2020 Investment Outlook

The Last Hurrah

December 2019

We enter 2020 more optimistic on the prospects for global growth and expect risk assets to follow the improvement in growth momentum higher.

Central banks have enacted a sharp U-turn on monetary policy, the manufacturing downturn has run its course and we should see some stabilization in uncertainty around the US-China trade war, which is crucial for the transmission of easier monetary policy into the real economy.

By no means will 2020 be risk-free with US elections, the potential for recession and fears that the emergence of inflation causes a premature tightening in monetary policy all likely to cause sentiment to oscillate between periods optimism and pessimism. However, there is a difference between recognizing risks and understanding when they will become headwinds (i.e. the sequencing of risks).

We recommend investors position for gradual reflation but on the basis that volatility will remain elevated. We think risks that could cause a more prolonged correction in risk assets and a sustained shift into a defensive asset allocation are likely to come in 2021 rather than over the coming 12 months.

For equities, we do not expect a repeat of 2019 where strong returns were in part, a payback from the weak finish to 2018 and the expected economic recovery into 2020. We think markets will follow the global economy gradually higher, but a rising tide will not lift all boats equally. The uneven nature of the economic recovery will mean markets which have clear valuation and cyclical upside are likely to outperform those markets where valuation headway is lower.

The saving grace for risk assets is that inflation pressures are likely to remain modest and this should allow central banks to keep monetary policy settings "ultra-easy". It also means that bond yields are unlikely to rise to levels that undermine the economic recovery or a modest increase in equity markets. It does however, mean that investors should position for higher yields and steeper yield curves and the potential underperformance of rate sensitive investments.

Closer to home, Australia's economic backdrop is likely to get better, but only marginally, and it will require further policy easing by the RBA and potentially additional fiscal support by the government. We think downside risks have passed their peak, but weak income growth and an overleveraged consumer is hampering the transmission channel of lower rates and tax cuts as consumers repay debt rather than increase spending.

Continued easing in the cash rate will provide an ongoing boost to house prices which have bounced strongly over 2H19. At this stage, the recovery in house prices has not been met with a meaningful rise in credit growth (which we see as an upside risk factor for the sector in 2020). Macquarie is expecting national average house prices to rise 6-7% in 2020. This would put them above the 2017 peak sometime in 1H20. While further declines in residential construction activity are expected into 2020, improving house prices are already driving approvals higher and we expect activity to follow with a lag into 2021/22.

A rise in global equity markets alongside a modest improvement in economic growth is positive for the domestic equity market, but rather than providing a broad economic tailwind (growth will not be strong enough for this), upside is more likely to be concentrated in sectors that are direct beneficiaries of policy support (such as housing, financials, offshore industrials and materials).

Unfortunately, the Australian equity market is now one of the most expensive developed markets in the world (17.7x vs 16.6x respectively) with a weak earnings growth outlook. These two factors will not prevent the market from rising, but they will prevent it from outperforming other more *"value / cyclical"* and/or *"growth"* centric markets in 2020. We think both global and Australian equities are likely to post more *"average"* year returns.

The bulls will always point towards the dividend yield (~4.5%) as a reason to own the market and this is particularly the case versus fixed income and bank deposits. However, the dividend yield is a downside support and not an upside driver. It is not a reason to expand the valuation multiple further and in addition, we don't think the current payout ratio is sustainable at ~70% if corporates are to sustainably raise investment (address underinvestment in the case of banks), in order to drive stronger earnings growth.

Consequently, we see little capacity for Australian equities to outperform global markets in the absence of a domestic round of quantitative easing/strong fiscal stimulus or unless global markets undergo a sustained correction.

Overall, our key message for 2020 is that markets will benefit from a gradual reflationary environment, bond yields will creep higher (but not as high as consensus is forecasting) and this will come against a backdrop where sentiment remains volatile. Central banks have given markets one more roll of the dice.

Macquarie's Investment Strategy Team would like to thank you for your support through 2019. We hope you have enjoyed reading our investment updates. We wish everyone a happy holiday season and a prosperous New Year.

Jason and the Investment Team

Our Key Messages

2020 should see the global growth gradually improve as the headwinds from trade related uncertainty, a manufacturing downturn and monetary policy tightening reverse and/or get gradually better.

US politics, Chinese growth and *“event risk”* that drives a systemic tightening in the corporate bond market are our biggest 2020 concerns. There are numerous other risks (i.e. recession, inflation, policy tightening), but the sequencing of these risks are more likely concerns for 2021/22.

Macquarie expect the **RBA** to cut the cash rate a further 25bps down to 0.50%. Thereafter, an additional cut and the potential for quantitative easing (QE) is conditional on the evolution of growth.

Stronger **global growth** alongside continuing accommodative monetary policy will remain positive tailwinds for risk assets. While equity markets are not particularly cheap, bonds are even more expensive. Consequently, in a reflationary environment, we favour equities over bonds.

Stronger **global equity markets** alongside a modest improvement in domestic economic growth is positive for Australian equities. But, rather than a broad-based rally, upside will be concentrated in sectors that are direct beneficiaries of policy support.

Stronger growth will push **bond yields** higher, but a lack of inflation will keep the increase modest. We don’t see bond yields rising to a level that undermines the economic recovery or further equity market upside.

Australia will benefit from an **improving global** backdrop, but the outlook is for a shallow recovery that only gets the economy back to trend by YE20. Upside will require further monetary policy easing by the RBA with the potential for fiscal stimulus adding further upside risk.

