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Points of Interest

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Welcome to the latest edition of our quarterly look at Australian and global economic and market developments. In this issue we review the major events of 2015, focusing on developments in China and the United States. We also look back at investment decisions made during the past year – what worked and what didn't. We conclude with a look ahead to 2016 and our view of the prospects for the stock market and the economy.

Executive Summary

- 2015 was dominated by events in China and the United States, though we view the state of the Chinese economy as being of most importance.
- The commencement of interest rate hikes in the United States has the potential to unsettle markets, posing a tricky challenge for the US Fed.
- We expect further volatility in financial markets, largely as a consequence of events in China. Despite this, share market valuations remain attractive, notwithstanding the prospect of further falls.

CHINESE ECONOMY
MARKETS
INTEREST RATE HIKES
VOLATILITY
MARKET VALUATIONS

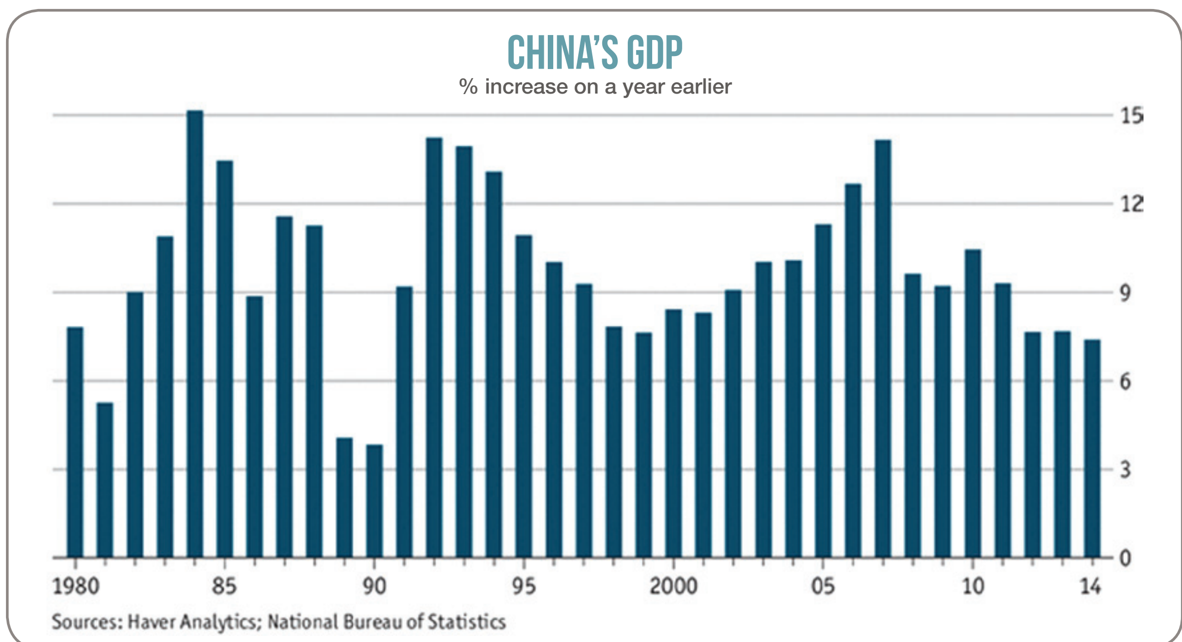
2015 – THE YEAR IN REVIEW

It seems that we say this at the end of every year, but it certainly does seem that the past 12 months were highly eventful, somewhat chaotic and at times even confusing. Investors would be forgiven for wishing for a period of relative peace and quiet over the coming year, as compared to the ups and downs of 2015. In this section we review the major economic and financial events during 2015 and discuss their impact on both the Australian and overseas stock markets.

As is fitting, the past year was dominated by events in the world's two largest economies – the United States and China. Unfortunately, the economic growth paths of these two superpowers were on different tracks, heading in different directions. The US economy continued to recover from the 'Great Recession' it experienced during the 2008 global financial crisis, while the Chinese economy struggled to deal with the end of the construction and investment boom of the past decade. From an Australian perspective, the slowing growth of the Chinese economy was slightly more relevant, given Australia's reliance on Chinese demand for its abundant mineral resources.

