the Sydney and Melbourne property markets.

Regarding the United States and other major developed economies, underlying economic data allow for cautious optimism. While the manufacturing sector everywhere is taking a hit from weak global trade and falling commodity production, the service sector has held up well and banks appear to be lending again for the first time in many years. The bull case centers around consumers spending the windfall from lower energy prices instead of saving it. This is particularly true in the United States, as wages are expected to rise amid a tightening labor market, but also applies to Europe, Japan, and even Australia.

That said, household spending and savings decisions are typically driven by consumer confidence. The risk facing the developed world is that the rise in financial market uncertainty may cause both businesses and consumers to continue to pull back. A variable worth watching is whether defaults among energy- and commodity-related borrowers cause credit markets to tighten up, further slowing growth.

In some respects, the current turbulence affecting global markets is similar to what struck in 2011, when markets became too complacent about signs of stalling growth momentum and were shocked back into reality by headlines about macro risks from a Eurozone break-up and US debt downgrade. After a sharp decline of nearly 20%, markets were able to recover, with the help of easy monetary policy from global central banks. Today, substitute China for the Eurozone, and energy companies for the US debt downgrade.

This time around, central banks will be more hesitant to pull the monetary trigger, as they are running low on bullets. But at a minimum, concerns about potential monetary tightening in 2016 are likely off the table. If China can avoid a financial crisis, and trouble in energy doesn't spill over to broader credit markets, the major developed markets economies should be able to avoid a recession, and global markets should post a recovery in 2016. Much hinges on how quickly investor and consumer confidence is restored.

