Economic Update

Sydney | 25-04-17

April 2017

Outlook for Investment Markets

The "Trump trade," which saw equities rise strongly, bonds sell off, and the U.S. dollar strengthen, has weakened as investors have reassessed the Trump administration's ability to implement its economic agenda. Bond yields have dropped back, and both bonds and bond proxies like property and infrastructure have benefited, while equities have temporarily stalled. More positively, recent data suggest that the world economy is strengthening, which is supportive of growth assets, although on current expensive valuations there is little room for corporate performance to fail to deliver. Valuations also appear to be paying too little heed to potential economic or geopolitical shocks. At home, the latest data suggest, tentatively, that the economy may be picking up out of its post-mining-boom slowdown, which would be helpful for growth asset performance, although there are the same issues in Australia as there are overseas around generally expensive asset valuations.

Australian Cash & Fixed Interest — Review

Once again, there has been no change to short-term interest rates: the 90-day bank bill yield remains around the 1.75% mark, reflecting the unchanged stance of monetary policy at the Reserve Bank of Australia (RBA). There have been correspondingly low returns from short-term investments, with the S&P/ASX bank bill index returning 0.55% for the year to date. Longer-term yields have broadly followed the evolution of U.S. bonds, with the local 10-year Commonwealth bond yield peaking in mid-March (as U.S. Treasuries did) and falling more recently to its current 2.5%, 23 basis points down for the year. The capital gain from lower yields has boosted the total return from the S&P/ASX Government Bond Index, which is up 2.1% for the year to date, while the equivalent corporate bond index is up 2.5%. The Australian dollar is generally stronger: apart from a 2.5% decline against the Japanese yen this year, the AUD is up against its other main counterparts and has gained 1.7% for the year to date in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The minutes of the RBA's most recent policy meeting gave no hint of the bank's likely next move. The minutes concluded by saying that "developments in the labour and housing markets warranted careful monitoring over coming months," which is very likely a coded message that it will raise rates if house price inflation gets out of hand and lower them if there are bad employment numbers. The big bank forecasters, however, are currently unanimous in thinking that, in the end, the RBA will stand pat and do nothing: All four banks think the cash rate will still be 1.5% in a year's time. The financial futures market agrees about the immediate future, though it also thinks there is a chance of a 0.25% increase by the end of next year.

The most likely outlook for local bond yields is that they will follow U.S. yields upwards. Although (as discussed in the International Fixed Interest section) expectations for the likely scale of a rise in U.S. bond yields have been revised downwards recently, forecasters in the U.S. still expect their 10-year bond yield to be 0.6% higher by the end of this year. Most local forecasters have a similar track in mind for the 10-year Commonwealth bond yield in the coming year, with the Commonwealth Bank, National Australia Bank, and Westpac Bank all expecting a rise to 3.2%-3.3% by next June. As with international bonds, the current climate of rising inflation and eventual monetary tightening is not one where bonds can be expected to do well.

Currency forecasting is a difficult exercise at the best of times, and no easier now with significant uncertainties around U.S. economic policy in particular. That said, the consensus at the moment from the big bank forecasters is that during the next year the AUD is likely to depreciate modestly to around USD 0.70–USD 0.72. Potential mechanisms behind the expected fall include the prospect that short-term U.S. interest rates will continue to climb

as the Fed tightens, but local rates remain on hold, reducing the relative yield differential with the USD, and the possibility that key export prices such as iron ore will continue to weaken. At the moment, in sum, the odds suggest some possible forex gains from unhedged overseas assets.

Australian & International Property — Review

The S&P/ASX200 A-REITs index turned on a dime in mid-March when bond yields peaked and started to fall. On March 14, it had been down 5.4% from its opening year level, but it has since risen by 8.8% and is now up 2.9% in year-to-date capital value and has delivered a total return of 3.8%.

