EBOOK

THE ONE THING INVESTORS CAN'T IGNORE IN 2020

Synopsis

2019. What a year it's been. Headlines were dominated by trade wars, franking credits, astronomical multiples for tech stocks, failed IPO's, the long-awaited crash (and unexpected recovery) in housing, and central banks drastically changing their stance on interest rates to keep the economy moving forward.

So what lies around the corner in 2020? We reached out to 45 of Australia's top fund managers and analysts and asked them to pick one idea for the year ahead and distill it into just a few paragraphs. From equities to fixed income, macro to alternatives, Livewire's 2020 eBook delivers some eye-opening insights across a variety of asset classes. We also got the thoughts of a few of our own familiar faces.

All the best for 2020

livewire

CONTENTS

CONTENTS

CONTENTS

CONTENTS

CONTENTS

Adam Bowe

Fixed Income Portfolio Manager, PIMCO

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"Fat tails refer to a probability distribution of outcomes that are skewed towards extreme positive and negative outcomes. We see a number of factors that contribute to this environment."

Don't trip on a fat tail

In our baseline forecast for 2020, the low-growth period of vulnerability from 2019 gives way to a moderate recovery in global growth.

However, our conviction in this baseline economic narrative is lower than usual, given our expectations of an environment of heightened uncertainty. In other words, we are wary of the possibility for fat tails in investment outcomes.

Fat tails refer to a probability distribution of outcomes that are skewed towards extreme positive and negative outcomes. We see a number of factors that contribute to this environment.

The first is trade policy. On one hand, a further escalation of the trade war could easily tip an already slowing global economy into recession. On the other hand, a comprehensive trade deal between the U.S. and China that removes a significant portion of the already imposed and prospective tariff increases could produce a synchronized reacceleration global growth in 2020.

Another factor is global monetary policy. If global central banks under-deliver relative to market expectations, this could result in a left-tail outcome.

As the sell-off in risk assets during the fourth quarter of 2018 showed, markets are very sensitive to more-hawkish-than-expected central banks.

Another upside risk to economic growth is that fiscal policy in major economies becomes more expansionary. While our baseline foresees only moderate fiscal stimulus over the cyclical horizon, there is a chance that slowing growth and – in Europe and Japan – negative bond yields and "QE infinity" incentivise governments to become more proactive in supporting growth.

In this environment of potential fat tails, we think it's prudent to focus on capital preservation, to be relatively light in taking top-down macro risk in portfolios, to be cautious on corporate credit and equities, to wait for more clarity, and to take advantage of opportunities as they present themselves.

Alex
Cowie

Content Director,
Livewire Markets

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"Today the Livewire audience numbers nearly 200,000 and we enjoy the honour of working with the best managers in the market..."

When compounding applies to start ups

No matter how often I run the numbers, compounding still seems like a magic trick.

For example, it you grow by 30% a year, after five years, you are not 1.5 times bigger (as an arithmetic return would suggest), but 3.7 times bigger. Then push out ten years, you are 13.8 times bigger. The numbers get crazy after that.

Why am I recounting basic laws of finance? Well, digging through the Livewire archives and looking at the content we published when we first publishing in 2014, and then how it evolved year-by-year since then, I don't think it's a stretch to say that our content has improved by 30% p.a. over each of the five years since then.

Through constant hard work and focus by the entire Livewire team, the audience has grown continuously, and the breadth and stature of our partners has grown with it.

Today the Livewire audience numbers nearly 200,000 and we enjoy the honour of working with the best managers in the market to create industry leading content with them. And as we enter a new year, we have the strategy and momentum to dial it up another notch for you.

So, while I freely admit I haven't a clue what markets will bring us in 2020, my tip is to read Livewire to help you better navigate through whatever does transpire!

Andrew Lockhart

Managing Partner, Metrics Credit Partners

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"By simply recognising this, investors can easily turn this – and their income – around and earn more."

The Future of the (Non) Banking Sector

Investors, of all types, can no longer ignore that they need to refine their income investments. With the major banks under continued regulatory pressure, the non-banking sector is set to dominate in 2020.

Not that long ago, portfolios were 'balanced' with a mix of equities and bonds (equities for growth and bonds for income) and the more conservative portfolios held more bonds – traditionally government bonds.

Those bonds are now returning 1% or less, less than inflation, which means investing in them means you are losing money, going backwards!

By simply recognising this, investors can easily turn this – and their income – around and earn more.

How? By simply taking a slight step up along the risk curve from government bonds to the corporate debt of ASX-listed and other sizeable companies that the big banks currently lend to.

The returns of such corporate loans can range from 4% to in excess of 10% currently.

They are often secured by direct security recourse over the company and covenants/rights; in the same way banks may hold security over the assets of a company they lend to. They are also well diversified, with in excess of 100 such corporate loan assets in one fund.

In addition, this alternative asset class provides income-seeking investors with reliable monthly income and an exposure through exposure to the Australian private credit market.

If you choose an ASX-listed investment vehicle you can also have daily liquidity, which is better than locking-up your cash in a term deposit for 90 days, 120 days or more.

In terms of their returns, corporate loans have a low correlation to other major asset classes including equities, government bonds, hybrids and term deposits, providing an excellent source of portfolio diversification for investors. Until recently, a key issue for many investors has been accessing the corporate loan market, which has traditionally been dominated by the big four banks.

This investment strategy should be considered by superannuation funds, insurance companies, charities, universities and other high-net-worth individuals. So, if you're an investor who isn't shopping around for competitive rates and looking beyond traditional assets, you are missing out on generating the best fixed income returns possible in a low interest rate environment.

So please don't ignore the potential of corporate loans and the benefits they can provide over money-losing cash and government bonds.

Andrew McAuley

Chief Investment Officer,
Credit Suisse Private Bank

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"Cash remains our least preferred asset class. Central banks are taking a "whatever it takes" approach to preventing a recession. Rates are falling and the RBA has stated it will continue to cut if necessary."

Time to consider buying alternatives

We believe the thing investors can't ignore for 2020 is how to get exposure to alternative asset classes.

At the beginning of the year, we wrote about the reasons to be optimistic for 2019, in the face of what seemed like a wall of worry. The consensus was the cycle was ending and it was time to think about getting defensive. Since then markets have had one of the best years' ever. Australian equities are up 22% as are international equities in AUD terms. Even bonds have returned around 10% as yields have fallen. With reasonable economic data, and central banks cutting rates aggressively, we suggested the ABC portfolio – Anything But Cash.

Do we still support the ABC portfolio?

The short answer is yes.

Cash remains our least preferred asset class. Central banks are taking a "whatever it takes" approach to preventing a recession. Rates are falling and the RBA has stated it will continue to cut if necessary.

That said, valuations for equities are full and bond yields low. Australian Government 10-year bond yields are only 1.24%. Returns for these traditional asset classes for the coming 12 months will be harder to come by.

Look to alternatives

Alternatives, by their nature, should provide lower volatility than shares but a better return than bonds. Fund options are available for those with smaller amounts of money to invest to provide diversified exposures to managers, strategies and groups of individual assets.

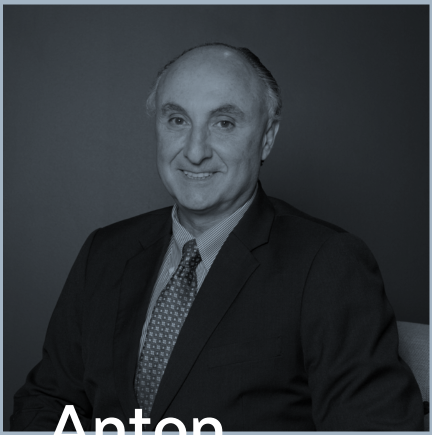
Investors should consider alternatives such as hedge funds, commodities, private equity, unlisted infrastructure, listed property and direct property, to provide uncorrelated returns to bonds and stocks.

The term hedge fund covers many strategies, but a true hedge fund is looking for some way to make a return that doesn't depend on markets going up. For example, a "special situations" strategy might entail buying the target of a takeover and selling the bidder. Another strategy is relative value. The manager may have a view that one country's share market will outperform another. The manager will buy the market it favours and sell short the unfavoured one, balancing out the risk but making money if the relative view is correct.

US election another wild ride

If we had to nominate a geopolitical event that investors can't ignore it is the US election. The leading Democrat contender is talking of breaking up big technology companies and increasing taxes on the largest companies.

Such a breakup occurred in the US Telco industry with the creation of the baby Bells from AT&T. The result wasn't good for shareholder returns. We saw the impact of the last US election with massive swings in markets on the day. The coming election looks like it will polarise America again, and it will be another wild ride.



Anton Tagliaferro

Investment Director,
Investors Mutual Limited

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"In 40 years of funds management, this is the only approach I've found that preserves capital, grows income and, importantly, withstands market cycles."

The only way to withstand a cycle

Given the unprecedented low level of interest rates in 2019, we believe the one thing investors cannot ignore in 2020 is stock selection based on fundamental value.

Over the past few years, we've seen a massive rise in passive, or index-linked, investment. By their nature, index/passive strategies do not use qualitative factors, such as fundamentals, to select securities for their portfolios.

Money flows to shares with the largest index weightings, regardless of the quality of a given company's business model and, in many cases, regardless of whether the company has any prospects of turning a profit in our lifetime.

The more money that flows into these strategies, the more that certain sectors of the market resemble a bubble – leaving investors highly exposed in the event of a downturn.

Given that ultra-low interest rates are forcing savers further along the risk curve – by increasing their allocation to shares, for example – we believe the only prudent way to ensure people, especially those in their later years, do not take on undue risk is an active, research-led, fundamental approach to stock-picking.

We look for a number of characteristics in any stock we consider for one of our portfolios including:

- Competitive advantage,
- Capable management,
- Recurring earnings and
- Quality at a reasonable price.

In the large-cap segment of the Australian sharemarket, we seek out good-quality industrials trading on attractive valuations that we believe are well-positioned over the next 3-5 years.

Three stocks that pass the filters

CSL, Tabcorp and Telstra are a few examples of companies with proven business models, a track record of earnings growth over the longer term, strong competitive advantages in their industries and a history of growing dividends.

In 40 years of funds management, this is the only approach I've found that preserves capital, grows income and, importantly, withstands market cycles.

The coming election looks like it will polarise America again, and it will be another wild ride.

Ben McGarry

Portfolio Manager,
Totus Capital

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"In recent months, we have seen the failed IPO attempt of WeWork and a de-rating in fellow past unicorns such as Uber, Lyft, Peloton and Slack to name a few, as well as a sentiment change in the Australian tech market."

Cash Earners over Cash Burners

At Totus, we like to invest in quality cash earners and with the ability to short and offset these with cash burners.

With 2019 coming to a close, one thing we believe investors can't ignore heading into 2020 is the risk of business models that are heavily dependent on external capital to fund their growth or even worse, keep their existing operations afloat.

Historically low rates have led to an increase in access to capital with the markets' (both public and private) willingness to pay up for growth. This abundance of capital has led to a range of questionable business models evolving and becoming publicly listed, which have not been tried or tested through a cycle and may never be profitable (even some self-proclaimed - Uber).

In addition, these companies have been priced to perfection, with some becoming known to the market as 'unicorns'. We believe that a lot of these valuations do not consider the inherent risk of access to funding and have limited valuation support during a market correction or worse a bear market.

In recent months, we have seen the failed IPO attempt of WeWork and a de-rating in fellow past unicorns such as Uber, Lyft, Peloton and Slack to name a few, as well as a sentiment change in the Australian tech market.

Could this be the initial sign of the market waking up to the unsustainable nature of these businesses and future funding requirements?

Who knows, but we do know the laws of combustion say that the fire will fizzle if the fuel becomes scarce.

YTD % Performance of Uber, Lyft, Peloton and Slack

Bob Desmond

Head of International Equities, Evans & Partners

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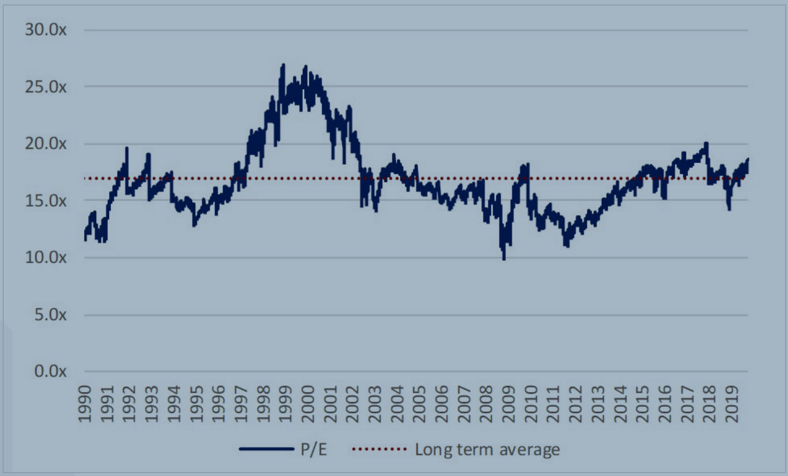
"Warren Buffett has said many times over the years, interest rates are like gravity for asset prices"

Where's the euphoria to herald a market top?

Market forecasting is perilous at the best of times. We don't know anyone in 2007 that predicted there would be $17tn of negative yielding bonds in 2019; or the large amount of monetary stimulus that would be applied with limited inflationary consequences; or who predicted Brexit or that Trump would become President of the USA.

With that caveat in place, we list below our thoughts on equity markets. We believe there are three key drivers of long-term market returns: valuations, interest rates and corporate earnings. We must admit to being somewhat bemused that most pundits describe markets as "very expensive" or "stretched". Below we chart the S&P 500 since 1990. The current trailing PE ratio of 18.9x might give some support to the bears, at 11% above the average over that period.

However, as Warren Buffett has said many times over the years, interest rates are like gravity for asset prices and we believe a more relevant metric is the difference between the earnings yield (the inverse of the PE ratio) and the return available on fixed interest assets. The current earnings yield is 5.4% versus a ten-year bond rate of 1.8%, leaving a premium of 3.6%. This compares to an average premium of 1.6% dating back to 1990. ▶



Source: Bloomberg

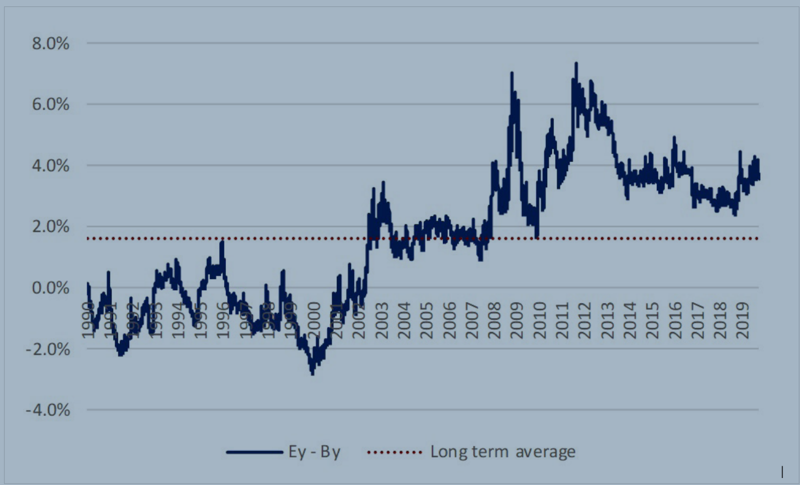
“Sir John Templeton’s maxim “bull markets are born in pessimism, grow on scepticism, mature on optimism and die on euphoria.” Anyone picking up a newspaper would hardly describe the world as euphoric!”

For the bears to be proven right in 2020 will either require a large rise in interest rates or a dramatic collapse in profits. Whilst this is always a possibility, our recent discussions with companies remain positive (apart from pockets of weakness in industrials) - in marked contrast to the bearish headlines we read about in the financial press. In a recent Barron’s survey, fund managers were described as the most bearish since the great recession and carrying above average cash holdings.

