Providence
Independent Investment Advisory

Global Outlook & Strategy

Issue 63: 30th September 2016

1. KEY POINTS

- We maintain an overweight to cash which is now more strategic rather than tactical
- Long-term asset class returns are expected to trend lower than in the past
- There is a high degree of uncertainty regarding central bank policy
- Most asset classes are fully valued
- There is value to be found in private markets and select boutique sectors in property

Providence recently attended a two-day conference in New York due to the quality of the speakers and the uncertain global macro and investment outlook. The global perspective provided much food for thought for our investment committee and we have provided a summary later in this document.

Complex, Complicated and Confusing

The current economic and investment outlook is clouded by a number of distortions within asset prices driven by the extraordinary policy by global central banks. We are arguably in the midst of a watershed moment in monetary policy history. The ECB and Bank of Japan appear to have run out of ammunition and ideas whilst the US Central Bank has lost credibility.

No matter which way you cut and dice the questionable data that economists rely upon, asset prices are extended and central banks have run out of what was previously regarded as unconventional policy. We would even go so far as to conclude that data relied upon for many cycles by central banks may be far less relevant in measuring growth in today's rapidly changing technology-driven world than it has been in the past. This conclusion may help explain the mixed messages from central banks.

There are also heightened geopolitical tensions that need to be understood. We are entering into a multipolar world with global military power more diffused as the US has faded from its peak of military influence and assertiveness. There is a rise of state powers within various regions of the globe whether it be Iran, Turkey and Russia, China, India and Pakistan or continental Europe. This is also at a time when populism is on the rise as the middle class voices its displeasure of increasing income inequality.

It's an environment that is likely to see heightened volatility, sharp corrections and lower long-term returns in our view.

2. INVESTMENT OVERVIEW

The global economic outlook is even more confusing that it has been previously. There is some strength around the globe with US growth posting an annualised growth rate of 3% buoyed by household spending offset by lower business spending. Within the US the wealth effect of higher house prices and strong equity markets has given consumers some confidence. Despite these stronger numbers there is no hint of inflation in any of the data. Fiscal stimulus is definitely on the US agenda irrespective of the November presidential outcome.

Growth within the Euro is still soft with an unemployment rate of 10% firmly entrenched. Chinese growth is gravitating towards 5-6% despite official numbers above this.

Australian economic growth has surprised on the upside at 3%+ boosted by net exports and increased government spending. Household consumption on the other hand, which is 53% of GDP, is at its weakest level for three years. We don't believe that net exports and government spending are sustainable at these levels and therefore we see growth fading towards 2%.

The household sector is under pressure with weakness in full-time employment and the lowest wage growth figure in 70 years. This is at a time of dangerously high household debt to income ratios at 178% (the US figure was 130% at its peak).

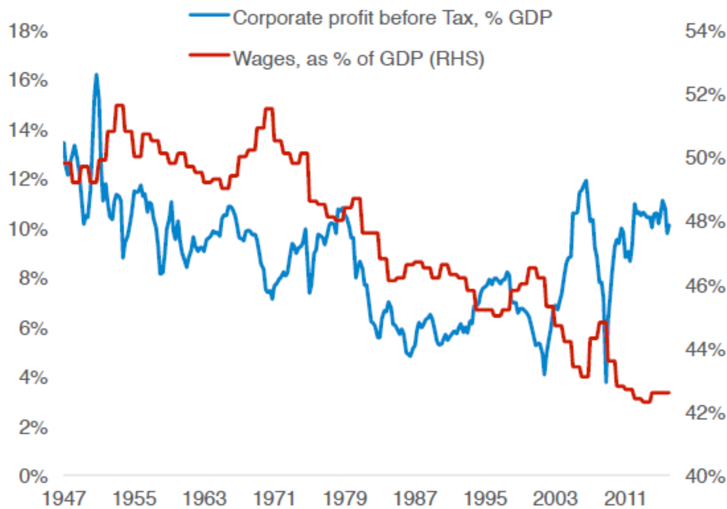
After 25 years of continual growth, high household debt levels and record house prices, caution is warranted. We are very cautious regarding house prices and therefore the economy as a whole. House prices in some mining towns are down 70%. Ouch!

A decade of monetary easing benefits the top quartile and unsettles the masses

The monetary-easing bonfire since the GFC has seen developed markets witness a euphoric rise in asset values, fuelling personal and corporate balance sheets at the upper level of the social food chain, at the expense of the masses. Income oppression has been most evident in key markets such as the UK, US, Germany and Japan.

