Providence
Independent Investment Advisory

Global Outlook & Strategy

Issue 62: 30th June 2016

Distortions in Asset Prices

1. Key Points

- We expect modest global economic growth for the remainder of 2016
- Global central bank policy remains the focus
- Economic growth in Australia is expected to fade
- Bond yields are depressed driving investors into higher risk assets
- Boutique property sectors with demographic support look attractive
- Valuations in risk assets are extended on an absolute basis but remain cheap relative to bonds
- We maintain an overweight to cash
- Long term asset class returns are expected to trend lower

"There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know". Donald Rumsfeld

The current investment environment is riddled with "known unknowns", be it the implications of the UK's vote to leave the European Union (Brexit), conflicts in the South China Sea, rising populism in the Eurozone or the proposition of "helicopter money" in Japan.

Coupled with these "known unknowns" is the prospect of the "unknown unknowns". We have seen a great divergence between what bond markets and risk assets are telling us about the health of the global economy. In our mind, this indicates the market's nervousness and the prospect of an "unknown unknown" presenting itself. In such an environment we believe an ongoing cautious and protective stance is still warranted.

2. Investment Overview

Global central bank policy remains the focus for global markets; however it appears that we live in interesting times. The global populous is now faced with multiple and ever-changing headwinds and uncertainty: Geo-political risk, terrorism, the rise of populism and global central banks doing what would have seemed incomprehensible in years past (negative rates and unheard of liquidity). In unchartered waters, a sage hat and cautious stance is “de rigueur”. The ramifications and unintended consequences of some of the more recent events like the unfolding of Brexit are very much unknown.

There are conflicting signals from bond and equity markets. Negative real and nominal bond rates along with flat yield curves would suggest the globe is headed for a period of deflation and global recession and signals investors that there is little chance of rates rising long-term. Yet within equity markets current PE multiples would suggest an expectation of impending earnings growth and global reflation. In such a scenario, a cautious stance is certainly warranted. For the past few years we have seen the strange phenomenon of falling bond yields coupled with rising equity markets, in other words bonds are suggesting a risk off environment and equities are suggesting a risk on environment (figure 1).

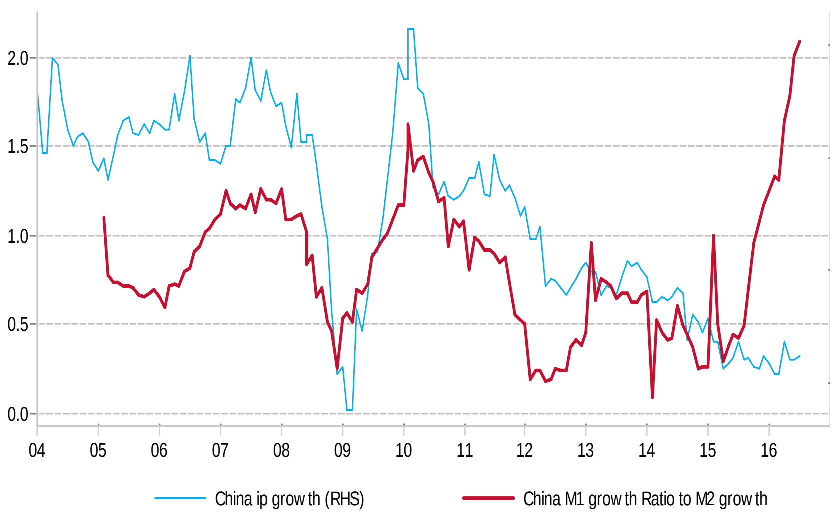
Figure 1: Australian 10 year bond and ASX 200 rolling 1 month correlation
Source: Heuristic, IRESS

Global growth, led by the USA, is expected to be in the order of 2.8-3.0%, in our view, which is weaker than a normal cycle although given the global backdrop of incredible uncertainty would be a reasonable result.

Despite some weakness in recent economic data from the US, we do not believe there are significant risks to the US economy at this juncture. Unemployment claims continue to fall, house prices continue to grow and consumer spending is still reasonably robust. Wage growth in the USA of ~3.6% may stoke inflation and impact corporate margins which is another aspect that the US Federal Reserve (FED) must take into account with regard to their rate setting policy. However, the FED and the markets appear to be in a constant feedback loop with markets reacting positively to delays in a possible rate hike leading to the FED increasing the likelihood of a rate hike followed by a sell-off in markets and a delay to rate hikes - the cycle feeds upon itself but must be broken at some point.

