JANUARY 2020

Investment Outlook Report

Lonsec

The **Investment Outlook Report** reflects Lonsec's latest views on investment markets and the economy, as well as providing dynamic asset allocation guidance against Lonsec's strategic asset allocation framework.

ISSUE 37

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Overview

What will markets bring in 2020?

Happy New Year and welcome back! It has been a tumultuous time for our country and our thoughts go out to those that have lost homes and loved ones due to the bushfires that have engulfed Australia.

Calendar year 2019 saw most asset classes generate very strong returns with many delivering double-digits returns. Australian equities, as measured by the S&P/ASX 300 Index, returned 23.8%, while global equities, as measured by the MSCI World ex Australia Index AUD, returned 27.6% for the year. At the other end of the asset classes spectrum, bonds also posted strong returns with Australian bonds, as measured by the Bloomberg AusBond Composite 0+ Year Index AUD, returning a solid 7.3% for the year. These returns were generated despite concerns over US-China trade tensions, Brexit, arguably high asset prices and mixed economic news.

A key factor contributing to this market strength has been the fact that interest rates appear to be on hold in the US and possibly heading lower in Australia. This is making investing in growth and interest rate sensitive assets, such as property and infrastructure, attractive when compared to holding your money in cash. Additionally, some of the economic indicators that were trending down, such as the PMI (Purchasing Manager's Index), seem to have stabilised and the consumer seems to be holding up.

In 2020 we are paying particular attention to three key themes:

Valuations

Asset classes are generally trading at fair to expensive territory with US equities appearing the most expensive based on most valuation measures. While interest rates are low these valuations may be sustainable in the near term. However, we expect that at some point valuations will come back into vogue. Timing turning points is difficult however on a forward-looking basis our expectation would be that 'expensive' asset classes will generate lower returns in the future.

The cycle

Much has been written about being late cycle and we think that we are at the later stages of the cycle. There are signs that some economic indicators have stabilised, which markets view favorably. Key things to watch in 2020 will be the consumer and household savings rate, which has been rising, and the possible flow on effect on consumption.

Economic Analysis
Market moves

X-factors

Despite strong market returns, 2019 saw bouts of volatility caused by geopolitical issues including the US-China trade tensions. We expect this geopolitical environment to continue in 2020. Furthermore, we have seen geopolitical tensions rise in the Middle East with growing concerns over US-Iran relations. Such events create market uncertainty and market volatility in the short-term.

We wish everyone a prosperous and safe 2020.

Index returns as at 31 December 2019

	3 Months (%)	6 Months (%)	1 Year (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)
AUSTRALIAN EQUITIES	0.71	3.28	23.77	10.33	9.07
GLOBAL EQUITIES	7.50	8.94	26.81	12.04	10.01
A-REITS	-0.73	0.40	19.57	9.54	11.21
GLOBAL LISTED PROPERTY	0.66	6.64	21.28	7.94	6.62
AUSTRALIAN FIXED INTEREST	-1.32	0.63	7.26	5.14	4.18
GLOBAL FIXED INTEREST	-0.76	1.56	7.19	4.15	4.20
CASH	0.24	0.52	1.50	1.72	1.91
AUD/USD	4.01	0.01	-0.4	-0.87	-3.00

MARKET INDICES:
S&P/ASX 300 ACCUMULATION INDEX
MSCI WORLD EX AUSTRALIA NR INDEX (AUD HEDGED)
S&P/ASX 300 A-REIT ACCUMULATION INDEX
FTSE EPRA/NAREIT DEVELOPED NR INDEX (AUD HEDGED)
BLOOMBERG AUSBOND COMPOSITE 0+ YR INDEX AUD
BLOOMBERG BARCLAYS GLOBAL AGGREGATE TR INDEX (AUD HEDGED)
BLOOMBERG AUSBOND BANK BILL INDEX AUD

Economic Analysis
Markets confronted with risk events

Equity markets continued to march higher in early 2020, supported by the combination of synchronised central bank policy easing and hopes of an economic recovery. While there have been some more positive signs out of China and possibly stabilisation in Europe, US growth continues to slow. Manufacturing and trade remain very weak globally although this has yet to translate into weakness in the consumer and service sectors.

A key development was the signing of the Phase One trade deal by the US and China on January 15, an agreement whereby the US will not lift tariffs further and will halve the tariff of 15% imposed in September 2019 on around US$120 billion of Chinese goods. The 25% tariff on a further US$250 billion of Chinese goods remains in place. For its part, China has agreed to increase imports from the US by US$200 billion over the next two years across the agriculture, manufacturing, energy and service sectors. China has agreed to provide the US firms greater access to several sectors and will strengthen protection of intellectual property. Existing tariffs will, however, remain in place.

The trade truce has been welcomed by markets as it reduces the risk of a further escalation in the trade war and recession, however full resolution of the trade conflict remains unlikely until at least 2021. Removal of existing tariffs is conditional on achieving the targeted increase in US imports over 2020-21. As such, trade tensions are unlikely to disappear anytime soon.

The outbreak of the coronavirus in Wuhan has rattled markets, especially in tourism- and travel sensitive sectors

The US economy has already been impacted by the trade war. The ISM manufacturing index has been in the contraction zone since July 2019. Orders for capital goods, a proxy for business investment, have been flat for the past six months while business confidence is on the cusp of recessionary levels.

The outbreak of the coronavirus in China's city of Wuhan has also rattled markets, especially in tourism- and travel-sensitive sectors. While the economic impact remains uncertain, it adds a further element of risk to the geopolitical landscape. The other major news item prior to Christmas was the impeachment of US President Trump – only the third president in US history to be impeached. On January 15, 2020, a group of seven US House prosecutors, known as impeachment managers, delivered the Articles of Impeachment Against Donald John Trump to the Senate chamber.

This marked the beginning of the impeachment trial to decide whether or not Trump pressured Ukraine to conduct investigations for his personal political benefit. To remove a president from office, two-thirds of the Senate must vote in favour. If the Senate fails to convict, as is expected in a Republican dominated Senate, a president is considered impeached but is not removed, as was the case with both Bill Clinton in 1998 and Andrew Johnson in 1868.

In Europe, there are some signs of stabilisation but little to suggest the manufacturing sector is about to recover. The UK economy has very low unemployment but recent trends in retail sales, manufacturing and inflation suggest a strong case for monetary easing. The Chinese economy has held up somewhat better than expected, owing in part to the stimulus measures put in place. Manufacturing PMI readings are back above the important 50 level, more so with the small-to-medium private sector. Exports have held up better than expected.

In Australia, the equity market has started off 2020 in the same vein as 2019. While Australia may well be close to what RBA Governor Philip Lowe described as a “gentle turning point” in the economy, there is no indication it will achieve a sustainable escape velocity. Markets are being buoyed by easier monetary policy and lower risk-free rate alternatives. The RBA has indicated that if it drifts further away from achieving its inflation and unemployment targets, rates will be cut.

