ALDER & PARTNERS
Private Wealth Management

ISSUE 12 — 2015

Economic & Market Update
OCTOBER 2015

Inside This Issue

Economic & Market Review

Markets have been very volatile over the past six months driven by a range of concerns. This included the solvency of Greece, the outlook for the Chinese economy, high fluctuations in commodity prices and the prospect of an increase in the interbank lending rate (the Fed Funds Rate) by the US Federal Reserve (the Fed). Political and geo-political issues also haven't helped. The following returns were achieved by major market indexes over the below periods:

Index	FY15	This calendar year to date (3/11/15)
ASX 300	1.1%	-2.5%
S&P 500 (US)	4.6%	2.5%
Euro Stoxx 50	8.0%	9.4%
Nikkei 225	33.5%	7.1%

Returns in respective currencies and excluding dividends.

Contact Us

clientservices@alderandpartners.com.au
www.**alderandpartners**.com.au
T: (08) 9386 1900 | F: (08) 9386 1901

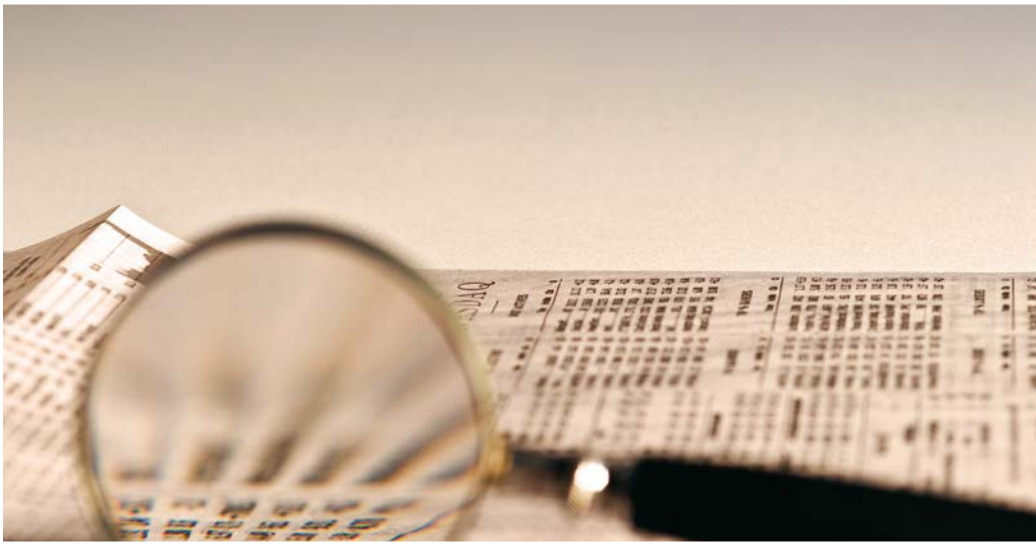
Alder & Partners Pty Ltd ABN 98 146 233 534
Australian Financial Services Lic. No. 382714

Alder & Partners

T: (08) 9386 1900
F: (08) 9386 1901

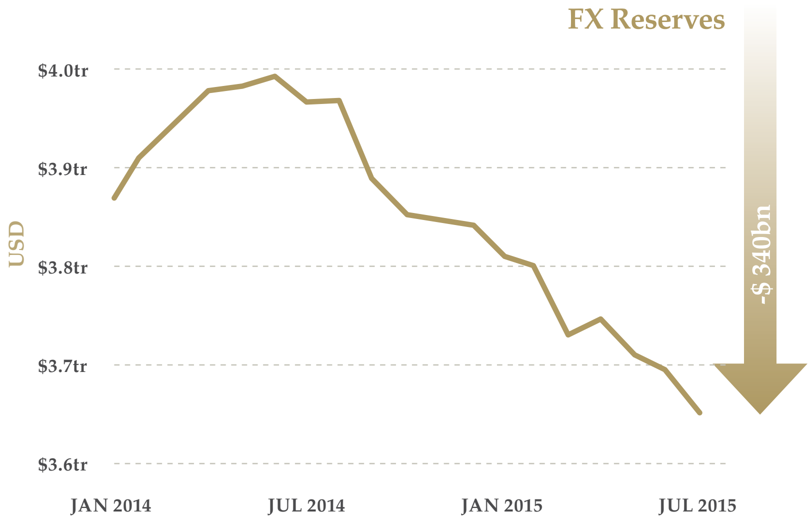
clientservices@alderandpartners.com.au
www.alderandpartners.com.au

129c Waratah Avenue Dalkeith WA 6009
PO Box 5140 Dalkeith WA 6009



Ironically Greece has agreed to harsher terms than those originally proposed by European authorities to obtain access to emergency funding. The important outcome is that anti-EU parties similar to Syrizia in key (and highly indebted) countries such as Spain and Italy may be less likely to gain favour amongst voters. Indeed polls indicate that the Spanish equivalent Podemos has drifted off in popularity since this time which provides hope that there shouldn't be any surprises in the November election.

