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SHERLOCK PARTNERS

Investment Market Conditions UPDATE

19 March 2018

Summary of key points

- The current combination of still benign monetary policy, increasingly 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, but this is not needed at this stage.
- It is still appropriate to hold a neutral or benchmark allocation to Australian and International equities given the current Valuation indicators and as long as the Momentum of equity markets persists and the Qualitative factors (as set out in Table 6) remain supportive.
- There may be events that disrupt equity markets in the short run, mainly emanating from the mercurial behaviour of the Trump administration. Policy maker mistakes are also more likely than before to come from the now more centralised apparatus in Beijing. Any resulting equity market sell offs may well offer the opportunity to accumulate equities at favourable prices, but care is needed when doing so.
- There may even be upside surprises such as an outbreak of peace and reconciliation on the Korean peninsula.
- One risk to watch is the approaching Australian election, which is more likely to be in early 2019. Current polling indicates that the ALP will return to government and with it the prospect of a roll-back of the Howard-Costello extension of the dividend imputation system that allowed unused excess franking credits to be claimed in cash from the ATO. If the ALP is elected to government and if they manage to get this measure through the Senate, then we should expect to see sales of the top 20 ASX stocks of which some 9% are held by SMSFs in pension mode. The sales activity would also extend to hybrids whose returns have a significant franking credit component.
- US Bond yields are expected to rise by up to 1.5% over the next two years to reach levels above 3.5% p.a. Therefore, the defensive or stabilising part of a portfolio should be an underweight to fixed Interest and have 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.

Summary of key points cont...

- The possible adverse impact of rising bond yields on listed property trusts also indicates a significant underweight to this asset class, showing some stress in terms of the yields in recent major transactions reaching very low levels.
- Based on historical evidence, we would not expect any major adverse effect on most listed equities unless and until the US ten-year Treasury bond yield was close to 4.0% p.a.
- Although a neutral weight to Australian and International equities is warranted, holdings in these asset classes should be well diversified, with a significant weighting to more defensive funds or stocks.
- In addition, a more significant 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 14/03/2018	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	5926	6.0%	6.0%	-2.3%	-2.3%
USA: S&P 500	2423	2673	2765	10.3%	8.7%	3.4%	2.6%
UK: FTSE 100	7312	7687	7138	5.1%	8.2%	-7.1%	-5.4%
Germany: DAX	12325	12917	12221	4.8%	8.4%	-5.4%	-0.7%
France: CAC	5120	5312	5242	3.8%	7.4%	-1.3%	1.1%
Japan: Nikkei 225	20033	22764	21740	13.6%	11.7%	-4.5%	-4.5%
China: Hang Seng	25764	29919	31206	16.1%	14.4%	4.3%	4.3%
Currencies							
USD/AUD	0.7689	1	0.7871		-1.5%		-0.8%
GBP/AUD	0.5901	1	0.5628		3.0%		1.8%
YEN/AUD	86.42	88	83.77		-1.7%		5.0%
EUR/AUD	0.6727	1	0.6345		3.5%		2.5%
Interest rates % p.a.							
Aus: 90 day bank bill	1.76	2	1.93	2.0%		15.0%	
Aus: 10 year govt bond	2.59	3	2.745	8.0%		7.5%	
US: Fed funds rate	1.16	1	1.42	26.0%		0.0%	
US: 10 year govt bond	2.3	2	2.83	11.0%		42.0%	
Commodities							
Copper US $ per tonne	5927	7247	6945	22.3%	20.5%	-4.2%	-5.0%
Gold USD/ounce	1241	1302	1328	4.9%	3.4%	2.0%	1.1%
Oil USD/barrel (WTI)	46.2	60	60.82	30.8%	28.8%	0.7%	-0.2%

- Equity markets have continued to recover from the setback in early February, with the US up 5.6%, China up 5.0% and the ASX up 2.0% over the last month. Earnings per share growth has been stronger so that the valuations have improved as well.
- US ten-year bond yields have stabilised for the time being, removing a source of stress from equity prices. Meanwhile the Australian ten-year bond yield has declined 0.15% p.a. in the last month, so that it is now below its US counterpart. This makes the Australian bond yield curve flatter but still nowhere near a negatively sloped curve, which would be a lead indicator of a recession and an equity market shakeout.
- Shorter term interest rates have also stabilised, and commodity prices have been more stable, with oil up a modest 1.8% in the last month, while copper rose 2.8% reflecting stronger synchronised world GDP growth.
- 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 persistently 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.

The assessment 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 estimate 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.

Table 3: Summary of equity markets assessments

Equity Markets Assessment - 14 March 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is better)	**97%**	**102%**
Momentum indicator	**POSITIVE, BUT WEAKENING**	**POSITIVE, BUT WEAKENING**
Qualititative indicator	**POSITIVE**	**POSITIVE**

Current assessment of equity asset markets cont...

- Valuation indicators have become less expensive mainly as a result of the growth in earnings and the scaling back of price to earnings ratios in most equity markets. All major markets, including the British equity market, are now back within the Fair Price range. Momentum has recovered slightly and judged over a six to eighteen-month period (over which it has historically persisted) it remains positive although weakened in most major equity markets. The Qualitative factors, which remain positive and these 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 when compared to 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.

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 2.75% p.a. to around 3.3% 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 of occuring.
- 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 - 14 March 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	**107%**	**103%**	**107%**	**106%**
China	**109%**	**104%**	**116%**	**110%**
Japan	**93%**	**90%**	**96%**	**94%**
Britain	**82%**	**78%**	**84%**	**82%**
Germany	**89%**	**85%**	**92%**	**89%**
France	**103%**	**99%**	**107%**	**103%**
Australia	**97%**	**93%**	**99%**	**97%**
Global (MSCI)	**102%**	**98%**	**103%**	**102%**

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

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 central 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. In the short run it may be distracted by scandals	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 more overweight allocation to well managed alternative equities that offer premium returns above cash rates and lower volatility investment in growth assets should be established. Consider an even higher 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