

STRATEGY OBSERVATIONS

HEURISTIC INVESTMENT SYSTEMS
Generating Intelligence for Investment Decision Makers



01 APRIL 2015

Market Extremes & Divergence

Contents

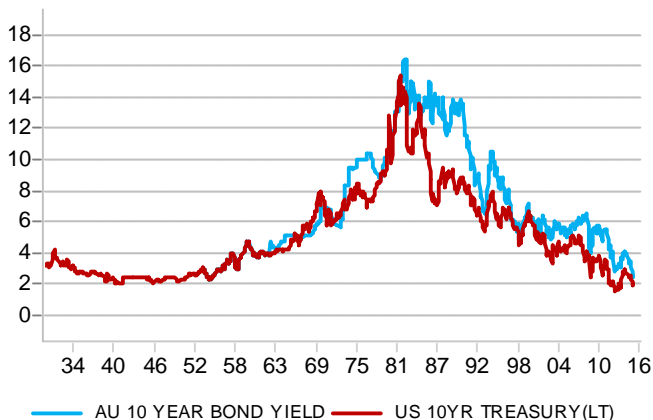
Market Extremes & Divergence	1
AUSTRALIAN BONDS	2
GLOBAL BONDS	3
MONETARY POLICY	4
.....	4
“LOWFLATION”	5
CHINA.....	6
EARNINGS	7
CURRENCIES.....	8
US.....	9
US GROWTH, PRODUCTIVITY & EPS.....	10
US GROWTH, PRODUCTIVITY & EPS.....	10
AUSTRALIAN ECONOMY.....	11
EUROPEAN ECONOMY	12
AUST & US HOUSEHOLD DEBT, NET WORTH	13
EMERGING MARKETS.....	14
AUSTRALIAN SECTORS	15
AUSTRALIAN SECTORS	16
OTHER ASSET CLASSES	17
OTHER OBSERVATIONS	18
Disclaimer & disclosure.....	19



AUSTRALIAN BONDS

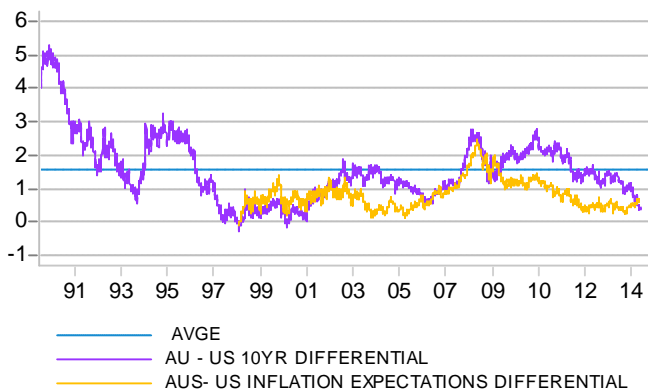
- At 2.35% Australian bond yields are now only 40 bpts above US bonds (compared with the 0-50 bpt range established over 1997-2001).
- At 0.3% indexed bond yields are at new lows and well below trend real GDP growth (last 5 years) of 2.6%.
- Nominal bond yields are more than 2% below trend nominal GDP.
- Bonds also appear overbought in the short term.

10 YEAR BONDS



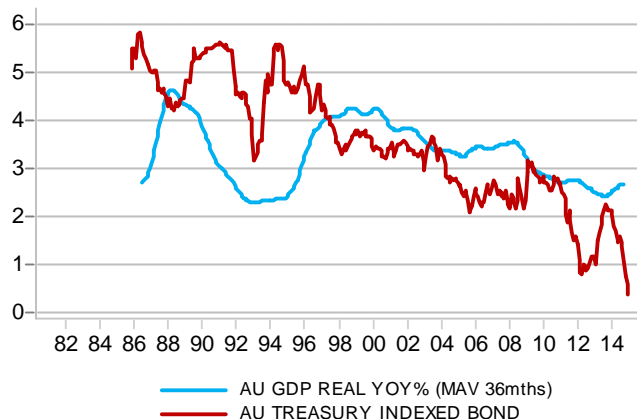
Source: IRESS

AU-US 10yr spread & Inflation differentials



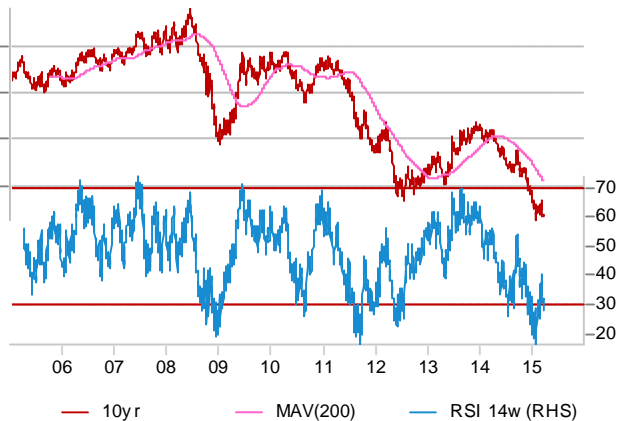
Source: RBA, ABS, IRESS

Australian Indexed Bonds & Real GDP

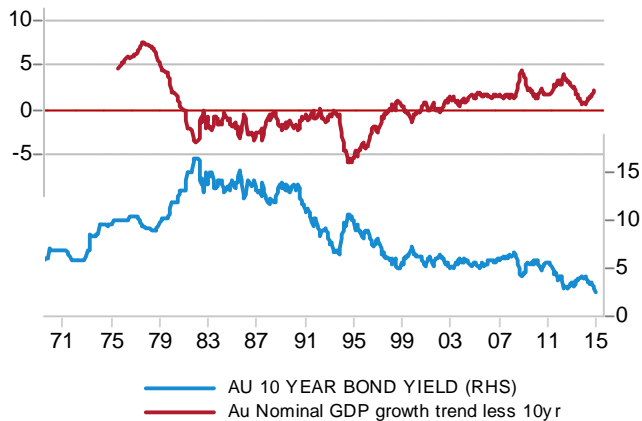


Source: ABS, RBA, IRESS, using proxy updates

Au 10-Year Bond & (RSI(14w))



AU GDP Nominal Growth 10yr ave less 10yr bond

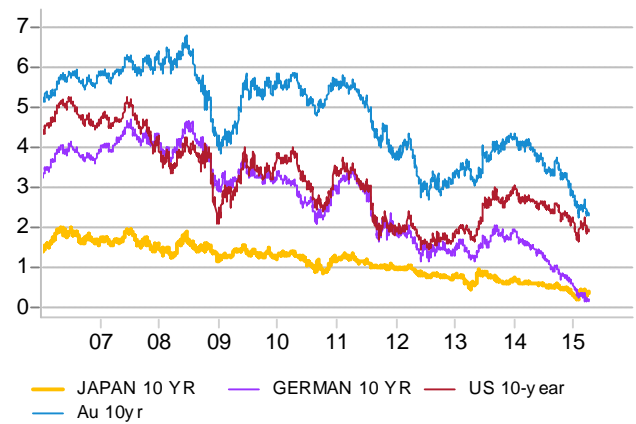


Source: ABS, IRESS

GLOBAL BONDS

- German and Japanese 10 year bond yields are 0.15% and 0.4%, respectively. The US 10 year is just below 2%.

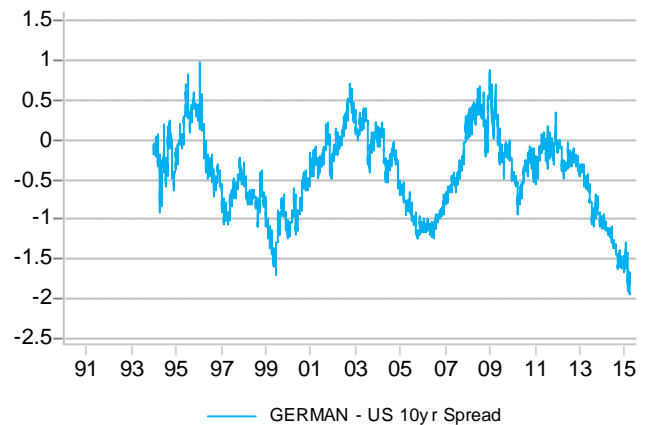
Global 10yr yields



Source: IRESS

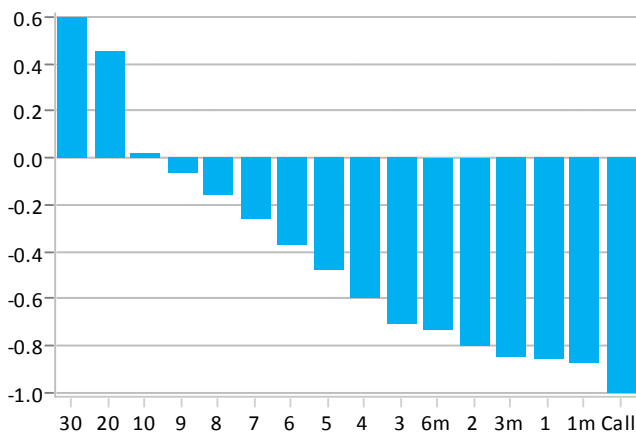
- At 0.15% German 10 year yields are a record 180 bpts below US 10 year bond yields.
- In Switzerland all maturities out to the 10 year have a negative yield.
- Based on the current yield curve in the US the implied 5 year yield in 5 years has slipped to 2.5% (red line) from over 4% a year earlier and that is despite a relatively strong year for the US economy (nominal GDP growth over the past 10 years has averaged 3.5%).

