The Financial Engineer

Australian Equities Portfolio Strategy

Wednesday 2 December 2015

EVANS & PARTNERS

Market Outlook

ASX200 Index Target December 2016 = 5300-5400

Positives

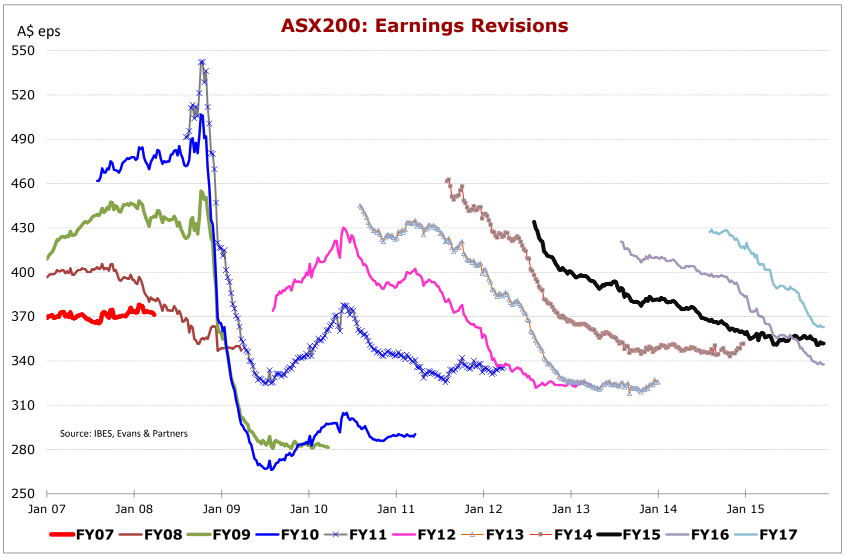
- The policy stance in Australia remains generous – low rates, low A$ & a receding drag from fiscal repair. Pressure for higher rates is unlikely to appear before 2017. At the moment, the pick-up in yield available from the equity market, relative to term deposit rates is attractive. This will help underpin the market in the year ahead.
- While the Australian economy continues to be held-back by a range of structural challenges, the cyclical outlook for 2016 is a little brighter. The bulk of the material hit to business investment should be booked in calendar 2015; housing construction activity will remain healthy; the East Coast consumer is well-placed and public sector investment should begin a multi-year recovery. While a plus for sentiment, a stronger domestic economy is unlikely to have a material impact on FY16/17 profit estimates. To the extent that some sectors do a little better; it will likely be countered by downgrades elsewhere.
- Outside China, corporate balance sheets are sound. Given extremely low borrowing costs & high PE multiples, global M&A activity should remain in high gear.
- Australia will continue to be a beneficiary of this trend. Viewed in USD terms, Australian assets – particularly those providing an attractive yield – are cheap. M&A activity – in both the listed & unlisted sectors – should help to underpin corporate valuations in 2016.
- Cash and property are still the investment of choice for most Australians; equities the least attractive; the contrarian is well-placed.
- The opportunity cost of near-zero cash rates in the US, Europe & Japan is significant. Investors will continue to look for higher yielding alternatives. Although the US looks to lift rates, the pace of tightening will be subdued. Holding cash will come with a high opportunity cost until at least 2018.

