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AROUND THE TABLE

AN EXCHANGE OF INVESTMENT IDEAS
CRESTONE INVESTMENT FORUM / OCTOBER 2016



finding a new
way forward
HOW MONETARY POLICY IS SHAPING MARKETS



Around the table

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finding a new way forward

Investors find themselves in uncharted territory. The widespread adoption of quantitative easing (QE) by central banks around the world has radically transformed the investment landscape. Central bank policies are increasingly driving markets, leaving fundamental valuation metrics and traditional investment correlations in their wake.

Investors are left with few options other than to follow the central banks' next moves even as new risks gather on the horizon. When markets are behaving in unprecedented ways, looking to the past provides few answers. It takes knowledge combined with experience to focus on the big picture.

We invited some of the brightest economic and investment minds in the business to discuss and debate these macro-economic issues at our latest Crestone Investment Forum. Their diverse views provide a rare insight into the complex array of market forces currently at play and, at a time of unprecedented change, critical guidance for investors.

Their enlightening views also act as important inputs to the Crestone investment process. We hope you also find some vital insights in these challenging times.

KEY POINTS FROM THE CRESTONE INVESTMENT FORUM

QE is here to stay and has underpinned markets

- QE has become a key tool which central banks will rely on for the foreseeable future. It has inflated asset prices rather than reviving economies as intended, but central banks have few other monetary policy choices left.

New portfolio diversifiers are needed

- The traditional diversification effects of equities and bonds have weakened. Investors need to seek out new sources of returns and ways to manage risk.

Geo-political risks are rising

- The rise of new political parties and heightened geo-political risks raises questions about the ability of future governments to enact fiscal policy.

Pressure points—China and Europe

- China's growing debt problem, as well as heightened European political risk, are creating ongoing uncertainty and heightened risk.

Bond yields can go lower

- Some participants expect bond yields to continue declining over the next year as most developed market central banks continue purchasing sovereign bonds as well as lowering interest rates or keeping them on hold.

CENTRAL BANKS AND QUANTITATIVE EASING

Central banks have rewritten the rule book in the wake of the Global Financial Crisis. The impact of monetary policy, reshaped by QE, has become a key driver of investment markets although this intent was far from the original aim. Participants in the Crestone Investment Forum discussed whether the current policy mix appears to be working, and what does the future hold for QE.

THE STORY SO FAR

Official interest rates were dramatically cut and central banks began buying a range of assets, such as government bonds on bank balance sheets, with newly created money. This was in the hope that it would encourage stronger consumer and business lending.

However, despite the massive stimulus, the impact was far less than expected. Loans, economic growth and inflation floundered wherever QE was used as a key strategy. Instead, asset prices surged as investors flocked to higher-yielding investments in a low interest rate environment.

"If the whole idea was to boost equity markets to try and get companies in a position to invest, then they succeeded in boosting equity markets," Credit Suisse Australian Equity Strategist **Hasan Tevfik** said.

This recent focus on asset prices marks a key change in the goals of central banks as they explore the limits of monetary policy.

IS THE CURRENT POLICY MIX WORKING?

While the mix of historic low interest rates and QE failed to stimulate economies as originally intended, it has propelled investor wealth to new heights.

Unfortunately, the trickle-down impact of this 'wealth effect' has also been less than hoped for although QE remains the only viable policy left for central banks to reinvigorate their economies.

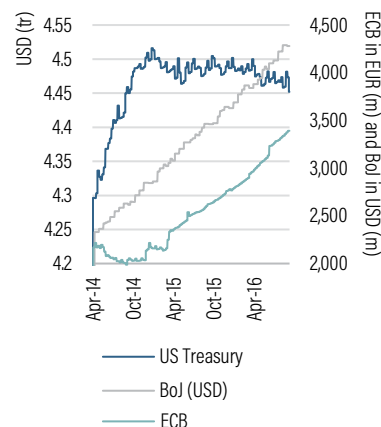
We may have, in fact, already seen the maximum benefit that the policy can deliver according to some panellists at the Crestone Investment Forum.