China continues to report growth around 6.7% due to the ongoing massive fiscal and monetary stimulus, albeit the growth is not reflecting anywhere near the anticipated industrial output given the amount of money supply made available. Between January and March this year there was US$1trn of new lending in China (that's 10% of GDP!), however this has yet to materially feed through to output (figure 2). The only flow-on seen to date from this increased money supply is a spike in speculative activity in real estate and commodities. Re-balancing the economy away from capital spending to consumption in China is underway although aggregate debt levels are concerning with China's private debt burden now larger than it is in every other emerging economy. We also note that government spending in China is currently ~10% of GDP vs. its peak of 25%.

Figure 2: China M1 Money Supply Growth and Chinese Industrial Production Growth
Source: Heuristic, NBS



The fallout from BREXIT may put some pressure on global trade although we must put this in a global perspective with the UK only 4% of global GDP. Pre Brexit, European growth was improving to a lowly 1.7% YoY growth. The implications of Brexit are widely reported to have a likely negative impact on EU growth in the order of 0.5% and 0.2% for global growth. Interestingly, The IMF recently marked down world growth projections post-Brexit by just 0.1% for this year and next and euro-zone by 0.2% for next year, well short of what they had been suggesting pre-Brexit. If we look at the UK economy specifically, it is a significant market for Germany, at 7% of exports while the EU takes ~55% of all UK exports. This highlights the sensitive nature of the EU negotiations ahead for the UK and all expectations are that the process will indeed drag on for a prolonged period of time. Putting EU growth into a global context, it represents ~16% of global GDP, while the USA represents 15.5%, China 17.5%, Japan 4% and Germany 3%. In the interim, there is little on the horizon that would suggest a tightening of monetary policy in the Eurozone. This bodes well for risk asset prices in the short term.

In Japan the likelihood of helicopter money is now firmly on the agenda given Japan now owns circa 40% of all Japanese government debt and there is little else that they can do. Helicopter money was first introduced as a concept in 1969 by Milton Friedman and is the process of distributing cash to the population in a one-off event, in all likelihood this will be through some form of fiscal spending. The desired result is a pickup in aggregate demand that should help support inflation. Recent media reports have suggested that the government is preparing a supplementary budget worth Y10trn, equivalent to 2% of GDP.

Within Australia, we expect GDP to fade despite the recent federal election. Australia remains in a transition phase away from mining investment towards non-mining investment and that process continues to drag on, providing a vacuum of much needed growth/demand. Government/policy inaction over recent years has also done little to encourage new corporate confidence or investment. Corporate Australia needs to be convinced that we are heading for a period of stable government and policy action, another known unknown. Final domestic demand will soften as household spending softens from unsustainable high levels. We expect Australian GDP growth in the order of 2.5 – 3.0% and continue to expect further rate cuts from the RBA. The most recent RBA minutes reinforce the importance of inflation data and this will be a key indicator for the RBA's next move, which by all estimates will be further cuts.

Overall, global growth is likely to remain subdued as a number of significant geopolitical events unfold. We remain very mindful of the increasing levels of risks that the globe now faces, be-it geo-political, economic, the rise of populism and the on-set of deflation (or the looming risk of it). While we expect the BREXIT process to take a considerable amount of time to evolve, we were surprised at how quickly global equity markets recovered, presumably on the on-going belief that central banks and/or governments will continue to come to the rescue.

Whilst we do not have a clear view of the likely scenario, given unprecedented central bank policy and how things will ultimately play out, it is safe to say these policies are causing distortions in asset prices and therefore warrant caution. We remain protective and cautious highlighting that portfolio returns are likely to remain below historical averages for some time.

3. Asset Class Review

3.1 Equities – *Prefer International unhedged and mid to small cap managers domestically*

On an absolute basis, we are finding it very difficult to find value in global equity markets. Figures 3 and 4 demonstrate that both global equities and Australian equities are trading on elevated multiples relative to their historical average, Australia more so than global equities.

