

# Investment Market + Portfolio

# UPDATE

29 January 2016

## Summary of key points

- ▶ Financial markets and the media are consistently preoccupied with short-term assessments of events such as the US Federal Reserve decision to lift interest rates for the first time in nine years and more recently the weakness in the Chinese stockmarket.
- ▶ There's a lot that investors could worry about. An incomplete list could include a British exit from the EU, political turmoil in Europe stemming from the refugee crisis, an Iran vs Saudi Arabia war, renewed fighting in Korea, naval battles in the South China sea, the election of Donald Trump as President of the USA, the Fed making a mistake and raising interest rates too quickly, Oil at \$20 per barrel, iron ore at \$25 per tonne.
- ▶ All of these feed into the collective angst which is gripping markets and they should not be totally ignored but in our view their influence on equity markets is offset by the continued very low level of interest rates and the size of the ongoing stimulus from monetary policy.
- ▶ The US Federal Reserve has just decided to keep its Federal Funds Rate target unchanged while it assesses the impact of global developments on the US economy.
- ▶ Stockmarket declines around the world have been significant in recent weeks but not catastrophic. Their significance lies in the opportunity that they may offer for accumulation of stocks at attractive prices.
- ▶ As we have concluded from our long-term Global Equity Fair Price Analysis, equities in the USA and Australia are attractive from a medium to longer-term point of view over the next three to five years.
- ▶ We expect the equity markets to continue to offer returns, which are attractive relative to cash and fixed interest over the medium to longer term of five to ten years.
- ▶ 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 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 27 JAN 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	4946	2.2%	2.2%	-10.3%	-10.3%
USA: S&P 500	1960	2057	1903	4.9%	28.9%	-7.5%	1.0%
UK: FTSE 100	6743	6620	5875	-1.8%	10.8%	-11.3%	-11.9%
GERMANY: DAX	9833	11083	9766	12.7%	13.0%	-11.9%	-6.5%
FRANCE: CAC	4422	4869	4327	10.1%	10.4%	-11.1%	-5.7%
JAPAN: NIKKEI 225	15162	20235	17163	33.5%	35.6%	-15.2%	-4.4%
CHINA: HANG SENG	23200	26250	19052	13.1%	38.9%	-27.4%	-20.8%
CURRENCIES							
USD/AUD	0.943	0.7679	0.7034		22.8%		9.2%
GBP/AUD	0.5511	0.4881	0.4919		12.9%		-0.8%
YEN/AUD	95.32	93.81	83.22		1.6%		12.7%
EUR/AUD	0.6886	0.6866	0.6472		0.3%		6.1%
INTEREST RATES							
AUS: 90 DAY BANK BILL % P.A.	2.68	2.19	2.27	-0.49		0.08	
AUS: 10 YEAR GOVT BOND % P.A.	3.54	3.01	2.69	-0.53		-0.32	
US: FED FUNDS RATE % P.A.	0.09	0.13	0.37	0.04		0.24	
US10 YEAR GOVT BOND % P.A.	2.53	2.32	2.00	-0.21		-0.32	
COMMODITIES							
COPPER US \$ PER TONNE	7035	5767	4539	-18.0%	0.7%	-21.3%	-14.1%
GOLD USD/OUNCE	1326	1175	1117	-11.4%	8.8%	-4.9%	3.8%
OIL USD/BARREL (WTI)	105	58.29	30	-44.5%	-31.8%	-48.5%	-43.8%

Since late December sentiment in equity and commodity markets has changed although it is not as clear whether the underlying fundamentals are really all that different. Stockmarket declines around the world have been significant but not catastrophic. Australian equities are down 3% since mid December, whilst most major international markets have fallen more heavily in local currency terms. The impact on Australian investors has been cushioned somewhat by the fall in the Australian Dollar against the US Dollar, Yen and Euro.

The price of oil has fallen more sharply, down 11% since mid December. This has potentially widespread implications. These include:

- An increase in defaults by emerging market borrowers and oil companies in the US, leading to much higher bad debt write offs by major global banks;
- Sustained weak inflation and perhaps the emergence of deflation in Japan and elsewhere.

Meanwhile both short term interest rates and long term bond yields have remained relatively stable at historically low levels, with the exception of US ten year treasury bond yields which have tracked significantly lower over recent weeks. As we have said before, ad nauseam, both short and long term interest rates remain supportive of financial asset prices in general and equity prices in particular.

