MLC

Flat earnings growth but share markets rocketed. What gives?

January 2020

Events over the past year suggest that the 'Powell put' (Jerome Powell being the US Federal Reserve chairman), has succeeded the 'Greenspan put' — named for former Fed chairman Alan Greenspan's tendency to cut interest rates to calm wobbly markets. The evidence; three cuts in official US cash rates in 2019 after gingerly increasing them in 2018 as part of tentative steps towards interest rate normalisation. It seems that markets have become so conditioned to ultra-low interest rates that anything even slightly different is unsettling.

It's always tricky to directly link one dynamic, in this case US interest rate cuts, to explain another, thumping global share market returns, but that's a hard-to-escape conclusion.

It is, of course, impossible to know what would have happened if *rates were not cut*, but it's difficult to imagine markets overcoming the 'wall of worry' from sharply rising trade tensions less than two years ago without the Fed's recent course reversal.

So, 2019 ended with the global share market up more than 25%[1] in $A terms despite lacklustre earnings growth. In other words, price-earnings expansion, not profits, powered share markets. That's usually a cautionary flag.

While this was great from a return perspective, it also underscores the complications associated with investing when markets have become so delinked from fundamentals, such as earnings and valuations. Moreover, such large market moves reduce the future return potential of risk assets, and that's not a good thing.

The 'Powell put' has temporarily, but not permanently, dampened the market-disrupting power of geo-political events. Nevertheless, December's Brexit-related developments were a reminder of the latent capacity of geo-politics to move markets. The Conservative Party's decisive election win appears to have broken the spell the issue held over the UK since 2016's victorious *Leave vote*.

There is now agreement among all major parties in the UK's parliament that the country will be leaving the European Union. Still, many details will need to be thrashed before the end of 2020 when formal separation is expected.

Dramas involving Brexit are important for investors as it is a microcosm of the affect populism has on policy action and financial market sentiment. The proliferation of anti-globalisation forces introduces greater impediments in the efficient allocation of capital and resources, which are subsequently negative for economic growth.

Subtlety in portfolio positioning

Brexit, and the multiple paths it could take and the many ways it can impact markets, has been a case study of how our unique Investment Futures Framework compels us to think about what *can* happen as distinct from what *will* happen.

Investment professionals can easily fall into the trap of trying to land on a preferred 'base case' and position portfolios accordingly. However, a single base case scenario runs up against the world's and markets' complexity and the platform provided by the *Investment Futures Framework* is an antidote to the risk of biases.

Our aim, through the *Framework,* is to understand the key things that could happen and then identify the most appropriate trade-off between risk and return, given each portfolio's objectives and constraints, and to find an acceptable outcome regardless of what happens.

For the MLC Inflation Plus portfolios, our focus is on limiting both the probability as well as severity of negative returns over each portfolio's time horizon, while extracting as much return potential as sensibly possible.

---

[1] **Source:** FactSet and MLC Asset Management Services Limited.

Flat earnings growth but share markets rocketed. What gives?

Despite the deterioration in the return potential of shares, owing to sharply rising valuations in the December quarter, we continue to maintain the increased allocation to Australian shares established across the Inflation Plus portfolios in the first half of 2019. The portfolios' Australian shares strategy is defensively-focused, currently accessing high yielding sources of return (such as domestic banks and utilities), with cost-effective hedging that dampens sensitivity to sectors and businesses that we believe could be derailed by unexpected events.

In response to the strong performance of the US share market, we took the opportunity to take some profit from a defensively structured option-based exposure to the S&P500 Index. Allocations to high quality hedge fund strategies are being maintained as they offer important sources of return potential at a time where it has become increasingly difficult to generate returns with reasonable risk.

For MLC Horizon portfolios, we are persisting with relatively defensive positioning partly from exposures to Inflation Plus, but also through deviations from benchmark fixed income allocations. We continue to have high conviction in the appropriateness of this positioning, but also recognise that the period of low bond yields (high bond prices) could be prolonged.

Other ways in which we've strengthened the MLC Horizon portfolios' defensive traits include reducing to benchmark weight the previous overweight to foreign currency. While foreign currency remains an important source of risk control, its power as a risk diversifier has reduced as the $A has declined significantly from peaks.

To reduce interest rate risk in the MLC Horizon and Index Plus portfolios, we've maintained an overweight to cash and underweight exposure to Australian and global bonds. This has been done in response to low bond yields, gradually rising risks of higher inflation and the possibility of a slow tightening in monetary conditions.

Finally, these portfolios' allocation to real return strategies continues to provide, what we judge to be, greater ability to preserve investors' capital in volatile markets while also enabling access to potentially better sources of return for the level of risk we are currently prepared to take.

Now is not the time for big swings in our portfolio positioning. A watchful eye on risk, consistent with extracting reasonable returns, is the balance we believe is required.

More information on each portfolio's positioning is available in the fund commentaries available on the Fund Profile Tool on https://www.mlc.com.au/fundprofiletool.

Important information

This communication is provided by MLC Investments Limited (ABN 30 002 641 661, AFSL 230705) (MLC), a member of the National Australia Bank Limited (ABN 12 004 044 937, AFSL 230 686) group of companies (NAB Group), 105–153 Miller Street, North Sydney 2060.

This information may constitute general advice. It has been prepared without taking account of an investor's objectives, financial situation or needs and because of that an investor should, before acting on the advice, consider the appropriateness of the advice having regard to their personal objectives, financial situation and needs.

You should obtain a Product Disclosure Statement (PDS) relating to the financial product mentioned in this communication issued by MLC Investments Limited, and consider it before making any decision about whether to acquire or continue to hold the product. A copy of the PDS is available upon request by phoning the MLC call centre on 132 652 or on our website at mlc.com.au.

An investment in any product referred to in this communication is not a deposit with or liability of, and is not guaranteed by NAB or any of its subsidiaries.

Past performance is not a reliable indicator of future performance. The value of an investment may rise or fall with the changes in the market. The returns specified in this communication are reported before management fees and taxes.

Any opinions expressed in this communication constitute our judgement at the time of issue and are subject to change. We believe that the information contained in this communication is correct and that any estimates, opinions, conclusions or recommendations are reasonably held or made as at the time of compilation. However, no warranty is made as to their accuracy or reliability (which may change without notice) or other information contained in this communication.

This information is directed to and prepared for Australian residents only.

MLC may use the services of NAB Group companies where it makes good business sense to do so and will benefit customers. Amounts paid for these services are always negotiated on an arm's length basis.