MAY 2018

HOUSE VIEW

EXECUTIVE SUMMARY

- We maintain our view that while we are approaching late cycle, shares can continue to garner support from solid growth and earnings, and accommodative financial conditions.
- For now the good times will continue to fade rather than crash.

OUR VIEW

We maintain the view that while we are relatively late in the investment cycle, shares can continue to garner support from solid growth and earnings, and still accommodative financial conditions.

Calendar year to date, both international and local shares have delivered flat to small positive returns, with the weaker Australian dollar resulting in stronger returns for unhedged international shares.

More subdued returns highlight the more challenging environment markets will continue to contend with in 2018 compared to the prior 12 months. Trade frictions, higher rates and signs that solid global growth is easing will remain headwinds to markets.

For example, in early May, the US Federal Reserve left interest rates unchanged but noted that inflation is close to target and the economy warrants further gradual rate increases. This is not unexpected, and we believe gradual rate rises from the US will prove challenging for markets as the year progresses particularly if wages and inflation trend meaningfully higher.

Our rationales for having a constructive view on shares returning mid to high single digit this year despite these headwinds include:

- Still strong global growth;
- Financial conditions are far from levels that would normally signal end cycle; and
- Central banks will only gradually tighten policy.

The recent recovery in returns likely reflects support from these drivers but overall we expect good times will continue to fade.

Good times fade, not crash
Overall, there was no change to the investment strategy and we retain a neutral positioning to growth assets.

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 May 2018.

STRATEGY POSITIONS

GROWTH ASSETS	
GLOBAL EQUITIES: NEUTRAL	We expect global equities to perform relatively well, with good economic and earnings momentum. Global financial conditions are supportive and central banks are expected to tighten monetary policy gradually. However, we have opted for a more cautious stance with behavioural and valuation indicators not yet attractive enough to move to an overweight position this late in the investment cycle. There is also some risk that economic and earnings data flows weaken from high levels, which if sustained would result in earnings downgrades. The expected gradual rise in interest rates also tempers our enthusiasm.
AUSTRALIAN & NEW ZEALAND EQUITIES: NEUTRAL	We expect 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, and solid global growth could further support the highly cyclical resource sector which makes up a substantial part of the Australian market. The New Zealand market faces less attractive valuations, lower earnings growth, and capacity constraints. **Note:** IMS portfolios do not include New Zealand equities.
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.
LISTED REAL ASSETS: NEUTRAL	In contrast to broader equity markets, real estate markets and infrastructure have underperformed on the back of rising interest rates. Valuations are becoming more fairly valued. Earnings remain consistent and fundamentals are still very supportive for the sector with low vacancy rates supporting property and economic growth infrastructure. Higher interest rates are a hurdle but, if as we expect, the growth backdrop remains firm and central banks reduce policy accommodation gradually, this sector can deliver stable cashflow and returns to portfolios.
DEFENSIVE ASSETS	
INTERNATIONAL FIXED INCOME: UNDERWEIGHT	The US Federal Reserve (Fed) has reiterated its commitment to gradually reduce the size of its balance sheet and 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 have risen to levels more consistent with where they should be in this part of the cycle. As bond yields rise, the return on bond investments will be low, although we don't see a substantial lift in bond yields from current levels with global economic growth peaking and inflation fairly well contained. Corporate bonds are expensive on a risk-adjusted basis and 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 where we expect to see a gradual removal of monetary policy accommodation countered by subdued local inflation, easing local supply growth and the Reserve Bank of Australia on hold. In light of this we expect low but positive returns.
CURRENCY	
AUD (NEUTRAL) **NZD** (UNDERWEIGHT)	Solid but easing global growth will remain supportive of the Australian dollar (AUD) although more likely at the lower end of the US0.75c to 0.80c range. The US dollar will likely remain under pressure due to large fiscal deficit, although high US rates relative to Australia will be a headwind to the AUD. The New Zealand dollar remains above fair value against the US dollar. We continue to expect the US dollar to eventually strengthen as concerns around twin deficits and relative growth rates elsewhere recede. Interest rate differentials could turn negative if expectations for Fed tightening lift and the RBNZ remains on hold.

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