Our Best Investment Ideas for 2019

Prepared December 2018

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Executive Summary

Welcome to MidSec's Best Investment Ideas for 2019.

For most of our clients the start of the New Year offers an opportunity to unwind and spend well-earned downtime with family and friends. This is also timely to take stock of your financial circumstances and make sure you are best positioned for future success – and our annual Best Investment Ideas report is a good start towards understanding the possibilities and potential investment pitfalls for the year ahead.

We draw on the deep and collective wisdom of the entire MidSec team to develop this report because it is important that we give you only the very best advice and insights.

For the year ahead we believe that it is steady as she goes – largely because we are experiencing neither the best of times or the worst of times. In fact, Australians enjoy a great outlook because we are now living longer, our children are healthier, and while the best of times may still be to come, there's still plenty of reasons to be thankful right now.

We've divided the report into a number of sections for you to read as you like. Our first section explores why the world is certain to be better and more prosperous in the years ahead. The surging international Middle Class amongst many of our trade partners will directly benefit Australia, as our export efforts continue to go from strength to strength.

The good news is that we expect inflation to stay low. Our love-affair with online shopping will continue, artificial intelligence breakthroughs will make daily life easier, and renewable energy and battery technology is expected to deliver real hip-pocket savings. Interest rates will remain low thanks to low inflation, allowing Australia to retain its reputation as being one of the greatest economies in the world.

And because blue skies can occasionally turn grey, we also share some possible clouds on the horizon. Our economy cycle is getting long in the tooth, and inflation growth offshore could trigger inflation here. European issues, such as Brexit, and sovereign debt could all influence the confidence of our own economy. The strong US dollar continues to put emerging economies under pressure, while the world watches the US and China trade dispute with bated breath.

Investment returns in 2018 were disappointing, but our view is that the medium-term future still looks good. Our MidSec Barometer shows a minor drop in the value of the Australian dollar, stable interest rates, inflation and valuations and economic growth both here and abroad – which is good for investment.

Economic growth is expected to be happening everywhere and while there have been recent hiccups, we believe that the recipe is for prosperous times ahead.

So what are our Best Investment Ideas for 2019? The final section provides greater detail, but we think investors should spend their risk budget and be fully invested. Asia is certainly emerging as an opportunity to diversify international investment assets, banks are likely to remain as an option, particular property and infrastructure assets are attractive, and natural gas may be an interesting journey for the stout-hearted.

Don't forget that the MidSec team is always available to support our clients, talk through any aspect of this report, and ensure your portfolio is best-suited for your individual circumstances.

Is it the best of times or the worst of times?

Charles Dickens in his iconic novel *A tale of two cities* coined the classic opening: "It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness." Now, more than 160 years later this observation rings true for the year just ended and the year ahead.

In fact, today is neither the best of times, nor the worst of times.

Steven Pinker (a Canadian-American cognitive psychologist, linguist, popular science author, and fact based optimist) proves in his 2018 book 'Enlightenment Now' that the human condition has actually never been better. The universally-agreed measures of human wellbeing (such as life expectancy, health, sustenance, prosperity, peace, freedom, safety, knowledge, leisure and happiness) can all be quantitatively measured, and he sets out a powerful case.

Life expectancy at birth in 1900 was 40. In 1988 it was 70, and now it's over 80 in developed countries - and getting higher everywhere else. In 1900 Europe, a newborn baby had a 15% chance of not reaching five year's old. Now European babes have a greater than 99% chance of doing so, and babies across the globe have on average a 95% chance of doing so too.

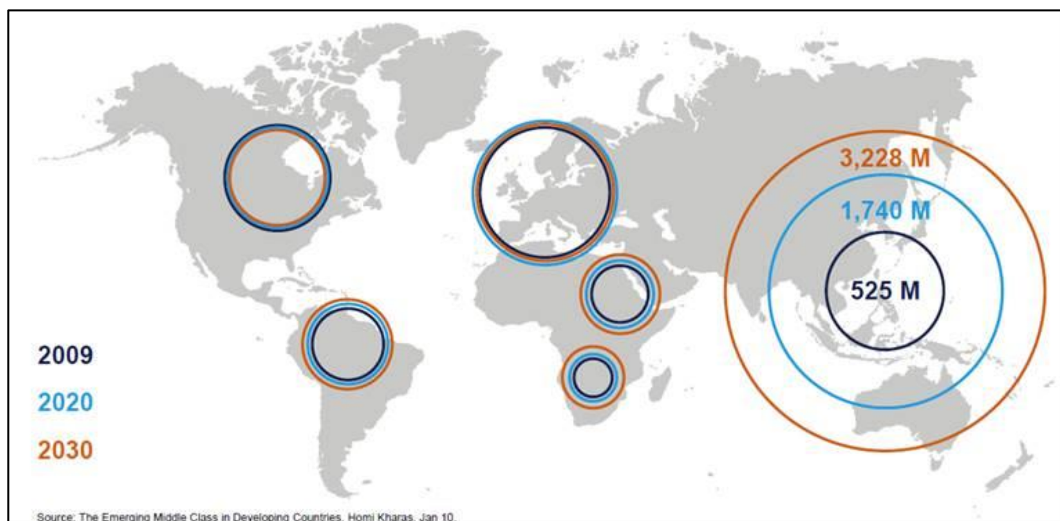
In 1900, 80% of the world's population lived in extreme poverty, but by 1988 it was down to 37%, and now it's less than 10% (and falling). Only 20% of people could read and write in 1900 and now 90% of all those under 25 can do both. Famine has been banished, and there hasn't been a war between big countries for 65 years. The Economist reported last month that globally the suicide rate is 29% lower than it was in 2000.

We're safer now than we have ever been in almost every way -and yet Steven Pinker argues that this isn't the best of times, because he says the best of times is yet to come.

We agree.

It is a certainty that the world will be better and more prosperous in five years than it is now. Investors everywhere will do well betting on this certainty, especially because most others aren't acting as if they believe it.

The surging Middle Class



The exceptional economic growth in India and China has given rise to an affluent middle class, forecast to grow by 1.5 billion over the next ten years. Right on our doorstep.

When you add Indonesia into the mix, you have an aggregate population of almost 3 billion people. That is 40% of the global population who are rapidly moving towards middle class lifestyles. This growth is expected to have profound implications for global business opportunities and investment for decades to come.

The knock-on benefits are enormous. As people are lifted out of a cycle of poverty the broader community becomes an even safer place to live, crime rates fall, the rate of population growth will decline, and people are less likely to become refugees.

Australia will be a beneficiary

Australia is a great trading nation. We have made the hard decisions to eliminate tariffs and expose ourselves to international competition, focussing on international trade and investment to power our economic growth. We have grown from having a history of primary industry exports to a focus on showcasing a sophisticated, export-oriented services sector.

As far back as the 1980s we worked to build productive relations with China and Korea – and our recent free trade agreements with China, Japan and Korea have only deepened these relationships. A Comprehensive Strategic Partnership with China continues to deliver mutual benefits, through burgeoning trade, investment, education and tourism opportunities. While minerals and energy remain important, Australian services, such as research and development, design, finance and logistics are now two fifths of our export activity.

In what is arguably the most productive period in trade policy in Australia's economic history, the Coalition has stated that it has either concluded, or is currently undertaking, free trade talks that represent more than $55 trillion in combined GDP and give goods and services exporters tariff free or preferential access to 3.6 billion consumers. Binding Free Trade Agreements are seen as one of the most effective countermeasures an open trading economy like Australia can adopt against protectionism - they lock in market access for businesses and establish business-friendly rules for trade and investment in goods and services.

The proposed 11-nation Trans Pacific Partnership, expected to be in force in early 2019, will significantly increase our market access across a regional free trade area, with a GDP worth almost $14 trillion. Negotiations also continue for a Free Trade Agreement with the European Union, which could be Australia's biggest of its type because it would ensure that access to that major market by Australian businesses is at least on a par with competitors.

Strengthening our trade ties with India is a work in process. By 2025 it is estimated that one-fifth of the world's working age population will be Indian, and by 2030 there will be over 850 million internet users in India. Our reputation for tertiary excellence can be leveraged, given India's tertiary-age population, aged 18 to 22, is already the largest in the world.

