

Investment Market + Portfolio

5 July 2016

UPDATE

Summary of key points

- ▶ Negative politics in the USA, Europe, Japan, Britain and now in Australia, is unsettling the various populations, making them more risk averse. Consumer spending and economic growth will slow.
- ▶ Earnings per share growth projections have been wound back by enough to offset much of the beneficial effects that lower interest rates and long-term bond yields have on equity prices.
- ▶ The US equity market is now more than slightly above being fairly priced while other international markets are even more expensive.
- ▶ The Australian equity market continues to offer better value but is no longer cheap overall.
- ▶ Momentum in equity markets has turned choppy with a bias toward the negative. Expect some significant equity market downturns however these will subsequently be recovered. Be guided more in the long term by valuation factors than by momentum or sentiment.
- ▶ Monetary policy almost everywhere is supportive of asset prices in the longer run of five to ten years so be careful not to be too underinvested in growth assets.
- ▶ The episodic declines in volatile equity markets offer opportunities for accumulation of stocks or equity funds at more attractive prices that offer the prospect of enhanced long-term returns.
- ▶ Use strategically set aside cash to invest in equities when prices are more attractive as part of a sound, long-term investment strategy.
- ▶ Maintain an allocation slightly below neutral or benchmark weight to Australian and international equities.
- ▶ Be cautious and patient and await a short-term pullback of 10% or more in equity markets, which will provide an opportunity to go overweight in equities, to benefit from the prospect of longer term equity price growth.



Where are we now?

Table 1: Financial market movements

MARKET INDICATOR	LEVEL AT 30 JUN 14	LEVEL AT 30 JUN 15	LEVEL AT 30 JUN 16	CHANGE 2014/2015 FINANCIAL YEAR		MOVEMENT SINCE START OF 2015/2016 FINANCIAL YEAR	
				IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD
EQUITY MARKETS							
S&P ASX 200	5394	5515	5233	2.2%	2.2%	-5.1%	-5.1%
USA: S&P 500	1960	2057	2098.86	4.9%	28.9%	2.0%	5.3%
UK: FTSE 100	6743	6620	6504.33	-1.8%	10.8%	-1.7%	-14.1%
Germany: DAX	9833	11083	9680.09	12.7%	13.0%	-12.7%	-10.5%
France: CAC	4422	4869	4237.48	10.1%	10.4%	-13.0%	-10.8%
Japan: Nikkei 225	15162	20235	15705	33.5%	35.6%	-22.4%	-4.9%
China: Hang Seng	23200	26250	20794	13.1%	38.9%	-20.8%	-18.3%
CURRENCIES							
USD/AUD	0.9430	0.7679	0.7444		22.8%		3.2%
GBP/AUD	0.5511	0.4881	0.5580		12.9%		-12.5%
YEN/AUD	95.32	93.81	76.60		1.6%		22.5%
EUR/AUD	0.6886	0.6866	0.6700		0.3%		2.5%
INTEREST RATES							
Aus: 90 day bank bill % p.a.	2.68	2.19	2.00	-0.49		-0.19	
Aus: 10 year govt bond % p.a.	3.54	3.01	2.00	-0.53		-1.01	
US: Fed funds rate % p.a.	0.09	0.13	0.32	0.04		0.19	
US10 year govt bond % p.a.	2.53	2.32	1.46	-0.21		-0.86	
COMMODITIES							
Copper US \$ per tonne	7035	5767	4845	-18.0%	0.7%	-16.0%	-13.3%
Gold USD/ounce	1326	1175	1328	-11.4%	8.8%	13.0%	16.6%
Oil USD/barrel (WTI)	105	58.29	48.46	-44.5%	-31.8%	-16.9%	-14.2%

Since the last Update:

- Short-term interest rates in Australia have declined and are now at record low levels. Short term rates in the USA have remained stable and low but importantly the prospect of an increase has been deferred by both the Federal Reserve and the financial markets;
- Long term bond yields in the USA and in Australia have declined, flattening the interest rate yield curve, which is often an early indicator of an approaching recession;
- The AUD has declined against all major currencies except the GB Pound, which has recently had its own political reasons for instability;
- The oil price has risen in recent months due to potential disruptions to supply as well as moderate continued growth in the US economy however copper prices, an indicator of industrial demand, have not been strong;
- Equity markets in the US and Australia have been volatile but have made little net movement over the period, while European and Japanese equity markets which were more extended have been weaker, reflecting their more difficult economic and political conditions. Overall momentum in equity markets has become unstable with a tendency to drift weaker.

