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## Around the table

AN EXCHANGE OF INVESTMENT IDEAS  
CRESTONE INVESTMENT FORUM / AUGUST 2017

# The path to *normalisation*







## Around the table

Jacob Mitchell  
FOUNDER AND PORTFOLIO MANAGER  
**ANTIPODES PARTNERS**

Brett Gillespie  
HEAD OF GLOBAL MACRO  
**ELLERSTON CAPITAL**

Robert Mead  
CO-HEAD OF ASIA PACIFIC  
PORTFOLIO MANAGEMENT  
**PIMCO**

Vimal Gor  
HEAD OF INCOME AND FIXED INTEREST  
**BT INVESTMENT MANAGEMENT**

Dr Phillipp Hofflin  
PORTFOLIO MANAGER, AUSTRALIAN EQUITIES  
**LAZARD ASSET MANAGEMENT**

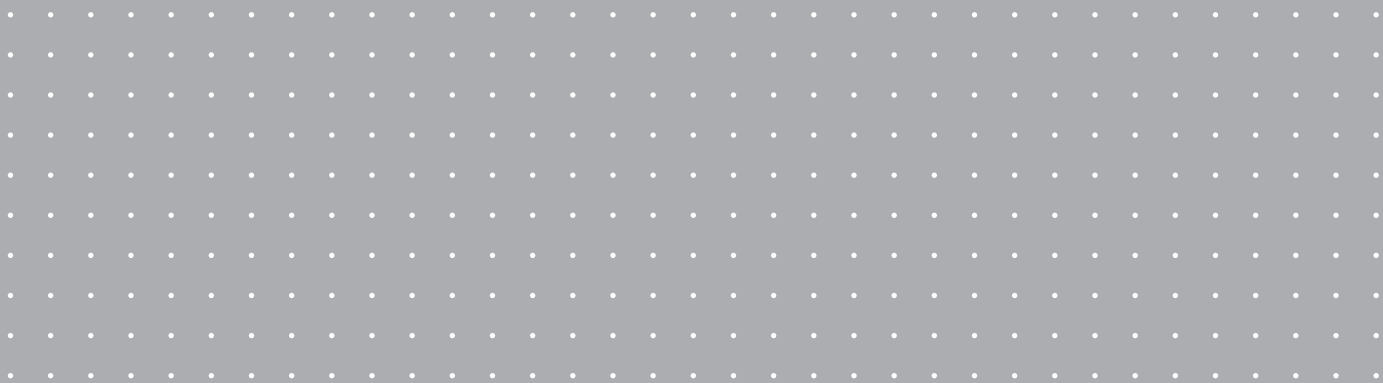
Dr Michael McCorry  
CHIEF INVESTMENT OFFICER AUSTRALIA  
**BLACKROCK**

Stephen Halmarick  
CHIEF ECONOMIST  
**COLONIAL FIRST STATE**  
**GLOBAL ASSET MANAGEMENT**

## CRESTONE WEALTH MANAGEMENT

David Sokulsky  
CHIEF INVESTMENT OFFICER

Ed Blight  
HEAD OF INVESTMENT MANAGEMENT



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# The path to *normalisation*

As we embark on the path from monetary stimulus to policy normalisation, questions remain around the impact this is likely to have on markets.

Latest economic data supports the notion that a supportive environment can continue for the foreseeable future. However, several factors have changed at the margin as central banks look to normalise monetary policy. This could have a major impact on markets going forward.

Although the risk to financial markets has seemingly increased, equity markets appear to be ignoring it, while sovereign fixed income markets are more sanguinely placed.

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 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 gain some vital insights in these challenging times.

