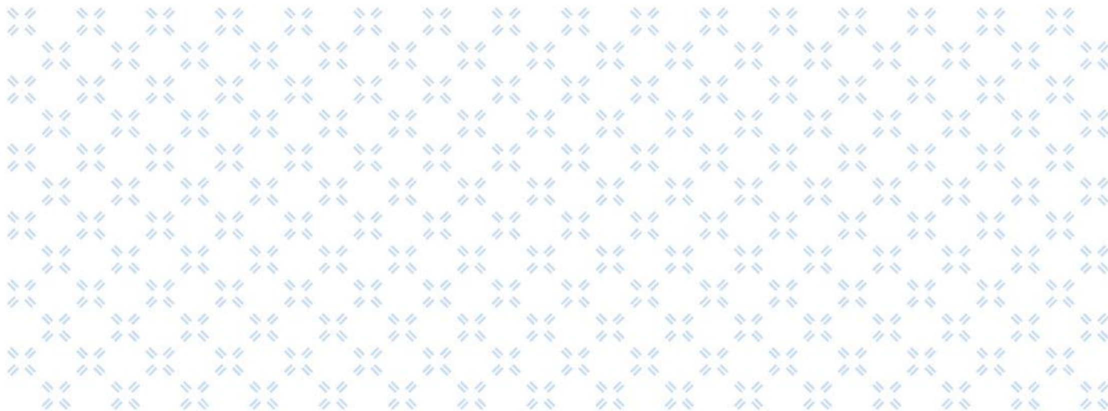
BT Investment Solutions

12 Month Outlook

March 2016



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Tim Rocks
Head of Strategy and Research

The start of 2016 saw concerns over China, a collapse in oil prices and efforts by central banks to support their economies. As the quarter progressed, commodity prices surged and there were some indications of recovery in China. Moving into the coming year, there are three key macro themes shaping our outlook for markets.

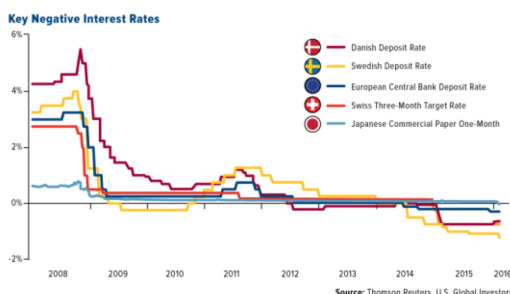
1. A new world for investors

We are living in unprecedented economic times. A range of secular influences have changed the risk and return profile of assets, have had profound effects on investor sentiment and require changes in investment strategy.

The first major change is we are much closer to the limits of central banking. Five major central banks now have negative interest rates on deposits as shown in Chart 1. The aim is to punish banks for holding excess reserves and force them to increase lending.

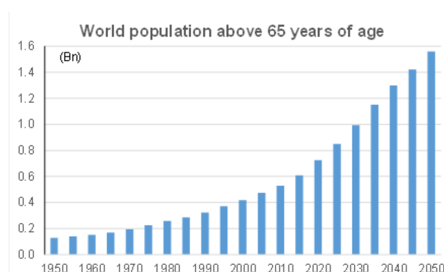
The ageing population is about to hit as shown in Chart 2. One billion people will retire between now and 2050 across the globe placing enormous financial strain on countries where pensions, healthcare and accommodation is inadequate.

Chart 1:



Source: Thomson Reuters, US Global Investors

Chart 2:

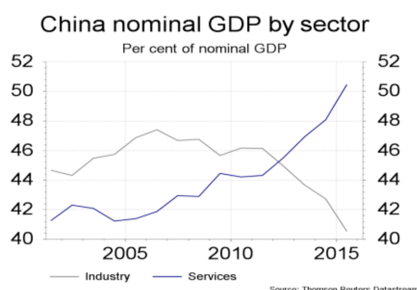


Source: Datastream

There are significant changes underway in the Chinese economy as China attempts to transition away from manufacturing and investment and towards services and consumption as shown in Chart 3.

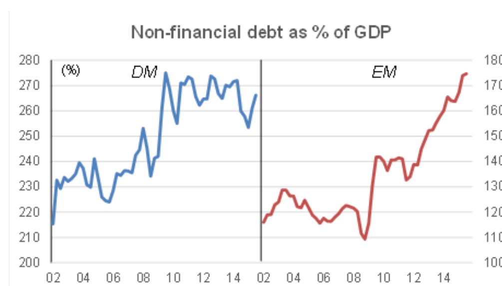
Global debt levels have risen significantly as shown in Chart 4. In recent years, this has been driven by emerging markets. Such a rapid growth in debt has assisted economic growth but cannot be sustained.

Chart 3:



Source: Thomson Reuters, Datastream

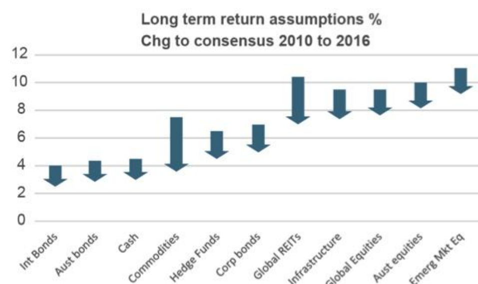
Chart 4:



Source: Datastream

These changes mean that trend GDP growth rates will be lower going forward, and this will translate directly into lower profit growth and equity returns. At the same time, returns on deposits and bond portfolios will be much lower given the low starting point for interest rates. Chart 5 shows how we have lowered our return assumptions in recent years; long term expected equity returns have been cut by around 2% for all major markets, and bond returns by around 1.5%. This reduction in expected returns has been accompanied by an increase in market volatility over the past year as investors have grappled with the implications of some of the macro trends described above. There has recently been about 8 days per month when global equity markets have moved more than 1% as shown in Chart 6.

