INVESTMENT MANAGEMENT

Investment Outlook 2016

Introduction

As 2016 gets underway, with a reminder that risk assets are called that for a reason, we have summarised the outcomes of 2015 and set out our investment experts' thoughts on the key themes for the year ahead.

Will the significant market volatility experienced at the start of the year continue, or will January prove to be a hiccup from New Year?

Whatever the outcomes, 2016 is likely to see the continued interplay between central banks and markets, suggesting volatility will be a key theme of the year. In this environment it is important investors remain focussed on the risks they are taking and the rewards they expect to receive.

Overall, as in 2015, there are likely to be significant investment opportunities for specific sectors and having the right investment partner is key.

Important Notice

Macro perspectives

Graham McDevitt | Global Strategist

- The global economic environment is characterised by divergent growth between and within countries.
- This has led to divergent monetary policy across countries, with the US now clearly intent on getting rates off their emergence levels resulting in dramatic repricing across foreign exchange rates.

Review of 2015

Europe joined Japan and the US in the use of unconventional monetary policy in 2015 with the result being a collapse in global short term rates, putting many countries into negative territory. Despite the massive easing of monetary policy the global economy struggled and in fact lost momentum.

2015 witnessed the future of the European Union again being taken to the brink with Greece going very close to default and exit. Elsewhere, China was in the spotlight, with growth slowing, followed by a surprising devaluation of their currency in August and a resultant collapse in commodity prices, across the board in 2015 representing both the global weakening of demand and also the lack of (needed) supply adjustment.

The US Federal Reserve lifted interest rates by 0.25% in December despite growth continuing to gyrate around 2%, as it has for the past several years. We believe a downward revision to estimated trend growth (to sub-2%); a collective desire to disentangle itself from unconventional policy and provide more flexibility for the future are driving Fed thinking.

The Australian economy has proven more resilient than expected and the labour market in particular. The Reserve Bank has been a cautious cutter of rates while fiscal policy and the weaker Aussie dollar have provided a buffer to the adjustment from the mining sector overhang.

Outlook for 2016

The global economy is expected to remain challenged, with the US Fed guiding toward a tighter monetary policy path and China struggling to manage its short term cyclical pressures against the need for long term structural reform. This environment does not suggest inflation risk will outweigh deflation pressures. Thus, the majority of global central banks are expected to maintain or extend easier monetary policy during 2016. These divergent economic and policy pressures are likely to lead to a period of volatility across asset markets, with foreign exchange markets in particular vulnerable to sharp moves.

Australia managed to avoid a recession in 2015 even with the terms of trade collapsing due to the structural rebalancing from the mining boom ending. The strength of the labour market surprised in 2015 and there is a risk that this could reverse in 2016. How this plays out should prove crucial for Reserve Bank policy setting. In addition, fiscal slippage has limited flexibility with the rating agencies watching developments closely and highlighting the vulnerability in the event of a negative external shock. Compared to the rest of the world, growth looks close to trend albeit with significant headwinds. With fairly stable and positive inflation, this suggests that further rate cuts are possible but likely to again be a drawn out process, as further exchange rate depreciation should do the majority of further easing for the RBA.

Global Fixed Income

Brett Lewthwaite | Head of Fixed Income and Currency

Review of 2015

- Less faith in central banks made it harder to 'paper over the cracks' of low growth, high debt levels and low inflation
- Markets were fragile and volatile, with commodities and names with commodity exposures hit hard

Markets were fragile and volatile in 2015, with few asset classes providing returns that were materially above zero and many in deeply negative territory. Developed market central banks overall continued to ease policy, led by the ECB and the Bank of Japan, though there was a growing sense of monetary stimulus fatigue as the year wore on. Compounding this, the Federal Reserve raised US rates in December, the first time since 2006, despite lacklustre growth and little sign of price pressures building. Less faith in central banks made it harder to 'paper over the cracks' of low growth, high debt levels and low inflation.

Commodities stood out as poor performers, from oil, copper, and iron ore, to soft commodities such as wheat and corn. The moves were driven by a combination of supply, global demand, and the stronger US dollar, which most commodity contracts are priced in. There were significant impacts on commodity producers, which clearly weighed on high yield credit and emerging markets.

China's surprise de-valuation of its currency, and the equity market boom and bust, focused attention on the imbalances and underlying strength of the economy. China has been a key driver of world growth in the last decade, and particularly important for the Australian economy.