It was almost the same story for global listed property. For the year to date the FTSE EPRA/NAREIT Global Index in USD is up 5.1% in capital value and has provided a tax paid net return of 5.8%, but again all of the performance is attributable to the period since March 14 when the previous upward trend of bond yields reversed course. Asia ex Japan has been by far the star performer, up 19.8% in terms of net USD return. The United Kingdom has also done well (9.1%), albeit off a previously depressed level, and the emerging markets have also recorded a good gain (6.4%). There were relatively small gains for the key U.S. market (2.9%) and in the eurozone (2.2%).

Australian & International Property — Outlook

Operating conditions remain reasonably good: Although the economy is still not growing as fast as it used to, industry participants are reporting that business conditions are acceptable. Industry confidence rose in the latest (June quarter) ANZ/Property Council of Australia, with previously depressed Western Australia finally appearing to emerge from the post-mining-boom bust and industry professionals taking a slightly more upbeat view of the economic outlook. And the first of a new joint venture survey series from two property advisory firms (U.S.-based Situs and Melbourne-based Urban Property Australia) found that property professionals typically reported investment conditions as "average" or "above average".

And some sectors–notably CBD office markets–are positively thriving. The Situs/Urban survey found that the CBD office sector (particularly in Sydney) was by a wide margin cited as the best investment opportunity on the sector, with similar results from the ANZ/PCA survey, where respondents reported high (and rising) expectations for capital gains in the office market, again primarily in Sydney but also in Melbourne.

That said, the sector is now expensive. It has been a favourite of global investors chasing yield, with (according to Real Capital Analytics) some AUD 18.5 billion invested from overseas in 2016. Situs/Urban said that "As a result of the increased weight of money seeking investment in Australian commercial real estate, yields across most sectors have fallen to record-low levels." The survey also found that few professionals (16%) think it is now a good time to buy, with the bulk of the industry split roughly 50:50 between holding and selling. Higher bond yields are likely to expose the current high valuations, although in a global property sell-off Australia may fare better than most: While its office yields may be at record lows, as Situs/Urban pointed out they are still attractive compared with the even lower yields on offer in major markets overseas.

The more severe valuation issues overseas are likely to cause problems for global listed property. Again, there is a reasonable macroeconomic backdrop for operating performance, and there have even been pockets of value on offer: Two of the listed property trusts in the U.K., for example, have already been taken private by buyers capitalising on the wide discounts to net asset value that have prevailed in the distressed sector since the surprise Brexit referendum last year, and more may follow. But in general, the yields on offer on overseas REITs–2.3% in Japan, 2.6% in Germany–make sense only in the context of unusually low inflation and unusually low bond yields. Those conditions are on the turn, and the overall sector

will need to offer more than its current 3.7% to remain competitive–an outcome that is likely to mean lower prices.

Australian Equities — Review

Australian shares have broadly followed the global trend–gaining in the Trump trade period through to mid-March, but showing little net movement since, with the S&P/ASX200 Index up 3.3% for the year to date and delivering a total return of 4.6%. By sector, the miners have been more affected than most by second thoughts about the strength of the post-Trump U.S. economy, and by falls in the iron ore price; while the S&P/ASX300 Metals and Mining Index is still marginally positive for the year (0.1% capital gain), it is also down 9.2% from its peak (in late January) when optimism was running stronger. In other sectors, consumer staples are up 6.4%, the financials 4.1%, industrials 3.7%, consumer discretionary 1.8%, and IT 0.9%.

Australian Equities — Outlook

The business cycle has proved hard to read. For some considerable time, the economy has continued to bumble along at a slower than usual rate of growth, with no knockout evidence that it risked slowing to unacceptably slow growth or that it was accelerating back to the pace it enjoyed before the mining projects boom came to an end.

The latest data do not settle the matter, either, though this time round they generally lean more towards the acceleration view. The March employment report was, at face value, a stunner. Seasonally adjusted, there was a 60,900 increase in employment, more than all of which (74,500) were full-time, with a corresponding 13,600 decrease in part-time unemployment. Although there was a big reported rise in jobs, the unemployment rate was unchanged at 5.9%, because at the same time more people entered the labour force to look for jobs (there was a rise in the participation rate), which is also a good sign of labour market strength.

