The Financial Engineer (Global Edition)

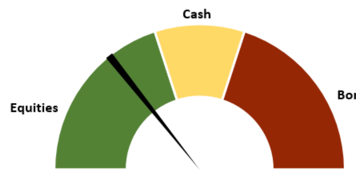
Portfolio Strategy

Tim Rocks – Chief Investment Officer

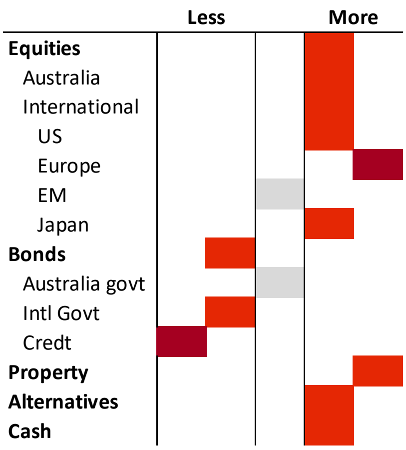
Wednesday 27 September, 2017

EVANS & PARTNERS

Asset Allocation:



Preferences - Next 12 months



Source: Evans & Partners

Key Forecasts

	Now*	12mth F'cast
$A	0.794	0.769
US 10 yr	2.22	2.30
Aust 10yr	2.79	2.70
ASX 200	5684	5800
S&P 500	2497	2500

**As at 26 Sep*

Source: Datastream Evans & Partners

Peak Recovery

Equity markets have benefitted from better economic growth, declining inflation and easy liquidity conditions over the past two years. We expect a weaker, though still positive, outlook over the next year:

- Chinese growth is likely to weaken as the lagged effects of the 2016 stimulus work through the economy and there is a step up in reform after the National People's Congress in October.
- Weaker Chinese growth is likely to result in weaker global growth and a peak in the global earnings cycle.
- A shift in liquidity conditions is likely to occur as the US Federal Reserve begins to unwind quantitative easing and the European Central Bank slows its pace of asset purchases.

These challenges need to be balanced against some expected strengthening in Europe and some likely improvement in the Australian economy.

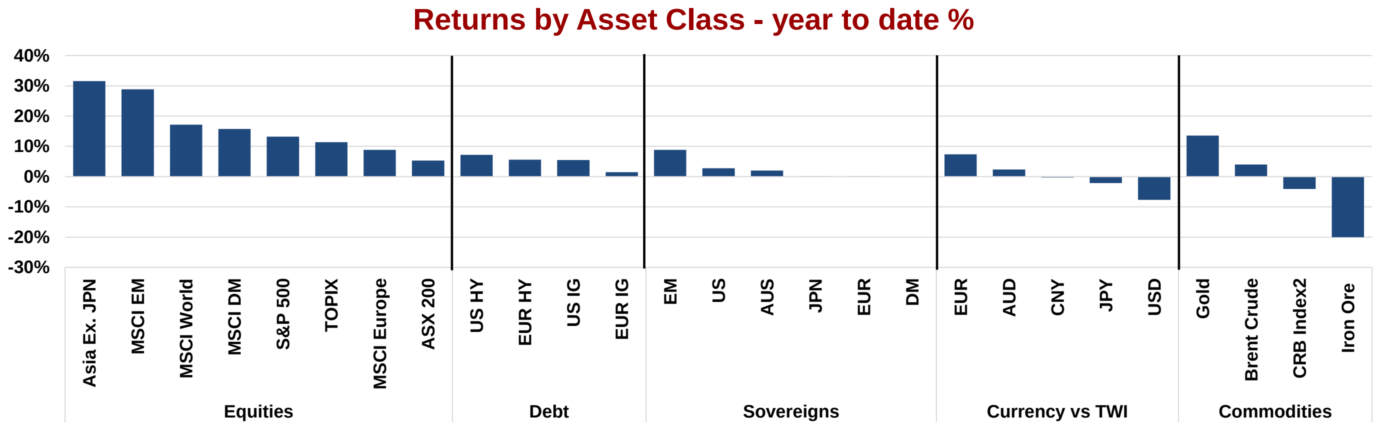
RECOMMENDATIONS

The implications for asset allocation are:

- We have reduced our expected return forecasts for equities based on some weakening in global growth but Equities are still preferred to Bonds given the low level of rates. We have reduced our 12-month forward forecast for the ASX 200 to 5,800 (from 5,900).
- Within equities, Europe is preferred given reasonable valuations and strong prospects for earnings. We have a neutral recommendation on emerging markets and small overweights on other regions.
- Within bonds, sovereigns are preferred over corporate credit and hybrids given extremely low levels of corporate and hybrid spreads. Australian sovereign bonds are preferred over their international equivalents.
- The decline in the $US has dominated all other factors in currency markets this year. Going forward, we expect some downside to the $A as commodity prices retrace and US rates rise relative to Australia. Our 12 month forward forecast for the $A is now $US0.77 (from $US0.72).