Credit markets suffered in 2015, particularly in the high yield and emerging markets sectors. Any names with commodity exposure or high leverage were hit particularly hard, and the broader universe sold off in sympathy, driven by a combination of macro and idiosyncratic events.

Outlook for 2016

- Bond markets will continue to be well supported and will continue to provide an important diversifier of risk during the year
- We see selective opportunities in credit markets based on attractive pricing

There is a large degree of uncertainty as we enter 2016. What is clear is that economic growth globally is still subdued, inflation pressures remain absent and the outlook for most asset classes is for more volatility. The Fed's outlook indicates another four interest rate hikes for 2016, in contrast we view the market expectation of two hikes as still being too optimistic.

Given the economic backdrop, debt levels, and fragile markets don't warrant significant further hikes, we believe the Fed will be forced to be much more gradual in hikes than many expect. Bonds markets will continue to be well supported, even at yield levels that don't offer exceptional value.

The downside case for 2016 is either a further global slowdown, or capital flight from emerging markets igniting a more systemic risk-off event. China's devaluation in 2015 and further volatility in recent weeks highlights how sensitive the world is to small movements here. Accordingly we remain out of emerging markets, given growth is faltering and debt levels have grown substantially.

Broader risk markets are a more interesting call for the year – we expect most markets to trade in a wide, volatile range, with sharp changes in sentiment offering opportunities for both adding and reducing risk. Credit markets have already repriced back to 2012 levels, and so do offer some opportunities. In contrast most equity markets are not far from their recent historic highs, so we see a better outlook for credit than we do for share markets generally.

Australian Equities

Patrick Hodgens | Head of Equities

Review of 2015

- Significant divergence in performance across sectors and stocks
- Active stock picking key to delivering returns to investors

The ASX200 finished up a relatively modest 2.6% on a total return basis for the year. Stripping out dividends, capital growth for the index was actually ~-2%. Investors experienced a volatile year with the market opening strongly, up over 10% in the first three months. Over the next six months the market gave back more than it had gained, dropping 12.7% to 30 September 2015. Only a strong October and a Santa rally in December (ASX200 up 2.7%) kept the index in the black for the years end. The performance of the Australian market mirrored that of many commodity prices, notably oil and iron ore. From May, oil resumed its sell off, falling some 50% to finish the year at its lows. The iron ore price also collapsed falling from ~$72 to ~$38 before recovering late in the year to close at ~$42.

While the overall market returns left a lot to be desired, there were significant opportunities available for stock pickers. Significant divergence across sectors and stocks provided plenty of opportunity for active managers to generate excess returns. For example, the resource and energy sectors took a bath. BHP Billiton and Rio Tinto were down ~33% and 23% respectively, while Origin Energy and Santos fell a staggering 54% and 49% for the year. On the flip side companies with exposure to the rising Asian consumer took flight with Bellamy's and Blackmore rising 725% and 519% respectively. Qantas also saw its fortunes rebound in 2015 rising 70%. The much maligned media sector also saw some strong gains for those that knew where to look, with Out Of Home advertising companies APN Outdoor and oOH!Media rising close to 140% each.

Outlook for 2016

- Continued weakness in commodity prices with supply/demand dynamics remaining conducive to lower for longer prices
- Rise of the Asian consumer to garner greater focus from Australian businesses

Low earnings growth and limited opportunities for multiple expansion have set the Australian equity market up for a positive year, but returns will be lower than historical norms.

Australia's domestic economy will likely be a bright spot of the year ahead. A new prime minister has increased business confidence – which should flow through to investment, and most consumer measures suggest strengthening in consumer discretionary spend. At this stage we expect the cash rate to remain flat at 2.0%, although unemployment may rise slightly from the current 5.8%.

From a valuation perspective the market currently looks better value than it did a few weeks ago with the market now trading in line with its long term average of 15 times forward earnings estimates. As with 2015, we expect 2016 will again be a stock picker's market.

We think the key risks to the performance of the Australian equity market are:

Commodity Prices: excess supply is set to continue with lower spot prices impacting share price valuations.

Election cycles in both Australia and the US: is likely to lead to a period of limited government legislative activity and an increase in regulatory uncertainty.

Decreasing attractiveness of yield: In the 'low yield' environment we continue to believe that "yield" stocks will maintain their current valuations, but are wary of the risk.

Currency: If the Australian dollar continues to fall, this may bring some relief to the Australian share market, particularly commodities and offshore based companies.

