

# Investment Market + Portfolio UPDATE

29 July 2016

## Summary of key points

- ▶ We expect to have low growth, low inflation and low interest rates for the next few years.
- ▶ Equity markets are pricing in low bond yields and growth in earnings that may not be sustainable, so caution is needed so as to not pay too much when investing in equities.
- ▶ Low inflation (below 4% p.a.) or even mild deflation has historically been good for equity returns over the long run and we expect conditions to favour long term equity investment.
- ▶ The good returns on equity come from a combination of low interest rates and the use of leverage or debt at these low rates. Leverage works both ways and can reduce capital values sharply in periods of economic slowdown when revenue growth goes into reverse.
- ▶ Investors seeking income returns will be better rewarded by investing in high quality equities (i.e. those that have a sustained ability to pay dividends above the long term bond yield) rather than fixed interest or cash, but total returns from equities, including capital movements, are very volatile over shorter run periods of up to three years.
- ▶ A key decision in portfolio strategy is how much to have in growth assets and this should mainly be driven by long term investment objectives and risk profile.
- ▶ Asset allocation of the portfolio on an ongoing basis involves a choice: either be static in asset allocation and stoic regarding short term return fluctuations or be nimble (and right) in anticipating short run shifts in relative prices of asset classes. Neither is easy to do well.
- ▶ A middle path or dynamic asset allocation approach will blend the advantage of long term asset allocation to equity or growth assets with some enhancement of returns via shifting between equities and cash.
- ▶ We adopt a dynamic asset allocation approach using analysis based on valuation, momentum and the assessment of qualitative factors such as fiscal and monetary policy as well as geopolitical stresses.
- ▶ Volatile market periods can offer opportunities to accumulate equities at better prices so that higher long-term returns are earned but this requires a sound valuation framework so that paying too much is avoided.
- ▶ Valuation points to the Australian and US equity markets being fairly priced at the moment, with all others looking expensive. Momentum factors are weak and unstable but currently mildly supportive of equities.
- ▶ Fiscal and monetary policies almost everywhere are supportive of asset prices in the longer run of five to ten years so be careful not to be too underinvested in growth assets.
- ▶ Geopolitical risks have increased in the USA, Britain and Europe as well as in China and Japan. We expect them to cause episodes where equity markets decline sharply for months at a time.
- ▶ These 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.
- ▶ Investors should use strategically set aside cash to invest in equities when prices are more attractive as part of a sound, long-term investment strategy.

# 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	LEVEL AT 26 JUL 16	CHANGE 2014/15 FINANCIAL YEAR		CHANGE 2015/16 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	5515	2.2%	2.2%	-5.1%	-5.1%	5.4%	5.4%
USA: S&P 500	1960	2057	2098.86	2168	4.9%	28.9%	2.0%	5.3%	3.3%	2.8%
UK: FTSE 100	6743	6620	6504.33	6710	-1.8%	10.8%	-1.7%	-14.1%	3.2%	0.8%
GERMANY: DAX	9833	11083	9680.09	10198	12.7%	13.0%	-12.7%	-10.5%	5.4%	3.6%
FRANCE: CAC	4422	4869	4237.48	4388	10.1%	10.4%	-13.0%	-10.8%	3.6%	1.9%
JAPAN: NIKKEI 225	15162	20235	15705	16397	33.5%	35.6%	-22.4%	-4.9%	4.4%	1.9%
CHINA: HANG SENG	23200	26250	20794	21977	13.1%	38.9%	-20.8%	-18.3%	5.7%	5.2%
CURRENCIES										
USD/AUD	0.943	0.768	0.744	0.748		22.8%		3.2%		-0.5%
GBP/AUD	0.551	0.488	0.558	0.571		12.9%		-12.5%		-2.3%
YEN/AUD	95.32	93.81	76.6	78.479		1.6%		22.5%		-2.4%
EUR/AUD	0.689	0.687	0.67	0.681		0.3%		2.5%		-1.6%
INTEREST RATES										
AUS: 90 DAY BANK BILL % P.A.	2.68	2.19	2.00	1.89	-0.49		-0.19		-0.11	
AUS: 10 YEAR GOVT BOND % P.A.	3.54	3.01	2.00	1.92	-0.53		-1.01		-0.08	
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	1.56	-0.21		-0.86		0.10	
COMMODITIES										
COPPER US \$ PER TONNE	7035	5767	4845	4899	-18.0%	0.7%	-16.0%	-13.3%	1.1%	0.7%
GOLD USD/OUNCE	1326	1175	1328	1320	-11.4%	8.8%	13.0%	16.6%	-0.6%	-0.6%
OIL USD/ BARREL (WTI)	105	58.29	48.46	43.16	-44.5%	-31.8%	-16.9%	-14.2%	-10.9%	-11.3%

