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Navigating market currents

The saying goes you can't drive a car by looking in the rear-view mirror, and the volatility we've seen in markets so far this year is evident that this also extends to investing.

2016 has been an eventful year where we've seen a major sell-off in Chinese equities, the US Federal Reserve (**Fed**) flip-flopping on their economic outlook, a surprise decision by the United Kingdom (**UK**) to depart the European Union (**EU**), and volatility in crude oil prices. Throughout all this uncertainty and surprise, the Australian economy actually surprised to the upside with a 3.1% annualised growth rate during Q1 2016.

With this in mind, this article looks at how investors can navigate market currents, and identifies four key themes which we believe will drive financial markets for the remainder of the year. In summary, we expect the UK economy to grind to a halt; US equities to continue to outperform; the Australian dollar to remain under pressure; and domestic fixed income to outperform.

UK economy to grind to a halt

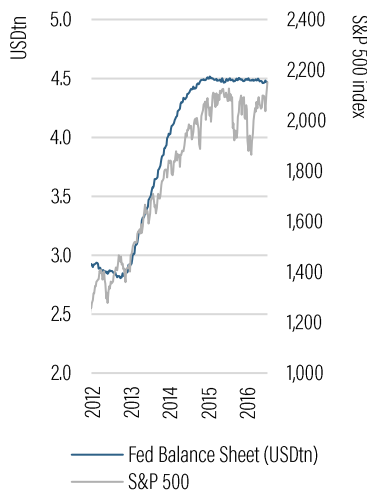
The full impact of 'Brexit' is yet to be felt

Last month's referendum saw the UK vote to exit the EU (**Brexit**). This caused significant volatility in equity, fixed income and currency markets in the days immediately following the vote. However, markets quickly stabilised on the promise of further monetary easing by the Bank of England, and the European Central Bank stood ready to add liquidity if needed.

The full impact of Brexit is yet to be felt, but already consumer confidence has fallen by the most it has in 21 years, the UK's construction Purchasing Managers' Index (**PMI**) has reached post-2009 lows, and the services sector has seen its largest contraction in seven years—the Markit Flash UK Services PMI fell to 47.4 in July 2016 from 52.3 in June. The reason for this sharp deterioration in data is simply that consumers and businesses don't have the confidence to spend and invest money in this uncertain environment. They're waiting for further clarity on how the exit process will work and what the extent of the impact will be. This will clearly slow the overall economy with near-zero economic growth expected in the second half of the year, and a recession being a real possibility. In addition, European authorities will seek to avoid further departures and will make the exit process as uncomfortable as possible in order to deter remaining members from leaving the EU. This is expected to add to the domestic angst as a 'nasty' negotiation process will only see consumer confidence and business spending contract further in the coming months.

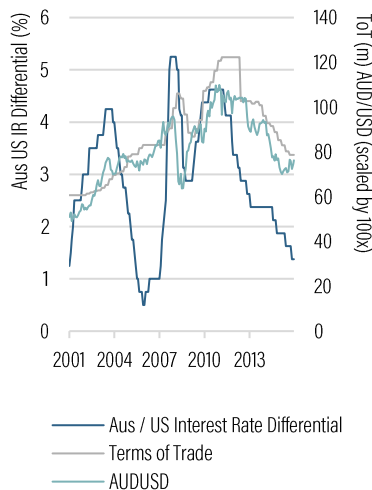
The financial sector is also expected to come under pressure as lower interest rates are likely to shrink bank profit margins and reduce lending in what promises to be a weaker economic environment with a flatter yield curve. Monetary easing and a weaker British pound may help the economy marginally but they're unlikely to make a meaningful impact given the magnitude of the negative factors.

Central bank quantitative easing supports equity markets



Source: Bloomberg

Australian and US terms of trade and interest rate differentials



Source: Bloomberg

Expect a refocus on central bank policies to support markets

This has implications for almost all global markets as it will lead to a refocus on central bank policies such as quantitative easing (QE) and the central banks' ability to support markets. In addition, it will have a major impact on currency markets with significant moves possible for major currencies including the US dollar (risk-off environment), British pound and Japanese yen (additional QE) and the Euro (increased political risk). The currency impact will also impact corporate earnings of companies that operate outside their domestic borders. None of this bodes well for the UK economy or domestically focused UK companies.

US equities to continue their outperformance

How improved economic fundamentals are expected to help

US equities have performed strongly over the last month with the S&P 500 index reaching a new record high on 11 July 2016. The market has since moved higher and this upward trend is expected to continue as improving economic fundamentals lead to improved corporate earnings.

UBS Global Research (UBS) expects US corporate earnings to grow at 3.0% during 2016 and 5.9% in 2017, and this is expected to see the S&P 500 price/earnings (P/E) multiple re-rated higher. The P/E for the S&P 500 index at the end of bull markets has averaged 19.7x over the last 60 years, implying that it could reach 2,350 on 2016 earnings expectations.

In addition to improved corporate fundamentals, the monetary environment is ultra-accommodative and will remain so irrespective of whether the Fed raises rates this year or not. Our base case is for the Fed to increase interest rates in December. However, it is concerned about global volatility and will keep rates on hold if there's any sign of financial market dislocation. With an equity earning yield of just under 6%, the spread over 10-year treasury bond yields is well above its average level of 3.80% since 1960, and should see capital continue to flow into equities.

There's no natural reason for the bull market to end

The S&P 500 index isn't cheap at the moment, but with no recession in sight, improving corporate earnings and shrinking investment options there seems to be no natural reason for the bull market to end. Inflation is the key variable which could counter this scenario as it would force the Fed to hike rates faster than expected. This would likely see the US dollar strengthen significantly. Under these circumstances, fears would increase that the Fed has lost control and is 'behind the curve' with its monetary policy. A large sell-off in the bond and equity markets could follow. This should mean that equities remain attractive relative to bonds for at least the remainder of the year, and possibly longer, as the economy recovers, interest rates remain low and earnings recover.

