First State Investments

The Yield Report.

Contents

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Welcome to First State Investments' yield report, exploring the potential implications of interest rate increases for seven asset classes across our portfolio of investment capabilities.

The background surrounding the historically low interest rates is well known. It was more than six years ago, in an attempt to stimulate the US economy, the Federal Reserve (the Fed) reduced its benchmark interest rate down close to zero, but that policy is now expected to change.

A potential rise in US interest rates has been one of the most discussed topics in recent months. With the US unemployment rate expected to drop towards 5% or lower in coming months, inflation expected to trend higher in the year ahead and the economy expected to grow by 2.5%-3.0%, the question is becoming not "will the Fed increase interest rates?", rather a question of "when will the Fed increase rates and by how much?"

Fed policy makers last met on July 28-29. Since then, the global economy has added an extra layer of risk to the Fed's timing. The slowing of the Chinese economy, the slumping price of oil, jarring downturns in global stock markets and a lower-than-expected jobs figure in August have all prompted questions over whether this is the best time for the Fed to begin raising rates.

What better time to delve into the key drivers of interest rate decisions and examine how this might affect portfolios and asset classes.

Please get in touch with your FSI contact with any questions or feedback.

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Economic Overview

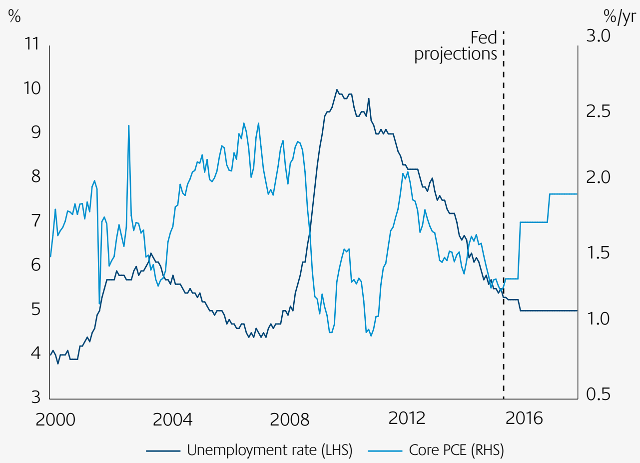
The Fed looks forward, but China risks grow.

The Chair of the US Federal Reserve (the Fed), Janet Yellen has indicated that the monetary policy normalization process should get underway before year-end 2015.

The minutes of the July Federal Open Market Committee (FOMC), released August 19, indicated that, at that time, the Fed did not yet have enough information or confidence to make the decision to begin raising interest rates. However, the Fed was clear that the economy was heading in the right direction.

The move to begin normalizing interest rates is supported by the Fed's forecast that the unemployment rate will move to 5% or lower in coming months, while inflation (as measured by the Core Personal Consumption Expenditure (PCE) Index) will trend back towards 2% over the medium-term (see chart 1). The Q2 15 Gross Domestic Product (GDP) report, showing growth of 3.7% seasonally adjusted annualized rate (saar), is also supportive of higher interest rates.

Chart 1: US unemployment rate and Core PCE inflation – Actual



Source: Bloomberg and FOMC. Data to July 31 2015 for unemployment rate, June 30 2015 for Core PCE. Fed projections as at June 2015.

However, since the release of the minutes of the July FOMC meeting, global financial markets have seen a significant increase in volatility. This has been driven not only by uncertainty around the expected trend to higher interest rates in the US, but also by concerns over the pace of economic growth in China and the ability of the authorities to support economic growth, equity market volatility and the depreciating currency.

Our view for quite some time has been that the monetary policy normalization process in the US would get underway at the September 16-17 FOMC meeting. We acknowledge that the recent significant volatility in global financial markets has reduced the likelihood of the first move being in mid-September.

If the Fed was to delay the first rate hike, it will have two more opportunities to increase interest rates this year – at the October 27-28 FOMC meeting and/or the December 15-16 meeting.

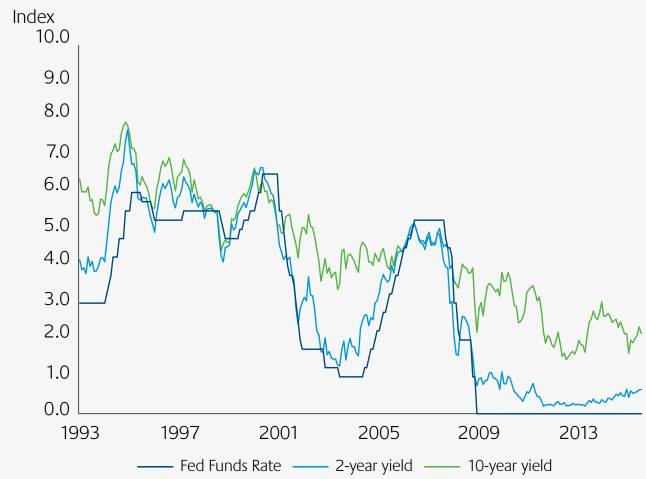
Note that we expect the first rate hike from the US Fed will be a 25bp increase, taking the Fed Funds target rate from the current 0%-0.25% range up to 0.25%-0.5%. This interest rate range or 'corridor' is expected to be bound by the Reverse Repo rate at the lower end and the Interest on Excess Reserves rate at the upper end.

After the first rate hike from the Fed, we would then expect this move to be followed by 25bp rate increases every second meeting after that. Our base case would be, therefore, for a rate hike before the end of 2015, followed by further moves in March, June, September and December 2016.

As demonstrated in chart 2, once the US Fed starts raising official interest rates, bond yields usually tend to follow. From current lows around 2.2%, the US 10-year government bond yield could be expected to trend higher in the year ahead, and indeed, this is our expectation.

This trend to higher longer-dated bond yields in the US is likely to have significant implications for financial markets – not just in the US, but around the world.

Chart 2: US Fed Funds rate and US 10-year bond yields



Source: Bloomberg, FSI. Data to August 13 2015. EMR forecasts to June 2018.

Will tighten really tighten? Maybe not

This 'tightening' cycle by the US Fed may have a very different impact on financial markets than previous rate hike cycles.

While, as stated above, the US Fed looks set to begin raising interest rates this year, it has also made it clear that this rate hike cycle will be very gradual. As noted, recent volatility in global financial markets could act as a catalyst for the US Fed to delay the start of the normalization process.

We have chosen to reflect the expected 'gradual' approach from the Fed by looking for a 25bp rate hike every second FOMC meeting, i.e. four rate hikes totalling 100bp per year. But it is clear that the US Fed is on no pre-set course and that the path of monetary policy will be data-dependent.

Nevertheless, even the 'gradual' rate hike cycle we expect is more aggressive than that currently priced into financial markets – with the market (as of August 27) priced for a Fed Funds rate of just 0.265% at year-end 2015 and 0.82% at year-end 2016.

It is important to note that even this gradual approach could itself be altered to reflect financial market developments.

This is expected to limit the risk of a 'blow-out' event in the bond market, or to put it another way, a repeat of the so-called 'taper tantrum' of 2013 is unlikely.

In addition, the possible end point for this tightening cycle is expected to be much lower than previous rate hike cycles by the Fed. This is likely given expectations that the long-run potential growth rate of the US economy has slowed and that economic activity will be more sensitive to higher interest rates after such a long period of very loose monetary policy.

Our own forecasts have the Fed Funds rate at just 2%-2.25% by the end of 2017, i.e. not much different from where US 10-year government bond yields are today, and peaking at 2.5%-2.75% in 2018. This is still well below the FOMC's own assessment of the long-run Fed Funds rate of 3.75%.

For the bond market, therefore, it is not so much when the US Fed rate hike starts that is important, but the pace and the end-point.

On both of these counts it would seem to be most likely that any sell-off in the 10-year US Treasury bond would likely see yields peak at around 2.75%-3% in the year or two ahead.

We would expect that 2-year Treasury bond yields will experience a more aggressive increase in yields, perhaps to around 2% from current levels closer to 0.7%.

This would imply quite a flattening in the US Treasury bond yield curve (2-10 years) over the next couple of years – from approximately 150bp at present to closer to 75bp-100bp in coming years.

Monetary policy – conscious uncoupling

The other significant difference for the coming US rate hike cycle is that it is expected to occur in a very different global context to most tightening cycles.

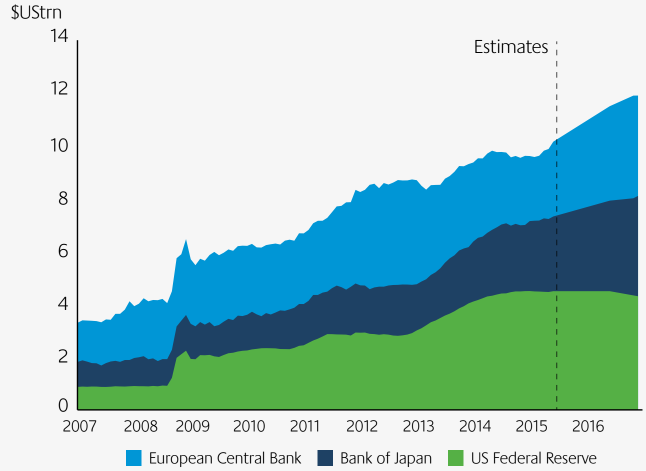
While we do expect the Bank of England (BoE) to start raising official interest rates in late 2015 or early 2016, all other major central banks are not in that camp.

We expect either steady monetary policy or further policy easing in Europe, Japan, China, Canada, Australia and New Zealand in the year ahead. In addition, many other emerging market economies will likely need to ease monetary policy – especially through their currency market.

In this context it is hard to see US or global bond yields selling off aggressively when the total monetary policy position for the global economy is likely to trend towards more easing.

We expect this will be significantly impacted by the ongoing large-scale quantitative easing programs in both Europe and Japan – which could be expected to hold down bond yields in these parts of the world and increase demand for US Treasury bonds from global investors.

