WATERHOUSE
WEALTH MANAGEMENT PTY LIMITED

Quarterly

SPRING 2019

INSIDE:

DNR investment review

BY **Jamie Nicol**

This month we review the shift that has occurred in the market and analyse the potential for the rotation to continue.

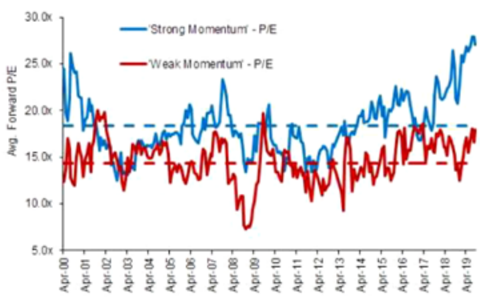
September saw a rotation from momentum to value. For the past year momentum has been with defensive and growth stocks. Sectors like health, information technology and REITs have struggled during September while resources, banks and energy stocks performed better. Our portfolios outperformed during this rotation.

Performance index

Source: Goldman Sachs Global Investment Research, FactSet

Despite the rotation, momentum stocks are still trading at high valuations, which suggests the rotation can continue should external events continue to be supportive.

Momentum valuations



Source: Goldman Sachs Global Investment Research, FactSet

A key factor driving momentum stocks has been the outlook for the economy and interest rates. The difference between the current market and the market prior to the GFC is that the high valuations ahead of the GFC were in cyclical stocks. A high degree of optimism meant the market was paying too much for diversified financials and resource-related stocks. Profit margins were very high in these sectors, yet defensive names offered relative protection.

The past decade has been an odd bull market. Driven by quantitative easing and low interest rates, nervous investors have gravitated to defensive and growth companies in an uncertain world. Stocks with perceived risks or cyclical exposure are trading cheaply. A rotation to these stocks would likely accelerate if the market becomes convinced that the recent economic softness is turning. We have seen stimulus in the form of lower interest rates across the globe and some modest fiscal stimulus in some markets.

We would not be surprised to see these efforts accelerate if the current economic climate remains subdued, albeit the political climate is making decisive action difficult. Furthermore, uncertainty regarding Brexit and trade wars has had a negative impact on business confidence.

Continued on page 3

Rumble or roar: the future for global equity markets

In the first of two articles, we look at three possible scenarios that could unfold in global equity markets over the next five years – are the roaring 20's upon us, or is there reason to tread more carefully as we head into the next decade?

KEY POINTS:

There are three main possible outcomes in markets over the next few years: a recession, the bull-market continues or the status quo.

Money supply and the cost of money is a big driver of equity markets – and this is one reason why they made such strong progress in the first half of 2019.

Assuming no major recession in the next five years, the most sensible prediction for equities is that they perform in line with company profits growth; modest but positive.

LOOKING BACKWARDS TO MOVE FORWARDS

Past performance is not indicative of future returns, but lessons can be learned from historic market events to help investors to take a forward-looking view. The last few years have been good for equity investors – it's been a bull market and one that has been led by the US.

Since the start of 2012, the US market (S&P 500 Index) has more than doubled (up approximately 170%, including dividends), while the MSCI All Countries World Index is up 75% (around 110% on a total return basis) in US dollar terms1. Valuations have not changed that much, which means that the world, as a whole, is valued (against the current earnings base) at roughly the same level as it was five years ago. Technology has produced the best earnings and the best performance but has become more expensive. Conversely, slower growth areas (financials, industrials and materials) have become cheaper.

More recently, fears of impending recession have caused more money to move into perceived lower-risk high quality companies. The premium for "quality" has risen to levels never seen before, particularly in Europe.

WHAT DOES THE NEXT FIVE YEARS HOLD FOR EQUITY MARKETS?

Given that markets are not that far from long-run average valuation levels in relation to current earnings (and are cheaper than 30-year averages on free cash flow valuation), probably the most sensible prediction s is that equity markets perform in line with company profits growth. This will be fairly modest but should be positive if we assume no major recession in the next few years.

The longer one's time horizon, the more important earnings growth is in explaining market moves. However, over shorter periods, other factors introduce greater volatility that overwhelms the impetus from earnings (in either direction). In particular, money supply and the cost of money is a big driver – and this is one reason why markets made such strong progress in the first half of 2019.

IT IS HELPFUL TO CONSIDER THREE POSSIBLE WORLD SCENARIOS FOR THE NEXT FIVE YEARS.

Under the first, we see recession and a fall in corporate profits. Under the second, markets rise significantly on a combination of higher earnings and higher valuations. Under the third, there is little if any earnings growth and markets stay roughly where they are. Whilst the middle path is the one that seems to make most sense to plan for, it appears that the "melt up" scenario is more plausible than the "collapse" case.

SCENARIO 1: RECESSION?

Although it is difficult to quantify the risks of a major geopolitical incident, a significant economic downturn seems unlikely in the next few years. In the past, classic recessions were caused by overinvestment and declining industrial returns but there is no evidence that economies have been adding too much capacity. (Indeed, healthy profit margins in many industries are evidence of this.)

