madison FINANCIAL GROUP

SHERLOCK PARTNERS

Investment Market + Portfolio UPDATE

8 September 2016

Summary of key points

- Nothing much has changed since our last update except that the US equity market has crossed the line into being expensive and property securities are also more expensive.
- We still expect to have low growth, low inflation and low interest rates for the next few years.
- Equity markets are still pricing in low bond yields and growth in earnings that may not be sustainable, so caution is needed so as to not pay too much when investing in equities.
- Investors seeking income returns will be better rewarded by investing in high quality equities (i.e. those that have a sustained ability to pay dividends above the long term bond yield) rather than fixed interest or cash, but total returns from equities, including capital movements, are very volatile over shorter run periods of up to three years.
- Valuation points to the Australian equity market still being fairly priced at the moment, with all others looking expensive.
- Geopolitical risks have increased in the USA, Britain and Europe as well as in China and Japan. We expect them to cause episodes where equity markets decline sharply for months at a time.
- These episodic declines in volatile equity markets offer opportunities for accumulation of stocks or equity funds at more attractive prices that offer the prospect of enhanced long-term returns.
- Investors should use strategically set aside cash to invest in equities when prices are more attractive as part of a sound, long-term investment strategy.

Where are we now?

Table 1: Financial market movements

MARKET INDICATOR	LEVEL AT 30 JUN 14	LEVEL AT 30 JUN 15	LEVEL AT 30 JUN 16	LEVEL AT 06 SEP 16	CHANGE 2014/2015 FINANCIAL YEAR		CHANGE 2015/2016 FINANCIAL YEAR		CHANGE SINCE START OF 2016/17 FINANCIAL YEAR	
					IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD
EQUITY MARKETS										
S&P ASX 200	5394	5515	5233	5429	2.2%	2.2%	-5.1%	-5.1%	3.7%	3.7%
USA: S&P 500	1960	2057	2098.86	2179	4.9%	28.9%	2.0%	5.3%	3.8%	2.3%
UK: FTSE 100	6743	6620	6504.33	6879	-1.8%	10.8%	-1.7%	-14.1%	5.8%	3.3%
GERMANY: DAX	9833	11083	9680.09	10672	12.7%	13.0%	-12.7%	-10.5%	10.2%	8.3%
FRANCE: CAC	4422	4869	4237.48	4541	10.1%	10.4%	-13.0%	-10.8%	7.2%	5.2%
JAPAN: NIKKEI 225	15162	20235	15705	17077	33.5%	35.6%	-22.4%	-4.9%	8.7%	5.7%
CHINA: HANG SENG	23200	26250	20794	23683	13.1%	38.9%	-20.8%	-18.3%	13.9%	12.3%
CURRENCIES										
USD/AUD	0.943	0.768	0.744	0.755		22.8%		3.2%		-1.4%
GBP/AUD	0.551	0.488	0.558	0.571		12.9%		-12.5%		-2.3%
YEN/AUD	95.32	93.81	76.6	78.8		1.6%		22.5%		-2.8%
EUR/AUD	0.689	0.687	0.67	0.682		0.3%		2.5%		-1.8%
INTEREST RATES										
AUS: 90 DAY BANK BILL % P.A.	2.68	2.19	2.00	1.74	-0.49		-0.19		-0.26	
AUS: 10 YEAR GOVT BOND % P.A.	3.54	3.01	2.00	1.90	-0.53		-1.01		-0.10	
US: FED FUNDS RATE % P.A.	0.09	0.13	0.32	0.41	0.04		0.19		0.09	
US: 10 YEAR GOVT BOND % P.A.	2.53	2.32	1.46	1.61	-0.21		-0.86		0.15	
COMMODITIES										
COPPER US $ PER TONNE	7035	5767	4845	4626	-18.0%	0.7%	-16.0%	-13.3%	-4.5%	-5.9%
GOLD USD/OUNCE	1326	1175	1328	1312	-11.4%	8.8%	13.0%	16.6%	-1.2%	-1.2%
OIL USD/ BARREL (WTI)	105	58.29	48.46	45.14	-44.5%	-31.8%	-16.9%	-14.2%	-6.9%	-8.2%

Since the last Update at the end of July:

