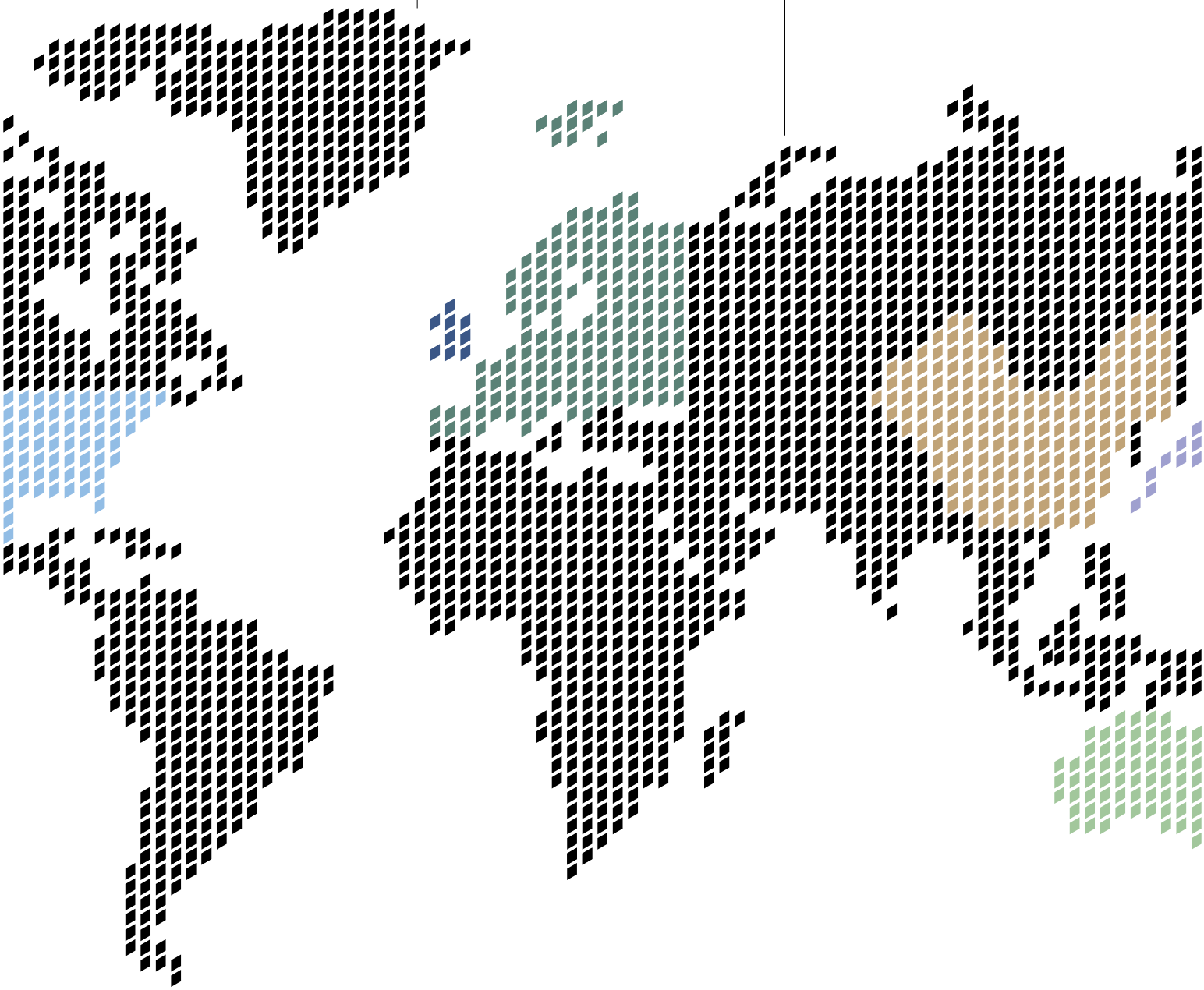
ESCALA
PARTNERS

AGENDA 2020

Chief Investment Office



Welcome

It is my pleasure to present our new annual investment publication, Agenda 2020. This publication is compiled by our investment team headed by our new Chief Investment Officer, Tracey McNaughton.

After an uncertain start in 2019, one that began in the shadows of a sharp retracement in financial markets, last year finished considerably better than expected. This was due in no small part to the quick turnaround in policy settings by the US Federal Reserve and a substantial easing of trade tensions and Brexit concerns.

What can we expect for 2020?

Central bank activity is unlikely to play as dominant a role in price discovery as it did in 2019 given how low interest rates already are. Having said that, we expect the current setting of global monetary policy to remain extremely accommodative for some time. Inflation pressures remain benign across the board, thanks in part to the commercialisation of new technology.

We are expecting governments to play a greater role in influencing market fundamentals in 2020. The increase in income and wealth inequality in the wake of the financial crisis has had its effect on elections, leadership and referendums. We expect it will now be felt in the form of stimulatory fiscal policy.

We believe the trend toward sustainable investing will accelerate this year. Among a growing number of fund managers we are seeing environmental, social and governance data being treated with as much reverence in the financial analysis of an investment as the income statement or the balance sheet. We expect this to continue.

Escala is committed to delivering tailored outcomes to our clients through the provision of thoughtful analysis and considered advice. I hope you find this outlook from our new look Chief Investment Office both interesting and relevant as you think about the path ahead.

Pep Perry
Chief Executive Officer

Contents

Our Views in Brief

Global Growth

We expect global growth to rise in 2020 as an easing of trade tensions puts a floor under global manufacturing activity. This will support emerging market economies, as will an easing in the US dollar. Monetary policy will largely be on the sidelines in developed markets but easing will continue elsewhere. Fiscal policy is likely to become slightly more accommodative.

Inflation

In our view inflation is one of the biggest risks to our base case scenario and one that is the least expected by the market. Despite the tightness of labour markets globally, wages are still largely contained reflecting a flat Phillips curve.

Interest Rates

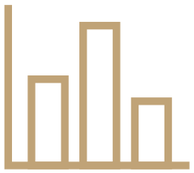
2019 was a year of global synchronized easing of monetary policy. We are unlikely to see that in 2020. Conventional monetary policy is all but exhausted in developed markets. Further easing can be expected in emerging markets, however, which will be supportive of growth.

Fiscal Policy

We expect governments to finally yield to the pressure for expansionary budgets in 2020. This is particularly the case in Japan, the UK, and Europe. Talk of infrastructure spending is likely to take centre stage in the US as the November election approaches.

Bond Yields

After an initial re-pricing of term premia, we expect bond yields to remain largely range bound for 2020. Our base case scenario suggests only a gradual move upwards in inflation as excess capacity in labour and product markets depletes. Interest rates at the short end will remain well anchored resulting in a steepening in yield curves.



Equities

Accommodative monetary policy, steeper yield curves, and an easing of trade tensions should support global equities in 2020. A weaker US dollar will be supportive of financial conditions in the US. Australian equities will be pressured by slowing economic growth, constrained fiscal policy and an expected rise in the Australian dollar.

Currencies

The US dollar should weaken with an easing of US-China trade tensions. The boost to Asian economies though re-configured supply chains will put upward pressure on commodity prices and the Australian dollar.

Alternatives

Private markets should continue to benefit from the illiquidity premium but the significant fund flows into the sector means valuations will be pressured higher. We like infrastructure for its income qualities and its diverse universe of sectors. It will also act as a hedge against inflation should that risk arise.

The Dickensian Economy

Tracey McNaughton
Chief Investment Officer

It has been the best of times and the worst of times for the US economy. While this expansion has been the longest on record at over 126 months, it has also been the weakest on record. Similarly, the equity market has had a record run, at least in terms of duration (the tech-inspired 1990–2000 bull market still leads the way in terms of total return). As we enter the third decade of the 21st century, our base case scenario for investors is that there is still too much policy support for this trend to end just yet.

We believe the key influencers of market returns in 2020 will be easing trade tensions, policy support and geopolitics. In our base case scenario, we are expecting trade tensions to ease as the focus for President Trump turns to the November presidential election.

