Madison Financial Group I A member of the PHAROS Financial Group

Investment Market Conditions UPDATE

31 October 2017

Summary of key points

- The key issues for investors to consider are:
    - Inflation and why it is persistently so low? - We think it will average between 2.0% p.a. and 2.5% p.a. in Australia over the next ten years.
    - The likely path back to normalised monetary policy by the world's central banks. We think it will be very gradual over the next five years, with the US leading and Europe and Japan lagging - so bond yields will be low enough to support equity prices for some time to come but will eventually put pressure on equities if US bond yields rise above 4% p.a.
    - The continued calm in world equity markets and whether turmoil will return in the near future. On balance we think that low volatility is more likely than not to continue over the next 12 months- but there are some potential triggers for a short term sell off.
    - The consolidation of power by Xi Jinping in China at the recent 19th Party Congress and what this may mean for economic growth in China and the entire world as well as commodity prices and equity markets. We think that it means a significant but controlled reduction in credit growth, slower GDP growth which is still strong by world standards and more significant constraints on coal and iron ore prices.
- 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.
- 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. This is 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. Our valuation work, combined with our assessment of the momentum and qualitative factors, supports this judgment.
- 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 27/10/2017	Change 2016/2017 financial year. In local currency	Change 2016/2017 financial year. In AUD	Change 2017/2018 financial year to date. In local currency	Change 2017/2018 financial year to date. In AUD
Equity Markets							
S&P ASX 200	5233	5721	5903	9.3%	9.3%	3.2%	3.2%
USA: S&P 500	2098.86	2423	2560	15.4%	11.8%	5.7%	6.3%
UK: FTSE 100	6504.33	7312	7486	12.4%	6.3%	2.4%	3.8%
Germany: DAX	9680.09	12325	13133	27.3%	26.8%	6.6%	5.6%
France: CAC	4237.48	5120	5455	20.8%	20.3%	6.5%	9.1%
Japan: Nikkei 225	15705	20033	21970	27.6%	13.1%	9.7%	9.7%
China: Hang Seng	20794	25764	28438	23.9%	20.0%	10.4%	10.4%
Currencies							
USD/AUD	0.7444	1	0.7641		-3.2%		0.6%
GBP/AUD	0.558	1	0.5821		-5.4%		1.4%
YEN/AUD	76.6	86	87.237		-11.4%		-0.9%
EUR/AUD	0.67	1	0.6568		-0.4%		2.4%
Interest rates (% p.a.)							
Aus: 90 day bank bill	2	2	1.75	-24.0%		-1.0%	
Aus: 10 year govt bond	2	3	2.78	59.0%		19.0%	
US: Fed funds rate	0.32	1	1.16	84.0%		0.0%	
US: 10 year govt bond	1.46	2	2.46	84.0%		16.0%	
Commodities							
Copper US $ per tonne	4845	5927	6986	22.3%	18.4%	17.9%	18.6%
Gold USD/ounce	1328	1241	1267	-6.6%	-9.5%	2.1%	2.7%
Oil USD/barrel (WTI)	48.46	46	52.62	-5.1%	-8.1%	14.4%	15.1%

- Short-term interest rates in both the USA and Australia have remained anchored at or near historical lows. The recent low inflation reading for Australia extends the likely time horizon until the RBA increases rates and this has caused some recent weakness in the Australian dollar;
- The long term bond yield in the USA has risen significantly over the latest month, reducing the margin of the Australian ten year bond yield over its US counterpart to just +0.32% p.a. This is unsustainable by historical standards. The previous dip in US bond yields proved to be temporary;

