INNOVA ASSET MANAGEMENT

INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS

REASSURANCE FOR TURBULENT TIMES: ECONOMIES AND MARKETS AREN'T AS CLOSELY LINKED AS WE OFTEN THINK

After a record run, the Australian economy is starting to falter. Long-held expectations of official rate rises have given way to successive rate cuts as the RBA attempts to spark wages and inflation growth.

Not surprisingly, investors are jittery about what this means for their assets and how they should respond.

But the current strength of the economy is not the same as the performance of investment markets. The former is often a product of past decisions, while the latter is forward looking. The media often conflates the two – and intuition suggests companies should perform better in a strong economy – but the data shows no direct link.

Just look at China, which has had one of the world's strongest economies for the past two decades, yet its share market has posted relatively weak returns.

Governments and central banks can pull the economic levers that underpin our lives, but even in that domain their influence has its limits.

Prime Minister Scott Morrison has claimed the Liberal Party's economic oversight has the Budget on track to return to surplus but the reality is without the sharp spike in iron ore prices over the past year (down to luck), it would have been impossible.

It takes a government to do something monumental to change the fact that investment markets drive returns – and that has rarely happened.

However, the most recent election presented one of the starkest choices between the two major parties, with shares in the banking, property and health insurance sectors spiking sharply in the days after the Liberal victory.

Would Labor's policies, which included changes to franking credit refunds, and winding back capital gains tax and negative gearing concessions, have proved to be the type of monumental change required to re-shape capital markets? We're not so sure.

Compare it to the watershed decision by former Prime Minister Paul Keating to implement the superannuation guarantee in 1992. It's hard not to argue that the decisions of super funds, which already own almost 40% of the ASX and are poised to hold more than half within 15 years[1], now play a key role in the direction of markets.

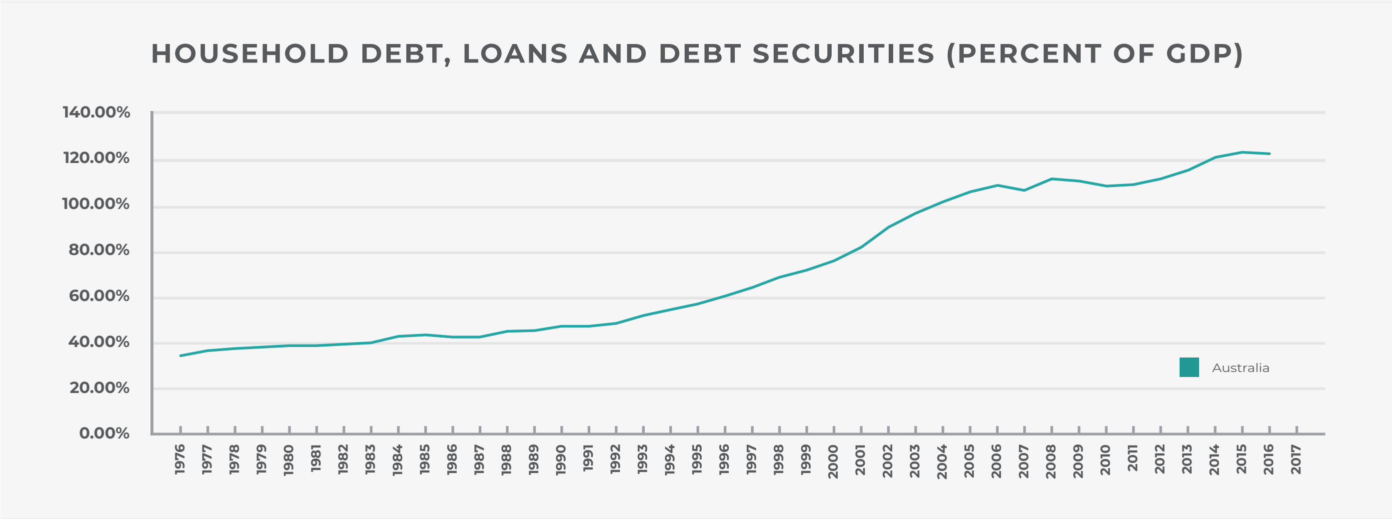
AUSTRALIA'S FALTERING ECONOMY

With the market betting on further RBA rate cuts, is Australia's economy heading for its first recession in 27 years – and if so, how will markets react? The bond market is currently pointing to a recession while the stock market is pointing to ongoing good times – they can't both be right.

