

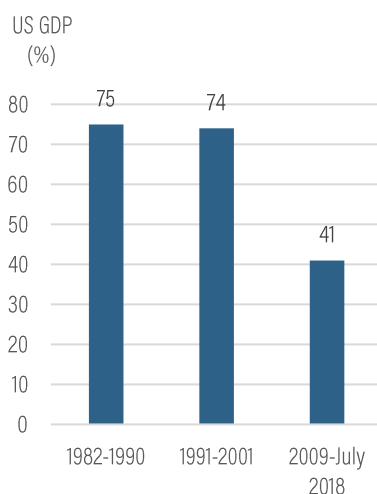


SCOTT HASLEM
CHIEF INVESTMENT OFFICER

“If countries will not make fair deals with us, they will be ‘tariffed!’”

US PRESIDENT DONALD TRUMP
SEPTEMBER 2018

US expansion has lasted 10 years but still has room to grow



Source: Northern Trust, Bloomberg.

Trade war escalation

Time to trim some risk

We are now choosing to trim some risk. This is not inconsistent with our ongoing desire to stay cautiously engaged with markets through the maturing phase of this cycle—we believe this global growth cycle has further to run. It is, however, about recognising shifting circumstances.

This month's US tariff announcement amounts to a higher-than-expected 25% import tax on almost half of everything the US imports from China. This was well above expectations for a rate closer to 10%. President Trump has also given little room for China to negotiate, threatening tariffs on a further USD 267 billion (covering the complete landscape of all China's US-bound exports) if China retaliates—even if this is less than a proportional response.

The trade war has escalated. The path to de-escalation was already narrow, as we noted back in July. It has now turned into the eye of a needle.

Reflecting this, while we still prefer equities over fixed income (given strong global growth and rising global interest rates), we are tactically reducing some of that risk appetite. Indeed, for the first time this cycle, we have moved slightly underweight equities. We retain a significant underweight to fixed income, balanced by overweight tilts to cash and alternative assets. We communicated this move on 19 September after the US tariff announcement.

Changes to our regional equity preferences include closing our overweight US equity position, held since the start of July (post the strong gains in US markets since then). More controversially, we are moving tactically to edge overweight emerging market equities. We recognise this may be premature. We are also tactically positioning our portfolios to better capture any rotation in market sentiment away from expensive growth-orientated investments toward value-orientated assets.

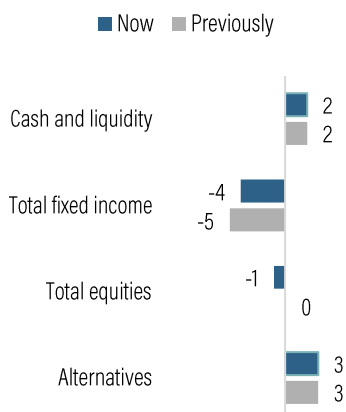
The global growth cycle has further to run

This investment cycle is not in its infancy. No-one's arguing that. What's more contentious is whether the cycle is on its last legs or actually maturing with some way to run, as we believe. Indeed, for those prepared to 'stay engaged' with risk markets, we expect positive returns are likely to persist in the near term—albeit decidedly less buoyant and less easy to find than last year—when virtually every asset class and region put on a stellar performance.

Judging the cycle to be at its end, as some have done (and mistakenly did earlier this year), arguably has to be more complicated than just observing stretched asset valuations or approaching an historical precedent for the length of 'normal' cycles. The depth of the global financial crisis a decade ago, the pace of technological advancement and the current plethora of geo-political tensions suggest this is anything but a normal cycle.

As former US Federal Reserve (Fed) Governor Yellen opined in 2015, "I think it is a myth that expansions die of old age". Cycles typically end because something goes wrong! Most often that comes in the form of restrictive policy, policy error or a financial crisis.

US tariffs could take the edge off growth so we are trimming some risk

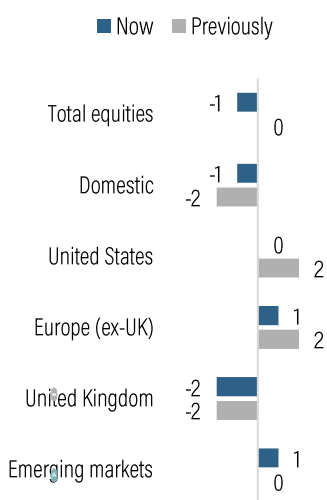


Source: Crestone.

