Economic Update

Sydney | 17-06-16

June 2016

Outlook for Investment Markets

World equity markets have had another episode of nervousness, partly linked to the UK's Brexit referendum and partly to some evidence that global economic growth, while continuing, is slower than previously expected. Further episodes look likely during the year as investors periodically reassess the downside risks to global business activity. On the positive side, assets seen as defensive (property, infrastructure, government bonds, gold, the yen) have been beneficiaries of heightened investor concerns. In Australia, the business cycle is improving, though growth is not yet consistently back up to pre-mining-boom rates, and corporate profitability will need to pick up from current levels to justify what are now expensive share valuations.

Australian Cash & Fixed Interest — Review

The Reserve Bank of Australia kept monetary policy unchanged at its most recent policy meeting on June 7, and short-term interest rates have consequently shown little change, with the 90-day bank yield steady just above 2.0%. Longer-term interest rates have fallen, however, influenced by a mixture of low domestic inflation and falling overseas bond yields, with the 10-year Commonwealth bond yield now also just above 2.0% (currently 2.04%), 0.8% lower than its opening level at the start of this year. For the year to date, the S&P/ASX Bank Bills Index has returned a (pretax) 0.97%, while the S&P/ASX Corporate Bond Index has returned 3.6%. As has been the case overseas, government bonds have been the asset of choice in periods of volatility, and the high demand has meant that the S&P/ASX Australian Government Bond Index has outperformed other fixed-interest options, with a 5.2% return. The Australian dollar has strengthened in recent weeks and, in terms of the headline AUD/USD rate, has now climbed back above its opening year levels: For the year to date it has gained 1.5% against the US dollar (currently trading at USD 0.741). In overall trade-weighted terms, however, the AUD is still a little below (negative 0.6%) its level at the start of the year.

Australian Cash & Fixed Interest — Outlook

Forecasters had expected the RBA to keep policy unchanged earlier this month but differ on the outlook from here. The RBA itself gave no clues about its future intentions in its latest policy announcement, and views range from no further cut in the cash rate from its current 1.75% level (National Australia Bank), to one 0.25% cut (ANZ Bank, Westpac Bank), to two 0.25% cuts (Commonwealth Bank). The financial futures market is pricing in one 0.25% cut by the end of this year. The likelihood is that even lower returns from the likes of bank bills and bank deposits look to be on the cards.

Forecasters continue to wind back their previous expectations of higher bond yields, principally because of the influence of lower-than-anticipated overseas bond yields but also partly because they expect inflation to pick up from its recent low levels. The big banks, for example, are predicting that the underlying inflation rate will rise from around 1.6% this year to around 2.0% next year, and bond markets are likely to require extra yield to maintain their "real" (after inflation) rate of return. But former expectations of the scale of the increase have been scaled back, and bond yields are now expected to rise only modestly, to around the 2.75% mark next year.

The recent rise in the AUD has been an unwelcome development for the RBA, which said in its latest policy decision that "an appreciating exchange rate could complicate" necessary adjustment in the post-mining-boom economy. The RBA has not had much choice in the matter, however, as most of the recent rise appears to be down to events beyond its control, particularly the likelihood of US interest rates now looking to rise more slowly than previously thought. In recent days, Brexit worries have also contributed as both the euro and pound sterling have been weaker. Most forecasters believe that the RBA's concern is correct and that the AUD will in time need to depreciate: Three of the big banks have the AUD

around USD 0.66-0.68 next year. But nothing is certain in foreign exchange forecasting, and the Commonwealth Bank's pick that the currency will still be around the USD 0.75 mark next year could also eventuate, especially if US monetary policy is very slow to move back to more normal levels of interest rates.

Australian & International Property — Review

Australian REITs have been one of the standout sectors of the Australian share market, and for the year to date they have outperformed all other sectors other than miners (which is a special case, as the miners have been recovering from an earlier slump). The S&P/ASX 200 A-REIT Index has provided a capital gain of 11.7% and a total return including dividend income of 12.7%.