We are reminded of Sir John Templeton’s maxim “bull markets are born in pessimism, grow on scepticism, mature on optimism and die on euphoria.” Anyone picking up a newspaper would hardly describe the world as euphoric!

As such, with equity markets still yielding very attractive returns relative to bonds, a benign economic backdrop with decent (although slowing) economic growth, muted inflation and an easing bias by central banks – there’s a case to be made that equity markets will keep climbing “the wall of worry.”

But as with most things Yogi Berra said it best and the reader should remember that “predictions are difficult, especially about the future.”



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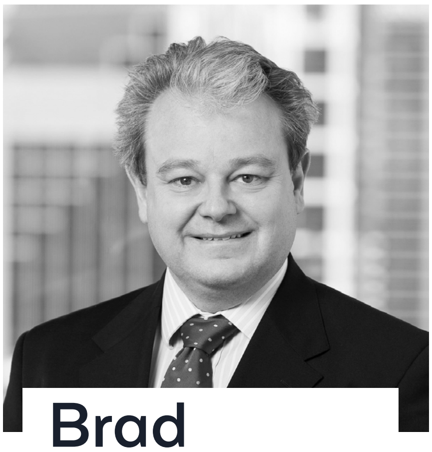

Brad
Potter

Head of Australian Equities, Nikko Asset Management

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"the valuation dispersion looks little changed with the bubble in the defensive and quality/ growth names still at extreme levels"

Will 2020 be the year for value stocks?

As 2019 draws to a close...The valuation premium for quality and growth has hit new decade highs, driving the ASX200 average forward PE to sit ~14% above the 20-year average. But the average always hides the detail: industrial PEs are sitting 36% above the 20-year average, miners 18% below and banks 15% below.

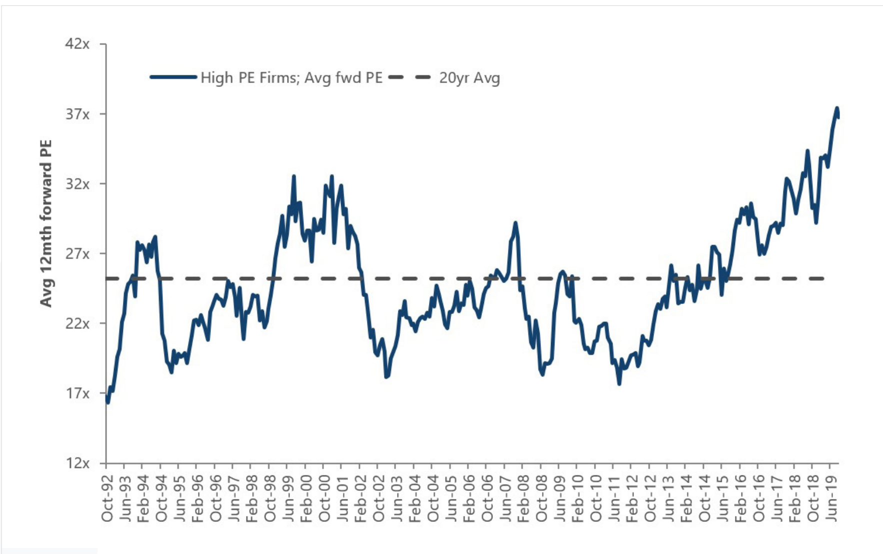
The most recent correction in momentum stocks sees this factor at a new YTD low. However, the valuation dispersion looks little changed with the bubble in the defensive and quality/ growth names still at extreme levels, as shown in the following charts.

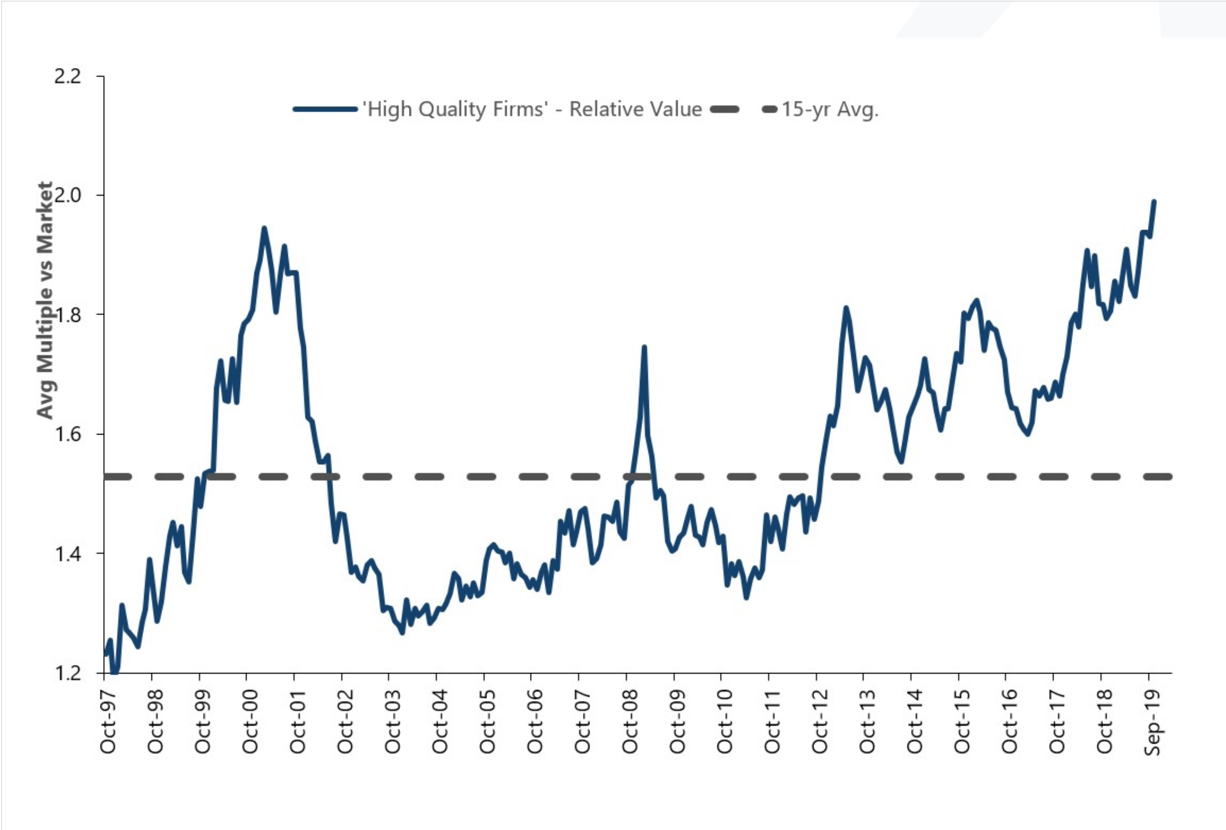
The door opens for a value bounce back

- Interest rates at multi-decade lows are causing bubble-like valuations across growth and quality names that will eventually burst given the heady multiples being paid.
- Donald Trump appears keen to sign a mini deal with China to avoid further tariffs that may hurt US voters prior to the 2020 presidential election.
- A no-deal Brexit tail risk has essentially become very unlikely and thus any further clarity on a sensible Brexit or a 'remain' will be viewed positively. ▶

| Chart 1 High PE firms trade an average forward PE of 36.7x, which is 45% above the 20-year average

Source: Goldman Sachs, as at November 2019





| Chart 2 High quality forms trading at levels above that seen during the 2000 tech bubble
Source: Goldman Sachs, as at November 2019

"Geopolitics has been one of the largest drivers of the slump in global growth and corporate profits over the past year. Therefore, less stress can be a powerful catalyst for a cyclical revival."

- The global manufacturing downturn is now essentially halfway through a typical three-year cycle with the 2H traditionally a bottoming out and recovery. Therefore, potential for reflation in 2020 as global PMIs trough is a powerful driver of the market. In times like this, cyclicals and economically sensitive stocks do well, and we expect defensive, growth and low vol stocks should reverse some of the exorbitant valuation multiples they are priced on.
- Geopolitics has been one of the largest drivers of the slump in global growth and corporate profits over the past year. Therefore, less stress can be a powerful catalyst for a cyclical revival. Compounding this is the cheap valuations and extreme positioning of the market that has the potential for violent rotations into the value end of the markets.

As a value manager, our conviction lies in a process that is based on long-term sustainable earnings and cash flows, priced on appropriate multiples. So, when the market reverts to more normal conditions, a patient active value manager (and investor) can benefit enormously.

Bruno Paulsen

Portfolio Manager, Morgan Stanley IM

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"in a world where scrutiny of corporates by both governments and consumers is rising sharply, managements need to be aware of the Environmental and Social risks facing their businesses and proactive in dealing with them."

Own well-managed, ESG-focused, high-quality compounders

We like to say that there are two ways to lose money in equities, falling earnings and falling multiples.

Two years ago, we were worried about the market's multiple. Following the de-rating in 2018 our main anxiety shifted to earnings. In one sense, this anxiety has proved relatively well placed, with 2019 estimates for the MSCI World Index down 10% over the last year, but in a more important sense, we were wrong to worry, as markets have ignored the subsiding earnings and revived strongly.

The MSCI World Index's multiple of 2019 earnings has surged from 13.4x to 17.2x1, boosted by the monetary generosity of the U.S. Federal Reserve and Mr Draghi at the European Central Bank. The multiple is probably helped by the perennial assumption of future earnings growth, with 2020 earnings expected to be 9% higher than 2019, arguably not a safe assumption.

Heading towards 2020, for the market as a whole we worry about both earnings and multiples, given that both are high, earnings look vulnerable and the current combination of falling earnings with rising multiples is unlikely to be sustainable.

More broadly, in a world where scrutiny of corporates by both governments and consumers is rising sharply, managements need to be aware of the Environmental and Social risks facing their businesses and proactive in dealing with them. There is clearly no room for complacency in this emerging political environment.

As such we would continue to advocate owning high quality compounders, with senior management who are aware and engaged on material ESG issues. The combination of recurring revenue and pricing power that such companies possess should protect revenues and margins, respectively, preserving their profits.

Campbell Neal

Managing Director, K2 Asset Management

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“With Australian corporates enjoying healthy balance sheets, low borrowing costs and strong equity market conditions, the question is are they aggressively enough pursuing growth?”

Easier credit would drive small caps

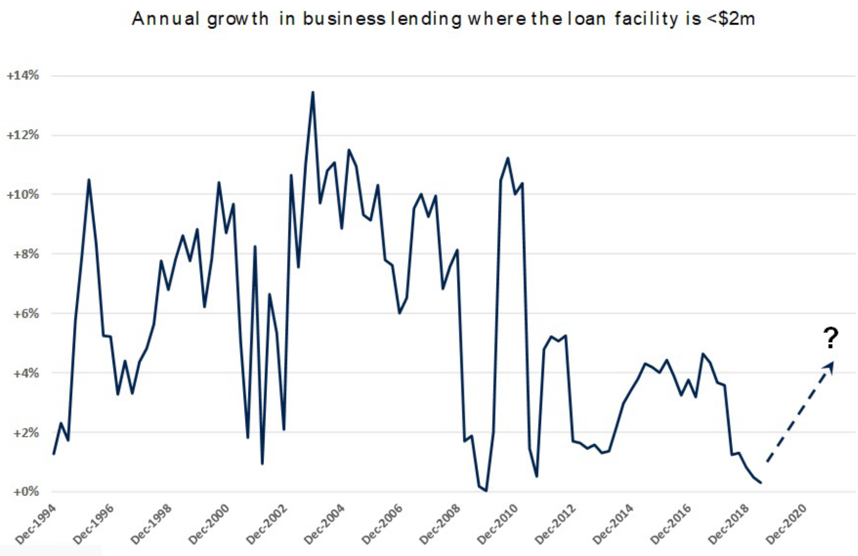
The one thing that investors can’t ignore in 2020 is business confidence.

Companies that initially list on the ASX tend to be smaller companies that are keen to pursue growth. If business leaders are lacking in confidence and are hesitant to invest for the future, shareholders tend to become restless and share prices subsequently decline. This is not lost on our Treasurer Josh Frydenberg who, in an opinion piece for the AFR back in August this year, stated;

“With Australian corporates enjoying healthy balance sheets, low borrowing costs and strong equity market conditions, the question is are they aggressively enough pursuing growth?”

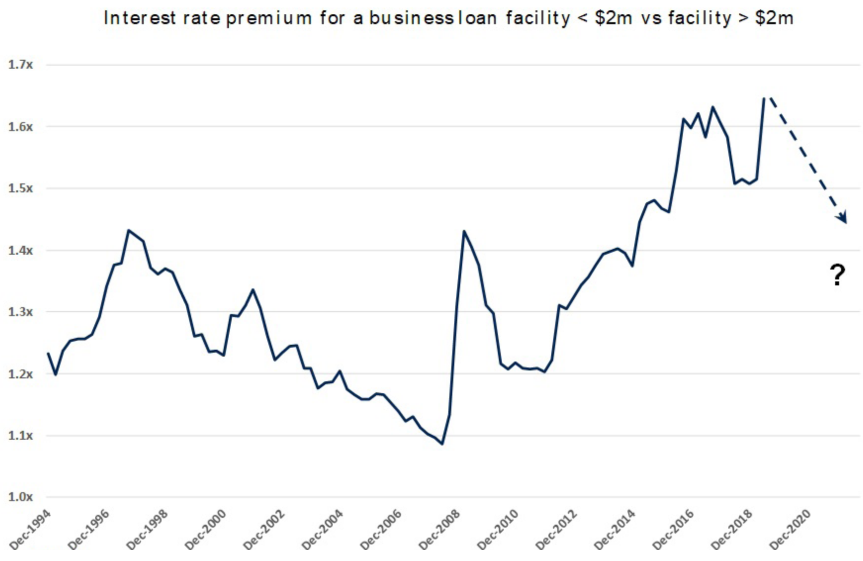
The clearest example of the aversion to growth is that bank lending to Small and Medium Enterprises (SME), which is the engine room of the Australian economy, has all but stopped. Have we lost our nerve or do SME’s have structural growth impediments?

Current regulations allow the major banks to apply a risk weight of just 37% to their loan books whereas Bendigo Bank, who has been lending money ▶



Source: RBA

"The major banks are therefore prioritising their lending efforts towards under-geared households and big businesses where superior risk adjusted returns can be generated."



| Source: RBA

to Australian's for 160 years, must use a risk weight of 52%. The major banks are therefore prioritising their lending efforts towards under-geared households and big businesses where superior risk adjusted returns can be generated.

Perversely, SME's are required to pay an interest rate that is more than 1.6x higher than their larger competitors in order to deliver appropriate risk adjusted returns to the major banks. This means that SME's have an uncompetitive cost of capital and have little motivation to pursue growth.

If Australia is going to prosper in 2020 then SME's access to competitively priced debt will need to improve. Risk weights for lending will need to be adjusted in favour of the non-major lenders. If this happens then we believe that business confidence will improve in 2020 and solid returns from SmallCap companies should be expected.

Catherine Wood

CEO & CIO, Ark Invest

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"What kind of growth do we anticipate? According to our estimates, the companies we invest in are leading, enabling and benefitting from five technology platforms that should generate more than $50 trillion in business value and wealth creation over the next 10-15 years"

Be on the right side of innovation

I founded ARK Invest to focus solely on disruptive innovation, primarily in the public equity markets because I believe that innovative public companies with forward looking growth are the most inefficiently priced part of the market.

Innovation typically offers long-term growth opportunities but, with an accelerating shift of funds toward passive and index-based investing, as well as outsized flows into private markets, I believe a void in research and portfolio management has opened up in the public markets. With our focus on public equities, ARK aims to fill this void by investing in the most innovative companies that we believe will deliver long-term growth during the next five to ten years.

