PERENNIAL VALUE MANAGEMENT

Perennial Perspective

What a difference the New Year makes!

by Brian Thomas

January market overview

They say that “context is everything” and this was certainly demonstrated in January with global markets perceiving the world economy in a dramatically new light to last year despite a similar world economic backdrop.

Essentially, the world is caught up in a period of sluggish and uneven growth below what many were expecting given the stimulus of low interest rates. On 6 January the World Bank downgraded its’ forecasted world growth for 2016 to 2.9% (which is still 20% higher than the 2.4% world growth that occurred last year). The press have focussed on weak US and China manufacturing numbers with the PMI Composite Index numbers just below the magic 50% level (anything below 50% indicates a contraction in manufacturing). In contradiction to this the services sector, which is a big driver of employment and growth in the US, and a smaller, yet growing part of the Chinese economy is growing in both countries. Adding to this mix there have been a number of brokers as well as commentators such as hedge fund legend George Soros, coming out with negative, headline worthy comments provoking further negative financial press.

Weak commodity prices have negatively affected economies that rely substantially on commodity exports but this has been offset substantially in a global sense by the relative strength of the developed world, particularly the US. In terms of commodities, there is a natural limit to commodity price falls, that is, lower prices will eventually lead to cuts in production leading to the demand/supply equation turning back in favour of demand, eventually supporting prices. In addition, lower commodity prices – especially lower oil prices - are a positive for the rest of the economy.

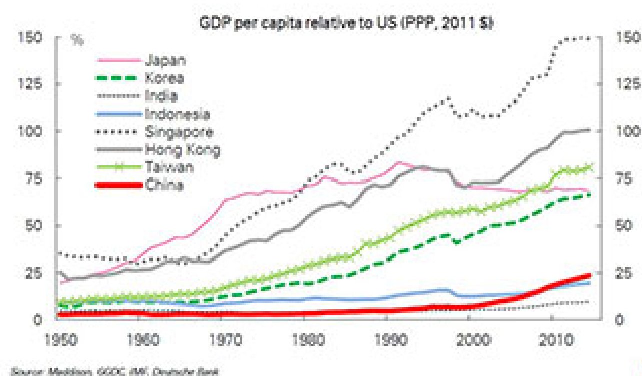
Rounding out the month we had a number of interesting developments including the Federal

Reserve (the Fed) announcement that whilst rates were on hold in January they are still looking towards a gradual increase in rates over time depending on how global events pan out; the surprise decision by the Bank of Japan to cut rates to negative 0.10% in an effort to force Banks to lend; as well as the US September-December GDP softening as expected to 0.7%, just below the median forecast.

China overview

Chinese authorities meddling in the Chinese share market added to the drama played out in the rest of the world markets. Only a small proportion of the Chinese population own shares so the effect on their wealth from these dramatic falls is nowhere near as pronounced as say in Australia (where most people own shares at least indirectly through their superannuation).

Adding to this new negative milieu was the news that Chinese Gross Domestic Product (GDP) for 2015 came in to just under 7% (6.9%) which is the slowest growth in 25 years. It wasn't that long ago (mid 2000s) that the Chinese economy was growing at double digits so to see growth at under 7% is worrying for many people. However, to put it all in perspective, China's GDP in 2005 was only $US2.3 trillion where today it stands at $US10.3 trillion, more than quadruple in size. This means that 6% Chinese growth today is still very significant and a major contributor to gross world product. And whilst China is making the transition from investment, manufacturing and urbanisation being the key drivers of growth to a more local consumption and services led economy, however it still has a long way to go in terms of development. This is illustrated by the chart below which shows GDP per capital relative to the US. Mainland China still sits well behind the US, in fact only 25% of the US GDP per capita, as well as other Asian nations in terms of development. They are essentially where Korea and Taiwan were in the 1970's.



