



Investment Matters

Reflation Before Recession

APRIL 2019

Reflation Before Recession



Investors are spooked. The calmness that prevailed for the first few months of the year has disappeared, and it has been replaced by a pervasive sense of uncertainty. Investors should be worried. Bond markets have been signalling an ongoing deterioration in the global growth outlook for

some time, with the recent and rapid shift in policy direction by key central banks, providing plenty of ammunition for supporting a bearish bond view.

Bond yields are leading PMI's lower

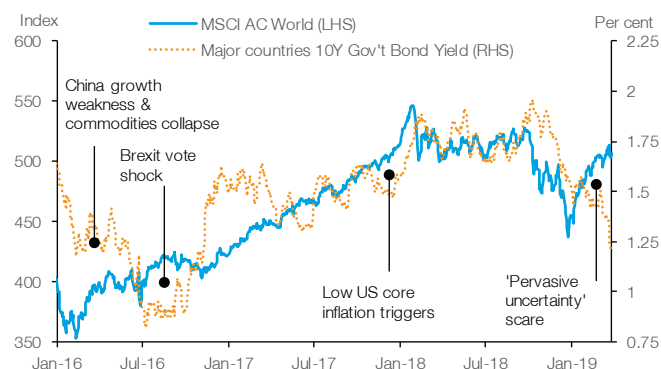


Source: Macquarie Research, MWM Research, April 2019

At this stage, it remains too early to tell whether growth *“catches down”* with the bearish bond market view or *“catches up”* to the more bullish equity market view. Our central case is the latter and that growth begins to recover rather than getting dramatically worse in the months to come.

We are not ignoring the message that falling bond yields and/or inverted yield curves are sending – investors should do so at their own peril. However, there are still few signs of pervasive weakness. Similarly, bond markets are leading central banks into a softer monetary policy stance and it has become increasingly clear that a lack of global inflationary pressure is providing ample headroom for policy makers to offset downside growth (geopolitical) risks should circumstances require it.

Will growth catch-down to bonds or catch-up to equities



Source: FactSet, MWM Research, April 2019

In fact, it is now clear that waning growth momentum coupled with rising financial market volatility has set the scene for global central banks to embark on yet another (potentially co-ordinated) bout of monetary policy stimulus. China has been ramping up monetary policy support for more than a year, Japan's monetary policy taps have never been turned off (or down) post GFC, Europe is on the cusp of stepping up its liquidity support and most recently, the Fed has done a significant monetary policy backflip with a tapering of quantitative tightening (QT), for all extent and purposes, also the equivalent of a rate cut.

We do not think that enough has been done to arrest the deterioration in global growth momentum or put a sustained floor in global risk assets. However, we think bond yields already reflect where growth might land, and so further weakness is unlikely to be met with the same degree of pessimism.

Thought of differently, it would take a substantial deterioration in the growth and inflation outlook for bonds yields to meaningfully fall from their current levels at which point falling yields would become a drag rather than tailwind for financial assets. On the other hand, we cannot say the same for equity markets where they remain vulnerable to downside risks in the period that it takes for data and/or liquidity to begin improving or for policy makers to shift from a more positive narrative to outright policy support.

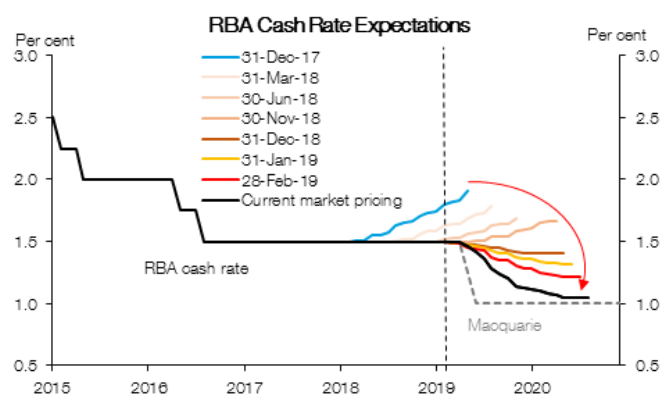
Ultimately, we think stronger growth and a stabilization in inflation will see bond yields creep higher and begin to

support equity markets (higher bond yields will provide equities with confirmation that the growth and inflation outlook is improving). This view remains predicated on the assumption that we see a rise in both real yields and a gradual rise in pricing pressures (easing of deflation fears).

This combination should keep financial conditions relatively easy and rates at (still) attractive levels for stocks. With valuations back around the long-term average (~15x forward earnings), this prevents us from becoming overly bearish on International Equities where a reflationary cycle is likely to provide increased support later in the year.

However, the dispersion in the growth outlook drives us to be tactically underweight Europe (despite an appealing valuation) while remaining overweight Emerging Markets. The latter might appear inconsistent with where risk aversion sits, but we think lower US\$ rates as well as support from China will ultimately win through as key drivers of EM returns.

Macquarie expecting 2 RBA rate cuts before YE19



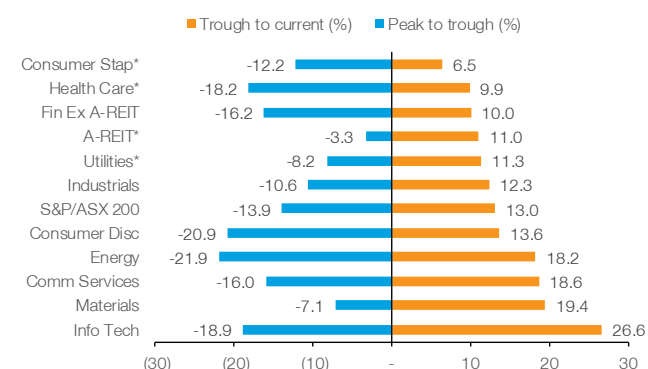
Source: Macquarie Research, MWM Research, April 2019

Domestically, Australia has not been immune to global slowdown pressures. Economic growth has deteriorated faster than expected due to the drags from weaker global growth as well as a slowing housing market. Consumption is being pulled down by falling household wealth and anaemic wage growth. We believe Australia should avoid a recession as it remains supported by elevated commodity prices and strong government spending.

However, headwinds are likely to persist for some time yet and there is limited cushion for the ripple effect of these risks to rise without a bigger negative feedback loop developing. Macquarie now expect the RBA to cut the cash rate by 50bps before year end – a forecast that would have look well out of place only 6 months ago.

This would take rates to a new all-time low, but in turn provide support for rate sensitive areas. This will put continued downward pressure on the A\$ and for government bond yields to remain sub 2.50% out through 2020/21.

YTD leadership has been defensives over cyclical



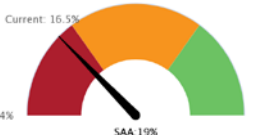







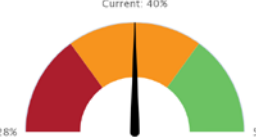

*denotes the defensive sectors

Source: FactSet, MWM Research, April 2019

Against a backdrop of deteriorating economic growth and an RBA that will be reactive rather than proactive to data weakness, we see little reason why the equity market will not trade lower, if not at best sideways. Earnings growth remains scarce with corporates already running relatively lean. Similarly, with valuations now back around the long-term average of 15.5x and bond yields having already taking the brunt of the downgrade to growth expectations, we don't think the environment is supportive of further multiple expansion. We downgrade our Australian equities allocation to underweight.