Global listed property has modestly outperformed global equities for the year to date: the FTSE EPRA/NAREIT Global Index in USD has delivered a net return (including the taxed value of dividend income) of 5.2%. The pattern of regional returns continues to reflect the impact of ultra-easy monetary policy: Japan (with a return of 7.0%) and the eurozone (6.9%, with Germany recording 12.0%) have led the way. The US market returned 5.7%. The weakest market has been the UK, where Brexit concerns have weighed heavily on the sector, and listed property has recorded a loss of 9.0% (all regional returns are on a common, net return in USD, basis).

Australian & International Property — Outlook

The latest (June quarter) ANZ/Property Council of Australia survey of property markets shows the patchy performance to be expected in an economy coping with the wind-down of the mining investment boom and consequently growing at a somewhat slower than usual rate. As ANZ Bank's commentary on the survey said, "Commercial property leasing conditions continue to reflect diverging economic performance across regions, sectors, and property grades."

Regionally, retail and office properties in New South Wales and Victoria have been doing well, but mining-affected markets in Queensland and Western Australia have been struggling. The survey found, for example, that in Queensland "public sector office space cutbacks have maintained office vacancies around 20-year highs," while in Western Australia "weak mining-related employment has driven [Perth] office vacancies to almost 25%," with no turnaround in sight. "These conditions are unlikely to improve in the near term, with both markets expecting a solid increase in new supply in the coming year." Sectorwise, survey respondents were most optimistic (in terms of except capital growth) about retirement living properties, followed by shopping centres and retail property. Expectations were more modest for industrial property, while little or no gain in value was expected for office properties; good conditions in New South Wales and Victoria were offset by deep degrees of pessimism in Western Australia and the Northern Territory.

Operating conditions have been somewhat secondary to the ongoing search for yield: As the survey noted, "strong investor demand, especially from Asian investors, has driven continued capital growth and yield compression," and with the REITs still offering 4.6% they are likely to continue to attract investor attention. The survey cautioned that "commercial property yields across a range of markets are approaching, and in some cases surpassing, the lows achieved in the immediate period before the GFC" and that these expensive valuations leave "Australian commercial property returns vulnerable to the potential risk of a capital withdrawal by these investors." Under the current yield-obsessed market conditions, however, the sector looks likely to be supported for some time yet.

Much the same applies to global listed property. JLL's latest (June quarter) Global Market Perspective shows moderately supportive economic conditions overall but with marked regional and sectoral overlays. In the global office market, for example, JLL expects a steady vacancy rate (at around 12%), though shortage of space in some key locations means that overall rentals will be able to grow by about 3%-4% this year. Retail properties are

doing very well in the US and selectively in Europe and Asia. Some specialised sectors are doing very well indeed: Delivery of e-commerce orders, for example, has led to a boom in warehousing. JLL reported that "In the US, [warehouse] absorption is still outpacing new supply, with the national vacancy rate at a 15-year low. Similarly, ongoing vigorous occupier demand in Europe is anticipated to result in take-up volumes remaining at 2015's record levels."

As in Australia, a generally modest operating outlook has taken a back seat in investors' considerations to the yield available. JLL said that "Recovery in investor sentiment since the mid-February low has been swift and there remains a huge amount of capital targeting real estate assets." With the yield on the bonds in the Barclays Global Aggregate Bond Index heading even lower again–now 1.27% versus 1.33% a month ago, with government bonds offering only 0.71%–the 3.6% yield on the EPRA/NAREIT Property Index is likely to continue to find takers.

Australian Equities — Review

Like many other equity markets, Australia's has been sideswiped in the past week by increased levels of investor nervousness over Brexit. The S&P/ASX200 Index is now down 1.7% in capital value since the start of the year. Adding on the value of dividend income puts investors marginally in credit, with a total overall return of 0.3%.

For the year to date, the miners have done best (capital gain of 19.2%), followed by industrials (6.9%), and there was also a small (1.8%) gain for consumer discretionary stocks. But overall performance was held back by the weak performance of the large financials sector, which has lost 8.0%, and to a lesser extent by weak consumer staples stocks (loss of 5.7%) and IT shares (loss of 2.5%).

