MUTUAL TRUST

Investment Review Q2 2018 & Outlook

Economies, Markets and Tactical Positioning

The first half of 2018 has seen a return of volatility in markets. Economies across the globe are witnessing diverging economic growth. We see a strong US economy contrasting with slowing economies in Europe, China and some emerging markets. Interest rates have hit higher levels, peaking in the short term as growth concerns begin to outweigh the prospect of strengthening inflation. The threat of trade wars, the North Korean - US summit nuclear deal, rising immigration controls, and a populist government elected in Italy all battled for headlines and impacted markets in the short term.

We expect that rising uncertainties and peaking growth and earnings to be priced in by markets in the next quarter or two.

Themes for 2018

1. Monetary (central bank) stimulus is receding, while fiscal (government budget) stimulus is rising;
2. Interest rates rise as inflation expectations rise.
3. Market volatility rising sustainably from low levels.
4. Global growth diverging across countries.

Investment Markets

Markets have been impacted by emerging inflation pressures and tightening financial conditions while economic growth is showing clear signs of rolling over in many markets, especially Europe, China and some emerging markets. The more buoyant economic conditions in the US combined with rising Federal Reserve cash rates have been very supportive of the US Dollar, which has rallied since April.

Global equity markets have been mixed with some strong markets in the US, particularly the Nasdaq outperforming the S&P 500. We are expecting a strong US company reporting season to follow on the momentum, but note that cost pressures, particularly in wages, are rising.

Government bonds, mainly in the US, have risen with selective markets elsewhere also responding to economic or political pressures with higher bond yields.

Credit has remained sought after for yield, keeping credit spreads low, contrasting with a drift higher in corporate leverage over the last few years.

Volatility has been elevated since the equity correction in February and subsequent rebound, only recently settling back into a more benign lower volatility level. We believe volatility will rise again and average higher levels this year compared to last.

Tactical Recommendations

Weighting	Asset Class
Overweight	
Moderate Overweight	Fixed Income – IG Credit Cash Hedge Funds (Global Macro)
Neutral	Fixed Income (overall) International Equities Private Equity (VC & Growth) Real Estate – Listed
Moderate Underweight	Australian Equities Fixed Income – Govt, HY Real Estate – Unlisted Currency – AUD vs USD
Underweight	

Economies

Australia

GDP was up by a strong 1.0 percent in the first quarter of 2018, an increase on an upwardly revised 0.5 percent from the previous quarter. The yearly pace of growth to the first quarter rose to 3.1 percent, up from 2.4 percent in the prior quarter. This was the highest yearly GDP growth rate since Q2 2016. There were positive contributions in the quarter mainly from exports, followed by government spending, household consumption and non-dwelling consumption.

Consumer prices in Australia rose 1.9 percent for the year to the first quarter of 2018, flat on the prior quarter's annual rate. While steady, the inflation rate is down a little from 2.1 percent a year ago.

The unemployment rate was flat at 5.4 percent in June of 2018 compared to May, and fell from 5.6 percent in April, now the lowest rate since November last year. The economy added a solid 50,900 jobs while the number of unemployed declined by 2,100, reflecting a rise in the participation rate to 65.7 percent from 65.5 percent the previous quarter.

Australia's AIG Manufacturing Purchasing Manager's Index (PMI) was slightly lower at 57.4 in June, from 57.5 in May. This is off the all-time high of 63.1 in March 2018 and the lowest level since December last year. The index is still clearly in expansionary territory, that is over 50, noting a loss of momentum arising from new orders while inventories resumed their expansion. The index has continued a record-breaking run by remaining above the 50-point threshold for 21 consecutive months, the longest run of expansion since 2005.

Corporate profits continue a strong run with a rise of 5.9 percent in March 2018 compared to the corresponding March quarter last year. Profits increased fastest in the mining sector followed by electricity and utilities.

Wage growth has picked up modestly and is now at a 2.1 percent annual pace, up from 1.9 percent four months ago, partly driven by a fall in part-time employment. We expect wage pressures to remain moderate as there is still spare capacity in the Australian economy.

Considering liquidity measures, the M1 Money Supply growth has been declining from levels around 7.5 percent for most of 2017 to around 1.5 percent year on year to May 2018. This is extremely weak growth contrasting to recent GDP strength. We continue to be concerned by the weakening of liquidity measures and look for evidence of sustainable financing of economic growth. We believe part of this story is the Australian government debt issuance program which is running well ahead of actual needs, resulting in a withdrawal of liquidity from the economy. This is showing up in tight short-term money market rates.

