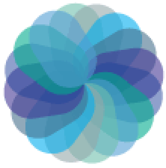

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Investment Market Conditions UPDATE

20 November 2018

Summary of key points

- The equity markets have recovered partially from the significant but not catastrophic sell-off in October. As we indicated earlier such episodes will become more frequent and severe in the unstable policy environment being driven out of Washington, which is part of what has been a noisy presidency.
- Equity markets are still fairly priced from a longer-term point of view, with both monetary and fiscal policy still supportive of economic growth as well as financial asset prices, but momentum is becoming fragile.
- Equity market momentum has been weakening back towards neutral. Increased caution is warranted with consideration of some reduction in equity allocation for more risk averse investors after any significant rises which will likely occur following further short run sell offs.
- The severity and the duration of the trade dispute between the world's two biggest economies is not yet clear, nor will it be for some time to come. From time to time optimism about a resolution builds in the equity markets but can suffer setbacks such as late in the week ending 9 November.
- The shape of the yield curve, a good forward indicator of recessions and downturns in equity markets, has flattened but has not yet turned negative and so is not yet signaling recession or a more severe equity market downturn.
- It is possible to see the emergence of the causes of a recession in 2020 or soon thereafter. They include:
    - A too rapid increase in interest rates in the US at the same time as fiscal stimulus is waning;
    - Too much tightening of credit availability in China;
    - Worsening disruption to global supply chains from the trade dispute between the US and China;
    - The failure to find a compromise between the European Commission and Italy on Italian fiscal and banking problems;
- Based on the mainstream scenario of continued growth in earnings and low but rising short term interest rates and bond yields, together with a yield curve that is not yet negatively sloped (where long rates are lower than short rates) a neutral weight to Australian and International equities is still warranted at this stage.
- Allowing for the risks to the mainstream scenario:
    - Holdings in the equity asset classes should be well diversified, with a significant weighting to more defensive funds or stocks. This will include equity funds that may from time to time hold enlarged cash balances for defensive or opportunistic purposes.
    - Be prepared to reduce equities if the US ten-year bond yield moves significantly above 3.5% p.a. or if the yield curve turns negatively sloped or if the US- China trade dispute concerns continue to worsen.

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 - financial year to date

Market indicator	Level at 30/06/2017	Level at 31/12/2017	Level at 9/11/2018	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	5929	6.0%	6.0%	-2.2%	-2.2%
USA: S&P 500	2423	2673	2806	10.3%	8.7%	5.0%	12.7%
UK: FTSE 100	7312	7687	7140	5.1%	8.2%	-7.1%	-4.3%
Germany: DAX	12325	12917	11527	4.8%	8.4%	-10.8%	-9.3%
France: CAC	5120	5312	5131	3.8%	7.4%	-3.4%	-1.8%
Japan: Nikkei 225	20033	22764	22465	13.6%	11.7%	-1.3%	4.8%
China: Hang Seng	25764	29919	26227	16.1%	14.4%	-12.3%	-5.9%
Currencies							
USD/AUD	0.7689	0.7805	0.7267		-1.5%		7.4%
GBP/AUD	0.5901	0.5731	0.5561		3.0%		3.1%
YEN/AUD	86.42	87.92	82.82		-1.7%		6.2%
EUR/AUD	0.6727	0.6501	0.6394		3.5%		1.7%
Interest rates % p.a.							
Aus: 90 day bank bill	1.76	1.78	1.94	2.0%		16.0%	
Aus: 10 year govt bond	2.59	2.67	2.79	8.0%		12.0%	
US: Fed funds rate	1.16	1.42	2.16	26.0%		74.0%	
US: 10 year govt bond	2.30	2.41	3.23	11.0%		82.0%	
Commodities							
Copper US $ per tonne	5927	7247	6155	22.3%	20.5%	-15.1%	-8.8%
Gold USD/ounce	1241	1302	1223	4.9%	3.4%	-6.1%	0.9%
Oil USD/barrel (WTI)	46	60	61	30.8%	28.8%	0.5%	8.0%

Where are we now? cont...

