MACQUARIE

Investment Matters

Survival of the Fittest

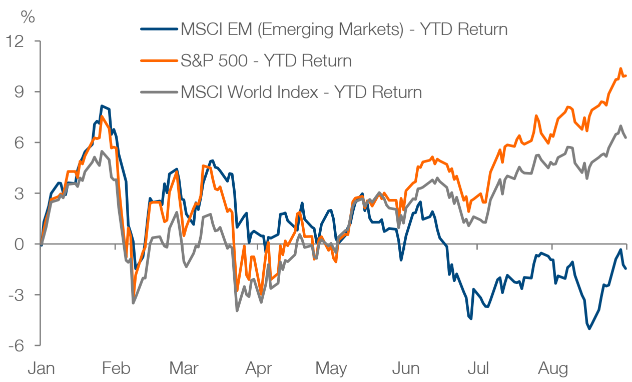
September 2018

Social Darwinists believed that societies, as do organisms, evolve over time. Nature then determined that the strong survive and the weak perish …. Charles Darwin

The bifurcation between the economically strong and the economically weak continues to drive financial market performance. The strong are prospering, in particular the US with equities posting multiple new all-time highs throughout the month of August. In contrast, the weak are perishing with selected emerging market currencies and bourses hitting new bear market lows (>20% declines), despite increased support from global agencies such as the IMF and counter-cyclical monetary policy tightening in an effort to stem currency depreciation.

As a result of this economic and financial market dispersion, it is hard to generalise on the outlook as there are two separate games playing out across the globe. What remains clear is contagion from the economically vulnerable has been minimal and concerns remain confined to a small sub set of EMs. On the other side, the US continues to power ahead, helping drag global growth along with it. 2Q18 GDP growth surprised on the upside and with limited evidence of inflation, monetary policy has tightened at a glacial pace. In addition, recent tax cuts provided a strong tailwind for US corporate profits, helping fuel the run in equities.

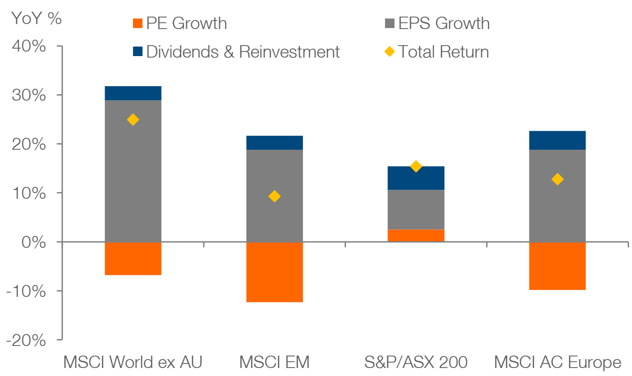
MSCI World vs MSCI EM vs S&P500



Source: FactSet, MWM Research, September 2018

We see no end to the current bifurcation between the developed and developing world. The main drivers of this dispersion – a strong US$ and a weak China – do not look likely to meaningfully change in the foreseeable future. We think the "trend is your friend" and rather than bet against areas of strength (i.e. the US), and/or bet on areas of weakness reversing course (i.e. emerging markets (EM)), we prefer to stick to a strategy that is working and which does not require raising risk in order to chase an uncertain level of returns. We do think US equities are priced for perfection while EM equities are priced for the risk of trade wars and continued US strength, but in general we would need to see evidence that either: 1) relative economic growth fundamentals are shifting; and/or 2) emerging markets have been overly discounted for the threat of trade wars and/or further US$ strength. Unfortunately we are not convinced this is the case.

Return decomposition: US, Europe, EM, AU (year to August)



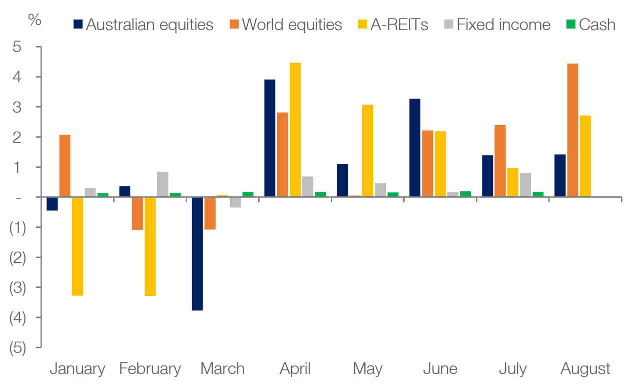
Source: FactSet, MWM Research, September 2018

Investors should understand that remaining constructive on equities in general, and the US in particular, does not mean we think the current run rate of returns can continue – which we do not. There are a number of factors to consider when looking at portfolio construction at the current time in the cycle. First, does the preference for equities over bonds remain intact? second, within equities what does regional allocation look like given the recent skew to performance? and third, how do we position in other asset classes to reduce risk and/or supplement return when downside risks are rising and performance is narrowing (i.e. areas which are going up are becoming fewer and fewer)?

Although the economic cycle is maturing and interest rates are gradually rising, the preference for equities over bonds remains in place. Moreover, this preference is strengthened further when there is limited signs of inflation and the need for policy makers to more aggressively raise interest rates. However, we are seeing signs that confirm the cycle is aging. The separation of the strong versus the weak is symptomatic of a mature cycle and of a change in economic conditions. Similarly, the severe discounting of stocks which disappoint on earnings. This is because stocks require earnings to support performance as the tailwind of falling interest rates begins to reverse – something evident in both the recent US and Australian corporate reporting season.

In regards to regional preference of equity allocations, investors should note that a rolling bear market has been evident across financial markets since the end of 2017. It started with bitcoin reaching peak euphoria back in December 2017, has spread to selected emerging currencies and equity markets, has enveloped certain commodities (i.e. copper) and is now working its way through a number of high PE, strong momentum market darling stocks. This supports the need to remain vigilant on positioning within as well as across assets as what is performing within equities has not been consistent.

Asset class performance from recent peaks



Source: FactSet, MWM Research, September 2018

Finally, as the economic cycle matures, the preservation of capital takes a step up in importance versus the return on capital because the former begins to taper off (risks go up and return goes down). Our base case is that the world can likely absorb concerns around trade wars and a gradual tightening in monetary policy. However, the extent of uncertainty that this creates means risk aversion is not stable and markets are likely to continue reacting violently to uncertainty and disappointment as we have seen with daily price volatility. This is the time in the cycle where diversification and holding assets with low correlation begin to have a much greater bearing on portfolio returns and consequently we recommend maximum exposure to alternative assets.

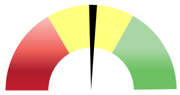
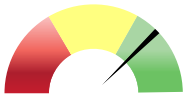
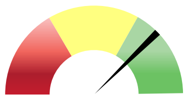
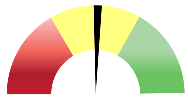
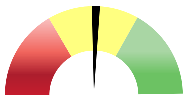
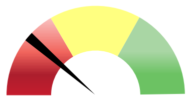
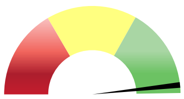
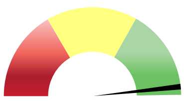
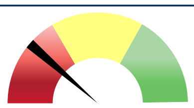
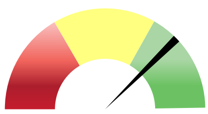
Closer to home, the Australian equity market has been a strong performer through what we would consider to be an average reporting season, amidst further evidence that housing weakness is not moderating and when up against rising domestic and international political uncertainty. The ASX200 hit a post GFC high during the month which is all the more surprising given the high number of earnings torpedoes that emerged and given post result earnings momentum broadly negative.

We believe that this has been a function of results being better than expected (i.e. retail as the discretionary spending barometer) and in turn providing confirmation that the economy is not tipping over. We have long held the view that the risk to high multiple growth stocks was not a rise in interest rates but rather the potential for earnings disappointment. This is core to our belief that growth stocks can trade on high multiples as long as they don't disappoint and that for the most part, they tend to de-rate on idiosyncratic (stock specific) rather than systematic factors. This view has been confirmed during the reporting season and we still prefer growth stocks but we expect relative outperformance to continue to slow and narrow from hereon in.

