JUNE 2019

HOUSE VIEW

EXECUTIVE SUMMARY

Prompted by a relatively sluggish recovery in Chinese credit creation and the escalation of the US-China trade war, we have lifted our international fixed income allocation to benchmark from its previous underweight position.

OUR VIEW

As we discussed in previous House Views, one of the key downside risks to our view of a firm base forming in the global industrial cycle is the resurgence of trade war, and in May we saw further actions which indicated that a near-term truce is unlikely.

It has been more than a year since the US and China began jousting on trade policy. The most recent move by the US was to lift tariffs on $US250 billion of Chinese goods by 15%, with President Trump threatening 25% tariffs on the remaining Chinese imports worth around $US300 billion. The US also banned US companies from supplying products to Chinese telecommunication powerhouse Huawei, which can no longer count on Google, Corning and ARM as suppliers. Indeed, US trade policy is threatening to unpick global supply chains that have evolved over the last 20 years.

The stakes are high for equities in this trade war. Manufacturers in emerging markets are particularly exposed to the break-up of global supply chains and the uncertainty this creates means capex plans may be put back in the draw. Of course the tariffs also directly raise costs for many US firms, with these costs passed on, absorbed, or offset against productivity gains. Regardless of the way firms choose to react, there will likely be slippage resulting in lower profit margins.

Through May key indicators like Chinese credit have eased and inventory remains relatively elevated across most regions and our capex leads have slowed further. Moreover, it is likely the trade war and the Huawei ban are downside risks to the data in the months ahead.

Moreover, these events are unfolding against a backdrop of our Investment Cycle Clock being elevated and closing in rapidly to levels normally associated with a sharp drawdown in equity returns of 20% or more. The NY Fed recession risk gauge is at 27%, still slightly below the 30% level that usually flags a recession within the next year or so. Usually, a flat to inverted yield curve, the ICC above 0.5 and expensive equity valuations are signals of a heightened risk of an equity sell-off. This month, we increased our assessment of recession risk from 25 to 30%.

Overall, even though fixed income assets have rallied strongly, we believe it is prudent at this point to raise our fixed income exposure given the many downside risks we are seeing at present. As a result, the RIC decided to lift international fixed income to benchmark from underweight. However, our recession risk leads while rising are not yet signalling elevated recession risk and with scope for both the Fed and China to ease if growth falters further we judge it is too early to move meaningfully underweight growth assets.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

We have tilted our portfolios away from growth assets, and now have a small underweight in Australian, developed market and emerging market equities. We have also increased the defensive positioning by raising listed real assets to benchmark from a small underweight at the expense of developed market equities. International fixed income has been moved closer to benchmark, and now is only a small underweight within our benchmark range. Australian fixed income remains at benchmark. Cash is overweight but is lower than last month as it funded the increased position in international fixed income.

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 Estate[1]	6%	6.0%	0%
Alternative Growth	6%	6.0%	0%
Defensive assets	30%	32%	+2.0%
International fixed income	8%	7.3%	-0.7%
Australian fixed income	12%	12.0%	0%
Cash	10%	12.7%	+2.7%
Foreign currency hedge ratio[2]	30%	28.5%	-1.5%

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: -2.0% underweight	Growth assets are set slightly below benchmark. Growth is around trend and valuations are broadly neutral while investor sentiment is neither excessive nor pessimistic. However, signs are emerging that the slowdown that began around September 2018, while initially basing, has now come under downward pressure from the escalation of trade wars and the Huawei ban pressuring capex and supply chains.
Developed market equities: -0.85% underweight	Macro lead indicators point to slightly below-trend global earnings growth. While incoming data was flagging a base was forming, the solidity of this base has now been called into question by the economic and confidence impact of trade wars and the Huawei ban. Valuations across most markets are around fair value. The US is a little overvalued, Europe fair value and Japan relatively cheap.
Australian equities: -0.75% underweight	Australian macro lead indicators have improved after weakening throughout 2018 with the domestic outlook a little better than it was at the end of last year. Valuations have now moved above fair value as the market has factored in policy support from tax cuts, further monetary policy support and some easing in lending restrictions. Earnings indicators are beginning to stabilise. Resources are benefiting from rising commodity prices due to supply constraints, particularly in iron ore and oil and a sharply lower AUD. Bank EPS outlook should be easily met, given funding costs are falling and credit growth now has some upside risk. If market expectations of a further 25 basis points (bp) cut to official interest rates this year is realised then this will make the asset class more attractive.
Emerging market equities: -0.4% underweight	Emerging market (EM) macro lead indicators and the EPS growth are still weak. Valuations remain generally more attractive than developed markets and a key reason why the asset class seems relatively attractive. However, many of the supply chains being disrupted by tariffs sit in the EM region, leaving downside risks to near-term earnings growth. The prospect of Fed policy easing has lifted in recent weeks and this could mean the US dollar comes under downward pressure in the months ahead. Overall, we think it is best to be positioned slightly underweight.
Listed real assets[1]: 0.0% at benchmark	Valuations in global listed property are now relatively expensive. This asset class generally does well in periods of uncertainty, while bonds yields are low. If the growth outlook deteriorates then the asset class should perform well. Furthermore, yields have fallen as markets are now

	pricing in the Fed to easy policy before year end. Listed infrastructure valuations have returned to the upper band of our fair value estimate as investors rotated into defensive sectors within the neutral range. Portfolios are neutral in both real asset classes due to improving economic prospects and our view that there is less downside risk to bond yields than upside risk if the global industrial cycle were to base.
Alternative growth: 0.0% at benchmark	Alternative growth assets are held at benchmark. Real asset returns should be around long-run average, but the asset class adds to diversification and it has less volatility than listed assets. The asset class 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 and the slide in global growth that have led to market expectations that the US Fed will ease policy before year end. 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 expect the RBA to ease policy again before year end, given the slowdown in growth evident in the Q119 national accounts and the continued run of weak inflation data.
International fixed income: -0.7% underweight	The slowdown in global growth and subdued inflation has supported 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 before year end. Slower global growth in the period ahead should anchor yields lower for longer and any slippage in growth will even add to these downward pressures. Subdued inflation also supports low yields.
Australian fixed income: 0.0% at benchmark	Australian fixed income has rallied strongly and our signals remain neutral, given the 25bp cut by the RBA in June and prospects of more to come by year end. Valuations are moderately expensive reflecting markets shifting the subdued growth and inflation outlook. However, a fiscal policy response is underway and this should help put a floor under growth over the medium term.
Cash: +2.7% overweight	We prefer cash over global fixed income in our defensive asset positioning, given investors are not compensated for holding duration. Tactically, we have reduced cash to build our benchmark position in global bonds.
FOREIGN CURRENCY HEDGE RATIO[2] -1.5% underweight	The headwind from interest rate differential to the US is partly offset by rising bulk prices and fiscal stimulus from the Federal Government. While easing global lead indicators have driven base metals, e.g. copper lower, 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 higher and thermal coal tracking lower. Overall, while our fair value estimate of the currency is at US78c, slower global growth, the headwinds from the housing market and subdued inflation pressure keep our positioning close to 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 dollar.

Representative diversified portfolio with 70/30 growth/defensive assets.
As at June 2019.

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