

# Investment Market + Portfolio UPDATE

17 November 2016

## Summary of key points

- ▶ The investment world may be at a pivotal point. Trump has triumphed, using a strategy of being a disruptor and not accepting the rules of the game by which politics is practiced in the USA.
- ▶ In his direct appeals to voters Trump has been light on policy detail but has said that he will:
  - Cut corporate taxes;
  - Spend big on infrastructure;
  - Renegotiate foreign trade arrangements.
- ▶ The medium term consequences are likely to include:
  - Bigger Federal deficits over the next four to six years and much more issuance of US long term bonds leading to yields being higher than they would otherwise be.
  - Faster economic growth and higher inflation.
  - Faster growth in earnings per share of US domestically oriented companies.
  - Slower growth in world trade with adverse impacts on countries such as China and eventually Australia as well as on earnings growth of multinational firms including those based in the USA.
  - China may seek to offset the effects of any global trade slowdown via increased infrastructure spending that in turn may boost iron ore and coal prices, in addition to the already supportive framework of fiscal deficits, monetary policy and a tendency to weaken the currency.
- ▶ In the shorter term the impact of having an apparently erratic and idiosyncratic leader of the USA may well disturb financial markets in general and equity markets in particular. Volatility may well continue for some weeks or months to come.
- ▶ Given the more positive medium term prospects in some areas, any shorter run declines in the equity markets may eventually prove to be an opportunity to accumulate equities at better than usual prices, albeit on a selective basis.
- ▶ Central banks are likely to slow any planned rate increases, especially the US Federal Reserve. This may extend for a longer period providing added support to equity prices for longer than was expected.
- ▶ In summary be watchful and patient in coming weeks but not lose sight of an emerging opportunity to redeploy cash into equities at what may be favourable prices given a change for the better in the medium term economic outlook.

*The investment world may be at a pivotal point. Trump has triumphed, using a strategy of being a disruptor.*

## Summary of key points cont.

- ▶ Consider potential shifts in stocks (or funds that invest in stocks). These would include:
  - Shifts away from large cap multinationals and emerging market companies that are dependent on exports and towards small and mid-cap domestically focused stocks in developed markets.
  - Shifts away from long term bonds and companies that are sensitive to bond yield increases such as REITs, utilities and even infrastructure stocks holding existing infrastructure assets rather than the new ones that may be built.
- ▶ Risk factors to be aware of include:
  - The potential for continued growth in Chinese credit and lending that is now being reined in selectively by provincial governments to stall or be interrupted.
  - Growing market concerns about the strength of some “globally systemically important financial institutions” in Europe, including the biggest banks in Germany and Italy respectively.
- The fact that virtually all central banks have run out of options for stimulating their economies further and as yet most governments (other than the US, China and possibly Britain) have not shown any capacity to fill the gap with more fiscal stimulus.
- Governing parties worldwide are subjected to populist pressures that constrain their policies. Political survival trumps effective policy and we may see more inaction than action in economic policy.
- ▶ These factors together with our updated valuation analysis lead us to recommend a cautious increase in weighting to Australian equities whilst maintaining an underweighting to international equities other than the US, as well as the property securities, materials and energy sectors of the Australian equity market.

**Table 1: 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
<b>ASSET CLASS</b>						
Cash					✓	
Fixed interest		✓				
Property			✓			
Australian equities				✓		
International equities			✓			
Alternative equities					✓	

