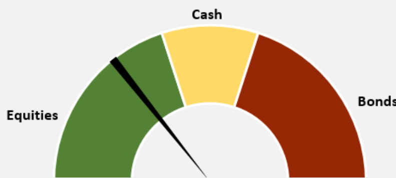
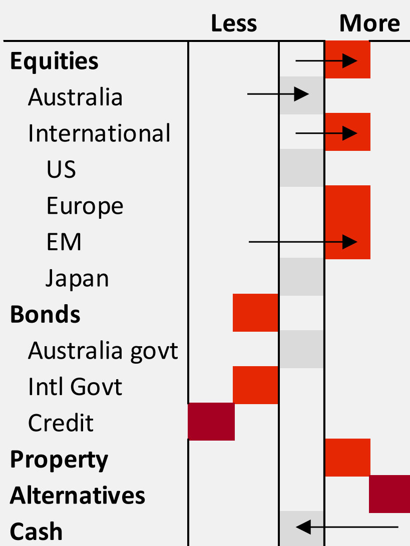
GLOBAL *engineer*

Q1 2019

Tim Rocks
Chief Investment Officer

Asset Allocation





Source: Evans & Partners

Seize the day

As 2018 comes to a close the political noise is deafening on a range of familiar issues. Fortunately, many of these event risks should pass early in 2019 and leave no permanent scars.

Looking across the full year of 2019 it is likely, in our view, that political risk will ease and the macro environment will be broadly healthy. Given equity valuations have significantly improved over the past two months, this sets the scene for a positive year for equity markets in 2019 and we recommend investors look for opportunities to increase their exposure.

There will be some important regional divergences in 2019. We expect macro conditions to soften in the US and improve in Europe and Asia, and we assume equity performance will reflect these trends. We have a neutral position on Australian equities, where we are balancing better valuations with rising uncertainties from the housing market and political cycle.

RECOMMENDATIONS

Our key recommendation heading into 2019 is a move back overweight international equities funded by cash. We recommend that this be done gradually over coming months so that investors are well positioned to take advantage of easing political and macro risks through the year. We remain underweight bonds, particularly credit, given low spreads and uncertainty around the end of quantitative easing in Europe.

Looking in more detail at our recommendations:

- Equities are preferred to bonds given the improvement in valuations in equities and the risk to bonds from higher US inflation and a higher US Federal Reserve (Fed) funds rate. International equities are preferred to domestic equities, assisted by our currency views.
- Within equities, we have changed our order of preference. Emerging markets, in particular in Asia, are most preferred, followed by Europe. We expect less upside in US given risks that the economy fades, and that this leads to earnings downgrades given elevated expectations in current analyst forecasts.
- Our 2019 target for the ASX 200 is 5,900 (around 8% upside). We have lifted our recommendation from underweight to neutral given better valuations but will wait for macro and political uncertainties to ease before considering moving overweight.
- Within bonds, sovereigns are preferred over corporate credit and hybrids given low levels of corporate and hybrid spreads and the risk of mark-to-market losses as spreads rise. Australian sovereign bonds are preferred over their international equivalents.
- We assume a further rise in the US dollar, which will influence other currency markets. We expect some mild further downside to the Australian dollar as commodity prices retrace and US rates rise relative to Australia. Our 12-month forward forecast for the Australian dollar is US$0.71.

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Seize the day

2018 has not turned out as many expected. Heading into the year there were hopes that the global economic expansion would remain synchronised, and that strong corporate performance would underwrite healthy equity market gains.

Instead the year was marred by rising political tension and the premature slowing of economic recoveries in Europe, China and many emerging markets. Perhaps the biggest shock was that US companies delivered one of the strongest profit performances on record (24% growth over the year) – yet US equity returns are potentially on track to be negative.

As 2018 comes to a close, the political noise is deafening on a range of familiar issues. Fortunately, many of these event risks should pass early in the new year and leave no permanent scars. Our expectation then is that the focus will return to the macro, where we expect outcomes to be broadly positive and support solid equity returns. In this report we move back overweight international equities and are looking for opportunities created from the turmoil. To date these opportunities have been created in Asia and Europe.

2018 vs 2019 risks

The main reason that markets have been weak since the start of October is the unusual confluence of a number of political event risks. Investors became overwhelmed with the sheer number of risks, which at the time included the US mid-term elections, the Iranian oil embargo, Brexit, Italian budget concerns and the trade war.

