

Investment Market + Portfolio UPDATE

6 October 2016

Summary of key points

- ▶ There has been little net change in financial markets since our last update but a number of factors have emerged that call for more caution in investment strategy.
- ▶ The caution should be expressed in terms of lower holdings in equities and property securities and a higher weighting to cash.
- ▶ The cash can then be redeployed into growth assets after any significant pull back that emerges over the next 6 to 12 months.
- ▶ The risk factors that have emerged include:
 - China: The continued surge in credit and lending which is now being reined in selectively by provincial governments which are imposing limits on property purchases.
 - USA: The uncertainty in the election result, which ebbs and flows (although it is flowing towards Clinton this week). In addition the projected earnings per share growth of major companies is set to slow from +9.3% p.a. to +5.5% p.a. putting the record level of share prices under pressure. The record level of US profits as a proportion of GDP looks difficult to sustain.
 - Europe: Growing market concerns about the strength of some “globally systemically important financial institutions” such as Deutsche Bank and Unicredit, the biggest banks in Germany and Italy respectively.
 - Japan: There is growing dissension within the Bank of Japan regarding the conduct of monetary policy, which has now been acknowledged as being at its limit of effectiveness.
 - More broadly, virtually all central banks have run out of options for stimulating their economies further and as yet governments have not shown any capacity to fill the gap with more fiscal stimulus.
 - Governing parties worldwide are subjected to populist pressures that constrain their policies. Political survival trumps effective policy.
- ▶ These factors together with our updated valuation analysis lead us to recommend an underweighting in international equities as well as the property securities, materials and energy sectors of the Australian equity market, with a build up of strategic cash holdings for the next few months, awaiting reinvestment at better prices.

A number of factors have emerged that call for more caution in investment strategy.

Summary of key points cont.

Table 1: 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					✓	

Where are we now?

Table 2: Financial market movements

MARKET INDICATOR	LEVEL AT 30 JUN 14	LEVEL AT 30 JUN 15	LEVEL AT 30 JUN 16	LEVEL AT 05 OCT 16	CHANGE 2014/2015 FINANCIAL YEAR		CHANGE 2015/2016 FINANCIAL YEAR		CHANGE SINCE START OF 2016/17 FINANCIAL YEAR	
					IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD	IN LOCAL CURRENCY	IN AUD
EQUITY MARKETS										
S&P ASX 200	5394	5515	5233	5458	2.2%	2.2%	-5.1%	-5.1%	4.3%	4.3%
USA: S&P 500	1960	2057	2098.86	2150	4.9%	28.9%	2.0%	5.3%	2.4%	0.2%
UK: FTSE 100	6743	6620	6504.33	7074	-1.8%	10.8%	-1.7%	-14.1%	8.8%	1.6%
Germany: DAX	9833	11083	9680.09	10619	12.7%	13.0%	-12.7%	-10.5%	9.7%	8.3%
France: CAC	4422	4869	4237.48	4503	10.1%	10.4%	-13.0%	-10.8%	6.3%	4.9%
Japan: Nikkei 225	15162	20235	15705	16735	33.5%	35.6%	-22.4%	-4.9%	6.6%	4.2%
China: Hang Seng	23200	26250	20794	23689	13.1%	38.9%	-20.8%	-18.3%	13.9%	11.5%
CURRENCIES										
USD/AUD	0.943	0.768	0.744	0.761		22.8%		3.2%		-2.2%
GBP/AUD	0.551	0.488	0.558	0.598		12.9%		-12.5%		-6.6%
YEN/AUD	95.32	93.81	76.60	78.32		1.6%		22.5%		-2.2%
EUR/AUD	0.689	0.687	0.67	0.679		0.3%		2.5%		-1.3%
INTEREST RATES										
Aus: 90 day bank bill % p.a.	2.68	2.19	2.00	1.79	-0.49		-0.19		-0.21	
Aus: 10 year govt bond % p.a.	3.54	3.01	2.00	2.12	-0.53		-1.01		0.12	
US: Fed funds rate % p.a.	0.09	0.13	0.32	0.40	0.04		0.19		0.08	
US: 10 year govt bond % p.a.	2.53	2.32	1.46	1.69	-0.21		-0.86		0.23	
COMMODITIES										
Copper US \$ per tonne	7035	5767	4845	4805	-18.0%	0.7%	-16.0%	-13.3%	-0.8%	-3.0%
Gold USD/ounce	1326	1175	1328	1270	-11.4%	8.8%	13.0%	16.6%	-4.4%	-4.4%
Oil USD/barrel (WTI)	105	58	48	49	-44.5%	-31.8%	-16.9%	-14.2%	1.4%	-0.8%

