WATERHOUSE
WEALTH MANAGEMENT PTY LIMITED

Quarterly

SUMMER 2019

INSIDE:

Retiree self-protection: A volatility-and-downturn 'bucket'

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DNR investment review

Is this a buying opportunity?

Global equities were down 7.6% in December, driven by concerns of slowing global growth and the potential for a monetary misstep by the US Federal Reserve (the Fed). Australia was the best performing region, with the S&P/ASX 200 Accumulation Index ending almost flat at -0.1%. It has been a challenging few months for markets with the Index falling 9.8% from its peak reached on 30 August 2018, and finishing the year 2.8% lower. To put this in perspective, this is only the second negative return since the global financial crisis.

ASX200 returned -2.8% (total return), first negative print since 2011

Source: RIMES, Morgan Stanley Research

Interestingly it was less than 12 months ago that markets were focused on a synchronised global growth story. Sentiment now seems reasonably bearish, or cautious, and focused on a synchronised global slowdown. This is generally a positive indicator, albeit there has not been outright panic.

Macroeconomic and geopolitical risks remain challenging to predict (in particular, trade wars, China growth outlook, US recession potential, Brexit scenarios and Australian housing downturn). The global economy has slowed in the face of these factors over the past six months, leading to the potential inversion of the yield curve. A negative yield curve means bond investors are expecting a slowing economy, and historically it has often, but not always, been a leading indicator of recession. Markets appear to be focusing on all the negatives and quickly joining the dots.

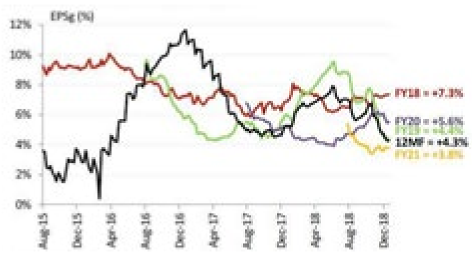
We remain constructive on the outlook. The US consumer fundamentals are healthy, and US lead indicators and manufacturing data are also positive. Furthermore, banks are well capitalised and the consumer in the US has less gearing. In China, there appears to be scope for broad-based easing, including further monetary easing. Earnings growth expectations in Australia appear modest with some small downside risk if housing deteriorates further (an RBA cut would be helpful).

Following the pullback, valuations are more reasonable, especially when compared to interest rates and bond yields. The S&P/ASX 200 is now trading on a 12-month forward price to earnings ratio (PE) of ~14x, a discount to the long-term average of ~15x, with consensus earnings growth expectations of ~6%.

ASX 200 – Latest: 14.1x

Source: RIMES, /BES, Morgan Stanley Research

Annual consensus EPSg Trends FY18-21



Source: RIMES, /BES, Morgan Stanley Research

We expect ongoing volatility, but are finding good bottom-up opportunities. Some of our strongest periods of outperformance have emerged from downturns as we use the volatility to add to positions held in quality businesses at attractive valuations. We have identified a number of high conviction ideas with significant excess returns on offer and have accumulated positions with active weights of 4% or higher. These stocks include Link Administration Holdings, Lend Lease, James Hardie Industries and Tabcorp Holdings.

Key themes for 2019

US AND CHINA TRADE WARS

Trade tension between the US and China is the largest source of uncertainty for financial markets. Financial markets enjoyed a brief relief following the G20 summit, with President Trump agreeing to postpone raising tariffs on Chinese imports by two months to March 1, and President Xi Jinping pledging to engage in substantive talks to open up the Chinese economy to US imports and addressing US concerns about forced technology transfers and intellectual property theft. While both sides have much to lose from an extended conflict, major hurdles remain for a trade deal that is palatable for both sides.

US ECONOMY: THE FED HIKING CYCLE AND BOND YIELDS

Assisted by fiscal stimulus and easing financial conditions, the US economy is on track to deliver its fastest pace of growth since 2004 (+3.3% GDP growth in 2018). 2019 is expected to slow to +2.3% (consensus) as fading stimulus, tighter financial conditions and slowing global growth act as headwinds. Nonetheless, ongoing fiscal stimulus, decent credit growth, rising wages and a decline in the savings rate should continue to support the economy. In our view, fears of an impending recession are overblown.

