



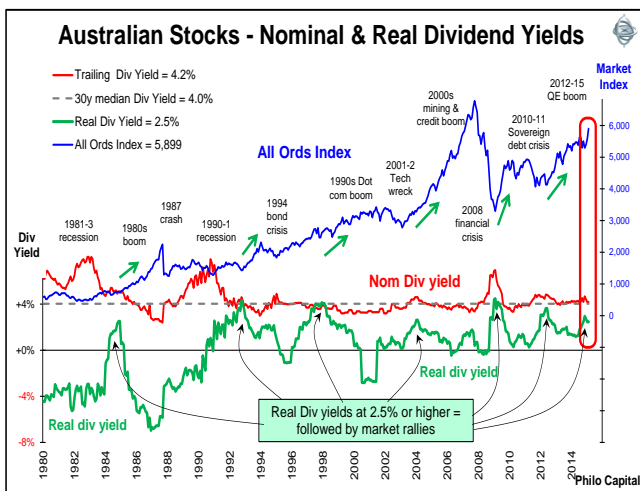
## REAL DIVIDEND YIELDS AND MARKET RALLIES

Over the past seven decades in Australia the level of 'real' dividend yields across the market has provided a pointer to broad stock market rallies ahead.

The 'nominal' dividend yield is the aggregate level of dividends for the market over the most recent 12 month period divided by the current market index level. The 'real' dividend yield is the 'nominal' dividend yield less the current or most recent annual inflation rate. A similar measure also works for the US market. The chart shows the Australian market since 1980 noting the booms and busts.

When the real dividend yield reaches 2.5% the market rallies for the next several quarters. This measure pointed to all of the rallies through the 2000s credit/mining boom, the GFC, the sovereign debt crisis and QE boom, and it has also worked in all prior cycles since WW2 (except in the high-inflation 1970s).

In 2014 the Australian market was flat but at the end of 2014 the real dividend yield once again reached 2.5% indicating the market was likely to rally, and it has indeed rallied strongly. At the end of February the real dividend is still 2.5% (4.2% nominal yield less 1.7% inflation), providing support for our bullish stance.