While the US Federal Reserve has indicated that it may have four further interest rate increases of +0.25% p.a. over the next year, there is now some emerging doubt that it will do so. If it backed away from further increases this may be taken as a sign that the US economy is not as well as had been hoped. This would likely lead to more weakness in equity prices, but the reality is that in the medium to longer run, the continued cheap money would be a plus for equity prices.

This reality is reinforced by the words and possible actions for of the European

Central Bank, whose president, Mario Draghi last week made another of his "whatever it takes" speeches. It will likely be given even more weight when the Bank of Japan decides to extend its stimulus as it contemplates yet another year of not achieving its minimum inflation target of 2% p.a.

Over the next three to five years, buoyed by the continued unprecedented level of monetary support, equity returns look set to continue to outpace bonds and cash interspersed with some short-term sell-offs. By and large these episodes should be awaited patiently and be seen as long-term accumulation opportunities.

In the longer run, eventually the central banks will have to unwind all of their stimulus, but that day still seems some way off. There will be a time for greater caution, selling equities and moving back into cash, but that is not now.

# What to do next with Investment Portfolio Strategy

- The allocation to Australian and international equities should be cautiously increased back up to benchmark levels over the next three to six months for portfolios that are underweight, or 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 and infrastructure, for the time being as, even though AREITS look cheap based on the valuation indicators, the sector is often correlated with the broader equity market and may well decline if there is a broader pull back in Australian equities.
- Fixed interest should be underweighted. Returns on typical bond portfolios and bond funds will continue to be low.
- 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
<b>ASSET CLASS</b>						
Cash				✓		
Fixed interest			✓			
Property & infrastructure				✓		
Australian equities				✓		
International equities				✓		
Alternative equities					✓	

# The role of equities in investment strategy

For most investors, equity investments are a significant part of their portfolio. They are the major driver of long-term returns as well as the cause of short-term volatility in portfolio value. Equities generally provide better long-term returns than cash or fixed interest but this comes at a price. The “price” of the extra return is having to put up with greater volatility of returns over shorter-term periods usually of one year or less.

The extra returns from equities come from the beneficial effects of leverage, which is also an underlying factor in the short-term volatility in equity earnings and prices. Leaving aside differences in how well particular companies are managed, their earnings will generally grow faster than their revenue because much of their costs are relatively fixed. Their costs do not grow in line with revenues. This is called operating leverage. Most companies also have the benefit of financial leverage as well, which, when used prudently by companies, is almost always useful in accelerating earnings per share growth. It is even more useful when interest rates are very low as they are now. Not all companies will benefit equally from global growth, as there is a wide variation in circumstances and managerial capability. Therefore care is warranted in selection of companies in a share portfolio or in the selection of fund managers who in turn can select the companies for the portfolio.

We also need to be clear that we cannot predict short-term movements in market prices. We cannot know whether we are buying in at the bottom of a dip. We can however assess the current market prices against an objective valuation based on long-term assessment of earnings per share growth and the yield available on long-term government bonds. We cannot control market movements but we can control how we react to them.

We 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 1900. Conversely the Japanese and European equity markets look quite expensive. At the same time our Fair Price analysis is indicating that if the ASX 200 is at levels at levels below 4900, Australian stocks are offering attractive long-term returns, although some specific sectors such as Materials (BHP, RIO) still look expensive even at their now reduced prices.

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:** 27 January 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator – scenario weighted (lower is better)	88%	113%	77%
Momentum Indicator	Neutral	Neutral	Neutral
Qualitative Indicator	Neutral	Neutral	Neutral

# The role 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. 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 low bond yields will provide continued support for equity prices, particularly in interest rate sensitive sectors such as real estate trusts.

