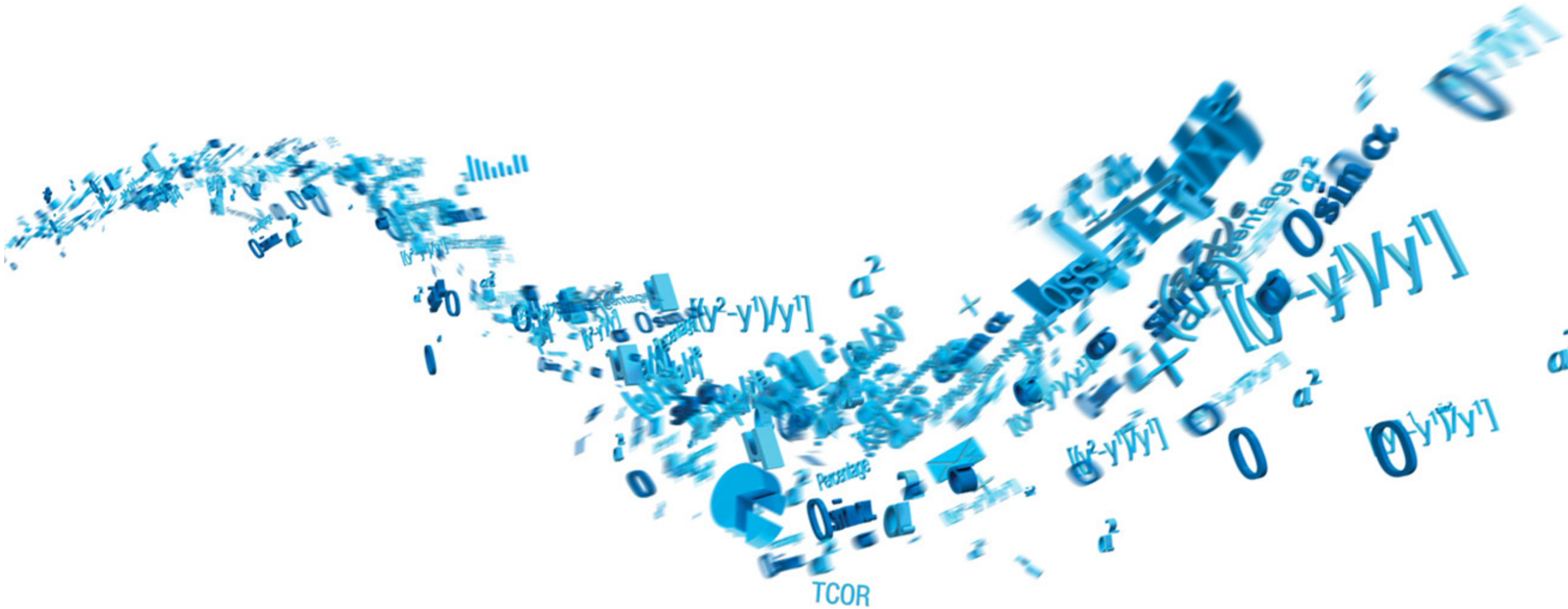


Australian Equities – A need to be patient

February 2016

Aon Hewitt | Global Asset Allocation | Global Investment Practice

Investment advice and consulting services provided by Aon Hewitt Investment Consulting, Inc., an Aon Company.

Empower Results®

Executive Summary

- **Australian equity market prospects are still underwhelming near-term. However, conditions are not unequivocally negative so if positions are underweight or light, it makes sense to consider adding and entry points this year look worth considering. We are more optimistic from 2017 onwards.**
- **Australian equities have struggled over the last two years**
  - Australian equities have performed in line with the commodity super-cycle over the long term. The recent end of this super-cycle and, in particular industrial metals, strongly weighed down on Australian equities.
- **Economic conditions have started to show some signs of improvement but are still weak**
  - The fall in industrial metals in the past 3 years has directly impacted Australian companies. The number of bankruptcies and unemployment has been rising over this period. The economic dataflow has been disappointing market expectations for a while as well.
  - On the bright side, the Purchasing Managers' Index has been improving recently and is now above 50, indicating expansion. Furthermore, unemployment growth is now starting to slow.
- **The earnings outlook is weak for 2016**
  - We see downside risk to consensus earnings forecasts. We believe earnings could decline more than 0.5% in 2016. Earnings for the two largest sectors, Financials and Materials, could also disappoint.
- **Absolute valuations are mixed, while Australian equities look attractive in the long term**
  - As with our view for global equity markets, Australian equities are supported on a relative basis against bonds. Similarly, Australian equities are attractive on a cyclically adjusted Price-to-Earnings measure. However, these two arguments are more relevant for the long term rather than medium term. When we look at medium term earnings based valuations for Australian equities, they do not yet appear cheap.
  - The recent market correction is moving our view towards being positive, but it appears too early to make a positive case, as we believe further underperformance is likely.

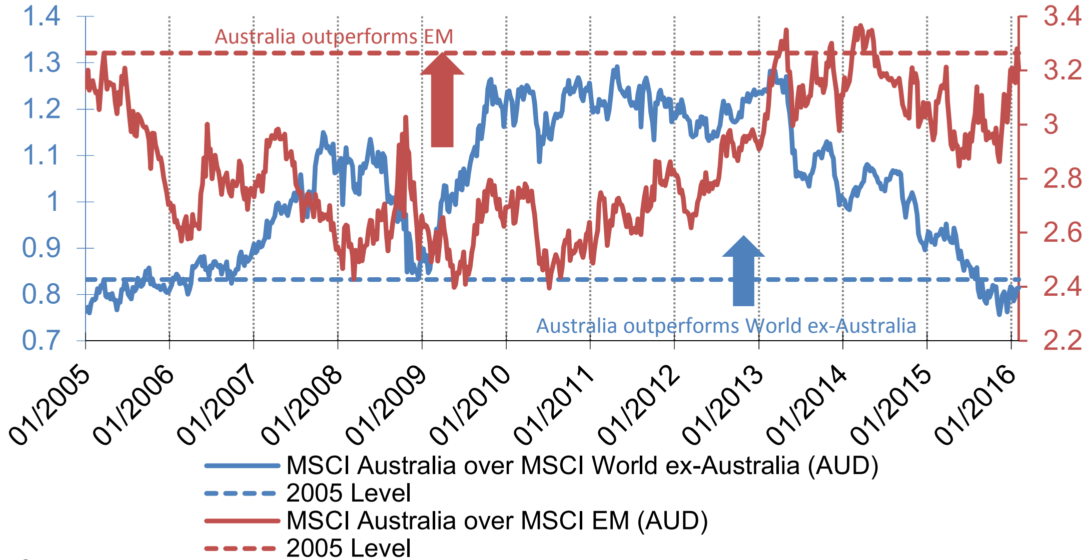
Performance Review

Performance vs. World ex-Australia Equities

Australian equities have underperformed significantly… Will this continue?

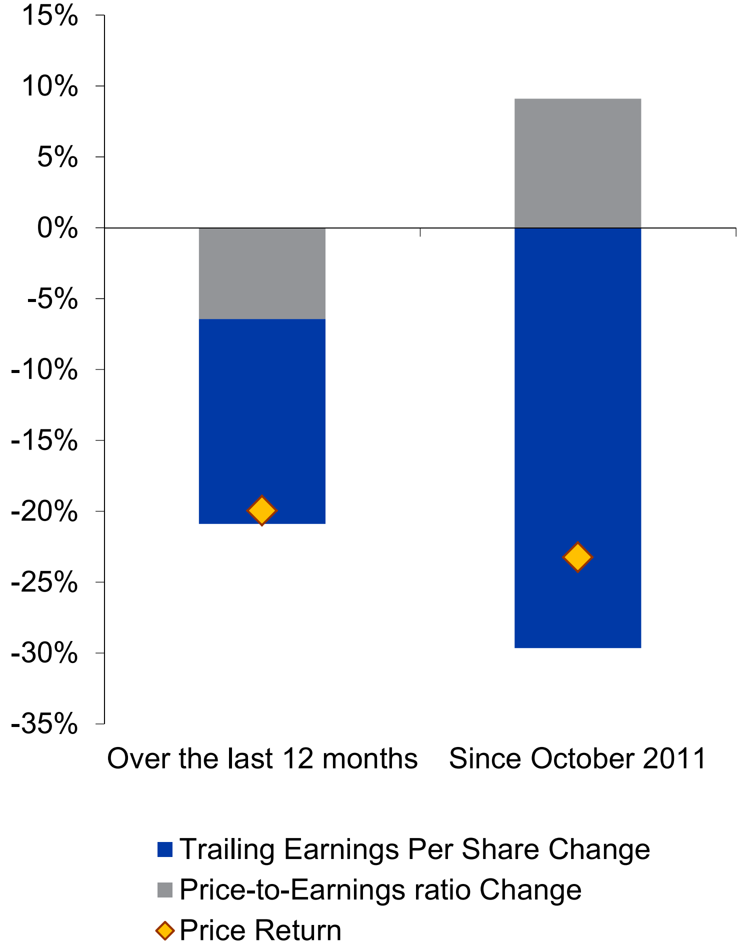
- Australian equities have underperformed World ex-Australia and Emerging Markets equities over the last 3 years.
- Australia has been directly impacted by the fall in commodity prices, especially industrial metals. The fall in commodity prices from the 2008 peak and more recently has been driven by Chinese growth slowing, decreasing CAPEX by companies and a slowdown in emerging economies in general.
- Underperformance started in 2011, when emerging economies began to struggle and commodities renewed their decline after recovering in 2009 and 2010. Since then, Australian equities have lost more than 20%, driven by lower earnings and contracting valuation multiples (see chart on the right).
- **When compared with World ex-Australia and EM equities, Australian equities are back to their 2005 level (see bottom chart). Could we see a rebound?**

Australian equities are back to their 2005 levels relative to the rest of the World and Emerging Markets



Source: Datastream, Aon Research

Australian underperformance has been driven by falling earnings and, more recently, falling valuation multiples too (data in USD)



Source: Datastream, MSCI, Aon Research

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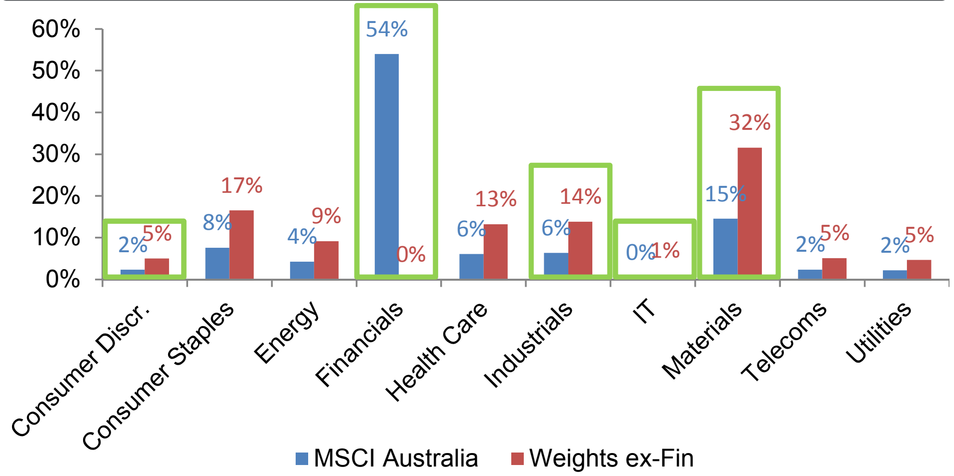
Australian Equities:
A very concentrated index and clearly pro-cyclical

- The Australian equity index is dominated by financials and materials sectors. If we recalculated the weights excluding financials, the materials sector would dominate (see top chart).
- Sector exposure is clearly weighted towards 'cyclicals' , as financials, industrials and materials represent 75% of the index. This pro-cyclical characteristic implies Australian equities should benefit from strengthening economic activity.
- Australian equities are very closely linked to commodity prices, especially industrial metals. Returns of both indices are highly correlated, with the 5 year rolling performance correlation slightly higher than 0.6.
- Both the MSCI Australia and the S&P ASX 200 are very concentrated indices and have a very similar sector breakdown. The top 10 holdings in the MSCI Australia index account for 56% of the index. If we extend this to the top 20 holdings, they sum to 72% of the index with financials reaching 46% of the index.
- As shown in the top chart, the financial sector represents 54% of the MSCI Australia index, 38% of which is the 4 major Australian banks.
- We will focus on the Financial and materials sectors further in the appendix, since they are so pivotal to the view on the overall index.

