MAY 2019

HOUSE VIEW

EXECUTIVE SUMMARY

We are gaining confidence that a base is forming in the global industrial cycle and from there we expect a U-shaped recovery. This is supportive of growth assets but our signals are tentative and we look to stronger evidence that earnings are in an upgrade cycle before considering an overweight position in growth assets.

OUR VIEW

Incoming data has been consistent with our investment strategy view that a base in the global industrial cycle would form through the first part of 2019. Share markets have recovered strongly in line with this view. Share markets have also been buoyed by the US Federal Reserve pausing its rate tightening cycle and moderate Chinese stimulus.

However, indicators are showing warning signs that the recovery would be tepid at best. With good news front loaded into share markets with valuations returning from cheap in late 2018 to fair or modestly above value we consider markets are now more vulnerable to disappointment.

A possible headwind to markets would be if the current recovery flat-lined with earnings disappointing in 2020. Current indicators that support a U-or even L-shaped recovery include: inventory is still at neutral or modestly high levels; the US dollar has held and has even lifted; the Chinese stimulus is moderate and is near complete; and US capex lead indicators are now slowing. A U-shaped recovery could work to extend the cycle and support growth assets.

Another headwind is that the market has largely discounted the possible re-emergence of the trade war. With only very tentative signs that the global industrial cycle is basing, a resurgent trade war could rapidly abort this recovery.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

If a base in global growth does progress as we expect and a modest improvement in the earnings outlook eventuates in line with our shallow U recovery, we would look more favourably towards growth assets. However, the potential risk to the current base transitioning to a recovery from a resurgent trade war and softer Chinese growth remains elevated.

For now, a sustained recovery is largely priced with global markets around fair value and our economic scorecard still suggesting caution towards growth assets given the current weak pace of economic growth. We consider the share market rally to remain vulnerable to event risk like a resurgent trade war until clear signs develop that an upgrade earnings cycle is emerging.

The RIC strategy for growth assets remains at neutral, but our actual portfolio positioning has a preference for global over Australian shares, reflecting the relative easing in financial conditions that favours international exposures and the risks that still surround the unwinding of the house price and construction cycles.

We continue to maintain an underweight to fixed income, with this concentrated in international markets with Australia at benchmark due to the relatively attractive level of rates and subdued inflationary pressures. We remain overweight cash. Global listed property and infrastructure are relatively expensive and are susceptible to an increase in yields which may unfold if growth levels out; portfolios are running a small underweight to both types of real assets.

STRATEGY TILTS

	SAA	TAA	Over/ Under weight
Growth assets	70%	70%	0.0%
Australian equities	26.0%	25.25%	-0.75%
Developed market equities	28.0%	29.35%	+1.35%
Emerging market equities	4.0%	4.0%	0.0%
Listed real assets[1]	6.0%	5.4%	-0.6%
Alternative growth	6.0%	6.0%	0.0%
Defensive assets	30%	30.0%	0.0%
International fixed income	8.0%	6.8%	-1.2%
Australian fixed income	12.0%	12.0%	0.0%
Cash	10.0%	11.2%	+1.2%
Foreign currency hedge ratio[2]	30.0%	30.0%	0.0%

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: **0.0% at benchmark**	Growth assets are set at benchmark underpinned by trend growth, broadly neutral valuations and investor remaining relatively subdued. However, signs are emerging that the slowdown that began around September 2018 has run its course, particularly in the industrial sector and this may lead to stronger growth in the months ahead.
Developed market equities: +1.35% overweight	Macro lead indicators point to below-trend but stable growth. However recent data suggests growth is not slowing further and may even be picking up again. Valuations across most markets are around fair value. The US is a little overvalued, Europe fair value and Japan relatively cheap. Within the neutral range, global equities are modestly overweight to counter modest underweights in Australian equities and listed real assets.
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 are now close to fair value. Earnings indicators are beginning to improve. Resources are benefiting from rising commodity prices due to supply constraints, particularly in iron ore and oil, and the consensus Bank EPS outlook should be easily met. However, market earnings remain constrained by weak credit growth and this is one of the key reasons why we prefer global equities over Australian equities. If market expectations of a 50 basis points (bp) cut to official interest rates this year is realised then this could be enough to lift Banks earnings and will make the asset class more attractive.
Emerging market equities: 0.0% at benchmark	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. EM will also benefit from any pick-up in the global industrial cycle. However, more sustained outperformance will depend upon the US dollar (USD) weakening. To this end, the Fed's decision to stop lifting interest rates assists, but broad USD weakness will depend upon regions outside the US doing more heavy lifting on growth. The portfolios are positioned neutral in this asset class, but our bias is towards moving overweight.

Listed real assets[1]: -0.6% underweight	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 recovery that is underway in global growth stumbles then they should perform well. Furthermore, yields seem capped by the Fed's decision to stop raising rates. Listed infrastructure valuations have returned to the upper band of our fair value estimate as investors rotated into defensive sectors. Portfolios are running a small underweight in both types of real assets due to improving economic prospects and our view that there is less downside risk to bond yields than upside risk.
Alternative growth: 0.0% at benchmark	Alternative growth assets are held at benchmark, given moderate real asset growth return expectations at this stage of the cycle and the diversification benefits they provide in this environment. Financial market volatility has been low in the past month or two and these assets should perform well if volatility were to return in the months ahead.
DEFENSIVE ASSETS 0.0% at benchmark	Defensive assets have continued to be supported by subdued inflation and the slide in global growth that have led to the US Fed pausing rate hikes and increased Chinese stimulus. Australian inflation is undershooting RBA forecasts and this is putting downward pressure on Australian yields.
International fixed income: -1.2% 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, our valuation for the US 10-year bond yield has fallen with Fed tightening expectations taken out for 2019 and expectations that the Fed will now ease. Slower global growth in the period ahead should anchor yields lower for longer, although a base in growth could exert near-term upward pressure.
Australian fixed income: 0.0% at benchmark	Australian fixed income has rallied strongly and signals remain neutral on subdued inflation and the RBA holding rates steady for an extended period. Valuations are moderately expensive possibly reflecting markets shifting to a rate cut. Inflation expectations are subdued compared to the rest of the world and in conjunction with an improved fiscal outlook will likely anchor yields below the US.
Cash: +1.2% overweight	We prefer cash over global fixed income in our defensive asset positioning. Negative bond yields in Europe and Japan and low term premia in other markets with higher bond yields mean investors are not being compensated much for holding bonds over cash. Furthermore, US bond yields have risen by some 15bp in the past few months as risk appetite has risen, but inflation has remained subdued. It doesn't seem likely that yields can rise significantly further in the near term, so cash is providing a relatively good risk-adjusted return.
FOREIGN CURRENCY HEDGE RATIO[2] 0.0% at benchmark	The headwind from interest rate differential to the US is partly offset by rising bulk prices. 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 and the headwinds from the housing market and subdued inflation pressure keep our positioning 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 May 2019.