

Investment Market + Portfolio

29 April 2016

UPDATE

Summary of key points

- ▶ The oil price has rebounded further in spite of a failure of major producer nations to agree on production caps. The short-term return to a balance between demand and supply due to disruptions in Kuwaiti and Venezuelan supply as well as a contraction in US shale oil production seem to be the key drivers.
- ▶ The US equity market is slightly above being fairly priced while other international markets look outright expensive.
- ▶ The Australian equity market is offering better value.
- ▶ The Australian real estate investment trust sector looks particularly cheap overall, especially given the low level of bond yields, however this is driven mainly by the low PE of two of the dominant stocks in this concentrated sector, so be careful.
- ▶ Momentum has turned positive in most equity markets but in the past has proven to be both unstable and only slightly correlated with subsequent market returns. Be guided more in the long term by valuation factors.
- ▶ Monetary policy is supportive of asset prices almost everywhere in response to continued slow global growth prospects which were recently confirmed by the IMF and the G20 finance ministers and central bankers.
- ▶ Overall policy settings and financial conditions are supportive of growth asset prices over the next year or two, but some caution is needed.
- ▶ Equity markets will continue to be volatile with some significant declines to be expected from time to time. They will offer an opportunity for accumulation of stocks at more attractive prices with the prospect of enhanced long-term returns.
- ▶ Using strategically set aside cash to invest in equities when prices are attractive is part of a sound long-term investment strategy.
- ▶ At this stage we see no reason to change asset allocation strategy, maintaining a neutral or benchmark weight to Australian and international equities.
- ▶ We are, however, still cautiously awaiting a short-term pullback of 10% or more in equity markets, which will provide an opportunity to go overweight in equities, based on 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 29 APR 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	5220	2.2%	2.2%	-5.3%	-5.3%
USA: S&P 500	1960	2057	2094	4.9%	28.9%	1.8%	1.0%
UK: FTSE 100	6743	6620	6284	-1.8%	10.8%	-5.1%	-12.6%
Germany: DAX	9833	11083	10262	12.7%	13.0%	-7.4%	-7.0%
France: CAC	4422	4869	4526	10.1%	10.4%	-7.0%	-6.7%
Japan: Nikkei 225	15162	20235	17353	33.5%	35.6%	-14.2%	-6.4%
China: Hang Seng	23200	26250	21407	13.1%	38.9%	-18.4%	-19.1%
CURRENCIES							
USD/AUD	0.943	0.7679	0.7737		22.8%		-0.7%
GBP/AUD	0.5511	0.4881	0.5304		12.9%		-8.0%
YEN/AUD	95.32	93.81	85.97		1.6%		9.1%
EUR/AUD	0.6886	0.6866	0.6838		0.3%		0.4%
INTEREST RATES							
Aus: 90 day bank bill % p.a.	2.68	2.19	2.45	-0.49		0.26	
Aus: 10 year govt bond % p.a.	3.54	3.01	2.66	-0.53		-0.35	
US: Fed funds rate % p.a.	0.09	0.13	0.38	0.04		0.25	
US10 year govt bond % p.a.	2.53	2.32	1.91	-0.21		-0.41	
COMMODITIES							
Copper US \$ per tonne	7035	5767	4998	-18.0%	0.7%	-13.3%	-14.0%
Gold USD/ounce	1326	1175	1241	-11.4%	8.8%	5.6%	4.8%
Oil USD/barrel (WTI)	105	58.29	43.35	-44.5%	-31.8%	-25.6%	-26.2%

Since the last Update:

- Short term interest rates in Australia and the USA have been stable and have remained at very low levels;
- Long term bond yields in the USA have been stable while in Australia they have moved up slightly by about 0.1% p.a. reflecting the prospect of greater bond issuance by the Federal Government to finance its deficit which now appears to be more persistent;
- The Oil price is up by a further 10% in US dollar terms since the last update due to the failure of major producers to agree on a cap on production. Short term production losses in Kuwait (due to a strike) and Venezuela (due to withdrawal of key US equipment suppliers) appear to be restoring the oil market to a balance of supply versus demand but this is likely to be short lived. The price is still down 26% over the course of the current Financial Year. The importance of the oil price is that it has become a key driver of equity market sentiment in recent months;
- With the oil price holding up and interest rates looking likely to remain lower for longer than previously expected, all major equity markets were up over the course of the month, between 2% and 5%;
- The Australian dollar was stronger against the US Dollar, Euro and the Yen but oddly enough slightly weaker against the British Pound, which ought to be under some pressure due to the speculation about the potential for a British exit (Brexit) from the European Union. The generally stronger than expected AUD is putting pressure on trade exposed businesses in Australia such as the major mining companies. The strength in the AUD appears to be due to the strong demand for Australian government bonds from international investors. They are the highest yielding triple A rated government bonds in the world.

