HAMILTON
wealth management

Investor Insight 24 – July 2015

The second quarter of 2015 has seen markets give back some of the gains of the first quarters strong equity market performance. To put this into perspective we saw a year's return in one quarter, and markets never go up in a straight line.

The second quarter though was dominated by the global sell off in bonds and what does this mean for risk based assets going forward? We discuss bond markets and what keeps us awake at the end of this *Insight* in a more comprehensive discussion of this asset class.

The last month of the quarter was dominated though by Greece, Grexit and referendum. This also needs discussion, which we have done in the Global Equity section of this *Insight.*

The Federal Budget was released for 2015-2016 during the quarter and as we mentioned last month, Treasury has acknowledged a weaker economic outlook, but are the forecasts realistic?

A cash deficit of $41.1Bln has been estimated for 2014-2015 and $35Bln for 2015-2016, reducing to $14.4Bln in 2017-2018 and returning to surplus a year later. The deficit reduction is driven by revenue increases not cost savings, which rise from 23.9% of GDP in 2014-2015 to 25.7% in 2017-2018 whilst outlays remain steady through that same period from 26.1% to 26.0%.

GDP growth has been estimated at 2.5% in 2014-2015 growing to 2.75% in 2015-2016.

It is also important to discuss Greece as this is impacting markets but please note these views are relevant as of the 2nd of July as this is a very fluid situation and changing daily.

Australian Equities

After the 9.0% rally in domestic equities in the first quarter, Greece dominated in June and we saw the ASX fall 5.51% to 5459 in June 8.97% off the markets peak of 5997 in April and delivering a 1.17% return for the financial year.

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It is over three years since we have seen the ASX correct by 5% in a month.

Given the volatility it is important to look at where equities are both domestically and globally.

Value is returning to the domestic market and we will be reviewing our asset allocation towards Australian Equities, but we do want to see the volatility around Greece die down.

Global Equities

The MSCI World Index ex Aust (USD), increased 0.5% for the second quarter after a gain of 1.82% for the first quarter and 1.93% for the year.

The S&P500 finished the financial year at 2063 +6.71% off 3.35% from its peak, the Bloomberg Euro 500 finished the year at 257 +14.03% off 8.77% from its peak, the FTSE finished the year +2.78% at 6521 off 8.45% from its peak, and the Hang Seng +15.95% for the year off 8.18% from its peak.

Capital Economics have a 2016 target of 2,200 on the S&P500, 6.64% higher than where it is today, and expect the Treasury Yield at 3.5% against 2.4% where it is today.

We remain positive towards European equities and any weakness is a buying opportunity. As we have mentioned often Europe has manufacturing capacity, both in labour and manufacturing capacity.

US Federal Reserve (Fed) Governor Yellen has stated many times that she will lift rates gradually. Whilst we support a rate increase in 2015 we think it will be a series of very small steps perhaps in increments of 0.125% and that the US economy is strong enough to support this.

The potential tightening of the Fed's Funds rate after 9 years of cuts weighed on equity markets during the quarter on the back of bond market volatility, pre Greece and its issues.

Greece has made a lot of headlines and we came to work on Monday morning with the bears telling us markets would lose 5-7%, however with the exception of Shanghai, most markets fell somewhere between 1.9% and 2.3%.

Markets have since recovered by more than 1.5% against these lows earlier in the week but why?

Some simple facts on Greece, it is 0.4% of global GDP, 3% of European GDP and a stock market capitalisation of EUR13Bln (one 50th of Apple).

The government has brought this on themselves hence why the Germans are now playing hard ball and refusing to deal with Prime Minister Tsipras or Finance Minister Varoufakis and their alternative proposals before Sunday's referendum. An interesting move as this effectively pressures the government to call the referendum off.

After a third day of capital controls, pension rationing and the expiry of the bailout the government must come to realise they may lose the vote. The closer we get to Sundays vote the greater the potential a Yes vote will carry and that the government may subsequently fall.

Whatever the result on Sunday, Greece with 0.2% of the world population has a hard road ahead of it, but this will have a minimal effect on Europe and the rest of the world.

Currency

As we have often repeated we will never make a projection on the AUD but we are prepared to discuss direction.

