FEBRUARY 2019

HOUSE VIEW

EXECUTIVE SUMMARY

We remain conscious that downside risks to earnings continue to dominate and any rally will likely be primarily fuelled by multiple re-rating, boosted by a lift in investor sentiment rather than a fundamental improvement in the earnings environment for the foreseeable future.

OUR VIEW

There was healthy debate at the February RIC meeting with participants discussing their views on the Chinese and European growth outlook and whether the global growth slowdown would level out in the latter part of 2019, or continue to slide as liquidity continues to tighten.

In China, the Purchasing Managers Index (PMI) has signalled 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 in the US-China trade negotiations.

Over 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.

These two regions, particularly China, are key drivers of global growth so the RIC spends significant time monitoring the mixed variables now in play and discussing the ramifications of their impacts on global growth and on RIC investment decisions.

For now, the RIC has decided to maintain the current neutral position to growth assets and the Australian dollar and maintain the benchmark position to Australian fixed income and our underweight to international fixed income. This decision reflects a recognition of three main developments that have allowed markets to look through the current slide in growth and earnings between the December share market plunge and the January rally:

1. The Fed has paused for the foreseeable future;
2. China looks set to continue to add targeted stimulus measures; and
3. The prospect of a less confrontational stance on both sides of the US-China trade war.

While the Fed pause is transparent, the other two developments are less so. Therefore, while these policy developments align with our baseline 2019/20 investment scenario of a gradual slowdown/soft landing, a high degree of uncertainty is still attached to the Chinese outlook and the trade war.

We remain conscious that downside risks to earnings continue to dominate and any rally will likely be primarily fuelled by multiple re-rating boosted by a lift in investor sentiment rather than a fundamental improvement in the earnings environment.

Therefore, failing a solid recovery in the earnings outlook, we will be closely watching our valuation and behavioural scorecards as if they become stretched as compared to current readings that would signal heightened risks.

STRATEGY TILTS

Notes:
Equities, fixed income, cash and currency are relative to benchmark.

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

As at February 2019.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	Macro leads have softened further to below-trend growth with US leads now also slowing. Following the recent correction and subsequent rally, valuations across most markets have moved from the cheap side of fair value back to fair value. Earnings momentum is now slowing across all regions and most sectors including the US and now the technology sector. We believe consensus 2019 global earnings per share (eps) has declined from double digits to around 6%, but we consider further downside is likely, possibly to 0%. Investment sentiment after plunging in December has now returned to neutral.
AUSTRALIAN EQUITIES: NEUTRAL	Macro leads have eased and have now caught up with the global slowdown. Valuations in December shifted to the cheap side of fair value but have now largely returned to 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 the Reserve Bank of Australia (RBA), and now the US Fed, holding rates steady for an extended period.
EMERGING MARKET EQUITIES: NEUTRAL	Macro leads are still weak and despite the rally, valuations are still modestly on the cheap side of fair value. A cap and possibly weaker US dollar with the Fed on hold will assist these markets. Outflows out of the region have improved, but the outlook for the USD and China policy easing are key factors in the period ahead.
LISTED REAL ASSETS: Global REITS/Infrastructure NEUTRAL	Valuations in global listed property have recovered from the 2018 correction with valuations now at the expensive end of fair value. With the Fed pausing rate-tightening, this sector will be supported by a cap on yields but this is likely fully reflected in rich valuations. After initially performing poorly, infrastructure has recovered solidly as markets have turned somewhat more defensive. Valuations have recovered to the upper band of fair value as the market rotated to defensive sectors. Listed infrastructure valuations are not as stretched as GREITS.
DEFENSIVE ASSETS	
INTERNATIONAL FIXED INCOME: 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, our valuation for the US 10-year bond yield has fallen with US Fed tightening expectations taken out for 2019 with even a whiff that policy could be eased.
AUSTRALIAN FIXED INCOME: NEUTRAL	Australian fixed income has rallied strongly and signals remain neutral on subdued inflation and the RBA 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.
CURRENCY	
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. Supply disruptions in Brazil favour higher grade iron ore. Overall, slow global growth is a headwind to our fair value estimate of US77c.