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Asset Allocator

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Investment Strategy

Asset allocation outlook for 2019

Global equity markets suffered a correction in late 2018 to end the year lower. Markets were impacted by heightened political and trade uncertainty, central bank tightening, oil price volatility and downturns within emerging markets. Bonds rallied and ended the year with modest positive returns. The Australian dollar fell almost 10% over the year, while crude oil and major base metal prices dropped 17-25% YoY. In this note, we update our Tactical-Dynamic Asset Allocation views.

International Equities: The correction has pushed valuation metrics into attractive-to-very attractive territory. A positive inflection away from central bank tightening seems likely, led by the Federal Reserve. Earnings indicators have moderated but are expected to remain positive. Investor sentiment has quickly become cautious. We remain overweight international equities.

Australian Equities: Absolute valuation is at average levels, while relative equity valuation is unattractive. Earnings indicators are deteriorating and at below average levels. That said, liquidity conditions remain supportive, though the Reserve Bank of Australia (RBA) appears well away from easing. We remain underweight Australian equities.

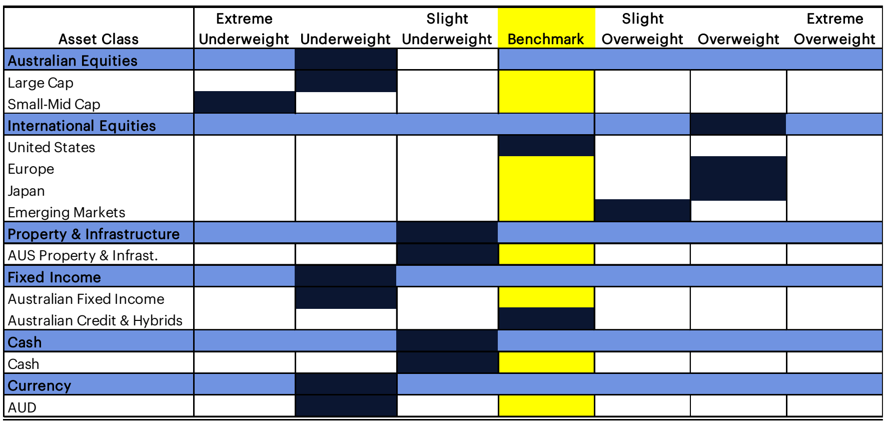
Fixed Income: Bonds generally remain expensive in absolute and relative terms. In the major markets, growth indicators and inflationary pressures are higher than bonds are discounting. Bond supply is at record levels in the US. We remain underweight.

Property & Infrastructure: A-REITs appear expensive, trading at an above-average PE premium and discounting very low cap rates. We see significant challenges for the retail sub-sector. We increase our underweight.

Currency: The AUD faces challenges from record negative rate spreads, deteriorating relative growth, Australia's high household and foreign debt, and China's challenges. We recommend unhedged international exposures.

Investment implications: We switch part of our emerging markets exposure from VGE, an ETF which tracks the FTSE Emerging Markets index, to FEMX, an actively managed EM Fund managed by Fidelity. FEMX has a strong track record, stable team and is offered at a reasonable fee.

FIG. 1: Tactical-Dynamic Asset Allocation recommendations



Source: Baillieu. Notes: Dark blue = current recommendation; Brown = last quarter's recommendation; Yellow = benchmark

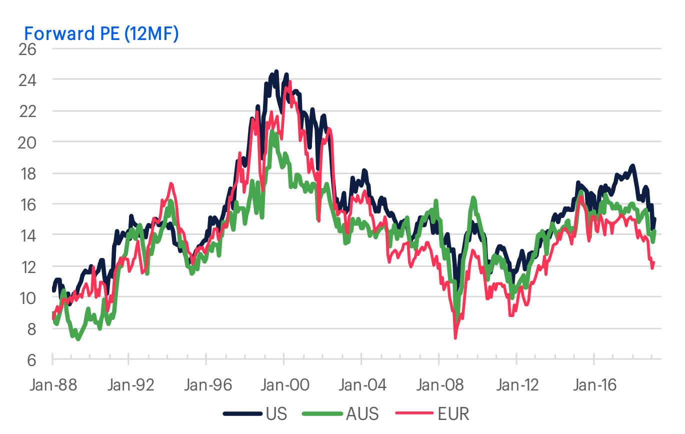
Asset allocation outlook for 2019

- The global economy slowed more than expected in 2018, impacted by a combination of heightened political and trade uncertainty, central bank tightening, higher oil prices and downturns in some emerging markets (EM). This drove an equity market correction and bond market rally in 4Q18. For the year, global equities fell 10.4% in US dollars, or -0.7% in AUD-terms, while bond markets yielded modestly positive returns. Crude oil and major base metal prices fell 17-25% YoY. In this note, we present our views on the major asset classes for 2019.

