madison FINANCIAL GROUP

SHERLOCK PARTNERS

Investment Market + Portfolio UPDATE

9 March 2017

Summary of key points

- There has been little real change in financial market conditions over the last month.
- It is still appropriate to hold a neutral or benchmark allocation to Australian and International equities and an underweight to Property and Fixed Interest.
- Risk factors to be aware of include:
  - Any deadlock that emerges between the US Congress and the President in the implementation of the tax cuts that have been factored into US equity prices.
  - Any economic policy stumble by the Chinese leadership in the run to the 19th Party Congress later this year such as choking off credit and lending to loss making state enterprises too quickly.
  - Any capital raising problems of "globally systemically important financial institutions" in Europe, including the biggest banks in Italy and Germany (although the risk of this seems to be receding).

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 06 MAR 17	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	5746	2.2%	2.2%	-5.1%	-5.1%	9.8%	9.8%
USA: S&P 500	1960	2057	2099	2375	4.9%	28.9%	2.0%	5.3%	13.2%	10.7%
UK: FTSE 100	6743	6620	6504	7350	-1.8%	10.8%	-1.7%	-14.1%	13.0%	1.5%
Germany: DAX	9833	11083	9680	11958	12.7%	13.0%	-12.7%	-10.5%	23.5%	15.2%
France: CAC	4422	4869	4237	4972	10.1%	10.4%	-13.0%	-10.8%	17.3%	9.4%
Japan: Nikkei 225	15162	20235	15705	19345	33.5%	35.6%	-22.4%	-4.9%	23.2%	8.9%
China: Hang Seng	23200	26250	20794	23667	13.1%	38.9%	-20.8%	-18.3%	13.8%	11.4%
CURRENCIES										
USD/AUD	0.943	0.768	0.744	0.761		22.8%		3.2%		-2.2%
GBP/AUD	0.551	0.488	0.558	0.621		12.9%		-12.5%		-10.2%
YEN/AUD	95.32	93.81	76.60	86.63		1.6%		22.5%		-11.6%
EUR/AUD	0.689	0.687	0.67	0.718		0.3%		2.5%		-6.7%
INTEREST RATES										
Aus: 90 day bank bill % p.a.	2.68	2.19	2.00	1.83	-0.49		-0.19		-0.17	
Aus: 10 year govt bond % p.a.	3.54	3.01	2.00	2.80	-0.53		-1.01		0.80	
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	2.49	-0.21		-0.86		1.03	
COMMODITIES										
Copper US $ per tonne	7035	5767	4845	5858	-18.0%	0.7%	-16.0%	-13.3%	20.9%	18.3%
Gold USD/ounce	1326	1175	1328	1226	-11.4%	8.8%	13.0%	16.6%	-7.7%	-7.7%
Oil USD/barrel (WTI)	105	58	48	53	-44.5%	-31.8%	-16.9%	-14.2%	9.7%	7.3%

Since the last Update in February:

- Short-term interest rates world-wide are little changed although Janet Yellen, Chairman of the Federal Reserve in the USA, has given a strong indication that the Fed Funds rate will rise in March and perhaps several times more in the next two years. In Australia, the RBA kept the official rate at 1.5% p.a. at its meeting on 7 March. The short term cost of money remains near historic lows nearly everywhere that matters;
- Long-term bond yields have also changed little over the last month. The world cost of long-term money is still low by historical standards and provides great support for asset prices everywhere. Even though it may rise by as much as 1% p.a. over the next year or so, it would still be cheap by historical standards and broadly supportive of equity prices;
- Commodity prices were little changed over the last month. The Chinese Premier, Keqiang, who is nominally in charge of Chinese economic policy, indicated in his Work Plan report earlier this week, that they favoured stability this year over action that might make commodity prices crash;
- Recent stronger commodity prices led to a strong result in the Australian GDP thereby avoiding a recession. Australia now seems to have a two speed economy- a strong export oriented sector and a domestic sector with low wage and price growth;
- The Australian dollar was slightly weaker against the US dollar, a trend that might continue if the US passes new tax cut laws. It was slightly stronger against the Yen, the Pound and the Euro, reflecting the strong commodity driven GDP result as well as the attractive Australian bond yields;
- Equity markets were all up between 2.2% and 3.4% over the month. They are still finding support from the prospect of lower taxes, higher spending and less regulation in the USA. In addition the implementation of these changes now looks slightly less uncertain to many market participants;
- In the financial year to date, equity markets have provided positive returns to Australian based investors;

