MACQUARIE

Investment Matters

Staying the course

MARCH 2018

We think February 2018 will be looked back upon as the month where bond yield expectations finally shifted meaningfully higher after having remained frozen at near crisis levels for the past 10 years.

The repricing of interest rates represented a significant change for financial markets which were not priced for such a sharp reversal. As a result, equities fell more than 10% over a 6 day period, in turn breaking an extended run of uninterrupted gains that had been supported by improving growth momentum and exceptionally low volatility.

Mounting evidence of stronger growth is encouraging. After a decade of the global economy being on life support and never quite having the resilience to absorb post-GFC shocks like the European crisis or the collapse in the oil price, there is increasing evidence that the global economy can sustain itself without the need of such extraordinary levels of monetary policy support. Importantly, inflation is not dead, it was just dormant.

On the other hand, the ferocity of the equity market sell-off was a strong reminder that markets don't always go up in a straight line and that the cushion for absorbing disappointment and higher interest rates has shrunk considerably after a prolonged period of positive returns and accompanying valuation expansion.

We think financial markets are at an important cross road. They have become use to central banks moving policy in a synchronized fashion which has helped to supress volatility. We are now entering a much more dangerous phase where markets have to deal with the uncertainty that stronger growth and inflation bring for policy making.

In addition, recent moves by the US administration to implement tariffs on steel and aluminium have sparked fresh concerns over potential trade wars and retaliation that bypasses the World Trade Organization (WTO) and a negotiated process of settlement. The push for nationalism over globalism is not new. Global trade peaked more than a decade ago and restrictions on the flow of goods, capital and humans has been increasing in recent years. At this stage, we don't see trade concerns as a major threat to the global economic recovery. However, the end game of greater protectionism is higher prices and potentially inflation and interest rates. This is an additional headwind for markets already absorbing a change in macroeconomic conditions.

However, although markets are entering a new phase most likely characterised by lower returns, it is not time to get bearish on risk assets. Investors should not fear a stronger growth backdrop and we maintain our overweight on equities vis-à-vis bonds while staying underweight property where higher rates are causing substantial valuation compression.

Turning points are not measured in days and therefore some patience will be required in coming months. We think being prepared to forgo some of the upside in order to avoid the risk of large downside is prudent as the world recalibrates. We are trying to avoid a portfolio payoff that is binomial (heads we win and tails we lose) which would imply staying much closer to the centre than betting big on the tails. This is the time of the cycle where diversification and holding assets with low correlation begin to have a much greater bearing on portfolio returns (i.e. alternative assets and commodities).

Our check list:

1. The world economy continues to heal and stronger growth is now feeding into improving corporate earnings expectations – Australia included;

2. Stronger growth supports a pro-growth strategy of being long equities and short bonds. In addition it raises the attractiveness of assets which have low correlations with both asset classes and/or provide a hedge against rising inflation. We are overweight Alternative assets (Macro Funds and Commodities);

3. Australia remains de-synchronized with the rest of the world and this should allow the Reserve Bank of Australia (RBA) to remain on hold throughout most of the year with the A$ largely range bound. We stay underweight property but like the outlook for domestic equities;

4. Signals for a more defensive tilt are not yet evident:
    - Corporate bond yields remain well behaved with no signs of corporate stress emerging;
    - Leading economic indicators remain solid with labour markets improving and business investment intentions strong;
    - Corporate profits are rising strongly across both developed and developing markets. Expectations for Australia have also risen post the February reporting round;
    - Commodity prices continue to track higher, with oil also underpinned by tight production agreements; and
    - The US$ has not hit a new uptrend despite Fed rate hike expectations.
5. It is highly unusual for equities to suffer a sustained downturn outside of a recession and leading indicators suggest this would be 2020 at the earliest. In addition, equities lead a downturn by 2-3 quarters so it would appear premature to be getting bearish if growth and earnings fundamentals remain strong.

For now, we stick to our current asset allocation and will look to taper the tails as signs emerge that either interest rates will be raised more aggressively than expected or leading growth indicators are beginning to roll over. The next 6 months will be bumpy as every turning point generally is. We are looking to come out of this transition period owning high quality growth stocks and/or those where cyclical upside works to support valuations.

Jason and the Investment Team

Asset class preferences

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight	Reason
Allocation						
Australian Equities						Total return expectation of 13% and relatively cheap.
International Equities						Growth favours cyclicals despite creeping bond yields.
US						High quality earnings momentum. Valuation a constraint.
Europe						Value proposition with strong cyclical momentum.
Japan						Fundamentals and stimulus supportive but has run ahead.
EM						Benefits from global growth but vulnerable to liquidity shifts.
Property						Sensitive to rising bond yields, not yet flashing "cheap".
Fixed Interest						Risks still skewed to the downside despite rate reset.
Alternatives						Falling correlations should drive better performance.
Cash						Reflects balance between stronger equity and weaker bonds.

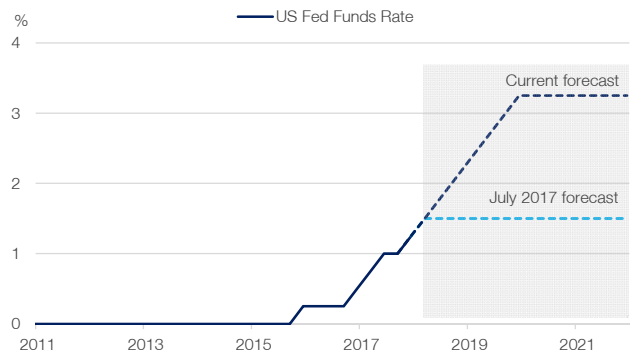
Source: MWM Research, March 2018

Global economics– Growth becoming more self-sustaining

The global economic recovery is gathering pace, but up until recently, markets had remained sceptical about the durability of the rebound. In the past few of months we have seen a fundamental change in market psychology, as incrementally better news has finally focused minds on a sustainable inflation upswing.

The persistent strength of economic and inflation data has led to significant revisions of US interest rate forecasts by Macquarie's economics team. They now expect the Federal Reserve to hike the Fed Funds rate by four times in 2018 and another three or four times in 2019. These expectations have been rapidly embedded in consensus expectations.

Interest rate expectations rising rapidly



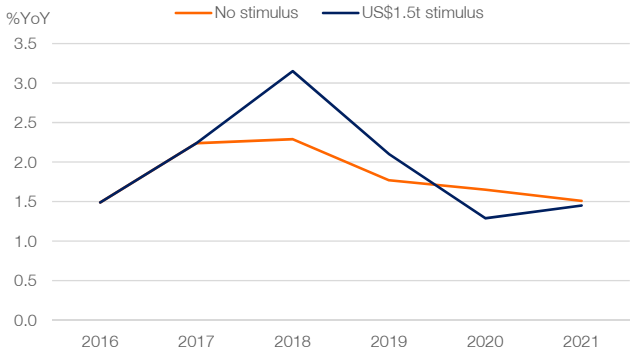
Source: Macquarie Research, MWM Research, March 2018

As the for the 10-year yield, 3.0% is potentially the critical level which, if breached, is likely to see yields quickly push higher towards our 2019 year-end target of 3.75% by end 2019. In our view, the combination of strong growth, a large US fiscal stimulus and surging animal spirits has finally forced markets to begin to shake off the "secular stagnation" shackles that dominated pricing in recent years. However the surge in volatility has also seen investors question whether the recovery can withstand higher interest rates. On balance, we think higher interest rates and increased volatility is simply markets pricing in a revised outlook for growth and inflation, and is consequently unlikely to derail the recovery provided corporate and high yield spreads remain relatively well-behaved. We see no signs of stress in this area yet.

While we expect interest rates to continue to rise (particularly in the US), we feel that continued highly accommodative monetary policy in Europe and Japan will keep the global cost of capital below its "equilibrium rate" for some time yet, giving us confidence that gradually higher US rates will not kill off the recovery.

The large fiscal stimulus in the US should also significantly reduce the chances of an economic slowdown this year. With growth currently the most broadly based seen for many years (almost all countries are currently expanding), the global outlook will get another boost from highly stimulatory fiscal policy in the United States, where the general government budget deficit will increase more than one per cent of GDP in 2018, adding over half a percentage point to US growth.

