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CIO MONTHLY / AUGUST 2019

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CHIEF INVESTMENT OFFICER

"There are two kinds of forecasters: those who don't know, and those who don't know they don't know."

JK GALBRAITH
ECONOMIST 1908-2006

How expensive are *equity markets?*

Are we on the cusp of a global recession? If so, equity markets are indeed expensively priced, and the risk of a significant and sustained drawdown exists. Or will renewed central bank easing globally turn out to be insurance cuts that extend the growth cycle for another couple of years? This would be an environment where global risk assets should deliver moderate returns ahead, certainly exceeding current very low interest rates and bond yields.

After Q1's solid bounce in economic data, global growth for Q2 took a turn for the worse—most notably in the UK, Europe and China. With global business investment intentions fading and stark weakness in trade and manufacturing, fingers have pointed squarely at the unexpected early-May re-escalation in the US-China trade dispute. Together with an inflation 'about-face' lower, central banks in Europe, the US and Australia (among others) have flagged (or delivered) renewed easing. As Jay Powell, Chair of the US Federal Reserve (Fed) noted, "uncertainties around the outlook have increased" and the Fed would "act as appropriate" to sustain the longest expansion in US history.

Yet, history reveals that when the Fed is cutting rates, visibility can be limited on whether they are insurance cuts that ultimately extend the growth cycle (think 1995 and 1998) or if they're precursors to a recession (think 1990, 2000 and 2007). We argue that the fundamentals for global growth remain intact, with tight labour markets, supportive policy and low inflation. Central bank cuts in non-recessionary periods have tended to aid activity and lift equity prices, and there's good reason to expect this will be the case again. In this month's update, we ask just how expensive equity markets have become.

How expensive are equity markets?

While in an absolute sense, equities have ventured to the expensive side of fair, they are not at historic extremes. Moreover, on a relative basis, very low interest rates argue forcefully that equities are 'cheap'. Still, macro matters. If we are right that global growth will stabilise into 2020, then a rise in bond yields will likely challenge the absolute attractiveness of equities, requiring a return of earnings growth for equities to sustain their upward trajectory. Later in this article, we examine the key indicators we need to see in coming months to gather confidence this is unfolding. Improving conditions in Australia have led us to become less negative, while the election of Boris Johnson as UK's prime minister (which raises the risk of a no-deal Brexit), sees us return to an underweight position in UK equities.

Equity markets have rebounded strongly from their Q4 2018 lows

To date, 2019 has been hot and cold from both a growth and geo-political perspective. Overall though, global and domestic growth has slowed, and geo-political tensions have escalated. Moreover, bond yields here and overseas have fallen sharply as markets fret about the growth outlook and the risk of a near-term recession. Despite this, equity markets have rebounded strongly from their Q4 2018 lows, rising by 17% in H1 2019. For the 2018-19 financial year, gains have been solid, with a total return of 6.2% for global equities (11.9% in Australian dollars) and 11.5% for domestic equities.

Valuations have drifted to the 'expensive' side of fair…

In an **absolute** sense—and reflecting both the market's rise and slower global growth weighing on earnings—most equity markets have drifted to the expensive side of fair on forward price to earnings (P/E), as shown in the following table. Arguably though, no market is more than 0.5 P/E points above its recent five-year average, while the US and emerging markets are both well *below* the valuation peaks reached in very early 2018.

Comparing equity market valuations

	P/E 12-MTH FORWARD	5-YR AVERAGE	SINCE 2000	MAX Q1 2018	MAX 2000-01
World ex-Australia	15.8	15.8	15.4	17.6	26.4
US	17.0	16.7	15.8	18.8	24.8
Europe	13.7	13.3	12.5	13.8	26.1
Emerging markets	12.2	11.7	11.4	13.4	24.7
Japan	12.5	13.6	17.6	15.2	46.9
Australia	15.7	15.4	14.3	16.3	17.5
UK	12.4	14.1	11.8	14.6	24.9

Source: UBS, Crestone, as at 22 July 2019.

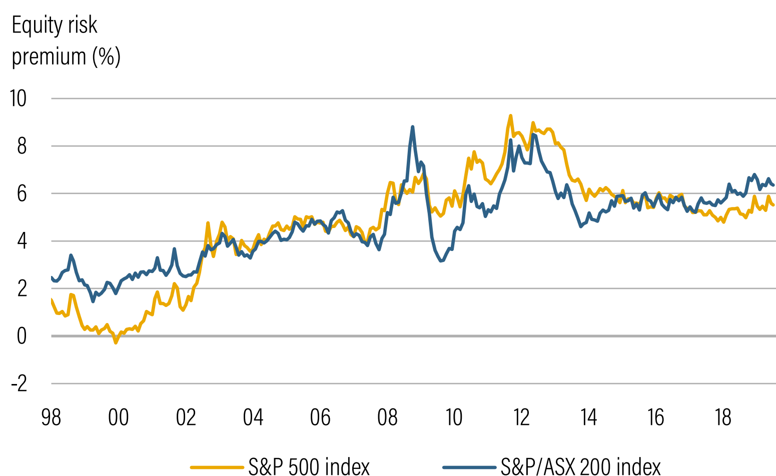
Negative interest rates are back in a big way, with the universe of negative-yielding bonds now over $13 trillion.

