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Economic Update

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Outlook for Investment Markets

Markets have been focused on the search for yield as US bond yields have stayed low and European yields have headed lower. Property and infrastructure have been the main beneficiaries, while equities have been subdued, with Middle Eastern political risk also constraining equity performance. Looking ahead, well-priced investment opportunities are becoming harder to find as both bonds and equities are on historically expensive valuations. In Australia, growth in the economy remains in a slower than usual phase as other sectors have not recovered from the slowdown in mining investment and the corporate profits outlook is below par.

Australian Equities – Review

Australian shares have shown little change: the S&P/ASX 200 index is close to its levels of a month ago and a quarter ago and has shown little net movement year to date, with a marginal 0.6% gain.
Within the overall stability of share prices, the resources sector has been losing ground, with the latest international political volatility adding to the ongoing weight of weaker economic data out of China. Mining shares are down 4.7% for the past month and 8.0% year to date. Shares linked to consumer spending have also struggled in an environment in which the economy has been growing more slowly than usual and unemployment has risen. In the year to date, consumer staples stocks are down 2.6% and consumer discretionary stocks are down 3.5%. Industrials (+1.1%) and financials (+3.7%) have performed better, while tech shares have benefitted from the globally high (and arguably over-exuberant) appetite for the sector, with the IT index up 5.6% year to date.

Australian Equities – Outlook

Although the economy temporarily did rather better than expected in the March quarter, more recently the previous pattern of lower than trend growth has re-appeared, with the sharp fall-off in resource sector investment not being made up by strong growth in the non-mining economy. Consequently the economy is back into a slower than usual period of business activity.

The latest (May) suite of sectoral performance indices produced by the Australian Industry Group, for example, shows that manufacturing, services and construction were all in poor shape (though not quite as weak as in April). Consumer confidence has fallen, with the Westpac Melbourne Institute survey showing it dropped sharply after the Federal Budget and that "the absence of a significant bounce in sentiment in June is disappointing. The initial response to a budget can sometimes be an overreaction that reverses in following months", but not on this occasion.

Nor is there any clear indication of any likely acceleration out of current sub-par conditions is imminent. As the Reserve Bank of Australia (RBA) put it in the minutes of its June policy decision, "substantial falls in mining investment, below-average growth of public demand and non-mining investment remaining subdued for a time implied that the pace of growth was likely to be a little below trend over the rest of this year and into the next, before gradually increasing". Or as the NAB economists put it in commenting on their latest (May) monthly business survey, "Business conditions dipped slightly again in the month, revealing an emerging trend lower since the start of the year. Together with the poor conditions

reported by wholesale – a bellwether industry – it suggests little scope for improvement in domestic demand". The Westpac Melbourne Institute Leading Indicator is also giving the same signal: "Despite an improvement over the last month, the Leading Index continues to point to a significant loss of momentum. The growth rate has now been below trend for four months in a row and is consistent with a slowdown over the second half of 2014 carrying into early 2015."

This prolonged period of sub-par activity is proving to be a challenging environment for corporate profits. For example, the latest quarterly ACCI-Westpac Industrial Trends survey found that in manufacturing, "Profits are expected to weaken over the year ahead, with a net 4% anticipating a decline, little changed from a net 5% in the March survey. Investment intentions are tentative, with a net 2% expecting to lift plant and equipment spending over the coming year."

With shares already reasonably expensive from some valuation points of view (the current price/earnings ratio is about 17 times earnings), it would not be surprising if the share market continued to tread water until there was clearer evidence of an upturn in the economic cycle.

Australian Cash & Fixed Interest – Review

Once again short-term rates are unchanged, reflecting the Reserve Bank's unchanged monetary policy settings (the bank held the cash rate at 2.5% at its most recent meeting on June 3). Ninety-day bank bills yields have remained at just under 2.7%. Local bond yields followed the same pattern as overseas markets, falling to late May (the 10-year Commonwealth bond yield reached a low of just under 3.65% on May 30) but rising in June, with the 10-year yield now back up to just under 3.8%. The Aussie dollar showed little net change in May, starting and finishing the month around the US92.5¢ mark but more recently has appreciated to about US94¢. In the year to date, the A$ is up 4.8% against the US$ and by much the same (4.7%) in overall trade-weighted value.

