Morphic Asset Management

HALF YEAR REPORT

July - December 2017

Morphic Asset Management

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MORPHIC ASSET MANAGEMENT TEAM

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Jack Lowenstein

Managing Director

Dear Investor,

Calendar 2017 has come to an end – delivering solid gains for investors in both the Morphic Global Opportunities Fund (MGOF) and the Morphic Ethical Equities Fund (ASX: MEC).

By and large, Australians and New Zealanders still do not have enough of their wealth invested outside their home countries. The benefits of diversification were highlighted in the year just passed when our Funds did better than the Australian All Ordinaries index, despite facing the headwind of an unexpectedly resilient Australian dollar which was up 8.7% over 2017. Both Funds were up 8% over the half.

During December our head of marketing, Irene Kardasis, crisscrossed Australasia, accompanied by myself or Morphic co-founder Chad Slater meeting investors in our Funds.

We found enthusiastic support for our decision earlier last year to formally embrace the ethical investing process that Chad and I have followed since our days at the former Hunter Hall, which in my case started in 1997. Both Morphic Funds are now certified by the Responsible Investment Association of Australasia and Morphic is a signatory of the Principles for Responsible Investment.

We were gratified about the positive feedback we have had to the Morphic Ethical Charter which can be found on our website. Investors were also pleased to hear about the way we are integrating our reviews of Environmental, Social and Governance (ESG) issues into our investment decisions. We believe there are important linkages into our risk management processes. Our head of research, James Tayler, has done some excellent work in developing a practical analytical template that enables us to identify and manage ESG risks effectively.

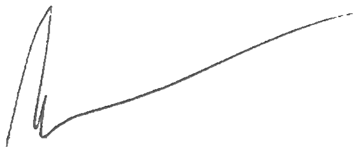
There are few funds offering exposure to ethically screened global equities in Australia, and virtually none that use a long/short process and have our intense focus on risk management.

Surprisingly this is also true in Europe. We received some third-party endorsement when we were approached last September by an Irish fund management platform, that wanted us to replicate our current Funds for European investors. Chad was invited to speak at the inaugural Expert Investor ESG Congress in Berlin in December, and he and James then met with many prospective investors in Germany, Switzerland and the UK. We expect to launch the Trium Morphic ESG L/S Fund in the next few months.

Once again, we continue to deepen our investment capabilities. During the half, Claudia Kwan joined us as an analyst. Claudia previously worked for Morgan Stanley in Hong Kong before joining an Asian-focussed small company fund.

As ever, please feel free to contact us with any questions, and we hope you enjoy the report.

Regards,



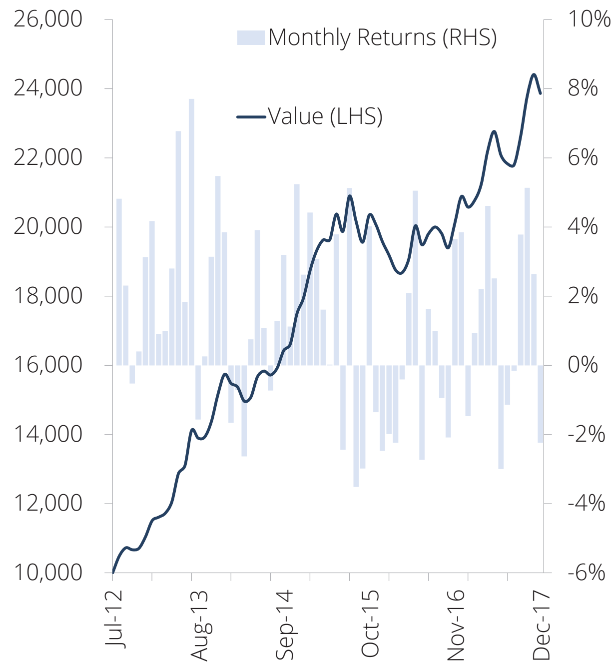
MORPHIC GLOBAL OPPORTUNITIES FUND

CERTIFIED BY RIAA

INVESTMENT RETURNS[1]

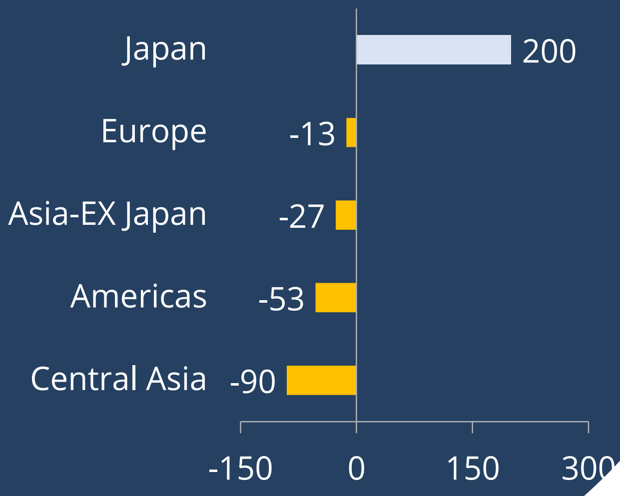
	MGOF	Index[2]
6 Months	8.07%	9.06%
1 Year (p.a.)	14.28%	14.77%
3 Years (p.a.)	9.96%	10.95%
ITD p.a.	17.42%	17.88%

PERFORMANCE OF AUD $10,000



Past performance is not an indication of future performance.

6-MONTH EQUITY ALPHA BY REGION



TOP ALPHA CONTRIBUTORS OVER THE LAST SIX MONTHS[3]

- **Open House** 102 bps
- **Investors Cloud** 58 bps
- **Macromill** 28 bps

TOP ALPHA DETRACTORS OVER THE LAST SIX MONTHS[3]

- **SES** -56 bps
- **D.G. Khan Cement** -39 bps
- **Platinum Asset Mgmt** -33 bps

1 As at December 2017; 2 The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD; 3 Attribution; relative returns against the Index excluding the effect of hedges. Past performance is not indicative of future performance.