Negatives

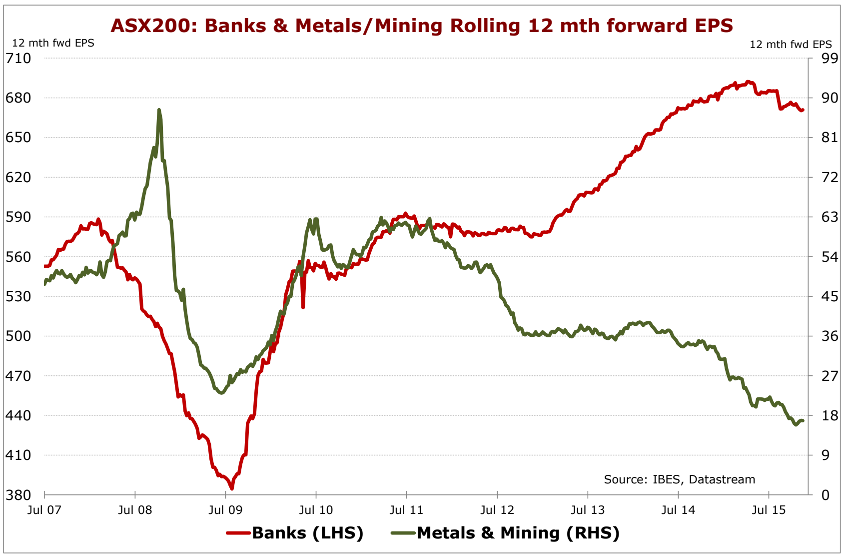
- In FY17, the ASX200 will mark a decade where earnings-per-share has failed to break above the FY07 peak. While the resources sector accounts for the majority of the pain, the lack of earnings momentum remains a fundamental cap on aggregate market performance.
- Resource sector earnings are on track to contract again in 2016. To date, the industry response to oversupplied iron ore, aluminium, thermal coal and oil markets has been disappointing. While production cuts will deepen in the year ahead, the prospect of another year of weak commodity demand in China suggests supply/demand balances will remain elusive. Resource stocks will remain vulnerable until the market can see a tangible base in earnings.
- Share price weakness in 2015 has been largely confined to the banks and resources. Outside this universe, valuations are generally full-to-stretched (i.e. non-bank industrials). The marginal investor is willing to pay a large price for earnings certainty. While this is unlikely to change in the year ahead, already rich valuations are likely to limit share price performance.
- In theory, the shift to a tightening bias from the US Federal Reserve should not be a major risk to global markets in 2016. The Fed are not out to slow the US economy and the overall policy stance will remain very supportive. The removal of the zero rate cash rate anchor to the US yield curve, however, will be

interesting to monitor. The trading range for long term government bond yields – including those in Australia – could well widen.

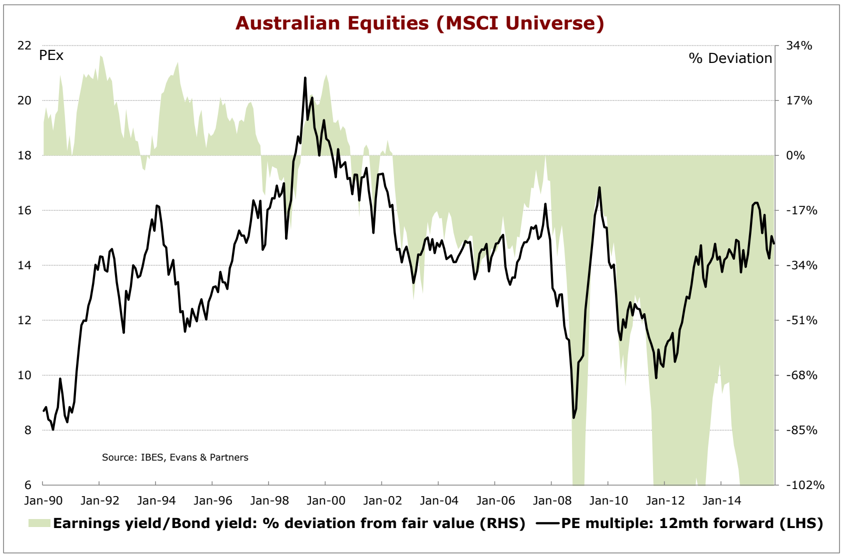
- While significant bad news has already been booked with respect to the downturn in China and the implications for commodity demand, sentiment is likely to remain fragile in 2016. The Australian equity market will remain very sensitive to news flow from China.
- Global geo-political risk is very high. Events in the Middle East have created a vacuum that will be an ongoing source of volatility. Policy tension between China and the West remains significant.



FY16/17 earnings estimates remain under pressure, largely on the back of lower commodity prices. Forward commodity price expectations are now depressed so the pace of negative earnings revision should ease unless export volumes – which are holding up well – are impacted by steel capacity closures in China. Domestically, the next test for FY16 earnings will be the strength of Christmas sales. We believe the early signs are supportive for a healthy Christmas trading period.



