Perpetual Investments, Multi Assets

QUARTERLY MARKET INSIGHTS

October 2018.

KEY INSIGHTS

- The message from data and the markets in early October was abundantly clear - yields are rising and growth is slowing, which means portfolios need to shift. A structurally larger US fiscal deficit and a Federal Reserve which is determined to raise rates to neutral or above is pushing nominal and real US bond yields higher. While rates are rising, they remain low relative to history and inflation is at or below target in most major economies, which gives central bank optionality on the pace and timing of policy withdrawal. However, above trend growth and large deficits reduce the probability of bond yields falling, unless the outlook materially weakens.

- Rising rates have brought end-of-cycle risks into focus, capped equity market valuations and underpinned intra-market rotations on a sector and style basis.Since May, defensive sectors such as utilities and consumer staples have outperformed their cyclical peers including IT and consumer discretionary which is highly unusual while growth is strong and bond yields are rising. This has occurred at a time when historic and forward-looking US earnings growth has peaked, and valuations appear stretched. So far, the impact of rising bond yields has been on sharemarket valuations, but eventually regional earnings expectations will reflect a softer macro backdrop.

- Economic growth is slowing in most major economies including the US, Europe, China and many other emerging markets, but it remains elevated relative to potential. Low rates and above-trend growth suggest that the global cycle still has considerable runway and that global recession risks, at this stage, are low. As with all previous cycles, there are several risks that could destabilise things including a trade war between the US and China which has little chance of a near-term resolution. Our base case is that 25% tariffs are applied to the next USD200 billion of Chinese imports in early 2019 and that China will implement a smaller response. While US and Chinese producers and consumers will bear the brunt of this battle, there will be collateral damage through global supply chains, especially component manufacturers in Asia, who are also dealing with a slowing China. Another concern is Italian debt dynamics which are on an unsustainable path and will collide head first with the European rule book in November. Meanwhile, the Brexit negotiations are going around in circles and risks of a no-deal exit are growing by the day. These three risks are all under-priced by markets and could cause severe dislocation if optimistic expectations are not met.

- An environment of elevated valuations, slowing growth, optimistic expectations and rising interest rates is not a mix that makes for high risk-adjusted returns. Accordingly, we have been slowly reducing our risk exposures in our Diversified Real Return Fund and increased our exposure to diversifying opportunities and employed explicit downside protection strategies to defend returns.In 2019 we feel that market returns will be modest and accompanied with higher volatility, so diversification and increased protection in portfolios are likely to be increasingly important as the cycle's end draws nearer.

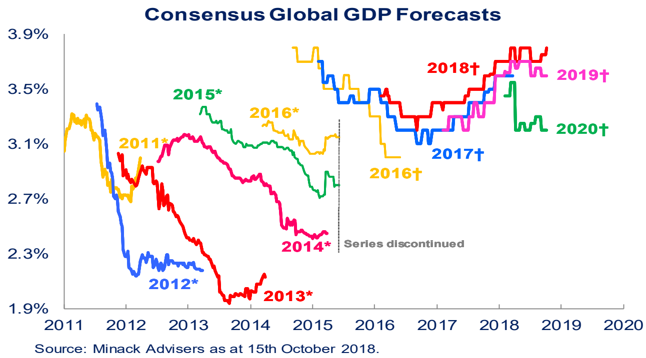
1. THE MACRO ECONOMY

GLOBAL TRENDS

KEY POINTS

- Global GDP accelerated to a 7-year high in June 2018 and has since moderated but it still remains well above trend. Despite this slowdown, the cycle still has considerable runaway as real interest rates and core inflation both remain low relative to history.
- There have been three key developments from a cycle point of view - growth has peaked mid-year, key central banks have continued the process of policy withdrawal and the global recovery has become less synchronised. This has been evident in numerous key regions and economists have begun to downgrade their 2018 and 2019 growth forecasts, albeit not by much (Chart 1). We are not of the view that having seen the growth peak for this cycle in mid-2018 that global economic growth will slide to an inevitable recession in the next 15 months.