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DNR investment review

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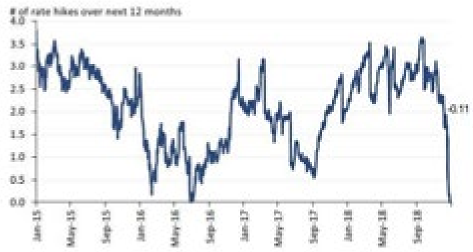
The Fed hiking cycle

As expected, the Fed delivered another rate hike on 19 December 2018 to a target range of 2.25–2.50%. Projections are now for two more 25 basis point hikes in 2019. However, the Fed's hawkish projections are at odds with signs of a slowing US economy with the Fed funds futures curve pricing in less than one rate hike in 2019, and rate cuts beyond then.

Pace of Fed hikes: Futures market pricing in change of Fed cuts



Source: Bloomberg, Morgan Stanley Research

This has added uncertainty to the outlook for global financial markets and was a key catalyst for the equity market sell-off in December. Importantly however, Chair Jay Powell and President and Chief Executive Officer John Williams have made it clear that Fed policy is not on a predetermined path and that it will take a patient approach to raising rates.

Bond yields

Global bond yields have rallied with yields falling >33bps in December (we also saw one part of the US yield curve inverting at the beginning of December). This was driven by a shortfall in inflation expectations (due to lower oil prices and slowing global growth). We believe that structural drivers are likely to push bond yields higher in the longer term. We are cautious on companies that trade on high PEs, have high payout ratios and high levels of gearing. These stocks benefited the most as bond yields fell and we expect will underperform as bond yields push higher.

CHINA OUTLOOK

The Chinese economy is currently enduring a slowdown, but to put this in perspective Chinese GDP growth is expected to slow from +6.9% in 2017, to +6.6% in 2018 to +6.2% in 2019. While there is potential for headwinds from US trade barriers (exports to the US currently account for 4% of China's GDP), Chinese policymakers appear willing (financial support for small businesses, cuts to interest rates on SME loans and accelerated mixed ownership reform). If Chinese growth is to rebound, domestic demand will need to reaccelerate. There appears to be scope for broad-based easing to stimulate growth and liquidity conditions (including further monetary easing).

BREXIT SCENARIOS

UK Prime Minister Theresa May survived a leadership contest, but was forced to announce that she will step down before the 2022 election. Both UK bond yields and the British pound fell sharply in response to the government's delay to a parliamentary vote on the Brexit deal. There is still significant uncertainty for May's plan to navigate towards a 'soft Brexit', although UK-exposed stocks seem to be already pricing a 'hard-Brexit' scenario. If a failure to negotiate a deal (either with the EU or her own party) leads to an early election, the potential for a Labour government under Jeremy Corbyn is a negative scenario not currently priced into UK-exposed stocks.

AUSTRALIAN ELECTION OF THE AUSTRALIAN LABOR PARTY (ALP)

An election must be held by 18 May 2019. While an ALP victory appears likely (betting markets now imply an 88% probability of an ALP victory), we note that the 2016 election was only decided by a shift in opinion in the final month and that the Coalition government is likely to try and win votes with its 2019 budget (i.e. tax cuts, public/ infrastructure projects, funding for health and education). Nonetheless, below we outline key ALP policies and the likely impact for investors.

Franking

- Franking scale-back would largely return the franking system to the pre-2000 system where excess franking credits were not refundable.
- This would most likely negatively impact individuals on low taxable incomes receiving franked dividends and ~200,000 SMSFs.
- However, the near term return of franking credits may be attractive in the form of special dividends or off-market buybacks, for example Woolworths Group and Wesfarmers.

Capital gains tax

- The ALP has promised to reduce the capital gains tax discount for assets held longer than 12 months to 25% from 50% (for small businesses and individuals). Existing assets will be grandfathered.
- This policy may result in a bring forward of stock/asset purchases to take advantage of the grandfathering.

Negative gearing

- The ALP plans to retain negative gearing (in its current form) for new housing only.
- As such, negative gearing losses for other assets will only be allowed to be deducted against investment income and capital gains.
- We expect the ALP to be sensible about when it introduces any changes to mitigate any further negative impact on property prices.
- However, a less attractive tax regime is likely to weigh on investor lending and property prices.

