ALDER & PARTNERS
Private Wealth Management

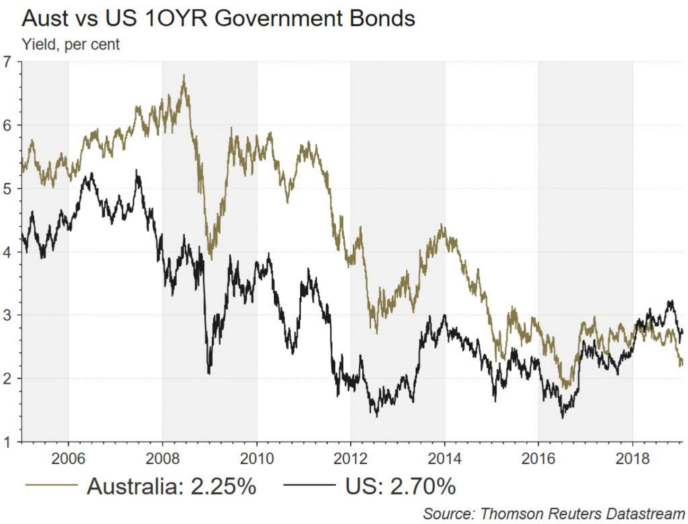
Economic & Financial Markets Update

January 2019

Following a period of strong performance in the earlier part of the 2018 calendar year sharemarkets globally experienced historically large falls in the final quarter. Capital flowed into fixed interest bonds resulting in a performance recovery from this asset class.

Market Benchmarks	6M	1YR	5YR p.a.
Australian Shares	-7.0%	-3.1%	5.6%
International Shares	-4.6%	1.5%	9.8%
Australian Property	0.2%	3.3%	12.5%
Australian Bonds	2.9%	4.7%	4.9%
International Bonds	1.6%	1.7%	4.8%
Cash	0.8%	1.5%	1.8%

To 31 December 2018



International Outlook

These movements were triggered by a sharp change in sentiment primarily driven by concern around the pace of unwinding of stimulatory measures by Central Banks, softening economic data readings, an escalation in the trade dispute between the US and China, political uncertainty in Europe including Brexit and a short-term oversupply of oil.

At the core of the market's concern was that the US Federal Reserve (Fed) was using aggressive language in terms of the speed that it would unwind stimulatory measures at a time when economic data was softening, and the risk of a trade war induced slowdown was increasing. This language was pared back substantially over the course of the final quarter and the Fed is now indicating two rate rises in 2019 rather than three.

We feel that it is now equally as likely that the Fed and other major Central Banks will pause tightening measures for a period, however, communications will be become gradually more dovish before reflecting this. Indeed, the Fed's statement in late January 2019 suggests this. In the world of Central Banks perception is critical and these institutions cannot be seen to be suddenly tacking course when financial markets throw tantrums.

Adjustments in the Fed's direction are very important as interest rates globally are generally correlated to the US 10-year government bond yield. Changes in the outlook for this impact the market's perception of the economic outlook, earnings growth of companies and the valuation of all assets. Sensitivity of each of these to small changes in global interest rates is increased when rates are low and debts are high, as is presently the case.

Whilst short term economic indicators can be incredibly fickle the below summary highlights that a trend of softening growth has emerged in recent months.

US	Latest	3M Prior	Comment
GDP	3.4%	4.2%	Softened
Manufacturing PMI*	54.9	55.7	Softened
Services PMI*	54.2	54.8	Softened
Industrial Production	4.0%	5.6%	Softened
Exports	3.5%	5.7%	Softened
Retail Sales	4.2%	6.4%	Softened
Core Inflation	2.2%	2.2%	Flat
Unemployment	3.9%	3.7%	Increased

