Investment Market Conditions UPDATE

28 September 2017

Summary of key points

- Little seems to have changed over the course of the last month. Trump and Kim are still ranting at each other, although it seems to have a harder edge more recently. The Fed is still planning four rate rises by the end of 2018 and the markets still don't believe it. Merkel is still the Chancellor of Germany, albeit with a more complex parliamentary situation to deal with. The US equity market is still at or near a record high in spite of all the worries that it seems to be ignoring.
- Bond yields worldwide are still at historically low levels, providing the main support for equity asset prices, along with earnings growth that is holding up and even accelerating in places.
- Our valuation work, combined with our assessment of the qualitative factors, shows that it is still appropriate to hold a neutral or benchmark allocation to Australian and International equities, using a longer-term perspective.
- There are risks of a shorter-term sell off in the months ahead. If this happens, the next likely move is to go overweight equities on weakness, although the prospects of prolonged weakness would also need to be carefully appraised.
- It is not hard to find potential triggers for a short run sell off in equities. The main recent events of significance have been:
    - The US Federal Reserve announced that it expects to increase short interest rates four times in the next fifteen months and that it will also be reducing its holdings of long term bonds and mortgage securities by at least $10 billion per month. The pace of this Quantitative Tightening will eventually pick up to $50 billion per month and this will put upward pressure on US ten-year bond yields. In turn this will put downward pressure on equity prices in the US and elsewhere.
    - The Deputy Chairman of the Fed, Stanley Fischer, a steadying influence on policy, announced his retirement within the next few months. This will leave four of the seven Board seats at the Fed empty, to be filled by the Trump administration but subject to Congressional approval. Given the state of Trump-Congressional relations, this may lead to a period of uncertainty in Fed policy just as it is implementing the great unwinding of the highly stimulatory monetary policy adopted since the GFC ten years ago.
    - Trump did a deal with the Democrats to stave off the debt ceiling crisis from September to

Summary of key points cont.

December, much to the chagrin of congressional Republicans. While this takes pressure off financial markets, it is only temporary. The dynamics of the US Congress are still unstable, as shown most recently by the inability of the Republicans, who have a majority in both houses, to pass the repeal of the Affordable Healthcare Act (Obamacare). Looking beyond the debt ceiling issue, the fate of tax reform and tax cuts that have been largely factored into equity market prices is by no means clear.

  - Nonetheless, at the time of writing, reports out of Washington indicate that Trump and senior Republican Congressional leaders, have agreed on the main terms of tax changes that are about to be announced. These are reported to include a cut in the corporate tax rate from 35% to 20%, immediate full tax deductions for capital spending for the next five years and an end to taxation of offshore company profits from now on. If true, this would be very encouraging for investors in US equities, which could be expected to reach new highs. There are also significant changes to personal tax being mooted. The lack of detail on how this would be paid for suggests an increase in the US Federal deficit and more upward pressure on bond yields.
  - China moved closer to its five –yearly election of the Politburo leadership, which is usually a very controlled event, but S&P joined other major rating agencies in downgrading China's sovereign debt rating, pointing to the very high level of debt that has accumulated as a result of the stimulatory policies of the Xi regime in the last five years.
  - Prime Minister Abe of Japan announced a snap election, hoping to capitalize on the weakness of the official opposition and the tension generated by North Korean missiles traversing Japanese airspace. This may yet backfire as the very popular Governor of Tokyo has said she will challenge the governing Liberal Democratic Party. Abe is widely perceived to have not done enough to implement needed economic reform, the third arrow alongside the other two: fiscal and monetary stimulus, which have carried the burden of rekindling economic growth over the last five years. With short and long-term interest rates at zero, there is a need for the burden to be carried by real economic reform, if economic growth is to be sustained.
  - The oil price has strengthened in part because OPEC has announced further limits on production, in part because US shale oil production is increasing less than expected, in part due to hurricanes hitting the production in the Gulf of Mexico, but also due to the Kurdish independence referendum in Northern Iraq. In response, the Turkish President Erdogan, who wants to stave off Kurdish independence in Southern Turkey, has said that Turkey will block Iraqi oil exports, which flow by pipeline across Turkey.
  - Among all of this the most likely Factor X remains USA versus North Korea situation. As we indicated previously, if ignited, this would impact Japan, South Korea and China, with flow on economic effects to Australia via the trade channel.
  - There would also be effects transmitted via the global financial markets, which would probably quickly overreact to an outbreak of war. A sell-off of 20% or more within a week or two could easily occur.
- Notwithstanding the shorter-term risk factors, it is still appropriate to hold a neutral or benchmark allocation to Australian and International equities using a longer-term perspective, mainly because record low interest rates are sustaining equity valuations and will do so until bond yields have increased by more than 1.5% p.a.
- Bond yields are expected to rise by 1% p.a. to 1.5% p.a. over the next two years. Therefore, in the defensive or stabilising part of the portfolio, there should be an underweight to fixed Interest combined with a shorter duration position in fixed interest. In addition, given the low spread or margin available for taking credit risks, the exposure to credit risk should be very limited.
- The possible adverse impact of rising bond yields on listed property trusts also indicates a significant underweight to this asset class.
- A modest overweight to alternative equities, which target an absolute return higher than cash or fixed interest would be helpful in stabilising portfolio returns without giving up too much in return.

