



Economic & Market Update

Presented by:

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- “ Some thoughts on share investment
- “ The big short?
- “ World economies
- “ Commodities & A\$
- “ Australia
- “ AU stock market

Equal-Weight Blue Chips Portfolio

May 16, 2016

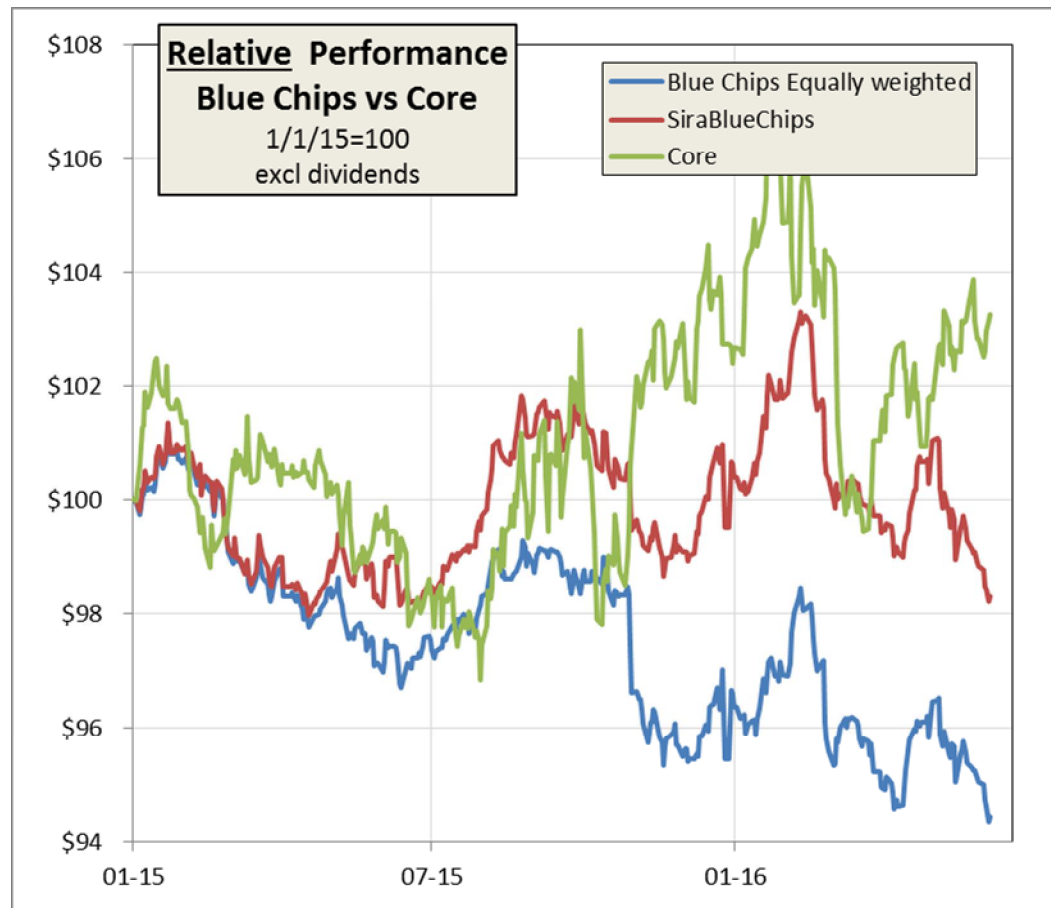
		Score	Weight	Mkt Cap	Prosp Pre-Tax Yield*	Prosp EPS gr	Index	Price
<i>minimum portfolio size \$25K</i>								
ANZ	ANZ Bank	2.5	8.0%	73202	10.3%	2.1%	20	25.09
BHP	BHP-Billiton	4.1	8.0%	59513	2.8%	100.0%	20	18.53
CBA	Commonwealth Bank	2.2	8.0%	129922	8.1%	2.4%	20	75.75
CSL	CSL Limited	2.4	8.0%	53932	1.6%	15.7%	20	117.11
GPT	GPT Group	1.5	8.0%	9691	4.5%	3.1%	50	5.39
NAB	National Australia Bank	2.3	8.0%	70038	10.7%	0.6%	20	26.48
RIO	Rio Tinto Limited	2.8	8.0%	18469	4.4%	5.1%	20	43.54
TCL	Transurban	2.7	8.0%	24182	4.4%	52.3%	50	11.88
TLS	Telstra	2.3	8.0%	68341	8.2%	5.5%	20	5.59
WBC	Westpac	2.4	8.0%	99940	9.1%	3.5%	20	29.96
WES	Wesfarmers	2.8	8.0%	45541	7.8%	9.4%	20	40.44
WOW	Woolworths	1.9	8.0%	27762	6.4%	1.5%	20	21.71
Cash	Cash	2.5	4.0%		1.8%	0.0%		

Weighted Average	2.5	100.0%	6.3%	16.1%
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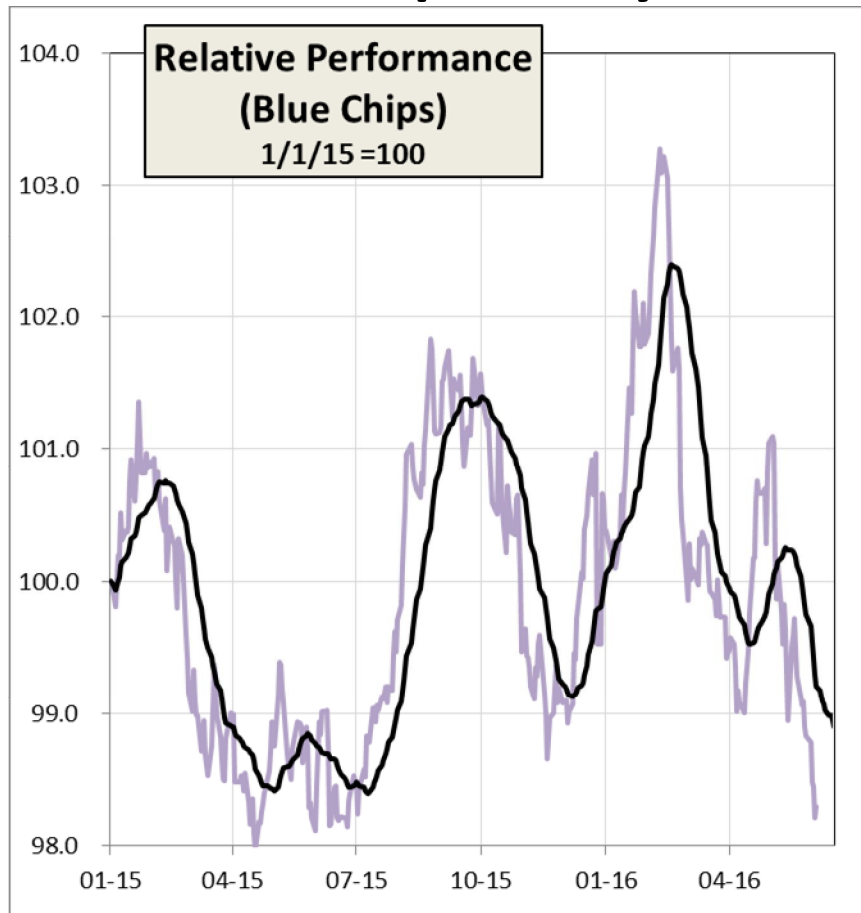
* includes add-back of franking credits

=40% of total mkt

Huge underperformance



... even traded blue chip portfolio pretty ordinary

**Since inception** $\alpha^* = -0.7$ (annual, %) $\beta^* = 0.97$

* excl income, fees

Why?

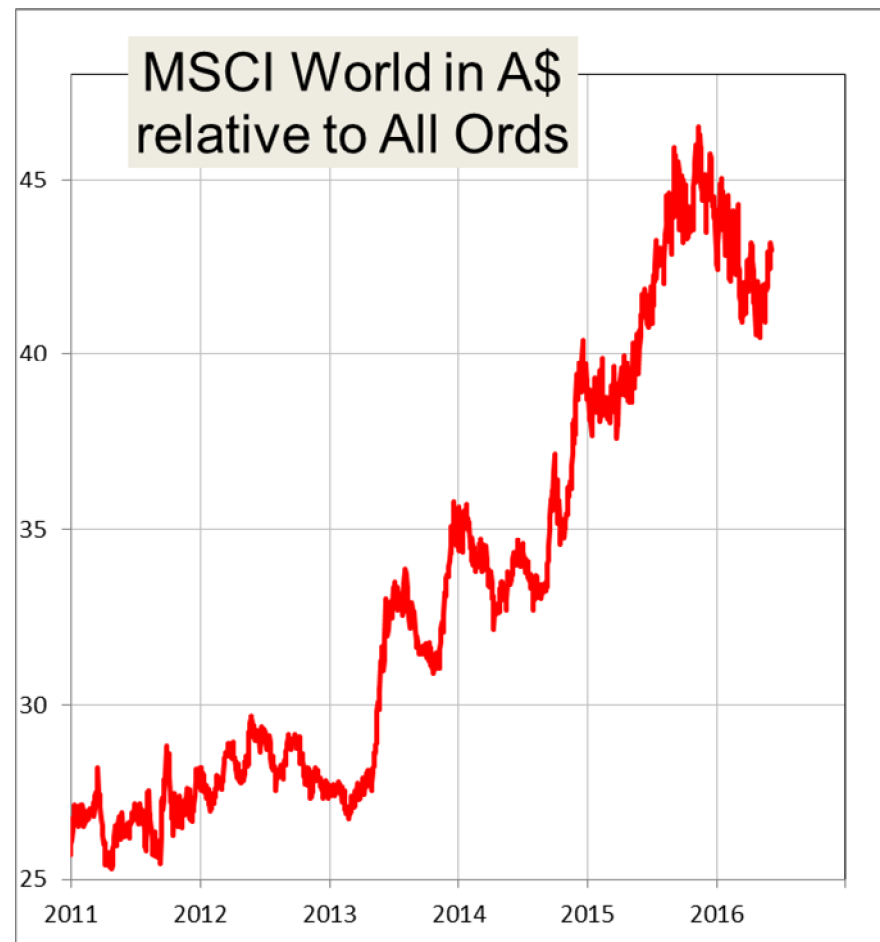
- “ Underperformance of the banks
- “ Resources in secular decline
- “ Retail duopoly (Coles, Woolies) under pressure from Aldi + weak spending growth
- “ Domestic earnings weak—any large cap company unable to shake off sluggish nominal economy

How to generate better performance

“ International:

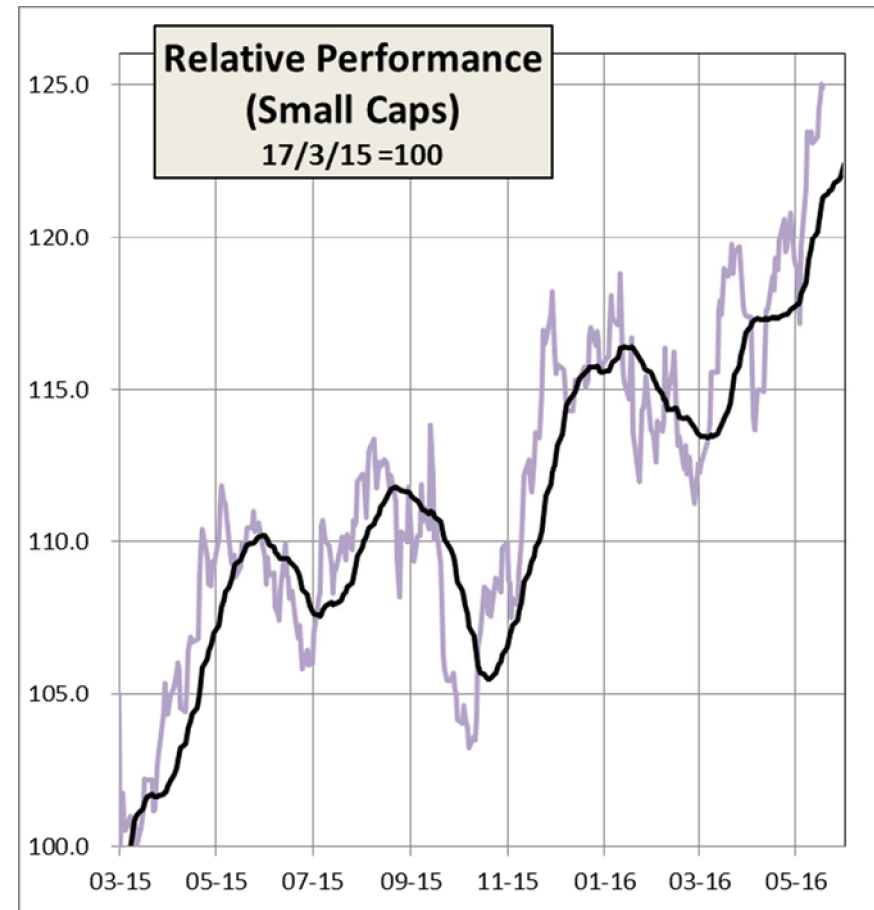
(also companies with international earnings: COH, CSL, WFD, NXT, etc)

(New currency hedged ETFs: HJPN, IHVV, HEUR)



” And smaller caps:

(Each small cap has its own story, more or less independent of the economy)