The devaluation of the Chinese Yuan on 11 August, which is pegged to the US dollar, came as a surprise to the market. As illustrated in this chart courtesy of Magellan Financial Group significant foreign reserves have been repatriated by the People's Bank of China since July 2014. Magellan believe US $0.5 trillion to September which accounts for a significant portion of its foreign capital reserves. This has been used to neutralise significant outflows of capital (which are finding their way into cities all around the world including our own), repair the balance sheets of debt laden corporates and prop up equity markets. The devaluation of the Yuan has allowed these funds to be brought back to China without pushing up the currency and reducing the competitiveness of exporters.



Source: Magellan Financial Group

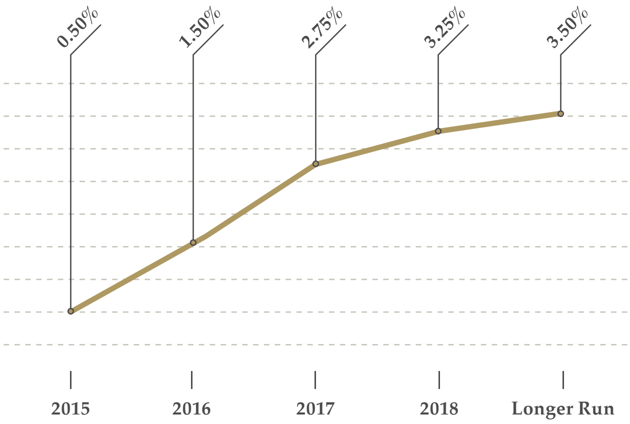
To us the falls in Chinese equity markets appeared entirely rational given the extreme valuations that were being seen. These did in part unsettle global markets, however, what created greater concern amongst global investors was the way in which authorities reacted. Some of the actions seemed to directly contradict principles of a free market economy. There is also a view that they showed signs of desperation (in seeking to prop up a market clearly in bubble territory) and that this provided a signal that other parts of the economy were not going so well. Whether we agree with these thoughts or not is irrelevant as they created high volatility in international markets including our own.

China Shanghai A Share
Price return index

Source: Thomson Reuters/ Fathom Consulting

US economic results have generally been positive without being outstanding, although recent jobs numbers have not met expectations. The Fed provided downbeat commentary on the outlook for the global economy following its September meeting which further unsettled markets. It also provided guidance that rates were unlikely to be raised whilst global uncertainty prevailed. As a result it has beholden itself further to the movements of financial markets and we are no clearer as to when rates in the US may begin to rise. The forecasts for rates by Governors of the Fed is roughly summarised as follows, which represents a less steep trajectory than 12 months ago.

The US Federal Reserves Forecast of the Fed Funds Rate



Another important event that has occurred has been APRA's move to tighten the capital holding requirements of our banks. Around the time of the Global Financial Crisis the large four banks and Macquarie were given authority to undertake their own risk weighting assessments of loans that they provided. Risk weighting refers to the probability of a loan going bad, and as a result the probability that was applied dropped from a flat 50% to an average of around 16% on Australian residential mortgages (collectively the banks largest exposure). The capital that banks are required to hold only relates to this part (the 16%) and the result of this was that the banks were able to increase profitability substantially. Unfortunately leverage also increased and a significant advantage was provided versus smaller regional banks. With great effort APRA has put a stop to this and told the banks that they must increase the risk weighting of mortgages to at least 25% by 1 July 2016. Additionally they have provided guidance that capital holding requirements will need to be at least 2% higher over the medium term (although have not specifically outlined what this means), and forced a tightening of lending standards.

These polices have driven the significant bank capital raisings and asset sales that we have seen, although these have only provided around half of what is required in our view.

Investment Performance Review

On balance results from the most recent reporting season were pleasing. On average the 15 largest individual companies in our client portfolios (at the time) delivered underlying earnings per share growth of -2.9% and underlying dividends per share growth of 13.6% versus the previous corresponding reporting period.

