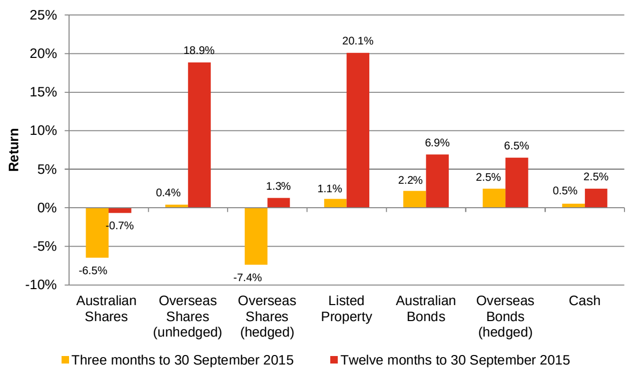
Market mayhem...just another day in the office

30 September 2015

September 2015 Quarter

The September quarter got off to a shaky start as a result of international market volatility and uncertainty that continued from the end of the June quarter. Greece's position in the Eurozone has been stabilised for the time being, while manufacturing and trade data released by China indicated that economic activity is slowing down.

Significant events in the quarter were the change in political leadership in Australia, the unexpected devaluation of the Chinese yuan mid-August, Greece's third stimulus package being approved and the decision by the US Federal Reserve (Fed) to not raise rates in the current quarter.



1. *All market returns shown above are before tax and before investment costs.*
2. *Indices used are outlined in the Disclaimer section of this newsletter.*

Equity markets fell sharply in August due to fears of a slow-down in China's economy and uncertainty leading up to the Fed's interest rate decision in September. The Australian equity market had a turbulent quarter largely influenced by subdued economic conditions, continued weakness in commodity prices, and external events in international markets. The ASX300 index returned -6.5% for the quarter.

Overseas shares fell by a similar amount, but returns were assisted by a fall in the Australian dollar. The Australian dollar fell below US$0.70 for the first time in over five years during the quarter. Overseas shares returned -7.4% on a $A hedged basis and +0.4% unhedged over the quarter.

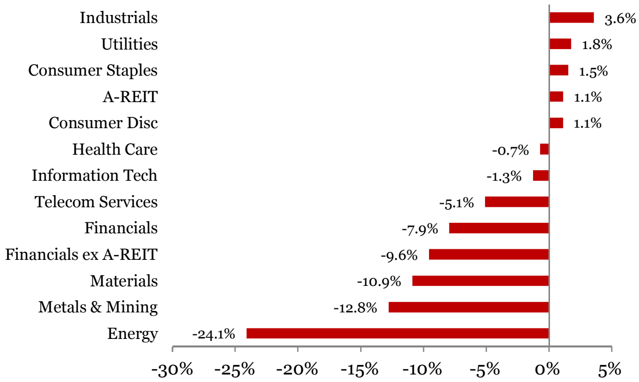
The Fed announced in September that it would keep US interest rates near zero for the time being due to the volatility in global markets and a lack of global confidence. The Fed has signalled that it still expects an interest rate hike by the end of the year.

The Japanese equity market returned -13.7% over the quarter as manufacturers felt the effects of falling demand in China. Europe returned -7.2% over the quarter, while the UK market returned -6.6%. The German and Spanish markets delivered poor returns of -11.1% and -11.3% respectively.

There was significant dispersion between the sectors within the Australian equity market. Energy was one of the worst performing sectors, returning -24.1% for the quarter.

With China's slowing growth leading to lower demand, and high levels of supply for most commodities, prices continue to be low and show little sign of rebounding.

ASX Sector Returns – September quarter



Industrials (+3.6%) led the market, followed by positive returns of between 1 and 2% for the Utilities, Consumer Staples, A-REIT and Consumer Discretionary sectors.

Since 30 September 2015

Most equity markets have rebounded in October, and as at mid-October have recovered just over half of the September quarter losses. The Australian dollar has also recovered some ground from the US$0.70 low in September.

