HOUSE VIEW

EXECUTIVE SUMMARY

- The loss of global economic momentum and earnings downgrade across most regions and sectors intensified in late 2018 and has carried into 2019.
- Valuations across most share markets are now on the cheap side of fair value but until clear signs emerge that global growth momentum has based, markets will remain vulnerable.

OUR VIEW

The loss of global economic momentum and earnings downgrades across most regions and sectors intensified in late 2018 and has carried into 2019. In particular earnings have fallen sharply in the US with leading sectors like IT and energy recording large downgrades. This has resulted in US momentum now converging to the softer profile that emerged across other markets and sectors through 2018.

The Australian outlook remains under pressure from falling house prices, although to date there have been few signs of stress. The loss of global momentum if sustained could result in the housing situation developing into a more significant headwind.

The sharp loss of global and now US economic momentum, tighter financial conditions and the large fall in the oil price have seen markets move to expect the US Federal Reserve (Fed) to pause its rate hikes in 2019 and possibly even to scale back the magnitude of its quantitative tightening programme. China has eased policy but to date the magnitude has been much more modest than was the case in 2015.

These developments have eased upward pressure on the US dollar (USD) and have driven a large rally in higher quality sovereign bond yields, particularly in Australia. Consequently, valuations for some high quality sovereign bonds are now on the expensive side of fair value.

Is the current correction temporary?
Many commentators have made comparisons between the current market correction to the 2015 mid-cycle pause. Based on our analysis, we note three key differences between the two periods: 1. US yield curve has continued to flatten, 2. our investment cycle clock has continued to lift, flagging later-cycle caution and 3. we do not expect China to launch a major policy stimulus programme akin to 2015.

As a result, share markets have corrected sharply with PE multiples now discounting sharply slower growth, tending towards a mild recession in 2019/20 across most markets. Valuations across most markets are now on the cheap side of fair value and markets such as the UK FTSE are now considered 'cheap'. This view is likely somewhat more bearish than the signal from the US yield curve which while flatter has yet to invert and signal recession.

Trade wars, Brexit and possible political instability across the US and Europe remain headwinds to markets. Though a Fed pause would likely provide some support. The recent bounce in equities likely reflects the large decline in valuations and sharply weaker investor sentiment driving some recovery. However until growth momentum stabilises we consider rallies will remain vulnerable.

Investment strategy
Overall, we hold our view that until clear signs emerge that the growth slide consolidates, we continue to favour a neutral position to growth assets with a preference for rate sensitive, lower volatility defensive growth assets. We also retain a benchmark position to Australian fixed income and the Australian dollar. We are underweight international fixed income and overweight cash.

STRATEGY TILTS

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

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

1. Comprises of 50/50 split between GREITs and infrastructure securities.
2. Cash is the balancing asset class.

As at January 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, valuations across most markets are now on the cheap side of fair value. Earnings momentum is now slowing across all regions and sectors including the US and IT. We believe consensus 2019 global earnings per share (eps) has declined from double digits to around 8%, but we consider further downside is likely to mid-single digit.
AUSTRALIAN EQUITIES: NEUTRAL	Macro leads have eased but remain better supported than our global leads. Valuations have shifted to the cheap side of fair value. Consensus 2019 eps growth is moderate at around 4% and we see limited risk of a sharp downgrade cycle. We continue to expect Australian equities to perform relatively well given attractive yields and RBA holding rates steady.
EMERGING MARKET EQUITIES: NEUTRAL	Macro leads are still soft and valuations are now on the cheap side of fair value. Outflows out of the region have improved however the outlook for the US dollar 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 as markets have shifted from growth to defensives and value. Listed infrastructure after initially performing poorly has recovered solidly as markets have turned somewhat more defensive. This sector has gained support due to interest rate expectations coming down although valuations are no longer attractive.
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, valuations for US 10-year bonds have rallied strongly 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 Reserve Bank of Australia 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 which favours higher grade iron ore. Overall, slow global growth is a headwind to our fair value estimate of 0.77c.

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