Quarterly Outlook

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Quarterly Outlook

'Mini-cycle' may not sustain markets for long

There are signs of improving economic conditions in Australia, including in the housing sector, which has stabilised as banks have revised their lending criteria following changes to APRA's minimum lending standards.
Meanwhile, positive news on trade war and Brexit fronts have helped boost sentiment, at least by reducing some of the downside risk to growth. Valuations haven't changed materially since last quarter, but we saw recoveries or up-cycles in 2013 and 2016 and we may see another mini-cycle over the next six to twelve months.

We are currently at the base of the cycle and the yield curve is positive after inverting in August but the risk of recession is still present. The global economy is supported by reasonable valuations and improving liquidity, while momentum indicators are also positive, but risk indicators still look elevated relative to history, so we would warrant caution at present. A 'mini-cycle' recovery may not be as strong as previous ones as EPS growth is not as strong, business confidence is still low, and China still has issues.

Australian Equities

The Australian equity market traded sideways over the December quarter. The market eked out a 0.7% gain as measured by the S&P/ASX 300 Accumulation Index. The gains during the recent quarter has contributed to a very strong calendar year 2019 return of 23.8%.

The return was led by the health care sector which gained 13.6%, driven by CSL's performance continuing its positive momentum underpinned by strong earnings outlook through its commercial pipeline of new applications and treatments. The other sectors that preformed reasonably well over the December quarter was energy which rose by 6% with Brent oil price up 11.3% as OPEC agreed to cut production by an additional 500,000 barrels per day. Resources sector returned 5% as investor optimism remained upbeat on the global growth outlook and positive developments on the trade front between US and China moving towards a 'Phase 1' agreement. Consumer discretionary sector finished up 2.8%, a resilient performer with solid retail sales figures on the back of better than expected data emanating from Black Friday and Cyber Monday events.

The laggard sector performer was the heavily weighted financials sector which fell -6.3% in December quarter. The banks face ongoing structural and cyclical headwinds from the regulators and a weaker macroeconomic environment which investors are now factoring in a softer earnings outlook. The regulator blow torch was highlighted with the announcement that Westpac is facing substantial fines over significant contraventions under the anti-money laundering and counter terrorism financing act legislation (AUSTRAC) that resulted in key executive departures including the CEO Brian Hartzer and chairman Lindsay Maxsted.

REITs sector experienced an underwhelming performance in the December quarter down -0.7% as the sector is trading at relatively elevated valuations levels across most of its key metrics. Amongst the AREIT sub-sectors; Diversified (+0.1%) performed the strongest, followed by the Retail (-0.6%) and Office (-0.7%). The Industrial sub sector (-4.7%) was the weakest primarily driven by the underperformance of Goodman Group.

The Small cap segment of the market experienced a similar return outcome in the December quarter to its large cap counterparts returning 0.8% as measured by S&P/ASX Small Ordinaries Accumulation Index; with the Small Resources flat whilst the Small Industrials eked out a 1% rise.

Australian share index performance to 31 December 2019 (total return)

	1 Month	3 Months	1 Year (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)
S&P/ASX 300 TR INDEX AUD	-2.02	0.71	23.77	10.33	9.07
S&P/ASX SMALL ORDINARIES INDEX	-0.29	0.76	21.36	9.98	10.65
S&P/ASX 300 HEALTH CARE	-2.66	13.61	44.93	29.23	20.71
S&P/ASX 300 INFORMATION TECHNOLOGY	-3.89	2.87	37.39	22.87	16.48
S&P/ASX 300 CONSUMER DISCRETIONARY	-2.21	2.47	33.43	11.18	12.55
S&P/ASX 300 INDUSTRIALS	-3.05	3.70	27.82	14.67	14.23
S&P/ASX 300 MATERIALS	1.82	4.46	27.21	16.33	13.87
S&P/ASX 300 CONSUMER STAPLES	-7.75	-2.51	20.98	15.18	9.91

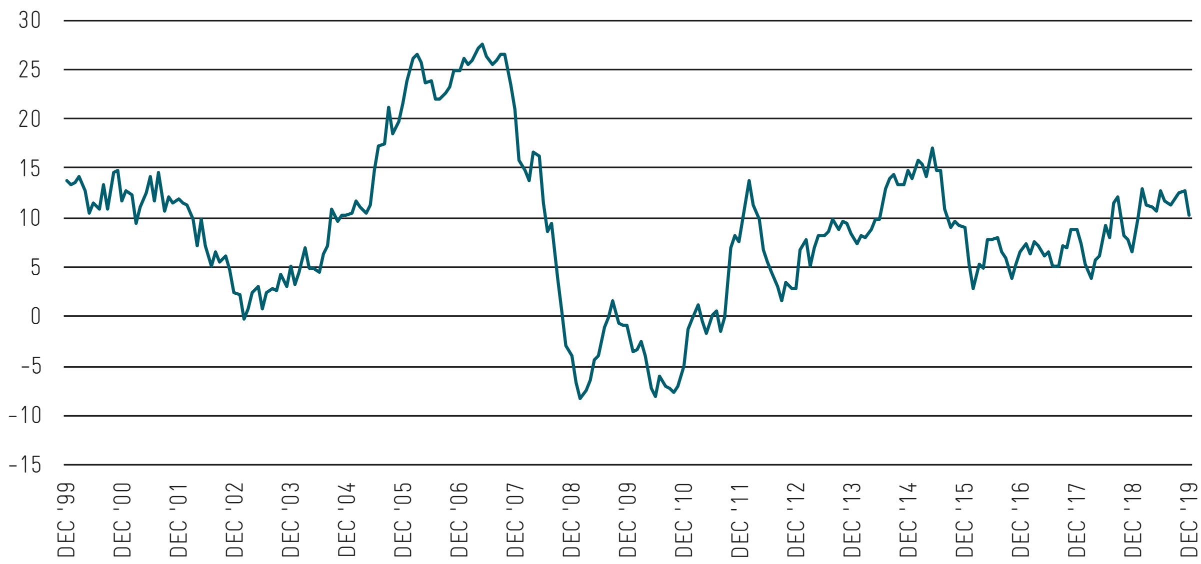
SOURCE: FINANCIAL EXPRESS

The IT sector was the standout performer driven by strong returns from companies such as Bravura, IRESS and Technology One. The Consumer Discretionary sector retreated -4% as companies like A.P Eagers and Bapcor fell heavily as car sales remained near depressed conditions to post their worst trading activity numbers since 2011. The Consumer Staples sector shed -5% for the quarter, with the impact of both the bushfires and the drought weighing heavily on the near-term earnings forecasts and sentiment from soft commodity exposed producers such as Costa, GrainCorp and Freedom Foods.

Outlook

Currently the 12-month forward P/E for the Australian equity market stands at 17.4 times nearing its highest level since 2001, with earnings growth for FY20 coming at a moderate 5% which signifies a relatively expensive market, but investors need to be cognisant of the continuation of ultra-low interest rate settings providing a meaningful valuation support for equities. Could this market backdrop see a reversion to ‘value’ investing in 2020....time will tell!