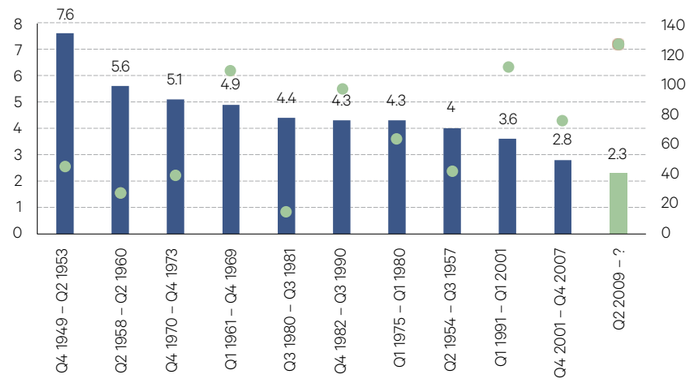
2019 saw the greatest number of central bank rate cuts since 2008.

This will support global manufacturing and trade, providing some relief for the most export-oriented economies such as Germany, South Korea and Mexico. Monetary policy will remain largely on hold (outside of emerging markets) given the benign outlook for inflation, while fiscal policy will become more expansionary, particularly in Japan, the UK and to a lesser extent Europe. Geopolitical risks will continue to cause intermittent volatility.

The premise behind our bull case scenario is that the green shoots that have already started to appear in the manufacturing sector start to resemble trees more than weeds. The amount of liquidity pumped into financial markets by global central banks will find its way out of cash and into financial markets as confidence returns in the wake of the US-China trade deal. Emerging market economies will once again support global trade and growth will pick up in Europe and Japan resulting in a more synchronized global growth cycle.

In our bear case scenario, trade tensions re-escalate as President Trump doubles down adding Europe to his tariff hit list. Growing fears of a Democrat winning office in the US election weighs on market expectations for corporate earnings given fears of a wind back of the 2017 tax cuts. Significant expansionary fiscal policy remains wanting and so the heavy lifting continues to sit with central banks who are increasingly bereft of growth-boosting ideas.

"The best of times, the worst of times"
Longest, but weakest recovery in post WWII era

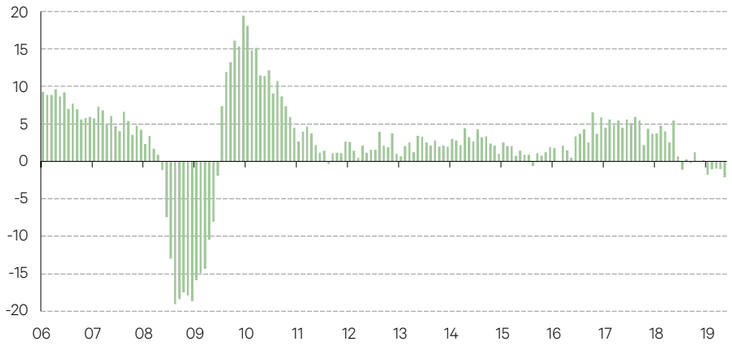


Bars: Avg GDP gth in the expansion (%)
Dots: Duration of expansion in mths (R)

Source: Bloomberg

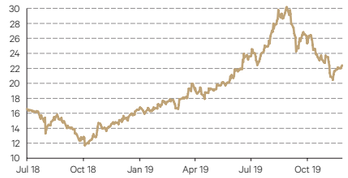
Global trade growth has weakened considerably since the escalation of the trade war in May last year. An easing of trade tensions, re-configuration of supply chains, and increasingly accommodative monetary and fiscal policy should see at least a partial bounce back in trade this year.

Global Trade Volume (YoY %)



Source: Bloomberg

Share of Negative Yielding Debt (% total)



At the beginning of the decade, there wasn't $1 of negatively yielding debt in the world. Today there is $15 trillion worth representing 22% of total global debt on issue.

Source: Bloomberg

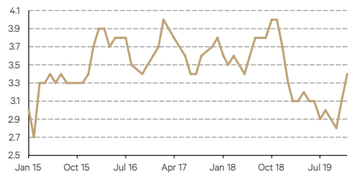
Five key causes of US Recessions

Recession	Industrial	Oil	Monetary	Financial	Fiscal
Aug-1918					■
Jan-1920			■		■
May-1923	■				
Oct-1926	■				
Aug-1929				■	
May-1937			■		■
Feb-1945					■
Nov-1948	■				
Jul-1953					■
Aug-1957			■		
Apr-1960			■		
Dec-1969			■		
Nov-1973		■	■		
Jan-1980		■	■		
Jul-1981			■		
Jul-1990		■	■	■	
Mar-2001				■	
Dec-2007				■	

Recession risk in the US receded significantly by the end of 2019. Historically, the main cause of a recession is tighter monetary policy. Since 1955, there have been nine recessions. Seven of those were directly caused by monetary policy. The last two recessions in 2001 and 2007, caused by the bursting of the tech and housing bubbles respectively, were indirectly caused by tighter monetary policy. The about-face on policy by the US central bank last year went some way to heading off the risk of a recession in 2020.

Source: Goldman Sachs

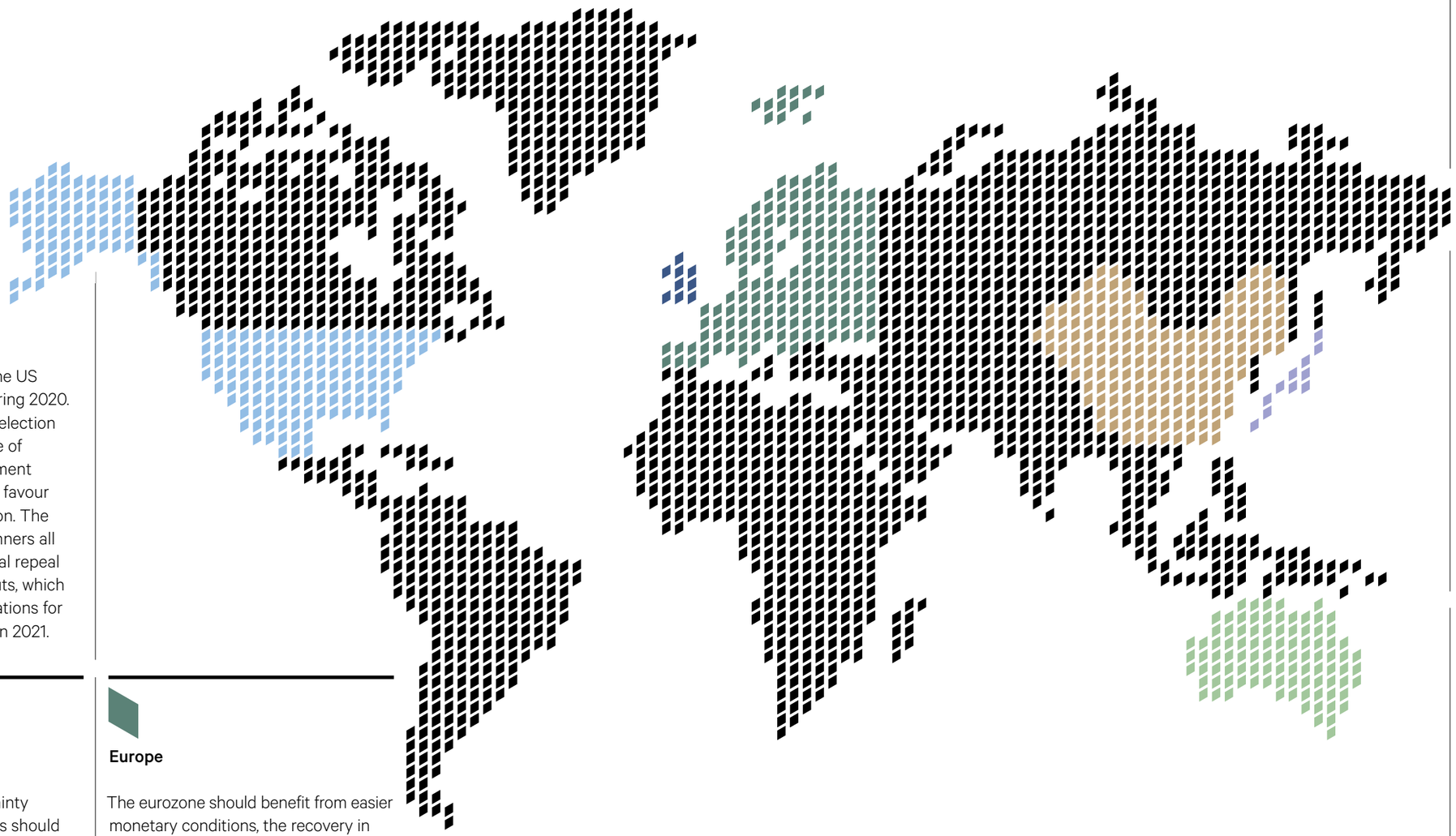
World Economy Weighted Inflation (YoY %)



The main reason for the longevity of this cycle has been the persistence of economic slack which in turn has been facilitated by record low interest rates. While this has allowed the US and other developed economies to grow without generating significant inflation, it has resulted in a rise in what the Bank of International Settlements calls "zombie" companies – companies that subsist only because of cheap financing." In other words, Schumpeter's "creative destruction" is not working. It is very hard to go bankrupt when the central bank is your underwriter.

