



DR DAVID SOKULSKY  
CHIEF INVESTMENT OFFICER

## *Risk and reward*

# Striking the right balance

What a year 2016 was! The US equity market reached all-time highs, global bond yields reached all-time lows, commodity markets saw a reversal of fortune and, closer to home, the Reserve Bank of Australia (**RBA**) cut interest rates to their lowest level ever. On the political front, we also saw two unthinkable events take place—the UK voted to leave the European Union (**EU**) and Donald Trump became the 45<sup>th</sup> president of the United States.

Since the inception of our business last year, we were overweight international equities via the US, which proved to be profitable for our investors. We were also underweight high grade bonds which was the right decision, as these securities sold off late in the year.

Now, as we start a new year, it's time to consider the right balance between risk and reward. In this month's article, we outline what we see as key drivers and risks for markets. There's little doubt that macro risks have increased, and the potential for a downside move in the price of assets such as equities is higher than it was last year. On the other hand, global economic growth is improving, and the monetary environment is expected to remain accommodative in aggregate, despite higher US interest rates.

### **A recap of where 2016 ended**

Despite a heavy sell-off at the start of the year, and the array of events that followed, equity markets finished the year in positive territory with the S&P 500 index up 11.24% for the calendar year and the S&P/ASX 200 index up 7.50% over the same period. The CBOE Volatility index remained relatively subdued and finished the year at 14.04—close to its post-financial crisis average.

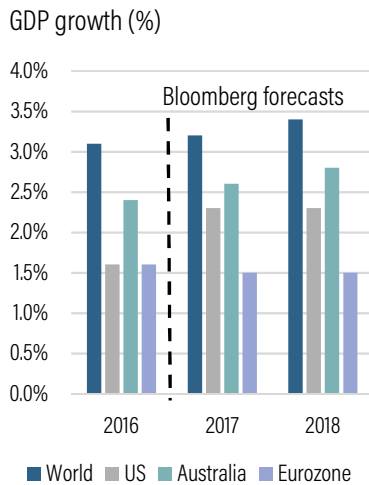
Bond markets experienced extreme intra-year volatility. German bunds finished the year at 0.21%, marginally lower than where they started, and US yields spiked sharply higher following the US presidential election, but surprisingly were only 17 basis points higher for the year, up 2.44%.

The US dollar rallied post the US election to finish higher versus both the Japanese yen and the Euro currency, while the British pound was significantly weaker following the Brexit result. The Australian dollar traded in a tight range around USD0.75 for most of the year.

### **Outlook for the global economy is positive**

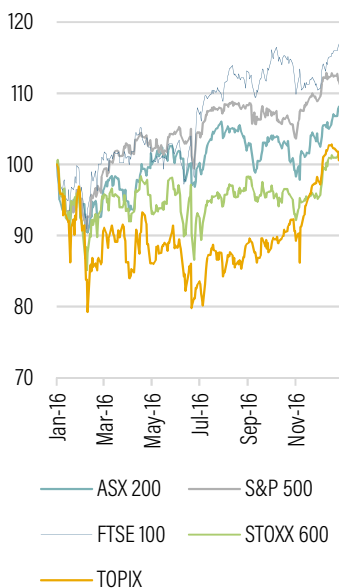
As we start 2017, the outlook for the global economy is relatively positive. The International Monetary Fund is forecasting growth of 3.4%, while UBS Global Research (**UBS**) is slightly more optimistic, expecting global economic growth to come in at 3.6%. The improved growth is expected to come primarily from a recovery in the US, and countries such as Russia, Brazil and Argentina no longer acting as a drag on growth.

## Positive outlook for the global economy



Source: Bloomberg, January 2017

## Global equity markets' performance in 2016



Source: Bloomberg

The domestic economy is expected to grow strongly with the International Monetary Fund forecasting it to expand by 2.8% in real terms. Housing construction is expected to remain a key driver given ongoing low interest rates and the number of approvals in the pipeline. An easing of previous headwinds such as the collapse in capital expenditure is also expected to provide support. The major risks for the domestic economy are the potential for the Australian dollar to move significantly higher if commodity prices continue rallying, and any potential fallout should trade tariffs be placed on China.

