QUARTERLY REVIEW – March 2017

The Australian share market (ASX 200) rose by around 7% over the 2016 calendar year and with the tailwind afforded by the "Trump growth rally" it added a further 3% in the new year to post a 12 month high of 5,883 points on 16 February'17.

Last time we put pen to paper we were somewhat surprised by the speed with which markets were able to digest the "calamitous" news that was "Brexit". Shares around the globe dropped like a stone for 5 days and then pushed back up to make fresh highs within the following 5 days. In a similar vein, late last year, we were greeted by the unthinkable news that Donald Trump would be the 45th president of the United States and after less that 24 hours of carnage on equity markets, US stocks have now risen a further 16%, with the Dow Jones posting fresh all-time highs.

The rise in equities has been driven by the market's presumption that Trumps key economic policy measures (eg lower corporate taxes, increased spending on infra-structure, a reformed (read: lower cost) health system and reduced company regulation) are all stimulatory measures. The only problem is that investors have now "bought the rumour" or, to put it another way, they have already priced in much of the likely positive effect of Trump's stated policies, leaving markets exposed at some point to a "selling of the fact".

Trumponomics

Equity markets have taken at face value Trump's promise to lower taxes and increase infrastructure spending. When overlaid with his policies to strip-back regulation and reduce (non-defence) spending we have a cocktail for significant fiscal stimulus. Of course the devil will be in the detail and the question remains how much of his policy agenda will he get through and what is he prepared to sacrifice along the way. The answer here will reflect the character of the beast.

In an interesting piece penned by Jeffrey Sachs (Professor at Columbia University, 2 March'17), Sachs writes about "The Three Trumps" – with each persona reflected to a greater or lesser extent in all of Trump's policies. The first Trump is the "Friend of Putin", with a "growing body of circumstantial evidence suggesting Trump has been backed by Russian. money for decades". The second version of Trump is the "Greedy Businessman", which suggests that Trump is intent on transforming his presidency into another source of personal wealth, citing the fact that he is retaining his business empire "while family members maneuver to monetise the Trump name around the world". The third persona, and one often cited in the media, is the "Populist Demagogue". To quote Sachs specifically – "this Trump is a non-stop front of lies, who brushes aside the inevitable corrections by the media with the charge of fake news".

Trumps policies on taxation, trade, healthcare, immigration, and the like are being honed through these prisms.

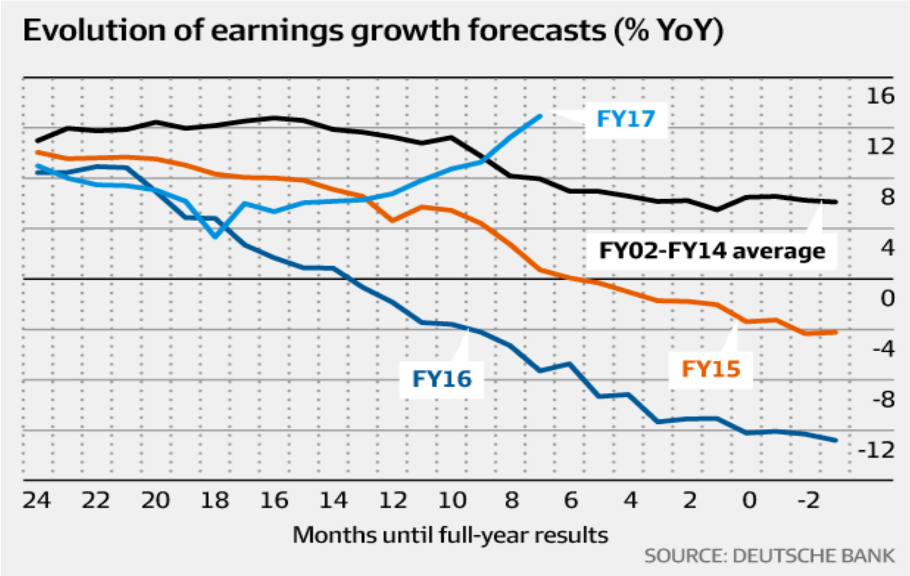
In terms of what we can assume about the implementation of his policies, there will certainly be tax cuts, but short term cost to the budget and fears of over-stimulating the economy (forcing the Fed to raise interest rates more quickly) are likely to keep a lid on these. Similarly, there will be a boost to infrastructure spending, however this will need to be targeted and funded to the satisfaction of House Republicans. The trade & social policies, however, are likely to be much more problematic – as we are presently witnessing with the proposed repeal of Obamacare. These "tougher" policy matters may impede progress on the much vaunted economic reforms. Hence, it is this **policy sequencing risk** that poses the greatest risk to equity markets.

