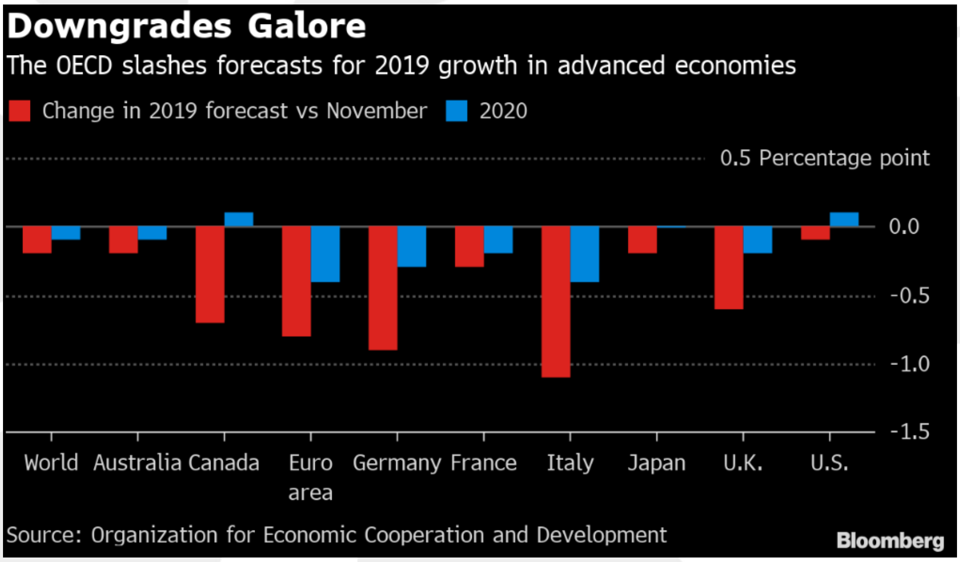
# Quarterly Asset Allocation Update
# February 2019

To borrow the popular sporting phrase, 2018 was certainly a game of two halves when we look at Australia's economic growth. Indeed, we can make the same observation for just about all the major economies around the world. Forecasters have been downgrading the growth outlook, even if in a lot of instances it is only quite modestly. This generates a lot of negative headlines, which consequently leads to a negative impact on business and consumer sentiment. It is not hard to then see how this becomes somewhat of a self-fulfilling phenomenon, as households rein in spending and businesses delay investment and hiring decisions.

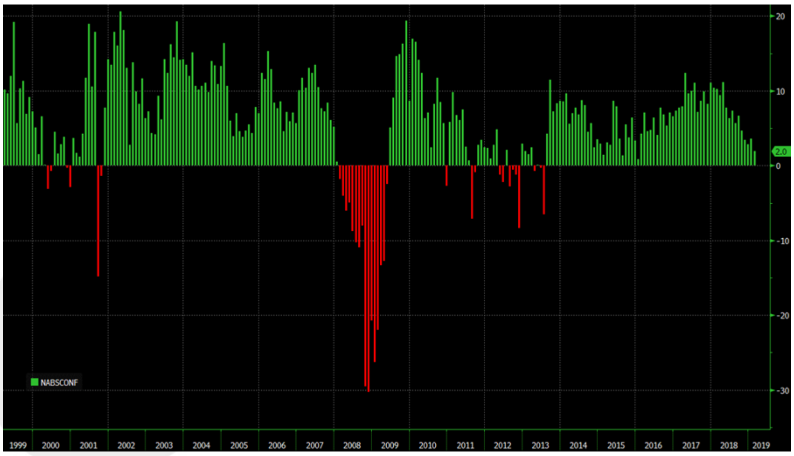
If we consider that this global slowdown in growth is occurring at a time of some major economic and geopolitical uncertainties, then it is all the more remarkable to observe the strong rebound rally in equity markets in the early months of 2019. Equally, it is understandable that there are some questions as to the sustainability of this rally. As always, we strive to maintain a focus on fundamentals and a long-term view, and it is within that framework that we will explore recent activity in financial markets.




The red bars show the reduction in growth as the OECD updated its forecast between November 2018 and February 2019. On the left you see why we used the term 'modest' above to describe the change in world growth, and that certainly applies to the Australian economy as well. Europe is under pressure for a variety of reasons, and the UK is at the precipice of Brexit.