Chart 1: Global growth is now being downgraded for 2019 and 2020



- Policy rates remain highly accommodative with Fed rates at neutral, the ECB on hold at record lows, with the PBoC and BoJ still providing stimulus. However, continued, albeit gradual, policy tightening in the US could cause financial stress in countries with high US dollar funding and/or large current account deficits, but stresses in countries like Argentina and Turkey have been ring-fenced, at least so far.
- While the overall picture remains upbeat, several key economies have been subjected to higher oil prices, increased uncertainty around US-Sino trade policy, central bank tapering or liquidity withdrawal and reduced spare capacity. This combination has culminated in softer-than-expected growth in Europe, Japan and more recently China.

OUTLOOK

- In 12 months, the current global economic cycle will become the longest on record and this remains our base case two reasons. Firstly, real interest rates remain very low and secondly, we have not seen the build-up of traditional excesses (in housing and business investment) which combine with policy tightening to end the cycle. This does not mean that there are no material economic risks to monitor, but it means that if there was a global recession in the next 18 months, it is highly unlikely to emanate out of the US and far more likely to originate in the emerging markets or Europe (where the debt build-up, currency trends and state of balance sheets are more concerning). Our 2019 base case is that growth will moderate more from its +3.4% June 2018 peak to 3.1% given a rapid fading in the US fiscal impulse and a notable tightening in financial condition around the world. Our bear case involves defaults on Italian debt and an out-right trade war between the US and China, and while these remain low probability events, their impact on global growth could be catastrophic.

DEVELOPED ECONOMIES

KEY POINTS

- Recent news flow suggests that most major advanced regions have recorded a moderation from the peak growth levels recorded in 2018. Some of the slowdown is cyclical (for example European and Japanese industrial production has moderated in line with the slowdown in China), whereas others are structural (a fading US fiscal impulse).
- Trade tensions remain an important wild card and the latest news on this front is worrisome. The US announced an additional 10% tariff on USD200 billion of Chinese imports and China responded with retaliatory tariffs on USD60 billion worth of US exports. This tit-for-tat situation is likely to intensify as these US tariff rates are scheduled to rise to 25% at the beginning of 2019 and the US has threatened to impose tariffs on the remaining USD267 billion of Chinese imports in response to any Chinese retaliation. At present, it is becoming harder to prevent a deterioration from the current situation, and things may well worsen because its resolved.
- A major threat to global growth would arise if tariffs expand from a narrow trade conflict with China to trade relations with the rest of the world. On the positive side, the US now has formal and informal agreements with Korea, Japan, Mexico, Canada and the EU and has shown a willingness to compromise. This has allowed the US to pivot to the Eastern front of China and the key for a resolution is whether China's growth slows materially, or whether pain thresholds in the US (in the form of US public opinion, consumer pushback, consumer and business confidence and equity market weakness) are reached.

OUTLOOK

- Growth in most G20 advanced economies remains above trend as de-leveraging has ceased, policy remains highly accommodative, investment has picked up and labour markets continue to record strong hiring. However, growth in most regions is moderating back to trend levels. Despite the US demand surge, European and Japanese growth remains sluggish and momentum continues to soften for idiosyncratic reasons. Tail risks remain in the form of a no-deal Brexit, Italian budget woes and the impact of a slowing China on Europe. The impact here is cushioned to some extent by still lose financial conditions, robust labour markets and less stringent fiscal policy.

CHINA & EMERGING MARKETS

KEY POINTS

- China posted real GDP growth of +6.7% y/y in the June quarter which was an equal 9-year low but still above the 2018 +6.5% growth target. Since then traditional cyclical indicators including credit growth, M1 money supply growth, retail sales, industrial production and fixed asset investment have all trended lower, suggesting downside risks for the remainder of 2018. This slowdown does not reflect the impact of US tariffs and is simply a delayed reaction to a credit tightening in 2016/17 as authorities made the first serious attempt to contain the build-up of leverage since the 1998 financial crisis and the impact has been larger on nominal GDP (-2.3% to +10.9%) than real GDP (-0.2% to +6.7%).
- Although China's nominal growth issoftening there are very early signs that it could stabilise in coming months as gains in the monetary conditions index, rising input prices from the manufacturing PMI and lower interest rates provide support. These factors have our model hinting that nominal GDP growth will trough in September (at 5.0%) and close 2018 near +6.5% (Chart 2). As this potential turnaround is modest, considerably more stimulus will need to be unleashed which means interest rates are likely to be cut, the reserves requirement ratio will be further eased, and the Yuan will have to depreciate more. China will use monetary policy more than fiscal policy as households are chronic savers, there aren't as many tax payers as you might think, and they need to lower their real effective exchange rate given the trade war and the declining current account surplus.
- Emerging markets (ex-China) are one of the few regions to be growing below trend in 2018 as rising US dollar debt funding costs, trade links with a slowing China and slowing investment growth all weigh on activity. The recent pullback in growth has been largest in countries with significant external funding vulnerabilities including Turkey, Argentina and Brazil, which culminated in numerous central banks having to lift interest rates to defend currencies at the expense of the domestic economy. This could generate disruptive spill-overs through financial tightening and offset the positive impulse of stronger US demand.

