Providence
Independent Investment Advisory

Global Outlook & Strategy

Issue 68: 1st Quarter 2018

A Year of Change

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1. KEY POINTS

- **Inflation expectations are likely to rise over the course of 2018**
- **Global growth to remain strong**
- **Higher bond yields and inflation will undermine elevated valuations**
- **Final stages of the bull market in risk assets**
- **2018 will be a year of change**
- **Potential US recession 2019**
- **Diversification, quality, relative value and overweight cash the focus**

Potential for a rapid recalibration of inflation expectations

Central banks have been tipping kerosene on a bonfire with wet wood for some time. We believe the wood is nearly dry.

Inflation has been the missing link following the Central Bank's US $14 trillion of stimulus and the subsequent return of synchronised global growth.

In our view, the market may be underestimating the potential for a pickup in inflation and subsequent increase in interest rates.

A rapid recalibration of inflation expectations and subsequent rise in global interest rates is likely to undermine extended valuations in most assets.

The current dislocation between market expectations of the level of US interest rates and the US Federal Reserve's (Fed) rate increase trajectory remains in place. The bond market does not believe the Fed will increase rates as much as they have indicated. This is despite the Fed delivering exactly what they said they would, with regards to the number of rate hikes in 2017.

We believe this time around the market is underestimating the level in which interest rates will peak.

We expect a change in the market's mindset during 2018 as inflation indicators turn up and a subsequent price adjustment to some risk assets ensues.

The pickup in inflation, however, is likely to be cyclical not structural. The overarching structural issues that have emerged (ageing population, elevated levels of debt, impact of technology on prices etc.) over the last five-plus years are likely to provide a cap on the level of global inflation.

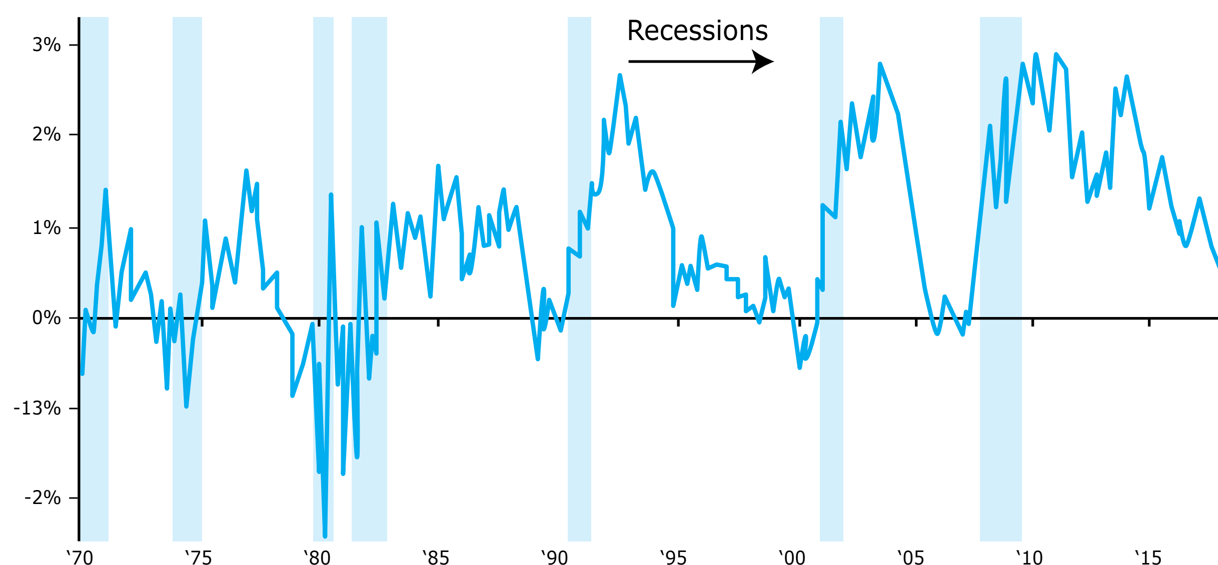
This means that although a correction in risk assets could be sharp, central banks will once again come to the rescue and cut rates.

Looking further out, there are some indicators that suggest the potential for a US recession in 2019.

The yield curve (the difference between short-term and long-term interest rates) is starting to flatten (**Figure 1**). A flat yield curve has historically been a strong indicator of a potential recession.

Figure 1: The US Yield Curve Suggests a Looming Recession
Source: JPM Asset Management

YIELD CURVE SPREAD
10-year less 2-year U.S. Treasury



The real Fed funds rate is forecast to be above neutral by the end of 2018. The neutral rate is broadly defined as the interest rate consistent with full employment, trend growth and stable prices, with little requirement from a central bank to either stimulate or slow an economy via monetary policy. The current neutral rate as indicated by the Fed is 2.8% nominal over the medium term. If this is in fact the case, the risk of recession in the US in 2019 will increase. The market will start to focus on this issue through the course of 2018.

European economies continue to recover with a relatively strong company earnings growth trajectory, all the while the ECB remains with an accommodative stance. Growth is currently above trend. However, inflation remains contained due to excess capacity within the EU.

Within Japan, the Bank of Japan remains firmly in the accommodative phase. While still tackling deflation, there are now signals of growth emerging with very little scope for rate hikes and attractive valuations.

Our central theme is that we are very late in the economic and market cycle. Valuations are very much at the top end of any long-term range, inflated by the unprecedented printing of money by global central banks. Exuberance has replaced the fear and concern seen in early 2017 and is evidenced by the re-emergence of typical late market behaviour: large mergers and acquisitions, increasing numbers of IPOs and rampant speculation (Bitcoin). The focus very much needs to be on the protection and preservation of capital at this juncture.