Australian Cash & Fixed Interest – Outlook

For the most part, forecasters are expecting little change in short-term interest rates in coming months. As the RBA said its June policy meeting minutes, "market expectations of the future path of the cash rate in Australia implied a considerable period of stability", with the financial futures market forecasting that the 90-day bank bill rate will still be close to current levels in a year's time and will rise only slightly in the second half of next year to 3% by the end of 2015.

There is also reasonable agreement on the outlook for local bond yields, where a modest and gradual rise in yields looks on the cards, partly reflecting the knock-on effect of the likely gradual rise in US bond yields. Forecasters typically have the 10-year Commonwealth bond yield in the low to mid 4% range in a year's time: the Commonwealth Bank is picking 4.25%, Westpac 4.5% and NAB 4.6%.

There continues to be a wide disparity of views about the near-term and longer-term outlook for the A$, as everyone from the Reserve Bank on down is having difficulty figuring out what has been driving it. The bank, for one, has noticed that the A$ does not seem to have fallen as much as might have been expected given recent falls in commodity prices and other forecasters are equally bemused. The upshot is that some forecasters think the A$ will be substantially lower in a year's time (NAB US83¢, ANZ US84¢), some think it will be about the same (Westpac US92¢) and some think it could rise even higher than it is today (the Commonwealth Bank expects it to be close to parity with the US$ by next March and to still be high, at US95¢, next June).

Australian & International Property – Review

Listed property everywhere has benefitted from the global search for income yield as a result of lower US bond yields and the prospect of extended periods of very low bond yields in the eurozone and Japan. Australian property has been no exception: REITs have benefitted from investors' sharpened appetite for yield, with the S&P/ASX 200 REITs index outperforming the wider share market both over the past month and year to date. The index has produced a total return (including dividend income) of 1.7% over the past month and of 10.3% year to date, compared with the little changes S&P/ASX 200 index over both periods.

Similarly, global listed property has been in strong demand, with the EPRA/NAREIT Global index of listed property up 11.7% year to date (total return, including income, in overseas currency terms). The largest component of the index, the US market, delivered a return of 16.7% (in US$), while the eurozone chipped in with 15.9% (in euros). The UK delivered a lower return of 5.8% (in sterling), with property shares dropping sharply in June, probably as a reaction to the prospect of UK interest rates rising earlier than the markets previously had anticipated. Japanese property was weak, with a -8.7% return year to date (in yen). Like the rest of the Japanese share market, it dropped sharply earlier in the year on apprehension about the impact of a higher sales tax and although property share prices have been rising since mid-April, they are still adrift of their pre-sales tax levels.

Australian & International Property – Outlook

The recent good returns from REITs have everything to do with investors looking for sources of sustainable yield as a result of ever lower fixed interest yields and little or nothing to do with improving fundamentals for the sector. As noted elsewhere, the economy continues to grow at a slower than usual pace, which is not enough to take up the excess supply in the office sector, nor to help with rentals, which are still falling in the office and retail sectors.

The latest price rises mean the sector has become rather more expensive, with the yield falling to around the 5.2% mark and there are other signs that the sector is getting overvalued. REITs typically are trading at a premium to their net tangible asset (NTA) value and investors in this income-chasing environment apparently are prepared to pay progressively higher premiums. One example is the recent bid by Singapore's Fraser Centrepoint for Australand: it is hoping to leapfrog an existing approach from Stockland and is offering to pay a 21% premium to Australand's NTA value.

The hunt for yield may support the sector for some time but absent any clear improvement in the pace of the domestic economic cycle, it is becoming increasingly vulnerable to potential changes in investor yield appetite and in particular to the reduction in the sector's relative yield attraction as and when local bond yields start to rise.

Overseas property markets generally are benefiting from the growing world economy and there have been patches of very strong property performance where previously weak economies are in the process of turnaround from fiscal austerity or debt workouts to a resumption of economic growth.

The UK is a vivid example: growth in the British economy has proved unexpectedly strong and property has been a prime beneficiary, especially as the improved UK fundamentals have coincided with investors' increased interest in property yields. IPD's latest monthly price indices for the performance of directly held property in the UK show a total return (in sterling) over the past year of 16.0%, led by offices (21.4%) and industrial property (20.7%). There also has

been strong interest in property in some of the eurozone "PIIGS" economies, which are emerging from their previous recessions, notably Ireland and Spain. The SCSI/IPD index of directly held Irish property, for example, rose by 7.2% in euros in the March quarter alone.