German - US 10yr Spread



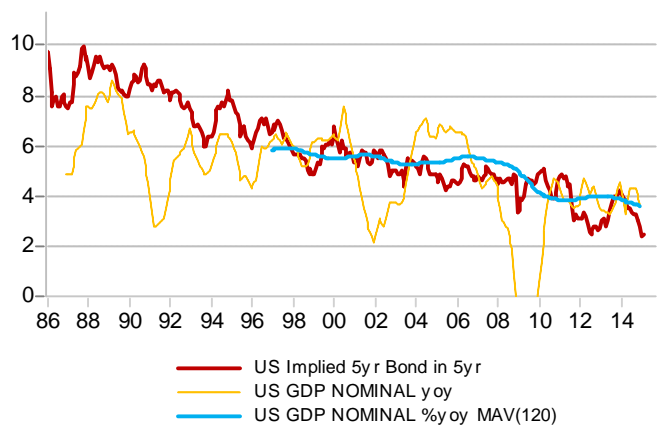
Source: IRESS

Swiss yield curve



Source:SNB

US Implied 5yr bond in 5yrs & trend GDP

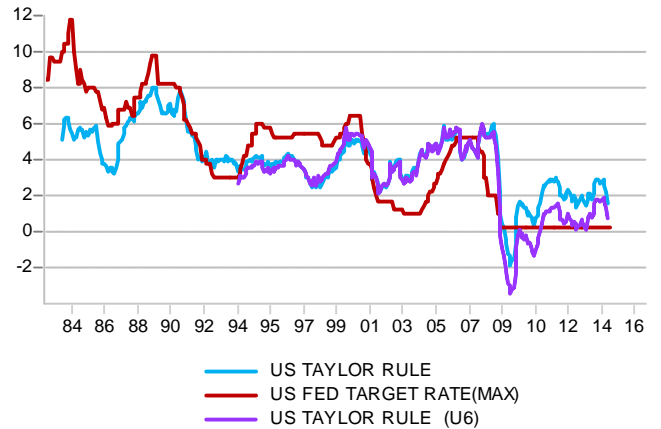


Source: US Fed, BLS

MONETARY POLICY

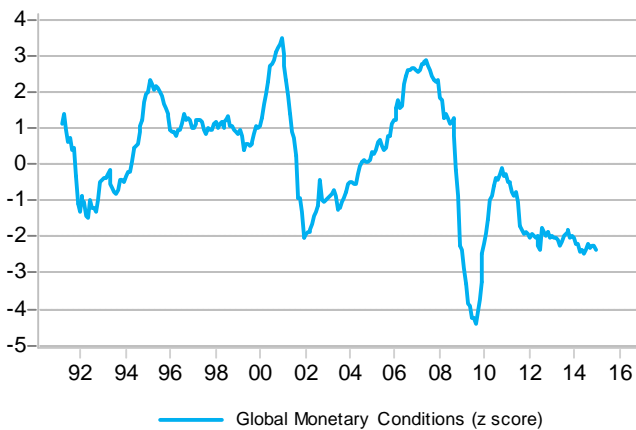
- The US Taylor rule suggests the Fed funds rate should be around 2%. If we use the underemployment rate rather than the unemployment rate the Taylor rule suggests 1% Fed funds (purple line).
- The Fed’s “deviation” from meeting its dual mandate widened with the March FOMC projection of a lower NAIUR.
- US implied Fed funds (from the futures market) are 50-100 basis points below that of downwardly revised March FOMC Fed funds rate projections.
- Global monetary conditions (as measured by real cash rates and excess liquidity) are still extremely easy (ex GFC).

US TAYLOR RULE & US FED FUNDS



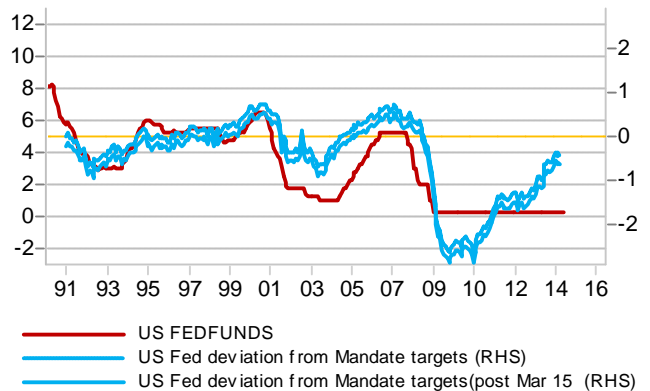
Source: BLS, US Fed, BEA, HIS est.

Global Monetary Conditions



Source: Fed, OECD,

US Fed funds & Fed Dual Mandate

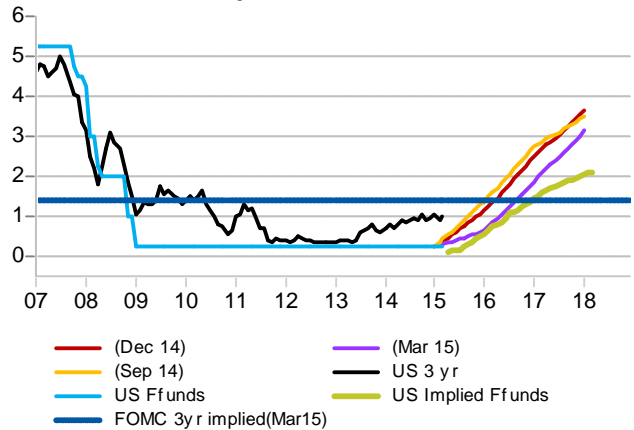


Source: Fed, BEA

Central Banks	Easy	Neutral	Tight	
US Fed	▼			ended QE Oct 2014
ECB	▼			announced QE Jan 2015
BOJ	▼			extended QE Dec 2014
BoE	▼			
Canada	▼▼			eased 25 bp to 0.75% Jan 21st
Switzerland	▼	▼		eased 25 bp to -0.75% Jan 15th
Denmark	▼			eased 15 bp to 0.05% Jan 19th
Norway	▼			eased 25 bp to 1.25% Dec 11th
RBA	▼			eased 25 bp to 2.25% Feb 3rd
RBNZ		▼		switched to neutral bias Jan 2015
Brazil		▼	▼	tightened 50 bp to 12.75% March 4th
India		▼		eased 25 bp to 7.5% March 4th
Korea	▼			eased 25 bp to 1.75% March 12th
PBoC	▼	▼		eased 25 bp to 5.35% Feb 28th
Russia			▼	eased 100 bp to 14% March 13th
Turkey		▼	▼	eased 25 bp to 7.5% Feb 24th
Sweden Repo rate	▼			eased 15 bp to -0.25% March 18th

Sources: various Central Banks, Latest values & 2M ago

US Fed Funds Projection

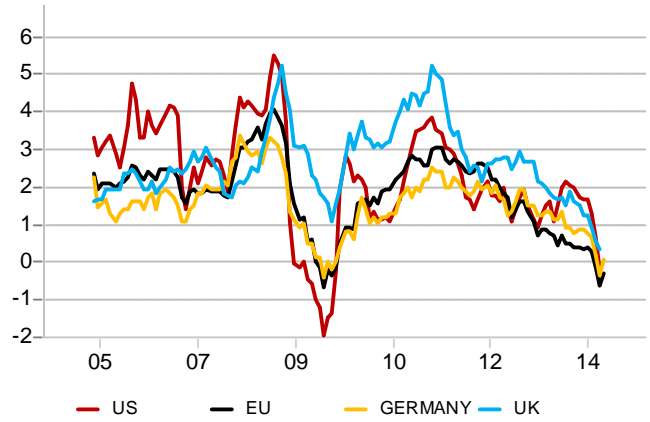


Source: St Louis Fed, CME, FED

“LOWFLATION”

- Headline annual inflation rates as at February were essentially flat or slightly negative across the US, Europe, Germany and the UK.

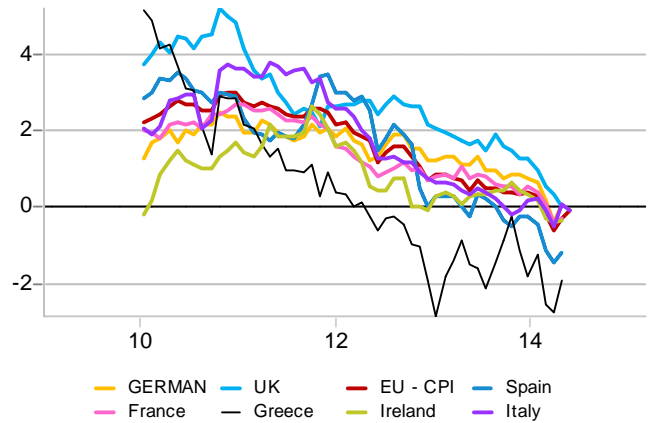
Global Inflation



Source: UK National Statistics, ECB, Bundesbank, BLS

- Within Europe, Inflation was flat at best on an annual basis with more pronounced declines in Greece (-1.9%) and Spain (-1.2%).

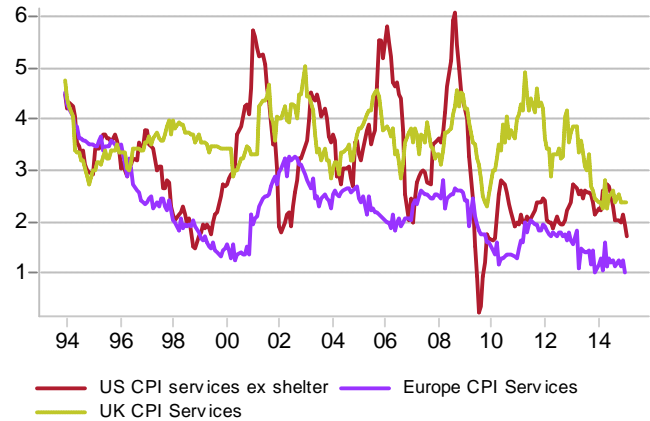
Europe Inflation



Source: OECD, Office National Statistics

- Services sector inflation is traditionally less volatile, or is considered “sticky” but is currently near or through GFC lows in the UK (2.4%) and Europe (1%) and near the lowest levels ex-GFC in the US (1.7%). Services sector CPI tends to reflect wages growth.