Sentiment is most often measured using the results from surveys of businesses and households, and we have seen noteworthy declines in a broad range of these, again in both Australia and in many other countries. Examples include the Westpac Bank's gauge on consumer confidence which in the most recent result dipped below 100, indicating that there were more respondents with a pessimistic view than an optimistic one. Not surprisingly, the accompanying commentary made mention of the correlation between areas where the housing market has been weakest and the most negative readings on sentiment. Just as we see a positive wealth effect when house prices are increasing, the same holds when house prices decline. "Consumers in Sydney, which has seen the largest house price declines over the last 18 months, recorded a sharp 10 percent fall in sentiment."[1]

When it comes to the business sector, there is a similar dynamic playing out. This chart shows the National Australia Bank's reading on confidence going back 20 years. The red bars in the middle of the chart show quite literally the depths of the Global Financial Crisis. On the far right we can see that sentiment has declined in the business community, though for now it remains a green bar and just in positive territory.

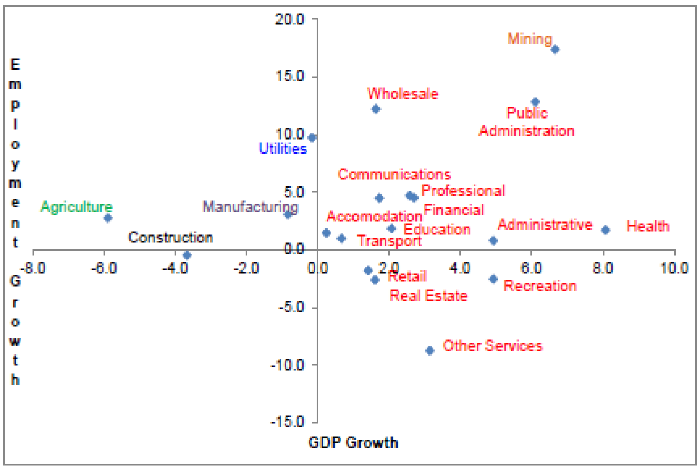



The key question then is do things continue to get worse from here, or are we at an inflection point?

## AUSTRALIA

The quarterly GDP growth figures for 2018 in Australia were +1.1%, +0.8%, +0.3% and +0.2%. Let's first simply notice that despite the second half slow down they all have a plus sign out the front, and the economy is still growing. For what it is worth, and that is certainly debatable, the current consensus forecast for Q1 2019 is for a return to a quarterly GDP growth rate of +0.8%.

**Figure 4. Employment and GDP growth: yearly percentage change**




Source: ABS and Citi Research

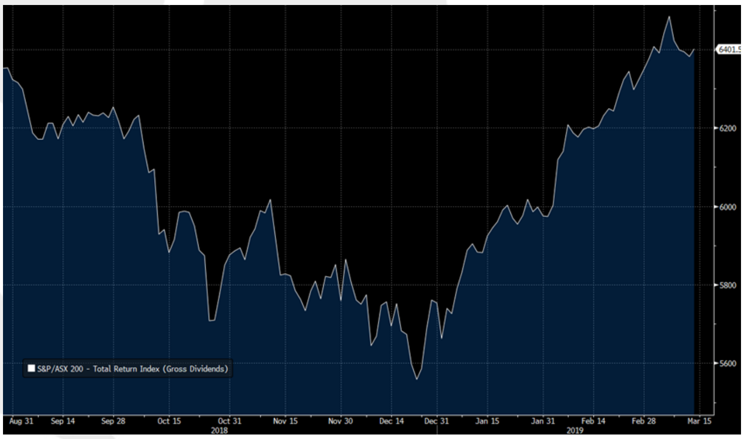
There is less debate about the importance of the labour market to our outlook though, and here the research team at Citi identified continued strength in the recent data. "All of the 14 measured service sectors (shaded red in Figure 4) produced positive GDP growth in Q4. Furthermore, 10 of these sectors recorded positive economic growth and positive employment growth in 2018 (top-right quadrant of Figure 4). These sectors account for almost two-thirds of the total level of Australian employment. Furthermore, they are favourably exposed to solid population growth, e-commerce trends, rising service exports and public sector demand, and therefore should continue to exhibit ongoing positive employment growth in the future."[2]

In the same note there was further evidence provided to support the inflexion point hypothesis mentioned above, and to negate the sensationalist headlines which confront us every day. Financial conditions have been especially tight last year as the banks navigated the royal commission, but there are signs emerging that some easing is occurring here which would help both households and businesses. In fact, expectations are for a pick up in business investment in both the mining and non-mining sectors as solid growth in company profits and capital imports continues. To a large extent the drag on growth as the previous peak in mining investment recedes is now complete. This input is now expected to shift from a drag to having only a neutral impact on GDP going forward. Wage data continues to show modest growth, but a more robust reading comes when total remuneration (including bonuses) is considered. In the residential property market there are early signs of activity picking up, particularly as auction clearance rates in Sydney and Melbourne have been stronger in early 2019 than they were in late 2018. It would be brave to call a bottom in these housing markets at this time though.