The sticking point remains, as ever, the valuations of the sector, where the global hunt for yield has led to low levels of property yield in absolute terms and to modest differentials between property yields and both fixed interest yields and equity dividend yields. In the UK, for example, there is now no significant difference between the yield on the listed property sector (3.1%) and the yield across UK equities generally (3.2%) and in some equity markets (Germany, notably) the property yield is the lower.

While the occasional market still offers some relative value – the French property market yield of 5% is well north of the French government bond yield (1.75%) and the French equity market yield (2.9%) – most listed property markets overseas are now at risk of losing investor support if preferences for yield diminish or shift to other asset classes.

International Fixed Interest – Review

The surprising fall in US Treasury bond yields in May has partly reversed. After reaching a low of 2.44% on May 26, the US 10-year Treasury yield has risen to 2.6% currently. The recent small rise means the bond yield remains well below its level at the start of the year (just over 3%).

Ongoing low bond yields in the US have helped bond yields move lower in other markets. In Europe, bond rates also fell in reaction to the European Central Bank's latest policy initiatives. It said on June 6 that it was cutting its already minimal lending rate from 0.25% to 0.15%, introducing a negative interest rate (-0.1%) on the deposits commercial banks hold with it and, most importantly, that it intended to carry out the same sort of program of asset-buying ("quantitative easing") that other major central banks had already been using.

The ECB's purchases, when they eventuate, are intended to keep bond prices high and bond yields low, as well as to provide banks with cheap funds to lend to industry and markets reacted accordingly by starting the process of taking bond yields to lower levels, in some cases to levels that have not been seen in more than two centuries. The 10-year government bond yield in Spain, for example, is now only 2.65%, a full 2% lower than its level at the start of the year and there have also been large falls in bond yields in Greece, Ireland, Italy and Portugal.

US bond yields moving lower since the start of the year, the recent ECB decisions, and investors' willingness to buy lower quality and emerging market debt (sending its price up), have helped produce positive returns for global fixed interest. Year to date, the Barclays Capital Global Aggregate has produced a total return of 3.8% (in US$), with European government bonds (+6.2% in euros) and emerging markets bonds (+6.5% in US$) doing especially well. The downside, however, is that running yields have reached very low levels, with the yield on the Global Aggregate only 1.85% and returns for taking credit risk have fallen. The yield on the Barclays Global High Yield (low credit quality) is now only 5.0% and the yield on emerging markets debt is only 4.7%.

International Fixed Interest – Outlook

The very low yields available on mainstream, high-quality bonds in the developed world have led to fixed interest investors chasing the higher yields on offer in other parts of the fixed interest marketplace. The result is that there is increasingly poor value on offer as

investors bid up the price of alternatives to large developed economy bonds.

Portugal, for example, which only recently emerged from a debt bailout, now pays only 3.4% on its 10-year debt. Greece, which still offers a smorgasbord of severe economic, political and debt problems, is paying under 6% on its 10-year debt, 4% less than it was paying at the start of this year. New sovereign borrowers are able to issue debt in large volumes at relatively low cost. Kenya, for example, has just raised US$2 billion of five- and 10-year debt, the largest initial debt raising of any African country, and was able to issue the debt at lower than expected costs in a heavily oversubscribed sale. And Ecuador, which defaulted on its debt in 2008, is in the process of raising new debt and (according to media reports) is experiencing strong demand for its issue.

Credit spreads on corporate debt have also been falling to levels that now offer questionable value for money. For example, Markit's iTRAXX indices, which measure the credit margin investors require to insure against defaults of corporate debt, fell substantially over the quarter. The iTRAXX Europe index, which measures the credit premium on investment grade European corporate bonds, dropped from about 80 basis points (0.8%) to about 60 basis points, while the iTRAXX Crossover index, which measures the credit premium required on lower quality European companies, dropped from about 300 basis points to about 240 basis points (and was as low as 220 basis points before the higher political risk of recent days).

As a result, both high-grade developed economy fixed interest and higher yield alternatives are now offering yields that are low in absolute terms, low relative to the historical record and to the risk involved. It is possible that this situation could persist for some time.

