# Entrust Quarterly Commentary
# December 2019

DUNCAN MACKINTOSH, CFA
DIRECTOR & AUTHORISED REPRESENTATIVE (458414)
SENIOR INVESTMENT ADVISER
Dir: +61 8 9476 3945 | dmackintosh@entrustwealth.com.au

ENTRUST WEALTH MANAGEMENT PTY LTD
Authorised to Provide Financial Services | AFSL 222152 | ABN 80 100 088 168

# December 2019 Quarter

The December 2019 quarter continued the momentum of the previous quarter, with another solid performance across the various mandates we run. There was, however, a greater dispersion this quarter in the performance between asset classes.

Equities were the key contributor, with International Equities outperforming Australian Equities. The Alternatives portfolio also added to performance. Fixed Income portfolios were flat to slightly negative, as floating rate exposures helped offset a sharp rise in bond yields. Exposure to listed Real Estate (REITs) detracted from performance as the rise in bond yields had a negative impact on market pricing.

2019 calendar year returns were strong with solid performances across all asset classes, other than cash. A key reason for running multi-asset class portfolios is to diversify portfolio risk by investing in asset classes that are not highly correlated (ie they do not move in the same direction at the same time). The past year, however, would seem to be an exception to this theory. This result is perhaps surprising given the list of risks that markets had to navigate during the year such as US/China trade tensions, weakening global GDP growth, falling corporate earnings expectations, and more specific to Australia; weak consumption, falling house prices, high household debt and weak wage growth.

A key catalyst for this strong performance was the shift in interest rate expectations following the US Federal Reserve's policy pivot in the December 2018 quarter. This shift, and the subsequent cuts to the cash rate, would seem to have forced investors out of cash in search of more palatable returns. This also likely helped provided a backstop for markets during periods of volatility as those that were slow to make the initial switch out of cash, used these dips as buying opportunities.

Given the starting point of valuations across all asset classes, it would seem reasonable that return expectations for the coming year may need to be tempered somewhat from what we have recently enjoyed. Any significant shifts in expectations around cash rates and future interest rate expectations will be a key risk to keep a close eye on.

**Model Portfolio Movements**

Over the quarter we continued to take profits in our gold exposure by selling the balance of our holdings in global gold equities (GDX). We also reduced exposure to USD gold bullion (QAU), but have maintained a small holding.

In the Australian Equities portfolio, we took advantage of some price weakness to lift our exposure to Future Generation Investment Company Limited (FGX) and News Corporation (NWS). We also established a new position in Platinum Asset Management Limited (PTM) based on improved investment fundamentals and an attractive valuation. (Please note that post quarter end, we exited PTM as the impact on the Chinese economy from Novel Coronavirus potentially puts a spanner in our original thesis so we felt it prudent to protect the profits we had made on this position.) During the December 2019 quarter, we also exited Mineral Resources Limited (MIN) post their announcement they were putting the Wodgina lithium mine on care and maintenance.

In the International Equity portfolio, we established a new position via the IPO of VGI Partners Asian Investments Limited (VG8). VGI are a fund manager that we hold in high regard and VG8 is targeted to provide exposure to very high-quality Asian regions and companies. Investing via the IPO also gave investors the opportunity to pick up shares in the head company, VGI Partners Limited (VGI), at no cost. VGI sits in our Australian Equity portfolio and is a company we are keen to build exposure to for the long term. We also added to our Hearts and Minds Investments Limited (HM1) position via a very attractively priced rights issue.