Chart 2: Our lead indicator suggests that China's nominal economy is improving

OUTLOOK

- Chinese authorities have increased support through additional liquidity measures and a lower Yuan to take the sting out of the de-leveraging process. In addition, tax cuts have also been legislated for the household and corporate sector, but these are unlikely to boost growth much as the corporate reductions are very small and Chinese households are chronic savers. One avenue to improve prospects has been the large amount of bond issuance by local government which has previous foreshadowed improved infrastructure spending. When this stimulus hits the real economy in 2019, it is likely to cushion the growth downside, but it's more leverage and China hasn't yet figured out how to support growth without increasing its debt burden.
- Meanwhile, the EMs remain a mixed bag. PMIs suggest that growth is still declining in Brazil and India, whereas Russia is now improving after a harsh adjustment process. Elsewhere, the aforementioned decline in stimulus, growth and the synchronicity in the global recovery, has tightened EM financial conditions with trade concerns are also weighing on activity and confidence. The key risks here remain the US dollar (which remain close to a 16-year high in trade weighted terms), US bond yields (which are at a 5-year high) and China (whose growth is at a 9-year low). Accordingly, while the EM cycle is young, at the moment the region remains sub-trend and it is likely to stay there until 2019, at least.

AUSTRALIA

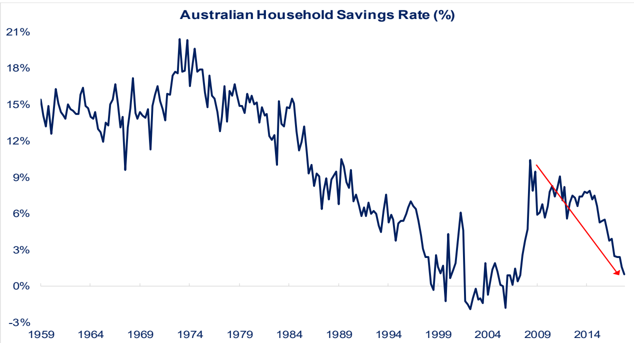
KEY POINTS

- Despite anaemic wages growth, elevated housing construction risks and a slowing China, the Australian economy has remained quite resilient in

2018. Growth remained above-trend in the June quarter as the economy wrapped up its 27th consecutive year of growth with an expansion of +0.9% q/q which lifted the annual rate to a six-year high of +3.4%. Among the components, consumer spending (+0.6% q/q) continues to be supported by strong population growth, robust hiring and another decline in the national savings rate, whereas government added a bit (+0.2% q/q) and investment was flat. Robust GDP growth has been in line with the high levels of labour market hiring with a total of +281K jobs created over the past year three quarters of which (++223K) have been fulltime.

- Strong payrolls growth and a falling savings rate to a 11-year low of +1.0% (Chart 3) have outweighed near record low wages growth and has supported consumer spending but falling house prices may see household increase their precautionary savings, especially as Australian household balance sheets remain the second most indebted relative to GDP and disposable income in the entire OECD.

Chart 3: The decline in Australian household savings is now exhausted



OUTLOOK

- We believe that the pace of the Australian expansion will progressively ease back to a more sustainable pace in 2019, but the driver of this moderation will be different to other G20 advanced economies. The key adjustment is likely to be in the household space as decline in the national savings rate ceases and consumption growth is driven by still anaemic wages growth. Meanwhile, the recovery in capex after the mining investment unwind seems patchy and governments are still improving the fiscal trajectory, which suggests that growth in 2019 will moderate towards a trend pace and this will culminate in the RBA remaining on hold into 2020 as they try to determine how to normalise policy without triggering large-scale dislocation in the housing market.