What to do next with Investment Portfolio Strategy

- Longer term growth prospects combined with very low long term interest rates indicate that for portfolios which are managed on a medium to longer term basis, without a capacity to easily make shorter term shifts in asset allocation, the allocation to Australian and international equities should be maintained at levels slightly below the neutral or benchmark weight. Portfolios that are managed more tactically should consider moving more into cash with a view to reinvesting after any subsequent significant fall.
- Where the portfolios are significantly underweight relative to benchmark levels the allocation should be increased over the next six months. If the client fund allocation to any of Australian equities, International equities or Property 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 over a subsequent six month period.
- The prospects for lower interest rates in Australia combined with subdued commodity prices means that the AUD is more likely to fall than rise against the USD, so international investment at this stage should be unhedged.
- Portfolios should maintain a neutral weighting to property securities given their current valuation.
- A slight overweight to well managed alternative equities that offer lower volatility investment in growth assets should be maintained.
- Fixed interest should be underweighted. Returns on typical bond portfolios and bond funds will continue to be low with the prospect of increased losses on credit securities from some sectors of the economy. One third of all bonds issued by major developed countries are now trading at negative yields.
- Holding cash or cash funds will be more attractive than bond funds and more flexible than term deposits. Over time, as they mature, term deposits in portfolios should be replaced with cash accounts or cash funds. This will provide more flexibility to take advantage of equity accumulation opportunities.

Table 2: 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					✓	
Fixed interest		✓				
Property				✓		
Australian equities			✓			
International equities			✓	✓		
Alternative equities					✓	

Current assessment of equity asset markets

The allocation to equity assets is a key driver of portfolio returns so it is important to conduct an assessment of the pricing of equity markets. We take into account valuation factors, momentum factors and qualitative factors such as monetary policy, fiscal policy and geopolitical factors. Table 3 summarises our overall assessment:

Table 3: Summary of equity markets assessments

Date: 30 June 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator – scenario weighted (lower is better)	108%	131%	111%
Momentum Indicator	Weaker	Weaker	Weaker
Qualitative Indicator	Weaker	Weaker	Weaker

VALUATION FACTORS

Valuation is the most important part of our assessment. Essentially we compare the current pricing of equities in world share markets with an estimate of the longer-term Fair Price of each market.

The key assumptions in the assessment of the long-term Fair Price are long-term bond yields and long run earnings per share growth. A lower expected long-term bond yield implies a higher Fair Price for equities, as lower bond yields make cash flows from equity markets more valuable. A higher expected long-term bond yield has the opposite effect. We expect that the current low level of bond yields will provide continued support for equity prices for some time to come, particularly in interest rate sensitive sectors such as financials, real estate trusts and infrastructure.

The assessment of the long-term rate of growth in earnings per share 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. These are summarised in table four below.

We have revised our assessments of earnings per share growth rates, reducing the effect of real GDP growth as well as allowing for more persistent low inflation. The assumptions we are using about earnings per share growth for each major equity market and for each major sector of the Australian equity market are quite realistic and do not rely on any extraordinary factors coming into play.

Table 4: Earnings per share growth rates for equity markets

Date: 30 June 2016

Changed assumptions since last analysis highlighted in blue.

