Economic Update

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Outlook for Investment Markets

The world economy remains in generally good shape, but world equities have been held back by concerns about trade wars and other geopolitical tensions. Bond yields have risen particularly in the U.S. as world growth has led to rising inflation and central banks have started to pull back from their previous policies of ultra-low interest rates. The global economic outlook remains favourable for risk assets and unfriendly for bonds and bond proxies, though the ongoing global expansion could be derailed by any intensification of protectionist policies, or by central banks normalising interest rates too quickly. In Australia, the economic outlook is for a gradual pickup in the rate of economic growth, which may not be enough to lift investor confidence about corporate profits.

Australian Cash & Fixed Interest — Review

Short-term interest rates have risen a bit further, with the 90-day bank bill yield now a little over 2.0% (at the time of writing 2.07%). The rise reflects tighter funding conditions for the banks and not any change to monetary policy, with the Reserve Bank of Australia, or RBA, continuing to hold the cash rate at 1.5%. Long-term bond yields have continued to follow the pattern of the U.S. bond market: the local 10-year Commonwealth bond yield dipped below 2.6% on March 28, but has since followed U.S. yields back up, and at the time of writing a little under 2.8%. Year to date, the Australian dollar has weakened, and is down 3.2% in overall trade-weighted value. It is down on all the major cross rates, but particularly against the Japanese yen (down 5.6%) and the Chinese renminbi (down 5.4%).

Australian Cash & Fixed Interest — Outlook

The RBA has given few clues away about its future intentions, but in the minutes of its April policy meeting the bank said that "it was more likely that the next move in the cash rate would be up, rather than down." But any eventual increase is still some considerable distance away, with the RBA saying that getting inflation back to its target level, and getting unemployment down, would be a very gradual process. As Westpac said, commenting on their latest (April) consumer confidence survey, "markets which six months ago were fully priced for a rate hike by August 2018 are now not priced for a move until mid- 2019."

Currently the local 10-year bond yield (2.78%) is below its U.S. equivalent (2.96%). This is an unusual situation, other things being equal, as investors normally receive a premium for the country risk involved in preferring Australia over the U.S. and it is unlikely to persist. As inflation gradually rises in Australia back over 2%, and a more traditional relationship with the U.S. yield re-emerges, local yields look set to rise by at least as much as U.S. rates. With forecasters expecting the 10-year U.S. yield to rise by 0.2% during the rest of this year, and by a further 0.3% next year, local yields look likely to be at least 0.5% higher by the end of 2019.

Currency forecasting is always problematic. Many forecasters, for example, would have expected the Australian dollar would have dropped even further than it has against the U.S. dollar when local interest rates have fallen below U.S. levels. Other factors such as the commodity backing of the currency in a strongly growing world economy and overseas portfolio investment into the likes of local equities and property have evidently been enough to counteract some of the effect of the adverse interest differentials. But it is questionable whether the Aussie dollar can hold onto its current levels as U.S. rates rise further. In recent weeks, the U.S. dollar has started to appreciate in overall value, and the likelihood is that the Australian dollar will give up some further ground in coming months.

Australian & International Property — Review

Local listed property has underperformed the (itself weak) wider sharemarket. Year to date the S&P/ASX 200 A-REITs index is down 7.0% in capital value and has delivered an overall loss of 6.1% including dividend

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income, well adrift of the overall 2.0% loss from Australian equities overall.

Global listed property has also lost ground, and the FTSE EPRA/NAREIT Global index has registered a 3.9% year-to-date loss in terms of net return in U.S. dollars, compared with the small 0.4% net return from the MSCI World index. Once again, the outcome has been driven by especially poor performance by the U.S. REITs, which are down 7.8% overall, with the typical subsectoral pattern of industrial doing best (a loss of only 1.5%) buoyed by e-commerce logistics demand and retail correspondingly doing worse (a loss of 13.3%, with shopping centres losing a remarkable 17.8%).

Australian & International Property — Outlook

Two recent surveys show the commercial property sector believes better economic conditions lie ahead.