What kind of growth do we anticipate? According to our estimates, the companies we invest in are leading, enabling and benefitting from five technology platforms that should generate more than $50 trillion in business value and wealth creation over the next 10-15 years. The five platforms we have identified are

- Artificial intelligence,
- DNA sequencing,
- Robotics,
- Energy storage, and
- Blockchain technology.

We believe they are approaching tipping points as costs drop, unleashing exponential growth across sectors and geographies and spawning more innovation.

Today, however, they account for less than $6 trillion in global equity market capitalization, giving investors an opportunity to capitalize by almost 10-fold if they extend their time horizons and position their portfolios on the right side of innovation.

Chad Slater

Joint CIO, Morphic Asset Management

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"2020 could be the "breakout year" as there is a US Presidential Election campaign that will see many more Millennials as a portion of the voting population, as 2019 was the year that Millennials passed the Baby Boomers in adult cohort size in the USA. "

Greta. Get used to more of her

There's a pre-Greta world and a post-Greta world. In the post-Greta world, 11-year-old trick-or-treaters now knock on my door with plaited hair for Halloween. Whilst a cohort of some would prefer to see this a ghoulish trick, I'm sad to say to expect more of them in 2020.

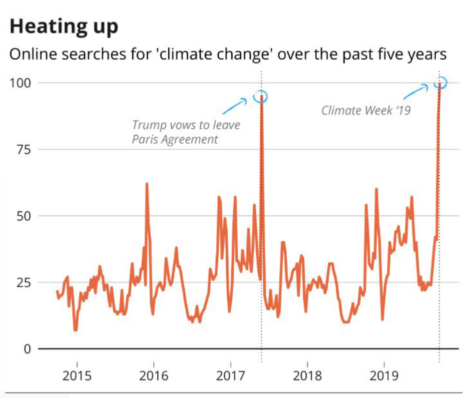
Irrespectively of any opinions about Greta, she has changed the debate. 2019 was the year it went mainstream, with "Climate Change" searches finally passing Game of Thrones.

2020 could be the "breakout year" as there is a US Presidential Election campaign that will see many more Millennials as a portion of the voting population, as 2019 was the year that Millennials passed the Baby Boomers in adult cohort size in the USA.

If there's one thing politicians are keenly aware of, it is their own self-interest. And self-interest here involves getting re-elected. With the raging California fires, a majority of Americans now see climate change as an issue regardless of voting preferences.

So, coming into 2020, we have a major political event being both a Presidential election but also Upper and Lower House elections, combined with a change in the mix of voters, combined with changing views that have gone somewhat un-noticed. This to me is a set-up that will seem obvious in hindsight" when you see more and more initiatives in the USA focused on Climate action.

What does it mean for your portfolio? More funding for Green energy; at the margin, less demand for the resources that Australia (the USA isn't a large marginal user, it's China); and perhaps an injection of optimism for your children.



Source: Google Trends

Charlie Aitken

CIO, Aitken Investment Management

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"With growth slowing in manufacturing and trade around the world, the US consumer has remained the sole bright spot of the ongoing economic expansion"

Mr & Mrs USA, can they keep on trucking?

We believe "the one thing investors can't ignore in 2020" will be the financial health and confidence of the US consumer. Will Mr & Mrs USA just keep on trucking?

With growth slowing in manufacturing and trade around the world, the US consumer has remained the sole bright spot of the ongoing economic expansion – not a huge surprise, given that nearly 70% of US GDP is exposed to consumer spending.

US consumers have had very solid tailwinds over the last few years: unemployment sits at multi-decade lows; real wage growth has picked up and household balance sheets have been substantially improved from levels seen prior to the Global Financial Crisis.

Combined with very low inflation and some tax relief, the average American consumer is feeling wealthier, and has therefore been inclined to continue spending.

However, consumer spending is ultimately highly correlated with confidence in the future of the economy, both at a household and business level. The weak economic data seen in the second half of 2019 has been largely at the business level, and the main cause seems to be the confidence- and certainty-sapping effects of the ongoing trade war.

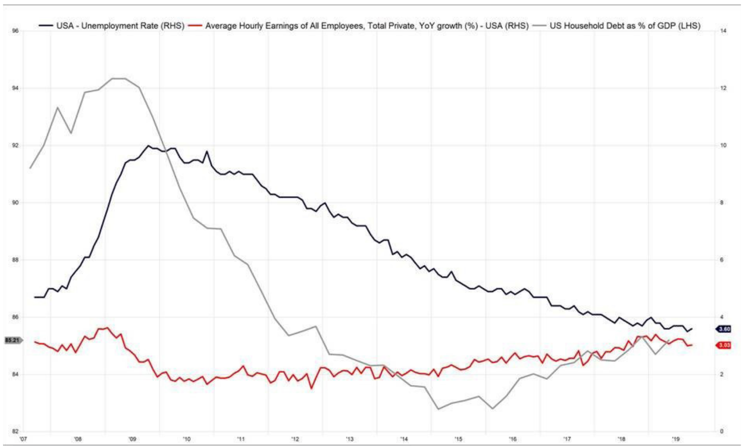
US consumers, on the other hand, have mostly shrugged off the uncertainty. The decline in 30-year fixed mortgage rates have positively impacted housing activity, and refinancing volumes have increased significantly over the last year as rates have come down. Household durable purchases have remained solid.

Given that 2020 is also a Presidential election year in the States, it would seem obvious that the White House understands it cannot afford consumers to feel the pinch if President Trump wants to see a second term.

Should US consumer confidence roll over and spending slow dramatically, it will have a disproportionate effect on US – and global – economic growth.

Vice versa, if the US consumer remains confident... Time will tell, but in our view, this is the key variable of 2020.

Chart source: US Department of Labour, Factset.



Charlie Jamieson

Chief Investment Officer,
Jamieson Coote Bonds

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"Finding quality and safety, and predictable yield in a world of negative interest rates will be paramount in helping investors through some potentially bumpy times ahead."

AAA-rated countries (as at 6-Nov-19)	Level of 10Y bond yield in local FX	Calendar YTD TR in local FX
Singapore	1.76%	3.6%
Canada	1.54%	4.3%
Norway	1.49%	1.9%
Australia	**1.27%**	**8.3%**
Sweden	-0.00%	2.9%
Finland	-0.00%	4.3%
Netherlands	-0.21%	4.8%
Denmark	-0.31%	6.1%
Germany	-0.34%	4.2%
Switzerland	-0.48%	3.7%

The Global Economy Is Fragile

Looking ahead, investors cannot ignore just how fragile the world economy actually is. While we are not forecasting an imminent global recession, our ongoing analysis suggests a rising probability of the inevitable.

Consider the notable challenges currently in train – with little sign of resolution:

- A fatigued consumer complex that is experiencing the fading of one-off US tax cuts.
- An extended US/China trade war that has crimped confidence and capital investment – global macro data worsening is likely.
- South-east Asian export nations – the world's 'factory' that takes in nations like South Korea, Taiwan, Indonesia, Singapore – continue to materially deteriorate.
- Some ten plus years on from the global financial crisis, financial markets are still discussing Quantitative Easing (QE).
- An Australian economy that is highly linked to Chinese fortunes, a story structurally under sufferance. The RBA may apply QE. Should the RBA follow much of the developed world into a program of QE, the currency impacts will likely be profoundly negative.

Adjust the mindset

Investors need to adjust their mindset in this late-cycle environment for 2020 and beyond – what got you 'here' previously won't necessarily get you 'there' moving forward.

A greater emphasis on defence in a lower-return environment (alongside with higher volatility) will provide much needed balance against a wide dispersion of possibilities ahead. In this 'defensive' conversation, high grade sovereign bonds may provide liquidity, stable income and capital preservation against market volatility.

In this late-cycle stage, high-quality assets such as AAA-rated sovereign bonds can play a role in mitigating risk by diversifying portfolios. Additionally, the returns over time and compounding income (see figure 1) mean high grade bonds, whilst offsetting higher risk exposures have performed well for investors.

Figure 1: AAA-rated countries' 10-year yields and calendar year total returns in local currency. Investors should consider their portfolio asset allocation in these times of heightened uncertainty.

Finding quality and safety, and predictable yield in a world of negative interest rates will be paramount in helping investors through some potentially bumpy times ahead.

Curtis Cifuentes

Investment Director,
Avenir Capital

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Chinese and Indian middle classes flying high

While not a 2020-only issue the emergence of the Chinese middle class is one of the world's great success stories of pulling almost a billion people out of poverty over three decades. This growth provides many potential opportunities for investors.

"we've seen the number of air passengers grow three-fold over the last decade, yet the number of flights per capita is still just one-sixth that of the United States or Australia."

One good example would be the steady rise in air travel in China, where we've seen the number of air passengers grow three-fold over the last decade, yet the number of flights per capita is still just one-sixth that of the United States or Australia.

We have invested in companies that benefit from this steady growth in passengers, such as TravelSky (a GDS provider – GDS or global distribution system is a network that enables travel agents to book airlines, hotels and rental cars) and Safran (a jet engine maker).

India is at a similar point in development to China about a decade ago. Using the air travel example, there's about one flight for every ten Indians annually, compared to 2.6 for every American (so 25-times as many flights per capita).

These opportunities are not free of risks, however. Western companies are going to have to navigate a China that is increasingly leveraging its economic might to effectively export their own censorism.

Twenty years ago, when trade with China normalised, the belief was the Internet and trade would inexorably lead to China following the west's path towards liberalisation and democracy, but instead today we have businesses like the NBA and Apple, for example, being forced to make hard choices between ideals and profits.

Also, while air travel only accounts for about 2% of global greenhouse gas emissions, the industry has yet to identify a clear path to zero emissions and is potentially at risk of boycotts or regulation.

Source: ICAO, World Bank

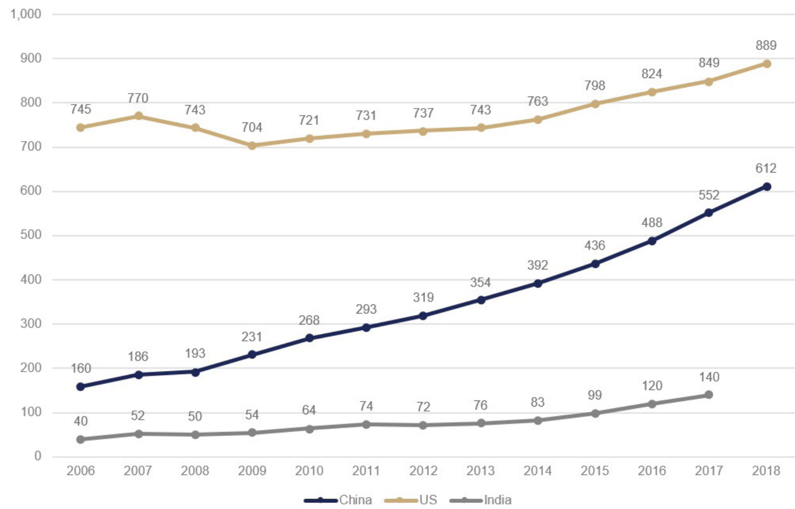

Figure 1: Annual air passenger numbers in the US, China and India (millions)

Don Hamson

Managing Director, Plato

Click to Follow

"Investors with current term deposits will need to come to terms with negative interest rates in 2020"

Boosting income when real rates are negative

No matter which measure you use, interest rates after adjusting for inflation are now negative. That means people living on these forms of income are going backwards after one takes account of inflation.

We expect this situation will worsen in 2020, with the market pricing in another 0.25% cut in official overnight cash rates and the RBA jawboning about quantitative easing (essentially pushing down long term bond yields by the RBA aggressively buying bonds). Investors with current term deposits will need to come to terms with negative interest rates in 2020.

What can investors do to boost their income levels? Well the RBA is encouraging/making investors take on more investment risk, whether that be by taking on credit risk in the fixed or floating debt market, or moving into property, infrastructure or equity investments.

For example, the ASX200 index still yields almost 6% when one takes into account franking credits, handsomely more than the income on safe assets like bank term deposits.

We would encourage investors to look to the one free lunch there is in investments – diversification.

Spreading your investments across a range of asset classes and a range of different investments within asset classes can help reduce the investment risks taken.

Emanuel
Datt

Principal, Datt Capital

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"As such we believe today's interest rate environment reflects a credit environment where supply outweighs demand for credit..."

Boosting income when real rates are negative

One thing that investors cannot ignore in 2020 is the risk of recession and a potential fall in interest rates.

We consider that interest rates are a sound proxy for economic growth and can be thought of as a function of simple supply-demand. For example, when economic growth and confidence is strong there is a commensurate increase in credit demand driven by business investment.

As such we believe today's interest rate environment reflects a credit environment where supply outweighs demand for credit; typified by the large fall in bond yields over the past 12 months. This fall in interest rates affects everyone: investors cannot obtain sufficient real yields in less risky assets, whilst lower serviceability requirements and debt covenants encourage borrowers to take upon more debt.

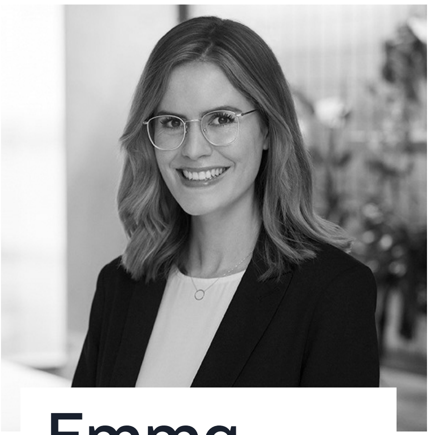
History tells us that these circumstances can change suddenly without warning.

Our solution to this issue is:

1. Invest locally, but think globally
By investing in local markets, risk is cut significantly via less exposure to currency fluctuations and a consistent legal environment. A free-floating currency like the Australian dollar helps an economy adjust relative to global competitors during times of recession. Global markets should be monitored due to the connect nature of the global economy in this era.

2. Conservative Asset Allocation
Investors should diversify their capital allocation strategies across asset classes. For example, holding a reasonable portion of cash can allow investors to take advantage of investment opportunities in times of sudden stress.

3. Invest in earnings growth at reasonable prices
in a time of low growth and returns, companies that are growing rapidly can be a great source of rare, out-sized returns at relatively low risk. Careful assessment must be made to ensure that the opportunity can growth throughout economic cycles, leading to a lower risk profile.



Emma Fisher

Portfolio Manager,
Airlie Funds

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“a strong balance sheet can be a source of optionality and future returns. ”

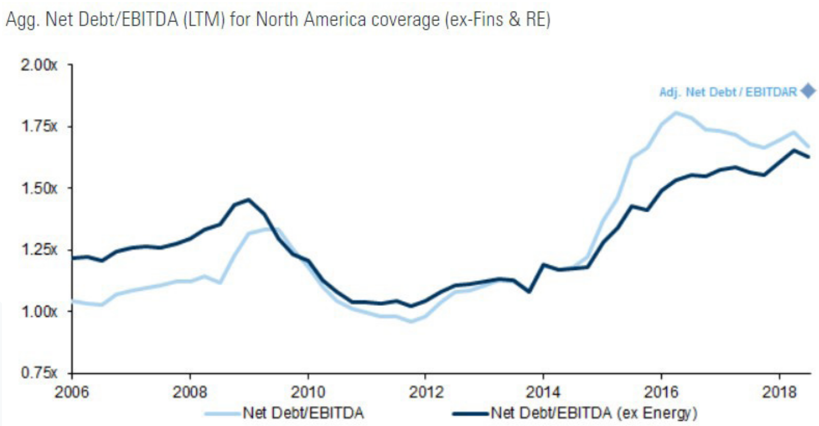
Focus on the balance sheet next year

In 2020, the one thing investors can’t ignore is the balance sheet. While I would argue it should never be ignored, it becomes particularly important as we head into 2020, with markets globally making all-time highs and the world awash in cheap, covenant-light debt.

