

## Themes and Trends – December 2017

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The following comments are based on our discussions with investors and investment managers over the last quarter. We have referred to investors in the comments below but in most instances investors will be working closely with their consultants and you can infer that a reference to one is a reference to the other also.

Synchronised and steady global economic growth resulted in most investment markets performing strongly over 2017. Investors seem relatively relaxed that growth will be sustainable even as monetary policy settings become gradually less accommodative over time. Although geopolitical risks seem to have largely been put to one side, on the basis they are impossible to defend against anyway, many commentators are focusing more now on valuations. World equity markets (in aggregate) are at all-time highs and the US has enjoyed a virtually unbroken 9+ year share market rally. Some forecasters point to an assortment of measures such as simple aggregate market P/E, Schiller CAPE, Margin-adjusted P/E, Tobin's Q, BEER ratios, dividend yields, inflation, Treasury yields and so on, as technical indicators that the market is due for a significant correction. However, others argue that, in the absence of any obvious catalyst (a China debt crisis for instance), markets could continue to rise for some time yet, albeit with somewhat greater volatility.

Competition for private market assets, rising interest rates and arguably fully valued equity markets are presenting challenges for investors trying to make beta decisions to achieve target outcomes. Investors being less reluctant to add to listed equity market exposures, compared to fixed income, perhaps reflects the symmetries of these asset classes – although investors are somewhat cautious on both, there is a greater risk in being underweight an asset class that has unlimited upside (equities) than one which is capped by the absolute level of yield (fixed income).

Many super funds have reduced target returns (CPI+3% being close to a standard) in the last few years and are reasonably confident they can be met without having to add too much risk to portfolios. Nonetheless, niche alternative assets (preferably offering some uncorrelated return) and active strategies which can exploit anticipated increases in market volatility are of obvious interest. Currency is one such 'asset' class identified as relatively uncorrelated to traditional investments and with the potential to generate alpha; although, this view is contested. However, many investors tend to leave any currency bets with their active global equity managers.

Themes and Trends we have identified since our previous quarterly update are as follows:

- As stated above, despite concerns about aggregate market valuations, investors are still investing in equity markets - even so-called growth stocks following their strong performance of recent years. One reason, as stated above, is that they recognise the risks of being underweight equities that may continue to rise for a while yet. Another reason is that more thorough research into the equity markets reveals that the aggregate market data is dominated by a small group of mostly large cap stocks which disguises the attractive opportunities still available to enter into, and to hold, if and when the market corrects;
- Non-investment grade credit performed strongly over 2017. Investors seem mostly comfortable that the asset sector is sound given steady economic growth and low defaults (reflecting better structured balance sheets); however, some are avoiding longer duration assets such as high yield bonds, given relatively low yields, and others are waiting for more attractive entry points. Sub asset classes with some immunity against a general rise in interest rates (e.g. loans and CLOs) continue to experience flows as do other sub asset classes that could be described as having an additional 'complexity premium';

- Emerging markets debt, particularly local currency and blended approaches, seems to be increasingly on investors' radar. Once investors educate themselves on the myriad of issuers, the more enterprising ones are also quite interested in Frontier debt given it offers relatively high returns and is less susceptible to increases in 'hot' money flows and changes in US interest rates which tend to sometimes bedevil emerging market debt;
- Perpetual and Infrastructure Partnership Australia's 'Australian Infrastructure Investment Report' identifies that investors have been discouraged from investing in Australian projects (in South Australia in particular) because of unpredictable Federal Government policies on energy and ongoing squabbling between the Government and Opposition as well as between Federal and State Governments. However, the finding was more a warning that domestic political risk could damage Australia's value proposition; Australia is still seen as "one of the world's most attractive and sophisticated infrastructure markets";
- The Investor Group on Climate Change (IGCC) released a paper in October – 'Coal, Carbon and the Community Investing in a just transition'. The paper considers in detail the potentially debilitating impacts on various Australian regions of the evolution / decline of coal mining and associated industries (considering the end use of the coal and alternative uses, the markets for that coal, regional infrastructure and demographics, existing non-coal related regional businesses etc.). The paper does not provide solutions to the problems likely to be faced by coal industry dependent regions but rather draws out the issues which need to be considered and flags the potential for public private partnerships to assist with the transition by investing in new businesses and transformative industries. Clearly the task will be a massive one, perhaps unnecessarily complicated by political diversions; impact investing has been a hot topic for some time and it will be interesting to see whether Governments can work proactively with the super funds to develop investable opportunities rather than responding reactively as closures are confirmed (as observed in the paper);
- The Australian Institute of Health and Welfare estimates that by 2056, 22% of the population will be aged 65 and over (8.7 million people – the figure was 3.7 million in 2016). Arguably, Australia is relatively unprepared to service the accommodation and healthcare needs of a rapidly aging population. We have noted in previous commentaries that several funds have already stepped up by investing in retirement living, dementia care and similar under the broad categorisation of impact investing.

We also note that, as greater numbers of superannuants reach retirement age, with higher levels of savings, there has been an increased focus on 'transition to retirement'. By this we refer not simply to developing suitable retirement savings products (such as CIPRs/Comprehensive Income Products for Retirement, recommended by the Financial Services Inquiry), but also services supporting individuals in coping with the change from work-life to potentially decades-long retirement.

Rather than ceding responsibility at the point of retirement, or shortly thereafter, superannuation funds may become more involved in the post-retirement lives of their current members (some already have); in-sourcing or out-sourcing the expertise required. In the longer term, one wonders whether supers might expand/evolve to provide more broadly based post-retirement services in relation to retirement living, aged care etc.

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