MSCI Australia index exposure by sectors



Source: Datastream, MSCI, Aon Research

MSCI Australia Index - Top 10 Holdings

Company	Sector	Weights in MSCI Australia
Commonwealth Bank of Australia	Financials	12.22%
Westpac Banking Corporation	Financials	9.48%
Australia And New Zealand Banking Group Limited	Financials	6.96%
National Australia Bank Limited	Financials	6.80%
BHP Billiton Limited	Materials	5.26%
CSL Limited	Health Care	4.24%
Wesfarmers Limited	Consumer Staples	3.88%
Woolworths Limited	Consumer Staples	2.72%
Macquarie Group Limited	Financials	2.21%
Telstra Corporation Limited	Telecommunication Services	2.08%

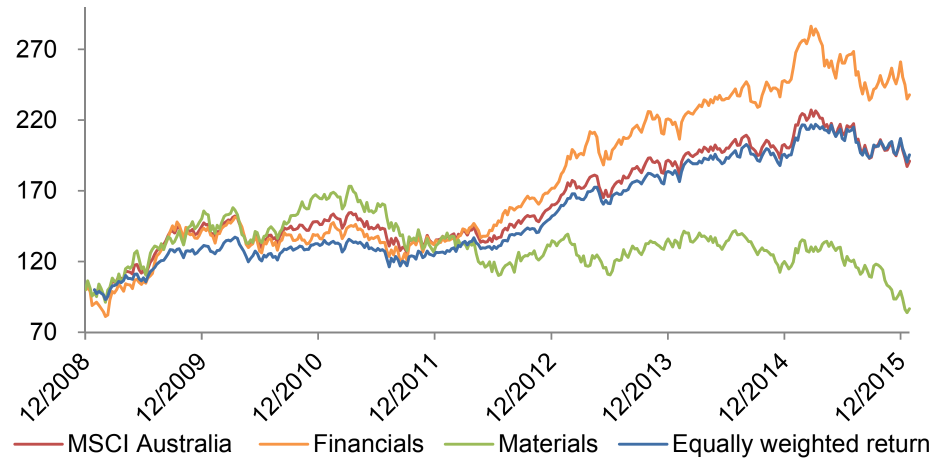
Source: MSCI as of 30 November 2015

"Cyclicals" using MSCI classification

Australian Equities:
How the sector exposure impacts the performance?

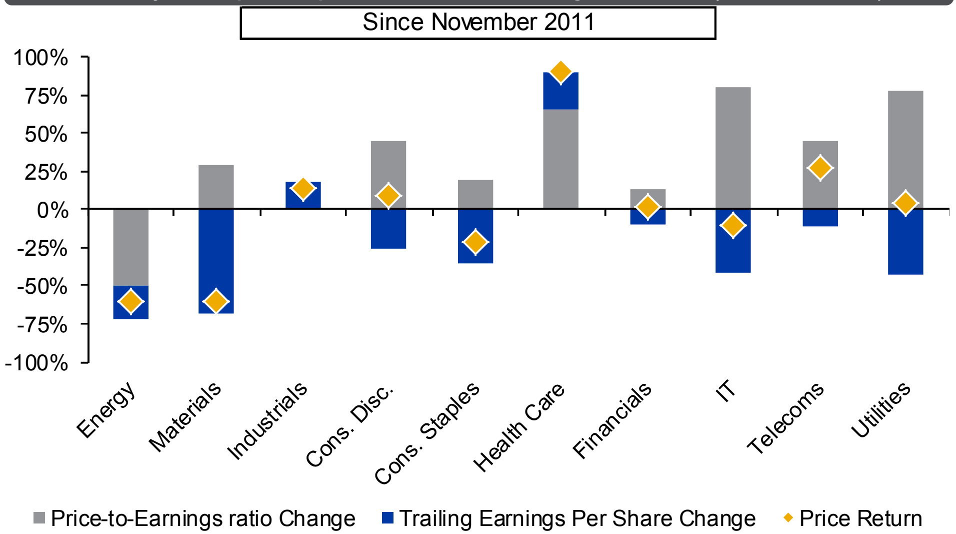
- So what would happen if we adjusted for the sector weightings? The answer is that the performance of the index would have been the same.
- In the charts, **we have calculated sector neutral versions of the MSCI total return indices and it is clear that this displays no significant difference in returns over the past 7 years compared to the standard index.**
- The standard index outperformance between the end of 2008 and the first quarter of 2011 came from the overweight in Financials and Materials sectors. Since 2011, the underperformance in materials has been offset by the strong performance of financials explaining that equally weighted and the standard index are in line.
- The bottom chart shows that all Australian sectors, except Industrials and Health Care, suffered earnings declines since November 2011. Materials suffered the largest earnings decline with a fall of 67.7%
- We emphasise that **this situation is unsustainable and earnings must rebound to support a rally of Australian equities.**

MSCI Australia index exposure by sectors



Source: Datastream, Aon Research

Returns by Multiple Expansion and Earnings Growth (data in USD)



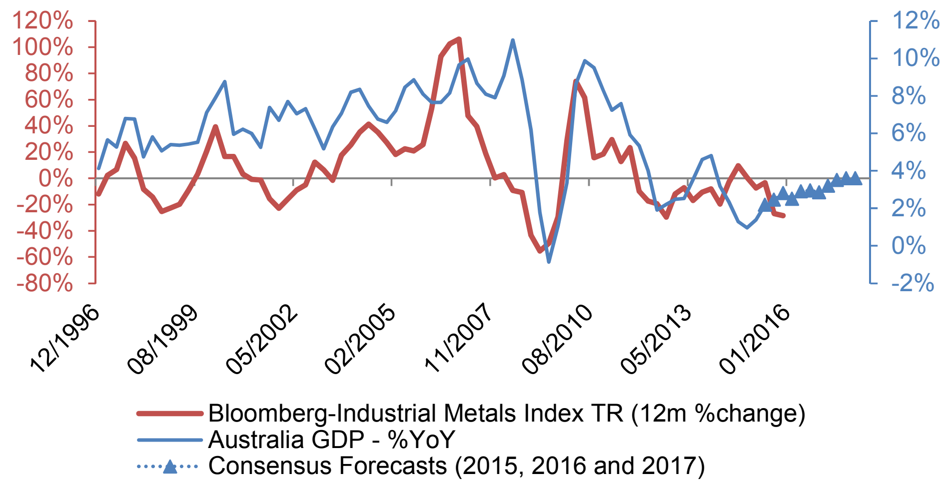
Source: Datastream, MSCI

Macro Backdrop and Monetary Policy

The fall in industrial metals has hurt the Australian economy

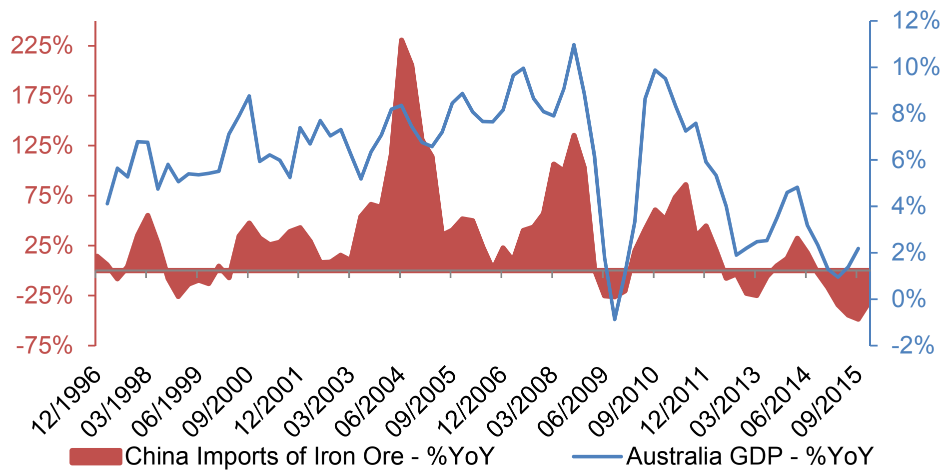
- Australia's economy has fared very well over the last dozen or so years. Economic growth has been relatively stable, and consistently at or above 2%. The economy has only undergone 2 quarters since 2001 of negative quarter-on-quarter GDP growth. To give some perspective, the US has undergone 9 such quarters over the same period, with 14 for the Eurozone and 22 for Japan.
- China was a massive help, providing ample demand for exactly what Australia had to offer – raw materials. China is Australia's biggest export market and exports of Iron Ore and Coal account for a third of Australia export revenue in the last few years. However, now lower commodity prices, in combination with China's growth transition towards consumers and away from infrastructure investment, should raise Australia's already large current account deficit.
- **The fall in bulk commodity prices has adversely affected government revenue, company profits and household disposable income.**

