Economic & Financial Markets Update
August 2019

Both share and bond markets rallied strongly over the six months to June 2019. The S&P 500 and ASX 200 recovered all of the losses of the last quarter of calendar year 2018 and in index points terms (price and not valuation) are near all time highs. ASX listed Australian Property has also performed strongly.

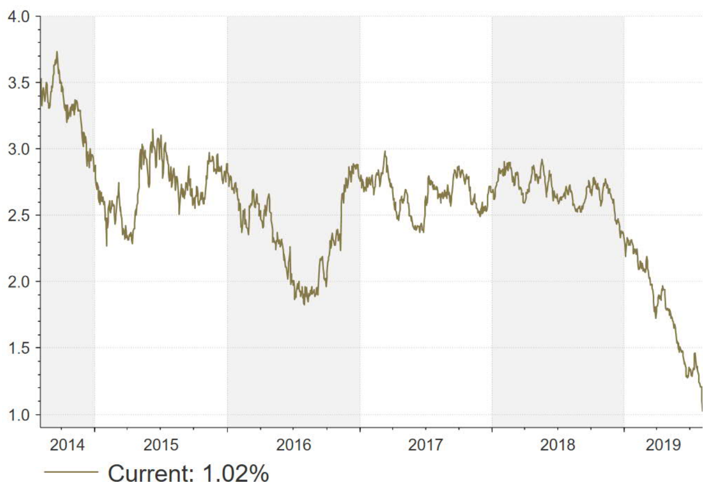
Market Benchmarks	6M	1YR	5YR
Australian Shares	19.8%	11.4%	8.9%
International Shares	17.3%	12.0%	13.2%
Australian Property	19.1%	19.4%	13.8%
Australian Bonds	7.1%	10.2%	5.3%
International Bonds	5.6%	7.2%	4.8%
Cash	0.7%	1.5%	1.7%

To 30 June 2019

Market Outlook

As we forecast was a possibility in our January 2019 newsletter Central Banks did indeed pause measures to tightening monetary policy, led by the US Federal Reserve (the Fed). We expected a gradual shift in stance, however their language changed very quickly and they have now gone a step further and increased stimulus by cutting the Fed Funds Rate. The European Central Bank (ECB) and the Reserve Bank of Australia (RBA), although more domestic related, have followed in action or intent and discussion around an Australian Quantitative Easing (money printing) program is getting louder.

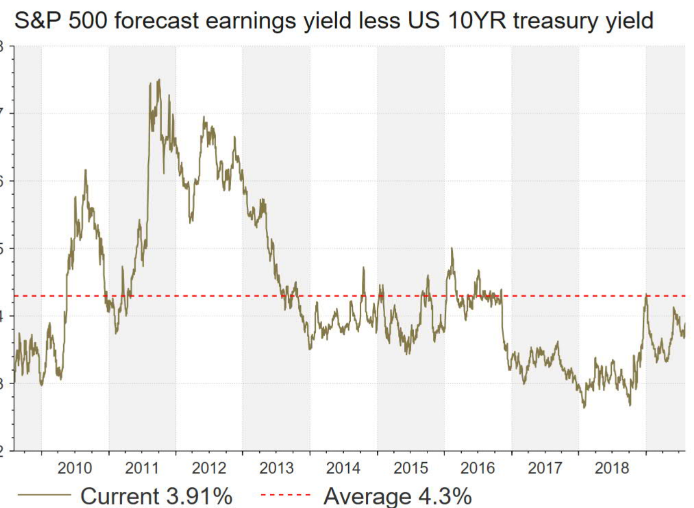
This complete about face led to a substantial fall in expectations for long term interest rates globally (bond prices up, income yield down) which lit a fire under higher risk assets such as shares.



Interest rates, or more specifically the income yield of 10 year government bonds, impact the valuation of all assets. When they fall the relative attractiveness of returns from alternative asset classes increases and the prices of these assets go up, and vice versa when they rise. Of course this assumes the earnings streams from these assets are stable which is not normally the case.