# Where are we now?

**Table 2: Financial market movements**

MARKET INDICATOR	LEVEL AT 30 JUN 14	LEVEL AT 30 JUN 15	LEVEL AT 30 JUN 16	LEVEL AT 11 NOV 16	CHANGE 2014/2015 FINANCIAL YEAR		CHANGE 2015/2016 FINANCIAL YEAR		CHANGE SINCE START OF 2016/2017 FINANCIAL YEAR	
					IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD
<b>EQUITY MARKETS</b>										
S&P ASX 200	5394	5515	5233	5370	2.2%	2.2%	-5.1%	-5.1%	2.6%	2.6%
USA: S&P 500	1960	2057	2098.86	2164	4.9%	28.9%	2.0%	5.3%	3.1%	1.7%
UK: FTSE 100	6743	6620	6504.33	6730	-1.8%	10.8%	-1.7%	-14.1%	3.5%	-4.2%
Germany: DAX	9833	11083	9680.09	10667	12.7%	13.0%	-12.7%	-10.5%	10.2%	6.0%
France: CAC	4422	4869	4237.48	4489	10.1%	10.4%	-13.0%	-10.8%	5.9%	1.9%
Japan: Nikkei 225	15162	20235	15705	17374	33.5%	35.6%	-22.4%	-4.9%	10.6%	5.3%
China: Hang Seng	23200	26250	20794	22238	13.1%	38.9%	-20.8%	-18.3%	6.9%	5.5%
<b>CURRENCIES</b>										
USD/AUD	0.943	0.768	0.744	0.755		22.8%		3.2%		-1.4%
GBP/AUD	0.551	0.488	0.558	0.602		12.9%		-12.5%		-7.4%
YEN/AUD	95.32	93.81	76.60	80.51		1.6%		22.5%		-4.9%
EUR/AUD	0.689	0.687	0.67	0.697		0.3%		2.5%		-3.8%
<b>INTEREST RATES</b>										
Aus: 90 day bank bill % p.a.	2.68	2.19	2.00	1.76	-0.49		-0.19		-0.24	
Aus: 10 year govt bond % p.a.	3.54	3.01	2.00	2.56	-0.53		-1.01		0.56	
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	2.15	-0.21		-0.86		0.69	
<b>COMMODITIES</b>										
Copper US \$ per tonne	7035	5767	4845	5549	-18.0%	0.7%	-16.0%	-13.3%	14.5%	13.0%
Gold USD/ounce	1326	1175	1328	1224	-11.4%	8.8%	13.0%	16.6%	-7.8%	-7.8%
Oil USD/barrel (WTI)	105	58	48	43	-44.5%	-31.8%	-16.9%	-14.2%	-10.8%	-12.0%

### Since the last Update in early October:

- Short-term interest rates in Australia and internationally have been stable at record or near record low levels;
- Long-term government bond yields in the USA and Australia have risen sharply following the election of Donald Trump as president of the USA. Markets have assessed that his stated policies of lower taxes, higher spending, particularly on infrastructure, leading to increased deficits and borrowing are more likely than not to be enacted with the help of a Republican controlled Congress. US ten year government bond yields rose +0.46% p.a. and Australian ten year bond yields rose +0.44% p.a., demonstrating once again the tight correlation of the Australian bond market with that of the US. In spite of bond market yields still being somewhat artificially repressed due to central banks buying or holding record amounts of bonds, they are now signalling less risk of a recession and more likelihood of growth and inflation;
- Commodity prices have diverged with copper, an indicator of industrial production, up sharply by 15% on the strength of possible growth due to US infrastructure spending. Meanwhile gold fell 3.6% over the month, signalling more confidence among equity investors. Oil fell 12%, driven more by the prospect of the recent OPEC supply constraint agreement failing to hold, as each producer pursues their own cash flow needs. The message from commodities is mixed but with a tendency to reflect more upside than downside in the medium term out to two years;
- The Australian Dollar was slightly weaker (by 0.8%) against the US dollar over the course of the month, but ended stronger against other major currencies, particularly the Yen (by 2.8%) and the Pound (by 2.6%) as both the Japanese and British economies face risks of policy induced recessions. The relative strength of the AUD partly reflects Australia's relatively higher interest rates;
- Prices in major equity markets worldwide were generally weaker in the run up to the US election, fluctuating with the week by week shifts in the prospects of Clinton and Trump. By the end of the week of the election, the US market had more than recovered its earlier losses, as investors became focussed less on the risk of a Trumpian contraction of world trade and more on the benefit of US corporate tax cuts and increased Federal spending on infrastructure and defence. So far these effects have outweighed the negative effect of the rising bond yield on valuations of equities and equity cash flows. The German and Japanese equity markets also recovered their levels of a month earlier while the Australian market did not quite do so. The British and Chinese equity markets remained down by a more significant extent over the month, by 4.9% and 6.1% respectively, reflecting their own particular situations rather than the more upbeat US market prospects;
- Overall momentum in equity markets remains unstable as it has been over the last year and is not a supportive factor. Long term valuation analysis tempered by shorter to medium term qualitative analysis is more useful;