What to do next with Investment Portfolio Strategy

- Taking into account the outlook and the global equity market valuations, which are set out more fully below, the allocation to Australian and international equities should be increased back up to benchmark levels over the next three to six months for portfolios that are significantly underweight and maintained at those levels for those that are already at benchmark or neutral weight.
- 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.
- Portfolios should maintain a neutral weighting to property securities despite their apparent cheapness.
- 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. 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 a three-year horizon

RECOMMENDED ASSET ALLOCATION RELATIVE TO BENCHMARK OR NEUTRAL	ZERO	MAJOR UNDER WEIGHT	UNDER WEIGHT	NEUTRAL OR BENCHMARK WEIGHT	OVER WEIGHT	MAJOR OVER WEIGHT
ASSET CLASS						
Cash				✓		
Fixed interest			✓			
Property				✓		
Australian equities				✓		
International equities				✓		
Alternative equities					✓	

The importance of equities in investment strategy

Equity investments are the major driver of long-term returns in most portfolios. They are also the biggest source of short-term fluctuations in portfolio returns.

We adopt a long-term approach and use a Fair Price method of assessing each of the world's major stock markets. This method compares the current stock market prices with the price required to produce a ten year total return from dividends and growth which is a margin 5% p.a. above the long term government bond yield.

This method is currently indicating that the US equity market as measured by the S&P 500 index is fairly priced at levels below 1925. It is currently well above that level but not by so

much as to represent a sell signal. Conversely the Japanese and European equity markets look quite expensive. At the same time our Fair Price analysis is indicating that Australian stocks offer attractive long-term returns when the ASX is below 5800, although some specific sectors such as Energy and Materials (BHP, RIO) still look expensive even at their current prices.

In addition to valuation factors we also take into account momentum and qualitative factors when assessing equity markets for investment. In summary our current assessment for the Australian and International equities markets as well as Australian listed real estate trusts is as follows:

Table 3: Summary of equity markets assessments

Date: 26 April 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator – scenario weighted (lower is better)	89%	128%	60%
Momentum Indicator	Positive	Positive	Positive
Qualitative Indicator	Neutral	Neutral	Neutral

The importance of equities in investment strategy cont.

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, which makes current equity market prices more attractive. A higher expected long-term bond yield has the opposite effect. Bond yields have been relatively stable in recent months, so this factor has not changed much.

As part of our assessment we calculate the ratio of current equity market prices to the long-term expected Fair Price for each major equity market. Our current assessment is summarised in Table Five below.

As indicated earlier 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 real estate trusts and infrastructure.

Our 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 unchanged from our previous assessments and are set out in table four below.

Table 4: Earnings per share growth rates for equity markets.

Date: 26 April 2016

No changes to assumptions since last analysis.

		REAL GDP GROWTH % P.A.	INFLATION % P.A.	EPS GROWTH % P.A.
AUSTRALIAN EQUITY MARKET				
ASX S&P 200		2.25%	2.00%	2.25%
ASX AREITS		2.25%	2.00%	1.25%
ASX Financial ex AREITS		2.00%	2.00%	0.50%
ASX Materials		2.25%	1.00%	1.25%
ASX Energy		2.00%	1.00%	1.00%
ASX Industrials		2.25%	2.00%	2.25%
INTERNATIONAL EQUITY MARKETS				
USA	S&P 500	2.50%	1.50%	2.50%
Canada	S&PTSX	2.50%	1.50%	2.00%
Japan	Nikkei 225	1.00%	1.00%	0.50%
Britain	FTSE 100	2.50%	1.50%	2.00%
Germany	DAX	2.25%	1.25%	1.50%
France	CAC	1.75%	1.25%	1.00%
Italy	FTSE MIB	1.25%	1.25%	0.50%
Brazil	Bovespa	2.00%	6.00%	4.00%
Russia	MICEX	1.50%	5.00%	2.50%
India	BSE SENS	4.00%	5.50%	5.50%
China	Hang Seng	4.00%	2.50%	2.50%

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.