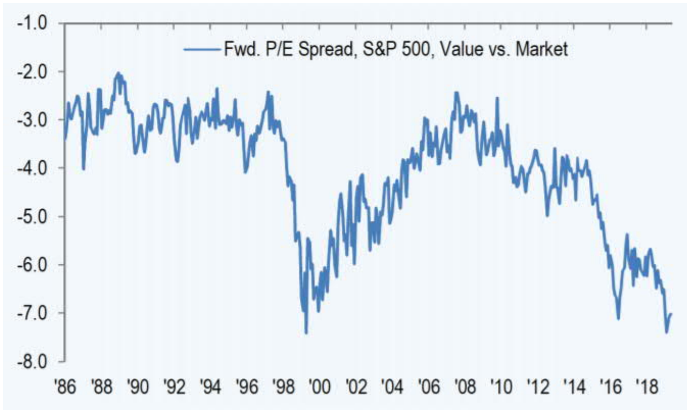
This relationship is amplified in a low interest rate environment where the returns from cash, term deposits and low risk bonds (loans to high quality governments and corporates) are insufficient to keep up with growth in the cost of living. Inflation in Australia is currently 1.6% and the 10 year government bond yield is 1.0%.

Another way to illustrate this is to compare the earnings of shares to the earnings of bonds. The below chart indicates that, despite the strong rally in prices, valuations of shares are not overly excessive relative to bonds.



Earnings yield is profits divided by share prices. Above average is attractive and below average is expensive.

This high-level analysis fails to recognise the divergence that is occurring both in international share markets and in the Australian market between the haves and have nots. Investors have been willing to pay ever increasing multiples for high growth companies, whilst those that are lower growth have languished as illustrated by the next chart. 'Value' refers to companies on lower price to earnings multiples and includes those that are being disrupted and are in structural decline and deserve to be de-rated. However, as can be seen valuation dispersion is extreme.

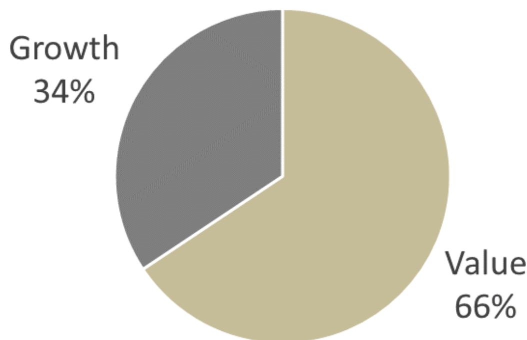


Source: L1 Capital, JP Morgan

Whilst some of these high growth companies have excellent prospects there is a large contingent who are highly unlikely to produce the cash flows required to justify their valuations in a reasonable timeframe. This euphoria is most obvious in the technology sector.

With the rise of index investment, which generally bases decision making on a company's size rather than its prospects or the value of its future cash flows, a virtuous cycle has emerged. As these companies have become a larger part of indexes more money has flowed to them, which has increased their size relative to the market resulting in more flows of money.

We are not sure what the catalyst is for a shakeout of these imbalances but are confident that the current trend is unsustainable and believe it is ever more important to stay disciplined and focus on high quality assets with proven cash flows. We roughly estimate exposure of growth vs value companies and funds in Alder & Partner client portfolios to be as follows.



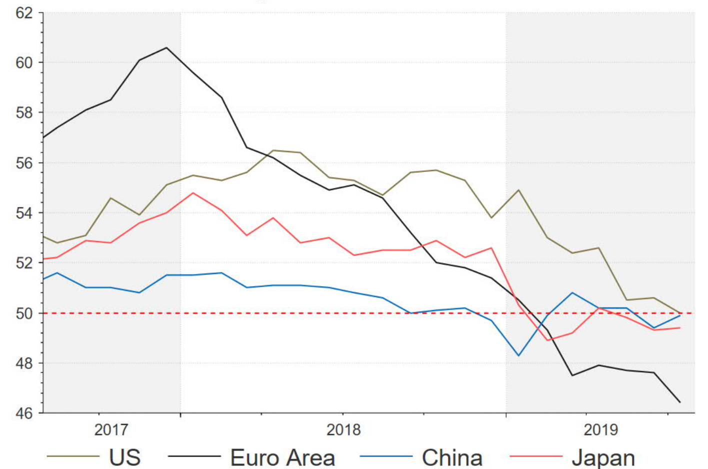
Note that 'Value' includes cyclical companies such as banks and resources. Individual portfolios differ.