Current assessment of equity asset markets

Our current overall assessment taking into account valuation factors, momentum factors and qualitative factors such as monetary Our current overall assessment taking into account valuation factors, momentum factors and qualitative factors such as monetary policy, fiscal policy and geopolitical factors is essentially unchanged since last month and is summarised in Table 3.

Table 3: Summary of equity markets assessments
Equity Market Assessment: 7 March 2017

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator (scenario weighted, lower is better)	95%	114%	122%
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.

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 continued some 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 last month, are summarised in table four below.

Table 4: Earnings per share growth rates for equity markets

		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%	2.25%	4.50%	-1.00%	3.50%
Australian property	ASX AREITS	2.00%	2.25%	4.25%	-2.00%	2.25%
Australian Financials	ASX Financial ex AREITs	2.00%	2.25%	4.25%	-1.00%	3.25%
Australian Materials	ASX Materials	3.00%	2.25%	5.25%	-1.00%	4.25%
Australian Energy	ASX Energy	3.00%	2.25%	5.25%	-1.00%	4.25%
Australian Industrials	ASX Industrials	2.25%	2.25%	4.50%	-1.00%	3.50%
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	2.00%	1.25%	3.25%	-1.00%	2.25%
Germany	DAX	2.00%	1.00%	3.00%	-1.00%	2.00%
France	CAC	2.00%	1.00%	3.00%	-1.00%	2.00%
India	BSE SENSEX	5.00%	4.00%	9.00%	-4.00%	5.00%
China	Hang Seng	5.00%	2.50%	7.50%	-4.00%	3.50%

Current assessment of equity asset markets cont.

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 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 2.8% p.a. to around 3.6% p.a. This is a more demanding hurdle that provides a buffer of safety in our forecasts.
- 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 is also bad for equity prices. This higher inflation prospect 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. The more positive outlook for the US economy leads us to rate this scenario of slower growth perhaps with mild deflation over the next for the next 3 to 5 years as 20% 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: 7 March 2017 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	96%	105%	90%	97%
Canada	104%	113%	99%	106%
Japan	194%	199%	203%	197%
Britain	106%	111%	107%	108%
Germany	121%	126%	123%	123%
France	129%	135%	131%	131%
Australia	93%	100%	91%	95%
India	143%	149%	146%	145%
China	106%	109%	111%	108%
MSCI	112%	120%	110%	114%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	120%	126%	122%	122%
ASX Financials	104%	111%	102%	106%
ASX Materials	110%	117%	108%	112%
ASX Energy	118%	126%	116%	120%
ASX Industrials	92%	98%	89%	93%

Current assessment of equity asset markets cont.

In summary, the valuation work indicates that the Australian equity market is overall fairly priced with the Financials and Materials sectors in the slightly expensive part of the fair price range while AREITs are definitively expensive.

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. Historical analysis suggests that rising US bond yields can rise above 3.5% p.a. (they are now at 2.5% p.a.) before threatening equity market prices.

Elsewhere, equity markets in Canada, Britain and China are also fairly priced. Other international equity markets are still expensive from the point of view of an Australian investor, although the German market is almost in the fair value range.

Momentum

Momentum in major equity markets has continued to be positive in the last month and has continued to consolidate support for equity investment. This does not rule out the risk of bouts of instability in equity markets as they react to events.