- Interest rates at the short end of the yield curve were again stable over the course of the last month, especially in Australia, where the RBA kept its official rate at the long-running low level of 1.5% p.a. In its most recent Statement of Monetary Policy, released on 9 November 2018, the RBA is still optimistic that the decline in residential property prices will be modest and not impact consumer spending or economic growth too much. The price of short-term money is still at historically low levels in most places, even in the USA, where the rate of increase has been very gradual and well flagged in advance.
- The long-term end of the US yield curve ended up +0.06% p.a. over the course of the last month, having initially fallen about 0.10% p.a. during the equity market sell off as some investors shifted to bonds. As the equity market calmed down and reversed some of the decline, the bond yield rose again. There is still the risk that the ten-year Treasury yield will continue to rise towards 3.5% p.a. or more due to the increased flow of Treasury bond sales needed to fund the growing US Federal budget deficit. If this level were reached, it would start to put more serious pressure on equity market valuations.
- Commodity prices were weaker with oil in particular down by more than 14% over the course of the last month. The oil price had run up sharply following the announcement of increased sanctions by the US against Iran. There was the prospect of a major fall in Iranian production from 2.7 million barrels per day to around 1 million barrels per day, which is material enough to move the global price of oil up sharply, however the rise has been reversed after it became clear that the US would allow some oil companies an exemption from the sanctions. Overall there is great uncertainty on both the demand and supply sides of the oil market.
- In addition, the recent fall in the oil price reflects some reduction in confidence about continued global GDP growth. There is a growing realisation that the US China trade tensions may take years rather than months to resolve and that the world economy may become less globalised and supply chains may be seriously disrupted.
- This realisation also adversely affected the equity markets in late October. There was a partial recovery in early November, as we had foreshadowed, as the factors of earnings growth and low interest rates partly reasserted themselves in the minds of investors. The net effect on a calendar year to date basis is that all major equity markets are lower in their local currencies, with the exception of the US, which is still up by a net 5%.
- The Australian dollar was slightly stronger against most major currencies over the course of the last month, due mainly to a weakening of the US dollar.

Where to next?

- Equity market volatility will continue but equity market prices will still be supported, at least for the next six months by:
    - Continued global economic growth, albeit at a slightly slower pace;
    - Continued earnings per share growth in the US that matches or beats expectations;
    - Supportive monetary policy in the form of historically low short-term interest rates, even in the US, as well as historically low long-term bond yields (although the level and shape of the US yield curve needs to be closely watched).
- Eventually the prospect of the next recession will grow in importance. Firstly, the fiscal stimulus in the US will dissipate and US GDP will fall back from its current robust rate of 3.5% p.a. to around 2% p.a. by 2020 or soon after. Secondly, the Federal Reserve will continue to increase its Fed funds rate until it reaches 3.5% p.a. or more by mid to late 2020. Thirdly, Chinese authorities will continue to rein in credit growth which has become excessive, with GDP growth slowing markedly towards 5% p.a., well below its recent level. This tightening together with the adverse effects of the continuing trade dispute with the USA has prompted President Xi to indicate recently that private sector

Where to next? cont...

firms as well as state owned enterprises will be bailed out rather than trigger a rise in unemployment which would be socially disruptive and politically challenging for the Chinese Communist Party. The private sector has already suffered disproportionately from the credit tightening that has already taken place and has curtailed its investment spending. Investment is a major component of Chinese GDP growth, much more important than exports, and its rate of growth has already fallen from 10% p.a. in 2015 to 7.2% p.a. in 2017 and further to 5.3% p.a. in 2018.

