Providence
Independent Investment Advisory

Global Outlook & Strategy

Issue 66: 3rd Quarter 2017

Stem the Tide

1. KEY POINTS

- **Global growth remains buoyant despite pockets of uncertainty**
- **Valuations in some asset classes are very extended**
- **Australian economy is sending mixed messages; outlook uncertain**
- **Geopolitical concerns remain elevated**
- **Remain with elevated cash and well diversified**

Momentum in global growth, but at what price? The old heads are nervous.

Global risk assets (equities, property and credit) continue to grind higher despite mixed messages regarding the pace of economic growth and increasing debt levels. In some instances, valuations are now at levels that do not justify the increasing risk. While we do not see an immediate catalyst for a correction, we remain mindful that the last throes of exuberance can see valuations overshoot to the upside even further. Momentum has been a significant driver of risk markets over the past year, despite the various global geopolitical events. If we do not feel comfortable with the risk/reward dynamic of any asset class, we will temper our position. When US Federal Reserve board members are suggesting the US equity markets are 'running on vapour', one should take note.

An overweight cash position over the last 12 months was relatively easy to justify given the series of 'known unknowns' that made their way into the markets sphere throughout the course of 2016 and into 2017 (Brexit, Trump and China). Despite the high cash weightings, returns have been solidly supported by rising equity markets.

Bond markets are signalling stalling growth, whereas equity markets are suggesting continued strong corporate earnings. Volatility has essentially evaporated, complacency has given way to momentum, and this rising tide is lifting all boats. The FED is desperate to restore some 'normality' to interest rates and yet the market appears in total disbelief that this is remotely achievable.

The old heads are nervous, but momentum is positive. Valuations are full, and we are very late in the recovery cycle.

Caution is still warranted.

2. INVESTMENT OVERVIEW

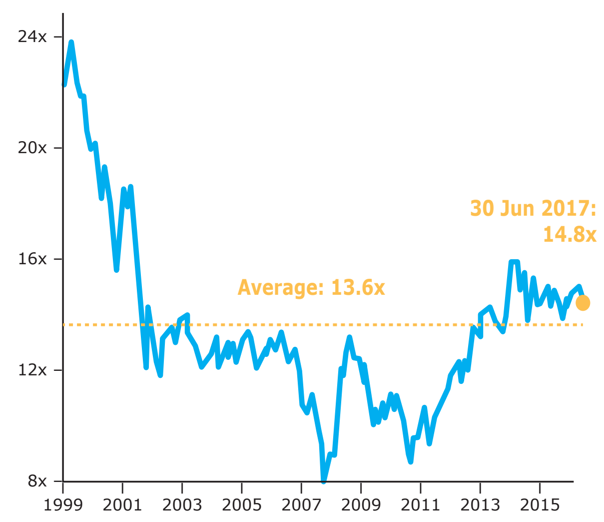
When the US Central Bank is telling people one thing about the amount of interest rate increases, and the markets are painting a less aggressive stance, we take note. While the FED will always want the market to believe their messages, and there is always a bit of give and take, the gap between the two remains rather wide. This disbelief explains some of the rationale behind the rise of the US equity market. That, coupled with the huge inflows into passive (index replicating) investing, has seen a lot of positive news factored into US equity markets. We suspect that the US economy, after eight years of recovery, is coming into the later stages of this cycle. Valuations in the US are elevated and credit markets (in the form of high-yield corporate spreads) are essentially pricing in almost a zero chance of a recession in the US.

We are, however, encouraged by the ever-improving data within the euro area. Considering the political bashing the broader European community has had to endure in the last twelve to eighteen months (Brexit, French elections, Dutch elections, UK elections and the looming Italian electoral process), the data throughout this time has been quite robust. Earnings expectations in the euro area (as indicated via the Stoxx 50) continue to paint an encouraging picture, **(Figure 1, right chart)** and valuations are by no means stretched relative to the US, remaining close to long-term averages **(Figure 1, left chart)**. We are encouraged by the type of growth being delivered in Europe, largely by consumption, investment and exports.

The 'X-factor' for Europe may well lie with Italy. The electoral process has yet to really commence, with an outcome (electoral) to be concluded by May 2018. We remain mindful of the negative 'sentiment' in Italy towards the euro and the broader monetary union.

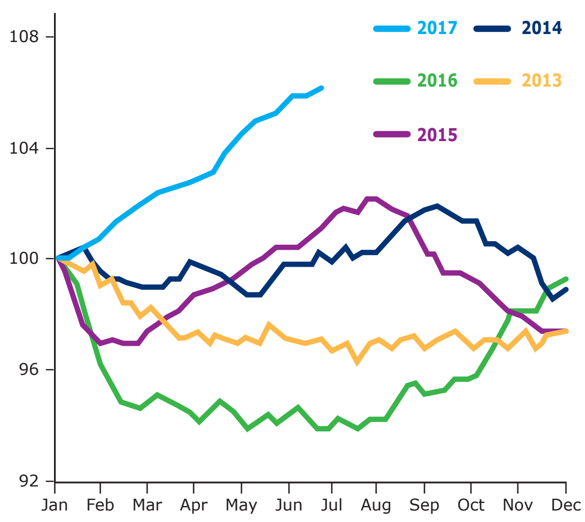
Figure 1: MSCI Europe forward price to earnings ratio (left chart) and the Stoxx 50 Index earnings trend (right chart) with particular attention to the 2017 forecasts
Source: JPM