Jason and the Investment Strategy Team

Asset class preferences

Recommendation	Quick takeaway
 <p>Current: 16.5% SAA: 19%</p> <p>Australian Equities</p>	<p>We downgrade our neutral allocation to underweight. Our 5 markers for the equity market are all either negative or at best neutral and we see little chance that Australia will outperform global equity markets. The macro environment is weak with little near term upside; corporate earnings growth is poor and unevenly distributed, valuations are neutral (expensive for some areas and a value trap for others); technicals are stretched following a strong 1Q19 rally and sentiment is mixed. We don't think these are conditions that drive a large re-rate particularly when political uncertainty remains high.</p>
 <p>Current: 24% SAA: 23%</p> <p>International Equities</p>	<p>We continue with a neutral allocation to global equities. Within global equities we prefer emerging markets to developed markets were a reflationary China and a softer US\$ should drive outperformance into 2H19. Within developed markets, we stick with our preference for US equities over European and Japanese equities. The US is supported by a more dovish Fed, a solid economy and reasonable valuations. In comparison, European equities, while cheap, face increased macro headwinds as economic growth deteriorates.</p>
 <p>United States</p>	 <p>Europe</p>
 <p>Japan</p>	 <p>Emerging Markets</p>
 <p>Current: 5% SAA: 5%</p> <p>Property</p>	<p>We upgrade REITs to neutral. The moderation in growth momentum has potentially reduced the absolute level of upside in global bond yields but ongoing volatility will likely keep a reasonable bid in the sector. Domestically we continue to expect further declines in short rates which also has the potential to lower the term structure. We prefer pure growth exposed REITs over those under cyclical and/or structural pressures such as retail and developer (house/apartment) exposed REITs. Political risk and potential policy around negative gearing and capital gains tax add to the performance bifurcation.</p>
 <p>Current: 8% SAA: 8%</p> <p>Alternatives</p>	<p>We move to overweight in Alternatives from maximum overweight. Coordinated Central Bank action suggests to us that the increasing volatility we witnessed over the course of 2018 will begin to subside. As a result we see greater potential for diversified returns from fixed income allocations.</p>
 <p>Current: 40% SAA: 40%</p> <p>Fixed Interest</p>	<p>We move to neutral fixed income but prefer credit markets to developed sovereign markets in general. The accommodative stance taken by Central Banks globally should be supportive of credit markets generally. Our base case remains there will be no recession and as such we view it as too early to overweight fixed income. Our move to neutral fixed income overall reflects a cautionary stance on the global growth outlook.</p>
 <p>Current: 9% SAA: 5%</p> <p>Cash</p>	<p>We increase our overweight to cash as we take profits on our Australian equities position.</p>

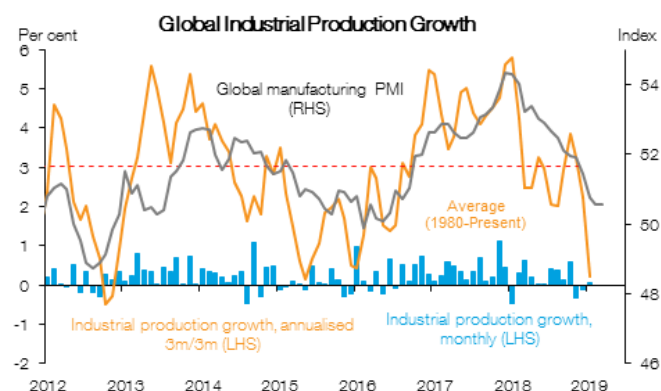
Global economics – Bond yields indicate sharper slowdown possible

- US consumer resilient, capital spending under pressure;
- China policy easing improves sentiment;
- Europe leading the global slowdown.

The most recent Markit manufacturing PMIs for March continue to indicate deceleration, with Europe weak (led by a big downside miss in Germany) and the US rolling over. This latest data is reinforcing the view that it might appear optimistic to expect a sharp 2H rebound in global growth.

Bond yields have moved in tandem with the deterioration in growth momentum driving an inverted yield curve (3mth less 10yr) for the first time since 2007. While many commentators are debating the forecasting merits of yield curve inversion, our view is that the yield curve is one factor that should be considered in assessing the likelihood of global recession. Methods combining this measure with others such as unemployment and equity market levels have a higher success rate in forecasting growth slowdowns.

Global slowdown continues apace



Source: Macquarie Research, MWM Research, April 2019

Macquarie estimate that the end of year slowdown saw global GDP growth fall from 2.75% in Q4 to around 2.25% in Q1, with industrial production and exports noticeably weaker.

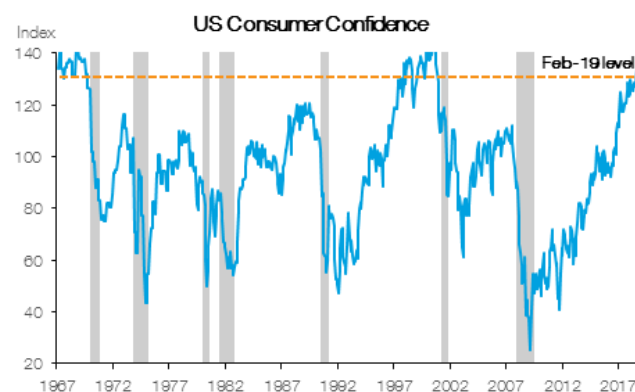
It is yet to be seen how economies respond to central bank policies quickly pivoting to shore up growth (given it remains largely the promise of more rather than immediate action). Issues like the trade war and Brexit have taken a back seat to slowing growth rates and resolution of these issues may no longer provide the positive stimulus to sentiment required to counteract the economic slowdown. Macquarie's view remains that a

continued slowdown will be met with rate cuts with the prospect of recession in the next year unlikely.

United States: Fed on slowdown watch

US growth began its deceleration in 2H18 and looks likely to continue this trajectory. After the fiscal stimulus of the Trump tax cuts, real GDP growth peaked at 4.2% (Q2), then tailed off to 3.4% (Q3), 2.2% (Q4) with Q1 market forecasts standing at around 1.5%. The impact of government shutdown on Q1 activity is difficult to quantify however Macquarie believe 2Q19 should see a bounce back as government spending kicks back into gear. Post this bounce, the forecast is for soft real growth of 2.2% for 2019 and 2.0% for 2020 with inflation trending higher but remaining contained. The US labour market remains strong, with jobs growth at a pace that should further reduce unemployment. The tight labour market has also kept wages growth moving to a cycle high.

US consumer confidence buoyant



Source: Macquarie Research, MWM Research, April 2019

Consumer spending is forecast to underpin US growth going forward. Household balance sheets are in relatively good shape compared to pre-GFC and consumer confidence moved higher in February after soft months in December and January.

If there is going to be a trouble spot in the US economy, it's likely to be corporate balance sheets. Triple-B rated debt as a percentage of investment grade debt has grown from 30% 10 years ago to over 50% today. As economic growth slows, companies will increasingly be faced with making capital spending cuts in order to not fall below investment grade. This process may be associated with a mild manufacturing recession, but the rise of the services sector should favour resilience across the broader economy.

Only a matter of months ago, the market and the Fed expected a policy path of several rate rises designed to take the heat out of the labour market. Markets are now giving the Fed the benefit of the doubt when it comes to being able to shore up growth with any necessary rate cuts. Macquarie believe a “soft landing” has proved difficult to execute historically with the Fed will continue to watch upcoming data for clues as to which way US economic growth is likely to fall.

China: Policy easing improves sentiment

China’s own policy U-turn involves a move from deleveraging to escalated stimulus at the start of the year in order to shore up growth. Total social financing has risen to 10.1% yoy (year-on-year) vs 9.8% last year with companies looking to issue corporate bonds rather than bank loans given the large drop in bond yields.

China credit growth leads GDP



Source: Macquarie Research, MWM Research, April 2019

Strong credit growth in Jan-Feb now appears to be filtering through to certain parts of the Chinese economy. After slowing to 2% growth in 2018 from 15-20% growth over the previous 5 years, infrastructure spending has rebounded since 4Q18 thanks to government spending. The property market looks set to have a more subdued 2019. Land sales dropped by more than 34% yoy in Jan-Feb and property sales continue to slow as well.

It is questionable whether this strong credit growth will continue given the current state of the economy. First, the credit growth this year is mainly driven by short-term corporate lending, especially bill financing. This stopped quickly after Premier Li warned that bill financing could be used for arbitrage which does not support the real

economy. Second, credit demand remains an issue as developers are refraining from land purchases and Local Government Financing Vehicles (LGFVs) are still under tight controls.

