Providence
Independent Investment Advisory

Global Outlook & Strategy

Issue 64: 31st December 2016

Heightened Risk; Patience and Diversification the Key

1. KEY POINTS

- Central Banks openly acknowledge that monetary policy has run its course and fiscal policy is the future pathway
- Deflation appears to be on hold, reflation is now the focus
- Some signs of a pickup in global growth
- A lot has been priced in quickly; we expect a correction in markets
- Valuations short term are stretched in our view

Markets are focused on global fiscal stimulus as the austerity tap is tempered

Through the December quarter we witnessed what we have suspected for some time. Globally, the monetary policy experiment had run its course and wasn't gaining sufficient traction to ensure sustainable growth. Central Banks acknowledged this and encouraged governments to focus on fiscal spending. While central bank policy may have stemmed a more pronounced slowing of global growth and the possible systemic issues that may have ensued, we are now past that point. While the phrase 'deflation' may have been laid to rest for the time being, we are not yet convinced of a substantial, sustainable pick-up in global growth.

The Trump-induced 'risk on' trade (funds allocated to growth assets) over the past quarter has many markets assuming a strong rebound in global growth and earnings.

While there are now a good number of favourable economic indicators signalling that the global economy has a 'pulse', valuations in some instances are now stretched for what growth may be delivered in the future. It's never wise to put the cart before the horse.

Thus, we are not chasing the current momentum-driven equity and property market but will look to use any shorter-term pullback in risk markets as a buying opportunity for long-term investing. We retain a healthy level of cash, have zero weight to long-duration assets in fixed income e.g. government bonds and look for private markets and alternatives to provide diversification and non-correlated returns.

Patience, diversification and an acknowledgment that there are a number of unknown unknowns are the keys to the protection and preservation of capital whilst delivering modest returns above cash.

Given the challenging global environment Providence has recently committed to having a full-time professional on the ground in the global financial capital, London. This will enable direct input from global fund managers and investment professionals regarding the drivers of global investing. We believe this will enhance our ability to make informed investment decisions on behalf of clients in a volatile and difficult investment environment that we expect will continue over the next few years.

2. INVESTMENT OVERVIEW

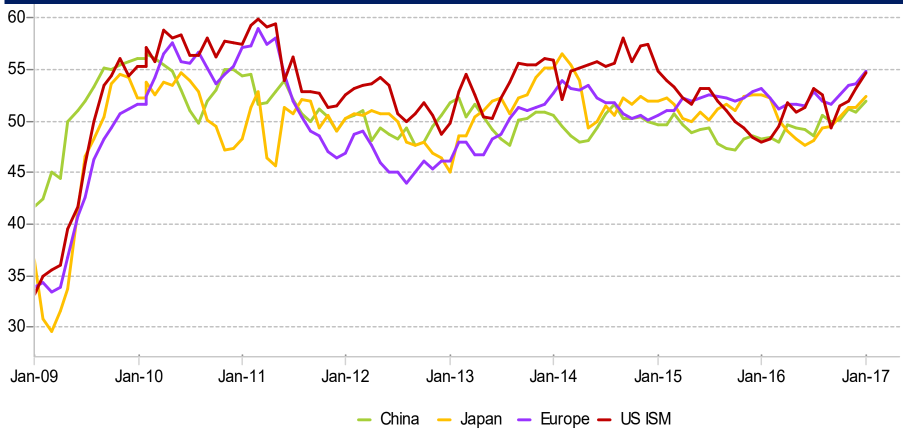
Secular Stagnation or Global Reflation. Is either sustainable?

Recent data suggesting a pick-up in global growth led by the US and the subsequent sell-off in government bonds (higher yields) has many commentators predicting the end of the 30-year bull market in bonds and the beginnings of a reflationary cycle. Indeed the Trump trade of buying equities and risk assets given the great promise of "Making America Great Again" has encouraged momentum traders (investors who follow the current trend) to jump on the Trump bandwagon and declare we are in for a period of global reflation at last.

But wait … excessive global debt, the demographic impact of an ageing population and the rise of populist political movements are still ever present. Can we sustain the current reflationary environment or revert back to sub-par growth?