MSCI EUROPE forward P/E ratio



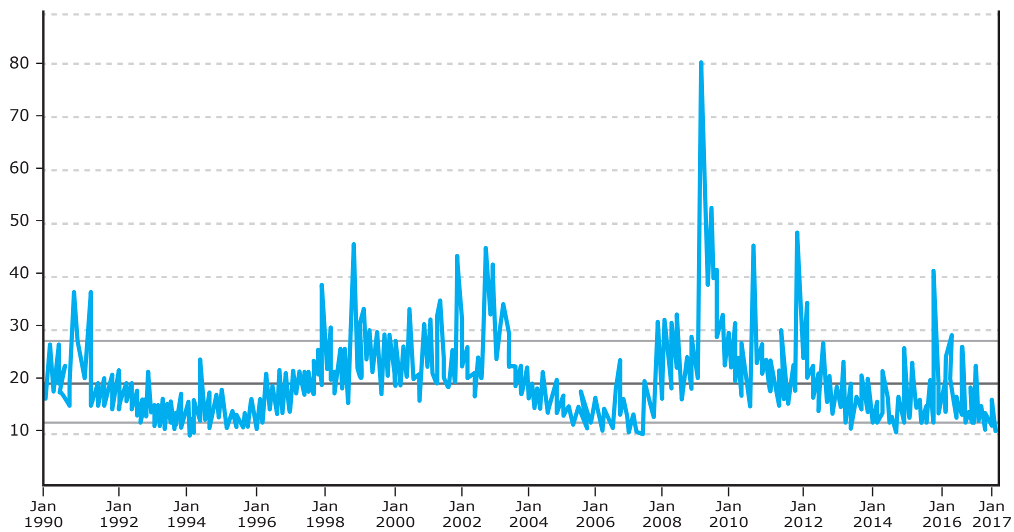
STOXX 50 yearly earnings trend

EPS, rebased to 100 in January



In other corners of the globe, geopolitics, however, do remain front of mind; easily dismissed in a rising momentum-driven market. The tensions in the South China Sea, the provocation by North Korea with their missile testing, the ultimatum given to Qatar by allies of The House of Saud, the USA's domestic agenda plus other middle-east issues (Syria etc.) all sit in the background and may just emerge as one of the 'X-factors' that causes risk markets to stumble. All the while, volatility across the globe and especially in the USA remains remarkably benign **(Figure 2)**.

Figure 2: USA volatility index remains low
Source: CBOE, Factset



Where we determine that an asset class (or a sub-set of an asset class) is just not rewarding investors for the risk that may be present, we are mindful of scaling back exposure. With investing, one should always remember that the reward must be commensurate with the risk.

Tail risks, a major move away from normal, in Australia are increasing after 104 quarters of uninterrupted GDP growth. After a series of bank-bashing, borrower-penalising measures and higher capital imposts, we ponder what's next for the Australian economy.

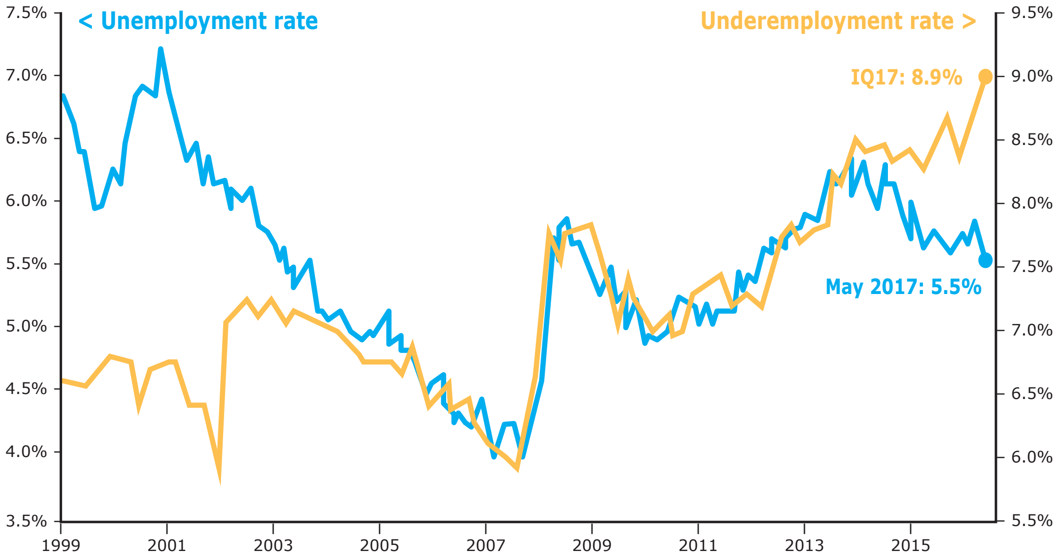
As at today, it is very difficult to fathom how the Australian government's own treasury forecast of ~3% GDP growth in 2018 and beyond is just going to materialise. Wages growth (as mentioned in previous dispatches) is just not evident in Australia. We note that recent growth in Australian employment has largely been centred around lower-paying industries and has not flowed through in any meaningful way to the broader wages measures.