As we look out more broadly, our key messages remain the same. Markets are not collapsing and in fact have withstood a number of hits year to date. However, global equities have failed to surpass their January highs and we do not think the concerns that have been battering markets are about to dissipate. Tightening liquidity, trade war fears and a lack of any meaningful improvement in global growth momentum. Any of these factors could easily deteriorate further and we see limited chance that they will improve to any large degree. However, global growth remains solid, earnings growth is strong, bond yields are yet to fully price in the outlook for rising inflation and equities still remain the best house in a bad neighbourhood. This means we stick with our preference for risk assets over defensive assets, remaining overweight equities versus bonds. We see limited upside in the Australian equity market from this point forward, particularly with no evidence of a broad earnings recovery and the market (ex financials) trading on a record high valuation. We recently moved overweight A-REITs and remain comfortable with this more defensive tilt. The current backdrop requires a cool head, staying true to your investment objectives and avoiding the need to chase returns when risks are elevated.

Jason and the Investment Team

Asset class preferences

Recommendation	Quick takeaway
 -5% 19% +5% Australian Equities	Market upside is capped by weak earnings growth and expensive valuations; Large portions of market cap are facing regulatory & structural competitve pressures; Valuation dispersion has reached record levels but will not normalise without a earnings recovery.
 -7% 23% +7% International Equities	Catalysts for a sustained developed market correction are not evident; US equities remain a clear pocket of strength, supported by strong corporate earnings; Equities will take a moderate rise in bond yields positively from recent levels.
	 United States  Europe  Japan  Emerging Markets
 -3% 5% +3% Property	Provide a safer and more secure yield than other bond proxies; Are now trading back in line with NTA, providing some cushion for a potential rise in the cost of capital; Favour growth REITs while avoiding housing and retail related.
 -3% 8% +3% Alternatives	Alternatives provide diversification benefits when asset correlations are not stable; We like commodities on the back of China fine tuning that is underway; We prefer fundamental equity long/short and relative value strategies due to the attractive spreads and elevated deal activity.
 -12% 40% +12% Fixed interest	The long term trend for sovereign yields remains higher, however, we expect some sharp reversals due to increasing volatility; Credit markets remain well supported but are expensive given the risk; Emerging market debt remains under pressure although there are no signs of contagion.
 -5% 5% +5% Cash	Reflects rising uncertainty across risk assets and the potential for positive Bond-Equity correction

Source: MWM Research, September 2018

Global economics – China steps up fine tuning, US remains the engine

- Global growth remains firm in the face of an escalating US-China trade war;
- US economic strength eliciting rate rises. China "fine tuning" policy in response to weak growth;
- Emerging economy currency weakness accelerating.

Global growth momentum has remained relatively firm throughout the past few months despite being buffeted by a multitude of factors – rising trade war concerns, signals that US policy rates will remain on an upward trajectory, further Chinese growth weakness, a substantial drop in global exports and further declines in PMI's.

Macquarie believe that Global GDP still grew at a well above average 3.5% saar (seasonally adjusted annual rate) in Q2. In large part, the slowdown in Q1 and subsequent recovery in Q2 probably reflects a degree of statistical volatility. However, looking through the noise, global GDP grew by around 3¼% saar in the first half of 2018, modestly slower than the 3.4% seen in H2 last year, but still at a reasonable clip.

The three major talking points over the month were: 1) the escalation in global trade wars; 2) additional weakness in the Chinese economy; and 3) weakness in a number of emerging economy currencies as a result of a rising US$.

Trade war tensions escalate: The US-China tariffs tit-for-tat has taken another turn with President Trump reportedly wanting an additional $US200 billion of tariffs on Chinese imports to the US. If implemented this would mean that over half of all Chinese imports would be subject to tariffs. The tariffs would be implemented after the public-comment period concludes and would mark a major escalation in the trade war so far. As the trade war takes a step up, Oxford Economics estimate that a full-blown trade war could result in a cumulative global GDP growth loss of 0.8% by 2020.

From an economic viewpoint, the trade tensions are coming a time when the US economy appears to be operating at full capacity and global trade is slowing. US production is not prepared to fill the gap created by import tariffs and is also not geared towards producing the type of goods imported from China. Low borrowing costs have encouraged corporates to leverage up the balance sheet and buy back shares, rather than invest in growing productive capacity. With an unemployment rate already below 4% and capacity utilisation at the long term average, further tariffs on imported products will only exacerbate already visible inflationary pressures.

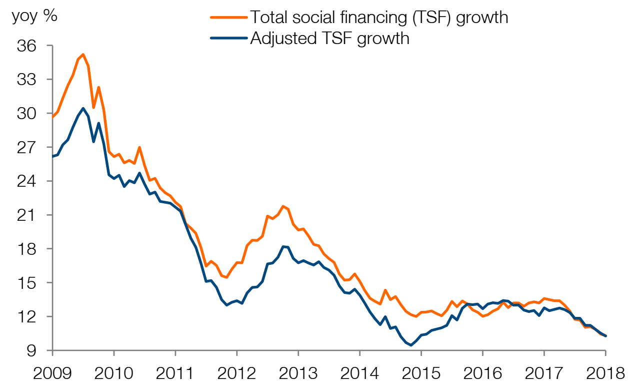
Employment cost index close to pre-GFC levels

Source: FactSet, MWM Research, September 2018

Chinese authorities stick to fine tuning: Macquarie expect the recent Chinese growth slowdown to continue into August and with policy easing to stay at a "fine tuning" level rather than reaching outright stimulatory (i.e. targeted RRR (reserve requirement ratio) cuts, liquidity injection through open market operations, lower reverse repo (repurchase agreement)/MLF (medium-term lending facility) rates, window guidance for increasing credit supply and changes of wording in policy documents).

This would suggest that at the current juncture, policy makers appear to be comfortable loosening formal banking and fiscal controls, but keep tight controls on shadow banking, shadow fiscal and property. According to past experiences, while fine tuning is not enough to reverse the broad downtrend of the market and the economy, it could lead to a short-term stabilisation of economic data and trigger a technical rebound in financial markets. Moreover, Macquarie's China economist believes the PBoC (People's Bank of China) sent a clear signal to defend the RMB at 7.0 to the US$.

Slowing Chinese credit growth

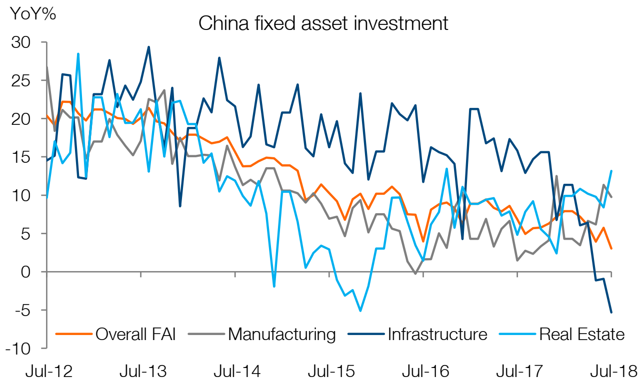


Source: Macquarie Research, MWM Research, September 2018

With China entering a new political cycle, top leaders are set to take a longer-term perspective compared with the past five years, when the focus was on power consolidation. A way to view the current situation is that Macquarie believe policy makers are stress-testing the economy and the RMB.

While they still have a bottom line to defend, the tolerance level seems to be much higher than the past five years. As such, we expect the current credit down-cycle is only halfway through and the economy could face stronger headwinds in 2H18 and 2019. We might see the second-level easing coming very late this year or even next year, suggesting that the ride could still be bumpy in the coming months.

Infrastructure a drag on fixed asset investment



Source: Macquarie Research, MWM Research, September 2018

Emerging market risks contained: To date emerging economy weakness has remained confined to those whose external vulnerabilities remain large. In fact, there has been a clear distinction between the less vulnerable (particularly within Asia such as Thailand, Korea and Malaysia which run current account surpluses) versus those who are more vulnerable within Lat Am and Europe who run large account deficits such as Turkey and Argentina.

