December 2017

Outlook for Investment Markets

The world economy continues to improve, and investors have been further encouraged by the U.S. tax cut package they have been anticipating for some time. The economic fundamentals are still signalling support for growth assets in coming months. Even allowing for the positive outlook, however, valuations are expensive across many asset classes, investors appear to be systematically discounting true levels of risk, and it is difficult to see how 2018 will be able to repeat 2017's strong investment returns. In Australia, there are some signs that the business cycle is turning for the better, but it is still not clear whether the improvement is meaningful enough to make a big difference to corporate performance.

Australian Cash & Fixed Interest — Review

As expected, the Reserve Bank of Australia once again left monetary policy unchanged at its latest meeting on December 5, so short-term interest rates have been steady, with 90-day bank bill yields close to 1.75%. Long-term bond yields have also shown little movement, with the 10-year Commonwealth bond yield at 2.6%. The Australian dollar has been volatile throughout the year: It appreciated in the first half of the year, only to give up all the gains by midyear, and repeated the same exercise in the second half of the year, so that it is once again roughly back to where it started. The overall value of the Australian dollar is slightly up (0.6%) for the year; in terms of the headline U.S. dollar rate, however, it is up from USD 72.4 cents to USD 76.75 due to the global weakness of the U.S. dollar.

Australian Cash & Fixed Interest — Outlook

As usual the RBA's policy announcements have given nothing away about where the RBA might go next. Some forecasters reckon it will do nothing at all for an extended period: Westpac, for example, expects that the current target cash rate (1.5%) will be maintained all the way out to late 2019. But others look at the combination of inflation likely returning to the RBA's 2% to 3% target range, against a background of an economy doing reasonably though not outstandingly well, and wonder why the RBA needs to keep interest rates so low. The other big banks have the RBA raising rates modestly in the second half of next year, and the futures market agrees, with its current pricing of one 0.25% increase in interest rates next year.

There is a consensus that long-term bond yields are likely to rise modestly over the next year: Forecasters generally have the 10-year yield in the low 3%s by the end of next year. This mirrors similar U.S. forecasters' expectations for U.S. bond yields, which influence local yields. As with international bonds, fixed interest will face economic headwinds over the coming year.

Currency forecasting is always imprecise, and is not helped currently by factors that pull in opposite directions. Interest-rate differentials, for example, are moving in favour of the U.S. dollar as the RBA looks likely to raise rates more slowly than the Fed, but the local business cycle remains relatively good by international standards and may attract portfolio investment into Australian dollar assets (as noted elsewhere, one of the biggest A-REITs accepted a takeover bid from a European buyer this month). Overall, forecasters mostly see a somewhat lower Australian dollar over the coming year, with three of the four big banks expecting the Australian dollar to be in the low AUD 70s against the U.S. dollar in a year's time. That view also has the merit of likely suiting the RBA's purposes, as the RBA does not want to see the Australian dollar higher than it is today. But it is always possible to read the entrails in a different way, and the Commonwealth Bank continues to believe in the possibility of the Australian dollar rising to USD 83 cents by next December.

Australian & International Property — Review

In early December investors in the S&P/ASX200 A-REITs index were roughly all square for the year: The good news was that prices had recovered well from their July low point, but the bad news was that the recovery had only

made good the losses in the first half of the year. All that changed, however, with the surprise news on December 12 that European mall owner Unibail-Rodamco had made an agreed takeover bid at a substantial premium for Westfield. Westfield's share price shot up from AUD 8.70 to AUD 9.70 (currently AUD 9.35). The direct effect of Westfield's rise, and the knock-on impact on the sector more generally, means that the index is now showing a year-to-date 3.7% capital gain and a 7.3% total return.

Global listed property has delivered a year to date net return of 12.9% in U.S. dollar terms—a result that would have been a lot better but for the very small contribution from U.S. property shares and, to a lesser extent, a weak result from Japan. Excluding the slow U.S. market, developed-market property shares returned 17.5%. The main source of return was the eurozone, thanks to a combination of robust property market conditions and a strongly appreciating currency: Eurozone REITs returned 28.6% in U.S. dollars, led by a remarkable 42.1% rise in German property shares.