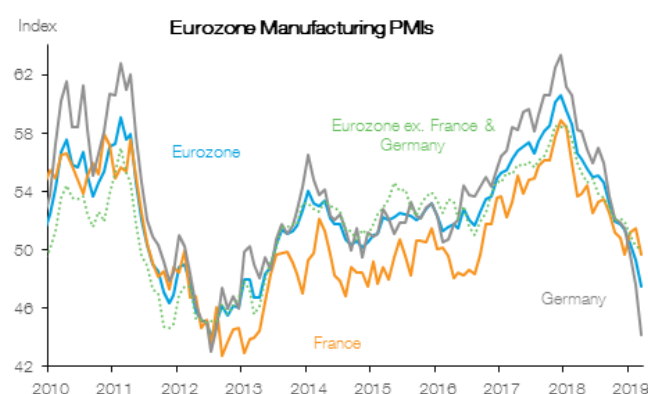
With a growth target of 6.0-6.5%, policy makers may feel the need to do more if the 6% lower bound looks like being breached. Any stimulus would likely focus on easing controls of LGFVs and/or the property sector after corporate earnings growth had turned negative for 2-3 quarters.

Trade growth remains weak with Jan-Feb exports falling 5% yoy after growing 10% last year. The timing of Chinese holidays may have played a role but very soft Korean exports (-8% yoy in Jan-Feb vs +5% in 2018) suggest the problem relates to weaker external demand.

Europe: Looking for a trough

The latest Markit manufacturing PMI numbers suggest European growth continues to fall precipitously, with Germany leading the way. The overall Eurozone measure has dropped to 48 with Germany falling below 45. Despite this weak read, Macquarie believes broad growth should stabilise over the year as exports continue at current rates and German auto and pharmaceutical issues move to be a modest support. If the broader global slowdown does drag Europe lower the ECB might be forced to explore measures other than rate cuts to stimulate the troubled European economy.

Eurozone manufacturing contracting



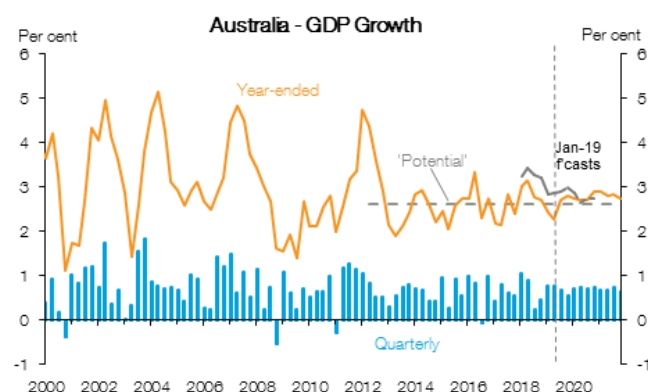
Source: Macquarie Research, MWM Research, April 2019

Australian economics – Heading lower

- Economic growth has deteriorated faster than expected due to weaker global growth and a slowing housing market. Consumption is being dragged down by falling household wealth and anaemic wage growth;
- Australia should avoid a recession due to elevated commodity prices and strong government spending. However, headwinds are likely to persist for some time yet;
- Macquarie expect the RBA to cut the cash rate by 50bps before year end. This would take rates to a new all-time low, but in turn provide support for rate sensitive areas;
- Expect continued pressure on the A\$ and for government bond yields to remain sub 2.50% for an extended period.

Australian growth slowed significantly in H2 2018 as the global backdrop weakened and further declines in housing activity began to impact domestic consumption and activity. We expect both factors to persist for some time and consequently Macquarie have downgraded its Australian growth outlook as well as lowered the RBA cash rate and long bond yield forecasts. While there have been minor downward revisions to the A\$, Macquarie believe it will remain relatively firm despite broader growth pressures.

Macquarie growth forecasts lowered



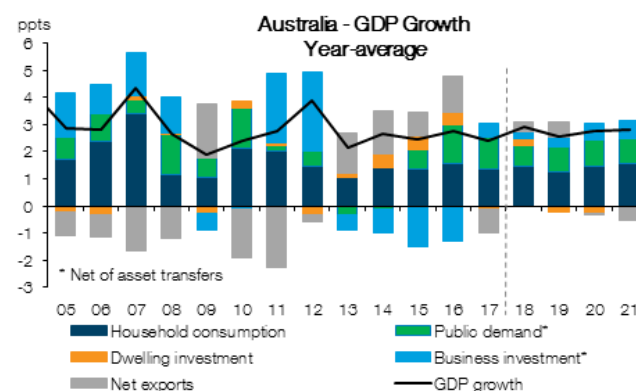
Source: Macquarie Research, MWM Research, April 2019

Domestically, it is clear that falling housing prices are acting as a substantial drag on consumption and (soon to be) housing construction, despite a still healthy labour market and historically low interest rates. Growth in consumer spending – especially discretionary consumption – has slowed markedly and poses risks to an otherwise solid business investment outlook. We expect dwelling investment to fall sharply from a high

level. Resource exports will also contribute less to growth than in recent years, though prices are expected to remain relatively resilient.

Macquarie now expect GDP to expand by just 2.1% over 2019 following an already sluggish 2.3% over 2018. While growth is likely to be softer than previously expected, we still believe that **the risk of a recession remains quite small**. In part, this resilience is due to continued **strong government spending (23% of GDP), which we are forecasting to increase by 5.0% this year, following an increase of 5.5% over 2018**. Most of this is government consumption, supported by the NDIS rollout and increased spending on (other) health as well as education. Infrastructure spending, while smaller, is also expected to continue growing strongly and support the business investment outlook.

Dwelling investment expected to weigh on growth



Source: Macquarie Research, MWM Research, April 2019

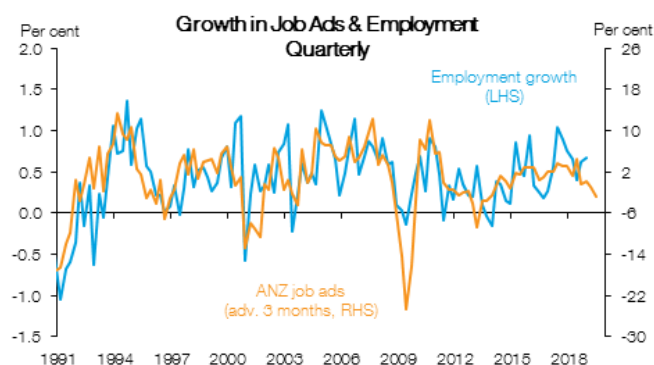
Key highlights:

- **Labour market – unemployment to tick higher:** While the official unemployment rate remains at a low 5%, Macquarie now expect some increase in the jobless rate in coming quarters as employment growth slows. The post-GFC experience suggests “hours worked” falls more than “heads employed” as growth slows. This would imply that the rise in the unemployment rate may not reflect the overall softness in the labour market.
- **Inflation – still not hitting the lower target:** Ongoing spare capacity in the economy and the slowing in growth mean that inflation remains below the RBA’s 2-3% target and is not expected to return to within the target band until 2021. Global experience suggests that inflation that is “too high” is unlikely to be a concern for

the foreseeable future even if the unemployment rate were to fall noticeably below 5%.

- **Consumer spending – downside pressures unlikely to relent soon:** Consumer spending continues to be hampered by weak income growth, declining household wealth and more recently falling confidence. Macquarie are forecasting an ongoing improvement in wages growth but disposable income growth will remain weak with tax bracket creep also acting as a headwind.
- **Housing – further declines coming:** There are some signs that the rate of decline in housing prices in Sydney and Melbourne hasn't worsened in early 2019, but equally it has not improved. This is supported by housing price data, slightly higher auction clearance rates (after seasonal adjustment) and anecdotal information. We expect house prices to continue to weaken over the coming 12 or so months, but believe the correction is likely already half way through.