2. INVESTMENT OVERVIEW

The backdrop of 'easy money' led by global central banks and synchronised global growth has seen risk assets perform strongly over the past 12 months. **This is as good as it gets, and we are in the last throes of this momentum-driven, central bank-fuelled market run.**

Although late cycle behaviour can see markets overshoot to the upside, we already have valuations that are at historical highs. The bears have become bullish.

The takeaway message here is that the equities market is telling us all is okay, and that growth momentum will continue (higher equity prices), all the while the bond market is telling us it's not so convinced (low interest rates).

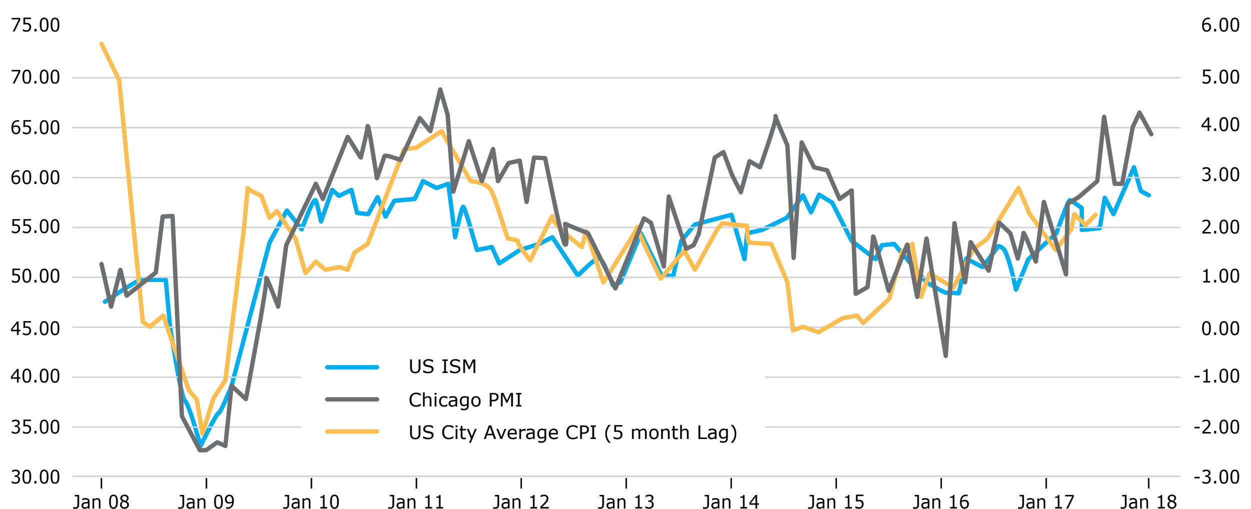
A spike in inflation in the US, if it does arrive as we expect, will rapidly arrest some of the current exuberance.

Client portfolios are positioned for this to materialise.

The unemployment rate in the US is at its lowest level since 2000 at 4.1% — essentially full employment. This would suggest that wage inflation will ultimately become an issue and remains the missing link. The US PMI (Purchasing Managers Index) and NAPM (National Association of Purchasing Managers) indexes are peaking (**Figure 2**) suggesting upward pressure on inflation. Since 1980, the US ISM (Institute of Supply Management) index has only been higher than the current level 9% of the time. The same chart shows a lagged CPI gauge that is trending higher.

US GDP growth could potentially have a '4' in front of it during the next year, possibly fuelled by recent tax changes, which will put upward pressure on short-term interest rates. Positive data is also coming out from Europe despite unemployment levels above 8.5%. We expect growth to continue to improve and the deflationary cycle is past the inflection point. China is undergoing further reform yet still maintains a healthy 6% growth rate, buoyed by global growth. Even the Japanese economy is showing good signs of growth and appears to be close to the end of a very long deflationary cycle.

Figure 2: US ISM, NAPM, PMI All Tracking Higher. CPI (inflation) Following the Same Path.
Source: Factset



Australia, on the other hand, is running at half-paced growth potential. The household sector is struggling under increased energy prices, higher mortgage costs and high debt levels. This pressure is most noticeable with poor retail sales numbers. The reliance on housing and the very poor policy environment is holding back growth potential. Tourism, education, health and aged care and agriculture sectors are the best supported sectors. Commodities are holding onto recent gains in the main. It is unlikely that the Reserve Bank will be in a position to raise official interest rates for all of 2018 and potentially into 2019. Therefore, we see some downside pressure on the AUD in this environment, especially when the US is raising rates.

The surprise in 2017 was the stronger global growth picture, yet bonds remained steady with no uptick in inflation. We do not believe this will be the case in 2018.

The investment outlook therefore is more challenging with some concerning indicators:

- **Margin debt in the US is at historical highs**
- **The US cyclically adjusted PE is 30% above the 60-year average and has only ever surpassed the current level once over the past decade**
- **Corporate credit spreads are effectively pricing in almost no scope for a recession (default rate of 2% or below)**
- **Complacency is high with the VIX (Volatility index) just above its all-time low**
- **Merger and acquisition activity has picked up dramatically**
- **Rampant speculation, such as Bitcoin and 300% leveraged ETFs are evident**

Perhaps the most rampant sign of exuberance and FOMO (fear of missing out) can be evidenced by surge in value and the subsequent roller-coaster ride in the price of Bitcoin in the last few months. If ever there was a sign of unsophisticated 'all-in' speculation, 2017 has shown that Bitcoin won that prize. While there may well ultimately be a place for cryptocurrencies in our ever-changing, digitally focused world, Bitcoin highlights some of the perils of speculation. Such speculative behaviour has been seen before and is yet further evidence of where we are in the cycle.