There are clear risks facing the Australian economy: the RBA has never had so few levers left to pull if things go wrong; we have one of the most expensive property markets in the world; and, of most concern, households still carry record levels of debt (mainly residential property).

[1] *Rainmaker Information, May 2019.* **https://www.medianet.com.au/releases/175575**

AUSTRALIAN PRIVATE DEBT TO GDP



Source: IMF

Unfortunately for many Australians (but not first home buyers), house prices have fallen over the past 18 months as the prudential regulator has forced the industry to tighten lending standards. A key question is whether this will cause consumers to feel less wealthy and save more (known as **the wealth effect**)? The Westpac-Melbourne Institute consumer survey fell 4.1% in July, reaching a two-year low, suggesting Australians are nervous.

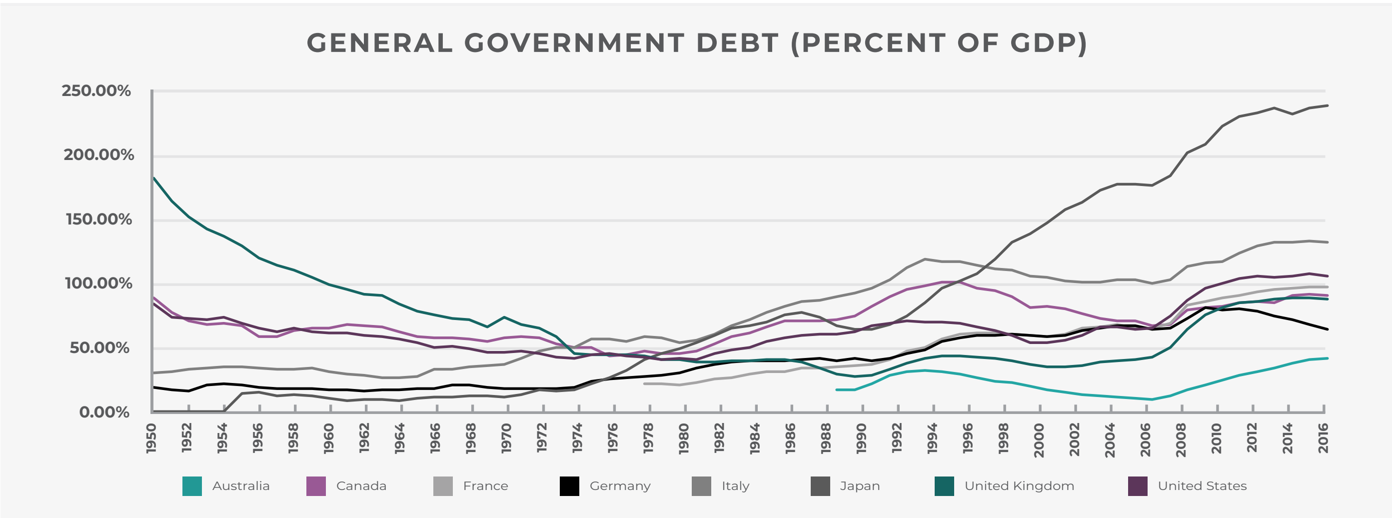
While a potential higher savings rate is a long-term positive, it tends to hurt the economy in the short-term because people are spending less. However, with a savings rate rumoured at only 2%, Australians can probably afford to tighten their belts a little (remember, 9.5% of wages earned by those working is funnelled to Superannuation – implying we're spending 7.5% more than our disposable income[2]).

The state of jobs growth and employment will be crucial as the housing and construction sectors weaken. A combination of widespread job losses striking highly-leveraged households would sound recession alarm bells.

However, crystalizing these risks is a worse-case scenario.

The government has plenty of firepower to stimulate job growth through infrastructure spending (which is good for productivity) plus the fall in house prices appears to have bottomed out. Productivity growth has been climbing, population growth has been positive, and most importantly, our terms of trade have been expanding since 2016.