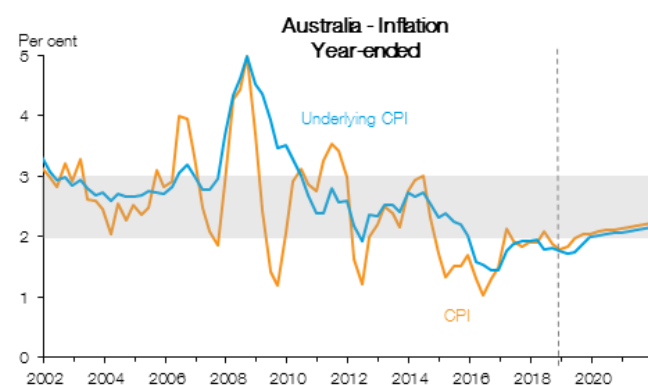
Job advertising has slowed markedly



Source: Macquarie Research, MWM Research, April 2019

We believe the **lower Australian dollar has also been playing its usual 'shock absorber' role but it hasn't extended beyond that.** Our FX strategist, Gareth Berry, has flagged the risk of a dip in the Australian dollar towards US\$0.68 from the current level just above US\$0.70, but this is contingent on an orderly decline in house prices and stable to slightly weaker commodity prices. Anything different could see further downward pressure on the currency. We now expect the RBA to move to shore up growth, with a 25bp cut in May and another in August (the timing could slip a little later if the Bank feels they need more hard data to justify cutting rates). Long rates should also remain low, with the 10-year government bond yield likely to remain below 2.50% until end 2020. This is not a particularly rosy outlook, but we remain confident that a hard landing (recession) is not likely at this stage. Similarly, while declining house prices will remain a sore point for households, we do believe around half of this adjustment has already been seen.

Inflation expected to remain below the RBA's target



Source: Macquarie Research, MWM Research, April 2019

International equities – Vulnerable to deteriorating sentiment and/or a slower growth rebound

- We are neutral International equities. Near term downside risks have risen but Central Banks stand ready to offset a more meaningful or prolonged correction;
- We are underweight Europe where we believe cheap valuations will not be enough to offset deteriorating growth momentum;
- We remain overweight Emerging Markets. While they will suffer in a risk-off environment, they should benefit from a dovish Fed and more aggressive PBoC;
- US equities remain our preferred Developed Market exposure but at no more than neutral. Corporate earnings growth is slowing and valuations, while not expensive, are not flashing “buy”.

Excluding the last 2 weeks of 1Q19, international equities have had a remarkable quarter, recovering almost all of their 4Q18 losses. The problem is that this occurred while economic growth momentum has been deteriorating, and while bond yields were making new multi-year lows.

Equity markets remain close to their YTD highs



Source: FactSet. MWM Research, April 2019

The narrative to explain this outcome has been relatively simple. Equity investors have been looking at the backdrop via glass half filled while bond investors have been looking at this backdrop via glass half empty. Simply put, growth weakness has been enough to spur a dramatic change in central bank policy which is enough for equity investors to believe that downside growth risks will be offset by further policy easing. Bond investors have simply been reacting to growth deteriorating by discounting near term growth and inflation expectations.

We think global equity markets are vulnerable to any further deterioration in growth and inflation expectations but that investors should not position for a sustained downturn. We are not ignoring the message that lower bond yields are sending for risk assets, but this message has been heard loud and clear by central banks.

The problem for equities is not that the outlook should get better, but that the timing of the improvement and the base from where this improvement begins to take place remain uncertain. Add into the mix a period of weaker earnings growth (US corporate earnings may well enter a technical recession through 2Q and 3Q), and a mix of valuations that are not overly appealing, and this puts markets at the mercy of growth momentum and sentiment.

In addition, despite a strong rebound in global equity markets, leadership has been concentrated in defensives (rate sensitive stocks) over cyclicals, fund flows have generally been weak and cash positions have been rising. None of these signs point towards bullish equity market sentiment.

Average lead for yield curve inversion is ~250 days

Yield curve* inversion date	S&P 500 peak date	Delta in days
27/12/1965	9/02/1966	44
2/04/1968	29/11/1968	241
16/01/1973	11/01/1973	-5
18/08/1978	13/02/1980	544
12/09/1980	28/11/1980	77
13/12/1988	16/07/1990	580
26/05/1998	17/07/1998	52
2/02/2000	24/03/2000	51
27/12/2005	9/10/2007	651
Average		248
Median		77

*10Y-2Y, 10Y-Effective Fed funds rate prior to 1976

Source: FactSet. MWM Research, April 2019

Perhaps most concerning for equity markets has been the inversion of yield curves (the US 3mth-10yr in particular). We think investors should take note of the message being sent but should not base their investment allocations on this indicator in isolation.

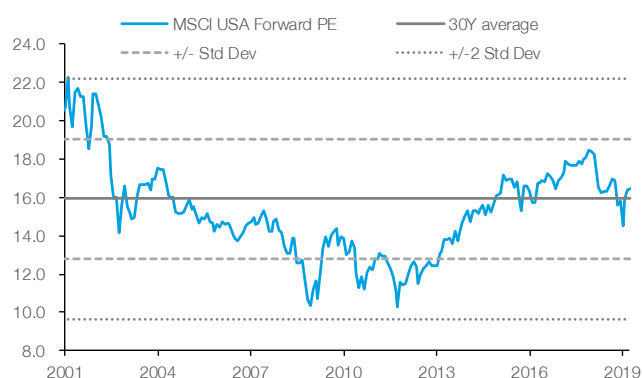
The yield curve has been a consistent signal of recession but there are significant timing variations (leading on average by about 250 days) and secondly, there have been instances where it has sent incorrect

signals. We believe the key message from curve inversion is that rates are likely to now have a lower trajectory for the next few years and that short rates could well move significantly lower.

This would suggest that the valuation premium paid for rate sensitive areas has expanded but that cyclicals might yet get a boost from greater policy stimulus although this is yet to be determined and we remain wary of pre-empting this.

Consequently, we think the equity cycle remains intact, but with short term downside risk that will be differentiated by where domestic fundamentals are tracking. We prefer Emerging markets over Developed markets and US equities over both Japan and Europe. Our stance on EM's is premised on the view that global growth is not collapsing and that the more dovish tilt by central banks in general, and the Fed in particular, will drive a softer US\$ and lower US rates environment which are both EM supportive. In addition, while we are not expecting a large one-off Chinese stimulus, we do believe that the PBC (People's Bank of China) is now firmly committed towards supporting growth and liquidity.

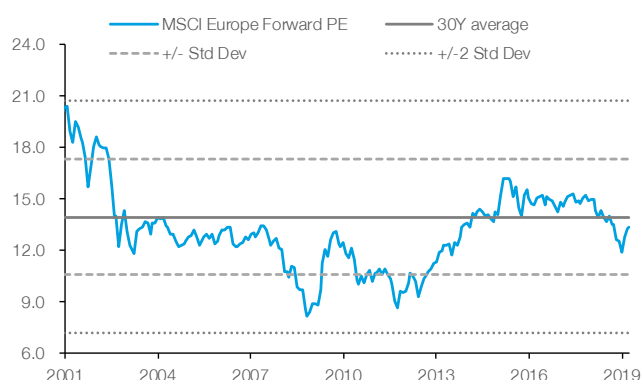
US equities pricing improved economic outlook



Source: FactSet. MWM Research, April 2019

We remain neutral on US equities following what has been a sharp v-shaped recovery. The S&P 500 has rallied ~500 points since late December and is now only 150 points below last year's high which we continue to view as a key psychological level. We are not expecting a sharp deterioration in fundamentals but, it is difficult to see what drives the market meaningfully higher when growth momentum remains weak and corporate profits are being downgraded. Currently, the market has priced in Fed cuts and an improvement in economic growth in 2H19. As such, we view it as prudent to lock in some gains with a view to reallocating at more attractive valuations and with less downside risk.