Australian GDP growth suffers from the fall in metals prices



Source: Datastream, Aon Research, Barclays, J.P. Morgan

The slowdown in China has directly impacted Australian GDP

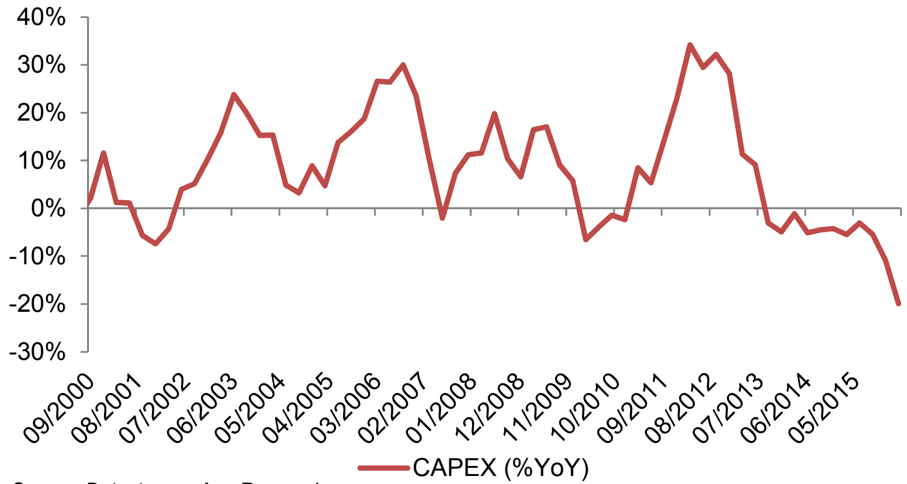


Source: Datastream, Aon Research, Barclays, J.P. Morgan

Companies have had to manage a decline in profits

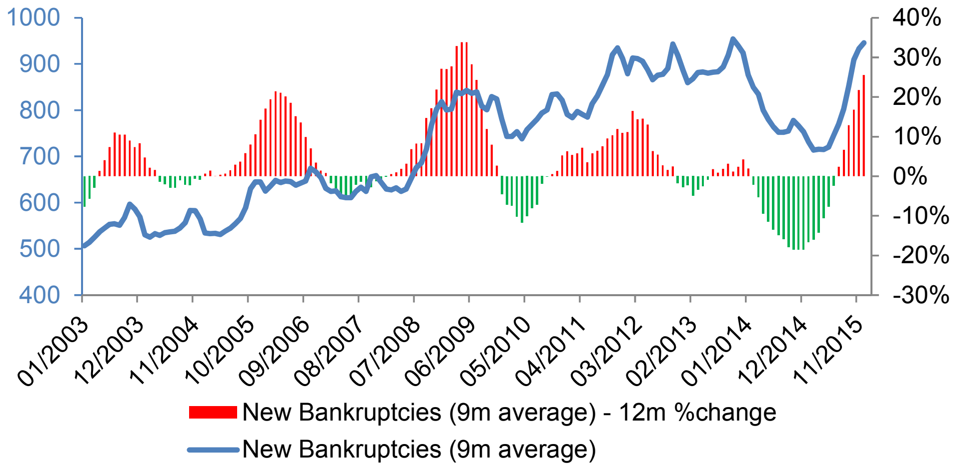
- Companies related to the mining sectors have had to adjust their production levels and limit commitments to business spending. However, it appears that the decline in commodity prices and company profits have been bigger than anticipated and **companies have responded with further cost-cutting measures and by reducing capital expenditure (CAPEX) even more**.
- Non-mining companies have also suffered from the exchange rate weakness associated with commodity price declines. Since Australia imports lots of its capital goods, many companies have cut investment spending (See top chart).
- This has had a direct impact on employment levels in Australia. **Unemployment has been rising over the last 4 years** (bottom right chart). More recently the number of bankruptcies has significantly increased too (bottom left chart).

CAPEX collapses over the last 4 years



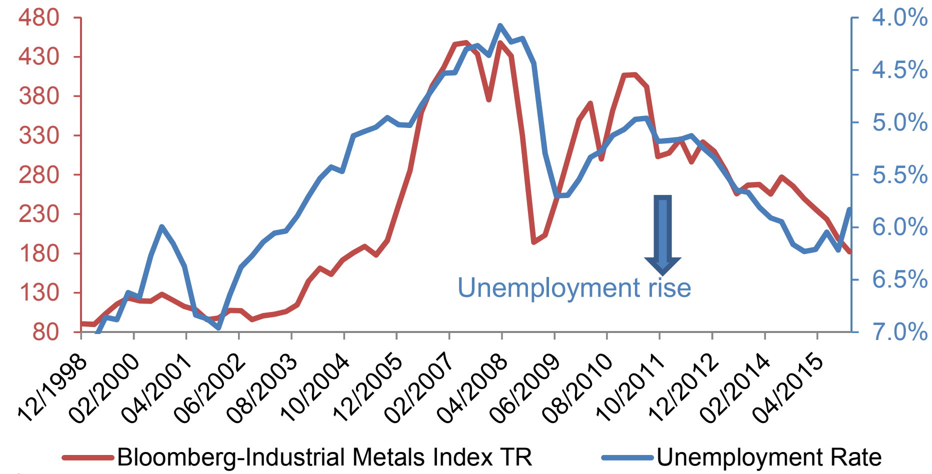
Source: Datastream, Aon Research

Number of bankruptcies has been increasing over the last 12 months



Source: Datastream, Aon Research

Unemployment has been rising since 2011

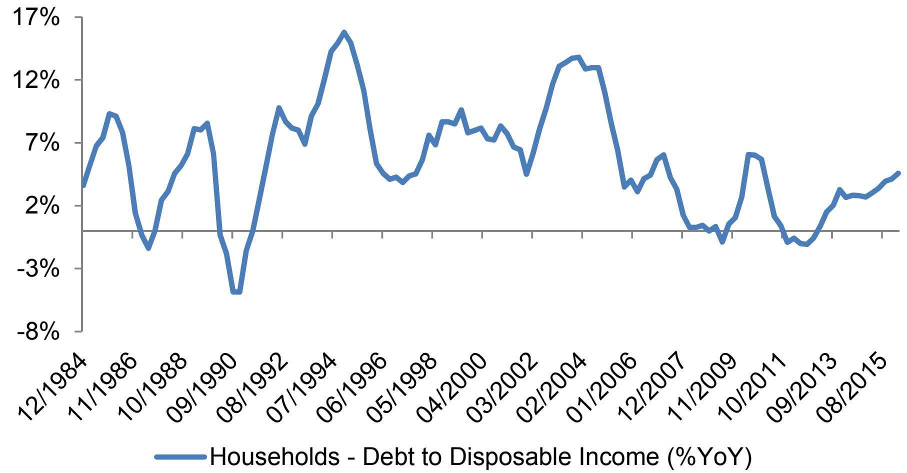


Source: Datastream

The Australian domestic economy is under pressure

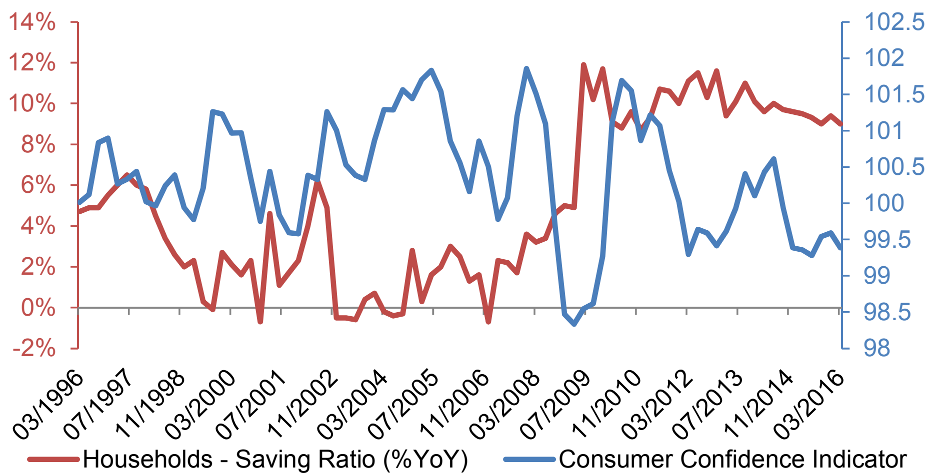
- From the previous slide, it is not surprising to see that household disposable income growth is slow, much lower than the pre-crisis level. Therefore, household final consumption has been growing slowly as well (see bottom right chart).
- Moreover, high household debt and what some are labelling a housing bubble present downside risks to growth that cannot be ignored (see top chart). In the appendix we have taken a closer look at the housing market.
- Household demand is relatively low as indicated by a high savings ratio and falling consumer confidence (see bottom left chart).
- **The Australian domestic economy appears relatively weak and has limited power to support GDP growth.**

Households debt to disposable income is rising



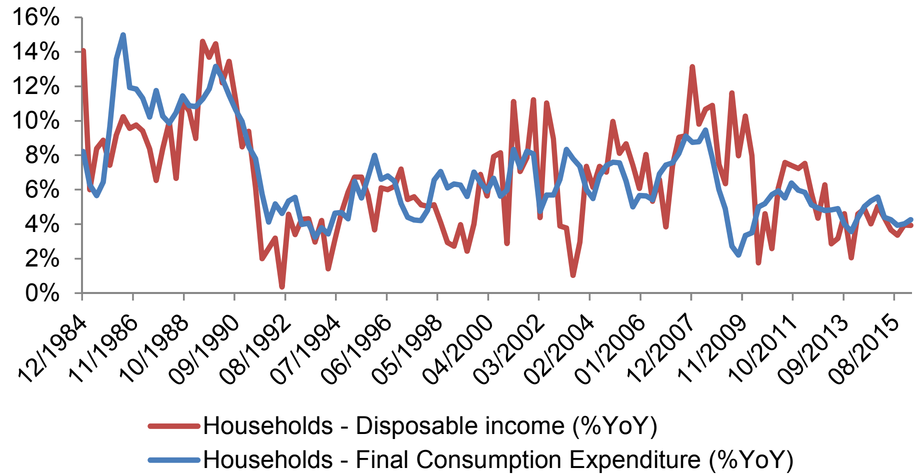
Source: Datastream, Aon Research

Consumer confidence and saving ratio weighing on demand



Source: Datastream, Aon Research

Weak disposable income and consumption growth

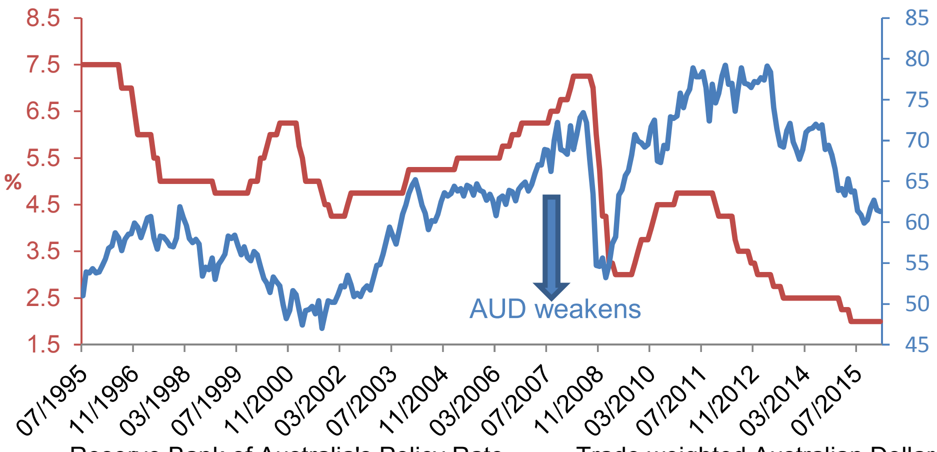


Source: Datastream, Aon Research

But Australia is showing signs of resilience thanks to an accommodative monetary policy

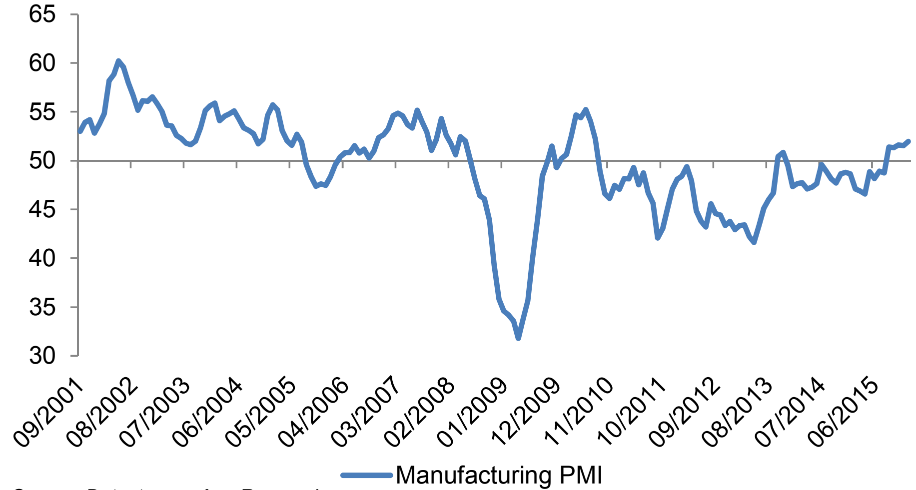
- The Australian government is maintaining an accommodative monetary policy to support economic activity, but this could take time to translate into a GDP growth pick-up and further rate cuts could be needed to have a stronger impact.
- This should help the non-mining sectors, which are more sensitive to interest rates, and exporters through the Australian dollar depreciation.
- Australia's Purchasing Managers' Index has shown some improvement over the last 6 months and is now above 50, indicating expansion.
- The Australian economy is adapting to a new environment after the commodity boom that we think will last until the end of 2016. The Australian government is acting to support the economy, but the speed at which the economy will expand is key.
- **Even if Australia is showing some signs of resilience in employment, wages and business activity, we believe the process will be slow and significant improvement should only start to occur from 2017.**

