CIO Monthly Note

September 2015

The China Slowdown and the Fed



The month of August was a difficult month for global equity markets which suffered their worst monthly performance since 2012. The weakness was mostly driven by uncertainty surrounding the state of the world's second largest economy, China.

The Chinese economy is expanding at a slower pace compared to previous years. While on the surface this isn't too alarming and mostly expected, investors are concerned about the pace of the slowdown. So the recent devaluation of the Yuan was a sign that maybe growth was slowing faster than the market and policy makers were expecting.

This is clearly not a good sign and markets did what markets do when receiving such news — they corrected.

As a fix, both the central bank and Beijing need to work together on targeted stimulatory measures coupled with language aimed at supporting confidence. The recent rate cut by the Chinese central bank, the PBoC (the fifth since November) is a good start but I believe more will be needed.

The domestic market had its reporting season with capital management, a focus on dividends and weak FY16 guidance all prominent themes.

The challenges for corporate Australia were confirmed with consensus earnings growth for FY15 (ASX200) revised down from +1.0% (already a low hurdle rate) to -1.8% with only 50% of companies beating analyst expectations.

Looking forward, the outlook for global equity markets will be dependent on growth and monetary policy. On growth, we expect it will remain positive but moderate with uneven performance across countries and regions.

Developed economies are expected to perform better than emerging economies on the back of ongoing solid growth in the US. However, there are growing risks in emerging markets as weak global trade, weak commodity prices and tightening credit conditions all weigh on activity.

On monetary policy, underlying activity in the US continues to improve and it will be appropriate for the Fed to begin to raise rates soon. However, given ongoing deleveraging, subdued inflation and weak labour force participation, it is likely that US bond yields will remain low and the Fed's rate rises will be very gradual.

Locally, the outlook is for sub-trend growth to continue as the economy transitions from mining. A lower AUD combined with lower interest rates are still required to boost growth.

On equities, given modest but positive growth and supportive monetary policy, equities should continue to grind higher over the next 12 months with dividend returns accounting for a larger share of total returns.

Equity valuations are no longer expensive and compared to other asset classes the risk and reward trade off continues to look attractive. However we maintain a cautious approach. Our portfolios remain defensive and we prefer companies that have solid growth profiles and high free cash flow yields.

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(this note was written 6 September 2015)