Inflation will stay low

The Information Revolution

eCommerce leaders such as Amazon, eBay, and ASOS, have paved the way when it comes to redefining, narrowing, and in some cases eliminating, relationships between suppliers, manufacturers, wholesalers, retailers, and consumers. This disintermediation cuts out the traditional middleman and gives consumers cheaper and more efficient transactions as they move away from brick-and-mortar retailers to eCommerce platforms that connect wholesalers directly with customers. Not only has this trend protected buyers from potential price increases and predatory pricing, it has allowed consumers

to buy at wholesale prices from the convenience of their loungeroom and provided access to a much wider selection of goods.

Artificial Intelligence is now science fact

In time, Artificial Intelligence (AI) I will play a critical role in improving employee productivity as well as streamlining and automating workflows. In time, a digital assistant will be able to quickly locate a needed file and search statistics and figures in seconds.

Similarly, driverless vehicle technology is sure to change the way people get around. The time gained by not focussing on driving will be better spent preparing for a meeting, taking a call, or talking to other passengers rather than stressing out during peak-hour traffic snarls. Car ownership models are sure to change too, with some swapping ownership for the convenience of a driverless Uber, while others will choose to own a car but send it out to earn money in the downtime rather than having it sit idle all day in a carpark.

The agriculture sector stands to be a big winner from AI. Introduction of “Ag-bots” on farms will achieve automation that is precise, efficient, and cost-effective. AI can learn to identify weeds in pastures and treat them accordingly, while small rovers will map the location and condition of ripening fruit as but two examples.

Renewable Energy and Battery Storage

With energy costs continuing to dominate headlines, Australians have every right to be excited at the recent report from the Smart Energy Council that predicts up to 35,000 people could be working in the nation’s energy storage industry by 2020 and up to 450,000 small scale storage systems could be installed across the country.

The Climate Council’s Fully Charged: Renewables and Storage Powering Australia report reveals over 20,000 new household lithium-ion batteries – used for renewable energy storage – were installed last year, up from 6,750 in the previous year. Over the last eight years, the cost of lithium-ion batteries has fallen by 80 per cent and by 2025 it is expected that the cost will halve again.

With low inflation, interest rates will remain low

In its November 2018 statement, the Reserve Bank of Australia confirmed that domestic economic conditions have improved over the past year and will continue to be supported by low interest rates and a strong global economy. The report says that GDP growth has picked up to its fastest year-ended rate since 2012, which was around the peak of the mining investment boom, while the unemployment rate is at its lowest level since that time and overall labour market conditions remain positive.

Underlying inflation has been relatively stable - between 1¾% and 2% - over the past couple of years. Forecasts suggest that interest rates will be kept ‘on hold’ until the end of 2020, pointing towards a period of prosperity potential for investors.

Australia - one of the great economies on Earth

We’ve enjoyed a relatively smooth transition from the heady days of the mining boom into one which has seen a surge in infrastructure spending. While the shift has been borne out of necessity, the strong outlook for infrastructure is essential given the nation’s still-rapid population growth. Australia has now ticked over 25 million people and continues to grow by about 1.6% a year, well in advance of most other developed economies. So infrastructure spending will be with us for a long time.

Australians are known as being a resilient lot, and our economy is the same – to the point where we have arguably the world's most successful economy. We were left largely unscathed from the Asian crash of 1997, shrugged off the impacts of the global financial crisis, and weathered the resources bust unlike many other commodity-exporting countries.

We've bucked the trend amongst rich countries when it comes to stagnating wages, with strong growth achieved. We've opened the immigration doors to as many as 190,000 newcomers per year at a time when other countries are sending some foreigners back home. Our annual population growth is twice America's rate and a third faster than Canada. In fact, half of all living Australians are now born abroad or are the child of someone who was, reflecting the acceptance and cultural tolerance that is a hallmark of our great nation.

There's no doubt that prudent reforms back in the 1980s and 90s are paying economic dividends today. While other 'rich' governments are now struggling to pay for pensions and healthcare, it was shrewd decision-making by the Hawke/Keating governments that saw saving for retirement become compulsory through superannuation. While every Australian has access to Medicare, subsidies to encourage greater take up of private health insurance has ensured decent, affordable health care which sees government only fill two thirds of the bill.

Of course, not everything is perfect in the land of Oz. While we don't put our economic eggs in one basket, we do currently have a heavy reliance on China as the biggest buyer of our minerals and wool, it is the single biggest source of tourism and foreign students, and the country is the largest consumer of our outstanding wines.

The Clouds on the Horizon

The best of times is yet to come, but that doesn't mean there won't be hiccups along the way.

- **The cycle is getting long in the tooth**

  Australia's economy grew at an annualised pace of more than 4% in the first half of 2018, and the RBA expects growth will remain strong in the years ahead. However, we have experienced low inflation globally for a long period of time and there are fears of inflation picking up. The global economy is close to full capacity, particularly in the advanced economies. With the US fiscal stimulus now very close to full capacity, we can look at the experience of the late 1960s to understand that this could lead to higher inflation in the US, which could see greater tightening in monetary policy than expected.

  The knock-on effect of inflation growth offshore could trigger depreciation of the Australian dollar, and if that occurs it would boost domestic output and lead to inflation here.

  Our view is that the main threat is that a combination of expanding free trade, disintermediation, artificial intelligence and lower energy prices will lead to deflation. Inflationary pressure could well be what's needed.

- **Problems in Europe**

  Next year is the turning point for Brexit, with 29 March 2019 as the date to watch. What has emerged as a bigger risk than Brexit is a possible Labour government led by Jeremy Corbyn. While Labour and the Conservatives are neck-and-neck in opinion polls, the aftermath of the Brexit vote could see an early election called before May 2022. If the Corbyn Labour government comes to power, his socialist agenda includes renationalisation of key infrastructure assets and utilities,

higher company and personal tax rates, and a major overhaul of corporate governance to give workers greater sway over boards and share registers.

- **Sovereign and other debt**

  There are plenty who still remember the significant sovereign debt crisis caused by Greece in 2012, even though a bailout package from the European Commission, the European Central Bank and the International Monetary Fund stopped the spill-over to other European governments and financial institutions.

  While Australia is unlikely to be at risk of a sovereign debt crisis, several governments across the world, especially in Europe, Japan and specific states within the US remain at significant risk of experiencing a sovereign debt crisis – which could create global market ripples.

- **The strong US dollar making things tough for emerging economies**

  The recent rebound in the US has seen interest rates return back to normal and has pushed the US dollar higher, which in turn puts emerging economies and other big debtors under increased strain. While emerging economies will be helped if the US Federal Reserve reduces the pace of rate increases in 2019, fewer rate rises can also see global central banks have less ammunition if they have to cut rates in response to another recession.

- **Trade disputes between China and the USA**

  President Trump's trade war cease fire decision at the G-20 means the current tariff rate remains at 10% on 1 January 2019 rather than rising to 25% and puts a hold on proposed tariffs for the next $267 billion in Chinese exports to the US. China has also agreed to purchase a "very substantial" amount of agricultural, energy, industrial, and other product from the US to cut the trade deficit. The two super-powers have agreed on more talks aimed at structural changes that focus on forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture – so watch this space!

- **A slump in property prices in Australia**
  The OECD (Organisation for Economic Co-operation and Development) has recently suggested the Australian economy may be vulnerable if the recent falls in property prices in Sydney and Melbourne go too much further. The main concern isn't that there will be a plethora of home loan defaults, but rather the with the impact of perceived diminishing wealth. People are more relaxed about running up credit card debt when they see increasing equity in the personal real estate. But if perceived wealth drops there is a tendency to rein in spending. A pullback in consumer spending is a growing concern for retailers as it would exacerbate already difficult trading conditions. It would also put the brakes on economic growth making it a concern for investors as well.

The Clouds on the Horizon will cause occasional showers, nothing more.

The old saying is that 'no news is good news' and the corollary is that 'good news isn't news'. The good news is that the world will be a better place in five years, and this news goes unreported. Instead our media focus on things it believes we should worry about. We have covered the most popular concerns above and it would be unlikely that at least one of them doesn't cause disruptions.

If they do, the timing and the extent of the impact is unknowable. It is extremely unlikely that any set back will be as serious as the global financial crisis ten years ago – that one was a doozy. It's impossible that any of these potential setbacks will change the course towards the inevitable 'best of times' ahead.