The Australian dollar to weaken

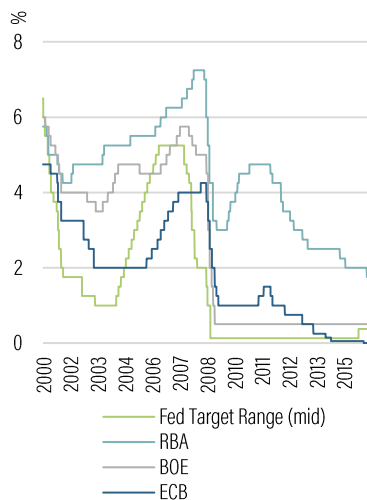
Australia has experienced a major decline in inflation

The Australian dollar has rallied off its lows from earlier in the year but is expected to reverse direction and head back towards USD0.70 over the next six months. Australia has experienced a major decline in inflation over recent quarters with the underlying Consumer Price Index now well below the Reserve Bank of Australia's (RBA) target band of 2–3%. This has already led the RBA to cut interest rates once this year to 1.75%, and it's expected to cut rates again given that the downward trend in prices appears well established. The potential for the RBA to ease further is the opposite of what the Fed is expected to do later this year. This creates a divergence in monetary policy expectations, which should send the Australian dollar lower.

Commodity prices expected to weaken

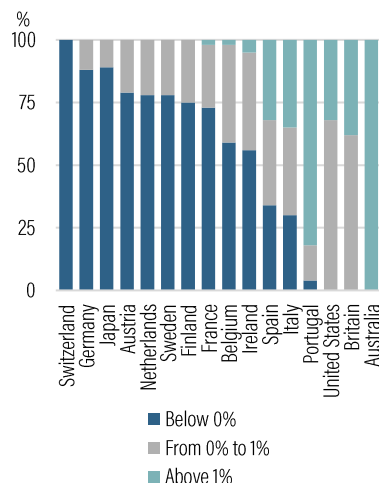
Additionally, commodity prices are expected to weaken in the second half of the year impacting Australia's terms of trade which has historically had a negative impact on the Australian dollar. Although the Fed is expected to remain dovish, the US dollar is expected to strengthen given that the Fed will

Central bank target rates



Source: Bloomberg

Developed world bond yields are increasingly negative



Source: UBS Global Research, Bloomberg

eventually raise rates and the markets will price it in well before the hike actually takes place. This is expected to weigh on commodity prices given the inverse relationship between the two. This is because commodities are priced in US dollars. China's economic growth rate is expected to slow in coming months as the effects of the massive stimulus package in Q1 2016 and credit injection fades. Seasonal factors as the country heads into winter should also negatively impact commodity demand and, hence, prices.

The balance of risk remains to the downside

The risk is primarily centred on the monetary policy stance of the major global central banks, and the magnitude by which they expand monetary efforts. Further QE could see capital flow into Australia due to lower global rates and a wider yield spread, as well as increased global currency risk. The balance of risk appears to remain to the downside for the Australian dollar.

Domestic fixed income to outperform

The RBA has scope to reduce rates further

The RBA is one of the few major central banks with the capacity to cut interest rates this year. This should benefit domestic fixed income relative to offshore markets. With the official cash rate at 1.75%, the RBA also has scope to reduce rates by a greater magnitude than other central banks, thus providing greater potential upside for bonds. Australian 10-year government bonds have already rallied strongly over the last three months, and are currently yielding approximately 1.91%. However, there is further downside for yields with UBS expecting Australian 10-year yields to finish the year at 1.75%.

With over USD11 trillion of global sovereign debt yielding zero or less, we believe there is still scope for capital to grow (yields to fall) in Australia, and for fixed income investors to receive a higher fixed rate coupon.

Additional monetary stimulus by the Bank of Japan should be beneficial

Domestic fixed income should also benefit from the Bank of Japan adding an estimated JPY20 trillion (approximately USD94 billion) of additional monetary stimulus in either August or September 2016. Japanese investors and pension funds are major buyers of domestic fixed income given the higher interest rates on offer relative to Japanese rates. The addition of further liquidity could see an additional flow of capital into the sector, thereby benefitting prices.

The corporate space has the greatest return potential

While there is upside in domestic high grade securities, the corporate space has the greatest return potential with fixed rate bonds expected to benefit the most from lower official interest rates. Strong economic growth and near record low levels of bad debt mean they are attractively priced relative to the underlying risk. The European Central Bank's EUR80 billion per month bond purchase program will also help drive down credit spreads.

The expected return on the investment grade fixed rate corporate sector is around 3.50%—however, with the RBA still easing, we expect to see continued capital gains which will contribute to overall absolute returns.

What does this mean for portfolios?

We have positioned our portfolios to reflect these four key trends and our belief the global economic and financial market outlook for the next six months is more favourable than the general consensus view.

We have an overweight exposure to international equities relative to fixed income, and have increased our overweight to US equities and reduced our overweight to European high yield debt. The increase in our tactical overweight to US equities is based on an improving economic outlook, an expected pick-up in earnings, and the Fed remaining on hold for longer than previously thought. The reduced overweight to European high yield debt is reflective of the recent outperformance, and yields no longer being attractive now they are close to historic lows. We remain neutral on domestic equities—select companies may benefit from lower interest rates and a lower currency. We expect the yield trade to remain popular, especially if the RBA cuts rates.

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