MACQUARIE

Investment Matters

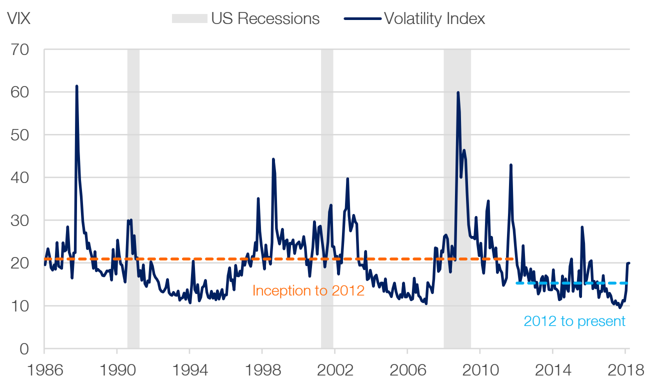
Fundamentals trump fear

APRIL 2018

Markets have had a shaky start to 2018. This has been driven by a combination of factors - rising US inflation expectations, fear of a Trump induced global trade war, a sell-off in US tech sector market darlings and most recently an unexpected spike in bank borrowing cost.

Market concerns to linger: These concerns are likely to linger with markets susceptible to the ebb and flow of political and economic developments in coming months. However, fundamentals remain solid and despite the sharper than expected rise in market volatility (chart below), we do not see signs that global growth has been meaningfully disrupted.

Equity Market Volatility: Resetting to a higher level

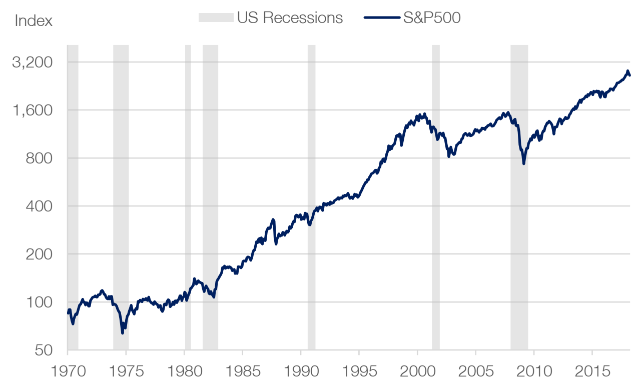


Source: FactSet, MWM Research, April 2018

Equity markets reverting back to normal: Equity markets do not usually go up in a straight line. The high annualised return and the accompanying low level of volatility experienced in recent years have not been normal. While it is a painful pill to swallow, markets are in the process of reverting back to a more normalised trading pattern where daily returns go down as well as up.

A return to normal should not be feared by investors. However, it is a backdrop where they must recalibrate their return expectations to a lower level and become reaccustomed to portfolio capital values that may have greater short term fluctuations.

Sustained corrections rare outside recessions



Source: FactSet, MWM Research, April 2018

Global growth has not been de-railed: Global economic growth momentum likely peaked in January/February and risks to growth assets have risen. However, this does not mean that global growth is at risk of collapsing and domestically we are confident that the economy continues to get better with monetary policy support likely to remain easy. Investors should take comfort from the fact that equity markets very rarely go through sustained corrections outside of recession periods and there are few signs pointing towards this happening in the coming 12-18 months (chart above).

We think this supports continued global equity market outperformance versus bonds with the Australian equity market also likely to perform solidly given strong dividend yield support, reasonable valuations and a slight improvement in corporate earnings growth.

Keeping powder dry (for now): The mini correction in global equity markets has raised the attractiveness for longer term investors (prices have fallen while earnings have continued to rise), but we are not putting additional capital to work at this stage. We believe markets need to digest the current swag of negative news and the slowdown in growth momentum. This will take some time and we would like to see signs that sustainable upside catalysts are emerging to take equities higher and not just that the negative news flow is dissipating (the first drives the extent of upside while the second limits the downside).

We think upside catalysts will need to come from either slower than expected increases in interest rates, a positive growth surprise (potentially led by the US) or stronger than expected earnings growth that gives global markets a leg up and drags the domestic equity market along with it.

Domestic equities remain attached to global markets: Unfortunately, we don't see much capacity for the local bourse to decouple from the direction of global markets without the potential for a much stronger than expected rebound in growth out of China or evidence that, domestically, consumer spending pressures are abating. These are not strong possibilities. Ultimately, investors must be cognisant of rising risks, but we do not think it is time to abandon our positive view on equities vis-à-vis bonds. We list 10 reasons why we stick with this call:

1. Bull markets nearly always end with recession. There is little evidence that a recession is imminent even if equity markets move with a 6-9 months lead;
2. Global growth momentum has peaked but is not collapsing. Global industrial production growth continues to grow at an above-average pace and fears of a significant Chinese growth slowdown are not evident in data yet;
3. Rising equity and bond market volatility is a symptom of being late cycle. Interest rates are rising and central banks are in various stages of policy unwind but this is normal as the cycle matures;
4. De-globalisation / Trade ructions are structural. President Trump did not start the decline in trade and he will not end it. A trade war is one requirement to become negative on growth;
5. Borrowing costs are being squeezed higher but there are few signs of contagion. High yield, investment grade and emerging market (EM) debt spreads are not blowing out;
6. Earnings growth is strong led by Europe and the US but including Australia. Earnings growth is cyclical and revisions are tied into confidence. The Australian outlook is solid at 6% for FY19;
7. Global valuations have corrected (15.2x). Australia is attractive on earnings based valuation metrics at 14.8x versus the long term average of 15.4x;
8. Markets were significantly overbought into 4Q17, especially technology. Part of the correction is technical in nature and this takes time to work through;
9. The Reserve Bank of Australia (RBA) remains firmly on hold. There is limited inflation pressures and improving growth is absorbing excess supply rather than driving near term inflation pressures;
10. Australia is not exposed to the *"problem child"* … technology. It is overweight banks and resources and underweight growth stocks. Resources are cashed up and banks have pricing power and are inexpensive.

We remain overweight equities with a preference for Europe over US, followed by Australia. We recently went maximum overweight Alternative Assets and also recommend gold as a hedge for increased volatility. We maintain our underweight stance on Fixed Income, Property and Cash.