We use these to derive the long run fair price estimates in the analysis set out below in Table 5.

The importance of equities in investment strategy cont.

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 = 2.66%

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	35%	20%	35%	100%
EPS GROWTH ASSUMPTIONS				
Current EPS changed by	0.0%	5.0%	-15.0%	-4.72%
Long term EPS growth rate changed by	0.0%	0.2%	-1.0%	-0.34%
Bond yield equal to current yield multiplied by	1.00	1.30	0.70	0.95
COUNTRY	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %			SCENARIO WEIGHTED AVERAGE %
USA	99%	105%	121%	109%
Canada	124%	131%	151%	136%
Japan	140%	144%	169%	152%
Britain	174%	183%	212%	191%
Germany	146%	153%	178%	160%
France	147%	153%	179%	161%
Australia	81%	86%	99%	89%
Brazil	186%	194%	226%	203%
Russia	64%	65%	77%	69%
India	101%	108%	124%	111%
China	86%	87%	103%	93%
MSCI	117%	123%	143%	128%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	55%	57%	66%	60%
ASX Financials	87%	89%	105%	94%
ASX Materials	146%	151%	177%	159%
ASX Energy	153%	157%	185%	166%
ASX Industrials	79%	84%	96%	87%

In summary, the valuation work indicates that:

1. The US equity market is still fairly priced overall but looks more expensive in the event of a recession, which still seems less likely than continued growth;
2. The European, British and Japanese equity markets are 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 even though the US market which makes up almost 60% of global equities is not particularly expensive;
3. The Australian equity market is fairly priced to slightly cheap overall;
4. Within the Australian equity market, AREITs (listed property trusts) and Industrials look cheap, while the Materials sector (BHP, RIO) is expensive. Financials including the banks look slightly expensive if we are headed into a recession scenario but otherwise look fairly priced to slightly cheap.

The importance of equities in investment strategy cont.

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 nine months 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 have neither a significantly positive or negative influence on returns over the subsequent twelve month period, even though in the latest month they have turned positive.

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) 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 but still positive at 2.0% p.a. in real terms and 2.9% p.a. in nominal or money terms. Nonetheless, new unemployment benefit claims are at their lowest level since 1973. This is encouraging but is not enough to encourage the Federal Reserve to revert to its earlier plan to lift interest rates four times this year. It is still in back-down mode and this is providing joy to the equity markets. The low cost of money is offsetting generally weaker earnings growth and propelling the US equity market to 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 its fiscal policy is by default supportive of growth, it is unlikely to become more so. Any addition to stimulus would need to come from monetary policy but this too is unlikely to increase unless there is a widespread global economic downturn originating in Europe or elsewhere.

CHINA

Real GDP growth is now reported at 6.7% p.a. with inflation at 2.3% p.a. Reported economic growth in money terms is therefore 9.0% p.a. Credit is growing even faster as the authorities appear to be extending loans to prevent major bankruptcies and employment lay-offs. This is stimulating the real estate and construction sectors and has caused a run up (in the short term at least) in the iron ore price. In addition the government is running a fiscal deficit of 3% of GDP.

All of the qualitative factors in China are currently either positive or neutral in terms of their effect on global equity markets.

JAPAN

Growth has picked up marginally and inflation is now positive (at 0.3% p.a.) rather than negative. 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 still has a goal of having inflation at 2% p.a. – a long way to go, it would seem. Fiscal policy is also highly stimulative with the government deficit running at 6.2% of GDP. Overall nominal GDP growth, which influences earnings per share growth, has picked up to 1.0% p.a.

EUROPE

The Eurozone has zero inflation and just 1.6% p.a. real GDP growth with 10.3% unemployment. Its fractious leading politicians not only quarrel amongst themselves but also make public statements undermining the credibility of the European Central Bank. Fiscal policy is still broadly supportive of economic activity, with EU governments on average running a deficit of 1.9% of GDP. Monetary policy is even more stimulatory. 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. While the real economic effects are yet to be seen, the equity markets have reacted positively to the latest ECB policy moves, pushing prices even further above long term fair value. Nominal or money GDP growth in the Eurozone is still low at 1.6% p.a. – not enough to support earnings per share growth to justify current equity prices.