JIM MCDONALD,
CHIEF STRATEGIST
NORTHERN TRUST, JULY 2019

…but still appear 'cheap' compared to bond yields

In a **relative** sense, compared with extremely low bond yields, equities appear 'cheap' as shown in the chart below. Since the end of September 2018, US 10-year bond yields have fallen from 3.05% to 2.01%—while in Australia, they have fallen from 2.67% to 1.19%. Reflecting this, the 'equity risk premium'—the expected return pick-up of equities over bonds—has moved to its highest level in some time, and well above levels over recent years.

This supports our stance to prefer equities over bonds



Source: UBS.

This relative valuation supports our overall portfolio stance to prefer equities over bonds. Moreover, if global growth stabilises in coming months and into 2020, bond markets could suffer capital loss if central banks do not cut rates as much as the markets are pricing and bond yields retrace moderately higher. With markets looking for the Fed to cut 100 basis points (bps), and further cuts expected by the European Central Bank (ECB), long duration has become one of the most crowded global trades (as reported in the June Bank of America Merrill Lynch Fund Manager Survey). Of course, rising bond yields will also challenge the valuation support for equities over time, increasing the onus on renewed earnings momentum.

Relative valuations support our overall portfolio stance to prefer equities over bonds.

Macro matters…watching for stabilisation

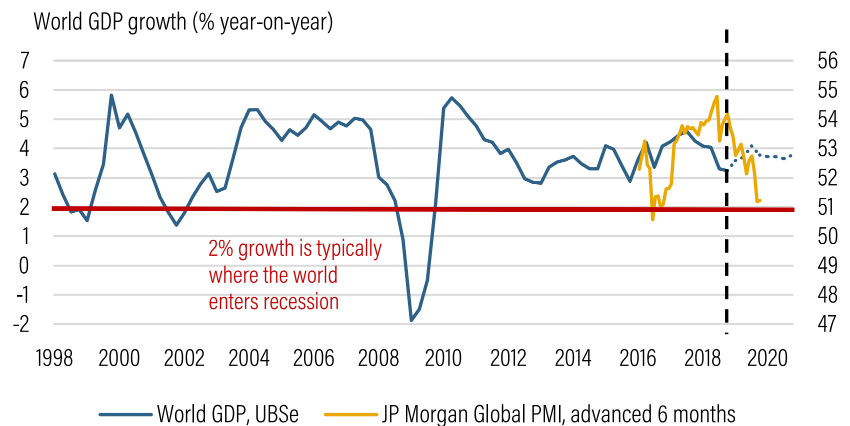
This is precisely why the 'macro matters'. If we are right that global growth will stabilise into 2020, then a rise in bond yields will likely 'chip away' at the absolute attractiveness of equities, requiring a return of earnings growth for equities to sustain their upward trajectory.

Globally, business condition surveys have fallen sharply, flagging a significant pull-back in global growth in H2 2019.

More recently, angst surrounding equity market valuations and the risk of a significant correction have also been heightened by the recent renewed re-escalation of geo-political tensions (between the US and both China and Iran). Recent Q2 economic data reveal that this has weighed heavily on global trade and manufacturing sectors.

Globally, business condition surveys, such as purchasing manager indices (PMIs), have fallen sharply in May and June, flagging a significant pull-back in global growth in H2 2019 (see chart below). Elsewhere, China and European export data have weakened through Q2, while US housing and jobs data have turned more mixed. In Australia, lending data have yet to reveal any pick-up post the May election or June easing of regulatory credit restraints—while consumer sentiment has continued to weaken over recent months.

A fall in PMIs is flagging a pull-back in global growth



Source: UBS, Factset.

Central banks are responding to increased uncertainty over the growth outlook and low inflation outcomes…

…bond yields have rallied, leading to periodic inversions of yield curves and a return to negative interest rates.

With central banks responding to increased uncertainty over the growth outlook and low inflation outcomes, bond yields have rallied, leading to periodic inversions of yield curves and a return to negative interest rates, particularly in Europe. These are important signals to keep an eye on. However, the vagaries surrounding such signals' accuracy and timing given central banks' dally into unconventional policy argue against over-reliance.