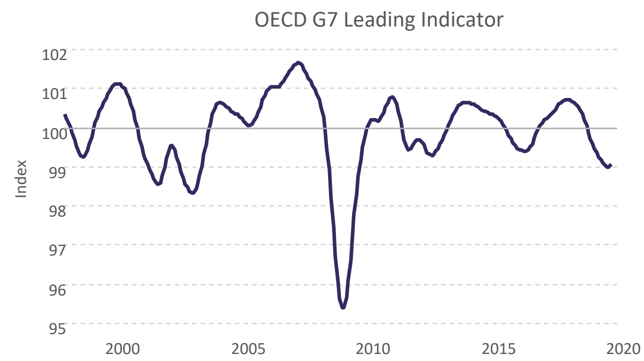
# December 2019 Quarter

For the Australian Fixed Income portfolio, we added to National Australia Bank Capital Note 3 (NABPE), following some price weakness that provided an attractive entry point.

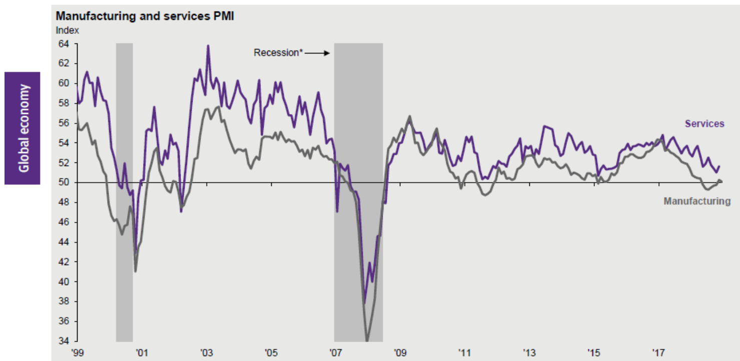
## OUTLOOK

Global growth remains subdued as it continues to be impacted by falling industrial production and trade. However, there have been some encouraging signs in recent data points.

As can be seen in the chart below, the OECD leading indicator suggests that growth is starting to stabilise in most advanced economies, although the rate of growth remains below long-term trends. Global PMI's are also showing signs that a trough in the recent weakness has formed.




Source: Refinitiv Datastream



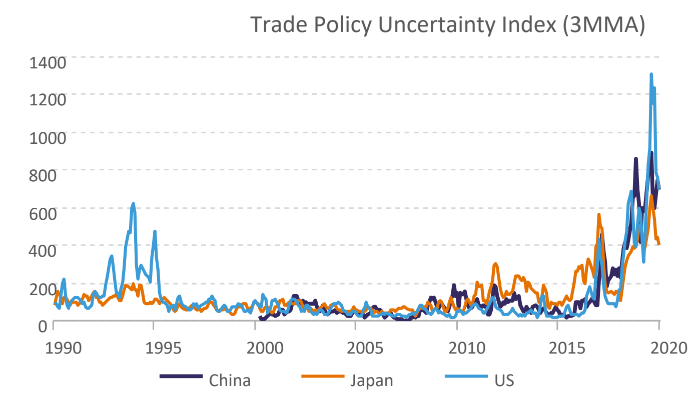

Source: Markit, J.P. Morgan Asset Management. *Recession is U.S. economic recession.
*Guide to the Markets – Australia*. Data as of 31 December 2019.

An important driver of this improvement likely stems from the easing of some left tails risks we highlighted in out last quarterly.

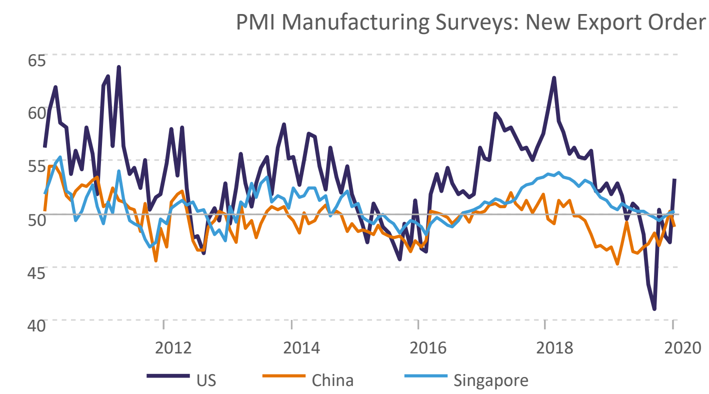
Firstly, the US and China officially signed their phase one trade deal in January easing, for now at least, a key tension that has been overhanging the global economy. There is much left to debate before a phase two resolution is reached but we suspect President Trump will push this out until after the 2020 US election.