- Short-term interest rates in Australia have declined further, reflecting the cuts in official interest rates while short term rates in the USA and elsewhere have been largely stable;
- Long-term bond yields in Australia have declined slightly, but the interest rate yield curve has steepened slightly as short rates fell by more.
- Long-term rates in the US rose slightly but the yield curve is still very low and not very steep. The prospect of continued slow growth with some risk of recession in the USA is being signalled by the bond market;
- The AUD has risen slightly against all major currencies taking the edge off improved returns on international assets;
- Commodity price signals were mixed. The oil price has risen slightly while copper prices, an indicator of industrial demand, were down sharply and gold was down slightly;
- With the exception of Australia (which was down slightly) and the USA (which was flat and near its record high), major equity markets worldwide were up significantly over the last month. The recovery continues to be driven by the pursuit of yield in world of ultra low or negative fixed interest yields;
- The bond markets appear to be signalling weaker economies exacerbated by more difficult political conditions in some major countries but the low level of yields has just as much to do with sustained repression arising from central bank buying during so called quantitative easing programs. Bond yields may in fact be artificially low and the outlook for the economy may not be as bad as it seems;
- Equity markets are certainly behaving as if the outlook is not bad at all. They have mostly risen well again in the last month. Overall momentum in equity markets is positive but has shown itself to be quite unstable in the last year.

What to do next with Investment Portfolio Strategy

- Use strategically set aside cash to invest in equities when prices are more attractive as part of a sound, long-term investment strategy.
- Meanwhile, maintain an allocation slightly below neutral or benchmark weight to Australian and international equities. Be cautious and patient and await short-term pullbacks of 10% or more in equity markets, which will provide an opportunity to go overweight in equities, to benefit from the prospect of longer-term equity price growth. There are enough short to medium term risk factors around to generate at least one sell off of equity markets of the order of 10% or more in the next six to twelve months.
- In the medium to longer term, growth in the economy and earnings will resume and long-term equity returns will outpace cash and fixed interest. So do not hold too much cash for too long and keep a moderate amount in growth or equity assets relative to the long-term portfolio neutral position in these assets.
- Where the portfolios are significantly underweight relative to benchmark levels the allocation should be increased over the next six months. If the client fund allocation to 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 over a subsequent six month period.
- The prospects for lower interest rates in Australia combined with subdued commodity prices means that the AUD is more likely to fall than rise against the USD, so international investment at this stage should be unhedged.
- Consider taking profits from listed property securities as their yields decline as result of price rises.
- A slight overweight to well managed alternative equities that offer lower volatility investment in growth assets should be maintained.
- Fixed interest should be underweighted. Returns on typical bond portfolios and bond funds will continue to be low with the prospect of increased losses on credit securities from some sectors of the economy. Holding cash or cash funds will be more attractive than bond funds and more flexible than term deposits.

Table 2: 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					✓	
Fixed interest		✓				
Property			✓			
Australian equities			✓			
International equities			✓			
Alternative equities					✓	

Current assessment of equity asset markets

Growth or equity assets are the key drivers of long-term portfolio returns so it is important to allocate enough to equity assets to drive returns without paying too much for growth. How much is too much? Our current overall assessment 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 Market Assesment: 6 September 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator (scenario weighted, lower is better)	105%	138%	111%
Momentum Indicator	Weaker	Stronger	Weaker
Qualitative Indicator	Weaker	Weaker	Weaker

Discussing these assessments in more detail:

VALUATION FACTORS

The valuation assessment is based on a comparison of the current pricing of equities in world equity markets with an estimate of the longer-term Fair Price of each market.

Long-term Fair Price is based on the long-term bond yields and estimates of long run earnings per share growth. A lower expected long-term bond yield implies a higher Fair Price for equities, as lower bond yields make cash flows from equity markets more valuable. A higher expected long-term bond yield has the opposite effect. We expect that the current low level of bond yields will provide continued support for equity prices for some time to come.

The assessment of the long-term rate of growth in earnings per share 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. These are summarised in table four below. Our assessments of earnings per share growth rates are unchanged since the last Update.

Table 4: Earnings per share growth rates for equity markets

EPS growth assumptions over ten years as at 6 September 20166

Changed assumptions since last analysis highlighted in blue.

		REAL GDP GROWTH % P.A.	INFLATION % P.A.	EPS GROWTH % P.A.
AUSTRALIAN EQUITY MARKET				
ASX S&P 200		2.25%	2.00%	1.75%
ASX AREITS		2.00%	2.00%	2.00%
ASX FINANCIAL EX AREITS		2.00%	2.00%	1.50%
ASX MATERIALS		3.50%	1.00%	2.50%
ASX ENERGY		3.50%	1.50%	2.50%
ASX INDUSTRIALS		2.25%	2.00%	2.25%
INTERNATIONAL EQUITY MARKETS				
USA	S&P 500	2.50%	1.50%	2.00%
CANADA	S&PTSX	2.50%	1.50%	2.00%
JAPAN	Nikkei 225	0.75%	0.75%	0.50%
BRITAIN	FTSE 100	2.00%	1.25%	0.75%
GERMANY	DAX	2.00%	1.00%	0.50%
FRANCE	CAC	1.50%	1.00%	0.00%
INDIA	BSE SENS	3.00%	5.50%	4.50%
CHINA	Hang Seng	3.50%	2.50%	2.00%

