Economic Update

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Outlook for Investment Markets

The world economic outlook has continued to brighten, but the consequent strong rises in equity prices look unsustainably rapid, particularly for emerging-markets shares, and some correction is likely during the coming year. Investors remain underappreciative of true levels of risk. Global interest rates have started to rise, especially in the United States, and both fixed-interest and bond-proxy assets like property and infrastructure have been struggling. In Australia, the economic outlook also looks to be turning for the better, but it is not yet clear whether the improvement will be enough to make a big difference to the performance of local asset classes.

Australian Cash & Fixed Interest — Review

Short-term interest rates are once again unchanged in line with the unchanged monetary policy setting of the Reserve Bank of Australia: 90-day bank bill yields remain close to 1.8%. Long-term bond yields have followed overseas yields higher, and year to date the 10-year Commonwealth bond yield is now 0.2% higher at 2.83%. The Australian dollar has gained 1.2% in overall trade-weighted value, almost completely due to a rise against the U.S. dollar, with the headline U.S. dollar rate rising from USD 78 cents to USD 80.9 cents.

Australian Cash & Fixed Interest — Outlook

Forecasters continue to have mixed views on the outlook for short-term interest rates. Westpac, for example, believes that there will be only a very modest pickup in economic growth this year (it expects 2.5% compared with last year's 2.3%), so it expects the RBA will have to remain supportive of the economy. Westpac thinks the current cash rate (1.5%) will still be 1.5% at the end of 2019. But others lean more to the idea that recent good economic news (as discussed in the Australian Equities section below) will reduce the need for such an extended period of monetary policy support. The ANZ Bank, for example, thinks there could be a 0.25% increase as early as the June quarter, and another 0.25% increase by September. The futures market also expects at least one, and perhaps two, 0.25% increases by the end of the year. Investors may see some small improvement on returns from the likes of bank deposits this year, but we are still at the very early stages of a return to what depositors used to be able to earn.

The outlook for bonds mainly depends on two factors: local inflation, and developments in overseas bond markets, particularly the U.S. On inflation, the December quarter Consumer Price Index will be released on Jan. 31, and forecasters expect that core inflation for the quarter will have been 0.4%-0.5%. If so, inflation will remain on track to be heading into the RBA's target 2% to 3% band, and bond yields are also likely to have to track upwards to compensate investors. There is a risk, however, that inflation could be a bit less than expected (as happened with the December CPI figure in New Zealand), which would moderate any rise in bond yields.

The other influence looks more straightforward: U.S. bond yields have been rising, and look likely to rise more, and there is likely to be a further knock-on effect on local yields.

The exchange-rate outlook has been complicated by conflicting policy statements from senior U.S. officials about policy towards the U.S. dollar. Initial statements favouring a weaker greenback were responsible for the large jump by the Australian dollar (and other currencies) against the U.S. dollar, which was only partially unwound when President Donald Trump later talked about a desire to see a strong American currency.

Before the latest U.S. policy confusion, most forecasters had been leaning towards some modest depreciation of the Australian dollar over the course of this year. That is probably still the most likely outcome, especially if the Fed and the RBA continue on their likely policy paths, which would result in U.S. interest rates becoming progressively more attractive than local ones. If U.S. officials continue to talk the U.S. dollar down, however, it is possible that the Australian dollar could appreciate enough against the U.S. dollar to maintain its overall trade-weighted value. If so, hat-tip to the minority view of the Commonwealth Bank forecasters, who for some time have been picking an appreciation of the Australian dollar (to USD 83 cents by the end of this year, on their latest view).

Australian & International Property — Review

The S&P/ASX200 A-REITs Index has started the year poorly, with a capital loss of 3.3% and a total loss including dividends of 3.2%. As the latest performance figures show, the rise in A-REITs prices after the surprise overseas bid for Westfield last month was all too brief, and year to date the A-REITs sector has underperformed the wider equity market.

Global listed property has fared somewhat better, with the FTSE EPRA/NAREIT Global Index up 1.9% in net return in U.S. dollar terms, though the recent pronounced weakness of the U.S. dollar means that many investors in global property will be looking at losses in their home currencies. The result reflected strength in Asian markets (up 5.9%) and particularly Japan (up 11.0% on a combination of higher local share prices and a currency gain for the yen). The key North American markets, however, did badly, with a loss of 2.6%.

