Providence
Independent Investment Advisory

Global Outlook & Strategy

Issue 72: 1st Quarter 2019

Recalibration

CONTENTS CONTACT

1. KEY POINTS

- **Clear slowdown in global growth outside the US**
- **The change in central bank policy will increase volatility**
- **Record global debt a concern**
- **The Australian economy is vulnerable to the housing downturn and weaker Chinese growth**
- **Valuations are more attractive after the Q4 correction**
- **Increasing exposure to growth assets at the margin**

Recalibration

The global coordinated experiment by central banks of quantitative easing (QE) is now ending. It is now slowly moving towards quantitative tightening (QT) as central banks look to unwind their balance sheets and increase interest rates.

However, recent slowing in global growth and the impact of trade tensions (coupled with increased market volatility) may inhibit the extent to which central banks are willing to raise interest rates. Central banks could collectively find they have limited monetary firepower if a more severe downturn eventuates at a time of record global debt.

The QE experiment, forced onto central banks via the threat of a global depression in 2008, saw a collective benefit to all asset classes. The past downturn had its origins in inflated asset values, excessive debt and a myriad of complex structured products.

Alarmingly the same can be said for aspects of the current environment. While the GFC stemmed predominantly from over-leveraged US households and banks, this time the elephant in the room may be the significant amount of US investment grade debt that sits just one notch above junk. Any significant pressure on the investment ratings of this debt (via a US economy that will arguably slow in the next few years) may cause a slew of 'forced' sellers of said debt that is no longer investment grade and cannot be held by certain investors.

As central banks endeavor to normalise monetary policy via higher interest rates, **market volatility is likely to be higher than recent years.** We had a taste of this during the final throes of December 2018.

The US Fed is in uncharted waters. It is managing a new narrative of shrinking its balance sheet by up to ~US$50bn per month (QT). It is also managing interest rate increases in a highly indebted world and trying to appease jittery investment markets. All this whilst dealing with an interfering President and trying to keep the US economic cycle from tipping over. Despite raising rates by 175bps over the last two years, US official interest rates are still yet to be in "restrictive" territory according to the Fed. The sheer quantum of this series of rate rises (from where the Fed Funds rate was at the beginning of 2017) should not be discounted, from 0.5% in December 2016 to 2.25% currently. This may explain recent press commentary suggesting many investors believe the Fed has finished raising rates. Inflation in the US continues to remain at bay.

The question now is whether the Fed pauses its interest rate increases and possibly allows the US economy to overheat a little. A precarious pathway to navigate with an unforgiving and impatient market and US President!

Recalibration can be a tricky path.

2. INVESTMENT OVERVIEW

There is clear evidence of a slowdown in global growth (**Figure 1**) with the US economy remaining the one standout exception. This is despite some leading indicators starting to soften. However, global financial conditions are tightening, putting pressure on elevated equity market valuations as shown in Q4 of 2018. Momentum appears to still favour the US economy, extending this cycle for now. This makes the "data dependent" Fed the one to watch for 2019. We suspect, amongst other data points, wages growth will be the FEDs primary focus throughout 2019. A wages growth number above 3.5% (currently 3.1%) may be the data point that dictates what the FED does regarding interest rates this year. US households are in a strong position with leverage well below the pre-GFC peak (**Figure 2**). Add to that improving wages growth, good job prospects and relative ease in finding new, higher-paying work, the prospects for further US inflationary pressures are real and likely. The market appears at odds with this scenario playing out. Key US economic data points throughout 2019 will be closely watched as they set the narrative for how markets and the Fed will behave this year. The flat yield curve in the US (10-year government bond yield less 2-year government bond yield, currently at 16.5bps) points to a looming economic slowdown.

The prospect of greater market volatility around economic data points, particularly in the US, remains significant and something investors should expect throughout the year.