Support for low income earners

- The ALP is promising to protect penalty rates and future policies are likely to be supportive of low-income earners.
- The ALP is also proposing to reinstate the budget deficit repair levy of 2% for those on incomes in excess of $180,000.
- This will be positive for companies with end markets that include low income households like Tabcorp Holdings and Caltex Australia.

Healthcare

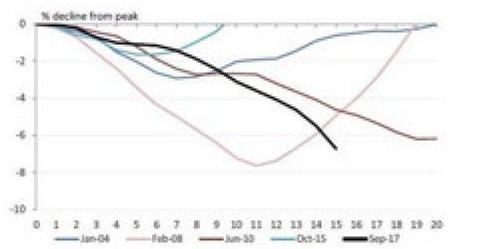
- The ALP is proposing to cap the increase in private health insurance premiums (~2% average), which will be detrimental to health insurers and private hospitals.
- The Victorian ALP has already promised to fund 345 new public hospital beds, also detrimental for private hospital operators.

IMPLICATIONS OF AN AUSTRALIAN HOUSING DOWNTURN

While the Australian Prudential Regulation Authority (APRA) recently removed the 30% benchmark for interest-only housing lending, we do not expect this to noticeably ease tight credit supply.

National house prices were down 6.1% during 2018 and are now down 6.7% from their peak. House prices in Sydney are down 11.1% from their peak.

House prices have now fallen further than the 2010/11 downturn



Source: Corelogic, Morgan Stanley Research

With housing sentiment low and household deleveraging likely, the risk is that there is a broader economic impact resulting from the correction. The wealth effect has already been seen on high-value items (e.g. car sales are down 15% yoy).

Article source: https://dnrcapital.com.au

Retiree self-protection: A volatility-and-downturn 'bucket'

BY **Robin Bowerman**

The latest fall in share prices close to the 10-year anniversary of the global financial crisis (GFC) is likely to prompt more retirees and near-retirees to think about creating a volatility-and-downturn cash bucket.

This is a straightforward strategy intended to reduce the possibility of retirees – particularly those with many years of retirement ahead – having to sell investments at depressed prices to maintain their income in the event of an extended future downturn.

WHAT IS A VOLATILITY-AND-DOWNTURN CASH BUCKET?

Retirees and investors approaching retirement often set aside about two to three years of living expenses if possible in a volatility-and-downturn cash bucket. This provides a buffer against being forced to sell assets at the wrong time, which may cut the expected longevity of a portfolio and its ability to produce enough future growth.

In a recent commentary, actuaries Rice Warner emphasises how disciplined investor behaviour is critical to handling a sharp fall in share prices and how a cash bucket can assist them to remain disciplined.

There is typically a close link to market behaviour and investor behaviour. (Regular Smart Investing readers may have read our past discussions of these buckets.)

"The behaviour of stock markets is unpredictable as sentiment big part in short-term price movements," Rice Warner comments. "When people are upbeat about the economy, prices often rise exuberantly; when the market turns down significantly, it is usually fast and without notice.

"So, while we can say that investment markets," Rice Warner adds, "follow a cyclical pattern, no one can predict when the market will rise or fall. We also know that markets usually recover their losses over time, sometimes quite quickly."

And as the commentary says, the impact of a market downturn could be magnified for investors who "lock in losses by moving into more defensive strategies [such as switching to all-cash portfolios] at an inopportune time".

WHEN AND HOW CAN I CREATE A CASH BUCKET?

Investors often begin to build-up a cash bucket or buffer in their last few years before their planned retirement. For instance, some investors direct a proportion of their super contributions from their last few years in the workforce into a cash bucket within their super funds.

Other opportunities may arise to create a cash bucket including, say, an inheritance or the sale of an investment property. Some investors will simply increase the asset allocation to cash in their super funds – perhaps when periodically rebalancing their portfolios.

HOW BIG SHOULD I MAKE MY CASH BUCKET?

While investors often set aside two to three years of living expenses in their volatility-and-downturn bucket, the size of the buffer and how it is built-up will depend on such personal circumstances as the size of an individual's retirement savings, age, investment timeframe and perhaps professional advice. When determining the size of your cash bucket, keep the age pension in mind if applicable.

HOW CAN I TOP-UP MY CASH BUCKET?

Some investors direct a proportion of unspent income from their main diversified portfolio, such as a balanced or growth super fund, to top-up their cash bucket from time to time – particularly during stronger-performing years. And proceeds from regular rebalancing of an investor's main diversified portfolio can provide top-up money.