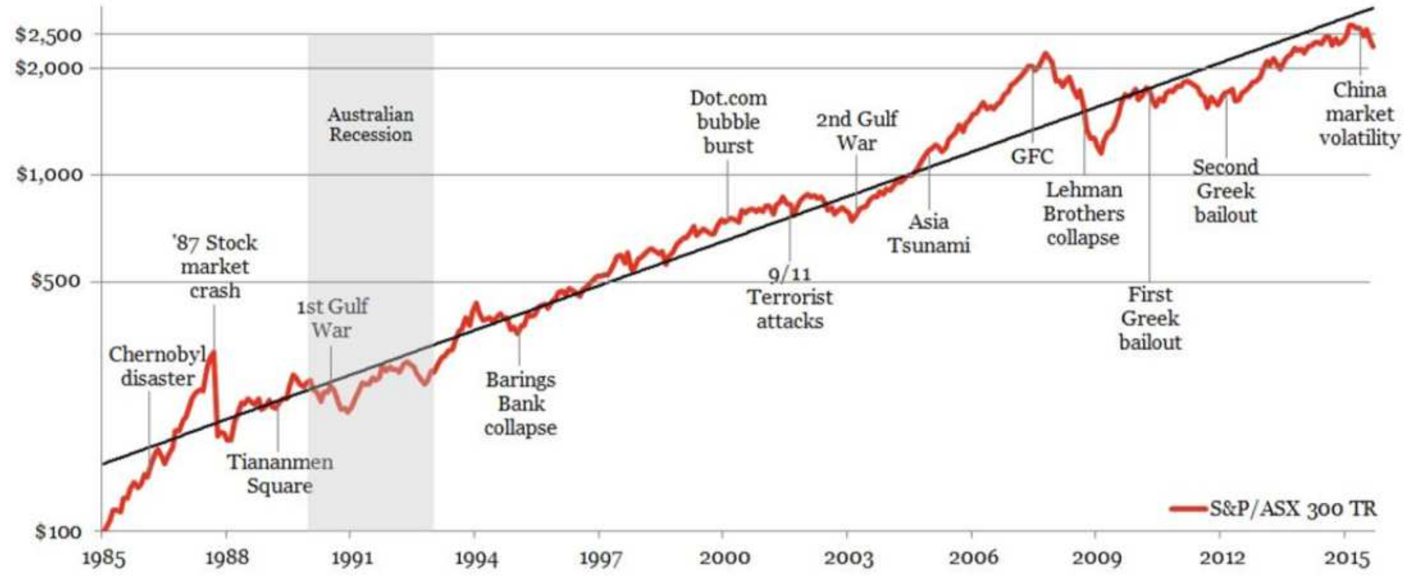
The Metals & Mining, Materials and Energy sectors have rebounded strongly returning 13.5%, 10.3% and 10.1% respectively for the first half of October.

Some longer term themes

Some key issues going forward include:

- **Chinese Economy** – The markets continue to be focussed on the slow-down in the Chinese economy, and fears that it will be worse than expected. The annualised growth rate in Chinese GDP fell to 6.9% in the September quarter, which was slightly ahead of expectations, but other recent economic data has pointed to lower growth.
- **Resource/Commodity Prices** – Resource and commodity prices have fallen substantially, circa 50-70% since their peak several years ago. These prices are unlikely to recover in the short-term due to supply still outstripping demand; however, prices may have reached the bottom for this cycle.
- **Fed Rate Rise** – The Fed has deferred its rate hike, and may defer it again into 2016. Inflationary pressures remain weak, but speculation around the timing of the rate hike will likely lead to continued volatility.
- **European refugee crisis** – Over 500,000 refugees have entered Europe this year primarily from Syria. The economic impact is not known, however, it is expected the refugee influx will put strain on the EU.

Volatility – a long term perspective



Currently the economic slowdown in China is dominating headlines worldwide, largely based on the knock-on effects it may have on global growth. Over the past 30 years numerous large scale events and perceived crises have occurred, but in each case the Australian equity market has managed to recover and ultimately returned to its long term growth trend-line.

Despite all of this, over the full period the Australian equity market has achieved a return of 10% per annum.

The two larger corrections over this time (the 1987 crash and the GFC) occurred following periods where the market clearly got ahead of itself.

The logarithmic scale used in the above chart hides some of the recent volatility, but this chart seems to show that over the long term the market will reward investors, and that with the benefit of time a 'crisis' is not as bad as it seemed at the time.

> *"History says the greatest bull markets climb the wall of worry. When no one has any worries when there's no clouds on the horizon that's when I want to get out of the market." – Jeremy Siegel*

The World according to Market Capitalisation

The following chart shows a map of the world based on free-float market capitalisation ($US bn):

The map is dominated by the US, with a market cap of $US19.7 trillion, it represents 52% of the world's market cap. With a population of 300 million, the US share market is over twenty times the size of the Chinese market which has a population of 1.5 billion.