		REAL GDP GROWTH % P.A.	INFLATION % P.A.	EPS GROWTH % P.A.
AUSTRALIAN EQUITY MARKET				
ASX S&P 200		2.25%	2.00%	1.75%
ASX AREITS		2.00%	2.00%	2.00%
ASX Financial ex AREITS		2.00%	2.00%	1.50%
ASX Materials		3.50%	1.00%	2.50%
ASX Energy		3.50%	1.50%	2.50%
ASX Industrials		2.25%	2.00%	2.25%
INTERNATIONAL EQUITY MARKETS				
USA	S&P 500	2.50%	1.50%	2.00%
Canada	S&PTSX	2.50%	1.50%	2.00%
Japan	Nikkei 225	0.75%	0.75%	0.50%
Britain	FTSE 100	2.00%	1.25%	0.75%
Germany	DAX	2.00%	1.00%	0.50%
France	CAC	1.50%	1.00%	0.00%
India	BSE SENS	3.00%	5.50%	4.50%
China	Hang Seng	3.50%	2.50%	2.00%

Current assessment of equity asset markets

We use these assessments of long term earnings per share growth, together with the bond yield, 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:

- Modest earnings growth (this includes disinflation) such as we have had for most of the last 30 years, where inflation and interest rates fall or at least do not rise; this is good for equity prices. We still rate this as the most likely scenario for the next 3 to 5 years with a 40% to 50% likelihood.
- Faster earnings growth with more inflation such as we had in the 1970s and 1980s where inflation and interest rates rise above 4% p.a. This is not necessarily good for fixed interest or equity prices. We rate this as the least likely scenario for the next 3 to 5 years with a less than 20% likelihood.
- Recession and possible deflation such as we have seen in Japan and in some parts of Europe in recent years and globally in the 1930s. Where inflation and interest rates turn negative and there is a risk of the economy being trapped in a zero or negative growth pattern. Following the Brexit vote we now rate a scenario of mild deflation over the next for the next 3 to 5 years as a greater than 30% likelihood.

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

Changed assumptions since last analysis highlighted in blue.

Date: 26 March 2016

10 yr Bond Yield = 1.95%

Equity Risk Premium = 5.00%

Red = Expensive (Above 120%)

Black = More or less Fair Value (80% To 120%)

Green = Cheap (Below 80%)

SCENARIO	ONE: MODEST EARNINGS GROWTH	TWO: FASTER EARNINGS GROWTH	THREE: RELAPSE INTO RECESSION	AVERAGE OF SCENARIOS ONE -THREE
Probability of scenario	40%	20%	30%	100%
EPS GROWTH ASSUMPTIONS				
Current EPS changed by	0.0%	5.0%	-15.0%	-3.89%
Long term EPS growth rate changed by	0.0%	0.2%	-1.0%	-0.29%
Bond yield equal to current yield multiplied by	1.40	1.70	0.90	1.30
COUNTRY	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %			SCENARIO WEIGHTED AVERAGE %
USA	111%	113%	131%	118%
Canada	124%	126%	146%	132%
Japan	134%	135%	159%	143%
Britain	147%	148%	173%	156%
Germany	154%	154%	181%	163%
France	179%	179%	212%	190%
Australia	100%	102%	119%	107%
India	125%	127%	148%	133%
China	90%	90%	106%	95%
MSCI	122%	123%	144%	130%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	103%	105%	122%	110%
ASX Financials	85%	86%	100%	90%
ASX Materials	137%	138%	161%	145%
ASX Energy	343%	347%	405%	364%
ASX Industrials	85%	87%	100%	90%

Current assessment of equity asset markets

In summary, the valuation work indicates that:

1. There are no longer any cheap equity markets. The positive effect of very low long-term bond yields is counterbalanced by slower earnings per share growth prospects.
2. The US equity market is still fairly priced overall but looks more expensive in the event of a recession. While this is less likely than continued growth it is a significant risk going into 2017.
3. The European, British and Japanese equity markets are all still expensive under all scenarios which we have identified. As these markets make up over 30% of the world market, a global equity portfolio would still be expensive overall.
4. The Australian equity market is fairly priced but is no longer cheap overall.
5. Within the Australian equity market Financials (such as banks) and Industrials look cheaper than other sectors. The Materials sector (BHP, RIO) is expensive. AREITs (listed property trusts) now look slightly expensive especially if we are headed into a recession scenario.

