Bennelong Wealth Partners

Market and Asset Allocation Views

January 2018

Dynamic Asset Allocation (DAA) Calls

Asset Class	Opportunity Set	Negative	Neutral	Positive	Change from last Qtr
Equities	Australia	○○○	○	●○○	
	US	○○○	●	○○○	▲
	UK	○○○	○	●○○	
	Europe ex-UK	○○○	○	●○○	
	Japan	○○○	○	●○○	▼
	Asian ex-Japan	○○○	○	●○○	▼
Property	Australia	○○●	○	○○○	▼
	International	○○●	○	○○○	▼
Alternatives	Alts Aggregate	○○○	○	●○○	
Fixed Income	AU Aggregate	○○●	○	○○○	▼
	Hybrids	○○○	●	○○○	
	International	○○●	○	○○○	▼
Cash	Cash	○●●	○	○○○	▼▼
FX	AUD	○○○	●	○○○	

Index Performance – as at 29 Dec 2017

Asset Class	Index	3 Month	1 Year
AU Equity	S&P/ ASX 300 Accumulation Index	7.74%	11.94%
US Equity	S&P 500 Index AUD	6.56%	10.45%
European Equity	MSCI Europe Index AUD	2.54%	16.19%
Asian Equity	MSCI AC Asia ex Japan NR Index AUD	8.57%	31.20%
AU Property	S&P/ASX 300 A-REIT TR Index AUD	7.79%	6.44%
Int'l property	S&P Global REIT TR Index AUD	3.69%	0.47%
Alternatives	Barclay CTA Index AUD Hedged	1.24%	1.65%
AU Fixed Income	Bloomberg AusBond Composite 0+ Year Index	1.44%	3.66%
Int'l Fixed Income	Bloomberg Barclays Global Aggregate TR Index AUD	0.90%	3.68%
Cash	Bloomberg AusBond Bank Bill Index	0.42%	1.75%

Market and Asset Class Views

Australian Equities: ●

- Broad macro environment is "Goldilocks". The Reserve Bank increased GDP growth forecast from 2.5% to 2.75%. Cash rates continue to remain at record lows. The slowdown in the property market and poor bond market fundamentals make the equities market more attractive in terms of the yield.
- Market performance has been very strong. The Accumulation Index was up 7.6% for the Dec quarter and 11.8% for the year. Forward PE ratio is around the long-term average. VIX index remains at record low.
- Year-end rally in commodity prices, improving earnings outlook and strong momentum from small-cap and resources also provide a steady lift to the Australia equity markets.

As the Australian shares are modestly undervalued relative to global peers and local rates will remain low, we are still moderately optimistic about the local equities going forward.

US Equities: ●

- Economy expanded 2.3% in 2017, strongest since 2014. Robust wage growth strengthens personal consumption. Global synchronization of economic growth boosts business confidence and corporate spending.
- Economic indicators like core PCE inflation, commodity prices and ISM prices show signs of increasing inflationary pressures in mid-2018, but in the near term, our expectation remains below the 2 percent target.
- Valuations on US equities are high relative to a historic average.

Technically supportive momentum, recent successful passage of the $US1.5 trillion tax code reforms and upward revisions to growth forecasts have swung our view on US equities from Underweight to Neutral, but caution remains warranted if interest rates accelerate, forcing risk assets to reprice.

European Equities: ●

- The Eurozone is enjoying its fastest economic expansion since 2011. We expect a continued economic acceleration in a short run, especially after the ECB left its benchmark interest rate unchanged last week.
- The strengthening euro may hurt export-reliant European businesses, but immediate risk to growth is low.
- European political backdrop appears to have improved, business capex is on the rise and valuations are still more appealing than in the US.
- However, withdrawal of QE and potential normalization of interest rates may upset equities if inflation picks up faster than anticipated.

We continue to see opportunities in European equities, but economic growth may be subdued from mid-year. Watching for signs of inflation will be crucial.

