David Jarman – Chief Investment Officer

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Markets – Where to from Here?

Global growth: Recent **US** partial indicators suggest the economy is shrugging off yet another unseasonably harsh winter and weak start to the year. Real GDP is expected to have risen at an annualised rate of 2.5-3% in Q2, a pace we broadly expect to be maintained in the quarters ahead. That said, partial economic data is far from unencumbered good news. New Home Sales in June were at their lowest level since last November. The Market private sector Manufacturing Purchasing Managers Index (PMI) edged higher in July, but remains below the post-crisis average level, while Consumer Confidence in July was at its lowest level since last September 2014. Lift-off is still on target for late 2015 but does need stronger wages growth. In **China**, the share market decline may be grabbing the headlines, but despite the increase in margin lending that occurred, the overall wealth effect is relatively modest. Of greater ongoing concern to us is the infrastructure and property overhang, which remains substantial. Steel prices continue to fall and the Caixin July Flash Manufacturing PMI at 48.2 is at a 15 month low, which continues to bode poorly for commodities. The PBOC continues to ease monetary policy, but substantive fiscal stimulus is not expected. In **Europe,** near term fears of "Grexit" have eased, but the current in principle agreement reached is unlikely to be sufficient to obviate the re-emergence of this issue at some juncture. Nonetheless it allows the focus to return to the ECB's commitment to reflationary monetary policy (the magnitude of the ECB's Quantitative Easing program) the weakness in the Euro and weak oil prices, which are all supportive of growth. Similar policies (ultra-easy monetary policy and a weakening exchange rate) are also supporting a cyclical recovery in **Japan.**

Global monetary policy: Stronger US growth supports Fed Funds Rate lift-off later in 2015 but the still patchy evidence on the wages front tilts the odds to December. Of greater import than the fixation on the timing of lift-off is the pace of tightening, which we are confident will be very cautious. Policy settings elsewhere in the world remain very accommodative at a monetary level, and constrained on the fiscal front. China is likely to resist meaningful fiscal stimulus capacity.

Global equity markets: Remains our preferred asset class. Within the developed markets we retain a preference for Europe ex-UK and Japan hedged into US dollars.

Domestic growth: A soft nominal economy continues to bear down on real growth as the terms of trade decline. Monetary policy is supporting housing and related consumption. Business investment and public sector capex is weak, as is business investment. Weaker AUD is supportive.

Domestic monetary policy: The RBA reduced rates by 0.25% in February and May to 2.0%. We expect US dollar strength and commodity price declines and further weakness in the Australian dollar. Under this scenario we do not see further easing in the current cycle, even though the inflation and wages outlook is benign.

Domestic equity markets: Finding companies with sound earnings growth prospects at a reasonable price remains challenging. The market's 12 month forward PER, at 15.6X as at 29 July remains above 2H 2014 average levels (circa 14.5X). Reporting season beckons, but at this juncture FY16 EPS growth prospects are negligible (ASX200 basis), while FY17 looks subject to downward revision.

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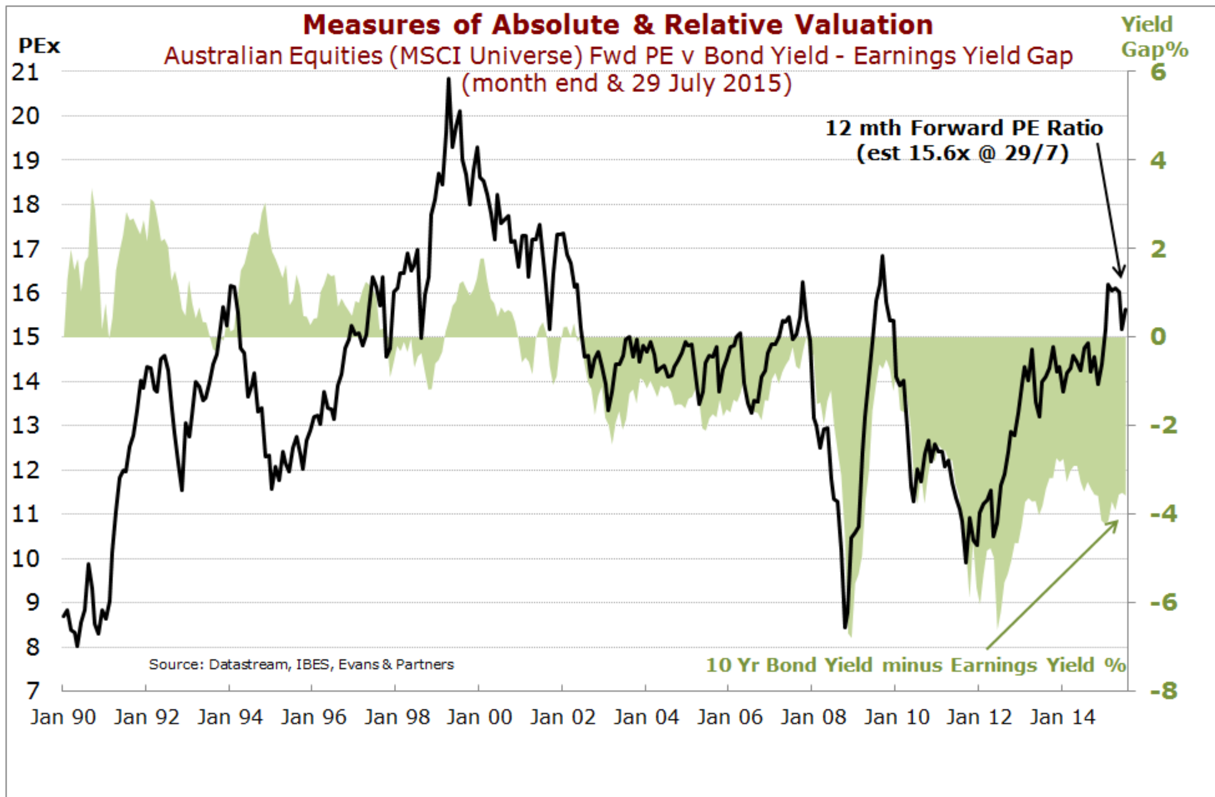
Measures of Absolute & Relative Valuation
Australian Equities (MSCI Universe) Fwd PE v Bond Yield - Earnings Yield Gap
(month end & 29 July 2015)
PEx
Yield Gap%
12 mth Forward PE Ratio
(est 15.6x @ 29/7)
10 Yr Bond Yield minus Earnings Yield %
Source: Datastream, IBES, Evans & Partners
21
20
19
18
17
16
15
14
13
12
11
10
9
8
7
6
4
2
0
-2
-4
-6
-8
Jan 90
Jan 92
Jan 94
Jan 96
Jan 98
Jan 00
Jan 02
Jan 04
Jan 06
Jan 08
Jan 10
Jan 12
Jan 14

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