



**ANZ 2018
GLOBAL MARKET OUTLOOK**

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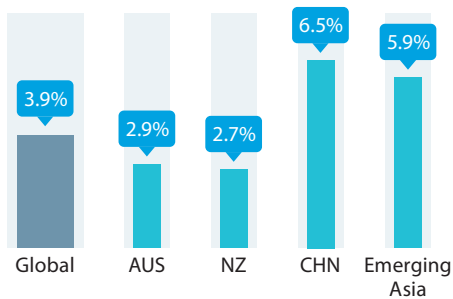
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2018 AT A GLANCE

GLOBAL GROWTH

GDP GROWTH STARTS 2018 WELL



GOOD TIMES FADE



- 2017's double-digit share returns to moderate in 2018.
- Caution on how much the positive earnings story will translate into returns given current elevated valuations.

IT'S GETTING LATE



- Current economic conditions are supportive of share markets.
- Investment Cycle Clock suggests we are within 18 months of conditions that flagged the peak in the 3 previous share market cycles.

TOO EARLY TO GO DEFENSIVE



- Robust economic conditions to persist for some time yet.
- Too early to go to a defensive portfolio allocation.
- Rising risks on the cycle's longevity need to be considered, constraining our overweight to shares.

POLICY SUPPORT WANES



- With unemployment rates hitting pre-GFC lows, monetary policy support by major developed market central banks is expected to be reduced.
- RBA to lag Fed.

CURRENCIES



- AUD fair value.
- Mixed drivers from firmer commodity prices and less favourable interest rate differential to the US.

LOOKING BACK

SYNCHRONISED GROWTH

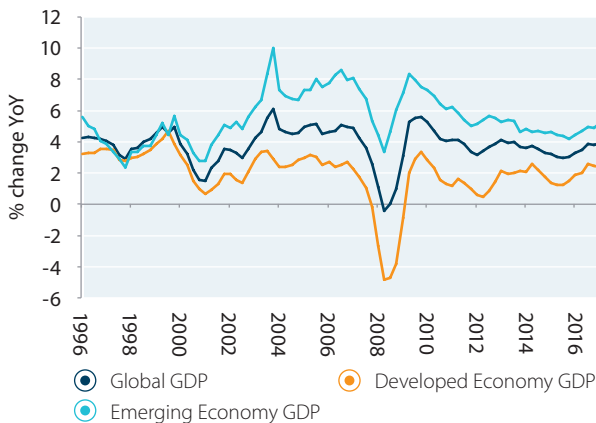
Before delving into our outlook for 2018, it is important to take a step back and look at where we have come from to get a better sense of where we are heading.

The sharp slowing in global growth in 2015 provided the pre-conditions for the strong recovery in 2017 that is now extending into 2018. At the epicentre of the 2015/16 economic slowdown was the sharp slowing in Chinese growth, particularly across the industrial sector, which spread globally. Slower Chinese growth reflected shorter-term cyclical forces but also a longer-term structural slowing in Chinese growth.

In essence, the 20 year Chinese supply side boom and double digit growth that commenced around 2000, primarily absorbed by the increasingly indebted US households, came to an end in 2008. US households have continued to de-lever. Overall, it was clear that the trend pace of global growth had meaningfully shifted down as households reduced leverage and workforce growth slowed. As a result, China became more dependent on domestic drivers of growth.

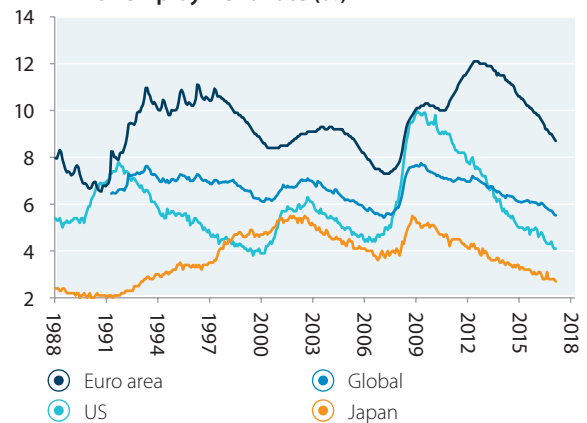
China responded to this slowdown by implementing major policy stimulus. Moreover, European and Japanese policy makers stepped up policy support and the US Federal Reserve (Fed) went on hold. This stimulatory environment formed the base for the synchronised lift in global growth and sharp drop in volatility across most asset classes that developed through 2017. In short, a 'good times' environment of strong growth, subdued inflation and easy financial conditions had unfolded. Late in 2017, commodities and Australian shares also rallied strongly, primarily reflecting the positive global backdrop.

