MACQUARIE

Investment Matters

Courage under fire

MAY 2018

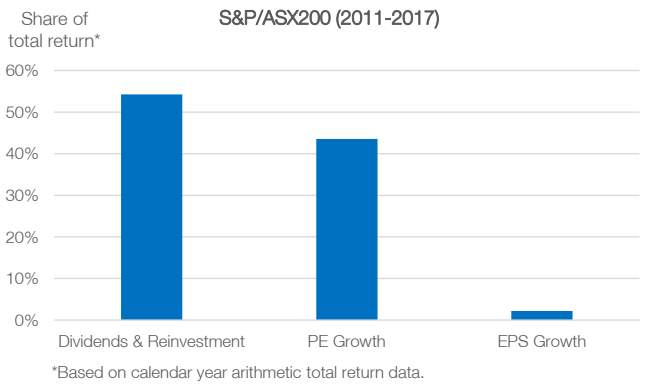
It has been a tough start to the year for equity markets which have oscillated between bouts of risk-on and risk-off.

The bulls have focused on solid growth fundamentals and (still) favourable equity market conditions. The bears have been focused on what is potentially around the corner – an end to the economic cycle and higher interest rates.

Unfortunately we don't see this tug-o-war between the bulls and the bears abating anytime soon. This means financial markets will be quick to price in positive news but equally quick to discount negative developments. In other words, the backdrop that has prevailed for the first 4 months of the year is unlikely to change much in the short term.

Every cycle ultimately comes to an end and one that has been so supportive for *"wall street"* over *"main street"* is unlikely to end without a small dose of pain. However, it is important to keep long term objectives in mind when markets are in a transition phase. Volatility breeds fear and behavioural characteristics drive investors to act on this fear. We urge some restraint over coming months and to focus on the underlying fundamentals for markets within the context of wealth creation goals.

PE expansion has accounted for 44% of total Australian equity market returns since 2011

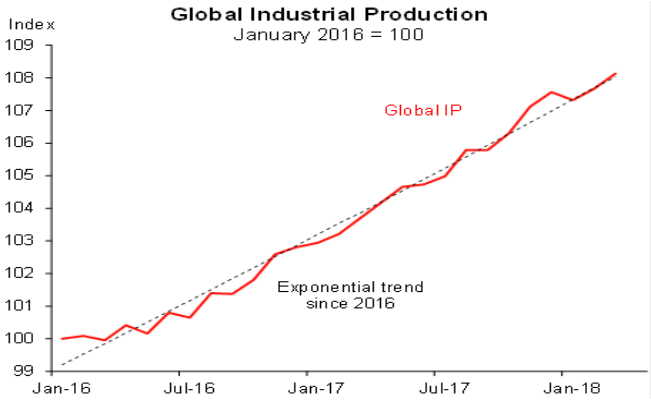


Source: FactSet, MWM Research, May2018

We think it is too early for investors to abandon risk assets in favour of defensive assets. Markets are returning to normal where investors must recalibrate return expectations lower and become reaccustomed to portfolio capital values that exhibit greater volatility. A maturing asset cycle is the time when portfolio diversification can have its greatest benefit in reducing volatility and spreading risk.

This is why we are recommending exposure to alternative assets which have a low correlation with equites and why we are underweight areas of vulnerability (property and interest rate sensitive stocks) rather than trying to push an outright defensive asset allocation at the present time.

Global Industrial Production back to trend



Source: Macrobond, Macquarie Macro Strategy, May 2018

Macquarie do not yet see signs that the global economic cycle is about to turn down and while growth momentum has likely peaked, the slowdown to date has been back towards the trend level. Similarly, while trade disputes are not likely to disappear, the fear that they will rapidly undermine the economic backdrop has faded substantially in recent weeks.

On the domestic front, we continue to see policy settings providing a highly supportive macroeconomic backdrop for the equity market (including a potentially positive pre-election Federal Budget containing some spending and tax cut sweeteners). This should help sustain business and consumer confidence as well as provide a growing tailwind for business investment into the second half of the year as house prices remain under pressure.

The constraint for the Australian equity market has been the substantial underperformance in recent months of interest rate sensitive sectors (Real Estate, Telcos and Utilities) as well as Financials (Banks). It has been encouraging to see the market rally so strongly off its April low supported by only a handful of stocks/sectors (Energy, Materials and Healthcare). On the other hand, without an improvement in breadth (the number of stocks that are rising versus the number of stocks that are falling), the equity market will struggle to reach a sustainable new high and will likely remain range bound and susceptible to swings in global sentiment.

We maintain our overweight to global equities versus bonds and expect the Australian equity market to perform solidly given undemanding valuations and easy monetary policy. We maintain our underweight to fixed income and believe the environment supports a maximum allocation towards alternative assets which have a low correlation with equities and provide strong portfolio diversification benefits by reducing volatility and providing some downside portfolio support.

We similarly remain underweight Property where despite the increased valuation appeal we think the asset class will struggle to outperform given the overhang of rising interest rates. We are less fearful of broader macro risks impacting the asset value cycle for the sector or that dividends are at risk, but investors should be prepared for a bumpy ride as the multi-year tailwind of compressing cap rates also begins to normalize and impact valuations. We still believe Europe and US equities will outperform Emerging Market (EM) equities through year end, but our tolerance has been tested year to date as a weaker US dollar has not seen pressure on EM currencies or a liquidity tightening as we have expected.

Jason and the Investment Team

Asset class preferences

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight	Reason
Allocation						
Australian Equities						Market remains supported by valuation and easy policy
International Equities						Equity market fundemantals still positive
US						High quality growth supported by strong earnings growth.
Europe						Value proposition with strong cyclical momentum
Japan						Solid run of fundamental data supported by monetary policy but market has run ahead
EM						Supported by rising growth but vulnerable to liquidity shifts and higher yields
Property						Passive REITs are cheaper but we prefer growth REITs
Fixed Interest						Underweight duration, continue to expect rising global rates
Alternatives						Hedge against equities and high volatility
Cash						Reflects a balance between stronger equity and weaker bond returns

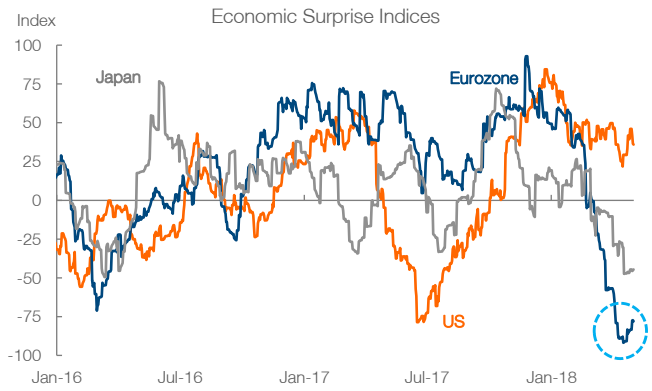
Source: MWM Research, May 2018

Global economics – A bumpy road ahead

- Global growth momentum has peaked but growth to remain above trend through 2018;
- Concerns around trade wars are fading but will remain an oscillating risk factor for markets;
- US continues to lead the economic recovery. China is slowing but not collapsing and Europe should recover from a weak first quarter.