Also, following the December 2019 election, the UK has now formally exited the European Union and entered an eleven-month transition period. There is still work to be done as the UK and the EU thrash out a trade deal but again it would appear that another can of uncertainty has been kicked down the road for another time.

This has seen a de-escalation in trade policy uncertainly indicators with new export orders appearing to have also turned off the bottom.




Source: Refinitiv Datastream



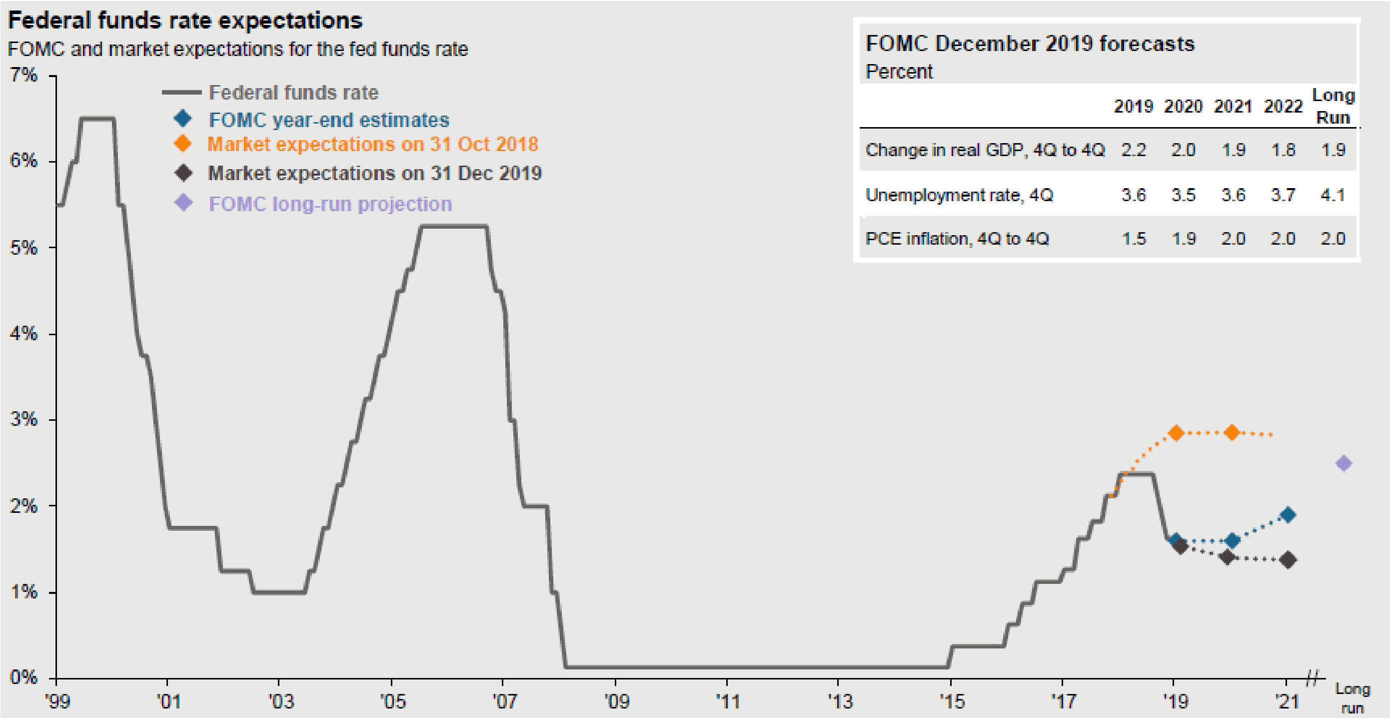

Source: Refinitiv Datastream

# December 2019 Quarter

We are yet to see any meaningful signs that corporates are feeling more confident, with capex intentions remaining subdued. Evidence of a lift in corporate investment will be important to become more comfortable in the growth outlook.  Fortunately, for the US market at least, the economy is being supported by a strong consumer that is enjoying low mortgage rates, rising house prices, low unemployment and reasonable wage growth.