Euro Zone	Latest	3M Prior	Comment
GDP	1.6%	2.2%	Softened
Manufacturing PMI*	50.5	52.0	Softened
Services PMI*	50.8	53.7	Softened
Industrial Production	-3.2%	0.9%	Contracted
Exports	2.8%	4.0%	Softened
Retail Sales	1.1%	2.2%	Softened
Core Inflation	1.0%	0.9%	Flat
Unemployment	7.9%	8.0%	Reduced

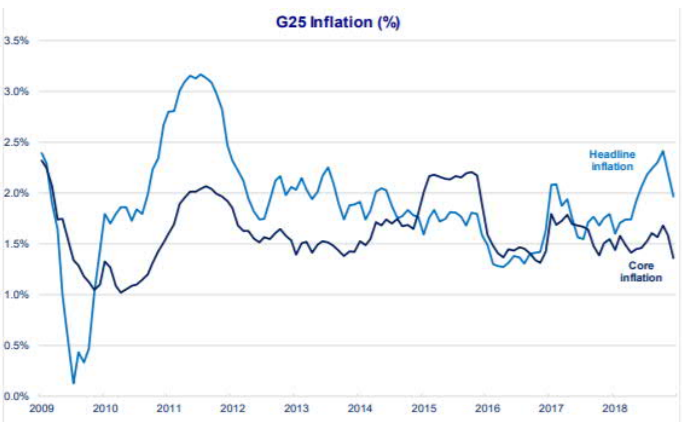
China	Latest	3M Prior	Comment
GDP	6.4%	6.5%	Softened
Manufacturing PMI*	49.7	50.0	Contracted
Services PMI*	53.9	53.1	Accelerated
Industrial Production	-0.5%	-0.8%	Contracted
Exports	-4.4%	13.9%	Contracted
Retail Sales	8.2%	9.2%	Softened
Core Inflation	1.8%	1.7%	Softened
Unemployment	3.8%	3.8%	Flat

**Purchasing Managers Index. Above 50 represents expansion in the particular economic sector and below 50 represents contraction.*

Notwithstanding this trend of softening growth most readings remain solid and our greater concern is that sentiment in the financial economy flows through to the 'real' economy perpetuating further softness or a broader contraction (i.e. we talk ourselves into a recession).

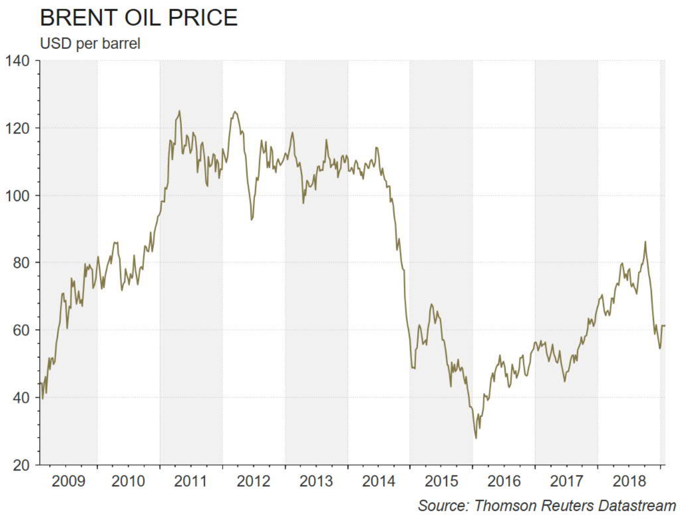
In the short-term political influences including the outcomes of US China trade dispute and Brexit will impact market sentiment, as well as company outlook statements through the current US and local reporting seasons. Markets may rally strongly if a trade agreement is reached, however, this is expected to be primarily dependent on China providing genuine protection of intellectual property.

Should indicators begin to deteriorate rapidly we expect that further monetary and fiscal stimulus will be pursued by authorities globally. The European and Japanese Central Banks did increase asset purchases recently and the Chinese have reduced bank capital holding requirements to stimulate credit growth. There is also speculation China may implement large scale tax cuts and further infrastructure focused stimulus. Persistent low global inflation provides the scope for Central Banks and Governments to pursue further stimulus.

