INVESTMENT MANAGEMENT

MACQUARIE

July 2014 Investment Outlook

Half year update

It's been six months since we looked at the outlook for markets as part of our January 2014 Investment Outlook. As the second half of the year gets underway we've taken the opportunity to look back over the last 12 months and offer our views on the investment outlook for the rest of 2014 and into 2015.

1 Economic Review

Richard Gibbs, Head of Economics, discusses the gradual recovery in developed economies and the expectation of continued pro-growth strategies from the major central banks.

2 Australian and Global Fixed Income

Brett Lewthwaite, Head of Fixed Income and Currency, takes us through the strong performance in fixed income markets and how speculation around the impact of central banks' policies will be a key driver of global bond markets.

3 Australian Equities

Patrick Hodgens, Head of Equities, looks at the key drivers of performance in the Australian equity market and how all eyes will be on earnings in 2014.

4 Global Equities including Emerging Markets

Roy Leckie and Charlie Macquaker from Walter Scott examine the uncertainty in global markets and the current state of valuations in equity markets.

5 Asian Equities

Macquarie Asian News Stars Portfolio Manager Sam Le Cornu, takes us on a tour of Asian markets and looks at the opportunities in China.

6 Infrastructure Securities

Jon Ong, Portfolio Manager, discusses why infrastructure securities have performed well over the last 12 months as well as offering some insights into the year ahead.

RICHARD GIBBS | HEAD OF ECONOMICS

ECONOMIC REVIEW

2013/14

Gradual recovery but strength of the global business cycle remains disappointing by historical standards.

2014/15

Pro growth stance from majority of central banks expected to continue and US Federal Reserve will again be the centre of attention following the expected conclusion of quantitative easing.

How did the global economy perform over the last 12 months and what were the key drivers?

Over the last 12 months global macro conditions have been characterised by the ongoing but gradual recovery in the key developed economies and increasingly volatile activity in many emerging economies. The strength of the global business cycle has remained disappointing by historical standards, and has seen the maintenance of very low inflation and interest rates. Against this backdrop, financial markets have been surprisingly buoyant even in the face of steadily increasing geopolitical risks.

The US economy was severely affected by harsh winter weather in late 2013/early 2014, resulting in a large contraction in GDP growth during March quarter which is still causing some unevenness in the pattern of economic activity.

In Europe, persistently low inflation provoked concerns about the risks of a deflationary spiral and prompted the European Central Bank to redouble its monetary stimulus efforts. In contrast, the UK economy was propelled to stronger GDP growth by a robust recovery in house prices and associated increases in consumer spending.

The Australian economy continued its transition from mining investment driven activity to non-mining investment. But consumer and business confidence remained at low levels, in part due to concerns about the implementation of the Australian government's FY15 Budget measure.

In Asia, the majority of the past year has witnessed the emergence of more volatile and punctuated economic cycles, notably in China and India as these key economies grapple with structural reform agendas. Japan's economy also faces similar structural reform issues with the previous strong growth momentum also challenged by the effects of the 1 April hike in the consumption tax.

What do you think the drivers of global economic performance will be over the next 12 months?

We anticipate a further gradual uplift in the momentum of global growth in 2014-15, supported by still favourable financial conditions as the major central banks remain focused on pro-growth policy. The drag on growth from fiscal tightening in the developed economies is expected to recede, while household income growth should improve as labour market conditions stabilise and recover. We expect global GDP growth to pick up to 3.8% in 2014-15, compared to 3.5% in 2013-14.

The US Federal Reserve will again play a pivotal role in shaping global macro conditions as the central bank concludes the current winding down of its 'quantitative easing' bond purchase program, expected in September/October. Speculation will then shift to the timing of the first hike in the key Fed funds rate and the impact of this policy shift on global capital flows, notably to emerging economies. In contrast, central banks in Europe and Japan are expected to maintain their focus on reflationary policies as they work to overcome still large negative output gaps.

