

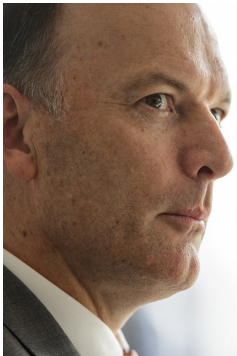
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Around the table

AN EXCHANGE OF INVESTMENT IDEAS
CRESTONE INVESTMENT FORUM / MARCH 2018



Finding value in a
maturing cycle



Around the table

Sunny Bangia

DEPUTY PORTFOLIO MANAGER
ANTIPODES PARTNERS

Vimal Gor

HEAD OF INCOME AND FIXED INTEREST
BT INVESTMENT MANAGEMENT

Brett Gillespie

HEAD OF GLOBAL MACRO
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Matt Sherwood

HEAD OF INVESTMENT STRATEGY
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Tracey McNaughton

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Anthony Kirkham

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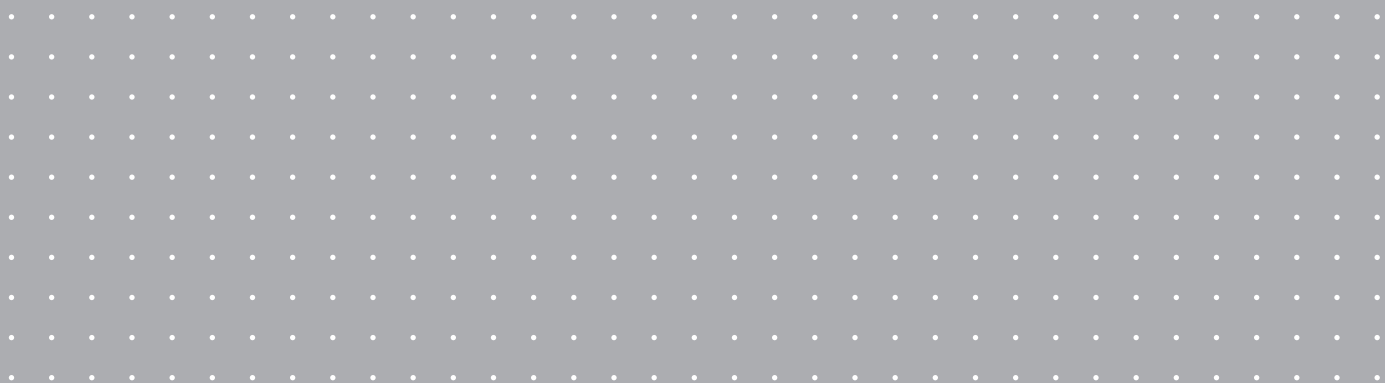
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Finding value in a *maturing cycle*

At our last investment forum in August 2017, one of the key questions asked was “can the global economy continue to accelerate?” The view from our panel was that it could. And while the risks shouldn’t be ignored, there didn’t seem to be any significant threats that were imminent.

Now, volatility has increased in early 2018, and the prospect of a faster-than-expected rise in inflation and bond yields is weighing on markets. Our investment forum panellists, whilst still generally comfortable with markets, are more alert to the building risks.

Four key themes emerged from the forum

- **Equities can continue to deliver solid gains in 2018**—Equities, for now, remain the preferred asset class for 2018. However, gains will likely be more moderate than last year, and will come with higher volatility. Valuation was seen to be a more important driver of performance in the year ahead, and investors must remain alert to the risks of inflation and higher bond yields. The pace at which yields rise was seen key to the extent this could challenge equity returns.
- **Investment-grade credit remains a reasonable place to invest**—When yields rise, credit spreads are typically more susceptible to underperforming. However, given the strong macro conditions and low default rates, investment-grade credit remains a reasonable place to invest. However, caution was needed in relation to non-investment-grade debt, and particularly in those countries and sectors exposed to high levels of leverage.
- **Emerging markets still favoured for their attractive valuations**—Despite a very strong 2017, emerging markets are still favoured for their attractive relative valuations and superior earnings profiles. With global growth being increasingly driven by rising industrial activity, infrastructure and business investment, this is likely to be supportive for earnings momentum.
- **Australia will continue to lag the global cycle**—Australia remains an economy in transition. While jobs growth is strong, housing is slowing and low wage growth has muted consumer spending. Reflecting this, company earnings growth is likely to be less buoyant than in offshore markets, although bond yields are likely to rise less materially than offshore.