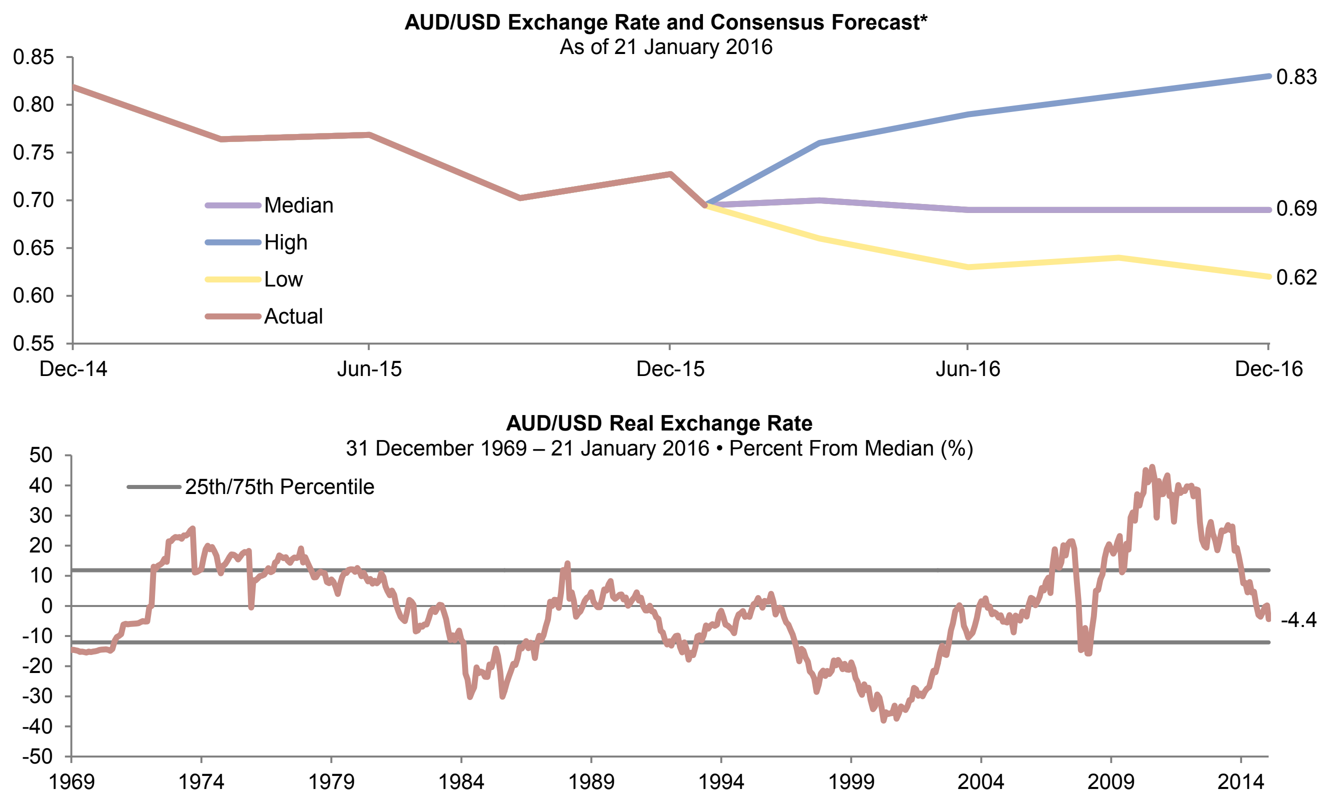
Australian Dollar: More Weakness Ahead

Given this backdrop, we expect continued volatility and weakness in the Australian dollar. The currency tumbled alongside markets in early January, reaching AUD/USD 0.68 at one point. Bloomberg consensus estimates are for the currency to end 2016 at roughly the same level, albeit with a potential range between 0.83 and 0.62 (Figure 4).

While we do not make explicit currency forecasts, we continue to see more downside for the Australian dollar. First, from a long-term valuation standpoint, the currency is not particularly cheap in real terms, unlike in 2008 or 2001. Second, we expect continued weakness in the renminbi and lingering China concerns to weigh on the Australian dollar. At the same time, the RBA views weakness in the Australian dollar as a key shock absorber for the economy, helping the transition away from mining-reliant growth. Thus, weakness in the dollar will not prevent the RBA from cutting rates if needed; nor will the RBA be inclined to hike rates to give the dollar a boost.

In the near term, a large rally in the currency cannot be ruled out should global risk appetite turn positive, which would result in a flat currency this year. However, we remain structurally negative on the Australian dollar, as the adjustment from previous overvaluation is not yet complete.

Figure 4. Australian Dollar Valuations



* Forecasts are as of 12 January 2016.

