madison FINANCIAL GROUP

SHERLOCK PARTNERS

Investment Market Conditions UPDATE

21 February 2018

Summary of key points

- Three weeks ago, we said that the more likely catalysts for a short term market sell-off included policy maker mistakes, such as too much monetary tightening in China or too rapid an increase in interest rates by the Federal Reserve in the USA, and that the early warning signs of these sorts of catalysts will be easier to discern and act on than geopolitical shocks. In our view that remains the case, but a significant portion of the US equity market has anticipated a policy maker rise in US interest rates in response to a single data report.
- The slide in US equity prices in early February was largely self-induced and was apparently triggered by a reaction to a report that wages growth in the US had accelerated from a reported +2.7% p.a. at the end of December 2017 to +2.9% p.a. as at the end of January. This preliminary figure, reported on Friday 2 February, seems hardly worth worrying about, but it pointed to potentially higher inflation and higher interest rates and a possible Federal Reserve increase in interest rates beyond what had been priced in by the equity market.
- Although it was a modest uptick in wages inflation and is subject to revision, it was enough to tip the scale in favour of selling equities and buying bonds. The slide was probably made worse by program trading that added to the sales momentum.
- The continuing reality is that worldwide inflation and short-term interest rates remain lower than usual and are likely to do so for the next few years and long-term bond yields are still very low, although they have started to move up, as we expected.
- The rise in the US ten-year Treasury bond yield has accelerated, moving up over 0.4% p.a. since the end of December. The most recent budget proposal from the Trump Administration adds significantly to what was already an increased fiscal deficit, extending over the next ten years. This will add a lot to the need of the US treasury to sell more bonds over that period. We therefore expect the rise in long term bond yields to continue, but based on historical evidence, it is not expected to affect equity prices adversely in any lasting way until it reaches 4% p.a. This will probably take several years but it could conceivably happen within the next two years. We need to continually monitor the US ten-year Treasury bond yield- the world price of long term money.

- We think that the current combination of benign monetary policy, stimulatory fiscal policy and synchronised world GDP growth will probably support equity markets through 2018 and possibly into 2019. We will continue to monitor conditions to anticipate the need to make a significant shift from growth assets to defensive assets.
- In the meantime, events such as those in early February may cause more equity market declines of up to 10% over relatively short periods. While we need to be watchful and patient we should not lose sight of the opportunity to add to equities holdings at what may be more favourable prices taking into account a medium-term outlook over the course of 2018 and early 2019.
- Notwithstanding the possibility of a shorter-term sell-off in equity markets and that there are no overtly cheap equity markets, it is still appropriate to hold a neutral or benchmark allocation to Australian and International equities as long as the Momentum of equity markets persists and the Qualitative factors (as set out in Table 6) remain supportive.
- US Bond yields are expected to rise by up to 1.5% p.a. over the next two years. Therefore, in the defensive or stabilising part of the portfolio, there should be an underweight to fixed i nterest combined with a shorter duration position in fixed interest. In addition, given the low spread or margin available for taking credit risks, the exposure to credit risk should be very limited.
- The possible adverse impact of rising bond yields on listed property trusts also indicates a significant underweight to this asset class, which is also showing some stress in terms of the yields in recent major transactions reaching very low levels.
- A modest overweight to alternative equities, which target an absolute return higher than cash or fixed interest and which are not highly correlated with equity markets, would be helpful in stabilising portfolio returns while still achieving a total return significantly above the cash rate.

Table 1: Recommended asset allocation positioning for portfolios

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	

Where are we now?