Importantly we highlight that the vast majority of higher growth exposure is in companies with proven business models that are already highly profitable and we feel that prices paid on entry are reasonable relative to the growth outlook. This of course does not mean that they are immune to changes in sentiment that can impact short term market prices.

So why have Central Banks changed course?

In short, leading economic indicators have continued to deteriorate since January. In combination these highlight that there is concern around the outlook for global growth.

- Manufacturing readings are largely contractionary.
- Business and consumer sentiment indicators have been mixed.
- Some well followed bond market indicators have been providing signals consistent with previous recessions.
- Export data has been volatile.
- Copper prices, which are a proxy for views on growth, have been falling.
- Gold, which is a proxy for inflation (subdued) and/ or fear, has awoken from a six year hibernation.



Above 50 indicates expansion and below contraction.

Concerns around the dispute between the US and China over trade and intellectual property protection and the impact of tariffs on growth have been a primary driver of this. There is a risk that this escalates, which has indeed occurred in early August, with growing bipartisanship in the US and other western democracies to take a tough stance on China and campaigning for the US Presidential Election in November 2020 ramping up.

Consequently Central Banks have reacted aggressively to try and preserve a buoyant mood. Maintaining sentiment is critical to maintain growth. The Fed cut the Fed Funds Rate 25bps to a range of 2.00% to 2.25% in late July 2019 and the ECB has indicated that it will follow and also potentially relaunch its bond buying program.

It is possible that recent market volatility forces Central Banks to become even more aggressive, and potentially a fresh wave of government spending could also be announced. If this were to occur the global economic cycle will be extended which share markets would respond positively to.

What is interesting is that while the above sentiment driven indicators are deteriorating 'real' economic data, for the most part, remains reasonable and unemployment trends are particularly positive.

United States	Most recent	12M prior
GDP	**2.1%**	3.5%
Industrial Production	**1.3%**	3.4%
Retail Sales	**3.4%**	6.0%
Unemployment rate	**3.7%**	3.9%
Wage Inflation - QoQ	**0.7%**	0.5%
Core Inflation	**2.1%**	2.3%

Eurozone	Most recent	12M prior
GDP	**1.1%**	2.2%
Industrial Production	**-0.5%**	2.4%
Retail Sales	**2.6%**	1.7%
Unemployment rate	**7.5%**	8.2%
Wage Inflation - YoY	**2.5%**	1.9%
Core Inflation	**1.1%**	0.9%

China	Most recent	12M prior
GDP	**6.2%**	6.7%
Industrial Production	**6.3%**	6.2%
Retail Sales	**9.8%**	9.0%
Unemployment rate	**3.6%**	3.8%
Wage Inflation - YoY	**2.1%**	2.2%
Core Inflation	**1.6%**	1.9%

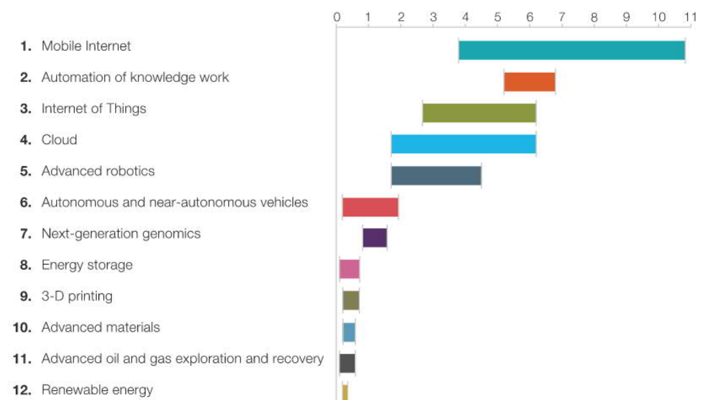
Overall interest rates remain very low, energy prices are below average, US and Chinese governments are already employing fiscal stimulus and there is increasing pressure for European governments to do so.