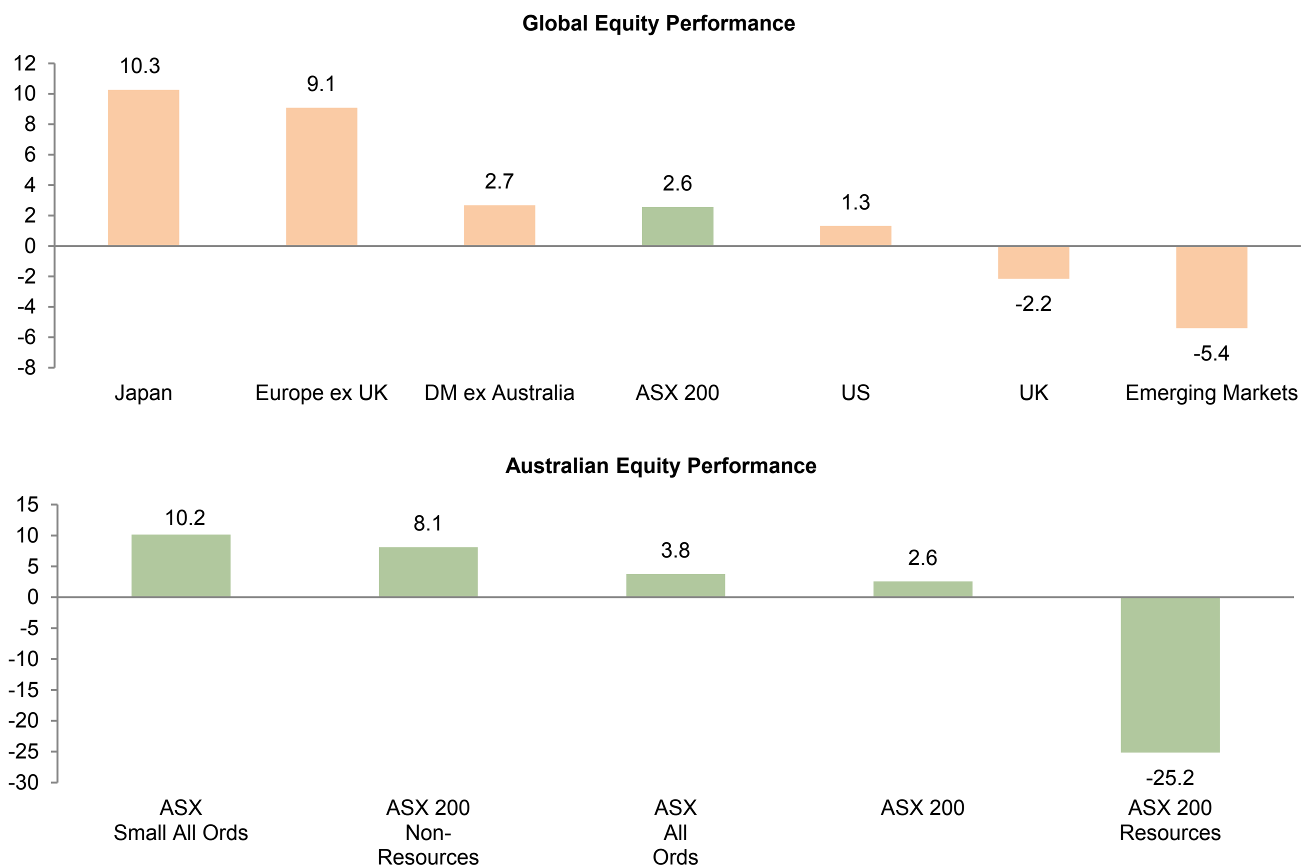
Australian Equities: Cheaper Prices, but Not Yet Value

Australian equities had a lackluster 2015, with the ASX 200 down 2.1% in price terms, but returning 2.6% thanks to a 4.7% dividend yield. This return was in line with broader developed markets equities. Australian equities actually outperformed US equities and fared much better than UK equities (another resources- and bank-heavy market) and China-centric emerging markets (Figure 5). But index-level returns continue to hide a bifurcated market, with the non-resources segment of the market returning 8.1% and small caps, 10.2%. Thus, 2015 was a good year for active managers that continued to shun resource-related stocks and banks, which also had a lackluster year.

Even before January's market rout, it was hard to be too excited about equities; consensus forecasts expect ASX 200 earnings to be slightly negative in 2016 (-1.4%), driven by further falls in resource earnings and muted growth in other sectors.

One area investors should be critically examining is dividends, as Australian companies have maintained dividend policies despite pressure on earnings. This has resulted in high payout ratios that may not be sustainable if

Figure 5. Australian Equity Performance: Calendar Year 2015
Local Currency Terms • Total Return (%)