A further escalation of geopolitical risk cannot be ruled out in the event of a broadening of the current Iraqi/Syria and Russia/Ukraine conflicts and an associated spike in global energy prices. In this event, we expect these risks to have a greater impact on growth, rather than fuelling an inflationary surge; and as such would likely provoke central banks to sustain their current supportive monetary policy settings.

BRETT LEWTHWAITE | HEAD OF FIXED INCOME & CURRENCY

AUSTRALIAN AND GLOBAL FIXED INCOME

2013/14

Strong performance from fixed income markets driven by investor confidence.

2014/15

We expect interest rates to stay low for a prolonged period and central bank policies will be a key driver of markets.

How did Australian & global fixed income perform over the last 12 months and what were the key drivers?

The main theme in financial markets continues to be the unprecedented central bank support, which has seen interest rates lingering around zero in major developed economies and significant quantitative easing programmes in the US and Japan. Over the last 12 months, the US Federal Reserve has reduced its asset purchase program, though the impact of this has been somewhat offset by the loosening of monetary policy in Europe. These exceptional policies have bolstered investor confidence and driven strong performance in fixed income markets. In contrast to strong financial asset performance, the pace of global economic growth improvement remains subdued and global indebtedness remains high.

Global credit markets were well supported this financial year as low default levels, improved company fundamentals and the quantitative easing induced a 'chase for yield' mentality underpinning performance in all sectors, with Financials performing particularly well. Government bond markets traded within a volatile range over the last 12 months, with US 10 year yields moving from 2.5% to 3% and back to 2.5%. Recently however, there has been a significant drop in volatility, with markets trading in tighter ranges across all asset classes and consequently investors have focused on carry trade strategies.

Activity from the major central banks, including tapering by the US Federal Reserve and further monetary stimulus from the European Central Bank, has driven domestic bond markets. The Reserve Bank of Australia (RBA) cut rates to the historic low of 2.5% in August 2013. More recently, a lower volume of domestic issuance in credit markets compared to previous years has provided support, given the healthy demand from both local and offshore buyers.

What do you think the drivers of Australian & global fixed income will be over the next 12 months?

The outlook for the investment grade credit market is generally positive, as corporate balance sheets remain strong and default rates are likely to remain low. However, spreads have tightened considerably over the last several years, meaning performance in recent periods is unlikely to be repeated and returns will increasingly be driven by sector and single name selection. In addition, concerns remain around liquidity, as current low dealer inventory levels mean a sell-off may be sudden and pronounced.

Volatility measures across asset classes remain very low, potentially driving complacency amongst investors, and there is increasing uncertainty surrounding the effects of central bank policies. The European Central Bank has just announced a negative deposit rate and preparatory work for potential quantitative easing policies. It remains unclear as to whether central banks will be able to withdraw these extreme levels of liquidity from markets, let alone increase interest rates which we expect will be the next focus for markets.

In regard to global bond markets, we expect high sovereign indebtedness and sub-par economic activity, observed in many countries, to keep interest rates low for a prolonged period. In this low yield environment, speculation as to the potential impact of central banks' policy will continue to be a key driver of global bond markets. Domestically, the RBA continues to hold the cash rate at historic lows with a neutral bias and continued reference to stability in interest rates. We expect offshore events to continue to lead the domestic market.

PATRICK HODGENS | HEAD OF AUSTRIALIAN EQUITIES

AUSTRALIAN EQUITIES

2013/14

Strong equity market returns for the year to June 2014, driven by low interest rates and reasonable reporting seasons.

2014/15

The coming year is likely to be slightly more subdued for the Australian equity market as a whole, although we expect good opportunities for stock pickers.

How did Australian equities perform over the last 12 months and what were the key drivers?

The S&P/ASX200 accumulation index returned a stellar 17.4% for the year to June 2014. Low volatility, low interest rates, coupled with two reasonable reporting periods drove returns over the twelve months. The US market (as measured by the S&P 500) actually did a touch better, being up over 22% over the same period. The major reason for this was the Australian markets higher weighting to the Mining sector.

