Economic Update

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March 2018

Outlook for Investment Markets

World equities have been recovering from their February sell-off and are now back up to where they started the year. On the plus side, the outlook for the global economy has strengthened further and provides a promising backdrop for corporate profits. On the down side, many asset classes remain expensive and are vulnerable to further rises in bond yields. Investors also risk being too blasé about risk and may not be prepared for the likes of tariff trade wars or other geopolitical surprises. In Australia, the economy appears to be picking up a faster head of steam, but it is not obvious that growth will be fast enough to deliver a strong boost to corporate profits.

Australian Cash & Fixed Interest — Review

Short-term interest rates have crept a bit higher: The 90-day bank bill yield, which had been steady around 1.75% earlier in the year, has risen in the past two weeks to a little over 1.9%. Long-term bond yields have followed the lead of the U.S. bond market: After peaking in February, when the 10-year Commonwealth bond yield reached 2.92% on Feb. 5, the yield has drifted down to its current 2.72%. The Australian dollar has weakened for the year to date and is down 1.5% in overall trade-weighted value. Although it gained a little against the globally weak U.S. dollar, it has dropped against other major currencies, most notably against the yen (down 4.7%).

Australian Cash & Fixed Interest — Outlook

The latest policy decision from the Reserve Bank of Australia (RBA) on March 6 said nothing specific about the bank's future plans, but analysts paid quite a bit of attention to the end of the sentence that read, "Further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual." The "gradual" reference was taken to mean that the bank would need to leave interest rates where they are for even longer: National Australia Bank, for example, responded by cutting its forecast from two 0.25% increases by the bank this year to one and also said "it is not impossible that the RBA stays on hold for all of 2018 and raises rates in early 2019." The futures market agrees, with a roughly 50:50 chance of one 0.25% increase towards the end of this year. The era of low returns from cash and bank deposits remains well entrenched.

Although U.S. bond yields have drifted back down again in recent weeks, the likelihood (as noted in the "International fixed interest" section) is that the longer-term track for U.S. bond yields is upwards: The U.S. Federal Reserve is in the process of adjusting monetary policy back towards more normal levels, and other overseas central banks are likely to follow later on in the piece. Higher overseas bond yields are likely to feed through to higher local rates, probably much in line with the consensus forecast for U.S. yields – up by around 0.3% this year and by a further 0.4% next year, which would take the 10-year Commonwealth bond yield to around 3.4% by late 2019.

The outlook for the Australian dollar remains hard to call, partly because there continues to be a high degree of uncertainty around U.S. economic policy, not helped by the latest change in key personnel, with a new director of the White House National Economic Council. While there are potential upside factors – a "commodity-backed" currency, as the Australian dollar is sometimes classified, would be expected to do well in the current conditions of strong global trade growth – the downside pull of relative interest-rate differentials may be more decisive, with U.S. short-term rates likely to rise in coming months but local ones likely to remain unchanged. NAB, for example, with its new forecasts of little change in local monetary policy, has the Australian dollar dropping from its current USD 78.7 cents to USD 75 cents by the end of this year.

Australian & International Property — Review

The global February equity sell-off was mainly caused by concerns about rising interest rates, an issue that is particularly relevant for property shares, and, unsurprisingly, the Australian listed property shares have

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continued to struggle. For the year to date, the S&P / ASX200 A-REITs Index has recorded a capital loss of 6.9% and an overall loss of 6.0% including dividend income. It has underperformed the wider sharemarket by 5.0% on a net income comparison.

Global property has also been similarly affected, and the FTSE EPRA/NAREIT Global Index has registered a 3.3% loss in terms of net return in U.S. dollars, again well adrift of the wider global sharemarkets, which registered a 1.8% gain on the same basis. The American market continued to dominate the overall outcome: Prices of the U.S. REITs fell by 7.25%, though the loss was a bit less (6.5%) for the top 50 most-traded REITs. Most other markets also saw losses in U.S. dollar terms, other than the emerging markets (buoyed by faster global growth prospects) and Japan (currency effect of a stronger yen). Italian REIT prices dropped by a substantial 12.9% as worries resurfaced about the postelection outlook for the Italian economy.

Australian & International Property — Outlook

The latest (December quarter) survey of commercial property specialists run by National Australia Bank found that operators in the sector were reasonably upbeat about the business outlook, although they did not expect the outlook to translate into strong gains in capital value and rentals or sharp falls in vacancy rates. The overall picture concealed some sharp sectoral variations: Of the major subsectors, industrial is in best shape, with NAB finding "reports of high demand for warehousing arising from strong online retail (including Amazon)." Retail, on the other hand, is in outright poor shape: Respondents expected falling rentals, slightly lower capital values, and rising vacancy rates, and they expected the sector to be oversupplied with space for at least the next five years.

