FINANCIAL REVIEW

SE Portfolio

HD **Focus on profits, not pesos**

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Experts are adamant that the meltdown in emerging markets is unlikely to have a lasting impact on Australian shares. But as confession season kicks into high gear, companies that repeatedly miss expectations may find themselves permanently sin binned.

The skittishness of investors the world over follows a strong close to 2013, especially in developed world markets, but the buzz has come off just as quickly.

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Broad measures of sharemarket health such as the United States S&P 500 and Australia's ASX 200 were down about 3 per cent in the first month of 2014 after recording total returns of more than 22 per cent and 15 per cent respectively over the previous year.

But while Australia has been facing its own unique set of economic challenges related to the end of the **mining** investment boom, the late January spike downwards was mostly attributed to a mini-crisis erupting in several emerging market economies.

A run on a number of emerging market currencies was sparked by the well-signalled Federal Reserve decision on January 29 to **wind** back its quantitative easing program by a further $US10 **billion** – which, following a similar call last December, reduced the US central bank's total monthly bond purchases down to $US65 **billion** ($74 **billion**).

Most notably, Turkey and South Africa, were forced to dramatically jack up interest rates to counter plummeting currencies as other economies, including Brazil, Indonesia, India and Thailand were flagged as possible capital flight risks.

In its latest Global Economic Prospects published this January, the World Bank highlights how a rapid withdrawal of monetary stimulus could trigger an emerging market rout.

Despite rating an orderly return to more normal global monetary conditions as more likely, the World Bank report does say "the risk of more abrupt adjustments remains significant, especially if increased market volatility accompanies the actual unwinding of unprecedented central bank interventions".

Based on its modelling, the World Bank says if global bond yields increase by 1 to 2 per cent within a couple of quarters as central banks tighten, this "could **lead** to a sharp reduction in capital inflows to developing countries by between 50 and 80 per cent for several months".

"Some developing countries could face crisis risks should such scenario unfold," the World Bank report says.

"Focusing on an assessment of prevalent factors in past banking crises, evidence suggests that countries having seen a substantial expansion of domestic credit over the past five years, deteriorating current account balances, high levels of foreign and short-term debt and over-valued exchange rates could be more at risk in current circumstances."

The latest emerging market currency run inevitably invited comparisons to the 1997 Asian Crisis, which began in a similar fashion and spread quickly to the developed world.

As Sean Callow, Sydney-based senior currency strategist at Westpac Institutional Bank, told the Dow Jones news wire service late in January, emerging market concerns "have not left us" with the sector capable of causing "unexpected collateral damage in the rest of the world" if the uncertainty ramps up.Idiosyncratic illnesses, not global pandemic

In spite of its viral potential, however, many commentators are picking the current emerging market flu will more likely be contained in the most vulnerable economies (as defined by the World Bank report) – remaining idiosyncratic illnesses rather than a global pandemic.

Mark Arnold, chief investment officer of boutique Australian funds management **firm** Hyperion Asset Management, says in the short term some **equity** markets will suffer withdrawals as emergency level global monetary stimulus is scaled back.

"This reduction in the level of extra liquidity created by the Federal Reserve and other key central banks is likely to result in higher levels of interest rates and this should flow through into higher discount rates and lower market prices," Arnold says.

"The sharemarkets that are likely to get hit the most are those located in emerging markets. These markets tend to benefit the most from loose global monetary policy and they also tend to suffer the most from tighter liquidity levels."

But not all emerging markets will feel the pain equally, according to Hasan Tevfik, Credit Suisse Australia**equity** strategist, with those countries most important to the Australian economy in reasonable health.

"The bigger part of the emerging market economy is in Asia and most of those countries have current account surpluses and managed or controlled foreign exchange regimes," Tevfik says. "Also [most Asian economies] have relatively better investment conditions – for example, they have inflation under control.

"I don't think the current emerging market volatility will spread to Australia."

But whether the Australian market will fall under the weight of the country's own idiosyncratic problems is another question.

Alexander Batten, government bond analyst with UK-based fund manager Threadneedle Investment, says as the **China**-driven **mining** boom recedes, "Australia will have to rebalance its economy to other areas such as consumption or alternative sources of investment".

"The signs so far indicate that whilst the economy is rebalancing, this is not happening at a significant enough pace to avert a slowdown," Batten says.

"However, this is not a new story and asset prices have corrected significantly already. For example, the Australian dollar has fallen almost 18 per cent against the US dollar since the middle of last year and approaching 25 per cent against the NZ dollar since 2011. In the bond market, the record low RBA rate has led to a near all-time steepness in the yield curve.

