EXECUTIVE SUMMARY

- It was a strong year for share markets in 2017 with double-digit returns across key market indices. This is not unusual as the investment market approaches the end of an investment cycle.
- While we expect 2018 to be another year where growth assets will outperform defensive assets, the key challenge is the outlook for wages and inflation as even a slightly faster lift in inflation could potentially change market dynamics.

OUR VIEW

It was a strong year for share markets in 2017 with double-digit returns across key market indices. This is not unusual as the investment market approaches the end of an investment cycle. The still accommodative monetary policy and easy financial conditions have further boosted markets. The challenge for 2018 is, will this continue? If so, how long can this all last?

What's in store for 2018?

We envisage 2018 to be more of the same in terms of economic growth, but as we start the new year, some of the key indicators we have been monitoring, such as the US yield curve (the difference between the yield on the 10-year treasury bond and the 2-year treasury bond), are starting to turn amber from the green zone (though still far from the alarming red flag zone when the gap turns negative).

The key challenge we foresee in 2018 is the outlook for wages and inflation, particularly in the US as its economy reaches full capacity. We expect the combination of the US unemployment rate shifting below 4% and the US fiscal stimulus to be delivered this year to potentially boost wages.

We are also seeing key central banks gradually reining in the accommodative monetary policy that has been in place since the GFC, which arguably has been a strong force behind the share market rallies in recent years. The European Central Bank has stated it would reduce the amount it purchases from this month and the US Federal Reserve (Fed) has raised rates three times last year and will likely raise rates another three times in 2018.

All these point to the possibility that if wages were to rise somewhat more rapidly we may see financial conditions tighten quicker than anticipated as other central banks could join the Fed in synchronised policy tightening.

We expect three headwinds will build through 2018:

1. The US moving into the boom phase with heightened inflation risk and more US Fed hikes than expected;
2. China continuing to steadily tighten financial conditions; and
3. The steady reduction in central bank balance sheets as quantitative easing (QE) is unwound.

Moreover, we believe political risk will remain elevated. To date economies and financial markets have been largely insulated from rising political risk possibly due to stronger growth and easy policy. Firmer policy could be expected to create a more fertile environment for political risk to become a driver.

We expect the environment will favour growth over defensive assets in 2018 therefore we hold riskier assets around the top of the neutral range. However, history suggests that the nascent amber signals can shift to red if wages and inflation were to lift even just somewhat faster than currently factored into financial markets. This suggests caution is warranted.

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.

As at 5 January 2018.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	2017 has been a strong return year for global equities primarily driven by stronger growth and earnings across most regions. Financial conditions have eased as credit risk has improved. High valuations relative to history temper our view but we continue to see value in global equities relative to bonds. Consensus earnings-per-share (eps) for 2018 is around 11% which is above our expectations of 8%, therefore we expect eps to be revised down through 2018 in line with the normal long-term trend profile. This process is already unfolding for European equities. We expect Q4 reporting season to be solid and strength should hold into 2018 although expectations have lifted and positive surprises are more challenging.
AUSTRALIAN AND NEW ZEALAND EQUITIES: NEUTRAL	We expect Australian and New Zealand equities can continue to perform well relative to bonds and offer an attractive yield. Australian equities look slightly more attractive due to improving global growth and this should assist the highly cyclical resource sector which makes up a substantial part of the Australian market. The banking sector is also expected to do better in a rising interest rate environment. The New Zealand market is more comparable with the industrial sector of the Australian market and both are expected to deliver reasonable earnings and dividend growth this year. Valuations could be considered to be on the expensive side in this sector and this may limit the upside in both markets, especially with improved opportunities for growth in offshore markets. The New Zealand market has the added headwind of political uncertainty to overcome.
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 but this is still attractive relative to developed market equities.
LISTED REAL ASSETS: NEUTRAL	Capitalisation rates globally have narrowed substantially indicating elevated valuations and the potential for more modest returns going forward. However, earnings have held up given firm global growth and gradual policy normalisation. Returns will be supportive to the extent that we consider the current lift in bond yields will be capped by gradual central bank tightening and only a gradual lift in wages and inflation. A long cycle should favour real assets.
DEFENSIVE ASSETS	
INTERNATIONAL FIXED INCOME: UNDERWEIGHT	The US Federal Reserve has reiterated its commitment to gradually reduce the size of its balance sheet and to 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 are now at levels more consistent with where they should be in this part of the cycle. As bond yields continue to rise, the return on bond investments will be low. In this benign economic environment high grade corporate bonds can provide better returns relative to government bonds, although should risk aversion rise, government bonds will be an important feature in diversified portfolios. High yield spreads are too narrow in our view given the equity-like risk inherent in this market.
AUSTRALIAN AND NZ FIXED INCOME: NEUTRAL	Local bond markets are largely going to be driven by rising interest rates offshore. However, we expect the Reserve Bank of Australia will lift rates by 2x25bp in 2018. The yields on bonds are low but we continue to advocate holding bonds at neutral reflecting softer growth and inflation and higher quality of market.
CURRENCY	
AUD and NZD: Neutral	With our fair value around 0.76c and limited downside risk to the global cycle we hold our neutral view. The NZ dollar is fairly valued around 0.70c against the US dollar and we expect movements to be fairly limited around this range depending on shifts in risk appetite and an eventual appreciation in the USD as the US Federal Reserve tightens monetary policy so less hedging than normal is required. **Note:** IMS portfolios do not include New Zealand equities.

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