How to navigate

- Prepare for a market adjustment to a pickup in inflation
- Expect the market to increase their expectation of more US rate hikes this year than currently anticipated
- Choose tempered and selective investing
- Expect lower returns this year with higher volatility
- Watch for any pickup in Chinese-led reforms that may inhibit growth

What we favour

- Elevated cash levels in preparation for any meaningful pullbacks
- A preference for quality assets with capital preservation in mind
- Selective property exposures
- Alternatives not correlated to equities or credit

3. ASSET CLASS REVIEW

3.1 Equities

The Cyclically Adjusted PE for the US market, using 5-year average earnings, has only surpassed this point once in the past 100 years (**Figure 3**). It reminds us that we are late in cycle and the US economy is essentially at full capacity. Historically, we would have seen wage pressure already emerging in the US and yet its absence remains puzzling. It's no coincidence that the soon-to-depart Chair of the Federal Reserve, Janet Yellen, mentioned in dispatches late 2017 that the US economy really did not need tax reform right now — another possible stimulatory fuel.

Should the Fed ultimately need to raise rates faster and more aggressively than currently expected in response to a sharp pickup in inflation, then the equity market is in for a bit of a fright this year, as complacency remains high.

Australia has been a broad underperformer on the global equities stage throughout 2017 **(Figure 4**). This can be partly explained by our lack of government policy progression, but is also due to the dominant weighting in the Australian equities market to financials. While offering an attractive yield, financials (banks in particular) offer little in the way of earnings growth in the forward years. That, coupled with the continued focus on our elevated housing market and the exposure of the banks to housing, makes it easy to understand why the Australian market has been unattractive to global investors.

Figure 3: Five Year Cyclically Adjusted US Price/Earnings Ratio
Source: Factset

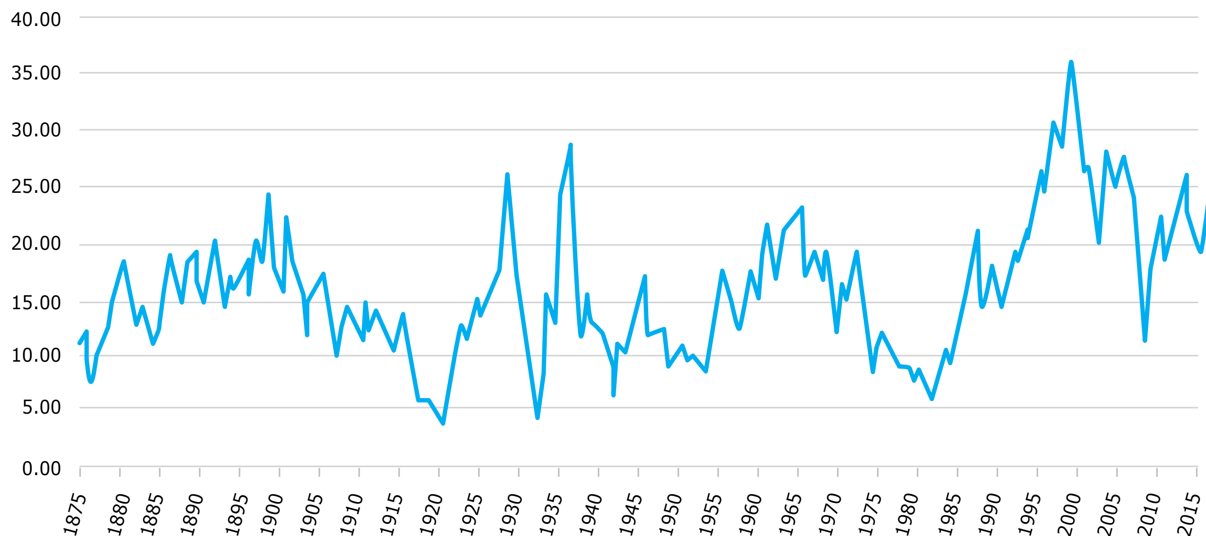
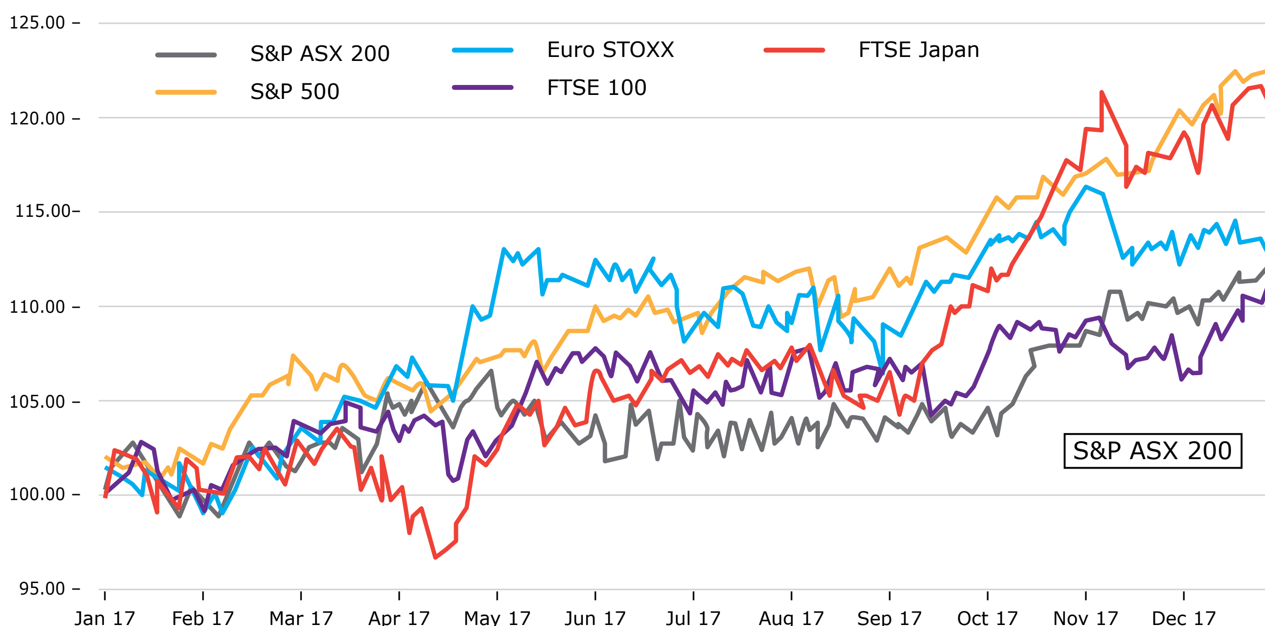


