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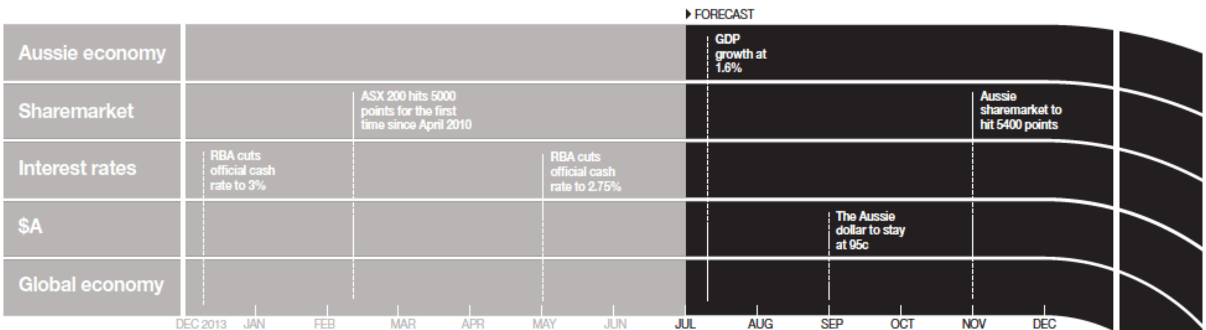

CommSec's Savanth Sebastian, Macquarie Private Wealth's Riccardo Briganti, Perpetual's Matt Sherwood and PrimeValue's Fiona Clark talk to *Smart Investor* about the forces shaping our economy and share their projections for the coming financial year, writes **Zoë Fielding**.

2014

What's the outlook for Australia's economy?

FC: Domestically, we have some considerable concerns that the transition from the mining sector boom did not flow through well enough to the rest of the economy. That two-speed economy should have blended a bit better by now and as the mining sector moderates that, there is a significant risk that the rest of the economy won't lift enough to maintain growth.

SS: It's a multi-speed economy, but up until the election I think businesses won't want to do anything because uncertainty is a big driver for them. The Reserve Bank looks likely to cut rates again. [With] the pull-back in the mining sector, there's a lot of slack that the non-mining sector has to pick up.

MS: We think economic growth in Australia is going to halve in the next 12 months down to around 1.5 per cent. That will be cushioned by the Australian dollar coming off and also by further RBA rate cuts. Confidence is a major drag on the economy at the moment and probably will remain so until after the election.

Then one tends to think the new government will have to make further spending cuts to bring the budget back onto a more sustainable path and that will weigh on markets.

Overall, I think the gains we will see in markets will be just about income.

RB: Our forecast is for 1.6 per cent growth in Australia. It is all due to slowing of mining investment. If you don't get the replacement for that, you're not going to get above that growth. If anything, the risks are that it may even be weaker because mining investment may come off more quickly than expected.

The headline number is pessimistic; having said that, the 3.5 per cent growth we've come from was, in effect, equivalent to what we're going into, because it was so mining-centric. It may look different if you view the official statistics, but it's not going to feel different for a big part of the population and households.

SS: We're seeing the shift to a different type of economy going forward. We're talking about 2 per cent growth for Australia. This time around it's going to be driven by household consumption rather than other sections of the economy. In the March quarter, we've had some of the best retail sales, for instance, for a calendar year since 2007. That was driven by the biggest drop in prices in 13 years, but going forward if we look at household balance sheets, the RBA says they've repaired well, over time.

MS: The biggest challenge for Australia is the state of household balance sheets. I don't think they're in particularly good shape. Net disposable income is around the same level as it was five years ago. Credit growth is modest. That's a challenge for the economy, particularly with rising unemployment.

FC: I don't agree that the consumer has stepped up to take the place of the mining sector, notwithstanding the better data, I think that's a catch-up. Sentiment is still poor. I agree that the deleveraging cycle still has a long way to go. The GFC is still burned deeply into the minds of people I speak to. [The withdrawal from the Australian market of] Ford being splashed on the front pages of newspapers, for consumers, will create a real issue with the focus on the manufacturing sector and how uncompetitive Australia is.