Equities: Overweight International; underweight Domestic

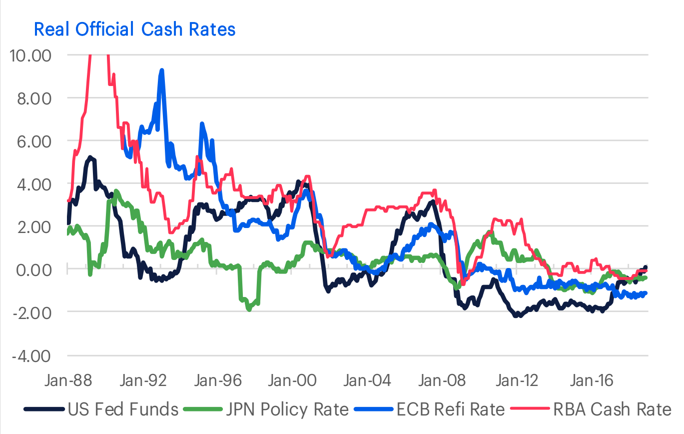
- **Valuation extreme – equities attractive to extremely attractive:** The correction in global equity markets has substantially improved equity valuations. The US, at slightly above 15x, is moderately below its long-term average 16x, while Europe, on 12.5x, and EM, on 11.0x, are well below average levels. Japan, on 10.5x, is at a valuation extreme (Figure 2). Australia is the exception, trading at its long-term average 14.5x. Versus rates, short- or long-term, equities are far more attractive than average across all markets, but particularly in Japan and Europe. Dividend yields are attractive in absolute terms, as is the price-to-book value when compared to expected return on equity. In relative terms, Australia and the US are expensive versus Europe and Japan. Overall, composite valuation metrics range from slightly attractive in the US to moderately attractive in Australia, very attractive in Europe and EM, and extremely attractive in Japan.

FIG. 2: Forward PE valuations have significantly derated – led by the US – to below-average-to-extreme levels



Source: Datastream, Baillieu

FIG. 3: Real short rates are flat-to-negative – still extremely accommodative

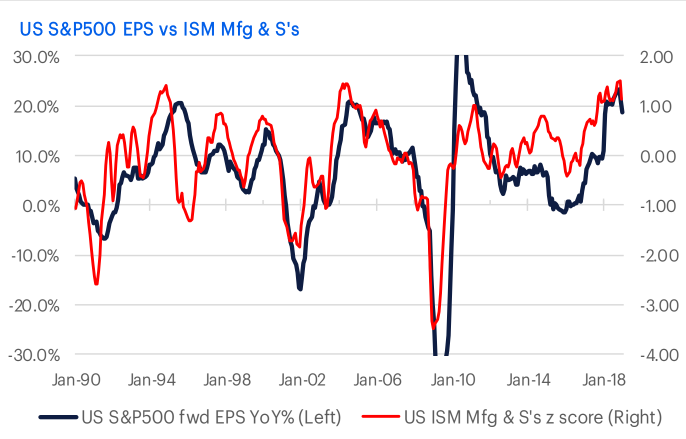


Source: Datastream, Baillieu

- **Liquidity conditions inflection point – US negative, but set to improve, while others are positive:** An inflection point in central bank policy should drive an improvement in liquidity conditions. The rate rises and shifts away from quantitative easing seen over the past 12-24 months should give way in 2019 to a policy pause led by the US Fed. Indeed, we see the Fed on hold for 6-9 months, the ECB on hold for an "extended period" now it has ended its asset purchase program, whilst the Bank of Japan should keep its ultra-accommodative policies. In China, the PBOC is looking to ease the SME credit crunch, effectively easing policy. In Australia, while rates are at record lows, we see the RBA as reactive, given its current bullish views. Overall, real rates should stay at low levels (Figure 3). A supportive Fed and a recovery in growth expectations should help the US yield curve to steepen. Rate spreads, already at multi-decade highs, should continue to favour markets outside the US.

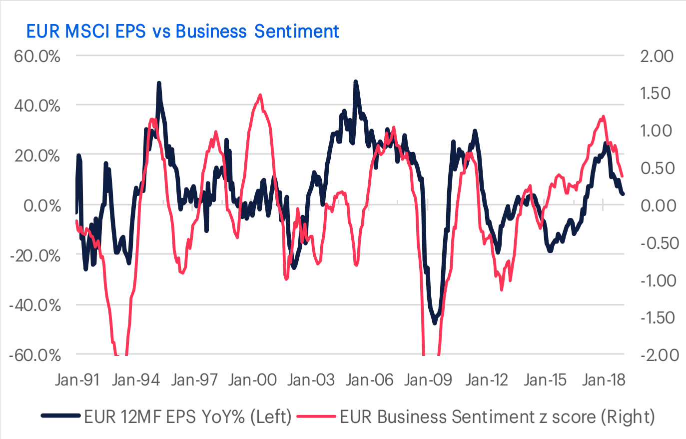
- **Earnings outlook: US and Japan positive; Europe and Australia soft; EM weak:** Earnings growth expectations have deteriorated as purchasing manager and business sentiment surveys have softened, and oil prices have fallen as much as 40%. A US soft landing, supported by robust underlying fundamentals in its consumer and business sectors, should support earnings (Figure 4). We also see solid underlying fundamentals in the oil market as assisting a gradual oil price recovery, another relative positive for the US. In the interim, lower oil prices are a short-term positive for growth in most markets. A robust Tankan should support an ongoing positive earnings outlook in Japan (Figure 6). China stimulus and resolution of the US-China trade tensions should help China and, with it, EM and Europe (Figures 5 and 7). Softening business confidence in Australia, reflecting the housing downturn and squeeze on consumers, should continue to moderate its earnings momentum (Figure 9).