## Monetary policy won't be as supportive for markets

Unconventional monetary policy, including ultra-low (or negative) interest rates and quantitative easing (QE), has been the key driver of asset prices since the global financial crisis. While this expansionary environment is expected to continue throughout 2017, it's not expected to be as supportive of markets as it has been in previous years.

- The US Federal reserve (**Fed**) has ended its QE program, and is now in the process on raising interest rates—at least two hikes are expected this year subject to the inflationary impact of Trump's policy mix;
- the European Central Bank is expected to begin tapering its QE program in the latter part of the year with no further rate cuts expected;
- the Bank of England (**BoE**) is the only developed market central bank expected to reduce interest rates this year, and
- in Australia, the RBA is expected to keep rates on hold through 2017. Low inflation will mean the RBA comes under pressure to cut rates—but higher commodity prices, strong economic growth and low unemployment should see the status quo hold.

While the monetary environment is set to remain accommodative, this doesn't mean that market interest rates will remain low. US 10-year treasury yields have increased 120 basis points from their low point in July last year with more than half of this increase happening after the US election. This has had a meaningful impact on market interest rates with the 30-year fixed rate mortgage rate in the US now rising to 4.32% from 3.54%—an increase of 0.8% in just three months. Australia is also feeling the impact with domestic banks forced to pay higher funding costs in the US market.

## What are the key risks to look out for?

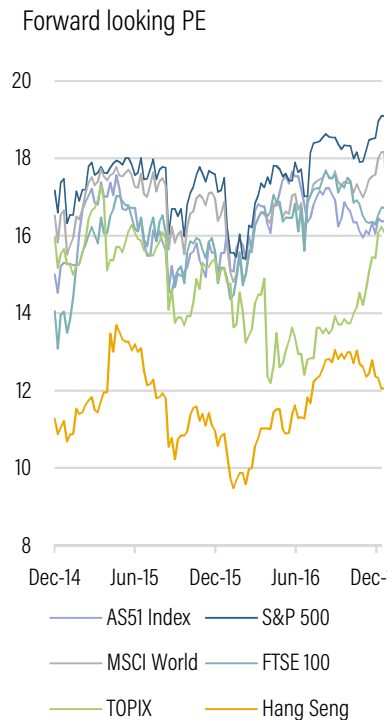
There are several risks to watch out for this year. These include Brexit negotiations, increased political risk in Europe, China's economic stability, and Russia's growing global presence. However, none will be more important than the impact that newly-elected US president Donald Trump will have on the world. Trump's policy mix is thought to be somewhat binary—it will either be great for markets or terrible!

## The greatest risk is the impact Trump will have on the world

Trump has undoubtedly increased macro uncertainty, and the potential downside of his policies needs to be considered. Despite the rally post the election last year, this kind of uncertainty and increased risk is expected to weigh on markets this year—especially if inflation rises markedly, and the Fed is forced to raise rates faster than expected. For investors, however, the biggest issue is likely to be whether he cuts personal and corporate tax rates, and/or whether he imposes tariffs on imports into the US.

Lower taxes should be supportive of the US economy and the corporate sector, but would have negative repercussions in terms of increased fiscal deficits and higher inflation. Tariffs would be inflationary for the US, and reduce global trade, causing a negative impact on numerous countries—most notably China and the countries that supply it, including Australia.

## PE ratios are high compared to historical averages



Source: Bloomberg, January 2017

## Increased political risk in Europe is the other major concern

Not only will European authorities need to manage negotiations with the UK when it's expected to invoke Article 50 in March, but elections are also due to be held in Germany, France, the Netherlands and Norway. The primary concern with the elections is the rise of 'populist' parties which could ultimately lead to a breakup of the EU. National Front Party Leader Marine Le Pen in France and Geert Wilders of the Freedom Party in the Netherlands are currently ahead in their respect polls. One can only imagine the impact on markets should the EU break apart!