Chart 1: Global GDP Growth (real % change)



Source: Thompson Reuters Datastream and ANZ Wealth

Chart 2: Major Developed Economy Unemployment Rate (%)



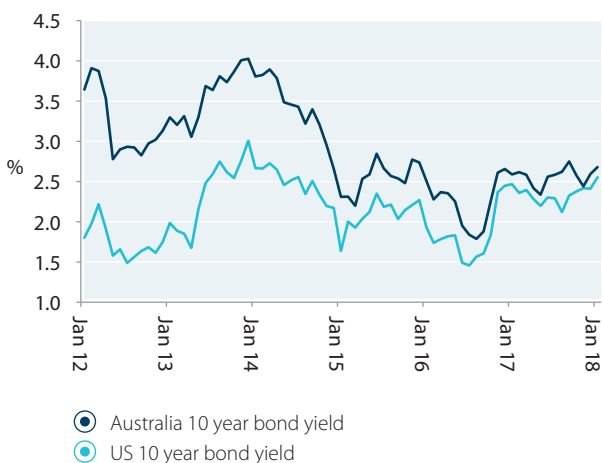
Source: Thompson Reuters Datastream and ANZ Wealth



Global growth in 2017 will recorded its strongest pace since 2011 (Chart 1) there are now clear signs that growth is finally shaking off the headwinds of the global financial crisis (GFC) with global unemployment falling sharply to around pre-GFC levels (Chart 2) and capital spending finally starting to recover across most developed economies. Growth is now broad based and global trade has recovered. In contrast to pre-GFC leveraged growth, GDP appears more balanced between sectors and across regions.

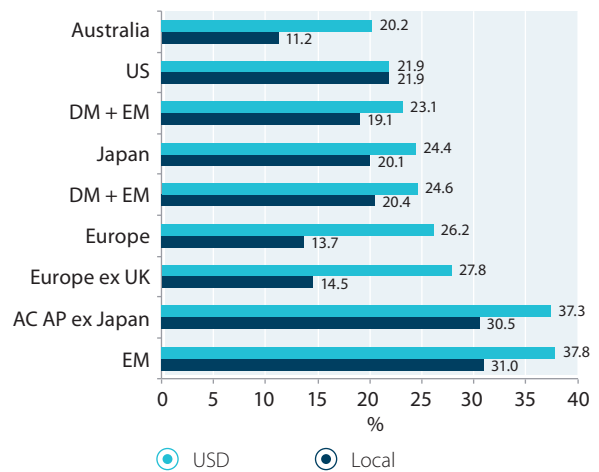
Somewhat surprisingly, given the strong lift in global growth and decline in the global unemployment rate, wages and inflation remained subdued in developed markets. As a result longer dated yields were largely anchored in 2017 despite Fed tightening (Chart 3). Clearly a combination of Bank of Japan (BoJ) and European Central Bank (ECB) bond purchases contributed to bond yields remaining capped. Emerging market economies also benefitted from a softer US dollar (USD), tighter credit spreads, easier financial conditions, strong global growth and a lift in trade. This very favourable environment drove strong returns across share markets (Chart 4) and most other asset classes in 2017.

