Economic Update

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Outlook for Investment Markets

World equity and bond markets fell in recent weeks, and although equities have recovered somewhat since, the episode is a reminder that expensive equity, bond, and bond-proxy prices are at risk from the end of ultra-low cash and bond yields. On a brighter note, the world economy has been strengthening and the improved cyclical outlook will assist growth-oriented assets. In Australia, the current business expansion looks to be picking up, but it remains to be seen whether the pickup will be strong enough to reverse the recent underperformance of local equities.

Australian Cash & Fixed Interest — Review

The Reserve Bank of Australia once again left monetary policy settings unchanged at its Feb. 6 policy meeting, with the cash rate kept at 1.5%. Short-term interest rates consequently are also unchanged, with the 90-day bank bill yield remaining close to 1.75%. Long-term bond yields followed overseas yields higher in January and February: The 10-year Commonwealth bond yield is now 2.9%, 0.3% up since the start of the year. The Australian dollar is a little lower (down 0.6%) in overall trade-weighted value for the year to date, as appreciation against the globally weak U.S. dollar was outweighed by weakness against other major currencies (particularly the Japanese yen).

Australian Cash & Fixed Interest — Outlook

While policy decisions have given very little away about future RBA intentions, the governor was more forthright in evidence to the House of Representatives economics committee on Feb. 16. He said that the bank's "central scenario for the Australian economy is for a further reduction in the unemployment rate and an increase in inflation towards the midpoint of the target range." and that "if this is how things play out, at some point it will be appropriate to have less monetary stimulus and for interest rates in Australia to move up … In other words, it is more likely that the next move in interest rates will be up, rather than down." He said the first change isn't imminent--"the Reserve Bank Board does not see a strong case for a near-term adjustment of monetary policy." Currently, the futures market believes the first 0.25% increase will be in September this year.

Bond yields are likely to keep following overseas yields upwards, as it now looks likely that the firming world economy, and strong economic conditions in the U.S. in particular, no longer require central banks to keep rates as low as they have been. The latest (February) semiannual Fairfax Media *Scope* survey of forecasters on average expected the 10-year yield to rise a little, from around 2.8% at the time of the survey to 2.9% by the end of this year. This forecast may have been left behind a bit by events, given further rises in overseas yields since then, and it would not be surprising if the local yield drifted a bit higher into the low 3% range by December.

The exchange-rate outlook remains complicated by the outlook for the U.S. dollar. A number of factors would suggest the USD should be stronger rather than weaker: higher short- and long-term interest rates and the prospect of further increases and a strong economy. In reality, however, it has been steadily weakening in overall value since early 2017 apart from a brief period after President Trump's election: It has dropped by 3.4% in overall value since the start of this year. Global wariness of the USD could result in further rises for the Australian dollar.

Currently, however, market expectations on balance are that the weak-USD influenced rise in the Australian dollar may have run its course. In the *Scope* survey, forecasters said they expected the AUD to drop to around USD 75 cents by the end of this year. A minority (four out of the 22 forecasters) thought that the global USD weakness is not over yet, however, and felt that the currency could appreciate towards USD 83-84 cents. (It was around 80 cents at the time of the survey.)

Australian & International Property — Review

Listed property has underperformed an equity market that was itself under selling pressure, so the year-to-date numbers are ugly, with the S&P / ASX200 A-REITs Index showing a capital loss of 8.6% and an overall loss including dividend income of 7.8%.

It was the same underperformance story overseas: For the year to date, the FTSE EPRA/NAREIT Global Index has registered a 3.9% loss in terms of net return in U.S. dollars, compared with the 1.9% gain for the MSCI World Index on the same basis. The outcome was largely due to the 8.5% loss from the North American market--unsurprisingly, given that interest rates have risen more in the U.S. than elsewhere.

