Economic Update

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Outlook for Investment Markets

Global financial markets have recovered from their June sell-off after the United Kingdom's Brexit vote. Bond yields, which had dropped to exceptionally low levels as safe-haven assets were snapped up post-Brexit, have picked up modestly, while equity prices have advanced both at home and overseas. Looking ahead, the world economy looks set to continue to grow, albeit at a slower than usual pace. This will provide some support for global equities, although there are a number of potential downside risks which could materialise. Bond yields are likely to remain "lower for longer", which will maintain demand for alternative sources of yield (notably property and infrastructure, and equities in higher yielding equity markets). In Australia, the business cycle may be picking up a bit, but possibly not enough to justify further substantial gains for shares and property, which are now on the expensive side of normal valuation yardsticks. The Reserve Bank looks set to cut interest rates a bit further.

Australian Cash & Fixed Interest — Review

Short-term interest rates are unchanged, with the 90-day bank bill yield continuing to trade at a little under 2%, reflecting the unchanged monetary policy stance of the Reserve Bank of Australia. Longer-term interest rates have mostly followed global trends, with the 10-year Commonwealth bond yield reaching a low point of 1.88% on July 6 and July 7. Since then, however, local yields have not moved higher in line with global bonds, with the yield still at 1.92%, probably reflecting an assessment of lower interest rates to come from the RBA. Year to date the S&P/ASX Bank Bills Index has returned a (pre-tax) 1.18%, the S&P/ASX Australian Government Bond index 6.16%, and the S&P/ASX Corporate Bond Index 4.21%. Until the last few days, the Australia dollar had benefited from post-Brexit vote uncertainty: At its recent peak on July 15 it traded at USD 0.763, and was 2.6% up in overall trade-weighted value on its opening-year level. More recently, the Australian dollar has sold off, possibly in anticipation of a monetary policy easing, and is now trading at USD 0.748.

Australian Cash & Fixed Interest — Outlook

The RBA gave little away about its monetary policy intentions on June 19, when it released the minutes of its latest July 5 policy meeting. The minutes said that the bank would wait to see what the next set of economic data brought along (the most important will be the inflation rate for the June quarter, which will be released on July 27), and would also want to see what the updated forecasts from bank staff looked like. It gave no indication which way it was likely to move next, or indeed if it was likely to move at all.

The big bank forecasters have consequently formed their own views, and while they differ, on balance they point to somewhat lower interest rates: Averaging them out, a 0.25% cut looks the most likely outcome. National Australia Bank thinks there will be no change to the current 1.75% cash rate, but both the ANZ Bank and Westpac think there will be one 0.25% cut to 1.5%, while the Commonwealth Bank thinks there will be two, to 1.25%. The financial futures market is also going for the middle-of-the-pack option: It expects the 90-day bank bill yield to be 1.75% by the end of this year, which again is consistent with a single 0.25% move by the RBA.

As has also been the case overseas, forecasters have been forced to lower their expectations in light of the global "lower for longer" environment about which Morningstar's Expert Panel meeting had commented on in July. Although yields (at home and overseas) are often at all-time lows, the reality appears to be that they will stay at these exceptionally low levels, and for longer than forecasters had originally anticipated. Last month's update noted that local forecasters had been winding down their expectations of a normalisation of bond yields, and the process is ongoing. Last month, the forecasters at the big banks were expecting the 10-year Commonwealth bond yield to rise to around the 2.75%

mark by this time next year: This month, they have cut back their forecasts to around 2.5%, and it would not be surprising to see lower forecasts again in coming months.

Morningstar's Expert Panel had expected some eventual depreciation of the Australian dollar, although the scale and timing was hard to call, given that it will remain dependent on the state of global investor confidence, which is difficult to predict. Other forecasters tend to share the view of an eventually lower Australian dollar, particularly as the RBA continues to say (in the latest minutes) that, "the lower exchange rate since 2013 had continued to assist the traded sector of the economy", and that, "an appreciating exchange rate could complicate the necessary economic adjustments" from the mining boom era. Three of the big banks currently have a similar view, and expect the Australian dollar to be around the USD 0.69 mark in a year's time, but the scenario that the Australian dollar will continue to attract investor support from countries with even lower interest rates cannot be discounted entirely. The Commonwealth Bank, for one, thinks the Australian dollar will stay around current levels over the coming year, and could even creep a bit higher (they think to USD 0.77) by the end of next year.