Australian Equities — Outlook

In Australia, there was unexpectedly strong gross domestic product growth in the March quarter; the economy grew by 3.1% over the year to March compared with the 2.7% consensus forecast. Other, more recent data point to the economy continuing to perform reasonably well. The Australia Industry Group's latest (May) sectoral indexes show that manufacturing has now been expanding for 11 months in a row, the services sector (the largest in the economy) moved into clear expansion mode during the month, and only construction went backwards, mainly because of the oversupplied apartment sector.

The latest (May) monthly business survey from National Australia Bank was also encouraging. Business "confidence" may have dropped a little–the NAB team suggested the general election may have played some part–but "confidence" tends to be a fickle indicator. A better insight into what is happening is NAB's measure of business "conditions," which is a mix of what is actually happening to businesses' sales, profits, and employment. NAB's conditions measure is much more upbeat: As NAB commented, "Business conditions remained at an elevated level in May (at +10 index points), which is an above-average result and close to post-GFC highs...The elevated level of business conditions (unchanged from last month) was due to a notable improvement in trading (sales) and profitability, which offset a disappointing moderation in employment demand."

The strong profitability reading is especially important. The latest official data on company profits had disappointed: Analysts expected companies' gross operating profits to be roughly unchanged in the March quarter compared with the December 2015 quarter, but in the event profits fell by 4.7% (seasonally adjusted) or, alternatively, by 3.1% on the statisticians' "trend" basis, which tries to detect the underlying pattern behind the usual statistical volatility. Either way, it was not encouraging: Analysts had hoped that profits in the nonmining parts of the economy would by now have been enough to make up for the substantially lower profits in the mining sector. In the event, in the year to March,

mining profits were indeed down, by 21.7%, but nonmining profits were also down, by 3.3%.

Profits picking up from their current lacklustre levels will be critical for equity performance, as shares are expensively priced. On the mining side, it looks as if world commodity prices have at least stabilised: the RBA's latest index, for May, showed that prices are now only 2.5% lower in AUD terms than a year ago, China is still growing strongly, if not quite as strongly as previously, and analysts expect some modest rise in mining profits after the slump of 2015. On the larger, nonmining side, profits should also improve on the back of lower interest-rate costs, modest wage rises, and ongoing economic growth: Estimates vary, but Credit Suisse's latest forecasts, for example, have nonmining earnings per share growing by 8.5% this year. Without earnings growth of that order, Australian shares, which are trading on a historically expensive 17.6 times expected earnings, will remain vulnerable to any adverse surprises.

International Fixed Interest — Review

Global bond yields have fallen in recent weeks for a variety of reasons. A much weaker than expected jobs report in the US led people to conclude that the Fed would be unlikely to start tightening monetary policy as early or as strongly as earlier thought; inflation has remained stubbornly low in a number of countries, suggesting that ultra-easy monetary policy will be maintained or even intensified in the eurozone and Japan; and in recent days Brexit polls have shown a rising risk that the UK might leave the European Union, which the bond markets believe might require lower UK interest rates to compensate for the adverse impact on the UK economy. The Brexit risk has also led to a general rise in investor anxiety, which has fuelled increased demand for the safety of government bonds.

The upshot has been that fixed-interest yields, and government bond yields in particular, have fallen to even more remarkably low levels. At time of writing, the yield on the 10-year Japanese government bond yield had dropped to a record low of negative 0.17%. German 10-year yields have flirted with negative territory: They are currently marginally positive, at a tiny 0.02%. And according to a recent estimate from ratings agency Fitch, there are now some USD 10.4 trillion of sovereign bonds trading on negative yields.

Fixed interest has consequently performed well: The Barclays Capital Global Aggregate Bond Index has returned a pretax 8.1% for the year to date in USD terms. The recent rise in investor anxiety, on top of episodes of fragile confidence earlier this year, has meant that government bonds have performed best, with the Barclays index of global bonds returning 10.0%: The yield on global government bonds is now down to only 0.71%. The Barclays index of corporate bonds has returned 5.2%, held back in recent weeks by a Brexit-linked widening of corporate credit spreads. Markit's iTRAXX Crossover Index of the credit spreads on lower-quality European debt has risen to 3.7% from 3.2% as the Brexit polls have shifted more towards a UK exit.