Figure 1: Global Manufacturing PMI prints are softening, the exception remains the US
Source: Heuristic Investment Systems

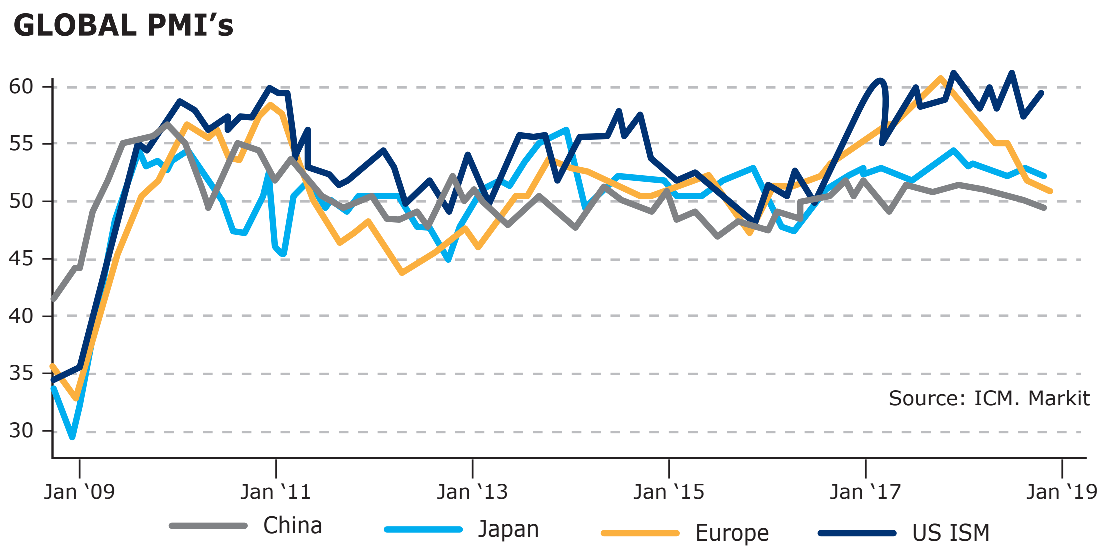
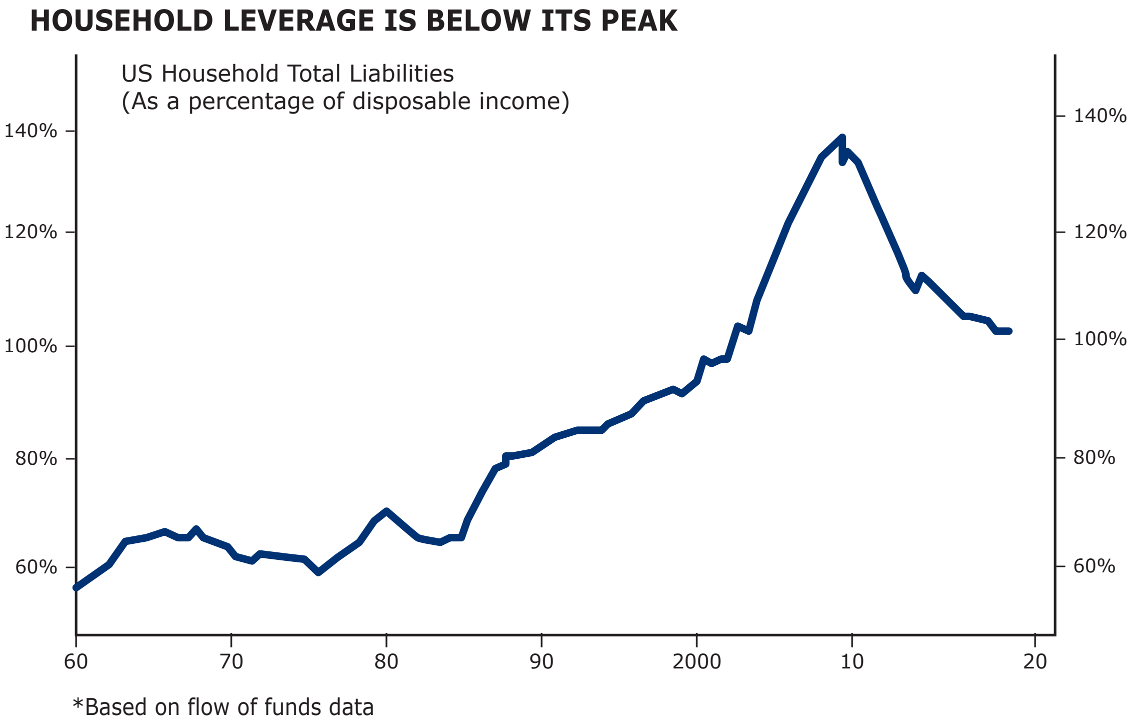