Jason and the Investment Team

Asset class preferences

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight	Reason
Allocation						
Australian Equities						Total return expectation of 15% on valuation pullback
International Equities						Economic improvement continues to support growth assets (equities)
US						High quality growth supported by strong earnings momentum. Valuations have corrected
Europe						Value proposition with strong cyclical momentum
Japan						Solid run of fundamental data supported by monetary policy but market has run ahead
EM						Supported by rising growth but vulnerable to liquidity shifts and higher yields
Property						Passive REITs are cheaper but we prefer growth REITs
Fixed Interest						Underweight duration, continue to expect rising global rates
Alternatives						Hedged against equities and high volatility
Cash						Reflects a balance between stronger equity and weaker bond returns

Source: MWM Research, April 2018

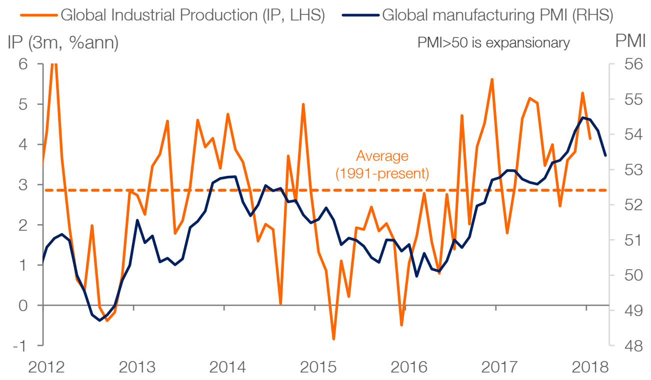
Global economics – Trade wars raise growth uncertainty

- Global growth momentum has peaked but growth to remain above trend through 2018;
- Risks to growth are rising – trade wars in particular. At this stage growth has not been de-railed;
- US continues to lead the economic recovery. China is slowing but not collapsing.

Macquarie believe the synchronised global economic expansion remains intact despite growth momentum appearing to have peaked earlier in the year. This slowdown has been notable in Europe where business survey data has weakened from multi-decade highs.

Recent concerns have centred on the uncertainty created by the Trump administration's moves to implement trade barriers and the potential for retaliation. In addition, there is some risk that further interest rate hikes might have the potential to undermine the economic recovery before it reaches a self-sustaining level.

Global growth momentum peaked in January



Source: Factset, MWM Research, April 2018

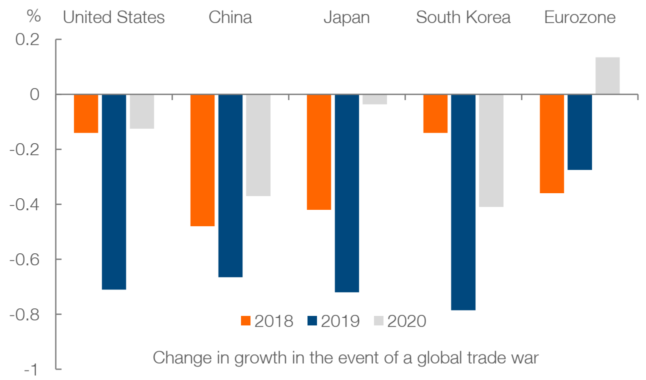
We acknowledge the unpredictability of recent trade ructions and that growth momentum has almost certainly peaked for the near term. However, absent a major trade war that brings markets and confidence down or a near term spike in borrowing rates, Macquarie continue to hold the view that global growth should remain above average through 2018 and at least into the beginning of 2019. In addition, we believe monetary policy settings will remain easy as stronger growth primarily eats into spare capacity.

How much bite to Trump's bark?

Following the recently announced tariffs on steel and aluminium imports into the US, President Trump has upped the ante, taking aim at China by proposing 25% tariffs on Chinese imports totalling US$50 – US$60 billion per year. The response from China has been in kind with proposals to levy 25% tariffs on imports of 106 US products ranging from soybeans to automobiles to chemicals and aircraft.

A trade war remains a key risk for the global economy following China's response to US tariffs. However, Macquarie believe that the economic impacts are likely to be less significant than the uncertainty that it is now adding to financial markets. The US has limited exposure to global trade at less than 10% of gross domestic production (GDP). This compares with Europe which sits close to 19% and Asia at around 17%. In fact, it is the US which emerges relatively well in a skirmish that gains traction with Europe and Asia being the most at risk should Sino-American relations deteriorate further.

Worst case scenario: a costly global trade war



Source: Oxford Economics, MWM Research, April 2018

At this stage it is hard to predict the unpredictable, but a worst case scenario could involve escalation into consumer electronics and telecoms equipment manufacture which would then have more far reaching consequences for other key Asian nations.

Oxford Economics believe the next threat would be an extension of restrictions into NAFTA (North American Free Trade Agreement) reducing its openness as well as potential tensions relating to US-European auto trade. There worst case scenarios for major export regions/countries are shown in the chart above and range from 60-80 basis points for 2019.

There is added uncertainty to how central banks might respond to a brewing trade war that impacts confidence and financial markets. Comments from the US Federal Reserve (Fed) in relation to the threat of trade tariffs have been cautious, with Powell stating that the risk of a more protectionist stance had increased but that so far it did not change the board's view of the economy. There is every reason to believe that a less hawkish tone could quickly be adopted by central banks if needed to offset or short circuit a deterioration in the outlook posed by trade concerns.

We remain positive on the European economy despite a recent pullback in business survey data. Indicators suggest that the rapid expansion in regional activity will slow towards a more sustainable pace, albeit still above trend rates. The deterioration in data surprised investors, and suggests 1Q18 economic growth will be below current consensus expectations. Euro strength is likely a major contributor to the weakness.

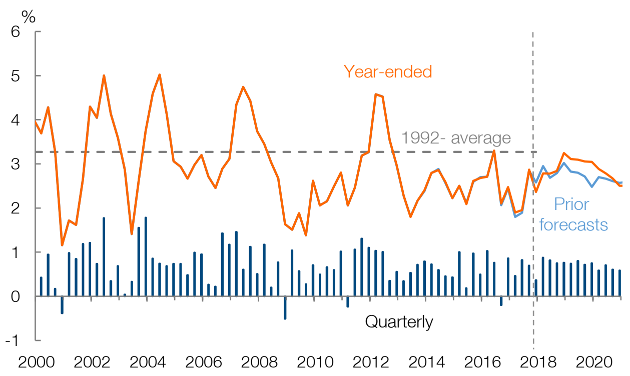
Australian economics – Starting to surf the global upswing

- The outlook for the Australian economy remains solid with GDP growth forecasted ~3% in 2018;
- Australia does remain susceptible to a number of risks both domestically and globally driven;
- The Reserve bank of Australia (RBA) is not expected raise the cash rate until early 2019.

We remain constructive on the Australian economic outlook and expect to see gradual improvement through year end.

While the economy is not firing on all cylinders, it is benefiting from stronger global growth with substantial support from elevated government (infrastructure) spending which is running at a double digit pace and as the drag from the collapse in mining investment comes to an end.