Chart 5:



Source: Datastream

Chart 6:

Source: Datastream

These changes require some changes in the approach to investing. Investors should be prepared to look at a broader range of assets, be more active in their investment decisions to take advantage of opportunities when they arise, and reconsider targeted returns from their portfolios.

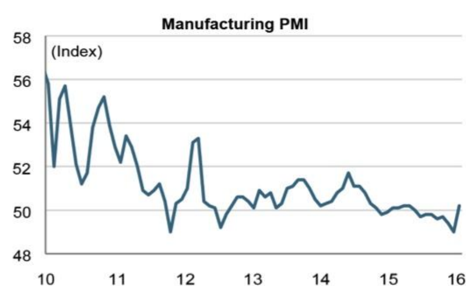
2. China focusing back on growth

While the economic transition in China is a negative for global growth in the medium term, the shorter term could be a different story. Chinese authorities embarked on an ambitious reform program in 2013, focused on government financing, corruption and the overall structure of the economy. Through 2015, it became clear this was creating pressure on their economy. At the recent National People's conference, the leadership announced a change in focus on policy from reform back to supporting economic growth. This has been accompanied by a range of measures.

+ The People's Bank of China (PBoC) has lowered reserve requirements for Chinese banks, allowing them to lend more. Indeed, credit growth has picked up sharply in the first two months of 2016.
+ Restrictions on property market transactions have been eased in recent months.
+ Fiscal spending is set to ramp up. The Government has stated it intends to fast track a number of large-scale infrastructure projects in the first half of 2016.
+ Margin lending restrictions on Chinese shares have been removed. This is an important development because households are large holders of mainland shares.

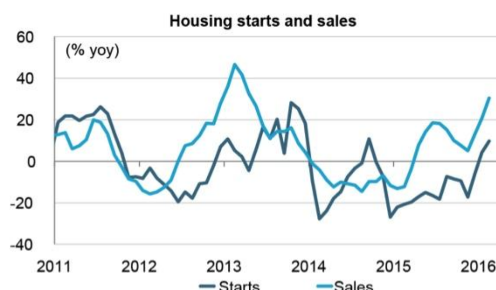
It may take a while for these measures to boost activity, but there are some early signs that they are working as indicated in Charts 7 and 8. This will have a positive impact on a number of assets, including Australian resource companies, commodity prices and emerging market assets.

Chart 7:



Source: Datastream

Chart 8:



Source: Datastream

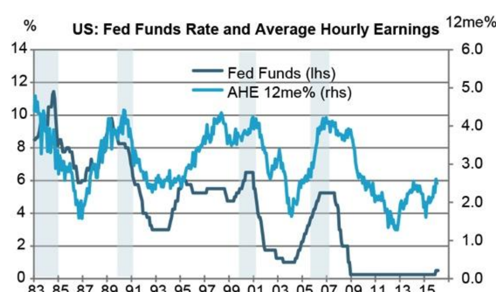
3. US wages a key risk to markets

As the US economy has moved towards full employment, the threat of a wages growth outbreak and its implications for inflation has been an ongoing focus for the US Federal Reserve (Fed). While the

Fed has indicated recently that a period of faster wages growth would be welcome after several years of subdued growth, they would be reluctant to stand back and accept a significant acceleration in wages. History indicates that to do so would require a more rapid and sharper increase in rates as shown in Chart 9.

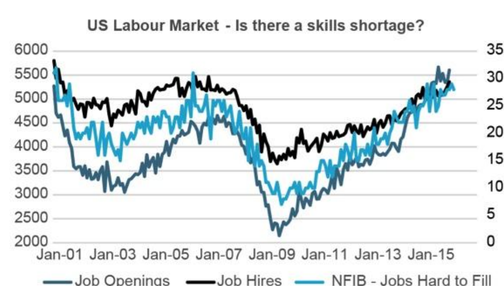
The latest data on US wages suggests we are still some way from this being a major concern. However, the broad evidence points to some further acceleration in wages over the coming year. The unemployment rate in the US is below 5%, which suggests that there is little slack remaining in the labour force. Indeed, it is becoming apparent that businesses are finding it difficult to fill positions, which could indicate a skills shortage as demonstrated in Chart 10.

Chart 9:



Source: Datastream

Chart 10:



Source: Datastream

If wages growth continues to strengthen, the Fed may feel compelled to respond by raising the Fed Funds Rate at a faster pace than what is currently envisaged. We continue to believe the Fed will err on the side of caution before acting, particularly if financial market volatility and uncertainty surrounding the global growth outlook remains high.