Low interest rates and low exchange rates provide support to the domestic economy



Source: Datastream

Australia's Purchasing Managers' Index has improved recently too



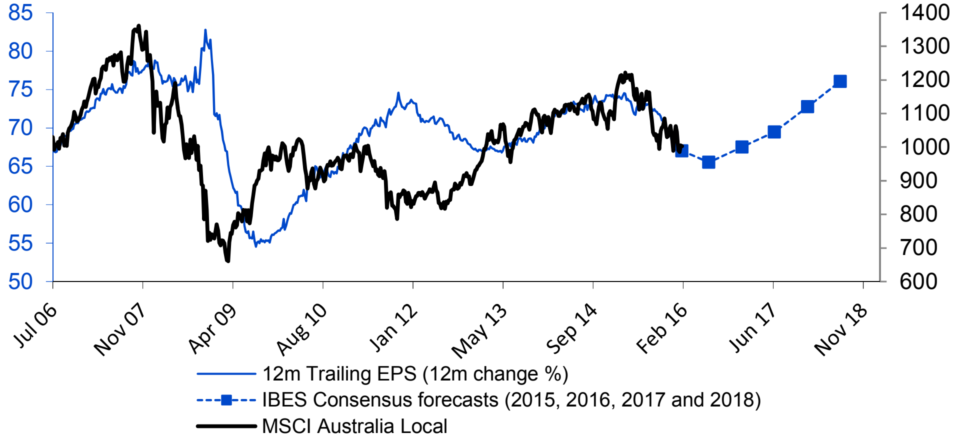
Source: Datastream, Aon Research

Earnings Outlook

Australian Earnings Expectations:
Growth is expected to be broadly muted over the next 18 months

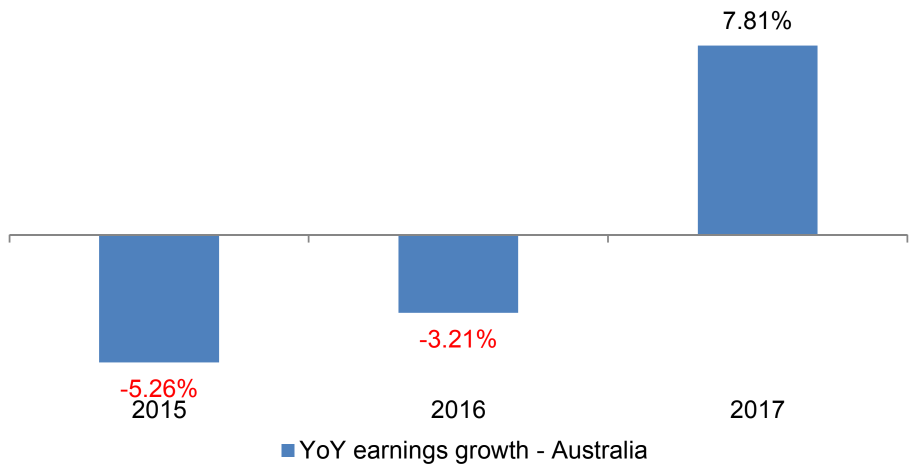
- Earnings peaked in October 2014 and have been decreasing ever since, on the back of declining commodity prices and industrial metals in particular (see top right chart).
- Looking ahead, earnings are not expected to rebound strongly (see bottom chart). This is due to the slowdown in EM countries, in particular China, as well as the ongoing supply overhang of commodities.
- Sales growth forecasts have been deeply affected by the China slowdown, with the latest expectation of -1.2% growth in 2016, followed by a rebound to 4.7% growth in 2017.
- Unsurprisingly with negative sales growth, earnings growth for 2016 is also expected to be negative at -2.4%.
- The fall of industrial metal prices has removed less efficient iron ore producers from the market and we believe now that most of the downward pressure is gone, even though the market still looks oversupplied. We expect to see the supply/demand balance become more even over 2016, but the real impact won't be until 2017. This should help the materials sector to recover.
- **The real rebound in earnings is expected in 2017, but will only happen if global growth accelerates.**

Earnings declined significantly in 2015



Source: Datastream, IBES, Aon Research

Earnings are expected to rebound in 2017



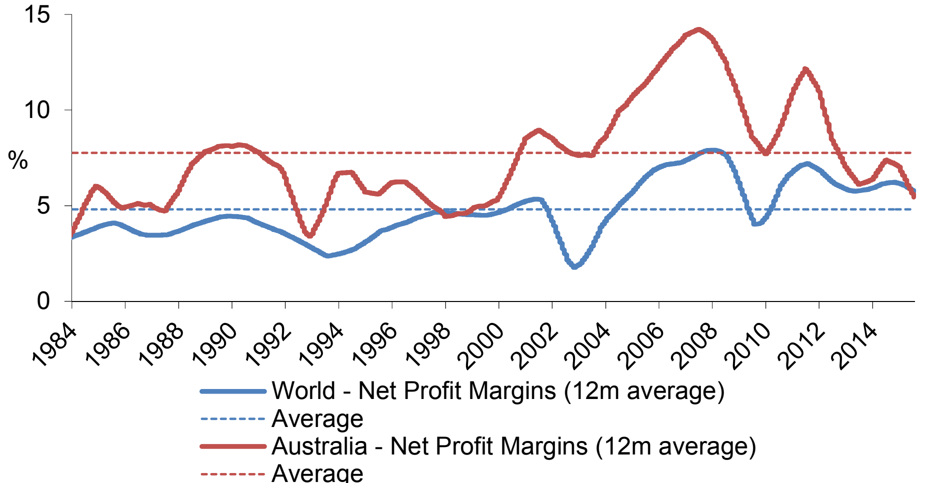
Source: Datasteam, IBES, Aon Research

Australia vs. World Profit Margins

Australian net profit margins could continue to disappoint

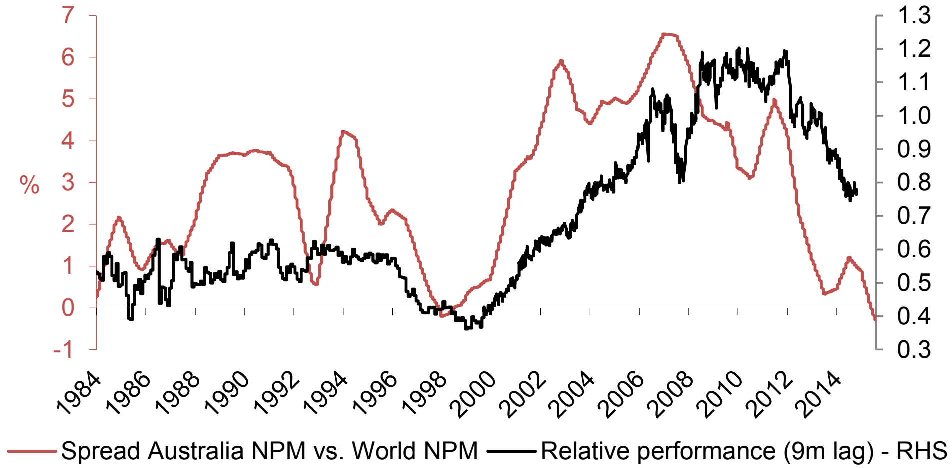
- Company net profit margins have been falling all over the world. In the context of declining commodity prices, Australian company net profit margins have suffered. They are now back to their early 2000s levels, before the commodity "Supercycle" became prominent. Moreover, they are still heading lower.
- The relative trends in profit margins between Australia and World equities will be critical to Australia vs. World performance. The bottom chart shows that trends in relative performance follow trends in relative profit margins.
- From this indicator and the actual net profit margins numbers, we believe some further underperformance is likely for Australian equities.
- We believe that the outlook for commodities, and in particular for industrial metals, will be weak. Industrial metals prices are being penalized by excess global supply and weaker EM demand for metals (see our recent note: Commodity Outlook: Is the worst behind us?).
- **Therefore, a strong improvement in net profit margins looks unlikely in the near term.**

Australia NPMs are low, but still have some room to disappoint



Source: *Datastream, Aon Research*

The gap between World NPMs and Australian NPMs indicates further underperformance is likely

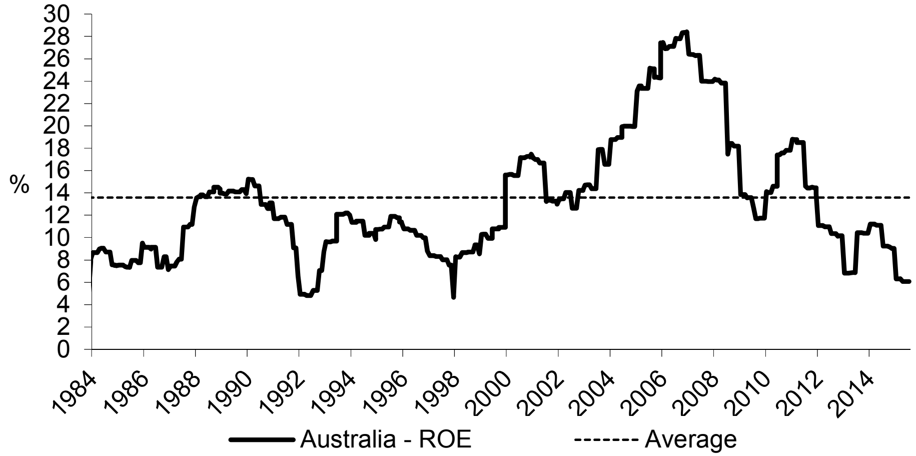


Source: *Datastream, Aon Research*

Australian Return On Equity should be supported by the increase in leverage seen over the last 12 months

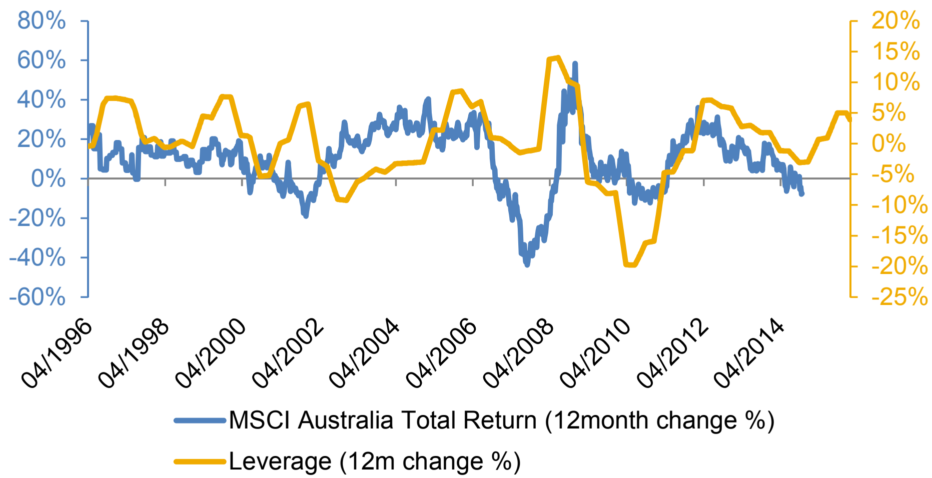
- The return on equity (ROE) for Australian equities is significantly lower than its 30 year average.
- We believe that ROE will improve from current levels, not driven by increasing profit margins (previous slide), but thanks to the increase in leverage that occurred over the last 12 months, which was in turn triggered by the Reserve Bank of Australia's accommodative monetary policy.
- The bottom chart shows that leverage of the non-financial sector is below its 30 year average. If confidence improves gradually and the central bank maintains its accommodative monetary policy, a rise here will boost profits.
- **If ROE improves, it further suggests that current earnings growth expectations are sensible.**