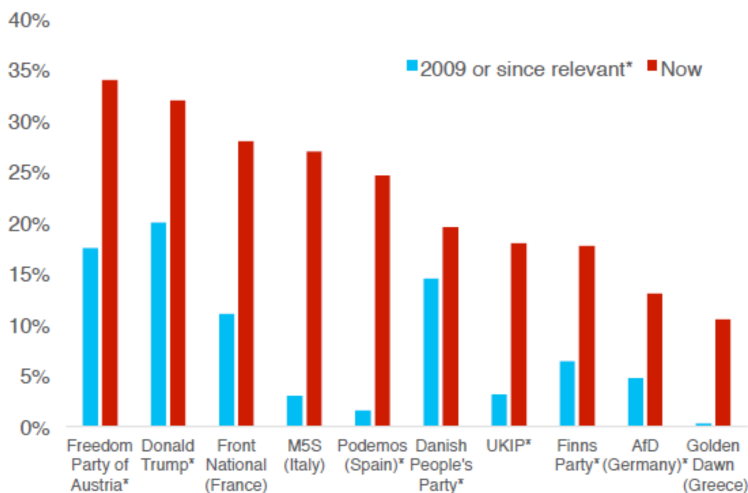
In the US, while the median household income rose by ~5.2% from US$53,700 in 2014 to $56,500 in 2015, the largest increase the bureau has ever recorded, it still remains below pre-recession levels. However corporate profits, as a percentage of GDP continue to surge relative to wages (Figure 1).

Figure 1: Corporate profits have risen, not wages
Source: Algebria Investments (UK) LLP, FRED



The points above highlight that the winners of unconventional monetary policy in more recent years has been at the corporate level and at the top of the income threshold. The reference to this point reinforces in our minds the rise and rise of inequality in key developed markets and the sense of ‘entitlement’ at the top of the social ladder thus fuelling the disenfranchised nature of the electorate. This is not just centred on one country, this is a growing developed market phenomena.

Figure 2: Support for radical and populist politics is on the rise
Source: Algebria Investments (UK) LLP, Wikipedia



No better way can this be emphasised than via the chart below (Figure 2), depicting the rise and rise of radical and populist parties/politics across the globe. This is a new paradox that has a significant amount of momentum behind it and will no doubt shape politics, policies and indeed economies for years to come.

It is no coincidence that the polls got Brexit so wrong. No-one took the populist movement seriously and no-one read the power of the disenfranchised and how that collective vote can shape outcomes. Fear and inequality has a new voice.

How to navigate

- Retain a healthy cash buffer to take advantage of heightened volatility
- Remain in quality assets and reputable managers
- Don’t chase returns
- Be patient
- Be realistic about future returns
- Ensure the total fee level is commensurate to returns
- Ensure a high level of diversification and non-correlated assets
- Seek active managers providing alpha
- Be sceptical of conventional wisdom and strong dogmatic views.

What we like

- Private equity and debt
- Cash
- Corporate loans
- Alpha managers
- Niche property (non-residential)
- Potentially agriculture
- Long-short equity strategies
- Micro-caps in equities.

We have witnessed a 30-year bull market in bonds which has been a tailwind for risk assets, particularly equities, property and infrastructure. With 30% of the developed world’s global government bonds now trading at negative yield it’s time to recognise that this era is more than likely behind us.

We remain protective and cautious highlighting that portfolio returns are likely to remain below historical averages for some time whilst the global system resets and adjusts to this new paradigm.

3. ASSET CLASS REVIEW

3.1 Equities – Valuations are full but supported by dividend yields

We continue to favour selective Australian small cap exposures, where we can identify economy-agnostic operators at reasonable valuations. Given the elevated PEs of many companies in the Australian market, we will continue to seek out value where we can, identifying companies that have solid operating models, proven management, healthy balance sheets and are suitable for longer-term investing.

