Quarterly Investment Strategy Q3 2019.

Answering the big questions

CommonwealthPrivate

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About the author

David Berthon-Jones is the investment strategist at Commonwealth Private. He is responsible for the investment strategies of Commonwealth Private and the formulation of House Views across all asset classes. David is also responsible for the management of diversified investment portfolios.

The Investments and Research Team

The Investments and Research team specialises in investments, strategy and portfolio recommendations to support Commonwealth Private's Private Wealth Managers. The team researches investment markets and produces a range of publications to help clients deepen their understanding of investing. The team also constructs multi-asset portfolios to help our clients manage and grow their wealth.

All portfolio changes and product recommendations are overseen by the Commonwealth Private Investment Committee.

Summary

Since our last note in early July, quite a few US economic indicators are looking past their peak. Given the US is a monetary "superpower" and wields a disproportionate impact across all asset classes – from bonds to shares to property – we spend a considerable amount of time analysing US data for market implications.

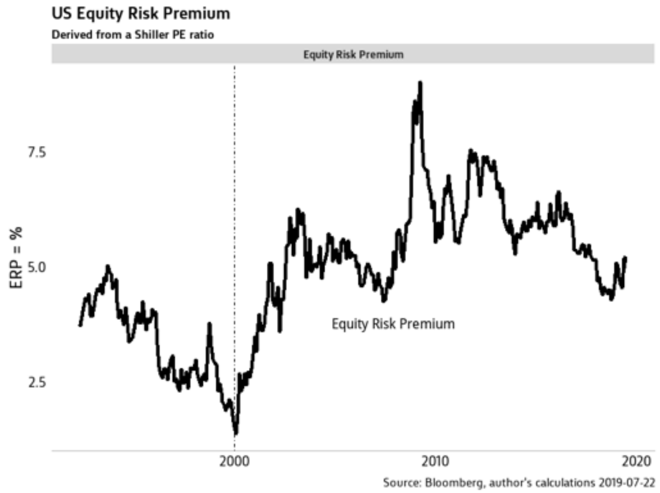
Measures including housing, and surveys of business health – like Purchasing Manager Indexes – have all slowed. Why?

We don't have to look too far for the answers:

1. Escalation of trade wars (a largely "self-inflicted" issue) between the US and China
2. Tighter monetary policy (again, self-inflicted, due the cumulative impact of rate hikes from 2015)
3. Slowing global growth (related to both points 1 & 2, in addition to the more general story of weak Eurozone demand and a slowing China narrative)
4. Fading stimulus (the Australian Tax Cuts and Jobs Act of 2017)

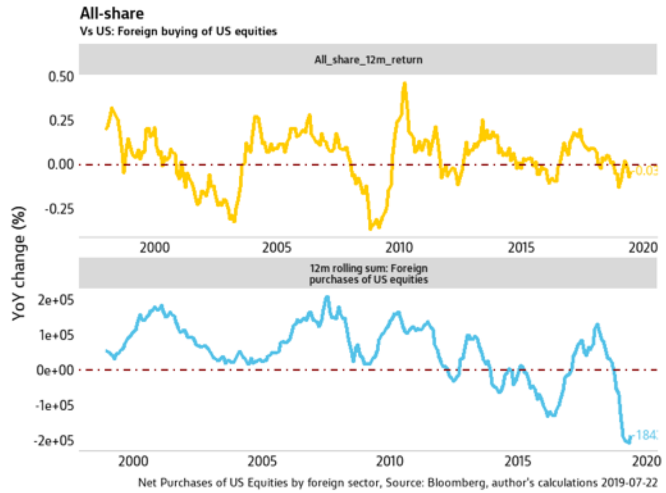
But what to do as a result of this slowing? Change our asset allocation mix? Reduce our US equity exposures?

For the moment, probably not. While the macro data might have moderated, specifically the valuation data, the US equity risk premium (see below chart) does not look unduly low, suggesting we're not getting a poor deal compared to bonds. In fact it's still quite high.



Expectations of growth do not look unduly high either, with the [survey of professional forecasters] conducted by the Federal Bank of Philadelphia, predicting growth at a relatively sustainable 2%. This reduces the likelihood that stock markets are supported by exuberant growth expectations.

Likewise, the percentage of money flows in to the US from other regions is not especially strong. When investors go abroad, they typically do so when feeling particularly positive, and this positivity *is in fact negatively correlated* to market returns over the subsequent 12 months.