Australian & International Property — Review

Other than the mining stocks, which have been staging a recovery from previously depressed levels when commodity prices had plunged, the A-REITs have been far and away the strongest sector of the share market. The S&P/ASX 200 A-REIT Index has provided a year-to-date capital gain of 19.9%, and a total return including dividend income of 22.7%.

Global listed property has had a strong run, but as with world equities more generally, investors had to be invested in the subset of regions that have delivered the goods. The FTSE EPRA/NAREIT Global Index in U.S. dollars has delivered a year-to-date net return (including the taxed value of dividend income) of 11.5%, outperforming the 4% U.S. dollar return from the MSCI World Index. Measured on a common U.S. dollar basis, the key U.S. market did well (+14.6%), as did Asia (+13.2%) and select parts of the eurozone (notably Germany, +18.8%). Investors have also been taking a more optimistic view of emerging markets, and this was also true of emerging-market property (+21.0%). But there were also very sharp falls in some markets. Brexit was terrible news for U.K. property (-20.2%), and potential political and financial instability in Italy was highly damaging for Italian property shares (-13.6%).

Australian & International Property — Outlook

The outlook for the operating performance of property remains the same as before. Overall, the economy's subpar growth is translating into reasonable rather than strong property returns, with marked regional and sectoral differences. As JLL recently said, there is a huge difference in office vacancy rates, ranging from 7.1% in the strong Sydney market through to 24.7% in the dismal Perth market.

The latest research on the office markets by Savills has found the same patterns. In Sydney, rentals for Grade A CBD space are up 15% year over year, reflecting "an increased level of tenant demand, falling vacancy rates and low levels of net supply". In Perth, however, rents are falling, given that Savills found that there are 179 full floors of prime office space currently vacant.

The latest (September quarter) ANZ/Property Council of Australia survey of property markets showed that property professionals are only marginally positive about the economic outlook, and that industry confidence levels have fallen (though, as the Property Council mentioned, the fall may have been temporary, and partly related to the drawn-out election campaign). There are some strong areas—there are high expectations of capital growth in the retirement village and hotel sectors, for example—but very modest expectations in others, especially housing (particularly in Western Australia).

Combine average operating conditions with rather expensive valuations—the A-REITs are priced well above normal valuation metrics on almost all measures—and at first glance the outlook for the sector looks unpromising. However, the one measure that is not signalling expensiveness is the one that currently matters most: The A-REITs are still offering their usual yield differential to bond yields. While this is only possible because bond yields have themselves fallen to all-time lows, the differential is what has been driving strong overseas investor buying interest. The sector is likely to remain attractive while bond yields remain unusually low.

The same issues are in play with global listed property. The global economic business cycle is, at best, in modest shape, and again with strongly contrasting regional and sectoral patterns.

The pick of the developed markets is the U.S., where as recent commentary by NAREIT, the U.S. industry body, recently said, "Many economic indicators have shown improvement in recent months...In the office, retail and industrial sectors, vacancy rates have fallen 50 bps or so over the past four quarters to pre-crisis levels...at current trends these markets are set to continue to firm throughout this year and next. This will likely cause further declines in vacancy rates, supporting rent growth and property valuations". Some emerging markets are also performing strongly.

At the other extreme, the U.K. commercial property market, and particularly the office sector, is in near crisis: Listed vehicles have been sold off heavily, and unlisted funds have had to suspend redemptions as investors have tried to flee. Uncertainty will persist for some time until the shape of the U.K. disengagement from the European Union, and the terms of any eventual access to the European single market, become clear. Some eurozone markets, particularly Italy's, are also highly vulnerable to the fragility of their local banks.

The economic fundamentals of operating performance may, however, continue to play second fiddle to the global search for yield, which continues to prop up the sector. The yield on the EPRA/NAREIT Global Property Index may be only 3.5%, but it still stands in comparison with the 0.62% yield on the global government bonds in the Barclays Aggregate Index.

Australian Equities — Review

Like many overseas markets, the Australian share market has recovered from its post-Brexit sell-off, and investors, after having spent most of this year on the loss-making side of the ledger, have finally moved into profit. The S&P/ASX200 Index is now up 3.6% in capital value since the start of the year, and is up 6.0% in terms of total pre-tax return.

By sector, and excluding the A-REITs (covered elsewhere), year to date the recovering resources sector has been the strongest performer, with a capital gain of 29.9%. The industrials (+11.8%) and consumer discretionary stocks (+9.6%) have also done well. There were small losses for consumer staples (-1.3%) and IT stocks (-1.4%), but the biggest drag on performance was the financials (-4.1%).

