Entrust Quarterly Commentary
September 2019

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September 2019 Quarter

The September 2019 quarter was a solid start for the 2020 financial year with positive contributions from all of the asset classes within our model portfolio. International Equities delivered the strongest performance, with exposure to gold equities a key contributor. The Alternatives portfolio also performed well, as did the Australian and Fixed Income portfolios, as bonds rallied on the back of numerous central banks cutting cash rates in response to weakening economic growth.

Over the quarter we were net sellers of assets, largely due to taking profits in gold assets. This was done progressively, as the USD gold price hit but failed after several attempts to push through the resistance around $1500 oz that we highlighted in our last quarterly.

USD Gold Price – 10 Year Chart

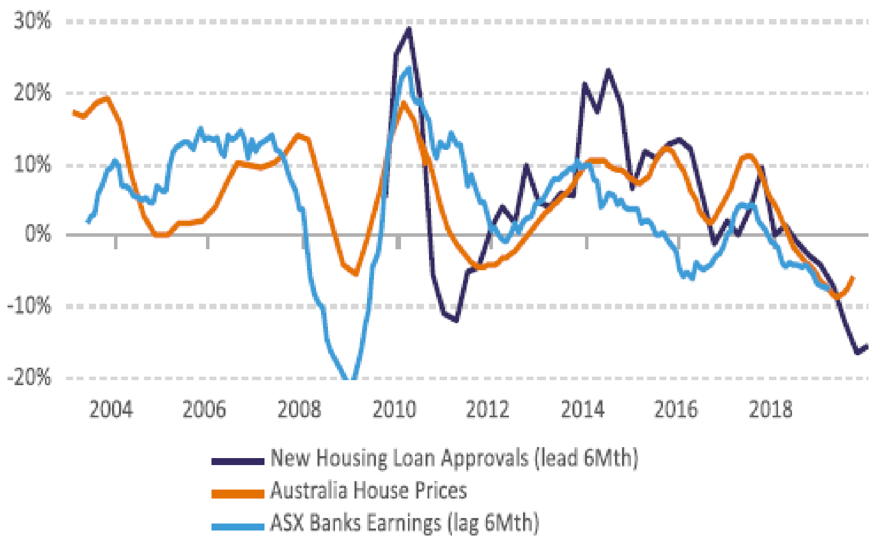
Source: Iress

Very early in the quarter, we took the opportunity to lift our banking exposure in the Australian Equities portfolio via an increase in National Australia Bank Limited (NAB) due to the improving fundamentals and reasonable valuations we pointed to in the June quarterly. Pleasingly, not only did NAB have a strong quarter but it significantly outperformed the other major banks.

September 2019 Quarter

While there are plenty of economic and regulatory headwinds for the banks, which may cap the near-term upside to valuations, it is encouraging nonetheless to see some potential troughing in both Australian property prices and loan approvals. As the chart below shows, bank earnings tend to be highly correlated to these indicators.

Australia Housing & ASX Banks Earnings (12 Mth Growth)



Source: Refinitiv Datastream, ABS, CoreLogic from 2010

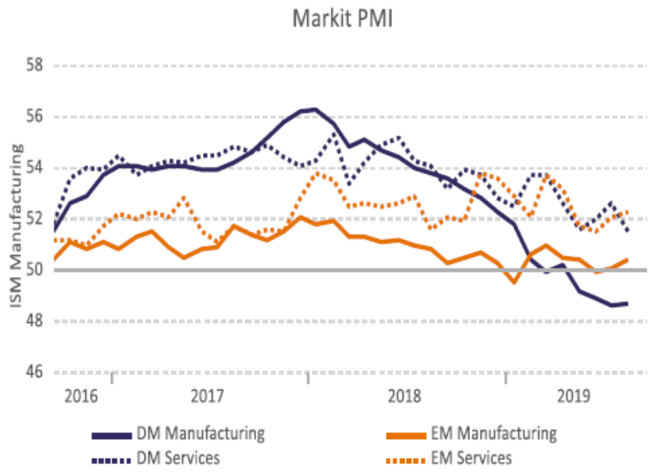
Within the Australian equity portfolio, we also took the opportunity to lift our exposure in Macquarie Group Limited (MQG) via their share purchase plan. This allowed us to bid for stock at what ended up being an attractive discount to the prevailing market price.

For the Alternatives portfolio, it was pleasing to see an improvement in performance from some of the long/short equity managers with a contribution from both the performance of their underlying portfolios as well as a reduction in the discount to net tangible assets (NTA) for those with a listed investment company structure (LIC). To that point, we are starting to see an increase in corporate activity for those LIC's trading at a discount to NTA aimed at reducing these discounts. Across the LIC sector, these discounts to NTA remain prevalent, which is frustrating when evaluating portfolio performance, however it also presents opportunities as there is a very real prospect that these discounts will narrow over time.