Source: Bloomberg

Global Economy Breakdown



United States

Low inflation should keep the US Federal Reserve on hold during 2020. The November presidential election is likely to be a major source of uncertainty. Low unemployment and trend economic growth favour President Trump's re-election. The current Democratic frontrunners all lean towards at least a partial repeal of the 2017 corporate tax cuts, which would have negative implications for corporate earnings growth in 2021.

United Kingdom

The easing of Brexit uncertainty and increased fiscal stimulus should support the UK economy in 2020. A significant boost from fiscal policy would reverse a decade of deficit reducing austerity. A post-election economic revival combined with low unemployment will be partially offset by the impact on business investment of trade uncertainty with Europe.

Europe

The eurozone should benefit from easier monetary conditions, the recovery in global manufacturing, the lifting of the US-China trade-war uncertainty and Chinese policy stimulus that increases import demand from emerging markets. The absence of inflation means the ECB is unlikely to lift interest rates and will continue to expand its balance sheet by buying back bonds.

China

We believe that Chinese stimulus will be modest – enough to provide a small boost to the domestic economy, but smaller than the previous stimulus episodes in 2012 and 2016. Other emerging markets have similarly shifted toward an interest rate easing cycle, after tightening in 2018.

Japan

Japan should benefit from the stimulus from China and an easing of trade tensions. A boost to spending and tourism will come from hosting the 2020 Olympics. Adding to its record levels of public debt, the government is preparing to launch a sizeable fiscal stimulus equivalent to 1.8% of GDP to support fragile economic growth.

Australia

A pull forward of infrastructure spending and record low interest rates won't be enough to stymie a slowdown in the economy weighed down by weak household income and poor credit growth. Bank loans as a share of deposits are at their lowest level since 2013. Some boost to the economy may come in the form of re-building efforts in the wake of the summer bushfire crisis. We expect the Reserve Bank of Australia to ease further in 2020.

Theme 1: A Technology Tipping Point

Since Apple released the first iPhone in 2007, few industries have been left unscathed. This transformational device was a tipping point in turning entire business models upside-down, while also impacting everyday lives at a more fundamental level. Think retail, banking, communication, and entertainment just to name a few.

The past decade has been replete with similar ideas that have the potential to transform the way we work, live, shop and relax. Investors now need to position for the next 10 years as the ideas become increasingly commercialised and embedded into the fabric of the economy.

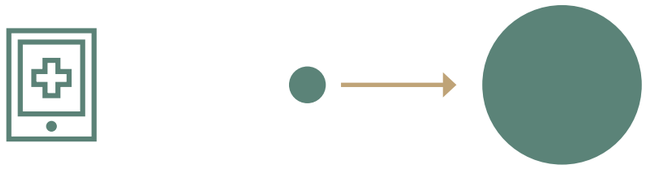
A World Economic Forum survey in 2017 predicted a series of "technological tipping points" for the coming decade. They included 3D-printing, driverless vehicles and artificial-intelligence. According to IDC, spending on AI and cognitive systems alone is expected to reach $52.2 billion by 2021, double what it was in 2019. The number of devices connected to the internet is expected to rise from 22 billion in 2018 to 38.6 billion by 2025. Mobile payment volume is set to increase tenfold by 2021 to $US274.4 billion.

Demographics will provide a headwind to this change. Sectors like e-commerce will be supported as close to 150 million millennial and Gen Z consumers exercise their growing spending power. More affluent, older, consumers, will drive demand for healthcare and smart-home innovations.

As the variety and volume of innovations grow, the rate of change for technology breakthroughs is also gaining ground.

Escala seeks to ensure our clients participate in these transformations through our various investments in venture capital, private equity, and private debt funds.

Big Data is at the centre of healthcare transformations



Growth in healthcare data: 1 exabyte = 1 billion gigabytes

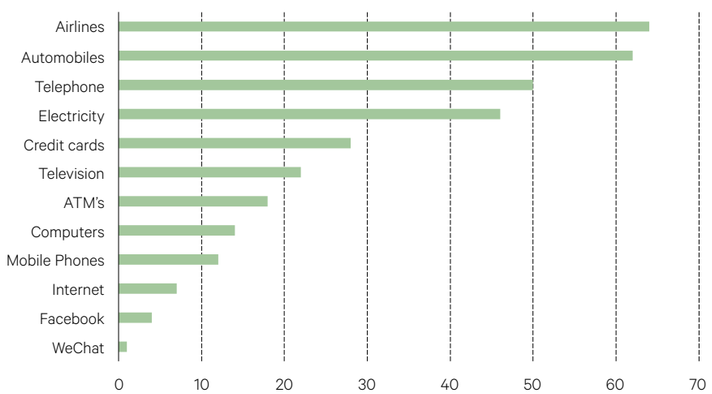
2013: 153 exabytes

2020: 2,314 exabytes

To put that into perspective, data centres globally only have current capacity for an estimated 985 exabytes.

Source: Cisco Global Cloud Index

Speed of Adoption: Time it takes to reach 50 Million Users (Years)



Source: DesJardins (2018)

As we prepare to enter a new decade, where will the next bolt of innovation strike?

Several technologies are poised to drastically change the future as we know it.

Smart phones have helped to reduce supermarket checkout lines. According to Euromonitor International, this has contributed to a 15% decline in chewing gum sales since 2007.

Health

Around the world, researchers are increasingly thinking smaller to solve some of the biggest problems in medicine. One practical example of this technology is the use of the smart pill that wirelessly tracks and controls (through a smartphone) the dosage of a particular drug. While smart pill technology is not a new idea – a "pill cam" was cleared by the FDA in 2001 – researchers are coming up with innovative new applications for the concept.

Other potential transformative discoveries in health include pocket-size ultrasound devices that cost 50 times less than the machines in hospitals (and connect to your phone), virtual reality that speeds healing in rehab and artificial intelligence that's better than medical experts at spotting lung tumours.

Energy

Advances in renewable energy have already seen wind and solar become more cost-effective than conventional sources[1]. As a result, the IEA estimates that by 2024 the global combined capacity of renewable sources of energy will add 1,200 GW of capacity, the equivalent of installed power capacity in the United States today. The next advance is in energy storage. Pairing a storage system with a renewable energy system will help to address reliability issues. Other advancements are in distribution. Microgrids are localized distributors of energy that can operate autonomously to a larger grid making them more cost-effective to build and maintain than large scale networks. This technology is particularly relevant for emerging markets where a billion people live without electricity and hundreds of millions have unreliable or prohibitively expensive energy sources.

1 Source: IMF

Digital IDs

According to the World Bank, over 1.1 billion people worldwide still have no way to prove their identity. At the same time, companies and financial institutions in both traditional and digital markets are being required to follow more stringent know-your-customer (KYC) initiatives. Under the ID2020 Alliance, companies like IBM, Microsoft, and Cisco are migrating to the blockchain to securely and privately verify users. Combined with biometrics (thank you Apple), blockchain technology is eliminating the need for physical identification, replacing it with digital IDs. This not only protects consumers interests but makes their lives easier. Changing service providers from insurance to banking to energy will become seamless.

Theme 2: ESG Investing Comes of Age

Only one thing matters between now and 2030: climate change.

Mark Blyth
Professor of International Political Economy, Brown University

It began as a niche desire. Originally, socially responsible investing (SRI) was confined to a subset of investors who wanted their investments to match their values. The process used mostly negative screens such as not investing in alcohol or tobacco. In recent years, the strategy has grown dramatically in size and sophistication and has broadened to incorporate environmental and governance standards.