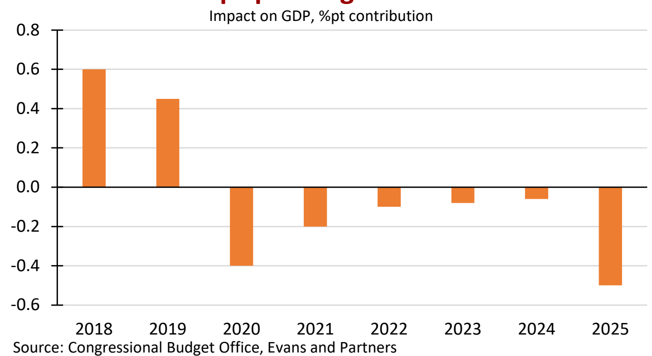
Importantly as we leave 2018, the first two of these have passed with no negative surprises, while several others are reaching a crescendo. They will potentially linger for a few more months but, importantly, there is the prospect of much clearer air from the middle of the year.

This will be a relief to markets and should see equities move higher as some risks ease. Unfortunately, however, this relief could be tempered by another growing risk, as we expect that US economic and profit growth will slow through the year. We expect this to be partially offset by better outcomes in the rest of the world, but nonetheless, it will be another hurdle for markets to overcome.

The case for slowing in the US

2018 was a stellar year for the US economy but there are several reasons why this may not be sustained into 2019:

- Fiscal stimulus will peak. Trump tax cuts played a major role in 2018 as profits surged, business confidence improved and corporate investment increased. The problem is that this was a one-off effect that will fade. Trump also had spending plans approved that will similarly peak during 2019.

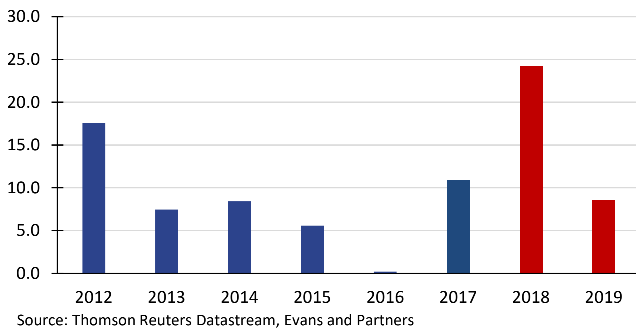


Source: Congressional Budget Office, Evans and Partners

- The trade war effect potentially becomes negative – up until now it has been a positive because of consumers buying ahead of higher prices. This has been a key factor behind the improvement in consumer spending this year.
- The squeeze from higher Fed rates will be extended. The housing market has been the most affected as mortgage rates have jumped. This has seen a drop in new home sales and caused a slowing in new building. The fall in new housing permits suggest homebuilders will significantly slow construction next year.

Source: Thomson Reuters Datastream, Evans & Partners

The corporate sector has been the largest beneficiary of tax cuts and hence is particularly vulnerable to this effect fading. The chart below shows the 24% growth in earnings per share (EPS) that occurred in 2018 that was likely heavily boosted by tax cuts. Our main concern for the US market next year is there is a very high base for earnings that will be hard to surpass. Given this, we are very surprised that analysts are forecasting another 8% EPS growth in 2019. Unfortunately, this raises the risk of earnings downgrades through the year. A higher US dollar will also affect earnings since around 30% of US company earnings are generated from offshore.



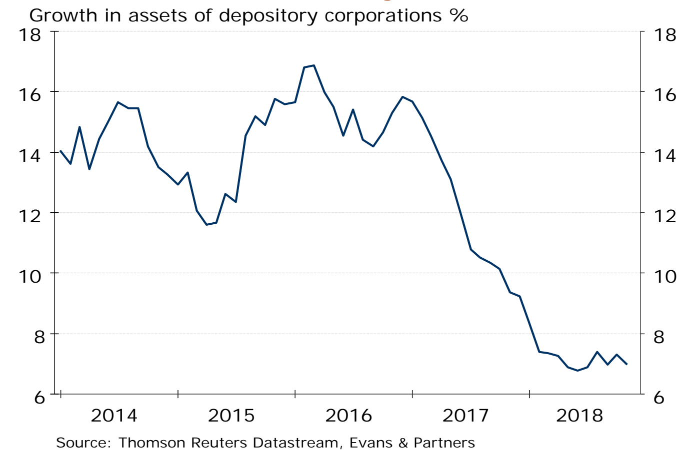
Source: Thomson Reuters Datastream, Evans and Partners

An additional concern for equity markets is that the tax cuts also resulted in record stock buybacks in 2018. This is also unlikely to be repeated in 2019 since it was partly facilitated by a one-off repatriation of foreign cash holdings due to tax changes.