Chart 3: European Central Bank (ECB) and Bank of Japan (BoJ) Quantitative Easing to swamp US tightening



Source: Bloomberg and FSI estimates to December 2016. Assumes Fed will stop reinvesting in 2H 16 and ECB and BoJ continue at current pace till end 2016.

Scenarios for the US bond market: what could go wrong?

While our base case expectation is a relatively gradual increase in US Treasury bond yields and a flattening of the yield curve, we are aware of some scenarios (see below) that pose a risk to this base case.

Higher yields – behind the curve?

As noted, US Treasury bond yields are starting the monetary policy normalization process near historically very low levels. Indeed, the current very low level of inflation and term premiums within the Treasury bond market likely means that there is more upside risk than downside risk to yields from current levels.

As financial markets continue, in our view, to significantly under-estimate the pace and extent of Fed monetary policy tightening (even given recent volatility in markets), it would be easy to imagine that the bond market reaches a 'point of panic'. This could occur perhaps after two or three rate hikes, when there is a realization that that the Fed is serious about raising interest rates and consequently, bond yields need to adjust sharply higher. This could easily see US 10-year Treasury yields above 3.25% or higher.

In addition, any signs of unexpected inflation would also likely prompt a sell-off in the Treasury bond market on expectations that the Fed's 'gradual' approach will leave the Fed 'behind the curve.' An upward repricing of commodities could be a factor to cause unexpected inflation.

The other key factor for the bond market will be the Fed's policy towards its balance sheet. At $US4.5 trillion as of early September 2015, the Fed's balance sheet is significantly larger than the level of just under $US1 trillion that was in place prior to the collapse of Lehman Brothers in September 2008.

The Fed has indicated that part of its monetary policy normalization process in the years ahead will be returning the balance sheet to a more 'normal' size.

At this stage, it is widely expected that this will occur only through allowing bond holdings to mature and not through active selling of bonds in its portfolio. In this way, balance sheet normalization would take many years, i.e. some estimates are suggesting out to 2022.

If, however, the Fed was to bring forward the balance sheet normalization plans in any way (i.e. a more immediate decision to cease reinvestments and/or a potential decision to sell bonds out of the balance sheet), then this would likely result in a sharp spike higher in Treasury bond yields. The Fed could be prompted to undertake this policy if the reaction in the bond market to Fed tightening was muted and was not removing the accommodative conditions as quickly as the Fed had hoped.

Lower yields – lower for longer?

There is also the risk that the Fed's policy tightening process could see longer-dated Treasury bond yields decline. Given that the Fed is expected to start raising interest rates with the Core PCE Index (their favored measure of inflation) at just 1.2%, there is a risk that the market behaves as if the Fed has made a 'policy error' and there is no chance of inflation returning to its 2% target.

The market could believe instead that inflation is more likely to fall, rather than rise from here. This could occur as a result of either the strong US dollar (USD) and/or further potential declines in energy prices.

A fall in inflation and any signs that the Fed has made a 'policy error' or that the pace of further rate hikes will be reduced significantly, could create an environment where US 10-year bond yields head back towards their cyclical lows of around 1.5%.

Additionally, given the sharp rise in global financial market volatility in recent weeks, the Fed may indeed decide to hold interest rates at their historical lows for a longer period – delaying the policy normalization process.

If the Fed did delay lifting interest rates into 2016, and commodity prices took another sharp leg lower, this could see US 10-year bond yields continue to rally down to levels well below 2%.

A rally in US Treasury bond yields could also occur if we were to see substantial further monetary policy easing by other major central banks, such as the ECB, BoJ and/or People's Bank of China (PBoC).

Such policy easing could lead to more capital inflow into the US Treasury bonds, both lowering yields and strengthening the USD.

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Australian Equities

Like for other asset classes, the question of how interest rate changes in the US will affect Australian equities is a complex one. In investment markets, it is rare that single factors alone – even those as important as monetary policy in the world's largest economy – drive binary investment outcomes. There are always other important factors to consider. Investors need to consider all of these, first in determining allocations within a diversified investment portfolio and subsequently at the stock selection level.

Do US interest rates matter for ASX-listed companies?

It is important to remember that few Australian companies are directly affected by US interest rates. Some are affected to varying degrees by the pace of economic activity in the world's largest economy. Building materials provider James Hardie Industries and shopping centre operator Westfield Group, for example, both derive a meaningful component of their earnings in the US and growth rates are therefore important. Few, however, could argue that upward or downward movements in the US Federal Reserve's (Fed) Funds rate have a direct impact on their earnings.

While the direct impact is modest, the indirect impact is likely to be much more significant due to the high correlation that exists between Australian equities and their US counterparts. The correlation has declined in the most recent past, likely as the two economies are recovering at different rates given the end of Australia's mining boom, but has averaged 0.67 over the past 15 years.

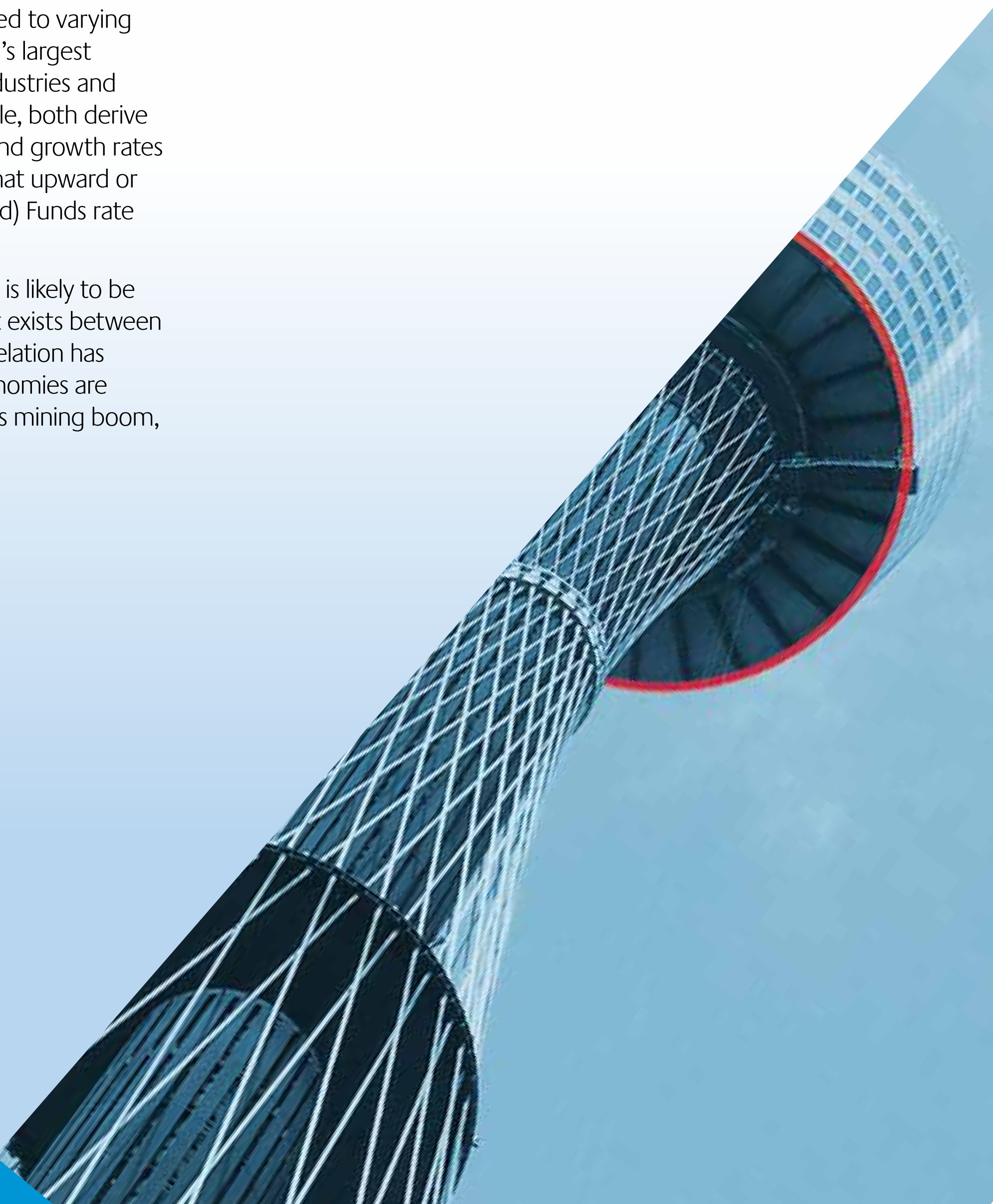
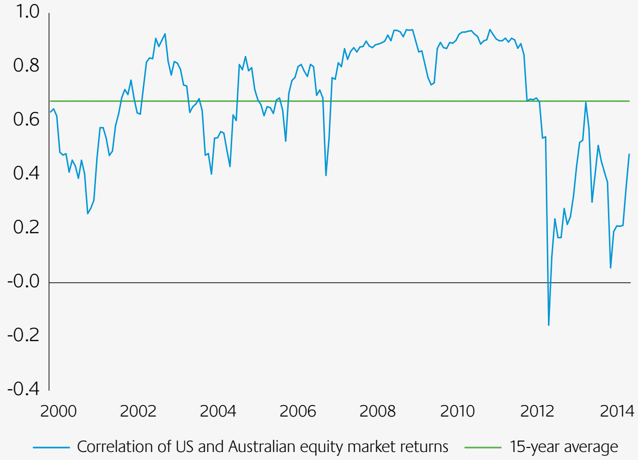


Chart 1: Correlations between Australian and US equity market returns



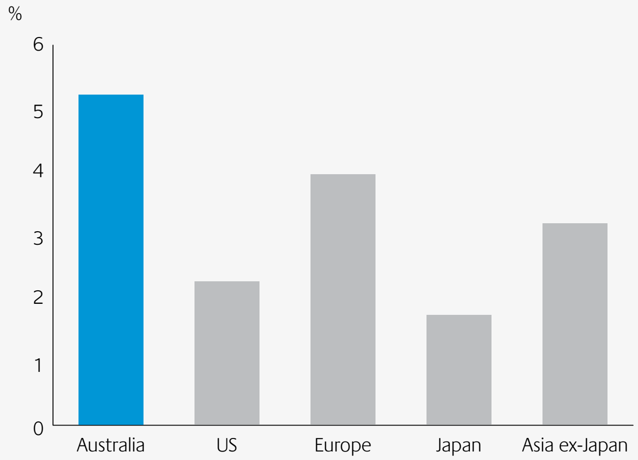
January 2000 to August 2015, S&P/ASX 200 Index and S&P 500 Index total returns.
Source: UBS Research.

