HOUSE VIEW

EXECUTIVE SUMMARY

Central bank easing continues to support the services and the household sectors although the global industrial and trade cycle has continued to weaken. The risk remains that policy support is inadequate to offset industrial sector weakness and this will eventually erode employment and consumption, and increase the risk of recession. At this stage, our indicators are showing the industrial cycle will likely stabilise in 2020.

OUR VIEW

Over September, both the US Federal Reserve (Fed) and the European Central Bank (ECB) eased monetary policy. Australia's central bank followed suit in October, trimming its rates to a historic low of 0.75%.

In our view, these policies should continue to support the services and household sectors, countering the weakness in global trade. The key risk is whether the global industrial cycle weakens further and starts to erode consumption and the current solid pace of employment, curbing efforts by central banks to combat recession.

At this stage, our indicators are showing the slowdown in the industrial cycle should level out in 2020 though it would remain fragile against further negative shocks such as a further escalation of the trade war. Another headwind is emerging signs that the large drop in the US unemployment rate is starting to increase labour costs, which would eat into corporate margins and profitability.

The trajectory of the industrial cycle is also important for the Australian dollar as the currency will likely soften against the US dollar along with industrial cycle weakness. If, as we expect, the industrial cycle stabilises next year, the Australian dollar should also stabilise.

Overall our score cards and recession risk indicators are currently signalling a neutral or modestly underweight position to growth assets with Australian equities displaying the most negative score. Supportive financial conditions particularly for US households argue that policy easing should gain traction and likely extend the cycle for another 12 months.

Valuations are around fair value across most asset classes, although Australian and US equities are close to the top of our fair value range. Riskier assets (the Australian dollar, emerging market and value equities) are around the bottom of fair value while rate sensitive and higher quality assets are at the upper end. Our key leads suggest little earnings for global share markets in the year ahead implying downgrades will likely continue across most markets and sectors.

We believe markets have factored in excessive US Fed rate cuts, and that as these are revised lower we can expect some modest upward pressure on yields from August levels. Overall, we consider yields are broadly capped unless a recovery forms across the global industrial sector.

While growth has been slowing across the global industrial sector, cost pressures have been gradually lifting with wages and unit labour costs rising and corporate margins declining for most sectors. The lift in labour cost/lower margins is in line with normal late-cycle environments.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

Following the recent share market rally, valuations have moved above our estimate of fair value in both Australia and the US. As we continue to invest for an economic slowdown, but not for a recession, the diversified portfolios only have a small underweight in growth assets, concentrated in Australian, developed market and emerging market equities. The more defensive listed real assets and alternatives are at benchmark levels. International and Australian fixed income are also at benchmark, with the defensive overweight in cash.

STRATEGY TILTS

	SAA	TAA	Over/ Under weight
Growth assets	70%	68%	-2.0%
Australian equities	26%	25.25%	-0.75%
Developed market equities	28%	27.15%	-0.85%
Emerging market equities	4%	3.6%	-0.4%
Listed Real Assets[1]	6%	6%	0%
Alternative Growth	6%	6%	0%
Defensive assets	30%	32%	+2.0%
International fixed income	8%	8%	0%
Australian fixed income	12%	12%	0%
Cash	10%	12%	+2.0%
Foreign currency hedge ratio[2]	30%	30%	0%

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: -2.0% underweight	Growth assets are set slightly below benchmark underpinned by continued global growth, reasonable valuations and investor sentiment remaining relatively subdued. However, signs are emerging that the slowdown that began this time last year has now come under further downward pressure from the escalation of trade wars pressuring capex and supply chains.
Developed market equities: -0.85% underweight	Macro lead indicators point to below-trend growth in the global industrial cycle. Though data had flagged a base was forming a year ago, the solidity of this base has now been called into question by the economic and confidence impact of trade wars and softer capex leads. Valuations have firmed with the US at the upper band of fair value; Europe around fair value while Japan is on the cheap side of fair value. 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 are now expensive 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 AUD. If market expectations of further cuts to official interest rates this year are realised this may be enough to lift Bank earnings and make this asset class more attractive.
Emerging market equities: -0.4% underweight	Macro lead indicators for the region and the earnings-per-share (EPS) growth are still weak. Valuations remain generally more attractive than developed markets. Emerging markets should benefit from any pick-up in the global industrial cycle. However, more sustained outperformance will depend upon the US dollar (USD) weakening. To this end, the 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]: 0.0% at benchmark	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. Listed infrastructure valuations are also above our fair value estimates. Investors have rotated into defensive sectors, but this has now become a crowded trade. Portfolios are neutral in both real asset classes to provide some defensive equity exposure in the current uncertain environment.
Alternative growth: 0.0% 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 **+2.0% overweight**	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 yield and lifting expectations of further rate cuts.
International fixed income: 0.0% at benchmark	The slowdown in global growth and subdued inflation has supported a solid rally in fixed income. After trading around fair value, our valuation for the US 10-year bond yield has fallen with the expectations that the Fed may ease further. Slower global growth in the period ahead should anchor yields lower for longer, although a base in growth could exert upward pressure in 2020. Subdued inflation also supports yields. Technical and sentiment factors are stretched and some repositioning is likely.
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. 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.
Cash: +2.0% overweight	Our cash position reflects our slightly defensive stance to growth assets. We consider markets have likely factored in excessive rate cuts for the US Federal Reserve and we expect that as these expectations are revised lower this will be reflected in some further modest upward pressure on bond yields from August levels.
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 and prospects for the Fed to cut rates. 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. Overall, while our fair value estimate of the currency has eased from US80c to 0.77c, slower global growth and domestic headwinds such as soft housing keep our positioning neutral.

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 October 2019.