Since the last Update at the end of June:

- Short-term interest rates in Australia have declined further while short term rates in the USA have risen slightly but are still very low;
- Long term bond yields in Australia have declined, flattening the interest rate yield curve. This is often an early indicator of an approaching recession.
- Long-term rates in the US rose slightly but the yield curve is still very low and not very steep. The prospect of slow growth or recession in the USA is being signalled by the bond market;
- The AUD has risen against all major currencies taking the edge off improved returns on international assets;
- The oil price has reversed recent rises indicating weaker demand while copper prices, an indicator of industrial demand, have been relatively static;
- Equity markets worldwide have recovered from the shock of Brexit in late June. The recovery has largely been driven by the pursuit of yield and returns in an environment where bond yields are at record lows and in many places have turned negative;
- The bond markets appear to be signalling weaker economies exacerbated by more difficult political conditions in some major countries. The low bond yields may be due more to sustained repression arising from central bank buying during so called quantitative easing programs. Bond yields may in fact be artificially low and the outlook for the economy may not be as bad as it seems;
- Equity markets are certainly behaving as if the outlook is not bad at all. They have all bounced well in the last month. Overall momentum in equity markets has recovered but may change at any time as sentiment has shown itself to be quite unstable in the last year;

# What to do next with Investment Portfolio Strategy

- Investors should use strategically set aside cash to invest in equities when prices are more attractive as part of a sound, long-term investment strategy.
- Meanwhile, 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. 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 twelve to eighteen 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.
- 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.
- 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 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
<b>ASSET CLASS</b>						
Cash					✓	
Fixed interest		✓				
Property				✓		
Australian equities			✓			
International equities			✓			
Alternative equities					✓	

# Current assessment of equity asset markets

Growth or equity assets are the key drivers of long-term portfolio returns. It is important to allocate enough to equity assets to drive returns without paying too much for growth. This leads us 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**

**Equity Market Assessment:** 26 July 2016

ASSET CLASS	AUSTRALIAN EQUITIES	INTERNATIONAL EQUITIES	PROPERTY (AREITS)
Valuation Indicator (scenario weighted, lower is better)	104%	135%	113%
Momentum Indicator	Stronger	Stronger	Stronger
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 equity 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.

Our assessments of earnings per share growth rates are unchanged since the last Update. 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**

EPS growth assumptions over ten years as at 26 July 2016

*Changed assumptions since last analysis highlighted in blue.*

		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%	1.75%
<b>ASX AREITS</b>		2.00%	2.00%	2.00%
<b>ASX FINANCIAL EX AREITS</b>		2.00%	2.00%	1.50%
<b>ASX MATERIALS</b>		3.50%	1.00%	2.50%
<b>ASX ENERGY</b>		3.50%	1.50%	2.50%
<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%	2.00%
<b>CANADA</b>	S&PTSX	2.50%	1.50%	2.00%
<b>JAPAN</b>	Nikkei 225	0.75%	0.75%	0.50%
<b>BRITAIN</b>	FTSE 100	2.00%	1.25%	0.75%
<b>GERMANY</b>	DAX	2.00%	1.00%	0.50%
<b>FRANCE</b>	CAC	1.50%	1.00%	0.00%
<b>INDIA</b>	BSE SENS	3.00%	5.50%	4.50%
<b>CHINA</b>	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 and other emerging political instability such as in the USA and China 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.*

