INVESTMENT MANAGEMENT

Investment Outlook 2015

Investing in unusual times

2015 Outlook

Economic Outlook

Fixed Income

Australian Equities

International Equities

Asian Equities

Infrastructure Securities

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Introduction

As 2015 gets underway we have spent time with our investment experts to give us their views on markets in 2014 and share some perspectives on key themes for the year ahead.

Summary

- At a macro level, the divergence in central bank polices is likely to be one of the major factors impacting investment markets in 2015
- There are likely to be significant investment opportunities for specific sectors

Macro themes

- **Global growth -** is expected to continue at a moderate and uneven pace through 2015, encumbered by both the legacies of the financial crisis and a number of new challenges.
- **Interest rates -** although a move up in US interest rates in 2015 still seems dependent on improving economic data, many other economies are now facing the potential of interest rate cuts in 2015. This divergence in central bank policy could affect investment markets in many ways and with unintended consequences.
- **Markets and volatility -** investors are likely to disagree about whether a given market is attractively valued. However, in the current environment, investors need to be sure they are being appropriately rewarded for the level of risk they are taking. There are likely to be new investment opportunities throughout the year, but in an environment of divergent central bank policies and potential increased volatility, investors are likely to need to be increasingly vigilant and active in their approach.

Economic Outlook

Richard Gibbs | Head of Economics

Economic conditions continue to diverge widely across the major economies with an expectation that central banks will maintain stimulatory policy settings for the foreseeable future.

In Australia, economic conditions continue to suggest lower growth rates as policymakers attempt to smoothly transition the economy from mining investment-led growth to non-mining demand.

Review of 2014

Economic conditions diverged widely across the major economies in the second half of 2014 as policymakers maintained their efforts to overcome the legacies of the financial crisis while at the same time addressing structural weaknesses.

US economic data shows that the economy has been expanding at a pace close to, or even a little above trend. Business investment has picked up noticeably in recent months, and firms have stepped up the pace of hiring. Consumer spending has continued to grow steadily, in line with growth in incomes; and public demand is no longer weighing on growth, in contrast to recent years.

The Australian economy entered an 'income recession' in the third quarter of 2014. Whilst production rose, the 'pay cut' delivered by the rest of the world to Australia means that the economic wellbeing of Australians, on average, declined.

The economy is producing more, but earning – and able to spend – less. This development has complicated the task of policymakers to smoothly transition the economy from mining investment-led growth to non-mining demand.

Outlook for 2015

The global economy is expected to continue to grow at a moderate and uneven pace through 2015, encumbered by both the legacies of the financial crisis and a number of new challenges, as policymakers and investors anxiously wait and hope for a more uniform and robust economic expansion.

The US and UK economies will remain in the vanguard of the recovery, although both face potentially unsettling political environments through the course of the year and the rise of more 'nationalist' sentiment. In the Eurozone and Japan, expanded 'quantitative easing' (**QE**) measures will take both central banks into uncharted waters and possibly raise renewed concerns about the limitations of unconventional monetary policy.

Meanwhile, the major developing economies will remain engaged in efforts to achieve macroeconomic stability, with China and India expected to embrace expanded structural reform programs in an effort to place their economies on more efficient, transparent and sustainable growth paths.

The Australian economy is expected to have grown at a sub-trend pace of 2.7% in 2014, and a little further moderation in the rate of growth is expected in 2015 as activity is weighed down by lower income growth. Housing and consumer spending will likely be stabilised by expectations that the RBA has ample capacity to cut interest rates further in 2015 in an effort to cushion the economy from the full effects of the current 'income recession'.

Fixed Income

Brett Lewthwaite | Head of Fixed Income and Currency

Government bonds were the standout performer in fixed income markets.

Increased divergence in central bank policies is likely to cause further market volatility and uncertainty.

Review of 2014

Markets continued to be dominated by central bank activity in 2014, though the last six months differed significantly in that the world's major central banks began moving in different directions. The US Federal Reserve's (**Fed**) quantitative easing (**QE**) program (which has been providing broad based support to global markets) finished in October. At the same time, central banks in Japan, China and Europe have increased their commitment to easing. The divergence has already contributed to significant market moves, with the strong appreciation of the USD and volatility in commodities and some portions of the credit markets. This is occurring despite the Fed only beginning to consider a rate rise, confirming the return of volatility after a first half of very mild market conditions.