Macro forecasts

The table below shows our macro forecasts for the major regions. The key points are:

+ Growth in the **US** is expected to remain around its current pace, with subdued business investment and external demand offset by a stronger consumer sector. Confidence among consumers has held up well despite volatility in markets, while the robust labour market and improved household balance sheets are also supportive for consumption and housing. Inflation is expected to gradually move closer to the Fed's 2% target. As such, we expect the Fed Funds Rate to be increased twice in the second half of our forecast horizon. Nevertheless, we believe the risks are slightly tilted to the downside and will likely be the result of weaker global growth and financial market volatility.
+ **Australia** is expected to grow at a below-trend pace over the coming year. Consumer spending is supported by a robust labour market, but it is vulnerable to a housing downturn. The outlook for business investment remains weak, with little evidence that corporates are planning to lift their investment intentions. Meanwhile, the falling Australian dollar had buoyed non-mining sectors such as tourism and education, but the Australian dollar has moved higher in recent months and is less supportive at current levels. We expect inflation to move towards the middle of the RBA's target range. On the basis of below-trend growth and well contained inflation, we expect the RBA to cut interest rates by 25bps over the forecast period. The wildcard for RBA policy will be their comfort level around the Australian dollar.
+ **Chinese industrial activity** is likely to stabilise then strengthen through 2016. The industrial sector, which is highly important for Australian commodity exports, has been under pressure since President Xi Jinping implemented his reform agenda. But aggressive policy action in recent months should see a reversal. Our forecast GDP growth number is little changed from last year at around 6.5% but the change in composition in favour of manufacturing and investment will be important for markets and is currently underestimated.
+ **Japanese** activity is expected to be very weak in the coming year. Abenomics appears to be under pressure, with the Japanese economy slipping back into recession. Wage negotiations between unions and employers has not resulted in a meaningful pick up in wages growth, while the government's plan to raise the consumption tax in 2017 looks at risk. Furthermore, corporates are being hurt by the Japanese yen, which has appreciated sharply since the start of the year. Monetary policy is anticipated to remain very supportive, with further asset purchases expected from the Bank of Japan (BOJ).

- Growth in **Europe** is expected to remain soft over the coming year. Although the European Central Bank (ECB) is to be applauded for its latest bout of monetary initiatives, much uncertainty remains regarding the impact of the ECB's negative deposit rate on the efficacy of the European banking system. Indeed, both the Swiss and Swedish experiences of negative interest rates have led to an ominous decline in broad monetary aggregates.

Economic & Market Forecasts to end March 2017

	GDP		CPI		Official Rates		10 Year Bond		FX/USD	
	Latest	Mar- 17	Latest	Mar- 17	Latest	Mar- 17	Latest	Mar- 17	Latest	Mar- 17
US	1.4	2.0	1.7	1.9	0.5	1.0	1.98	2.2		
Australia	3.0	2.3	2.0	2.5	2.0	1.75	2.6	2.7	0.756	0.75
Euro zone	1.5	1.25	1.0	0.7	-0.4	-0.4.	0.15	0.0	1.10	1.05
Japan	0.8	0.0	0.1	-0.1	-0.1	-0.2	-0.05	-0.2	112	120
China	6.8	6.5	1.5	1.25	4.35	3.7	N/A	N/A	6.5	6.9

Source: Datastream

Market forecasts and positioning

The table below shows our forecasts for major asset classes. The key points are:

- Australian and international equities will comfortably outperform global bonds. Both will be supported by low bond yields. International and domestic equities will return broadly in line. International equities will have better earnings growth led by Japan and Europe but Australian equity returns will be boosted by dividends and franking.
- Property will deliver strong returns over the next year and perform in line with broader equity markets as income growth and yields remain healthy.
- Australian and international fixed interest will underperform equities. The Fed will raise rates only very slowly and this slow pace will ease concerns in the bond market seeing bond yields only increase slightly. The RBA will cut interest rates one more time in 2016 as business investment fails to recover in the non-mining sector.
- Commodity returns will be modest but better than recent years. Gold and softs may make moderate gains, while macro stabilisation in China will help metals and bulks.

Source: Datastream

Based on these forecasts, the table below shows our preferences for each asset class relative to our strategic long term asset allocation benchmarks.

	Underweight		Neutral	Overweight	
Australian Equities				■	
International Equities				■	
US			■		
Europe				■	
Japan			■		
EM			■		
Property					
Australia				■	
Global				■	
Credit	■				
International Bonds	■				
Domestic Bonds		■			
Defensive Yield			■		
Alternatives	■				
Commodities			■		
Cash		■			

+ We are **overweight Australian equities** primarily on valuations. Australia has lagged other markets during the bounce from market lows, and this is now reflected in better valuations. There is also some prospect for an earnings recovery as commodity prices stabilise. Earnings have been relatively resilient ex-resources due to extensive cost cutting by companies.
+ We are also **overweight International equities** through Europe in particular. We expect healthy earnings growth in Europe as their economic recovery progresses and the expansion in quantitative easing affects a broad range of asset classes. We are neutral on US equities and have moved back to neutral on emerging markets given the pick-up in economic activity in China.
+ We are **overweight property** in Australia and internationally. Low bond yields could push capitalisation rates lower and income growth is steady in most markets.
+ We are **underweight credit**, particularly international government bonds. We do not expect rates to rise significantly and coupon rates are so low that returns will be meagre. Domestic bonds will perform better than international bonds as we assume bond spreads will narrow further.
+ We are **significantly underweight alternatives**. Hedge funds will continue to struggle with a reduced opportunity set from poor market liquidity and dampened volatility.
+ We are **neutral on commodities**. We assume that the economic recovery in China provides a better backdrop for industrial metals and energy, and there are small positive returns from precious and agricultural commodities.
+ The **Australian dollar** is currently trading around fair value, with the risks evenly balanced.