Global Equity Market Valuation indicators

**Date:** 26 July 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	SCENARIO WEIGHTED
Probability of scenario	40%	20%	30%	100%
<b>EPS AND EPS GROWTH ASSUMPTIONS</b>				
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	116%	118%	137%	123%
Canada	128%	130%	151%	136%
Japan	143%	144%	169%	152%
Britain	151%	152%	179%	161%
Germany	160%	160%	189%	170%
France	184%	184%	218%	196%
Australia	98%	99%	116%	104%
India	128%	130%	151%	136%
China	96%	95%	113%	101%
MSCI	127%	129%	150%	135%
<b>AUSTRALIAN MARKET SECTORS</b>				
ASX AREITS	107%	108%	126%	113%
ASX Financials	87%	88%	103%	93%
ASX Materials	137%	138%	161%	145%
ASX Energy	361%	365%	427%	384%
ASX Industrials	88%	90%	104%	94%



# Current assessment of equity asset markets

In summary, the valuation work indicates that:

1. There are no longer any cheap equity markets. Slower earnings per share growth prospects now counterbalance the positive effect of very low long-term bond yields.
2. The US equity market is at a record high and now 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. Overall, on a scenario-weighted basis, the US equity market is bordering on expensive for Australian based investors.
3. The European, British and Japanese equity markets are all still expensive under all scenarios that we have identified. As these markets make up over 30% of the world market, they make a global equity portfolio would still be expensive overall.
4. The Australian equity market is still fairly priced on a scenario weighted basis 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. It is time to consider taking profits in the AREITs sector.

## 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 have now shifted and have a slightly positive influence on returns over the subsequent twelve month period. However the effect is not strong and may not last.

## 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

The prospect of a tightly contested US presidential election between two almost equally unlikeable candidates may destabilise US consumer sentiment and economic growth, which has already been quite subdued compared with many other recoveries. Growth is still positive at 2.1% p.a. in real terms and 3.1% p.a. in nominal or money terms but it is prone to become fragile. The Federal Reserve may yet increase interest rates once this year even though it 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. As we have said before, the retreat by the Fed has given support to the equity markets that have now reached record levels in spite of some slowdown in earnings

growth. The low cost of money is offsetting weaker earnings growth and keeping the US equity market at or near its record high for the short term at least.

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. Our assessment is that neither Trump nor Clinton is likely to find it easy to negotiate more stimulatory fiscal policy with the US Congress, even for supposed populist causes such as wall building.

While earnings on US equities are down some 18% from their 2014 peak, there are three powerful forces underpinning equity prices which in aggregate are now at record levels:

- The resilience of US economic growth, albeit slower than previous recoveries;
- The stimulus from monetary and fiscal policy, albeit these are not becoming more stimulatory; and
- The lack of attractive alternative investments.

### CHINA

The strong growth in China in the first half of the year was largely supported by much looser credit fostered by the economic leadership of Premier Li. Credit has grown 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. This stronger credit growth has led to a sharp and semi-public dispute between Premier Li and the more powerful President Xi, who has been taking steps to take over economic policy in recent months. In our assessment there is now an increased risk of a sharper slowdown in Chinese GDP growth as well as demand for imports of iron ore and coal.

# Current assessment of equity asset markets

Nominal GDP growth has been running at 8.7% p.a. down slightly on earlier rates, but we now allow for a nominal GDP growth rate of just 6.0% p.a. over the next ten years in our long term equity market valuation for China. Overall the qualitative factors in China are still currently either slightly positive or neutral in terms of their effect on global equity markets, but this will weaken over the coming year.

Longer term, China will continue its march into the middle class along with a growing cohort of wealthier citizens. The main risks to this are a threat to Communist party rule due to internal disputes or a miscalculation in its military expansion in the seas to its east. The risk of a real war with either or both of Japan and the USA has increased somewhat over the last year but is still low. The prospect seems still too far away to have a discernible impact on the prospects for investment returns over the next five to ten years. Should warfare occur the US still has enough naval and air power to prevail, but not without incurring major losses to a much-strengthened Chinese navy. This may make the US think twice before committing to defend the western pacific region, especially under a Trump presidency. The more proximate risk is that of a sharper than expected economic slowdown in the next two to three years, but episodes of antagonism between the US and China would exacerbate market panics.

## JAPAN

The Abe government won a big majority in the recent upper house elections. This improves its ability to put in place important structural reforms, which are sorely needed to achieve longer-term growth in the economy. Reform is also needed to arrest the decline in the population and the size of the labour force, which has accelerated in recent years. Immigration, which benefits many economies, is an unlikely source of a solution. An increase in the birth rate seems to be a long shot as well.

