



Morphic Global
Opportunities Fund

HALF YEAR REPORT

January - June 2017

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MORPHIC ASSET MANAGEMENT TEAM

*Jack Lowenstein, Chad Slater, Geoff Wood, James Tayler,
Irene Kardasis, Nadeem Ali, Cameron Halkett, Lucina Martin, Daniel Hayman*

ACKNOWLEDGEMENT

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Jack Lowenstein

Managing Director



Dear Investor,

It is hard to believe that time has gone so quickly, but we have already passed the halfway mark of 2017.

The first half has been exciting for the Morphic Global Opportunities Fund (MGOF) unitholders and Morphic as a business. A pivotal event was Morphic launching an ethically screened version of the MGOF on the ASX, the Morphic Ethical Equities Fund Ltd (ASX: MEC), raising almost \$50m.

As many of you know, prior to setting up Morphic in 2012, Chad and I both worked at Hunter Hall, which was once Australia's largest ethically screened manager. This background meant many former and prospective investors have long wanted an ethically screened version of the MGOF. Thus, when the opportunity came up to work with Geoff Wilson, the pre-eminent manager in the listed investment company format, it was clear that the timing was right.

The MGOF has always been run to ethical standards and reflecting this, at the time we launched, all the stocks in the MGOF were eligible for MEC. Details of our ethical charter can be found on [our website](#). As part of the process, we also undertook to have both the MGOF and MEC certified by the Responsible Investment Authority of Australia (RIAA) and we are a signatory of the UN Principles of Responsible Investing.

Meanwhile it has been a good year for MGOF investors, with the Fund up 5.74% over the half and 13.31% over the financial year. As it approaches its fifth anniversary in August, it is gratifying to see that the MGOF is ranked in the first quartile versus peers (many of whom are large global firms) in the Mercer survey data over the last 3 years as of April 2017. This ranking confirms the belief Chad and I have that we have entrusted your – and our – money with a world class investment team.

Our growth from launching the MEC is allowing us to invest further in talent. Lucina Martin and Daniel Hayman interned at Morphic in 2016 from the University of Sydney Business School. The quality of students we receive is excellent and Lucina and Daniel have been among the best, so we have offered them part-time analyst roles while they complete their studies.

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

Regards,

A handwritten signature in black ink, appearing to be 'J Lowenstein', written in a cursive style.

Jack Lowenstein

REFLECTIONS ON THE HALF

“To doubt everything, or, to believe everything, are two equally convenient solutions; both dispense with the necessity of reflection.”

Henri Poincaré

	FUND	INDEX
6 months	5.7%	5.2%
1 year	13.3%	15.3%
3 years (p.a.)	11.7%	12.3%
Since inception (p.a.)	17.5%	17.8%

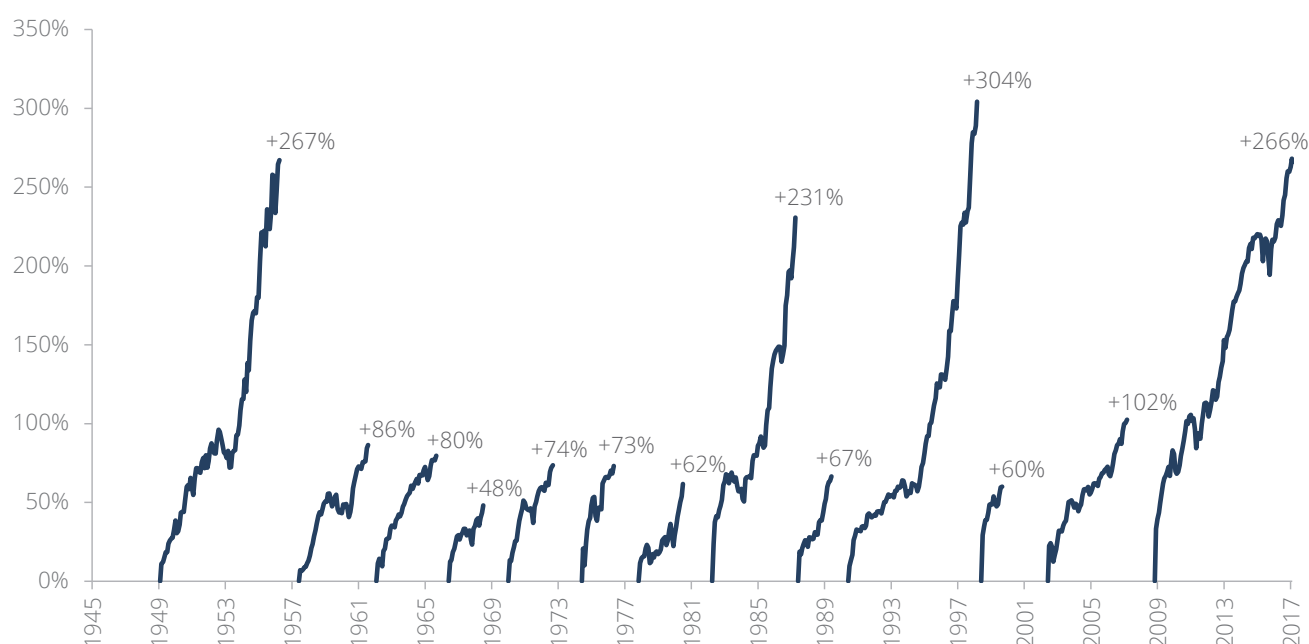
Onwards and upwards has been the story of 2017 thus far. The bull market is now over eight years old, which puts it in rarefied air compared to prior bull markets (**Figure 1**), though it has been an odd grinding bull market, with more fear than euphoria thus far.