FIG. 4: US earnings have boomed on the back of strong PMIs and the tax cut



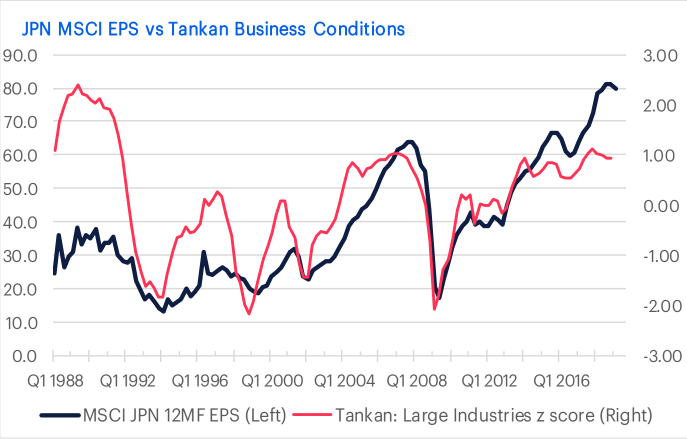
Source: Datastream, Baillieu

FIG. 5: Europe earnings expectations have moderated along with business sentiment



Source: Datastream, Baillieu

FIG. 6: Japan robust earnings performance has been consistent with the strong Tankan survey



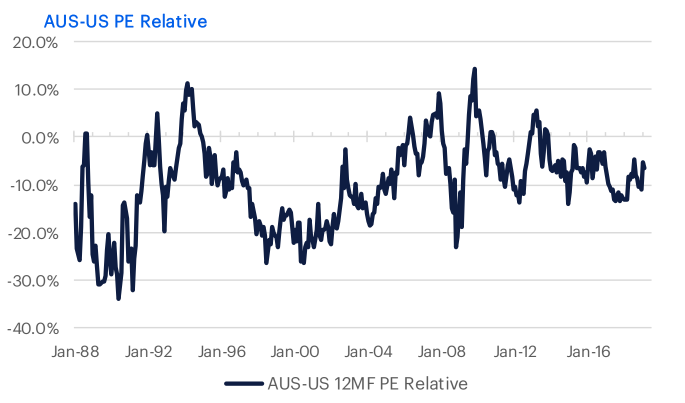
Source: Datastream, Baillieu

FIG. 7: EM earnings expectations have slowed, consistent with a softer China PMI

Source: Datastream, Baillieu

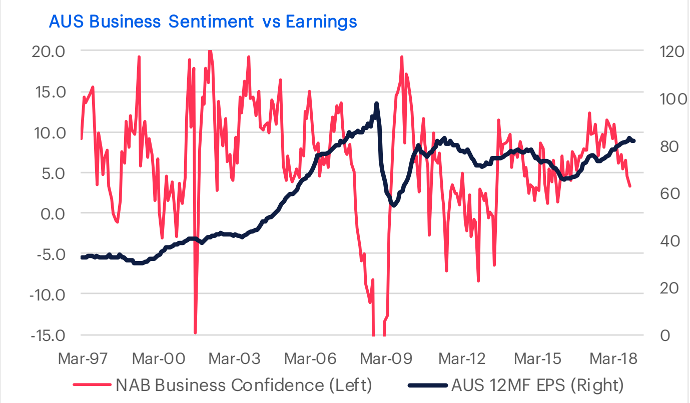
- Consensus earnings growth momentum has moderated sharply over the past three months, reflecting softer economic data, lower oil prices and analyst caution. By market, trends include:
  - US: +0.2% over three months, 3.4% over six months and a tax cut lifted 18.5% YoY. Forward earnings expectations have moderated to just 8% above trailing earnings, but if adjusted for the long-term average analyst bias of ~5.5% and a 2% contribution from buybacks, are effectively close to zero.
  - Europe: -2.7%, -0.1% and 4.2% over 3, 6 and 12 months respectively. This weakness is consistent with the significant slowdown seen in Europe (Figure 5) on the back of political uncertainty, oil price volatility, auto emission issues, the China slowdown and Turkey's downturn. Cycling some of these negatives and reduced uncertainty should be constructive for Europe.
  - Japan: 0%, 2.7% and 11.3% over 3, 6 and 12 months respectively, supported by a robust Tankan survey (Figure 6). This is a strong achievement given the China slowdown, and reflective of improving internal performance. Lower oil prices should be another positive.
  - EM: -2.9%, -4.4% and -1.2% over 3, 6 and 12 months respectively, impacted by the China slowdown (Figure 7) and hits to EM's from Fed tightening, including downturns in Turkey and Argentina. China easing, and our expected Fed rate pause, should be supportive in 2019.
  - Australia: -0.1%, +1.3% and 6.6% over 3, 6 and 12 months respectively, supported by bulk commodity price resilience to the China slowdown, solid domestic growth and a lower AUD. We expect a domestic slowdown, but expect some earnings support from a lower AUD.
- **Supply-demand dynamics – US buybacks supportive:** In the US, whilst outflows from mutual funds and ETFs have totalled a net US$51.5 billion over the past year, more than reversing the US$41.4 billion net inflows of the prior year, corporate share buybacks have risen 39%, or ~US$200 billion, to US$720 billion. Sentiment indicators are cautious, a positive contrarian indicator.
- **Overall outlook – overweight International:** With attractive valuations, improving liquidity conditions, a US-led soft landing and a forecast moderation in current high levels of uncertainty, we see international equities as attractive. We remain overweight international equities.
- Within international equities we prefer Japan given extreme valuation, positive earnings momentum and ongoing liquidity support. Our positive views on EM and Europe, which lack the earnings positives of the US and Japan, need the catalysts of effective China policy easing and reduced trade and political uncertainty. We are positive on the US but see more upside elsewhere.
- **Overall outlook – underweight Australia:** valuation in absolute terms, and relative to other equity markets, is neutral-to-unattractive (Figure 8). Earnings momentum is likely to continue to deteriorate as the domestic slowdown becomes more apparent (Figure 9). While liquidity conditions remain supportive, we expect the RBA to be reactive – as opposed to pre-emptive – to the housing and consumer slowdown. We are underweight Australian equities.