ROE is close to its lowest level for many years



Source: Datastream, Aon Research

The annual change in leverage leads Australian equity performance

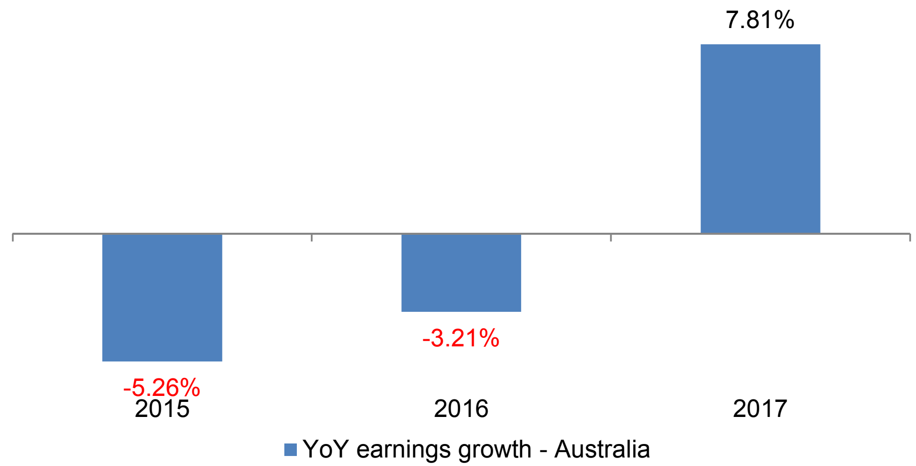


Source: Datasteam, IBES, Aon Research

The Earnings Outlook:
The fall will slow over 2016, but will not rebound until 2017

- We believe the fall in Australian earnings is likely to continue for now. 2016 forecasts still look slightly optimistic to us as we believe earnings could decrease more than 0.5% due to low profit margins and negative sales growth expectations.
- We expect the equity market will stabilize during 2016 thanks to some resilience in the commodity market.
- **The combination of the weak earnings outlook, unfavorable economic conditions and slightly above average valuations leads us to think that further underperformance from Australian equities is likely in 2016. Beyond the 1 year horizon, the outlook is better and Australian equities are more attractive.**

2016 and 2017 earnings growth expectations look more sensible than for the rest of the World



Source: Datasteam, IBES, Aon Research

MSCI Australia Local Valuation & Fair value analysis based on 12 month Forward Earnings				
Current Spot Price	1002.47			
Current 12M trailing Earnings	67.0			
Current implied P/E	13.55 x			
Long term Average 12M Forward PE	14.24 x			
	Estimated Earning	P/E	Est. Value	Over/Under
Calendar 2016	65.5	15.30 x	932.7	7.5%
Calendar 2017	69.5	14.43 x	989.1	1.3%
Calendar 2018	76.1	13.18 x	1082.7	-7.4%

Source: Datasream, IBES, Aon Research

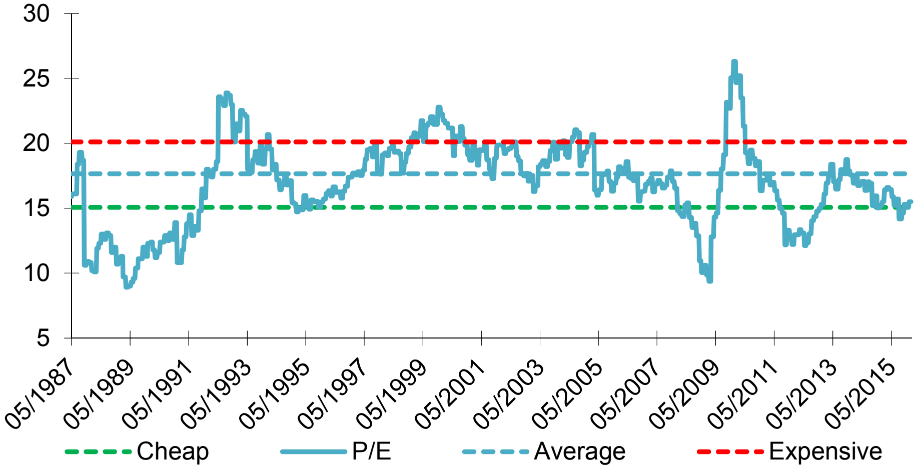
The equity market is already priced in line with 2017 earnings

Valuations

Australian Equity Valuations:
Australian equities do not look expensive but should not be considered cheap yet

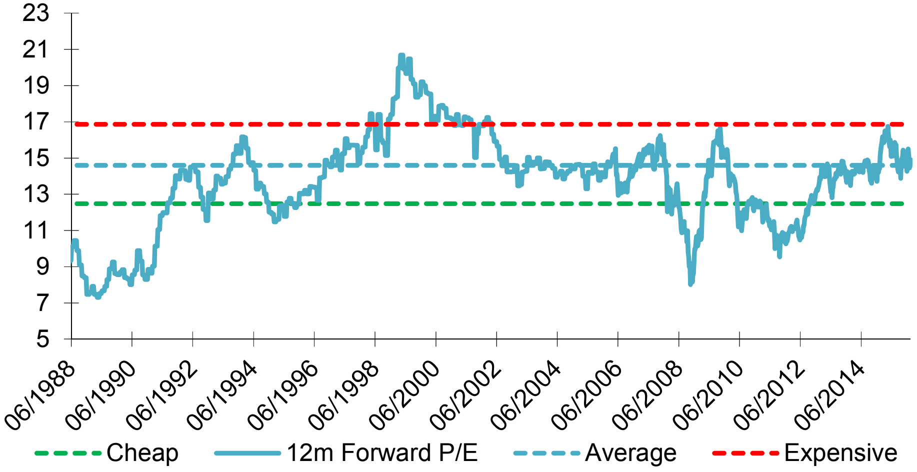
- The Price-to-Earnings ratio on the basis of trailing earnings is currently below its 15th percentile level using 20 years of data (see top chart). This means that Australian equities look cheap when compared to history. However, we caution against looking at valuations in isolation because we see several economic and wider challenges, which will make it difficult for these attractive valuations to be reflected in higher prices. Indeed, Australian equities could well get cheaper before they start to rise in price because earnings are still expected to decline in 2016.
- On a 12 month forward basis, it is interesting to note that price-to-earnings do not look as obviously cheap and even appears to be slightly above its 20 year average (see bottom chart). This supports the view that valuations actually have more room to fall further.
- **Valuation metrics for Australian equities are mixed. Some downward correction has clearly already occurred but it could continue in the near-term as commodity prices are still trending lower and earnings should continue to fall.**

Australian equities look cheap on a Price-to-Earnings basis



Source: Datasteam, IBES, Aon Research

12month Forward Price-to-Earnings ratio is less attractive



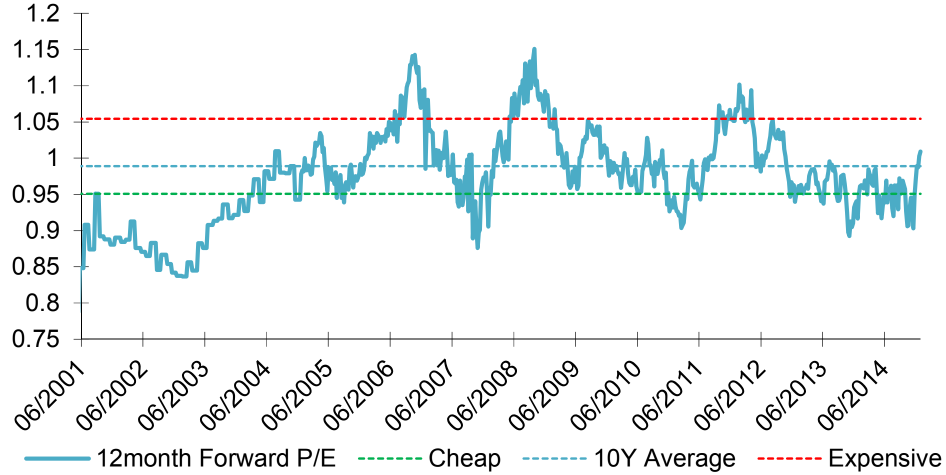
Source: Datasteam, IBES, Aon Research

Relative Valuations :

Australian equities are starting to look attractive despite the threat of underperformance

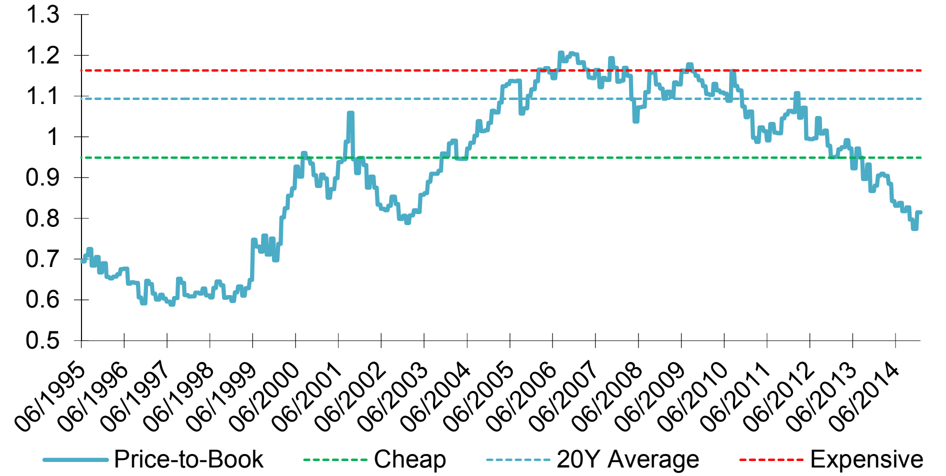
- Compared with global equities (here represented by the MSCI World ex-Australia index), Australian equities are now starting to look relatively cheaper after a couple of years of underperformance. They are still far from pre-commodity cycle levels highlighting that some underperformance could be seen in the near term.
- We can see this through different indicators, such as the Price-to-Book ratio, 12m Forward Price-to-Earnings ratio and some others (see charts).
- The Price to Book ratio is low relative to the one for global equities. Adjusted for their relative Return On Equity measures, this looks fair. The key point though is that the room for Return-On-Equity improvement is much better for Australia.
- **This provides some support to holding or considering adding Australian equities to a global portfolio, but we reiterate that some underperformance could be seen in the near term as the global economic environment is still a detractor. We would need growth to really pick up and commodities to stabilize before seeing Australian equities rebounding.**

Relative valuation ratio (MSCI Australia over MSCI World ex-Australia)



Source: Datastream, IBES, Aon Research

Relative valuation ratio (MSCI Australia over MSCI World ex-Australia)