The reality is that Trump will likely muddle through with some of the "best bits" of his policy agenda. Whilst the republicans control both houses of the US parliament, there are many in his own party who do no support elements of his policy platform. The belief is that there are enough checks and balances in the US Congress to ensure his policies become more pragmatic during their passage through the legislature. That said, Trump will be keen to ensure that the "populist demagogue" scores enough victories to secure his re-election in 3 ½ years time.

Reporting Season

The recently completed company profit reporting season here in Australia saw 73% of companies meet or beat earnings expectations (Macquarie Research, 3 March'17). The quality of profits continued to improve and there was an increased tendency for CEO's to provide supportive outlook commentary (as opposed to previous years where commentary has been largely negative or absent). Clearly, a lot of the growth is coming from the turn-around in the resource & material stocks, but most sectors reported a turn around in EPS growth.

There has been a recession in earning growth for a few years now, but this most recent reporting season has marked a turn around in this trend. Historically, market expectations for growth are invariably positive a couple of years out from the forecast period. However, as we move closer to the start of the actual period, forecasts are wound back. Over more recent years, this has seen positive forecasts for EPS growth usually revert to a negative consensus view within 6 to 12 month of the financial year start date. As is evidenced by the Deutsche Bank chart below, we are actually seeing upward revisions to earnings as we approach 1 July'17 – the turn around in earnings growth is clearly evident.



OUTLOOK

The global economy and equity markets enter 2017 on a considerably firmer footing than last year. Growth momentum has picked up over the second half of 2016 and risk assets, particularly in developed markets, have continued to benefit from the "Trump" rally.

The OECD is forecasting the global economy to grow at 3.3% in 2017 (up from 3% in 2016) and in excess of 3.6% in 2018 (OECD Interim Economic Outlook – 7 March'17). In Australia, real GDP is expected to be on trend (around 2.8%). The macro-economic backdrop here is quite positive and will be supported by:

- Low interest rates (unlikely to change for the remainder of 2017)
- A falling currency (heading back towards the range of 68-72 cents)
- Increased exports
- Steady consumer spending
- Continuing spare capacity in the labour market
- A recovery in commodity prices (which will see resource companies lift their dividends)
- A strong housing market

Turning to technical factors, the month of March is typically a seasonally "soft" month for equities – we've seen the highs and lows of the profit reporting period baked into stock prices and many companies go ex-dividend. Combine this with a significant run-up in large cap share prices (particularly in the US) and we are likely to see some profit taking in the short term which will see markets drift lower into early-mid April'17.

The chartists then split into two camps – those that subscribe to a traditional "sell in May" thesis and those that place greater emphasis on the "7th" year and post presidential election year cycle. Both the latter technical patterns imply a stronger push up through into July, before a pull-back into November'17. Both camps are looking for higher tops later in the year or early 2018.

In light of sound fundamental factors and encouraging technical patterns, we remain constructive on equities.

Superannuation Reforms

From 1 July, the following changes to the Australian superannuation system will come into effect:

- **Concessional Caps** – The annual concessional (or pre-tax) contribution cap will be lowered from $35,000 (for those above the age of 49 years) to $25,000.
- **Non-Concessional Caps** – The annual non-concessional (or after-tax) contribution cap will reduce from $180,000 to $100,000. The accompanying bring-forward arrangement will reduce from $540,000 to $300,000 (transitional arrangements will apply). In addition, those with super balances in excess of $1.6m will no longer be able to make non-concessional contributions. Similarly, the bring forward option for those with balances approaching the $1.6m cap will also be curtailed.
- **Transfer Balance Cap** – the amount that an individual will be able to transfer into a tax exempt pension (from accumulation phase) will be caped at **$1.6m**. Note that this cap applies retrospectively, so anyone with a pension balance currently in excess of the cap will need to make arrangements to transfer the surplus back into accumulation mode, or out of the super system altogether, before 30 June'17. Note that the cap only applies at the point of balance transfer – thereafter, pension balances can (for example) rise above the $1.6m cap without any action required.
- **Transition to Retirement Pensions** – TTRPs will **lose their "nil" earnings** tax concession and instead, revert to a 15% earning tax arrangement (commensurate with the existing super tax regime).
- **CGT Relief** – For both the Transfer Balance Cap and TTRP changes, individuals will be given the opportunity to seek capital gains tax relief by way of an **adjusted cost base** for assets transferred back into accumulation phase or out of the super system.

Unfortunately, the Government is still making amendments to the supporting legislation/regulations and, consequently, we have the issue under active notice. In the lead-up to the end of the financial year, we will be in contact with effected clients to recommend appropriate strategies.

Regards

Andrew & Stephen
20 March 2017