FIG. 8: ASX 200 is at a narrow 5% discount to the US



Source: Datastream, Baillieu

FIG. 9: AUS business confidence softening points to slower earnings growth expectations

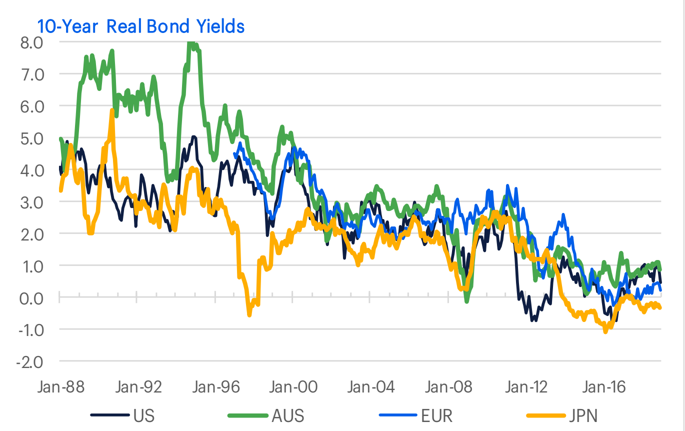


Source: Datastream, Baillieu

Fixed Income: Underweight

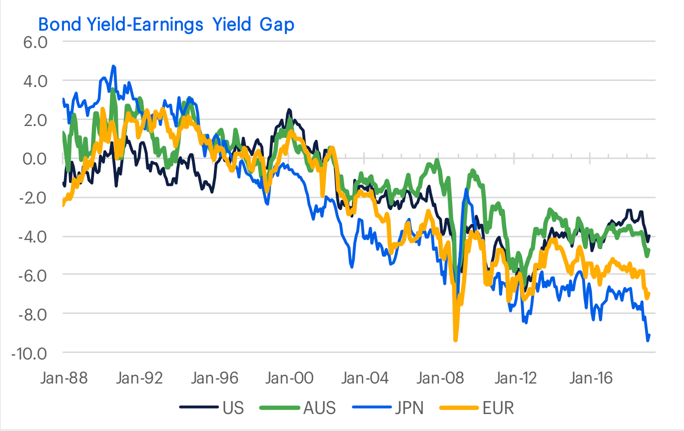
- Major bond markets rallied in 4Q18 and generated low positive returns for the year. US and Italian yields rose 27 and 76bps respectively in 2018, whilst yields in other major bond markets fell 4-30bps. Bond yields range from 0.0% in Japan to 2.75% in the US and are still within 20-120bps of record low yields. Looking ahead, we see five sources of upside risk in bond yields:
  - **Expensive absolute valuations:** Real bond yields are well below average, ranging from -0.3 to 0.5% (Figure 10). The US real yield of 0.5% compares to the long-term average of 2.1%, Europe at 0.2% (2.3% long-term average), Japan at -0.3% (1.5% long-term average) and Australia at 0.5% (3.0% long-term average).
  - **Unattractive relative valuations:** Bonds are back at extreme valuations relative to equities (Figure 11). European equities are back at Eurozone debt crisis spreads, while Japan is at a record extreme and even US and Australian equities are at spreads not seen outside the GFC and its aftermath.

FIG. 10: Real bond yields in major bond markets remain very low at -0.3-0.5%



Source: Datastream, Baillieu

FIG. 11: Relative valuation: Bonds are expensive vs equities outside the GFC

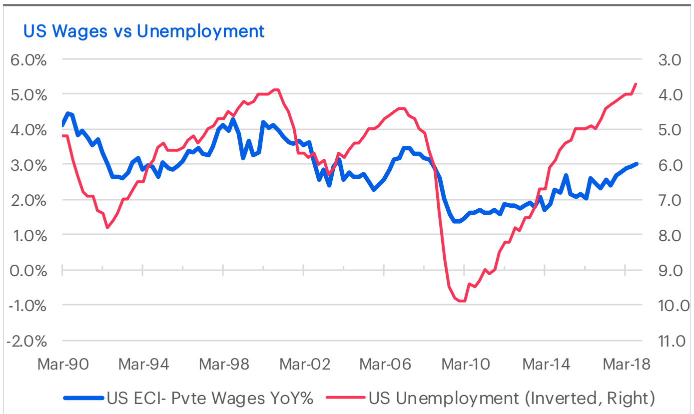


Source: Datastream, Baillieu

- – **Depressed growth expectations:** Weaker PMIs have reduced growth expectations. Even so, PMIs are still at above average levels and, in our view, the typical pre-conditions of downturns – tight policy, financial excess and/or commodity shocks – do not appear to be present. We expect the policy pause, reduced uncertainty and the tailwind from lower oil prices to support growth expectations in 2019, a negative for bond yields.
- – **Inflation outlook:** Whilst the recent fall in oil prices will lower inflation in the near-term, labour markets in the major economies are now the tightest since at least pre-GFC, consistent with gradually rising labour costs and inflation. In the US, unemployment is around 50-year lows at 3.9%, which has driven a gradual recovery in wages growth to ~3.2% YoY, in line with the long-term average (Figure 12). In Japan, unemployment at ~2.5% and wages at ~1.5% YoY are both at their best levels in 25 years. Even in Europe, unemployment is at a decade low 7.9% and wages have recovered to an average 2.5% YoY (Figure 13).
- – **Record bond supply in the US**: With the US fiscal stimulus and Fed quantitative tightening, US net bond supply is back at levels seen in the depth of the GFC, when private credit demand was falling. The risk of 'crowding out' pushing up rates seems high given positive credit growth this time around, though we note the Fed has begun to talk about ending its quantitative tightening program potentially sooner-than-expected.