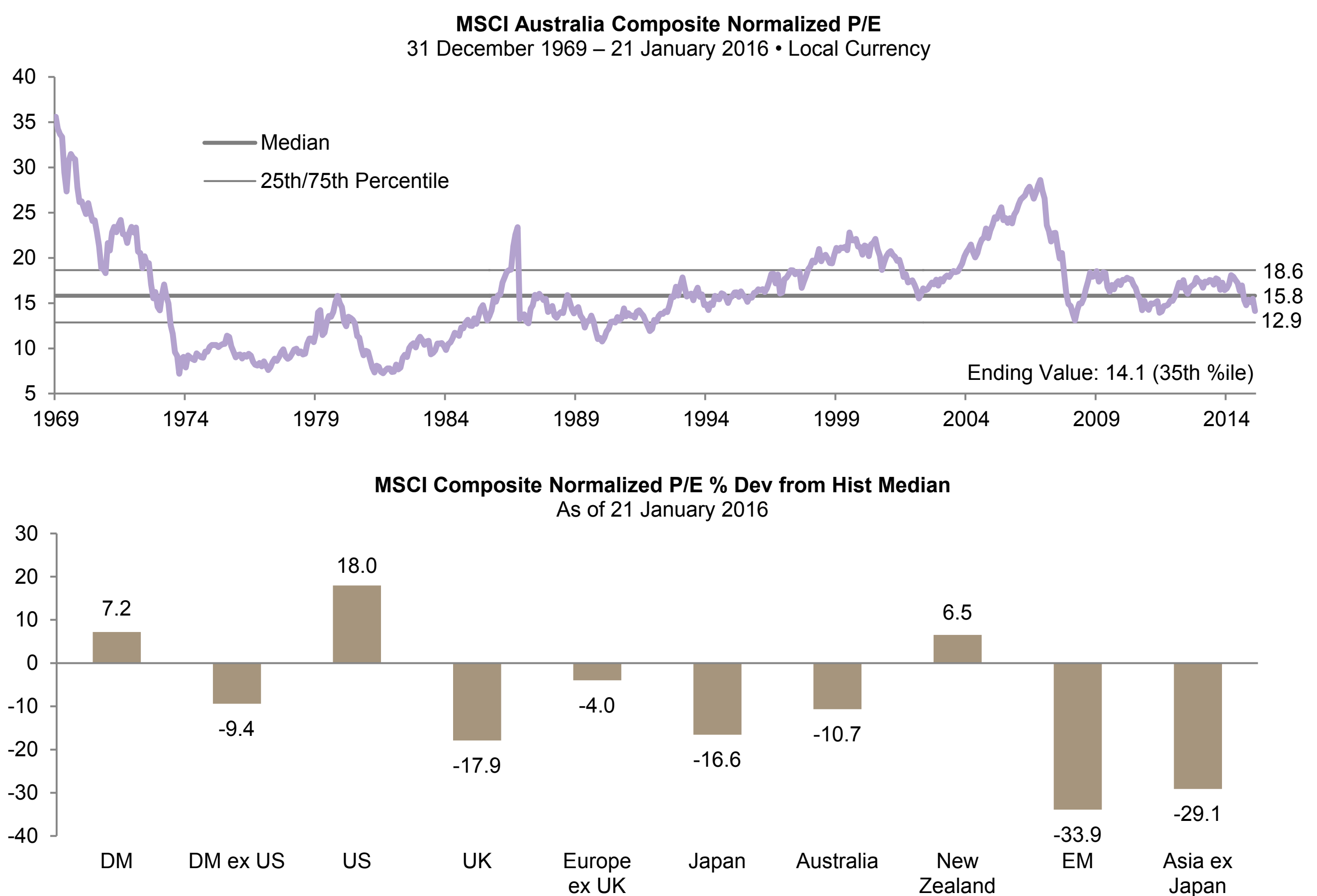


the economy weakens more than expected, especially for high-yield plays such as certain REITs and infrastructure stocks. These segments of the market have done very well in recent years; these stocks have appeared expensive, while leverage has been rising to maintain attractive yields in some cases.

In terms of the overall market, at the end of 2015 Australian equities were fairly valued, trading on par with their historical median composite normalized P/E[2] (Figure 6). However, this largely reflects the cheapness of resource stocks and fair value for the major banks; industrials and the rest look slightly expensive. All sectors have sold off at the start of 2016, with Australia 11% below fair value on our metric. Yet knowing what has been priced in and when fundamentals will improve is difficult. For instance, commodity-related sectors (17% of the MSCI Australia Index) continue to face overcapacity issues and fading demand from China, while heavyweight banks (37% of the index) are exposed to tighter capital regulations and a property market that seems to have peaked. Thus, Australian equities are not particularly cheap at the moment, especially compared to non-US equities (Figure 6).

[2] 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.