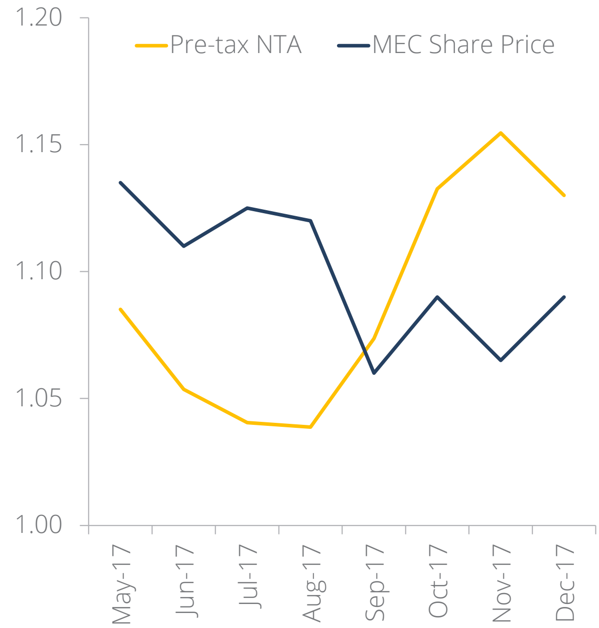
MORPHIC ETHICAL EQUITIES FUND

CERTIFIED BY RIAA

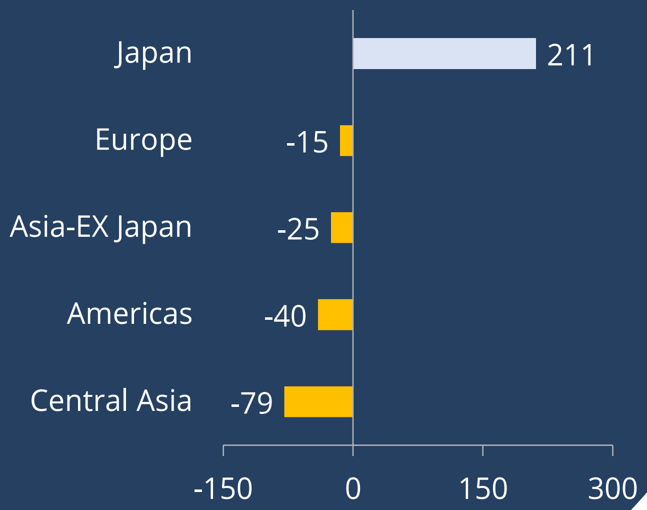
INVESTMENT RETURNS[1]

	MEC	Index[2]
3 Months	5.61%	6.07%
6 Months	7.85%	9.06%
ITD	7.10%	9.18%

MEC SHARE PRICE VS NTA[3]



6-MONTH EQUITY ALPHA BY REGION



TOP THREE CONTRIBUTORS OVER THE LAST SIX MONTHS[4]

- **Open House** 107 bps
- **Investors Cloud** 58 bps
- **Macromill** 31 bps

TOP THREE DETRACTORS OVER THE LAST SIX MONTHS[4]

- **SES** -55 bps
- **D.G. Khan Cement** -41 bps
- **HCA** -33 bps

1 As at December 2017; performance is net of investment management fees, before company admin costs and taxes; 2 The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD; 3 Net Tangible Asset Value before tax, in AUD, between May 2017 and December 2017; the figures are unaudited; 4 Attribution; relative returns against the Index excluding the effect of hedges. Past performance is not indicative of future performance.

REFLECTIONS ON THE HALF

> *Life can only be understood backwards; but it must be lived forwards.*
>
> **Søren Kierkegaard**

As managers of your (and our!) money, we may never have felt a moment of calm, but with immediate hindsight, the second half of 2017, like the first, will go down as the "salad days" of this bull market.

What made 2017 exceptional was the combination of high returns and low volatility. Here are a few highlights:

- The broad global index rose in US dollar terms **every single month**;
- Including dividends, the US S&P 500 went up **every single month;**
- Over the year, US equity markets had a once in a century high Sharpe Ratio (a measure of return to risk) of 5. Through history the Sharpe Ratio has averaged 0.6;
- Emerging Markets (EM) had their smallest monthly drawdowns on record over a full year.

Whilst there have been higher return years, normally equity investors have to "sweat for it". In 2017 it was truly a year of buy, hold and forget, when as one commentator put it, you got "equity returns for bond like volatility".

The second half saw a continuation of the trends of the first half: winners stayed winners – sector leadership was incredibly narrow with the technology sector accounting for most of the gains in the US market. "Growth" stocks more generally were the favoured stocks globally, while "value" stocks, especially energy and telecoms, continued to lag.

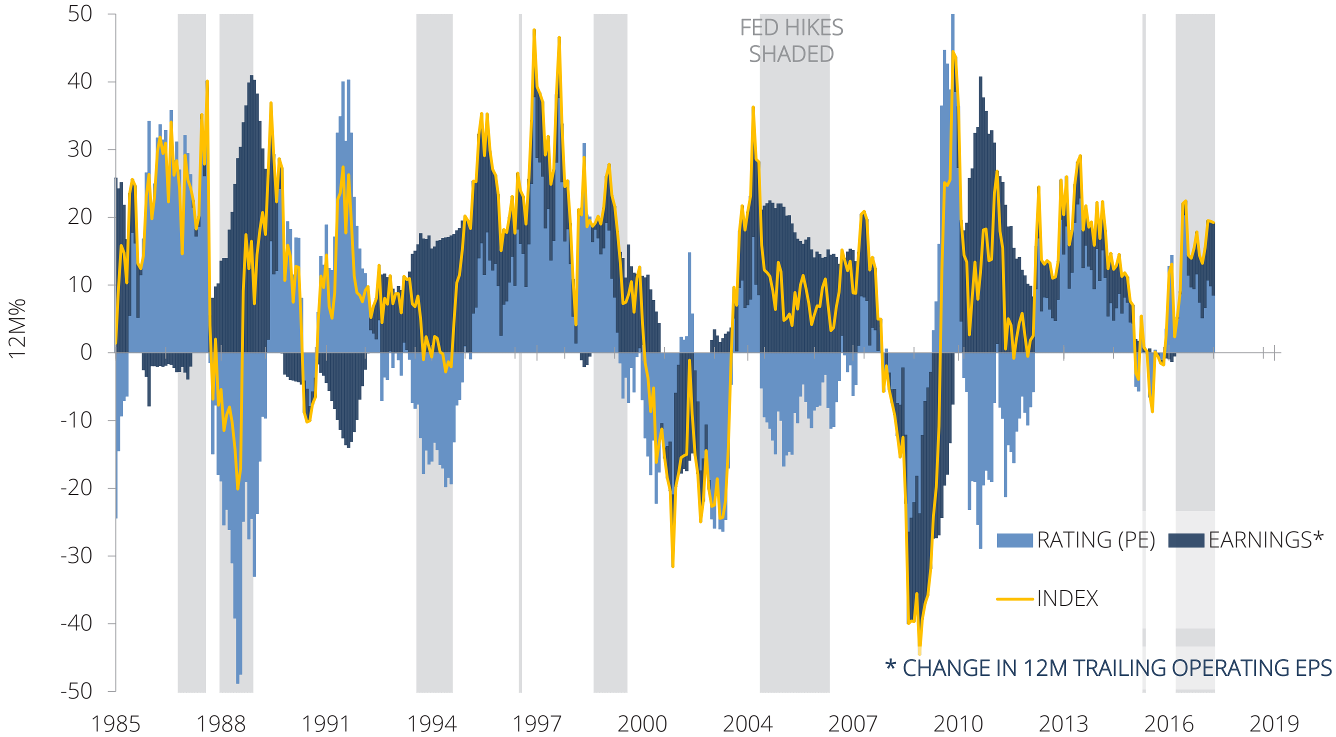
Equity gains were also widespread globally, with most countries enjoying double-digit returns. Confounding early 2017 expectations, Emerging Markets were the standout performer, up 34%. In Europe optimism on an improving economic outlook failed to deliver spectacular returns in local currency terms as the strength in the Euro sapped offshore earnings, but even so, were up a more respectable 23% in US dollars. Japan delivered similar returns over the year.