Ansell provided another excellent result and the benefits of recent acquisitions which have provided new product capabilities, technologies and cross selling opportunities are expected to begin to flow through in future results. However, the market has sold the company down heavily on lower expected US dollar earnings (as a result of a lower Euro and the translation impact), concerns over the outlook in emerging markets and a slowing of activity in some key markets.

Amcor, the banks, Telstra and Wesfarmers provided strong results, and the benefits of the conversion of Kurnell (Botany Bay) from a refinery to an import terminal has started to flow through to Caltex's results.

Transurban's earnings per share fell, however, this was driven by higher depreciation (non-cash expense) and interest expenses relating to the acquisition of the toll road assets in Brisbane. On a cash profit basis per share, which is a much better measure for this company, underlying earnings increased by 13.4% per share.

Commodity producers BHP and Woodside experienced significant declines in earnings although this was not unexpected given the decline in commodity prices that has occurred over the past 12 months. Woodside's sensible dividend policy that links payments to earnings resulted in an equivalent decline in the dividend payment.

BHP's progressive dividend policy is quite unique, particularly for a company that sells products with a volatile price. It requires that the dividend cannot be reduced (in US dollar terms), it can only be increased or held steady. This provides income seeking investors with more certainty, however, it under-rewards shareholders during the good times and presents a risk to the company's balance sheet during the more difficult periods. Indeed current forecasts show that BHP is likely to have to draw on its debt facilities over the medium term to fund part of its dividends. It also encourages the board and management to make acquisitions and undertake additional developments during the highs and creates restraint on their ability to do so during the lows, when they should be doing these things. Clearly we agree with those in the market that take the view that the board should adopt a payout ratio target, as they have sensibly decided to do with the demerged South32.

Transport company Qube Holdings is expected to experience a difficult period in the short-term with commodity prices impacting customers and much more subdued growth in the movements of goods as a result of the end of the resource construction period. The company unveiled plans for the inter-modal terminal at Moorebank in Western Sydney in May, which will be as large as the Sydney CBD. It will reduce freight times, handling and congestion as a result of a direct rail link to Sydney's major port at Botany Bay and provides significant operational and property development opportunities for Qube. It also noted that Qube has recently formed an allegiance with other shareholders to take a blocking stake in Asciano to prevent a takeover by Brookfield and launch a separate proposal carving up the company's assets. Asciano owns key port assets that management know well when both they and the assets were part of Patrick Corporation.

Berkshire Hathaway has continued to build its portfolio of businesses with two significant acquisitions over the past six months. The first was Kraft Foods through a merger with the already partly owned (in a joint venture) Heinz creating the 3rd largest food and beverage company in North America and material cost and infrastructure synergies. The second was the US $37.2bn purchase of Precision Castparts Corp. which manufactures sophisticated components, mainly for the aerospace industry with its major customers being Boeing and Airbus. The acquisition provides leverage to long-term growth in air travel. The half on half decline in earnings was driven by volatility in financial markets and lower insurance profits.

Company	Underlying Earnings Per Share Growth	Underlying Dividends Per Share Growth
Amcor	7.5%	2.0%
Ansell	10.9%	10.3%
ANZ Banking Group	0.0%	1.7%
BHP Billiton	-51.6%	0.0%
Berkshire Hathaway Inc.	-17.3%	N/A
Commonwealth Bank	5.0%	5.0%
Caltex Australia	45.0%	135.0%
Qube Holdings	7.5%	7.8%
Transurban Group	-30.3%	14.3%
Telstra Corporation	11.1%	3.4%
Tox Free Solutions	-2.0%	42.0%
Westpac Banking Corp.	2.0%	3.0%
Wesfarmers	9.9%	5.3%
Woolworths	-0.7%	1.5%
Woodside Petroleum	-39.9%	-40.5%
Average Growth (not weighted)	-2.9%	13.6%

Earnings and dividends versus the previous corresponding period in each company's reporting currency.

We continue to be very active in our search of new investments and have built a long-list of interesting prospects that we are methodically reviewing. In the past four months we have met with nearly 20 CEO's or fund management groups in addition to countless conference call presentations during the reporting season. The majority of funds that we meet with do not meet our litmus tests but the meetings are normally very worthwhile as we benefit from hearing other opinions on particular investments and the markets more broadly.

We have also reviewed over 20 bond funds to try and find exposure to reliable credit securities (loans to governments and corporates). Direct access to these is still very limited in Australia. Unfortunately we have come to the same conclusion that we have on numerous other occasions over the past two years; returns of highly rated securities are not attractive enough versus the risks and clients are better off in term deposits; funds that do provide reasonable returns either have high exposure to poorly rated and junk grade securities; or they apply aggressive trading strategies that include derivatives, currency trading and shorting. These do not meet our criteria for what are meant to be defensive investments.