A strong first half for equities and credit

A healthy economic backdrop resulted in strong returns to equity and credit in the first half of 2017. The best performing equities have been in emerging markets and Asia while Australia has lagged. Commodities, other than gold, have been the worst performing asset class this year partially reversing their strong gains during 2016. In currencies the major development has been the fall in the US dollar that has resulted in appreciations in most other major currencies.



Source: Bloomberg, Evans & Partners

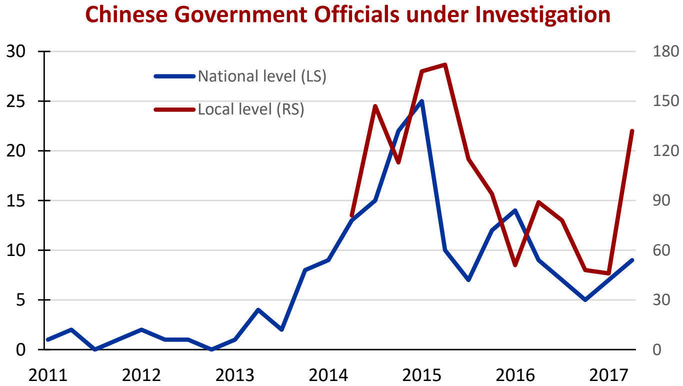
Key issues

Better economic growth, declining inflation, easy liquidity conditions and a falling $US have all contributed to a golden backdrop for equity markets over the past two years. This equity strength has been sustained through the past few months despite increases in geopolitical risk and some softening in the Chinese economy.

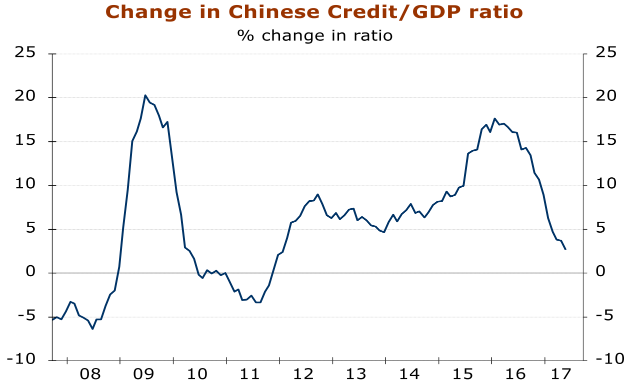
We now expect a weaker period for returns as these effects fade. Chinese growth will weaken as the lagged effects of the 2016 stimulus work through the economy and there is a step up in reform after the National People's Congress in October. This will lead to some softening in the global GDP and earnings outlook. At the same time there will be a shift in liquidity conditions as the US Federal Reserve (Fed) begins to unwind quantitative easing and the European Central Bank (ECB) slows its pace of asset purchases. These challenges need to be balanced against a strengthening outlook in Europe and some likely improvement in the Australian economy.

1. Peak growth due to China

The global economy has benefitted significantly from the kick-start to the Chinese economy that occurred in early 2016. There was a surge in credit and infrastructure announcements and a decline in corruption investigations around that time as the Chinese leadership sought to manufacture a strong economy in the lead up to the five-yearly National People's Congress that will occur this October.



Source: Central Commission for Discipline Inspection, Evans & Partners



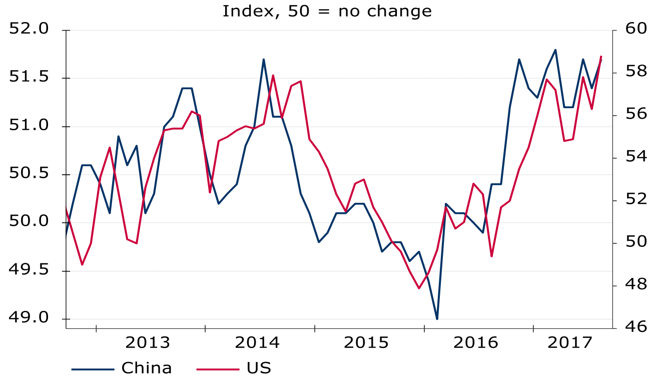
Source: Thomson Reuters Datastream, Evans & Partners

A peak in Chinese activity means a peak in global GDP and earnings. The bounce in the Chinese economy from early 2016 had a strong and immediate impact on the US, as shown by the tight correlation between the main business surveys in the two countries (the PMIs in the chart below). We expect this same relationship to hold as Chinese activity retraces over the next year.