Can China fill the void?

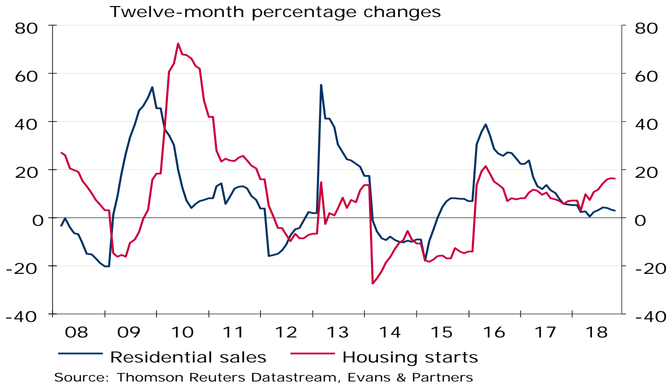
Economic activity slowed in China in 2018. Importantly this was not – as President Trump claims – a result of US tariff rises. In fact, the depreciation of the yuan has more than offset higher tariffs and exports have actually risen.

Instead it has been a deliberate government induced slowdown aimed at improving the long-term sustainability of the Chinese economy. Authorities are attempting to wean the economy off its reliance on debt and have imposed an aggressive tightening of credit. Broad credit growth has fallen from around 15% - where it has averaged for a number of yearsto around 7%. Importantly, this rate of growth will likely ensure a decline in the overall debt/Gross Domestic Product (GDP) ratio.



Source: Thomson Reuters Datastream, Evans & Partners

Such a debt squeeze was always going to have economic consequences. These are increasingly apparent now and spreading to a range of sectors. The infrastructure sector was the first affected – because it was the most dependent on bank debt – and recently the property market has also felt the pinch. Property construction had held up relatively well until recent months, when sales began to slow and offshore funding markets effectively shut. The greatest risk to the economy in 2019 is a significant cut in developer construction. Some have recently reduced their prices to encourage higher sales but to little effect.



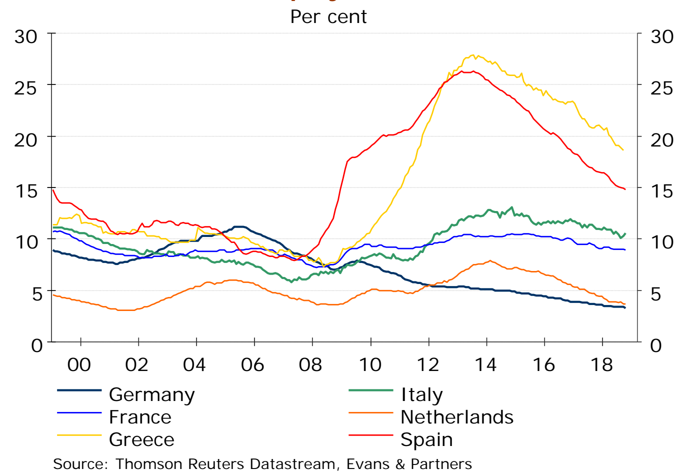
There has also been some evidence of weakening consumption. This also has its genesis in financial reform – specifically the government's targeting of poor practices in shadow banking, internet financing and peer-to-peer lending. This has starved some consumers of finance and curtailed some spending. However, an offset will be major cuts to income tax, introduced in two stages from October 2018 and January 2019. The changes allow taxpayers to deduct a range of spending on items like healthcare and education. Some analysis suggests this will mean only 15% of the population will pay any tax, down from 45%. This should help to ensure consumption will not weaken for long.

The broader point here, however, is that the government can ease the credit squeeze at any point and allow the economy to reaccelerate. We expect some policy easing and income tax cuts to support a stronger economy through 2019.