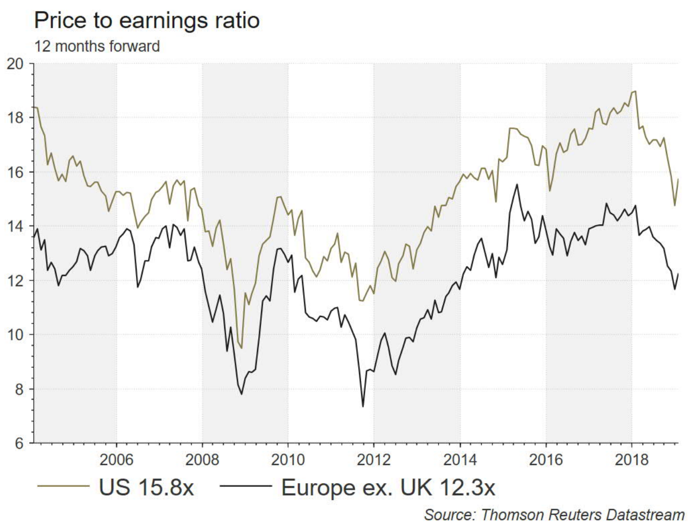


Source: Perpetual Investments

Other than changing sentiment and politically driven interruption conditions remain highly accommodative to growth with low interest rates, low energy prices, ongoing productivity improvements from technology and population growth. Energy is an input into everything and oil prices are currently 50%+ lower than they were in 2014.

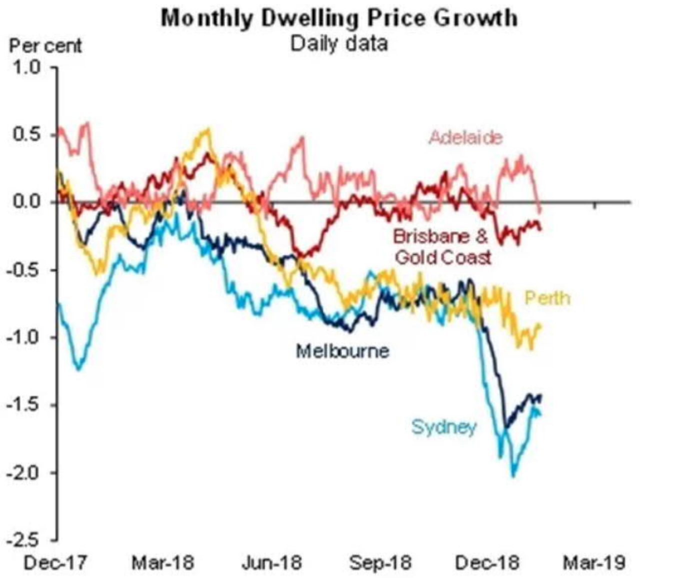


Overall, we feel that whilst the global outlook is uncertain it remains reasonable and asset valuations are meaningfully more attractive than they were. Short term sentiment, data and outlook statements may result in a downward revision in company earnings forecasts. However, equally there is the prospect of an extension or increase in supportive stimulatory measures, and this combined with low energy prices, is supportive of growth and therefore earnings.