### Interest rates remain supportive

As mentioned above, a key support for asset classes over CY2019 was the change in interest rate expectations. The chart below highlights this with the light grey line showing the current US Fed funds rate, the orange dots the market expectation of where rates were heading back in October 2018 and the dark grey dots showing the markets outlook for rates as at the end of CY2019.




FOMC December 2019 forecasts
Percent

| | 2019 | 2020 | 2021 | 2022 | Long Run |
|---|---|---|---|---|---|
| Change in real GDP, 4Q to 4Q | 2.2 | 2.0 | 1.9 | 1.8 | 1.9 |
| Unemployment rate, 4Q | 3.6 | 3.5 | 3.6 | 3.7 | 4.1 |
| PCE inflation, 4Q to 4Q | 1.5 | 1.9 | 2.0 | 2.0 | 2.0 |

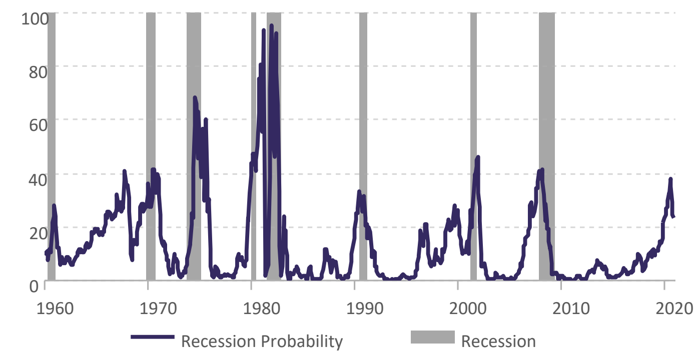
Source: FactSet, U.S. Federal Reserve, J.P. Morgan Asset Management.
*Guide to the Markets – Australia.* Data as of 31 December 2019.

From recent commentary, the US Fed looks to be in a holding pattern. However, they, like a number of other central banks, have indicated that if inflation becomes more prevalent they are likely to allow the economy to run hotter than normal before raising rates. Conversely, they remain watchful of the data and are prepared to add further stimulus should it be required. As a result, the bar to raise rates looks high at the moment meaning monetary policy is likely to remain supportive for the short to medium term.

### What does that mean for the current state of the investment cycle?

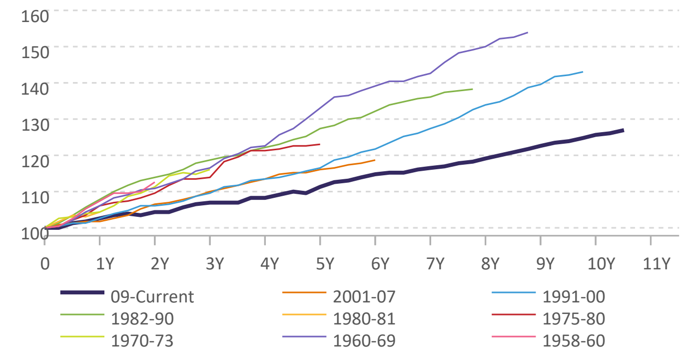
We have previously said that we believe we are late cycle, but how long we remain in that part of the cycle, is uncertain. There are certainly some late cycle red flags in the US at present, such as the negative unemployment gap (unemployment rate less the nonaccelerating inflation rate of unemployment (NAIRU)), solid wage growth, rising corporate debt levels and declining corporate profitability. However, there remains a few key elements missing such as below trend growth, low inflation and interest rates well below the neutral level. Given this and the potential troughing in some of the economic indicators mentioned above, the US Fed has recently reduced its probability of a recession. So, despite its growing age, the current slow grinding cycle looks like it wants to grind on for some time yet.