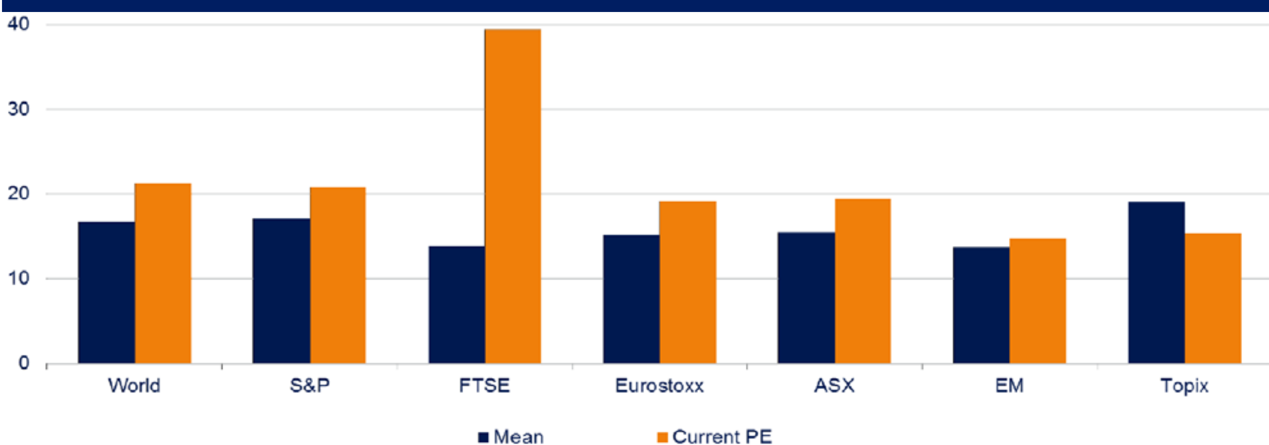
We remain cautious towards many utilities stocks, which have benefited materially from the low interest rate environment. For our utilities exposure, we would want to continue to seek companies that have exposure (through their operating model) to a pick-up in economic activity.

On a 10-year Cyclical Adjusted Price Earnings ratio (CAPE) global equities look dangerously expensive.

The CAPE on the S&P500 is now at 27 times, well above its 50-year average of 20 times, and is at the same level it was prior to the GFC. As with all statistics, data can be manipulated to serve our purposes. Adjusting for a change in accounting standards since the GFC and utilising both private and public company profits the multiple looks more benign at 19 times, just above its 50-year average of 17 times.

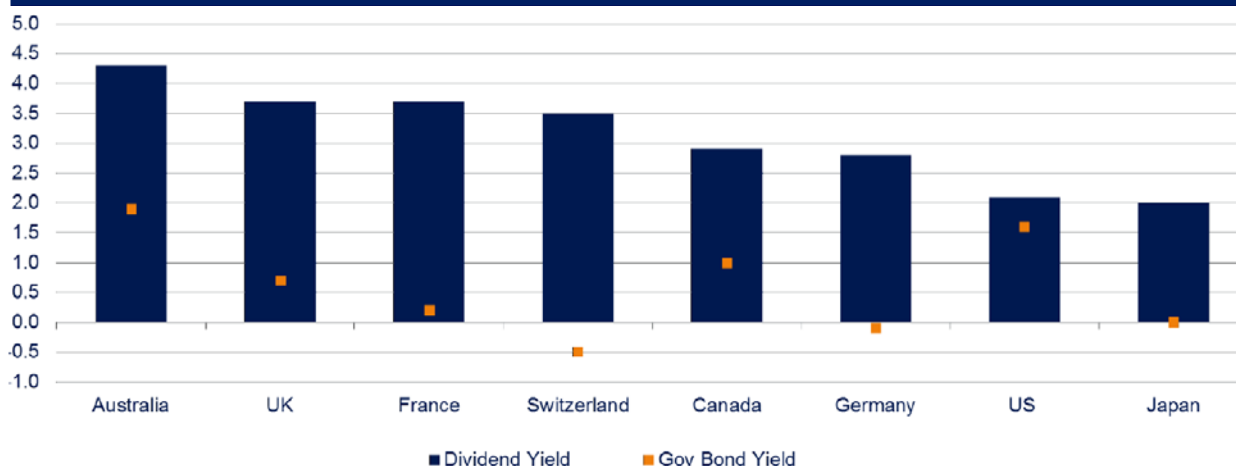
No matter what number serves your purpose equites are not cheap. Using 12-month trailing PE ratios, it is evident that all developed markets are trading significantly above 10-year averages (Figure 3).

