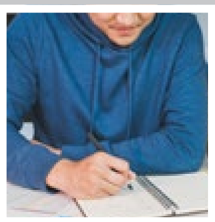
WATERHOUSE
WEALTH MANAGEMENT PTY LIMITED

Quarterly

AUTUMN 2019

INSIDE:



A checklist for a healthy financial year
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DNR investment review

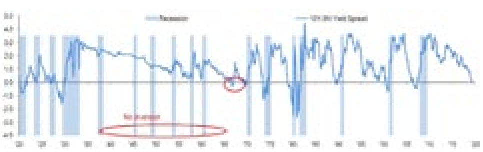
This month we discuss the implications of the bond yield inverting, which is often a signal for potential recession, and our portfolio positioning in response to this. The markets have enjoyed a strong quarter, yet market nervousness remains. Stocks with reliable earning streams continue to be very well supported.

BOND YIELD INVERT SIGNALS POTENTIAL RECESSION

The inversion of the bond yield is where the 10-year bond yields trade below short-term interest rates. US 10-year treasury yields have fallen to below 2.4%, the lowest since December 2017, and Australian rates have largely followed suit, now at an historical low of 1.78%. While yield curve inversions have been a leading signal in the last seven recessions in the US, not all inversions eventually lead to recessions-Australian yields have inverted three times since the last recession.

While investor concerns over these moves are understandable given the strong link between inversion and subsequent recession, in three of the last ten instances when yield curves inverted there was no recession over a subsequent two-year window. We will discuss in detail whether the yield curve inversion is 'different this time', and our response to the move.

Yield curve



Note: Recession bars based on the NBER's Business Cycle Dating Committee's chronology of the US business cycle. Average monthly yield except the last data point (26/3/2019). Source: J.P. Morgan US Equity Strategy and Quantitative Research, Bloomberg

ASPECTS OF THIS CYCLE REMAIN UNUSUAL

While a negative yield curve has been a strong signal in the past and clearly needs due consideration, many aspects of the current cycle are unusual and therefore we believe need to be interpreted with some caution. Inflation remains low and quantitative easing (QE) means the market does not have a clear understanding of the neutral interest rate environment. Perhaps the market's previous interest rate expectations were too high?

The 10-year bond yield is made of future interest rate expectations and a premium for the risk of holding for 10 years. This premium is at a record low level (and in some cases negative), reflecting global demand for defensive assets (possibly a continuing impact of QE). The US Federal Reserve (the Fed) balance sheet has dropped from a peak 25% of gross domestic product (GDP) to 19%, but the balance sheet of the G4 nations has dipped only marginally from 37% of GDP to 36%.

Even in those instances where yield curve inversions did predict a recession, the range of lead times between the inversion and the subsequent recession is quite large (between 8 and 22 months). Further, this lead time is typically prolonged during periods of muted inflation.

THIS TIME IT IS DIFFERENT

It is always dangerous to assume it is different this time but nonetheless we highlight a range of areas that suggest some caution in interpreting the current yield curve.

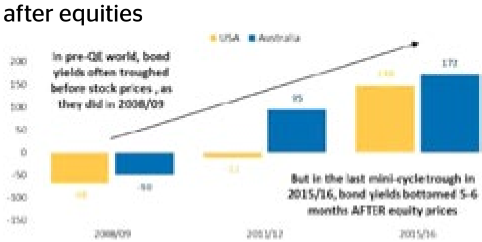
Falling long-term rates have been the driver more than rising short-term interest rates. During previous late-cycle episodes, concern about the Fed over-tightening has tended to push front-end yields higher. In each of the episodes of curve inversions since the late 70s, two-year rates have risen an average of 160bps in the year prior to the inversion, while long rates have risen an average of 70bps. The current episode is unusual in that short rates are largely unchanged. Typically, this sort of 'bull-flattening' is usually a net positive for risk assets.

