Personal Wealth

Summer 2016 A Quarterly Newsletter for **Lifespan Clients**

Season's Greetings

We wish to express to you our sincere appreciation for your confidence and loyalty. We are deeply thankful and extend to you our best wishes for a happy and healthy holiday season.

What's inside...

- The People Have Spoken
- Investment Markets

The People Have Spoken

What it could mean for investment markets

This last year has seen a populist, anti-establishment political trend emerge through the Brexit vote in June and now the election of Donald Trump as the most powerful person in the world.

We also saw this trend continue when the Italian people voted No on Sunday 4 December, in a referendum to change the Italian Constitution of the 3rd largest economy in the Eurozone to effectively give the government more power to make changes and pass laws.

The "No" vote is the third big anti-establishment revolt this year and could cause much instability throughout the Eurozone. Firstly the Italian Prime Minister Matteo Renzi has resigned. Secondly, the "No" campaign was backed by parties that support Italy leaving the euro zone, and with Mr Renzi dethroned, it is quite conceivable for one of those parties to come to power.

Regardless of how you feel about Trump, Brexit and now a possible Italexit from the EU, the emergence of this trend undoubtedly tells us that the average punter has lost

faith in the traditional political system and who can blame them!

In most developed countries, a tiny portion of the population controls the vast majority of the wealth and income distribution.

Interestingly, the poor or middle class people who have arguably benefited most over the last 50 years of global economic growth are those from developing countries who have moved out of poverty to the "middle class" largely as a result of capitalism and globalisation.

It can be said that the general feeling in the developed world is that big business hasn't shared enough of the fruits of this with the middle class. Indeed people everywhere are acutely aware that wealth and income inequality have been increasing dramatically since the end of World War 2 but at an even greater rate in the last 25 years.

This can be seen across the US and much of Europe where the minimum and average wage has not moved much in real terms in the last 25 years, however company profits have soared (especially in the last 7 years) largely on the back of government stimulus which mainly benefits large businesses.

Distrust of our politicians is also a significant factor as the public frequently complain about being misled. The irony of this is that Trump will probably exacerbate this lack of trust issue as in the three and a half weeks since being elected indications are that he will go back on at least some of his election promises.

In the short term, it is hard to know whether these changes will be positive or negative for investment markets because it is impossible to know what Trump is going to do and what Brexit will actually look like.

Even his proposed infrastructure spending and tax reductions have been criticised as they will probably put the US into much greater debt.

Some fear that some of Trump's reforms could actually result in global unrest between the US and other military powerhouses, even if it was just another cold war type scenario. However most take comfort in the belief that sanity should prevail in Congress and some of his more extreme policies will not be supported.

The other more likely scenario that would have an enormous destabilising impact on global economies is Trump imposing tariffs on certain countries as promised which he may be able to do without congressional approval.

In the long term and at the very least our so called "Establishment" politicians should get the message that they need to change their strategies and the way they conduct themselves. If we survive a Trump presidency with little damage, this should be one big positive to come out of this.

It is too early to predict the impact of Trump on investment markets as he is essentially unpredictable. What we do know is there has never been a greater need for ongoing short and medium term monitoring of markets than now, as what lies ahead in the short and medium term could be even more volatile than the past. Britain's decision to exit the EU followed potentially by Italy can only aggravate market volatility.

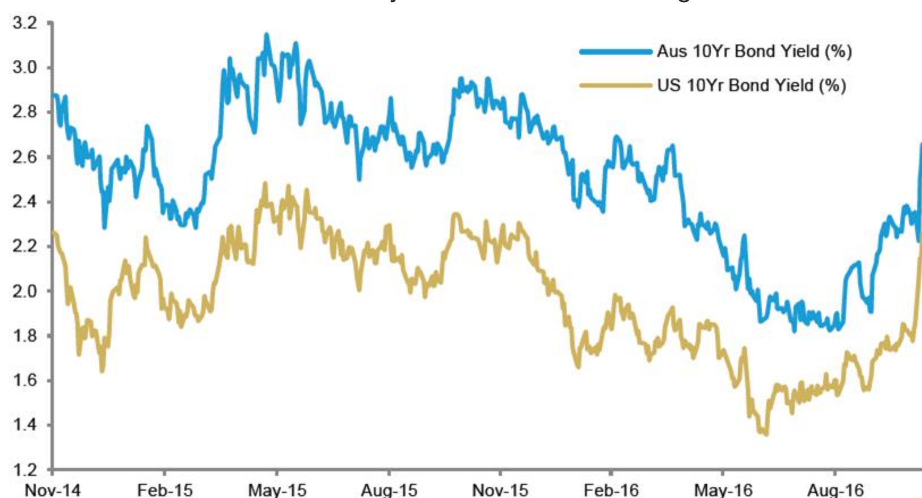
Investment Markets

Recent Events

Equity markets reacted positively to the election of Donald Trump as the next US president with US equity indices currently at or close to record highs. However Emerging markets did not do as well amid uncertainty over US trade policy and protectionism.

Global bonds were sold off with yields rising sharply as markets factored in higher inflation forecasts. The US dollar strengthened against most currencies, particularly those of Emerging countries. Commodities prices, particularly iron ore and coking coal were mostly higher over the period.

Chart 1. US and Australian 10 year Bond Yields: Betting on Reflation



Source: Bloomberg, Morgan Stanley Wealth Management Research, 17 Nov 2016

The Australian share market returned 1.3% for the 3 months to the end of November. Australian Small Cap Equities underperformed large caps returning -4.4% for the same period. Small Cap indices underperformed large caps for the second consecutive month for the first time since mid-2015.