## The following themes emerged from the forum

- **The path to 'normal' is cloudy**—The US Federal Reserve (**Fed**), and most other central banks in developed markets, are looking to normalise their monetary policies. However, the path to 'normal' is cloudy, and the messages from the Fed, in particular, have been inconsistent. This has the potential to disrupt markets.
- **Repricing across markets may occur**—The economic environment is supportive of asset markets but, if normalisation leads to meaningfully higher fixed income yields, repricing across markets will be needed. This may take longer than many expect given that inflation is stubbornly low and is showing little sign of increasing significantly.
- **Risks are growing domestically**—Australian economic growth remains acceptable, but risks are growing due to the stronger dollar, housing market vulnerability and a squeezed consumer. In saying that, some may be making too much of the potential downturn in housing and the impact it could have on markets. They may also be downplaying the potential benefit that a recovery in Western Australia could have on overall economic growth.
- **Investors should be looking for other opportunities**—Europe continues to be an attractive investment opportunity. But as traditional asset classes are expected to provide lower returns and higher volatility, investors should also be looking towards other opportunities such as emerging markets and alternatives, like hedge funds and private equity.

# AVOIDING A SHOCK TO MARKETS

The current global landscape has often been referred to as the ‘Goldilocks Scenario’. A combination of sustained growth, low inflation and ultra-low interest rates has provided an environment that is ‘just right’ for investors.

Many global central banks have recently expressed a stronger desire to normalise monetary policy, yet markets appear unfazed by any potential tightening. The panellists discussed what the tightening cycle might look like globally, and what central banks need to do to avoid a shock to markets.

**Brett Gillespie**, Head of Global Macro at Ellerston Capital, said “We are coming into the normalisation phase for central banks globally. The question is—can they undertake normalisation painlessly or will there be catastrophic effects? The key in normalising monetary policy is whether inflation and wages allow it to be achieved in an orderly manner. At the moment, it would appear that inflation is saying ‘yes, you can’. We have had four low inflation prints in the US and that is buying time”.

## ARE CENTRAL BANKS TRYING TO BUY THEMSELVES SOME FLEXIBILITY?

Markets currently appear unfazed by any potential tightening, but the situation could change quickly. The process of normalisation must be handled delicately if central banks want to avoid shocks to asset markets. Communication from many central banks has been confusing in recent times, shifting from hawkish to dovish from one week to the next. Some panellists viewed this as a deliberate attempt by the banks to move away from specific guidance and give themselves more flexibility.

**Robert Mead**, Co-Head of Asia Pacific Portfolio Management at PIMCO, believes that “Central banks want to give themselves more degrees of freedom. They have made that very clear by making big statements and walking back from them. You need to ask yourself—how capable will they actually be of implementing any tightening?”

## COULD THERE BE A CO-ORDINATED APPROACH TO TIGHTENING?

The panellists discussed whether there could be a co-ordinated approach to central bank tightening. This is an important point as the US is now in its third longest period of uninterrupted growth in its history.

**Stephen Halmarick**, Chief Economist at Colonial First State Global Asset Management, noted that “Economic cycles don’t just die of old age, there needs to be a catalyst.”

**Mead** added that “When you get to the point where the European Central Bank (ECB) might want to start tightening, the US will have been in the longest period of growth ever. It’s important to think about what economies and markets will look like at the point where policy can legitimately be tightened, rather than thinking in terms of today’s backdrop.”



**BRETT GILLESPIE**  
HEAD OF GLOBAL MACRO  
ELLERSTON CAPITAL

*“The key in normalising monetary policy is whether inflation and wages allow it to be achieved in an orderly manner”*

# AVOIDING A SHOCK TO MARKETS

## WHAT DOES THIS MEAN FOR MARKETS?

Years of unconventional monetary policy have lowered price divergence across asset classes to historic levels. This has led to several anomalies both across and within asset classes.

With regards to fixed income, **Jacob Mitchell**, Founder and Portfolio Manager at Antipodes Partners, commented that “You don’t need inflation in Europe to make a case that bond yields should be higher. There is not a lot of margin for error in the riskier parts of the bond market—junk bonds, for example. You don’t need a change in inflationary expectations to drive volatility, just a movement in the risk premium applied to that asset class.”

**Mitchell** also observed that “Significant price/earnings dispersion exists across sectors and within sectors. There has been a big shift to passive [investing], and we think investors should be questioning how long they will remain in passive exposures.”

## WHICH ASSET CLASSES ARE MOST AT RISK OF DISRUPTION?

**Vimal Gor**, Head of Income and Fixed Interest at BT Investment Management, supports this view—but rather than trying to determine when the Goldilocks Scenario might end, he is focused on avoiding positions that are most susceptible to imbalances.