Finally, the prices for many of our key export commodities remains strong, and this is providing a boost to the government's coffers. Iron ore prices appreciated by just shy of 50% between late November 2018 and early February 2019 before settling back somewhat. Similarly, the strength in prices for coal and the enormous investment in natural gas production has supported continued strength in our terms of trade (ratio of export prices to import prices). That these commodity prices are well above even those included in the Treasurer's Mid-Year Economic and Fiscal Outlook delivered in December, will not have escaped the attention of the government as we are now months away from a federal election.

It is thought that up to $10 billion will be added to the war chest of the incumbent government as they seek to avoid what many think will be an inevitable electoral defeat. Leaving the political ramifications aside for now, the result is that households are likely to see some quite sizeable, quite direct fiscal stimulus in the near future. The Citi analysts expect to see one-off cash transfers not just announced in the early April budget, but actually delivered between that time and the likely election in May. This will be in in addition to the $9.2 billion that the government has already set aside for personal income tax cuts.

We published the last of these quarterly notes in November last year, at what turned out to be close to the eventual bottom a few weeks later in late December. In it we said, "tumult remains the order of the day."




Here we show you the return of the ASX200 index (including dividends), and let the chart make the point again that not over-reacting to volatility, but rather focusing on underlying fundamentals and a long-term view will deliver good portfolio outcomes.

Albert Einstein is quoted as saying "not everything that can be counted counts, and not everything that counts can be counted." In this context, good portfolio management requires not just the data feeds to a forecasting model that support decision making, but the confidence and patience to stay the course.

Kind regards,

*Asset Allocation and Investment Committee*

## Ten Year Forecast Returns

| | Australian Equities | Inter Eq - Dev Mkts | Inter Eq – Emerg Mkts | Listed Property | HY Income Securities | Income Securities |
|---|---|---|---|---|---|---|
| Current Yield | 6.1% | 2.4% | 2.8% | 4.8% | 6.6% | 4.3% |
| + Currency Impact | | 0.3% | -2.2% | | | |
| + EPS Growth (10 Yrs) | 2.6% | 2.4% | 6.1% | 2.9%* | | |
| + Valuation Effect | 0.2% | 1.1% | 2.1% | -0.3% | -2.0% | |
| Index Return (Pre-Tax) | 8.9% | 6.2% | 8.8% | 7.4% | 4.6% | 4.3% |

1: Forecast Distribution Growth

*Please note that the active asset allocation targets mentioned below apply to both the Exchange Traded Fund portfolios managed by Implemented Portfolios and the portfolios that own direct shares which are managed by Joseph Palmer & Sons. However, commentary below about individual investments is in relation to the ETF portfolios only.*

## Australian Equities

| Australian Equities | No. 1 | No. 2 | No. 3 | No. 4 | No. 5 |
|---|---|---|---|---|---|
| Neutral | 10.0% | 15.0% | 20.0% | 27.0% | 40.0% |
| Target* | 13.6% | 20.3% | 27.1% | 36.0% | 49.9% |

Through the drawdown and recovery we have persisted with the both the target specified above and the composition of the asset class model. We did however guide the portfolio management team to complete buying on weakness to maintain those targets, when the market declines lead to these targets drifting lower. We have been pleased with the recent performance of Australian Equities, and not least among the holdings the Financials ETF as it starts to recover. In the last three months the total return from each of the ETFs in the model portfolio are as follows: ASX50 +12.2%, Financials +10.3%, Midcap +10.4% and Small Companies 12.5%.

