# Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Perspectives</strong></td>
<td>5</td>
</tr>
<tr>
<td>Investor roundtable</td>
<td>6</td>
</tr>
<tr>
<td>Equity style perspectives</td>
<td>8</td>
</tr>
<tr>
<td><strong>Global equities</strong></td>
<td>13</td>
</tr>
<tr>
<td>Developed markets large-caps</td>
<td>14</td>
</tr>
<tr>
<td>Small- and mid-cap perspectives</td>
<td>18</td>
</tr>
<tr>
<td>Emerging markets equity investor roundtable</td>
<td>23</td>
</tr>
<tr>
<td><strong>Global fixed income</strong></td>
<td>27</td>
</tr>
<tr>
<td>Global fixed income perspectives</td>
<td>28</td>
</tr>
<tr>
<td>Global credit views</td>
<td>30</td>
</tr>
<tr>
<td>US high yield debt</td>
<td>31</td>
</tr>
<tr>
<td>US municipal bonds</td>
<td>32</td>
</tr>
<tr>
<td>Emerging markets debt</td>
<td>34</td>
</tr>
<tr>
<td><strong>Real assets and alternatives</strong></td>
<td>37</td>
</tr>
<tr>
<td>Real assets perspectives</td>
<td>38</td>
</tr>
<tr>
<td>Inflation perspectives</td>
<td>38</td>
</tr>
<tr>
<td>Global listed real estate</td>
<td>40</td>
</tr>
<tr>
<td><strong>About the contributors</strong></td>
<td>42</td>
</tr>
</tbody>
</table>
Perspectives

As forces ranging from rising rates to trade disputes have raised the stakes for global markets and investors, our investing leaders step back for big-picture views of what these may portend for equity, fixed income, and real assets and other alternative markets.

In this section:
- Investor roundtable
- Equity style perspectives
2019 could be an inflection point

Roger Early
Global Co-Head of Fixed Income | Philadelphia

Brett Lewthwaite
Global Co-Head of Fixed Income | Sydney

John Leonard
Global Head of Equities | Philadelphia

Stefan Löwenthal
CIO, Global Multi-Asset Solutions Team | Vienna

From economic growth to trade issues, from rising rates to the question of inflation, the outlook for 2019 may be shaping up to be an important inflection point. Will US growth slow and other economies pick up the baton? What impact will trade tensions, tightening monetary policy, and potential inflation have on asset classes ranging from fixed income to emerging markets? Four of Macquarie’s investment leaders provide views in this roundtable discussion.

Going into 2019, where are we and how would you characterize the investment climate?

Brett Lewthwaite: Overall, the current investment backdrop is one where the challenges arising from the monetary policy shift from quantitative easing (QE) to quantitative tightening (QT) continue to emerge, with certain markets faltering in response. However, at a more macro level, it’s also fair to acknowledge that global growth remains relatively robust, although momentum has begun to soften.

Roger Early: Let’s focus for a moment on the US economy, since much of what happened in 2018 and what’s likely to happen in 2019 hinges on its performance. We’re probably at the end — or very close to the end — of the peak benefits provided by the US tax cuts in 2018. The uptick in economic growth that we’ve had in the US, especially in the second and third quarters of 2018, just doesn’t seem sustainable. I don’t think this means that we’re headed for a recession — I think it just means that we’re not going to keep growing in the 3.5% to 4% range. I doubt we’ll see growth that strong in the fourth quarter of 2018 or throughout 2019. I grew up in a world where 3% to 4% growth was normal. We aren’t back to that world yet, in my opinion.

Stefan Löwenthal: It’s hard to imagine anything else right now that could lead to a renewed boost in US gross domestic product (GDP) apart from massive infrastructure spending — especially if you look at it in terms of the budget deficit and the debt-to-GDP ratio. These are pretty clear signs to me that we’re near the end of the cycle.

John Leonard: I’m marginally more optimistic about the US economy in 2019. I see strong pent-up demand among corporations for making capital expenditures that will extend into 2019. Unemployment is low and wages are growing. Overall, I expect a reasonably good year for the US in 2019, even if we do cool off a bit from some of the GDP numbers we saw in 2018.

Roger Early: It’s true that a recent increase in corporate spending may have some legs, but I’m increasingly concerned about the American consumer in 2019. I think there’s going to be a huge shock when middle- and upper-income Americans file their 2018 income taxes in April 2019. The decreased withholding on paychecks that benefited them in 2018 — and that has helped to stoke the economy — is going to have to be paid back. Some who normally get a tax refund may not get one. And those who aim to break even in taxes may end up sending a check to the government. So, while the corporate growth may carry on, I think many Americans may be in for an unpleasant surprise, one that could curb spending and US economic growth.
What about the role of central banks around the world and interest rates — where are we now and what should we expect?

Brett Lewthwaite: In 2018, we finally began to see central banks around the world trying to wind down a very long period of mass liquidity and negotiate a soft landing. If you look back over the past 10 years, we have had a stream of central bank support that has translated into average growth and elevated asset prices. It’s led to crazy things like negative interest rates and it’s been fantastic for financial markets. In effect, the QE tide previously lifted all boats, but now we’re in a period of transition with QT. We think some vulnerabilities are likely to be revealed as this once great central bank tide recedes.

I’m not convinced that the US Federal Reserve and other central banks will go much further and tighten too much or that we’ll see rates escalate much from here in 2019. It’s important to keep in mind that much of the world would struggle with higher rates because there’s a huge amount of debt globally and higher rates would be very challenging. So, while it may be easy to expect interest rates to continue to rise into 2019 and beyond, I’m not so sure that will materialize. In other words, let’s not give up on “lower for longer” because it very much might still define the environment we are in.

Roger Early: I agree with that thinking. As we move into 2019, the federal funds rate might well be near the upper end of its range. We may be tight enough. While estimates suggest that 2019 will continue to be a year of tightening, let’s not get too carried away. We don’t believe it will be as big as many might think.

Investors more willing to pay up for growth stocks

Forward price-to-earnings (P/E) multiples

![Bar chart showing P/E multiples for different indices]

The US economy and central banks aside, what else is shaping up to be a driving force in the investment world looking at the year ahead?

Stefan Löwenthal: One key theme that emerged in 2018 and remains on the table is inflation, both in the US and on a global level. If we look back on market performance in 2018, it was actually inflation — or the fear of inflation — that led to the global equity market correction in February 2018, when we saw higher-than-expected wage growth in the US. Looking ahead, we still see some signs of inflation. I do think it’s manageable and is unlikely to run away as it did in previous decades — but let’s not ignore this as a potential issue.

Brett Lewthwaite: In the fixed income group, our models haven’t been indicating a great deal of meaningful inflation pickup in the near term, but we acknowledge those stronger convictions. That’s why we remain alert to inflation as a potential market theme.
As for other themes, trade is a huge uncertainty in our view. It’s quite difficult, if not impossible, to sense how much of the chatter on restrictive trade is just that — chatter. The concern, of course, is that if it escalates from chatter to policy, it might cause a partial walk-back of the strong benefits of globalization. As a result, that could create complexities and challenges for many multinational corporations. It’s not clear where we’re going with all of this — but it is clear that we’ve gone from an in-sync world to one marked by divergent interests.

Roger Early: The whole issue of trade is such a big unknown. Is this posturing for negotiations, or a harbinger of gigantic protectionist policies? It’s hard to know. I wouldn’t make any bets based on trade outcomes or assumptions.

John Leonard: We should add volatility to the list of driving forces and risks, even though volatility is a fallout from other risks. We had been in a sustained period of an extreme lack of volatility in most developed markets, and were almost lulled into thinking it’s the new normal. However, market volatility has been ratcheting up in late 2018. It’s a critical factor to the degree that volatility can impact the markets.