CHINA – THE SLOWING DRAGON

While the Chinese economy is still growing at a rate which most countries can only envy (assuming the official statistics can be believed), there are two factors at play within the economy which caused concern (from an Australian perspective) over the past year. Firstly, the rate of economic growth in China, while high on a relative basis, is significantly slower than that experienced for much of the past two decades. Officially GDP growth is around 7% per annum, still high but substantially lower than the rates of growth in the 1990's and 2000's (as shown in the chart below).



This slowdown is to offset some extent by the fact that the Chinese economy is now much larger than it was in 1990 or 1995, however the trend of slowing Chinese economic growth is unmistakeable.

The second factor at play within the Chinese economy, is that the composition of Chinese economic growth is changing. Even as the rate of growth slows, it is also evolving, shifting from a reliance on massive infrastructure and construction investment, to one where households and the services they consume begins to play an increasingly important role. This is a trend which we have highlighted before and one which should be expected to continue. This has obvious implications for Australia and Australian businesses, who have focused on providing the raw materials required to build the roads, highways, bridges and airports which China constructed over the past two decades. We should expect less of this type of economic activity and more demand for services such as education and healthcare. Australia's challenge is to change with China, focusing on providing services to an ever-growing Chinese middle and upper class. While iron ore, copper and coal will still have their place, Australia's future prosperity rests on meeting the needs of Chinese consumers, not builders.

THE CHINESE STOCK MARKET

For all the wrong reasons, the Chinese stock market garnered an even greater level of attention than the state of the Chinese economy. The ending of the Chinese stock market bubble (which likely has even further to run) generated significant volatility across global stock markets during the year and into 2016. The falls during the second half of 2015 were particularly severe, leading to unprecedented government intervention in the market. This ranged from bans on short-selling and instructing the government pension fund to buy shares, to an outright ban on the sale of any shares by major shareholders. Clearly the Chinese authorities' tolerance for free markets can only be taken so far.

From its mid-year peak to the end of 2015, the important Shanghai Index lost over 30% of its value, despite the government intervention. Global markets, including the ASX, have fallen in tandem with the Chinese market, resulting in heavy losses during 2015 and in early 2016. While the falls in the Australian share market are concerning, it is important not to overstate the impact of the volatility we are seeing in the Chinese market.

In that regard we have replicated a table which we presented to those clients who attended our September 2015 Investment Update function, where we discussed the events in China. While the Chinese market crash makes for good headlines, the impact on the broader Chinese economy should not be overemphasised. The Chinese stock market is more akin to a casino than a source of financial capital for Chinese businesses. The role of the Chinese stock market is far less important, from an economic standpoint, as compared to say the ASX or the New York Stock Exchange. Continued volatility and fearful headlines are likely to be generated by the Chinese market over the coming year, but we suggest you pay them little heed. What happens to the Chinese economy over the coming years is going to be far more important to Australian businesses and investors, than the daily ups and downs of the Chinese stock market.