Risks to our portfolio

As part of our risk assessment process, we develop a number of alternative macro scenarios. The major foreseeable potential risks that we have considered are:

- Less accommodative central bank policy, particularly in the US. We have run a number of different scenarios involving different outcomes for growth, inflation and interest rates in the US. Our conclusion is our current portfolio will perform well in most scenarios except if the Fed keeps raising rates and the economy slows. This would most likely occur if wages growth accelerated and stayed high.
- Rising financial strains in China or emerging markets. The impact on financial markets depends on the extent of contagion to financial systems in the developed world. If the crisis does not cause systemic risk, then the impact will not be great. Given the greater focus on financial stability by central banks since the financial crisis, and the increase in the amount of oversight in this area, our view is that there is a higher degree of resilience now. Recent policy actions in China and the recovery in commodity prices have reduced these risks for the time being.
- Political developments in the US, Europe and Middle East. The major events in 2016 will probably be the US election, and the potential vote in the UK to exit the Eurozone. There is also the risk of further political flare-ups in Syria, Iraq or ISIS related events. Such events cannot be predicted but we will continue to monitor developments closely.

We will monitor a number of indicators throughout the year to assess whether the economic momentum is shifting from our central case scenario of normalisation to one of the other paths, and whether we need to make adjustments to our portfolios to reflect this. The indicators that we see as most important here include the US labour market, US inflation, Chinese growth indicators, and key commodity prices.

Sonia Bluzmanis

Portfolio Manager

Australian Equities

After a tumultuous ride, the Australian equity market posted a negative return for the first quarter of the year, leaving investors wondering if the sharp rotation experienced across sector and style would roll into a persistent trend or whether it was merely a short lived correction. It was unusual for a quarter to include both a broad-based sell-off due to global growth concerns and a strong market recovery led by cyclical stocks, however in some respects this was not an unexpected journey; coming into the end of 2015 the extreme divergence exhibited in the market was bound to result in some element of mean reversion – in January we highlighted that value dispersion was at its widest since the GFC.

The year kicked off with a terrible sell-off, due to concerns around China's slowing growth, a collapsing oil price, weak US economic data and a surprise policy announcement by the BoJ. During January, the Australian market dropped to its lowest level since 2013, and sector performance reflected the trends seen in 2015 with Materials and Banks sold off in favour off of REITs, Telcos and Utilities.

February saw a change in sentiment with the remarkable resurgence of the Resources sector, a clear theme for the quarter. Commodity prices bounced on the back of a weaker US dollar, additional central bank easing, potential supply restrictions in some key markets and fading concerns of a hard landing in China – combined with attractive valuations, there was strong support for a broad-based rerating. Short covering was also a key driver. The extraordinary surge in iron ore prices (23.4% for the quarter) carried up the Australian dollar, which has gained 11.8% since hitting a multi-year low of 0.685 in mid-January. The spot gold price also rose, up 16% while US Brent crude finished 6.8% higher at $US40.12 a barrel.

The Small Ordinaries Index continued to outperform large caps, driven by the strong rally in small resources (up 17%) and lack of banks. The other major story for the first quarter was the continued weakness in the banks and underperformance of the Financials X-AREITs sector. Coming into the first quarter, there was debate around normalisation of bad and doubtful debt (BDD) in the Australian banks, and the robustness of the Australian housing market, along with concerns around funding costs and further capital build. While the initial sell-off was a function of global growth concerns, the fears of rising bad debts took over later in the quarter; this was set off by ANZ's announcement of increased BDD provisions associated with the resources sector.

In aggregate, reporting season delivered results mildly more upbeat than expectations, but results seemed to be overshadowed by central banker comments and commodity price moves. For the first time in years, the domestic cyclicals performed better than the offshore earners, and while large dividend cuts by Resource firms (BHP and RIO) captured the headlines, dividends were actually ahead of expectations overall.

Looking forward, the economic backdrop has not changed with sluggish growth globally and a lack of cyclical tailwinds, but we do not foresee a major downturn. Domestically the outlook is for sub-trend growth as the economy continues to transition from mining investment to non-mining investment, consumer-driven and other industries such as tourism and education. With subdued business investment – a lack of 'animal spirits', growth will be sourced from the government and the consumer.

We are starting to see an increasing number of managers shifting toward the beaten up resource names, and closing underweights with a view that valuations are too attractive to ignore. With the recent climb in commodity prices, the China reflation story and positive dialogue from global oil suppliers, the risk now appears to be to the upside in this sector. Domestic cyclicals are also gaining support over defensives which have had declining earnings and are priced to perfection. Nonetheless, there is still caution around the state of the global economy, and whether monetary policy levers are actually effective in generating inflation and stimulating real growth, not just driving up financial asset prices. Thus markets are likely to swing between risk on/risk off until an earnings upgrade cycle appears again.

The valuation premium of offshore stocks has come back recently but the USD depreciation will dampen earnings, thus domestic cyclicals may continue to be supported in the short term. From a market cap perspective, the larger end of town currently exhibits some of the more compelling valuations, namely in the big four banks, plus the miners and energy stocks - Origin just left the top 20 for Transurban which has been well bid in the search for defensive yield. Banks may offer some of the best trade opportunities but the market is pricing in risks for a reason; BDD from resources is unlikely to be systemic, but other issues may weigh on share prices including high household debt and slowing growth domestically, funding costs and shrinking margins, along with further capital adequacy requirements.

From an asset allocation perspective, we remain overweight on Australian equities, primarily on valuation. Valuation dispersion remains elevated despite the rotation from growth to value recently, and ex-resources the economy has been quite resilient, evident from the labour market. While

increased exposure to cyclical names and 'value' characteristics are warranted, at least in the short term, the outlook remains cautious, thus a balanced approach to portfolio construction is sensible. We need to be wary that the market reacts to the smallest macro news, or central bank comments. Any shocks or unforeseen events could trigger a flight to quality and renewed support for the higher quality and growth names, despite valuation. Plus equities still look cheap relative to bonds and yield continues to be supported globally.