The ECB and the Bank of Japan are highly likely to keep bond yields very low and as both the Ukraine and Syria/Iraq have demonstrated this year, there is enough political risk around to keep up a healthy level of "safe haven" demand for high-quality bonds (and hence a high price and a low yield). It is also possible that the developed world is in for an extended post-GFC period of slower than usual economic growth and lower than usual inflation, which would be consistent with bond yields staying low for an extended period.

Nevertheless, the fundamentals of the international fixed interest markets are unprepossessing and may be vulnerable to setbacks as and when some of the major central banks decide that their economies no longer require the same degree of monetary policy life support.

The UK, in particular, seems to be getting closer to that point. The governor of the Bank of England, Mark Carney, said this month that the first interest rate increase “could happen sooner than markets currently expect”, which resulted in a change in expectations for the first interest rate increase to later this year from early in 2015.

And in the US, economists (as surveyed in the latest *Wall Street Journal* poll) reckon that while the first interest rate increase is still some way off, it's now on the visible horizon. Roughly 60% of the economists are picking the second or third quarter of next year, which agrees with the wording of the Fed's June decision, where it said it would keep rates low until "some considerable period" after it has finished its bond buying program, which is likely to happen around November. The economists correspondingly have a forecast for the US 10-year bond yield to rise to 3.2% by the end of this year and to about 3.75% by the end of 2015.

With the starting point for interest rates so low, even a relatively small increase from current levels has the potential to lead to painful capital loss. In addition, as was seen in late 2013, the prospect of higher yields becoming available in the developed economies can lead to a crush at the exits from developing and low-quality debt. Markets in emerging and low-quality debt are less liquid and large numbers of investors simultaneously trying to sell (say) their Kenyan debt and go back home can find few takers at acceptable prices.

International Equities – Review

World shares had been somewhat volatile in the first four months of the year – mostly on political uncertainties, especially in January and February at the height of the Ukraine crisis – but the past two months have brought steadier progress. Between April 11 and June 10, the MSCI World index rose by 6.5% in overseas currency terms. In the past few days, however, politics has returned to the limelight, mostly due to the latest developments in the Middle East where the emergence of the unforeseen ISIS (Islamic State of Iraq and Greater Syria) movement and some further tensions between Russia and Ukraine (with Russia cutting off gas supplies) have again raised the level of investors' anxiety. Despite this latest weakness, however, global shares have banked a respectable year to date gain of 4.4% in overseas currency terms, though the gain in effect has been wiped out in local investors' terms by the 4.7% appreciation of the A$ over the period.

A number of important markets reached record highs in the past month. In the developed economies, the S&P 500 index in the US at time of writing had just closed on another record high, partly due to the Fed's policy decision that was seen as supportive for the US economy and it is now up 3.8% for the past month and 5.9% year to date. German shares have also been doing well, with the DAX index cracking 10,000 for the first time on June 10 after the European Central Bank said it would provide greater support to the eurozone economy and although the index has drifted back a little below 10,000 in recent days, it is still up 2.8% for the month and 4.0% year to date. European shares more generally have also benefitted, with the FTSEurofirst 300 up 5.4% year to date. And the Indian market also has been very strong on expectations that the incoming Moti government will enact structural economic reforms that will improve the economy's performance. The Sensex index is up 19.3% year to date, much of that in a concentrated burst over the past six weeks as the likely election result became clearer (the index is up 13.0% since May 8).

Elsewhere the picture is more mixed. Japanese shares had been struggling as they faced the immediate impact of a higher sales tax kicking in from April 1 – a month ago, the Nikkei index had fallen 14% from its opening level at the start of the year – but more recently shares have picked up again as investors have started to focus more on the post-tax outlook. The Nikkei is up 7.9% for the past month and the year to date loss has been pared back to 7.2%.

Partly due to the strength of the Indian share market, emerging markets in general have also made gains, with the MSCI Emerging Markets index up 3.5% year to date, while another of the key "BRIC" economies, Brazil, has also continued to improve with a 7.2% gain, although this overstates the underlying state of the economy. The rise has come after a sharp sell-off in late 2013 and early 2014 on concerns over the economic competence of the administration and share prices have yet to regain all of the ground previously lost.

The other two BRIC economies, however, have not done so well. Although, formally, China's share market

is slightly down year to date (the Shanghai Composite index is down 2.8%), a better summary is that it is essentially unchanged since the start of the year, while the Russian market is still wearing the impact of the Ukraine crisis. It is up from its low levels in the early days of the crisis in March and April, but the FTSE Russia index is still down 5.7% year to date.

