HAMILTON
wealth management

Investor Insight 43 – January 2017, The Year ahead

Last month we published '**Hamilton Wealth Management, Investor Insight 42: the year that was**, reflecting on what shaped 2016.

This month we publish our outlook for the year ahead.

We referred to 2016 as the year bond values peaked.

In projecting a theme for 2017, we believe it will be the return of inflation. Monetary policy effectiveness is at its limit and economic growth globally is stubbornly low therefore engineered inflation appears to be the next roll of the dice.

We have used the word "cautious" a lot during 2016 as that has been our approach towards Asset Allocation and Asset Selection. While there are tentative signs of a pickup in global growth, looking ahead we continue to remain cautious. We will be particularly watchful of bond markets. If the bond selloff of the last few months were to accelerate again then this would be very troublesome for other asset classes, particularly equities.

We believe there is more bond weakness ahead but most the move has now occurred. Over the course of 2017 10 year US Treasuries may move up towards 3.50 per cent and 4.00 per cent by the end of 2018 from the current level of 2.44 per cent and 10 year Australian Treasuries may move up towards 3.25-3.5 per cent from their current level of 2.76 per cent. We believe the markets can absorb such a move *provided* it occurs in an orderly manner.

Geo-political developments will also be important in determining market sentiment in 2017. In the US, while the general thrust of Trump's domestic agenda seems clear the detail is still to be determined and on foreign policy and trade we can only speculate as to what the new administration will do. Elections in the Netherlands, France and Germany will be critical for determining future policy in those countries and the broader EU, and the UK will continue working through its Brexit process. China will be closely watched for further developments in the South China Sea and for its response to the Trump administration's foreign policy developments. This will have a flow on impact throughout the region.

Getting back to asset classes, it is important to consider how we position for the big picture.

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Our key assumptions for 2017 are:

Fixed Income

Fixed Income is primarily used in portfolios for defensive purposes, to control and reduce risk. Our concerns with Fixed Income arise from short term interest rates still being near global historical lows and bond markets having peaked. We will continue to support a low duration strategy.

In continuing to position portfolios for exposure to fixed income we have the following overlay:

- **Negative (underweight)** towards domestic exposure and we have built up cash as a default exposure, **Negative (underweight),** towards international exposure.
- **Neutral** towards Investment Grade credit, which provides an attractive yield pickup over sovereign bonds with low default risk.
- Using managers that have neutralised or avoided exposure to duration as by doing so we are minimising interest rate risk.
- We treat hybrids as equity, not as fixed interest. Many of these securities display equity-like volatility, especially during more difficult periods, and we have no exposure in portfolios.
- Overall **Negative** (underweight) traditional Fixed Interest and **Positive (overweight)** cash equivalents.

Currency

As with last year, we are not prepared to forecast the Australian Dollar (AUD), but we are prepared to give direction. We see the AUD trending lower in 2017.

The AUD is closing 2016 at around 0.7224 against the USD, having started the year at a marginally higher level 0.7302.

We have introduced partial hedging strategies, especially for International Equities, against the USD. On a Purchasing Power Parity (PPP) basis we believe fair value is currently around 0.70 but we also believe the AUD never trades at fair value and that it may overshoot on the downside. Stronger commodity prices should provide support but narrowing interest rate differentials with the US will provide some offsetting weakness therefore the AUD should trend lower to 0.700.

Equities

In 2016 we have seen a divergence in returns across not only International equities but also in an Australian context.