Balance sheet risk looks particularly elevated for US stocks, many of whom have borrowed to finance share buyback programs over the last 7 years. The average stock in the US now has net-debt-to EBITDA of 1.7x times. Corporates are now far more geared than they were heading into the GFC, when corporate leverage was 1.25x.

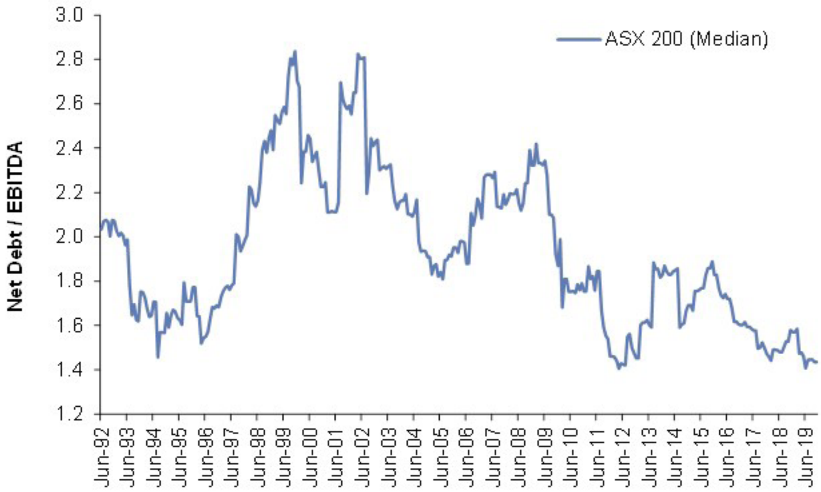
By contrast, balance sheets for Corporate Australia appear in better shape, with average company gearing of only 1.4x times net debt to EBITDA, well down from 2.0x pre-GFC. However, as the saying goes, “when the US sneezes, the world catches a cold”. Most (if not all) financial crises have their origins in the credit market, and most local equity market drawdowns are led by equity market falls in the US.

So, who to worry about in the Aussie market? We think the answer is those companies that have high operating leverage, which can be a deadly combination when you throw in financial leverage. For this reason,



Source: Goldman Sachs

"Investors should be looking at 2020 as the year to own companies with rock-solid balance sheets..."



| Source: Goldman Sachs

we prefer to see very little debt for business models like retailers, advertisers, building materials and agricultural companies.

When sales fall away, fixed costs can tank the bottom line and an "ok looking" balance sheet can quickly look precarious. The recent raising for Costa Group is a good example. Screening for industrial stocks in the ASX200 that have current net debt to EBITDA over 3x reveals a list of companies in such industries, and poor share price outcomes. Qube appears the only company to have bucked the trend.

The flip side is that a strong balance sheet can be a source of optionality and future returns. Wesfarmers' share price is up 25% since it announced a surprise special dividend of $1 in February, ending the year with net debt to EBITDA of 0.6x. Investors should be looking at 2020 as the year to own companies with rock-solid balance sheets that allow them to weather any economic outcome.

Companies with ND/EBITDA >3x	1-year change in share price
Graincorp	-5%
Incitec Pivot	-7%
Ooh Media	-44%
Speedcast International	-70%
Qube	40%

Gopi Karunakaran

Portfolio Manager,
Ardea Investment
Management

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"With interest rates collapsing globally, investors are under intense pressure to find ways to boost returns"

Growing liquidity risk in fixed income portfolios

Liquidity, like the plumbing in your house, gets little attention until something goes wrong.

Across the fixed income asset class, core government bonds sit at the most reliably liquid end of the spectrum, with liquidity then progressively decreasing for credit-risky securities such as corporate bonds, emerging market debt, loans and securitised investments, all of which can become hard to buy or sell, particularly in adverse market environments.

To be clear, illiquid securities are not inherently bad. They can be attractive when liquidity risk is explicitly recognised, well compensated and the time horizon of capital is appropriate.

Problems arise when liquidity risk is hidden and creeps into portfolios that are expected to remain liquid and intended to play a defensive role.

In our view, the following themes can't be ignored.

1. Hidden liquidity risk
Liquidity in credit-risky segments of fixed income has deteriorated due to bank balance sheet constraints. (see chart below)

This hasn't yet been obvious because the sheer volume of yield chasing inflows to credit markets has provided an illusion of liquidity. It's only when the inflows turn to outflows that the reality of illiquidity will become clear.

2. Illiquidity creep
With interest rates collapsing globally, investors are under intense pressure to find ways to boost returns. As a direct result of this, portfolio allocations to higher yielding, but less liquid bonds and loans has been creeping higher.

Most vulnerable to a future liquidity crunch are those running a growing mismatch between the regular liquidity they promise investors and the illiquidity of their underlying investments.

We expect to see more liquidity related problems surface as the desperate search for yield compels ostensibly liquid portfolios to keep pushing the limits.

James
Abela

Portfolio Manager,
Fidelity

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"The heady days of reckless momentum have passed their peak and for investors, I think the new year will see a return to reality"

Reality bites - the importance of long-term sustainability

The one thing I think investors won't be able to ignore in 2020 is genuine sustainability. And by that, I mean a company's ability to create and maintain sustainable earnings and cashflows as we move through the cycle.

Over the last few years, a scarcity of growth and yield has led to a premium being applied to companies that have exhibit those characteristics and consequently valuations have become exuberant and sometimes completely irrational.

Globally we've seen instances of this in the tech space with companies such as Uber, WeWork, Lyft and Pinterest. If we look at tech giant Uber as an example - the company has experienced massive growth in a relatively short period of time, completely changing the way we commute.

But despite being a major disrupter Uber continues to lose money each quarter. In April Uber's much anticipated Initial Public Offering (IPO) was predicted to see the companies market cap reach the US$ 90 billion mark, today it's sitting at US$55 billion. It's currently not a sustainable cash generating business model and that's why we've seen billions wiped off its market cap since the company listed in May of this year.

Closer to home, in the domestic small cap market six small cap IPOs have been withdrawn from listing in the last six weeks due to insufficient raising demand. We're seeing a resurgence in valuation discipline as investors take a closer look at pricing and just what they're paying for. And without an established track record, investors are a lot more cautious.

2020 could be a year for some tough lessons. 1987 provided us with a lesson on economic cycles. 2008 opened our eyes to debt cycles and balance sheets. Now we may be due for a lesson on liabilities such as the impact of negative interest rates, a lack of capital discipline not to mention the limits of monetary policy to keep providing stimulus.

The heady days of reckless momentum have passed their peak and for investors, I think the new year will see a return to reality and serve as a good reminder to be discerning and look for long-term sustainability.

James Gerrish

Primary Contributor,
Market Matters

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“The $A is largely driven by interest rate differentials amongst other factors but it’s the positioning around the $A which makes the local currency a fascinating subject to us at the moment...”

Targeting 80c for the Aussie dollar

When thinking about the obvious macro factor that investors should be across in 2020 global bond yields spring to mind, however at Market Matters we’re not about pondering the obvious,

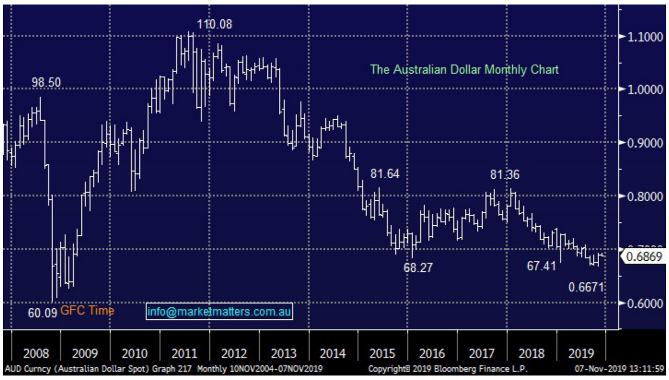
we’re about highlighting the non-consensus views which could have a bigger impact on asset prices, so in this piece, we give an honorary mention to bond yields and our expectation that the nadir on the downside has been and gone however we’ll highlight the Australian Dollar as the most influential macro factor for 2020.

The $A is largely driven by interest rate differentials amongst other factors but it’s the positioning around the $A which makes the local currency a fascinating subject to us at the moment – we believe investors are positioned for a lower for longer $A implying the more aggressive move could happen on the upside.

We have a contrarian bullish opinion on the $A which if correct will remove the major earnings tailwind that has been helping Australian companies with significant $US earnings. We are bullish the $A targeting the 80c region.

Australian Dollar ($A)

Our view is primarily driven by a bearish outlook for the $US which we believe has reached a major point of inflection after a decade long rally since the GFC. As we approach the November 2020 election in the US, the President will likely pull all stops for re-election and applying pressure on the currency in various ways would be very supportive of economic growth. ▶



| The Australian Dollar Monthly Chart

| The$US Index Monthly Chart

| The Australian & US 10 Year Bond Yields Weekly Chart

| The $US Index & Bloomberg Base Metals Index Chart

"in 2020, currency markets remain the area that could experience meaningful change to engrained trends..."

While the Federal Reserve cut rates in October, Chairman Powell made it very clear that any rate hikes will be conditional upon a marked and sustained uptick in inflation while they will cut again if economic conditions warrant it.

If a trade resolution is successfully negotiated between China and the US which improves global confidence and ultimately global growth at a time when the US are more dovish, then the US currency could well decline sharply.

The $US Index Chart

Historically, it's extremely rare to see Australian 10-year bond yields below their American counterparts but that's very much the case today, a huge contributing factor to the prolonged bear market for the $A. If we are correct and Australian bond yields again converge and eventually go above their US equivalent, as has been the norm for the past 50-years, it's easy to envisage the $A back up around 80c.

Australian & US 10-year Bond Yields Chart

The chart above illustrates over the last few years the clear inverse correlation between the $US and Base Metals, if our opinion is correct on the $US then we believe there's a strong likelihood that resource stocks will outperform in 2020. We are bullish base metals and resources moving into 2020.

The $US Index & Bloomberg Base Metals Index Chart

So, in 2020, currency markets remain the area that could experience meaningful change to engrained trends. While engrained trends take time to change when they do the weight of money that needs to change with them is substantial.

We are bearish the $US, bullish the $A and bullish resource stocks, as a consequence.

James Marlay

Co-Founder,
Livewire Markets

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"While the outlook and opportunity for Australia remains positive, there is a growing call for the government to play a more active role in supporting economic growth."

A prediction for all you haters

There are two types of people out there in the investing universe, those that love predictions and those that hate them. As sure as night follows day, there will be a chorus of keyboard warriors ready to tell you just how wrong all the predictions that get made at this time of year are going to be.

They're correct of course and there is plenty of evidence that demonstrates how hard it is to make accurate predictions. For example, in Livewire's 2019 Predictions Survey the consensus view on 7 out of 7 scenarios has turned out to be wrong.

So, for my 2020 piece I'm going to highlight the one investment decision you can make that will improve your returns. That decision is to lower your cost of investing. In a world where we are being told that we will receive less on our investments the cost of executing your strategy will have a proportionately larger impact on the return that you generate.

For some people this automatically means switching to low cost strategies like ETFs and maybe there is a case for doing that. However, if you step back a little further you'll see that businesses are competing and innovating like never before to win your business. I lowered the cost associated with my wrap platform by $500 a year with a single email to my adviser. The RBA has cut rates three times this year … a call to a mortgage broker will, at the very least, give you some leverage for a conversation about more competitive rates with your existing lender. Online brokerage fees of $9 per trade on ASX listed stocks are available on SelfWealth or you can buy US stocks on Stake for virtually nothing.

So, I'll leave the analysis on where to make or protect a dollar to the experts, but I'll be surprised if any of the haters out there can't find at least one way to lower their cost of investing in 2020.

Jay Sivapalan

Co-Head Of Australian Fixed Interest, Janus Henderson

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“While the outlook and opportunity for Australia remains positive, there is a growing call for the government to play a more active role in supporting economic growth. ”

Government action (or inaction)

We believe that 2020 will be the year that really separates the winners from the losers in the monetary policy ‘experiment’ of the past few years.

Livewire readers will be aware that monetary policy has reached extreme levels around the world, arguably now doing more harm than good. Through this next critical phase, economies with the ability, and more importantly, the willingness, to complement existing monetary policy with government support will be better placed to continue to grow; the key here is the concurrent deployment of fiscal policy.

Conversely, economies that aren’t in a position to provide government stimulus – those shackled with elevated levels of debt or constrained by demographics – will struggle to keep their economies expanding.

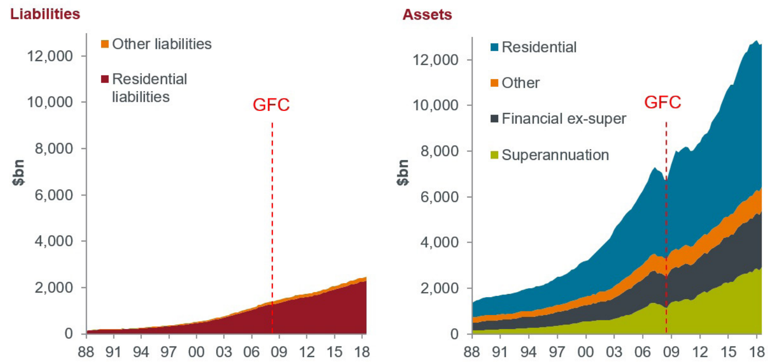
While developed economies such as the US have a greater ability to fare well through 2020 and beyond, economies like Europe and Japan are more at risk from an economic growth perspective.

These markets’ economic risks result from elevated debt levels, fiscal policy inability and demographic factors.

In Australia’s case, debt levels are healthy in the government and corporate sectors, but obviously stretched in the household sector. However, Australians’ ability to service their household debts (taking income levels into account) remains strong.

Australian households’ net worth has also grown strongly over the past decade (when the asset side of the ledger is included). ▶

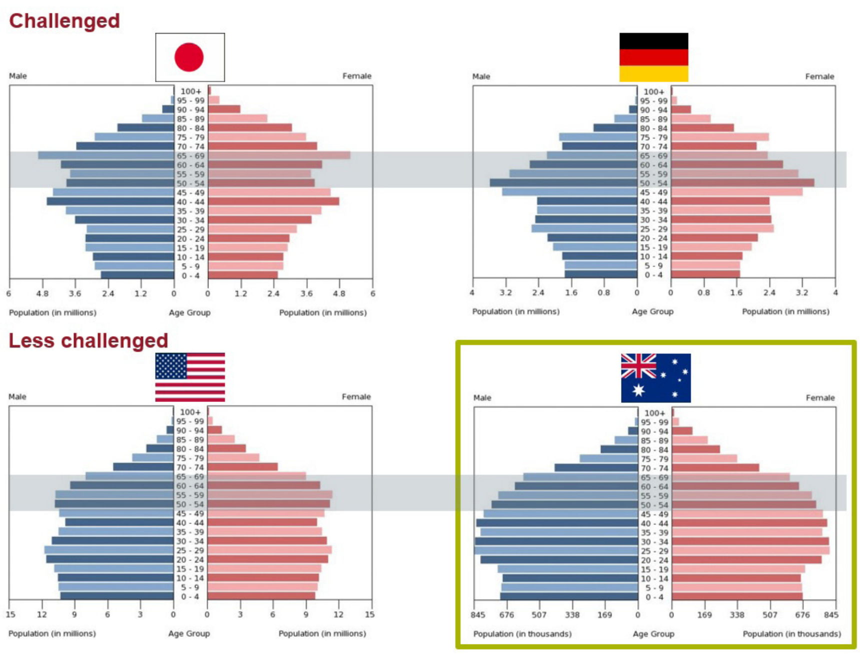
“We are indeed the lucky country”



| Source: Janus Henderson, Bloomberg, ABS. to 30 June 2019. Data for households

Chart 1: Australian households’ liabilities and assets

Demographically, Australia’s population is much less challenged than many other parts of the developed world.



| Source: Janus Henderson, The Factbook. As at 2016

Chart 2: Population demographics

While the outlook and opportunity for Australia remains positive, there is a growing call for the government to play a more active role in supporting economic growth.