Brett Lewthwaite: Let’s not forget currency and the effects that can have. The US dollar has been strong throughout 2018. If continued strength results in headwinds for US growth, other currencies could gain on the dollar, which would help support growth in other regions, such as Europe, Japan, and emerging markets. We think it’s quite possible that 2019 just might be the year that the rest of the world picks up the baton from the US and takes a leadership role.

With that backdrop, what are the implications for investments in 2019?

Stefan Löwenthal: One way of looking at it is that 2018 performance was all about strong US growth, which has implications for other areas. With the US growing at 4%, for example, suddenly emerging markets growth of 4% to 5% doesn’t seem so hot. There’s no need to assume emerging markets risk if the growth is on par with the US. So, if the US growth story starts petering out in 2019, I suspect investors’ attention will turn to other markets: China, Japan, and emerging markets. The US just overshadowed every other market — but we might see a reversal in that sentiment.

EQUITY STYLE PERSPECTIVES

Is value investing dead?
Reports are greatly exaggerated

Sharon Hill
Head of Equity Quantitative Research and Analytics | Philadelphia

Many models underlying quantitative investing, smart beta, and similar systems rely on the value factor. This refers to any investment process that favors cheap stocks over expensive stocks, using fundamental measures such as book, earnings, and cash flow. Research going back to the well-known 1992 paper from Eugene Fama and Kenneth French has made the case for value by its performance in many markets over long time horizons, both in and out of sample.

Over the past year or so — an eternity for professional active managers — the market has not been rewarding value factors. Cheap stocks have stayed cheap, while expensive ones have grown ever more expensive. So naturally, investors are questioning whether the factor will ever revert to its former glory. A number of Macquarie Investment Management teams make use of value factors, often as part of their initial screening process before conducting more detailed fundamental analysis. The teams use nuanced measures of value, which we believe to be more sophisticated than those used by some competitors, and we also rely on optimization techniques to mitigate risk. However, when the market is rewarding other attributes, reliance on value isn’t helpful. When there’s a storm at sea, even the yachts get rocked.

Human emotion, rather than macro forces

Predictions about when value will return to favor have cited indicators, such as the slope of the yield curve and rising inflation, but we do not think that the value/growth rotation is principally driven by macro forces. Instead, we believe that it is motivated by
complicated human emotion, which is what causes value to work in the first place. Investors’ expectations for future growth have been unreasonably high, especially in the US. One way to view this is through aggregate estimates for long-term earnings growth for the Russell 1000® Growth Index. As the chart to the right shows, growth rate estimates have risen precipitously over the past couple of years, from a range of 12% to 14% to a level approaching 18%. Outsized expectations are precisely the behavioral underpinnings of the value premium. As soon as disappointment begins to surface, those of us who appreciate the value factor will likely stand to benefit.

John Leonard: As I mentioned, I don’t think we’re done with the US rally. That said, I don’t have wildly optimistic price targets. We’re looking for about 2,800 for the S&P 500® Index next year, which is flat to slightly higher than at the close of 2018. No one is very positive, comfortable, or constructive about the US equity market, which leads me to think it’s probably not yet time for it to come unwound.

Brett Lewthwaite: For fixed income, we believe the backdrop warrants a continuation of more defensive positioning — by that we mean accumulate duration and be wary of credit risk, especially in the higher beta sectors, acknowledging we are late in the cycle and that further abrasion is likely as global central banks, the Fed in particular, tighten policy.

Do you see 2019 as the year that the bull market in US stocks ends?

Brett Lewthwaite: In short, that’s unlikely in my opinion, but a lot depends on how far central banks push rates up. Overall, I suspect that they won’t push too far and will keep rates fairly contained in a range that won’t impact asset prices too markedly.

Investors have questioned whether the factor will ever return to its former glory.

Growth rate estimates have risen dramatically
Russell 1000 Growth Index, long-term EPS growth estimates
John Leonard: When it comes to bull markets, they don’t have to end with a seismic repricing of the market. They certainly can end that way, but they can also end with a sideways, grinding movement. What’s important to recognize is that the returns from US equities over the past few years have stemmed from growing earnings — not because of expanding multiples. Yes, the market is high, but in our view it should be high because earnings are so robust. That means I’m not really concerned about valuations being too high here. When it comes to US equities, the gap in valuations between the US and Europe has narrowed since corporate America has done well and Europe is catching up. So, while slowing growth in the US is likely, the US still looks solid as we move into 2019.

What specific opportunities seem appealing as we shift into 2019?

Roger Early: Let’s look at fixed income. This asset class has historically provided three things: income, liquidity, and downside protection. Well, income is finally coming back — but it’s as important as ever to do good credit work and make sure that the debt you’re investing in is backed by a solid business and operating model, and, in the case of corporate bonds, that companies haven’t overextended themselves. High yield spreads are pretty tight with good credit, so there’s no real reason to add risk, in my view. We’re in an era where monetary policy doesn’t follow the text books. So, it’s important to choose credits carefully and not chase risk — if you do that, I find no reason to fear longer maturities. As we’ve said for a while now, duration is not the enemy.

John Leonard: We think that there is still plenty of scope for further upward movement in equity markets too. There may be corrections from time to time, which will be painful, but we don’t see any good reason why equity markets would suddenly collapse. As we have discussed, the big risks to this outlook are geopolitical, in the form of a trade war or something along those lines. But if the environment remains fairly stable, then we think there will be opportunities to be found in the US, in other developed markets, and also in emerging markets. In recent quarters, a lot of attention has been given to expensive megacaps with high projected growth rates, and there are plenty of other stocks which still look attractively priced by comparison. We think this could be a good environment for bottom-up stock pickers to find great companies at reasonable prices.

Stefan Löwenthal: I agree with Roger and John. Looking at the edges of traditional asset classes such as equity and fixed income assets, I see another very promising opportunity in global listed real assets. Of the subgroups that comprise real assets — listed infrastructure, natural resources, real estate investment trusts (REITs) — all have some sort of inflation protection and have distinct benefits depending on the part of the cycle we’re in. For example, we’re leaning toward listed infrastructure now because it’s well suited for a slightly inflationary, late-cycle environment, and we’re slightly less positive on REITs, where companies, especially outside the US, appear a bit overlevered.

On emerging markets, I think there are some emerging market asset classes that could be quite interesting next year. It’s impossible to time a bottom, but we seem close. In 2018, we saw some significant currency devaluations — in Turkey and Argentina, for example. This could have been the first sign of fundamental stabilization in these countries — and that could be a proxy for a turnaround in the whole group.

In general, I think we can agree that there will be many forces driving the markets in 2019. Even if only some of the topics we discussed continue to evolve, it should be an interesting year for active managers like ourselves.
Global equities

It was another interesting year for equities in which the US markets continued to show robust growth for most of 2018 even as volatility picked up and other areas such as emerging markets tended to struggle. This section zeros in on equities for 2019, including a roundtable discussion about the important emerging markets area.

In this section:

- Developed markets large-caps
- Small- and mid-cap perspectives
- Emerging markets equity investor roundtable
Fundamentals drive a cautious long-term view

Ty Nutt
Large-Cap Value Equity | Philadelphia

As patient, long-term investors, our thinking is based on a time horizon of at least three to five years. This is because, in our view, shorter-term market movements are more unpredictable, driven by human emotion and crowd psychology. To us, in the longer term, fundamentals matter most. In that regard, looking out over the next three to five years, we are cautious about the prospects for US equities because of the potential for slower economic growth, the outsized returns investors have already experienced, and, most importantly, high stock market valuations.