Figure 3: Trailing 12 month P/E ratios (current vs. 10-year average)
Source: Thomson Reuters DataStream, Schroders



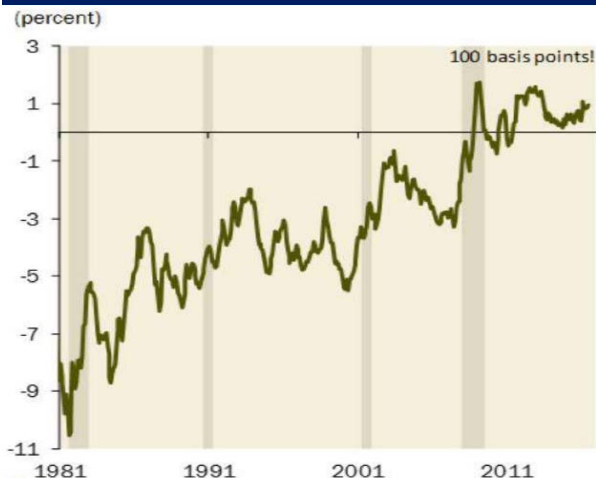
Given low global bond yields, investors and pension funds have been pushed into equities which provide a higher income yield. Figure 4 identifies that dividend yields across all major markets are well above their respective 10-year bond rates. With sources of income scarce, equities could well be supported from a dividend yield perspective.

Figure 4: Country dividend yield and 10-year government bond yields
Source: Thomson Reuters DataStream, Schroders



Ten years ago, the US 5-year treasury note would yield you 4.7% vs the S&P500 at 1.9%, a difference of 2.8%. Thus 10-year government bonds would provide you income and equities would provide you growth. Currently, this relationship has reversed with the S&P500 yielding 2.1% vs the 5-year US treasury at 1.6%. By investing in equities, you are receiving an additional 90bps of income over the US 10-year treasury (Figure 5). Arguably this is what is supporting the S&P 500.

Figure 5: S&P 500 yield minus 5-year treasury yield
Source: Haver Analytics, Gluskin Sheff



There has been little top-line revenue growth given the muted global economies and therefore the 15.9% p.a gain in the MSCI World Ex Australia Index over the past 5 years has been driven primarily by an expansion of multiples not earnings growth.

Within sectors we favour domestic consumer stocks, companies aligned to infrastructure spending, oil and cyber security whilst utilities, property, global industrials and commodities look at risk.

Overall, future returns from equities are likely to be modest based on current valuations.

3.2 Property

After three years of around 20% p.a. unit price growth, listed A-REITS valuations also look full.

Although cash-flow yields remain at a reasonable spread to bond yields and currently offer a relatively attractive 5.0% return, it is difficult to see much growth. Expected cash-flow growth is generally a function of inflation and with inflation expectations muted for the foreseeable future, it is difficult to put forth an aggressive cash-flow growth assumption. Furthermore, we must assume that the current 20% premium to Net Asset Value (NAV) will revert to actual NAV over time. Fortunately, A-REITS have remained relatively under-geared which provides flexibility should we see some domestic economic distress.

Figure 6: REITS return assumptions
Source: Heuristic

	REITS
EPS growth	2.25
Valuation effect	-2
Price performance	0.25
Dividend yield	4.75
TOTAL RETURN	5.0

Given our view of fading domestic economic growth and high household debt levels, caution is also warranted in the residential property space.

Within direct property we have a preference for more boutique sectors and are selectively looking at medical and aged-care sectors.

3.3 Fixed Income

The 'safe haven' of global government bonds is now arguably the most expensive asset class with over 30% of all developed market sovereign bonds having a negative yield and ~70% of all developed market sovereign bonds yielding <1%.

It must be understood that 'risk free' Government Bonds have an imbedded risk as interest rates climb, known as duration risk. As an example, US 30-year bond yields moved from 1.44% to 1.59% from 1 July to 30 September, a total move of approximately 15bps. While this sounds benign, this marginal move in interest rates resulted in a 3.2% decline in the asset price. To put this into context, a 1% increase in interest rates would result in a 21% decline in the asset price. Not so risk free? Given that government bond yields are at such historically low levels we would be cautious about taking duration risk at this point in the cycle.

Within Credit, High Yield looks vulnerable at current spreads. At the headline number spreads look ok; however, given the re-leveraging of the corporate sector and factoring in higher defaults given the timing on the business cycle, we believe investors are not being compensated for the risk they are assuming (Figures 7 and 8).