While the earnings dilution from the recent round of bank capital raisings has been booked, forward estimates will remain under pressure from competitive pressures – particularly in business & institutional banking, the sluggish demand for credit and the likelihood that bad debt provisioning will trend higher. Earnings will be very sensitive to even a small deterioration in credit quality. Most commodity prices relevant to Australia continue to trend down. As noted, this reality is now reflected in share prices. The risk for 2016 will be the resilience of sales volumes.



The Australian economy and equity market face numerous challenges, but corporate financial health is sound and dividends, on average, are sustainable. In the absence of positive earnings surprise, valuations are still full, particularly across the non-bank Industrials. Unless greed overwhelms the marginal investor, PE multiple expansion has little to give to market performance, particularly if the Federal Reserve gradually lift rates through 2016.

Portfolio Design – Mike Hawkins, Portfolio Manager*

By definition, if you are a client of Evans & Partners you believe in advice-driven active portfolio management. 2015 has provided the ultimate confirmation of the superiority of this approach relative to that of the index and DIY investor.

In 2015, performance has basically been a product of the extent to which a portfolio has had exposure to the Top 10 stocks. A relatively limited exposure has ensured a solid outcome (given what has generally been strong gains across the non-bank industrials); a relatively large exposure, on the other hand, has delivered a head ache. The basic portfolio performance differential between these two strategies has been at least 10%.

The superiority of advice-driven active portfolio management is that it should deliver a well-structured portfolio which is constantly seeking to maximise exposure to quality, opportunity, earnings growth and dividend growth. These are the attributes that not only deliver performance over the medium term but also reduce risk.

The structural and cyclical limitations of the majority of Top 10 stocks will remain a drag on absolute and relative share price performance in the year ahead. If you are disappointed with how 2015 played out, procrastination will not deliver a better 2016. Now is the time to ensure your portfolio is designed to capture quality, opportunity, income and earnings growth. Talk to your adviser.

** Michael Hawkins is the Australian Equities Portfolio Manager. His material is not a product of the Research Department.*

Ideally, the primary drags on aggregate market performance in 2015 will fade in 2016.

In particular:

- **China:** Construction activity in China is set to end 2015 at a six year low, but the prospect of a base being formed in 1H16 may not necessarily provide relief to global commodity demand or the markets general scepticism towards China's economic health. Financial stress is widespread across Chinese producers of steel, aluminium & copper – excess capacity remains overwhelming. The State may decide to continue to prop-up the living dead in which case production will continue to the detriment of price. If financial reality is allowed to proceed, metal production in China will contract at a greater rate than we have seen to date – ultimately a plus for prices but potentially a hit to bulk commodity imports – in particular. Unfortunately, we suspect China will remain a drag on aggregate market performance in 2016.
- ***Commodities***: In 2011, **BHP** generated EBITDA of US$37.1bn; in 2016 it is projected to be US$13.9bn. **RIO** generated EBITDA of US$28.5 in 2011; in 2016 it is expected to be US$13.0bn. **WPL** generated EBITDA of US$5.2bn in 2014; in 2016 it is expected to be US$2.9bn. Commodity price forecasts have been slashed but with the higher cost producers yet to capitulate (less-so oil); new iron ore supply continuing to come on stream and the aggregate demand outlook in China still vulnerable, supply/demand

equilibria will remain elusive. When it comes to resource stocks, the marginal global investor will not look at "valuation" until earnings have clearly based.

- ***Negative Earnings Revision***: Since January, the market has revised down its expectations for ASX200 earnings in FY16 by 12% and FY17 by 14%. Ideally, 2016 will prove far less threatening in terms of earnings revisions. While the miners remain vulnerable, the dilution created by capital raisings across the major banks will not be repeated and the relative health of the East Coast economy should assist many domestic-facing businesses. One source of upside over the past 2 years – the weaker A$ - may, however, be a more neutral contributor going forward.
- ***Major Bank Capital Intensity***: The regulator-driven step-up in capital intensity – and resulting dilution in shareholder returns – will not be repeated in 2016. Share price performance, however, will still be capped by the flat/subdued earnings momentum created by soft credit growth, an increasingly competitive industry and the likelihood of an up-tick in bad debt provisions.
- ***A flat US Market***: The rapid appreciation of the US Dollar in 2014 and the slump in the oil price robbed the S&P500 of earnings growth in 2015. When combined with a full valuation, the market was left to languish. With the earnings drag from the US$ and low oil now cycling off, earnings momentum for the US market should improve. If the Federal Reserve continue to pander to Wall Street (refer below) the prospects for the US market in 2016 are a little brighter.