Macquarie believe the synchronised global economic expansion remains intact despite growth momentum appearing to have peaked earlier in the year. This has been notable in Europe where business survey data has weakened from multi-decade highs with 1Q data confirming a slowdown in momentum from 2H17.

Citi surprise index – Eurozone bottoming out?



Source: Factset, MWM Research, May 2018

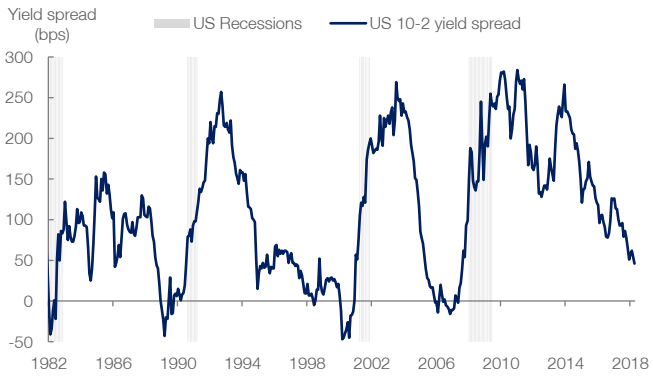
Our global economics team think that while the degree to which global growth slows down is uncertain, absent a major trade war, growth should remain above average over the course of 2018, with the US remaining a locomotive as the fiscal expansion and still easy monetary conditions support activity (see *Global Growth: Is the Slowdown Over? Beware the Prowling Bond Bear*).

They highlight that the Citi data surprise indices for both Europe and Japan also appear to be bottoming out - in the case of Europe at around the same level we have seen in recent mini cycles – providing further support to the idea that much of the growth slowdown has already occurred.

We reiterate the view that while a trade war remains a risk for the global economy, the economic impacts are likely to be less significant than the uncertainty that it is now adding to financial markets. Ultimately, we think markets have past the apex for uncertainty created by the threat of trade disputes even if they continue to drive periodic bouts of concern.

Elsewhere, we remain positive on the European economy despite a recent pullback in business survey data. Indicators suggest that the rapid expansion in regional activity will slow towards a more sustainable pace, albeit still above trend rates.

Yield curve still some way from inversion



Source: US FRED, MWM Research, May 2018

Should we worry about the US yield curve?

Macquarie's economics team do not think the flattening US yield curve (difference between the 2-year and 10-year bond yield) is yet a signal to get overly bearish. They believe that if the current trend of flattening were to persist then the curve would not invert until the middle of 2019. There is also no evidence that growth systemically slows as the spread approaches zero.

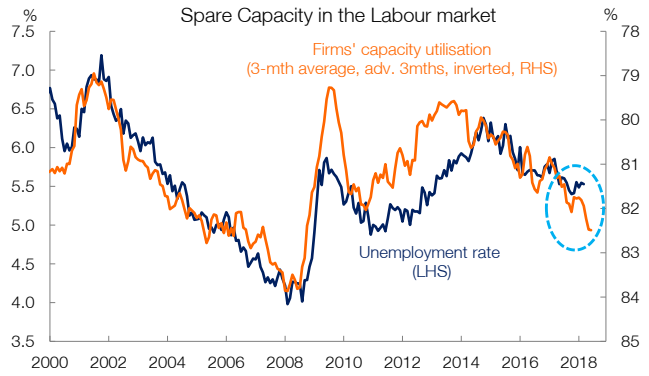
Rather, the sudden (and normally unanticipated) dip into recession has always followed the inversion by a significant period. Of the five most recent recessions, the average gap between the curve inverting and activity contracting has been around 15 months. They believe that this, along with the US fiscal stimulus, suggest that the risk of recession in the next year or two remains low (see *Curve Flattening and Recession… Is the US Bond Market Flashing Red?*).

Australian economics – Steady but far from spectacular

- The outlook for the Australian economy remains solid with the prospect of an election-friendly budget in the coming weeks;
- The Reserve Bank of Australia (RBA) is likely to keep interest rates on hold until early next year, although risks have shifted slightly towards a later start;
- Key inflation metrics remain around the bottom of the RBA's target band at ~2% however the improving economy should result in underlying inflation trending slowly higher over the next year.

The Australian economy is growing at a steady pace with consumer confidence continuing its positive trajectory and businesses remaining very optimistic about the outlook. The key brgight spot, the labour market, has shown some signs of weakness over 1Q18. However, we continue to forecast the unemployment rate to gradually fall through the year, with other forward labour market indicators continuing to signal near term healthy market conditions.

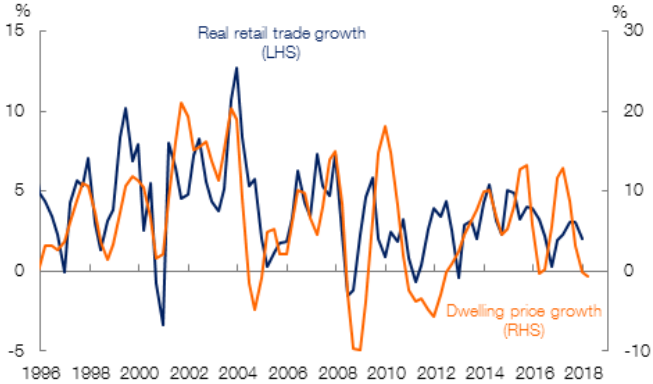
Forward labour market indicators point to a reasonably positive outlook



Source: Macquarie Research, MWM Research, May 2018

Despite the softening in jobs growth, consumer spending is showing a mildly improving trend. This is in line with our expectations that there will be a gradual improvement in consumption, but from a weak starting point. The key uncertainty is how households will react to slower growth in their wealth as housing prices remain flat and equity market volatility picks up. We expect that this will be a modest headwind with consumption growth expected to track around 2.9% this year and next.