US yields

Source: Goldman Sachs Global Investment Research, Haver

Furthermore, it is not necessarily clear that bond investors would have greater insights than other markets. In 2007/08 the problems in the US originated in credit markets and credit spreads blew out as short-term interest rates were increasing. Recently, the market has been focused on growth (or lack of it) as a driver of markets. Perhaps equities have had better insights in this regard as noted in the chart below.

Days long bond yield troughs before/after equities



Source: Macquarie Securities Research

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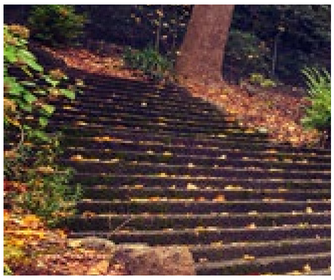


Housing prices go up and down, but your emotions don't have to

Until recently, Australian house prices have marched upward so steadily that buying a house, while pricey, was rather predictable. That perception changed over the last year, as house prices fell 8.1% in Sydney and 5.3% in capital cities. It's a healthy reminder that whether you are buying or selling, real estate, like any investment, can be volatile.

Australians have been conditioned to think of a house as an investment, but for most people buying somewhere to live is more of a practicality and an expense. We often forget that because rising property markets have the same effect as rising share markets, they focus people's minds on gains and can cause them to overlook costs. Costs, however, always matter. It's an eternal truth, whether you're talking about your super fund or that charming cottage overlooking the bay.

Of course, charming cottages overlooking the bay have an emotional pull that, say the ASX 200, does not, so before diving in, take a step back to consider what you really want out of a home.

Owning property should perhaps not be your goal in and of itself. Having shelter that meets your needs within your budget is perhaps more sensible. Buying a house you can barely afford may only achieve the goal of keeping you up at night.

So before you go surfing on real-estate sites, take some time to plan how you want to live. How much space do you need? Owning may make more sense than renting for a family with children because large rental options can be hard to find, for example. How do you prefer to commute? If you don't like to drive, getting a smaller place that costs more but is near your city job may be the way to go.

As you think about costs, some consideration should be given to the things that are hard to quantify in your decision. For example what is the lack of maintenance costs on a property worth, versus the peace of mind you might gain from not having to worry about a landlord moving you out of your rental property.

Most costs, however, are more concrete. Australians are fond of saying that rent money is dead money, but so is mortgage interest paid to the bank. Just 4.5% interest paid over 25 years on a $400,000 loan adds up to about $267,000.

A host of other one-time fees — stamp duty, conveyancing fees, legal costs, search fees, pest and building reports — add up to tens of thousands of dollars, although first home buyers get a break on some of them.

And then there are the ongoing costs, such as maintenance, council and water rates, insurance and, in some cases, body corporate fees. If you rent and have the discipline to invest the deposit you would have put towards the house and the cost savings, you could well generate a higher return than you would buying a house, according to Morningstar.

If you don't have the discipline to invest the difference, maybe the forced savings of owning a home is the right option for you. The key is to chart a path toward your own individual goals rather than slavishly follow the ups and downs of the housing market.

Keeping up on your super contributions during volatility

After a downturn in share prices and higher market volatility, many super fund members may think twice about continuing to make voluntary contributions. In contrast, compulsory employer contributions power on – regardless of prevailing market conditions.

Members who ease back on their voluntary contributions may be acting against their best long-term interests, depending upon their circumstances.

By adjusting their super contributions in reaction to share-market movements, super fund members are attempting a form of market-timing – that is attempting to pick the best times to invest or not invest. As Smart Investing periodically comments, even experienced market professionals rarely succeed consistently at market-timing.

The rewards of maintaining voluntary contributions throughout the ups and downs of markets include: continuing concessional tax treatment, compounding long-term returns, sticking to your long-term investment strategy and paying less for shares after prices have fallen.