We believe the size of the affected economies make it unlikely, at this stage, that weakness in emerging economies will spill over into the developed world or create enough uncertainty that it would alter the path of either the ECB (European Central Bank) or the Federal Reserve who appears unmoved in its quest to continue rising rates. Importantly, we do not see signs that emerging markets weakness is becoming a more systemic problem and while there has been no softening in view from the Fed, it would not look past weakness that begins to spill over into broader global asset prices and confidence levels.

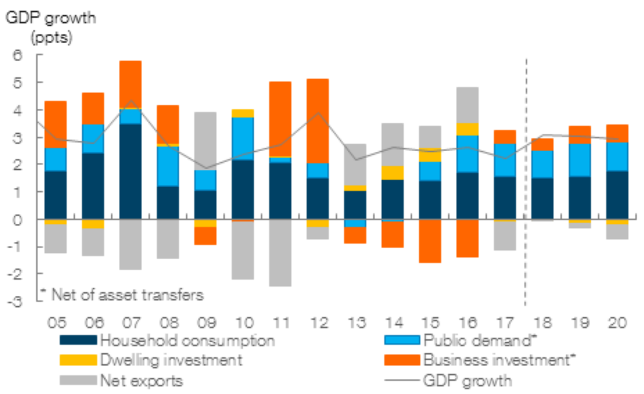
Looking ahead, while there is little doubt that the trade war has the potential to disrupt activity, Macquarie continue to feel that the tariffs planned to date are unlikely to be big enough to have a large direct impact on growth. On balance, while global growth will probably slow a little further into 2H, the house view is to expect an above average pace over the remainder of this year, with policy stimulus in China and the US in the main offsetting the impact of modestly higher tariffs.

Australian economics – Housing downswing accelerates

- The Australian economy continues its solid but unspectacular run. 'Low-flation' ensures the RBA will remain on hold for some time to come yet;
- The downturn in housing is now accelerating. Further credit tightening raises downside risks for luxury/ discretionary consumer spending;
- The threat of a global trade war is real, but should be contained. A weaker A$ provides some cushion for the domestic economy.

Australia continues to track slightly above trend growth with spare capacity diminishing albeit at a very gradual pace. Our Economics team is forecasting growth to pick up to 3.1% in 2018 and 3.0% in 2019, supported by low interest rates and a generally favourable view on the global economy. There remains ample spare capacity in the economy but unfortunately, Macquarie believe, this will linger for some time to come. It appears likely that it won't be until 2020 that Australia's unemployment rate will decline into the 4% range, suggesting a modest outlook for wage growth and little pressure on the RBA to begin raising the official cash rate until 2020.

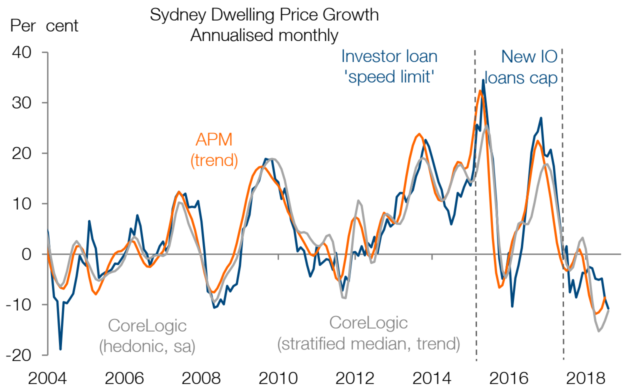
The drivers of GDP growth are changing



Source: Macquarie Research, MWM Research, September 2018

Q2 business investment appears to have been weak with firms remaining cautious on the outlook. The experience of recent years suggests they are probably being too pessimistic. Q2 real capex (capital expenditure) fell 2.5% q/q (quarter-on-quarter), with non-mining capex declining 0.5% q/q following a period of strength. However, the real weakness was in mining capex which declined 7.2% q/q. Looking ahead, slower growth in business investment does appear likely. In that vein, non-residential building approvals have declined this year (despite a jump in July) and also foreshadow weaker building activity. Residential activity is also slowing with the housing construction cycle now clearly moderating. The key question is at what pace this occurs going forward. Low interest rates (notwithstanding recent modest increases) and strong immigration provide fundamental support to housing demand. However, evidence of weaker pre-sales, more scarce developer finance and lower housing prices continue to raise downside risks.

House price decline accelerating



Source: Macquarie Research, MWM Research, September 2018

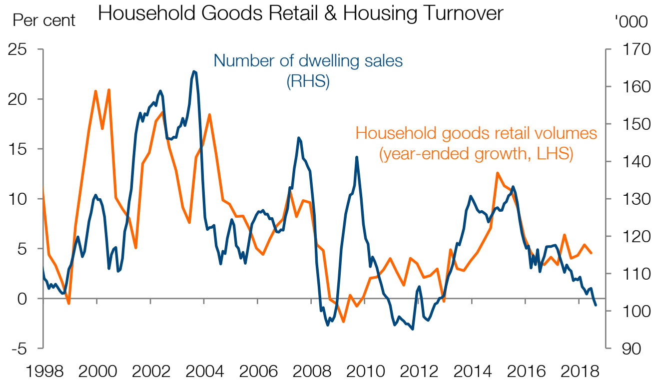
August has proved to be another weak month for the housing sector with CoreLogic estimating that house prices (after seasonal adjustment) declining a further 0.6%m/m (month-on-month) which was in line with prior month. In total, prices have now fallen only 3% from the 2017 peak, but a number of disturbing trends are emerging.

First, Sydney recorded the largest monthly price decline in 10 years at 0.9%. Prices are now down 6.2% from peak but have fallen at an annualised 7.9% rate over the past 3 months. Second, six of the eight capital cities are now recording negative house price growth. Only Adelaide and Canberra are still in positive territory. Third, credit conditions continue to tighten and mortgage costs continue to rise. We see no near term let up in these borrowing conditions. Macquarie expect dwelling prices to decline around 10% from peak although given we are already at more than half this level, the potential for larger declines, and for the slowdown to become the longest on record, is shifting towards a more central outcome.

Against a backdrop of stagnant wage growth and declining collateral values, we expect consumer spending to remain under pressure. Retail sales were unchanged in July, which was weaker than consensus and Macquarie expectation. The flat outcome followed three strong prints so in that regard it was not too surprising. Similarly, the decline in household goods retail in July could have reflected changing seasonal patterns given this has now happened for four consecutive years. Excluding food, however, retail sales were just 2.1% higher over the year. Not a particularly encouraging run rate.

Macquarie are forecasting consumption growth to slow in the second half of the year to around 2.5% before picking up into calendar 2019 although it is difficult to see where large upside surprises might come from in regards to the consumer spending outlook.

Weaker house price growth foretells weaker spending



Source: Macquarie Research, MWM Research, September 2018

The threat of a global trade war remains an overhang for all externally exposed economies. The potential for a weaker A$ provides a shock absorber for any initial impact on trade volumes, although it is difficult to think that the net effect will not be negative if tensions escalate further and begin to crimp confidence, business investment and ultimately demand.

All told, and as we head into the second half of the year, the broader economy is holding up relatively well. There are clear areas of strength (particularly government investment) and the consumer has remained relatively resilient to date. However, pockets of weakness are beginning to deepen as the housing downturn accelerates. The potential for further credit tightening and a self-reinforcing downswing in house prices are clear risks for consumer spending and ultimately growth. The threat of an escalation in global trade wars also overhangs the backdrop. This is not a bearish outlook, but one where upside surprises become harder to identify in the near term.

International equities – US equities, stay with strength

- We expect current trends of trade war escalation, heightened volatility and US equity outperformance to continue;
- The US-China trade war shows no signs of reversing course. Further escalation will drive currency volatility and divergent asset class returns;
- US equities are still our preferred global exposure. While emerging market valuations look tempting we believe it is too early to turn positive.

The last month saw now well embedded trends continue to dominate proceedings. US equities outperformed, emerging markets volatility escalated, and the Australian dollar declined. As we wrote last month we believe a continuation of current trends is more likely than mean-reversion. We still think it is too early to turn positive on emerging markets despite compelling valuations.

Our bias remains to the US which continues to deliver robust earnings growth. The stronger US dollar is weighing on guidance from US corporates but we prefer the relative safety of the US to emerging markets in a Fed rate rising / stronger dollar environment. Europe is facing the macro headwind of declining central bank support and is increasingly caught in the tariff crosshairs. However, a significantly weaker Euro lends support and keeps us on neutral.