Australian & International Property — Outlook

As with global listed property, the outlook will be the net result of two conflicting forces: the improved operational performance (lower vacancies, higher rents) from some modest improvement in the domestic economy, versus the various adverse impacts of higher bond yields (higher debt costs for the REITs, improved attractiveness of fixed interest as an alternative investment option, and higher 'cap' rates which lead to lower property valuations).

Year to date, investors have evidently been focussed more on the potential downside from higher bond yields, and they may well have come to the right conclusion about how the rest of the year will play out.

Some property sectors are in strong shape: Industrial property, in particular, has benefited from the logistical demands of e-commerce. As Savills said in a recent report on the Sydney industrial sector, "The rise of online retailing continues to underpin demand for warehousing, transport and logistics facilities across Metropolitan Sydney...The overall prime net face rent has risen by 5.9% year on year to $142/m^2 as at October 2017. This is the highest level of rental growth since Knight Frank began to track the series in January 2007."

But the other side of that coin is the downbeat outlook for the retail sector: The March quarter ANZ Bank/Property Council of Australia survey of commercial property, for example, showed deteriorating confidence in the sector. Overall, there does not appear to be a strong enough pickup in the local economic cycle to fully offset the headwinds for the sector from rising bond yields.

The same dynamics are playing out overseas. On the plus side, the acceleration in global business activity is more pronounced than in Australia. As the latest (December) quarterly survey of global commercial property by the Royal Institution of Chartered Surveyors showed, "The Q4 2017 RICS Global Commercial Property Monitor suggests that sentiment remains generally upbeat across the majority of real estate markets covered by the survey. The positive mood music is also reflected in the forward looking indicators, most visibly in the readings for expectations twelve months out."

On the negative side, however, valuations are more exposed to bond yield rises. The pre-tax yield on the FTSE EPRA/NAREIT Global Index is 3.77%, well below Australasian equivalents, and a U.S. 10-year bond yield already close to 2.7%, and likely to rise further, looks likely to put real pressure on global property valuations. The RICS survey also found that there were valuation concerns in a number of markets: Large majorities of industry participants in the key eurozone economies Switzerland, Hong Kong, and Japan rated their local markets as 'expensive', with very few takers for 'cheap'. Further underperformance looks likely until better value is on offer.

Australian Equities — Review

The Australian market is off to a slow start for the year, with the S&P/ASX200 Index slightly down so far: The index is 0.25% lower in terms of both capital value and total return. With only a limited year-to-date trading history the sectoral returns are not especially meaningful, but for the record the resources sector has fared best (up 3.2%) on the back of stronger world commodity prices—year to date the Bloomberg Commodity Index in U.S. dollars is up 3.4%. Excluding the A-REITs, discussed in their own section) the industrials have fared worst (down 1.6%) with the stronger Australian dollar the likely catalyst.

Australian Equities — Outlook

The latest economic news has generally been for the better. In particular, 2017 ended with a very strong rise in jobs. Employment had already risen very strongly in November (by 63,600 on the latest figures) and forecasters had been expecting something of a hiring lull in December, and were picking a more modest 15,000 net new jobs for the month. In the event, there was a further substantial 34,700-person rise in people employed. As the Commonwealth Bank of Australia economists said, "The final employment report of 2017 completed a phenomenal calendar year of monthly labour force releases...Over 2017 the ABS {Australian Bureau of Statistics] reports that employment rose by a staggering 403k...These are very strong numbers which over 2017 have significantly bettered consensus and RBA expectations."

Other indicators have also been improving. The latest (January) Westpac/Melbourne Institute survey of consumer confidence showed households in a more upbeat frame of mind: Westpac said that "While the mood is 'cautiously optimistic' rather than buoyant, this is the best monthly index read since late 2013 and the most positive start to a calendar year since 2010."

From the same stable, the Westpac/Melbourne Institute leading indicator has also been signalling better times ahead. The December reading was, according to Westpac, "a very strong above trend reading and, following the solid results in October and November, points to solid above trend growth in the early part of 2018." Economic forecasters are in general agreement that 2018 looks likely to be a better year for economic growth than the 2.3% likely to have been recorded last year (official data are not yet to hand).