Current assessment of equity asset markets

We use these assessments of long term earnings per share growth, together with the bond yield, 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:

- Modest earnings growth (this includes disinflation) where inflation and interest rates fall or at least do not rise; this is good for equity prices. We rate this as the most likely scenario for the next 3 to 5 years with a 40% likelihood.
- Faster earnings growth where inflation and interest rates rise above 4% p.a. This is not necessarily good for fixed interest or equity prices. We rate this as the least likely scenario for the next 3 to 5 years with a 20% likelihood.
- Recession and possible deflation where inflation and interest rates turn negative and there is a risk of the economy being trapped in a zero or negative growth pattern. Following the Brexit vote and other emerging political instability such as in the USA and China we now rate a scenario of mild deflation over the next for the next 3 to 5 years as a 30% likelihood.

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

Changed assumptions since last analysis highlighted in blue.

Global Equity Market Valuation indicators

Date: 6 September 2016
10 yr Bond Yield = 1.90%
Equity Risk Premium = 5.00%

Red = Expensive (above 120%)
Black = More or less Fair Value (80% To 120%)
Green = Cheap (below 80%)

SCENARIO:	ONE : MODEST EARNINGS GROWTH	TWO : FASTER EARNINGS GROWTH	THREE: RELAPSE INTO RECESSION	SCENARIO WEIGHTED
Probability of scenario	40%	20%	30%	100%
EPS AND EPS GROWTH ASSUMPTIONS				
Current EPS changed by	0.00%	5.00%	-15.00%	-3.89%
Long term EPS growth rate changed by	0.00%	0.20%	-1.00%	-0.29%
Bond yield equal to current yield multiplied by	1.40	1.70	0.90	1.30
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	116%	117%	137%	123%
Canada	133%	135%	158%	141%
Japan	152%	152%	180%	161%
Britain	153%	153%	181%	162%
Germany	174%	174%	206%	184%
France	179%	179%	212%	190%
Australia	99%	100%	117%	105%
India	137%	138%	162%	145%
China	110%	109%	130%	117%
MSCI	130%	131%	154%	138%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	105%	106%	124%	111%
ASX Financials	91%	92%	108%	97%
ASX Materials	132%	133%	156%	140%
ASX Energy	160%	162%	190%	171%
ASX Industrials	90%	92%	107%	96%

Current assessment of equity asset markets

In summary, the valuation work indicates that:

1. There are no longer any cheap equity markets. Slower earnings per share growth prospects now counterbalance the positive effect of very low long-term bond yields.
2. The US equity market is at a record high and would be very expensive in the event of a recession. While this is less likely than continued growth it is a significant risk going into 2017. Overall, on a scenario-weighted basis, the US equity market is now definitively expensive for Australian based investors.
3. The European, British and Japanese equity markets are all still expensive under all scenarios that we have identified. As these markets make up over 30% of the world market, this suggests that a global equity portfolio would still be expensive overall.
4. The Australian equity market is still fairly priced on a scenario weighted basis but is no longer cheap overall.
5. Within the Australian equity market, Financials (such as banks) and Industrials look cheaper than other sectors. The resources sectors are very expensive. AREITs (listed property trusts) now look more expensive, especially if we are headed into a recession scenario. It is time to consider taking profits from or reducing exposure to the AREITs sector.

MOMENTUM

Momentum has turned positive for a number of major equity markets in recent months with Australia and the USA being exceptions. Momentum has also turned negative within the AREITs sector within Australia.

QUALITATIVE FACTORS

In making our assessments of equity markets, we also take into account monetary and fiscal policy as well as overall economic conditions and geopolitical factors, which can influence financial markets. Overall our current assessment is that the positive factors (supportive monetary and fiscal policy) only slightly outweigh the negative factors (slow economic growth and political paralysis and discord).

Current assessment of equity asset markets

Our baseline scenario for the next twelve to twenty-four months that incorporates these factors is as follows.