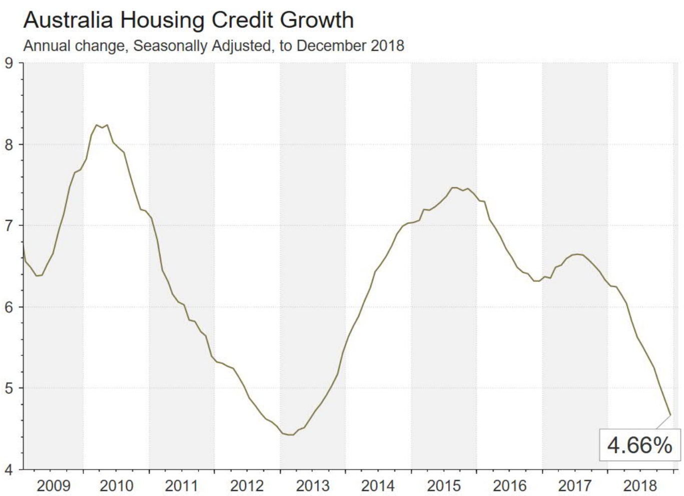
Australian Outlook

We remain cautious on the outlook for Australia. Over the course of the last six months sentiment in key East Coast property markets has deteriorated sharply with accelerating price declines.



Source: CoreLogic, Macquarie, Business Insider

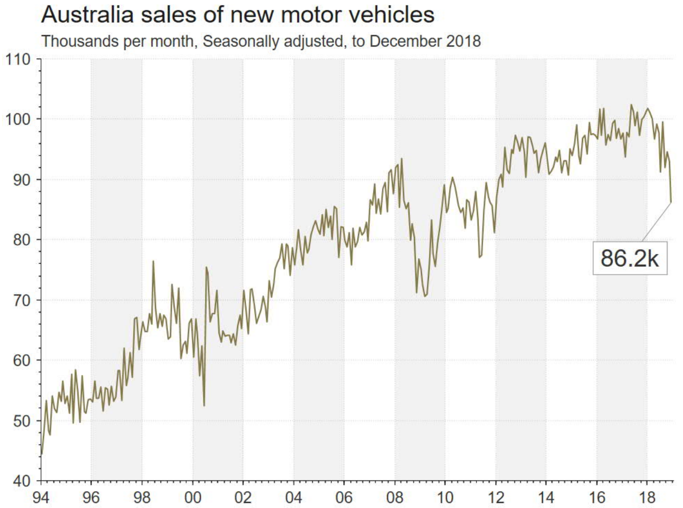
As outlined in our previous newsletter in July 2018 lending standards have been tightening and credit growth is now slowing with a direct flow through impact to housing prices as the quantity of capital available for purchasing has seen a step change downwards.



Source: Thomson Reuters Datastream

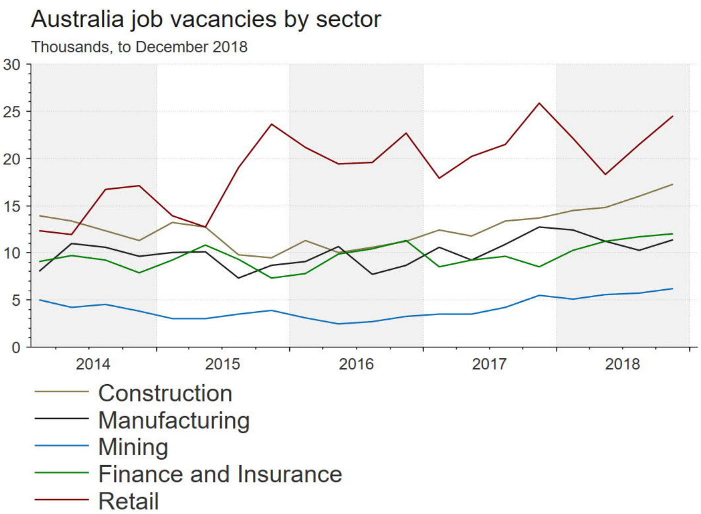
We maintain our view that the multiplier effects on the economy of reducing credit supply at the top of a debt cycle are being under-estimated. Notwithstanding this view the rate of deterioration over the past six months, as is evident in some recent company outlook statements and leading economic indicators, has surprised us.

New vehicle sales, for example, appear to have turned sharply and various reports suggest that consumer spending over the Christmas period was patchy to weak.