Where to focus in 2016

Within the Australian equity market we believe the best performers over the next year will be domestic and globally exposed Industrials. The offshore based earners will benefit from any further depreciation in the Australian dollar, as well as any uptick in growth in the US. Australian industrials are seeing some increase in business confidence, and an improving consumer discretionary spend from recent wealth increases.

Resources continue to face strong headwinds, as previously mentioned, from excess supply and weak demand in China. Spot commodity pricing is not yet reflected in share prices.

Yield stocks, largely driven by the banking sector, may maintain their valuations but further outperformance is challenging. The payout ratio for the market is now a staggering 78% - the highest over the past 20 years. This means dividend growth will be limited to earnings growth for most companies with higher payout ratios, particularly the banks.

Infrastructure Securities

Jon Ong, Portfolio Manager

Review of 2015

- Differentiated returns across infrastructure
- Some stocks caught in the downdraft of lower commodity prices

Global listed infrastructure stocks experienced mixed returns in 2015. There was a wide spread of returns across the range of infrastructure sectors. Transport infrastructure stocks such as toll roads and airports did well, benefitting from ongoing volume growth in vehicle traffic and passengers respectively. The lower interest rate environment remained supportive, particularly for the long duration toll road stocks.

On the flip side, energy infrastructure stocks, particularly in North America, underperformed sharply, as markets became concerned about the potential flow-on effect of the sharply lower oil and gas prices. While our preferred stocks have minimal direct commodity price exposure, their share prices were not able to withstand the pessimism pervading the broader energy sector. Expectations of fewer growth opportunities contributed to the underperformance. As their operational performance and outlook remained positive, some compelling valuation opportunities emerged as the year progressed.

Outlook for 2016

- Regulated utilities to benefit from the growth in renewables
- Valuation opportunities in energy infrastructure
- Opportunities from the growth in demand for data
- Valuation opportunities in China

Regulated electricity utilities

We believe that interest rates globally will remain lower for longer, and see specific benefits for the electricity utilities sector. Investment by regulated utilities is relatively independent of economic growth, and can be driven by current trends like the growth of renewable sources of electricity. We believe further renewable penetration into the electricity generation business is inevitable. Electricity transmission networks will need to expand as renewable generation is located in geographies that are different from traditional generation sources.

Ongoing investment, combined with relatively stable, regulated rates of return tends to deliver consistent earnings over time for the regulated electricity utilities.

Weak Energy Prices

While the pipeline sector experienced a notable decline in 2015, we believe that many stocks were oversold relative to their fundamentals, suggesting meaningful valuation upside. In addition, the companies in which we invest continue to show a disciplined approach to capital allocation, positioning them well to benefit from any mispriced assets, potentially from distressed sellers, that become available in the marketplace.

Growing demand for infrastructure to support data demand

There is strong growth in the use of mobile data globally. For example, current projections are for the average U.S. smartphone to consume almost 4 times as much mobile data by 2019 as in 2015. An even greater increase in average usage is projected for network connected tablets which are expected to consume nearly double the amount of an average smartphone by 2019. We see telecommunication tower companies as a relatively low risk way to benefit from the strong global growth in mobile data usage, which is providing those companies with an attractive growth profile.

Valuation opportunities in China

While several renewable energy stocks were sold off last year, the demand for more renewable energy remains strong. The government is still very focused on reducing pollution and our long-term positive view of renewable energy in China remains intact.

Chinese ports were also sold down, but we believe the market has overreacted to expectations of slower economic growth and the potential impact on container volumes slowing at the ports. While the market is concerned about slowing Chinese economic growth, given the greater importance of exports (vs imports) to overall port revenue, it is actually economic growth in key export markets which is more important to the fundamentals of the Chinese ports.

Overall, the expected economic environment of relatively slow growth and low interest rates is one in which infrastructure assets can perform well, as the assets are less linked to the economy than the more cyclical sectors of the equity markets.

Asian Equities

Sam Le Cornu | Head of Investments

Review of 2015

- Volatile year for markets and China dominated the headlines
- Our disciplined process delivered strong returns by remaining focused on risks

China grabbed most of the headlines in 2015 on everything from contagion risks of the A-Share stock market meltdown and grave concerns over a possible hard-landing. We wrote in the last Investment Outlook 2015 that the challenge would be macro shocks and increased volatility. As such we dialled back the risks and remained conservatively positioned when markets rallied up to April 2015. China was very volatile whilst ASEAN was sold off the most, both India and Korea were flat. But was it all bad? The answer is no. Domestic demand and local consumption sectors (product and services) fared well. We see this as a direct result of China rebalancing the economy away from overcapacity sectors like steel, materials and cement (this had very clear consequences on commodity prices) towards consumption sectors. Favourable policies and reforms benefited the rise of the middle class. Healthcare, Telecom Services and Consumer stocks did well in the context of 6 interest rate cuts and 5 reserve requirement ratio (RRR) cuts in China.