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Asian Equities:

- We expect 2018 will be another strong year for the region, driven by robust growth in Japan and China as well as benefiting from the healthier global economy.
- Central bankers will remain relatively supportive, albeit with some small rate hikes.
- Solid earnings and economic reforms will support momentum in the Asian market, but valuations are looking a bit expensive.
- Key risks: North Korea risk, trade policy risk and Chinese slowdown due to deleveraging efforts.

We remain overweight but have trimmed expectations. In particular, we are more bullish on Japan and China relative to the rest of Asia.

Property:

- Affordability concerns and more stringent lending in Australia means proportion of new loans for investment purposes is declining.
- Chinese money has dried up but money from other countries is still chasing direct commercial property. Cap rate compression continues in terms of commercial portfolio revaluations of portfolios outside the retail sector.
- The improving global economy and falling unemployment rates in most developed countries provide a solid foundation for a higher quality international property markets in 2018, but the impact of rising global interest rates on valuation poses some risks.

Overall we are slightly more bearish to neutral on both international and domestic property market given rising interest rates and bond yields.

Alternatives:

- Equity Valuations becoming stretched. Rising (actual and anticipated) Bond Market yields putting pressure on duration based Fixed Income, Infrastructure and property asset classes.
- Defensive Alternatives need to balance out with the Fixed Income asset class being hard to build out so we recommend unconstrained bond funds to be directed from Defensive Alternatives to Fixed Income.

Retain an overweight position as we continue to direct clients to increase holdings into non-correlated asset classes or those that are inverse to growth classes (as a substitute to long duration Fixed Interest). We also like momentum based CTA funds and long/short funds.

Fixed Income:

- Global government bond yields rose to multiyear highs. Rising wages and oil prices propelled headline inflation higher, lifting market expectations of policy normalization and imposing an upward pressure on bond yields.
- US unemployment rate dropping to 4.1% the lowest in over 16 years and Trump's tax cuts as a stimulus to economic growth also signal higher inflation is around the corner.
- Australian economic activity is relatively tepid relative to US and Eurozone, albeit with some noticeable improvements. Low wage growth and restrained improvement in unemployment growth suggest RBA is not ready for an immediate monetary policy tightening, but we may see some modest rate rises in the medium term.
- Growing investor confidence in Australian economy has pushed 10-year government bond yield up to 2.86%. We anticipate this trend to continue but may see strong bear market rallies from time to time.

Our sentiment has swung against this asset class from Neutral to Underweight based on our bearish view on global bonds and Australian bonds. For now, being more selective in markets with solid fundamentals and higher yielding credit will be a suitable strategy. Floating rate securities can be used to benefit from rising rates, but need to be mindful that these securities have become expensive in trading margin metrics.

Hybrids:

- 2017 was a positive year in hybrid market with supportive issuer fundamentals (i.e. adequate capital reserve, steady earnings growth) and limited supply ($4.6 billion less in market supply).
- Looking out to 2018, lack of new supply and the ongoing low interest rate environment will continue to support hybrid valuations, however timing and fundamentals are important in a tight margin environment.
- The key risk to Australian banking system remains the highly leveraged residential housing market. Trading margins across the capital structure have marched lower amidst the global search for yield with margins approaching pre GFC levels.

We retain neutral on Australian hybrid market as we see few factors jeopardising the strength in the current markets and we continue to see support from falling funding costs and low levels of market volatility. In particular, we prefer short-dated securities.

Cash:

Given the outlook for unchanged interest rate, this theme is expected to persist in the coming quarter. We are now allocating more to growth markets and alternatives due to the low reward of carrying excessive amount of cash.

Foreign exchange:

- As elevated US asset valuations and benign global economic backdrop steer investment away from the US, we expect the US Dollar to remain under pressure for an extended period of time.
- The faster-than-expected expansion of Chinese economy and strong global growth continue to support Australian exports, consolidating the strength of AU Dollar.

We remain neutral on the AUD/USD with a bias towards a short term up-tick driven by weakness in the US Dollar. In the long term, we still remain neutral on the pair due to competing and opposing forces.
We expect a 0.75c low to hold through-out the year, with headwinds occurring around 82c with an expected overshoot to land around 85c.

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