Europe stumbles

Europe has had a disappointing year. The nascent recovery in 2018 has stumbled in the face of weakening manufacturing activity and political angst in a range of countries. This has led to slump in business confidence, which has affected investment intentions.

However, this should be a temporary setback. The underlying economy remains healthy as highlighted by the labour market. Unemployment is falling steadily in most countries and is at multi-decade lows in Germany.



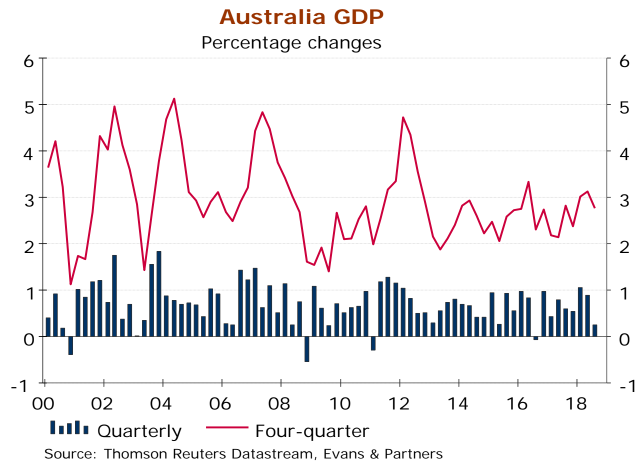
Strong labour markets are resulting in an improvement in the wages outlook – which, in turn, is supporting retail sales. There is also a construction boom underway, particularly in Germany, Denmark and the Netherlands.

A critical factor for an improving outlook will be a recovery in the auto sector. Changes to emission standards and tariff rises have been a cruel combination in a sector that is critical for European exports. Elsewhere, the corporate sector is in healthy shape and the financial sector has been reformed. We expect some recovery to occur in 2019, however its strength will depend on some resolution of local political issues in a range of countries – particularly in Germany (where a leadership transition is in train), France, Italy and the UK.

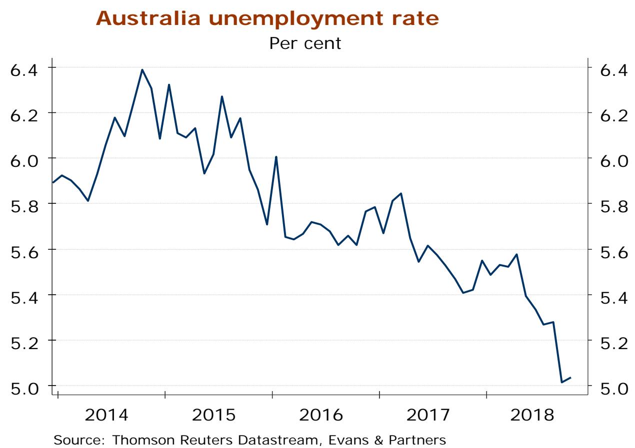
Australian uncertainty

Australia has had a strong year in 2018, with GDP growth at close to its highest rate in 5 years. This was an exceptional result in a year where the global economy weakened and concerns emerged over the housing

outlook. The strongest parts of the economy have been construction and exports.



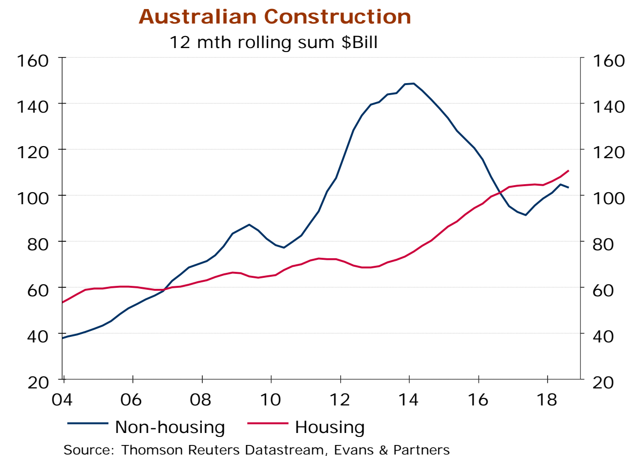
This strong economy has been reflected in a significant improvement in the labour market and a drop in the unemployment rate to around 5%. This is the rate that the Reserve Bank of Australia (RBA) considers to be the effective rate of full employment, which raises questions about whether labour availability will become an issue.



