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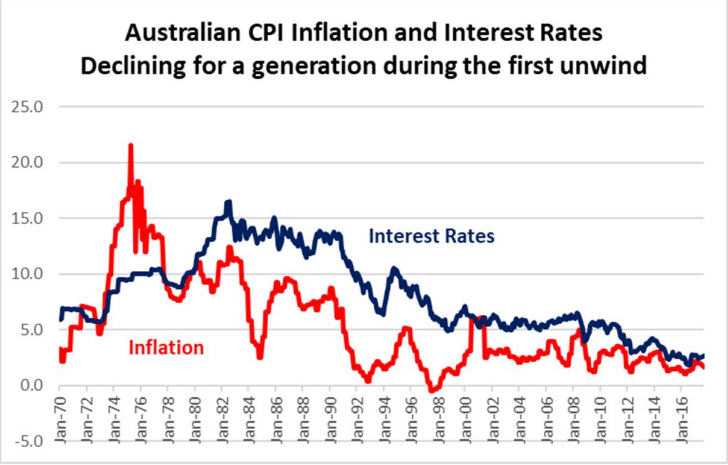
Investment & Economic Review

October 2017

In 1975 Australia's consumer price inflation rate reached 20%. Between 1981 and 1987 the yield on the *risk-free* Australian Government Bond averaged 13.9%. Similarly, the US ten-year Treasury Bond averaged 10.6% for all of the 1980's! For a generation now, investors, regulators and consumers have been dealing with a monumental 'unwind' process, that sought to and succeeded in shaking this bane of inflation and high interest rates out of the global economic system. In more recent years these concerted and aggressive acts of governments and central banks have consequently pushed this fix-up barrow too far, such that inflation and interest rates are now *too low*, and when combined with globalisation and process automation, have caused dramatic increases in global indebtedness, thereby putting at risk the pace of economic activity, and constraining job and wage growth.

So now we head into the another great unwind, the 'normalisation' phase where interest rates start to rise and inflation returns. But there's a problem. Monetary authorities in the last few years have embarked on mass money-printing programs, which in turn have stimulated large increases in debt. Consequently, the forthcoming unwind process needs to contend with the dual risks of unpredictable inflation consequences and massive debt – so the progression might become disorderly, which would create volatility, and interest rates might spike unexpectedly higher, which is problematic when there's too much debt……



Thankfully, this unwind process is likely to take many years, so will be one of the dominant investment themes of the future. The dichotomy of the need to raise rates to dampen speculation, whilst containing the possible negative consequences of doing so, will be an oft-discussed topic in investment and government circles for 2018 and years beyond.

Global geopolitics will remain an important investment theme in 2018. Britain is working its way towards its

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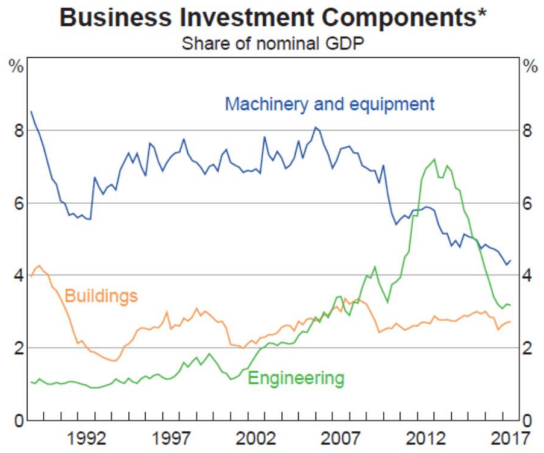
History • Experience • Foresight