SS: It comes down to confidence. If confidence turned around, there's a different metric for the economy. We talk about the

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Savanth Sebastian
EQUITIES ECONOMIST, COMMSEC

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Matt Sherwood
HEAD OF INVESTMENT MARKET RESEARCH, PERPETUAL

> THE RESERVE BANK SHOULD BE CONGRATULATED BECAUSE WE'RE COMING OUT OF A 150-YEAR PEAK IN MINING INVESTMENT AND ALL OTHER MINING INVESTMENT PEAKS HAVE LED TO A MASSIVE RECESSION AND HIGH INFLATION AND WE DON'T HAVE EITHER OF THOSE.

consumer as being despondent in this environment, not wanting to spend. It's going to take time for that to happen. We look at internal metrics. If you take things like website hits to the mortgage repayment calculator, it's up 20 per cent on a year ago. Fixed rates are falling and the banks will be cutting rates outside RBA policy and at some point, the psychology will change. This is a down the track but the potential is there.

What about local equity markets?

RB: What happens in the US is going to drive what happens in equity markets [here] so we have a relatively optimistic view on what's happening to equities. There is going to be a rotation domestically away from yield plays and probably more into cyclical stocks, those that are leveraged to growth. Interest rates are being cut and the Australian dollar coming down reinforces that move.

FC: We're more positive on the equity market than we are on the economy more generally, because Australia is geographically positioned in a wonderful spot, located close to where all of the global growth is going to come from, but it still has a strong political and education system.

RB: Companies have instituted significant cost savings. We wonder: do you need the same level of sales growth to get earnings growth compared to four years ago? What we have had for the past three or four years is continual downgrades to earnings expectations. Even with more bad news coming out analysts aren't cutting their earnings growth forecasts in general.

MS: The variable in Australia and globally is earnings growth. We've had a large run-up in valuations on the back of central bank policy, yet 17 of the largest 20 markets have had earnings contraction expectations this year. Earnings are only expected to rise in Japan, the US and India. Everyone else is expected to go backwards.

I think we've seen as much valuations expansion as we're going to. Yield sectors are beyond stretched and we're starting to see a pull back. I think it's going to come down to a stock-by-stock basis. The success of investment portfolios may rely on the skill of the fund manager. Quality is key. Balance sheets are key. The question to ask is about the robustness of the balance sheet to generate earnings growth.

What's the outlook for interest rates?

SS: Our view is there will be another 25 percentage points cut around August, just before the election. The value of term deposits in the market outweighs the value of owner-occupied mortgages, so when you're cutting interest rates, you're cutting income to savers rather than interest payments on mortgages, so the impact of rates cuts is muted … so potentially one more cut then the RBA will hold off and let the weaker Aussie do the work for them.

MS: The currency is doing part of the bank's job for it but after that further cuts would be meaningless as they're not going to trigger a leveraged response. There's still some impact there, on the currency, which will have a larger impact on the economy than the cut itself.

We're not expecting the next rate cut until well into the next half.

RB: We've got an outlying view. We think the Reserve Bank is going to cut to 2 per cent by the end of the year and they need to cut because that's what it's going to take to get consumers spending at a level that will avoid

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a recession. Housing finance numbers might be trending up, but there are no signs that they're bubble-like. If anything, the inflation figures say there's further scope to cut.

What are your views on the Australian dollar?

SS: In the short term, between US95¢ and parity seems to be the new trend. A lower Aussie will be beneficial for the export sector and companies that derive an income from overseas, so markets will start to price in further growth in earnings.

FC: We also expect downside, but it's more of a US dollar story than an Australian dollar story. It'll be good for tourism and education. I think it'll also be good for consumer sentiment – it'll certainly be good for the mining companies.

RB: If you're investing in international markets, the currency is a big risk and can provide returns as well. When the $A was strong, US shares in particular were attractive. As the Aussie has come down, the currency pick up from international investing has been reduced and investors who invested into US stocks 12 months ago might want to think about locking in some of those gains, start thinking about hedging the currency.

MS: The Australian currency has moved from the top of its three-year trading band to the bottom. That's been between US95¢ and $US1.05 since early 2010. Of the traditional drivers of the currency, none are supporting it at the moment. Commodity prices have come off, capital flows are slowing down, the RBA is cutting rates and the mining investment boom is over. Therefore you would expect the currency to be coming off. We expect the $A to drift lower for the rest of the year. We have a target for the end of the year of US95¢. If the US economy starts to improve we'd expect to see a more significant pick-up.