There have been some leading indicators pointing to a pick-up in global growth **(Figure 1)** across most regions, particularly in the US. Momentum in the US economy has accelerated with third-quarter data indicating an annualised growth rate of 3.5%. Consumer confidence, retail sales, housing starts and a pick-up in inflation indicates that this positive momentum can carry into 2017. This, along with the promised fiscal spending by the President, will prompt the Fed to gradually increase the Fed funds rate. The US bond market is already factoring in higher growth and inflation with yields increasing by 85bp during the fourth quarter from 1.59% to 2.44% for 10-year Treasuries. Europe, despite the entrenched problems in their banking system and high unemployment rates, has also seen a flicker of light with GDP growth heading towards 1.6%. China continues to grow in line with its official 2016 'target' of 6.5–7% and Emerging markets have bounced from a deep downturn.

Figure 1: Global PMI's
Source: Heuristic, Markit, ISM



The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector, based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The Australian economy, on the other hand, is likely to see a slowdown from current levels. The household sector is under pressure from elevated debt levels, slightly higher mortgage costs driven by the repricing of banks' mortgage books, higher energy costs and very weak wage growth. Elevated government spending is likely to subside under budgetary constraints and trade volumes are likely to be lower despite prices being above expectations. There are already cracks appearing in the housing sector with some developers having difficulty in financing new developments (concentrated on apartments). Settlement risk on a number of off-the-plan apartments is also of concern. We therefore expect GDP growth to fade towards 2–2.5%. This is all in the backdrop of a likely reshaping of US trade and foreign policy, the potential collapse of the Italian banking system, the rise of populist political parties (particularly in Europe), the potential of serious destabilisation in The House of Saud and escalating tensions in the South China Sea with China.

However, as we saw in 2016 with Brexit and the election of Donald Trump, the obvious is not always obvious. There are still a number of unknowns.

What we do know is that global debt is very elevated, valuations are stretched by historical standards, the population in developed economies is ageing, there is a significant shortfall in pension schemes and the masses are unsettled.

Longer-term returns in our view are likely to be lower than in the past 30 years and volatility is likely to remain high (see Providence Whitepaper 2017 *Lower Longer Term Returns*)**.**

We doubt the reflationary environment can be more than a short cycle and therefore would be cautious in joining the chorus of commentators and day traders calling for an end to the entrenched structural issues facing the globe.

With momentum and low interest rates pushing assets to excessive levels, having a healthy level of low-returning cash will be key in order to take advantage of an eventual correction where assets once again will provide attractive entry levels.

How to navigate

- Be vigilant for any short-term pullback in risk markets as a buying opportunity
- Invest new capital gradually in order to smooth potential portfolio timing risk
- Expect heightened volatility as markets continue to adjust and therefore have a high level of diversity
- Maintain cash for future investment opportunities
- Include non-correlated and private assets within investment portfolios

What we favour

- Domestic equities over international equities at the margin after a long period of under-performance and the weaker AUD
- Domestic small caps equities over large caps
- Non-correlated absolute return funds and private equity and debt
- An elevated level of AUD cash
- Short-duration fixed income
- Healthcare related direct property exposure

3. ASSET CLASS REVIEW

3.1 Equities – Susceptible to a major correction after momentum-driven rally

Even in strong periods of performance there are meaningful pullbacks along the way. Since the low of 2009 and despite the 150% increase in the Australian index there have been four pullbacks of 10% or more **(Figure 2).** Volatility as measured by the VIX index is normally at a low point prior to these corrections (investor complacency low at high points in the market). **Figure 3** provides some long-term history of the characteristics of bull and bear markets with reference to the duration and return in such market environments (over time).

Figure 2: Market Pullbacks and Volatility
Source: JP Morgan Asset Management, Standard and Poors, CBOE