The Big Aussie Short

- “ It was like a scene from the film *The Big Short*. A hedge-fund manager and an economist pose as a gay couple on a combined income of \$125,000 and tour Sydney's western suburbs viewing housing developments and meeting mortgage brokers for research to determine if there's a housing bubble.
- “ **The conclusion is it's worse than they thought.**
- “ **"The further west I went, the more irrational it felt. Lots and lots of supply and prices that bore no resemblance to construction cost and income of people around there,"** says John Hempton, Bronte Capital's chief investment officer.
- “ He joined with Jonathan Tepper, an economist and founder of Variant Perception, and toured suburbs across north-west and south-west Sydney and met 20 mortgage brokers three weeks ago.
- “ As Tepper has written in a report, **"we asked if the bank would call our employer, and both reputable and disreputable brokers said banks rarely verified payslips"**.
- “ Hempton says they were also told the checking of documents was sometimes done by Indian call centres. What also concerned Hempton was that on loan applications **low-income earners were often offered discounts on the advertised mortgage rate of up to a 1 percentage point, increasing the vulnerability of the banks if there were a correction.**
- “ "The banks have always said their underwriting is of high quality," says Hempton. "We just went around and this was not the story we were told. **We were coached on how to get things through banks.**"
- “ (Source: AFR)

Banks re-open door to property investors

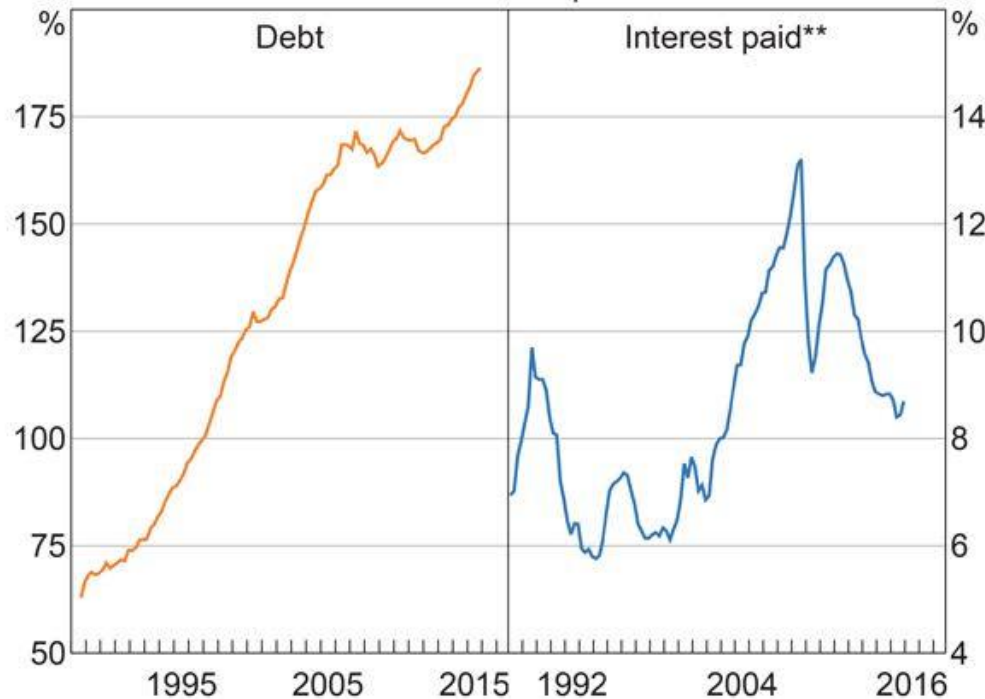
- “ A looming election has led to an increase in property investment as buyers race to beat changes in negative gearing laws.
- “ After banks put the brakes on lending to property investors in 2015, several are now easing off the pressure and **trying to spur on more borrowing among buyers who drove the recent housing boom.**
- “ The changes are intended to lift banks' loan growth after a regulatory crackdown, but economists also say stronger lending to property investors could create new risks, amid signs house prices are heating up again.
- “ In what mortgage brokers say is a clear trend, **several banks have recently shown a greater willingness to lend for property investment.**
- “ Westpac, the country's biggest lender to landlords, this week began **allowing customers to include the tax benefits from negative gearing in their loan assessments,** unwinding changes made last year, and last month it started accepting smaller deposits from investors.
- “ Bank of Queensland last month raised its **maximum loan to valuation ratio (LVR) for investors to 90 per cent, from 80 per cent,** a change that allows investors to have smaller deposits.
- “ Australia's biggest credit union, CUA, also **lifted its maximum LVR to 85 per cent, from 70 per cent.**
- “ Other banks are using the other big "lever" at their disposal to ramp up growth – price.
- “ Lenders including Bankwest, ME and UBank have cut three-year fixed rates for investors below 4 per cent, and brokers say lenders including Commonwealth Bank are prepared to offer discounts of up to 1.5 per cent off their advertised interest rates.
- “ The changes follow a near halving in housing investor credit growth, from a peak of 11 per cent a year in 2015 to 6.5 per cent, after the banking regulator capped growth in this market at 10 per cent a year.

(source: SMH)

High debt to income ratio

Household Finances

Per cent of household disposable income*



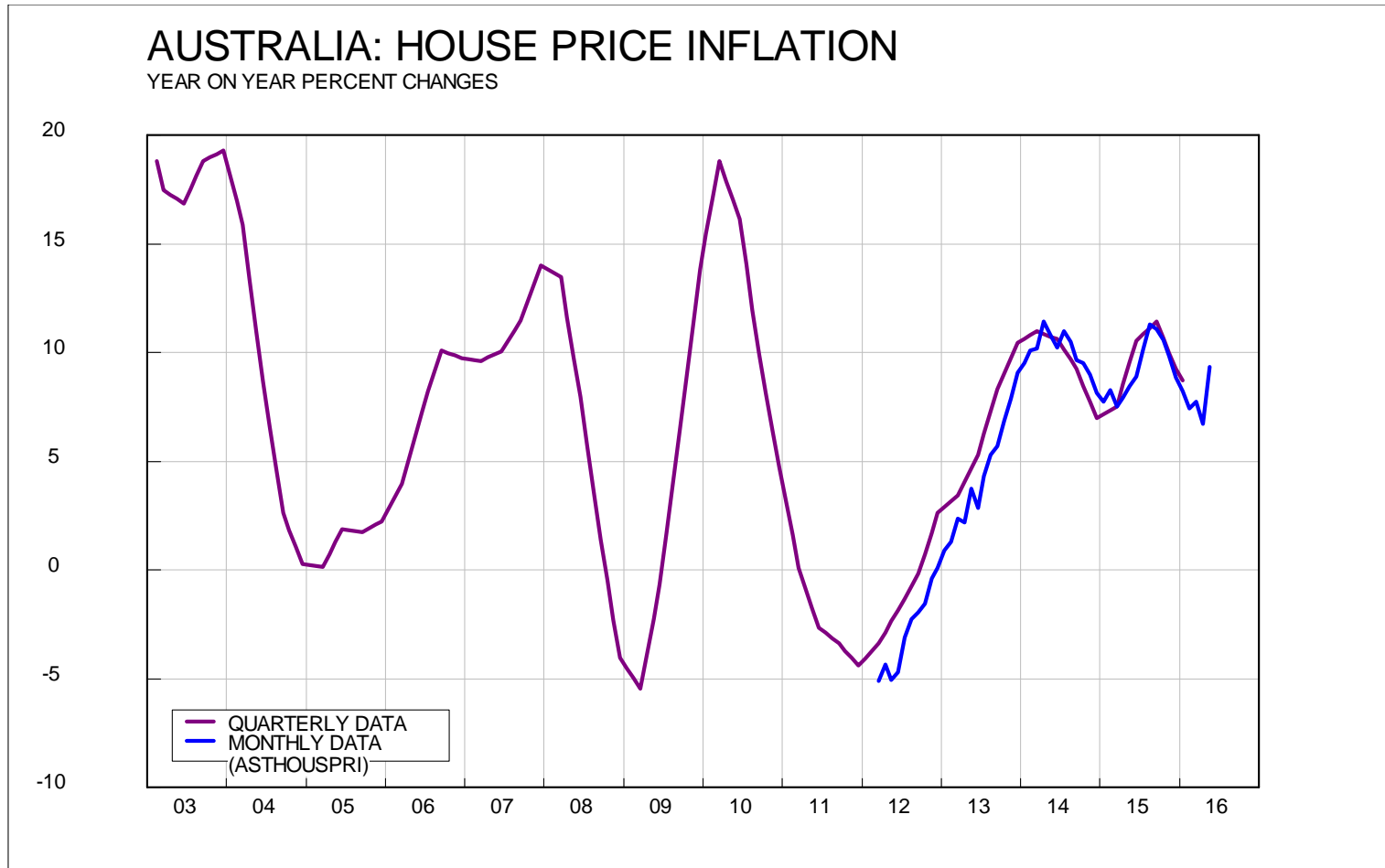
But mortgage delinquency rate stable at 1.2% -- nowhere near US levels pre GFC