House prices will continue to build on their 2H19 recovery and we now expect a period of sustained price appreciation. We think national average house prices will take out their prior 2017 peak sometime in 1H20 and rise a further 6-7% through the year.

Unlike 2019 where key **equity markets** posted 20+% returns, we think 2020 will be a more “average” like return year with significant variation across markets and regions. Upside will be more contingent on valuation headroom and cyclical exposure as a rising tide will not lift all boats.

Australian equities are likely to underperform global markets given the headwinds posed by elevated valuations, weak earnings growth and a modest cyclical upswing. However, high dividend yields relative to bond yields will continue to provide downside support for market.

GLOBAL MARKETS

The Last Hurrah

1

2019 was a year of exceptionally strong returns despite violent swings in sentiment. 2020 should see growth momentum improve despite ongoing concerns around politics and an end to the economic cycle.

2

Markets are in a sweet spot. Stronger growth alongside accommodative monetary policy conditions are significant tailwinds for risk assets.

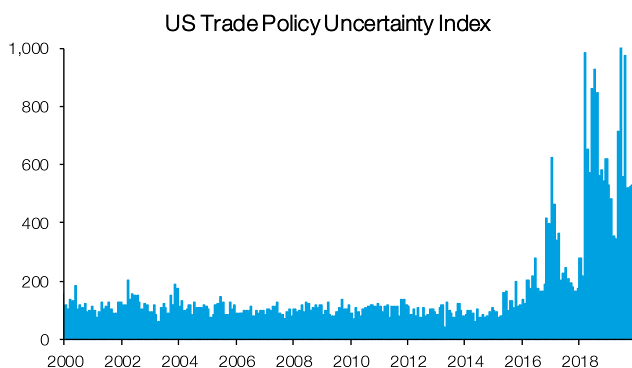
3

Bond yields are likely to edge higher but not enough to undermine equity markets. We expect equities to outperform bonds and rate sensitive assets.

2020 Outlook:

2019 does not seem like a year we want to remember. Political uncertainty rose exponentially, bond yields started the year at their highs and then collapsed, negative yielding bonds became outrageously popular (to the tune of US$14tn), global yield curves inverted and fears of recession spiked as the industrial economy collapsed on an escalation in US-China trade war concerns.

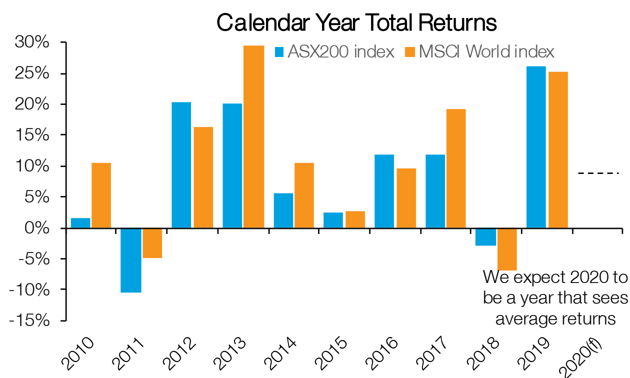
2019 was a year of elevated political uncertainty



Source: Boston College, MWM Research, December 2019

One could be forgiven for thinking that 2019 was finally the year that marked the end of the decade-plus economic expansion. However, history will show this was not the case. For investors, 2019 will be remembered as a year of exceptionally strong returns despite significant bouts of volatility and a more elevated level of risk aversion. Both global and domestic equity markets rose in excess of 20% and for the most part, powered through periods of rising risk aversion and fears of economic weakness – much to the chagrin of a growing chorus of bears.

Equity markets have had a stunning year



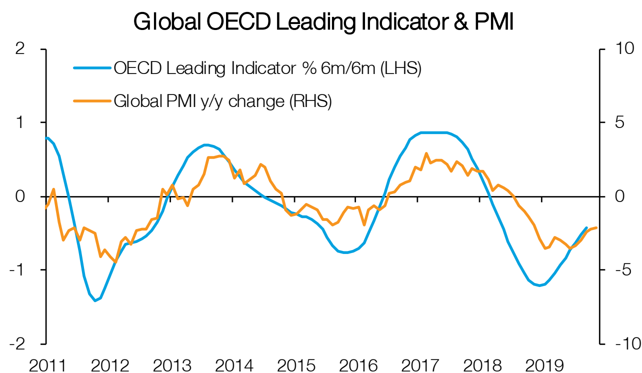
Source: FactSet, MWM Research, December 2019

In addition, and despite a final year end sell-off, bonds also provided solid returns as did defensive assets like gold and rate sensitive areas of the equity market. They say fortune favours the brave and these words rang true in 2019. Those investors who wilted on any number of downside risks and/or Trump tweets, were the unlucky ones. As we look backwards, we think the ability of risk assets to perform through rising periods of volatility and an elevated fear factor was due to three main reasons:

- First, the willingness of central banks to (once again) support and extend the economic cycle with further rounds of extraordinary monetary easing and strong forward guidance as growth momentum deteriorated;
- Second, "consensus" got too bearish. Sentiment collapsed but "hard" economic data did not. There was a risk that weakening consumer and business confidence would become self-fulfilling on the downside and/or that manufacturing weakness would infect the services sector, but this did not transpire. As a result, bonds yields followed sentiment down, but equities did not; and

- Third, in a low rate environment, equities remained the best house in a bad neighbourhood. As policy rates fell in response to weaker growth, the attraction of equities rose even further. This reflected the belief that if the economy avoided recession, equities would remain supported by falling bond yields and that the way to manage this was to de-risk within your equities allocation rather than de-risk your asset allocation.