## International Equities

| International Equities | No. 1 | No. 2 | No. 3 | No. 4 | No. 5 |
|---|---|---|---|---|---|
| Neutral | 5.0% | 10.0% | 15.0% | 23.0% | 35.0% |
| Target* | 5.2% | 10.4% | 15.4% | 23.6% | 34.0% |

The committee continues to consider an adjustment in this asset class, and that is focused particularly on the Asia-Pacific (ex-Japan) ETF. We expect a future move will both slightly reduce the overall exposure to this region, but that it may also involve a reduction in the current broad regional exposure in lieu of more targeted country or thematic exposures. There are a wide range of choices which we will consider at length and of course keep you informed of our thinking ahead of implementing any changes. The overall reduction in exposure is likely to be offset with additional exposure to Japan, which does seem to have a better outlook than Europe for now. Whilst we continue to monitor the relevant exchange rates, for now we remain comfortable being unhedged and note that this has added between 1% and 3% gains to your portfolio return in the last three months. A$ returns over that time have been: Japan +3.2%, Asia-Pacific +10.4% and Developed Europe (Ex-UK) +10.2%.

## Listed Property

| Listed Property | No. 1 | No. 2 | No. 3 | No. 4 | No. 5 |
|---|---|---|---|---|---|
| Neutral | 5.0% | 5.0% | 10.0% | 10.0% | 10.0% |
| Target* | 6.6% | 6.6% | 12.9% | 12.7% | 12.5% |

This asset class continues to be a very strong contributor to portfolio performance. As outlined early in the year when we added exposure here, there also continues to be a durable inverse relationship between bond rates and listed property. That has proven to be a very useful tool in our decision making, as evidenced by the 12% price appreciation since the buying was completed. The figures above represent that January move to a 25% overweight stance (e.g. target 12.5% vs neutral of 10.0%), and also the impact of the rising prices as we let the target weight float higher with strong performance.

## High Yield Income Securities

| HY Income Secs | No. 1 | No. 2 | No. 3 | No. 4 | No. 5 |
|---|---|---|---|---|---|
| Neutral | 10.0% | 15.0% | 15.0% | 15.0% | 10.0% |
| Target* | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |

We remain 100% underweight this asset class on valuation grounds. More specifically, as the table of forecast returns outlines, the pick-up in yield for this risky asset class is not sufficient to justify an exposure here when compared with the defensive asset class Income Securities.

## Income Securities & Cash

| Income Securities | No. 1 | No. 2 | No. 3 | No. 4 | No. 5 |
|---|---|---|---|---|---|
| Neutral | 40.0% | 40.0% | 30.0% | 20.0% | 0.0% |
| Target* | 54.5% | 52.8% | 37.7% | 23.7% | 0.0% |

| Cash | No. 1 | No. 2 | No. 3 | No. 4 | No. 5 |
|---|---|---|---|---|---|
| Neutral | 30.0% | 15.0% | 10.0% | 5.0% | 5.0% |
| Target* | 20.0% | 10.0% | 7.0% | 4.0% | 3.7% |

The defensive investments have been very solid performers, particularly the investment grade corporate bond ETFs. These have similar underlying assets but some differences in the average maturity profile (duration), which explains the difference between otherwise very pleasing results. PLUS has returned +5.4% and CRED +6.9% since the latter was launched in mid-2018.

** The Target weights outlined above reflect both the active asset allocation stance as determined by the committee and also the impact of market price changes as portfolios use a floating weight regime for securities within an asset class, and asset classes within each of the respective Investment Programs.*

JIGSAW PRIVATE WEALTH

Implemented Portfolios

## ASSET CLASS TIPPING POINTS

Taking a view between November and February there has been a good deal of consistency in the valuations depicted below. As performance has picked up strongly in recent times, there has been a reduction in the expected long term forecast returns, however the relativities between asset classes has not changed and hence the composition of both the asset class models and the dynamic asset allocation targets has been quite consistent.

### Asset Class Tipping Points - February 2019

**Australian Equities**

| All Ords | 10 Year Forecast | Valuation | 28-Feb |
|---|---|---|---|
| 10,200 | 1.7% | Overpriced | |
| 9,900 | 2.1% | Overpriced | |
| 9,600 | 2.5% | Overpriced | |
| 9,300 | 3.0% | Fully Priced | |
| 9,000 | 3.4% | Fully Priced | |
| 8,700 | 3.9% | Fully Priced | |
| 8,400 | 4.4% | Fully Priced | |
| 8,100 | 4.9% | Fully Priced | |
| 7,800 | 5.5% | Fair Value | |
| 7,500 | 6.1% | Fair Value | |
| 7,200 | 6.7% | Fair Value | |
| 6,900 | 7.3% | Fair Value | |
| 6,600 | 8.0% | Cheap | |
| 6,300 | 8.8% | Cheap | Aust 8.9% |
| 6,000 | 9.5% | Cheap | |
| 5,700 | 10.4% | Cheap | |
| 5,400 | 11.3% | Cheap | Fin'l 11.2% |

| | | |
|---|---|---|
| Income | 6.1% | p.a. |
| Earnings | 2.6% | p.a. |
| Valuation | 0.2% | p.a. |
| **Forecast** | **8.9%** | **p.a.** |