But as Westpac also mentioned, "there are still key negatives around housing, household incomes and the consumer which are likely to challenge the sustainability of any upswing in 2018." The prospect of falling house prices in Sydney, in particular, is likely to remain a significant brake on consumers' feelings of financial wellbeing and on their propensity to spend in the shops. The end result is that cautious consumers will limit the scale of the pickup in economic growth: The latest consensus forecasts point to gross domestic product growth of around 2.8% this year.

The modest improvement in the local economic outlook is a plus for the market, as is the pickup in global economic activity (and especially helpful for the resources sector). But the cautious consumer sector, and the ongoing drag of the bank shares, which have a heavy weight in the benchmark indexes, and which are subject to royal commission scrutiny, mean that Australia shares may repeat 2017's pattern of gains that fall short of those in overseas sharemarkets.

International Fixed Interest — Review

Global interest rates have risen since the start of the year. In the U.S., the key 10-year Treasury yield has risen from 2.4% to 2.66%, and there have also been modest increases in other major markets, with the equivalent German yield up from 0.43% to 0.63% and the U.K.'s up from 1.19% to 1.45%. The only exception has been the ongoing low level of bond yields in Japan, where the 10-year government bond yield is only marginally higher (0.08% compared with 0.05% at the start of the year).

In one of the more significant indicators of how the global yield tide has turned, one of the talismans of the era of ultra-easy monetary policy—the negative 10 year Swiss government bond yield—has returned to positive territory. The yield first turned negative in the middle of 2015 and got as low as negative 0.6% in the middle of 2016. As recently as the middle of last December it was still around negative 0.15%. But this month it has finally turned positive, and is now 0.07%.

The outcome is that investors have suffered small losses for the year to date. Going by the Bloomberg Barclays Aggregate indexes, the U.S. market has returned negative 0.74%, the eurozone negative 0.19%, the U.K. negative 1.4%, and Japan negative 0.2% (all in their local currencies).

International Fixed Interest — Outlook

No matter where you look—the Fed's own projections, financial futures pricing, forecasters' predictions—the answer comes out the same: There is a strong consensus that U.S. monetary policy will be progressively tightened over the course of this year. The current view is that there will be three 0.25% increases in short-term interest rates by the end of the year, which would take the Fed's target range for the fed funds rate up to 2.0%-2.25%.

Higher short-term rates are likely to lead to higher yields on shorter-maturity U.S. Treasury bonds: At time of writing the two-year yield had just crossed 2.0% for the first time since late 2008. And the same forces that are leading the Fed to take monetary policy, slowly, back to more normal levels—inflation rising closer to where the Fed would like to see it, a strong U.S. economy—are also likely to lead to progressive rises in longer-term interest rates.

In the eurozone, for the time being the European Central Bank is sticking to its current policy (short-term interest rates around zero, a monthly bond-buying programme of EUR 30 billion a month up to the end of September): It confirmed current settings at its latest policy meeting on Jan. 25. But as the bank's latest (March quarter) survey of European professional forecasters showed, expectations for headline inflation, core inflation, and economic growth in the eurozone are all being revised upwards. While the euro's recent rise against the U.S. dollar is a complication—it lowers eurozone inflation and makes the ECB's 2% target harder to reach—the likelihood is that the ECB will also start to sidle up to some modest withdrawal of current monetary policy ease by the end of this year.

Even in Japan, which is likely to be the last bastion of ultra-easy monetary policy, there are the first tentative signs of a rethink. The governor of the Bank of Japan was quoted, at the current World Economic Forum meeting in Davos, as saying that Japan is finally close to getting inflation back up to 2.0%. This may be premature—consensus forecasts see inflation this year more like 1.0%—but it is indicative of the change in the wind.

Expectations of higher inflation have disappointed before now, and there are also likely to be episodes where outbreaks of equity market volatility during the year lead to renewed safe-haven buying of bonds. That said, the wider global economic fundamentals are likely to pose an ongoing challenge to the asset class.

International Equities — Review

Global sharemarkets have had a buoyant start to the year, with the MSCI World Index of developed economy sharemarkets up by 5.4% in the currencies of its component markets and by 6.9% in U.S. dollar terms due to the global weakness of the U.S. dollar. Most of the media attention has been focussed on the U.S. market, where the Dow and the S&P 500 have recorded a series of new records, but the gains have been widespread, with most other developed markets also contributing.

There have been even stronger outcomes in the developing world, where the MSCI Emerging Markets Index is up 8.1% in the emerging markets' currencies and by 9.9% in U.S. dollars. The key BRIC (Brazil, Russia, India, China) markets have all chipped in, with an extraordinary 13.1% year-to-date surge for the group in U.S. dollar terms.