Australia on the other hand was a laggard, rising 7% in local currency. With commodity prices coming off last year's highs and macro prudential measures reducing the banks' appetite to lend, it was hard for the market to rally significantly. We suspect the same will be true in 2018.

Superficially, the macroeconomic calls of higher rates did pan out – the Federal Reserve raised rates three times this year. What did not work were forecasts of a stronger US dollar. The Federal Reserve raised rates in part due to the continuation of strong economic growth globally as global manufacturing surveys made new six-year highs in the second half of 2017. US unemployment reached new cycle lows, falling to 4.1% by year end.

In the face of this good data, long end bond yields fell, flattening the curve. Traditionally as the cycle strengthens and earnings recover, rising interest rates became a headwind to performance as earnings growth is offset by Price to Earnings (P/E) de-rating (though the net effect may still be positive for share prices). **Figure 1** next page shows this effect through prior cycles. In 2017, however, falling long rates and continued tightening of credit spreads led to a re-rating of P/E into a US Federal Reserve rate hiking cycle, an anomalous outcome.

Figure 1 – Decomposing 12 Month S&P500 returns



Source: Minack Advisors

In July, we wrote that the world was becoming more optimistic, but was still far from moving into "new paradigm" phases of mania although we warned the emergence of crypto-currencies could portend this. Little did we know at the time just how "crypto" things would become. The rise of Bitcoin from $2,600 when we wrote our last half yearly to over $18,000 in December has been meteoric.

We have no intention of being drawn into a debate on the merits of Bitcoin in this forum. What we do think is interesting is what Bitcoin represents: the maturing of a cycle that is still awash with easy money. Like internet stocks in 1999 or small cap mining stocks in 2006, we see Bitcoin as a symptom. For individuals to speculate rampantly, they need to be comfortable in their job and confident in the outlook. In this environment "Fear" can be replaced by "Fear of Missing Out".

What made 2017 memorable was evidence of the investment cycle going "mainstream" as non-professional investors reacquainted themselves with the taste for speculation. It is the marker that has been missing since the gut-wrenching shock of the Global Financial Crisis (GFC) and at some stages we even doubted whether it would return.

A year and a half ago, we felt like the lone bulls in the room. Today it feels the room is crowded. If we made an error, it was underestimating how many more people could join the room. What is difficult to gauge now is whether we are in 1997 or 1999 or 2007. Our Outlook section will delve more into some of the conflicting signals on that front.

Turning the focus to the Funds' performance over the half, both Morphic Funds rose by about 8%, slightly lagging global equity markets, which were up 9% over the six months to the end of December. Performance of the stocks and hedges matched the index, with the difference being largely fees.

Whilst at some level this is frustrating, the key in the late stages of a bull market is not to fall too far behind "in the race" whilst at the same time not betraying your investing framework to the latest fad.

Decomposing where returns were made and lost over the half, Japan was (by a long way) the largest positive contributor to active returns.

Underperformance in the US, India, Pakistan and Australia offset this. Macro hedges were a marginal negative contributor.

Our pairs trades, which have been increased through time, added value. On the other hand, outright shorting proved to be challenging over the half, with both "thesis reversal" at the stock level and a factor shift in November proving to be headwinds. Nonetheless shorts provide an important risk hedge and should help when markets do not go up every month.

Japanese inner-city town house developer **Open House (3288 JT)** along with an offsetting short leg in peri-urban developer, **Iida Group (3291 JT)** were together the largest contributor at the stock level. We have written at length on them before, but this half saw even better than expected results from Open House drive the stock to new highs in November, lifting returns to more than 70% in the half. Iida Group, despite being in the same sector, dropped heavily on its poor results, which saw us cover the short. We believe this vindicates our view that Japan offers rich rewards for stock pickers who can identify winners and losers from its ongoing shift to better governance and enhanced shareholder returns.

Also in Japan, **Investors Cloud (1435 JT)** was the second largest contributor over the half. The company has developed a "virtual property developer" business model that is disrupting a staid and fragmented industry. (Click here for a talk by Joint CIO Chad Slater on it). Investors Cloud achieved an important milestone in November when its version of "BrickX" – a crowd sourced funding model for smaller investors in new apartment complexes – received regulatory approval.

In January last year, we held high hopes for Pakistan, driven in part by the country's transition from "frontier" to "Emerging Market" status. After a strong run in the first five months of the year, the formal transition to EM status in June marked the top. The removal of former Prime Minister Nawaz Sharif for corruption, combined with increasing pressure to devalue the currency led to it being one of the worst global markets for the full year. We avoided the worst of the sell-off through our stop-loss rules, but Pakistan as a whole was one of our largest detractors for the half, led by cement company **D.G. Khan (DGKC PA)**. Nevertheless, we still believe the country is on the right track even if the Twitter musings of President Trump suggest otherwise.