Australian & International Property — Outlook

Unsurprisingly, the Westfield takeover had a big impact on the sector. As APN Property Group commented, "REIT investors have had a tough time of it lately, what with Amazon's arrival, slow wages growth and a number of retail chain collapses. This has created a sense of malaise in the sector, depressing AREIT share prices. This deal offers a fillip to the negative sentiment, an example of a global property giant not only seeing beyond it but using it as an opportunity to create value. As the implications of the deal sink in we'd expect to see the oversold retail sector rebound. This could be the change in sentiment property trust investors have been waiting for."

While investor sentiment may well be more positive to the sector, the post-Westfield warm glow will face some headwinds. Slower-than-usual economic growth is still holding back operational performance, and the Westfield transaction does not mean the end of the sector's e-commerce issues. As consulting group BDO said in its latest annual review of the A-REIT sector, the top end of the retail sector may cope: "Large, premium grade properties, with low vacancies and differentiated offerings to the online market may find themselves well insulated against the Amazon threat." But smaller malls and other outlets unable to transform into "destinations" will face tougher times.

There is also the cyclical issue of rising bond yields, or as BDO put it, "The challenge for A-REITs will be to maintain their share price and total return if [yields on] global low risk investments such as long-term bonds continue to increase." While it would be helpful if the sector continued to benefit from post-Westfield sentiment, a more likely outcome is ongoing underperformance relative to the wider equity market.

Globally, the detailed sectoral breakdown of U.S. REIT performance gives a clear insight into the main trends affecting the outlook. For the year to date, the big winners have been the beneficiaries of e-commerce and IT generally: There have been very sizable gains from REITs involved in infrastructure (34.9% total return), data centres, (29.6%) and the industrial warehouse and logistics space (23.2%). At the other end the big loser has been the retail sector (-5.7%), with the smaller-end shopping malls doing much worse (-11.7%) than the bigger "regional" malls (-4.4%). Free-standing retail property has been relatively unscathed (up 3.0%).

At a sectoral level, these trends will continue next year. As Colliers International put it in their recent report on the outlook for the U.S. market in 2018, "The industrial sector will continue its star turn as the best-performing property type, and the sector most desired by investors. Much of its success is at the expense of the beleaguered retail sector, where the shakeout will renew in force after the holiday season."

Beyond the sectoral issues, there are three broad factors likely to influence next year's outcomes. The first is clearly positive: The global economy is strengthening pretty much

everywhere. But the others are more troublesome. One is that property prices are generally now very expensive: The pretax yield on the Global Index is only 3.72%. The other is that bond yields are likely to rise, which adversely affects the "cap" rates used to value properties.

It may be, as industry group NAREIT recently argued, that bond yields have been unusually low, and the gap between cap rates has consequently been unusually large: "At more than 300 bps, cap rate spreads are still wide and provide a cushion for commercial real estate prices against possible future increases in interest rates." Even so, we are past the period of low interest rates, and one of the bigger props supporting the sector is being gradually withdrawn. Returns are likely to be lower in the new environment.

Australian Equities — Review

Australian shares had stagnated for most of the year—at the end of September prices were still close to where they had started the year—but the past few months have seen a distinct improvement. Much of the gains occurred in one large move in October, but there have also been further smaller increases more recently, and year to date the S&P/ASX200 Index is now up by 5.8% in capital value and by 10.3% in total return including the pretax value of dividends. In terms of capital gain, the tech stocks in the IT index have done very well (21.7%) in line with strong global investor tech demand, and the industrials (15.9%), consumer staples (15.1%), and miners (14.1%) have also booked large gains. The more modest overall result, however, reflects the ongoing drag of the large financials sector, which is showing a small year-to-date capital loss (-1.0%).

Australian Equities — Outlook

The latest official gross domestic product data, for the September quarter, showed that the economy grew by 0.6% in the quarter and by 2.8% year on year. Both measures were a little lower than forecasters had expected, and remained shy of the rates north of 3.0% that would signal that the economy was fully recovered from its post-mining-boom slowdown. There were pluses in the data, notably strength in various categories of public and private investment, but the overall outcome was held back by a still-cautious household sector: Consumer spending barely grew (0.1% in the quarter).