Figure 4: Australian Equity Market Return vs. Global Markets Total Returns (incl. Dividends)

Source: Factset



With the broad-based level of global growth now evident (in December the IMF cited that growth had accelerated in about three-quarters of the countries it monitors, the highest since 2010), commodities are likely to remain well supported.

Any aggressive stance (not yet evident but certainly a risk) taken by China to reign in excess credit and embark on any significant environmental and/or financial reform may impact commodity prices and hence remains a tail risk for Australia given China's importance as a trading partner. While not our central view, it does remain on watch as one could argue that Chinese President Xi Jinping is now, post the Chinese Congress in November last year, at peak power.

Interestingly, while gold was up 13% in 2017, historically it has been a solid inflation proxy and to date, its price performance appears consistent with the broader market's view that they will "believe the inflation story when they see it".

Given our views that the US market remains elevated and the US economy is late cycle, our preference in global markets remains Japan and Europe. Despite the very strong PMI (Purchasing Managers Index) prints in Europe (**Figure 5**) the overall performance of the broader EuroStoxx 50 European Index in 2017 was a relatively subdued 6.5% and valuations remain attractive relative to the US in particular (**Figure 6**).

Passive investing, as mentioned in dispatches throughout the year, has played a big part of key market moves. We expect any change in investor mindset or direction, including in or out of key markets or themes, will be over-accentuated by the sheer weight of money in passive investments supercharged by ETFs (exchange traded funds).

Figure 5: Global Purchasing Managers Index. Note European Strength.
Source: Heuristic Investment Systems

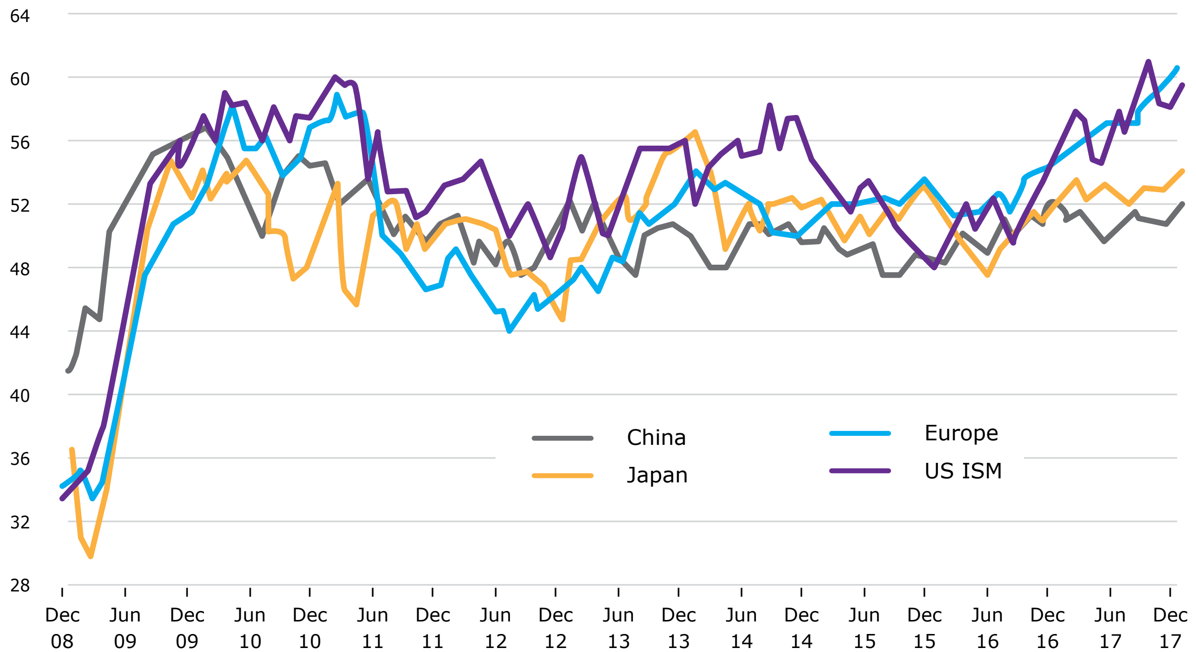
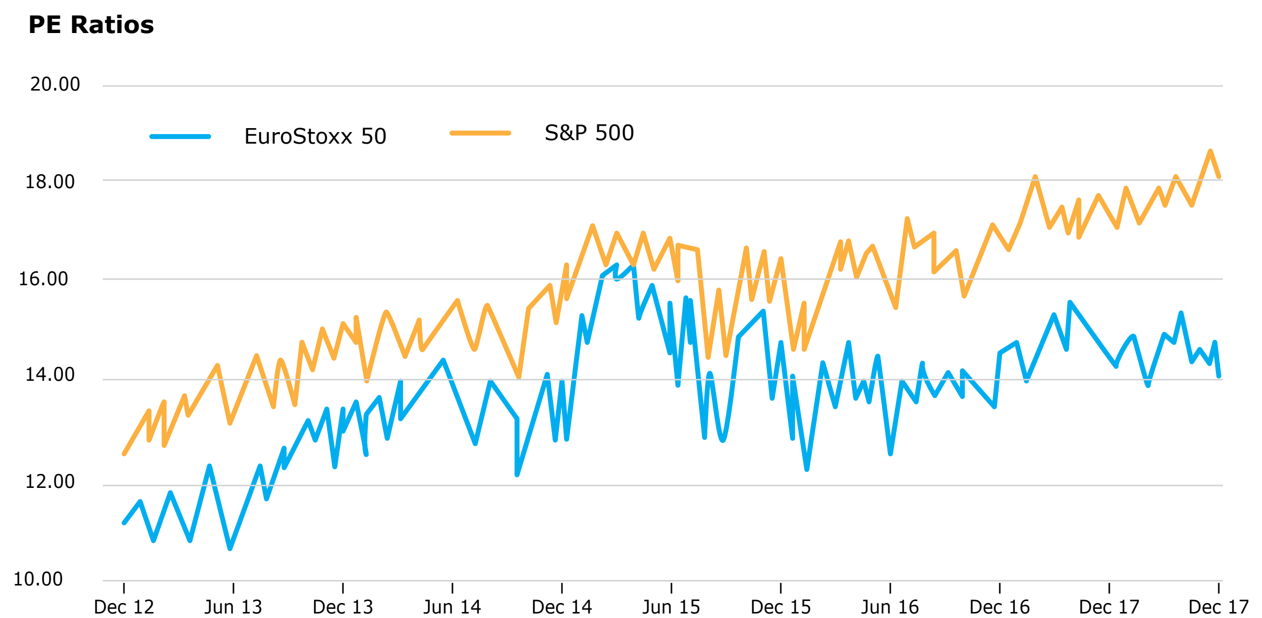