As always, it will take more than the demise of yesterday's problems to deliver a healthier market. A new wave of risks/constraints could easily emerge to impact earnings and/or valuation multiples. In this regard, apart from the ongoing issues in China the knowns that we need to monitor include:

- ***The US Federal Reserve:*** In itself, the shift to a tightening bias by the Federal Reserve and a scenario where the cash rate moves from ~0% currently to ~1.2% by end-2016, does not constitute a material direct threat to the US economy or equity market. The implications for the latter will play-out via the USD and/or the behaviour of the US yield curve. 2016 could all get a bit circular. If the Fed's actions were to trigger a further surge in the US Dollar and/or a spike in long term borrowing rates – both detrimental to the macro/market outlook – it would probably see the Fed quickly step-back from the tightening bias. Order would then be restored and we would start the circuit again.
- ***Currency Volatility***: The currency implications of the divergence in policy approaches across global central banks will be a particular focus, including Australia where the A$ could well be buffered in both directions. Since it hit US$0.93 in mid-2014, the subsequent weakness in the A$ can all be explained by US$ strength. Outside a negative shock from China, the A$ could surprise with its resilience in 2016 – particularly if the US$ is shown to have already priced-in the Fed's initial phase of policy tightening.
- ***Geo-political Risk***: We have been surprised that the market (via the risk premia it attaches to asset valuations) has not been more sensitive to the steady deterioration in geo-political stability. In retrospect, it would have been wise to have been a more aggressive seller of **BHP**, but one of the reasons it remains in our discretionary portfolios (at an index weight) is for the oil exposure which may yet prove a useful portfolio hedge if the Middle East continues to slowly implode.
- ***Regulatory Change***: An ever present issue for the market that effectively touches all sectors. In the year ahead we will see a series of inquiries that will impact the health sector; the roll-out of competition reform (for example, trading hour deregulation); the crystallization of a broad tax reform agenda and the normal threats & promises associated with an election campaign.

Despite these qualifications, we believe the ASX200 can still have a slightly better year in 2016.

On the critical assumption that negative earnings risk will abate, we feel the market enjoys significant valuation support ~4900. The high dividend yield relative to cash and the attraction of Australian assets to offshore investors (i.e. M&A activity) will encourage/sustain the marginal buyer.

As has been the case in 2015, the upside will be securely capped by the lack of earnings growth. After contracting by an expected 3% in CY2015, ASX200 earnings are likely to be flat at best in 2016. As such, valuation support is quickly absorbed as the index approaches 5400, more-so if the US Federal Reserve gradually lifts rates – a shift that will work against further valuation multiple expansion in US/global markets.

While 2016 will ideally prove less threatening with respect to negative earnings risk, the aggregate earnings picture remains uninspiring given:

- A further step-down in the resources sector.
- A basically flat outlook, on average, for the major banks.
- Better news across the universe of non-bank financials, but this is in large part already reflected in market expectations/valuations. It is also not a given that A$ weakness will continue to drive upgrades for the global exposed industrials.

RESEARCH RECOMMENDATION DEFINITIONS

Positive	Stock is expected to outperform the S&P/ASX 200 over the coming 24 months
Neutral	Stock expected to perform in line with the S&P/ASX 200 over the coming 24 months
Negative	Stock is expected to underperform the S&P/ASX 200 over the coming 24 months
Speculative Buy	Stock has limited history from which to derive a fundamental investment view or its prospects are highly dependent on event risk, *eg.* Successful exploration, scientific breakthrough, high commodity prices, regulatory change, etc.
Suspended	Stock is temporarily suspended due to compliance with applicable regulatory and/or Evans & Partners policies in circumstances where Evans & Partners is acting in an advisory capacity.
Not Rated	Stock is not included in our investment research universe.