But "at face value" and "reported rise" are important qualifications: The data from the statisticians have been unusually volatile, and some commentators feel the series is not as reliable as it might be. Other evidence, however, has also been on the bright side.

The latest (March) quarterly business opinion survey from National Australia Bank (NAB) found "an encouraging picture of both current business activity and the outlook. Leading indicators mostly improved in Q1 2017, which has been reflected in better outcomes in terms of investment and hiring intentions going forward. Both near and longer-term employment expectations recorded solid improvements." And the three sectoral indexes compiled by Australia Industry Group all moved into expansion territory in March: The services index, which had previously been signalling that the sector had been going backwards, joined the manufacturing and construction indexes in showing positive growth.

At the same time, there are still soggier readings from other indicators. The ANZ–Roy Morgan survey of consumer confidence, for example, has been falling since the middle of last year; in particular, households' views of the economic outlook during the next five years have been falling since the start of this year and are now well below long-run levels. There are also well-known risks in the housing market–not just the risk of excessive prices unwinding, but also the prospect of house construction turning from supporting GDP growth: On both the Commonwealth Bank and NAB calculations in their latest forecasts, the volume of housebuilding will grow modestly this year but contract a bit next year.

If the latest upbeat indicators are the better signal, however, and the economy is indeed looking a bit perkier, Australian shares could make further progress. But as in many other markets, corporate profits will need to live up to investors' high expectations. With the market trading on a forward-looking P/E ratio of 16.25 times earnings (on S&P's latest calculations), there is not much room for macroeconomic or corporate underperformance.

International Fixed Interest — Review

Much of the performance of the asset class has been driven by U.S. events. U.S. bond yields rose sharply after the election of President Trump and remained high up to the Fed's mid-March policy meeting, when the U.S. 10-year Treasury yield hit a peak of 2.62%. Since then, however, the markets have taken a different view of the outlook, and the U.S. 10-year yield has fallen to its current 2.23%, which is 0.22% below where it started the year.

A lower yield during the period has meant capital gains, and the Bloomberg Barclays Global Aggregate Index has delivered a total return in USD of 3.1% (government bonds 3.5%, corporate debt 2.6%). The traffic has not been all one way: In the eurozone, the Bloomberg Barclays Eurozone Aggregate Index has recorded a loss of 0.5% in euros, as it now looks more likely that the European Central Bank (ECB) has gone as far as it is going to with its very stimulatory monetary policy.

The ongoing hunt for pockets of yield in this low-interest-rate environment means that emerging-markets bonds have remained in high demand, with the Bloomberg Barclays Emerging Markets Index up 4.2% in USD. Another popular option, global high-yield (low-credit-quality) bonds, have fared less well, with the total USD return on the Bloomberg Barclays index only 1.9%, less than the return from safer investments.

International Fixed Interest — Outlook

The earlier rise and more recent decline in U.S. bond yields reflects a reassessment of how fast the U.S. economy was likely to grow under Trump administration policies. Originally expectations had been high: Equities boomed, the USD rose, and bonds sold off as inflation was expected to pick up quicker in a hotter economy. More recently, however, President Trump's failure to get Obamacare repealed raised doubts about his ability to implement his agenda to the schedule the financial markets had initially expected, and there were also some unexpectedly weak economic data (notably the March jobs numbers).

As a result, expectations of the likely rise in interest rates have been scaled back. Last October, for example, before the U.S. election result, the forecasters in the *Wall Street Journal*'s survey were expecting the 10-year Treasury yield to be 2.3% by the end of this year, and in the subsequent Trump trade conditions they raised their forecast to a peak, in the March survey, of 2.94%. In the latest (April), survey, however, they have pared back their forecast to 2.84%.

While a new, more realistic view of the U.S. outlook has generated some capital gains for bond investors, it is a rather fortuitous outcome that happens to be based on point-to-point comparison of peak Trump trade optimism (around the start of the year) and a less upbeat view (today). The reality is that, even if the U.S. economy is not going to be booming as much as expected, it will still be doing well enough for the Fed to keep raising interest rates. The markets' current view, from futures pricing, is that the Fed will raise the federal-funds rate by at least 0.25% by the end of this year and could well raise it a further 0.25%. And even if the U.S. 10-year yield does not rise as much as previously thought, it will still (on the latest expectations) be 0.6% higher than today's levels by year-end, and a further 0.5% higher by the end of next year.