The US economy appears to be benefiting from a number of key supports that include low unemployment, strong consumer sentiment, a boost in corporate earnings, and rising business investment. We think some of these have been helped by the recent tax law changes, and we wonder to what extent their effects will be temporary. As we look out several years, it’s our view that the rate of economic growth will return to below-trend levels. We see this occurring because of the high degree of indebtedness throughout the economy, a growing budget deficit, aging demographics, rising short-term interest rates, and the removal of Federal Reserve stimulus.

It’s been more than nine years since the broad market S&P 500® Index experienced a bear market, defined as a decline of at least 20%. From the market bottom on March 9, 2009, through Sept. 30, 2018, the S&P 500 rose fivefold, posting a cumulative total return of 426%. This equates to an extraordinary annualized total return of 19% (source: FactSet Research Systems).

The price-to-earnings (P/E) ratio of the S&P 500 Index is 25 times based on trailing 12-month reported earnings, down from its post-recession high of 26 times reached in January 2018, but still 56% higher than its long-term average of approximately 16 times. Another valuation measure, price-to-sales ratio (P/S), tells a similar story. At 2.3 times, the P/S ratio for the S&P 500 Index is at the same level at which it topped out in March 2000 at the peak of the tech bubble (sources: Ned Davis Research, The Leuthold Group).

From these levels, prospective returns will likely be below average, in our view, while potential risks seem higher than usual. Given the importance of starting valuation to long-term equity returns, we can foresee annualized total returns in the mid-single-digit range. Our concerns about equity valuations and potential market risks mean that we remain defensively oriented with a focus on higher quality businesses that offer attractive relative value.
US and China loom large in developed global markets

Ned Gray
Global and International Value Equity | Boston

It is often the case that the most significant countries driving returns in the developed international equity markets are the very two not included that group — the US and China. The US is the world’s largest and most dynamic end market. China is a critical waypoint in global supply chains and, increasingly, an important end market unto itself.

Today, as the US presses for a reconfiguration of the global trading regime, we must add to those economic qualities a political dynamic with enormous disruptive potential and a highly uncertain outcome. The strength and mix of prospective equity returns in 2019, in our view, will be a function of these overlapping economic and political factors, all subject to the market’s evolving verdict on these developments, expressed in price valuations.

- We see cyclical trends suggesting greater recovery potential in non-US markets, such as Europe and Japan, that have experienced slower and more extended recovery periods than other regions, and continue to benefit from ongoing stimulative monetary policy and low-capacity utilization. They stand in contrast to the extended position of the US market, which has enjoyed a decade of uninterrupted growth, with interest rates now rising and unemployment near all-time lows.

- The scope and aggressiveness of shifting US trade policy is a new phenomenon in the lifetimes of most market participants and must be taken seriously. Two key elements have related but distinct implications: first, domestic economic concerns behind demands for equality in enforcing a level playing field among trading nations, and second, long-range strategic geopolitical calculations aimed at defending the pre-eminent place of the US in the world, with a clear eye toward China. The first has already had a disruptive impact on global supply chains and the myriad companies tied to them, initially through price, but with volume-related supply and demand effects likely to follow. We believe the likely the winners of these shifting competitive winds will be companies with adequate pricing power to pass new costs along to their customers. Beyond winners and losers, we see continued escalation in trade tensions likely to force companies across numerous industries to bear higher capital costs as they adapt to reconfigured supply chains. The second, geopolitical question carries potentially broad and very significant consequences, but ones that are highly uncertain and long-tailed in nature. Not least among them will be the place of long-standing partnerships between developed markets that have had both economic and strategic elements. Traditional US allies in Europe and Japan may be affected, for good or ill, while other newly emerging economies will likely see their significance enhanced.

- While underlying causes of the past several years’ global equity performance, including the factors discussed above, may be difficult to parse, one pattern is clear to us: The US has dominated ever since it troughed against the non-US developed markets in September 2009 and against the emerging markets a year later. Admittedly, the non-US world’s combination of slower growth and interim recession, institutional dysfunction in Europe and the United Kingdom, and perceived risk elsewhere may justify a good deal of its performance lag. This contrast is not entirely new, though, and long-term relative valuation trends suggest we have seen a dramatic overshoot in favor of US equities.
As indicated in the chart below, the current price-to-earnings (P/E) discount of the MSCI EAFE Index to its US counterpart is more than triple its long-term median. We have not seen a valuation gap of this magnitude since the global financial crisis of a decade ago. Although gradual improvement in the underlying operating performance of non-US companies may be unlikely to trigger an inflection in this relative valuation trajectory back in their favor, some of the other factors we have cited may contain the seeds of just such a reversal.

With the country’s clearest concentration of competitive distinction, the US technology sector has played a critical role in driving its relative performance as well as its valuation premium. The sector is also distinguished by one of the most globally integrated supply chains in existence — one that may be subject to stress in the event of further reprisals in the ongoing trade dispute. With current US valuations implicitly discounting not only the sustainability of these businesses, but also the sustainability of their rate of growth, a slight turn in sentiment may trigger a dramatic response. These observations lead us to reconfirm our conviction that diversification into non-US equities is a prudent response to the world’s uncertainties.

**EAFE versus US, by price-to-earnings (P/E)**

Source: MSCI via FactSet.
Searching for opportunities, with an eye on the long term

Until the stock market volatility late in the year, US stateside was the place to be in 2018 for small-cap and mid-cap stocks, we observed. Worries about blowback from protectionist measures can prompt investors to focus on companies with less global reach. US tax cuts positioned smaller companies to benefit disproportionately, compared with larger companies that can pay up to 40% of taxes overseas. Also contributing was the long-running US economic expansion. While small- and mid-caps experienced volatility along with other asset classes in late 2018, the focus for managers in 2019 is on discovering opportunities in the pullback and keeping an eye on the long term.

Unearthing the underappreciated

Joseph Devine
Global Ex-US Equity | San Diego

The environment for small-caps and mid-caps in emerging markets continues to be challenging. Negative sentiment continues to surround them and there are definitely areas at higher risk than a year ago, particularly among companies that are exposed to global supply chains threatened by political influence. In the short term, that overhang means companies with strong earnings, such as those we invest in, are not being rewarded. But if you look back at how emerging markets have historically performed, you will notice many periods like this one, in which macro headwinds come and go and the group has tended to be pretty resilient.

In some cases, those headwinds can even accelerate longer-term trends. We believe that’s happening in the Chinese technology sector, which was already experiencing a long-forming secular theme around economic nationalism. In recent years, the Chinese government has introduced a handful of initiatives meant to take ownership over certain technology areas. Semiconductors is one: China has committed $150 billion to stand up its own industry rather than continuing to rely on companies in the West (source: US Chamber of Commerce analysis, 2017). Ditto for advanced manufacturing, an area in which the government has unveiled its “Made in China 2025” plan to make hefty investments in research and innovation and has placed firm targets on sourcing local manufacturing content. Other similar initiatives involve energy technology and artificial intelligence, where China already has some of the most advanced systems in the world.

These plans were already in place, as China is well aware it needs to have leading technologies in order to be a strong economic power going forward. But the trade tensions that have dominated the headlines this year have raised fresh concerns over constrained supplies. China doesn’t want exposure to a situation in which its access to these critical technologies is compromised. That’s likely to push China to aggressively develop its own technology. We see this as an underappreciated opportunity that will play out over the next 5 to 10 years and should, in our view, generate many opportunities.

We also see what we call “positive change” occurring in emerging markets outside of both China and the tech area. We’re looking for companies that, in our view, are entering or focusing on more advantageous or profitable markets, entering new countries or regions, introducing new products or services that cater to the growing middle class, exiting ventures that proved unprofitable, or making leadership changes needed to achieve better success.
Christopher Beck
Small/Mid-Cap Value Equity | Philadelphia

This asset class tends to do well when the economy is growing and we expect that to continue in 2019. The leading economic indicators appear to be pointing up. Unemployment in the US is the lowest in almost 50 years with little fear among workers of losing their jobs. Consumer confidence is near all-time highs. When consumers are confident, they're spending money.