INVESTING IN A MATURING CYCLE

As we enter a more mature phase of this cycle, we asked how the panellists are allocating capital and which asset classes are expected to outperform. In particular, we asked if equities can still deliver strong gains in 2018 as inflation, bond yields and central banks 'normalise' higher.

WHERE ARE THE OPPORTUNITIES?

For **Matt Sherwood**, Head of Investment Strategy at Perpetual Investments, the key question is whether the changing macro environment will reveal fragilities in asset valuations. He noted the importance of being "driven by valuations, aware of the cycle and responsive to opportunities".

The hallmarks of a reflationary cycle tend to be rising bond yields, falling equity valuations and strong performance for commodities. **Sherwood** sees greater opportunities in international equities over domestic equities and prefers emerging markets, which are trading at a larger than normal discount to developed markets, and appear to still be early cycle with conservative earnings estimates for 2018. He also advocated for investors to be more focused on risk management than return management, given rising interest rates and trade war risks. He sees 2018 as being late cycle and, as such, asset allocation and portfolio construction are increasingly important to manage risks.

Tracey McNaughton, Head of Investment Strategy at UBS Asset Management, described her view as "cautiously optimistic." UBS sees an extension and a broadening of the current cycle, leading to a recently-initiated overweight position in MSCI equities. This is largely due to tax reform in the US, which **McNaughton** believes is significant for earnings and investment. "Businesses will be replete with cash and looking for opportunities to deploy that cash, via dividends, investment or merger and acquisition activity."

UNPRECEDENTED FISCAL STIMULUS IN THE US

The fiscal stimulus announced in the US is unprecedented, especially when viewed in the context of an economy that is approaching full employment. **Brett Gillespie**, Head of Global Macro at Ellerston Capital, sees growth in the US approaching 3.1% and the unemployment rate potentially falling as low as 3.2% in 2018. "That is an incredibly tight labour market, 1% through NAIRU (non-accelerating inflation rate of unemployment). If you are ever going to see a sharp increase in wages, this is the year it will happen. That said, we have talked about wages popping for a few years, but you would have to put a 30-50% chance on it happening this year. If that occurs, it will be a negative for bonds and also for equities."

Gillespie agreed that the current environment of solid growth with low inflation could continue but stressed the need to watch wages and inflation very closely for the next three to six months. "If wages don't pop, you can have a slow rise in bond yields and equities can deliver a 5-10% return over 12 months, as they did in 2004-2006. But the risks have increased."

Sherwood agreed that the late-cycle risks have been amplified by the US tax cuts, noting that, while earnings growth in the US is still running at a healthy 16.8%, which is extraordinary nine years into a recovery, valuations are the second highest ever on a cyclically-adjusted price/earnings basis. "The only time US valuations have been higher was during the TMT [technology, media, telecommunications] bubble of the early 2000s and, as we saw in 2001, bubbles don't have a tendency to end nicely."



TRACEY MCNAUGHTON
HEAD OF INVESTMENT STRATEGY
UBS ASSET MANAGEMENT

"Businesses will be replete with cash and looking for opportunities to deploy that cash, via dividends, investment or merger and acquisition activity."

