HAMILTON
wealth management

Investor Insight 54 – November 2017

We are constantly getting questions from clients about yield and returns, yet worried about asset prices across all asset classes.

Investors continue to be in a situation where the opportunity cost of exiting well performed investments remains high. The reason for this is that we are not in a cycle like other cycles (we refrain from saying not normal). It has been a tepid yet a long cycle which will continue for some time as economic slowdown is not evident.

Equity valuations are and continue to look stretched but compare favourably to other asset classes. Forget the endless talk about President Trump, yes if he gets the tax cuts through that will enhance US earnings, but this market has rallied on fundamentals and global earnings growth and not because of US politics.

If there is a bubble in equities, there is a larger one in fixed income. As we mentioned last month rates are at a cyclical low and will rise from here. This is factored in too many forecasts however if we see the US bond market sell off (interest rates increase) beyond 3.0 per cent, even to 3.5 per cent, this will create demand for fixed income. Therefore, the margin for error is small.

With unemployment at a cyclical low both in the US and Australia, wage price inflation is inevitable. Past Governor Glenn Stevens published a paper through Ellerston Capital on the inevitability of the return of inflation. It is a fantastic read and we are happy to send this to readers upon request.

One concerning thing is the lack of volatility and consequently the predictability of market reaction in the immediate term. It is one month short of a year since global equity markets have experienced a 3 per cent or move downward move, and it is 103 months since the global equity bull market commenced its run.

Global fund managers are underweight and are avoiding our own market. The Australian equity market has desynchronised from global equity markets. Yes, the market closed up for the month but continued to lag global counterparts and has failed to reach the 6000 level.

We spent last week visiting Shanghai and Hong Kong. Through this visit we were fortunate to listen to Chairman and CEO of JP Morgan Jamie Dimon and Stanford University Political Science Professor and ex-US Secretary of State, Condoleezza Rice, and other speakers and fund managers on the second largest economy globally.

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Last month we touched on our appetite for Emerging Markets and over the last few weeks we have ensured where it is appropriate that clients have adequate exposure to this asset class. Having visited China and seen first hand what is going on in this country which represents 28 per cent of the EM index (which will increase with the inclusion of A Shares), this is the correct call.

It is unprecedented how China has lifted its people out of poverty, built great cities and built great global companies such as Alibaba and Tencent but it also has an export engine, a focus on infrastructure and a cheap cost of labour.

The future for this country is around innovation, which they will deliver. There are more IP registrations presently out of China than the US and it’s this innovation that they need to concentrate on, combined with market forces.

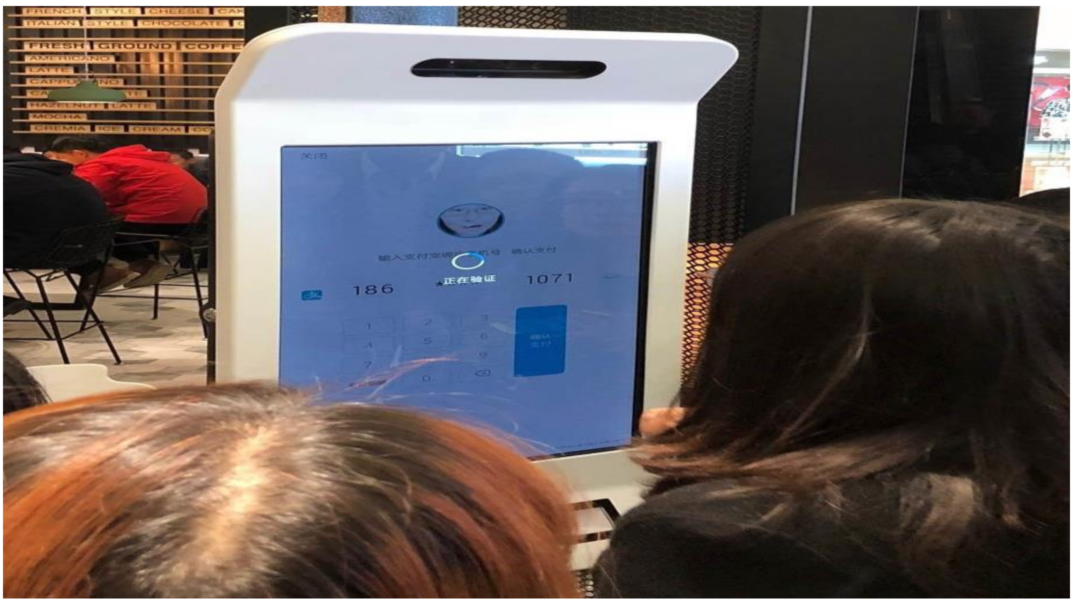
It is naturally entrepreneurial and must ensure it continues to further unleash the potential of its people. You will stop seeing “Made in China” and see a move to “Designed in China”.

There is no doubt that Chinese and international growth are bound together. On the One Belt One Road policy, it will come down to how China can show the developing nations that they can benefit as nations beyond simply seeing Chinese investment in their economies.

What the Chinese are not good at is brand building. Yes, they make great phones and great Electric Vehicles (EVs), they are not good at marketing these brands.

An example of how China are getting around this is automotive producer BYD, which has been supported by Berkshire Hathaway (Warren Buffet), and which recently purchased Volvo. They are working hard to further develop the batteries of EVs and China is in fact the largest lithium battery manufacturer today. They will put this technology they develop in Volvo cars and market it through Volvo.

The below photograph we believe highlights the advancement of China.



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This photo is of facial recognition payments linked to the purchaser's bank account at KFC. Yes, she is purchasing KFC using facial recognition technology (FRT). This outlet does not accept cash, the majority of payments are done via FRT or the purchaser's telephone via WeChat. The credit card has been skipped for domestic consumption in China.

One thing we noticed is taxis are difficult to get in Shanghai as you book and pay via an App effectively as Uber works.

All this said, this digital penetration is predominantly in the east. There are 695 Million mobile internet users therefore as a percentage of the population there is a lot of upside.

As mentioned previously, China represents 28 per cent of the Emerging Markets (EM) index. With over 70 per cent of the index being Asia, you need Asia to perform for EM to perform. In June next year MSCI is bringing A-shares into the index with an initial weighting of 5 per cent of the free float and an increase in weighting of 1.5 per cent therefore China will represent 30 per cent of the EM index. I would therefore conclude that without China performing it will be difficult to get EM to perform.

We were amazed at what we witnessed however ESG is important when analysing China. The G being Governance is important, with a lack of independent boards, related party transactions and lack of CEO equity participation in many cases.

Many fund managers are starting to invest in A-shares and what is pleasing is the strong approach to fundamentals that is being taken. Yes, this approach knocks out many participants, but it is essential, and the rational investor sees this combined with ESG as refining rather than limiting the A-share investment universe.

There is no question that presently retail investors have a significant influence on the Shanghai A-shares momentum. However, as the A share market is maturing, institutional investment flows are starting to mitigate the retail influence through lower turnover and the initiation of proper research disciplines on A-share investments.

China starts a new political era after the 19th Party Congress with the emphasis being on stability and the abandonment of growth targets which gives the economy flexibility.

China debt is always raised as an issue and whilst household debt to GDP at 45 per cent is high, it is corporate debt which is concerning. Mitigating this is that in China debtors and creditors are owned by one entity, which, in the case of the debt becoming unmanageable, means that the central government can step in.

As it was mentioned in Shanghai, the Chinese know a lot about us and the reality is we know very little about them. One thing I do know is this is a true growth part of the world, investors with the correct China exposure will benefit from continued above average growth, but expect the ride to have periods of volatility.

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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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