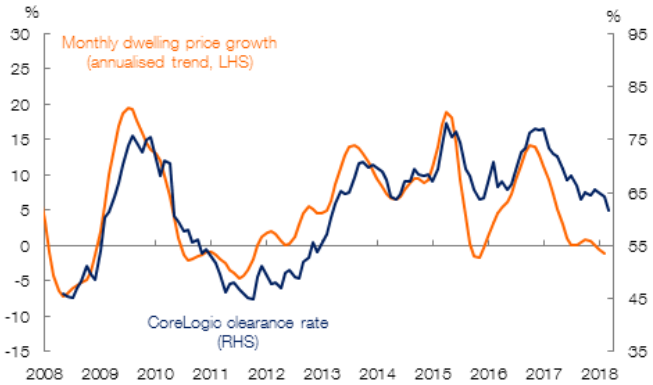
Uncertainty for retail - consumer spending reacts to slower wealth gains



Source: ABS, CoreLogic RPData, MWM Research, May 2018

Australian auction clearance rates continue to moderate, down to 63% from 74% a year ago. Factors contributing to the softening residential housing market include tighter lending standards, affordability constraints, and ongoing weakness in household income growth. We see these headwinds continuing to remain in place for the housing market, although we think national average prices are more likely to be flat to slightly down over the coming 12 months than suffer a more meaningful decline.

Moderating clearance rates and dwelling prices



Source: CoreLogic RPData, MWM Research, May 2018

Consumers appear to be more optimistic about the broader economy, as sentiment towards current and future economic conditions rose in the final week of the month according to the ANZ- Roy Morgan survey. This could be the potential budget effect, particularly the increasing chatter about personal tax cuts with Treasurer Scott Morrison flagging this as a budget fillip.

The RBA has left the cash rate unchanged at 1.5% this month. The low level of interest rates is continuing to

support the Australian economy. The Australian dollar ($A) has resumed its weakening trend versus the US dollar, weighed down by falling interest rate differentials. With the official cash rate remaining at 1.5% and the US Federal Reserve expected to remain hawkish, we expect the $A to see continued pressure particularly in the near term. This is in line with the Macquarie forecast that the $A will remain anchored around the mid- to high US$0.70s.

We remain constructive on the Australian economy as it continues to benefit from stronger global growth and elevated infrastructure spending by the government (also likely to remain a focus in the upcoming budget, particularly given a more favourable revenue line). Improving demand is soaking up excess capacity and having limited impact on inflation and the need for the RBA to engage in earlier than expected tightening.

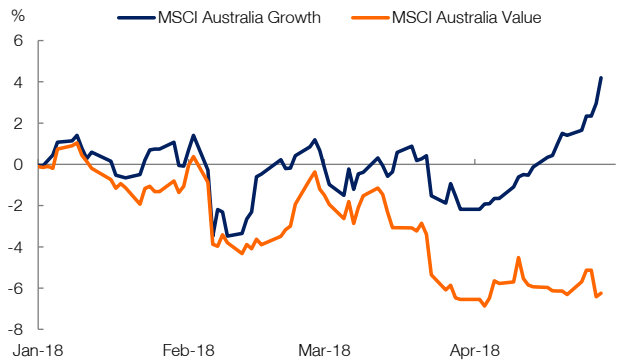
Australian equities – Being held back by rate sensitive areas

- We remain overweight Australian equities with support from yield, valuations and improving earnings growth;
- Our preference remains to growth companies with sustainable earnings momentum;
- Banks remain challenged and will weigh on index returns, but divestments will support dividends and capital levels.

We maintain our overweight to Australian equities despite narrowing breadth and pressures on the financial sector. The Royal Commission has been worse than expected and will likely weigh on sentiment, particularly leading into the Federal election. The major banks are deeply discounted but we take some comfort from yield support and capital levels. While earnings growth will remain tepid, we think the broader index can still trade higher into year-end on improved sentiment towards the banks as capital returns come into focus.

Our preference remains for growth over value (see Investment Matters – Aging Bull) where we argued investors should seek stocks/sectors with earnings upside, despite higher valuations. The year to date performance gap between growth and value increased further during April (see chart below) with value held back by the banks and insurers.

Value stocks have been decimated versus Growth stocks of late



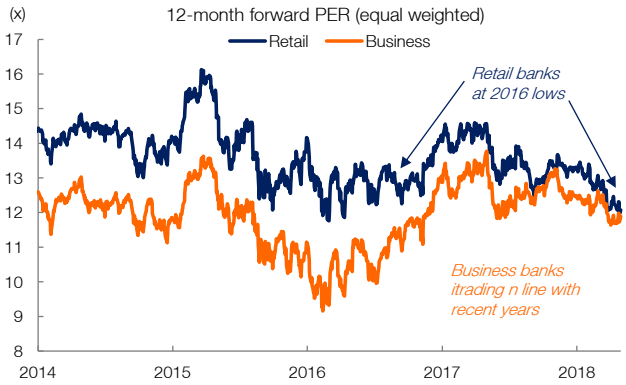
Source: FactSet, MWM Research, May 2018

A dearth of positive news has seen significant pressure on the banks lately, particularly from offshore investors, despite undemanding valuations. A key issue for the banks is dividend sustainability (although if dividends can be held at current levels then valuations look attractive). ANZ Bank (ANZ) and Commonwealth Bank (CBA) are supported by divestment programmes which will bolster capital levels and support capital returns. Our analysts also assume a special dividend for Westpac (WBC) in 2H18, although this will be subject to the group's capital generation. National Australia Bank (NAB) is the main exception with Macquarie expecting a dividend cut in 2019 to bring NAB's payout ratio to a more reasonable level (it will be 100% for 1H18).

Earnings momentum has been patchy of late. Commodities (alumina, nickel, oil) have received the largest upgrades while momentum has been solid for offshore firms with upgrades for Resmed (RMD), CSL Ltd (CSL), Computershare (CPU), Brambles (BXB) and Aristocrat Leisure (ALL).

Downgrades have mostly come from domestic firms including Retail Food Group (RFG), G8 Education (GEM) and Perpetual (PPT). Overall, this supports our view of sticking to companies with compelling growth trajectories and where the risk of disappointment (and valuation compression) remains relatively low.

Retail bank valuations need to recover lost ground



Source: FactSet, MWM Research, May 2018

While there are several headwinds to outperformance, we think Australian equities can still creep higher, driven by a slightly stronger offshore lead, valuation support from deeply discounted financials, ongoing commodity sensitivities and further support from growth stocks via earnings growth and multiple expansion.

We reiterate our key views below:

1. Remain overweight areas with strong and/or transparent earnings upside. We like Alphinity Concentrated Australian Share (HOW0026AU) and Bennelong Concentrated (BFL0002AU).
2. Underweight bond-proxies, particularly those with structural growth issues (Telstra, retail REITs). Our preference is to income generating growth stocks and the banks. Our preferred income fund is Niko AM Australian Share Income (TYN0038AU).