S&P/ASX 300 TR Index three-year rolling returns (% p.a.) to 31 December 2019



SOURCE: LONSEC, FINANCIAL EXPRESS

An ongoing thematic is the very high dispersion between so-called high P/E sectors and lower P/E sectors which currently stands at 35x. Sectors that are typically associated with greater earnings certainty and/or higher growth prospects i.e. healthcare and IT are being rewarded with materially higher P/E multiples relative to the overall market. Due to the improvement in investor sentiment in 2019, cyclical sectors including retail have participated in the rally whilst banks and insurance companies continue to be assigned lower P/E multiples on a relative basis primarily due to industry specific issues and tempered outlook.

IT stocks are trading on expensive valuations and look increasingly vulnerable without supportive earnings growth. Investors remain bullish in this segment of the market due to the long duration growth potential that is difficult to come by.

There has been anecdotal evidence since tax cuts started hitting household budgets in the September quarter that consumers have been deleveraging and less appetite for taking on more debt leaving discretionary consumption growth at below trend levels.

Positively, residential house prices started to rebound in most major capital cities during the latter part of 2019 which should translate into more robust household consumption in 2020/21.

Global Equities

It proved to be another volatile quarter as the Trump administration in Washington turned up the temperature in the simmering trade war with China. The latest frog to be boiled was Huawei, China's privately-held telecommunications and emerging consumer goods champion.International equities continue to endure the crosswinds created by the US-China trade wars and global central banks unleashing a fresh round of easing. Against this backdrop, the MSCI World NR Index AUD benchmark extended its gains during the September quarter to finish 4.6% higher and lifted the rolling one-year return to 9.2%. The MSCI Emerging Markets NR Index AUD benchmark finish 0.4% lower for the quarter but was 5.1% higher on a rolling one-year basis.

The trade wars have weighed on business sentiment, which is taking its toll on manufacturing and export-sensitive sectors across several regions, particularly Europe, Japan and China. However, the services sector has remained relatively resilient, primarily driven by the robust US consumer sector, which has enjoyed healthy balance sheets, steady employment and wage growth, and low interest rates. The US economy expanded by 2.0% during the June quarter, while unemployment remains at a 50-year low of 3.7% and wage growth is expected to exceed 3.0%.

On the other hand, the eurozone remains anaemic and expanded at a below-trend rate of 0.8% during the June quarter, hampered by reduced consumer spending and trade tensions. Additionally, uncertainty surrounding Brexit appears to be catching up with the UK economy, which contracted 0.8% in the June quarter. The pronounced dispersion in performance across international equities sectors and regions should see investment opportunities increase for active managers.

Emerging markets remain in the passenger seat of the ongoing trade wars, which saw emerging market equities remaining under pressure. Export-dependent economies such as China, Taiwan and South Korea continue to feel the negative impact, which has been exacerbated by tensions between Japan and South Korea. Growth in China slowed to 6.2% year-on-year during the June quarter as the escalating tensions weakened business confidence and export growth. Even emerging markets that are less exposed to global trade, such as India and Brazil, have seen a slowdown due to weakness in consumer spending and a lack of progress on much needed government reforms.

Global equities finished the 2019 calendar year on a positive note with the MSCI World ex-Australia (AUD) Index up 4.3% during the quarter, and up 28% for the year. Market sentiment remained constructive for much of the quarter and was assisted by subsiding fears of a global recession and the improving global growth outlook, despite the market volatility created by ongoing geopolitical concerns and trade tensions.

The US and China reached a trade deal late during the quarter, and subsequently announced the first phase of the trade agreement that was signed on 15 January, which should provide significant relief to markets after two years of tit-for-tat retaliations between the two sides.

US equities surged during the quarter, which saw the S&P 500 Index up 9.1%, and up 31.5% for the year (in USD terms). The strong performance was predominately led by the Information Technology and Healthcare sectors. However, the theme of weaker earnings growth continued during the quarter, with third quarter earnings growth declining by 2.2%, albeit was ahead of market expectations for a 4.1% decline.

Markets are expecting a further decline during the fourth quarter of 1.5%, which would mark four consecutive quarters of negative earnings growth for the first time since 2016. Despite the weaker earnings growth, the US economic backdrop remains positive supported by the US Federal Reserve lowering interest rates by 25 bps in October 2019, and healthy consumer spending on the back of a record low unemployment rate of 3.5% and wage growth hovering around 3%.

European equities also gained ground with the MSCI Europe Index up 4.6% during the quarter, and 24.3% for the year despite the modest economic growth rate of 0.2% during the third quarter. The manufacturing sector in the Eurozone contracted for the eleventh consecutive month in December 2019, and was hampered by the ongoing Brexit uncertainty and trade tensions, which prompted the European Central Bank to restart its asset purchase program back in September 2019.

Pleasingly, the worst appears to have passed for the Eurozone, with the Brexit bill being passed by the UK parliament in January 2020, possible fiscal support from the German government, and the largest increase in exports in two years helped by the weaker Euro currency. Markets are now expecting earnings growth in the Eurozone to increase by 1.3% during the fourth quarter after three consecutive quarters of declines.

Global share index performance to 30 September 2019 (net return in AUD)

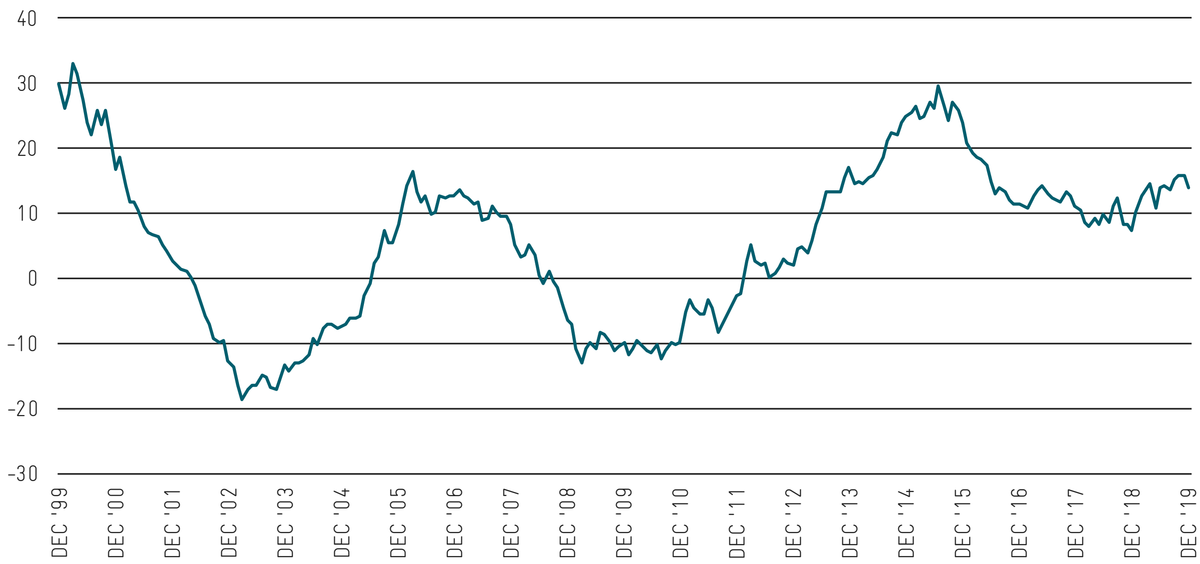
	1 Month	3 Months	1 Year (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)
MSCI AC WORLD INDEX	2.00	4.02	8.76	14.43	12.35
MSCI WORLD EX AUSTRALIA INDEX	2.01	4.65	9.13	15.01	13.01
MSCI WORLD EX AUSTRALIA INDEX (AUD HEDGED)	2.30	1.34	1.92	11.24	9.29
MSCI WORLD EX AUSTRALIA SMALL CAP INDEX	1.97	3.15	1.33	12.36	12.77
MSCI EMERGING MARKETS INDEX	1.80	-0.37	5.12	10.53	7.80

