2016
Smart Income Report

Global economic growth slow, but not "recessionary"

Markets to overreact, both up and down

Volatility to remain extreme as the world comes to terms with slower growth for longer

Equity markets still have 10-20% downside

Oil supply issues to keep prices down

The AUD to continue to fall against the USD and GBP

10 March 2016

FIIG | The fixed income experts

Contents

Executive summary

- World economic growth will be lower for longer due to the prolonged perfect storm created by demographics, fiscal debt, slowing emerging economies' growth and the aftermath of Quantitative Easing
- Central bank responses to stubbornly lower growth will drive asset returns and volatility for the next few years
- The US is by far the strongest global economy, but it is not yet strong enough to withstand a major slowdown in China or the EU
- The world fears a China slowdown for good reason, it has contributed more to world growth over the last 10 years than the US and EU combined, and data remains either unreliable or volatile
- Concerns about leverage will also rise, as global debt levels are higher now than they were in 2007 by US$27 trillion, particularly in China
- This year will be challenging for equity investors due to:
  - Lower expectations of global growth
  - Volatility caused by uncertainty, resulting in large swings from fear to greed and back
  - Disappointing earnings growth, putting downward pressure on dividends
- Price earnings ratios are well above average levels despite weak global growth, excess capacity and falling earnings
- Interest rates to stay lower for longer despite the US Fed's own forecasts
- The RBA to cut interest rates at least once in 2016 to 1.75%, with a second cut to 1.50% possible, but not likely
- Australia's economic expansion may make it to 25 years in 2016 without a recession
- Commodity markets were weak in 2015 and it is difficult to see conditions improving in 2016. Oversupply is harming prices and meaningful cuts are needed to restore market balance, but are not yet evident
- Australian banks are becoming safer as new regulations force them to hold more in reserve. Last year, the 'Big 4' raised $19.5 billion in new common equity capital
- The cost for the 'Big 4' to raise funds via the global bond market has increased and the term deposit market is again starting to look attractive
- We suggest five strategies depending on your risk and return appetite with per annum returns that range from 3% to 7%

Section 1: The year ahead for income investors

Welcome to the 2016 Smart Income Report…

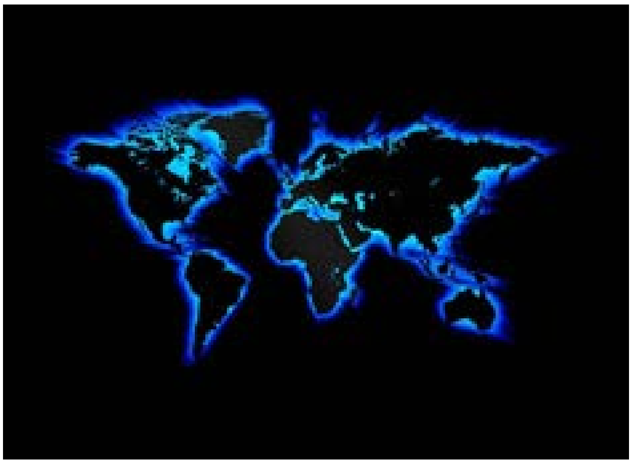
A different way of looking at the outlook for the world's economy - through the eyes of the income seeking investor.

In 2015 we introduced the "Smart Income Report"; a research report written exclusively for investors seeking income as a strong bias in their portfolios.

Income is critical to many investors, and if that's your focus, this report is a must. FIIG is a fixed income expert, so cash and bonds feature throughout the report, but we also cover the opportunities for reliable income from equities, property, currency and infrastructure.

We take this approach because we find most investors are less worried about what "asset class" they invest in, but rather they worry about the stability of their capital and the reliability of their income.

Thus our focus is on the fundamental economic and market themes that will drive any investment that produces reliable income in 2016. Many of these themes are likely to continue for the next 10 to 15 years.



The IMF has lowered its 2016 global economic growth forecast from 3.8% to 3.4%

We have a few biases in our research reports. One of these is to focus on economic fundamentals, rather than getting wrapped up in the short term obsessions that financial markets watch day to day. Similarly, rather than looking backwards and assuming that the world will return to historic levels just because it always has, we look for rational, intuitive, fundamental drivers of future economic health.

It's still about the economy, stupid…

Bill Clinton
presidential campaign slogan,
1992

Last year was the year that many financial markets started to ignore the economy, and instead obsessed about how long the Fed would give them cheap debt for. US equity markets were amongst the worst of these, with stock prices rising whenever economic news disappointed, and valuations stretching to very high levels despite falling earnings.

In our 2015 report, we started out by forecasting that global economic growth would disappoint; global interest rates would be lower than expected; earnings growth would be lower than markets expected; commodity prices would be weaker; the AUD would fall; geopolitical tensions involving Russia would rise; and that the bond market bull run would continue.

This turned out to be pretty accurate, so we start our 2016 report in much the same place, that is, with the major themes driving the global economy and therefore shaping investors' returns:

- World economic growth and central banks' responses it
- Lower growth impacting asset returns and volatility for the next few years
- The recovery in the US, the slowdown in China, the attempts at recovery in Europe and the 20 year stagnation in Japan

These factors, far more than micro economic factors such as technological shifts and earnings growth, will drive markets in 2016 and beyond. These macro forces are discussed at length in the report.

Section 2: The world in 2016

US economy: Good, but not great

The US economy became stronger through much of 2015, continuing the recovery started in 2011/12. Job growth has been high enough to drive a pickup in consumer spending, which has flowed into business investment and a sustainable recovery.

However the recovery is good, not great. Manufacturing is in a recession due to the high US dollar and weak global economy. Consumer spending weakened into the end of the year. Full year 2015 GDP growth is likely to be around 2.4%pa, after a very volatile year. This year's growth might be able to beat that pace, but the global economy presents an increasing risk to the US economy particularly if consumer and business confidence declines suddenly because of negative headlines and the stockmarket's reaction.

Of all the major economies in the world, the US economy is by far the strongest, but it is not yet strong enough to withstand a major slowdown in China or the EU, the next two largest economies in the world.

This conclusion of "good, but not great" has two main implications for investors:

1. **US equities are overvalued**

   Despite falls in early January 2016, US equities are still at very high Price/Earnings (PE) valuations, which either requires earnings to climb by 20% or more or requires prices to fall in order for valuations to be justifiable. Economic growth is not strong enough for domestic revenues to push up earnings, and the rest of the world's growth is weak, so it is hard to see how earnings growth will be achieved. This leaves a fall in prices as the most likely outcome. As we've already seen early in 2016, this is likely to be triggered by an external shock such as concerns about the Chinese economy, or falling oil prices.

2. **US government bond yields will remain low**

   The US economy needs export growth. If the US Fed increases interest rates too quickly while the rest of the world are holding rates lower (Section 3, Theme #2 on page 15), the USD will rise quickly. This will reduce the competitiveness of US exports, slowing the economy. This already hppened in 2015 in a small way, with exports dipping after the USD's rapid climb early in the year.

   This threat to export growth will mean that the Fed will be patient, increasing rates only if inflation threatens to climb above its 2%pa target rate. With wage growth still low and oil likely to remain flat or even move lower during 2016, inflation risk is low. This means that the outlook for US government bond yields is that they will remain near 2% (for the 10 year benchmark) or lower (for shorter terms).

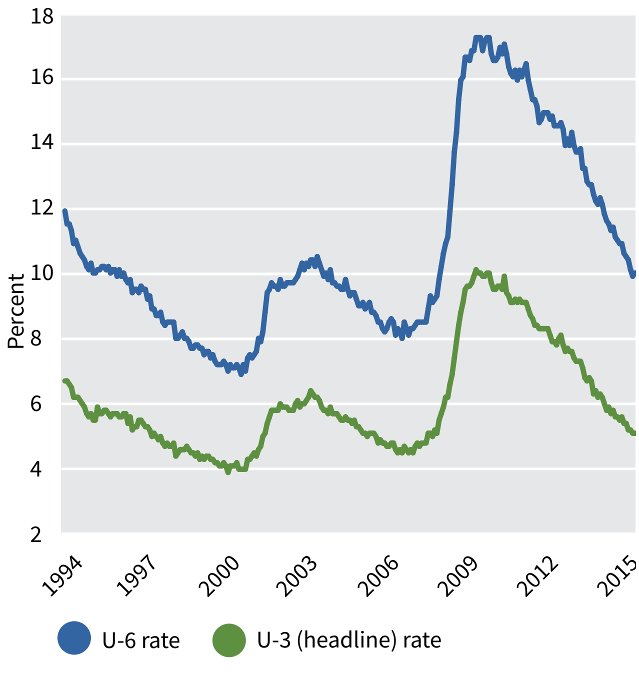
   While history is a poor indicator of the future, it must be noted that there has never been a rate tightening (increase) period in which both inflation and GDP growth has been below average. History supports the above rationale for rates being very slow to increase from here. See Section 3 for further discussion.

On a brighter note, unemployment while still high, as shown in Figure 1, is recovering rapidly. Wage growth has started to indicate a healthy labour market, with average growth rates approaching long term averages. Wage growth is still held back by the high level of "underemployment" (the darker "U-6" line), but there are pockets of the economy showing early signs of full employment. Wage growth typically occurs when competition for labour starts, which is in turn when the economy approaches "full employment". With U-6 still at 9.9%, the US still has around 3 million people underemployed so wage growth pressure is a way off yet.

Figure 1: The real rate of unemployment in the US, the "U-6", Is still a long way above average contrary to the headlines

"U-6" rate of underemployment vs "U-3" headline rate, Jan 1994-Dec 2015

Source: Federal Reserve Economic Database



Section 2: The world in 2016

China: Soft or hard landing; that is the question

China makes everyone nervous. This is actually with good cause, particularly for Australians. China's economic growth has driven most of the world's growth for the past decade as shown in Figure 2. Since 2008, a massive 54% of the world's economic growth has come from China, compared to 26% from the US and India as the 3rd highest contributor at 8% (the EU and Japan detracted from global growth).

Since 2011 the IMF has named China as the largest economic risk to the global economy. Furthermore, China's economic data is seen as less reliable or even manipulated, and its property market is often considered dangerously overheated.

Even at the slower rates now projected, around 25% of growth in the next five years is expected to come from China, versus 20% from the US. In other words, whether looking backwards or forwards, China's growth is critical to world economic growth, and therefore to equities and commodities prices.

China's equity market had an extraordinary 2015, rising more than 100% before it collapsed. Much of the rise was attributed to leverage, in particular retail investors borrowing to invest in the market. Aside from the nervousness caused by leverage, the other triggers for the sudden decline were actions by the Chinese central bank, the PBoC, to lower interest rates and devalue their currency; clear signs that those closest to the truth in the opaque Chinese economy were getting worried.

What happens in China has repercussions for the entire world economy

Maurice Obstfeld, IMF, 2014

Near term downside risks for emerging economies have increased…

IMF, September 2015

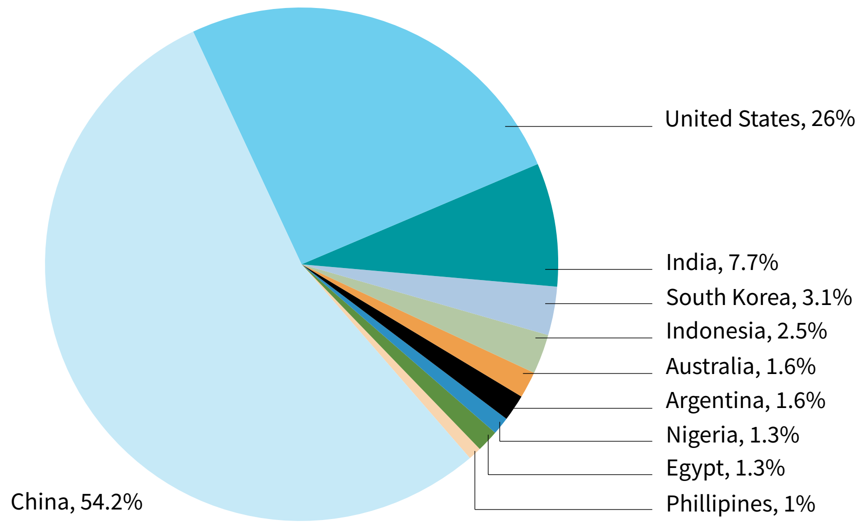
The year will offer an abundance of challenges…. Emerging markets will be at center stage

IMF, January 2016

Figure 2: The world fears a China slowdown for good reason – it has contributed far more to world growth over the past eight years than the US and EU combined

Contribution to growth in the world economy, 2008-2015

Source: International Monetary Fund



Section 2: The world in 2016

Further global equity market falls very early in 2016 were caused by similar concerns about growth and overvaluation, but also selling ahead of the end of the freeze on certain Chinese institutions selling Chinese equities. That date was originally set at 8 January but was eventually extended indefinitely by the Chinese Government. This move doesn't solve the market's nervousness about how much selling pressure will come when these institutions are allowed to sell; it just pushes it down the road. Look out for more volatility when they eventually try to lift the selling freeze later this year.

Further falls in Chinese equities are dangerous for global equities simply because US equities are still overvalued and so any sign of global weakness causes nervousness in the US. Wall Street is looking for an excuse to begin a correction which almost started in August 2015, and again in January 2016. It is a question of when this correction comes, not if.

Lack of transparency has become more of a problem than China's economic health

There is no doubt that parts of the Chinese economy are suffering. The construction sector shed a massive 15 million jobs in 2015. Steel manufacturing and other heavy industries are in recession due to overcapacity and falling prices, resulting in the steel manufacturers alone expected to shed 400,000 jobs this year.

But the consumer economy and services sector continues to grow strongly. Selling products to Chinese movie cinemas, global luxury goods brands or premium food and beverage outlets have been growth areas that have persisted.

The outlook for the Chinese economy appears to be that a controlled slowdown is the most likely scenario. A hard landing would be very damaging to world markets, particularly Australian share prices and the Australian dollar.

The real problem with China is the markets' distrust of the data. Figure 3 illustrates the issue oft-cited about perceived government manipulation of China's GDP data. The official data seems out of line with the more transparent data, so we prefer to use other factors such as power output and freight.

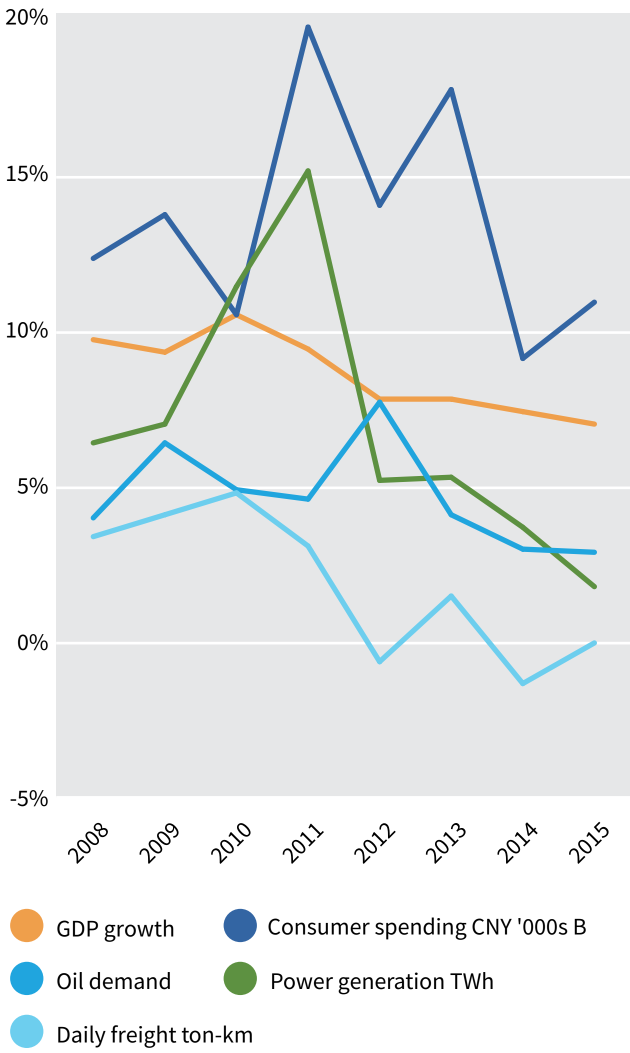
This figure also shows that the measures of industrial activity in the Chinese economy have slowed dramatically in recent years and are implying lower overall growth of 4-5%pa or less.

China is transitioning to a consumer led economy, and so the continued growth in consumer spending at more than 10%pa is encouraging. But if this consumer spending were to slump, China will almost certainly head into a hard landing.

Figure 3: Industrial sector (as illustrated by oil, power and freight data) approaching 0% growth, but consumer spending still growing at more than 10%pa, implying the overall economic growth rate is 4-5%pa, not the official figure of 6.9%pa.

Comparison of more reliable activity data to official GDP data

Source: World Trade Organisation



So what does this all mean? Is it good news or bad news?

Clearly investing in Chinese equities is not for the faint hearted at any time. Now, it is highly speculative given the dramatic change and volatility.

But for the majority of investors, there are only two relevant points to watch out for in regards to China:

1. **Hard landing risk**

   If China manages to stabilise its slowdown, this will be good news for the Australian economy. To be clear, one week of good news does not mean China has turned the corner. The risks are still very much on the negative side, but with the data pointing to a stabilising of the slowdown and persistence of strong consumer spending, the hard landing scenario is fading. If the slowdown stabilises and can be trusted, resource stocks and bonds could represent good value, but again this is not for the fainthearted.

2. **Declining current account surplus**

   Whether or not China grows at 7%pa or 6%pa matters little to the rest of the world. What matters is whether it is contributing to net demand or net supply. If its current account surplus is falling, this means that it's contributing more net demand to the global economy. That is, the Chinese are buying more from the rest of the world. So even if China's economy slows to 3-4% but it buys more from the rest of the world, the global economy will benefit. Commodity producing economies such as Australia will still experience the pain of a drop in GDP growth as a consequence of much lower investment.

China (and India) are great long term bets, if you can survive the ride

Over the next 10-20 years, China offers a compelling investment proposition. The physical and financial infrastructure built over the past three decades and the transition to capitalism has created a platform for China to use to capitalise upon its massive population advantage. The 13th "Five Year Plan", the government's core economic planning document, due for release in 2016, is likely to include plans to enhance productivity and to build renewable energy infrastructure. There is little doubt that China will eventually outsize even the US economy, probably around 10-15 years from now.

In that time, China will add economic output of around US$8.1 trillion, that is they will grow their economy by about the total size of the Japanese economy today. The US by comparison will add output of around US$4.5 trillion. Remembering that economic growth drives investment values upwards over the longer term, this spells opportunity for the patient, risk tolerant investor. This is why markets fear a Chinese slowdown so much at present.

Bringing together this short term view of uncertainty with the positive longer term outlook; find assets that can survive the volatility but in the end profit from China's inevitable growth. This includes investment grade miners like BHP Billiton, the agriculture sector, education and some parts of tourism (high quality companies only).

While India's economy is much smaller than China's today, it is starting to grow faster than China and has an even greater population advantage than China. Over the next five years, India will add around US$2.1 trillion, or about half of the growth contributed by the US economy. This makes India the 4th largest contributor to world growth, after China, the US, and the EU, and ahead of Japan and the UK, as shown in Figure 4, which like Figure 2 shows the contribution of each country to world GDP growth, but while Figure 2 looked at the past, Figure 4 looks at the future.

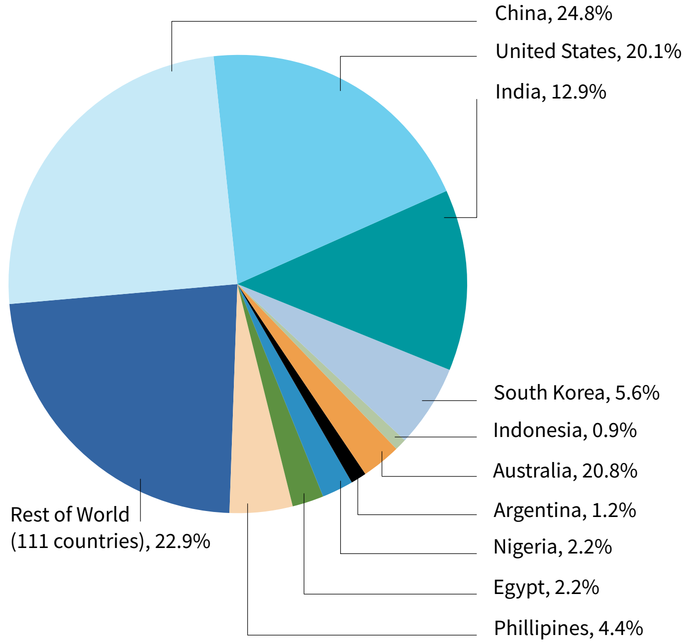
But India's attractiveness as an investment destination is clouded by the uncertainty of its political system, slow pace of infrastructure development and the bottlenecks that currently causes, and therefore whether India can continue to unblock its economic potential. Not something for low risk investors, but one to keep a keen eye on over the next few years.