The larger cap end of the universe may currently exhibit some attractive valuations but is also more exposed to macro drivers thus the small and mid cap segments have appeal, offering more organic growth, or 'undiscovered' opportunities and information arbitrage. Cross sectional volatility has also kicked up, making this a great environment for stock pickers (and active managers) to generate excess returns above the concentrated market cap index.

International Equities

Mark Vrkic
Portfolio Manager

Global equities experienced an extremely volatile start to the year. Perceptions of issues such as Chinese currency sustainability, oil prices, the high-yield debt market and Eurozone banking systems ebbed and flowed violently, while policy-makers in several geographies significantly adjusted rhetoric and approaches. Furthermore, volatility continues to be exacerbated by very low market liquidity. Last quarter, we moderated our positive return expectations for the year as we felt that the risk-reward for global equities appeared to have decreased. We continue to believe that the return trajectory for global equities is flattening with high absolute valuations reducing the buffer for shocks and increasing the risk of drawdowns. We see little scope for further multiple expansions over the year and expect only moderate earnings growth.

We continue to remain overweight global equities as we still expect it offers the best return prospects versus other asset classes. Growth expectations are reasonable, relative valuations remain attractive, excess liquidity remains supportive, central bank balance sheets are expected to expand further (ex US), corporate sector buying should continue and tactical indicators are also generally supportive. While we remain broadly constructive, we anticipate increased volatility to persist. Increased volatility and sometimes sizable corrections are a characteristic of a maturing bull-market but can lead to wide trading ranges and greater tail risk. Higher volatility expectations are based on the rates cycle and uncertainty around central bank policy and extremely low levels of market liquidity. High levels of geopolitical risk will also add to market volatility.

Our expectations for returns in this asset class are based predominately on expected earnings, rather than any further revaluations. Valuation expansion has been a key driver of equity returns in recent years but we continue to believe that there is less scope for multiple expansion going forward given valuations in most developed markets are at the high end of their ranges and we expect higher volatility ahead. As long as the macro environment remains supportive and there are no shocks, we do believe high valuations can be sustained. Consequently, there is scope for greater dispersion and more sensitivity to headlines. Returns for hedged and unhedged are now similar as we believe the Australian dollar will likely remain at similar levels over the next 12 months.

We remain neutral on the US despite earnings headwinds and higher relative valuations. The speed of policy normalisation and the trajectory of the US dollar will be important in determining US equity returns. We continue to prefer developed market equities over emerging markets given the latter's earnings vulnerability to its own subdued growth, potentially stronger dollar, and relatively high cost of capital however our view on emerging markets has improved to a more neutral outlook given recent encouraging signs of economic activity in China. Our baseline forecast is for no hard landing in China although the risks continue to remain. Within developed markets, we continue to be more favourable towards Europe as improving growth momentum, accommodative policy, a weaker euro and stronger earnings prospects provide tailwinds. We have tempered our view on Japan to being more neutral as progress on improvements in corporate governance has stalled while the strength of the yen is posing greater risk to earnings expectations. Across-sector dispersion is expected to stay high globally, offering opportunities to boost lower expected returns. We still like financials selectively given their attractive valuations and hedge against potential rate rises despite negative interest rates across Europe and Japan. We are still the most cautious on commodities given declining earnings expectations and expected US dollar strength, despite their recent rally during late February-March.

The major foreseeable risks to global equities remain:

1. Central bank policy remaining less accommodative, particularly if Federal Reserve were to raise US interest rates while wage growth accelerated amid signs of economic slowdown.
2. Rising financial strain in China or emerging markets from volatility in commodity prices and currency - the impact on global equities is dependent on the degree of contagion expected. Given the greater focus on financial stability by regulators and central banks since the GFC, our view is that there is a higher degree of resilience rather than the potential for another Asian Crisis as seen in 1997.
3. Political developments in the US, Europe and Middle East. In particular, the US Election and the potential Brexit vote in the UK to leave the Eurozone. Similarly, the risk of further political flare-ups in Syria, Iraq or ISIS related events exists and is difficult to predict. The key indicators for these risks remain the US labour market, US inflation, Chinese growth indicators and key commodity prices.

Given the more subdued outlook for equities in our base case and expectations for increased volatility leading to wider return outcomes, it is worth highlighting the characteristics of our bull and bear case scenarios. Our bull case scenario would be built around either:

1. Further PE re-rating as the turn in US monetary policy fosters greater confidence in the durability of the cycle and encourages an asset allocation shift from bonds to stocks;
2. Stronger than expected rebound in emerging market growth that allays global growth/deflation concerns and boosts commodity prices and EPS surprises; and
3. US dollar weakness that provides a boost to US earnings and is also positive for commodities and emerging markets.

Key risks underpinning a bear case scenario would be:

1. Higher than expected rebound in inflation that implies tighter monetary policy;
2. Emerging markets deteriorating further due to combination of stronger US dollar, higher global bond yields and high leverage;
3. Growing currency tensions around substantial moves up or down in FX rates (particularly US dollar strength and renmimbi devaluation); and
4. A slowdown in the US economy while the central bank is tightening. Other risks to our base case forecast are primarily focused on geopolitical dynamics.

