THE AUSTRALIAN

SE Business

HD **Cooling economy and ‘home bias’ leave many exposed**

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WC 2,051 words

PD 4 October 2014

SN The Australian

SC AUSTLN

ED Australian

PG 34

LA English

LP

Domestic market at risk as flow of funds shifts offshore

Australian investors’ longstanding obsession with local shares could be leaving many exposed, as the dollar starts to trend lower and the economy cools.

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Indeed, many professional investors are starting to turn their back on domestic shares and are setting aside a bigger slice of funds toward global markets.

And with more funds being diverted offshore, this could have major implications for the outlook of the local sharemarket. Australia’s near $2 trillion superannuation pool has traditionally had a strong “home bias”.

Super funds typically invest about 30 per cent of their members’ contributions in domestic equities, and just 25 per cent in offshore equities, despite the fact that Australia is just a small part of the global economy.

For the $550 **billion** self-managed super pool, increasingly made up of ordinary investors, the so-called home bias is closer to 40 per cent.

But the numbers from the past month are telling. The Australian dollar has dived 6.3 per cent against the US dollar, its biggest fall in 15 months. At the same time, the benchmark S&P/ASX 200 stock index fell 5.9 per cent, its biggest drop in more than two years.

In US dollars, the Australian market fall was more than 12 per cent. By comparison, the Morgan Stanley Capital International World index, which tracks global sharemarkets, lost just 2.9 per cent.

“If you were running a solely long-only Australian share portfolio, there was not much you could do to avoid the carnage last month, apart from raising some cash,” says Nader Naeimi, who helps manage funds worth about $130bn, as head of dynamic asset allocation for AMP Capital.

Shares globally are overdue for a pullback, but the Australian market may be more vulnerable than most. The local market does have tax benefits available for domestic investors, but **China**’s slowing economic growth and the end of the US Federal Reserve’s money printing and zero-interest-rate policies will favour US dollar-denominated assets over Australian.

The two main pillars of the Australian sharemarket, resources and banks, are increasingly under pressure from falling commodity prices and concern around US interest rates. Falls in Australian banks and miners have outpaced losses in the S&P/ASX200 index over the past month.

The concentration of funds in the domestic market worked well for locally focused investors last decade, as a **China**-fuelled resources boom and relatively small exposure to sub-prime lending saw Australia side-step the worst of the global financial crisis.

Miners surged as China's economic growth pushed commodity prices up to record highs. Banks and other high-yield equities rode a wave of cheap money as central banks cut interest rates to prevent a worldwide depression after the financial crisis.

The US Federal Reserve launched three rounds of "quantitative easing" through money printing and bond buying, driving bond yields down so much that investors globally were forced to direct money into other asset classes such as shares.

US quantitative easing also boosted commodity prices by weighing on the US dollar. The combination of strong Chinese growth and a rising Australian dollar encouraged offshore investors to park their money Down Under.

"Virtually every asset is mispriced due to quantitative easing and near-zero interest rates in the major economies," says MLC's head of investments, Susan Gosling.

"We have been a safe haven in a world where central banks have deliberately taken away the traditional safe havens of cash and bonds. At the same time, we've had this China growth story." Now there are cracks in both — quantitative easing is ending in the US while China's growth rate has slowed. "We have been worried about this for a long time and finally it seems to be happening, but it's still not fully appreciated," Ms Gosling adds.

"We have a property market that's extremely overvalued. We've borrowed a lot and bought a lot of houses, rather than productive investments. Australia is vulnerable — we've got very high levels of household debt. I can paint a very nasty scenario." High unemployment after the mining boom is the link through which a slowing Chinese economy could affect the housing market and the banks.

"All these things are interlinked," Ms Gosling says. "One would not expect the worst-case scenario to occur, but it's a risk that we need to be aware of." MLC sold Australian shares in June and August, leaving its traditional funds "underweight" in Australian equities. The money was redirected to its hedge fund and absolute-return funds, both of which are designed to protect against sharp market falls.

"The high Australian dollar was a great diversification opportunity, so we took advantage of that in all our funds," Ms Gosling adds. MLC's most aggressive fund now holds about 30 per cent global shares and 8 per cent Australian shares, down from 12 per cent earlier in the year. Unlike most diversified funds, it has no exposure to property trusts.

Last month's falls in local equities and the Australian dollar could mark the end of the so-called "carry trade" — borrowing cheaply in one market to invest in a higher-yielding market — which boosted the Australian dollar and shares, particularly banks, property trusts and telecommunications companies.

The carry trade pushed the Australian sharemarket up to a six-year high in August.

"There's no doubt that the carry trade is over and we have been preparing the portfolio by short-selling a lot of high-yield stocks that have been really bid up to high valuations," says Paul Skamvougeras, Perpetual's deputy head of equities. "We will remain short some high-yield stocks because we see it as inevitable that interest rates will start to go up.

