

2019

GLOBAL MARKET OUTLOOK

LOOKING BACK AT 2018

2018 was bookended by periods of weaker share market returns and high volatility with markets off about 20 per cent or so late last year from recent peaks. Since then markets have done a U-turn and unwound about half of this fall.

We see this trend of higher volatility continuing in 2019 which we believe will be a challenging year for investors.

Our portfolio positioning is framed by three key indicators: valuations, the economic backdrop and sentiment.

There are risks for company earnings with inflation and wage pressures slowly building against a backdrop of higher interest rates and slower global growth. The trade war between China and the US adds another dimension to these pressures. However, the recent market falls have pulled valuations back to a more reasonable level.

While slowing, the global economic environment still has a solid outlook. It's just returning to around trend after a couple of years of above-trend growth. Further, policymakers have started to respond to the headwinds with the US Federal Reserve likely to pause rate hikes while China continues to ease policy. These efforts are likely only to stabilise growth rather than generate a genuine reacceleration in 2019.

Economically, it's a similar story for Australia. Growth will likely slow but remain solid. Public spending, business investment and net exports should all contribute to keep growth around trend. However, wages growth is expected to remain weak with falling house prices in both Sydney and Melbourne adding to concerns. Despite these risks, the government budget is in good shape. The Reserve Bank of Australia's (RBA) cash rate is likely to remain at 1.5% for at least another year.

From a sentiment perspective, investor confidence has fallen back from its exuberant peaks of last year to more sombre levels, and as such in a contrarian sense, is supportive of growth assets.

In summary, our view is cautious towards growth assets such as shares for the coming year. While share valuations have improved, our analysis shows that the global economy has slowed, with further earnings downgrades in prospect. All up, we expect returns to be below the average of recent years.

I trust this document provides you with a good guide to what we are expecting. On behalf of ANZ I'd like to take this opportunity to wish you all the best for 2019. Thank you for your continued support.



Mark Rider
Chief Investment Officer

OVERVIEW

TACKLING INTO HEADWINDS

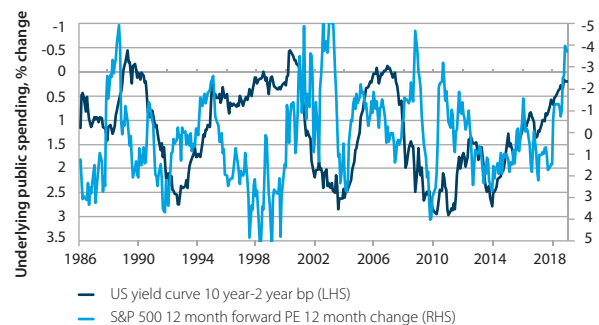
The combination of the US economy being late in its business cycle and slower Chinese growth frames our thinking about where we should be invested in 2019.

We consider the outlook for the US Federal Reserve (Fed), China stimulus and the US dollar will be key navigation points for returns in 2019. The backdrop is likely continued political uncertainty across the major developed countries. The direction of the global economy is being reset around the US-China relationship (particularly with regard to technology) and the large debt burdens that overhang both economies.

Risks for growth assets are skewed to the downside, with cyclical cost and wage pressures slowly building against a backdrop of higher interest rates and slower global growth. In 2018, White House economic policy added further to these pressures, with the introduction of trade tariffs on Chinese imports and threats to escalate the trade war. The collapse in the oil price has eased inflation pressures. Policymakers have started to respond to these headwinds, with the Fed likely pausing rate hikes at least over the first half of 2019 and China continuing to ease policy. Given the normal lags, we would not expect stimulus to be reflected in Chinese and global growth until well into 2019.

Despite solid earnings across most markets in 2018, particularly the US, the trade war, some deceleration in global growth and Fed tightening dealt a blow to investment returns for growth assets relative to expectations (Table 1). While earnings were solid and broadly in line with our expectations, the decline in the PE multiple was more significant than we expected when we set our forecasts last year under our “good times to fade” baseline. The sharp decline in PE multiples was primarily due to de-rating reflecting the continued flattening of the US yield curve (Chart 1). In late 2018 markets formed the view that if the Fed continued its tightening regime the yield curve would invert, signalling recession. This was more bearish than our baseline view and in line with our downside recession risk. As a result share valuations fell to the cheap side of fair value across most markets late 2018.

CHART 1: US YIELD CURVE AND CHANGE IN S&P 500 FORWARD PE



Source: ANZ Wealth, Thomson Reuters Eikon, Bloomberg

The flipside of the underperformance of growth assets was the outperformance of defensive assets versus our expectations. Reflecting somewhat slower growth, the Australian dollar was weaker than we expected.

The trade war seems likely to spill over into 2019 – it, Fed policy and weaker Chinese growth are the key risks to our 2019 return expectations. We expect that the Fed is already in the neutral range and will adopt a more cautious data-dependent approach to policy rather than a pre-set profile. The Fed has now gone some way to meeting market expectations by pausing its tightening cycle while China has continued to ease policy. Both China and the US are also now more actively pursuing a resolution of the trade war.

TABLE 1: INVESTMENT RETURNS

Asset class	2017	2018
Australian shares	12%	-3%
International shares (hedged)	20%	-8%
International shares (unhedged)	13%	2%
Emerging market shares	27%	-5%
International property	11%	-4%
Australian fixed income	4%	5%
International fixed income	4%	2%
Cash	1.8%	1.9%
AUD/USD	0.78	0.71

Index information: International shares hedged - MSCI World ex Australia Net Index (hedged to AUD) | International shares unhedged - MSCI World ex Aust (Net) | US shares - US S&P 500 | European shares - MSCI Europe | Emerging market shares - MSCI Emerging Markets (Net) in AUD | Australian Shares - S&P / ASX 300 Accumulation | International -fixed interest - Bloomberg Barclays Capital Global Aggregate (hedged to AUD) | Australian -fixed interest - Bloomberg AusBond Composite 0+ Yr Index | International property - FTSE EPRA/NAREIT Developed Rental Index ex Australia (hedged) | Infrastructure - FTSE Developed Core infrastructure 50/50 Net Hedged to AUD | Cash - Bloomberg Barclays Bank Bill Index.

Source: JP Morgan

The 2018 correction means that growth asset valuations are now much more fairly valued than they were at the start of 2018. This tempers the downside risks for returns in 2019. Moreover, investor confidence is far from its normal late cycle exuberant level and is best described as sombre. However, earnings momentum continues to slow and a solid base will need to form before the cycle risk abates.

We estimate the current valuation for global equities (as at the end of December 2018) was factoring in around flat to a moderate earnings recession for 2019 in line with the flatter yield curve. Currently analysts expect global earnings around 7% in 2019, already down from double digit late 2018. Our sense is that analysts, as usual, are still overly optimistic, but valuations in late 2018 were overly bearish and likely factoring in continued Fed tightening of around 50 to 75 basis points in 2018 and a mild recession with most markets the cheap side of fair value.