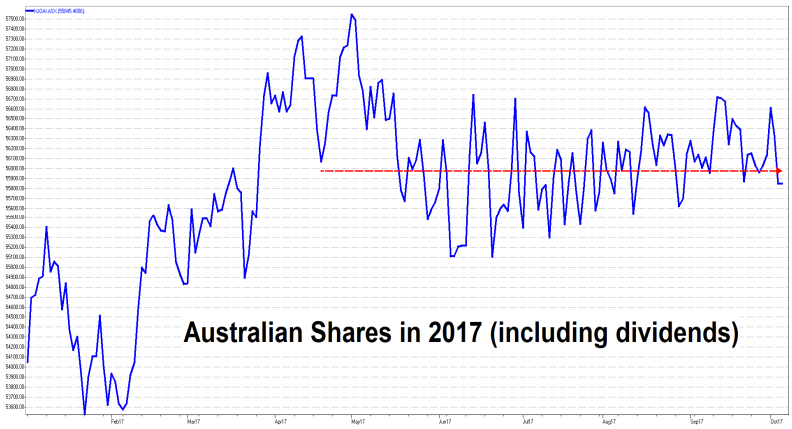
excruciating Brexit outcome, the triggering of Article 50 inferring a March 2019 EU exit. Italy has an election due in 2018, the primary relevance for investment markets being the degree of success or failure of the populist Five Star Movement - success potentially leading to an unusually dysfunctional (even for Italy) parliament, with all sorts of alternative policies promulgated, including the possibility of Ixit, Italy's version of separation from the European Union. Meanwhile, Spain is suffering a constitutional crisis due to the secessionist movement in Catalonia, one of their most economically prosperous regions. Presumably the Catalonian independence push will reference the economic privileges afforded to the Basque region, which arose from their own nationalistic, and more violent, secessionist attitude.

In the United States the Trump administration is approaching its first anniversary, but has yet to fulfill much of its policy plan. Meanwhile, US government debt and their budget deficit is soaring, which is a very un-Republican dogma. The right and tea party factions of the Republicans are becoming increasingly agitated, such that the push towards an Article V instigated constitutional convention, based on balancing the budget, is gaining real momentum. Thankfully this is an unlikely outcome, but the very possibility of a constitutional amendment that forces Congress to balance the budget, and thereby presumably results in massive cuts to public spending, is frightening. I'll be keeping a wary eye on this in the coming years, particularly as 27 of the required 34 (two-thirds of the 50 States) State legislatures have already passed such a resolution.



In Australia, there have been some positive economic trends, particularly in services, construction, infrastructure, public sector works, and tourism sectors, but this has been offset by weak wage growth, stubbornly high under-employment, low inflation and a worrying decline in business investment. Markets have reconciled this by becoming stagnant – share prices have drifted a bit lower and interest rates have remained fairly steady.

Australian Shares



The Australian stock market rallied to a temporary peak in May 2017, then lost momentum such that the index return for the 2017 year to date is a pitiful 0.5%, or 3.3% when dividends are included. For the September quarter the share index was remarkably stable, oscillating within a very narrow range, but ended the quarter down by 0.7%. This lackluster performance was caused by underwhelming corporate profits when they were announced in August, and a relatively weak forward outlook, plus some general economic concerns, particularly weakening retail sales, low

inflation and wage growth and rampant household debt. Dividends payouts remained very high for most companies, which is good for shareholders, but lessens the retained earnings that companies have for future investment.

Our strategy during this period of relative weakness is to maintain a higher than usual emphasis on capital preservation, by holding significant cash in investment portfolios. This strategy has been progressively adopted during 2017 by not reinvesting proceeds from shares sold.

Within our managed share portfolios, we have concentrated sectoral exposure within the financial, healthcare and consumer defensive sectors, and have tended to avoid real estate and other interest-rate sensitive areas. We've long favoured investment in Australian bank shares, and currently hold positions in ANZ, CBA, Westpac and Macquarie. This sector has performed similarly to the lackluster market of late, but has had more volatility, notably CBA falling due to their well-publicised governance issues, and Macquarie rising following an upgrade to their profit projection.

Our healthcare stocks have also shown some divergence – CSL continuing its stellar performance as it expands further globally, whilst both Ramsay healthcare and Sonic Healthcare shares fell recently due to a slowing pace of profit growth. Investment in healthcare stocks remains one of preferred investment themes.

In the energy and mining sectors we hold BHP Billiton, Woodside and Santos. BHP has performed well this year, benefiting from a combination of higher (though volatile) commodity prices, and reduced costs of production. Santos' share price has recovered somewhat, as their LNG operations reach full operational capacity.

Telstra is a share that we have persevered with, but has proved to be disappointing. Strategically, the company is seeking to change direction, focusing on more technology growth as a filler for the NBN induced earnings hole. Telstra has slashed their annual dividend from 31c in 2017 to a projected 22c in 2018 which we think to be a sensible move, as it allows profit retention to be applied to more business growth oriented areas.