Official data, however, are necessarily behind the play. More recent survey data, while reasonably good, still do not settle the question of whether the economy has lifted a gear from the sub-3% growth of recent years.

The National Australia Bank Monthly Business Survey has been erratic in the past few months (big jump in October, reversed in November), but is showing some business strength: "Despite the drop, business conditions remained at a reasonably solid +12 index points (down 9), which is still well above the long-run average for the series." Although the overall picture looks solid, there continue to be strong differences between sectors, with construction very strong (boosted by both housebuilding and infrastructure construction) but the retail trade lagging everything else.

Other surveys are also reasonably upbeat: The Commonwealth Bank's overall purchasing managers' index picked up in November "to signal a quickened pace of private sector activity expansion. The upturn was broad-based, with both the manufacturing and service sectors posting accelerated rates of growth." The similar indexes produced by the Australian Industry Group also showed that manufacturing, services, and construction all grew faster in November.

The Westpac Melbourne Institute Index of Consumer Sentiment has also strengthened. In December all of the components of the index improved, with Westpac saying that reduced fears of interest-rate rises, possible tax cuts, a clearly more upbeat view of the labour market and job security, and an easing of geopolitical tensions around North Korea all likely played some part in the overall higher optimism. Households' perceptions of a stronger labour market appear to be accurate. The latest (November) jobs numbers were very strong (61,600 new jobs) and while one

month's numbers may overstate the situation, it is clear that more people are being enticed into the firming labour market.

Overall, there is some evidence of the current business cycle becoming a bit stronger, and on the latest consensus forecasts compiled by the *Economist* magazine in London, GDP growth will pick up from 2.4% this year to 2.9% in 2018. But that does not look like the degree of acceleration that would make a meaningful improvement to the outlook for corporate profits. Just before publication of this update, the government's Mid-Year Economic and Fiscal Outlook came to the same conclusion: Company profits, on Treasury's estimates, will grow by 5.5% in the year to June 2018, slightly slower than thought at the time of the 2017 budget back in May, and will grow by only 3.75% in the year to March 2019.

The recent lift in share prices could reflect investors beginning to believe that, finally, clearly faster domestic growth is imminent. Alternatively, it may be that Australian shares have merely got swept up in the globally friendly environment for equities. Investors still need some clearer signal of a pickup in domestic business momentum.

International Fixed Interest — Review

The main event in the international fixed-interest space has been the Fed's decision to raise interest rates: As widely expected, on December 13 it raised its target range for the fed funds rate by 0.25%, to a range of 1.25% to 1.5%. Financial markets had been well primed to expect the decision, and there was little reaction on the day. If anything, the latest inflation data, also released on December 13, and which showed inflation a tad lower than expected, had more of an influence, with U.S. bond yields dropping slightly. Overall, however, there has been little net movement in the benchmark 10-year Treasury yield, which at 2.36% is very close to where it was a month ago.

There have also been minimal moves in other major bond markets over the past month. The 10-year benchmark bond yields in Germany (0.32%), Japan (0.05%), and the U.K. (1.22%) are all close to where they started.

Year-to-date, the Bloomberg Barclays Global Aggregate Index in unhedged U.S. dollar terms has returned 7.0%. The outcome mainly reflects U.S. bond yields being lower than where they started the year (they had risen in late 2016 and early 2017 on the back of the "Trump trade", only to drop back later), creating modest capital gains, and has also benefited from lower corporate credit spreads, which have also generated capital gains. Two of the main strategies for investors unable to find acceptable yield in the major mainstream markets have continued to pay off: global "high yield" (lower credit-quality) bonds have returned 9.9%, while emerging-markets debt has returned 8.1%.

International Fixed Interest — Outlook

The process of normalisation of interest rates in the major developed economies is, very slowly and gradually, getting under way, and interest rates look likely to rise in 2018, creating issues for bond investors.

