# The View From The Outer

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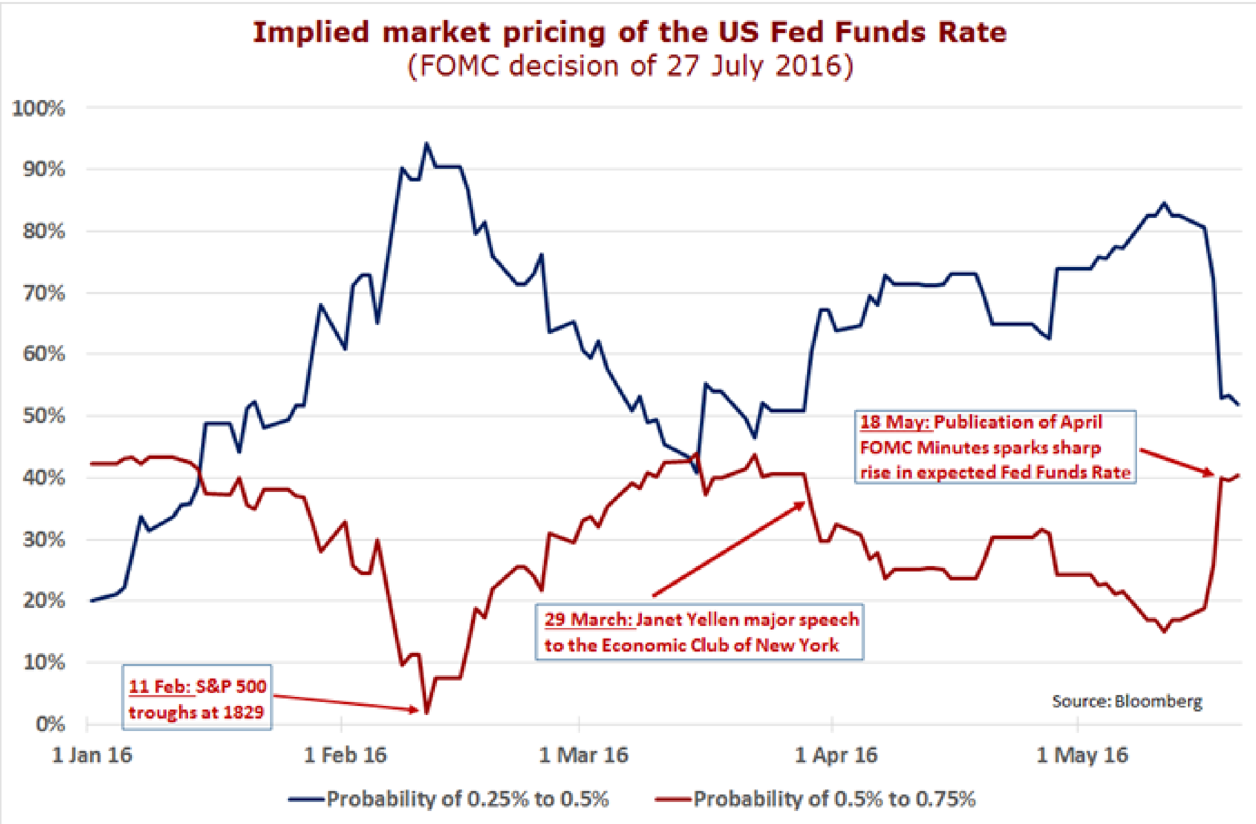
## Fed talks up the prospects of a northern summer tightening.

The past week has seen a significant rise in the implied market pricing of a 0.25% US Fed Funds Rate increase at or before the July FOMC. The immediate catalyst was the publication of the April FOMC minutes (Wednesday, 18th May) which appear to adopt a more "hawkish" tone than most assumed from the Statement issued upon the conclusion of the meeting on 27 April. Markets have also been "softened up" by an array of comments from various Federal Reserve Regional Presidents and FOMC members. The collective tenor of these comments has been that at the June 14th and 15th FOMC an increase in the Fed Funds Rate is very much a live option and that if the economy continues to proceed in line with recent forecasts then a tightening at the June or July meeting is a reasonable prospect.

FOMC voting member and New York Fed President William Dudley, for example, observed last week that *"If I am convinced that my own forecast is sort of on track, then I think a tightening in the summer, the June – July timeframe is a reasonable expectation."* Janet Yellen is scheduled to speak publicly on Friday, which will clearly be closely watched. In addition to being "data dependant," the Fed also appears to be "market dependant" and keen to avoid surprises (remember the "Taper Tantrum" in 2013). Thus it was interesting to note that William Dudley also observed that he was *"quite pleased"* that market pricing reflected increased prospects re the timing of the next rate increase.