The RBA cash rate remains unchanged at 1.5 percent for the last year. Our view is that the progress of RBA cash rate hikes will be a slower process than the market expects. We would see the RBA's cash rate remaining on hold for the rest of the year and well into next year given GDP potential growth at 3.0 percent, is being more driven by commodity prices than other core areas of the economy, and there is room for further employment growth.

United States

US GDP for the March quarter declined to 2.0 percent on an annualised equivalent basis, down from 2.9 percent in the December 2017 quarter. The year on year US GDP series is less volatile, which we prefer to focus on, which rose to 2.8 percent to March 2018. This was an increase from 2.6 percent year on year to December 2017, rising consistently for the last 7 quarters to March 2018.

Headline inflation has been moving up with an acceleration to 2.8 percent for the year to May, up from 2.5 percent in April. This upward trend has resumed in the last quarter following sideways movement at plus 2.1 percent or minus 0.1 percent between September 2017 and February 2018, after picking up from cyclical lows in the prior 8 months.

The Fed's preferred measure of inflation is the Core Personal Consumer Expenditure (PCE) index, which rose to 1.95 percent in the year to May, narrowing in on the Fed's policy target, as weaker inflation from a year ago rolls off the annual calculation.

Further wage pressure is likely to continue to flow through into inflation as the number of job openings has overtaken the number of job seekers, indicating an economy beyond full capacity.

The unemployment rate has picked up to 4.0 percent in June as more people entered the workforce, after hitting a cyclical low of 3.8 percent in May. This is down from a 12-month high of 4.4 percent ten months ago. for the last four months to January, having declined from 4.7 percent a year earlier.

The Institute for Supply Management's Manufacturing PMI in the US rose back over 60 to 60.2 in June, rising from 58.7 in May. The index has been very strong and has been bouncing around the 60 area since first breaching this level in September last year. This is indicative of a strong and expansionary US economy that is not showing any meaningful signs of slowing down. We watch underlying features of the survey such as an increased rise in supplier delivery times which may provide early indication of further wage and price pressures.

Money Supply measures in the United States on both M1 and M2 measures have decreased their rate of growth. The Fed's M1 measure, (representing cash at call with banks and in circulation), is now down to 4.5 percent growth on a year on year basis to May 2018, down from 7.7 percent as at December 2017 year end, and off the peak of 10.7 percent growth in October 2016. The Fed's M2 measure, (representing both cash at call with banks, in circulation, as well as short term deposits and money market accounts), decreased to 3.8 percent

on a year on year pace in May, down from 4.7 percent at year end and off the peak of 7.7 percent in October 2016. These measures are relevant as they represent sources of liquidity for the real and financial economies and have been subject to withdrawal of liquidity as the Fed allows bonds to mature off their balance sheet and pulls liquidity out of the economy. As the world has need for USD for businesses to operate, for trade and financial instrument purchases and collateral usage, this effects the demand for USD and a competition for USD between the real and financial economies.

Fed Chair, Jay Powell, is encouraging more clear communication of Fed policy and in his recent Fed press conference confirmed that the Fed will have press conferences after every Federal Open Markets Committee (FOMC) meeting, beginning in January 2019. Powell is emphasising that the Fed is undertaking a very data driven path towards normalisation of interest rates, noting 'We don't put our interest rate decisions on hold or on autopilot, because the economy can always evolve in unexpected ways'. That said, we believe it is more likely that the Fed will complete four cash rate hikes this calendar year, and possibly four next calendar year, which would take the Fed Funds Rate to 3.5 percent by the end of 2019, above a neutral rate of interest of around 3.0 percent.

In government policy measures, the imposition of higher tariffs that were threatened by the Trump administration were put into place on $34 billion of Chinese industrial and technological goods entering the US, effective on 6th July 2018. China responded immediately with their own $34 billion of tariffs on mainly agricultural goods such as soybeans and pork. The US countered with a move for up to 10 percent extra tariffs on a further $200 billion of Chinese goods imported into the US. Neither side is likely to back down quickly and markets are starting to react on the second-round tariffs from the US. According to comments in recent Fed official's speeches, the impact of the trade tariff implementation, if it is persistent, may have a detrimental effect on company investment decisions, offsetting some of the positive effects of tax reform on business investment decisions.

