

NEWSLETTER

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The MacroView

The exceptionally low volatility that has characterised equity markets in 2017 is highly consistent with the global economic backdrop, which has remained comfortably stable. Despite expectations of higher inflation following the change in the U.S. presidency at the end of last year, upward price pressures have been largely absent. This has allowed interest rates to remain near record lows at a time when global economic growth has continued to improve and labour markets have continued to tighten. Even those interest rate increases that have taken place have been telegraphed well in advanced and welcomed by financial markets. The environment has been near perfect for equity markets, with positive demand growth and the absence of cost pressures allowing earnings to rise; whilst flat bond yields ensure the relative risk premium available from share markets remains attractive – even at these very elevated valuations.

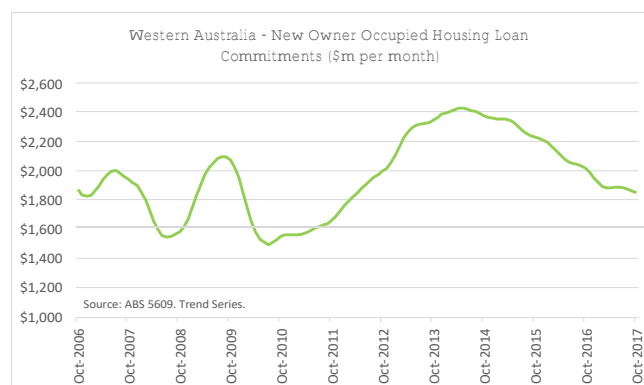
Contrary to most expectations, the economic evidence of the past 5 years highlights that sustained low interest rates can co-exist with low inflation. This could be a function of the current age, whereby digitisation has created a lower demand for capital in the production process, implying a more permanent shift towards lower interest rates. The ageing profile of advanced economy populations may also be a key factor – creating a surplus of savings and increasing the proportion of the population relying on interest income to fund consumption. After all, the household sector is a net saver, and low interest rates will constrain, rather than stimulate, spending in a growing proportion of households.

With the global economic system appearing to be in equilibrium with no obvious catalyst for change, the case for changing investment strategies is difficult to make. Although the equity market rally may simply run out of steam, the absence of any imbalance suggests the current pattern could persist for some time, with valuations tracking company earnings higher from this point. However, despite the calmness of markets, it is not a time for investor complacency. Highly elevated share markets are more vulnerable to correction simply because they have further to fall. Early signs of an unexpected jump in inflation or bond yields should be a trigger for a reassessment of strategy, as equity markets may react strongly to such a change. Similarly, evidence of a peaking in the economic growth cycle would have similar negative connotations for investors.

Locally, it is disappointment with economic growth that may result in our share market continuing to underperform. The unwinding of the housing boom, both in terms of price growth and construction activity, provides a significant gap that needs to be filled with other sources of activity if a slowdown is to be avoided. Real wages, unemployment and per person consumption spending have all been moving sideways of late. The removal of the housing stimulus could have significant implications for the already struggling retailers and shopping centre owners.

For the all important banking sector, a housing downturn may have larger than expected consequences. A serious escalation in loan arrears may well be avoided; however, it is the impact on loan book growth that is perhaps being underestimated by the market. At the height of the recent boom, housing loan books grew at the somewhat modest rate of 7.5% per annum. With new lending constraints, a material shift away from interest only loans on existing