Australian & International Property — Outlook

There are some pluses for the sector. Although there are still mixed views on the business outlook, on balance the economy looks to be showing signs of growing faster than in recent years, and some sectors--particularly prime offices in the central business districts of Sydney and Melbourne, and industrial/logistics space everywhere--are already experiencing strong operating conditions. There is also a firm level of underlying overseas investor demand for Australian property: As Colliers International noted in its outlook for 2018, "It can't be underestimated just how unique Australia's investment potential is when placed in a global context. Global property funds, as well as pension and sovereign wealth funds, have taken notice, and continue to allocate money to invest in Australian commercial property."

But the elephant in the room remains the prospect of rising bond yields. At current yields, the A-REITs are offering a slightly higher-than-usual yield pickup over Commonwealth bond yields and in theory could arguably withstand some further modest rise in bond yields. But as the recent market outcome suggests, investors are not currently impressed by the value on offer, and further rises in bond yields are likely to keep the REITs under pressure.

The same outlook applies to global listed property: The economic outlook is improving, but rising bond yields are again likely to be the more dominant influence. In the U.S., for example, the half-percentage-point rise in the 10-year Treasury yield has already had a strong impact, overwhelming any improvement in the operating outlook. Even sectors in strong demand, such as industrial sites servicing e-commerce and computer data centres, have lost ground (within the 8.5% loss for American property, industrial property was down 6.0% and data centres 9.2%).

The same process is likely to play out elsewhere as other central banks also remove ultra-easy monetary policy. As Cushman and Wakefield said in their February research report on the outlook for European property, "prime [property] yields will soften across Europe as the [monetary] policy environment changes and as base rates increase. This dampens our total return expectations in the later years of the forecast outlook, meaning that overall for the next 5 years we expect European all sector prime total returns to deliver less than 3% per annum." So far, the sell-off in global listed property has only gone a small way to improving property yields: The tax-paid yield on the FTSE EPRA/NAREIT Global Index is up from 2.9% at the start of the year to 3.1% now. There is likely to be further upward pressure (and price declines) while investors digest the prospect of rising bond yields.

Australian Equities — Review

The Australian share market missed out on the rise in global equity prices in January--it was essentially unchanged for the month--but unfortunately the same was not true on the downside, with local shares following global equities down in February. The S&P / ASX200 Index is down for the year to date by 2.7% in capital value and by 2.4% after including dividends. Apart from the mining sector (up 3.1% on ongoing evidence of faster global growth) and the globally in-demand IT sector (up 1.4%), it was minus signs all around for the rest of the market, with financials down 3.5% and industrials down 5.0%. Consumer-linked equities also sold off, with consumer staples down 2.5% and consumer discretionary down 5.1%.

Australian Equities — Outlook

Opinion is still split between those who see more of the subpar same for the Australian economy and those who detect an improvement in the pace of business activity.

At the cautious end of the spectrum, the Fairfax Media *Scope* survey of forecasters found, for example, that the panel expected gross domestic product growth of 2.7% this year, which would be only a small improvement on the likely 2.3% outcome in 2017 and would not be enough to make much of a difference to the current unemployment rate. Unsurprisingly, they had a correspondingly modest end-year target for the S&P / ASX 200 Index of 6,205, which was only a 2.3% advance on the 6,065 prevalent at the time of the survey.

More optimistically, the governor of the RBA said at his appearance in February before the parliamentary economics committee that, "Over this year and next we expect GDP growth to be a bit above 3%, which is faster than our current estimate of trend growth for the Australian economy," the last bit being econospeak for a growth rate fast enough to reduce the unemployment rate.

The latest business surveys have also generally supported the more optimistic view. The first monthly business opinion survey of the year from National Australia Bank was a good one, with NAB saying that "Strong trend business conditions provide further confirmation of robust business activity in Australia." The three surveys of manufacturing, services, and construction run by the Australian Industry Group showed the same picture, with the pace of expansion picking up in all three, although this was not confirmed by the very similar Commonwealth Bank surveys of manufacturing and services, which detected a modest slowdown.