- The Australian long-term bond yield was stable over the latest month and has edged up over the year to date. The margin above its US counterpart, at +0.32% p.a. is much lower than the historical average, so there is plenty of scope for this gap to widen. 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 which may be gradual but likely to be inexorable;
- Commodity prices have been mixed in recent weeks. The oil price was up slightly in US dollar terms. Copper, a bellwether of industrial production, rebounded +8.9% over the last month, bringing its rise for the Financial Year to Date to 18.6%. This reflects the prospect of continued strong GDP growth in China.
- Global equity markets were all stronger over the most recent month. All international equity markets have had significantly positive returns in Australian dollar terms in the financial year to date. Uncertainty about the implementation of US tax cuts has reduced further over the latest month.
- Australian equities also rose significantly over the latest month, by +4.5%, but still lag other equity markets over the financial year to date, when measured in price terms without factoring in dividend yields. While Australian dividends are very attractive (average gross yield 5.4% pa. versus a global average of 2.4% pa), the recent results reporting season in Australia was not that positive. Only 30% of ASX 200 companies beat earnings expectations versus a traditional 35% while 37% fell short of expectations compared with an historical average of 27%.
- The prospect of war in East Asia has so far been discounted by the equity markets. 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.

The outlook for key factors influencing financial markets

Looking at each of the key issues that can influence future investment returns:

- **Inflation** has continued at low levels in most countries, undershooting central bank targets. The most recent example is the September quarter inflation rate for Australia, which is now running at 1.8% p.a., below the Reserve bank target range of 2% to 3% p.a. Central bankers including RBA Deputy Governor Debelle and Chairman of the US Federal Reserve Board, Janet Yellen, have commented that the causes of the low rate of inflation are not well understood, with the assumed relationship between higher inflation and low unemployment (the Phillips curve), appearing to break down in recent years. Daniel Tarullo, a former Governor of the Federal Reserve Board, recently observed that "Economists do not, at present, have a theory of inflation dynamics that works sufficiently well to be of use for the business of real time monetary policy making." Our view is that there is no mystery. Over the last thirty years, there has been a major structural shift in labour markets from permanent to casualization accompanied by a fall in trade union membership and a shift from manufacturing to services. All of this, together with the shock of the GFC, has made workers less inclined to bargain for wage increases, but instead focus on getting enough work and keeping their jobs to support their cost of living. In Australia, a recent study by ME Bank showed that only 12% of employees ask for a pay rise in any given year (and 70% of those asking to get one). Overall there is no pressure for wage increases that anticipate future inflation as there was in the 1970s or 1980s. Glenn Stevens, the recently retired RBA Governor commented recently that central bankers want more inflation, but markets are not pricing in much inflation. We do not expect this to change in the next few years. Looking out over the next ten years, we expect inflation in Australia to average between 2.0% and 2.5% p.a.

- **Monetary policy normalisation** by the world's central banks is under way but at a very slow pace. Normalisation will eventually mean the return of short-term real interest rates (i.e. the margin above inflation) to the level last seen before the GFC. It will also involve the central banks reducing the size of their holdings of assets such as government bonds to the level that prevailed before 2007. The US Federal Reserve has indicated that it is now doing so at a rate of $US10 billion per month and will step up this rate to $US50 billion per month by late 2018. This sounds like a lot, but it needs to be judged against the Fed holdings which total over $US4.3 trillion. The unwinding of the big balance sheet built up after the GFC will take at least five years even if the pace picks up somewhat.

In Europe, the ECB has announced that rather than cut back its balance sheet, it will grow it more slowly for the next nine months, at a rate of EUR30 billion per month. A shift from quantitative easing to quantitative tightening is not happening yet and will likely not start until at least 2019. There is real constraint on the ECB selling rather than buying government bonds. This is that its quantitative easing program purchases amounted to over seven times the bond issuance by Eurozone governments. In other words, the ECB has effectively been financing the continued fiscal deficits of European governments. Meanwhile, the ECB continues to keep its key interest rate negative. This helps underpin the low level of yields in the world's bond markets with over $US8 trillion or 17% of the total on issue trading at negative yields. In Japan, the Bank of Japan has not yet decided to trim its level of bond purchases, let alone revert to selling its bond holdings. It is maintaining negative short-term deposit rates and targeting a yield of 0% for the ten-year Japan Government Bond. The result is that although there is some prospect of a gradual rise, bond yields worldwide are still at historically low levels, providing major support for equity asset prices, along with earnings growth that is holding up and even accelerating in places.

