| | Price | 5 Day % Change | 3 Month % Change | 1yr % Change |
|---|---|---|---|---|
| S&P/ASX300 | 62,224 | 3.51% | 3.01% | 8.20% |
| MSCI World Ex-Aus. (Unhedged) | 9,236 | 1.89% | 0.44% | 10.57% |
| MSCI World Ex-Aus. (Hedged) | 1,623 | -0.08% | -2.42% | 2.57% |
| Bloomberg AusBond 0+ Composite | 9,688 | 0.66% | 3.91% | 6.60% |
| BloombergBarclays Global Agg. (Hedged) | 999 | 0.29% | 3.10% | 3.97% |
| S&P/ASX300 Property | 53,066 | 3.64% | 10.03% | 22.05% |
| FTSE/Epra NAREIT (Hedged) | 2,712 | 1.19% | 4.99% | 15.66% |
| S&P Global Infrastructure (Hedged) | 4,911 | 0.29% | 4.62% | 7.84% |
| BarclayHedge Global Hedge Fund Index (USD) | 5,403 | N/A | -6.25% | -5.15% |
| AUDUSD | 0.7088 | -2.23% | -2.32% | -8.91% |
| AUDEUR | 0.6260 | -1.05% | -2.01% | -1.49% |
| AUDNZD | 1.0515 | 0.05% | -2.18% | -2.51% |
| AUDGBP | 0.5475 | -1.21% | -1.47% | -2.14% |
| AUDJPY | 77.7880 | -2.05% | -6.41% | -8.77% |

Source: Bloomberg, S&P Dow jones, MSCI, FTSE/EPRA, Barclays, 9th February 2019

**This week we highlight the change in the outlook for Australian monetary policy, weaker leading indicators and discuss portfolio positioning going forward. We suggest allocating some international equity exposure away from Quality to Low Volatility stocks, retaining a focus on developed markets.**

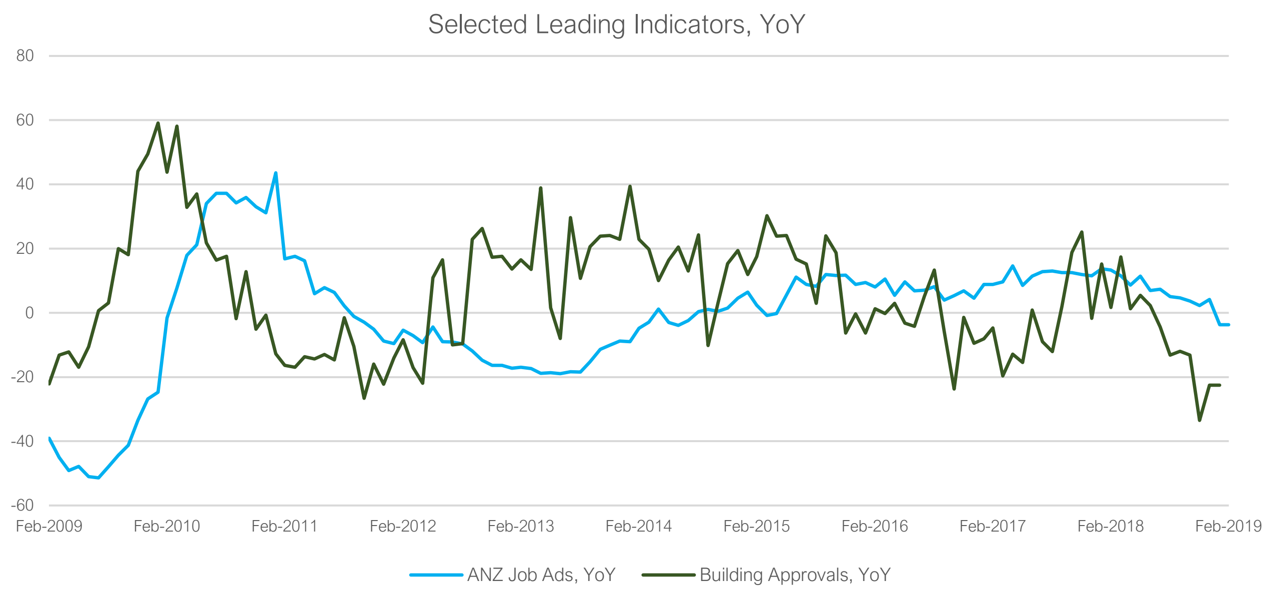
It was a busy week for analysts as the Royal Commission report was published on Monday and we had three major releases from the RBA . The first was the monthly meeting on Tuesday that seemed stubbornly hawkish despite lower growth and inflation forecasts, followed by the far more dovish National Press club address and quarterly Statement on Monetary policy.

The Reserve Bank now sees roughly equal probability that the next rate move will be up or down. Crucial to the outlook is the extent to which household spending will be affected by the housing correction taking place in Sydney and Melbourne – a correction that was “inevitable” in the Bank’s eyes. The Bank hopes that the employment market will continue to strengthen, and wage rises will be enough to support consumption.