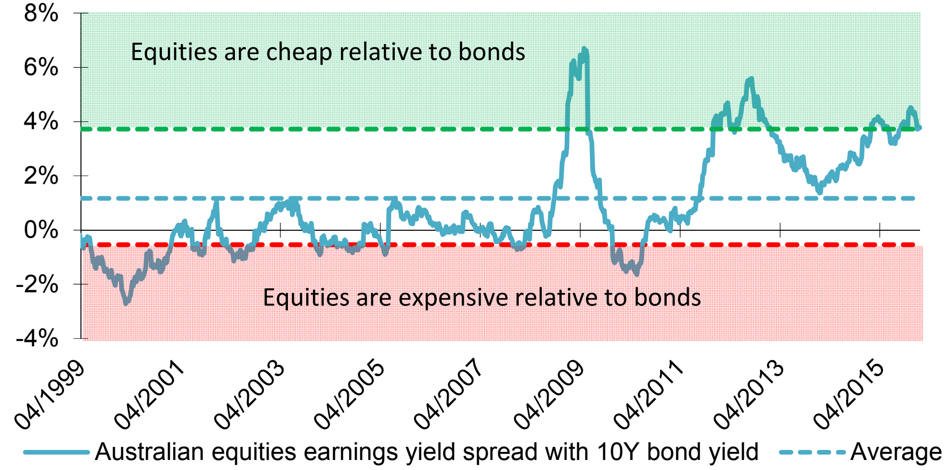


Source: Datastream, IBES, Aon Research

Australian equity long term valuation measures are attractive

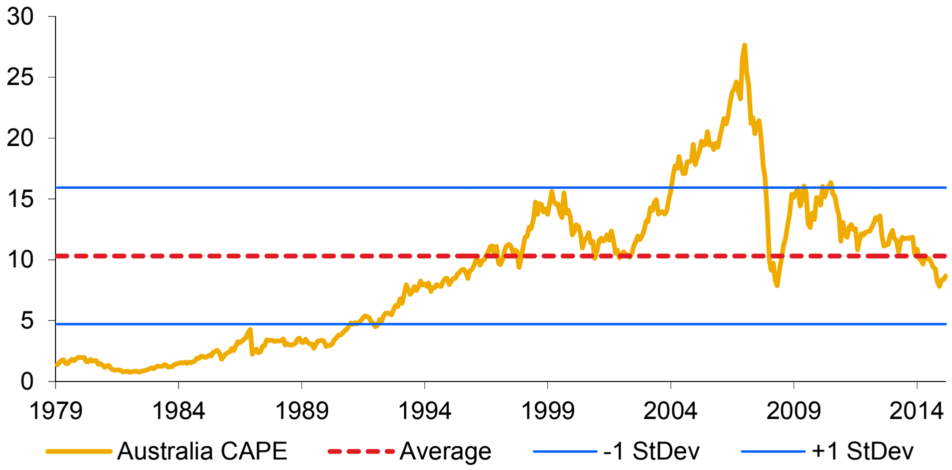
- One important support to Australian equity market valuations has been the low level of bond yields. Australian yields have been decreasing significantly since 2008 (see bottom left chart). The spread between the earnings yield and the 1 year government bond yield (the equity risk premium), is a support for Australian equities (see top chart).
- It is often useful to look at valuations from a long term perspective as well. Based on Robert Shiller's version of the cyclically adjusted price to earnings ratio, Australian equities look attractive (relative to their own historical average). The discount relative to the 10-year average stands at 19.4%. We must keep in mind that, while this is important, actual market price fluctuations can deviate markedly from this indicator's conclusions and for long periods of time. Nonetheless, it gives an indication of where market movements might be over a 5 year period.
- **Australian equities are attractive based on long term valuation metrics, especially relative to bonds.**

Australian equities look cheap relative to bonds



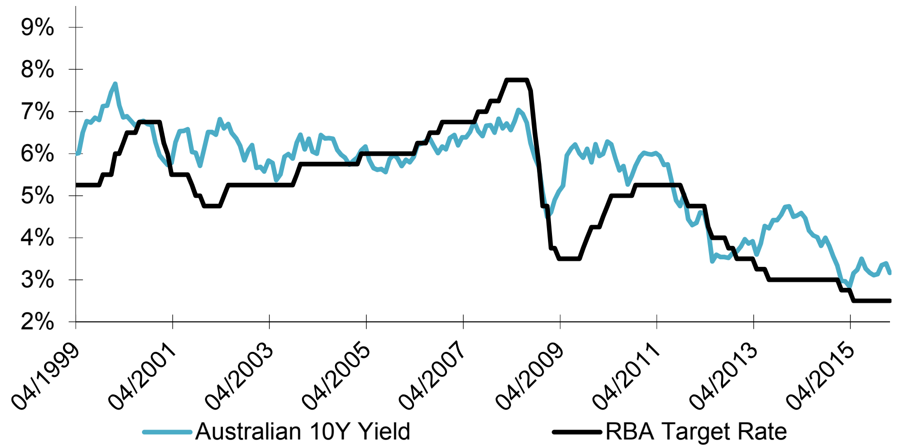
Source: Datasteam, IBES, Aon Research

Australia Cycle-adjusted P/E is at 8.3x, 19.4% below average



Source: Datasteam, Aon Research

Yields have been decreasing as the RBA has cut its target rate



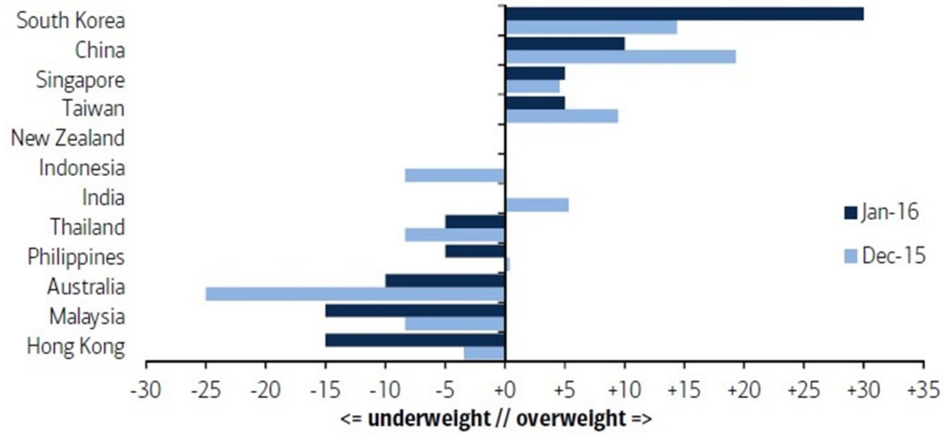
Source: Datasteam, IBES, Aon Research

Sentiment

Fund Manager Sentiment is still relatively negative for Australian equities

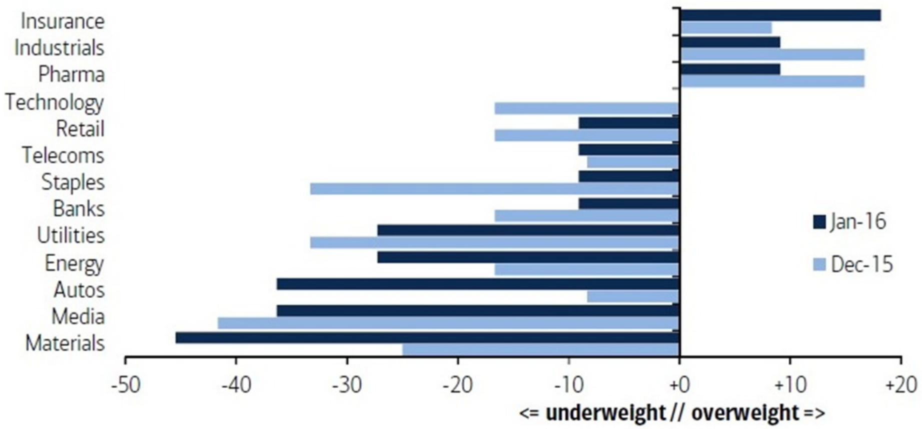
- Investor sentiment is important for determining short term movements in equities but we think taking a contrarian view can sometimes be a better strategy than simply following the herd.
- According to the most recent Fund Manager Survey published by Bank of America Merrill Lynch, managers are reducing their weighting to Australian equities (top chart). **We think this highlights the negative sentiment on Australian equities.**
- Australian equities are also suffering from the strong negative sentiment on commodities in general and material sector in particular. The share of investors saying they are underweight global commodities has increased over the last 3 months.

Asia Pacific ex-Japan investors are still underweight Australia



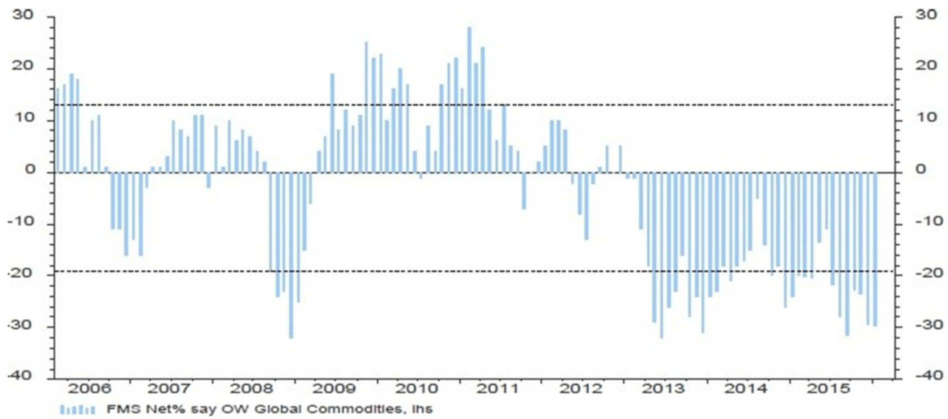
Source: BofA Merrill Lynch Global Fund Manager Survey

Asia Pacific ex-Japan investors are still commodity-linked sectors



Source: BofA Merrill Lynch Global Fund Manager Survey

Net % asset allocators say they are overweight commodities



Source: BofA Merrill Lynch Global Fund Manager Survey

Conclusion

- **Australian equity market prospects are still underwhelming near-term. However, conditions are not unequivocally negative so if positions are underweight or light, it makes sense to consider adding and entry points this year look worth considering. We are more optimistic from 2017 onwards.**

- We expect the global economic backdrop and the commodity outlook to remain weak in 2016. We agree with the consensus view of modestly slower growth in 2016 before rebounding in 2017 and 2018.

- However, monetary policy remains accommodative, and low interest rates and bond yields provide valuable support to equities.

- The earnings outlook will continue to be challenged by a weak commodity outlook weighing on the material sectors. Financials will suffer from their strong exposure to the housing market, which could struggle in the medium term.

- Australian equities could not be yet considered attractive as the current valuation look slightly extended in the context of our current earnings outlook on both an absolute and relative basis.