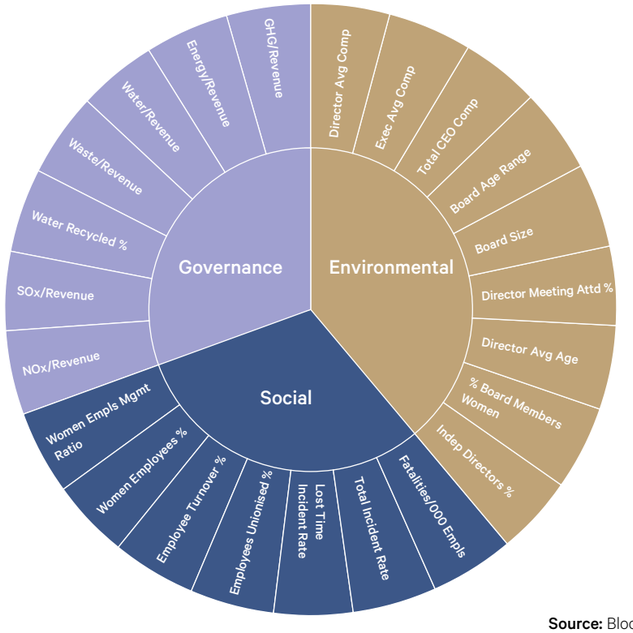
Today, environmental, social and governance (ESG) investing is estimated to be worth over $30 trillion, equivalent to around a quarter of all professionally managed assets[1]. In many markets it is seen as an important part of a manager's fiduciary responsibility. More recently, ESG has come into focus among financial market regulators. In 2019, the US Securities and Exchange Commission began scrutinising funds' ESG policies.

A challenge for many years was a lack of data. Corporate disclosure on ESG issues has improved significantly with the launch of the Global Reporting Initiative (GRI) in 2000. Now, 80% of the world's largest corporations report on GRI standards. New entrants and new technology mean the market for ESG data is maturing in quantity and quality.

Many investors now consider ESG factors alongside traditional financial analysis. At Escala, every manager that we review is investigated for its attention to ESG – not just as an overlay to investment decisions but as an integrated part of the investment analysis.

1 Global Sustainable Investment Review 2018, gsi-alliance.org

ESG Performance Metrics



Source: Bloomberg

Investors are increasingly becoming more climate aware

1. BP shareholders overwhelmingly adopt climate resolution.
2. Oil firm Equinor agrees climate change targets with investors.
3. Shareholders call on ExxonMobil to set greenhouse gas reduction targets.

Despite the strategy's growth, lingering misconceptions remain.

MYTH #1

Sustainable investing only works for equities

All asset classes incorporate ESG analysis to varying degrees. One of the metrics increasingly being used to classify bonds is sustainability. "Green" bonds are those issued for sustainable purposes while "Olive" bonds are those issued by companies that have improved their sustainability metrics. The analysis goes much deeper, however. Corporate governance has always been an important consideration for bond investors, particularly in emerging markets where there are typically higher levels of corruption and fraud and the rule of law is weaker. The size and quality of collateral backing a bond issue is a key determinant of its price in the market. Verifying this collateral is a critical role for a credit analyst. A spate of corporate bond defaults in India, for example, has given rise to what Bloomberg calls, "snatch-and-grab" finance. Where bond holders grab any of the collateral they can regardless of where they sit in the credit queue[2]. Incorporating ESG analysis will help to avoid these situations.

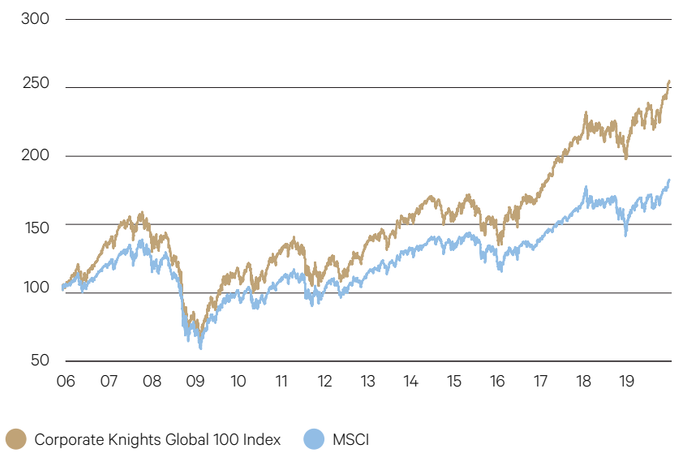
2 www.bloomberg.com/opinion/articles/2019-10-17/india-s-bad-loan-crisis-turns-into-a-melee-to-seize-collateral

MYTH #2

ESG underperforms traditional investment strategies

The performance of the 100 most sustainable corporations (the Corporate Knights Global 100 Index) exceeds the performance of the benchmark index. Between January 2006 and December 2019, for example, the Global 100 Index made a total investment return of 257.2%, compared to 182.9% for the MSCI All Country World Index (ACWI).

Performance of ESG vs Traditional Investment Strategies (Indexed: Jan-06=100)



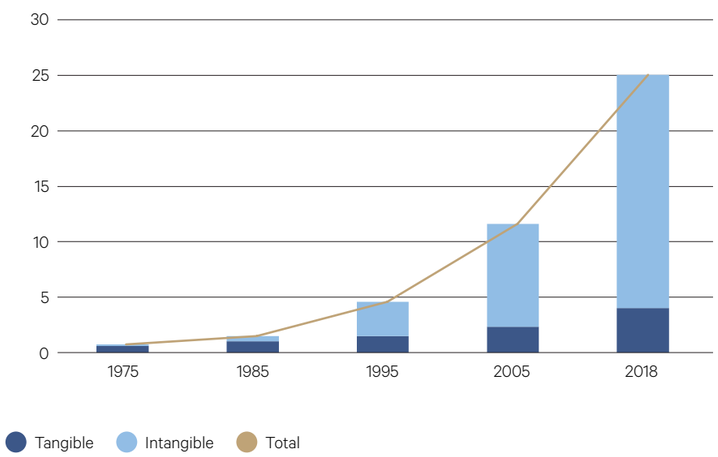
Source: Bloomberg

MYTH #3

ESG is a passing fad

ESG is becoming more important with the rise in intangible assets. The proportion of "intangible assets" of S&P 500 companies, assets tied to reputation, brand and intellectual property rather than evaluable tangible assets, have reached record highs. Analysis of financial metrics simply won't suffice anymore.

Tangible vs Intangible Assets for S&P500 ($tn)



Source: 2019 Intangible Assets Financial Statement Impact Comparison Report

Theme 3: Let the Fiscal Phoenix Rise

Inequality of wealth within countries has grown in recent decades, particularly in advanced economies. The post-crisis policy response of injecting some $16 trillion of central bank sponsored liquidity into the financial system has not been the panacea policymakers hoped for.

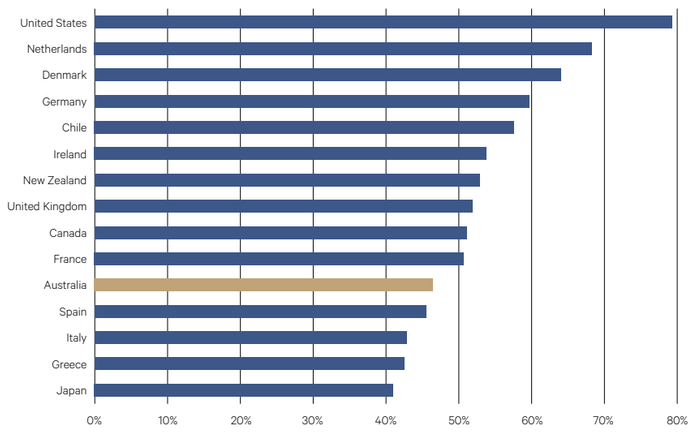
The rise in asset prices and wealth the easy monetary policy created was unevenly spread giving rise to a new age of populism. As governments around the world are beginning to realise, populism depletes political capital making effective, productivity-enhancing policy making difficult.

We know this all too well in Australia with our seven Prime Ministers in eleven years. Strong majority governments are increasingly a thing of the past. In its place are coalitions, often of disparate groups of minor parties (see Germany's first ever 'Jamaica coalition' between the Conservatives, the pro-business FDP, and the environmentalist Green Party). The 2016 Australian election saw the share to minor parties rise to a record 23%. This makes undertaking structural reform difficult.

Still, discontented voters are increasingly looking to governments to address the imbalances. Fiscal policy is likely to take centre stage in 2020 as monetary policy becomes increasingly less effective. The economic and inflation outlook remains weak and the cost of funding a budget deficit (through fiscal policy) in the developed world is nearly zero. Quantitative easing will stay in the toolkit (and may even be introduced in Australia) but faces challenges as demonstrated in Europe and Japan. Incredibly, the Bank of Japan now holds 43.9% of all outstanding Japanese government debt, up from just 8% in 2008. Despite this, its economy is still struggling to produce growth higher than 2%.