Lastly, each half we like to introduce a new stock idea we have been working on that has reached the stage of "graduating" to a large position size in the Funds – in this case **China Everbright International (257 HK)**: one of China's largest waste recycling and waste-to-energy generation businesses.

In this year's rush by investors to buy software and computer companies, rubbish businesses have been left behind. China is focussing its efforts to reduce pollution which helps explain the banning of rubbish importation from Australia and the rest of the world. This is part of a much broader effort to reduce landfill and waste. China Everbright sits at the heart of that effort. One of our analysts went to China and spent time travelling around with the company to their waste plants (a highly sought-after trip), which confirms that both provincial and central governments are eager to incentivise China Everbright to expand plants in their cities. We will publish more on this stock in the coming months once we have built our position to full size.

ETHICAL INVESTING IN FOCUS

In December, Chad and James attended the Expert Investor ESG Congress in Berlin looking at Environmental, Social and Governance within an investing framework.

The overwhelming sense we get is that investors of all ages and around the world want to see more ethical and responsible behaviour: they want companies they invest in to recognise that they operate in a community with externalities. And they want their fund managers to communicate this on their behalf. Perhaps we are ending the "greed is good" era that began in the 1980s?

光大國際
Everbright International

14 **BILLION KWH**

GREEN ELECTRICITY SUPPLIED BY CHINA EVERBRIGHT INTERNATIONAL

HASEKO

WE INVEST IN COMPANIES THAT MAKE A DIFFERENCE

2,010

PAID FACILITIES & HOUSING FOR THE ELDERLY OPERATED BY HASEKO

22.1 **MILLION**

ELECTRIC VEHICLES BY 2020*

** Total EV stock by 2020 from those on the road end 2016 (2m) plus car sales target (2017-20)*

GLOBAL TARGET

RISK MANAGEMENT

> *There is a fine line between fishing and standing on the shore like an idiot.*
>
> **Steven Wright**

It was another relatively quiet half with few risk events of note.

The stand out was the escalation of confrontational rhetoric between US President Trump and the North Korean Supreme Leader Kim Jong-Un. For the media this provided an excellent source of headlines, in a theatrical set up that pitted the "Dotard" against the "Rocket Man".

As a general rule we believe we should avoid being drawn into the panic that surrounds such events, and as we noted at the time in our blog our posture was "Keep calm and buy shares".

While each situation is different, it is useful to bear in mind that geopolitical events tend to have little impact on medium-term asset valuations. This is largely because so few people and companies in the world are actually impacted by them, and for most, life goes on as normal.

Figure 2 shows how many months it took for the US stock market to recoup losses after a historic geopolitical shock. This highlights just how quickly markets bounce back.

The good news is that we spent most of the last six months fully invested, and the several tail hedges we had in place were only a small drag on performance.

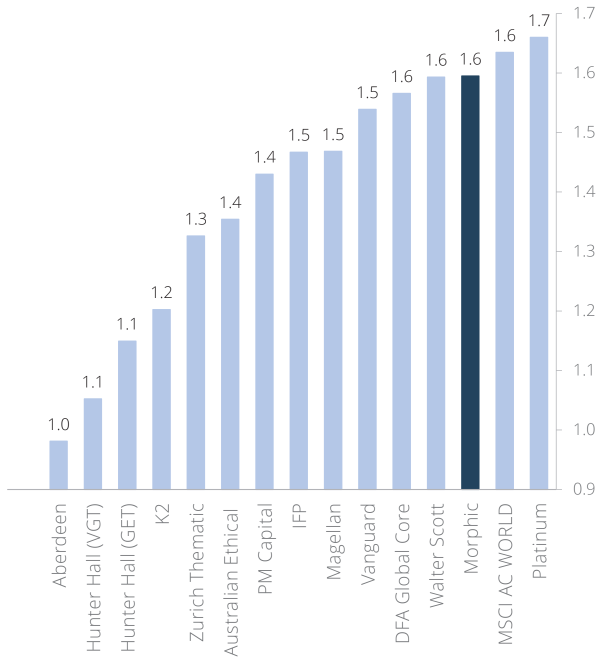
The Fund's ratio of reward to risk taken continues to be favourable amongst peers as shown on **Figure 3**. We note that this is particularly true compared to the handful of ethically screened funds available to Australian retail investors.

Figure 2 – Bounce back period for major geopolitical events of the last few decades

Events	Year	Months taken for the US market to regain highs
Iraq War I	1990	6
9 11	2001	2
Iraq War II	2003	1
London Terror Attacks	2005	0
Russian Invasion of Ukraine	2014	1

Source: Bloomberg, Team Analysis

Figure 3 – Morphic's Sharpe Ratio vs relevant peers* (August 2012 to December 2017)



Source: Peers' websites, Team Analysis

** Walter Scott Global Equity Fund, Morphic Global Opportunities Fund, MSCI AC World Index, IFP Global Franchise Fund, DFA Dimensional Global Core Equity Trust, Vanguard Index International Shares Fund, Platinum International Fund, Magellan Global Fund, Zurich Investment Unhedged Global Thematic Share Fund, PM Capital Global Companies Fund, K2 Select International Fund, Hunter Hall Global Equities Trust, Hunter Hall Global Value Limited, Aberdeen International Equity Fund, Australian Ethical International Share Fund. Our Sharpe Ratio calculation methodology changed from using the USD as the risk-free rate to the Australian RBA Cash rate.*

SPECIAL FOCUS: FREE CARS FOR ALL

"If I had asked people what they wanted, they would have said faster horses."

Henry Ford

Can I interest you in a free car? Sounds too good to be true you might say. But as you already get your new iPhone for "free", is it that hard to reimagine the concept of car ownership?

This was just one idea that was presented last December at the Expert Investor ESG Congress that we attended in Berlin. Presenters and panellists discussed investment opportunities and potential winners and losers in the global shift that is taking place to incorporate ESG and sustainable investing into markets. Investors who believe this is just a fad risk missing some fundamental shifts taking place around them.