Figure 6: Chart of EuroStoxx 50 PE vs. S&P 500 PE
Source: Factset



3.2 Property

It is hard to find value in the sector given compressed cap rates for traditional property sectors. Where we have found value is in some of the boutique areas like healthcare, child care, medical centres and student living etc.

Another area of interest is those assets held by some institutional owners. Many asset owners have allowed capex and maintenance to decline with some assets needing some active management. This is a result of cap rates declining due to weight of money rather than the owner improving the overall asset. Asset price momentum has provided more than enough levels of return in recent years, to the point where many assets are now being cycled off by owners at significant premiums to where values were only a number of years ago. Many institutional owners were able to enjoy the upwards revaluation of assets without having to shell out capital for improvements. This has resulted in nimble and active managers being able to acquire assets with the intent of adding value via refurbishment and repositioning the asset, resulting in enhancing an asset without reliance on declining cap rates.

We also noted the increased level of mergers and acquisitions with the Westfield transaction being the eye-opener.

There's not much value left in the sector at such compressed cap rates. Any material increase in interest rates will make distribution yields seem less attractive on a relative basis.

3.3 Fixed Income

Global credit spreads remain compressed and indicate pricing by the market consistent with the view of almost zero chance of a default which is simply not sustainable (**Figure 7**).

We have reflected these credit market concerns over the past 6 months by migrating our existing credit exposure to lower risk asset-backed securities. This has improved the quality of client fixed income investments.

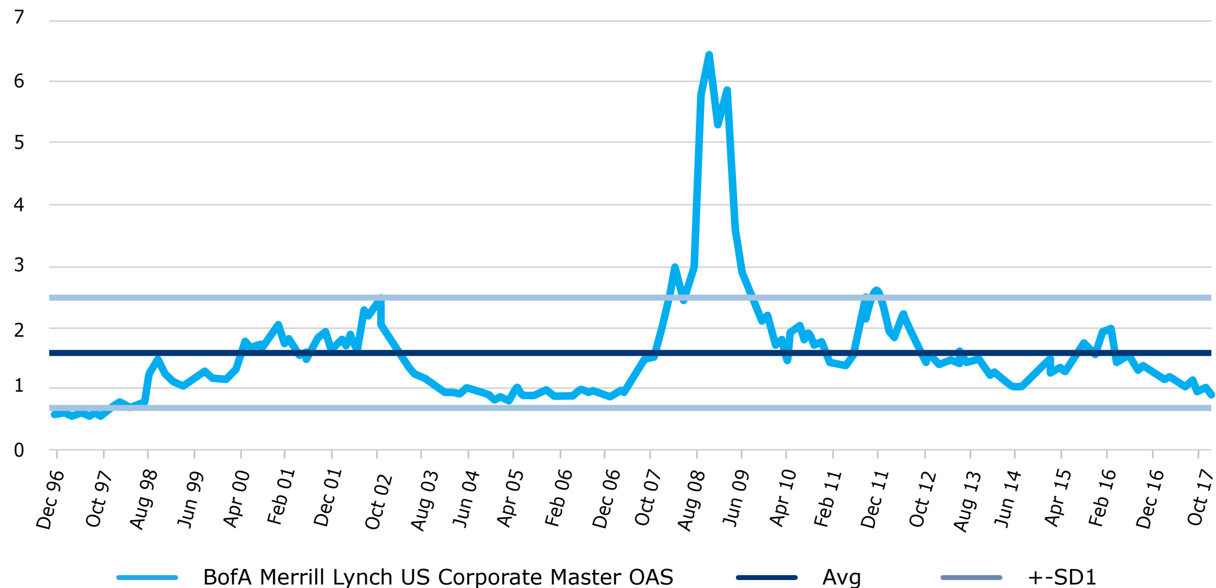
We are remaining short duration meaning that we do not hold long-dated bonds given our view of rising interest rates. As interest rates rise, the price of bonds reduces.