Figure 3: Australia Forward PE
Source: Heuristic, IBES

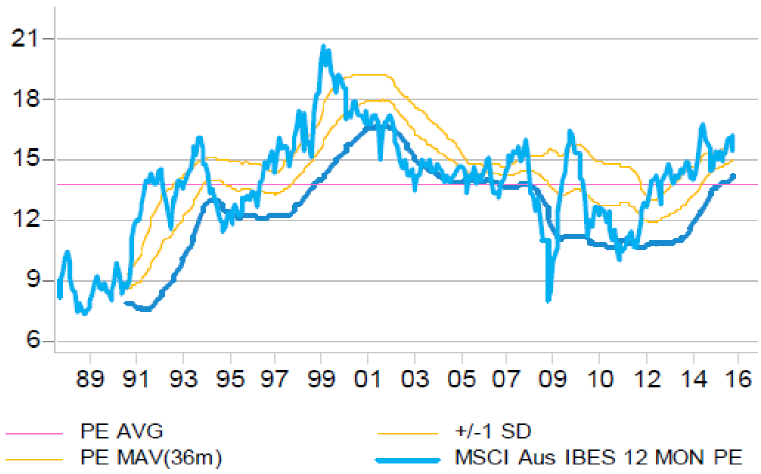
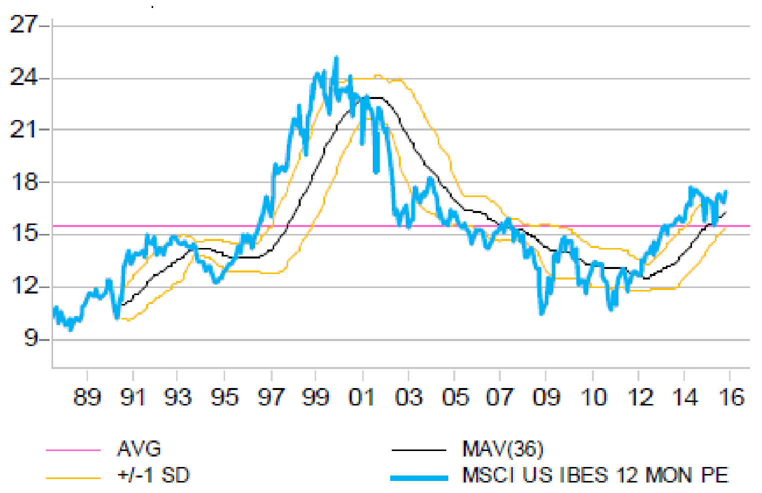


Figure 4: MSCI US Forward PE
Source: Heuristic, IBES



These equity valuations continue to rise despite a lack of earnings growth. In the US, for example, we have now seen 6 quarters of declining revenue growth yet Price to Earnings multiples have expanded to 17.5x from their historical average of 15.2x. The same can be said for most developed equity markets.

The key reason for this is the relative value support that equities have received as investors are faced with low, and in some cases, negative bond yields. With a lack of an alternative, and the aging population's need for income, investors are being forced up the risk curve. Today we have the largest gap between global equity earnings yields (2.8%) and global bonds (0.8%) since 1950 (figure 5), the same can be seen in Australia (figure 6).

Figure 5: Australia Real Earnings – Bond Yield Ratio
Source: Heuristic, IBES, IRESS, RBA