A faster rate of economic growth could improve the sector's prospects, but as matters stand the economic outlook is only fair rather than robust, and even if operating performance picks up to some degree, the big challenge for the sector has not gone away. The prospect of higher bond yields is likely to lead to further underperformance.

Overseas, the economic outlook has been steadily improving, with forecasters upgrading their expectations for economic growth both this year and next. The impact of faster business activity is already being felt in a number of property markets, particularly in Europe where growth had previously been sluggish. Knight Frank's latest report on the outlook for European property found that "Q4 [2017] was a stellar quarter for a number of European office occupier markets, with take-up in Dublin, Madrid, Munich and Prague increasing by well over 50% year-on-year ... On the back of strong demand and tightening availability, European rental growth gathered momentum in Q4. Markets such as Amsterdam, Berlin, Brussels, Frankfurt, Madrid and Paris all recorded increases in prime office rents."

But once again there is the lurking valuation threat from higher bond yields. Some specialists in the sector believe it will not be an issue in 2018: Knight Frank, for example, thinks that European cap rates (the interest rates used to value property) could fall a bit further before stabilising around the end of this year. CBRE, in its latest outlook report on global property, also argues that "Overall, cap rates will largely be stable globally in 2018, supported by positive investor sentiment and capital availability."

But this may prove on the optimistic side: Although the tax-paid yield on the FTSE EPRA/NAREIT Global Index has improved a little after the recent sell-off, from 2.92% to 3.07%, the attractiveness of the sector remains vulnerable to further rises in global bond yields.

Australian Equities — Review

The Australian market has not quite managed to get back to where it started the year: The S&P / ASX200 Index is down by 2.1% in capital value and by 1.0% after including dividends. At a sectoral level, only the IT sector is up for the year, with a 4.6% capital gain. The large financials sector continues to hold back performance, recording a 2.1% loss, and even the miners, which might have been expected to do well against the background of a clearly

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strengthening global economy, are also down, by 3.3%. Consumer-linked stocks are also lower (staples down 0.4%, discretionary spending down 3.2%), and industrials are down 3.0%.

Australian Equities — Outlook

It is still unclear whether the pace of business activity is picking up, but the most recent data give some cause for optimism. The latest (February) monthly National Australia Bank business survey was particularly encouraging. The thing to watch in the NAB survey is not business "confidence": It can be overly affected by reactions to items in the news headlines, and indeed it dipped this time around because of the global equity sell-off in February. Rather, the important reading is business "conditions," which reflect the reality of firms' own trading, profit, and hiring. On the more important "conditions" reading, February was excellent: "The business conditions index increased a further +3pts to +21 index points. This is a record high since the monthly survey commenced in March 1997 ... On a trend basis [i.e. taking out transitory seasonal movements], conditions are at the highest level since late 2007, just before the GFC." Looking at the three components of "conditions," "Both trading conditions (sales) and profitability, already at high levels, posted small gains while employment conditions recorded a large rise, increasing to 16 index points, a record high."

The Reserve Bank, for one, buys the idea that the business cycle is picking up. After its March policy meeting, the bank said that "The Bank's central forecast is for the Australian economy to grow faster in 2018 than it did in 2017 [it likely grew some 2.8% in 2017, meaning growth is likely to be 3% plus]. Business conditions are positive and non-mining business investment is increasing. Higher levels of public infrastructure investment are also supporting the economy. Further growth in exports is expected after temporary weakness at the end of 2017."

The bank mentioned that cautious consumers could still hold the economy back, and the latest (March) Westpac / Melbourne Institute consumer confidence survey suggests the bank is right to be wary of a strong upturn in the economy. Households are, by a small margin, net optimists about their outlook, but they are well short of the confidence levels that would support a strong rise in spending. That said, there were some hints in the survey that formerly tight purse strings could be loosened somewhat this year, although an outright splash-up looks unlikely.

Overall, there is a reasonable prospect of 2018 turning out to be a stronger year for business, but the question is how strong an impact will modestly faster growth have on corporate profitability. So far, profit growth has been distinctly modest: CommSec's tally of the latest profit reporting season showed that profits were actually 1.5% lower than a year earlier. As CommSec noted, the weak aggregate outcome was affected by three big items (BHP, Commonwealth Bank, Telstra), but, even after leaving them out, profit growth was an anaemic 3.2%.

The outlook for 2018 is stronger: Credit Suisse's latest forecast, for example, is that earnings per share will grow by 7% this year. CommSec also thinks that faster growth is on the cards and expects to see the S&P / ASX200 trading somewhere in the 6,150 to 6,550 region by the end of the year. At the midpoint of 6,350, that would represent a 7% capital gain from present levels. That would present a pleasant turnaround from an extended period of subpar performance: Over the past 10 years, the index has averaged an annual price gain of only 0.8%. But it will require some further and stronger evidence of an acceleration in the current business cycle before it looks a probability rather than a possibility. It is also likely to require some turnaround in how investors view the prospects for the big banks, which remain mired in regulatory hearings for now.

