HOUSE VIEW

EXECUTIVE SUMMARY

- A faster-than-expected slowdown in Chinese growth spilling over to other regions has reappeared as one of the key risks to global growth.
- For Australia, we are cautiously optimistic that a recovery is underway as captured by still firm readings for business and consumer confidence. Although downside risks from housing and softer Chinese growth are headwinds.

OUR VIEW

Our investment strategy continues to revolve around our view that global economic growth will remain at or above trend in 2018 with most major developed economies performing well. In contrast to the synchronised growth in 2017 however, economic momentum between economies is now diverging. Economic momentum has softened across the Japanese, Chinese and European economies while US growth remains solid.

The passage of tax reform in the US and robust business and consumer confidence continue to support strong earnings growth. However, the US Federal Reserve continues to gradually raise rates and in conjunction with some strengthening in the US dollar we have started to see financial conditions tighten. This tightening in financial conditions has flowed to a sharp correction across most emerging markets.

For Australia, we are cautiously optimistic that a recovery is underway as captured by still firm readings for business and consumer confidence. However, tighter financial conditions particular across the residential sector is emerging as a headwind to growth. In addition, signs that Chinese activity is continuing to slow could be a further headwind to growth.

The two key warning signs are the continued flattening of the US yield curve (the difference between the US 10-year and 2-year sovereign bonds) to below 30 basis points and the very sharp slowing in Chinese credit creation. Both indicators have considerable lead times on actual economic activity but both signal a sharp slowing of growth prospects through 2019. On balance we remain cautiously optimistic and continue to expect shares to outperform bonds and cash. Other risks we are watching out for are:

1. A rise in economic nationalism and protectionism, reducing global trade and hurting global economic growth and momentum. This would favour high quality bonds with the more resilient US equities accumulated on a correction.

2. A faster-than-expected slowdown in Chinese growth spilling over to other regions. A one percent slowdown in Chinese GDP is estimated to reduce global GDP by 0.4%. This would favour high quality bonds and shares on a substantial correction.

3. In an environment where risks and volatility are rising, rapid central bank tightening resulting in financial conditions quickly deteriorating could see negative earnings growth for companies and cause severe debt affordability issues for consumers.

4. In Australia, high household debt, weak wage price inflation and weak property markets could pressure consumer spending. The government's royal commission into the financial services industry could result in further weaknesses in the residential property and equity markets.

STRATEGY TILTS

Preference level	LOW	NEUTRAL	HIGH
GROWTH ASSETS	–		+
Australian shares	–		+
International shares	–		+
Emerging markets	–		+
Listed real assets[1]	–		+
DEFENSIVE ASSETS	–		+
Fixed income	–		+
Australian	–		+
International	–		+
Cash[2]	–		+
CURRENCY - AUD	–		+

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 July 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 could result in earnings downgrades. The expected gradual rise in interest rates also tempers our enthusiasm.
AUSTRALIAN & EQUITIES: NEUTRAL	In Australia, equities are more fairly valued and earnings momentum appears sustainable. We expect Australian equities can continue to perform well relative to bonds and offer an attractive yield. The banking sector remains a key concern while under investigation from the royal commission into financial services.
EMERGING MARKET EQUITIES: NEUTRAL	While global growth remains solid, momentum has eased. In conjunction with a gradual tightening of policy and a firmer USD, we consider the outlook will become more challenging. China remains a risk as the impact of firmer policy comes through, but recent indicators have stabilised.
LISTED REAL ASSETS: NEUTRAL	In contrast to broader equity markets, real estate and infrastructure have both underperformed on the back of rising interest rates. Valuations are close to fair value and earnings growth is generally solid. In Commercial Office property, vacancy rates are low. Higher interest rates remain a hurdle but, if as we expect, the growth backdrop remains firm and central banks reduce policy accommodation gradually, this asset class can deliver stable cashflow and returns to portfolios.
DEFENSIVE ASSETS	
INTERNATIONAL FIXED INCOME: UNDERWEIGHT	Bond yields have started to consolidate after rising higher at the start of 2018 as global trade tension and geopolitical risks have seen a lift in the demand for US treasuries. However, we believe that bond yields have not yet peaked this cycle and when bond yields rise, the return on bond investments is low. That said, 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, we expect corporate bonds to 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 RBA on hold. In light of this we expect low but positive returns.
CURRENCY	
AUD (NEUTRAL)	We expect solid but easing global growth to support the AUD although more likely at the lower end of the 0.75 to 0.8 range. Over the medium term, the USD will likely remain under pressure due to large fiscal deficit, although growth and rate differentials currently favour the USD.

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