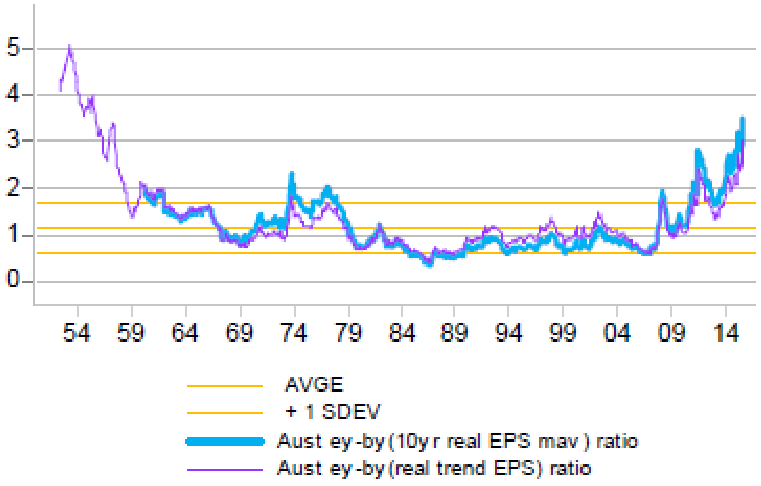
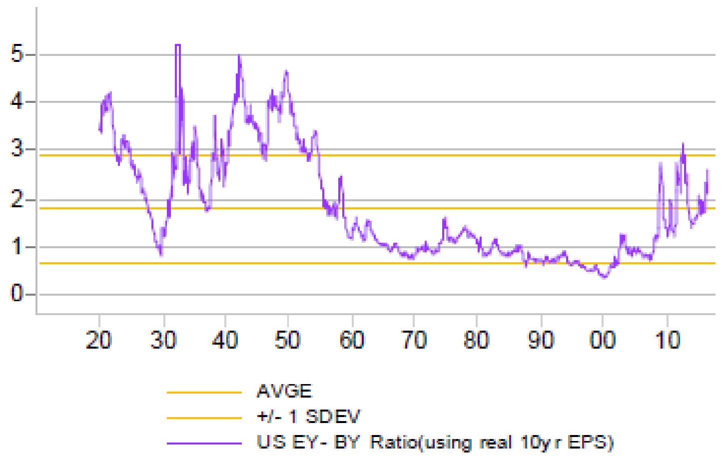


Figure 6: US Real Earnings – Bond Yield Ratio
Source: Heuristic, IBES, IRESS, R Shiller



With the likely back drop of continued loose monetary policy, and therefore low bond yields, we expect the equity markets to continue with this momentum. We are keeping a close eye on any changes to monetary policy and bond yields as these may well be the catalyst for a reversion back to the historical average PE multiples.

We still marginally favor global equities relative to domestic equities. This is mainly due to the diversification benefits available through international equity markets when compared to the financial and resource dominated Australian market.

3.2 Property

We believe that house prices within Australia are likely to, at best, stagnate around current levels with the potential of heavy falls in the apartment market as offshore demand and stricter lending requirements by the banks puts pressure on settlements and ongoing demand.

Wages growth remains weak at 2.1%, which is the lowest growth level since the 1990's. Without real wages growth, this will also have an impact on housing despite the continuation of favourable interest rates to the borrower.

A-Grade commercial property yields are also full once again supported by low borrowing costs.

We prefer more boutique sectors such as Medical Centres, Aged Care and Child Care for direct investments. These opportunities are underpinned by various long dated demographic factors. For example, child care centres are beneficiaries of the increasing female labour participation rate, up to 59.1% in 2015 from 44.9% in 1984 (figure 7), while aged care is a beneficiary of the aging Australian population (figure 8).

Figure 7: Female Labour Participation Rate
Source: Heuristic, IBES

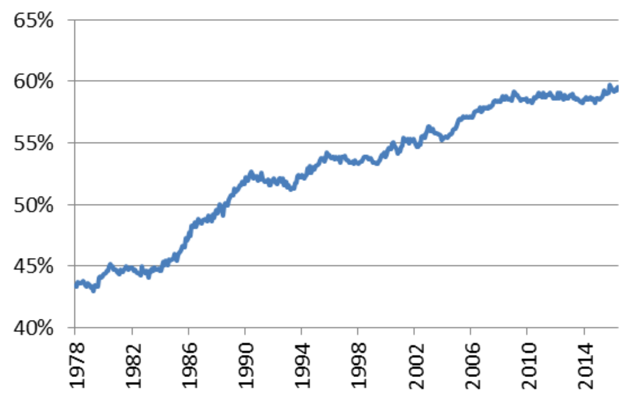
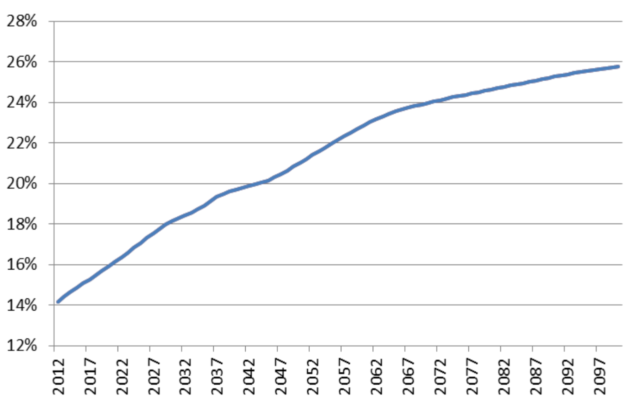