GDP growth modestly higher in 2019



Source: Macquarie Research, MWM Research, April 2018

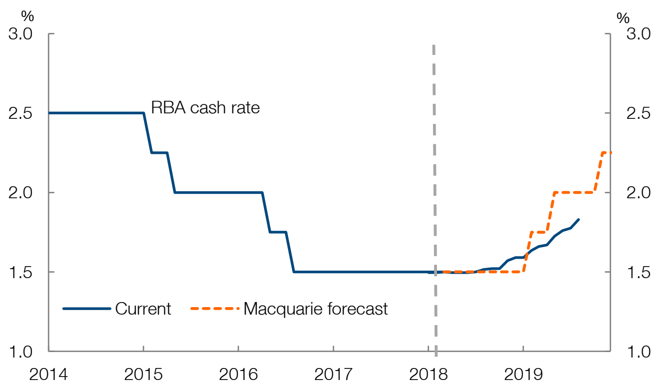
Business conditions are also sitting at more than decade long highs with a similar trend in business confidence. Employment growth has been a bright spot, continually surprised on the high side for more than a year. The increase in jobs through the 12 months to February was a little over 420k which puts growth at ~3% (well in excess of the rate of GDP growth).

However, there exists significant slack in the labour market with the unemployment rate sitting at 5.6% (recently ticking higher as the participation rate has nudged up). The key issue for the Australian economy remains the elevated levels of underutilised workers with the underemployment rate – the share of the labour force that is employed and seeking more hours of work – standing at 8.4% in February.

This is expected to come down, albeit from elevated levels, which should see wage pressures start to increase. However, this will be a modest path higher. Macquarie's expectation is that wage growth will only gradually increase in the next few years.

The subdued pace of growth in wages is expected to keep a lid on price inflation with underlying inflation expected to remain in the bottom half of the RBA 2-3% inflation target band. The substantial slack in the labour market and only modest wage inflation are the primary reasons behind Macquarie's view that there is no-near term trigger for a rise in the cash rate.

Australia: RBA Cash Rate Expectation



Source: Macquarie Research, MWM Research, April 2018

Macquarie expect the RBA will err on the side of supporting growth for longer to erode spare capacity and have confidence that inflation is firmly moving back into the 2-3% target. We are now expecting the RBA to hold off on raising interest rates until early 2019, versus a prior expectation of the first rate hike in towards the end of 2018.

Australia does remain susceptible to a number of risks both domestically and globally driven. On the local front, there are increased negative feedback loops from slowing housing price growth and rising equity market volatility. In addition, while monetary policy is expected to remain unchanged through 2018, there are increasing risks that Australian banks may react to the recent increase in offshore borrowing costs by passing this onto domestic households.

Although mortgage rates have largely been unaffected to date, higher borrowing costs would pose a substantial risk for a consumer sector that is already under duress. The RBA has already flagged this as a something they will continue to monitor over coming months.

Macquarie Research's Economics & Financial Market Forecasts

	2016	2017(f)	2018(f)	2019(f)	2020(f)
Household Consumption	2.9	2.7	2.9	2.9	3.0
Total Dwelling Investment	8.5	-2.4	0.4	-3.1	-6.2
New Residential Construction	12.1	-2.0	0.3	-4.5	-9.4
Alternations and Additions	2.2	-3.2	0.7	-0.3	-0.1
Total Business Investment^	-9.6	3.7	3.3	4.7	5.0
New Non-residential Building Construction	-7.7	6.1	9.0	5.0	4.2
New Machinery & Equipment Investment	-0.4	3.5	5.5	3.9	4.2
New Engineering Construction	-25.8	-0.5	-4.4	5.9	6.1
Government Demand^	5.2	4.5	5.1	4.7	4.3
*Government Investment^*	9.4	8.1	10.9	9.8	7.8
Government Consumption	4.2	3.6	3.6	3.2	3.2
Domestic Demand	2.0	2.8	3.2	3.2	3.1
Net exports (%pts contribution)	1.2	-0.9	-0.4	0.0	-0.3
Exports	6.8	3.8	3.4	4.9	3.2
Imports	0.2	7.6	4.8	4.2	4.0
Gross Domestic Product	**2.6**	**2.3**	**2.9**	**3.1**	**2.7**
Private Non-financial Corporation GOS	3.5	18.8	4.0	2.4	4.6
Current Account Balance (%) GDP	-3.1	-2.3	-2.5	-2.7	-2.7
Unemployment Rate (year-end)	5.7	5.5	5.2	5.0	4.8
Employment Growth	1.7	2.2	2.7	1.9	1.6
Wage Cost Index	2.0	2.0	2.2	2.6	3.0
Commonwealth Budget Balance ($Abn)*	-40	-33	-24	-20	-6
Commonwealth Budget Balance (% GDP)*	-2.4	-1.9	-1.3	-1.1	-0.3
Dwelling Completions ('000)	212	218	216	205	188
Headline Inflation	1.3	1.9	2.0	2.2	2.3
Underlying Inflation	1.5	1.8	1.8	2.0	2.2
$A/$US (year-end)	0.72	0.78	0.78	0.75	0.75
Terms of Trade	0.2	11.6	-0.4	-1.7	0.8
Target Cash Rate (year-end)	1.50	1.50	1.50	2.25	3.00
10-year bond yield (year-end)	2.77	2.63	3.10	3.60	3.90
Credit Growth	6.0	5.2	5.3	5.2	4.6

Year-average % change unless noted otherwise

^excludes asset transfers with the private sector * indicates fiscal year

Source: Macquarie Research, April 2018

At a global level, the threat of further escalation in trade tensions could quickly become a drag on confidence and export demand if the outlook for China deteriorates. While this is not our central case, the risk premium for trade uncertainty / unpredictability has risen and will likely remain elevated for some time to come.

The following updates have been made to Macquarie forecasts:

- GDP growth: has been revised up modestly for 2019 from 2.75% to a little more than 3%. Forecast growth for 2018 remains broadly unchanged at 2.9%.
- Consumer spending: has been revised higher with estimates now showing consumption grew 2.9% over 2017 and we expect it to continue at this level this year and next.
- Australian dollar: now expected to spend most of 2018 anchored around the high US$0.70s rather US$0.80.

Australian equities – When boring is better

- Australia remains a low-growth, low-beta market;
- Valuations for blue-chips have retraced with high-growth sectors remaining expensive;
- We remain overweight Australian equities with support from yield, valuations and improving earnings growth.

We retain our overweight to Australian equities. The domestic equity market has been "true to form" through recent volatility, outperforming global markets through both February and March.