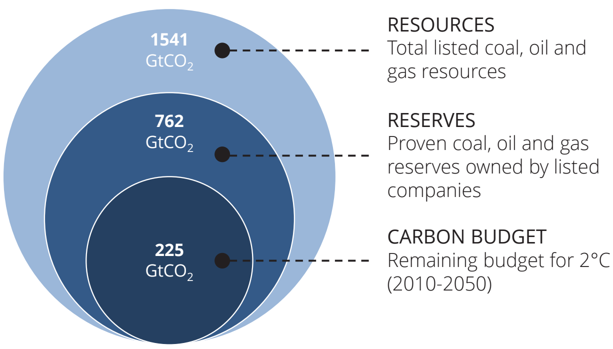
Returning to the "free car" idea, consider this: the average car is not used 90% of the time. Typically, it is driven from home to work and spends most of the day in a garage or a car park. We also know that battery storage is the biggest problem currently facing the grid in dealing with the intermittent supply of renewable energy. Lastly, we know that electric cars have relatively large batteries.

Why not bring this together: charge your car overnight using wind, solar or off-peak conventional power, drive it to work and plug it into the grid. In return for your car being "free", you agree with an energy provider to allow the batteries to be drained to supply peaking power into the grid during the day as needed (leaving a minimum to get home of course!). Now your car is not free just as your phone is not free – you have sold the battery capacity for future years to reduce the upfront cost.

Sound far-fetched? Wrong – it is already a pilot project in the UK with Nissan. For a country like conference hosts, Germany, a place renowned for its auto makers, the impact of being among the winners who get this shift right could be quite profound.

Another presentation on winners and losers presented a simple chart, reproduced below, comparing the estimated losses from the "carbon bubble". The physics of burning hydrocarbons is relatively straightforward in calculating emissions, even if the range of outcomes are large. **Figure 4** below shows the proven reserves of the world's hydrocarbon companies. Burning all of these would emit 762 Gigatons (Gt) of carbon dioxide (CO_2). If global warming is to be limited to 2 Degrees Celsius (2D) as agreed by the world leaders, only enough to emit 225Gt of this – less than a third – can be burnt.

Figure 4 – Carbon bubble in a 2°C world



Source: Wermuth Asset Management

So, outcomes become straightforward: we either meet 2D and many of these companies' assets are worthless and need to be written off; or we burn their assets and, well, the companies are worthless since a functioning global equity market in 5D world with 800m displaced people is somewhat improbable.

The value of the assets that will probably need to be written off may shock you: it is more than double the write downs from the US housing bubble of 2007.

Investors need to consider where their carbon investments sit within this bubble. As aircraft still need to use hydrocarbons, for example, there will remain some need for oil. Saudi Aramco, due to float soon, is actually a winner out of this shift. Its reserves are high pressure and cost little to extract. Given the low cost of solar (**Figure 5**), they can power processing cheaply. Fracking and US oil on the other hand are probable losers. As we wrote recently, Australian-listed Oil Search has also been nominated as a potential loser.

Lastly, to the sceptics out there – and the financial services industry has many of those – one panellist appealed to self-interest, because, as the old saying goes "always back self-interest in a race, at least you know it is trying".

His message was to consider the data on millennials whose parents have passed away leaving them an inheritance. Of these, 80% quickly sacked their parent's financial adviser because they felt their beliefs did not align. And what are those beliefs? When asked in a survey, over 75% of millennials globally nominated doing social good ahead of returns in importance. For boomers it is the inverse.

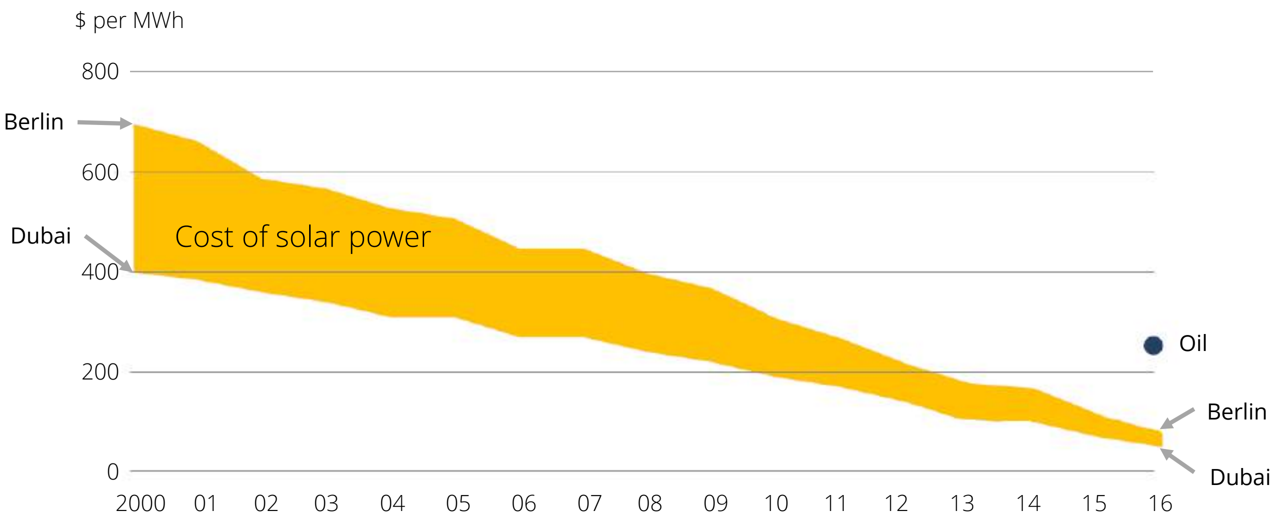
One ultra high net worth advisor we spoke with, who advised over $2bn of family assets, summed it up as: "based on the feedback from clients' children, I am here at the conference because if we do not start to offer investments that align with them, I do not have a business". This chimes with the 79% of institutions at the conference nominating client demand as the main reason for their interest. It is not coming from managers pushing product, investors are dragging in their advisers!

Funds managers, bankers and financial planners will need to move from a model solely focussed on high returns and "who cares where they come from" to suites of products offering a range of socially conscious options through to impact investing (such as microfinance in India where there is an explicit social good in the objective).

For an industry held in such low regard that it faces a Royal Commision, a tighter focus on ESG may not be a bad thing. It is how capitalism is supposed to work: self-interest leading to better outcomes for everyone.

This is an edited version of an article first published in the AFR in a column written by Chad Slater.

Figure 5 – Solar power's decreasing cost is now more competitive than oil



Source: Wermuth Asset Management

OUTLOOK

“Doubt is not a pleasant condition, but certainty is absurd.”