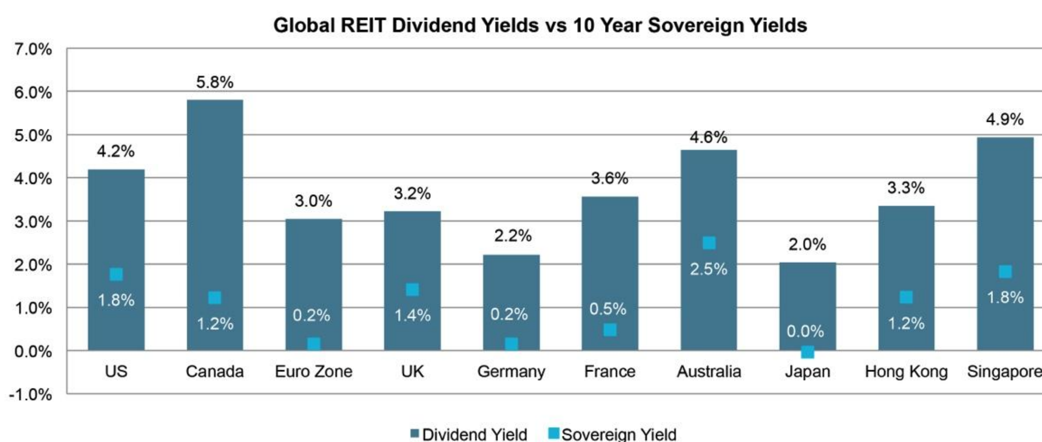
Property

Dimitra Voutas
Portfolio Manager

Globally, real estate stocks have performed well to start the year, yet the increased volatility for all investment markets during the beginning of 2016 understandably has investors more on edge, fearing a slowdown in global capital flows, which could potentially impact real estate values. In Europe, the Middle East and Africa, there is considerable uncertainty around the outlook in the UK. While fundamentals look supportive, the impending European Union (EU) referendum vote is likely to continue exerting negative pressure on sentiment in the short term. Elsewhere, the focus on the Fed in terms of the pace of future hikes will continue into 2016 adding to short term volatility.

Despite the uncertainties about the global economy, we believe this is the perfect environment for real estate. Funding costs are low and access to capital is relatively easy. The increasing sophistication of the debt market offering to real estate investors has allowed REITs to diversify their sources of funding and increase the maturity of their debt profile. In the past, debt was usually priced according to the bank's prime rate. In today's market, debt providers offer pricing pegged to a variety of rates and the rise of non-traditional lenders, such as hedge funds, credit funds, business development funds and sovereign wealth funds, means real estate investors can source debt packages that are not closely tied to rates in short term markets.

Property yields (cap rates) for physical property have firmed to pre-credit crisis levels in many countries, but as the spread to bond yields (or funding costs) remain wider than normal as shown below. We believe Australia, US, Continental Europe and the UK are the more robust real estate markets. If local 10 year government bond yields remain low, we expect REITs can continue to rise. If 10 year government bond yields moved up by 100bp, we do not expect values would come under the same pressure as in other markets such as Singapore and Hong Kong.



Source: Datastream

In Australia, although we remain cautious on macroeconomic fundamentals, we believe the RBA is likely to keep rates on hold throughout 2016 with a possibility of a rate cut. A low rate environment makes this sector attractive on dividend yield alone. Offshore demand for Australian real estate continues to be exceptionally strong helped by currency debasing and continues to be reflected in capital values as mentioned above. We expect M&A and transactional activity to continue to drive up asset values which will flow on positively to REITs. With the sector now yielding just under 5.0%, and with bond yields around 2.5%, the yield premium of the sector continues to reside above its long term average of 1.9%. Furthermore, financial leverage is low, with gearing across the sector approximately 30% (Debt to Total Assets) making the sector a relatively low risk investment choice.

In summary, while there is continuing reappraisal of risk and return requirements for all investment classes, real estate securities valuations currently appear fair by longer-term standards, given a relatively attractive yield and solid, fundamentally driven earnings growth prospects. On a relative basis, global real estate trusts could continue to outperform other asset classes given their more durable near-term earnings growth, attractive dividend profile and discounted valuation levels. We see the current yields on REITs as attractive and safe, with the prospect of another year of dividend growth.

Alternative Strategies

Chris Thompson
Portfolio Manager

Significant differentiation across emerging markets is set to continue in the face of lower commodity prices, higher US interest rates and very different domestic agendas at an individual country level. These themes should be exploitable by global macro style managers. We would recommend that investors look to specialist emerging market managers to capitalise on this through strategies that can invest both long and short particularly through FX, rates and credit markets. This is particularly true at present as pockets of value in certain emerging markets are beginning to appear.

We like merger arbitrage as a strategy. There are still a sufficient number of deals to invest in, leading to less concentration risk and a lack of capital available to close the available deal spreads. We will be monitoring spreads during the year though, as there is a chance this opportunity will close quickly as new capital enters from the hedge fund community and/or the number of deals reduces, making the return for risk taken less attractive.

The sell-off in corporate credit and structured credit has created plenty of value for those prepared to accept some mark-to-market volatility caused by the lack of liquidity in the asset class.

The dispersion of returns within equities has been at historically low levels for a long period of time. Should this revert to historical norms, this would imply a good environment for long-short equity managers. We are also targeting specific sectors where we have reason to believe that dispersion will be higher and where a skilled specialist manager would be expected to be able to use their expertise to generate good returns. Examples are Energy, Healthcare and Europe.

According to Credit Suisse, the gross exposure of long short managers on its prime services platform has decreased from 170% a year ago to 115% today. This is close to the gross exposure levels during the European crisis in 2011. This means that there is currently much less risk of further deleveraging negatively impacting returns in the near term.

Managed futures (commodity trading advisers (CTA) managers) still have an important role to play in the portfolio construction process. Long-term trend followers are expected to add to diversity if economic conditions falter from this point. We believe that strategies that protect ones portfolio against tail events are very important and will come into their own should any of a number of possible risks transpire. This was certainly the case at the beginning of this year when these strategies again came into their own.