Article source: www.vanguardinvestments.com.au

Handy tips for travelling overseas

BY **Financial Writers Australia**

Even for seasoned travellers there's a little bit of magic involved in hopping on a plane in Australia today and disembarking in a far-off destination like Istanbul or London tomorrow. For most people their travels will be a safe and wonderful experience, but things can go wrong. While you can't control everything, a little bit of preparation can help to create cheerful memories.

- Let's start with something most people don't associate with an overseas holiday – make sure your Will and powers of attorney are up to date and your executor and/or attorney know where to find important information. If there isn't anyone that holds your power of attorney, consider appointing one before you leave. This can either be an enduring or a limited power of attorney.
- Prepare a list of your accommodation details including addresses, phone numbers and dates. Place a hard copy in each of your bags and give copies to your travelling partners, including any accompanying children. It may help to reunite you with lost bags or lost companions, but is perhaps most useful when giving directions to taxi drivers. Showing them the written address avoids the inconvenience and expense that occurs when mispronunciation or a misunderstood accent delivers you to the wrong hotel.
- Most of us rely on our phones to look after our contacts, so who could you get hold of if you lost your phone? Take hard copies of your key contacts list, including family members, travel insurer, credit card and travel card providers, banks, airline, and travel agent. Give a copy to your attorney or executor. It's also a good idea to back up your phone to your home computer before you leave. If you do lose your phone you can upload everything back onto a new one upon your return.
- Split cash, credit cards and travel money cards with your travelling companions. If travelling alone, consider taking two wallets (in separate bags or keep one in the hotel safe), so you have backup cash and cards if a wallet is lost or stolen.
- Security screening, which now can include full body screening, can be intimidating and seem intrusive, but it's there to make our travels safer. Follow your airline's instructions on what can be taken in hand luggage otherwise certain items will be confiscated. Remove even the smallest items from your pockets, and if you want to keep your water bottle, you may have to empty it before screening. Be prepared to put your phone, wallet, watch, small change, belt and, in some cases, your shoes into the tray for x-ray scanning. You also have to remove your camera, laptop or tablet from hand luggage before it is scanned. This all takes time so allow for it before boarding.

- Attracted by the beauty of Venice or Dubrovnik? So are several million other people. Crowds provide an ideal operating environment for pickpockets. So does public transport. In such situations stay alert to what's going on around you. If you're carrying a backpack, maybe wear it on your front. You don't need to lock all the zips, perhaps tie them together with twist ties to slow down entry. This also can deter the unscrupulous from adding stuff without your knowledge. Wear shoulder bags diagonally across the body so they can't simply be slipped off your shoulder. And choose bags with slash-resistant straps.
- While credit cards are widely accepted, smaller restaurants may only take cash. If you're relying on plastic to pay for a meal, check that cards are accepted before you sit down.
- Do not use internet cafes or public Wifi to access your bank accounts. If you use these services to access social media, don't save your login or password or any other personal information on the computer. These connections are never 100% secure.

Of course the aim is to travel with confidence and wonder, not fear. The purpose of these tips is to help build that confidence because when you're fully prepared it's easier to sit back, let your adventure unfold, and allow yourself to be touched by the magic of exotic destinations.

Article source: https://financialwriters.com.au

Meet Yuliya Ryan – Wealth Management Administration Officer

We are very pleased to welcome Yuliya Ryan to our team at Waterhouse Wealth Management. Yuliya is the administrative hub of our Wealth Management operation. She holds two degrees: a Bachelor in Business Informatics from Moscow and a Master of Professional Accounting from the Holmes Institute in Sydney. Born in Belarus, she moved to Sydney in 2011.

Yuliya loves the variety that working with Waterhouse Wealth Management clients brings. She embraces new challenges and thrives on learning different aspects of our rapidly changing business environment.

Yuliya enjoys outdoor pursuits particularly snowboarding and is a regular visitor to the local gym where she challenges herself with different strengths and endurance exercises. She packs all this in whilst raising two children.

The addition of Yuliya brings our Wealth Management team to three, and allows us to enhance the offering that we are able to provide to our clients. We are looking forward to a successful 2019 working with you.

- Mark Waterhouse: Principal/Adviser
- Samantha Lecky: Paraplanner/ Client Service Manager
- Yuliya Ryan: Administration Officer

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