Our view is that there are some emerging signs of peaking US growth in leading indicators but not yet conclusively in data such as the ISM Manufacturing Index. This potential slowdown is moderating the risk of overheating from the net new fiscal stimulus in an economy with no labour slack. Inflation, a lagging economic variable, is expected to continue rising this year. The inflation pressures are expected from rising input costs, particularly wages, and pass through of costs from higher trade tariffs.

US financial markets may well focus on the potential of US business growth and inflation changing trajectory and their impact on company earnings causing a reassessment of share price levels in the next two quarters.

Europe

Eurozone GDP rose by 2.5 percent for the year to March 2018, down from the previous quarter of 2.8 percent to December 2017. We have seen a raft of economic data indicating that this was the cyclical peak, including a collapse in the Citigroup Economic Surprise Index for Europe over the past six months. It is consistent with a range of forward indicators that peaked in the past six months.

European Union headline CPI accelerated to 2.0 percent for the year to May, up from 1.5 percent in April, picking up from recent lows of 1.4 percent in February. Within the Eurozone currency block countries, inflation was up 1.9 percent in the year to May, from a prior reading of 1.3 percent in April.

European Union unemployment was steady at 7.0 percent in May from the previous month, having fallen over the past year from 7.7 percent. Within the Eurozone currency block, unemployment was 8.4 percent, which was flat on the prior month and down from 9.2 percent a year earlier.

Among EU Member States, the lowest unemployment rates in May were recorded in the Czech Republic (2.3 percent) and Germany (3.4 percent). The highest unemployment rates were observed in Greece (20.1 percent in March 2018) and Spain (15.8 percent). There continues to be significant divergence in employment across Europe, however the highest and lowest countries decreased their unemployment rates over the last quarter.

The IHS Markit Eurozone Manufacturing PMI was down to 54.9 in June 2018 declining from a prior month reading of 55.5. Since peaking at 60.6 in December 2017, there has been a consistent sequential deceleration over six months with each reading lower than the last. That said, despite the slowing, the manufacturing sector's performance remained one of the strongest seen over the 20-year survey history. We do see this consistent deceleration as indicative of weaker economic performance to come which we signalled from the emergent trend last quarter.

The ECB held its benchmark refinancing rate at 0 percent on 14th June, as expected, The ECB also confirmed that quantitative easing (QE) net asset purchases are intended to run at a monthly pace of €30 billion until the end of September, then at a pace of €15 billion until the end of December 2018, by which time the purchase program will end. The ECB also signalled that the first rise in the benchmark refinancing rate will likely be in the European summer of 2019.

Our view is that Europe's rate of growth has conclusively peaked, noting it still remains positive. We see this in purchasing manager indices, slowing retail sales and falling inflation. Therefore, we continue to be more comfortable with a more neutral to underweight position compared to the rest of the world.

China

The Chinese economy expanded at 6.8 percent year-on-year in the first quarter of 2018, unchanged on the prior quarter. As the market is sceptical regarding the accuracy of official Chinese GDP data, we also look at a range of real economic activity indices. Examples of real activity indicators are the Li Keqiang Index which is volatile but weakened over the last year, and proprietary indicators such as a composite China Short Leading Indicator which has fallen further than the Li Keqiang index, as global trade conditions remain poor and real M1 growth continues to slow. Economic data out in May shows that industrial output, retail sales and investment were all softer than economists' expectations. The 70 City house price index is another measure of activity and this has remained at or near lows for the overall index and for each of the Tier 1, 2, and 3 city indexes. The Citi Economic Surprise Index for China has turned negative in June and July having tracked at a positive pace in January through May this year.

China's consumer prices rose by 1.9 percent year-on-year in June of 2018, after a 1.8 percent rise in the prior month. The National Bureau of Statistics reported in detail on May's data and stated that food prices rose by 0.1 percent for the year and non-food increased by 2.2 percent. Growth in consumer goods was up 1.3 percent while consumer services was up 2.0 percent for the year to May.

The officially registered unemployment rate in China decreased marginally to 3.86 percent in the March 2018 quarter from 3.90 percent in the fourth quarter of 2017. This version of unemployment data has not had a lot of variation over it's history in the last 10 years with the most recent data point being the low and the high of 4.30 percent for the whole of 2009. The official surveyed unemployment in urban areas shows more variation albeit a shorter monthly history. This shows a low of 4.8 percent in May down from 4.9 percent in June and off the high of 5.4 percent in February 2017.