*Short-term interest rates in Australia and internationally have been stable at record or near record low levels.*

# Current assessment of equity asset markets

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. These are discussed in more detail later on.

**Table 3: Summary of equity markets assessments**

**Equity Market Assessment:** 11 November 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator (scenario weighted, lower is better)	109%	119%	127%
Momentum Indicator	Neutral	Neutral	Weaker
Qualitative Indicator	Neutral	Positive	Neutral

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. It is important to note that while we regularly review the valuation factors, they are a guide to long term direction rather than shorter-term timing of equity markets. We do however put greater weight on the valuation assessments, the further that current market prices diverge from the long term Fair Price estimates, such as the current high valuation indicator for listed property securities.

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, but this effect will weaken if bond yields continue to rise in the US, if prospects of higher federal deficits and borrowing continue to emerge under President Trump. It is important to note that a rising bond yield can have a more significant effect on high dividend, low growth stocks such as Real Estate Investment Trusts, infrastructure stocks and utility stocks, as the valuation of the cash flows from their dividends are more sensitive to increases in the discount rate used in valuing the cash flows. This is usually closely linked to the current ten-year government bond yield. While a 1% p.a. increase in the ten year bond yield will cause around a 7% fall in the price of a ten-year bond, it will often cause a fall of closer to 15% in the price of REITs or infrastructure securities, which have a much longer dated average term of the expected cash flows. The longer the effective term of an investment's cash flow, the greater the effect of a shift in the yield used to discount the cash flow to arrive at the value of the security.

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. Since the last Update we have upgraded the long-term inflation and real GDP growth assumption for the USA (and Canada), to recognise the likely effects on the North American economy of a bigger spending US Federal Government. This increase in earnings per share growth in the US has more than offset the effect of the upward shift so far in the bond yield, on US equity valuations.

Apart from Australian property, all other assessments of earnings per share growth rates are unchanged since the last Update. For Australian Property (AREITs), we have increased the assumed need for new stock issuance to fund maintenance capital expenditure, as most AREITs now distribute virtually all of their earnings. This has the effect of decreasing the projected earnings per share growth on AREITs to just 1.5% p.a. Together with the increase in bond yields, this combines to make AREITs more expensive relative to long term Fair Price, even after the recent price declines. It appears that there are more declines to come.

## Current assessment of equity asset markets cont.

**Table 4: Earnings per share growth rates for equity markets**

*Changed assumptions since last analysis highlighted in red.*

		REAL GDP GROWTH % P.A	INFLATION % P.A	NOMINAL GDP GROWTH % P.A	DILUTION DUE TO NET STOCK ISSUANCE % P.A	EPS GROWTH % P.A
Australia	ASX S&P 200	2.25%	2.00%	4.25%	-2.25%	2.00%
Australian property	ASX AREITS	2.00%	2.00%	4.00%	-2.50%	1.50%
Australian Financials	ASX Financial ex AREITS	2.00%	2.00%	4.00%	-2.50%	1.50%
Australian Materials	ASX Materials	3.50%	1.50%	5.00%	-2.00%	3.00%
Australian Energy	ASX Energy	3.00%	1.50%	4.50%	-2.00%	2.50%
Australian Industrials	ASX Industrials	2.25%	2.00%	4.25%	-2.00%	2.25%
USA	S&P 500	3.00%	2.25%	5.25%	-1.00%	4.25%
Canada	S&PTSX	2.75%	2.25%	5.00%	-1.00%	4.00%
Japan	Nikkei 225	0.75%	0.75%	1.50%	-1.00%	0.50%
Britain	FTSE 100	1.50%	1.25%	2.75%	-2.50%	0.25%
Germany	DAX	1.50%	1.00%	2.50%	-2.50%	0.00%
France	CAC	1.50%	1.00%	2.50%	-2.50%	0.00%
India	BSE SENSEX	4.00%	5.50%	9.50%	-4.00%	5.50%
China	Hang Seng	4.00%	2.50%	6.50%	-4.00%	2.50%