Since the last Update at the beginning of September:

- Short-term interest rates in Australia and internationally have been largely stable;
- Long-term government bond yields in the USA and Australia have fluctuated based on changes in market assessments of US monetary policy and overall have risen slightly by about 0.15% p.a. . Bond market yields are still somewhat artificially repressed due to central banks buying or holding record amounts of bonds. In the absence of this factor, they would be signalling a risk of recession;
- The Australian Dollar rose slightly against all major currencies, reflecting Australia's relatively higher interest rates, taking the edge off returns on international assets;
- The oil price rose 7% in reaction to the recent OPEC announcement of production limits. Copper prices, an indicator of industrial demand, were also up slightly while the gold price eased;
- Prices in major equity markets worldwide were essentially little changed after some short term significant fluctuations up or down, depending on the market reactions to the daily news flow;
- Equity market prices are reflecting the very low level of cash and bond yields and they imply continued long term growth in earnings per share, albeit at a subdued pace compared with the last thirty years;
- Overall momentum in equity markets is now neutral and has been quite unstable in the last year.

Over the course of the last few weeks:

- Central banks appeared to do little to change their very easy monetary policies, which are among the main driving forces of asset values worldwide. This apparent lack of action included the US Federal Reserve, the Bank of Japan, The European Central Bank and last but not least, the Reserve Bank of Australia which kept its official rate at the all time low of 1.50% p.a. for another month.
- In the US, after weeks of public sparring between some of its senior members the Fed decided to leave its key Fed Funds rate unchanged at a near record low of 0.5% p.a. while noting that three of the ten members of the Federal Open Market Committee dissented and thought that the rate hikes should start now. This indicates that the balance may well tip towards more rate rises soon.

- A potential bond and equity market sell-off was avoided by Chairman Yellen setting out at some length the need for a gradual (and deferred) set of interest rate rises. The bond and equity markets rejoiced, recovering much of the slump in prices that had occurred in the run up to the decision.
- The Bank of Japan announced the results of a major review of its monetary policy, which has arguably not been working in terms of the boost that it was intended to give to real GDP growth and inflation. It decided to keep in place its policy of negative short term interest rates but change its quantitative easing program under which it buys assets from the bond market.
- The BOJ bent to the wishes of its commercial banking brethren and undertook to sell rather than buy JGBs in order that their yield is held at least to 0%, whenever it becomes necessary. The Japanese bond market responded directly and the equity market followed. The most recent slump in share prices, the third since June, was turned around.
- The recent announcements of the US Federal Reserve and the Bank of Japan have provided investors with more time to consider the vulnerabilities of their portfolios to a period of rising interest rates and long-term bond yields. Investors would be well advised to use the extra time well. Continual vigilance is needed as financial market conditions evolve.
- The potential sources of such a shorter-term crisis are many and varied. While it is hard to predict any single cause, the candidates include policy reversals from the aforesaid central banks, emerging difficulties in the European banking system and not least the upcoming US presidential election.
- The fragility of the European banking system, which was not recapitalised after the GFC in the way that the US banks were, has been thrown into focus by growing market concerns about the strength of some "globally systemically important financial institutions" such as Deutsche Bank and Unicredit, the biggest banks in Germany and Italy respectively.
- Deutsche Bank is widely interconnected with over two hundred financial institutions in the derivative markets alone. With several of these counterparties said to be reviewing their willingness to accept Deutsche bank credit risk in the wake of the recent US Department of Justice demand for a \$14 billion settlement in relation to misdemeanours in the mortgage securities market, the German government has made clear that it has no current plans to bail out Deutsche.
- That may change. To put it into perspective the \$14 billion demand is large relative to Deutsche's market capitalisation of EUR16 billion but manageable relative to its stated cash and liquid assets of EUR 215 billion. It could pay the debt if forced to but the shareholders would take a big hit. It would not be a catastrophe for markets as was Lehman in 2008 but the bank's interconnectedness is extensive and the full consequences are yet to be discernible. We would expect an adverse reaction in European equity markets that may well spread.