While many developed nation governments bear debt-to-GDP ratios well over 100%, the Australian government's debt-to-GDP is still only at 40%, meaning it can boost spending to support the economy if necessary:



Source: IMF

PRICE REMAINS THE KEY TO RETURNS

A 27-year run without a recession is unusual and not always a good thing. Like a bushfire, recessions clean out the cumulative excesses and lay the ground for fresh growth. Their absence can enable bad business models and poor economic policies to flourish unimpeded.

There are warning signs on the horizon, but there are also buffers in place to help prevent a potential downturn from becoming catastrophic.

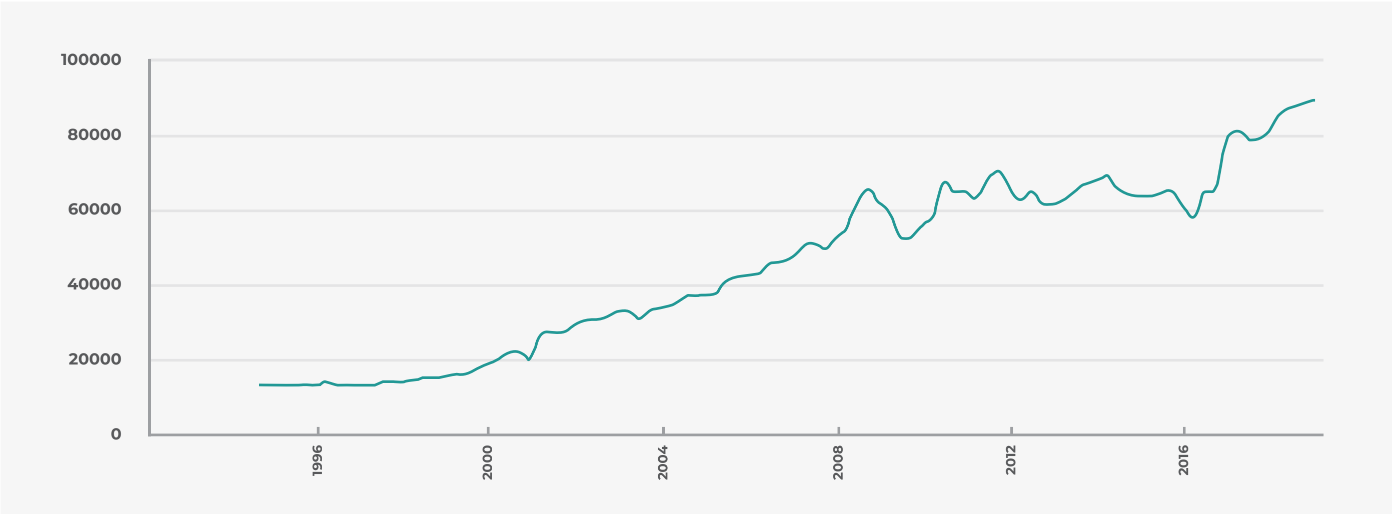
The most likely scenario is we see an economic slowdown for

[2] *This is not exact as it doesn't include the retired who are no longer earning a wage, but you get the idea*

some time before growth resumes at a more normal pace. However, none of this is guaranteed and only time will tell what will happen.

We don't invest in economies, we invest in markets. While there are looming risks on the horizon, corporate profitability has never been higher, which gives some comfort to investors.

AUSTRALIAN CORPORATE PROFITS



Source: Tradingeconomics.com

The economic outlook may be uncertain but investment principles that deliver over the long-term remain solid.

The strongest factor that drives return is the initial price you pay. If you pay too much, even a quality investment is unlikely to deliver over the long-term while conversely, even a bad asset can make money if the price is right.

Risk management is even more critical when the outlook is uncertain. This means true diversification according to underlying risk factors rather than broad asset classes. It also means understanding risk in direct relation to an investor's goals.

For example, investing in long-term government bonds paying less than the rate of inflation is risky for most retirees, as is investing in growth stocks with blue-sky potential but miniscule underlying earnings growth. We would argue in the current environment, the attractive price of emerging markets more than factors in the asset classes' traditionally higher risk factors.

Economic shifts are just one part of the investment landscape but focusing on it above all else risks not seeing the wood for the trees. Some of those trees will fall, but a sound investment approach can help preserve the forest for generations to come.

Contact Innova Asset Management for further information about our goals-based investment approach.

Dan Miles
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Dan Miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios for 8 years. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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