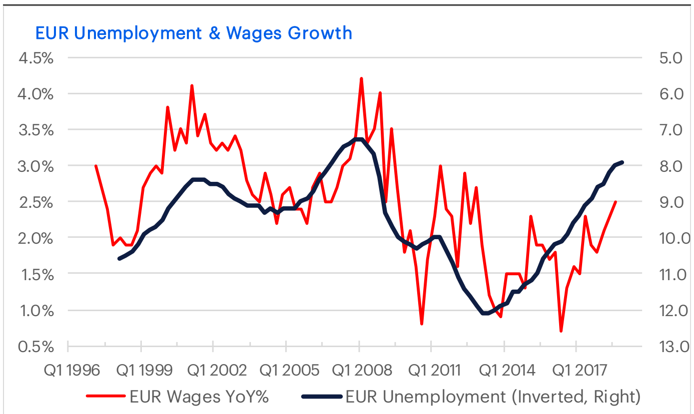
- In our view, this combination of five headwinds should see bond yields rise in the year ahead. The central bank policy inflection point seems likely to slow, but not avert this process. We see US bond yields ending the year above the recent peak seen in 2018, or above 3.25%. We remain of the view that US yields will eventually reach 3.5-4.0%. Outside the US, with policy tightening and growth both lagging well behind the US, bond yields are likely to rise, but more slowly.
- Within fixed income we continue to prefer floating rate securities that protect investors from interest rate risk.

FIG. 12: US: Lower unemployment has gradually lifted wages growth



Source: Datastream, Baillieu

FIG. 13: Europe: Falling unemployment helping lift wages growth

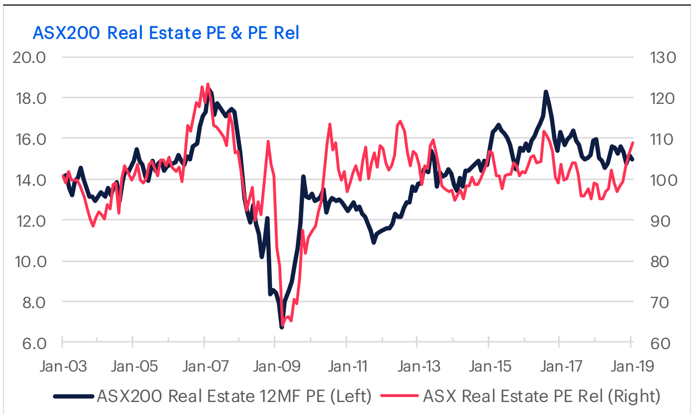


Source: Datastream, Baillieu

Property & Infrastructure: Increase Underweight

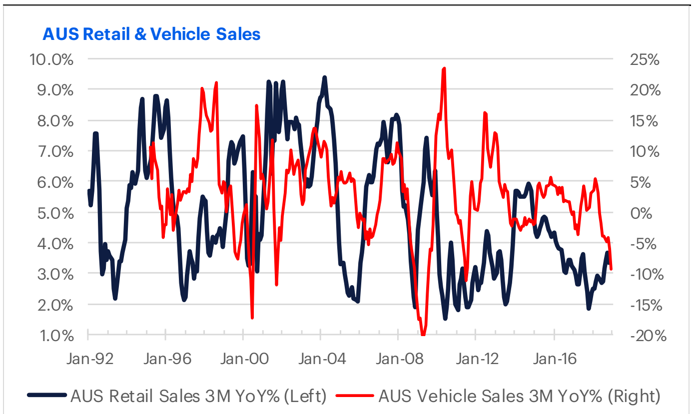
- The ASX A-REIT sector modestly declined in 2018 but outperformed the broader market. By contrast, the utilities and telecom sectors significantly underperformed. The performance of the A-REITs has pushed relative valuation to unusually high levels (Figure 14). In our view, the cap rates underlying A-REIT NTAs are also expensive (i.e. unusually low).
- A key sub-group within the A-REIT universe is retail. We remain concerned about this sub-sector for two key reasons:
  - **The household sector squeeze**: Household spending is being pressured by low wages growth, rising interest and debt burdens, tax bracket creep and a negative wealth effect from falling home prices. Vehicle sales in December fell 14.9% YoY and November retail sales rose just 2.8% YoY (Figure 15).
  - **Intensifying online competition**: With Amazon Prime and eBay Plus well established in Australia, and traditional retailers expanding their offerings, bricks and mortar retail sales should trail total sales on a structural basis.
- Infrastructure assets are somewhat exposed to the domestic slowdown and energy policy risks. Sydney Airport, for example, is seeing slowing traffic growth, with domestic traffic falling in year-on-year terms in three of the past four months. Utilities are vulnerable to a more hostile regulatory regime, cutting permitted rates of return and tightening the treatment of capex.

