| | Price | 5 Day % Change | 3 Month % Change | 1yr % Change |
|---|---|---|---|---|
| S&P/ASX300 | 62,375 | 0.24% | 6.32% | 6.92% |
| MSCI World Ex-Aus. (Unhedged) | 9,417 | 1.96% | 4.81% | 9.75% |
| MSCI World Ex-Aus. (Hedged) | 1,666 | 2.63% | 1.62% | 1.38% |
| Bloomberg AusBond 0+ Composite | 9,687 | -0.02% | 3.65% | 6.64% |
| BloombergBarclays Global Agg. (Hedged) | 998 | -0.02% | 2.84% | 3.96% |
| S&P/ASX300 Property | 53,100 | 0.06% | 11.82% | 22.44% |
| FTSE/Epra NAREIT (Hedged) | 2,718 | 0.23% | 5.31% | 14.01% |
| S&P Global Infrastructure (Hedged) | 4,968 | 1.15% | 6.80% | 6.08% |
| BarclayHedge Global Hedge Fund Index (USD) | 5,403 | N/A | -6.25% | -5.15% |
| AUDUSD | 0.7141 | 0.75% | -1.87% | -10.12% |
| AUDEUR | 0.6321 | 0.97% | -1.61% | -0.51% |
| AUDNZD | 1.0393 | -1.17% | -2.51% | -3.19% |
| AUDGBP | 0.5540 | 1.17% | -2.81% | -1.71% |
| AUDJPY | 78.8950 | 1.40% | -4.81% | -6.88% |

Source: Bloomberg, S&P Dow jones, MSCI, FTSE/EPRA, Barclays, 16th February 2019

Improvements in the outlook for trade negotiations with China and the avoidance of a government shutdown helped the S&P500 break upwards through the 200-day moving average this week. This was despite surprisingly weak US retail sales, but the market may well be right not to read too much into December's result.

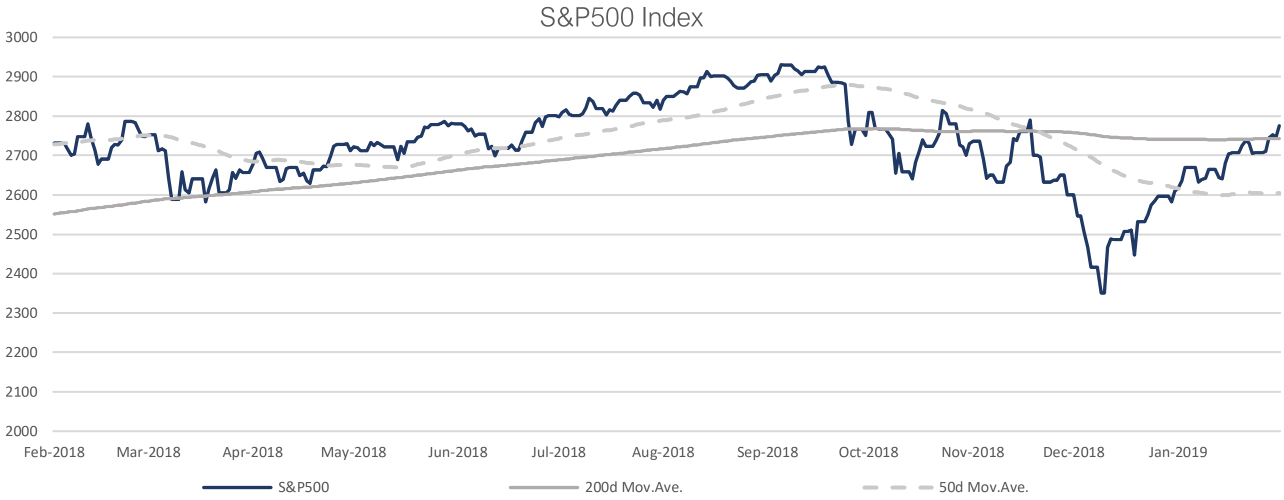
Australia saw a slight improvement in business and consumer confidence, but not enough to alter our central scenario. This week's unemployment data will be hugely important, given the RBA's reliance on an improving labour market.

We also saw further evidence of the slowdown in global manufacturing and in European growth. Taken together, the current stream of data is likely to keep central bankers on hold for the time being.

Looking ahead, earnings are increasingly likely to dictate whether equities can hold on to the recent gains. The outlook for earnings globally is not as strong as in 2018 and the satisfaction with corporate results is likely to fade. Relative to analysts' forecasts, we view the global outlook fairly constructively, albeit with the risks skewed to the downside.