At the Fed's latest meeting, the policy participants made forecasts (the "dot plot") of where they think the fed fund rates will go over the next few years. This time round, the forecasts were, on average, for three further 0.25% increases by the Fed in 2018. That's rather more than financial markets currently think will actually happen. Futures prices, as recast in the CME Group's "FedWatch" tool, say there is only a 7% chance of all three increases, with only one looking rather more likely. But either way the Fed is clearly moving away from its previous very stimulative stance, via both higher short-term rates and a wind-down of its bond-buying, which had been keeping bond yields low.

Some other major central banks have also moved away from their previously ultra-easy policy, notably the Bank of Canada and the Bank of England. However, the European Central Bank thus far has only reached the point of buying fewer bonds each month than previously: It is still adding

to its stock, whereas the Fed has progressed to running down its stockpile. At its latest policy meeting on December 14 the ECB made it clear any outright retreat from its current stimulus is still a long way away. And the Bank of Japan will be keeping to its current very low interest-rate policy for the indefinite future.

Overall, however, the outlook is that the regime of ultralow interest rates is gradually likely to be chipped away, which is to be expected when all the evidence suggests that the global economy is strengthening and less in need of such unusual levels of monetary policy support. Even in Europe, the recent strength of the eurozone economy suggests that we may see the ECB moving a bit faster to normalise policy than it currently expects. The upshot is that bond yields—more in the U.S. than elsewhere—are likely to rise. The latest *Wall Street Journal* poll of U.S. economic forecasters expects a 2.9% U.S. 10-year yield by the end of 2018, and 3.25% by the end of 2019. The expected rises are not dramatic, but they are likely to be a consistent headwind for fixed-asset performance.

There are alternative scenarios. One is the major puzzle, which economists and policy makers have not cracked, of inflation staying very low even when economies like the U.S. are in strong shape (the latest U.S. unemployment rate is only 4.1%). If inflation continues to surprise on the downside, upwards pressures on bond yields could be less. Another potential positive is the value of bonds as insurance against any unexpected setback to the U.S. or global economies. While that does not look likely at the moment, the current U.S. expansion is already quite mature: The American economy came out of the global financial crisis recession in late 2009, so the current expansion is eight years old, quite lengthy by historical standards. Late in economic cycles, accidents can happen, and might reignite demand for safe-haven government bonds.

On the other hand, an unexpected economic setback would be very unwelcome news for the parts of the bond market that have lately been most in favour—the junkier end, and the emerging markets. There have been some genuine reasons for these sub-classes doing well—turnarounds like Ireland and Portugal, and a largely synchronised global cycle that has lifted many emerging economies with it—but any unexpected slowdown would be likely to see a rapid re-evaluation of what investors need as compensation for the true risks involved.

International Equities — Review

In a year that started off coping with the major surprise of President Donald Trump's election, and that had to grapple with a serious geopolitical conflict (North Korea) as well as the dysfunction of American policymaking and the tortuous Brexit process, in hindsight global equities in 2017 performed remarkably consistently. Although intermittent squalls along the way seemed important at the time, looking back with hindsight at global equity indexes shows more or less steady progress throughout the year. Currently the MSCI World Index is up 16.0% (in terms of the overseas markets' own currencies) and up 19.1% in U.S. dollars (21.3%) including the taxed value of dividend income).

Most of the major markets have contributed: in local currency terms, the S&P 500 in the U.S. is up 19.5%, and the Nikkei in Japan up 18.0%. In Europe the apparent rise is smaller—a 7.0% rise in the FTSE Eurofirst300 Index—but that was on top of a strong rise in the euro against the U.S. dollar (it is up 11.7%). Even the U.K. has managed to claw back previous Brexit-related share and exchange-rate losses, with the FTSE100 Index up 4.9% and the pound up 8.3% against the U.S. dollar, as some progress has been made in its difficult exit negotiations.

There have been even stronger performances from the emerging markets, where the MSCI Emerging Markets Index is up by 24.6% in the emerging-markets' currencies and by 29.7% in U.S. dollar terms. By region, Asia was strongest (up 30.4%). By country, the heavy lifting has been done by Brazilian and Indian shares, with a smaller contribution from China, but little change in Russia.

International Equities — Outlook

The strength of world equities has some solid backing from the economic fundamentals. In the U.S. the economy continues to do well, the much-awaited tax cuts finally look likely to kick in, and the global economy has been strengthening.