Figure 7: High yield spread: actual minus estimated
Source: BofA Merrill Lynch, Lehman Livian Fridson Advisors LLC

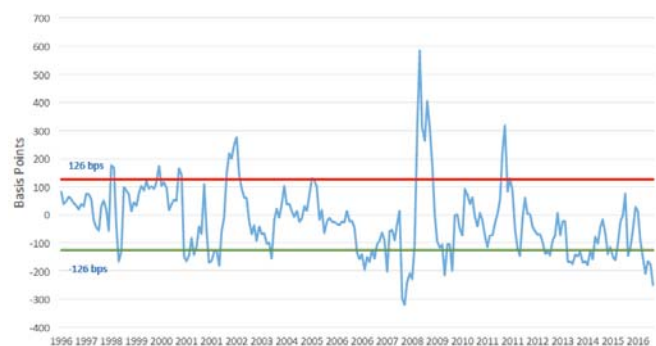
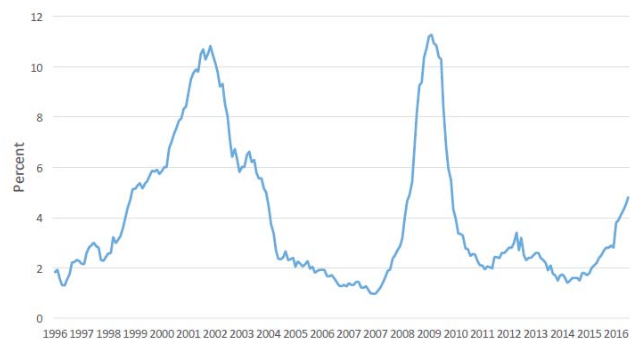


Figure 8: Speculative grade default rate, Jan 1996-Aug 2016 (monthly)
Source: S&P, Lehman Livian Fridson Advisors LLC



Given the re-leveraging of the corporate sector (Figures 9 and 10) and recent contraction of spreads we are cautious on corporate credit particularly in the high-yield sector.

Australian corporate loans and commercial property senior secured loans look the most attractive in the credit sector. We are very wary of Residential Mortgage Backed Securities (RMBS) within Australia in the current cycle.

Figure 9: US corporate debt issuance is now out of control...
Source: Societe Generale, Thomson Reuters Datastream

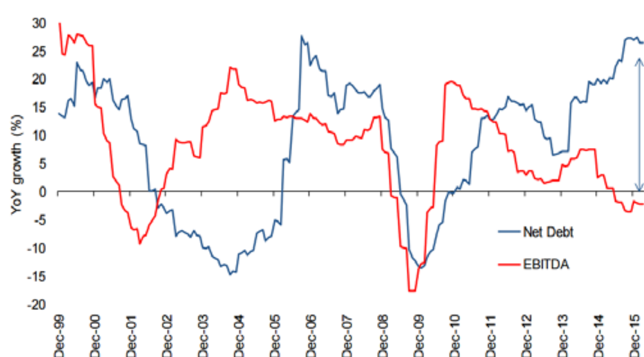
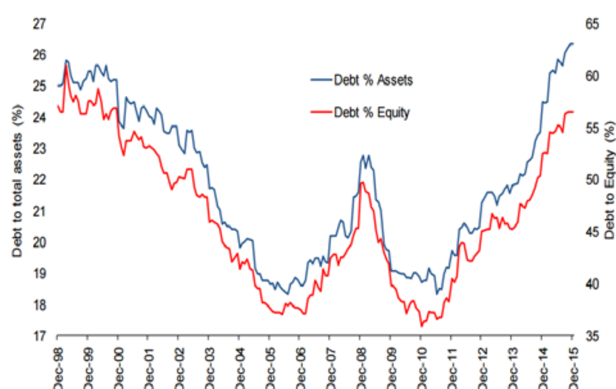


Figure 10: ...while median leverage ratios are very high
Source: Societe Generale, Thomson Reuters Datastream



3.4 Alternatives

The main purpose of having an 'Alternatives' exposure in the portfolio is to dampen the overall volatility of the portfolio and introduce investments which are non-correlated or have low correlation to equities and credit.

Hedge funds had a better quarter with most strategies delivering positive returns as risk assets rallied and hedge funds with beta exposure performed reasonably well. Although it is pleasing to see positive returns, we are cognisant of how much beta we are exposed to in the 'Alternatives' sector of our portfolios.

The commodity space was quite volatile for the quarter but ended either flat or slightly negative. Most commodities are priced in USD so any strength in the dollar equates to weakness in commodities. Oil was particularly volatile as it reacted to not only movements in USD but also conflicting news on whether the oil-producing nations had reached an agreement on reducing supply or not.

An area we continue to look at but have yet to implement is agriculture. We like the defensive, non-correlated nature of the asset class but this has to be weighted up with the cost and illiquidity associated with it.