That said, once we get further into the year, we think we’re going to face more difficult year-over-year earnings comparisons against the boost many US companies received from the drop in their corporate tax rates from tax reform that went into effect in 2018. As a result, we’re focusing on those companies that have historically paid high cash tax rates because they’re enjoying an increase in their cash flow as well as in their earnings. That means they can decide to reinvest the savings in the business or put more money back in shareholders’ pockets. In 2018, they chose the latter. We saw a very large level of dividend payments and corporate buybacks. We also saw a large number of corporate takeouts, including several in both our small-cap and mid-cap portfolios.

We expect these trends to continue in 2019 — and we’re looking to take advantage. Financials were among the biggest beneficiaries of tax reform since they pay higher taxes than most, and now they’re selling at a reasonable discount to the market given that most of their loans are variable rate and reset higher when the Federal Reserve hikes rates.

Consumer discretionary firms also tend to be higher taxpayers and they aren’t overly expensive given how confident consumers are. We’ve seen a big recovery in retail stocks despite continued secular pressure from ecommerce companies, and certain restaurant stocks look particularly attractive.

Even one of the economy’s current weak spots could turn into a source of strength in 2019. Housing has hit a bit of a rough patch, but that likely was necessary to correct supply-and-demand imbalances in the market. Soaring home prices have kept younger Americans from buying homes, so the big spending jolt that most have been expecting from millennials hasn’t really kicked in. That could change in a hurry if housing prices continue to stall, making starter homes more affordable. If that happens, we believe that we could see a significant increase in new and existing home sales, as well as all the spending that goes along with home purchases, such as furniture and appliances.

The expansion continues

Alex Ely
Small/Mid-Cap Growth Equity | New York

There is plenty of discussion about cyclical concerns as rates move up and foreign markets falter. We believe that fear is misguided, an aftereffect of the experiences of 2008. Instead, we see continued economic and fundamental strength ahead for 2019. Unfortunately, most investors aren’t prepared for this strength, as they are too conservatively positioned in our view. We call it alligator-armed investing, as we see too many allocations in a rising yield environment that favor income over risk assets, such as small-cap stocks. We believe the risk ahead will be in not taking one.

As a group, we look to find strong trends in the economy in order to take advantage of the continued expansion. The trends we see are either all-new businesses such as social networking or a wholesale transformation of a business, such as what streaming media has done for content. Trends we are currently invested in are large in scope and gaining in momentum. As a long-time growth manager, we find it hard to contain our excitement as enormous markets such as food, content, transportation, and banking are being completely transformed.

In our view, this disruptive process shows no signs of slowing as it is technologically induced, providing many industries with a better, faster, cheaper way of doing things. Even when the next downturn comes, we believe these trends will continue to play out because of the value proposition they provide.

Despite our positive stance, we don’t want to completely disregard cyclical concerns. There are basic risks that we monitor, such as global trade wars or an overly aggressive Federal Reserve, but what will likely finally end this run, in our view, will be inflation. We believe all the stimulus from both monetary and fiscal resources will eventually cause prices and yields to rise and bring about change in the constructive economic conditions we have today. We don’t think this threat will happen soon. Rates are still historically low in the US, and many foreign countries have bond yields near zero. While corrections can happen at any time, we don’t think we’re nearing a recession or bear market. Within this environment, we’re confident growth-oriented companies should do well.
Historically, US small-cap stocks have performed their best when real GDP growth has been in the 2% to 4% range. This relationship exists as US small-cap companies, on average, derive 81% of their revenues from within the US. This has made those companies more isolated — relative to US large-cap companies — from earnings headwinds related to the US dollar and global trade. Looking forward, some economists have projected the US GDP growth rate to be 2.9% for 2019, the highest growth forecast for any country in the G7. (Source: FactSet economic estimates.)

We see a number of reasons to be both optimistic and pessimistic next year, while on balance, the glass is more than half full, in our view. Coming into 2018, we had expected the new lower tax rate on US corporations to provide an earnings boost of sorts and this has held true. On a weighted basis, the effective tax rate on companies in the Russell 2000® Index is on pace for 24% this year, versus an effective rate of approximately 33% two years ago. We anticipate that earnings-per-share (EPS) growth rates will likely come down from their current pace, which is in the high 20% range. However, we think EPS growth rates won’t fall too far, as current Wall Street estimates for 2019 earnings growth are in the mid- to upper teens, which should be sufficient, as long as margins and capital spending remain healthy.

A steepening yield curve has historically benefited small-cap companies, relative to large-cap companies, while a flattening or inverted curve can hinder small-cap performance, given that it’s a strong indicator of slowing economic growth. While a flattening curve concerned investors in the summer of 2018, it had not flipped to an inverted curve near year end. Inflation is another worry, though our concerns are mixed. Expected inflation has historically led to relative outperformance of small-cap stocks versus large-cap stocks. At the sector level, higher inflation can put downward pressure on growth-oriented sectors while benefiting traditionally value-oriented sectors. Lastly, rising wages have started to apply additional pressure on an extremely tight labor market in the US.

Overall, this translates to a market that is trading, in our view, at attractive valuation levels — levels that are at a sizable discount to their large-cap brethren. Historical forward return analysis, based on relative valuations, suggests positive market returns when looking out 12 months.

One area where we’re finding these inefficiencies is in capital goods makers. Such companies have benefited from lower taxes, reduced regulations, and the strength of the overall economy. However, the sector’s performance during 2018 was weaker than we would have expected. Some of the weakness likely stems from the big runup we saw in these stocks ahead of the tax reform of late 2017, but the increased capital expenditures that were expected didn’t immediately materialize. Recently, capital expenditures have started to appear, and valuations have corrected, making us more optimistic about the sector. We do see some risk through — in particular, tariffs pose a threat to the sector and raw materials costs are pinching margins, leading us to pay close attention to the financial impact.

Moving into 2019, we will continue to maintain our strategy of investing in companies that, in our view, have strong balance sheets and cash flow, sustainable competitive advantages, and high-quality management teams that we believe have the potential to deliver growth.
With a lackluster showing from emerging markets (EM) equities in 2018, Macquarie portfolio managers focused on developing market investments have recently been sharing insights about what’s behind the underperformance and the outlook for the investment class.

As we head into 2019, where are we with investing in emerging markets?

Joe Devine: 2018 was difficult, after a strong 2017. EM was derailed by the strong US dollar and the trade war. It is probable, in my view, that we get back on track in 2019. Sentiment is very low, which is a buy signal for the contrarian investor.

Daniel Ko: Emerging markets were driven in 2018 by several factors: US interest rates and the US dollar, elections, international relations, and particularly trade. Joe’s right, there’s not much new here — trade tensions were flagged as a risk going back to the 2016 US election and worries about Federal Reserve tightening have spooked the market every 18 months or so. Investors appear to be more highly focused on these concerns as they seem to dominate the headlines more often. Usually we find these environments create an opportunity to find good businesses that are underappreciated because of how the broader market is acting.

Stefan Löwenthal: To me, EM continued to underperform in 2018 because of the stronger-than-expected performance of the US, where growth exceeded just about everyone’s expectations. As a result, the rest of the world looks weak by comparison. An emerging market country growing 4% or 5% doesn’t look so great when the US is also in that range. So, it wasn’t because EM growth was very weak, but because the US was so strong.

What can change — and what stand out as potential drivers for the asset class in 2019?