We remain neutral on Australia following a soft reporting season with the outlook hampered by political uncertainty and house price declines. Again, the weaker local dollar is bolstering the index despite a tepid outlook for earnings.

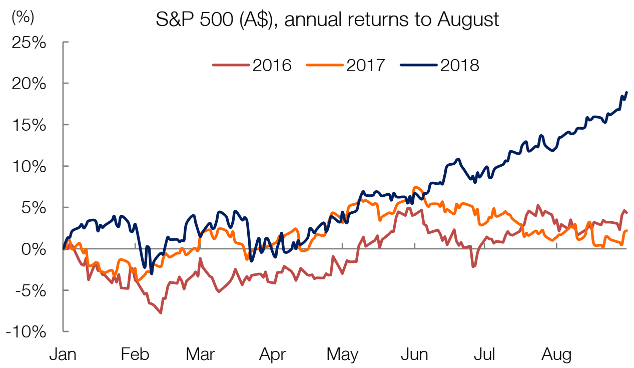
Equity market preferences

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

Source: MWM Research, September 2018

The Australian dollar's decline this year has delivered outsized gains to unhedged US equity positions. Year-to-date returns for the S&P 500, in Australian dollars, are already +18.9%. If the current trajectory is maintained it could well be the best year for the index since 2013.

US equity returns bolstered by weak A$



Source: FactSet. MWM Research, September 2018

Despite the solid performance, valuations have actually fallen with the 12-month forward price-earnings ratio currently 16.9x, down from 18.3x in early January, due to a 17% lift in earnings. While the stronger US dollar does provide a headwind, we do not believe this will stop the bull market by itself given strong earnings momentum.

Emerging markets have been hit hard by US tariffs and that appears unlikely to change anytime soon. The Trump administration's proposed tariffs on $200billion of Chinese imports looms as the next potential source of volatility. It is possible Trump applies a 25% tariff rate, rather than 10%, as a show of force ahead of the midterm elections.

The period of public comment ends on September 6 with the complete list of goods subject to tariffs also to be finalised. Tariffs can be implemented thereafter. An escalation of such scale lends itself to further US dollar strength and Renminbi weakness.

It remains to be seen how China responds. Further currency devaluation and targeting of US companies appears a given, but the potential for a large-scale domestic stimulus is the primary risk to our underweight call on EM equities. While there have been a few recent signs of domestic credit loosening, which appear to be feeding through to the infrastructure sector, these moves have been only gradual to date.

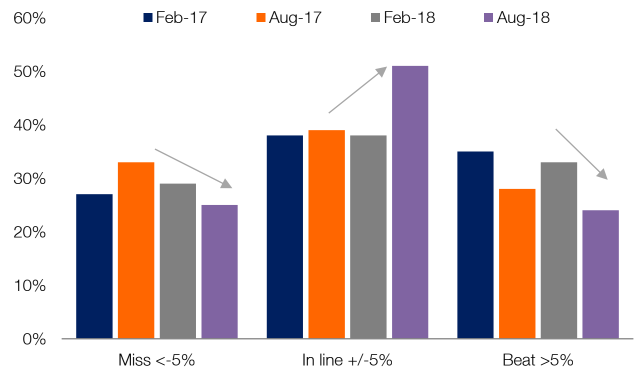
Australian equities – Reporting season disappoints

- We retain our neutral allocation to Australian equities. The August reporting season was underwhelming and confirmed our view the Australian market lacks a strong earnings impulse;
- Rising costs weighed on several sectors, most notable mining, resulting in earnings downgrades. The tailwind of lower interest rates has reversed. Companies are increasingly turning to M&A to drive growth, classic top of the cycle behaviour;
- We retain our preference to growth companies able to maintain earnings momentum. Offshore earners are best placed to avoid the political distractions at home while benefiting from the soft A$.

The August reporting season was by any measure disappointing. As we have written this year we have struggled to identify a robust earnings recovery for Australian equities that can drive the index sustainably higher. While we would prefer to be proven wrong here that unfortunately was not the case.

Only a quarter of companies beat expectations, down from a third in February, with most companies reporting in line results.

FY18 results mostly in line but less beats



Source: Macquarie Research, MWM Research, September 2018

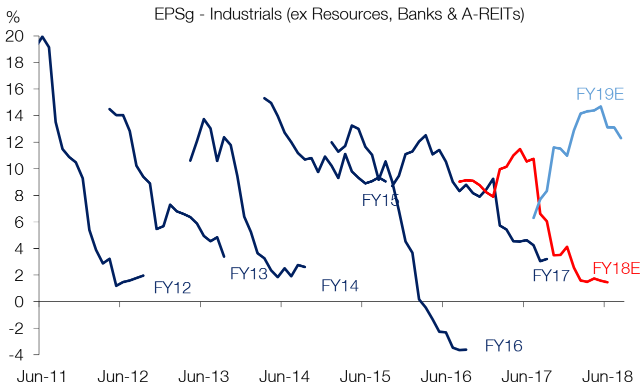
Perhaps the positive spin is fewer companies missed expectations. This was most evident for beaten up sectors such as consumer discretionary and financial services, where results were not as bad as feared and a combination of suppressed multiples and short positioning resulted in sharp rallies. Notable examples include Super Retail Group (SUL), Baby Bunting (BBN), JB Hi-Fi (JBH), AMP (AMP) and Boral (BLD).

For the most part we do not see the start of a strong earnings recovery in these sectors so view this as more of a valuation correction than a sustainable earnings trend.

Macquarie's current estimate for FY18 earnings per share growth (EPSg) for Industrials (excludes resources, banks and A-REITs) is a paltry +1.3%, repeating the well-worn path of prior years with expectations a year earlier for growth of +12%.

Company profit guidance for FY19 was also below expectations. We have been highlighting the downside risk to FY19 earnings for industrials which had been looking overly optimistic. This has begun to play out as expected with relatively soft company guidance flowing through to analyst downgrades. FY19 earnings growth has declined from 15% to 12% currently but we expect further downside as the year progresses.

Wash, rinse, repeat – FY19 earnings start to slide



Source: Macquarie Research, MWM Research, September 2018

A combination of rising costs, weather, weaker housing and intense competition were the key themes contributing to the softer outlook.

Rising costs were evident across almost every sector this reporting season. Raw material costs weighed on industrials but it was the higher quality names (Amcor, Brambles) that were able to illustrate the ability to pass costs through, while smaller companies (Asaleo, Pact Group) had less success.

The mining sector was one of the most impacted. Higher labour, transport, exploration and development costs were evident both domestically and offshore with several miners issuing soft volume guidance, resulting in analysts slashing earnings forecasts. While the sector is mostly awash with cash – balance sheets have been deleveraged and cash is being paid out – it appears margins have peaked for now which does not bode well given the lack of upwards momentum across the commodities complex.

The housing sector continues to trend lower with ramifications for many domestic sectors. We expect the trend to continue given the undesirable cocktail of looming state and federal elections, rising mortgage rates, tight credit conditions and soft auction clearances. We are cautious on sectors exposed including domestic retailers (negative wealth effect), banks (fewer listings = mortgage competition) and apartment developers.

Organic growth is likely to remain subdued given margin pressure from rising costs and competition. As such, management teams are increasingly turning to acquisitions. Animal spirits have clearly picked up within Australian boardrooms with a swathe of company-defining mergers announced in the last few months. Amcor's acquisition of Bemis and Bingo's move on Dial-a-dump are two notable examples.

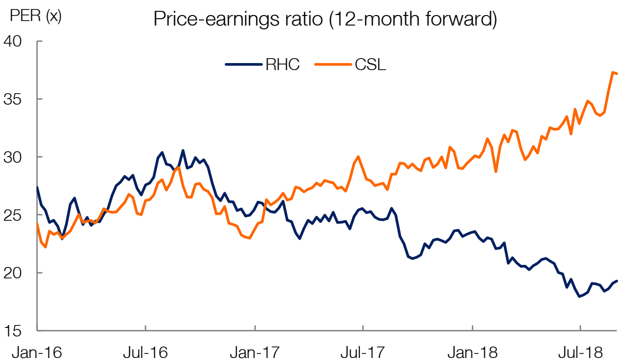
Survey data suggests a continuation or increase in deal-related activity. KPMG's Evolving Deals Landscape survey report, which collates feedback from 230 senior Australian executives on the outlook for deal activity, reports almost half of respondents expect an increase in M&A activity over the next 12 months.