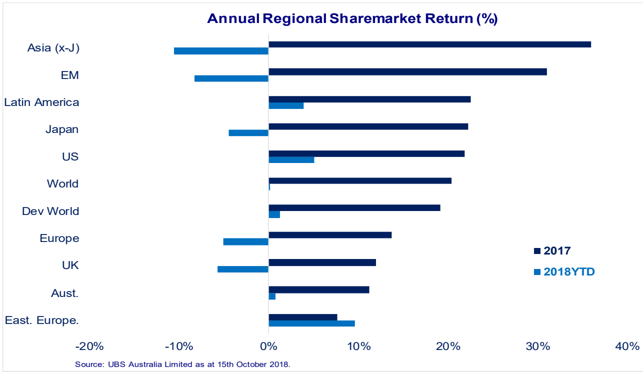
2. ASSET CLASS REVIEW

GLOBAL SHARES

DEVELOPMENTS

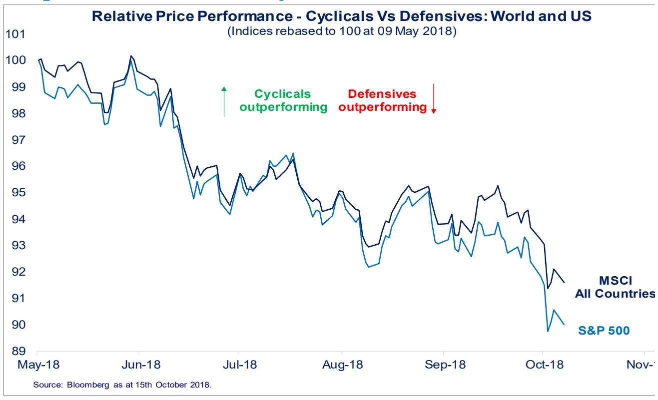
- The US sharemarket rallied strongly in the September quarter (a total return of +7.7% q/q) in the wake of a strong reporting season which saw consistent, albeit modest, earnings upgrades (+2.6%). Profits were supported by very strong economic growth (+4.2% in June) and late cycle tax cuts, which culminated in one of the strongest quarters of US EPS growth (+25%) since 2009. The 80% beat rate is the highest on record, which pushed 2018YTD US returns into positive territory (Chart 4). Although Japan (+5.9%) also enjoyed a strong quarter, most other regions were little moved with Europe (+1.2%), Australia (+1.2%) and emerging markets (+0.1%) all oscillating around the breakeven line, which kept 2018 returns at uninspiring levels. In 2017, 10 of the 11 regions listed in Chart 4 recorded total returns above +10%, but none have achieved this milestone, so far, in 2018.

Chart 4: 2018 regional sharemarket returns have been low relative to 2017



- One of the key signs of 'late cycle' dynamics is the change in market leadership. Since early June defensive sectors (which have low correlation with the economic cycle) have outperformed their cyclical peers by around +10% (Chart 5) in both the MSCI World and the S&P 500 indices. Defensive sectors have been supported by attractive valuations in utilities and consumer staples, whereas cyclicals have struggle with elevated P/E ratios and the higher US dollar weighing on foreign earnings in the IT and industrials space. During periods of rising bond yields, cyclical sectors would be expected to outperform, as these times are associated with a strong economy, so their underperformance since May is very rare. Although they remain low at present, this suggests that a further material back up in bond yields could increase end-of-cycle risks.

Chart 5: Defensive share sectors have outperformed since May 2018



OUTLOOK

- From an investment point of view, record low interest rates and massive central bank asset purchase programs enabled financial markets to outperform a weak economic recovery between 2009 and 2016. In 2019, a combination of slowing growth and policy withdrawal is set to lower returns and increase volatility. Accordingly,the outlook for global shares for the remainder of the cycle will be increasingly challenging as growth rates in major economies are moderating (albeit from above-trend levels), valuations are already elevated, and the cost of capital is slowly rising. Other risks include a worsening in the US-Sino trade war and heightened uncertainty around Italian debt, European banks and emerging market economies with large US dollar funding. This suggests that the easy gains this cycle have already been seen and in this world investors may seek to sell cyclical sectors and cyclical markets, and rotate their portfolios into areas which have superior defensive qualities, and which trade at a discount to their cyclical peers.