Stefan Löwenthal: A big factor that we began to see starting from mid-2018 was massive devaluation of some emerging markets currencies. Those moves either have led, or will shortly lead, to reductions in current account deficits in these nations. In some cases, we will even see current account surpluses for the first time in more than a decade. That could turn things around pretty quickly in terms of those countries and sentiment for the group on the whole.

Daniel Ko: Short term, it’s always difficult to call a bottom. Typically, we’ve found that periods like this tend to be good buying opportunities. We stick to focusing on finding competitively positioned companies, which, in our view, have good long-term prospects and the ability to deal with near-term economic and market volatility. When sentiment calms down and investors begin to focus on the underlying fundamentals more, these investments can end up doing very well.

Is there something particular at the moment that you view optimistically?

Stefan Löwenthal: Going forward, we think that the rest of the world will catch up to the US in terms of its growth rate. It seems inevitable that the US will slow down from its 2018 pace. We are not expecting a recession in the US, but a slowdown. If that happens, then emerging markets will grow faster than developed markets (DM). That should lead to some renewed outperformance from emerging markets equities, or on the fixed income side. And, again, the currency devaluations can make a big difference in some markets that were giving investors major concern.

Joe Devine: And I like to point out that they’re called emerging markets because there are issues that need to be improved: corporate transparency, corporate governance, and the rule of law. These are not trivial matters. These issues are slowly improving, but investors remain bearish and look at the glass as half empty. They don’t see the physical energy on the ground in these countries or the massive size of the emerging millennial
consumer. We believe the entrepreneurial spirit is alive and well in EM. This has the potential to translate into tremendous investment opportunities.

Daniel Ko: Emerging markets countries and companies have undergone a lot of adjustment over the past several years. There are important secular shifts going on in the way people in these countries live and work. Consumer culture is growing and developing in conjunction with technological change. As a result, we anticipate a lot of wealth will be created, and the businesses that do well are going to be a different set from those in past market phases. As an investor, you have to be able to look past the noise to things that you can have confidence in over the long term.

Stefan Löwenthal: Looking long term, there’s a fairly compelling growth story that’s underpinned by demographics, and it’s possible to miss if you’re focused only on current headlines. Take for instance the notion of a “rebalance” of global trade: US companies do have potential to capitalize in emerging markets that enjoy favorable demographic trends as well as latent demand.

What are causes for concern?

Stefan Löwenthal: Trade’s certainly an issue. If tensions between the US and China escalate, that could lead to one or both of those economies slowing down. Of course, if tensions ease, China could turn into a massive outperformer. The jury is still out on that one.

Meantime, several countries in Eastern Europe continue to grow fast — arguably too fast — and have had to cut their rates to a very low level following the lead of the European Central Bank. Poland, Hungary, and the Czech Republic in particular, and in part, Romania, are among the countries we’re monitoring closely. They have reached wage growth in excess of 10%. Some are closer to 15% wage growth, while their interest rates are very low. (Source: Eurostat.) Historically, this has been a clear sign of overheating.

John Bugg: The major force not only in the Asian region, but for EM altogether, is China. That’s why we think the trade dispute between China and the US that heated up in 2018 will likely continue to be a big driver in 2019. That also means the potential for a somewhat softer 2019 Chinese economy, which could then have a wider impact on the region. That said, China has many economic tools at its disposal and may be able to stimulate growth to head off any negative effect. All told, we think investors may have devalued the region too harshly due to the trade wars and, in our view, China continues to offer great potential for 2019.

Daniel Ko: I agree that China is by far the single most important country in the EM universe. It’s also undergoing an economic transformation from industrial-driven to consumption-led growth. There hasn’t been a hard landing, and a lot of change has already happened. However, the process will take years
and there will be periods when people are more or less worried about the risks. Politics have always created volatility in emerging markets, and that’s just something we have to be aware of when we look at the resilience of the businesses we own and what’s implied in the valuations.

**How has EM equity investing changed in recent years?**

Daniel Ko: There’s been a shift in the companies that comprise the EM universe — natural resources have become a smaller part of the Index, while technology has become nearly one-third. This makes it hard to compare the market’s valuation as a whole with, say, 10 years ago. It has also tended to mean there are better opportunities for minority investors to do well as the growing sectors tend to be less state dominated in how they make business decisions. Information flow is also much better than in the past.

**Any specific opportunities you’d like to highlight?**

Joe Devine: We believe China is going to become an epicenter of technological change. When you look at the world, you have two tech powerhouses — the US and China. Recent political developments are driving China to accelerate its investment in tech. China is strong in Internet and social media, but lacks leadership in semiconductors, telecom equipment, and software. This must change. Development of the 5G network is strategic to China’s growth strategy. Artificial intelligence is strategic. China is the world’s largest importer of semiconductors. It would like to shift this dynamic to its benefit and not rely on tech imports to power its next stage of growth. In our view, global tech leadership is going to change. New winners and losers will emerge.

Daniel Ko: I agree that there are a lot of opportunities within China, both in the Internet and consumer space. Lately we have found attractive companies in the semiconductor industry. This is particularly true in the memory industry — there has been structural change on both the supply and demand side but the stocks still trade at low valuations that we believe don’t really reflect the reality. We have found more opportunities of late in Mexico, where political uncertainty has been weighing on valuations.

Stefan Löwenthal: Moving away from China, on the upside we see real positives for commodity prices and inflation, and we tend to like countries that are exporting commodities. Number one is Russia, which has suffered in the last five years partly because of some sanctions, partly because of lower commodity prices.

Apart from Russia, we favor other commodity exporters, like Kazakhstan. We also favor Brazil and Mexico, which both became attractively valued, also from an FX perspective. All of these countries are commodity exporters, as well as a couple in Africa like Nigeria, which is a very large commodity exporter.
Global fixed income

Fixed income markets in 2019 could very well continue to be marked by some of the same forces from 2018 — divergence in growth between the US and the rest of the world, the effect of rising interest rates, and other vulnerabilities exposed by the receding tide of central bank policy.

In this section:

- Global fixed income perspectives
- Global credit views
- US high yield debt
- US municipal bonds
- Emerging markets debt
When the weather report warns of low visibility, you know to expect a reduced line of sight into the distance. As we enter 2019, we think that’s an apt description for global fixed income markets. Thanks to policy questions facing the US and China, things could play out along several different lines in the year ahead. The choices of these two superpowers will influence the rest of the globe via interest rate, foreign exchange (FX), and commodity price trends. When we consider this state of affairs alongside high valuations for fixed income assets, we see an environment for incremental defensiveness.

**A new divergence story: US versus China**

Going into last year, a key issue in global markets was the divergence in growth between the US and the rest of the developed world. Indeed, US growth surged, and the rest of the developed world and the dollar were high enough to produce fallout. Emerging markets debt and FX came under pressure — but crucially, these effects didn’t cycle back to dampen real GDP growth in the US.

This year, the focus is shifting to the delta between the US and China. From the former’s perspective, the course of 2018 positioned the US with an upper hand in trade negotiations. Amid peak employment, strong growth, and stable inflation, trade war worries and Federal Reserve interest rate hikes have so far only been bumps in the road for US investors.

China, on the other hand, spent 2018 in a state of managed slowdown. As the country plans strategically for its long-term position, policymakers emphasized deleveraging state-owned enterprises and other shadow-banking institutions. The country retaliated in trade tariffs against the US, but all evidence points to China being in the weaker position in negotiations.
Convergence ahead
Beyond the US and China, we still see a story of growth muddling along. A decline in the euro may have gone far enough to spark a rebound in the euro zone’s real GDP. Still, global markets face added stresses from higher US rates, a slower China pressuring demand and metals prices, and lower global trade volumes. These headwinds add to the instability that continues to emit from populist-driven protectionism around the globe — and by late 2018 it was still anybody’s guess how Brexit might turn out.