Where are we now? cont.

- The trajectory of Chinese growth is also a factor to consider. Much of the credit expansion that was deployed earlier this year to support growth via the property and construction sector, was funded via the so called secondary or shadow banking system, which has grown by 30% in the last year and now has assets equal to 79% of China's GDP. There is concern that some of these assets may not be realisable.
- The Deputy Director of the Prudential Regulatory Bureau of the China Banking Regulatory Commission, has sought to reassure by saying that only 17% of shadow banking assets are in high risk, high yield products owned by private investors via wealth management products. This amounts to only 1.5% of the total banking assets in China. The products attracted investment by offering yields above 10% p.a. and they were backed by investment in assets such as property development. It is said that losses from the property developments will be borne by the individual investors, although there is some evidence that this is causing civil unrest. This is anathema to the ruling Communist Party.
- The bottom line is that the losses will have to be borne somewhere. If not by the private investors then most likely by the banking system. While China appears to have the resources to sort this out, its overall debt level is 255% of GDP, which is high for a still developing economy.
- There will be a de facto deceleration in the growth of the money supply, most of which has come via the growth of the wealth management products that are now causing problems. Any such deceleration will impact real economic growth that could come in well below the 6.7% p.a. rate set in the five-year plan.
- Australian Treasurer Scott Morrison has recently spoken about developments in China, pointing out that the credit expansion was directly behind the surge in iron ore prices from \$US 40 per tonne to \$US 60 per tonne this year (much to the benefit of the Federal Government's tax collections). He commented that any significant slow down in credit growth in China would see the iron ore price headed back towards \$40 per tonne.
- Meanwhile, Chinese provincial governments have been saving their local steel mills by getting the banks that they can influence to renegotiate and extend loan facilities to the mills. Eventually some of this debt may end up with the central government, which has a low level of debt by world standards (40% of GDP) and so should be able to absorb it.
- Nevertheless this will add to the tension already evident in (an unusually) public debate between the two most senior political leaders about the direction of economic policy. This may not be settled until the Peoples Congress in late 2017, when decisions are due to be made about the next generation of leadership of China. This extends the time during which these stresses and strains may yet cause policy errors and adverse reactions in financial markets, such as we saw in 2015- 2016.
- On a positive note, there is the prospect of order returning to the oil market, with OPEC announcing agreed production cuts at its recent meeting in Algiers. As noted earlier, the oil price has already recovered 7%, taking some pressure off many nations that depend on oil to balance their budgets. There is evidence that oil price rises correlate with equity market price rises. The effect is stronger if the oil price rise is due to stronger demand for oil rather than cuts in production, but there is still expected to be a positive effect as long as the agreement is in place and working.
- Saudi Arabia can be expected to be motivated to keep the price up as it depends on oil for 70% of its revenue and the recent oil price falls moved its budget from a surplus of 13% of GDP to a deficit of 15% of GDP. All it needs is for Nigeria, Venezuela, Iran and Iraq not to break ranks and keep the price support in place.
- Finally, on Tuesday 4 October, the RBA kept its official rate steady at 1.5% p.a. It noted (without any apparent concern) that actions of Chinese policymakers had been supporting growth but the underlying pace of growth in China has been moderating. It also noted (without any irony) that financial markets have continued to function effectively with "funding costs for high quality borrowers" remaining low. There was no comment on deposit rates. It expects inflation and interest rates to remain low for some time to come.

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Current assessment of equity asset markets

Our current overall assessment taking into account valuation factors, momentum factors and qualitative factors such as monetary policy, fiscal policy and geopolitical factors is summarised in Table 3. These are discussed in more detail later on.