Figure 8: Per cent of Australian population over 65 projection
Source: ABS series A population projection

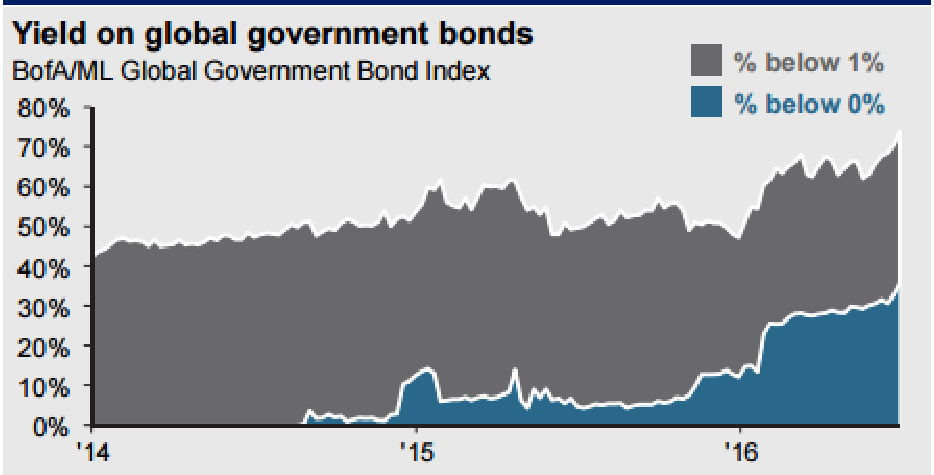


Australian listed REITs have been the star performer over the past 12 months driven by lower bond yields and lower cap rates within the direct space. As investors search for yield in a low to negative interest rate environment risk assets are being sought to supplement income requirements.

3.3 Fixed Income

Within fixed income, there is now more than $US10trn of bonds providing negative interest rates. The lower bond yields are a reflection of central bank policy. We are now faced with the reality that >30% of all developed market sovereign bonds have a negative yield and ~70% of all developed market sovereign bonds have yields <1% (figure 9). A bi-product of this phenomenon is the demand this is creating for Australian bonds yielding significantly higher returns versus the alternatives in many developed economies.

Figure 9: Yield on Global Government Bonds
Source: JP Morgan, BofA/ML Global Government Bond Index



Australia today offers a unique club to the global investor, yield. This continues to apply upward pressure to the AUD, which is and will remain a thorn in the side for the RBA managing official rates in Australia. For global insurance companies, and other similar businesses that need to offset their long-term liabilities, Australian bonds, even at current rates, do look attractive when faced with negative rates in many traditional markets.

In such an environment we remain committed to our zero weighting to government bonds. We prefer floating rate securities that provide a margin over a floating rate (such as BBSW). This will allow portfolios to benefit from any potential increase in interest rates; however this will not provide the cushioning affect that bonds have historically provided in an equity market downturn. As demonstrated in our Investment Overview, the traditional correlation between rising equity markets and rising bond yields has been replaced by the inverse (figure 1). We therefore argue that perhaps bonds will not provide the historical levels of portfolio protection that they once did.