The June quarter ANZ Bank/Property Council of Australia survey of commercial property found that confidence in the industry has risen to a record level in the six-year history of the survey. Respondents were more optimistic about economic growth and were more optimistic about capital growth for their properties across most sectors, and were especially upbeat about retirement villages and industrial property. It helped that the previously devastated Western Australian market has also turned the corner towards better times. The major exception was the retail sector, where already weak conditions looked like getting worse again.

It was a similar picture from the March quarterly survey of commercial property from National Australia Bank. Again, confidence has risen further to well above historical averages, and respondents were positive about rental growth and capital gains for the office, industrial and hotel markets, but were also increasingly downbeat about the retail sector, which continues to be battered by cautious levels of consumer spending and the threat from e-commerce.

Clearly improving business conditions (ex retail) are obviously a plus for the A-REITs, but so far investors have preferred to focus more on the threat from rising bond yields. Better operating results, in time, may change their minds, but for now the A-REITs looks as overshadowed by rising bond yields as other income-focused asset classes.

The same outlook applies overseas. As CBRE recently said in their *Global Vision* report, a synchronised global upturn has been positive for performance: "Solid occupier demand has coincided with relatively limited new supply in most markets, increasing occupancy levels and rents and boosting cashflows."

But again higher interest rates are coming into play. As CBRE put it: "Cap rate compression has powered much of the outsized real estate return performance of recent years," with "cap rate compression" meaning the interest rates used to value property had fallen, boosting capital values. However, "the situation is now starting to reverse. Interest rates are beginning to rise in many countries, most notably in the U.S. Although low inflationary expectations will keep rates moderate by historic standards, they are trending up over the five-year forecast period, putting upward pressure on cap rates." Further valuation losses look likely in coming months.

Australian Equities — Review

This year has not been kind to equities, and Australian shares have also felt the pain. The Australian share market has weakened year to date, with the S&P/ASX 200 index down by 3.2% in capital value and by 2.0% including dividends. The financials sector has been particularly weak, hit by the various revelations from the royal commission of inquiry, and is down 7.6% in capital value. There were also capital losses for consumer discretionary shares (down 5.0%) and the industrials (down 3.8%). Consumer staples were all square, and the only sectors to go against the losing grain were the miners (up 3.7%) and IT stocks (up 2.0%).

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Australian Equities — Outlook

The first of this year's NAB quarterly business surveys—more comprehensive than their monthly surveys—was robust. As the bank commented, in the March quarter "Business conditions reached a new post-GFC high in this quarter's survey and while the monthly survey indicates conditions eased late in the quarter, the bottom line is that they remain strong reflecting robust trading conditions, profitability and employment growth." The latest (March) Australian Industry Group sectoral indices of activity in manufacturing, service and construction also showed a strong picture, particularly for manufacturing.

The latest employment data, however, was not especially encouraging. In March, there were only 4,900 new jobs, well below the 20,000 forecasters had expected. Commentary on the weak number suggested that a one-off month is neither here nor there, especially after an earlier series of strong employment increases. The statisticians' "trend" version of the data, which takes out random month-to-month volatility, was rather better (14,000 new jobs), plus it showed a rise in the proportion of people participating in the labour market to an all-time high. Given that the data goes back to 1978, that is a significant milestone, and the labour market is likely stronger than the latest data suggested.

The economy looks like it is picking up. As the RBA said in their latest minutes, "the recent data had generally been consistent with the forecast for a gradual improvement in growth." One factor holding it back, however, is that households are not yet wholly on board with the idea the outlook is brightening. In the latest (April) Westpac/Melbourne Institute consumer confidence survey, Westpac said that household sentiment is only in "slightly optimistic territory ... at 102.4 the Index is still well below the strong 105–115 levels typically associated with a robust consumer." And in the ANZ/Roy Morgan consumer survey, families have been saying for some time that, although their own situation is a bit better than usual, they think the outlook for the wider economy is a bit weaker than usual. The Westpac survey showed, for example, that households were rattled by news of potential international trade wars.