CHART 2: WORLD SHARES, 12 MONTH FORWARD EPS EXPECTATIONS


We consider that under our base case earnings will hover close to mid-single digits, although risks tilt to the downside. However, we expect the Fed will pause in 2019 and this suggests positive returns are possible in the year ahead, although this is hostage to a base forming in the current down shift in global growth and China adding stimulus.

While a relatively low probability risk, particularly given the large decline in the oil price as growth has slowed, a sharper lift in inflation is the main risk to the outlook as it would make it more difficult for the Fed to pause. On balance, policymakers appear willing to put a floor under the risk of a sharper decline in growth if inflation remains subdued.

Even though we expect growth to ease further, we anticipate improved mid-single digit returns to growth assets in 2019 compared to 2018. This view is anchored primarily by current valuations and policy support from a Fed pause and modest further China stimulus. However, until clear signs emerge that the global growth slide has eased we would expect markets to remain choppy. While the yield curve has flattened, we do not expect it to invert in 2019 as the Fed can pause its tightening cycle due to relatively benign inflation and if growth bases the curve could even steepen from late 2018 levels.

Overall our current asset allocation is close to benchmark, with a modest underweight bias. While valuations have improved, our economic scorecards continue to evidence slowing. However, improved valuations, poor investor sentiment (a contrarian indicator) and signs that policymakers will support growth certainly both temper the negative economic signal and support a broadly neutral position to asset allocation.

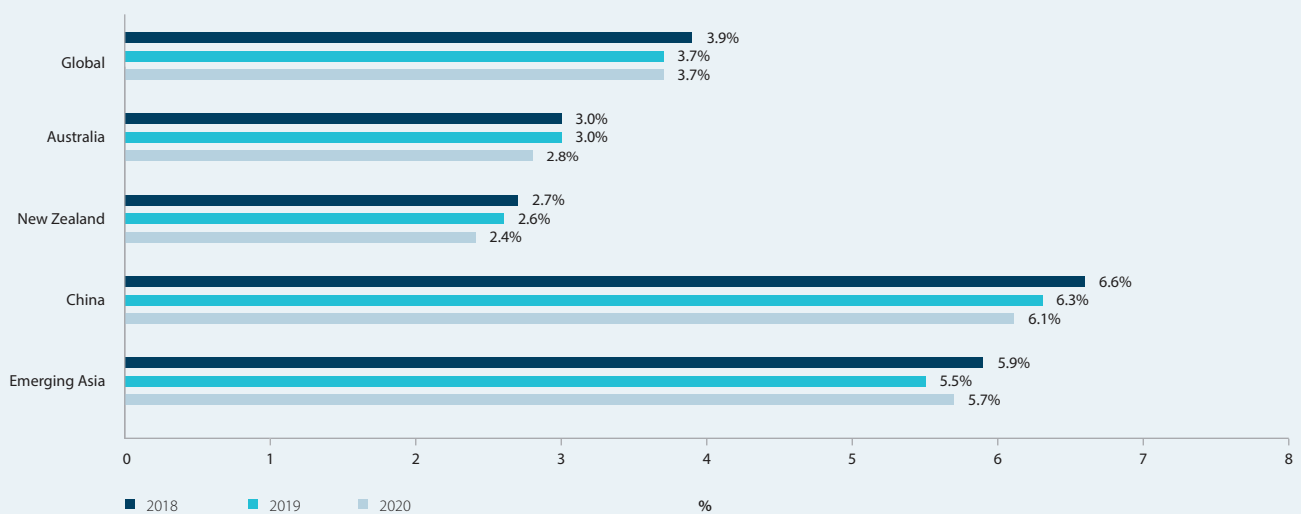


ECONOMIC OUTLOOK

RETURN TO TREND

The risk-off environment at the end of 2018 is tempered somewhat by a still-solid, albeit slower, outlook for global economic growth in 2019. To be clear, the global economy is slowing but, in our view, back to around trend after a couple of years of above-trend growth.

CHART 3: GLOBAL GDP GROWTH



Source: ANZ Research

Inflation is more of a threat in the US than other advanced economies, but we expect it to remain broadly in line with the Fed's target, with the large decline in oil helping to contain inflation pressures. In most other economies, inflation is not expected to threaten central bank targets.

During the past three years, the Fed has been the only major central bank raising policy rates and we now expect the Fed to pause at least through the first half of 2019. The Fed will pause due to the impact on interest rate-sensitive sectors of the economy such as housing and autos already slowing and signs that capital goods spending is easing. It was not so much the level of US rates but the speed of tightening that likely hurt the rate-sensitive sectors.

China remains a key engine of global growth as has been amply demonstrated in 2008 and again in 2015 when China stimulus helped lift global growth. Chinese growth and policy are now clearly a major, if not the major, determinant of earnings. Through the first half of 2019 we expect Chinese growth to slow a little more as the authorities continue to prioritise structural reform over growth. The 2018 downside risks were met with incremental policy easing, mainly via the banks' Reserve Requirements Ratio and some incremental fiscal easing. We expect policy to take a similar gradual stimulus path in 2019 but remain well below the levels of 2008 and 2015.



UNITED STATES

In the US, the fundamental backdrop is solid although clearly slowing back to trend with the consumer in good shape, underpinned by a strong balance sheet and favourable income growth. The business investment outlook is positive although lead indicators are now easing, while residential investment is under modest downward pressure from higher interest rates. The China-US trade tensions appear to have eased a little after the G20 meeting late last year, but remain a threat to global supply chains. Other risks to growth are the fading US fiscal stimulus and the trade war. More positively, interest rate normalisation seems nearly complete and with inflation steady this has created scope for the Fed to pause its tightening cycle.



CHINA

In China, growth momentum has turned down. The Purchasing Managers Index (PMI) signals that growth is stalling. Moreover, growth in the Producer Price Index has slowed sharply, suggesting the industrial sector is slowing. The downbeat news on manufacturing output is tempered somewhat by data showing that service sector leads have held. Overall, this suggests that reform is moving towards rebalancing the economy towards more domestic growth drivers. The good news is that this overlaps with US concerns and creates some common ground for a deal. That said, technology will remain an ongoing point of conflict.