- Trump and Xi are scheduled to meet at the G20 in Argentina later in November and there is some talk of a deal being done on trade. Neither can be seen to be backing down, so a substantive change in the trade tensions is unlikely. Post 2020, we expect that both will still be in office and a deal may be more possible then.
- The US mid-term elections produced a stalemate in Congress with the Democrats controlling the House and the Republicans slightly increasing their majority in the Senate. It is difficult to see the Trump administration being able to pass much legislation in the next two years. Any extension to the fiscal stimulus by way of tax cuts or major spending outside of some selected infrastructure that both sides like, seems very unlikely. As noted above this will make a reduction in GDP much more likely and the margin for avoiding a recession smaller.
- Barring a US recession before November 2020, Trump has established a solid base for re-election. Apart from gaining 2 or 3 Senate seats (Florida is subject to a recount at the time of writing), a feat unequalled by a first term president since the 1930s, the Republicans limited their loss of seats in the House to much less than at most mid-term elections in recent decades. We should not be surprised if both President Trump and the very contentious nature of US politics persist for another six years rather than two.
- It is possible that an early trigger for a global recession may come from a financial crisis, most likely in Europe. The prime candidate is not Brexit but a continued impasse between the relatively new government of Italy, which wants to tax less and spend more to keep its supporters happy and the European Commission, which is insisting on a much-reduced fiscal deficit. With no traditional party having more than 20% of the vote, the new Italian government is a coalition of the populist Five Star Party (on 28%) and the nationalist Lega Nord (on 34%) and has inherited an economy that is still smaller than it was pre GFC with government debt at 131% of GDP. The Italian government is projecting real GDP growth of just 1.5% p.a. next year while the European Commission is even more pessimistic at 1.1% p.a. and it has asked the Italian government to rewrite its budget. A compromise solution within the next two years looks difficult to achieve and Italy is much larger and more economically important than Greece, which in similar circumstances eventually knuckled under to European demands. In the absence of a solution that saves face for all, Italy could exit the Euro and perhaps even leave the EU.
- In Australia we are likely to see slower population growth (less immigration, some further house price falls, slower housing credit growth, flat wages and slower consumer spending growth. Domestically focussed businesses such as the major banks will need to get used to slower earnings growth and the CEOs of the big four banks have all recently allude to this in their results announcements. Internationally focussed businesses have the capacity to grow earnings more, assisted by a weakening Australian dollar. However, those firms dependent on Chinese imports of commodities will face greater cyclical risks to earnings.
- Taking all of this into account, the outcomes expected under our mainstream scenario over next three years to five years are as follows:
  - Short term interest rates rise in the US, rising to 3.0% p.a. over the next year and above 4.0% p.a. within five years;
  - Short-term interest rates in Australia stay at 1.5% p.a. for the next year or so before rising towards 3.5% p.a. (the RBA neutral rate) by 2022;
  - Long-term bond yields in the US rising above 3.5% p.a. within the next year or so at which time equity allocations should be reduced;
  - The AUD weakens towards USD 0.65 or lower, adding to international equity returns for Australian investors as well as assisting the earnings of internationally focused Australian companies such as CSL;

Where to next? cont...

- Equity prices in most developed markets will rise modestly, driven by EPS growth, which continues for the next year or two but is likely to falter after that.
- Equity markets need to be continually re-assessed as outlined in section 3 below, considering the effects of shifts in the long-term bond yield, changes in earnings per share growth as well as momentum effects and other more difficult to assess qualitative factors.
- The main risks to this mainstream scenario include:
  - The US ten-year Treasury bond yield rises more quickly to a level closer to 4% p.a., leading to a major shift from equities to bonds. If this occurs, then a fall of 20% or more in equity markets could easily occur within the next two years;
  - The US China trade war becomes more severe or more protracted and a recession is triggered sooner rather than later;
  - A financial crisis arising in Italy or via defaults in emerging market entities such as major corporates or governments transmit stress to the entire global economy via the banking system, causing a crisis and a major world recession.

Assessment of equity asset markets

The assessment of equity markets is central to deciding how much of the portfolio to allocate to growth assets over time. Our current assessment of equity markets, which is summarised in Table 3, considers:

- The Valuation of equities comparing current prices to long term Fair Prices;
- The Momentum of equity market price movements; and
- Qualitative indicators that consider the impact of fiscal and monetary policy as well as economic and political factors.

Table 3: Summary of equity markets assessments

Equity Markets Assessment - 9 November 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted,lower is better)	**95%**	**94%**
Momentum indicator	**WEAKENING TO NEUTRAL**	**WEAKENING TO NEUTRAL**
Qualititative indicator	**POSITIVE**	**POSITIVE BUT WEAKENING**

Our valuation indicators have shown little net change over the course of the last month although the Australian equity market is now slightly less attractive than international equities mainly as a result of relative market price movements. All major markets are still in the Fair Price range.

Momentum remains positive but is weakening towards neutral in some major equity markets including Australia and now the USA.

The Qualitative factors 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, but political and economic risks are growing.

Assessment of equity asset markets cont...

Valuation is the most important part of our assessment. 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 equity market is the price at which the 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 continued to assume a required equity risk premium of 5% p.a. for developed equity markets and 8% p.a. for emerging markets.

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 as well as the major international equity markets.

Table 4: Earnings per share growth rates for equity markets

		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%

These assessments of long-term earnings per share growth are unchanged since last month. 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.

These assessments are made for a number of scenarios of what may happen over the next ten years. Each scenario implies a different financial market regime and with its different relative returns for the various asset classes. We have reviewed the three long-term scenarios and have kept the assessments unchanged since our last update as well as the assessed likelihood of each of them:

Scenario 1: Modest earnings growth where inflation and interest rates do not rise by much. This is good for equity prices. We rate this as the 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 2.8% p.a. to around 3.6% p.a. This extra yield margin of +0.8% p.a. provides a buffer of safety in our valuation analysis.