### MAJOR MARKETS

		Current position	Direction / Trend	Pace of growth
<b>Australia</b>	Local investment markets are being driven by three main factors – monetary, fiscal and political. On the monetary front the Reserve Bank has had to keep cutting interest rates to try to bring down the dollar and to stimulate business investment. The plan is not working as intended. The dollar is still too high and business investment has stalled. Banks are not lending to businesses and businesses are not borrowing or investing. Investment has collapsed in the resources sector (thanks to falling commodities prices, over-supply and weak demand), and it has also stalled in other sectors due largely to political uncertainty and the budget crisis. Instead the rate cuts have fuelled asset price booms driven by foreign and local investors. Foreign investors have so far not been deterred by currency losses. They continue to chase our relatively high interest rates and yields on bonds, commercial property and shares, which are still high compared to the rest of the world. Local investors are finally shifting money out of bank deposits and chasing higher yields in 'risky' assets at high prices. On the political front the month started badly for the Liberals with a landslide defeat in the Queensland state election and a federal leadership spill that was inconclusive at best. It went downhill from there, with leadership speculation crippling the government, and almost daily crises and policy back-flips. A large part of the problem is the fiscal crisis – the budget deficit blow-out - along with the lack of decisive leadership in the government and the hostile and unpredictable Senate. The government has been canvassing various measures to cut back spending – eg charging for previously 'free' doctors' visits, counting the family home in assets tests for welfare, and means testing childcare subsidies. These may sound logical and sensible but they will cost votes the government cannot afford to lose. The labour market is weakening, the unemployment is rate rising, wage growth rate is slowing, and inflation is declining. But for investors, the extraordinarily loose monetary policy (low interest rates) and fiscal policy (budget deficit blowout) are supporting asset prices (shares, bonds and property). Long may they continue!	Below average growth rate	Growth slowing	
<b>Europe</b>	The number one driver of markets emanating from Europe is still the on-going Greek debt crisis. The situation is now even more volatile with the new far left wing anti-austerity Syriza party in power following the Greek elections on 25 <sup>th</sup> January. The second bail-out deal was due to expire at the end of February but a four month extension was agreed just in time to avert the next crisis. But before the ink was even dry on the latest deal, the Greek government started talking up the prospect of non-payment, with the Greek Finance Minister admitting "we will definitely have problems in making debt payments to the IMF now and to the ECB in July". The government also said it would stop previously planned asset sales to raise much-needed cash. Even the IMF's Christine Lagarde commented on how loose and vague the conditions on Greece were in this deal. Meanwhile Greek banks were crippled by withdrawals of deposits as citizens raced to get their money out of Greece and into non-Greek banks in case Greece exits the Euro.	Still virtually Stagnant	Growth stalled	
<b>US</b>	All eyes remain focused on the US Federal Reserve for signs of the likely timing and pace of interest rate hikes in the US. The labour market is tightening and wages are rising. Home sales are relatively strong, and are flowing through to increased sales in hardware stores, homewares and retailers. Mortgage lending growth is showing early signs of picking up, assisted by mortgage interest rates that have fallen to ultra-low levels tracking bond yields down since the start of 2014. Fed Chair Janet Yellen appears to be preparing the market for rate hikes to start around the middle of this year but there are recent signs this may be delayed further. The unemployment rate ticked up a little last month but is still on a steady trend down from its 10% peak in 2009, and on the 26 <sup>th</sup> February the US CPI inflation rate showed its first year-on-year decline in prices since the economic collapse in 2009. Core inflation, excluding fuel and food prices, is running at an even lower rate. These signs portend a slower pace of rate hikes, and that is keeping the asset boom afloat.	Below average growth rate	Recovery gaining pace	
<b>Asia</b>	The Chinese economy appears to be growing at a rate well below what the official figures claim, and probably below the government's 7% target. China's CPI inflation rate fell to an annualised 0.8% in January, the lowest in 5 years, and wholesale prices fell by another 4.3%, much weaker than expected. The biggest sector of the economy – residential construction – is coming under increasing pressure with price declines across the country continuing in the all the major cities and regions. The central bank stepped in mid-month to cut its bank Reserve Requirement Ratio for the first time since 2012, to encourage more lending. Toward the end of the month the government switched from being happy with growth, to now admitting that fiscal policy (government spending) should be 'proactive' and should be 'stronger and more effective' to prop up growth rates. The problem will probably flare up in the banking and 'shadow banking' sectors once again. Banks are now starting to increase their bad debt charges but they are still running at very low levels, officially at just 1.3% of loans across all banks. The reality is probably many times higher than that.	<b>China:</b> Cyclical slowdown  <b>Japan:</b> Back out of recession	<b>China:</b> Lower structural growth trend  <b>Japan:</b> Growth stalled	 