Voltaire

The world enters 2018 with an incredibly robust macroeconomic backdrop. Strength in economic data is as broad as we have seen in many years. One measure, the US Purchasing Managers Index new orders, less inventories, is approaching levels not seen outside of the 2009 bounce, 2004 or the mid 1990’s, which we can also observe on the Global PMI surveys (**Figure 6**).

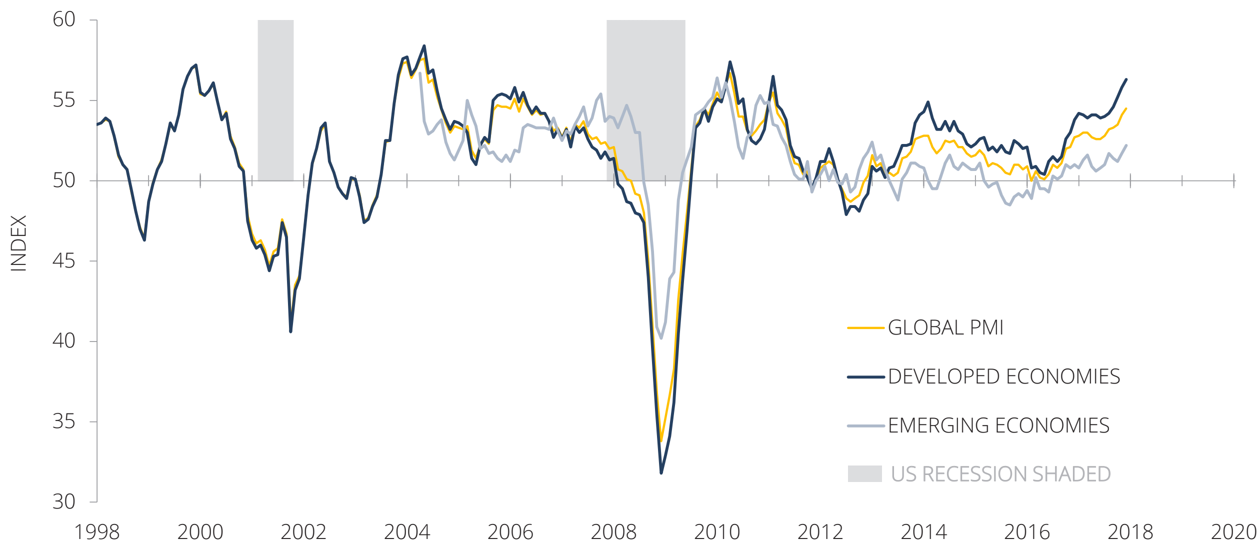
The consensus view is that the bull market is in its last stages, using the length of prior expansions as a guide. This is not unreasonable, but our conviction is tempered by the fact that this has been an odd cycle: one that has incorporated a financial crisis as well as an economic recession. So, this half we take our lead from Voltaire and consider our “doubts”, forcing ourselves to take a fresh look at prospects for the year ahead.

What matters for the length of a cycle is not its calendar age, but rather its capacity to keep growing without stimulating excess inflation. This is taken as indicative of a lack of spare capacity or an overheating economy and usually brings accelerated interest rate hikes that end the cycle.

Bloomberg’s economic team suggested considering real Gross Domestic Product (real GDP) output growth in the cycle, from start to finish, as one alternate metric to use instead of calendar age.

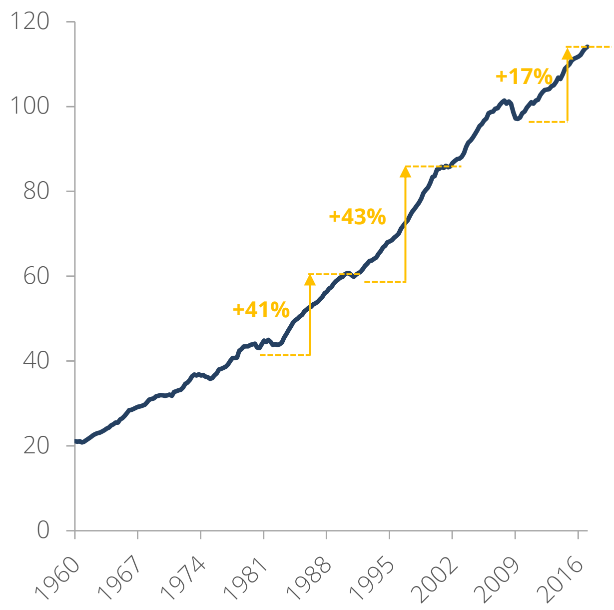
As can be seen in **Figure 7** (next page), US real GDP has now expanded by 17% from the lows of 2008. Wonderfully steady, but spectacularly dull, compared to other recent cycles like those in the 1990s and the 1980s, during each of which real GDP increased by over 40%, let alone the 1960s, when it grew over 50%.

Figure 6 – Purchasing Managers Index globally, in Developed and Emerging economies



Source: Minack Advisors

Figure 7 - US real GDP since 1960



Source: Bloomberg, Team Analysis

This slow rate of expansion has left the economy devoid of the typical signs of imbalance - overheating inflation, acute labour shortages and wage pressure or excessive capital investment.

Typically, rising business investment is a hallmark of the middle stages of an economic cycle. Early on, businesses have limited incentive to make capital expenditures, given that they have ample capacity and do not face substantial labour cost pressures. The slow pace of expansion to date has forestalled the need for businesses to deploy capital, but this appears to be on the brink of changing. As the economic expansion not only extends, but accelerates, intensifying capacity constraints are begetting the need for investment in technology, equipment and structures. US tax cuts are only likely to accelerate this trend.

While the economic cycle is in its ninth year, business investment behaviour resembles what ordinarily occurs around a cycle's midpoint.

But what about higher wages and inflation? Increased bargaining power among workers would mark a notable change from the past several years but would neither be unusual at a point when the economy crosses beyond full employment, nor a harbinger of an immediate top in the business or market cycles.

In the record-long 1990s economic cycle, full employment was reached around 1995, and the cycle endured until mid-2001. In the last expansion, full employment occurred around 2004, and the cycle continued until 2007.