Section 2: The world in 2016

Figure 4: India will continue to contribute more to world growth over the coming years

Contribution to growth in the world economy, 2015-2019

Source: World Bank



Section 2: The world in 2016

Is the EU the new Japan?

Demographics is the megatrend that is transforming economies and societies around the world…

United Nations,
Ageing in the 21st Century, 2012

The EU and Japan share more than just ailing economies and massive quantitative easing programs; they both face unprecedented population declines.

Japan's population is currently 126 million. It is expected to fall to 100 million over the next generation, but even that forecast assumes that the fertility rate will climb from 1.4 to 2.1 (a jump that has never been achieved by any economy in history without the intervention of war); and that immigration increases to 200,000 foreigners per year, highly unlikely for the traditionally closed Japanese culture with just 2% of the population currently foreign.

The EU faces similar challenges. Deaths have outnumbered births in the EU's strongest economy, Germany, since 1972 and its population is expected to fall by a further 10% by 2040. Their birth rate is ranked 217 out of 220, with only Japan, South Korea and Singapore lower. France has the highest birth rate in Europe at 160th (just behind the US and China at 158 and 159, and just ahead of the UK and Australia at 161 and 162).

These figures lead to the unavoidable reality of economics that a country's economic growth can only come from two variables: more workers and more productivity per worker. At present, not one major economy on the European continent has a fertility rate high enough to sustain its population once the baby boomers population dwindles. Death rates are very hard to change and birth rates take generations to shift, absent a war. Productivity gains are more manageable than birth rates, but notoriously hard to achieve, and of course the older a population, the lower their propensity to take the risks necessary to increase productivity.

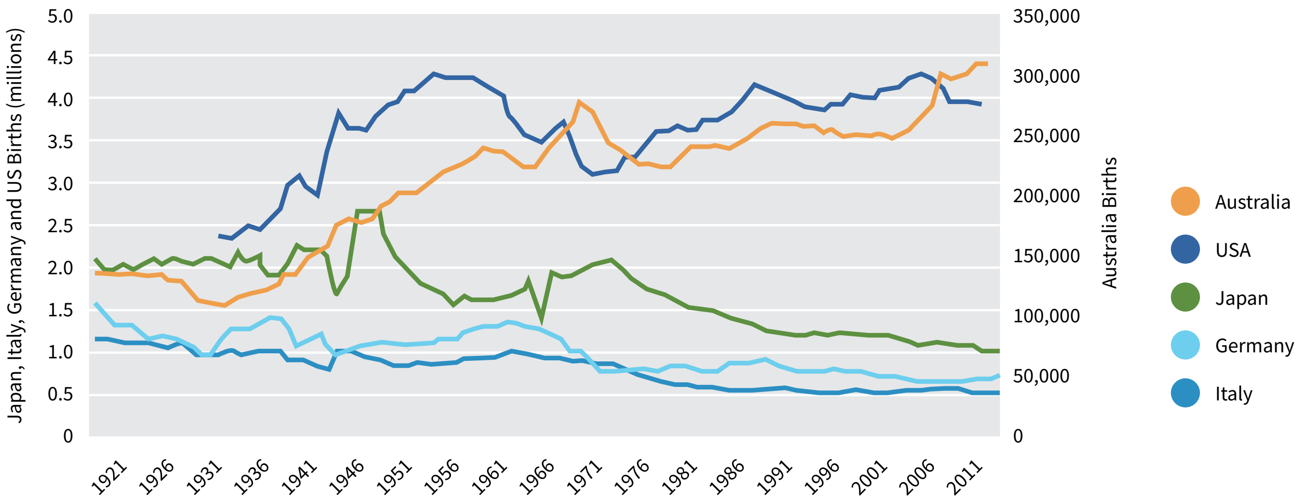
So that leaves immigration. Unlike Japan, Europe is seen as a desirable location for migrants. In the long run this might be saviour for Europe as it will provide workers, likely at a low cost, for their factories. Therefore increased economic growth, but only if Europe countries open their borders more freely, and this isn't favoured by voters, making it very challenging.

But immigration is only beneficial if these countries can keep hold of their workers. The longer the economic slump in Europe lasts, the worse the emigration gets. Portugal for example sees 100-120,000 people leave each year, mostly to the economically stronger UK, while its number of births is the lowest since the 1700s, at 90,000.

Figure 5 shows the declining births that Japan and Europe's largest countries face, which results in declining population. The US and Australia's births are shown on the same chart to illustrate the contrast.

Figure 5: Birth rates in much of Europe and Japan have plummeted, while the US and Australia have maintained a strong pace

Annual number of births by country, 1921 to 2015. Source: World Bank



Section 2: The world in 2016

In 1921, Italy had 1 million more births than Australia; now that gap is just 200,000 and falling. The US had roughly the same number of births as Japan in 1935 and now has four times as many.

Europe has limited options to reverse this trend, and it is running out of time to do so. The greater the lure of economic prosperity in the US, Asia and eventually Africa, the weaker Europe's prospects for attracting migrants. And even if they could attract migrants, the social attitudes towards migrants is still far more negative than in America or Asia.

Without migration, Europe is on course to become the next Japan, facing economic headwinds caused by the burdens of government debt and an aging population. Japan has faced this reality for over twenty years, so unless investors have a view that Europe has the ability to defeat demographics and their debt burden, long term investors should minimise exposures to Europe (and Japan).

Special note on UK economy

The UK economy is tied to Europe in terms of trade, but differs due to its large services sector and also in terms of demographics, specifically its ability to attract migrants.

Its trade ties to Europe create strong dependence on EU economic growth. It makes the UK vulnerable to the EU's attempts to devalue its currency which in turn makes the UK's exports less competitive compared to local product. This linkage is well understood and will be a headline in months to come due to the pending EU exit referendum.

Less understood however are the services sector advantage and the demographic link with the EU's economic prospects.

Services sector

The UK has one of the world's largest services sectors as a percentage of its total GDP at around 78%. In a world flooded with excess manufacturing capacity, this is a significant advantage relative to the EU, Japan and China in particular (the world's largest manufacturing economies). This structural advantage will put the UK in a strong position for the next decade while manufacturing driven economies attempt to work their way out of the capacity driven slump.

Figure 6 illustrates this point clearly. Global manufacturing has lagged dramatically behind global services for the past few years, and as identified earlier in this report, we expect this to continue for some years to come.

Demographics

Because the UK economy is unique in the EU region, in particular London is one of the world's leading financial centres, and the relative ease of adopting to English given its universal inclusion in schools globally, it will likely remain a popular destination for emigrants from Europe. In particular, as the weaker economies in the south of Europe continue to struggle to provide jobs for their youth, many are leaving with the UK being the number one destination.

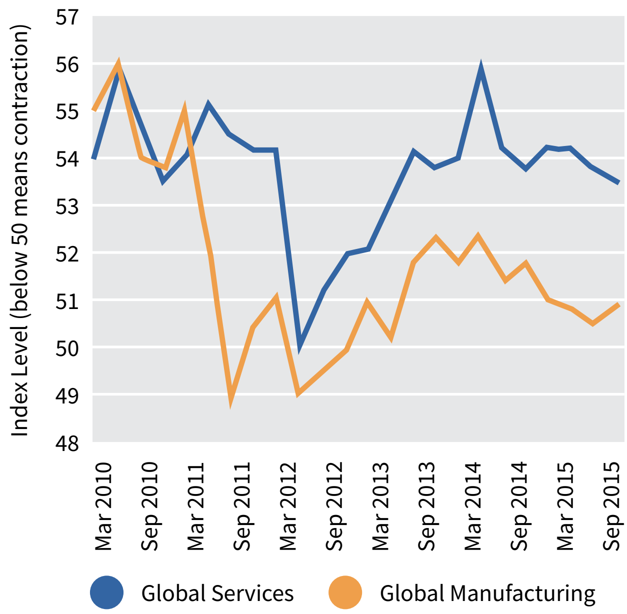
Over the past eight years since the GFC started, a net 2.1 million people have migrated to the UK from Europe and Africa. Estimates of the contribution of this net migration to economic growth range between 25-40%. What's more, migrants tend to be younger and more willing to work for lower wages, helping the UK economy retain fiscal balance as the native baby boomers retire, and helping to keep inflation at bay through lower wages.

The outcome of these two factors impacting the UK economy is that we expect a similar growth pattern to the US, that is, good, but not great. In terms of interest rates, we expect inflation to remain low and therefore for the Bank of England (the UK's central bank) to keep rates on hold for all of 2016 to allow the UK economy to continue to recover.

The GBP is one of just two international currencies that we consider to be favourable for Australian investors.

Figure 6: Services sector outperforming manufacturing globally due to massive excess capacity

JPMorgan Markit PMI Index, 2010-2015. Source: World Trade Organisation



Section 3: Major themes

Theme #1: Earnings growth expectations will fall, ending the equity bull market

To get investment going you need less uncertainty…

Joaquin Levy,
Brazil's Minister for Finance,
Davos World Economic Forum, 2015

One could be forgiven for thinking that the bull market has ended, but not according to most equity analysts. In our view, 2016 will be the nail in the bull market coffin, regardless of how optimistic the analyst.

The economic outlook provided in Section 2 clearly points to challenges for companies trying to increase earnings. Since the GFC, cheap credit has enabled corporate earnings to rise as companies reduced costs. But in 2015, earnings growth stalled, particularly in the US and Australia.

This year will be a very challenging year for equity investors for three primary reasons:

1. Lower expectations of global growth.
2. Excess capacity in the manufacturing sector putting downward pressure on prices globally.
3. Disappointing earnings growth, putting downward pressure on dividends.

Excess capacity: QE and ultra low interest rates causing deflation, not inflation

The global central banks' responses to the GFC was to flood the world with cheap credit in the form of low interest rates and Quantitative Easing (QE). This has in turn pushed up asset prices unsustainably, including equities.

But what is less well known is how much excess industrial capacity that cheap credit has created. In the US and China in particular, fixed asset investment benefited greatly from these stimulus strategies. The problem now is that the world has an unprecedented excess of industrial capacity at the same time as global demand is weakening rapidly.

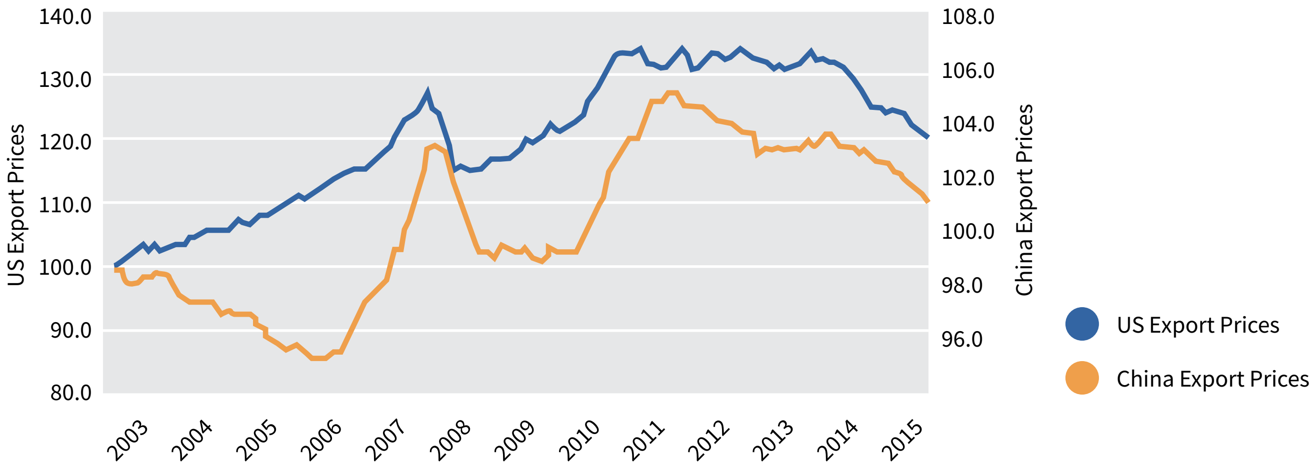
The result is more competition and falling prices, as shown in Figure 7. Excess industrial production capacity has been an issue for Japan since the 1990s, and China since around 2004. It became a US problem in 2013. Since that time, prices of exports from both the US and China have started to drop.

US export prices fell more in 2015 than in any other year since the data was first recorded in 1985, regardless of whether the volatile food and fuel exports are excluded, partially fuelled by the rising USD but also due to US manufacturers inability to command higher prices when global manufacturing excess capacity is so high.

This excess capacity issue is what is driving down inflation. This is somewhat ironic given that most people thought that QE would cause inflation. It may in fact cause weak inflation for several years as manufacturers that have used cheap debt to build new factory capacity, have to lower prices to utilise their factory capacity.

Figure 7: Excess capacity in the US and China is creating deflationary pressure

US and China Export Prices, 2003-2015. Source: FactSet



Weak global growth, excess capacity and falling earnings, but PE ratios well above average levels

Worldwide PE ratios are far above long term averages. The longer term CAPE Shiller Index (Yale University index created by Dr Robert Shiller looking at 10 year P/E ratios and adjusting for interest rates) is currently around 24-25x, compared to its average of 16.6x since 1881. The conventional 1 year P/E ratio is 20.4x compared to its long term average of 15.5x. The price to sales ratio is 20% higher than it was in 2007, and at its highest since the dot com bubble. Margin debt is also 21% higher than its previous peak in the dot com bubble.

These indications of high valuations would be sustainable if earnings growth was also above average. However, earnings growth is not high. In fact, US earnings growth in 2015 was -9% and FY16 ASX200 earnings growth similarly expected to be negative. Revenue growth is the problem, which is a direct result of a slowing world economy and excess industrial capacity across the world caused by years of cheap credit and Quantitative Easing.

Equity markets are persistently too optimistic. This hurts investors the most when valuations rise too far.

Figure 8 clearly illustrates this persistent bias. Since 1988, the average analyst's forecast for earnings growth has never once been negative. In only eight out of those 28 years have they forecast a lower growth rate than the actual result.

The result is that on average analysts have forecast earnings growth at more than double the actual rate achieved; analyst's forecasts average 15.6%pa, while actual growth was 6.8%pa.

The worrying part is that even after the falling momentum in earnings growth, particularly revenue growth in 2015, analysts' forecasts were still averaging 7.5% growth in earnings in 2016 as at Christmas Eve 2015, although by mid Feburary that had already been revised downwards to just 4.0% growth.

The biggest loser from lower world growth expectations will be equities, particularly for markets and companies that are priced above normal levels. The biggest concerns are:

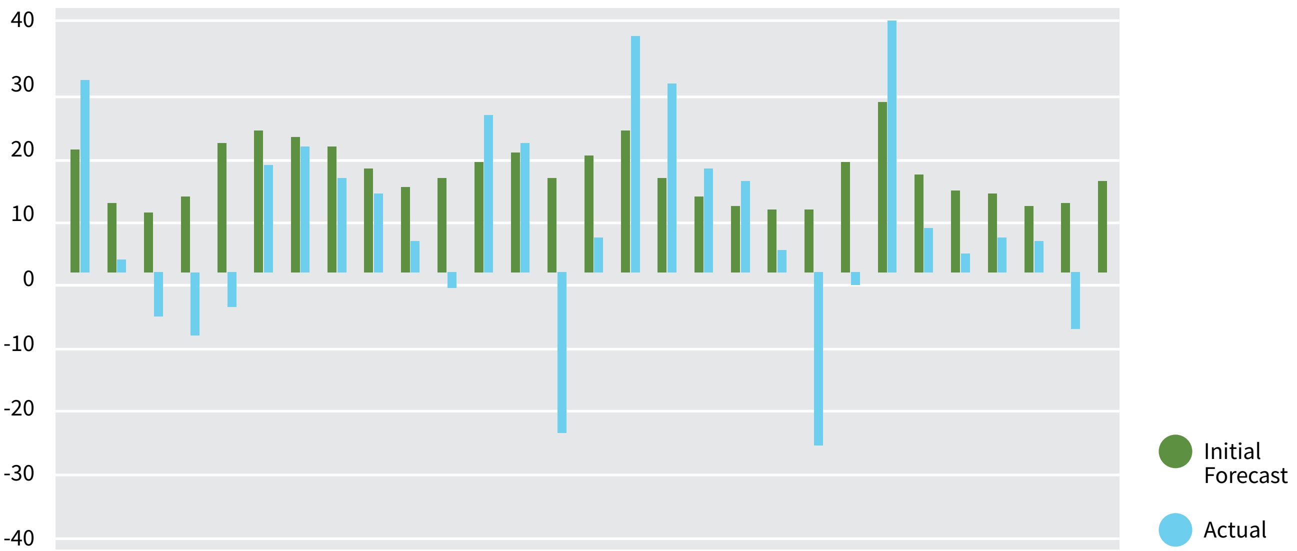
1. The US equities market, due to the high valuation levels.
2. Companies with a high dividend payout ratio (the percentage of their earnings that they pay as dividends).

Stocks with high dividend payout ratios are concerning as a lower earnings cycle will force them to reduce their dividends, hurting income seeking investors, or borrow the cash needed to maintain dividends which increases risk.

All of the world's largest miners, Glencore, Anglo American, Vale, BHP and RIO have now ditched their "progressive dividend policy", meaning that they can lower dividends when earnings fall.

Figure 8: Persistently optimistic earnings forecasts will hurt investors in a downturn

S&P500 earnings forecast error. Source: S&P, Bloomberg



Section 3: Major themes

Baby and the bathwater - Don't go selling all of your equities

This less than rosy outlook for equities doesn't mean investors, even conservative investors, should sell all of their equities. Equities are the growth engine of a portfolio, and provide strong income in the form of dividends. What it does mean is that investors should consider derisking by selling growth stocks, particularly those with high PE ratios; those paying out most of their earnings as dividends; or simply those with low dividend yields. The lack of earnings growth over the next few years will severely limit the upside on these stocks.

We kicked off 2015 calling out a risk that the US market was approaching long term record highs and that earnings expectations were too high. We similarly expected Australian corporate earnings to disappoint.

These warnings proved warranted and timely. Australian earnings per share fell 4%, compared to forecasts by the major banks and research houses of an increase of around 9%. In the US, analysts expected 11% growth, compared to the result of -9%.

This persistent bias toward assuming earnings growth will continue regardless of the economic fundamentals really hurts investors. Researchers, such as investment banks and 'independent' research houses don't get paid to forecast declining equity markets, but it is their clients that suffer when the biases cloud the reality of a challenging earnings environment.

This was certainly the case in 2015. Australian SMSFs' largest equity holdings are the four major banks, BHP, Wesfarmers, Telstra, and Woolworths. This portfolio was down 8% in 2015 and for the first two months of 2016, down a further 13% based on price, displaying the possible volatility in commonly held blue chip shares. At the start of 2015 analysts' forecasts of an 8% increase in capital value were well out of line with the eventual loss of 8%. More of this in Section 4.

The market will slowly readjust its expectations of the global outlook and will then have to adjust earnings expectations. Alternatively, if earnings expectations are not adjusted, earnings will continue to disappoint until a market correction occurs, bringing PE ratios down to a level that better reflects the economic reality.

Section 3: Major themes

Theme #2: Divergent central banks and currency wars

This year will see the world's largest central banks diverge for the first time in 21 years. The US Federal Reserve has commenced a tightening cycle, while Europe remains "ultra loose" (a modern market term to describe a central bank policy that combines 0% interest rates with additional stimulus through quantitative easing). The world's next two largest economies, China and Japan, are also loosening monetary policy through lower rates and QE respectively.

The impact that this will have on global currencies is largely untested. The last time that the US and Europe went in different directions was 1994, before there was a Euro or an ECB; and China was 1/20th of its current economic size. But generally speaking currency markets are particularly sensitive to divergent policy directions, so despite the USD's strength in 2014 and 2015, there is still plenty of upside left the longer this divergent policy is expected to continue.

