JULY 2019

HOUSE VIEW

EXECUTIVE SUMMARY

The May share market correction was rapidly reversed in June as the US Federal Reserve (Fed) surprised markets by signalling a possible interest rate cut as growth weakens. While recent events have seen markets rally, our key indicators have failed to keep pace, leaving us cautious of near-term outlook.

OUR VIEW

Global share markets rallied hard in June, with the MSCI World ex Australia Index gaining more than it lost in May in unhedged terms. The reversal is largely due to investors reacting positively to the Fed's change of heart; with rate cuts back on the table.

The rally has spilled over into July after the Trump-Xi meeting at the G20 signalled that both China and the US are back working to smooth trade relations. President Trump has lifted the Huawei ban we referred to last month, and China agreed to buy more US agricultural goods. For the moment, the trade war has entered a ceasefire period once again. But in our view, it is unlikely to be permanent.

The strong share market rally has seen valuations move back above our estimate of fair value, particularly Australian shares which are more stretched than their global counterparts. By some measures, the ASX is the most expensive versus fair value in over a decade. The rally in shares is based upon an expectation of better growth ahead. However, our composite of key indicators of global activity has only recently started to stabilise, and has not kept up with the recent rally. In our view, it is still very early days and while we believe recession is unlikely, we remain cautious of the near-term growth outlook.

WHAT THIS MEANS FOR OUR DIVERSIFIED PORTFOLIOS

Reflecting our current caution, the diversified portfolios have a small underweight in Australian, developed market and emerging market equities. The more defensive listed real assets and alternatives are at benchmark levels.

International fixed income is now only a small underweight within our benchmark range while Australian fixed income is at benchmark. Cash is overweight.

The portfolio's currency hedging position remains below benchmark reflecting our concerns over the outlook for US and China trade relations. The Australian dollar is sensitive to shifts in global growth prospects, which appear tilted a little to the downside. This negative impact is in addition to the even lower level of interest rates in Australia versus the United States. Nevertheless, the Australian dollar is being well supported by bulk commodity prices, which remain at high levels and have remained resilient to the Chinese slowdown thus far.

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 Assets[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%**	**27.8%**	**-2.2%**

SAA – strategic asset allocation
TAA – tactical asset allocation

STRATEGY POSITIONS SUMMARY

GROWTH ASSETS: **-2.0% underweight**	Growth assets are set slightly below benchmark. Global growth is slowing even though it remains around trend and indicator data is suggesting it took a leg down in June. The impact of trade tensions on global supply chains and investment is a big downside risk in the months ahead. However, valuations are beginning to get a bit stretched on the promise of central banks' easing.
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 in the US are now a little expensive; however, Europe is fair value and Japan and the UK 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. Back-to-back interest rate cuts by the RBA and tax cuts have been positive for the outlook. However, valuations have now moved above fair value. Credit supply appears to be increasing again as the banks ease lending conditions. Earnings indicators, after stabilising, have recently weakened again. Resources are benefiting from rising commodity prices due to supply constraints, particularly in iron ore and oil and a sharply lower Australian dollar (AUD). The consensus EPS outlook for the banks seems a low hurdle that can be met.
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. However, the supply chain disruptions created by the trade tariffs are concentrated in the EM region, leaving downside risks to near-term earnings growth. The prospect of Fed policy easing has risen in recent weeks and it has placed some downward pressure on the US dollar. Whether or not the depreciation gathers momentum will be important for the EM region. 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 further and the major central banks begin easing policy then the asset class should perform well. Listed infrastructure valuations are also above our fair value estimates. Investors have rotated into defensive sectors, but this has now become a crowded trade. Portfolios are neutral in both real asset classes to provide some defensive equity exposure in the current uncertain environment.
Alternative growth: 0.0% at benchmark	Alternative growth assets are held at benchmark. The asset class adds to diversification and it has less volatility than listed real assets. It 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 which has led to market expectations that the US Fed will soon ease policy. 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 think there is a good chance the RBA will ease policy again before year end. However, tax cuts will begin boosting household income in the next few months and this makes another interest rate cut before year-end less likely.
International fixed income: -0.7% underweight	The slowdown in global growth and subdued inflation has ignited 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 add to these downward pressures. Inflation remains subdued and unlikely to threaten central bank targets for some time.
Australian fixed income: 0.0% at benchmark	Australian fixed income has rallied strongly and our signals remain neutral, following two cuts by the RBA and some prospects of more to come by year end. Valuations are moderately expensive reflecting markets shifting the subdued growth and inflation outlook. However, tax cuts could come to the rescue and 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 recently reduced cash to build our benchmark position in global bonds.
FOREIGN CURRENCY HEDGE RATIO[2] -2.2% 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 ore higher and Thermal Coal tracking lower. Overall, while our commodity price based fair value estimate of the currency is at US78c, slower global growth, and the prospect of more interest rate cuts by the RBA 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 dollars.

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