Local investors might not always like it, but overnight movements on Wall Street almost always set the tone for the ASX the following day. We do not expect this inter-relationship to weaken in the months ahead. Accordingly sentiment towards the Australian equity market as a whole is likely to continue to be dominated by sentiment towards US equities, which certainly could be affected by the Fed's interest rate decisions. Global investors are keen not only to know when the first US interest rate increase will occur, but also the pace with which monetary policy will normalize once the process begins. The Fed knows this and has been extremely careful in its language, keen to avoid any unexpected actions that could erode investor confidence and potentially result in significant and unintended volatility in investment markets globally.

Yields continue to support Australian equities

One of the most important pillars of support for Australian shares in recent years has been the relatively high dividend yield that is on offer. The S&P/ASX 200 Index currently offers a dividend yield of around 5%, which remains appealing relative to the very low returns available from bonds and cash deposits. It is also higher than the dividend yields on offer from most other global equity regions increasing the appeal of Australian shares for overseas investors.

Chart 2: Forward dividend yield estimates of major global equity regions



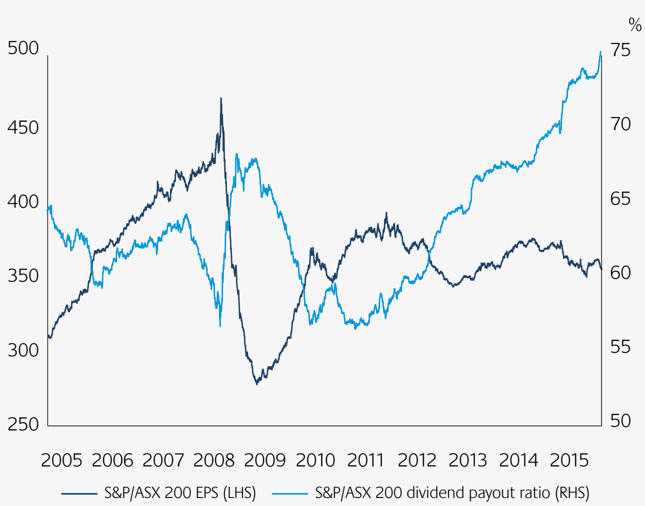
Source: Bloomberg August 20 2015.

Against this background, yield stocks such as A-REITs have enjoyed a particularly strong tailwind from falling bond yields. Careful stock selection in these areas of the market will remain critical if bond yields start to trend higher.

Boards are giving investors what they want

The general hunger for yield among the investor base appears to have been noted by the management teams of ASX-listed companies. As chart 3 shows, dividend payout ratios have steadily been increased in the past four years or so, rising at a much quicker pace than earnings. Companies appear to be satisfying investors' demand for income rather than reinvesting profits for growth.

Chart 3: The disconnect between dividend payout ratios and earnings



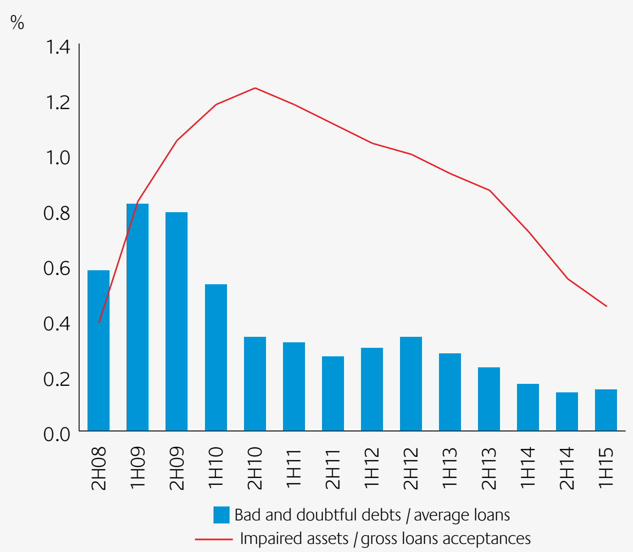
August 2005 to August 2015. Source: FactSet.

We have seen a continuation of this theme in August as companies have reported their most recent results. Earnings have been little changed on the whole, while the average payout ratio of ASX 200 companies has reached 75%. In part, this may be due to growth options being difficult to identify. It also likely reflects growth options becoming increasingly expensive as asset prices have re-rated. There appears to have been an element of 'giving investors what they want' – positive share price reactions when companies have announced higher payout ratios or other methods of returning excess cash to shareholders will have been noted by management teams of comparable companies.

What other drivers are important for Australian equities currently?

Aside from global macro concerns, there are a range of other factors dominating sentiment towards different parts of the Australian share market. The most important issue for the four major banks, for example, remains the more stringent capital requirements that are being imposed by APRA. An increase to the required level of tier 1 capital from July 2016 has forced the major lenders into substantial equity raisings and might require future dividend reinvestment plans to be fully underwritten. Investors are also keeping a close eye on the level of bad and doubtful debts in the sector. Defaults are close to 20-year lows of just 0.15% of loans, but will undoubtedly tick higher at some point.

Chart 4 : Bad and doubtful debts and impaired loans; four major banks



Source: Company reports and FSI research.

The impact of China on Australian shares

News flow and economic statistics from China remain critical for resources stocks. We have seen time and time again how Chinese nervousness can impact commodity prices and, in turn, the share prices of miners and associated services companies. Most recently commodity prices have remained under severe downward pressure as various indicators have suggested the pace of economic growth in China might be closer to 5%/yr rather than Beijing's official reports of 7%/yr.

Indeed going forward it seems reasonable to assume that China as the next great superpower will have an increasingly significant influence on sentiment towards Australian shares; perhaps even greater than today's influence from the US. China's geographic proximity to Australia and other important Asian trading partners means the fortunes of many Australian corporates are becoming increasingly linked to China. August's sudden and unexpected devaluation of the yuan highlights that Chinese policymakers do not feel obliged to provide investors with transparency around their future intentions. There is a very clear difference between this approach and the deliberate, investor-friendly communications that the Fed has provided in recent times. Australian equity market investors might need to become accustomed to these periodic announcements and comfortable with the ensuing equity market volatility that could follow.

How is the Australian dollar affecting sentiment?

Another critical factor for stocks in industrial sectors is the level of the Australian dollar (AUD). Almost all large cap ASX-listed companies have some level of currency exposure to consider, including costs borne and revenues sourced in other currencies. A volatile currency – the Australian dollar has weakened from ~US$1.10 to around US$0.73 in just four years – can have a significant influence on earnings as these costs and revenues are restated into local currency terms. Management teams of ASX-listed corporates will be more interested in the currency impact of US interest rate movements than on the magnitude of the movements themselves.

Fluctuations in the AUD are not only affecting investor sentiment towards particular stocks; they also appear to be influencing policy setting by the Reserve Bank of Australia (RBA). As it strives to facilitate the transition in growth from mining to non-mining areas of the domestic economy, it is undoubtedly in the RBA's interest to promote a weaker currency. Unrelenting strength in the Sydney and Melbourne domestic property markets has, thus far, limited the RBA to two interest rate cuts in this cycle. More could follow, however, particularly if US interest rate increases are not forthcoming and if the dollar remains close to current levels. Australian Equities, Core portfolios maintain exposure to a number of companies with overseas earnings streams, but this is due to their individual attractive characteristics rather than being indicative of any particular view on the AUD.

How are US interest rate expectations affecting stock selection in Australian Equities, Core portfolios?

The Australian Equities, Core team is taking no more or less notice of global macro drivers than usual. While there is a large degree of uncertainty over how markets will react when interest rates in the US are inevitably raised, we are no more informed than anybody else regarding the timing and pace of policy normalization. Accordingly, we are not tilting portfolios towards any particular outcome or scenario. Stock selection continues to be driven from the bottom up.

With valuations of Australian shares remaining towards the upper end of recent ranges, a detailed analysis of valuation remains a key component of our stock selection process. As a fully invested manager, we tend to consider a stock's valuation relative to peers rather than to its historic average. There remains a fair degree of valuation divergence between different sectors of the market. Defensive sectors and USD-sensitive stocks continue to trade at a premium to the market average, while cyclical industrials continue to trade at a discount.

While the actions of the Fed are undoubtedly one of 'the' most important things for the market to grapple with, in time the 'event' will pass and the next 'big thing' will hit the headlines and become critical in driving investor sentiment. That is the way it has always been in investment markets and we do not expect it to change in future. It therefore makes little sense for us to become preoccupied with these temporary factors over which we have no control.

As a 'core' style manager, our focus is on the delivery of a strong information ratio over the long-term. An ability to add value through all market conditions is paramount – we aim to deliver consistent, risk-adjusted returns irrespective of prevailing market conditions. In pursuit of this, we diligently and consistently apply the Australian Equities, Core investment process to identify companies that can generate sustainable long-term returns. This process has proven the test of time, adding value for investors over nearly 20 years. Our investors should feel assured that we have no intention of deviating from it now.

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Global Fixed Income and Credit

Will historical correlations hold?

Historically, rising interest rates have been positive for credit market performance; that is correlations between rates and spreads have typically been negative. However, the current fear within credit markets is an increase in correlations between the two as investors move to sell all fixed income exposure simultaneously. Although this has happened to some extent during recent bouts of bond yield rises, on balance we think a measured normalization of cash rates globally (as economic activity improves) is positive for credit markets. That said, we expect a pick-up in volatility as we approach normalization from the US Federal Reserve (Fed) and other central banks. In summary, if rates rise for the "right reasons" (i.e. improving growth, lower unemployment, and higher economic activity), then we would see any market sell off as an opportunity to add credit exposure to client portfolios.