CHART 4: CHINA CREDIT IMPULSE

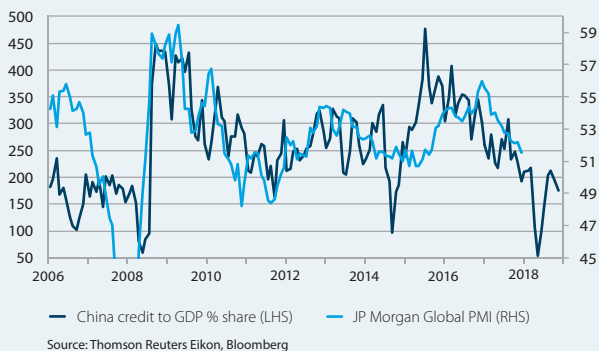
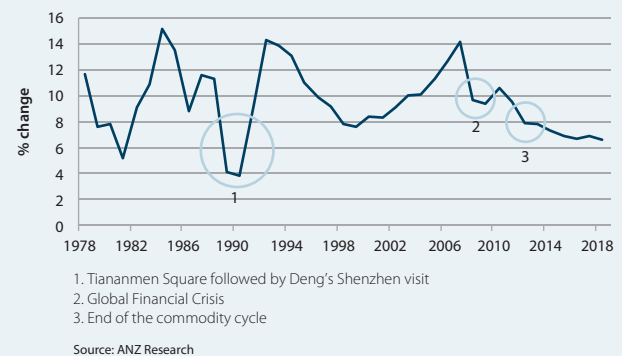


CHART 5: CHINA GDP



EUROPE

In Europe, forward indicators of growth point to the 2018 economic slowdown spilling over into 2019. We expect the European Central Bank (ECB) to end its asset purchase program, but there is a risk that policy rates remain below zero for the foreseeable future. The European external sector is the prime driver of European growth and it is under pressure from trade tensions with the US, e.g. German autos, and sharply slower Chinese industrial growth.



UNITED KINGDOM

In the UK, Brexit is the key issue. Prime Minister May survived a leadership spill late last year, but her proposed deal has been roundly rejected and revised proposals for parliament are in a state of flux. Time is ticking on this issue, with the UK scheduled to leave the European Union on 29 March. Reflecting these uncertainties, the UK share market (FTSE) is trading at cheap to fair value. Brexit would clearly erode confidence across an already slowing sharply EU.



JAPAN

In Japan, the lift in the consumption tax from 8% to 10% will be a key issue for the economy. Unemployment is 2.4%, a multi-decade low, and a modest rise in wages is underway that will support the consumer as the tax is introduced. Despite the low unemployment rate, inflation remains stubbornly below the Bank of Japan's (BoJ) 2% target due to anchored deflationary expectations. Japan's external sector is feeling the weight of the Chinese slowdown, but manufacturing has remained relatively resilient. We are positive on the capex outlook, with capacity utilisation remaining stretched. Growth is further supported by very easy financial conditions.



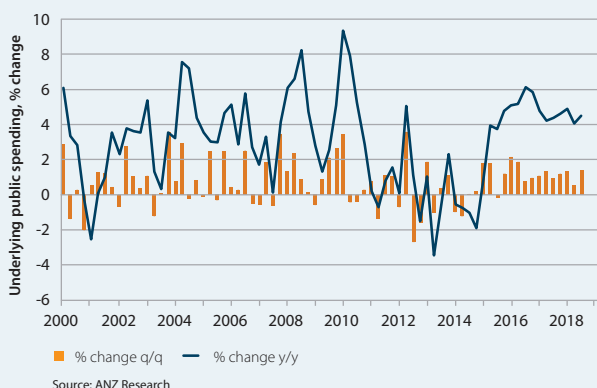
AUSTRALIA

In Australia, we expect growth to slow, but remain solid. Public spending, business investment and net exports should all contribute to keep growth around trend. However, the risks are probably skewed to the downside, with wages growth expected to remain weak and falling house prices in both Sydney and Melbourne adding to concerns.

The weakness in the Sydney and Melbourne property markets has occurred due to tighter lending conditions imposed by the banks and poor affordability. Late last year APRA moved to remove its last remaining macro-prudential policy – the 30% restriction on interest-only loans as a percentage of all new loans. This doesn't mean that credit restrictions are likely to ease, but it may mean that both existing and new borrowers could see lower interest rates at some stage. Clearly, the fall in house prices has improved affordability.

We expect the RBA target cash rate to remain at 1.5% until the second half of 2020. Despite the risks from housing, the Federal Government budget is in good shape and the government has forecast a surplus by the 2020 financial year.

CHART 6: AUSTRALIAN PUBLIC SECTOR SPENDING



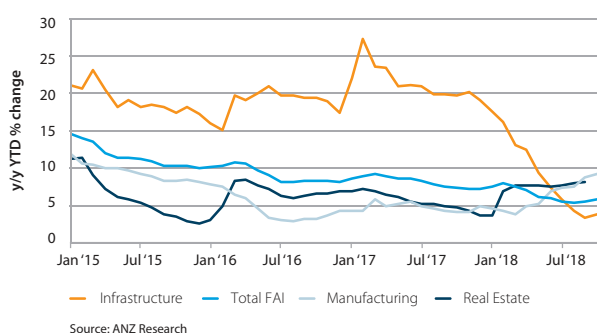
COMMODITY PRICES

The lift in global growth from 2016 through to mid-2018 supported commodity prices. However, the slowdown in global growth that unfolded through 2018 and has now spread to the US has driven commodity prices lower. Nevertheless, some bulk commodity prices have been somewhat more resilient, likely reflecting Chinese supply-side cuts.

Following the late 2018 plunge in the oil price, which we consider primarily reflected softer demand, we expect that the

crude oil market should remain relatively firm this year as supply is curtailed and prices move moderately above the 2018 low. We think the recent sell-off is overdone with risks of further supply disruptions lurking in the background, although we only envisage a moderate bounce as the growth slide consolidates through 2019.

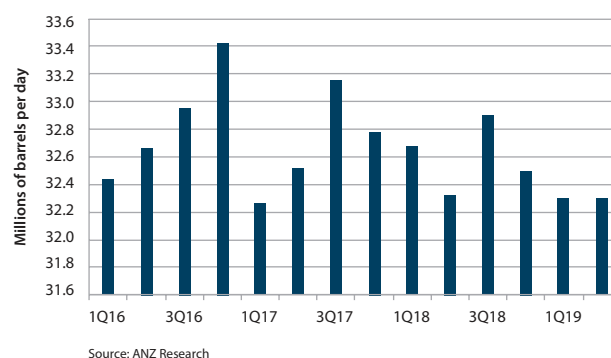
CHART 7: CHINESE FIXED ASSET INVESTMENT



China's supply-side reforms should continue to be the key driver of iron ore price movements in the near term. Demand for steel from real estate, infrastructure and manufacturing should remain solid supporting high grade iron ore prices.

Coking coal has been besieged by supply disruptions which look set to continue. In Australia, rail maintenance

CHART 8: OPEC PRODUCTION



and operational issues have been drags on production. We expect prices to remain above \$US200/t in the first half of 2019.

The thermal coal market is being impacted by temporary port trade restrictions in three Chinese ports that handle around 50% of foreign imports. Aggressive restocking ahead of winter has forced the restrictions and just prior to the end of 2018 stockpiles were at record highs.