Chart 3: 10 year bond yields



Source: Bloomberg

Chart 4: 2017 Share Market returns across regions

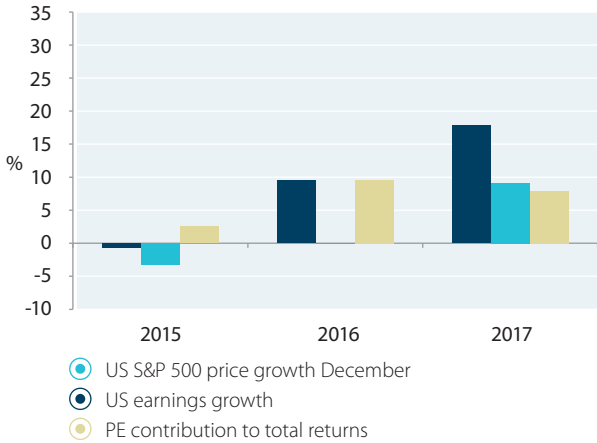


Source: Morgan Stanley MSCI and ANZ Wealth

While we held a constructive view on growth in our 2017 Annual Outlook, clearly we under-estimated the magnitude of returns across most asset classes in 2017. While Fed tightening was broadly in line with our expectations, in 2017 financial conditions eased rather than tightened as we expected; PE multiples lifted in the US (across most other markets PE multiples modestly declined) due to the re-rate of the tech sector and business

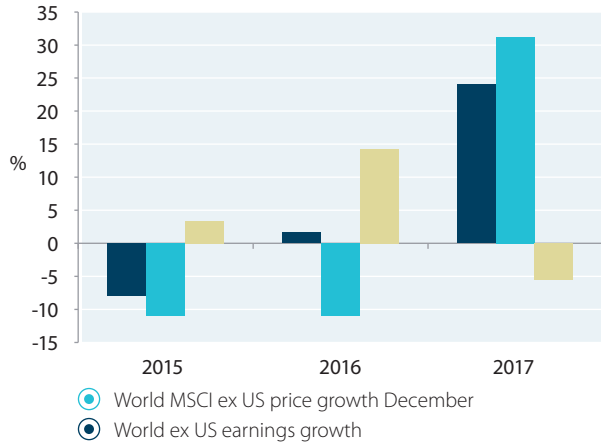
surveys and earnings strengthened into the end of 2017, rather than easing. Apart from the US, where earnings were around 10%, global earnings were much stronger than we expected lifting between 20 to 30% across many markets. Overall, share markets were primarily driven by sharply improved earnings, although the PE multiple of the US tech sector moved higher supporting high double digit US returns (Charts 5 and 6).

Chart 5: US equity returns



Source: Thompson Reuters Datastream

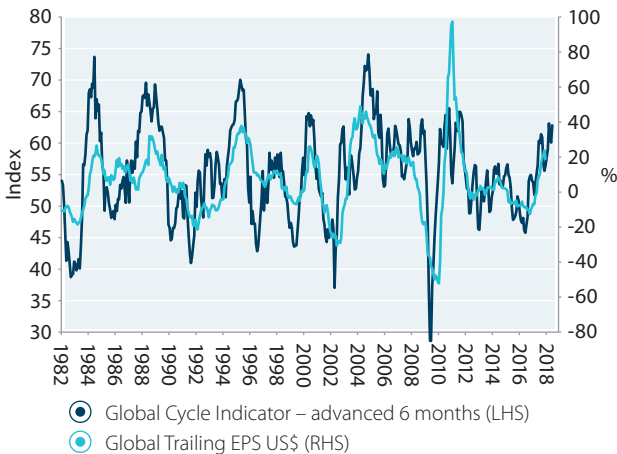
Chart 6: World equity returns ex US



Source: Thompson Reuters Datastream

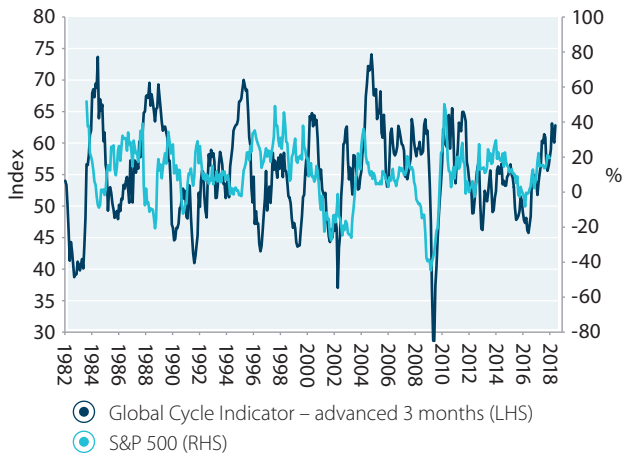
As we reflect on 2017, our composite Global Cycle Indicator suggests that global earnings could lift to at least 20% through the first part of 2018 with equity returns remaining strong (Charts 7 and 8).

