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HD **The equity outlook round table: more gains during 2014**

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Australian shares will not repeat their 2013 rises, but they are still the asset class to be in. Sally Rose reports.

Six leading fund managers polled by The Australian Financial Review all tipped the local sharemarket to notch up another year of gains in 2014, while expecting a more modest rise than the double-digit returns achieved in the past couple of years.

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However, opinions were mixed on where the best returns will come from.

Respondents were divided on whether Australian shares will outperform their international counterparts in 2014.

In 2013, the S&P/ASX 200 Index climbed 15.1 per cent, fuelled by the combination of an improving global growth outlook that was supported by easy global monetary policy and record-low domestic interest rates, which saw money switch out of bank deposits and bonds into shares.

It was the best year for the Australian benchmark index since the 30.9 per cent rally of 2009 that followed the global financial crisis wipeout of 2008.

Reece Birtles, Legg Mason: Domestic equities still look like good value as compared to other asset classes, especially when you consider franked dividend returns. The double-digit returns of 2012 and 2013 are unlikely to be matched, but the local market is still trading on an average price-earnings ratio of 14.5 times, which is quite attractive.

Garth Rossler, Maple-Brown Abbott: We still prefer equities as an asset class over both bonds and cash. The local market is close to fair value and we expect mid-to-high-single-digit returns. There is a risk of additional volatility in 2014 given the impact of tapering in the US and of non-traditional monetary policies being adopted elsewhere, such as Japan.

Rob Osborn, Lazard Asset Management: We don't like to try and predict market over a period as short as one year, but from a long-term perspective the market looks to be trading at the more expensive end. However, there are many individual investments which are trading below fair value and provide strong investment opportunities.

Patrick Noble, Zurich Financial Services: The local market is likely to keep rising in the year ahead, provided the elusive earnings recovery we have all been waiting for finally comes through. Despite some downgrade shockers during November's annual general meeting season, there were also a number of companies that said their outlook was improving.

George Boubouras, Equity Trustees: On a 12-month view we remain tactically overweight equities and underweight bonds. A correction in the local equity market in early December, of circa 7 per cent from recent highs, should be seen as buying opportunity on a one year view. Our S&P/ASX 200 target remains unchanged at 5750 points for June 30, 5950 for year-end.

What will drive **company** earnings growth in 2014?

Osborn: We expect the most significant earnings growth over the next few years to come from some of the depressed domestic sectors, such as media and building materials, for which earnings often remain significantly below the average level of the past decade. Some high-quality industrial companies, particularly those that may benefit from foreign-sourced earnings, should also prosper in an environment of a weaker Australian dollar.

Birtles: The earnings environment in Australia is looking better as we are starting to see housing market data consistent with low interest rates being effective, which should flow in to **company** earnings. A lower dollar, continued low interest rates, and government plans to invest in infrastructure programs should help.

Rossler: In dollar terms, the most earnings growth is likely to come from the banks, followed by the large resource companies, given their dominance of the benchmark. In terms of percentage change, domestic cyclical stocks are likely to grow earnings at the fastest rate – assuming some improvement in the domestic economy.

Noble: Over the past couple of years earnings growth has mostly come from cost cutting. The 12 months ahead will be about reaping the benefits of productivity improvements, particularly for the big miners. Commodity prices have held up better than expected and we don't expect any sharp pullbacks in 2014.

Ewen Cameron Watt, BlackRock: The value of the Australian dollar is driven more by international commodity prices than the domestic economy. Despite their aspirations to talk the Aussie dollar down the Reserve Bank of Australia can only exert a relatively small role in setting the value of the currency.

Osborn: We agree with the Reserve Bank's view that the value of the Australian dollar has been unsustainably high above US90¢. Unless the US experiences significantly higher inflation rates than Australia over the coming years, a range of US70¢ to US80¢ appears more appropriate.