One of the reasons China's position appears relatively small on this map is the fact that a large portion of Chinese shares (China A Shares) are restricted for most foreign investors. As a result Chinese shares are not fully reflected in the global market indices, despite their significant market cap.

Source: Bank of America Merrill Lynch

Providers of global market indices such as MSCI intend to add Chinese A shares to their indices, but this is conditional on resolving issues around accessibility for foreign investors. Chinese regulators have been working to reform its stock exchanges, but even once these issues have been resolved, the inclusion of Chinese A shares in global indices is expected to be a very gradual process.

At full weight, China's total weight in the MSCI Emerging Markets Index would double from current levels of about 20% to over 40%, and would reach almost 6% in the MSCI All Countries World Index.

Most global equity investors benchmark themselves against a market capitalisation index like the MSCI World Index, which means that at their neutral position 52% of the portfolio is invested in the US. The US is a very attractive place to invest, but do we really believe that 52% of the investment opportunities in the world are located in the US?

Bitcoin and Blockchain Technology

Stone & Chalk, the first financial tech hub in Australia, launched in Sydney late August 2015 with 41 start-ups and 120 people. The initiative received over $2 million in funding from corporations and the government in an effort to improve innovation in the financial services sector. One particular focus area, blockchain technology, is generating significant interest not only in the financial sector, but in the broader world.

How does it work?

A blockchain is essentially a record of a set of events that have occurred over a particular time frame. Transactions are recorded as they occur and are stored in a way such that historical transactions cannot be altered or manipulated. Users can contribute to the network by providing computational power to assist with the verification of transactions in real time in a process called “mining”. The technology has become increasingly popular because:-

- Data can be stored securely. Blocks are stored as read-only under a unique block ID. Any changes made to the block will alter the block ID and the chain will be broken. The blockchain is only updated by a consensus of a majority of the participants in the system.
- The blockchain system is distributed so that a single node failure will not shut down the entire network.
- The technology has made major improvements in the costs and efficiencies in making transactions by removing the use of a third party or centralised authority (i.e. a bank or a government) in each transaction.
- A digital audit trail is created without compromising the privacy of its users.
- Participation is restricted only by access to technology, rather than by factors such as having a credit history or bank account.

Blockchain is the technology that sits behind Bitcoin and other cryptocurrencies. A cryptocurrency is a medium of exchange like a traditional currency. It has no physical form thus making transmission of value easier and safer from counterfeiting.

Current Use

A report by Juniper Research predicts that Bitcoin will have 5 million active users by 2019.

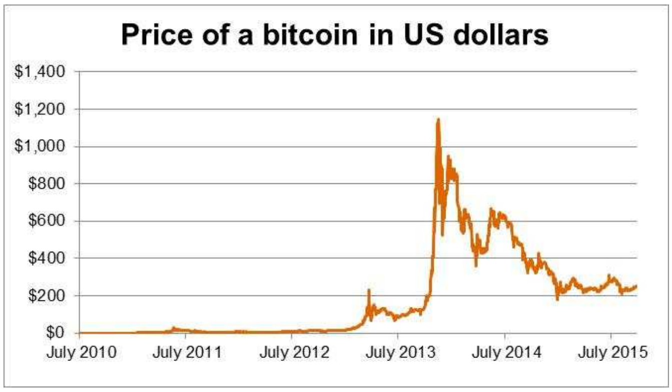
Blockchain technology has already had an impact on the way we bank today. Major companies such as Dell, Expedia and Microsoft already accept Bitcoin payments, and major banks such as Barclays have already started collaborating with blockchain start-ups.

Estonia currently secures much of its banking infrastructure on blockchain technology and boasts the lowest rate of credit card fraud in the Eurozone.

The technology has also made a social impact in recent times, particularly in the refugee crisis in Europe. BitNation, a blockchain-based initiative, provides refugees with digital identities as well as easier and faster access to funds.

Challenges

Growth in the market has been driven largely by investors financing the technology infrastructure or seeking to profit from price fluctuations rather than by consumers actually using the technology. The challenge going forward is growing acceptance among consumers and vendors. Price volatility and the opportunity for speculative investments encourage consumers to use cryptocurrencies, such as Bitcoin, to trade rather than to purchase goods and services. Greater understanding and consumer protection is likely to encourage widespread acceptance among consumers and vendors.