"In the last three years, everyone benefited from a rising market, whereas now, with things being more volatile and valuations looking very full, people are looking for alternative ways to take advantage of the volatility … having funds that can short-sell shares gives you that ability to make money when the market is going down." Perpetual's funds favour Australian companies with offshore income, based on the view that Australian-dollar weakness will continue. "The Aussie dollar is now starting to reflect more wholly our terms of trade and economic prospects," Mr Skamvougeras adds. "It is geared to what's happening in China and commodity prices. Obviously, it still has a yield advantage over other currencies, which is why it has been supported for so long." The funds he manages also hold shares in Australian companies that are sensitive to the economic cycle, such as those geared to housing and construction. "We think the construction boom on the east coast of Australia has some robustness, given the government infrastructure spend earmarked for the next three to five years is an underlying positive." But investors buying domestic shares for capital appreciation and yield may not be rewarded as handsomely as they were when China's growth rate was accelerating, and the Fed was expanding its balance sheet and holding interest rates down.

Shorting the Australian market or scouring the globe for quality companies at reasonable prices may be better bets for the next few years. "I strongly advise that if you didn't enjoy the cross-asset price volatility of the last 30 days then you need to reassess your asset allocation," Bell Potter executive director Charlie Aitken wrote in a note to clients.

“In my view, you should be getting out of equity index funds and into US dollar hedge funds.” AMP Capital’s Mr Naeimi believes diverging economic conditions globally will continue to provide opportunities to reallocate assets. “It’s a blessing in disguise that we are not seeing a synchronised global expansion,” he says. “It gives more opportunities and it means there is no broad upward pressure on interest rates and inflation. Equity markets don’t like very strong economic growth, which would lead to overheating and aggressive interest-rate hikes.” The global economy is recovering from a low base and the expansion has been two steps up and one step down. The European Central Bank recently launched further stimulus to offset a slowdown due to concern about the Ukraine conflict. “We have not seen strong US growth matched by strong growth in Europe, China and Japan, which would have caused overheating and higher interest rates,” Mr Naeimi says. “For some time, we have been of the view that Chinese shares are cheap, and now they are coming back.” AMP’s Dynamic Markets Fund, managed by Mr Naeimi, aggressively reduced its exposure to Australian equities and the Aussie dollar early last month, and started buying equity index futures in China and Europe.

As the bull market in global shares matures, more volatility and bigger dips are likely, according to Mr Naeimi. He says volatility will also increase as the Federal Reserve stops expanding its balance sheet and prepares to raise interest rates.

On a positive note, Mr Naeimi points out that the falling Aussie dollar is easing financial conditions for Australia as a whole.

“At some point, that will be positive for the local sharemarket,” he says. “If the Aussie dollar stays low, then, with a lag, it will create easier financial conditions and that will be positive.” But he cautions that initial share offers, most notably the $4 billion-plus float of Medibank Private, expected before year’s end, will be a “handbrake” on the Australian sharemarket this year.

“It has been quite different in the US market, with relatively more share buybacks and cash takeovers,” Mr Naeimi notes. “Europe is seeing relatively few IPOs, and I think there’s more chance of European companies following the US in terms of increasing share buybacks, given the low interest-rate policies of the European Central Bank.

“I’m actually surprised we are not seeing more share buybacks and cash takeovers in Australia because the cost of debt is very low and return on equity is high. “There are still concerns around China and everyone is nervous. There hasn’t been as much confidence in the Australian corporate world as there has been in the US.” Kristian Fok, who oversees $27bn as executive manager of Investment Strategy for Cbus industry super, says his firm has been positioning his fund for a lower exchange rate by hedging less of its overseas investments.

“We have 2.5 per cent more offshore currency exposure than we normally would,” Mr Fok says. “We expected there would be a market reaction to the end of the Fed’s quantitative easing and zero-interest-rate policies, so that’s not a surprise.

“We have about 12 per cent in cash, so we have the ability to take advantage of a significant correction. But, in the context of how far markets have gone up, we have had only a minor correction.” Indeed, for investors with a long-term horizon, the current pullback could just be an opportunity to buy more Australian shares. After all, the major global central banks appear to have learnt how to control inflation in the past two decades, so interest rates seem unlikely to return to high levels of the past decade.

“Not all funds are the same,” says Sam Sicilia, chief investment officer for the $16bn Hostplus industry superannuation fund.

“Demographics and the investment horizon matter a lot. We have the luxury of being able to hold investments for a long time.

“And if the sharemarket drops after the end of US money printing, and I’m not conceding at this stage that that’s an inevitability, we will be buying more, because our members are going to be in that game for 30 or 40 years.”Hostplus has 30 per cent of its funds in Australian shares and 25 per cent in international shares, which is roughly in line with the industry average, according to Mr Sicilia. It also has 40 per cent in unlisted assets including property, infrastructure and private equity.

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