Rossler: If the Aussie ranges between US85¢ to US90¢ during 2014, this would help earnings growth for a number of companies, but the impact is unlikely to be dramatic.

Birtles: The deprecation that has already happened has removed the headwind of a rising dollar and we are happy with that. We don't expect any significant further currency depreciation in the year ahead given the countervailing forces. On the one hand stronger world growth and a lack of money printing by the RBA will be negative for the dollar, while on the other hand tapering of US stimulus will be a positive.

Noble: Expecting the exchange rate to be lower at the end of 2014 is not a key assumption for our strategy but it could provide the cream on top. It is important to pick stocks on the basis of a strong underlying business rather than relying too much on one variable.

Boubouras: We expect a lower exchange rate by the end of 2014, however in the short term the currency outlook will continue to be a headwind for corporate Australia, companies will need to continue cost-cutting programs. Lower official interest rates would help.

Cameron Watt: The withdrawal of US central bank quantitative easing presents the biggest present risk to global markets for the year ahead. Volatility has declined a great deal over the past three to four years across all asset classes in large part due to central bank balance sheet expansion. If liquidity growth dwindles close to zero in 2014 then volatility will increase.

Rossler: The announcement in December that quantitative easing will begin to be phased out from this month presumes that the US economy is travelling better and so that should be supportive to markets. However markets, particularly the US, have already been so strong that there is the risk that much of the good news is already priced in. Hence increased volatility is likely during 2014, and if that is the case in the US that will be the case here.

Birtles: Investors still haven't figured out whether to accept the commencement of tapering as proof of a sustained recovery. The market is paying a premium for the safest companies, which is quite unusual. As QE is reduced and macro-economic risks reduce, that premium for safety will decrease and we expect to see performance from a broader range of stocks.

Noble: An orderly tapering process and a calm reaction to it is a key assumption behind our expectation the market will move higher in 2014. Investors seem ready to focus on the positive of the US economy improving rather than the negative of reduced liquidity.

Cameron Watt: BlackRock is reckoning **Chinese** growth will slow very gradually over next five to seven years. Reforms announced at the Third Plenum in November are the right things for the country to do but in the short term the changes will slow growth. Introducing market pricing will meet some opposition and cause disruption.

Osborn: **China**'s economy is critical to Australia's exports and terms of trade. It is very unclear what, if any, consequences will follow from the Third Plenum. We continue to focus on the risks to the residential property construction boom in **China** and the associated rapid growth in credit.

Rossler: Our base case for 2014 is that **China** continues to grow in line with its target growth rate of around 7.5 per cent. If there was a serious stumble there, we would expect a strong negative impact on our market, firstly on resources but then also on banks which would be facing the prospect of much slower economic growth, and rising bad debt charges.

Birtles: Leading indicators for growth in **China** look pretty good. However the **iron ore** outlook is not very positive given the amount of supply coming on.

Noble: The closure of some **Chinese** steel mills will mean less demand for our **iron ore** and **coal** exports. In the long term however, it will be good for Australia for our largest trading partner to have a more balanced and sustainable economy.

Rossler: We like stocks that are exposed to an improving domestic economy. This has become a smaller universe of names given more recent price moves, but stocks such as Toll Holdings and Harvey Norman look good. We also see some opportunities emerging in areas such as healthcare and property trusts. Among the big miners we prefer BHP due in large part to the new management's sharp focus on cost cutting.

Birtles: We are looking away from **iron ore**-focused **mining** stocks like Rio Tinto and Fortescue Metals Group and towards BHP Billiton, which is more diversified. We also like Iluka Resources as demand for their zircon, used in paint, will rise driven by rising by housing construction in the US and **China**.

The outlook is also promising for good stocks exposed to the domestic construction and housing sector, such as Lend Lease, Boral, and Harvey Norman. Insurance Australia Group is also looking good having announced premium rate rises that improve its position.

Noble: One of our biggest overweights is Twenty-First Century Fox. It is a good **company** with strong guidance, having divested its problem businesses in the News Corp spin-off in 2013.

