Central Bank Policy U-turns supports the rally. Economic Indicators and Corporate Earnings are subdued. Maintain quality focus.
EXECUTIVE SUMMARY

Central banks are conducting an about face, now either on hold or reversing interest rate hikes and balance sheet unwind. This means financial conditions are more loose which is more conducive to economic growth. The challenge for us is that central bank stimulus programs have had a variety of unintended consequences, including increasing the gap between workers (stagnant wage growth) and companies (higher share prices and corporate earnings), as well as decreasing savings (savings are an important source for future investments).

US economic cycle is in the “Late” stage, labour markets are tight and inflation is moving higher. This dynamic creates more volatility and increases the importance of a diversified asset allocation. There are also longer term challenges from challenging demographic trends and elevated debt levels.

Australian economic growth is steady, but downside risks abound. Negatives include soft wage growth, moderating credit growth and cooling housing market.

Global corporate earnings growth and country valuations have converged. Most developed markets are fairly valued vis-a-vis long term averages and offer modest growth in 2019, with stronger a 2020 currently forecast. Japan and China offer the best value, with China the best expected earnings growth.

Australian equities are highly priced vis-à-vis offshore markets. Valuations are at a small premium to long term averages. Retain bias to income generation, quality businesses and value tilts. Sector preferences include Financials (Yield) and Resources (Value and Inflation protection). Cautious on consumer facing sectors including Consumer Discretionary.

Offshore equities provide exposure to structural growth themes. Valuations are at small premiums. Sectors preferences include Financials, Information Technology, Health Care and Industrials.

Fixed Income markets are discounting lower growth ahead. Risks within credit markets include slower economic growth and higher credit spreads.

Equity markets have bounced from oversold conditions, but fundamentals have deteriorated in last few months. On a longer term view we are more cautious given economic headwinds will increase over 2019 and 2020 (tighter financial conditions, fading fiscal stimulus, trade-tariffs).
Central Banks have been expanding their balance sheets and purchasing assets since 2009.

January 2018 marks the end of these net purchases by the US Federal Reserve.

This unwind has had a marked negative impact on financial conditions, global bond and equity markets.

Recent rhetoric suggests the unwind may slow which has re-ignited asset prices over the first few months of 2019.
ECONOMIC CYCLE – LATE STAGE CONDITIONS PREVAIL. POSITION PORTFOLIOS APPROPRIATELY.

**Early Stage**: Recovery from Recession

**Mid Stage**: Lagging indicators are positive and plenty of slack in labor market.

**Late Stage**: Tightness in labor market

**End Stage**: Leading Indicators turn negative

Leading Economic Indicators point to continued expansion.
GLOBAL GDP — REMAINS SOLID BUT ROLLING OVER IN UK, EUROPE AND JAPAN

G4 GDP
Four-quarter percentage changes

Source: Thomson Reuters Datastream
EMPLOYMENT CONDITIONS — LABOR MARKET IS TIGHTENING, SIGNALS “LATE” STAGE CONDITIONS (RISING INFLATION AND RISING INTEREST RATES)

Source: Thomson Reuters Datastream
LEAD ECONOMIC INDICATORS — ROLLING OVER, BUT BOUNCE BACK IN JANUARY. SOFT LANDING POSSIBLE.
CORPORATE MARGINS ARE ROLLING OVER AND DEBT SERVICEABILITY LIKELY AT PEAK

Figure 17: Corporate business margins
Net operating surplus as % of gross value added, corporate sector

Source: BEA, J.P. Morgan

Figure 18: Net-debt to EBITDA and interest coverage ratio

Source: Federal Reserve Board, J.P. Morgan
GDP GROWTH AND LEADING ECONOMIC INDICATORS

Slower Economic Growth, but still Growing

Source: Thomson Reuters Datastream
STRONG LABOR MARKET AND WAGE GROWTH STARTING TO TURN HIGHER

Australia Unemployment Rate

Wage Growth

Source: Thomson Reuters Datastream, Chancellor Portfolio Services
HOUSEHOLDS ARE DRAWING DOWN SAVINGS TO DEAL WITH NO REAL WAGE GROWTH

**Savings Rate**

Source: Thomson Reuters Datastream

**Real Wage Growth**

Wage growth less inflation

Source: Thomson Reuters Datastream
HOUSING MARKET AND CREDIT GROWTH — CREDIT GROWTH IS AT LOWEST LEVEL IN 20 YEARS AS A RESULT OF INCREASED REGULATORY REQUIREMENTS. NEGATIVE FOR BANKS FUTURE EARNINGS GROWTH.

Credit Growth and Bank Share Prices

Source: Thomson Reuters Datastream, Chancellor Portfolio Services
RESOURCES AND CHINA — EQUITIES RESOURCES ARE PRICING IN A SIGNIFICANT CHINA SLOWDOWN. MARGIN OF SAFETY IN RESOURCE STOCKS.

Resources and China Leading Economic Indicator

Source: Thomson Reuters Datastream
Markets have had a strong start to 2019, after a poor December.

Commodities prices have also rallied in 2019, due to supply side constraints (iron ore and oil).

Bond Yields in AU (2.25%) and the US (2.7%) have declined sharply over 3 months pricing in a weaker economic outlook and lower terminal rates.
EQUITIES COUNTRY - PRICE AND PERFORMANCE
EQUITIES COUNTRY — VALUATIONS ARE CHEAP ACROSS THE WORLD

MSCI AUSTRALIA
Price Earnings Ratio

MSCI USA
Price Earnings Ratio

MSCI EUROPE
Price Earnings Ratio

MSCI UNITED KINGDOM
Price Earnings Ratio

MSCI JAPAN
Price Earnings Ratio

MSCI EMEA
Price Earnings Ratio

Source: Thomson Reuters Datasets
EQUITIES COUNTRY – EARNINGS GROWTH. 2019 IS OK, 2020 IS GREAT.