Source: Coindesk.com Bitcoin Price Index, October 2015

Another area of concern is the current use to enable activities such as money laundering and trading of illicit substances. While transactions are made public, user identity is harder to trace. Regulators have cracked down on some activities in the past; for example, Silk Road was shut down in October 2013 for facilitating such activities.

As regulation around blockchain technology continues to develop, heavy regulation has the potential to discourage user demand. International responses have been mixed, with Chinese regulators imposing strict restrictions on the use of Bitcoin while US regulators are keen to provide regulatory guidance as the marketplace evolves.

While the technology has been praised for increasing transparency and security, the system is still vulnerable to thefts and hacks, such as the recent cyber theft that swiftly drove the Bitcoin exchange Mt.Gox into bankruptcy in February 2014.

Additionally, as the network grows, control over the network may become concentrated as only a small group of parties will have the resources to keep the network running. This presents a serious security risk as the group is small enough to coerce or coordinate collusion.

Future Developments

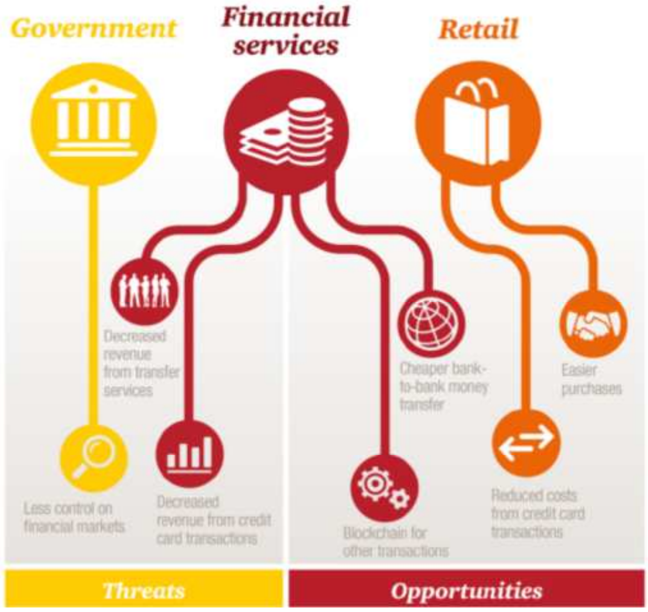
Blocks are able to record more than just transactional data, hence the increasing interest and development in other areas of modern society such as health records and lawsuits.

Source: “Money is no object: Understanding the evolving cryptocurrency market”, PwC August 2015

The technology could have a significant impact on securities trading if investors can trade shares directly and the middlemen, e.g. brokers, are removed. These parties are at risk of becoming obsolete in the near future, hence why many are actively embracing the developments in blockchain technology.

Blockchain transactions are not legal tender like state-backed currencies; however, digital currencies are being explored by Citi Venture.

In the coming years, we expect more challenges to emerge such as tax evasion, bribery payments and terrorist financing. The technological innovation of cryptocurrencies – speed, secure transfer and store of value, and user privacy – are and will be increasingly exploited by hackers and criminals. Regulators are developing solutions to prevent financial crime as well as tax and accounting issues. A major regulatory hurdle is the asset classification of cryptocurrency as currency, capital asset, security or commodity.



Source: "Money is no object: Understanding the evolving cryptocurrency market", PwC August 2015

Finally, given the low barriers to entry, blockchain technology could create new opportunities in the developing world where more people are likely to be to have a mobile or internet connection than a bank account. People would be able to carry out transfers locally and globally almost instantaneously at reduced costs.

These developments have the potential to 'disrupt' the banking and payments systems and many other financial services companies in the future. A world without notes, coins, and banks may be difficult to imagine, but it is not beyond the realms of possibility.

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Indices Used:

Australian Shares: S&P/ASX300 Accumulation Index

Overseas Shares (unhedged): MSCI World(Ex Australia) Index in Australian dollars

Overseas Shares (hedged): MSCI World(Ex Australia) Index (hedged)

Listed Property: S&P/ASX300 Property Trust Accumulation Index

Australian Bonds: Bloomberg AusBond Composite Bond Index (All Maturities)

Overseas Bonds (hedged): Citigroup World Government Bond (Ex-Australia) Index (Hedged)

Cash: Bloomberg AusBond Bank Bill Index

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