* Disposable income is after tax and before the deduction of interest payments

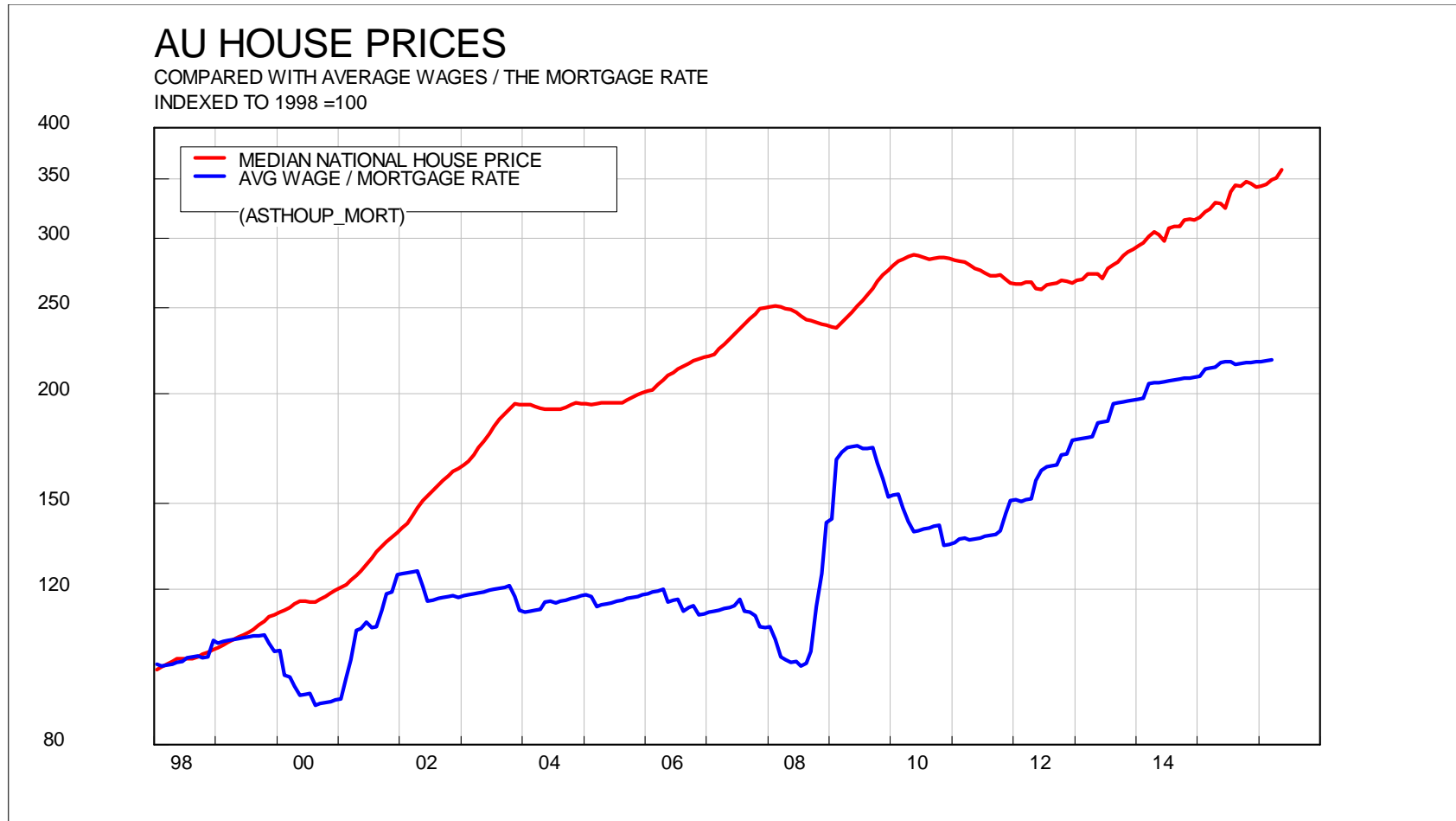
** Excludes unincorporated enterprises

Sources: ABS; RBA

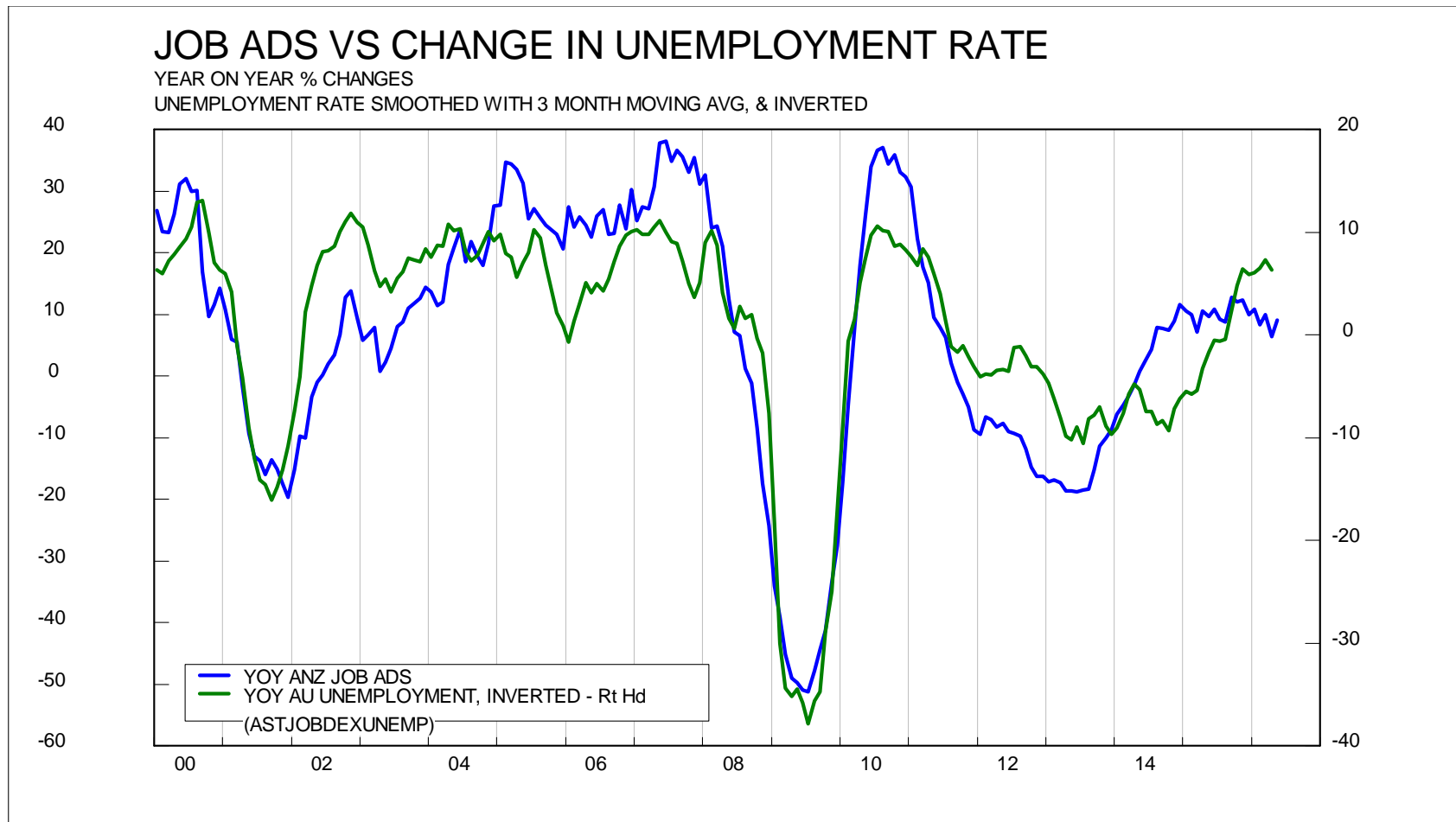
House prices picking up again



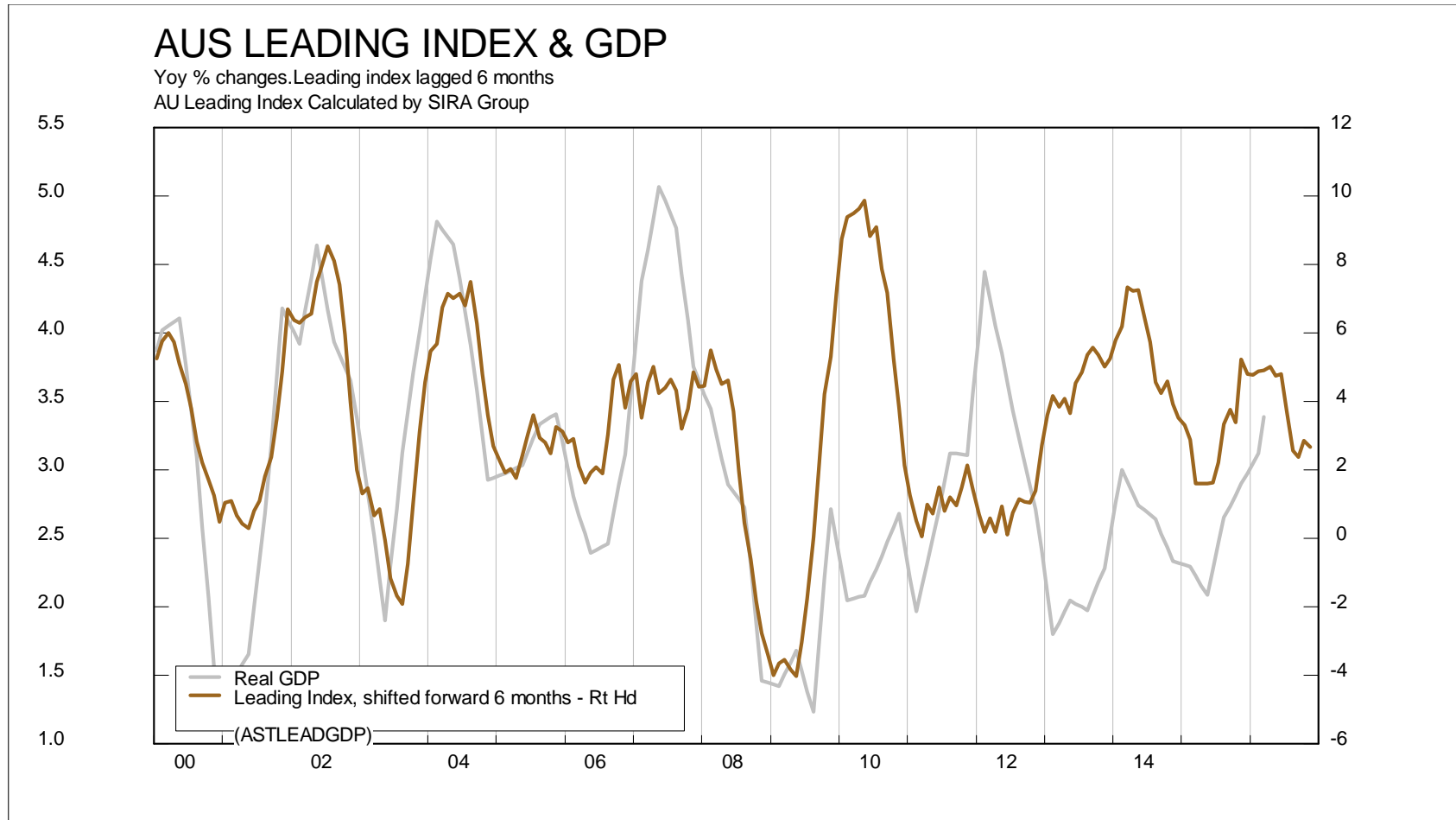
House prices overvalued



... but key is unemployment



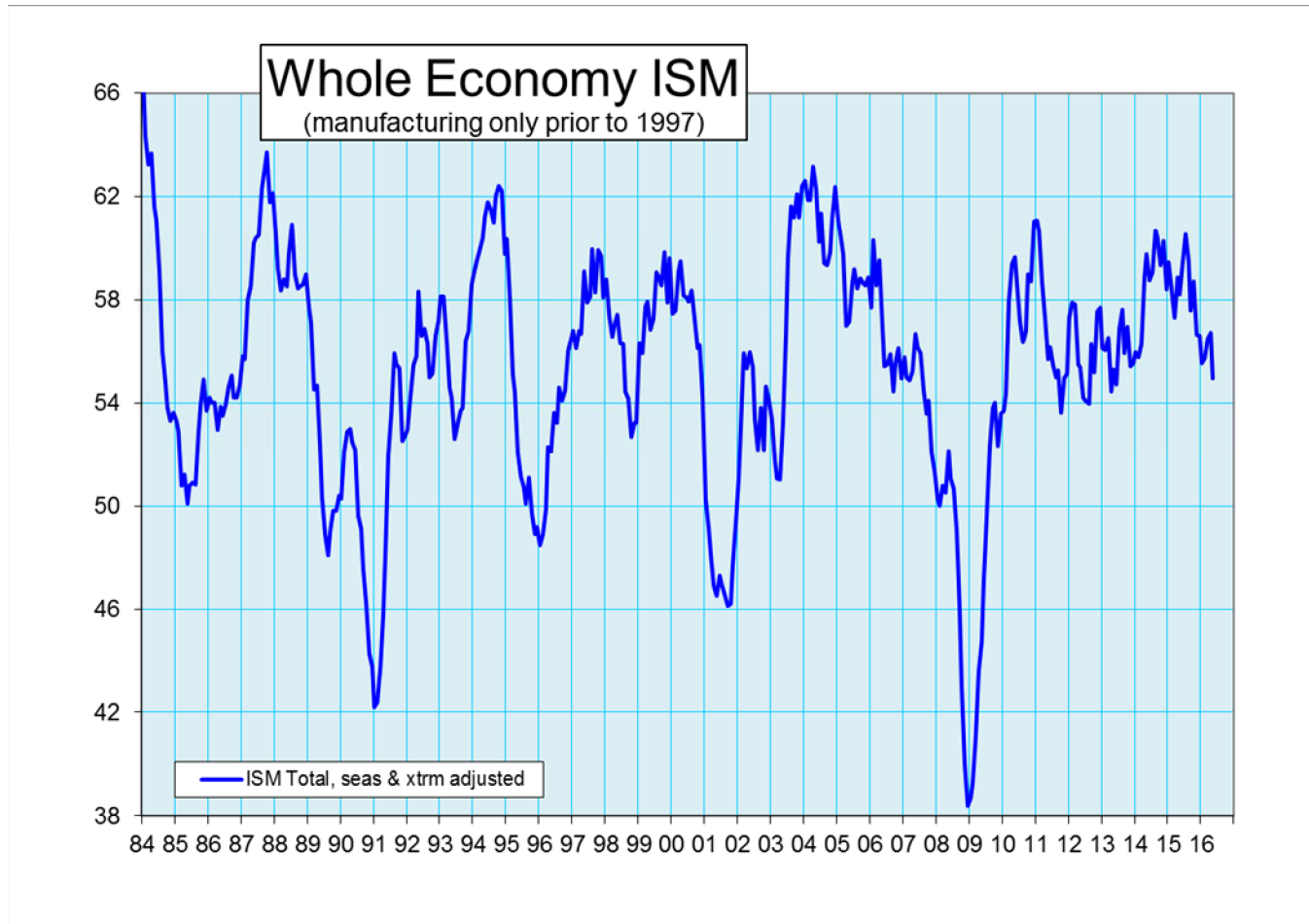
GDP growth likely to slow



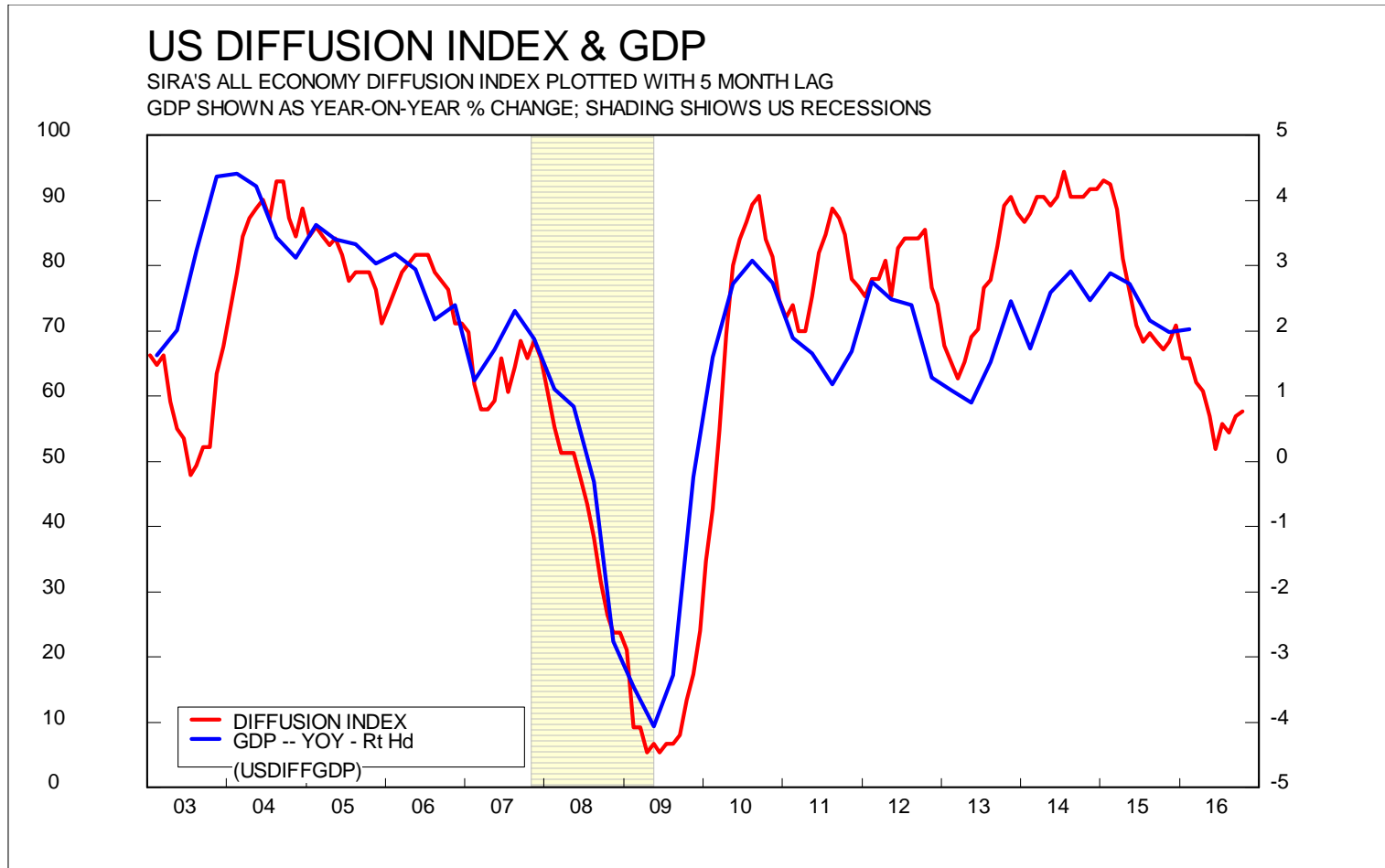
Housing conclusions

- “ House prices too high
- “ But—any fall likely to be limited, as long as unemployment doesn't surge
- “ Economy slowing
- “ RBA will continue with prudential tightening
- “ Negative gearing & capital gains tax removal >> lower house price inflation
- “ Worries affect banks
- “ If house prices plunge >> recession and A\$ collapse