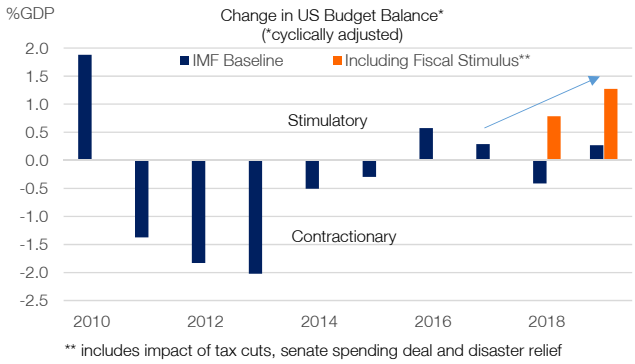
Fiscal stimulus delivers upgrades to US GDP growth



Source: Oxford Economics, MWM Research, March 2018

Most of the focus has been on tax reform, where the final package which will cost around US$1.5 trillion over the coming decade. In addition, the recent budget deal adds substantially to the stimulus, with new spending of US$300 billion over 2018/19.

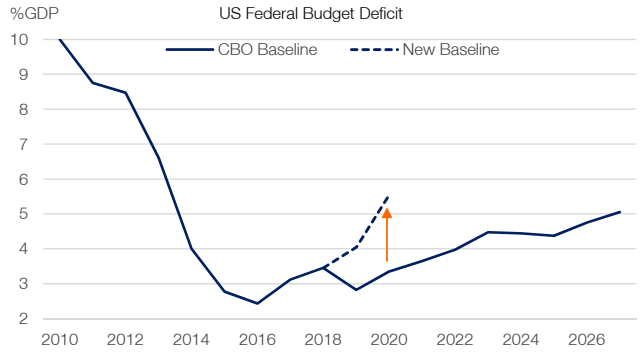
Substantial stimulus in the pipeline



Source: BCA Research, MWM Research, March 2018

This stimulus will arrive at a time when unemployment has fallen to 4.1%, and wages growth is approaching the levels prevailing before the crisis. The US budget deficit looks set to move above 5% of GDP in coming years, a level unprecedented in a period of full employment outside of war.

US budget deficit to hit 5.5% of GDP by 2019



Source: BCA Research, MWM Research, March 2018

As growth picks up further, unemployment is likely to fall well into the 3s over the course of 2018, with wages growth likely to have a "3" handle for the first time since Lehman fell. While it is likely to take some time for stronger wages growth to flow through to generalised inflation, in the near term, the year-on-year increase in the core personal consumption expenditures deflator should return to nearly 2% as the dip in March last year washes out of the calculation.

Growing budget deficits will weigh on the dollar

Source: FactSet, MWM Research, March 2018

We expect the recent increase in the US dollar to be short lived, with the Greenback resuming its slide over the remainder of the year as the deficit grows. A summary of Macquarie's change in interest rate forecasts versus consensus is provided in the table below.

Our bearish dollar view is predicated on the deterioration in the US budget and a widening in the trade deficit which more than offset the tailwind from the Fed raising interest rates. Our house view is for the euro dollar to rise to 1.33 by year end 2018 and to 1.40 by year end 2019. The dollar yen is expected to fall to 100 and 95 respectively.

Macquarie interest rate forecasts

	2018				2019			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Fed Funds rate (mid-point)								
New	1.63	1.88	2.13	2.38	2.63	2.88	3.13	3.38
Old	1.63	1.88	2.13	2.13	2.38	2.63	2.63	2.63
Consensus	1.63	1.88	1.88	2.13	2.13	2.38	2.63	2.63
2yr yield								
New	2.25	2.55	2.85	3.05	3.25	3.40	3.55	3.60
Old	2.00	2.25	2.50	2.65	2.65	2.65	2.65	2.65
Consensus	2.00	2.20	2.35	2.48	2.57	2.75	2.75	2.90
10yr yield								
New	2.85	3.00	3.10	3.25	3.40	3.55	3.70	3.75
Old	2.60	2.65	2.70	2.75	2.75	2.75	2.75	2.75
Consensus	2.57	2.70	2.80	2.90	3.00	3.01	3.13	3.20
10yr-2yr spread								
New	0.60	0.45	0.25	0.20	0.15	0.15	0.15	0.15
Old	0.60	0.40	0.20	0.10	0.10	0.10	0.10	0.10
Consensus	0.57	0.50	0.45	0.42	0.43	0.26	0.38	0.30

Source: Macquarie Research, MWM Research, March 2018

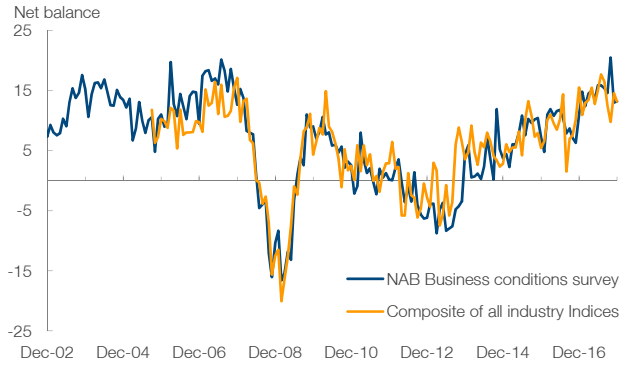
Australian economics – Starting to surf the global upswing

We are constructive on the Australian economic outlook. Stronger global growth is supporting a moderately better domestic outlook, as are supportive domestic monetary and fiscal policies.

Our Australian economics team is expecting the drivers of domestic growth to change as we progress through the year. Housing construction will take a step back, but non-mining business investment is expected to strengthen further. Government spending (23% of GDP) and resource exports will remain strong (although the latter is not expected to provide much employment upside), while mining investment's drag on growth will diminish further. The A$ is expected to provide modest support to exporting and import-competing firms, fluctuating around US$0.80.

Consumer spending is likely to muddle along amid ongoing weak wages growth. This is a continuation of the trend seen in recent years. The weak outlook for wages growth (~2.5% with real growth ~0%), coupled with some expected slowing in employment growth in 2018, implies that households' saving ratio must continue to decline to support even moderate rates of consumption growth.

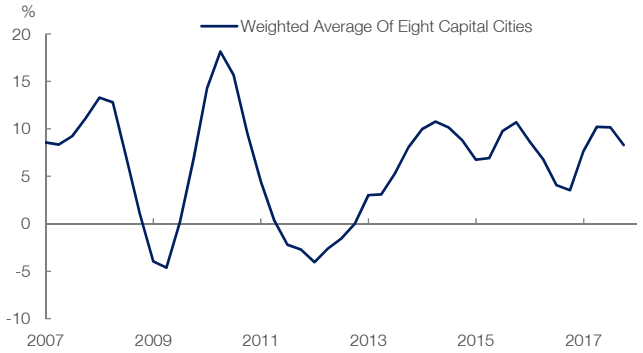
Australian business confidence at 10-year highs



Source: Macquarie Research, MWM Research, March 2018

We don't think this is a great outlook given consumption represents ~65% of GDP, but neither is it particularly bad. In fact, besides a faster than expected slowdown in the Chinese economy, we think the risks for growth remain skewed to the upside as Australia is dragged along by a rapidly improving global growth backdrop. The bears will point towards an over-leveraged consumer and elevated house prices as domestically driven downside risks. While these remain threats to the outlook, it is difficult to see either as the major source of downside over the coming 12 months. We think 2018 is a window for economic growth to find a firmer footing as major drags normalise.

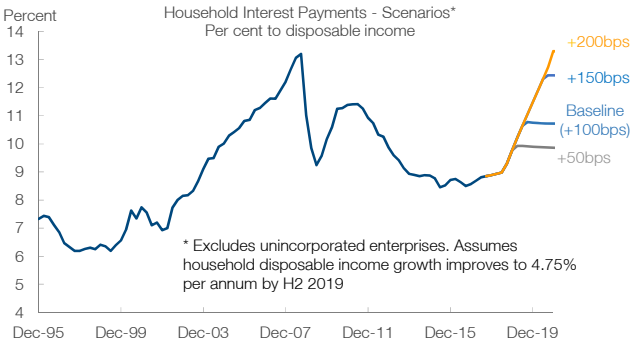
National house prices index has been deflating



Source: Macquarie Research, MWM Research, March 2018

At this stage, there is little reason for the RBA to step up its tightening rhetoric and/or surprise with an early hike. We expect the Reserve Bank to begin its tightening cycle in 2018 but not until 3Q with the cash rate peaking at only 2.75% over the following 2 years. High household debt will keep the economy susceptible to adverse shocks transmitted via weaker household incomes. However, this is becoming less likely in a world that remains on an upward growth trajectory.