Table 3: Summary of equity markets assessments

Equity Market Assessment: 5 October 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator (scenario weighted, lower is better)	108%	144%	140%
Momentum Indicator	Neutral	Neutral	Neutral
Qualitative Indicator	Weaker	Weaker	Weaker

Discussing these assessments in more detail:

Valuation Factors

The valuation assessment is based a comparison of the current pricing of equities in world equity markets with an estimate of the longer-term Fair Price of each market. It is important to note that while we regularly review the valuation factors, they are a guide to long term direction rather than shorter-term timing of equity markets. We do however put greater weight on the assessments, the further that current market prices diverge from the long term Fair Price estimates.

Long-term Fair Price is based on the long-term bond yields and estimates of 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.

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. Since the last Update we have downgraded the long-term real GDP growth assumption for France and Germany by 0.5% p.a. due to the potential disruption due to instability in the European banking system. This is centred mainly on two major banks, Deutsche Bank, the largest in Germany, and Unicredit, the largest in Italy. We have also slightly upgraded the real GDP growth assumptions for India and China due to the amount of fiscal and monetary stimulus in those countries. All other assessments of earnings per share growth rates are unchanged since the last Update.

Table 4: Earnings per share growth rates for equity markets

Changed assumptions since last analysis highlighted in red.

		REAL GDP GROWTH % P.A.	INFLATION % P.A.	NOMINAL GDP GROWTH % P.A.	DILUTION DUE TO NET STOCK ISSUANCE % P.A.	EPS GROWTH % P.A.
Australia	ASX S&P 200	2.25%	2.00%	4.25%	-2.50%	1.75%
Australian property	ASX AREITS	2.00%	2.00%	4.00%	-2.00%	2.00%
Australian Financials	ASX Financial ex AREITS	2.00%	2.00%	4.00%	-2.50%	1.50%
Australian Materials	ASX Materials	3.50%	1.00%	4.50%	-2.00%	2.50%
Australian Energy	ASX Energy	3.00%	1.50%	4.50%	-2.00%	2.50%
Australian Industrials	ASX Industrials	2.25%	2.00%	4.25%	-2.00%	2.25%
USA	S&P 500	2.50%	1.50%	4.00%	-2.00%	2.00%
Canada	S&PTSX	2.50%	1.50%	4.00%	-2.00%	2.00%
Japan	Nikkei 225	0.75%	0.75%	1.50%	-1.00%	0.50%
Britain	FTSE 100	1.50%	1.25%	2.75%	-2.50%	0.25%
Germany	DAX	1.50%	1.00%	2.50%	-2.50%	0.00%
France	CAC	1.50%	1.00%	2.50%	-2.50%	0.00%
India	BSE SENSEX	4.00%	5.50%	9.50%	-4.00%	5.50%
China	Hang Seng	4.00%	2.50%	6.50%	-4.00%	2.50%

Current assessment of equity asset markets cont.

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 as follows. These scenarios are unchanged since our last Update:

- Modest earnings growth (this includes disinflation) where inflation and interest rates fall or at least 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 40% likelihood.
- Faster earnings growth where inflation and interest rates rise above 4% p.a. This higher rate of inflation is generally bad for fixed interest or equity prices. We rate this as the least likely scenario for the next 3 to 5 years with a 20% likelihood.
- Recession and possible deflation 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 in the UK in June, the emerging fragility of major European banks and other emerging political instability such as in the USA and China we now rate a scenario of slower growth perhaps with mild deflation over the next for the next 3 to 5 years as a 30% likelihood.

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

Changed assumptions since last analysis highlighted in blue.

Global Equity Market Valuation indicators

Date: 5 October 2016 10 yr Bond Yield = 2.12% 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	SCENARIO WEIGHTED
Probability of scenario	40%	20%	30%	100%
EPS AND EPS GROWTH ASSUMPTIONS				
Current EPS changed by	0.00%	5.00%	-15.00%	-3.89%
Long term EPS growth rate changed by	0.00%	0.20%	-1.00%	-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 %	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	121%	124%	141%	128%
Canada	138%	141%	161%	147%
Japan	155%	156%	181%	164%
Britain	178%	179%	208%	188%
Germany	191%	192%	223%	202%
France	183%	184%	214%	194%
Australia	102%	104%	119%	108%
India	115%	119%	134%	122%
China	108%	109%	127%	115%
MSCI	136%	138%	159%	144%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	132%	135%	153%	140%
ASX Financials	96%	98%	112%	102%
ASX Materials	133%	135%	155%	141%
ASX Energy	172%	175%	201%	182%
ASX Industrials	94%	96%	109%	99%