Table 1: Recommended asset allocation positioning for portfolios

RECOMMENDED ASSET ALLOCATION RELATIVE TO BENCHMARK OR NEUTRAL:	ZERO	MAJOR UNDER WEIGHT	MINOR UNDER WEIGHT	NEUTRAL OR BENCHMARK WEIGHT	MINOR OVER WEIGHT	MAJOR OVER WEIGHT
ASSET CLASS						
Cash					X	
Fixed interest			X			
Property		X				
Australian equities				X		
International equities				X		
Alternative equities					X	

Where are we now?

Table 2: Financial market movements

Market indicator	Level at 30/06/2016	Level at 30/06/2017	Level at 27/09/2017	Change 2016/2017 financial year		Change 2017/2018 financial year to date	
				In local currency	In AUD	In local currency	In AUD
Equity Markets							
S&P ASX 200	5233	5721	5650	9.3%	9.3%	-1.2%	-1.2%
USA: S&P 500	2098.86	2423	2496	15.4%	11.8%	3.0%	0.5%
UK: FTSE 100	6504.33	7312	7285	12.4%	6.3%	-0.4%	0.3%
Germany: DAX	9680.09	12325	12605	27.3%	26.8%	2.3%	-0.2%
France: CAC	4237.48	5120	5268	20.8%	20.3%	2.9%	3.5%
Japan: Nikkei 225	15705	20033	20221	27.6%	13.1%	0.9%	0.9%
China: Hang Seng	20794	25764	27503	23.9%	20.0%	6.7%	6.7%
Currencies							
USD/AUD	0.7444	1	0.7881		-3.2%		-2.4%
GBP/AUD	0.558	1	0.5861		-5.4%		0.7%
YEN/AUD	76.6	86	88.54		-11.4%		-2.4%
EUR/AUD	0.67	1	0.6685		-0.4%		0.6%
Interest rates (% p.a.)							
Aus: 90 day bank bill	2	2	1.78	-24.0%		2.0%	
Aus: 10 year govt bond	2	3	2.77	59.0%		18.0%	
US: Fed funds rate	0.32	1	1.16	84.0%		0.0%	
US: 10 year govt bond	1.46	2	2.22	84.0%		-8.0%	
Commodities							
Copper US $ per tonne	4845	5927	6413	22.3%	18.4%	8.2%	5.6%
Gold USD/ounce	1328	1241	1295	-6.6%	-9.5%	4.4%	1.8%
Oil USD/barrel (WTI)	48.46	46	52	-5.1%	-8.1%	13.0%	10.3%

So far, this financial year:

- Short term interest rates in both the USA and Australia have remained anchored at or near historical lows;
- The long-term bond yield in the USA has fallen reflecting a flight to safer assets in recent weeks as geopolitical tensions have risen, particularly in Korea. This dip in bond yields will likely prove to be temporary;
- The Australian long-term bond yield has edged up, opening up a wider margin above its US counterpart, at +0.55% p.a. This is still lower than the historical average, indicating plenty of scope for this gap to widen. That is, we expect Australian bond yields to rise more than US bond yields over the next year or so, exacerbating any effect of rising US bond yields;
- Commodity prices have been mixed in recent weeks. The oil price has risen due to various factors noted earlier. Copper, a bellwether of industrial production, has fallen 5.6% over the last month, trimming its Financial Year to Date rise to 5.6%. This reflects the prospect of weakening GDP growth in China, especially as the likelihood of credit constraints in 2018 grows. The iron ore price has also fallen over the last month, but it is down more sharply than copper, falling by 20%. The fall was due in part to a reversal of previous speculative activity in the Dalian iron ore futures market, but most of the effect is due to a slowdown in iron ore and steel inventories in China. If this persists it will be adverse for the major iron ore producers, BHP, Rio and FMG as well as for the tax collections of the WA and Commonwealth Governments. The recent improvement in the Federal deficit on the back of higher company tax collections of the last six months may yet be reversed, but for now ScoMo is basking in the sunshine of a good set of recent numbers. Gold has not risen on the back of geopolitical tensions and actually fell 1.2% over the month. It seems that the security seekers favour US Treasury bonds over gold.
- Global equity markets, with the exception of Britain and China, have been moderately stronger over the last month. Uncertainty about the implementation of US tax cuts has reduced somewhat while the prospect of war in East Asia has been discounted by the equity markets so far, the combination of continued low bond yields and moderately stronger earnings per share growth for major companies is proving to be supportive of their equity prices.