The US has the highest level of inequality in the OECD measured by the share of wealth held by the top 10% of households.

Wealth Share of Top 10 Percent (% GDP)



Source: OECD

United States

The US has enacted two substantial fiscal policy changes in the last 2 years. One was the lowering of the corporate tax rate from 35% to 21% in 2017, the other a $320 billion lift in the discretionary spending caps allowing the government to keep borrowing for two more years. The outlook for fiscal policy will be dictated by the 2020 election with marginal changes expected prior. A change to a Democratic president may see a wind back of the tax cuts.

Japan and China

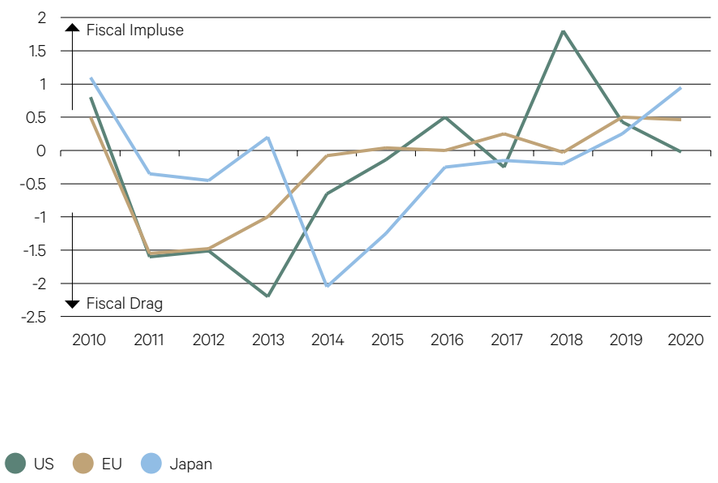
China has increased fiscal stimulus since growth began to slow last year, although its size is well down on the stimulus packages offered in 2009, 2012 or 2016. Japan's fiscal budget for 2020 is expected to be supplemented with a stimulus package worth 1.8% of GDP. Japan's government debt is already at record levels of over ¥1,000 trillion (or one quadrillion). The government recently raised the national consumption tax in an effort to address its debt levels, but the ageing population and subsequent social security expenditures create a headwind in curbing the spend.

Europe

Implementation of fiscal policy in Europe is nuanced. Fiscal rules are constrained, and historical periods of stagflation create a concerned mindset about high debt levels. Further, Germany can afford larger deficits, while others like Italy can't. Growing discontent is putting pressure on Germany to lead the way on fiscal spending considering inequality, weak growth, and public underinvestment and limited room on monetary policy. ECB President Christine Lagarde says fiscal policy is required "to respond to the threat of populism". With mounting pressures, Euro area fiscal policy will likely be somewhat expansionary in 2020, with most coming from Germany, and some from France and Italy.

In 2020, for the first time in history, across the world, the median age of a person will be older than 30.

Japan and EU are set to enjoy sizeable Fiscal Impulses in 2020
Change in Cyclically Adjusted Primary Balance (%GDP)



Source: Gavekal

Now it's high time I think for the fiscal policy to take charge.

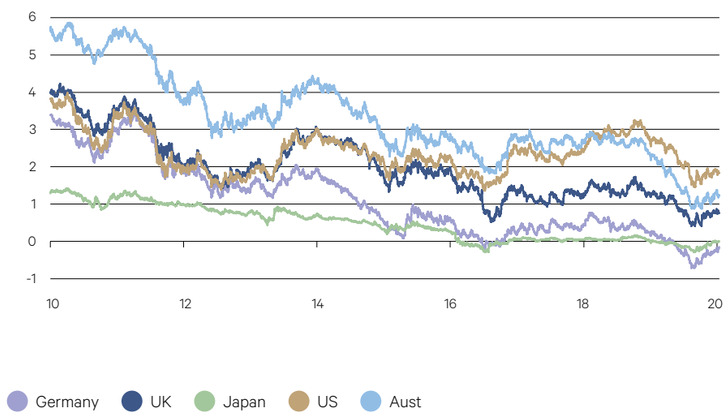
Mario Draghi,
Former ECB President

Fixed Income

Liz Harrison
Investment Analyst – Fixed Income

In 2019, total US corporate debt rose to nearly $10 trillion, a record 47% of the overall economy.

Global Bond Yields (%)



Source: Bloomberg

Fixed income assets had a strong year in 2019. Bond yields tumbled and credit spreads tightened in response to the dovish pivot by the US Federal Reserve and rate cuts by global central banks including Australia. While remaining accommodative, the extent of monetary policy easing is unlikely to be repeated this year, and the outlook is for more modest returns for fixed income in 2020.

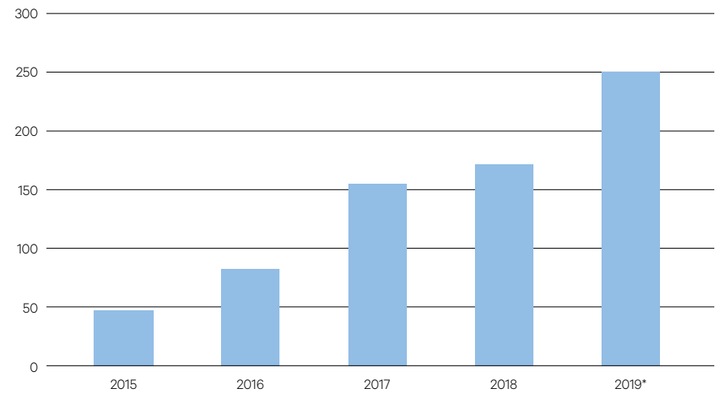
Within developed markets, short term interest rates will stay anchored by low official cash rates which are predicted to be 'lower for longer'. Longer term yields may rise in Europe and the US as growth lifts, aided by an easing of trade tensions, but benign inflation and ongoing unconventional monetary policy will cap yields. We expect US 10-year yields to trade between 1.5–2.5% – consistent with a real yield of around 1%, an inflation target of 2% and a term premium that has turned slightly negative in recent years. As a floor, last year's low of 1.45% will be a difficult technical level to break through. Bond managers will add alpha by trading the range and collecting the coupon, but significant capital appreciation is doubtful. Emerging Markets (EM) have scope to reduce interest rates further, and any deterioration in the US dollar will favour local currency bond performance.

Australia is potentially the outlier in developed markets. Weakening economic conditions put pressure on the Reserve Bank to ease further. Bond prices will rally (yields will move lower) if more than one rate cut is required. This likely results in a divergence between domestic and US bond rates, with the Australian rates market more likely to outperform its global peers in 2020.

Corporate credit spreads are narrow (the tightest since 2007), and corporate bonds are unlikely to get the tailwind from further contraction. At the same time, we do not expect spreads to widen from here. Investment grade and high yield sectors will be supported by strong fundamentals, low default rates, accommodative policies and the 'lower-for-longer' thematic keeping investors focussed on the search for yield. Coupon income will be the main source of return in 2020.

The average policy rate among emerging market economies has fallen to a record low of 4.6% (GDP weighted). The average policy rate among developed market economies sits 0.5% above its 2015 low thanks to the four interest rate hikes by the US Federal Reserve in 2018.

Green Bond Issuance (USD Billion)



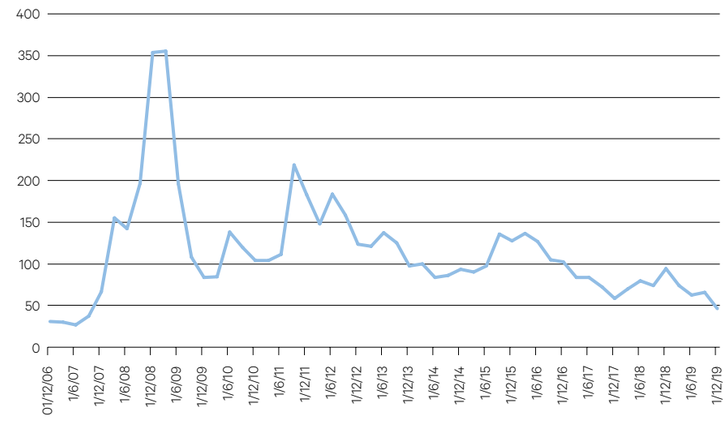
*Moody's estimate

Source: Climate Bond Initiative

Issuance of green bonds (corporate issuance used to fund sustainability-based initiatives) rose above US$200 billion in 2019, exceeding expectations. This growth is expected to continue with Climate Bond Initiative estimating US$330 billion worth of new issuance in 2020. Europe is likely to remain the biggest issuer of any region, with China and the US leading the way for a single country. The trend for corporates to issue green bonds is expected to be ongoing given the success of a $2 billion bond issue from Apple late last year. The cost of funding is attractive for participants with new deals often oversubscribed. Liquidity in secondary markets should be aided by issuance growth of the sector, larger bond sizes and diversity of issuers. These are positive developments for investors with an appetite for sustainable investments.