International Fixed Interest — Outlook

There are three factors that will determine the outlook for fixed-interest performance.

The most important is what happens to US monetary policy. Other economies have their own issues, but the impact of US interest rates tends to be ubiquitous, directly or indirectly. As expected, the US Fed left monetary policy unchanged at its June meeting, but there is still the possibility that it might raise rates later in the year. The Chicago Mercantile Exchange's "FedWatch" indicator, which calculates the financial futures market's implicit probability of Fed moves, currently indicates that the Fed, at most, will raise rates only once this year: there is a roughly 50-50 chance of an increase at its December meeting. To the extent that other bond markets mirror US developments, bond yields are likely to remain low given that the Fed's tightening (if any) will be slow and modest.

The second issue is the outlook for inflation. Nobody is entirely sure why inflation has remained as low as it has, despite monetary policy aimed at getting it back to more normal levels (around the 2% mark for both the Fed and the European Central Bank). In the eurozone, for example, prices in May were actually lower (by 0.1%) than a year ago; even allowing for lower petrol prices, the latest inflation rate of 0.8% was well adrift of the ECB's target. Other economies are also struggling to shift inflation higher: In Japan, for example, prices are unlikely to rise this year (according to *The Economist*'s latest survey of international forecasters), despite one of the world's most aggressively stimulatory monetary policies. Again, this suggests that there may be an extended period of low bond yields.

The third factor is safe-haven buying of government bonds. As discussed elsewhere, the global economic outlook, while moderately positive, could be derailed by unanticipated setbacks, which would increase investor anxiety, stimulate greater demand for low-risk assets, and further depress government bond yields. Corporate bonds, however, could be a casualty if the economic outlook darkened significantly.

Most of the likely developments tend to suggest that current ultralow government bond yields have a good chance of persisting in coming months and that bonds have a fighting chance of replicating this year's highly effective insurance of portfolio performance. How far this argument can be pushed remains highly problematic, however: These are very unusual times, and from a longer-term perspective investors may well ask how likely is it that benchmark bonds in important markets can continue to see lenders paying borrowers.

International Equities — Review

World shares have struggled to make net progress for the year to date, as periods of optimism about corporate performance have alternated with outbreaks of anxiety about the financial or political outlook. In the past couple of weeks anxiety has had the upper hand, mainly on concerns about the outcome of the Brexit referendum, and world shares have slipped back below their levels at the start of the year. The MSCI World Index is down 2.8% in capital value for the year to date, in the currencies of its component markets, and by 1.0% in USD terms. The 1.5% appreciation of the AUD against the USD has increased the loss to 2.5% in AUD terms.

Understandably, European markets have been the most affected. The FTSEurofirst Index is down 10.7%, with German shares down 10.1% and French shares down 8.8%, while the UK's FTSE 100 Index is down 3.2%. Japan's share market looks even worse at first sight, with a 15.8% year-to-date decline in the Nikkei Index, but on the other hand the foreign exchange gains from an appreciating yen (up 13.2% against the USD) have compensated for much of the share price decline. The US is the only major market that is up on its starting-year level, but even there the gain for the S&P 500 has been a distinctly modest 1.7%.

Emerging markets are up slightly in USD terms, with the MSCI index showing a capital gain of 1.9%. Strong recoveries in Brazil (political change) and Russia (improved oil prices) have outweighed little change in India and a sharp fall in Chinese share prices. The Shanghai Composite Index has been broadly stable since February and has been unable to recoup January's large sell-off.

International Equities — Outlook

The outlook for international equities remains much as it has been all year–shares have the benefit of ongoing global economic growth, but they are expensively priced for the growth that looks likely and are prone to sell-offs when any of a number of potential downside risks to global growth looks like materialising, as Brexit has in recent days.