Debt servicing highly sensitive to rising rates



Source: Macquarie Research, MWM Research, March 2018

The first estimates for 2018/19 capex spending as well as 4Q wages were released. Both sets of data support a solid although not spectacular picture for the domestic economy. Growth in 4Q wages was slightly stronger than expected but private sector wage growth remained weak, growing only 0.48% for the fourth consecutive quarter and 1.9% year on year (YoY).

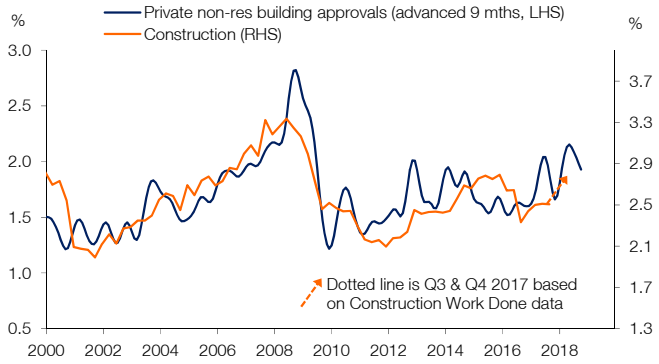
Real wages growth remained subdued at just +0.2% YoY, or basically zero for private-sector workers! It is hard to agree with the RBA's view that any pick-up in wages growth over the next few of years is likely to be gradual. Even as the drag on wages growth from Australia's lower terms of trade wanes, the global experience has been that wages growth has improved only slowly despite unemployment rates falling to, or beyond, levels consistent with estimates of 'full employment'.

Wage growth still paltry

Source: Macquarie Research, MWM Research, March 2018

Finally, the capex intentions survey was also released during the month and this showed encouraging trends in our view. We think the first cut at 2018/19 expectations support the view of growth in private non-residential building, that there remains a large pipeline for infrastructure work (supporting our call on capex-related equity stock exposure) and with some signs of a rise in mining capex outside the LNG sector that has dominated prior spending trends.

Private sector building approvals rising quickly



Source: Macquarie Research, MWM Research, March 2018

Australian equities – low return but lower risk

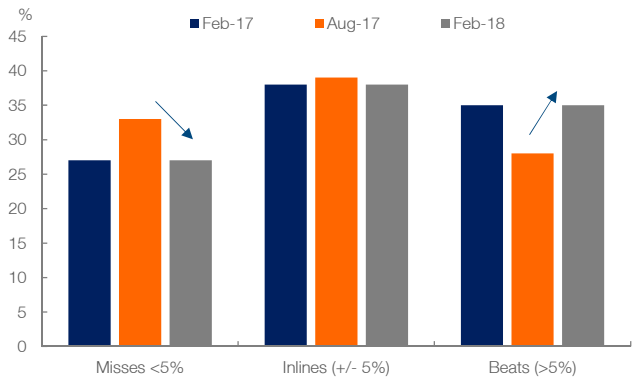
We upgraded Australian equities to overweight in our last Investment Matters report and while it was a volatile month for markets, Australia came through relatively unscathed. Despite dropping 193 points on the 6th February to post the single largest fall since September 2015, the Australian equity market finished the month down only 0.4% (a credible outcome against US equities which fell 3.9% and Europe which was down 6.1%).

The outlook for Australian equities remains relatively attractive although without the potential for significant large upside surprise. Australia lacks the earnings growth upside of other more cyclically concentrated global equity markets, but it has been true to form (acting as a low beta) through the past month as volatility has risen. We think this will be a key attraction over the coming 12 months as variability in equity markets becomes much greater.

If the domestic economy can deliver on current growth expectations (Macquarie Research estimates 3.0% for 2018 and 2.6% for 2019) then we see the potential for some minor upside in earnings growth estimates via banks, construction, resources and even some consumer areas which have been savaged over the past 12 months on a combination of fears – not least Amazon's entry.

The next 12-18 months will be a bumpy ride for domestic equity investors. However, the risks that appear to have captured the majority of mind share – rising interest rates, an overleveraged consumer, expensive valuations and a lack of earnings growth – are headwinds for outperformance rather than reasons to become overly negative in aggregate.

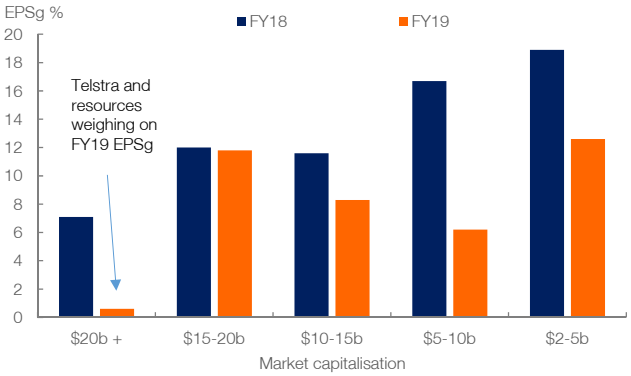
Reporting season was an improvement on August



Source: Macquarie Research, MWM Research, March 2018

February saw the conclusion of the bi-annual corporate reporting season which on balance was not a lot different from the trends that have generally been established in the half year reporting season for the past 3-4 years. That is, earnings surprises and disappointments were quite evenly split, current year estimates were downgraded (across the board) while the next forecast period was upgraded. In fact this has broadly been the trend of analyst revisions into and out of the reporting season since we saw the last upgrade cycle back in 2006.

Mid/small caps driving earnings growth



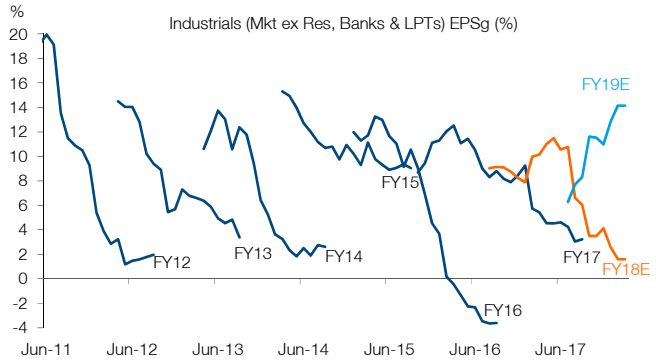
Source: Macquarie Research, MWM Research, March 2018

Smaller companies delivered the largest number of surprises, both positive and negative, and as we have seen post the GFC, are also set to deliver stronger earnings growth than their large-cap peers. Australian blue-chips are offering meagre earnings growth in FY19 primarily due to the banks (~1-4%), Telstra (-5%) and the diversified miners (-10 to -20%). CSL (+19%) is the only notable exception and continue to growth at a level that squares with its very elevated valuation multiple.

The more compelling growth of mid/small caps is being driven by a greater exposure to offshore economies (Aristocrat, Cochlear and Treasury Wines), cyclical strength (Boral and James Hardie), disruptive technologies (REA Group, Seek and Wisetech Global) and an uplift from US tax cuts. While banks don't offer much in the way of growth, they are our preferred sector (over bond-proxies) for those seeking income due to attractive valuations and fully franked yields. The sector is now trading back close to what we would consider "crisis" levels seen during the GFC and again when they raised capital in 2015.

The chart below illustrates forecast earnings growth for industrials (ex banks, resources and A-REITs). It tells a familiar story with FY19 industrial earnings growth looking overly optimistic. If history is a guide, analyst numbers will be downgraded as the year rolls on. QBE currently accounts for approximately one third of FY19 earnings per share growth (EPSg) and will be key to whether earnings are maintained. We think 5-10% is more realistic and would be a good result relative to prior years. Adding a 4-5% dividend yield would then get us close to an 8-10% total return.