Europe and Japan's severe economic headwinds and China's transition challenges mean that the USD will continue to see strong support for years to come

We expect the policy divergence to continue for several years, particularly in the case of Europe. For reasons stated in the global economic summary in Section 2, Europe faces long term severe challenges to creating economic growth. The market hasn't fully priced in this view yet, and so we believe that investors are better positioned holding USD than EUR for the foreseeable future.

There is very little doubt that the ECB, PBoC and BoJ wish to devalue their currencies against the USD at least, if not each other. That is the whole point of the "currency war" argument. Central banks lower interest rates, making their currencies less attractive for cash deposits, resulting in funds selling out of their currencies and pushing the prices down. With currencies lower, exporters from those countries become more competitive, boosting their economies.

The problem is however, that if all three of the economies are attempting this currency war approach at the same time, they will not gain competitiveness against each other, but will against economies with a rising currency. This is likely to be limited to the US and the UK, of the major economies.

In particular, there will be enormous upward pressure on the USD. If the USD rises, US exporters will become less competitive, threatening the US's recovery. Evidence that this has already started is shown in Figure 7; namely in the form of lower export prices. That in turn will lead to a shallower tightening cycle by the US Federal Reserve, only increasing rates by small amount in this cycle.

For Australia, this currency war has become very important. Early in 2015, the RBA officially stated that it was using interest rates to push the AUD lower. If commodities keep declining, currency markets are likely to push the AUD down without RBA actions, but if commodity prices remain at current levels and the AUD remains above 70 cents against the USD, we expect the RBA to lower interest rates. See Section 4 for more on Australia's outlook.

Section 3: Major themes

Theme #3: Interest rates to stay lower for longer, despite the Fed's own forecasts

Now that the question of when the US Fed will finally increase interest rates is answered, the next big question for global markets is: How far will they increase rates?

We have consistently held a very strong view, as published throughout 2015, that the Fed will be patient, and much more so than the market expects. There are two primary drivers of this, and only one of these is really needed not both:

1. **Currency wars**

   As outlined in Theme #2, the stance being taken by China, Europe and Japan, all attempting to lower their currencies through loose monetary policy, leaves the US Fed in a predicament. If the Fed raises rates too quickly or too far, the USD will escalate very quickly. The Fed will obviously be acutely aware of this and so they will only raise rates further if they have to due to inflation rising above their 2%pa target level.

2. **Weak inflation outlook due to weak wage price pressure**

   That brings us to the second driver of our belief in a patient Fed; weak inflation. A Central banks' role is to maximise employment while keeping inflation at or below a stated target level. The US Fed's target rate of inflation is 2%pa, and it prefers "Core PCE" as a measure of inflation, which is the increase in personal consumer expenditure items excluding food and energy. Using this measure, US inflation is just 1.33%pa as at December 2015. Add back food and energy, and it is just 0.39%pa.

This level of inflation would ordinarily mean very little chance of the Fed increasing rates, unless economic growth was so high that inflation was a major threat. Figure 9 illustrates this point. The 2015 cycle, kicked off with the rate increase in December 2015, is the only cycle in which both inflation and growth are below average.

In fact, growth is lower than the only other cycle in which the Fed has increased rates despite below average growth; the 1980 war on inflation in which inflation was running at 11.2%pa. At that time, the Fed was going to reduce inflation no matter what it did to the economy.

Similarly, inflation is equal to the lowest inflation reading previously recorded in 1963 that the Fed started to increase rates. But in that cycle, growth was running very hot at 5.6%pa and so inflation was a significant risk. With GDP growth so high, the Fed at that time would have been concerned that unemployment was going to fall so quickly that wage growth would have jumped and suddenly pushed up inflation.

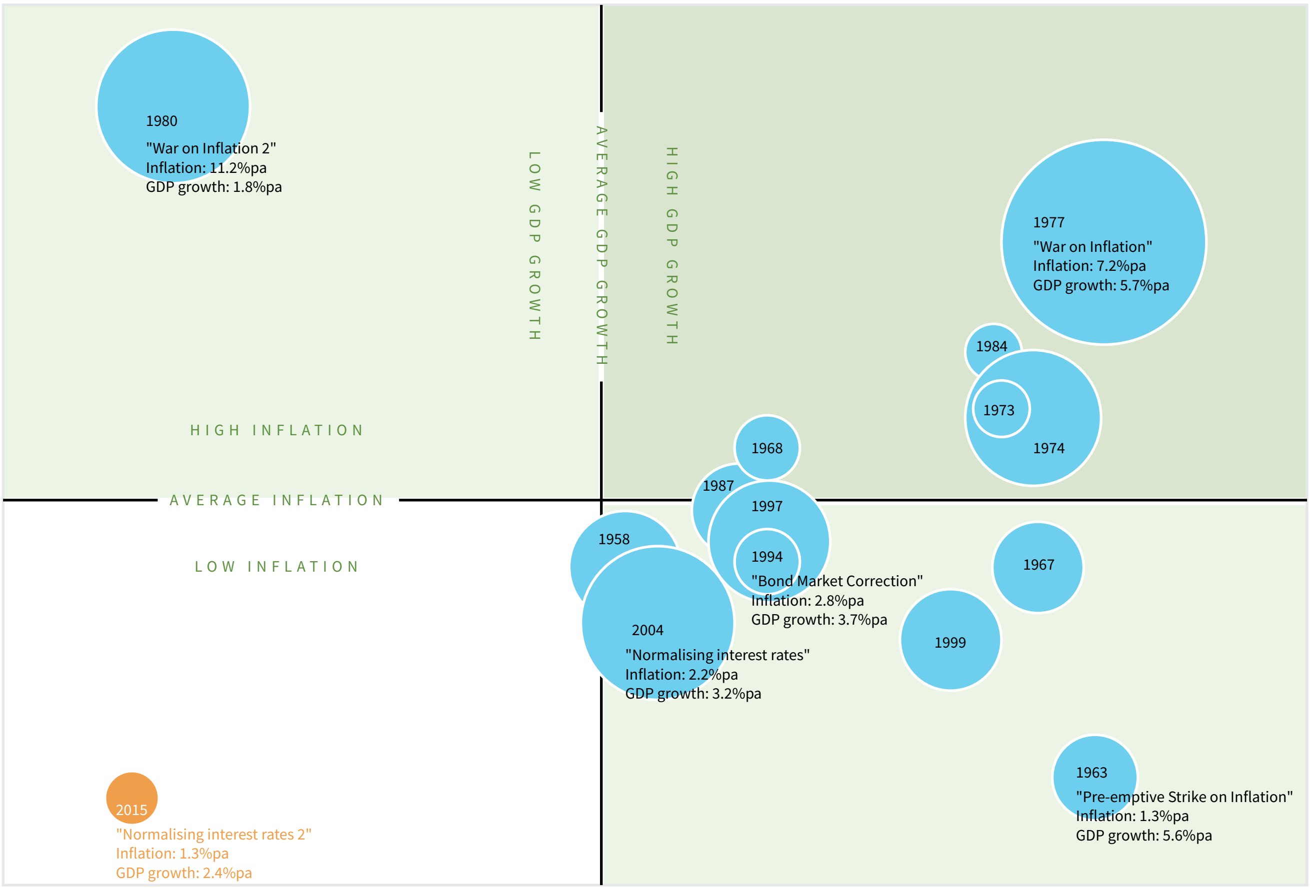
That is not a risk this time, not just because GDP growth is a below average 2.4%pa, but also because labour market conditions are still slack due to a high level of underemployment.

Section 3: Major themes

Figure 9: US Fed interest rate increases have never occurred when both growth and inflation have been below average

US interest rate increases, 1958-2015 vs GDP growth and Inflation. Size of the bubble represents interest rate increase during cycle

Source: Federal Reserve Economic Database



Section 3: Major themes

Wage growth will not put pressure on the Fed in 2016 because underemployment is still high

A sign of heightened inflation risk is wage inflation, that is rising wages will typically occur before goods and services' prices are increased. Wage inflation typically follows a labour market reaching the point at which employers have to compete for labour, that is when the pool of unemployed is small.

This is the basis of our argument for US inflation remaining weak in 2016; labour market slack. Specifically that there are still a very high number of Americans looking for more work. They are employed, but underemployed. This is shown in Figure 1 in Section 2.

Without pressure to increase rates, and with the currency wars underway globally, the Fed will be patient. Patience can be interpreted to mean increases will be slow and only as necessary. Looking at historic rate increases in Figure 9, there is no pattern or rule that says that the Fed is obliged to increase more than once. Given we are coming off zero interest rates, it is reasonable to assume that they will raise at least 3-4 times during this cycle to give some space to ease again if they have to, but the cycle could be 2-3 years long.

We believe that the Fed will most likely increase rates just once during 2016, which has shifted from a relatively pessimistic view just two months ago, compared to bank and equity market economists, to a more optimistic view than most. Markets are volatile and we think they will stabilise with a view similar to ours, but there will be opportunities to benefit from this volatility in the meantime.

Implications for Australian interest rates

Australian interest rates are not set in isolation from rates around the world. A slower than expected rise in US rates will mean that China, the EU and Japan will also be slower to raise rates, and so the global currency war will continue.

The RBA will not want the Australian dollar to rise against any of its major trading partners. So with rates remaining low around the world, their bias will be toward low rates. Any economic weakness could see them lower rates even further.

Considering the domestic factors that we look at in Section 4, we believe the RBA will lower rates at least once in 2016, with a second cut possible but not likely.

More importantly for investors, we believe that rates will stay around 1.5% to 2.5%pa for more than five years. The global economy will not provide the growth that Australia needs, so in time we will either need to transition our economy to be a service provider to the Asian region, or face far lower growth in the future than we have experienced in the past 50 years.

This outlook means that the long term interest rates are likely to fall. The benchmark Australian government 10 year bond yield is likely to fall to below 2.50%pa, and perhaps test the same levels as the US 10 year treasury, that is, below 2.00%pa.

Section 3: Major themes

Theme #4: Fears about debt levels, now higher than 2007, will start to drive volatility

Markets are realising that central banks can no longer repress financial volatility. And they are repricing to a new volatility paradigm

Mohammed El-Erian,
chief economic adviser Allianz
and former PIMCO Co-CEO, 2016

Global debt levels are higher now than they were in 2007 by US$27 trillion. The cheap credit and QE programs applied by the world's largest central banks has leaked its way into China and other emerging markets, creating credit bubbles that are hard to control in a world of free capital market flows.

When the GFC struck in 2008, emerging market economies had relatively low debt levels and strong momentum. Now two of the "BRICs", Brazil and Russia face recessions, and China has slowed considerably. The stimulus applied by most emerging economies has meant many debt levels have risen substantially.

Figure 10 shows the change in debt levels between 2007 and 2014, split by the part of the economy that has incurred the debt. Key takeaways are:

1. **China**
   a. For every $3 of debt raised in the world in this timeframe, $1 was borrowed by China
   b. In the corporate world, $2 of every $3 of debt was borrowed by Chinese companies
   c. In terms of households, most countries around the world reduced their debt, but China was larger than the total of all of those that did grow
   d. Only in government debt was China not the highest contributor, ranking 4th behind the US, EU and Japan (with Australia alarmingly in 5th place)
   e. Most concerning however is the banking sector's dramatic growth. Chinese banks increased their debt by US$4.3 trillion, offsetting the US's financial sectors US$4.2 trillion deleveraging
2. **US**
   a. The US government accounted for $1 in every $4 borrowed by any sector globally ($6.1 trillion)
   b. The US corporate and household sectors however repaid $3.5 trillion in that time
3. **EU**
   a. Ranked in terms of the increase in debt relative to GDP, Europe has 14 of the top 20 global borrowers (China doesn't even make that list of 20, it is ranked 22nd).
   b. France, Spain, Italy and Ireland stand out as some of the world's largest borrowers. France and Italy are in the top 10 borrowers in all four categories
   c. Germany barely increased its debt to GDP ratio in this time and now ranks below Australia

4. **Japan** - Government debt is the only significant increase
5. **Brazil and Russia** experienced small increases in corporate and household debt
6. **India** had no change in debt, with a small increase in corporate debt offset by government debt reductions

This huge increase in worldwide debt means that if the global economy were to face another debt crisis or recession, the macroeconomic and monetary policy ammunition needed to stimulate a recovery is largely already spent.

It also means that when the next recession hits, these debts will not be repaid. This will threaten the balance sheets of some banks and even sovereign nations. The OECD's head of review committee and former chief economist for the Bank of International Settlements, William White, said at Davos in January 2016 that "it was the European banks that would take the biggest haircuts".

Mr White was one of the few central bankers globally to have rung the alarm bell in 2005 and 2008, stating that western finance was "heading for a fall" and the global economy was "susceptible to a violent crisis".

The implications of this enlarged debt position, and the potential to impact Europe is that Europe's banks are likely to need to be massively recapitalised.

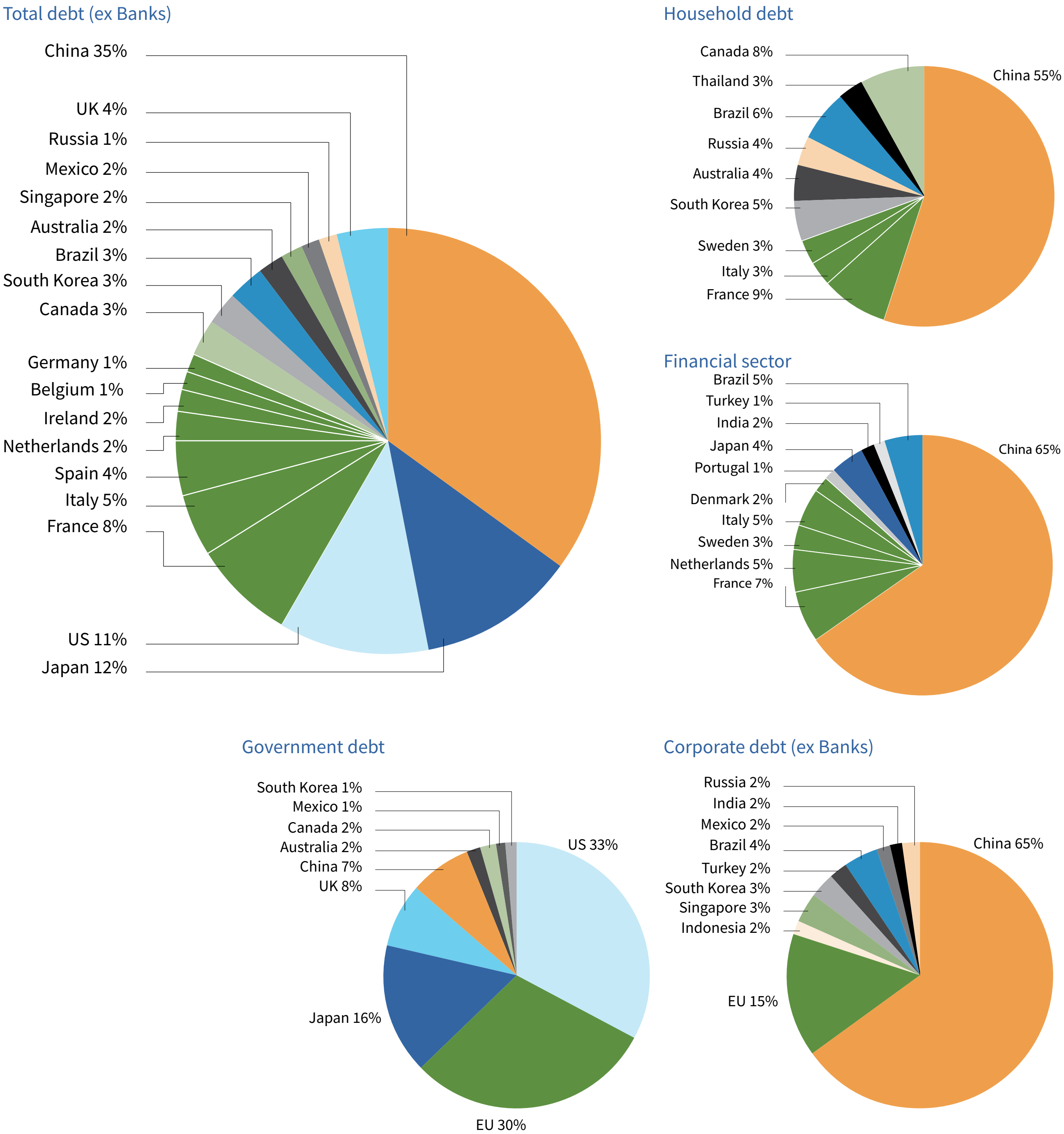
Volatility peaks when nervousness peaks. Some people refer to the Volatility Index, or the "VIX" as the fear index, but this isn't accurate. Volatility actually requires both fear and greed. When greed pushes prices beyond where most people are comfortable, they get nervous that prices could fall suddenly. Then it takes a shock, sometimes a relatively small one, to cause fear that a fall is coming, and ironically the immediate selling pressure caused by the fear then causes the fall.

As discussed earlier in this report, cheap debt and QE have combined with greed to push many asset prices well beyond justifiable levels, particularly given the strong enough outlook for the global economy. Any global news such as: overvalued equity markets, a China hard landing or oil price volatility, fears of a debt crisis, particularly triggered by failing oil producing nations or European banks, will create ripple effects across all markets.

Section 3: Major themes

Figure 10: China accounts for one third of the total global increase in debt; including two thirds of the increase in corporate debt and financial sector debt, and half of the increase in household debt. France, Spain, Italy and Ireland are equally concerning given their more limited ability to repay.

Increase in debt between 2007 and 2014, by country and sector. Source: McKinsey&Company



Section 4: Outlook for Australia

Australia, better than most, clear gap between best and worst

China will halve its investment growth rate over the next five years, shaving a third of Australia's growth potential…

IMF, 2015

The cloudier the outlook for China, the cloudier the outlook for Australia. The reality being China's industrial economy is barely growing. Australia needs to transition with the Chinese economy and leverage its services economy more, or we will face a generation of slower than average historical economic growth.

Like China, the Australian economy needs to reposition itself for the next decade and beyond. The mining investment boom is over and unlikely to return in a hurry. Construction activity has provided Australia with some respite, but Melbourne and Brisbane are already shifting into an oversupply situation, with Sydney likely to follow by 2017. Oversupply in property will result in falling yields and a slowdown in construction.

Australia is placed at China's and India's doorsteps, but without direction it will struggle to make full use of this geographic advantage. For the next decade we will be supported by immigration and the associated construction, inbound investment, education and financial services, but these alone will not lift us to average GDP growth levels.

Australia needs a pick up in business investment activity and consumer spending. Outside of mining investment, business investment has been underperforming for years, and 2016 is likely to be the same. A recent survey of Australian CEOs showed a very steep fall in business confidence. The survey found that 73% of CEOs planned to cut costs and 41% to cut staff, up from 12% in 2015. Consumer confidence will weaken on negative house price, or international economic news.

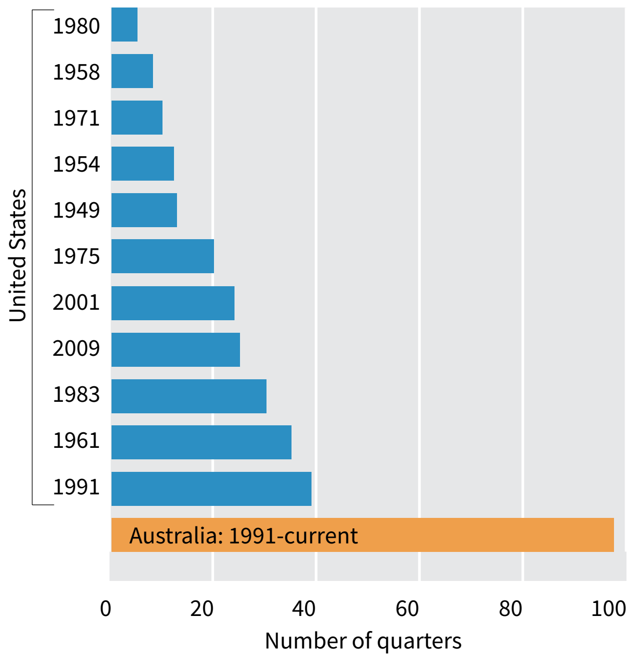
Below we look at the outlook for Australia's corporate sector (see: "Australian corporate outlook, Muted with clear sector divergence"), but first we look at the economic outlook for Australia in the context of our outlook for the global economy detailed in Section 2.