SOURCE: FINANCIAL EXPRESS

Asian equities breathed a sigh of relief following the trade deal between the US and China, which saw the MSCI Asia ex-Japan Index finish 7.3% higher for the quarter, and 18.4% for the year. Despite the trade tensions, the Chinese economy continued its expansion, growing by 6.1% during the quarter. Industrial production and retail sales both improved, which saw the local CSI 300 Index finish the quarter 7.4% higher, and 38.9% higher for the year.

The region was also supported by accommodative monetary policy, with the central banks of South Korea and India both cutting interest rates in October 2019. However, the Japanese economy continues to face significant headwinds, with industrial production slowing the most in a year and business confidence declining to a seven year low. Likewise in Hong Kong, the city continues to be crippled by large scale protests impacting business activity, retail sales and tourism, causing the city to enter its first recession for a decade. During the quarter, the MSCI Emerging Markets Index was up 7.3%, and up 18.6% for the year.

MSCI World ex Australia NR Index three-year rolling returns (% p.a.) to 31 December 2019



SOURCE: LONSEC, FINANCIAL EXPRESS

Outlook

Global equities have remained resilient towards the end of the 2019 calendar year in the face of ongoing geopolitical concerns and trade tensions, and improvements late in the quarter should provide further support for equity markets. The US and China trade deal and first phase of the trade agreement, the Brexit bill being passed by the UK parliament, and the lesser publicised US budget agreement between the Democrats and Republicans have all contributed to the improvement in market sentiment. While the events on their own are not expected to have a meaningful impact, they have removed much of the negatives that have hampered global equities.

Against this backdrop, central banks have played a key role in the strength of global equities led by the US Federal Reserve pivot in January 2019, followed by others in cutting interest rates and maintaining their accommodative monetary policy. In the absence of further deterioration in the global growth outlook, the work of central banks appears to be finished for now, particularly in the US leading up to the presidential elections in November. The accommodative monetary policy of the European Central Bank and Bank of Japan as well as improvements in the two regions are expected to remain supportive for global equities.

However, valuations across most regions remains above their long term average from a PE standpoint, albeit remains relatively attractive from a dividend and bond yield standpoint. Market expectations are for positive earnings growth following the declines experienced in 2019, which should benefit active, bottom-up managers who can identify companies with improving earnings while avoiding excessive valuations. The risk remains that against the positive backdrop of improved market sentiment and accommodative monetary policy, global equities can continue their strong upwards trajectory.

Additionally, two near-term uncertainties remains around the US and China trade agreement and US presidential elections. While both events are not expected to have a meaningful impact on global equities until there is further clarity around the second phase of the trade agreement and proposed policies of the presidential candidates, both will remain potential sources of market volatility well into 2020, which should create further opportunities for active managers.

Cash and fixed interest

The RBA maintained the official cash rate at an historical low of 0.75%, with rates left on hold post the 25 bps cut in October. The RBA noted in December that notwithstanding the Australian economy appearing to have reached a gentle turning point, they remain in easing mode prepared to cut rates further if required to support economic growth, employment, and to achieve the inflation target. While the RBA expect inflation to gradually increase (as it did at the most recent print in January), subdued wages growth and restrained levels of consumer spending remain the key risks to this not being achieved.

Consumer spending has been relatively weak despite recent fiscal stimulus and interest rate cuts boosting household disposable income. With low wage growth in recent years and little expectation of this to change markedly any time soon it is hard to see a catalyst for consumer spending to pick up. The drought and fallout from the unprecedented bushfires will provide a further drag on confidence, and the economic impact will not be known for some time.

The strong turnaround in the housing market continued over the quarter for Melbourne and Sydney, and to a lesser degree across other established markets. Early indications are that the housing market will continue to strengthen in 2020.

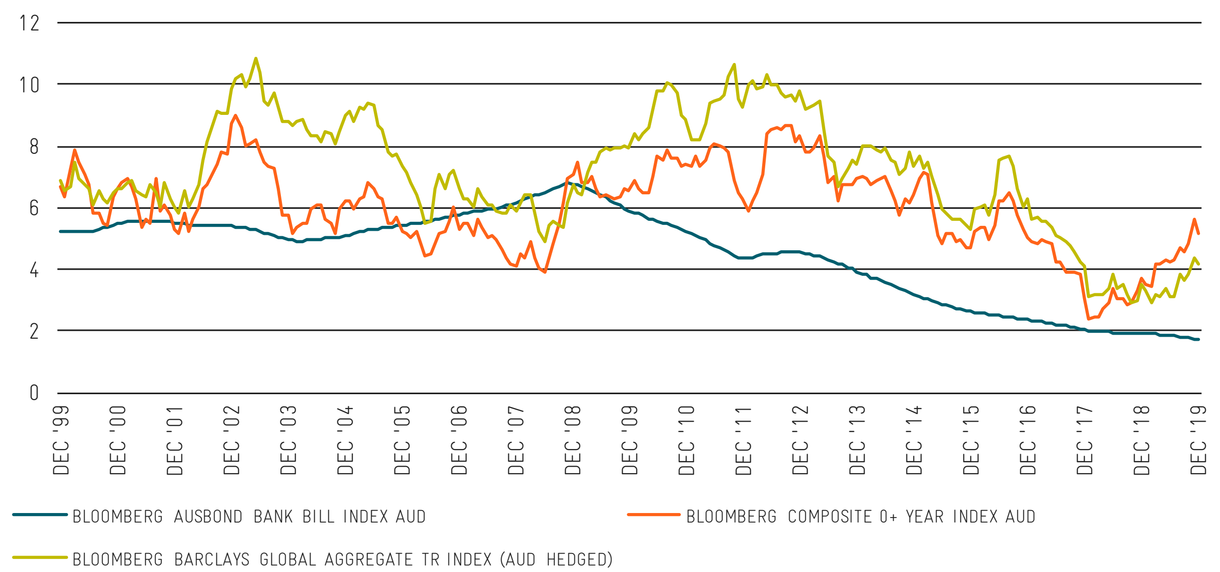
Geopolitical noise dominated global markets in 2019 with US-China trade conflict and Brexit matters dominating headlines and distracting from fundamentals. The year ended on a relatively upbeat note with the UK election win providing the required majority to aid in Brexit passing, and promising developments regarding US-China trade situation. However, tensions have flared in the Middle East with the deteriorating US-Iranian relationship being a concern. The RBA see the outlook for the global economy as reasonable with risks to the downside albeit to a lesser degree than previously.

