# Monthly Economic & Investment Market Commentary

## September 2021

In the Weekly Portfolio Commentaries we generally highlight a selection of the issues that have been prevalent in the minds of investors for that particular week. There is never a shortage of such potential inclusions, and so the task is to try and identify those that are likely to have the greatest relevance to your portfolio. Candidly though, whilst we need to be aware of and make assessments as to the importance of these issues, most will come and go and will not have any direct or material impact on the portfolio management decisions that we make.

Like markets themselves, the frequency of such issues tends to be cyclical, sometimes we are bombarded from one day to the next, and at other times we enjoy at least some relative peace and quiet. Our aim in writing both the weekly and these longer notes is to share with you our thoughts and assessments of the issues of the day, but to do so in the context of what is relevant to our long-term forecasts. The framework for making such an assessment is always; what impact this issue will have on the amount of income your portfolio generates, the rate at which that income will grow and how the valuation that is applied to your investments will change from now into the future.

There is no better recent example of this than America, which has just temporarily dispensed with another ridiculous episode of brinksmanship around raising their debt ceiling. Anyone who has followed markets for any length of time has seen this absurdity play out many times before, and so we can assign a high degree of probability that it will get resolved again at the last minute, as proved to be the case this time around. It is important to acknowledge though that a view on the likelihood of an adverse event needs to be considered in the context of its consequences were it to eventuate. There might only be a very small chance that the United States would not raise their debt ceiling and therefore default on their debt, however, were that to happen, the impact would very likely be catastrophic for markets and portfolios.

A US investment manager commented: "It is amazing how much of the daily 'news' is useless noise… it's not just events like the debt ceiling dance; nearly all of the noise around markets and stocks and investing turns out to be nowhere near as important as it feels in the moment." Then referencing research which catalogues the array of issues that have come and gone, he goes on to say, "the amazing thing about these collections of mainstream news articles – terrible headlines, all full of ominous warnings of terrible things to come – is that when viewed with a bit of distance and context, they look utterly absurd. Most of the time, most of the things we worry most about turn out to be mostly meaningless. They work themselves out without any help from us. It is an important lesson for investors."[1]

In the last part of the quote above, we should acknowledge though that there is a heavy reliance on the words most and mostly, as distinct from all and always. Here again the framework of our forecasts is invaluable when assessing what impact a given issue is likely to have on long-term return expectations.

**China**

An example of where we have recently adjusted the qualitative inputs in our return forecasts is China, as they deal with what looks to be a meaningful slowing in their economy.

There has been extensive coverage lately of issues with some of the largest Chinese property development companies including Evergrande, where huge debts look likely to need restructuring, and where interest payments on that debt are already being missed. The real estate sector is an unusually large component of the overall Chinese economy. In the past it has also been a sector through which a policy-directed recovery could be relied upon to combat past episodes of economic slowing. Even China though has a limit to the extent to which the rate of urbanisation can support the long-term, large-scale expansion of housing supply that has taken place over the last couple of decades.

President Xi Jinping has been vocal recently on promoting a set of policies designed to foster "Common Prosperity." A significant focus of these policies reflects an intent to deal with China's widening wealth inequality, which is exacerbated by high prices in the housing sector. Xi has been quite direct in saying that the housing market should not be the source of speculative gains for those with the means to invest, and that would seem to imply a decent likelihood that prices will moderate. That will have a flow-on effect that is likely to curtail activity and spending, as lower values on real estate will have a negative wealth effect on the many Chinese who have used this asset class for a significant portion of their savings.

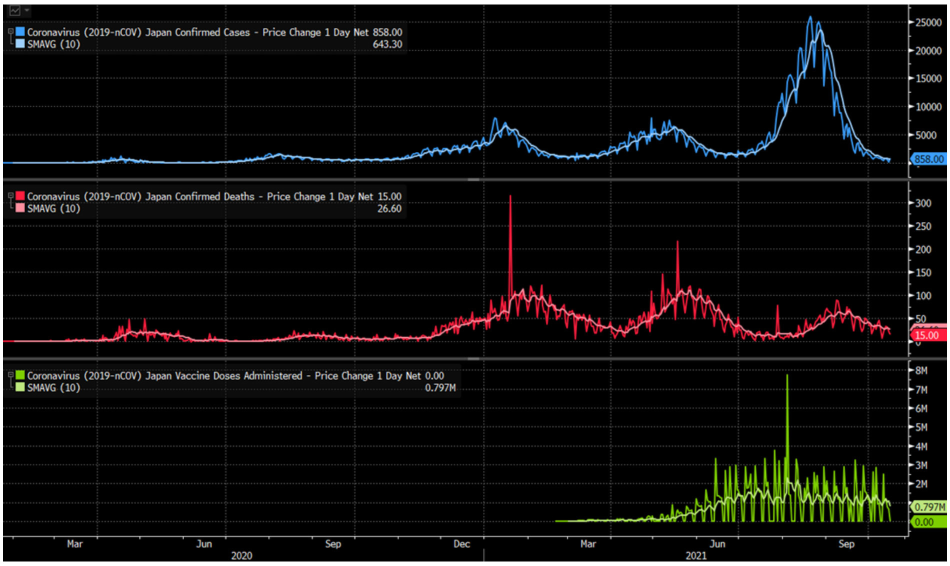
"Even if, as seems likely, the Chinese authorities can keep the fallout from Evergrande from becoming a Lehman-type shock, a downturn in the property and construction sector could well aggravate China's looming economic slowdown. Some expect China's growth rate to slide to 1% to 2%, for a while at least… Banks and property companies are likely to restrict building activity and financing as they restructure broken balance sheets and Chinese households will be wary about taking on new mortgages… With income rising only slowly, especially in the gig or informal economy, which now accounts for about three-fifths of employment, households are likely to remain on the backfoot."[2]

