QUARTERLY REVIEW – February 2018

Equity returns for the 2017 calendar year were rather polarised. Here in Australia, the ASX 200 rose by just on 7% over the year. The only other major bourse to record single digit growth was the UK FTSE (7.6%). At the opposite end of the spectrum, the HK Hang Seng index rose by 36%, the US Dow Jones by 25% and the Japanese Nikkei posted 19%. Sitting somewhere in between, the German DAX grew by 12%. These differences reflect prevailing macro-economic conditions and company fundamentals (ie where markets are in their business cycles). To this point, economic growth and company earnings have not been synchronized across the globe, however, many economies now appear to have turned the corner – see "The Macroeconomic Environment is the Litmus Test".

Despite a positive end to the calendar year and solid returns through January 2018, over more recent weeks, we have now seen share markets around the globe pull back amidst concerns about rising interest rates and falling bond prices. The Dow Jones gave back over 10% in the first four trading days of February (its biggest fall since December'15), whilst here in Australia, the ASX 200 fell by around 5%. It is therefore timely to ask whether this is the start of something more sinister or an overdue technical correction.

So what happened to markets in early February

For some time now share prices (particularly in the US) have been rising consistently without drawing breath. The longer this trend persists, the more likely "investors" are to look for reasons to take profits.

For almost eighteen months, bond rates have been rising (which over an extended period of time, counters against equities). In late January, longer term treasury and bond rates "spiked" (they actually only went up a little bit more quickly than they had been), however, this jolted inflationary expectations and generated an equities sell-off that was exacerbated by the collapse of several complex volatility-linked funds and algorithmic trading strategies. As Macquarie Research noted at the time, "computer and passive investment driven markets are not good at deep analysis but prefer to shoot first and think later."

Historically, rising interest rates are bad for equities. The cost of capital increases for companies, consumer spending slows and (over time) bonds become a more attractive investment than equities.

In response to these issues we would note that US interest rates in this post-GFC cycle were dropped to zero and, even after five rate rises, US rates are still at historic lows. In terms of bonds it is important to note, however, that whilst ever interest rates continue to rise, bonds remain a risky investment due to the inverse relationship between yield and price. That is, as interest rates rise, the price of bonds fall, thereby generating capital losses for the investor. Investors are not currently pulling their funds out of equities and putting them in bonds, merely taking profits and holding cash for the next opportunity to buy the dip.

Is the bull market finally over?

There is an old investing adage that says "bull markets don't die of old age" (nor do they just run out of steam). Share markets need a significant jolt to switch momentum to the downside for an extended period of time – witness the GFC, the Asian financial crisis, the tech wreck, the great depression, etc. We would need to see a significant macro event to cause the "death" of this bull. Commentators often point to "the usual suspects" in this regard, including recession, rising interest rates or war. But in terms of the macro facts presented below, its hard to see either a recession or over-heated economy (leading to rates being increased higher, or more quickly, than would be prudent).

We also often talk about fundamentals and in particular whether markets are relatively expensive or relatively cheap (over-priced markets can be subject to corrections). The metric of choice here is the price earnings (or PE) ratio. Based on the oft-quoted Shiller PE (a 10 year rolling average), the US market is at its highest level since the "dot com" days (higher than pre-GFC) – at around 33 times. This is hardly surprising given the retrospective nature of the Shiller measure and the growth we have witnessed in US company earnings. If we adopt a forward looking metric (say, the 12 month expected operating EPS), the US market is well down from the dot com boom and below pre-GFC levels – at around 24 times, it is high but not "exuberant".

There has been some commentary around a graph released late last year by Bank of America-Merrill Lynch which shows the relationship between the Federal Reserve's balance sheet and the S&P 500. The correlation between market returns and liquidity has been strong (to say the least) – see below:

Chart 4: Fed balance sheet has peaked, ECB & BoJ to follow

Source: BofA Merrill Lynch Global Research, Bloomberg

The simplistic view is that in the absence of liquidity, markets will inevitably fall. A more holistic interpretation of the graph is that (indeed) monetary policy has been driving economic activity to the point where macro-economic factors are now leading the market higher. There is a risk that if withdrawn to quickly, “the patient might relapse” but the Federal Reserve is clearly taking a steady as she goes approach to monetary policy.

The Macroeconomic Environment is the Litmus Test

The International Monetary Fund has estimated that global economic growth will rise from 3.6% in 2017 to 3.7% in 2018. Growth actually bottomed in 2016 and has been steadily recovering across all economies – we have now seen six quarters of above average global growth. Domestic demand is now growing in all major regions with the rising tide is likely to lift all boats, despite the managed slow down underway in China. This improvement in domestic demand has been accompanied over more recent times by improvement in business investment (even here in Australia) and this has seen global exports rebound with continued growth likely over coming years.