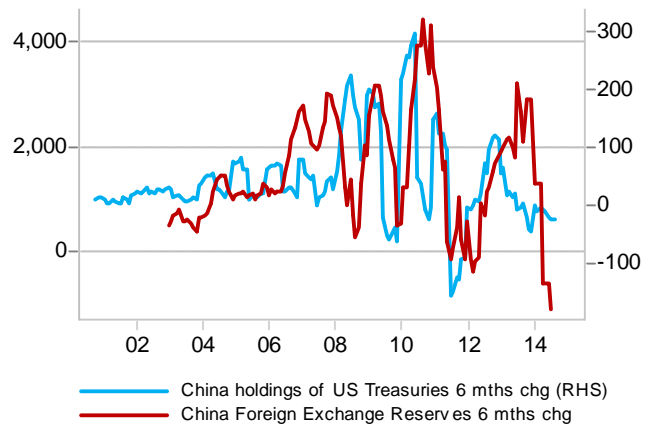
Services Inflation



CHINA

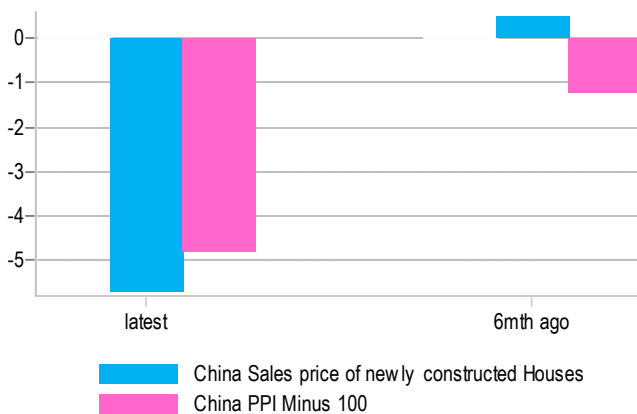
- China's FX reserves hit US\$4 trillion in mid-2014 but have since dropped to US\$3.84 trillion, the largest decline recorded. Revaluation of the EUR will have had an impact while a surge in capital outflows was also a driver.
- The real effective exchange rate continues to push higher.
- In the meantime, house prices are down 5.7% yoy to February and the PPI declined by 4.8% yoy, the 36th consecutive decline.
- Private credit to GDP is over 185%, with "shadow banking" continuing to grow.
- Investment spending has slowed but at around 46% of GDP it is a reminder of the level of overinvestment and the prospect of an ongoing slowdown in trend growth.

Chinese FX reserves & US Treasury Holdings



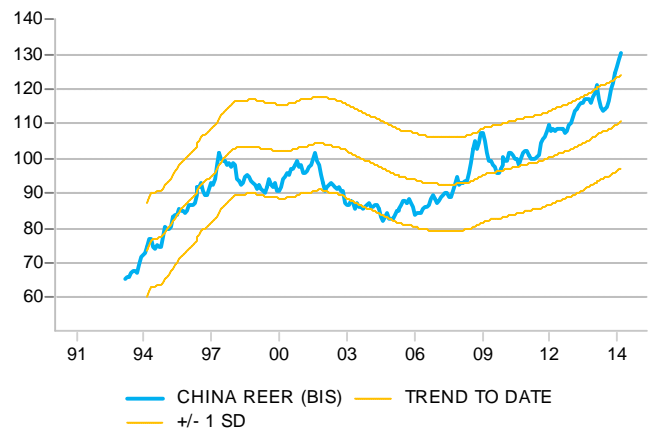
Source: US Treasury, PBoC

China PPI & House prices



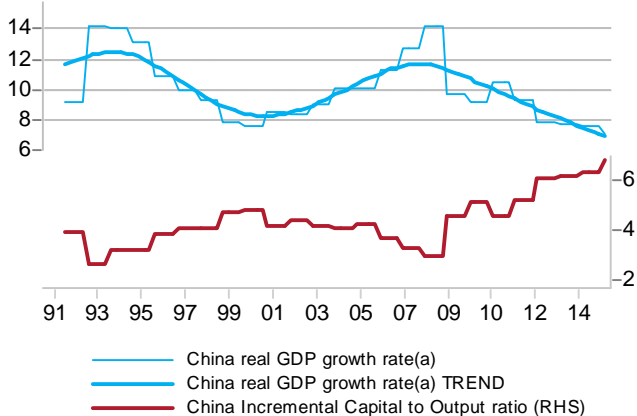
Source: National Bureau of Statistics of China

CHINA REER



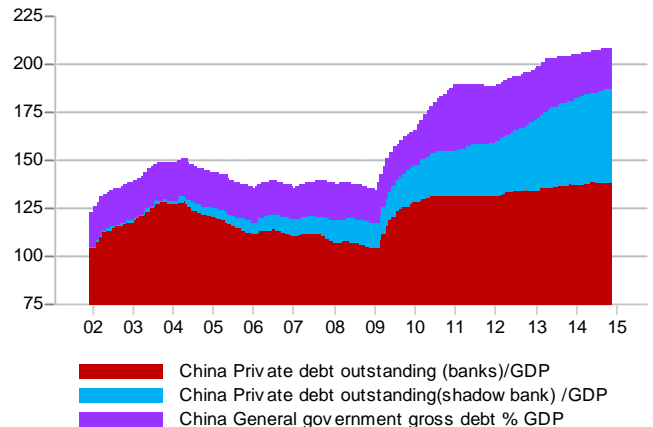
Source: BIS

China GDP Growth rate & trend



Source: IMF

China Total credit to GDP

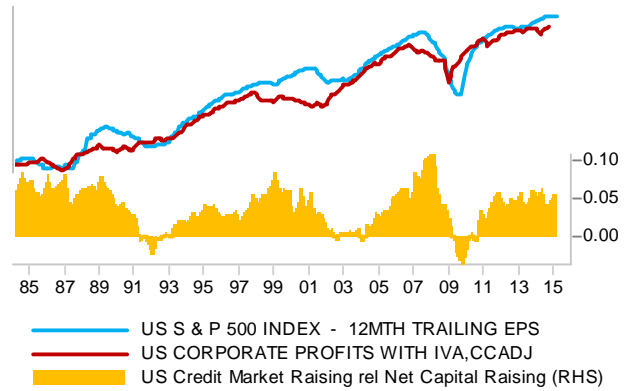


Source: National Statistics Office, World Bank

EARNINGS

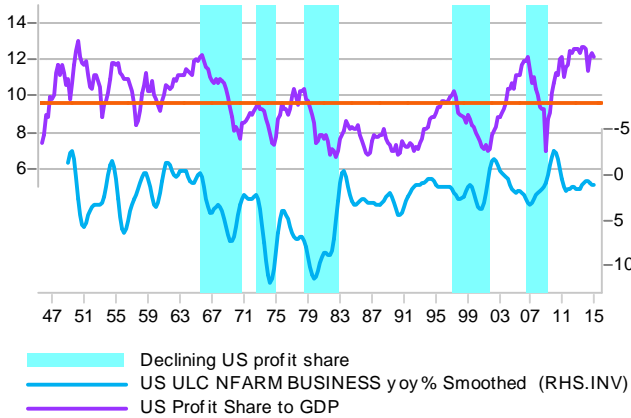
- Earnings growth and the NIPA measure of profit growth for the US have slowed over the past 12 months. EPS growth was around 4% while NIPA profits were flat. Net credit raisings to equity issuance as a % of GDP continues to rise (credit issuance 3.2% of GDP, equity issuance -2.4% of GDP) suggesting increased leverage and divergence between EPS and profits.
- US profit share remains around 12% but is showing signs of rolling over as unit labour costs pick up to 1.2% yoy and the USD rises.
- The US Earnings revision ratio on a 3-month average basis is close to the 1sdev level below the longer term average.
- Globally, forward EPS measures show an extreme divergence between Japan and other regions. In Europe trailing EPS levels are close to post GFC lows although recent activity data suggests a turnaround.