Table 2: Financial market movements

Market indicator	Level at 30/06/2017	Level at 31/12/2017	Level at 12/02/2018	Change FY 2017/2018 to 31/12/17		Change since 31/12/17	
				In local currency	In AUD	In local currency	In AUD
Equity Markets							
S&P ASX 200	5721	6065	5809	6.0%	6.0%	-4.2%	-4.2%
USA: S&P 500	2423	2673	2619	10.3%	8.7%	-2.0%	-2.3%
UK: FTSE 100	7312	7687	7092	5.1%	8.2%	-7.7%	-6.4%
Germany: DAX	12325	12917	12107	4.8%	8.4%	-6.3%	-3.1%
France: CAC	5120	5312	5079	3.8%	7.4%	-4.4%	-2.6%
Japan: Nikkei 225	20033	22764	21382	13.6%	11.7%	-6.1%	-6.1%
China: Hang Seng	25764	29919	29713	16.1%	14.4%	-0.7%	-0.7%
Currencies							
USD/AUD	0.7689	1	0.7831		-1.5%		-0.3%
GBP/AUD	0.5901	1	0.5651		3.0%		1.4%
YEN/AUD	86.42	88	85.07		-1.7%		3.4%
EUR/AUD	0.6727	1	0.6379		3.5%		1.9%
Interest rates (%p.a.)							
Aus: 90 day bank bill	1.76	2	1.75	2.0%		-3.0%	
Aus: 10 year govt bond	2.59	3	2.89	8.0%		22.0%	
US: Fed funds rate	1.16	1	1.42	26.0%		0.0%	
US: 10 year govt bond	2.3	2	2.85	11.0%		44.0%	
Commodities							
Copper US $ per tonne	5927	7247	6755	22.3%	20.5%	-6.8%	-7.1%
Gold USD/ounce	1241	1302	1326	4.9%	3.4%	1.8%	1.5%
Oil USD/barrel (WTI)	46.2	60	59.74	30.8%	28.8%	-1.1%	-1.5%

- The positive momentum in equity markets in the latter half of 2017, which continued into the first month of 2018, has spectacularly given way with a significant short-term reversal in the early part of February.
- The strength in equity markets to the end of December was in spite of a significant increase in US Treasury ten-year bond yields over the preceding four months, up from 2.04% p.a. in August to 2.40% p.a., at the end of December.
- In late January this accelerated with the yield spiking to 2.84% p.a. on the day that (slightly) faster wages growth in the US was reported.
- As we have noted previously, rising bond yields tend to come from rising inflation, which in its early stages is good for equities, as earnings growth tends to pick up, boosting the cash flows that are being valued at a slightly harsher discount rate. Eventually the rise in inflation and bond yields overcomes the growth in earnings effect. Historically, at a bond yield around 4% p.a.; it starts to adversely affect equity market prices more generally.
- The rise in bond yields this time has mostly come from factors other than inflation, which is very low worldwide. Instead they have mainly been driven up by shifts in the demand and supply dynamics. The demand for bonds is reducing as the central banks re-duce their QE programs. The supply is being increased by the major scope of the US tax cuts that have been legislated. These are adding over $1 trillion to US Treasury debt in the next ten years, before the further effects of the Trump budget proposal, with its major increase in spending, is factored in.

Where are we now? cont...

- The world price of long-term money is going up. The rising prospect of inflation, albeit so far based on a single piece of evidence, has added to the pressure for rising bond yields, with knock on effects on equity markets. Whether this is likely to lead to persistent weak equity returns, is the subject of our more detailed equity market analysis set out below.

Current assessment of equity asset markets

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 - 12 February 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is better)	**96%**	**106%**
Momentum indicator	**POSITIVE, BUT WEAKENING**	**POSITIVE, BUT WEAKENING**
Qualititative indicator	**POSITIVE**	**POSITIVE**

- Valuation indicators have become less expensive as a result of the fall in equity prices since the end of January. The exception of the British equity market, all major equity markets are now within the Fair Price range. Momentum has taken a slap in the face in the last two weeks, but judged over a six to eighteen month period (over which it has historically persisted) it remains positive in most major equity markets. It could well continue to be so for the next six to twelve months. The Qualitative factors, which remain positive also, are summarised in Table 6. In particular, monetary and fiscal policy in most major countries, are still both very supportive of earnings growth for equities and of equity prices in general.
- The Australian and Japanese equity markets are more attractive than most other International equities markets, based on valuation factors alone, while the Australian market has positive but weaker momentum than that of the US equity market.
- Our current assessment of equity markets in Australia and elsewhere takes into account:
  - The Valuation of equities comparing current prices to long term Fair Prices;
  - The Momentum of equity market price movements; and
  - Qualitative indicators that take into account the impact of fiscal and monetary policy as well as economic and political factors.
- Valuation is the most important part of our assessment (although it can be misleading in the shorter term out to three years). Essentially, we compare the current pricing of equities in world share markets with an esti-