And perhaps most importantly, members who keep up their voluntary contributions are taking a disciplined, non-emotional approach to investing.

DOLLAR-COST AVERAGING

Super fund members having contributions regularly paid into their diversified super accounts are practising a form of a disciplined investment strategy known as dollar-cost averaging.

Dollar-cost averaging simply involves investing the same amount of money into, say, shares or broadly-diversified managed funds at regular intervals over a long period – no matter whether market prices are up or down.

Under a dollar-cost averaging strategy, investors automatically buy more, say, shares when prices are lower and fewer when prices are higher. This averages the purchase prices over the total period that an investor keeps investing.

Yet the main attribute of dollar-cost averaging is not so much the price paid for securities. It is the adherence to that disciplined, non-emotional approach to investing that is not thrown off course by prevailing market sentiment and higher volatility.

Practising dollar-cost averaging through contributions super provides a ready, easy-to-use means to make regular investments into the super portfolio of your choice. Simply inform your employer that you want to regularly make salary-sacrificed contributions.

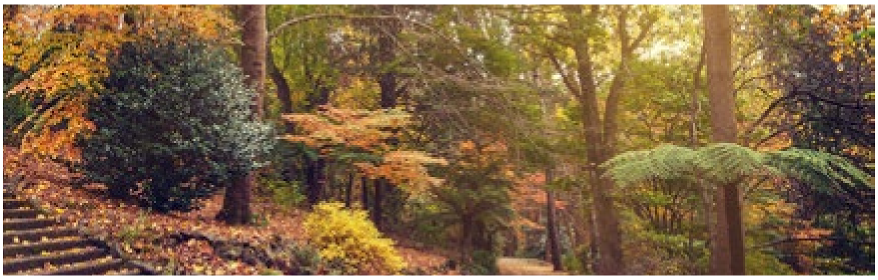
TAX CUSHION

Significantly, the tax benefits of salary-sacrificed contributions can help cushion your investments from the impact, on paper at least, of a downturn in market prices. This is because these so-called concessional contributions are made in pre-tax dollars and subject only to the standard 15% contributions tax.

Yet the same amount of money invested outside super would have been first subject to pay-as-you go tax; typically meaning that less is left to invest. With more money initially invested, fund members are somewhat cushioned from a downturn in prices.

DIVERSIFICATION CUSHION

Keep in mind that most super fund members are investing in diversified portfolios. This diversification typically cushions a member's super savings from the brunt of a turndown in share prices. And fund members can always choose, of course, to direct their new contributions into particular asset classes.



A checklist for a healthy financial year

A year may not seem like a long time, but a lot can happen in 365 days. Since last February, you may have changed jobs, received a raise, gotten married or divorced, brought home a baby or had one of your kids move out of home.

A yearly financial checkup can ensure that your financial plans are in tune with your life. It doesn't need to take long. You can do a big-picture review quickly and save follow-up tasks for later, start now if you have 15 or 30 minutes, or pin this list on your fridge or at the top of your to-do file to get 2019 off to a profitable start:

- Add up your assets, including your super and other investment and savings accounts, and your liabilities such as your mortgage or car loan. Can you access all those accounts easily? That is, do you know the account numbers for each and where the password is if you have online access?
- Figure out whether your net worth (assets minus liabilities) is growing or shrinking. Ideally, your assets should be growing and your liabilities shrinking. If that's not the case, figure out why. You may have a good reason, such as making a down payment for a house with a mortgage that increased your liabilities. But if the reason is not positive, decide whether you need to change anything to get those numbers heading in the right direction.
- Review big changes in the last year that may affect your finances. For example, if you got a raise, consider directing some or all of it into your super or another investment. If you had a child, you may want to start saving for university or review your insurance to determine whether your coverage is still appropriate. Do you need to change beneficiary designations on any accounts?
- Consider rebalancing your portfolio to make sure your investments continue to be aligned with your financial goals. Your asset allocation – the amount of your portfolio dedicated to shares, bonds and cash – should be diversified according to your goals, age and risk tolerance. The ups and downs of financial markets may put your allocations out of whack. Selling assets that have appreciated and reinvesting in those that have fallen in proportion to your overall portfolio can restore your desired allocation and reduce your vulnerability to a decline in a single asset class.
- Take a look at your budget. Is your spending aligned with your income and your personal goals? If you don't have a budget, create one. You don't have to track every gold coin unless you want to, just be sure you capture the majority of your expenditures. If you want help, you could try out some popular budgeting apps.