INFLATION IS NOW ON OUR DOORSTEP

Scott Haslem, Chief Investment Officer at Crestone, observed that, until recently, the economic conversation was fixated on secular stagnation and disinflationary forces, such as disruption, globalisation, ageing demographics and a lack of wage pressure. All of a sudden, the view seems to have shifted to inflation being on our doorstep. How should one balance these two sides of the inflation debate?

Sherwood noted that we have had 10 years of zero interest rates combined with large fiscal deficits, and the US is the only major developed economy within reach of its 2% inflation target. "I think sub-2% inflation may well be the new normal, and this is just a cyclical upswing within a lower structural environment."

McNaughton added her view that we have moved back from an 'emergency level' of quantitative easing, but not much more. "The case for inflation is overstated, despite low unemployment."

WHAT DOES THIS MEAN FOR BOND AND EQUITY MARKETS?

Anthony Kirkham, Head of Investment Management at Western Asset Management, argued that the bond market is telling us something. "You have seen the US yield curve flatten and 30-year yields coming down since the Fed [US Federal Reserve] started tightening. We are seeing a bring-forward of growth with tax cuts. However, the back end of the yield curve suggests that growth is going to be OK but not spectacular."

"It's nirvana, isn't it?" asked **Vimal Gor**, Head of Income and Fixed Interest at BT Investment Management. "Growth is reasonably strong. Inflation is going to 2% then stopping. That is brilliant for equity markets. But what if inflation pushes bond yields higher?"

On this point, the panellists agreed that the pace of change in bond yields matters more than where they land. **Gillespie** noted that "you can get to 3.5% on [US 10-year] Treasuries by the end of the year and equities won't be too bothered. If you get to 3.5% in 2 months' time they will be very bothered".

The Crestone view: *A sharp rise in bond yields is most likely if wages and inflation are seen to be rising too rapidly. This would be viewed as a clear negative for equities. In the absence of abrupt movements, the case for equities remains sound.*



MATT SHERWOOD

HEAD OF INVESTMENT STRATEGY
PERPETUAL INVESTMENTS

"The only time US valuations have been higher was during the TMT bubble of the early 2000s."

WHICH FACTORS ARE LIKELY TO INFLUENCE CREDIT SPREADS?

At the corporate level, the sentiment for risk remains constructive and default rates are low. However, when yields rise, credit spreads have historically also become more susceptible to widening. We asked the panellists which factors are likely to influence credit spreads going forward.

INVESTMENT-GRADE CREDIT IS A REASONABLE PLACE TO INVEST

As **Kirkham** noted, "if you are talking about equities being OK and fundamentals being OK, then clearly there is support for investment-grade credit. We continue to see these issues well over-subscribed."

Kirkham added, "we are hearing from clients who have been short bonds but now want to have a conversation again. If there is a risk of Treasuries at 3.5% in two months, those clients may want to protect their portfolios."

IT'S ALL ABOUT RELATIVE VALUATIONS

The key to investing in credit at this point in the cycle is to identify and avoid the highly-leveraged sectors. Bonds and equities are looking to each other for a lead. But as **Gor** highlighted, there is a point at which the gap between bond yields closes sufficiently for investors to allocate back to bonds for diversification and a higher running yield. He thinks that investing wisely at this point in the cycle is all about relative valuations, which manifest particularly in credit. "If you look at rising yields with higher wages and volatility, that has to be a negative for credit". **Gor** is indifferent to the valuation of the S&P 500 index and US Treasuries but has a strong view that most scenarios point to higher credit spreads in certain sectors.

WHICH AREAS LOOK VULNERABLE?

Sunny Bangia, Deputy Portfolio Manager at Antipodes Partners, observed that 'leveraged yield' (i.e. companies that rely on debt to fund distributions) has materially underperformed recently. "You are seeing a distinction where companies that have performed well in a low rate environment are no longer performing. At the same time, financials are leading the market higher. That is interesting because they are typically beneficiaries of higher rates." The areas he sees likely to struggle are bond proxies, such as infrastructure stocks and businesses that have sourced funding from high-yield markets.

