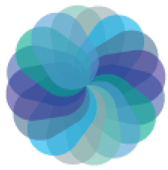

madison
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Investment Market Conditions UPDATE

22 June 2017

Summary of key points

- The main drivers of returns are equity market returns. In turn the main drivers of returns on equities are low bond yields (even though these will have a tendency to rise) and reasonably solid earnings growth.
- Over the latest month, equity market valuations have improved slightly in the USA, Australia and Europe as bond yields declined and long-term earnings per share growth estimates were maintained.
- The main events of the last month were:
  - The Federal Reserve increasing its Fed Funds Rate as expected by markets- so no adverse impact.
  - US deleveraging since the GFC appears to have stopped and may be turning around, leading to more support for corporate earnings growth.
  - The Japanese economy has moved out of deflation improving the outlook for corporate earnings growth. Higher dividend payout ratios following government pressure are adding further to the stock price outlook.
  - European Central Bank reaffirming a policy of very slow scaling back of its major monetary stimulus.
  - The French election confirming the power of newly elected President Macron and consolidating the forces in favour of preventing a break up of the Eurozone, which would be very disruptive to global financial markets.
  - Periods of equity market weakness resulting from political factors, but proving to be transient.
  - Chinese growth continuing but with more emphasis on services versus manufacturing, indicating some increase in resilience in GDP growth.
  - A major fall in the oil price showing the structural weakness of the OPEC attempts to boost prices by limiting production. This will reduce the level of inflation worldwide and reduce the risk of an inflationary overshoot caused by continued monetary policy stimulus. Overall positive for most equity market sectors but not for the energy sector.
- Our valuation work combined with an assessment of the momentum and qualitative factors indicates that it is still appropriate to hold a neutral or benchmark allocation to Australian and International equities and an underweight to Property and Fixed Interest.

Summary of key points cont.

Risk factors to be aware of include:

- Delays in the implementation of the tax cuts in the USA due to distraction of the Congress by issues relating to the possible impeachment of the President. There is also the risk of stalling the continuing budget resolution that may cause a Federal government shut-down at the end of September.
- Any economic policy mistake in China such as reducing credit and lending to loss making state enterprises too much or too soon

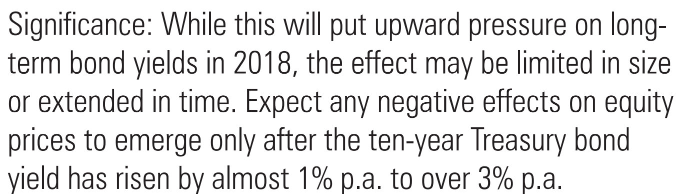
Table 1: Recommended asset allocation positioning for portfolios managed with a three-year horizon

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					X	
Fixed interest			X			
Property		X				
Australian equities				X		
International equities				X		
Alternative equities					X	

Recent events & their significance to Investment Strategy

USA

- The Federal Reserve increased its key interest rate to a range of 1.00% - 1.25% p.a. This was widely anticipated by markets and so its announcement had no effect. The markets view of future increases diverges from the announced view of the Federal Open Markets Committee, which sets the Fed Funds rate. The FOMC is indicating one more increase of 0.25% p.a. in 2017 and three more of 0.25% p.a. in 2018. Even if this happens it will bring the Fed Funds rate up to just 2.25% p.a. by the end of 2018, which is still a very low level that is supportive of equity asset prices. Financial markets are pricing in just two increases by late 2018. It needs to be borne in mind that the Fed mandate is to target inflation and unemployment and not asset prices. The Fed is concerned about weak inflation and underemployment, so it is tightening monetary policy very gradually. This includes its plans to reduce the size of its balance sheet. It currently holds $4.3 trillion of government and mortgage backed bonds, which is likely to be reduced over an extended period of five years or more.



Significance: While this will put upward pressure on long-term bond yields in 2018, the effect may be limited in size or extended in time. Expect any negative effects on equity prices to emerge only after the ten-year Treasury bond yield has risen by almost 1% p.a. to over 3% p.a.

- Equity market volatility as measured by the VIX index that is traded on the Chicago market has generally been low, in contrast to the increased volatility of US politics. Significance: Equity markets are largely discounting US political or legislative uncertainty and focussing more on earnings reports, which are running at healthy levels.

CHINA

- There is increased commentary about the need for authorities to remedy the interrelated problems of loss making state owned enterprises, the funding of these losses by increased debt via borrowing from the second tier or shadow banking system and the growth of doubtful debts in the shadow banking system. Eventually all of these will need to be fixed but the solution appears to be deferred until 2018 or later. Significance: There may be a delayed but sharper slow down in Chinese economic growth with consequent effects on global growth, commodity prices, profitability of Australia's major mining companies and Australian Federal and State tax revenues.
- The Chinese A share markets, which are the second largest stock markets in the world, were admitted to the MSCI Emerging markets Index with a weight of 0.7%. Significance: This will cause some rebalancing of global investors portfolios towards these markets, but the effect will be limited. Inclusion of the Chinese a share markets in the much broader MSCI World index would be much more significant but is not expected for some time.

