Welcome to the June 2014 edition of the Martin Bros Monitior.

In this edition of the Martin Bros Monitor:

Where's the Volatility?

Since our last Martin Bros Monitor (March) the market has weathered several negative events that two years ago would have seen a 5-10% selloff almost immediately. In part, this reflects where the market is at present – what would be described as a bull market. More accurately, what will be described as a bull market, because bull market definitions don't normally get used (by the general media anyway) until very late in the cycle or after the cycle has finished.

As you will know from reading recent MBM's, this bull market cycle is being driven by very low global interest rates, making the equity risk premium that is usually attached to buying shares, seem low in comparison to the potential returns (particularly dividend yields versus term deposit rates). At present we cannot see the end of this cycle and if we had to guess, we would suggest that we are about half way through the current bull market cycle.

Although the current equity market could best be described as a Bull market, volatility in share prices is still a normal part of this cycle. However, over recent months, volatility has been greatly lacking. This is evidenced by the VIX (Volatility Index over the US equity market) reaching a post GFC low of $10.70 last week versus a long term average of about $14 and a trading range over the last two years of $12 - $20. This index is often a reverse leading indicator. When the cost of volatility protection is low, equity markets tend to experience a sell off shortly thereafter, and vice versa. Trying to pick the timing of this, like anything market related, is the hard part, but as a general rule this is one of the market indicators we watch to gauge the short term health of market (amongst many others).

May to September is seasonally a weak period for the market. Seasonally in this case means more often than not, but not to be confused with always. In Australia we had the Federal Budget in May and the media has been beating up the “draconian” nature the Budget and how disastrous it is. In our view, this is way overblown and for the overwhelming majority of Australians, they will notice very little difference in their financial health. Most likely thanks to the media, consumer confidence plummeted post the Budget and has yet to show any sign of recovery.

China has been in the headlines recently for two reasons. One, their dramatically slowing property market. Residential property construction and sales has been a major contributor to growth since the GFC but now seems to be reversing. Property prices have reportedly fallen by over 10% and developers are selling new apartments at up to 40% discounts in an attempt to clear excess stock. Vacant and unsold apartments are now estimated to be in excess of 3.5 million. Although this number is arguably not excessive for a country with the population of China, the most concerning part is the falling property prices across the board, including in the major cities. The reason being, when property prices fall, people sit on their hands because the do not want to “catch a falling knife”. This can lead to an extended period of flat to negative price growth and significantly impact new construction activity in this sector.

The second development in China has been the commodity trading / lending scandal. It is now accepted that several large Chinse borrowers were using the same commodity stockpiles (held in mega factories at Chinese ports) as collateral on multiple loans. This is now coming unstuck and is part of the reason for the recent sell off in global Copper prices.

Whilst these two issues can in no way be helpful to the outlook for China, the market is taking these developments in its stride at present, presumably because China is a dictatorship and the government can control to a large extent where money is spent, including new stimulus measures such as infrastructure building. This stimulus will continue to underpin the demand for Australian commodities, and therefore, the Australian dollar.

In the US, tapering of the federal reserves bond buying program is continuing and within a few months this will have been ceased altogether. The next step is for them to start to increase the official cash (interest) rate from the very low present level of 0.25%. Both of these factors will have an impact on the equity markets as the equity risk premium is narrowed. Initially the impact should not be severe, but would likely cause some degree of volatility in equity markets.

Recently there has been the Thai military coup, while not significant in a global equity market context, did not even register a blip on the daily price activity of sharemarkets around the globe. Now to add to the geopolitical mix, it appears Iraq is once again teetering on the brink of an extremist controlled government.

With all of the above potentially negative factors, you would expect equity markets to be experiencing some volatility, however over the last few months they have been very benign, to the point that in the US the volatility index has hit 6 year lows. In Australia we have full year earnings season starting in mid August and with consumer confidence low, a seasonally weak period upon us and all of the above factors, we would not be surprised to see volatility increase. Several retailers in Australia have already put out profit warnings on the back of slowing spending post the Budget and unseasonable warm start to winter, and we suspect the general company outlook statements during the upcoming reporting season will be tempered.

Any sell off over the next few months will be a buying opportunity, as the underlying driver of this equity market cycle – low global cash rates – is still playing out and will continue to for at least the next couple of years. We should just be prepared for some more volatility.