Europe slowdown outweighs relative value



Source: FactSet. MWM Research, April 2019

We continue to reduce our allocation to European equities. While valuations are appealing, Europe trades as a cyclical basket and in the absence of improving momentum, we prefer to remain on the short side. A more dovish ECB (European Central Bank) is positive for the outlook but we are looking toward a steepening yield curve and more consistent performance from banks in order to signal that a cyclical improvement is on hand. Cheap valuations might put a floor in on the downside but they are not sufficient to drive upside when sentiment is poor.

We see further downside to the Australian dollar with our economist now expecting the RBA will be forced to cut rates later this year. As such investors should remain fully unhedged within global equities, particularly against the US which is not priced for further rate hikes.

Equity market preferences

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Allocation					
Australian Equities		←			
International Equities					
US					
Europe	←				
Japan					
EM					→

Source: MWM Research, April 2019

Australian equities – Taking profits

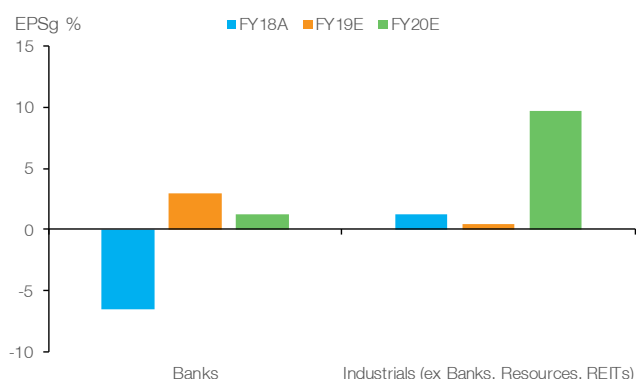
- We move to an underweight position on Australian equities. Earnings momentum remains weak with industrial earnings likely to be negative for FY19;
- We previously upgraded to an overweight position in late October when the S&P/ASX 200 hit 5,650. We see limited upside at current levels with the index ~100 points below its 2018 highs;
- Market leadership has been narrow with miners and bond-proxies leading the way. We view these sectors as vulnerable to mean-reversion.

Australian equities started 2019 on a solid footing with an 11.1% return for the March quarter. This was the largest March quarter return since 1991 (+13.8%) and more than offset the December quarter losses (-9.0%). A stronger iron ore price and a benign Royal Commission were the key drivers for large caps while smaller companies rebounded from oversold valuation levels.

We continue to believe last year's August high of ~6350 for the S&P/ASX 200 is an important psychological barrier and a level where profit taking is prudent. The index has now fully recouped its December quarter losses and now trades on a 15.6x 12-month forward price/earnings multiple, up from 13.7x in late December.

We previously upgraded in October when valuations looked oversold and the risk/reward equation was more supportive. With the index now trading only slightly below last year's peak we see only limited upside and move to an underweight position.

Australia lacks earnings growth outside resources



Source: FactSet, MWM Research, April 2019

Earnings revisions for Australian corporates have remained firmly negative post reporting season and we continue to struggle with the lack earnings growth. Earnings growth for industrials (ex resources, banks, REITs) in FY19 is currently only barely positive (+0.4%),

well down from +14% mid-2018, and will likely end FY19 in negative territory.

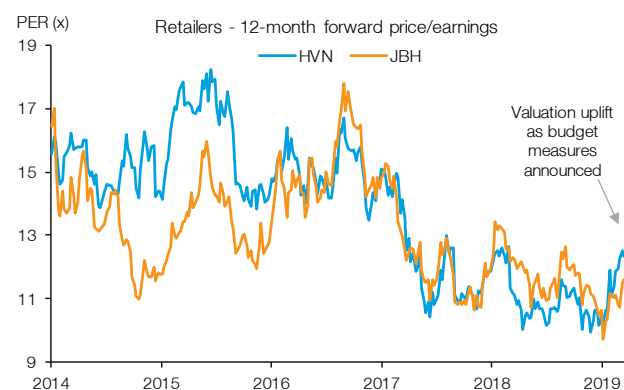
While earnings expectations for the major banks are hardly aggressive (see chart), we see the balance of risks skewed to the downside. Macquarie's bank analysts believe potential RBA rate cuts could prove a negative earnings event for the banks. This runs counter to the historical relationship of rate cuts providing a repricing opportunity and hence being earnings positive.

Our analysts believe the current political and regulatory environment does not support bank repricing and there is a risk of regulatory intervention to reduce the difference between front book and back book pricing ("loyalty tax"). The aggregate impact of normalising back book pricing would be very material at 10-27% earnings downside with the regionals and retail banks most affected. Ongoing remediation charges will also likely remain elevated through FY19-20 with Westpac's latest \$260m increase to provisions illustrating the point.

The resource sector has been the saviour for domestic earnings. The combination of buoyant spot pricing and disciplined management teams (no mega-acquisitions) has proved potent with BHP and RIO hitting multi-year highs. We expect resources can continue to do the heavy lifting in the short-term, but are less positive into the medium term with our commodities team reiterating a year-end \$70/t iron ore price.

The Federal budget predictably contained few negative surprises ahead of the May election. The main positive was for retailers with low to medium income households receiving tax cuts and cash payments for energy bills. The combination of fiscal stimulus, upcoming rate cuts and elevated short interest has seen retailers Harvey Norman (HVN) and JB Hi-Fi (JBH) re-rate, but we remain wary of the sector as housing continues to slow.

A much-needed shot in the arm for retailers



Source: FactSet, MWM Research, April 2019

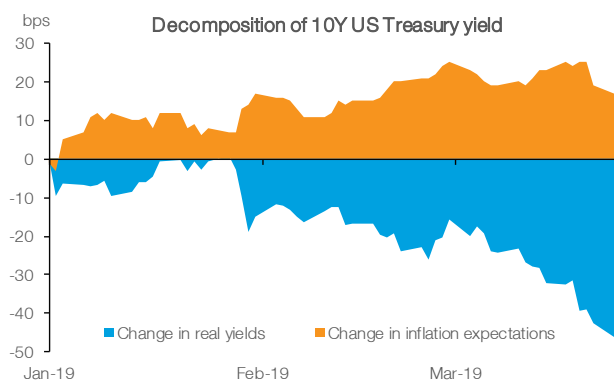
Fixed interest – Central Banks altogether now

- A coordinated accommodative stance by Central Banks globally suggests investors should be wary of taking directional positions in the near term in interest rate markets;
- We retain our preference for credit securities over sovereign securities but stress the importance of credit selection in the current environment. The market is unforgiving of any corporate issuer that disappoints with bonds repricing swift and severe;
- Within sovereign securities, over a medium to longer term, we view inflation linked securities at current valuations as compelling particularly given Central Bank rhetoric regarding inflation overshoots.

Developed Sovereign yields – Central banks line up

The long end of sovereign bond markets rallied strongly as the Fed delivered a dovish surprise by taking a rate rise in 2019 off the table. This drove the US curve to invert for the first time since 2007 and took nominal German 10-year Bund yields negative. In the US, a sharp fall in real yields has driven the 10-year bond lower, while inflation expectations have only fallen slightly over recent weeks.

Rising uncertainty in the global growth outlook has driven yields lower



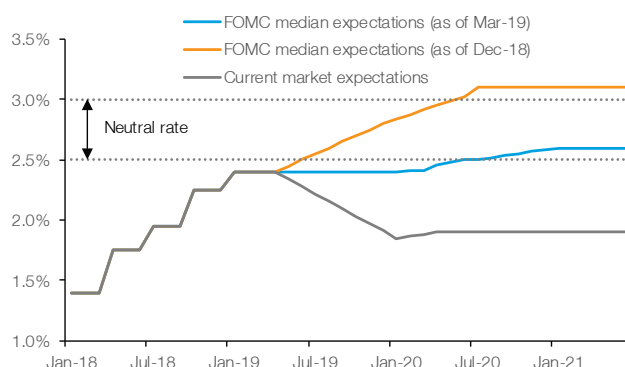
Source: FactSet, MWM Research, April 2019

At the time of writing, the Reserve Bank of New Zealand was the latest to join the conga line of policy makers that have taken a dovish turn – the Fed, the Bank of England, the European Central Bank, the Bank of Japan, the Reserve Bank of Australia for example.

