JANUARY 2020

HOUSE VIEW

EXECUTIVE SUMMARY

Ample liquidity, a basing in the global industrial cycle and improving investor sentiment have driven a further rally in equity markets. We retain a constructive outlook for equity markets in the year ahead, but see asymmetric risks to the downside in the shorter term as equity markets have run too far ahead of fundamentals

OUR VIEW

Share markets have rallied further in the opening weeks of 2020 following strong returns in 2019. Indicators over the past month continue to point to a base forming in the global industrial and trade cycle after slowing for most of the past two years. The base in the industrial cycle is not a direct result of developments in US-China trade relations, but more due to progress made in working off excess inventory. The market has also been comforted by a continued easing in tail risks, with a "Phase 1" trade agreement reached between the US and China and a UK election outcome that reduces the risks of a hard exit. For the moment the heightened tensions between the US and Iran have passed without any lasting effect.

If our base case plays out – moderate economic growth, restrained inflation, accommodative central banks and range trading bond markets – the return outlook is moderately tilted in favour of equity markets in 2020. So while we are comfortable that the downside risks to growth have been removed, we are not convinced the global economy is going to respond strongly to the improvement in financial conditions from US Fed rate cuts, easier policy from the ECB and the Chinese monetary authorities.

With expectations of a significant moderation in returns this year, we believe equity markets have moved too far ahead of a turn in the economic cycle. While still constructive on equity markets for the year ahead, we see asymmetric risks to the downside in the shorter term.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

We have moderately reduced risk in the discretionary diversified portfolios. Growth assets have been reduced to a small underweight reflecting the near term risks we have identified. The de-risking has been concentrated in global developed market equities which have moved from a small overweight to an underweight. The reduction in global equities has been concentrated in hedged shares, implying a fall in the foreign currency hedge ratio, providing a more defensive positioning for our international exposure.

Valuations do vary across equity markets and Emerging Markets (EM) shares do look relatively attractive. However, due to its cyclicality as well as our mild dislike towards overall risk, we stay away from upgrading EM at this point in time from its current benchmark position.

Australian shares remain underweight. Macro lead indicators have softened and valuations are beginning to look stretched. Earnings expectations are soft and have been downgraded in recent months. The market's key sectors (Financials and Resources) have a fairly subdued outlook. The overvaluation is concentrated outside these sectors, with the Industrials ex Financials PE ratio trading at over 26 times, and above its average of a little below 16 times.

Given the more cautious portfolio positioning, with bond yields towards the top of their range and recent underperformance in global property, Real Assets have been moved back to benchmark.

Within defensive assets we are now long duration, with global fixed income moved from benchmark to overweight. Duration remains one of our preferred diversifiers in a potential risk-off environment. Rates markets remain supported by a modest recovery in growth, easy central bank stance, hunt for (positive) yield by investors and (geo)political risks. Tactically, we see yields range-bound and hence there are opportunities to use flexibility in order to manage portfolio risk. Australian fixed income remains at benchmark.

STRATEGY TILTS

	SAA	TAA	Over/ Under weight
Growth assets	**70%**	**68%**	**-2%**
Australian equities	26%	25%	-1%
Developed market equities	28%	27%	-1%
Emerging market equities	4%	4%	0%
Listed real assets[1]	6%	6%	0%
Alternative growth	6%	6%	0%
Defensive assets	**30%**	**32%**	**2%**
International fixed income	8%	12%	**4%**
Australian fixed income	12%	12%	0%
Cash	10%	8%	-2%
Foreign currency hedge ratio[2]	**30%**	**20%**	**-10%**