We expect to see a more robust contribution in the form of further government infrastructure initiatives and fiscal policy over 2020.

We feel this will ensure Australia enjoys its 30th year of uninterrupted economic growth. We are indeed in the ‘lucky country’.

Joe
Magyer

Chief Investment Officer,
Lakehouse Capital

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"The $A is largely driven by interest rate differentials amongst other factors but it's the positioning around the $A which makes the local currency a fascinating subject to us at the moment..."

Beware the Chinese Slowdown

I am a long-term, business-focused investor who does not spend too much time on macroeconomics. Still, as a Sydney-based global manager, I would be remiss to not acknowledge the slowdown facing Australia's most important trading partner, China.

The Middle Kingdom consumed 31% of Australia's exports in 2018, according to the ABS, which is more than Australia's next four largest trading partners combined, so I suggest Australian investors of all stripes sit up and pay attention as well.

China's remarkably steady drumbeat of GDP growth has slowed to 6.0% year-on-year growth in the third quarter of 2019. While still an impressive mark for most countries, this is the slowest growth rate in this tightly managed number since the Chinese government began publishing quarterly GDP numbers in 1992. Also note that China is clamping down on capital flight– not something that typically happens when the local mood is positive.

A tailwind to China's growth over the past decade has been its expanding balance sheet. The Institute of International Finance estimates that China's total debt is now 303% of GDP, up from the mid-to-high 100%'s prior to the GFC. Not only has this debt made the economy less robust but the likely lack of a repeat expansion means the next decade of Chinese growth likely will look very different to the last.

Some investors are quick to point out that the internalised nature of much of China's debt and the tight grip the Chinese government has over its economy should help the country navigate a crisis. Both are true to a point – but only to a point – and place considerable faith in bureaucrats who have relied very heavily on stimulation as a solution.

I'm not wholly bearish on China and wish the country well. I am wary about the current health of its economic model, though, and have less exposure to this much-touted economy than most would expect.

Mary Manning

Portfolio Manager,
Ellerston Capital

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"The $A is largely driven by interest rate differentials amongst other factors but it's the positioning around the $A which makes the local currency a fascinating subject to us at the moment..."

Get ready to invest in Chinese Unicorns

China has recently galloped ahead of the US in terms of the number of unicorns. According to the Hurun Global Unicorn List 2019, there are currently 206 unicorns in China versus 203 in the US. The 3 largest unicorns in the world are all Chinese and there are now more than twice as many unicorns headquartered in Beijing and Shanghai as there are in Silicon Valley.

Investors can benefit from the rise of China as an entrepreneurial power in two main ways. Firstly, investors can participate directly in unicorn IPOs. Secondly, investors can hold mega cap "unicorn incubator" stocks like Tencent and Alibaba as part of their core portfolio.

In terms of IPOs, the most exciting listing slated for 2020 is ByteDance, which owns the short video app TikTok and news aggregator Jinri Toutiao and is valued at approximately $75 billion as per its last funding round. In terms of investing in unicorn incubators, the table below shows that Tencent is ranked second in the world for investing in and incubating unicorns with 46 in its stable. Alibaba is ranked 7th with 22. Other Chinese stocks like JD, Ping An and NetEase have also invested in and spun off (or will spin off) successful unicorns.

In the wake of the WeWork debacle and severely disappointing IPOs by Uber and Lyft, investors may question ▶

Country	# of Unicorns	City	# of Unicorns	Unicorn	Est. Value
China	206	Beijing	82	Ant Financial (China)	$150b
USA	203	San Francisco	55	ByteDance (China)	$75b
India	21	Shanghai	47	Didi Chuxing (China)	$55b
UK	13	New York	25	Infor (USA)	$50b
Germany	7	Hangzhou	19	JUUL Labs (USA)	$48b

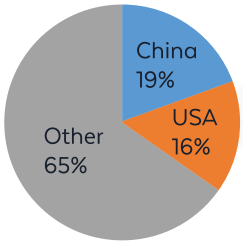
Source: Hurun Global Unicon List 2019.

Top Unicorn Investors	# of Unicorns	Company	Investments/Spin Offs
Sequoia	92	Tencent	WeBank, Tencent Music
Tencent	46	Alibaba	Ant Financial, Cainiao, Lazada
SoftBank	42	Ping An	Lufax, Ping An Healthcare Technology
Tiger Fund	36	JD	JD Digits, JD Logistics, JD Health
IDG	31	NetEase	Youdao, Cloud Music

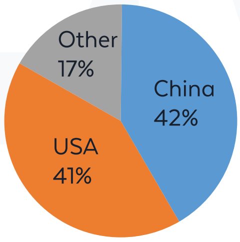
Source: Hurun and Ellerston Capital.

"It is only a matter of time before China's share of the benchmark pie is meaningfully bigger.

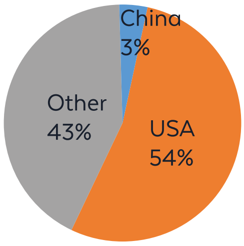
| Share of Global GDP (PPP)



| Share of Global Unicorns



| MSCI AC World Index



| Source: IMF, Hurun and MSCI

the hype around some these unicorns. But Chinese unicorn listings, on the whole, have fared much better than their US counterparts. Biotech stock Wuxi Apptech is up over 300% since listing in late 2018 and Chinese electric car battery stock CATL is up 211% since its June 2018 IPO. Better known Chinese stocks like Pinduoduo and Meituan are up 129% and 40% since IPO, respectively.

Finally, some food for thought about what the size and number of Chinese unicorns imply for global asset allocation. The pie charts below show China's share of world GDP (19%), China's share of global unicorns (42%) and China's share of MSCI AC World Index (3%). This mismatch doesn't make sense. It is only a matter of time before China's share of the benchmark pie is meaningfully bigger.

So, get ready to invest in Chinese unicorns. It will be a blessing in 2020.

Matt Reynolds

Investment Director,
Capital Group

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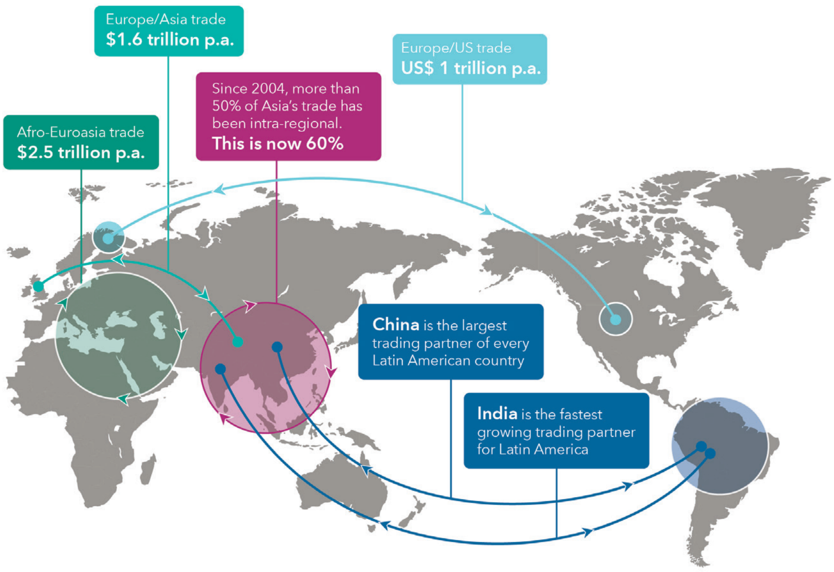
"Shifting focus away from the narrow US-China dynamic could open up a wealth of opportunities in terms of identifying companies that stand to benefit from a potential sea change in trade relationships."

Trade: Looking through the noise

There is one main reason I think trade tensions can't be ignored in 2020 and that is because the media won't let us. But issues that grab the headlines don't always tell the full story. There are a couple of other reasons why investors shouldn't get distracted by hype around trade negotiations.

1. The trade story is bigger than the US and China.
Trade is not a one-way, or even two-way, street. It's more like a complex, multi-laned freeway system with traffic flowing in all directions.

Global trade is just that – global, and there are several major trading blocs outside these two players. Shifting focus away from the narrow US-China dynamic could open up a wealth of opportunities in terms of identifying companies that stand to benefit from a potential sea change in trade relationships. ▶



Global trade flows reveal some surprising statistics

"...companies in a variety of sectors – from consumer goods to information technology and health care – have the potential to ride the demographic tailwind from Asia..."

2. Asia is bigger than China
The trade flows above highlight the fact that the whole of Asia is a major player – not just China. Yes, China plays a significant role, but arguably this significance is overstated. The demographics of Asia ex China are more compelling than China alone.

Much is made of China's 1.4 billion-strong population. However, in the context of the Asian region, whose population stands at 4.5 billion, it accounts for just 30%. And population size is just one factor. Of the three billion Asians not in China, most live in countries that have a younger median age than China and faster growing economies.

It is this broader Asia opportunity that I believe could drive the next exciting wave of growth.

I believe that companies in a variety of sectors – from consumer goods to information technology and health care – have the potential to ride the demographic tailwind from Asia, presenting some compelling investment opportunities over the medium and longer term.

Matthew Kidman

Principal and Portfolio Manager, Centennial Asset Management

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“Since the Banking Royal Commission hit town in early 2018, the banking sector has been overwhelmed with costs associated with better compliance and systems. The old objective of prudent lending has taken a back seat.”

Double package of things to think about

As we step into the new decade, there are plenty of topics consuming investors’ thoughts including trade wars, Brexit, the Trump impeachment hearings, US presidential elections and protests in Hong Kong.

While these issues should not be discounted completely, they are well explored and have been in existence for some time. They are all capable of moving markets briefly but as time passes, investors adjust. What typically propels a market higher or lower is the undisclosed and undiscounted factors.

I’m going to go with two considerations you cannot ignore in 2020.

What next for China?

Firstly, does China reaccelerate growth in 2020 after a period of slow down? A reacceleration would be a boom for many Australian sectors including the big miners, agriculture, tourism, education and food products. If the Chinese economy was able to outperform expectations of growth falling to below 6 per cent in 2020, it would set the Australian share market alight.

Alternatively, if the Chinese economy faltered and growth stalled then an Australian recession could easily set in.

I’m betting the Chinese economy might surprise on the upside and help the cyclical stocks that pepper the Australian market, from the big BHP to the small McPhersons stocks, and the economy as a whole would benefit.

The big 4

The second variable that cannot be ignored in 2020 is the behaviour of the Australian big 4 banks. It is critical for the domestic economy that CBA, ANZ, Westpac and NAB all increase lending growth beyond the current levels of 2 to 3 per cent.

Since the Banking Royal Commission hit town in early 2018, the banking sector has been overwhelmed with costs associated with better compliance and systems. The old objective of prudent lending has taken a back seat.

This lending strike inspired a sharp slowdown in housing construction and a dive in house prices. Soon after it curtailed general retail spending on cars, clothing, leisure etc. If loan growth managed to move into the 4 to 5 per cent range it would be fillip for the domestic economy, obviously lead by housing.

It can’t be that difficult given the loan growth rate was 10 per cent plus before the Global Financial Crisis.

Michael O'Dea

Head of Multi Asset, Perpetual

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"The next decade will be shaped by many factors including how policy makers respond to the next economic downturn."

Guard against complacency

Towards the end of the market cycle there is little reward for risk. Whilst this is true today, the current cycle is somewhat different to most. Government bond yields and cash rates are lower than they have ever been, while equity valuations are elevated and credit spreads are tight.

All hopes are placed on the fact that the Fed can extend this cycle because if it can't then there is little conventional monetary policy ammunition left to fight an economic recession, and low cash rates disincentivises investors from seeking shelter. A conundrum created by ultra-easy monetary policy.

There's a joke about a lost Englishman asking a local Irishman how to get to Dublin. His response was, "Well I wouldn't be starting from here." The same could be said for the starting point for markets.

The key to successful investing over the longer term is to remember that future returns are primarily driven by the price you pay for an investment. As it stands today, we should prepare for much lower (and more volatile) returns than we've enjoyed in the past ten years. That has profound implications for people's ability to retire when they want, and the type of lifestyle they will be able to afford.

A prudent approach is to adopt comprehensive portfolio risk management strategies in the forms of genuine diversification, hunting for value, avoiding over indebted companies, and buying portfolio protection (e.g. put options). "Value" and "volatility" are perhaps the two most unloved asset classes, and both of which are likely to help build portfolios resilient to a range of different outcomes (e.g. a recession, or stronger growth with higher rates) and not simply ones which succeed when equity markets go up.

In addition, having cash or term deposits in portfolios means that you will not earn much, but it does give you flexibility which could enable you to buy equities at the time when others are forced to sell. This flexibility can be very valuable to long term returns provided you can act at the right time.

Great companies will continue to prosper irrespective of the economic environment. It is well worth the effort trying to find these businesses while being disciplined about not over-paying for growth which is yet to come. Today's disruptors are not immune from being disrupted – and while cash rates are so low, there is plenty of money chasing "the next big idea".

The next decade will be shaped by many factors including how policy makers respond to the next economic downturn. Will it lead to ever more debt and kicking the can down the road? Will it lead to a debt write off and potentially spark inflation, or will there be structural reforms which can drive productivity higher?

We are likely to see a mix of policy responses and shouldn't underestimate how creative and determined policy makers are. That said, we should not outsource portfolio risk management to "the Fed".

The one thing we should all do is guard against complacency.

Michelle Lopez

Head Of Australian Equities, Aberdeen Standard Investments

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" identifying companies with above-industry earnings growth will be key."

Two Areas for real growth in 2020

Buoyed by easy monetary policy, Australian stocks have been on a tear for a decade. The Reserve Bank of Australia has cut interest rates no fewer than 15 times since 2011.

This allowed firms to borrow at lower rates to build their businesses. Consequently, investors have backed companies in high-growth sectors such as consumption, health care and technology.

But with Australia's cash rate at 0.75%, authorities are running out of firepower. Without this buffer, companies whose share prices have run ahead of their earnings potential risk a material correction.

Already we have seen investors rotate out of growth and into companies with tangible assets that appear undervalued. It will be vital to choose firms with real earnings growth to underpin their valuations over those whose prices have re-rated due to cyclical factors such as lower discount rates.

However, global growth is slowing and the domestic economy fragile. High household debt, a near-zero savings rate and low wage growth continue to squeeze Australian consumers. At least surging commodity prices have afforded the government budgetary room to provide fiscal support, such as income tax cuts. That could provide a catalyst to stimulate spending.

Two areas for real growth

We see two areas investors might target for real growth in 2020:

1. Companies with non-discretionary offshore earnings; and
2. Self-reliant domestic firms that don't depend on external stimulus.

Examples of the former include Cochlear, CSL and Pro Medicus. Each provides essential health-care products or services and has strong penetration overseas. This points to sustained demand.

For the latter, Monadelphous provides services to the resources and energy sectors, and Bapcor parts and accessories to the auto industry. Reliable client bases and promising business pipelines equate to earnings growth into 2020.

As monetary policy loses potency and authorities turn increasingly to fiscal stimuli next year, identifying companies with above-industry earnings growth will be key.

Nick Griffin

CIO, Munro Partners

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“Making zero emissions a binding goal ...easy to say, but it’s going to cost a lot of money, and we are following the money”

2020 Vision: Let the Smog Clear

It’s hard to ignore the chants of thousands of young people outside your office window on a seemingly weekly basis demanding action on Climate Change. We see this and sustainability more broadly as the pivotal theme for 2020.