While the Abe government has enhanced its capacity to act decisively on the economy it may well not do so. It may instead focus on defence and foreign policy especially given the rise in tensions in the South and East China seas. The Bank of Japan may well need to do even more to support the economy even though the strength of the effect of monetary stimulus on economic growth is not at all clear. Japanese ten-year bond yields are now firmly negative and this is putting pressure on the profitability of Japanese banks and insurers that hold large amounts of bonds. For example regional banks are predicting an 18% year on year fall in profits. The pressure is forcing a pursuit of borrowers especially in the real estate sector with developers now being offered fifty-year low interest fixed rate loans.

Fiscal policy is also very loose with the government deficit running at 6.1% of GDP. As we have said before neither this nor 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 and the decline and ageing of the population.

## 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. There is the prospect that it may be well managed by the new Prime Minister Theresa May. The government needs to act decisively to combat growing uncertainty that could well see investment spending deferred substantially, to avoid real GDP growth stalling or slumping. Wages growth is slow. While inflation has been low this has been tolerated to a degree. That tolerance would wear thinner if inflation picked up, spurred by the effect of a falling pound boosting the prices of much needed imports.

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.

## EUROPE

The EU awaits the start of the real exit negotiations with Britain. Meanwhile deflation across the Euro zone as a whole is now a reality as is the spread of the negative long-term interest rates. Fiscal policy is still broadly supportive of economic activity, with EU governments on average running a deficit of 1.9% of GDP. This is much less so than that of the USA, Britain or Japan because fiscal austerity is still an underlying aim of many policymakers in Europe.

The ECB's monetary policy is stimulatory but legally constrained from doing much more. We expect it to remain much as it is until at least 2020. Interest rates are however low enough or negative enough to be very supportive of high equity prices. Most European equities are very expensive from the viewpoint of an Australian investor and are likely to remain so for some time. Eventually some crisis will force them into a sharp decline. The main candidate for a trigger for this in the short to medium term is the level of bad debts in the undercapitalised Italian banking system. The EU did not deleverage debt as quickly as the US in the wake of the GFC. The European banks are generally more fragile than their US counterparts. The Italian banks need to raise equity capital to meet regulatory minimum standards but it is very expensive. The Italian government is prohibited from providing capital to the banks under EU rules. The resolution needed in this large and systemically important country may be that it needs to leave its membership of the EU that it helped found in the 1950s. The example of Brexit may be too tempting to ignore especially with the government under pressure from the Eurosceptic Five Star and Liga Nord parties, which are growing in electoral strength in the major cities. Meanwhile it is the risk emanating from the Italian banking system that is part of the impetus driving investors to pay governments to borrow their money via negative bond yields in Germany, Switzerland, Sweden and Denmark.

## TURKEY

Turkey has had a failed coup that has led to the assertion of even stronger control over the military, the judiciary and the education system by President Erdogan. Geopolitically Turkey is important. It has a large population that is becoming wealthier. It acts as a bridge between western Asia and Europe as well as bulwark against both radical Islamists in Syria and Iraq and also as key member of NATO versus Putin's Russia. Either the EU or the USA, both of which need Turkey, will not unduly sanction it. Overall the economic impact will be slight and short lived. Except for dedicated fans of emerging market equities and bonds it will remain a low priority as an investment destination.

## OIL

Oil seems to be stuck in a channel of between USD40 and USD 50 per barrel. Some major Gulf producers need a price well above USD 50 to balance their national budgets (UAE USD70, Saudi Arabia USD66 and Kuwait USD52). In theory they should cut production to force the price up, but in doing so they would merely cede market share to others such as Nigeria, Russia and Venezuela, all of which have great need of foreign exchange earnings. No major producers are cutting supplies. They pump oil at lower than desired prices to make up cash flow from volume rather than price, as long as it sells for at least USD25 per barrel, their marginal cost of extraction. Meanwhile highly leveraged shale oil producers in North America may well go bankrupt at prices below USD50, but the production from their wells does not stop. The new owners (banks and others) will pump oil as long as it selling above the marginal cost of production which now does not include interest servicing costs on loans that have been written off. The world will therefore continue to be awash with oil that is much cheaper than it was two years ago. This will continue to anchor a low inflation rate.