## US bond yields could continue to rise

While rates have risen, global markets seem comfortable with where they are at present. The risk, however, is that US yields continue to rise via a combination of Fed rate increases and higher inflationary expectations. In this scenario, fixed income would sell off, and equities would be negatively impacted. This is because much of their current valuations are based on low fixed income yields, and the premise that equities are relatively attractive.

While higher US and global yields seems like the most probable trajectory given Trump's policies, there's no guarantee and many of the major research houses are mixed in their outlook. According to Bloomberg, the weighted average forecast for the US 10-year bond yield at the end of the year is 2.82%. However, expectations range from a low of 1.35% and a high of 3.71%.

## Are you being adequately compensated for risk?

As an investor, one of the most important questions to ask yourself in the current environment is whether you're being adequately compensated for the risk you're taking. The answer ultimately comes down to valuations, and the price you're willing to pay for potential upside.

While the environment remains attractive for risk assets such as equities, much of the good news appears to have been priced which leaves little upside potential. The post-election rally has driven equity markets to a level where they look fully valued relative to expected earnings growth. For example, the US market is trading at a price to earnings (**PE**) ratio of 17.7x next twelve month (**NTM**) while the Australian market is trading at a PE ratio of 16.1x NTM. Both figures are greater than historical averages, and assume optimistic outlooks for earnings growth. While we expect the technology and healthcare sectors to remain strong, the only sector with real potential for an upside surprise is energy.

UBS forecasts the S&P/ASX 200 index to finish the year at 5,700, almost exactly its current level. Likewise, there's less than 1% upside to UBS' target of 2,300 for the S&P 500 index.

This suggests that 2017 may be a year of modest returns unless earnings surprise meaningfully to the upside. It also suggests that investors need to remain focused on portfolio exposures, and ensure that risk is managed by diversifying sufficiently.

### IMPORTANT NOTE

This document has been prepared by Crestone Wealth Management Limited (ABN 50 005 311 937, AFS Licence No. 231127) (Crestone Wealth Management). The information contained in this document is of a general nature and is provided for information purposes only. It is not intended to constitute advice, nor to influence a person in making a decision in relation to any financial product. To the extent that advice is provided in this document, it is general advice only and has been prepared without taking into account your objectives, financial situation or needs (your Personal Circumstances). Before acting on any such general advice, we recommend that you obtain professional advice and consider the appropriateness of the advice having regard to your Personal Circumstances. If the advice relates to the acquisition, or possible acquisition of a financial product, you should obtain and consider a Product Disclosure Statement (PDS) or other disclosure document relating to the financial product before making any decision about whether to acquire it.

Although the information and opinions contained in this document are based on sources we believe to be reliable, to the extent permitted by law, Crestone Wealth Management and its associated entities do not warrant, represent or guarantee, expressly or impliedly, that the information contained in this document is accurate, complete, reliable or current. The information is subject to change without notice and we are under no obligation to update it. Past performance is not a reliable indicator of future performance. If you intend to rely on the information, you should independently verify and assess the accuracy and completeness and obtain professional advice regarding its suitability for your Personal Circumstances.

Crestone Wealth Management, its associated entities, and any of its or their officers, employees and agents (Crestone Group) may receive commissions and distribution fees relating to any financial products referred to in this document. The Crestone Group may also hold, or have held, interests in any such financial products and may at any time make purchases or sales in them as principal or agent. The Crestone Group may have, or may have had in the past, a relationship with the issuers of financial products referred to in this document. To the extent possible, the Crestone Group accepts no liability for any loss or damage relating to any use or reliance on the information in this document.

This document has been authorised for distribution in Australia only. It is intended for the use of Crestone Wealth Management clients and may not be distributed or reproduced without consent.

© Crestone Wealth Management Limited 2017