Qualitative factors

Overall our current assessment is that the positive qualitative factors (supportive monetary and fiscal policy) 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). In the USA, we expect an increase in GDP growth, fiscal stimulus (lower taxes and higher spending) together with a reduction in political and policy paralysis, albeit with some unconventional surprising aspects emanating from the White House (or from wherever the President happens to be tweeting).

Our baseline scenario is as follows:

- Inflation is low but rising modestly worldwide.
- Real GDP growth is slow with a capacity to rise in the USA.
- Outside of the US and China, governments are weak and not prepared to borrow and spend, even on much needed infrastructure but fiscal deficits and consequent stimulus for the economies are still widespread.
- Short term interest rates are low worldwide with some capacity to rise as central banks slowly retreat from the stimulus given to fill the void left by governments.
- Government bond yields are low but also rising especially in the USA.
- Equity earnings growth is slower than normal during this stage of a recovery (now 8 years old) but will be picking up in the US as tax cuts come into play.
- Equity markets are fairly priced in the US, China, Britain, Canada and Australia due mainly to low bond yields.
- Equity market momentum is generally positive but very fragile at times.
- Commercial property valuations are supported by low bond yields but may come under threat.

Over the next 12 to 24 months we expect the following to occur:

- 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.
- 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.
- Real economic growth is slower than it has been 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 perceived political constraints, but they still remain expansionary over 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 but not until 2018, i.e. after the 19th Party Congress later this year.
- 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. The main reason is that consumers remain on strike as their incomes continue to grow slowly (if at all).
- 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.
- Equity market prices continue to be driven by earnings per share growth, low bond yields and low cash rates but are prone to significant short term falls whenever there is a shock, such as a European banking crisis or a setback in US legislation.

The valuation work indicates that the Australian equity market is overall fairly priced with the Financials and Materials sectors in the slightly expensive part of the fair price range.

What to do next with Investment Portfolio Strategy

- Maintain a neutral or benchmark weight to Australian equities and International equities.
- Stay short in duration in fixed interest to avoid capital losses as bond yields increase.
- If the client portfolio allocation to either of Australian equities or International equities is less than 50% of the currently recommended target allocation, then the allocation should be increased to 50% as soon as practicable with the balance of the difference to be invested progressively over a subsequent six month period.
- 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					✓	

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.

COUNTRY	INDEX	CURRENT LEVEL AT 6 MARCH 2017	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2375	2436	2193	2924	Hold
Canada	S&PTSX	15629	14752	13277	17703	Hold
Japan	Nikkei 225	19041	9652	8687	11582	Reduce
Britain	FTSE 100	7099	6576	5918	7891	Hold
Germany	DAX	11958	9712	8740	11654	Reduce
France	CAC	4972	3789	3410	4546	Reduce
Australia	ASX S&P 200	5748	6065	5458	7278	Hold
India	BSE SENS	29048	19968	17971	23961	Reduce
China	Hang Seng	23672	21852	19667	26222	Hold
World ex Aus	MSCI World	1863	1634	1471	1961	Hold
AUSTRALIAN MARKET SECTORS						
ASX AREITS	ASX AREITS	1374	1123	1011	1348	Reduce
ASX Financials	ASX Financial ex AREITs	7492	7095	6385	8514	Hold
ASX Materials	ASX Materials	10027	8970	8073	10764	Hold
ASX Energy	ASX Energy	8774	7299	6569	8758	Reduce
ASX Industrials	ASX Industrials	5072	5438	4894	6526	Hold

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

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

1. Reduce investment in the Energy sector of the Australian equity market that has benefited from a run up in oil prices.
2. Reduce the weighting in AREITs as they are exposed to increases in bond yields.
3. Hold other sectors of the Australian equity market.
4. Hold a neutral or benchmark position in US, Canadian ,British and Chinese equities but be cautious and underweight international equities elsewhere, unless investing via funds managed by proven, superior international stock pickers.