Furthermore, the increasing levels of underemployment **(Figure 3)** make it difficult to see where future wage growth will come from and hence any improvement in household expenditure. Underemployed refers to people who are employed part-time but want to work more hours, or were full-time employed but working part-time hours. The under-employed have little job security, have difficulty gaining access to credit and have persistently low income. As such, as the under-employment rate continues to track higher, it is unlikely that wage growth can meaningfully improve.

Figure 3: The rise and rise of underemployment in Australia

Source: J.P. Morgan Asset Management

Unemployment and underemployment rates (Seasonally adjusted)



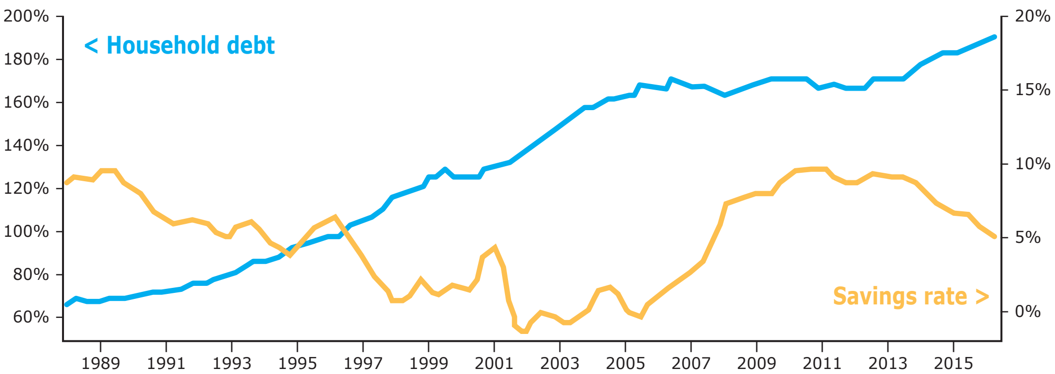
House prices remain extremely elevated in certain parts of Australia and given the spate of mortgage price increases (owner-occupied, interest only), we can't help but feel that the Australian consumer may reduce their discretionary spending, which makes up 57.8% of Australian GDP (household final consumption). Any material lift in interest rates (as espoused in some recent press articles) in Australia seems hard to rationally justify and could potentially cause severe tail risks to the Australian economy. Couple that with a pullback in consumer spending and those tail risks in Australia will rise substantially. The surging debt levels in Australia coupled with the declining savings rate, is a perilous cocktail for the economy **(Figure 4)**.

Figure 4: Australian household debt has surged upward in recent years at the same time as the savings rate has declined

Source: J.P. Morgan Asset Management

Household debt and savings ratio

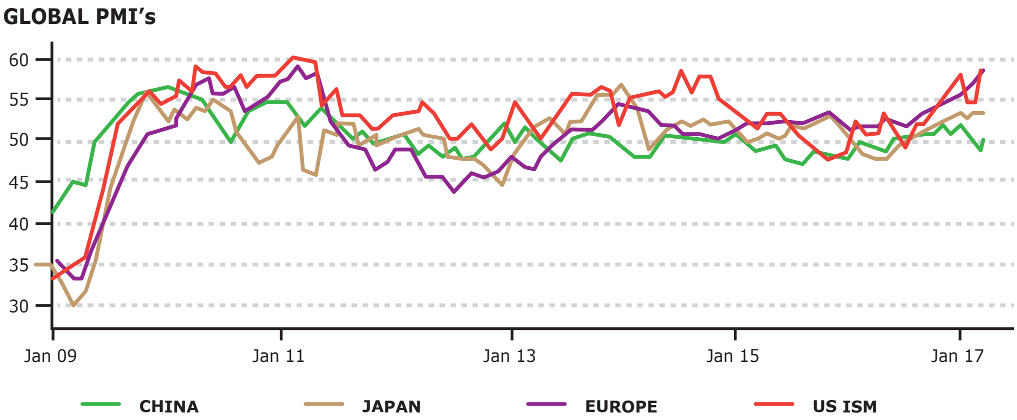
Percentage of annualised household disposable income



Although there has been a slight pause in global growth momentum, predominantly in the United States (which we view as a temporary stall) and to a lesser extent in China, Central Bankers around the globe are flagging their intention to normalise policy gradually, reflecting their expectation of stronger, sustained global growth. The favourable signals for growth on the global stage do remain largely intact **(Figure 5)**.

