Investment Spotlight

ANZ Wealth Chief Investment Office

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Tacking into headwinds

2018 was bookended by periods of weaker share market returns and high volatility. Since then markets have done a U-turn and unwound about half of this fall. But what's ahead for the rest of 2019? Read on for more.

Reversing course?

Share markets have rebounded from their sharp drop in December, reversing about half of the 20 per cent loss we saw late last year. Indications of the US Federal Reserve (the Fed) pausing on rate hikes and an easing in trade tensions between the US and China boosted investor sentiment. It's a nice start to the year but it hasn't changed my mind on 2019 being a challenging year for investors.

End or just late cycle?

First up is the challenge of the investment cycle. The US economy is late cycle and China is burdened by elevated debt which constrains stimulus measures as compared with 2015. However, the majority of our indicators suggest that the current, already long, growth cycle will limp forward rather than falling into recession. The main reason is that price and wage inflation remains moderate and this gives policymakers the ability to pause and add stimulus when downside risks to growth build.

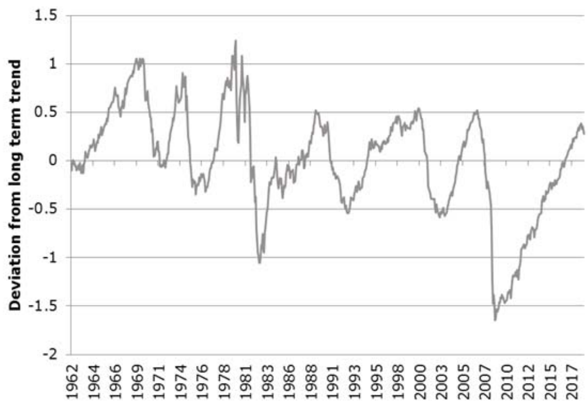
Navigating the cycle

Our Investment Cycle Clock (ICC – Chart 1) anchors our medium-term view as to where we are positioned in the full business cycle. The ICC uses market risk premium (yield curve, credit spreads and the equity risk premium) and the economic cycle to pinpoint where we're at.

The ICC normally peaks around, if not before, equity market peak, although in 1994-98 the peak was elongated rather than sharp. This indictor was calling for caution through 2018. While it is approaching levels generally consistent with markets being expensive and the economic cycle sitting in the "late boom-slowdown" phase, it has appeared to be too early to shift to an outright negative view towards growth assets.

Currently share valuations are close to fair value, investor confidence low and inflation risk relatively contained. This view is reinforced by the yield curve that, while much flatter, has not yet inverted.

Chart 1: US Investment Cycle Clock (ICC)

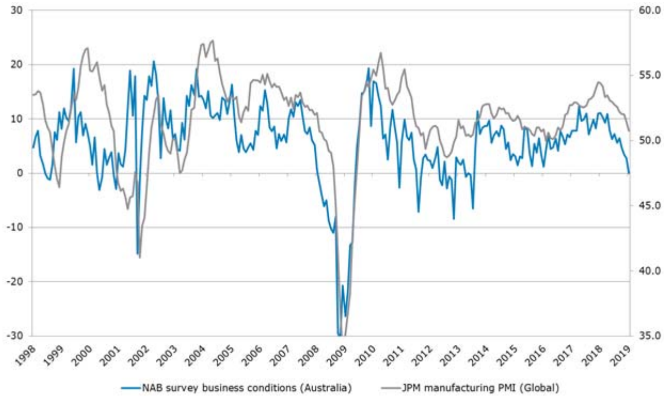


Source: Thomson Reuters Eikon, Bloomberg

Growth is slowing

But economic growth is slowing in both Australia and offshore. Our global economic scorecards have continued to ease, although US growth, while slowing, still remains elevated relative to the remaining developed markets. However, the gap between US growth and the other developed markets is converging. Our Australian economic scorecard has also eased and is showing early signs of convergence as well.