Market expectations are still for further rate cuts in 2019. The main question for us is do we expect more or fewer rate hikes than is currently priced in to the market? In the US, the market is currently pricing in ~31bps of rate cuts. With Central Banks, and the Fed in particular, all

eyeing stubbornly low inflation expectations, it is difficult to rule out at least one cut. Certainly, the Fed's latest guidance was simply marking to market. However, historically rate cuts have only occurred when the economy is heading into recession.

Markets have moved quickly to price in rate cuts



Source: FactSet, MWM Research, April 2019

Recession is not our central case. With the exception of the inversion of the 3mth-10yr yield curve over the past week, there are few other signs of widespread weakness. As a result, we think it is too early to go overweight fixed interest and think that the market has got ahead of itself in pricing in outright rate cuts overall.

Having said that, the risk remains that the inversion of the yield curve persists, central banks do not ease sufficiently either through guidance or via monetary policy and as a result, the recovery in global growth and inflation expectations we expect does not materialise. As a result, we are adopting a cautionary position and move to a neutral fixed income position in a multi-asset portfolio.

Dovish Fed is credit supportive

In February we reduced our underweight to fixed income to take advantage of a corporate spread widening. A dovish Fed is supportive of corporate bonds as are easing financial conditions.

Our central case of a recovery in global growth supported by Central Banks should see corporate spreads remain contained. So far credit markets have not reacted much to the gyrations of the sovereign bond markets – cash bond spreads to swaps are largely stable and credit derivative markets (the more liquid market) have widened by less than 10 bps on average at the time of writing. Demand remains strong in the primary market for good quality credits both in high yield bonds and in senior secured loans. In fact, anecdotal

evidence suggests market pricing is coming in at the tight end of price guidance in the primary market. However, for non-investment grade issuers in particular, the market is in an unforgiving mood for those that fail to deliver, repricing is swift and sharp. We would caution against a “beta” play here and prefer active managers over passive products at this time.

We maintain our preference for credit securities over sovereigns within a fixed income portfolio however, stress that in this environment credit selection itself is critical. We remain cautious and are looking for signs of deterioration in the default outlook. A spike in job cut announcements would have us reassess our view on credit markets and the default environment in general.

Within sovereign markets investors need to be cautious given both the shape of the yield curve and the absolute level of interest rates. Many active managers have recently positioned their duration portfolios such that

they are neutral duration but positive carry by being short the middle part of the curve (where it is most inverted). We like inflation linked securities at current valuations and believe, for the patient investor who can handle some short-term negative mark to market, that these securities should benefit portfolios if our base case plays out and we see inflation expectations increase late this year.

RBA - May cut unlikely

Macquarie economists now view a cut to the Australian cash rate in May as unlikely. This follows from mixed signals from the labour market. Recent job vacancies over the last three months showed a further increase which is in line with the falling unemployment rate to February. However, they have pencilled in 25bp cut in August and in November this year.

Alternative assets – The rise and rise of private markets

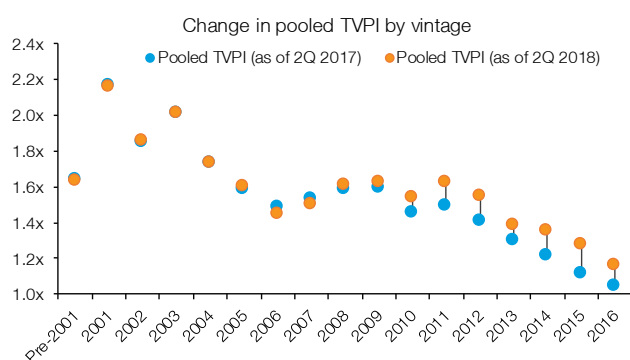
- We reduce our maximum overweight in alternatives;
- Private markets to remain well supported to dominate as dry powder is put to work in equity and debt raisings keeping competition fierce;
- We continue to prefer strategies with low beta to listed equity markets.

We reduce overweight to alternative assets to fund our move to neutral in fixed income. Our maximum overweight to alternative assets was driven by our desire for diversified sources of return as interest rates around the world rose causing an increase in volatility both across asset classes and within sectors. The broad shift in stance of global Central Banks to accommodative means that we see greater opportunity for diversified returns from fixed income markets and reduce our overweight position.

Private markets

Private equity Dry powder levels continue to get headlines as they did for much of 2018. Like public markets, valuations are expensive; meaning that multiples (measured by Total Value Paid In (TVPI) in the chart) will likely continue to fall.

Multiples by vintage are expected to remain compressed



Source: Pitchbook, MWM Research, April 2019

Certainly given the raft of IPOs announced PE (specifically VC firms) will probably have lots of cash to return to investors. Lyft priced last week at USD72 a share implying a valuation of USD24billion. As well as Lyft, in the technology sector alone, Airbnb, Uber and Pinterest are all sounding the market. The implication is that while investors will of course be happy should the IPOs be successful – they simply have to find new PE opportunities to maintain the strategic asset allocation.

Recent research released by Pitchbook suggests that while returns from private equity have been highly

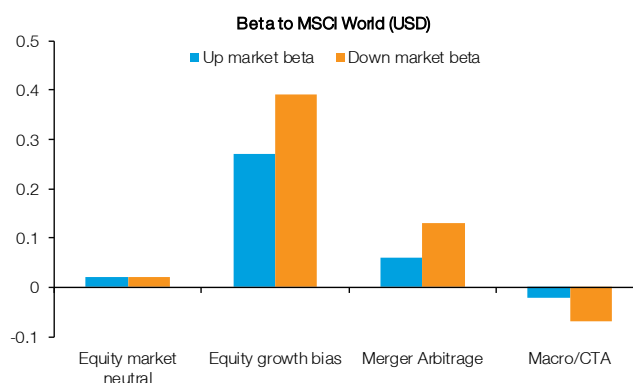
correlated to public equity markets, that relationship tends to break down in periods of high volatility, as well as sustained run-ups or drawdowns in the market. Pitchbook expects that in 2019 short term returns will fall for PE funds but performance relative to equity markets will improve.

Private debt activity continues to grow in the Australian markets. Certainly, we are seeing an increasing number of opportunities in this space. Much of the opportunity has been driven to date by the ongoing slowing of activity by traditional banks. In general, at the smaller end of the market, yield and terms remain debt-holder friendly although there is evidence of increasing competition in the larger end. Credit process and terms of loans are the two critical issues in this space particularly as most vehicles available to investors are closed end structures. Security over assets and receivables can also make this style of lending attractive via higher recovery rates in the event of default.

Hedge funds – directionless strategies are preferred

Within hedge funds, we prefer strategies that have low equity market beta. Merger arbitrage strategies remain our preference however, lower interest rates can result in lower deal spreads.

Aggregate performance masks performance dispersion



Source: Preqin, MWM Research, April 2019

Fundamental macro and systematic strategies are also typically low beta, although fundamental macro strategies may find the increasingly accommodative stance of central banks difficult to navigate. We continue to like systematic macro/trend follower strategies as an effective tail risk hedge however, expect some volatility in upcoming return numbers due to the sudden shifts in macro policies that have driven rapid changes in market direction and positioning.

Real assets – Macro attraction offset by Micro risks

- We are raising our REIT's allocation back to neutral;
- While both retail and residential remain weak and with the outlook for office also dimming, macro tailwinds, in particular, low bond yields are likely to remain highly supportive;
- Playing REITs requires a more micro approach (fund managers & office over retail and residential) than a macro approach given stock specific risks.