Global volatility and uncertainty will drive investors towards safe haven currencies and we cannot see appreciation in the AUD.

The Australian Dollar finished the financial year at 0.7707 against the USD, declining 18.3% over the twelve months.

Markets are at near record levels positioned for further AUD weakness and USD strength. If these positions were to be unwound it could trigger a sharp correction.

Economic fundamentals however, especially the expected tightening of US rates and the potential for US GDP to exceed 3%, we believe will lead to further strengthening of the USD against the EUR, GBP, JPY and the AUD.

Fixed Interest

In Australia, we saw a 25 basis points rate cut in early May at the short end of the yield curve in the RBA Cash rate to 2.00%, however Australian bonds sold off during the month to 2.73% up from 2.64% finishing the financial year at 3.00%

The trough to peak though the 2015 calendar year in many bond markets is approximately 70 basis points. These are large moves, and this volatility has continued into June after Fed Chair Yellen's observation on the 22nd of

May that she still expected to take a first step toward policy normalisation later this year.

With the RBA cutting the official cash rate by a total of 50 basis points through two cuts over the past six months, many investors have been caught up in the so called “hunt for yield”. Whilst attempting to gain extra return by the way of yield, there is an emerging danger of becoming complacent about risk in fixed income markets.

In any asset class, it is true that quality can get an investor through periods of volatility.

One of the concerns that came from the 2013 Taper tantrum and has been a focus for fixed interest managers according to Scott Weiner from Payden and Rygel in his paper, *Secondary market for corporate bond markets liquidity in 2014,* “is the troubling lack of liquidity”. As he put it “the ability of buyers and sellers to transact quickly in volume with minimal price impact and little price differentiation between the two sides of the market”.

Weiner emphasises that the corporate bond market is in “significant upheaval”, and that the regulatory changes to the role of broker dealer through Basel III to support the banks “has caused a new insidious liquidity risk”.

Bond Exchange Traded Funds are another concern of Weiners, as investors have an expectation that they can exit an ETF like a stock.

Yet if the underlying securities or bonds are not easily traded, there is hence a “mismatch in underlying liquidity and the expectations of investors” – and a heightened risk.

In his May 2015 newsletter, Vimal Gor from BT Investment Management put the comments from Weiner into perspective from a domestic perspective. Gor said that government bonds “are the only asset class that gives you a strong negative correlation to equities” and that government bond yields are low “because they are in high demand because of the security they offer”.

Gor extends on the liquidity argument saying “numerous credit securities e.g. corporate bonds, emerging markets, high yield etc., have attractive characteristics but they also have positive correlations to equities in times of stress, with hybrids being the worst as they are negatively convex (look like bonds in the good times and equities in the bad times)”.

This should be noted as many investors of recent years have eagerly taken up the many hybrid issues based on the yield these securities offer. They have often done so without fully appreciating the potential risks in the liquidity of these securities and downside risk to their capital by behaving more like equity than fixed interest in, as Gor puts it, the “bad times”.

We also argue that hybrids are part of the equity asset class for asset allocation purposes not fixed interest.

Whilst it looks likely the US Fed will imminently raise rates for the first time in nine years, it is this move that will shape market direction for most asset classes in the short term.

Bond market volatility is thus illustrating an anticipation that we will start to see rate rises in official cash rates however, it is important to put this into perspective that this is from historically low levels globally.

Tightening yield spreads (buy-offer spread) at the levels we see today especially in securities outside of government bonds, (as investors have chased yield) don’t correctly reflect liquidity conditions.

Fixed Interest markets need to gradually adjust their pricing for liquidity and investors should take note the risks in chasing return for little yield pickup.

Conclusion

Any weakness from here in equity markets we believe should be seen as a buying opportunity.

Global equities remain where we believe the best opportunity exists especially if you focus on fundamentals which show a slow recovery in the global economy assisted by accommodative central bank policies.

Hamilton Wealth Management is a Fee for Service, independently owned Wealth Management business and as such our advice is built around the conviction to our process and philosophy and our strong belief in diversification.

We would be happy to discuss this further with you, please don’t hesitate to contact us.

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