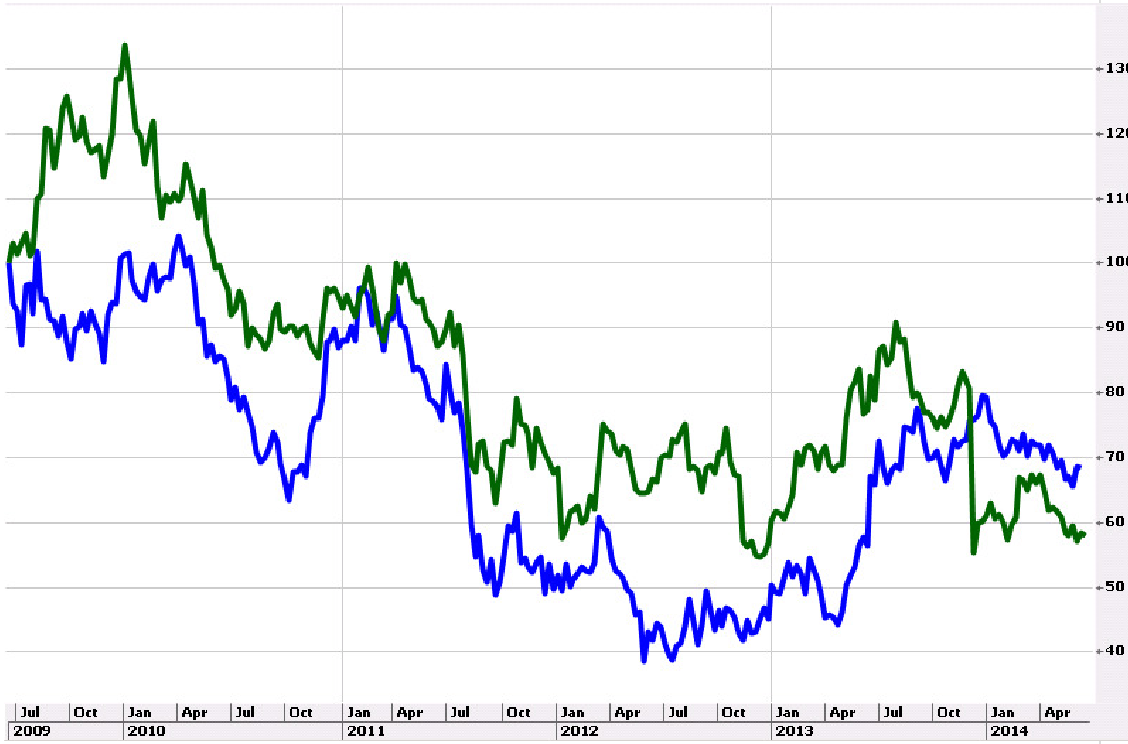
Stock Review - QBE Insurance Group (QBE)

QBE Insurance Group (QBE) is an international general and reinsurance group underwriting most major commercial and personal lines classes of business through operations in 46 countries. QBE's business has been under pressure for several years since the GFC with margins under pressure in the US and Europe. Management have taken steps to re-structure the business in line with current market conditions and stabilise insurance margins.

Whilst the admin work still needs to be done, we are confident that management can deliver on their strategy. QBE will always be impacted by the external operating and risk (events) conditions, such is the nature of the insurance business. However, QBE management have a very good track record of making sound investment decisions and positioning the company to benefit from any improved market conditions.

QBE's share price has historically been highly correlated to the US 10 year bond yield. This is predominantly due to their leverage to interest bearing deposits such as government bonds and treasury deposits. Insurance business earnings are largely impacted by what they can earn on their "free float". This float is the timing difference between their collected premiums and when their benefit payments on claims are made. Coincidently, this is how Warren Buffet has been able to build such a successful business (Berkshire Hathaway) - by using this float to buy other businesses to generate profits. All other insurance companies invest this float into liquid investments. QBE has always been very conservative in investing this float which served them well during the GFC. However, in an interest rate environment like we have been in for the last few years, their float is not a large contributor to earnings. Once interest rates do start to go up, predominately in the US (as a large part of their business is in the US), so will their earnings on this float. Hence you can see why their share price has been highly correlated to the US 10 year bond yields.

The US 10 year bond yield is currently at 2.60%. As a general rule, 10 year bond yields of any developed nation would normally equal the country's current or future expected growth rate, plus inflation. In the US, this would be about 3% and 1.5% respectively. So in a "normal" market, this would equate to a US 10 year bond yield of 4.5%. As we know, any markets are rarely normal but this does provide us with a standard methodology to determine if something is overvalued or undervalued. The reason US 10 year bond yields are overvalued by a substantial margin at present is because the Federal Reserve had been buying $85 billion worth of these per month until recently - this is what is meant by Quantitative Easing (QE). This QE is now been "tapered" and within a few months they will no longer be buying. After this, the US will begin to raise the official "cash rate". Therefore, over the next couple of years, US 10 year bond yields should move closer to 4.5%, or higher, depending upon growth in the US.