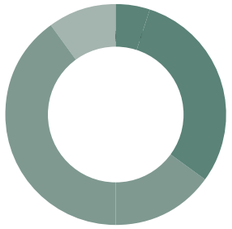
Spread premium on investment grade credit nearly halved in 2019, with the Australian iTraxx Index falling from 95bp to 49bp. In addition to clipping the coupon, security selection and market timing (trading the range) will be critical for credit managers to deliver decent returns in this tight spread environment.

Australian Investment Grade Credit Spreads (iTraxx Index)



Source: Bloomberg

Australian Equities



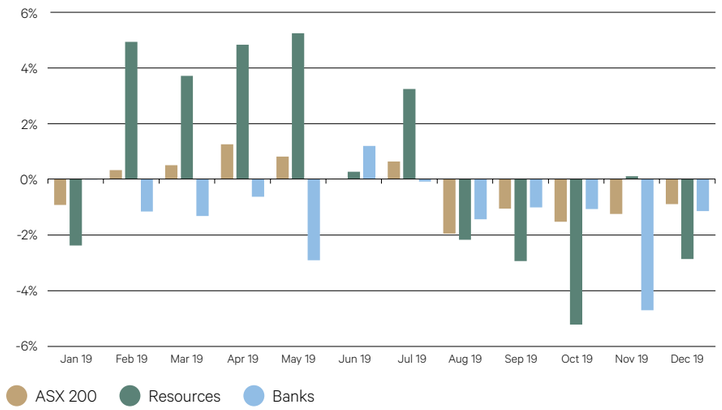
David Bruty
Investment Analyst

After a strong year for domestic equity returns, the outlook is for a more benign outcome in 2020. Underpinning this view is the starting point for valuations. PE expansion was the primary driver of the Australian market's returns over the last year, largely an outcome of falling domestic and global interest rates. The forward PE of the market now stands at 17.4x, the highest level since the dot.com boom early this century.

The earnings environment remains fairly soft, a trend that has been in place since August's disappointing reporting season. Contributing to this has been three key factors: further downgrades for the banking sector; a decline from a cyclical high in iron ore prices, which has translated into lower forecasts for the miners; and broad-based weakness for companies exposed to domestic demand.

As such, momentum is weak heading into the new year. Of the three factors noted above there is the potential for improvement from an uptick in the global economy (for the mining sector) and fiscal stimulus, which would support a broad cross section of companies. However, the headwinds for the largest sector of the market, the banks, are numerous and unlikely to subside, capping the outlook for the broader market. Companies that derive a high proportion of revenue overseas are better placed to deliver better growth outcomes, subject to the movements in the Australian dollar.

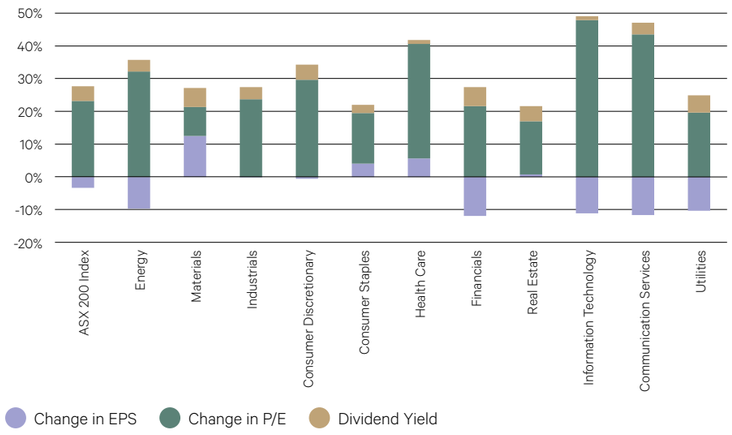
Monthly Change in Forward EPS



The positive earnings lift from iron ore dissipated into the second half, while downgrades to the banks also pulled the market lower.

Source: Bloomberg

Composition of Returns (2019)

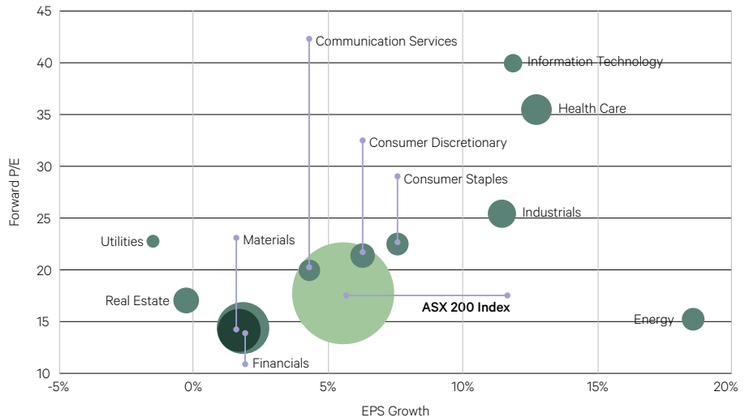


PE expansion was the primary driver of returns in 2019, particularly among the higher growth sectors of the market.

Source: Bloomberg

The outlook for the Australian economy is for sluggish economic growth. Consumers are weighed down by high debt levels and weak wage growth. Further rate cuts from the Reserve Bank can be expected in 2020.

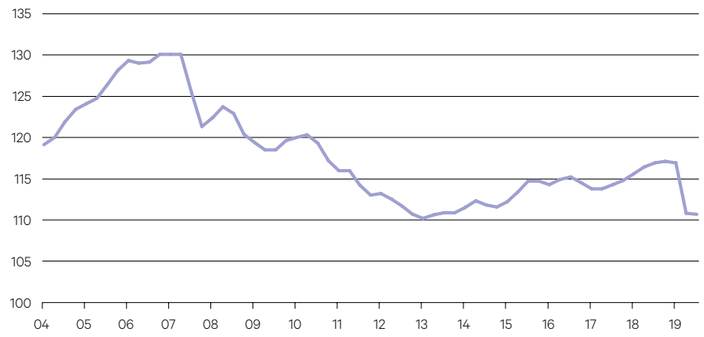
Sectors P/E and EPS Growth



A large part of the market is forecast to deliver modest earnings growth in the year ahead.

Source: Bloomberg

Bank Loans as a share of Deposits (%)



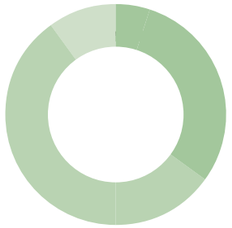
Bank loans as a share of deposits at the lowest since 2013 reflecting weak credit growth and macroprudential tightening by the RBA and APRA.

Source: Bloomberg

The forward yield of the ASX 200, at 4.1%, while somewhat compressed, is still attractive and particularly relevant for defensive stocks with low volatility and predictive dividends that have been adopted as bond proxies, such as infrastructure, REITs and utilities. The dovish stance adopted by the Reserve Bank of Australia and the possibility of a domestic quantitative easing program is expected to keep bond yields low, supporting these sectors and the market's high valuation. In turn, the inclination of companies to retain high payout ratios at the expense of capital expenditure is expected to remain, underscoring the income focus of many investors in the market.

Relative to international equities, Australian equities are more expensive, offer lower prospects for growth and face a more challenged economic environment. Given this backdrop, we begin the year with a tactical underweight exposure to the Australian equity market.

International Equities



Tracey McNaughton
Chief Investment Officer

Our base case scenario remains favourable toward global equities in 2020. Within the US, the Federal Reserve still has room to ease policy should it be required while outside of the US there is growing support for expansionary fiscal policy. While some markets on some measures do look overvalued, we believe a bottoming in the manufacturing cycle and an easing of trade tensions will support earnings.

Corporations have by far been the largest buyers of stocks since 2009.