TABLE 2: GDP, INFLATION AND COMMODITY PRICE FORECAST

	GDP Growth (%)				Consumer Price Inflation (%)			
	2017	2018	2019	2020	2017	2018	2019	2020
US	2.2	3.0	2.3	1.8	2.1	2.5	2.1	2.0
Euro Area	2.4	1.9	1.8	1.7	1.5	1.7	1.6	1.7
Japan	1.7	0.9	1.2	1.0	0.5	1.0	1.3	1.5
China	6.9	6.6	6.3	6.1	1.6	2.1	1.9	1.3
UK	1.7	1.4	1.6	1.7	2.7	2.4	2.2	2.0
Australia	2.4	3.0	3.0	2.8	1.9	1.9	2.2	2.3
World	4.0	3.9	3.7	3.7	2.6	2.9	3.0	2.6
Commodity Prices								
	Dec 18		Dec 19		Dec 20			
Iron ore (US\$/t)	67		72		60			
Coking coal (US\$/t)	222		170		155			
Thermal coal (US\$/t)	102		95		90			
Brent crude (US\$/bbl)	60		75		70			

Source: ANZ Research

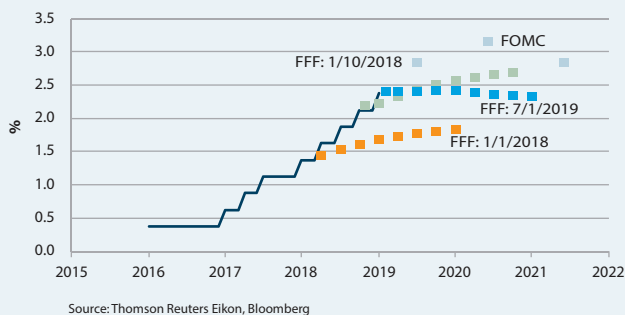


INVESTMENT THEMES FOR 2019/20

FED POLICY

The Fed has been the only major central bank raising interest rates. With activity across a range of rate-sensitive sectors slowing, the Fed is probably approaching a crossroads in its guidance and will likely pause. Higher interest rates and the strong US dollar have been tightening financial conditions and it appears likely that US growth will slow to be more in line with other major economies.

CHART 9: FED FUNDS RATE



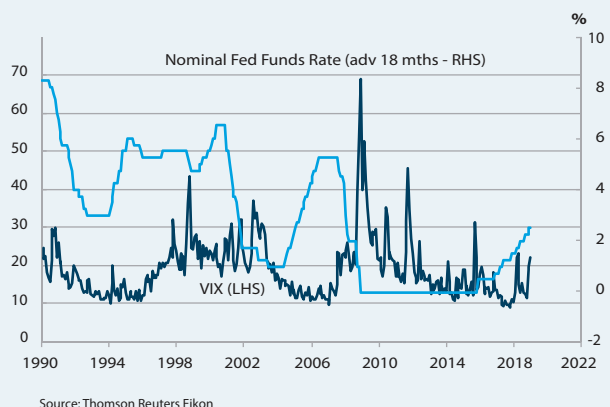
Futures markets are now pricing for the Fed to pause in 2019. The Fed has acknowledged downside risks and its willingness to pause. This should see a platform build for some recovery in risk assets that is likely now unfolding. It is also possible the yield curve could steepen slightly as expectations for short-term interest rate rises are scaled back. However, the rally is unlikely to be accompanied by stronger earnings and this will probably limit the magnitude of any rally that will primarily initially be driven by a higher PE multiple. To date, a pause in the Fed's tightening campaign has been well received by shares, particularly if accompanied by further Chinese stimulus and a trade war truce. However, this support needs to be anchored by a base forming in the current earnings downgrade cycle which could support a brighter earnings outlook in 2020.

HIGHER VOLATILITY

The Fed has been the lone ranger of the major central banks since December 2015 while others sat back and watched. Financial market volatility while the Fed is raising interest rates is normal. But it has been remarkably low since the Fed started its tightening campaign. Indeed, the only periods of significant volatility were in 2016 and the last couple of months in 2018.

We think the recent spike in volatility is likely to be more common next year as risks are shifted back to investors from central bank balance sheets. We are mindful that tactically trading shifts in market sentiment can create opportunities.

CHART 10: US INTEREST RATES AND SHARE MARKET VOLATILITY



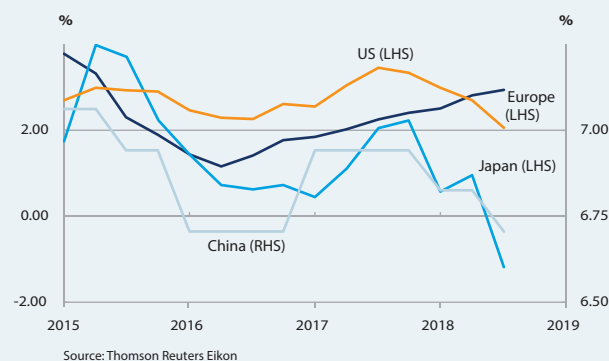
GLOBAL GROWTH BATON CHANGEOVER

With US growth prospects for next year diminishing and economic conditions in Europe and Japan remaining soft, the world may need to look to China for leadership. The economy slowed considerably in 2018 and helped drag down both Europe and Japan. However, Chinese policymakers have been depreciating the Yuan and cutting banks' Reserve Requirement Ratios. In addition, local government entities have ramped up investment in infrastructure in the past couple of months.

The stimulus is relatively small at this stage and unlikely to accelerate growth significantly, but it will likely put a floor under downside risks. The authorities do not seem likely to make room for more state-owned enterprise leverage and this means the size of the stimulus provided will likely be contained.

Of course the elephant in the room is the trade war with the US and recent rhetoric from both sides suggests that some common ground could emerge, albeit likely only a temporary truce. In the first half of 2019, the US government plans to raise the tariff on \$US200bn of Chinese goods from 10% to 25%. Furthermore, it has threatened to introduce tariffs on a further \$US267bn of Chinese imports.

CHART 11: GLOBAL GDP GROWTH



The trade war doesn't seem to have had much of an impact on Chinese growth as yet, but does appear to be raising the cost base of US corporates. This may not provide a meaningful boost to US inflation, but it is impacting the margins of US corporates that also face headwinds from a stronger US dollar. Indeed, similar to the 2018 fiscal stimulus, it has been poorly timed and adds to late cycle cost and inflationary pressures.

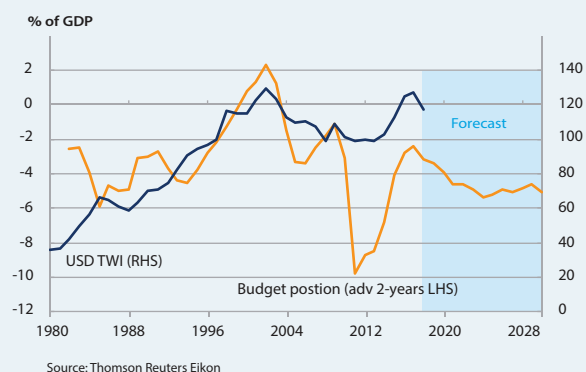
A US DOLLAR PEAK

One of the key issues for markets in 2018 was the strength of the US dollar supported by the Fed's tightening campaign. If the Fed pauses in accordance with market expectations, then the US dollar could come under some pressure in 2019, particularly if the economy is struggling to maintain a solid growth trajectory while trying to absorb the narrowing budget deficit. The Congressional Budget Office (CBO) expects the deficit to peak in early 2019.