In summary, the valuation work indicates that:

1. All international equity markets, except for China, are expensive from the point of view of an Australian investor. Holdings should be reduced to underweight.
2. The US equity market is near a record high and would be very 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 Australian equity market is still fairly priced overall but the property, materials and energy sectors are all expensive. The allocation to property (AREITs) should be reduced to an underweight position.

Momentum

Momentum in most major markets has become unstable in recent months and is no longer a supportive factor for equity investment.

Qualitative factors

The qualitative factors that impact equity markets include monetary and fiscal policy as well as overall economic conditions and geopolitical factors. Overall our current 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 as well as possible instability in the European banking system).

Our analysis of factors that will have impact over the next twelve to twenty four months takes place within a framework over ten years that provides the driver of long term asset allocation strategy. This longer-term framework is as follows:

- Inflation will be subdued worldwide, driven by aging demographics that lead to an excess of savings over investment, continued low inflation expectations among populations and overcapacity in manufacturing worldwide.
- Real GDP growth will be slow but still mainly positive and nominal GDP growth (i.e. growth in money terms) will also be slower than has been usual in the past.
- Governments are weak and not prepared to borrow and spend, even on much needed infrastructure (China has been an exception).
- Short-term interest rates will continue to be low or negative worldwide as central banks fill the stimulus void left by governments but the US Federal Reserve will gradually lift its cash rate to around 3% p.a. over the next five years.
- Government bond yields will be low or negative as central banks buy bonds to add more stimulus.
- Equity earnings growth will be slow overall, constrained by low nominal GDP growth.
- Major equity market valuations are not cheap despite low bond yields.

Our baseline scenario for the next 12 to 24 months includes:

- Real economic growth is slower in China, Europe and Japan and slightly faster in the USA. Overall world real GDP growth is the same or slightly slower.
- Inflation is unchanged and very low worldwide and does not break out in spite of the massive monetary stimulus.
- Fiscal policies are unchanged due to political gridlock, collective timidity of professional politicians and their adherence to the monetarist dogma from the 1980s.
- Monetary policies of central banks reach the limits of their efficacy with limited further reductions in short term interest rates (including further moves into negative rates) in Japan and Europe.
- US monetary policy tightens only slightly with modest increases in the Federal Funds rate while the China cuts rates to avoid a hard landing.
- Major central banks do not shrink their balance sheets, keeping most of the government bonds that they bought under the quantitative easing programs that followed the GFC. Most of the increase in government debt since the GFC continues to be funded by central banks rather than private sector investors.
- The USA has a more protectionist president regardless of who wins, who is unable to break the fiscal deadlock with the Congress.
- World trade contracts slightly as it faces the headwinds of growing protectionism.
- In Japan, Prime Minister Abe continues in power and effects some structural change but not enough to boost either the population or the labour force.
- In China Xi continues to exert dominance especially over economic policy, reducing credit growth and increasing the risk of a recession.
- In Europe, established parties in Germany, Italy, France and Spain face major challenges at elections from populists of both left and right, paralysing policy.
- Britain takes a long time to negotiate its trading arrangements in the wake of Brexit causing a slow down in its economy. There is less fiscal austerity and more government debt.
- Earnings per share growth slows in many stock market sectors especially financials and consumer staples.
- Equity market prices continue to be driven by ultra low or negative bond yields and low cash rates but are prone to episodic falls whenever there is a significant shock, such as a European banking crisis or a Trump victory.