In other words, the arrival of full employment, which arguably only occurred at the start of 2017, is a compelling signal that the economy may have entered the second half of the cycle - but remains far from its twilight stage. Drawing a parallel with the 1990s cycle, from a labour market perspective, 2018 looks a lot like 1996.

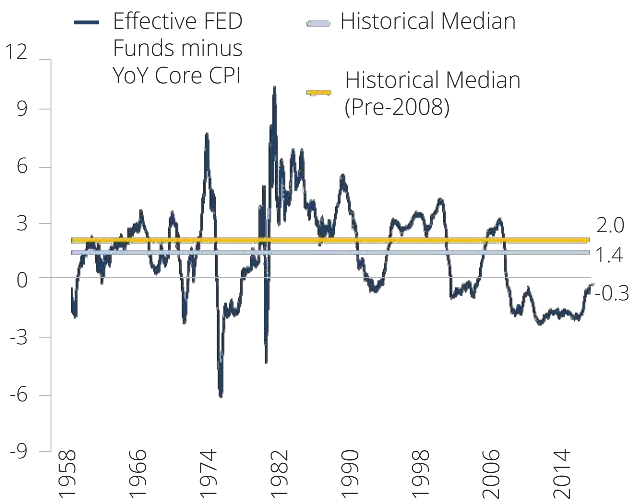
All of which assumes 2018 **is** the year in which wages pressure build. The US does look as though it is close to full employment, but most other regions, especially Europe, are still some way off. The exception is Japan, but if this is any guide we may still be searching for signs of rising wages in the US this time next year. Unemployment in Japan, continues to hit new lows, and is now well below 3%, and total employment is making new highs, yet still wages are not taking off.

In our Reflections on the Half section, we commented that 2017 will likely be remembered as the year the cycle went "mainstream" – when "fear of missing out", overwhelmed "fear of loss" (we blogged here about this in more detail). Bitcoin and the way it went "mainstream" in 2017 (Team Morphic was peppered by family member questions about this over the summer holidays), is indicative of this confidence.

In this context we believe it would be absurd if the current position persists where global real interest rates remain below zero (**Figure 8**), even if wage inflation takes a little longer to emerge.

This makes us conscious that 2018 may finally be the year when interest rates rise more than expected. As US 10-year treasury yields scarcely rose over 2017, this may seem a brave call, not backed by any sign of momentum, but we see room for them to reach 3% from their current 2.4% levels.

Figure 8 – US real 12-month interest rate



Source: Pension Partners

The outcome may ultimately depend on two potentially conflicting drivers, a US Federal Reserve which is "guiding" for three official rate hikes this year, and stubbornly low bond rates in Europe. It will be hard for US bond rates to rise too much if German bonds do not lift a bit.

On the other hand, if US treasury yields stay low despite Fed Funds rate hikes, and the yield curve (the difference between short-term and long-term borrowing) flattens, we would simply see this as another indication we are still closer to the mid-point rather the end of the market cycle.

How do equities react to this and what kind of continuing mid-cycle share market rally are we expecting?

We think 2018 will be more like 2005 than the mid-1990s (or 2017 for that matter) when tech mania carried markets higher at the expense of cyclical and value stocks. In a 2005 like environment Japan, Europe and Emerging Markets (all of which have more cyclical and value stocks than the US) will lead, driven by both rising earnings and P/E rerating.

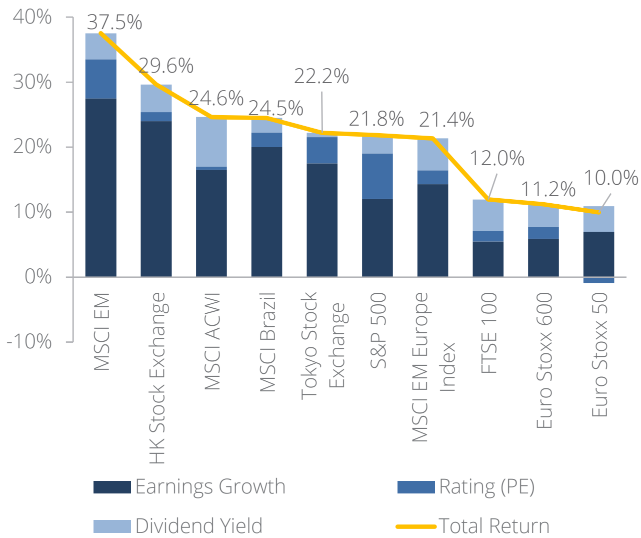
However, all is not lost for US markets. We may have been wrong in calling for P/E contraction last year, but we will repeat the call this year. But unlike 2017, when the US had to play it's "get of jail card" of last year through P/E expansion even as earnings failed to keep up (**Figure 9**), in 2018 we expect rising corporate earnings to offset P/E contraction for a positive outcome for stocks. This mix will probably come with more volatility than last year – though that is not a brave call!

All of which sounds like the playbook from last half. Investors, who having read this far hoped for more sound and fury, will be disappointed. But the reality is that when the real economy (as opposed to the financial economy that markets operate in) gets momentum, that momentum is hard to break – like a supertanker.

Risks? A recession in 2018 remains unlikely. If we were to nominate a risk, it is that the financial economy fails to adjust in an orderly manner to reflect the changed (stronger) real economy. This could cause a bond market rout as investors get excessively concerned about inflation, which contaminates other assets.

But we see this as unlikely at this stage – and it would probably be a mistake to position for it before late 2018.

Figure 9 – Composition of global markets total returns in 2017



Source: Bloomberg (forward Consensus EPS/PE), Morgan Stanley

HOSTAGES TO FORTUNE: ANTI-PREDICTIONS FOR THE FIRST HALF OF 2018

> *If you have to forecast, forecast often.*
>
> **Edgar R. Fiedler**

As usual we finish our report with a series of "non-predictions" for things we do not think will happen between now and June 30th, 2018.

BACK CHECK

First, we must reflect on the performance of our last set of "anti-forecasts" over this half that just ended.

Emerging Markets will NOT finish the year higher than current levels.

Miss! Off to a bad start for the predictions. The Emerging Markets rally carried on, to finish up 34%. It also broke records for low volatility: we now have a new benchmark for Emerging Markets with a year of no 10% falls in it. This had not happened before. A buy, hold, and forget year.

Australia will NOT cut interest rates this year.