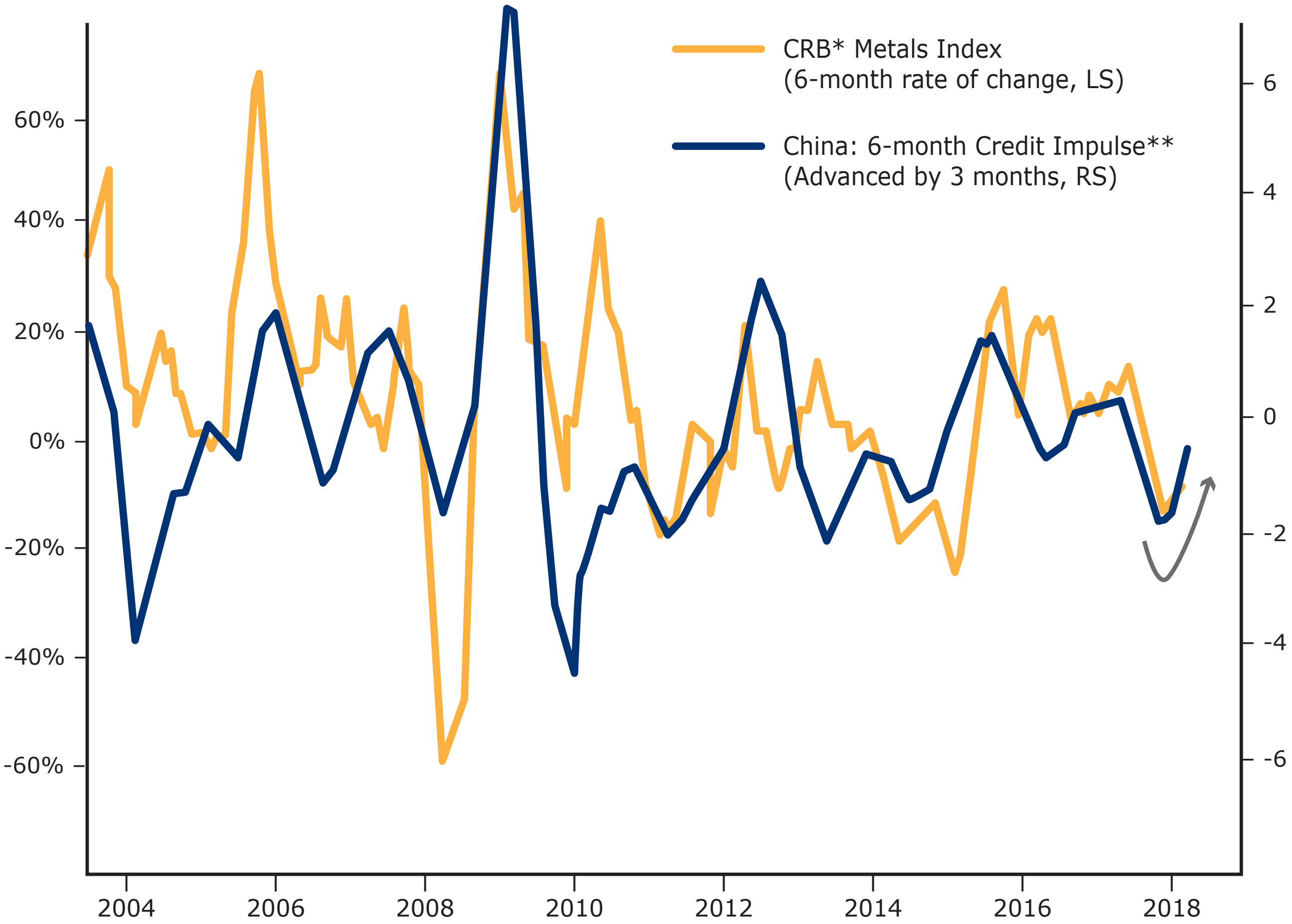
Figure 2: US household balance sheets remain strong and leverage remains well below pre-GFC levels

Source: BCA



Trade tensions between the US and China are already having an impact on trade volumes and data. Domestic financial tightening measures (implemented by the Chinese government in 2018) have led to a slowdown in the Chinese economy, much of which relates to slower domestic demand (consumption). The recent downgrade to revenue expectations from Apple is evidence of this. China has given some indications of further stimulus if their economy fails to improve. An important prospect for emerging markets, commodity prices and Australia's economic fortunes. More recent money supply indicators suggest a possible improvement (**Figure 3**), however, there remains scope for China to default back to debt-induced stimulatory measures during 2019.

