Lee Mickelburough
Head of Perennial
Growth Management

Perennial Growth Management

- Eight investment professionals with an average of 19 years industry experience.
- $2.1 billion in funds under management as at 30 June 2013.

OIL SEARCH LIMITED

OilSearch in brief

- Established in 1929, Oil Search Limited is an oil and gas exploration and development company.
- It is Papua New Guinea's largest oil and gas producer and operates all of PNG's currently producing oil and gas fields.
- Listed on the Australian and PNG stock exchanges, the current market capitalisation is approximately USD10 billion.

The end of global zero interest rate policy: Time to get your skates on!

The post global financial crisis world has been a difficult period for investors. Overall, economic performance has been weak, contagion risks have been high and investor confidence has been low. Asset prices however, have defied this backdrop and rallied strongly. The major influence has been the accommodative monetary policies of the major central banks in what can be best described as a Low or Zero Interest Rate Policy (ZIRP).

While ZIRP has led to a reduction in some of the tail risks such as the collapse of the Euro and US recession, it has also led to a three year rally in bonds and dividend paying stock prices.

Companies with capital expenditure and growth ahead of them have been, and are, penalised in favour of short term yield. Recent examples include the reaction to Woodside shelving a large development in the Browse basin and increasing its dividend and Incitec Pivot announcing the US growth project. In Woodside's case, the stock rallied strongly and you guessed it, Incitec Pivot stock was sold off. The reason, it's all about the short term yield for the vast majority of investors.

These are not isolated examples. The mining sector is reducing capital expenditure and shelving development plans almost on a daily basis now. The new mantra is to focus on costs and cash returns to shareholders. In the context of the Australian economy, this move is a concern for what was an important growth engine for the economy. We are already seeing some much needed policy adjustments taking place. The RBA has shown a bias to being more accommodative on monetary policy and we are finally starting to see the Australian dollar fall to levels more in line with the fundamental outlook.

In the US, the economy has started to see the benefits of the prolonged period of low interest rates and low currency. The shale oil boom is also providing cheap energy and an engine for economic growth. All this means that we are now getting closer to the day that the US Fed starts to withdraw monetary stimulus from the system. This will mean interest rates in the US are likely to move higher as will the US dollar.

What does all this mean for investors? It is important for investors to start positioning their portfolio for the post low interest rate policy world. As one of the most famous and successful ice hockey players in the world, Wayne Gretzy, put it: "I skate to where the puck is going to be, not where it has been."

The way we see it:

- Given Australian bond yields are highly correlated to US bonds yields, we expect local bond yields to track higher with US bonds.
- The RBA will cut the official Australian cash rate at least once, and probably twice, as it attempts to stimulate the non-mining sectors of the economy.
- The Australian dollar will continue to fall, particularly against the US dollar.
- Those stocks, i.e. yield stocks and particularly those companies which have high dividend payout ratios and limited growth opportunities such as Telstra, that have performed well in the ZIRP environment are likely to underperform. In some respects, this has already started - during May 2013, we saw the stocks that led the market up were those that led it down.

As we see it, the "puck", or the place to invest, is in those companies with growth projects that will deliver strong cash flow growth over the next few years. As these stocks come into favour, the reaction to the Woodside and Incitec Pivot announcements should be reversed. In addition to Incitec Pivot, we see Oil Search as a standout opportunity. We are also "skating" towards those companies with quality overseas businesses, such as Brambles, which we believe will outperform as the Australian economy is likely to struggle with the adjustment to the end of ZIRP.

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