US S&P EPS Growth & US Profits & Credit market raisings v Equity issuance



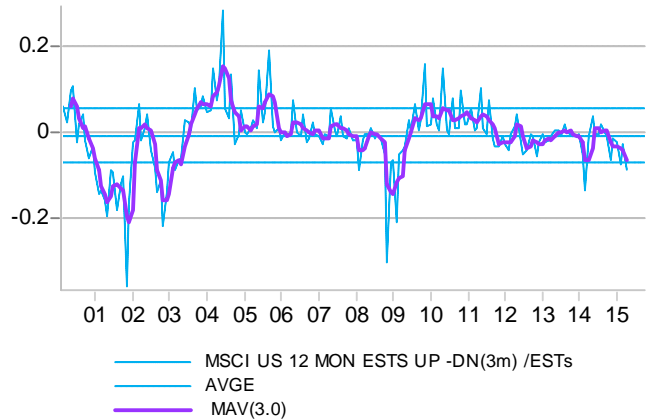
Source: US Fed, BEA

US Profit Share & ULCs



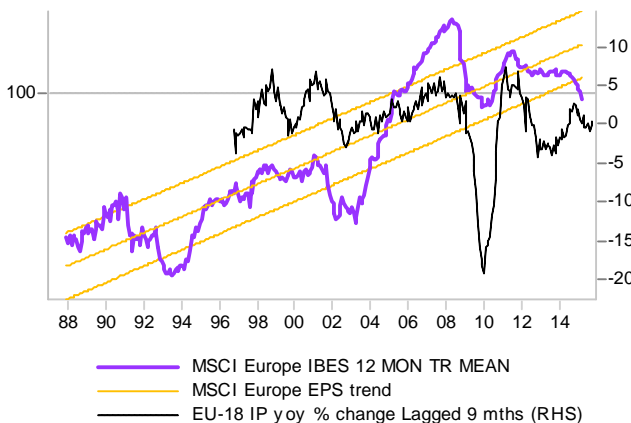
Source: BEA

US Earnings Revisions



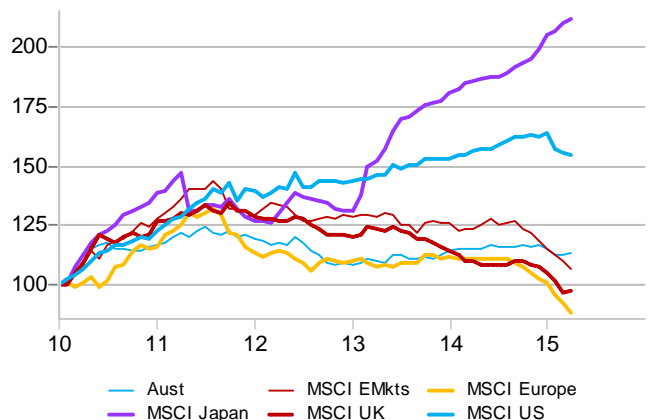
Source: IBES

MSCI Europe EPS v trend



Source: IBES

Global EPS

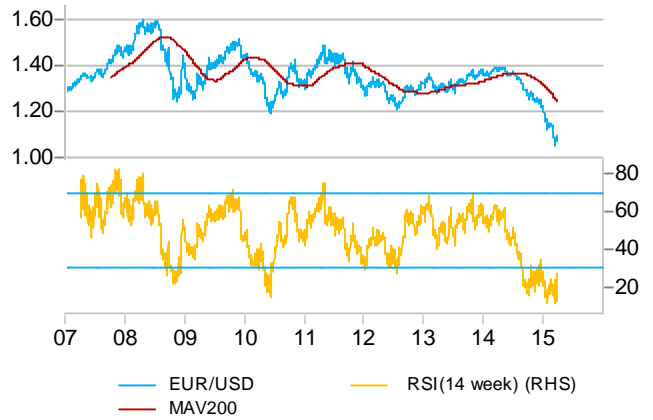


Source: IBES

CURRENCIES

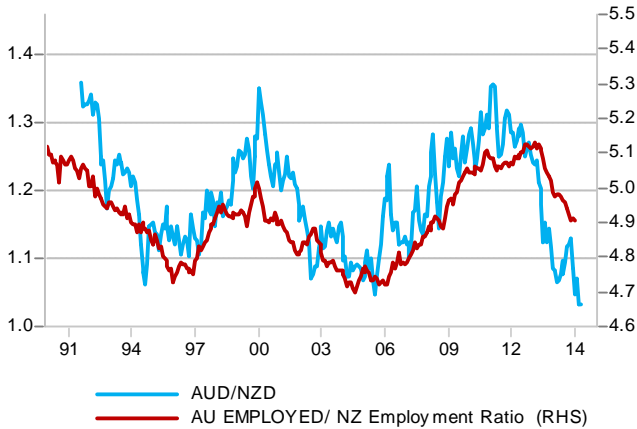
- The EUR would appear to be oversold (USD overbought).
- The EUR is reflecting the sharp decline in the interest rate differential (German 5-year yields are over 150 bpts below US 5-years).
- On a REER basis the yen is close to 30-year lows.
- The NZD is close to parity to the AUD, driven by a divergence in growth rates and monetary policy dynamics. NZ 90 day bills are 140 bpts above Australian levels (close to 2005-06 levels) and set to move higher.

EUR/USD & RSI



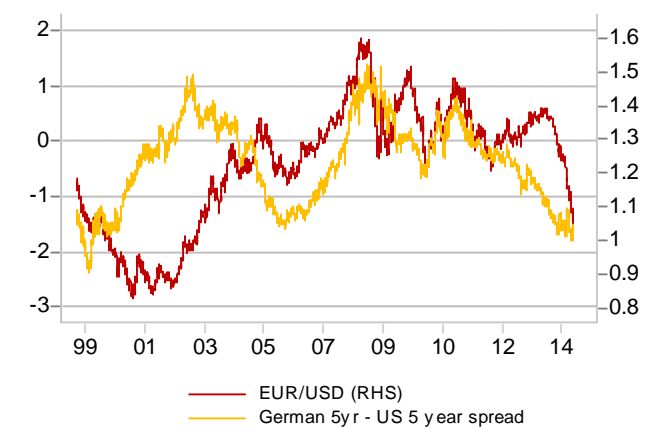
Source: IRESS

AUD/NZD & AU EMPLOYED/ NZ Employment Ratio



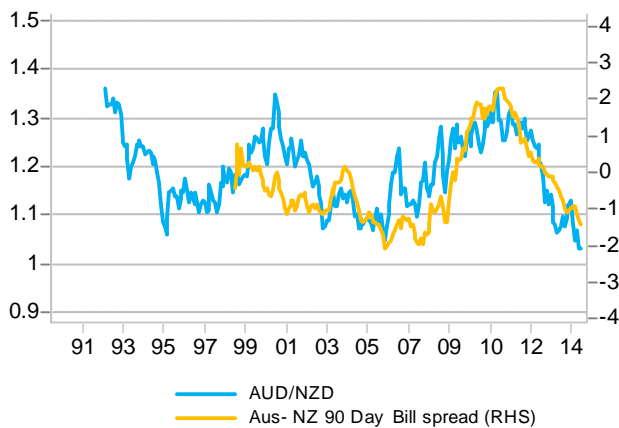
Source: RBNZ, IRESS

German - US 5yr Spread & EUR



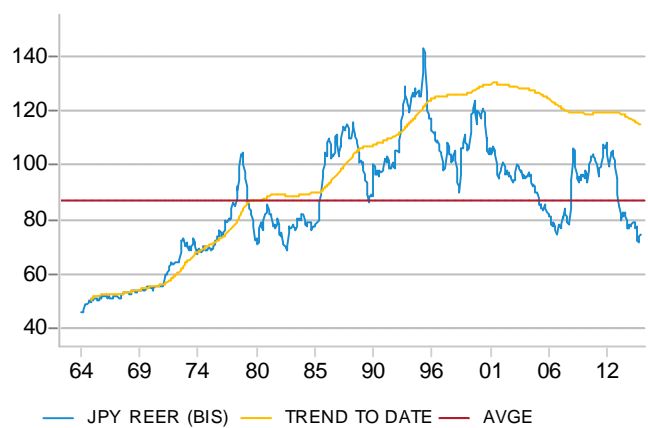
Source: IRESS

AUD/NZD & Aus- NZ 90 Day Bill spread



Source: IRESS, RBNZ

JPY REER

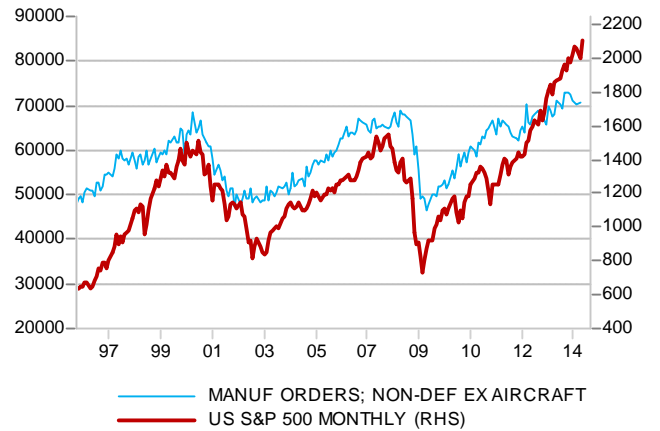


Source: BIS

US

- The US equity market has diverged considerably from the level of business investment as measured by core manufacturing orders.

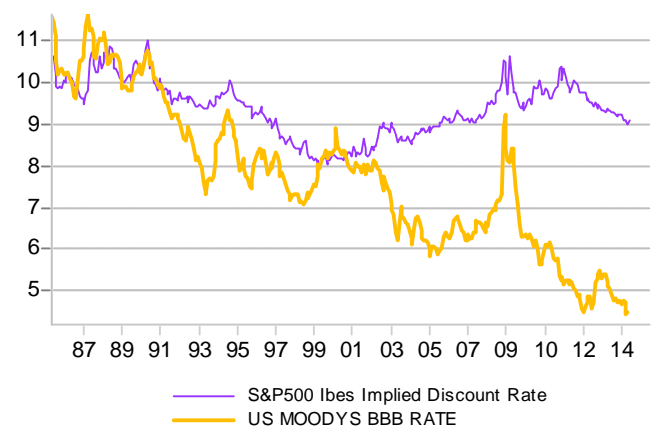
US CAPITAL GOODS ORDERS & EQUITIES



Source: Census Bureau, IRESS

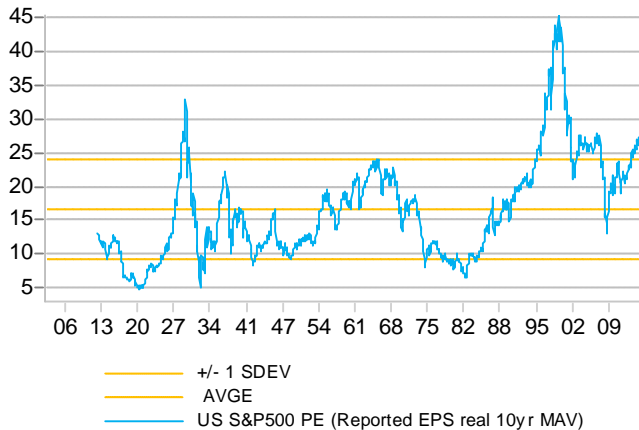
- The gap between the cost of equity and the cost of debt is extremely wide, prompting increased buybacks and increased leverage.
- Yields within the BBB market and in high yield are near historic lows. However, default rates are also very low. With low borrowing costs and buybacks the US equity market has become expensive on a Shiller basis.

US Cost of Equity & US BBB yield



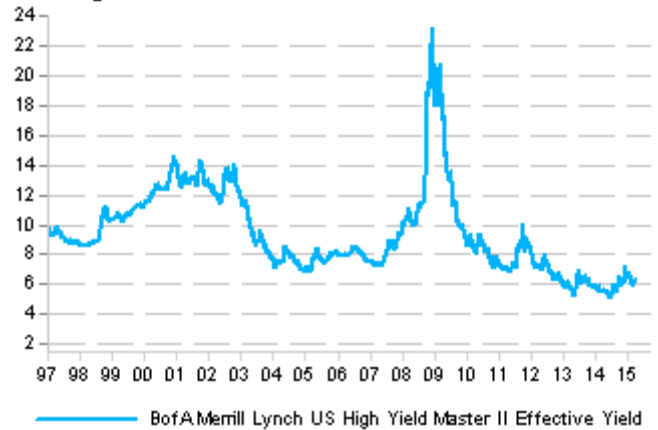
Source: IBES, Fed

US PE (real reported 10yr mav EPS)



Source: IBES, Shiller

US High Yield

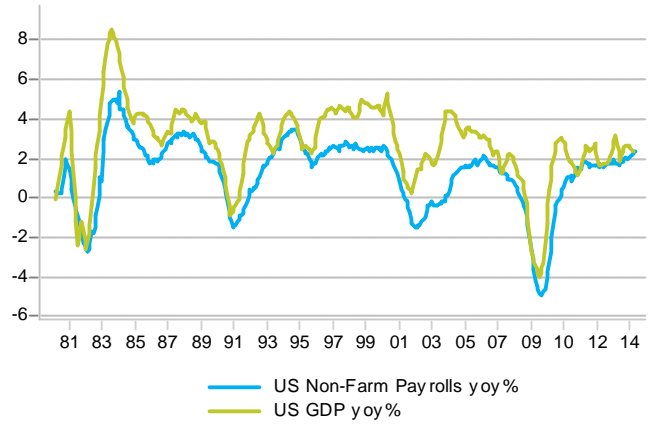


Source: St Louis Fed, BoA

US GROWTH, PRODUCTIVITY & EPS

- An unusual aspect of the US recovery in recent years has been the diminished gap between GDP growth and employment growth.