"We are evolving from a world where central banks have been positioning the market for a 'whatever it takes' position to an 'I've given you everything I've got' position," UBS Chief Economist **Scott Haslem** said.

While QE will continue, there are signs that central banks and governments are slowly changing tack. The US Federal Reserve (**Fed**) is now raising rates while last December the European Central Bank (**ECB**) opted to extend the size of its QE program rather than increase it.

This will have implications for investors given the willingness of central banks to use their capital to support asset markets over long periods of time—a practice which has also artificially dampened market volatility.

Central bank balance sheets have continued to expand



Source: Bloomberg, UBS Global Research



SCOTT HASLEM

CHIEF ECONOMIST
UBS

We are evolving from a world where central banks have been positioning the market for a 'whatever it takes' position.

CENTRAL BANKS AND QUANTITATIVE EASING

"There are periods of relative stability interrupted by a tantrum and I think that's the environment we'll be in for the next few years," according to UBS Asset Management, Head of Investment Strategy **Tracey McNaughton**.

"There isn't an obvious trend in markets at the moment. When you do have a period of stability, it creates crowded trades, making markets very susceptible to a sell-off after which you get central banks or governments stepping in and calming things down. From there a period of stability returns."

WHERE TO NOW?

We believe that QE and the actions of central banks are set to drive markets for the foreseeable future.

Kapstream Capital Portfolio Manager **Steve Goldman** said few governments are willing to expand budget deficits leaving QE as the only choice.

"We're going to see it as far as the eye can see. In my mind, you've got to grin and bear it—even though bond yields are at record lows, they're going to stay at record lows for a very long period of time."

Commonwealth Bank of Australia's Chief Currency Strategist and Head of International Economics, **Richard Grace**, also believes that QE had become an established part of the new world.

"QE is here to stay as a policy tool—it's just how much and when."

While the US economy is improving, the Fed's rate hiking path has been slower than expected in response to some mixed economic data. The US economy underperformed during the second quarter with annualised GDP growth of 1.4 per cent but is expected to strengthen in the second half of the year.

"This tightening cycle from the Fed is going to be the slowest ever, and whilst they probably want to get to a higher interest rate to guard against a future downturn, I don't think they're going to get there," **McNaughton** said.

"It means the prospects of using unconventional monetary policy at the next downturn are almost definitely there."

The Crestone Investment Forum also debated whether the Fed had underestimated the neutral rate (the rate at which real GDP is growing at its trend rate and stable inflation).

"If that's the case, the Fed has been stimulating the economy a lot less than it thought and that has transitioned into the growth numbers we've been seeing," Perpetual Head of Investment Strategy, Multi-Asset **Matt Sherwood** said.

Japan and many countries across Europe will also continue strong QE policies in an attempt to revive their ailing economies.



STEVE GOLDMAN

PORTFOLIO MANAGER
KAPSTREAM CAPITAL

...even though bond yields are at record lows, they're going to stay at record lows for a very long period of time.



RICHARD GRACE

CHIEF CURRENCY STRATEGIST AND HEAD OF
INTERNATIONAL ECONOMICS
COMMONWEALTH BANK OF AUSTRALIA

QE is here to stay as a policy tool—it's just how much and when.

CENTRAL BANKS AND QUANTITATIVE EASING

"I would argue that much of the European banking sector is insolvent—they have no credible regulator," **Goldman** said. "That will be the next problem that happens. They will have a EUR10 trillion balance sheet at some point because ECB President Mario Draghi is going to do 'whatever it takes'."

The actions of the Bank of Japan are harder to predict as they undertake a far more experimental approach to monetary policy in an effort to revive their lacklustre economy.

"People are figuring out that Japan's economy is probably beyond saving. So it's really a question of how you cushion the blow because of an extremely challenging economy and debt levels," **Sherwood** said.