In [our Half Yearly report from this time last year](#), we used the quote from Sir John Templeton: “Bull

markets are born in pessimism, grow on scepticism, mature on optimism, and die of euphoria”. This year could be characterised as thus far being the cementing of optimism into people’s views. If and when we move to euphoria remains to be seen.

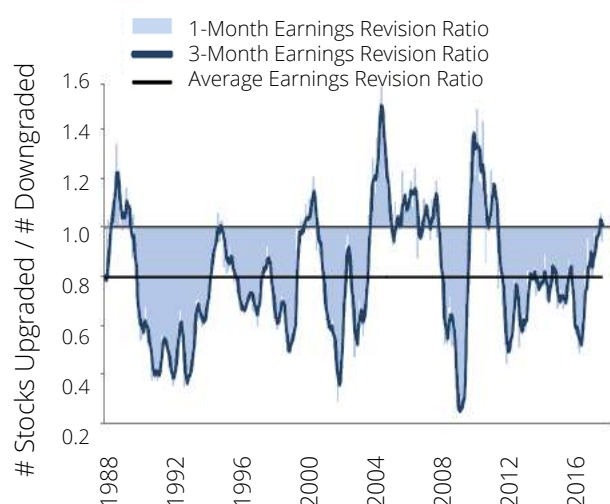
Global growth forecasts have improved across the year, with regions outside the US now also

Figure 1 – Cumulative S&P 500 gains in post-war bull markets



Source: Bloomberg, Team Analysis

Figure 2 – Global Earnings Revision Ratios 2017



Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, IBES

picking up and Europe showing improving signs of growth. This is flowing through to earnings forecasts globally which now stand at some of the best levels in six years (**Figure 2**).

Reflective of this new-found optimism, money flowed into Europe and Emerging Markets, with those regions performing the best over the half and the US being the laggard, along with Australia.

Our local market performance was symptomatic of the other rotation that took place over the half: markets bought back into the FANG stocks (Facebook, Apple, Netflix, Google) and growth stocks in general and sold down the winners from the “Trump trade” last year – namely financials commodity and cyclical stocks. The high level of financial and commodity stocks compared to the rest of the world, and the limited number of growth stocks, were the main drivers of Australian markets' underperformance.

As the “Trump trade” faded, so did the belief in the Federal Reserve increasing interest rates as much as it or the market expected at the start of 2017. This has led to lower interest rates in the US, causing downward pressure on the US dollar, with the result being a higher Australian dollar despite lower commodity prices. Later in

the half this was exacerbated by several non-US central banks discussing their paths towards more normal rates.

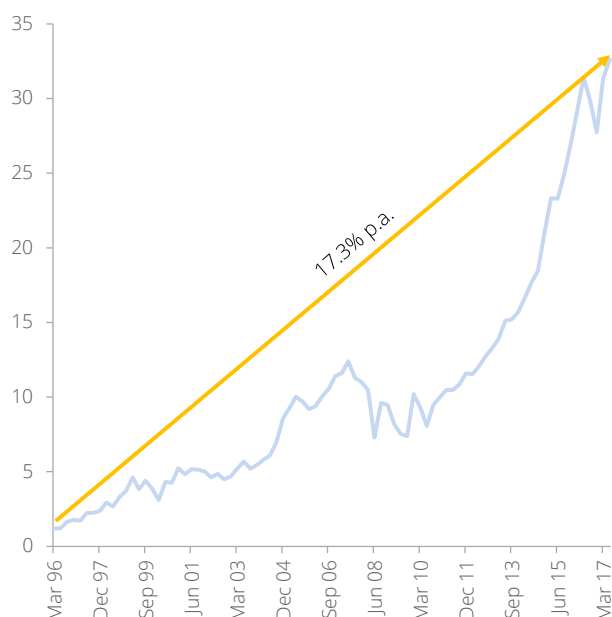
The rising Australian dollar over the half dampened returns for our investors but the Fund rose 5.7% over the half, outperforming global markets which rose 5.2%. Stock selection was the key driver of outperformance over the half. Country allocation added value driven by our large weighting to India. Market neutral and short positions added value. Our hedging detracted value over the half.