Current assessment of equity asset markets

Our current assessment of equity markets, taking into account valuation factors, momentum factors and qualitative factors such as monetary policy, fiscal policy and geopolitical factors, is summarised in Table 3.

Table 3: Summary of equity markets assessments

Equity Markets Assessment - 27 September 2017

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted, lower is better)	**100%**	**114%**
Momentum indicator	**NEUTRAL**	**NEUTRAL**
Qualititative indicator	**POSITIVE**	**POSITIVE**

Valuation indicators have deteriorated slightly for both Australian and International equities over the last month. The current pricing of the Australian equity market is now in line with the long-term Fair Price assessment. International Equities have also become slightly more expensive relative to the long-term Fair Price. There is more detail on the Valuation Indicators in Table 5 below, which shows that the US equity is better value than the European or Japanese markets.

The medium to long-term assessment of the effect of Momentum in equity markets, which usually persists between six months and eighteen months, recently shifted from positive back to neutral and remains there.

Qualitative factors are mostly unchanged in their effect, with both fiscal and monetary policy still very supportive of equity prices in most countries and markets. Geopolitical factors have a role to play and are very uncertain. Our assessment of these is set out in Table 6 below.

Our assessment of likely earnings per share growth for major equity markets over the next ten years is based on forecasts of real GDP growth and inflation. These remain unchanged since last month and are broadly in line with forecast from the IMF.

Table 4: Earnings per share growth rates for equity markets

Scenario 1 - base EPS growth assumptions over ten years

		Real GDP growth % p.a.	Inflation % p.a.	EPS growth % p.a.
USA	S&P 500	2.50%	2.00%	3.50%
China	Hang Seng	5.00%	2.50%	3.50%
Japan	Nikkei 225	1.50%	1.50%	2.00%
Britain	FTSE ALL SHARE	2.00%	2.50%	2.50%
Germany	DAX	2.00%	2.00%	2.00%
France	CAC	2.00%	2.00%	2.00%
Australia	ASX S&P 200	2.75%	2.00%	2.75%

These assessments of long-term earnings per share growth, together with the bond yield, are used to derive the long run Fair Price estimates in the analysis set out below in Table 5. We do so for a number of scenarios, which imply different financial market regimes. While there are many possibilities, the three main ones in our assessment are as follows. These scenarios are essentially unchanged since our last Update and we have not changed our assessment of the likelihood of each of them:

- Modest earnings growth where inflation and interest rates do not rise by much. This is good for equity prices. We rate this as the most likely scenario for the next 3 to 5 years with a likelihood of 50%. In this scenario we are assuming that the ten-year Australian bond yield will rise from the current 2.7% p.a. to around 3.4% p.a. This is a more demanding hurdle that provides a buffer of safety in our forecasts.
- Faster earnings growth where inflation and interest rates rise above 4% p.a. This higher rate of inflation is generally bad for fixed interest and to some extent is also bad for equity prices. This higher inflation prospect is reflected in the higher assumed long-term bond yield. This effect is offset to some extent by the faster rate of earnings per share growth. We rate this scenario as a 30% likelihood.
- Recession and possible deflation where inflation and real interest rates fall significantly and may even turn negative and there is a risk of the economy being trapped in a zero or negative growth pattern. We rate this scenario as a 20% likelihood.

Table 5: Fair Price assessments for the Australian and International equity markets

Equity Market Valuation indicators from Australian Investor Perspective - 27 September 2017

Scenario:	One: Modest earnings growth	Two: Faster earnings growth	Three: Relapse into recession	Scenario weighted
Probability of scenario	**50%**	**30%**	**20%**	**100%**
EPS AND EPS GROWTH ASSUMPTIONS				
Current EPS changed by	**0.00%**	**5.00%**	**-15.00%**	
Long term EPS growth rate changed by	**0.00%**	**0.50%**	**-0.50%**	
Bond yield equal to current yield multiplied by	**130.00%**	**150.00%**	**80.00%**	
Bond yield in % p.a.	**3.60%**	**4.16%**	**2.22%**	
Country	**Ratio of current market value to long term fair value**	**Ratio of current market value to long term fair value**	**Ratio of current market value to long term fair value**	**Ratio of current market value to long term fair value**
USA	**109%**	**105%**	**106%**	**108%**
China	**111%**	**106%**	**116%**	**112%**
Japan	**121%**	**116%**	**124%**	**121%**
Britain	**154%**	**147%**	**154%**	**153%**
Germany	**116%**	**111%**	**118%**	**116%**
France	**121%**	**116%**	**123%**	**121%**
Australia	**100%**	**96%**	**100%**	**100%**
Global (MSCI)	**116%**	**111%**	**115%**	**114%**