HAVE THE RISKS INCREASED?

The impact of this shifting macro-economic landscape is being further clouded by rising geo-political risks across the globe.

Europe faces new challenges as the United Kingdom (UK) prepares to exit the European Union (EU), and national elections are due to be held in Germany, France, the Netherlands, Hungary and potentially Italy. Minority political parties are increasingly being elected amid discontent surrounding the gap between rich and poor, immigration policies and the impact of globalisation.

Against this backdrop, we asked participants whether they feel the risks to markets have increased.

"I think in the next 10 years we're going to have a war against inequality which will become a huge global thematic," **Sherwood** said. "That's going to become the new norm and make parliaments largely ineffective. It means you can't get fiscal responses."

Meanwhile, China's economy is slowing amid concerns about bad debts in the banking sector and whether the People's Bank of China can continue to prop up growth with its policy initiatives.

Most participants in the Crestone Investment Forum still expect a soft landing but remain wary of the potential risks to Australia given China is its largest trading partner.

"China is the ultimate X factor," **Sherwood** said. "It's the source of growth, but it's also the source of risk, and Australia is going to cop it in the neck if something happens—and it will inevitably."

The threat of terrorism presents another risk while military tensions have risen between Japan and China over the South China Sea.

These changing global currents are creating new risks although there isn't a single point on the horizon which could tip the global economy into a new era.



MATT SHERWOOD

HEAD OF INVESTMENT STRATEGY, MULTI-ASSET
PERPETUAL

China....is the source of growth, but it's also the source of risk.

Elections and political signposts

2016

- 8-Nov: US presidential election

2017

- Apr—Jun (TBD): French presidential and parliamentary elections
- Aug—Oct (TBD): German parliamentary election

2018

- Early 2018: China's National People's Congress
- Feb (TBD): Italian parliamentary election
- Mar (TBD): Russian presidential election

Source: Citi Research

WHAT DOES IT MEAN FOR ASSET MARKETS?

The asset price surge spurred by central banks' QE strategies, and likely ongoing central bank support, has continued to play out across major markets. We discussed whether this trend was likely to continue.

"Markets have been rallying while earnings have been falling five, six, seven consecutive quarters," according to **McNaughton**. "You've had this huge price-earnings multiple expansion because of what the Fed has been doing, so they do have a vested interest."

While the US economy is strengthening, many European countries remain saddled with debt and under pressure, with the full impact of the UK leaving the EU (**Brexit**) yet to be felt across the region. This may encourage European authorities to ease austerity measures to appease members and help lift their economies.

"We suspect that you're still to see the earnings downside coming out of Brexit which will be global—the currency tells you that," according to **Tevfik**.

He suggested that real bond yields may finally be on the rise which will place initial pressure on Australian equities, particularly stocks with high valuations, payout ratios and financial leverage.

"It certainly means an allocation shift in the equities market, and it could actually mean that we're going to be in for a tough time for equities," he said.

The action of central banks is also weakening the long-term diversification benefits of bonds and equities as central bank QE programs continue to drive down bond yields.

"That bond-equity diversification has worked really well because falling yields were associated with a weak economy and falling inflation, which is bad for equities and good for bonds," according to **Sherwood**. He also noted that both asset classes have simultaneously declined in only five of the last 115 years.

"But now, you're not going to get the return or diversification from holding bonds that you have typically got."

Goldman, who helps manage more than \$10 billion in fixed income at Kapstream Capital, agreed that bonds may no longer be a strong diversifier, but said there are still attractive opportunities in the Australian, US and New Zealand markets.

"Bonds aren't the diversifier that they used to be, but in a world where you have a lot of risk on the equity side due to valuations, it's a question of where do you put your money?"