The U.S. macroeconomic backdrop will, in sum, remain a significant headwind for bond performance and will be reinforced by the eventual prospect of European monetary policy also being normalised from its previous ultra-stimulatory stance. In the circumstances, it is not surprising that fund managers are wary of the asset class. The latest (April) Bank of America Merrill Lynch survey of global managers found that they were overwhelmingly underweight to bonds (a net 62% underweighting, which is the number you would get when 81% are underweight and only 19% are overweight).

Some of the higher-yield sectors that investors have been using to boost returns from the sector may also have run their course, as demand has pushed yields and credit spreads to unsustainably compressed levels. As a recent *Weekly Letter* from Merrill Lynch noted, for example, in the corporate high-yield market "Spreads are well below average levels for the sector as a whole and for every credit category within it, with prospective returns for the buy-and-hold investor hovering in the mid- to low 3% range. Yields are quite low by historical standards and are barely covering average credit losses for bonds rated CCC and below."

International Equities — Review

The strong Trump trade gains in global equity prices from November through to mide to late March have run out of steam more recently, with little net move in prices since then. Despite this recent pause, the MSCI World Index is still up 4.0% for the year to date (in its component currencies) and up 5.2% in USD terms (5.8% including the taxed value of dividends). The outcome in AUD terms, however, was materially affected by the AUD's 4.1% appreciation against the USD.

The gains earlier in the year mean that in the U.S. the S&P500 is up 4.9% for the year to date. Ongoing signs of an improving eurozone economy have helped European equities: The FTSE Eurofirst 300 Index is up 3.9%, with Germany's DAX up 4.9% and (despite the major uncertainties around its presidential election) France's CAC up 3.9%. News of an unexpected snap election in the U.K., on the other hand, has done U.K. equities no favours, with the FTSE100 Index down 0.4%, although the losses have been cushioned by a modest recovery in the U.K. pound since its big post-Brexit sell-off. Japan, where growth prospects remain unclear, has also missed out, with the Nikkei down 2.6%.

Emerging markets have continued to outperform, with the MSCI Emerging Markets Index up 7.8% in capital value (in terms of the emerging markets' own currencies) and by 11.5% in USD terms. The key BRIC economies gained 11.6% in USD, with India the best performer (a 9.9% rise in its Sensex index, boosted by a 5.1% appreciation of the rupee against the USD), followed by Brazil (Bovespa index up 5.7% and the real up 3.5%).

International Equities — Outlook

The most recent survey data suggest that while the pace of growth in the U.S. may have come off the boil, improved prospects elsewhere have helped the global economy to keep growing.

In the U.S., for example, the latest (April) IHS Markit Purchasing Managers' Index (PMI) showed that the American economy "lost further momentum at the start of the second quarter," although there were indications that it could pick up later in the year: "With inflows of new business picking up slightly in April and business optimism about the year ahead also brightening, there's good reason to believe that growth could revive again in coming months." Whatever temporary slowdown is occurring in the U.S. has been counterbalanced, by upturns elsewhere, particularly in the strengthening eurozone economy. The latest (April) IHS Markit PMI data for the eurozone found that "Eurozone economic growth hit a fresh six-year high in April...Job creation also rose to the highest for almost a decade as firms boosted operating capacity in line with buoyant demand and widespread optimism about future prospects."

The International Monetary Fund (IMF) in the latest (April) update of its flagship *World Economic Outlook* report was also positive: "Global economic activity is picking up with a long-awaited cyclical recovery in investment, manufacturing, and trade. World growth is expected to rise from 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018."

This outlook for ongoing global growth is shared by institutional fund managers. In the latest (April) monthly Bank of America Merrill Lynch (BAML) survey of global fund managers, they said they were optimistic about global corporate profits (a net 50% expect profits to grow

during the coming year). They do not believe there is great value on offer–a net 32% think global equities are overvalued–but the outlook for the global economy means they are still prepared to favour equities (a net 40% are overweight).