FIG. 14: A-REIT relative valuation is 10% above average



Source: Datastream, Baillieu

FIG. 15: AUS consumer indicators are soft



Source: Datastream, Baillieu

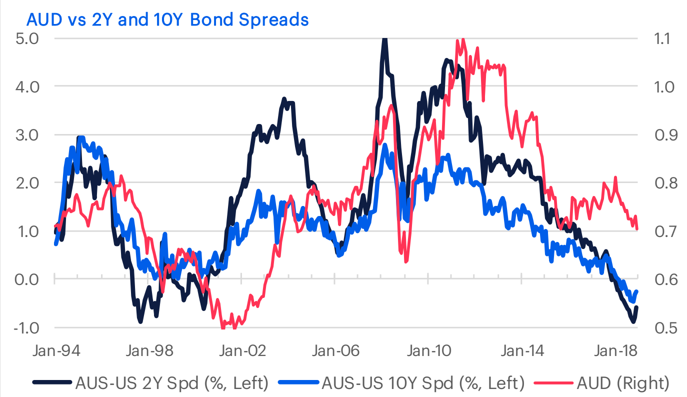
Currency: Underweight AUD

- Despite declining 9.7% against the US dollar in 2018, we see material further downside for the AUD in 2019-20 given:
  - **US dollar strength**: US growth and interest rates are well above other major markets. A relatively positive outlook should be reinforced by a US soft landing.
  - **Record low rate spreads**: The Australia-US cash spread is a record low -88bps. The 2-year and 10-year spreads at -80bps and -50bps are at-or-around post-float (35-year) lows (Figure 16). Rate spreads should continue to widen in 2019-20.
  - **Deteriorating relative growth and economic fundamentals**: Australian real GDP growth has slipped below the US. On our outlook it will remain below the US for some time. Australia faces multiple headwinds, from the housing downturn and squeezed consumer, to elevated political risks, a lack of pro-market reforms and poor productivity performance.

– **Structurally lower rates than the US**: Reflecting Australia's unsustainable household debt ratio of 189%, versus 99% in the US, it will be challenging for neutral interest rates in Australia to exceed US levels of ~3%.
– **Australia's high net foreign debt level at 56% of GDP:** While the current account deficit at 2-3% of GDP appears manageable, a high level of foreign debt, with Australian rates at a record discount to the US amid a housing downturn, could prove a challenge for refinancing at current AUD levels, which are around long-term average levels (ex-the resources boom).
– **China growth slowdown**: Australia's bulk commodity export prices have held up extremely well in the context of China's weakest growth in 28 years (Figure 17)! China faces significant challenges – including negative demographics, high debt levels, advanced urbanisation and US trade tensions – but has strong external surpluses, low foreign debt, low inflation and the policy capacity to contain downside risks. Personal and SME tax cuts and targeted improved credit availability seems to be the policy focus rather than another property-infrastructure boom which would favour Australian commodity exports.

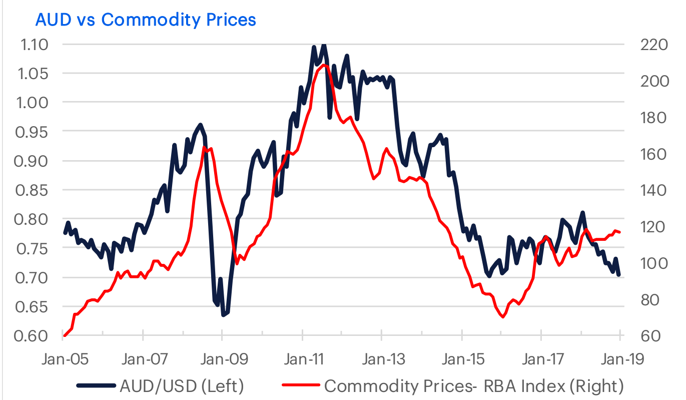
- We expect the AUD to fall ~10% to the low-to-mid-60s (vs USD) over the next year or so. A deeper-than-expected housing and household spending downturn would augur further downside. An aggressive policy easing – large rate and tax cuts – would pressure rate spreads and push the currency lower as well. AUD upside probably requires US weakness, aggressive bulk-intensive China stimulus and a limited housing downturn.

FIG. 16: AUS-US rate spreads at-or-around record negative levels



Source: Datastream, Baillieu

FIG. 17: AUS commodity prices have remained resilient, supporting the currency



Source: Datastream, Baillieu

Tactical Asset Allocation signals

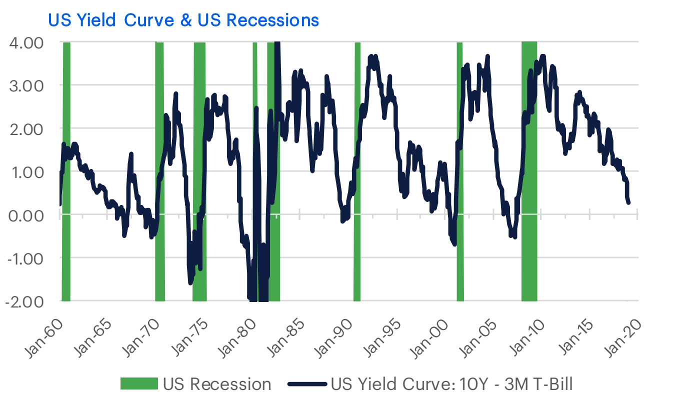
- We regularly track eight key Tactical Asset Allocation signals. Updating the signals:

– **#1: Relative valuation – equities very attractive versus both bonds and cash (Figure 9)**: US bond-earnings yield gap remains much wider than pre-GFC, whilst Europe and Japan are at-or-close to extreme lows.
– **#2: Absolute valuation – bonds very expensive (Figure 10); equities neutral-to-attractive (Figure 2):** Bonds suffer from very low real yields despite above-average growth indicators. Australian equities are at average valuations, while the US is modestly below average, but Japan, EM and Europe are very attractive.
– **#3: US yield curve – negative for equities:** The curve has flattened to a well-below average ~30bps (Figure 18), impacted by concerns about global growth, trade and political uncertainties and some softer US data.