Demand is likely to remain strong for domestic fixed income with the market currently pricing in a further 25 basis point rate cut by the Reserve Bank of Australia. **Goldman** said there is a strong possibility that Australian 10-year bond yields may decline from their current rate of about two per cent to about one per cent over the coming year.

"I look forward six, nine, 12 months from now, and it's hard for me to see why yields are going to be higher than they are today," he said.



TRACEY MCNAUGHTON

HEAD OF INVESTMENT STRATEGY
UBS ASSET MANAGEMENT

Markets have been rallying while earnings have been falling.



HASAN TEVFIK

AUSTRALIAN EQUITY STRATEGIST
CREDIT SUISSE

We suspect that you're still to see the earnings downside coming out of Brexit.

WHAT DOES THIS MEAN FOR ASSET CLASSES?

Some investment managers, such as Magellan's Head of Macro **Sam Churchill**, are also using higher cash weightings as a buffer against any potential market shocks.

"A big part of that is the upside interest rate risk story in the US that we think markets aren't pricing in at the moment," he said.

WHAT CAN INVESTORS DO IN THIS ENVIRONMENT?

While the traditional diversification benefits of bonds and equities have been reduced, we believe that a globally diversified portfolio, which includes a wide range of assets, still offers many benefits.

Alternative assets, such as hedge funds, private equity and infrastructure can potentially play a more important role in this environment due to the low correlation they exhibit to traditional asset classes. A diversified exposure to these assets may help to reduce the volatility of returns within your portfolio and provide some capital protection in an environment where traditional asset classes such as equities, bonds and property are under pressure.

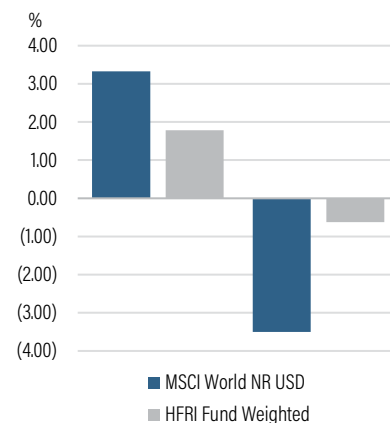


SAM CHURCHILL

HEAD OF MACRO RESEARCH
MAGELLAN FINANCIAL GROUP

...the upside interest rate risk story in the US [is something] we think markets aren't pricing in at the moment.

Average monthly returns of alternatives and equities (during positive and negative months for equities)



Source: Bloomberg, Crestone Wealth Management

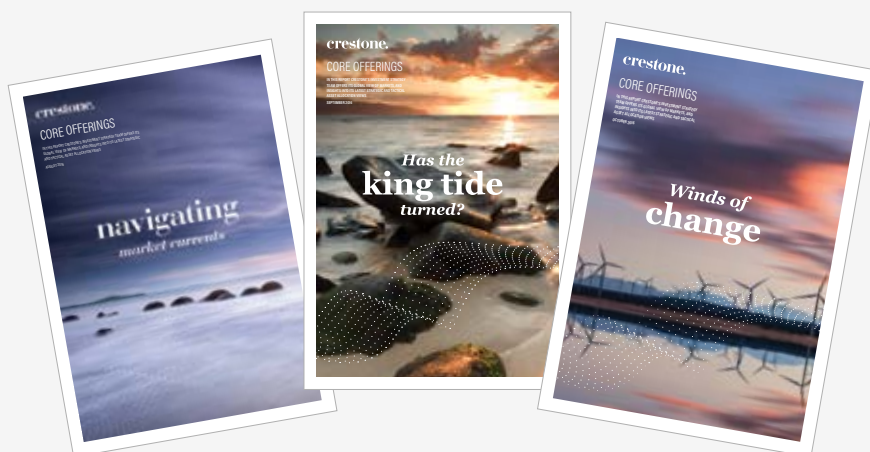
Important notes: Based on USD total returns from 1 January 1990 to 30 June 2016. The use of indices is for illustrative purposes only. Past performance is not indicative of future results.

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