Leading indicators will need to lift in coming months

Markets can only move so high on valuation expansion. Improved macro conditions and a stabilisation in earnings (which is currently modest) would likely be needed to support any further expansion. While the services sector in most economies remains robust, history shows us that if there is sustained weakness in manufacturing and trade, this will drag broader activity lower. There are already early indications that global business investment plans are being scaled back, if only due to elevated levels of uncertainty. The bottom line is that leading indicators will need to lift over coming months to confirm a global recession has not already been set in play.

Although positive fundamentals for the outlook remain intact (as listed on the following page), we will be watching a range of global indicators ahead to gather confidence that the outlook is improving, and earnings can rise to support valuations. Geo-political tensions will also need to remain at bay.

- **Manufacturing PMIs** need to recover to signal second-order impacts of the Q2 trade war escalation (which are now simmering) are not continuing to damage activity.
- **China's stimulus** needs to be seen to be supporting infrastructure and property activity in China, while also underpinning a positive uplift in European and emerging market PMIs.
- **US housing** needs to show signs it is responding to lower mortgage rates with positive uptrends in new home sales and housing starts.

For Australia, in the wake of the Coalition government's return, together with announced tax cut policies, recent Reserve Bank of Australia (RBA) interest rate reductions and the reversal of some credit restrictions, the key indicators that need to signal a stabilisation in growth include:

- A renewed **fall in unemployment**, which signals that the nascent uplift in wages growth can continue to strengthen over the coming year.
- A **stabilisation in housing lending,** with currently negative growth giving way to a flattening out.
- A **rise in retail sales** from its near-zero monthly average to indicate some of the tax cuts are being spent in the broader economy.

The following fundamentals are supportive of the economy

- Ongoing low inflation is providing ample scope for central banks to engage in another round of easing in H2 2019, supporting consumer and housing sectors globally. In addition, fiscal policy is not restrictive.
- Global labour markets continue to tighten, with falling unemployment and a gradual rise in wage growth underpinning better consumer income. Here, productivity is absorbing cost pressures, limiting inflation.
- China is continuing to increase policy stimulus to support growth, which should underpin activity in emerging markets and Europe.
- President Trump has an incentive to ensure US growth and markets are healthy as he approaches re-election in H2 2020.

Where to play in equity markets?

The composition of the US market suggests pockets may prove relatively defensive.

Our view on the US—One may think that the spectre of a US recession would discourage investors from US equities. Yet the composition of the US market, where a net cash technology sector commands a 22% weight, suggests that pockets of the market may prove relatively defensive in a global context. The US market's bias toward growth stocks also supports a relatively positive stance towards US equities, as growth stocks tend to outperform as expectations for earnings growth fall (or turn outright negative). However, it is also worth noting that corporate leverage is close to its previous peak on a net debt to EBITDA ex-technology basis.

To be more positive on Europe, growth and trade need to stabilise.

Our view on Europe—For us to be more positive on Europe we would need to see some stabilisation of economic growth and better export conditions. To the extent that this leads to higher bond yields, it would be especially positive for the European banking sector. European banks are the most correlated to Bund yields and, with valuations relative to global banks at their lowest levels since the GFC, there is clearly scope for stronger performance should economic data stabilise, and yields rise from their current very low levels.

Emerging markets would be a key beneficiary of rising global growth.

Our view on emerging markets—The crosscurrents of global growth and geo-political tensions create a wide range of scenarios for emerging market equities. Once again, the trade-off between growth and bond yields is key. Emerging market equities have historically performed better in periods of above-average growth than below-average bond yields. Over the past 20 years, the average monthly return of emerging market equities during periods of above-average growth has been 1.2% versus 0.7% for periods of below-average bond yields. Emerging markets would likely be the key beneficiary of rising global growth or some resolution to the US-China trade dispute.

Australia's upcoming earnings season may be too soon to know if conditions have lifted.

Our view on Australia—This month we have closed our underweight. It is tempting to put the market's recent strong performance down to positive sentiment and short covering. But Australia is one of the few regions to have seen positive one and three-month earnings per share (EPS) revisions. The upcoming reporting season will be important, although it may be too soon to know if cash rate and tax cuts have fed through to better consumer spending and confidence conditions. In all likelihood, clarity on this will not be seen until annual general meetings take place in October and November. Any lift in underlying conditions that leads to a re-assessment of future RBA rate cuts suggests bond-proxy equity sectors could be vulnerable in the period ahead.

Taking a measure of risk should be rewarded

While there are always investment concerns on the horizon, we believe taking a measure of risk will be rewarded over the coming year. While returns later in the cycle are likely to be more modest and volatile, we believe risk assets will outperform cash returns over the coming year. Defensive positioning is encouraged via an overweight allocation to (defensive) alternative assets that can deliver resilient cash flows—such as alternative real property, real estate, infrastructure and debt.

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