Research Criteria Definitions

Recommendations are primarily determined with reference to how a stock ranks relative to the S&P/ASX 200 on the following criteria:

Valuation	Rolling 12 month prospective multiples (composite of Price-to-Earnings Ratio, Dividend Yield and EV/EBITDA), or long-term NPV for resource stocks.
Earnings Outlook	Forecast 2 year EPS growth.
Earnings Momentum	Percentage change in the current consensus EPS estimate for the stock (rolling 1 year forward basis) over the consensus EPS estimate for the stock 3 months ago.
Shareholder Returns	Composite of forecast ROE (rolling 1 year forward basis) and the percentage change in ROE over 2 years.
Debt Servicing Capacity	Rolling 12 month EBIT Interest Cover ratio.
Cyclical Risk	Qualitative assessment of the 2 year outlook for a stock/industry’s profit cycle.
Industry Quality	Qualitative assessment of an industry’s growth/returns potential and company specific management capability.
Financial Transparency	If we don’t understand it, we won’t recommend it.

For stocks where Evans & Partners does not generate its own forecasts, Bloomberg consensus data is used. Analysts can introduce other factors when determining their recommendation, with any material factors stated in the written research where appropriate.

GENERAL RESEARCH DISCLAIMER, WARNING & DISCLOSURES

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

Please see our website at www.evansandpartners.com.au/uploads/default/source/2015/04/58751.ResearchConflictofInte.pdf for important information regarding Evans and Partners research.

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 **future** 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
ASH	Evans and Partners has arranged, managed or co-managed a public offering of the company or its affiliates.
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. 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.
AYUHB	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
BENPF	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
CIE	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 was appointed as Placement Agent in respect of the company's renounceable rights issue and received fees for acting in this capacity.
EAI	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months
EGI	Evans and Partners arranged, managed or co-managed a public offering of the company or its affiliates in the past 12 months.
MGC	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.
MQGPB	Evans and Partners has arranged, managed or co-managed an offering of securities of the company or its affiliates in the past 12 months.
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.
SWM	A director of Evans and Partners Pty Ltd is a director of Seven West Media Limited.
TGG	Evans and Partners Pty Ltd was appointed as Sponsoring Broker in relation to the 1 for 4 pro-rata entitlement offer (and any subsequent shortfall) of Templeton Global Growth Fund Limited (TGG) and will receive fees for acting in this capacity.

RESEARCH ANALYST CERTIFICATION

We, David Jarman, Lorraine Robinson, Chris Hernandez, Simon Fitzgerald, Will Dowd & Cathy Moises & hereby certify that all the views expressed in this report accurately reflect our personal views about the subject investment theme and/or company securities. We also certify that no part of our 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, CSL, DXJ, EAI, HEWG, IEU, IVV, MPL, NAB, S32, WOW, Cooper Investors Brunswick Fund, Evans & Partners International Managed Fund (Unhedged), IML Equity Income Fund and Macquarie Asia New Stars No.1 Fund.

I, Lorraine Robinson, and/or entities in which I have a pecuniary interest, have an exposure to the following securities and/or managed products ANZ, BHP, WBC, NAB, CBA, WOW, WES, TCL, BXB, AMP, MQG, CSL, WES, ENE, ORI, ORG, SPO, MPL.

I, Chris Hernandez, and/or entities in which I have a pecuniary interest, have an exposure to the following securities and/or managed products: A2M and BGL.

I, Cathy Moises and/or entities in which I have a pecuniary interest, have an exposure to the following securities and/or managed products: TIG, OZL, GCY, MDL and PRU.

I, Will Dowd, and/or entities in which I have a pecuniary interest, have an exposure to the following securities and/or managed products: AAPL, TME, WOW, CAR, OFX, SYD, STO, ORG, ASX, IVV

I, Simon Fitzgerald, and/or entities in which I have a pecuniary interest, have an exposure to the following securities and/or managed products: FMG, SDG, IAG, NWS, WFD, SCP.

DISCLAIMER