ASSET CLASSES			Current position	Long term returns (1)
Shares	Australian shares	The local stock market followed up its strong January with an even stronger February. The broad market had its best month since October 2011 (which was when it rebounded from the US downgrade crisis and Greek debt crisis in August-September 2011). Everything worked well over the past month: The profit reporting season contained few downside surprises; the big banks were helped by the rate cut and low bad debt provisions thanks to rising house prices; miners cut costs and had a brief respite from collapsing commodities prices; and industrials were assisted by the dollar's decline over the past six months. Others like QBE benefited from big turn-around stories. The only large stocks that fell were Woolworths after a poor profit result, and insurers IAG & Suncorp suffering from local weather events. We have been over-weight Australian shares since early 2012, near the start of the current 'QE' asset boom, and we are still reasonably bullish for the local market for now.	Near fair value on long term measures	Around average long run returns
	Developed markets shares	Global shares surged in February after a two month pause, with all of the main 'developed' country stock markets up solidly. The UK market reached a milestone during the month, becoming only the third developed world market to finally recover and exceed its pre-GFC all-time share price index peak. (Denmark did it in January 2013, and the US S&P500 index did it in March 2013). We have been over-weight global shares (with a bias toward US shares) since early 2012, near the start of the current 'QE' asset boom, and we are still reasonably bullish on the current outlook.	Mixed – US over-priced on long term measures, but other markets varied	Lower than average long run returns, but currency gains expected (2)
	Emerging markets shares	Emerging markets also had a good month but for different reasons. Chinese and Indian markets had another quiet month after their explosive run-ups in the second half of 2014. In China what is slowing the market is the gathering bad debt storm as the economy slows and property prices continue to fall. Central banks in China and India have recently cut interest rates to stimulate growth. At the other end of the scale, stock markets in Russia and Brazil rebounded strongly with the stabilisation of oil prices, and in the case of Brazil, stabilisation of iron ore prices as well. Central banks in both Brazil and Russia have raised interest rates recently to stem inflation and support their currencies.	Hard to value. Many now appear expensive but are reliant on fickle global sentiment	Moderate long run returns, with high volatility (2)
Fixed Income	Australian Fixed Income	During February yields at the long end remained very low but at the short end yields fell even further, as investors plan for a slower economy and lower cash rates in the current cycle. On the day of the 9 <sup>th</sup> rate cut from the Reserve Bank, long yields plunged to new depths below even the previous lows in July 2012. The shape of the yield curve indicates that investors, mainly foreigners, are banking on two things occurring: a local recession (and more rate cuts); and also for the Aussie dollar to stabilise or even rise. Such a combination is highly unlikely! In an economic contraction countered with further rate cuts, any gains from rises in bond prices (falls in yields) would probably be more than wiped out by currency losses for the foreign investors driving the bond market. Further rate cuts, together with a likely worsening of the budget deficit and political crisis, would probably trigger a race for the exits from both bonds and the Aussie dollar, driving the dollar and bond prices even lower.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Interest rates on bank TDs continue on their downward path, and they are likely to fall lower still if cash rates are cut even further. Even if rates are not cut, lower TD rates are likely if bank lending remains weak. Recent tightening of rules for US money market mutual funds may restrict Australian bank access to that market and this may flow through to a firming of rates paid on local banks deposits including TDs in the coming months if lending demand picks up.	Rates below long run average	Below average long run returns
	Global Bonds	Bond yields in the recovering economies of the US and UK turned a corner at the start of February and rose strongly during the month, but yields in stagnating Europe and in Japan remained more or less flat at extremely low levels. One significant milestone during the month was that German bond yields fell below Japanese yields for the first time since early 1981. Back then 10 year yields in both countries were above 9% per year (with inflation in both countries running at more than 5%). Now 10 year bonds are yielding just a fraction of 1% per year, a sign that investors are expecting long term stagnation and deflation in both countries. The overall global government bond index was down a little for the month – the first decline since late 2013. We hold global government bond funds tactically in portfolios because of their smooth moderate returns in this type of environment.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	In the first week of February the Reserve Bank cut its target cash rate for the 9 <sup>th</sup> time in this cycle, after an 18 month pause since the 8 <sup>th</sup> cut. Money markets are still pricing in at least another cut in the coming months. We hold minimal cash in portfolios. Every other asset class has generated higher returns over the past couple of years and is likely to do so again in the coming months.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market continued to do well during the month, ahead 3% compared to January's 8%. The big corporate move for the month was the bid by Federation Centres (ex-Centro) to acquire Novion (ex-Colonial Retail, ex-Gandel). As usual the acquirer's price fell while the target's price surged. Aside from a flat Westfield, all other trusts rose for the month, driven by the relentless search for yield. The problem is that yields have already been forced down to just 4% or 5% or worse, lower than for 'blue chip' shares, but without the tax benefits or real growth potential of shares. The whole sector is trading at a sizeable premium over book value, and the underlying buildings are in turn over-priced on unrealistically low yields. We continue to favour listed property over unlisted property, and returns from the listed market have been more than double the returns from unlisted property.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	The residential market received another shot in the arm from the latest interest rate cut. The central bank and the government are trying to hose down the market with lending restrictions aimed at investors and now the possible banning of gearing inside self-managed superannuation funds. There is also a plan to introduce fees for foreign purchasers of residential property, but at only nominal levels that are unlikely stem the tsunami of foreign demand, mainly from Chinese buyers. Unless there is a deep recession with much higher unemployment rates, the housing market is probably only going to be stopped by significant interest rate hikes, and that looks like a long way away from here.	Varies by market and by property	Varies by market and by property
	Australian dollar (AUD)	After three months of declines, the AUD rose after the RBA rate cut. It ended flat for the month against the US dollar but it rose against the weaker Yen, Euro and Swiss franc. The 17% surge in the US dollar over the past 6 months finally paused in February as the Fed appears to have pushed out its rate hike plans to later in the year. We have been un-hedged in our global equities portfolios over the past couple of years, benefiting investors from the AUD's decline. Even after the recent slide the AUD is still over-valued on fundamentals and we remain strategically un-hedged for global shares.	AUD above fair value	Currency gains for Australian investors as the AUD falls

(1) Expected "long term" returns refers to periods of 10+ years (looking through economic cycles) starting from the current position

(2) Returns for non-Australian assets are in AUD terms – ie including any profits/losses from hedging or currency movements