International Fixed Interest — Review

Bond yields have retreated a little in the U.S. over the past month. At its peak on Feb. 21, the U.S. 10-year Treasury yield had reached 2.95%, but in recent weeks it has dropped back to its current 2.81%. Other key global yields

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have also eased back with (for example) the 10-year German government bond yield dropping from its recent 0.77% high on Feb. 15 to its current 0.6%.

Despite the recent declines, bond yields are generally modestly higher than where they started the year, with the only important exception being Japan, where the 10-year yield has held steady at 0.05%. The corresponding capital losses have affected the performance of global fixed interest. While the Bloomberg Barclays Global Aggregate Index is formally showing a year-to-date gain of 1.5% in U.S. dollar terms, the headline result does not allow for the weakness of the U.S. dollar, which is 3.0% lower in overall value for the year to date: Many investors will be looking at losses in own-currency terms. Eurozone investors, for example, who hedged an exposure to the Global Aggregate back into euros, are showing an overall loss of 1.1% for the year to date.

International Fixed Interest — Outlook

The recent modest declines in bond yields have encouraged global equity markets, which had sold off heavily in February on fears of rising bond yields. Higher yields had the potential to undermine the relative valuations of bonds and equities and would also have had an impact on corporates' borrowing costs, which have been unusually low.

Any relief is likely to be temporary, however, particularly in the U.S., as bond yields look to have turned the corner from the era of unusually easy monetary policy and unusually low inflation.

The Federal Reserve still looks set to tighten monetary policy progressively over the course of this year. Its current target range for the fed funds policy rate is 1.25% to 1.50%: Currently, the futures market (going by the "FedWatch" indicator created by the Chicago Mercantile Exchange) is predicting a very high (88%) likelihood of a 0.25% increase at the Fed's next meeting on March 21, with further rate increases to come. The futures market's current best guess at the end-year target range is 2.0% to 2.25%.

The reasons for the Fed's likely moves are straightforward. It has a dual mandate of a low unemployment rate and an inflation rate of around 2.0%, and it is close to achieving both. The latest unemployment rate is only 4.1%, and the economists in the latest (February) poll of U.S. forecasters run by *The Wall Street Journal* reckon that it will go below 4% this year and average 3.8% in 2019. Similarly, the inflation target is not far away, either: "core" inflation (ex volatile food and energy prices) was 1.8% in the year to February. There is consequently no good reason for continuing to run with the previous easy monetary policy stance. The *WSJ* panel reckons that the upshot will be a rise in the 10-year Treasury yield to 3.1% by the end of this year and to 3.5% by the end of 2019.

Policy is also, very modestly and gradually, on the turn in the eurozone. The European Central Bank surprised forecasters when it announced at its latest (March) policy meeting that it was dropping its commitment to increase its bond-buying programme if inflation looked as if it was not going to rise to the ECB's 2% target. The ECB clearly now feels that the risk it will have to loosen policy further is now remote.

It was only a modest step, but it showed that the ECB is, very carefully, starting to march back from peak monetary ease. On the latest Reuters poll of economic forecasters, the ECB is likely to increase its main policy rate from its current negative 0.4% to negative 0.25% by the middle of next year and increase it further, to zero, by the end of 2019.

The economic fundamentals of faster global growth, modestly higher inflation, and less supportive monetary policy add up to a set of challenges for fixed-interest performance. There may be periods where safe-haven buying may re-emerge – media comments suggest that the recent declines in bond yields, for example, were linked to investor nervousness over potential trade wars – and there are likely to be periods where the markets question whether inflation is, indeed, reappearing after being absent

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for so long. Fixed interest may, as a result, have periods of reprieve, but, barring some major geopolitical or economic shock, the later stages of a broad global economic upturn are not likely to be friendly to the asset class.

International Equities — Review

World shares, after large rises in January but even larger falls in the first half of February, have recovered in recent weeks, and the MSCI World Index of developed markets is now back roughly to where it started the year. In the currencies of its component markets, the MSCI World Index is up by 0.4% for the year to date, and in U.S. dollar terms is up by 1.5%.

The U.S. market, with its 2.8% gain for the S&P 500, is largely responsible for the World index inching into the black: Ex the U.S., the World index would have down a little (down 0.8%). The other major markets lost ground: In Europe the FTSE Eurofirst300 was down 4.1%; in Japan, the Nikkei lost 4.3%; and in the Brexit-befuddled U.K., the FTSE100 dropped by 7.2%.