Goldman Sachs

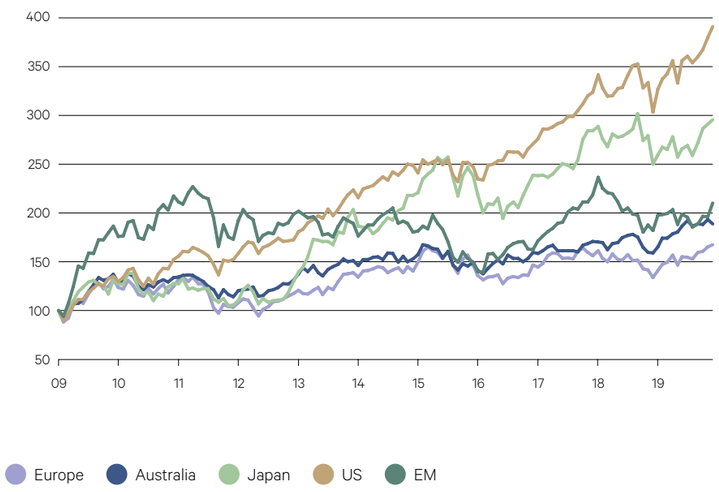
The big drivers of global equity markets in 2019 are expected to continue in 2020. Central banks have learnt lessons from tightening too early and too quickly as was the case in the US in the final quarter of 2018. New monetary policy tools are being adopted to manage market liquidity conditions, as is the case with the Federal Reserve's balance sheet management program. Corporate buyback activity may ease after the heady pace of 2018 and 2019 but with some level of uncertainty still clouding business investment, we expect it to remain a tailwind in 2020.

Inflation pressures that were previously dormant have started to stir somewhat but will not be enough to bring a tightening of monetary policy into play anytime soon. Deflation is feared more than inflation by central banks because of its impact on the effectiveness of monetary policy (as Sweden has realized with the negative interest rate "experiment"). The hurdle to raise rates, therefore, is far higher than it is to cut rates. While low interest expenses and higher inflation will support profit margins, the benefit will be partly offset by higher labour costs.

Within emerging markets, an expected easing of the US dollar will be favourable as will easier monetary policy by many emerging market central banks.

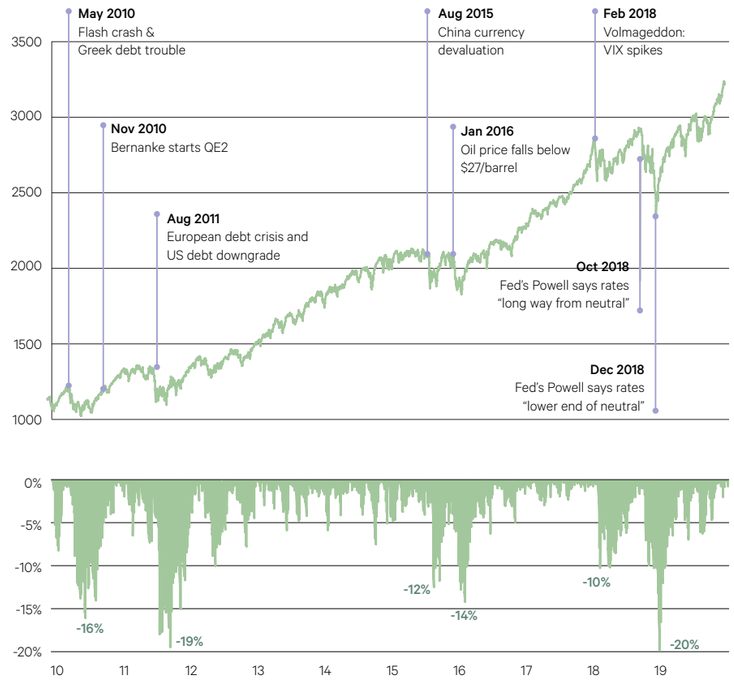
One of the biggest risks to our base case scenario is the potential for a rollback of the 2017 corporate tax cut in the US following the November presidential election. All of the current Democratic front-runners are in favour to varying degrees of a rollback. At the very least, the fear that this may happen will likely create market volatility this year.

Global Equity Market Performance since 2009



Source: Bloomberg

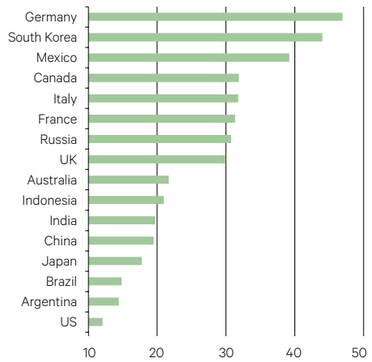
US S&P500 – Level and Drawdown



The US S&P500 rose by 184% over the past decade but there were six drawdowns of greater than 10% – 2010/11, 2015/16 and 2018/19.

Source: Bloomberg

Export Exposure (Exports as % GDP)



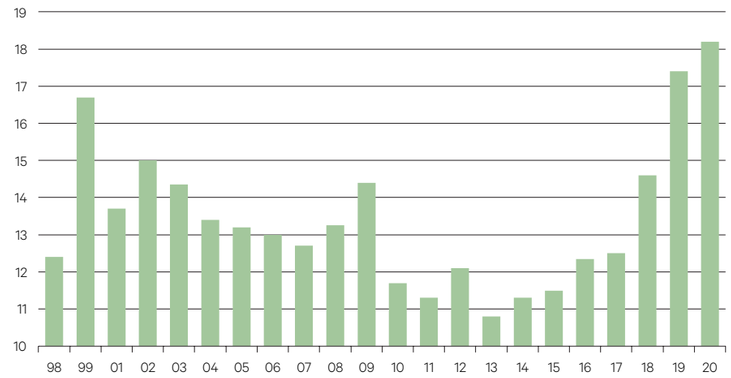
Germany is among the most heavily exposed economies to global trade with 47% of its economy made up of exports.

Source: Bloomberg

European equities are likely to benefit from an easing of the US-China trade tension and with financials such a large share of the equity complex, a steepening of the yield curve will be supportive. A slight tailwind may also come from renewed ECB asset purchases and growing momentum toward expansionary fiscal policy.

There is a growing concentration risk in the US S&P 500 driven in part by the stellar performance of a handful of big stocks (Microsoft, Facebook, Apple, Amazon). The S&P500 is a market cap weighted index so when the big names perform well their weight in the index rises. The top five firms in the S&P500 make up 18% of the index, an historical high. Information Technology is the largest sector at 23% displacing Financials following the global financial crisis.

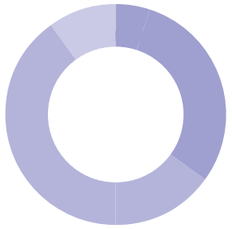
Total Market Cap of Top 5 Companies in S&P500 (% total)



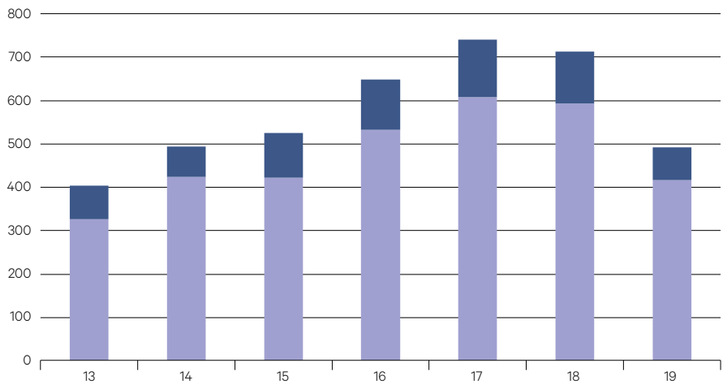
Source: Gavekal

Alternatives

Tracey McNaughton
Chief Investment Officer



Global Private Debt and Equity Fundraising (USD Billions)



2019 was a quieter year for private equity raising.

Source: Preqin, JP Morgan

We define alternatives to be any asset that is defined by ASIC as a hedge fund or has an illiquidity premium embedded. This makes for a very heterogenous asset class. Unlisted infrastructure, direct property, private debt, private equity, commodities and hedge funds are all part of our alternatives universe.

We expect the lower-for-longer environment to continue in the near to medium term. This means the delicate balancing of low growth with low discount rates and high levels of market liquidity makes for frothy markets that can be prone to bouts of volatility from time to time. Alternatives are an attractive asset class in this environment and explains why they have grown in popularity in the last decade or so. A recent study by BCG Consulting Group shows that assets under management in alternatives have been growing faster than those in all other investment categories apart from passive investments.