Australian fixed interest

Australian Government bond yields ultimately moved higher over the quarter with the 10-year government bond rising 38 bps to 1.39% as at 31 December. As at the time of writing, bond yields have rallied sharply in the opening weeks of 2020 (0.96%). Initially yields fell post the RBA's October decision to cut official rates by 25 bps by mid-October. Australian Government bond rates had moved off their lows along with US, UK and German counterparts.

Despite Australian government bonds being better value currently than a few months ago, we currently prefer US bond exposure over domestic.

Australian fixed interest three-year rolling returns (% p.a.) to 31 December 2019



SOURCE: LONSEC, FINANCIAL EXPRESS

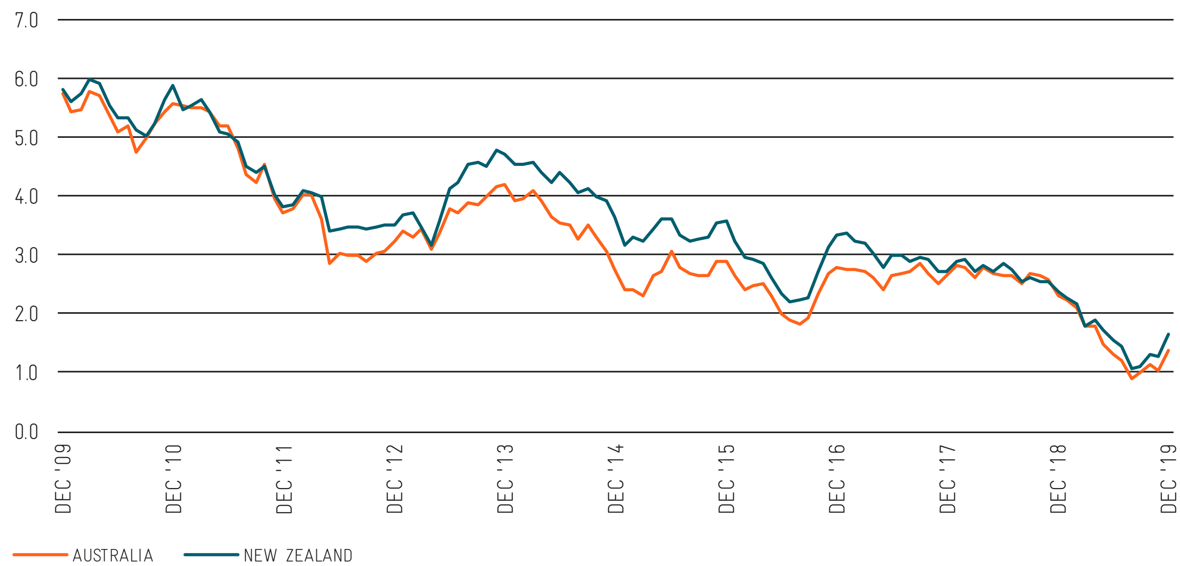
The Australian bond market, as measured by the Bloomberg AusBond Composite 0+ Yr Index, fell 1.32% over the quarter driven by increasingly positive market sentiment surrounding geopolitical events. Yields remain low across both government and corporate sectors, however the search for yield remains strong. The market consensus continues to be an expectation of at least one further RBA rate cut in this financial year with a high probability priced in that the official cash rate goes as low as 0.25%.

The RBA has indicated 0.25% represents the lower bound for the official cash rate. If further stimulus is required by the RBA it would be in the form of unconventional policy. The RBA has intimated the desire to see the currency avoid appreciation has played a part in rate cut decisions.

Global fixed interest

Globally interest rates are low, with expectations of further easing largely scaled back. It is now generally accepted growth globally is and will remain slow for some time, with global trade and geopolitical risk and now the spread of coronavirus, which is an x-factor for markets.

Australian and New Zealand 10-year government bond yields (%)



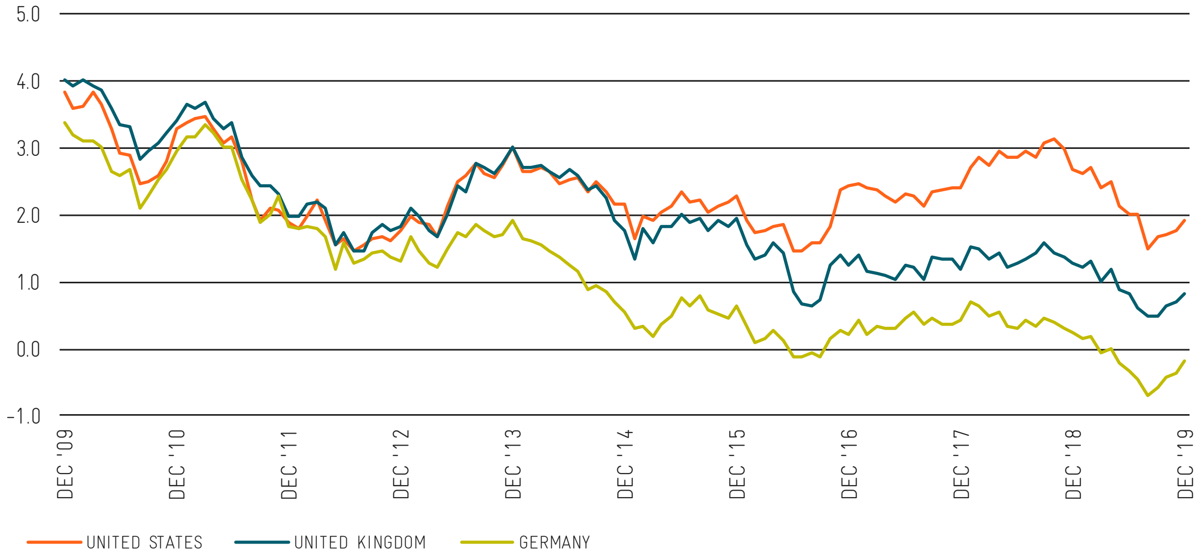
SOURCE: LONSEC, BLOOMBERG

The US 10-year treasury note ended the year at 1.92% a 0.26% rise on end of September. US labour market data is pointing to moderate growth with constrained wage growth. This supports the Feds aim to keep rates on hold until such time as inflation picks up. With business confidence levels in Europe at similar levels to those experienced in a recession, investment is being impacted. The manufacturing sector remains weak in particular for Germany where motor vehicle production is off 14% year-on-year.