Source: Thomson Reuters Datastream

Conversely employment data continues to be very strong. Australia created 135.4k jobs over six months to December 2018 and unemployment remains low at 5.0% despite the percentage of the population looking for work being around an all-time high of 65.6% (unemployment readings do not include those not seeking work or who can't). Furthermore, job vacancies in key sectors have continued to rise.



Source: Thomson Reuters Datastream

Maintaining a solid labour market is critical given the indebtedness of the Australian household. Consumer/household facing sectors including retail and property make up a very large component of jobs, and consequently the trickle-down multiplier effects of household tightening on employment conditions could be meaningful.

We are of the view that major agencies including the RBA, Treasury and APRA are working on policy to respond should conditions deteriorate. We have increasing conviction that desire to maintain a triple A credit rating could be swept aside if support for the labour market is required.

Notwithstanding our caution over the outlook for the domestic consumer economy and therefore the earnings of companies that face this, broadly speaking valuations of Australian companies are the most attractive they have been for some time.

Federal Election

A change of Federal Government at the upcoming election appears likely. Unsurprisingly, in two party preferred polls Labor leads the Coalition ~53% to ~47% indicating a strong victory in the lower house.

In the Senate we understand that the voting distribution system provides for a less clear outcome. However, it appears that if left leaning parties are able to gain an additional four seats they may establish a majority in the Senate providing Labor with easier passage of its policies, noting that the make-up of left leaning parties (the ALP, Greens and one independent) is much less fragmented than the make-up of right leaning parties.

	Left	Centre	Right
Not up for re-election	16	2	18
Up for re-election	19	1	20
Senate Total	**35**	**3**	**38**

We expect this election outcome to be the most important for the Australian economy and investment markets for a long time. There are a range of sectors including banking, property, telecommunications, electricity and healthcare that will all be impacted by Labor policy and mostly negatively for investors. We do expect that some of these policy positions could be softened once in Government, or through the passage of the legislature.

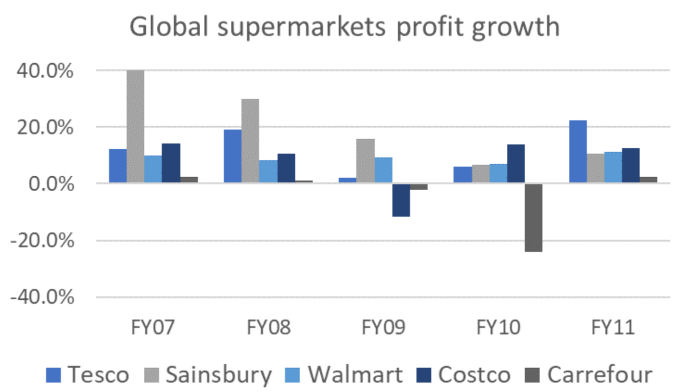
Portfolio Positioning

We remain broadly comfortable with portfolios, particularly given more attractive valuations, however we have taken some actions recently to manage risk. These include further reducing exposure to cyclical businesses that ultimately face the Australian consumer and reducing exposure to specialist funds managers that invest in the mid and small capitalisation Australian companies. Whilst underlying companies typically have exciting prospects they can trade on higher valuations, be more illiquid and have less diversified product, customer, input and end market exposure and as a result be more volatile.

We have maintained a low exposure to Australian banks following reductions over recent years. Valuations appear attractive at current levels, however, medium term returns will be impacted by the direction of property markets from here. Bad debts are at historical lows and it would only take a small rise in these for earnings to be meaningfully impacted and therefore dividends. The calculation below highlights that, in Westpac's Consumer Bank Division, bad debts would only need to rise to 1.1% of loans to neutralise profit. We do note that given substantial equity of many borrowers, and Australian banks ability to claw back against the broader asset bases of mortgagees, the amount of the loan book that would need to be stressed for this to occur is much higher.