Chart 2: US and Australian business sentiment

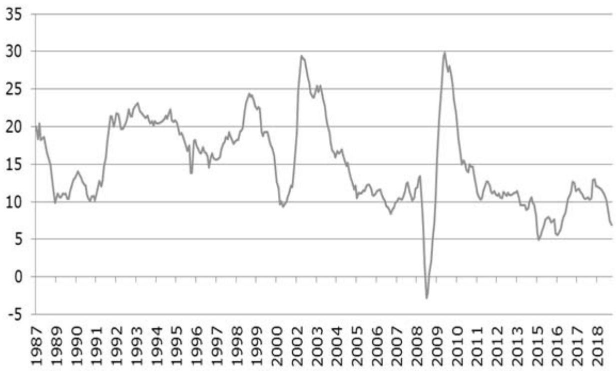


Source: JP Morgan, Thomson Reuters Eikon

To be clear, while slowing, our base case for Australia and the global economy still has a solid outlook, returning back to a 'trend' level after a number of years of above-trend growth.

Earnings revised down
With growth slowing, the earnings outlook is deteriorating. But the share market is lower since the third quarter of last year and valuations across a number of share markets have factored in softer earnings. This means that shares are now trading close to around fair value, putting them on a more sustainable footing, and giving investors more reasonable expectations of what returns can be anticipated this year.

Chart 3: World shares 12 month forward EPS expectations



Source: Thompson Reuters Eikon

Sentiment normalises
Investor sentiment has also returned to more normal levels. It fell sharply late last year from exuberant levels with fears of recession rising as investors rotated to defensive exposures. Now it has rebounded back to around average levels.

Nicely balanced, but …
Overall, the correction in shares coupled with more neutral behavioural indicators has lowered the bar for expected earnings. Therefore, while our economic scorecards continue to slow, to a considerable extent this has now been factored into investor expectations.

This is all nicely balanced but the risks are skewed downward as we are now late in the investment cycle. We've been in an upward growth phase for about 10 years, and it can't go on for ever. There is always a cycle to investment market performance, but the question is, what form will it take?

Dangers at sea
Along with our base case outlook we look to identify the risks for the next 12 to 18 months. In plotting our course for this year, we have identified a number of scenarios to navigate the outlook and the varying implications these have for asset allocation and prospective returns.

Currently we identify three broad scenarios for the period stretching to mid-2020. Clearly numerous combinations are likely but we consider our three broad scenarios go a long way to capturing the essential risks of our journey.

Risks skewed to the downside
Our three key scenarios differ in the pace of economic growth, the broader backdrop and policy responses. While our base case suggests a moderately positive outlook, our two risk scenarios are not so rosy.

- The most likely scenario is our main focus – a **gradual slowdown**. We see the investment and economic cycle continuing to slow with inflation only gradually lifting. Central banks will balance attempts to dampen any financial market 'exuberance' while working against recessionary forces. This isn't a bad outcome.
- In terms of risks, our upside growth scenario assumes a **sharper lift in inflation** and more aggressive US Fed tightening. Such a situation could lead to negative returns for investors for both bond and share markets.
- A **mild recession** is a little more likely than this. In this case, the Fed has overdone the rate hike cycle and China maintains only a moderate stimulus. A company earnings fall on lower growth and tariff escalation due to the US-China trade war would compound this situation.

Setting the course for 2019
Our current portfolio positioning is slightly underweight growth assets with a defensive growth tilt to rate sensitive sectors. We favour Australian fixed interest relative to international fixed interest with the level of rates low and the RBA likely on hold for an extended period. Our broadly neutral allocation reflects the slowdown in global growth partly offset by more neutral share valuations and behavioural indicators.

Overall, we consider markets have captured the risks of a gradual slowdown. The downdraft from our weaker scorecards is being moderated by improved valuations, washed out investor sentiment and policymakers moving to support growth. Crucially, the yield curve, while much flatter, is not signalling a GDP recession over the next six to 12 months, although earnings could still tumble towards flat or even slightly negative by end 2019.

However, for markets to sustain modest returns the loss of economic momentum will need to stabilise, as currently suggested by our lead indicators, by around mid-2019. Therefore, we expect returns to remain choppy around mid-single digit for developed shares with risks tilted to the downside.

Mark Rider, Chief Investment Officer

Mark is responsible for delivering an overarching investment strategy, including asset allocation, investment themes, investment manager and product selection and monitoring for ANZ Wealth in Australia. Before joining ANZ in 2013, Mark spent 15 years at UBS and 10 years at the Reserve Bank of Australia, making him a well-recognised and respected member of the Australian investment community.