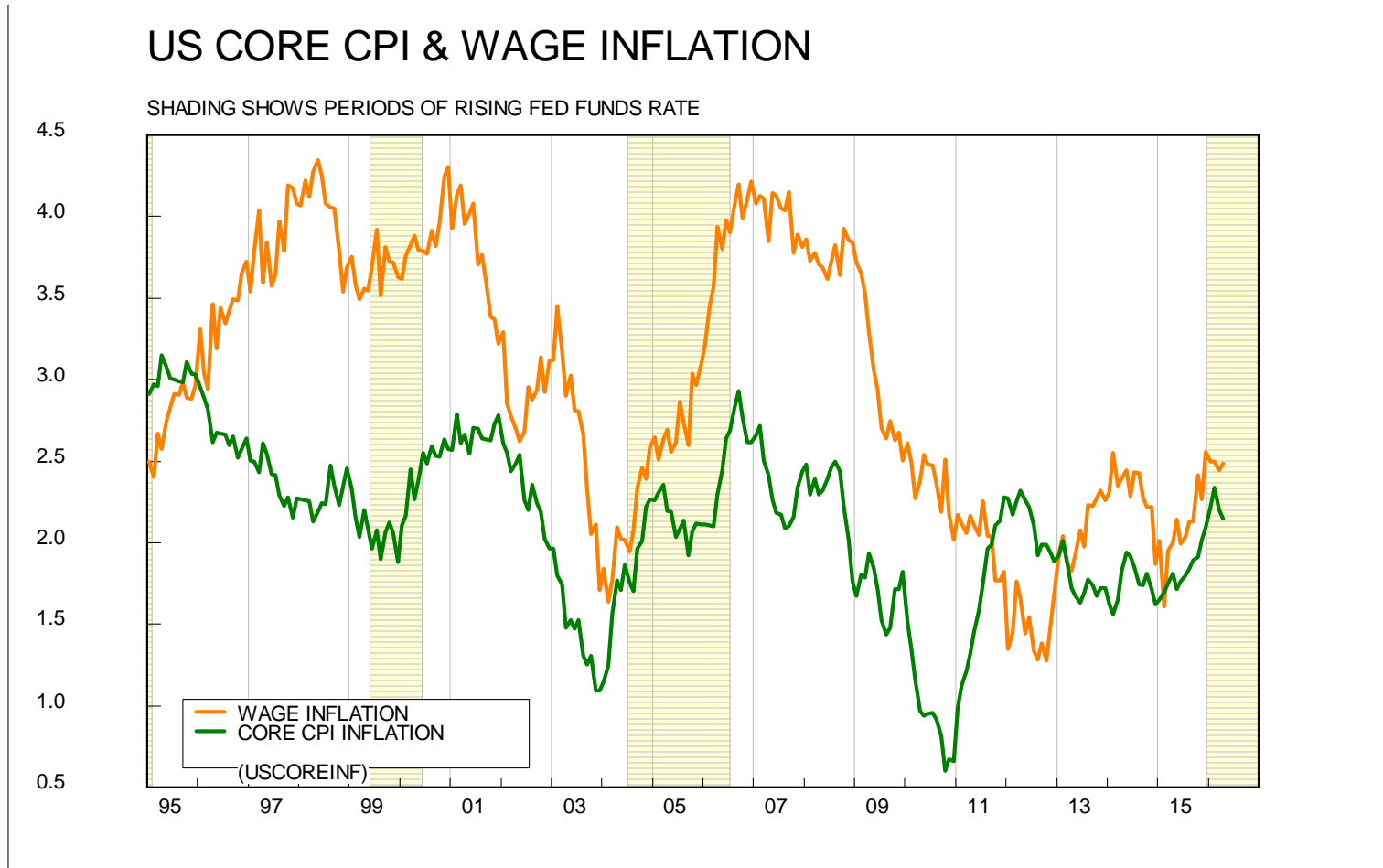
US still slowing



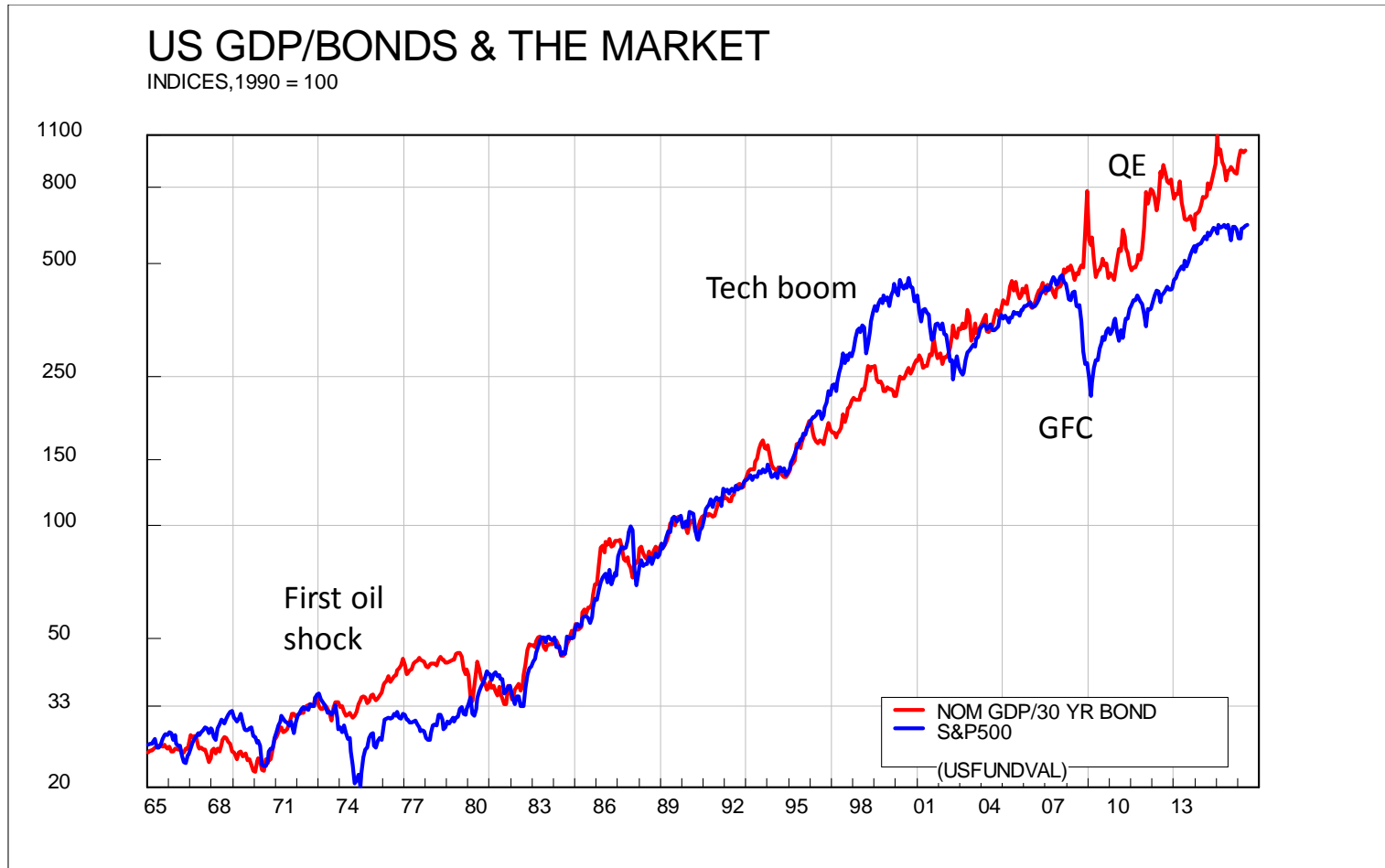
US econ slowing



Inflation has picked up



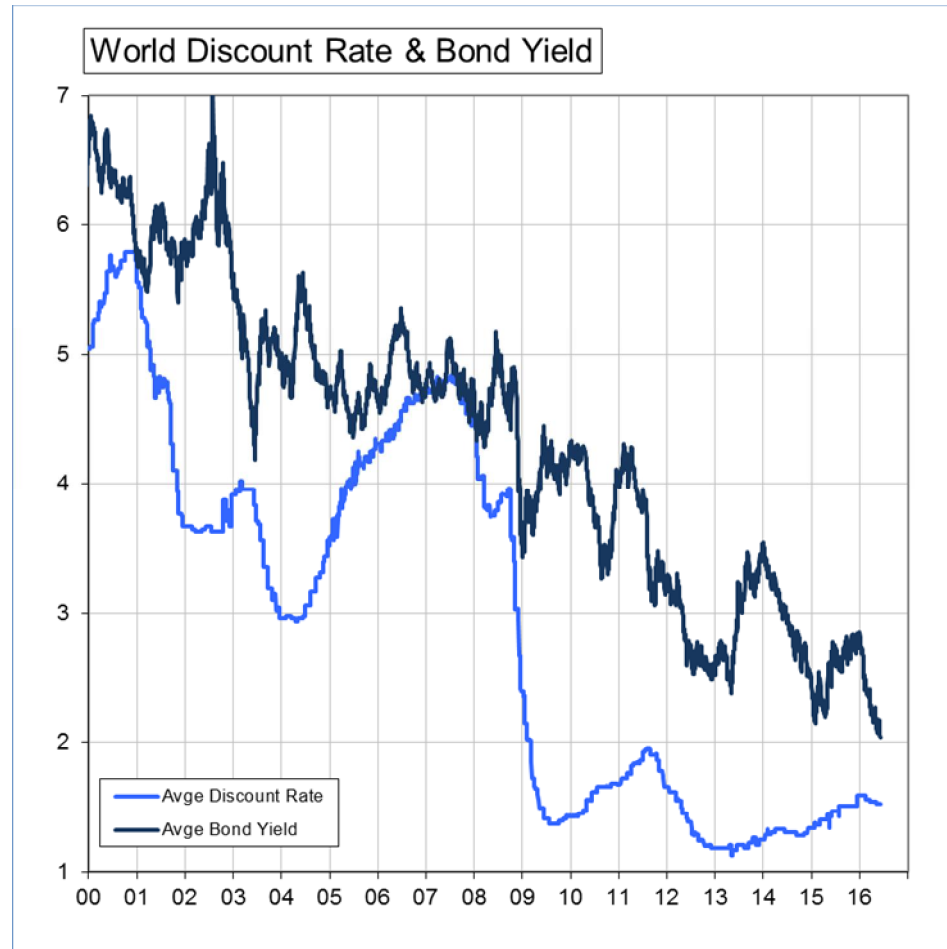
Market cheap rel to bonds



Market in new uptrend



Bond yields still falling

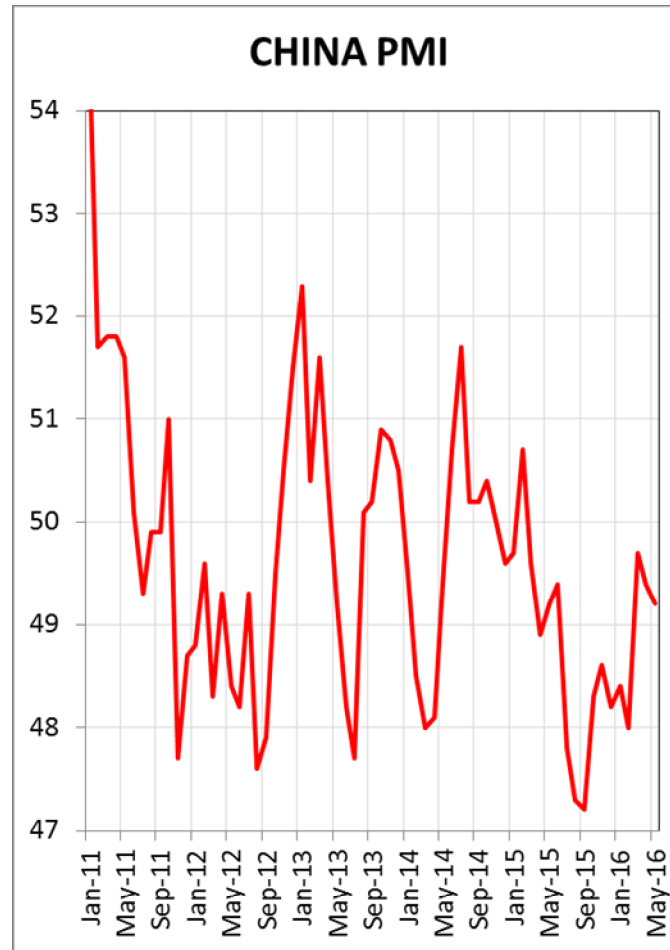