The Caixin Manufacturing PMI in China was slightly softer in June 2018 at 51.0 compared to 51.1 in the prior month and modestly above expansionary level of 50. It was the lowest reading since November 2017.

China's M2 money supply rose by 8.3 percent, year on year to May 2018, reflecting no change on the prior month but reflects a declining trend over the past two years.

Monetary conditions have remained tighter for the last year with some recent relief in the last three months with the China 3-month interbank rate (SHIBOR) at 3.62 percent in mid-July, down from around 5 percent to the end of December 2017.

The People's Bank of China (PBOC) announced in June a cut in the reserve requirement ratio (RRR) for banks of 0.5 percent to 15.5 percent to take effect on 5th July 2018. This follows an earlier cut in April of the RRR of 1.0 percent from 17 percent to 16 percent. This monetary easing for banks is somewhat offsetting tightening of reforms in fiscal policy in state owned enterprises.

Our view is that China is slowing further from here as the lagged impact from the combination of reforms and prior tightening of financial conditions kick in. The Peoples Bank of China (PBoC) is showing some relief for banks in lowering RRR ratios and is also prepared to let the currency fall as a defence against US imposed trade tariffs on Chinese goods. China is more able to manage an orderly devaluation now as it has imposed more strict currency controls over the last two years. The risk we identified for Australia from Chinese slowing may well have some relief from Chinese policy makers actions, softening the risk to Australia's economy and currency. Australia may be a beneficiary of the US – China trade wars as Australia has an exemption from US steel tariffs and also has the benefit of the weaker Chinese currency and cheaper Chinese goods that aren't exposed to additional Australian tariffs on those goods.

Japan

The Gross Domestic Product (GDP) in Japan expanded at a 1.1 percent yearly pace in the first quarter of 2018, down from a 1.9 percent pace in the fourth quarter of 2017.

Consumer prices in Japan rose by 0.7 percent in May 2018 on a year on year pace, up from 0.6 percent in April. The inflation rate has softened from the recent peak of 1.5 percent in February of 2018.

The unemployment rate in Japan has dropped further to 2.2 percent in May 2018, continuing a longer term down trend in unemployment, nearly halving from five years ago. Labour force participation has risen over the same period to a peak of 61.7 in May 2018 from 60.5 in January and lows of 58.5 in December 2012. Employers are competing for a smaller pool of younger employees as a larger group of older people move into retirement. The jobs to applicant's ratio has also continued to trend up with May 2018 featuring a new high of 1.6 jobs advertised for every one applicant.

The Nikkei Japan Final Manufacturing PMI ticked up to 53.0 in June 2018 from 52.8 in May. The overall level, while still expansionary, is near lows off the recent high of 54.8 in January 2018, indicative of a peaking in manufacturing growth.

Money Supply M2 in Japan grew at a 3.2 percent yearly pace, which is around the cyclical lows of the last four years, and off recent highs of 4.1 percent in October 2017. As the Bank of Japan (BoJ) continues with their quantitative easing program, this provides a steady liquidity addition to the Japanese economy.

The BoJ, at its 15th June Monitory Policy Meeting, left the key short-term policy interest rate unchanged at -0.1 percent and continued the policy to anchor 10-year Japanese Government Bond yields close to zero percent. There has been no change to these policies for some time and no sign of change any time soon.

Our view is that Japan's economy remains modestly positive while continuing the slowing in pace from last year. The aberration of falling CPI in an economy with significant labour shortages and hence potential wage pressure is unusual, perhaps due to capital investment in automation to minimise the effect of scarce new labour. The composition of spending in the economy may also be due to conservative ageing consumers who have had minimal pension entitlement increases.

Financial Markets

Markets have continued their recalibration of the expected path of inflation, the pace of Federal Reserve cash rate hikes and the follow through of longer bond yields rising. We believe the market still isn't pricing in the full extent of the Fed's likely path of one cash rate hike a quarter in 2018 and 2019.

