The View From The Outer

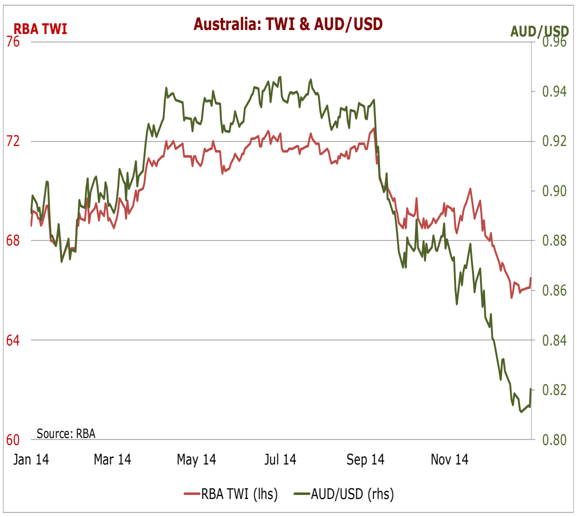
David Jarman – Chief Investment Officer

January, 2015

EVANS & PARTNERS

2014 Surprises and Investment Themes for 2015

- **At the end of 2013, global markets expected 2014 to be a year of strengthening global growth and rising US bond yields. Markets were braced for increased volatility as QE – Quantitative Easing – was unwound and a subsequent Federal Funds rate increase anticipated.**
- **In the event and despite a robust US economy from mid-year, world output growth has disappointed. The IMF October World Economic Outlook forecasts growth will only match the 3.3% increase in 2013, which in turn was the slowest year since the GFC. The global bellwether bond, the US ten year Treasury Note yield, which ended 2013 at 3.0%, is now only 2.2%. German two year Bund yields are negative (-0.1%). Disinflationary pressures are sweeping the globe. Wages growth is still stubbornly low in major jurisdictions and the price of oil has fallen by $US50/bbl.**
- **The global "reach for yield" investment theme and "lower for longer" interest rate environment has prevailed thus far. For an Australian equity investor, however, it has been a mixed year. The S&P/ASX200 Price Index at 5411 is only 1% above end 2013 levels with dramatic resource underperformance the feature. Recent oil price weakness, together with a halving of the spot Iron Ore price and the ASX200 Resources Index is now 19% below end 2013 levels.**
- **Through all this we have made only one change in our recommended Strategic Asset Allocation tilt in 2014. In April, we moved our recommended Strategic tilt from "aggressive" or overweight equities to a "neutral" stance relative to benchmark; recognising client's individual benchmarks will vary according to their personal circumstances.**
- **Within this "neutral" overall asset allocation, we retain a strong overweight to international equities (90% unhedged) and an equal offsetting underweight in Australian equities.**



Perhaps the most obvious conclusion to draw from the above is that investment markets will inevitably serve up some surprises in the year ahead. These in turn will have unintended consequences. Exquisite short term investment logic can be blown away in the blink of an eye in response to an unexpected exogenous event. That is why we prefer to invest where intrinsic value is on our side, and preferably and if appropriate, when we are paid to wait.

This has been our approach with the Australian dollar, even though the RBA's Trade-Weighted Index (TWI) has remained stubbornly high for most of 2014, despite dramatic commodity price weakness. Indeed, in trade-weighted terms, the Australian exchange rate did not fall below its early January 2014 level on a sustained basis until the end of November.

Investment themes and key issues for 2015:

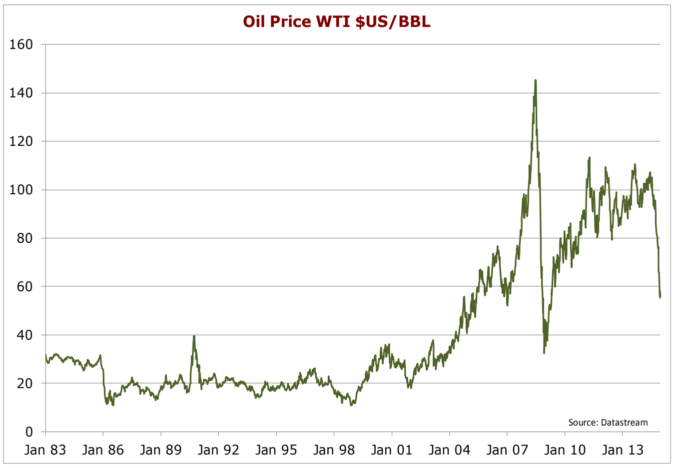
Oil: From its recent peaks in June, the oil price is now off by over $US50/b. While iron ore is by far our largest export, for the world economy, it is still oil that really matters. The Economist newspaper noted on 6 December that a $40 price cut shifts some $US1.3 trillion from produces to consumers. Certainly demand growth has softened and supply growth in the US shale industry has been rapid, but surely nowhere near enough to warrant the magnitude or speed of the current price decline. The difficulty is that given the apparent faith that had existed in OPEC's capacity and desire to maintain the price, we can't really be sure what the free market price of oil was.