We expect Australia to remain a low-beta play on global equities but the attraction is not just as a relative defensive asset class that proves to be an effective hedge in a broader risk-off environment. We think the market also provides reasonable return potential under our base case scenario of a world that continues to get better and a domestic economy that gets marginally stronger through year end.

Australian equities remain attractive within a portfolio context. The S&P/ASX 200 has retraced 6.9% since peaking in January with the forward dividend yield rising to 4.6%, implying a year-end target of ~15% based on Macquarie's 6,500 index target.

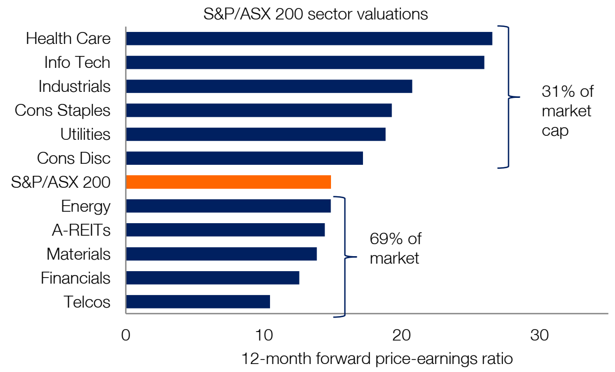
On a forward 12-month price / earnings (PE) multiple, 16.0-16.5x has been the limit for this cycle (see chart), which has been similar to prior peak periods. We don't see current conditions as supportive of higher valuations, but the recent pullback has at least created room for valuations to move back above the average level.

Multiple expansion phase is over for the cycle

Source: FactSet, MWM Research, April 2018

The market isn't necessarily cheap overall. The headline index valuation has been dragged lower by financials and materials (see chart). Higher growth sectors of health care and IT have only experienced modest corrections and remain elevated. While multiple compression would be unavoidable in a risk-off market, companies with compelling growth profiles should be well placed to ride out the volatility.

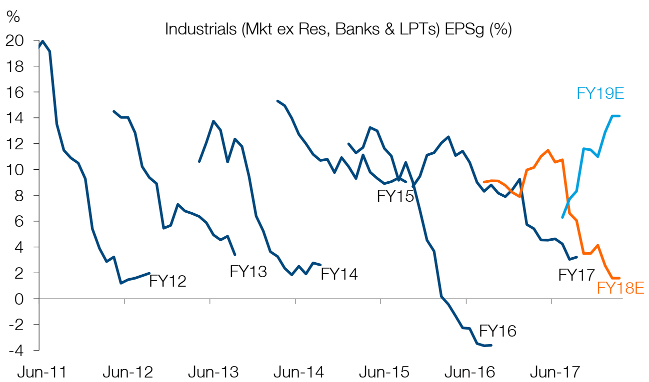
Large-caps cheap, pockets still expensive



Source: FactSet, MWM Research, April 2018

We think conditions are supportive for a *gradual* earnings improvement given the RBA is likely on hold till 2019, business conditions are near all-time highs and the Australian dollar has retraced (financial conditions have eased). However, Australia lacks the earnings growth to drive a sharp market increase with the major banks in the political / regulatory crosshairs and the consumer still fragile.

Expect gradual earnings growth, FY19 looks toppy



Source: FactSet, MWM Research, April 2018

Recent proposals surrounding dividend imputation tax credits suggest that politics and policy will require a rising risk premium as we head into year end. Next year's federal election could be a substantial headwind to outperformance with taxes (franking, negative gearing) and private healthcare caps already weighing on sentiment. Corporate tax cuts, if passed, would provide a much needed boost to the competitiveness of domestic firms, but have also become an election issue with Labor vowing to rollback tax cuts.

Overall, we think this lends further relative support for companies that have offshore generated earnings given stronger growth prospects and potentially lower stock specific policy risk.

While there are several headwinds to outperformance, we think Australian equities can still creep higher as the year progresses, driven by a slightly stronger offshore lead, valuation support from deeply discounted financials, ongoing commodity sensitivities and further support from growth stocks via earnings growth and multiple expansion.

We reiterate our key views below:

1. Remain overweight areas with strong and/or transparent earnings upside. We think this applies to commodity stocks, offshore earners, infra / capex beneficiaries, and banks. We like Alphinity Concentrated Australian Share (HOW0026AU) and Bennelong Concentrated (BFL0002AU) as high conviction managed funds.

2. Underweight bond-proxies, particularly those with structural growth issues (Telstra, retail REITs). Our preference is to income generating growth stocks (infrastructure) and the attractively priced major banks. Our preferred income fund is Niko AM Australian Share Income (TYN0038AU).

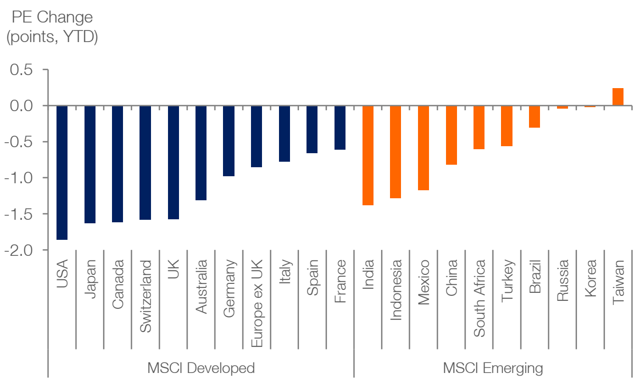
3. Overweight offshore industrial stocks leveraged into the global upswing. We like Aristocrat Leisure (ALL), Boral (BLD), James Hardie (JHX), Brambles (BXB), CSL, (CSL), Reliance Worldwide (RWC) and Treasury Wine Estates (TWE).

International equities – Sticking with a positive allocation

- Global valuations have fallen across most markets YTD;
- Solid global growth continues to support corporate earnings improvement;
- Europe remains our preferred regional exposure followed by the US. We remain underweight EM.

1Q18 has been tough for global equity markets (MSCI World, US and European market returns). Not only have returns been weak, but investors have become more circumspect, leery of unnecessary risk and sceptical of the longer-term outlook for equities given lofty valuations and geopolitical spats. For perhaps the rest of this bull market (aging but not dead), investors will lean more heavily on relative valuation (playing catch up when stocks / markets are discounted) or on earnings and dividend yield.

Valuations not compelling despite adjustment



Source: FactSet, MWM Research, April 2018

The impending conclusion to quantitative easing (read as easy/free money) continues to see global bond yields and borrowing rates lift while volatility in equities markets is also settling into a higher band.

While price performance may suggest otherwise, the backdrop of synchronised global growth and slow, steady monetary tightening is unchanged. We continue to think that the broad, positive cyclical outlook will be the major driver of markets over the medium term but this is being temporarily (and periodically) overwhelmed by short term factors.