All told, we see a strong case for some convergence among developed economies in 2019 — but it’s not likely to come from a surge in growth. It’s more likely to be a result of easing momentum in the US as the aftershocks of its 2018 strength start to filter back into economic activity.

Rangebound rates, or not
These trends, in our view, point to a rangebound year for global rates. The 10-year US Treasury is likely to head higher in the short term, unless US growth drops off, in which case we could see considerable softening. We expect yield curve flattening to continue, and we believe an inverted yield curve could be a real possibility in 2019. While we are reasonably certain that the Fed will hike rates, we don’t know where its runway stops — it all depends on growth momentum and whether aftershocks materialize.

Beyond the US, we expect to see rates tick up slightly, but no sharp moves. Globally, developed economies are beginning to align a bit more than last year with regard to removing liquidity and looking ahead to rate hikes, but there’s little evidence to hurry the process. Inflation remains benign, and growth is too fragile to warrant big moves, in our view. Credit spreads are near tights, so we see very limited upside across assets, with emerging markets as the possible exception.

Valuations as a deciding factor
With the US going strong, investors can’t park on the sidelines. But the issues across global markets should keep investors on notice. High valuations across most assets imply little upside and higher downside risks. In our strategies, we are staying invested but choosing our risks carefully. We’re positioning for less credit exposure and more duration, in some instances, while moving higher on the capital structure in others. Essentially, we are expecting a year with flight-to-quality episodes favoring risk-free assets as investors contend with Fed actions and the potential ripple effects.

MFI Pulse: Divergence turns to convergence?


Citigroup® Economic Surprise Indices cross over

Global credit investors are faced with some mental gymnastics in the year ahead: Company fundamentals are strong, but we may face growing signs of recession. The stresses of 2018, especially ripple effects from the trade war under way between the US and China, could carry into 2019 and contribute to the end of the credit cycle at some point off in the distance. Or, the good news at companies could continue, driving credit spreads even tighter. Against this backdrop, we anticipate a coupon-like return for 2019 in both scenarios, because rates and spreads are in a zone where they could offset. The low-visibility environment prevails, and in that context, our strategy is to pick credits carefully, avoid blowups, and pay attention to liquidity.

The good. Coming off a year where earnings per share (EPS) growth at US firms was north of 20% (source: Bloomberg, Macquarie), it may seem nonsensical to be thinking about safe mode. The fallout from US strength and trade wars did create distress in some emerging markets, but all told, that was contained. Consumer and business confidence are incredibly high in the US, and earnings are growing faster than absolute debt levels, driving leverage slightly downward (not typical in a late stage of the cycle). Capital expenditures are finally showing signs of life and could support upside in 2019. What’s there to worry about?

The bad. We can’t ignore the flattening yield curve, which tells a different story: one where Federal Reserve tightening in the US and incremental withdrawal of liquidity around the world may portend the end of this cycle, one way or another. Credit investors must reckon with a number of threats. The trade-war stresses between the US and China are likely to continue, posing a greater headwind to global trade volumes and rippling further into the emerging markets world via the supply chain and commodity prices. When coupled with global monetary plans to withdraw liquidity in the year ahead, these risks might start to affect the broader price of risk in markets.

The possibility of ugly. Pockets of stress from tighter financing conditions are evident, including pressure on homebuilders and materials in the face of higher mortgage costs. Meanwhile, leverage at companies is still high compared to historical trends. The biggest risk, in our view, is an old-fashioned recession, courtesy of monetary policy. If US financial conditions tighten too much, either because of a Fed misstep or because of unwanted inflation, we see volatility ahead. With tight valuations, there is little upside and more downside.

Investment grade investors have to hold two conflicting realities in their minds: Things are great, and it’s time to be on notice. We’re resolving this quandary by staying invested but moving incrementally more defensive. In our strategies, we’re being vigilant about credit decisions, positioning toward neutral on duration, and paying close attention to liquidity.

Earnings, free cash flow growing faster than absolute debt levels

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Source: Bloomberg, Macquarie.
Moderation in all things

Adam Brown
Portfolio Manager | Philadelphia

John McCarthy
Portfolio Manager | Philadelphia

High yield debt was a relative bright spot for fixed income markets in 2018. As we look at the year ahead, we're taking a stance of moderation across the board. US corporate fundamentals have been strong, and we expect that to continue. Valuations are rich, though not at all-time tight levels. Furthermore, spread differentials across credit ratings and maturities within the high yield market are tight. In this environment, we believe it’s time for moderation in positioning, with balanced exposure across the risk spectrum. We also think this backdrop calls for careful selection aimed at avoiding negative credit events. In markets like this, we see little price upside, and negative events are more likely to drive performance differentiation.

Fundamentals in good health
US companies are in a strong position, in our view. The tax cut legislation passed late in 2017 served to further boost company profits, driving double-digit earnings growth through much of 2018. Activity is also high on the consumer side. With a tight job market and unemployment the lowest it has been in decades, consumers are confident, and they are spending accordingly.

Leverage is trending lower at non-investment-grade issuers. For one thing, operating profits and cash flows have been growing faster than absolute debt levels, pushing leverage ratios down overall. Companies also benefited from tax incentives to repatriate cash held abroad, reducing their need to access funding.

Interest costs are also comfortably low. Thanks to widespread refinancing in recent years, many issuers have locked in lower rates and longer terms. Taken together, these fundamentals reflect the strong condition of high yield issuers, in our view, and point to a continued low default rate.

High valuations, shifting technicals
Unsurprisingly, valuations are high across the market after this extended period of strong growth. Credit spreads are not at all-time tights but are rich generally by historical standards. We’re also finding tight spreads between ratings categories and across maturities. In that sense, we don’t see standout opportunities from an allocation perspective.

Technicals have also shifted, such that we’re seeing incrementally less demand from abroad as the dollar has moved higher, while lower new issuance restricted supply in 2018. We believe those trends are likely to continue. However, it is noteworthy that we are seeing higher leverage in issuance connected to leveraged buyout (LBO) transactions, a typical trend late in the cycle. We are watching those metrics carefully, given that we do not feel there is adequate compensation for taking on incremental risk.

Differentiated outlooks to continue
We’re in a market that reacts to credit events and in which companies are punished for earnings misses. This scenario is markedly different from earlier in the cycle, when extreme liquidity around the globe was a rising tide that lifted all boats.

In 2019, we see a strong case for moderation in positioning. Our stance is duration neutral, and we are mindful of rate-sensitive sectors and the early signs of tighter credit conditions that accompany this stage of the monetary cycle. But otherwise, success in this market is a credit-by-credit process with emphasis on avoiding negative credit events. By all measures, we are late in the cycle, and we believe there is little to be gained from extreme positions on the risk spectrum.
Could the municipal market see a silver lining in 2019?

Joe Baxter
Head of Municipal Bonds | Philadelphia

The municipal bond market is coming off a transition year in 2018, in which the new US tax law had the effect of reducing both supply and demand in the market, the lack of any infrastructure legislation was a disappointment, and rising interest rates continued to have an impact. While some of these challenges will likely continue — we anticipate supply and demand to stay lower, and short rates to continue to rise — we believe some mitigating factors could improve the environment for municipal bonds in 2019.

Effects of the new tax law
The Tax Cuts and Jobs Act of 2017 had several implications for the municipal market in 2018. While the tax law dropped the corporate tax rate significantly to 21%, the top rate for individuals declined only modestly from 39.6% to 37%. But because tax preference is the value proposition for municipal bonds versus taxable bonds, lower tax rates tend to diminish this value. As a result, the tax law had a negative effect both on municipal bond demand and on returns.

