DECEMBER 2019

HOUSE VIEW

EXECUTIVE SUMMARY

We have become more certain that a base has formed in the global industrial cycle and a muted recovery is likely through 2020. However, we are still hesitant to increase our growth asset exposure until economic fundamentals continue to recover and that a US-China trade deal can be reached in the new year.

OUR VIEW

Our score cards and recession risk indicators have improved, strengthening signs that a base has formed in the global industrial cycle. That said, our indicators continue to flag question marks over the longevity and the strength of the recovery. Additionally, a resumption of the trade war would be a major headwind.

Investments markets will likely be nervous as we approach the December 15th deadline for the next round of China tariffs. If these tariffs are implemented, markets would take a dimmer view on the likelihood of a US-China trade deal, which would in turn threaten the recovery.

OUTLOOK FOR 2020

Overall, we remain generally quite positive on the world economy, although we expect only a muted recovery through 2020. However we continue to retain our neutral position on growth assets until clear signs emerge of a more sustained recovery, and that the US-China trade conflict can reach a truly workable deal in the New Year.

We consider an extended low to flat return environment to be the case next year with around mid single-digit returns that favour growth exposures with a value style tilt.

Equities

Despite the sharp slowing in growth, a recovery in the global cycle is generally supportive of equities. Moreover, policy support from the US Federal Reserve (Fed) and the European Central Bank (ECB) saw government bond yields falling to very low levels relative to the earnings yield on offer in equities.

On a regional basis, we think Australian equities are less attractive than other markets with valuation above our estimate of fair value, and sharply lower earnings momentum. Overall, we believe Japanese, European and emerging market equities (as well as the Australian dollar, see the 'Foreign exchange (FX)' section) to offer the best value to leverage the nascent recovery.

Bonds

We believe bond yields now adequately reflect the base in growth with markets winding back their previous excessive expectations of Fed rate cuts. In our view, bond yields will be capped at, or below 2% for the first half of next year unless the base in growth shifts to a strong recovery.

Foreign exchange (FX)

Signs that the industrial cycle has been levelling out saw some stability return to FX markets. We expect the strength of the US dollar to soften (though modestly) as evidence emerges that the global economy is recovering. While a recovery would normally support the Australian dollar we expect that it will remain under downward pressure as the Reserve Bank of Australia (RBA) is expected to continue cutting rates next year. However, if the recovery solidifies as we expect, the Australian dollar may offer good value.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

With firmer signs of stabilisation in the economic cycle, likely better earnings outcomes, and the possibility of an interim trade deal, the outlook for equities has improved. However, the risk of the US-China trade deal falling over against a tentative recovery backdrop means that we remain cautious in our approach and we retain our benchmark position to growth assets concentrated in developed market equites.

We expect bond yields to remain low for an extended period and as such Australian and international bonds are kept at benchmark.

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STRATEGY TILTS

	SAA	TAA	Over/ Under weight
Growth assets	**70%**	**70%**	**0%**
Australian equities	26%	25.25%	-0.75%
Developed market equities	28%	29.35%	+1.35%
Emerging market equities	4%	4%	0%
Listed real assets[1]	6%	5.40%	-0.60%
Alternative growth	6%	6%	0%
Defensive assets	**30%**	**30%**	**0%**
International fixed income	8%	8%	0%
Australian fixed income	12%	12%	0%
Cash	10%	10%	0%
Foreign currency hedge ratio[2]	**30%**	**30%**	**0%**

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: 0.0% at benchmark	Due to firmer signs that the global industrial cycle is basing, we have retained our benchmark position to developed market and emerging market equities exposures.
Developed market equities: +1.35% overweight	Macro lead indicators point to below-trend growth in the global industrial cycle. However, signs are building that the global industrial cycle is basing. This development has been supported by rate cuts and progress on a US-China trade deal. Valuations are around fair value overall for global shares, with Europe and Japan relatively attractive versus the US range. Technical and sentiment are stretched for rate sensitive sectors, but overall supportive for equities.
Australian equities: -0.75% underweight	Australian macro lead indicators have softened. Valuations look stretched and above our estimate of fair value as the market has factored in policy support from tax cuts, lower rates and some easing in lending restrictions. Earnings indicators were beginning to stabilise but have softened again. Resources are benefiting from rising commodity prices due to supply constraints, particularly in iron ore although prices have fallen sharply recently, and a lower Australian dollar (AUD).
Emerging market equities: 0.0% at benchmark	Macro lead indicators for the region and the earnings-per-share (EPS) growth are still weak, although signs of a base in the global industrial cycle are supportive. Valuations remain generally more attractive than developed markets. However, more sustained outperformance will depend upon the US dollar (USD) weakening. To this end, the US Fed's decision to cut rates assists, but broad USD weakness would depend on regions outside the US doing more heavy lifting on global growth.
Listed real assets[1]: -0.6% underweight	Valuations in global listed property are now expensive. This asset class generally does well in periods of uncertainty while bonds yields are low. If the growth outlook deteriorates further and the major central banks continue easing policy then the asset class should perform well. However, signs that growth could improve is a headwind relative to cheaper asset classes. Listed infrastructure valuations are also above our fair value estimates. Investors have rotated into defensive sectors, but this has now become a crowded trade.

Alternative growth: 0% at benchmark	Alternative growth assets are held at benchmark. This asset class adds to diversification and it typically has less volatility than listed real assets. It should provide protection if volatility in risk assets increases in the months ahead.
DEFENSIVE ASSETS **0.0% at benchmark**	Defensive assets have continued to be supported by subdued inflation and the slide in global growth that have led to the US Fed to cut rates, and the ECB to relaunch quantitative easing. Australian inflation is undershooting RBA forecasts and this is putting downward pressure on Australian yields and lifting expectations of further rate cuts. However, signs that growth is stabilising has seen yields rise. Nevertheless, with expectations of (at best) a modest recovery in growth, bond yields are likely to remain low for an extended period, and as such we have kept Australian and international bonds at benchmark.
International fixed income: 0.0% at benchmark	The slowdown in global growth and subdued inflation have supported a solid rally in fixed income. Signs that growth is likely levelling out have been a headwind with yields rising as further central bank easing has been scaled back. Technical and sentiment factors are also stretched and some repositioning is likely. Nevertheless, we expect subdued inflation and modest growth to continue supporting yields at low levels.
Australian fixed income: 0.0% at benchmark	Australian fixed income has rallied strongly and signals remain neutral on subdued inflation and expectations that the RBA would ease further in the new year. Inflation expectations are subdued compared to the rest of the world, and in conjunction with an improved fiscal outlook, should anchor yields below the US. However, in line with global yields, the improved growth outlook has lifted local bond yields.
Cash: 0.0% at benchmark	We are neutral between cash and fixed income at present. With early signs of a basing in the industrial cycle, the positive data flow for fixed income markets has reversed in the past month. Nevertheless, subdued inflation and below-trend economic growth continue to provide a supportive environment for bond markets.
FOREIGN CURRENCY HEDGE RATIO[2] 0.0% at benchmark	The headwind from interest rate differential to the US is partly offset by rising bulk prices. While easing global lead indicators have driven base metal prices lower, China’s supply side reform and supply disruptions in Brazil mean that iron ore has good support at relatively high prices. We need firmer signs to emerge that the current base moves to a recovery to change from a neutral position.

Notes:
1. Comprises of 50/50 split between GREITs and infrastructure securities.
2. Percentage of developed market and emerging market equities hedged from foreign currency into Australian dollars.

Representative diversified portfolio with 70/30 growth/defensive assets.
As at December 2019.