We do not view the US-China trade dispute as a short-term US election-focused tussle...

...but a more long-lived ideological dispute over global dominance” ...

Tilting more towards value in our regional equity preferences



Source: Crestone.

US President Trump's fiscal largesse may well be the policy error that has seeded the next recession, potentially in 2020. But for now, the tell-tale signs that this cycle is imminently confronting a hard roadblock, such as rapid inflation, a financial crisis or a stall in global growth, remain broadly absent.

For sure, wage growth is belatedly rising across the US, Europe and Japan, but remains well below that seen in prior cycles. Inflation has also risen toward, but is yet to move above, central banks' key targets in any major jurisdiction. Moreover, trends in business surveys have recovered from their early-year weakness to signal ongoing above-average global growth ahead.

As Northern Trust, one of the world's largest custodians, recently highlighted, the US cycle has "plenty of room to grow" based on previous expansions, with growth rising 41% over the past decade, compared with around 75% in both the 1980s and 2000s expansions (see chart on previous page).

This should be supported by ongoing relatively low global interest rates. The Fed is only just approaching its estimate of a 'normal' rate, and new Chair Powell at the August central bank talkfest in Jackson Hole noted that "there does not seem to be an elevated risk of overheating." In Europe, interest rates are on course to rise from their negative level to only 'zero' by the end of 2019.

This cycle also has the added challenge of persistent (and unforecastable) trade wars and other geo-political risks that could weigh heavily on risk appetite. The recent US tariff announcement is a case in point.

Trade war escalation—trimming back some risk

So, despite this positive backdrop, we believe an additional degree of caution is warranted after President Trump's announcement of a second round of tariffs on USD 200 billion of imports from China. The two key issues for markets leading up to this announcement were:

1. whether the tariff rate would be at 10% or a materially higher 25%; and
2. whether there would be further escalation with a third round of tariffs that covered everything the US imports from China.

While the tariff rate was set at 10% from 24 September, the US announced an expedited automatic hike to 25% from the start of 2019 (just a few months away). It also signalled that any retaliation by China would see a third round of tariffs (on USD 267 billion) covering everything China exports to the US.

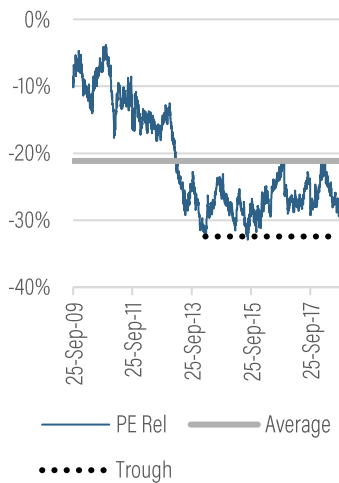
We do not view the US-China trade dispute as a short-term US election-focused tussle, but a more long-lived ideological dispute over global dominance. There is some chance that, post the US mid-term elections, negotiations will limit further escalation and constrain the tariff rate to 10%. But, on balance, we expect the tariff will rise to 25%. As UBS has noted this week, "neither side seems especially eager to take [the de-escalation] path. If that path is eschewed, we see a multi-lane expressway to further escalation and substantive negative economic effects to both countries."

For some time, we have focused on two primary risk developments to our tactical asset allocation positioning. Firstly, an acceleration in global wage and inflation pressures that leads central banks to tighten more rapidly and, over time, bring the cycle to its end. Secondly, developments, which cause the global growth cycle to prematurely falter, such as a trade war escalation.

We continue to view the cycle as maturing not ending and are conscious of prematurely adopting a portfolio stance that is too defensive. However, reflecting recent developments, we are choosing to trim some risk.