Acquisitions provide the quickest means of reaching scale, albeit with significant execution risk. We expect the current backdrop of tepid organic growth, cheap finance and elevated valuations (almost everything is 'accretive') will see the recent bout of M&A continue.

Our preference remains to growth over value. The divergence in returns has reduced in recent months, in line with expectations, as a number of market darlings have inevitably failed to meet elevated expectations. But we continue to believe companies that can meet expectations can hold their valuations.

Arguably one of the best examples here is CSL and Ramsay Health Care (RHC). CSL started the year 'expensive' on a 12-month forward price-earnings multiple (PE) of 29x while RHC was 'cheap' on 23x. The two had traded in-line only a few years before. CSL delivered an in-line FY18 result during August and guided to 11-15% constant currency profit growth in FY19. RHC downgraded FY18 earnings in June and now expects only 2% EPS growth in FY19. Hence, CSL now trades on 37x while RHC has reduced to 19x.

Meeting expectations is key for valuations



Source: FactSet, MWM Research, September 2018

Amcor's (AMC) mega-acquisition of US-listed Bemis Company Inc appears an excellent strategic fit, but investors are clearly questioning whether management is lacking top of the cycle discipline. The transaction will create a clear global packaging leader, providing the combined group with the scale required by its global clients. We think recent share price retrace creates an opportunity for those prepared to take a long-term view.

The Australian dollar remains the liquid proxy for investors looking to get short risk-assets on the back of emerging market volatility. There are few direct linkages from Turkey and Argentina, but the A$ will remain the shock absorber given China exposure. Offshore earners are best placed to avoid political distractions at home while benefiting from the weaker Australian dollar. We like Amcor (AMC), Orora (ORA), Seek (SEK), Reliance (RWC) and Boral (BLD).

A$ weakness to support offshore earners

Source: IRESS, MWM Research, September 2018

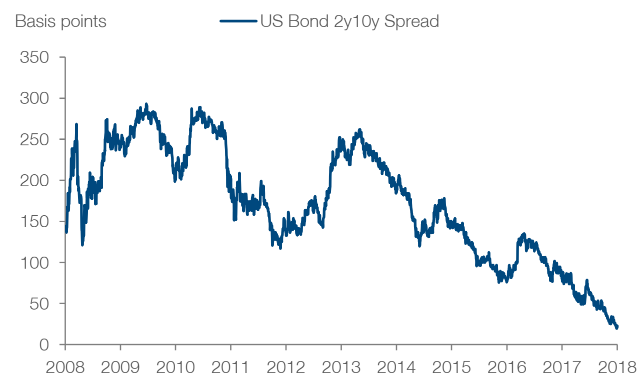
Fixed interest – Crying for Argentina while the Fed stargazes

- Developed market yields likely to remain well bid in the short term as volatility increases;
- Emerging market debt markets to remain under pressure as Argentina raises rates by 15%;
- No indication of any change in Fed policy at Jackson Hole meeting.

We remain underweight fixed income. The start of the month saw fixed income markets reeling from Turkey. The end of the month saw them reeling from Argentina. These two events bookended what was otherwise a quiet month due to the northern hemisphere summer.

In central bank land, market participants waited with much anticipation for the Jackson Hole meeting to take place. In our view, there was no change to Fed rhetoric – the tune remained the same, slowly raising rates, slowing withdrawing liquidity. However, some saw Chairman Powell's comments as dovish. There was a lot of talk around what the neutral rate may be (r star) and also some speculation around the full unemployment figure (u star). In the end, the markets agreed with us, with the long end of the curve falling and the difference in two and ten-year treasury yields reaching a new low since the Global Financial Crisis.

US curve flattens some more



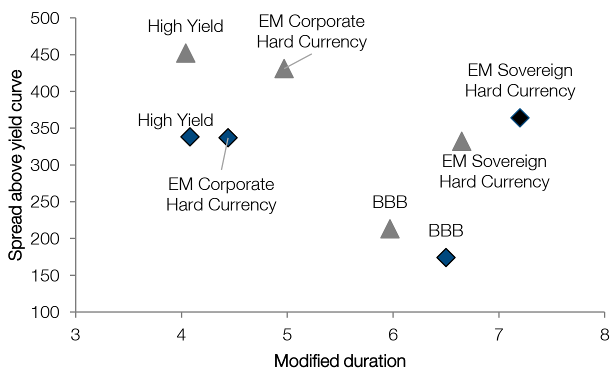
Source: FactSet, MWM Research, September 2018

Inflation is starting to appear but what matters in bond markets is unexpected inflation – and there is no sign yet that the Fed has let inflation run away from it.

Argentina and Turkey the focus

The month began with problems in Turkey and finished with Argentina. Both countries were battered by the debt markets as well as the currency markets. There was much digital newsprint on the risks to Eurozone banks from exposure to Turkish lenders, specifically, property lenders, however much of this was overblown. The reality of it is neither Turkey nor Argentina are big enough in global debt markets to cause more than a blip. They do remind us however, that risks are rising and now is not the time to chase yield.

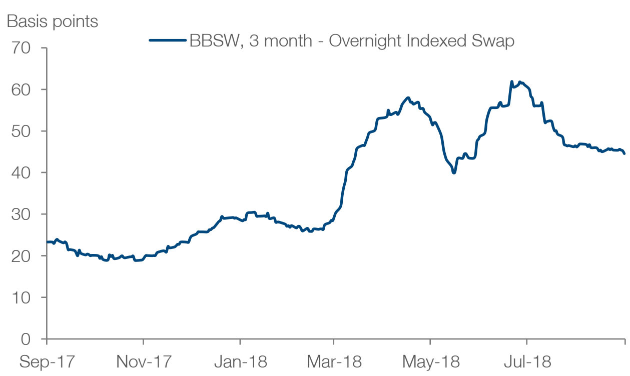
Value is hard to fund in fixed interest markets



Source: Bloomberg, MWM Research, September 2018

Credit markets were largely benign which is typical in August. The market remains largely supported and we expect this to continue while growth in the US remains strong. Typical late credit cycle behaviour abounds however, with covenants continuing to be weakened and credit spreads remaining largely contained.

Bank funding costs increasing



Source: FactSet, MWM Research, September 2018

Signs that liquidity conditions are tight are showing up in bank funding costs. Aussie banks commonly tap the offshore funding markets. Costs are increasing, and Westpac was the first of the Aussie banks to pass this onto consumers. However, more broadly, this is evidence of why inflation still remains well contained in global developed markets, the cost of money has increased.

Looking forward as the northern hemisphere returns from summer holidays, the focus will turn to Italy. The populist party is due to put forward its first budget. Markets are worried that there will be a move to end (or at least dial back) austerity which in turn will reignite pressure on the single currency. As a result, we expect this month to be another that is characterised by sharp reversals in the level of sovereign yields, as investors move to the typical safe havens of US and German sovereign bond markets. In the fixed interest space, our preference remains short-dated credit securities.

Alternatives – The time is now

- We maintain our maximum overweight to alternatives amid rising volatility;
- Dispersion across markets and within sectors to continue to drive opportunities for alternative strategies;
- We continue to favour fundamental equity long/short managers, merger arbitrage funds, trend following and discretionary macro in this environment.

We maintain our maximum overweight to alternative assets.