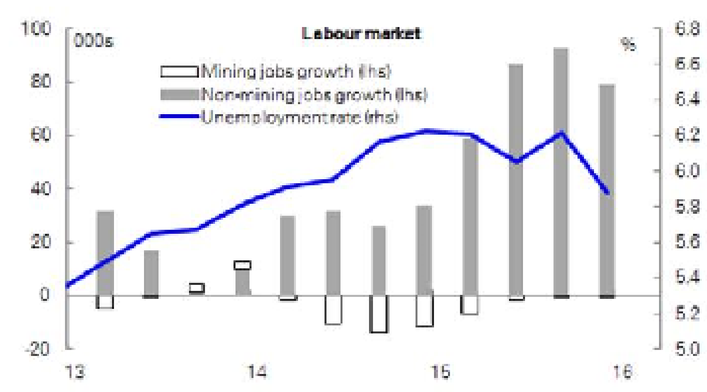
"Super" Mario Draghi comforted markets somewhat during the month around the China slowdown and the falling oil price, with his commitment to take further action. He stated "The European Central Bank (ECB) has the power, the willingness, the determination to act, and the fact that there are no limits to our action to bring inflation up to its target."

What does it all mean for our economy and share market?

Back home the Australian economy is re-balancing from the mining investment boom, with the lower exchange rate a key enabler. Growth is coming from strong construction, healthcare, professional services, tourism and education sectors. History tells us that most commodity/terms of trade booms typically see a rebalancing economy as the exchange rate falls and stimulates other sectors of the economy. The major positive for our economy was

the good employment numbers that were released mid-January with our unemployment rate remaining at 5.8% and more full time jobs created than expected. Looking at Chart 2 below the quarterly numbers to December 2015 show that the trend of mining job losses coming to an end and employment picking up.

Unemployment Boosted by Non-Mining Jobs Growth

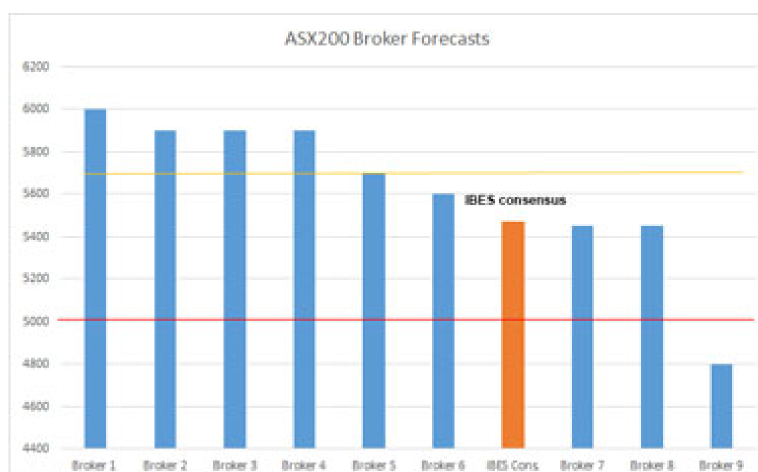


Source : Deutsche Bank

The Reserve Bank of Australia (RBA) tends to pay attention to these official numbers so this would most likely rule out a near term rate cut. Importantly however, the RBA has some ammunition left to cut rates further (compared to most other developed economies) if the negative market sentiment spills over into our real economy.

In terms of valuations, whilst the share market Price to Earnings ratio (PE) is just above long term averages (at around 14.5x), it is logical for PE’s to remain elevated whilst interest rates are so low.

We are finding value in this high PE low interest rate market with our overall portfolio having a grossed up one year forward yield of 7.2% for 2016. Though most of the press focusses on the price index (excluding dividends) owning shares also means that you receive a dividend stream that is an important contributor to total returns. It is also worth noting that in terms of growth in the market the chart below shows that most of most brokers are forecasting growth in our share market for 2016. The Institutional Brokers Estimate System (IBES) consensus numbers are also shown below.



2016 Broker Forecasts Source :- Perennial, Bloomberg, Morgan Stanley Research January 2016

Outlook

Whilst markets will remain volatile while they come to grips with this new 2016 “wall of worry” the early results of the February reporting season are positive with Commonwealth Bank, Boral and Stockland all producing solid results, a good early indicator that the Australian economy is on track to continue the post-mining transition.

Brian Thomas
General Manager- Investment Services
Perennial Value Management

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