HOUSE VIEW

EXECUTIVE SUMMARY

- While key financial indicators remained supportive of the investment cycle, risks have risen. Our economic signals have also eased across most regions.
- The shift in the composition of growth to the US relative to the rest of the world may curb US Fed tightening as other central banks struggle to keep pace.

OUR VIEW

At the latest RIC meeting, all participants agreed that our current view of 'good times fade' remains intact and we continue to expect mid-to-high single digit returns for shares this year.

There were also quite a number of discussions around recent events and the changes we noticed on our economic score cards and investment cycle clock.

Emerging market woes

We note near-term prospects for emerging market shares are at greater risk with further US dollar strength and likelihood of more rate hikes in the US. Also, recent troubles in Argentina and Turkey pose additional threats though we don't expect a spill-over into other markets should instability eventuate in these countries.

Divergence in central bank policies

While the US continues to grow solidly, with the recent earnings season mostly positive, there are signs that the EU, Japan, China and emerging markets are slowing. This divergence is different to what we witnessed in 2017 and if sustained could potentially limit further US Federal Reserve rate hikes and the magnitude of tightening by the European Central Bank (ECB).

ICC tracking higher

Our Investment Cycle Clock (ICC) framework, which looks at a longer term, 18-months+ period, has tracked gradually higher, flagging caution as we close in on the later/end cycle investment environment in the coming 12 months.

A gradual or a sharp slowdown matters

As we approach the mid-year mark, we have begun to take a closer look at what 2019 may bring. At this stage, it appears 2019 is shaping up as a year of slower growth and higher uncertainty as central banks tighten further.

A gradual slowdown with central banks meeting market expectations would extend the investment cycle. In contrast, a deeper end-cycle earnings trough driven by a sharp lift in the ICC on the back of rising inflation expectations would see the investment cycle end, supporting a much more defensive investment stance.

The key determinant of the speed and depth of the trough is the outlook for wages and inflation. To date US wages and inflation have continued to rise slowly and this supports our "good times fade" baseline. A more rapid pick-up in inflation would bring the cycle end forward.

Investment strategy decision

Overall, there was no change to the investment strategy and we retain a neutral positioning to growth assets.

ANZ PRIVATE

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 and Cash 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. Cash is a residual to Portfolio Manager's overall implementation of other asset class strategies. It continues to form part of the overall defensive asset allocation, with PMs having flexibility in terms of how to implement the stated defensive asset strategy across fixed income and cash. In the RIC model cash overweight to facilitate an underweight position we hold in international bonds and to manage overall fund duration.

As at June 2018.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	We expect global equities to perform relatively well, with good but easing economic and earnings momentum. Global financial conditions while firmer are still supportive and central banks are expected to tighten monetary policy gradually. However, we maintain a cautious stance given the elevated level of our ICC and a relatively flat yield curve signalling a greater vulnerability to risks. The decline in forward PEs despite solid earnings reflects the market's acceptance and continued vulnerability to risks.
AUSTRALIAN & NEW ZEALAND EQUITIES: NEUTRAL	New Zealand & Australian equities can continue to perform well relative to bonds and offer an attractive yield. Australia looks slightly more attractive than New Zealand both on valuation and earnings. Improving global growth could further support the highly cyclical resource sector, which makes up a substantial part of the Australian market. **Note:** IMS portfolios do not include New Zealand equities.
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, low 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	The US Federal Reserve has reiterated its commitment to gradually reducing the size of its balance sheet and raising interest rates. The ECB won't be buying as many bonds but remains committed to accommodative monetary support and is some way from raising interest rates in 2019. However, some softening in growth leads with inflation lifting flags that yields will trade in a fairly tight range unless we see a more sustained lift in wages. EU bonds look expensive particularly outside of Germany and will be challenged as the ECB moves to tighten policy. Corporate bonds while providing a premium over treasuries will struggle as leverage increases and the investment cycle matures.
AUSTRALIAN and NZ 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)	Solid but easing global growth will remain supportive of 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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