While climate concerns have been building for years, we feel the tipping point has been reached as zero carbon policies get enacted into government legislation and corporate strategies all around the world.

Making zero emissions a binding goal ...easy to say, but it’s going to cost a lot of money, and we are following the money.

The key point is corporates are now moving ahead of government policy. Their stakeholders are demanding it: customers, employees and $30 trillion in ESG mandates mean CEOs will listen and act.

The cost to go net zero emissions will go well into the trillions of dollars. ▶

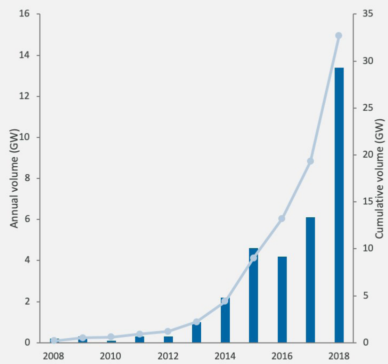
37 COUNTRIES & 155 COMPANIES ADOPT ‘NET ZERO’...

... EMISSION TARGETS BY 2050 REPRESENTING 16% OF GLOBAL GDP AT $4.5 TRILLION IN REVENUE

A list of countries and states that have adopted net zero by 2050

	Net Zero: CO2/GHGs		Date	Formality
Net Zero targets under consideration				
EU	GHGs		2050	Proposed
Germany	CO2		2050	Under consideration
New Zealand	TBA		2050	Bill being drafted
Net Zero targets that have been adopted				
New York	GHGs		2050	Bill passed
UK	GHGs		2050	Bill passed
France	GHGs		2050	Bill passed
California	Unclear		2045	Executive Order
Sweden	GHGs		2045	Bill passed
Denmark	Unclear		2050	Bill passed
Norway	GHGs		2030	Bill passed

Corporate renewable PPAs* are rising in importance as more corporates directly source clean energy



*Private Power Agreements

Source: Bernstein, Munro Partners

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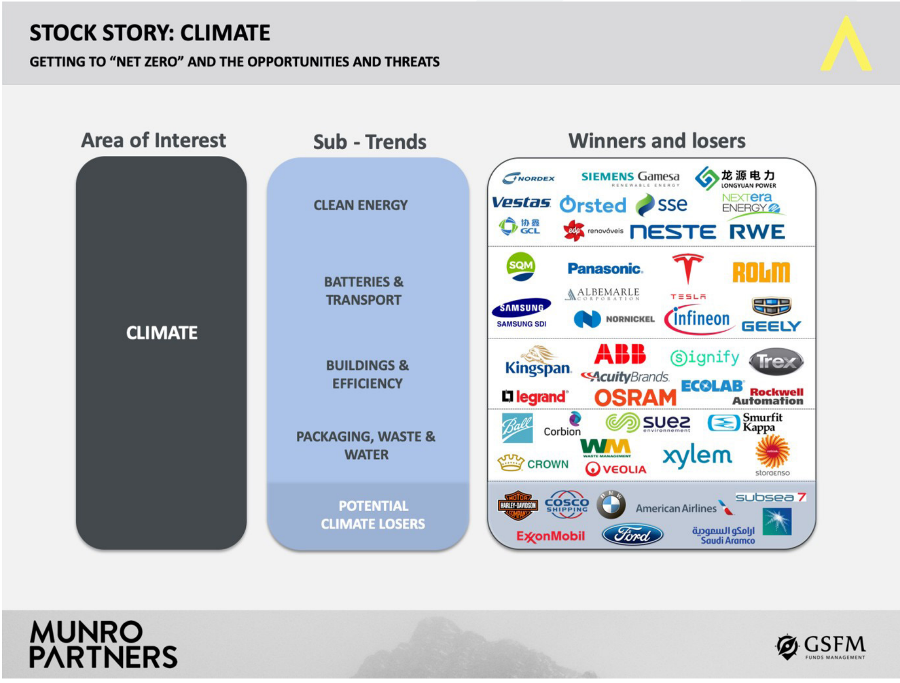
"There is a laundry list of businesses which will need to adapt or die..."



As stock pickers, we are drilling down on investing in some of the beneficiaries: companies that are leveraged to clean energy; batteries; storage supply chain; more efficient transportation, as well as other businesses that are catching on to consumer trends around food, packaging and sustainable buildings.

As always, there will only be a small handful of winners worldwide and a long tail of losers. There is a laundry list of businesses which will need to adapt or die and above is a small subset from which we will disclose our key investments early in the new year.

Patrick Poke

Senior Editor,
Livewire Markets

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"The last few years have repeatedly demonstrated that the market's most dearly held beliefs often turn out to be untrue. "

I wouldn't be so sure about that...

The most important thing in 2020 will be staying humble and keeping in mind how little we know for sure.

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

(The above quote is often credited to Mark Twain, but the true source is unknown)

The last few years have repeatedly demonstrated that the market's most dearly held beliefs often turn out to be untrue.

In 2012, markets were certain that we'd see major defaults across sovereigns and banks in Europe. But the ECB came to the rescue and Europe struggled on.

In 2013, oil traders were sure that prices would stay high for longer, but increasing US domestic supply put an end to that party and prices fell by more than 65%.

In 2016, pundits everywhere were sure that Clinton would be the next POTUS, and Trump had no chance. But come November 9th, those pundits were proven wrong by the polls

At the end of 2018, markets were certain that tightening monetary policy would cause a bear market and possible recession. Then the Fed Reserve did a 180.

Up 'til May 2019, most Australians were certain that we were in the midst of a major housing crash. The unexpected return of the Liberals (which everyone was sure wouldn't happen) appears to have prevented this for now. But I'm not certain that we've seen the end of this.

At the end of 2020, one thing you can be sure of, is that investors will look back at some of the things they thought were certainties just a year earlier, and realise their folly.

So, don't be one of the crowd. Stop thinking in binary outcomes, start thinking probabilistically, and don't be afraid to say, "I don't know for sure".

Pete Morrisey

CEO, Real Estate Securities, APN Property Group

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“Rates are already low; they’re going lower; and they’re likely to stay there for a long time. If you’re looking for income in all the places you used to find it, you’re going to be disappointed. ”

Where to collect an easy 4.5% yield

At Livewire Live recently, Magellan’s Hamish Douglass revealed a chat with two former US central bankers.

Earlier this year, the company’s models assumed rates would rise over the long term.

“Hamish”, said one of his advisers, “you need to understand that every major central bank is going to start aggressively cutting interest rates now and your scenario of increasing interest rates is just incorrect, that’s just not going to happen”.

This was news to Douglass and, no doubt, to millions of investors relying on regular dividend payments for their daily expenses. It is one thing to know of the phrase ‘lower for longer’ but quite another to live it.

The cash and fixed interest components of a typical balanced portfolio can be significant. Sadly, the returns from these assets have been steadily diminishing over many years and are likely to diminish further.

Rates are already low; they’re going lower; and they’re likely to stay there for a long time. If you’re looking for income in all the places you used to find it, you’re going to be disappointed.

Is there anything income investors can do other than cancel Netflix and crack open the cat food?

We think so.

Lower rates for longer move liquid commercial real estate to the fore. As a cashflow-generating alternative to bonds and bank products, lower rates make AREITs relatively more attractive.

Derived from high quality commercial real estate, the ASX AREIT 300 Index currently yields 4.5% and the potential for sustainable capital growth.

Peter Meany

Head Of Global Listed Infrastructure,
First Sentier Investors

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“there is no more important time to do the basics well. This means consistently executing the investment process.”

Stick to your investment process

With key equity markets at all-time highs, bond yields racing to zero, central banks out of dry powder and governments consumed by politics, 2020 promises to be a year of uncertainty for investors. The one thing investors can’t ignore is the investment process.

There is a Zen proverb, which says:

“Before enlightenment; chop wood, carry water.

... After enlightenment; chop wood, carry water.”

For investors confronted by market noise and volatility, there is no more important time to do the basics well. This means consistently executing the investment process.

1. Focus on companies with pricing power, an industry or regulatory structure that allows price increases at or above inflation, and structural growth, where growth reflects long-term change rather than the ebb and flow of the economic cycle. Infrastructure companies like toll roads and mobile towers offer these characteristics and can be particularly valuable to a portfolio during periods of uncertainty.

2. Spend time with management to understand what motivates them, where they are going and what contingencies they have in place if things don’t go to plan. Our team conducts over 500 management, site visit and regulator meetings each year – we will do 500 if markets are up and 500 if markets are down.

3. Assess the quality of companies, from barriers to entry and financial leverage to management incentives and board independence. Infrastructure companies with positive environmental and social impacts should minimise political and regulatory risks and preserve their licence to operate.

4. Identify companies with value, relative to history or a considered range of risk scenarios. When stocks trade above these scenarios, have the discipline to sell. When stocks trade below, have the conviction to buy.

5. Be aware of changing macro conditions when constructing portfolios, to ensure these conviction stock calls remain the primary driver of returns.

In times of stress, it pays to do the basics well.

Peter Rutter

Head of Equities,
Royal London Asset Management

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"...our analysis suggests that markets and investors have priced in much of the status quo – in terms of market levels, long-term bond yields and the dominance of certain themes and styles in markets."

Surprise fiscal support would make a big impact

An important issue for investors to consider in 2020 is the potential shift in the relative importance between monetary and fiscal policy in driving the global economy and investor sentiment.

Will the baton pass from central banks attempting to drive the economy through low interest rates, to governments and politicians taking responsibility for driving growth and avoiding recessions through tax cuts and government spending?

After more than a decade of central banks and low interest rates dominating economies and markets, 2019 saw the emergence of a debate on its long-term efficacy. Whether it is concerns about the limits of central bank influence, the unintended long-term impacts of low or negative rates and/or the emergence of populist politics supported by low government borrowing rates, change could be afoot.

It's not so much we have a strong view that this actually happens, but our analysis suggests that markets and investors have priced in much of the status quo – in terms of market levels, long-term bond yields and the dominance of certain themes and styles in markets.

As such any shift in the balance between monetary and fiscal policy could have a profound impact on market levels and leadership. Examples might be growth stocks versus value stocks, the loss of capital on government bonds currently with negative yields or cyclicals versus defensives.

Each of these dichotomies has basically trended in one direction for much of the last decade. Ever lower interest rates and bond yields driven by central banks have captured the economy and markets. While that may continue, a key thing to watch out for in 2020 might be that dynamic changing: given how markets are currently positioned, the impact could be very significant.

Rachel Cole

Investment Analyst,
NAOS Asset Management

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"The balance sheet is one thing that investors should never ignore, and it becomes particularly important in cyclical downturns when earnings are challenged."

With small caps, focus on the balance sheet

Sometimes the most basic principles can be the ones that are most easily overlooked.

When investing in small caps, balance sheet strength is not only important for companies to remain a going concern, but it is also imperative in ensuring that these companies can grow and deliver a return on shareholder's capital. For some investors, the balance sheet can become a box ticking exercise, and you can see why; it's not quite as exciting as double-digit earnings growth, a huge addressable market, or a store rollout, but it can become very exciting (in a bad way) when things go pear shaped.

The balance sheet is one thing that investors should never ignore, and it becomes particularly important in cyclical downturns when earnings are challenged. Recently, we have seen headwinds across several industries including consumer discretionary, building materials, and (rather severely) in agriculture. Over this time there has been a common theme: capital intensive, cyclical businesses raising money following their share prices falling to pay down their debt (that they previously thought could be paid down with earnings).

This exercise can dilute existing shareholders and makes it more difficult for companies to earn an adequate return on capital – especially when the cost of equity is significantly higher than debt.

Some recent examples are Nufarm Limited (ASX: NUF), Bega Cheese Limited (ASX: BGA), Wagners Holding Company Limited (ASX: WGN) and Costa Group Holdings Limited (ASX: CGC).

Looking out towards 2020 investors can learn from these events to ensure they don't ignore the balance sheet for companies facing earnings headwinds – especially for companies with high fixed costs and large capital requirements. Buying a beaten-up stock when everything is going wrong can, in the right circumstances, be a winning strategy for generating returns, however, ensuring the balance sheet is strong is crucial to help protect returns.

Source: Bloomberg

Rhett
Kessler

Senior Fund Manager,
Pengana Capital

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"Growing earnings from loss positions to justify multi-billion valuations usually require non-trivial execution, substantial capital and a fair amount of good luck."

Don't ignore growth stock volatility

We have made regular comments regarding the plethora of domestically listed companies exhibiting excellent business models, exceptionally competent management, yet unfortunately, are only available at spectacularly high prices. While we agree that quality will always demand a premium it would seem that many valuations exceed even the most optimistic assumptions on valuation fundamentals.

Strange things do tend to happen when the cost of money gets really low. Every investor (ranging from the disciplined professional to the unsophisticated retiree) start to notice that the rewards for staying in low-risk cash deposits are diluting their efforts to cover costs and increase wealth. As money starts to move (some would say put to work harder) it cascades out of term deposits into increasingly riskier asset classes in search of income/yield/return (essentially taking more risk for more return, hopefully).

Good businesses with good management generally produce good results. Good results drive share prices higher. If a company is already on a very high multiple, attempts to assess the required lift in the share price based on the latest good news becomes an extremely subjective calculation. In layman's terms, once a company is on a multiple of 100 times next year's earnings, determining whether 75 v 125 times is the correct number is "difficult".

High growth businesses investing heavily for their future create an additional challenge, namely the lack of earnings can be interpreted as management's ability to deploy ever-larger amounts of money into driving future value. While I have no doubt that this will be held true in some cases, my experience has been that the execution risks are often underestimated. Growing earnings from loss positions to justify multi-billion valuations usually require non-trivial execution, substantial capital and a fair amount of good luck.

Investor return envy (otherwise known as FOMO) has created a collection of companies meeting the above description: Good businesses on flabbergasting multiples. We have compiled a list of 8 companies with a combined value of $65 billion with an average price to earnings multiple in excess of 150 times (Market weighted). These are not small companies.

So, in response to the question of what is 'the one thing investors just can't ignore in 2020', we ask: can we afford to ignore the recent volatility demonstrated by the share prices of companies with exceptionally high investor expectations?

Rishikesh
Patel

Lead Portfolio Manager,
LGM Investments

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"...combined with the significant influence China has in the global economy cannot be ignored by international investors any longer."

The "Gold Rush" in China a shares

There is a growing buzz around accessibility of Chinese onshore (A) equity to a wider investor base (due to the further inclusion in widely used market indices).

While it is not optimal that it took an index provider to spur interest, the growing accessibility to the market, combined with the significant influence China has in the global economy cannot be ignored by international investors any longer.

The narrative around China needs to shift from that of a simple secular growth opportunity to a dynamic asset class with improving governance and resilience. The market has undergone a tectonic shift from an exporter of cheap manufacturing goods to a dynamic and thriving market which is globally competitive and at the cutting edge in many sectors.

There is a deep pool of possible investments across sectors and industries. Some nuances in the market making it highly appealing to stock pickers, for example:

- The market is dominated by retail investors (70-80% of market turnover)
- Foreign investors account for about only 5% of market cap
- Lack of research coverage and institutional engagement
- Insufficient supervision on companies listed, and lack of a de-listing system in A-shares

This speculative behaviour leads to significant mispricing in the market that may result in an attractive opportunity for skilled active managers to generate alpha over the long term. There are of course some concerns that there may be a "gold rush" as the index providers continue to increase the weight of the A share market in the mainstream indices. This will inevitably lead to a large amount of capital being blindly allocated to any and all companies when clearly there is material difference between the highest and lowest quality.

While headlines are dominated by the current trade spat between the US and China, we believe having an open mind towards the market is something investors cannot ignore in the coming years.