But they also had pronounced views about which equity markets they preferred: Some markets are seen as offering much less value than others. The overall overvalued status of world equities stems almost entirely from the U.S., where an all-time record (net 83%) think the U.S. market is overvalued, and the percentage underweighting (net 20%) is the highest since January 2008 in the early days of the GFC. Fund managers also thought the U.S. dollar was overvalued, making it a double whammy for U.S. equity allocations. The main counterpart to underweight U.S. allocations is principally overweight eurozone exposure (a net 48% overweighting) assisted by a positive view on the euro, which a net 30% believe is undervalued. Emerging markets are another favourite: Fund managers are a net 44% overweighting, with a net 47% of the view that emerging-markets equities are undervalued.

The IMF mentioned that the generally positive outlook nonetheless carried risks that are "tilted to the downside," though the IMF thought they are more likely to cause trouble somewhere down the medium-term track than imminently in the next few months. It listed six in particular: protectionism, uncertainty around the U.S. policy agenda, financial sector fragilities, potential setbacks to emerging markets, ongoing problems in the weaker eurozone countries, and noneconomic factors, where it said that "Geopolitical tensions as well as domestic strife and idiosyncratic political problems have been on the rise in recent years, burdening the outlook for various regions."

The fund managers in the BAML survey broadly agree with the IMF's list. They see the main risks as European Union disintegration (chosen by 23% as their main concern), delayed U.S. tax reform (21%), and trade wars (17%).

Unfortunately, global equity markets appear to be putting a low probability on any of these risks materialising in a meaningful way. Investors continue to pay high valuations by historical standards for equities, especially in the U.S., and the VIX measure of expected U.S. share market volatility remains at unusually low levels, despite (for example) the unexpected U.S. air strikes on Syria, which worsened U.S.-Russia relations, or the current heightened tension over North Korea. The gold price, a traditional indicator of investor fear, has admittedly risen this year (by 11.4%) but is now only back to where it was a year ago, and it remains well down on its high-crisis levels seen at the end of the GFC.

The outlook, in sum, is unchanged: There is a reasonable economic outlook supportive of equity performance, but equities remain susceptible to reassessments of the value on offer and to risks materialising that investors do not currently seem to be prepared for.

Performance periods unless otherwise stated generally refer to periods ended April 21, 2017.

Copyright, Disclaimer & Other Information

This report has been issued and distributed by Morningstar Australasia Pty Ltd ABN: 95 090 665 544, AFSL: 240892 and/or Morningstar Research Limited, subsidiaries of Morningstar, Inc.

To the extent the report contains any general advice or 'class service' this has been prepared by Morningstar Australasia Pty Ltd and/or Morningstar Research Ltd, without reference to your objectives, financial situation or needs. Please refer to our Financial Services Guide (FSG) for more information including our conflict management procedures at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement (Australian products) or Investment Statement (New Zealand products) before making any decision to invest.

Copyright

Trademarks

Morningstar and the Morningstar logo are registered trademarks of Morningstar, Inc.

Disclaimer

All care has been taken in preparing this report. However, please note we base our financial product research on current information provided to us by third parties (including financial product issuers) which we cannot necessarily verify. While we use all reasonable efforts to obtain information from reliable sources, we do not guarantee the data or content contained herein to be accurate, complete or timely. To the extent that our research is based on information received from other parties, no liability is accepted by Morningstar, its affiliates nor their content providers for errors contained in the report or omissions from the report. Morningstar determines its ratings on information disclosed to it by financial product issuers and on past performance of products. Past performance is no guarantee of future performance.

More Information

If you wish to obtain further information regarding this report, licensing and our services, please contact us on:

Morningstar.com.au subscribers
Tel: 1800 03 44 55
Email: help.au@morningstar.com

Advisers/Institutions/Others
Tel: +61 2 9276 4446
Email: helpdesk.au@morningstar.com

For further information on our analysts and research methodologies, we recommend you visit www.global.morningstar.com/au/researchdocuments