This backdrop is supportive of medium term economic growth and therefore company earnings. And indeed markets have, for the most part, been signalling that they expect both growth in earnings and falling interest rates which is unusual. The latter is normally associated with a contractionary cycle.

As a result we expect that any sign that earnings will be below forecasts or any increase in risks to earnings (as recent US/ China tensions have created) to result in a re-emergence of volatility.

Disruptive Technology

A feature of the past 10 years has been a growing wave of disruptive technologies. Low interest rates have fuelled the flow of capital into investment vehicles that support start-up businesses. These technologies are altering the way we communicate, shop, pay, manufacture, power, transport and treat disease and ageing. In addition we have seen the rise of business models, as employed by Amazon and Netflix, that have complete disregard for profitability and pricing rationality in pursuit of market share for long term gains.



Source: McKinsey & Co 2013. Remains relevant.

Incumbents, including those that have strong balance sheets and profit margins, that have been slow to innovate and react, have been caught flat footed by these trends and are being disrupted.

In addition to the implications described above this also has implications for interest rates. Persistent low inflation and wage inflation in much of the developed world is generally blamed on weak growth, high debts, falling cost of goods, surplus labour and labour offshoring.

An alternative view in the market is that we are at the start of a technology led deflationary boom, much like the one experienced in the early part of the last century when electricity, the automobile and the telephone all came together around the same time. The technology platforms that will drive the upcoming wave of productivity include batteries and solar, robotics and automation (including in transport), gene editing, 3D printing and blockchain.

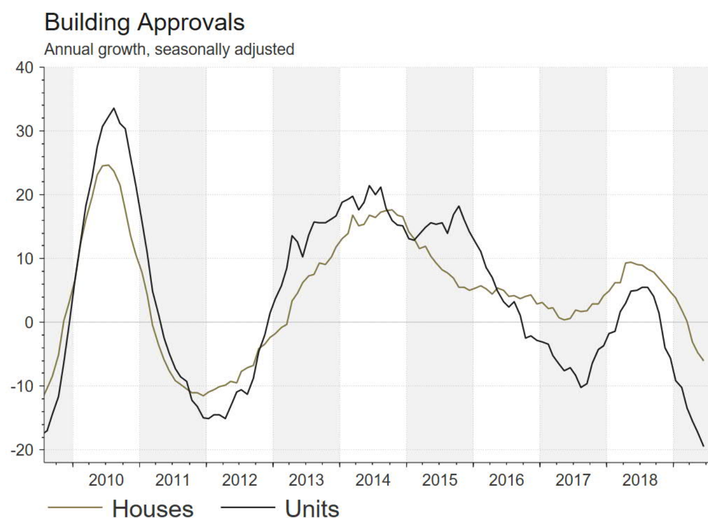
Australian Economy

Sentiment in Australia has been boosted in recent months by the surprise Coalition win at the Federal Election, two RBA cuts to the Cash Rate reducing it to 1.00%, the successful passage of the Coalition's personal income tax cuts, and loosening of loan stress test criteria by APRA that in effect increases household borrowing capacity.

Savings from the tax and RBA cuts to a household with a single pre-tax income of $150k and a $400k mortgage may be as follows.

	2019	2023	2025
Home loan	$400,000	$400,000	$400,000
Cash Rate reduction passed on	0.40%	0.40%	0.40%
Reduction in interest cost	$1,600	$1,600	$1,600
Income - single earner	$150,000	$150,000	$150,000
Income tax reduction	$135	$2,565	$6,540
Increase disposable income	**$1,735**	**$4,165**	**$8,140**
Increase disposable income %	**2.0%**	**4.7%**	**9.3%**

Whilst this is very positive short-term benefits of these cuts are less than the rate of inflation of living expenses. As a result we believe that governments need to do more to stimulate jobs with housing construction activity about to slow dramatically. This sector is a substantial employer and has been a significant source of growth in employment in recent years with multiplier effects through the economy. Consequently the real test for Australia will emerge over the next 18 to 36 months.