“We know we are in a Goldilocks Scenario now. When that scenario ends, which asset classes are at most risk of disruption? High yield looks overleveraged and overvalued. In equities, the FAANGs (Facebook, Amazon, Apple, Netflix, Google) look overvalued. In Europe, the bond market looks overvalued. So, there is an unstable equilibrium where everything looks fine—but the question is—how much further can that go? Trying to call the end to it is difficult, but what we can do is try to identify the assets that will dislocate when it does end.”

## The Crestone view:

*Diversifying your investments and taking an active approach to investing is the optimal way of navigating the current environment.*



**VIMAL GOR**

HEAD OF INCOME AND FIXED INTEREST  
BT INVESTMENT MANAGEMENT

*“Trying to call the end to it is difficult, but what we can do is try to identify the assets that will dislocate when it does end”*

# WHERE HAS THE INFLATION GONE?

Central banks typically have a dual mandate: to maintain a reasonable level of economic growth and to control inflation. Global growth is currently running at a modest pace of 3.6%—however, there is little observable inflation. The panel discussed what has led to such low inflation, whether it is likely to persist, and what this means for the neutral rate.

The panel observed that one of the reasons we have such low inflation is due to the lack of upward pressure on wages. The unemployment rate has come down significantly since the global financial crisis but wages haven't increased. Two main causes were identified—technology and the global labour supply.

**Halmarick** observed, "If you are in Sydney, you could have a competitor in India rather than just a competitor down the street."

## THE IMPACT OF TECHNOLOGY—LOW WAGE PRESSURE IS JUSTIFIED

**Mead** shared his views specifically regarding the impact of technology. "The conundrum between zero wage pressure and low productivity is that the firms investing in technology, artificial intelligence and robotics still haven't shed their labour forces. At some point, they will start to reduce their labour forces, and we will find that low wage pressure is, in fact, justified because people didn't feel as secure about their jobs while the robots were being built next to them."

The other panellists agreed that employees are valuing the security of having a job more than they did in the past, leading to low pressure for pay rises. According to the Reserve Bank of Australia (RBA), labour market turnover, which is the rate at which people change jobs, is the lowest on record.

**Gor** weighed in on the technology discussion believing that the current leaders in the technology space are having a limited impact on growth and productivity. "I struggle to see a secular increase in productivity. For all the fanfare around the FAANGs and new technology, we are yet to see any part of it coming through in the numbers. They really don't compare with the big (industrial) changes we have seen in the past. Cars, electricity, lighting— these were all far more significant. The current crop of tech firms is fun and interesting, but I don't see where the productivity gains come from."

## WHAT THIS MEANS FOR THE NEUTRAL RATE

Low inflation has influenced what central banks regard as their neutral interest rate. This is the rate at which an economy's real GDP is growing in line with its long-term trend. While policy normalisation can push rates higher, low inflation is having the opposite effect. Which one of these factors proves to be the most potent will be a key driver of asset markets in coming years.

**Halmarick** noted that "The Fed has been saying it can get interest rates to 3%. I think the neutral rate is a lot lower. The RBA has said the neutral rate in Australia is 3.5%, which also looks too high. I think 3%—or maybe lower than that. As central banks move to unwind monetary policy, both in terms of rates and adjusting their balance sheets, the question is how high can rates go?"

## The Crestone view:

*On the back of low wage growth, we expect low inflation to persist for some time, but for yields to ultimately increase as policy normalisation takes place.*



**STEPHEN HALMARICK**

CHIEF ECONOMIST  
COLONIAL FIRST STATE GLOBAL ASSET MANAGEMENT

*"If you are in Sydney, you could have a competitor in India rather than just a competitor down the street"*



# AN ECONOMY IN TRANSITION

The economy continues to grow at an acceptable but sub-par rate. Risk, however, is growing as the Australian dollar has strengthened, the housing bull market has extended, and the consumer has come under pressure. Our panellists discussed each of these issues, and what this means for an economy in transition.