The Clash of the Titans

It is inevitable that sometime soon China will replace the USA as the world leader.

The baton of leadership passed from Europe to the USA probably after WW1 when Woodrow Wilson set up the League of Nations. 100 years later the baton is poised to pass again, this time from the West to the East. The transition is unlikely to be without some tensions that could challenge the Goldilocks view espoused in the previous article.

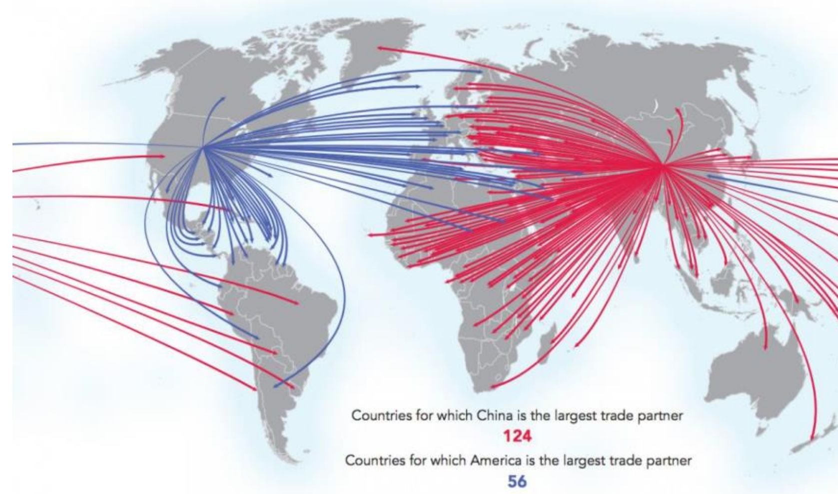
The battle for dominance between the capitalist world and the communist world played out over forty years after the Second World War, in the period known as the Cold War. Tensions abounded throughout, taking the world to the brink of nuclear devastation. This was a battle in the true sense, and for much of the time the ultimate winner was unknown.

That's not the case this time. The ultimate winner is known and lots of people in the USA are looking for ways to delay the process. What makes a country the most important nation on Earth? There are several measures of a country's world power and some of them are:

- Population;
- Trade dominance;
- The size of the economy;
- The size of the army; and
- The intelligence and educational achievement of the population.

The first measure of world dominance is the number of people living in a country. But that is not the only factor, because if it was, China and India would've been the most powerful countries years ago. China's population is 1.41 billion and India's is 1.35 billion. The US has 327 million and Indonesia has 267 million. Brazil, Pakistan and Nigeria follow with around 200 million each. Size does matter in this context but it's not the only thing to consider.

How important a country is to other countries when it comes to trade is a good measure. The picture below tells a thousand stories. China's trading partners outnumber the US by a factor of two. That is, if you asked 180 countries who is most important to them for trade, 124 would say China and 56 would say the US. So, if trade matters, then China is more important than the US already.



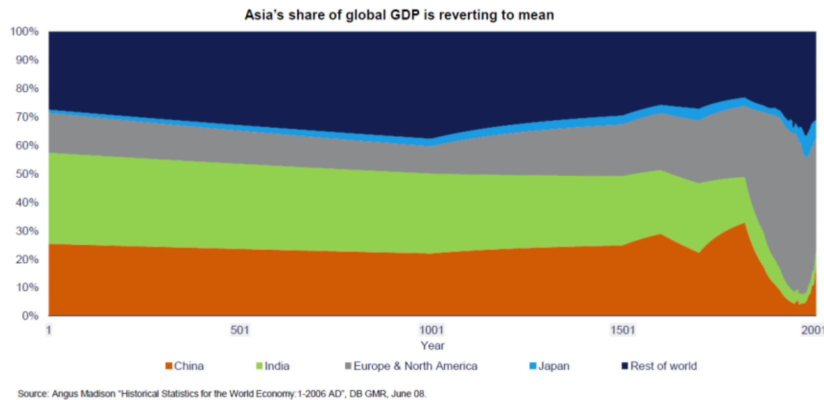
Source: visualcapitalist.com, Parag Khana 2016 – presented at 2018 Lonsdale and IOOF Alliances Conference, Hong Kong

The size of the economy, both in terms of the US$ Gross Domestic Product (GDP) and Purchasing-Power Parity (PPP), is the third significant measure of who's number one in the world.

China is reverting to its previous share of world GDP after two hundred years in the wilderness. China's gaining ground by taking away from North America, as well as Europe and Japan.

The table below shows how the charge is on for the share of the global economy.

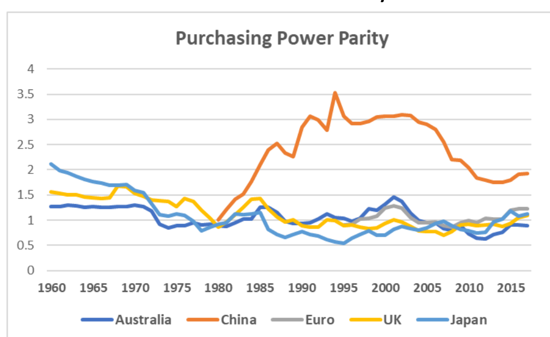
THE MOTHER OF ALL "MEAN REVERSION" TRADES IS UNDERWAY



Since the start of the common era until about 200 years ago China and India between them shared between 50-60% of the world's economic production. In the psyche of the Chinese, they have always been the most important country on Earth, they've just had a bad run for 200 years. Before too long the natural reality will be restored.

In 2017, the US GDP was US$19.4 trillion and was 1.6 times that of China at US$12.0 trillion. That's the measure in US dollars, but is that the best measure?

The chart shows the comparison between the exchange rate of various countries and what you could buy with the money (how many eggs, or Big Macs). For most developed countries the exchange rate reflects the cost of living in each country. The Chinese have kept their exchange rate artificially low, so in 2017 the Chinese could buy twice as many eggs with the equivalent of one American dollar than Americans could.



Measured using Purchasing Power Parity, the Chinese economy is already 20% bigger than the US economy, and it's growing at a much faster rate. As China's economy transitions to a more normal balance between export demand and local demand the existing trend for the currency discount to narrow will make the difference even greater.

But right now most Chinese are still much poorer than the average American. Even on a Purchasing Power Parity (PPP) basis that adjusts for price differences, the average person in China still only has about one third of the spending power an American has so there's a very long way to go for China in using that measure.

The size of the US army dwarfs that of China but the gap is closing rapidly. According to a recent report from the US Congressional Research Service summarised by *Business Insider*, China's armed forces has 2.3 million people while the US has about 1.4 million active service members. With a population of

around 1.4 billion to draw from, more than four times as much as the population of the US, China has a much lower number of personnel as a percentage of the population.

Again, while size matters it is important to give a big weighting to military arsenal, especially nuclear, that a country is building up without our knowledge. That's where it's difficult to accurately measure military strength of a country - but by all accounts China is catching up to the US.

Another measure of power is the education level of the general population. This is also only one piece of the puzzle, because if it was a stand-alone factor then the Scandinavian countries would be considered the most powerful in the world. Also, educational levels are an extremely subjective measurement and it depends who is doing the assessment.

In 2016 the Organisation for Economic Co-operation and Development (OECD) ranked Canada as the world's most educated country. The OECD defined a country's adult education level as the percentage of people between the ages of 25 and 64 who have completed some tertiary education in the form of a two-year degree, four-year degree or vocational program. Canada had 56 per cent of their population recorded as graduates and Japan came second with 50 per cent. Israel was third, Korea fourth and the UK fifth. The US was sixth with 46 per cent and Australia was next with nearly 44 per cent. China wasn't included in this ranking.

There are many ways to approach education levels and much of it is anecdotal. We know from high-achieving Chinese students who migrate to Australia, or who come here for tertiary studies, that they are extremely diligent and disciplined and strive to reach great heights in their education pursuits. We can't truly measure the relative levels of education between China and the US from afar, but the proof will be in the pudding when we see great numbers of highly educated Chinese impacting the economic success of China.