Global leading economic indicators are turning up

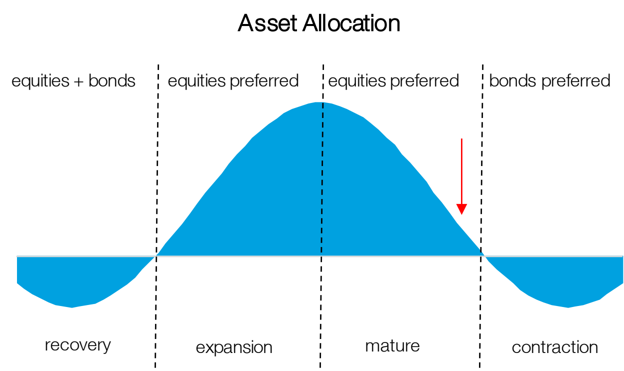


Source: Bloomberg, MWM Research, December 2019

Looking forward, we believe 2020 presents a short-term sweet spot for equities and risk assets. Economic growth is set to accelerate with strong support from easy monetary policy. This will continue to push bond yields higher, but not at a speed nor to a level which will undermine the equity market. While we expect the backdrop to be punctuated by periods of uncertainty – much the same as in 2019 - we believe there is a short window where cyclical upside will drive equity outperformance versus bonds.

The threat of a more severe correction in risk assets is always real but remains a tail risk that we believe should be hedged against via higher than average cash levels, but not positioned for given economic momentum is set to pick up off low expectations. The risk of a significant move higher in bond yields is relatively low given still weak inflationary pressures and this keeps the bar set high for central banks to reverse current easy policy settings. At some stage during the next 12 months we are likely to face increased fears of recession and the possibility of a bear market, but we don't need, or expect to have either, given the same powerful forces that have boosted asset prices and minimized volatility over the past decade are likely to remain in place for a while longer even if they are becoming less effective in doing the same job.

The cycle still drives a preference for equities



Source: MWM Research, December 2019

We are less positive on the Australian macro and financial market backdrop. Low wage growth and weak consumption growth will remain significant headwinds for the economy despite further monetary policy support. We expect the equity market to surf the coattails of stronger global markets but for weak corporate earnings growth to cap the upside (particularly as the market is already trading expensively).

Should the RBA embark on unconventional monetary policy early in the year, then further declines in the cost of capital should support Australian over global equities. In the absence of unconventional monetary policy or if it were to come much later in the year, the combination of elevated valuations alongside a poor earnings outlook are not conditions for strong returns nor global outperformance.

While a cyclical improvement does support better performance from the value end of the equity market, we think the style shift will be more pronounced in global than Australian equities. We think investors should focus on stocks that are good value rather than stocks that are value growth.

Global Economics

Another roll of the dice – the cycle goes on

1

2019 headwinds are abating, and the global economy should look modestly better by YE20. Easy monetary policy is the fuel for a recovery as well as providing insurance against negative *'event'* risk

2

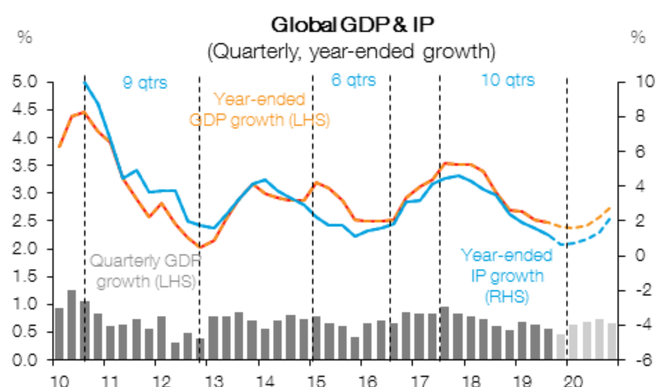
The US remains strong while China is working hard to arrest its growth slowdown. Europe should improve off a very anaemic base. A weaker US$ provides an upside catalyst for EM's

3

The harder central bankers work to prolong the cycle the deeper the next downturn unless the drivers of growth (cheap money and rising debt) change

2019 has been a most "dangerous year", with the trade and technology conflict between the United States and China never far from the headlines. The new tariffs have had a major impact on global trade and industrial production, with the associated uncertainty also weighing on business investment, which is now falling modestly in the major economies. However, in contrast, consumption has so far remained relatively resilient.

2020 should see a modest growth rebound



Source: Macquarie Research, MWM Research, December 2019

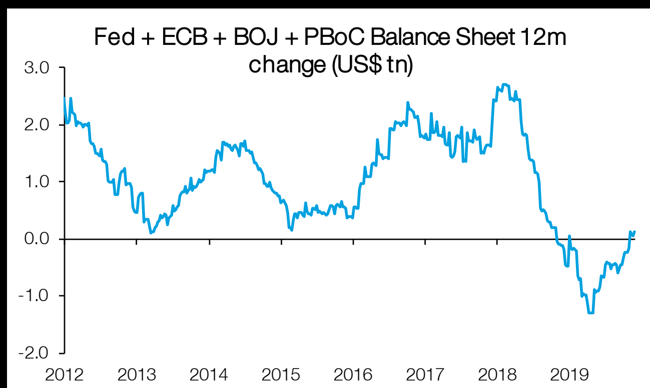
As has been the case for some time, the big "known unknown" is the path of the trade war. If a trade deal is indeed struck, we feel that a growth inflection point will soon follow, with the current cycle likely to bottom out in Q4. We believe the global economy will gradually get better in 2020 but at a very mild rate. We think a number of factors will support an improving growth backdrop.