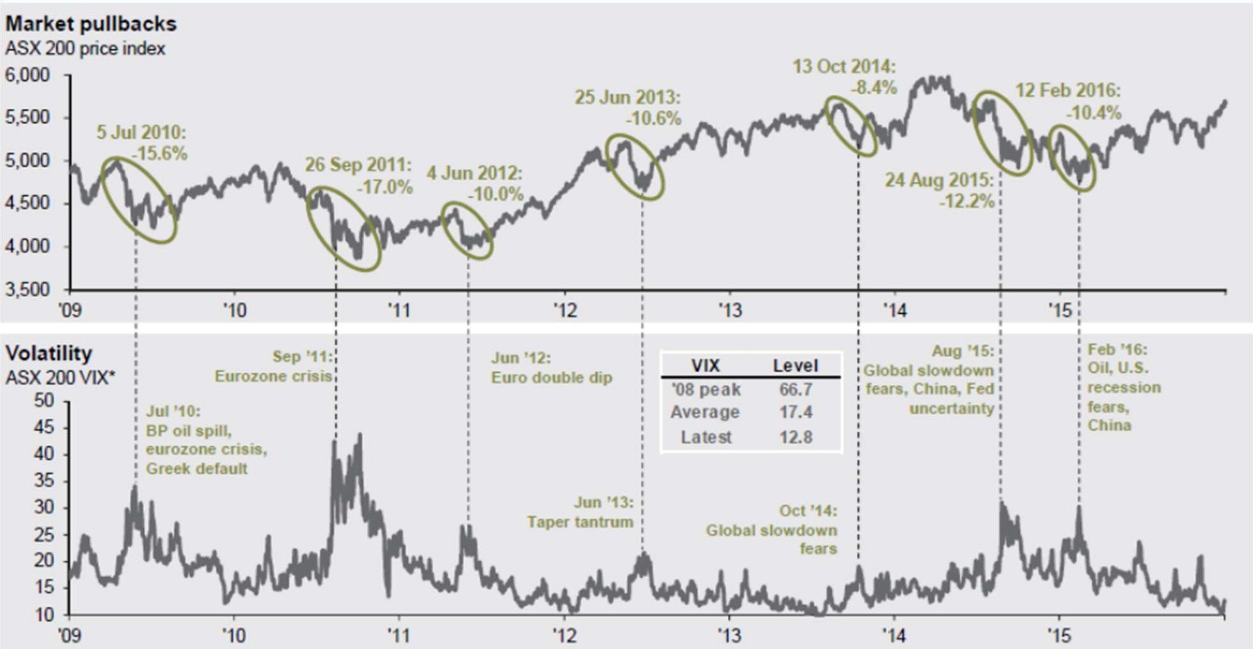


Figure 3: Bull and Bear Market Characteristics, Duration and Return
Source: JP Morgan Asset Management

Characteristics of bull and bear markets

	Market corrections	Bear markets			Macro environment				Bull markets		
		Mkt. Peak	Bear return	Duration (months)	Recession	Commodity spike	Aggressive Fed	Extreme valuations	Bull begin date	Bull return	Duration (months)
1	Crash of 1929 - excessive leverage, irrational exuberance	Sep 1929	-86%	33	◆			◆	Jul 1926	152%	38
2	1937 Fed tightening - premature monetary tightening	Mar 1937	-60	63	◆		◆		Mar 1935	129	24
3	Post WWII crash - post-war demobilisation, recession fears	May 1946	-30	37	◆			◆	Apr 1942	158	50
4	Flash crash of 1962 - flash crash, Cuban Missile Crisis	Dec 1961	-28	7				◆	Oct 1960	39	14
5	Tech crash of 1970 - economic overheating, civil unrest	Nov 1968	-36	18	◆	◆	◆		Oct 1962	103	74
6	Stagflation - OPEC oil embargo	Jan 1973	-48	21	◆	◆			May 1970	74	32
7	Volcker tightening - whip inflation now	Nov 1980	-27	21	◆	◆	◆		Mar 1978	62	33
8	1987 crash - programme trading, overheating markets	Aug 1987	-34	3				◆	Aug 1982	229	61
9	Tech bubble - extreme valuations, dotcom boom/bust	Mar 2000	-49	31	◆			◆	Oct 1990	417	115
10	Global financial crisis - leverage/housing, Lehman collapse	Oct 2007	-57	17	◆	◆	◆		Oct 2002	101	61
	Current cycle								Mar 2009	231	95
	Averages	-	**-45%**	**25**					-	**154%**	**54**

Global equities, particularly in the US, have been largely driven by PE expansion rather than earnings growth. The near 300% rally in US equities since the low in 2009 has been a result of aggressive central bank policy driving income return from defensive assets to record lows and, in some cases, negative yields. This has resulted in stretched valuations across most asset classes, not seen in aggregate in history. Unless earnings catch up, equity market PEs are lofty/excessive. The current long-term cyclically adjusted PE for the US is 1 standard deviation above average at 24.1x which in its own right is not an accurate predictor of a market's future performance but does highlight the elevated levels at present and potentially limits potential future returns.

In addition, if the recent increase in bond yields continues, the relative attractiveness of dividend yields within equity markets, particularly in utilities/defensive stocks, may fade.

The current forward PE of World equity markets is also elevated at 16.1x vs. a 10-year average of 13.8x with the price to book around its long-term average of 2.1.

Equities continue to be priced post Trump for a reflationary cycle. Whilst there is certainly scope for fiscal and broader economic stimulus in a Trump era, a lot is now in the price.