Figure 3: Some evidence of an improvement in China's credit impulse can be seen
Source: BCA



*Commodity Research Bureau, Inc.
**Based on Seasonally-Adjusted Total Social Financing

Recent European data and news flow has been disappointing, especially in key economies such as Germany (in December, business confidence fell to its lowest level since 2016) and France (Government suspends fuel tax rise after riots, putting pressure on their budget). Italian budgetary issues remain ever present (Italy promises budget cuts in December to avoid EU sanctions) and Brexit remains uncertain with severe impacts for the UK either way (both economically and politically). If nothing else, Brexit reminds us of the perils of populism and the complexities of politics to actually "get things done" and keep the electorate content.

The Australian economy is holding up well despite the clear downturn in housing, aided by robust exports, due to lower commodity prices and a surge in LNG export volumes. A pick-up in government-funded infrastructure projects will continue to provide an economic buffer. The lag from the more recent boom in housing building activity will also support growth for a time. However, with the prospect of further falls in house prices still real, a slowing Chinese economy and higher global interest rates, the Australian economy and AUD appears vulnerable. Recent increases in Australian bank international wholesale funding costs (via rising LIBOR rates) remains a pressure point as a significant percentage of Australian bank wholesale funding is sourced from overseas. This is important as the higher funding impost borne onto the banks will no doubt largely be passed onto the heavily indebted Australian household, already pinched by rising costs of living and a lack of wages growth. **This suggests it is unlikely the RBA will increase interest rates in the foreseeable future.**

In this current environment, investment decisions will require a greater level of scrutiny:

- Within equities: Can companies withstand higher funding costs? Are cashflows sustainable in a weaker economic environment? Are dividends maintainable? Are valuations reasonable? All questions that will be asked of a market that, while cheaper than more recent times via the Q4 sell-off, is still only modestly fair value by historical standards.
- Within property: Is the rental income secure? Is the property in a growth location and is gearing manageable? Does the manager have a good track record? Is the distribution yield sufficient versus the risk-free rate?
- Within fixed income: Are your investment-ratings high enough on the credit curve to withstand defaults? Are the companies appropriately geared? Can the values withstand higher interest rates?
- Within alternatives: Have the managers proven that they can perform in volatile markets?

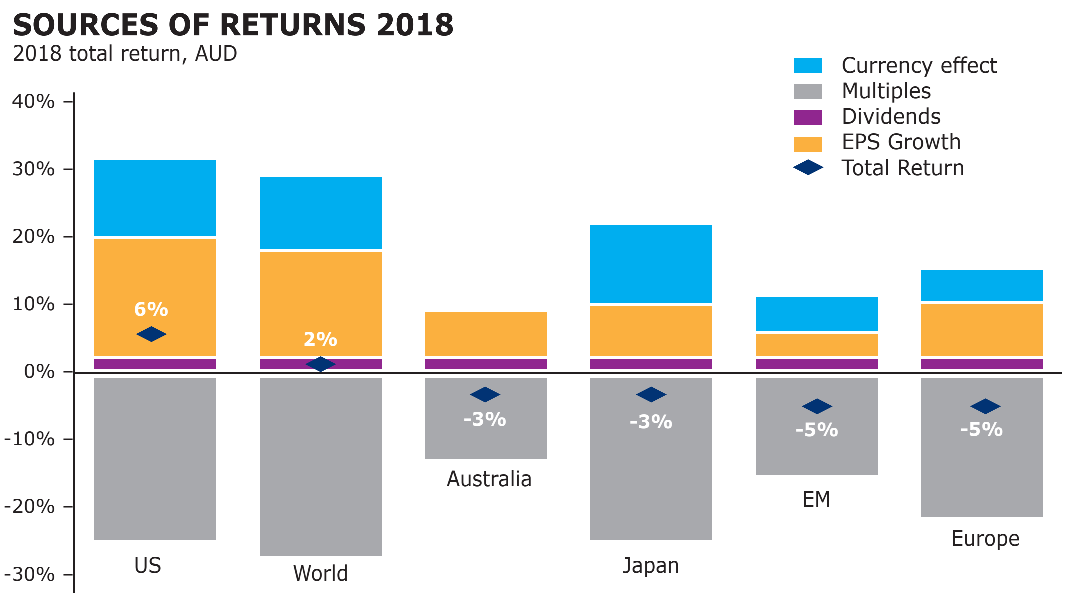
Discipline, patience, diversification and humility will be the key over the next few years as the world recalibrates. Volatility, although unsettling, can also bring opportunities if the appropriate due diligence is thoroughly undertaken.