Earnings growth looks optimistic as usual



Source: Macquarie Research, MWM Research, March 2018

We reiterate our key views below:

1. Remain overweight areas with strong and/or transparent earnings upside. We think this applies to commodity stocks (energy and mining), those with direct offshore earnings exposure (US and Europe), those leveraged into the "investment" thematic (private sector via mining and public sector via infrastructure) and banks (as a benign credit cycle offers the potential for write backs in provisioning). We like Alphinity Concentrated Australian Share (HOW0026AU) and Bennelong Concentrated (BFL0002AU) as high conviction Australian equity managed funds.

2. Underweight bond-proxies. We continue to avoid pure income generating rate sensitive areas which are suffering from structural issues and price pressures (Telcos & retail REITs) with a preference towards income generating growth stocks (Infrastructure) and/or those which are historically cheap with some pricing power capacity (Banks). Our preferred income fund is Nikko AM Australian Share Income (TYN0038AU) and our preferred income constituents are shown in the Equity Portfolio tables on page 17.

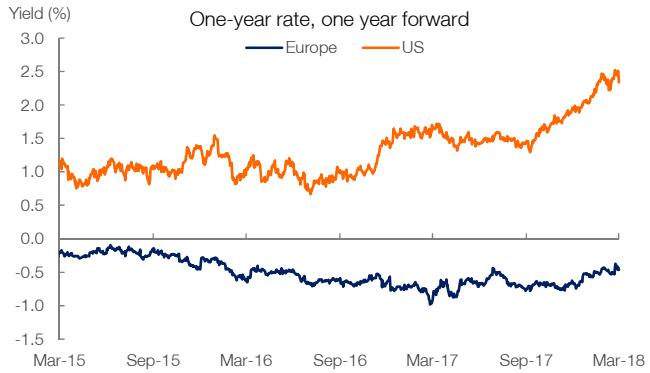
3. Overweight offshore Industrial stocks which are leveraged into the global upswing (predominantly the US after recent tax cuts). Money managers have a short window for flows and performance driver upside. We like Aristocrat Leisure (ALL), Boral (BLD), James Hardie (JHX), Bingo (BIN), Brambles (BXB), CSL, (CSL), Reliance Worldwide (RWC) and Treasury Wine Estates (TWE).

International equities – Persevering with pro-cyclical allocations

We are revising our tactical view on European equities relative to the US. We are overweight both US and Europe but switch the relative preference at a regional level with Europe now preferred over the US. This decision takes into account a number of factors which we think tilts the scales back in favour of Europe. We still believe that these are the two best markets to be invested in for the time being, and we retain our clear preference for equities over fixed income.

Firstly, interest rates. The coming 12-18 months will see interest rates diverge markedly as the US continues with its rate tightening cycle, and Europe maintains its bias towards monetary policy accommodation orchestrated by the European Central Bank (ECB) president Mario Draghi.

Europe and US on vastly different interest rate paths



Source: FactSet, MWM Research, March 2018

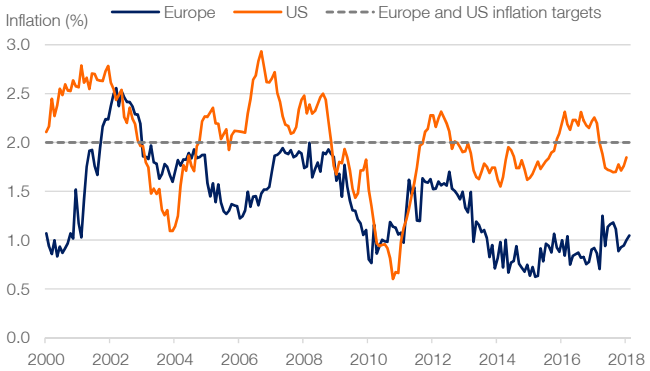
We accept that there is the risk of another exogenous shock, although we would attribute only a slim probability to such an event occurring (e.g. geopolitical tensions/protectionism sparking retaliation/war, or the bursting of the debt bubble in China). In the event that a shock precipitates a rapid contraction in global economic activity, the economy with higher interest rates will tend to have greater capacity to absorb the shock, reducing rates in order to help stimulate growth. The US is well into a tightening cycle, with a further four interest rates hikes expected in 2018, and embarking on a programme of balance sheet normalisation.

In Europe, the key interest rate is negative and quantitative easing (QE) measures are very much still in play. However, the stimulatory effect of the ECB's accommodative policy stance is working, and the broader European economy, driven by powerhouse Germany, is increasingly gaining momentum.

Secondly: inflation. Globally, inflation remains weak but there is clear evidence that a trend of steadily increasing prices will emerge in the US, driven by an acceleration in wage growth. Wage growth is widely reported to have been the catalyst for the equity market sell-off in early February, technical factors aside. Further strong wage and inflation prints emanating from the US could prompt yet another leg down in equity markets, which may trigger broader impacts in the real economy. Core consumer price inflation is approaching the 2% threshold desired by the Federal Reserve. Further to this, the wave of deflation and disinflation being exported from China is also diminishing, and in economies like the US that run enormous trade deficits, this was playing havoc with attempts to achieve price stability.

In Europe, inflation remains tepid, and there is no urgency that the ECB get in front of the inflation curve- there is no curve. This implies the highly accommodative stance of monetary policy will be maintained. The data suggests that inflation may have bottomed, and comments made by Draghi indicate that he is confident aspects of the quantitative easing programme can be wound back this year, satisfied the ECB's 2% inflation target is finally within reach. However, there is a big question mark over the degree of economic slack that exists in the European economy, which may mean it takes longer than expected to hit 2% inflation.

Europe is a long way from its inflation target



Source: FactSet, MWM Research, March 2018

Thirdly: economic slack, or the output gap. This refers to the difference between actual output and potential output. In the US, the economy is currently operating at, or slightly beyond, potential. The unemployment rate is at its lowest point since December 2000 and is now below the estimate of non-accelerating inflation rate of unemployment. This implies an inflationary impulse is not far behind. The Trump administration's fiscal stimulus will push the economy further beyond potential output, likely leading to overheating, necessitating Federal Reserve action on interest rates to control inflation.

There is actually a trade-off being made here- faster growth now, deeper recession later. In Europe, the situation is quite different. There is plenty of slack left in the economy, a long growth runway you might say. Nowhere is this more visible than in the labour market, where unemployment is currently 8.7% versus 4.1% in the US. Europe can continue to grow for some time, absorbing economic slack, before inflation and the need for tighter monetary policy becomes a hindrance. Europe's labour markets have largely healed, with many of the structural and frictional impediments that prevented firms from finding workers having subsided.

Fourthly: the business cycle. The timing of the end of the business cycle is closely tied to the inflation outlook. In the US, the business cycle is late stage. Now, consider the US$1.5 trillion to be spent goosing a US economy that is running at (or beyond) potential output. Markets have been anticipating the effect this may have and stocks have responded favourably. However, the possibility exists that little incremental growth is delivered by this largesse, as the economy can't run much hotter. Inflation would be the result, forcing the Fed to act quickly to avoid falling behind the inflation curve. We feel that the downside to investors perhaps outweighs the upside at this late stage, particularly in light of recent events that have largely been attributed to inflation data.

Europe is an economy in which manufacturing represents a far larger component of output than it does in the US. Based on leading economic indicators and business survey data, Europe is seeing a broad-based expansion in manufacturing activity. We expect Europe, notably Germany, to benefit disproportionately from faster global growth.

European cyclicals EPSg 50% higher than in the US

Source: FactSet, MWM Research, March 2018

Fifthly: the earnings upgrade cycle. This is well advanced in the US, and in its early stages in Europe where better than expected economic performance is flowing through to company earnings. Europe is currently growing earnings per share (EPS) at 22.5% versus US's 17.2%. European industrials, a cyclical sector, is growing EPS at 25.1%, 7.6ppts ahead of the US equivalent. The European consumer discretionary sector, also cyclical, is growing earnings at 29.0%. In the US, discretionary EPS growth is 10.7%. The narrative around cyclical earnings growth in Europe is compelling, and we expect these conditions to persist at least for the rest of the year. European equities are approximately 15% cheaper than the US, although there are structural and regulatory reasons that prevent this gap from normalising.