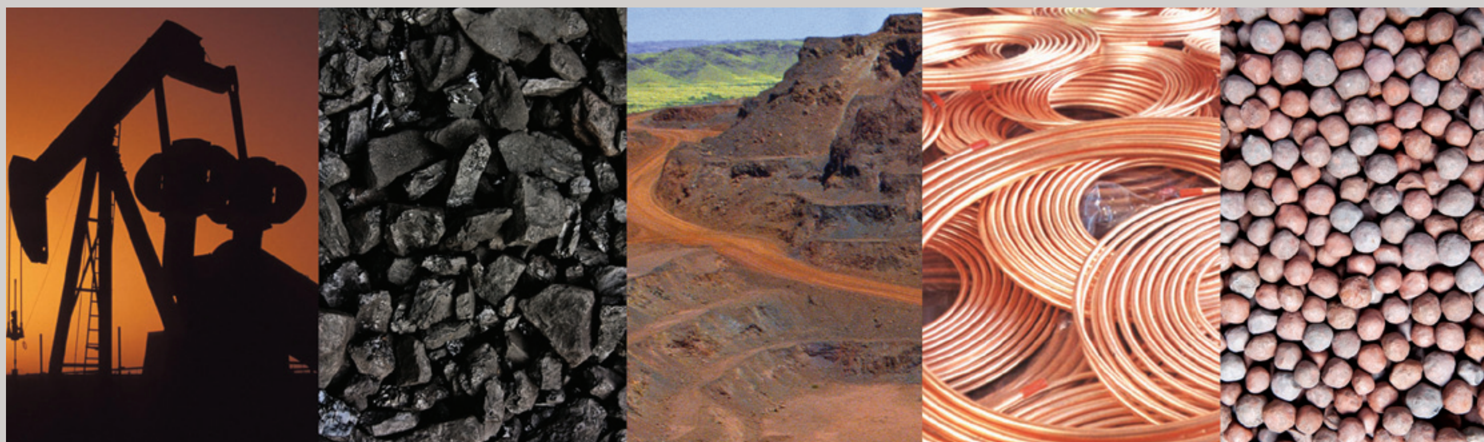
DOES THE CHINESE MARKET MATTER

China's Stock Market	The Australian Stock Market
Retail investors dominate (80% of all trades)	Institutional investors – 41% Foreign investors – 43.2% Retail investors – 14.40%
Questionable accounting practices	Adherence to global accounting standards
Significant level of government interference	No government involvement
Emphasis on speculation, not income	Focus on both growth and dividends
Not an important source of capital	Very important to companies as a source of capital
"Gambling"	"Investing"

THE UNITED STATES – WE HAVE LIFT-OFF

In the US, the long-awaited increase in interest rates finally occurred, with the US Federal Reserve (the 'Fed') increasing interest rates by 0.25% at its December meeting. This follows an unprecedented period of over 7 years of holding interest rates at effectively 0%. In fact, this was the first interest rate increase by the Fed since 2006.

A rise in interest rates in the US is a positive development, signalling that the world's largest economy has reached a sustainable level of growth and the Fed is comfortable enough in the medium term outlook to move the economy off life-support. There are risks however, if interest rates either increase too quickly for the economy to cope or if they increase faster than market expectations. Current market expectations are that rates will only increase slowly from this point, but any sign of a breakout in inflation may compel the Fed to act with more urgency. While inflation is currently under control, the US unemployment rate has fallen to the point where wage pressures may begin to tell. An unexpected rise in interest rates in the US would put downward pressure on bond prices, in addition to placing pressure on developing and emerging economies who would be subject to capital flight back to the US. The US Fed may face the tricky task of containing inflation while minimising any harm caused by an unexpected rise in interest rates.



OIL AND COMMODITIES

The other major development during 2015 and one which had particular bearing on Australia, was the significant fall in the prices of commodities, including oil. Both the oil market and key commodity markets such as iron ore, coal and copper are suffering from a supply/demand imbalance. Shale oil production in the US, coupled with decreased global demand for oil has resulted in the oil price falling close to US$30. It is a similar situation in commodity markets, with increased supply in key commodities coinciding with lower demand from China, who was responsible for much of the increased demand in recent years.

It's important to remember that all commodities, including oil, are subject to cycles. High prices encourage exploration and increased production, which results in increased supply, which results in an excess of supply versus demand, leading to lower prices. Lack of exploration as a result of low prices eventually results in supply falling below the level of demand, pushing up prices and so on. At some point prices for oil and other key commodities are likely to rise, although further falls will test investor patience.

While 2015 certainly had its fair share of destabilising events, ranging from terrorism, wars and natural disasters, to stock market crashes and plunging commodity prices, it is important to remember that nearly every year is like this. Every year comes with crises and emergencies, we tend to just remember the most recent ones with greatest clarity. The year ahead is just as likely to have as many ups and downs as 2015; the best approach is to maintain a robust investment strategy based on preservation of capital and avoiding undue risk.

MEA CULPA

The start of a new year is also an opportunity to look back at investment decisions made over the past 12 months – what we got wrong, what worked, what didn't and what we should have done. Of course, with hindsight it's easy to get every decision right and the purpose of this exercise is not to flagellate oneself for not predicting every significant event in advance; rather, identifying and acknowledging investment mistakes or omissions should be considered part of a robust investment process.

