SEPTEMBER 2018

HOUSE VIEW

EXECUTIVE SUMMARY

- We are carefully balancing near-term positive signals with longer, 12-month signals that point to slower growth and returns in 2019.
- While our key indicators continued to move to slowdown, the strength of the negative signal is mild and a significant number of other shorter-term key indicators we track remain expansionary.

OUR VIEW

As mentioned in August, our lead indicators are now displaying slowdown or neutral signals, although US leads have started to lift. Continued trade tensions, tighter US monetary policy, and a strong US dollar will likely continue to weigh on markets and economies.

With the pace of US Federal Reserve (Fed)'s rate tightening as a key risk we monitor, it is positive to note US Fed Chairman Powell's confirmation that there are considerable uncertainly attached to the underlying economy and that the Fed will watch the data flow and not be on autopilot in terms of rate rises. This is important as emerging signs that trade tensions, if sustained, could be impacting the global outlook. This could see the Fed pause tightening as it approaches the neutral rate of around 3%.

Another risk we are keeping a close eye on is China. The second largest economy in the world is experiencing a sustained slowing in credit growth and this is significant as our analysis shows a slowdown in credit growth has traditionally had a strong correlation to production growth both in China and also globally. While this is a lagging indicator, by around a year, we would expect global momentum to slow in 2019 under the weight of higher US rates and tighter China credit.

Bond yields have tracked higher but still remain modestly above fair value with central bank balance sheets likely to contract modestly in 2019 and Japan allowing the Japanese government bond yields to rise. Behavioural factors are neutral with the exuberance of early 2018 now washed out.

While our key indicators continued to move to slowdown, the strength of the negative signal is mild and a significant number of other shorter-term key indicators we track remain expansionary (credit spreads, loan officer surveys), suggesting that developed economies' financial conditions remain expansionary. In contrast, financial conditions across many emerging market economies have tightened.

Overall, 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 prudent in the year ahead.

STRATEGY TILTS

Notes:
Equities, fixed income, cash and currency are relative to benchmark. Currencies are relative to an absolute return outlook (short term).

1. Comprises of 50/50 split between GREITs and infrastructure securities.

2. Cash is the balancing asset class.

As at September 2018.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	We expect global equities to perform relatively well, with good but easing economic and earnings momentum. Global financial conditions while firmer are still supportive and central banks are expected to tighten monetary policies gradually. However, we maintain a cautious stance given the elevated level of our ICC and a relatively flat yield curve signalling greater vulnerability to risks. The decline in forward PEs for the S&P500 despite solid earnings reflects the markets' acceptance and continued vulnerability to risks.
AUSTRALIAN EQUITIES: NEUTRAL	We expect Australian equities to continue performing well relative to bonds and offer an attractive yield. Despite headwinds to financials, the resource sector is delivering strong earnings, although the risk for sharply slower Chinese growth hangs over the sector. To date however, bulk commodity prices have been much firmer than base metals like copper which have fallen sharply.
EMERGING MARKET EQUITIES: NEUTRAL	While global growth remains solid, momentum has eased particularly across emerging market economies largely due to the gradual tightening of US monetary policy and a firmer US dollar. We consider the outlook will become more challenging as the US Federal Reserve (Fed) continues to tighten. China remains a key risk.
LISTED REAL ASSETS: Global REITS/Infrastructure NEUTRAL	In contrast to our expectations for 2018, real estate markets initially underperformed but have recovered strongly over recent months. Valuations in the global listed property market are no longer fair value but are still relatively attractive relative to shares. Earnings remain consistent and fundamentals are still supportive for the sector with low vacancy rates in good locations and demand for good quality assets remaining high. US retail remains under structural pressure to technology. Higher interest rates are a hurdle but, if as we expect, the growth backdrop eases and central banks reduce policy accommodation gradually, this sector can deliver stable cash flow and returns to portfolios. 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 Fed has reiterated its commitment to gradually reduce the size of its balance sheet and to raise interest rates. The European Central Bank (ECB) won't be buying as many bonds but remains committed to accommodative monetary support and is some way from raising interest rates in 2019. The Bank of England rose rates by 25 basis points to 0.75% in August. Some softening in growth leads with inflation lifting flag that yields will trade in a fairly tight range unless we see a more sustained lift in wages. EU bonds look expensive particularly outside of Germany and will be challenged as the ECB moves to tighten policy. Corporate bonds, while providing a premium over treasuries, will struggle as leverage increases and the investment cycle matures.
AUSTRALIAN FIXED INCOME: NEUTRAL	Local bond markets are going to be partially influenced by rising interest rates in overseas markets countered by subdued local inflation, easing local supply bond growth and the Reserve Bank of Australia holding rates steady. In light of this we expect low but positive returns.
CURRENCY	
AUD (NEUTRAL)	Despite its recent decline, we expect solid but easing global growth to remain supportive of the Australian dollar (AUD). The AUD has been better supported on the trade weighted index as compared to the US cross reflecting the sharp weakening in the Chinese RMB and other emerging market currencies. We see solid support for the US dollar from higher US rates and reduced risk appetite.