Our view is that markets are struggling to come to terms with the collision of the transition of policy settings with divergent economic growth outlooks, compounded by considerations of trade tariff uncertainty and political impacts from populist shifts in Europe. The net effect of this is that we expect elevated volatility to continue. We expect that the immediate headline concerns are shielding investors from seeing longer term trends such as the structural shift lower in Chinese growth and the consequences of a disengaging and dysfunctional US superpower on matters of trade and foreign policy. It is more useful to contrast the short-term and long-term influences on policymakers and reconcile these considerations with policy makers choices and constraints in the future. Markets may well react first before economies and then feed into expectations of businesses and consumers. Markets in their reading ahead of short term considerations, may force the hand of policy makers to respond more quickly.

Equities

In the last quarter we have seen the US equity market, as measured by the S&P 500, in a choppy range while recovering from lows in February and April. Performance was up 3.4 percent in the quarter and 14.4 percent for the year to June

2018. Volatility in the S&P500 options, reflected by the VIX index, has cooled from peaks in February and dipped back into more benign levels below 15 for most of May through to mid-July. We have seen temporarily spikes higher in volatility, mainly on trade wars and European political concerns. We would expect markets to remain choppy as divergent growth, inflation and policy pressures remain on investors' minds.

The Australian equity market price action has been remarkably strong in the last quarter, rising from lows in the ASX/S&P 200 in early April of 5750 to above 6100 in mid-May. There was a further bounce off lows just below 6000 in late May as Italian political and bond market concerns were in focus, to then rally to ten-year highs just under 6300 in early July. This performance including dividends translates to 8.7 percent for the quarter and 14.6 percent for the year. This is even more impressive as the local index outperformed the S&P500 over the same period and strongly exceeded the local January 2018 highs. We believe there are a mix of factors behind this performance. The factors were a strong USD and consequent weaker AUD. This helped offshore earners, a weaker emerging markets sector may have attracted asset allocators to safer and cheaper markets, and within Australia the delayed shift of asset allocators towards Australian equities neutral weights from underweights, and late allocations from superannuation members with top up additional voluntary contributions.

To get a sense of the scale of one of these factors, we start with the size and flows of the Australian superannuation system. APRA reports that the total assets in Super was $2.6 trillion in the March quarter, with $23 billion of inflows over the year with $14 billion of that in the June quarter 2017. The average asset allocation of the entire system is 50 percent to equities, of which Australian equities comprises 24 percent. The average daily volume of the S&P/ASX200 index is around 700 million a day according to Bloomberg. If we average the $14 billion from last year over 63 trading days in the quarter, superannuation allocations to Australian equities comprise about 8 percent of total market volume – a significant proportion of daily flow if just averaged, and material on days where this trading might be clustered.

European equity markets as measured by the Eurostoxx 50 index had a volatile quarter to June, starting the second quarter a little up from lows for the year in late March. The index was up 3.4 percent for the quarter and down 2.2 percent for the year to June including dividends. The index was also up strongly in the first two weeks of July.

China's equity market, as measured by the Shanghai and Shenzen 300 Index, has had very poor performance to the end of June 2018. The quarter was down 8.9 percent, and the year down 2.2 percent including dividends. The index has struggled to move higher in the weeks to mid of July.

Japan's equity market, as measured by the Nikkei 225 Index, performed well to the end of June 2018, up 5.5 percent on the quarter and 13.5 percent on the year including dividends. It has continued to perform well through to mid-July.

Our tactical view for equity markets is that the US is preferred over Europe and Asian markets given the tactical weakness in stock markets and the relative strength of the US. This is despite the Fed tightening and ECB and BOJ remaining accommodative as company profits and economic conditions are currently more supportive in the US. Overall, we recommend a neutral weighting be maintained for international shares.

Interest Rates

Central bank policy cash rates are low and flat almost everywhere except for the US which is guiding that it will continue with three and possibly four rate rises in 2018 as economic conditions permit. We believe in practice this will mean four hikes in 2018 and another four in 2019.

We are seeing a continuation of the Fed's quantitative tightening program as they allow bonds on their balance sheet to mature, and in Europe an end to quantitative easing which will finish the tapering of purchases to zero by the end of December 2018.

US government bonds have continued to rise most strongly at the short end, continuing the theme of yield curve flattening from last quarter. The US 2-year bond continued in an uptrend to levels of 2.52 percent at the end of June and 2.57 percent in the first two weeks of July, with a high of 2.58 percent on the 12th of July. This is strongly up from 1.38 percent in June 2017. The 10-year bond had a very strong rise to peak at 3.11 percent on 17th May this year before settling at 2.86 percent to the end of June. This was up from 2.73 percent to the end of March and up from 2.30 percent from June last year.