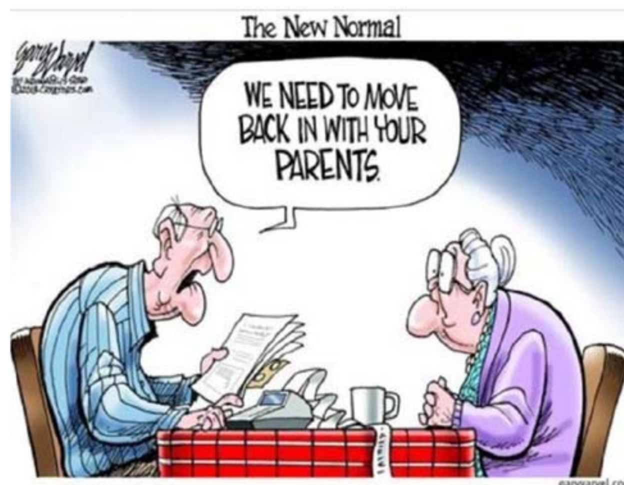
4. CONCLUSION

The current global macro-economic and investment environment is very complex and uncertain so continues to warrant a high level of caution. We can expect unintended consequences resulting from current global central bank policies at some stage in the future. Valuations are reasonably full across all asset classes driven by the search for yield. Global debt levels are extremely high and corporate balance sheets are deteriorating. This is at a time of deteriorating demographics and political uncertainty.

This all means that investment returns are more likely to be structurally lower than in the past (see Providence Whitepaper on website).

A structurally higher weighting to cash is paramount in the current environment in order to protect portfolios from increased volatility whilst keeping a watching brief on quality investment opportunities, particularly outside public markets.

For those around the globe who have underfunded pension plans or savings the current low-return environment will cause some pain.



Summary

There was honesty at the conference with senior experienced speakers admitting that no-one really knows how the current unconventional central bank policy will play out.

The current investment and economic environment is complex, complicated and confusing. There was a general concern regarding aggregate debt levels including corporate leverage. Keynote speaker Larry Summers, former US Treasury Secretary and President Emeritus at Harvard University,still maintains the secular stagnation theme is not a concern given his/the lower-rates-for-longer view and concludes that perhaps leverage is appropriate in the current environment.

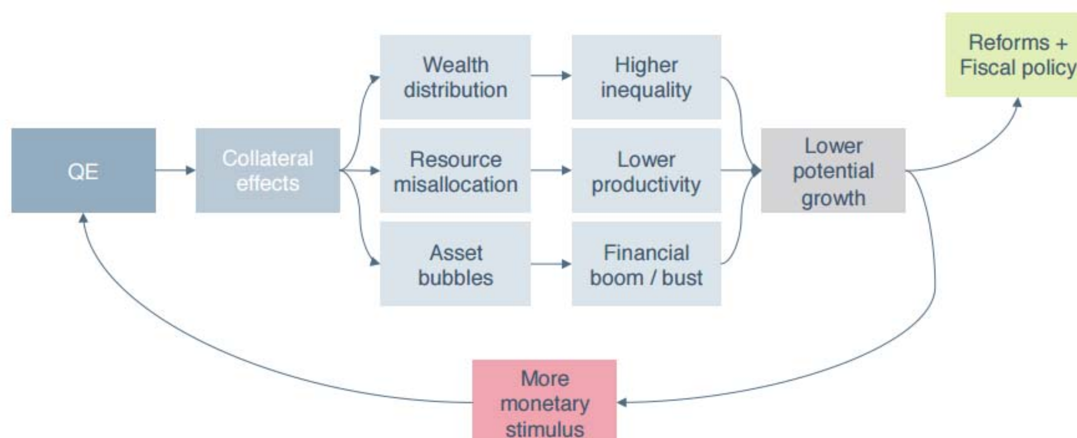
The general view was that valuations across ALL asset classes are full. Consensus for the S&P500 Index over the next 12 months is flat to up 5%. Within fixed income, there was serious concern regarding corporate credit and High Yield credit spreads with the view that you are not being compensated for the risk.

The US election was the butt of many jokes although concerning to all. The consensus was that whoever wins, there is likely to be significant fiscal spending.

There was a lot of discussion around Central Bank policy. Consensus was that the FED has lost credibility given their previous guidance regarding interest rates and subsequent zero action.