Market neutral and equity hedge funds are returning to favour

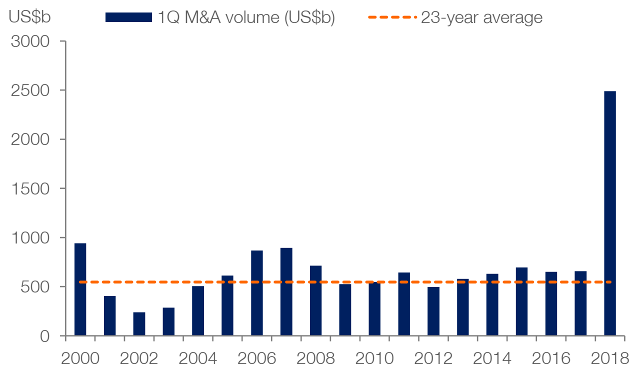
Equity hedge funds continue to attract flows after a difficult first half in 2018. Market neutral and long/short equity funds struggled to deliver performance earlier in the year. Analysis released by Morningstar showed that this was partly due to the significant underperformance of the value factor in equity markets that saw market neutral strategies and some long/short equity funds struggle.

Overall equity hedge funds, both quant and fundamental, had a negative month as the bulk of returns driven largely by quantitative strategies. We continue to prefer fundamental based equity hedge fund strategies.

Relative value and event driven strategies

August saw positive returns as many of the event driven strategies recovered from the blow-out in July from the NXP/Semiconductor deal. Relative value and event driven strategies in general remain attractive. These strategies seek to exploit market mispricings between different securities of the same company (coco's versus the option on the stock, stocks versus bonds for example). These types of strategies are dependent on bottom-up portfolio construction rather than broad market themes. And large deals keep coming. Coca Cola just announced a GBP3.9 billion bid for Costa while a few weeks ago PepsiCo announced its plan to acquire SodaStream. The regulatory risk is increasing.

M&A activity shows no signs of slowing

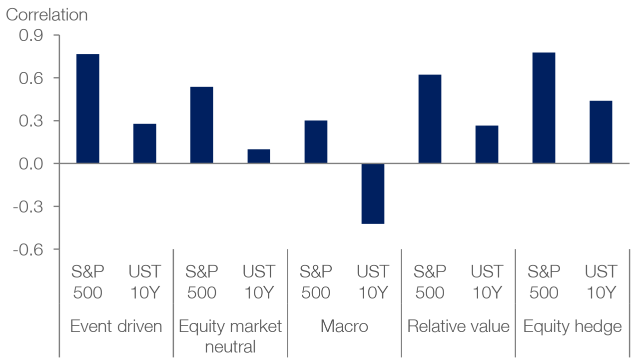


Source: Dealogic, MWM Research, September 2018

Macro strategies well placed to deliver uncorrelated returns

Macro strategies are well worth considering in a rising rate environment. Looking at the average correlation, Macro strategies tend to display negative correlation with movements in the US 10 year treasury as well as relatively low (less than 0.5) correlation with movements in equity markets.

Macro strategies provide the greatest diversification benefits



Source: FactSet, MWM Research, September 2018

Additionally, Macro strategies are well suited to market environments exhibiting dispersion across asset classes and sectors. As central bank policies and economic growth rates continue to diverge, we expect Macro strategies to deliver diversification benefits to multi-asset portfolios.

Real assets – REITs reporting season – no surprise there

- We remain overweight property. The sector offers both growth and yield. Our preference is for growth REITs which are more insulated against the risk of higher bond yields;

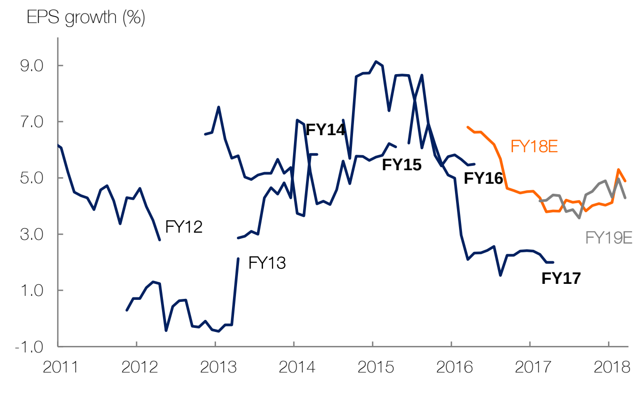
- Sydney and Melbourne office markets remain strong, with forecast rental growth of 8-10% in both cities;

- Remain cautious and selective on residential and retail REITs as house prices continue to fall and consumer spending remains weak.

Our overweight call on A-REITs is underpinned by the following factors: (i) strong transactional activity for quality assets (in particular in office REITs) which is expected to drive net tangible asset (NTA) growth; (ii) solid M&A activity which is putting a floor on valuations in some areas; (iii) abating concerns of rising interest rates with expectations of a rate rise delayed to 2020; and (iv) a strong and stable yield compared to traditional bond proxies.

After underperforming earlier in the year, A-REITs have risen 13.9% over the last 6 months outperforming the broader market (+7.2%). The past month has been dominated by FY18 reporting season which was largely in line with expectations. On a relative basis, property outperformed the broader market in terms of beats versus misses although earnings were revised down marginally with 2019 growth to only 4.3%.

REITs provided relatively consistent EPS growth forecast



Source: Macquarie Research, MWM Research, September 2018

Some of the **key themes** from the recent reporting season:

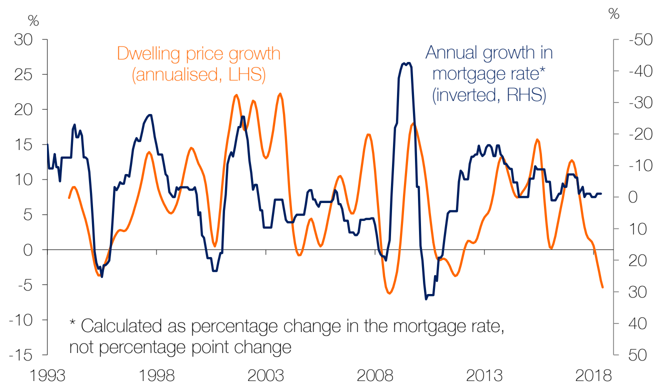
Cost pressures impacting earnings: Rising costs are becoming a more widespread headwind for the sector as has been evidenced by higher electricity costs for SCA Property (SCP), GPT and Charter Hall Retail. GPT has also indicated higher borrowing cost across its unhedged debt will have a negative 0.5% impact on FY18 earnings (ending 31 December). SCA Property also expects cost of debt to start to increase, which is estimated to have a 2.3% headwind to earnings in FY2019.

Residential market continues to soften: National dwelling prices have fallen by 3.0% since the peak in 2017 according to CoreLogic. In Sydney, house prices have fallen 0.9% month-on-month (seasonally adjusted prices), the largest fall in 10 years! This translates to a fall of 6.2% from the 2017 peak and by an annualised 7.9% in the past 3 months. The weakness is widespread across Australia, with house prices falling in six of the eight capital cities, which will remain a significant headwind for residential REITs. Transaction volumes are also down 9.8% over the year.

Mirvac (MGR) forecasts a lower volume outlook in FY2019, with the expectation of a 26% decline in settlements and a tail of unsold units upon practical completion. However, defaults have remained low, below 2%. Similarly, Stockland (SGP) is forecasting a 6% decline in volumes in FY2019, which is expected to be offset by strong margins (18.5%) in the near term due to embedded profits.

Property indicators including auction clearance rates, building approvals and ratio of sales to new listings suggest further fall in house prices. Residential building approvals are down 16% from the 2016 peak, and we expect to see further declines in the next 12-18 months from weaker pre-sales, lower house pricing and tighter developer finance.

Rising mortgage rate will impact housing prices



Source: CoreLogic, Macquarie Macro Strategy, September 2018

Retail remains 'dark and gloomy': Retail net operating income (NOI) growth was softer due to negative leasing spreads (total spreads for SCG -4.5%, VCX -4.1%), in particular for new leases and shorter-term deals (VCX: -11.5%). The outlook of retail REITs remains challenging over the next few years. In response, Vicinity (VCX) and Scentre Group (SCG) are looking at increasing the mixed-use component of their businesses (residential, office and hotel opportunities) to drive income and elevate customer experience. However, these developments are multi-year projects.

Sydney and Melbourne office markets remain under the spotlight: Dexus (DXS) expects strong gross rental growth of 8-10% in Sydney and Melbourne, with effective leasing spreads of more than 15% across the CBD portfolio. GPT indicated supply to remain low in Sydney as the larger projects could be delayed until 2022 at the earliest which will keep vacancy rates low. There is new supply coming in Melbourne over the next few years, but the strong demand from industry super funds, healthcare and the education sectors could partially absorb some of the supply. The solid market conditions in both cities will continue to support higher rental growth and valuations.