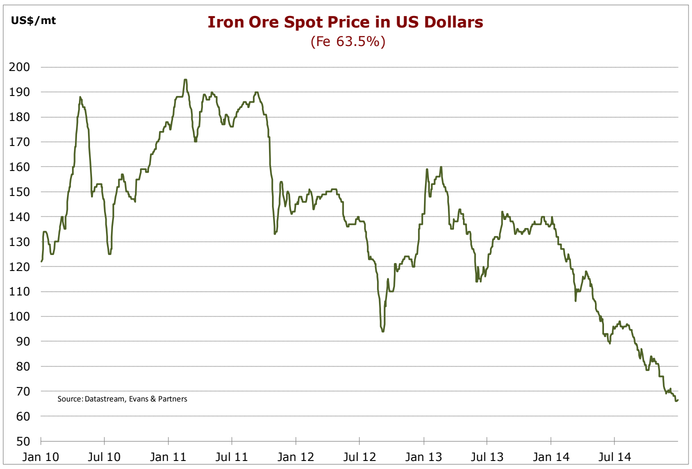
In looking to history, the halving of the oil price in the first half of 1986 is of interest. OPEC appeared to adopt a swing producer approach from 1983-85, before Saudi Arabia increased production seemingly to punish excessive quota cheating by other OPEC members. The price remained low through 1986 before a gradual recovery. By contrast, the oil price movements around the GFC appear to provide little guidance in the current environment. (At that time, an extraordinary demand shock and destocking, was quickly followed by the massive commodity-intensive Chinese stimulus).

One important distinction with the past is that role that shale oil production has made to supply growth at the margin. Shale oil is a very different business to conventional oil. As Peter Stamoulis (Oil Price Commentary 15 December, 2014) observed in our recent research note: *"Previous large supply additions (North Sea, Prudhoe Bay and Gulf of Mexico) are characterised by large upfront capex but low ongoing maintenance/opex which depressed oil prices for years. Shale oil is characterised by continuous drilling activities to maintain leases and production rates, which implies considerable ongoing capex. Thus, OPEC's decision not to cut production will curtail shale oil production as companies cut back forward capex. We are already seeing early signs of this - drilling permits fell 37% in November from the previous month in the USA."*

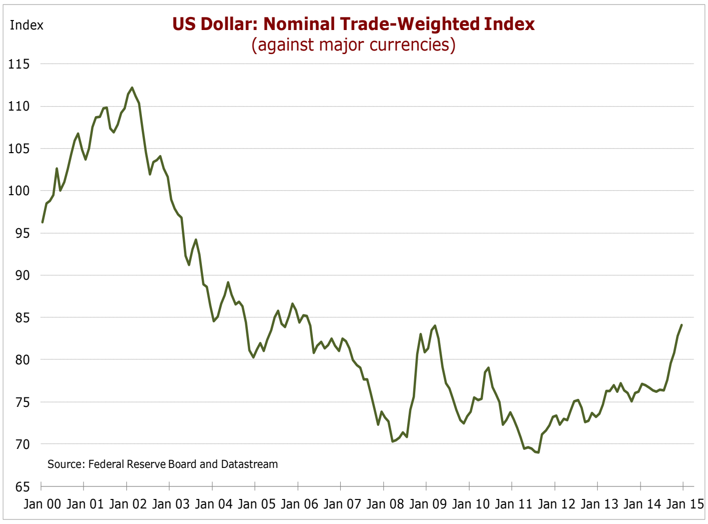
We do not profess to know how low the oil price may fall in the short term, if indeed it falls any further at all. We do, however, expect that Saudi Arabia/OPEC will maintain current production quotas, keeping oil prices low for long enough to knock out higher cost shale oil production. As the ongoing capex required to maintain production levels can no longer be justified, supply will inevitably adjust. Indeed the previous (now seemingly excessive) reliance of US shale companies on the US High Yield Bond Market to fund ongoing activities will be a further potential source of financial pressure (and reduced production).