After a strong year, bonds were among the worst performing asset classes in December and the global bond market, as measured by the Bloomberg Barclays Global Aggregate Index (USD Hedged) delivered a return of -0.49% over the quarter. Notably this was the first negative return for the index over a quarter since September 2018. Looking at the Global Equity to Global Bond return ratio charted against the G7 unemployment rate suggests there may be further downside risk for bond returns. Going forward it is anticipated growth may pick up with many central banks easing in past few months stimulating economies. We continue to favour global bonds over Australian bonds largely from a valuation and diversification perspective.

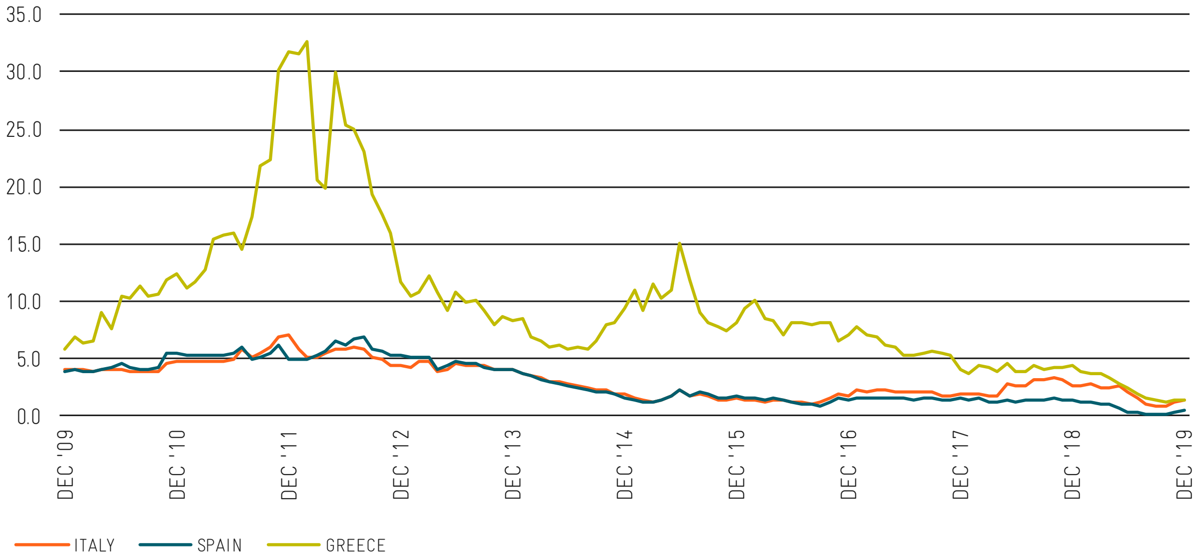
Quarterly Outlook

US, UK and German 10-year government bond yields (%)



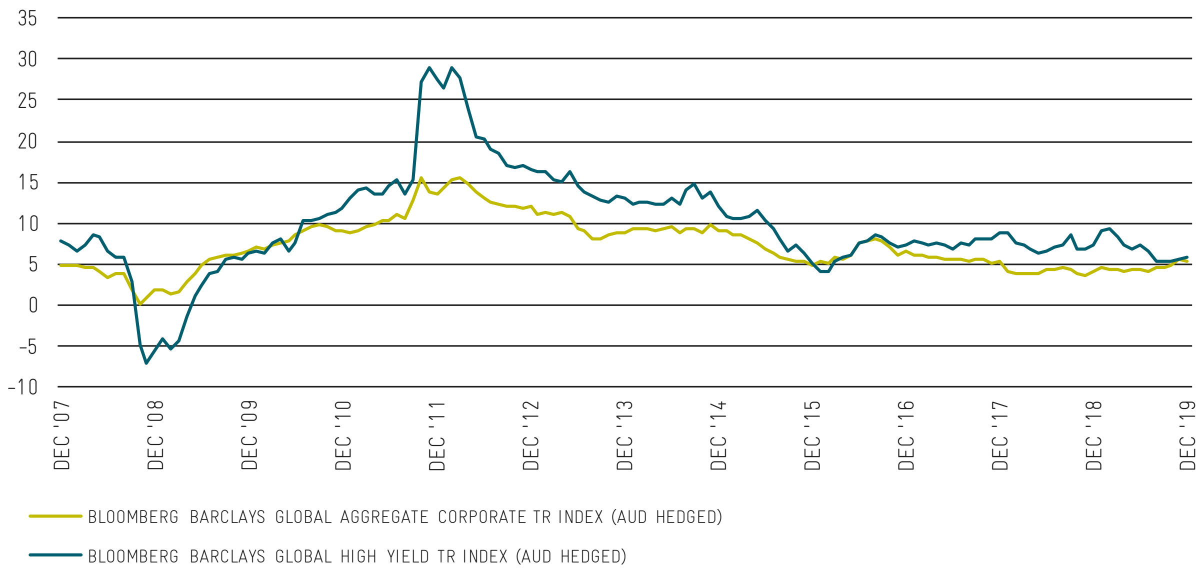
SOURCE: LONSEC. BLOOMBERG

Italian, Spanish and Greek 10-year government bond yields (%)



SOURCE: LONSEC. BLOOMBERG

Investment grade and high yield credit three-year rolling returns (% p.a.) to 31 December 2019



SOURCE: LONSEC. FINANCIAL EXPRESS

Credit

The Australian iTraxx index tightened from 67 bps at September to just 47 bps by end of December. Globally both Investment grade and high yield spreads tightened over the quarter, the differential narrowed with high yield tightening to a greater extent. The above chart shows both Investment grade and high yield currently returning roughly the same over a rolling three-year period. Bloomberg Barclays Global High Yield Total Return index outperformed over the quarter returning 2.67% against Bloomberg Barclays Global Aggregate Corporate Total Return index returning 0.53%. The fundamental view remains unchanged while credit spreads remain expensive, offering select points of value. In addition, volatility is expected to continue over the coming year.

Emerging markets

Emerging Markets are an attractive option for investors seeking yields well beyond what is on offer in other developed markets, with many active managers choosing to utilise a portion of their risk budget in these assets. Even more seductive in that regard are those countries bucketed in frontier markets such as Ghana, Kenya or Egypt which yield around 10-20% on their local currency bonds. The decision of whether to invest in hard or local currency exposure is also part of an allocation decision, one which can impact returns greatly.

Unrest in Chile through the last quarter saw spreads widen and International interest increase. The Chilean government has announced intentions to issue billions of US dollar and Euro denominated debt in the coming year. We highlight that although attractive in a yield sense, emerging market debt can be highly susceptible to a number of factors, such as geopolitical risks, a strengthening US dollar, for most of the rise and fall of commodity prices, and idiosyncratic factors.

Property and infrastructure

The December quarter 2019 was a subdued finish for **Australian Property Securities** (-0.9% average of S&P ASX200 & 300 indices), although the sector outperformed the broader **Australian Equities** index (-2.2%). Calendar 2019 was a strong year, where the **Australian Property** sector gained 19.5%, but underperformed Australian Equities (+23.4%).