Figure 6. Australian Equity Valuations



Last year, we recommended Australian investors remain neutral on Australian equities, while tilting global allocations away from US equities and toward Eurozone and Japan on a hedged basis. We further advised considering modest overweights to emerging markets equities, with a preference for Asia ex Japan. These tilts largely paid off, especially underweighting US equities in favor of Eurozone and Japan. Although emerging markets exposure was a drag, Asian equities did outperform broader emerging markets, especially once adjusted for currency movements.[3]

For 2016, we retain these views. We are neutral on Australian equities, as a compelling valuation case for or against does not yet exist, especially as valuations excluding resources are not yet cheap. Within Australia we continue to prefer active managers given the top-heavy and bifurcated nature of the market, although we would be wary of chasing yield plays. Outside of Australia, modestly underweighting US equities in favor of non-US equities is attractive on valuation grounds, as are emerging markets equities, although such an exposure may not pay off in the near term.[4]

[3] In AUD terms, emerging markets equities returned -3.9%, compared to 2.5% for the Asia ex Japan index.
[4] Please see Sean McLaughlin and Wade O'Brien, "Outlook 2016: Do You Know Where Your Risk Tolerance Is?," Cambridge Associates Research Report, December 2015.

Australian Government Bonds: Still One of the Best Yields on Offer

Australian government bonds' yield premium over their global counterparts (Figure 7) resulted in the asset class (2.3%) outperforming global government bonds (1.3%) in 2015 in local currency terms, and rising risk aversion has benefitted the asset class into 2016. The Australian ten-year government bond yield ended 2015 modestly higher than 2014, at nearly 3.0%. In early 2016, bond yields went to 2.70% at one point.

While Australian government bonds look overvalued at current levels, we think investors should maintain allocations. First, given macro risks, yields certainly have scope to move lower. We doubt the RBA will raise rates this year, and the Fed may be on hold as well. Even amid rising US rates, Australian yields could move lower should economic conditions warrant; in the late 1990s/early 2000s, Australian government bonds effectively had no spread over US Treasuries (Figure 8).

While Australian bond yields could sell off sharply if negative macro sentiment appears overdone, such an outcome should see equities rally and thus overall portfolio returns turn positive. In short, we are not concerned about bonds, and we would keep some mixture of cash and long-duration government bonds in the portfolio given our views on the macro environment and attractive yields relative to global bonds.

Figure 7. Global Ten-Year Government Bond Yields
31 December 2013 – 21 January 2016

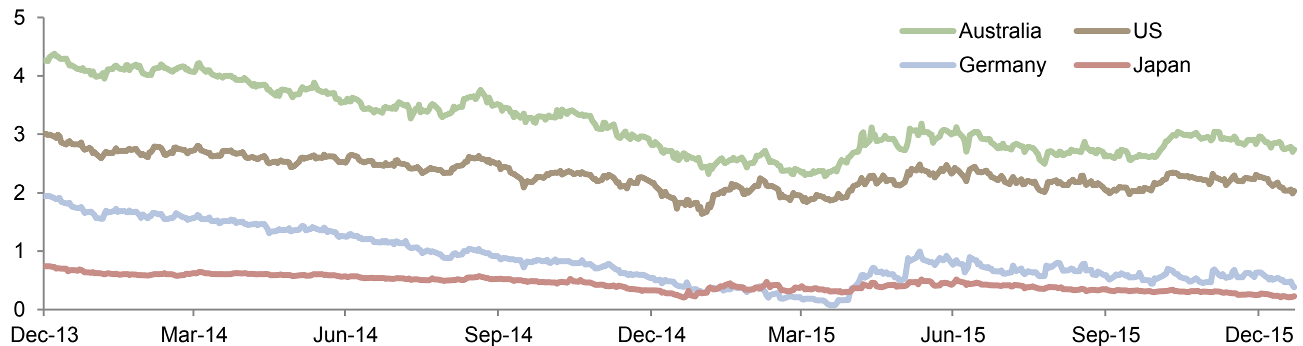
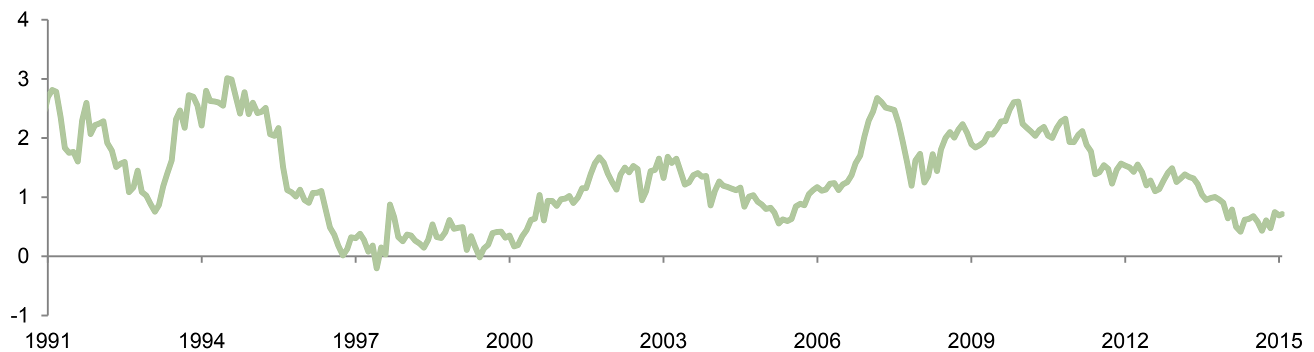


