Perpetual Investments, Multi Assets

QUARTERLY MARKET INSIGHTS

January 2019

KEY INSIGHTS

1. 2018 will be remembered as a year where market volatility returned, underpinned by the loss of three key multi-year anchors – rising economic growth, massive central bank liquidity injections and investor's 'buy the dip' mentality. The reversal of these tailwinds culminated in the MSCI World Index recording its largest quarterly decline in seven years (of -12.8%) with the December quarter decline in the US market (-14%) being the third largest since 1941.

2. The 2019 sharemarket outlook is challenged as expectations remain elevated, growth is slowing across the world and margins are under considerable revenue and cost side pressure. At present, analysts expect +7.6% EPS growth in 2019 for the MSCI World Index but our model indicates that it is more likely to be negative than positive. While earnings growth is being downgraded to levels better aligned with the economic environment, this process has a considerable way to go, but central banks are seemingly stepping back from their policy withdrawal guidance, which provides some downside cushioning (through valuations), if the prospects for global growth can stabilise.

3. Global growth has entered its third deceleration phase of this cycle. While we can attribute the first two to concentrated drags – the European debt crisis in 2011-12 and from the unwind of a commodity supply and EM corporate credit boom in 2015-16 - the forces weighing on global growth nowadays are a bit more complicated. Nevertheless, at the epicentre of this is Chinese growth and global trade, the latter of which highlights how important net exports are to growth trends, and how dangerous it is as a political football. There were material slowdowns in Europe, Japan and China in 2018 and only the latter has unleashed stimulus to cushion downside risks. Other economies are stepping back from the policy withdrawal process, but so far have not turned the stimulus taps back on, which limits the upside risks to global growth.

4. After two years of above-trend growth, the global economy is set to return to a below-trend pace in 2019. Much of the growth slowdown in 2018 (a decline of -0.2% to 3.0%) came from the trade channel, but this is expected to flow through to consumption and investment, especially in the US. As 2019 progresses, investment in shale production capacity will decline given lower oil prices and consumption will slow as the impact of tax cuts fades. Consequently, the US growth slowdown (-0.6% in 2019) will be greater than China (-0.4%), Japan (-0.3%) and Europe (-0.1%).

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ASSET CLASS REVIEW

GLOBAL SHARES

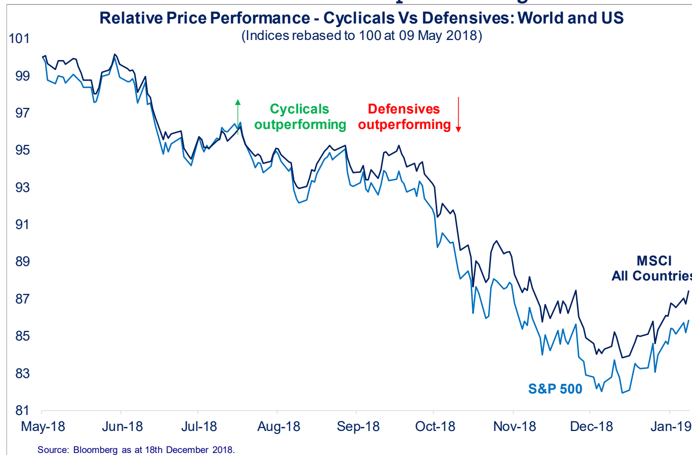
DEVELOPMENTS

In December, global shares completed one of their worst quarters since 2008 as the MSCI World Index dropped -12.8%. This represented the largest quarterly decline since September 2011 and culminated in the first calendar year loss for global shares (-9.5%) since 2008. The problem for investors by end-2018 was not earnings delivery (which was upbeat for the year at +16%, given the strong US economy and the largest US tax cuts since 1986), it was expectations of earnings growth being much weaker in 2019.