The importance of equities in investment strategy cont.

GREAT BRITAIN

Real GDP growth has recovered very slightly to 2.1% p.a. from 1.9% p.a. With inflation at just 0.5% p.a., nominal GDP growth is also up slightly to 2.6% p.a. While this is better than that of the Eurozone, it hardly underwrites a lot of earnings per share growth. In addition the UK equity market is heavily weighted towards financials and mining companies, both of which are suffering cyclical downturns. The financial sector would also be adversely affected by a British exit (Brexit) from the European Union. The country goes to the polls to vote on a referendum on this in about eight weeks time. The result is hard to pick at this stage, but already enough damage has been done to the once dominant Cameron government to affect its capacity to focus on economic policy that will boost growth.

Monetary policy is still very supportive of financial asset prices with interest rate confirmed again at its 300 year low. Even if the Bank of England starts raising rates in the next year, they will hardly rise enough to undermine equity prices, which continue to look too expensive to be justified by the prospects of earnings per share growth.

AUSTRALIA

Monetary policy in Australia is close to neutral with the RBA keeping its key rate on hold at 2.0% p.a. last month. The most recent Consumer Price Index announcement on 27 April surprised the market by showing a fall of 0.2% in the March quarter, with the year on year rate falling back to 1.3% p.a., which is below the RBA target range of 2% to 3% p.a. The market now assesses the chance of the RBA cutting its official rate next week at 50%.

The RBA may well not act on this latest reading, preferring to wait for more confirmation from subsequent data. At this stage growth in the economy looks fairly good at 3.0% p.a. in real terms or 4.3% p.a. in nominal or money terms.

The RBA has 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 2.5% p.a. Should Australian inflation readings continue to be lower than expected or a global downturn occur, a cut in the rate by the RBA to 1.5% p.a. in two steps of 0.25% would not surprise us.

IN SUMMARY

- The Australian equity market is still in the fair value range and is significantly more attractive than most international markets.
- The US equity market is still reasonably attractive compared with other international markets on a long-term valuation basis.
- There is still the prospect of instability in monetary policy and financial market reactions to it, so 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.

The importance of equities in investment strategy cont.

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 26 APRIL 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2094	1925	1732	2310	Hold
Canada	S&PTSX	13826	10152	9137	12182	Reduce
Japan	Nikkei 225	17353	11423	10280	13707	Reduce
Britain	FTSE 100	6284	3290	2961	3948	Reduce
Germany	DAX	10262	6406	5765	7687	Reduce
France	CAC	4526	2816	2535	3379	Reduce
Australia	ASX S&P 200	5220	5852	5267	7022	Accumulate
Brazil	Bovespa	52029	25575	23018	30690	Reduce
Russia	MICEX	1936	2789	2510	3347	Accumulate
India	BSE SENS	26007	23331	20998	27997	Hold
China	Hang Seng	21407	23074	20767	27689	Hold
World Ex Aust	MSCI World Ex Australia	1695	1320	1188	1584	Reduce
AUSTRALIAN MARKET SECTORS						
ASX AREITS	ASX AREITS	1390	2330	2097	2796	Accumulate
ASX Financials	ASX Financials ex AREITS	6457	6846	6162	8215	Hold
ASX Materials	ASX Materials	7757	4869	4382	5842	Reduce
ASX Energy	ASX Energy	7535	4526	4074	5432	Reduce
ASX Industrials	ASX Industrials	5117	5897	5308	7077	Accumulate

These indicators are sending the same message as the valuation indicators in table 3:

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.

This document and its contents are general in nature and do not constitute or convey personal advice. It has been prepared without consideration of anyone's financial situation, needs or financial objectives. Formal advice should be sought before acting on the areas discussed. This document is a private communication and is not intended for public circulation other than to authorised representatives of the Madison Financial Group and their clients. The authors and distributors of this document accept no liability for any loss or damage suffered by any person as a result of that person, or any other person, placing any reliance on the contents of this document.