Morphic's Joint CIO Jack Lowenstein has been a regular visitor to India since 1980. Two of the top three contributors for the half came from India, with **Rural Electrification Corp** being the largest and **IRB Infrastructure** (IRB) being the third largest. This year, as investors globally have become comfortable with interest rates not going as high as they first feared, high yielding stocks in countries like India benefited. The flow on effects to the Indian economy and Prime Minister Modi's ratings after the botched implementation of demonetisation (discussed in [our last Half Yearly report](#)) have been limited. In Rural Electrification's case, good operating earnings results plus a cheap starting valuation (the stock traded on less than 5x earnings) has helped.

IRB is the largest developer and operator of toll roads in India. Anyone who has visited India can attest to the dire state of infrastructure there. With the passing of the demonetisation issues, focus this year turned to IRB's spinning out of some of its mature toll roads into a high yielding infrastructure fund. We believe the **IRB Infrastructure Investment Trust** (IRB Invit), India's first such vehicle, will prove to be a turning point in the perception of Indian toll roads, and funding for future infrastructure assets.

The spinning out of operating toll roads as high yield vehicles is common in Australia and has been extremely successful for both the company and investors. What is now called Transurban has delivered investors total returns of 17.3% per annum in the 22 years since

Figure 3 – Transurban's total return including dividends



Source: Bloomberg, Team Analysis

it listed (**Figure 3**), meaning investors have doubled their money every four years!

Morphic has taken a stake in IRB Invit, although much like similar Australian vehicles in their early days, returns have been disappointing. We think local Indian investors don't appreciate what the high yield (it will pay over a 9% yield) will mean for foreign investors. With still no analysts' estimates, it means the stock is not yet picked up by the screens that a lot of foreign investors use.

Clearly the risks of investing in India are higher than Australia, but with 5% inflation, and tolls linked to inflation, we can see total returns in IRB Invit of around 12% per annum. If investors were to bid those yields lower, to say 5%, then returns could average closer to 15% per annum. We think these returns more than compensate our investors for the risks.

The second largest contributor came from our paired investment in Hong Kong: long **Ping An Insurance** and short **People's Insurance Company of China** (PICC). In these types of investments we take a focussed view on management quality rather than sector or stock views. So here we weren't expressing a view on Chinese insurance, rather the strength of the

team behind Ping An. With some exceptional results earlier in the year, the stock has returned to trading at a significant premium to PICC. As such we have substantially reduced the position size, reflective of the lower upside we see from here.

We like to introduce one or two new stocks to our investors each half and in this report, we showcase **Macromill** in Japan which was the fourth largest contributor to performance over the half.

Japan is a fascinating market in so many respects, both culturally and economically. Japan has one of the largest capital markets in the world, with over 3,500 stocks listed, putting it not far behind the US (4,300) but receives much less coverage. Macromill is a specialist in market research and digital marketing to enterprises of all sizes. It recently re-listed after a period under the ownership of private equity firm Bain, during which Macromill expanded and acquired a business in Europe.

One of the paradoxes of Japan is that the country can be so export focussed (think of the great Japanese brands globally) and yet so inward focussed at the same time. This results in most companies hiring only locals for senior roles. Clearly this is not the case at Macromill which has a "gaijin" (foreigner) as CEO and other foreigners on their leadership team. With Japanese companies being no different to others globally in their need to develop digital expertise and branding, we see Macromill as being well positioned to sell best practices into the Japanese market.

The stock floated in March and was a "failed float", in that it fell on listing, which is rare in Japan due to the "loss of face" for all concerned. We used the opportunity to acquire shares that we had not been able to get in the float. We met with management as soon as the blackout period finished and have been impressed with the quality of the team. We look forward to talking more about this holding in the future.

WE INVEST IN COMPANIES THAT MAKE A DIFFERENCE

MACROMILL
GROUP



Research Panel Network

90 million people
across **90** countries



WE ADVOCATE FOR GENDER DIVERSITY

CEOs or
Chairpersons
in FTSE 100
companies



7
WOMEN



14
DAVIDs



17
JOHNs



Power Grid



पावरग्रिड



88
MILLION
AUD

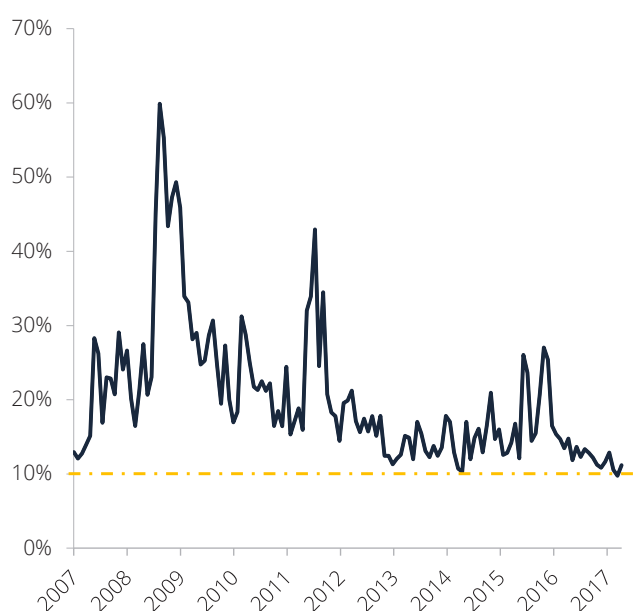
*Last Year's Environment
Protection Expenditure*