Figure 8: Australian Ten-Year Government Bond Yield Spread Over US Treasuries
31 December 1991 – 21 January 2016



Conclusion

Rising macro risks make it hard to have conviction in the outlook for 2016. We suggest investors remain calm and be prepared to ride out another volatile year, much like 2015 or 2011. The reality is that investors never know in real time whether a recession is at hand, nor can they necessarily profit from knowing so. Australia has not had a technical recession in 24 years, yet has experienced three major equity bear markets over that period.

The good news amid the January turmoil is that markets are increasingly priced for bad outcomes. The price of oil has fallen below US$30, while yields on US energy-related high-yield bonds have reached 19%, effectively pricing in potential defaults to come. Global equities have fallen nearly 20% from their 2015 highs, the cusp of a bear market. While there may be further downside in asset prices in the near term, the quicker asset markets price in negative outcomes, the faster markets can recover should the worst-case scenario not unfold.

Last year, we were cautious on the outlook for Australian asset classes and the Australian economy. This year, our views remain much the same.

Economic data improved somewhat toward the end of 2015, and the RBA does have room to further ease monetary policy. However, headwinds from low commodity

prices, indebted households, and a property market that seems to be losing its steam have not subsided and will continue to weigh on Australian economic growth and inflation. The RBA has communicated its preference to use a weak Australian dollar to assist in the economy's transition from the mining boom, while headwinds from China and lingering overvaluation keep us structurally bearish on the currency.

We are neutral on Australian equities on an absolute and relative basis. While valuations have become more attractive versus the past 12 months, we would caution that it is unclear how much of the macro headwinds have been priced in. Australian earnings growth and dividends may come under pressure if the economy weakens further. We still prefer active management. With respect to equity allocations outside of Australia, we uphold our advice to overweight Eurozone and Japanese equities and hold a small overweight to Asia ex Japan equities.

Continuing to hold some Australian government bonds makes sense, despite concerns about overvaluation, as macro risks remain and Australian bond yields are more attractive than most other developed markets. ■

Index Disclosures

Cambridge Associates does not provide stock selection recommendations, and any reference to specific companies is not to be interpreted as a recommendation of that company as an investment option.

Bloomberg 10-Year Australian Govt Bond Yield Index
The rates are composed of Generic Australian Commonwealth Government Bonds.

MSCI AC Asia ex Japan Index
The MSCI AC (All Country) Asia ex Japan Index is a free float–adjusted, market capitalization–weighted index that is designed to measure the equity market performance of Asia, excluding Japan. The MSCI AC Asia ex Japan Index consists of the following ten developed and emerging market country indexes: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

MSCI Australia Index
The MSCI Australia Index is a free float–adjusted, market capitalization–weighted index that is designed to measure the equity market performance of Australia.