Using the CBO's projections and projections of a decline in 10-year yields from around 2.9% to 2.5%, the US dollar could decline by up to 10% during the year.

In the past, budget deficit declines have gone hand-in-hand with a weaker US dollar and unless there is further fiscal expansion, it seems likely the US dollar will weaken in line with the unwind of the budget deficit. If the US dollar weakens as we expect, then base metals and commodities may rally and support would build for a number of emerging economy markets. A large adjustment in the US dollar is probably unlikely given the economies of the other major currencies are relatively weak.

CHART 12: USD TWI AND BUDGET POSITION



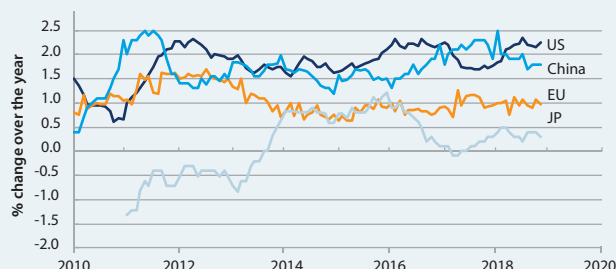
NO INFLATION BREAKOUT, BUT PRESSURES LINGER

Inflationary pressures began building in 2018, but generally remained well-contained, particularly given the collapse in the oil price. The US is probably where the risks are most acute, with the unemployment rate at its lowest level in 49 years and the economy clearly growing above trend for most of the year.

In Europe and Japan, inflation rose from the dead, but remains less of a threat than in the US because of the slowdown in economic growth in these economies. Nonetheless, neither the BoJ nor the ECB has plans to begin raising interest rates. However, the ECB is likely to complete its asset purchase program by year end.

If the Fed can engineer a slowdown in growth to around trend or slightly below with only a few more interest rate rises then inflation is unlikely to be a problem. On the other hand, if growth remains resilient to these interest rate rises then inflationary risks will rise and cause problems for the Fed.

CHART 13: CORE INFLATION



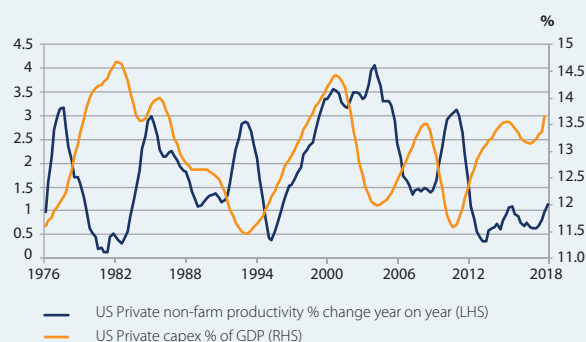
Source: Thomson Reuters Eikon, Bloomberg

A SQUINT OF PRODUCTIVITY

One risk in the two-way trade-off between growth and inflation is whether or not productivity improves. The trade-off we mentioned assumes there is no change in the productivity landscape. However, if US firms can extract more output out of their workforce for every hour worked by cleverly being more efficient, then margins of US firms can hold up even in the face of rising cost pressures. This means US firms don't pass on cost pressures to their customers – they look to offset them by finding efficiencies in the way they produce goods and services.

Of course productivity is not achieved easily and often firms only start looking for efficiencies once cost pressures rise or demand drops off. There are also sometimes limits on how much they can squeeze the lemon. However, generally productivity rises once firms decide to invest and some rebound in productivity growth could occur given the reasonably strong growth in investment over the past few years (Chart 14).

CHART 14: US PRODUCTIVITY AND CAPITAL GOODS SPENDING



Source: Thomson Reuters Eikon

If productivity can lift this will drive a wedge between cost pressures and inflation and this may mean the economy can keep growing at a solid pace without the need of the Fed to become heavy handed and put the brakes on growth. It also means the non-inflationary pace of growth is faster and the Fed needs to lift its estimate of where interest rates need to be so they are neither a brake nor accelerator on growth.

GEOPOLITICAL UNCERTAINTY

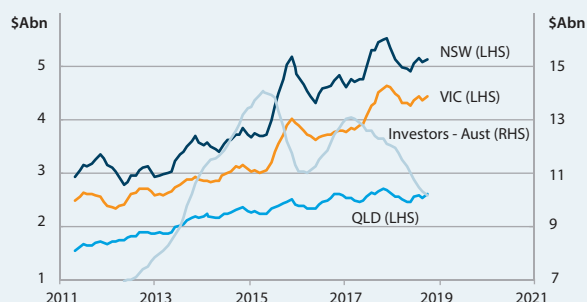
- Markets always need to absorb some geopolitical uncertainty. In 2019, US-China trade war escalation is probably the most important risk. Recent jousting suggests both sides are willing to discuss the issue, which is very fluid and highly uncertain, but escalation seems to be the most likely outcome.
- Nonetheless, there was progress at the G20 Summit in Argentina where the US agreed to delay the increase in tariffs on \$US200bn of Chinese goods from 10% to 25%. The US has also mentioned that it is prepared to introduce tariffs on a further \$US267bn of goods.
- The other major geopolitical risk is Italy. The new far-right coalition government was at loggerheads with the European Commission over its budget plans. While an agreement has now been reached, high debt will remain problematic for markets. Italy's borrowing costs are already around 250bp above Germany's and further fiscal uncertainty could send this spread even wider.
- The US mid-term elections delivered a resounding win for the Democrats in the House, with the party gaining 37 seats. However, the Republicans gained two seats in the Senate, leaving Congress split. The President will have his eye on the 2020 election and a cornerstone of his campaign will be the strong economy and buoyant stock market. He has made it clear he thinks the Fed is gnawing away at his key campaign anchor each time it raises rates. This political interference creates problems for the Fed because it undermines its independence and public confidence. It seems likely the President's criticism will only grow as the presidential election approaches and this may lift interest rate volatility.

DOMESTIC HOUSING MARKET

Probably the largest downside risk to the domestic economy is declining house prices creating fallout large enough to drag down consumer spending. We make several points:

- The global economic backdrop remains positive, despite the risks we have identified. The key to limiting the fallout is to keep employment growth strong and in turn this depends on the strength of the global economy.
- The weakness in the Sydney and Melbourne property markets has occurred due to tighter lending conditions imposed by the banks and poor affordability. Late last year APRA moved to remove its last remaining macro-prudential policy – the 30% restriction on interest-only loans as a percentage of all new loans. This doesn't mean that credit restrictions are likely to ease, but it may mean that both existing and new borrowers could see lower interest rates at some stage. Obviously, the fall in house prices has improved affordability.