Overcoming the "home-bias" (the propensity to only invest where you are familiar) tends to occur at precisely the wrong time.

Lastly, the ability of the Federal Reserve to provide a put under the market (as Chairman Powell has shown a great willingness to do) and the ability of the White House to engineer a solution to trade wars, also helps to underpin the US markets.

We are overweight (owning more than we otherwise ordinarily might throughout an economic cycle) in international equities across our Diversified Investment Portfolios, and broadly equal weight in the US, which are ~55% of international benchmarks.

Commonwealth Private House View – August 2019

	Asset class	Sub sector	House View	Over the cycle (strategic asset allocation)	Current (dynamic asset allocation)
▼	Australian equities	Large cap	Very under	22.5%	15.3%
		Small cap	Neutral	2.5%	1.7%
▲	International equities	FX hedging level	20%		
		Developed markets	Very over	16%	25.4%
		Emerging markets	Very under	4%	1.1%
▼	Property	Global REITs (hedged)	Neutral	1.9%	1.0%
		Australian REITs	Under	1.9%	1.0%
		Australian direct property	Under	3.8%	2.0%
▲	Fixed income	Australian government bonds	Very over	5.5%	14.1%
		Global government bonds	Neutral	5.5%	4.6%
		Investment grade credit	Very under	9.0%	3.2%
		High yield and EM debt	Under	2.5%	1.1%
		Other (RMBS, ABS, CDO)		0.0%	2.1%
▲	Alternatives	Real alternatives	Neutral	7.5%	4.4%
		Absolute return growth	Neutral	5.0%	6.1%
		Absolute return defensive	Neutral	2.5%	7.0%
=	Cash	Cash	Neutral	10.0%	10.0%
▼	Growth - Tilt	Growth assets	Very under	65.0%	58%
▲	Defensive Tilt	Defensive assets	Very over	35.0%	42%

Things you should know:
Above, we illustrate our views by asset class. We outline our 'House View' on each asset class, and whether we recommend adding or reducing exposure to an asset class. These weightings relate to our Balanced asset allocation profile and are made with a medium term (one-to-three year) investment horizon. The percentage terms are indicative only and may vary depending on your objectives, financial situation and needs. This information is based on information available at the time of publishing, information which we believe is correct and any opinions, conclusions or forecasts are reasonably held or made as at the time of its compilation, but no warranty is made as to its accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Private nor any of its related entities accept liability to any person for loss or damage arising from the use of the information herein. This document has been prepared without taking into account your objectives, financial situation or needs, so before acting on the information herein, you should consider its appropriateness, having regard to your objectives, financial situation and needs and, if necessary, seek professional advice.

Summary of Asset Allocation Themes

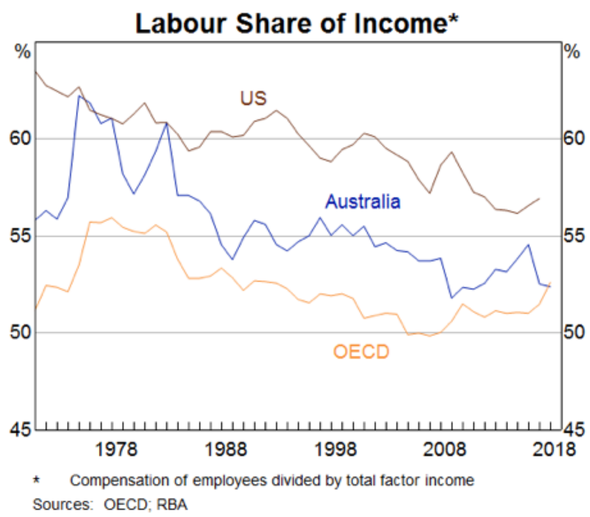
Asset class	Themes	Strategies
Australian equities	‣ Negative 'spill overs' from the housing market into the broader economy (known as the wealth affect, given the marginal propensity to consume out of housing wealth) to drive economic and market underperformance	‣ Underweight in cyclical sectors such as banks, retail, resources, and construction ‣ Overweight in domestic defensives across healthcare, utilities, telecommunications, and technology
International equities	‣ Valuations are accommodative, however global macroeconomic data is very mixed ‣ Tightened global liquidity is impacting both growth and risk premiums	‣ Modest preference for German/Japanese equities, but mainly spread across international markets without a major tilt ‣ Underweight in Emerging Market equities
Currency	‣ Remain short on the AUD given narrowing interest rate differentials, anticipated weaker commodity prices (which affect the terms of trade) and generally weaker economic data	‣ Low hedging of 20% will benefit portfolios as the AUD weakens again over time
Fixed income sovereigns	‣ Australian government bond yields will follow both expected inflation and lower growth ‣ US short rates likely to continue upwards from here. Expect term spread to remain suppressed	‣ Currently short duration in the face of rising rates, but expect to move to a long-duration position if rates move up aggressively ‣ Similarly, we're likely to deploy cash (moving further overweight in fixed income) in the event of higher rates
Fixed income credit	‣ Spreads are much more reasonable post the December market correction, however, we still prefer Government bonds for now	‣ Prefer investment-grade credit to high yield ‣ Prefer Australian government bonds to investment grade credit
Cash	‣ Term deposit returns are low after inflation and tax ‣ We're maintaining around 10% cash (in our Balanced Portfolio)	‣ Reduce cash positions given modest real returns
Alternatives	‣ Alternatives will provide another source of growth and diversification for portfolios outside of equities, which is valuable in this lower-return environment	‣ Continue building an allocation to alternatives which should improve risk-adjusted portfolio returns
Property	‣ Property valuations appear stretched, with cap rates at elevated levels in office, industrial and retail ‣ Given increasing supply and tighter credit conditions, expect property to deliver more modest returns than previously	‣ Prime or premium-grade properties ‣ Target high occupancy, with anchor tenants ‣ Maintain minimal exposure to developers and constructors