Whether a gradually improving economy will translate into higher equity prices, however, remains to be seen. Local equity market sentiment remains adversely affected by global uncertainties, and the financials sector, mired in bad publicity from official inquiries, continues to drag on performance, with the latest casualty being AMP. At the time of writing, year-to-date its share price has dropped from AUD 5.20 to AUD 4.32 and it had seen its CEO resign. A good string of strong local economic data, and some resolution of international tensions, could improve investor sentiment, but a more likely outcome is another period of subpar outcomes while investors wait on the side lines.

International Fixed Interest — Review

The key development has been that U.S. bond yields, after easing back a bit in March and early April—the 10-year Treasury yield reached a low of 2.73% on April 2—are now on the rise again, and the 10-year yield is now back up to just shy of 3% (currently 2.96%). Bond yields in other markets are also up from where they started the year.

So far, the yield rises have been relatively modest, unless investors had opted for very long duration, where the impact is highest. The Bloomberg Barclays index of long maturity U.S. Treasury bonds, for example, has lost 5.9% this year. But the capital losses that come with even modest rises, combined with the very low running yields, have meant that overall returns from international fixed interest have been poor. The Bloomberg Barclays Global Aggregate index is showing a year-to-date gain of only 0.5% in U.S. dollar terms, and non-U.S. dollar-based investors will typically be looking at modest losses.

International Fixed Interest — Outlook

The rise in U.S. bond yields reflects the ongoing strength of the U.S. economy: unemployment is low; wage and

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price pressures though still modest are rising; and the Fed is in the process of successively removing the various policies that had previously kept both short- and long-term interest rates ate unusually low levels.

The likelihood is inflation will reach the Fed's target 2%, and that a combination of higher inflation and the knock-on effects of tightening of monetary policy will see bond yields rise further. In the latest (April) survey of U.S. forecasters by the *Wall Street Journal*, or WSJ, inflation is expected to be 2.2% to 2.3% all the way out to 2020, and yields will have to rise to provide a reasonable "real" rate of return over and above the higher inflation rate. The WSJ panel sees the 10-year U.S. rate rising by 0.2% during the rest of this year, and by a further 0.5% in 2019, taking it to 3.5% by the end of 2019.

The move to higher bond yields is also likely to spread beyond the U.S. In the April Bank of America Merrill Lynch survey of fund managers, an overwhelming majority (a net 82%) think global inflation is on the rise. In the latest (April) update to its *World Economic Outlook*, the IMF predicts inflation in the developed world, which was only 0.8% in 2016, has already picked up to 1.7% in 2017 and is en route to 2.0% this year and 1.9% in 2019. The fundamental driver behind the rise in inflation is the take-up of previously underemployed resources as the global business cycle has rolled on. The world has changed from easy availability of labour and equipment to one where capacity constraints are starting to bite, leading to rises in their prices.

The likely rise in bond yields is not huge and is capped by the likely re-emergence of higher demand for bonds once yields have risen enough to make bonds more attractive. Interestingly, the latest BAML survey asked fund managers what level of U.S. 10-year yield would turn them into sellers of equities and buyers of bonds, and the answer was 3.5%—close to the level likely to be on offer late next year. And inflation is likely to emerge later in some countries than in others with Japan, for example, likely to see very low interest rates persist for some time yet. But even with relatively modest increases on the horizon, the cyclical outlook is uncongenial for bonds, and arguably particularly for corporate bonds as previously very low credit spreads for taking on corporate risk return to more normal levels.

International Equities — Review

World shares continue to reflect the impact of two adverse shocks—heightened fear of rising interest rates in January/February, and more recently worries over a potential trade war between the U.S. and China and of higher geopolitical tensions more generally. While global equities have had some good days when speedy or low-cost resolution of trade issues has looked more likely, in general, equities have not been able to progress against these new headwinds, and year to date, the MSCI World index of developed markets is slightly below where it started the year. It is down 1.0% in the currencies of the overseas markets but only marginally down (0.2%) in U.S. dollar terms.