## AUSTRALIA

Following the interest rate cut in May, the RBA left it unchanged both in June, in the run up to the election and in July following the very close result. We thought that the election was 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. This now seems the reality that the Turnbull government will inhabit until it dares to go to the polls again. We expect little overall change in fiscal policy that should be mildly supportive of economic growth.

The RBA has again noted that the rate of growth in China has moderated and that Australia's terms of trade remain much lower than in recent years.

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 between 1.0% p.a. and 1.5% p.a. over the next year would not surprise us.

Overall the Australian equities market seems close to being fairly priced, by which we mean that an investor could expect a ten-year total return from dividends, growth and franking credits of about 8% p.a.

This overall picture masks different sectoral prospects. The materials sector is suffering a bleaker outlook that is not yet fully factored into prices. For example the iron ore price on which Rio and BHP and other depend for higher profitability was assumed to be USD55 per tonne as recently as the May Budget by the Commonwealth Treasury. This followed a run up in the first four months of 2016 boosted by vast amounts of iron ore futures speculation on the Dalian market in China, fuelled by much stronger credit growth under Premier Li's policies. Now that President Xi may rein in credit growth in China the outlook for iron and coal may change. The Office of the Chief Economist of the Commonwealth Department of Industry has recently revised its forecast price for iron ore down to USD44.80 per tonne. At this price the Federal Budget would have an additional AUD 13 billion on its deficit for 2017.

While populist politicians in South Australia, Queensland, Britain, France and the USA may achieve electoral success in rallying against globalisation, the real economy and financial markets are well and truly linked to global factors. The materials and energy sectors are still vulnerable and overpriced.

The banking sector is priced closer to fair value but it has its own pressures. The stocks are offering very attractive dividends, which by them achieve the required fair price 8% p.a. return over ten years, assuming the prices remain stable. This may not happen given that the major banks have to raise more capital to meet regulatory safety standards. They may also have difficulty maintaining their dividend rates given the high rate of payout required to do so combined with pressure on their return on equity (ROE) due to eroding net interest margins (NIM). For example, a reduction in the NIM of 0.5% p.a. such as they have experienced on home loans over the last three years would, if sustained, translate into a 5% p.a. reduction in their overall ROE from above 15% p.a. to well below that level. This is the result of the banks having over 50% of their margin earning assets in home loans combined with their true leverage of around 20 to 1. A reduction in ROE eventually drives a cut in dividend payouts.

Having said this, the banks' ordinary shares still offer a superior return for risk compared with the newer bank convertible preference shares (hybrids). The gap in the gross dividend yields has grown from +1.5% p.a. in favour of the ordinary shares in 2014 to over 5% p.a. in 2016.

With the exception of a few stocks such as Westfield, property securities (AREITs) are relatively sheltered from direct global pressures. They continue to look attractively priced by virtue of their income yields ranging mainly from 4% p.a. to 6% p.a. versus bonds at around 2% p.a.



# Current assessment of equity asset markets

## IN SUMMARY:

- The Australian equity market is 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	CURRENT LEVEL AT 26 JULY 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
USA	S&P 500	2168	1758	1583	2110	REDUCE
Canada	S&PTSX	14498	10672	9604	12806	REDUCE
Japan	Nikkei 225	16411	10812	9730	12974	REDUCE
Britain	FTSE 100	6710	4178	3760	5013	REDUCE
Germany	DAX	10198	6013	5412	7216	REDUCE
France	CAC	4388	2244	2020	2693	REDUCE
Australia	ASX S&P 200	5515	5288	4759	6345	HOLD
India	BSE SENS	28086	20609	18549	24731	REDUCE
China	Hang Seng	22192	21948	19753	26337	HOLD
World ex Aus	MSCI World ex Australia	1723	1274	1147	1529	REDUCE
AUSTRALIAN MARKET SECTORS		CURRENT LEVEL AT 26 JULY 2016	FAIR PRICE LEVEL	ACCUMULATE BELOW	REDUCE ABOVE	IMPLIED ACTION
ASX AREITS	ASX AREITS	1547	1364	1227	1636	HOLD
ASX Financials	ASX Financial ex AREITs	6683	7209	6488	8651	HOLD
ASX Materials	ASX Materials	8446	5813	5232	6976	REDUCE
ASX Energy	ASX Energy	8381	2182	1964	2619	REDUCE
ASX Industrials	ASX Industrials	5519	5874	5287	7049	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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