CHART 15: OWNER OCCUPIER AND INVESTOR LOAN APPROVALS

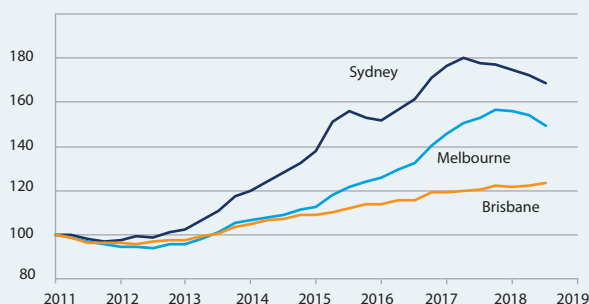


Source: Thomson Reuters Eikon

NB. Owner-occupier approvals are established properties less refinancing

The condition of the housing market will be an important consideration for the next move in monetary policy. It is difficult to see the RBA raising interest rates into an environment of declining house prices even if the risks to inflation have turned up. Equally, the RBA has been unfazed by the decline in house prices thus far, so the prospects of a similar adjustment throughout 2019 probably would not attract its attention unless wealth effects kick in and a broader economic downturn takes hold.

CHART 16: ESTABLISHED HOUSE PRICE INDEX



Source: Thomson Reuters Eikon



INVESTMENT STRATEGY

NAVIGATING ROUGH SEAS

With the US economy approaching late cycle and China burdened by elevated debt which constrains stimulus measures as compared with 2015, we expect that 2019 will be another challenging year for investors.

However, the majority of our indicators suggest that the current, already long, growth cycle will limp forward rather than falling into recession. The main reason is that price and wage inflation remains moderate and this gives policymakers the ability to pause and add stimulus when downside risks to growth build. However, the cost is often more debt akin to the Japanese experience post the bubble economy.

In assessing the market outlook and the appropriate investment strategy, we set our course against the following key navigation aids:

- Investment Cycle Clock: identifying the point in the whole investment cycle that can span a decade;
- Scorecards: that track shorter market valuations, economic indicators and behavioural factors indicative of market sentiment; and
- Scenario analysis: our base case outlook and the risks around it over the next 12 to 18 months.

THE INVESTMENT CYCLE

WHERE ARE WE IN THE CYCLE?

Our Investment Cycle Clock (ICC) anchors our medium-term view as to where we are positioned in the full business cycle. This indicator uses market risk premium (yield curve, credit spreads and the equity risk premium) and the economic cycle to pinpoint where we are. The current growth cycle has been elongated, likely reflecting the very low base in 2009. This does open the possibility that the ICC may also display an elongated peak before the cycle actually breaks down.

The ICC normally peaks around, if not before, equity market peak, although in 1994-98 the peak was elongated rather than sharp (Chart 17). This indicator was calling for caution through 2018. While it is approaching levels generally consistent with markets being expensive and the economic cycle sitting in the “late boom-slowdown” phase, it has appeared to be too early to shift to a meaningful underweight to growth assets.

We note it is unusual at this late stage of the investment cycle to have share valuations relatively attractive (rather than expensive), investor confidence low and inflation risk relatively contained. This view is reinforced by the yield curve that, while much flatter, has not yet inverted. Recognising this environment, we reduced our small overweight to growth assets through last year and shifted our growth asset exposure to be a more defensive strategy focused in more defensive exposures to Global Infrastructure and Global Real Estate Investment Trusts (GREITs).

CHART 17: US INVESTMENT CYCLE CLOCK

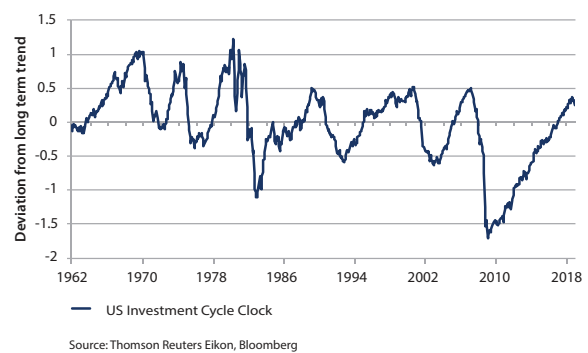
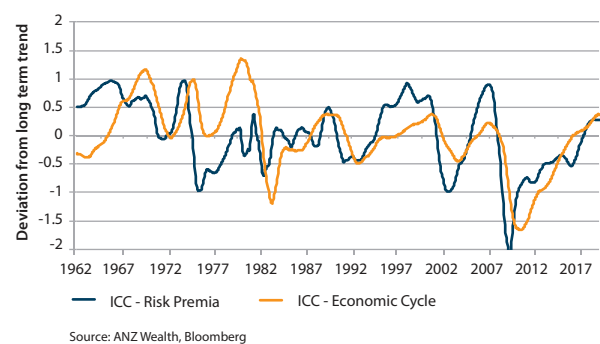


CHART 18: US ICC - RISK PREMIA AND ECONOMIC CYCLE



SCORECARDS

TRACKING SHORTER-TERM DEVELOPMENTS

Whereas the ICC has a medium-term focus, our scorecards provide a 'real time' reading of how the various forces shaping markets are evolving. They provide a little more colour about our thinking on asset class positioning by rating three key fundamental and behavioural drivers that underpin the returns for the asset classes.

Future share market returns are normally anchored by both valuations and earnings. For example, high valuations make it more difficult to generate excess returns because a lot of optimism is in the price and vice versa when valuations are fair to cheap. Similarly, shares normally rally when the earnings outlook is improving and normally sell off when it is deteriorating.

Table 3 shows the reading as at end December for each major asset class across valuations, economic and behavioural indicators. After beginning 2018 in expensive territory, most share markets are close to or below fair value in early 2019. Behavioural indicators (contrarian signal) are now also favourable for shares. Our economic scorecard is now the main headwind to shares.

TABLE 3: SCORECARDS SUMMARY

	Valuations	Economics	Behavioural
Growth assets	+	--	++
Developed market shares	+	-	++
Australian shares	+	-	++
Emerging market shares	+	--	++
Real assets	0	0	0
Defensive assets	0	0	--
Australian fixed income	-	+	--
International fixed income	0	-	--
AUD	+	--	+

Our economic scorecards have continued to ease, although US growth while slowing still remains elevated relative to the remaining developed markets. Our Australian economic scorecard has also eased but remains relatively elevated as compared to most developed market economies. Slower growth reflects:

- An elevated base relative to trend through the 2017 episode of synchronised growth
- US Fed tightening becoming an increasing headwind to rate sensitive sectors like housing and autos
- US fiscal stimulus that lifted earnings washing out through 2019
- Challenges to the global manufacturing cycle from softer Chinese growth
- Signs that global manufacturing inventory spiked above trend in late 2017
- Rising wages and cost pressures starting to impact margins.

Currently the pace of decline in our global lead indicator has broken below -0.5, often associated with below-trend growth but just short of a mild earnings recession. If the Fed were to continue to tighten by two to three times in 2019 we would expect that this indicator would shift to recession, often associated with a reading towards -1. Clearly if the Fed pauses and China continues stimulus measures this risk would abate. We expect a base will form around mid-2019.