MOMENTUM

Our momentum assessments analyse the pattern of the change in equity markets over the preceding six months. These patterns have some correlation with market returns over subsequent twelve-month periods, although the correlation is relatively weak. The increase in month-to-month volatility over the last year has rendered the momentum indicators neutral and somewhat unstable, on a month-to-month basis. Overall, in both the Australian and International equities asset classes, our current assessment is that momentum factors now have a slightly negative influence on returns over the subsequent twelve month period.

QUALITATIVE FACTORS

In making our assessments of equity markets, we also take into account the status of key qualitative factors such as monetary and fiscal policy as well as overall economic conditions and political factors, which can influence financial markets. Overall our assessment is that the positive factors (supportive monetary and fiscal policy) only slightly outweigh the negative factors (slow economic growth and political paralysis and discord). Our current assessments relating to each major equity market are set out below:

USA

US economic growth is quite subdued compared with many other recoveries but it is still positive at 2.0% p.a. in real terms and 3.0% p.a. in nominal or money terms. The Federal Reserve has backed away from its earlier plan to lift interest rates four times this year, citing concerns about the labour market as well as volatile conditions abroad, including the recent vote by the British to exit the European Union. In recent testimony to the US Congress, Fed Chair Janet Yellen

said "Without a doubt, in the last several months a number of different metrics suggest a loss of momentum in terms of the pace of improvement." She added that while they expect this to turn around they are "taking a cautious approach to make sure that expectation is borne out before we proceed to raise interest rates further". This retreat is providing support to the equity markets. The low cost of money is more or less offsetting generally weaker earnings growth and keeping the US equity market near its record high.

The Federal government continues to run at a deficit and given the political stalemate in Washington, this is unlikely to change any time soon. While this fiscal policy is currently supportive of economic growth, it is unlikely to become more so. Neither major candidate in this year's presidential election is likely to find it easy to negotiate more stimulatory fiscal policy with the US Congress.

CHINA

Nominal GDP growth is now running at 8.7% p.a. down slightly on earlier rates. Credit is growing faster than the economy as a whole, indicating that the authorities are extending loans to prevent major bankruptcies and employment lay-offs, thereby maintaining social peace. The IMF estimates that corporate debt in China is very high at 145% of GDP and that state owned enterprises (SOEs) account for 55% of the debt while producing 22% of economic output. There is growing evidence of an intense debate among policymakers in China about eventually reining in the amount of debt fuelled stimulus and making more permanent structural reforms to the economy. This may take some years to resolve. Meanwhile the qualitative factors in China are currently either positive or neutral in terms of their effect on global equity markets, but this may well be steadily wound back over the coming year.

Current assessment of equity asset markets

JAPAN

Industrial production in Japan is declining and so is nominal GDP. Monetary policy remains very supportive of both the economy and asset prices with a bias to becoming more so if needed. The Bank of Japan may well need to do more sooner rather than later. Fiscal policy is also highly stimulative with the government deficit running at 6.1% of GDP, however neither this nor the looser monetary policy seems to be having much effect. The outlook for earnings per share growth is being held back by the sluggishness of the overall economy.

EUROPE

With the UK voting to leave, the crisis in confidence among the political elite of Europe seems to be deepening. Deflation across the Euro zone as a whole is now a reality as is the spread of the negative long-term interest rates. While fiscal policy is still broadly supportive of economic activity, with EU governments on average running a deficit of 1.9% of GDP, it is much less so than that of the USA, Britain or Japan. Fiscal austerity is still an underlying aim of many policymakers in Europe. Monetary policy is also stimulatory, but constrained by legal limits especially in Germany. The large scale Quantitative Easing program that has been underway for quite some time is now being backed up with a policy of negative interest rates that penalises banks that do not lend to consumers and businesses, but it is yet to secure tangible results in terms of accelerated growth or more jobs. The equity markets have reacted to the news of the UK referendum and have become somewhat more volatile.