International Equities — Outlook

The immediate cyclical outlook for the global economy continues to strengthen. Earlier in January the World Bank had said (in its latest *Global Economic Prospects* update) that 2017 had proved better than forecasters had originally expected, and also upgraded its forecasts for 2018. More recently the International Monetary Fund came to a very similar conclusion in the latest quarterly update to its *Global Economic Outlook*.

It too found 2017 to have turned out better than anticipated: "Global growth for 2017 is now estimated at 3.7 percent, 0.1 percentage point higher than projected in the fall [i.e. at the time of the last quarterly forecasts in the northern hemisphere autumn]. Upside growth surprises were particularly pronounced in Europe and Asia but broad based, with outturns for both the advanced and the emerging market and developing economy groups exceeding the fall forecasts." It also upgraded the outlook for this year and next: "The stronger momentum experienced in 2017 is expected to carry into 2018 and 2019, with global growth revised up to 3.9 percent for both years (0.2 percentage points higher relative to the fall forecasts)".

Faster global growth for longer has been very welcome news for the equity markets: As the IMF put it, "Equity prices in advanced economies continued to rally, buoyed by generally favourable sentiment regarding earnings prospects, expectations of a very gradual normalization path for monetary policy in a weak inflation environment, and low expected volatility in underlying fundamentals. Emerging market equity indices have risen further since August, lifted by the improved near-term outlook for commodity exporters."

The latest (January) Bank of America Merrill Lynch poll of global fund managers has shown the impact of this stronger world business outlook on asset allocation. More of them now expect the global equity bull market to continue into 2019, whereas in previous surveys they were more inclined to expect a peak somewhere in 2018. Fund managers are now holding a bit less cash; they are heavily overweight to equities and underweight to bonds; and given the pickup in global business activity they have shifted to preferring cyclical stocks (such as tech and industrial shares) over defensive stocks (such as telecoms and utilities). Regionally they have strong preferences for the eurozone (where the positive growth surprise has been largest), Japan, and emerging markets, and against the U.S. (presumably on valuation grounds) and, especially, against the U.K., where the consequences of Brexit apparently continue to weigh heavily on fund managers' minds.

While this might seem to add up to plain-sailing ahead for the equity markets, both the big international institutions like the World Bank and the IMF, and the surveyed fund managers, pointed to risks. For the fund managers the most worrisome risk was potentially higher inflation, and the likely higher bond yields that would ensue as a result. This would upset the relative valuations of equities and bonds. Their second-most-cited risk was in the same general area of higher interest rates—a monetary policy mistake by either the Fed in the U.S. or the ECB in the eurozone, which has the potential either to disrupt the current cyclical upswing or, again, to upset the easy financial conditions which have helped support equity valuations.

For the IMF, the near-term economic outlook seems robust enough to ride out any immediate issues, but it too worried about longer-term risks. It also picked out higher interest rates as a key issue, and added the threats from "inward-looking policies" to world trade (such as renegotiation of the North American Free Trade Agreement and the U.K.'s post-Brexit arrangements) and from noneconomic factors. It pointed to geopolitical tensions (especially in East Asia and the Middle East) and political uncertainty (it mentioned Brazil, Colombia, Italy, and Mexico). Although the IMF did not say so explicitly, it is clear that investors are currently not factoring any unpleasant surprises into their investment planning. Measures of expected sharemarket volatility remain very low, and other measures of investor confidence (such as surveys of individual investors and of market newsletter authors) also show unusually high levels of bullishness.

While the world economic cycle supports an overall optimistic view, the risk is that investors are drifting into gung-ho mood, where prices do not reflect the true range of possible outcomes and where momentum and bandwagon effects may be carrying prices beyond sustainable levels. Self-evidently, gains cannot continue at recent rates. The *Wall Street Journal* noted (on Jan. 26) that the pace of the latest share price rises is historically unusual, with "the most records for the S&P 500 in a single month since June 1955." Others also worry about the current pace. The chief international strategist at BoAML commented on the release of the latest fund manager survey that "By the end of Q1, we expect peak positioning to combine with peak profits and policy to create a spike in volatility."

Performance periods unless otherwise stated generally refer to periods ended Jan. 26, 2018.

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