CHART 19: MACRO LEAD INDICATOR

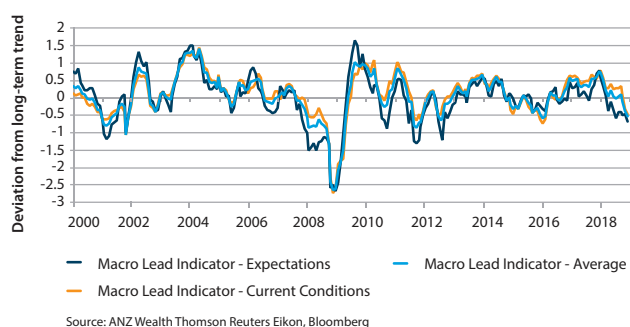
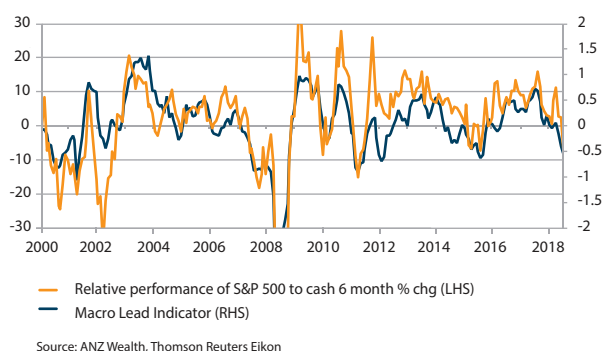


CHART 20: RELATIVE PERFORMANCE OF THE US SHARE MARKET



EVIDENCE IS EMERGING THAT THE GAP BETWEEN US GROWTH AND THE OTHER DEVELOPED MARKETS IS CONVERGING.

VALUATIONS

Currently the earnings outlook is deteriorating, but valuations across a number of share markets are factoring in softer earnings. This means that shares are trading modestly to the cheap side of fair value. Overall this suggests that until clear signs emerge that downward earnings revisions have eased, shares will remain under pressure and subject to swings in sentiment. Our estimate

of fixed income fair value has improved due to the slide in global growth and the large drop in the oil price. The Australian dollar is undervalued but with a negative signal from global growth. It is not unusual for the Australian dollar to trade at a discount to fair value.

CHART 21: INTERNATIONAL SHARES FAIR VALUE

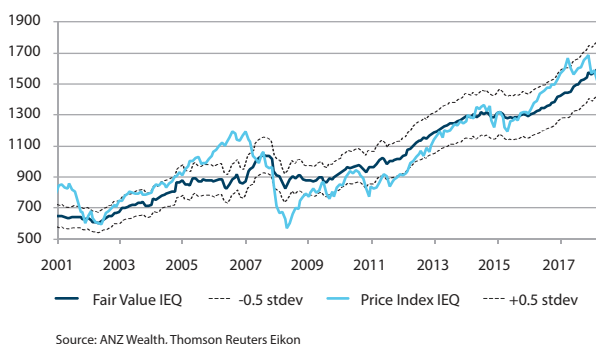


CHART 22: AUSTRALIAN SHARES FAIR VALUE

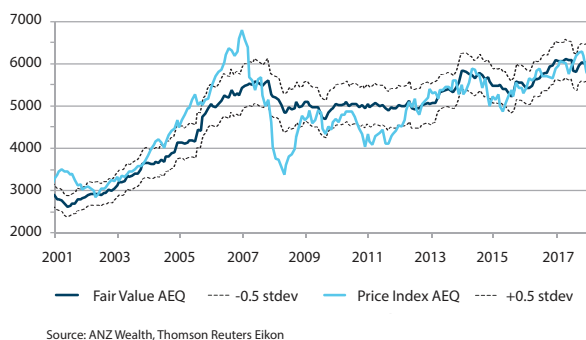
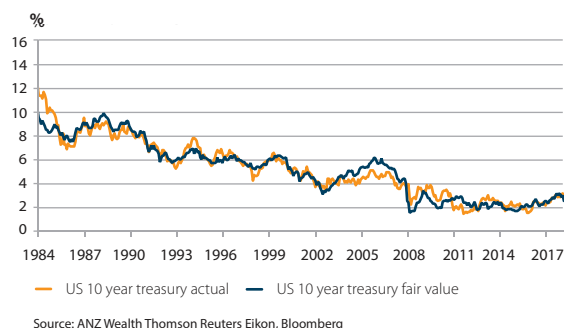


CHART 23: AUSTRALIAN DOLLAR



CHART 24: US 10 YEAR TREASURY BOND



BEHAVIOURAL

Investor sentiment and technical factors, both of which are contrarian indicators, are supportive of growth assets. Investor sentiment has fallen sharply with fears of recession rising. Investors have rotated to defensive exposures and have built cash.

Overall, the correction in shares coupled with bearish behavioural indicators has lowered the bar for expected earnings. Therefore, while our economic scorecards continue to slow, to a considerable extent this has now been factored into investor expectations. With signs that the US Fed will pause its tightening cycle and China beginning to add policy support, this environment has been supportive of some recovery in growth assets and the Australian dollar.

BRINGING IT ALL TOGETHER

SCENARIO ANALYSIS 2019

Navigating challenging cross-currents and stormy seas requires us to be cognisant of risks before setting out to sail and making adjustments during the journey. In plotting our course for this year, we have identified a number of scenarios to navigate the outlook and the varying implications these have for asset allocation and prospective returns.

Currently we identify three broad scenarios for the period stretching to mid-2020. Clearly numerous combinations are possible but we consider our three broad scenarios go a long way to capturing the essential risks of our journey.

Our central case – ‘**gradual slowdown**’ – is our preferred baseline for 2019/20. Our view assumes that the economic and investment cycle will continue to slow but relatively subdued inflation means that policymakers can take a gradual approach to tightening policy (Fed pause until at least mid-2019) due to softer US housing and chemicals/autos and signs that capital expenditure is easing. Our view is premised on wages and inflation gradually lifting, moderately firmer financial conditions from current neutral to supportive levels and yield curves continuing to remain flat and possibly lifting through 2019 when we expect that growth momentum will base.

We consider the key risk to our ‘gradual slowdown’ is ‘**mild recession**’. This scenario assumes that the Fed is on hold in 2019 due to a sharp slowing in activity and softer inflation. The Fed quantitative tightening program also pauses. The US dollar will likely find support despite the Fed pausing as slower growth will support a bid for US dollar funding. Higher corporate spreads will likely ignite a moderate default cycle. Earnings will be negative due to higher costs and sharply slower top line growth. This scenario assumes current tariffs lift to 25%, plus remaining tariffs on Chinese goods are also levied at 25%.

Finally, we assign a much lower probability to a lift in growth and a sharp spike higher in wages and inflation. This would see markets scramble to factor in more aggressive Fed tightening. The ‘**inflation scare slowdown**’ will be a much more severe headwind to markets than a mild recession and will result in a sharp decline in earnings and sharply lower PE multiples as bond yields rise. This environment delivers deeply negative returns across most classes except cash and a sharp drawdown in share markets in excess of 20%.