Decreased credit market liquidity may exacerbate volatility

The key risk to this view is the potential technical impact on credit markets, which may be exacerbated by decreased market liquidity. Over recent years, supported by quantitative easing (QE) and forward guidance, many investors have been implementing an assortment of carry trades, including in credit. As QE comes to an end, we would look for many of these carry trades to unwind, which in an environment of reduced dealer balance sheet capacity and liquidity, could see a dramatic increase in market volatility and spreads gapping wider. In the credit space, the fear is that any such move could be exaggerated as retail investors, who still view fixed income as a low risk asset class (despite actively seeking extra returns through a leveraged carry trade), may receive a shock by negative absolute returns as interest rates rise and spreads widen. This fear has been reflected in a push for liquidity over the last year and in the growing divergence between 'liquid' credit derivatives and the less liquid physical assets. July's price action has shown just how volatile the rebalancing of risks may be with spreads widening sharply.

Credit fundamentals remain solid, for now

On the other hand, fundamentals remain generally supportive of tighter credit spreads and recent spread widening has presented an interesting entry point from a valuation perspective. Despite the challenges from a potential interest rate action by the Fed, on-going Greek debt problems, the geopolitical concern surrounding Ukraine and Russia, and continuous stress from the energy sector, the corporate debt market is expected to remain fairly stable, at least in the near term. Helped by steady economic growth in the US and extraordinarily accommodative monetary policy around the world, which provides the market with ample and cheap liquidity. Apart from energy-related weakness, Moody's-rated speculative-grade companies have remained mostly in good shape as reflected in solid liquidity, stable cash flows and a lack of maturity and covenant pressure.

Standard & Poor's Global Fixed Income Research[1] estimates that the US corporate trailing-12-month speculative-grade default rate will increase to 2.9% by June 2016, from 1.8% in June 2015 and 1.6% in June 2013. Some volatility has appeared since fourth-quarter 2014 in the form of increased yields on the lowest-rated issuers, and it is our expectation the Fed will begin increasing benchmark interest rates this year. Still, we believe this has the potential to push the default rate only slightly beyond our forecast if these challenges prove harsher than we expect. Corporate leverage is at the upper end of what we consider to be reasonable for the investment grade universe, albeit offset by very strong interest cover. With the US economy improving (hence the need for a rate increase) this is generally supportive for corporate profits and company health.

Valuations look attractive, but watch out for M&A

Valuations are now also favorable. While spreads had narrowed markedly from the wides during the Global Financial Crisis, and had reached levels where value was neutral at best (probably slightly expensive in high yield) the recent widening into the end of August has seen value again become attractive from a longer term perspective.

Mergers and acquisition (M&A) activity is a risk to credit fundamentals going forward and we will be tracking developments closely. Recently, M&A deals have been funded with a mixture of debt/cash and equity. Nonetheless, default rates remain extremely low, credit conditions remain relatively accommodative, and as a result, spreads currently over-compensate investors for credit risk incurred.

Our credit strategy and process employs a disciplined approach in the credit assessment and selection process, as issuer decisions will contribute meaningfully to overall portfolio performance. We believe that returns often overcompensate for credit risk, and that diversification across a large pool of lowly correlated assets will generate positive 'value-for-risk' outcomes for our portfolios.

1 Standard & poor's: Grade Default Rate Is Expected To Rise To 2.9% By June 2016," published Aug. 24, 2015.

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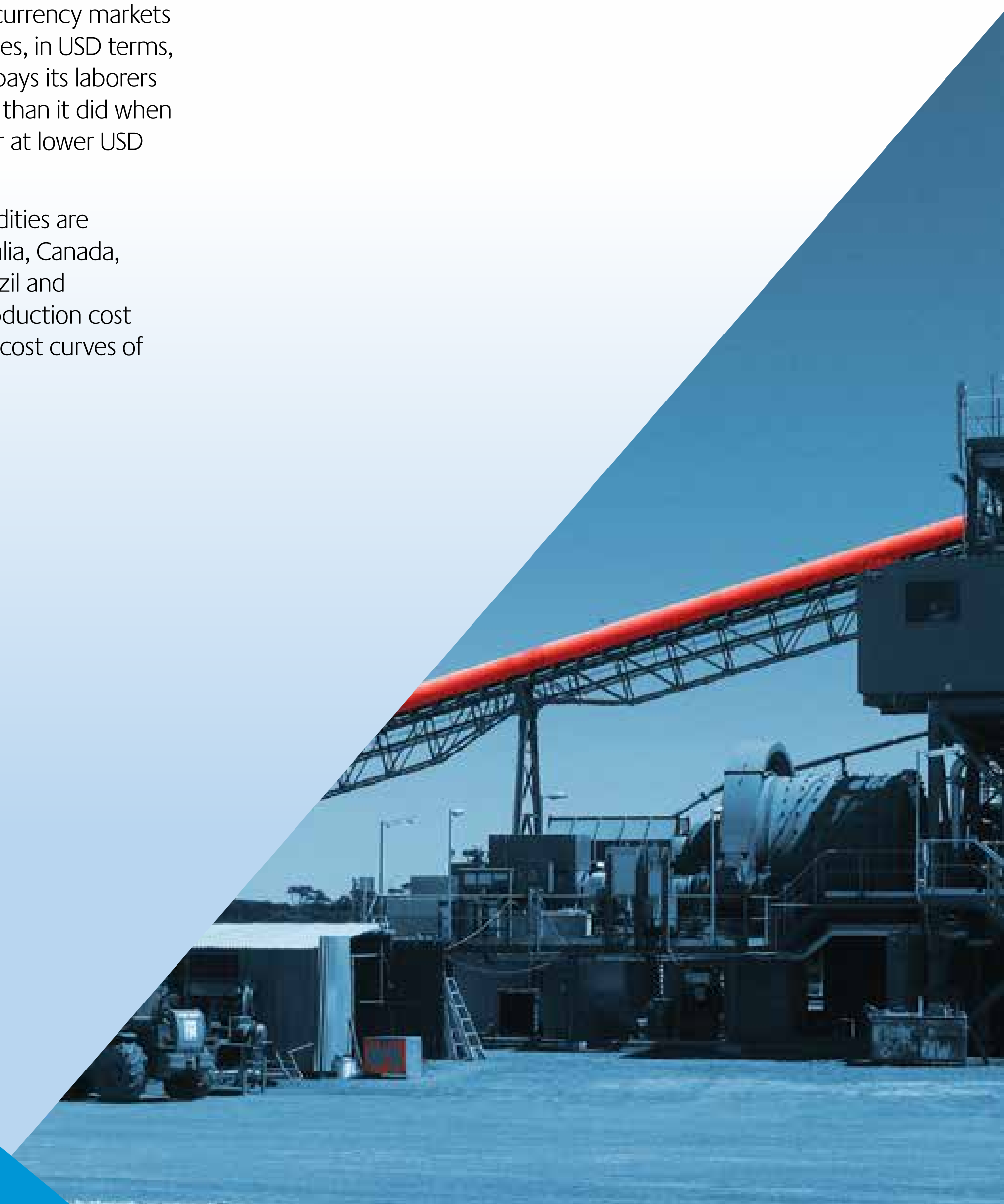
Global Resources

Transmission mechanisms between currencies and commodities.

Speculation over monetary policy direction in the US has contributed to increased volatility in global financial markets this year. In particular, the stronger US dollar (USD) – and by corollary, weaker emerging market (EM) currencies – have impacted producers of commodities such as iron ore, oil and copper that are priced in USD terms. In simple terms, there are two main transmission mechanisms between currencies and commodities. The first relates to operating costs. The second relates to demand.

In the first instance, a stronger USD and weaker EM currency markets mean that the overall production cost of commodities, in USD terms, decline. For instance, a copper mine in Chile, which pays its laborers in Chilean Peso (CLP), pays out a lower USD wage bill than it did when the CLP was stronger. This allows them to sell copper at lower USD unit prices.

Because such a significant portion of global commodities are produced outside of the USA (in countries like Australia, Canada, South Africa or traditional emerging markets like Brazil and Chile), a very large part of the industry receives a production cost benefit from a stronger USD. In technical terms, the cost curves of commodity production edge lower.



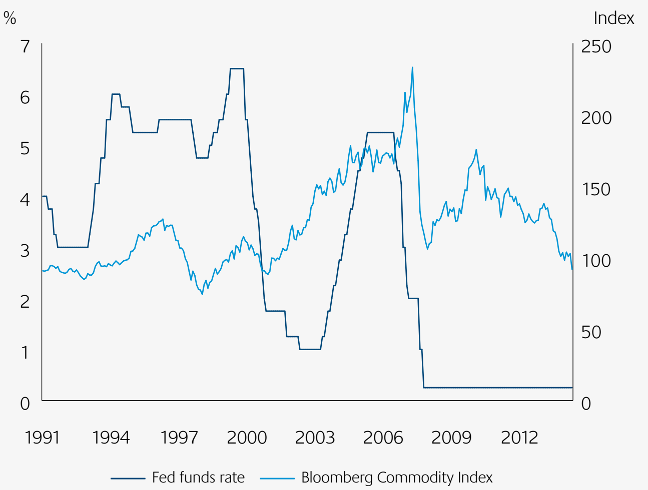
The second related issue is demand. Given EM countries are the largest consumers of commodities, and given that weaker EM currencies are an indicator of weaker economic performance in those regions, this type of macro environment is liable to be one of tepid demand growth. Weaker demand results in less price tension in commodities.

At the same time, the 'ripple' effect of excess supply in global commodity markets has increased deflationary risks, amid a sharp fall in commodity prices. While this is considered 'transitory' by some US Federal Reserve (Fed) members, the effect on inflation of low commodity prices and a strong currency may persist. However, a strong USD is supporting the domestic US consumer's purchasing power and employment growth.

Commodities have performed well historically in a rising interest rate environment.

Chart 1 shows previous monetary policy cycles in the US alongside Bloomberg's physical commodity price index. The chart indicates that tightening cycles in the US saw the prices of oil and industrial metals rise steadily through the full duration of the Fed tightening cycle both in the mid-1990s and the early part of last decade. On both occasions, this was in response to accelerating economic growth.

