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FINANCIAL GROUP

Investment Market Conditions UPDATE

28 June 2018

Summary of key points

- Continued earnings per share growth together with interest rates and bond yields that are still low by historical standards have been underpinning share price growth across a number of major equity markets.
- Continued growth is now under increasing threat from the impacts of a worsening trade dispute between the USA, China, Europe and Canada.
- For the time being, this threat is offset by two major factors:
    - Major budget deficits in most places are providing ongoing support for global economic growth.
    - All of the major central banks, including the US Fed, are running monetary policy that is very supportive of the economy and equity prices.
- The Trump administration has a disruptive approach to implementing policies that are themselves designed to disrupt the status quo. This disruption may include an unplanned US recession.
- Outcomes expected over next two years to five years include:
    - Short term interest rates rise in the US rising to 2.5% p.a. over the next year and above 4.0% p.a. within five years, in line with Federal Reserve forecasts, unless a US recession occurs (which is now more likely)
    - Short term interest rates in Australia lag the US and stay at 1.5% p.a. for the next year or so before rising to 3.5% p.a. (the RBA neutral rate) by 2022.
    - In the meantime, the AUD weakens towards USD 0.65, providing a cushion for international equity returns for Australian investors.
    - In the absence of a US recession over 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. The Australian ten-year bond yield also rises but continues to lag.
    - Expansion in PE multiples is limited as bond yields rise, so equity prices driven mainly by EPS growth, which continues for the next year or two.
- Risks to this mainstream scenario include:

- The US ten-year Treasury bond yield rises more quickly, and equity market valuations quickly become much more expensive leading to a major shift from equities to bonds. A fall of 15% or more in equity markets could easily occur.
    - The US goes into a trade war induced recession and bond yields stall or fall, but so do earnings. Either way it gets tough for US equities.
    - A protracted or worsening trade dispute could also slow China markedly and have more direct effects on Australian exports. China's central bank is worried about this and is loosening monetary policy to support its banks and their corporate customers.
- Overall, we are at an inflection point but not yet a turning point in equity markets.
- Based on the mainstream scenario of continued growth in earnings and low but rising short term interest rates and bond yields, a neutral weight to Australian and International equities is warranted.
- Allowing for the risks to the mainstream scenario:
    - Holdings in the equity 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.
    - Be prepared to reduce equities if the US ten-year bond yield moves significantly above 3.5% p.a. or if trade dispute concerns continue to worsen.

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 - financial year to date

Market indicator	Level at 30/06/2017	Level at 31/12/2017	Level at 20/06/2018	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	6139	6.0%	6.0%	1.2%	1.2%
USA: S&P 500	2423	2673	2762	10.3%	8.7%	3.3%	9.0%
UK: FTSE 100	7312	7687	7603	5.1%	8.2%	-1.1%	0.9%
Germany: DAX	12325	12917	12677	4.8%	8.4%	-1.9%	5.9%
France: CAC	5120	5312	5390	3.8%	7.4%	1.5%	3.2%
Japan: Nikkei 225	20033	22764	22238	13.6%	11.7%	-2.3%	-2.3%
China: Hang Seng	25764	29919	29468	16.1%	14.4%	-1.5%	-1.5%
Currencies							
USD/AUD	0.7689	0.7805	0.7398		-1.5%		5.5%
GBP/AUD	0.5901	0.5731	0.5619		3.0%		2.0%
YEN/AUD	86.42	87.92	81.48		-1.7%		7.9%
EUR/AUD	0.6727	0.6501	0.6391		3.5%		1.7%
Interest rates (% p.a.)							
Aus: 90 day bank bill	1.76	1.78	2.09	2.0%		31.0%	
Aus: 10 year govt bond	2.59	2.67	2.63	8.0%		-4.0%	
US: Fed funds rate	1.16	1.42	1.90	26.0%		48.0%	
US: 10 year govt bond	2.30	2.41	2.88	11.0%		47.0%	
Commodities							
Copper US $ per tonne	5927	7247	6840	22.3%	20.5%	-5.6%	-0.4%
Gold USD/ounce	1241	1302	1275	4.9%	3.4%	-2.1%	3.3%
Oil USD/barrel (WTI)	46	60	65	30.8%	28.8%	8.1%	14.0%

- Most equity markets are down or flat over the most recent month. The calendar year to date returns are still positive in the US and Europe and (only just) in Australia.
- Long-term bond yields, a key driver of asset prices in the medium to longer term, have eased back in the USA in the last month but are still up sharply since the start of the year. This may yet turn into a trend that eventually threatens equity prices, but for the time being a flight to the safety of US Treasury bonds has stalled the increase in yields.
- Over the latest month, the Australian dollar was weaker against the USD and Yen but stronger versus the Euro and Pound.
- Oil was down sharply over the month, reflecting the emerging deal between OPEC and Russia, to increase supplies (both Russia and Saudi Arabia, which can increase production, need the cash). The prospect of growing tensions in the Gulf, which could worsen due to the US withdrawal from the agreement with Iran, could lead to higher oil prices, towards $100 per barrel.