Now, make a list of follow up tasks, and you're on your way.

Articles on pages 2–3 from www.vanguardinvestments.com.au

DNR investment review

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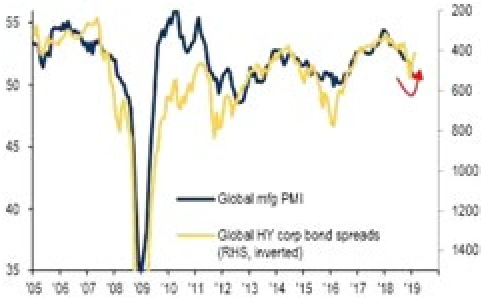
NOT ALL SIGNALS ARE NEGATIVE

Equities bottomed in December 2018, reflecting the slowdown in global growth, but have since run up on expectations that stimulus will improve economic activity.

Credit spreads have improved in contrast to the last cycle, suggesting greater confidence by credit markets in corporate solvency.

Credit spreads {inverted)



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, ICE

Commodity prices remain strong. Therefore, while the inverted bond yield is a negative indicator, other markets are not as negative. Given the added confusion in bond markets thanks to low inflation and QE we are reluctant to interpret the move too cautiously, especially when other signals are improving.

Copper

Source: IRESS

GLOBAL ECONOMY BEING STIMULATED

The US economy is currently not overheating, with inflation well contained. This suggests there will not be a sharp increase in interest rates. The Fed's real funds rate is also very low compared to the past (0.3 vs. 1.3, the average during past inversions). Usually in the tenth year of a cycle, wage and price inflation visible, possibly accelerating especially if unemployment rate is near record low level. Historically the Fed has hiked rates, on average (by 13bps, 50bps, 63bps and 138bps after one, three, six and 12 months) post the first inversion day in 10-year-three-month. In this cycle, the Fed is expected to keep rates on hold, or even cut rates over the next 12 months.

China is implementing fiscal and monetary policy to stimulate the economy, and this is beginning to be reflected in the data. Manufacturing data indicates expansion, and this is being driven by internal demand rather than in exports where it awaits a deal with President Trump.

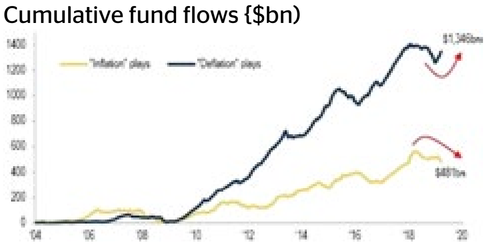
China manufacturing PMI

Source: Refinitiv, Markit, Credit Suisse research

FURTHERMORE, PORTFOLIO POSITIONING IS COMPLICATED BY HIGH PRICES FOR DEFENSIVES

Ordinarily, based on the bond yield inversion, we would position the portfolio in defensive assets. However, defensives are already trading at highs and as we have noted the bond inversion could prove to be misleading. Defensive stocks look expensive. Equities sold off aggressively in the December 2018 quarter and even though there has been a bounce, flows have remained elevated in these defensive stocks.

Cumulative fund flows {$bn)



Note: Inflation assets – European equities, Japan equities, EM equities, Materials, Energy. Deflation assets – HY corp bonds, IG corp bonds, REITs, EM debt.
Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

Article source: DNR Capital Pty Ltd

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