US Real GDP & Payrolls

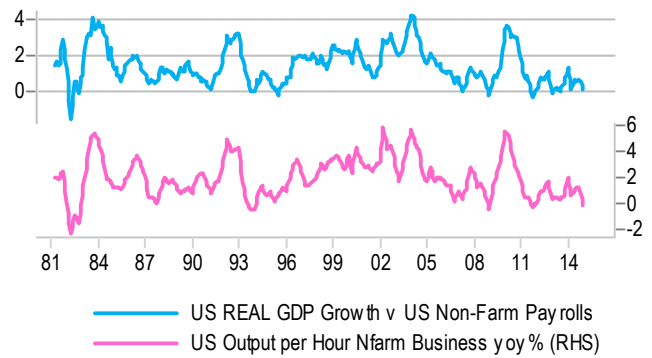


Source: BEA, BLS

Source: BEA, BLS

- A closure of the gap (blue line) is indicative of a slowdown in productivity (pink line) (currently around 0.5%).

US REAL GDP Growth v US Non-Farm Payrolls & US Productivity

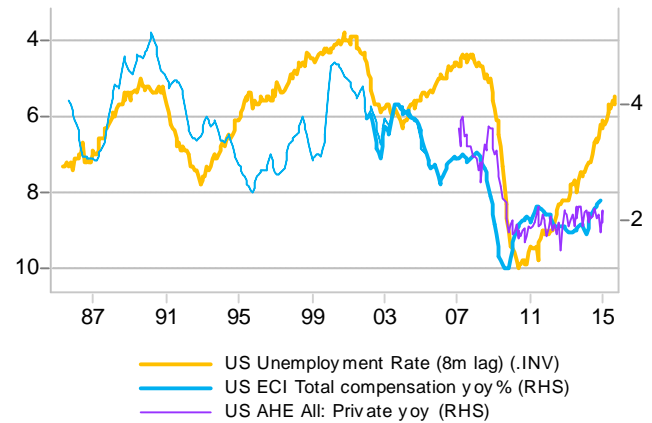


Source: BEA, St Louis Fed, St Louis Fed

Source: BEA, St Louis Fed, St Louis Fed

- With the US unemployment rate at 5.5% wages growth might ordinarily be expected to increase. At present the divergence is significant.

US Wages & unemployment



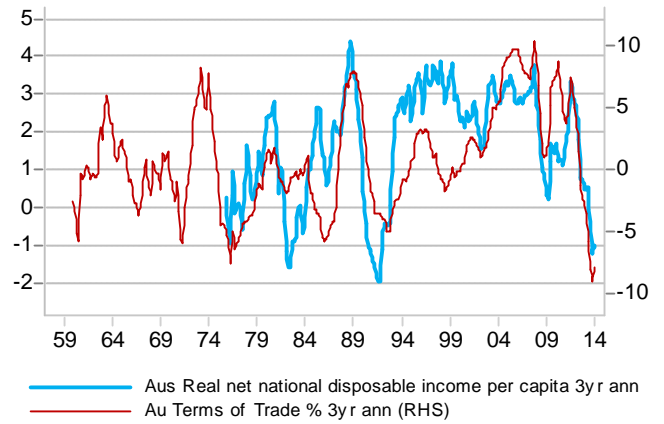
Source: NBER, Department of Labor

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AUSTRALIAN ECONOMY

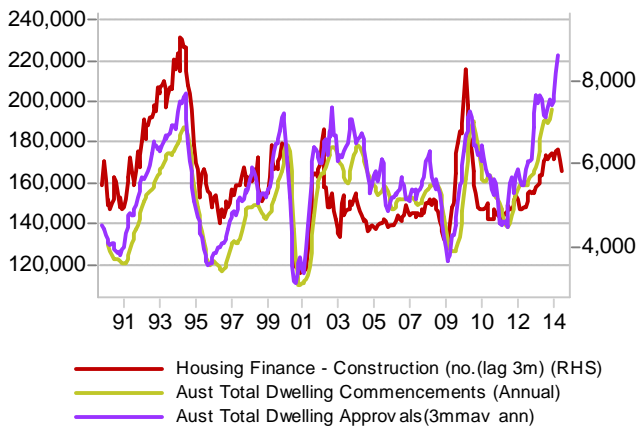
- Real net national disposable incomes have declined at a 1% annualised pace over the past 3 years, driven by the 8% annualised decline in the terms of trade over the same period.
- Mining capex as a % of GDP is expected to decline from the 5% level to 3-3.5% of GDP by mid-2016.
- The transition to domestic growth sources is occurring. Dwelling approvals over the past 3 months are consistent with annualised commencements of over 220,000 (with a record share of high density approvals).
- Investor loans account for more than 41% of housing loans while overall housing credit represents more than 60% of outstanding credit.

Aus Real net national disposable income per capita



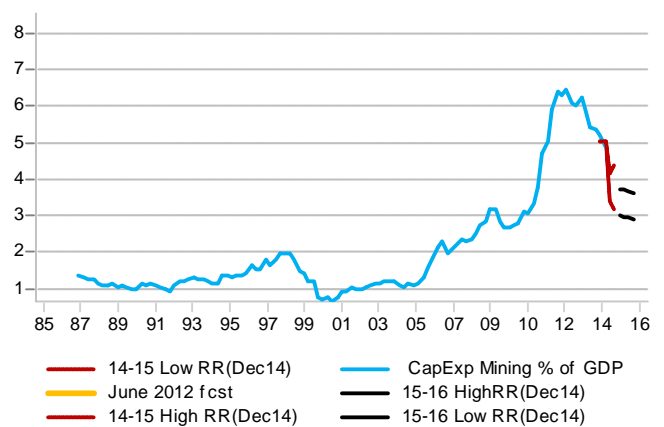
Source: ABS, RBA

Housing Commencements



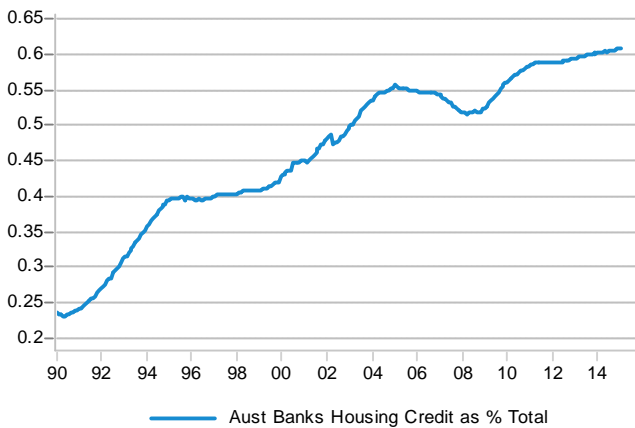
Source: ABS

Aust Capital Expenditure- Mining % of GDP



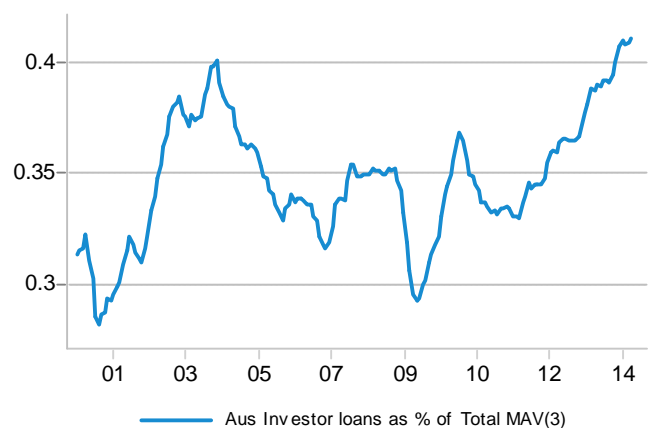
Source: ABS

Aust Banks Housing Credit as % Total



Source:RBA

Aus Investor loans as % of Total (MAV(3))

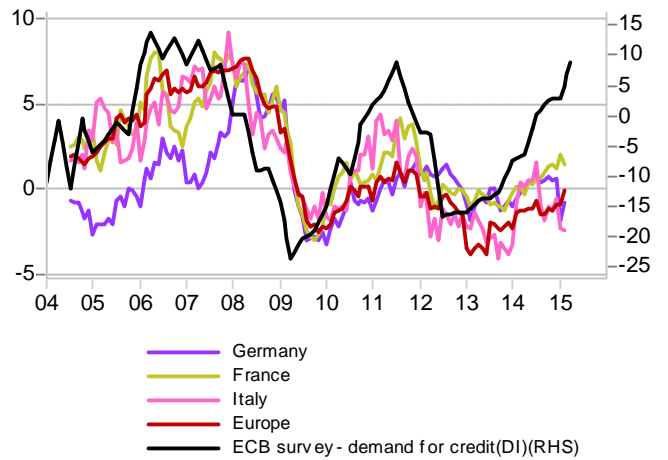


Source:ABS

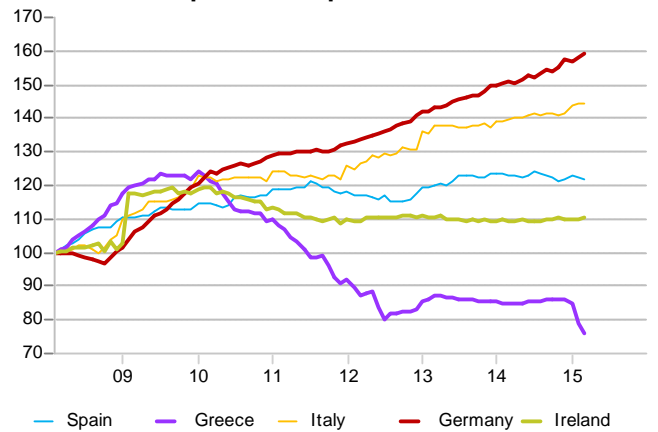
EUROPEAN ECONOMY

- According to latest ECB lending survey, the diffusion index for credit demand is at its highest level since 2011, suggesting an upturn in lending.
- Meanwhile household deposits in Greece tumbled almost 10% in January-February as uncertainty around the Greek bailout extension undermined confidence.
- Unit labour costs in Greece have declined by over 20% since 2011-12 while in Italy, unit labour costs continue to increase (and they have now grown the most since 2001).
- The ECB's QE program has helped push the EUR and European bond yields lower and the DAX higher over recent months. The correlation between the DAX, EUR and 10 year yields is at extreme levels.