As we have written in several recent reports, we find very little cause for optimism due to the widening between falling unemployment and the stubbornly high underemployment figures. The December retail sales figures that were released this week also surprised to the downside. The smoothed quarterly figures show very low rates of sales growth. Leading indicators such as ANZ job advertisements and residential building approvals also suggest that investment and employment may struggle this year (see charts below). We firmly believe that the next move will be down, and the market is now pricing a 66% chance of a cut in the cash rate by the end of the year.

The Governor also stated that he saw one of the main risks to the Australian economy as the slowdown that is taking place globally. The Australian economy is definitely affected by the global economy, albeit with some degree of lag. The recent falls in long-term bond yields definitely give some cause for concern, although portfolios would generally have benefitted from falling yields and the gains made in interest rate-sensitive sectors, such as listed property and infrastructure. But the question of where to allocate capital going forward is now a little trickier.


Source: Bloomberg, ABS, 9th February 2019




Source: Bloomberg, ANZ, ABS, 9th February 2019

This week the S&P500 stalled and failed to penetrate the 200-day moving average. This suggests a more bearish outlook for equities since the US still has the strongest momentum of all the major economies. A comment from the President that he would not meet with Xi before the March 1st trade negotiation deadline was blamed for the softer session on Friday. But there are several major events with fast-approaching deadlines that concern investors. In addition to the possible imposition of 25% tariffs on a wider range of Chinese imports, Trump must also reach a deal with the Congress to avoid another government shutdown. In his State of the Union address this week he indicated that he is willing to work with Democrats on shared policy objectives such as reducing the costs of healthcare and spending more on infrastructure. But he redoubled his commitment to a physical barrier at the southern border, the principal source of disagreement. Lastly, the UK is to leave the European Union, with or without a deal, on 29th March. The deadline is being used as a negotiation pressure point by the UK government and there is little chance of a deal being reached much earlier than the end of March.


Source: Bloomberg, S&P Dow Jones, 9th February 2019

The combination of slowing growth, obvious geopolitical risks and central banks that are no longer tightening monetary conditions - but not loosening either - makes for a difficult environment for straight market beta to drive returns.

In the last few weeks we have suggested including physical gold as an insurance in portfolios. We have also suggested funding the gold position by holding Australian equities underweight on a dynamic basis. Events this week have done little to change our view.

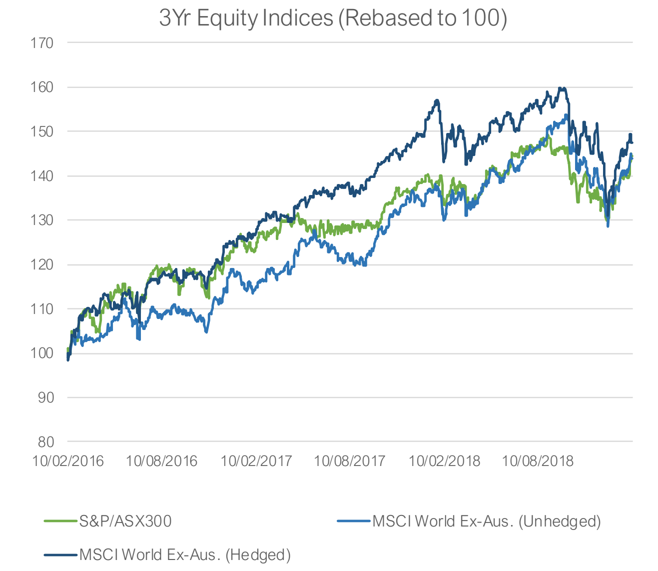
There are pockets of value in the Australian market. The terrible accident at Vale in Brazil has lifted iron ore prices and the S&P/ASX300 materials sector looks relatively attractive at 13.8x forward earnings. Financials rallied 6.6% over the week as the Final Report of the Royal Commission was much kinder than expected to the major banks in particular. Financials still appear relatively cheap despite the rally this week, but the discount is obviously much narrower. Most other sectors continue to look expensive.

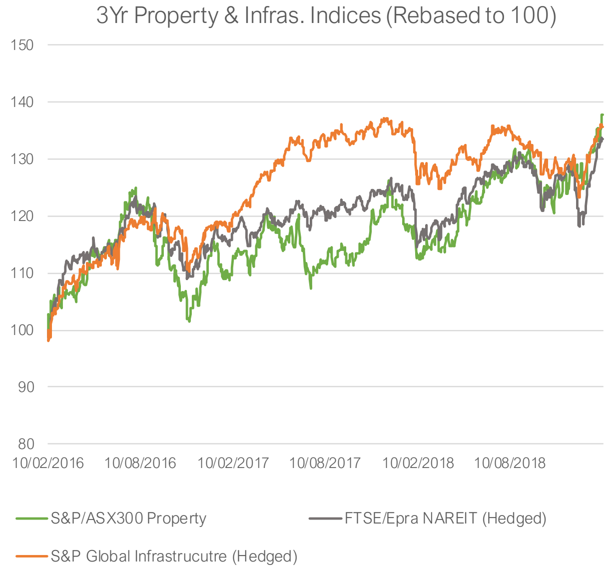
Given the outlook for the Australian economy, it is likely that the Australian dollar will fall below 70 US cents at some point in the months ahead. But there is a danger of having a portfolio too skewed towards a bearish outlook. By reducing Australian dollar exposures and holding some gold, a portfolio would already be tilted to protect against bearish scenarios. Holding global stocks underweight in favour of bonds would tilt a portfolio further in that direction. If, for example, a Brexit compromise is reached at the last minute, or if a shutdown is avoided and the US economy reaccelerates, the most likely result is a rally in global shares. International equity valuations are also more attractive than for Australian shares. So holding international shares underweight would deprive the portfolio of potential upside should the outlook improve. In these scenarios, US interest rates would also be more likely to begin to rise again and that would present a headwind for emerging markets in particular. For that reason, we continue to focus on developed markets.