3. Overweight offshore industrial stocks leveraged into the global upswing. We like Aristocrat Leisure (ALL), Boral (BLD), James Hardie (JHX), CSL (CSL), Reliance Worldwide (RWC), Resmed (RMD) and Treasury Wine Estates (TWE).

International equities – Absorbing the blows

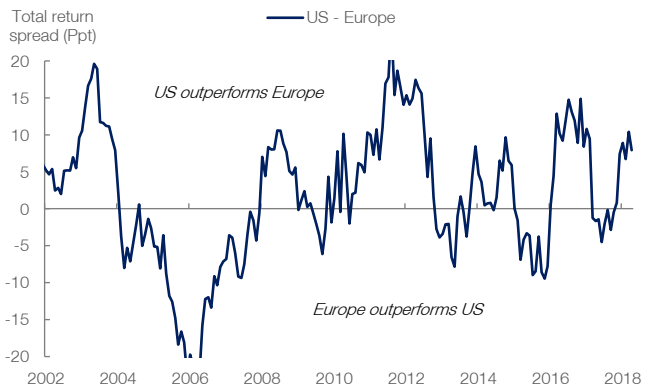
- Strong earnings growth and relatively easy monetary conditions support equities;
- Soft sentiment data and a strong euro weigh on relative performance of European equities despite solid economic fundamentals;
- Emerging markets strong but at risk of liquidity tightening.

We maintain our overweight to international equites within a tactical portfolio allocation but adjust the allocation to Europe from strong overweight to overweight. Economic fundamentals in the Eurozone remain strong, but currency headwinds are weighing on corporate earnings and sentiment is softening.

We believe equity markets generally remain supported by strong earnings growth and (still) relatively easy monetary conditions. In addition, while leadership is narrowing with the demise of global tech darlings and the shift in performance towards cyclical sectors (eg Energy), valuations have seen some compression in recent months as optimism has fallen and profit taking increased. We have been caught out by emerging markets (EM) outperformance year-to-date (YTD), but maintain our fundamental reasons for this underweight position.

Europe – confidence hit but fundamentals sound: After several quarters of economic expansion that consistently beat consensus expectations, data from the Eurozone saw some softening through the first quarter of this year. It now appears that when 1Q18 gross domestic product (GDP) data is released in late June, it will show that growth has slipped. However, it will have slipped to more moderate but still robust, and indeed sustainable, levels that are above the long term trend.

Weak sentiment and strong euro weigh on Europe

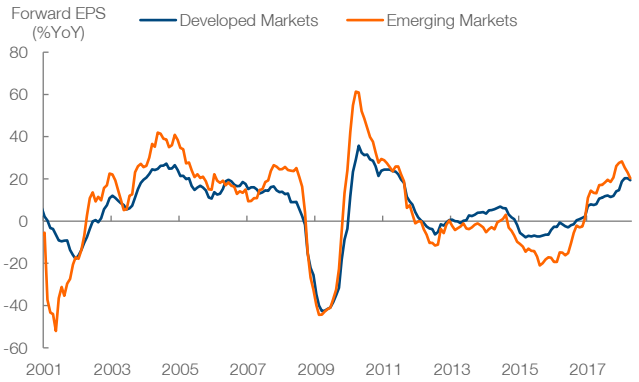


Source: FactSet, MWM Research, May 2018

Surveys show sentiment has also taken a bit of a hit, with the German Ifo and Zew, indicators of business climate and economic expectations respectively, trailing off over the past two months. Manufacturing Purchasing Managers' Index (PMI) data for the region also softened from highs reached at the end of 2017, but remain firmly in expansionary territory.

The crop of weaker data has seen investors questioning the outlook for European economic growth as central banks globally move slowly but surely onto a path of monetary policy normalisation. European equities had a strong run of seven consecutive quarters of positive returns, abruptly brought to a close when higher than consensus US wage inflation in February prompted a significant upward revision in interest rate expectations. Macroeconomic factors will continue to push European equities around, with the pullback in sentiment having the potential to weigh on returns in the short term. However, leading indicators were falling from historically elevated levels, and even after the declines, remain high.

EM earnings growth slowing from high levels



Source: FactSet, MWM Research, May 2018

European economic fundamentals are still supportive for equities, and that the region is still in the very early stages of a cyclical upswing, particularly relative to the United States. Earnings growth in Europe is broad-based across sectors and increasing at a healthy clip, faster in fact than the US. Forward earnings per share are forecast to grow at over 23%, while the US grows at 20%. Valuations also favour Europe, with the region trading at a 12% discount on a forward price to earnings basis, and over a 40% discount on forward price to book relative to the US. Perhaps the biggest headwind to the region's performance will be a persistently strong euro driven by a massive trade surplus, which is taking its toll on international earners.

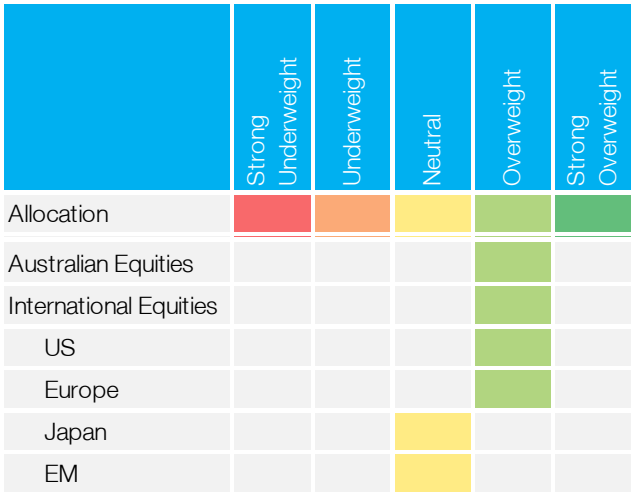
EM outlook robust but at risk from liquidity tightening: We have played our EM underweight by the book.

Traditionally, EMs have underperformed when US policy rates have risen and as global liquidity has found its way back to the US. Year-to-date this has not been the case.

We are running the risk that this time is different and that strong fundamentals continue to underpin outperformance by EMs. The bull case for EMs is quite transparent. The equity market outlook is generally favourable, supported by economies at relatively early stages of the business cycle, and by central banks that overwhelmingly maintain a dovish stance on monetary policy. Valuations are attractive still, despite a 26% discount to developed market equities contracting to 22% over the past year. Returns on equity and dividend yields are comparable, if not better than developed markets.