Nonetheless, we think that after individual taxpayers assess the net effect of some tax law provisions on their tax returns — notably the elimination of state and local tax (SALT) deductions and capping of property tax deductions — there may be a reckoning leading some investors to return to municipal bonds. If there is any effect on demand, we would expect to see it after the first quarter of 2019.

Advance refunding aspect revisited?
Another aspect of the tax law that lowered new-issue supply in 2018 was the law’s prohibiting the practice of issuing advance refunding bonds to refinance older, more costly debt. The advance refunding method had allowed municipalities to pre-refund old debt with new debt — but in doing so, permitted two issues for the same project to remain outstanding until the first call date of the original issue. Viewed as a tax loophole, this resulted in the advance refunding prohibition.

However, this effect has been disproportionate on municipal bond issuance in the past year. As of Sept. 30, 2018, data from The Bond Buyer show overall municipal bond supply was down -15% versus the year before. But of that amount, new-dollar issuance was up 26%, while refundings were down -49%. The chart below shows the impact on advance refunding bond issuance in 2018.

Despite the advance refunding elimination, an influential public interest group, the Government Finance Officers Association, has indicated its resolve to get the provision reinstated. We think the group, which in the past has represented state and local interests to Congress, may find a sympathetic ear in the incoming 116th Congress.

Infrastructure financing
Another area important to municipal bond market watchers is the need for infrastructure investments in the US. However, hopes were dashed when legislation on federal funding of infrastructure projects failed to materialize in 2018. We think there is a possibility that the new 116th Congress could be open to such legislation, at least to help fund the types of projects undertaken by municipalities, such as roads, bridges, and airports. Because these types of projects are so essential and currently needed, we believe that supply of this type of municipal bond issue will not be adversely affected, regardless of whether federal legislation comes about.
Rising rates remain the big story

Ultimately, 2018 was about rising interest rates more than supply and demand. The municipal bond market performed poorly as a result, on both an absolute and relative basis. Through Sept. 30, 2018, the municipal bond market, as measured by the Bloomberg Barclays Municipal Bond Index, returned -0.40%. However, this compared favorably to most other taxable bond indices except for high yield corporate bond indices. In our view, short rates are likely to continue to rise, but in light of the Federal Reserve’s projections of at least four more hikes by the end of 2019, we are cognizant that the Fed remains dependent on data such as unemployment figures and longer-term trends in its decisions on normalizing monetary policy. We are also aware that, historically, long interest rates began their decline prior to the Fed’s discontinuing rate hikes.

We anticipate that the municipal market should face some of these same technical issues in 2019 as the Fed continues to normalize rates, but perhaps the biggest surprises will emerge from the 2017 tax legislation and the new 116th Congress.
After the tipping point

Mansur Z. Rasul
Emerging Markets Credit Trading | Philadelphia

The year 2018 proved to be a tipping point for emerging markets (EM) debt as global headwinds converged on the asset class. We expect those dynamics to continue into early 2019, with the short-term fates of the US and China, and their relationship, driving EM asset prices in the near term. But the news isn’t all bad. Valuations are starting to look attractive to us, while underlying positive fundamental trends appear intact across many EM countries. Some political risks have eased incrementally. All told, this could prove a good entry point for long-term investors.

The big three: Rates, the US dollar, and China

As US growth momentum outpaced global peers in 2018, US rates and dollar strength followed suit. When we consider the key macro pressures on EM assets, higher interest rates and a higher US dollar are two out of three.

China’s growth, meanwhile, has eased incrementally as the country undertakes structural deleveraging, dampening demand for commodities and other value-chain inputs. Trade wars with the US pushed conditions to the tipping point, lowering potential global trade volumes and heightening uncertainty. Add in a slower China and we’re at three out of three.

We see the possibility of these three factors moderating in the year ahead. In the US, we anticipate further rate hikes (and a higher US dollar), but conflicting signals, including trade-related volatility and a potentially inverted yield curve, could complicate matters. China is balancing conflicting aims of its own. It will likely continue to pursue structural reforms but also has incentives to stimulate in the face of a trade war.

Aftershocks and improved fundamentals

The damage of 2018 lay partly in the suddenness of these forces. But we do see some positive outcomes: Some of the most structurally imbalanced countries — Argentina, Turkey, and South Africa — confronted and improved a number of their fundamental issues. As always, politics play a sizable role in EM dynamics, and we also saw marginal improvement in some of the political uncertainties of 2018. Trade deals between the US and South Korea, Mexico, and Canada appear close to resolution. A busy election cycle has closed largely as expected, although presidential elections of a far-right populist in Brazil and a far-left populist in Mexico raise divergent concerns.

Broad EM valuations may have retreated too far. Fundamentals are in better shape than they were 10 years ago, and the market has grown significantly in breadth and depth since the last global downturn. We believe the asset class is still attractive on a long-term basis — although currency risks and other risks associated with emerging markets must always be taken into account — and these developments may just turn out to be a good entry point.

Macro drivers converge on EM

**FX is driving broad EM sentiment**

J.P. Morgan Emerging Markets Currency Index (Spot)

**Hard currency part of EM relative value**

EM hard currency sovereigns (ex Venezuela) versus EM corporate spreads (as of September 6, 2018)

Source: J.P. Morgan, as of September 2018. CEMBI BD is the J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified. EMBIG is the J.P. Morgan Emerging Markets Bond Index Global.
Real assets and alternatives

As 2019 dawns, some of the more traditional asset classes such as equities and fixed income may be late in the cycle, leading some investors to focus more on investments in physical assets like real estate, infrastructure, commodities, and natural resources. Here, we examine a wide range of real assets and alternatives, and what they might bring for 2019.

In this section:
- Real assets perspectives
- Inflation perspectives
- Global listed real estate
REAL ASSETS PERSPECTIVES

Now more than ever?

As we enter 2019, inflation has been starting to pick up around the world, with prices rising in the US, across the European continent, and in many emerging markets. Meanwhile, the US bull stock market has entered a second decade, a record length, and the economic cycle in several markets looks fairly extended. Amid that backdrop, 2019 might be a time when many institutional investors take a fresh look at the role of real assets in a diversified portfolio.

There has been much debate about why inflation has not been more pronounced since the 2008 global financial crisis. One perspective about this phenomenon, shared within our multi-asset team, is that wage growth has merely been delayed by the massive dislocations that resulted from the crisis and recession, as well as more structural factors such as demographics, productivity, and technology. The case can easily be made that financial stimulus, strong economic growth, and the introduction of tariffs are relatively new in this recovery, in turn making a stronger case for inflation yet ahead.

Some recent economic studies claim to show evidence that technology innovation might have been effective in dampening inflation in recent years — something our own in-house research also generally bears out. However, there are also signs that this technology effect could peter out, while the overheating effect might take over and lead to a more pronounced rise in inflation. With this in mind, we offer a look at three charts that help examine what US inflation data could be showing or hiding. We chose to focus on US inflation because, with the US leading the recovery cycle, it’s also leading, in our view, the inflation cycle.

The advent of ever-increasing price transparency driven by the Internet and mobile technology might have depressed inflation rates globally since 2008. As long as these technologies are applied to new markets (from retail to movies, taxis, apartment rentals, and so on) there is a case that inflation could remain low or even negative in some items of the consumer basket.

However, we caution from looking at inflation in the rear-view mirror, as many of the underlying forces that led to subdued inflation in recent years might now come to an end, while others that lead to higher inflation, like tariffs or increasing wages, might eventually begin. Only time will tell if the inflation theme will play out in 2019, but absent a recession, our research indicates that now might be a good time to prepare for higher inflation rates than we have seen in the past decade.

