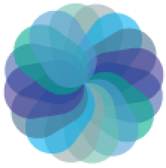

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Investment Market Conditions UPDATE

23 October 2018

Summary of key points

- Both short and long-term US interest rates rose by enough to trigger a significant but not catastrophic sell-off in US equities. This spread to other equity markets. It is likely to be short lived, with equity prices recovering, however, such episodes will become more frequent and severe in the unstable policy environment being driven out of Washington.
- 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, given the opaque decision-making processes of the US and Chinese governments.
- Against this backdrop, equity markets are still fairly priced from a longer-term point of view. The largest equity market by far, that of the US, still has solid earnings growth and stock price momentum notwithstanding the recent short-term falls.
- Both monetary and fiscal policy in most major countries are supportive of economic growth as well as financial asset prices.
- We continue to watch the level and the shape of the yield curve closely as it has been a good forward indicator of recessions and downturns in equity markets. So far, the curve has flattened but not yet turned negative, which would be a lead indicator of recession.
- In addition, the US ten-year Treasury bond yield has not yet reached the historically sensitive range of 3.5% to 4.0% p.a. but has fluctuated closer to it in the last month.
- 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 12/10/2018	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	5877	6.0%	6.0%	-3.1%	-3.1%
USA: S&P 500	2423	2673	2728	10.3%	8.7%	2.1%	11.8%
UK: FTSE 100	7312	7687	7006	5.1%	8.2%	-8.9%	-2.9%
Germany: DAX	12325	12917	11539	4.8%	8.4%	-10.7%	-5.3%
France: CAC	5120	5312	5106	3.8%	7.4%	-3.9%	1.8%
Japan: Nikkei 225	20033	22764	22477	13.6%	11.7%	-1.3%	8.6%
China: Hang Seng	25764	29919	25386	16.1%	14.4%	-15.2%	-7.0%
Currencies							
USD/AUD	0.7689	0.7805	0.7122		-1.5%		9.6%
GBP/AUD	0.5901	0.5731	0.5380		3.0%		6.5%
YEN/AUD	86.42	87.92	79.92		-1.7%		10.0%
EUR/AUD	0.6727	0.6501	0.6135		3.5%		6.0%
Interest rates (% p.a.)							
Aus: 90 day bank bill	1.76	1.78	1.91	2.0%		13.0%	
Aus: 10 year govt bond	2.59	2.67	2.74	8.0%		7.0%	
US: Fed funds rate	1.16	1.42	2.18	26.0%		76.0%	
US: 10 year govt bond	2.30	2.41	3.17	11.0%		76.0%	
Commodities							
Copper US $ per tonne	5927	7247	6242	22.3%	20.5%	-13.9%	-5.6%
Gold USD/ounce	1241	1302	1223	4.9%	3.4%	-6.1%	2.9%
Oil USD/barrel (WTI)	46	60	71	30.8%	28.8%	18.0%	29.3%

Where are we now? cont...

- Interest rates at the short end of the yield curve were stable over the course of the last month in most markets, except for the USA where the Federal Reserve stuck to its announced plan and raised the Federal Funds Rate at which it will lend to banks by +0.25%. In doing so, Jay Powell, the Chairman of the Fed, commented that the US economy was in strong shape, with real GDP growing at 4% p.a. in the latest quarter, inflation still low and unemployment at 3.9%, its lowest point since 1969. President Trump criticised the Fed in the most intemperate terms, making it clear that he preferred a lower interest rate structure, a stance unsurprising for a former (and perhaps still active) property developer. Powell responded by saying that the Fed was focussed on its mandate of maintaining economic growth, low unemployment and low inflation without paying attention to political factors.
- Meanwhile the long-term end of the US yield curve, although still low by historical standards, also rose by +0.28% p.a., to a level of 3.26% p.a. at one point, well on its way to the more dangerous level of 3.5% p.a. It is clear that the rise in the ten-year Treasury yield has more to do with the burgeoning flow of Treasury bond sales necessitated by the increased Federal budget deficit following the large-scale Trump tax cuts that have improved corporate earnings in the last two years.
- Commodity prices were strong with copper up 3.5% and oil up 5.5% over the latest month, reflecting continued confidence in global GDP growth, notwithstanding that it is less synchronised this year than it was in 2017.
- Higher US interest rates boosted the US dollar versus the Australian dollar, but the latter was weaker against all major currencies, reflecting the continuation of the low interest rate policy of the RBA which kept its official rate at 1.5% p.a. for yet another month.
- The stumble in the equity markets in the week ending 12 October, started in the US and ricocheted around the world. All major equity markets were down over the course of that week and also over the course of the last month. The fall in the USA was caused by the market eventually realising that the long-term price of money (the ten-year bond yield) had risen to a level that reduced the value of future corporate cash-flows to the extent that the recent record level share prices may not be sustainable. At the same time, the equity market seems to have taken fright that the US-China trade tensions may become more serious and last years rather than weeks.