We feel political risks in Europe are receding and the unity of the continent is much stronger now than immediately after Brexit. On the currency, the euro has rallied since early 2017, gaining 16%. If this trend continues, it will weigh on the competitiveness of the region's exporters and impact earnings via translation effects. However, we believe the prospects for European economic growth overwhelm the currency impacts at this stage, and a reversal in US dollar weakness could amplify European earnings growth.

For tactical tilts to European cyclical growth, we prefer Platinum Europe Fund (PLA0001AU) which has ample exposure to cyclical sectors. For passive exposure, options include Vanguard FTSE Europe Shares ETF (VEQ) and iShares Europe ETF (IEU). Investors should note the above ETFs have an approximate 30% exposure to the UK while Platinum Europe only has a 12% allocation to the UK.

Asset class Preferences – Upgrade Europe

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Allocation					
Australian Equities					
International Equities					
US					
Europe					
Japan					
EM					

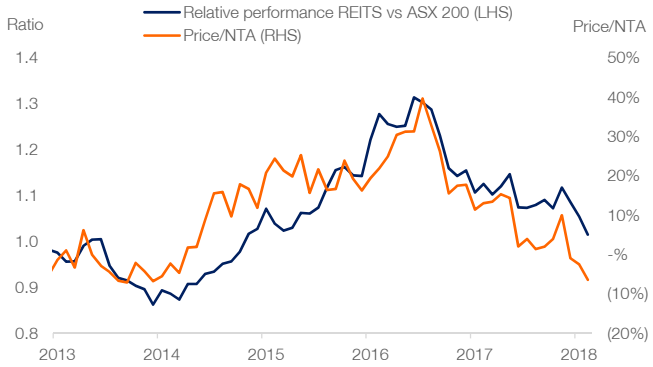
Source: MWM Research, March 2018

Real assets – Still not cheap enough to cushion for rising rate risks

We maintain an underweight position on listed property. The sector is down 9.2% in absolute terms since peaking on 1 August 16 and down 23.3% in relative terms over the same period of time. However, valuation de-rating has been driven by a change in the cost of capital as well as a gradual deterioration in the earnings growth backdrop and growth drivers for key areas such as retail and residential.

In part, this price decline was also a function of reversing out some of the valuation expansion that had occurred simply because the sector had been exposed to falling bond yields (the entire outperformance that began in 2013 has unwound over the past 12 months).

A-REITs have given back 3 years of gains

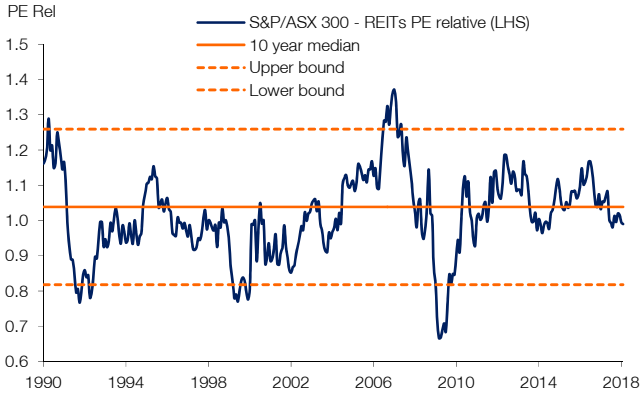


Source: Macquarie Research, MWM Research, March 2018

The bull case for REITs is that they are now beginning to discount a meaningful increase in bond yields. Passive A-REIT rent collectors are back to trading at a 6% discount to net tangible assets (NTA) versus an exceptionally overvalued peak of 40%! Similarly, the dividend per share (DPS) spread versus the 10-year bond yield sits at 260 basis points which is a relatively large cushion compared with the historic average of 200 basis point.

However, the premium to the bond yield has been bouncing around between 220-270 basis points for the past year and we do not see this as the trigger for driving a change in investor perceptions around valuation nor asset allocation. As we know, relative valuation can change via either the 10 year bond yield rising at the same time capital values decline. If we incorporate Macquarie's 10-year bond yield forecast of 3.3% for year-end 2018, the DPS-bond yield spread would compress back to the long term average of 200 bps. If the bond yield were to rise further, this would imply that A-REIT's have further downside and are not priced attractively at the current spread.

REIT's are not sending a strong "buy" signal

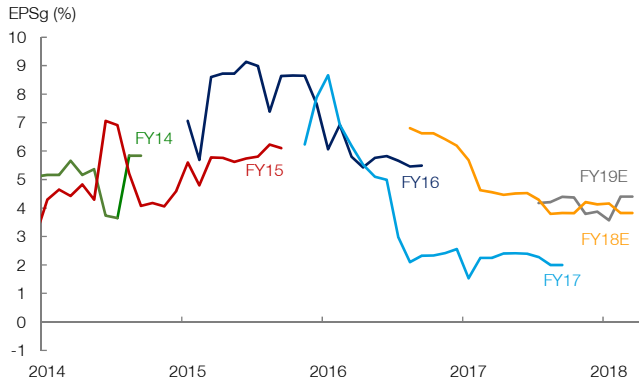


Source: Macquarie Research, MWM Research, March 2018

We did not see the reporting season as a meaningful upside catalyst for the domestic property sector. Macquarie revised 2018 earnings growth from 4.2% down to 3.8% but offset these downgrades with a commensurate upgrade to 2019 estimates which went from 3.6% up to 4.4%. Goodman Group (GMG), Dexus (DXS), SCA Property (SCP) and Charter Hall (CHC) upgraded their FY18 guidance, whilst Vicinity Centre (VCX), Scentre Group (SCG) and GPT reported guidance slightly below Macquarie's expectations. Mirvac (MGR), Dexus (DXS) and Lend Lease (LLC) announced new buybacks, while Vicinity (VCX) surprisingly paused its current buyback due to capital requirements for mall redevelopment and the new mixed use strategy.

Some of the key themes from the reporting season were: continued challenging conditions for retail REITs; moderating apartment pre-sales, but low defaults and strong land and lot developer margins; and moderating headline numbers for office REITS due to asset specific issues.

A-REITs not showing much earnings growth upside

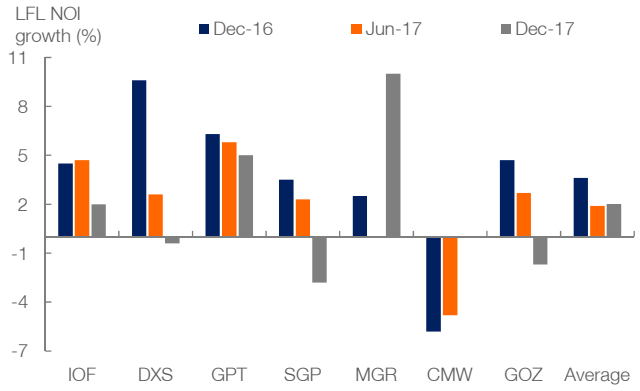


Source: Macquarie Research, MWM Research, March 2018

Retail: Generally poor. Most retail REITs reported moderating comparable net operating income in 1H18. Average retail releasing spreads have slowed with GPT and Scentre Group (SCG) reporting negative leasing spreads. Tenant retention have deteriorated across retailers (VCX reported 54% retention rates vs historical average of 70-80%). This has driven greater tenant churn, downtime (GPT: average holdovers tenancy for retails is 10 months) and increasing short-term leases. Retail REITs also reported elevated capital expenses (capex), with Mirvac (MGR) spending twice as much than its peers to support their stronger rental spreads and sales growth.

Office: The headline numbers for office REITs was not as strong as expected predominantly due to specific asset expiries and one-offs. Excluding specific asset issues and one-offs, Investa Group (IOF) and Dexus (DXS) reported 4.5% like-for-like (LFL) net profit income growth and 6.1% comparable net operating income (NOI) growth. However, underlying metrics are still strong, with positive releasing spreads (MGR: 12.2%, IOF 6.8%) and strong occupancy (IOF 97%, DXS 96.5%). Sydney and Melbourne office markets continue to be strong, while Perth and Brisbane remain weak.

Office REITs impacted by one-offs



Source: Macquarie Research, MWM Research, March 2018

Residential: Increasing land prices and continued demand from owner occupiers are driving strong land and lot developer margins. Mirvac (MGR) reported 40% price growth in some residential sites with 50% of its lots reported gross margins of more than 25%. Apartment pre-sales continue to moderate with further delays in settlement, but defaults remain low at less than 1% for LLC and less than 2% for MGR.