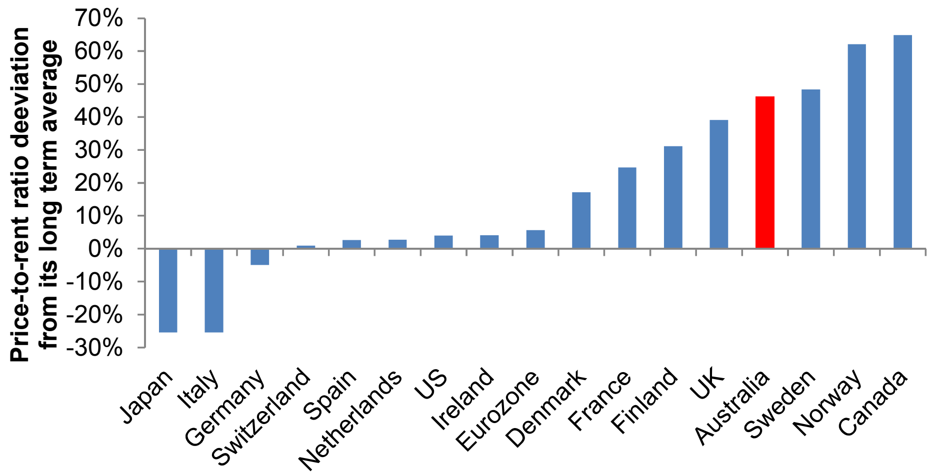
- Using long-term cyclical earnings adjustments, the Australian equity case is positive, but in the near term, we believe Australian equities do not look especially cheap and further derating is likely to come in 2016.

Appendix – Key Sectors

Financials (1/3): They have been outperforming since 2009, but could now start to suffer from their exposure to the Housing market

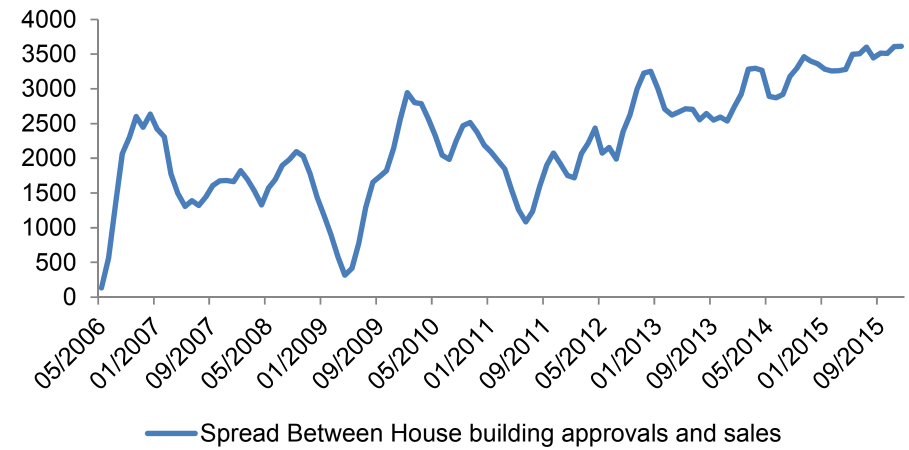
- The financials sector has significantly outperformed the wider index and is the second best performing Australian sector after Healthcare since 2008. This rally has been supported by a strong recovery in earnings per share.
- The housing market represents more than half of the assets of Australian banks, and the financial sector has benefited from the sector's buoyancy, with investors based in China and Chinese new immigrants being very important buyers.
- The Australian housing market is expected to struggle in the medium term for four reasons:
  - Among the developed economies, the Australian price-to-rent ratio is one of the highest compared to its long term history (see top chart)
  - Sales of new homes have been slowing since 2014 and actually decreased over the last 12 months
  - Despite slowing and falls in building approvals, the difference with home sales is still increasing, thus indicating excess supply (see bottom chart)
  - Chinese buyers have been a significant support for the Australian housing market, but it appears that Chinese demand for property is falling
- **The Australian financial sector is not the only sector that is set to be negatively impacted by an end to the housing boom. All housing related sectors, such as building materials, homebuilders and housing retailers are likely to be challenged too.**

The Australian housing market appears expensive



Source: Datastream, Aon Research

The gap between building approvals and sales keeps rising

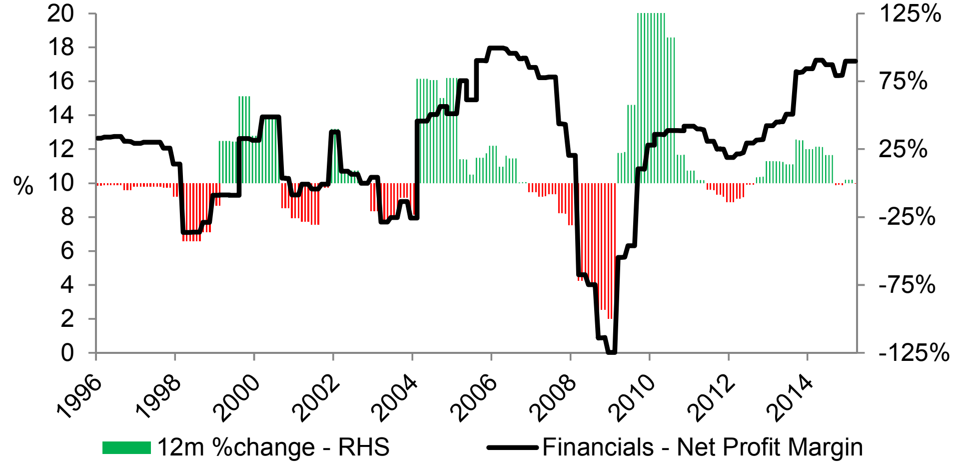


Source: Datastream, Aon Research

Financials (2/3): Improvement in net profit margins appears to be limited for financial companies

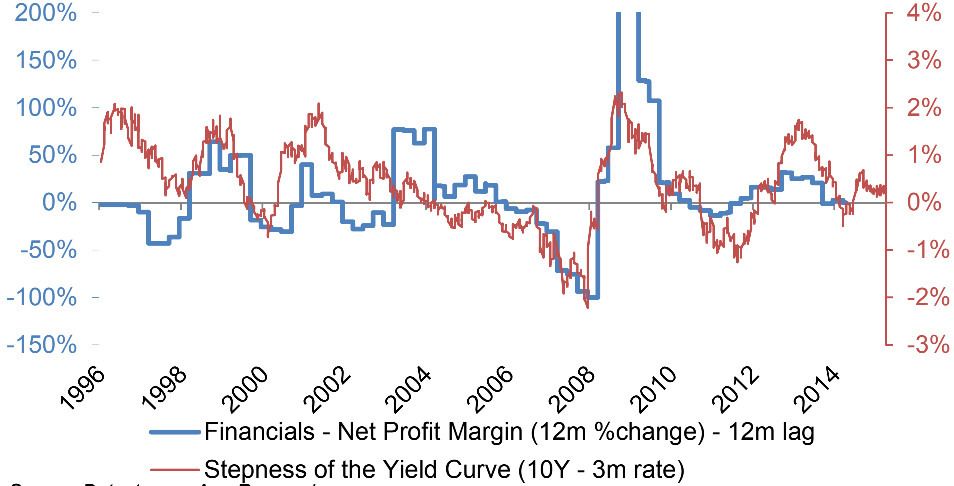
- As for all sectors, net profit margins are an important driver of the total returns for financial companies. Net profit margins are almost back to their all-time peak. After a strong recovery since 2009, margins stopped increasing in 2015 and they have been relatively flat for the last 12 months (see top chart).
- The margins for financials are negatively impacted by the flattening of the yield curve. As shown on the bottom chart the difference between 3 month and 5 year yields has been a leading indicator of the 12 month percentage change in net profit margins.
- Current expectations are that we will not see the curve significantly steepen over the medium term. Therefore, **we believe there is more downside risk than upside risk for net profit margins of financials companies in Australia.**

Australian Financials Net Profit Margins close to their highest level



Source: Datastream, Aon Research

Financials Net Profit Margins suffer from the flat yield curve

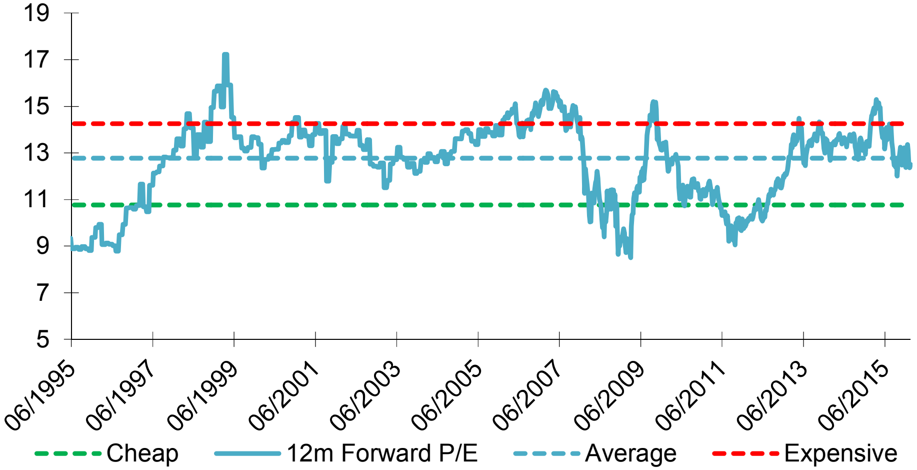


Source: Datastream, Aon Research

Financials (3/3): Slightly above average valuations, but the weak earnings outlook could lead to disappointments

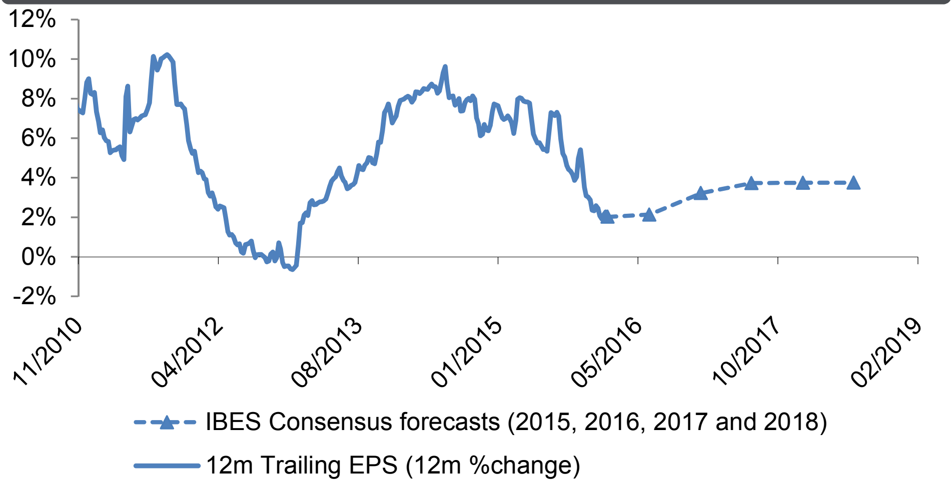
- Since margins provide very limited upside potential, earnings growth could be generated by an increase in sales figures. As shown in the previous slide we believe that the housing market, constituting more than 50% of the revenue of financials, is starting to struggle and analysts expect global sales growth to slow down in 2016.
- For these reasons, we think that earnings growth expectations are optimistic.
- Furthermore, on a 12 month forward basis, the price-to-earnings ratio is higher than its 20 year average, which indicates relatively expensive equities.
- **A relatively weak earnings outlook coupled with extended valuations lead us to expect underperformance by financials in 2016.**