Scott Haslem

CIO, Crestone

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"Optimism and reduced geo-political stresses count for something. Better economic growth will count for more."

It's all about the 'E' (earnings)

E (earnings)—This is going to be one of the key market drivers as we transition 2020. The year is drawing to a close and investors have been leaning a little more into risk, buoyed by some progress around less cathartic geo-political developments over recent months.

Of course, while progress on delivering a 'soft' Brexit (and a potentially more stable majority UK government) is a clear de-escalation of geo-political risk, the US-China 'phase one' trade deal, if delivered, holds less hope of permanent progress. Still, there is potential for such developments to improve business certainty, reverse the fall in capex plans and see the global economy avoid recession in 2020, particularly as President Trump is likely to want the US economy to be doing well as he seeks re-election in November.

But even if world growth can stabilise and recover, equity market valuations are already elevated. This will limit the ability of equity markets to continue to grind higher in 2020 simply via improving optimism and multiple (P/E) expansion.

While valuations can stretch to extremes for a while, the US 12-month forward price earnings ratio is 17.2 times, above its five-year average of 16.6, and in Europe and Australia, forward P/E ratios are also 1-1.5 points above average. This is why 'E' is a key variable not to be ignored.

With recent reports showing actual equity earnings tracking closer to zero in the US and Europe, far weaker than forward earnings that are still running close to 10% for calendar 2020, this is a gap that will need to close if equity markets are going to rise.

Optimism and reduced geo-political stresses count for something. Better economic growth will count for more. But for equity returns, neither will count for enough if global and Australian company earnings trajectories don't start to trend higher as 2020 unfolds.

Simon Mawhinney

Simon Mawhinney, Managing Director and CIO, Allan Gray

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"We shouldn't forget though that the future is far less certain than we like to admit."

Watch out for buses!

It's important to get a few truths out of the way early on. There isn't 'one thing you can't ignore in 2020', or if there is, I don't know it. Even if I did, I'd be reluctant to share it. With that knowledge, I'd be planning our family's imminent retirement in some tropical paradise!

A friend once said, "it's the bus you don't see that kills you". Yet, as investors, a lot of our collective energy is channelled towards identifying catalysts that might undo an investment thesis. Where we can't identify one, companies are often described as having large moats or as being 'high quality' companies or better yet, 'compounders' (today's Holy Grail). Our lack of tolerance for volatile earnings streams has drawn us to pay very high prices for these companies, many of which are priced for perfection.

The converse is true too. The investment pariah is a company that has either been, or is about to be, hit by a known bus. When this happens, it is almost always impossible to determine the full extent of the injuries that follow, or the time required to convalesce. These are difficult companies to own.

We shouldn't forget though that the future is far less certain than we like to admit. The one thing, if I must: there are a lot of buses on the road at the moment, some we can see and some that we can't.

Simon Shields

Principal, Monash Investors

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“The main opportunity is military, with management estimating the potential market at $2b of the next 10 years.”

One small cap winning the arms race

EOS uses lasers to track satellites in space and to target enemy vehicles on the battlefield. It might sound like science fiction but it has $250m of sales and $36m of EBIT locked in for next year, with sales growing at 40%, and EBIT 50% the following year. It has no debt. At a PE of 20x for FY21, surging earnings and positive announcements to come, EOS is our number 1 pick for 2020.

It operates in three divisions, only one of which is currently being valued by the market. Let’s start with that one.

These remote weapon systems sit on top of vehicles and are armed with machine guns, cannons and missiles. The division has an order backlog of more than $600m and has tender submissions worth more than $2.5b with existing customers. There is no competitor system as cheap, light or effective, so they have had a 100% tender win rate. We expect the tender pipeline to strengthen strongly in the near term due to the need of the West to stay ahead of Chinese and Russian technology, and the emerging threat from drones.

Space

EOS makes more than 15,000 space tracks each week. Their infrastructure is much cheaper to build and operate than the established global radar networks. It is also developing lasers to manoeuvre space debris in orbit. The main opportunity is military, with management estimating the potential market at $2b of the next 10 years. This division currently operates close to break even. ▶

Communications

EOS has formed a Communications

"The main opportunity is military, with management estimating the potential market at $2b of the next 10 years."

division by merging its space communications assets with EM Solutions, which provides mobile microwave satellite communications, as a way of introducing its new laser-based technology to the communications market. This new division is already EBIT positive.

Conclusion

While we expect that the stock price will climb in 2020 on contract wins from the Defence division, we believe that the Space and Communications divisions will ultimately be worth more than the current value of the company.

It's products might look like they are straight out of a movie, but they are protecting our freedom, improving our standard of living, and it's a great company visit.

Simon Stevenson

Deputy Head of
Multi-Asset, Schroders

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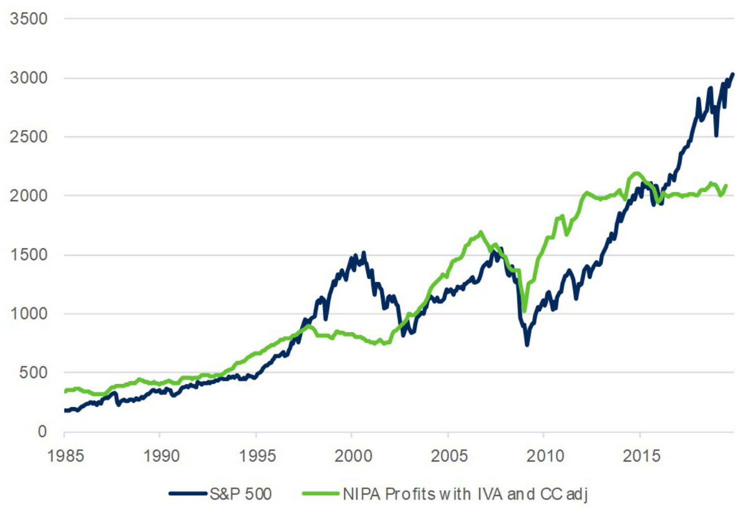
"US industry has become more "winner take all" with large companies taking all the profits, which is a new take on the "new" and "old" economy discussion of the 90s."

The market is partying like it is 1999!

Currently we are seeing a repeat of the late 1990s, with the US equity market powering on, while profits, as measured by the National Income and Product Accounts (NIPA or GDP accounts) have been flatlining. This dynamic is being driven by the fact that reported earnings of the S&P companies have been much more robust, which the equity market has followed – while NIPA profits have grown 10% over the last 6 years, S&P earnings have grown by 50%.

NIPA and the S&P profit measures differ in both coverage and accounting methodologies. First, NIPA attempts to capture all US corporates, while S&P focus on large listed companies. Second, NIPA measures profits from current production, and does not include capital gains and losses. Lastly, NIPA is based on data collected from corporate tax returns, while S&P earnings come from financial reports.



The positive spin on this divergence is that US industry has become more "winner take all" with large companies taking all the profits, which is a new take on the "new" and "old" economy discussion of the 90s. However, previous experience has shown that when a significant gap opens between the two measures, S&P earnings have converged back to NIPA, and NIPA profits have led S&P earnings.

This is most likely driven by two factors: NIPA is less subject to accounting trickery and therefore more likely captures the underlying fundamentals. Also, there is a limit to how much large companies can diverge from the broader economy.

The US equity market is an accident waiting to happen. When the liquidity taps are turned off, a lack of underlying profits and high corporate debt, suggest US corporates will most likely be the epicenter of the next crisis. Combined with stretched valuations, it is consistent with a circa 50% fall in US equities.

Tim Humphreys

Head of Global Listed Infrastructure, Ausbil

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"a relatively small advantage at the outset, if sustained, can compound into a very large benefit over time. Such compounding is one thing investors can't ignore."

The power of serial compounders

In the 13th century, the writer Ibn Khallikan records the story King Shirham, so enamoured of the game of chess he sought to reward its inventor, Grand Vizier Sissa ben Dahir. When asked to name his prize, Sissa simply asked for all the grains of rice that would fill a chess board by doubling the grains on each subsequent square, beginning with just one grain on the first. His wish was granted, until the quantum of the prize was determined, over 18 quintillion grains of rice.

While this may seem extreme, it makes a compelling point; that a relatively small advantage at the outset, if sustained, can compound into a very large benefit over time. Such compounding is one thing investors can't ignore.

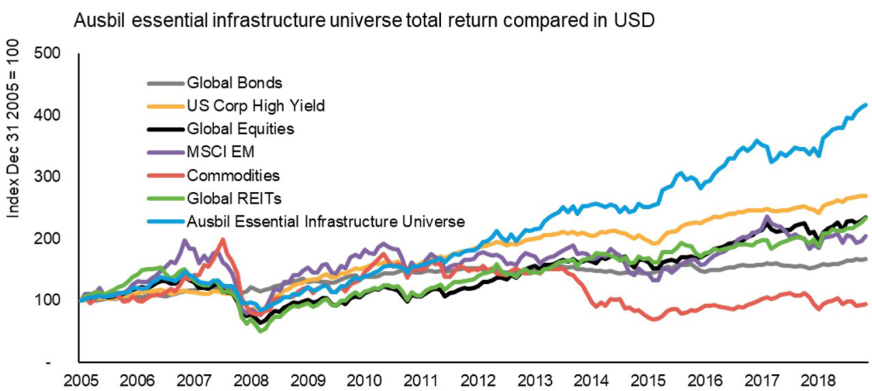
We see this principle at work in the outperformance of essential infrastructure in Chart 1, largely the result of Ausbil's strict definition of the listed essential infrastructure universe that gives it an edge over others which can compound to a large difference over time.

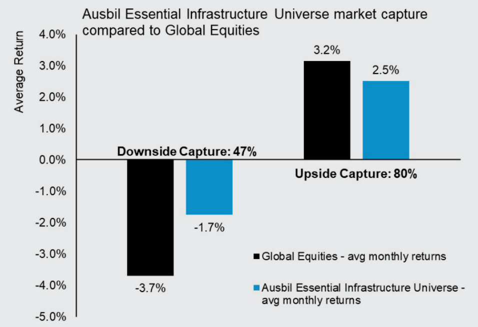
Chart 1: **Essential infrastructure**: Limiting downside offers long-term outperformance against other asset classes

Ausbil's strict definition of a listed essential infrastructure universe captures some 80% of the upside movements in global equities markets over time, while conceding just 47% of the downside movements of global equities, as illustrated in Chart 2. ▶

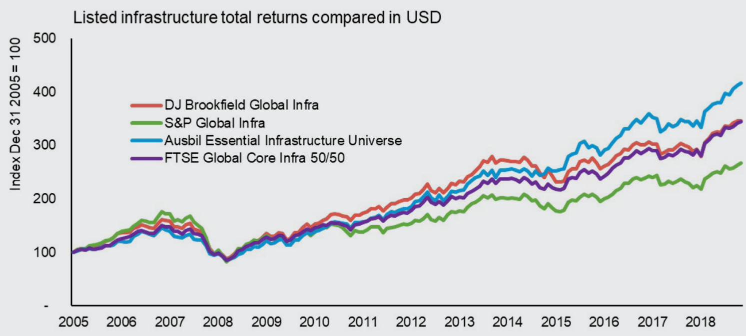
| Chart 1

Source: Ausbil, Bloomberg from 31 December 2005 to 31 December 2018. Global Equities as MSCI World Index, Commodities represented by SPGSCI Index, Global REITs represented by RUGL Index, MSCI EM represented by MSCI EM, US Corp High Yield represented by Bloomberg Barclays US Corporate High Yield. Global Bonds represented by Bloomberg Barclays Global Aggregate Bond Index. All data is Total Return, USD.

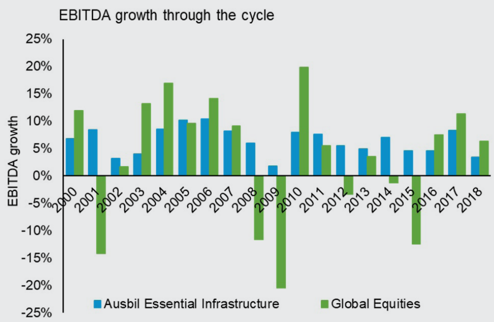




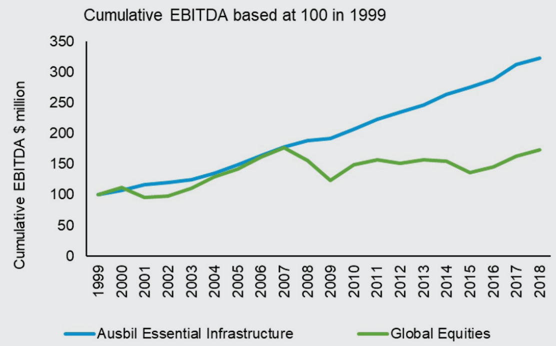
| Chart 2:
Source: Ausbil, Bloomberg from 31 December 2005 to 31 December 2018. Capture ratios vs MSCI World Index. Total Return, USD.



| Chart 3:
Source: Ausbil, Bloomberg. DJ Brookfield represented by DJBGIT Index, S&P Global Infra represented by SPGTIND Index, FTSE Global Core Infra 50/50 represented by FGCIICUT Index, Total Return, USD.



| Chart 4:
Source: Ausbil, Bloomberg, Citi Global. Essential Infrastructure is represented by Ausbil Essential Infrastructure Universe, Global Equities represented by MSCI World Index.



| Chart 5:
Source: Ausbil, Bloomberg. DJ Brookfield represented by DJBGIT Index, S&P Global Infra represented by SPGTIND Index, FTSE Global Core Infra 50/50 represented by FGCIICUT Index, Total Return, USD.

Chart 2: The essential infrastructure universe as defined by Ausbil: Capture of up and down-market movements

The result of this upside capture advantage over time for Ausbil's definition of the essential infrastructure universe is well illustrated in the compound outperformance over other asset classes (Chart 1) and other, older listed infrastructure definitions, as illustrated by the indices in Chart 3.

Chart 3: How more tightly defined essential infrastructure outperforms index definitions over time

The steady compound outperformance of essential infrastructure as an asset class comes down to one important thing, the superior stability of cash flows generated by the earnings (represented by EBITDA) of infrastructure assets compared to the more lumpy and unpredictable flows from global equities, as illustrated in Charts 4 and 5.

Chart 4: The more stable earnings of essential infrastructure over the cycle...

Chart 5: ... can translate into an edge that outperforms global equities over time

Chart 5 demonstrates the power of compounding these more stable essential infrastructure earnings cash flows, generated by infrastructure with regulated and contracted revenue streams, and why it pays to focus on companies that are serial positive compounders of cash flow. This would be the one thing we suggest focusing on in 2020: enlisting the power of compounding in your portfolio.

Toby Warburton

Co-Head of Portfolio Management, State Street Global Advisors

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"One of the most important of those imbalances has manifested itself in a seeming disregard for valuation discipline, which has been overlooked for too long, but we believe is the key thing that should not be ignored in 2020. "

Be laser-focused on valuations in 2020

The second half of the post-GFC period has been an extraordinary one for global markets. Government action and unprecedented monetary policy from Central Banks around the world diminished the threat to the global economy. The slow economic improvement ensued and was finally bolstered by a massive tax boost in the US. These actions have resulted in a "bull market in everything". Equity, bonds, infrastructure, private equity, real estate have all delivered juicy returns to those with exposure to them globally.

But the long-term effects of unconventional policy are yet to be fully realised, or understood, and the imbalances created by these actions have been quietly accruing over the past decade. One of the most important of those imbalances has manifested itself in a seeming disregard for valuation discipline, which has been overlooked for too long, but we believe is the key thing that should not be ignored in 2020.

Not only have equity markets, for example, delivered near double digit annual returns, but we've seen reckless dispersion within markets, as investors lurched between a search for growth, to a search for safety whilst all the while disregarding the price being paid. This left some subsets of stocks trading at over-optimistic valuations, just look at Australian Growth stocks, which by some measures have become the most expensive in the world; whist other sectors have been entirely unloved.