Australian economic outlook

Amazingly, this year Australia's economic expansion may reach 100 quarters, that is 25 years without a recession. Throughout this period which included the Asian financial crisis, the global financial crisis and mining boom to bust cycle, Australia has had only three isolated quarters of negative real GDP growth (a recession is two consecutive negative quarters). Figure 11 illustrates Australia's expansion versus the US's expansions since WWII.

Figure 11: Length of economic expansions

Source: FIIG Securities, Haver Analytics



In this section we consider if the prosperity will continue and what this means for Australian corporations in 2016. We begin by explaining the credit cycle and point out where the Australian and US economies likely sit. The key economic drivers most likely to impact corporate Australia are then highlighted and we conclude by assessing which sectors are likely to benefit.

The main theme in 2016 is the continued economic divergence of industry sectors as the Australian economy adjusts post mining boom and the credit cycle fades.

Section 4: Outlook for Australia

Where are we in the credit cycle?

The credit cycle

The credit cycle is one aspect which drives the business cycle and is seen by many as a good leading indicator. Understanding where an economy is within the cycle can lead to expectations about what will happen next. Understanding the cycle can be useful for equities, credit and fixed income investors as it helps to identify when good companies can be bought at better value prices simply because of market dynamics rather than any issues with the companies themselves.

A credit cycle in its simplest form involves access to funding by borrowers. The cycle first goes through periods in which funds are easy to borrow and is characterised by lower interest rates, reduced lending requirements and an increase in the amount of available credit. These periods are followed by a contraction in the availability of funds as interest rates climb and lending rules become stricter. The contraction period continues until risks are reduced enough to support the beginning of the next cycle.

The following table characterises each stage including typical credit spread behaviours.

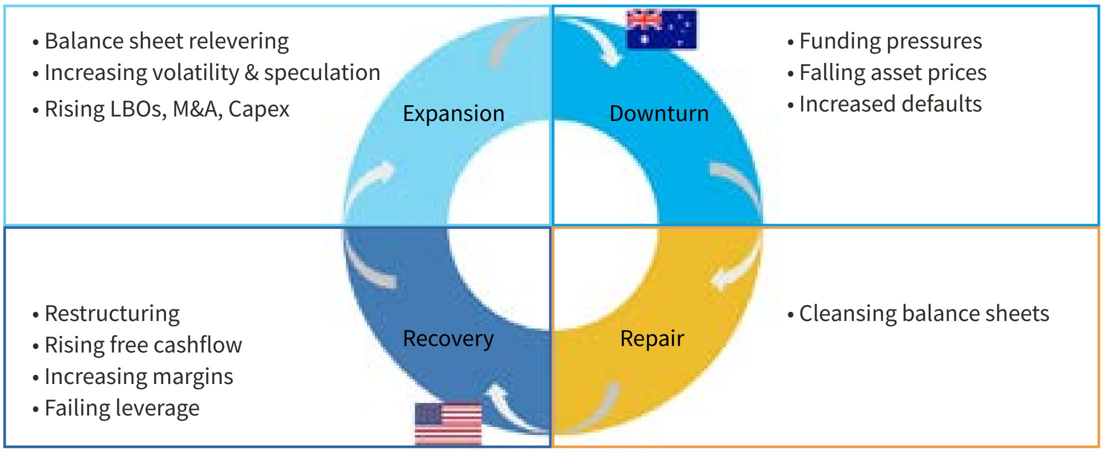
Phases of the credit cycle

PHASE	CREDIT SPREADS (additional yield paid over the "risk free" government or bank bill rate)	CHARACTERISTICS
1. Downturn	Spread widening	• **Investors should diversify as this phase starts** • The worst phase for corporates • A downturn in economic activity leads to declining profits and higher levels of corporate leverage • Banks reduce their lending and tighten credit standards, and companies start to de-leverage their balance sheets in the face of declining cashflows • Central banks are easing monetary policy or cutting rates • Falling asset prices • Increasing number of credit ratings downgrades and defaults
2. Repair/recovery	Spread tightening	• **Investors best positioned to be holding diversified high yield going into this phase** • The economy tends to be moving out of recession and into recovery mode • Accommodative monetary policy • Repair of balance sheets, rising free cash flow, increasing margins and falling leverage
3. Expansion	Spread stability	• **Investors should gradually reduce credit risk throughout the cycle, and take more floating positions** • The economy recovers and there is improved business and consumer confidence • Banks start to increase lending and corporate cash flow improves • Increasing amount of debt on balance sheets, rising volatility and speculation, growing numbers of leveraged buyouts, mergers and acquisitions, and capital expenditures • Central banks eventually tighten policy to counteract signs of an overheating economy

Source: FIIG Securities

Section 4: Outlook for Australia

Figure 12: So where are we in the cycle?
The following chart illustrates the estimated position of the Australian and the US economies.
Source: FIIG Securities

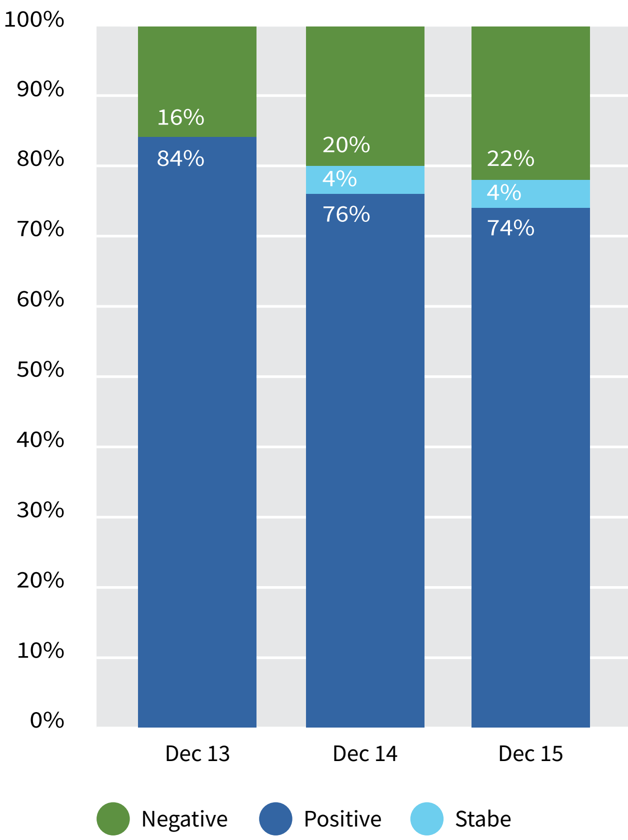


Australian credit cycle - Downturn

Compared to the US, which is moving through the early stages of the recovery phase (indicated by the Fed's decision last December to begin raising interest rates after seven years of unprecedented accommodation), Australia is progressing through a downturn as indicated by the following characteristics:

- General expectations for a modestly slower growth year in 2016 compared to 2015 given diminishing tailwinds in the non mining economy
- Commodity price deflation, signs of house price deflation in some areas
- Rapidly falling investment and weak household income growth
- Banks have restricted investment lending, leading to dramatic falls in investment loan growth (after regulatory intervention)
- Negative credit rating outlooks continue to increase (see Figure 13) which shows the proportion of negative outlooks increasing to 22% as at December 2015 compared to 16% at December 2013

Figure 13: Distribution of Australian ratings outlooks
Source: FIIG Securities, Moody's



Section 4: Outlook for Australia

Interest rate expectations

Our interest rate view remains the same as 2015; we expect interest rates in Australia to remain between 1.5% and 2.5%pa for at least the next five years, and assuming inflation remains muted, probably for the next ten to twenty years. For 2016, we expect the RBA to cut rates once to 1.75%pa, with a small but growing risk of another cut to 1.50%pa.

For income investors, the outlook for 2016 is far less relevant than the longer term outlook. There is little that can be done to improve your portfolio based on the 2016 view for interest rates. However, if you take a view that rates will stay lower for longer, the current market pricing for Australian bonds provides an opportunity to lock in higher income, but the outlook for income from cash remains very poor.

Long term bond yields in Australia still imply that interest rates will increase beyond 2020, returning to levels of around 3-3.5%pa at that time. This appears to be purely based on the historic range that Australian interest rates have moved.

We believe this market view to be misguided. Global interest rates have entered a new era of ultra low rates. Australia is far too small an economy to be far out of step from the rest of the world. Further, China's slower economic growth means that the Australian economy itself is likely to experience several years of below average growth.

Our forecast for the Australian 10 year bond yield is for it to fall over time as markets adjust to this new paradigm until it settles in a range of 2.0% to 2.2%pa, slightly above US rates.

Key themes for Australian corporations

Australia is likely to experience more modest economic growth in 2016 than 2015, driven by the familiar challenges of commodity price deflation, rapidly falling investment and weak household income growth. A clear divergence has developed between sectors, which is likely to increase. Deteriorating sectors will experience more equity raisings, slowing dividend growth or cuts and less merger and acquisition (M&A) activity. Key points to note:

1. Capital raisings

Last year featured significant new equity issuance (banks and energy firms in particular) with net equity supply running at two times its historical average (net equity supply increased by greater than $60bn in 2015 or 4.2% of the total equity market capitalisation). This trend is likely to continue.

2. Slowing dividend growth or cuts

After five years of Australian firms delivering large dividend increases, 2015 marked somewhat of a turning point with an increased risk of dividend cuts. At 31 December 2015 the forward yield on the ASX 200 was 5.1%pa which is 15% above its 20 year average and at levels that have only been breached during periods of market crisis. These levels are unsustainable. See our "Dividend Enhancement Strategy" in Section 7 for more on this topic.

3. Slowing export neighbours

Eight of Australia's top 10 export destinations are in Asia, comprising 70% of total merchandise exports in FY15, led in order by China, Japan and Korea. The slowing in the Asian region, largely driven by China, is not the only drag on Australia. It is also the changing composition (from investment to consumption) that is negative for Australia, impacting demand for bulk resources and commodity prices.

4. The continued fall in mining investment

The RBA expects mining investment to continue to unwind over the next two years. Weakness here has been a major contributor to consistent RBA growth downgrades over the past two years.

5. A lower AUD

A weaker AUD is aiding transition from resource to service sector activity. The total value of service exports rose 8%, to around $64bn over the past 12 months, and inbound tourist spending grew by a solid 10% in 2015, to $33bn.

6. The possibility of political stability

Malcolm Turnbull's ascension to prime minister and the possibility of a period of relative political stability could translate to improved business sentiment.

7. Possibility of worsening drought

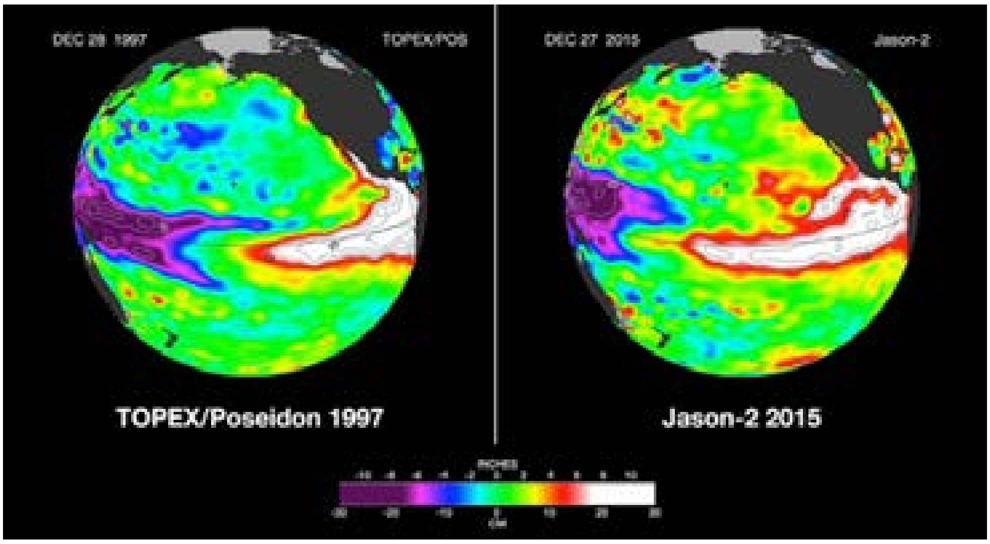
Early warning indicators suggest Australia could be facing one of its most severe droughts with the Australian Bureau of Meteorology suggesting the 2016 El Niño is likely to rank in the top three events of the past 50 years.

Section 4: Outlook for Australia

Figure 14 gives a comparisons of Pacific Ocean sea surface height (SSH) anomalies as at December 2015 compared to the last major El Niño event in 1997. SSH can be used to calculate how much heat is stored in the ocean which is a major indicator of an El Niño event. The 2015 imagery shows much broader heating than in 1997, as shown by the much larger area of white and red (highest levels of the scale meaning more heat) and less green and blue (lowest levels).

Figure 14: El Niño surface height anomalies

Source: FIIG Securities, NASA



- Nomura has estimated this may lead the agriculture sector to subtract close to 0.75% off total Australian economic growth (Global Annual Economics, 4 December 2015)
- Energy retailers would benefit as consumers turn on fans and air conditioners
- Insurers also tend to benefit from drier weather due to lower catastrophe costs. Storm damage tends to be more costly than droughts and bushfires. Catastrophe losses during El Niño events are on average 40% lower than in periods when La Nina occurs (Morgan Stanley)

Section 4: Outlook for Australia

Positive outlook for airlines, tourism and education

Sectors

A key trend is the changing sectoral composition of growth in Australia. In particular, weakening capital intensive mining has given way to stronger growth in labour intensive service industries.

The following is a 'heat map' for rated Australian corporates based upon two key credit ratios as at the second half of FY15. The ratios are: funds from operations to debt (FFO/debt) and debt to earnings before interest, tax, depreciation, and amortisation (debt/EBITDA). The dark blue coloured cells represent modest financial risk; pale blue cells intermediate risk; and orange high risk.

Heat map - key credit ratios for Australian corporations

Source: FIIG Securities, S&P Capital IQ

	Consumer discretion	Consumer staples	Energy	Health care	Industrial	Info tech	Material & mining	Real estate	Telecoms	Utilities	Total
FFO/ debt	32%	44%	24%	38%	18%	27%	38%	7%	46%	10%	26%
Debt/ EBITDA	2.3x	1.7x	3.5x	2.1x	3.8x	2.5x	1.9x	9.0x	1.6x	6.4x	2.8x

This is a very simple analysis and is by no means absolute in its assessment. It is just a simple way to represent sectorial credit strength of Australian corporates at this point. Remember that sector groups can be very diverse in their credit quality. For example, Real estate is a mix of highly leveraged property developers and relatively stable REITs and the Materials sector includes mining and commodities. Also of note, is that while Utilities are highly geared, the risk is largely mitigated by the industry being regulated, which lends stability to company performance.

Sector analysis

So how will the above key financial themes and our position in the credit cycle impact individual sectors? The following highlights the possible impact of these financial forces for various industries.

Financial forces on various industries

Source: FIIG Securities

Positive	Neutral	Negative
Airlines	Retail	Mining and resources
Tourism	Consumer	Oil and energy
Education	Building & construction	Banks (equity)
	REITs	
	Agriculture	

Section 4: Outlook for Australia

Airlines/Airports/Tourism

A lower Australian dollar is encouraging stronger inbound tourism. The following charts detail international visitor numbers by yearly total to 2014 as well as by month which indicates that 2015 numbers will again increase compared to prior years.

Figure 15: International visitor numbers to Australia per year

Source: FIIG Securities, ABS

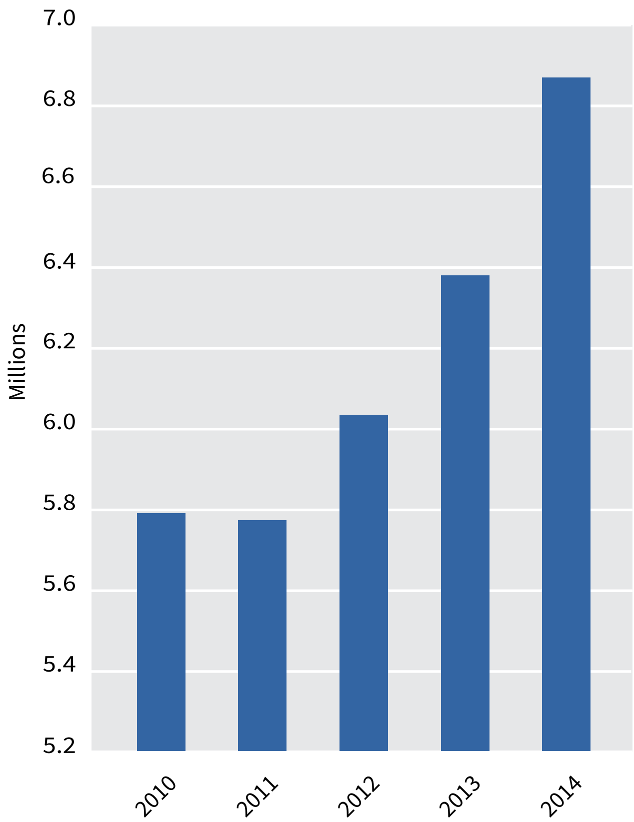
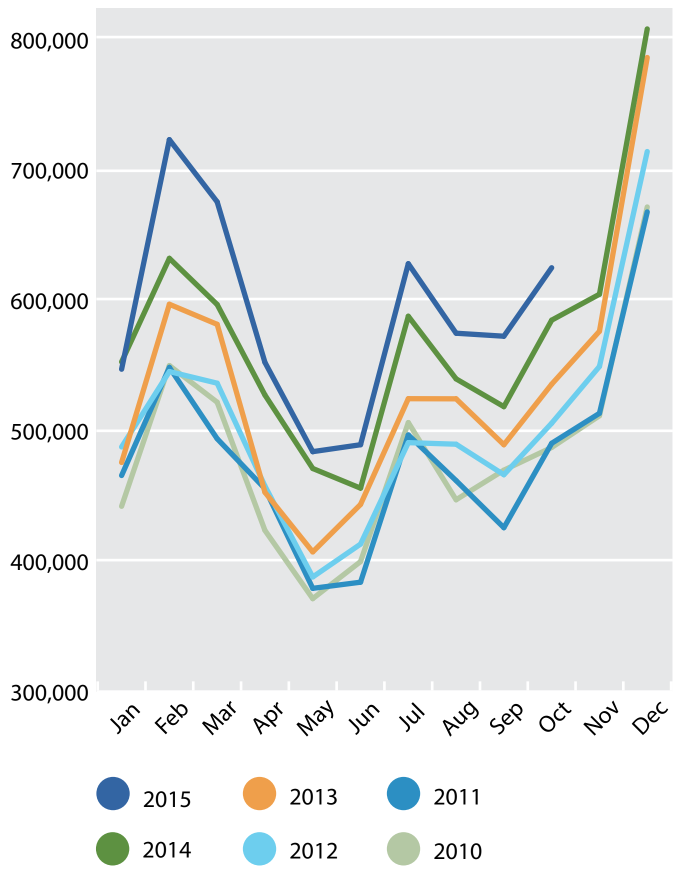


Figure 16: Visitor numbers per month

Source: FIIG Securities, ABS



- A weaker AUD is also positive for the sector with some passengers choosing domestic over international flights, as well as making Australia a less attractive market for foreign competition given lower revenue
- The lower oil and therefore fuel prices continue to support airline operating margins and further debt reduction

Section 4: Outlook for Australia

Consumer and Services

Historically, sectors relying on discretionary income benefit from low interest rates and petrol prices given the increased free household cashflow. However, weakening household income growth and rising import prices (given a weakening AUD) are offsetting the benefits to discretionary income. Consumer sentiment therefore remains low and range bound as detailed in Figure 17.