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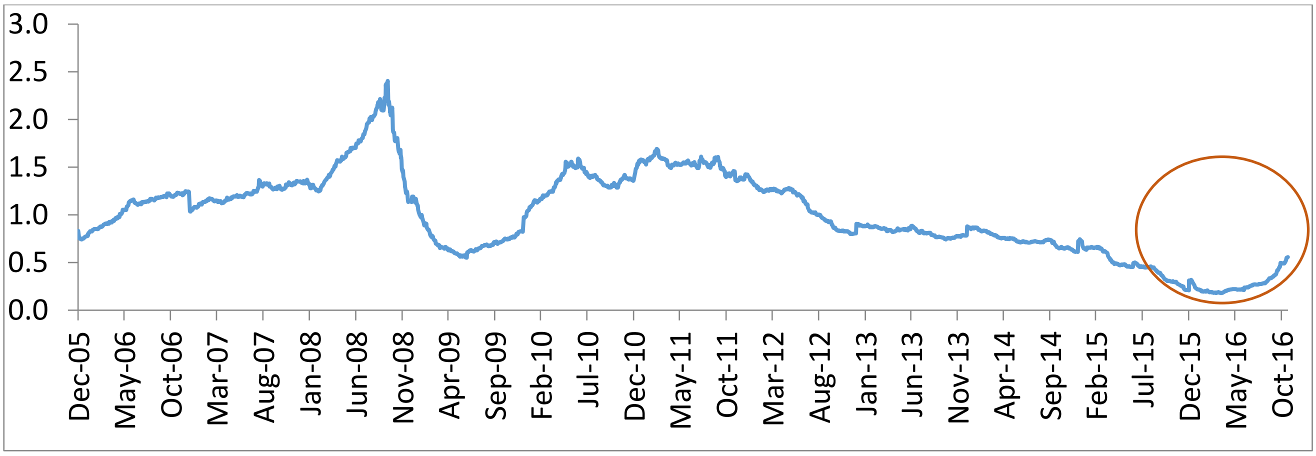
Equity markets were not only volatile throughout 2016 but market returns also varied greatly as per the table below.

Market 31 Dec 2016	Index	Closing Level	1 Month Change	1 Year Change
Australia	ASX 200	5,666	4.14%	6.50%
	ASX 300	5,618	4.10%	6.55%
United States	Dow Jones	19,763	3.09%	13.42%
	S&P 500	2,239	1.82%	8.50%
	NASDAQ	5,383	2.43%	7.50%
Europe	BB Euro 500	242	6.52%	-1.97%
Germany	DAX	11,481	9.20%	6.87%
United Kingdom	FTSE 100	7,143	6.12%	14.43%
Japan	Nikkei 225	19,114	4.40%	0.42%
Hong Kong	Hang Seng	22,001	-3.45%	0.55%
China	Shanghai Comp	3,104	-4.50%	-13.13%

Source: Bloomberg

We believe equities will generally trade sideways in 2017 but with large sector rotation in Australia, particularly out of the "yield bubble" equities which performed so well in the first half of 2016. We expect **global resources** will continue their recent return to favour and should provide outperformance. Diversified resource company earnings appear to have bottomed (see chart below) as does their performance relative to the broader market.



Source: Henderson Global Investors

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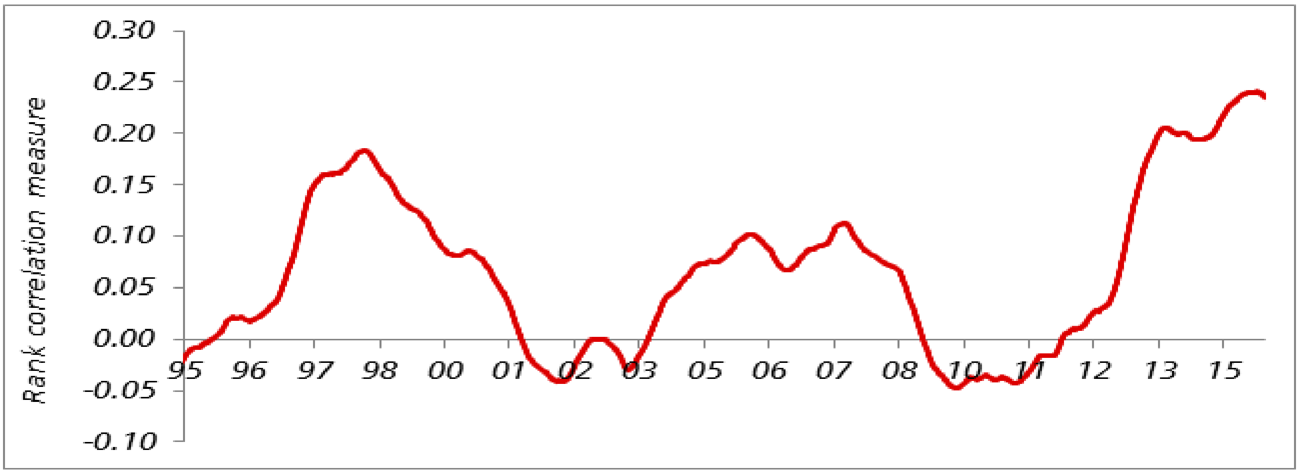
The table below is a rank correlation of companies in the ASX 300, the higher the correlation the more trending/momentum is taking hold in a market (the winners keep winning and the losers keep losing). As the line declines it demonstrates mean reversion and unwinding of the high premiums that have been attributed to strong trending stocks.



