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Investment Market + Portfolio UPDATE

21 December 2016

Summary of key points

- The mild Trump inspired euphoria continues in the equities markets while pain persists in the bond markets.
- Both are driven by the same expectations of a Trump administration:
  - Major cuts in corporate taxes
  - Increased federal spending and deficits
  - Reduced regulation
- If these are implemented we will likely see:
  - Much more issuance of US long term bonds leading to higher bond yields.
  - Faster economic growth and higher inflation.
  - Faster growth in earnings per share of US domestically oriented companies.
- In the shorter-term equity markets may well be disappointed if there is any extended delay or disruption to the Trump agenda. Volatility may well continue for some months to come.
- Given the more positive medium term prospects in the US, 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.
- Monetary policy may become less accommodative but withdrawal of the stimulus of the last eight years will be gradual, providing support to equity prices for longer than was expected.
- In summary be watchful and patient in coming months but do 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.
- Risk factors to be aware of include:
  - Any deadlock that re-emerges between the US Congress and the President.
  - The potential for 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 Italy.
- These factors together with our updated valuation analysis lead us to recommend continued underweighting with a cautious increase in weighting to Australian equities whilst maintaining an underweighting to international equities other than the US.

Be watchful and patient in coming months but do not lose sight of an emerging opportunity to redeploy cash into equities at what may be favourable prices.

Summary of key points cont.

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
ASSET CLASS						
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 16 DEC 16	CHANGE 2014/15 FINANCIAL YEAR		CHANGE 2015/16 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	5532	2.2%	2.2%	-5.1%	-5.1%	5.7%	5.7%
USA: S&P 500	1960	2057	2098.86	2258	4.9%	28.9%	2.0%	5.3%	7.6%	9.7%
UK: FTSE 100	6743	6620	6504.33	7011	-1.8%	10.8%	-1.7%	-14.1%	7.8%	2.8%
Germany: DAX	9833	11083	9680.09	11404	12.7%	13.0%	-12.7%	-10.5%	17.8%	12.7%
France: CAC	4422	4869	4237.48	4833	10.1%	10.4%	-13.0%	-10.8%	14.1%	9.2%
Japan: Nikkei 225	15162	20235	15705	19401	33.5%	35.6%	-22.4%	-4.9%	23.5%	9.9%
China: Hang Seng	23200	26250	20794	22020	13.1%	38.9%	-20.8%	-18.3%	5.9%	8.0%
CURRENCIES										
USD/AUD	0.943	0.768	0.744	0.730		22.8%		3.2%		1.9%
GBP/AUD	0.551	0.488	0.558	0.585		12.9%		-12.5%		-4.6%
YEN/AUD	95.32	93.81	76.60	86.12		1.6%		22.5%		-11.1%
EUR/AUD	0.689	0.687	0.67	0.700		0.3%		2.5%		-4.3%
INTEREST RATES										
Aus: 90 day bank bill % p.a.	2.68	2.19	2.00	1.78	-0.49		-0.19		-0.23	
Aus: 10 year govt bond % p.a.	3.54	3.01	2.00	2.83	-0.53		-1.01		0.83	
US: Fed funds rate % p.a.	0.09	0.13	0.32	0.66	0.04		0.19		0.34	
US: 10 year govt bond % p.a.	2.53	2.32	1.46	2.59	-0.21		-0.86		1.13	
COMMODITIES										
Copper US $ per tonne	7035	5767	4845	5635	-18.0%	0.7%	-16.0%	-13.3%	16.3%	18.6%
Gold USD/ounce	1326	1175	1328	1134	-11.4%	8.8%	13.0%	16.6%	-14.6%	-14.6%
Oil USD/barrel (WTI)	105	58	48	52	-44.5%	-31.8%	-16.9%	-14.2%	7.1%	9.2%

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Where are we now? cont.

Since the last Update in mid November:

- Equity markets have generally modestly continued their post-Trump rally spurred by the prospect of lower taxes, higher spending and less regulation;
- Bond markets have sold off with the prospect of increased deficits and borrowing, with US ten year bond yields up sharply by a further +0.44% p.a. The US long-term bond yield is now 1.13% p.a. higher than it was in June of this year. The Australian ten-year government bond yield also rose, but not by as much. This has led to the margin of Australian over US bond yields being compressed to a historically narrow 0.24% p.a. which may not be sustainable, especially if Australia is downgraded from AAA status;
- Commodity prices have diverged again with gold down and oil up sharply. The oil price rose +20.1% over the course of the month, driven by the new agreement by OPEC members and Russia to restrict production in order to boost prices;
- The Australian Dollar weakened 3.2% versus the US dollar over the course of the month, but ended stronger against the Yen, which weakened more against the USD. The relative strength of the AUD partly reflects Australia's relatively higher interest rates;
- Overall momentum in equity markets has been slightly positive but remains unstable. Long term valuation analysis tempered by shorter to medium term qualitative analysis is still needed when deciding how much to allocate to equities;

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: 16 December 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator (scenario weighted, lower is better)	114%	127%	133%
Momentum Indicator	Positive	Positive	Neutral
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.