Chart 7: Global Cycle Indicator and trailing EPS growth



Source: Bloomberg, Thompson Reuters Datastream and ANZ Wealth

Chart 8: Global Cycle Indicator and S&P returns



Source: Bloomberg, Thompson Reuters Datastream and ANZ Wealth

While the economic backdrop remains very constructive valuations across most markets have already captured the good news. We estimate that both global and Australian share markets are expensive, with the US S&P 500 leading the way (Chart 9). However, the estimated equity risk premium (earnings yield to the real cash rate) which values

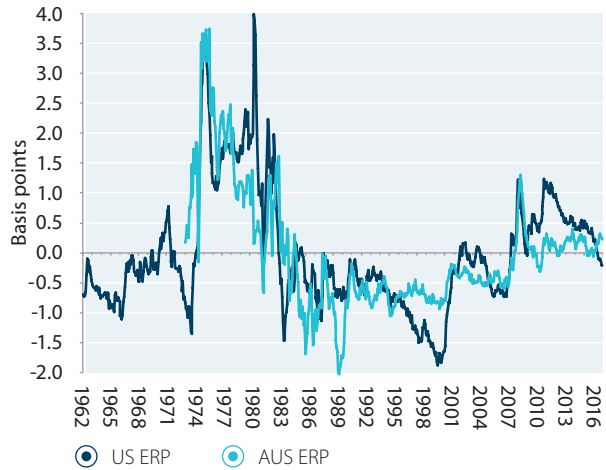
Chart 9: US and Australia % deviation from fair value



Source: Bloomberg, Thompson Reuters Datastream and ANZ Wealth

the market relative to the current low interest rates suggests the S&P 500 is only modestly expensive, reflecting still negative real cash rates (Chart 10). Australia and Europe's equity risk premiums are close to their long run average. This points to a more supportive story for equity markets but highlights the risk from a lift in the low rate environment.

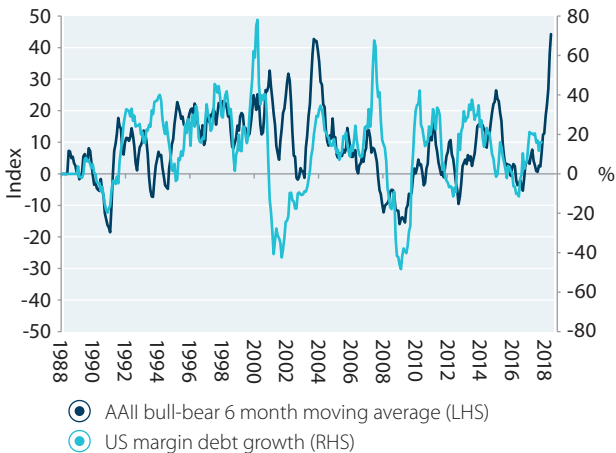
Chart 10: US and Australia equity risk premium (ERP)



Source: Bloomberg, Thompson Reuters Datastream and ANZ Wealth

Despite the supportive economic backdrop, to date, behavioural indicators have remained relatively subdued. For individual investor's, sentiment (as measured by the American Association of Individual Investors survey) has recently lifted sharply and belatedly reconnected with the strong economic backdrop (Chart 11). That said, US margin lending, one of the more reliable indicators of cycle peaks, while lifting remains well below the levels associated with "irrational exuberance" of the Tech and GFC periods.