At a macro level, beyond a trade war and overarching investor concern about a slow shift to protectionist policies globally, the sources of risk for EMs include the potential for increasing inflation, rising yields and a stronger US dollar (USD). If sentiment remains positive, and fears of a trade war (or any major crisis) recede, EMs will continue to see supportive capital inflows. Fundamentally, EMs are a leveraged, but lagged bet on global growth. While they have evolved considerably in recent times, they remain economies linked to commodity markets that perform well when increased global demand drives up manufacturing, mining and extraction activity across EMs. The synchronised nature of global economic growth is supporting commodity prices and this in turn flows through to EM economic momentum. Our fear is that if the USD begins to appreciate that the capital flows support quickly vanishes. We maintain our underweight position but it is the lowest conviction call within the equities space given the fundamental tailwinds.

Equity market preferences



Source: MWM Research, May 2018

Real assets – Softer residential market is here to stay

- Remain underweight listed property;
- Property stock valuations and earnings to remain constrained by rising interest rates and cap rates;
- Residential market to remain soft amid stricter lending standards and higher borrowing costs.

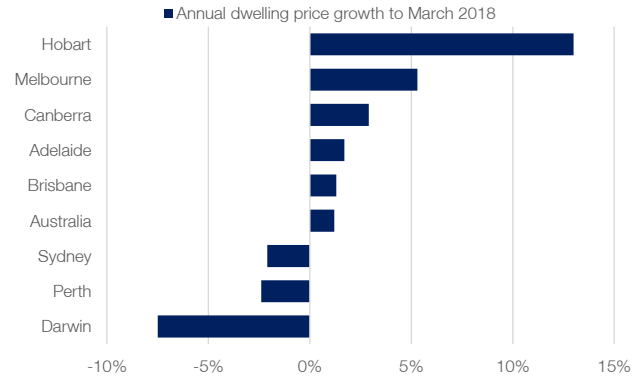
We remain underweight listed property. Our call is based on the likely negative impact of a long, protracted rise in bond yields on property valuations and earnings. This is evident in the underperformance of A-REITs sector (+1.0%) compared to the broader market (+5.5%) over the last year.

Current valuations look relatively undemanding: a 4% discount of price to net tangible asset for passive REITs (rent collectors), vs a peak of a 40% premium, and a 243 basis points (bps) dividend yield spread to the Australian 10-year bond yield (vs average long-term of 200 bps). However, we think it will remain hard for the sector to outperform until there is greater conviction on where interest rates will settle.

Our residential market outlook has not changed

A supply glut and waning demand from tighter regulations and lending conditions on investor and foreign buyers continue to weigh on dwelling prices.

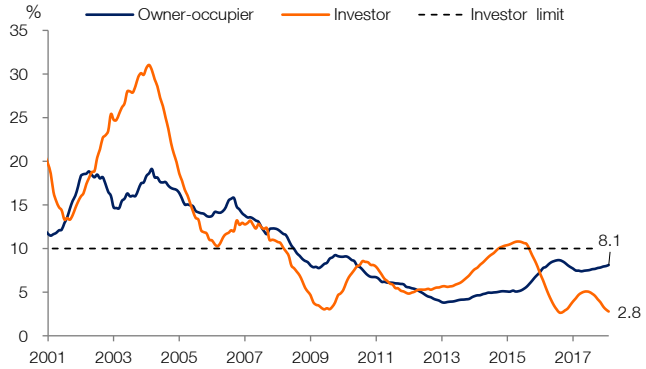
Moderating dwelling prices



Source: CoreLogic, May 2018

Annual investor lending growth decreased noticeably to only 2.8% in February 2018, down from 10.8% when the investor loan cap was introduced in December 2014. With softer house prices and a substantial slowdown in investor credit growth, banking regulator, Australian Prudential Regulation Authority (APRA) recently announced plans to remove the 10% investor lending growth cap on lenders that have demonstrated stronger lending standards. This change would be effective from 1 July 2018. All four major banks lowered investor credit growth to levels well below the imposed APRA 10% limit.

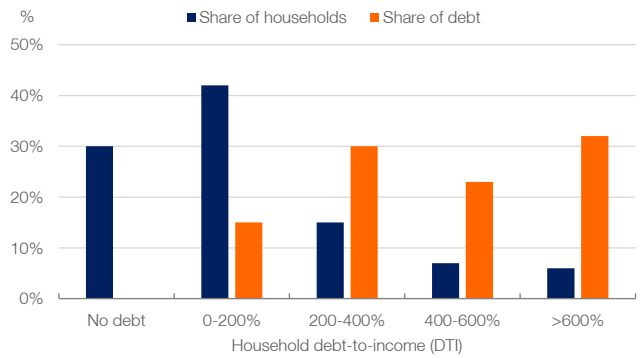
10% cap has dampened investor lending growth



Source: RBA, Macquarie Research, May 2018

Our property team believe the removal of the lending cap should be net positive for domestic investor demand and eventually dwelling price growth, although the impact is likely to remain muted if borrowing rates and lending standards are both rising at the same time the cap is removed. However, in time it is most likely to support apartment developers (previous hot spot for investor activity), such as Mirvac, Lend Lease and Stockland.

Highly indebted households have the largest share of debt



Source: HILDA Release 15.0-2014 data, RBA, May 2018

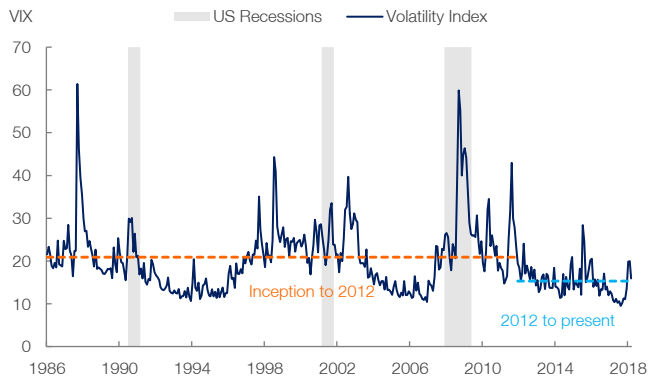
We don't see APRA's recent changes as a sign of easing lending conditions. In fact, we think housing credit growth will continue to slow from the current rate of 5.9% to a low of only 2.5% over the coming 2 years. While listed property has corrected substantially, we see few drivers that will prompt outperformance. Maintain underweight.

Alternatives – Volatility strikes back

- Maintain maximum overweight to alternatives amid high valuations for listed equities and rising volatility;
- Managed futures, diversified strategies and gold may perform reasonably well in prolonged periods of rising volatility:
- Equity related strategies including long/short and market neutral strategies should benefit from widening stock and sector dispersions.