Government bonds were the standout performer in fixed income markets, with yields heading lower as investors surveyed a world of limited growth with continued and concerning disinflationary trends. With the fall in oil and other commodity prices, investors have embraced the asset class despite the heavy debt levels of the sovereigns. Even the US, with a more upbeat economic outlook, saw its yields fall despite the Fed's messaging that it may begin hiking rates in 2015.

Credit markets were weaker in the second half of the year, with volatility returning and investors increasingly eyeing liquidity as critical in their portfolios. The US market, in particular, was softer, reflecting its weighting to energy issuers, heavy supply and tighter financial conditions. In contrast, European and Australian credit continued to perform quite well, with European credit supported by growing expectations of stimulus.

Outlook for 2015

Despite little concrete evidence that there is a positive link between QE and economic growth, markets have placed a lot of faith in unconventional monetary policies. With the Fed exiting its QE policy, the question this year will be whether the Bank of Japan and the European Central Bank can provide the same support to financial markets. Whilst the Fed's stimulus impacted all corners of the world given the USD's world reserve currency status, asset purchase programs from other central banks may not have the same effect of broadly supporting asset prices.

Investment grade credit continues to be supported by strong balance sheets and low default rates. However, without the rising tide of Fed stimulus to lift the broader market, sector and single name selection will be key to performance. Yields are lower and dispersion of returns is likely to be higher. Investors must also focus on liquidity. With the receding Fed support beginning to expose illiquid positions, should conditions worsen, investors will head for the same exit doors.

The unintended consequences of extraordinary policies are increasingly generating trends we believe will continue. The divergence in central bank policies has significantly strengthened the USD putting pressure on emerging markets which have traditionally used the USD for a large portion of their funding. Low global inflation has been exacerbated by falling energy prices and raises the risk of deflation in some regions, despite QE policies that were designed to spur spending and boost inflation. Given market sensitivity to central bank actions observed thus far, we remain sceptical that any central bank can materially withdraw stimulus without derailing the slow global recovery.

Australian Equities

Patrick Hodgens | Head of Equities

2014 produced divergent sector level performance with the healthcare sector performing strongly and energy and resources sectors suffering weakness.

Looking forward, the Australian market looks fairly valued, but market volatility will provide investors with opportunities during 2015.

Review of 2014

The ASX200 finished up a moderate 5.6% on a total return basis for the year with dividends accounting for ~80% of the total return. The market displayed two distinct periods. The initial nine months provided strong returns for Australian equity investors with a total return of 10%. From October onwards the market experienced increased levels of volatility, specifically across commodity prices with iron ore and oil falling sharply, leading to the ASX200 falling just under 5% in that time.

While the overall market has only delivered moderate returns, there has been significant divergence across sectors and stocks from which to generate active returns. For example, the banks, after strong outperformance from 2010-2013, held in line with the market. The health care sector, which was the best performing sector, appreciated 24% while weakness was experienced in energy (-12%) and resources (-11%).

Outlook for 2015

The businesses we look at are generally in pretty good shape. Gearing has been brought down to reasonable levels post the global financial crisis (**GFC**), efficiency drives have left businesses with robust margins and many are now looking at growth opportunities.

Despite opportunities for some, we continue to see industries facing excess supply. Excess supply often leads to a reduction in prices and can lead to market share wars, both of which generally lead to lower company earnings. Industries that are facing oversupply include resources (iron ore, oil and mining services) and Australian retailers.

From a valuation perspective the market currently looks fairly valued, trading at around its long term average of 14 times forward earnings estimates. As stronger performance over preceding years was largely a result of multiple expansion, future performance will need to be led by earnings growth.

Market volatility is throwing up all kinds of opportunities for us to invest in great undervalued businesses. Many of these opportunities are outside an individual investor's typical portfolio with approximately 70% of our portfolio currently invested outside the top 10 largest companies by market capitalisation.

We are not shying away from risk and in fact, we are taking hold of opportunities once we have gained conviction through our rigorous fundamental research process.

Australian Equities

Patrick Hodgens | Head of Equities

What are the key issues you will be monitoring in 2015?

Two of the key issues we will be monitoring in 2015 are the oil price and the state of the Australian consumer.

Oil Price

Over 10% of the ASX200 has a meaningful exposure to oil production and the direction of oil is important for the whole market. In November 2014, OPEC, which controls around 30% of oil supply, held a meeting and decided not to cut supply. A cut in supply was expected given an increasingly oversupplied market driven by the US oil boom. OPEC won't meet again until June 2015, and if nothing changes we expect low prices to persist. The wild card that would lead us to turn positive would be supply disruption. Despite massive geopolitical issues including Russia / Ukraine & Iraq, there was very little supply disruption in 2H 2014. We are carefully watching supply out of Libya, Iraq, Iran and Nigeria which combine to produce 10% of the world's oil.