REIT's have had a strong start to 2019, outperforming in a very strong equity market environment. For the most part, this has been the result of continued declines in bond yields with the Australian 10 year yield falling from 2.32% down to a post GFC low of 1.73% late in the quarter.

Defensive sectors have led the market higher in 1Q

Sector	Returns % (excluding distributions)			
	Weekly period	Month rolling	Quarter rolling	Year rolling
Materials	1.48	2.02	16.18	19.12
Telecoms	1.32	3.47	15.11	3.28
Property Trusts	0.63	6.03	10.93	20.27
Industrials	0.47	1.30	9.92	11.33
Consumer Staples	-0.03	3.65	3.24	6.52
Consumer Discretionary	-0.62	1.08	10.15	4.24
Financials ex-Property	-0.63	-2.84	5.14	-4.07
Financials	-0.63	-2.84	5.14	-4.07
Utilities	-0.64	0.87	10.20	7.76
Health Care	-1.10	0.66	5.06	16.68
Information Technology	-2.72	2.61	21.30	25.69
Energy	-4.08	-4.67	12.67	9.20

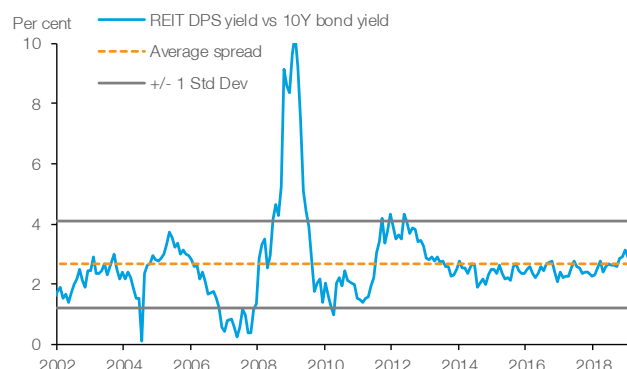
Source: IRESS, MWM Research, April 2019

For the most part, we think the tactical call for REITs rests with the direction of bond yields and sentiment towards risk assets. If equities decline and bond yields fall further, then REITs will resume their outperformance.

We think bond yields are more likely to remain relatively flat over coming months as domestic growth data continues to track on the weaker side. This is not likely to drive a large positive tailwind for the sector, but we don't believe that rates will rise enough to generate a large negative headwind. This will ensure that micro factors become the more dominant driver of performance over the next few quarters with large differentiation across sub-sectors and stocks likely to remain a key feature.

We think fund managers and office will be the best performers against retail and residential. This remains the case even given the potential for RBA rate cuts to improve sentiment for the more cyclically challenged areas.

Value evident but mostly in 'high' risk retail



Source: Macquarie Research, MWM Research, April 2019

Retail: We believe cyclical and structural headwinds facing landlords are now biting, with remixing away from troubled sectors diluting earnings (via downtime, or lower rents) or occupancy costs requiring to be reset. The reporting season highlighted that metrics across the retail sector are under substantial pressure including weaker NOI growth, declining releasing spreads, rising capex requirements and asset divestiture. A number of retail REIT's have also guided lower.

Residential: Residential market conditions have continued to moderate, with results over reporting season appearing to have contracted below what could be described as a 'normalisation'. Lacklustre volumes are likely to also impact the outlook for residential earnings. Projects acquired between 2010-2014 are likely experiencing strong embedded margins, however as these projects complete, listed residential developers are likely to see a step down in margins. Therefore, the outlook for earnings growth appears difficult, outside of cash collection of pre-sales at significant projects. While settlement risks are rising, defaults have remained benign and Macquarie do not ascribe to a scenario of mass defaults, while settlement periods are clearly elongated).

Office: Office remains the preferred sub-sector, with comparable NPI, incentives and occupancy trending in the right direction. Given upcoming supply pipelines, we believe metrics will likely moderate from here (lower rental growth, higher capital intensity, etc.), but we believe this will be a gradual slowdown and fundamentals will remain positive relative to the speed of deterioration in both retail and residential.

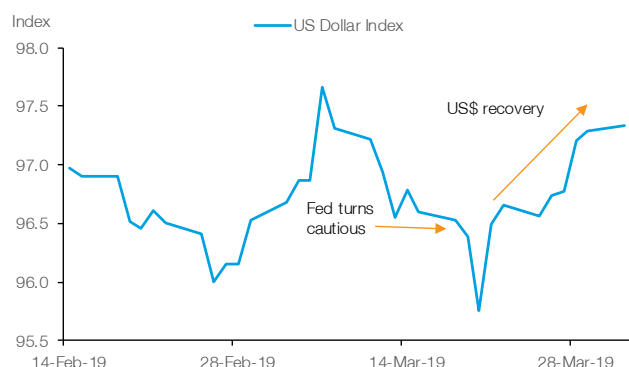
Overall, we don't see a lot of underperformance risk for REIT's while the outlook for the equity market is weak and bond yields modest. However, generating alpha will become increasingly stock specific. Our team is most

attracted to REITs that are genuinely growing earnings. We think these stocks will continue to outperform retail mall peers and those with high residential exposures.

Currencies – USD strong despite cautious Fed

US\$ fills the gap: The Fed announcement on March 20 that they will pause rate hikes in response to growth risks saw the US\$ sell off. This response was short lived through as the dollar proceeded to spend the next few days recovering close to recent highs. Those looking for US\$ weakness on the back of disappointing growth have found that FX is a relative game and the US still appeals as a safe haven in an environment when global growth continues to surprise on the downside.

US\$ strong despite dovish Fed



Source: FactSet, MWM Research, April 2019

Euro weakness: The latest PMI data out of the Eurozone confirms the tough economic outlook that faces the region. The Euro weakness vs the US\$ is expected to continue as the ECB looks to implement policy designed to slow what is now an economic contraction.

CNY trade resolution delayed: The CNY recovery from 2018 lows has stalled as the resolution of the US-China trade war gets pushed out. Our longer term view is for the CNY to trend lower as Chinese exports remain under pressure from slowing global growth and the currency is used as a tool to make the Chinese exports more competitive.

A\$ holding despite weak growth prospects: Macquarie Research has lowered the long term AUDUSD forecast to \$0.75 from \$0.80. The previous forecast incorporated a tightening cycle which would have restored Australia as a higher yield investment option. The RBA's recent shift to a neutral stance means this scenario has been pushed out significantly. Macquarie still sees long term upside from current levels of \$0.71 based on a stabilising housing market and commodity prices likely to remain above average historic levels. Near term we still see the AUDUSD as coming under pressure with the prospect of a weak economy eliciting RBA rate cuts.

Commodities – Policy provides a kick

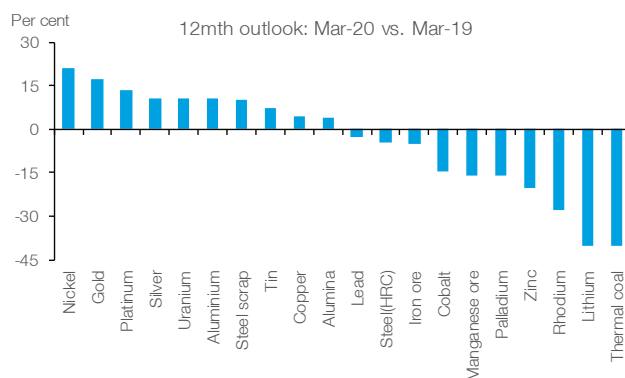
- Gold and silver expected to be the main beneficiaries of the Fed's dovish tilt;
- Nickel expected to be the biggest winner due to China's stainless steel industry reform and robust demand dynamics;
- Coal and lithium prices expected to remain soft due to supply glut.