From an investors' perspective, we conclude the following: From a longer term perspective, the oil price is in significantly oversold territory already. The current period of lower oil prices is setting in train a meaningful supply and demand response. In an Australian equity market where value has been hard to find, look to selectively add to low cost energy exposure, but be prepared for ongoing volatility and potentially lower prices still in the short term. Of course we recommend you speak to your Adviser with regard to the appropriateness of this for your portfolio.





US Dollar Strength: The trade-weighted value of the US dollar has risen by 10% in 2014. This theme has further to run. In addition to the United States' superior economic performance, the ongoing disappointment elsewhere has underscored the case for the US dollar. It has become increasingly clear through the year that the approach to monetary policy is diverging across the major central banks (the Fed relative to the BOJ, ECB and PBOC). QE has ended in the US, continues apace in Japan and surely must be embraced soon in Europe. Europe and Japan are both desirous of a lower exchange rate. Further, the US dollar is still 10% below its average level since 1980. While now a "consensus trade" the case for a stronger US dollar remains compelling.



A stronger US dollar has a number of implications. Firstly, it has historically provided challenges to Emerging Markets, compounded for many outside Asia by the collapse in the oil price. Unhedged exposures to US dollar borrowing are said to be low on average, but no doubt casualties will emerge in unexpected places.

Secondly, a stronger US dollar will import disinflationary pressure at the margin from Europe and Japan into the US. Together with the low oil price, the long awaited increase in the Fed Funds rate may still take longer than the market expects.

Thirdly, for China, with an economy in transition that is slowing, and monetary policy continuing on an easing trajectory; would they a want to maintain a relatively stable USD/CNY exchange rate? (The Chinese renminbi is now 27.9% of our TWI).

Australian Dollar Weakness: Over the course of 2014, the Australian dollar depreciated by 8.3% against the US dollar and by 3.5% as measured by the TWI, most of which occurred in November/December. Our views on the Australian dollar have been regularly canvassed and remain intact. *(See The View From The Outer of 10 October, 2014).* Given the magnitude of the decline in commodity prices and Australia's competitiveness issues, we continue to expect the Australian dollar to weaken again in 2015. Particularly given our view of US strength, we feel confident in forecasting the AUD/USD will trade at USD0.75 before end-2015.

Higher Volatility: One of the factors that supported the Australian dollar in the face of commodity weakness is our relatively "high" interest rates, at least by international standards. An environment of relatively low volatility through much of 2013 and 2014 (until September) supported strong foreign capital inflows attracted by our interest rates. An environment of greater global currency volatility and diverging monetary policy settings between the US and other major economies reduces the attractiveness of the carry trade. This in turn should reduce the support for the Australian dollar.

RBA Policy Response If The TWI Does Not Weaken? While a further reduction in the Australian Official Cash Rate has not been our core assumption, we have acknowledged it is a chance if the TWI does not continue to decline. *(Refer our email of 4 December, 2014: "What chance a rate cut?").* We doubt the RBA wants this; they (in our view rightly) seem comfortable with the view that*: "On present indications, the most prudent course is likely to be a period of stability in interest rates." (Statement by the Governor, 2 December 2014).* Credit growth for investment housing at 10% pa certainly needs no further encouragement. There appear few other constraints to lower rates, however, if the TWI doesn't continue to weaken. The annual increase in Wage Price Index has been running at 17 year lows, oil prices have collapsed, and inflation is seemingly not a constraint. The Terms of Trade (-24.5% from peak) continue to bear down on National Income, and real GDP growth is currently running below trend (2.7%).

We expect the TWI will continue to weaken, so market discussion of a possible Australian rate cut is likely to diminish. If this is not the case, market expectations of a rate cut would gradually build.

Still Lower for Longer – At Least At The Short End Of The Curve: We do expect 2015 will be the year in which the US Federal Funds Rate finally increases. (We assume September/October.) We remain of the view that risks are skewed to the Federal Funds Rate remaining at the zero lower bound for longer than expected. US employment growth is the strongest in 15 years, but the price of labor, reflected in wages growth, needs to pick up towards average pre-GFC levels more consistent with the Fed's 2% inflation target. As Janet Yellen and the FOMC consider policy in 2015 note that the price index level is now some 3% below that implied by constant 2% inflation since Ben Bernanke took office in 2006. Excessive vigilance at inflation a little above 2% in the short term is unlikely unless other circumstances warrant it.