Commodities

Chris Thompson
Portfolio Manager

A weaker US dollar has in recent times provided some relief to the downward trajectory of commodity prices.

The recent rally in Energy may have more to do with short covering than a significant change in fundamentals. There has been some supply reduction from the US but a further critical factor will be the ability of OPEC producers to agree on production caps. However, even if they do, there is currently a significant glut in world markets which will take a long time to clear.

In the medium term, the oil price can't go too much lower without impairing supply so we should be at or close to a baseline. A price closer to $60 is required in the longer term to incentivise new exploration and material production.

Within Precious Metals, fundamentals in gold and to a lesser extent, silver, have taken a back seat to projected real interest rates. Should the ECB and BoJ continue to pursue loose monetary policy and the Fed remain slow to raise rates, gold would benefit. Interest in gold has been so high from investors this year that BlackRock had to temporarily stop issuing shares in the iShares Gold Trust.

Within Base Metals, sentiment seems to have turned with positive G20 announcements and relatively benign global data. This sector will also benefit from an economic recovery in China. Nickel and zinc are markets that are rebalancing more quickly which should provide impetus to their returns.

Favourable growing conditions over the last three to four seasons have seen grain prices correct, but levels are now supportive of supply cuts or a demand response. This year's El Nino and associated weather patterns may be a catalyst for higher prices.

Within Softs, weather and supply cuts have pushed coffee and sugar prices higher in recent months. However cotton prices remain capped by a significant supply overhang through Chinese stockpiles.

We anticipate a positive return for commodities over the next 12 months. However there is plenty of scope for variability around this forecast and an allocation to commodities will remain a diversifier in a diversified portfolio as well as insurance against geopolitical and unexpected inflation risks.

Cash

Chris Thomas
Assistant Portfolio Manager

Cash remains a reasonable place to park assets for liquidity purposes ahead of further deployment into other asset classes. Other asset classes with positive expected returns are more compelling from an investment perspective.

We still call for one further rate cut from the RBA over the next 12 months which would take us from the current official interest rate of 2.0% to 1.75%. The bias for further monetary policy in Australia remains to the downside despite rate rises being on the cards elsewhere in the world, most notably the US.

Inflation, while still not apparent at present, should not be expected to remain the benign threat it has been in recent years. Global deflationary fears are subsiding, and there are potential scenarios when inflation may appear again, potentially with some pace. This is certainly not a base case at this point, but given cash has proven a particularly effective safe haven alternative to falling asset classes of late, there is perhaps some complacency building in portfolios.

Real returns, after all, are actual returns minus inflation. Any back of the envelope calculation in recent years has left off that minus, as zero has been a fair proxy. Even a 1.7% CPI, as seen year on year to December, somewhat washes out against negative returns seen in various places in recent years. While there are only nascent warning signs of a re-emergence of problematic inflation, and indeed there are still plausible deflation scenarios, it's worth being reminded that over the long term, cash allocations are not only opportunity costs but can see purchasing power decline.

Banks remain capable of funding what credit growth they have through functioning global markets (Royal Commissions and Australian credit rating downgrades notwithstanding). As such, deposit wars seen in years gone by show few signs of resuming. 12 month term deposits in the high twos or low threes are hardly exciting.

Opportunities are expected to remain for modest duration management with the potential to pick up a few basis points here and there, but the outlook largely remains that cash is cash.

Chris Thomas
Assistant Portfolio Manager

Australian Fixed Interest

Australia remains fertile ground for foreign issuers. Bond managers in Australia last year were happy to lend to the Apples of the world and this is expected to continue. Certainly the breadth of the domestic market remains interesting, and there is plenty to pick from to diversify a portfolio. The ability to express global views through an Australian fixed interest portfolio continues to increase.

We expect currency to continue to be a focus for managers over the coming year, with large recent movements in the Australian dollar, especially against the US, showing little sign of abating. While Australia's exporters would welcome a lower Australian dollar, the influence of the RBA and other players remains tenuous. We would expect them to continue jawboning a falling currency lower while being conspicuously absent from the conversation when the dynamics are against them.

Yield curve positioning is expected to continue to see interesting dynamics as managers continue to attempt to reconcile short term monetary policy with longer term growth prospects, when both remain uncertain both domestically and globally.

The upcoming Federal Budget may hold a few surprises, and while the popular focus is on deficit reduction, there is the potential for one or two long dated projects that would require substantial sovereign issuance. The other outcome from this, of course, is Australia's AAA credit rating, and we would expect efforts to be made to retain this, as the flow on impacts from a cut to this rating are unpleasant.

The next 12 months also sees a Federal Election, and while we do not expect a change of government, this is not the slam dunk it was three months ago. Policy is not expected to change dramatically from current positioning, although efforts to ease political gridlock, while welcome, represent both opportunities and risks from a portfolio standpoint.

Sentiment and confidence indicators remain a mixed bag, with recent business confidence ticking up while consumer confidence fell. There's no specific view outside trend here, but the noise seen in the indicators is perhaps as good a predictor of a continued muddle through for the economy.

It has been pleasing to see as smooth a handover as we have had between the west and north of the country to the east and south. Given the scale of the shift in contributions to GDP between miners and banks, things could have been much worse. While there's the potential for some additional after-effects of this to play out (think Arrium etc), we seem to have avoided the hard landing. Recent commodity price improvements and the potential for China reflation point to upside risks here.