RISK MANAGEMENT

“ The world is a stage, but the play is badly cast. ”

Oscar Wilde

Figure 4 – Volatility Index (VIX) since 2007



Source: Bloomberg, Team Analysis

It was a relatively quiet half with few risk events of note. The price of insuring against market falls is shown by the volatility index (VIX). This index measures the anticipated swings in markets over the following year. It is also called the “fear index” as it is a good guide to how concerned investors are about a significant market drop. this index tracked towards multi decade lows over the half reflecting a healthy market backdrop with few major risk events. Historically the VIX has ranged from high single digits to more than 50% during the GFC. During the half, this market traded below the psychological level of 10% which worried many investors about market complacency (**Figure 4**).

We remained positive about the outlook and cash was not raised over 10% at any point keeping the portfolio largely invested

throughout the period. Hedging costs over the period were negative though small.

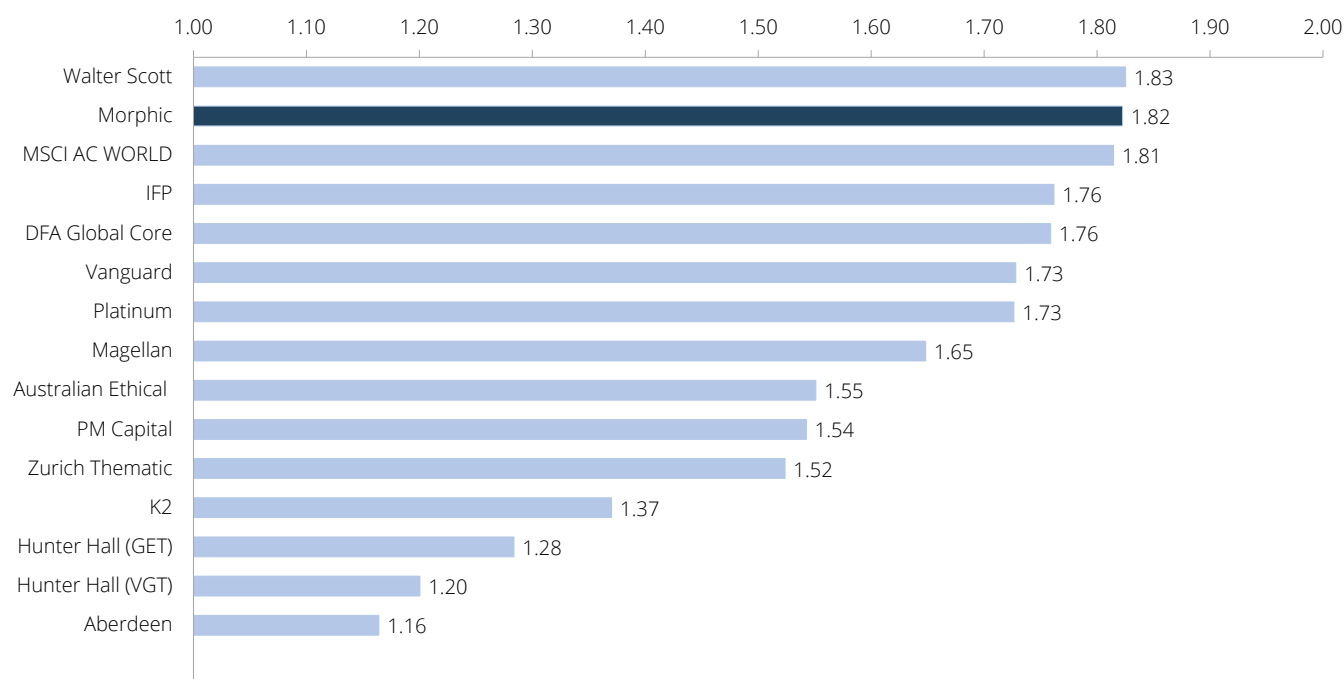
To us, the most important concern over the half surrounded policy changes in China where tightening in monetary and regulatory conditions appeared to put at risk the growth trajectory of the world’s second largest economy. This commenced around the time Trump won the US election. Chinese authorities were increasing regulations on financial markets outside of the banks, which are a material source of credit to the economy, while also raising interest rates to help reduce capital outflows (see **Figure 5**). However, the Chinese government cleverly took the opportunity to implement this when strong global growth served as a support for the export sector. Therefore, this move has largely been ridden out. We believe most of the tightening has been done for now but it is still an area to watch keenly.