It is valuations at the long end of the curve that trouble us. The long end of the government bond curve is one place where a genuine asset price bubble has formed globally, as the "reach for yield", abundant liquidity, Quantitative Easing and a lack of demand for credit have pushed these markets to valuation extremes. US 10 year Treasury Notes are now yielding 2.2%, even as the market ponders the timing of the first rate rise. Japanese 10 year JGB's are yielding 0.3% and German 10 year Government Bund yields are approaching 0.5%. These rates seemingly imply ten year nominal GDP in these economies that are way too low.

An Unchanged Asset Allocation View: There has been no change to our recommended asset allocation strategy since April, 2014. Our main call has been a strong overweight position in unhedged Global Equities, offset by an underweight in Australian Equities. This has been far more than a view on the currency (although that is one factor in our competitiveness problem). It also reflects the relative lack of diversity and structural weaknesses in the composition of the Australian Equity market, particularly in the current environment.

GENERAL RESEARCH DISCLAIMER, WARNING & DISCLOSURES

This document is provided by Evans and Partners ABN 85 125 338 785, holder of AFSL 318075.

The information is **general advice only** and does not take into consideration an investor's objectives, financial situation or needs. Before acting on the advice, investors should consider the appropriateness of the advice, having regard to the investor's objectives, financial situation and needs. If the advice relates to a financial product that is the subject of a Product Disclosure Statement (e.g. unlisted managed funds) investors should obtain the PDS and consider it before making any decision about whether to acquire the product.

The material contained in this document is for information purposes only and does not constitute an offer, solicitation or recommendation with respect to the purchase or sale of securities. It should not be regarded by recipients as a substitute for the exercise of their own judgment. Investors should be aware that past performance is **not an infallible indicator** of f**uture** performance and future returns are not guaranteed.

Any opinions and/or recommendations expressed in this material are subject to change without notice and Evans and Partners is not under any obligation to update or keep current the information contained herein. References made to third parties are based on information believed to be reliable but are not guaranteed as being accurate.

This document is provided to the recipient only and is not to be distributed to third parties without the prior consent of Evans and Partners.

EVANS AND PARTNERS DISCLOSURE OF INTERESTS

Evans and Partners and its respective officers and associates may have an interest in the securities or derivatives of any entities referred to in this material. Evans and Partners does, and seeks to do, business with companies that are the subject of its research reports.

EVANS AND PARTNERS CORPORATE RELATIONSHIP DISCLOSURE

Company	Nature of Relationship
ANI	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
ASH	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
AUI	The Issuer has appointed Evans and Partners as Broker to an on-market buy-back. Accordingly, Evans and Partners is unable to give Sellers advice in respect to a sale of this security.
BENPC	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
CGL	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months. A Director of Evans and Partners Pty Ltd is a director of The Citadel Group Limited.
CTNG	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
DUI	The Issuer has appointed Evans and Partners as Broker to an on-market buy-back. Accordingly, Evans and Partners is unable to give Sellers advice in respect to a sale of this security. Evans and Partners has been appointed as Placement Agent in respect of the company's renounceable rights issue and will receive fees for acting in this capacity.
EGI	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
HSO	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
IDR	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
IMF, IMFHA	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
MBLPA	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
MPL	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
MQG	A director of Evans and Partners Pty Ltd is a director of Macquarie Group Limited.
NAB	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
PGH	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
PNC	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
REG	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
SAR	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
SPO	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
SWM	A director of Evans and Partners Pty Ltd is a director of Seven West Media Limited

RESEARCH ANALYST CERTIFICATION

I, David Jarman hereby certify that all the views expressed in this report accurately reflect my personal views about the subject investment theme and/or company securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

RESEARCH ANALYST DISCLOSURE OF INTEREST

I, David Jarman, and/or entities in which I have a pecuniary interest, have an exposure to the following securities and/or managed products: BHP, CBA, IVV, MPL, NAB, WOW, Evans & Partners International Fund (Unhedged), IML Equity Income Fund and Macquarie Asia New Stars No.1 Fund

DISCLAIMER Except for any liability which cannot be excluded, Evans and Partners, its directors, employees and agents accept no liability or responsibility whatsoever for any loss or damage of any kind, direct or indirect, arising out of the use of all or any part of this material. All information is correct at the time of publication; additional information may be available upon request.