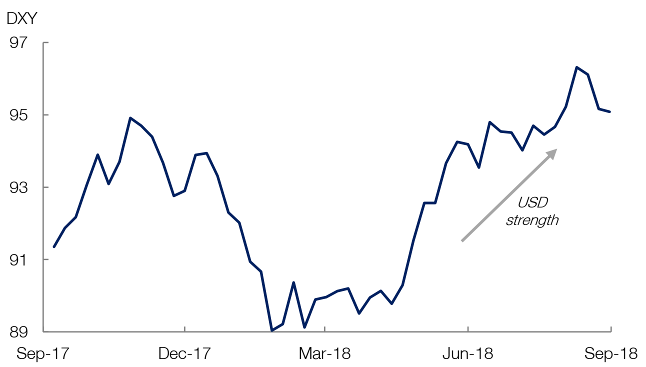
Against this backdrop, we continue to prefer REITs with solid earnings growth prospects including Lend Lease (LLC), Goodman Group (GMG) and Charter Hall Group (CHC). Unibail-Rodamco-Westfield (URW) offers the best value.

Commodities – outlook mixed but China backdrop improving

- A stronger US dollar, escalating trade tensions and slowing global growth remain headwinds for the commodities complex. We maintain a neutral stance;
- China policy is turning more positive for infrastructure spending, but we do not expect large-scale stimulus;
- China's iron ore import demand has likely peaked.

US dollar strength remains a significant headwind to commodity outperformance. Ongoing trade tensions and the upward trajectory of US rates lend support to the dollar while emerging market currencies are far more vulnerable. The weakness seen in emerging economies (China, Turkey and Argentina) is forcing governments to provide domestic support.

US dollar strength remains a drag on commodities



Source: Iress, MWM Research, September 2018

China announced in late July the possibility of an economic stimulus to offset the external shock of a trade war. We are yet to see a large-scale stimulus, and this is not our expectation, but survey data through August did show some improvement.

The official manufacturing purchasing manager's index, which tracks larger companies and state-owned entities, had been forecast to drop to 51.0 but rose to 51.3. The Caixin Manufacturing PMI, which tracks smaller firms, recorded improving operating conditions. Macquarie's monthly proprietary surveys of China's steel and copper sectors also pointed to stabilising demand and improving sentiment on the ground.

The Chinese Finance Ministry instructed local governments mid-month to ramp up issuance of 'local special bonds'. These are bonds issued by local governments to support infrastructure projects such as highway developments. As such, it appears likely credit growth and fixed asset investment (FAI) growth will bottom out this month.

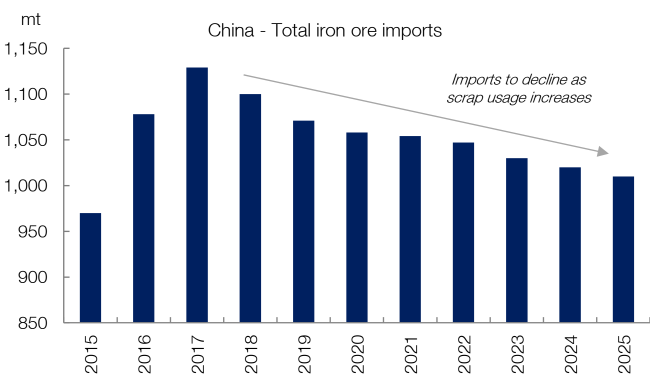
China appears to be stabilising in the short-term, but long-term uncertainties remain. Our economist believes credit and FAI growth are bottoming out, but property and export growth are close to their peak. There will likely some front-end loading before $200 billion of US tariffs are introduced. If a large-scale stimulus is announced our commodities team believe base metals, iron ore and steel would be the largest beneficiaries.

Thinking longer-term, Macquarie's commodities team believe China's import demand for iron ore has peaked and is set to decline in the coming years. The seaborne iron ore market was initially supported by strong steel production growth (2003-2014) then mass domestic iron ore mine closures (2015-2018). China's demand appears to have reached a peak at 1.1 billion tonnes, or 70% of seaborne trade.

China imports of iron ore have been flat year to date despite steel production rising 6.5%. Domestic iron ore production and iron ore inventories at ports and mills have also been relatively flat year to date. This suggests most of the growth in steel production year to date has been fuelled by China's emerging scrap market. Macquarie's commodity team expect this scrap market to grow significantly in the next decade, contributing to a trend decline in China's iron ore imports.

There is no other country of sufficient scale to offset China's gradual retreat. India is a rising regional force but has ample domestic ore supplies. As such, the seaborne market will likely report a small surplus from 2019 which will require the removal of high cost supply. The seaborne market is expected to remain in surplus through to 2021 with 62% fines pricing expected to bottom out at US$63/tonne in 2020.

China's iron ore imports have peaked



Source: Macquarie Research, MWM Research, September 2018

Currencies – Emerging selloff accelerates

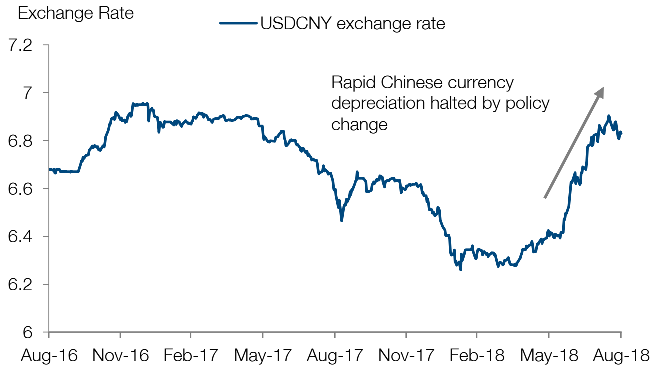
USD: Defiant rate rises

August has seen a rise and fall in the US$ index after the US Fed again came under attack by President Trump. In July Trump said that he was "not thrilled" with the Federal Reserve under his appointee Jerome Powell, for raising interest rates and that they should do more to help him boost the economy. The president nominates the Fed's chairman but the agency is independent and these comments are a departure from the norm as the Fed's independence has always been seen as important for economic stability. More recently Trump has said he expected Powell to be a "cheap-money" chairman in his most personal criticism so far. While the US$ did sell off aggressively following these unexpected comments it only gave back the rally that occurred in the first half of the month.

RMB: Policy support

The rapid depreciation in the RMB vs the US$ since mid-June has unnerved financial markets following an appreciation of a similar amount over the previous 12 months. These moves have been more substantial because of a change by China's policymakers to let market forces have more say over the direction of the exchange rate. The key rate is viewed as a proxy for the Chinese economy and the change in momentum is being linked to a slowdown in Chinese growth.

Policy intervention halts rapid depreciation in RMB



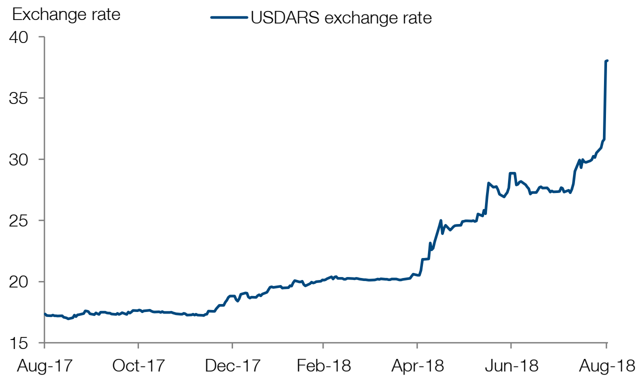
Source: FactSet, MWM Research, September 2018

There is speculation that the recent RMB depreciation is being deliberately engineered to offset the impact of the trade conflict with the US. While China would consider some easing beneficial, a rapid depreciation could encourage capital outflow and financial instability. In response, authorities have taken steps to dampen the depreciation and the policy to support the RMB has now been made explicit by reintroducing the "counter-cyclical factor" as they set the fixing rate. Markets took this as a positive sign of support, reflected by a bounce in the rate from mid-August.