Chart 1: Commodities and the Fed Funds rate



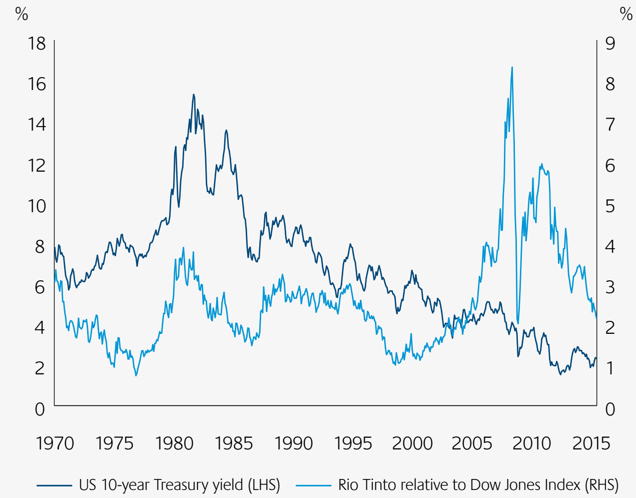
Source: Bloomberg.

What does this mean for resources equities investors?

If we now focus on specific mining equities, such as large global diversified miner, Rio Tinto, we can also evaluate whether a period of increasing US nominal interest rates has been generally positive or negative for mining companies' returns.

As shown in chart 2 below from Citi, the US 10-year Treasury bond yield can be used as a proxy for bond market investors' pricing of the federal funds rate since 1970. This is plotted against Rio Tinto relative to the Dow Jones Industrial Index, all expressed in USD terms for comparison purposes.

Chart 2: US 10-year Treasury bond yield (%) and Rio Tinto vs. Dow Jones Industrial Index ($US) – during commodity super-cycle

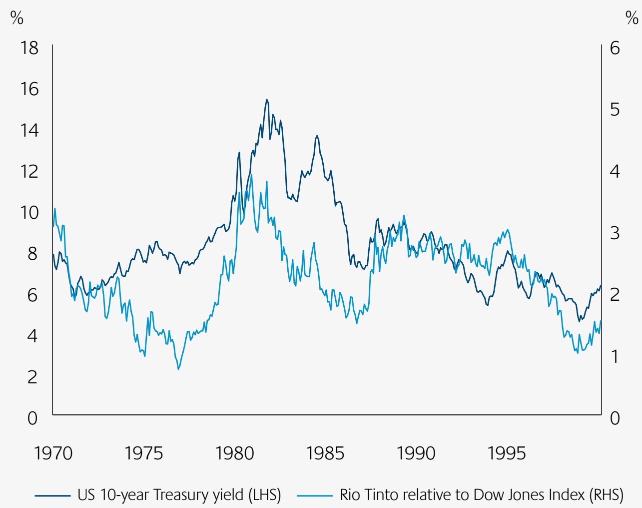


Source: Citi and Datastream.

As depicted above, the emergence of the China demand-driven commodity super-cycle (i.e. 2000-2010) has disrupted the historical relationship between metal prices and mining equities relative to interest rates.

As such, if we take the period prior to the super-cycle (i.e. 1970-1999), chart 3 shows that Rio Tinto has generally performed well relative to the Dow Jones Industrial Index over periods when US 10-year Treasury bond yields (interest rates) have been rising.

Chart 3: US 10-year Treasury bond yield (%) and Rio Tinto vs. Dow Jones Industrial Index ($US) – before commodity super-cycle



Source: Citi and Datastream.

While our earlier commentary implies that expected interest rate hikes should contribute to a strengthening USD, which in-turn is negative for commodity prices and mining equities, the USD will only respond positively to the tightening of monetary policy if the magnitude of the hike is greater than rate hikes in other currencies.

This is the case currently where the nascent Eurozone economic recovery is being supported by the European Central Bank's (ECB) ultra-accommodative policy settings (i.e. main refinancing rate of 0.05%) and €1trn quantitative easing (QE) program. Our Economic and Market Research team is forecasting that the ECB's QE program will remain in place until at least September 2016.

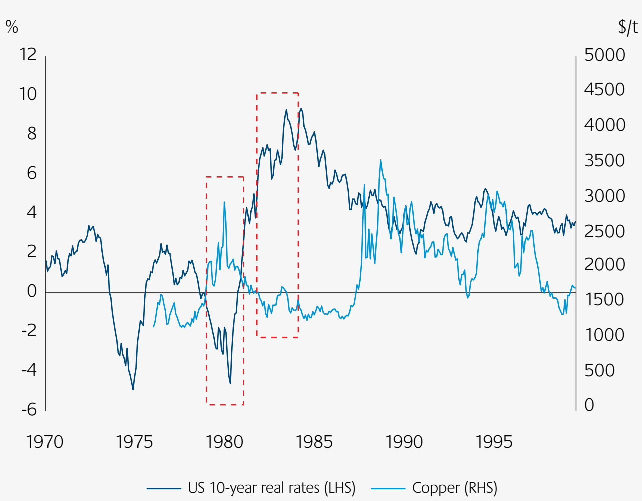
US economic growth momentum is positive for commodities and resources equities demand

Given this divergence in central bank monetary policy, we expect US economic growth momentum to be the principal driver of the next Fed interest rate tightening phase. Central banks typically begin increasing interest rates when there is evidence of strengthening economic activity and aggregate demand. Signals such as positive and accelerating consumption, business capital spending, housing and labor market data are examples. Therefore, upward GDP growth momentum (i.e. forecast by EMR team to be 3.0% in 2016) should be positive for metals and mining demand, as has been the case in previous periods of US output expansion.

Historically, interest rates have been a fairly 'blunt' policy instrument, with a lagged effect, taking a considerable amount of time to work their way through the real economy, impacting commodity demand. Commodities, and resources equities, should therefore enjoy a 'free ride' of ongoing demand momentum for some time following the first Fed rate hike.

This is evidenced by the copper price in chart 4, which is widely considered a proxy for economic growth momentum.

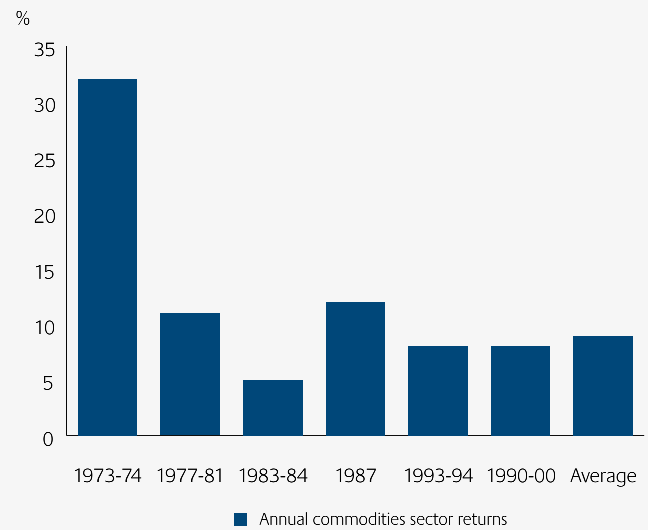
Chart 4: US 10-year real rates (%) and Copper (US$/t)



Source: Citi and Datastream.

As expected, the copper price increased when real interest rates were declining (i.e. A & B periods), given the economic stimulus. However, there is little correlation from 1985 onwards, suggesting that rising real interest rates may not necessarily hamper commodity price appreciation.

Chart 5: Commodity sector returns during six rising interest rate periods



Past performance is not indicative of future performance.
Source: Welton Investment Corporation.

Analysis from Welton Investment Corporation shows that commodities have been a consistently strong and reliable asset class performer over historical periods of rising interest rates. The average annualized return over the period was 8.9% per annum, as shown in chart 5.

These periods, excluding the late 1990s, were characterized by high inflation due to events such as the removal of the gold standard, the OPEC oil embargo and large government budget deficits. Commodities have the potential to deliver attractive returns in challenging economic and political environments.

Conclusion

In summary, investors in resources equities should not fear the imminent increase in the Fed Funds target rate. The Fed has already signaled that this tightening phase will be very gradual, with our Economic and Market Research team forecasting only a 0.75%-1.0% increase in the federal funds rate in 2016 to 1.5%-1.75%. A new long-term neutral cash rate of 3.0% is not expected until after 2017, with ultra-low borrowing costs continuing to be supportive of resources companies.

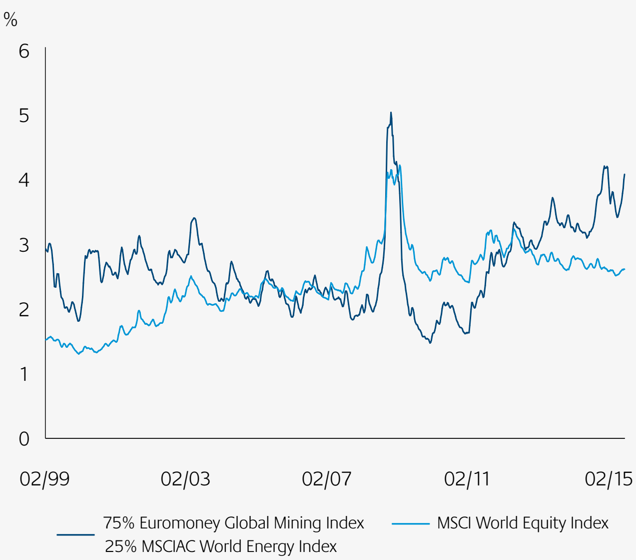
Mining equities have attractive dividend yields

While companies have been under pressure recently, due to falling commodity prices, with equity prices also declining following earnings and cashflow downgrades, the resources equity sector has a higher dividend yield than the broader equity market.

As shown in chart 6, our flagship CFS Wholesale Global Resources Fund's* customized benchmark – the Euromoney Global Mining Index (75%)/MSCI World Energy Index (25%) has an average dividend yield of 4.2%, which is significantly higher than the MSCI World Equity Index at 2.6%. Large diversified miners, such as Rio Tinto and BHP Billiton, have attractive current dividend yields of 6.7% and 7.8%, respectively.