Europe Non-Financial corporations Loans 6m%

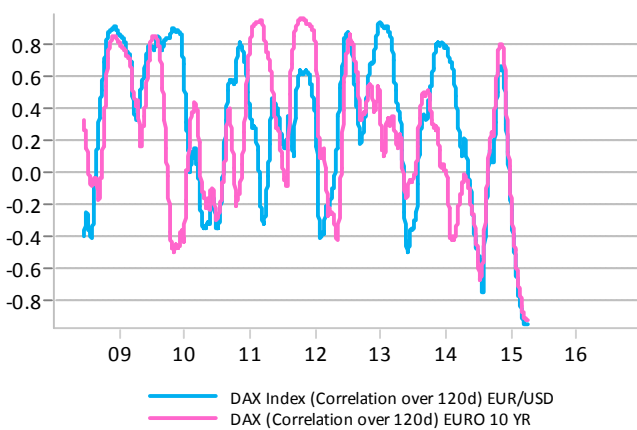


Household deposits Europe



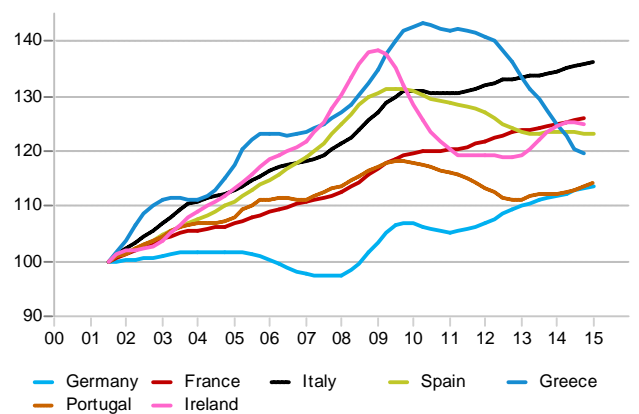
Source: ECB

DAX (Correlation over 120d) EUR/USD & EU10



Source: IRESS

Europe Unit Labour Costs

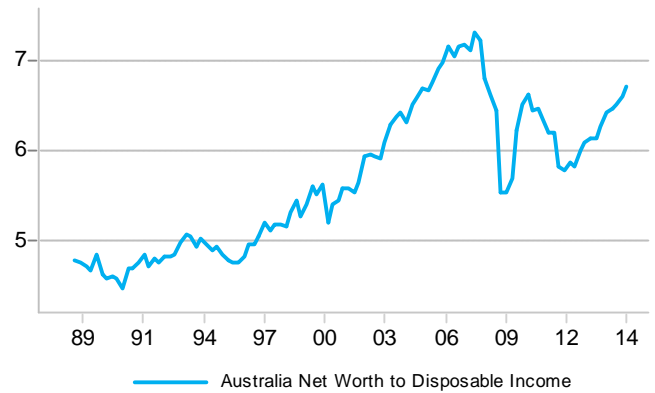


Source: ECB

AUST & US HOUSEHOLD DEBT, NET WORTH

- Australian household wealth to disposable income has risen to 6.7 times

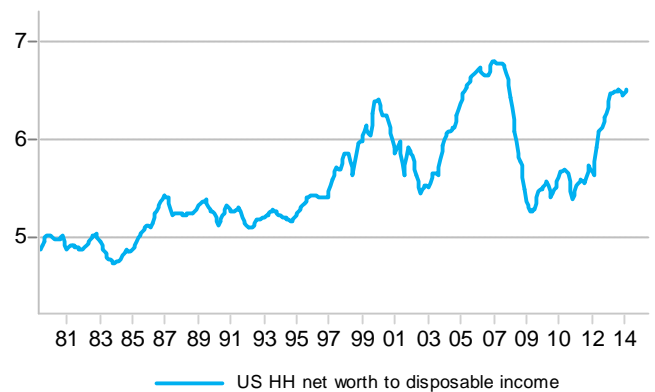
Australia Household wealth as % of Disposable Income



Source: RBA

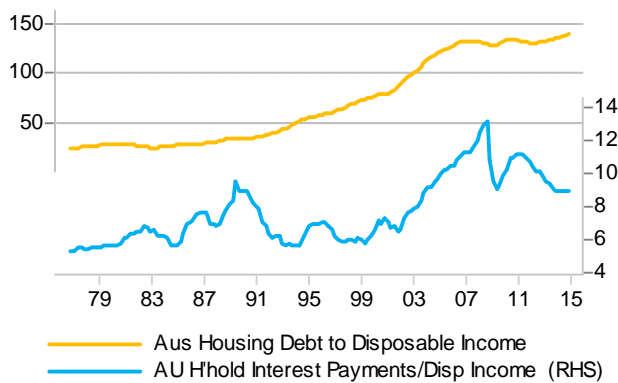
- US household net worth to disposable income has jumped up to around 6.5 times.
- US Household sector debt to income has dropped from 135% in 2007 to 106%. In Australia that ratio continues to climb...now at 154%.
- The household debt service ratio in the US has dropped to 9.9% from 13% at the peak while in Australia it is just under 9%.

US HOUSEHOLD NET WORTH AS % OF DISPOSABLE INCOME



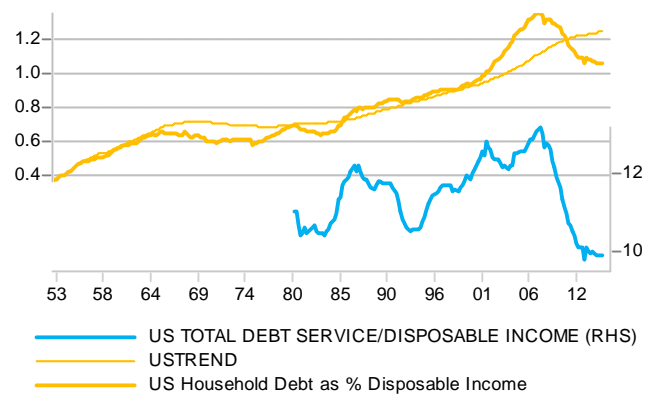
Source: US Fed

Australian Household sector debt % debt servicing



Source: RBA, Fed

US HOUSEHOLD SECTOR DEBT & DEBT SERVICING

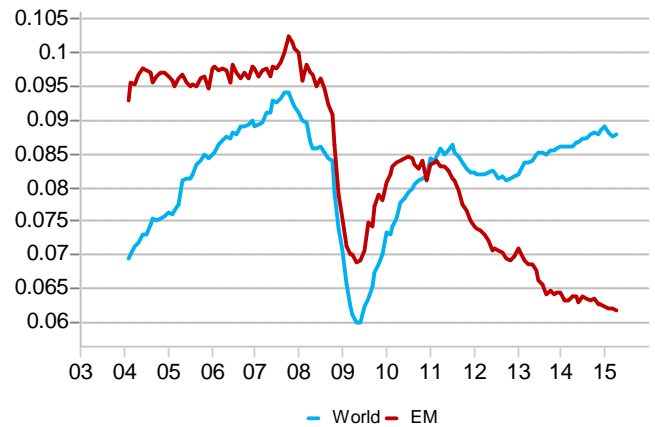


Source: BEA

EMERGING MARKETS

- Based on IBES data, profit margins in emerging markets have dropped to 6.2% while in developed markets profit margins are 8.7%.

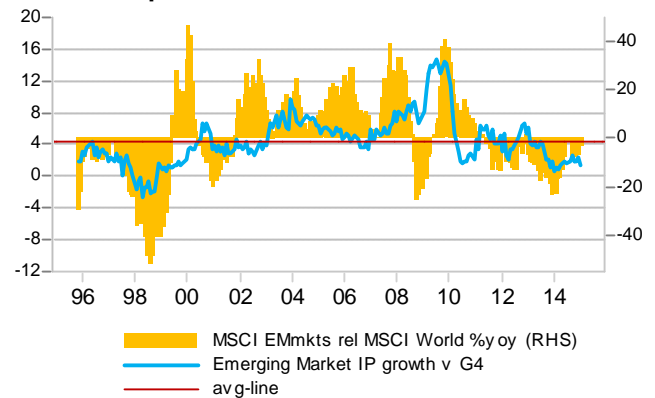
Profit Margins EM v World



Source: IBES

- Emerging economy industrial production growth slowed to 3.2% yoy in January taking the “premium” IP growth rate over advanced economies to 1.4%, well below the average 4% and back to levels last seen in the late 1990’s.

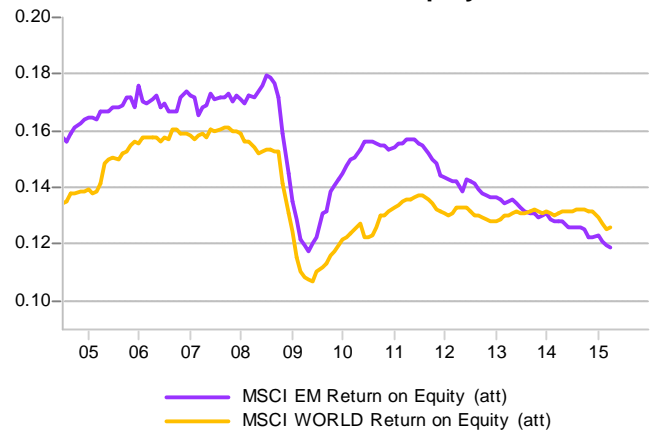
Emerging Market Output v OECD & relative performance



Source:,OECD, MSCI

- Return on equity from emerging markets is at GFC lows, at just under 12%, below that of developed markets.

