madison FINANCIAL GROUP

SHERLOCK PARTNERS

Investment Market Conditions UPDATE

January 2018

Summary of key points

- The key issues for investors to consider are:
  - While worldwide inflation and short-term interest rates remain lower than usual and are likely to do so for the next few years, long-term bond yields have started to move up, as we expected.
  - This will not severely impact equity prices until the US ten-year Treasury bond yield moves from where it is now, around 2.7% p.a., to over 4% p.a. This will probably take several years but it could conceivably happen within the next two years. We need to be watchful that the current strong momentum in equity markets doesn't run out and reverse.
  - Equity market volatility is more likely than not to continue to be low (below 25 as measured by the VIX) over the next 12 months.
  - There are some potential triggers for a short term sell off, such as tensions and possibly war between North Korea and the USA or between Iran and Saudi Arabia, but the eventuality and the timing of these are hard to predict.
  - More likely catalysts include 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. In addition, there is the prospect that the current de facto currency devaluation war between the US and Europe and Japan could escalate and become a source of greater instability. The early warning signs of these sorts of catalysts will be easier to discern and act on than geopolitical shocks.
  - In summary, with equity markets continuing their upward momentum at the same time as bond yields are rising, the tension between the two markets is rising and we are now closer to the resolution of the conflict, which usually comes in the form of an equity market decline. While we are closer to this, 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 shift from growth assets to defensive assets.
- 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. There is a need to continually review these, especially as the Valuation factors for most equity markets are now transitioning from the upper end of Fairly priced to the lower end of Expensive.

- 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 Interest 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 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 BENCHMAR	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 29/01/2018	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	6085	6.0%	6.0%	0.3%	0.3%
USA: S&P 500	2423	2673	2872	10.3%	8.7%	7.4%	3.6%
UK: FTSE 100	7312	7687	7665	5.1%	8.2%	-0.3%	-0.2%
Germany: DAX	12325	12917	13340	4.8%	8.4%	3.3%	3.2%
France: CAC	5120	5312	5529	3.8%	7.4%	4.1%	3.8%
Japan: Nikkei 225	20033	22764	23749	13.6%	11.7%	4.3%	4.3%
China: Hang Seng	25764	29919	33131	16.1%	14.4%	10.7%	10.7%
Currencies							
USD/AUD	0.7689	1	0.8091		-1.5%		-3.5%
GBP/AUD	0.5901	1	0.5725		3.0%		0.1%
YEN/AUD	86.42	88	87.99		-1.7%		-0.1%
EUR/AUD	0.6727	1	0.6521		3.5%		-0.3%
Interest rates (% p.a.)							
Aus: 90 day bank bill	1.76	2	1.8	2.0%		2.0%	
Aus: 10 year govt bond	2.59	3	2.85	8.0%		18.0%	
US: Fed funds rate	1.16	1	1.42	26.0%		0.0%	
US: 10 year govt bond	2.3	2	2.68	11.0%		27.0%	
Commodities							
Copper US $ per tonne	5927	7247	7085	22.3%	20.5%	-2.2%	-5.7%
Gold USD/ounce	1241	1302	1349	4.9%	3.4%	3.6%	-0.1%
Oil USD/barrel (WTI)	46	60	66.39	31.3%	29.4%	9.9%	6.0%

- The positive momentum in equity markets in the latter half of 2017 has continued into the first month of 2018, with the exception of the British market, which appears to be the most overpriced on our valuation analysis (see Table 5).
- The strength in equity markets is in spite of a significant increase in ten-year bond yields.
- Historically, 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, which 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.
- This time, however, the rise in bond yields is not being driven by inflation, which is very low worldwide. Instead they are being driven up by shifts in the demand and supply dynamics. The demand is reducing as the central banks reduce their QE programs. The supply is being increased by the major scope of the US tax cuts which is adding over $1trillion to US Treasury debt in the next ten years.
- In addition, it has been reported that the Peoples Bank of China had indicated that it might reduce the scale of its purchases of US treasury bonds. The Chinese authorities have been major buyers of these securities as a safe haven for their burgeoning $US 3.1 trillion of foreign exchange reserves that result from its trade surpluses.

Where are we now? cont...

- Those trade surpluses have become a major issue for the Trump administration. Even though the campaign promise of a 45% tariff on Chinese imports to the US has not come to pass (yet), there is still a lot of tension. The newly empowered Xi regime in China is sending signals that it can retaliate. Apart from not adding to its $1.2 trillion stash of US Treasury bonds, it may also sell some, increasing the cost to the US of financing its continuing deficits. While a rise in the bond yield would come at a cost to China via a fall in the value of its existing holdings, China has demonstrated that it is prepared to invest strategically in all manner of ways, from naval bases in Pakistan, to the Belt and Road initiative, to building new islands in the South China Sea.
- While the PBOC denied the story about reducing its purchases of bonds, those close to the story confirmed it and said that it was set up to allow plausible deniability. This is given more weight by the decision this week of the Chinese owned Dagong Global Credit Rating Company, to reduce the sovereign debt rating of the US from AA minus to BBB plus with a negative outlook, citing concerns about the US Federal deficits growing as a result of the tax cuts. This is at odds with the major (US owned) rating agencies but would not have been done without at least tacit approval from the Party.
- Therefore, while the withdrawal of the central banks from their QE programs is expected to have a gradual upward effect on bond yields over the next few years, with the US Treasury yield maybe not reaching the critical 4% p.a. level, the less predictable demand from China could well decline and put the bond yields over the critical threshold.
- The world price of long-term money is going up. It may be faster than we think, depending on how much President Trump and President Xi decide they need to work together. This is one more factor to consider in the pricing of equity markets, currently buoyed by synchronised global economic growth, earnings per share growth, US corporate tax cuts and money that is cheap (so far).

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 - 29 January 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is better)	**102%**	**119%**
Momentum indicator	**POSITIVE**	**POSITIVE**
Qualititative indicator	**POSITIVE**	**POSITIVE**

Current assessment of equity asset markets cont...

- Valuation indicators have become more expensive particularly for International equities since the end of December 2017. They are now on the cusp of moving into the expensive zone and this signals that a correction is now more likely, but the timing remains uncertain. Momentum remains very positive and could 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 both very supportive of earnings growth for equities and of equity prices in general.
- The Australian equity market is more attractive than International equities based on valuation factors alone, while it has positive but weaker momentum than that of the US equity market.
- 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, 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 2.85% 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.

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

Equity Market Valuation indicators from Australian Investor Perspective - 29 January 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	117%	113%	116%	116%
China	122%	117%	129%	123%
Japan	119%	114%	121%	119%
Britain	138%	133%	141%	138%
Germany	126%	121%	130%	126%
France	121%	116%	125%	121%
Australia	102%	98%	103%	102%
Global (MSCI)	120%	116%	121%	119%

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

Current assessment of equity asset markets cont...

The valuation analysis indicates that, except for the British market, all major international equity markets are now on the cusp of becoming expensive, following recent momentum driven rises. The British equity market is definitively expensive. The Australian equity market stands 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.	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 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 BENCHMAR	MINOR OVER WEIGHT	MAJOR OVER WEIGHT
ASSET CLASS						
Cash					X	
Fixed interest			X			
Property		X				
Australian equities				X		
International equities				X		
Alternative equities					X	