As Australians we have dealt with the sharp end of China's policy retaliations against perceived grievances, but this impact is also felt indirectly in other countries. It is likely to influence foreign investors to have a heightened sense of sovereign risk with regards to China, and it comes with an impact on confidence and pricing in China's offshore credit market. The inputs to our forecast that we have recently adjusted relate to our long-term views on expected rates of profitability and valuations in the Chinese share market, the effect of which is to trim expected returns for Chinese equities by a bit more than 2% per annum.

It is important though to also consider some portfolio history here, and if we look back to five years ago, we had China as comfortably the largest country exposure in the International Equities asset class. It was then and continues to be the largest exposure within the broader Asia-Pacific fund in your portfolio. Over recent years though the exposure to Asia-Pacific and China has been steadily reduced, initially with increased weights to Japan and Europe, and more recently with a new fund that invests in equities from the United Kingdom. As an investment committee, we have noted how often the signals provided from the long-term forecasts provide a reliable guide towards which of the issues of the day warrant attention, and particularly those that lead to forecast adjustments and therefore actual portfolio adjustments.

**Japan**

The baton of leadership in terms of individual countries within the International Equities asset class has been very much passed to Japan, which is now comfortably the largest exposure. The format of the chart below will hopefully be familiar to most readers, it tracks the covid cases in the top panel, then deaths in the middle and then finally the number of vaccinations in the bottom panel.




This Japanese version of the chart shows the very significant spike in cases that coincided with the Olympic Games, but then also the remarkable success in suppressing that spike. It is not that difficult to remember some of the commentary from the time that confidently predicted doom and gloom for Japan's economy and by extension for investors in their equity market.

Japan is also no different in that there is no shortage of issues that need to be considered and assessed, but these too will mostly come and go without requiring a direct portfolio adjustment. Just in very recent times there has been a change in Prime Ministers, and the associated uncertainty about the trajectory of key policies. The country has been under a state of emergency until very recently, like the rest of the world their export industry has been disrupted by the global recession, and of course there are always ongoing geopolitical tensions with neighbouring countries in the region.

So, at the risk of being repetitive, whilst we monitor and evaluate these ongoing issues, principally our portfolio decisions, including to significantly increase exposure to Japan in recent years, have been driven by the fundamentals of the Japanese equity market. In recent years Japanese companies have shared an increasing proportion of their profits with investors in the form of dividends, those dividends are forecast to grow at the fastest rate among the world's largest developed markets, and valuations remain relatively attractive when compared to global peers, so we expect Japan to continue to be a meaningful exposure.

We need to thank you again for your patience with the delayed publication of this commentary and assure you that as life returns to normal in Sydney, we very much look forward to getting back to the regular schedule. We also hope to be able to recommence travel and meet in person with you in the months ahead. To close, we return to the opening discussion, and suggest that as you encounter the daily noise and distractions in investment markets and the broader world, remember the words of Mark Twain who said, "I've lived through some terrible things in my life, some of which actually happened."

Kind regards,

**Asset Allocation & Investment Committee**

# Asset Class Tipping Points

The version of the tables below has been updated through mid-October rather than the end of September, even though changes over the last couple of weeks are fairly minor. One area where there has been a notable change is in the sustained push higher in government bond yields. This translates to the expected risk-free return, which in turn coincides with the threshold where an asset class below crosses from being Fully Priced to Overpriced. We use an average of recent bond yields, and this has recently been increased to 1.5%, which also means that the estimate of when an asset class starts to become Cheap is when expected returns are at least 6.5%. With a modest pullback in markets recently, which increases expected returns, the net effect of both of these changes is to largely offset each other.

## Asset Class Tipping Points - October 2021

**Australian Equities**

| All Ords | 10 Year Forecast | Valuation | 15-Oct |
|---|---|---|---|
| 11,000 | 1.1% | Overpriced | |
| 10,700 | 1.4% | Overpriced | |
| 10,400 | 1.8% | Fully Priced | |
| 10,100 | 2.2% | Fully Priced | |
| 9,800 | 2.6% | Fully Priced | |
| 9,500 | 3.1% | Fully Priced | |
| 9,200 | 3.5% | Fully Priced | |
| 8,900 | 4.0% | Fair Value | |
| 8,600 | 4.5% | Fair Value | |
| 8,300 | 5.0% | Fair Value | |
| 8,000 | 5.6% | Fair Value | |
| 7,700 | 6.2% | Fair Value | Aust 6.2% |
| 7,400 | 6.8% | Cheap | Fin'l 6.9% |
| 7,100 | 7.4% | Cheap | |
| 6,800 | 8.1% | Cheap | |
| 6,500 | 8.9% | Cheap | |
| 6,200 | 9.7% | Cheap | |

| | | |
|---|---|---|
| Income | 5.4% | p.a. |
| Earnings | 0.9% | p.a. |
| Valuation | 0.0% | p.a. |
| **Forecast** | **6.2%** | **p.a.** |