OUTLOOK

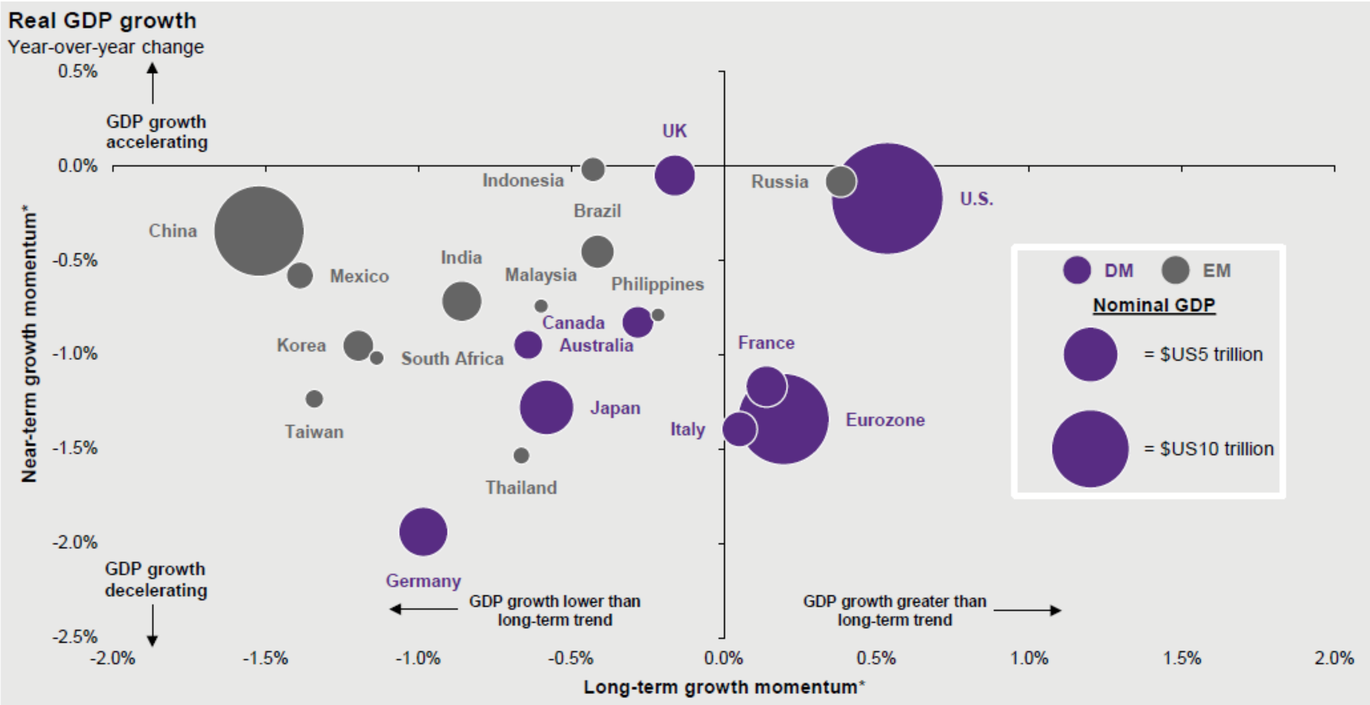
From a global macroeconomic perspective, the September quarter saw a continuing trend of slowing growth. It is clear that the ongoing trade dispute between the US and China is impacting global trade with a natural flow through to weaker manufacturing data and capital investment. However, there are some tentative signs that a trough may be forming in the manufacturing data. Services and consumption appear to be holding up but could be at risk if we see a deterioration in the employment outlook caused by firms responding to the softer environment by reducing employment costs. For the moment though, the data around employment remains supportive.

Source: Refinitiv Datastream



Source: Refinitiv Datastream, Markit

The current environment of slowing growth is clearly shown in the graph below, which highlights those counties where GDP growth is below its long-term average (vertical line). What is interesting is the cluster of counties in the bottom left quadrant. For these countries, growth is not only below their respective long-term averages, but also below their twelve month prior growth rates, suggesting momentum remains weak.



Source: Source: IMF World Economic Outlook, J.P. Morgan Economic Research, J.P. Morgan Asset Management.
**Near-term growth momentum is the difference in percent growth in real GDP for the average of the last four quarters less the average of the four quarters a year ago. Long-term growth momentum is the difference in percent growth in real GDP for the average of the last four quarters less the average since 2Q 1990. Bubble size represents nominal GDP in U.S. dollar.*
Guide to the Markets – Australia. Data as of 30 September 2019.