Emerging Markets: Slip sliding

The decline in the Turkish lira against the US$ accelerated during August, moving from 4.88 at the start of the month to finish at 6.55. The lira dominated the currency news initially but the Argentine peso managed some headlines of its own before the month end. Drastic action by Argentina's central bank failed to stop a plunge of 12 per cent on the second last day of the month. Interest rates were pushed to 60 per cent, an increase of 15 percentage points in an attempt to stop the crash. The two day sell-off was triggered by President Macri requesting that the International Monetary Fund speed up the release of its $50 billion bailout package to shore up next year's budget. The final day of the month saw some relief across the emerging market currency spectrum with the peso strongest, bouncing 4.5%.

Investors exit the Argentine peso



Source: FactSet, MWM Research, September 2018

Europe: Summer holidays

With Europe on summer holidays the euro finished the month flat against the US$. The pound regained some ground against the US$ late in the month as the EU's chief Brexit negotiator signalled a potential breakthrough in the talks. The uncertainty surrounding the negotiations has impacted sports as well as the financial markets as currency hedging businesses in the UK have reported strong demand from football players to hedge their earnings.

AUD: Political turmoil

The Australian dollar was jittery in August, suffering from uncertainty around the leadership turmoil. It bounced on the news that Scott Morrison would be the new Australian Prime Minister before again falling sharply late in the month as Westpac raised rates to compensate for higher funding costs and capital expenditure and building approvals both missed expectations. We continue to expect that interest rate spreads will cap the A$ with risks on the downside tied to slowing global growth.

Monthly performance - August 2018

Australian equities

The benign reporting season helped the Australian market to refresh 10-year record highs, despite the shock of the Australian Prime Minister being replaced. The S&P/ASX 200 Accumulation Index closed August trading 1.4% higher, a fifth straight month with positive returns. The outperforming sector, Telecoms (+13.1%) continued to lead the increase, driven higher by the merger talk between Vodafone Hutchison Australia and TPG Telecom. Materials (-4.8%) and Energy (-1.2%) were the worst performers due to the recent weakness in commodities.

Amongst larger companies the best returns were from CSL Limited (CSL, +15.6%) and Telstra Corporation (TLS, +11.8%), while the underperformers were Origin Energy (ORG, -18.6%) and Rio Tinto Limited (RIO, -8.3%).

The S&P/ASX Small Ordinaries Accumulation Index (+2.5%) outperformed S&P/ASX 200 Accumulation Index, driven higher by two information technology companies Appen Limited (APX, +41.1%) and Wisetech Global Company (WTC, +40.1%). The worst performer was the Isentia Group (ISD, -54.4%) and RCR Tomlinson (RCR, -47.2%).

International equities

US stock markets were a clear standout among the losses seen in other international markets. Thanks to the technology companies' strong bounce, the Nasdaq closed higher by +5.7%, followed by S&P 500 (+3.0%) and Dow Jones (+2.2%).

Uncertainties associated with the Brexit negotiation outcome weighed on the European equity markets, which saw substantial redemption from the European equities. The worst regional performers were Italy (MIB 30,-8.8%), followed by Spain (IBEX 35, -4.8%), UK (FTSE, -4.1%), Germany (DAX, -3.4%), and France (CAC 40, -1.9%).

Pessimistic sentiment continued to dominate the Hang Seng and Shanghai Composite performance, the former witnessing a fourth decline in a row. Japan was a standout in the regional Asian market, closing the monthly trade with a 1.4% rise.

Property

Australian REITs (+2.7%) reinforced the prior five months' increase, reporting the sixth consecutive positive return in August. Goodman Group (GMG, +11.1%) and Mirvac Group (MGR, +6.6%) led the strong rally, while Abacus Property Group (ABP, -7.0%) and BWP Trust (BWP, -2.4%) lagged behind.

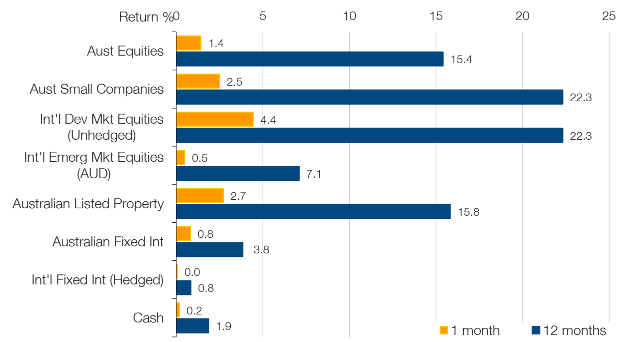
Fixed interest and cash

The US 10-year bond yield lingered below the physiological benchmark 3.0%, finishing the month at 2.9%. The 10-year Australian government bond regained its popularity among the investors, with the yield drifting lower to 2.5%. The Bloomberg AusBond Composite 0+Yr Index climbed higher by 0.8%, with Government bonds (+0.9%) outperforming. The short-term (0-3-year, +0.3%) bonds index increased marginally, contrasted by the long-term (+10-year) bonds index which surged by 1.5%.

Currency

The Australian leadership replacement caused rising concerns on the Australian dollar exchange rate, with the rate against all major currencies in the red. The $A/$US plunged by 3.2% to close lower at 0.7192. The $A also deprecated against other major currencies, being weaker against Japanese Yen (-3.8%, 79.92), Euro (-2.4%, 0.6198), the UK Pound (-1.9%, 0.5551), and New Zealand Dollar (-0.3%, 1.0863).

Market Performance – August 2018



Source: IRESS, Bloomberg, MWM Research, September 2018

Market performance – August 2018

Market Indices	1 month %	3 month %	YTD %	1 year %	3 year %pa	5 year %pa
31-August-18						
Australian Shares						
S&P/ASX 200 Accumulation	1.42	6.19	7.71	15.40	11.46	8.94
S&P/ASX 200	0.63	5.12	4.67	10.59	6.67	4.24
All Industrials Accumulation	2.89	8.06	8.22	14.14	10.37	9.98
All Resources Accumulation	-4.43	-1.15	5.77	21.50	16.88	4.40
All Industrials	2.07	6.90	5.04	9.20	5.40	5.03
All Resources	-5.11	-1.85	3.15	17.10	13.08	0.83
S&P/ASX 100 Accumulation	1.27	6.44	7.63	14.69	11.01	8.84
S&P/ASX Small Ordinaries All Accumulation	2.49	2.53	6.79	22.32	16.90	9.19
International Shares						
MSCI World Index Hedged in A$	1.24	4.66	4.65	12.60	10.84	10.94
MSCI World Index (A$ Unhedged)	4.44	9.31	12.29	22.32	9.37	12.82
MSCI Emerging Markets (A$ Unhedged)	0.48	-0.81	-0.92	7.09	8.51	7.07
Regional Markets (local currency returns)						
Dow Jones	2.16	6.34	-0.71	18.30	16.25	11.88
S&P 500	3.03	7.25	2.75	17.39	13.73	12.18
Toronto Comp	-1.04	1.25	1.95	6.91	5.48	5.15
Nikkei	1.38	2.99	-1.01	16.38	6.57	11.30
STOXX® Europe 600 Net Return	-2.14	0.30	0.58	5.10	4.63	8.07
German Dax	-3.45	-1.91	-6.26	2.56	6.42	8.82
FTSE 100	-4.08	-3.20	-1.34	0.02	5.96	2.99
Hang Seng	-2.43	-8.47	-15.20	-0.29	8.77	5.12
NZSE 50	4.14	6.93	8.20	14.86	13.43	10.69
Property						
S&P/ASX 200 Property Trust Accumulation	2.71	5.97	10.43	15.82	10.52	13.04
Cash and Bonds						
Bloomberg Composite Bond All Maturities	0.81	1.45	2.95	3.84	3.08	4.48
Bloomberg Bank Bill Index	0.17	0.51	1.12	1.85	1.95	2.20
Citigroup World Government Bond Index Hedged	0.05	0.18	0.61	0.84	3.32	4.90
Citigroup World Government Bond Index Unhedged	1.81	2.90	5.67	6.97	1.35	4.93

Source: IRESS, Bloomberg, MWM Research, September 2018

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