GREAT BRITAIN

The British may well have created their own home-grown shock that will push Britain into recession, by voting to leave the EU, but with no certainty as to how this will be given effect nor to the timeframe over which it will occur. Both the government and the opposition have become more unstable adding to the growing uncertainty that could well see investment spending deferred substantially. Real GDP growth, which had recovered very slightly is now likely to stall or slump. The Bank of England is running a very supportive monetary policy and has made clear that it will cut interest rates further from the 300 year low of 0.5% p.a. While this is supportive of equity prices they are already very expensive relative to the potential growth in earnings per share.

AUSTRALIA

Monetary policy in Australia had been close to neutral prior to the most recent cut by the RBA of its key rate from 2.0% p.a. to 1.75% p.a. It now may need to go further given the shock to world growth of the British exit vote. This may well be compounded in the weeks ahead by Australia's own vote which looks likely to lead to either a minority government or at best one with a small majority in the House but little prospect of getting its program approved by the new Senate.

The RBA has expressed concern about the rate of growth in Chinese corporate debt and the risks that this may pose to the Chinese banking system, the rate of growth in China and the risk of a contraction in Australian exports to China.

The RBA does have scope to cut its Official Rate further should it be needed and this would trim the AUD, which has been strengthening given the attractiveness of Australian government bonds to global investors. There are no other AAA rated governments offering a ten year bond yield of around 2.0% p.a. A cut in the rate by the RBA to 1.0% p.a. over the next year in three steps of 0.25% would not surprise us.

Current assessment of equity asset markets

IN SUMMARY:

- The Australian equity market is now on the slightly expensive side of fair value but is significantly more attractive than most international markets.
- The US equity market is still more attractive compared with most other international markets on a long-term valuation basis.
- There is an increased prospect of instability in politics that will have a negative feedback effect on the economy in Australia and elsewhere. Caution is still warranted.
- The low level of bond yields and short term interest rates and the pursuit of yield are the key factors making Australian and the US equities markets appear to be reasonably fairly priced against other asset classes.
- Given the volatility of markets we could not rule out a further significant pull back in prices in Australia or in the US of the order of 10% or more. This would offer an attractive accumulation opportunity for investors operating on a longer-term 5 to 10 year timeframe as we see continued low bond yields being fairly supportive of equity prices in the medium to longer term.

Table Six sets out guide points for buying and selling various share markets, for those who wish to manage portfolios on a long term basis with reference to accumulation or reduction guide points as an alternative to the approach of setting weightings relative to long term strategic benchmarks.

Table 6: Stock Market Investing Limits

COUNTRY	INDEX	LEVEL AT 30 JUNE 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2098	1776	1599	2132	Hold
Canada	S&PTSX	14064	10668	9601	12802	Reduce
Japan	Nikkei 225	15607	10946	9851	13135	Reduce
Britain	FTSE 100	6504	4170	3753	5004	Reduce
Germany	DAX	9680	5942	5348	7130	Reduce
France	CAC	4237	2229	2006	2675	Reduce
Australia	ASX S&P 200	5233	4898	4408	5877	Hold
India	BSE SENS	26999	20285	18256	24342	Reduce
China	Hang Seng	20794	21801	19621	26161	Hold
World Ex Aust	MSCI World Ex Australia	1671	1277	1150	1533	Reduce
AUSTRALIAN MARKET SECTORS						
ASX AREITS	ASX AREITS	1467	1332	1199	1599	Hold
ASX Financials	ASX Financials ex AREITS	6354	7035	6331	8442	Hold
ASX Materials	ASX Materials	8023	5522	4970	6627	Reduce
ASX Energy	ASX Energy	8221	2257	2032	2709	Reduce
ASX Industrials	ASX Industrials	5214	5768	5191	6922	Hold

These indicators are sending the same message as the valuation indicators in table 5:

1. Reduce exposure or be underweight to some of the more expensive international equity markets and the Materials and Energy sectors of the Australian equity market;
2. Hold other sectors of the Australian equity market and in the US equity market.

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