3. ASSET CLASS REVIEW

3.1 Equities

The driver of share price performance is largely earnings growth and changes in valuation multiples. Multiple expansion over recent years, was a primary driver of returns. This multiple expansion reversed in 2018 (**Figure 4**) with the Q4 equities retracement. The tech bellwethers (Apple, Facebook, Google, Amazon & Netflix) are down a staggering 31% from their recent peak (wiping $1.1trn off their cumulative market capitalisation).

Figure 4: Multiple contraction (grey box) was a primary detractor of share market returns in 2018
Source: JP Morgan



In key markets for example, price-to-earnings multiples are now more attractive and are closer to their long-term averages. In the US, forward price/earnings multiples are now 15.1x vs. their 15-year average of 14.7x. In Europe, the same measure is at 12.2x vs. long-term of 12.2x and in Australia, 14.7x vs. long-term 14.0x.

In Australia, the S&P/ASX dividend yield is 4.9% vs. the Australian 10-year bond rate of 2.20%.

Australian banks are now offering a forecast dividend yield of ~7%, or 10% grossed up (net of franking credits). NAB is the highest at 11.24% grossed up, while CBA is lowest at 8.65% for example.

Overseas equities investments via non-hedged exposure offer an element of cushioning on any weakness in the AUD which helps offset any share price-related weakness.

Equities broadly are back to a level that warrants some tempered increase in exposure at what are now more appealing valuations longer term.

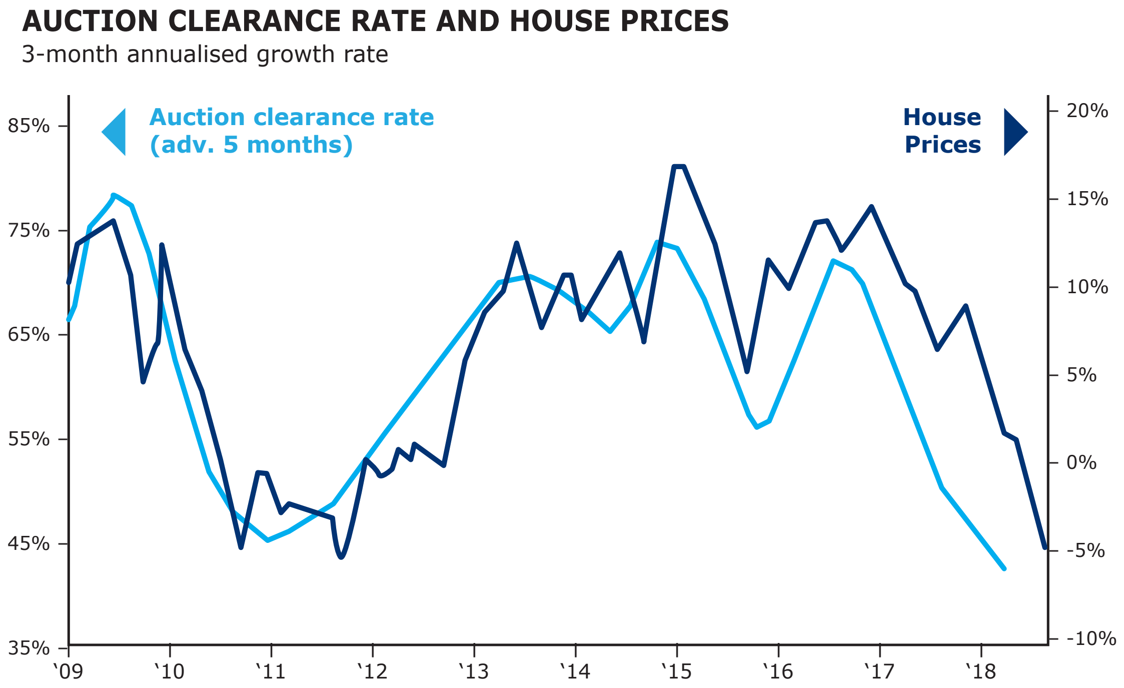
We recently increased our Australian equity exposure in recent weakness.

3.2 Property

The inevitable correction in Australian house prices is now in full swing. The majority of pain is within the apartment sector after a significant over supply issue. This is still to fully playout and may possibly create some investment opportunities at the margin. The correction has been brutal in some areas with units off-the-plan valued and selling at up to 30% below their original list price. There is likely to be further collateral damage as the over-supply issue washes through the system.

