UniSuper

September 2015

Investment market update

"This imaginary person out there—Mr Market—he's kind of a 'drunken psycho'. Some days he gets very enthused, some days he gets very depressed. And when he gets really enthused, you sell to him and if he gets depressed you buy from him."

- Warren Buffet

This month's update focuses on "Mr. Market".

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	-7.7	-3.7	-3.2	10.9	7.9
US Shares (S&P 500) in US Dollars	-6.0	-4.1	0.5	14.3	15.9
US Shares (S&P 500) in Australian Dollars	-2.6	4.0	32.6	29.6	21.3
Asian Shares (MSCI Asia)	-8.5	-13.3	-11.3	2.8	1.7
Australian Dollar (AUD/USD)	-3.5	-7.8	-24.2	-11.8	-4.4
Australian Fixed Interest (BBG AUB Composite)	0.6	1.9	6.3	5.1	6.4
Cash (BBG AUB Bank Bill)	0.2	0.4	2.5	2.8	3.5
Balanced option*	**-3.3**	**-0.2**	**7.8**	**12.3**	**9.7**

Returns are for periods to 31 August 2015. Past performance is not an indication of future performance.

* *Returns relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.*

See performance information for all options

The horrible month of August

You may have seen our recent *'A perfect storm causes crash in markets'* article. It would be nice to report that August had a happy ending, or that September is off to a good start, however this isn't the case. The performance of the Australian market (-7.7%) was the worst monthly performance since the GFC.

At time of writing all major stock markets were sharply off their recent highs as the following table shows.

Extent of decline from recent high to low

MARKET	% DECLINE
USA	-12.4%
Europe	-19.7%
Asia (ex-Japan)	-27.1%
Japan	-14.7%
China	-43.3%
Australia	-16.3%

The August article referred to four key factors driving the recent market crash, being fully valued markets, the impending rate rise in the US, fears of a Chinese slowdown and collapsing commodity prices.

We'd now like to expand on this, with particular references to Australia and the Asian region which fared worse than most major markets.

Australian reporting season

Over the course of August most of Australia's major companies reported their full financial year results which didn't make for pleasant reading. Of the 143 companies that reported, revenues edged up 0.4%, while expenses grew 3.1%, resulting in a 31.9% fall in net profit. The lacklustre outcome was heavily influenced by plummeting profits in the resources sector (down -48%).

In this context and given that the share market is fundamentally a barometer of profit expectations, it's unsurprising that we're experiencing some weakness.

Major banks adding to woes

On top of being engulfed in the same storm as the rest of the world, Australian investors also had to endure the additional impact of ANZ and Commonwealth Bank (CBA) announcing substantial capital raisings.

In response to higher capital requirements enforced by the Australian Prudential Regulation Authority (APRA), the two banks announced plans to raise a total of $8 billion. Capital raising of this nature involves creating and selling new shares, and in this instance the volume involved is a large bite for the Australian market. Furthermore, the new shares were offered at steep discounts to their prevailing market prices. Accordingly, together with bank shares being sold, shares of other companies were also sold as investors raised funds to take up their discounted entitlements.

At time of writing, the Australian major bank share prices were on average 22% below the levels they reached in March. The dramatic fall in price now sees dividend yields ranging from 8.3% (CBA) to 9.5% (ANZ) if we include the full benefit of franking. Historically, these levels have provided strong valuation support and barring a severe recession, yields at these levels are likely to provide support again.

Is there light at the end of the tunnel?

In times of extreme market stress, a negative inference tends to be applied to all news. Behavioural finance has taught us that the fear of losing a sum of money is much higher than the satisfaction of making the equivalent amount. Indeed, following historical patterns, UniSuper members actively switching investment options has recently spiked as members seek the safety of defensive options. However, just as markets don't rise forever, neither do they fall forever. While things could get worse before they get better, it's important to remember the business cycle never dies. The typical circuit breaker for plummeting markets is reassurances from central bankers and potential injections of liquidity. However, with interest rates already so low (in many cases zero), we have to look elsewhere for possible relief. A few possibilities come to mind.

(i) Valuation support

In all crashes, share prices will ultimately hit a point where they represent great value even given a pessimistic outlook for the economy. Whether or not we're currently at the point time will tell, although to get an idea of just how far valuations have fallen consider the Asian market. The following graph plots the "P/B" of the combined Asian markets excluding Japan. P/B is a metric that compares the price per share (P) to the book value per share (B) of a company.

Asia ex-Japan price-to-book

Source: MSCI; Credit Suisse

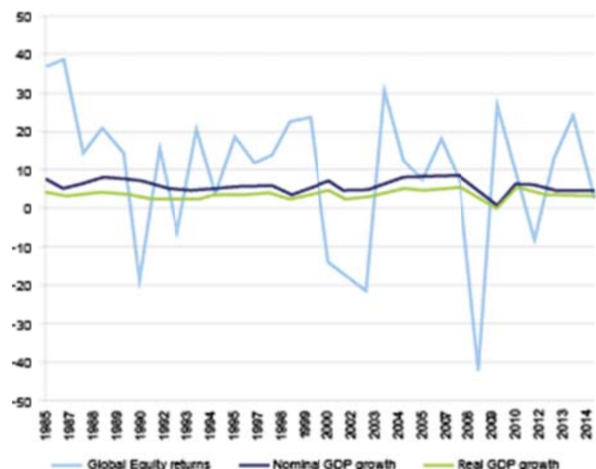
Past performance is not an indication of future performance.

