HOUSE VIEW

EXECUTIVE SUMMARY

- We're currently at a point where we're carefully balancing near-term positive signals with longer, 12-month signals that point to slower growth and returns.
- Our score cards indicate that global growth momentum has peaked, primarily due to a modest slowdown in Europe and China and early signs that US momentum is now also easing. Recent events in Turkey tell us about the elevated vulnerability of the Turkish economy and the impact of higher US rates on riskier assets more broadly.

OUR VIEW

At our August RIC meeting, members decided to retain the current investment strategy of a benchmark position to growth assets. Members agreed that this positioning is best equipped to balance the upside potential of supportive near-term indicators and signals that point to slower growth and returns in 12-months' time.

Our fundamental lead indicators have continued to ease with all now displaying slowdown or neutral signals. In particular, business expectation surveys have eased while signs are emerging that US housing has softened. This is possibly due to higher interest rates, potentially flagging that we may already be at or beyond the neutral real rate (CPI adjusted) in the US. The lift in US rates is also increasing stress on many emerging markets including Turkey.

We see three key risks that could drive our current slowdown signals to recession:

1. More rapid rate rises in the US (greater than 100 basis points) on stronger US inflation pressures – inflation sustained above 2.5%;
2. A sustained slowing in Chinese credit growth with policy easing failing to stabilise/support growth;
3. A more severe trade war.

Our score cards signal that global growth momentum has peaked, primarily due to a modest slowdown in Europe and China and early signs that US momentum is now also easing. Valuations continue to hover around the upper end of fair value for most developed share markets, although emerging market equities have returned to fair value and negative momentum is stabilising. However, recent sharp depreciation of the Turkish lira may have some contagion effects on other emerging market currencies, although Turkey is much more vulnerable than Asian emerging markets.

Bond yields have tracked higher but still remain modestly above fair value with central bank balance sheets likely to contract modestly in 2019 and Japan allowing the Japanese government bond yields to rise. Behavioural factors are neutral with the exuberance of early 2018 now washed out.

While our key indicators continued to move to slowdown, the strength of the negative signal is mild and a significant number of other shorter-term key indicators we track remain expansionary (credit spreads, loan officer surveys).

Overall, we recommend continuing to hold a neutral position to most asset classes. However, we consider that a more defensive stance around a neutral position will become prudent as we expect growth to moderate further and our investment cycle clock (ICC) continues to flag heightened vulnerability to downside risks.

STRATEGY TILTS

Notes:
Equities, fixed income, cash and currency are relative to benchmark. Currencies are relative to an absolute return outlook (short term).

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

2. Cash is the balancing asset class.

As at August 2018.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	We expect global equities to perform relatively well, with good but easing economic and earnings momentum. Global financial conditions while firmer are still supportive and central banks are expected to tighten monetary policy gradually. However, we maintain a cautious stance given the elevated level of our ICC and a relatively flat yield curve signalling greater vulnerability to risks. The decline in forward PEs for the S&P500 despite solid earnings reflects the markets' acceptance and continued vulnerability to risks.
AUSTRALIAN EQUITIES: NEUTRAL	We expect Australian equities to continue performing well relative to bonds and offer an attractive yield. Despite headwinds to financials, the resource sector is delivering strong earnings, although the risk for sharply slower Chinese growth hangs over the sector. To date however, bulk commodity prices have been much firmer than base metals like copper which have fallen sharply.
EMERGING MARKET EQUITIES: NEUTRAL	While the global growth remains solid, momentum has eased particularly across emerging market economies largely due to the gradual tightening of US monetary policy and a firmer US dollar. We consider the outlook will become more challenging as the US Federal Reserve (Fed) continues to tighten. China remains a risk as the impact of firmer policy comes through, although modest easing may limit the pace of slowing.
LISTED REAL ASSETS: Global REITS/Infrastructure NEUTRAL	In contrast to our expectations for 2018, real estate markets initially underperformed but have recovered strongly over recent months. Valuations in the global listed property market are no longer fair value but are still relatively attractive relative to shares. Earnings remain consistent and fundamentals are still supportive for the sector with low vacancy rates in good locations and demand for good quality assets remaining high. US retail remains under structural pressure to technology. Higher interest rates are a hurdle but, if as we expect, the growth backdrop eases and central banks reduce policy accommodation gradually, this sector can deliver stable cash flow and returns to portfolios. Listed infrastructure after initially performing poorly has recovered solidly as markets have turned somewhat more defensive. We consider rising rates will continue to be a headwind to this sector, although valuations have now shifted from expensive to around fair value.
DEFENSIVE ASSETS	
INTERNATIONAL FIXED INCOME: UNDERWEIGHT	The Fed has reiterated its commitment to gradually reduce the size of its balance sheet and to raise interest rates. The European Central Bank (ECB) won't be buying as many bonds but remains committed to accommodative monetary support and is some way from raising interest rates in 2019. However, some softening in growth leads with inflation lifting flag that yields will trade in a fairly tight range unless we see a more sustained lift in wages. EU bonds look expensive particularly outside of Germany and will be challenged as the ECB moves to tighten policy. Corporate bonds, while providing a premium over treasuries, will struggle as leverage increases and the investment cycle matures.
AUSTRALIAN FIXED INCOME: NEUTRAL	Local bond markets are going to be partially influenced by rising interest rates in overseas markets countered by subdued local inflation, easing local supply bond growth and the Reserve Bank of Australia holding rates steady. In light of this we expect low but positive returns.
CURRENCY	
AUD (NEUTRAL)	Solid but easing global growth will remain supportive of the Australian dollar although more likely at the lower end of the 0.75c to 0.8c range. The Australian dollar has been better supported on the trade weighted index as compared to the US cross reflecting the sharp weakening in the Chinese RMB and other emerging market currencies. We see solid support for the US dollar from higher US rates and reduced risk appetite. Over the medium term, the US dollar will likely remain under pressure due to its large fiscal deficit.