MSCI EASEA Index (also known as MSCI EAFE ex Japan)
The MSCI EASEA Index (also known as the MSCI EAFE ex Japan Index) is an equity index that captures large- and mid-cap representation across developed markets countries across the world, excluding Canada, Japan, and the United States. Developed markets countries include: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

MSCI EM Index
The MSCI EM Index represents a free float–adjusted, market-capitalization index that is designed to measure equity market performance of emerging markets. As of January 2016, the index includes 23 emerging markets country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

MSCI Europe ex UK Index
The MSCI Europe ex UK Index captures large- and mid-cap representation across 14 developed markets countries in Europe. With 330 constituents, the index covers approximately 85% of the free float–adjusted market capitalization across European developed markets excluding the United Kingdom.

MSCI Japan Index
The MSCI Japan Index is a free float–adjusted, market capitalization–weighted index that is designed to measure the equity market performance of Japan.

MSCI New Zealand IMI Index
The MSCI New Zealand Investable Market Index (IMI) is designed to measure the performance of the large-, mid-, and small-cap segments of the New Zealand market. With 29 constituents, the index covers approximately 99% of the free float–adjusted market capitalization in New Zealand.

MSCI UK Index
The MSCI UK Index is designed to measure the performance of the large- and mid-cap segments of the UK market.

MSCI US Index
The MSCI US Index is designed to measure the performance of the large- and mid-cap segments of the US market. With 617 constituents, the index covers approximately 85% of the free float–adjusted market capitalization in the United States.

MSCI World ex Australia Index
The MSCI World ex Australia Index captures large- and mid-cap representation across 22 of 23 developed markets countries: Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

MSCI World ex Japan Index (also known as the MSCI Kokusai Index)
The MSCI World ex Japan Index captures large- and mid-cap representation across 22 of 23 developed markets countries (excluding Japan). The developed markets countries in the index include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

S&P/ASX 200 Index
The S&P/ASX 200 is recognized as the institutional investable benchmark in Australia. The index covers approximately 80% of Australian equity market capitalization. Index constituents are drawn from eligible companies listed on the Australian Securities Exchange. The S&P/ASX 200 is a highly liquid and investible index, designed to address investment managers' needs to benchmark against a portfolio characterized by sufficient size and liquidity.

S&P/ASX 200 Non-Resources Index
The S&P/ASX 200 Non-Resources Index provides investors with an exposure to the Australian equity market excluding companies classified in the Energy sector (GICS® Tier 1), as well as companies classified in the Metals and Mining Industry (GICS® Tier 3).

S&P/ASX 200 Resources Index
A sector sub-index of the S&P/ASX 200 Index, this index provides investors with a sector exposure to the resources sector of the Australian equity market as classified as members of the GICS® resources sector. Resources are defined as companies classified in the energy sector (GICS® Tier 1), as well as companies classified in the metals & mining industry (GICS® Tier 3).

S&P/ASX All Ords Index
The S&P/ASX All Ords represents the 500 largest companies in the Australian equities market. Index constituents are drawn from eligible companies liste d on the Australian Securities Exchange. Liquidity is not considered as criteria for inclusion, except for foreign domiciled companies.

S&P/ASX Small All Ords Index
The S&P/ASX Small Ordinaries Index represents the small cap members of the S&P/ASX 300 Index, but excludes those in S&P/ASX 100 Index. The S&P/ASX Small Ordinaries index is used as an institutional benchmark for small cap Australian equity portfolios. The index covers approximately 7% of Australian equity market capitalization.

Jason Widjaja, Associate Investment Director
Aaron Costello, Managing Director

Exhibit Notes

1. **Australian Economic Indicators**
   Source: Bloomberg L.P.
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   Source: Thomson Reuters Datastream.
3. **Interest Payments and Debt as a Percent of Household Disposable Income**
   Source: Thomson Reuters Datastream.
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   Note: Total returns are gross of dividend taxes.
6. **Australian Equity Valuations**
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7. **Global Ten-Year Government Bond Yields**
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8. **Australian Ten-Year Government Bond Yield Spread Over US Treasuries**
   Source: Thomson Reuters Datastream.

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