What could be different? Over the next two years, events could diverge from the long-term baseline scenario in ways that would impact asset returns. Some possibilities include:

- In the USA, President Trump is elected. This will likely be bad news for world trade and real GDP growth but could be good for US domestic growth if it leads to major spending on infrastructure that is successfully negotiated through a Republican congress. It is likely that the initial reaction from equity markets would be very negative.
- Trump could turn out to be a surprisingly good president, like Teddy Roosevelt or Harry Truman, getting agreement from Congress to fiscal repair and major infrastructure stimulus to the US economy, dragging China out of the clutches of recession, with iron ore and coal prices surging once again.
- China: Leadership tensions and policy disputes over economic policy and the use of expanding credit to support growth could culminate in public disputes at the Peoples' Congress in late 2017. The key issue in dispute is the pace with which the growth of debt in the economy is wound back. President Xi favours a sharper cut back than Premier Li. We expect the president to prevail.
- In addition, military activity in the South China Sea could cause a disruption to trade that is meaningful on a global scale.
- Japan: The policies and actions of the Government and the Bank of Japan continue to fail to lift the country out of recession. We expect little by way of structural reform, increasing the risk of a relapse into recession.
- European Union: Banking system problems cause economic disruption especially in Italy and Germany. The current stress on Deutsche Bank may be the beginning of a protracted major banking crisis.

- Great Britain: Brexit negotiations are mishandled and this leads to recession.
- Oil: Notwithstanding the recent OPEC announcement, Saudi Arabia and Iran flood the market with oil supply as they strive to maintain and increase cash flow. This weakens oil majors, oil service companies that supply them and ultimately major banks that lend to the latter. A chain reaction from the oil market to the credit markets.

In summary:

- There is an increased prospect of instability in politics that will have a negative feedback effect on the economy in the USA 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 US equities 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 equity prices in the US of the order of 10% or more within the next six months. 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.
- There are some not insignificant risks of a more substantial and lasting fall in equity markets and these risks need to be monitored closely.

Over the next two years, events could diverge from the long-term baseline scenario in ways that would impact asset returns.

What to do next with Investment Portfolio Strategy

- Maintain an allocation slightly below neutral or benchmark weight to Australian equities, favouring financial and industrials over property (AREITs) or resources.
- Move more underweight in International equities.
- Be cautious and patient and await short-term pullbacks 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. There are enough short to medium term risk factors around to generate at least one sell off of equity markets of the order of 10% or more in the next six to twelve months.
- In the medium to longer term, growth in the economy and earnings will resume and long-term equity returns will outpace cash and fixed interest. So do not hold too much cash for too long and keep a moderate amount in growth or equity assets relative to the long-term portfolio neutral position in these assets.
- Where the portfolios are significantly underweight relative to benchmark levels the allocation should be increased carefully and progressively over the next six months. If the client's fund allocation to 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 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.
- 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. Holding cash or cash funds will be more attractive than bond funds and more flexible than term deposits.

Table 6: 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					✓	

What to do next with Investment Portfolio Strategy cont.

Table Seven 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 7: Stock Market Investing Limits

COUNTRY	INDEX	CURRENT LEVEL AT 5 OCT 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2150	1679	1511	2014	Reduce
Canada	S&PTSX	14521	9896	8907	11876	Reduce
Japan	Nikkei 225	16735	10208	9187	12249	Reduce
Britain	FTSE 100	7074	3753	3378	4504	Reduce
Germany	DAX	10619	5250	4725	6300	Reduce
France	CAC	4503	2324	2091	2789	Reduce
Australia	ASX S&P 200	5460	5042	4538	6051	Hold
India	BSE SENS	28334	23172	20855	27807	Reduce
China	Hang Seng	23689	20673	18606	24808	Hold
World ex Aus	MSCI World ex Australia	1727	1197	1077	1437	Reduce
AUSTRALIAN MARKET SECTORS						
ASX AREITS	ASX AREITS	1427	1022	920	1226	Reduce
ASX Financials	ASX Financial ex AREITs	6600	6468	5821	7761	Hold
ASX Materials	ASX Materials	9074	6447	5803	7737	Reduce
ASX Energy	ASX Energy	8413	4616	4155	5540	Reduce
ASX Industrials	ASX Industrials	5252	5292	4763	6350	Hold

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

1. Reduce exposure or be underweight to international equity markets and the AREITs, Materials and Energy sectors of the Australian equity market;
2. Hold other sectors of the Australian equity market.

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