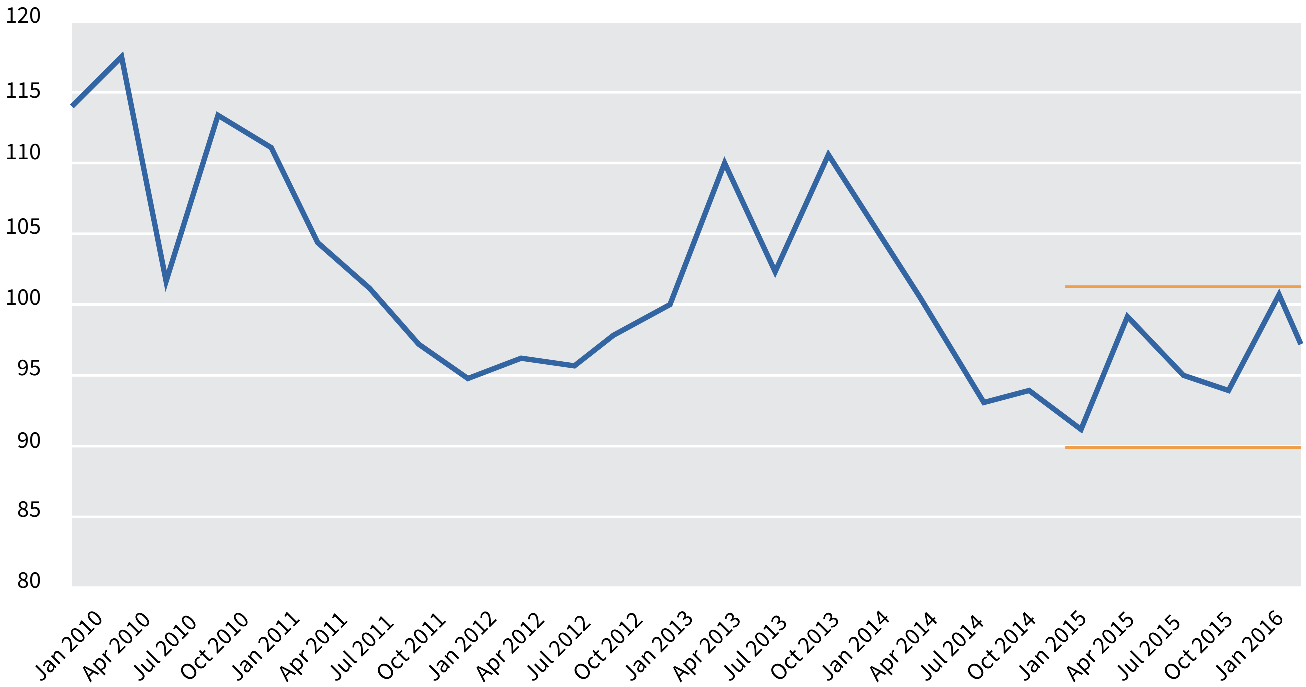
Retailing/Wholesaling

The lower Australian dollar has had positive and negative effects for retailers; more consumers are shopping locally, however face higher wholesale prices for imported products.

- Personal and recreational services are benefiting from a similar trading environment to the hospitality sector, with consumers favouring more services over goods (from retailers)
- Education is another winner and has seen higher international student numbers supported by the weakening Australian dollar, a more stable student visa environment and access for international students to post study work rights

Figure 17: Consumer sentiment index

Source: FIIG Securities, Bloomberg



Section 4: Outlook for Australia

Slowing construction and more housing regulation

Construction

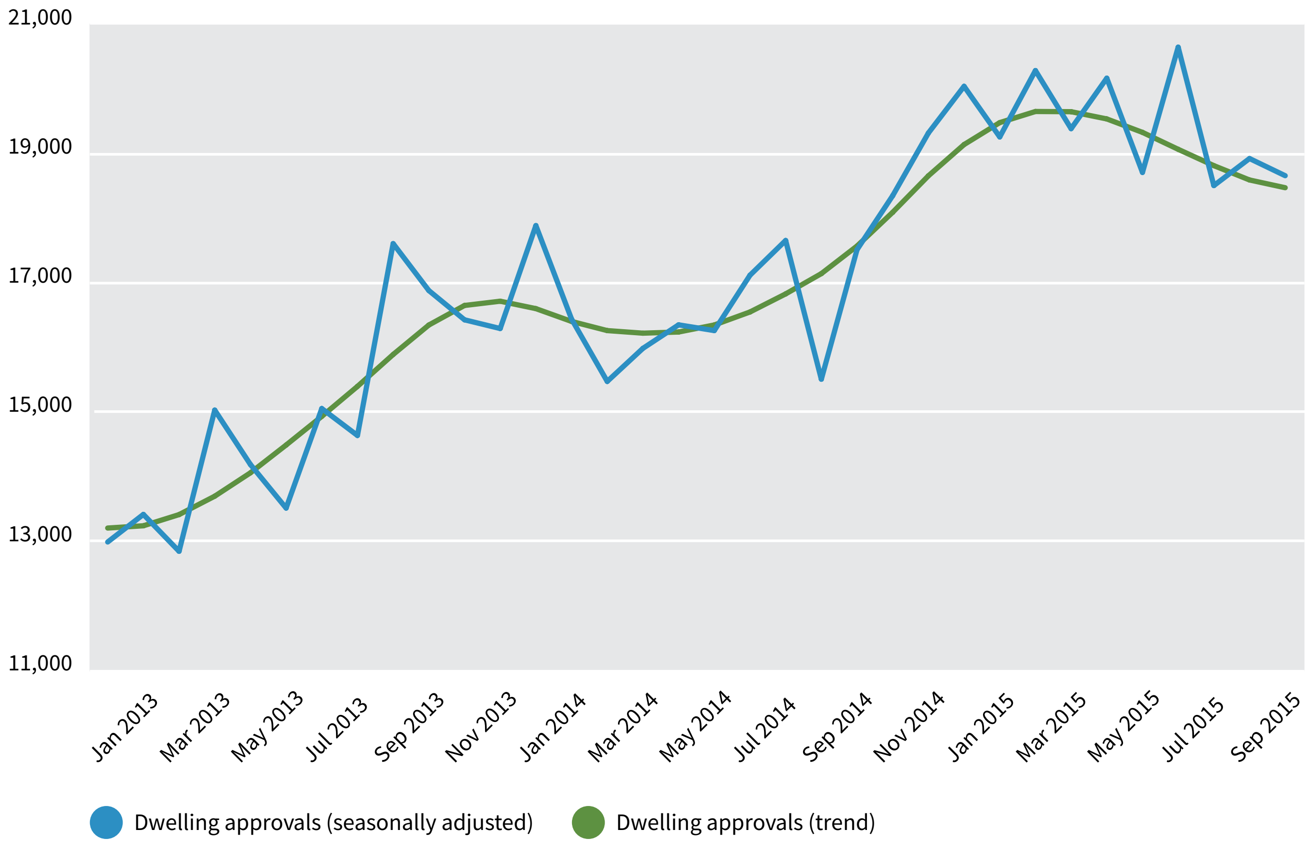
- Overall earnings are expected to be flat as the industry transitions from resource related spending
- Government spending on road and rail infrastructure may help offset a decline in resource investment spending from 2016
- There are high office vacancy levels which limit commercial construction appetite, however there is a clear divergence in CBD office vacancy rates between Sydney/ Melbourne (stable) and Perth/Brisbane (vacancies up)
- Demand for residential property continues to drive solid residential building activity however this is slowing particularly in the investment market
- A low interest rate environment provides support

Housing

- The housing market was a clear driver of growth in 2015 however, appears to have peaked and will likely become a less powerful force going forward.
- Housing prices have increased significantly across the major Australian cities but macro prudential controls are limiting the capacity of banks to lend to the investor segment of the market and mortgage rates have risen from their lows
- The Australian consumer is also already the most levered in the world
- Building approvals look to have peaked as detailed in Figure 18
- Finance commitments for construction purposes are displaying a negative trend and the residential investment sector in particular has slowed dramatically in the latter half of 2015 due to regulatory intervention

Figure 18: Total number of dwelling approvals in Australia

Source: FIIG Securities, ABS



Section 4: Outlook for Australia

- Regulation is increasing in response to the significant growth in investment and interest only loans. In December 2014, the Australian Prudential Regulation Authority (APRA) introduced a 10% guideline for investment loan growth for banks. The regulator has also recently increased risk weights for residential property investment lending for major banks. Further, the Australian Securities and Investment Commission (ASIC) also published recommendations to improve the robustness of loan serviceability assessments for interest only loans
- As a result of increased regulatory scrutiny, Australian banks increased lending rates for investment loans for both new and existing customers in July and August 2015. Some banks also lowered their maximum allowable Loan to Value (LTV) ratios and introduced stricter serviceability tests
- This led to a sharp contraction of growth in the investment housing market as detailed in Figure 19 which illustrates the value of total investment housing financed
- All the above indicators do not necessarily imply a significant correction to property prices, but they do limit the ability of the sector to contribute to economic growth in the coming years

Banks

- Regulatory requirements are more positive for credit compared to equity given higher capital levels dilute shareholders equity but increases bondholders buffer
- Generally however, banks have a subdued outlook for earnings given weaker volume growth as housing cools and a low margin environment remains. Bad debts have also started to rise off a very low base, see Section 6

Mining and commodities

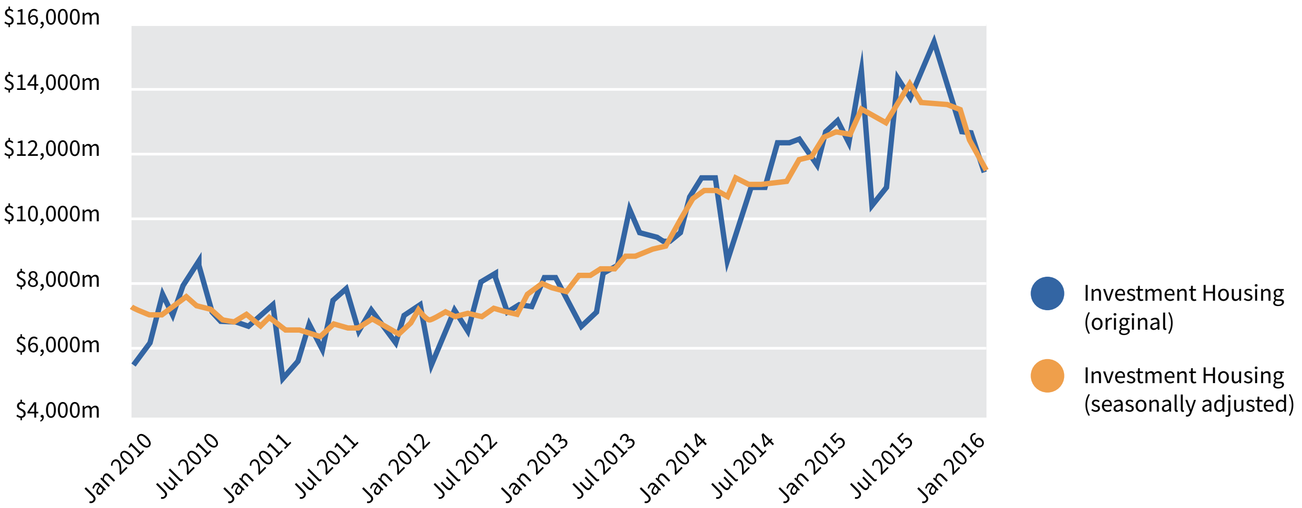
- Resource investment spending continues to decline
- Softer Chinese and global economic growth weighs on prices
- Ongoing cost/capital expenditure reductions are necessary to support margins and liquidity
- The AUD devaluation provides some support
- Credit metrics and liquidity will continued to be under pressure
- Single commodity producers and mining services most impacted compared to large diversified producers, see Section 5

Conclusion

Australia's economic expansion may make it to 25 years in 2016 without a recession. However as the mining boom fades and the credit cycle begins a downturn, the economic divergence of industry sectors within Australia continues to become more pronounced.

Figure 19: Financed value of investment housing

Source: FIIG Securities, ABS



Section 5: Commodities

Still challenging times ahead

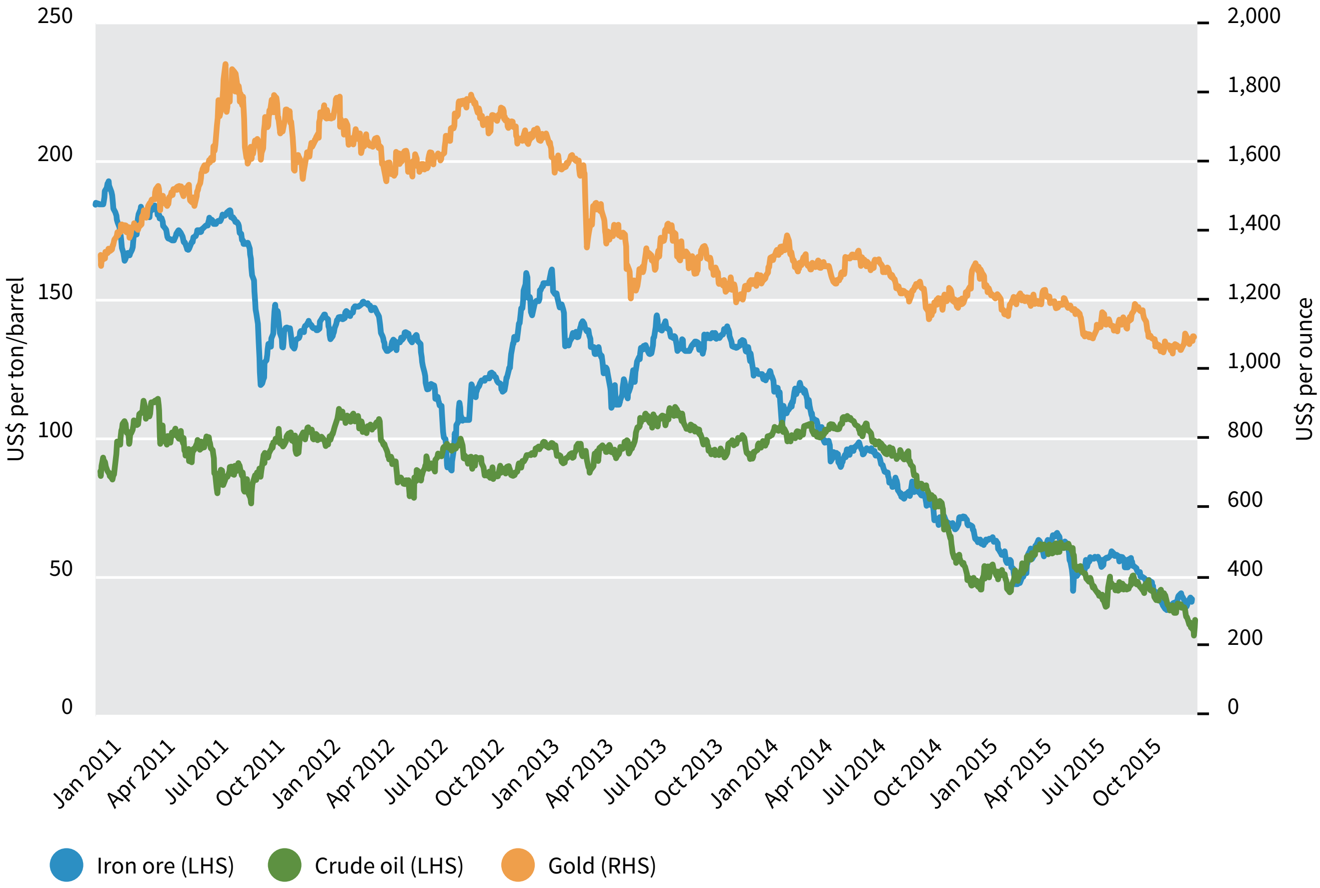
The commodities sector has faced significant challenges over the past couple of years and if the start of 2016 is anything to go by we are heading for another turbulent year. In the midst of this, there has also been major volatility in credit spreads for mining and energy related companies, which are facing increasing balance sheet and cashflow pressure with falling commodity prices hitting the bottom line.

Commodity markets continued to experience weakness over the course of 2015 and it is difficult to see conditions improving in 2016. Oversupply is harming key commodity prices such as oil, iron ore and coal. Meaningful cuts are needed to restore market balance but are not yet evident. Credit rating agency, S&P recently warned that 50% of US high yield bonds in the energy sector, worth US$180 billion, were at risk of default.

We do not foresee any improvement in conditions in the commodities sector in 2016. There are question marks over whether the current downturn is cyclical or represents a more structural shift in the value of resources. Whereas previous downturns have been cyclical, the effect of slowing growth in China indicates a fundamental change that will heighten credit risk for mining companies.

Figure 20: Five year commodity price history

Source: Bloomberg, FIIG Securities



Section 5: Commodities

In a low commodity price environment it becomes even more important to choose companies which have the best chance of withstanding further price weakness. For investors considering exposure to the commodities sector, we would recommend selecting producers which are mining at the most competitive cost of production, and/or have the balance sheet strength to withstand a sustained period of low prices.

Let's be clear – we are not expecting these better performing mining companies to 'shoot the lights out' in terms of financial performance. Quite the opposite, it is likely FY16 financial performance will be at the weakest levels seen in recent years.

From an income investor's perspective, investing in commodity based equities is unlikely to provide income certainty in the current environment, with the majority of the mining industry cutting dividends to preserve cashflow. While commodity sector fixed income investments are expected to exhibit greater volatility than other sectors we believe there continues to be positive themes and opportunities for investors which we have summarised below.

Bonds will be the best way to access an income from commodities in 2016

Theme	Relevant bond issuers
Credit strength, characterised by free cashflow generation and balance sheet position, will be critical success factors for credit performance	• BHP Billiton • BlueScope Steel
Gold producers are expected to be best positioned in the current commodities environment	• Newcrest
Airlines and motorways will continue to benefit from low oil prices	• Qantas • Virgin • Ansett Aviation Training • Transport Queensland (Sun Group)
Australian based miners are well placed to withstand further stress in commodity prices	• BHP Billiton • Fortescue • Newcrest
Despite facing near term difficulties, the Australian coal industry is expected to remain viable over the medium to long term	• Adani Abbot Point Terminal • Dalrymple Bay Coal Terminal • Newcastle Coal Infrastructure Group

Source: FIIG Securities

We look at each of these themes below and highlight some specific commodity/sector names which we prefer as investment opportunities.

Section 5: Commodities

Cashflow, balance sheet and liquidity are key

Critical success factors for credit performance

Continued positive free cashflow generation in a weak commodities market will be seen as a positive. Balance sheet strength is characterised by low to moderate leverage and good liquidity levels through cash holdings and available funding sources.

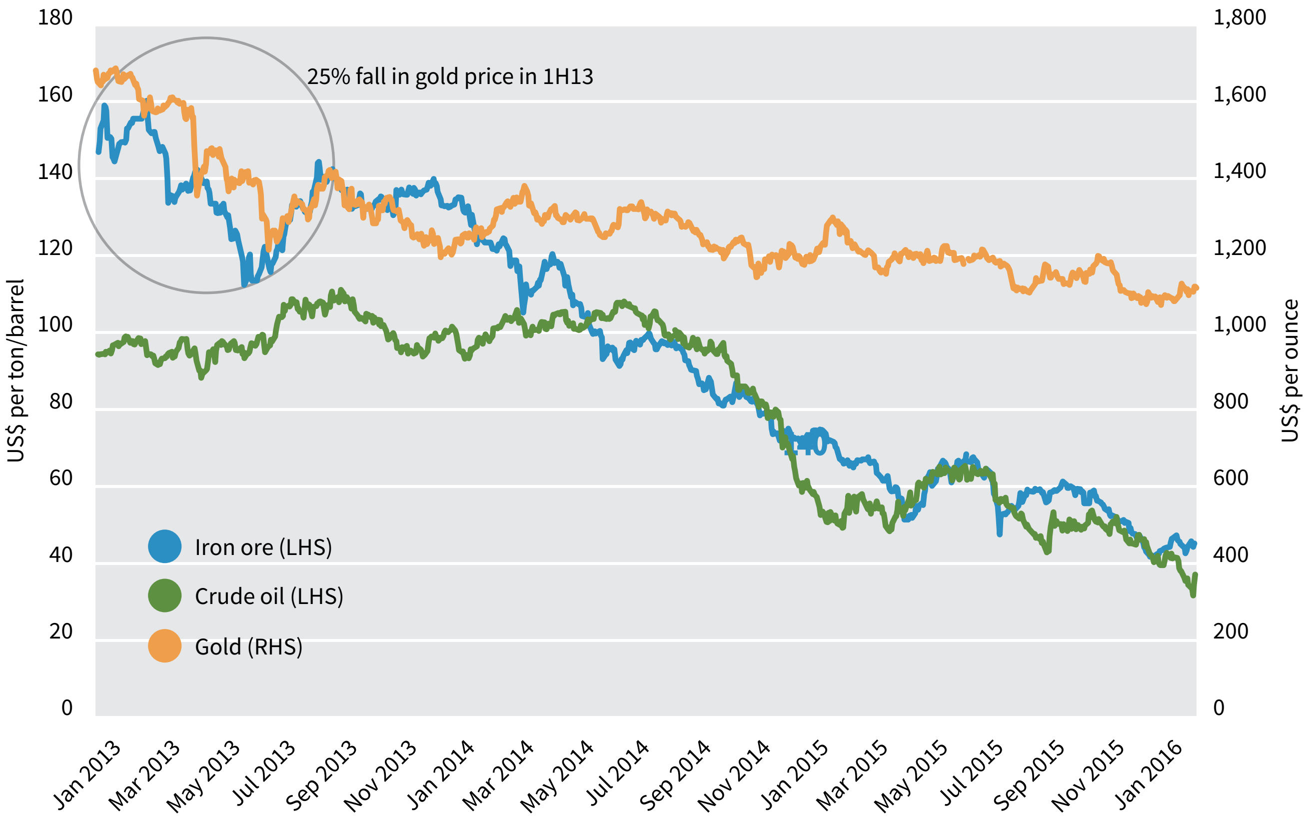
In the anticipation of lower commodity prices, mining companies have significantly altered financial policies to help counter the impact of lower metal prices on earnings and cashflow generation. Some companies, such as Glencore, have chosen to suspend dividends while others such as BHP Billiton has moved away from a progressive dividend policy. Most mining companies have cut capital expenditure (capex) to the bare minimum, which has had a positive impact on free cash flow generation. Many companies, including Santos and Anglo American, have announced their intention to sell non-core assets to reduce debt.