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 level of bond yields, which is still low by historical standards, will provide some continued support for equity prices, but this effect will weaken as bond yields continue to rise in the US and elsewhere.

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. Our current assessments, which are unchanged since our last update, are summarised in table four below.

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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 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%.
- 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 rate this scenario as 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 this scenario of slower growth perhaps with mild deflation over the next for the next 3 to 5 years as a 20% likelihood.

Modest earnings growth where inflation and interest rates do not rise by much; this is good for equity prices.

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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: 16 December 2016 Current 10 yr Bond Yield = 2.83% 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%
EPS AND EPS GROWTH ASSUMPTIONS				
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	99%	108%	92%	100%
Canada	108%	117%	102%	110%
Japan	201%	207%	210%	205%
Britain	136%	139%	143%	138%
Germany	156%	160%	164%	159%
France	175%	179%	184%	178%
Australia	112%	117%	114%	114%
India	193%	203%	194%	196%
China	160%	164%	170%	163%
MSCI	125%	133%	124%	127%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	131%	136%	134%	133%
ASX Financials	121%	125%	124%	123%
ASX Materials	130%	136%	132%	132%
ASX Energy	185%	192%	189%	188%
ASX Industrials	106%	111%	106%	107%

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Current assessment of equity asset markets cont.

In summary, the valuation work indicates that:

1. The 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, most international equity markets are now definitively 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.
2. 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 fairly priced from a long term perspective.
3. The Australian equity market is still reasonably fairly priced overall but the property, materials and energy and now even the financial sectors are all expensive. This implies a need for careful stock selection with an emphasis on industrials or in funds that invest this way.

Momentum

Momentum in most major markets has been more positive in the last month but remains unstable from a slightly longer perspective of six to twelve months. Momentum is still not a reliably 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.

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 (slower than usual economic growth in many places, 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 continue to 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, at least in the USA and Canada.
- 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 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. The Federal Reserve has just lifted its target rate from 0.5% p.a. to 0.75% p.a. and indicated further rises to 1.50% p.a. over the course of 2017. 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 within a five year time frame 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. The European Central Bank has also announced a modest scaling back of its bond buying from EUR80 billion per month to EUR60 billion per month, but has extended it for a longer period.
- 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.

Momentum in most major markets has been more positive in the last month but remains unstable from a slightly longer perspective of six to twelve months.

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Current assessment of equity asset markets cont.

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

- The USA breaks its fiscal deadlock between the President and the Congress and directly stimulates the US domestic economy while borrowing more to cover the increased deficits.
- 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, at least for the next two years.
- 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, France and the Netherlands face major challenges at elections from populists of both left and right, paralysing policy at least until 2018.
- 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 but is effectively tightened more by the rising US Dollar.
- 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.

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 reality. 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.

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What to do next with Investment Portfolio Strategy

- Remain underweight to Australian equities but cautiously increase to neutral or benchmark weight over the next six months, favouring industrials and, to a lesser extent, financials, over property (AREITs) or resources.
- Remain underweight in International equities, but cautiously increase to neutral weight on market weakness over the next six months, 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.

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
ASSET CLASS						
Cash					✓	
Fixed interest		✓				
Property		✓				
Australian equities			✓	✓		
International equities			✓			
Alternative equities					✓	

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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 16 DEC 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2258	2256	2031	2708	Hold
Canada	S&PTSX	15252	13889	12500	16666	Hold
Japan	Nikkei 225	19401	9472	8525	11366	Reduce
Britain	FTSE 100	7011	5068	4562	6082	Reduce
Germany	DAX	11404	7183	6465	8619	Reduce
France	CAC	4833	2713	2442	3255	Hold
Australia	ASX S&P 200	5532	4842	4358	5811	Hold
India	BSE SENS	26489	13500	12150	16200	Reduce
China	Hang Seng	22020	13483	12134	16179	Reduce
World ex Aus	MSCI World	1757	1380	1242	1656	Reduce
AUSTRALIAN MARKET SECTORS						
ASX AREITS	ASX AREITS	1335	1004	903	1205	Reduce
ASX Financials	ASX Financial ex AREITs	7179	5849	5264	7019	Reduce
ASX Materials	ASX Materials	9913	7501	6751	9001	Reduce
ASX Energy	ASX Energy	9245	4927	4434	5912	Reduce
ASX Industrials	ASX Industrials	5113	4767	4290	5720	Hold

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

- Reduce investment in the AREITs, Materials, Energy and Financials 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.

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