Gor believes that the market dynamics present risks for credit. "I worry about the consumer. There has been a run down in the savings rate and consumption is not as strong as it should be." He believes volatility will continue to increase and this will feed into certain asset classes. From that point of view, he is worried about credit—not from a valuation perspective but from a volatility perspective.

There was general agreement that non-investment-grade sectors of credit look vulnerable, including US high yield and a range of emerging markets in South America, South Africa and Eastern Europe.

The Crestone view: *While we believe credit spreads can remain tight, meaningful compression from here appears less likely. At this stage of the cycle, we favour the investment-grade market, and we are increasingly cautious about high-yield debt.*



VIMAL GOR

HEAD OF INCOME AND FIXED INTEREST
BT INVESTMENT MANAGEMENT

"If you look at rising yields with higher wages and volatility, that has to be a negative for credit."

HOW ATTRACTIVE ARE EMERGING MARKETS?

Having expressed comfort with investing in equities generally, the discussion turned to emerging markets, which have enjoyed another stellar year of performance.

The panellists discussed whether liquidity risks and uncertainty warrant a more cautious view—or if relatively attractive valuations and a potentially weaker US dollar support a sustained overweight position.

ATTRACTIVE VALUATIONS AND SUPERIOR EARNINGS PROFILE

For **Sherwood**, emerging markets is a favoured position on the basis of lower valuations and higher earnings relative to historical averages. “Emerging markets generally trade at a two times discount to developed markets; the discount is currently 4%. It traditionally has an earnings premium of 2%; that was 3.5% at the start of 2018. So, emerging markets are cheaper, and the earnings profile is superior.”

MUCH HINGES ON CHINA

The panellists favoured Asia for their emerging markets exposure and were of the opinion that much hinges on China. There has long been an expectation of a significant slowdown in China, which hasn't eventuated. Significant reform is being undertaken, with a focus on 'better quality growth' rather than growth at all costs. Recent revisions meant China's growth was seen slowing moderately.

The greatest near-term risk that investors have typically associated with investing in China relate to the financial system. Much of the recent reform and regulation has focused on the banking sector and lending practices.

Bangia noted that “it is hard to know exactly what phase of the regulation and reform process we are in, but it seems to be moving in the right direction”.

Another positive for China is that the consumer is in “fantastic shape”. **Bangia** observed that “there is a USD 23 trillion savings pool within the consumer sector. Debt-to-GDP is very low. Consumers are starting to apply for loans but with low loan-to-value ratios.”

Strong household balance sheets should allow China to navigate deleveraging in the corporate sector whilst consumer spending remains solid. **Bangia** is positive on China, along with other North Asia economies, including South Korea and Taiwan.

WHAT ARE THE RISKS FOR EMERGING MARKETS?

The panellists saw sharply rising US bond yields as the key risk in emerging markets, but that risk was viewed as lower now than it has been in the past.

The Crestone view: Fundamentally, we believe emerging market equities look attractive. However, the valuation discount has been significantly priced away, and if global volatility rises, market liquidity would be a concern.



SUNNY BANGIA

DEPUTY PORTFOLIO MANAGER
ANTIPODES PARTNERS

“It is hard to know exactly what phase of the regulation and reform process we are in, but it seems to be moving in the right direction.”

WHEN WILL RATES RISE IN AUSTRALIA?

For all the talk of rising rates in the US, Australia remains an economy in transition. While jobs growth is strong, housing is slowing and low wage growth has muted consumer spending. Panellists discussed which parts of Australia may pick up ahead.

THE CASE FOR REMAINING ON HOLD

The ability of households to service higher mortgage rates appears limited in an environment of sluggish wage growth and rising household costs. For these reasons, panellists agreed that the Reserve Bank of Australia (RBA) looks set to keep the cash rate on hold for 2018.

