OCTOBER 2018

HOUSE VIEW

EXECUTIVE SUMMARY

- Our view assumes that the investment cycle has around 12 months to run before slowdown and recession risks dominate.
- We see increased probability of 'growth slide' happening with China and higher US rates the key risks.

OUR VIEW

In the October RIC meeting, discussion among participants centred on a number of scenarios for the outlook for investment markets and the varying implications these have for asset allocation and prospective returns.

Overall, we now consider for 2018/19 the risks are balanced between softer growth and a lift in inflation. Our central case - **'good times fade' –** remains our preferred baseline. However, we have reduced the probability of this outcome over the next 12 months and we have increased the likelihood of a more meaningful slowdown in 2019.

Our view assumes that the investment cycle has around 12 months to run before slowdown and recession risks dominate. This view is premised on wages and inflation gradually lifting, policy steadily tightening across most major central banks, firmer financial conditions from current still accommodative levels and yield curves continuing to flatten but not invert. Growth is good, but central banks have started to steadily drain liquidity and shift volatility onto investors. The escalation in trade wars adds to the growth headwinds while also adding to inflation risk.

We consider the key risk to our 'good times fade' is **'inflation scare'** that could see the yield curve inverting much faster possibly by mid-2019.

To date the relatively muted lift in US wages has broadly tracked our lead indicator. However, by around end-2018 our indicator suggests that wages could accelerate to around 3.5% from 2.9% and lift to over 4% by mid-2019. This should lift core PCE inflation to 2-2.2% by end-2018 in line with our baseline view. This would drive the US Federal Reserve (Fed) to tighten more rapidly.

Finally we have lifted our probability of a '**growth slide'.** China remains the key growth risk as the world's second largest economy continues to slow and given the normal long leads between Chinese growth and a range of key variables, it is reasonable to assume that the China slowdown continues to permeate the outlook and is likely already a headwind to global growth. We believe the recent policy easing by China may arrest the pace of moderation rather than lifting growth.

Overall, while we've reduced the probability of our central case of good times fading into mid-2019, current signs are continuing to signal that an extended late cycle will be sustained due to inflation expectations remaining well anchored and the Fed hiking rates gradually.

As a result, we continue to hold a broadly neutral position to most asset classes. However, we consider that a more defensive stance around a neutral position will become more appropriate in the next 12 months.

STRATEGY TILTS

Preference level	LOW	NEUTRAL	HIGH
GROWTH ASSETS	–		+
Australian shares	–		+
International shares	–		+
Emerging markets	–		+
Listed real assets[1]	–		+
DEFENSIVE ASSETS	–		+
Fixed income	–		+
Australian	–		+
International	–		+
Cash[2]	–		+
CURRENCY - AUD	–		+

Notes:
Equities, fixed income, cash and currency are relative to benchmark.

1. Comprises of 50/50 split between GREITs and infrastructure securities.
2. Cash is the balancing asset class.

As at October 2018.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	Macro leads have softened to neutral. Valuations are moderately expensive. By region US leads earnings while emerging markets remain weak. EU has stabilised after a soft start to the year and Japan is improving. The IT sector is strongly supported by earnings rather than stretched valuations, although the macro processor cycle is under pressure. We believe the 2019 global earnings per share (eps) is stretched at 11%; our expectation is 8%.
AUSTRALIAN EQUITIES: NEUTRAL	Macro leads are solid but have eased. Valuations have now moved above fair value. 2019 eps growth has moderate upside to consensus of 6.6%. We continue to expect Australian equities to continue performing well relative to bonds and offer an attractive yield.
EMERGING MARKET EQUITIES: NEUTRAL	Macro leads are still soft and valuations have returned to fair value from moderately expensive. Outflows out of the region have improved however the outlook for the US dollar and China policy easing are key factors in the period ahead.
LISTED REAL ASSETS: Global REITS/Infrastructure NEUTRAL	Valuations in global listed property have come down due to the recent correction. Listed infrastructure after initially performing poorly has recovered solidly as markets have turned somewhat more defensive. We consider rising rates will continue to be a headwind to this sector, although valuations have now shifted from expensive to around fair value.
DEFENSIVE ASSETS	
INTERNATIONAL FIXED INCOME: UNDERWEIGHT	The European Central Bank is expected to slow bond purchases from this month, which could see yields rise modestly in the euro area, and the Fed is expected to raise rates again in December. Valuations for US 10-year bonds are back to the lower band of fair value (3-3.2%). We would look at closing our current underweight position at upper end of the range.
AUSTRALIAN FIXED INCOME: NEUTRAL	Australian fixed income signal remains neutral on subdued inflation and the Reserve Bank of Australia holding rates steady. Valuations are moderately expensive with fair value around 3.6%. Inflation expectations are subdued compared to the rest of the world and a key driver holding yields below US yields.
CURRENCY	
AUD (NEUTRAL)	Moderately positive signal as valuations below fair value (US80c) with bulks elevated relative to base metals. Headwind from interest rate differential to the US is partly offset by sold bulk prices. While easing global lead indicators have driven base metals (e.g. copper) lower, this has been offset by bulks (iron ore, coal), driven by China's supply side reform which favours higher grade iron ore.

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