MSCI EM & WORLD Return on Equity

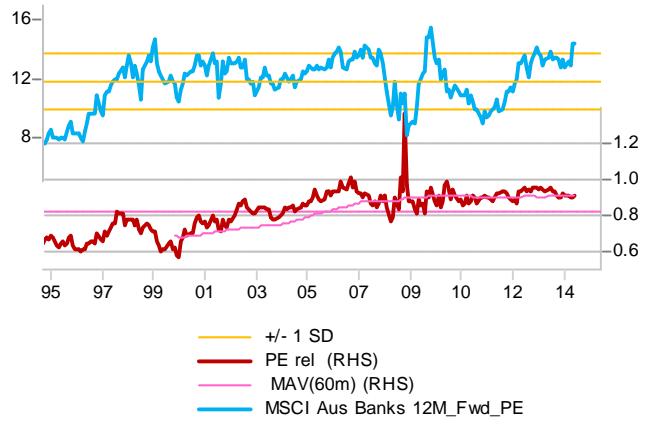


Source:,IBES

AUSTRALIAN SECTORS

- At 14.4 times, the forward PE for banks is near record highs.

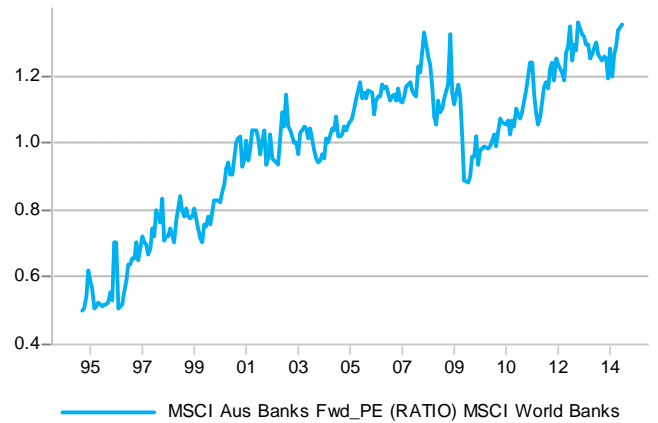
MSCI Aust Banks 12mth Fwd PE



Source: IBES, using proxy updates

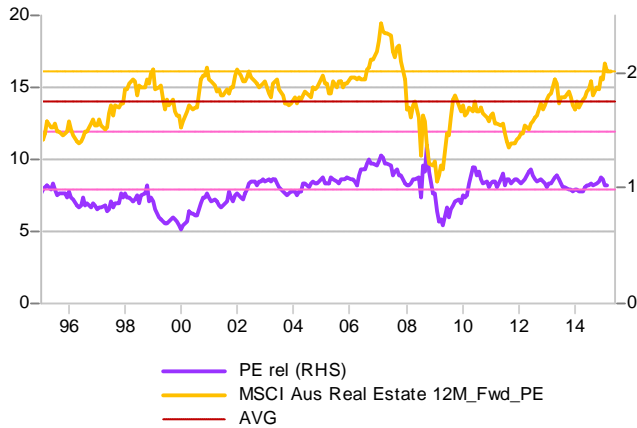
- Relative to global banks, domestic banks are also near record highs.
- The forward PE for A-REIT's is also at /near record highs excluding the immediate pre-GFC period.
- The dividend yield for telecoms relative to the market is back to GFC levels (zero).

MSCI Aus Banks Fwd PE rel World Banks



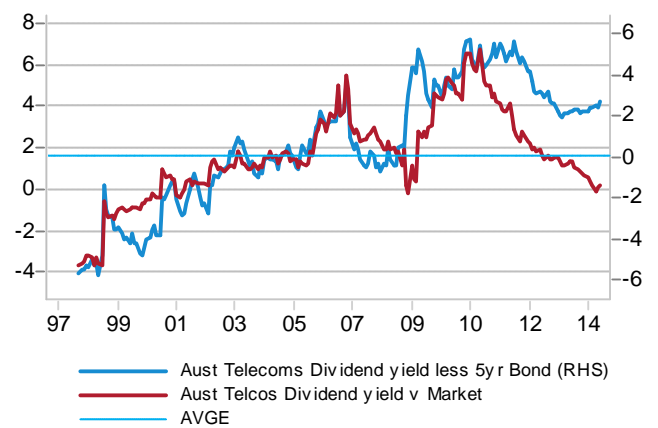
Source: IBES, using proxy updates

MSCI Aust Real Estate Forward PE



Source: IBES, using proxy updates

Telecom Servs Dividend yield v market & bonds

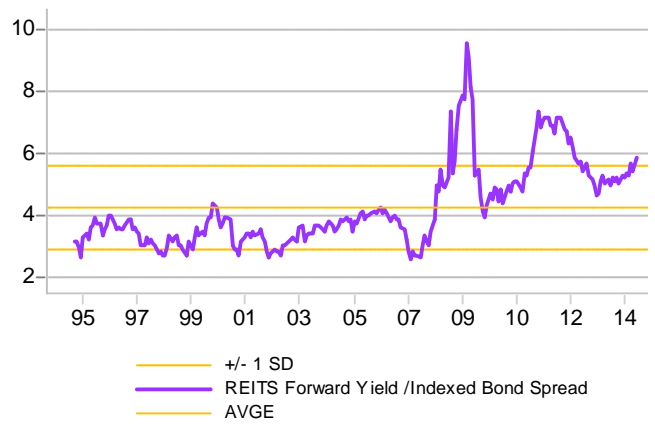


Source: RBA, IRESS, IBES

AUSTRALIAN SECTORS

- However, relative to real yields, the forward yield on A-REIT's is close to 6%.

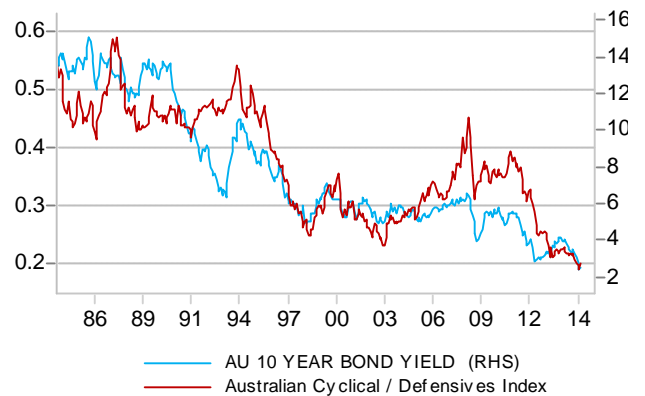
REITS Forward Yield less 10yr Real



Source: IBES, IRESS, using proxy updates

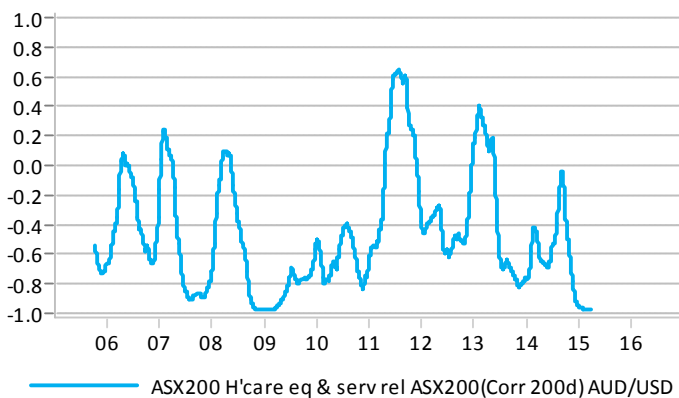
- Cyclical sectors have been underperforming defensive sectors for a long period, largely reflecting the ongoing decline in bond yields.
- Recent improvement in “discretionary” retail sales relative to staples suggests some outperformance from the consumer discretionary sector.
- The relative performance of the healthcare equipment and services sector has been highly (negatively) correlated with the (declining) AUD.

Australian Cyclical Sectors / Defensives & Aus 10 yr bond



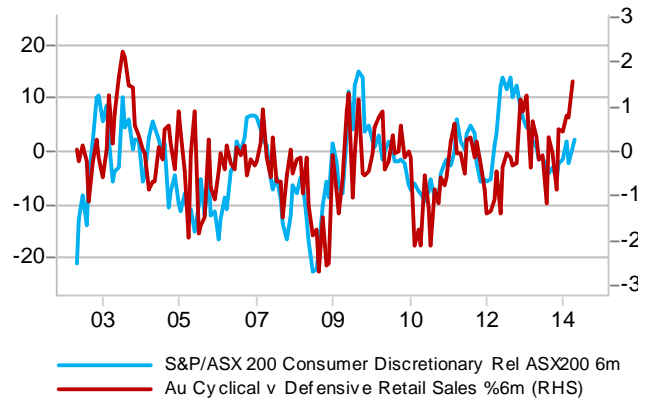
Source: IRESS

S&P/ASX200 H'CARE EQUIP & SERV rel ASX200 (Correlation over 200d) AUD/USD



Source: S&P, IRESS

Consumer Discretionary & Cyclical v Defensive Retail Sales

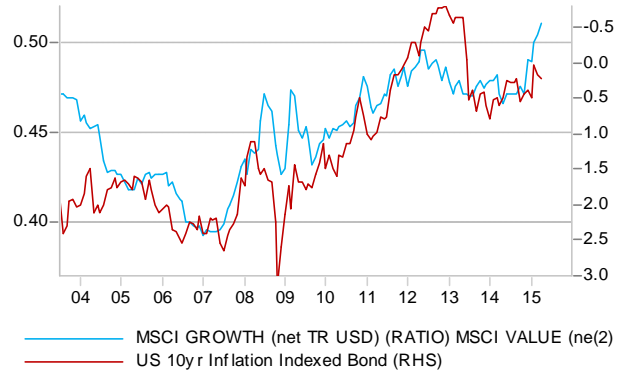


Source: IRESS, ABS

OTHER ASSET CLASSES

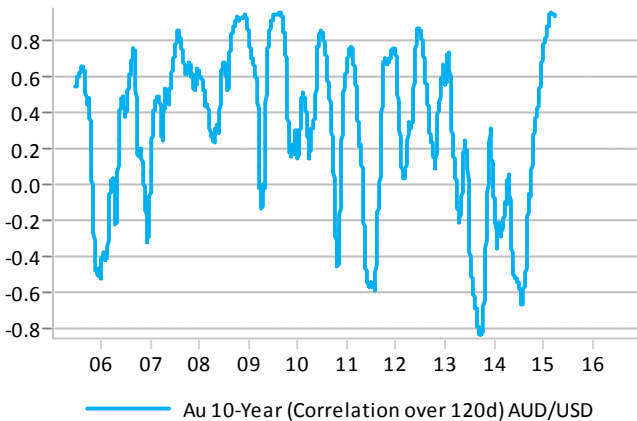
- Growth continues to outperform value globally.
- Despite weakness in the G3 PMI recently, small caps globally have managed to outperform global equities.
- The Australian 10 year and the AUD/USD have been extremely highly correlated in recent months (i.e. declining AUD and bond yields reflecting the weak growth/declining commodity price environment).
- US 10 year yields have been more highly correlated with the G3 PMI rather than the US ISM over the past 18 months. (i.e. global weakness).
- The gold to oil ratio has risen to extreme highs (25 times).