In the meantime, beneficiaries of the lower oil price include transportation companies, airlines and the Australian consumer.

The Australian Consumer

Household consumption is the single largest driver of the Australian economy, accounting for approximately 55% of Gross Domestic Product (**GDP**). A similar proportion of the ASX200 is comprised of companies exposed to the Australian consumer.

We forecast disposable income post savings to increase by just 4.2% in FY15, the lowest level of growth since FY09. In this environment we typically remain wary of investing in companies that rely on a buoyant Australian consumer to deliver earnings growth – most notably retail and consumer goods companies.

We will be closely watching the unemployment rate which has a direct impact on household gross income and any potential tax or net social assistance drags which could be introduced by the government in an attempt to repair the budget.

International Equities

Roy Leckie and Charlie Macquaker | Directors, Walter Scott

Europe remains extremely fragile with indications of outright deflation.

Confidence within the investment team remains robust, stemming not from a contrarian stance but from a conviction that the outlook for the companies held remains strong.

Review of 2014

Market volatility picked up towards the end of year in tandem with the US Federal Reserve's comments on potential interest rate rises, the tumbling energy price and concerns around the euro zone. The global snapshot looks increasingly polarised, across regions and countries, which perhaps helps explain why volatility has picked up as correlation across markets (and the actions of central bankers) has started to diverge. At one end of the spectrum, the US recovery looks to be going well, with unemployment falling, incomes rising and the property market recovering. Hence, it is not surprising the Fed is starting to manage expectations for a rate rise in mid-2015.

Europe remains extremely fragile with indications of outright deflation. There are few hopes of economic recovery - despite the European Central Bank's best efforts through its recently announced €60bn-a-month bond-buying programme – and there is every expectation that political uncertainty will grow. It is a similar scene in Japan where, for policy makers, it is like pushing on a piece of string to stimulate growth. Deflation exacerbates the real value of bad loans in the banking system and, in turn, constricts growth. However, as with Europe, there are encouraging signs of improvement in the corporate sector.

Outlook for 2015

Whilst the US recovery looks set to continue, the outlook for Europe and Japan is less than encouraging. In Asia, although there is noise (as there always is) over slowing growth in China, it is still growing, and at a rate which any developed economy would be envious of. The lower oil price has yet to show signs of any significant revival going into 2015. This will be a boon for the consumer but has potentially far-reaching detrimental consequences for companies in the energy sector. The businesses held within this sector tend to either be key facilitators (such as oil services firms) or E&P companies that – our analysis tells us – benefit from relatively low costs of production. This should ensure these companies are resilient, even in the event of a prolonged low-oil price environment.

At the corporate level, there is a distinct wariness about valuation levels, with growth being under pressure, particularly considering some of the deflationary headwinds that are out there. With that said, confidence within the investment team remains robust, but that confidence stems not from a contrarian stance but from a conviction that the outlook for the companies held remains strong. Portfolios are well diversified and the companies held have strong franchises, good cash generation and stable balance sheets. On the whole, we continue to tap into growth vectors of the global economy – such as ageing demographics, innovative healthcare companies and industrial automation.

Asian Equities

Sam Le Cornu | Senior Portfolio Manager

China continues to be the key driving force in Asia and the continual reform process is likely to uncover new opportunities for investors.

Potential for macro shocks in Asia is high and this could lead to increased volatility.

Review of 2014

The paradigm shift past "the point of maximum pessimism" in 2014 marked an increase in positive sentiment in Asian equity markets. The convergence on appetite-for-risk has been untimely for those underweight China. Quintessentially, being greedy when others are fearful and fearful when others are greedy through 2014 has paid off. Such contrarianism always requires discipline and the appropriate articulation of pricing risk. In the same context; the question for Asian markets in 2015 is whether this will be a year where all boats rise in a high tide or a year of sinking ships?

For 2015 the mantra for Asia will be China (MSCI China up 4.7% 2014 in 2014, PE 9.6x '15). The Chinese Government is systematised and pragmatic in its reforms. This is revealing a wave of opportunity for investors. The buoyancy of the economy is lead by strong leadership under Xi Jingping, arguably the most significant moderniser since Deng Xiaoping led far-reaching market economic reforms until 1992. The corruption crack-down under Xi being one source of tangible evidence not achievable under any other administration.