## ARE THE RISKS IN HOUSING OVERSTATED?

**Halmarick** feels that the risks in the housing market have been overstated. In trying to answer the question about whether there is a bubble in the housing sector, he feels that not enough people are focusing on 'net' household debt to income. Instead, they are looking at rising gross household debt to income (190% on average), and this distorts their view.

"They have been saying that for 25 years and have been wrong for 25 years, because of the way our mortgage market works with offset accounts and redraw facilities. As interest rates have come down, most people have kept mortgage repayments the same—they are just paying off principal quicker."

"Net household debt to income has been flat at around 100 per cent for the last decade. If rates rise, we could see issues quickly emerge but [RBA Governor] Phillip Lowe knows this. He is not going to put rates up aggressively enough to cause the housing market to blow up."

## SO, WHERE ARE THE RISKS?

The panellists agreed that if there are risks building in the Australian housing market, they are focused in 'pockets', rather than being broad-based.

The issue is whether risks can be contained. Unlike the housing crisis in the US, which was focused on low-income earners, the risks in Australian housing lie with higher-income earners and investors.

**Halmarick** observed "The top 40% of income earners in Australia have household debt to income of 200%. The bottom 40% have 50%. So, the debt is with high-income earners not low-income earners."

**Mitchell** said "Maybe the systemic issue is the composition. 15% of mortgages have an LVR (loan to value ratio) greater than 80%. Antipodes estimates 15% of households have about 45% of the nation's mortgage debt. That is the potential weakness in Australian housing. To the extent that there is an interest rate shock, how much does that 15% affect the rest of the market?"

## IT'S NOT ALL ABOUT THE CASH RATE

There was general agreement that the RBA is very mindful of the impact of rate rises on debt serviceability in the residential housing sector. However, while the RBA controls the cash rate, there are other factors at play.

Mortgage holders are being squeezed in other areas. Healthcare, insurance and utilities costs have all risen—in some cases, very sharply. Wages, however, have remained flat—so disposable income has decreased. Consumers have less money to spend elsewhere, which may explain why the economy ex-housing looks soft.

**Mead** noted, "If you think about the macro-prudential measures we have seen to interest-only loans, the rates on interest-only loans, the rates on investor loans and the move in the Aussie, we have arguably already had at least one hike in the traditional sense, maybe more than one."



**JACOB MITCHELL**

FOUNDER AND PORTFOLIO MANAGER  
ANTIPODES PARTNERS

*"Maybe the systemic issue is the composition. 15% of mortgages have an LVR greater than 80%"*



# AN ECONOMY IN TRANSITION

## DON'T RULE OUT THE POWER OF SPECULATION

**Phillip Hofflin**, Portfolio Manager, Australian Equities at Lazard Asset Management, was of the view that rates don't matter as much as investors' view of future price moves.

"Based on tax records, the \$1.7 trillion of investment property in Australia loses money. There is virtually no cash flow in this enormous asset—investors are speculating on a future capital gain. Therefore, the risk may be that people's confidence in future capital gains evaporates. If investors think the market is going down, interest rates become irrelevant."

## IS A HIGHER CURRENCY A RISK TO THE ECONOMY?

After trading in a range of around USD 0.75 for some time, the Australian dollar, or Aussie, has recently climbed towards USD 0.80—largely due to the interest-rate differential and the strength in commodity prices. The panellists discussed the impact of a higher Aussie on the domestic economy, and what the RBA can do to drive the currency lower.

According to **Gor**, "When the Australian dollar is in a range of 65 to 75 cents, the impact is benign. When you hit 80 and above, it becomes problematic and ultimately squeezes the economy."

Some panellists, however, felt that the drag on the economy from a higher dollar was being replaced by growth in other areas, citing Western Australia as an example.

**Gillespie** said "We have a reasonably upbeat view on the Australian economy. The piece most people miss is that Western Australia has effectively been in recession and is now coming back quite smartly. Western Australia has dragged 1-1.5% off Australian GDP growth in recent times. We are going to see Western Australia come back as we go into next year. We think housing will take 0.5% off growth next year, but this is more than compensated for by the pick-up in Western Australia."

## WHAT CAN THE RESERVE BANK OF AUSTRALIA DO ABOUT THE CURRENCY?

Although it may not be pleased with the recent appreciation in the Aussie, there is little the RBA can do to drive it lower. Any further cuts to the RBA cash rate would add momentum to an inflated housing market. Instead, it must rely on other nations, particularly the US, to raise rates.