Hit! The interest rate market has done a full 180-degree turn and is now pricing hikes for next year. Incredibly strong job growth, even with low wage growth, has set the scene for a debate over when first hikes are, rather than cuts.

Chinese credit tightening will NOT jeopardise the Chinese Economy.

Hit! One of the biggest stories of the second half of 2017 was to see global GDP is growing strongly, without being dependant on China. This has allowed Beijing to tighten in focussed areas, with the economy still able to grow. This has turned out to be a potent mix for Chinese equities.

Global bond markets will NOT crash.

Hit! US Bond yields started the half at 2.3%... and finished at 2.3%. A snooze-fest. With shorter term rates rising, this says yield curves flatten, but it was a potent mix for equities.

Japan will NOT underperform global markets.

Hit! After a slow start, Japanese equities roared home, rising 12% since September to outperform global markets. Good global growth and Abe's success in the elections, drove renewed interest in Japan.

Scoring 4/5 it was one of our better performances on anti-forecasts and a definite step-up from this time last year where we scored a paltry 2/5.

NEW VIEWS

So here are our predictions of what WILL NOT happen by June 30th, 2018

European Banks will NOT be a graveyard for investors (Deutsche Bank to outperform world stocks).

If our call for continued strong European and global growth plays out in the first half, maybe, just maybe, the concept of paying to own European Bonds may lose its allure. Combining this with growing credit demand and the passing of peak regulation, we could see an explosive rally in even the most unloved of European banking stocks.

The Australian dollar will NOT go anywhere (ie stay in a range of plus or minus three US cents).

One risk of forecasting is the need to believe that something always happens. Often nothing does! 2018 could see competing forces. Probable positives for the Australian dollar include robust growth, rate hikes from the Reserve Bank of Australia and a continued diversification by international investors from US dollars into other currencies. Opposing this we see slowing growth in commodity prices hurting Australia's terms of trade combined with US rate rises. In this tug-of-war is an Australian dollar that stays relatively flat, a rare outcome for such a volatile currency!

Global growth will NOT falter.

The synchronised expansion has more room to run. Global growth's strength and breadth shows little in the way of abating, and while we expect the impacts of US monetary tightening to start showing, we do not expect it to derail the positive forces at play - US tax reform, strong global trade and business optimism.

Weak Australian consumers will NOT buckle the Australian economy.

Current concerns around weak Australian retail are overdone. The ongoing positive global and local business backdrop combined with positive fiscal developments in Australia will encourage the consumer to refrain from slowing spending any further.

Pakistan will NOT lose to India.

Sadly, no test matches are planned between the two nations until December 2019. However, after a horror 2017 for the Pakistani stock market, and an excellent one for India, prospects for a change of leadership look strong in these terms at least.

Even by its own standards Pakistan is now cheap on almost any metric – and despite a year of political turmoil and Trumpian attacks both corporate earnings and economic growth prospects remain solid.

By contrast, valuations in India are now exceptionally elevated. This has recently been reflected in foreign investors trimming their holdings, whereas in Pakistan there are early signs of a return.

GLOSSARY

Alpha
Alpha, sometimes called the 'active return' on an investment, gauges the performance of an investment against a market index or benchmark which is considered to represent the market's movement as a whole.

Bond
A bond is a fixed income investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate. Bonds are one of the three main generic asset classes, along with stocks (equities) and cash equivalents. The indebted entity (issuer) issues a bond that contractually states the interest rate that will be paid and the time at which the loaned funds (bond principal) must be returned (maturity date).

Consumer Price Index (CPI) and Core CPI
The Consumer Price Index (CPI) is a broad measure of inflation within an economy in relation to the cost of goods and services. That figure can have a significant impact on the value of a currency in relation to the currencies of other nations. The Core CPI excludes costs in the energy and food sectors, which tend to experience greater price volatility over time.

Credit Spread
A credit spread is the difference in yield between a Treasury bond and a debt security with the same maturity. To illustrate, if a 10-year Treasury bond has a yield of 2.54% while a 10-year corporate bond has a yield of 4.60%, then the corporate bond offers a spread of 206 basis points over the Treasury bond.

Dividend Yield
A financial ratio that indicates how much a company pays out in dividends each year relative to its share price. Dividend yield is represented as a percentage and can be calculated as follow:
Dividend Yield = (Annual Dividend Per Share) / (Price Per Share).

Federal Funds Rate
The federal funds rate is the rate at which depository institutions (banks) lend reserve balances to other banks on an overnight basis and is set by the Federal Reserve. The fed funds rate is one of the most important interest rates in the U.S. economy since it affects monetary and financial conditions, which in turn have a bearing on critical aspects of the broad economy including employment, growth, and inflation.

Gross Domestic Product (GDP) and Real GDP
The market value of all goods and services produced within the economy in a given period of time.
Real GDP is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year.

NTA
Net tangible assets are meant to represent a company's total amount of physical assets minus any liabilities within the company.

Pairs trade
A basic long–short trade in which an investor is long and short equal currency amounts of two common stocks in a single industry.

Price to Earnings Ratio (P/E)
The ratio of a company's current share price to its per-share earnings. the price-earnings ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. A high P/E ratio suggests that the company's share price is expensive relative to the company's profits, which usually implies that investors are expecting the company's future profits to grow quickly.

Purchasing Manager Index (PMI)
The Purchasing Managers' Index is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Real interest rate
A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. The real interest rate is calculated as follow:
Real Interest Rate = Nominal Interest Rate - Inflation (Expected or Actual).

Sharpe Ratio
The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. The Sharpe ratio has become the most widely used method for calculating risk-adjusted return. The ratio describes how much excess return you are receiving for the extra volatility that you endure for holding a riskier asset.

Short Selling or Shorting
A transaction utilised to generate a profit from the fall in price of a financial security such as shares, indices, commodities or other financial assets. Short selling is the sale of a security that is not owned by the seller or that the seller has borrowed. It may be prompted by the desire to hedge the downside risk of a long position in the same security or a related one.

US 10-year treasury yields
It refers to the return on an investment in a US government 10-year debt obligation. The 10-year U.S. Treasury bond can help gauge investor sentiment. High investor confidence means falling prices and demand for the 10-year Treasury, and therefore a higher yield, because investors are confident they can find other investments with better returns. Prices rise and its yield decreases when confidence is low as there's more demand for this safe investment.

Source: CFA Institute and Investopedia

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