This concern contrasted with the volatility earlier in 2018 which reflected concerns about growth being too strong which had seen central bank tighten policy and sent valuations lower. Nevertheless, investor confidence in the global outlook rapidly deteriorated in Q4 reflecting rising concerns about the impact of the US-China trade war, elevated geopolitical risks in the UK and Italy, and emerging signs that growth in China and Europe was much weaker than consensus. This combined with the loss of key anchors over the past five years of central bank liquidity support and changes in investor behavioural traits of 'buy in dips' sending market prices lower and many major markets entered bear market territory (a loss of -20% or more).

During this process investors continued to reduce their exposure to growth sectors such as IT, energy, industrials and consumer discretionary (Chart 1) and increase their holdings in defensive sectors including utilities, consumer staples and healthcare. This portfolio switching was widespread and underpinned the underperformance of growth markets such as Japan (-17.8%) and the US (-14.0%), relative to defensive-type markets including Europe (-11.6%) and Australia (-9.0%).

Chart 1: Defensive stocks are outperforming



OUTLOOK

Regional sharemarket valuations have returned to long-run averages and there could be further downside if the market's current view on Fed policy (no hikes this year) proves too optimistic. We don't think this will be the case as there is no need for the Fed to move rates up as growth is slowing and core PCE inflation is just below +2% and is showing no sign of acceleration, despite a very tight labour market. Accordingly, the biggest threat to equities in 2019 will be declining earnings. Much of the foreseeable economic risks have seemingly been priced in, but pressure on margins from rising labour costs may not have been. Our model of global EPS growth says it is set to be around -5% in late 2019 (Chart 2) and could weaken further if lead indicators continue deteriorating. Earnings estimates are being cut in all major regions, and this will culminate in regional sharemarkets remaining increasingly volatile and low returning in 2019, with potentially limited diversification across sectors and markets.

Chart 2: 2019 global EPS growth could be negative

AUSTRALIAN SHARES

DEVELOPMENTS

Australian shares also recorded their worst quarterly performance (-8.4% q/q) in several years (since September 2015), but they outperformed their regional peers on a relative basis. Much like the US market, it was the cyclical sectors which led the pace of decline with energy (-21.3%), consumer discretionary (-14.5%) and IT (-14.0%) all recording double digit falls (Chart 3), whereas defensive sectors such as consumer staples (-6.1%) and utilities (-4.1%) outperformed in a relative sense.

Despite serious worries about domestic credit tightening and slowing Chinese growth, the domestic market was supported by its defensive structure where 60% of our index stocks are yield plays, which benefited as investors sought the protection of safe havens. Meanwhile, the -

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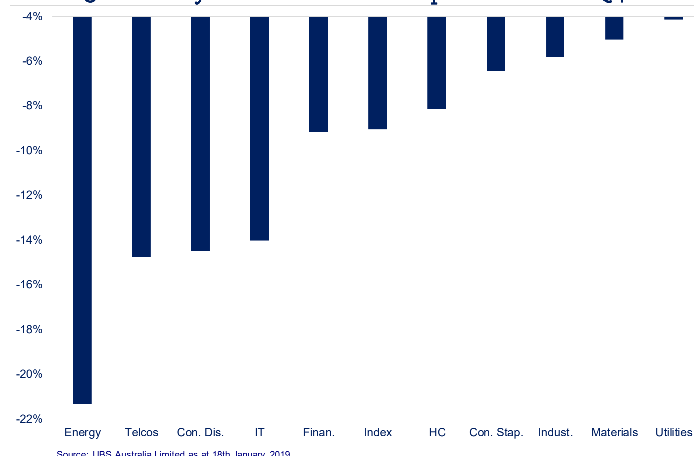
2.3% quarterly depreciation of the Australian Dollar against the Greenback provided some respite for our foreign earners including Rio Tinto and BHP Billiton whose strong balance sheets underpinned robust capital returns last year (both dividend growth and buybacks) which were highly sought by investors and this culminated in materials (-5.0%) outperforming most of its peers despite the sector's large-scale China exposure.

