Late Cycle Conditions: Move Forward with Caution
Central banks are withdrawing liquidity from financial markets via unwind of their balance sheets. What has been a supportive “rising tide” environment is now receding, the result being higher volatility and lower valuations. Cash is now a viable alternative to risk assets from an income and capital protection perspective.

US economic cycle is in the “Late” stage, interest rates are rising and inflation 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-a-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 no growth sectors including Consumer Discretionary and Telecommunications.

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. Federal Reserve is pausing its rate hikes, which is providing relief for markets in the near term.

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 is having a marked negative impact on financial conditions, global bond and equity markets.
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

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

Labour Market Tightness
Unemployment rate minus natural unemployment rate

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
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

Real Wage Growth
Wage growth less inflation
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

STOP
RESOURCES AND CHINA — EQUITIES RESOURCES ARE PRICING IN A SIGNIFICANT CHINA SLOWDOWN. MARGIN OF SAFETY IN RESOURCE STOCKS.
ASSET RETURNS

6/02/2019

Indices

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• Australian and International Equities 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
All equity markets are cheap, while the strongest growth is expected to come from China and the US. Australian equities are modestly cheap, but 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 Performance Diagram]

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

**Sector Returns & Momentum**

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

**12 Month % (Vertical Axis)**

**3 Month % (Horizontal axis)**
AU SECTOR VALUATION & GROWTH

AU - Sector Relative Valuation and EPS Growth

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%

Relative PE Expensiveness (Cheapness)

ENERGY

Financials

Materials

Utilities

Consumer Discretionary

Consumer Staples

Industrials

Health Care

Information Technology

ASX 200

BUY

SELL
AU SECTOR VALUATIONS - CYCLICALS

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

ASX200 Finan S
Price Earnings Ratio
Source: Thomson Reuters Datasream

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

ASX200 Mater S
Price Earnings Ratio

ASX200 Energ S
Price Earnings Ratio

Source: Thomson Reuters Datastream

GO

GO
AU SECTOR VALUATIONS - DEFENSIVES

ASX200 C. Sta S
Price Earnings Ratio

ASX200 Health S
Price Earnings Ratio

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

SLOW

GO

Source: Thomson Reuters Datastream
US SECTOR VALUATION AND GROWTH

US - Sector Relative Valuation and EPS Growth

Attractive

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

Unattractive

Forecast Earnings Per Share Growth

Relative PE Expensiveness (Cheapness)

-15.0% -10.0% -5.0% 0.0% 5.0% 10.0% 15.0% 20.0%
Put/call ratio reset to neutral

Volatility index has reset after spike in December 2018
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 – UPTRENDS BROKEN, MOVING AVERAGES ROLLING OVER. SELL THE STRENGTH.

ASX 200

S&P 500

Source: Thomson Reuters Datastream
INVESTOR SENTIMENT CAPITULATION — POSITIVE FOR NEAR TERM RETURNS.

Returns over the near term are expected to be strong due to investor sentiment reaching capitulation levels.
BREADTH CAPITULATION DECEMBER 2018 WAS CONSISTENT WITH SHORT TERM LOWS.

Returns over the near term are expected to be strong due to stock market breadth capitulation.
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)
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