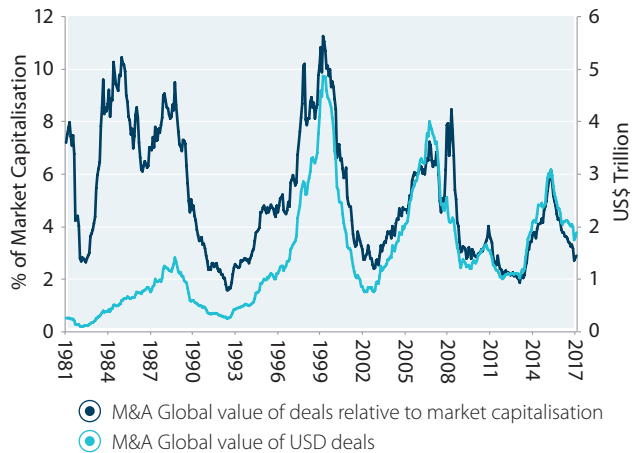
Chart 11: AAIL bull-bear and margin debt



Source: Bloomberg American Association of Individual Investors (AAIL) and ANZ Wealth

Behavioural indicators of corporate sentiment to date have also remained relatively subdued, with M&A easing since 2015 (Chart 12) and Initial Public Offerings relative to market capitalisation half or less than in 2000 and 2007. On balance, behavioural indicators are not indicating a market top any time soon. This suggests one of the positive risks for the market in the period ahead is the impact of improving sentiment and the flow on effect to pricing - 2000 illustrated the classic example of a share market "melting up" as behavioural factors approach "irrational exuberance" levels.

Chart 12: Global M&A Activity



Source: Bloomberg and Minack Advisors

Finally, political risks while elevated were largely firewalled from the economic and financial outlook. Clearly very accommodative policy and stronger economic growth was an offset to political risks.

LOOKING AHEAD

WILL THE GOOD TIMES ROLL OR FADE?

In summary, from a weak 2015 base, 2017 was a very favourable 'good times' (high double digit returns) environment with synchronised above trend global growth, softer than expected inflation, easier financial condition even as the Fed tightened policy and US tax cuts adding to stimulus.

The critical question is can 2017's good times roll through 2018, or even longer? We consider it is more likely that 'good times fade' rather than 'roll on' in 2018/19. We expect solid single digit equity returns this year, but are cautious on how much of the positive earnings story translates through to returns at current valuations and low volatility given we consider risks are tilted to monetary policy being

tightened somewhat faster than markets currently expect. In particular we see the risk that US wages and inflation will lift more rapidly than currently expected by markets. With the risk to both growth and inflation now tilted firmly to the upside in 2018/19 (Table 1) this will likely be a headwind to another year of high double-digit returns.

Table 1: Global economic forecasts

	Real GDP forecast (%)			Inflation forecast (%)		
	2017	2018	2016	2017	2018	2019
US	2.2	2.5	2.1	2.1	2.3	2.2
Eurozone	2.3	1.9	2.0	1.5	1.3	1.7
UK	1.6	1.4	1.6	2.7	2.5	2.3
Japan	1.5	1.0	1.0	0.5	1.0	1.3
China	6.8	6.5	6.3	1.7	2.6	3.0
India*	6.2	7.2	7.6	3.3	3.8	4.3
Australia	2.3	2.9	3.0	2.0	2.3	2.4
New Zealand**	2.3	2.7	3.0	1.9	1.8	2.2
World	3.8	3.9	3.8	3.1	3.3	3.3

*Fiscal years – for example 2017 is year-ending March 2018

**NZ GDP numbers are production based GDP(P).

Source: Consensus Economics, Thomson Reuters Datastream, IMF, ANZ Research

**OUR CENTRAL CASE VIEW IS WHAT WE HAVE TERMED ‘GOOD TIMES FADE’,
WHICH WE ASSIGN A 60% PROBABILITY TO**

SCENARIO ANALYSIS FOR 2018

When thinking about the outlook for markets and the appropriate investment strategy, we consider a number of scenarios for the outlook and the varying implications these have. Our central case view is what we have termed **‘good times fade’**, which we assign a 60% probability to. Our view assumes that the investment cycle has between 12-18 months to run before slowdown and recession risks rise. Our view is premised on a market starting the year on elevated valuations with wages and inflation gradually lifting, policy steadily tightening across most major

central banks, firmer financial conditions from current very accommodative levels and yield curves continuing to flatten. Growth is good, but central banks have started to steadily drain liquidity and shift volatility onto investors as their balance sheets are reduced and short rates rise. However, given the elevated level of debt we consider central banks will maintain a gradual trajectory under our core views.

