

HOUSE VIEW

EXECUTIVE SUMMARY

Investors were alarmed by the brief inversion of the yield curve in August given its track record in forecasting recessions. However, we are in an extraordinary period with exceptionally low rates aimed at averting the very thing that the inverted yield curve is signalling. With central banks continuing their quest to support economies, we expect the investment cycle to be extended for a while longer although risks have increased.

OUR VIEW

The yield curve, defined as the difference in yields between the 10-year and 2-year US Treasury bonds, inverted briefly in August. This means that the long-term rate at that point in time was lower than shorter-term rates, meaning an investor is no longer being rewarded for holding the bond over the longer term. The yield curve is closely watched given an inverted yield has occurred, on average, 12-15 months ahead of every US recession in the past 50 years.

The brief, intraday inversion in mid-August had investors worried, and understandably so as growth prospects have indeed slowed and corporate earnings have been revised lower. But, we are in a very different environment to those of the past: we've never had such extraordinarily easy monetary policy with rates globally at record lows, with some banks in Europe even paying customers to take out loans.

This different setting is the key in putting the August yield curve inversion in perspective. While it suggests caution, it is signalling so in quite an unusual backdrop given many indicators are still showing positive momentum.

For example, US indicators such as mortgage applications, retail sales and some regional business surveys are still solid. Investment grade credit spreads are still reasonably tight – they usually widen sharply before share markets see a recession coming. The US Fed's loan officers' survey is showing credit supply is not tight – it normally indicates tight conditions before a recession.

Furthermore, our scorecards indicate share markets were not particularly overvalued prior to the recent correction. Valuations are now returning closer to our estimate of fair value. With bond yields so low, we still believe that even with flat earnings, shares look relatively more attractive.

However, for this to eventuate, we are looking for central banks to ease policy rates further and support the investment cycle for longer. We would also like to see the yield curve steepen a little in the months ahead, with other indicators continuing to be supportive.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

Following the recent share market corrections, valuations have moved closer to our estimate of fair value, particularly in Australia. However, the diversified portfolios continue to have a small underweight in Australian, developed market and emerging market equities due to the continued trade tensions between the US and China, and as growth and inflation continue to disappoint in economies such as Europe. The more defensive listed real assets and alternatives are at benchmark levels. International and Australian fixed income are also at benchmark. Reflecting our caution, cash is overweight.

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 ratio²	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. Global growth is slowing and lead indicators suggest that momentum may have softened over recent months. The impact of trade tensions on global supply chains and investment is a big downside risk in the months ahead. Share valuations in Australia are now close to fair value after recent corrections.
Developed market equities: -0.85% underweight	Macro lead indicators point to below-trend global earnings growth through 2020. While incoming data was flagging a base was forming, the solidity of this base has weakened again in mid 2019. Valuations in the US are now closer to fair value; Europe is fair value; and Japan and the UK are relatively cheap. Relative to very low bond yields, and with rate cuts still to come, shares appear relatively more attractive.
Australian equities: -0.75% underweight	Australian macro lead indicators have stabilised with the domestic outlook a little better than it was at the end of last year with house prices stabilising. Back-to-back interest rate cuts by the Reserve Bank of Australia (RBA) and tax cuts have been positive for the outlook. After the recent correction, valuations have now moved close to fair value. Credit supply appears to be increasing again as the banks eased lending conditions. Earnings indicators, after stabilising, have recently weakened again through the latest reporting season.
Emerging market equities: -0.4% underweight	Emerging market (EM) macro lead indicators and the EPS growth are still weak. While valuations remain generally more attractive than developed markets, the supply chain disruptions created by the trade war are concentrated in the EM region, leaving downside risks to near-term earnings growth. The USD has remained solid despite the recent rate cut, and is the key headwind to the EM region.
Listed real assets¹: 0.0% at benchmark	Valuations in global listed property are expensive, but 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 has less volatility than listed real assets. It should provide protection if volatility in risk assets accelerates in the months ahead.
DEFENSIVE ASSETS +2.0% overweight	Defensive assets have continued to be supported by subdued inflation, the slide in global growth and the likelihood of a series of rate cuts by the US Federal Reserve. Chinese stimulus, thus far, has not provided a big bang lift to growth prospects and this has also added to the performance of defensive assets. Meanwhile, inflation globally remains subdued. Closer to home, markets think there is a good chance the RBA will ease policy again before year end. However, tax cuts should begin boosting household income in the next few months and this makes another interest rate cut before year end somewhat less likely.
International fixed income: 0.0% at benchmark	The slowdown in global growth and subdued inflation has ignited a solid rally in fixed income. After trading around fair value, our valuation for the US 10-year bond yield has fallen with expectations that the US Federal Reserve will be easing policy again before year end. Slower global growth in the period ahead should anchor yields lower for longer and any slippage in growth would likely add to these downward pressures. Inflation remains subdued and is unlikely to threaten central bank targets for some time.
Australian fixed income: 0.0% at benchmark	Australian fixed income has rallied strongly and valuations are moderately expensive. Though markets continue to factor in further rate cuts, we expect tax cuts and the weaker AUD to help put a floor under growth over the medium term.
Cash: +2.0% overweight	Our cash position reflects our slightly defensive stance to growth assets.
FOREIGN CURRENCY HEDGE RATIO² 0.0% at benchmark	The headwind from interest rate differentials to the US was partly offset by rising bulk prices and fiscal stimulus from the Australian Federal Government. However, iron ore prices have now fallen sharply, resulting in our fair value estimate for the Australian dollar falling from around 0.80c back to mid to low 70c level. Slower global growth, and the prospect of more interest rate cuts by the RBA keeps our foreign currency hedge positioning at neutral, although downside risks dominate.

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 September 2019.

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