Equally, a recession caused by a stressed banking system seems also highly unlikely given that around the developed world banks have rebuilt capital and a large part of the riskier assets have been removed from balance sheets and are now held by hedge funds and other investors.

A more likely recession scenario is the "Japanese style" recession that we have seen a number of times in the past 30 years. These are short-term downturns, often caused by industrial inventory cycles, that are met with monetary stimulus and government spending initiatives. This can lead to opportunities to pick up oversold stocks at the gloomiest moments.

SCENARIO 2: THE BULL MARKET CONTINUES?

As monetary policy remains loose (and may ease further) and it is highly likely that governments will step up spending to mitigate economic softness, there is a reasonable chance that markets rise to higher valuations. After all, the last five years have seen markets rise despite investors taking money out of equity mutual funds.

Now that equities provide a dividend yield that is significantly higher than government bonds and offer some potential inflationary protection, maybe investors will allocate more to equities in the next five years. A major "melt up" in markets cannot be a central case but could be argued to be at least as likely as a major correction.

SCENARIO 3: STATUS QUO?

In the more likely scenario of low global growth (lower than the past few years due to geopolitical and trade uncertainty), earnings can be expected to grow at a modest pace. Free cash flow is a positive and should continue to drive share buybacks which in turn augments underlying growth in earnings-per-share.

In this relatively low growth scenario, we should also expect periods of volatility in markets. Rather than trying to avoid them entirely, we should be ready to look for opportunities that will be thrown up along the way.

In part two of this piece we outline six key themes that we believe investors need to consider over the next five years and discuss how these issues could shape and impact market leadership from here.

Article from Fidelity

WATERHOUSE
WEALTH MANAGEMENT PTY LIMITED

Love and loans

Has a family member or friend asked you to be a 'co-borrower' or guarantee a loan for them? Before you say yes, think carefully – you could lose not only your money, but valuable assets such as your house or car.

WHAT IS A GUARANTOR OR CO-BORROWER?

- **Co-borrower:** You are a co-borrower if you sign a loan with someone else. In most instances both you and the other co-borrower are jointly and individually liable for the debt. If the person you borrow the money with is unable to pay their share of the loan, you will be responsible for repaying the full amount outstanding.
- **Guarantor:** If a credit provider is not willing to give a loan to a person on their own, they may ask for a guarantee. If you sign a guarantee for a friend or family member, you are known as the 'guarantor' of the loan.

When you sign your name as a guarantor, you are legally responsible for paying back the entire loan if the other person cannot or will not make the repayments. You will also have to pay any fees, charges and interest.

As a guarantor you don't have the right to own the property or items bought with the loan.

REASONS YOU MIGHT HAVE TO SAY NO

Think very carefully before guaranteeing a loan. Is there another way you could help without becoming a guarantor? For example, could you contribute to a deposit so that a guarantee is not needed?

Consider how you will pay back the loan if your friend or family member can't. Can you afford the repayments? Do you have savings you can use or assets you can sell to pay the debt? If you do have to use your own money or assets to pay off someone else's loan, you could be risking your financial future.

What about your relationship with the borrower if something goes wrong? It may be better to say 'no' now and avoid damaging your friendship.

THE EFFECT ON YOUR FUTURE LOANS AND CREDIT REPORT

You will need to tell your credit provider about any loans you are a guarantor for, when you apply for credit. They may take into account the loan repayments on the loan you have guaranteed when they assess your ability to repay a new loan. This may stop you getting a new loan even if the person who's loan you are guaranteeing is making the repayments.

You may end up with a bad credit record if you and the borrower can't pay back the guaranteed loan. The loan will be listed as a default or non-payment on your credit report, making it hard for you to borrow money for several years.

You may also affect your credit score, a number based on an analysis of your credit file, at a particular point in time, that helps a lender determine your credit worthiness.

If you provide security, such as a mortgage on your home, to guarantee someone else's loan, you may not be able to use your home as security for your own loan. You may even end up losing your home if you don't pay out the guaranteed loan.

You may also be made bankrupt by the credit provider. Even assets you haven't offered as security for a guarantee may then be sold to pay the outstanding debt.

CASE STUDY: CONNIE GUARANTEES A BUSINESS LOAN FOR HER SON

Connie's family ran cafes for years until her late husband became too ill to work. Her son Leo grew up working for the family business, and Connie thought he could make a go of it. But she didn't know he had a gambling problem.

Continued on page 4

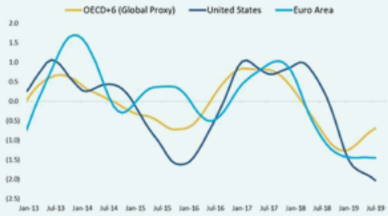
DNR investment review

Continued from page 1

At the beginning of the year the market was complacent regarding the trade war risks, but now there is little expectation of a resolution, the balance of risk is weighted to the upside in the event that there is a resolution.

Nonetheless, economic data remains mixed. We are seeing some positive lead indicators emerge but manufacturing remains soft. Consequently, maintaining some balance across the portfolios continues to make sense.