Chart 3: Local cyclical stocks underperformed in Q4



OUTLOOK

Consensus views are that the Australian markets will be flat-to-down in 2019. While economic risks here are probably larger than in other advanced economies (due to a combination of both housing and China), Australia has more policy ammunition than other countries. In this world a lower Australian dollar would provide assistance to our offshore earners, fiscal policy could be unleashed to cushion the household sector (and support domestic industrial stocks) and lower bond yields would support the remaining yield plays. Meanwhile, considerable bad news has been factored into bank share prices in relation to the Hayne Royal Commission.

SOVEREIGN BONDS

DEVELOPMENTS

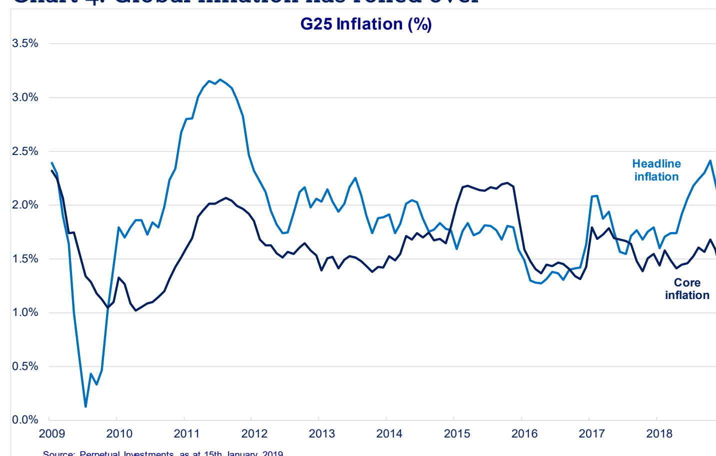
Regional sovereign debt rallied in the December quarter as investors increased their exposure to safe-havens. The potent combination of soft economic data, sustained low inflation and elevated political uncertainty saw investors price out policy tightening expectations, with a modest amount of easing priced in for 2019. This policy 'room' is facilitated by inflation remaining incredibly low despite extremely tight labour markets with both price gauges of G25 inflation rolling over in the December quarter (Chart 4).

The decline in headline inflation has been driven by falling oil prices which in the US has declined from +2.9% in July to +1.8% in December with further declines expected in early 2019. Broader analysis shows that only three countries in the G25 recorded higher headline inflation between September and December. More worryingly for central banks is that despite two years of above trend growth and multi-decade lows in unemployment, the average G25 core inflation rate is very close to an 8-year low. This indicates that the structural forces holding inflation down (debt, demographics and disruption) are more powerful that the cyclical forces lifting it up (above-trend growth and tight labour markets). Consequently, we have most likely seen the inflation peak for the cycle, and only one major central bank is providing additional stimulus (China) which highlights a real problem for the world. That is, aside from the US and Canada most DM central banks do not have room to cut rates which means '*low for long*' forward guidance is the last tool in their kitbag.

OUTLOOK

Yields have already declined a considerable way given lowered expectations for central banks and inflation. Accordingly, further yields compression from here will more likely reflect a decline in real yields (rather than lower inflation) and growth is certainly expected to slow in 2019 in nearly all major regions. Central banks ceasing their asset purchases will be no inhibitor to lower yields, nor will be tight labour markets, or larger deficits, but the clear sign to watch for is a large-scale stimulus program in China. The key question here is not whether China has the government balance sheet room to do it (they do), but rather, do they feel they have a necessity to do it. If that is the case, yields could rise as global growth is reflated by China stimulus (like in 2009 and 2015), but that is not our central scenario for the year.

Chart 4: Global inflation has rolled over



CREDIT

DEVELOPMENT

Unlike the March quarter 2018, the December selloff in equities caused widespread contagion in credit markets as evidenced by a blow-out in spreads by the widest margin since H2 2015 (Chart 5). The primary concerns here were the deteriorating global growth picture for 2019 and concerns of a potential monetary policy error by the US Federal Reserve. While resilient relative to their offshore counterparts, Australian credit spreads also widened and the trend here was amplified by poor liquidity, especially as year-end approached. However, primary market issuance in the corporate and securities markets were front-loaded for the quarter, which may have prevented a larger blow out in spreads as risk rose after November.