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: **-2% underweight**	We have moderately reduced risk in the discretionary diversified portfolios. Growth assets have been reduced to a small underweight as markets have run too far ahead of fundamentals. The de-risking has been concentrated in global developed market equities which have moved from a small overweight to an underweight. While still constructive on equity markets for the year ahead, we see asymmetric risks to the downside in the shorter term.
Developed market equities: -1% overweight	Tail risks have continued to moderate over the past month and indicators point to a base forming in the global industrial and trade cycle after slowing for most of the past two years. Along with ample liquidity this has driven a further rally in equity markets. But markets have run too far ahead of fundamentals. The removal of tail risks regarding trade and Brexit seem to be fully reflected in markets at current levels. Market positioning and sentiment have moved up to more neutral territory while recent multiple expansion and a weak macro environment leaves room for disappointment. We prefer to take a more cautious stance tactically also given year-to-date gains and an increasing probability that political risks might escalate again down the road.
Australian equities: -1% underweight	Australian macro lead indicators have softened. Valuations are stretched and are now above the top of our fair value range as the market has factored in policy support from tax cuts, lower interest rates and some easing in lending restrictions. Earnings indicators were beginning to stabilise but have softened again. Given the relatively large concentration the market has in both Banks and Resources, investors not wanting an exposure to either Banks or Resources are forced to buy elsewhere - the Industrials ex Financials PE ratio is trading at over 26 times, and above its average of a little below 16 times. The Australian market tends to do well relative to other markets during periods of risk aversion or when global bond yields are falling – with little earnings support the market appears to be running on "lower for longer" bond yields.
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. The US-China trade war remains a key downside risk, which means that the earnings outlook would continue to be trimmed, albeit at a slower pace for the year ahead. Our indicator of EPS growth suggests consensus expectations of around 10%, which look too optimistic. All up, due to its cyclicality as well as our mild dislike towards overall risk, we stay away from upgrading EM at this point in time from its current benchmark position.

Listed real assets[1]: 0% benchmark	While valuations in global listed property and infrastructure are expensive in absolute terms and relative to core equities, relative to bonds this asset class is trading broadly in line with its own historical experience. Real assets generally do well in periods of uncertainty while bond yields are low given attractive dividend yields and the low cyclicality around much of the sector's earnings. The direction of bond yields going forward is important for this asset class. With a move to a more cautious portfolio positioning, with bond yields towards the top of their range and recent underperformance in global property, Real Assets have been moved back to benchmark.
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 +2% overweight	Within defensive assets we are now long duration, with global fixed income moved from benchmark to overweight. Duration remains one of our preferred diversifiers in a potential risk-off environment. Rates markets remain supported by a modest recovery in growth, easy central bank stance, hunt for (positive) yield by investors and (geo)political risks. Tactically, we see yields range-bound and hence there are opportunities to use flexibility in order to manage portfolio risk.
International fixed income: +4% overweight	Rate cuts have been delivered and further cuts have been priced out for the foreseeable future. The US Fed is in a wait and assess mode. While we don't expect another cut from the Fed, we do not expect hikes to be priced in any time soon. The US Fed's current bias is to ensure inflation moves back to at least 2%, skewing the outlook for US yields towards lower levels. With inflation falling short of target in Europe and Japan, monetary policy will remain supportive of low yields well into the future. We see the ECB on hold for now until next year given Lagarde is taking over a divided council and needs to sort out easing fatigue vs. recessionary fears/ de-anchoring in inflation expectations concerns. Credit is expensive but euro spreads in particular are likely to be supported by the ECB's asset buying program along with at least some stabilisation in the economic environment.
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 2020. 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. The fragility of the domestic economy creates the bull case for Australian bonds. The unemployment rate has been stuck around 5.3% for a few years now and wages growth remains soft. The RBA has indicated a willingness to cut the cash rate by a further 0.50% if required. The recent bushfires at the margin add to this case. The RBA is also open to implement a quantitative easing program if the economy weakens sufficiently further.
Cash: -2% underweight	We prefer to take a more cautious stance tactically given year-to-date gains and an increasing probability that political risks might escalate again down the road. Duration remains one of our preferred diversifiers in a potential risk-off environment The upside on yields is limited at present as subdued inflation and below-trend economic growth continue to provide a supportive environment for bond markets.
FOREIGN CURRENCY HEDGE RATIO[2] -10% underweight	The reduction in global developed equities has been concentrated in hedge shares. This implies a fall in the foreign currency hedge ratio, although the overall foreign currency exposure of the portfolio is unchanged. This provides a more defensive positioning for our international equity exposure, consistent with asymmetric risks to the downside in the shorter term. Weakness in the domestic economy provides another downside risk to the currency from its current levels, although upside risks from a weaker US dollar may eventuate if a stronger global recovery plays out. The net of this is that there are downside risks to the Australian dollar from current levels in the first half of 2020.

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 January 2020.

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