The S&P500 index is once again trading above the 200-Day moving average. It is unusual for the index to rally into a long weekend. So, pushing through the important level of resistance is significant.

Of the three major concerns for markets (US - China trade, US government shutdown and Brexit), the two that are centred on the US have seen positive developments. Even though the Democrats may challenge the decision by President Trump to declare a state of emergency in order to build the southern border wall, a second government shutdown has been averted. Similarly, the outlook has improved regarding the trade dispute with China. President Xi stated that talks would continue in Washington this week and the market is clearly expecting some positive news. The third major concern for markets, that the UK would leave the EU on 29th March without agreeing a deal, saw a minor setback this week. Prime



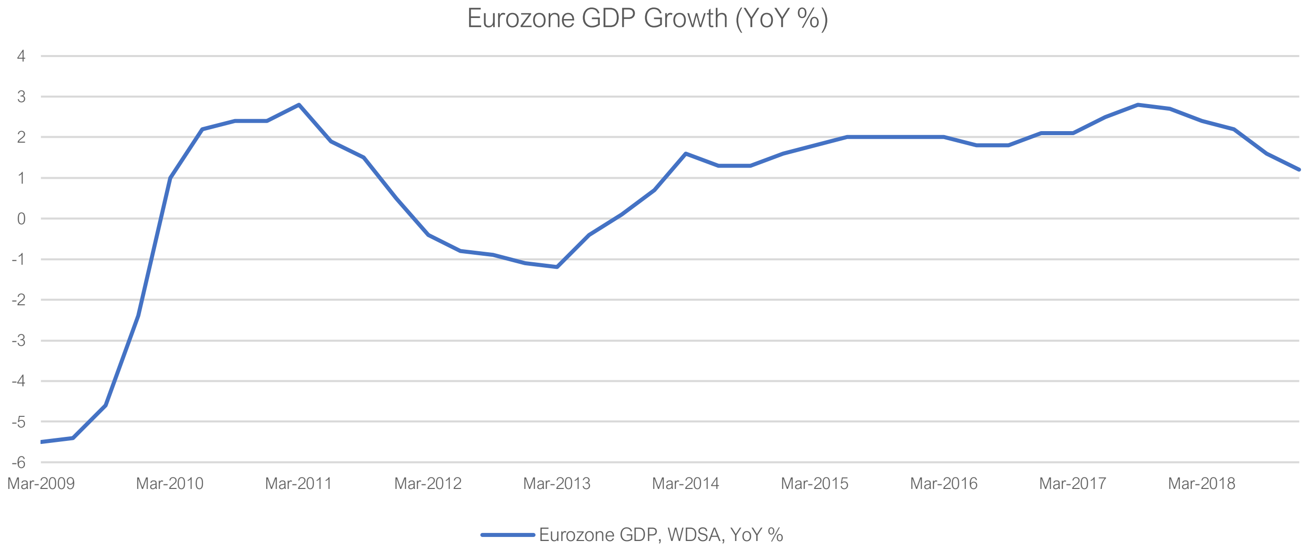

Source: Bloomberg, S&P Dow Jones, 16th February 2019

Minister May lost a vote in Parliament regarding her negotiation tactics. However, the vote has few practical implications and is unlikely to alter the government's negotiating stance.

Positive steps in two out of three major risks carried the market higher. It was little affected by the disappointing US retail sales numbers for December, and this reaction appears right to us. The market bottomed on 24th December and did not rebound substantially until January, when members of the FOMC suggested that the Fed may slow the pace of monetary tightening. Since then, the government shutdown has ended, the stock market has risen off the lows and consumer sentiment has also rebounded (see chart below). We believe that this rebound in confidence augurs well for future consumption. Moreover, in the UK where December retail sales were also disappointing, the January figures have already been published. They were much stronger than in December. Some have suggested that the December weakness was in part due to the large volumes of "Black Friday" sales at the end of November. In the US, we see a similar pattern, although it was October that was relatively strong.

We therefore believe that we will see an improvement in US consumption in January and February, notwithstanding cold weather effects. But the December weakness has prompted economists to revise down the Q4 GDP estimate for the US to below 3% (annualised). Industrial Production of -0.6% for the month of January matched the regional Fed surveys in showing that the US manufacturing sector is experiencing a slowing in activity, as in other international regions.