At the same time the boost to equity markets from strong global earnings is also near a peak. Global earnings have grown by 17% over the past year due mostly to accelerating activity but also assisted by weakness in the $US and higher oil prices. We expect all of these factors will be working in reverse over the next year. This suggests that the 10% growth in earnings being forecast for global equities in 2018 is probably not going to be achieved and downgrades may start to weigh on market performance.

China and US PMI

Index, 50 = no change



Source: Thomson Reuters Datastream, Evans & Partners

Global GDP and Earnings Growth

Yr chg %

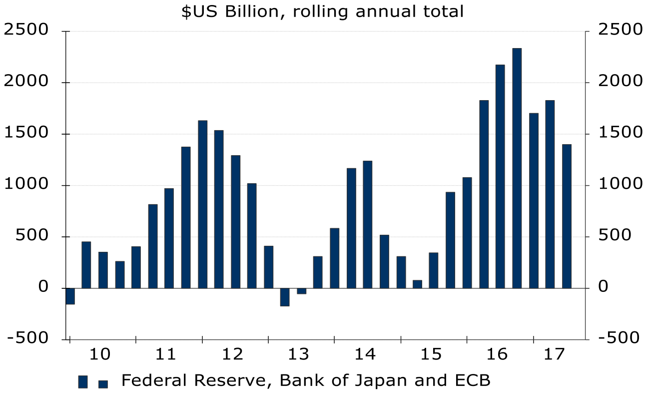
Source: Thomson Reuters Datastream, Evans & Partners

2. Goodbye easy liquidity

The second challenge is a major turning point for market liquidity as the Fed begins to reduce its balance sheet and the ECB slows down its asset purchases. Total central bank buying of debt securities was around $US1.5 trillion over the past year (for some perspective this is equivalent to about 2% of global equity market cap) and the impact on markets has been significant, particularly for corporate credit. Over the next year net purchases may be close to zero depending on the pace of unwinding by the Fed and tapering by the ECB. At the same time, liquidity conditions have also been buoyant in China as shown by the growth in M1 but this is also likely to turn down in line with broader Chinese tightening in 2018. There is the risk that such a major shift could have a significant impact across asset markets.

Central Bank Asset Purchases

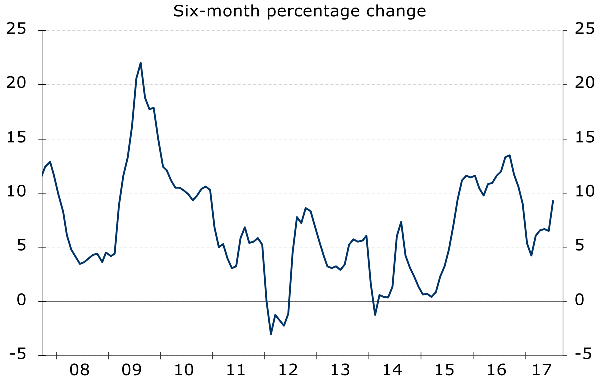
$US Billion, rolling annual total



Source: Thomson Reuters Datastream, Evans & Partners

China M1

Six-month percentage change

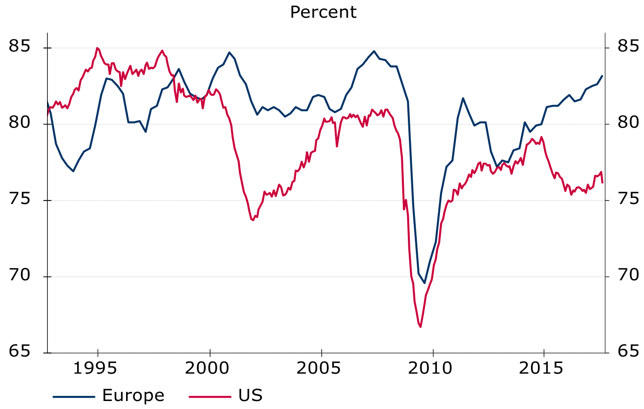


Source: Thomson Reuters Datastream, Evans & Partners

The pace of liquidity withdrawal will depend on the path of inflation. US inflation readings have been surprisingly weak over the past year given the strength in activity, and the critical question is whether this will continue. The complication is that there have been a number of one-off factors that have held down US inflation such as sharp falls in telecommunications, drug and second-hand car prices, and price falls of these magnitudes will not be sustained. As these effects fade, US inflation could revert back towards 2%. The Fed has recently made clear that it sees the decline in inflation as transitory and it may raise rates further in anticipation of an increase in the inflation rate next year.