Auction clearance rates have slumped, impacting overall valuations of Australia's housing stock (**Figure 5**). This is something that cannot go unnoticed given Australia's heavy household indebtedness, lack of wages growth and the impact to consumer behavior. A very relevant factor for the RBA to continue to consider given domestic consumption represents ~60% of Australia's GDP. It's no coincidence that the Australian 10-year bond rate is now back to levels last seen in 2016. It is also why there is a growing chorus in some corners of the prospect of an RBA rate cut. A big call perhaps given the highly accommodating 1.5% cash rate currently. We will also watch with interest to see if APRAs removal of the cap on interest-only residential mortgage lending by ADIs in mid-December has any bearing on pricing and demand for housing.

Figure 5: A rapid reversal in auction clearance rates and a commensurate impact to house price values
Source: JP Morgan



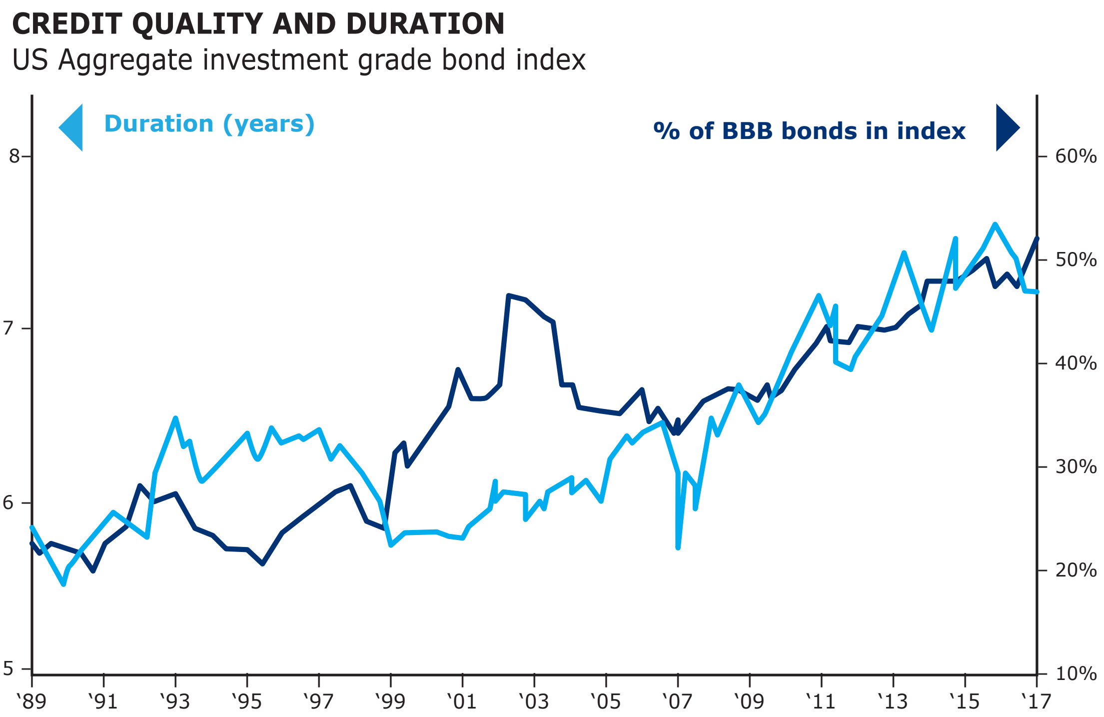
3.3 Fixed Income

A prolonged period of low interest rates and, more recently, investors scrambling for yield has resulted in global corporates borrowing record amounts of debt to fund acquisitions, expansion projects and a significant amount of share buybacks of their own equity. To the end of September, for example, the 12-month total return for the S&P 500 in the US was ~20.4% (15.7% price return + 1.81% dividend + 2.93% for buy-backs), with buy-backs representing ~14.4% of that overall return.

Investors in credit have become less vigilant regarding covenants, resulting in over 50% of investment grade credit in the US now BBB rated (**Figure 6**), one notch above junk. Any distress in this heavily invested sector (via debt being downgraded to junk) may trigger forced selling by large investors whose mandates do not allow exposure to sub-investment grade credit. Not an issue currently with momentum still present in the US economy. **Investment grade credit may prove to be an X-factor for markets in the latter part of 2019 should the US economy begin to slow, putting pressure on these indebted corporates. This is the crowded trade to be wary of in 2019.**

Figure 6: Half of investment grade credit in the US is BBB, one notch above junk

Source: JP Morgan



Along with this chase for yield, many funds and ETFs (exchange trade funds) have flourished, promising daily liquidity and spurring huge investor inflows. However, the assets they ultimately own don't necessarily have daily maturity. Should investor sentiment reverse, there will likely be a significant market dislocation. At this point in the cycle, our preference within this asset class remains asset-backed securities.