Figure 5: Global PMIs indicating continued strength, driven by USA and Europe

Source: Heuristic



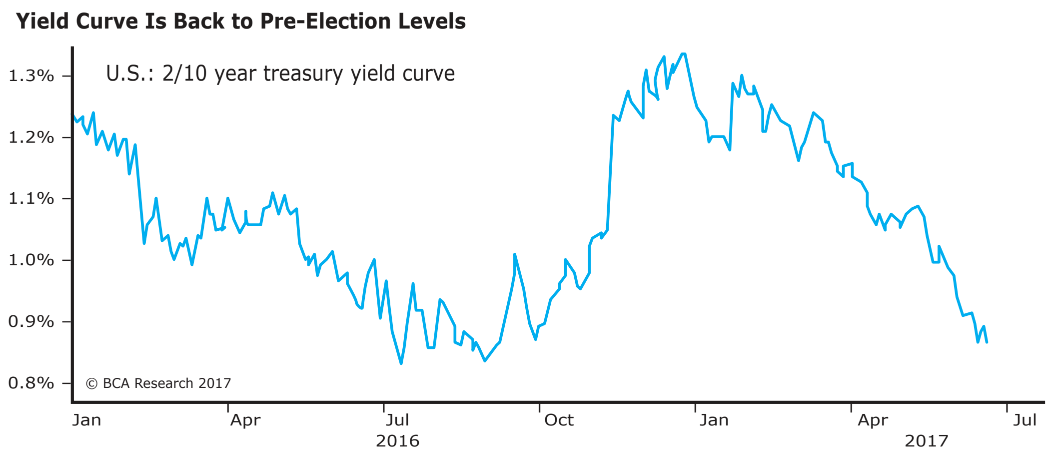
Global PMIs for June show an improvement on April-May. The US ISM for manufacturing jumped to 57.8 from 54.9, fully reversing the declines over March-April. Europe continues to push higher while China surprised to the upside with a reading of 50.4 from 49.6.

We expect US growth to regain momentum in the second half of 2017 to an annualised rate of 2.2%. Chinese growth is expected to remain firmly in the mid 6% range. European growth may be the surprise, with GDP growth now at 1.7%, which is above the growth rate of Australia.

Positive global growth momentum and rising corporate profits have been reflected in risk assets (property, equities and credit) with strong returns over the past 12 months.

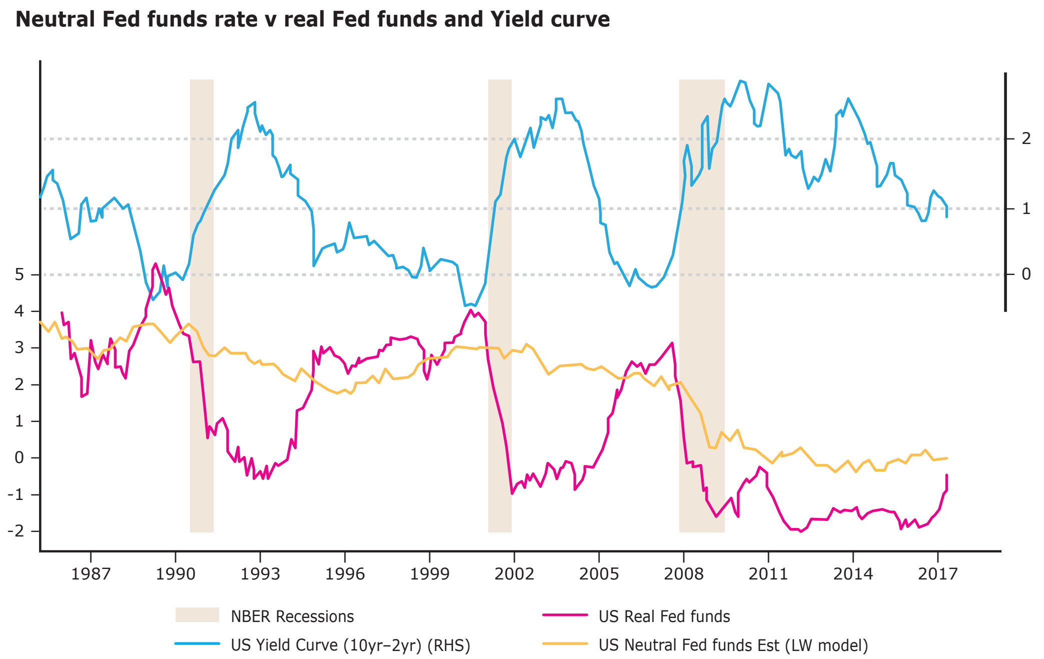
However, there is a disconnection between risk assets and the bond market. The US bond market, after initially selling off with higher yields reflecting the reflation trade, has now reversed reflecting doubts about the sustainability of the growth outlook **(Figure 6)**.

Figure 6: The USA yield curve has given back most of the exuberance post the Trump election victory as the realities sink in that politics is a tough gig
Source: BCA Research



An important indicator to watch regarding recession risks is the yield curve. A negative yield curve (10 year bond rate below the 2 year interest rate) has a high level of success in predicting a recession **(Figure 7)**. Currently this indicator is flashing orange.