Chart 5: US credit spreads blew out considerably

The spread widening was reinforced by weak September quarter Australian GDP growth (+0.3% q/q) which showed both consumption and investment growth stalling, which forced default risk premiums higher. This move could have been reinforced by the RBA who left the Target Cash Rate at a record low +1.5% and maintained their neutral policy stance, although several Assistant Governors highlighted downside risks to the Australian economy (which was a major change in the tone of their communication).

OUTLOOK

The credit market outlook around the world is challenging. We are late cycle, which is usually a stage where growth slows, and spreads and default risk rise. Despite the recent spread widening, both domestic and offshore credit markets continue to trade tight relative to their long-term averages in both investment grade and high yield spaces, and investors may question if there is enough spread compensation to offset growing cycle risks. Volatility in both bonds and equities is also adding to investor angst about adding to risk positions in the current environment. Rising geopolitical risks in the US, China, UK, Italy and the rest of Europe are also a concern which have the potential to dry up market liquidity overnight which suggests spreads may need to widen further to adequately compensate investors for risks.

MACRO ECONOMIC OUTLOOK

GLOBAL MARKETS

KEY POINTS

The global economy has entered its third distinct growth-deceleration phase of the post-2009 expansion. In the first two periods of moderating growth it was easy to identify the trigger as the growth drags were one dimensional, underpinned by the European sovereign debt crisis in 2011/12 and the unwind of the commodity and EM corporate credit booms in 2015/16. However, the trigger for the current cycle slowdown is a bit more complicated but at its epicentre is a slowing China as it curbs excessive credit growth, the US-Sino trade war, the associated impact on regional supply chains, central bank policy withdrawal, a weak European banking system and geopolitical risks in Italy and the UK.

The combination of these factors culminated in a weak Q4 set of data which meant that global growth in 2018 moderated -0.2% to around +3.0% (Chart 6), with slowdowns in both DM and EM economies. From a national accounting perspective, the only common growth drag in all major economies was lower trade volume, with domestic demand remaining intact in most regions. However, signs are emerging that global activity is starting to slow more aggressively as evidence by the global manufacturing PMI falling -0.5 to 51.5 in December (50 is the level which separates expansion in activity from contraction) which represents a 27-month low. There was a similar sized easing back in service sector activity of -0.6 to 53.1, which is close to its lowest level since October 2016. All of this is indicative that global growth is facing significant headwinds in 2019, but very little policy support has been unleashed so far.

OUTLOOK

After two years of above trend growth, global growth is set to return to a sub-trend pace over the course of 2019. Markets are clearly pricing in slower growth, but the solid December US non-farm payrolls report was a warning that the slowdown may take longer to take hold than current expectations suggest. On the positive side,

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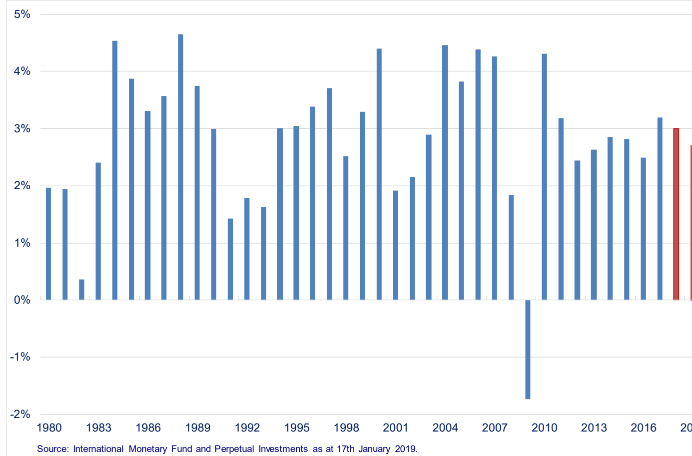
Chart 6: 2019 growth will return to a sub-trend pace



Source: International Monetary Fund and Perpetual Investments as at 17th January 2019.

unemployment is very low, policy is not restrictive and wages growth is rising. However, there is no denying that the cycle is old, geopolitical risks are rising, government balance sheets are in poor shape, central banks outside of China have not provided any support and the synchronised nature of growth in 2017 and early 2018 is long gone. I suspect growth will moderate to about +2.7% in 2019 (around levels seen in 2014 and 2015) providing that geopolitical risks in China, US, UK and Italy can be resolved constructively. If that is not the case, then the balance of risks to this forecast is to the downside.