Australian Equities

At a client event, we were asked about the impact of the recent minimum wage hike here in Australia. Our client was particularly interested in whether such a rise would essentially render us uncompetitive, given we now have the highest minimum wages in the world (adjusting for a few things, like purchasing power parity).

It's absolutely true some businesses will struggle. Margin businesses, unable to either absorb or pass on higher costs, will find the hike difficult, and thus the focus has been on the starting (or anchor) point for wages.

But in aggregate, our labour share of income is no higher than the OECD average, shown below.



That's what matters economy wide. For a very long time, the gap between Australia and the rest of the world was quite large, and thus we *probably did have a valid complaint* about the rate of growth in wages relative to productivity. But this gap has closed over the past 10 years, to a level that's now relatively unremarkable.

This is really important. For many, their views on Australian labour costs are borne out of, quite reasonably, the past 30-odd years' worth of data. But that story has gradually, grudgingly changed. Ten years' of relatively flat wages growth will do that.

More generally, our Real Effective Exchange Rate (REER) is not unusually high, and has trended down in-line with the fall in the nominal FX rate (which at time of writing hovers around ~.70c).

The REER is a term that attempts to compare currencies not based on just the market conversion rate, but adjusts for how far your purchasing power goes in a given market.

For example, Ireland and Germany both share the Euro, but inflation in Ireland was much higher than Germany in the years leading into the Euro Sovereign Debt Crisis. This led to a much higher REER, thus indicating a material loss of competitiveness.

Our REER, when calculated against our trading partners, does not show any material loss of competeviness.

The last point is a somewhat subtle one. Higher wages support higher incomes, which support higher expenditures. This is trivially true in the accounting sense, but the broader implication is still valid. In the circular flow of our economy, wages growth, particularly if it is at the lower end, leads to rounds of spending, driving the economy in aggregate.

This is due to a high-marginal propensity to consume out of income, and is higher in the lower-income deciles, and lower in the higher deciles. To an extent, this is precisely why Stage 1 of the local tax cuts are likely to be effective in stimulating the economy.

In summary:

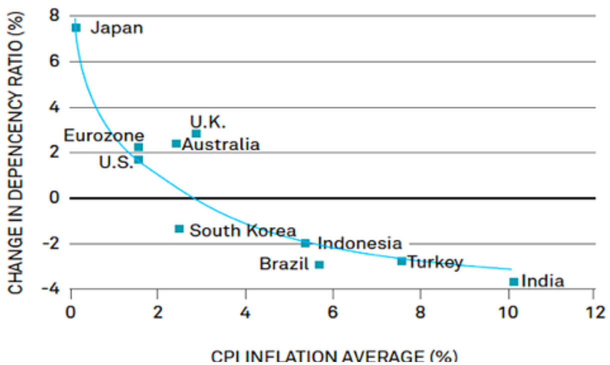
- High wages = high incomes = high expenditures
- Our labour share of income now equals the OECD average. However, this wasn't true for around 30 years
- Real Effective Exchange Rates (AUD REERs) do not indicate material loss of competitiveness, relative to trading partners.