Figure 5 – Chinese Interest Rates since July 2014



Source: Bloomberg, Team Analysis

Figure 6 - Morphic's Sharpe Ratio vs relevant peers (August 2012 to June 2017*)



Source: Peers' websites, Team Analysis

Ultimately the biggest risk for the Fund turned out to be the rising Australian dollar. We entered the year expecting further dollar strength which would have benefited investors. Trumps pro-growth agenda combined with Republicans having both the House and the Senate was an auspicious backdrop for further strength of the US economy and support for the US dollar. However, Trump has had little success in implementing tax cuts and other pro-growth initiatives, and over the half, the US dollar gave back gains on nearly all crosses. This has left the Australian dollar in a directionless range between 70-80 US cents for several years now creating an unfavorable regime to form firm directional views on, so we remain unhedged.

The Fund's Ratio of reward to risk taken (also referred to as Sharpe Ratio) continues to be favorable amongst peers as shown on **Figure 6** above.

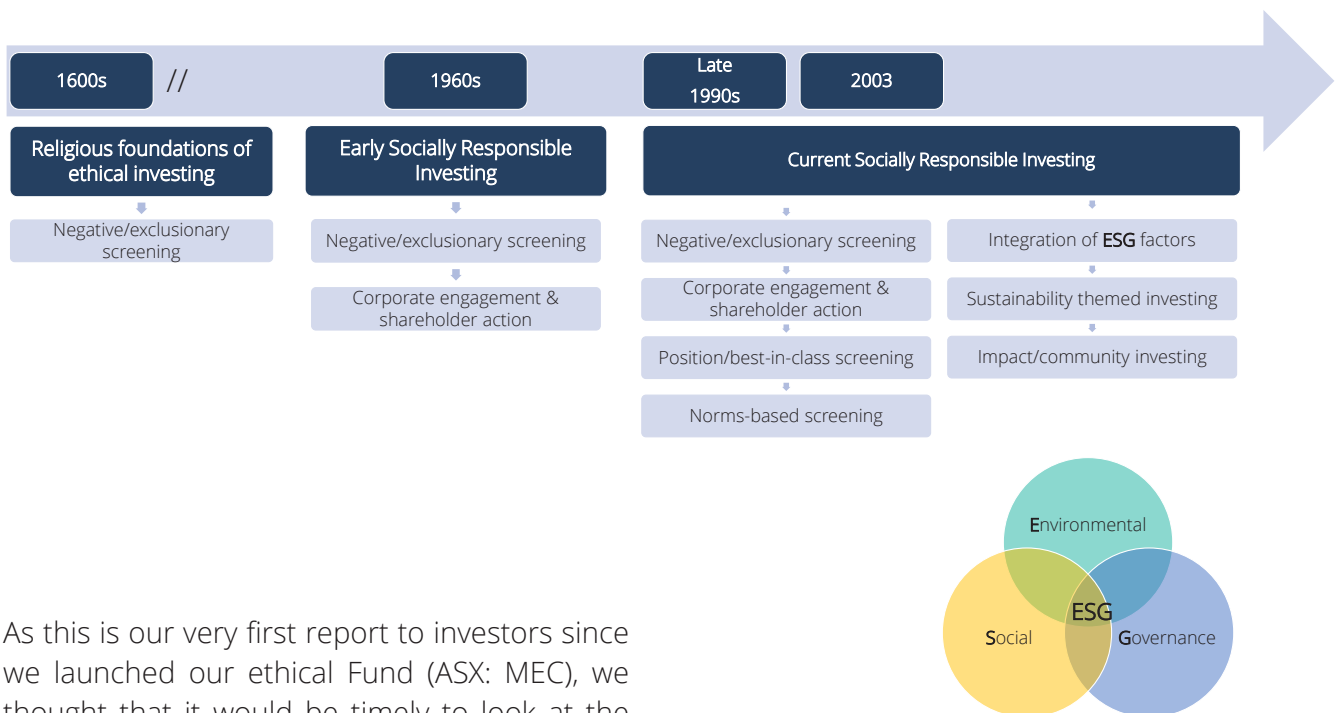
* Walter Scott Global Equity Fund, Morphic Global Opportunities Fund, MSCI AC World Index, IFP Global Franchise Fund, DFA Dimensional Global Core Equity Trust, Vanguard Index International Shares Fund, Platinum International Fund, Magellan Global Fund, Zurich Investment Unhedged Global Thematic Share Fund, PM Capital Global Companies Fund, K2 Select International Fund, Hunter Hall Global Equities Trust, Hunter Hall Global Value Limited and Aberdeen International Equity Fund.

SPECIAL FOCUS: THE EVOLUTION OF ETHICAL INVESTING

“Values are like fingerprints. Nobody's are the same, but you leave them all over everything you do.”