- First, we have seen a substantial easing in global monetary policy as central banks have taken out insurance against trade war uncertainty and the manufacturing slowdown. Globally, central banks are now adding liquidity back into the system. This is a far cry from the tightening in policy that started in 2017 and which drive a substantial increase in financial market volatility;

- Second, the manufacturing slowdown appears to have run its course. The global manufacturing cycle has on average lasted around 36 months, split evenly between expansion and contraction. The current weak patch has lasted around 18 months with global inventories now run down and the potential for pent up demand to drive the cycle higher. We have already seen a pickup in manufacturing indicators such as the orders to inventory ratio as well as in selected PMI's. A further de-escalation of trade tensions should also provide a much-needed tailwind for the manufacturing sector; and

- Third, China is now working to arrest its growth decline. While it does not appear that they are likely to provide a 2011/12 or 2016 type stimulus, it is unlikely that the Administration is willing to tolerate any further meaningful decline in growth momentum. China has been adding additional liquidity into the financial system alongside modest tax cuts and increased public infrastructure spending. However, this comes against the headwinds created by continued constraints in the shadow banking system and the desire to prevent another wave of speculation in real estate.

Global liquidity is now expanding



Source: Bloomberg, MWM Research, December 2019

While we expect a 2020 rebound, we do not expect a repeat of the sharp recovery seen over 2016 and 2017. In part this reflects the fact that there is less spare capacity – unemployment in most major economies is now around multi-decade lows. It also reflects our expectation that China will refrain from a large stimulus and while many hold out hope for a fiscal stimulus in Europe, we remain sceptical. Finally, while US government spending will remain robust, it is highly unlikely that a divided Congress will allow a significant stimulus in an election year.

Major economies GDP Growth and 10-year bond yield forecasts

	GDP Growth (y/y, %)				10Yr bond yield (%)			
	2019	2020	2021	2022	2019	2020	2021	2022
US	2.3	1.8	2	1.4	1.8	2.5	2.25	1.25
Canada	1.6	1.6	1.2	0.3	1.5	1.75	1.6	0.4
Eurozone	1.2	0.9	1	0.7	-0.3	0.5	0.25	-0.5
Japan	0.9	0.3	0.5	0.6	-0.1	0	0	-0.15
China	6.1	5.9	5.7	5.5	3.1	3.5	3.1	3
India	5.3	6	7.1	6.2	6.9	7.4	7.1	6.5
Australia	1.7	2.3	2.8	2.7	1.3	1.9	1.7	1.3
New Zealand	2.2	2.2	2.5	2.3	1.4	2.05	1.7	1.3

Source: Macquarie Research, December 2019

We therefore believe that central banks and policy makers are working hard to prolong the cycle but that the next phase will be a more protracted downturn rather than upswing. Similarly, it is unlikely that we have one last synchronized growth rebound. Major countries and/or regions are all dealing with their own specific headwinds or tailwinds that are unlikely to all move in the same direction.

Growth upside dependent on further policy help

1

Economic growth should pick up, albeit only modestly into 2020. A gradual recovery remains contingent on further monetary policy easing with increased fiscal support a catalyst for a much sharper growth recovery

2

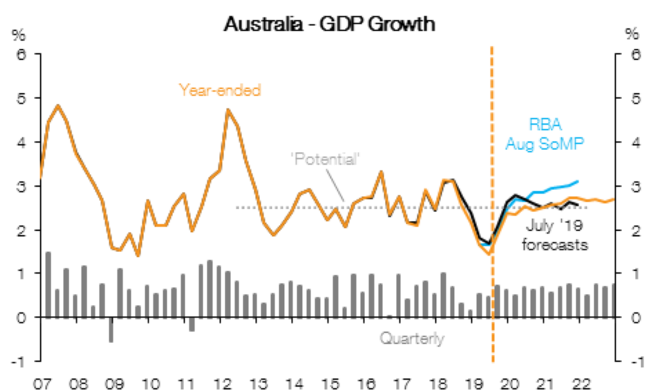
We expect the RBA to cut the cash rate by a further 25bps and thereafter further easing (rates and QE) will be contingent on the economic backdrop

3

Government spending will remain strong. Consumer spending will improve off recession like levels as house price increases continue, but modest wage growth and over indebtedness will weigh on spending decisions

We expect a very gradual improvement in economic growth over the next 12 months. GDP growth is forecast to rise to 2.3% over 2020, a relatively small improvement on expected growth of 2.0% over 2019.