Outlook for 2015

In China, the focus will be on financial and State Owned Enterprise (**SOE**) reforms and significant policy changes. RMB internationalization, asymmetric rate cuts, special trade zones, deposit insurance for banks, corporate deleverage and land reforms will dominate the headlines. Chinese regulators are likely to announce wave after wave of reforms. We predict 7% GDP growth in 2015. We see positive sentiment towards China being de-correlated from the rest of Asia by virtue of these policy influences. We believe the way to navigate this market fog is simply to study the fundamentals and position the portfolio accordingly.

In the Asean region, we expect mixed performances. We believe Malaysia (MSCI Malaysia down 13.4% in 2014, PE 14.9x '15) and Singapore (MSCI Singapore flat in 2014, PE 13.1x '15) will be negatively impacted by a soft oil price. Indonesia (MSCI Indonesia up 24.1%, PE 14.8x '15) under new leadership in Joko Widodo is likely to see the common person and therefore consumption benefit. Philippines (MSCI Philippines up 23.7% 2014, PE 18.8x '15) remains a strong economy but in our view an expensive equities market and

Thailand (MSCI Thailand up 13.3% in 2014, PE 13.3x '15) under military leadership is hoping for a strong economic rebound off a low base.

Korea (MSCI Korea down 12.6% PE 10.0x '15) must see loose monetary policy and exports need to recover for growth estimates to be met. Product overlap between Korea and Japan is large and the plunging Yen is taking its toll. One area of advantage remains the influx of Chinese tourists into Korea and this is benefiting the consumer stocks.

Taiwan (MSCI Taiwan up 6.9% 2014, PE 13.2x '15) is a low growth, low inflation environment and is lacking growth drivers with soft exports of machinery and tech.

The real challenge for Asian stock markets is the potential for macro shocks and with them increased volatility. In these choppy conditions it's best you have a good stomach and this applies to investing in them too!

Infrastructure Securities

Jon Ong | Portfolio Manager

Central bank polices are likely to continue to be a key driver of the market's near term direction.

Expect to see further asset sales by companies or by governments in Europe, due to weak economic outlook and ongoing debt pressures.

Review of 2014

Global infrastructure securities performed strongly in 2014, significantly outperforming global equities. This was driven by the continued solid earnings of infrastructure companies, positive stock specific news, the demand for higher yielding stocks in a low interest rate environment and the valuation support of lower bond yields.

At a sector level, electric utilities performed well, benefitting from higher earnings growth and lower bond yields. The pipelines sector was another strong performer, notwithstanding some negative sentiment toward the end of the year due to sharply lower oil prices.

The sector saw some very positive stock specific activity, such as the consolidation by Kinder Morgan, Inc, of its subsidiary companies in a US$70billion stock and cash transaction. Enbridge Inc was also a very strong performer as the company both increased its dividend and forecast dividend growth due to the strength of the underlying business.

In the rail sector, Groupe Eurotunnel, which owns and operates the train tunnel between England and France, was up strongly as it saw further increases in both truck and passenger volumes.

Outlook for 2015

Market volatility increased towards the end of 2014 and created some attractively valued opportunities. Given the current level of monetary stimulus in the global economy, the portfolio remains positioned with a moderate defensive bias, well diversified by both country and sector and with exposure to the attractive characteristics investors seek from infrastructure assets.

Given the weak economic outlook and ongoing debt pressures in Europe, we expect to see further asset sales either by companies or by governments, which may provide investment opportunities. European electric utilities Enel and E.On sold assets in 2014 and the Spanish government is expected to complete the sale of a group of major airports in the first quarter of 2015. In Australia, electricity privatisation is high on the agenda in Queensland and NSW, subject to election results early in the year.

Our overall approach remains focused on identifying and selecting undervalued companies globally that own and/or operate infrastructure assets that we believe provide essential services, have strong strategic positions, are appropriately capitalised and are well positioned to generate sustainable and growing cash flow streams for shareholders from their infrastructure assets.

As part of that approach, we will continue to closely monitor the pressure on some regulators in difficult economic times. We will also remain focused on the flow-through impact (both positive and negative) of the lower oil price on a range of infrastructure assets. Central bank policy is likely to continue to be a key driver of the market's near term direction.

For more information call Macquarie Investment Management on 1800 814 523,
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Convictions that run deep.

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> We are custodians of our clients’ interests
> The ability to deliver drives our reputation
> Our extensive experience and expertise gives us an edge

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