The domestic macroeconomic fundamentals may be turning a bit more positive for equities, and there may be more upside for equities than the *Scope* panel envisaged. The firming global economy is also a plus for the resources sector. But any bullishness needs to be tempered by the ongoing cautiousness of the Australian household, particularly in areas such as Sydney where house prices are at risk, and by the likely drag on overall performance from the bank shares, which remain overshadowed by the investigations of the banking royal commission.

International Fixed Interest — Review

The bond markets, particularly in the U.S., have played a key role in the recent global financial market volatility. In the U.S., the key benchmark--the yield on the 10-year U.S. Treasury bond--is now almost a full half a percent higher since the start of the year, having risen from 2.4% to just under 2.9% (currently 2.88%). Other than in Japan, where monetary policy remains set on highly supportive, bond yields elsewhere have also risen: The 10-year government-bond yield in Germany, for example, is up by a fourth of a percentage point to 0.7%, and in the U.K., the equivalent yield is up 0.4% to 1.6%. The Swiss 10-year yield, which last year was negative, has moved further into positive territory (now 0.16%).

Investors in fixed interest have consequently faced difficult conditions. The headline results in U.S. dollar terms for the Bloomberg Barclays global indexes do not quite capture the setback, as the outcome includes foreign exchange gains from holding non-USD bonds when the USD has been weak: The Global Aggregate, for example, is up 1.0% for the year to date in USD terms. But even in USD terms some of the Bloomberg Barclays indexes are now showing losses for the year (Global Corporate Bonds down 0.6%, the Emerging Markets Aggregate down 1.6%, long maturity U.S. Treasuries down 6.3%)). Many investors will be experiencing losses when hedged back into their domestic currencies.

International Fixed Interest — Outlook

The proximate cause of the U.S. bond market sell-off was evidence that wages and prices have started to pick up after a long period when they had both been surprisingly low given the strength of the U.S. economy. If there was one single catalyst for the bond market sell-off and the associated equity volatility in February, it was the news on Feb. 2 that average hourly earnings in the U.S. in January were running 2.9% higher than a year earlier, more than forecasters had been expecting.

The subsequent release on Feb. 14 of the January consumer price index cemented the idea that the period of very low wage and price growth was winding down. The headline annual inflation rate was 2.1%, and the more important "core" (ex food, ex energy) rate was 1.8%.

The latest data, in short, strongly suggested that the Fed had done enough to work inflation up to its target 2.0%, that monetary policy could be tightened from where it had previously needed to be, and that bond yields would need to rise to reflect the higher inflation rate. Forecasters, and the futures markets, are now firmly of the view that the Fed will raise short-term interest rates a number of times this year. The latest (February) *Wall Street Journal* poll of U.S. forecasters, for example, expects the Fed's target range for the fed-funds rate--currently a range of 1.25% to 1.5%--to be raised to a range of 2.0% to 2.25% by the end of this year, incorporating three 0.25% hikes.

Longer-term yields are also likely to rise further. *The Wall Street Journal* panel expects American inflation to be running at 2.2% to 2.3% a year over the next couple of years, which means that bond yields will need to be comfortably above current levels to offer a "real" (above inflation) return. The *WSJ* panel expects the U.S. 10-year Treasury yield to reach 3.1% by the end of this year and to rise a bit further to 3.5% by the end of 2019.

Inflationary pressures are a good deal less in the eurozone and Japan, and their central banks and bond markets are still a long way from needing to follow the U.S. lead. But with the global economy outside the U.S. also picking up steam, the need for ultra-low short- and long-term interest rates in the rest of the world is also becoming progressively less compelling. Absent geopolitical or other shocks that might resurrect "safe haven" buying, these are likely to be difficult market conditions for fixed interest. It is no surprise that in the latest (February) Bank of America Merrill Lynch survey of fund managers, a net 69% have underweightings to bonds, the largest proportion in the survey's 20-year history.