TABLE 4: OUR THREE SCENARIOS AND PREFERRED ASSET CLASSES FOR 2019/20

	Mild recession	Gradual slowdown	Inflation scare
Developed Economies GDP (end 2019 momentum)	Less than 1%	1.7%	2.3%
Developed Economies Inflation	Less than 1.2%	1.5% - 2.2%	Above 2.5%
Asset Class			
Shares	--	+	--
Bonds	++	-	--
Australian dollar	--	0	-
Alternative defensive	+	+	-
Cash	+	+	++
US dollar	++	-	+

Source: ANZ Wealth

The key risk to this outlook is a sharper slowing in growth that is termed a mild recession, although as we have noted policymakers appear more willing to now put a floor under this risk. Markets started to gravitate towards a mild recession over the latter part of 2018 but have pulled back in early 2019 on signs that the Fed will pause, China will add stimulus and possibly an interim truce in the trade war. Our upside growth scenario assumed a sharper lift in inflation and more aggressive US Fed tightening. This scenario would result in our ICC breaching the 0.5 level relatively quickly through 2019 as the unemployment rate continues to fall and a deeper recession.

However, we consider that central banks while wishing to avoid recession will continue to drain liquidity and shift volatility onto investors in order to lean against a burst of financial market irrational exuberance. We assume no new tariffs this year but existing tariffs will likely lift to 25% (Table 5).

TABLE 5: EVENT ASSUMPTIONS FOR OUR THREE SCENARIOS

Event	Mild recession	Gradual slowdown	Inflation scare
Fed and quantitative tightening (QT) policy	On hold. QT on hold	On hold H1 2019. QT continues	3*25bp December 2019 plus continued QT
Tariffs	25% all US/China trade	10 to 25% existing China tariffs, no new tariffs	25% all US/China trade
Brexit	Hard exit	Muddle through	Muddle through
Italy	Sovereign crisis	Muddle through	Muddle through
Australian house prices	>20% fall, severe wealth effects from slower growth	20% fall limited wealth effects as global growth bases	>20% fall on Fed tightening
China stimulus	Ineffective	Moderate further easing	Large stimulus

TABLE 6: WHAT WE ARE WATCHING

Mild recession	Gradual slowdown	Inflation scare
ANZ Global Composite below -0.5 for 3-6 months	ANZ Global Composite between +0.3 to -0.3 6-12 months	ANZ Global Composite above 0.5 3-6 months
US yield curve <0	US yield curve >0	US yield curve <0
ICC above 0.5	ICC at or below 0.45	ICC >0.5
US dollar strong	US dollar consolidates/softens	Strong US dollar
US 10-year government bond below 2.25%	US 10-year government bond 2.75%-3.2%	US 10-year government bond above 3.75%

Table 6 details the key indicators we are tracking to assess where we may be located across these three broad scenarios. Currently the balance of indicators sits within our preferred baseline with drift towards softer growth.

Overall, we consider markets have captured the risks of a gradual slowdown and in late December were tracking towards mild recession. The correction has improved prospective returns somewhat. With policymakers now providing some support, the downdraft from our weaker scorecards is being moderated by improved valuations, washed out investor sentiment and policymakers moving to support growth. Crucially, the yield curve while much flatter is not signalling a GDP recession over the next six to 12 months, although earnings could still tumble towards flat or even slightly negative by end 2019.

However, for markets to sustain modest returns the loss of economic momentum will need to stabilise, as currently suggested by our lead indicators, by around mid-2019. Therefore, we expect returns to remain choppy around mid-single digit for developed shares with risks firmly to the downside. However, if the US dollar softens by around 5 to 10% as we expect (due to a base in global growth as China credit growth improves with the Fed on hold to late 2019) over the year emerging markets could deliver high single-digit returns.

Current portfolio positioning is slightly underweight growth with a defensive growth tilt to rate sensitive sectors. We favour Australian fixed interest relative to international fixed interest with the level of rates low and the RBA likely on hold for an extended period. Our broadly neutral allocation reflects the slowdown in global growth partly offset by undemanding share valuations and behavioural indicators flashing relatively low investor sentiment.

ASSET ALLOCATION

Preference level	Low	Neutral	High
Growth assets	-		+
Australian shares	-		+
International shares	-		+
Emerging markets	-		+
Listed real assets ¹	-		+
Defensive assets	-		+
Australian fixed income	-		+
International fixed income	-		+
Cash	-		+
Currency – AUD	-		+

Notes: Shares, Fixed income and Cash are relative to Benchmark.

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

Source: ANZ Wealth



ASSET CLASS SUMMARY

INTERNATIONAL SHARES

Modest underweight 

Macro leads have softened further to below-trend growth with US leads now also slowing. Following the recent correction, valuations across most markets are now on the cheap side of fair value. Earnings momentum is now slowing across all regions and sectors including the US and IT. We believe consensus 2019 global earnings per share (eps) has declined from double digits to around 6%, but we consider further downside is likely.

AUSTRALIAN SHARES

Modest underweight 

Macro leads have eased but remain better supported than our global leads. Valuations have shifted to the cheap side of fair value. Consensus 2019 eps growth is moderate at around 3% and we see limited risk of a sharp downgrade cycle that would threaten dividends. We continue to expect Australian equities to perform relatively well given attractive yields and RBA holding rates steady.

INTERNATIONAL PROPERTY

Neutral 

Valuations in global listed property have recovered from the 2018 correction as markets have shifted from growth to defensives and value.

LISTED INFRASTRUCTURE

Neutral 

Listed infrastructure, after initially performing poorly, has recovered solidly as markets have turned somewhat more defensive. This sector has gained support due to interest rate expectations coming down although valuations are no longer attractive.

INTERNATIONAL FIXED INTEREST

Underweight 

The slowdown in global growth and the collapse in the oil price have supported a solid rally in fixed income. After trading around fair value, valuations for US 10-year bonds have rallied strongly with US Fed tightening expectations taken out for 2019 with even a whiff that policy could be eased.

AUSTRALIA FIXED INTEREST

Neutral 

Australian fixed income has rallied strongly and signals remain neutral on subdued inflation and the Reserve Bank of Australia holding rates steady for an extended period. Valuations are moderately expensive. Inflation expectations are subdued compared to the rest of the world and in conjunction with an improved fiscal outlook are key drivers holding yields below US yields.

EMERGING EQUITIES

Modest underweight 

Macro leads are still soft and valuations are now on the cheap side of fair value. Outflows out of the region have improved however the outlook for the US dollar and China policy easing are key factors in the period ahead.

AUD

Neutral 

Moderately positive signal as valuations are below fair value (US77c) with bulks elevated relative to base metals. Headwind from interest rate differential to the US is partly offset by solid bulk prices. While easing global lead indicators have driven base metals (e.g. copper) lower, this has been offset by bulks (iron ore, coal), driven by China's supply-side reform which favours higher grade iron ore. Overall, slow global growth is a headwind to our fair value estimate of US77c.