**International Equities - Developed**

| World ExAust | 10 Year Forecast | Valuation | 15-Oct |
|---|---|---|---|
| 3,700 | 1.2% | Overpriced | |
| 3,600 | 1.5% | Overpriced | |
| 3,500 | 1.8% | Fully Priced | |
| 3,400 | 2.1% | Fully Priced | |
| 3,300 | 2.5% | Fully Priced | |
| 3,200 | 2.8% | Fully Priced | Dev 2.9% |
| 3,100 | 3.2% | Fully Priced | |
| 3,000 | 3.6% | Fully Priced | |
| 2,900 | 4.0% | Fully Priced | |
| 2,800 | 4.4% | Fair Value | |
| 2,700 | 4.8% | Fair Value | |
| 2,600 | 5.3% | Fair Value | |
| 2,500 | 5.8% | Fair Value | |
| 2,400 | 6.3% | Fair Value | EU 6.3% |
| 2,300 | 6.8% | Cheap | Japan 6.8%<br>UK 6.8% |
| 2,200 | 7.4% | Cheap | |
| 2,100 | 7.9% | Cheap | |

| | | |
|---|---|---|
| Income* | 2.3% | p.a. |
| Earnings | 1.7% | p.a. |
| Valuation | -1.1% | p.a. |
| **Forecast** | **2.9%** | **p.a.** |

**International Equities - Emerging**

| Emerging Markets | 10 Year Forecast | Valuation | 15-Oct |
|---|---|---|---|
| 1,900 | 1.0% | Overpriced | |
| 1,850 | 1.3% | Overpriced | |
| 1,800 | 1.6% | Fully Priced | |
| 1,750 | 1.9% | Fully Priced | |
| 1,700 | 2.3% | Fully Priced | |
| 1,650 | 2.6% | Fully Priced | |
| 1,600 | 3.0% | Fully Priced | |
| 1,550 | 3.4% | Fully Priced | |
| 1,500 | 3.7% | Fully Priced | |
| 1,450 | 4.2% | Fair Value | |
| 1,400 | 4.6% | Fair Value | |
| 1,350 | 5.0% | Fair Value | |
| 1,300 | 5.5% | Fair Value | EM 5.6% |
| 1,250 | 6.0% | Fair Value | Asia-P 6.4% |
| 1,200 | 6.5% | Cheap | |
| 1,150 | 7.0% | Cheap | |
| 1,100 | 7.6% | Cheap | |

| | | |
|---|---|---|
| Income* | -0.4% | p.a. |
| Earnings | 4.5% | p.a. |
| Valuation | 1.6% | p.a. |
| **Forecast** | **5.6%** | **p.a.** |

**Listed Property**

| ASX200 Property | 10 Year Forecast | Valuation | 15-Oct |
|---|---|---|---|
| 2,425 | 1.0% | Overpriced | |
| 2,350 | 1.4% | Overpriced | |
| 2,275 | 1.8% | Fully Priced | |
| 2,200 | 2.2% | Fully Priced | |
| 2,125 | 2.7% | Fully Priced | |
| 2,050 | 3.1% | Fully Priced | |
| 1,975 | 3.6% | Fully Priced | |
| 1,900 | 4.1% | Fair Value | |
| 1,825 | 4.7% | Fair Value | |
| 1,750 | 5.3% | Fair Value | |
| 1,675 | 5.9% | Fair Value | |
| 1,600 | 6.5% | Cheap | A-REITs 6.4% |
| 1,525 | 7.2% | Cheap | |
| 1,450 | 8.0% | Cheap | |
| 1,375 | 8.8% | Cheap | |
| 1,300 | 9.6% | Cheap | |
| 1,225 | 10.6% | Cheap | |

| | | |
|---|---|---|
| Income | 4.2% | p.a. |
| Dist Grwth | 1.4% | p.a. |
| Valuation | 0.8% | p.a. |
| **Forecast** | **6.4%** | **p.a.** |

** Income for International Equities includes dividends and forecast currency impact.*


*Sources*

1. *B Ritholtz, "Raising the Debt Ceiling" – The Big Picture. 6-Oct-21.*
2. *G Magnus, "End to China's Estate Market Boom Could Spell Trouble for the Economy" – The Guardian. 15-Oct-21.*


***NOTE:*** *It is important to note that each portfolio is managed to its own mandate, which can mean that activity mentioned above is not reflected in your own portfolio. This may be because it is more beneficial to your portfolios after tax performance to complete the trading at a different time, or may be due to individual customisation that you have requested. This flexibility is an integral part of the investment process. If you would like to discuss the tailoring of your portfolio, please contact your Adviser.*

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