JAPAN

- There has been an 8.9% year on year increase in exports and real growth in GDP is now running at 2.2% p.a. There have been five quarters of expansion, the longest expansion since 2006. Abenomics appears to be working with manufacturing profits up strongly and the Nikkei equity market index at a 17 month high. Significance: Japanese equities have become reasonably fairly priced
- The crisis on the Korean peninsula has dropped off the media front pages lately. It is still serious and potentially more so for Japan than any other major market. Significance: Potentially quite large but hard to predict.

EUROPE

- The French Assembly elections consolidated the power of President Macron who, together with Chancellor Merkel of Germany, can now act as a positive counterweight to an erratic US administration. Significance: the prospect of a Eurozone break up has receded markedly together with the consequent economic and financial market disruption that would follow such an event.
- The European Central Bank at its most recent meeting did not indicate any reduction in its EUR 60 billion per month of bond purchases. This was counter to expectations and indicates that the tightening of monetary policy will be far more gradual. Significance: European equities will remain fairly priced for longer.

Recent events & their significance to Investment Strategy cont.

AUSTRALIA

- Moody's, a rating agency, joined its competitor, S&P, in downgrading the credit rating of major Australian banks by one notch, citing concerns about their exposure to losses on mortgages on residential property which has experienced strong price growth in recent years. Residential property market price growth has fallen back slightly in the last month or so but is not yet showing any real signs of a sharp fall. A prolonged plateau is more likely at this stage. The effect of the credit rating downgrade will be a modest increase in wholesale borrowing costs of the major banks. The equity market reaction has been volatile and generally more extreme than warranted to this factor alone.
  Of greater significance is the potential slow down in the growth of bank lending as a result of constraints imposed by APRA. This may lead to longer-term slower growth in bank earnings per share and dividends. Ultimately, banks could experience a decline in Return on Equity from circa 14% p.a. to circa 10% p.a., the level that many international banks operate on. This would cause a re-rating and decline in bank stock PEs by as much as 30%.
- The Governor of the Reserve Bank, Phillip Lowe has made some statements about the RBA's optimism that "animal spirits" will re-emerge and encourage greater investment spending by companies, while at the same time employees should press for higher wage increases. The latter statement reduces the credibility of the former. It may be that the RBA is more concerned than it is letting on about the impact of the very low wage growth and its effect of consumer spending which is still the largest component of demand. Wage growth appears to be constrained by the increase in the proportion of the work force that is part time (rising from 10% of the total work force in 1966 to 32% in 2016) and the shift into casualised or less unionised sectors such as hospitality or contracted arrangements via labour hire companies. Significance: The RBA wants inflation and growth to pick up, in line with the optimistic assumptions of the Commonwealth Treasury in its budget tax revenue forecasts, but both are likely to be disappointed. The Treasury will have yet another case of underestimating the Federal budget deficit (after seven in a row). The outlook for earnings in retailing and other sectors depending on discretionary spending will be adversely impacted.

"Residential property market price growth has fallen back slightly in the last month or so but is not yet showing any real signs of a sharp fall.
A prolonged plateau is more likely at this stage"

Where are we now?

Table 2: Financial market movements

Market indicator	Level at 30/6/14	Level at 30/6/15	Level at 30/6/16	Level at 20/6/17	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
Equity Markets										
S&P ASX 200	5394	5515	5233	5783	2.2%	2.2%	-5.1%	-5.1%	10.5%	10.5%
USA: S&P 500	1960	2057	2099	2453	4.9%	28.9%	2.0%	5.3%	16.9%	14.7%
UK: FTSE 100	6743	6620	6504	7523	-1.8%	10.8%	-1.7%	-14.1%	15.7%	8.3%
Germany: DAX	9833	11083	9680	12888	12.7%	13.0%	-12.7%	-10.5%	33.1%	31.1%
France: CAC	4422	4869	4237	5310	10.1%	10.4%	-13.0%	-10.8%	25.3%	23.4%
Japan: Nikkei 225	15162	20235	15705	20303	33.5%	35.6%	-22.4%	-4.9%	29.3%	16.9%
China: Hang Seng	23200	26250	20794	25963	13.1%	38.9%	-20.8%	-18.3%	24.9%	22.5%
Currencies										
USD/AUD	0.943	0.7679	1	0.7588		22.8%		3.2%		-1.9%
GBP/AUD	0.5511	0.4881	1	0.5958		12.9%		-12.5%		-6.3%
YEN/AUD	95.32	93.81	77	84.73		1.6%		22.5%		-9.6%
EUR/AUD	0.6886	0.6866	1	0.6803		0.3%		2.5%		-1.5%
Interest rates (% p.a.)										
Aus: 90 day bank bill	2.68	2.19	2	1.76	-49.0%		-19.0%		-24.0%	
Aus: 10 year govt bond	3.54	3.01	2	2.41	-53.0%		-101.0%		41.0%	
US: Fed funds rate	0.09	0.13	0	1.16	4.0%		19.0%		84.0%	
US: 10 year govt bond	2.53	2.32	1	2.18	-21.0%		-86.0%		72.0%	
Commodities										
Copper US $ per tonne	7035	5767	4845	5724	-18.0%	0.7%	-16.0%	-13.3%	18.1%	15.9%
Gold USD/ounce	1326	1175	1328	1245	-11.4%	8.8%	13.0%	16.6%	-6.3%	-6.3%
Oil USD/barrel (WTI)	105	58.29	48	44	-44.5%	-31.8%	-16.9%	-14.2%	-9.2%	-10.9%