Rossler: Financial stocks have dominated market returns over the past few years and while conditions are likely to remain pretty benign for them in 2014, we think valuations are generally quite full, despite the allure of yield.

Birtles: We are most bearish on the most overvalued, defensive stocks that don't have much valuation upside, such as Telstra, Woolworths and Wesfarmers, and the big four banks.

Noble: There are lots of value traps in the market where stocks look cheap but the risk is still too high, especially in **mining** services.

Osborn: Neither. We remain selective about our investments in the metals and **mining** sector. The major banks are the most relatively highly priced for almost 20 years. Westpac and Commonwealth Bank, in particular, trade on quite demanding earnings and book multiples.

Rossler: It is not always an either or argument but we see better value in the miners. The banks are great companies with a strong industry structure but look relatively fully priced. Analysts are quick to point out that resource stocks are at risk from high commodity prices, but there is little focus on the fact that banks have benefited from extraordinary credit growth over the past 15 years to 20 years so are also facing significant headwinds. Regulation remains an ongoing risk as seen by the new capital requirements for domestic systemically important banks.

Noble: Value remains in both the big banks and the big miners and it makes sense to hold both. Bank yields are still attractive, so are a good, quality asset even if a little expensive and entering a holding pattern. The big miners will continue to benefit from better than expected **iron ore** and **copper** prices. We still like BHP Billiton, Rio Tinto and Fortescue Metals Group.

Rossler: We prefer the Australian market over the US market. Profitability in the US looks well above average levels, while multiples have also recovered strongly – a combination producing an exceptionally strong market that is vulnerable to setbacks. We quite like the European markets for their profit recovery potential.

Birtles: Compared to the US the valuations look good in Australia. Earnings per share ratios in the US are above 2007 levels, whereas Australian earnings per share ratios are yet to recover to pre-GFC levels. Australian margins have more scope to improve, while elevated US margins are likely to come under pressure.

Noble: We still favour global shares despite having a pretty positive outlook for the local market. Japan's Nikkei Index went on a tear in 2013 and that will probably pull back a bit, although if the "Abenomics" reforms continue then Japanese stocks will keep rising. The glass still looks half full for US stocks, with momentum in the housing and shale gas sectors positive indicators for the broader economy. If the Aussie dollar falls then an unhedged exposure to global shares will deliver a kicker.

Boubouras: We retain an overweight to both domestic and international equities with an underweight to fixed income and **bonds**. We expect much lower returns from global equities this year than last year, but with a lower dollar likely to provide some additional real returns.

Rossler: We like the Asian markets. Asian stocks, ex-Japan, have significantly underperformed developed markets over the past year. Concerns over US tapering have seen large capital outflows from the region that look over done. Unlike most other regions, price-earnings multiples in Asia declined sharply last year as earnings growth generally outpaced market performance.

Noble: We favour the US followed by Japan. Abenomics and aggressive quantitative easing should help Japanese shares post another very solid performance this year although it will be important to watch how the economy deals with an increase in consumption tax. If there is not a wage increase, expect increased Bank of Japan stimulus.

Cameron Watt: Japan looks very good, particularly if the currency starts to drop. Other Asian **equity** markets also look good. There is potential for reforms in India post the election that could encourage more investor tourism. The marginal dollar is starting to move into European markets. The US market will probably remain expensive.

Birtles: Recent IPO activity reflects just some of the backlog given how few listings have launched since the GFC, so we expect the float rush to continue this year. The interesting question is when merger and **acquisition** activity will pick up. There was surprisingly little **M**&A in 2013 given how difficult it is for companies to achieve organic growth at the moment and the low interest rate environment that lowers the cost of borrowing.

Noble: If the US can remove the obstacle of finalising a debt ceiling deal earlier than the February deadline that will help global equities get a positive start to the year. A more stable European economy would also provide a better macro-economic backdrop.

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