Government bonds have not been an attractive place to invest given record low interest rates and duration risk (a measure of a bond's price sensitivity to changes in interest rates). Given longer term concerns regarding a likely US recession and risk to the Australian economy, we have set entry levels in place. We have already begun a gradual implementation to Australian Government bonds.

3.4 Alternatives

Many strategies are not correlated to equities or credit and provide an adequate return above cash with lower volatility of risk assets. We prefer market neutral, long/short equity funds and private equity. Those managers that benefit from higher volatility should now have their time in the sun.

We are in the process of reviewing exposure to alternatives which are meant to provide uncorrelated returns to risk assets. We currently utilise market neutral, long/short and private equity strategies which aim to provide an adequate return above cash with lower volatility of risk assets.

Thoughts from a Contrarian

From the end of February, it's likely you'll see a lot of charts. They will appear in glowing articles in the financial press, large adverts in these publications and on TV with images of content retirees strolling on the beach, driving sports cars and lounging on yachts.

On the 28th February 2009 the All Ordinaries index reached its GFC low (the chart in question is the 10 -year performance numbers of funds managers from 1st March 2009). Since that point, the market has risen steadily all the way back to where it was in February 2008. With the price index almost doubling over 10 years - but going nowhere over 11 years - what are the chances of seeing an 11-year chart?

If you're expecting financial journalists to ask the obvious question, don't hold your breath. In March 2014 our leading financial paper carried a front-page story about a group of managers who returned well over 20% p.a for five years. The only problem was these same managers had lost over 70% during the GFC. The stellar returns achieved had roughly moved investors back to square one. In the article, managers explained the investment process they used to achieve returns of over 20%. These were presumably the same strategies used to lose three-quarters of their capital in the first place.

To be fair, funds management these days is largely about marketing. You can't blame a company for showing its product in the best possible light and 10 years is a legitimate time frame to measure returns. The problem with this particular 10-year period is that just about nobody actually invested at the bottom. After all, stocks were falling during the GFC because investors were redeeming fund units not piling into them. In any given fund I would be surprised if one-tenth of a percent of unit holders invested anywhere near the bottom. Long-term graphs and the data they present are obviously a legitimate measure of performance for either a company or a fund manager. However, on rare occasions where the starting point is at an extreme level, the information is distorted. We are approaching such a time. If you see a performance chart and are afflicted by a case of FOMO, don't worry. I suspect there are more lottery winners over the last ten years than investors who filled out an application form on the 28th February 2009.

Providence Investment Committee

Steven Crane

Steven has over 40 years of investment experience having started in financial markets in the early 1970s. 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 Chair of NIB Holdings limited, APA Group, Bank of Queensland, Taronga 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 a Director of several Asian-focused investment funds. He Chairs Boardroom Australia and is a Director of Boardroom Limited in Singapore. Chris also acts as an executive coach.

Stephen Roberts

Stephen has over 40 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 over 30 years of experience in investment markets. He has served as Head of Industrial Research at BZW Australia, and before that specialised as an analyst in the bank and chemicals sectors. He was previously Treasurer and Director of Médecins Sans Frontières Australia and is currently a Member of the Psychology Board of Australia. He holds a B.Sc. in Chemistry, B.E. in Chemical and Materials Engineering, and a Graduate Diploma in Finance and Investment.

Jonathan Pain

Jonathan has over 30 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 30 years of experience in equity research, investment strategy and portfolio management. He has held such positions as Equity Analyst with Meares and Philips and 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 strategic global equity investments for the Lowy Family Private Fund. He currently heads his own investment firm.

Richard Nicholas

Richard has over 30 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.

Grant Patterson

Grant has over 30 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 Head of Corporate Liaison.

Michael Ogg

Michael has over 20 years of experience in investments, starting his career at JPMorgan Investment Management in London in the early 90s. 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 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 and is a Trustee Director and Chairman of the Investment Committee of major industry super fund QSuper.