Since the last update in May:

- All major international equity markets are up in local currency terms. (US +2.3%, Japan +3.0% and China +2.3%, with Europe more mixed with France declining by 0.7%).
- The Australian Dollar was stronger versus the three major currencies (+1.8% vs USD, +1.6% vs JPY and +2.1% vs EUR). From the point of view of Australian investors, this offset gains in International equity markets.
- The Australian equity market had little net change over the period (+0.4%).
- Short-term interest rates rose in the US as a result of the Federal Reserve decision to lift its key rate by 0.25%. Notwithstanding this the Fed Funds rate is still very low at 1.16% p.a. In Australia the RBA kept its key rate stable at the historic low of 1.5% p.a.
- The long-term price of money as measured by ten-year government bond yields declined in both the USA (by 0.06% p.a.) and Australia (by 0.07% p.a.) This had the effect of providing continuing support to equity market prices.
- Exchange traded commodities were relatively unchanged except for a very significant fall of over 14% in the oil price as a result of growing disarray among OPEC producers.

Since the last update in May cont.

The 2016/2017 financial year is almost completed and over that period equity markets are up strongly in Australian dollar terms. The US market has delivered a total return of +14.7% with Japan producing +16.9%. European markets have been stronger as well with the German market at +31.1% and even Great Britain at +8.3% notwithstanding the fall in its currency following the Brexit vote.

These equity market gains came even though the tailwind from historically low long-term bond yields has weakened over the last year. The yield on US ten-year Treasury bonds was up sharply by +0.72% over the year, reflecting the shift in market perception about Federal Reserve policy on interest rates. Even after this shift the US ten-year bond is still at a relatively low level when judged against longer-term history and is likely to eventually move higher. Australian ten-year bond yields also moved up but not by as much. The increase of +0.41% p.a. over the year meant that the margin over the US Treasury rate has been squeezed to a low level of +0.2% p.a. This margin is probably unsustainable in the longer term. This means that as US bond yields rise, Australian bond yields will probably rise by more. This will put greater competitive pressure on Australian equity prices than on International equity prices.

Among commodity prices, oil has fallen significantly for the third year in a row. This indicates the difficulty that the OPEC producers face in maintaining the price by restricting their production. The members of OPEC comprise a collection of interests which are both too disparate (and desperate) to succeed.

Meanwhile the copper price, a bellwether of economic growth, is up by over 15% over the financial year to date. This reflects a brighter outlook for world GDP growth that is seen in the cautious forecasts of the International Monetary Fund and The European Central Bank and the somewhat less cautious forecasts of the US Treasury and the Australian Treasury.

Nominal GDP growth (i.e. real growth plus inflation) is expected by to be +4.4% p.a. for the USA and +8.8% p.a. for China over the course of the next year.

Current assessment of equity asset markets

Overall, financial market conditions are very supportive of equity market prices. The assessment of equity markets is of central importance to portfolio strategy, given that equity assets are significant drivers of overall returns.

Our current assessment of equity markets, 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 Markets Assessment - 20 June 2017

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is better)	**86%**	**104%**
Momentum indicator	**POSITIVE**	**POSITIVE**
Qualititative indicator	**POSITIVE**	**POSITIVE**

Valuation Factors

The Valuation indicators have improved further over the last month due to the fall in the ten-year bond yield while our assessment of the projected ten-year growth rates for equity earnings per share has been maintained unchanged. (See Table 4 below).

The medium to long-term assessment of the effect of Momentum in equity markets, which usually persists between six months and eighteen months, has weakened a little over the course of the latest month but is still supportive overall.

Qualitative factors are mostly unchanged in their effect, with both fiscal and monetary policy still very supportive of equity prices in most countries and markets.