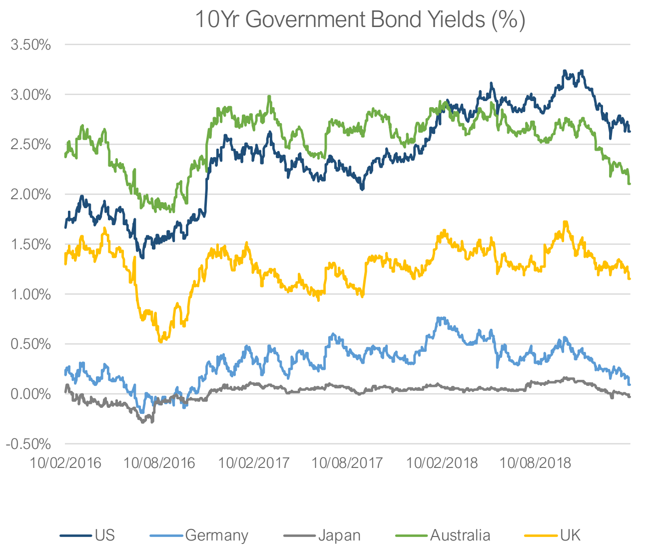
In recent weeks we have focused on Quality stocks and we continue to recommend holding a bias to Quality. However, the outlook for earnings growth this year is not as strong as 2018 or 2020. Next year is also likely to see more revisions, which may well be downwards. Equity markets could be quite skittish given the uncertainties. Although Quality offers excellent returns over the long run, it can become susceptible to high drawdowns, particularly if the factor becomes crowded. Therefore, we would suggest allocating exposure to the more defensive low volatility factor, while maintaining an overall neutral exposure to international shares, as well as bonds and property.

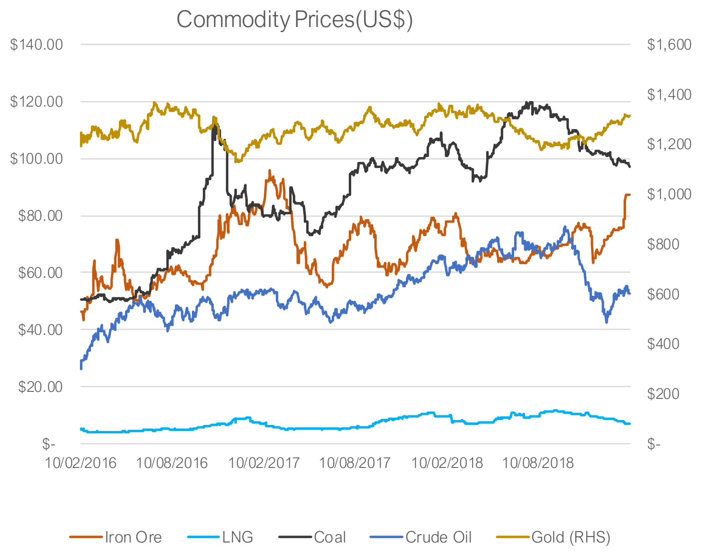
Significant Upcoming Data:

| | Monday | Tuesday | Wednesday | Thursday | Friday |
|---|---|---|---|---|---|
| Australia | | Home Loans; NAB Business Cond. & Conf.; Investment Lending | Westpac Consumer Conf. | | |
| US | | NFIB Small Business Optimism | CPI; Real Earnings; MBA Mortgage Applications; JOLTS Openings | PPI; Retail Sales | Industrial Production; Capacity Utilisation; Empire Manufacturing; U.Mich. Sentiment |
| Europe | UK GDP & Ind.Prod.; Danish, Norwegian and Swiss CPI; | | UK Inflation; Riksbank Meeting; Eurozone Ind.Prod. | Eurozone, German, Danish & Dutch GDP; Eurozone, French & Swedish Unempl.; | UK & Dutch Retail Sales; Spanish CPI |
| Japan | | Money Stock M2/M3; Machine Tool Orders; Tertiary Industry Index | PPI | GDP | Industrial Production; Capacity Utilisation |
| China | | | | Trade Data | CPI; PPI; Balance of Payments |

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