International Equities – Outlook

The outlook for global economic activity remains modestly supportive for corporate performance but it remains unclear whether this moderately positive outlook justifies currently expensive equity valuations, particularly against a background of political uncertainties.

In the US, most of the recent evidence points to ongoing growth in the economy. As was widely noted in the media, the 217,000 new jobs created in May meant employment in the US, however slowly and belatedly, has managed to get back to its pre-GFC levels and industrial production, for example, rose by a larger than expected 0.6% in May. While this year's GDP growth will end up wearing the effect of a terrible winter in the northern hemisphere – the Fed, in announcing its latest policy decision, said it expected GDP growth would turn out to have been only 2.1-2.3%, compared with the 2.8-3.0% growth it had been expecting when it last ran its numbers in March – 2015 is looking distinctly brighter. The Fed expects economic growth of 3.0-3.2% and the forecasting community is in the same ballpark. The latest *Wall Street Journal* poll of American forecasters shows they expect growth to pick up to 2.9% next year from 2.2% this year.

In the UK, economic performance has been significantly stronger than expected. The quarter to April saw the largest number of new jobs created (344,000) since the data started to be collected back in 1971 and the unemployment rate has dropped to 6.6%, its lowest level in more than five years. As a result, forecasters are raising their estimates of how well the UK will do this year and next. The *Economist*'s latest (June) survey of international forecasters has revised up the consensus forecast for 2014 to 3% and for 2015 to 2.6%

In the other main developed economies, the growth outlook points to a more modest improvement. The eurozone (on the *Economist* poll reading) is likely to grow by 1.5% next year, a little faster than this year's expected 1.1%, and some of the previously most embattled economies look to have turned the corner, with Spain, for example, expected to grow a little this year (+0.9%) and a bit faster next year (+1.4%).

Japan has been somewhat hard to read as the economy has been suffering from the introduction of a higher sales tax in April, which led Japanese households to spend up before the tax increase and to close their wallets and purses since. Markit's Purchasing Manager Index (PMI) for Japan suggests the economy likely contracted in April (significantly) and May (marginally). The forward-looking indicators within the Market PMI, however, are looking more positive, with employers looking to hire and being modestly upbeat about their business prospects over the next year. The *Economist*'s poll expects that Japan will also manage modest growth, of 1.3-1.4% this year and next.

Emerging markets are a mixed bag, with Markit's latest Purchasing Manager Indices suggesting uphill conditions ahead for Brazil and, especially, Russia. On the brighter side, India's new administration is expected to begin to deliver more growth-friendly policies. And the major concern over the emerging markets – the state of the Chinese economy – looks to be easing, with assorted recent data showing the

economy appears to be stabilising at quite a high rate of economic growth, likely to be in the 7% a year region this year and next. Markit combines the emerging and developed markets surveys it compiles to form the JPMorgan Global Purchasing Managers Index, which is signalling that the world economy has been picking up pace (to its fastest growth rate since September of last year).

As it has been for some time, the question remains whether this reasonable, though far from impressive, outlook justifies the kinds of valuations equities now command. There is considerable evidence of frothy conditions in the major equity markets, as shown not only by quite high P/E ratios (the S&P 500 is trading on close to 19 times earnings) but also by the extremely high prices being paid for tech listings – reminiscent of the headier days before the tech wreck of 2001 – and by the upsurge in mergers and acquisitions, where companies clearly are of a mind to put their shares to some productive use while they are still so generously priced.

It is also possible that investors are being as over optimistic about geopolitics as they appear to be about corporate profitability. In the US, for example, the VIX index is a widely tracked measure of how much volatility investors expect to encounter in the share market. It is currently at levels that signal investors expect remarkably little to emerge from the woodwork and neither the Ukrainian events nor the Syria/Iraq developments have caused anything other than a small, and temporary, rise in investors' hackles.

It could be that investors may well be proved right, that high levels of optimism about corporate profitability and tech stock performance and low levels of anxiety about the political state of the world will work out as expected and that equities will go on to record further decent gains. But equally it would not be surprising to see current lofty expectations disappointed and equity markets encounter episodes of correction to less exuberant levels. ■

Performance periods refer to the period ending 18 June 2014.

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