Historical analysis shows that commodities and mining equities, such as Rio Tinto, have been consistently strong performers from a relative return perspective over periods of rising interest rates, particularly during periods of strong US economic growth.

Chart 6: Resources dividend yield relative to MSCI World next FY



Source: Jefferies and Bloomberg.

Mining equities also have the added attraction of higher dividend yields in an environment where yields across all global asset classes are expected to remain at low levels for a considerable amount of time.

Overall, our Global Resources team's approach is to combine stable companies, with high-quality assets and low costs of production, with earlier stage opportunities to create the potential for sustainable returns.

Our high conviction stock selection focuses only on those resources companies with robust businesses and wider-than-average margins.

These companies are likely to be able to withstand current macroeconomic challenges and volatility in commodity markets, with reduced downside valuation risk, positioning them well for an eventual cyclical recovery.

For illustrative purposes only. Reference to the names of each company mentioned in this communications is merely for explaining the investment strategy and First State Investments does not necessarily maintain positions in such companies. Any fund or stock mentioned in this presentation does not constitute any offer or inducement to enter into any investment activity nor is it a recommendation to purchase or sell any security.

* The CFS Wholesale Global Resources Fund is not available for investment by US persons. Fund information is being provided as an example of First States Investments' expertise in the strategy. Differences between fund-specific constraints or fees and those of a similarly managed mandate would affect performance results.

First State Investments

The Yield Report.

Emerging Markets Debt

Central bank policy, particularly that of the US Federal Reserve (Fed), will continue to be an important driver of global markets. In the last few months, the market focus has been firmly on the timing of the first hike in the Fed Funds rate since June 2006. Given the 'data dependency' of the US Central Bank, bond market volatility has increased in recent weeks, as markets try to interpret US economic data and speeches by Fed governors. So far in 2015, the yield on the 10-year US Treasury bond has fluctuated between a low of 1.64% in January, when markets priced-in a global deflation scenario, and a high of 2.48% in June, when markets priced a more optimistic growth scenario. Amidst these volatile markets, investors are wondering how emerging market (EM) debt markets would react to a rise in US interest rates.

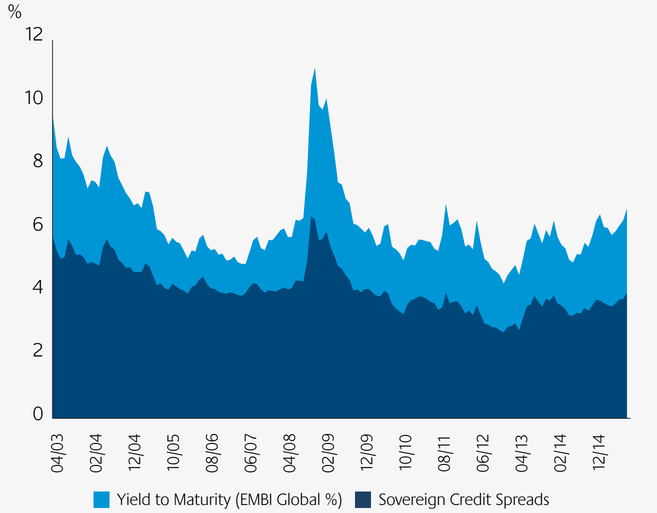
From a fundamental perspective, there are two important ways in which US hikes can impact EM debt. First, expectations of a rise in short-end rates can strengthen the US dollar (USD) and cause volatility in capital flows, particularly in countries running current account deficits that require dollar funding. Second, rising long-term US yields increases debt servicing and would result in weakening public debt sustainability[1] in those EM countries with higher debt to GDP ratios.

1 Julio Escolano and others, 2015, "Global Monetary Tightening: Emerging Markets: Debt Dynamics and Fiscal Crises", IMF Working Paper

Historical precedents of US Fed tightening cycles offer a mixed picture for EM debt, with sudden changes of stance (1994 Mexico crisis, 2013 'taper tantrum') having tended to cause large negative market reactions, while well-communicated tightening cycles (1999, 2004) were absorbed with less disruption. For example, the 2004 rising interest rate cycle was particularly benign for EM fixed income, with both EM credit spreads and EM local debt index experiencing rallies to multi-year highs right after the first hike.

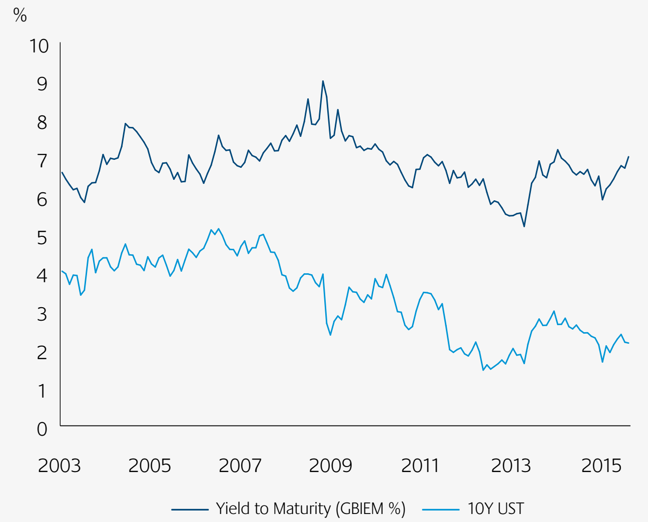
Currently, capital flow dynamics are a source of concern since EMs have seen a period of exceptional inflows over the past six years, probably associated with the effects of unorthodox monetary policy in core countries. The World Bank has found that private capital inflows post-2008 into EM countries have averaged about 6% of EM GDP, which is far above trend. Along the same lines, the International Monetary Fund (IMF) in 2013 concluded that approximately US$500 billion excess inflows into EM were linked to the effect of successive QE programs[2] in the US. At the same time, the Institute of International Finance estimates net capital outflows from EM countries since its peak, at a cumulative US$300 billion (see chart 4). Therefore in our view, it is likely that a significant part of these excess inflows would have reflowed back by the time the first rate hike takes place. Finally, another paper by the IMF concludes that risk appetite is a more important factor than yield levels in explaining capital flows[3]. We will therefore pay close attention to the language used by the Fed in its communication of the interest rate cycle and its impact on global risk appetite.

Chart 1: External debt yields



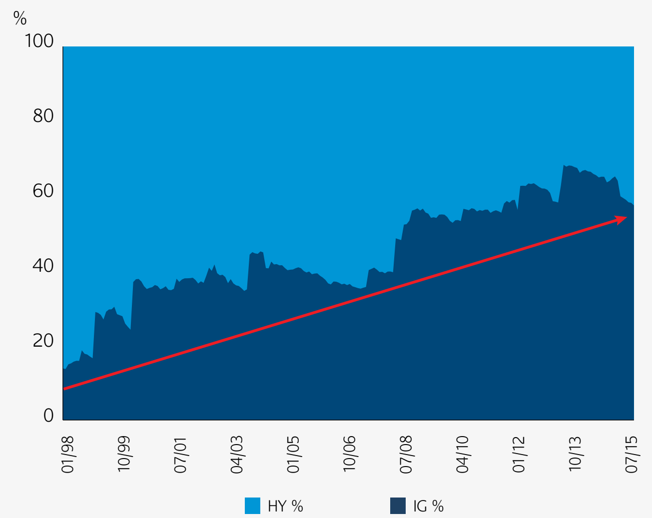
Source: Bloomberg.

Chart 2: Local debt yields



Source: Bloomberg.

Chart 3: EM fundamentals have improved relative to past hiking cycles % of investment grade countries in the EMBI DIV Index

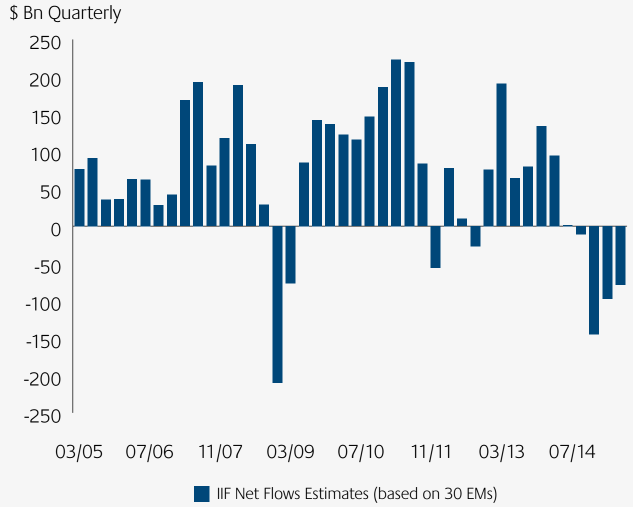


Source: JP Morgan.