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:** 27 January 2016

*No changes to assumptions since last analysis.*

		REAL GDP GROWTH % P.A.	INFLATION % P.A.	EPS GROWTH % P.A.
<b>AUSTRALIAN EQUITY MARKET</b>				
<b>ASX S&amp;P 200</b>		2.25%	2.00%	2.25%
<b>ASX AREITS</b>		2.25%	2.00%	1.25%
<b>ASX FINANCIAL EX AREITS</b>		2.00%	2.00%	0.50%
<b>ASX MATERIALS</b>		2.25%	1.00%	1.25%
<b>ASX ENERGY</b>		2.00%	1.00%	1.00%
<b>ASX INDUSTRIALS</b>		2.25%	2.00%	2.25%
<b>INTERNATIONAL EQUITY MARKETS</b>				
<b>USA</b>	S&P 500	2.50%	1.50%	2.50%
<b>CANADA</b>	S&PTSX	2.50%	1.50%	2.00%
<b>JAPAN</b>	Nikkei 225	1.00%	1.00%	0.50%
<b>BRITAIN</b>	FTSE 100	2.50%	1.50%	2.00%
<b>GERMANY</b>	DAX	2.25%	1.25%	1.50%
<b>FRANCE</b>	CAC	1.75%	1.25%	1.00%
<b>ITALY</b>	FTSE MIB	1.25%	1.25%	0.50%
<b>BRAZIL</b>	Bovespa	2.00%	6.00%	4.00%
<b>RUSSIA</b>	MICEX	1.50%	5.00%	2.50%
<b>INDIA</b>	BSE SENS	4.00%	5.50%	5.50%
<b>CHINA</b>	Hang Seng	4.00%	2.50%	2.50%



# The role of equities in investment strategy cont.

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

**Date:** 27 January 2016

**10 yr Bond Yield** = 2.69%

**Equity Risk Premium** = 5.00%

**Red** = Expensive (Above 120%)

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

**Green** = Cheap (Below 80%)

*Changed assumptions since last analysis highlighted in blue.*

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	88%	94%	107%	97%
CANADA	108%	114%	131%	118%
JAPAN	126%	131%	153%	138%
BRITAIN	150%	158%	182%	164%
GERMANY	127%	133%	154%	139%
FRANCE	131%	136%	159%	143%
AUSTRALIA	81%	85%	98%	88%
BRAZIL	133%	138%	161%	145%
RUSSIA	79%	81%	96%	86%
INDIA	95%	101%	116%	105%
CHINA	67%	69%	81%	73%
MSCI	103%	109%	125%	113%
AUSTRALIAN MARKET SECTORS				
ASX AREITS	71%	74%	86%	77%
ASX FINANCIALS	88%	91%	106%	96%
ASX MATERIALS	142%	147%	172%	155%
ASX ENERGY	84%	86%	101%	91%
ASX INDUSTRIALS	80%	85%	98%	88%

In summary, the valuation work indicates:

1. The US equity market is now fairly priced on a scenario weighted basis;
2. The European, British and Japanese equity markets are still expensive;
3. A worldwide equity portfolio based on the weightings in the MSCI international world index, would still be expensive;
4. The Australian equity market is slightly cheap on a scenario weighted basis;
5. 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 role 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 six to nine months has rendered the momentum indicators neutral and somewhat unstable, on a month-to-month basis.

## 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. Our current assessments are set out in table 4.

### USA

The US economy is growing at 2.5% p.a. in real terms and slightly above that level in money terms given the very low level of inflation at 0.2% p.a., which has been driven down in part by falling oil prices. Further interest rate increases have been foreshadowed by the Federal Reserve. They may not emerge if inflation remains subdued. Even if there are increases, they will be limited and gradual. The real rate of interest will likely continue to be negative and therefore supportive of investment for some time.

Real growth in the US economy is sufficient to support some continued growth in corporate earnings per share. The effects of growth are not evenly spread across the population, with real median wages lower now than they were thirty years ago. This is fuelling a sense of anger which is feeding into the political fortunes of Donald Trump. The possibility of his election as President is not really fully factored in by financial markets. If it becomes more of a prospect as we move towards election day in November, it may be another cause of market jitters.

### CHINA

Reported Real GDP Growth is holding at around 6.8% p.a. but we expect Real GDP growth to fall to 5% p.a. or below within the next two to three years. This will be a continuing negative influence on the prices of oil, coal and iron ore, with implications for Australia's major mineral exporters and through them the Commonwealth Government's revenues. Having said this the prospects of a hard landing by the Chinese economy appear to be overstated, with investors extrapolating from the parlous state of the Chinese equity markets back to the real economy. While manufacturing is in decline, the service sector is still expanding and now makes up just over 50% of GDP.

