madison
FINANCIAL GROUP

Investment Market Conditions UPDATE

18 May 2018

Summary of key points

- Continued earnings per share growth together with interest rates and bond yields that are still low by historical standards are underpinning share price growth across a number of major equity markets.
- Australia is something of an exception where earnings growth is being offset by specific problems affecting some of the leading stocks such as the banks and Telstra.
- Major budget deficits in most places provide ongoing support for the synchronised global economic growth.
- Although interest rates and bond yields are rising in the USA, all of the major central banks are running monetary policy which is very supportive of the economy and equity prices.
- This combination will probably support equity markets through 2018 and into 2019 but we need to monitor conditions in case they change.
- Major threats may emanate from the multi-tasking White House which is currently turning its hand to brinkmanship in Korea, threatening Iran and the oil market, trade tensions with China while cutting its tax revenue base at home.
- Over the medium term of the next three to five years, US ten-year bond yields are expected to rise by up to 1.0% p.a. or more to reach levels above 4% p.a. This has historically been an important trigger level for a major sell off in US equity markets.
- Although a neutral weight to Australian and International equities is warranted, holdings in these asset classes should be well diversified, with a significant weighting to more defensive funds or stocks. This will include equity funds that may from time to time hold enlarged cash balances for defensive or opportunistic purposes.
- In addition, a more significant overweight to alternative equities, which target an absolute return higher than cash or fixed interest and which are not highly correlated with equity markets, would be helpful in stabilising portfolio returns while still achieving a total return significantly above the cash rate.

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 30/06/2017	Level at 31/12/2017	Level at 16/05/2018	Change FY 2017/2018 to 31/12/17		Change since 31/12/17	
				In local currency	In AUD	In local currency	In AUD
Equity Markets							
S&P ASX 200	5721	6065	6106	6.0%	6.0%	0.7%	0.7%
USA: S&P 500	2423	2673	2711	10.3%	8.7%	1.4%	5.6%
UK: FTSE 100	7312	7687	7734	5.1%	8.2%	0.6%	3.7%
Germany: DAX	12325	12917	13011	4.8%	8.4%	0.7%	7.3%
France: CAC	5120	5312	5561	3.8%	7.4%	4.7%	7.0%
Japan: Nikkei 225	20033	22764	22717	13.6%	11.7%	-0.2%	-0.2%
China: Hang Seng	25764	29919	31110	16.1%	14.4%	4.0%	4.0%
Currencies							
USD/AUD	0.7689	0.7805	0.7498		-1.5%		4.1%
GBP/AUD	0.5901	0.5731	0.5562		3.0%		3.0%
YEN/AUD	86.42	87.92	82.55		-1.7%		6.5%
EUR/AUD	0.6727	0.6501	0.6360		3.5%		2.2%
Interest rates (% p.a.)							
Aus: 90 day bank bill	1.76	1.78	1.91	2.0%		13.0%	
Aus: 10 year govt bond	2.59	2.67	2.88	8.0%		21.0%	
US: Fed funds rate	1.16	1.42	1.69	26.0%		27.0%	
US: 10 year govt bond	2.30	2.41	3.06	11.0%		65.0%	
Commodities							
Copper US $ per tonne	5927	7247	6808	22.3%	20.5%	-6.1%	-2.2%
Gold USD/ounce	1241	1302	1289	4.9%	3.4%	-1.0%	3.1%
Oil USD/barrel (WTI)	46	60	71	30.8%	28.8%	17.3%	22.1%

Where are we now? cont...

- Long-term bond yields, a key driver of asset prices in the medium to longer term, have moved up markedly in the USA in the last month and are now up sharply since the start of the year. This may yet turn into a trend that eventually threatens equity prices.
- Meanwhile all major equity markets except for Japan and Australia were up significantly over the last month.
- The Australian dollar was weaker against all of the major currencies, providing a further tail wind to returns on international equities for Australian investors.
- Oil was up sharply over the month, reflecting growing tensions in the Gulf, which could worsen due to the US withdrawal from the agreement with Iran.
- China continues to rein in its debt to GDP ratio and it now looks likely that continued strong nominal GDP growth will solve this problem over the next five years or so. China can reduce its debt to GDP ratio without crashing its economy.

Current assessment of equity asset markets

The assessment of equity markets is central to deciding how much of the portfolio to allocate to growth assets. Our current assessment of equity markets, which is summarised in Table 3, takes into account:

The assessment takes into account:

- The Valuation of equities comparing current prices to long term Fair Prices;
- The Momentum of equity market price movements; and
- Qualitative indicators that take into account the impact of fiscal and monetary policy as well as economic and political factors.

Table 3: Summary of equity markets assessments

Equity Markets Assessment - 16 May 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is	**101%**	**101%**
Momentum indicator	**POSITIVE**	**POSITIVE**
Qualititative indicator	**POSITIVE**	**POSITIVE**