NY Fed US Recession Probability




Source: Refinitiv Datastream, FRBoNY

US Real GDP Growth (index end recession)

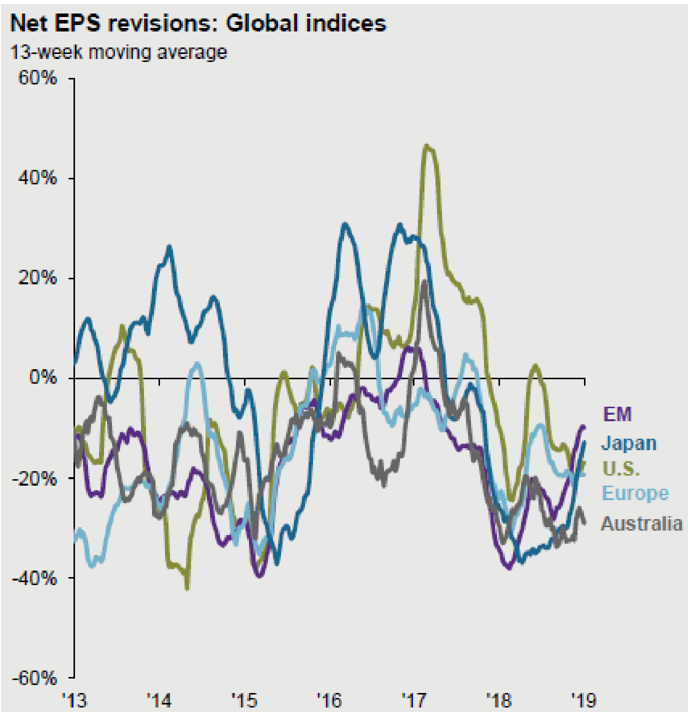


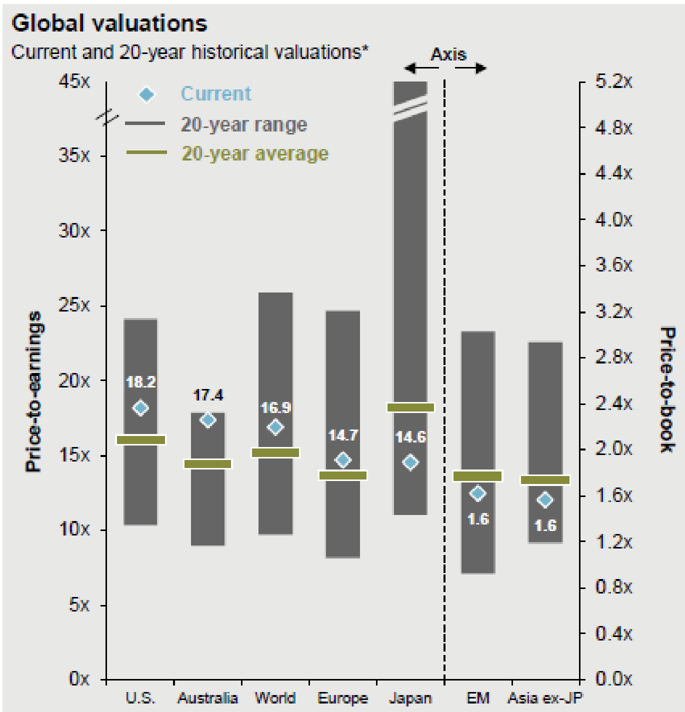

Source: Refinitiv Datastream

Having said that, we are conscious given where bond rates are currently sitting that when we do finally face a recessionary period, central banks are likely to have less ammunition available to them. Therefore, the negative economic impact at that time may be more pronounced than normal.