International Fixed Interest

Chris Thomas
Assistant Portfolio Manager

Dynamics appear to be shifting around the low duration call that has been so popular in recent years. This is the desire to reduce sensitivity to interest rates, to avoid a large reduction in capital value from a normalisation in interest rates. The basis for the call was an assumption that central banks would remove emergency settings for rates, forcing rates higher and bond prices lower. Those who have held short duration positions in recent years have been hurting, and rate rises, certainly from the Fed, keep getting pushed out. Now, with zero no longer seen as an impenetrable bound and negative rates appearing in various countries, the expectation of a quick bounce-back is fading, and temporary protective positions are beginning to lose their appeal. Those who have been positioned long duration have largely done well, and there appears to be some capitulation amongst those who are short.

Ironically, the risk has not abated, and indeed there are opportunities for those with fresh capital to deploy at this point. There are various reasons why the Fed may err on the side of slowing rate rises. One scenario has them falling off the back of a wave of inflation, and needing to catch up through a series of rapid rises. This very much remains an edge case at this stage, but is nonetheless a risk to be considered. The base case on Fed hikes is for one more this calendar year and another (which will be the third in total) in early calendar 2017. Just as when this started, the risk, is that this will take longer.

We expect to continue to see negative interest rates in various countries, especially in Europe. The effectiveness or otherwise of such dramatic monetary policy measures is indicative of the unchartered waters we find ourselves in. While some countries are beginning to show signs of economic recovery, which markets have largely viewed positively in recent months, we run the risk of returning to that good news is bad news environment, where positive data increases the risk of a rate rise, spooking investors.

The outlook for corporate credit remains favourable in 2016, as valuations appear attractive due to the credit spread widening in 2015 and early this year. The ECB's announcement on 10 March of its extended asset purchase program, now including investment grade corporate bonds, is likely to act as a tailwind for credit markets, at least in the near-term. However, corporate default rates are likely to increase from cyclically low levels as we enter the late stages of the credit cycle.

An interesting dynamic in international fixed interest that we expect to see continuing over the next twelve months is the shift of corporate financing by banks to private debt markets. The growth in this sector internationally comes as banks laden with capital requirements find it increasingly difficult to lend. Returns in this space are compelling but the opportunities require specialist expertise.

The next 12 months will also see a new President of the United States of America, with a less than inspiring field of candidates remaining. On current thinking, a Trump nomination would see a Clinton presidency, which throws up a new range of risks and dynamics in the US economy and financial markets globally. While a Trump presidency (still a low probability) might not be the calamity some are expecting, an alternative Republican nomination would be more likely to succeed at the general election, and indeed this would be the most favourable scenario for markets generally.

Currency

James Kerr
Portfolio Manager

The US dollar was weak across the G10 complex* in the first quarter of 2016. Market participants continued to focus on the path for US interest rates and the implication a sharp rally in the US dollar would have on financial assets. Market expectations of interest rate normalisation to reflect at least four hikes in 2016 was strongly negated by softer data and Central Bank comments indicating a very shallow trajectory for the pace of normalisation. Secondly, the Fed's increased sensitivity to the financial market's stability has complicated the policy role central banks are now responsible for in the broader economy. This development has muted our expectations for further strength in the US dollar throughout the next 12 months, and we see a higher probability that the US dollar is now trading into a range bound period, though directional volatility may be varied given positioning and particularly given the divergence in monetary policy measures exhibited relative to Europe and Japan. Commodity exporting currencies including the Australian dollar remain vulnerable to further depreciation in a non-linear rate though we see the current global monetary policy settings as limiting any further significant depreciation over the short term from current levels.

Our Australian dollar to US dollar forecast continues to be driven thematically by the domestic economy continuing to grow sub-trend amongst a back drop of lower global growth and, as a result, we see signs of a further rate cut from the RBA as likely. Domestic growth remains the key risk where any change in Asian economic momentum or Commodity sentiment will likely drive the outcome in the short term, however recent stabilisation in these factors has led to short term support. We view the Australian dollar to US dollar exchange as trading in a range around 0.75 over the next 12 months, higher than our previous quarters forecast given the resilience experienced across the domestic labour market (with possible downside risks to this remaining evident) and slower US interest rate normalisation path. The outlook for the Euro zone is challenging and this will continue to weigh on sentiment towards the euro, not to mention the announcements by the ECB reiterating possible further “Quantitative Easing' measures are available. Our one year forecast for Australian dollar to the euro has been modestly increased from last quarter to 0.71 as partly a reflection of the divergence in policy. Stimulus measures taken by the Bank of Japan have continued though it remains extremely difficult to forecast what its ultimate success will be and our expectations are that additional measures are likely over the coming months. Our one year forecast for Australian dollar to the Japanese yen remains strongly tied to the strength of the US dollar and we have revised upward our forecast for the Australian dollar to the Japanese yen to near 90 in reflection of a more favourable short term environment for carry currencies. This implies that on balance the yen will marginally weaken against the US dollar. The yen does benefit from its safe haven status, so in the event of a correlated sell-off in markets, this could significantly change the terminal outcome.

We believe that within emerging market currencies volatility will continue to remain elevated as the US moves down the path of interest rate normalisation though at a slower pace. Even with an improvement in the health of the global economy, many emerging markets face difficult times ahead. Some of these economies have been distorted by global monetary policy in recent years which has seen massive portfolio flows into small markets. This has resulted in lax fiscal policies relating to entitlements, structural reform and current account deficits which remain unresolved and exposed going forward. This means that an approach to emerging market currency exposure in the next 12 months will need to be more discerning.

*The G10 includes Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK and the US.

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