Dear Client,

QUARTERLY REVIEW – JULY 2019

The ASX 200 finished the 2018/19 financial year at 6,618, some 424 points or 6.8% higher – what would be described as a solid return for Australian equities. However, the year on year performance belies the intra-period volatility that was spurred by concerns about the potential for rising interest rates in the US. These concerns pushed our market to a low of 5,410 in December'19, before it recovered 22% by 30 June'19.

In a turnaround from previous years, most of the gain in our burse was fueled by large cap stocks – specifically the top 20 stocks. Predictably, with commodity prices up significantly, the mining stocks were key contributors (BHP & RIO were both up around 30%), the banks were mixed, but improved subsequent to the final report of the Royal Commission and the oft neglected Telstra rose over 50%. On the flip side of the ledger, the small companies index was flat.

Heading offshore, the global MSCI was up just over 4%, again however, this result was driven overwhelming by the Dow Jones, which posted a rise of 9.6% (USD) over the period. Europe again struggled to post positive returns (DAX 1.3% and FTSE -0.2%) whilst Asia was generally positive, led by the Shanghai index that posted a 7.3% rise (albeit with significant volatility).

There are a couple of "known unknowns" that continue to attract significant attention in the media. The course that is charted in respect to the US v China trade war, together with central bank moves on interest rates (also code for global growth) will determine the direction of equity markets over the next twelve months and beyond.

Interest Rates & the Infamous "Inverted Yield Curve"

Interest rates globally are at historic lows. Over the latter part of 2018 most central banks (including our own) were positioning themselves to raise cash rates. The US Fed had actually commenced a steady tightening cycle during 2017 that had accelerated over the latter part of 2019. However, lower economic growth and an absence of inflationary pressures (specifically wage growth) forced the Fed to recant from this position and once more adopt a dovish view on the direction of rates. Here in Australia, the RBA has now twice lowered the cash rate in as many months, with the official rate now sitting at a record low of 1%.

During the early part of 2019, talk about the shape of the yield curve grew louder, as short term rates stayed firm and longer term rates fell away (given the apparent about-face by central banks). A normal sloping yield curve is upward sloping – with short term interest rates sitting well below longer term rates.

Financial literature is full of analysis showing that over the past 50 years, every US recession has been preceded by an inversion of the yield curve. So, with the US yield curve going into a technical inversion earlier this year, what does this mean for equities?

There are two key observations here:

- There is a material lag between inversion and any impact on equities.
- Not all yield inversions are the same – there are "bull" and "bear" inversions.

Recent analysis by Bernstein Advisers & LPL Financial (Dec'18) concluded that over the past 50 years, equity markets peaked, on average, **19 months after inversion**. Those that sold out of markets at the time the yield curve inverted, missed out on average returns of 22% associated with the subsequent market peak.

The other important consideration is, which part of the yield curve moves to prompt the inversion (ie the short end or the long end). Myron Scholes (Nobel Prize in Economics) & Ash Alankar (Global Head, Janus Henderson Investors) released analysis in April'19 indicating that a "bear inversion" (caused by a front-end rise in rates) has a much more devastating effect on equity markets. These types of inversions have been the norm over many decades, with the Fed rapidly tightening monetary policy to fight inflation and counter other stimulative policies.

However, in 2019, rather than aggressive Fed rate increases, the inversion has been caused by a change in the stated direction of interest rates, with the Fed pausing rate rises and consider interest rate reductions. This caught markets on the hop and lead to longer dated bond rates dropping considerably. This is known as a "bull inversion"

The other key consideration in this analysis was the position of inflation relative to interest rates. Today, the yield on shorter dated (3 month) Treasury Bills is less than 30 basis points above core inflation. In every prior recession since 1960, the Treasury Bill yield exceeded inflation by around 200 points. As Scholes & Alankar conclude "money is relatively cheaper today than before any prior corrections" (Bloomberg, 9 April 2019).

So whilst we are reluctant to use the phrase, maybe this time "things are a little different" given the relative level of interest rates and the "bullish" nature of the inversion. Moreover, history does indicate that irrespective of the nature of the inversion, we have some time up our sleeve and pulling risk off the table too soon, can result in missing out on significant upside.

US v China Trade Wars

As we have observed previously, ignoring geopolitical tensions has been a good strategy over the last decade or more. President Trump first imposed tariffs on Chinese goods back in July'18. Since this time there has been retaliatory action from China and (again) by the US. Since July'18 the US equity market has risen almost 10% and the Chinese market over 7%.

The reality is that neither China nor the US will benefit from a prolonged trade war. Their respective equity markets seem to understand this fact and have largely priced in a "resolution", notwithstanding short term rhetoric (and financial pain).

The utterances following the recent G20 meeting have been positive, but Trump will probably be expecting to squeeze a little more from any "deal". Accordingly, we expect that after a period of further negotiation, the US will likely apply the final tranche of tariffs (10%) on the remaining imports from China in September'19. Importantly, however, the key to a Trump presidential re-election lies in the swing states that have been hardest hit by the tariff war – including Iowa, Michigan, Penn & Ohio. To consolidate his popularity in these states, Trump needs to bring back business orders & reinstate crop sales. Accordingly, we would expect a trade agreement to be reached later this calendar year – clearing the decks for the run-up to the presidential elections in 2020.

OUTLOOK

Whilst global economic growth has slowed, an extended run of accommodative monetary policy is likely to support equity markets over the medium term ("don't fight the Fed"). Here in Australia we are positioned at an earlier point in the economic/business cycle and (along with Asia and in due course Europe) have the potential to outperform US equities.

Whilst there are certainly risks on the horizon, many of which are geopolitical in nature, (eg US/China trade, Brexit, Iran, North Korea etc), the impact of these factors is not likely to be large or prolonged.

We favour a pull-back in global equities over the shorter term before another leg higher into the latter part of 2019. Here in Australia, we have come within 100 points of an all-time market high (set in 2007). Technically, whenever previous highs are re-tested, we expect to see resistance and hence, we would anticipate some level of consolidation and/or retracement.

However, with a potential resolution of the US v China trade war likely later in the year, together with further interest rate reductions, we expect the ASX to make new (all-time) highs in the latter part of 2019.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Neutral):** We expect that the Australian market may consolidate around current levels in the short term, with a potential move higher late in the calendar year.
- **Global Equities (Underweight):** The US market is looking stretched/late cycle. Asian and European markets appear to have more headroom.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield (and reductions to interest rates), but these macro tailwinds have now abated.
- **Fixed Interest (Slightly Overweight):** Given the level of interest rates, it is preferable to hold a little more in fixed interest instruments relative to cash.
- **Cash (Slightly Overweight):** As a result of our positions in other asset classes, our net cash position is slightly overweight.

Regards

Andrew & Stephen
9 July 2019