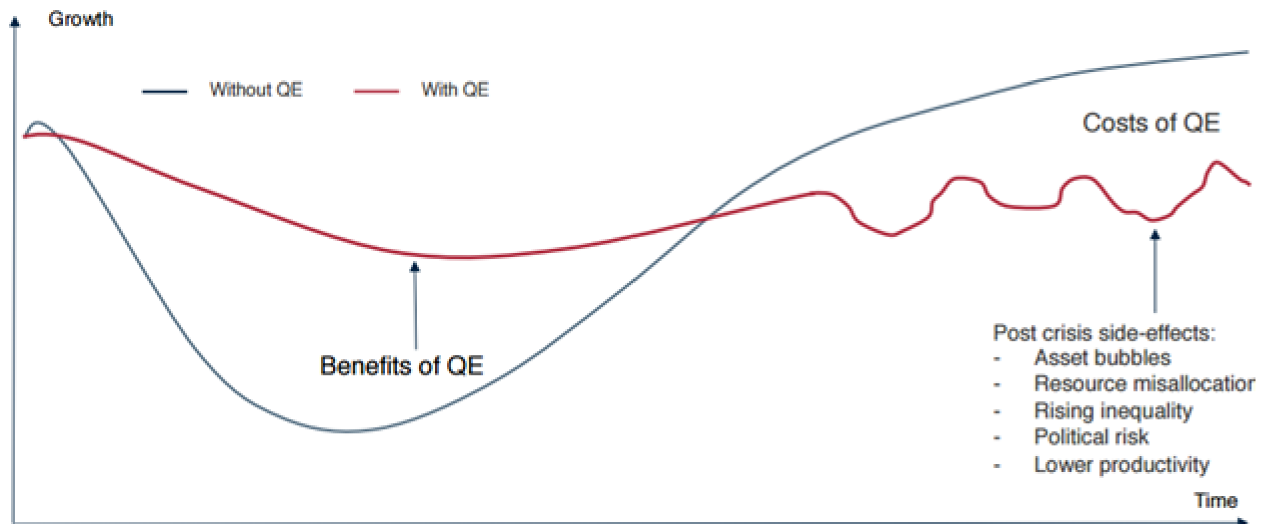
The central banks are rethinking QE.

Figure 11: The QE infinity trap
Source: Raghuram Rajan, Former Governor of the Reserve Bank of India, April 2016 (quote), Algebris Macro Credit Fund



"If every time a central bank starts moving towards normalcy, it says 'no, no, exchange rate appreciating, turmoil etc., we got to go back,' we're in it for a long time ... then this is not QE2, 3, 4, it's QE infinity, we keep doing it."
Raghuram Rajan, Former Governor of the Reserve Bank of India, April 2016

Figure 12: Payback time – prepare to pay for QE
Source: Algebris Macro Credit Fund



"Sometimes the criticism directed at our policies implicitly attributes responsibility for the low-interest rate environment to central bank policies. But the truth is precisely the opposite: central banks are simply reacting to and trying to correct a situation that they did not create."
Vitor Constâncio, ECB Vice President, 25 August 2016

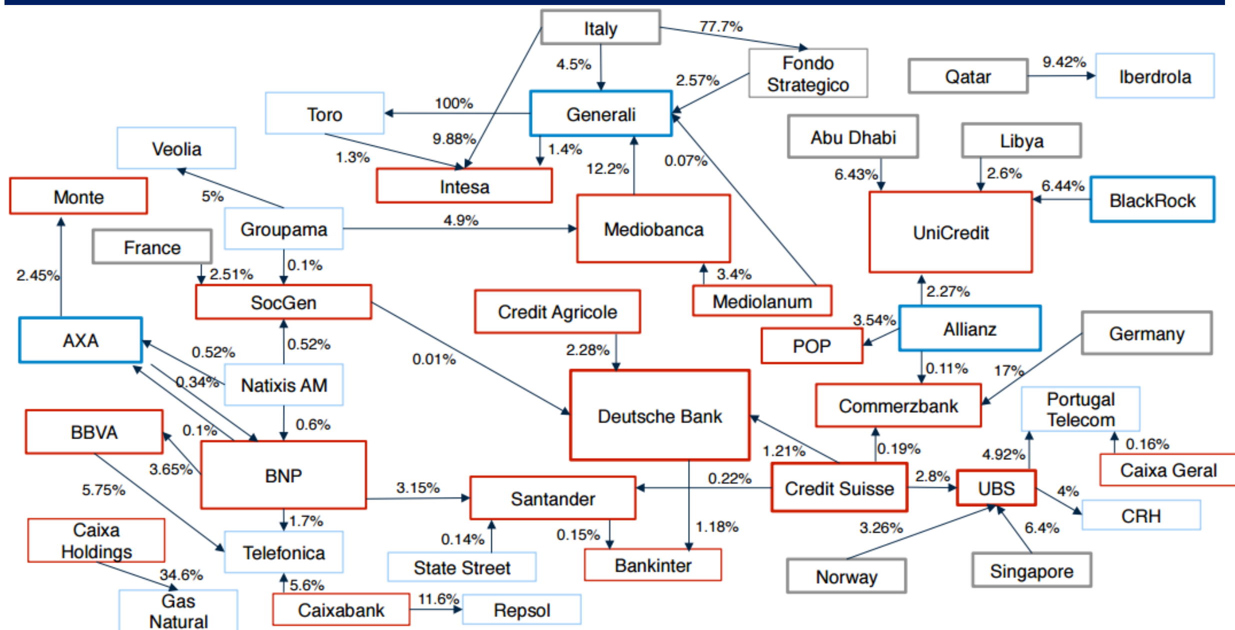
Surprisingly, the majority of participants judged that a recession is likely in the US within 2–3 years along with concerns that there won't be enough ammunition in the arsenal for The Fed to deploy in the next cycle. Much has been written recently about the decline in the real equilibrium, or neutral interest rate level, both locally and in overseas markets, meaning that the 'normalised' level of real interest rates is ratcheting lower over time. The inference being that in future cycles, central banks will have less ability to prop up economies via conventional monetary policy tools.

