QUARTERLY REVIEW – July 2017

The Australian share market (ASX 200) closed on 31 July'17 at 5,720 – down just over 2% for the quarter. The big movers over the period were the major banks which fell by an average of almost 10% - although they did manage to peg back some of the losses over more recent times. Three of the four majors went ex-dividend in the period and, most notably, the Federal Government announced a new "bank levy" as part of the May Federal Budget. Over the same period, global shares (MSCI ex-Aust) added around 3% in USD terms, driven disproportionately by a continued move up in the Dow Jones (4.5%).

The US share market continues to make new highs with each month that passes so we spend a little time this quarter trying to get a perspective on the relative value of the US share market. We also examine the RBA's likely way forward on monetary policy and document a few facts about China's debt situation.

Are US Equities Over-Valued?

The US equity market has risen consistently since the GFC to the point where it has now exceeded pre-GFC levels by almost 60% (here in Australia our market needs to rise by a further 20% just to regain its pre-GFC level). In the US, the market has been driven by a triumvirate of rock bottom oil prices, the policy action of the Fed (near zero interest rates and QE), together with a strengthening US economy. So as interest rates and oil prices start to rise, and with the Dow Jones at all-time highs, it is only prudent to question whether or not US equities are indeed over-valued?

From a "fundamental" perspective, the answer would appear to be a resounding "yes". With shares prices currently running at around 25 times underlying earnings, the US market has only been more expensive on three other occasions – the great depression, the dot-com bubble and the GFC. Its historic average has been around 16 times.

However, as is often the case, value is a relative concept and when viewed against the backdrop of historically low interest rates, together with an emphasis on forward earnings rather than trailing earnings, some argue that there is still plenty of upside in the US market. The AFR (Philip Baker, 13 July'17) reported comments by London based Economist John Higgins, who argues that using the US Federal Reserve's own valuation model, indicates that shares are under-valued compared to bonds.

According to the Fed's model its all about the forward earnings yield and how this compares to the yield on 10 year US treasury bonds. Back in the late 1990's the 10 year treasury bond yield was 6.2% and the S&P earnings yield was around 5% - signaling shares were over-valued. In the following 2-3 years the US market lost around 35% of its value.

Today, the bond yield is around 2.4% and the equity yield is around 5.6% "so if equities were over-valued relative to bonds in the late nineties, then they seem **distinctly undervalued today**" Higgins concluded. Even after adjusting for inflation, the equity yield is still very attractive.

For the record, Higgins does not see the US market moving back in any meaningful way before late 2019.

Reserve Bank - Between a Rock and a Hard Place

A sluggish domestic economy combined with record household debt means that the reserve bank will have to use all its finesse in guiding monetary policy over the next twelve to eighteen months. Economic growth is below trend, wages growth is non-existent and inflation is below target. With the mining investment boom now well and truly over and the housing market cooling, the RBA is hoping (and praying) that business investment, together with an uptick in consumer spending, will keep the Australian economy's head above water in the coming year.

In its July'17 Bulletin the RBA reported that Australian households owed debt equal to 190% of their yearly disposable income – a new all-time high. The Australian consumer and ergo the broader economy, is now much more sensitive to interest rate movements than at any time in history. The RBA will no doubt draw on lessons from international history in managing interest rates from this point.

The following extract from a speech by the Governor of the Bank of Japan outlines the impact monetary policy had on the Japanese economy following the asset price bubble in the late 1980's – the parallels with Australia's current situation are quite freakish:

Until the end of the 1980s Japan experienced strong economic growth, to a large extent fuelled by an asset price bubble that resulted from excessive loan growth. At the beginning of the 1990s, the Bank of Japan raised lending rates and the bubble burst, forcing firms and financial institutions to repair their balance sheets. In response to the economic slowdown, Japanese consumers became far more cautious. Faced with stagnant sales, firms started to cut expenses, including labour costs, by shifting to non-regular employees, including part-time workers, and by reducing the wages of regular employees. A vicious circle of declining wages, prices and aggregate demand was set in motion.

To improve the outlook for both employers and employees, and encourage wage growth, the Bank of Japan tried to stimulate the economy through monetary policy. But by now wage-setting practices had changed, and non-standard forms of employment were here to stay (Haruhiko Kuroda, 2014 – Governor, Bank of Japan).

In the circumstances, we feel that the RBA would be unwise to contemplate increasing interest rates any time over the next twelve months (or more). Maintaining rates at their current low levels would also assist in curbing the value of the Australian dollar, which has moved up to uncomfortably high levels over the last 2-3 months.

A Quick Word on China's Debt

We continue to see "worrying" reports on the level of debt in China and theories abound about how dangerous this could be for global growth. The main concern is focused on corporate debt which has "sky-rocketed" to 169% of GDP (Bank of International Settlements). There are, however, a couple of key points that need to be borne in mind:

- Most of the corporate debt actually belongs to state owned enterprises (SOEs), which should more correctly be categorised as public/government debt.

- All of the Chinese debt is internally funded – they don't borrow from, and hence are not reliant upon the good graces of, overseas counterparties (unlike the Greeks).

Remember also that the Government controls the money supply in China so they can give themselves time to work through any issues that emerge.

We continue to see the Chinese turn-around story developing according to plan. Growth is continuing to trend a little lower – anticipated to be 6.5% this year. Efforts to implement supply side reforms (eg reduction in over-capacity and structural reform in cyclical industries) continue at a pace and the transition from an export driven economy to one focused on personal consumption & services is on track.

OUTLOOK

As we indicated last quarter, the US share market has continued to factor in most of the upside of Trump's intended economic policies. The reality of what he will actually be able to deliver (or not as the case maybe) is beginning to sink in and markets are ripe for a pull back.

Moreover, the removal of liquidity by the Federal Reserve is likely to cause volatility in markets. Interest rate increases are now an accepted part of the US land scape and the market is comfortable with the approach being taken by the Fed in this regard. However, The Fed has now flagged that at some point soon it will commence reducing the size of its balance sheet (ie allowing treasury bonds to mature without replenishment) and this will curb the liquidity that has supported the growth in equity prices. In the same way that the initial speculation about Fed interest rate rises created uncertainty and drove markets lower (2015/16), we can see a situation where debate about "quantitative tightening" will fuel investor uncertainty and drive markets down.

Here in Australia, the market has been trading in a tight range for some time (broadly between 5,600 and 5,800). Profit reporting season was (in aggregate) uninspiring, particularly when the earnings growth and dividend payments of the miners are backed out of the equation. The economic backdrop is tepid and, as noted above, the RBA needs to be very careful about how it manages interest rate policy over the next 6-12 months as the economy waits for non-mining business investment and consumer spending to kick in.

Turning to technical factors, the second half of the calendar year is traditionally softer than the first. As noted last quarter, the "7th year" charts, when overlaid with the market history associated with the first year of a presidential cycle, also point to a pull-back in coming months.

Hence, we see equity markets easing back over the next few months, lead by falls in the Dow Jones (US). It is conceivable that the Dow will give back around 50% of the "Trump gains", which translates into a fall of around 8% (for the technically minded, a Fibonacci retracement (61.8%) would see the market drop by just over 10%). Here in Australia, the ASX 200 is also likely to soften, with initial resistance sitting around 5,500 and key support at 5,200 (just on 8% below current levels). The low in markets should be in place by early November, before a seasonal upswing into Xmas and the new year.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Underweight):** Whilst we remain constructive on Australian stocks in the medium term, we are anticipating a short-term pull-back.
- **Global Equities (Slightly Underweight):** The US market is looking vulnerable and 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 were off over 9% last quarter.
- **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
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