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 as follows. These scenarios are largely unchanged since our last Update but we have shifted the likelihood of each:

- 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 and have upgraded its likelihood from 40% to 50%.
- 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 for equity prices and this is reflected through the application of a higher assumed long-term bond yield. This effect is offset to a greater or lesser degree, in the case of equities, by the faster rate of earnings per share growth. We now rate this scenario as somewhat more likely for the next 3 to 5 years with a 30% 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. Notwithstanding the Brexit vote in the UK in June and the emerging fragility of major European banks, the more positive outlook for the US economy leads us to now rate a scenario of slower growth perhaps with mild deflation over the next for the next 3 to 5 years as a 20% likelihood.

## Current assessment of equity asset markets cont.

**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: 11 November 2016 10 yr Bond Yield = 2.56% 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	50%	30%	20%	100%
<b>EPS AND EPS GROWTH ASSUMPTIONS</b>				
Current EPS changed by	0.00%	5.00%	-15.00%	-1.50%
Long term EPS growth rate changed by	0.00%	0.20%	-0.50%	-0.04%
Bond yield equal to current yield multiplied by	1.30	1.60	0.80	1.29
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	96%	104%	91%	97%
Canada	74%	80%	71%	75%
Japan	179%	183%	189%	182%
Britain	130%	132%	138%	132%
Germany	147%	149%	156%	149%
France	113%	115%	121%	115%
Australia	107%	111%	110%	109%
India	187%	195%	190%	190%
China	158%	160%	169%	161%
MSCI	117%	123%	117%	119%
<b>AUSTRALIAN MARKET SECTORS</b>				
ASX AREITS	124%	128%	130%	127%
ASX Financials	108%	111%	112%	110%
ASX Materials	126%	131%	130%	128%
ASX Energy	177%	182%	184%	180%
ASX Industrials	98%	102%	100%	100%

In summary, the valuation work indicates that:

- The recent increase in bond yields has made all international equity markets more expensive. This has been offset by higher growth prospects in North America but not elsewhere. Except for the US and Canada, and in some circumstances France, most international equity markets are now expensive from the point of view of an Australian investor. Holdings in international equities should be tilted towards the less expensive markets either directly or via funds that invest in them.
- While the US equity market is near a record high continued growth going into 2017 together with bond yields that are not yet high (or even average) by historical standards, makes the US equity market close to fairly priced from a long term perspective.
- The Australian equity market is still reasonably fairly priced overall but the property, materials and energy sectors are all expensive.

### Momentum

Momentum in most major markets has become more unstable in recent months. It is still not a supportive factor for equity investment. Given the uncertainties that abound in Europe and the lack of policy certainty that is still the case in the USA, we expect market volatility to be higher in the months ahead than it has been for much of the last few years.

### Qualitative factors

The qualitative factors that impact equity markets include monetary and fiscal policy as well as overall economic conditions and geopolitical factors. Overall our current assessment is that the positive factors (supportive monetary and fiscal policy) now more forcefully outweigh the negative factors (slow economic growth and political paralysis and discord as well as possible instability in the European banking system).