There was a fascinating presentation by the ex-director of the CIA regarding cyberterrorism and the conflict in Syria. There are deep tectonic shifts in world order with the changing nature of power and the role of the US. Things we thought were stable are not; the future role of the US is becoming unclear and there is a growing concern regarding US/Sino relations. Terrorism and cyberthreats are a derivative of these tectonic shifts.

Another thought-provoking session was an insight into the workings of The Fed given by Kevin Warsh, Ben Bernanke's advisor during the GFC. They were making it up on the go. There was a regime shift to address the seismic issues but they have never switched back to a more normalised FED operating mantra. They are now very data dependent, and that data is viewed as unreliable. Economists believe they know the numbers, likening themselves to physicists. Unfortunately within the Fed, they believe them.

And how complicated? Look at this cross-shareholding chart of financials in Europe!

Figure 13: Cross shareholdings of European banks
Source: Algebris Macro Credit Fund



Our Main Takeouts

- Be cautious with high-yield credit
- Australian Government bonds and equity dividend yield look relatively attractive
- The Fed has lost control and credibility
- Expect a pickup in US inflation with greater fiscal spending after the election
- No-one really knows the implications of current Central Bank policy
- Negative real rates are not that uncommon since WW2
- Retain a minimum 20% cash as a strategic holding

Keynote Speakers

- Lawrence (Larry) H. Summers - Charles W. Eliot University Professor, Harvard University
- Paul A. Volcker – Chairman, Volcker Alliance. Former Federal Reserve Chairman (1979-1987)
- Johannes Zhou – Former Chief Strategic Officer, China Investment Corporation
- General Michael Hayden - Former Director Central Intelligence Agency and National Security Agency
- Kevin Warsh – Visiting Fellow, Stanford University. Former Federal Reserve Governor
- Martin Barnes - Senior Vice President & Economic Advisor, BCA Research
- Elga Bartsch – Global Co-Head Economics and Chief European Economist, Morgan Stanley

Providence Investment Committee

Steven Crane
Steven has over forty 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 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 as 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 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 andthe manager of the branch office network for stockbroker Rivkin Croll Smith based in Melbourne. Since 1998 he has managed 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 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 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

Alpha	The level of outperformance relative to a benchmark
Credit Spread	The margin paid over the risk-free rate (government bonds)
Cyclically Adjusted Price Earnings Ratio (CAPE)	The price of a security or index divided by the moving average of ten years of earnings, adjusted for inflation
Economy-agnostic	Unlikely to be impacted by the fluctuations in the economic cycle
Fiscal Stimulus	Increasing government spending or reducing tax levels to stimulate and/or support economic growth
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
Inflation	When the inflation rate is above 0 and the general price level of goods and services increases
Leverage	An alternative term for gearing i.e. a measure of how much debt a company has relative to equity
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
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
PE 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
Sovereign Bond	A bond issued by a government
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 making 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.

Safe Passage

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

MELBOURNE
Level 27, 101 Collins St
Melbourne VIC 3000
T +61 3 9653 6406

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