Table 2: Our Three Scenarios and preferred asset classes for 2018

Scenario	Growth slide	Good times fade	Inflation scare
Probability	10%	60%	30%
Global GDP	Less than 3.2%	3.5-3.9%	Above 4%
Global Inflation (developed)	Less than 1.5%	1.7-2.2%	Above 2.5%
Asset Class			
Shares	-	+	+
Bonds	++	-	--
AUD	-	o	++

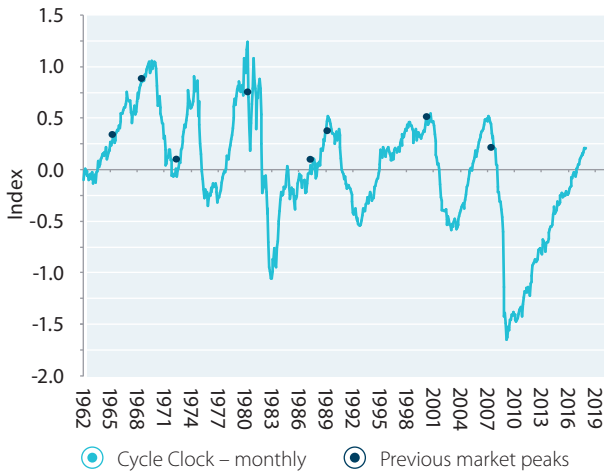
Source: ANZ Wealth

Our central view assumes that the Fed will tighten policy three times by 25 bps in 2018 and continue to reduce its balance sheet, with ECB QE finishing late this year. In conjunction with a net increase in treasury issuance (reflecting fiscal stimulus and a reduction in the Fed's balance sheet) we assume US 10 year yields will lift to just short of 3% by end 2018 and the 2 year bond to lift to 2.5%, implying a further flattening of the yield curve in 2018. Taken together this suggests some caution, although the overall backdrop remains supportive of risk assets, primarily due to strong economic and earnings growth.

While the immediate outlook remains supportive of growth assets, our longer term focused Investment Cycle Clock (ICC) framework flags caution. The ICC is a tool to identify where we are in the investment cycle and the prospects for it continuing by combining a number of

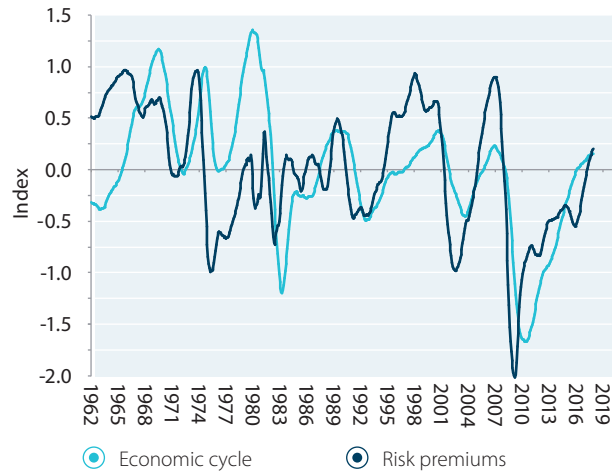
indicators of the economic cycle and market pricing. Currently our combined ICC is rising steadily and at its current pace will reach the 0.5 reading that forewarned of an approaching peak in equity markets in the previous 3 cycles within 18 months. As shown by the red dots in Chart 13 the ICC has typically peaked with or led the onset of a bear market by up to 6 months. While it is approaching levels generally consistent with markets being expensive and the economic cycle sitting in the "Boom" phase it suggests it is too early to go to a defensive portfolio allocation, but flags we are late cycle with risks rising. In short the current signal is likely telling us about the relative performance of shares to cash in H1 2019. The signal is broadly consistent with positive returns to shares in 2018 with downside risk rising later in the year and into 2019.