OECD leading indicators



Source: Macquarie Research

At present we are performing better as the market rewards value. In September we have reduced our position in the banks, which balances out our underweight to bond proxies. The outlook for bank earnings in a low interest rate environment is poor.

In addition, other business lines like forex, credit cards and payments face pressure. Banks have bounced since the election as the fear of a deterioration in housing eased.

Valuations do not appear particularly attractive although the dividend yield will retain attraction for some investors. We see earnings declining over the next three years and this might place downward pressure on dividends.

We have added to our resource position given recent underperformance has improved relative attractiveness.

Article from DNR Capital

Love and loans

Continued from page 3

A few months after Connie guaranteed a business loan for him, Leo fell behind in his repayments. Then he was evicted from the cafe for not paying rent. She asked relatives to contribute to Leo's repayments but even with their help, there was not enough money to pay off the debts.

The bank and landlord contacted Connie to pay back what was owed. Connie is talking to the bank about repayment arrangements, including postponing enforcement proceedings, but is resigned to the fact she may have to sell the family home to pay off Leo's debts.

QUESTIONS YOU MUST ASK BEFORE YOU SIGN THE LOAN

Before you guarantee a loan, ask the credit provider the following questions.

- **What type of loan am I guaranteeing?** Be very careful about guaranteeing a loan that has no specific payback time, such as an overdraft. This kind of loan could potentially go on forever.
- **What should I check if I am asked to guarantee a business loan?** Find out everything you can about the business. Ask for a copy of the business plan to understand how it will operate. It's also important to look at the business' financial state. For example, check past financial statements and speak to the business' accountant to make sure the company is in good financial health and has good prospects.
- **Is the guarantee for a fixed amount of money, or is it for the total amount owing?** You are better off guaranteeing a fixed amount because you will know exactly what you owe. If you sign a guarantee for the total amount owing, you will be legally responsible for what the borrower owes now and in the future. This could include interest, fees, charges and penalties. If you think there has been an increase in the amount you agreed to guarantee without your consent, seek legal advice straight away.
- **Exactly how much am I guaranteeing?** The guarantee should clearly describe how the amount of money you owe will be calculated if the worst happens and the borrower does not pay. If you are not comfortable with the amount, ask if you can reduce it.
- **Do I have to put up assets as security?** If the loan is not for personal, household or domestic purposes, you may be asked to put up an asset, such as your house, as security. This means the credit provider can sell your house to pay the debt if the borrower defaults on their loan.
- **What should the loan contract tell me?** Get a copy of the loan contract from the credit provider. It should tell you:
  - The amount of the loan
  - The interest rate, fees and charges
  - Whether the loan is secured (where the borrower has to put up an asset, such as their house, as security)
  - How long the borrower has to repay the loan
  - The amount of the repayments.

HOW TO GET HELP AND FREE LEGAL ADVICE

Never let a family member pressure or force you into signing anything. If you're feeling pressured, seek financial counselling – it's a free and confidential service.

You can also visit our webpage on financial abuse for some red flags to watch out for, as well as the contact details of organizations that can help you.

If a large amount of money is involved, talk with a lawyer or get free legal advice so you understand the risks you are taking on.

CHALLENGING A CLAIM

In certain situations, guarantors may be able to challenge a claim even though they have signed contracts.

You should get advice immediately if you:

- Only agreed to sign through pressure or fear
- Suffered from a disability or mental illness at the time of signing
- Did not receive legal advice before signing and did not understand the documents or the extent of the risk you were taking on; for example, you thought you were guaranteeing a certain amount but a much larger amount is now being claimed
- Believe the credit provider or broker used unfair tactics, or tricked or misled you.

WHAT TO DO IF A PERSONAL RELATIONSHIP BREAKS DOWN

A breakdown in your personal relationships affects every part of your life, including your finances. If you were a guarantor or co-borrower for your ex-partner, you may be liable for their debts if they can't or won't repay their loan.

In most cases, you won't be able to get out of loan contracts you made in the past, but speak to a lawyer or get free legal advice about where you stand. Also see divorce and separation and relationships and money for more information.

Stop and think before agreeing to be a co-borrower or to guarantee someone's loan. If they cannot or will not pay off the debt, you will be responsible for the debt. Take the same care that you would if you were taking a loan out for yourself.

Article from ASIC MoneySmart

With compliments from Waterhouse Wealth Management Pty Ltd

Head Office
Suite 12 Level 3, Gateway Building
1 Mona Vale Road
Mona Vale NSW 2103

T 02 8973 2222
F 02 8078 4040
E wwmadmin@waterhouseca.com.au
W www.waterhousewealth.com.au

WATERHOUSE
WEALTH MANAGEMENT PTY LIMITED

Waterhouse Wealth Management ABN 41 059 645 126 is a Corporate Authorised Representative of
The Advice Exchange Pty Ltd ABN 55 107 629 194 Australian Financial Services Licence No 278937
Registered Office: Level 2, 177 Toorak Road, South Yarra, 3141