AUSTRALIAN SHARES

DEVELOPMENTS

- In contrast to the rest of the world, the defensive nature of the Australian sharemarket weighed on the local price performance as utilities (-5.5%), consumer staples (-2.7%) and financials (-1.4%) lagged the performance of the overall index. Pressure on the banks was maintained in the wake of the Hayne Royal Commission and concerns around the state of the domestic housing market. The depreciating Australian dollar helped our foreign earners even though the pass through to materials stocks (-3.1%) was limited as base metals priced declined. The major corporate news was the recovery of Telstra's share price (+21.8%) which benefited from reduced industry competition given the merger between Vodafone and TPG.

- The domestic reporting season was pedestrian with 29% of companies reporting EPS above consensus, but 28% missed street estimates. Meanwhile, expected EPS growth has begun to trend lower after a modest recovery in August and at +5.8% is the lowest among the major regions. However, the Australian economy is one of the few advance economies where growth is above +3%, which would normally provide a solid backdrop for corporations, but sectors exposed to household spending may not enjoy the usual strong tailwinds, given the state of household balance sheets, falling house prices and weak wages growth. This could curb spending despite a robust labour market.

OUTLOOK

- The Australian sharemarket (+0.7%) has outperformed most of its advanced economy peers in 2018 given the strong domestic economy, some gains in regional commodity prices, an on-hold central bank and a well-timed depreciation of the Australian dollar. Despite wages growth remaining low over the past year,one of the key themes in the last reporting was 'costs' with firms worried about labour shortages and the need to invest more heavily to update depreciated technology. Increased investment will strengthen the Australian economy, but it may be the case that this investment will require firms to lower their payout ratio, which will weigh on dividend growth and share price performance overall.

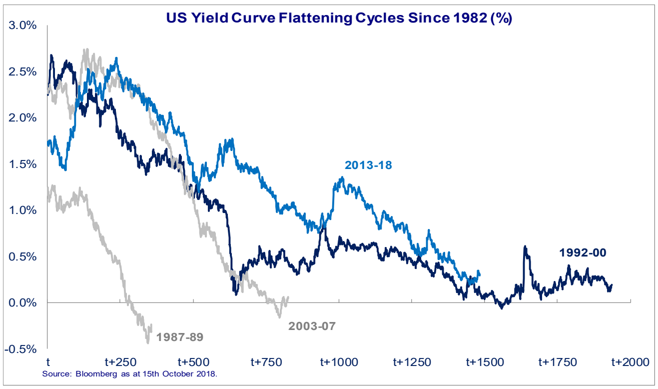
- There are also the overhangs of a slowing Chinese economy, trade wars and the domestic housing market. This suggests that the Australian share market will remain challenging for investors; with only modest revenue growth forecasts and cost-out opportunities nearing exhaustion, which culminates in limited EPS upside. Having said that, Australia's defensive index composition (with two-thirds of the market being yield plays) should provide some respite from any rise in volatility, at least on a relative basis.

SOVEREIGN BONDS

DEVELOPMENTS

- US 10-year treasury yields increased +0.2% in the September quarter which is the second largest quarterly gain since 2016 and this coincided with rises in nearly all developed markets. The yield rise was driven by reduction in central bank asset purchases, rises in official interest rates in a few key economies and the structural rise in the US Federal budget deficit by the Trump Administration. Accordingly, it was higher real yields which underpinned with rise, rather than inflation compensation, with core gauges showing little change in most G20 countries and headline inflation appearing to have peaked as the base effects of rising energy prices become more challenging. Despite little material inflation pressure, the US Fed completed their eight rise in the Fed Funds Rate this September (to 2.12%), but these moves have led to a flattening in the US yield curve to just 30 basis points in October (Chart 6).

Chart 6: The US yield curve is flattening much like it did between 1992 and 2000



- Despite global growth rising to a 7-year high, sustained low inflation gives central banks optionality about the size and timing of policy withdrawal, and sustained low yields has also been reinforced by fewer central banks being synchronised in policy changes with the US Fed hiking rates and selling assets, the ECB being on hold and set to close their asset purchases in December and the BoJ is still undertaking asset purchases and yield curve control. Elsewhere, Australian yields only rose by 5 basis points over the quarter, with core inflation below the 2%-3% target band which combined with housing risk, is keeping the RBA on hold, and our 10-year bond is trading below its US counterpart with the spread at a record high of 49 basis points. With Australia's huge household debt burden and elevated housing risks, we see the RBA on hold until 2020.