Elvis Presley

Figure 7 – Timeline of the Evolution of Sustainable Investing



As this is our very first report to investors since we launched our ethical Fund (ASX: MEC), we thought that it would be timely to look at the evolution of ethical investing over the last 20 years and also provide some thoughts on where the sector may be heading. This can help inform both us and investors as to the best way to spend our efforts to get the best outcomes as after all, it is outcomes that ultimately matter.

Figure 7 provides a schematic on the sector through time. Ethical investing was originally thought of as a niche to provide investors with investment products that satisfied their own personal values. The achievement of this goal was done through excluding certain companies, the most common being tobacco, armaments and nuclear-related, but over time this has expanded to include carbon emitters (energy and coal) and in some cases animal testing and alcohol.

Source: DBCCA analysis, GSIA, Team Analysis

We think it would be fair to say that early adopters of ethical investing have been “on the right side of history”. The past 20 years have seen a broader acceptance of these values amongst the investment community.

Over the past 10 years, the sector has expanded to focus on other areas such as Environmental, Social and Governance norms (ESG), sanctioning for example a lack of diversity on Boards of Directors. As such it has moved from excluding certain sectors to attempting to benchmark companies against “best practice” in these additional areas. [Empirical evidence](#) has provided support showing that “unethical” or “poor governance” companies have produced

substandard returns to investors.

Across Europe, in particular, it has become accepted practice to incorporate an ESG framework into investment decisions at many mainstream firms. Australia has seen some degree of adoption of these principles, but it would seem the Australian funds management community has been slower to adopt them than other regions.

This brings us up to today: an industry with some products that focus on screening out stocks, with others that additionally focus on screening out specific companies. However, there would seem to be a growing frustration that just not buying or divesting doesn't have the impact on behaviour that is required to change norms.

For certain, our industry will not stand still with the next development being the concept of impact investing. This refers to investments which are made with the intention to generate a measurable and beneficial social and environmental impact alongside a financial return.

Another potential area of success could be the shorting of the ESG-underperformers, in a "name and shame" approach. A lower share price may force management to adjust their thinking lest their company gets taken over and they lose their job. This is an approach that is open to the MEC.

A variation on these approaches, which we have discussed with one of the leading ESG-focussed firms in Europe, is the idea of "nudge investing". The concept of "nudging" was brought to prominence by Richard Thaler in 2008 in his book **Nudge**.

The idea is that positive reinforcement and indirect suggestions can be more powerful motivators to change behaviours than trying to force change through. It follows from the lack of success a number of ESG and governance teams have had in changing corporate behaviour, even when they were large shareholders.

Put simply, people respond better to positive feedback than they do to being yelled at or accused of being bad. Refusing to invest in

a company that does some things you may disagree with, but trying to do less of them could result in more bad outcomes rather than less, which isn't helpful to what ethical investors are trying to achieve.

In practice, it involves looking for companies that may not have great governance or environmental track records, but have expressed publicly that they are looking to change or improve. It is easier said than done, so it's important to engage to see if it is only words.

In these cases, shareholders can try and work with management to publicise the good work that management is doing, to help increase the revenue the company receives and hence its profitability. These results encourage management to do more and hence shareholders have been "nudged" towards better outcomes for investors and the environment. This may mean considering investment in companies that inhabit the "grey areas", not definitively passing or failing a negative screen, or ESG assessment.

Here in Australia, AGL could be considered a test case. AGL currently owns a number of coal fired power stations, but has vowed to get out of coal. Many are sceptical, but it is hard to argue that if done, this is a great outcome for Australia.

Offshore we have recently started to engage with some Japanese stocks we own. Japan has a poor record of diversity on their management boards, with women in Japan being poorly represented. Yet numerous studies have shown that more diverse boards make better decisions. Japan has a culture of "loss of face" so we are trying to work within these cultural norms to "nudge" management.

We are invested in a company which has already shown that they are progressive in other areas (with one board member under 40, which is very rare in Japan), so we are hopefully working with a receptive team. We want them to improve their business and for us to showcase them if we can have some success. We would hope to report back to our investors in the future on this.

OUTLOOK

“Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria.”

Sir John Templeton

The last half yearly outlook section began with the Charles Gave quote¹ about how increasing interest rates by central banks tends to have little to no effect for some time but ultimately, they always do and usually in a spectacular way.

It would seem this cycle, extraordinary in so many other ways, is following the old playbook again. The US Federal Reserve has now increased interest rates three times in six months (December 2016, March and June 2017), having raised rates before that only once in seven years. Emboldened and sensing a lack of impact thus far, they seem intent on doing another rate increase and beginning the reduction in the size of their balance sheet before the year-end.