Current assessment of equity asset markets cont...

mate of the Fair Price of each market. The lower the ratio of Current Market Price to the assessed Long Term Fair Price, the more attractive investment in a particular share market appears. The Fair Price of an individual stock or of a whole equity market is the price at which the stock or the share market should trade in order to achieve the long term Fair Value Return. The Fair Value Return is the required return that fairly compensates for risk. It equates to the current long-term government bond yield in the investor's home country plus a margin or Equity Risk Premium. We have assumed a required equity risk premium of 5% p.a. for developed equity markets and 8% p.a. for emerging markets. This implies a required rate of return on developed market equities significantly in excess of 8% p.a. over the next ten years, to justify an overweight position in equities.

- A key assumption in the assessment of the long-term Fair Price is the long-term rate of growth in earnings per share. In turn this 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. We monitor and adjust where necessary our long-term assumptions about inflation and real economic growth in the major developed countries as well as in the major developing economies. Table 4 below sets out our current assessment of this critical factor for the Australian equity market and its major sectors as well as the major international equity markets.
- There is more detail on the Valuation Indicators in Table 5. An important component of the valuation analysis is the assessment of likely earnings per share growth for major equity markets over the next ten years. This is based on forecasts of real GDP growth and inflation. We have not changed these although the global GDP growth forecasts by both the IMF and the World Bank have recently been upgraded marginally for the next two years. The IMF forecast for US GDP growth has been increased more significantly from 2.3% p.a. to 2.7% p.a. for 2018 and from 1.9% p.a. to 2.5% p.a. for 2019. Our US GDP forecast was already at this level.

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	2.50%	2.00%	3.50%
China	Hang Seng	5.00%	2.50%	3.50%
Japan	Nikkei 225	2.00%	1.50%	3.50%
Britain	FTSE ALL SHARE	2.00%	2.50%	2.50%
Germany	DAX	2.00%	2.00%	2.00%
France	CAC	2.00%	2.00%	2.00%
Australia	ASX S&P 200	2.75%	2.00%	2.75%

Current assessment of equity asset markets cont...

- These 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 of what may happen over the next ten years, which imply different financial market regimes and different relative returns for the various asset classes. 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 2.85% p.a. to around 3.4% p.a. This provides a buffer of safety in our valuation analysis
    - Faster earnings growth where inflation and interest rates rise to around 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 continue to rate this scenario as 20% 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 continue to rate this scenario as 30% likelihood, although a recession is more likely to occur after 2019 than before.
- By way of comment, we have noted the following from the recent Scope Economic Survey of 26 leading economists in Australia, with regard to forecasts for the next year or so. The forecasts are generally clustered close to each other, although there are some outliers. They also tend to be anchored around the current level or rate for the item being forecast.
- The average rate of world GDP growth for the next year is +3.7% p.a. with a range of forecasts between a low of 3.2% and a high of 3.9%- a strong consensus. Australian GDP growth is clustered around +2.7% p.a. (low 1.0% and high 3.1%), while Chinese GDP growth is expected to come in at +6.5% p.a. (range 6.1% p.a. to 7.2% p.a.) – above our long-term base assumption.
- Forecasts by economists of currency exchange rates and share market levels one year hence, have in the past been on very shaky ground. This year's average forecast are for the AUD/USD to be at $US0.75 and the ASX200 at 6205- close to the level that applied at the time of the survey. In general, there seems to be little information value in relying on forecasts of economists for financial market indicators. Our preferred approach is to make more frequent (i.e. monthly) assessments of valuation and momentum indicators, knowing that they can be variable from month to month.