INFLATION PERSPECTIVES

Inflation: Reading the tea leaves on asset prices

There has been much debate about why inflation has not been more pronounced since the 2008 global financial crisis. One perspective about this phenomenon, shared within our multi-asset team, is that wage growth has merely been delayed by the massive dislocations that resulted from the crisis and recession, as well as by more structural factors such as demographics, productivity, and technology. The case can easily be made that financial stimulus, strong economic growth, and the introduction of tariffs are relatively new in this recovery, in turn making a stronger case for inflation yet ahead.

Many real asset classes also generally share inflation protection as a common trait. The nature and degree of that inflation protection differs considerably by asset type — a full review of which requires longer discussion than fits in this space.

Investors who deploy alternative and real assets often face a wide range of considerations that are unique to each strategy, as they seek to construct ideal portfolios that match institutional need with specific investment outcomes. With this in mind, we offer a brief overview on global inflation, followed by our experts’ reviews and outlooks for a number of these unique asset categories.
Personal consumption rates show an overall subdued effect

A view of the average item-level inflation distribution in the Personal Consumption Expenditures Price Index (PCE) basket shows both left and right tails (price increases or cuts of >15%) have been rising. For example, in 2016, 3.3% of the goods in the PCE have experienced price increases of 15% or more, while in 2017, there were already 3.7% rising 15% or more. Since both tails were rising, they partly offset each other, leading to only a subdued increase in overall inflation thus far.


Does a closer look show overheating?

While the tails in the first chart show both have been rising, more recently there is a significant pickup of the right tail, which could be interpreted as first signs of overheating. For example, as of September 2018, the 10% items with the biggest price increases rise by 12% year over year or more, whereas three years ago, the price increase was only 8%, and thus even less than the 9% price decrease of the items with the largest price cuts. Our reading of this chart is that since late 2017, overheating effects, maybe driven through the combination of a tight labor market, strong economic growth, and the threat of new tariffs, have gained much more momentum, outpacing the steady increase of the technology effect.


Federal Reserve underlying gauge points to inflation pressures

Survey-based indicators, which typically are leading inflation indicators, also point to a bigger rise in prices than we have seen in recent years.

For example, the New York Federal Reserve’s underlying inflation gauge (which captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data), recorded an all-time-high in 2018 (source: Bloomberg). Our research indicates that this might be a leading indicator for US core inflation, which, if historical correlations hold, would suggest a rise closer to 3%, while it has hovered around 2% for the last seven years.

Juergen Wurzer
Portfolio Manager, for the Global Listed Real Assets team
Real estate investment trusts (REITs) came under pressure in recent quarters, as rising US interest rates led to underperformance relative to other equity assets during a stretch of 2018. However, continued US economic strength generally led to stabilized yields and positive earnings surprises in sectors such as retail, which more recently appeared to buoy REIT markets.

For some time, it could be said that REIT investors are being “paid for buying growth” — that is, more likely to post gains when critical pockets of earnings strength in specific sectors can be successfully identified. Strong-performing sectors such as residential REITs in Germany and Sweden, and manufactured homes in the US, are examples of areas recently driving growth within REIT markets. Asia, where housing continues to be expensive, is a region where we see notable weakness, and our strategy is well underexposed there.

Late-cycle security selection holds key
It has been our team’s experience across various market cycles that real estate securities often can perform soundly in a steadily rising rate environment when there’s also economic growth. So a key barometer of the year ahead is clearly the economy, in our view. As global REIT investors, we continue to monitor late-cycle economic phenomena such as US wage growth that could signal higher inflation or the potential for widening credit spreads, and sharper interest rate spikes that could have negative effects on REITs in general. At this writing, however, we see US economic strength continuing. As investors, we recognize the lateness of the cycle, and how it underscores the need for a conservative approach, with emphasis on stock selection. For stock pickers, it’s become a matter of using the precision of a rifle rather than a shotgun approach at this stage of the business cycle.

Global opportunities
Globally, our strategy is underweight in Asia, as noted. We see Hong Kong as the world’s most expensive real estate market by many measures, but especially due to its housing market. Sydney housing, also expensive, has taken a turn to the downside. We have zero exposure in China, which has an obvious debt problem in our view. Despite deleveraging and releveraging economic cycles, the government is not always able to slow its real estate markets, and the risks inherent to oversupply and the debt as seen in China is a phenomenon that is broadly true for us across emerging markets.

Europe still has the benefit of low interest rates, compared with the US, and while European REITs have trailed US REITs, we continue to find parts of its residential markets attractive in particular.

The US by contrast has the highest economic growth currently, and we are monitoring our US investment mix, remaining opportunistic and discriminating. Sectors like self-storage in the US are negatively affected by oversupply, while US retail continues to grapple with headwinds from the ongoing shift to ecommerce. We do, however, carefully seek opportunities that may emerge via the transformation of retail. Nascent trends such as cashier-less stores are clearly worth monitoring, in our view, and speak to the validity of the “bricks and clicks” models that blend online and physical business presence. New mixed-use concepts also could present potential opportunity, as REITs turn to such businesses as hotels and call centers to transform former retail or industrial properties.

Private capital impact
A notable story for REITs in recent years has been the strengthening capital flows from private equity investments. Private capital flows have often helped keep cap rates stable, even in the face of rising interest rates. (Cap rates, or capitalization rates, reflect a property’s return on investment based on its generated income, calculated as net operating income to market value.) The effect can be twofold: A strong flow of private real estate investments in a market could inhibit publicly traded REIT performance at times. However, it also could alter the overall dynamics of a market in other ways that may benefit the larger real estate market to the upside.

Less-liquid private equity investments require a long view, and with enough private capital in a given market, we believe that longer time horizon has the potential to reduce volatility. One example can be seen in London, where Brexit has already caused uncertainty. However, significant privately
sourced inflows from, for example, Singapore and the Middle East, have helped create investment in office and residential, improving supply and demand in the market. Similar effects could play out elsewhere in Europe and can help buoy our confidence in those sectors that we may still view as secular growth stories.

Residential is one of these sectors. In the UK, institutionalization of the rental market is only a fraction of other big real estate markets. We continue to find apartment markets in Germany and Spain (still coming off a bottom) attractive. Cell towers and data centers both generally continue to grow apace, and are examples of more thematic, longer-term growth sectors.

Private capital also has helped encourage growing specialization in real estate markets. University endowments and private equity funds have helped spur investment in the urban core, or innovations such as mixed-use operating models for shopping centers and struggling malls. Today, specialty REITs are growing, and while innovation can be net positive, not every development team or REIT company has the expertise to oversee or guide each business model to success, which calls for careful analysis and appropriate selection.

What to monitor
We believe fewer broad trends can be easily exploited currently in the REIT markets, in terms of seeking performance. Secular growth stories exist, but we think it’s also important for investors to recognize the late cycle. We remain upbeat about REITs’ ability to perform up to par in a gradually rising rate environment, but we are also cautious and selective, as global REIT markets become increasingly dynamic.
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The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Index measures the performance of the small-cap segment of the US equity universe. The Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the US equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 2000 Value Index measures the performance of the small-cap value segment of the US equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. 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Morgan Emerging Markets Bond Index (EMBI) Global Diversified ex-Venezuela Index tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities, excluding Venezuela, that include Brady bonds, loans, and Eurobonds, and limits the weights of the index countries by only including a specified portion of those countries’ eligible current face amounts of debt outstanding. The J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad Diversified Index tracks US dollar-denominated emerging market corporate bonds, limiting the weights of countries with larger corporate debt stocks by including only a specified portion of those countries’ eligible current face amounts of debt outstanding. The J.P. Morgan Emerging Market Currency Index (EMCI) is a tradable benchmark that tracks short-term interest rates for emerging markets currencies versus the US dollar. 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Finding opportunities that matter

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