The longer these imbalances persist, the closer we inevitably get to the tipping point3, or the seemingly small trigger, that will bring a longer-term change in leadership. Its timing though is unknown, as are fluctuations in bond markets and evolutions to the global economy.

With uncertainty and stretched positioning will likely come volatility, particularly within those most affected segments of equity markets.

A consideration of risk and paying attention to valuations will likely be essential for navigating our way through the markets of 2020.

Troy Angus

Troy Angus, Director,
Paradice Investment
Management

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"We think that the beginnings of a growth to value shift is evident and may represent a once in a decade opportunity to make money..."

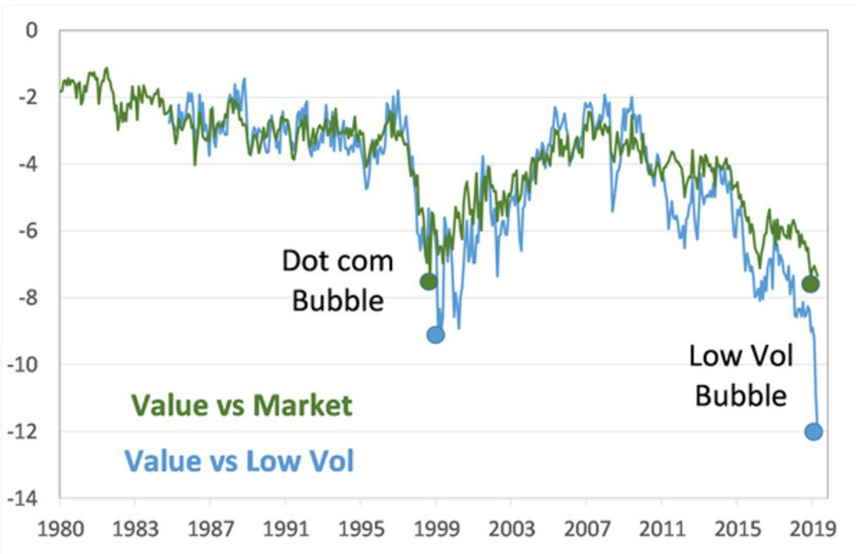
Preparing for the great wildebeest migration

Over the last decade in Australian equities factor returns for growth and momentum-based strategies have been astonishingly successful vs value and earnings volatility as investors have been happy to pay up for companies exhibiting strong earnings growth and share price momentum.

This investor desire to own companies growing quickly and or with certain earnings profiles has led to a significant re-rate in the multiple that investors are willing to pay for these companies. This is best illustrated by looking at the USA equity market as JP Morgan does in the below chart which compares the price to earnings (PE) ratios of the different strategies depicted.

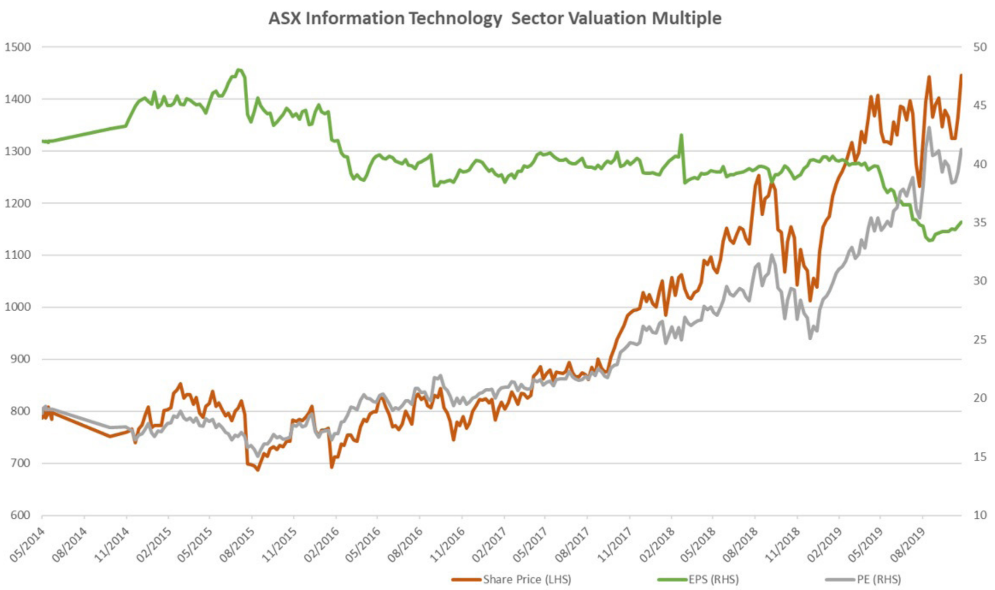
The chart also highlights that investors are paying the highest PE premium ever for "low volatility" or earnings certain growth stocks despite a substantially better economic backdrop than what was experienced through the global financial crisis.

A similar thematic is illustrated in the domestic equity market by the move in the Woolworths share price over calendar 2019 where the stock has re-rated from a PE of 20 to 26 times today. ▶



Source: JP Morgan – Marko Kolanovic

Source: Paradice Investment Management, Bloomberg



Source: Paradice Investment Management, Bloomberg

Woolworths is a great company with excellent management however a PE re-rate of this magnitude given the company's earnings growth outlook is just not normal.

We think that the beginnings of a growth to value shift is evident and may represent a once in a decade opportunity to make money given crowded investor positioning in growth and certainty coupled with absurd valuations, witness the 41x PE multiple being paid for the ASX IT sector despite earnings declining over the last five years.

Much like the migrating wildebeest of Africa factor based systematic strategies can quite easily change direction, in their case from growth and certainty to value and cyclicality, if the necessary pre-conditions are met. As an investor in Australian equities you are going to need to either stand aside from the stampeding herd or pivot as quickly as they may to make money in the year ahead.

With the herd positioned defensively, holed up in an oasis of ultra-expensive growth and earnings certainty stocks, we at Paradice have headed into the desert to buy value and cyclicals before it rains, and the herd arrives. Albeit, we have packed our swags in case it's an overnighter.

Victor Gomes

Principal And Portfolio Manager, Eiger Capital

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“Solar and wind are now the lowest cost energy sources, with batteries helping manage fluctuations in generation and frequency. ”

Two ways to play the move to EVs

The last major structural shift in transportation took place just over 100 years ago. In the space of 13 years the world went from all horse and carriage to all internal combustion engine (ICE) cars. We think it will happen again, this time from ICEs to EVs. Climate change and fuel efficiency standards will accelerate this shift.

The runaway success of Tesla’s Model 3 is proof positive that consumers will buy EV’s given a good product. The Model 3 had the highest Q3 sales revenue of any luxury car in the US, by a factor of 3. It also had the third highest revenue of all car sales in the US.

The global auto giants are spending more than US$60bn in R&D on EVs over the next decade so expect an avalanche of new models for consumers to choose from over the next 3-5 years.

The trend to electrification won’t just happen with cars. Change is also impacting grid energy. Solar and wind are now the lowest cost energy sources, with batteries helping manage fluctuations in generation and frequency. Further, wind turbines which just like EVs, require permanent magnets, made with the help of a key rare earth (NdPr).

Two ways to play the move to EVs
Taking a longer-term view (3-5 years), Pilbara Resources (PLS) and Lynas Corp (LYC) are good pure play exposures.

PLS has very large lithium spodumene reserves and targets bottom quartile global cost curve. Key short-term negative is oversupply in lithium which may clear quickly. Nevertheless, PLS requires a higher investor risk tolerance.

LYC is the only non-Chinese scale supplier of rare earths used in these sectors. NdPr is critical for EV motors and wind turbines. NdPr can only be sourced from LYC (20% global share) and China (80% global share). Lynas has a plant in Malaysia and mine in Australia with funded expansion plans.

As a demand reality check for Pilbara and Lynas;

- every Tesla Model 3 needs 1kg of NdPr and 420kg of spodumene
- every 1Mw of wind turbine capacity needs 200kg of NdPr

Disclosure – The Eiger Australian Small Companies Fund has positions in both Pilbara Minerals and Lynas Corp.

Vihari Ross

Head of Research, Magellan

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"Given the elevated prices we see today, Quality will prove key to navigating the uncertainties of 2020 and beyond."

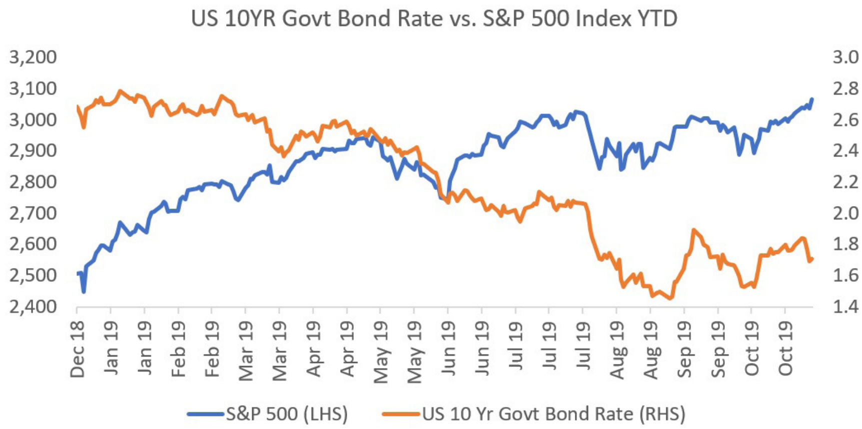
Business quality matters more than ever

2019 has seen share markets reach fresh highs after the Fed's about-turn in monetary policy stance in January. This shift in market expectations from rate increases and quantitative tightening amid the drawdown of late 2018 to a lower for longer scenario has played out with the Fed cutting three times since.

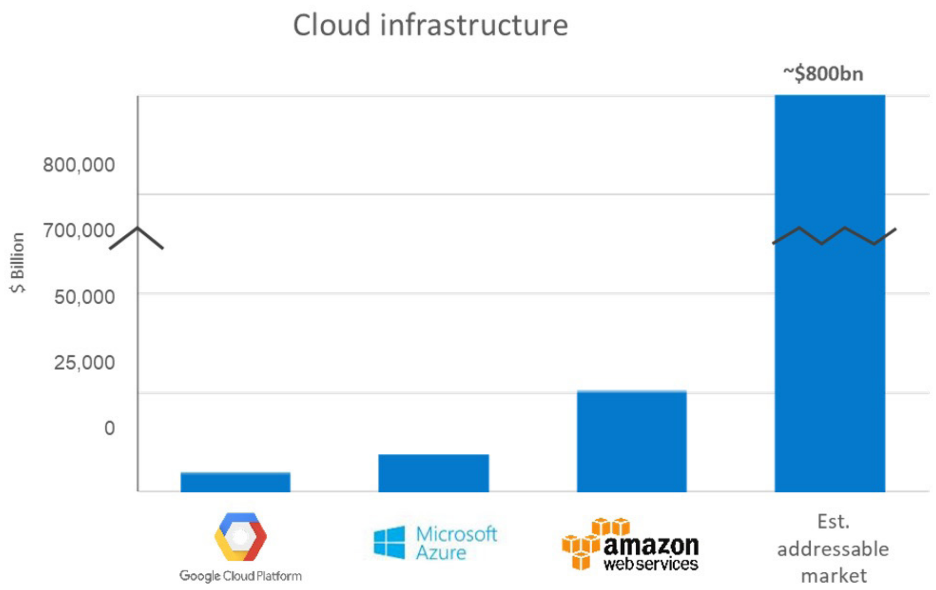
This move has helped extend a multi-decade decline in long-term bond rates, itself a function of structural factors like high debt burdens, ageing populations and the deflationary impacts of technology adoption. All else equal, lower interest rates, and therefore discount rates, imply higher stock valuations as we've seen year to date.

What does this lower rate scenario imply however for economies overall? It reflects a broad slowdown in economic growth and proportionately lower forecast cash flows and in fact no net elevation in valuations!

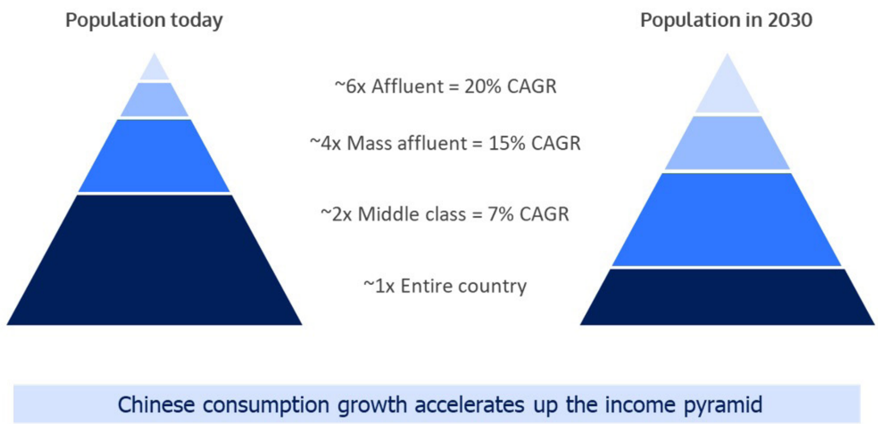
But while it is a mistake to inflate all valuations with lower rates, it is equally important to distinguish which businesses are deserving of a valuation uplift coincident with lower rates... the companies where cash flows are resilient due to structural growth. ▶



Source: Bloomberg



Source: Company disclosures Gartner, Magellam estimates, Google Images. Company revenue figures in 2019, estimatedaddremable in 2030



Source: Source: Bain, BCG, EIU, Euromonitor, McKinsey, MFG Asset Management. Annual incomes: middle class = $10,000 - $30,000; mass affluent = $30,000 - $50,000; affluent >$50,000

Structural growth can be driven by significant technology shifts like cloud computing and e-commerce or demographics such as the doubling of the Chinese middle class in the next 5-10 years or indeed the affluent class increasing 6-fold in the same time period. The key feature of this growth is that it is agnostic to economic circumstances or inflation rates.

Business quality matters in this context because quality provides confidence the company won't befall disruption threats, quality helps determine which businesses will actually be positioned to benefit from these tailwinds we have identified and in the context of lower rates; quality provides conviction in the predictability of the cash flows a business will generate and therefore what it is worth.

Given the elevated prices we see today, Quality will prove key to navigating the uncertainties of 2020 and beyond.

Warryn Robertson

Portfolio Manager/ Analyst, Lazard Asset Management

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"At some point, there will be a reckoning, either earnings are going to disappoint (because growth is lower) or over time rates have to rise."

Interest rates are low for a reason

Many equity market investors seem to be falling into the trap of thinking that interest rates are low purely for their benefit. Ironically, if you were to ask the average person in the street, why rates were at emergency levels, they would tell it is because the economy is struggling. Yet professional investors seem to be pricing in earnings growth expectations at normal levels, such that low interest rates are seemingly the rationale for paying an ever higher multiple.

I have been talking about this issue a lot, as I believe it is at the heart of why so many investors are getting their company valuations wrong. If you lower the discount rate (because bond yields are so low) but maintain trend earnings, it is very easy to justify some of the crazy multiples we are seeing. It's seemingly easy but we believe it is wrong.

In our valuations, we always link nominal GDP growth, which is the key driver of earnings, with nominal risk-free rates, which is the key driver of multiples or discount rates. We think that is a really solid foundation on which to base your valuation model and it means your valuations are also less exposed to the vagaries of the economic cycle.

I would encourage investors to think very carefully about using low bond yields as a justification for higher equity market valuations. At some point, there will be a reckoning, either earnings are going to disappoint (because growth is lower) or over time rates have to rise. Either way, that is going to be a painful process for the share price of many companies.