**Asset valuations**

Equity markets have moved swiftly up recently in response to the improving outlook. Once again, this strength has been driven by an expansion of PE's rather than a lift in earnings growth. Clearly, the improving economic signals we have highlighted above need to translate into improved corporate profitability to justify this strength. Until this happens there remains ongoing volatility risk for equity markets. However, despite markets not being particularly cheap, in a long-term context, they are arguably not at extreme levels either, especially when current interest rates are factored into the equation. Therefore, while the upside for interest rates and inflation remains muted we feel that any meaningful sell offs in equity markets are likely to continue to be bought.




Source: J.P. Morgan Asset Management; (Left) Thomson Reuters Datastream; (Right) FactSet, MSCI, Standard & Poor's,. *Valuations refer to NTMA P/E for Europe, U.S., Japan, Australia and developed markets (world) and P/B for emerging markets. Valuation and earnings charts use MSCI indices for all regions/countries, except for the U.S. and Australia, which are the S&P 500 and ASX 200, respectively. Valuations for Australia start in 1999. Past performance is not a reliable indicator of current and future results.
*Guide to the Markets – Australia.* Data as of 31 December 2019.

### A word on corporate debt

Over recent years, corporate balance sheets have become more leveraged. This is perhaps understandable, given the low cost of and ability to access debt. From our reading, there has been a large increase in the source of that funding coming from nonbank loans such as private credit. This is also understandable as private investors seek out higher returns.

However, if the encouraging economic signals we have discussed do not end up translating into growth some of these more leveraged and cyclical corporates are vulnerable. This vulnerability stems from a reduced ability to be to meet their interest obligations as well as the risk these private funders retreat from the market, meaning some of these corporates may have difficulty in rolling over their debt. Given their experiences during the GFC, traditional banks are also likely to ration credit availability in any slowdown. We have already had a taste of this in the December 2018 quarter when high yield debt markets essentially froze to new issues. From our discussions with those involved in these markets, this was one of the key reasons for the Feds about face on rates.

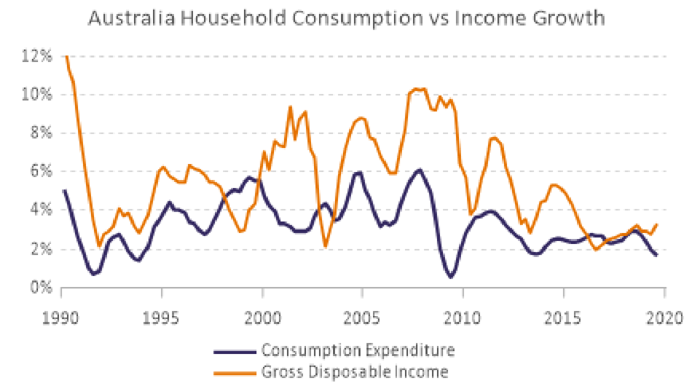
This supports our ongoing view, particularly at present, to focus on quality when looking at both equity and credit investments.

### Australia

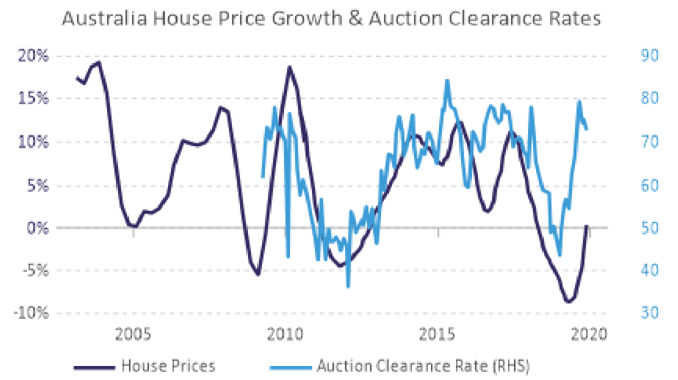
In Australia, GDP growth has been slowing, largely driven by weak domestic demand. Housing construction has fallen sharply with Government spending not enough to counter it at this point. Employment growth has been solid, although there does appear to be a reasonable level of spare capacity in the system.