Figure 7: The yield curve is currently negative (10 year bond rate is below the 2 year bond rate)
Source: Heuristic



Although we are very late in the recovery cycle, we believe that global growth will remain solid for the remainder of the year. Structurally, (longer term) however, we are more concerned. Major headwinds exist including global debt levels, ageing demographics, inequality of wealth and high valuations. We believe longer term returns will be below the levels seen over the past 20 years (see Providence White Paper "Lower Longer Term Returns" available at www.providencewealth.com.au for more detail).

Then there's The President of The United States of America. We suspect he may not serve a full term. The mid-term elections in the USA next year will be very telling. All 435 seats in the US House of Representatives and 34 of the 100 seats in the US Senate will be contested. History tells us the mean result for a Presidential party in post-war midterms is a loss of 25 house seats. Next year, the Republicans need to lose at least 24 seats to lose the house. This creates an interesting quandary for the Republicans and may see them look to accelerate some of their party's agenda prior to the mid-term elections, thus possibly sending very mixed messages to risk markets.

Our current stance remains cautious, retaining a healthy buffer of cash and remaining well diversified across asset classes. We feel that valuations are elevated across most assets, and we are very long into the recovery cycle, particularly in reference to the USA.

How to navigate

- Selective reduction of asset allocation to areas where we do not feel you are being rewarded for the risk
- Be ever mindful of the tail risks both locally and globally
- Selective investing on any pullback where we see appropriate

What we favour

- A well-diversified investment portfolio with a decent buffer of cash
- Equities over global government bonds
- Alternative assets (long-short equity, private equity, global macro)
- International currencies over AUD
- Active funds management over passive at this stage of the cycle
- Boutique sectors within property (medical, aged care, value-add opportunities)

3. ASSET CLASS REVIEW

3.1 Equities

The tidal wave of funds shifting to passive investments (index funds/ETFs) and away from active managers has seen the performance of the US equity market driven by some of the larger companies in those bourses. Five of the top technology companies- Facebook, Apple, Amazon, Microsoft and Google have contributed 33.7% of the total return of the S&P 500 over 12 months. This has driven the US S&P 500 Index to an unsustainable Schiller PE of 29, as at the end of May, more than 40% above the long-term average.

Maybe it's different this time, but human behaviour being what it is, we don't think so. Certain pockets of the market are trading on sky-high multiples. Debt levels in the USA have also been creeping up **(Figure 8)**, while the debt coverage ratio has been falling. This is something to be mindful of in the only economy where rates (albeit slowly) are moving higher.

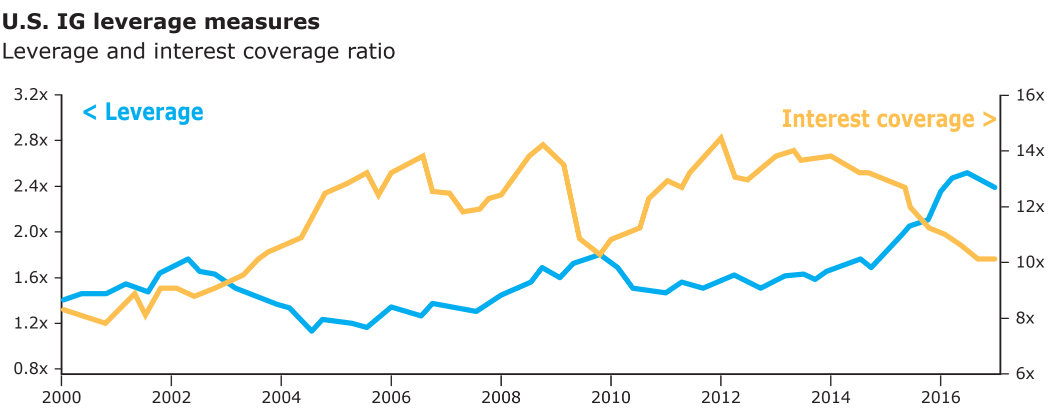
European and Japanese multiples look more palatable particularly given the positive momentum in their underlying economies. Our cautious view on the Australian dollar warrants our international equity holdings to be largely in overseas currencies.

The Australian market as always, is dominated by two sectors, Financials and Resources. As previously mentioned, there are increasing tail risks in the Australian economy, predominately around the housing market. It is difficult to see what will drive Australian bank share prices in the immediate term in such an environment but for the attractive dividend yield currently on offer but potentially under pressure. On both 5 and 10-year averages, the banks still appear expensive on a price to book, price to earnings and price to net tangible assets measure. The only attractive valuation metric is their fully franked dividend yields, notwithstanding the capital price volatility they may encounter going forward.

We also note that this year in Australia is one of the first years when earnings estimates for Australian companies have not been declining through the year, perhaps propped up by the recovery in resources earnings in the earlier part of the year. This is quite possibly clouding the real economic picture given the dominance of the financials and resources sectors in our market.

More broadly and on a global context, we remain concerned about the massive flow of funds into passive investment strategies (Index funds and ETFs). This is typically late cycle behaviour as the Fear of Missing Out (FOMO) drives the market rather than fundamentals.

Figure 8: USA debt remains elevated. Interest coverage has fallen
Source: J.P. Morgan Asset Management



3.2 Property

As mentioned previously, we are concerned regarding residential property values in Australia and would not be committing investment funds to this area at this stage.