"The cash rate drives mortgage rates, and the consumer looks pretty fully invested there," said **Kirkham**. "The RBA can't really move the cash rate until wages move. (Governor) Lowe has made it clear he is sitting on his hands for the rest of the year." **Gor** agreed. "Nothing to see here. Until we get unemployment falling and wages picking up, the RBA is on a wait-and-see brief."

Bangia expressed concerns around clusters of mortgage debt, particularly in high-income areas. He noted that by Antipodes Partners' estimates, 50-60% of mortgage debt is in high loan-to-value ratio (LVR) mortgages. Further, the higher LVR mortgages (80% and higher) and high debt-to-income mortgages (six times and higher), make up around 10% of mortgage stock or \$165 billion. This appears particularly vulnerable to Antipodes Partners.

THE CASE FOR HIKING

Gillespie described his view on Australia as "sanguine" noting he has pushed back his expectations for a rate hike from May or August to August or November. "The market has 17 basis points (bps) of rate hikes priced for 2018, so not hugely different to us. Western Australia continues to recover, and our forecast is for [national] unemployment to hit 5% around the middle of the year. I think that is enough for the RBA to hike, despite wages still being low."

DOES THE RBA NEED TO SEE WAGES PICK UP BEFORE HIKING RATES?

Sherwood believes that "it is important not to look at Australia through a US lens. We were very late to disinflation; we will be late to reflation and inflation. In the meantime, Australia is arguably in the midst of a housing unwind, so Governor Lowe will be looking at below-target inflation and a consumer with high leverage and no real wages growth— despite some apparent tightening in the labour market. Lowe must ask himself, "do I really want to front run all those risks with policy tightening?" The balance of risk says he will wait for wages growth first."

Gillespie reminded the panel that a focus for the RBA, as popularised by former Governor Glenn Stevens, is: "What is the policy of least regret?"

"At a cash rate of 1.5% and an economy approaching NAIRU, the policy of least regret is to start inching your way back to neutral. We have a view that they will do 50 bps per year for the next three years. Macro prudential measures are not a tool the RBA likes. They would rather inch rates higher."

The Crestone view: *While we are neutral equities overall, we see better opportunities in international relative to domestic. We also expect domestic bond yields to rise less than those in the US.*



ANTHONY KIRKHAM
HEAD OF INVESTMENT MANAGEMENT
WESTERN ASSET MANAGEMENT

"The cash rate drives mortgage rates, and the consumer looks pretty fully invested there."

WHERE ARE YOU ALLOCATING YOUR INCREMENTAL DOLLAR?



SUNNY BANGIA

DEPUTY PORTFOLIO MANAGER
ANTIPODES PARTNERS

"It's an environment for stock pickers. We're positive on countries outside the US, such as Europe and emerging markets."



VIMAL GOR

HEAD OF INCOME AND FIXED INTEREST
BT INVESTMENT MANAGEMENT

"We're short US fixed income and believe there are pockets of value around. We're cautious about being too short the US dollar."



BRETT GILLESPIE

HEAD OF GLOBAL MACRO
ELLERSTON CAPITAL

"We believe that if you get US Treasuries right, that will dictate other positions. We're still positive US growth and positioning for higher long-term rates."



MATT SHERWOOD

HEAD OF INVESTMENT STRATEGY
PERPETUAL INVESTMENTS

"We like parts of the equity market. We don't own duration or US growth. For us, the stand-out is emerging markets, where valuations and the point in the cycle are constructive."



TRACEY MCNAUGHTON

HEAD OF INVESTMENT STRATEGY
UBS ASSET MANAGEMENT

"We're long global equities but are keeping a watchful eye. The biggest risk is the Fed and how well it can tighten policy without causing a recession."



ANTHONY KIRKHAM

HEAD OF INVESTMENT MANAGEMENT
WESTERN ASSET MANAGEMENT

"We are somewhat defensive and are allocating into short-dated credit, as we expect this to continue to perform well."

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