Euro GDP above pre GFC peak

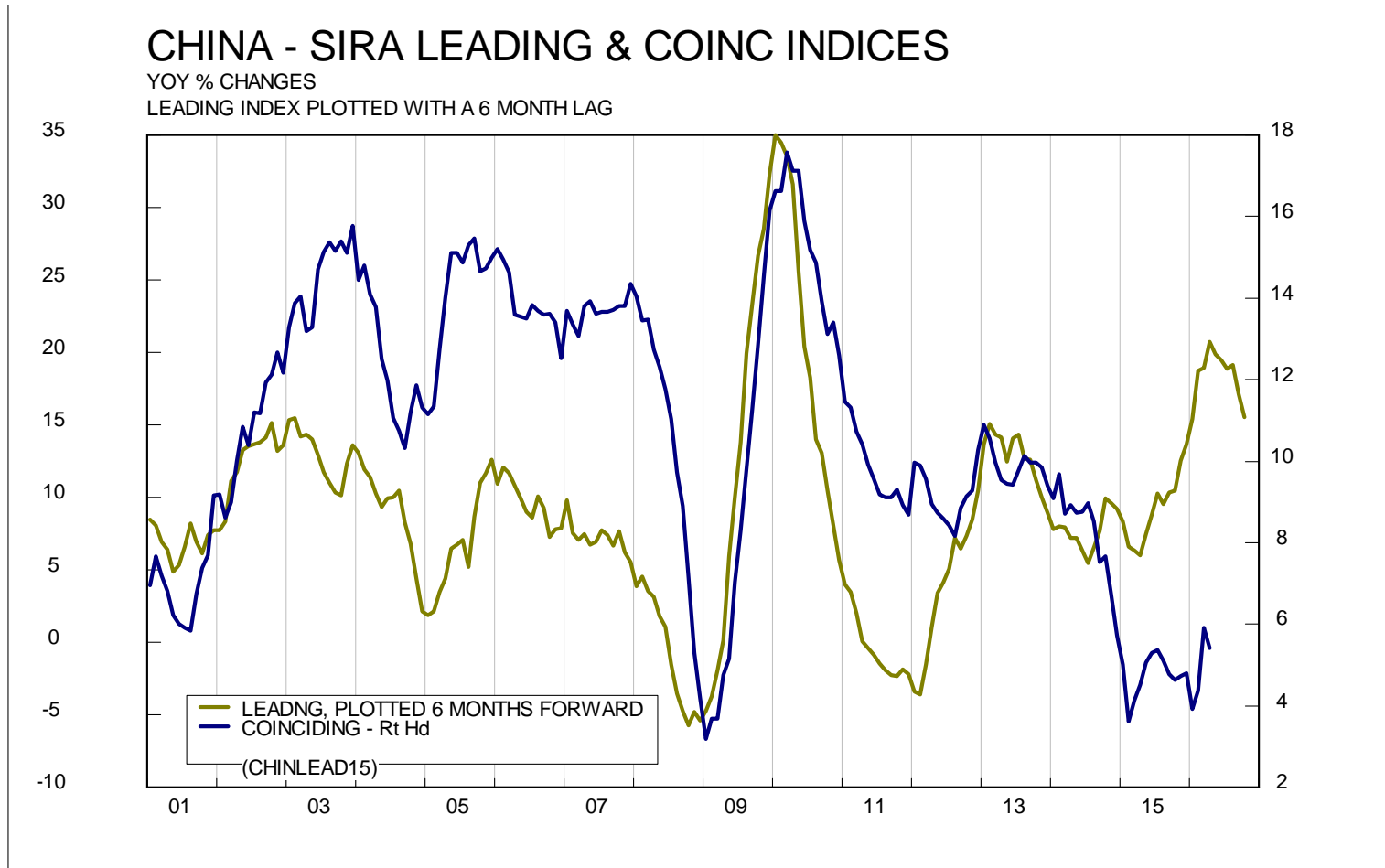


...but growth rate since Q1 2008 is just 0.2% per annum

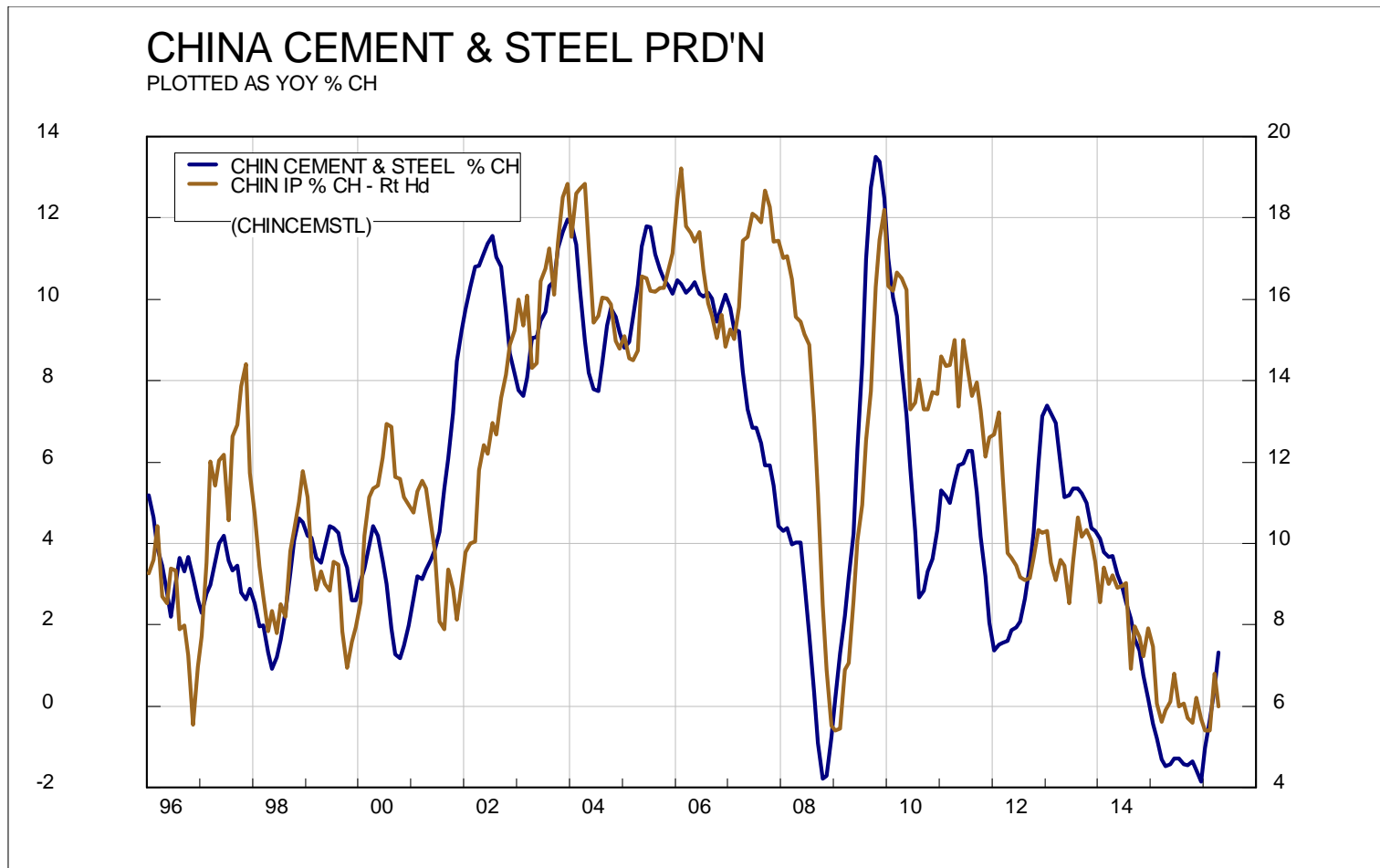
China PMI picking up



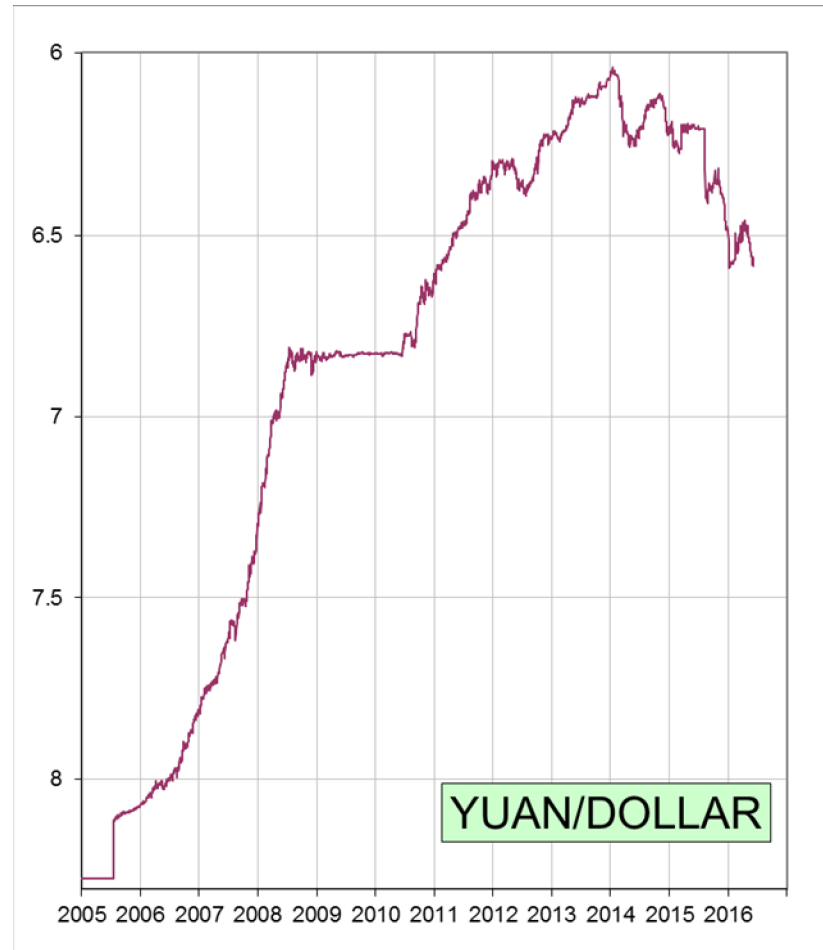
... and leading index rising