Scenario 2: Faster earnings growth where inflation and interest rates rise to around 4.2% p.a. This higher rate of inflation is bad for fixed interest and is also bad for equity prices. This higher inflation prospect is reflected in the higher assumed long-term bond yield. This effect is offset by the faster rate of earnings per share growth. We continue to rate this scenario with a 20% likelihood of occurring.

Scenario 3: Recession 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 with a 30% likelihood of occurring, although a recession is more likely to occur after 2020 than before.

Assessment of equity asset markets cont...

Table 5: Fair Price assessments for the Australian and International equity markets - 9 November 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	99%	95%	93%	96%
China	81%	77%	83%	81%
Japan	95%	91%	93%	93%
Britain	87%	84%	85%	86%
Germany	91%	87%	90%	90%
France	105%	101%	105%	104%
Australia	97%	93%	94%	95%
Global	96%	92%	92%	94%

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

All major equity markets are in the Fair Price range. Overall, the valuation factors are supportive of investment in equities without being overly compelling.

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 (the risk of mistakes by policy makers) Our summary of the qualitative factors and their effects on equity market returns for each major region is set out in Table 6.

Qualitative factors used in the overall assessment

cont...

Table 6: Qualitative factors affecting equity markets over the next 3 years

Region	Monetary Policy	Fiscal Policy	Economy (GDP growth)	Politics and Public Policy	Overall
USA	Fed policy is still supportive of asset prices, but this will reduce gradually as the Fed continues to reduce its holdings of bonds while raising short-term rates. The normalisation of US monetary policy may take several years but it may happen more quickly if the Fed becomes concerned that inflation is rising too fast. An interest rate overshoot would add to negative pressures on the equity markets.	Positive and increasing over the next 6-12 months mainly due to the effect of the tax cuts. This effect will run out in 2020 unless there is a further round of tax cuts or major spending initiatives. Neither of these are likely following the mid-term election results with control of Congress split and bipartisanship in short supply. Meanwhile the rise in Federal borrowing needed may eventually push the US ten-year Treasury bond yields up towards 4.0% p.a., a critical level affecting equity market pricing adversely.	Has been positive and increasing and has been reflected in earnings per share growth of companies but has recently reached an inflexion point and is expected to slow down especially if trade tensions with China and the EU are not resolved and we move into a phase of deglobalistion and slower world GDP growth.	Has been positive but volatile but following the US mid-term elections a two-year period of stale mate is expected. This may not necessarily be bad for the economy and corporate earnings.	Positive but softer.
China	Positive. The PBOC, the central bank, has been injecting liquidity into the banking system to ward off risks from its policy of deleveraging as well as from the trade dispute with the USA.	Positive as there is a need for continued spending on health care and education as well as infrastructure. Fiscal deficit is 3.6% of GDP.	Positive but with a strong prospect of a decline in the rate of growth towards 5% p.a. over the next three years. This degree of decline could be very adverse for commodity prices.	Positive, but the main risk is if the policy makers make a mistake. The responses to US tariff moves will be critical. The degree to which credit growth is restrained is also important and may already have been overdone.	Positive but now more fragile than at any time since the GFC.
Japan	Positive with the BOJ continuing to keep short rates negative and bond yields near zero.	Positive with fiscal deficit of 3.8% of GDP adding to overall demand.	Positive but stalling slightly with real GDP growth easing back to 1.3% p.a.	Positive.	Positive.
Europe	Positive but weakening in 2019 if the ECB eventually reduces its rate of stimulus. This may yet be deferred.	Slightly positive with Euro area fiscal deficit at just 0.7% of GDP although there are wide variations from country to country.	Positive with modest growth but some threats may emerge from some major bank losses due to exposure to emerging market debt.	Positive but with some growing political constraints on policy.	Positive.
Great Britain	Positive.	Positive due to fiscal deficit running at 1.7% of GDP.	Weakening due to Brexit.	Negative and divided. There is much uncertainty about Brexit and hence about the government.	Positive but weakening as Brexit approaches.
Australia	Positive with the RBA rate likely to be unchanged till late 2019.	Slightly positive with Federal deficit at a low level of 0.9% of GDP.	Positive due to infrastructure spending by the states.	Negative due to lack of policy focus by Federal government.	Positive.

What to do next with Investment Portfolio Strategy:

- For the time being keep a neutral or benchmark weight to Australian equities and International equities but be prepared to reduce allocations both Australian and International equities at some stage in the next six to twelve months.
- 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., weighted average lease expiry (WALE) longer than the life of the fund or trust, maximum debt of 45% of gross assets, good tenants, and great managers with a proven track record.
- 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.

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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