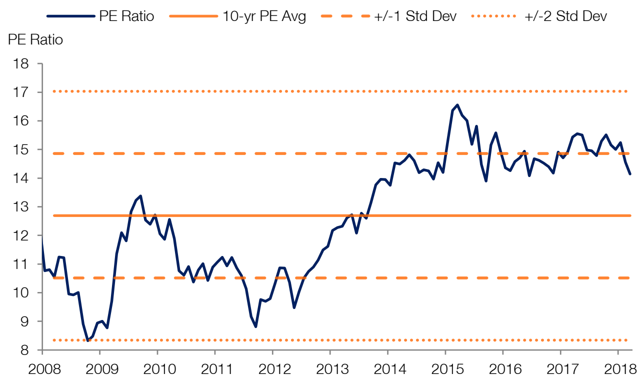
Fears around a global trade war have recently become the source of short term weakness as concerns that an escalation will have serious spill over impacts into major Asian and European exporting economies. Pricing unpredictable responses is always difficult, but we believe trade concerns reduce the upside risk for markets rather than creating a strong signal to sell equities.

However, markets might find it difficult to completely look through this uncertainty and despite increasingly attractive valuations we are not choosing to add to our risk exposure. For those who take a more negative interpretation (capital preservation), the shift would be towards cash while also reducing some of the underweight in fixed income.

Beyond tariffs, there are long term implications for China if the US succeeds in slowing the pace of technology transfer. China's ascent of the value-added chain will almost certainly slow, and local monopolies and oligopolies will be more susceptible to foreign competition as China increases access to it markets, impacting revenues and margins.

Europe remains our preferred regional exposure: We think Europe continues to offer the most attractive medium term equity market return potential but comes with commensurate risk. The region is highly leveraged into trade and hence will likely underperform if trade war concerns escalate but we like its valuation appeal (touching 4 year PE lows), its lack of technology sector weighting (where the US is currently under pressure) and its leverage into a steepening yield curve via its large banking sector. The European Central Bank (ECB) remains well behind the US on rate hikes and this should ensure monetary conditions remains accommodative.

Europe approaching four-year PE lows



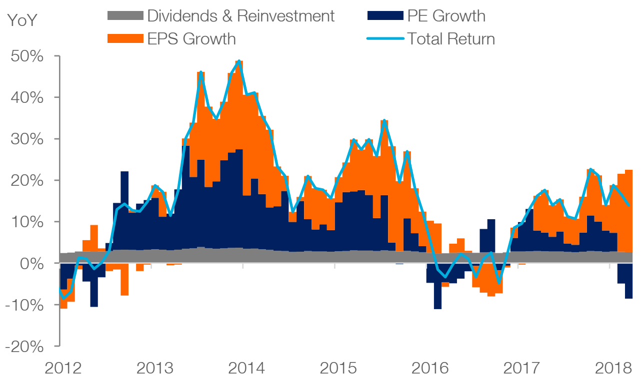
Source: FactSet, MWM Research, April 2018

US – more volatile but the quality equity play: The US might appear in the "eye of the storm" and while we do expect to see lower returns from the equity market, it remains well supported by strong earnings growth and a positive tailwind from economic growth. Valuation multiples have also corrected but this has been more concentrated within the high flying technology sector.

We like the leverage that the weaker US dollar is creating for offshore earners (>30% of the S&P500). We continue to think solid fundamentals will support the market despite rising volatility.

EMs to be pressured by stronger US dollar and slowing China: At present, the emerging markets (EM) outlook is fuelled by faster economic growth, capital inflows, ongoing positive revisions to EM earnings growth and attractive valuations relative to developed markets (DM) equities. A key risk to broader EM equities is slower economic growth as a result of restrictive trade policies aimed at China, where economic momentum slowing. Further to this, creeping uncertainty will affect market sentiment and weigh on capital inflows to developing economies, particularly those with strong economic links to China, which could have knock-on effects to equities, forex and monetary policy. We retain our underweight on EM vs. DM markets until we have more clarity on the US dollar, funding costs and the growth outlook.

Strong returns to EM threatened by trade war



Source: FactSet, MWM Research, April 2018

Equity market preferences

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

Source: MWM Research, April 2018

Real assets – Affordability to weigh on the Australian dream

- Remain underweight listed property despite de-rating
- Property valuations and earnings to be negatively impacted by rising interest rates;
- Residential housing market affordability not likely to improve materially over coming 12 months;

We maintain our underweight on listed property. We continue to think that rising bond yields will prove challenging for interest rate sensitive assets, including REITs, despite the de-rating they have already encountered.

There are many ways to cut and dice the listed REIT's space. We have a preference for A-REITs that come with growth prospects such as Goodman Group (GMG), Mirvac (MGR), Lendlease (LLC) and Charter Hall (CHC) which are expected to outperform passive REITs (rent collectors).

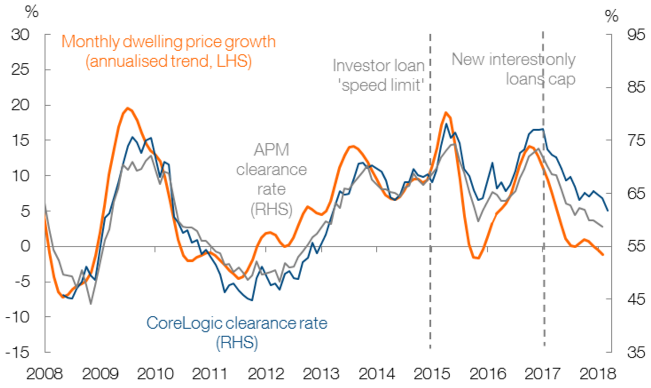
The logic behind our underweight call on the asset class is relatively simple. Rising global bond yields are expected to place upward pressure on capitalisation rates which negatively impacts property valuations (driving them lower). However, not all investments are expected to have the same increase in cap rates. Macquarie's property team is not expecting to see a significant cap rate expansion for better quality assets. High quality office cap rates are forecast to compress by a further 5 basis points (bps) while low quality retail cap rates to expand by up to 20 bps, hence driving a preference for higher quality over lower quality assets.

In addition, REITs are expected to face a rising cost of debt as short term interest rates increase. Macquarie estimates that a 25 bps increase in the cost of debt will likely impact earnings for the sector by between -1% and -4%. REITs with high gearing and a relatively low cost of debt are most susceptible to these pressures such as ALE Property, Westfield and Scentre Group.

What is the outlook for Residential?