3.4 Alternatives

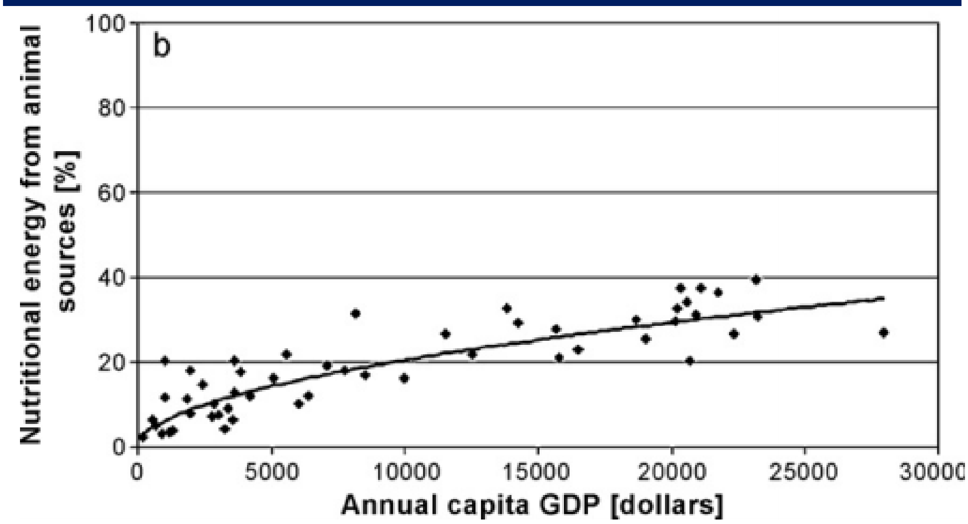
We have made an investment recently in the Private Equity space which gives investors access to equities at cheaper multiples than the listed market and with less daily volatility. Our view is that listed markets are starting to look quite expensive and we are therefore reducing this exposure at the margin and using the proceeds to fund the Private Equity investment.

Hedge funds have struggled to deliver on their non-correlated performance promise over the last 12 months. Central bank rhetoric has been the main driver of positive asset prices for a number of years now, but the market is becoming more skeptical of the power of central banks which is being reflected in an increase in volatility. This has made it difficult for hedge funds that require momentum or strong consistent global macro themes to deliver positive returns.

The commodity space has also seen mainly negative returns as fears of a global slowdown, particularly in China, has impacted on most commodity prices. The only commodity to buck this trend is gold which has been well supported as a safe haven investment as yields are now extremely low or even negative in the traditional defensive area of Government bonds. We have not made a direct investment in gold but have exposure to gold shares through some of the managed funds we use.

An area we would like to get exposure to is agriculture as a defensive, non-correlated asset class. The investment thematic of an ever increasing demand for protein as the emerging world moves up the wealth curve is well known (figure 10). However, finding the right fund manager with the appropriate investment structure is proving to be more difficult.

Figure 10: Nutritional Energy from Animal Sources and Annual GDP per Capita
Source: P.W. Gerbens-Leens, S. Nonhebel, M.S Krol (2010)



Providence Investment Committee

Steven Crane
Steven has over forty years of investment experience having started in financial markets in the early 1970's. He has held such positions as Senior Portfolio Manager and member of the Asset Allocation Committee at AMP. For seven years he was the Chief Executive of ABN Amro. His current Directorships include among others: Chair of NIB Holdings limited, APA Group, Bank of Queensland and Transfield Services.

Chris Grubb
Chris has held senior Fund Management and Broking positions within the Jardine Fleming Group in Japan, Hong Kong and Singapore. He was also a Director of Jardine Fleming Ord Minnett and Chairman of Investor's Mutual and Investor Web and is currently a Director of several Asian focused investment funds. He also Chairs Boardroom Australia and is a Director of Boardroom Limited in Singapore. Chris also acts an Executive Coach.

Stephen Roberts
Stephen has over forty years of experience as an economist and financial markets strategist in banking, broking, and funds management. He has worked as Chief Economist with Equitilink and UBS. He worked on the Secretariat of the Australian Financial System Inquiry (Campbell Committee) in 1980, helping draft recommendations that led to the deregulation of the Australian financial system. He is an honours graduate in Monetary Economics from the London School of Economics.

Peter Hooker
Peter has held such positions as an Industrial Analyst at BZW Australia (now ABN Amro), Director reporting to Head of Research, was on the Equities Executive Committee, and Director and Head of Industrial Research. He has a B.Sc. in Chemistry, B.E. in Chemical and Materials Engineering, and Graduate Diploma in Finance and Investment. He has over 25 years of experience in investment markets.

Jonathan Pain
Jonathan has thirty years of international investment experience. He has held such positions as Chief Investment Strategist of HFA Asset Management, Chief Investment Officer of Rothschild Australia Asset Management, Head of Investments at Gulf International Bank in Bahrain, and Chair of the International Asset Allocation Committee at Paribas Asset Management in London. He holds a joint honours degree in Economics and Politics from Keele University, and a Masters degree in the Economics of Finance and Investment from Exeter University.