MSCI GROWTH (net TR USD) (RATIO) MSCI VALUE & US 10yr TIPs



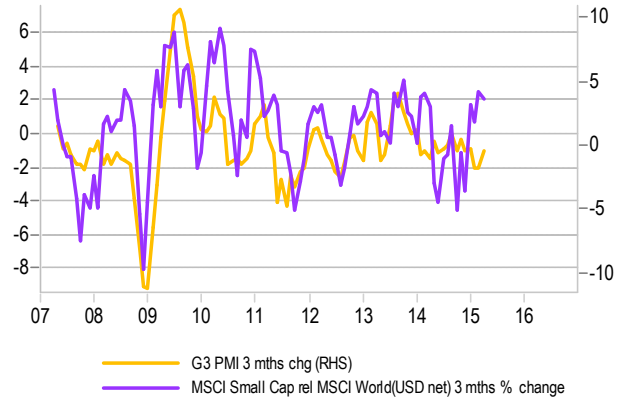
Source: MSCI, FED, using proxy updates

Au 10-Year (Correlation over 120d) AUD/USD



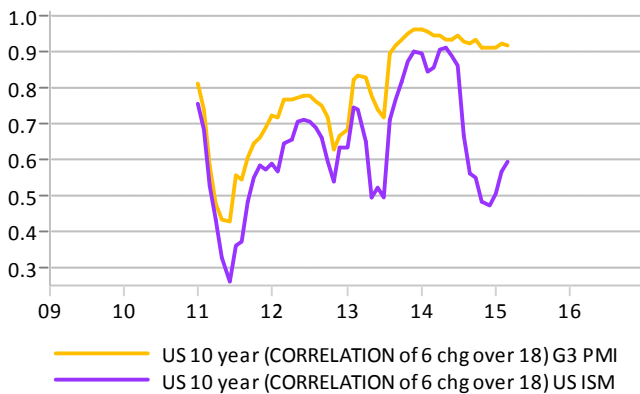
Source: IRESS

G3 PMI & Global Small caps



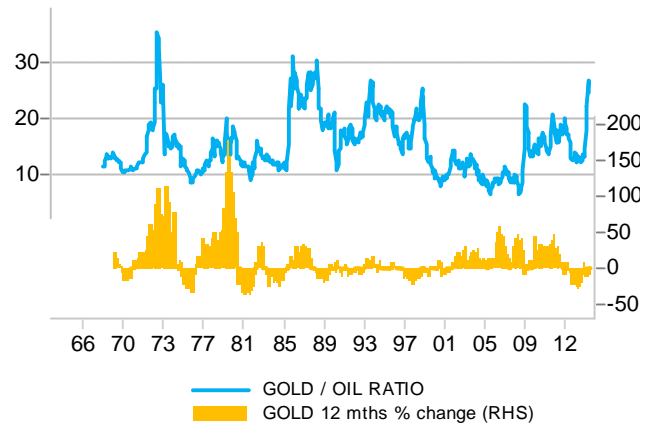
Source: Markit, ISM, MSCI

US 10 year (CORRELATION of 6m chg over 18m) with G3 PMI & US ISM



Source: RBA, ISM, RBA, Markit, ISM

GOLD / OIL RATIO

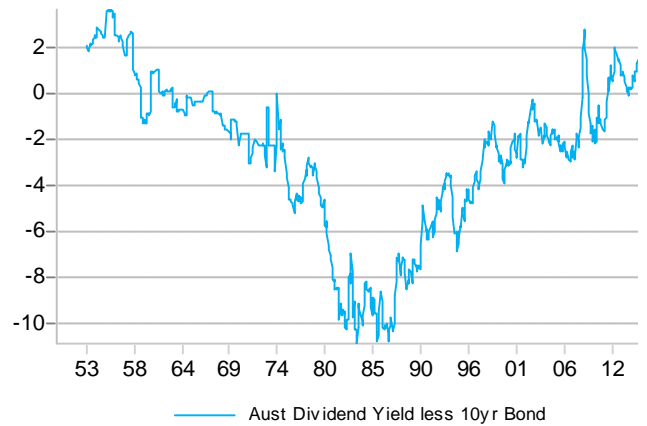


Source: IRESS

OTHER OBSERVATIONS

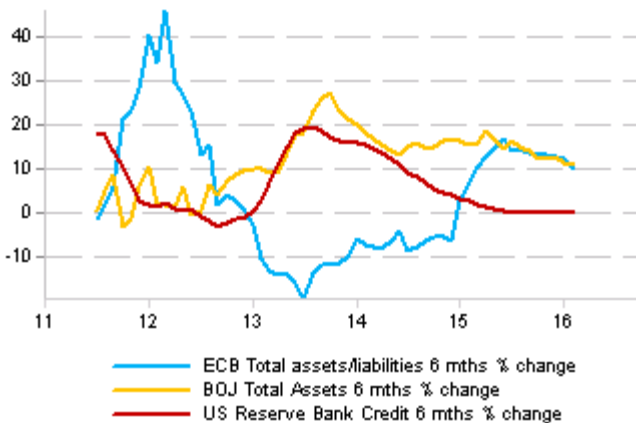
- The Australian market dividend yield relative to the 10 year bond is close to record highs (2%).
- Central bank balance sheets in Europe and in Japan are set to expand 25-30% over the year.
- The drop in oil and US gasoline prices to around US\$2 should prove positive for real disposable incomes (freeing up at least 1 percentage point).
- Iron ore is in the low \$50's range (down 50% over the year), partly reflecting no growth in Chinese steel production.
- Chinese exports expanded by 48% over the year to February. Notwithstanding problems with over-invoicing, the strength in US and European consumer spending is supporting export growth.

ASX 200 Dividend Yield less 10yr Bond



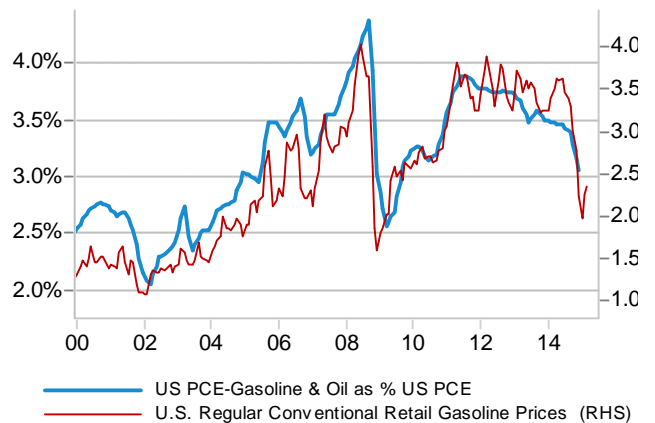
Source: IRESS, RBA, using proxy updates

Central bank balance sheet growth



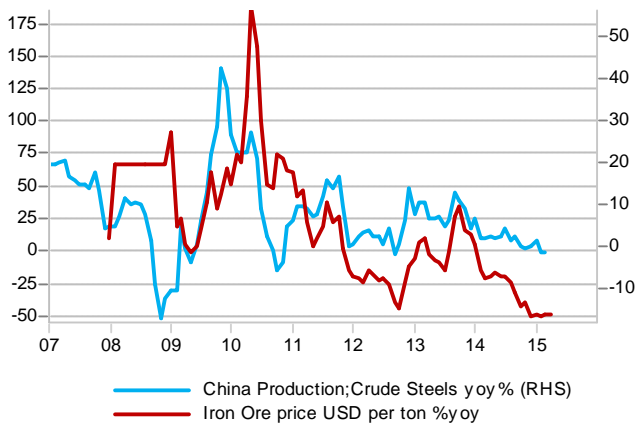
Source: ECB, Economagic, FED, using proxy updates

US PCE-Gasoline & Oil as % US PCE



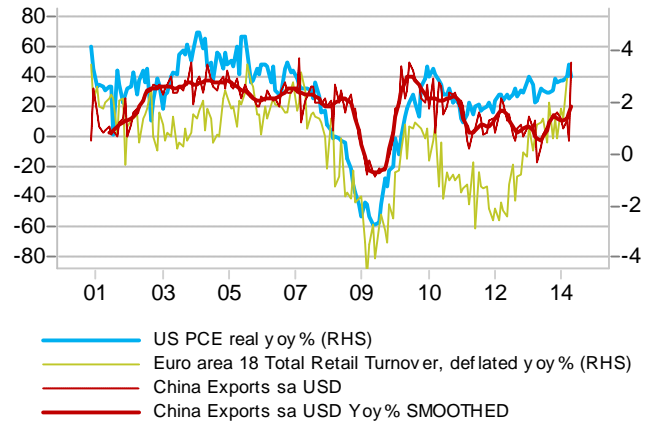
Source: BEA

Iron Ore & China Production;Crude Steels



Source: China NBS, IMF

China Exports & US & Europe consumption



Source: NBS, BEA, ECB

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