James Smith

James has over 20 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

Active Managers	A portfolio investment strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index
Alpha	The level of outperformance relative to a benchmark
Alternatives	A non-traditional asset with potential economic value not found in a standard (or traditional) investment portfolio
A-REITS/REITS	Listed Australian real estate investment trusts giving access to property assets
BPS	Basis points
Cap Rates	The rate of return on a real estate investment property based on the income that property is expected to generate
Correlation	A measure of what degree two securities or investments move in relation to each other
CPI	Consumer Price Index
Credit Spread	The margin paid over the risk-free rate (government bonds)
Cryptocurrencies	A digital asset used as a medium of exchange, a source of digital currency
Cyclically Adjusted Price Earnings Ratio (CAPE)	The price of a security or index divided by the moving average of 10 years of earnings, adjusted for inflation
ECB	The European Central Bank
Economy-Agnostic	Unlikely to be impacted by the fluctuations in the economic cycle
ERP	Equity Risk Premium
ETFs	Exchange Traded Funds
Fiscal Stimulus	Increasing government spending or reducing tax levels to stimulate and/or support economic growth
FOMC/Fed	The US Federal Open Market Committee, the US central bank
GDP	Gross Domestic Product - a measure of an economy's total output
Gearing	A measure of how much debt a company has relative to equity
GFC	Global Financial Crisis
High-Yield Corporate Debt	Debt issued by a corporation that has a credit rating that is below investment grade
IMF	The International Monetary Fund
Inflation	When the inflation rate is above zero and the general price level of goods and services increases
IPO	Initial Public Offering - the first time the stock of a private company is offered to the public
ISM	Institute of Supply Management
Leverage	An alternative term for gearing i.e. a measure of how much debt a company has relative to equity
Long/Short	An investment strategy that involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value
Managed Futures	The use of futures contracts as part of an overall investment strategy providing portfolio diversification among various types of investment styles
Monetary Policy	The process by which a country's monetary authority (usually a central bank) controls the supply of money, traditionally by setting short-term interest rates
MSCI	A US provider of equity, fixed income and hedge fund stock market indexes
MSCI World Index	A market cap weighted stock market index of 1652 world stocks maintained by MSCI
NAPM	National Association of Purchasing Managers
Net Asset Value (NAV)	The value of an entity's assets less the value of its liabilities
Non-Correlated	An asset class that does not move in a similar direction to another asset class
Passive Investing	Asset management associated with mutual and exchange-traded funds (ETF) where a fund's portfolio mirrors a market index
PE Ratio	Price Earnings Ratio - the share price divided by the earnings per share of the company
PMI	Purchasing Managers Index
Populism	A belief that the majority of a population is being mistreated by a small circle of elites
Private Equity	Investment in assets that are not publicly traded
Relative Value	A method of determining an asset's value when taking into account the value of similar assets
Sovereign Bond	A bond issued by a government
Systemic (issues)	A problem due to inherent issues in the overall system rather than a specific or isolated factor
Total Return	A measure of return that takes into account capital appreciation and income received by a portfolio
Variable Beta	The ability to significantly change exposure to the market depending on the view of the fund manager
Volatility	The degree of variation of a price over time

DISCLAIMER: General Advice Only

Providence Wealth Advisory Group (AFSL 245643) has made every effort to ensure that the information in this report is accurate, however its accuracy, reliability or completeness is not guaranteed. This document contains general investment advice only and individuals should refer to their financial advisor as to the appropriateness of the recommendations. No warranty is made to the accuracy or reliability of neither the information contained nor the specific recommendation for the recipient. Accordingly, before acting on any advice contained in this report, you should determine whether the advice is appropriate to your own financial objectives. Providence Wealth Advisory Group, its subsidiaries, affiliates or employees may have interests in securities or investment opportunities mentioned in this report. Providence Wealth Advisory Group, and its employees, disclaims all liability and responsibility for any direct or indirect loss or damage, which may be suffered by the recipient through relying on anything contained or omitted in this report.

HOME CONTENTS CONTACT

Safe Passage

www.providencewealth.com.au

info@providencewealth.com.au

Providence
Independent Investment Advisory

SYDNEY
Grant Patterson, Michael Ogg
Level 9, 20 Martin Place Sydney NSW 2000
PO Box R536 Royal Exchange NSW 1225
T +61 2 9239 9333

MELBOURNE
James Smith
Level 30, 101 Collins St
Melbourne VIC 3000
T +61 3 8793 8383

W providencewealth.com.au
E info@providencewealth.com.au
F +61 2 9239 0355

Providence is an independently owned and operated investment advisory group. ABN 42 003 224 904 | AFSL 245643