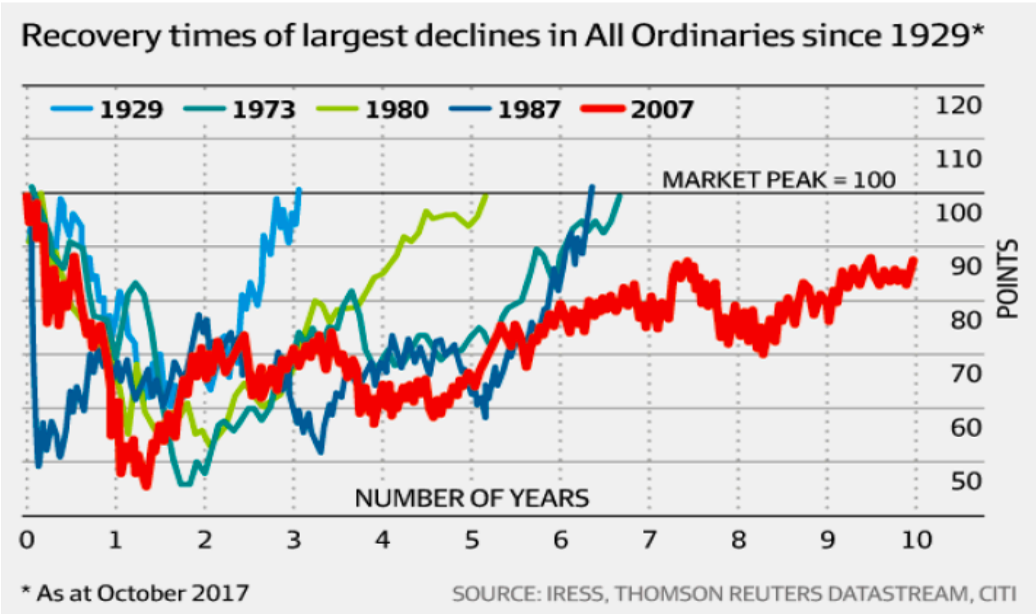
Along with this positive growth backdrop, interest rates sit at historic lows, the inflation genie remains in the bottle and oil prices (thanks to non-OECD supply) remain low.

Anatole Kaletsky (Economic Consultant, Chairman of the Institute of New Economic Thinking and Governing Counsellor of the Royal Economics Society), writing for Portfolio Construction Forum in Nov’17 noted that “What many analysts still see as a temporary bubble, pumped up by artificial and unsustainable monetary stimulus, is maturing into a structural expansion of economic activity, profits and employment that probably has many more years to run.”

OUTLOOK

The macro economic backdrop remains supportive around the globe, both now and into the foreseeable future. We see Australia at an earlier stage in the business cycle with consequential potential for the ASX to outperform the Dow Jones in 2018. In this regard, the current profit reporting season in Australia which is just completing has seen over 90% of companies declare profits - the highest level since before the GFC.

Paul Taylor (Head of Equity Investments at Fidelity) writing in the AFR late last month postulated that Australia was benefiting from the aftermath of the GFC. He noted that the "2007 crisis was a balance sheet down turn, which take longer to recover from. But on the upside, the length of the recovery and the repair work done to corporate balance sheets has helped to build a stronger foundation for the market."



We acknowledge that there are some uncertainties on the horizon (eg the likely pace of US interest rate increases, the budgetary impacts of Trumps company tax cuts & infrastructure spending, levels of margin lending, geo-political instability - to name a few); but the probability attaching to these "black swans" is not high. That said, simmering concerns about these, and similar issues, will see equity markets subject to considerably more volatility over 2018 than has been the case over recent years.

We believe a first quarter floor is now in pace for Australian & Global equities. If the ASX 200 stays above 5,850 over coming weeks, it is then likely to take out the post-GFC high of 6,150 on its way to a (new) seasonal high in late April. Given the trading patterns of markets to this point, we then expect a reasonable correction based on the "sell in May and go away" premise. The second half of the calendar year then looks quite promising with both US and (particularly) Australian markets potentially moving to new highs.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Overweight):** We expect a short term bounce in Australian stocks before a correction into May. Macro economic and fundamental metrics point to ASX outperformance in 2018.
- **Global Equities (Slightly Underweight):** The US market is looking vulnerable after a number of strong years. Uncertainty about "Quantitative Tightening" may spook markets.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and reductions to interest rates), but these macro tailwinds have now fully abated. REITs are off over 12% since December.
- **Fixed Interest (Slightly Overweight):** Given the level of interest rates, it is preferable to hold less in cash and a little more in fixed interest instruments (such as income securities).
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes, our net cash position is slightly overweight.

Regards

Andrew & Stephen
23 February 2018