Ian Wenham
Ian has over thirty years of experience in equity research, investment strategy, and portfolio management. He has held such positions as Equity Analyst with Meares and Philips, Research Director of BZW Australia: covering equity strategy and industrial research. He was also Regional Research Director with BZW Asia, and Director of Asian Research at Lehman Brothers Asia: where he chaired the Investment Policy Committee and was the firm's supervisory Analyst for the Asia Pacific Region. He has also managed the strategic global equity investments for the Lowy Family Private Fund. He currently heads his own investment firm.

Richard Nicholas
Richard has over thirty years of experience in private client portfolio management in London, Hong Kong, and Australia. Richard started his career with Deloittes in London, before cutting his investment teeth with The Rothschild family. He was the founding research director at S&P Fund Research UK, and Investment Director at Hill Samuel Pacific in Hong Kong. He has also held senior positions with Hambros Pacific in Hong Kong, Alliance Capital in Asia, and ANZ Private Bank. He is currently director at Peak Investment Partners.

David Croll
David has over twenty years' experience in stock broking and funds management. He has held such positions as a dealer on the options trading floor, the manager of the branch office network for stockbroker Rivkin Croll Smith: based in Melbourne. Since 1998 he has managing several private companies involved in options trading and investment in listed and unlisted equities. He is currently the Managing Director of Noontide Investments Ltd. He has a Bachelor of Arts majoring in Politics from Macquarie University.

Grant Patterson
Grant has over thirty years of experience in equity markets. Prior to forming Providence he was a Director of ABN Amro, and Head of Retail Broking. He has also held other senior positions such as Senior Institutional Dealer, Head of the Sydney Institutional Dealing Desk, and also Head of Corporate Liaison.

Michael Ogg
Michael has over twenty years of experience in investments, starting his career at JPMorgan Investment Management in London in the early 90's. In Australia, Michael worked for AMP Asset Management holding senior roles in institutional equities, and for Deutsche Bank as a Client Advisor in Private Banking. Michael has an MA(Honours) Economics from Aberdeen University.

Stephen Christie
Steve has over 20 years of investment and finance experience, including as Director and Head of Private Wealth for Ord Minnett, Chairman of the Ord Minnett Investment Committee and Head of Asset Allocation for Goldman Sachs JBWere Private Wealth Management. Steve holds a PhD in Applied Finance, is an Honorary Fellow at Macquarie University, an Adjunct Professor at Notre Dame University Sydney and a Trustee Director of major industry super fund QSuper.

James Smith
James has over twenty years of investment market experience (cash equities). Prior to joining Providence, he held the position of Deputy Head of Domestic Sales at CIMB Securities (Australia) and was a member of the CIMB Equities (Australia) Management Committee. He has also held positions as Director - Sales at RBS, ABN AMRO and Sales at Deutsche Bank. James was responsible for Melbourne Sales/Account management in his previous roles over the last decade and in the last two years, was also responsible for New Zealand.

Glossary of Terms

BBSW	Bank Bill Swap Rate - wholesale rate that financial institutes are willing to lend/borrow from each other over specific maturities
Correlated	In this context, the degree to which asset prices move together. Non-correlated assets should exhibit no relationship in how their prices move.
Deflation	When the inflation rate is below 0 and the general price level of goods and services decreases.
Demographics	Characteristics of a population for example, age, ethnicity, income etc.
Fiscal Stimulus	Increasing government spending or reducing tax levels to stimulate and/or support economic growth
Helicopter Money	An unconventional form of monetary policy involving printing large sums of money and distributing it to the populous to stimulate the economy.
Industrial Output	A measure of output from the industrial sector (manufacturing, mining and utilities)
Inflation	When the inflation rate is above 0 and the general price level of goods and services increases.
Monetary Policy	The process by which a countries' monetary authority (usually a central bank) controls the supply of money. Traditionally by setting short term interest rates.
Monetary Stimulus	Increasing the supply of money or credit available in an economy.
Nominal Bond yield	The coupon rate attached to a bond.
PE Multiple/Ratio	Price Earnings ratio - the share price divided by the earnings per share of the company.
Populism	A belief that the majority of a population is being mistreated by a small circle of elites.
Real Bond Yield	The coupon rate attached to a bond less inflation.
US Federal Reserve	The US Central bank. Responsible for setting US monetary policy
Volatility	The degree of variation of a price over time.
Yield Curve	The level of interest rates across multiple points in time.

Safe Passage

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