Source: Allan Gray

Until very recently the trending has been at levels not seen since the technology boom of the late 1990's. As a house that believes in Value first our approach is challenged in the late signs of momentum driven markets. We also believe that the trend is returning towards value as we approach this stage of the cycle.

Our overall position for 2017 is slightly **Negative** towards equities. This includes maintaining our **Negative (underweight)** position in International equities and we have recently downgraded Australian equities to **Neutral**. We believe the domestic market yield of 4.8% against a bond yield of 2.8% supports equities but we are concerned about a further sell off in bonds which could change this position.

We take into 2017 a **Negative (underweight)**, stance in international equities which to break this down regionally our positions are:

- **Negative(underweight)**, US Equities given valuations. The US market has so far been encouraged by the prospect of a Trump administration potentially overdoing this, and if rates rise more quickly than expected and the economy reaches full capacity (output gap closes) sooner than expected then something must give.
- **Negative (underweight)**, European equities, with economic projections looking mixed for 2017 and heightened geo-political risks.
- Slightly **Positive (overweight)** Japan with earnings continuing to strengthen in 2017.
- Slightly **Positive (overweight)** Emerging Markets given attractive valuations but mindful that a stronger USD could limit any upside.

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REITs

After their severe selloff in Q3 we believe REITs are approaching fair value again but they are still not cheap. We remain underweight REITs and note that further weakness in bond markets would be negative for the sector. Fair value is not enough on itself therefore having reduced exposure during the past year to **Negative (underweight)**, we are looking at when is the appropriate time to neutralise this position, and believe it could be oversold due to equity market rotation.

Alternative Assets

This is an asset class we have increased focus on in 2016 and will continue to do so in 2017. This also reflects our caution towards markets.

We hold the belief that our clients should fully understand what they are investing in therefore our support in this sector is primarily for asset class long/short funds, equity market neutral and event driven strategies. These are strategies we can research thoroughly and recommend with confidence to clients with the right risk profile to understand them.

Finally

Successful investors never forget risk as a key component of strategy and the need for prudent risk management. Looking towards 2017, we do not believe now is the time to be increasing risk in portfolio construction. To be blunt about it, there is limited upside for potentially large downside. At **Hamilton Wealth Management,** we will always position client portfolios for a full market cycle and will not be distracted by short term "noise". Underlying asset valuations and credit quality are important to consider but asset allocation is the key and investors who are bold when markets are out of line with valuations will achieve the best results.

Therefore, the combination of manager selection combined with diversification through asset allocation, discipline and patience should ensure portfolio outperformance is delivered.

Please do not hesitate to contact us if you wish to discuss in further detail and we wish you all the best and success in your investment strategies for 2017.

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Hamilton Wealth Management is a Fee for Service, independently owned Wealth Management business and as such our advice is built around the conviction to our process and philosophy and our strong belief in diversification.

We would be happy to discuss this further with you, please don't hesitate to contact us.

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