In other international bond markets, both longer and shorter dated bonds in Europe rose in yield through May as concerns about the budget plans of the new Italian government caused Italian 10-year bonds to spike from 1.78 percent to 3.13 percent and even more remarkably the 2-year Italian government bond from rose in yield from -0.32 percent to a peak of 2.63 percent over the course of the month of May. Bonds have settled backdown with Italian 10-year government bonds at 2.67 and 2 years at 0.66 percent to the end of June. German 10-year government bonds were lower over the same period to end the June quarter at 0.29 percent, down from 0.49 percent at the start of the quarter.

Not much change has happened with Japan's government bond yields, and the Bank of Japan's policy continues to manage the 10-year yield near zero and the cash rate at minus 0.1 percent. Government bonds ended the June quarter at 0.022 percent for the 10-year bond and minus 0.14 percent for the 2-year bond.

In Australia the short end of the yield curve remains anchored by the RBA cash rate at 1.5 percent. 10-year bonds were almost unchanged on the quarter and year, ending at 2.63 percent to the end of June, up from 2.60 percent at the end of March and 2.60 percent in June 2017. This does not reflect the very broad trading range from lows of 2.47 percent in November 2017 to highs of 2.93 percent in January. The wide trading range and broadly rising lows reflects various global and local concerns which impacted the perception of the economy and inflation locally. The 2-year bond has risen over the year, ending June at 1.98 percent, flat on the quarter but up from 1.72 percent on a year ago.

Credit remained well supported noting some recent widening from lows in some but not all credit default swap indices. High yield spreads are at extremely narrow levels with the US High Yield CDX Index ending June at 105 basis points, almost flat on a year ago. In Australia we have noted the Itraxx CDS Index has widened a little to 80 basis points at the end of June, up from 70 basis points at the end of March and off a post GFC low of 52 in January this year.

Overall, these credit spread levels are near multi year lows. We are monitoring credit for more meaningful signs of spread widening, and perceived weakness in corporate debt.

Commodities

Iron ore has had a flat quarter to June, finishing around USD 63 per tonne, while metallurgical coal was also flat at USD 196 over the same period. Coal has fallen in the first two weeks of July to USD 177 per tonne.

Oil bounced back from recent lows in February and June to finish the June quarter a USD 74 per barrel for West Texas Intermediate Oil. Prices are up from USD 63 a quarter ago and USD 46 last June.

Copper, a global indicator of industrial production, fell towards the end of June to US 6,625 per tonne from USD 6,679 at the end of March. Over the course of the last year, copper is still up from US 5,927 per tonne at the end of June 2017.

Agricultural commodities have shown some mixed trading with Wheat trading up to USD 497 per bushel at the end of June, up from USD 451 at the end of March. Corn has fallen quite suddenly to USD 350 at the end of June, down from USD 387 at the end of March.

Gold has weakened in USD terms over the last quarter as the USD has strengthened against other currencies. Gold ended June at USD 1,252 per ounce, falling from USD 1,325 at the end of March, and in line with the price of USD 1,241 a year ago. Our view from a quarter ago was that there appeared to be a support level of around USD 1,320 and that if this level is broken, a down trend was possible. Gold tends to be inversely correlated to the USD over longer term time periods.

Foreign Exchange

Foreign exchange markets have been responding to USD strength as the dominant theme in the quarter. The Australian dollar has fallen over the quarter to $0.7405 at the end of June, near the low for the year, down from $0.7679 for the quarter and from $0.7689 from June last year. There has been a few periods of broad range trading and trending with highs in July and September last year and a high for the year in January at $0.81 in late January. A previous low was $0.7509 in early December last year prior to the strong rally into January. As noted last quarter, the AUD trades with variable linkages to relative interest rates, commodity prices and relative economic performance. The last quarter is more a story of relative USD strength more than anything else.

The USD on a trade weighted basis has strengthened since April after range trading for a couple of months. It lifted from the 90 index level at the end of March to 94.47 at the end of June. This follows a fall over the course of the last year from 95.62. As we proposed in March if the global economy continues to strengthen we would expect the USD to be driven by fund flows out of USD into other areas of investment. The US economy has been performing well, while other economies have lost momentum. This difference is aided by repatriation of cash due to corporate tax reforms, and as a consequence we are seeing fund flows back into the US.