One of the events during 2015 which we underestimated was the extent to which oil prices would fall. For some time we have written and spoken about the significant increase in US oil production on the back of technological advances in drilling techniques. The increased and more efficient exploitation of US shale oil reserves brought about a large increase in oil supply during recent years. It is likely this supply increase could have been absorbed, were it not for a reluctance from OPEC to cut oil production, coupled with lower demand from oil consuming nations such as China. Regardless, the oil price fell further and faster than we expected, impacting oil and gas companies such as Woodside, Origin Energy and Santos. Of course the solution to low oil and gas prices is low oil and gas prices. In time the supply/demand imbalance will be resolved and oil and gas prices (and company share prices) can be expected to recover.

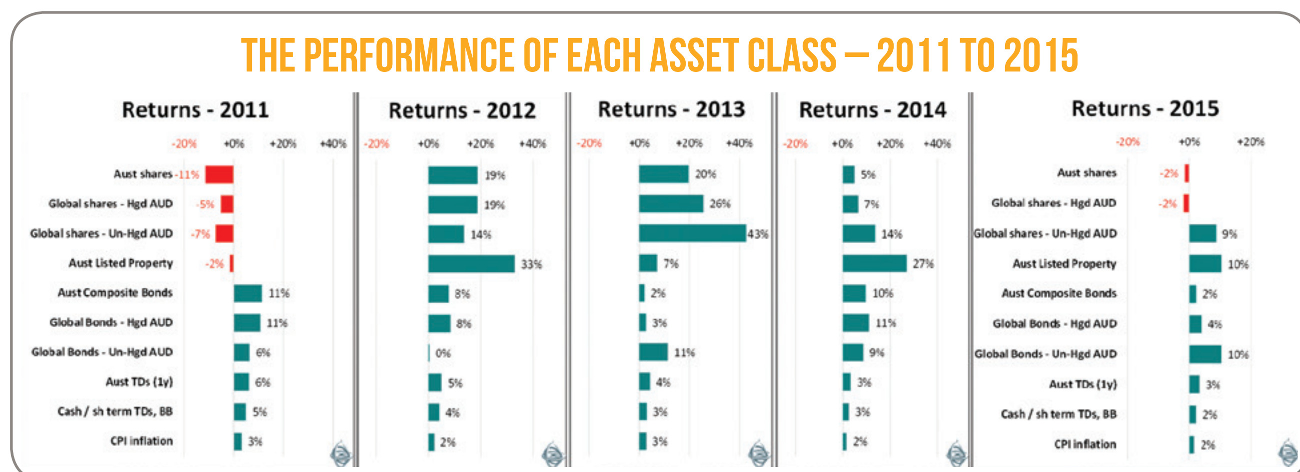
The severity of the slowdown in the mining sector was also somewhat unexpected. While we have, for some time, warned of the eventual end of the so-called 'mining super-cycle', it was still surprising how quickly commodity prices (and miner's profits) collapsed. The relatively low level of dividend payouts by mining companies has always meant we had little or no exposure to the mining sector, and where we did it was restricted to companies such as BHP Billiton or even less frequently, Rio Tinto. These 'best of breed' miners, with world-class assets, strong free cash flow and healthy balance sheets, should have been expected to weather any downturn better than their smaller, more-indebted rivals. As it turned out however, nearly every mining company (and mining service provider) was equally and harshly treated by the share market during 2015. Again, as with oil and gas, the solution for low commodity prices is low prices, and we expect BHP and Rio to use their balance sheets to great effect during the bottom of the mining cycle, when assets become available at fire-sale, once-in-a-generation prices. We're not there yet, but the increasing numbers of smaller mining companies shutting down production and calling in the receivers indicates the bottom of the cycle is not far away.

An unexpected drag on portfolio performance during 2015 came from the listed securities within the fixed-interest asset class. Comprised of securities issued by the major banks and other corporate entities, this sector (also commonly called hybrids) is traditionally less volatile than equities, with the primary investment objective of earning a consistent and attractive income stream. The past year however, saw quite significant falls in the market prices for most of the securities within this sector, with losses of 10% not uncommon. Although these paper losses were to some extent offset by the income received from each security, overall returns were still sharply lower than had been experienced in previous years. The primary cause of this underperformance can be traced to interest rate reductions by the Reserve Bank. Even though interest rates were only cut by 0.50% during the course of 2015, the impact on the market prices of these investments was somewhat larger, undoing much of the outperformance generated by the equity component of client portfolios. As these investments are predominately held for income, and we generally have no intention of selling within the short-term, our approach will be to await the inevitable upswing in the interest rate cycle, at which point valuations can also be expected to return to normal.