International Equities — Review

After a strong start to the year, global sharemarkets have been volatile in recent weeks, with the American market being the catalyst: It was especially weak in early February, when the S&P500 dropped by 8.5% between Feb. 1 and Feb. 8. Most other developed markets followed it down over the period. Ironically, the cause of the sell-off has recovered in recent days, with the S&P 500 now up 2.2% for the year to date, but several of its collateral casualties elsewhere are still in the red for the year (Germany's DAX down 3.6%, Japan's Nikkei down 4.6%, and the U.K.'s FTSE100 down 5.1%). For the year to date, the developed markets in the MSCI World Index are marginally up (0.15%) measured in their own currencies, and up 1.6% in U.S. dollar terms because of the weakness of the USD.

Emerging markets encountered even more-severe turbulence, with the MSCI Emerging Markets in USD terms dropping by 10.2% between Jan. 26 and Feb. 9. Since then, however, prices have shown considerable resilience, and the emerging markets index in USD is now up 3.6% for the year to date. Brazil and Russia have accounted for the bulk of the gain, with prices little changed in India and weaker in China.

International Equities — Outlook

The recent global sell-off in equities reflected a range of factors--some one-offs, some ongoing.

Among the one-offs, the pace of equity price rises in January had simply been unsustainably fast: As just one example, the MSCI Emerging Markets Index in USD had risen by very nearly 10% between the start of the year and Jan. 26. Ten percent growth per month if maintained would have trebled prices in a year. Greater realism was always going to interject.

Other factors, however, are likely to remain ongoing themes for 2018. A key one (as documented in the "International fixed interest" section) has been the start of the end of ultra-low interest rates and ultra-easy liquidity. Many asset classes, and particularly equities in the U.S., had been boosted to unusually expensive valuations because their income streams were valued much more highly when interest rates were so low. There will be ongoing reassessment throughout the year of the absolute and relative valuations of equities as bond yields rise further.

Valuations got a boost from low interest rates but also contained some element of excessive risk-taking and herd behaviour. Several surveys of fund managers, for example, had shown that they regarded equities as overvalued, but nonetheless had substantial overweightings to shares as they appeared to be the "only game in town."

Investors had also been notably complacent about potential setbacks. One of the best-known measures of investor volatility expectations--the VIX indicator of expected volatility for the S&P 500, often used as a "fear gauge"--had been trading at close to all-time low levels in late 2017 and early 2018. The VIX tends to range from around 10 (extreme comfort with the outlook) to upwards of 70 on particularly fraught occasions (at the height of the global financial crisis, for example): It had been trading just above 10 in early January. Currently, it is trading around the 20 mark, indicating that investors, at least temporarily, are taking a more prudent view of the potential for left-field surprises.

Shaking out some of the risk and valuation excesses from global equity markets is no bad thing: Investors are getting modestly better value than previously. It has also helped that the world economy is strengthening. The JP Morgan Global Manufacturing and Services PMI, or purchasing managers index, which aggregates national business PMI surveys into a global total, has started the year very strongly: "The start of 2018 saw a further solid and broad-based expansion of global economic activity, with growth rising to a 40-month high. Output increased across the six categories of manufacturing and service sector activity tracked and in almost all the national PMI surveys available at the time of publication … Forward-looking indicators such as new orders, backlogs of work and business confidence also suggest that this solid phase of expansion will be maintained in coming months."

The central scenario is that the strength of the world economy will deliver the sort of profit growth implicit in still quite high P/E ratios: the MSCI World Index, for example, is trading on a forward-looking P/E ratio of 15.3 times expected earnings. Emerging markets are cheapest (12.2 times); the eurozone, Japan, and the U.K. are on similar ratings (13.4 times to 13.8 times); but the U.S. remains relatively expensive at 17.3 times expected profits. Equities remain vulnerable, however, to further reality checks if profits disappoint or if investors revert to their previous underestimation of potential adverse surprises.

Performance periods unless otherwise stated generally refer to periods ended Feb. 16, 2018.

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