Against a background of bond yields edging back up, **Global Property Securities – AUD Hedged** (+0.6%) significantly lagged a surging **Global Equities – AUD Hedged** (+7.3%) for the December quarter 2019, with unhedged returns (-2.4%) reduced by the stronger AUD. For calendar 2019, **Global Property Securities** performed well (+16.3% AUD Hedged), but trailed the **Global Equities** index (+26.7% AUD Hedged).

Global property markets

The best performing sub-sectors were similar to the last update. **Manufactured Homes** and **Single Family Homes** reflected the improved residential sector, although the **Apartments** sector performed in-line with the index over calendar 2019 as some changes to regulations in New York and Los Angeles took effect. **Data Centres** and **Industrial** earnings are beneficiaries of the digital and ecommerce revolutions. The Industrial, Technology Real Estate, Residential and Diversified Triple Net Lease sectors are the most favoured sectors in the US for 2020.

Despite the poor sentiment for **US Retail** property securities, **Shopping Centres** (+25.0%) and **Free-standing Retail** (+24.8%) performed in-line with the FTSE NAREIT REITs index (+26.0%) over calendar 2019. The sector was dragged down by the negative returns from **Regional Malls**. This again emphasises that investors need to be discerning and Shopping Centres that are anchored by food/service retailers are still highly sought after. Nevertheless, the sector overall will continue to be affected by the global trend towards on-line retailing, with retail property landlords readjusting the tenant mix to cater for the changes to how consumers shop. Department stores, clothing and fashion seem to be the hardest hit. Yet it is not all one-way traffic – interesting to note that selected automotive retailers are setting up showrooms in shopping centres.

Lodging/Resorts and **Self-Storage** were lagging sectors in 2019, with the former affected by variable occupancy levels, while the latter continues to have a reliable but moderate earnings profile. These sectors are estimated to have below average earnings growth in 2020. **Healthcare** and **Office** sectors are expected to see earnings growth in line with the US average.[1]

[1] CBRE Clarion Securities, January 2020

Europe (+27.3% in US$) was the best performing region in calendar 2019. The civil disruption in **Hong Kong** was highlighted in the last issue and the Asia region's performance during 2019 lagged (+17.1% in US$), held up by **Japan** (+27% in US$) and **Australia** (+20% local currency). Earnings growth across regions in 2020 is expected to be fairly even (+4% to 6%), except for Canada and Hong Kong.[1]

As at 31 December 2019, the Global REIT sector is trading at a modest 2% discount to Net Asset Values and US REITs at a 5% premium (which is above the long-term average of around +2%). Global property securities dividend yields are in the 3.8%-4.0% range.[1] However, valuations of sub-sectors and regions vary and most Managers are positioning their portfolios according to their assessment of relative value of stocks within their sector and region.

US REIT performance

Strongest sub-sectors	Calendar year 2019	Weakest sub-sectors	Calendar year 2019
MANUFACTURED HOMES	+49.1%	RETAIL – REGIONAL MALLS	-9.1%
INDUSTRIAL	+48.7%	SELF-STORAGE	+13.7%
DATA CENTRES	+44.2%	LODGING/RESORTS	+15.7%

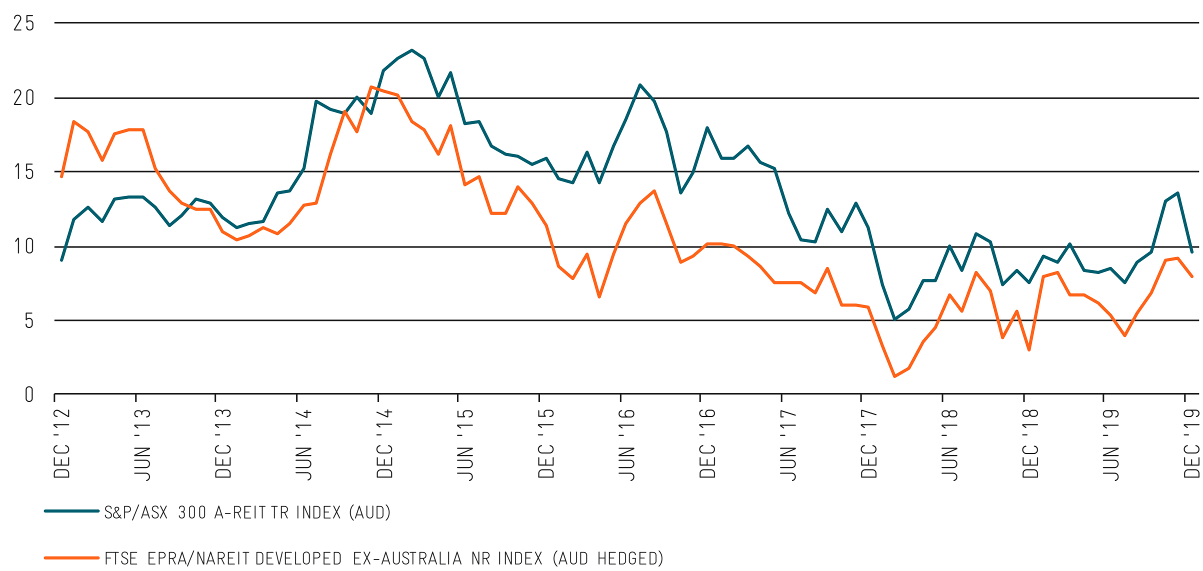
SOURCE: FINANCIAL EXPRESS

We are still of the view that global property markets are in the mature part of the cycle, albeit it appears the tail of which is being extended while inflation/interest rate pressures are kept at bay. This is supported by CBRE Clarion's analysis that "REIT's perform best when the Conference Board's Leading Economic Index (LEI) is Moderating and worst when Contracting. The LEI has been Moderating since July 2018."[1]

Australian commercial property markets

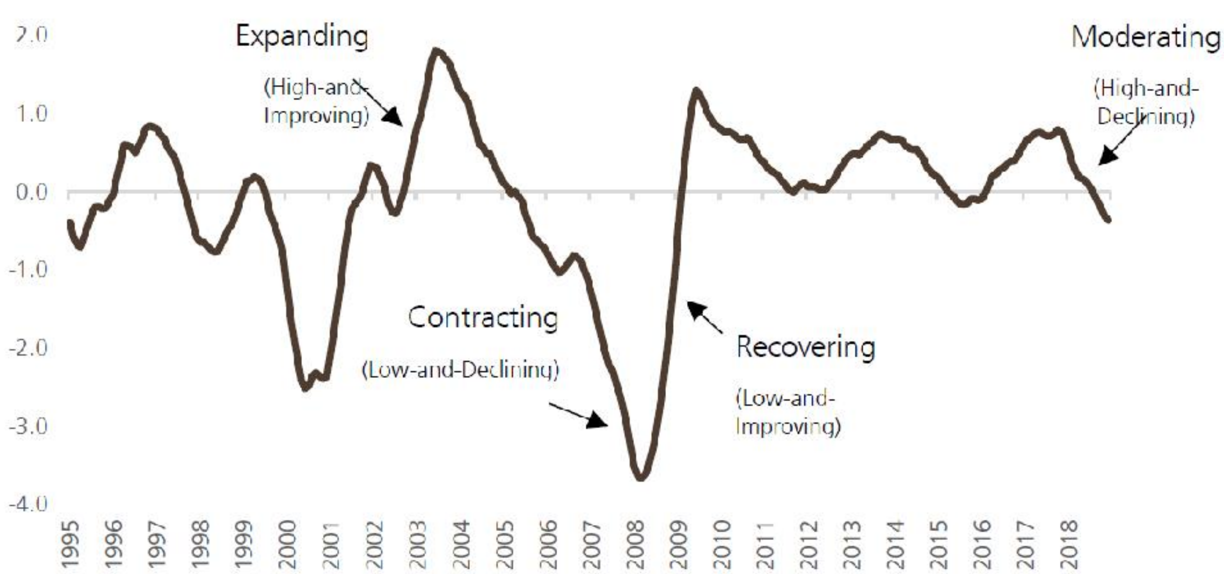
From a macro perspective, while we believe the Australian real estate market to be late in the cycle, 'lower for longer' monetary policies have extended this cycle's duration. With capitalisation rates having fallen significantly over the past few years, future returns are likely to be driven more by asset-level net operating income (NOI) growth.