In Australia, sectors that did well included Banks which continued their strong performance, up 22%, Technology up over 19% and Energy up over 18%. Sectors that struggled included, Consumer Discretionary down 2%, Resources down 1% and Healthcare also down 1%.

Some of the best performing stocks for the period included Fairfax Media up 89%, Henderson Group up 81% and Seek Limited up 75%. Worst performers were generally found in the small/mid caps environment with the main underperformers the mining and mining services names.

Over the year the market was buoyed by increasing business confidence. Employment levels improved and consumer confidence was strong up until the May 2014 budget. The local market also benefited from the gradual improvement in key international markets. The US growth and unemployment numbers all improved over the year to June. In China, despite fears, GDP growth remained reasonably steady and Japanese and European markets bounced strongly off their lows. Reporting seasons were also broadly positive, with reasonable earnings growth – although it's worth noting that the majority of this growth was due to improved cost efficiencies as top line growth was somewhat sluggish.

At a corporate level positive momentum continued with over $10bn of new issuance (IPOs) and over $17bn of mergers and takeovers completed over the 12 months.

What do you think the drivers of Australian equities performance will be over the next 12 months?

We believe the upcoming results season will effectively "set the scene" for the next 12 months returns. In general we are expecting approximately 10% earnings growth, predominantly from a strong reversal of resource earnings plus continued growth in non domestic industrials. The key will be an improvement in sustainable revenue. As mentioned, revenue growth has been positive but generally lacklustre in most segments of the Australian market for a year or two now. Many investors (and the market) are expecting a reasonable uptick in revenue in coming results seasons.

Over the next 12 months, we expect globally exposed businesses, particularly ones with growing revenue and strong positions within their selected industries to offer attractive returns. At a sector level, the non resource materials sector should benefit from slowly improving global growth. Energy stocks are expected to continue to do well as the supply/demand mechanics within oil markets look favourable. We also like industrials with global exposure - but we do expect that purely Australian based industrials may struggle over the next 12 months due to the weakening economy and increased competition. Finally, we believe Banks will continue to perform at or above the market, as long as unemployment does not spike up and the housing market remains buoyant.

We expect the IPO market to continue to be very strong for at least another 12 months with the possibility that we could see another $10bn of new listings over the coming year. Mergers and takeovers are also likely to increase as relatively cheap debt and strong balance sheets will motivate company management to expand their business via acquisitions.

ROY LECKIE AND CHARLIE MACQUAKER | DIRECTORS, WALTER SCOTT

GLOBAL EQUITIES INCLUDING EMERGING MARKETS

2013/14

Bullishness abounded as investors searched for yield and the economies of the US and UK, in particular, continued to show signs of a recovery.

2014/15

Sentiment, which is inherently short-term, remains positive, yet a pause for breath sometime soon seems possible.

How did Global Equities perform over the last 12 months and what were the key drivers?

In the aftermath of the "Great Financial Crisis", central bankers began the "Great Financial Experiment" - quantitative easing on an unprecedented scale. The effect of this monetary policy on equity markets cannot be overstated. Bullishness has abounded as investors search for yield and the economies of the US and UK, in particular, continue to show signs of a recovery. At the same time, there are positive signs of corporate confidence with investment becoming evident and acquisitions now very much back on the corporate agenda.

It is also a time to exercise caution. This is particularly true in Europe, where growth continues to be stagnant and there is little evidence to suggest that equity valuations are supported by growing corporate profits. At some point the weak manufacturing data across the euro zone, which has even reached into Germany, must weigh on profitability.

That there are uncertainties in the world is a constant yet they do seem particularly pronounced at present. Economically, things may be much more encouraging and there has been a definite change in tone in our dialogue with company management. In the geopolitical sphere, beyond the strict confines of the financial world, risk cannot be ignored – whether it be the situations in Russia-Ukraine, China-Japan, China-Vietnam, Iraq or the Middle East.

The team does not attempt to gauge the next step of the central bank chess game, or the geopolitical quagmire that appears upon us, instead efforts must centre on diligent research and debate. Despite the chaos and uncertainty that surrounds us, on the basis of those endeavours with a long-term outlook, the team at Walter Scott remains optimistic.