We recommend a maximum overweight to alternative assets. The backdrop of high valuations for traditional assets and rising financial and economic volatility make alternatives an attractive diversifier of returns.

Volatility is settling at historic long term levels



Source: IRESS, WMW Research, May 2018

Following a prolonged period of calm markets, February's sudden volatility spike caught investors off guard, resulting in simultaneous weakness in both equity and bond markets. Unfortunately, some hedge fund strategies were caught out. Short volatility strategies got burnt, which led to liquidation of a number of short volatility ETFs. Managed futures also suffered during this period as they held risk-on positions across asset classes immediately prior to the volatility shock and subsequently missed out on the market rebound as these funds were forced to de-risk their positions following the spike in volatility.

Which hedge funds will thrive in this environment?

A maturing US economic cycle, divergence in monetary policies, geopolitical uncertainty and the withdrawal of quantitative easing will see stock and bond volatility remain more elevated than investors have become use to. This type of environment has historically been more fertile for hedge fund strategies.

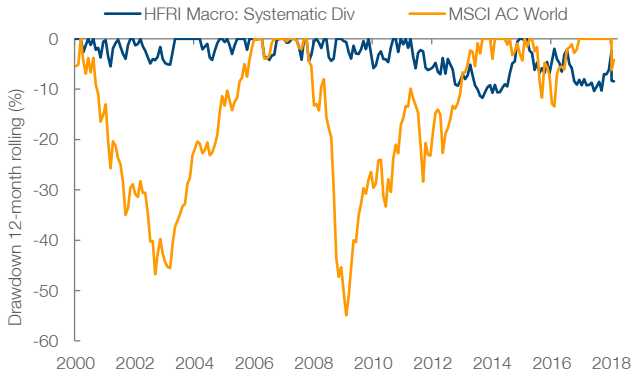
We separate Alternative Investments into 4 categories:

1. Macro strategies

   i. Systematic macro/managed futures: Uses quantitative trading programs to exploit strong and persistent directional moves. These strategies may struggle in short, sharp bouts of volatility and choppy markets. However, they provide downside protection in equity market drawdowns and sustained periods of volatility (i.e. during the tech bubble and financial crisis). We recommend Winton Global Alpha.

   ii. Discretionary macro: Employs directional positions across asset classes based on fundamental analysis of political or economic events. These strategies stand to benefit from diverging policies of central banks and political uncertainty in major economies.

Managed futures do well in prolonged volatility



Source: Markov Processes International, HFRI Research May 2018

2. Diversified strategies

   i. Risk premia: Uses systematic and rules based approach to capture the factors/risk premia. These strategies are well placed in environments of rising volatility due to its relatively low correlation to traditional markets. We recommend AQR Delta.

   ii. Absolute return: Invests across a wide range of asset classes and strategies, aiming to deliver returns in both rising and falling markets. These diversified funds have the ability to shield the portfolio from market volatility.

3. Equity related strategies

i. Long/short equity: Generates alpha in both their long and the short positions. Rising volatility should lead to wider sector, geography, stock dispersions and reduced correlations among stocks will present opportunities. However, we are cognisant the strategy will not be able to insulate the portfolio if there is a large drawdown in equity markets due to its high correlation to this asset class.

ii. Market-neutral: Invests in both long and short positions with the attempt to achieve zero beta to markets. Similarly, they benefit from stock dispersions, but tend to have a higher correlation to equities in a market downturn albeit having low correlation over a longer period.

4. Commodities

We also consider commodity specific funds as Alternative assets which also provide some hedging properties against traditional equities and bonds. We think gold offers these attributes and is a solid hedge against political risk as well as declines in risk assets. We recommend ETF Physical Gold (GOLD.ASX)

In short, hedge fund strategies that rely on diversified sources of alpha that can deliver more dependable, less volatile returns, with low correlation to traditional market risks will be best placed to navigate volatile periods in the markets.

Fixed interest – the reset to higher rates is not yet complete

- US bond yields to continue to creep higher, dragging other global long rates with them;
- Credit spreads to gradually widen, but supported by low corporate default risk and a solid growth backdrop;
- The RBA to remain on hold through early 2019 but the Australia-US long bond spread differential is already close to its lows.

We remain underweight fixed income. We believe the rise in global government bond yields is only partially complete. We are now long past the inflection point in the way investors view inflation risk, and it is clear that, in the US at least, we have transitioned from a deflationary and disinflationary era to one of potential inflation surprises. This has been the key reason why US bond yields have steadily marched higher, as equities have struggled with elevated volatility.

US inflation breakeven rates have further to rise

Source: FactSet, MWM Research, May 2018

After testing the psychologically important 3% level in February, US 10-year yields hit 3.03% towards the end of April, its highest level since July 2011. Macquarie believe that long bond yields will consolidate around the 3.00-3.10% level before lifting off towards the end of the year with an expectation that they hit 3.75%. While we are bearish fixed income, we are not expecting to see a bond market rout (where bond yields spike dramatically higher), but equally, the headwind even from a gradual increase in bond yields will remain in place for financial markets.

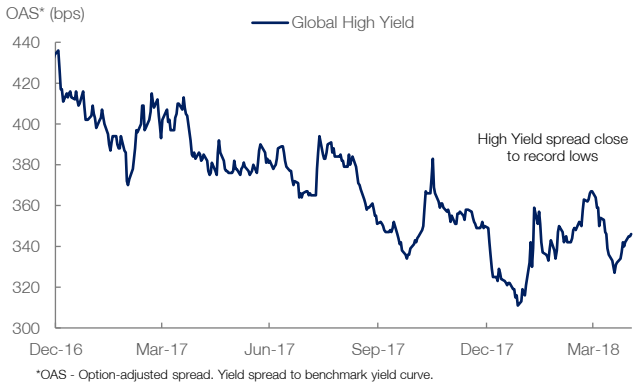
The encouraging change over the past month has been the stabilization in funding costs following a sharp rise earlier in the year. In addition, there has been limited evidence of contagion across corporate credit markets. LIBOR-OIS spreads, have in the past 2 weeks, settled between 55-60 bps. It is true that they have risen to their highest level post GFC, but the panic that accompanied the initial spike has not spread into other funding markets with high yield spreads closing in on their record YTD tight levels.

Yields lift along with inflation expectations

Source: FactSet, MWM Research, May 2018

A similar trend has been seen in other corporate credit markets (eg. emerging market bond spreads, investment grade and high yield). We think credit spreads are close to their lows, but limited corporate default risk against a robust backdrop of strong global growth and modest inflation should keep spreads reasonably well behaved on the upside.