"Given these extreme moves in valuation, we think the question is not whether Australia is headed for a correction but more whether it has corrected too much."Market correction unlikely: Boubouras

George Boubouras, **Equity** Trustees (EQT) chief investment officer, puts the probability of an Australian sharemarket correction, which he defines as a drop of 10 per cent in a short space of time, as quite low in the year ahead.

Boubouras says while the Australian economy is "more uneven", a broad decline in equities would surprise.

"When the reporting season begins this February it will highlight the uneven nature of the economy," he says, but there will still be opportunities in Australian shares – albeit requiring greater discrimination by investors.

"You'll have to invest on a case-by-case basis," Boubouras says, "the Australian market will suit bottom-up investors."

For example, he says EQT has gone "overweight" Australian companies that are sensitive to the US dollar, betting on stocks such as Amcor, Brambles and Macquarie Bank, which will benefit from the falling Aussie.

Despite the much-publicised slowdown in the mining sector, Boubouras says the shares of some companies, particularly large players like BHP and Rio, will retain value.

"Big firms like BHP and Rio will have increased volumes while bringing down their costs of production, which [while good for their profits] is bad for mining services stocks," he says.

Overall, Boubouras says EQT has a "strong conviction there's more upside than downside" in the sharemarket, with "the event risk smaller than previously".

In a global sense, EQT favours developed-world equities – especially the US and Europe – over emerging markets, a position Riccardo Briganti, head of research for Macquarie Private Wealth, also takes.

"We're confident about growth in developed markets, and in the US market in particular – and Australian companies that are leveraged to that growth," Briganti says.

Like Boubouras, however, he says the ASX will become even more of a stock pickers' market, even within sectors exposed to global growth.

"Stocks will need to deliver earnings growth this year, and not just the promise of growth to come, which was easier to get away with last year," Briganti says.

"Some companies will struggle to deliver whatever sector they're in. For example, The Reject Shop has issued a profit downgrade warning while JB Hi-Fi looks like it's going to deliver returns as expected."Climb in 2013 represented a normalisation

He says while Australian stock valuations, as measured by price-earnings (P/E) ratios, climbed in 2013, that represented normalisation rather than irrational exuberance.

"[Rising share valuations] reflect the initial phase of recovery," Briganti says. "But we need confidence on the earnings side to maintain equity valuations at current levels."

Hyperion's Arnold says over the long term the Australian sharemarket should return a nominal 9 to 10 per cent per year on average.

"This return comprises 5 per cent EPS [earnings per share] and DPS [dividends per share] growth and 4 to 5 per cent dividend return," Arnold says. "P/Es don't significantly impact long-term returns unless they are at extreme levels at either the beginning or end of the investment period. However, over short-term periods such as a year, changes in P/Es tend to be the dominant driver of returns. We believe the current level of P/Es for the [Australian] market are sustainable in a low-inflation environment."

Credit Suisse is also relatively sanguine about the rising P/E of the Australian sharemarket, according to Tevfik.

"Equities are not cheap, but they're not expensive either," he says.

"Australian P/Es are now about 16-times – that's only about 10 per cent above the long-term average."

In fact, Tevfik says the Australian shares always look expensive compared to most global markets as measured by P/E or price-book (P/B) ratios.

"Right now Australian shares are the most expensive based on P/Es – and our call is that they will become more expensive – but they're also the cheapest compared to dividend yields," he says.

And Tevfik says over the year ahead more investors are likely to move into high-dividend shares out of low-yielding cash, keeping demand for Australian equities high. Furthermore, he says dividend-seeking self-managed super fund (SMSF) investors are also sustaining Australian share prices.

In a Credit Suisse analyst report published in January, titled Rise of the Selfies, Tevfik wrote SMSFs "own $220 billion, or 16 per cent, of the Australian equity market".

"We estimate selfies are currently committing an additional $2 **billion** net per quarter to the asset class. Strong inflows will continue for a number of years," the report says, implying SMSF investors will support Australian share prices at elevated levels for some time to come.

Kieran Kelly, managing director of Sydney-based boutique advice and investment **firm** Sirius Fund Management, agrees with Tevfik that SMSF investors have an inordinate influence on Australian stock prices now.

However, Kelly, whose clients include SMSF investors, says the sector as a whole "can't invest counter-intuitively" and can't be relied upon to prop up the market.

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