12month Forward Price-to-Earnings ratio is above long term average



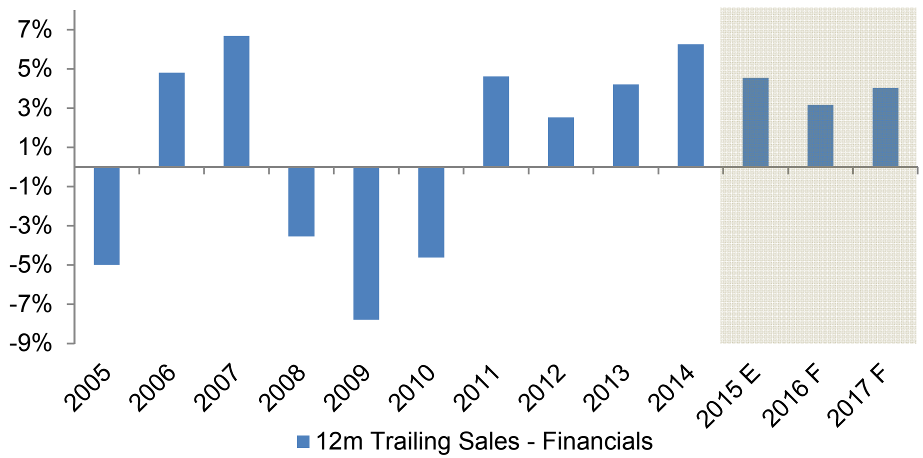
Source: Datasteam, IBES, Aon Research

Earnings growth expectations look optimistic



Source: Datasteam, IBES, Aon Research

Sales growth in financials is slowing down



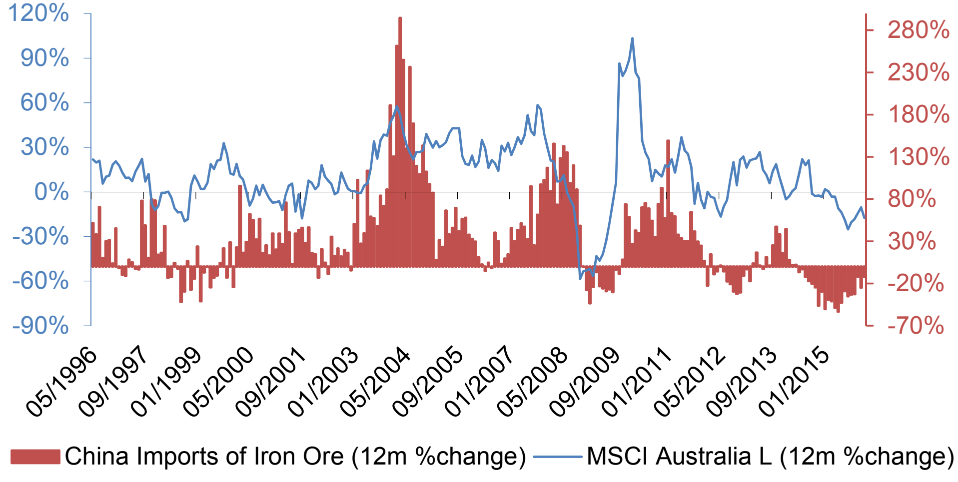
Source: Datastream, IBES, Aon Research

Materials (1/2): They will continue to suffer from the weak industrial metals market

- The metal markets are suffering from a combination of:
  - Eroding demand for metals
  - Excess supply from over investment in production when prices were at their peak (see bottom right chart)
  - A slowdown in the Chinese real estate sector, a significant player in iron ore imports (see top right chart)

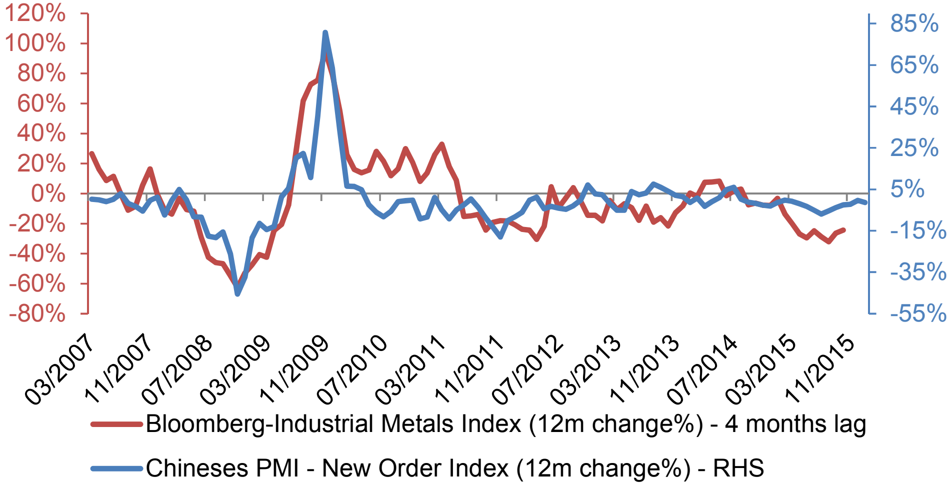
- **We believe that the outlook for industrial metals will be weak, driven by excess global supply and weaker EM demand for metals. China's shift away from over investment in infrastructure will be a significant headwind.**

Chinese iron ore imports have been declining for a while



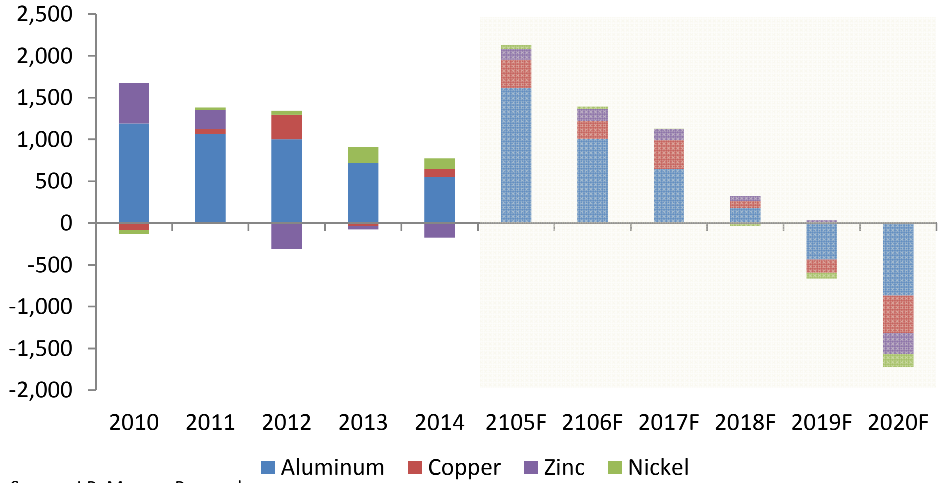
Source: Datastream, Aon Research

Industrial metals price vs. Chinese PMI



Source: Datastream, Aon Research

A surplus in the global balance is expected until 2017 - 2018

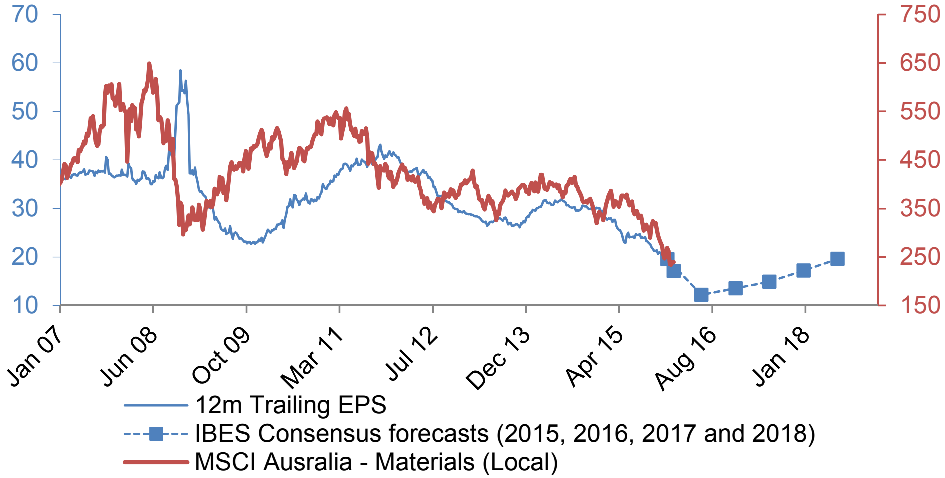


Source: J.P. Morgan Research

Materials (2/2): Equities suffered from a strong fall in earnings

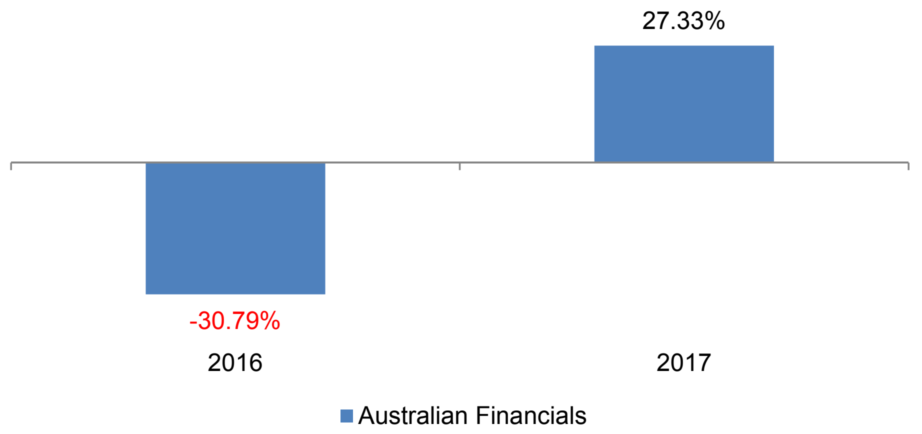
- The slowdown in Emerging Markets, and especially China, has reduced global demand for industrial metals and has significantly lowered their price since 2011.
- Earnings for materials companies have been continuously declining since the third quarter of 2011, and this is expected to continue into 2016.
- On a 12m forward basis, the price-to-earnings ratio looks expensive as this is back to levels seen in late 2009, when equity markets were strongly rebounding.
- **A combination of high valuations and a weak earnings outlook due to commodity price weakness lead us to believe materials will continue to underperform. That being said, 2016 could provide a good entry point as we see some recovery further out.**

Continuous fall in earnings drove materials equities lower



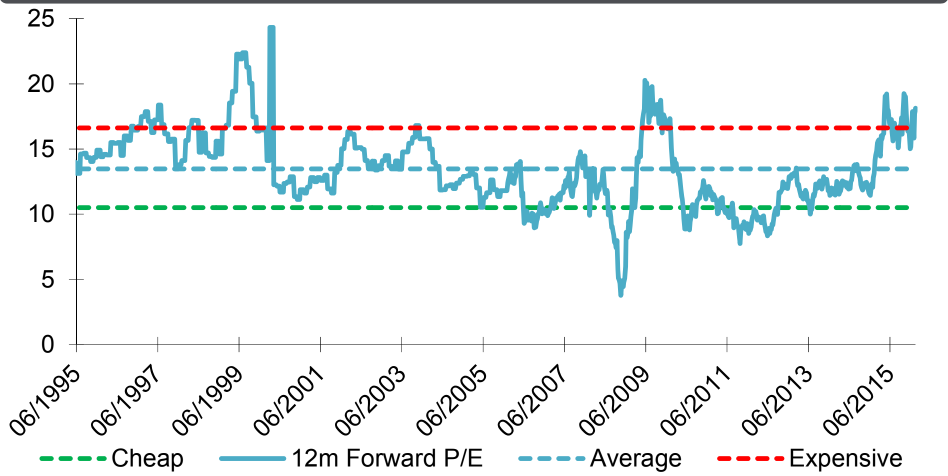
Source: Datastream, IBES, Aon Research

Earnings are not expected to rebound in 2016



Source: Datasteam, IBES, Aon Research

12month Forward Price-to-Earnings ratio looks extended



Source: Datasteam, IBES, Aon Research

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