There is little factored into credit for an increase in default rates. This is not an issue at this stage given strong growth; however, in our view, as investors you are not being rewarded for the risk.

Figure 7: US Credit Spreads Continue to Point to Almost Zero Chance of Default. Unsustainable!

Source: Heuristic Investment Systems

US Corporate Spreads



3.4 Alternatives

The objective of our exposure to alternatives is twofold:

1. Providing investment exposure that has low or no correlation to risk markets
2. Capturing investments that are not available by traditional means

We use several strategies in this area including long and short equity, private equity, global macro and managed futures. Although they may be slightly impacted by a major market correction, we believe they will cushion the impact and provide solid diversification.

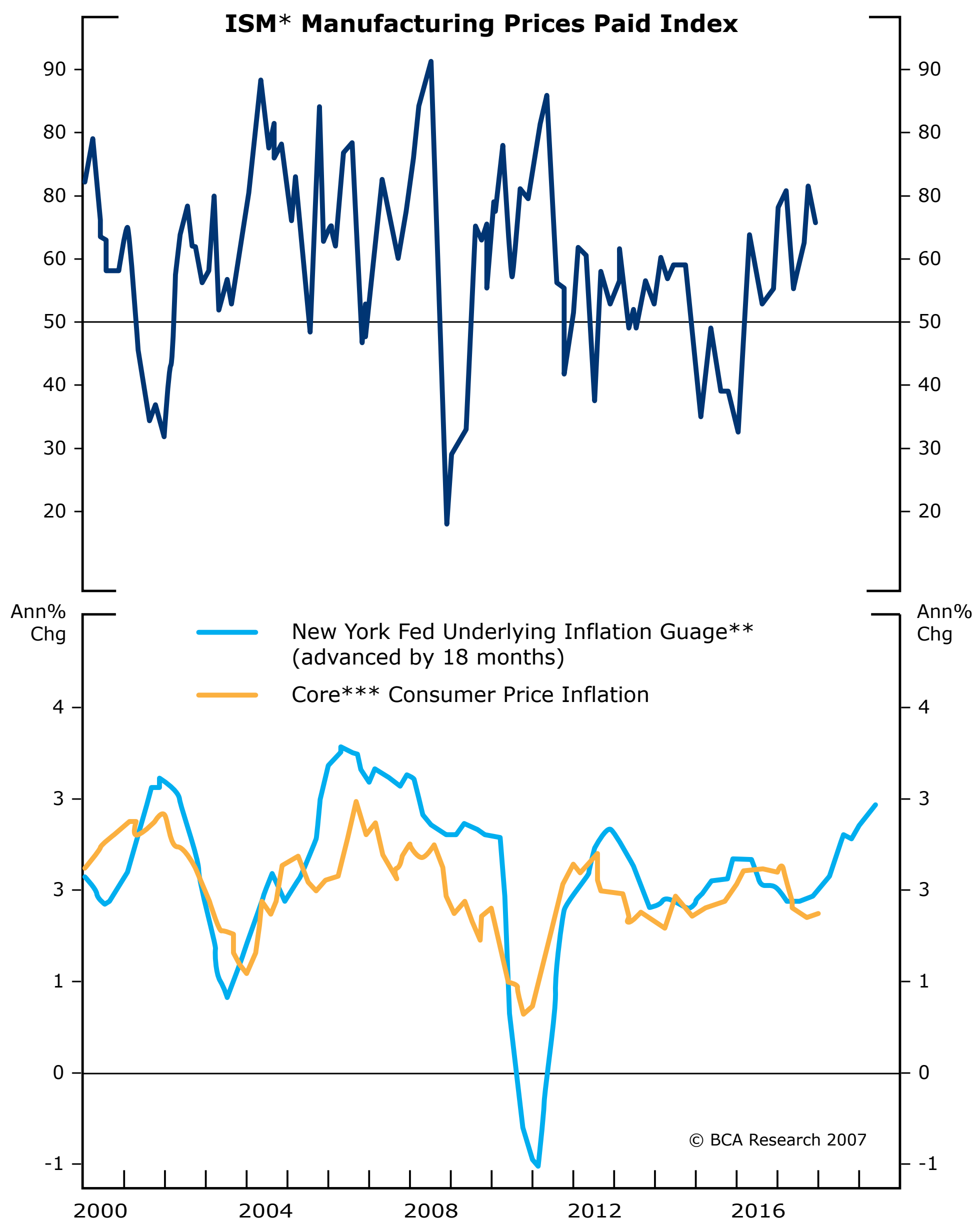
Many hedge fund managers have found the low-volatility environment particularly challenging. Any material increase in volatility is likely to see these funds have more scope to provide returns.

Bitcoin, although alternative, does not meet our investment criteria.

4. CONCLUSION

We view the market as currently complacent with regards to the potential of a rising inflationary environment into 2018, despite signals to the contrary (**Figure 8**). Timing will be difficult to predict. The biggest risk in 6 to 9 months is that central banks remain too accommodating and are hit with inflation faster so need to play catch-up and accelerate their interest rate rise path. This would be potentially very challenging for a momentum-wired, complacent market.