- **#4: Liquidity conditions – equity positive:** A Fed pause, particularly at a real rate of about zero, is equity positive (Figure 19). Europe, Japan and Australia remain ultra-accommodative. China is likely to accelerate its effective easing.
- **#5: Credit spreads – credit neutral; equity positive:** spreads have widened but are at-or-below post-GFC average levels.
- **#6: Business activity expectations – US and Japan positive**: US and Japan surveys remain at high levels, while Europe has moderated to above-average levels (Figure 21). Business confidence in China and Australia has fallen below average.
- **#7: Consumer expectations – US positive, AUS slight negative:** US confidence is slightly below 18-year highs (Figure 22). Europe has slipped but remains above-average. Australia has softened to slightly below-average levels.
- **#8: Unexpected inflation – bond negative:** US implied inflation has fallen to 1.5%, well below current core CPI of 2.2% YoY (Figure 23). We see above-average inflationary pressures.

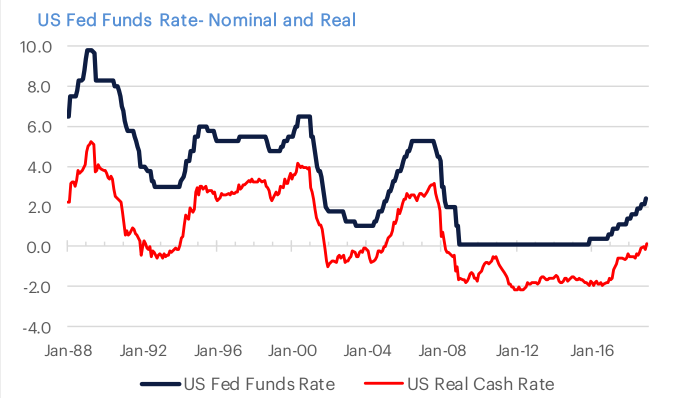
• Conclusions: The TAA indicators are generally positive for equities (but watch the US yield curve) and more so for international markets than Australian equities. The bond market indicators are generally negative.

FIG. 18: US yield curve: Flattened to a still-positive ~40bps



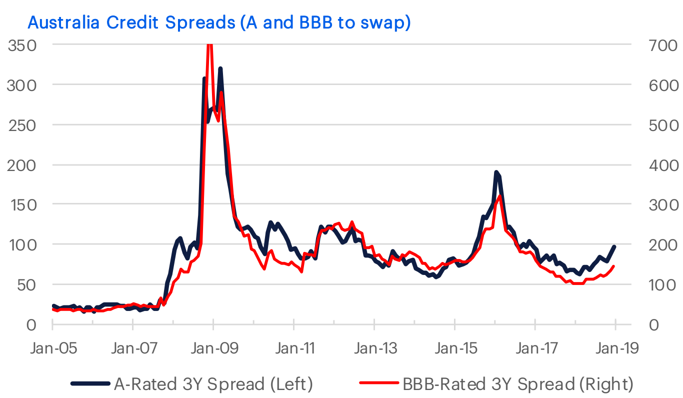
Source: Datastream, Baillieu

FIG. 19: Liquidity conditions: US real fed funds rate just 0.1% vs average 1.6%



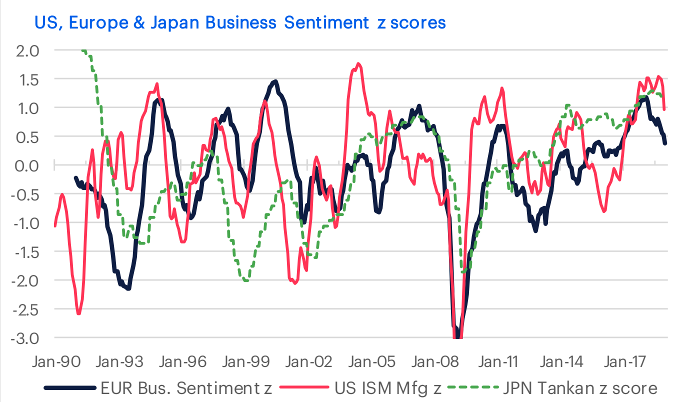
Source: Datastream, Baillieu

FIG. 20: Credit spreads: AUS spreads have widened but remain below post-GFC average levels



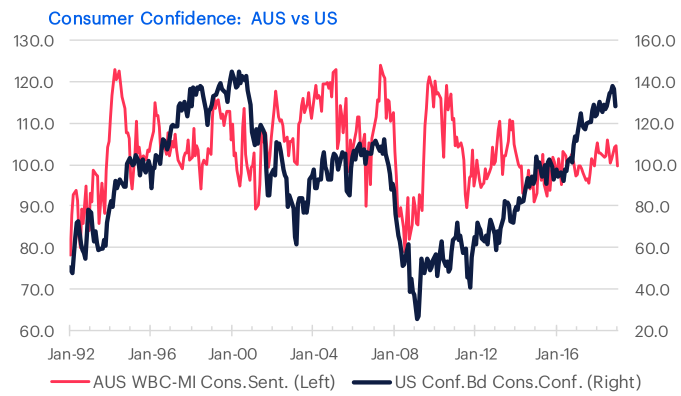
Source: Datastream, Baillieu

FIG. 21: Business expectations: US, Japan strong; Europe has moderated



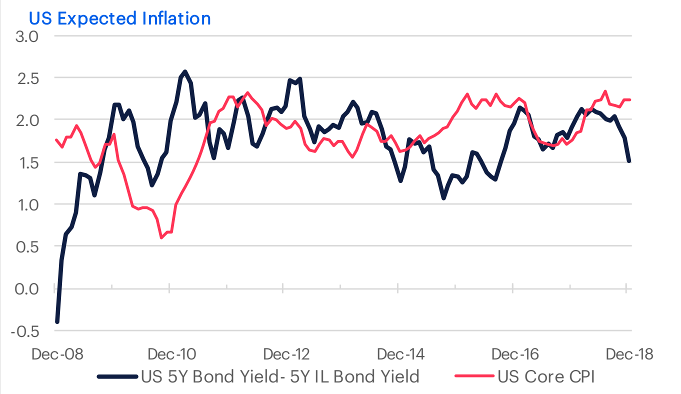
Source: Datastream, Baillieu

FIG. 22: Consumer confidence: US just below 18-year highs; AUS back to slightly below-average