Outlook for 2016

- Asia will be heavily dominated by policy and reform measures that benefit the consumer
- A significant 'QE China style' program is already underway and will intensify
- China will dominate the headlines again in 2016 as the PBOC significantly eases monetary policy and the NDRC announces targeted (limited) measures of policy stimulus

What's going to turn things around in Asia this year?

We expect 2016 will see significant 'QE China style' leading to further interest rate cuts, RRR cuts and enormous amounts of cheap liquidity going into the financial system in China. In short what the rest of Asian central banks do won't matter nearly as much. Towards the end of 2015 China became part of the Special Drawing Rights (SDR), interest rates have been fully liberalised and policy tools such as Pledged Supplementary Lending (PSL) are now in full force. The SDR inclusion endorses the credibility of the RMB currency and will legitimise significant QE. What does this mean for Asia and China? We see a lot of opportunity. Last year we were cautious. This year we are cautiously optimistic. Valuations look cheap. Any market rally won't be based on fundamentals, rather, a results of the China QE program. We believe the way to navigate this is to remain extremely disciplined and not change our investment style, as always we remain bottom up and focused on the fundamentals. We will continue to favour domestic demand sectors such as Healthcare, Chinese Insurers, Consumers and Utilities.

International Equities

Charlie Macquaker
(Director, Walter Scott)

Roy Leckie
(Director, Walter Scott)

Review of 2015

- With earnings growth scarce for all but the very best companies and the ripple of economic risk, in depth scrutiny of all company investments is demanded.

Few dispute the importance of learning the lessons that history teaches us. Yet, so often this is forgotten. The allure of the promise of a new path, can lead to old-fashioned and often difficult tensions being left behind. Inflation has been forgotten. Interest rates above one or two percent have become a misplaced norm. The multi-faceted impact of the Federal Reserve's first step in increasing rates should not be underestimated.

The hand of central bankers across the major economies of the world has lifted financial assets and brought forward spending over recent years. Equity markets have risen strongly, yet consumer and corporate spending has remained constrained. The long-anticipated capital expenditure bonanza has not materialised. The M&A spree witnessed over the past 18 months should prompt concern not celebration. At best, it highlights a desperate pursuit of earnings growth. At worst, it is a blatant swap of over-valued equity, for cash in order to paper over strategic failings.

P/E expansion across the board cannot be relied upon, instead further share price gains over the near to medium term will require earnings growth. In such a market, there is no hiding place. Selectivity reigns. Earnings growth is now demanded but only those companies with meaningful growth prospects and stellar financial characteristics look likely to meet those demands.

2015 saw the team retreat from financials as the potential growth of individual holdings was outweighed by the inherent risks. Banks in particular continue to regularly win the prize for least transparent financial accounts. So too, the extremely challenging environment facing energy companies, given the languishing oil price, prompted review of a number of holdings, with divestment in some instances and increased investment in others. Emerging markets fell from vogue, which impacted both direct investment and those with indirect exposure. Yet, research trips to China and India in the final quarter of the year reminded us all of the opportunities in these markets amongst many others.

Given Walter Scott's demanding investment criteria, direct investment opportunities remain few and far between, but the long-term opportunities for global corporations remain material. Those with the balance-sheet strength and scale, to allow investment through the good times and bad, are better placed than ever.

Outlook for 2016

- The case for an active, highly selective stock picking approach is as strong as ever
- Over the long-term earnings growth drives returns

2015 saw the return of the stock picker. Markets became more discerning. We expect this to continue in 2016. The rising tide of equity markets that has lifted all, differentiated between none and masked mediocrity, may well have now ended.

Aligning portfolios with companies able to deliver robust earnings growth and meaningful wealth creation, which will translate into share price gain over time, is paramount. This approach is especially valid in periods of enduring flat markets where the effect of every incremental stock decision is amplified.

The hand of investment is critical, with team experience paired with innovative and diligent research key. We believe that through that research we can accrue an information advantage that will in turn identify true global leaders and inform better decision making.

For more information call Macquarie Investment Management on 1800 814 523, email mim.clientservice@macquarie.com or visit the website at macquarie.com