A spike in optimism and the expectation of improving earnings growth has been driving market momentum, primarily in the US (**Figures 4 and 5**). This has been coupled with stabilising and improving Emerging Market economic outlook aided by rising commodity prices. The explosive growth of ETF's (index funds) has also exacerbated the momentum as funds have moved out of bond funds to equity funds this trend.

Figure 4: US Long-term Earning Growth Expectations
Source: BCA Research

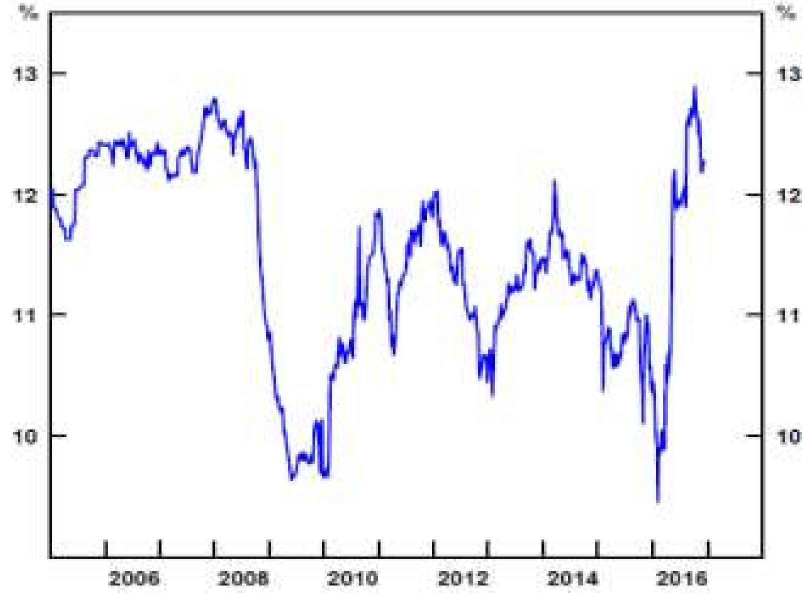
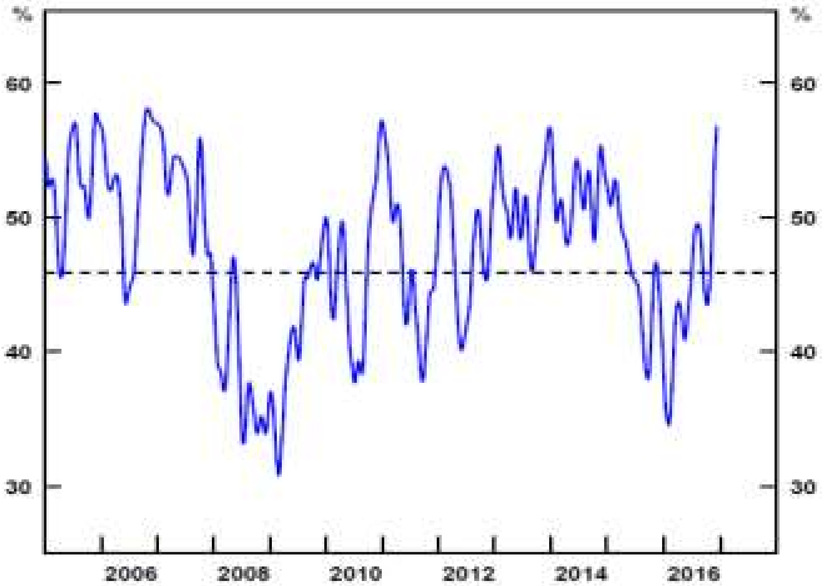