A-grade commercial property has also seen strong gains with cap rates compressing to levels which we find hard to justify.

A-REITs have given back some of their stellar gains over the past 12 months with the retail exposed sectors struggling under the threat of Amazon. We believe this is a little overdone and may represent some value.

Within direct property we continue to focus on the boutique sectors of medical, healthcare and targeted education or commercial where the manager can add real value by repositioning or development.

3.3 Fixed Income

High yield credit spreads have compressed sharply with credit quality deteriorating. At current spreads, credit is discounting almost any chance of a recession **(Figure 9)**. All the while, corporate debt in the USA continues to rise unabated **(Figure 10)**.

We have reduced our exposure to this sector. Global bond interest rates are likely to move higher given central banks' desire to normalise policy and stronger global growth. Therefore, we have little exposure to global bonds. We believe Australian Government Bonds may represent some value in managing tail risk given our cautious view of the Australian economy.

Figure 9: High yield spreads are indicating almost zero chance of a recession... overly optimistic?
Source: Heuristic

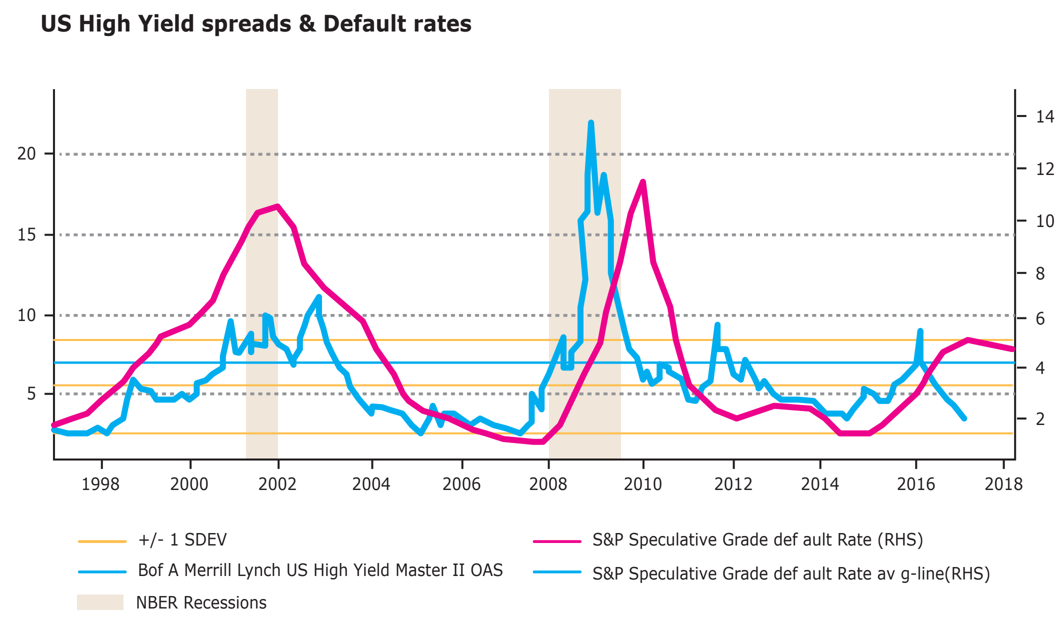
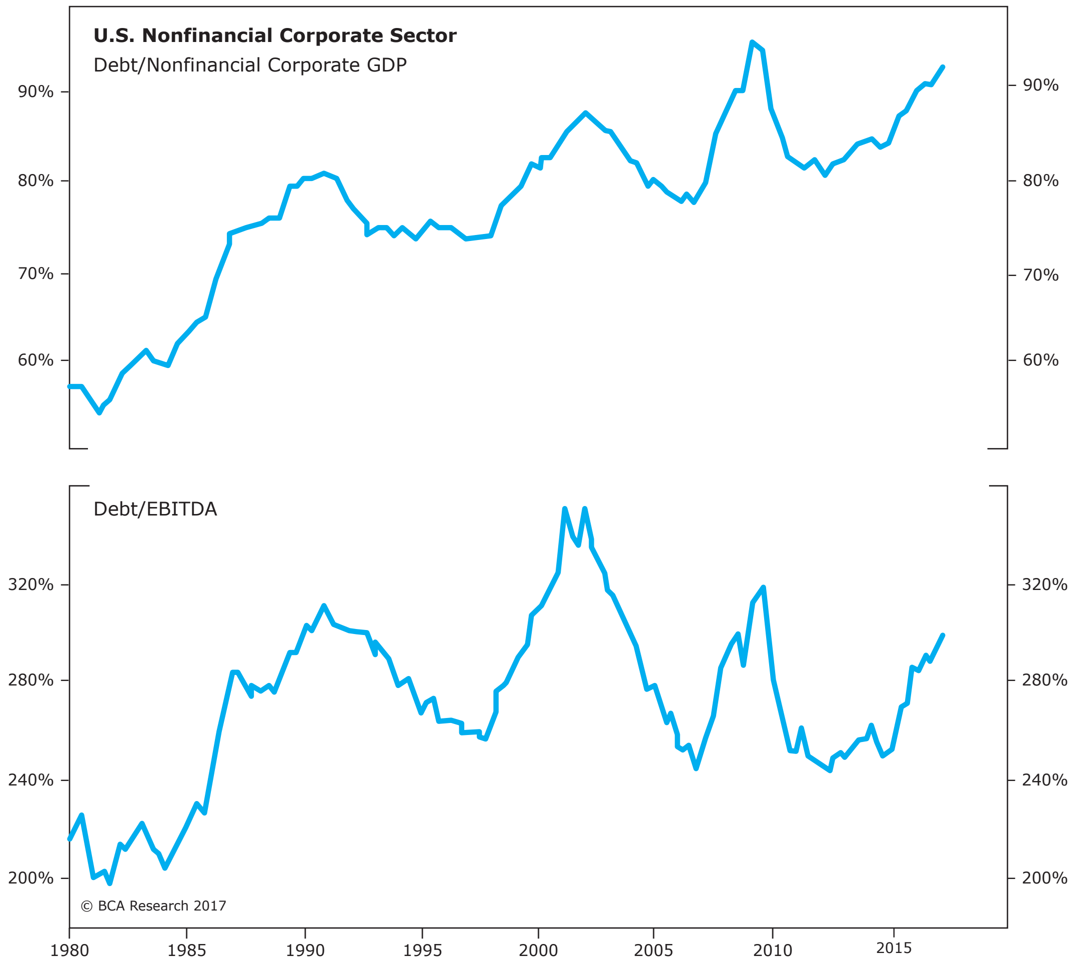