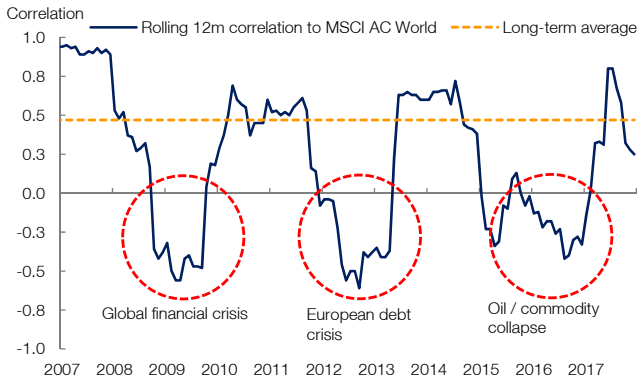
We expect tighter regulations and lending conditions, deteriorating affordability and an increase in borrowing costs will continue to impact negatively on the residential markets. According to CoreLogic, national dwelling values declined 0.1% in February following a 0.3% fall recorded over previous two months. Macquarie forecast national housing price growth to be in low single digits on average for the next several years.

Alternatives – offering diversification when most needed

Alternatives provide diversification benefits for multi-asset portfolios due to the low correlation with traditional asset classes. We recommend a maximum overweight in alternative assets amid lofty equity valuations, rising bond yields, a reduction in central bank liquidity (unwind of QE) and increasing de-synchronization of economic growth and inflation cycles.

This month we focus on systematic macro, also known as managed futures or commodity trading advisers (CTAs). CTAs utilise statistical/quantitative trading programs to exploit strong, persistent directional moves by taking long or short positions in liquid futures contracts across equities, bonds, commodities or currencies.

Correlation is low when protection is most needed



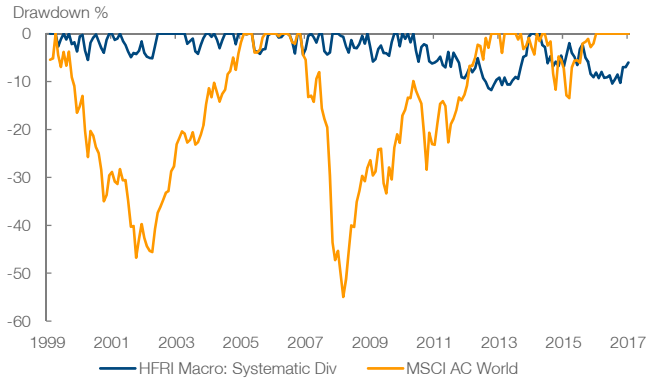
Source: Markoff Processes International, MWM Research, March 2018

Alternative assets are good portfolio diversifiers over longer periods of time or when market conditions are changing as we see happening now. Historically, this asset class has had a relatively low correlation with equity markets. More importantly, this correlation is negative when markets suffer corrections. This was the case for CTAs during the tech crash (2000-2002), the global financial crisis (2008-2009) and the European debt crisis (2010-2012) as illustrated in the above chart.

CTAs have had a tough decade (as Warren Buffet's famous bet that the S&P 500 would outperform a selection of hedge funds for the 10 years post the GFC proved). This was partly due to the lack of persistent trends in other markets, low volatility and high correlations.

However, as we move into a maturing economic cycle, with central banks commencing / stepping up their interest rate hiking cycles and unwinding QE stimulus, together with a divergence in monetary and fiscal policies, the result should be greater volatility, falling cross-asset correlations and increasing dispersion in performance across asset classes that provide a more fertile environment for macro hedge funds.

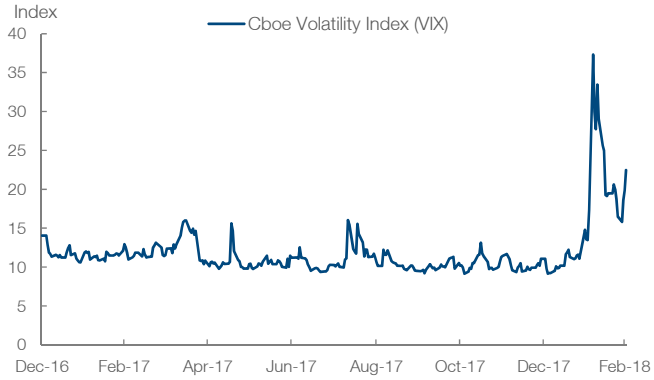
CTAs performed better in times of crisis



Source: Markoff Processes International, MWM Research, March 2018

The recent spike in volatility and unwinding of short volatility trades reflects the much needed re-pricing of risk. We don't think this is the time to be bearish, but do believe that alternatives offer a useful hedge that will profit if markets do go through a more sustained correction and if correlations continue to break down.

A spike in VIX "fear gauge" hurt CTAs in February



Source: IRESS, March 2018

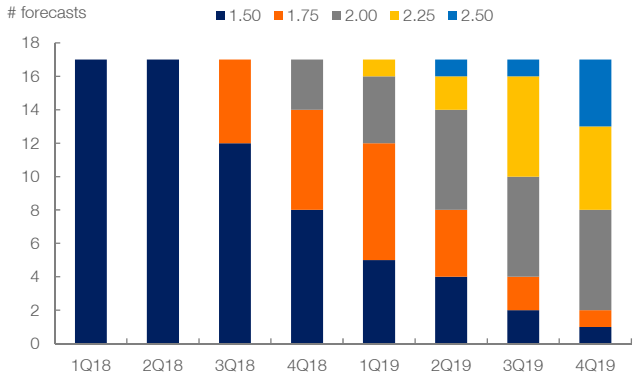
Our preferred alternatives fund is Winton Global Alpha, which is a multi-asset manager that invests across bonds, rates, base metals, precious metals, crops livestock energy, currencies and equities. Winton now considers non-trend following forecasts, which helps diversify sources of returns. This differentiates Winton from its peers.

Fixed interest and cash – Stick with the big trends

We continue with our tactical underweight to fixed interest. Our preference remains towards short duration investment grade credit over government bonds. Domestically, recent inflation data suggest there is no strong imperative for the RBA to follow other global central banks and raise the cash rate until at least the back part of 2018. Market pricing for an RBA rate hike has shifted lower in the past few months. A mid-year rate hike was a 50/50 bet in early January but is now priced at only a 20% chance. The key variables of inflation and wage growth have remained soft while jobs data was a little patchier (reliant on part-time jobs growth) than was the case through late 2017.

At this stage, Macquarie maintain the case for two rate hikes in 2H18, but acknowledge the risks of a later 'lift off' – potentially in 2019. This risk appears heightened after a soft run of data with several economists recently shifting their 2018 rate hike forecasts into mid-2019. While there is a significant amount of attention towards when the RBA will list interest rates, we think it is becoming a moot point.

Economists have mostly deferred rate hikes to 2019



Source: Bloomberg, MWM Research, March 2018

Whether the RBA bank raise rates in 3Q18, 4Q18 or 1Q19 should not have a material impact on how we see the path for financial assets or for borrowing rates (particularly as banks have been pushing through out-of-cycle rate hikes for the past 12 months). Banks have already been doing a lot of the hard work for the RBA as they have been responding to the prudential regulator by tightening credit conditions. Slowly deflating Sydney and Melbourne housing markets in recent quarters has been a credible outcome. We think the real downside for property will come when the RBA begins to formally raise interest rates but this remains some time off.

Movements in the US bond yields have been the key development for the past 4-6 weeks. Jerome Powell, the newly appointed Fed Chair, surprised investors by talking up the strength of the US economy in early February and expressing confidence that inflation would increase through 2018. The comments have pushed the US 10-year inflation breakeven rates to levels not seen since mid-2014.

Inflation expectations repriced, contained for now

Source: St. Louis Federal Reserve, MWM Research, March 2018

The US 2-year is hovering around a recent high of 2.25% while the 10-year is touching 3.00%. Macquarie now expect the Fed to raise rates 4 times in 2018 with the potential for a further 3-4 rate hikes in 2019 (~200bps). This is likely to push the US 10 year yield up to a cycle peak of 3.75%. We don't think the market has fully factored in these rate expectations yet. We think it's still too early to get positive on government bonds, but duration could have some appeal in the year ahead. For the moment we prefer well diversified short duration investment grade credit which limits duration risk and the potential downside of higher yields.