The race is on. China is chasing the US and when they overtake it on all measures discussed above, and we're sure they will, the US is unlikely to take it gracefully. The US voters elected Donald Trump on the promise of "making America great again" but that's not so simple and when it doesn't play-out that way there could be extreme global unsteadiness.

When measuring the most powerful country in the world, the US is no longer a clear winner. If China hasn't already become number 1, it will soon – it's inevitable.

This is a fundamental shift in world order and the tensions this transition creates will likely cause investment market volatility. Everyone is currently concerned that the ongoing trade tensions between China and the US will develop into a trade war and from an Australian perspective, we would hope our politicians are able to maintain good relations with both powers. The worst outcome would be if China and/or the US asked us to make a choice – because we have to make a decision about who's side we would take.

Market Uncertainty – Cash (and Cashflow) is King

Everyone is a little nervous. Investment returns in 2018 were disappointing and disconcerting news abounds.

Our view is that the medium-term future looks good. Despite strong underlying fundamentals, valuations have come down so that everything looks to be reasonably priced (See the next article). So, the quandary is; do you stay invested and hope the storm doesn't occur, or isn't too bad; or do you look to protect the portfolio by going to cash or buying portfolio insurance?

The problem with these options is they can be very expensive. Ideally our clients will have as much invested in the markets as they can, because over the medium term this will almost always provide a superior outcome.

We believe that the amount of cash flow needed to take from your investment portfolio is the fundamental factor in determining how your money should be allocated between the various asset classes of cash, fixed interest, Australian shares, international shares and, property and infrastructure.

We call this 'bulletproof' investing, and this approach has held our clients in good stead over the long term, largely due to the strength and resilience it gives to a portfolio during the bad times, while also enjoying the benefits of the good times.

At the heart of bulletproof investing and the allocation process, is having around five years of spending requirements set aside in Defensive assets such as cash, term deposits and other fixed interest investments. This is an absolute amount of money, that will almost guarantee you'll be safe, it's not a percentage of your portfolio.

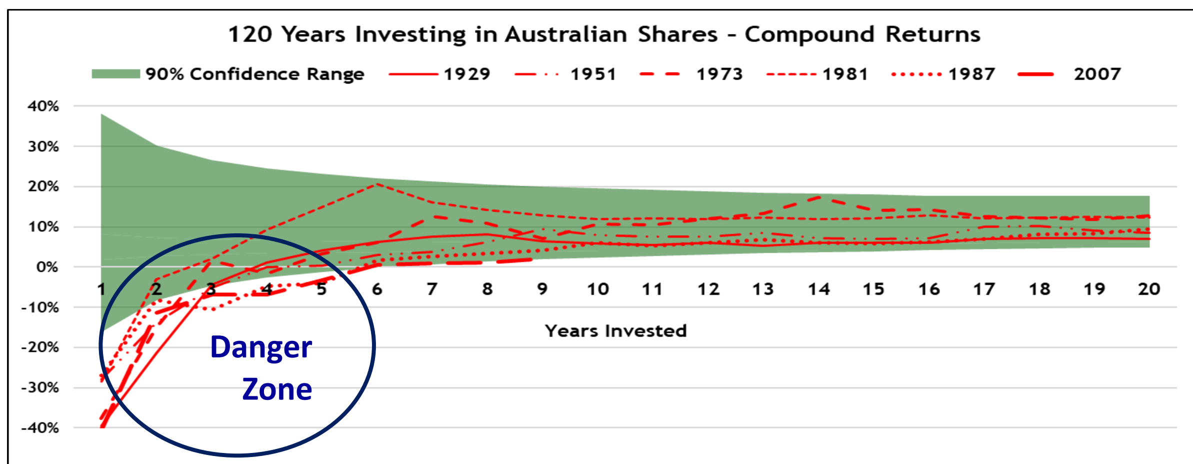
For example, a retired couple with $2 million investment assets, spending $100,000 per year would have $500,000 or 25% of their portfolio invested defensively and the rest in market assets. Another couple with $500,000 spending $60,000 per year might be getting $25,000 of age pension and need the rest from the portfolio. They would have $175,000, or 35% of their portfolio in defensive assets.

Those still working who don't need any income from the portfolio would have only a small amount in defensive assets. Intuitively, this outcome makes sense as you'd expect to be a bit more conservative in retirement than you would be while you're working.

But the purpose of it is deeper than that.

The biggest risk for people seeking good long-term portfolio returns is the possibility that they may be put in a position where they have to sell their growth investments at the worst possible time. There have been six really bad periods in investment markets in the last 120 years – The Great Depression in 1929, the Post War recession in 1951, the Oil Crisis of 1973, Fraser's recession in 1981, the 1987 Sharemarket Crash and, who could forget, the Global Financial Crisis of 2007.

Interestingly, in nearly all cases the preceding years provided great returns and, with high portfolio values, many people would have felt financially comfortable, looking forward to retiring and living off their healthy portfolio balances. If that person happened to be you, with 100% of your investments in the market, and you retired just before any of these six events, the red lines in the following diagram outline what your experience was like.



The green shaded area in the chart above outline shows, with 90% confidence, what share market investor's returns would have been over the 20-year period. For instance in year 1, 90% of the time the investor could have potentially received a return as high as nearly 40%, or a negative return as low as around -15%. That's a pretty broad range for the one-year performance.

However, if we look out to the 20-year return, the potential range of returns narrows to between 5% pa to 18% pa. The longer the investment timeframe, the narrower the range of returns. What it also means is that the longer the investor stays in the portfolio, the less likely they are to experience a negative total return, even if they had a really bad start.

The red lines show the performance achieved if you had invested at some of the worst times in the past 120 years. It's comforting to know that, if you received terrible returns in the first few years, it didn't mean you ended up with terrible returns after 20 years. Of course, that is as long as you have the nerve and the strategy to ride it out, rather than selling at the worst time. The two main reasons you might have chosen to sell in the first few years are:

- You were too stressed by it all; or
- You needed the money.

By setting aside 5 years of cash flow requirements in defensive assets, we ensure clients are never forced to sell growth assets at the worst time. This is critical, because if they're forced to sell, they won't participate in the eventual recovery. Unfortunately, no one really knows when the bad times will come. By the time we know it's bad the damage is often done, so it's vitally important to be able to be patient and wait for the recovery by having the means to do so.

This is the cheapest and most effective form of portfolio protection because the cost is the lesser return received on defensive assets when the markets are performing well. Over time for someone with 20% in defensive assets this self-insurance is costing around 1% in underperformance.

We can say with certainty that there will be tough times at some point in every investors' career - we just can't say when that will be. However, by using our approach we give clients every chance of moving through it as unscathed as possible, at very little cost.

Having defensive assets is extremely important, but investing in quality assets that pay healthy dividends and income to top-up the spent cash is also important. Often in the weaker periods, the cash flow received from the investments reduces and you may need to draw from capital to provide for your lifestyle needs. When you have stable defensive assets to draw on, you can leave the growth investments as they are, or even add to them, so you can fully participate in the eventual recovery.

This is where cash flow comes in - knowing where your cash flow is coming from during difficult times gives you the ability to be patient and ride things out.

If you have money in one of the bigger public superannuation funds that's paying you a pension, we encourage you to think about organising your superannuation assets this way. If you are drawing pension money from a standard 'Balanced' portfolio, it's likely that around 40% of your pension is being funded by defensive assets, while 60% is being funded from your growth assets. In a market downturn, the pension payments will force the sale of growth investments at the worst time and lock in losses that can never be recovered. If you invested at the start of 2008 (ie the GFC) and were drawing a pension from your Balanced fund, the value of your investment capital would be around 10% lower than someone who had drawn the pension only from defensive assets.

A 'bulletproof' portfolio can add tremendous portfolio value over time. And importantly, it engenders peace of mind and confidence, so you can spend your life doing the things you want.