Economic growth expected to head back to trend



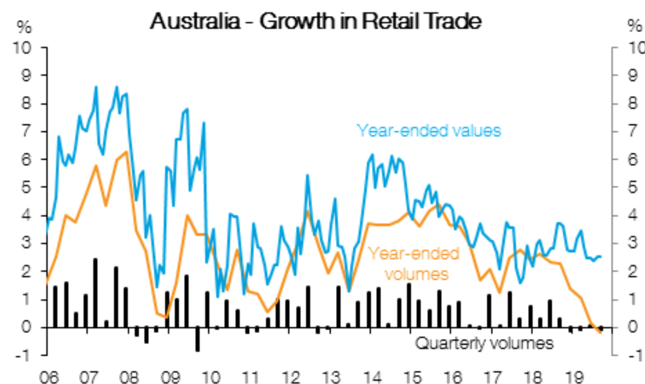
Source: Macquarie Research, MWM Research, December 2019

We expect growth to improve gradually for a few reasons: improving global growth next year; monetary policy easing and modest tax relief; and private demand growth is expected to lift amid rising housing prices and turnover. Falling dwelling investment is expected to drag on growth for another year or so and subdued consumer spending growth is forecast to continue in the near term before improving slowly next year. In contrast, business investment is expected to strengthen following recent weakness, in part due to improving mining investment.

Australia's unemployment rate is expected to remain within earshot of the current rate of 5.3% through 2020. With ample spare capacity persisting in the economy, inflation isn't forecast to reach the RBA's 2-3% target for a long time. We believe subdued wages growth will continue to weigh on upside in consumer spending, which is also hampered by elevated debt levels, although some offset is likely to come via the recovery in house prices, recent interest rate declines and tax cuts.

In contrast to ongoing weakness in the private sector, growth in government spending is expected to provide meaningful support to overall growth (including jobs growth given its labour-intensive nature). Public infrastructure spending has hit an "air pocket" as some projects have been completed or are winding down and there is a risk that this softness could persist into 2020. However, the broader outlook for government investment is that it will remain quite solid over the next couple of years.

Retail sales set to improve only modestly into 2020



Source: Macquarie Research, MWM Research, December 2019

Overall, we think the outlook is far from bad, but far from good. Monetary conditions are ultra-easy, and this is unlikely to change for many years, but easy conditions also need to be accompanied by strong confidence at both a business and consumer level if it is to transmit into the broader economy. We are confident that outside a global mishap the Australian economy is on a path of strong growth, but it will not fire on all cylinders and this will keep it in a subpar backdrop for a few years to come.

While building approvals have been weak (a lagged effect from the recent housing downturn) house prices have been rising sharply, with CoreLogic's national Home Value Index surging 1.7%m/m in November, the fifth consecutive monthly increase. Sentiment turned around following the

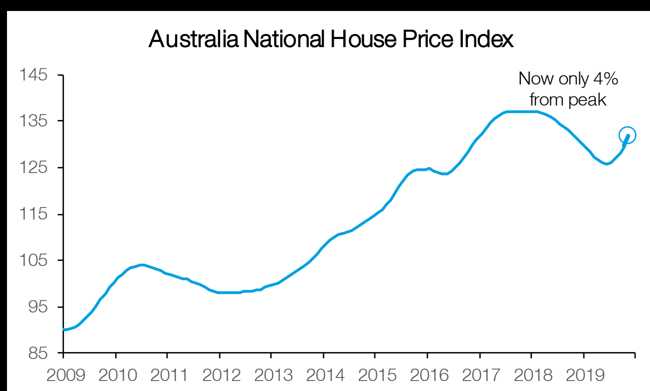
Coalition victory in the Federal election in May, easing concerns over negative gearing changes. While actual residential construction still has a long way to fall, historically rising dwelling prices have led residential building approvals by several months, and we would therefore expect to see approvals bottom and begin rising into 2020. Construction of detached houses should trough around mid-2020 while demand for high-rise apartments, however, is likely to remain much weaker than in recent years, in part due to much lower domestic investor and foreign interest in Australian housing. Macquarie is expecting national average house prices to rise by 6-7% through YE20. This would put them above the prior high by around mid-year. However, affordability has been boosted substantially by falling interest rates which is providing a large offset to rising prices to income ratios.

Australian Economic Forecasts

		Annual			
		2019	2020	2021	2022
GDP	y/y	1.7	2.3	2.8	2.7
CPI	y/y	1.6	1.8	1.8	2.0
AUD/USD		0.69	0.70	0.70	0.70
Policy rate	%	0.75	0.50	0.50	0.50
10Yr bond yield	%	1.3	1.9	1.7	1.3

Source: Macquarie Research, December 2019

Australian housing prices near previous peak



Source: CoreLogic, Macquarie Research, MWM Research, December 2019

GLOBAL and AUSTRALIAN EQUITIES

Modest reflation to underpin equities

1

We are positive on the 2020 equity market outlook. Improving economic growth alongside easy financial conditions will remain positive tailwinds

2

While there are pockets of overvaluation evident across and within many equity markets, we think equities as an asset class remain undervalued versus bonds which are even more expensive

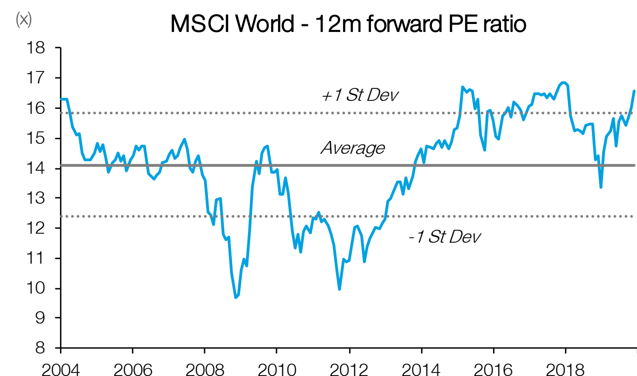
3

Australian equities will be dragged higher by global markets, but a weak profit backdrop is likely to see it underperform global equities.