It has not helped that the latest forecasts for world growth from the World Bank have downgraded the likely pace of global growth. Its latest (June) update of its

Global Economic Prospects still has the world economy growing by 2.4% this year and by 2.8% next year, but these numbers are lower than the World Bank's previous set of forecasts in January (lower by 0.5% for this year and by 0.3% for the next). They do not leave much slippage room for things to go wrong, especially in the developed economies, which the World Bank reckons will grow by only 1.7% this year, although growth in emerging markets will be rather stronger (the World Bank is forecasting 3.5%).

Somewhat more sombre expectations were reinforced by the latest US jobs numbers, which once again have proved to be one of the key influences on global financial markets. There was an unexpectedly poor outcome in May, when there were only 38,000 new jobs. This was well below the roughly 160,000 jobs forecasters had been expecting (having allowed for a strike at telco Verizon, which temporarily took 35,000 jobs off the numbers). While the unemployment rate dropped to 4.7%, this was also more a sign of weakness than strength, as it reflected discouraged people withdrawing from the labour force and not being counted by the statisticians as unemployed.

Global business surveys confirm the mediocre growth in economic activity. As Markit commented on the latest (May) JPMorgan Global Manufacturing and Services Purchasing Managers Index, "The global economy remained in a low growth gear in May, continuing its generally weak start to the year. A slower expansion was seen at service providers, while manufacturing production broadly stagnated. Both sectors again reported lacklustre trends in new orders. Market conditions will need to stage a noticeable improvement if growth of global GDP is to break out of its current slow steady pace."

The modest outlook is also beset with what the World Bank called "pronounced downside risks." Its short list of immediate issues included further slowdown in major emerging markets (especially among commodity exporters), rising policy uncertainty (the bank mentioned Brexit but could also have added Trump), persistent geopolitical risks, financial market fragility, stagnation in the advanced economies (Japan and the eurozone in particular), and increasing protectionism. It could only think of one potential upside (the benefit to consumers from lower oil prices).

In the circumstances, it is not surprising that investors have been prone to intermittent loss of confidence. Credit Suisse's global Risk Appetite Index, for example, has been in pessimistic mode since the middle of last year (with an outright "panic" reading around the turn of the year). The VIX Index, a measure of the volatility investors expect to encounter in the US share market, has jumped in June as the Brexit vote has loomed. It is not up to the alarm levels of January and early February, but it is well above 'plain sailing' readings.

Rising levels of investor apprehension have also been evident in the rising price of gold, the demand for government bonds, and, oddly, the appreciating yen, which apparently has also become a safe-haven option despite the weakness of the Japanese economy.

As for Brexit itself, at the time of writing the outcome was very uncertain. The *Telegraph* newspaper in the UK runs a poll-of-polls survey that averages the last six polls excluding don't knows: the latest reading had Leave at 51% and Remain at 49%. But there is a large number of don't knows–around 15%–and how they eventually vote (if they do) clearly has the potential to determine the result. For people who believe the best adage is "'follow the money," the *Telegraph* reports that the latest odds from bookmaker PaddyPower are 8-15 on a Remain vote and 6-4 on a Leave vote (that is, Remain is still the most likely option).

Brexit is a good example of the risks that could derail global equities. On the other hand, investors need to ask whether any individual risk is a show-stopper: will it derail the consensus view of ongoing but modest global growth? A good example is the recurrent issue of whether

Chinese growth will disappoint. People may be paying too much attention to small unanticipated changes in Chinese data, which does not make a lot of sense, given that Chinese data are of debatable quality. The bigger picture on latest (May) data is of retail sales running at 10% up on a year earlier, industrial production up 6%, and fixed-asset investment by close to 10%. This is remarkably strong growth: Markets may well worry that it does not match previous expectations, but the more important conclusion is that a very large economy will continue to grow at a rapid rate.

In current circumstances, where uncertainty is high, it is hard to say that there is a clear-cut outlook for world equities. The most likely scenario is that the world economy will continue to grow and that profit performance will improve, helping to sustain currently expensive valuations. But the likelihood that this scenario will unfold has dropped in recent weeks.

Performance periods unless otherwise stated generally refer to periods ended 14 June 2016.

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