Gold producers best positioned in a tough commodities market

While many commodity producers are currently being forced to adjust their operational and financial behaviours in the wake of a weak commodities environment, gold producers have already adjusted to the 'new world' of commodities. In the first six months of 2013, gold was given an early warning shot with a 25% fall in the underlying gold price. As a result, gold companies were forced to take the painful actions which the rest of the commodities sector has to take now. Dividends were cut, capital expenditure was significantly pared back, non-core assets were sold and balance sheets slowly improved.

Figure 21: Gold producers - first to feel 'pain' and first to respond

Source: Bloomberg, FIIG Securities



Section 5: Commodities

This decisive early action from the gold sector has meant it is well positioned as a sector relative to other non-gold mining assets. We have also seen the underlying gold commodity price hold up reasonably solidly versus other key commodities such as oil, iron ore and coal. Gold's status as a 'safe haven' asset has meant that the gold price has remained relatively stable, and in fact has rallied during times of market distress.

We believe gold will provide a good 'natural hedge' in what is expected to be a volatile year for commodities. In the gold space, Newcrest is our preferred name given:

- It is free cashflow positive under spot commodity prices
- Capital expenditure is rolling off
- Strengthening balance sheet
- Cash on balance sheet
- Cost reduction
- Production growth

Airlines and motorways will continue to benefit from low oil prices

The airline sector has been a clear beneficiary of the fall in oil prices in 2015. Oil prices are currently at decade lows which are expected to continue into 2016. The financial performance of the domestic airlines, Qantas and Virgin, will continue to benefit from lower fuel costs.

We expect Qantas to deliver record profitability in 2016 and it is likely that Moody's will follow S&P's suit and upgrade Qantas' credit rating to investment grade in 2016.

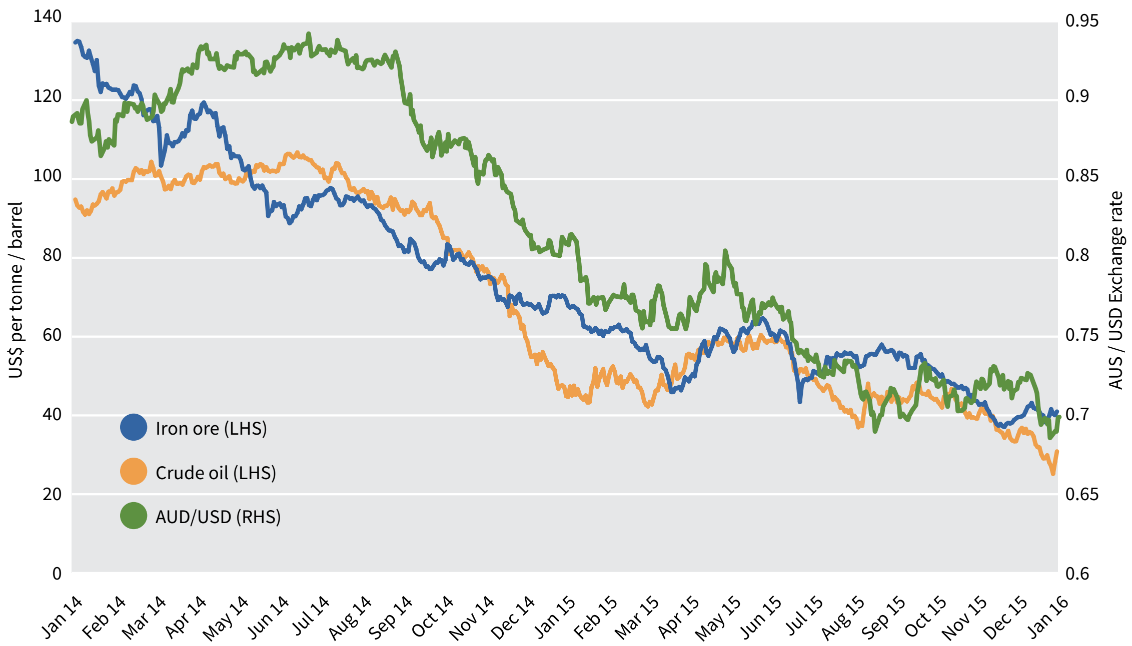
In a continued low oil price environment, exposure to the airline sector is a sound investment given so much of their underlying profitability is determined by fuel costs and we believe that Qantas and Virgin should continue to perform well on this thesis. In addition, companies exposed to the aviation sector, such as the FIIG originated Ansett Aviation Training are worth considering.

The low oil price environment is also driving increased traffic growth, which is of course a positive story for bonds in the transportation sector. To think that petrol prices could again fall below $1/litre in Australia was once considered a remote possibility, but has happened in parts of the country.

Our preferred bond in the transportation space is Transurban's Transport Queensland (TQ) bonds (formerly Sun Group) which are secured bonds issued against the Brisbane tollroad network partially owned by Transurban.

Figure 22: AUD versus key commodity prices

Source: Bloomberg, FIIG Securities



Section 5: Commodities

US commodity prices give AUD cost based producers a natural hedge

Australian producers are well placed to withstand further stress in commodity prices

Australian mining companies, whose business operations are predominantly in Australia, are well positioned to withstand further stress in commodity markets. As commodity prices fell through 2014 and 2015, so too did the Australian dollar (as did the currency of other 'producer' economies such as Canada and Russia), proving to be a panacea for ailing miners. See Figure 22. With commodity prices expressed in US dollars, having a predominantly Australian dollar cost base provides a level of natural hedge for producers as their cost base reduces with a weakening Australian dollar.

The Australian coal industry is expected to remain viable over the medium to longer term

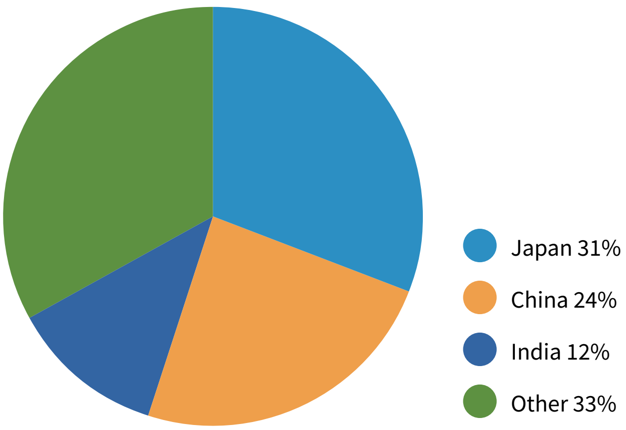
There is no doubt the global coal market is facing significant difficulties. The key concerns for coal are:

- Current low prices and how long and how many producers can survive at these levels
- How quickly oversupply can be balanced
- Is this downturn different given stronger climate policies
- The increasing competition from other sources, such as renewable energy

According to the International *Energy Agency's Coal Medium Term Market Report for 2015*, the primary export destinations for Australian coal in 2014 remained Japan, with 31% of total exports and China, with 24%. Shipments to Japan decreased by 1.2% compared with 2013 to a total of 116 Mt, while exports to China increased strongly by 10% to 91 Mt.

Figure 23: Export destinations for Australian coal

Source: International Energy Agency



The graph shows that Japan actually buys more of our coal than China. It's a common misconception that the coal story for Australia is all about China but clearly that is not true according to the statistics. When it comes to power generation, Australia's thermal coal has an advantage for its high calorific value (which means it takes less coal to burn the same amount of energy) versus other coal producers such as Indonesia. You could say that Australia has some of the 'cleanest' coal in the global market, which will mean there will be an underlying demand for Australian coal so long as coal remains a source of power generation.

While demand for coal has certainly slowed, Australia's market share of the seaborne export market is expected to increase. Australia's high quality coal means it is well positioned to remain globally competitive in the seaborne export coal market, aided by the weakening Australian dollar and proximity to key Asian markets, in particular India which is showing an increasing demand for coal growth. Australian coal producers are also expected to benefit from the extensive cost cuts they achieved in recent years, which will make Australian coal competitive in the international market over the medium term.

For the bonds with exposure to coal, namely coal infrastructure assets Adani Abbot Point Terminal (AAPT), Dalrymple Bay Coal Terminal (DBCT) and Newcastle Coal Infrastructure Group (NCIG), the message is that while these entities will face credit pressure and potential rating downgrades in the near term, over the medium to long term we expect that these assets will continue to remain necessary and viable in servicing the Australian coal export market. Each of the coal infrastructure assets represent essential components of the coal export chains which they service and coal exports from Australia are at record high levels. In addition, new investments in coal infrastructure have largely been discouraged by low prices in Australia, meaning the existing operational coal terminals are expected face less competition in a low commodity price environment.

Section 6: Australian banks and cash

Tougher outlook due to lower interest rates and higher cost of funds

Banks typically make more money in a declining interest rate environment. They tend to take their time cutting interest rates on lending products, while deposits rates are readjusted much faster. Since the easing cycle began in 2008, they have capitalised on the RBA's easing bias. But the cycle is beginning to slow. Over the last year we saw two cash rate cuts of 25 basis points each in February and May, taking the current cash rate to 2.0%pa, the lowest on record. Current expectations are for at least one further cut in 2016 but a year is a long time and the Reserve Bank Board will be slow to make changes one way or the other.

Our conviction that interest rates will be lower for longer is likely to impact the banks. Low interest rates have reduced returns on capital and compressed net interest margins. Low growth should see commercial lending slow and competition for loans increase. NAB has already cut margins on its commercial lending business in order to protect its leading market share. Is it prepared to go further?

Recently we have seen the cost to raise funds in overseas bond markets increase and the major banks have re-entered the competition for term deposits, increasing rates available to investors. Both measures have increased bank costs.

The housing market is slowing with auction clearance rates down in many states and APRA guiding the banks to cap lending for residential property to 10% of new loans. This should curb a profitable source of revenue especially given total investment in residential property lending makes up about 40% of the majors' loan books.

Low interest rates, higher cost of funding and a slowing residential housing market combined present a much tougher outlook for the major banks.

Rising Costs

Regulation - Still causing the banks' headaches

The banks are becoming safer in the wake of the 2008 global financial crisis as new regulations force them to hold more in reserve and ensure their continuity should another GFC scenario eventuate. Last year, new common equity capital, fully paid ordinary shares, of $19.5 billion was raised by the 'Big 4' to enable them to be ranked in the top quartile of global banks. In aggregate, the new capital added more than 100 basis points or 1% to the Common Equity Tier 1 ratio (CET1). Ratios calculated on an internationally comparable basis are all over 13%.

Much work has been done to improve CET1 and the focus rolls forward to the Total Loss Absorbing Capital framework (TLAC) requirements which we expect APRA to detail in coming months, in line with global bank regulations.

New TLAC regulation is likely to further require the banks to raise more "loss absorbing" capital – currently loss absorbing instruments include:

- Equity, known as Common Equity Tier 1 (CET1), consisting of share capital and retained earnings that are readily available to absorb losses. CET1 is the highest ranking/ best form of capital from the bank's point of view as it is freely available to absorb losses, thus the 'Tier 1' notation
- Hybrids and preference shares known as Additional Tier 1 (AT1) that contain a capital trigger clause and a bail-in clause
- Subordinated debt or Tier 2 (T2) that includes a bail-in clause

There's much talk about a new class of bail-inable senior debt. Previously untouched in Australia, in Europe a new class of debt known as Tier 3 allows senior bank debt containing specific clauses so that it can absorb losses, to be bail-inable to support the survivability of the bank. Previously senior debt in Europe was untouchable given its equal ranking with deposits and the unpalatable nature of inflicting losses on deposit holders.

However, in Australia, senior debt is subordinate in the capital structure to term deposits, making it easier to target in a statutory sense should the need eventuate. If a new class of securities was developed, the cost to issue would rise given specific ability to bail-in the senior debt which may put further pressure on the cost of funds.

Nonetheless, TLAC is likely to require the banks to hold even more capital. Goldman Sachs estimates $14bn of extra capital would be needed over the next three years.

The Financial System Inquiry (FSI) recommended that Australian Banks increase capital so that they are "unquestionably strong" that positions them in the top quartile of internationally active banks, so, as global banks are required to hold more capital, so too are our domestic banks.

For the biggest 30 globally systematically important banks (G-SIBs), TLAC is still being defined but potentially total capital requirements may be in the range of 19.5% to 27%, far above our banks' current international equivalent of 13%.

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This year APRA will also begin consultation on implementing the Net Stable Funding Ratio (NSFR).The NSFR is defined as the amount of available stable funding relative to the amount of required stable funding. This ratio should be equal to at least 100% on an ongoing basis. In essence banks should have enough funding to sustain themselves for a year.

$$NSFR = \frac{\textit{(Available amount of stable funding)}}{\textit{(Required amount of stable funding)}} \geq 100\%$$

Two other important developments:

1. APRA provided regulatory guidance to cap growth in investment property loans to 10% per annum.
2. During 2015, NAB and ANZ reclassified some housing loans with the result that investment property loans now account for about 40% of the 'Big 4's" Australian housing loans.

More regulations mean more reporting and systems requirements, adding to the cost of compliance.

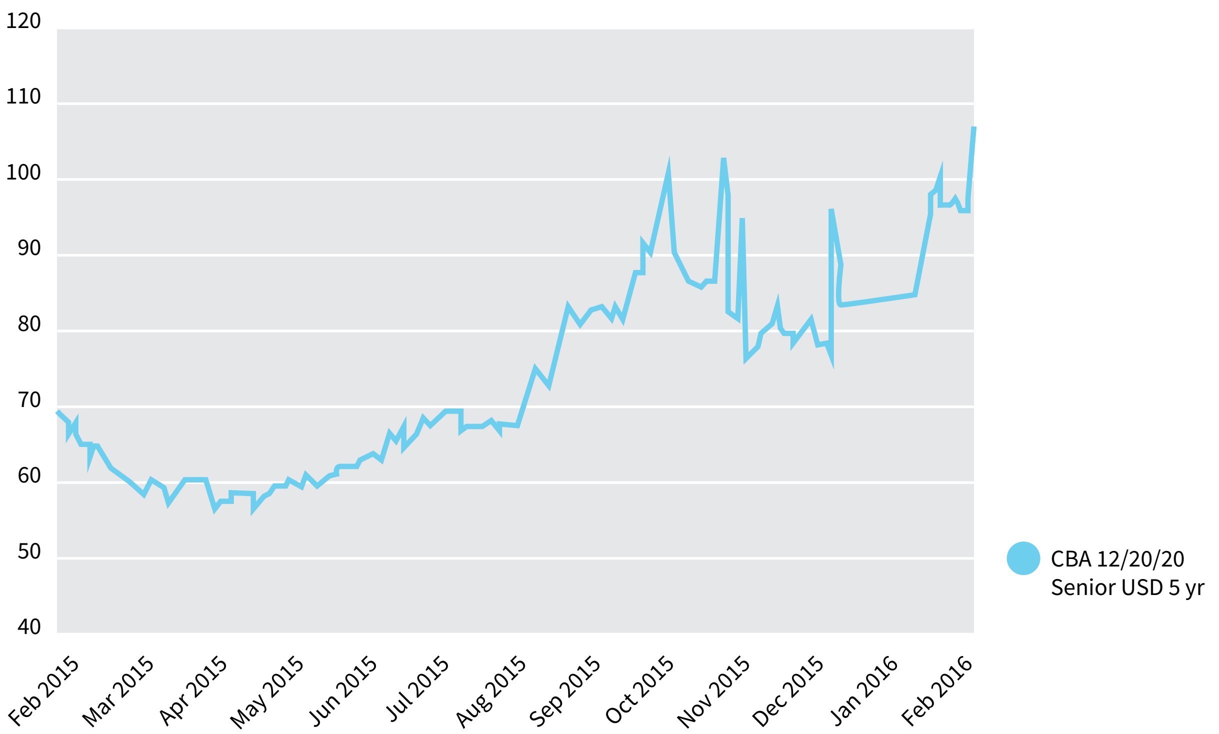
Increasing spreads

The major banks all raise substantial funds in global markets to help fund their operations with over $100bn raised last year. CBA and Westpac had the highest issuance last year of over $30bn each, with NAB around $28bn and ANZ just under $20bn. The major banks' cost of funding is very close, as the perceived risk between the four banks is minimal. Spreads have been increasing, making senior bank debt more appealing to investors than it has for some years. Five year senior credit default swap spreads are trading around 110 basis points (see Figure 24), while subordinated debt spreads are trading at around double that of senior spreads, offering good relative value.

Regional banks do not have the same funding pressures as the major banks due to much smaller funding gaps between deposits and loans. Further, many credit unions are fully funded through significant deposit holdings. New risk weights for housing loans, levels the home loan market and should make it easier for other financial institutions to compete with the majors for loans.

Figure 24: CBA Senior Debt 5yr CDS

Source: FIIG Securities, Bloomberg



Technology

Technological costs are ongoing and rising.

- Consistently listed in the top three risks to business, the cost of defending against cyber-attack is increasing. Banks need to stay at the technological forefront to protect their clients, a continually evolving threat.
- Recent figures on cashless transactions show use of electronic payment methods is accelerating. A total of 82% of Australian payments are already in non-cash dollars. Forecasters suggest we will be a cashless society in the next five to 10 years as mobile devices are used for financial transactions.

Ability to transfer rising costs

During 2015, APRA announced that the 'Big 4' needed to provide additional capital to protect against defaulting housing loans and the percentage or risk weight was increased from 18% to 25%, in line with regional bank capital requirements.

The majors promptly increased interest rates on both owner occupied and investment property lending even though the new regulation doesn't come into force until mid-2016, ensuring a boost to revenue and profit in the short term. The move highlights just how easy it is for them to transfer higher regulatory costs and place the burden of more stringent regulation on the consumer, somewhat reinforcing their resilience.

The move shows the banks can increase rates out of cycle and tend to act in favour of shareholders. However, costs that aren't system wide such as various technological improvements won't be as easy to transfer and should directly affect returns of individual banks.

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Dividend sustainability and the best opportunities throughout the capital structure

Regulatory change will continue over the next few years, forcing the banks, particularly the majors, to hold more capital. Theoretically, they will have less available to invest in loans which offer higher returns, putting pressure on returns. Further, significant capital raisings in 2015 mean dividends will need to be spread more widely and we think at best, dividend rates will be the same in 2016 as 2015, although this still means an effective cost rise for the banks in dollar terms. There is a growing case for dividend cuts.

Income investors attracted to bank shares and hybrids have already been disappointed in 2015/ early 2016 as prices on both securities fell and yields have risen. The hybrids have followed the shares downwards, as we previously forecast, to more realistic income levels.

Various ways to invest with banks, from lowest risk to highest risk.