.

Equity markets perform best when valuations are cheap, earnings growth is rising, when interest rates are low and/or financial conditions easy and when positioning is light. It is hard to think that all these conditions will prevail in 2020. However, we believe there will be reasonable support from improving economic momentum (coming off a low base), continued low interest rates, easy financial conditions and fund flows out of bonds and defensive assets.

EM's and Cyclical markets suppressing global valuations

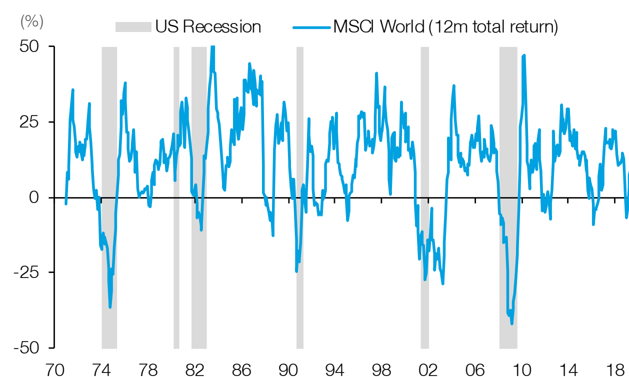


Source: FactSet, MWM Research, December 2019

Equity markets are unlikely to match their 20+% returns generated through 2019, but outside of a sharp deterioration in the economic outlook, a US election shock or a spike in inflation, we expect global equity markets to trade higher as sentiment around the growth backdrop improves and money comes out of recession proof assets.

At any given time, it is always possible to produce a long list of risks or events that might upset the direction of growth and risk assets. This list becomes more acute as the economic cycle matures, excesses begin to emerge, and as financial asset valuations rise.

Equity bear markets coincide with recessions



Source: FactSet, MWM Research, December 2019

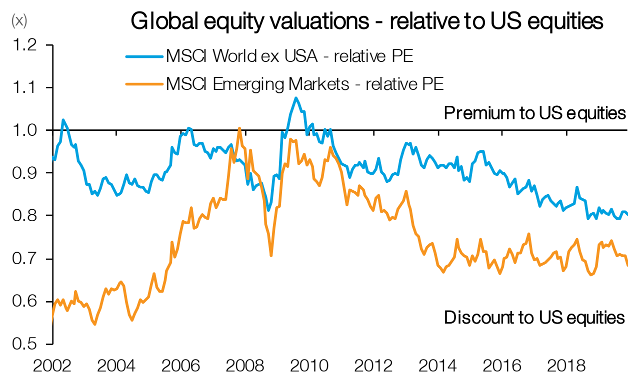
Traditionally, the two most common causes of bear markets are an economic recession, or a valuation shock driven by an unexpected increase in interest rates. We believe the risk of either of these events remain relatively low as we move into 2020. If there is a takeaway from 2019, it is to focus on the things that matter and try to filter out the noise that appears to be getting louder and louder.

Thus, while events like BREXIT, Middle East tensions, the US Presidential election, elevated asset prices, rising consumer leverage, deteriorating credit conditions, negative rates and ballooning negative yielding bonds are just some of the concerns likely to (re)emerge sometime in 2020, we believe it will be the economy and central bank policy rates that will and should remain the key area of focus for investors.

Similarly, we think the sequencing of risks (when they become a headwind) is more important than simply identifying what might/could go wrong. We think recession risks are more likely to emerge in 2021/22 and that the threat of a sharp spike in interest rates are for the next economic cycle rather than the current one.

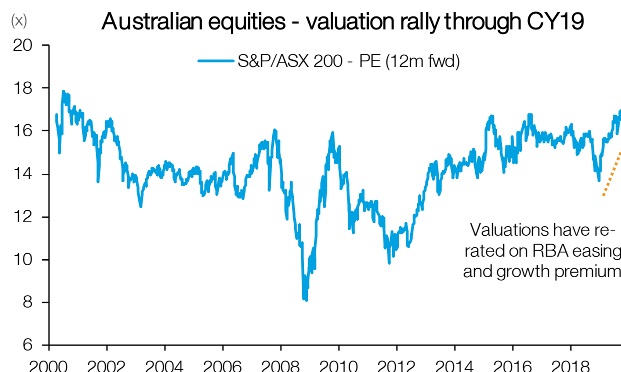
Prolonging the economic cycle via unsustainable debt growth will only make the next downturn more severe. But that is a story unlikely to emerge in 2020. We believe investors should be positioned for mild reflation against a gradual rise in downside risks.