The Midsec Barometer for 2019

Midsec Barometer aims to capture the investment environment by considering the four major determinants of future investment performance;

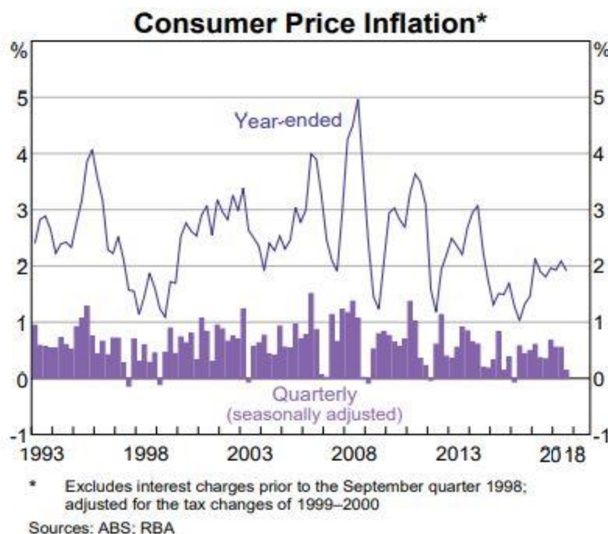
- The movement of the ***Value of the Australian Dollar*** will have an impact on the profitability of Australian companies and on the level of return Australian investors are likely to receive on international investments. A falling Australian Dollar (↓) will enable Australian businesses to be more competitive and will increase returns on international investments. A rising currency may indicate the country is in good shape, but it is bad for investors (↑). If the currency is likely to remain unchanged the impact is neutral (→).
- The rate of ***Economic Growth*** will eventually determine the direction of business profitability and the capacity of the economy to increase personal and business incomes to support property prices. If the Australian and International economies are growing (↑) it is good for investment markets. Flat or shrinking economies are bad (→↓). Little arrows are for a minor effect on the economy.
- Historically an increase in the ***Inflation Rate*** (↑) is potentially bad news for investors. Increasing inflation can make it difficult for businesses who find it difficult to increase prices quickly enough to keep up with increasing costs. If inflation is high for a period, it will usually flow through to higher interest rates and when investors can make more by investing defensively, they will often reduce how much they will pay for market assets like shares and properties. Conversely falling inflation would normally be considered to be good (↓).
- Similarly, increasing ***Interest Rates***, while often appreciated by defensive investors, are not welcomed by share and property investors. Increasing rates (↑) increases the borrowing costs of businesses and makes it harder to expand the business and make a good profit. Increasing interest rates also makes it more expensive to borrow for investment purposes. Higher interest rates mean investors need more income from investments to pay the interest bill. The only way they can get more income from investments is by paying less to buy them. Unsurprisingly, low and falling interest rates are good for investors (↓).

	Valuations	**Inflation**	**Economic Growth**		**Interest Rates**	**Value of the A $**
			Domestic	**Overseas**		
2019	→	→	↑	↑	→	↓
2024	↑	→	↑	↑	↑	→

Lots of Blue, some Green and a tiny bit of red create an interesting pattern we haven't seen for a while. Normally there's important stuff we are worried about over a five-year perspective. However, the current outlook is amazingly positive. Economic growth will be happening everywhere and while there have been recent hiccups, the recipe is for prosperous times ahead.

While wages growth remains low, Inflation looks set to be low and flat for some time. This relates directly to the Reserve Banks control of interest rates. This will encourage people to pay more for investment assets. Over time interest rates will creep up, and while this may create a drag on valuations it will be masked by the anticipated earnings growth.

The Inflation Rate

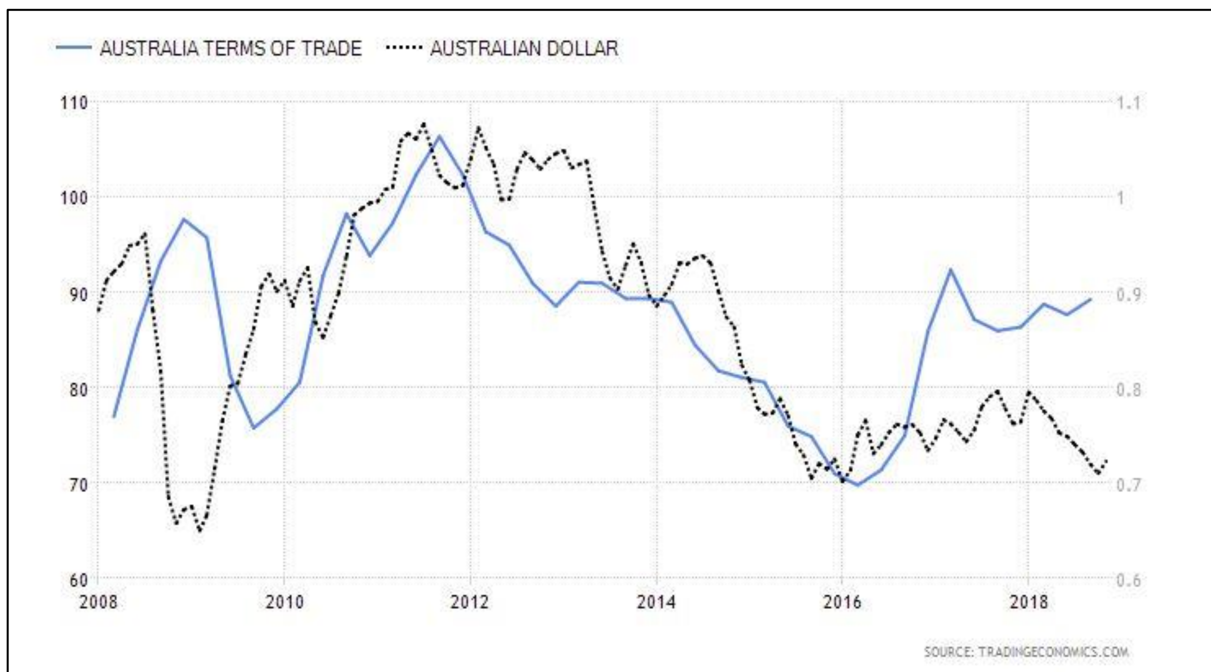


The Reserve Bank has set a target for inflation of 2-3%. However, the inflation rate remains below target. With low wages growth, a slack labour market, a highly competitive and disrupted retail market and downward pressure on rental growth, underlying inflation has been persistently lower than the Reserve Banks' median target of 2.5%.

The Reserve Bank has stated repeatedly that it is unlikely to move on interest rates unless underlying inflation shows signs of increases.

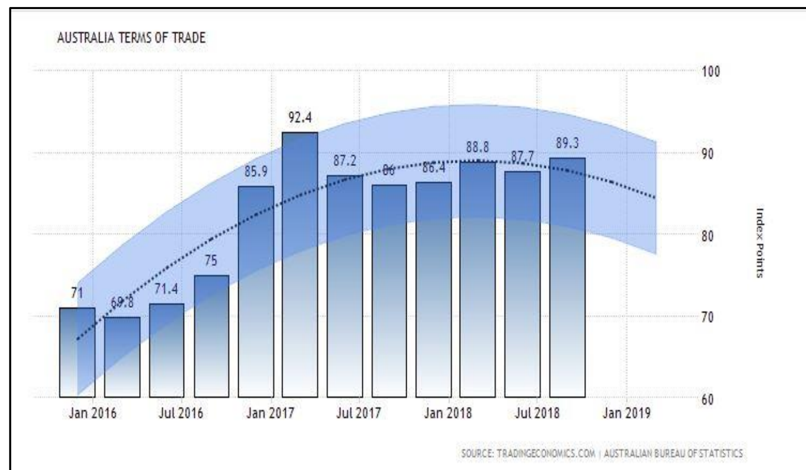
The Value of the Australian Dollar

Over the past two years the Aussie Dollar has traded within a range that is largely in line with the Terms of Trade. Twelve months ago, we thought the Dollar would travel between 70 and 80 cents and pleasingly, it has. Things may change though – and we expect them to.



Over the past twelve months our Terms of Trade have largely moved sideways, and yet our Dollar has slid, largely because interest rates are rising in the USA and staying low in Australia.

The Reserve Bank suggests that the Terms of Trade have already begun to roll over and will continue to do so in the next twelve months. With the widening interest rates gap between the USA and Australia causing a net cash outflow, our Dollar may dip. That would be great for exporters but not for importers. This may nudge inflation up – just the trigger the RBA needs to move interest rates upward.



