APRIL 2018

HOUSE VIEW

EXECUTIVE SUMMARY

While growth remains supportive, markets are becoming concerned that elevated valuations and steady tightening by central banks leave markets vulnerable to:

- heightened risk of protectionism; and
- cracks are beginning to emerge across the FAANG[1]/IT sector.

OUR VIEW

There was general agreement among RIC members that we are now in late cycle. However views varied as to how late in the cycle we currently are.

The key point of discussion between members was whether we are late cycle with some time to end cycle, or whether we have already entered end-cycle investment markets.

All members of the RIC agreed that the environment is becoming increasingly challenging for markets, particularly as the economy is approaching late cycle with the US Federal Reserve steadily lifting rates. Factors that have injected uncertainty into the late cycle environment include:

- Short-term funding costs have risen across most markets including Australia reflecting a range of temporary and likely longer lasting factors;
- Political risk surrounding tariffs/protection continue to build, although to date the overall impact remains relatively modest;
- The FAANG[1]/IT sector has corrected, in part reflecting Facebook revelations and generally lofty valuations; and
- Signs are building that upward momentum in global growth is peaking.

However, most members were of the view that while markets are more vulnerable, these factors are not yet of sufficient magnitude to end the investment cycle.

And while shares have been much softer in recent times, the RIC continues to be constructive on prospective share returns, expecting returns of mid to high single digit this year. Rationales for this view include the RIC's belief that:

- Still strong global growth;
- Although somewhat tighter, financial conditions are far from levels that would normally signal end cycle;
- Central banks will only gradually tighten policy; and
- The correction is still within bounds of a normal correction.

Showing the disparate range of views, some RIC members expressed views that a deeper correction may even provide an opportunity to buy shares.

In contrast, some consider we may have already entered an end-cycle phase and believe the emerging headwinds are permanent and will continue to intensify.

Investment strategy recap
Overall, the RIC retained its neutral position to growth assets with a constrained overweight bias to growth assets.

1. FAANG is the acronym for four high performing technology stocks in the market as of 2017 – Facebook, Apple, Amazon, Netflix, and Google (now Alphabet, Inc.).

STRATEGY TILTS

Asset class	Position relative to Benchmark / Outlook[1]
GROWTH ASSETS	**Neutral**
Australian equities	Neutral
International equities	Neutral
- **United States**	Neutral
- **Europe**	Neutral
- **Japan**	Neutral
- **Emerging markets**	Neutral
Listed real assets[2]	Neutral
DEFENSIVE ASSETS	**Neutral**
Fixed income	Underweight
- **Australian**	Neutral
- **New Zealand**	Neutral
- **International**	Underweight
Cash[3]	Overweight
CURRENCY	
AUD / USD	Neutral
NZD / USD	Neutral
USD TWI	Neutral

Notes:

1. Equities, Fixed income and Cash are relative to Benchmark. Currencies are relative to an absolute return outlook (short term).

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

3. Cash is the balancing asset class. Cash is a residual to Portfolio Manager's overall implementation of other asset class strategies. It continues to form part of the overall defensive asset allocation, with PMs having flexibility in terms of how to implement the stated defensive asset strategy across fixed income and cash. In the RIC model cash overweight to facilitate an underweight position we hold in international bonds and to manage overall fund duration.

As at 3 April 2018.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	We expect global equities to perform relatively well, with good economic and earnings momentum. Global financial conditions are supportive and central banks are expected to tighten monetary policy gradually. However, we have opted for a more cautious stance with behavioural and valuation indicators not yet attractive enough to move to an overweight position this late in the investment cycle. There is also some risk that economic and earnings data flows weaken from high levels, which if sustained would result in earnings downgrades. The expected gradual rise in interest rates also tempers our enthusiasm.
AUSTRALIAN & NEW ZEALAND EQUITIES: NEUTRAL	We expect New Zealand & Australian equities can continue to perform well relative to bonds and offer an attractive yield. Australia looks slightly more attractive than New Zealand both on valuation and earnings, and solid global growth could further support the highly cyclical resource sector which makes up a substantial part of the Australian market. The New Zealand market faces less attractive valuations, lower earnings growth, and capacity constraints. **Note:** IMS portfolios do not include New Zealand equities.
EMERGING MARKET EQUITIES: NEUTRAL	Emerging markets have run hard and while we remain constructive we remain concerned that slower growth in the Chinese industrial sector in conjunction with gradual Fed tightening will become a headwind in 2018. This asset class has delivered strong returns as earnings bounce from the 2015 trough. Analysts continue to revise forward estimates higher on the back of robust global growth, strong pricing power and improvement in manufacturing and trade activity. Valuations across the market are no longer cheap but moderately expensive on an absolute basis.
LISTED REAL ASSETS: NEUTRAL	In contrast to broader equity markets, real estate markets and infrastructure have underperformed on the back of rising interest rates. Valuations are becoming more fairly valued. Earnings remain consistent and fundamentals are still very supportive for the sector with low vacancy rates supporting property and economic growth infrastructure. Higher interest rates are a hurdle but, if as we expect, the growth backdrop remains firm and central banks reduce policy accommodation gradually, this sector can deliver stable cashflow and returns to portfolios.
DEFENSIVE ASSETS	
INTERNATIONAL FIXED INCOME: UNDERWEIGHT	The US Federal Reserve (Fed) has reiterated its commitment to gradually reduce the size of its balance sheet and raise interest rates. The European Central Bank won't be buying as many bonds but remains committed to accommodative monetary support and is some way from raising interest rates. This has resulted in a modest lift in growth and inflation expectations in bond markets and bond yields have risen to levels more consistent with where they should be in this part of the cycle. As bond yields rise, the return on bond investments will be low, although we don't see a substantial lift in bond yields from current levels with global economic growth peaking and inflation fairly well contained. Corporate bonds are expensive on a risk-adjusted basis and while providing a premium over treasuries, will struggle as leverage increases and the investment cycle matures.
AUSTRALIAN and NZ FIXED INCOME: NEUTRAL	Local bond markets are going to be partially influenced by rising interest rates in overseas markets where we expect to see a gradual removal of monetary policy accommodation countered by subdued local inflation, easing local supply growth and the Reserve Bank of Australia on hold. In light of this we expect low but positive returns.
CURRENCY	
AUD (NEUTRAL) **NZD** (UNDERWEIGHT)	Solid but easing global growth will remain supportive of the Australian dollar (AUD) although more likely at the lower end of the US0.75c to 0.80c range. The US dollar will likely remain under pressure due to large fiscal deficit, although high US rates relative to Australia will be a headwind to the AUD. The New Zealand dollar remains above fair value against the US dollar. We continue to expect the US dollar to eventually strengthen as concerns around twin deficits and relative growth rates elsewhere recede. Interest rate differentials could turn negative if expectations for Fed tightening lift and the RBNZ remains on hold.