Equities outside the US offer relative value



Source: FactSet, MWM Research, December 2019

Australia equities will start 2020 at a higher valuation



Source: FactSet, MWM Research, December 2019

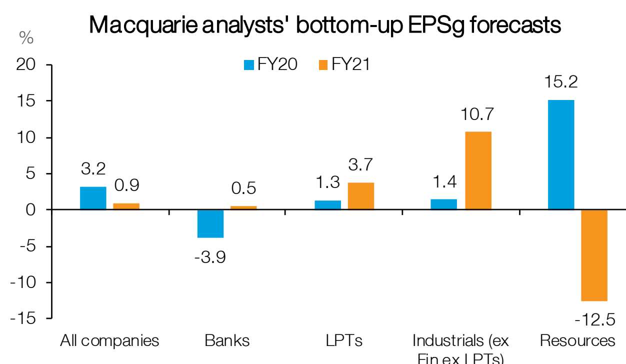
Under a scenario where the global economy avoids recession and central banks continue to stimulate, then we expect performance to favour the riskiest markets and regions which are recovering from 2019 trade war inventory corrections and growth slowdown fears. This includes Emerging Markets, Europe and Asia (manufacturing sensitive countries such as Korea, Japan and Taiwan) where valuations are also strongly in favour and where a peak in the US$ will also provide liquidity and fund inflows. While there are pockets of overvaluation evident across and within many markets, we believe equities as an asset class remain undervalued versus bonds which are even more expensive.

We think the outlook for US equities remains solid, but it is unlikely to outperform higher beta/cyclical regions if growth momentum continues to improve. US equities therefore remain our preferred growth exposure, but we think performance will become more volatile in 2020 given the overhang of the US presidential election is likely to keep political uncertainty elevated.

Similarly, concerns around the end to the corporate earnings cycle are also overdone. Profit growth has been slowing, but there are few signs pointing towards a more protracted decline. Corporate health remains solid and at this stage there are few signs of stress. As a result, we do not expect the private sector to be the catalyst for a major (systemic) credit event particularly while Fed policy remains ultra-accommodative. On this basis, we think US equities maintain their fundamental support but as is the case with our preference for the more cyclical markets, we would expect small and mid-cap stocks to outperform large caps in a more risk-on environment.

We believe the outlook for Australian equities is less encouraging and while it will take its cue from offshore markets, the ability to outperform will depend on whether the economy picks up faster than expected and/or whether further (unconventional) monetary policy stimulus is provided. At this stage, we see little prospect of a strong cyclical upswing in the domestic economy. We don't see it getting worse, but there are powerful headwinds that are likely to prevent a "V" shaped recovery. This implies that earnings growth will also remain muted as the corporate sector battles both cyclical and structural profit pressures in key sectors such as agriculture, banks, building and construction, property and retail.

Weak EPS growth continues for most sectors



Source: FactSet, MWM Research, December 2019

It is normal that investors look through the bottom of the earnings cycle and bid valuations higher on the expectation of a cyclical improvement. However, we are not confident that the conditions are in place for this to occur. Australia has long suffered from weak earnings growth and a recovery that only takes the economy back to trend is unlikely to drive a substantial improvement in the profit outlook. Furthermore, with large parts of the market cap under structural profit pressure (such as banks at ~20%), this will continue act as a drag on overall market upside outside of periods of valuation normalization.

This implies that the potential for further valuation re-rating is likely to be the biggest upside driver of the equity market through 2020. We think in the absence of QE, the potential for a cyclical re-rate is relatively low. This is because the market is already trading at elevated valuations and because a cyclical re-rate requires a cyclical upswing, and this is not likely in 2020.

However, if the RBA was to implement unconventional monetary policy to stimulate the economy then we see strong potential for the market to rise and in turn outperform offshore equities. Policy action that reduces bond yields and the cost of capital will flow through into higher valuations across the entire market. This is likely to support cyclically depressed areas such as retail, property and construction while also supporting the more expensive (growth) areas of the market.

In sum, investors should be prepared for further volatility in equity markets but for a mild reflation trade to be the underlying trend. Strong interest rate support will be a positive tailwind for equities and help offset downside risks. We think a more risk-on environment will favour markets where the valuation or cyclical appeal is highest. Australia is likely to be a “middle of the road” performer after a strong 2019 return.

Global and Australian Fixed Income

Yields to rise on cyclical upside

Fixed Income markets had an extraordinary year as yields on government bonds tumbled on the back of a combination of recession fears and heightened geopolitical uncertainty. Globally, coordinated easing by central banks saw cash rates tumble at the same time. This was a potent combination for fixed income markets, with total returns for broad based market indices exceeding 10%.

1

Long bond yields pushed higher by stronger economic growth. Geopolitical uncertainty remains so expect volatility in safe-haven sovereign bonds.

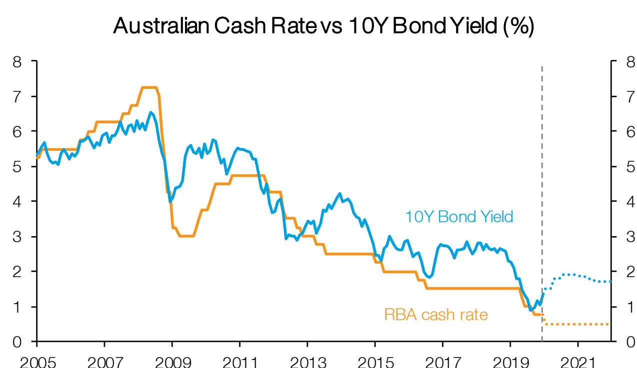
2

Easy financial conditions combined with strong demand for yield will see credit spread product supported. We expect corporate debt to outperform sovereigns.

3

We prefer Australian fixed income to global fixed income as our less positive view on the Australian macro backdrop relative to global markets should see Australian yields rise less.