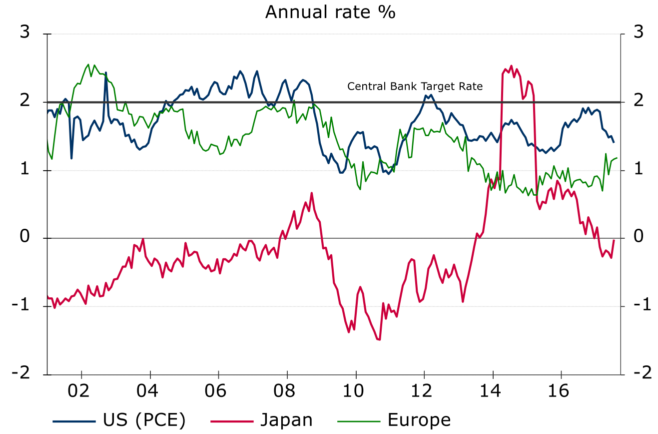
There is also the prospect of accelerating inflation in Europe. There is some evidence of capacity constraints emerging and this could lead to higher prices over the next year. This could force the ECB into a more rapid withdrawal of support.

Capacity Utilisation



Source: Thomson Reuters Datastream, Evans & Partners

Core inflation

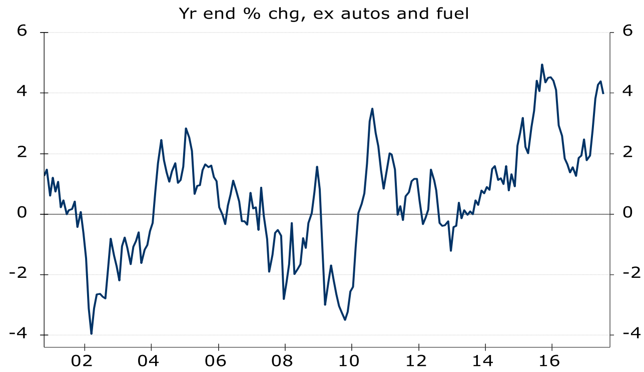


Source: Thomson Reuters Datastream, Evans & Partners

3. Europe the bright spot

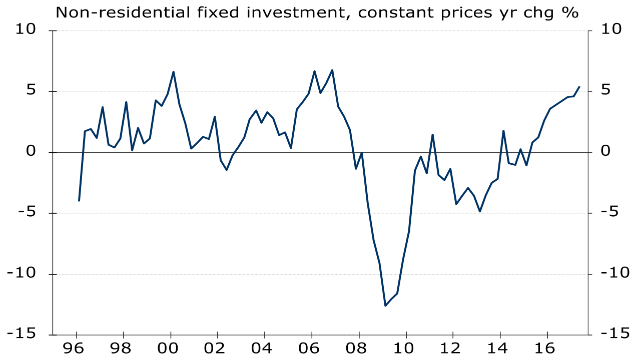
A partial offset to weakness in China could come from Europe where cyclical and structural factors are combining to drive a spectacular and sustainable recovery. Germany has led the charge but better conditions have now spread to all regions including previously challenged areas like Spain and Italy. Business indicators such as the German IFO index are near record highs and this is leading to a rise in business investment. Consumer spending is also rising, particularly in Germany. There is scope for this recovery to be sustained for some time given the underpinnings of structural improvements in the banking sector and government finances.