2 Sahay, Ratna and others, 2014, "Emerging Market Volatility: Lessons from The Taper Tantrum," IMF Staff Discussion Note 14/09

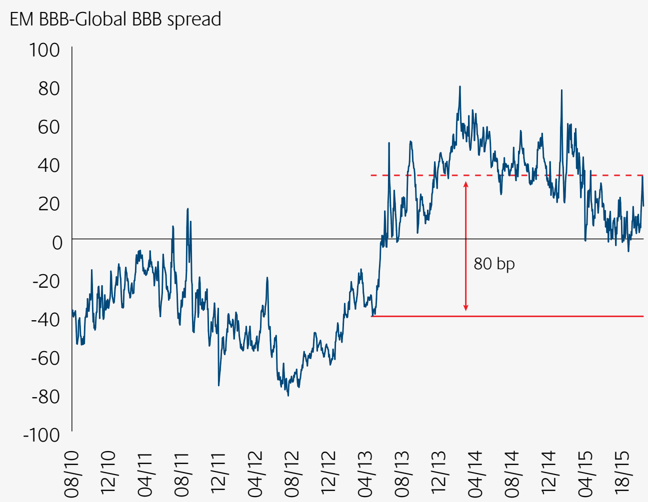
3 Eugenio Cerutti and others, 2015, "Push Factors and Capital Flows to Emerging markets: Why Knowing Your Lender Matters More Than Fundamentals", IMF Working Paper

Chart 4: Net capital flows to emerging markets have been negative



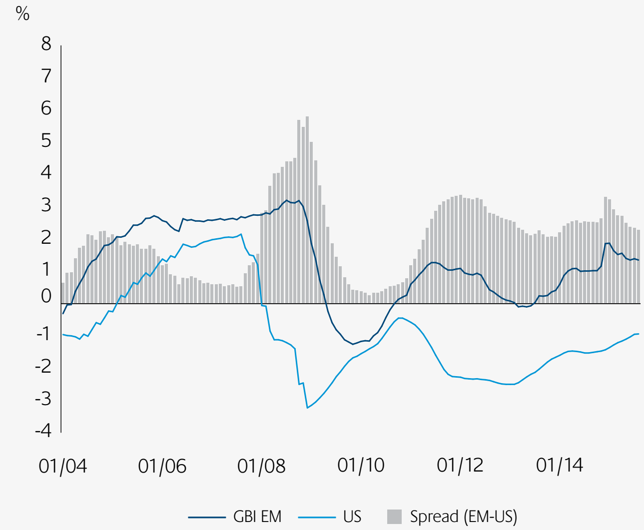
Source: IIF.

Chart 5: External debt valuations offer a larger buffer than in the pre-tantrum period



Source: Deutsche Bank.

Chart 6: Local debt valuations: No increase in real yields relative to the US has taken place since the tantrum



Source: UBS, Bloomberg.

While acknowledging that the external funding environment has become more challenging due to the end of ultra-supportive Fed policies, it is also the case that EM fundamentals are now stronger than they were before the Fed was getting ready to increase rates. More than 57% of the EM index of reference is currently Investment Grade, whereas in April 2004 it was less than 41% (see chart 3). Foreign exchange reserves are also now much higher than before, while inflation-targeting regimes in an increasing number of countries, have allowed for more flexible currency arrangements that serve as an additional buffer against economic shocks and cyclical downturns.

Much of the above is, quite unsurprisingly, well-known to market participants. Hence, it begs the question of how much is reflected in current prices. In the case of external debt, yields are now just above six per cent and the spread of EM BBB to equally-rated debt instruments outside the EM space have widened by more than 80bp since the 'taper tantrum', suggesting considerable re-pricing (see chart 5).

Local currency debt has returned a negative 28% since the taper tantrum, suggesting a significant re-pricing. But most of it has been due to the depreciation of the currencies that these bonds are denominated in. Real rate differentials relative to the US have not increased materially, which warrants caution.

Conclusion

EM investor concerns have become focused on the effect that potential Fed hikes could have on capital flows. We conclude that first, past market behavior and economic research indicate that private capital flows to emerging markets are less sensitive to Fed action than is generally perceived. Secondly, valuations in hard currency denominated EM debt suggest that an increase in Fed funds rate has been priced in to a large extent. In the case of local debt, although nominal yields are high from a historical perspective, the same cannot be said about real yields. Furthermore, EM currencies may continue to re-price lower, to reflect this lack of yield cushion. We would also highlight that EMs are likely to be more resilient to changes in capital flows than in the past thanks to stronger credit fundamentals, the introduction of exchange rate flexibility and an improved net international investment position. Lastly, within EM debt there is likely to be significant differentiation in returns in an environment where funding is more challenging, creating relative value investment opportunities.

First State Investments

The Yield Report.

Global Listed Property Securities

It is an interesting time for investing in long duration real assets as there remains a great deal of emphasis on the implications of rising US interest rates. As bond yield curves steepen and as the internal rate of return (IRR) of long duration assets normalize, we will be focused primarily on preserving capital, and secondly on allocating it efficiently to deliver the most compelling risk-adjusted returns for our investors.

Total returns from global property securities have been well above historic averages in recent years. Cheap and plentiful capital has inflated the valuations of 'risk assets' and resulted in sharp declines in capitalization rates in direct property valuations. Given the probability of US interest rate increases in the months ahead, the key questions for investors are how the asset class will behave against a background of tightening monetary policy; and whether regional factors will reassert themselves as the key driver of local property market returns. In this report, we address both of these issues.

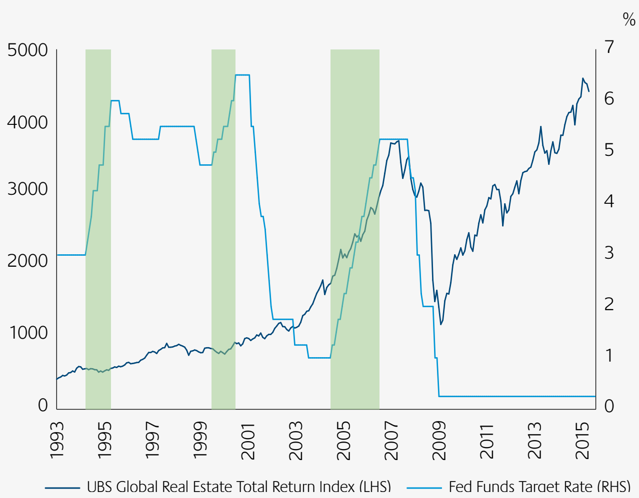
How will rising US interest rates affect sentiment towards global property securities?

There remains a misconception among some investors that property securities are unable to deliver positive returns during periods of monetary policy tightening. It is assumed that the appeal of property securities' dividend yields will fade as the returns available from alternative income-generating investments such as bonds and term deposits increases. While the logic has some merit, it would be short-sighted to abandon the asset class based on this one factor.

The unique circumstances facing investment markets in this cycle means we are hesitant to use history as any guide as to how the asset class will perform when US interest rates are raised. Several commentators have referred to quantitative easing (QE) globally as 'a grand experiment' – nobody really knows how investment markets will behave when liquidity is withdrawn and as the cost of capital increases towards historic norms. There are no precedents.

That said, previous cycles have shown that property securities are able to generate favorable returns for investors during periods where interest rates have been increased substantially. In the three most recent periods of US monetary policy tightening, highlighted in green in the chart below, global property securities delivered average monthly returns of ~1.5%, or ~18% annualized. We are not anticipating returns of this magnitude in the next few years, but those assets which can leverage the improving economic fundamentals and translate it into cash flow growth will likely generate reasonable returns. In spite of the prospect of interest rate increases in the US, total return expectations for our global property security portfolios remain above 10% for the next 12 months.

Chart 1: Global property securities returns (USD) and US interest rates



January 1993 to May 2015 (the UBS Global Real Estate Index was retired in May) Source: FactSet.

With the above factors in mind, how are the global property securities strategies currently positioned?

In its recent rhetoric, the US Federal Reserve (Fed) has made it clear that monetary policy will only be tightened if a further improvement in employment is observed. The Board would not be contemplating increasing interest rates if the economy was not sufficiently strong to warrant them. Some investors appear to have become so preoccupied with the prospect of higher rates that the health of the underlying US economy may have been overlooked. Annual GDP growth is forecast to remain around 2.5% for the next 12 months. Five quarters of uninterrupted economic growth have enabled the unemployment rate to drop to 5.3%; a significant improvement on the near 10% rate seen in late 2009 and not too far off pre-global financial crisis levels. Robust employment growth augurs well for the real estate market.

Occupancy rates in the US have improved alongside employment growth and have reached very high levels. Upward pressure on rents is unlikely to moderate, in our view, especially as there is only moderate new supply in the pipeline. Furthermore, operating expenses on the whole are trending only slightly higher than inflation, resulting in improving operating margins and enabling average property net operating income growth to outpace nominal GDP growth.

Conditions are particularly favorable for coastal apartments, hotels and West Coast office buildings and our US exposure remains concentrated in REITs within these sub-sectors. Investment in the industrial sector is more modest. US dollar (USD) strength appears to be acting as a headwind to industrial production, and could continue to do so if higher interest rates prompt further appreciation of the greenback. Lower export volumes will be a concern for domestic manufacturers.

The outlook for Canada remains less positive, partly due to the slowdown in resource-based industries associated with the lower oil price. Annual GDP growth decelerated to just 0.5% in May and employment growth appears to have dried up. This has prompted the Bank of Canada to lower interest rates to 0.50%. While the outlook for growth is underwhelming, pockets of the Canadian real estate market do look appealing, especially as valuations have come down significantly in recent months. The strategy has negligible exposure to resource-based territories such as Alberta and Saskatchewan, but maintains exposure to the office, retail and senior living sub-sectors in Montreal and Toronto.

Unlike in the US, where the QE tap was finally turned off nearly a year ago (albeit the coupons continue to be reinvested), the European Central Bank (ECB) continues to pump €60 billion per month into Europe via its own QE program. The Bank has suggested the program will run until at least September 2016, by which time the economy will have been boosted by more than €1 trillion of ECB support. Success has been mixed, thus far.

Past performance is not indicative of future performance.

Southern European nations (except Greece) have stabilized, with signs of growth from a low base in Spain. However, high levels of unemployment and national debt remain. Conditions in Northern Europe are benign. German industrial production remains positive, for example, and unemployment is steady at 6.4%. Our European exposure remains focused in Germany, predominantly in the social housing sub-sector, where high occupancy and embedded rental growth continue to appeal.

Over the Channel, property market fundamentals continue to improve in the UK. The unemployment rate has declined to 5.6%, supporting occupancy rates. Rental demand in the London office market remains particularly strong and is outpacing that in other regions. Vacancy rates in London are at low levels – below 4% in the City and less than 3% in the West End – and are expected to remain low given the lack of material new supply that is anticipated before 2018-19, at the earliest. Rental growth for 'A' grade office buildings in both the City and West End is currently in the double digits, supporting investments in companies such as British Land and Hammerson, which own privileged assets in the UK capital. The growth rates are impressive, but we believe we are only part way through an extended period of the market rental growth cycle in London.