SS: Foreigners own 49 per cent of our market. A lot of these guys who looked at Australia as being attractive since the mining boom will look to repatriate funds to the US given their capital and currency growth.

If there's volatility in the currency I think it's going to cause an outflow of funds from Australia. From a long-term perspective, it's a buying opportunity.

I think with the lower currency more merger and acquisition activity will start to take place, more in the agricultural space.

Fiona Clark
SENIOR INVESTMENT ANALYST, PRIMEVALUE

"THERE'S A TRANSITION IN THE CHINESE ECONOMY FROM CONSTRUCTION TO THE CONSUMER, AND AS AUSTRALIAN EQUITY FUND MANAGERS WE'RE TRYING TO IDENTIFY HOW TO TAKE ADVANTAGE OF THAT. WE'RE NOT BULLISH ABOUT CHINA, BUT WE'RE CAUTIOUSLY OPTIMISTIC."

Turning to the rest of the world, what's the outlook for the US?

RB: Our high level economic view is that there's a dislocation between what's happening in the US and what's happening in Australia. We're at different points in the cycle.

The risks to Australian growth are greater than the risks to US growth.

SS: We think the US economy is in a pretty healthy, robust recovery, really driven by the turn around in housing. That's going to ensure jobs growth continues to be a key driver. Our view is that [the US Fed] will hold the asset purchase program going until they're comfortable about the recovery and it's a matter of now getting the market ready for the eventual pull back.

MS: What's holding growth down is the state of global balance sheets. In many ways the debt problems that were amplified during the GFC haven't been resolved, they've just been delayed through the quantitative easing process. US growth for the next year is going to remain at around 2 per cent. It's the weakest recovery in

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Riccardo Briganti
HEAD OF RESEARCH,
MACQUARIE PRIVATE WEALTH

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history and that is because recoveries after balance sheet recessions are always subdued.

What's the outlook for Europe?

MS: Europe's issues still haven't been resolved. We're expecting an entire year of negative growth and whilst the rate of contraction will lessen in the 2014 financial year, it's still going to be there. Europe remains the key risk for the entire global economy given the state of corporate balance sheets, banking systems and loan quality, as well as high government debt. That can turn into a lethal cocktail if people lose confidence with the central banks.

SS: With the European Central Bank stepping in last year as a lender of last resort, that's the reason Greece has been able to be upgraded, because it can borrow at cheaper rates; but in terms of the economies, they're in recession territory over the coming years. If anything, France will go back into recession and Germany is just barely hanging on. You can't really rely on them to be the world's growth story.

RB: I've got a more optimistic view on the impact that [Europe in recession] has on the world. The risks in Europe are well known.

We've had what I would say are very risky developments – like events in Cyprus, which goes to the stability of the European banking sector and the security of funds in the banks. But the financial impact of Cyprus was minimal. Was it because we underestimated the impact? Or was it that we now see that even if there's a serious sovereign risk in Europe, we no longer think it will become a global financial stability problem? My view is that as soon as you break the nexus between a sovereign problem and global financial stability, the European problems have a different dimension.

Outlook for China?

SS: They've got inflation under control and it should be remembered the slowdown in China was self-induced to start with. I don't think they expected the collapse in Europe and that has had a huge impact. China is, to some degree, happy they can pick up commodities at cheap prices.

Overall we're relatively upbeat on China. Growth is around 7.5 to 8 per cent, but over the medium term there are concerns that can provide shocks to the market. That can also provide a buying opportunity when markets get too high.

FC: China plays a strong role in our portfolio construction. Overall we're positive on the market, but for some time China has been three steps forward, two steps back. Having said that, authorities there have managed the economy positively. The market is preoccupied by the rate of growth rather than the fact that the economy is growing at a rapid speed and that 6 to 7 per cent now is great, even though it was growing at 10 per cent a few years ago.

RB: There's only one big story that I can see [in China] and that's the move from investment to consumption. Whether growth is 5 per cent or 12 per cent, it doesn't matter if there's a shift to consumption, because resource companies aren't going to benefit from that growth.

We've always thought of China as a purchaser of our resources, but the danger in that thinking is that when the PMI figures start trending up again, investors start thinking they should get back into resource stocks but you should be looking at the trend. ■

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