- **Equity markets** remain calm, at least as measured by volatility, which is close to historic lows. The US equity market has made more than fifty new record highs this year, but each has been modestly higher than the last. Historical precedents indicate that eventually turmoil and increased volatility will return but the trigger for this is not evident. Eventually, a trigger will come. It may be in the form of major disappointment of US equity markets if tax cuts are not forthcoming. We judge this to be unlikely in the run up to Congressional elections in November 2018. (68% of fund managers surveyed in the USA expect tax cuts to proceed but not all of the effect has yet been priced into the equity market.) It may come in the form of an outbreak of war in Korea. This would cause a severe sell off, but may not be that long lasting, as military action would be swift. A larger and more prolonged downturn could be triggered if China decides to slow its credit growth too quickly.

- **China** has seen the consolidation of power by President Xi Jinping at the 19th Party Congress of the Chinese Communist Party. Xi is now the most powerful leader since Deng, who transformed the Chinese economy from 1978 onwards. His thoughts have been enshrined, with his name, in the Chinese Constitution, alongside those of Deng and Mao. He and his allies now form the majority of the seven man Standing Committee of the Politburo. This body, together with the Small Working Groups set up and managed by Xi, run all aspects of policy. Xi has more effective control of economic and financial market policy than most of his predecessors but at a time when China is more significant than ever to the world economy and financial markets. China has 19% of the world's population and 18% of its GDP (at purchasing power parity) but it contributes 37% of world GDP growth and accounts for 46% of industrial metal imports. The growth of the Chinese economy is vital to overall global growth and to Australia in particular. The key question is how fast Xi will use his enhanced power to tackle the issue of the indebtedness of Chinese state-owned enterprises (SOEs). China's overall debt to GDP grew rapidly in the aftermath of the GFC as the government sought to stimulate the economy. The IMF estimates that between 2007 and 2015, 63% of the increase in world money supply came from China. The total money supply in China is now bigger than that of Japan and Europe combined. This not only prevented China from going into recession, it also limited the downside in global GDP growth while causing the boom in iron ore and coal prices which were of great benefit to commodity exporting companies and Australia. The level of corporate debt (include that of the SOEs) grew to 160% of GDP, while total debt, including that of households and government grew to 250% of GDP. Most recently debt has been growing at 15% p.a., a rate which the Bank Of International Settlements (BIS) as well as major rating agencies consider is unsustainable. It led one of the latter, Standard and Poor's to downgrade China's sovereign debt rating earlier this year, the first downgrade since 1999. Much of the growth in credit has gone into less productive industries which have overcapacity. These include steel, coal, cement, glass, paper and non-ferrous metals. They have also contributed to worsening pollution. The combination of overcapacity and pollution has led China's policy makers to target a 10% reduction in capacity in some of these industries (which may translate into an increase in unemployment of over 4 million) as well as a 50% cut back in steel production in Beijing, Tianjin and 26 other steel producing cities, during the coming winter. This will have a direct negative effect on Australia's exporters of iron ore and coal, which has not been fully anticipated. In the run up to the Party Congress, few senior Chinese officials made much comment on the challenges facing Xi. One exception was Zhou Xiaochan, the head of the central bank, the

Peoples Bank of China. Zhou, who is 69, will be retiring soon. He made the following observations, which were unlikely to have been without authorisation from Xi:

- "GDP growth may continue at 6.9% p.a. or even higher"
- "If we are too optimistic when things go smoothly, tensions build up, which could lead to a sharp correction, what we call a Minsky Moment. That's what we should particularly defend against." (Minsky Moment refers to a phenomenon described by economist Hyman Minsky, where prolonged periods of calm generate overconfidence as banks engage in ever more speculative lending, such as happened in the GFC. Zhou's use of the term was unusual for a central banker and significantly unsettled Chinese equity markets"
- "The main problem is that corporate debt (including that of the SOEs) was too high"
- "The intergovernmental relationship has lots of problems. There is no clear financial discipline to constrain local governments." (This referred to the complex and opaque system whereby the banks, some of them state owned, provincial governments and more than 300 county governments, borrow to on lend to corporations, some of them private and some state owned.)"
- "The government will gradually tackle these problems"