Our preferred credit funds are listed below:

- Kapstream Absolute Return Income Fund (HOW0052AU)
- Macquarie Income Opportunities (MAQ0277AU)
- VanEck Australian Floating Rate ETF (FLOT)

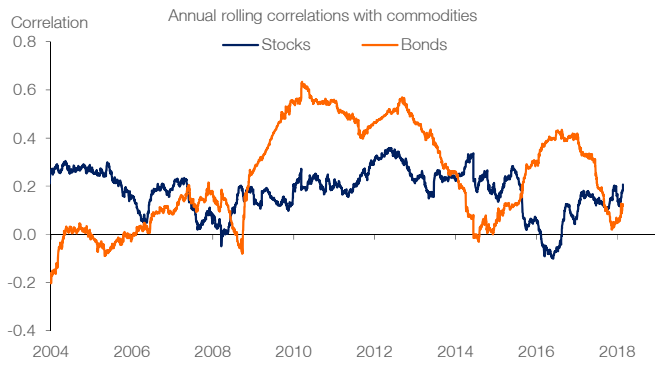
Commodities – offering a low correlated hedge against inflation

We now recognise a potential new driver for commodities demand and prices, based on a shift in the market perception about growth and inflation. A combination of strong global growth, a large US fiscal stimulus, and the presence of inflation in the US has prompted investors to leverage growth (rising demand) but to hedge against inflation. We think commodities, as an asset class, offer investors these properties.

More specifically, we think the following developments over the next few years will allow a strong contribution from commodities to portfolio returns: 1) Multiple rate hikes: Macquarie now forecast 4 US Fed rate hikes in 2018 with an additional 3-4 hikes in 2019; US 10-year yields to rise to 3.00% by late-2018 and hit a cycle peak of 3.75% by sometime late 2019; and 2) Macquarie expects further US dollar weakness, believing that the currency has peaked and will experience sustained downward pressure in coming years on an increased US budget deficit and ECB tightening.

We also see commodities as appealing on the grounds of relative value, as investors increasingly recognise strengthening aggregate demand growth and inflation drivers. Global growth has improved and looks more sustainable. While this does not mean that commodity prices will always go up, it does suggest a period of relative stability ahead, after the turmoil of the past few years. Unlike bonds, strong global growth will benefit commodities, with industrial commodities still giving good leverage to the industrial cycle (we expect global industrial production growth to remain well above average both this year and next).

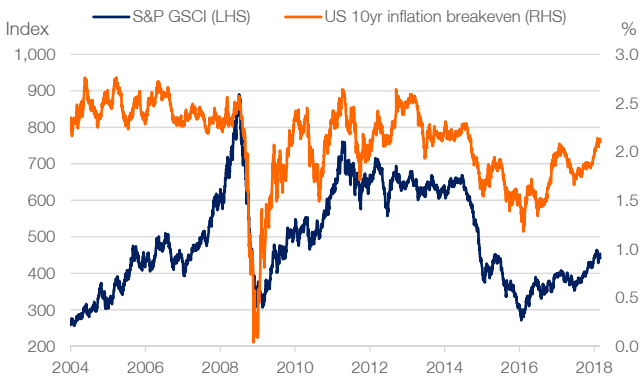
Commodities: strong positive correlation to inflation



Source: Macquarie Research, MWM Research, March 2018

Increasing inflation is also positive for commodities. While much of the focus is on the benefits of precious metals as an inflation hedge, gradually increasing inflation is also supportive for the industrial commodity complex, with commodities often the source of near term inflation, thereby providing an effective hedge.

Commodities: strong positive correlation to inflation



Source: FactSet, MWM Research, March 2018

Following the results of the US Department of Commerce (DoC) Section 232 investigation on steel imports into the US, President Trump announced the intention to implement 25% tariffs on steel imports and 10% on aluminium imports. This is at the more punitive end of the three proposals submitted by the DoC to the President. While this has boosted the prices of US steel producers, it will weigh on the competitiveness of the wider US manufacturing sector.

The biggest losers from the implementation of blanket tariffs on steel are likely to be Canada, Mexico and Brazil, while China is not even among the top ten economies importing steel to the US.

Our US economist believes the direct impact of the tariffs on the US economy will be relatively modest (total imports of steel and aluminium are ~US$46bn (~0.25% of GDP). Impacts could prove more severe for trade partners, particularly Canada (largest exporter of both products to the US).

There has been no change to our preferences within the commodities space. We continue to prefer precious metals to base and industrial metals.

Strategic portfolios

The strategic portfolios are designed for long-term wealth accumulation. They are driven by strategic asset allocation and the selection of best of breed investment managers. The portfolios are designed for five risk profiles at three levels of active management. The intuitive structure enables the two most important investment decisions to be made:

1. What mix of assets best fits my risk profile?

2. How much active or passive management to include?

These portfolios are built for long term investing. The models range from the passive, low cost, broadly diversified and tax efficient portfolios (Core), through a core-satellite approach (Core Plus), to actively managed funds offering potential for outperformance (Active). The strategic portfolio is unlikely to be the best performer in any one period, but is designed to preserve wealth in crises and participate in good times and in so doing, grow the most over the long term.

Asset class	Style	Investment	APIR Code / Ticker
Domestic Equity	Active	Investors Mutual WS Australian Share	IML0002AU
		Alphinity Wholesale Australian Equity	HOW0019AU
		SGH ICE	ETL0062AU
	Passive	iShares core S&P/ASX 200 ETF	IOZ
International Equity	Active	MFS Global Equity Trust	MIA0001AU
		Magellan Global	MGE0001AU
		Lazard Global Small Cap W	LAZ0012AU
		Aberdeen Emerging Opportunities	ETL0032AU
	Passive	Vanguard MSCI Index International Shares ETF	VGS
		iShares MSCI Emerging Markets ETF	IEM
Domestic Property	Active	Cromwell Phoenix Property Securities	CRM0008AU
	Passive	Vanguard Australian Property Secs Index ETF	VAP
International Property	Active	Resolution Capital Global Property Secs	WHT0015AU
	Passive	Vanguard Intl Property Secs Index Fund (Hdg)	VAN0019AU
Growth Alternative	Active	AQR WS DELTA 1F	PER0554AU
		Winton Global Alpha	MAQ0482AU
	Passive	ETF Physical Gold	GOLD
Domestic Fixed Interest	Active	Legg Mason Western Asset Aus Bd A	SSB0122AU
		Kapstream Wholesale Absolute Ret Inc Fd	HOW0052AU
	Passive	iShares Core Composite Bond ETF	IAF
International Fixed Interest	Active	PIMCO Global Bond W	ETL0018AU
		Macquarie Income Opportunities	MAQ0277AU
	Passive	iShares Core Global Corporate Bond (A$ Hdg) ETF	IHCB
		Vanguard Intl Fixed Interest Index (Hdg) ETF	VIF

Please contact your adviser to choose a portfolio which is appropriate for your return objectives and risk tolerance.