Where to next?

- The stumble in the equity markets may continue but is likely to have run its course in a few weeks. The reasons why equity market prices are likely to stabilise and recover the earlier losses include:
    - 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).
- 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 to 3.5% p.a. (the RBA neutral rate) by 2022;
    - Long-term bond yields in the US rising above 3.5% p.a. within 1 to 2 years at which time equity allocations should be reduced;
    - The AUD weakens towards USD 0.65 or lower, adding to international equity returns for Australian

Where to next? cont...

investors;
    - Equity prices in most developed markets rise modestly, driven by EPS growth, which continues for the next year or two even though GDP growth is becoming less synchronised than it was last year. 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 goes into a trade war induced recession sooner rather than later;
    - 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.

Table 3: Summary of equity markets assessments

Equity Markets Assessment - 12 October 2018

Asset class	Australian equities	International equities
Valuation indicator (scenario weighted, lower is better)	**93%**	**95%**
Momentum indicator	**WEAKENING TO NEUTRAL**	**WEAKENING TO NEUTRAL, BUT LESS SO IN USA**
Qualititative indicator	**POSITIVE**	**POSITIVE BUT WEAKENING**

Based on our analysis, valuation indicators have become slightly less expensive over the course of the latest month (by around 2% for Australian equities and 6% for International equities) mainly as a result of 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 but not by as much in 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.

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 for developed equity markets of 5% p.a. 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.

Where to next? cont...

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 which could occur over the next ten years. Each scenario implies a different financial market regime and 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%. In this scenario we are assuming that the ten-year Australian bond yield will rise from the current 2.7% p.a. to around 3.6% p.a. This provides a buffer of safety in our valuation analysis.

Scenario 2: Faster earnings growth where inflation and interest rates rise to around 4.1% 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 as 20% likelihood.

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 as 30% likelihood, although a recession is more likely to occur after 2020 than before.

Where to next? cont...

Table 5: Fair Price assessments for the Australian and International equity markets - 12 October 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	100%	96%	94%	97%
China	78%	74%	80%	78%
Japan	99%	95%	97%	98%
Britain	97%	93%	95%	96%
Germany	89%	85%	89%	88%
France	107%	103%	106%	106%
Australia	94%	90%	92%	93%
Global	97%	94%	94%	95%

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.

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	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 but may occur surprisingly faster.	Positive and increasing with fiscal deficit heading towards 6% of GDP, which is high by historical standards. However, this will eventually push the US 10-year Treasury bond yields up towards 4.0% p.a., a critical level affecting equity market pricing	Has been positive and increasing and has been reflected in earnings per share growth of companies. This may now stall if trade tensions with China and the EU continue to increase.	Positive but volatile. The Trump administration has a disruptive approach to implementing policies that are themselves designed to disrupt the status quo.	Positive but weakening.
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 with a strong prospect of a decline in the rate of growth towards 5% p.a. over the next three years.	Positive, but the main risk is if the policy makers make a mistake. The responses to US tariff moves will be critical.	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 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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