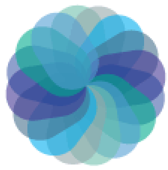

madison FINANCIAL GROUP

SHERLOCK PARTNERS

Investment Market Conditions UPDATE

23 April 2018

Summary of key points

- Synchronised world GDP growth continues, and it is underpinning earnings per share growth across a number of major equity markets.
- Major budget deficits in most places except for Germany provide ongoing support for this synchronised growth.
- If rhetoric turns to reality in trade policy, then a major slowdown in global growth will follow, but we are some way off this prospect, with the main participants still in the posing and chest beating phase.
- Asset prices continue to be further supported by very benign monetary policy from all of the major central banks.
- This combination will probably support equity markets through 2018 and into 2019 but we need to monitor conditions in case they change.
- It is still appropriate to hold a neutral or benchmark allocation to Australian and International equities.
- As we have said before, the mercurial behaviour of the Trump administration may cause short run disruptions to equity markets that may well offer the opportunity to accumulate equities at favourable prices, but care is needed when doing so.
- Over the medium term of the next three to five years, US ten-year bond yields are expected to rise by up to 1.5% p.a. or more to reach levels above 4% p.a. This has historically been an important trigger level for a major sell off in US equity markets.
- 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 18/04/2018	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	5861	6.0%	6.0%	-3.4%	-3.4%
USA: S&P 500	2423	2673	2706	10.3%	8.7%	1.2%	1.7%
UK: FTSE 100	7312	7687	7290	5.1%	8.2%	-5.2%	-0.6%
Germany: DAX	12325	12917	12568	4.8%	8.4%	-2.7%	2.8%
France: CAC	5120	5312	5370	3.8%	7.4%	1.1%	4.4%
Japan: Nikkei 225	20033	22764	22158	13.6%	11.7%	-2.7%	-2.7%
China: Hang Seng	25764	29919	30284	16.1%	14.4%	1.2%	1.2%
Currencies							
USD/AUD	1	1	1		-1.5%		0.5%
GBP/AUD	1	1	1		3.0%		4.8%
YEN/AUD	86	88	83		-1.7%		5.6%
EUR/AUD	1	1	1		3.5%		3.3%
Interest rates % p.a.							
Aus: 90 day bank bill	2	2	2	2.0%		42.0%	
Aus: 10 year govt bond	3	3	3	8.0%		7.5%	
US: Fed funds rate	1	1	2	26.0%		26.0%	
US: 10 year govt bond	2	2	3	11.0%		42.0%	
Commodities							
Copper US $ per tonne	5927	7247	6877	22.3%	20.5%	-5.1%	-4.7%
Gold USD/ounce	1241	1302	1352	4.9%	3.4%	3.8%	4.3%
Oil USD/barrel (WTI)	46	60	68	30.8%	28.8%	12.1%	12.6%

Where are we now? cont...

- Long-term bond yields, a key driver of asset prices in the medium to longer term, have been little changed over the course of the last month.
- Equity markets have been more affected by sentiment swings, driven by political noise, mainly emanating from Washington. The US and Chinese (and Australian) markets have weakened over the course of the last month, reflecting the potential impacts of a trade war between the USA and the PRC. Meanwhile, earnings per share growth in the USA have continued to underpin stock prices to an extent. The Japanese and European equity markets have strengthened.
- Both bond yields and shorter-term interest rates have been stable over the last month.
- With the exception of oil, which rose 11% over the course of the month as Middle East tensions rose, commodity prices have been stable, with copper down 1.0% and gold up by a modest 1.8%.

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.

Table 3: Summary of equity markets assessments

Equity Markets Assessment - 20 April 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is better)	**95%**	**99%**
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 are now in the Fair Price range.
- Momentum needs to be judged over a six to eighteen-month period over which it has historically persisted. Judged on this timescale, Momentum remains positive, although weakened in most major equity markets.
- The Qualitative factors, which remain positive, 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.
- 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 at, 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 i.e. 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 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 are unchanged. Together with the bond yield, they 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% of occurring. In this scenario we are assuming that the ten-year Australian bond yield will rise from the current 2.75% p.a. to around 3.30% p.a. This provides a buffer of safety in our valuation analysis.
- Faster earnings growth where inflation and interest rates rise to around 4.00% 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 having a 20% likelihood of occurring.
- 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 having a 30% likelihood of occurring, 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 - 20 April 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	**104%**	**100%**	**103%**	**103%**
China	**99%**	**95%**	**106%**	**100%**
Japan	**95%**	**91%**	**97%**	**95%**
Britain	**84%**	**80%**	**86%**	**84%**
Germany	**90%**	**86%**	**93%**	**90%**
France	**113%**	**109%**	**118%**	**114%**
Australia	**95%**	**92%**	**97%**	**95%**
Global	**100%**	**96%**	**101%**	**99%**

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...

All major equity markets are in the Fair Priced range. The Australian equity market is slightly cheaper than the international markets in general. The US equity market is also close to fairly priced but is slightly expensive compared to the average of world markets or the Australian equity market. Overall, the valuation factors are supportive without being overly compelling.

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 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 another 8 to 10 years.	Positive and increasing with the US Federal deficit already at 4.5% of GDP and increasing further over the next two years.	Positive and increasing. Wage inflation is still mild. It could increase but is probably restrained by institutional factors (weaker bargaining power of unionised labour) as well as structural factors such as technology.	Probably positive but very volatile in the run up to the midterm Congressional elections in November 2018. If you can predict what the President will do you may have it figured out.	Positive
China	The PBOC is aware of the size of the debt problems in state owned enterprises and provincial governments but is still running a supportive monetary policy.	Positive as there is a need for continued spending on health care and education as well as infrastructure. The budget deficit is 3.5% of GDP.	Positive with some prospect of a decline in the rate of growth from 6.9% p.a. towards 5% p.a. over the next five years.	Positive, but the main risk is that the policy makers may make a mistake and tighten too quickly. The prospect of a trade war with the USA actually encourages caution in economic policy.	Positive
Japan	Positive with the BOJ confirming that it will keep near zero bond yields in place and also continue its QE program for the foreseeable future.	Very positive with the budget deficit at 4.95% of GDP.	Positive with real GDP growth averaging 2.0% p.a. over the last year although this may weaken due to the ageing of the population leading to spending shifts.	Positive since the return of the Abe government but Abe may resign as soon as June 2018 due to corruption allegations.	Positive
Europe	Positive but may weaken in 2019 if the ECB actually reduces its rate of stimulus	Positive but mildly so with overall budget deficit at just 1.05% of GDP due to strength of German surplus.	Positive and keeping pace with the USA.	Has shifted to be more positive, with political uncertainty in Germany resolving.	Positive
Great Britain	Positive with Bank of England rate still near all-time low.	Positive and increasing with budget deficit now at 4.4% of GDP	Has weakened due to Brexit related uncertainty and is now running behind the Eurozone but is still positive	Negative and divided	Positive
Australia	Positive with the RBA rate likely to be unchanged till 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 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 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. 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

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