Major bank investments	Income pa (Running yield) (pa)	Total return (yield to call/ maturity) (pa)	Investment considerations
3 year term deposit	2.70%	2.70%	Government guarantee below $250,000. Low known income but income subject to inflation risk.
3 year senior debt	3.40%	3.40%	Known income and minimum return. Defensive asset with potential to outperform in distressed markets, improving total return making senior debt more attractive. Fixed rate bonds subject to inflation risk.
3 year sub debt (old style)	3.50%	3.15%	Marginal pick up in income and lower total return than senior debt make these expensive. We suggest current investors sell and consider senior or new style sub debt. Limited available issues remaining.
5 year sub debt (”bail in”)	4.70%	4.70%	Spread over benchmark swap is double that of senior debt. A great pick-up and a key recommendation. However, bonds are floating rate and income could decrease if rates continue to be cut.
8 year hybrid (“bail in”)	7.50%	7.5% assuming issuer calls at 8 years which is subject to APRA approval	Hybrids underperformed last year as investors demanded higher returns for the risks involved. Current returns look attractive but as costs to issue hybrids rises, older issues with lower margins become cheap finance for the banks making them less likely to be called at the first opportunity. Hybrids are floating rate and income could decrease if interest rates are cut and remain low for longer than anticipated.
Ordinary equity - shares	8%	Unknown	Income levels have risen in the last 12 months as all major banks’ share prices have fallen. Growing speculation that dividends will be cut, reducing income. Much volatility in share prices which needs to be factored in. The major banks may not grow as fast as they did in the past.

Source: FIIG Securities, Bloomberg

The gap in yield between subordinated debt and hybrids is indicative of the difference in risk between these securities. Subordinated debt investors have the certainty of a maturity date and are not subject to the "capital trigger" clause that hybrid investors must contend with. They sit higher in the capital structure, so benefit from an increased loss absorbing buffer beneath them, compared to hybrids.

Hybrid investors need to sort through the myriad of complex terms and conditions of individual hybrids and try and analyse the various options on when, how and if they will be repaid.

Factors to consider include:

1. Cost of replacement funding at conversion/ repayment.
2. Will current hybrids be considered "cheap funding"? In which case the bank may chose not to convert or repay and investors are left holding perpetual securities.
3. Bank share price at conversion/ repayment. Falls in the share price may not satisfy hybrid conversion requirements.
4. Uncertainty over payment of distributions. Payments can be foregone and never have to be made up. Each hybrid has different terms and conditions for non-payment which needs factored into the risk assessment.
5. Investor's capacity to withstand volatility. Hybrids have shown to be much more volatile than subordinated debt.

Deposit market

What a difference a year makes! Low overseas borrowing rates for the major banks meant they had virtually withdrawn from the term deposit market last year. The prospect of higher deposit rates for investors was dim.

Two cash rate cuts during the year and even lower rates on offer, sent investors seeking higher returns in other asset classes. Roll forward 12 months and it's a different story:

- The cost for the majors to tap into the global bond market has increased and the term deposit market is again starting to look like an attractive place to raise funds. Two major banks are active and rates are moving higher
- Lower Chinese growth, commodity prices, global stock market declines and volatility has put more emphasis on capital preservation for investors and funds are flowing back into deposits

While cash should be a component in every portfolio, views on the amount to hold differs wildly. It's well known that SMSFs and many middle market clients have large allocations to cash. The latest Australian Taxation Office figures show average cash holdings at 28% as at 30 September 2015.

A number of superannuation funds suggest holding two years' worth of living expenses as cash. However, one superannuation fund's members had average allocations to cash of 20%, while the fund's allocation was half that at 10%.

Low rates of return are even worse if you take inflation into account. Coupled with inflation, low rates of return make holdings unsustainable. All investors, both large and small, need to search for the best return, as even small differences can make an impact especially in the longer term.

Year end equity market volatility and a collapse in resource stocks such as BHP Billiton are forcing investors to rethink their portfolio allocation strategies. The continued uncertainty means we expect capital preservation to become an increasing focus and a greater allocation to cash/ deposits is a likely result.

Expectations for 2016

Interest rates are low and are expected to stay low for many years. Two benchmarks we use to assess forward expectations of interest rates are the Commonwealth government bond yields and the Swap curve.

The 10 year Commonwealth government bond yield was 2.445% as at 9 February 2016, indicating low interest rates for the next decade.

Swap is a more commonly used reference point. Figure 25 shows a snapshot of Swap compared to the best term deposit

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rates from: major banks, regional banks and credit unions where FIIG has a relationship. The Swap curve is fairly flat rising to around 2.7% in 10 years' time.

Major banks are paying up for three month deposits offering rates of 2.8%, only marginally less than regional banks at 2.85%. The respective margins over swap are 51 basis points (bps) versus 56bps.

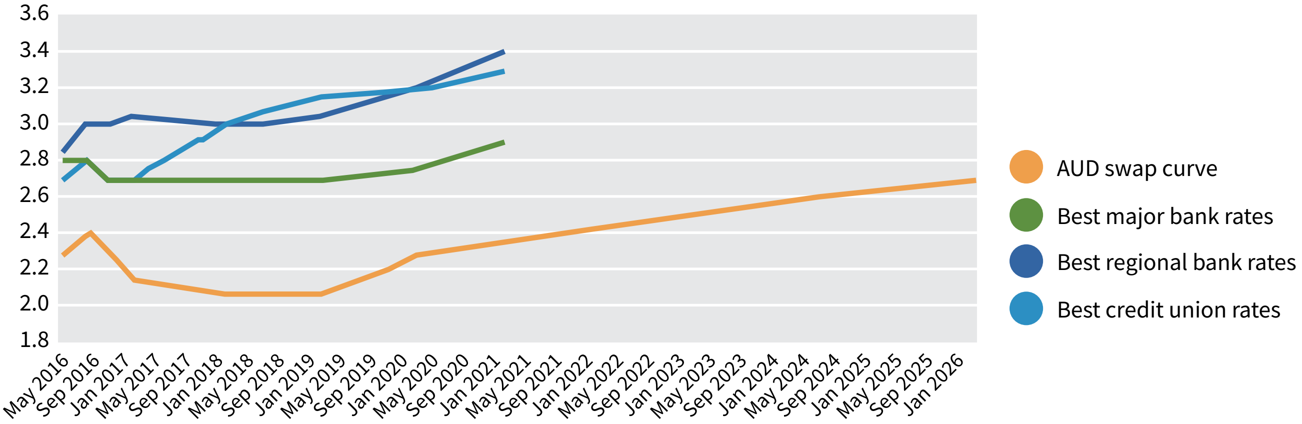
The major banks are less competitive over a year with a margin over swap of 56bps compared to 91bps for regional banks.

Regional bank rates beat both major banks and credit unions for periods up to two years. Credit unions then offer the best rates for two to five years.

The widest margin over swap is for three year funds at 98bps offered by credit unions.

Figure 25: AUD swap curve versus term deposit rates

Source: FIIG Securities



Please note rates are indicative only and accurate as at 5 February 2016 but subject to change.

Term deposit rates in 2016 will be influenced by:

1. The outlook for the Australian economy and the possibility of further cuts to the cash rate.
2. The cost to raise funds in global bond markets.
3. Competition for deposit funds from other institutions, particularly foreign banks.

While we would usually expect to see a cut in the cash rate reflected in lower overall deposit rates, this may be offset by further spread widening in global markets for senior and subordinated bonds, motivating the banks to re-examine rates on domestic deposits.

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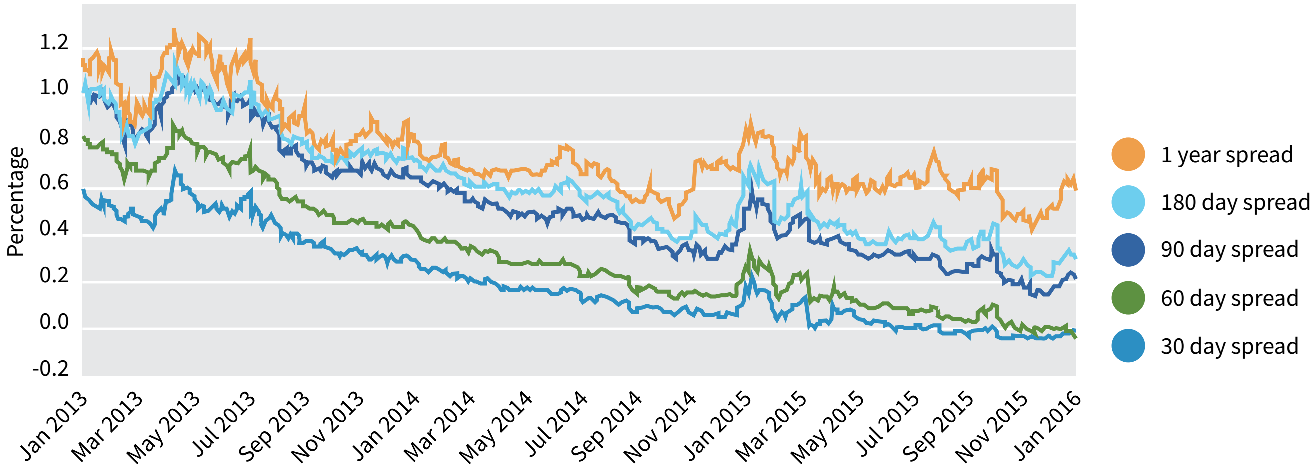
Review of term deposit margins and outright rates

Over the last year, spreads on term deposit rates have generally declined. If we consider the one year spread over swap the margin was approximately 82 basis points (100 basis points (bps) = 1.00%) at the start of 2015, then reached a low of around 40bps late in the year, but since then has risen to around 60bps in early February 2016.

Spreads on 90 and 180 day term deposits have also improved from the same low point.

Figure 26: Term deposit margins - January 2013 - 2016



Opportunities for cash and term deposits in 2016

The average term deposit rates (as shown in the table below) range from 2.55% for 30 days to 3.05% for one year, or just half a percent for locking funds away for the longer period. At the same time last year, a 30 day deposit earned 3.20% while one year was 3.55%.

Best deposit rates as at 5 February 2016

Term	Return (p.a.)
30 day	2.55%
60 day	2.55%
90 day	2.85%
180 day	3.00%
1 year	3.05%

Source: FIIG Securities

Note: the above rates are accurate as at 5 February 2016 and are subject to change. Minimum amounts range from $20,000 to $500,000 depending on the institution.

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Institutional and middle market outlook

Last year, major bank lack of interest in the deposit market was reflected in even lower deposit rates for institutional and middle market clients compared to retail investors. Retail deposits are more attractive from a capital point of view as these deposits are considered more 'sticky'.

This year, the general pick up in term deposit rates has also been reflected in the institutional market as the majors compete across the board. Deposits from wholesale investors have once again become attractive to the banks.

Last year, a 30 day term deposit with a major bank offered 15 basis points (bps) over swap and a second tier bank paid 20bps. The major bank is now showing 25bps over for the same term, while regional banks are paying between 25 and 40bps. An A1 rated Chinese bank is paying 25bps over the rest of the market.

Institutional clients have shown little interest in At Call Accounts and have been slow to embrace the non vanilla Notice Saver style accounts.

We still see value in the Notice Saver Accounts for institutional clients. They are similar to term deposits in that they are unbreakable investments. While investors must provide at least 31 days' notice, higher notice periods of 60 and 90 days offer even higher returns, helping banks meet capital requirements but also offering a nice margin pick-up for institutions.

Major banks are offering higher returns than regionals on Notice Savers. On a 31 day Notice Saver, major banks are offering RBA cash plus 45-50bps on funds. On a 60 day notice saver the spread on offer is 60bps and this increases to 65bps for the 90 day option. Once notice is given, returns typically fall back to the cash rate or flat BBSW, whichever is highest on the day.

We are also seeing value in term deposits that have different terms and conditions. For example, combinations of fixed and floating interest rates on deposits. Investors just need to be comfortable locking in for six months to a fixed rate then switching to a floating rate or vice versa. The major banks are comfortable with fixed to floating, or floating to fixed.

In their quest for deposit funds, banks are trying to tempt investors to invest for longer periods. For example, at times, common terms of six months and a year will show lower rates that nine and 18 months, investors that can invest beyond the most popular buckets can earn higher returns.

FIIG related tips:

- The two active major banks are paying up for large sums and we are able to negotiate better than advertised rates for sums of $5m plus.
- Advisers that use the FIIG term deposit service give their clients a distinct advantage over others that don't. Advisers are notified of up and coming roll-overs and can place the funds with the institution offering the best rates by just referring to the FIIG ratesheet. Further, as funds rollover on same days and amounts accumulate, we have an increased ability to negotiate higher rates on bulk holdings.
- Banks are realising the value that FIIG offers. By offering specials through us they can complete funding shortfalls without advertising positions and thus rates to a broad audience.

Retail market outlook – Need a magic '3 handle'

Low interest rates during the year made it difficult for banks to raise funds unless the rate on offer had a magic '3 handle'. Under three per cent did not motivate investors to lock their funds away. We are now commonly seeing offerings of 3% or more. As mortgage margins have increased, so have deposit margins. At the time of writing, one major bank was showing 3% for nine months, 3.05% for a year and 3.10% for 18 months.

The general perception in the market is that there will be higher rates later in the year.

Retail investors currently, commonly invest for six month terms, which the banks know, so offering better rates for slightly longer terms, such as nine months, entices investors to commit for longer, reducing handling by staff.

Some of the best rates on offer are coming via online investment. Older investors are hesitant to invest online even though the government guarantee on deposits of $250,000 or more in available from around 160 authorised deposit taking institutions.

Retail investors have also been slow to embrace the Notice Saver Account preferring vanilla term deposits.

FIIG tips

- Don't just let your term deposit roll with the same institution, particularly over six month terms
- If you use the FIIG deposit service one Deposit Service Authority enables you to invest across multiple banks, making it easy to change banks or periods to find the best rate. The product disclosure statements for all banks are available in one central location

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- The expectation is that deposits rates could move higher this year, but that there will be at least another interest rate cut. Our best suggestion is to keep some funds 'short' so that if deposit rates rise, you can take advantage of market conditions. But also invest some for longer, say a year to 18 months just in case rates don't rise, and we do get another cash rate cut or two

Other possibilities

All investors need to maximise earnings from their portfolios. Over allocating to cash/ deposits will reduce your income in the short term. Over the longer term, investors will miss out on higher returns that can compound, with income far exceeding an equivalent cash holding.

One possibility is substituting some cash with an allocation to floating rate bonds.

A floating rate bond or more commonly termed a floating rate note (FRN) is a security that pays interest linked to a variable benchmark. In Australia, the benchmark is usually the bank bill swap rate (BBSW) which moves up and down (or 'floats') with movements and expectations of the RBA cash rate.

Interest on FRNs is set as a fixed margin over the benchmark. For example, the interest rate on the Rabobank senior floating rate bond with expected maturity of 11 February 2020 is quoted as 3 month BBSW + 1.05%. BBSW will move up and down but the margin is fixed and doesn't change.

Short dated floating rate notes where interest is recalculated according to BBSW each quarter make good substitutes for cash, especially for those investors that are always on the hunt for better returns.

Floating rate bonds as alternatives to term deposits

COMPANY NAME	MATURITY/CALL DATE	MARGIN OVER BBSW (+BPS)	CAPITAL STRUCTURE	YIELD TO MATURITY/CALL	MINIMUM FACE VALUE PARCEL
DBCT Finance Pty Ltd (Dalrymple Bay)	9 June 2016	180	Senior debt	4.10%	$10,000
Genworth Financial Mortgage	30 June 2016*	225	Lower Tier 2	4.6%*	$10,000
G8 Education Limited	3 March 2018	410	Senior debt	6.15%	$10,000
Morgan Stanley	22 February 2017	80	Senior debt	2.95%	$10,000
National Australia Bank Ltd	28 November 2017*	105	Lower Tier 2	3.15%*	$10,000
Elm Bv (Swiss Re Insurance Co)	25 May 2017*	300	Tier 1	5.10%*	$100,000

Source: FIIG Securities

Note: the above rates are indicative only accurate as at 15 February 2016 and are subject to change. Bonds in red available to wholesale investors only.

*Call date/yield to call.

Section 7: Five investment strategies for the income seeking investor

Cash is often a maligned asset, targeted by anyone in finance to increase investment in shares, bonds or property. The reality is that cash is just like any other investment; how much you choose to invest is a personal choice based on your objectives. See Section 6.

Bonds offer a low risk alternative for investors wanting to reduce their capital risk but earn more than deposits.

In this section we lay out five investment strategies that can be used to either increase income from assets sitting in cash, or to reduce risk. These strategies are laid out illustratively in Figure 27 to show the range of income available and how the strategies compare on risk.

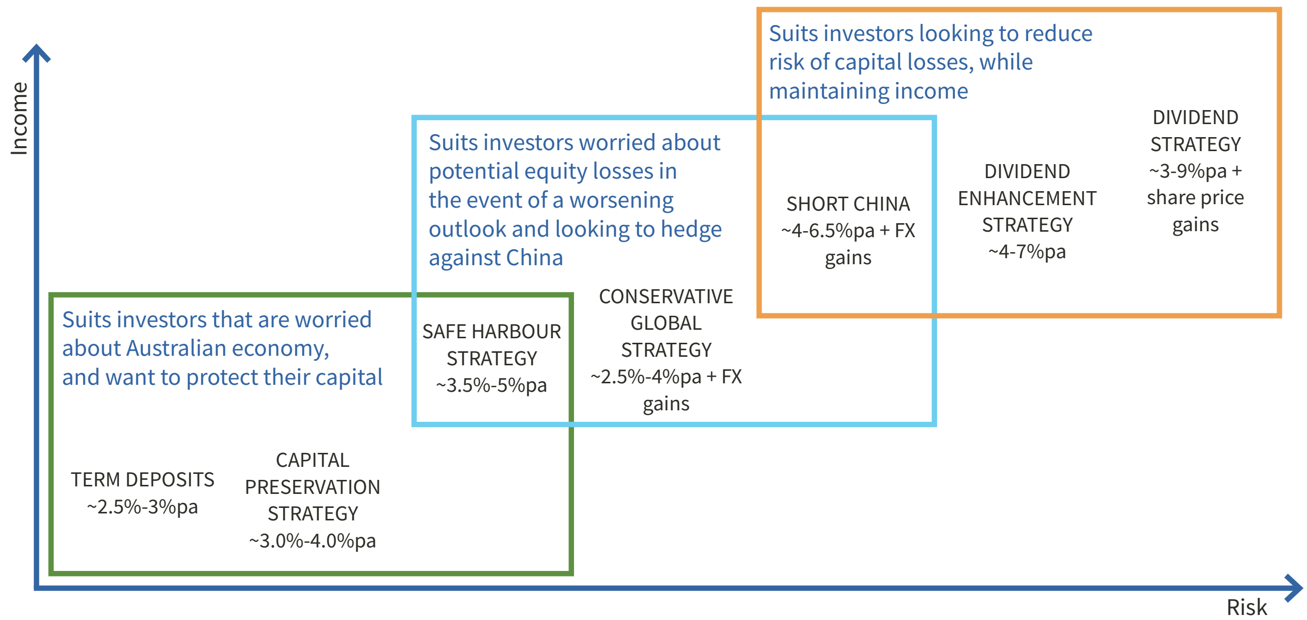
We stop short of listing specific portfolios of bonds to execute this strategy as this will depend upon which represent best relative value at the time. This is something best discussed with your FIIG relationship manager when you are ready.

> You always want enough cash around so that nobody else can determine your future…
>
> Warren Buffett, 2010

Figure 27: Spectrum of investment strategies for income investors:

How to combine term deposits, bonds and shares to achieve your target income without taking excessive risks

Source: FIIG Securities



Note: This report doesn't cover the first or last strategy being the term deposit or dividend strategies.

Section 7: Five investment strategies for the income seeking investor

Strategy #1: Capital preservation strategy

Suits investors looking to increase income from cash returns but maintain capital

Likely to yield 3-4%pa

The Capital preservation strategy involves taking the most conservative corporate and infrastructure bonds on the market and using them to supplement cash holdings. This is a variation of the Safe harbour strategy in which investment grade rated corporate bonds are added to that strategy's infrastructure bonds.