Valuations in Asia are now around the levels we saw during the tech crash at the turn of the century and the GFC. Furthermore, they're not that much higher than we saw during the Asian crisis in the late 90's, when many Asian countries were on the brink of bankruptcy due to excessive leverage and low reserves. While a couple of Asian countries still appear vulnerable (Indonesia in particular), the rest of the region is in much stronger shape than it was during the crisis. Note the question mark we've used to label the current downturn in the graph above. Unlike other crisis situations, it's difficult to pinpoint the nature or epicentre of the current crash. Is it due to the impending USA rate tightening, or Chinese slowdown, collapsing commodity prices, or a combination? Maybe we just label it 'the perfect storm'.

(ii) The disconnect between the stock market and the real economy

When Warren Buffet describes the market as "kind of a drunken psycho" he is referring to the market's propensity to exaggerate what is happening in the real economy (and company earnings). As the following graph shows, Mr Market frequently oscillates between extreme pessimism and euphoria, whereas economic growth is a lot more stable.

Stock market movements vs. global growth



Source: IMF and MSCI

Past performance is not an indication of future performance.

As mentioned in a previous update, the market is often pricing in a best and worst case scenario, when in reality either scenario rarely happens. That global recessions are very rare shouldn't come as a major surprise. In an uncertain world we can be pretty sure that over the next 24 hours the sun will rise in every part of the world. In that period about seven billion people will be eating, drinking, and seeking shelter and clothing. More people will be attempting to join the global workforce than ever before. Of course some will be more successful than others in these endeavours and many will be consuming far above their basic needs. However, no matter how rich or poor, it's a fair bet that everyone will hope that tomorrow is better than today and will endeavour to fulfil such hope. And that's basically why global recessions are extremely rare.

(iii) China

The epicentre of current concerns is the Chinese economy and the doomsayers appear to have plenty of supporting evidence. Or do they?

While news from China hasn't been great, it's possible that a negative interpretation is being applied to *all* news from the country, when the reality isn't so dire. Another human foible that we've learnt from behavioural finance is 'confirmation bias'. That is, human nature is to accept information that confirms a pre-conceived bias, while dismissing other information. Hence while it is indisputable that the Chinese economy is slowing, it's the second largest economy in the world and still growing at a rate well in excess of any other major economy. While it's true that Chinese manufacturing is contracting, their service industries are still booming (in a country that is consciously attempting to rebalance from investment to consumption). Much has been said of the negative impact on the economy of the 40% decline in the stock market, yet very few expected the preceding 145% rise in the stock market to boost the economy. The 2.5% devaluation of the Yuan was widely interpreted as the start of a new currency war, precipitating the onset of deflation. Yet freely floating currencies fall by over 2% on a frequent basis and it normally passes without much mention.

The performance of the Chinese economy will of course have great significance for Australia and our share market. If China can engineer a growth rate of around 6-7%, it is highly likely that Australia can avoid a severe recession. This is important when considering market implications.

When the ASX300 hit 4,950 on 24 August the market was down 16.3% from its recent high. Strategists from Deutsche Bank[1] pointed out that over the past 55 years there have been 13 episodes when the market has declined by 15% or more over a six-month period.

In the six-month periods following such declines, the market has been flat on average. However, on all but one occasion when the market correction was not followed by a recession, the market has risen by an average of 10%.

Well, what's next?

So using history as a guide, the outlook appears binary. If Australia manages to avoid a recession then stocks appear to offer good value, but the converse also applies. At the time of writing, the Reserve Bank (RBA) just announced that "moderate expansion in the economy continues". The RBA kept interest rates unchanged at 2% and reiterated that monetary policy will remain accommodative. The RBA's reluctance to follow other central banks in a more aggressive cutting of rates seems to indicate that they are reasonably sanguine about Australia's ability to avoid a recession, while enduring a period of sub-trend growth. Let's hope they're right.

This is not intended to be an endorsement of any of the listed securities named above for inclusion in personal portfolios. The above material reflects UniSuper's view at a particular point in time having regard to factors specific to UniSuper and its overall investment objectives and strategies.

Past performance is not an indicator of future performance. This information is of a general nature only and may include general advice. It has been prepared without taking into account your individual objectives, financial situation or needs. UniSuper's investment strategies will not necessarily be appropriate for other investors. Before making any decision in relation to your UniSuper membership, you should consider your personal circumstances, the relevant product disclosure statement for your membership category and whether to consult a licensed financial adviser. This information is current as at 7 September 2015.

[1] Deutsche Bank strategy update, 28 August 2015