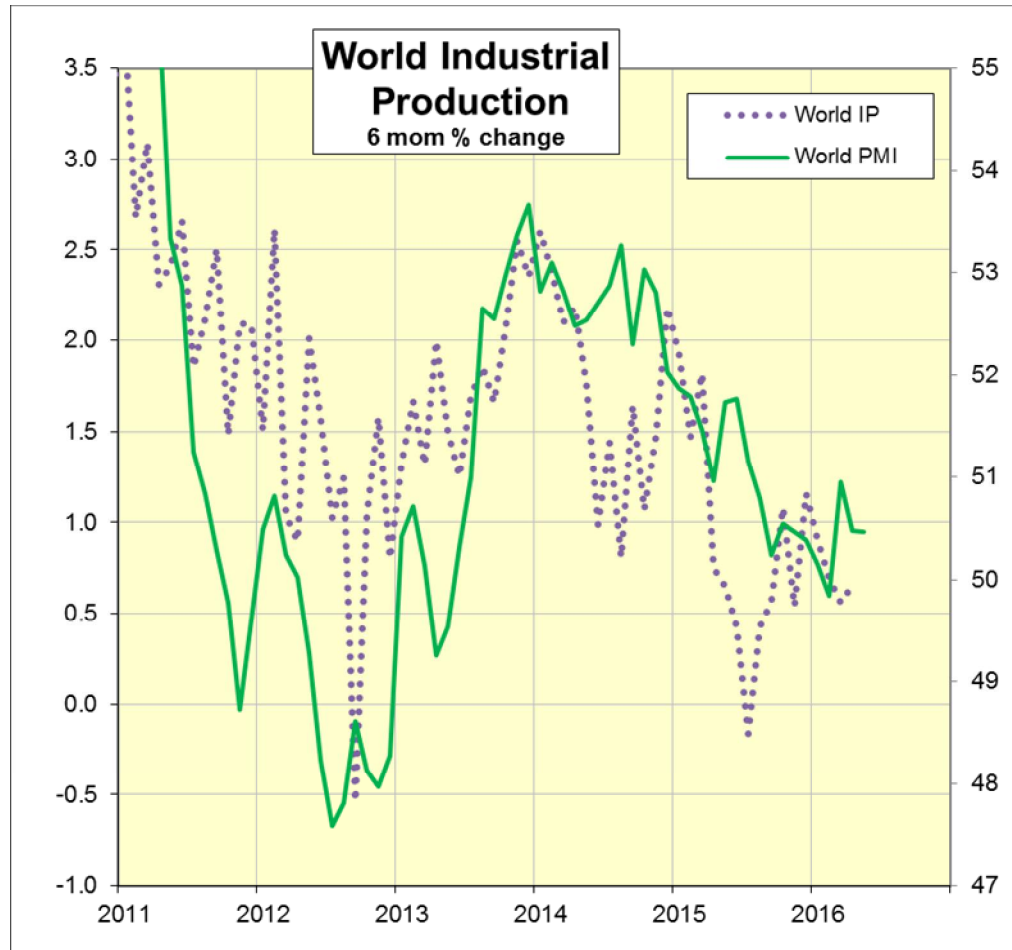
Steel & Electricity up



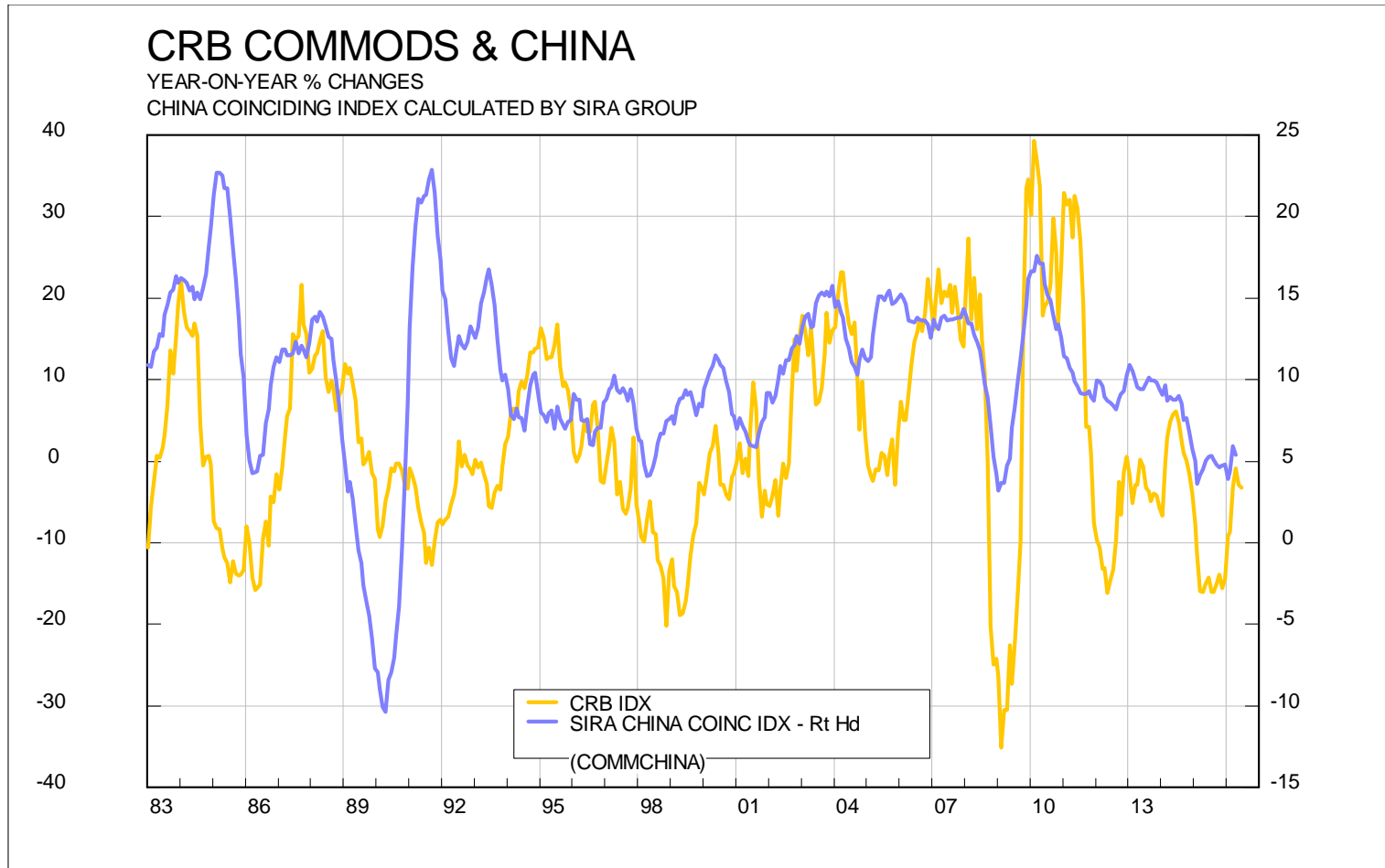
Yuan being nudged lower



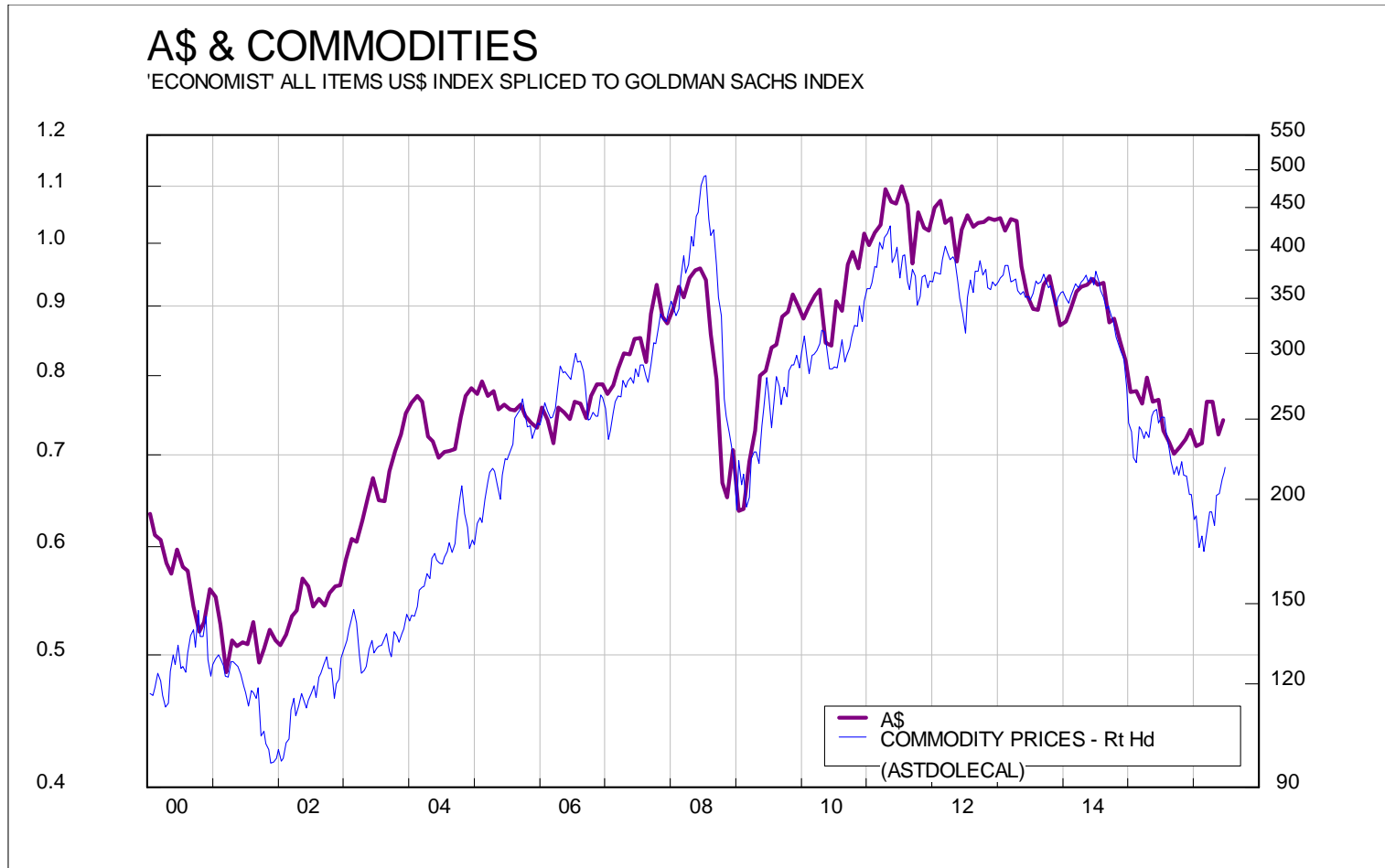
World IP still weak ...



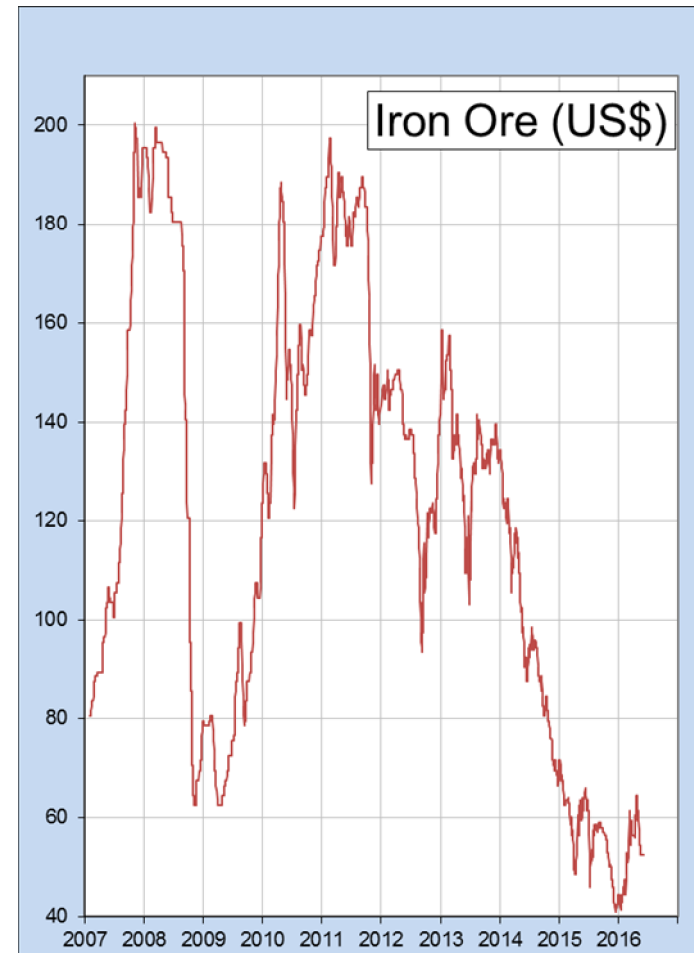
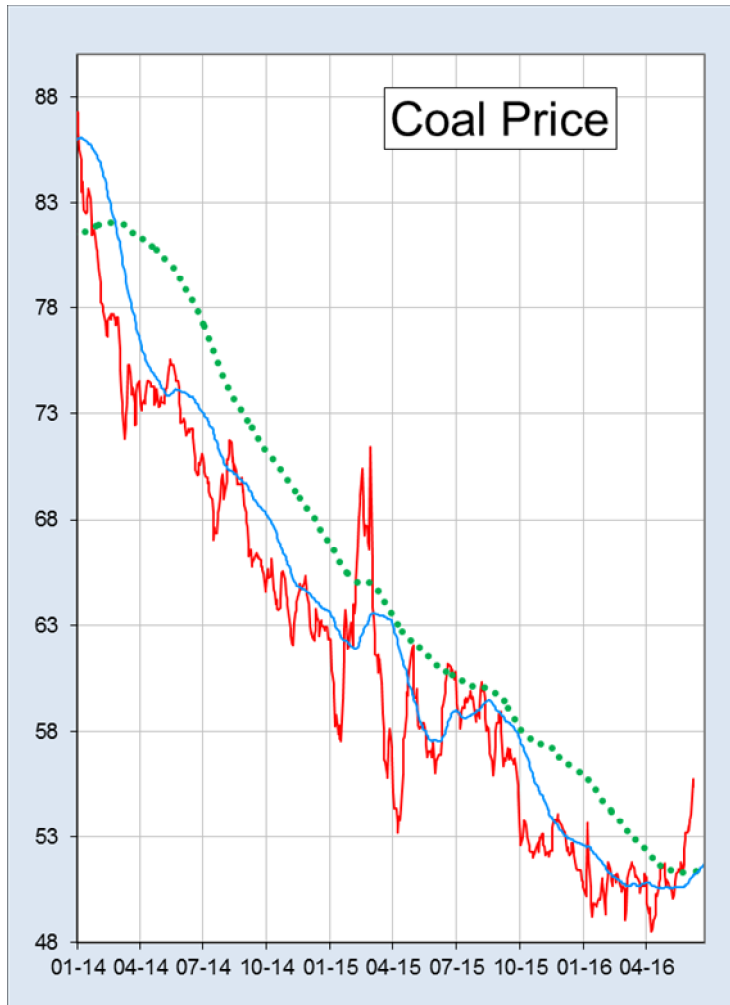
China may be lifting commods