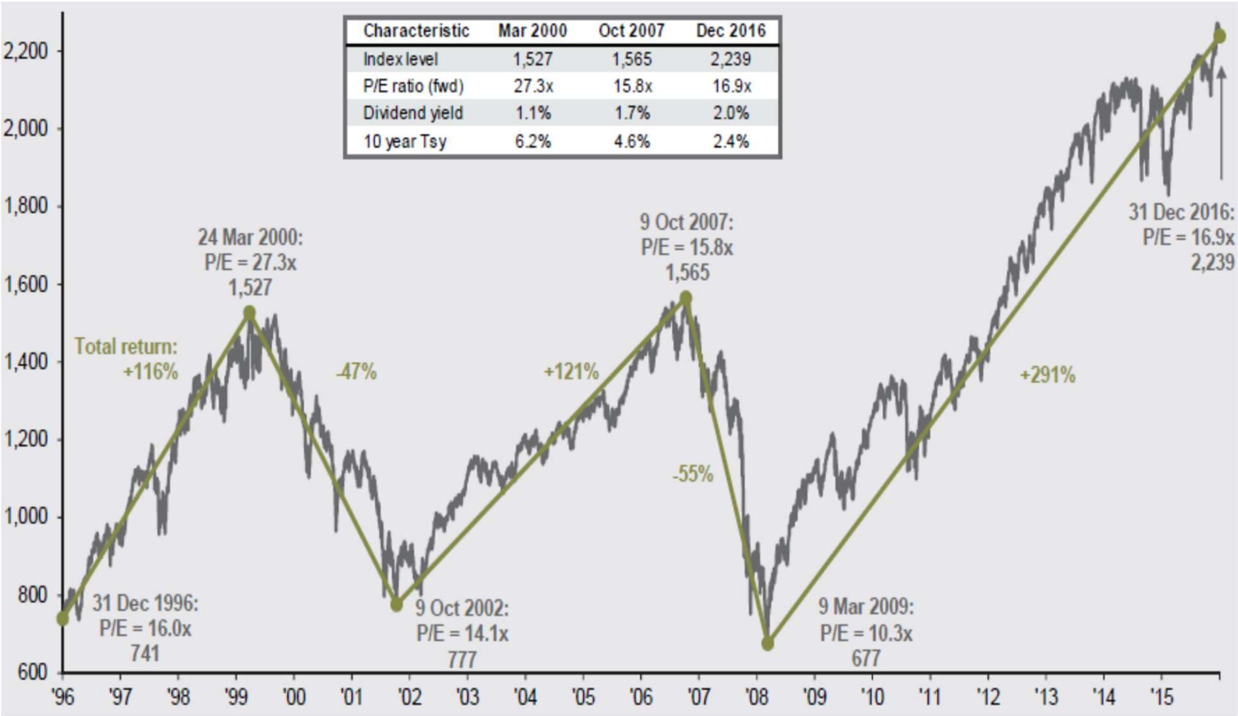
Figure 5: US Composite Sentiment Indicator
Source: BCA Research



The current bull phase in the US is the second longest in history, currently 95 months in duration and second only to the 115 months from October 1990 lows.

USA equities as a result of the Trump trade are now somewhat expensive **(Figure 6)** and are likely to remain so given the expectations of rising USA corporate earnings in the coming years in a Trump world. The risk with this expectation is that, as is often the case, markets overshoot in the short term and we would suggest we are likely in that situation at present. While we like equities longer term as global growth recovers, we would suggest that the prospect of a short-term correction in the order of 10%+ is elevated. A correction of this magnitude, in our mind, would provide an opportunity for longer term investing. Given that momentum indicators are currently 'on', the risk however remains that markets continue to stay elevated, because they can.

Figure 6: S&P 500 Index
Source: JP Morgan Asset Management



The Australian Equity market is trading on the same forward PE as it was at the low of 2009 at 15.7x **(Figure 7)** despite a 150% increase in the index. However, the yield pick-up with dividends vs. 10-year bonds is at a 1.2% premium vs. a 3% discount at the low. This highlights the dominance of the financials in the index accounting for a 44% weighting. Any cuts to the current high payout ratios and lacklustre growth would put pressure on index levels. Given our concerns of a fading Australian GDP number, financials may be vulnerable. Resource stocks, which are referred to as materials, account for 16% of the index and have recently seen a strong recovery due to improving iron ore and coal prices. Once again these commodity prices need to hold to justify current prices.

Figure 7: S&P ASX 200 Index
Source: JP Morgan Asset Management

3.2 Property

A-REITs have pared back some of the strong gains of 2016 as global bond yields have risen. Duration assets (assets that have a fixed yield over a long period of time) were hit hard post the Trump election outcome and the response by the markets 're-pricing' these assets in favour of growth was swift. The market is now very much in the reflation camp and defensives or bond proxy assets as a result have seen a correction. However, despite the rise in the Real Bond Yield (yield after inflation) over the quarter, the spread between A-REITs and the Real Bond Yield still looks attractive **(Figure 8)**.

Figure 8: A-REIT Forward Yield less 10yr Real Bond Yield
Source: Heuristic, IBES, IRESS, using proxy updates

Although better value, the implied cap rate is still tight at 5.7% with the premium to NAV running at an 11% premium and premium to NTA at 25% **(Figure 9)**. With the distribution yield anticipated to be around 5.3% growing at 4% a year and reverting to trend fair value we see a total return of 6.5% as the maximum return achievable.