Above is a chart of the last five years, starting at a common base, showing the correlation between the US 10 year bond yield (blue line) and the QBE share price (green line). As you can see, they are highly correlated. QBE still has operating challenges and no one knows for sure when US 10 year bond yields will rise again. QBE currently is trading on 13x 2014 earnings per share (EPS). In the short term there are still risks, but if the above plays out how we expect over the next few years, the EPS could surprise on the upside, and when a cyclical stock like QBE becomes "favourable" in equity markets, the price to earnings multiple can jump (what is referred to as PE expansion). In this scenario, the share price is then boosted on two fronts - EPS upgrades and PE multiple expansion. QBE is currently trading at $11.10 and Morgans has a $12.56 price target.

2014 Federal Budget - Key Changes

Temporary Budget Repair Levy

This is the much-discussed "temporary" 2% increase in the top marginal tax rate, effective 1 July 2014 and payable over the next 3 years to 2017. That is, payable by Australian taxpayers earning over $180,000 p.a. The proposed levy will be in place until the Budget returns to surplus. If we consider the Medicare Levy of 1.5% will increase to 2% from 1 July 2014 to take into account the 0.5% Disability Care levy, the effective tax rate for high income earners will be 49% (which will be the highest marginal tax rate since 1990).

Taxable Income	2013/14 Current Tax & 1.5% Medicare	2014/15 Proposed Tax & 2% Medicare	Increase p.a.
$180,000	$57,247	$58,147	$900
$200,000	$66,547	$67,947	$1,400
$250,000	$89,797	$92,447	$2,650
$300,000	$113,047	$116,947	$3,900

Excess Contributions Tax on Non-Concessional Contributions

Similar to the rules now for Excess Concessional Contributions, the Government will allow individuals the option of withdrawing superannuation contributions in excess of the **non-concessional contributions** cap made **from 1 July 2013** and any associated earnings, with these earnings to be taxed at the individual's marginal tax rate. Final details of the policy will be settled following consultation with key stakeholders in the superannuation industry.

Super Guarantee Levy Rate Increase

The government will change the schedule for increasing the SGC rate to 12%. The legislated increase to 9.5% from 9.25% will still proceed from 1 July 2014. This rate will then remain as is until 30 June 2018 at which time it will increase by 0.5% each year until 12%.

Age Pension Qualifying Age

Age pension access is set to increase to age 70 by 1 July 2035. . We already know the retirement age is increasing to age 67 by 2023 (already legislated under previous Labor Government). This means those Australians born after 1 July 1958 will be affected by a gradual increase in the qualifying age from age 67 up to age 70 (anyone born on 1 Jan 1966 and later).

Commonwealth Seniors Health Care Card (CSHC)

Untaxed superannuation income will be included in the assessment of income to determine eligibility for the CSHC from 1 January 2015. The assessment of superannuation income will be the same for CSHC holders as for Age Pension recipients and will align with the *2013-14 Budget* measure to deem the balances of account-based superannuation of pensioners from 1 January 2015. All superannuation account-based income streams held by CSHC holders before the implementation date will be grandfathered under the existing rules.

Family Tax Benefits Part A and B

From 1 July 2015, the Family Tax Benefits Part B primary earner income limit will be reduced to $100,000 from $150,000. The Part B payment will also be limited to families whose youngest child is under 6 years of age from 1 July 2015.

Make your Concession Contributions to Super before June 30

A reminder of the concessional contribution limits for the 2013/14 financial year are listed below. Concessional contrbutions include any Superannuation Guarantee (SG) paid by an employer on your behalf as well as salary sacrificed amounts.

Concessional Contributions (deductable) for the 2013/14 Financial Year

- Up to age 75 - If over 65, must meet work test
- If employed (i.e. not self-employed), contribution must be made via employer.
- Limits are as follows:
  - Up to age 60 (born after 30/06/1954) $25,000 per annum per person
  - Age 60 and over (born before 01/07/1954) $35,000 per annum per person

As mentioned in the March 2014 edition, the concession contribution limits are changing from 1 July 2014 to the below limits:

- Up to age 50 $30,000 per annum per person
- Age 50* and over $35,000 per annum per person

** Individuals age 49 as at 30 June 2014 are eligible for higher limit*

Please contact us should you wish to discuss concessional contributions or anything e contained within this edition of the Martin Bros Monitor.