Emerging markets have continued to outshine their developed counterparts: Emerging markets tend to do relatively well in global cyclical upswings and are also on cheaper valuations than the developed markets. The MSCI Emerging Markets Index is up by 4.3% in the emerging markets' currencies and by 5.2% in U.S. dollars. The core BRIC economies (Brazil, Russia, India, China) were up 7.0%, thanks to strong rises in Brazil and Russia; Chinese and Indian shares have shown little net move for the year to date.

International Equities — Outlook

The economic and financial news continues to show that the world economy is picking up pace.

The single most important statistic for the investment markets, the monthly employment announcement in the U.S., has been impressive. In February, there were 313,000 new jobs, way above forecasters' advance estimates (the highest pick had been 230,000 and the average forecast had been 205,000). The unemployment rate has stayed at a low 4.1%, even though large numbers of people have decided to re-enter the stronger labour market, as there were enough jobs to absorb the new entrants.

Outside the U.S., the news has also been positive. The J.P. Morgan Global Manufacturing and Services PMI, which aggregates the national PMI indexes collated by IHS Markit, was strong in February: As J.P. Morgan commented, "The February PMI surveys signalled a further acceleration in the rate of expansion in global economic output. According to the PMI, growth hit a near three-and-a-half year high, as inflows of new business strengthened." The growth has been remarkably broad-based, with all sectors sharing in the expansion and with especially strong growth in telecoms services, the industrials sectors, and technology.

The OECD, in its just-released update to its *Economic Outlook*, is of the same view. "Global GDP growth is estimated to have been 3.7% in 2017, the strongest outcome since 2011," the OECD said, "with positive growth surprises in the euro area, China, Turkey and Brazil. Industrial production, investment and trade growth have rebounded, with global trade growth reaching an estimated 5¼ per cent in 2017, and business and consumer confidence remain elevated."

The outlook is also encouraging. IHS Market polls firms every four months on the outlook for their businesses: The latest results, for February, found that "The mood among global business executives is the brightest since 2014, with optimism about future growth and profits edging higher again in February. Hiring and investment intentions are also at multi-year highs, as firms expand to meet anticipated sales growth in the year ahead."

The OECD's latest forecasts have also been revised upwards. It said that "The world economy will continue to strengthen over the next two years, with global GDP growth projected to reach almost 4% in both 2018 and 2019. Growth in the United States, Germany, France,

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Mexico, Turkey and South Africa is projected to be significantly more robust than previously anticipated, with smaller upward revisions in most other G20 economies."

This is consequently a benign environment for corporate profits. With almost all the financial results now available for 2017 for the companies in the S&P 500, data company FactSet estimates that earnings per share in the December quarter were 14.8% higher than a year earlier, and even though the number was exaggerated by a doubling of profits in the energy sector, this year looks to do even better again. On the analysts' forecasts collated by FactSet, earnings per share are expected to rise by a strong 18.4%. Every sector other than utilities and real estate is expected to see double-digit growth in profits, led by the energy sector, financials, and raw materials.

Although the economic fundamentals have continued to improve, the outlook still faces some challenges. Despite the February sell-off, share valuations are still high, especially in the U.S.: While they are not as pricey as they were going into the "tech wreck" of the early 2000s, U.S. equities are priced at 17.2 times expected earnings, a reasonably high level by historical standards. Shares are consequently vulnerable to any earnings disappointments – a real possibility given the lofty level of profit expectations – and to the impact of the progressive removal of global monetary support. As the OECD commented, "The prolonged period of low interest rates and volatility has encouraged greater risk-taking, making the financial system more exposed to shifts in market sentiment as monetary policy normalises ... Further corrections in asset prices [i.e. beyond the ones that occurred in February] remain possible as monetary policy normalises, given the still-high valuations in some markets, including equity markets in the United States, housing markets in Canada and Australia, and corporate bonds."

There is also the potential for unpleasant geopolitical surprises, particularly given the unpredictable outlook for U.S. economic and foreign policy. In recent weeks, the Trump administration has lost the head of the National Economic Council and the Secretary of State, and their replacements are likely to be more hard-line on issues such as tariff wars (a key risk to the global economic outlook, in the OECD's view) and on confrontation with regimes such as North Korea.

It does not help that investors are putting little weight on the possibility of interruptions to the global business cycle. Although investors' level of concern (as measured by the VIX indicator of expected volatility for the S&P 500) rose sharply in February, largely on fears of the valuation impacts of higher interest rates, more recently they have dropped back to less worried levels. While they have not fully returned to the overcomplacent levels seen in late 2017 and early 2018, they do not appear to be signalling any significant concern over shocks from left field.

The most likely scenario is that the progressively strengthening state of the world economy will underpin ambitious profit expectations, and equities will benefit. But it also seems likely that 2018 will spring more February-style volatility along the way as investors periodically reassess the state of the global business cycle and, in all likelihood, confront geopolitical surprises they are not fully prepared for.

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