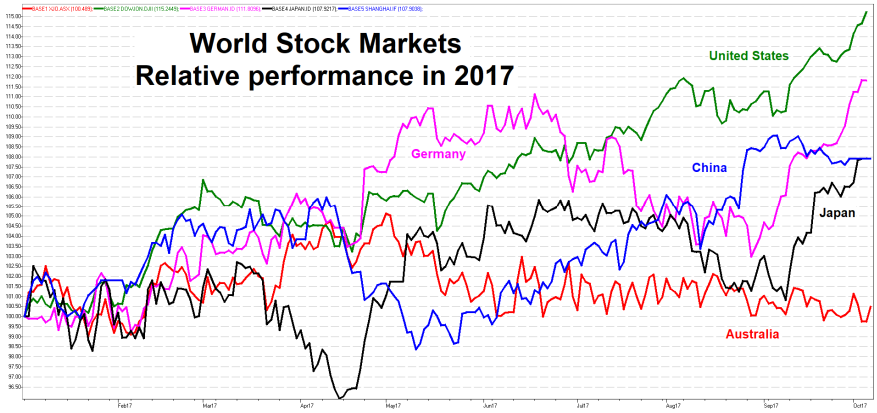
Australian shares continue to benefit from very low prevailing interest rates, and with some prices a bit lower, the investment outlook is slightly more appealing. Consequently, we plan to gradually apply some portfolio cash to new blue-chip investments such as shares in Amcor and Boral, each providing exposure to economic sectors currently underrepresented in our portfolio, and each with global operations. We also believe that some stocks within the real estate sector have become better value, as this sector has fallen sharply of late. Scentre Group, the domestic owner of the Westfield malls is a good example, having fallen by about 20% since their 2016 peak and now offering a distribution yield of more than 5%.

Global Shares

Stock markets in most major markets have been surprisingly strong in recent months, having been buoyed by a combination of ultra-low interest rates and some tentative improvement in economic activity. US prices were particularly strong, however local investors missed some of this gain due to

the rising Australian dollar. The strong performance overseas, and the weak market domestically, has improved the relative value of Australian shares as we look to 2018.

In our managed global portfolios, we have raised the cash component progressively during 2017, mostly by exiting some US stock exposure and have tactically shifted weightings towards European and Asian markets. We are inclined to retain a high cash component for a while, believing that better-priced new investment opportunities will arise within the coming months.



Global markets will have a few headwinds to deal with in 2018. The most difficult of these could be the timing and pace of interest rate rises in the United States, and correspondingly the manner in which the European Central Bank and the Bank of Japan tapers their quantitative easing (money printing) programs. Furthermore, there are geopolitical matters ahead, including the Brexit negotiations, the election in Italy, Spanish secessionist concerns, and the increasingly belligerent rhetoric between the United States and North Korea.

It would be good if global markets were to continue to rise, but it is our expectation that they will not endure the recent pace, and that some volatility will return to markets, thereby presenting us with some new investment opportunities. The US stock market also has a valuation problem, that being the historically high price multiple, when referenced to more normal interest rate settings, and this might contribute to some downside risk, particularly if then much vaunted Trump tax cuts don't eventuate, or if corporate profit growth fails to meet expectations.

Property Securities

The Real Estate Investment Trust (REIT) sector of the stock market was the hardest hit during the global financial crisis, as a consequence of too much debt, but subsequently staged a strong recovery between 2012 and 2016. Security prices in 2016 had become a bit stretched, due to rising underlying real estate valuations and very low interest rates.

REIT prices have declined since their July 2016 peak, in some instances very sharply. For example, Westfield is down by 30%, Scentre Group down by 25%, and BWP (Bunnings) down by 20%. Thankfully, income distributions have lessened this disaster. The interesting aspect is that these declines have occurred despite concurrent real estate valuations rising – clearly the stock market has adopted a negative forward view of the property market.

The brunt of the REIT decline has been felt by the retail shopping centre sector. Investors have been fretting about the Amazon effect, that is the probable decline in landlord pricing power and tenant renewals caused by e-commerce attaining a larger market share. There is evidence of this emerging