Developed Market Global shares slightly outperformed Australian shares returning 1.7% for the period. Bond yields rose sharply over the 3 months with the Australian fixed interest benchmark returning a negative -2.92% for the period. Australian listed property was sold off as a result of rising bond yields with the benchmark down -10.5% for the 3 months to November.

Economy

The Australian economy contracted by 0.5% in the third quarter of 2016 which was well below forecasts of a fall of 0.1%. This was only the fourth fall in quarterly GDP in 25 years.

Annual GDP growth fell from 3.1% in the second quarter only 1.8% in September. The bad number was attributed to lower government spending as well as a slide in business which knocked 0.4% points off economic growth, and a partly-weather related slide in construction knocked off another 0.3%. Looking back to other instances of falling GDP, it was generally a very significant event that led to the fall. In 2011 it was Cyclone Yasi in Queensland, in 2009 it was the GFC hangover, and in 2000 it was the aftermath of the Sydney Olympics.

While there was no one major event that precipitated the latest fall in GDP, most market analysts are not expecting a contraction in the next quarter (which would result in a technical recession). One of the reasons for this is that the income drag from falling commodity prices has ended with the terms of trade now rising strongly (the price of exports to imports). In addition the spending drag from falling mining capex will soon be a thing of the past.

It should also be pointed out that the best measure of living standards in Australia, real net national disposable income per capita, climbed by 0.5% in the September quarter to be up by 1.7% over the year.

Markets and Outlook

If Trump pursues his stated policies of tax cuts, deregulation and fiscal stimulus, we would expect some combination of stronger growth and accelerating inflation. One downside of this is that we may have a more aggressive Fed tightening than the market currently anticipates. This could impact market valuations by lowering equity market PEs.

There is no doubt that Trump's policies are positive for stocks and bad for bonds which is how it has played out post the election. For example the Dow Jones has made 11 record highs since election day.

We need to be somewhat cautious as equity markets have had a big move to the upside and nothing goes up in a straight line. Also it is normal for the US market to rally when the non-incumbent party candidate wins. However this rally has been stronger than those in the past. Possibly this is because the winning party controls the 3 branches of government and they now have the ability to actually enact a pro-growth, business

friendly agenda.

Markets have so far focused on the positive aspects of Trump's agenda. He has also talked about protectionism and anti-globalisation which would be a negative for global trade and especially Emerging market countries.

So how has the investment landscape changed lately? Markets were essentially positioned for a deflationary environment with negative interest rates in Europe and negative real interest rates in most of the rest of the world. In the last month bond yields have risen sharply and yield curves have steepened (chart 1) i.e. longer interest rates are now much higher relative to shorter term rates. Steeper yield curves are generally a sign that growth is likely to pick up. The driver has been the US which has lifted global bond yields but obviously problems still persist in Japan and Europe.

We should note that these policies are bullish for the US dollar which has been rising against most currencies. However, the impact on Australian dollar has been cushioned by the rally in commodities, particularly iron ore. A note of caution though is that the price of iron ore and coking coal has spiked partially as a result of the domino effect of the 276 day working week policy in some Chinese mines. We would expect this policy to be wound back which should impact the price of these commodities.

We believe the Investment landscape has broadened and the winners are not likely to be the bond proxies or the very high PE growth stocks of the recent past. If interest rates are rising, the bond proxies should maintain their correlation with bonds and will underperform. Also high PE growth stocks do best when growth is scarce. When growth is hard to find, the few high growth companies tend to get pushed to higher and higher PEs as they have scarcity value. We have already seen the impact of this in Australian small cap equities which have underperformed large caps for the last 2 months.

Also, Growth stocks have done much better than Value stocks globally in recent years but that that is no longer an easy call. We believe that disparity will likely narrow or possibly even reverse. Also steeper yield curves are very positive for US banks which should help shore up the valuations of Australian banks.

The Australian equity market with the ASX 200 at about 5,500 is trading at forward PE of over 16x,. This is well above the historical average PE which is in the low 14 times forecast earnings. However the market is currently in an earnings upgrade cycle largely driven by resources. The resources PE has now fallen from a high of 24.8x in April and is now trading at 17.0x (Morgan Stanley, 1 Dec 2016). The market is anticipating earnings per share growth of just over 9% in fiscal 2017. Note that this would be the first positive growth for 3 years.

Chart 2: Investment Returns to 31 October 2016 (% p.a.)

Asset Class	1 month	3 months	1 Year	3 Years	5 Years
Australian Shares	-2.15	-3.20	6.11	3.87	9.17
Global Shares	-1.14	-0.88	-4.32	11.01	15.45
Listed Property	-7.86	-14.29	6.06	13.54	16.78
Fixed Interest	-1.28	-1.08	4.04	5.71	5.82

Source: Mercer

ABN 23 065 921 735 Australian Financial Services Licence Number 229892
Level 23, 25 Bligh Street Sydney NSW 2000, PO Box R686 Royal Exchange Sydney NSW 1225
Tel: 02 9252 2000 Fax: 02 9252 2330 Email: info@lifespanfp.com.au Website: www.lifespanfp.com.au

Disclaimer: The articles in this newsletter are of a general nature only and are not to be taken as recommendations as they might be unsuited to your specific circumstances. The contents herein do not take into account the investment objectives, financial situation or particular needs of any person and should not be used as the basis for making any financial or other decisions. Lifespan directors and advisers may have investments themselves in any of the investments discussed in this newsletter or will earn commissions if Lifespan clients invest or utilise and any services featured. Your Lifespan adviser or other professional advisers should be consulted prior to acting on this information. This disclaimer is intended to exclude any liability for loss as a result of acting on the information or opinions expressed.