This month, we focus on the outlook for the residential property market. A supply glut and waning demand from tighter regulations and lending conditions on investor and foreign buyers continued to be headwinds for this sector. Not surprisingly, both Australian Property Monitors (APM) and CoreLogic data suggest flattening dwelling prices and moderating auction clearance rates over the last few months. These trends do not seem likely to abate in the near term.

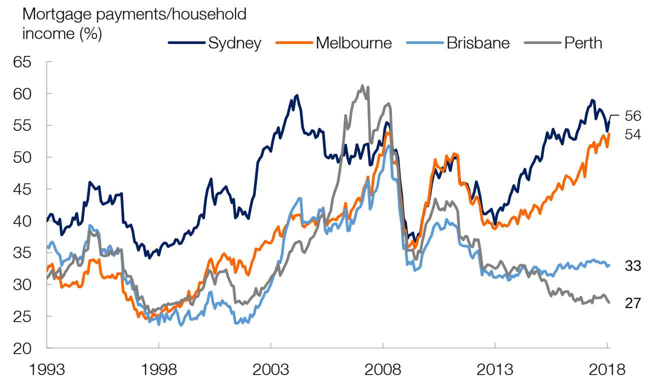
Moderating dwelling prices and clearance rate



Source: APM, CoreLogic RP Data, Macquarie Research, April 2018

Our economics team is forecasting dwelling price weakness to continue, with low single digit price growth forecast over the next few years (as compared to 6.5% p.a. over the past 5 years). Housing affordability remains the key challenge for the residential market in general but more specifically within the major East Coast cities.

Affordability remains a key issue in certain cities

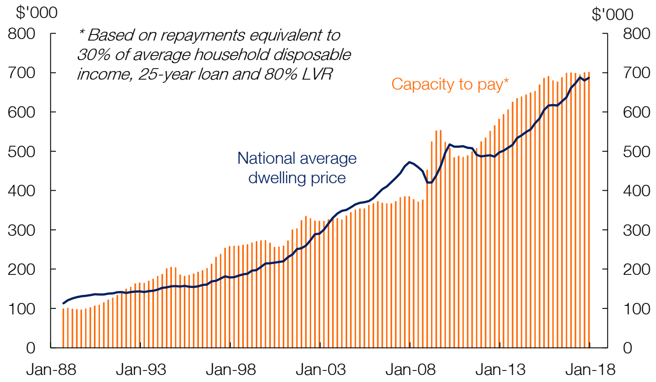


Source: APM, ABS, Macquarie Research, April 2018

Sydney and Melbourne mortgage payments (principal and interest) are at near all-time high, representing 56% and 54% of household income respectively! Any small changes to mortgage rates will place a significant strain on heavily indebted households.

Although further rate hikes are expected to be delayed to early 2019, our bank analysts expect the recent spike in short term funding to flow through to higher mortgage rates should this persist over coming months. We have already seen early signs with the recent increase in mortgage rates by Suncorp and MyState.

Capacity to pay for dwelling will cap price growth



Source: ABS, RBA, Macquarie Research, April 2018

We believe that relative house prices are now approaching levels which traditionally have driven interstate migration from NSW/VIC to QLD. Traditionally when the ratio of house prices in QLD have fallen to around 50% of that in Sydney we have seen a rise in interstate migration. Macquarie believe this trend works to de-risk the aggregate housing market but is unlikely in the near term to be strong enough, in isolation, to provide a trigger point for a turn in house prices amid continued oversupply.

- Stockland (SGP) and Lendlease (LLC) stand to gain the most from the net interstate migration from NSW/VIC to QLD.

- REITs residential margins should remain positive in the short term due to strong settlement volume and better than expected price growth compared to the feasibility period (1 to 3 years ago).

- Settlement volumes have softened in the first half of FY18 but this may continue with decelerating pre-sales. Settlement default rates remain low (below 2%) albeit a longer settlement period, due in part to increasing alternative financing options.

- Stronger migration is expected to underpin owner occupier demand going forward, partially offsetting declining investor activity.

- Corelogic reported an annual national dwelling price growth of 1.2% to March 2018 and we estimate low single digit dwelling price growth in the medium term

- Cromwell Phoenix Property is our preferred Australian property fund, which has exposure to the growth REITs (mentioned above) as well as positions in LLC and MGR which are beneficiaries of the residential market in the short term.

Alternatives – en vogue

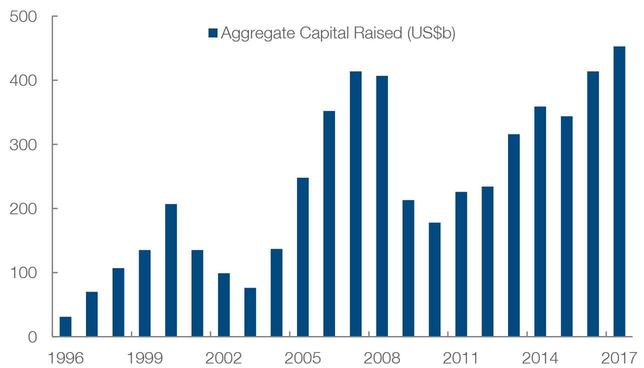
- Remain maximum overweight in alternatives amid high valuations for listed equities and rising volatility;
- We still favour private equity, but elevated purchase price multiples should drive lower returns;
- Small to mid-market buyouts with roll-up opportunities may offer some value;

We recommend a maximum overweight in alternative assets. The backdrop of high valuations for traditional equities and rising financial and economic volatility make alternative assets an attractive investment class as well as a hedge against the status quo.

Alternatives are a heterogeneous asset class. This month we focus on private equity, which involves investing in companies that are not publicly owned or listed on the stock exchange. Private equity investment has the potential to generate high returns through operational and corporate governance improvements and accretive sale price, while delivering lower volatility compared to the public market.

The strong appetite from large institutions for decent returns with less volatility have partly fuelled the influx of capital into this space and we expect this trend to continue in 2018. 2017 has proven to be the most successful year ever for global private equity fundraising well surpassing the pre financial crisis peak, with a total of US$453 billion capital raised and an unprecedented fund size (US$93 billion raised for Softbank Vision Fund) according to Preqin. Private equity dry powder (cash to be deployed) now stands at a record level of more than US$1 trillion!