OUTLOOK

- Over the next year, sovereign debt will remain in the cross fire between monetary policy withdrawal (given the end of its asset purchase programs) and falling regional headline inflation. Accordingly, the outlook for the sector over the medium term depends on whether the US Fed has to end its tightening cycle before rates reach its guided peak (3.375%) and whether there is more US Budget deterioration. At present, there appears little risk of an inflation breakout and as such further rate hikes would be expected to increase real US rates and flatten the yield curve. The risk here is that the Fed does not know where 'neutral' is as the Phillips curve is very flat and they have never seen late cycle tax cuts when the US economy is already fully employed.

CREDIT

DEVELOPMENTS

- Despite periodical rises in risk aversion over the past three months, the Australian credit market was quite well behaved as high issuance was absorb by a large maturity profile, culminating in little overall change in spreads. Major bank spreads were tighter in the short-end and short-dated corporates remain well bid even though spreads were little changed.

- The positive mood was reinforced by a very strong June quarter national accounts (economic growth at 3.4% y/y), an on-hold RBA and a very solid domestic reporting season which indicates that corporate Australia remains in solid shape from an interest cover perspective. Partially offsetting these strong domestic factors were occasional bouts of global volatility, which primarily emanated out of the emerging markets although the lower Australian dollar cushioned domestic investors to some extent.

OUTLOOK

- The credit outlook is challenging. On the positive side the above trend global and Australian economies suggest that credit is in the sweet spot in terms of defaults which are historically very low. However, housing and China concerns suggests that there could be a widening in spreads should equity market volatility spike higher, but the RBA is likely to remain on hold which provides additional cushioning against market volatility. At the same time corporate issuance has picked up in recent months as businesses have attempted to lock in attractively priced funding, and investors seek cash-plus income assets as corporate bond maturities pick up and domestic interest rates remain extremely low. From a relative valuation perspective, spread differentials between domestic and offshore paper remains tight and domestic swap spreads have normalised Accordingly, we remain vigilant regarding the fragility of the geopolitical landscape from trade wars, China slowing and rising US rates.

3. PORTFOLIOS

- In a lower returning and increasingly volatile world, our portfolios have been performing well. Key positions have been short duration which has added to relative performance given the back-up in bond yields and associated capital losses for bond investors.

- In addition, our long US dollar exposure has been constructive for returns as growth differentials and interest rate differentials have been supportive for the Greenback as has been President Trump's stimulus. At the same time the economy is late cycle and the fiscal impulse is set to fade quickly in 2019 and with

US Fed determined to lift rates to at least neutral, downside risks are becoming more material.

- This has culminated in a challenging environment for equities and credit markets and within our Diversified Real Return Fund we have we have been gliding down allocations to Return Seeking investments (i.e. investments with a positive correlation to equities) by reducing exposure to high beta sharemarkets and sectors including EM, European Banks and Japanese equities. We have used these proceeds to increase our exposure to both Downside Protection (i.e. assets with negative correlation to equities in a market downturn) through the explicit use of options (but only when volatility is attractively priced) and Diversifying Opportunities (zero correlation to equities) by increasing our use of safe-haven currencies. The long dated AUDUSD put option position has recently been restructured to lock in profits while maintaining participation in further Australian dollar depreciation. Meanwhile, the allocation to Inflation Protection (i.e. positive correlation to inflation surprises) basket is low as there are few signs of a sustained breakout despite tight labour markets.

- In the balanced funds, we have been underweight Australian equities and global equities and also Australian and global sovereign bonds (Table 1), both of which are offset by our cash and alternative investment exposures. We have also added some defensiveness through options given the trade battle between the US and China and rising global rates. While the defensiveness of the portfolios has increased at the margin, they are expected to participate in any market upside as these options are quite cheap and the Funds retain a diversified exposure to various equity, credit and unlisted markets. Finally, as a counter balance to high cash weightings, relative value positions remain elevated including exposure to equity alpha and foreign currency positioning (in preference to the Australian dollar), which are supported by our alternative investments.

Table 1: Our balanced funds are defensively positioned

ASSET CLASS (16 October 2018)	BALANCED FUNDS
Australian shares	UW
Global shares	UW
Credit	UW
Australian bonds	UW
Property	UW
Cash	OW
Other investments	OW

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