Current assessment of equity asset markets

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- Valuation indicators have become less expensive mainly as a result of the growth in earnings and the scaling back of price to earnings ratios in most equity markets. All major markets are now in the Fair Price range.
- Momentum needs to be judged over a six to eighteen-month period over which it has historically persisted. Judged on this timescale, Momentum remains positive in most major equity markets.
- The Qualitative factors, which remain positive, are summarised in Table 6. Monetary and fiscal policy, in particular, are very supportive of earnings growth for equities and of equity prices in general, in most major countries.
- Valuation is the most important part of our assessment (although it can be misleading in the shorter term out to three years). Essentially, we compare the current pricing of equities in world share markets with an estimate of the Fair Price of each market. The lower the ratio of Current Market Price to the assessed Long Term Fair Price, the more attractive investment in a particular share market appears. The Fair Price of an individual stock or of a whole equity market is the price at which the stock or the share market should trade at in order to achieve the long term Fair Value Return. The Fair Value Return is the required return that fairly compensates for risk. It equates to the current long-term government bond yield, in the investor's home country, plus a margin or Equity Risk Premium. We have assumed a required equity risk premium of 5% p.a. for developed equity markets and 8% p.a. for emerging markets. This implies a required rate of return on developed market equities significantly in excess of 8% p.a. over the next ten years, to justify an overweight position in equities.
- A key assumption in the assessment of the long-term Fair Price is the long-term rate of growth in earnings per share. In turn this depends on assumptions about the long-term rates of inflation and real economic growth as well as the rate of issuance of new equity or buy backs of equity. We monitor and adjust our long-term assumptions about inflation and real economic growth in the major developed countries as well as in the major developing economies, where necessary. Table 4 below, sets out our current assessment of this critical factor for the Australian equity market and its major sectors as well as the major international equity markets.

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%

Current assessment of equity asset markets
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The assessments of long-term earnings per share growth are unchanged. Together with the bond yield, they are used to derive the long run Fair Price estimates in the analysis set out below in Table 5. We do this for a number of scenarios which may happen over the next ten years, these imply different financial market regimes and different relative returns for the various asset classes. 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:

SCENARIO ONE

- 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% of occurring. In this scenario we are assuming that the ten-year Australian bond yield will rise from the current 2.88% p.a. to around 3.45% p.a. This provides a buffer of safety in our valuation analysis.

SCENARIO TWO

- Faster earnings growth where inflation and interest rates rise to around 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 continue to rate this scenario as having a 20% likelihood of occurring.

SCENARIO THREE

- 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 continue to rate this scenario as having a 30% likelihood of occurring, although a recession is more likely to occur after 2019 than before.

Table 5: Fair Price assessments for the Australian and International equity markets Equity Market Valuation indicators from Australian Investor Perspective - 16 May 2018

Economic Scenario:	One: Continued moderate growth	Two: Faster growth	Three: Relapse into recession	SCENARIO WEIGHTED PRICE TO FAIR VALUE
Probability of scenario	**50%**	**20%**	**30%**	
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	103%	100%	102%	102%
China	102%	98%	107%	103%
Japan	103%	100%	105%	103%
Britain	89%	86%	91%	89%
Germany	92%	89%	95%	92%
France	116%	112%	120%	117%
Australia	102%	98%	103%	101%
Global	102%	98%	102%	101%

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

Current assessment of equity asset markets cont...

All major equity markets are in the Fair Priced range. The European equity markets are slightly cheaper than the international markets in general. The US equity market is also close to fairly priced but is slightly more expensive than the average of the world markets. The Australian equity market is now in line with world equity valuations. Overall, the valuation factors are supportive without being overly compelling.

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 (mainly the risk of policy maker mistakes). Our summary of the qualitative factors and their effects on equity market returns for each major region is set out in Table 6.

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. The normalisation of US monetary policy may take 8 to 10 years	Positive and increasing due to the size of the tax cuts. Fiscal deficit is already 4.6% of GDP and heading towards 6%. This will push US ten year Treasury bond yields up towards 4.0% p.a., a critical level affecting equity market pricing adversely	Positive and increasing. This is being reflected in earnings per share growth of companies	Positive but volatile. The passage of the tax reform shows what can be done, but in the run up to the mid term Congressional elections in November 2018, it will still be an issue-by-issue process, with the President being the least predictable element	Positive
China	Positive but the PBOC is tightening more quickly. Credit growth has slowed from +8%p.a. in mid 2017 to below zero in early 2018	Positive as there is a need for continued spending on health care and education as well as infrastructure. Fiscal deficit is 3.5% of GDP	Positive with some prospect of a decline in the rate of growth from 6.9% towards 5% p.a. over the next three years	Positive, but tighter central control of all the key policy levers. The main risk is if the policy makers make a mistake	Positive
Japan	Positive with the BOJ confirming that it will keep near zero bond yields in place, further assisted by the reappointment of Governor Kuroda	Positive with fiscal deficit of 4.9% of GDP adding to demand	Positive but stalling slightly with real GDP growth easing back to 1.45 p.a. from 2.1% p.a.	Has been positive with the return of the Abe government with a strong mandate, but this may reverse with possible resignation of the PM due to scandal	Positive
Europe	Positive but weakening in 2019 as the ECB eventually reduces its rate of stimulus	Slightly positive with Euro area fiscal deficit at just 0.9% of GDP	Positive, but there is a risk that GDP growth weakens in 2019, hence the need for monetary stimulus to be continued	Positive with traditional non populist parties in government in most places	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 mid 2019	Positive and increasing as tax policy remains unresolved. Recent budget forecasts look over optimistic and fiscal deficit likely to persist for the next three years	Positive due in part to infrastructure spending by the states	Negative, still no one definitively in control of policy due to lack of ability to get key measures passed largely intact by the Senate	Positive

What to do next with Investment Portfolio Strategy:

- Keep a neutral or benchmark weight to Australian equities and International equities but be prepared to take profits on International equities at some stage in the next twelve months and increase holdings in alternative equities that are uncorrelated and offer some downside protection.
- Stay short in interest rate duration in fixed interest to avoid capital losses as bond yields increase.
- Avoid traded securities with credit risk, as credit spreads are 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 more overweight allocation to well managed alternative equities that offer premium returns above cash rates and lower volatility investment in growth assets should be established. Consider an even higher allocation, if moving money out of international equities to take profits.

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