The same study suggested the fastest sub-asset class within alternatives will be the illiquid assets – unlisted infrastructure, private debt and private equity. We would tend to agree.

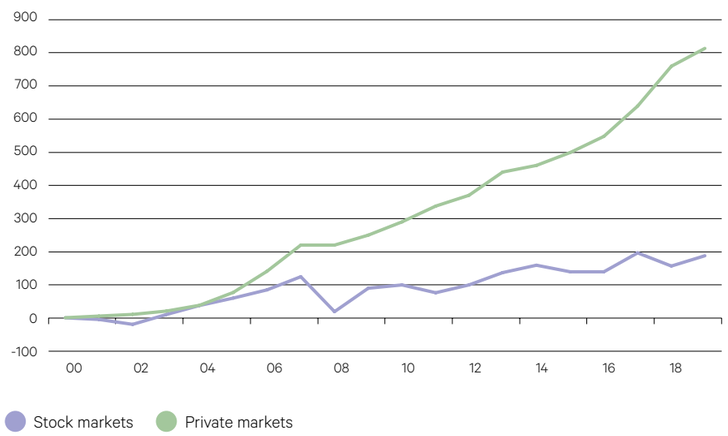
We are conscious of the demand for private assets driving valuations to the upper end of historical ranges. We favour managers that are disciplined in their approach and have wide networks within which to find attractive opportunities.

We also favour managers that have the ability and capacity to actively build out cash flows and improve valuations through value creation and entrepreneurial skill and good governance. Partners Group is one such manager in the private equity space that we favour. The Partners Group Global Value Fund (AUD) is a diversified private markets fund (mainly private equity but also private debt) invested in a broad range of investments. On a look through basis, the Fund is currently invested in approximately 1,500 private companies.

Infrastructure is an attractive, high yielding, sub-sector and the growing need for governments around the world to increase spending in this area opens up new opportunities for investors. We focus on large managers with a diverse range of assets that have deep, long term experience. An allocation to assets that operate in sectors and sub-sectors supported by long-term transformative trends is important, such as energy. ESG should also be an integrated part of an infrastructure manager's analysis as should an active approach in the management of the assets. An ability to release embedded value is an important driver of return. One such manager we like in this regard is Palisade.

The number of public companies in the US has declined by around 40% over the past twenty years. While this has reduced the opportunity set in public markets, it opens up a new universe of opportunities in the private markets.

Cumulative growth in Global Assets



Private markets, including $4.1 trillion in private equity, have soared 9-fold since 2000 to $6.73 trillion, growing 3x as fast as global public equities markets.

Source: World Federation of Markets, Preqin

While we do not expect inflation to significantly break higher anytime soon, infrastructure assets do offer an attractive hedge if it does.

The biggest risk with private markets is illiquidity and so position sizing and investment horizon inside a balanced portfolio should reflect this. Our focus is on ensuring this illiquidity risk premium is appropriately priced by the manager.

Asset Class Quilt of Market Returns

After a dismal 2018, global equity markets roared back to life in 2019 adding some $17 trillion in value over the 12 months. US equities were a standout performer rising almost 30%. Australian equities underperformed rising 24%. After being one of the best performing asset classes in 2018, cash was the worst performer in 2019 with just 1.5%.

Bond markets also had a standout year in 2019 boosted by a blizzard of rate cuts worldwide. In total, there were 157 rate cuts from 67 different central banks in 2019. This was the most significant easing cycle since the global financial crisis. This also helped propel the value of bonds trading with a negative yield to a record $17 trillion during the year.

An important lesson from the asset class quilt is the importance of diversification. As can be seen, every asset class, at some point, has been among the best performers in that year, even cash.

Best and worst performing asset classes each year

High ↑ / ↓ Low

2001	2002	2003	2004	2005	2006	2007	2008	2009
AE 10.1%	Gold 24.8%	EM Eq 51.6%	AE 27.6%	EM Eq 30.3%	EM Eq 29.2%	EM Eq 36.5%	AFI 14.9%	EM Eq 74.5%
IFI 8.3%	IG 14.8%	HY 32.4%	EM Eq 22.4%	AE 21.1%	AE 25.0%	Gold 30.9%	IFI 9.2%	HY 59.4%
AFI 5.4%	IFI 11.6%	IE 30.8%	HY 13.2%	Gold 17.9%	Gold 23.2%	AE 18.0%	Cash 7.6%	AE 39.6%
Cash 5.2%	AFI 8.8%	US Eq 26.4%	IE 12.8%	IE 7.6%	IE 18.0%	IE 7.1%	Gold 5.8%	IE 27.0%
IG 4.4%	Cash 4.8%	Gold 19.4%	IG 9.5%	IFI 6.6%	HY 13.7%	Cash 6.7%	IG -8.6%	Gold 24.4%
Gold 2.5%	HY 4.1%	AE 15.9%	US Eq 9.0%	AFI 5.8%	US Eq 13.6%	IG 6.7%	HY -26.9%	US Eq 23.5
HY 2.3%	EM Eq -8.0%	IG 14.3%	IFI 8.9%	Cash 5.7%	IG 7.2%	IFI 6.6%	US Eq -38.5%	IG 19.2%
EM Eq -4.9%	AE -8.1%	IFI 6.6%	AFI 7.0%	HY 3.6%	Cash 6.0%	AFI 3.5%	AE -40.4%	IFI 8.0%
US Eq -13.0%	IE -21.2%	Cash 4.9%	Cash 5.6%	UE Eq 3.0%	IFI 4.4%	US Eq 3.5%	IE -42.1%	Cash 3.5%
IE -17.8%	US Eq -23.4%	AFI 3.0%	Gold 5.5%	IG -3.6%	AFI 3.1%	HY 3.2%	EM Eq -54.5%	AFI 1.7%

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Gold 29.6%	AFI 11.4%	HY 19.6%	US Eq 29.6%	US Eq 11.4%	AE 3.8%	HY 14.3%	EM Eq 34.3%	AFI 4.5%	US Eq 28.9%
EM Eq 16.4%	IFI 10.5%	AE 18.8%	IE 24.1%	IFI 10.4%	IFI 3.3%	AE 11.6%	IE 20.1%	Cash 1.9%	IE 25.2%
HY 14.8%	Gold 10.1%	EM Eq 15.1%	AE 19.7%	AFI 9.8%	AFI 2.6%	US Eq 9.5%	US Eq 19.4%	IFI 1.6%	AE 24.1%
US Eq 12.8%	Cash 5.0%	US Eq 13.4%	HY 7.3%	AE 5.0%	Cash 2.3%	EM Eq 8.6%	Gold 13.5%	Gold -1.6%	Gold 18.3%
IE 9.6%	IG 4.3%	IE 13.2%	Cash 2.9%	IG 3.1%	US Eq -0.7%	Gold 8.1%	AE 12.5%	AE -3.5%	EM Eq 15.4%
IFI 9.3%	HY 3.1%	IG 11.2%	IFI 2.3%	IE 2.9%	IE -2.7%	IE 5.3%	HY 10.4%	IG -3.6%	HY 12.6%
AFI 6.0%	US Eq 0.0%	IFI 9.7%	AFI 2.0%	Cash 2.7%	HY -2.7%	IFI 5.2%	IG 9.1%	HY -4.1%	IG 11.5%
IG 5.8%	IE -7.6%	AFI 7.7%	IG 0.3%	HY 0.0%	IG -3.6%	IG 4.3%	AFI 3.7%	US Eq -6.2%	AFI 7.3%
Cash 4.7%	AE -11.4%	Gold 7.1%	EM Eq -5.0%	Gold -1.4%	Gold -10.4%	AFI 2.9%	IFI 3.7%	IE -10.4%	IFI 7.2%
AE 3.3%	EM Eq -20.4%	Cash 4.0%	Gold -28.3%	EM Eq -4.6%	EM Eq -17.0%	Cash 2.1%	Cash 1.7%	EM Eq -16.6%	Cash 1.5%

- **AE:** Australian Equities
- **IFI:** International Fixed Income
- **AFI:** Australian Fixed Income
- **IG:** Investment Grade Credit
- **HY:** High Yield Credit
- **EM Eq:** Emerging Market Equities
- **US Eq:** Us Equities
- **IE:** International Equities
- **Gold**
- **Cash**

Source: Bloomberg

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