Figure 8: US Inflation Signals Are Present
Source: BCA



* Institute for Supply Management
** Trend inflation measure based on broad price variables, macroeconomic variables and financial variables (Source: Federal Reserve Bank of New York)
*** Excluding food and energy

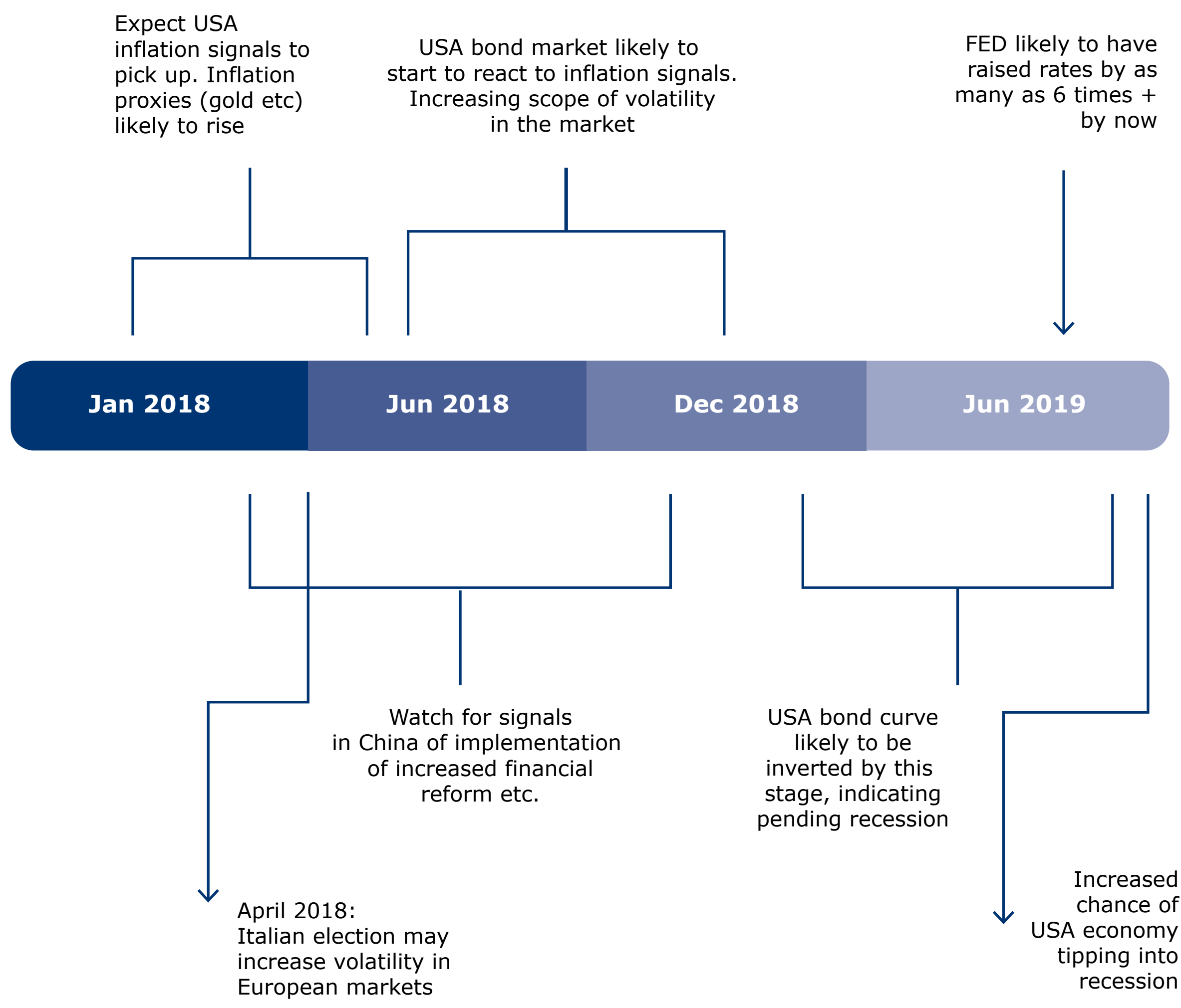
How the markets do react this year to data (inflation) and the central banks' response could be materially different to previous cycles, given the changed landscape for how investments are set. We are all too aware of how much passive money (now over US$4.5 trillion in global ETFs) has been on the one-way train over recent years and we are yet to see this momentum really tested.

However, we must be cognisant that the markets can rally very hard at the end of a bull market.

We outline (Figure 9) some of the issues that we identify as playing out in the next two years and a rough indication as to our expected timing. While a broad guide, it gives some pictorial indication as to what we are anticipating in the coming year and beyond.

Preservation of capital and a reasonable return above inflation is and always will be our focus and mantra.

Figure 9: A stylised example of how the next 12-24 months may play out
Source: PWAG



Comments from London

The final quarter of 2017 was busy for the London office. Following Grant's third quarter visit there was some refinement about what alternative funds are most appropriate at the current juncture. As a result, meetings were facilitated with over 30 managers mostly across the systematic, trend-following and event-driven segments of the hedge fund universe as well as those managers that have exhibited a negative correlation with equity markets during times of market stress.

Fortunately, four investment conferences hosted by Morgan Stanley, Bank of America Merrill Lynch, Credit Suisse and Kepler facilitated an introduction to some of the leading managers within these target segments.

Outside of the initial due diligence and face-to-face contact with managers, the opportunity to discuss the current market environment both with managers and like-minded investment professionals raised some interesting debate. Within the context of this document, Blue Bay Investment management noted that their recent discussions with members of the United States Federal Reserve were focused around these members' disbelief at the lack of market reaction to recent commentary and action by the Federal Reserve and its members. Certainly, we are supportive of the idea that the market may be 'behind the eight ball' when it comes to expectations of future monetary policy in the US.