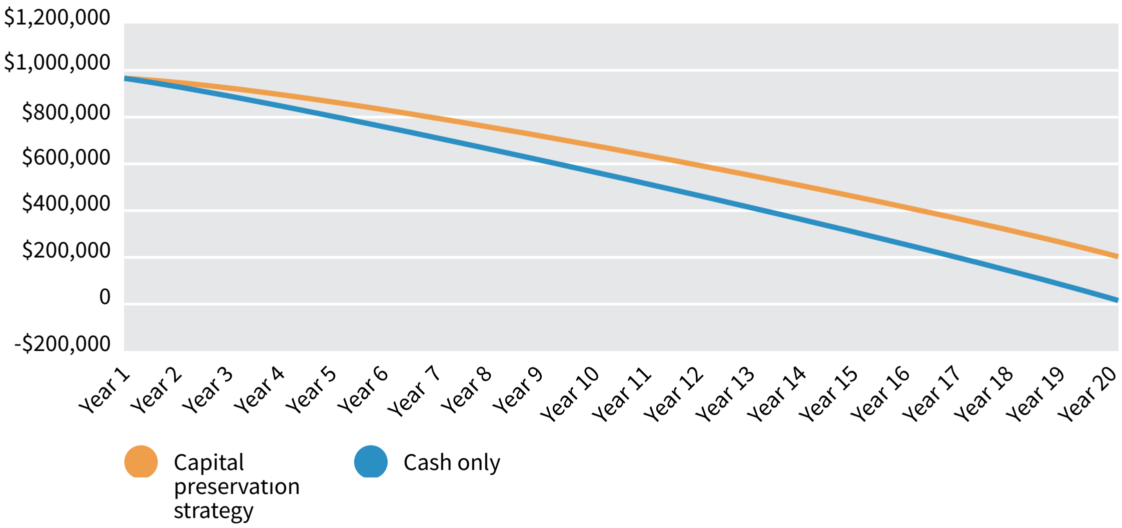
Figure 28 illustrates the difference even this minor adjustment in strategy can have on making capital last longer in retirement. The chart shows the balance of a $1 million superannuation balance allowing for a $66,000 per annum withdrawal.

The Capital preservation strategy approach still has a balance of around $200,000 after 20 years, while the cash only approach has run out of capital that year. Put another way, using the Capital preservation strategy approach would add $9,000 per year to your income.

Figure 28: Impact of Capital preservation strategy

A $1 million portfolio balance allowing for $66,000 per annum drawdown, assuming 2.8%pa for cash versus 3.8%pa for Capital preservation strategy

Source: FIIG Securities



Strategy #2: Safe harbour strategy

Suits investors nervous about an economic downturn and the impact on their other investments

Likely to yield 3.5-5%pa

The Safe harbour strategy minimises the investor's exposure to the global economy. It does this by investing in infrastructure debt, typically with an investment grade rating and some kind of inflation hedge, where income or capital rises if inflation breaks out.

The Safe harbour strategy will be a low yielding strategy regardless of how or when it is put together. Finding good value infrastructure debt will certainly increase income, but this strategy is specifically designed to be low risk while giving investors more income than term deposits.

Infrastructure offers a safe harbour from economic downturns

Infrastructure investment, whether debt or equity, earn revenue from usage of an underlying infrastructure asset. They are the physical assets that form the foundation of an economy and allow it to operate and grow but do not include the companies that use those assets.

For example, infrastructure typically includes transport assets such as airports (but not airlines); seaports (but not shipping companies); roads (but not logistics companies) or rail (but not rail operators). Airlines, shipping companies, logistics companies and rail operators are all subject to the vagaries of competition, meaning that their earnings are far more volatile. Infrastructure assets on the other hand typically have a monopoly position either by government edict or due to the sheer value of the asset and the length of time required to build a competing asset.

Consider Sydney Airport for example. The company is not a monopoly by legislation, but it is protected from competition by:

- The massive size of the asset
- Its location
- The cost and availability of land to build a competitor
- Cost and time to develop
- Community pressure to keep air traffic away from urban areas (and therefore lower viability)
- The democratic system in Australia which ensures no politician wants to make a decision that benefits their predecessors but costs them votes
- The cost of supporting infrastructure such as roads and rail

Sydney Airport earns income from statutory fees which are protected by legislation, rental income from large retail and corporate tenants that want to be onsite and carpark and taxi fees. Above all else, Sydney Airport's income is protected because even in a recession, air passenger and freight volumes do not fall much at all. Under similar conditions, airlines have to lower their prices to maintain yields on their assets (planes), but this is to Sydney Airport's advantage.

To further illustrate this point, we collected data on the usage of various infrastructure assets in the US in 2007 and 2009. We used the US for this research as they experienced a far greater downturn in their economy during that time, while Australia benefited from its mining boom. In 2007 the US economy was growing at an above average pace, but by 2009 it was in the middle of the worst recession since the Great Depression of the 1930s.

As shown in Figure 29, infrastructure assets experienced very little reduction in usage between 2007 and 2009. Most types of infrastructure experienced falls of less than 5%.

The worst impacted was airports, with a 9% drop. Compare this to airline revenues, which fell 16.5% during this time.

Even in a severe downturn, the economy still needed the same amount of water, electricity, road travel, and hospital patronage.

Executing this strategy in bonds or equities

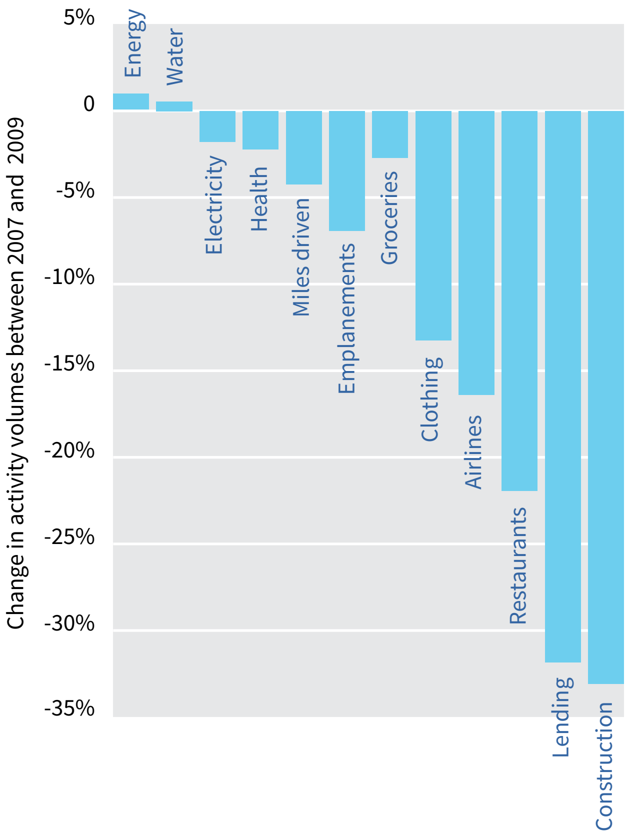
For the reasons above, we say that infrastructure assets are recession resistant. Then the choice comes down to whether to invest in the shares or the bonds of those infrastructure assets. As always, the shares of any given company are riskier than that company's bonds, by definition. The company is legally obliged to repay debtholders in full before shareholders receive anything. So in executing the Safe harbour strategy, infrastructure debt is better aligned with a low risk approach.

That said, infrastructure equities are typically lower risk than normal corporate equities and typically offer strong yields, so the income seeking investor wanting more income and willing to take on the additional risk could apply the Safe harbour strategy to equities, or in fact blend debt and equity.

Section 7: Five investment strategies for the income seeking investor

Figure 29: Infrastructure assets offer less volatility in a storm

Comparison of activity levels of various infrastructure and corporate sectors in the US between 2007 (pre-crisis) and 2009 (post-crisis)



Strategy #3: Conservative global strategy

Suits investors wanting to profit from a falling AUD, but minimise risk of global economic slowdown

Likely to yield 2.5-4%pa

The Conservative global strategy positions the investor to profit from a falling AUD by investing in other currencies. The strategy simply involves buying investments priced in a foreign currency, converting (that is selling) AUD cash to buy the investment, and then at some future date selling the asset and converting the money back to AUD. If the AUD falls in value during the holding period, this will be a gain to the investor in addition to any gains or losses made on the investment held during that time.

As Australian investors, when we invest in foreign currency assets like bonds, we are in effect betting against the AUD (Australian Dollar), as well as backing the other currency to perform. When the AUD/USD was at $0.94 in August 2014, we believed that the USD (US Dollar) was underpriced and the AUD overpriced, hence our strong conviction on USD denominated assets. At that time we forecast the AUD to reach $0.70-$0.75.

By early 2015 the USD had had a strong performance against all currencies, and so we believed that the USD was approaching fair pricing against most of the major currencies. However, we changed our forecast for the AUD/USD down to a range of $0.65-$0.70 on the basis of building weakness in China and commodities. We also added at that time that the UK's GBP (Pound) would also likely appreciate against the AUD. The AUD/GBP was around 50p at the time, compared to our forecast of 45p.

Now in early 2016, our view that the AUD/USD rate should fall to $0.65-$0.70 hasn't changed, nor has the AUD/GBP forecast of 45p. However, this assumes that China will have a soft landing, gradually slowing rather than a hard landing scenario. In a hard landing scenario, the AUD would likely fall to below $0.60 against the USD and as low as 40p against the GBP.

In this Conservative global strategy, we are concentrating on the view that the AUD is still overvalued and in fact has more downside risk depending upon the outlook for China. So, rather than focussing on just one currency, investors should focus on how to profit from the falling AUD and look for opportunities to diversify into other strong foreign currencies.

At present, there are two currencies that stand out: the USD and GBP. For Australian investors, the other popular holding currencies are the Euro, the Japanese Yen and the NZ Dollar.

Section 7: Five investment strategies for the income seeking investor

For the reasons outlined in Section 1 of this report, the Euro and the Yen are risky propositions and not as attractive as the USD and the GBP.

The relative strength of the US economy is covered in Section 1 also, but not the UK economy. Our rationale for including the GBP is summarised in the table below.

The UK economy has recovered well from the GFC

Strengths and weaknesses of the UK economy

GDP overall	**Strongest in the G7 for past three years** Slowing like the rest of the world did in 2015. Around 1.9%pa for 2015, vs 1.6%pa for the US.
Consumer spending	**Strong and improving** Retail sales are at a 27 year high, with low inflation supporting consumer confidence. Expected to continue strongly into 2016.
Employment	**Very strong** Workforce participation is at its highest level recorded at 73%. Unemployment has fallen from 8.4% in 2012 to its current 5.2% and is expected to approach its 2004 lows of 4.6%.
Construction sector	**Weakening from strong historic levels** Confidence remains high but activity dropped in November as skill shortages hampered activity.
Manufacturing	**Weakening** Like the US, a higher currency and falling orders from the energy sector have caused UK manufacturing to drop sharply in 2015. The UK also has a large steel sector, which is suffering from massive overcapacity globally. Aerospace and pharmaceutical sectors are growing strongly.
Services sector	**Steady** Services are 78% of the overall UK economy, growing strongly since 2009 but showing signs of moderating. Small business growth is very high, which is encouraging for long term growth.
EU referendum	**The biggest threat to the UK economy** The pending UK referendum regarding whether the UK should remain in the EU threatens the UK economy. This is not because of the exit, but because of the uncertainty it will cause in 2016. The UK, if it departs from the EU, will most likely successfully negotiate a trade relationship with the EU similar or better to that between Norway or Canada. It is in neither the UK's nor the EU's interest to risk such an important trade relationship.

Section 7: Five investment strategies for the income seeking investor

Executing this strategy in cash, bonds or hard assets

There are three variations on this strategy available to Australian investors:

1. Cash

Simply invest in foreign currencies bank accounts or using ETFs like the BetaShares USD ETF. Bank accounts typically come with large transaction costs depending upon your relationship with your bank. The advertised spread on the AUD/USD for example is around +/- 4%, that is, you would need the currency to shift 8% in total to breakeven. Non bank providers such as OzForex offer tighter spreads, as will the banks if you have a private bank or similar relationship with them, bringing the spread down to +/- 1-2%, reducing the breakeven threshold. Most currencies offer no income for cash investments, and may actually cost due to fees.

2. Bonds

Higher risk than cash, but using investment grade bonds, that is bonds rated BBB- or higher, substantially lowers this risk. Bonds in large companies, including many Australian companies such as CBA, BHP, Macquarie and even some infrastructure assets are often available for Australian investors.

This strategy could also be executed using government bonds priced in non AUD currencies. We believe that government bonds globally offer poor value at present due to yield compression caused by Quantitative Easing. For the reasons mentioned in Section 2, the ongoing currency wars are likely to see poor value for some time.

Note: This strategy can also be executed using lower rated bonds (high yield), but that comes with additional risk. This is the approach for "Short China strategy".

3. Offshore property or infrastructure

On rare occasions, Australian property or infrastructure may be offered in foreign currencies, particularly bonds. As this strategy is about a low risk approach to investing in foreign currencies, any property chosen should be very low risk. A blended approach could be used where low risk property is hard to access, by blending offshore cash with property to lower the overall risk.

Strategy #4: Short China strategy (aka High yield foreign currency strategy)

Suits investors wanting to profit from a falling China

Likely to yield 4-7%pa

The Short China strategy is really just a higher risk/ higher income version of the Conservative global strategy. The additional risk enables higher returns, but exposes the investor to more global economic risk than the Conservative global strategy.

This strategy would suit an investor with a view that the global economy will not go into a recession, but China will experience significant shorter term volatility. This is our base case view.

Again this strategy does not require highly complex trading or derivatives. A slowdown in China means a drop in the AUD is highly likely. So this strategy, like the Conservative global strategy deploys a "short AUD" approach, that is it invests in foreign currencies and therefore profits from a falling AUD.

The reason this strategy can be higher risk than the Conservative global strategy is that it is investing in higher yielding assets. This won't enhance the gains from the fall in the AUD materially, but will mean that there will be more income paid along the way. The higher risk strategy could mean the price of the securities falls due to an adverse change in the perception of the credit. If this was coupled with a higher AUD against the USD, investors could see significant overall loses.

A hedge against China is an important strategy for most Australians

The greater the volatility of the Chinese economy, or better still the greater the slowdown, the more this strategy should benefit. Australia is heavily exposed to China's prospects in everything from education, tourism and property to agriculture and mining. Over the past 10 years we have increased our export exposure to China from 8.5% in 2004 to 33.1% in 2015. This was great news when China was booming, but is now a major risk.

A hard landing for China represents the largest risk to Australian equities. Our economy will likely withstand a soft landing by keeping rates at or below current levels so long as we manage to transition our economy away from its reliance upon mining and construction. But a hard landing would cause heavy selling of Australian equities by foreign investors and put pressure on earnings across most sectors. Even the banks would not be immune with property prices hurt by a sudden slowdown in Chinese investors and higher unemployment driving up bad debts.

Almost all Australian investors have an exposure to Australian equities; typically in the magnitude of 30-50% of their portfolios. So a sudden downturn in China's prospects would come at a high cost. Selling out of Australian shares altogether leaves investors without growth prospects, and given that the China hard landing scenario is a risk, but not expected, this is unnecessary.

That's the basis of this strategy. It allows investors to hold income producing assets, while holding a "hedge", that is an insurance policy in the event that the world does get nervous about China and Australian equities suffer a sharp decline. In this event, the AUD would likely fall too (witness the fall in the AUD in August 2015 and January 2016 for example), creating an offsetting gain for investors to help reduce the losses from the equities fall.

An investor holding 30% of their portfolio in equities in a severe downturn of say a 30% drop in prices, will experience a 9% loss (30% x 30%) of overall portfolio value. Arguably equities will bounce back, but only when the market gets comfortable with China again and as seen with Japan there is no guarantee of that. So the Short China strategy, if held with say 20% of the portfolio and if the AUD fell say 20% (that is to 55c against the USD), would create a gain of 4% (15% x 20%), recouping some of the losses.

Executing this strategy in bonds, property or equities

There are three variations on this strategy:

1. Corporate bonds

A well diversified portfolio of corporate bonds using high yield bonds can offer investors yields of 5% or more in USD and GBP. GBP bonds are harder to source in the higher yield sector, so this strategy can be executed using high yield bonds in the USD, with the overall risk lowered as desired using investment grade bonds in GBP and USD.

Note that the high yield bond market includes a large number of energy companies. We expect they will be volatile in 2016, which means we think there will be good trade opportunities for those with the risk appetite.

2. Offshore property

As per the Conservative global strategy, but with more risk by allowing higher risk property assets to be included. This strategy is particularly appealing when Australian property is looking overpriced. Investors could consider selling some of their Australian property exposure and investing offshore, benefiting from a better value property market as well as the potential for currency gains from a falling AUD.

3. Offshore equities

Investing in international equities has received significant support in recent years, so we won't cover that ground here. But it is worth noting that high yield bonds and equities are highly correlated, that is their prices go up and down at similar times, so a blended portfolio of offshore equities and high yield corporate bonds will likely produce a similar risk and return portfolio to straight high yield or straight equities, but with more choice of companies and more opportunities to buy on the lows.

Note: Caveats to this approach - US equities are currently priced at very high valuation (PE) levels, as outlined in Section 2.

Section 7: Five investment strategies for the income seeking investor

Strategy #5: Dividend enhancement strategy

Suits investors looking to derisk equities exposures without reducing income

Likely to yield 4-7%pa

The Dividend enhancement strategy involves shifting some equity exposure to bonds to lower risk and increase income. This could be executed in one of two ways:

1. Switch higher risk, low dividend equities to high yield bonds. This will reduce capital risk and enhance income.
2. Switch between the equities and bonds of the same companies. By definition, this reduces risk, but it won't always increase income so it's a case by case assessment.

Investing in a company means believing its fundamentals. The question is how much you have to pay for the upside and how much income you will get along the way. Once again, Buffett said it best, "Favour substance over form".

There are two ways to invest in many Australian companies: own the company's equities or the company's bonds. The bonds are a legal obligation to make interest payments and to repay the amount borrowed on time. Shareholders are owners of the company. Bondholders, like bankers are repaid before owners. Bonds must be repaid in full before any money is paid to shareholders, making the bonds lower risk by definition.

Favour substance over form. It doesn't matter if an investment is public or private, fractional or full ownership, or in debt, preferred shares, or common equity.

Warren Buffett

Invest in substance…

Investing in these companies and applying Buffett's advice, means investing in their substance first. Is it a good company? Can it grow revenues? Does it have too much leverage? Is management strong? What is the state of its balance sheet?

Then pick the "form" that offers the best value

If the answers to these questions are positive, then you look to what represents best value. Is it the bonds or the shares? Remember, risk comes from paying too much regardless of the form you buy.

While shares offer more upside than bonds, they also display more volatility.

For investors seeking regular, reliable, secure income without too much capital risk, bonds are the typical choice as they involve less capital and income risk than equities.

Equities might make more sense, particularly where there is a strong likelihood of upside in the share price. Sometimes the bonds are overpriced, offering so little income that the equities make a better proposition most of the time. Telstra is a great example.

The point is that the cashflow drivers for these companies are the same for both equities and bonds. The difference comes down to whether you believe growth prospects are higher or lower than the market believes. If you believe it has lower prospects, the bonds will represent better value. If you believe there is more upside, the equities will represent better value.

Dividend expectations in particular need to be realigned

Dividend sustainability in 2016 will be a major theme in Australian equities, and an important one to understand for Australian income seeking investors.

Last year started with investors believing that BHP was committed to its "progressive dividend policy", meaning that it would continue to increase dividends. BHP was $27.60 at that time, down 30% or more from its peaks, but with many analysts calling for investors to be "overweight". By the end of the year, BHP was $17.30 and its progressive dividend policy under review at best. Late February, BHP cut its dividend by a massive 75%.

Section 8: Mapping your course in 2016

> If you don't know where you are going, you certainly won't get there…
>
> Yogi Berra

This year was shaping up to be a volatile year well before it started. We snuck out a draft of part of this report on 5 January, telling readers to buckle up for a rough ride. The next two weeks gave us some of the most volatile markets we have had since 2008.

Unfortunately we expect volatility to continue. US markets are still overpriced by at least 20%; the Chinese markets still have the overhang of institutional sellers banned from selling major stocks; oil will remain volatile until Iran's supply settles or the standoff between the US and OPEC ends; and the currency wars between China, Japan and the EU, including their QE campaign continues to distort markets.

Investors reliant upon their investments for income need to map a course for 2016, deciding what to do with their allocations to cash, bonds and equities. Volatility doesn't necessarily mean losses, but a fall in equity prices is unlikely to be recovered quickly now that the US QE program has finished.

Further, as earnings expectations are adjusted downwards, dividend payouts could fall or remain static. We don't think this will be the rule; rather the exception for companies like BHP.

If capital losses would have a meaningful impact on your lifestyle (or stress!), plan now to reduce your allocation to equities, not after further losses. And plan to replace the income from equities with an allocation to bonds using one of the above strategies.

The economic outlook in this report clearly implies that cash returns will be low for some years. So a reallocation from cash and equities into bonds can be done to improve income, and lower the level of capital at risk.

Choosing which approach you take to building a bond portfolio will depend upon what you have in bonds already and your view on the year ahead. We have laid out five strategies in this report with varying levels of conservatism. Whatever path you take in 2016, above all else, make sure you have a plan and some contingencies in the event of further volatility. And of course, we are here to help wherever we can!

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