DIVERSIFIED REAL RETURN FUND CLASS Z

December 2018

TOTAL RETURNS % (AFTER FEES)

PERPETUAL	SIZE $M	1 MTH	3 MTHS	6 MTHS	1 YR	2 YRS PA	3 YRS PA	5 YRS PA	7 YRS PA
Diversified Real Return Fund Class Z	1.74	0.68	-1.39	0.03	-	-	-	-	-
Benchmark*		0.00	0.44	0.80	-	-	-	-	-

* The Diversified Real Return Fund is constructed without reference to any benchmark. CPI is for comparison purposes only.

MARKET COMMENTARY

Global equity markets corrected sharply in the December quarter to the point where more than half of global equity markets were in a bear market (having declined more than 20% from their recent peak). Credit markets have also weakened notably and liquidity in these markets has become extremely poor. A number of factors coalesced to force a reassessment of the outlook. In particular:

- Notwithstanding signs of weaker growth, the tightening bias of US monetary policy which has prevailed since late 2016 continued, with the US Federal Reserve (the Fed) raising its policy rate in December.
- The liquidity backdrop for markets has changed profoundly over the past year – from massive expansion a year ago to marginal contraction now. By early 2019, only the Bank of Japan's QE program is in place and it has been scaled back substantially under its "Yield Curve Control" policy. The European Central Bank's (ECB) program has stopped and the Fed is 'on autopilot' in selling assets to gradually reduce its balance sheet.
- The global economic expansion is slowing as the US economy moves past the peak fiscal stimulus and Chinese economic growth continues to moderate due to its deleveraging policies.
- Oil prices fell dramatically in the quarter which, as usual, is a double edged sword – it provides some relief for consumers and businesses that are energy users, but it might also be an indicator of weakness in the global economy and it causes intense pressure on energy related companies in equity and debt markets.
- The uncertainty created by the trade war between China and the US (notwithstanding some more positive rhetoric from President Trump recently) and the growing strategic rivalry between these super-powers continues to hang over the markets
- Finally, in Australia, house prices in Sydney and Melbourne are finally falling which is a very good thing for housing affordability but the second round effects on consumption spending and the economy could be significant.

As a result of these developments, global profit growth is expected to slow sharply in 2019 (and could even be negative) and recession risks in the next two years have increased significantly in our judgement.

PORTFOLIO COMMENTARY

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The Fund's defensive strategies kicked in during the December quarter and added significantly to performance. These positions were managed actively over the quarter as the risk reward proposition changed. Profits were taken by rolling strike prices on bought option positions in equity and currency markets or by reducing or removing some other positions (including credit protection strategies in US high yield and Australian investment grade credit).

By the end of the quarter, the portfolio was still positioned defensively, but much less so than during height of the sell-off during October and December.

The portfolio retains strong defensive qualities reflecting the value and quality bias in equity allocations; a position in Australian sovereign credit default swap which will protect the portfolio in the event of a continued repricing of this risk; and a (reduced) position in US equity put options. Finally, the duration of the portfolio has also been increased in the past quarter.

Relative value positions have been reduced at the margin as we took profits on the overweight in Australian 10 year bonds versus US 10 year bonds. However, the Fund retains significant foreign exchange exposure with a position in the USD (although this has been significantly reduced), core emerging market currencies (such as Chinese Yuan, Korean Won and Taiwanese dollar) and the Japanese Yen as well as smaller positions in the Euro and Sterling.

OUTLOOK

Policy makers are showing some limited signs of responding to the deterioration in the growth outlook in 2019. The Chinese authorities continue to ease policy in an attempt to revive growth, but it appears a more dramatic intervention (like the fiscal easing in 2016) will ultimately be required. This means President Xi would have to back away from his policies to clean up the shadow banking system – a step he has been unwilling to take (so far).

The Fed is likely to be on hold for some time as the sell-off in equity and credit markets late last year tightened financial conditions significantly (similar to the correction in late 2015 and early 2016 which caused the Fed to go on hold for 12 months). Moreover, a slowdown in growth is already underway and inflation will fall below target again (due to lower oil prices) in the next six months.

In Australia, the Reserve Bank (RBA) has long maintained that the next move in rates is likely to be up. Now it looks more likely to be down as the growth outlook becomes more uncertain and inflation remains at or below the bottom of the target band. The Federal election in the first half of the year will no doubt further complicate the outlook.

Notwithstanding these signs of adjustments by global central banks, the tightening in the liquidity of financial markets caused by the change in global central banks' balance sheet policy is likely to continue.

We remain cautious about the market outlook. A correction of the magnitude we have seen in the December quarter is usually enough to create the conditions for a renewed bull market if the global economy has a soft landing. At the same time, the economic outlook has clearly deteriorated and the risk of recession in the next two years has increased notably. Finally, as we have been observing for some time, the economic and market cycle are very mature and the market performance in the December quarter increases the risk that this very long bull market is over. Accordingly, leading indicators for the global economy will be more than usually important in the months ahead.