It also raises the prospect of the return of wages growth. The RBA expects wages to start accelerating if the unemployment rate is sustained below 5%. Recently there has been some evidence of a return of some wages pressure – although there is still a fair way to go before this is a material concern.

Some of the drivers of the economy in 2018 will spill over in 2019 and should underwrite another solid year for the economy. However, there are a number of clouds that have been building and will require monitoring.

A major question will be the construction outlook. Housebuilding will inevitably slow as existing projects reach completion, but other forms of construction are booming again. The slump in mining investment appears to be over and infrastructure, hotel and office construction are in the early stages of what are looking likely to be multi-year booms. Infrastructure plans are significant in NSW and expanding in Victoria. Hotel construction will likely ride the Chinese tourism boom and commercial construction projects are also large.

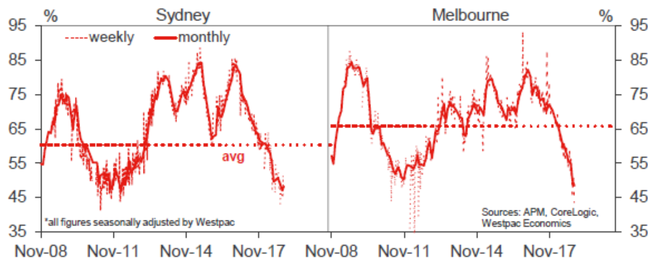


Booming tourism is a key support to the economy. As well as boosting hotel construction, it is ensuring strong growth in the broader hospitality industry. Tourism Australia estimates that Chinese tourism will triple again over the next decade as airline and airport capacity expands in both countries.

The greatest risk to the economy is that the downturn in housing deepens and begins to have a broader impact on the economy. There is no doubt the housing market is

under pressure and is yet to find a floor. Auction clearance rates have fallen sharply and have yet to stabilise in the major markets.

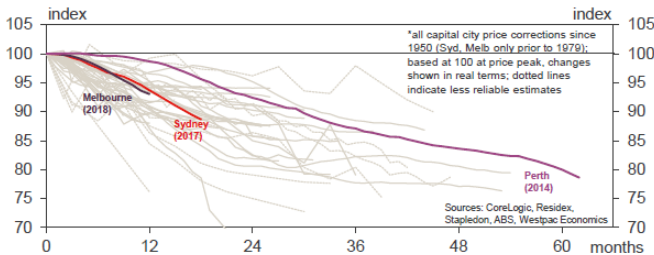
Auction clearance rates



Source: Westpac

Some recent analysis from Westpac looked at previous house price downturns in Australian cities. It found that downturns typically last three years and result in real price falls of around 20%. On this measure, Sydney is around half way through (12% fall and around 18 months so far) but Melbourne has further to go (6% and 12 months so far). Westpac does note that it is an unusual cycle though – because it has not been driven by higher interest rates or a recession – so this reduces the applicability of historical comparisons.

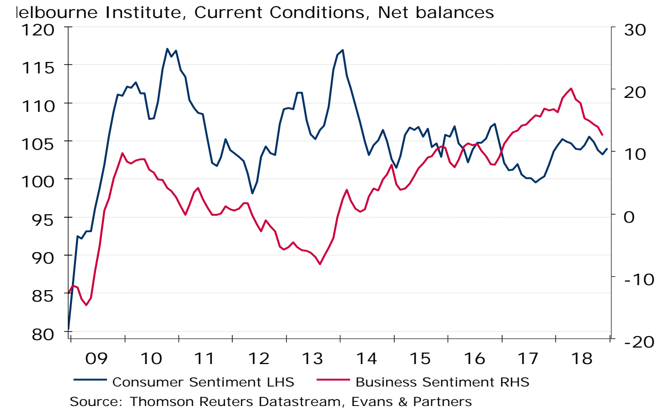
Previous Australian housing downturns



Source: Westpac

We are monitoring closely the flow-on effects of the downturn on the consumer and business sector. Consumers could slow spending due to perceived wealth losses, and businesses could also temper their spending plans. There is certainly a risk to the consumer sector, particularly since these growing concerns are occurring at the start of the Christmas shopping season and at a time when the savings rate is already at low levels. There has been a recent fall in business confidence that may be due to housing or heightened political concerns as we head into an election year.

Consumer and Business Conditions



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