Australian Equities — Outlook

The RBA's assessment (in its latest minutes) was, essentially, "more of the same", with the economy pottering rather than speeding along: "The transition of economic activity to the non-resources sector was now well advanced and recent data suggested that growth had continued at a moderate pace in the June quarter". The bank noted that there was a patchwork mix of better and worse news: Mining exports had started the year very strongly but had since slowed down, consumer spending was similarly up and down, part-time jobs were increasing but full-time jobs less so. Overall, the bank felt that gross domestic product growth in the June quarter was likely to have been a little slower than it had been in March (when it had grown by a strong 1.1% in the quarter, and by 3.1% year over year).

This lukewarm view of the business cycle could be a bit on the tepid side of the truth. The most recent business surveys, while not signalling a strong acceleration out of the post-mining-project slowdown, are definitely showing signs of clear improvement. NAB's quarterly business surveys take a more comprehensive shot of business conditions than their monthly ones: The latest, for the June quarter, showed that actual business conditions (sales, profits, employment) improved in the June quarter. Of those, the ones that matter most to investors—sales and profits—led the way: "The trading and profitability components have been the biggest drivers of higher business conditions, with both improving further in the quarter from already elevated levels". Firms also reported that they were positive about the next three months and the next 12 months than they are about the current state of the economy, suggesting that some further pick-up in activity is in the works.

The issue is whether this pick-up will deliver sufficient growth in corporate profitability to live up to the market's somewhat expensive valuations—"somewhat" being a necessary qualification, as measurements vary. On Standard and Poor's estimates, for example, the prospective P/E ratio is 17.0 times earnings, which looks reasonably expensive, whereas on J.P. Morgan Asset Management's calculations, the forward P/E ratio is a less-demanding 15.9 times, only modestly above the Morgan estimate of its long-term average (14.4 times).

Whether the current market valuation is seen as slightly expensive or somewhat expensive, either way there will need to be decent growth in corporate profitability to sustain it. On present estimates 2016 does not look like it is delivering it, with overall earnings likely to fall (held back by the miners and the banks). Early analyst takes on 2017 are looking rather better—both the miners and the banks are expected to pick up, while other sectors should also improve. But on the other hand early stabs at profit growth consistently start out overoptimistic, and are systematically revised down as greater realism takes over. Overseas buying attracted by an internationally competitive dividend yield of about 4.5% may continue to sustain the market, but ultimately further capital growth will depend on a clear acceleration of the current subpar business cycle.

International Fixed Interest — Review

Global bond yields, particularly on government bonds but also on the most creditworthy corporate bonds, fell to even more remarkably low levels in the wake of the U.K.'s unexpected vote to leave the European Union. Other issues were also preying on investors' minds, including the potential political knock-on effects of Brexit in other parts of Europe, and a rising risk of banking sector problems in the eurozone. Investors in the ensuing unsettled financial markets consequently sought the relative safety of fixed interest: At its lowest point, on July 8, the yield on the key U.S. 10-year Treasury bond dropped to 1.36%.

More recently, investors have recovered some confidence. The immediate shock of the Brexit vote has faded, an actual Brexit is still some distance away, and there is now a more reasonable range of opinions about its ultimate impact. As demand for safe-haven assets has eased, bond yields have risen modestly, and the 10-year U.S. Treasury yield has moved back up to 1.57%. Similarly, the yield on the 10-year German government bond has picked up from its low point on July 8 of negative 0.187% to its current level of marginally below zero (negative 0.01%), and the yield on its Japanese equivalent has also picked up a little over the same period, from negative 0.29% to negative 0.24%. In the market which started it all, the U.K. 10-year yield dropped from 1.375% just before the Brexit vote, to a low of 0.74%, and has risen only slightly since, to 0.84%.

The upshot is that although yields have picked up from the period of peak anxiety, they are still abnormally low, and below their levels at the start of the year, meaning that bond investors have benefited from the consequent capital gains. The Barclays Global Aggregate index in U.S. dollar terms has returned 8.0%. With government bonds

in recurrent demand in periods of heightened investor concern, the government bond component of the Barclays index has returned 9.7%, while the corporate bond component has returned a reasonable but lower 7.5%. High yield (low credit quality) corporate bonds, however, have performed strongly as credit spreads for more questionable issuers have fallen (generating capital gains in the same way as lower yields): The Barclays Global High Yield Index has returned 11.3%.

International Fixed Interest — Outlook

Barring some very unusual event, global bond yields are unlikely to move much over the coming year, principally because most of the major central banks in the developed world will still be maintaining very supportive monetary policies (and hence keeping both short-term and long-term interest rates as low as possible), and partly because inflation looks like it will be remaining very low.