US economic growth continues to look the strongest across the developed markets with growth still above its long-term average but as can be seen above is starting to be pulled back to the pack as its short-term momentum weakens.

Growth in Australia has continued to slow as household consumption and business investment remains weak. However, as mentioned above, house prices appear to have turned the corner, which is important for household wealth and consumption. Dwelling construction looks likely to continue to be a drag in the near term as approvals data remains weak, however Government infrastructure spending remains an important offset, albeit the pace of ramping up that spend is slower than expected. Income from commodity exports has been a key contributor to GDP growth but we are mindful that we may be past the peak for this contributor as global growth slows and supply imbalances in iron ore begin to normalise.

Increasing Stimulus

In response to the slowing growth, we have seen a general move by central banks globally to reduce cash rates while at the same time beginning to discuss the potential use of unconventional stimulus measures once again. There appears to be an element of staying with the crowd with the most recent rate cuts as central banks want to avoid being left with a relatively high currency in an environment of weak global trade and risk that country's export goods becoming uncompetitive.

There are signs that the benefits of these stimulatory measures are beginning to flow through; the improvement in Australian house prices and the recent troughing in global manufacturing data are two examples. However, there is also an increasing view that the runway for monetary policy to counteract an economic slowdown is getting very short. As a result, there is a growing voice that the baton needs to shift from monetary policy to greater fiscal spending initiatives by governments. When governments can lock in long term debt at historically low rates and even be paid for the privilege in some regions via negative interest rates, it is easy to understand the logic behind this push. So far though, this call has largely been resisted as decisions of this nature can become heavily politicised. Nevertheless, it is something we are watching as these sorts of rumblings can often build momentum to a point where they almost become inevitable.

That therefore begs the question; what would be the implication from an investment perspective, of a marked lift in fiscal spending? Given this would be seen as stimulatory we think it would be reasonable to expect rising support in markets for more cyclical investments and away from the defensive assets that have been bid up over recent months. This may provide a window for the more value orientated managers that have a cyclical tilt in their portfolios at present, an opportunity to make up some of their recent underperformance. It also justifies holding at least some direct exposure to companies that would benefit from an increase in demand for materials and other cyclical products.

As a core defensive asset, bonds may be one of the victims from the above, as yields rise on the prospect of a better economic outlook and increasing bond issuance. However, despite recognising there is certainly room for bonds yields to move higher, we feel the degree of upside remains capped in the medium term while inflation remains in check.

Easing left tail risks?

It would be fair to say that most of the current uncertainty and therefore risk in investment markets is politically generated, with US-China relations and Brexit key focal points. In regards to these issues, the pendulum seems to have swung ever so slightly back into the "nearing a resolution" quadrant. The US and China have agreed, in principle at least, to a phase one deal where the US will suspend a further lift in tariffs on US$250 billion of imports from China, while China has agreed to significantly increase its purchase of pork and soybean from the US, plus some other concessions including greater access to Chinese markets for US companies. In regards to Brexit, British MPs have given the green light for a general election on 12 December in an attempt to drive home a resolution on this issue one way or another.

Given the history on these issues, it is hard to be overly confident that either will make it across the finish line but it is worth considering that given the economic impact the US-China dispute is having on both nations, the incentive to find a resolution is no doubt rising. For China, they will be keen to see a stabilisation of growth and gain access to much needed agricultural supplies. For President Trump, he is unlikely to savour heading into an election year in 2020 with a weakening economic environment, which it might be argued he orchestrated. He would no doubt also like to shift the attention away from any impending impeachment proceedings. As such given some progress on these key issues have been made and concerted efforts by central banks to ease monetary conditions, it does feel like the left tail risks that have been acting as a dampener on sentiment have eased somewhat, at least for the short term.