In the U.S., the key indicator of progress is the monthly jobs numbers, and they continue to meet or exceed expectations: There were 228,000 extra jobs in November (more than the 190,000 expected), and the unemployment rate stayed at a low 4.1%. And, after a very rough passage through Congress, the Republicans' tax cut package was (at time of writing) very close to being voted through. It has been helpful that the latest Fed increase in interest rates and its prospective schedule of further rises have been and gone without upsetting investor sentiment. A "policy mistake" by one of the big central banks has been one of the key risks fund managers have talked about as a potential disruptor of strong equity markets.

Good economic conditions have translated into good profit outcomes: According to U.S. data company FactSet, corporate profits for the S&P 500 companies will have risen by 9.5% this year. While the number is exaggerated by a huge turnaround in U.S. energy companies' profits, and some sectors (notably those closest to consumer spending) missed out, there were large increases in some sectors (materials, information technology). FactSet, which collects brokers' forecasts, finds that 2018 is expected to be clearly better again, with a further 11.1% gain in S&P 500 profits, and that performance will be more widely spread. Materials and IT are still expected to do especially well, but so are the financials, and consumer-linked sectors also are likely to see significantly better outcomes.

World equity markets have not been flying on the one wing, however. Outside the U.S., the world economy also remains in good shape. The J.P. Morgan Global Manufacturing and Services Index, which aggregates a wide range of national indexes (including the Commonwealth Bank PMI for Australia) found that "November saw the rate of expansion in global economic output remain at its joint-highest over the past two-and-a-half years. The outlook also remained positive, with new business intakes rising at the strongest pace since September 2014 and backlogs of work increasing to the greatest extent in four years." The same information sliced by sector (in the IHS Markit Global Sector PMI) showed that all eight high-level sectors were growing in November, led by technology, and, remarkably, all 23 more detailed sub-sectors were also growing. There is clearly a broadly based momentum to the current world economy.

The outlook also looks upbeat. The *Economist's* collation of forecasts for virtually every country of any importance continues to show ongoing growth next year, with remarkably strong GDP growth expected for the two emerging-markets powerhouses, India (7.4%) and China (6.5%). Only one country (Venezuela) looks to be missing out on the benefits of widespread global growth.

To date, warnings about very expensive valuations and investor complacency about risk have made no difference to the outcome. Investors who backed the current synchronised global business cycle have been richly rewarded, and the current outlook suggests the cycle has further to run.

Even so, the warnings are still worth repeating. The recent monthly surveys of fund managers run by Bank of America Merrill Lynch, for example, have revealed that the big fund managers—while on board with the view that the global economy is likely to keep on doing well—are also convinced that equities, especially in the U.S., are expensive, even allowing for the good outlook. And the latest annual survey of equity managers run by Boston Consulting Group found that "Nearly half of the survey respondents (46%) are pessimistic about equity markets for the next year, a substantial jump from 32% in 2016 and 19% in 2015 ... Overall, 68% of respondents think the market is overvalued—by an average of 15 percentage points. This is more than twice the 29% of investors in last

year's survey who thought the market was overvalued. Among self-described bears in the 2017 survey, 79% cited market overvaluation as the reason for their pessimism."

Risk is also being underestimated. Investors in U.S. shares, for example, were alarmed earlier in the year by the North Korean atomic weapons scare, as they should have been. But going by the VIX measure of expected volatility in S&P 500 share prices, they did not get very worried by comparison with previous unsettling episodes, and they did not stay alarmed for long. The VIX is now back to all-time lows, as are similar measures (for example, expected volatility in bond prices, which is also exceptionally low). Investors no longer see much of a threat from Kim Jong-un, or indeed from anyone or anything else.

So far, the optimists have had the best of it, and investors will be hoping that 2018 will bring more of the same. It could well do, but investors should be aware that, in the U.S., they are buying into assets which are expensive this late in the current U.S. business cycle, that the tide of monetary policy liquidity that has supported equity prices everywhere is starting to go out, and that the true level of geopolitical and other risk is actually higher than is currently allowed for in asset valuations.

Performance periods unless otherwise stated generally refer to periods ended Dec. 15, 2017.

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