International Equities

At another client event, we were asked why inflation is so low, not just domestically, but almost everywhere you look globally.

Given inflation can erode the purchasing power of an asset base, and given rates tend to go up if inflation goes up, most clients still view a sudden resurgence of either interest rates or inflation with due concern. This proved a topical point of conversation.

Firstly, a graph:



Source: Bloomberg, author's calculations, 2019-04-30

You can see inflation and the old-age dependency ratio are quite correlated. So what gives rise to this correlation?

A few things:

1) Relative to the 1980s, Central banks now explicitly target inflation, via interest rates, and that target is 2% for most developed economies. So inflation fell, steadily, from double-digit to low single-digit numbers.

But that's not the main reason, and is really only making the point about developed countries.

2% is about the right inflation target, for developed countries that have aged or advanced population pyramids.

2) Mostly, inflation is about butting into resource constraints. You're growing fast, you have a young labour force, lots of capital, but it's not enough, and you keep running into resource constraints. Ergo inflation.

When your population is not growing fast, when you have more non-working people relative to working people, you aren't running into resource constraints. Typically, you have much more capital per working person, and proportionately lower growth. Ergo, low inflation.

So it's all about the resource constraint. That's what gives rise to the graph.

The interest rate is set by a number of things. One of those is the marginal product of capital. If capital is abundant (because people keep retiring but the capital doesn't) than the amount of capital per unit of output will rise. This equates to diminishing marginal returns to capital.

The marginal product of capital is the interest rate. And thus it falls.

Perhaps an even easier explanation: in order to prepare for living longer, the pool of savings needs to increase. And, as desired savings rise relative to desired investment, the interest rate falls.

Thus we have, with advanced age economies, a relationship of lower growth, lower inflation, and lower interest rates.

So, we can be confident of lower rates! And this, in turn, means we can be (relatively, not always) more comfortable with higher asset price valuations, due simply to lower discount rates.

Fixed Income

Again at a recent client event, we were asked about business investment, with a particular focus on the relationship between business investments and RBA monetary policy settings.

More specifically, one client stated another 25 basis points off the RBA cash rate was going to do little for his capex plans.

Now you might immediately think "well, this is just one example. There'll be plenty at the margin that will respond".

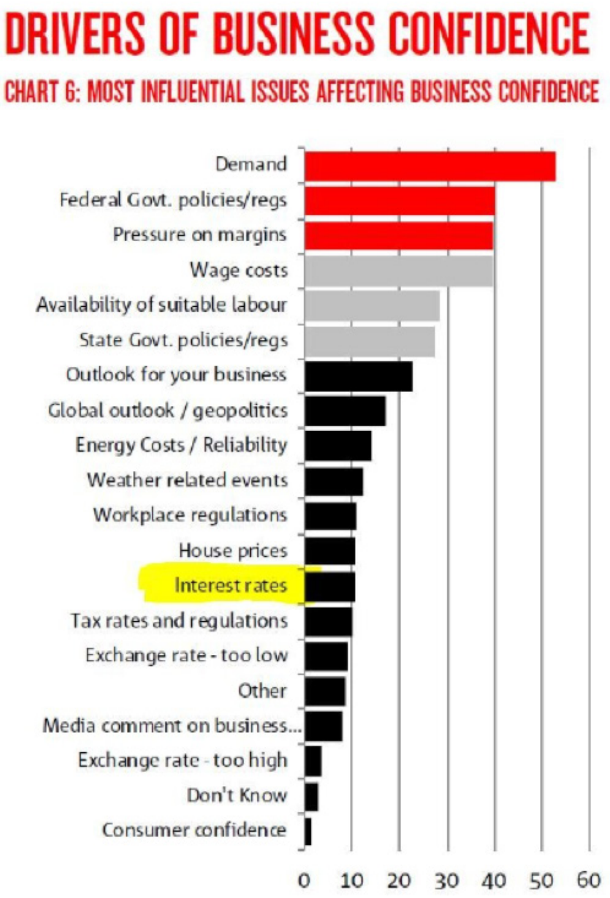
And you'd be right. There will be. *However*, there's quite a few less willing respondents than you may have imagined.

Results of the NAB survey at right shows corporate borrowing costs aren't problematic.

Overwhelmingly, what determines business investment, is expected future revenues and profit. If they don't anticipate much demand, they don't build another factory.

For that reason, you can see demand (in red) at the very top of the key drivers of business confidence, and interest rates much further down the list.