On average construction lags approvals by six months.

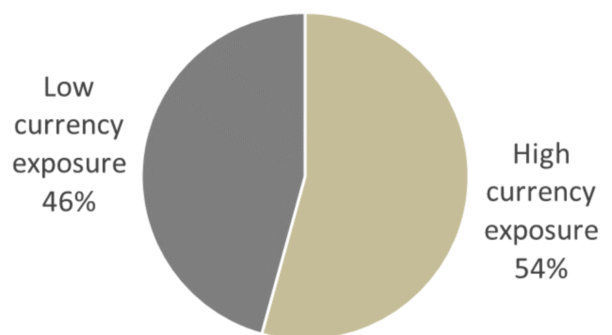
We maintain low exposure to domestic cyclicals and where we do hold these, positioning is very deliberate and company specific. Should a larger downturn emerge we would view this as a once in a generation opportunity to add to these and other companies that will benefit from Australia's long term development and population growth story.

Our favoured property developer Cedar Woods Properties (CWP), for example, is in an excellent position to capitalise on this cycle. In a climate where banks have been aggressively stepping away from lending to small and medium property developers CWP has been able to negotiate increased tenure of its debt, add an additional bank to its club facility and maintain a very low rate of interest (<3%). Small property developers are paying closer to 15%. This provides it with capacity to build its land bank at a time when there is potential for attractive assets to be forced into the market.

Ongoing immigration combined with a downturn in construction also has the potential to tighten property supply in the medium term and stabilise prices. Developers such as CWP with large ready-to-sell landbanks will be in a strong position to capitalise on this.

Whilst this landscape provides us with confidence in your investment in CWP we do expect the share price to be volatile and are managing exposure accordingly.

Alder & Partners client portfolios remain largely unhedged which should provide natural protection to any broader deterioration to the Australian economy.



Shares only. High currency exposure refers to the revenue of companies that is generated offshore and where this is not hedged. Individual portfolios differ.

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Concluding Remarks

Whilst share prices have appreciated strongly valuations of business cashflows are not excessive relative to income from bonds. Conditions are supportive of economic growth and therefore company earnings, however we remain cognisant and alert that conditions could change quickly. Sentiment led indicators ultimately do flow through to the real economy and company earnings.

The sell off in early August sparked by an escalation of the US/ China trade and technology dispute is a reminder of this. The potential for more aggressive monetary and fiscal stimulus has increased as a result which may extend the current economic cycle. This is supportive of continued returns from shares.

We expect interest rates will be low for a long time. There have been extended periods in the past where this has occurred.

As foreshadowed in our January 2019 newsletter we have deployed further funds into International Shares and Australian companies whose earnings are largely derived from offshore. We expect this to continue.

A range of positive events in Australia have lifted sentiment, however the real test for the housing sector and therefore broader economy will take place over the next 18 to 36 months. The government and key agencies (RBA, APRA and Treasury) have had a long time to prepare for a housing construction downturn and consequently we expect plans to support jobs are in place.

The re-election of the Coalition has retained the status quo for the tax treatment of franking credits and investment properties which assists with stability in local markets. We are pleased with the outcome on franking credits.

Overall returns from high quality defensive investments (cash, term deposit and bonds) remain insufficient to offset medium to long term inflation risks, and now more acutely short term inflation. We have difficulty gaining comfort in the higher return parts of the credit universe as described in our January 2019 newsletter. Our preference remains to seek excess returns from high quality shares (equity in businesses that can pass through rising input costs to customers), but with a measured approach to the quantum of exposure to these relative to defensive investments to provide some protection from short term share market volatility. Your agreed investment strategy sets the guidelines for how this is managed.

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