Credit spreads have bottomed for this cycle



Source: FactSet, MWM Research, May 2018

The big talking point across fixed income markets has been the continued flattening of the US yield curve (difference between the 2 year and 10 year bond yield). Macquarie's economics team do not think this is a signal to get overly bearish on the growth backdrop (see *Curve Flattening and Recession… Is the US Bond Market Flashing Red?).*

They believe that if the current trend of flattening were to persist then the curve would not invert until the middle of 2019. There is also no evidence that growth systemically slows as the spread approaches zero. Rather, the sudden (and normally unanticipated) dip into recession has always followed the inversion by a significant period. Of the five most recent recessions, the average gap between the curve inverting and activity contracting has been around 15 months. They believe that this, along with the US fiscal stimulus, suggest that the risk of recession in the next year or two remains low.

Domestically, at the May meeting of the Reserve Bank of Australia (RBA) Board, rates were left unchanged at 1.50%. In the Monetary Policy Statement, Governor Philip Lowe commented that the Board were comfortable with rates at current levels. They emphasised the expansionary nature of global financial conditions but introduced a slight dovish bias due to the tightening of local financial conditions caused by increasing short rates in the US.

We maintain our underweight call on fixed interest with a preference to short duration credit, our preferred funds are listed below:

Our preferred credit funds are listed below:

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

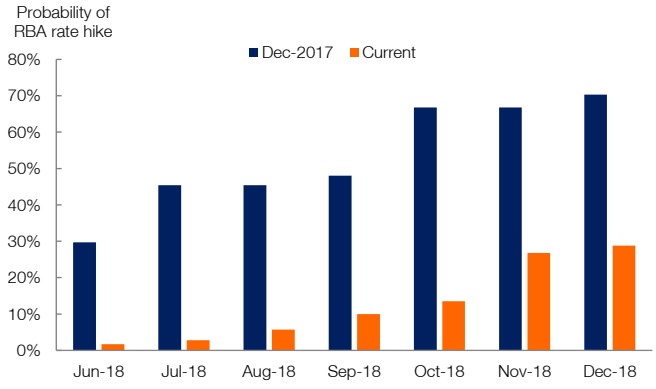
Currencies - RBA holds, AUD folds

- Market pricing for a rate hike has been pushed back again on soft inflation and an RBA content with holding rates steady;
- This has weighed on the A$ which has broken below US$0.75 and looks vulnerable to further USD strength;
- The USD has surged as inflation pressures mount, creating a divergence in central bank policy relative to the ECB and Bank of Japan (BoJ).

The Australian dollar recently fell below US$0.75, down substantially on its late January peak of US$0.81. The retrace has been a result of both weaker than expected domestic fundamentals and slightly stronger US fundamentals (in particular inflation and rate concerns). Over the past month, Australia has seen a slight pullback in jobs growth (still running at elevated levels), ongoing tepid wages, weak inflation and signs the RBA is in no rush to lift rates now the housing market continues to show signs of cooling.

As a result, we have seen market pricing for the first RBA rate hike materially pushed back from mid-2018 at the start of the year to late-2019 at present. It was only a few months ago that many market commentators were assuming two rate hikes for 2018.

RBA rate hikes pushed back yet again

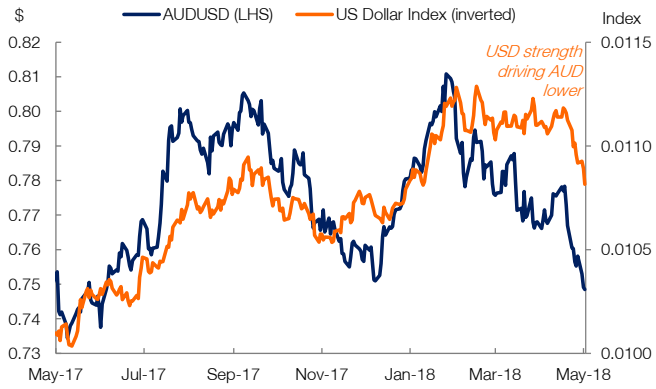


Source: Bloomberg, MWM Research, May 2018

On the other side of slightly weaker Australian data, the currency has been driven by a rebound in the US dollar as seen in the move higher in the US dollar index (inverted in the next chart). US dollar strength has been driven by an increase in interest rate hike expectations as US inflation picks up in line with output constraints and tariff-led price hikes.

The US 10-year breakeven inflation rate has been sitting above 2% comfortably in recent months and is now only slightly below pre-GFC levels. The US manufacturing ISM (Institute for Supply Management) report for April suggests inflationary pressures will continue with the prices sub-index at its highest level since 2011 as raw material price hikes are increasingly passed through supply chain and with the rise in oil prices also creating some concern that it will begin to have inflationary impacts.

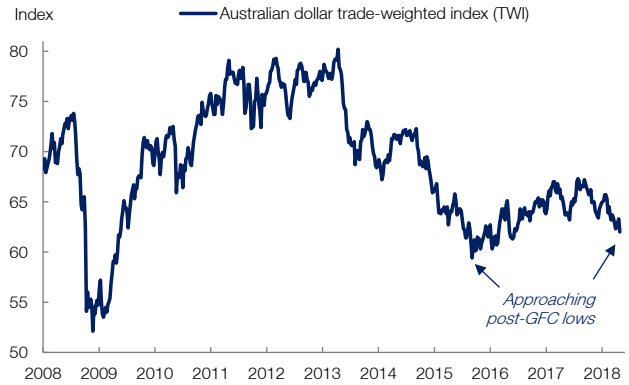
USD rebound could drive a further leg lower



Source: IRESS, MWM Research, May 2018

A weak currency is of course a positive for Australian exporters. Australia's trade weighted index (TWI) is weighted by Australia's goods and services trade so provides a better read of the country's position against major trading partners with the US accounting for only 10% of the index. The TWI has now retraced to levels last seen in June 2016, providing a welcome boost to domestic competitiveness. While this could help lift inflation it would likely come with a significant lag.

Cheaper currency a boon for exporters



Source: IRESS, MWM Research, May 2018

The euro has seen a pullback in recent weeks driven by soft German inflation, slower growth (manufacturing PMIs and GDP), and a cautious European Central Bank (ECB). Macquarie's currency strategists are relatively bearish on the euro following its move below US$1.20, pointing to a divergence in inflation pressures as evidenced in the US ISM survey.

Monthly performance - April 2018

Australian equities

The Australian equity market performed strongly during April, with all sectors ending the month in positive territory. The S&P/ASX 200 Accumulation Index closed 3.9% higher, successfully reversing the heavy loss seen in March 2018. The best performing S&P/ASX 200 sectors were Energy (+10.8%) and Materials (+7.6%) while Financials (+0.2%) and Telecoms (+2.0%) were the laggards.