Our analysis of factors that will have impact over the next twelve to twenty four months takes place within a framework over ten years that provides the driver of long term asset allocation strategy. This longer-term framework is as follows:

- Inflation will be subdued worldwide, driven by aging demographics that lead to an excess of savings over investment, continued low inflation expectations among populations and overcapacity in manufacturing worldwide. Exceptions to this now include the USA, Canada and Australia, where population growth rates are more supportive and in the USA, there is the prospect of greater fiscal stimulus.
- In many places, real GDP growth will be slow but still mainly positive and nominal GDP growth (i.e. growth in money terms) will also be slower than has been usual in the past. Again the USA, under a Trump administration, may prove to be an exception to this in the next four to eight years. To the extent that the US adopts more restrictive trade policies, GDP growth elsewhere, including China, may face even stronger headwinds.
- Governments are generally weak and not prepared to borrow and spend, even on much needed infrastructure. China has been an exception to this and now the US, with the Republicans controlling both an expansionary Presidency and both houses of Congress, may be about to become another important exception).
- Short-term interest rates will continue to be low or negative worldwide as most central banks continue to fill the stimulus void left by governments but the US Federal Reserve will gradually lift its cash rate to around 3% p.a. over the next five years. If US labour costs accelerate due to fiscal stimulus at a time of low unemployment, a Republican appointed leadership of the Fed may accelerate the rate increases to well beyond 3% p.a. and closer to 6% p.a.
- Government bond yields will be low or negative as long as central banks buy bonds to add more stimulus, but this may well be coming to an end in the English speaking world.
- Apart from North America and in some commodity-based economies, equity earnings growth will be slow overall, constrained by low nominal GDP growth.
- Major equity market valuations are not cheap from an Australian investor's viewpoint at current bond yields.

*The Australian equity market is still reasonably fairly priced overall but the property, materials and energy sectors are all expensive.*



Our baseline scenario for the next 12 to 24 months includes:

- The USA has a more protectionist president, whose announced policies adversely affects global trade growth, but who is able to break the fiscal deadlock with the Congress and directly stimulate the US domestic economy.
- Real economic growth is slower in China, Europe and Japan and faster in the USA. Overall world real GDP growth is the same or slightly slower.
- Apart from in the USA, fiscal policies are unchanged due the collective timidity of professional politicians and their adherence to the monetarist dogma from the 1980s. The USA becomes an important exception and may well be the harbinger of a global change away from a demonisation of government debt.
- In Japan, Prime Minister Abe continues in power and achieves some structural change such as more women in the work force but not enough to boost either the labour force or the economy by much.
- In China, Xi continues to exert dominance especially over economic policy, reducing credit growth and increasing the risk of a recession. The People's Bank of China cuts rates to avoid a hard landing.
- 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 trading arrangements in the wake of Brexit causing a slowdown in its economy. There is less fiscal austerity and more government debt.
- Apart from in the USA, inflation is mostly unchanged and very low worldwide and does not break out above 4% p.a. in spite of the massive monetary stimulus and significant US fiscal stimulus.
- 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.
- 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.
- Outside of the USA, 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 a European banking crisis.

What could be different? Over the next two years, events could diverge from the long-term baseline scenario in ways that would impact asset returns. Some possibilities include:

- Trump could turn out to be a surprisingly good president, like Teddy Roosevelt or Harry Truman, getting agreement from Congress to fiscal repair and major infrastructure stimulus to the US economy, dragging China out of the clutches of recession, with iron ore and coal prices increasing further.
- Chinese leadership tensions and policy disputes over economic policy and the use of expanding credit to support growth could culminate in public disputes at the Peoples' Congress in late 2017. The key issue in dispute is the pace with which the growth of debt in the economy is wound back. President Xi favours a sharper cut back than Premier Li. We expect Xi to prevail. This increases the risk of even lower growth rates in China than the 4% p.a. real GDP growth that we have assumed for the next ten years.
- Saudi Arabia and Iran flood the market with oil supply as they strive to maintain and increase cash flow. This weakens oil majors, oil service companies that supply them and ultimately major banks that lend to the latter. A chain reaction of financial stress will extend from the oil market to the credit markets and maybe to the equity markets