What do you think the drivers of Global Equity performance will be in 2014?

Sentiment, which is inherently short-term, remains positive, yet it would seem reasonable that we are due a pause for breath sometime soon. Markets have moved up virtually in a straight line since 2012, with market participants apparently shrugging off (at times) patchy economic data, with geopolitical tensions on the rise and market volatility in general being very low.

In the US, GDP growth has been revised down for the full year, yet consensus earnings targets have been revised up. It is worth noting that last year's earnings were nowhere near what had been expected. Hence what we've seen is significant price-to-earnings multiple expansion. Whilst valuations aren't overly stretched, they're certainly more vulnerable.

Elsewhere, Europe is intriguing. Sovereign debt yields in peripheral Europe have compressed dramatically, suggesting a near risk-free zone. The euro zone is flirting with deflation hence ECB deposit rates have moved into negative territory. Bank stress tests this autumn will provide some excitement as the cloak of mystery that surrounds the balance sheets of many European banks may be lifted with serious consequences.

In Asia, the picture is relatively encouraging. For a start, growth is stronger than in other parts of the world. Certain parts of the property market are no doubt vulnerable, but the scope for infrastructural development is still strong, especially if one is taking a 10-year view.

Likewise in Japan, the picture is reasonably encouraging. The recent Tankan Business Survey showed a pick-up in hiring expectations and capital investment trends have recently gathered pace. This is in contrast to the US and Europe where capital investment has been falling and it certainly suggests that Japanese companies are reasonably confident about the near-term outlook.

SAM LE CORNU | PORTFOLIO MANAGER

ASIAN EQUITIES

2013/14 Asian equity markets saw mixed returns as concerns around US tapering impeded the region in different ways.

2014/15 We believe the Asian growth story remains strong and, as before, all eyes will be on China.

How did Asian equities perform over the last 12 months and what were the key drivers?

The last 12 months have seen respectable equity returns in Asia. The MSCI Asia ex-Japan Large-Cap index saw a 14% share price appreciation and the MSCI Asia ex-Japan Small Cap index also performed well returning 12.9%. The catalysts varied in each region, so too did returns.

In India, the market rallied strongly with the MSCI India index up 26.2% for the period, and was the best performing country. Positive sentiment followed the result of the election announced on 16 May 2014 with Narendra Modi, the Prime Minister, assuming office on 26 May 2014. The best performing Indian sectors were arguably the most volatile being materials, industrials and IT. The forward PE now stands at 15.6x for the MSCI India, which we find difficult to find value in.

ASEAN saw mixed results. Indonesia and Thailand fell from their highs in May 2013 and the MSCI Indonesia and MSCI Thailand indices declined 13.7% and 4.4% respectively over the last 12 months, whilst the MSCI Philippines, MSCI Malaysia and MSCI Singapore indices saw positive returns of 5.9%, 2.8% and 6.5% respectively. The catalysts varied but the underlying commonality has been high valuations, with all 5 ASEAN regions trading well above their 10-Year PE average. Notably Indonesia and Thailand were impacted with QE tapering concerns and the exposed current accounts which are in deficit.

North-Asia, in terms of Hong Kong, China and Korea, all performed strongly, with the relevant MSCI indices up 14.3%, 12.7% and 23.4% respectively. Earnings Per Share (EPS) revisions were respectable in these countries and the low PE environment allowed stocks to rise off record low valuations. All 3 regions are notably trading at discounts to the 10 year PE averages which often seems to be a common buy-signal for contrarians.

What do you think the drivers of Asian equities performance will be over the next 12 months

The next 12 months will be very interesting for Asia, with many signals pointing to a rally. The bellwether is China. The bears will argue it remains the main area of systemic risk in emerging markets with shadow banking, soft property prices, high corporate debt levels and defaults dominating clouded asset allocation decisions. The bulls will argue opportunity has arisen to be bold when others are fearful.