Amongst larger companies the best returns were from diversified miners, South32 (S32, +15.5%) and Woodside Petroleum (WPL, +10.2%), thanks to a strong rally in base metals and crude oil. The underperformers were AMP Limited (AMP, -19.0%), dragged down by the negative revelations at the Royal Commission.

The S&P/ASX Small Ordinaries Accumulation Index (+2.8%) underperformed the S&P/ASX 200 Accumulation Index. The major contributors were Beach Energy (BPT, +30.1%) and technology company HT&E Limited (HT1, +23.9%). The worst performer was the fund manager Blue Sky Limited (BLA, -22.8%), which came under fierce attack from an offshore short seller.

International equities

Despite the better than consensus corporate earnings for 1Q 2018, the US equity indices finished only fractionally higher. The S&P 500 Index led the rise with a mere 0.27% increase, followed by the S&P 500 Index (+0.25%) and the Nasdaq (+0.04%).

The European stock markets were exceptionally strong, with the majority of indices witnessing a strong rally, something not seen in recent years. The best regional performers were Italy (MIB 30, +7.0%), France (CAC 40, +6.8%) and UK (FTSE, +6.4%) while Germany (DAX, +4.3%) and Spain (IBEX 35, +4.0%) rose with a less strong extent.

Asian equities showed a divergence in performance among the regional markets. Whilst the China mainland Shanghai Composite Index slid 2.7% in the month end, Japan's Nikkei and Hong Kong's Hang Seng returned 4.7% and 2.4% respectively.

Property

Australian REITs performed broadly in line with the other sectors in Australian market, closing April with a 4.5% return. Westfield Corp (WFD, +8.0%) and Goodman Group (GMG, +7.6%) were the clear standouts, leading the strong bounce, while Viva Energy REIT (VVR, +1.0%) and Vicinity Centres (VCX, +1.2%) were lagging behind.

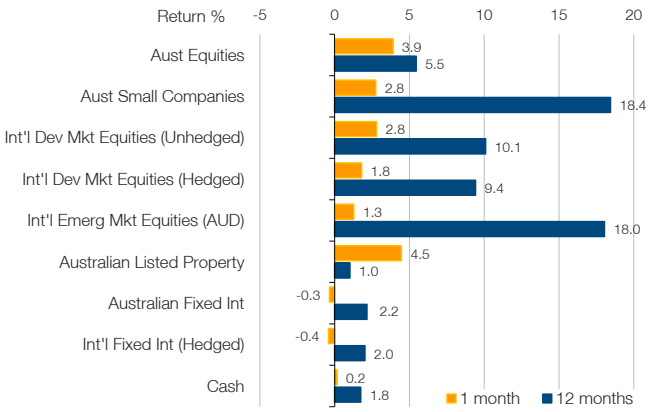
Fixed interest and cash

The US 10-year bond yield ended the month at 2.9%, with a short-lived break above 3%, last seen in 2014. The Australian 10-year government bond yield finished the month at 2.78%, down from the 2.91% high it reached in February this year. The Bloomberg AusBond Composite 0+Yr Index slipped 0.3%, with both Corporate bonds (-0.1%) and Government bonds (-0.6%) slightly down. Short-term bonds (Bloomberg Composite 0-3 year, +0.1%) outperformed long-term bonds (Bloomberg Composite +10-year, -1.2%).

Currency

The US dollar increased sharply during April. As a result, the $A/$US weakened by 2%, closing the month at $0.7530. The $A was stronger against the New Zealand Dollar (+0.9%, 1.0703), Japanese Yen (+0.9%, 82.32), flat against Euro (+0%, 0.6234), and weaker against UK Pound (-0.1%, 0.5470).

Market Performance – April 2018



Source: IRESS, Bloomberg, MWM Research, May 2018

Market performance – April 2018

Market Indices	1 month %	3 month %	YTD %	1 year %	3 year %pa	5 year %pa
30-Apr-18						
Australian Shares						
S&P/ASX 200 Accumulation	3.91	0.34	-0.11	5.46	5.70	7.53
S&P/ASX 200	3.88	-0.91	-1.36	0.99	1.10	2.88
All Industrials Accumulation	2.55	-0.58	-1.31	0.62	4.79	7.93
All Resources Accumulation	9.77	4.29	5.12	31.50	9.49	5.49
All Industrials	2.52	-1.70	-2.43	-3.78	0.04	3.05
All Resources	9.76	2.42	3.24	26.98	5.83	1.90
S&P/ASX 100 Accumulation	3.91	0.23	-0.14	4.37	5.27	7.42
S&P/ASX Small Ordinaries All Accumulation	2.75	0.44	-0.11	18.45	11.07	8.05
International Shares						
MSCI World Index Hedged in A$	1.81	-4.51	-1.01	9.42	6.55	10.06
MSCI World Index (A$ Unhedged)	2.81	0.60	2.68	10.10	7.08	14.19
MSCI Emerging Markets (A$ Unhedged)	1.28	-0.96	4.05	18.04	5.16	9.00
Regional Markets (local currency returns)						
Dow Jones	0.25	-7.60	-2.25	15.39	10.64	10.24
S&P 500	0.27	-6.22	-0.96	11.07	8.29	10.64
Toronto Comp	1.57	-2.16	-3.71	0.14	0.83	4.61
Nikkei	4.72	-2.73	-1.30	17.04	4.80	10.14
STOXX® Europe 600 Net Return	4.49	-1.49	0.15	2.31	1.87	8.27
German Dax	4.26	-4.38	-2.37	1.40	3.26	9.77
FTSE 100	6.42	-0.32	-2.32	4.24	2.56	3.15
Hang Seng	2.38	-6.32	2.97	25.16	3.07	6.26
NZSE 50	1.42	-1.13	-0.63	10.29	8.80	8.23
Property						
S&P/ASX 200 Property Trust Accumulation	4.47	1.10	-2.22	1.03	7.32	9.83
Cash and Bonds						
Bloomberg Composite Bond All Maturities	-0.35	0.79	0.52	2.16	2.71	3.91
Bloomberg Bank Bill Index	0.16	0.44	0.59	1.75	1.96	2.26
Citigroup World Government Bond Index Hedged	-0.41	0.89	0.22	2.03	3.14	4.45
Citigroup World Government Bond Index Unhedged	-0.30	6.24	4.20	4.10	3.94	7.20

Source: IRESS, Bloomberg, MWM Research, May 2018

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