Global private equity fundraising reached new peak

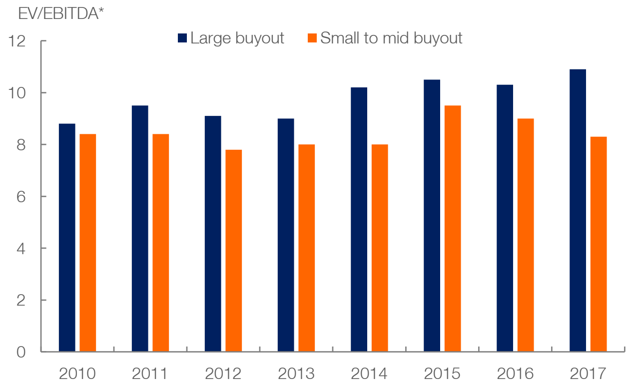


Source: Preqin Private Equity Online, WMW Research, April 2018

Not surprising, purchase price multiples are close to all-time high. The significant dry powder together with the heightened competition for deals will continue to underpin valuation multiples paid which is both a blessing and a curse, but in general investors should expect lower returns going forward. US private equity has delivered a handsome return of 16.9% over 12 months to September 2017, significantly higher than a 10 year annualised returns of 9.7% p.a. (according to Cambridge Associates).

Encouragingly, there are pockets of value in this space. According to Preqin, private equity firms are focusing on small to medium buyout segments and niche sectors due to more favourable entry pricing and continued demand for companies in fragmented industries with roll-up opportunities to scale their businesses.

Small to medium buyouts are better priced



*Enterprise value/earnings before interest taxes depreciation and amortisation
Source: M&A statistics, Torreycove Capital Partners, WMW Research, April 2018

Information technology remains hot property, the only industry which saw increased deal flow in 2017. Software has become a huge area of interest from private equity firms and there are few signs of slowing down. Capital has been deployed into maturing technology companies with recurring cash flows as well as nascent industries such as machine learning, autonomous vehicles and big data.

According to Pitchbook Data, secondary buyouts (which involve a private equity firm selling to another private equity firm) represented 50% of all private equity exits in 2017. Secondary buyout activity is expected to persist given an increase need for continuous source of deal flow as firms deploy capital and maturing funds seeking to sell their assets as they approach the end of the fund life. The resurgence of exit opportunities through the initial public offering (IPO) market is largely dependent on the IPO market condition.

Investing in private equity come with risks, which are not limited to illiquidity (long lock-up period), high leverage, high fee structures, high operational company risks and potential capital loss. Investors should be selective - focusing on diversified private equity funds which are managed by long-tenured, experienced teams with proven track records over the cycle from deal sourcing through to ownership and sale.

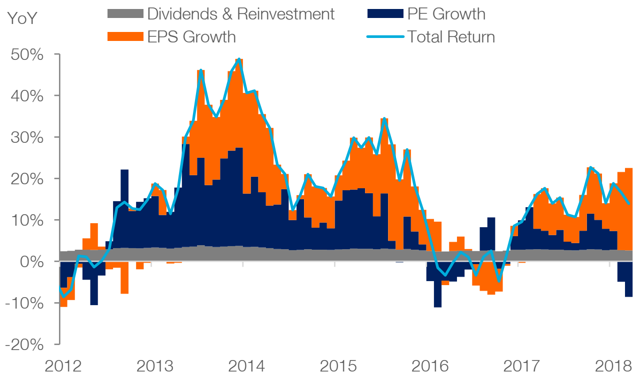
There are limited options in liquid private equity structures. Our preferred fund is Partners Group Global Value, a semi-liquid, private equity fund. The fund is diversified across geographies, vintages, financing stages (buyouts, venture capital and special situations) and transaction types (direct, primary, secondary). The fund has a robust track record, navigating throughout cycles and managing liquidity.

Fixed interest and cash – One direction

- We expect global yields to continue to move higher. We recommend underweighting duration;
- Investment grade credit is our preferred sub-sector within fixed interest;
- The US yield curve has flattened as short rates have tracked higher. High yield spreads are not sending a warning signal that higher credit costs are a threat;

Trade concerns lifted demand for safe-haven assets during April while softer US wage growth dampened inflation expectations. Long-term US bond yields are subsequently undergoing a period of consolidation with the 10-year yield unable to breach the key 3% level. We expect long-term yields to ultimately trend higher with Macquarie forecasting a US 10-year yield of 3.75% by December 2019.

Long-term yields are heading higher



Source: Macquarie Research, MWM Research, April 2018

While the Australian 10-year will trade in line with the US, the negative spread widened in the last month (Australia 2.63%, US 2.81%). A negative spread is unusual in a historical context, but is actually normal in the current market (see chart).

Fundamentally, we believe Australia should trade at a premium to the US to compensate investors for the higher risk of a smaller, resource-reliant economy. However, current conditions could well see tight (narrow) spreads continue for an extended period particularly while the RBA remains on hold.

Developments in the US fixed income market continue to provide the directional lead on rate markets globally. US bond yield expectations shifted dramatically in early February following Jerome Powell's first rate hike as Chair of the US Federal Reserve. The estimates provided by Fed Board members took a decidedly 'hawkish' turn with inflation rising and a total of five rate hikes are now estimated for the remainder of 2018-19.

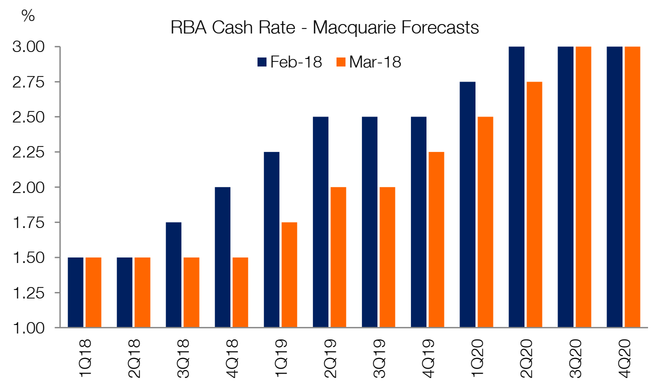
US-Australian negative spread is widening

Source: IRESS, MWM Research, April 2018

The combination of heightened rate hike expectations and a return of volatility has seen the US yield curve (US 10 year less US 2-year yield) flatten to lows last seen in early January. This is arguably one of the most important indicators to gauge where we are in the economic cycle as a flat to inverted yield curve has historically led recessions with a high degree of accuracy. As such, we believe adding duration to portfolios will become increasingly attractive as the curve flattens further.

The RBA now appears firmly on hold for 2018 with a pro-growth stance likely necessary to help lift inflation into the 2-3% target band. Wage growth is not supportive of that yet with the overseas experience suggesting a weaker linkage between jobs and wage growth this cycle. Macquarie's economics team has pushed back their rate hike expectations to 2019 with the chart below illustrating a more gradual trajectory.