We view the following are the preconditions for a near term US Fed Funds Rate increase:

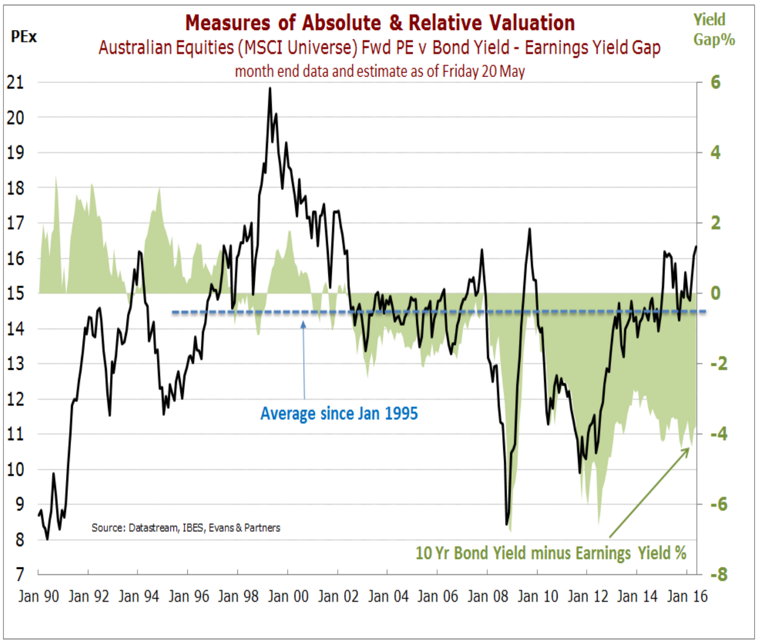
- The US economy continues to improve (as we expect) and inflation progresses towards target (likely in our view);
- markets hold together in the face of Fed-led changing monetary policy expectations (jury is still out for some time on this);
- Britain's EU membership referendum on 23 June is a vote to "stay" (likely in our view); and
- The US Dollar either weakens (unlikely) or does not strengthen strongly enough to do the Fed's work for it (likely).

In these circumstances, another 25 basis point tightening in July is a reasonable prospect, and which would likely advance market expectations for the timing of subsequent rate increases.

The US economy is more than robust enough to take this modest increase to still abnormally low interest rates in its stride. The US Dollar, however, is a potentially important transmission mechanism of US monetary policy change and has already appreciated modestly in recent weeks. Ongoing US Dollar strength would pose downside risks to commodity prices and a number of Emerging Market economies given their elevated corporate debt levels.

## Asset allocation implications and Australian equity market pricing:

From an asset allocation perspective, an environment of potentially higher US interest rates and risks of US Dollar strength with commodity price weakness is more likely than not a negative for Australian equities. (The possibility of further Australian Dollar weakness, however, is a partially offsetting positive). It is also becoming clearer that China's surge in credit growth in the March quarter was not the harbinger of a renewed debt-fuelled revival in growth rates in the "old economy" heavy industries. Both the subsequent China data for April and the apparent indications of official policy intentions signalled in the People's Daily this month are supportive of this view.




Notwithstanding this, Australian equities have become more expensive at the aggregate level. Of course interest rates are ultra-low and supportive of the yield trade. Certainly the RBA Cash Rate cut in May was not widely expected until after the release of the weaker than expected March quarter CPI data. However, relative valuation arguments (versus interest rates) tend to lose their appeal when market volatility re-emerges.

The broader market's twelve month rolling forward PE is back above 16X; only during the valuation bubble in the TMT boom/ dot com bubble (1999-2001) were PE Ratios above this level for an extended period. (See chart left).This leaves little in the way of a valuation buffer if equity risk premiums are re-appraised or earnings expectations continue to be revised lower.

From an asset allocation perspective, the relative valuation argument we find compelling is the comparison of Australian Forward PE Ratios with those of the MSCI World Index on a comparable industry basis. Of the nine GICS industry sectors, Australian stocks are trading at a premium on a twelve month Forward PE Ratio basis in seven of them. Each of these seven industry sectors is also trading at a higher relative PE premium than the average over the past five years. The other two sectors (Energy and Consumer Staples) have their own current peculiarities.


Since the S&P/ASX200 traded at over 5900 in March / April 2015 Australian Bank PE Ratios (and EPS expectations) have adjusted lower for good reasons. Other sectors, however, look historically expensive. In particular, based on consensus EPS estimates, the twelve month rolling Forward PE Ratio of the Industrials ex the Banks, REIT's and Utilities sits at close to 20X (as of 20 May). This is above the 19X level that capped out the market in March / April 2015 and pre GFC.

Resource PE Ratios tend to be more volatile, but the elevated Forward PE Ratios in the Resources Sector still appear to imply excessive optimism re commodity prices. The twelve month Forward PE Ratio of the Metals and Mining sector, for example, is still around a lofty 25X.

As has been Evans and Partners' view for some years now, our preference is for global equities over Australian equities. Too many of our biggest stocks face ongoing structural and cyclical headwinds, the composition of our equity market is less attractive and has become increasingly leveraged to Emerging Markets.

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