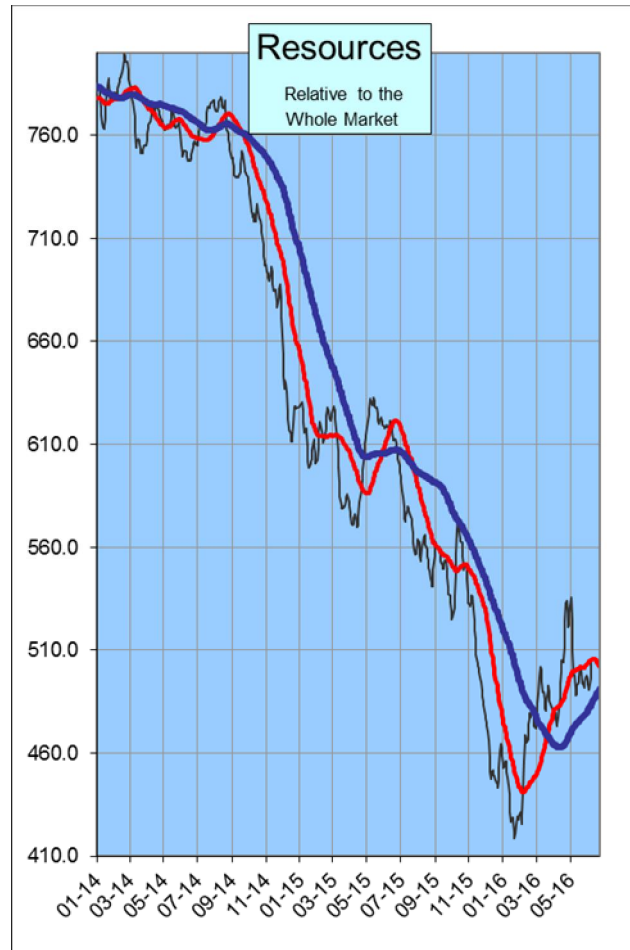
... hence odd rally in A\$



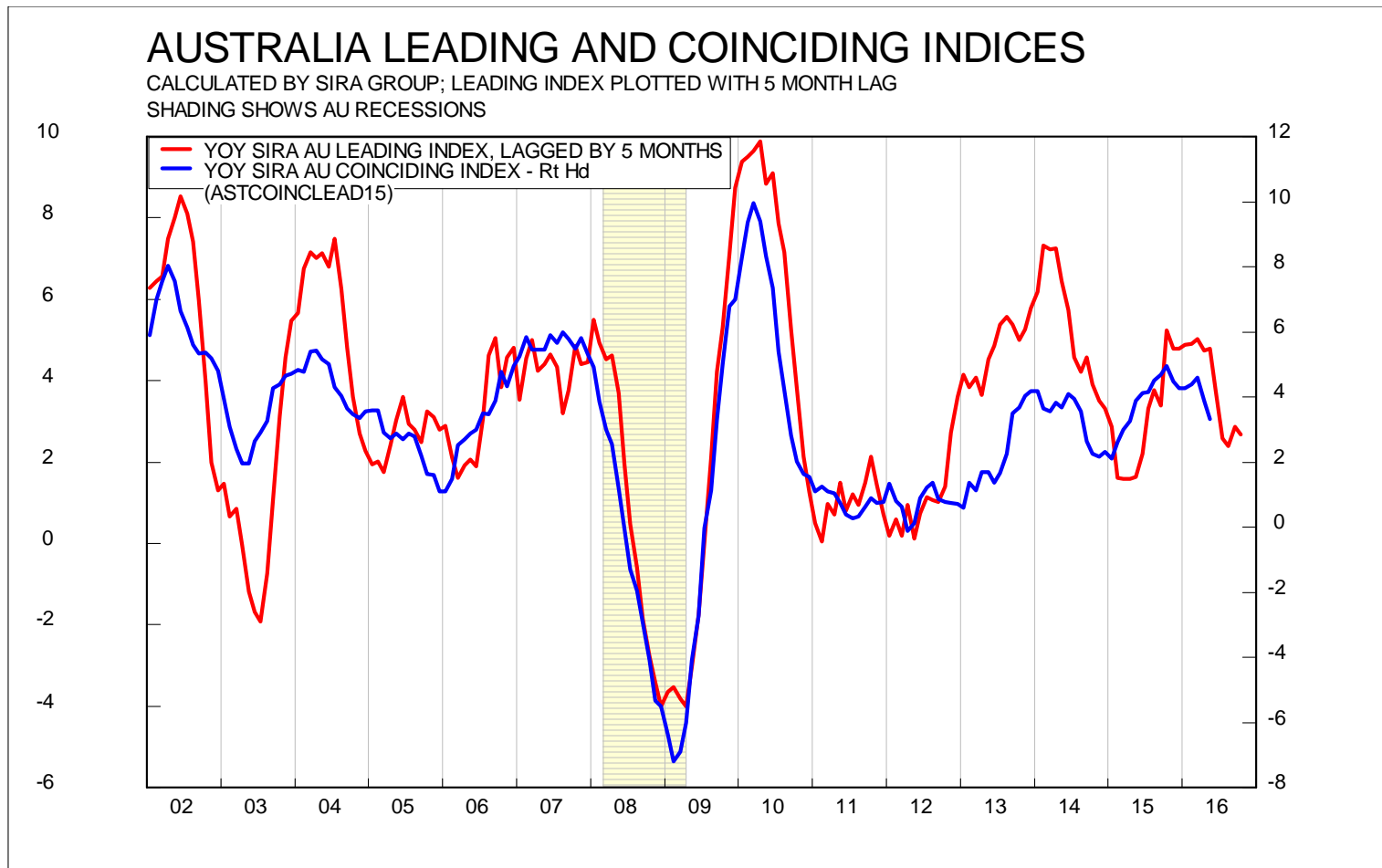
Iron and coal bottoming?



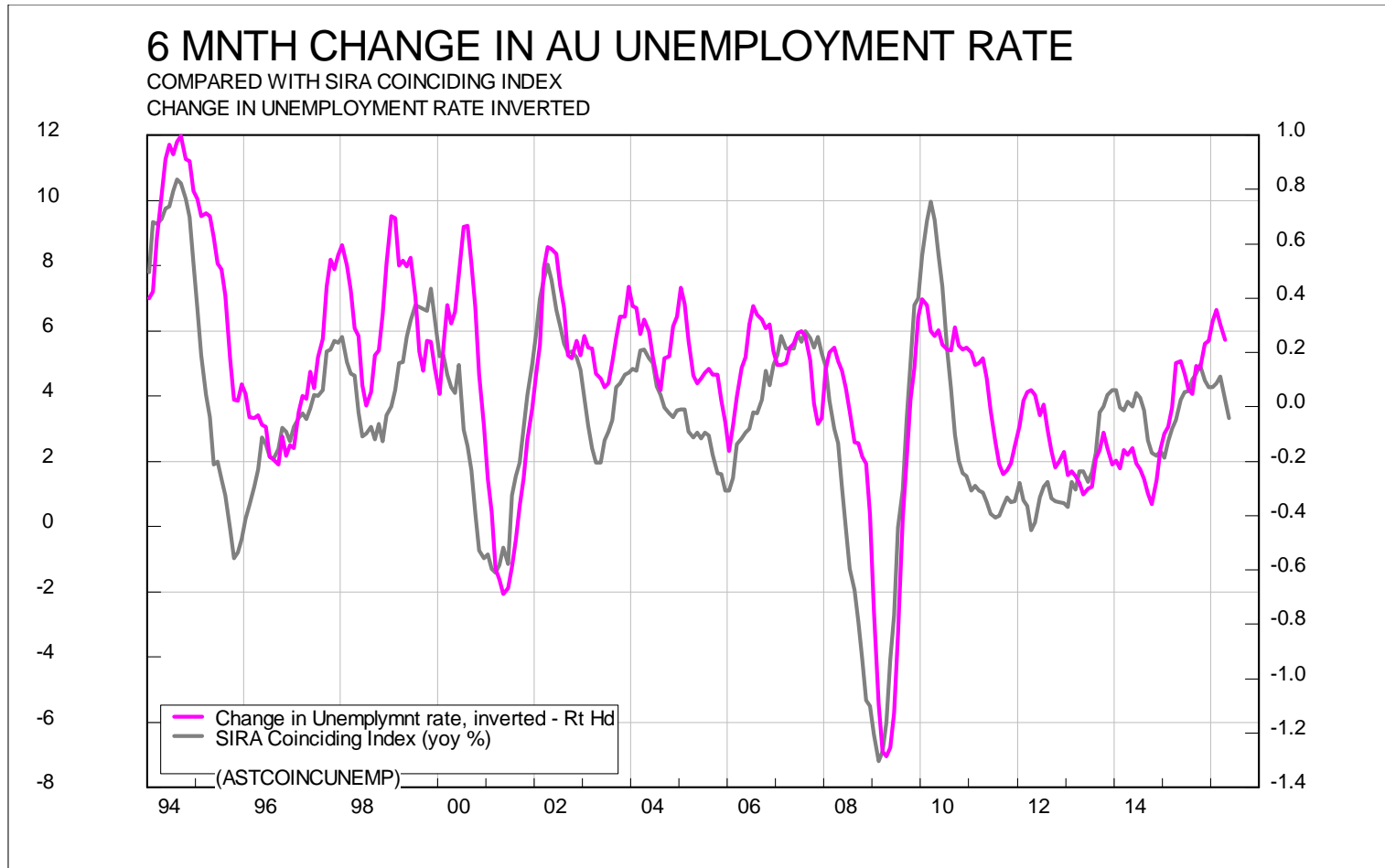
Resources relative improving



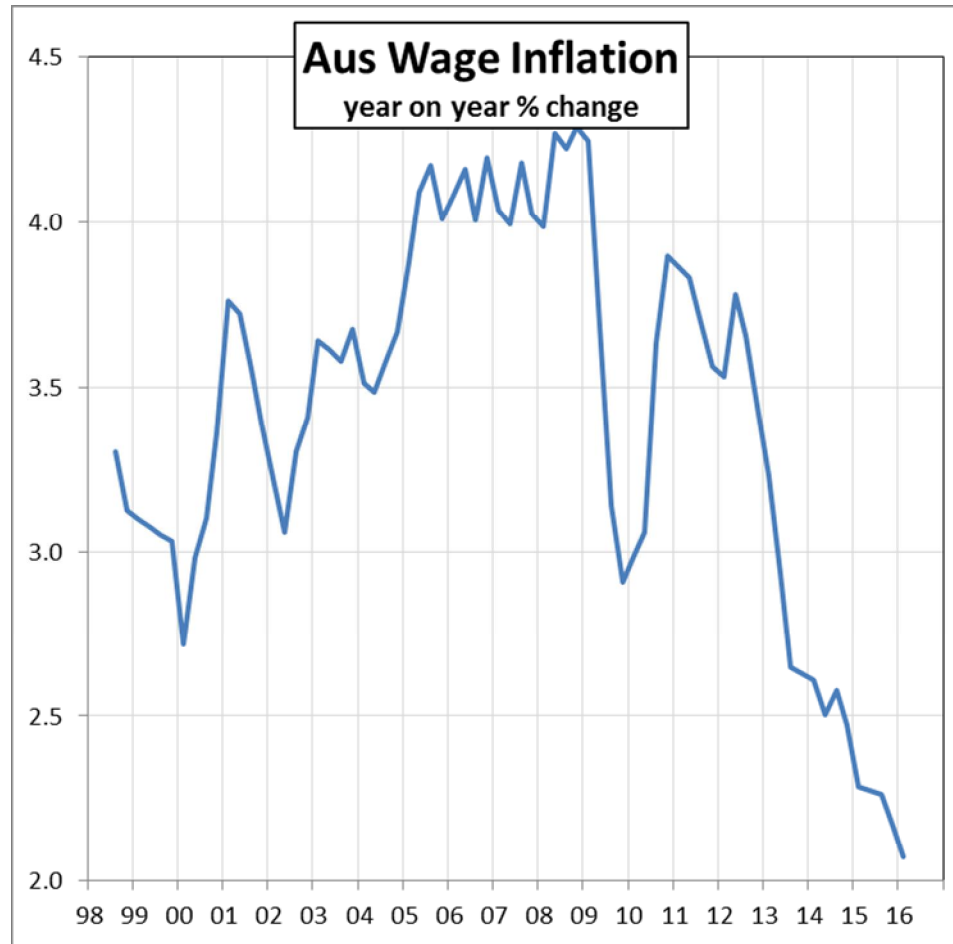
SIRA leading index rolls over



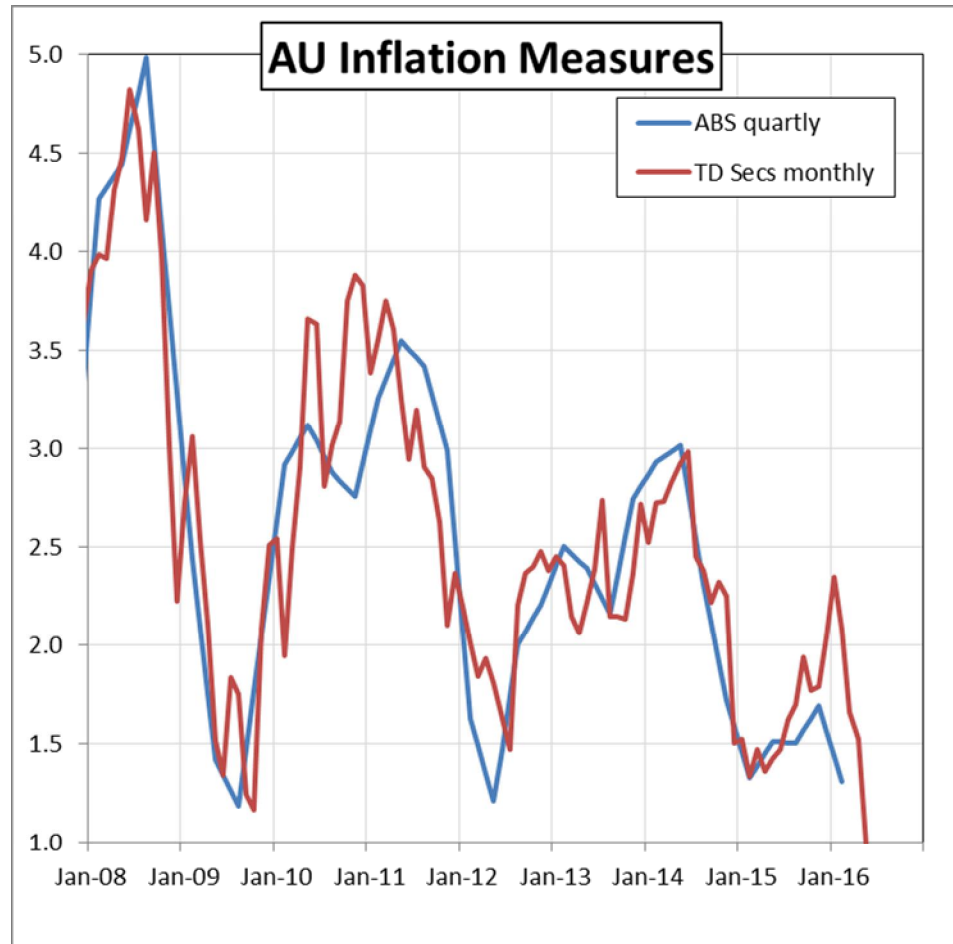
Unemployment to start rising?