Economic Growth in Australia

The Australian economy is a multi-faceted mix of dynamic ingredients. On the one hand we have factors that benefit the economy and on the other, there are forces that detract from its prosperity. The positives we see in the economy are:

- GDP growth is expected to remain above trend;
- Monetary policy is not expected to change greatly in the next twelve months;
- Tighter labour markets conditions and changes to income taxes may lead to an increase in household income and a likely increase in consumption (and around 50% of GDP is made up of Domestic Consumption);
- The tighter labour market will lead to an increase in wages growth, although it's not expected to be large – which will promote domestic expenditure;
- Growth in non-mining business investment is expected to remain strong and become more broadly based;
- Mining investment is close to its trough and, given strong and sustained growth in commodities, this should lead to an increase in investment;
- Non-residential building approvals have slowed, however there remains a large pipeline of current work;
- Generally, strong business profitability as a result of higher than expected commodity prices and generally robust domestic demand conditions support a stronger outlook for investment, employment and wages growth than currently forecast;
- There is significant spending on infrastructure across the country underway. Rail, roads, bridges and airports aplenty and this promotes building and construction activity and its associated flow on effects; and
- Our foreign customers are experiencing strong conditions and so our exports are expected to remain strong, especially with a slightly lower Australian Dollar.

However, amongst this heady mix are a few warning signs we must consider:

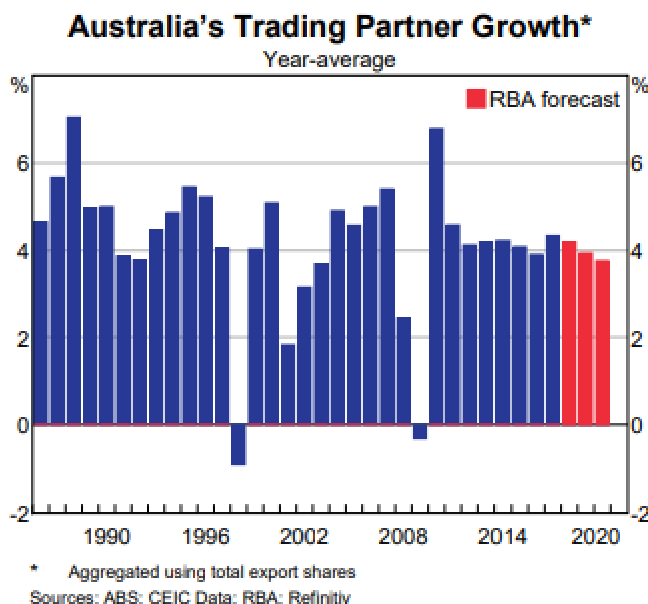
- The possibility that household income growth is faster than predicted, which will fuel inflation and possibly lead to monetary policy shocks from the Reserve Bank;

- How households react to continued housing price declines. It is possible that the spending decisions of highly indebted households and/or those without the ability to access credit could be more sensitive to easing house price growth, especially if income were to stagnate;
- There are international economic forces that would affect our economy. An escalation in trade tensions between the United States and China could lead to protectionism across the globe, general economic conditions in China and a faster rate of monetary tightening across the globe than predicted.

So, as we see it, these are economic factors that we can see and measure, but just how they play out will be the key to our prosperity. Everyone has expectations and if they are for the most part met, the general economic conditions domestically and across the globe suggest prosperity. If, however, the reality proves to be greatly different, we may be in for a bumpy ride.

Economic Growth Overseas

International economic growth remains positive and although it has slowed in some economies, it remains above average in most advanced economies. In the United States, recent fiscal stimulus along with generally accommodative monetary conditions have contributed to positive growth. Although the growth of Australia's major trading partners is expected to ease slightly, it still remains above trend.



This positive growth has consequently led to a tightening of labour markets and naturally there has been upward pressure on wages. Now, while this might lead to inflation, there are strong deflationary forces at work so it might not.

Trade tensions between the USA and China appear in press almost on a daily basis. The early indications are that recent tariff measures that came into effect in the past few months appear to be weighing on export orders for some economies. There is the possibility that as the big two continue to slug it out, protectionism will grow across the globe and pose a significant downside risk to global growth and business investment decisions. Who knows!

Growth in China has slowed over the past twelve months as conditions in the industrial sector have weakened. This is in part because government policies to contain financial risks associated with non-traditional forms of lending, as well as bringing transparency to local government, and in particular, finance. The mighty dragon has had its own way of doing things, but now is proactively aligning its practises with the rest of the world. Chinese authorities have been balancing these objectives with the need to continue the county's growth trajectory and have eased policies in a targeted way to ensure growth does not slow greatly while offsetting the impact of rising tariffs.

Growth in Asia has remained relatively strong to date. Export orders had decreased earlier in the year, but they have been relatively stable in recent times and markets, and decision makers like stability.

Domestic demand remains strong, especially in India. Growth in emerging economies however remains mixed, with many experiencing a difficult external financing environment.

Generally speaking, financial conditions in the major advanced economies have tightened slightly but remain with a bias toward growth. The various Central Banks are at different stages of their growth cycle and whilst some, like the US Central Bank, are expected to continue to increase rates, others such as the European Central Bank and the Bank of Japan are expected to retain highly expansionary policies for the foreseeable future.

Interest Rates

The Reserve Bank is clear in what it wants to achieve for the Australian economy. The low interest rate environment of the past few years has been designed to support and stimulate the economy and has resulted in progress towards full employment. Although inflation has increased in recent years it still remains below target.

The Reserve Bank is watching a number of factors in the economy, notably;

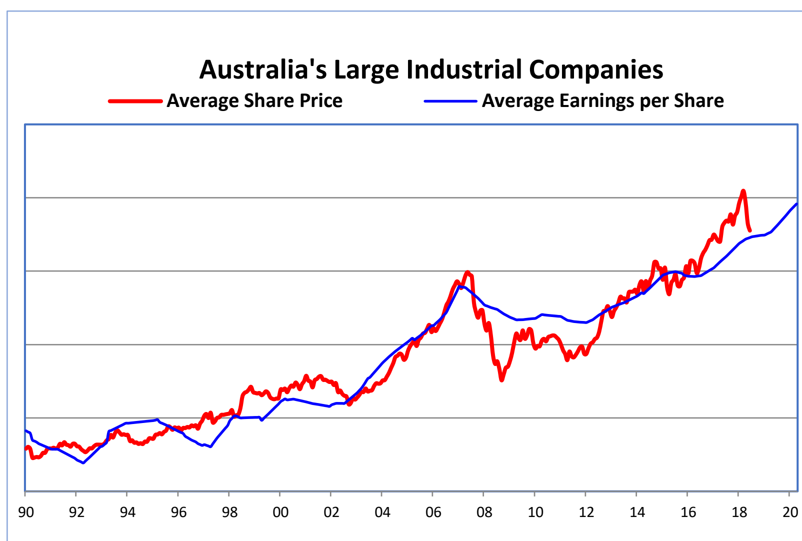
- Wage growth - a gradual increase in wage growth is expected as the economy continues to improve and is deemed necessary for inflation to reach the target range of 2-3%; and
- Household spending – although growing steadily, the Board is assessing the impact of slow growth in household income in an environment of high debt. Declines in housing prices add a little spice to the mix.
- Property Prices – the Reserve Bank has recently expressed concern at falling property prices and has indicated they would reduce interest rates if necessary, to support residential property markets.

If declining unemployment leads to higher wages and subsequently inflation, the RBA has made it clear that higher interest rates are to be expected “at some point”. However, given the slow meandering path toward that point, the Board has stated it has little reason to adjust rates presently.

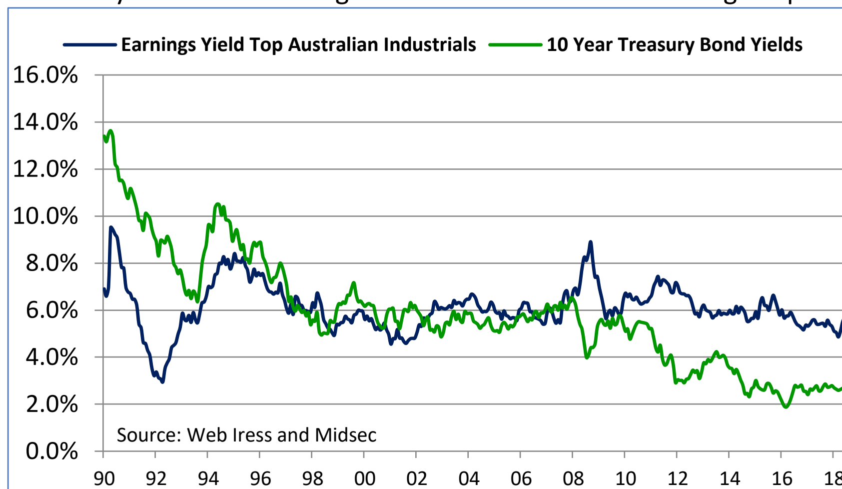
Valuations

The Australian equity market has fallen over the past twelve months, and as of December, was down approximately 7% since the start of the year. Two notable events have occurred though. Firstly, valuations between April and late August increased strongly with an 11% gain, followed by general "re-rating" of the market with a decline of 12%.

