EXECUTIVE SUMMARY

Global share markets have been spooked by the on-and-off again US-China trade wars and yields have plummeted. However, financial conditions remain supportive and we expect central banks' easing bias to extend the investment cycle for a while longer.

OUR VIEW

The on-and-off again US-China trade war does not appear to have an end date. Just last month we wrote about a ceasefire, yet the day after the US Federal Reserve (Fed) cut rates as expected to boost the economy, the US imposed further tariffs on China. China then retaliated by allowing its currency, the Yuan, to drop and halted US farm purchases.

Not only were global share markets spooked by this sudden turn of events, US Treasury yields tumbled on growing fears over a global economic downturn. The Australian dollar also dipped, particularly after the Reserve Bank of New Zealand also cut its rates in early August.

Volatility has certainly picked up as a result, yet the supportive financial conditions, particularly for US households, argue that policy easing (setting aside the gyrations of the trade war) would likely succeed in extending the investment cycle for another year or so.

That said, even with more rate cuts our lead indicators and scorecards suggest flat corporate earnings in 2020. But with yields plunging, real rates are negative across most economies and even flat earnings look relatively attractive if recessions can be avoided.

The good news is that incoming data for the US housing market suggests that rate cuts are already seeing a recovery start to build. However, soft Chinese credit data does suggest that the industrial sector would likely muddle-through at the current pace rather than a solid recovery.

Overall, we expect central banks' easing policies to be effective given supportive financial conditions and the cycle can be extended a bit more. However, given our expectation of low single digit returns to growth assets we maintain a small underweight to growth assets.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

The deterioration in US-China trade relations, along with the lagged impact of tighter Fed policy, are key factors holding back global growth. While we believe a recession is unlikely, we remain cautious of the near-term growth outlook and look for better signs of growth to emerge from China.

Valuations are also now above our estimate of fair value, particularly in Australia and the United States. Reflecting our current caution, the portfolio has a small underweight in Australian, developed market and emerging market equities. The more defensive listed real assets and alternatives are at benchmark levels. International and Australian fixed income are also at benchmark. 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 ratio[2]	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 again 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 both the US and Australia are now elevated on prospects for central banks to ease further. However, there are early signs that expected US rate cuts are already supporting some lift in US housing.
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 expensive; 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 after weakening throughout 2018 with the domestic outlook a little better than it was at the end of last year. Back-to-back interest rate cuts by the Reserve Bank of Australia (RBA) and tax cuts have been positive for the outlook. However, valuations have now moved above fair value. Credit supply appears to be increasing again as the banks ease lending conditions. Earnings indicators, after stabilising, have recently weakened again. Resources are benefiting from rising commodity prices due to supply constraints in iron ore and strong Chinese steel production. The consensus earnings-per-share (EPS) outlook for the banks seems a low hurdle that can be met.
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 Emerging Markets.

Listed real assets[1]: 0.0% at benchmark	Valuations in global listed property are now expensive. 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 Fed rate cuts. 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 will 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 Fed 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 RATIO[2] 0.0% at benchmark	The headwind from interest rate differentials to the US is partly offset by rising bulk prices and fiscal stimulus from the Australian Federal Government. While easing global lead indicators have driven base metals, e.g. lower copper prices, China's supply side reform and supply disruptions in Brazil mean that iron ore has good support at relatively high prices. Coal prices are more mixed with Met Coal following iron ore higher and Thermal Coal tracking lower. Overall, while our commodity price based fair value estimate of the currency is at US80c, slower global growth, and the prospect of more interest rate cuts by the RBA keep our foreign currency hedge positioning at neutral.

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 August 2019.