In China, the People's Bank of China continues to stimulate activity by easing monetary policy. The 1-year lending rate has been reduced to 4.6%, while the Required Reserve Ratio for large banks has been lowered to 18%. 1-year deposit rates have also been cut, to 1.75%. The housing market has shown some signs of improvement, particularly in the tier one cities, although confidence could be affected by the very heavy sell-off in Chinese equities since mid-June and in August, in particular. The strategy continues to have very modest exposure to the Chinese property market. Official growth rates of 7%/yr do not appear sustainable over time and we are unconvinced that domestic demand is increasing at this pace.

Elsewhere in Asia, zero interest rates and a significant QE program from the Bank of Japan appear to be supporting growth. Indeed, we have continued to see an improvement in office market fundamentals in Tokyo and have material investments in this market. The investment is concentrated in 'A' and premium grade office buildings. Vacancy rates in this area of the market have fallen to around 5% and asking rents for existing buildings are increasing at an annual pace of around 5%.

Office vacancy rates are significantly higher in Australia, with occupancy having declined to 87.5% nationally. Further, nearly a million square meters of new office space – equivalent to 5.6% of current supply – is under construction and due for completion before the end of 2016. Expectations for rental growth are subdued against this background, especially as landlords of new office buildings are enticing tenants with significant rent discounts. Other areas of the market are showing no material increases in tenant demand, reflecting softening growth expectations and fragile consumer confidence.

Strong interest in Australian commercial property from overseas investors has seen capitalization rates decline for these assets. Reflecting these premium valuations and low return expectations, our global strategies currently have no exposure to the Australian office sector. Investment in Australia remains focused in the self-storage sector.

Finally, we have become increasingly cautious on the Hong Kong housing market. Abundant liquidity and low mortgage rates have continued to drive housing prices higher, likely leading to affordability issues when interest rates eventually rise.

Will the returns of global property securities remain highly correlated?

The flood of liquidity provided by the world's major central banks in recent years saw the correlation of returns from different real estate markets increase. The fundamentally localized nature of real estate, however, means historically there has been a relatively low correlation between regional returns. We would expect local drivers to reassert themselves as the interest rate curve steepens.

In this environment, there can be significant valuation differences among global property securities and large pricing anomalies in the investment universe. Encouragingly, we have seen total return dispersions within the asset class track back towards historically high levels in recent months. Allocating capital efficiently against this background requires a clear understanding of current and anticipated real estate fundamentals at a local level, as well as the macroeconomic conditions which can influence real estate market cycles. Accordingly, our team consists of experienced investors with specialist local expertise, located across the world's major property markets of the US, Europe, Asia and Australia.

While there may well be some uncertainty when US interest rates are increased, this might be accompanied by a further increase in the dispersion of total return expectations within the sector. The ability to allocate capital efficiently will be critical to delivering positive absolute returns for investors. Returns from property securities may not match the 16% annualized returns seen over the past five years, but we believe the dispersion in return expectations will likely provide opportunities to take exposure to high quality real estate offering reasonable returns.

The Yield Report.

Global Listed Infrastructure Securities

Global listed infrastructure asset types include toll roads, airports, ports, railroads, utilities, pipelines, energy storage, mobile towers and satellites. Companies in these sectors own and operate stable, long duration assets with high barriers to entry, which generate predictable cash flows.

These characteristics give the asset class consistently strong pricing power and relative immunity to economic cycles. They can also make listed infrastructure relatively sensitive to changes in interest rates.

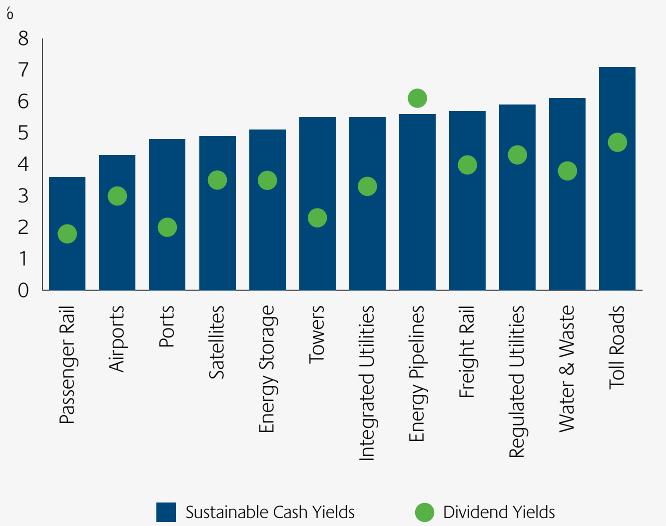
Since 2008, global interest rates and bond yields have been falling to what are now historically low levels. This has benefitted income-generative infrastructure sectors such as utilities, as the yield they offer has become increasingly appealing compared to alternative income-producing asset classes. Sectors with leveraged balance sheets, such as energy pipelines, have also benefitted from the lower cost of debt. Rising interest rates and bond yields could represent a headwind for these sectors' valuations.

The extent of the impact on the sector from US interest rate increases is likely to be determined mainly by the degree and speed of the changes, rather than by absolute interest rate levels. We would expect a relatively steady increase – for instance a 1% rise in interest rates over a 12-month period – to have a relatively benign impact on the asset class.

This view is based on analysis showing that listed infrastructure companies are in a sound financial position. With a few notable exceptions, dividend payout ratios are conservative at 65% and company balance sheets are in good shape. Leverage is reasonable at approximately 2x net debt/EBITDA; and is materially lower than the levels of 3-4x reached in 2005 and 2006.

The robust financial position of listed infrastructure companies is illustrated by chart 1 below. The blue bars show average distributable cash flow (after allowing for maintenance capex) for the main infrastructure sectors, overlaid with green dots showing the average dividend yield for each sector.

Chart 1: Infrastructure yields by sector



Source: FSI.

In most cases (energy pipelines aside), cash yields are significantly higher than dividend yields, implying ample scope for payout ratios to be raised. This is especially the case in the freight rail, toll road and mobile tower sub-sectors. This strength of balance sheets also suggests many companies have the potential to carry out share buy-backs, or to engage in merger and acquisition (M&A) activity in order to boost earnings and dividends, potentially offsetting the impact of higher interest rates.

These points indicate that listed infrastructure overall is well placed to thrive against a backdrop of steadily rising rates. Rising interest rates would also suggest an increase in economic activity levels, leading to higher demand for the vital services provided by infrastructure.

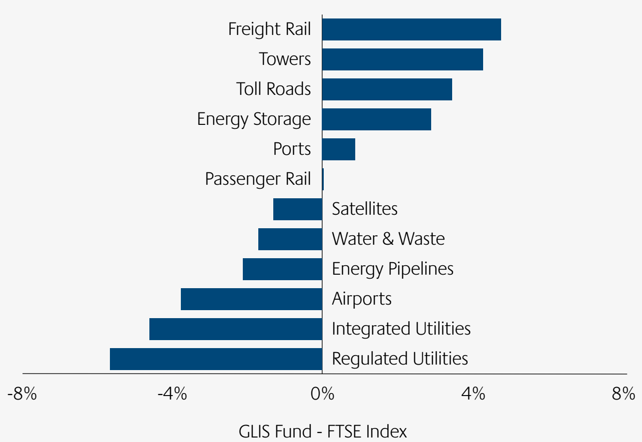
A sharp rise in interest rates – say a 2% increase over six months – would likely represent a much more significant headwind to the asset class. We would expect a move of this magnitude to result in absolute downside, and to deliver relative underperformance for listed infrastructure compared to other asset classes. However, we view this outcome as being relatively unlikely.

The value of active management

Considerable diversity can be found across different global listed infrastructure sectors. On aggregate, the beta of the investment universe is lower than that of the global equity market. However, while electricity and water utility earnings tend to be regulated, set in advance and highly predictable, the earnings of sectors such as toll roads, airports, rail and ports are largely volume-driven. They benefit from increasing levels of economic activity, giving these companies additional scope to grow earnings over time.

Part of our job as active managers is to take interest rate expectations into account when positioning portfolios. We are able to shelter portfolios from the impact of rising rates by tilting away from 'income' infrastructure sectors; and increasing holdings in 'growth' infrastructure sectors. The chart below highlights the end-July sector positioning of the flagship FSI Global Listed Infrastructure Fund.*

Chart 2: Active weights by sector



Source: First State Investments.

Utilities represent the largest underweight position. Within this space the portfolios have underweight exposure to bigger, more mature US utilities. We favor utilities with higher growth potential; for example, from transmission or renewables build-out.

* The FSI Global Listed Infrastructure Fund is not available for investment by US persons.

We have maintained a cautious stance towards energy pipelines, many of which have unwelcome commodity price exposure. As the gap between pipeline earnings and dividends in chart 1 illustrates, current dividend payout levels are in many cases dependent on future growth that now appears at risk. Downgrades to dividend payouts may prompt existing investors, many of whom were initially attracted to the high and growing dividends offered by pipeline companies, to consider exiting these positions.

The largest sector overweight is freight rail, which is relatively sensitive to broader economic growth rates. There are some North American operators that offer well-diversified volume growth and the prospect of margin expansion, driven by improving operating efficiency and the renegotiation of legacy contracts. Their low levels of debt make them relatively insensitive to rising bond yields.

Mobile towers are insulated from rate rises by structural growth in mobile data, and their highly cash generative business models. They can apply contracted price escalators; and they have the potential to add equipment from additional wireless service providers to existing tower assets – in effect growing the top line at minimal cost. We expect ongoing pressure on mobile phone carriers to improve network quality will underpin continued healthy earnings growth for tower operators.

We also believe the market continues to under-estimate the strength of pricing power and the potential recovery in volumes available to European toll road operators. We are attracted to the high quality of the toll road concession assets managed by these companies, their undemanding valuation multiples, and well-supported dividend yields of between 3% and 5%.

Conclusion

Over medium-term time frames, including during periods of steadily rising interest rates, we expect listed infrastructure to deliver returns of between 8% and 10% pa, with successful active managers able to add alpha to that base case. We expect the asset class to maintain its typical pattern of performance (sharing most of the upside in rising equity markets, and providing some protection from the downside during periods of weakness), given its barriers to entry, consistently strong pricing power and the relative immunity to economic cycles of its underlying assets.

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