DEVELOPED ECONOMIES

KEY POINTS

At the regional level, developed economies recorded a very slight -0.1% drop in growth in 2018 to +2.2%. However, there was considerable disparity across countries with declines in Japan (from +1.7% to +0.8%), Canada (+3.0% to +2.1%) and Europe (+2.4% to +1.6%) slightly outweighing improvements in the US (+2.2% to +2.9%) and Australia (+2.2% to 3.0%). In the US, the rising growth delta was underpinned by higher infrastructure spending and well as increased investment growth (+4.6% to +5.2%) primarily in the shale space as higher oil prices sparked a sharp rise in the US's rig count (Chart 7). In contrast, consumption growth was steady at +2.8% underpinned by the lowest unemployment level in 47 years and the highest wages growth in 10 years, with the savings rate remaining stable around 6%.

Meanwhile, European growth appears to have slowed further in the December quarter (to around +0.1% q/q) led by lower trade and a run-down of inventories. While one can constantly point to one-off factors impacting Europe, the region is still plagued by unresolved structural issues which means the economy can't reach escape velocity as evidenced by growth in H2 2018 (+0.5% annualised) being much weaker than H2 2017 (+2.7% annualised). Elsewhere, Japan's economy materially weakened in December (-0.9% q/q) driven by natural disasters and weaker trade.

OUTLOOK

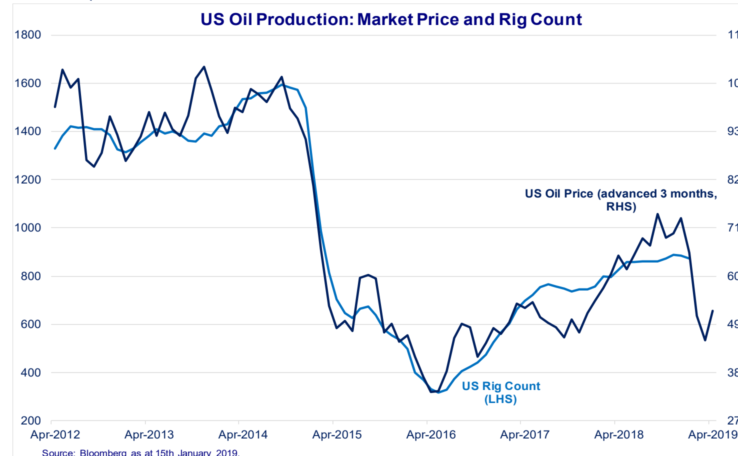
The slowdown in developed economies so far has mostly reflected the moderation underway in China and its impact on regional supply chains. This indicates that in many ways trade is a key driver of global growth changes and that it is dangerous to use it as a political football. US was immune to this process in 2018 given large tax cuts and government spending, but the impact here will fade by H2 2019 and US growth is set to materially slow by end-2019 to around +1.5%. While, most of the European slowdown reflects the trade and production sides of the economy, it is hard to see any material improvement in the former unless China pushes hard on the stimulus front, or the US dollar rises significantly despite the Fed now being on hold and growth differentials between the two regions are set to narrow this year. In contrast, Japan should be one of the rare advanced economies to record accelerating growth in 2019 as the hurdle is low, the government will almost certainly over-pump prime the economy to deal with the cyclical effects of the consumption tax increase in Q4 and infrastructure spending will continue in preparations for the 2020 Tokyo Olympics. Overall, DM growth is expected to moderate -0.3% to +1.9%.