Red is expensive (above 120%) **Purple is more or less fair value (80% to 120%)** **Green is cheap (below 80%)**

The valuation analysis indicates that, with the exception of the British market, major equity markets are within the fairly priced range, but none of them are cheap. Together with the shift in momentum back to neutral from positive, this indicates that caution is warranted and portfolios should not go overweight in equities yet, notwithstanding the positive contribution of qualitative factors as noted in table 6 below.

Qualitative factors used in the overall assessment

Overall our current assessment is that the positive qualitative factors (supportive monetary and fiscal policy) outweigh the negative factors (slower than usual economic growth in some places and instability in politics and policy making in the USA).

Our summary of the qualitative factors and their effects on equity market returns for each major region is as follows:

Table 6: Qualitative factors affecting equity markets over the next three years

Region	Monetary Policy	Fiscal Policy	Economy (GDP growth, unemployment etc)	Politics and Public Policy	Overall
USA	Positive but weakening gradually over the next two years as the FED gradually reduces its holdings of bonds (Quantitative Tightening) while it raises short term rates.	Positive and increasing but with uncertainty about the extent and timing of tax cuts that depend on the effective cooperation of the White House with Congress	Positive and increasing as the population gets on with its life in spite of the politicians ineffectiveness.	Probably positive but volatile and increasingly uncertain as to outcomes	Positive
China	Positive with possible sharp reductions in stimulus in 2018 after the power structure for the next five years	Positive as there is a need for continued spending on health care and education as well as infrastructure	Positive with some prospect of a decline in the rate of growth towards 5% p.a.	Positive, with the Xi administration continuing to strengthen its control of all the key policy levers	Positive
Japan	Positive with the BOJ confirming that it needs to keep near zero bond yields in place	Positive	Positive and increasing modestly with real GDP growth averaging 2% p.a.	Positive but subject to some disruption as the Abe government is challenged during the snap election	Positive
Europe	Positive but weakening in 2018 or 2019 as the ECB unwinds part of its stimulus	Positive	Positive	Has shifted from negative to slightly positive, but with more political uncertainty in Germany and Spain	Positive
Great Britain	Positive	Positive and increasing	Weakening due to Brexit	Negative and divided	Positive
Australia	Positive with the RBA rate likely to be unchanged till late 2018 or early 2019	Positive and increasing as tax policy remains unresolved and we approach the next election.	Positive	Negative with stalemate in the Senate	Positive

What to do next with Investment Portfolio Strategy:

- Keep a neutral or benchmark weight to Australian equities and International equities.
- Stay short in interest rate duration in fixed interest to avoid capital losses as bond yields increase.
- Stay short in credit duration, as credit spreads are mainly too tight to offer adequate return for risk
- Hold a major underweight to AREITs (Listed Property Trusts) and be selective about unlisted property assets - minimum yield of 6% p.a. maximum debt of 45% of gross assets, good tenants, and great managers with a proven track record.
- If the client portfolio allocation to either of Australian equities or International equities is less than 50% of the currently recommended target allocation, then the allocation should be increased to 50% as soon as practicable with the balance of the difference to be invested progressively over a subsequent six-month period.
- In the longer run beyond the next year or so, the prospects are for greater increases in short term interest rates in the USA relative to interest rates in Australia. This means that eventually the AUD is more likely to fall than rise against the USD, so international investment on a three to five-year horizon should be unhedged.
- A slight overweight to well managed alternative equities that offer premium returns above cash rates and lower volatility investment in growth assets should be maintained.

Table 7: Recommended asset allocation positioning for portfolios managed with a three-year horizon

RECOMMENDED ASSET ALLOCATION RELATIVE TO BENCHMARK OR NEUTRAL:	ZERO	MAJOR UNDER WEIGHT	MINOR UNDER WEIGHT	NEUTRAL OR BENCHMARK WEIGHT	MINOR OVER WEIGHT	MAJOR OVER WEIGHT
ASSET CLASS						
Cash					X	
Fixed interest			X			
Property		X				
Australian equities				X		
International equities				X		
Alternative equities					X	