The winds of change

1 June, 2015 Janine Mace 0 comments

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With China slowing and demand for our resources falling away as the commodities super cycle fades, the outlook for the Australian share market is pretty bleak - or so we're told.

Although this scenario makes a lot of sense after years of resources-driven rises, it is one that investment commentators believe does not convey the true outlook for local shares.

Andrew Lill

Stuart Rae, Alliance Bernstein's Asia ex-Japan Value Equities chief investment officer, thinks focusing on China's slowing economy is looking at only part of the picture when it comes to local shares.

"I think people should be careful about just automatically linking the slowing down of Chinese GDP growth and therefore the impact on the mining or the resources sector in Australia with a negative outlook for the China market. That would be naïve, in our view," he says.

"In fact, the slowdown in GDP is being connected with significant reforms in the Chinese economy, a rebalancing towards the consumer, an anti-corruption drive and the reform of state-owned enterprises, all of which is actually very positive to the outlook in the medium-term for China."

Andrew Lill, chief investment officer of Ibbotson Associates, agrees the situation is far more complex, arguing local share investors have already endured most of the necessary pain as the market adjusts to the new environment.

"The Australian equity market has been discounting for the slowing of China for 18 months, so when the numbers are in line with expectations, there will be no change in the Australian market," he says.

This discounting explains much of the local market's recent performance. "The impact has been factored in since the start of 2014 and we saw this in the Australian market's performance last year, which was worse than other equity markets," Lill says.

Despite these positive views, Brian Parker, NAB Asset Management's head of portfolio specialists group, still has concerns about the implications for client portfolios. "China is an important reason to be cautious about having too much Australian equity market exposure," he says.

"Australia is in a vulnerable position, as we are basically tied to the performance of the Chinese steel industry. Many countries are heavily exposed to China, but really we are not just tied to China, but to the performance of one industry, and that's steel."

Roy Maslen, Alliance Bernstein's Australian equities chief investment officer, agrees the ripples caused by China slowing and rebalancing its economy will be felt for some time to come. "After 10 years of a commodity price boom, we think we are potentially less than two years into a normalisation period, which is likely to continue, albeit with some volatility, over the coming years."

However, he argues the impact will be narrowly focused on the resources sector, rather than right across the local market. "In broad terms, when you think of resources, you have to be very selective

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Cautious but confident

Leanne Pan, joint chief investment officer of Prime Value Asset Management, is another who believes the fading China boom does not spell trouble for Australian equities. Her concerns are more about the gradual withdrawal of stimulus measures.

"A lot of the positive sentiment about equities is due to the liquidity factor and that is a global phenomenon. Quantitative easing is a macro factor and it is lifting all boats, so investors need to be mindful of that," she warns.

The wave of global liquidity helped lift the Australian market (S&P/ASX300) to a strong 10.31 per cent return in the March quarter and some commentators are now questioning whether local shares are too expensive.

Dalton Nicol Reid director, Jamie Nicol, has mixed views: "Certainly, the PE of the market at 16.3 per cent is looking high by recent historic standards. However, the dilemma for the market is that it has rarely looked cheaper relative to the current low bond yields and interest rates."

Despite the high prices, Nicol believes the Australian market offers interesting opportunities in growth, domestic consumer and even China exposed stocks, due to recent reforms and the loosening of Chinese bank reserve requirements. "We could see improved conditions later in the year in China, which is likely to support those companies exposed to China. This includes some of the resources companies, as well as tourism and education exposed companies."

Pan agrees some China exposed companies have good prospects. "With China growth it is not just about resources, as there is major growth occurring in the middle classes and this is creating new demand for services and soft commodities like milk powder."

She believes services companies could also benefit, such as firms operating in the wealth management area and those providing supporting services and platforms. There will also be growing demand for telecommunications and IT services.

"It is important to remember there are other opportunities outside resources. There are many interesting prospects if you look at the share market as a whole," Pan says.