### **In summary:**

- Increased instability in politics will have a negative feedback effect on the economy in Europe, China and elsewhere. The USA may look more stable, post Trump's election, with the Republicans in full control of the apparatus of government, but there is much to be settled before this becomes a done deal. Caution is still warranted.
- Even after recent bond yield increases, the level of bond yields and short term interest rates and the pursuit of yield are still important factors making US equities appear to be reasonably fairly priced against other asset classes in addition to the prospect of renewed fiscal stimulus.
- Given the volatility of markets we could not rule out a further significant pull back in equity prices 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. In the meantime there now appears to be a stronger long term argument in favour of a more fully invested equity market position in the US.

## What to do next with Investment Portfolio Strategy

- Increase the allocation to Australian equities to neutral or benchmark weight, favouring financial and industrials over property (AREITs) or resources.
- Reduce the underweight in International equities, favouring US equities.
- Before going overweight in equities, be cautious and patient and await short-term pullbacks of 10% or more in equity markets. These will provide an opportunity to go overweight in equities at more attractive prices, to benefit from the prospect of longer-term equity price growth. In our assessment 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.
- Beyond the next 12 to 24 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.
- 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.
- Where the portfolios are significantly underweight relative to benchmark levels the allocation should be increased carefully and progressively over the next six months. If the client fund allocation to any 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 over a subsequent six month period.
- The prospects for higher interest rates in the USA relative to interest rates in Australia means that the AUD is more likely to fall than rise against the USD, so international investment at this stage should be unhedged.
- A slight overweight to well managed alternative equities that offer lower volatility investment in growth assets should be maintained to maintain and increase cash flow. This weakens oil majors, oil service companies that supply them and ultimately major banks that lend to the latter. A chain reaction from the oil market to the credit markets.

**Table 6: 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
<b>ASSET CLASS</b>						
Cash					✓	
Fixed interest		✓				
Property			✓			
Australian equities				✓		
International equities			✓			
Alternative equities					✓	

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

Table Seven 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 7: Stock Market Investing Limits**

COUNTRY	INDEX	CURRENT LEVEL AT 11 NOV 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2164	2225	2003	2671	Hold
Canada	S&PTSX	14555	19395	17455	23274	Increase
Japan	Nikkei 225	17374	9547	8592	11456	Reduce
Britain	FTSE 100	6730	5099	4589	6119	Reduce
Germany	DAX	10667	7143	6429	8572	Reduce
France	CAC	4489	3895	3506	4674	Hold
Australia	ASX S&P 200	5370	4948	4453	5937	Hold
India	BSE SENS	26818	14112	12701	16934	Reduce
China	Hang Seng	22531	14031	12628	16838	Reduce
World ex Aus	MSCI World	1709	1441	1297	1730	Hold
<b>AUSTRALIAN MARKET SECTORS</b>						
ASX AREITS	ASX AREITS	1239	978	881	1174	Reduce
ASX Financials	ASX Financial ex AREITS	6606	6013	5412	7216	Hold
ASX Materials	ASX Materials	9659	7529	6776	9035	Reduce
ASX Energy	ASX Energy	8253	4587	4128	5505	Reduce
ASX Industrials	ASX Industrials	4926	4947	4452	5936	Hold

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

- Reduce investment in the AREITS, Materials and Energy sectors of the Australian equity market.
- Hold other sectors of the Australian equity market.
- Hold a neutral or benchmark position in US equities but be cautious and underweight international equities elsewhere, unless investing via funds managed by proven, superior international stock pickers.

*This document and its contents are general in nature and do not constitute or convey personal advice. It has been prepared without consideration of anyone's financial situation, needs or financial objectives. Formal advice should be sought before acting on the areas discussed. This document is a private communication and is not intended for public circulation other than to authorised representatives of the Madison Financial Group and their clients. The authors and distributors of this document accept no liability for any loss or damage suffered by any person as a result of that person, or any other person, placing any reliance on the contents of this document.*