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

Equity Market Valuation indicators from Australian Investor Perspective

- 12 February 2018

Economic Scenario:	One: Continued moderate growth	Two: Faster growth	Three: Relapse into recession	Scenario Weighted Price to Fair Value
Probability of scenario	50%	20%	30%	
Country	Ratio of current market value to long term fair value	Ratio of current market value to long term fair value	Ratio of current market value to long term fair value	Ratio of current market value to long term fair value
USA	105%	102%	104%	104%
China	109%	105%	116%	111%
Japan	95%	92%	97%	95%
Britain	126%	122%	129%	126%
Germany	111%	107%	114%	111%
France	110%	106%	113%	110%
Australia	97%	93%	98%	96%
Global (MSCI)	106%	103%	107%	106%

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

The valuation analysis indicates that, except for the British market, all major international equity markets are now fairly priced, following the recent short run falls in price. The British equity market is definitively expensive. The Australian and Japanese equity markets stand out as being the most reasonably priced, without being particularly cheap.

Qualitative factors used in the overall assessment

Overall our current assessment is that the positive qualitative factors (supportive monetary and fiscal policy) outweigh the negative factors (mainly the risk of policy maker mistakes). Our summary of the qualitative factors and their effects on equity market returns for each major region is set out in Table 6.

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 over the next five years as the Fed gradually reduces its holdings of bonds and raises short- term rates. The normalisation of US monetary policy may take 8 to 10 years.	Positive and increasing. The size and timing of the tax cuts for companies is now known and is already stimulating repatriation of cash by major companies and with it plans to invest more.	Positive and increasing.	Probably positive but volatile. The passage of the tax reform shows what can be done, but in the run up to the mid term Congressional elections in November 2018, it will still be an issue-by-issue process.	Positive
China	Positive but the PBOC is tightening more quickly. Reductions in stimulus in 2018 are now more likely.	Positive as there is a need for continued spending on health care and education as well as infrastructure	Positive with some prospect of a decline in the rate of growth from 6.9% towards 5% p.a. over the next three years.	Positive, but tighter control of all the key policy levers. The main risk is if the policy makers make a mistake.	Positive
Japan	Positive with the BOJ again confirming that it will keep near zero bond yields in place, further assisted by the reappointment of Governor Kuroda	Positive.	Positive and increasing modestly with real GDP growth averaging 2.1% p.a.	Positive with the returned Abe government having a strong mandate. It needs to act on this.	Positive
Europe	Positive but weakening in 2019 as the ECB eventually reduces its rate of stimulus	Positive	Positive, but GDP growth weakens in 2019, hence the need for monetary stimulus to be continued.	Has shifted to slightly positive, but with continued political uncertainty in Germany and Spain	Positive
Great Britain	Positive	Positive and increasing	Weakening due to Brexit	Negative and divided	Positive
Australia	Positive with the RBA rate likely to be unchanged till late 2018 or early 2019	Positive and increasing as tax policy remains unresolved.	Positive due in part to infrastructure spending by the states.	Negative, still no one definitively in control of policy	Positive

What to do next with Investment Portfolio Strategy:

- Keep a neutral or benchmark weight to Australian equities and International equities but be prepared to take profits on International equities at some stage in the next twelve months and hold more cash or increase holdings in alternative equities that are uncorrelated and offer some downside protection.
- Stay short in interest rate duration in fixed interest to avoid capital losses as bond yields increase.
- Avoid traded securities with credit risk, as credit spreads are too tight to offer adequate return for risk.
- Hold a major underweight to AREITs (Listed Property Trusts) and be selective about unlisted property assets- minimum yield of 6% p.a. maximum debt of 45% of gross assets, good tenants, and great managers with a proven track record.
- 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

What to do next with Investment Portfolio Strategy: cont…

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.

- In the longer run beyond the next year or so, the prospects are for greater increases in short term interest rates in the USA relative to interest rates in Australia. This means that eventually the AUD is more likely to fall than rise against the USD, so international investment on a three to five-year horizon should be unhedged.
- A slight overweight to well managed alternative equities that offer premium returns above cash rates and lower volatility investment in growth assets should be maintained. Consider a more substantial allocation, if moving money out of international equities to take profits.

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	