German retail sales



Source: Thomson Reuters Datastream, Evans & Partners

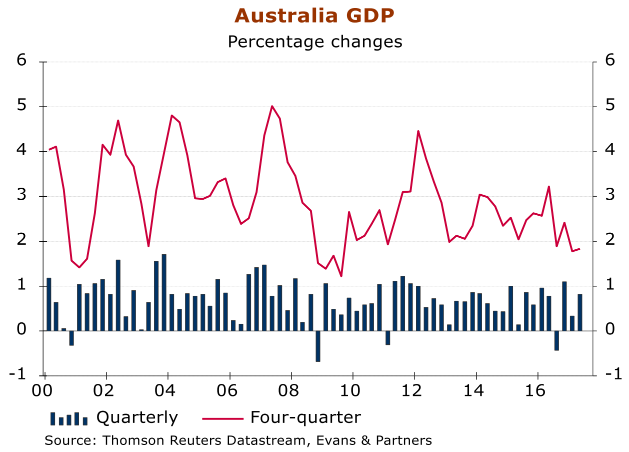
Eurozone Capex

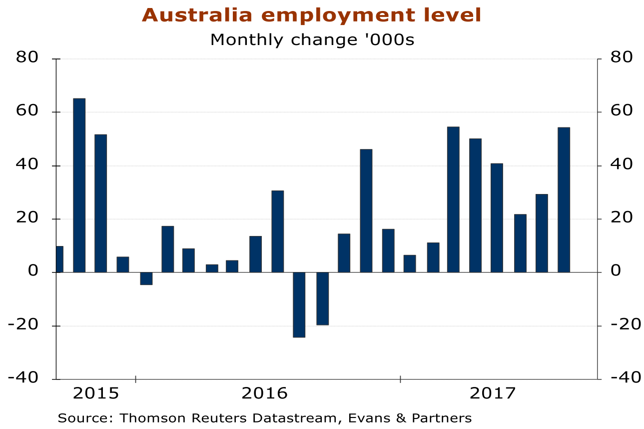


Source: Thomson Reuters Datastream, Evans & Partners

4. Australian economy at a trough

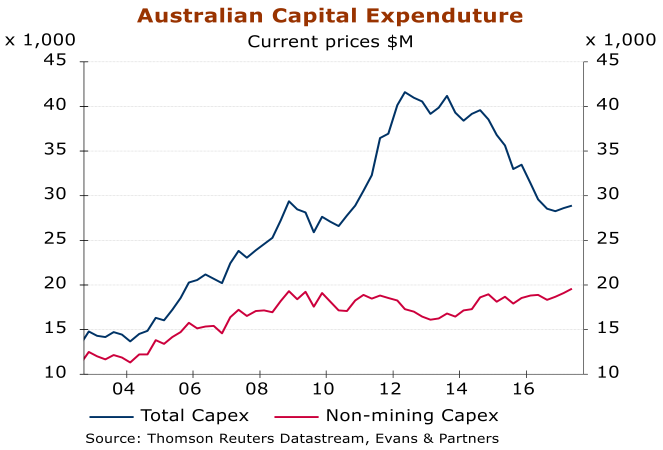
It has been a challenging period for the Australian economy. GDP growth has fallen below 2% and has been weaker than at any time since the financial crisis. Below the surface there has been a lot of moving parts with strong exports and housing not sufficient to offset soft consumption and slumping investment following the completion of a number of massive gas projects.

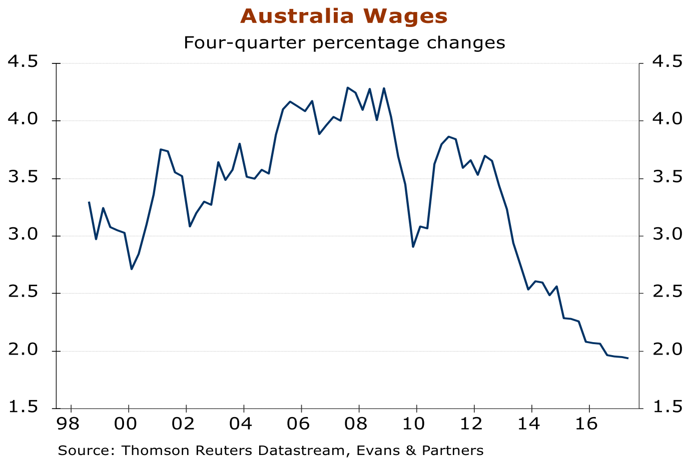




The year ahead is likely to be better but there are still challenges. The good news is that there is significant job creation now occurring in other sectors of the economy particularly tourism, healthcare and the infrastructure sector. This is a reflection of the broader transition in the economy away from mining and towards these service sectors. This is also being reflected in business surveys that are now at record highs, and investment indicators that are rising for the first time in five years.

The big question over the next year is whether this nascent strength is enough to offset the weakness from housing construction and a poor outlook for consumer spending. Consumer pressures will be intense from higher mortgage rates, substantial increases in electricity prices and weak wages growth; even though jobs are being created they are less well paid than those that have been lost.





The net result is likely to be a stronger economy but a better GDP performance does not necessarily mean a much stronger equity market given stretched valuations and earnings challenges facing the two largest listed sectors, banks and resources. We have reduced our 12-month forward target for the ASX 200 to 5,800 (from 5,900).

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