Key themes in client portfolios remain largely unchanged; no exposure to fixed interest bonds; exposure to offshore investments and companies listed in Australia with high overseas earnings on an unhedged basis (with a particular emphasis on the US and some exposure to Europe); minor and only very high quality exposure to companies that are directly exposed to commodities where China is the main customer (e.g. BHP for iron ore); businesses that provide recurring earnings and some exposure to those that are leveraged to a recovery in the Eastern Australian economy. Also, we have largely taken profits in listed property trust holdings but would be keen to re-enter this sector once valuations are at levels that more closely reflect underlying property values.

Outlook

Global markets appear to lack conviction at present and are waiting for a catalyst to provide direction. We believe that markets are particularly susceptible to any positive news given the extended period of bad news that we have had. Whilst definitive language from the Fed or a clearer outline of their strategy from Chinese authorities may provide this we feel that this uncertainty is likely to continue. As a result returns may vary more significantly than in the past between countries, sectors and particular companies. This means that some parts of portfolios are not likely to perform as strongly as they have in the past and we will need to reposition to provide exposure to sectors that have better medium term outlooks.

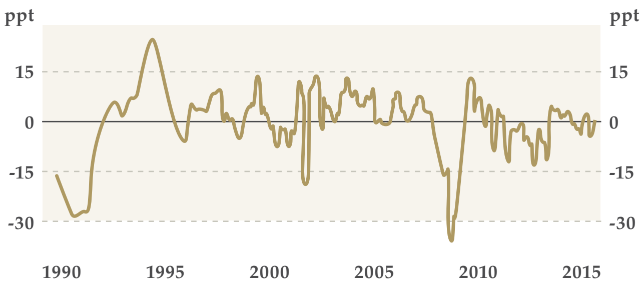
We consider this on an ongoing basis, and this is particularly the case in the Australian market that is dominated by banks and resource companies.

Since the Global Financial Crisis the banks have had an almost perfect set of circumstances that appear to have now peaked. Capital holding requirements were loosened and are now being tightened up again. Property prices have continued to rise, particularly in the key markets of Sydney and Melbourne, driving credit growth, whilst impairments have fallen to historical lows. Also Boards have been able to increase payout ratios. This along with the falling interest rates that have driven buying of high yielding investments has created strong demand for their shares. As some of these conditions become less favourable pressure is likely to be placed on bank profitability which will weigh on share prices. We do not feel that this is cause for alarm, the banks are likely to continue to experience moderate growth, are passing some costs on to customers and dividend payout ratios will be managed carefully. Repeating returns of previous years, however, would be surprising.

For commodity producers the outlook diverges significantly between sectors. Consumption based commodities such as oil and copper are likely to recover over time as supply normalises or consumption increases. The outlook for those that are linked to construction growth that is unlikely to be repeated such as iron ore and metallurgic coal is much more difficult.

There are some positive signs in Australia. A change in political leadership is currently being met with very strong approval ratings which bodes well for creating the power base that is required to advance the changes that our economy needs, and for confidence. The latter has been a missing ingredient for some time and will be an important catalyst for spurring economic growth.

Business Confidence



Source: NAB, RBA

We hear that highly sensitive tourist areas such as Cairns are starting to see an increase in activity thanks to the lower Australian dollar and active promotion in the Asian market place. This is a positive sign and also bodes well for other currency linked industries such as education.

Whilst free trade agreements require concessions to be made and there will be losers the opportunities that they create for some sectors, particularly those in agriculture are exciting. These have the potential to be significant drivers of growth into the future.

Global debt is an issue as it has risen significantly since the Global Financial Crisis. This presents a difficult challenge for central bankers and politicians and the likely result is that accommodative policy will need to continue for the foreseeable future and raising interest rates substantially will be a difficult prospect. The risk to this is inflation, however meaningful signs of this continue to be absent. We remain watchful particularly as the transitory impacts of falling energy prices fade from the numbers that central bankers rely on.

Importantly valuations are generally quite reasonable and we are seeing occasional bargains in the market. This combined with continued low interest rates is likely to continue to be very supportive for equity and property investments with sustainable income yields.

ALDER & PARTNERS
Private Wealth Management

T: (08) 9386 1900 | F: (08) 9386 1901 | clientservices@alderandpartners.com.au
129c Waratah Avenue Dalkeith WA 6009 | PO Box 5140 Dalkeith WA 6009
www.alderandpartners.com.au