Given that weak demand picture, it's also not surprising to see federal government policies (sitting second on the list) proving topical, with many looking to fiscal policy to shore up what looks like a wobbly economy.



Source: NAB Monthly Business Survey: 2019-06-30.

More broadly, one of the interesting things about monetary policy, is it basically works through housing and through the FX rate.

The implication here is if housing is less likely to respond than usual, given changes to the supply of credit, and ongoing issues around affordability and weak wages growth, then we are looking towards the Aussie dollar to do some of the heavy lifting.

And in turn, that is looking challenging. The US has shifted the direction of monetary policy quite dramatically over the past quarter, and is now signalling rate cuts. This would ordinarily put pressure on the USD and cause the AUD to lift. Other central banks, most notably the European Central Bank and Japan, continue to favour very accommodative policies.

Thus, it isn't clear the AUD has an automatic pathway to a lower value. To be clear, we have a negative view on the AUD, and do expect it to be weaker. However, we expect that weakness to come from weakness in the domestic economy that causes the AUD to weaken – not from pressure on the USD.

For clarity, we don't think the dollar will fall *before the fact*, to assist the economy (like an autonomic stabiliser). Rather, we think it will fall *after the fact*, as the result of a weak economy. The former would help an economy *avoid* a downturn. The latter will help an economy *out*.

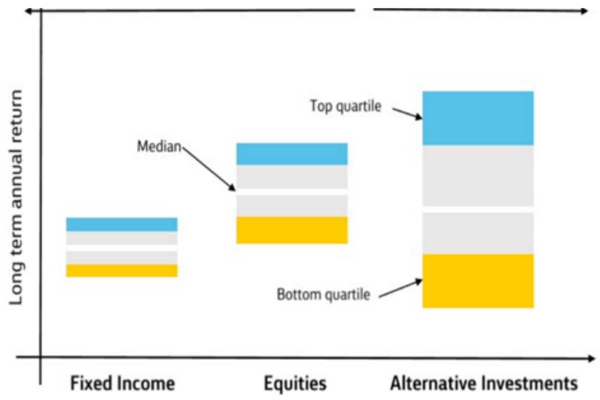
Alternatives

Another client question. How do we define Alternatives, and how do we engage Alternatives managers? Alternatives are anything that isn't a plain vanilla equity or bond portfolio. It's the realm of hedge funds, currencies, and commodities trading.

It includes less unusual sounding things like infrastructure, including unlisted infrastructure, which hold investments across power, water, roads, rail and the like.

Picking an Alternatives manager is quite challenging. To pick on an industry I've spent my entire life in, equities portfolio management, you'll note there are many, many managers out there, with similar products, doing similar things.

This is often borne out in the dispersion of returns, in which some managers do well, some do poorly, but the top quartile and the bottom quartile are not usually miles away from the median.



Source: Grosvenor Alternatives, author's calculations, 2019-06-30

It's even tighter in the fixed income space. Here, the return cluster is more tightly grouped, and to be fair, this is often what we are after.

Fixed income is meant to be much less volatile, much less risky, and that's reflected in more ways than one.

Alternatives are a very different kettle of fish. The difference between a good manager, and a poor one can be enormous, and the distribution of returns much larger.

Because of this, in Alternatives, we look to partner with dedicated specialists in the space. That is, managers who aren't engaged across multiple asset classes, but rather dedicated Alts experts.

We also want to find managers that have been doing this for a long time. Well-known institutions with good track records, but arguably more importantly, good reputations. Their reputations need to be sound with clients and investors, obviously, but also with counterparties and auditors.

An interesting example of late has been a collapsed investment management structure in the US, where a high-profile fund turned out not to have been a fund at all. While I'll avoid the specifics, there are a few general lessons worthwhile mentioning, like the lack of counterparties.

Big funds do trades with lots of different firms. They know each other. The have a sense of their flows, orders, intent. They know the people on the other dealing desk. They know the back-office staff, and the intermediaries. The account managers.

No-one had been (regularly) on the other end of a trade with this firm, which is unusual given the size of the assets under management. The number of employees in the firm was also unusually small, relative to the size of the assets managed.

The size of support staff is often quite a good indicator. In Alternatives, the need for a large team of lawyers, financiers, and strategy professionals in addition to the usual fund accounting specialists, can often lead to a ratio where the back-office functions outnumber the amount of investment professionals actually allocating the money.

More so than usual, in Alternatives, the need to weed out the left tail risks, the under-performers, and those who don't have the appropriate investment and operational due diligence, is paramount.

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