The Euro has weakened as the converse of USD strengthening, as Europe's economic expansion has lost momentum. The EUR fell over the quarter from US $1.23 per Euro at the end of March to US $1.16 at the end of June. The Euro is still a little higher than a year ago when it was US $1.14. Not helping the Euro was six falling PMI numbers in a row, and a raft of economic indicators have disappointed from the start of this year as indicated by a dramatic fall in the Citigroup Economic Surprise Index (CESI) for Europe.

The Japanese Yen has some similar character to the USD in that it is seen as a safe haven currency in times of crisis. The JPY has rallied over the course of the quarter from 106.28 at the end of March to 110.76 at the end of June. Over the year the JPY has fallen from 112.39, however we note in the first two weeks in July, the currency has rallied sharply to 112.57.

On cross rates the NZD has weakened against the AUD over the quarter from $1.0614 at the end of March to $1.0930 to the end of June. There is a perception that Australia will gain in economic performance over New Zealand in the next year or so, given the New Zealand Labour government is about to undertake measures that are less friendly to business and will likely increase spending on social and education programs. The AUD may also have strengthened on perceptions of Australian bulk commodity strength over New Zealand's agricultural commodities.

Themes in detail

Primary themes for 2018

1. Monetary (central bank) stimulus is receding but still accommodative, while Fiscal (government budget) stimulus is growing. We see initiatives such as tax reform, that might crowd out full capacity economies like the US and add to inflationary pressures. Trade tariff impacts are becoming somewhat known, at least in the implementation of the first couple of waves with China and Europe. The effects could be larger than initially thought as it may weigh on business investment decisions and confidence.

2. Interest rates should keep on rising following shrinking of central bank balance sheets and as late cycle wage and inflation pressures rise. The Fed may raise cash rates faster than the markets expect, where we expect one hike a quarter in 2018 and 2019, sowing the seeds for the next recession. We don't expect this to be one-way traffic as bonds will rally from time to time as weaker economic data comes through for periods in between stronger growth.

3. Market volatility of equity indices is now expected to remain in a moderate range on average, above the extreme low levels of the past year. This is due to a reassessment of market risks as we have more evidence emerging of late cycle inflation pressures. The unwind of short volatility carry trades, and new net speculative positioning long volatility has moderated, and implied volatility is settling down whereas realised volatility is still elevated compared to 2017.

4. Synchronised global growth is now more evidently undergoing a transition into divergent growth prospects across countries. We are seeing this emerging across countries already with European data disappointing for at least four months, as indicated by the Citigroup Economic Surprise Index for Europe declining dramatically, and manufacturing PMIs for broader Europe down for six months in a row. A divergence across countries of inflation and growth will lead to divergent equity and bond market performance, much more so than 2017 when there was a 'Goldilocks' environment of accelerating economic growth, low or declining inflation, and accommodative central bank policy cash settings.

Longer Term Themes

Secular trends are another way to label what we denote as longer-term themes. Many of these trends will appear obvious, however the time frame is not always obvious. Futurists contend that society tends to over-estimate the impact of these secular trends in the short term but underestimate the impact in the long term. One such futurist, Patrick Dixon, has a different way of saying this, in that we may agree that a certain technology will eventually happen, the only debate is when it will happen.

Our research seeks to analyse how and when these longer-term structural themes may or may not be influential on economies, markets and our portfolios.

Demographics is a well know influential secular trend, with ageing populations in most developed and some emerging market countries continuing to be a driver. Exposure to regions with growing populations and rising middle class incomes such as Asia will fare better. In some countries the ageing baby boomers are noted as most influential, however millennials will be larger by number than the baby boomer generation.

High debt levels of governments, businesses and households are a concern. Australian, Canadian and Scandinavian markets have high housing related debt and house prices that haven't materially reset since the GFC. Banks with high housing mortgage books in these countries could be vulnerable in a housing downturn. We are seeing some moderation of Australian house prices now. Governments in the developed world, particularly Japan, US and Europe have high and rising debt levels. Many emerging market countries that did have higher debt levels 20 years ago have managed to build significant domestic savings pools and refrain from high government debt levels. Some emerging market countries are still vulnerable to financing in US dollars, and so their reserve levels may still be susceptible.