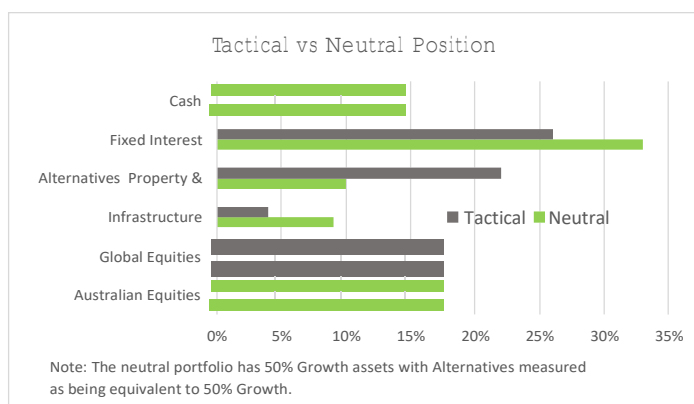
books and minimal personal or business credit growth, a housing down turn will make it very difficult for banks to grow their asset base. The accompanying chart shows the magnitude of the decline from the peak in new lending in the Western Australian. Ignoring the froth and bubble of the property investor segment, core new owner occupied loans have declined in value by approximately 25% in WA over the past 3 years. A decline of even half this magnitude on a nationwide basis could have serious implications for bank earnings growth.



Asset Class	Current Earnings Yield	BMIS Fair Value Estimate	Tactical Position	Comments
Australian Equities	6.0%	7.0%	Moderate Underweight	Non export orientated companies face subdued earnings outlook, weighed down slower asset growth in banks.
Global Equities	6.6%	7.5%	Neutral	Skew away from mega caps, which appear the most overvalued.
Property & Infrastructure	5.7%	6.5%	Moderate Underweight	Both property and infrastructure appear fully valued and vulnerable rising bond yields.
Alternatives	-	-	Large Overweight	Diversified strategies should be pursued as managed futures alone provides high levels of equity exposure currently.
Fixed Interest	2.2%	4.0%	Moderate Underweight	Although bond yields are taking longer than expected to increase, the opportunity cost of being underweight bonds is low.
Cash	1.5%	3.5%	Moderate Overweight	Surplus cash should be held to take advantage of any correction in growth asset values.

Note: Global equity yield adjusted for currency hedging margin. Earnings yield is the inverse of 1-year forward PE ratio. Yields sourced from S&P World ex Australia Fund, S&P ASX 200, S&P ASX 200 A-REIT, 5-year Aus Bond & overnight cash target.

The tactical program remains unchanged from the previous update in August. Notwithstanding elevated valuations, global equities continue to offer the prospect of attractive returns whilst ever the economic backdrop remains supportive. Either a slowdown in economic growth momentum or a rise in bond yields may trigger a correction on equity markets, however there remains no indication that either catalyst is imminent.



Any undervaluation that had emerged in the Australian listed property sector has been removed following the price adjustments that took place following the announcement of the sale of Westfields. The sector is vulnerable to both rising bond yields and deteriorating fundamentals in both shopping centre and office property markets.

An underweight position remains in place for fixed interest. Longer term bonds continue to offer insufficient compensation for the risks that inflation may ultimately normalise. Although higher yielding corporate debt securities have provided healthy returns to date, narrow interest rate margins now make the asset class far less attractive and at risk of capital loss should spreads widen.

TheCurrencyView

A bias towards unhedged currency positions continues to be recommended. Despite its recent falls, the \$A remains above its longer term purchasing power parity level. With interest rate differentials between Australia and overseas narrowing, there is a probability the Australian currency will come under further downward pressure.

Neutral Hedging Position	Current BMIS recommendation
100% Unhedged	100% Unhedged
50% Hedged	0% Hedged
100% Hedged	50% Hedged

Note: The above table shows tactical recommendations for 3 different neutral policy positions.

Given the \$A tends to be correlated to equity markets, an unhedged exposure may increase the defensiveness of a global equity portfolio.

Important Information

The following indexes are used to report asset class performance and calculate the benchmark returns for this model portfolio: ASX S&P 200 Index, MSCI World Index ex Australia net AUD TR (composite of 50% hedged and 50% unhedged), FTSE EPRA/NAREIT Developed REITs Index Net TRI AUD Hedged, Bloomberg AusBond Composite 0 Yr Index, Barclays Global Aggregate (\$A Hedged), Bloomberg AusBond Bank Bill Index, S&P ASX 300 A-REIT (Sector) TR Index AUD, S&P Global Infrastructure NR Index (AUD Hedged).

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