- Getting control of overall credit growth, without causing a sharp downturn is a feat not often achieved by any country. It will take a lot of effort and skill. The Chinese authorities have more chance of succeeding than most governments as they can exert more control on both lenders and borrowers even though this is not always direct. As credit growth slows, they will face difficult decisions about how to deal with debt defaults among SOEs. It is significant that in his three-and-a-half-hour speech to the Congress, Xi did not commit to a doubling of GDP over the next ten years, as had been done at the last Congress in 2012. Instead he emphasised financial stability and security implying more controls on the so-called shadow banking system, which has grown strongly and has become a source of potential instability. It is reasonable therefore to expect that while Chinese GDP growth will still be strong by world standards over the next ten years, it may be closer to 5% p.a. than 7% p.a., as a result of slower credit growth, which will perhaps be closer to 8% p.a. than the 15% p.a. experienced in recent years. This has implications for slower growth in global GDP and in commodity prices.

In other news...

- Chancellor Angela Merkel will continue as leader of Germany following the recent Federal election, but with a more complex coalition to manage. The main implication is that the Eurozone is still anchored by two major powers, which are rational and will continue existing pro-market and pro global trade policies.
- Almost half of the people of Catalunya voted for independence from Spain, which will lead to some economic disruption in the Spanish economy, a large economy within the Eurozone, which had been recovering albeit with high youth unemployment.
- The Brexit negotiations between Britain and the EU appear to be going nowhere and slowly, increasing the risk of a so-called hard Brexit, which could be very disruptive to European trade and corporate earnings.
- The pro- reform government of Japanese Prime Minister Abe won re-election by a big margin, with a super majority in both houses of parliament, which enables easier passage of reform legislation. As a result, we have increased the forecast real GDP growth for Japan by +0.5% p.a., for the next ten years.
- President Trump is said to be close to selecting the next Chairman of the Federal Reserve Board from among five candidates, who include the incumbent Janet Yellen, who is not considered the favourite. Betting on the President's choice is a fraught process, so we prefer to wait and see and then assess the outcome.

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 October 2017

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is better)	**103%**	**116%**
Momentum indicator	**POSITIVE**	**POSITIVE**
Qualititative indicator	**POSITIVE**	**POSITIVE**

- Valuation indicators have deteriorated slightly for both Australian and International equities over the last month. They are now slightly more expensive than last month but still within the broad fair value range. 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, which are bordering on expensive, while the UK equity market is definitively expensive.
- 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 back from neutral to mildly positive.
- 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 except for Japan; where as noted we have increased the forecast real GDP growth by +0.5% p.a., for the next ten years.

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	2.00%	1.50%	3.50%
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 2.78% p.a. to around 3.6% 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 October 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	**111%**	**107%**	**108%**	**109%**
China	**114%**	**109%**	**120%**	**115%**
Japan	**121%**	**116%**	**121%**	**120%**
Britain	**155%**	**149%**	**156%**	**154%**
Germany	**122%**	**117%**	**124%**	**122%**
France	**125%**	**120%**	**127%**	**125%**
Australia	**104%**	**100%**	**104%**	**103%**
Global (MSCI)	**117%**	**113%**	**116%**	**116%**

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 close to or within the fairly priced range, but none of them are cheap. Prices have risen over the last month so that they are closer to becoming expensive. This slightly less attractive valuation is partly offset by improvement in momentum, which has shifted back from neutral to positive. Notwithstanding this and the positive indicators from the qualitative analysis set out below, caution is still warranted. Portfolios should not go overweight in equities yet, but instead be ready to do so if there are any short-term shocks that cause significant equity market pull backs.

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 five years as the Fed gradually reduces its holdings of bonds and raises short term rates.	Positive and increasing but with uncertainty about the extent and timing of tax cuts.	Positive and increasing.	Probably positive but volatile and increasingly uncertain as to outcomes	Positive
China	Positive with possible reductions in stimulus in 2018 after the recent shift in the power structure for the next five years and beyond	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 and improving with the returned Abe government having a strong mandate.	Positive
Europe	Positive but weakening in 2018 and 2019 as the ECB reduces its rate of 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.	Positive due in part to infrastructure spending by the states.	Negative with stalemate in the Senate continuing after the citizenship saga.	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.

What to do next with Investment Portfolio Strategy: cont...

- 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	