The only major country where there is a realistic chance of rates rising is the U.S. Recent economic data have been good, and inflation is gradually rising: It could be close to the Fed's target of 2% by the end of this year, with the latest *Wall Street Journal* survey of U.S. forecasters predicting that American inflation will be 1.8% in December. Even there, however, any rise in interest rates will be distinctly modest. Although the Fed will no longer need to provide as much support to economic activity, nor have to keep pushing on an inflation rate that is too low, it is expected to take a very careful tightening approach. The *WSJ* forecasting poll is leaning towards only one 0.25% increase in the Fed funds rate, and it may not even amount to that: The futures market currently puts the odds of no change versus one increase at roughly 50:50. There are equally modest increases in the forecast for the 10-year Treasury bond yield, which is expected to be 2.3% at the end of this year.

Elsewhere there is a high probability that the Bank of England, the European Central Bank, and the Bank of Japan will continue to face slower growth than they would like and inflation lower than they would like, and will all be at least maintaining their currently supportive monetary policies, or even intensifying them a bit more again. The Bank of England may well be confronting a U.K. recession, and may ease interest rates or increase its quantitative easing programme (which keeps bond yields low). There are also currently strong market rumours that the Bank of Japan will move to some form of "helicopter money", where it simply prints money to fund government spending, or even dispenses free cash to other groups.

Investors are therefore unlikely to be faced with an abrupt return of bond yields to historically more normal levels anytime soon, and the risk of the associated sharp capital loss currently looks remote. Government bond yields may continue to provide effective insurance against ongoing volatility, though the scale of capital gains year-to-date is unlikely to be repeated, given finite limits on how far lower already minuscule bond yields can go.

For many investors, given the exceptionally low yields on government bonds, corporate bond yields have been a more attractive option (Morningstar's Expert Panel has been of the same view). But investors need to be careful about the risk/return package they are taking on. As investors have piled in—the latest Bank of America Merrill Lynch survey of fund managers found that being long U.S. or European corporate bonds is one of the world's "most crowded" trades—corporate credit spreads have fallen as the bandwagon arrived and bid up bond prices, but at the same time default risks have been rising.

At the start of this year, for example, Merrill Lynch's index of high-yield U.S. corporate bonds was yielding 8.76%, and offered a yield premium of 6.5% over the benchmark U.S. Treasury yield. Now, the same yield is down to 6.67%, and the yield pickup has dropped to 5.1%. This lower credit spread has to pay for deteriorating credit quality and rising default risk. Ratings agency Moody's recently estimated that the number of U.S. companies with credit ratings at the bottom end of single-B or below was near an all-time high, and it expects the default rate

on U.S. high-yield corporate debt to rise from 5.1% currently to 6.5% by the end of this year.

International Equities — Review

Investors in world shares, after initially being severely rattled by the unexpected Brexit vote in the U.K. on June 23, have recovered their nerve since, and are now showing a small positive return year-to-date. The MSCI World Index is up 1.9% year-to-date in capital value, in the currencies of its component markets, and by 2.7% in U.S. dollar terms. In terms of tax paid total return including dividends, the U.S. dollar index is up 4.0% (although the 2.4% rise of the Australian dollar against the U.S. dollar has eaten up a bit more than half of the return for local investors).

As the ads say, "your experience may vary", since the overall result depended on having at least a benchmark exposure to the U.S. market: the MSCI World in U.S. dollars, ex the U.S., has lost 2.1%. In the U.S., the S&P 500 has made a series of all-time highs, and at the time of writing had just closed at another one (2173.02), for a year-to-date capital gain of 6.3%. The U.K. has staged a strong post-Brexit vote recovery, with the FTSE100 Index up 7.8% year-to-date. European shares, however, have been markedly less resilient: The FTSEurofirst300 Index is down 6.4%, with both German (DAX index down 5.6%) and French (CAC index down 5.5%) equities contributing. The Japanese market has risen strongly in recent weeks, possibly reflecting the strong re-election win of incumbent Prime Minister Shinzo Abe as well as the global reduction in investor anxiety, but is still well adrift of where it started the year, with the Nikkei showing a year-to-date loss of 12.4%. Non-Japanese investors, however, have seen the loss counterbalanced by the strength of the yen, which has appreciated by 12.5% against the U.S. dollar.