This see-sawing of equity valuations should always be expected, and markets sometimes get ahead of themselves. They will revert to the true value based on company profits or earnings. This is clearly evident throughout 2018 with some degree of market exuberance. Valuations are once again in line with their expected earnings and our belief is that the economy remains strong.



The chart below compares the earnings yield from large Australian Industrial shares with the yield from 10-year bonds. Throughout most of the 1990's and right up to the GFC the two lines were in lockstep and a tantalising gap has developed since. The yield that investors can receive from decent industrial shares is close to 6.5%, yet Treasury bonds continue to yield only around 2.5%. As long as this difference remains, equities will continue to be a favoured asset class.



Projected returns for the major investment markets

This process is explained in the book "Kissing the Frog" by David and Phillip Middleton, originally published by ABC Books in 2007 and now available as an eBook. The source of international market data is Bloomberg. Source for Australian share market data is WebIress. Commercial Property Yields source Burgess Rawson. Residential Property Yields source is the Global Property Guide, press articles and anecdotal data.

Of key interest to investors is how much they are likely to make from different types of investments. Naturally, no-one knows the answer, but applying some of the assumptions from the Barometer and also assuming no external shocks (that are naturally unknown) some estimates can be made.

The starting point should always be defensive assets. Defensive assets are appropriately named to reflect their comparative security. The table shows estimates of the average returns from different types of defensive assets over the next ten years. A fair estimate is that a blend of defensive assets will provide a ten-year return of 3.9%, including a drag from Government Bonds. Excluding Government Bonds a ten-year defensive return is expected to be around 4.1% per year.

Defensive Assets

Cash (average over 10 years)	2.5%
Term Deposits (average)	3.5%
10 Year Government Bonds	3.0%
Corporate Bonds	5.0%
Mortgages	4.5%
Listed Income Securities	5.0%
A Blend of Defensive Assets	3.9%

Predicting returns from market assets over one-year periods is all but impossible but there is considerable evidence that 10-year predictions can be helpful. For Shares the fundamental drivers of returns are the income (and other benefits like share buybacks) that flow to shareholders plus the change in the value of the shares. The value of the shares will increase due to any increase in the average level of corporate earnings. The assumption is that the valuation (the Price to earnings ratio – 'PE'), will move from where it is now to the long-term median at some point in the next 10 years.

International Shares

	USA	UK[2]	Europe	Japan	Mean
Current PE	16.9	12.3	13.3	16.1	
Median PE	16.4	12.5	12.0	18.5	
Yield/Benefit [1]	4.1%	6.0%	5.3%	4.4%	4.6%
Earn Growth	6.0%	6.0%	5.0%	4.0%	5.0%
PE Reversion	0.0%	0.0%	-0.1%	1.4%	0.4%
10 Year Return	10.1%	12.0%	10.2%	9.7%	10.0%
	Impact of Currency (Hedging)				-1.0%
	A Blend of International Shares				9.0%

Australian Shares

Current PE	16.8
Median PE	17.1
Yield	4.9%
Tax Credits	1.8%
Earn Growth	6.0%
PE Reversion	0.1%
10 Year Return	12.7%

[1] The benefit to shareholders varies due to the different tax jurisdictions. The assumption is that one third of earnings are retained for the business and this aligns with Australian Companies over time (although current payout ratios in Australia are higher).

[2] The current uncertainty in the UK over just how the BREXIT negotiations will pan out suggests that it would be prudent to leave the UK long-term data out of the calculations. Future policies in the UK may well provide a fundamental shift in their economy and the implications of this are too difficult to predict at this point in time.

Property investments are valued based on their yield and the assumption is that at some time in the next ten years the valuations will adjust to restore the historic yield.

Listed Property and Infrastructure

Current Yield	5.1%
Median Yield	5.8%
Yield	5.1%
Yield Growth	4.0%
Yld Reversion	-1.2%
10 Year Return	7.9%

Residential Property

Current Rent	4.0%
Median Rent	4.5%
Yield	4.0%
Rental Growth	4.0%
Yld Reversion	-0.5%
10 Year Return	7.5%

Commercial Property

Current Rent	6.5%
Median Rent	8.0%
Yield	6.5%
Rental Growth	2.5%
Yld Reversion	-2.0%
10 Year Return	7.0%

Investment Implications

The above information tells us that interest rate increases in the USA and recent international uncertainty has resulted in a re-rating of valuations across the globe. As the various indices will tell us, share prices have retreated from their lofty heights of early October 2018. Some markets are now close to their historic mean valuation PE's (Price Earnings Multiples). This implies that future share price growth will be in line with historic growth. This is not a bad place for future investment – the chance of future returns is equally balanced between exceeding expectations and providing disappointments.

Of course, if interest rates start to rise faster than expected, some further retraction in valuations is likely. In the past, investors have traditionally sought a higher return from market assets than they expect to receive from defensive assets to reward them for the additional risk they are taking. This is called the Equity Risk Premium and over 50 years across 17 countries the risk premium they have received is 5%. Both International and Australian shares are providing this premium although it should be pointed out that part of the return from Australian shares is based on favourable tax treatments of franking credits. Government policy may not be so favourable in the future.

Property still appears to be above its long-term medium yield and some degree of negative reversion should be expected. This doesn't mean a decrease in property values over a 10-year period, only that the growth of yield, and accordingly prices, may not be as strong as historically it has been.

Our Best Investment Ideas for 2019

1. Spend your Risk Budget

All investors should set their risk budget, having enough exposure to defensive assets to ensure their capacity (so they will never become forced sellers in bad markets because they need money) and their risk tolerance (so they won't become forced sellers because they need a good night's sleep). Having done so, the remainder should be invested where the prospects are best.

Sometimes, when markets are overvalued, or times are turbulent, more defensive assets might be the answer. In other words, investors may choose to keep some of their powder dry waiting for better times or better ideas. We don't believe they should be doing so right now.

Asset values have fallen over the past twelve months despite solid economic growth everywhere. Last year we pointed out that value was hard to find because prices were higher than normal. But we felt that higher than normal valuations may be an ongoing theme in a prolonged low interest rate environment, and that investors would likely have to get used to it. This year, we can report that while investment values aren't cheap, on average they're not expensive either. The medium-term economic outlook is good, so the best course in our view is to invest to the limit of your risk budget.

We said this last year as well, and it turned out to be unrewarding. One day we'll be right!

2. Tilt towards Asia

The drift in economic and political power from the West to the East that started over a decade ago is becoming a surge. China is probably the most important country in the world already.

Many Australian investors have always sought to diversify by mixing their Australian assets with assets overseas. This gave them exposure to different economic environments and to industries not present locally. 'Overseas' almost exclusively meant Europe, Japan and North America for two main reasons. First, the economies elsewhere were predominately rural (often feudal), and the small industrial base was often either Government-owned or controlled. Secondly, the investment markets were small, difficult to access and under-regulated. This second concern hasn't been completely resolved.

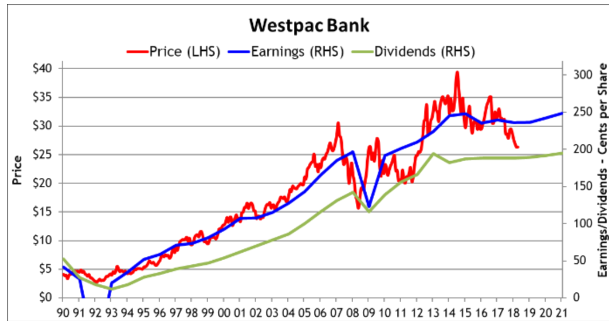
This lack of resolution is important, and some caution is required. The most likely access to Asian assets will be through managed funds, and the selection of a fund manager will be important.