Among the major markets year to date, the S&P500 in the U.S. has been relatively unscathed (down only 0.1%) with somewhat larger losses in most of Europe (FTSE Eurofirst 300 down 2.1%) other than France (CAC40 up 1.9%). The U.K., with its Brexit issues, continues to underperform, with the FTSE100 down 4.2%. The Japanese market has also been weaker, with the Nikkei down 2.6%.

Emerging markets have continued to outperform the developed markets, though not by as much as before, and year to date, the MSCI Emerging Markets index is up by 1.0% in the emerging markets' currencies and by 0.8% in U.S. dollars. Two of the core BRIC economies fell foul of the latest geopolitics. Although Chinese stock markets do not always closely track economic developments, they did this time, with the Shanghai Composite down 7.1%. And Russia, hit by U.S. sanctions, was also a casualty, with the FTSE Russia index down 1.7%. Of the other two BRIC economies, India's Sensex index is up 1.1% in rupee terms but down 2.3% in U.S. dollar terms, which means that all the heavy lifting behind the emerging markets'

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outperformance came from the Brazilian market, where the Bovespa index was up by 12.0% in local currency terms and by 8.8% in U.S. dollar terms.

International Equities — Outlook

The international economic outlook continues to be supportive of corporate performance, although there is a range of views about whether the world economic cycle has peaked or can yet strengthen further.

The latest global business surveys from Markit and J P Morgan suggested that while the world economy is still growing, the growth rate could be slowing down. On a closer look at the sectoral data, the slowdown could be due to an anomalous report of reduced activity in March in the production of technology equipment, which seems unlikely to continue (tech equipment had been one of the strongest sectors in February). But on its face, the latest reading still suggests that growth is coming off the boil.

The OECD, on the other hand, compiles a "leading indicator" measure which aims to pick up what lies down the track six to nine months ahead, and on its latest (April) reading, it is signalling steady growth. There may be slower growth ahead for the eurozone and the U.K., but the U.S., Japan, and Canada are trucking along at the same pace as before, and Brazil, India, and Russia look like growing faster. Overall the world economy looks like keeping up its recent pace of growth.

The IMF, in the latest (April) update to its *World Economic Outlook*, is more optimistic again. It says "The global economic upswing that began around mid-2016 has become broader and stronger ... Global growth seems on track to reach 3.9 percent this year and next, substantially above our October forecast. Helping to drive this output acceleration is faster growth in the euro area, Japan, China, and the U.S., all of which grew above expectations last year, along with some recovery in commodity exporters ... Growth this broad based and strong has not been seen since the world's initial sharp 2010 bounce back from the financial crisis of 2008–09."

Fund manager opinion is also split. In the BAML fund manager survey mentioned earlier, 18% of managers think the peak for equities is already behind us, 40% expect it will be in the second half of this year, while 39% think the peak will be next year or beyond. On balance, the managers still see further gains ahead, though they are now less positive about the outlook for global economic activity than they were—a net 20% expect profits to improve over the next year, which is the lowest proportion in 18 months—and they are no longer as overweight to equities as they have been.

If the economic outlook remains broadly positive, the risks remain significant. The IMF thinks they will not kick in in the very near term—risks "are balanced over the next several quarters, with the possibility of more buoyant growth than forecast balancing out unfavourable contingencies"—but further out the risks "clearly lean to the downside." The IMF said: "Downside concerns include a possibly sharp tightening of financial conditions, waning popular support for global economic integration, growing trade tensions and risks of a shift toward protectionist policies, and geopolitical strains."

The fund managers in the BAML survey have a very similar list, headed by trade wars and a hawkish monetary policy mistake by the Fed or the ECB, plus they also worry about market liquidity drying up (as it did in the worst of the GFC) and a crash in tech stocks. They have started to deal to the tech issue, with managers moving to their least overweight allocation in four years.

For investors, the outlook remains one where the economic factors look reasonably good, but the more unpredictable political factors look increasingly problematic. If the political skies stay clear, equities could make further gains, but in today's geopolitical world, it is a big ask to expect no surprises.

Performance periods unless otherwise stated generally refer to periods ended April 20, 2018.

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