CIO Monthly Note

December 2015

Festive cheer despite low growth, if you know where to look

The Australian Bureau of Statistics gave us an early Christmas present last week, reporting that the economy had grown by a better than expected 2.5% to September.

The key question is - what does this mean for investors?

Compared to other developed economies this is a pretty good result, but the growth was driven mostly by net exports. Is this a problem? Does it matter where the growth comes from? The answer is yes because not all growth is created equal.

Firstly, outside of some tax revenue for governments, most of the income generated from booming net exports is funnelled offshore via the large foreign holdings in our major mining companies. In addition, exporting raw materials is much less labour intensive than other forms of economic activity and therefore does not contribute as much to employment growth.

Secondly, although export volumes are booming, the price of Australia's exports relative to our imports declined by over 10% in the year to September. This means the revenue received for those exports is actually declining for the major Australian mining companies. More recently, this has been reflected in earnings downgrades for the major miners including BHP.

This latest GDP release reinforces our view that growth is still slow and the outlook for the domestic economy remains soft.

This means low interest rates and a lower AUD. Although the RBA is 'chilling out' over the Christmas break, they still have an easing bias and are unlikely to raise rates any time soon. They're hoping that the US Fed will begin to raise rates in December which will put downward pressure on the AUD and take the pressure off the RBA to do more.

While the Fed does look likely to begin rate rises in December, we expect the path of interest rate rises to be gradual. This will help keep bond yields low and will continue to support the economic recovery in the US.

Rising US rates will put further pressure on commodity prices and emerging economies via the impact of the higher USD. So we are likely to see more volatility in commodity markets heading in the New Year which will also help to contain any sharp selloff in global interest rates.

In this low growth and low interest rate environment, investors should be careful when investing in companies that are offering unsustainably high yields. The age old adage is that if it sounds too good to be true then it probably is! Although the resource sector appears to be offering an attractive yield at the moment, the underlying revenue stream of the sector is highly cyclical and at the whim of global commodity markets.

Instead we recommend searching for yield in those solid industrial sectors. We are finding attractive opportunities outside of the top-30 including in the diversified financials and consumer services sectors. I wish all my readers a Merry Christmas and hopefully Santa brings us all a little Christmas rally.

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