When the Federal Reserve looks around the world, they see plenty of evidence to support their case that the world can handle more tightening. Global GDP growth rates have improved this year, led by a rebound in China and Europe. Emerging Markets, once seen as likely to struggle with higher interest rates, have done well this year, showing little in the way of stress. Financial conditions indices, which capture the cost of credit, are loosening rather than tightening. Lastly, the US unemployment rate has fallen to levels seen over a decade ago, indicating little spare capacity and potentially incipient wage increases.

Which is why we used the Gave quote last half: it always looks like this towards the end of the cycle in macro data. It never looks like higher rates are having an effect, until it is too late.

The hard part as an investor is how to position yourself in this phase of the cycle.

There has been an increasing amount of press about fund managers raising cash levels, with many pointing out valuations are somewhat expensive. But focusing solely on valuations ignores the fact that markets are manifestations of human's views (although Artificial Intelligence may change that). Which is why we repeat the Templeton quote above: a reminder of the psychology of the phases that one passes through in a bull market.

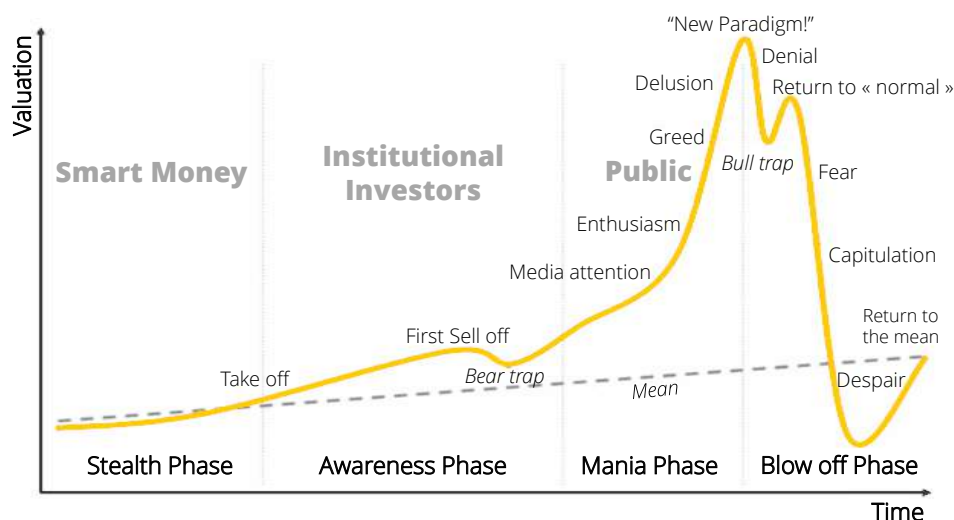
If we take what is happening in the macroeconomic data as returning to a “normal cycle”, then it suggests this equity bull market goes the same way in the end – normally. And “normal” in a bull market is characterised by extreme excitement and exuberance in the face of much higher interest rates. **Figure 8** gives a stylised example of a bull market.

As we can see in **Figure 8**, the biggest issue for investors, which also applies in most real-world cases, is that the last phase of a bull market tends to be the most profitable for investors. Selling early and carrying a lot of cash isn't just somewhat costly for investors, it's extremely costly. Markets charge a high fee to claim intellectual bragging rights.

We wrote in the Reflections on the Half section earlier that there is now “optimism” in the world. This, when combined with valuation levels, suggests to us that we are in the third phase,

¹ “I have often compared [Monetary policy] to dynamite fishing. One throws some dynamite sticks in the deep sea, to explode 300 meters below the surface. A large number of fish are killed. They rise to the surface belly up, the small ones first, the big ones some time later. And, finally, one or two whales emerge.”

Figure 8 - Stylised phases of the market valuation of a bull market



Source: Stocktwits.com

namely “Media attention and Enthusiasm”. Our experience says we haven’t reached the “New Paradigm” nor “Denial” phases quite yet, but some indicators of the new mania for Artificial Intelligence, technology and cryptocurrencies says we may not be that far away.

At the time of writing, the European Central Bank had discussed the phased ending of stimulus, in much the same way that the US Federal Reserve did in 2013. What has been interesting is that other central banks, namely the Bank of Canada and the Bank of England (BoE) intimated the same view at the same time. Coordination or coincidence? We would suggest the former. The BoE in particular has a history of failing to follow through on jawboning, so markets are somewhat sceptical, but it would suggest that the fall in interest rates seen this year is done for now.

Bringing it all together, we see that for some markets, such as the Nasdaq and growth heavy markets, the best returns of the year have already happened. That being said, prognostications about the movements of markets over the next six months is harder than usual, but we would conclude that being extremely negative is one of the less likely outcomes for markets near term. The Merrill Lynch model that correctly called markets to be higher from June last year based on a number of conditions they monitor, continues to suggest stocks will be higher a year from now.

We remain optimistic overall on Emerging Markets, though with these markets having rallied so much this year already, and given they are prone to bouts of pessimism, we think the next six months will likely be more of a challenge for returns in those markets, which may finish the year positive, but perhaps not higher or much higher than here. A rising US dollar is also generally a headwind. We retain high levels of exposure to India, but have trimmed our Pakistan exposures.