Change is constant

The sharp decline in resource company valuations has already changed the composition of the Australian share index.

"Currently, the biggest sectors are financials and real estate. There are new opportunities appearing in the market from initial public offerings, such as Medibank, and also in the aged care sector. The market itself is changing as industries come and go," Pan says.

Maslen thinks these shifts are creating opportunities. "Although we believe the growth in the non-mining economy is going to take some time to come through, ultimately that growth will be positive for a number of sectors, such as non-residential construction - we are already seeing a strong housing market - and transport and even consumer."

Lill believes planners should be seeking to identify the trends that will drive future growth for Australian companies, rather than looking backwards at the fading resources boom.

"Always look to the future. You need to consider that Australia has not had a recession for 24 years and we are probably at the inflexion point for the mining boom, making it harder to get a tail wind for the economy. So you need to look at where the potential profits will come from in the future," he says.

This means considering themes like the rising cost of capital when the US and UK central banks begin increasing interest rates, lower oil prices and new sources of demand for local exports, as the Australian currency continues to slide. "Companies that will do well are those with exposure to the US economy, such as healthcare or biotech, or those servicing the building sector in the US," Lill says.

"You need to think about the cycle and where Australia and the market will be in 2018. You need to think about future profits."

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He also believes that another key driver of the local market will be India. "The slowdown in China is important, but the question is how much will India take up the slack from China. India is likely to be the next source of global demand, but it needs LNG gas and coal - not iron ore - so it should be those companies that do well, rather than iron ore miners."

Franking remains in favour

One factor continuing to support a heavy weighting to local equities is their tax advantages, with benefits like franking credits playing a key role in many client portfolios. However, planners may need to assess whether this benefit outweighs the risks after the market's strong run in the first part of the year.

"Franking credits are an important consideration for clients and influence people's natural bias towards Australian equities," Pan says.

"It is important to remember Australian equities give you an imputation credit that can add up to a 1.5 per cent return annually."

Lill believes in the current environment a fondness for franking may be a dangerous motivation.

"Franking credits are an important input, but they are not the only input. There comes a time when they become too expensive and I think that time is now," he warns.

"Although tax efficiency benefits are useful, if they are the only reason you are investing in a company then that is a dangerous approach. This is the reason the banks and Telstra have gone so well and their valuations now look very strong."

Re-weighting to take advantage

Investment managers have been quick to act on the implications of a slowing China and fading resources boom, with most reporting they began re-weighting their portfolios several years ago.

"We've been cautious of resources for some time, in large part benefiting from our Hong Kong-based research team," says Alliance Bernstein's Australian equities chief investment officer, Roy Maslen.

Ibbotson Associates has also been circumspect about the local market, says its chief investment officer, Andrew Lill.

"We look for high quality earnings companies and those that appear cheap relative to other opportunities. We have been underweight the Australian dollar and Australian equities for three years."

In 2011, the firm looked at commodity cycles over time and decided resource companies were no longer the place to be. "We have been benefiting from that view and been heavily invested in the REIT sector since then," he explains.

The China story is also well in the past for Prime Value Asset Management. "In early 2000, China was one of our big thematics in the portfolio, with our allocation around 40-50 per cent to mining services companies. Now, it is nowhere near that level - maybe around 10 per cent," says Prime Value Asset Management joint chief investment officer, Leanne Pan.

"Some mining services companies are good operators and we still like them, but we are very mindful of the overall thematics as well."

To read about what David Kennedy CFP thinks about the outlook for Australian equities, click on the following link: ***Ask the planner***

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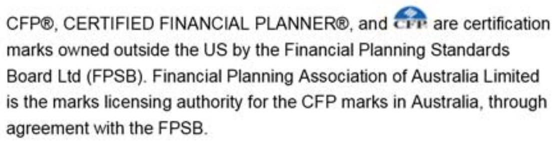

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