- We are moving slightly **underweight equities from neutral** and choosing to add that allocation to **international government bonds** (moving less underweight as US 10-year yields again reach seven-year highs). Recent tariff decisions are likely to take the edge off global growth, increase inflation and potentially weigh on corporate margins in 2019.
- We are taking the opportunity to **close our overweight US equities** position, held since the start of July, reflecting the 9% rise in US markets (in Australian dollars) since we made that decision.

MSCI Emerging Market index P/E relative to MSCI World index



Source: Bloomberg.

When the economic cycle turns, the market's ability to look through many of the geo-political risks that now confront us will undoubtedly be challenged.

- The risk of weaker global growth could also weigh on the market's demand for growth-orientated investments (which are now expensive) compared to value-orientated investments. This could benefit **European equities** (which we are trimming but keeping overweight) and **domestic equities** (which we are moving less underweight post recent weakness).
- We are also moving tactically to **overweight emerging market equities** (discussed further below). Emerging market equities have fallen 20% in US dollar terms. This provides a hedge should trade tensions de-escalate or the Fed pause, stalling the US currency's recent upward trend.

Is value appearing in emerging market equities?

The introduction of tariffs and heightened risk of a trade war have coincided with less synchronous global growth, a rising oil price, a rising US dollar and some tightening of global financial conditions. This has led to a very difficult environment for emerging markets this year.

Of course, not all emerging markets are created equal and the fragility of countries like Turkey and Argentina are in stark contrast to the generally stronger economic fundamentals across the broader emerging market complex, even relative to a few years ago.

First signs of value for investors wishing to gain longer-term exposure

Whilst the near-term outlook is volatile, the near 20% pullback in the MSCI Emerging Market Equity index over the past six months is beginning to show the first signs of value for those investors wishing to gain exposure to the longer-term structural demographic tailwinds of an emerging middle class.

In particular, policymakers in China have shifted decisively into easing mode in recent months. Elsewhere in Asia, the largely internally-focused economy of India should provide some insulation to bifurcated global growth. In Latin America, Mexico has been a stand-out in terms of performance, at both a foreign exchange and equity level. UBS views Korea, Singapore and Indonesia as the most attractive markets in Asia ex Japan, while Hong Kong, Taiwan, Thailand and Philippines are least preferred.

The MSCI Emerging Market Equity index has outperformed the MSCI World Equity index for 10 of the past 15 years, for an average outperformance since the end of 2013 of around 87 basis points (bps) per annum (or a cumulative 27%). Nor do investors need to sacrifice dividend yield in emerging markets, currently 2.6%, a premium to the MSCI world equity index of 30bps.

Furthermore, this higher yield comes with price to earnings (P/E) and price to book multiples that are about 30% cheaper. Although the MSCI Emerging Market Equity index is currently trading on a 2019 P/E multiple in line with its post-GFC average (10.8x), relative to the MSCI World index, it trades at a 30% discount versus its average of around 20%. Since the GFC, this discount has never been wider than 33%, suggesting value is beginning to emerge.

But active management remains key in this area of the market

We prefer active management in emerging markets, where experienced managers can address the inefficiencies that often exist in less researched markets. Such an approach is best able to efficiently access growth opportunities across a broad spectrum of emerging markets while addressing any potential governance issues more easily than a passive approach.

Later cycle investing demands caution, not disengagement

We continue to monitor developments. US-China negotiations post the US mid-term elections are likely to provide additional clarity and an opportunity to reassess tactical positions.

As always, later-cycle investing demands caution. This means not being overweight risk but still engaged with it. Allocations to risk assets should be close to neutral (or normal) not aggressively overweight. They should also be focused on regions and sectors where growth is strong or valuations more compelling. Returns are likely to be more moderate and more volatile than earlier in the cycle and keeping a weather-eye on the macro-economic signals for when the growth cycle is truly shunting meaningfully weaker.

Protecting capital through maturing cycles is also key. Investors should ensure ample liquidity. Seeking out high-quality uncorrelated alternative assets (such as hedge funds) that can protect capital when forecasts prove inaccurate is paramount. When the economic cycle turns, the market's ability to look through many of the geo-political risks that now confront us will undoubtedly be challenged. This should also be the point investors gather comfort from a diversified portfolio and can put to work liquidity into accumulating high-quality assets at relatively attractive prices.

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