Figure 10: The rise and rise of USA corporate debt
Source: BCA Research



3.4 Alternatives

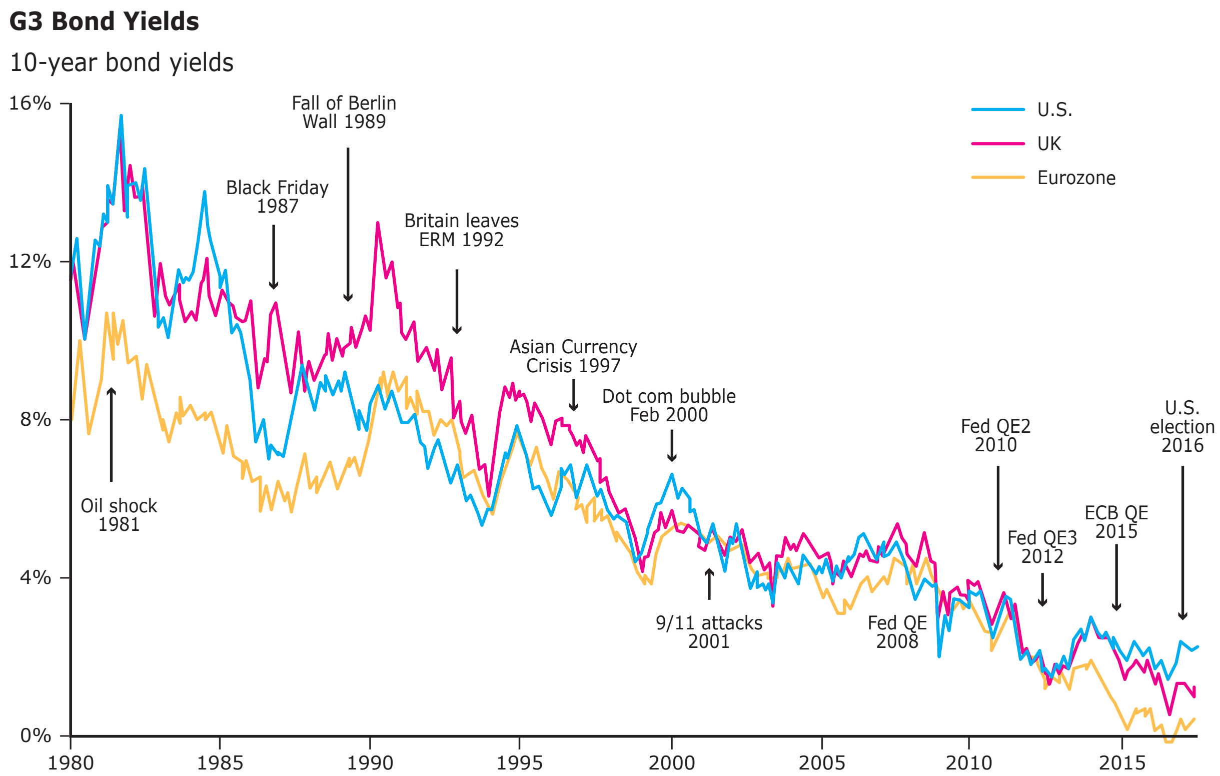
We have been increasing our exposure to this asset class endeavouring to remain well diversified in investment strategies that are non-correlated to the equity market. We are exposed to long-short equity, global macro and private equity. We continue to do our due-diligence on the agricultural sector, seeking the most appropriate investment pathway.