### JAPAN

Monetary policy is more supportive of both the economy and asset prices than it is in the USA and is very likely to become more expansionary as the Bank of Japan continues to chase its goal of having inflation at 2% p.a., well above the current rate of 0.6% p.a. In addition, fiscal policy is still highly

stimulative with the government deficit running at 6.8% of GDP. A key question is whether all of this stimulus will be enough to support better growth in corporate earnings per share so as to reduce the degree to which Japanese equities are over priced. Overall nominal GDP growth, which influences earnings per share growth, is just 1.3% p.a.

## EUROPE

Fiscal policy is still broadly supportive of economic activity, with EU governments on average running a deficit of 2.1% of GDP. Monetary policy is helpful for both the economy but has been disappointing financial markets despite the enlarged scale of the Quantitative Easing program that has been underway for some months. The disappointment has prompted the ECB to foreshadow significantly more stimulus, albeit acting within its mandate. Real GDP growth in the Eurozone is low at 1.5% p.a. while European equity markets are highly priced as if growth prospects were much higher.

## GREAT BRITAIN

Real GDP growth continues to be better than expected and is running ahead of the EU at 2.4% p.a. (versus 1.5% p.a.).

Monetary policy is still quite stimulatory. Interest rates are still at a 300 year low and even if the Bank of England starts to follow the US Fed in raising rates in the next year, they will hardly rise enough to undermine equity prices, but it has given no sign of this yet.

Fiscal policy is also very stimulatory with a deficit of 4.4% of GDP. A significant real risk to economic growth will come from the mounting political uncertainty about whether the British will vote in favour of leaving the EU. Given that the issue cuts across party lines, a yes vote is quite possible and it would foreshadow major disruption to many economic ties with Europe.

## AUSTRALIA

At this stage monetary policy in Australia is close to neutral. The RBA has kept its key rate on hold at 2.0% p.a. Should growth in the economy slow markedly, the RBA has scope to cut its Official Rate further. A rate of 1.5% p.a. in the next 6 months in two steps of 0.25% would not surprise us.

The possibility of a hard landing in China is a serious prospect even if it is less likely than many fear. It would mean there is still further risk to the Australian terms of trade and budget positions of the Federal government.

Based on the build-up of global supply in iron ore, the price could well fall towards \$30 per tonne or below.

As we have said previously, the banking sector may come under renewed pressure as more capital raisings are made in the next two years. Bank payout ratios are very high with dividends at more than 75% of earnings and are not immune to being cut.

We think that at the very least, bank dividend growth will be constrained but much of this is already factored into bank share prices as our valuation work indicates.

# The role of equities in investment strategy cont.

## IN SUMMARY:

- Given that momentum is essentially neutral, more reliance should be placed on the valuation and qualitative factors.
- 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 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 5% 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 27 JAN 2015	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	1903	1966	1769	2359	Hold
CANADA	S&PTSX	12331	10444	9400	12533	Hold
JAPAN	Nikkei 225	17163	12471	11224	14965	Reduce
BRITAIN	FTSE 100	5875	3576	3219	4291	Reduce
GERMANY	DAX	9766	7041	6337	8449	Reduce
FRANCE	CAC	4327	3025	2722	3630	Reduce
AUSTRALIA	S&P ASX 200	4946	5595	5036	6715	Accumulate
BRAZIL	Bovespa	37497	25829	23246	30995	Reduce
RUSSIA	MICEX	1722	2001	1801	2401	Accumulate
INDIA	BSE SENS	24489	23431	21088	28118	Hold
CHINA	Hang Seng	19052	26190	23571	31428	Accumulate
WORLD EX AUST	MSCI World Ex Australia	1661	1379	1241	1655	Hold
<b>AUSTRALIAN MARKET SECTORS</b>						
ASX AREITS	ASX AREITS	1297	1677	1509	2013	Accumulate
ASX FINANCIALS	ASX Financials ex AREITS	6484	6787	6109	8145	Hold
ASX MATERIALS	ASX Materials	6284	4057	3651	4868	Reduce
ASX ENERGY	ASX Energy	7078	7760	6984	9311	Hold
ASX INDUSTRIALS	ASX Industrials	4692	5322	4790	6387	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 sector of the Australian equity market;
2. Cautiously hold or accumulate in 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.*