Disposable incomes have continued to rise off recent lows, thanks largely to tax cuts and lower mortgage rates, but this is yet to lead to a rise in consumer confidence and consumption as households increase their savings rate.

House prices though have been a relatively bright spot as auction clearing rates have remained high despite a recent lift in listing volumes.




Source: Refinitiv Datastream




Source: Refinitiv Datastream, ABS, Bloomberg, CoreLogic

The RBA looks to be on hold for now but remain ready to cut interest rates again if the data points to further weakness. The key for them will be the employment data such as the unemployment rate drifting higher.

The bushfires are expected to be a drag on GDP growth although for how long is uncertain, however, the rebuild process may assist further down the track. This may also give the Government an excuse to loosen their fiscal spending belts.

**Novel Coronavirus**

The above discussion does not consider any potential impact from the Novel Coronavirus outbreak. This is something that is difficult to do as there remains significant uncertainty around the scale, likely duration and economic impact. A look at prior pandemics suggests that although economic impacts can be large, they are temporary.

As a reference, estimates of the 2002 SARS outbreak suggests it negatively impacted Chinese GDP growth by approximately 1% with a small impact on global growth. However, we are mindful that China is a much bigger part of the global economy these days. Closing factories and restricting travel in an economy the size of China is clearly going to have an impact on growth but to what degree and for how long is uncertain at this point. We expect the Chinese Government will respond by providing economic stimulus to help cushion the impact with some measures already announced.

Previous pandemics have also seen an initial negative impact on equity markets but these impacts have similarly tended to be relatively short lived.

Of course, we must not be complacent as past experiences occurred under different conditions to what we have at present, so we will continue to monitor the situation and take any actions we think are appropriate. The recent removal of Platinum Asset Management Limited (PTM) from the portfolio was a direct result of such risk management.

These events also highlight the benefits of running diversified multi-asset class portfolios as the fall in the AUD and rally in government bonds since the virus came to light has helped to cushion portfolios from the recent equity market volatility.

# Disclaimer

DUNCAN MACKINTOSH, CFA
DIRECTOR & AUTHORISED REPRESENTATIVE (458414)
SENIOR INVESTMENT ADVISER
Dir: +61 8 9476 3945 | dmackintosh@entrustwealth.com.au

ENTRUST WEALTH MANAGEMENT PTY LTD
Authorised to Provide Financial Services | AFSL 222152 | ABN 80 100 088 168

*Entrust Wealth Management Pty Ltd ABN 80100 088 168 AFSL No. 22 2152 ("Entrust") provides no warranty of accuracy or reliability in relation to any inf ormation contained in this document and to the extent permitted by law, no responsibility for loss or damage whatsoever arising in any way for any repre sentation, act or omission, whether express or implied (including responsibility to any person by reason of negligence) is accepted by Entrust or any officer, agent or employee of Entrust.*

*Entrust Wealth Management Pty Ltd, does not accept any liability for loss or damage suffered or incurred by any person however caused (including negligence), without limitation, the information contained within, any errors or omissions however caused or any person placing any reliance on this data, its accuracy, completeness or reliability. This information is of a general nature only and has been prepared without taking into account personal investment objectives, financial situations or particular needs. Those acting upon information contained in this material without first consulting with professional advisers do so entirely at their own risk. The Directors and/or employees of Entrust Wealth Management Pty Ltd, holder of Australian Financial Services License 222152 (and its parent company or any subsidiaries) may receive financial benefits as a result of a transaction arising from any advice. This document is subject to copyright. No part of it should be reproduced without the consent of the copyright owner. The model portfolio is a theoretical internal model used by advisers as a reference point for their investment decisions.*

*Actions on your portfolio may be materially different from those undertaken on the model portfolio. Please speak with your adviser to confirm your current holdings and recent transactions.*