Entrust

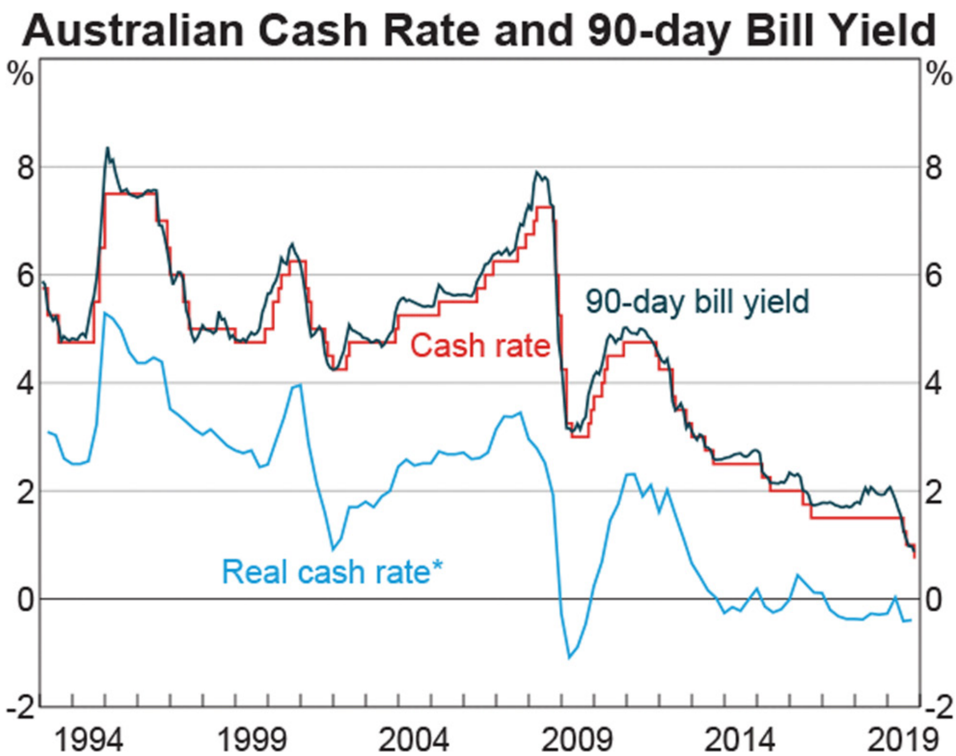
PORTFOLIO POSITIONING

There is no doubting the fact that the current environment is a difficult one to navigate for investors. This is not just our view but is the most common theme we come across in the many meetings we have with fund managers, asset allocators and other professionals across all asset classes. Depending on which lens you choose to look through you could mount arguments for both a pro-growth or pro-defensive stance. In trying to keep an open mind below is a summary are some of the key points we feel need to be considered at present:

- Due to political and macro uncertainties we are witnessing:
  - Slowing economic growth globally;
  - Weak global trade;
  - Businesses holding back on investment decisions;
- This as yet has not flowed through in a meaningful way to employment conditions;
- Analyst earnings growth expectations are slowing and if economic growth continues to remain uncertain there is a risk of further earnings downgrades;
- The US is currently in a reporting season and thus far the majority of companies have met or exceeded analyst earnings expectations albeit expectations that were recently downgraded;
- If the US and China can successfully reach a trade agreement we may see a flow of pent up investment demand from corporates;
- Equity market valuations are not cheap and if anything, lie on the expensive side of the fence, but one could argue they are not at extreme levels;
- Higher than historical average valuations should be expected to some degree due to the historical lows of interest rates;
- The recent strength in equity markets has been driven predominantly by PE expansions so an improvement in earnings expectations will be important for the positive momentum to be maintained;
- Central banks have been on the front foot to the slowing growth environment by adding monetary policy stimulus;
- Low inflation is allowing cash rates to remain stimulatory;
- Bond yields are at historical lows so the ability of monetary policy to continue to be able to offer support is raising questions;
- There is a growing voice for increased fiscal stimulus by governments;
- Given the level of indebtedness and lack of inflation the upside to yields is likely capped;
- Spreads on corporate credit are below historical averages but are not yet at historical lows;
- There has been an uptick in defaults on high yield credit although nothing extreme as yet;
- Technically a number of equity markets look to have, or are in the process of breaking higher.
- Underpinning all of the uncertainty are cash rates that are generating negative real returns, ie after inflation (see chart below), so hiding in cash for anything other than the short term would also appear not to be an optimal approach. If anything, this is helping to put a floor under the value of other asset classes. Therefore, for us it continues to highlight the importance of remaining invested and running a diversified portfolio, both across and within asset classes, while maintaining a quality at a reasonable valuation bias. Our general portfolio preferences currently are:

September 2019 Quarter

- High quality Australian and International equities diversified across regions and sectors;
- Exposure to Alternatives such as long short equity managers as part of equity allocations;
- High quality Australian and International Government and semi-Government bonds;
- Preference for investment grade corporate credit over high yield corporate bonds and generally avoiding the rising issuance of lower quality and illiquid debt exposures;
- Mixture of fixed rate and floating interest rate exposure to reduce but not eliminate interest rate risk with a preference for shorter maturity instruments to help mitigate the risk of a widening in credit spreads;
- Holding modestly higher levels of cash.



* Calculated using average of year-ended weighted median inflation and year-ended trimmed mean inflation

Sources: ABS; ASX; RBA

Disclaimer

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