4. CONCLUSION

Global growth momentum is still positive, albeit from pockets of the globe where we have become accustomed to a constant spray of negative news. Valuations in some markets are and remain elevated, whilst complacency is high. In this environment, tail risks remain a primary focus. We continue to monitor and act on asset classes where the reward just does not justify the risk undertaken.

The US and quite possibly (in time) European rates are rising from their slumber **(Figure 11)**. Traditional rates of return may not be found in the long-reliable corners of risk markets as they have in the past. Diversification remains the key.

Figure 11: Have USA and Eurozone yields finally bottomed?
Source: J.P. Morgan Asset Management



Comments from London

Providence attended the 17th Annual Morgan Stanley Hedge Fund conference. Over two and a half days we had formal meetings with eleven global hedge fund managers out of the 140 that were in attendance. One of the many panel sessions during the conference included former British labour MP Alistair Darling. Further to establishing relationships with the fund managers, the conference also facilitated professional relationships with like-minded family office and wealth management businesses.

A key issue raised at the conference is the continued high level of fees despite lower performance for many alternative strategies. The traditional 2% management fee and 20% performance fee (often referred to as "2 and 20") skews the share of performance to the manager in a low return environment. An investment manager needs to return greater than 5.40% (before fees) in order for the client's net return to be greater than the manager's. This begs the questions; where does the risk lie in the current environment, and, do such performance fees truly align the interests of the manager and the client? There was much discussion around the justification of such fees, though we would expect the traditional "2 and 20" fee structure to come under pressure in the medium term.

We also observed a trend towards increasing complexity and evolution of strategies. With bank trading desks and risk appetites all but disappearing in the current regulatory environment, many managers have filled the void and are taking positions that were traditionally held at investment banks where the diversity of positions could somewhat absorb adverse market conditions. While these products are marketed to sophisticated investors only, who should be able to understand these risks, it showed the desperation of investors who have struggled with extremely low or negative interest rates over recent times. They have been forced into unprecedented risk in order to achieve similar if not lower returns. Australia has certainly been more fortunate than most with respect to returns and has so far avoided untoward risk-taking in increasingly complex products. In most cases, these complex investment strategies have not been tested in a stressed market environment and it is therefore difficult to determine their risk in such a circumstance.

Providence also recently met with two of our existing managers, Standard Life Global Absolute Return Strategy (GARS) and Walter Scott Global Equity Fund in Edinburgh, Scotland. These were productive meetings involving portfolio managers, risk managers, dealers and analysts. This deep-dive due diligence led us to be comfortable with the risk management framework employed by both funds, consistent across all roles in their teams.

In markets, political risk is changing. The French election and polling for the upcoming German election suggests that political stability is returning to the region just as uncertainty is creeping in to the UK and USA. Many European assets have, quite rightly, traded at a significant discount to the UK and USA recently as the rise of populism spreads through the region, however this appears to be abating. While there are still some significant issues surrounding debt levels, the financial system and migration, it is quite possible that the political discount affecting European asset trading may narrow over the medium term.

Thoughts from a Contrarian

Ever since the era of modern activist Central Banking kicked off in 1987 with Alan Greenspan, we've had a financial crisis or crash in markets every ten years or so. It's fair to say those at the wheel didn't exactly see any of them coming. Greenspan himself, to be fair, was worried prior to the GFC. This may have been prescient, except he was worrying about double digit interest rates. It wasn't that long, of course, until interest rates didn't event rank a single digit. His replacement, Ben Bernanke, didn't fare much better. Asked in 2005 about the possibility of falling house prices in the US Bernanke's short answer was: "I guess I don't accept your premise". His rationale?... "we've never had a decline in house prices on a nationwide basis." Well, now we have, so at least he probably accepts the premise these days.

Once the crisis itself appeared on the horizon Bernanke's assessment was; "housing markets are cooling a bit. Our expectation is that the decline in activity will be moderate, that house prices will probably continue to rise". When the GFC was so obvious that even somebody that denied its possibility couldn't miss it, Ben still thought he had it under control: "At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seem likely to be contained". As late as January 2008 the Fed was "not currently forecasting a recession". Since then we've had the best part of a decade where the Fed was proven consistently overoptimistic.

It's concerning therefore, but not at all surprising, that Janet Yellen even with the benefit of witnessing 30 years of a recurring boom / bust cycle and having seen the predictions of those that preceded her left in tatters, has thought it through and come to what she sees as the perfectly obvious conclusion…. We've got this, no chance of a crisis here. Apparently, another financial crisis is not likely "in our lifetime". If the theories which Yellen, Bernanke and their fellow travellers have spent decades studying were correct her reasoning is logical. The problem is she's not accepting the premise they may be incorrect. Having probably spent 50 years studying them you can't really blame her. It's like Isaac Newton having developed a theory that apples fall upwards from trees simply ignored the multitude of apples lying on the ground and was genuinely surprised every time one hit him on the head. For those of us prepared to accept a premise that doesn't fit in with the central banker's world view the chances of another crisis during our lifetime is probably closer to 100%.

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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