3. Banks will be Banks

The old saying 'boys will be boys' stated explicitly that a certain level of naughtiness should be expected of youthful males, and implicitly that (to a point) this is a somewhat endearing characteristic. Recent events have provided sharper focus on this issue, and the point where naughtiness ends, and serious misbehaviour begins, is better defined.

The Royal Commission exposed that our banks are not charities and that if they needed to choose between what was good for the customers and what was good for the owners of the business, they will choose the course most beneficial for the owners. This probably isn't all that surprising. Investors already knew this, and they found it a somewhat endearing characteristic.

The findings of the Commission may dampen some of the worse behaviour of the banks, especially where a professional 'best interest' duty is required but is not delivered, and there may also be chunky

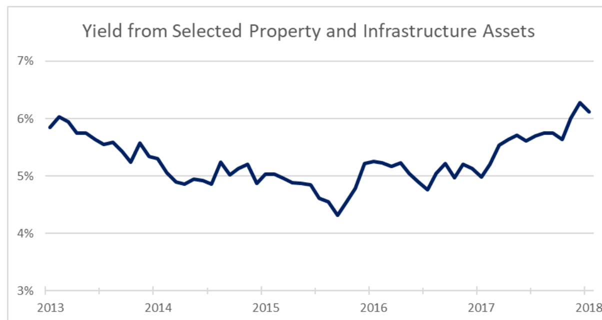


compensation payments to be made to those they have mistreated. But all this is at the fringe of what the banks do; they're banks – and traditional banking is where most of their profits have always been made.

The bad publicity has seen the prices of all the banks fall to the extent that all the likely bad news (and more) is already in the price. Yields may drop a little as they meet compensation payments and possibly retain more to strengthen their capital base, but they'll still be attractive. Earnings growth may be constrained but while the economy is growing there will be more money circulating and this provides more opportunity for the banks to siphon off some extra profits.

4. Rent is cheap

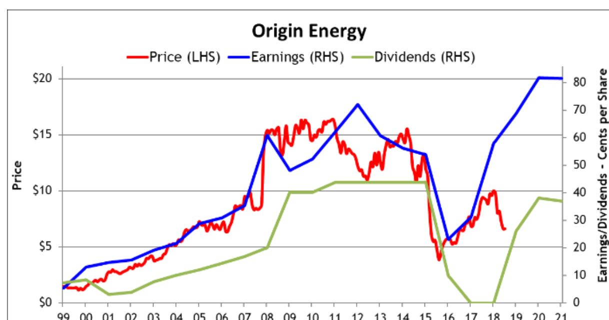
It isn't universal, but many property and infrastructure assets, including Stockland Group, Sydney Airports, Spark Infrastructure and Transurban have come down in price (or not increased in price) while distributions have been rising,



The chart shows that the average yield was 6% in 2013, and investors started buying, so by late in 2016 the increasing prices had caused the average yield to fall to just above 4%. At the end of November 2018, the yield was back above 6% again, and with the internal gearing, the yield is expected to rise at a greater rate than inflation. Given the security of this income, these investments are now very attractive.

5. Natural Gas might buck the trend

The price of energy looks to be moving inexorably downwards and the future for major fossil fuels like coal and oil looks bleak. It's true that aviation is likely to use oil for some time, but within ten years it'll become difficult to buy a new petrol-driven car. Coal is the bad guy for energy generation and will inevitably be replaced by renewables and batteries, regardless of the rear-guard action mounted by coal's cavalry.



Natural Gas is a special situation. While gas isn't clean and green, it is cleaner and greener, and it has a place in the transition away from fossil fuels altogether. Demand is already high and is set to rise, and right now there is a shortage.

The nature of the commodity cycle is that demand grows, and supply can't respond, so prices rise. The higher prices stimulate exploration and investment to bring on new supply (usually more than is needed). When this supply arrives, prices fall. During this period super profits are available. Share prices can go up by quite a bit, and then come down again. Natural Gas may provide an interesting ride over the next few years and for the stout hearted, it may be a journey worth starting, hopefully getting off at the right time. Other fossil fuel investments should be avoided.

6. The attack on Franking Credits

Our job is to limit the impact of taxation changes for clients. If the current proposal to stop paying excess franking credits back to investors proceeds, it's mainly Self-Managed Superannuation Funds (SMSFs) where the members are mainly in pension phase that will be impacted severely. There is more money in SMSFs than in any other superannuation sector, including industry super funds.

Superannuation funds are taxed as a whole (not member by member), so large superannuation funds that have many members in the accumulation phase of superannuation (where contributions and earnings are taxed) will be able to use all the franking credits to offset tax and will be able to allocate the franking credits to the members in pension phase.

Various strategies can apply, and these will need to be considered on a case by case basis. These include:

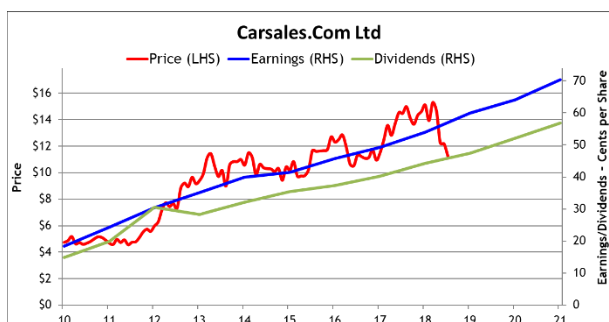
- Closing the SMSF and transferring to superannuation Wrap Accounts such as those currently offered by the big banks. The Wrap Account pricing has become competitive with SMSFs, and while there are some investment constraints, it's the next best thing to an SMSF, and it's likely most of the tax benefits pensioners currently enjoy will be retained
- Transfer only the Australian share component of the superannuation to a Wrap Account or an Industry Super Fund that offers a direct share portfolio option. There may not be the same choice, but the better tax outcome may be enough compensation.
- You could tilt towards international investments. For Australian investors the existence of Franking Credits provided an additional benefit not enjoyed by overseas investors, who, by virtue of their greater trading activity generally set the share prices. With no credits, international investments become relatively more attractive than before.
- Get other members into your SMSF. The funds can have up to six members and if Mum and Dad can get their children involved in the fund, overall, the family will pay less tax, and possibly lower fees. This makes sense for everyone.

As time goes on other approaches will be developed.

7. Capital Light Businesses

A capital light business has relatively few capital assets compared to its operations. The good ones, with little need for working capital or more equipment to meet demand, have the free cash flow to spend on marketing and growing their market presence. This can be hugely beneficial as many operate in sectors where the early winner takes all.

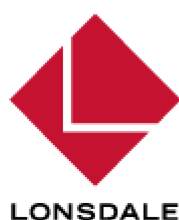
With lower capital needs the businesses will be less likely to raise capital in low price equity raisings, that dilute value for existing investors. And, capital intensive industries where the ratio of fixed costs to variable costs is high are much more vulnerable to economic slowdowns.



Carsale.com (CAR) is Australia's largest online pool of car buyers and dealers. With the size of their there's little reason for customers to go elsewhere when looking for a new car. The online marketplace doesn't require much capital to host, which facilitates the company's very healthy operating margin. At various times these businesses can be expensive. Right now, they're not!

8. Help the kids buy a home.

Property prices have been falling recently and they might come down a bit more, so the next year or so could be a really good opportunity for youngsters to buy their first home. But they might need some seed funding from the bank of 'mum and dad' (or granny and gramps) to encourage the real banks to come to the party. Struggle is character building, we know that, but this may be a once in a decade opportunity to get set.



About Midsec

Midsec is an Adelaide-based financial advice business owned and operated by its advisers. Collectively the advisers have over 100 years' experience in providing sound, holistic investment advice to their clients. We believe passionately that our clients have benefited and will continue to benefit from our disciplined approach to investment advice, our emphasis on clients maintaining sufficient cash flow to meet their spending requirements and achieving this by investing in a diverse range of asset classes.

Disclosure

Midsec is an Authorised Representative of Lonsdale Financial Group Ltd

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