Rising populism and social inequality continue to be an ongoing issue which we have previously written about, having some origins as far back as the setup of the World Trade Organisation and modern global trade. Our highlighting of the growing issues in Europe with the Italian populist coalition government came to a head in the last quarter with a bond market rout and major adjustment in yield expectations on Italian government bonds. Long term historical returns and correlations don't predict this type of market behaviour. We see populism as more of an issue in countries where the population perceives little to lose from political change, even if the reality may be different,

In the political arena, the theme of difficult coalitions is becoming more common. The German government finally formed a 'Grand Coalition' after four months of negotiations, in the previous quarter, however there are major frictions on immigration issues between the coalition partners which may see this government having to be reformed under a new coalition or new elections may have to be called.

In this era of rising populism and more fractured coalitions, are we not just seeing democracy in action? If so, we need to think like a politician and seek to understand the electorate's concerns to get re-elected. BCA Research use a concept from political science called the 'median voter theory', that is in order to get re-elected, no matter what political leaning a political party has, they should target the centre of mass of the electorate and understand their issues. Over the recent decade, there has been a noticeable shift to the left of this median voter.

Many other geopolitical concerns exist with North Korea, South China sea, Middle East, Eastern Europe, and Latin America. One aspect of geopolitics is the rising challenge to the established rules-based international order led by the US, as China and Russia exert growing influence in their regions. This is a natural consequence of a long period of a dominant global superpower that creates an environment of rules, safety and stability that allows others to grow in strength economically with trade and internal growth while not having the burden of a high military expenditure.

We continue to assess geopolitical risk in terms of what politician's preferences are versus their constraints (another of BCA Research's geopolitical principles). The market relevant impacts are also assessed in terms of how they will affect countries that we have equity and bond market exposure to, and their impact on international trade, particularly energy production and transportation.

Technology has a subset of themes, with artificial intelligence, fintech, blockchain, autonomous vehicles and internet of things. Some of these themes are represented in the Mutual Trust International Equities Model Portfolio. These themes have much longer exposition in the Thematic Overviews produced by the Mutual Trust International Equities team.

We are seeing an evolution of the role of sustainably in portfolios and assets, including environmental, social and governance factors. Another aspect in this evolution is impact investing, which we believe is another important step in the evolution of investor preferences, extending the social and governance aspects into more intentionality of impact and measurable impact outcomes.

Implications for the next 3 to 12 months

Overall, we continue to see a volatile and choppy market environment over the next 3 to 12 months. Because markets and economies have feedback loops between each other, we see a continual assessment of economic data and contrasting it to policy direction that will continue to have a more sensitive impact on markets this year than in 2017. The Italian bond market sell-off and equity market reaction to it was another reminder of the sensitivity of markets to changes in policy direction of governments. Our tactical weightings remain the same, and although we aren't seeing evidence of emerging recessionary conditions, we believe that markets may themselves provide the next signal which would then feed into economies, causing a recession later. This 'reflexive' nature between economies and markets and within asset classes means there are different feedback loops to watch and be aware of that may not originate in the area where there is ultimately the most impact.

With this in mind, and diverging global growth signals, and diverging inflationary pressures, we believe that the time to be underweight international equities is not right now (at the time of writing), but is drawing closer.

Our underweight to Australian equities remains in place, having gone against our views in the last quarter on higher than expected flows and relative value calls by global and local investors. We believe that Australian equities are more vulnerable than ever with higher valuations than a quarter ago, reflecting vulnerabilities of a slowing economy in China for our commodity and service exports, a declining housing market and growth from other sectors of the economy held up by government infrastructure spending.

Fixed income allocations should be shorter duration and mostly in investment grade credit. As interest rates rise over the course of the year, as we expected we have seen that this is not a straight path, with some upside constraints based on debt burdens (particularly Australian households). We are becoming more cautious of interest rate sensitive investments such as property, which we retain as underweight. In offsetting the volatility from other asset classes, we also recommend a higher weighting to absolute return alternatives, and in particular global macro strategies.

Tactical Recommendations

The tactical recommendations are summarised on the first page of this report for a 3 to 12-month view.

We provide some example guidance on what these positions mean for an example +/- 10 percent range around strategic asset allocation positions.

Tactical Ranges:

Using a +/- 10 percent range deviation from target, then:

Overweight	+6% to +10% (+8%)
Moderate Overweight	+2% to +6% (+4%)
Neutral	-2% to +2% (0%)
Moderate Underweight	-6% to -2% (-4%)
Underweight	-10% to -6% (-8%)

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