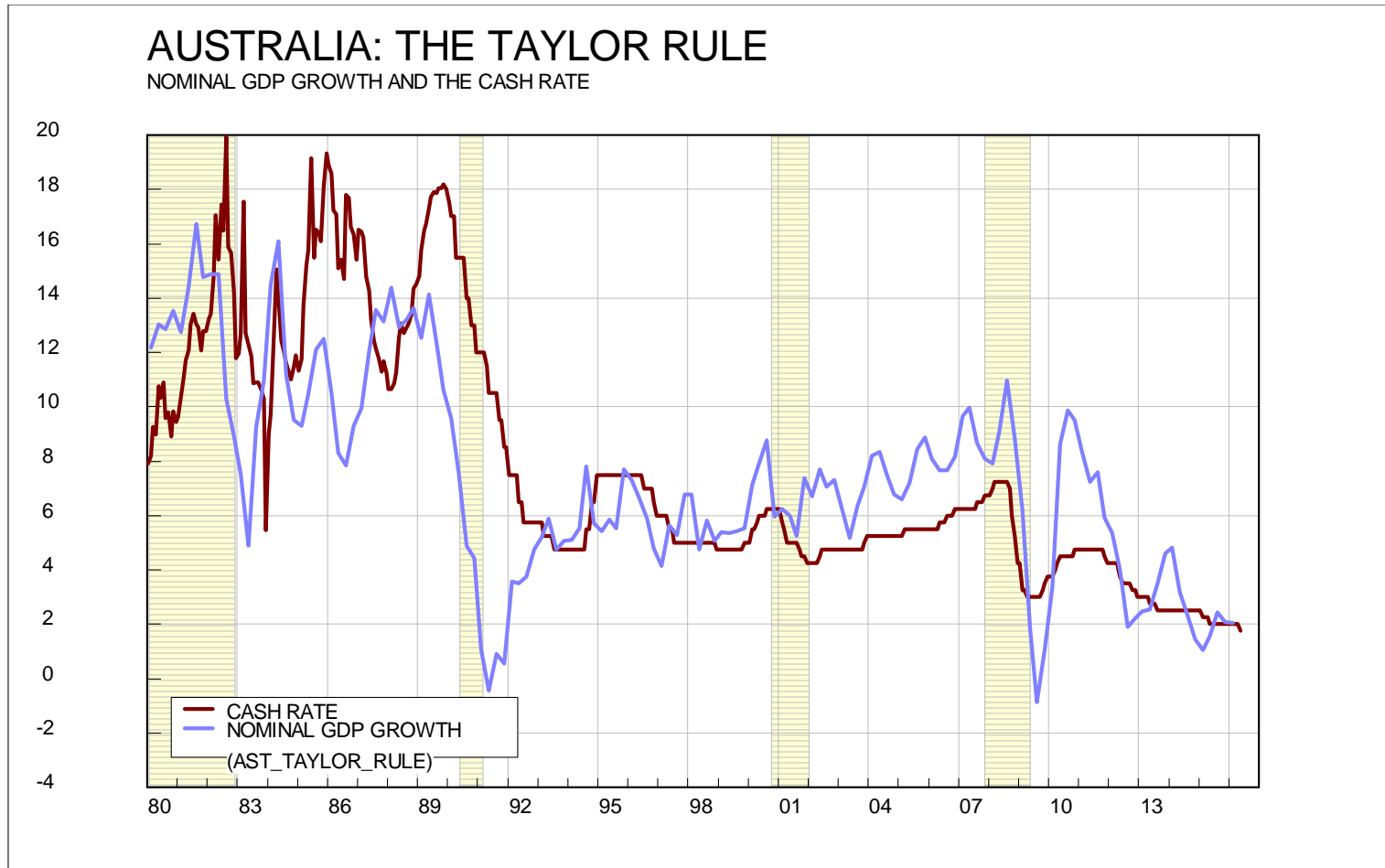
Wages growth just keeps on sliding



Inflation off the chart



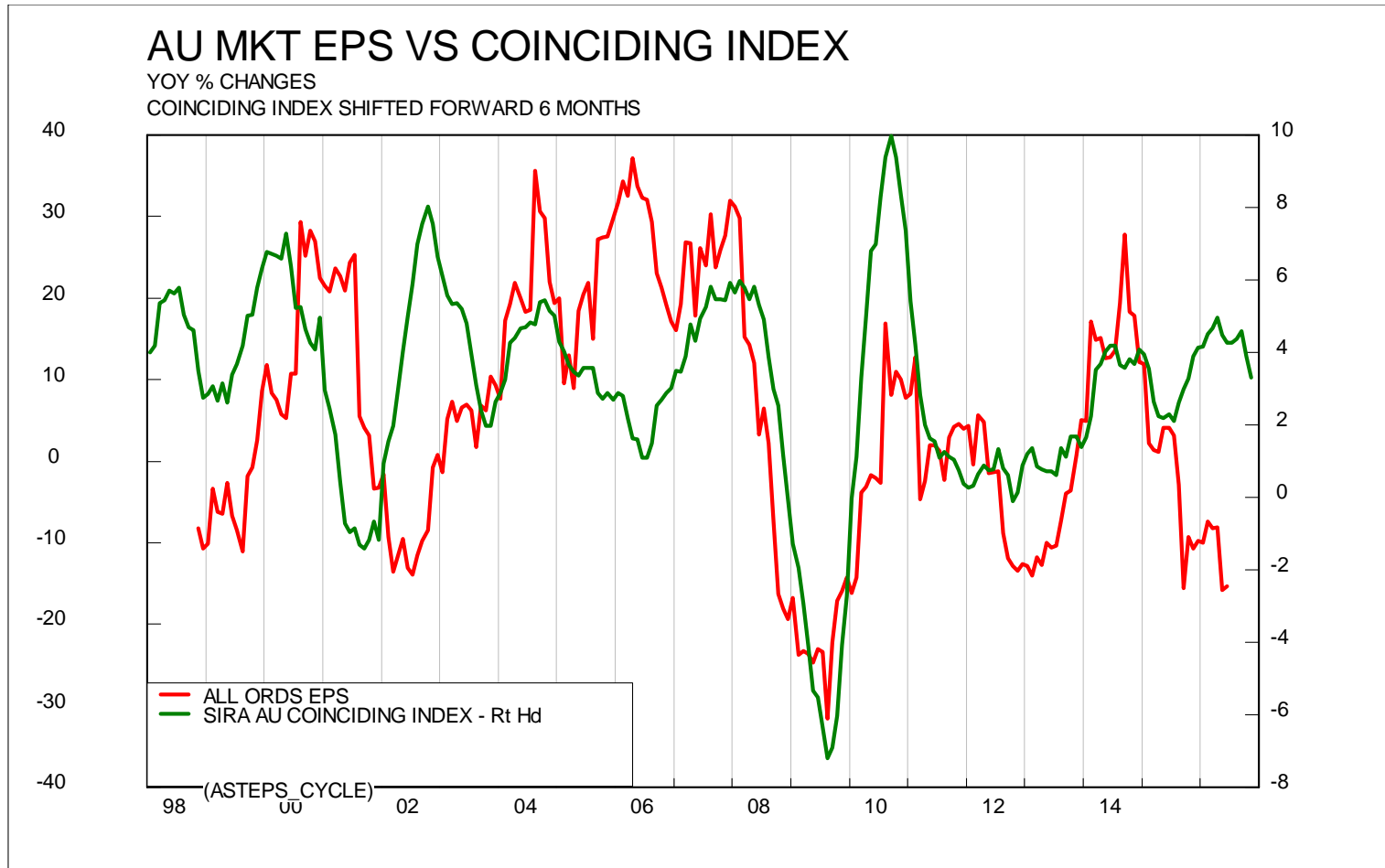
Cash rate headed south



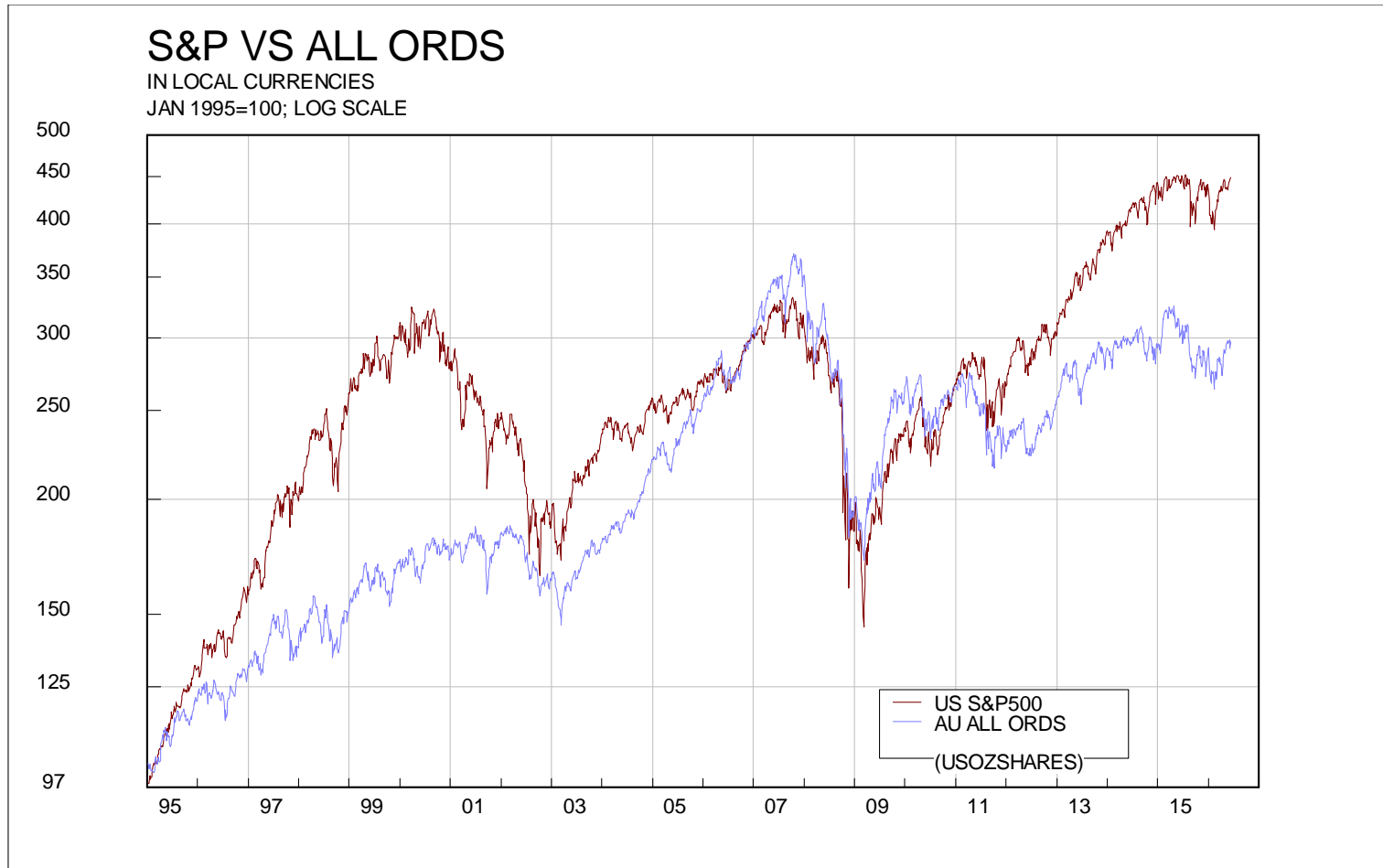
A\$ conundrum

- “ AU econ slowing
- “ Unemployment to edge up
- “ Inflation low
- “ Wage growth weak
- “ GDP growth misleading
- “ Housing structural negative
- “ Cash rates will fall
- “ Commods have bottomed – China (but not return to boom years)
- “ World growth bottoming. Maybe.
- “ Technicals supportive

Industrial earnings growth subdued



Australia usually follows US



Summary

- “ Big risk is housing – if unemployment rises
- “ Cash rate will keep sliding
- “ Bond yields likely to decline
- “ Industrial EPS sluggish except for foreign earnings
- “ Move from underweight resources to neutral
- “ US Market in new bull run; AU mkt to follow