Chart 13: US Investment Cycle Clock



Source: Bloomberg

Chart 14: US Investment Cycle Clock – economic and risk premiums

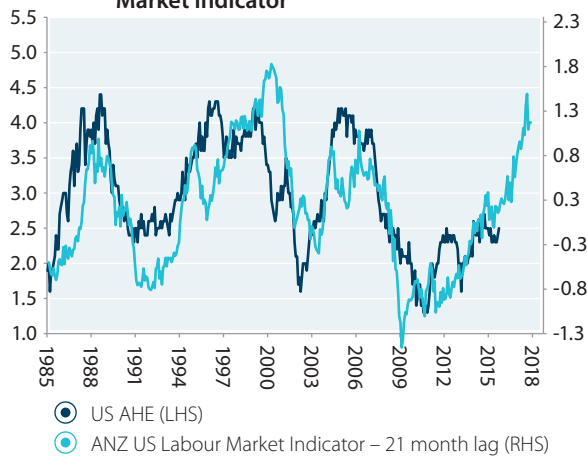


Source: Bloomberg

The two elements of our ICC – economic and risk premia – are currently broadly aligned. In the past couple of cycles the risk premia component has tended to run well ahead of the economic cycle through the boom phase (Chart 14). This environment is often associated with a 'melt up' in markets where valuations and behavioural factors run well ahead of economic fundamentals. A melt up could be driven by asset allocators fleeing bonds and allocating to shares on expectations of an extended cycle supported by very gradual central bank tightening. But at the moment behavioural indicators (Charts 11 and 12) don't as yet suggest we have entered this phase.

The Australian dollar in the growth fades scenario is expected to be well supported - current fair value on our commodity priced based model is around USD 79 cents (Chart 16). With global growth remaining above trend commodity prices and the Australian dollar may face further upward pressure, although bulk commodity prices such as iron ore and coking coal already look somewhat extended versus long run estimates. With a strong world economy, history suggests the USD is likely to remain under downward pressure as capital flows in seek riskier returns abroad.

Chart 15: US Average Hourly Earnings (AHE) & Labour Market Indicator



Source: Bloomberg and ANZ Wealth

Chart 16: AUD/USD – Model Forecast v’s Actual



Source: Bloomberg, Thompson Reuters Datastream and ANZ Wealth

We consider the key risk to our **‘good times fade’** view is a more pronounced lift in wages and inflation than we currently assume. The upside risk to wages is illustrated in Chart 15 which sets our US wage indicator against the change in US average hourly earnings with a 2 year lead. To date the relatively muted lift in US wages growth has broadly tracked our lead indicator. However, by around end 2018 our indicator suggests that wages could accelerate to around 3.5% from 2.5% by end 2018 and lift to over 4% by mid-2019. This should lift personal consumption expenditure (PCE) inflation to 2-2.2% by end 2018 in line with our core view.

The risk is labour market conditions continue to tighten unabated given above trend growth. Survey based measures in Europe point to a similar risk in Europe. Under our **‘inflation scare’** scenario with stronger than expected growth US wages growth would lift well above 4% and inflation would accelerate to above 2.5% by year end. The Fed would tighten more than 3 times in 2018 and the yield curve move close to flat. Moreover, if ECB tapering was brought forward markets could be confronted with a repeat of the 2013 taper tantrum. This environment would support a more defensive position at some point in 2018 with weak returns for both shares and bonds. The Australian dollar is expected to rise further on the back of strong growth and rising inflation expectations,

supported by higher commodity prices. We currently assign a 30% probability to this scenario. Our ICC in this case would more rapidly reach the 0.5 reading typical with market peaks

Finally we assign a 10% probability of a **‘growth slide’** with lower inflation with central banks on hold. With monetary and fiscal policy supportive of growth in the developed economies, the environment would likely be driven by a sharper than expected slowing in Chinese growth. This environment would support a more defensive position in 2018 with the environment favourable for bonds but a headwind for the AUD and Australian and international shares.