The counterargument to the potential inflation surprise is that tax reform and continued moves in interest rate policy will strengthen the USD through repatriation of offshore currency and relative attractiveness of short-term bills. It is argued that any strength in the USD will have a dampening effect on future inflation as imported products become cheaper, forcing domestically produced products to lower prices to become competitive.

York Asset Management note that the current environment feels like the late 1990s with individual stock volatility on the rise, which is not currently being captured at an index level. York certainly believes that this phenomenon has been exacerbated by the rise of passive investing that concentrates investors in the largest companies in an index, hence the low level of volatility while allocations increase. It remains to be seen what may happen when allocations to passive investments reverse, although a rebound in volatility is certainly a possibility.

Without doubt, the most common discussion point has been the current global synchronisation of economic growth. The argument persists about how long this will last. The bulls point to reasonable economic output gaps persisting across the developed world as a reason to believe that there are still years to run in this economic cycle, while the bears point to trade deals and quantitative tightening as the reason for a nearer term end. Interestingly, both sides of the argument agree that we can expect less synchronised returns across and within asset classes and geographies, with valuations generally stretched across the board.

Thoughts from a Contrarian

Careful what you wish for …

For a decade or so the world's central bankers have been frantically trying to generate inflation. Personally, I spend most of my time trying to avoid inflation, but that's economists for you. Currency debasement as a path to prosperity has been an article of indisputable dogma in economics for so long that everybody seems to have forgotten it's just a theory. A theory that's been tried multiple times throughout history and failed. They tried it in Rome and the empire declined; they tried it in France and had a revolution; they tried it again after the revolution and that ended badly as well. They tried it in Germany and that ended really badly. How it ends this time remains to be seen but what's more certain is that we'll get our wish sooner or later. Even if they end up dropping money out of helicopters to get us there. The alternative would be to question the theory itself and that's not going to happen.

A strong consensus is starting to emerge that inflation may finally gain some traction in 2018. It's not exactly the first time we've been here. There's been several false starts. Whether this time is different nobody knows at this stage.

What's also hard to predict is what's going to happen once the inflationary snowball gets rolling. Central banks have printed $14 trillion without any discernible impact because the money lay dormant in the financial system and never reached the broader economy. What happens when the velocity picks up and this money starts to multiply? In 2018 we may get to find out. The textbooks say that the central banks should be able to keep it under control ... That would be the same textbooks that said it should have arrived years ago.

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

Active Managers	A portfolio investment strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index
Alpha	The level of outperformance relative to a benchmark
Alternatives	A non-traditional asset with potential economic value not found in a standard (or traditional) investment portfolio
A-REITS/REITS	Listed Australian real estate investment trusts giving access to property assets
BPS	Basis points
Cap Rates	The rate of return on a real estate investment property based on the income that property is expected to generate
Correlation	A measure of what degree two securities or investments move in relation to each other
CPI	Consumer Price Index
Credit Spread	The margin paid over the risk-free rate (government bonds)
Cryptocurrencies	A digital asset used as a medium of exchange, a source of digital currency
Cyclically Adjusted Price Earnings Ratio (CAPE)	The price of a security or index divided by the moving average of ten years of earnings, adjusted for inflation
ECB	The European Central Bank
Economy-agnostic	Unlikely to be impacted by the fluctuations in the economic cycle
ETFs	Exchange Traded Funds
Fiscal Stimulus	Increasing government spending or reducing tax levels to stimulate and/or support economic growth
FOMC/Fed	The USA Federal Open Market Committee, the USA central bank
GDP	Gross Domestic Product - a measure of an economy's total output
Gearing	A measure of how much debt a company has relative to equity
GFC	Global Financial Crisis
High-Yield corporate debt	Debt issued by a corporation that has a credit rating that is below investment grade
IMF	The International Monetary Fund
Inflation	When the inflation rate is above 0 and the general price level of goods and services increases
IPO	Initial Public Offering - the first time the stock of a private company is offered to the public
ISM	Institute of Supply Management
Leverage	An alternative term for gearing i.e. a measure of how much debt a company has relative to equity
Long/Short	An investment strategy that involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value
Managed Futures	The use of futures contracts as part of an overall investment strategy providing portfolio diversification among various types of investment styles
Monetary Policy	The process by which a country's monetary authority (usually a central bank) controls the supply of money, traditionally by setting short-term interest rates
MSCI	A USA provider of equity, fixed income and hedge fund stock market indexes
MSCI World Index	A market cap weighted stock market index of 1652 world stocks maintained by MSCI
NAPM	National Association of Purchasing Managers
Net Asset Value (NAV)	The value of an entity's assets less the value of its liabilities
Non-Correlated	An asset class that does not move in a similar direction to another asset class
Passive Investing	Asset management associated with mutual and exchange-traded funds (ETF) where a fund's portfolio mirrors a market index
PE Ratio	Price Earnings Ratio - the share price divided by the earnings per share of the company
PMI	Purchasing Managers Index
Populism	A belief that the majority of a population is being mistreated by a small circle of elites
Private Equity	Investment in assets that are not publicly traded
Relative Value	A method of determining an asset's value when taking into account the value of similar assets
Sovereign Bond	A bond issued by a government
Systemic (issues)	A problem due to inherent issues in the overall system rather than a specific or isolated factor
Total Return	A measure of return that takes into account capital appreciation and income received by a portfolio
Volatility	The degree of variation of a price over time

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