Source: Bloomberg, University of Michigan, US Census Bureau, 16th February 2019



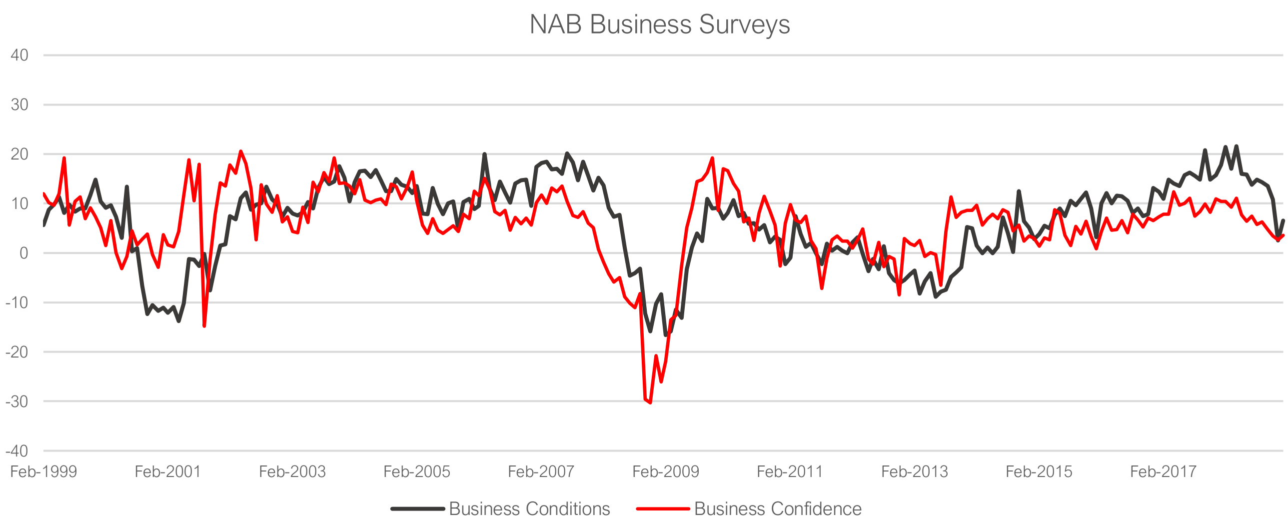

Source: Bloomberg, Eurostat, 16th February 2019

The New York Manufacturing survey for February released on Friday gave some hope that the slowdown may have stopped accelerating. In any case, the numbers are weak enough to ensure that the Fed remains on hold for the time being.

The Eurozone released a relatively soft Q4 GDP growth number of 1.2% last week. The number is similar to the low levels of growth seen in the UK, Japan and China. We know that Italy (-0.2%) is in recession. But the major Eurozone economies of Germany (+0.6%), France (+0.3%) and Spain (+0.7%) are also dragging the average for the region lower.

Chinese trade data last week saw a surprisingly strong +13.9% in exports, but it is difficult to extrapolate too much from these figures.

Australia saw some respite from the stream of disappointing data last week. There was a slight lift in the NAB business surveys, and the Westpac-Melbourne Institute Consumer Confidence also figure improved for February, but not enough to change our view that the domestic economy is weaker that the RBA believes. As the Reserve Bank recently indicated, the labour market will be the key factor in determining the outlook for interest rate policy. As a result, the employment figures released on Thursday have assumed greater importance than usual. Economists expect the unemployment rate to remain at 5%. We ultimately expect the labour market to soften and the overnight cash rate to decline in the months ahead.