**Gor** said "There is nothing the RBA can do about it. They don't want to jawbone it and they don't have the firepower to lean against it, so it goes where it wants to. All the RBA can do is try to deal with the outcome of a higher dollar until external forces, particularly the US, force it lower."

## The Crestone view:

*Australia is an economy in transition. We believe the opportunity set for investors offshore is better than domestically.*



**PHILLIP HOFFLIN**

PORTFOLIO MANAGER, AUSTRALIAN EQUITIES  
LAZARD ASSET MANAGEMENT

*"There is virtually no cash flow in this enormous asset—investors are speculating on a future capital gain"*

# OPPORTUNITIES AND RISKS

Whilst none of the panellists made the case for a high-conviction trade, there were some areas they believed investors should build or maintain exposure to.

## EMERGING MARKETS MAY PRESENT AN OPPORTUNITY

Notwithstanding strong returns over the past year, and resultant higher valuations, there was general agreement that emerging markets still present an opportunity.

**Mead** commented that fundamentals have improved significantly, but valuations have also risen. He suggested investors need to be very selective.

"PIMCO is overweight Mexico, which was the most punished emerging market nation post the election of Donald Trump. Across the rest of emerging markets, there are few countries PIMCO has exposure to, contributing to a broad overweight."

"We are nowhere near as concerned about a taper-tantrum style event like we have seen in the past. The investor base in emerging markets is a lot more 'permanent' than we saw in 2013-14. We expect the Fed to be measured. We are cautious on China leading up to Party Congress later this year, and expect more noise out of China next year."

**Gillespie** said, "In a low-volatility world, you want to have some exposure. We have a risk monitor, and once that flags any sort of concern, we step out of those markets. At the moment, on a scale of minus four to plus four, it is running at plus 3.8, so the world is a very happy place for the time being."

## EUROPEAN EQUITIES LOOK PROMISING

Panellists felt comfortable holding an overweight position in European equities but remained cognisant of the impact of a higher euro.

**Mitchell** said "We are overweight Europe, with an emphasis on sectors and companies that are less impacted by the stronger euro. We are underweight exporters and expensive defensives. We own cyclical domestics, like European banks, that have suffered in a flat yield curve environment."

**Michael McCorry**, Chief Investment Officer, Australia at BlackRock, added that BlackRock recommends an overweight to European equities relative to Australian equities.

## OTHER OPPORTUNITIES WORTH CONSIDERING

**Gor** reiterated his view that we are in an unstable equilibrium. "You need to focus on alpha generation, rather than riding the beta of markets. We are buying volatility for the end of the Goldilocks Scenario. Volatility is low but that will change quickly—so, you need to set your portfolio now."

**Mead** believes Australian investors are generally over-exposed to investments correlated with Australian housing. He has positions in bank capital securities (ex-Australia), where the regulatory environment is supportive and banks very well capitalised. He also likes private credit, given many public credit markets are looking expensive, although this means locking up capital for a period.

## The Crestone view:

*We continue to think that economic fundamentals are supportive of traditional asset markets, but investors should continue building positions in alternatives.*



**ROBERT MEAD**

CO-HEAD OF ASIA PACIFIC PORTFOLIO MANAGEMENT  
PIMCO

*"We are nowhere near as concerned about a taper-tantrum style event like we have seen in the past"*

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# CONTACT US

## **Crestone Wealth Management Limited**

ABN 50 005 311 937  
AFS Licence No. 231127

**E:** [info@crestone.com.au](mailto:info@crestone.com.au)  
**W:** [crestone.com.au](http://crestone.com.au)

### **Brisbane**

Level 11, Waterfront Place  
1 Eagle Street  
Brisbane QLD 4000

**T:** +61 7 3918 3600

### **Melbourne**

Level 18  
120 Collins Street  
Melbourne VIC 3000

**T:** +61 3 9245 6000

### **Sydney**

Level 32, Chifley Tower  
2 Chifley Square  
Sydney NSW 2000

**T:** +61 2 8422 5500