Figure 9: A-REIT Price to NTA
Source: SG Hiscock

We have also observed in the last quarter the aggressive rise in inflation expectations (even in Australia) reflected in bond pricing despite almost no evidence of inflationary pressures in more recent Australian data. This may present an opportunity to invest in A-REITs however we would prefer to see the current premium to NTA pull back before committing further investment funds.

We continue to assess and seek out direct property investment opportunities that meet our investment hurdles and criteria (Providence currently has a preference for Healthcare, Childcare and Aged-care exposures) and we are also mindful of the alternative, being A-REITS. Following the pullback in prices, we are somewhat more attracted to the A-REIT space vs. direct property. This is in part due to liquidity constraints with direct property, the level of gearing of a number of the direct property opportunities that we have more recently assessed (more recent direct property opportunities have had gearing closer to 50% vs. A-REITS at ~30%) transaction costs and the lock-up of funds for direct property vs. A-REITS. We will continue to seek out appropriate investment opportunities for our clients with a modest preference at this stage for A-REITS over direct property. We remain mindful of the returns required (over and above) for direct property vs. the alternative of A-REITS. From a risk-reward perspective, the overall return spread between the direct and A-REITS with some of the more recent investment opportunities that we have seen has been less favourable with direct property.

In summary, we remain selective in our property exposure. We are cautious about pending pockets of weakness in residential (predominantly certain suburbs and more likely concentrated to apartments) and some of the elevated prices that are being paid for direct property (as evidenced by passing yields on transactions and compressed cap rates). Gearing remains a focus (despite attractive interest rates). Returns (either via A-REITs or direct) must be commensurate with the risk taken. We see the market's overall view that the reflation bet is back 'on' as providing us with selective opportunities for our property allocation and exposure.

3.3 Fixed Income

Driven by deflationary forces and subsequent central bank policy global bond yields fell to negative real and in some cases negative nominal interest rates. The weight of money that drove yields to such unprecedented levels is now reversing its trend with the US 10-year bond rate rising from 1.59% to 2.44% over the quarter. This has seen a capital loss of 7.3% over the quarter, indicative of how risky government bonds can be in a low nominal yield environment.

We have remained in cash rather than Australian Government Bonds and despite the 4% decline in price of the bond index, we will avoid this asset class given concerns of global bond valuations.

Whether the 30-year global bond bull market is over is open to conjecture depending on your view of the sustainability of the current reflationary indicators. Demographics and debt will remain a drag on future global reflation and economic growth in our view.

Fundamentals for US investment grade bonds continue to deteriorate with leverage higher and interest coverage lower than the period leading into the GFC.

Credit spreads on US Investment Grade corporates contracted 21 basis points over the quarter to 123bp. We are currently seeing better value in Leveraged Loans with average credit spread being 461bp, with more attractive break-even spreads than Investment Grade. Leveraged Loan spreads are currently implying defaults at 6%; however, actual defaults being 2% make this area attractive on a relative basis.

3.4 Alternatives

Over the year, we have been selectively increasing exposure towards unlisted Private Equity as we believe listed markets are trading at the expensive end of their valuation ranges. This had been funded by reducing exposure to global equities that had benefitted from the unhedged currency exposure and rally in markets. Our preference is towards diversified global private equity across later financing stages, as opposed to single-asset early-stage venture capital.
We are in the process of reviewing Agriculture as a potential addition to client portfolios, which feature defensive returns uncorrelated to listed equity markets. It is an area that we have been reviewing for a number of years but were unable to find the right structure appropriate for clients either due to high fee structure, lack of track record, lack of diversification or a combination of the above. Risks in the Agriculture sector also involve commodity price risk, liquidity risk, adverse weather, government regulation and currency. We are in due diligence phase in this area and believe we have found the appropriate manager.

Across the wide spectrum of hedge funds, we remain cautious on strategies still exhibiting correlation to listed equities, despite paying more in fees, having less transparency and lower liquidity.

Our due diligence process favours those with strong access to the manager, transparency across investments (with confidentiality), a clear focus on risk management, quality of investment research, appropriate fee structures, reasonable liquidity and strong track record. Our research process is supplemented by several external research providers and input from members within our Investment Committee, making investment in Alternatives a robust process with significant rejection rates across the sector (e.g. event driven, global macro, relative value, long short, market neutral, CTAs, fund of funds etc.).

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 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 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 and 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

Safe Passage

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