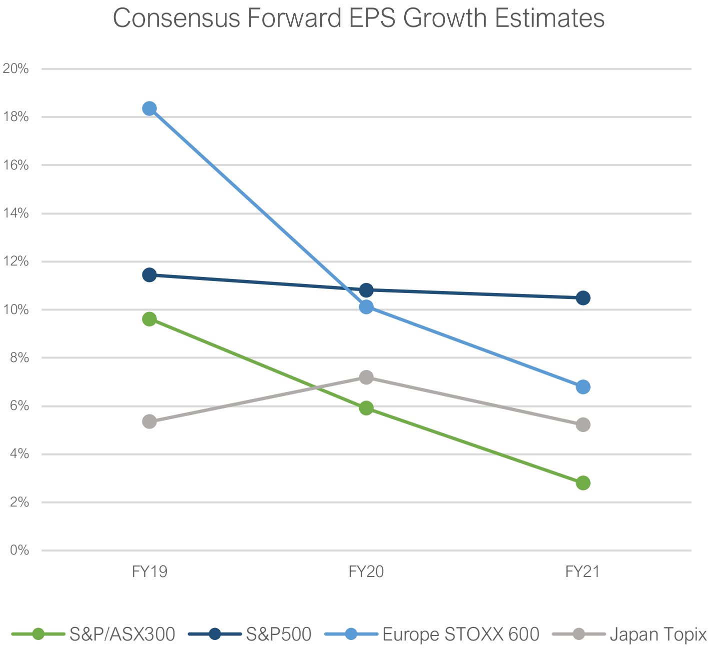



Source: Bloomberg, Eurostat, 16th February 2019

Turning to company profits, the Australian mid-year earnings season is well underway. 104 of 289 S&P/ASX300 companies have reported. So far it has made for unpleasant reading. Sales growth is a meagre 2.8%, while earnings-per-share are 0.3% down on the same period last year, and nearly 10% lower than forecasts. There have been some high-profile misses, including from the beleaguered AMP that saw profits all but wiped out by costs associated with the Royal Commission.

In contrast, the US quarterly earnings season has been much stronger. Roughly 80% of the S&P500 have published results, with profits up 11% on the Q4 2017. Of course, lower tax rates have helped, but revenues are also up nearly 7%, illustrating that the main driver is the underlying strength in the economy.

Europe has also seen decent earnings results over the last year, largely to the presence of large multi-nationals in the index.




Source: Bloomberg, 17th February 2019

Looking forward, analysts forecast that the pace of earnings growth is likely to decline in the next two years, with Australia and Europe seeing the largest declines (see chart).

The actual recorded level of growth will likely differ somewhat from these forecasts. It is typical for Australian estimates to be revised down as we approach the actual period, whereas in the US, actual results tend to beat forecasts. However, the critical question for today's outlook is whether the forecast level of US growth will actually be achieved. The current estimates imply that the economy will continue to expand, that the Fed remains benign and that there is no escalation in the trade dispute with China. If the Fed remains on the sidelines for the rest of the year, that may turn out to be true. But it does appear that the risks are skewed to the downside rather than the upside. In other words, the forecasts appear optimistic with little room for upside surprises. If we see a material uplift in wages for example, not only would the Fed tighten faster, but margins would come under pressure and earnings forecasts would quickly be revised down.

In conclusion, we can see why equity indices have reacted positively to recent news flow. But our belief is that the market will soon become more earnings-focussed.

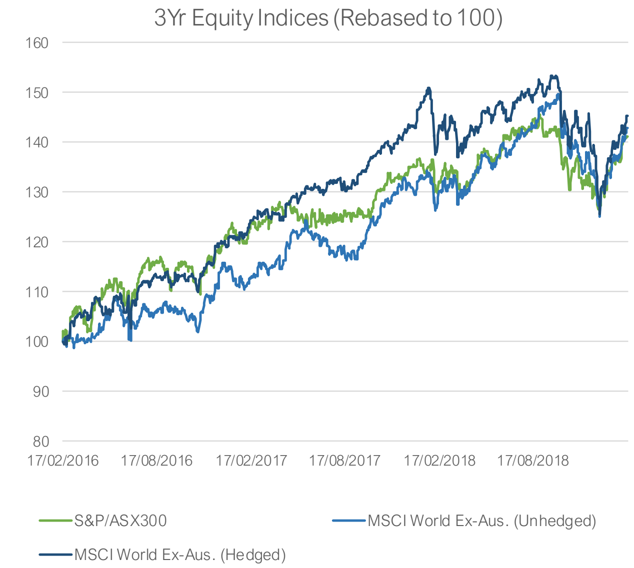
The outlook for earnings growth in Australia is very weak, as is the outlook for interest rates and for the Australian dollar as a consequence. Hence we have advocated an underweight position.

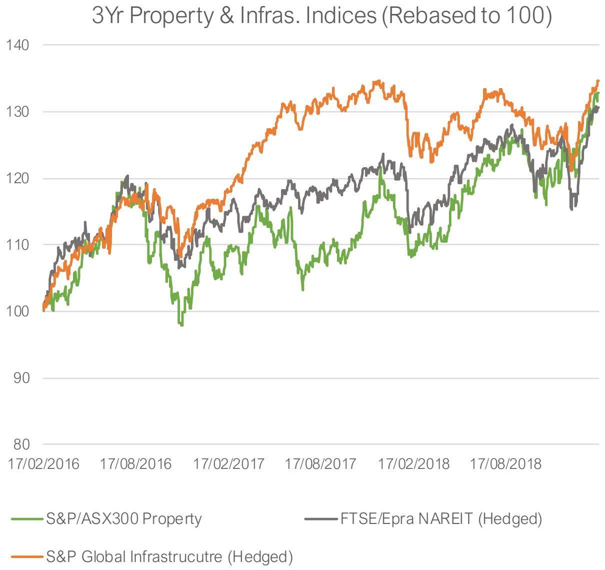
In international equities, the earnings outlook is stronger, and we may "muddle through". But there are plenty of risks to earnings that we can foresee, and with geopolitical tensions relatively high, volatility is likely to remain elevated.