Source: Datastream, Baillieu

FIG. 23: US expected inflation: At 1.5% it has fallen well below current core CPI of 2.2% YoY



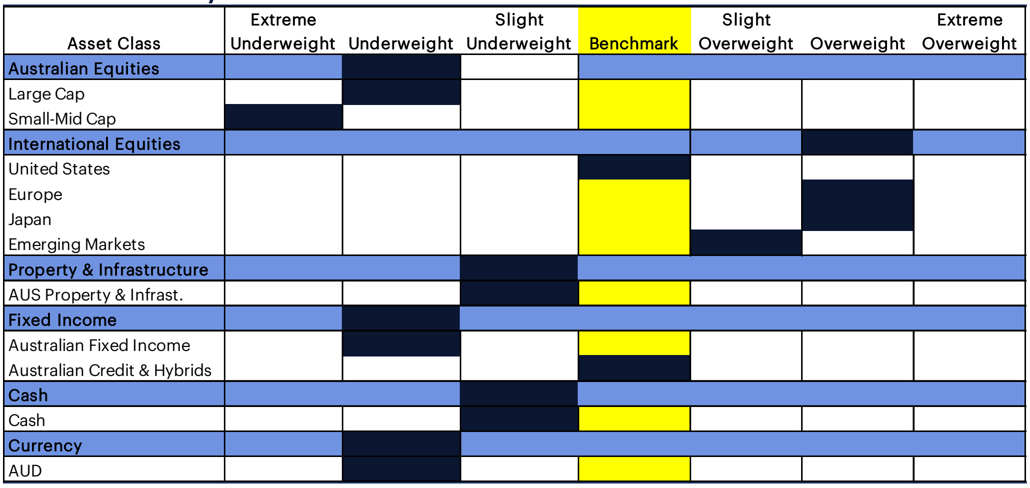
Source: Datastream, Baillieu

Investment implications

- In broad terms, we remain overweight international equities and underweight Australian equities, property, fixed income and cash. We modestly increase our property underweight, reflecting valuation and retail challenges, and add to cash. We remain extremely underweight Australian small caps, even with the recent pullback – small cap valuations remain extended in absolute and relative terms moving into a domestic economic slowdown.
- Within our international equities overweight, we are overweight markets outside the US, especially Japan, but also Europe and EM. Japan is extremely attractive, with strong business sentiment consistent with a positive earnings outlook and ultra-accommodative monetary policy that is unlikely to change.
- Implementation: We switch our emerging markets exposure from VGE, an ETF which tracks the FTSE Emerging Markets index, to FEMX, an actively managed EM Fund managed by Fidelity. FEMX is a concentrated 30-50 stock portfolio constructed with a strict focus on corporate governance and balance sheet structure. It believes that the market systematically underestimates the duration of returns and power of compounding over the long term in good businesses. We believe EM is an area where specialist managers with dedicated resources and tailored investment approaches may deliver superior performance outcomes over time, reflecting the substantial differences in geopolitical characteristics of countries within developing markets. FEMX, using the resources of 46 dedicated EM analysts, has a strong track record and can be accessed at a fee only moderately higher than VGE.

Tactical-Dynamic Asset Allocation: Detailed recommendations

FIG.24: Tactical-Dynamic Asset Allocation recommendations



Source: Baillieu. Notes: Dark blue = current recommendation; Brown = last quarter's recommendation; Yellow = benchmark

FIG.25: Tactical-Dynamic Asset Allocation detailed recommendations by investor type

Asset Class	ASX/mFund Code	Conservative	Moderate	Balanced	Growth	High Growth
Australian Equities		**6.0%**	**10.0%**	**18.0%**	**27.5%**	**27.5%**
Aus Direct Equities	-	6.0%	10.0%	18.0%	27.5%	27.5%
International Equities		**18.0%**	**29.5%**	**41.5%**	**52.5%**	**72.5%**
US Equities	VTS*	6.2%	9.6%	13.1%	16.0%	21.4%
European Equities	VEQ	3.1%	5.0%	7.4%	9.3%	12.6%
Japanese Equities	IJP	2.0%	3.1%	4.3%	5.4%	7.2%
Active Emerging Market Equities	FEMX	1.4%	2.8%	4.2%	5.6%	7.9%
Active Exposure US	MFF	2.4%	4.1%	5.7%	7.3%	10.5%
Active Exposure Europe	TGG	1.6%	2.7%	3.8%	4.9%	7.0%
Active Exposure Asia	APL	1.4%	2.3%	3.2%	4.1%	5.9%
Property & Infrastructure		**0.0%**	**2.5%**	**4.0%**	**5.0%**	**0.0%**
Aus Direct Property & Infrastructure	-	0%	3%	4.0%	5.0%	0%
Fixed Income		**19.0%**	**25.0%**	**22.0%**	**10.0%**	**0.0%**
Australian Fixed Income	IAF	5.5%	7%	6%	2%	0%
Active Domestic Diversified	PMF04	5.5%	7%	6%	2%	0%
Australian Hybrids	-	8%	11%	10%	6%	0%
Cash		**57.5%**	**33.0%**	**14.5%**	**5.0%**	**0.0%**
Cash		58%	33.0%	15%	5.0%	0%

Source: Baillieu

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