Table 4: Earnings per share growth rates for equity markets

Scenario 1 - base EPS growth assumptions over ten years

		Real GDP growth % p.a.	Inflation % p.a.	EPS growth % p.a.
USA	S&P 500	2.75%	2.00%	3.75%
China	Hang Seng	5.00%	2.50%	3.50%
Japan	Nikkei 225	1.50%	1.50%	2.00%
Britain	FTSE ALL SHARE	2.25%	2.50%	3.75%
Germany	DAX	2.00%	2.00%	3.00%
France	CAC	2.00%	2.00%	3.00%
Australia	ASX S&P 200	2.75%	2.00%	3.75%

The assessments of long term earnings per share growth, together with the bond yield, are used to derive the long run fair price estimates in the analysis set out below in Table 5. We do so for a number of scenarios, which imply different financial market regimes. While there are many possibilities, the three main ones in our assessment are as follows. These scenarios are essentially unchanged since our last Update and we have not changed our assessment of the likelihood of each of them:

- Modest earnings growth where inflation and interest rates do not rise by much. This is good for equity prices. We rate this as the most likely scenario for the next 3 to 5 years with a likelihood of 50%. In this scenario we are assuming that the ten year Australian bond yield will rise from the current 2.4% p.a. to around 3.2% 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 in the higher assumed long-term bond yield. This effect is offset to some extent by the faster rate of earnings per share growth. We rate this scenario as a 30% likelihood.
- Recession and possible deflation where inflation and real interest rates fall significantly and may even turn negative and there is a risk of the economy being trapped in a zero or negative growth pattern. We rate this scenario as a 20% likelihood.

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

Equity Market Valuation indicators from Australian Investor Perspective - 20 June 2017

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%	
Long term EPS growth rate changed by	0.00%	0.50%	-0.50%	
Bond yield equal to current yield multiplied by	130.00%	150.00%	80.00%	
Bond yield in % p.a.	3.34%	3.86%	2.06%	
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%	91%	94%	94%
China	107%	101%	114%	108%
Japan	118%	112%	123%	118%
Britain	151%	144%	149%	149%
Germany	104%	99%	105%	103%
France	101%	96%	102%	100%
Australia	87%	82%	86%	86%
Global (MSCI)	105%	100%	105%	104%

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

The valuation analysis work indicates that with the exception of the British stock market, most major equity markets are within the fairly priced range. None of them are cheap, so caution is warranted.

Momentum

Momentum in major equity markets has continued to be positive when measured over the last six months. It continues to be a supportive factor for equity investment. It has become prone to periods of shorter-term instability and it may cease to become supportive in the months ahead.

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 some places, instability in politics and policy making and possible instability in the European banking system).

The instability in European politics has subsided with recent election results in the Netherlands, German state elections and in the French presidential and assembly elections. In addition, potential crises in major banks have been averted or solved in Italy and Spain.

Britain is proving to be an exception, with the recent election result reducing the power of the government and markedly increasing both the uncertainty about its Brexit negotiations and the prospect of a recession in 2018 or 2019

In the USA we still expect an increase in GDP growth, with fiscal stimulus increasing due to lower taxes and higher spending although this may be delayed due to tensions between the Congress and the Presidency.

In China, the government is consolidating ahead of the 19th party Congress in the northern autumn and is not likely to tighten monetary or fiscal policy too much until at least 2018.

Japan is showing the benefits of the unusually long–lived administration of Prime Minister Abe and the success of at least some of his Abenomics policies such as fiscal and monetary stimulus.

Our summary of the qualitative factors and their effects on equity market returns for each major region is as follows:

Table 6: Qualitative factors affecting equity markets over the next three years

Region	Monetary Policy	Fiscal Policy	Economy (GDP growth, unemployment etc)	Politics and Public Policy	Overall
USA	Positive but weakening gradually	Positive and increasing but with increased uncertainty	Positive and increasing	Positive but volatile	Positive
China	Positive but weakening later	Positive	Positive	Positive	Positive
Japan	Positive	Positive	Positive and increasing	Positive	Positive
Europe	Positive	Positive	Positive	Has shifted from negative to slightly positive	Positive
Great Britain	Positive	Positive and increasing	Positive and increasing	Positive and increasing	Positive
Australia	Positive	Positive and increasing	Positive	Negative	Positive

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 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 7: Recommended asset allocation positioning for portfolios managed with a three-year horizon

RECOMMENDED ASSET ALLOCATION RELATIVE TO BENCHMARK OR NEUTRAL:	ZERO	MAJOR UNDER WEIGHT	MINOR UNDER WEIGHT	NEUTRAL OR BENCHMARK WEIGHT	MINOR OVER WEIGHT	MAJOR OVER WEIGHT
ASSET CLASS						
Cash					X	
Fixed interest			X			
Property		X				
Australian equities				X		
International equities				X		
Alternative equities					X	

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