CHINA & THE EMERGING MARKETS

KEY POINTS

The growth moderation was greater in EM (+5.1% to +4.7%) as slowdowns in Argentina (+2.9% to -2.7%), Turkey (+7.4% to +3.3%), South Africa (+1.3% to +0.6%) and China (+6.8% to +6.6%) outweighed improvements in economies such as India (+6.7% to +7.3%). The slowdown in the many high current account deficit economies were home-

Chart 7: Shale investment has risen behind oil



Source: Bloomberg as at 15th January 2019.

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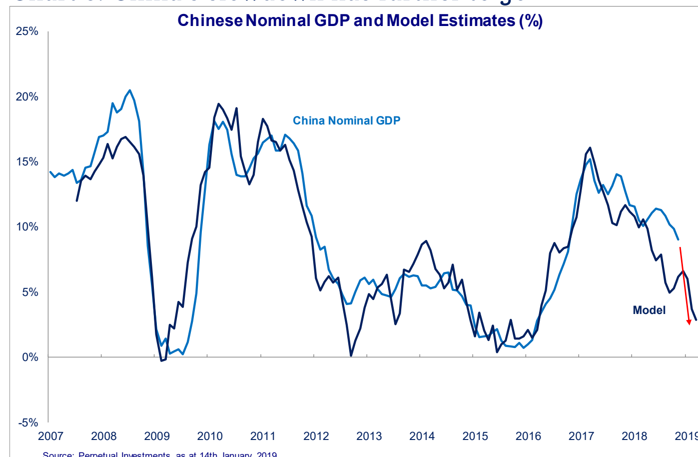
grown and reflected concerns about US dollar funding, given the stronger Greenback and higher bond yields. In contrast, China is reeling from the effects of the trade war and the lagged effect of its earlier attempts to tighten credit by clamping down on shadow lending. Nominal growth (the key for debt servicing) is still deteriorating and our model indicates this process has further to go (Chart 8). The nominal growth slowdown is driven mostly by price effects, but the Chinese authorities have indicated the 2019 growth target will be lowered to 6%-6.5%.

Chart 8: China's slowdown has further to go



OUTLOOK

Some of the headwinds which weighed on 2018 EM growth have faded, but others persist, and the most immediate problem centres of the continued slowdown in China. However, authorities have unleashed considerable stimulus to cushion the economy, with several RRR cuts (to provide more liquidity to the local banking sector) and tax cuts (to consumers and SMEs). There is little doubt this will be added to in coming months through a large infrastructure spending increase which should help stabilise growth in the second half of 2019 - just as the US economy slows more precipitously. Overall, EM growth is expected to further moderate this year (-0.3% to +4.4%) with moderations in Eastern Europe (-1.0% to +1.8%) and Asia (-0.3% to +5.7% and -0.3% to +3.4% excluding China and India) offset by an improvement in Latin America (+0.5% to +1.8%).