We think we have passed the point of maximum pessimism. We believe risk is rarely priced correctly and observe the ‘exodus’ selling that has been seen is a result of uninformed panic which has left valuations at record low levels. We have been and continue to be very disciplined and selective in identifying opportunities in healthcare, consumer and domestic demand names. Our mantra has been to put risk into perspective and we continue with our long held view that we don’t see a hard landing for China.

The reality remains China has a vast number of levers in monetary policy both conventional and the unconventional such as RRR (Reserve Requirement Ratio) cuts and LDR (Loan-to-Deposit Ratio) change of definitions to stabilise the economy. North Asia at the time of writing is seeing significant inflows for the first time in 2 years. We remain very optimistic with regard to our China positions and see the potential for strong returns amongst a backdrop of very attractive valuations.

China will be Asia’s barometer for performance in the next 12 months. The pendulum has swung towards more positive sentiment. EPS growth and fundamentals remain intact setting the stage for a very interesting 12 months ahead.

JON ONG | PORTFOLIO MANAGER

GLOBAL LISTED INFRASTRUCTURE

2013/14

Listed infrastructure performed well, driven by the attractive distribution yields and underlying cashflow.

2014/15

While we remain positive on high quality infrastructure assets, we remain vigilant in our analysis of each company's valuation.

How did global listed infrastructure perform over the last 12 months and what were the key drivers?

Policymakers in the major economies demonstrated their commitment to growth as they continued to confront structural weaknesses. Against this backdrop, global listed infrastructure posted a very strong return over the last year, outperforming global equities. This was driven by a number of factors including continued sound earnings from many infrastructure companies, their attractive distribution yield and underlying cash flow generation, and the overall favourable climate for equities driven by accommodative monetary policies worldwide.

At the sector level, one of the strongest performers has been North American energy pipeline stocks, including both traditional companies as well as many US domiciled Master Limited Partnerships (MLPs). These stocks often have attractive, low risk, organic growth opportunities such as the build-out of pipelines, storage facilities and LNG (Liquefied Natural Gas) export terminals. These opportunities are driven by the substantial change underway in the North American energy supply coming from the increase in non-conventional sources of oil and gas.

Electric Utilities performed well as investors were attracted to the stability of regulated assets and the relatively predictable cash flows and distributions the companies generate. Toll Roads and Airports also performed well, benefitting from growth in patronage driven by modest economic recovery. These factors were magnified in Europe, particularly in the "periphery," as much lower long-term sovereign yields combined with demand for higher yielding stocks to attract investor interest.

What do you think the drivers of global listed infrastructure will be over the next 12 months

Our positive secular view of the infrastructure sector is supported by our belief that there are significant investment opportunities at attractive returns that will require private sector investment, given the fiscal constraints facing many governments. The proposed transaction by Transurban in Melbourne to widen its CityLink toll road is such an example. We continue to expect global listed infrastructure to benefit from long-term earnings and dividend growth driven by high quality existing assets, as well as investments in much needed new infrastructure.

In an environment of modest economic growth, the likelihood of continued low interest rates and a low inflationary environment, we believe the outlook for global listed infrastructure remains bright. Infrastructure is well positioned in this environment, as its yield is supported by the earnings of quality assets in strong strategic positions which are providing essential services to their communities. Low bond yields continue to support valuations, through lower discount rates and lower costs of financing for infrastructure companies. However, the economic recovery remains subdued with operating metrics exhibiting only modest growth for infrastructure assets with GDP-linked revenue streams.

While we remain positive on high quality infrastructure assets, we remain vigilant in our analysis of each company's valuation. The elevated level of monetary stimulus globally has driven an apparent 'chase for yield,' sometimes with less regard for long-term asset quality. Relative to our investible universe, we have positioned the portfolio somewhat defensively. At the sector level, we continue to have a positive view on pipelines in North America, where a number of relatively low risk and accretive organic growth opportunities for our companies should continue to drive meaningful growth.

For more information speak to your financial adviser, call us on 1800 814 523, email mim.clientservice@macquarie.com or visit macquarie.com.au/mim.

IMPORTANT INFORMATION

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