**International Equities - Developed**

| World ExAust | 10 Year Forecast | Valuation | 28-Feb |
|---|---|---|---|
| 3,000 | 1.9% | Overpriced | |
| 2,900 | 2.3% | Overpriced | USA 2.5% |
| 2,800 | 2.7% | Overpriced | |
| 2,700 | 3.1% | Fully Priced | |
| 2,600 | 3.5% | Fully Priced | |
| 2,500 | 4.0% | Fully Priced | |
| 2,400 | 4.5% | Fully Priced | |
| 2,300 | 5.0% | Fully Priced | |
| 2,200 | 5.6% | Fair Value | |
| 2,100 | 6.1% | Fair Value | Dev 6.2% |
| 2,000 | 6.7% | Fair Value | |
| 1,900 | 7.4% | Fair Value | |
| 1,800 | 8.1% | Cheap | |
| 1,700 | 8.9% | Cheap | Eur 9.0% Japan 9.1% |
| 1,600 | 9.7% | Cheap | |
| 1,500 | 10.5% | Cheap | |
| 1,400 | 11.5% | Cheap | |

| | | |
|---|---|---|
| Income* | 2.7% | p.a. |
| Earnings | 2.4% | p.a. |
| Valuation | 1.1% | p.a. |
| **Forecast** | **6.2%** | **p.a.** |

**International Equities - Emerging**

| Emerging Markets | 10 Year Forecast | Valuation | 28-Feb |
|---|---|---|---|
| 1,925 | 1.5% | Overpriced | |
| 1,850 | 2.0% | Overpriced | |
| 1,775 | 2.4% | Overpriced | |
| 1,700 | 2.9% | Fully Priced | |
| 1,625 | 3.5% | Fully Priced | |
| 1,550 | 4.0% | Fully Priced | |
| 1,475 | 4.6% | Fully Priced | |
| 1,400 | 5.2% | Fully Priced | |
| 1,325 | 5.9% | Fair Value | |
| 1,250 | 6.6% | Fair Value | |
| 1,175 | 7.4% | Fair Value | |
| 1,100 | 8.2% | Cheap | |
| 1,025 | 9.1% | Cheap | Emrg 8.8% A-Pac 9.2% |
| 950 | 10.1% | Cheap | |
| 875 | 11.3% | Cheap | |
| 800 | 12.5% | Cheap | |
| 725 | 13.9% | Cheap | |

| | | |
|---|---|---|
| Income* | 0.6% | p.a. |
| Earnings | 6.1% | p.a. |
| Valuation | 2.1% | p.a. |
| **Forecast** | **8.8%** | **p.a.** |

**Listed Property**

| ASX200 Property | 10 Year Forecast | Valuation | 28-Feb |
|---|---|---|---|
| 2,200 | 1.9% | Overpriced | |
| 2,150 | 2.2% | Overpriced | |
| 2,100 | 2.5% | Overpriced | |
| 2,050 | 2.8% | Fully Priced | |
| 2,000 | 3.1% | Fully Priced | |
| 1,950 | 3.5% | Fully Priced | |
| 1,900 | 3.8% | Fully Priced | |
| 1,850 | 4.2% | Fully Priced | |
| 1,800 | 4.6% | Fully Priced | |
| 1,750 | 5.0% | Fully Priced | |
| 1,700 | 5.4% | Fair Value | |
| 1,650 | 5.8% | Fair Value | |
| 1,600 | 6.2% | Fair Value | |
| 1,550 | 6.7% | Fair Value | |
| 1,500 | 7.2% | Fair Value | A-REITs 7.4% |
| 1,450 | 7.7% | Fair Value | |
| 1,400 | 8.2% | Cheap | |

| | | |
|---|---|---|
| Income | 4.8% | p.a. |
| Dist Grwth | 2.9% | p.a. |
| Valuation | -0.3% | p.a. |
| **Forecast** | **7.4%** | **p.a.** |

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


**Source:**

1. M Hassan, "Australian Consumer Sentiment Drops as Weak GDP Spooks Households" – Bloomberg. 13-Mar-19.
2. P Brennan, J Williamson "Australia: Too early to call the start of the next RBA easing cycle" - Citi Research. 7-Mar-19.