What has not panned out thus far is a strong US dollar, or looked at the other way, our expected weakness in the Australian dollar. We outlined in the last report how the cost of capital would rise for firms if interest rates stayed where they were. These events did not occur and the fall in interest rates over the half helped stocks but also hurt the US dollar.

Looking forward we see the US dollar stabilising over the second half of the year. From an Australian dollar perspective, Australia’s terms of trade improvement are over; the housing bubble looks to be peaking under the pressure of increasing interest rates; and employment may be as good as it gets in this mini-cycle.

The one market that we continue to like from here is Japan. It has shown an ability to decouple from the currency to a certain extent; it does well in global growth phases; and there are genuinely interesting changes taking place there at the stock level.

HOSTAGES TO FORTUNE: ANTI-PREDICTIONS FOR THE SECOND HALF OF 2017

“My interest is in the future because I am going to spend the rest of my life there.”

C.F. Kettering

As usual we finish our report with a series of “non-predictions” for things we don’t think will happen between now and December 31st, 2017.

BACK CHECK

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

The oil price will NOT finish the half higher than where it started.

Hit! With oil falling from \$56 to \$48 over the half, or 14%, this was a successful call. We wrote that the issue for OPEC was likely to be the rapid response from US shale oil. So it transpired that OPEC cuts failed to offset US production increases.

Emerging Markets will NOT outperform Pakistan.

Miss! Emerging Markets outperformed Pakistan by over 25% over the half. In markets, sometimes it’s “better to travel than arrive”, and the local sellers have outweighed any prospective pick-up of inflows from Pakistan’s promotion to Emerging Market status. Increased taxes in Pakistan on capital and a currency devaluation also haven’t helped nor has an investigation into the Prime Minister.

Economic policy uncertainty will NOT abate.

Miss! The economic uncertainty index we used here actually fell over the half. Whilst hard to pin

a reason on why, given a potential impeachment in the US, successful French and Dutch election victories for mainstream parties probably helped.

Negative rates will NOT disappear.

Hit! Japan and Europe remain in their negative rate settings. The Trump spike in yields abated over the half and the year on year effects from the oil price increase have turned negative, leading to lower CPI. This means they are unlikely to be hiking soon.

Europe (Eurostoxx 600) will NOT underperform the US market (SPX).

Hit! Europe rose 14% in USD terms versus 8% for the US market over the half. Most of what we outlined played out: GDP data improved and money flowed in searching out the cheap valuations. What was somewhat unexpected was this was done with a stronger Euro, breaking the nexus of the inversely relationship between the Euro (fall) and local markets (rise).

The good news is that 3/5 is a decent hit rate for the half. The bad news was the Fund closed out some of the winning positions earlier in the half, thus not fully maximising gains from these calls.

NEW VIEWS

So here are our predictions of what WON'T happen by December 31st, 2017

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

Goldman Sachs recently published a fascinating statistic on Emerging Markets volatility, noting that every year there has been at least a 10% fall, without fail. With Emerging Markets up 18% already this year, we'll back history to hold true to form and see at least a 10% fall from here, that will see Emerging Markets up for the calendar year, but lower than their highs.

Australia will NOT cut interest rates this year.

The market is pricing in a very small chance of a rate cut this year. We think the hurdle for the RBA to cut rates here is very high, given its concerns about the housing bubble. Next year it will probably have to cut, but find itself cutting too little and then too late.

Chinese credit tightening will NOT jeopardise the Chinese Economy.

Ongoing monetary and regulatory tightening is seen as one of the largest risks to global financial markets. The tightening is a deliberate policy move to help manage the leverage in the economy. The Chinese Central Bank and regulators have a handful of powerful levers at their disposal as well as political sway on bank lending and are well placed to manage this stage of their ongoing transition. Scored by credit not widening beyond 8% over Government yields.

Global bond markets will NOT crash.

Bond market yields remain low by historical standards. While Central Bank money printing is often blamed, the structural low growth low inflation world explains most of the current levels. With the Federal Reserve on a steady and predictable course, only strong inflationary pressures or rising productivity could provoke a material sell-off in bond markets. US 10 year yields will not finish the half over 3.25%.

Japan will NOT underperform global markets.

As we noted in a series of blogs in recent weeks, the mind set in Tokyo has gone from the hubris of the 1980s to a state of permanent gloom. We believe low valuations and low expectations, plus signs we are on the verge of a pick-up in wage levels could see the start of some material and maybe protracted outperformance for Japanese equity markets.

Focussed Vigilant Agile



Morphic Asset Management Pty Ltd

ABN 33 155 937 901

Level 3, 139 Macquarie Street, Sydney NSW 2000 Australia

AFSL 419916

enquiries@morphicasset.com

+61 291 946 707

www.morphicasset.com