Australian and global property three-year rolling returns (% p.a.) to 31 December 2019



SOURCE: LONSEC, FINANCIAL EXPRESS

US Economic Cycle Indicator (based on the Conference Board's Leading Economic Index)



SOURCE: CBRE CLARION SECURITIES

The **retail sector** continues to suffer headwinds with a number of well-known retailers recently going into administration (Harris Scarfe, Jeanswest) or shutting down stores (Bose, Australian Geographic, and 166 year old Dimmys). While retailers received some relief towards the end of the December quarter 2019 thanks to an uplift in sales off the back of Black Friday promotions, this may have only brought forward Christmas consumer spending with anecdotal evidence indicating the holiday period was quite slow for business.

Australia's devastating bushfires may also have a part to play, with consumer sentiment declining over this period, albeit slightly above the four-year lows experienced in the previous quarter.[2] Retail bifurcation and 'flight to quality' continues to benefit shopping centres that are grocery-anchored and/or have a mix of experiential retail offerings in densely populated primary trade areas. Retail stocks had a mixed performance against the A-REIT 300 index (-1.0%) in the December quarter 2019 with some outperformers like **SCA Property** (+5.1%); **Unibail-Rodamco-Westfield** (+5.1%) and **Stockland** (+4.5%) which is a diversified stock with significant retail exposure. Underperformers included **Vicinity** (-0.2%); **Scentre** (-2.5%) and **GPT** (-6.9%) another diversified stock.

The e-commerce boom continues to power investors towards the **logistics/industrial sector** despite falling capitalisation rates. Tenants face a very limited supply of well-located warehouses, logistics and distribution centres with good transportation links and population proximity. 'Brown-field' sites which meet this criterion are especially difficult to find resulting in higher prices and rentals. Stocks with significant industrial exposure like **Goodman Group** (-4.7%) and **Charter Hall Group** (-3.4%) experienced a pull-back in the December quarter 2019, with some investors noting the risk to the development and funds management components of these companies earnings. Nevertheless, the near-term outlook remains sound for the industrial property sub-sector globally.

The **office sector** vacancies are at or near record lows in the Sydney CBD (4.0%) and Melbourne CBD (3.4%) with solid rental growth and falling incentives.[3] Driving factors are solid employment growth; record infrastructure spending over the next four to five years (NSW $90b; Victoria $60b)[4]; and strong tenant demand for well-located quality office space. A significant portion of the ~685,000sqm worth of new supply coming to market in these two cities over 2019-22 (Sydney 58%; Melbourne 82%) has already been pre-committed.[5] Looking ahead, we expect net operating income growth to play a larger part in overall returns as capital value appreciation over the past few years has been mainly due to falling capitalisation rates.

[2] Westpac Melbourne Institute Index of Consumer Sentiment (December 2019)
[3] Lonsec estimates based on JLL Research (December 2019)

The **residential sector** is turning around with the RBA's successive interest cuts and APRA's easing of credit lending guidelines stoking buyer interest to the extent that Melbourne house prices experienced an +8.7% increase over the December quarter 2019.[6] Loan commitments (a leading indicator) have risen, however are still down significantly from the highs of late 2017.[7] Demand for housing continues to be supported by strong population growth and solid employment markets, which is anticipated to flow through to improved sales for residential developers over 2020.

A-REIT market fundamentals remain sound with relatively low gearing (~29%)[8], dividend yields of ~4.7% p.a. plus earnings growth of 4%-5% for 2020 supported by the 'lower-for-longer' interest rate outlook. Valuations overall for the sector are sitting at a 2% discount to NAV (compared to the ten year average 4% discount), with the retail sector at a greater discount and more sought after sectors (logistics/industrial/specialised) at a premium.[9]

Global infrastructure markets

During the December 2019 quarter **Global Infrastructure Securities – AUD Hedged** (+2.1%) underperformed the surging **Global Equities – AUD Hedged** (+7.3%), with unhedged returns held back by a slightly stronger A$ (primarily against the USD). For calendar 2019, Global Infrastructure Securities (Hdg +23.5%; +26.7% Unhdg) slightly underperformed Global Equities (Hdg: +26.7%) amidst the rise in bond yields during the last quarter.

Better performing sectors over 2019 included **US Utilities** (upper end of historical range); **Towers** are looking expensive at 25x EBITDA and toll roads had a big re-rating over 2019 (EBITDA multiples 10-11x).[10]

The **UK utilities** sector performed strongly post the UK election result where the Labour Party's defeat meant their nationalisation plan of water and energy companies is not a concern for the foreseeable future. In addition, **United Utilities** also benefited from the water regulator Ofwat deciding on a less than expected reduction in allowable return for the next period.[11]

Energy Infrastructure (oil & gas pipelines) had a tough 2019. With listed valuations below 10x EBITDA multiple, private equity was active in acquisitions but still paying significantly more for specific unlisted assets.

[4] NSW/VIC Budgets (2019-2020)
[5] CBRE Research (September 2019)
[6] Domain (December 2019)
[7] ABS – Lending indicators (November 2019)
[8] Antares – Quarterly update (September 2019)
[9] UBS / CBRE Clarion – Australian REIT Outlook (January 2020)

The **Productivity Commission Review of Australian Airports** final report was released in October and predominantly reiterated the draft report recommendation that Australia's existing **'light-handed'** airport regulation (no need for a third-party adjudicator) remains fit for purpose at the four largest airports, although the Commission will revamp its airport monitoring process. This was positive for Sydney Airport and the unlisted owners of Melbourne, Brisbane and Perth Airports.

More recently though, international tourism has been hurt by the Australian bushfires and potentially the recent outbreak of the Coronavirus (some flights from China halted). While this has negatively impacted the **Sydney Airport** and **Auckland Airport** share prices, past events have shown these disruptions to be temporary.

[10] AMP Capital
[11] RARE Infrastructure, December Commentary (January 2020)
[12] AMP Capital