**WE CONSIDER THE KEY RISK
TO OUR ‘GOOD TIMES FADE’ VIEW
IS A MORE PRONOUNCED LIFT IN
WAGES AND INFLATION THAN
WE CURRENTLY ASSUME**

INVESTMENT

STRATEGY IMPLICATIONS

Our core view is that central banks have time and can tighten gradually and this will support trend returns for growth assets in 2018 while bonds will deliver flat returns.

We consider the prime risk is our Inflation Scare scenario. A stronger lift in wages and inflation than assumed in our base view would mean that our ICC would tick more rapidly. This would bring forward strategies to mitigate the risk associated with a more rapid central bank tightening.

Our tactical asset allocation strategy balances the risk of the various scenarios that may unfold. While the central case scenarios is clearly favourable towards shares over defensive assets we are cognisant of the risks posed by the inflation scare scenario and the late stage in the investment cycle as flagged by the ICC. Longevity of the economic expansion then comes into question. Our 'growth slide' scenario also calls for a defensive positioning but lower bond yields provide options for alternative positioning away from shares.

Table 3 below shows our return expectations taking into account the three scenarios, the likely asset returns and probability of achievement. The return assumptions balance our expectation of earnings growth versus PE multiple

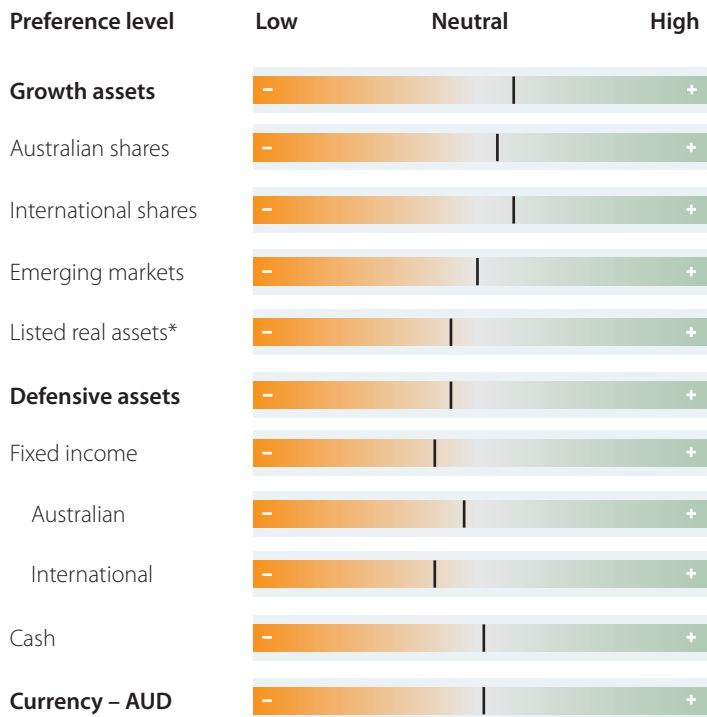
de-rate risk at a time of elevated valuations and a trend towards normalisation of interest rates. For example, the inflation scare scenario while having stronger double digit growth also experiences the most significant de-rate as inflation and rates surprise on the upside. Australia is less vulnerable to a de-rate than global markets due to more subdued wages and inflation and a more fairly valued market, although earnings are not expected to be as strong. In the growth fade scenario bonds have the superior return although this is not the case in the good times fade or inflation scare scenarios.

From a portfolio perspective we balance these risks by holding a small overweight to shares, with a bias away from interest sensitive sectors such as REITs and infrastructure. We hold an underweight to fixed income, focused in international bonds where we see more risks of upward surprises on inflation and continue to hold our neutral position to the AUD (Asset Allocation table over page).

Table 3: total returns table baseline

Asset Class	2017	2018 expectations
Australian shares	12%	6%
International shares (hedged)	20%	9%
International shares (unhedged)	13%	8%
Emerging Markets shares	27%	8%
Real assets (hedged)	11%	3%
Australian fixed income	4%	0%
International fixed income	4%	-1%
Cash	1.8%	2%
AUD/USD	0.78	0.79

ASSET ALLOCATION



Notes:

Shares, Fixed income and Cash are relative to Benchmark.

* Comprises of 50/50 split between Global Real Estate Investment Trusts (GREITs) and infrastructure securities.

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