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 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 - 6 June 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted, lower is better)	**100%**	**98%**
Momentum indicator	**POSITIVE BUT WEAKENING**	**POSITIVE BUT WEAKENING**
Qualititative indicator	**POSITIVE**	**POSITIVE BUT WEAKENING**

Based on our analysis, valuation indicators have become slightly less expensive over the course of the latest month (by around 2%) mainly as a result of the continued growth in earnings. All major markets are still in the Fair Price range. Market price to long-term fair value price on a scenario-weighted basis with Australian ten-year bond yield at 3.4% p.a. (versus current 2.6% p.a.) and unchanged ten-year EPS growth assumptions:

- Australian equities: 100% down from 102% last month
- International equities: 98% down from 101% last month

Based on lower World Bank growth projections out to 2020, equity markets look more expensive but are still within the fair value range:

- Australian equities: 105%
- International equities: 110%

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, although it has weakened in most major equity markets, except in Australia and in the US where it has strengthened.

The Qualitative factors remain positive and these are summarised in Table 6. In particular, monetary and fiscal policy in most major countries, are still both very supportive of earnings growth for equities and of equity prices in general, but political and economic risks are growing.

More on valuation of equity markets

Valuation is the most important part of our assessment (although it can be misleading in the short 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 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 where necessary our long-term assumptions about inflation and real economic growth in the major developed countries as well as in the major developing economies. 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

		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%

More on valuation of equity markets cont...

These assessments of long-term earnings per share growth are unchanged since last month. 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 so for a number of scenarios of what may happen over the next ten years, which 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:

- 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 2.6% p.a. to around 3.4% p.a. This provides a buffer of safety in our valuation analysis.
- 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 20% 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 continue to rate this scenario as 30% likelihood, although a recession is more likely to occur after 2019 than before.

Table 5: Fair Price assessments for the Australian and International equity markets - 26 June 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%	99%	98%	101%
China	93%	89%	96%	93%
Japan	101%	96%	99%	99%
Britain	84%	80%	83%	83%
Germany	90%	86%	91%	90%
France	109%	104%	109%	108%
Australia	102%	97%	100%	100%
Global	100%	96%	97%	98%

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

All major equity markets are in the Fair Price 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 expensive compared to the average of 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 mistakes by policy makers) 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)	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 but may occur surprisingly faster.	Positive and increasing with fiscal deficit heading towards 6% of GDP, which is high by historical standards. This will push US ten year Treasury bond yields up towards 4.0% p.a., a critical level affecting equity market pricing adversely.	Has been positive and increasing and has been reflected in earnings per share growth of companies. This may now stall if trade tensions with China, the EU and Canada and Mexico continue to increase.	Positive but volatile. The Trump administration has a disruptive approach to implementing policies that are themselves designed to disrupt the status quo.	Positive but weakening
China	Positive. The PBOC, the central bank, has started to loosen policy again in response to concerns about the looming trade war with the USA.	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 a strong prospect of a decline in the rate of growth from 6.9% towards 5% p.a. over the next three years.	Positive, but the main risk is if the policy makers make a mistake. The responses to US tariff moves will be critical.	Positive but now more fragile
Japan	Positive with the BOJ confirming (yet again) that it will keep near zero bond yields in place.	Positive with fiscal deficit of 4.9% of GDP adding to demand.	Positive but stalling slightly with real GDP growth easing back to 1.4% p.a. from 2.1% p.a.	Has been positive 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 modest growth.	Positive but with some growing political constraints on policy.	Positive
Great Britain	Positive, with Bank of England backing away from interest rate increases due to Brexit risk	Positive and increasing	Weakening due to Brexit	Negative and divided	Positive but weakening as Brexit approaches
Australia	Positive with the RBA rate likely to be unchanged till mid 2019	Positive. Recent budget forecasts look over optimistic implying higher deficit for longer.	Positive due to infrastructure spending by the states.	Negative to neutral, with policy having to pass 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 three to six months (previously 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.
- 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