- Real economic growth is unchanged in Europe and Japan, slightly faster in the USA and slower in China. Overall world real GDP growth is the same or slightly slower.
- Inflation is unchanged and very low worldwide.
- World trade contracts slightly as it faces the headwinds of growing protectionism.
- Fiscal policies are unchanged due to political gridlock, collective timidity of professional politicians and their adherence to the monetarist dogma from the 1980s.
- Monetary policies of central banks reach the limits of their efficacy with limited further reductions in short term interest rates (including further moves into negative rates) in Japan and Europe.
- US monetary policy tightens only slightly with modest increases in the federal Funds rate while China cuts rates to avoid a hard landing.
- Major central banks do not shrink their balance sheets, keeping most of the government bonds that they bought under the quantitative easing programs that followed the GFC. Most of the increase in government debt since the GFC continues to be funded by central banks rather than private sector investors.
- The USA has a more protectionist president regardless of the outcome in the election, who is unable to break the fiscal deadlock with the Congress.
- Abe continues in power in Japan and effects some structural change but not enough to boost either the population or the labour force.
- In China Xi continues to exert dominance especially over economic policy, reducing credit growth and increasing the risk of a recession.
- Iron ore prices fall back below $40 per tonne, oil is below $40 per barrel especially as the major producers take care of their own cash flow needs. Gold improves as there is a shift from holding paper money that has low or negative yields.
- In Europe, established parties in Germany, Italy, France and Spain face major challenges at elections from populists of both left and right, paralysing policy.
- Britain takes a long time to negotiate its Brexit although there is less fiscal austerity and more government debt.
- In Australia a weak and hamstrung government affects little real change in policies and the deficit is largely unchanged
- Earnings per share growth slows in many stock market sectors especially financials and consumer staples.
- Equity market prices continue to be driven by ultra low or negative bond yields and low cash rates but are prone to episodic falls whenever there is a significant shock, such as Brexit or a Trump victory.

WHAT COULD BE DIFFERENT?

- There could be significant turmoil in the Chinese leadership in the run up to the Party Congress in October 2017 contributing to the prospects of a harder landing. Equity markets could sell off by 30%.
- Interest rates could become more negative in Japan and/or Europe, trapping them in deep recession as consumers withdraw from the goods markets. Equity markets could sell off 20% especially as the financial sector is weakened.
- Major political unrest in Europe impacts their economies.
- World trade could shrink faster as politicians enact more protectionist barriers. Equity markets could sell off 15% or more on this prospect.
- Trump could turn out to be a surprisingly good president like Teddy Roosevelt or Harry Truman, getting agreement from Congress to provide fiscal stimulus to the US economy, dragging China out of the clutches of recession, with iron ore and coal prices surging once again

In summary

- The Australian equity market is on the slightly expensive side of fair value but is significantly more attractive than most international markets.
- The US equity market is still more attractive compared with most other international markets on a long-term valuation basis but is now expensive.
- There is an increased prospect of instability in politics that will have a negative feedback effect on the economy in Australia and elsewhere. Caution is still warranted.
- The low level of bond yields and short term interest rates and the pursuit of yield are the key factors making Australian equities and to a lesser extent US equities, appear to be reasonably fairly priced against other asset classes.
- Given the volatility of markets we could not rule out a further significant pull back in prices in Australia or in the US of the order of 10% or more within the next six months. This would offer an attractive accumulation opportunity for investors operating on a longer-term 5 to 10 year timeframe as we see continued low bond yields being fairly supportive of equity prices in the medium to longer term.
- There are some not insignificant risks of a more substantial and lasting fall in equity markets and these risks need to be monitored closely.

Table Six sets out guide points for buying and selling various share markets, for those who wish to manage portfolios on a long term basis with reference to accumulation or reduction guide points as an alternative to the approach of setting weightings relative to long term strategic benchmarks.

Table 6: Stock Market Investing Limits

COUNTRY	INDEX	CURRENT LEVEL AT 6 SEPT 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2179	1767	1590	2120	Reduce
CANADA	S&PTSX	14795	10457	9411	12548	Reduce
JAPAN	Nikkei 225	17081	10587	9528	12704	Reduce
BRITAIN	FTSE 100	6879	4240	3816	5088	Reduce
GERMANY	DAX	10672	5788	5209	6946	Reduce
FRANCE	CAC	4541	2388	2149	2865	Reduce
AUSTRALIA	ASX S&P 200	5515	5238	4714	6286	Hold
INDIA	BSE SENS	28532	19642	17678	23570	Reduce
CHINA	Hang Seng	23677	20302	18272	24363	Hold
WORLD EX AUS	MSCI World ex Australia	1718	1246	1121	1495	Reduce
AUSTRALIAN MARKET SECTORS						
ASX AREITS	ASX AREITS	1468	1317	1186	1581	Hold
ASX FINANCIALS	ASX Financial ex AREITs	6526	6740	6066	8089	Hold
ASX MATERIALS	ASX Materials	8540	6096	5487	7316	Reduce
ASX ENERGY	ASX Energy	8301	4867	4380	5840	Reduce
ASX INDUSTRIALS	ASX Industrials	5238	5460	4914	6552	Hold

These indicators are sending the same message as the valuation indicators in table 5:

1. Reduce exposure or be underweight to some of the more expensive international equity markets and the Materials and Energy sectors of the Australian equity market;
2. Hold other sectors of the Australian equity market and a reduced exposure to the US equity market.