Westpac Consumer Bank Division	FY18, $m
Net interest and other income	8,494
Operating expenses	*-3,542*
Earnings before tax and impairments	**4,952**
Impairment charges (bad debts)	*-451*
Profit before tax	**4,501**
Tax expense	*-1,361*
Net Profit	**3,140**
Total credit exposures	448,000
Impairments to credit exposures – FY18	0.1%
Earnings before tax and impairments to total credit exposures	**1.1%**

At present we are targeting increased exposures to defensive sectors of the economy, at reasonable valuations. Whilst we remain aware of competitive pressure for Australia's large incumbent supermarkets the earnings of global players largely proved to be resilient during the GFC. There were company specific growth programs that assisted, however, supermarkets can be a beneficiary of switching from eating out and switching to home brands during a more difficult economic climate.



We intend to further increase exposure to International Shares, and also have a strong weighting to Australian companies whose earnings are largely derived from offshore. The prospects for these companies are generally stronger with better underlying economic outlooks, and there is also a natural protection from the Australian dollar as these investments have almost wholly been made on an unhedged basis.

We spent a considerable amount of time in 2018 reassessing options for the defensive portion of portfolios, unfortunately with limited success in gaining comfort. The universe is very simplistically summarised as follows. Returns are generally rational relative to risk.

Credit Type	Potential Returns p.a.	Liquidity
Mortgages		
Mezzanine developer loans	12% to 20%	Not liquid
First ranking developer loans	8% to 11%	Not liquid
Secured residential loan pools	3% to 7%	Moderate
Corporate Credit		
High return/ low quality	10% to 20%	Not liquid
Moderate return/ quality	4% to 7%	Poor
Low return/ high quality	2% to 4%	Good
Government Bonds	1.5% to 3%	Good
Term Deposits	2.6%	Varies
Cash	1.5%	Liquid

Unfortunately, we continue to view high quality fixed interest government and corporate loans as providing insufficient returns relative to term deposits given the capital value of these fluctuates and the long-term risk is to the downside.

Corporate credit of moderate return and quality is of interest to us. These are mainly loans to large Australian companies, many of whom are listed and could easily raise equity in the event they ran into trouble providing protection for lenders. Most also have very good covenant protections. Unfortunately, investment options are limited as the sector remains dominated by the big banks and we have issues with the structure of available vehicles at this point in the cycle.

For the most part we are uncomfortable with the mortgage sector other than first ranking mortgages. These are secured against land and buildings at moderate gearing ratios, are normally short term and provide a reasonable return relative to risk. Given the current point in the Australian housing cycle, as described above, we feel the preference is to generally sit back and watch at this stage.

We are unlikely to pursue higher risk options at any stage, these are beyond our comfort zone.

Overall returns from high quality defensive investments (cash, term deposit and bonds) remain insufficient to offset medium to long-term inflation risks, and we have difficulty gaining comfort in higher return parts of the credit universe. 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 in which we manage this.

Franking Credits

Labor policy seeks to change the classification of franking credits from a ‘rebate’ to an ‘offset’. This means that franking credits can continue to be used to offset tax liabilities, but where these exceed tax liabilities the excess would no longer result in a cash refund from the ATO.

This is likely to impact clients that hold investments in self managed super funds (pension phase) and low tax rate individuals/entities. In simple terms the after-tax income from Australian share investments will be reduced. Given that portfolios contain a mixture of assets, including credit securities and international shares that do not attach franking credits we assess the impact on income to be moderate, a 0.5% to 1% per annum loss. However, individual circumstances vary.

We expect there to be small to moderate structural changes to valuation of income producing assets with some of those that pay franking credits experiencing a fall in demand and some of those that do not an increase. We will assess this on an ongoing basis as the political landscape evolves, there is substantial community pushback against the proposal and it remains unclear whether it will be successfully legislated.

Alder & Partners is supporting campaigns against this policy by several prominent fund managers with large investor bases.