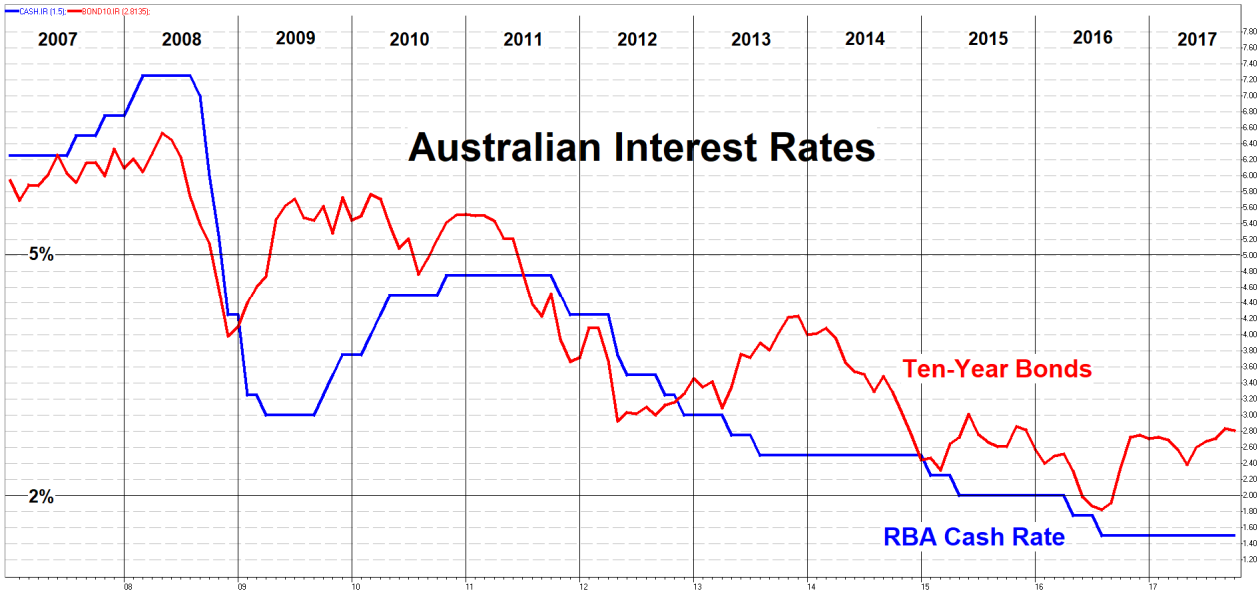
- witness the difficult trading conditions suffered by Myer and Target, for example, or the recent bankruptcy filing in the US by Toys R Us, and the store closures by Macy's and J.C. Penney. Nevertheless, the security prices of most REIT's have now declined to approximately the equivalent of their underlying net tangible asset value, so the sector is no longer expensive and now represents a better value investment proposition.

Within our managed REIT portfolios, we are now using some of the excess cash to top-up investments in some of the better-quality securities, such as Scentre Group and GPT Group.

Interest Rates

The Reserve Bank of Australia (RBA) has held the cash rate at 1.5% for 14 months now, an unusually long time without an adjustment. Their economic outlook rhetoric has tended to become more positive, which would infer an impending rate rise, but clearly, they have equally strong concerns about the degree of domestic household indebtedness, and weak wage growth, and the negative affect any rate rise might have. Consequently, they continue sitting on their hands, and are holding rates at what they call an 'emergency' low setting. That our Central Bank feels the necessity to maintain an 'emergency' rate setting is somewhat concerning, and a little confusing too, as they have also been musing about commencing an interest rate normalisation program, targeting a gradual return to a 3.5% cash rate.

Australian longer-term interest rates remain in the 2% to 2.5% range for five-year securities, and just a bit higher for longer dated maturities. The yield curve, the difference between short and long-term rates, has shifted a bit positive as very long-term rates have crept up a bit.



The components of our fixed interest portfolios are mostly shorter duration securities and deposits, as longer dated instruments have more price volatility risk. Term deposit rates remain stable at about 2.6%, and continue to offer a very safe investment. Major bank and corporate income securities offer a yield enhancing alternative, but have market price and capital structure risks that need to be carefully

considered. Corporate bonds represent a good compromise, generally less risky than hybrid investments, but with a higher interest rate than cash deposits.

The Australian dollar caught an uptrend recently, primarily due to a weakening US dollar and slightly better commodity prices. The trend for our dollar lacks any real momentum, as inflation remains low, commodity prices have stopped rising and our terms of trade is fairly stable.

Outlook

The international investment outlook remains a bit clouded by a combination of full-valuations, below-trend economic activity, and the risk-effect of a trend change in interest rates. Consequently, we are retaining a relatively defensive position in our global share investment portfolios. Domestically, the Australian stock market has drifted a bit lower, but this underperformance has improved valuations such that we are inclined to modestly increase local investments during the final quarter of 2017.

Economically, there are more negative than positive signals globally, which collectively have led to the maintenance of very low interest rates and slack industrial and economic growth data. Interest rates will remain low but share prices, which have had scant volatility of late, will likely be a bit more unpredictable in the coming months.

Yours sincerely,

Malcolm Palmer
Joseph Palmer & Sons