RBA rate hikes expected, just deferred



Source: Macquarie Research, MWM Research, April 2018

We maintain our underweight call on fixed interest with a preference to short duration credit, our preferred funds are listed below:

Our preferred credit funds are listed below:

- Kapstream Absolute Return Income Fund (HOW0052AU)
- Macquarie Income Opportunities (MAQ0277AU)
- VanEck Australian Floating Rate ETF (FLOT)

Monthly performance - March 2018

Australian equities

The Australian equity market took its cue from international market weakness in March, extending losses since the start of the year. The S&P/ASX 200 Accumulation Index lost 3.8% for the month, a drop which has not been seen since February 2016. The S&P/ASX Small Ordinaries Accumulation Index also declined, showing a loss of 2.3% for the month.

The best performing S&P/ASX 200 sector was Real Estate (+0.1%). March was another bad month for the Telecoms sector, which fell 6.1%. The Financial sector plunged 5.8% on the back of rising concerns as the banking royal commission got underway.

Amongst larger companies, the best returns were from Brambles Limited (BXB, +5.5%) and Wesfarmers Limited (WES, +0.6%), with the latter recently having announced their intention to demerge its Coles business. The underperformers were Insurance Australia Group (IAG, -8.8%) and Rio Tinto Limited (RIO, -7.6%).

Of the small capitalisation shares, the best performer was Bravura Solutions (BVS, +25.9%), a software and services provider specialised in wealth management and fund administration. The worst performer was the food franchise owner Retail Food Group (RFG, -54.4%).

International equities

The wide spread worries regarding the possibility of a trade war between the US and China triggered a big sell-off in international equity markets. In March, the Dow Jones (-3.7%) led the sharp fall, followed by the NASDAQ (-2.9%), which was dragged down by the negative sentiment surrounding Amazon and Facebook. The S&P 500 Index (-2.7%) also closed lower for the month.

Europe's major stock indices were not immune to the volatility in the US market, but declines were less severe. The best regional performers were Italy (MIB 30, -0.9%). The UK (FTSE, -2.4%), Spain (IBEX 35, -2.4%), Germany (DAX, -2.7%), and France (CAC 40, -2.9%) also felt the pain.

Asian equities also traded lower, with Japan's Nikkei (-2.8%), China's Shanghai Composite (-2.8%), and Hong Kong's Hang Seng Index (-2.4%).

Property

Australian REITs (+0.1%) closed March little changed, despite a spike in the middle of March. Cromwell Prop (CMW, +8.6%) and Iron Mountain Incorp (INM, +8.6%) led the strong bounce, while Westfield Corp (MGR, -2.7%) and Vicinity Centres (VCX, -2.8%) were laggards.

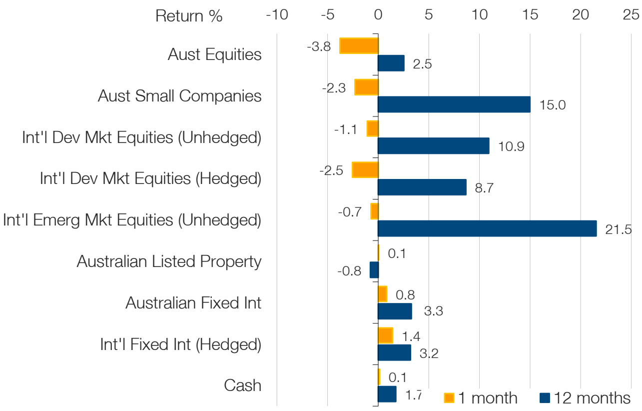
Fixed interest and cash

The US 10 year bond yield came off the peak this month, down from 2.86% to 2.75%, despite a Fed rate hike announced at the start of March. The 10-year Australian government bond yield continued to slide from the February peak, with the yield finishing at 2.60%. The Bloomberg AusBond Composite 0+Yr Index climbed higher by 0.8%, with both Government bonds (+1.2%) outperforming Corporate bonds (+0.4%). The short-duration bond (Bloomberg Composite Bond Index 0-3 Year Maturity, +0.1%) closed flat, whereas the long-term bond (+10-year) returned 2.6% through the month.

Currency

The depreciating trend of the Australian Dollar since the start of 2018 continued to play out. The $A/$US fell 1.0% to close at 0.7680. The exchange rate against the other major currencies also slipped, including Japanese Yen (-1.4%, 81.63), New Zealand Dollar (-1.5%, 1.0608), Euro (-2.1%, 0.6231) and UK Pound (-2.9%, 0.5474).

Market Performance – March 2018



Source: IRESS, Bloomberg, MWM Research, April 2018

Market performance – March 2018

Market Indices	1 month %	3 month %	1 year %	3 year %pa	5 year %pa
31 March 2018					
Australian Shares					
S&P/ASX 200 Accumulation	-3.77	-3.86	2.54	3.76	7.66
S&P/ASX 200	-4.27	-5.04	-1.80	-0.75	3.01
All Industrials Accumulation	-3.64	-3.76	-0.39	2.94	8.81
All Resources Accumulation	-4.34	-4.24	17.91	7.62	2.75
All Industrials	-3.92	-4.82	-4.75	-1.72	3.89
All Resources	-5.72	-5.94	13.86	4.03	-0.74
S&P/ASX 100 Accumulation	-3.90	-3.90	1.57	3.27	7.66
S&P/ASX Small Ordinaries All Accumulation	-2.29	-2.79	14.99	10.67	6.45
International Shares					
MSCI World Index Hedged in A$	-2.54	-2.77	8.66	6.28	10.26
MSCI World Index (A$ Unhedged)	-1.08	-0.13	10.92	5.58	14.31
MSCI Emerging Markets (A$ Unhedged)	-0.70	2.73	21.54	5.99	8.91
Regional Markets (local currency returns)					
Dow Jones	-3.70	-2.49	16.65	10.68	10.58
S&P 500	-2.69	-1.22	11.77	8.49	10.97
Toronto Comp	-0.49	-5.19	-1.16	1.03	3.80
Nikkei	-2.78	-5.76	13.46	3.76	11.59
German Dax	-2.73	-6.35	-1.76	0.36	9.19
FTSE 100	-2.42	-8.21	-3.64	1.38	1.94
Hang Seng	-2.44	0.58	24.81	6.52	6.18
NZSE 50	-1.70	-2.02	11.47	8.02	8.83
Property					
S&P/ASX 200 Property Trust Accumulation	0.07	-6.40	-0.77	5.39	10.61
Cash and Bonds					
Bloomberg Composite Bond All Maturities	0.84	0.87	3.28	2.45	4.30
Bloomberg Bank Bill Index	0.14	0.43	1.73	1.97	2.28
Citigroup World Government Bond Index Hedged	1.41	0.64	3.19	3.08	4.80
Citigroup World Government Bond Index Unhedged	3.50	4.51	7.89	3.31	7.59

Source: IRESS, Bloomberg, MWM Research, April 2018

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