Macquarie's commodities team recently published their Commodity Compendium which highlighted the key current drivers for commodity prices:

- 1) US-China trade resolution - while there is still no formal deal, talks are reportedly constructive which has been sufficient to boost global trade sentiment and speculative interest in commodities;
- 2) China discussions of stimulus strategies at the National People's Congress suggest a lack of growth supporting policy easing;
- 3) US\$ has shown signs that it peaked in late 2018. This offers short-term support for commodity prices – although this is a longer term risk should growth/trade deteriorate; and
- 4) Supply constraints due to the collapse in the mining capex rate as well as supply shocks for key commodity markets such as Vale's dam failure (iron ore), smelter closures (copper) and intermittent rail closures (metallurgical coal).

Against this backdrop the team has Nickel, Gold and Platinum as the big winners over the next 12 months. Bottom 2 picks thermal coal and lithium due to supply gluts.

Nickel's the top pick, followed by precious metals



Source: Macquarie Research, MWM Research, April 2019

Monthly performance - March 2019

Australian equities

The strong momentum from the beginning of the year has gradually slowed down in March, amid rising concerns regarding a US bond yield inversion. The S&P/ASX 200 Accumulation Index finished March 0.7% higher, whereas the S&P/ASX Small Ordinaries declined slightly by 0.1%. The best performing S&P/ASX 200 sectors were Real Estate (+6.2%) and Telecoms (+4.0%) while Energy (-4.1%) and Financials (-2.7%) were the worst performers.

Amongst larger companies the best returns were from Scentre Group (SCG, +6.2%) and Telstra Corporation (TLS, +6.1%), while the underperformers were ANZ Banking Group (ANZ, -7.0%), amid refreshed worries of challenging revenue conditions.

The S&P/ASX Small Ordinaries Accumulation Index (-0.1%) underperformed the S&P/ASX 200 Accumulation Index, dragged lower by vehicle fleet leaser Eclix Group (ECX, -67.6%). The best performer was Myer Holdings (MYR, +61.1%), whose better than expected financial result greatly alleviated the small-cap weakness.

International equities

US markets ended the final trading day of the first quarter on a strong note, with the S&P 500 posting its best quarterly performance since 2009. The blue chip heavy Dow Jones closed flat in March, whereas the Nasdaq (+2.6%) and the S&P 500 Index (+1.8%) delivered decent gains on the back of US-China trade talks resuming.

European equities brightened, with gains by Italy (MIB 30, +3.0%) and UK (FTSE, +2.9%) leading the surge, followed by France (CAC 40, +2.1%). The German market was marginally higher (+0.1%) but Spain (IBEX 35, -0.4%) closed the month lower after a short-lived spike in the middle of March.

March was another strong month for the Shanghai Composite Index (+5.1%), which delivered an impressive quarterly gain of 23.9%. Hong Kong's Hang Seng (+1.5%) and Japan's Nikkei (-0.8%) lagged behind.

Property

The low yield environment has fuelled Australian REITs' performance (+6.2%) through March, which has not been seen since December 2016. Charter Hall Group

(CHC, +16.7%) and Stockland (SGP, +10.0%) led the strong bounce, while Cromwell Property (CMW, +0.7%) and National Storage (NSR, +0.3%) were laggards.

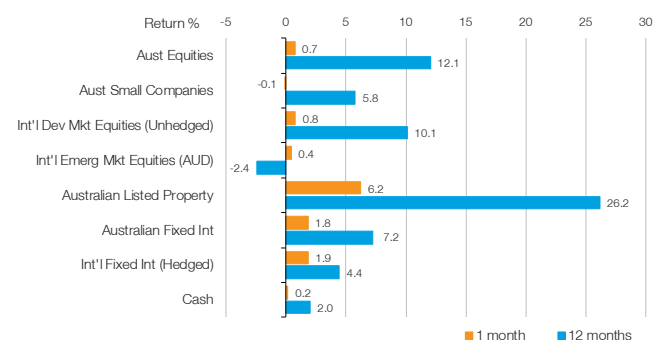
Fixed interest and cash

The US 10-year bond yield ended the month at 2.43% alleviating the yield curve inversion, which was widely read as an indicator of US economic slowdown. The 10-year Australian government bond yield dropped 30bps for the month to 1.8% as fixed interest regained investors' favour in a volatile month. The Bloomberg AusBond Composite 0+Yr Index added 1.8%, with Government bonds (+2.2%) outperforming Corporate bonds (+1.4%). Both the short-term (0-3-year, +0.5%) and long-term (+10-year, 3.9%) bonds posted gains in March.

Currency

The \$A/\$US changed little to finish the first quarter trade at 0.7096. Thanks to the relative strength in Australian dollar, the \$A against Euro (+1.4%, 0.6327) and UK Pounds (+1.8%, 0.5446) both recovered their earlier losses. The \$A against New Zealand Dollar (+0.1%, 1.0424) and Japanese Yen (-0.5%, 78.65) were relatively flat.

Market Performance – March 2019



Source: IRESS, Bloomberg, MWM Research, April 2019

Market performance – March 2019

Market Indices	1 month %	3 month %	YTD %	1 year %	3 year %pa	5 year %pa
31-March-19						
Australian Shares						
S&P/ASX 200 Accumulation	0.73	10.89	10.89	12.06	11.46	7.40
S&P/ASX 200	0.19	9.46	9.46	7.32	6.74	2.76
All Industrials Accumulation	0.39	8.88	8.88	8.37	8.23	7.42
All Resources Accumulation	2.04	19.02	19.02	28.25	28.57	6.79
All Industrials	0.05	7.69	7.69	3.67	3.45	2.62
All Resources	0.72	16.65	16.65	23.27	24.33	2.98
S&P/ASX 100 Accumulation	0.84	10.72	10.72	12.50	11.41	7.33
S&P/ASX Small Ordinaries All Accumulation	-0.12	12.59	12.59	5.78	11.40	7.97
International Shares						
MSCI World Index Hedged in A\$	1.37	11.94	11.94	4.52	9.79	7.48
MSCI World Index (A\$ Unhedged)	0.80	10.72	10.72	10.14	11.29	10.40
MSCI Emerging Markets (A\$ Unhedged)	0.43	8.43	8.43	-2.41	10.87	6.74
Regional Markets (local currency returns)						
Dow Jones	0.05	11.15	11.15	7.57	13.60	9.52
S&P 500	1.79	13.07	13.07	7.33	11.23	8.65
Toronto Comp	0.64	12.42	12.42	4.78	6.07	2.35
Nikkei	-0.84	5.95	5.95	-1.16	8.16	7.42
STOXX® Europe 600 Net Return	2.06	13.02	13.02	5.22	6.91	5.41
German Dax	0.09	9.16	9.16	-4.72	4.97	3.82
FTSE 100	2.89	8.19	8.19	3.15	5.64	1.98
Hang Seng	1.46	12.40	12.40	-3.46	11.82	5.57
NZSE 50	4.49	10.49	10.49	14.29	9.26	9.36
Property						
S&P/ASX 200 Property Trust Accumulation	6.22	14.75	14.75	26.17	9.90	14.75
Cash and Bonds						
Bloomberg Composite Bond All Maturities	1.82	3.43	3.43	7.20	4.17	5.07
Bloomberg Bank Bill Index	0.17	0.52	0.52	2.02	1.90	2.13
Citigroup World Government Bond Index Hedged	1.86	2.54	2.54	4.45	2.86	4.93
Citigroup World Government Bond Index Unhedged	1.42	0.83	0.83	6.29	3.67	6.09

Source: IRESS, Bloomberg, MWM Research, April 2019

The Wealth Investment Strategy Team



Jason Todd, CFA
Head of Investment Strategy
Team



Leah Kelly, PhD
Senior Investment Analyst



Aaron Lewis, CFA
Senior Investment Analyst



Stephen Ross, CFA
Senior Investment Analyst



Lizette Mare, B Com (Hons)
Investment Analyst



Fred Zhang, CPA
Investment Assistant

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Investment Matters April 2019 was finalised on 2 April 2019.

Recommendation definitions (Macquarie - Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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