Other concerns during 2015 tended to revolve around company-specific issues, where either bad management (Woolworths being a prime candidate) or regulatory changes were to blame (the large banks for example). In those instances we're satisfied that the problems are fixable (Woolworths again) or the market is overestimating the negative impacts (the banks and their requirement to raise additional capital for example).

Fortunately we did avoid a number of the more high-profile company disasters during 2015. This unwanted list of underachievers included Dick Smiths (-100%), Slater and Gordon (-87%), Bradken (-90%) and MMA Offshore Limited (-79%). While we strive to avoid investing in companies who eventually appear on this list, we are conscious that avoiding every bad investment is an impossible task. Shareholders in Dick Smiths and Slater and Gordon would have included some of Australia's largest superannuation funds and most highly-rated fund managers and we do not operate under the misapprehension that we hold special skills or have unique investment insights which they lack. Investment in any form requires taking a risk – our role is to balance the perceived risk and expected return and make investment judgements accordingly – everybody occasionally gets it wrong.

Overall 2015 was a mediocre year in terms of investment returns. As shown in the graphic below, Australian shares managed an annual return of -2% (increasing to less than 4% once dividends are taken into account). Listed property performed well, as well as unhedged global bonds and shares, although much of the total return was due to the fall in the value of the Australian dollar. After the reasonable performance from 2012 to 2014, perhaps some consolidation in investment returns was warranted, as we look forward to the year ahead.



OUTLOOK FOR 2016

In terms of our expectations for the year ahead, we unfortunately expect a continuation of the volatility which has impacted markets since mid-2015. While we view share valuations as being at attractive levels, sentiment and emotions pay little attention to the fundamentals, and further falls are as likely as any share price increases.

With regard to the Australian economy, we expect it to continue to muddle through – not growing particularly fast but most likely avoiding a recession. That's not to say that further interest rate cuts by the RBA should be entirely discounted. The rebalancing of economic growth away from mining and towards the services-based sectors of the economy is proceeding at a far slower pace than is desirable, leaving the economy vulnerable to any external or internal shocks. We also expect commodity prices (including oil and gas) to remain weak through the year, although some improvement is possible. It's not quite the beginning of the end, more the end of the beginning, but at least we're closer to an improvement than a year ago.

Geo-political issues can again be expected to have an impact – the long list includes the refugee issue in Europe, conflict in the Middle East, tensions in the Korean peninsula, arguments over Chinese national boundaries in the South China Sea, Russian aggression and the US Presidential election. Generally however we expect the market impact of many of these issues to be short-lived, barring significant escalation to the point where economies and thus market returns become threatened.

As always, a focus on the fundamental performance of each individual investment underpins our approach. Our preference for companies with healthy balance sheets, strong cash flow, astute management, a history of profitability and a sound business model remains in place. Occasionally even then we are left disappointed by the resulting returns, however this approach has generally served us well since 2003 and we expect it to continue to do so in the future.

BAIOCCHI GRIFFIN
PRIVATE WEALTH

We hope you have enjoyed this edition of our quarterly newsletter. As always, should you have any queries, questions or feedback, please do not hesitate to contact us. We wish all our clients and their families a healthy and happy 2016.

With kind regards,

Justin and Ray

FACTS & FIGURES AT A GLANCE

	Rate / Value	Change from last reading
Australian inflation rate	1.5% (September)	steady
Australian unemployment rate	5.8% (November)	+0.4%
RBA Cash rate	2.00%	steady
ASX 200 Index	5,295	+274 points
Australian $ vs. US $	$0.7306	+0.004c
Australian $ vs. UK £	$0.4929	+0.019c
Australian $ vs. Euro €	$0.6682	+0.025c

This newsletter provides general information only. Before making any financial or investment decisions, we recommend you consult a financial planner to take into account your particular investment objectives, financial situation and individual needs.

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