AUSTRALIA

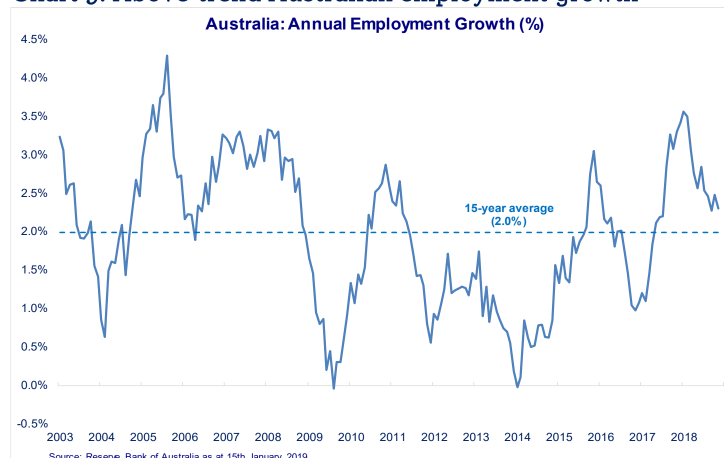
KEY POINTS

Data out in the past three months were mixed. The September quarter national accounts were a sobering set of statistics as real GDP fell to a 2-year low of +0.3% q/q, which dragged the annual rate down -0.6% to a trend-like pace of +2.8%. The composition was also poor with consumption growth recording a 6-year low (+0.3% q/q, +2.5% y/y) despite the savings rate hitting a 10-year low (+2.4%), and investment contracted yet again (-1.9% q/q, +0.7% y/y). These growth drags were partially offset by a surge in government spending (+1.5% q/q, +4.5% y/y) and a large contribution from housing construction (+1.0% q/q, +7.1% y/y) but one has to question the sustainability of these trends, especially given the leading indicators for the housing market. In contrast to the economy's growth rate, the Australian labour market created another +76k jobs in the past quarter which kept employment growth at an above-trend pace of +2.3% (Chart 9) with 78% of these jobs being full-time positions.

OUTLOOK

Australia's large trade and financial flow exposure to the slowing Chinese economy comes just as Australia's residential property market is in the grip of its worst downturn in 35 years, after a large run-up in household debt over the past decade. That leaves the Australian economy as a litmus test for how two of the biggest economic trends since the financial crisis, the rising importance of China and the mass accumulation of western economy debt, play out in 2019.

Chart 9: Above-trend Australian employment growth



These headwinds are set to send Australian growth back to a sub-trend pace in 2019 and 2020 with tighter credit supply, the continued slide in house prices and subdued wages growth weighing on consumption. The moderation in domestic and global growth is likely to weigh more on business investment, but the downside risk to growth is cushioned by the lower Australian dollar and large scale Federal and State Government infrastructure spending. Meanwhile, the RBA will soon initiate a clear easing bias as growth is set to decline and inflation will remain below the bottom of the 2%-3% target band. Upside risk to this outlook would materialise if either regulators further ease macroprudential policy, or the return to a Budget surplus is delayed or abandoned during the upcoming Federal election. Overall, recessions risks in Australia driven by the unwinding of the housing leverage boom are rising.

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PORTFOLIOS

In a lower returning and increasingly volatile world, our portfolios have been defensively positioned and have held up very well. For most of 2018 we have been gliding down the portfolio's risk exposure and in the December quarter we added to our Australian duration exposure (and sold our short position in US Treasuries) which boosted performance given the decline in sovereign yields.

In addition, our long US dollar position has been constructive for returns and we have maintained our put option exposure to the Australian Dollar as it will be a large portion of any policy response to weakness in domestic housing or China. We have also purchased some Japanese Yen given its safe haven status and also its potential to appreciate if the Japanese government increases its policy stimulus to boost growth.

Given the equites backdrop has become less favourable for 2019 in light of elevated valuations, lofty expectations, slowing growth and rising margin pressure we continued with the optionality of our equity exposures, especially in the US. When the S&P 500 declined sharply in December, we rolled down the strike of these put options, which enabled us to lock in profits and maintain protection if prices slid further. In addition, we reduced our credit exposure in both US high yield as liquidity is being withdrawn from the US financial system and given the potential for contagion from equities and we have also lowered our holdings in Australian investment grade credit.

Within our Diversified Real Return Fund, we have continued the process of gliding down allocations to **Return Seeking** investments (i.e. investments with a positive correlation to equities) by reducing exposure to shares and credit. We have used these proceeds to increase our exposure to **Downside Protection** (i.e. assets with negative correlation to equities in a market downturn) through the explicit use of options when volatility is attractively priced. The allocation to **Inflation Protection** (i.e. positive correlation to inflation surprises) is very low given the absence of a domestic inflation impulse for many years, and this basket was not changed over the quarter. Meanwhile, the exposure to **Diversifying Opportunities** (zero correlation to equities) remains elevated but was slightly reduced given the trimming of our Australian duration-US Treasury spread trade.

In the balanced funds, we have been underweight global equities, which has been offset by our cash and alternative investment exposures and we added some defensiveness through options at appropriate times. While the defensiveness of the portfolios has increased at the margin, they are expected to participate in any market upside as these options are quite cheap and the Funds retain a diversified exposure to various equity, credit and unlisted markets. Finally, as a counter balance to high cash weightings, relative value positions remain elevated (including exposure to equity alpha) and are supported by our alternative investments.

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