Equity portfolios

Growth portfolio

Code	Company	Recommendation	Target price ($)	EPSg (%)	ROE (%)
A2M	The a2 Milk Company	Outperform	13.00	125.3	55.5
ABC	Adelaide Brighton	Outperform	7.00	21.4	17.5
ALL	Aristocrat Leisure	Outperform	26.35	30.9	47.8
AMC	Amcor	Outperform	16.15	5.5	82.2
ANZ	ANZ Banking Group	Outperform	31.00	-0.6	11.3
BHP	BHP Billiton	Outperform	36.40	29.2	14.9
BLD	Boral	Outperform	8.50	10.1	8.7
BXB	Brambles	Neutral	9.92	7.7	21.4
CBA	Commonwealth Bank	Neutral	80.00	-1.8	15.1
CIM	CIMIC Group	Outperform	51.41	10.9	22.0
CSL	CSL	Outperform	172.00	21.7	44.2
JHX	James Hardie	Outperform	26.25	13.9	-165.3
MFG	Magellan Financial	Neutral	29.70	17.1	51.1
NAB	National Australia Bank	Outperform	32.50	-1.3	12.7
OML	oOh!media	Outperform	5.10	2.7	13.4
ORA	Orora	Outperform	3.54	11.9	13.2
RHC	Ramsay Health Care	Outperform	74.50	8.2	24.3
RWC	Reliance Worldwide	Outperform	5.10	31.0	37.1
SEK	Seek	Neutral	20.35	2.7	14.2
SIQ	Smartgroup	Outperform	11.53	14.8	30.8

Income portfolio

Code	Company	Recommendation	Target price ($)	Yield (%)	Franking (%)
AMC	Amcor	Outperform	16.15	4.2	0
AMP	AMP	Outperform	5.65	5.3	90
ANZ	ANZ Banking Group	Outperform	31.00	5.7	100
AZJ	Aurizon Holdings	Outperform	4.91	6.4	65
CBA	Commonwealth Bank	Neutral	80.00	5.8	100
CGF	Challenger	Neutral	12.95	2.9	100
DLX	Dulux Group	Neutral	8.00	3.7	100
DXS	Dexus	Outperform	10.52	5.1	0
GPT	GPT Group	Outperform	5.63	5.4	0
NAB	National Australia Bank	Outperform	32.50	6.6	100
SHL	Sonic Healthcare	Neutral	26.30	3.2	20
SUN	Suncorp Group	Underperform	13.25	5.4	100
SYD	Sydney Airport	Neutral	6.40	5.7	0
TAH	Tabcorp	Outperform	5.60	4.3	100
TCL	Transurban	Outperform	12.44	4.9	6
TLS	Telstra	Neutral	3.55	6.7	100
WBC	Westpac	Outperform	35.00	6.6	100
WES	Wesfarmers	Outperform	46.30	5.3	100

Monthly performance - February 2018

Australian equities

Reporting season results were largely overshadowed by a rapid deterioration in sentiment emanating from overseas equity markets. The S&P/ASX 200 Accumulation Index closed February 0.4% higher. The best performing S&P/ASX 200 sectors were HealthCare (+7.0%) and Consumer Staples (+2.2%) while Telecoms (-6.0%) and Energy (-3.7%) were the worst performers.

Amongst larger companies the best returns were from Insurance Australia (IAG, +15.2%) and CSL Limited (CSL, +11.4%), with the latter recently announcing a stronger-than-expected half year result. The underperformers were Woodside Petroleum (WPL, -9.0%) and Telstra Corporation (TLS, -6.7%), both of which saw the significant sell-offs over the course of the month.

The S&P/ASX Small Ordinaries Accumulation Index underperformed the S&P/ASX 200 Accumulation Index, finishing the month unchanged. The largest contributors were Nine Entertainment (NEC, +35.7%) and Mesoblast Limited (MSB, +32.84%).The detractors were a beauty care products manufacturer BWX Limited (BWX, -34.1%).

International equities

Major global equities markets closed in negative territory. What began in the US as a technical correction, became a fundamental repricing of equities valuations on firming expectations of Fed rates hikes. The Dow Jones led the fall with a 4.3% monthly loss, followed by the S&P 500 (3.9%) and Nasdaq (-1.9%).

Widespread weakness was recorded across European bourses. The worst regional performers were Spain (IBEX 35,-5.8%), Germany (DAX, -5.7%), the UK (FTSE 100, -4.0%), followed by Italy (MIB 30, -3.8%) and France (CAC 40, -2.9%).

The shorter month due to Chinese New Year Holiday did not see equities markets spared the rout that shook US and European stocks. The Shanghai Composite lost 6.4%, while the Hang Seng Index shed 6.2%. Japan's Nikkei also slipped 4.5% over the course of the month.

Property

Australian REITs continued to face the downward pressure, closing with a second consecutive monthly loss. The S&P/ASX Property Trusts Accumulation Index shed 3.29%. The winners among the property sector were National Storage (NSR, +2.0%) and Goodman Group (GMG, +1.5%), while Vicinity Centres (VCX, -7.8%) and Iron Mountain Incorp (INM, -5.9%) lagged.

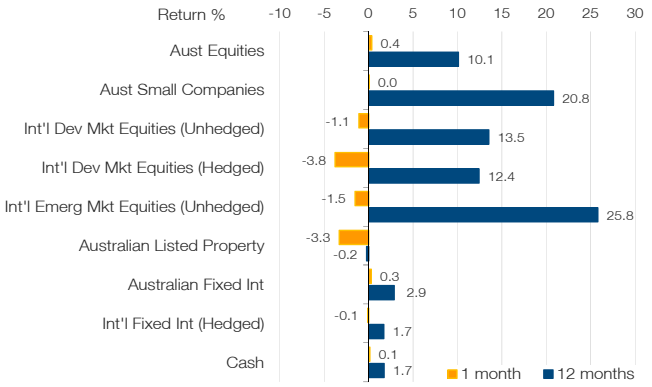
Fixed interest and cash

The US 10-year bond yield finished the month at 2.9%, after briefly reaching a four-year high of 2.95%. The 10-year Australian government bond yield was flat at 2.78%. The Bloomberg AusBond Composite 0+Yr Index added 0.3%, with Corporate bonds (+0.4%) outperforming Government bonds (+0.3%). Short-term (0-3-year) and long-term (+10-year) bonds both recorded a gain of 0.2%.

Currency

The $A/$US continued to drift lower on a weakening Australian dollar, falling by 3.7% to close at $0.7762. The $A also depreciated against other major currencies, including Japanese Yen (-5.9%, 82.82), Euro (-1.9%, 0.6365), New Zealand Dollar (-1.5%, 1.0770) and the UK Pound Sterling (-0.7%, 0.5640).

Market Performance – February 2018



Source: IRESS, Bloomberg, MWM Research, March 2018

Market performance – February 2018

Market Indices	1 month %	3 month %	1 year %	3 year %pa	5 year %pa
28 February 2018					
Australian Shares					
S&P/ASX 200 Accumulation	0.36	1.72	10.10	5.07	8.01
S&P/ASX 200	-0.36	0.77	5.32	0.49	3.34
All Industrials Accumulation	0.61	0.51	7.34	4.61	9.55
All Resources Accumulation	-0.68	7.30	24.07	6.92	1.80
All Industrials	-0.20	-0.56	2.44	-0.15	4.58
All Resources	-1.02	6.93	19.93	3.28	-1.56
S&P/ASX 100 Accumulation	0.37	1.71	9.22	4.69	8.05
S&P/ASX Small Ordinaries All Accumulation	0.03	2.67	20.81	10.81	6.22
International Shares					
MSCI World Index Hedged in A$	-3.77	0.81	12.43	7.02	11.40
MSCI World Index (A$ Unhedged)	-1.09	-1.03	13.52	6.19	14.65
MSCI Emerging Markets (A$ Unhedged)	-1.53	3.52	25.79	6.55	8.29
Regional Markets (local currency returns)					
Dow Jones	-4.28	3.12	20.26	11.34	12.23
S&P 500	-3.89	2.50	14.82	8.85	12.37
Toronto Comp	-3.19	-3.89	-0.13	0.45	3.79
Nikkei	-4.46	-2.89	15.43	5.49	13.81
German Dax	-5.71	-4.52	5.02	2.94	9.94
FTSE 100	-4.00	-1.29	-0.43	1.35	2.60
Hang Seng	-6.21	5.71	29.92	7.51	6.03
NZSE 50	-0.82	2.08	12.47	7.87	9.40
Property					
S&P/ASX 200 Property Trust Accumulation	-3.29	-6.24	-0.22	4.63	10.00
Cash and Bonds					
Bloomberg Composite Bond All Maturities	0.29	-0.50	2.87	2.42	4.08
Bloomberg Bank Bill Index	0.13	0.43	1.75	1.99	2.30
Citigroup World Government Bond Index Hedged	-0.10	-0.70	1.71	2.93	4.71
Citigroup World Government Bond Index Unhedged	2.96	-1.83	5.23	2.59	6.40

Source: IRESS, Bloomberg, MWM Research, March 2018

The Investment Strategy Team

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Head of Investment Strategy

James Freeman, CFA

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- Strategic Asset Allocation & Capital Market Estimates

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Fred Zhang, CPA

Research Assistant

- Data analysis
- Monitoring and reporting