Emerging markets have done well, with a year-to-date capital gain of 9.6% in U.S. dollar terms. Again, the regional performance has been very diverse, and investors needed to have been invested in two markets in particular to have done well. In Brazil, the benchmark Bovespa Index is up 30.5%, and shares in Russia have also soared (FTSE Russia index +27.1%, RTS Russia Index +25.1%). In both countries the equity market gains have been amplified by exchange rate gains, with the Brazilian real up 21.5% against the U.S. dollar and the Russian rouble up 12.7%. The other members of the key BRIC quartet, India and China, lagged behind. India's Sensex Index gained a relatively modest 6.9%, while China's Shanghai Composite Index is still 14.4% below its opening year level.

International Equities — Outlook

Morningstar's Expert Panel meeting in July had concluded that international equities still warranted a benchmark allocation. Global economic activity continued to progress, though more obviously in the U.S. than in other developed economies, monetary policy (as noted earlier in the International Fixed Interest section) was likely to continue to provide ample liquidity and to encourage investors to look favourably at equities on relative valuation grounds. There were, however, a range of downside risks, and although modest rates of economic growth remained the most likely scenario, investors should be prepared for further episodes of anxiety-driven volatility.

Events more recently have tended to confirm the panel's view, and particularly the relatively lopsided distribution of growth in the developed world, where the U.S. has been making all the running. On top of a better-than-expected jobs report for June, more recent data on retail sales and industrial production have also beaten expectations. This solid performance by the U.S. economy is not necessarily translating into immediate strong corporate profitability. U.S. data company FactSet, which tracks both companies' actual profit results and analysts' expectations for future profits, estimates that profits during the June quarter at the S&P 500 companies were 5.5% lower than a year earlier (2.0% lower ex the energy sector, where the U.S. "fracking" industry has been hard hit by the lower world oil price). But more positively,

profits are expected to resume year-over-year growth in the current quarter, and to pick up further in 2017.

Evidently, many investors have been taking a similar view to the panel's. The latest (July) Bank of America Merrill Lynch global survey of fund managers, for example, showed high degrees of risk aversion, low expectations for global growth and global profitability, and strong regional and sectoral preferences. The risk aversion could be seen from the proportion of cash held in portfolios: While still low in absolute terms, at 5.8%, the level of cash holdings was at its highest since late 2001. Greater anxiety could also be seen in the use of instruments to hedge equity risk. Although most fund managers have still not resorted to taking out hedging protection against equity declines, the proportion taking out protection has reached a new high (continuing a steady trend that started as far back as 2013). The biggest risks they are worried about are geopolitical risk (mentioned by 59%), protectionist risk (52%) and business cycle risk (52%)—the same trio that was foremost among the panel's top concerns for the coming year.

The fund managers were also more pessimistic about the equity outlook. They are only marginally positive about the global economic outlook over the next year (a net balance of +2%) compared with a much more upbeat net balance of +23% in June, and they were correspondingly more downbeat about global profits, with a net balance of 4% thinking they will deteriorate over the next year, compared with the net 10% last month who expected profits to improve. As a result, fund managers moved slightly underweight to global equities (a net balance of -1%) for the first time since 2012.

The fund managers also have strong regional and sectoral preferences. They are currently underweight eurozone (-4%), Japanese (-7%) and, especially, U.K. (-27%) equities, but overweight the U.S. (+9%) and emerging markets (+10%). When asked which markets they would most overweight or underweight over the next year, unsurprisingly, the post-Brexit U.K. market is again deeply out of favour (-39%), though managers are even highly concerned about Italy (-42%). Although the survey did not indicate the reasons, most likely the highly downbeat assessment represents a combination of higher political risk and severe problems within Italy's banking sector. By sector, managers are strongly of the view that a higher-risk outlook bodes ill for bank shares, and although they are still slightly underweight commodities (-4%), the degree of underweight allocation has dropped substantially in recent months as oil and other commodity prices have improved.

The panel's "muddle through" view of the global economy faces some challenges. Although world equity markets appear to have come more to terms with Brexit, it is still not clear how the U.K.'s departure will play out. A recent analysis by the European Commission has calculated that the impacts could range from relatively small (a cumulative loss of 0.3% of eurozone GDP over the two years 2016-17 and a loss of 1.0% for the U.K.) to quite significant (0.6% of GDP for the eurozone, 2.7% for the U.K.). And there are other risks: While investors are currently keen on emerging markets, the latest events in Turkey have shown that severe setbacks can occur virtually out of the blue (Turkey's bonds, equities, and currency all took large and immediate hits). The most likely outlook is that world equities can continue jaggedly upwards, absorbing reverses on geopolitical or other shocks along the way, but there is a higher degree of uncertainty than usual around that central scenario.

Performance periods unless otherwise stated generally refer to periods ended July 20, 2016.

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