Source: Thomson Reuters Datastream
Equity markets are expensive, while the strongest growth is expected to come from China and Emerging Markets. Australian equities are fully valued and offer benign growth prospects.
EQUITY STYLE — GROWTH BEATING VALUE — TYPICAL OF LATE CYCLE

Value Relative to Growth
Russell Value rel Russell Growth

Source: Thomson Reuters Datastream
AU SECTOR PERFORMANCE

Sector Returns & Momentum

- Leading but slowing
- Leading and growing
- Lagging but growing
- Lagging and slowing

- 12 Month % (Vertical Axis)
- 3 Month % (Horizontal Axis)

- Consumer Discretionary
- Consumer Staples
- Energy
- Industrials
- Information Technology
- Materials
- Financials
- Telecommunications
- Utilities
- ASX 200

- Lagging but growing
- Lagging and slowing
- Leading but slowing
- Leading and growing

- 0.0
- 2.0
- 4.0
- 6.0
- 8.0
- 10.0
- 12.0
- 14.0

- 0.0
- 5.0
- 10.0
- 15.0
- 20.0
AU SECTOR VALUATION & GROWTH

AU - Sector Relative Valuation and EPS Growth

- Energy: BUY
- ASX 200
- Consumer Staples
- Industrials
- Health Care
- Information Technology
- Utilities
- Telecommunications

Relative PE Expensiveness (Cheapness)

Forecast Earnings Per Share Growth

-40.0% -30.0% -20.0% -10.0% 0.0% 10.0% 20.0% 30.0% 40.0% 50.0% 60.0%

Growth

Declining

Cheap

Expensive

BUY

SELL
AU SECTOR VALUATIONS - CYCLICALS

ASX200 CONSUMER DISC S
Price Earnings Ratio
Source: Thomson Reuters Datastream

ASX200 Finan S
Price Earnings Ratio
Source: Thomson Reuters Datastream

ASX200 Indus S
Price Earnings Ratio
Source: Thomson Reuters Datastream
AU SECTOR VALUATIONS - RESOURCES

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ASX200 Mater S
Price Earnings Ratio

Source: Thomson Reuters Datastream

ASX200 Energ S
Price Earnings Ratio

Source: Thomson Reuters Datastream
AU SECTOR VALUATIONS - DEFENSIVES
AU SECTOR VALUATIONS — DEFENSIVES/ BOND PROXIES

Source: Thomson Reuters Datastream
US SECTOR VALUATION AND GROWTH

US - Sector Relative Valuation and EPS Growth

- Financials
- Industrials
- S&P 500
- Health Care
- Consumer Staples
- Consumer Discretionary
- Utilities
- Telecommunications
- Information Technology
- Materials
- Energy

Forecast Earnings Per Share Growth

Relative PE Expensiveness (Cheapness)

Attractive

Unattractive

DANIEL ROLLEY CFA

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RISK APPETITE — RESET AFTER TURMOIL IN DECEMBER 2018. REPRESENTS COMPLACENCY.

Volatility index has reset after spike in December 2018

Put/call ratio reset to neutral
EQUITIES VS BONDS — EQUITIES STILL CHEAP VS BONDS. BONDS ARE NOT OUR “SAFE HAVEN” PREFERENCE GIVEN GIVEN YIELDS.

Equity Risk Premia (Dividend yield less bond yields) remains attractive
Interbank lending rates have trended higher, though are not at extremes. High yield credit spreads have increased but are still low (credit is cheap for high yield issuers.)
The Yield Curve inverts between 6 and 24 months prior to recessions. This is driven by an increase in short rates as a result of higher official cash rates.

Currently inversion is still not apparent. As the Federal Reserve continues lifting official rates we would expect to see inversion take place.
High Yield credit has rolled over relative to defensive treasury bonds.

The pullback in this ratio is a warning indicator from fixed income markets that there is demand for safe haven assets vis-à-vis more risky corporate bonds.
TRENDS — V-SHAPE RECOVERY AND FLAT MOVING AVERAGES EQUALS TRENDLESS MESS. USE STRENGTH TO REBALANCE PORTFOLIOS INTO HIGHER QUALITY AND MORE PREDICTABLE INVESTMENTS.
INVESTOR SENTIMENT CAPITULATION WAS POSITIVE FOR NEAR TERM RETURNS.

V-shape recovery after capitulation in late 2018.
BREADTH CAPITULATION DECEMBER 2018 WAS CONSISTENT WITH SHORT TERM LOWS.

V-shape recovery after capitulation at end of 2018.
EQUITY ALLOCATIONS AND MARGIN LOANS

US households’ equity allocation
Percentage of total financial assets

Source: Thomson Reuters Datastream

US Household Margin Loans

Source: Thomson Reuters Datastream
A$ – DECLINED 10% IN THE LAST 12 MONTHS DUE TO DECLINING COMMODITY PRICES AND INTEREST RATE DIFFERENTIALS (HIGHER US RATES, FLAT AU RATES). WE THINK PATH LOWER IS MORE LIKELY DUE TO INTEREST RATE DIFFERENTIALS AND REVERSION IN COMMODITY PRICES.
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