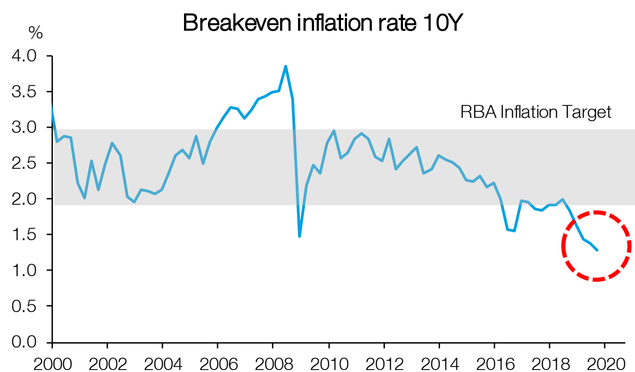
The story of 2019 was falling cash and bond yields



Source: Macquarie Research, FactSet, December 2019

Within sovereign bond markets we are unlikely to see a repeat of 2019. Rather the rapid decline in rates simply brought forward future returns. We expect sovereign bond yields to gradually move higher as real rates increase (off very low levels), driven by improving global economic growth. However, we expect that 2020, like 2019, will see bouts of volatility in bond markets due to their safe-haven status. Market uncertainty remains high surrounding geopolitical issues like US-China trade, elections and BREXIT despite the recent fragile calm.

Inflation expectations remain well below the target band



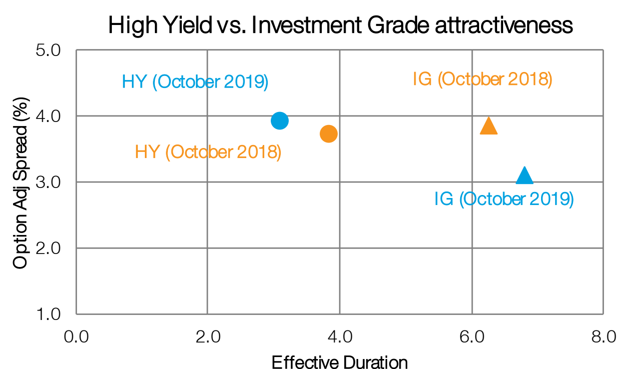
Source: RBA, MWM Research, December 2019

It is difficult to envisage a marked back up in sovereign bond yields without an increase in (unexpected) inflation. Consequently, low inflation remains the key driver of our expectation for continued easy monetary conditions.

Easy monetary policy settings will provide a positive tailwind for credit spread products as ample liquidity and low interest rates combine to keep borrowing costs low and the primary issuance market well supported. In general, corporate balance sheets remain healthy despite headlines forewarning of excessive corporate debt on issue and weakening earnings fundamentals. However, what matters for credit markets is not earnings growth, but whether debt serviceability remains strong, and it does.

We expect credit spread products to outperform sovereign exposure (duration matched), given our expectations that long end yields rise with real rates, central banks remain accommodative and mild earnings growth acts to support corporate debt markets.

High yield offering better risk-adj returns



Source: Bloomberg, MWM Research, December 2019

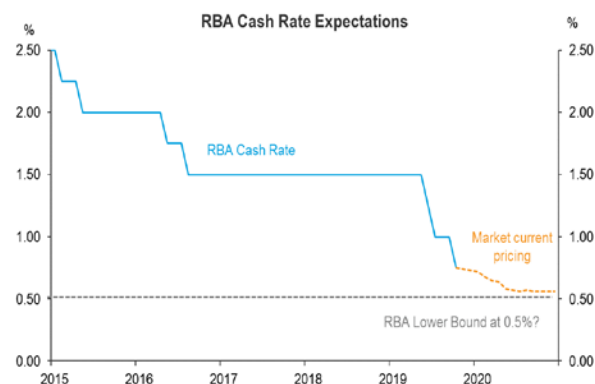
Within credit, we prefer high yield over investment grade corporate debt. This is because high yield is less sensitive to rising interest rates then investment grade debt. 2020 should also see continued improvement in the backdrop for emerging market (EM) debt issued in both local and hard currency terms. For now, we remain neutral on hard and local EM debt, although a weaker US$ will support moving towards a more overweight position.

A strong USD impacts the debt of EM issuers whether it is issued in hard currency or local currency. Hard currency debt suffers when the USD is strong since the interest burden increases in local currency terms and the longer this strength continues the harder the debt is to service. Local currency debt can struggle when the USD is strong since this typically means that the EM currency is weak. This can cause EM central banks to raise rates to defend the currency.

Domestically, we expect that the RBA will deliver a further rate cut in February 2020 taking the cash rate down to 50bps. At the time of writing, Governor Lowe confirmed that the RBA views the effective lower bound on interest rates to be 25bps. Quantitative easing (QE), if it were necessary, would be implemented via purchases of Australian government bonds as a means to lower the risk-free interest rate.

However, for the central bank to consider QE implementation there would need to be evidence that the key targets for the central bank (inflation and employment) were moving away from the target. At the time of writing, the RBA's own forecast does not have inflation reaching the target until the end of 2021. Consequently, the RBA will not be raising the cash rate for a very long time.

Expectations are for further rate cuts



Source: Macquarie Research, MWM Research, December 2019

In general, Australian economic growth is expected to be slightly better than this year which should see real rates rise causing higher long end yields. However, our less positive view on the Australian macro backdrop relative to global markets and the uncertainty surrounding QE implementation means that we expect that Australian bond yields will increase less than global rates in 2020. As a result, we prefer Australian fixed income in general relative to global fixed income.

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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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