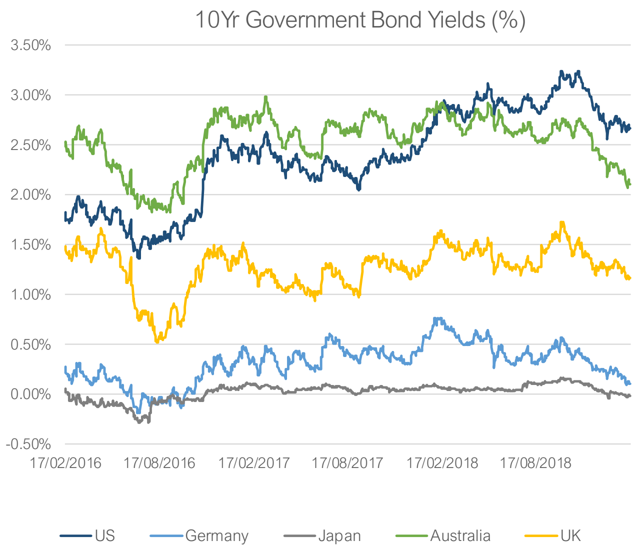
For these reasons we would remain overweight in international equities (with a bias to unhedged currency exposures based on the Australian outlook). Last week we discussed adding Low Volatility exposures to the portfolio, alongside the Quality exposures, in order to reduce volatility and to increase downside protection should some of these risks materialise.

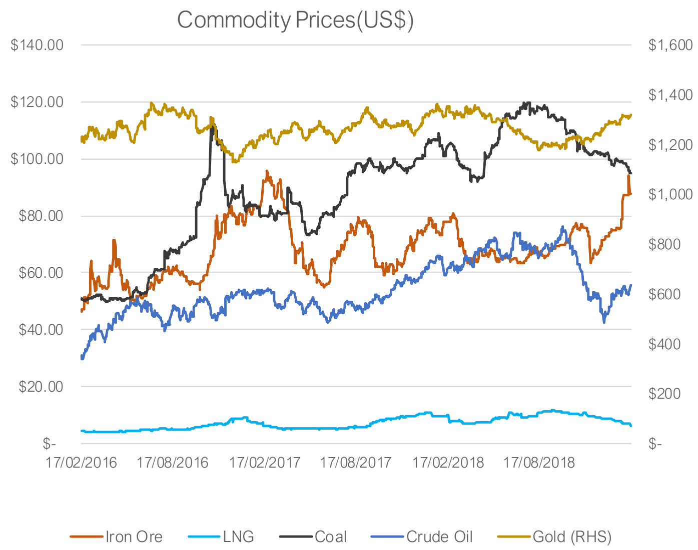
Significant Upcoming Data:

| | Monday | Tuesday | Wednesday | Thursday | Friday |
|---|---|---|---|---|---|
| Australia | | RBA Minutes | Wage Price Index | CBA Manufacturing PMI; Employment | Governor Lowe's Parliamentary Testimony |
| US | President's Day Holiday | NAHB Housing Index; MBA Mortgage Applications | FOMC Minutes; | Philadelphia Fed Survey; Durable Goods; Markit PMI | |
| Europe | | ZEW Survey; Italian & ECB Current Account; UK Unemployment; Italian Industrial Orders; Swedish & Finnish CPI | | Eurozone, German & French PMIs; Italian French & German CPI ; Dutch Unemployment; Eurozone Cons.Conf.; French Business Conf. | German GDP; IFO Survey; Eurozone CPI |
| Japan | Core Machine Orders | Tokyo Condo. Sales | Trade Balance | Nikkei PMI; All Industry Activity Index; Machine Tool Orders | CPI |
| China | | | | New Home Prices | |




Source: Bloomberg, S&P Dow jones, MSCI, FTSE/EPRA, 16th February 2019

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