Economic Update

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Outlook for Investment Markets

Growth assets have performed well year to date, initially on the "Trump trade" theme of a fiscally-stimulated U.S. economy, but more recently on the back of wider evidence of faster global economic growth and a happy outcome from the French presidential election. The stronger state of world business activity will provide further support for global growth assets, but there is little room for slippage. If corporate profits deliver to investors' high expectations, all well and good, but the risk is that current expensive valuations (especially in the U.S.) are priced for perfection and could be vulnerable to setbacks. Defensive assets such as bonds and property have been lagging, and will be under further pressure if, as seems likely, bond yields rise over the next year—an exception is infrastructure, which remains in high demand. In Australia, both the Reserve Bank of Australia, or RBA, and Treasury have recently predicted better times ahead, and the latest economic data has also been encouraging. An improvement in local prospects would help justify somewhat expensive share valuations, and could get local equity performance closer to the stronger results from overseas markets.

Australian Cash & Fixed Interest — Review

Short-term interest rates have been steady, with the 90-day bank bill yield continuing to trade close to 1.75%, given that the RBA has left monetary policy unchanged, most recently at its May 2 policy meeting. And the 10-year government bond yield has generally stayed around 2.6%, though with some occasional day-to-day volatility. Year to date, the S&P/ASX interest rate indices are showing pretax returns of 0.66% for bank bills, 2.09% for government bonds, and 2.83% for corporate bonds. The Australian dollar is marginally higher for the year, although while it has risen in terms of its headline U.S. dollar exchange rate, from USD 0.724 to USD 0.74, weakness on some other cross rates (including the yen, the euro and the British pound) means that in overall trade-weighted value, the Australian dollar is up by only 0.2%.

Australian Cash & Fixed Interest — Outlook

The minutes of the RBA's most recent policy meeting showed that the bank remains on the same course—ready if needed to raise rates, largely for prudential reasons to prevent overexuberance in the housing markets, but also ready if required to lower rates to give some further boost to the still slower-than-usual economy. While there are still some minority views among RBA-watchers that it will eventually need to lower rates a bit further, a much larger group (currently including all four big banks) think it will leave rates where they are out to the end of 2018. The futures market effectively agrees, though it thinks there could be one 0.25% increase towards the end of 2018.

Longer-term rates also look set to rise if, as seems probable, U.S. bond yields move higher. Local forecasters have different views on how high U.S. bond yields will go, and how closely local bond yields will follow them, but the consensus is that the local 10-year yield will be somewhere in the low 3s by the end of next year. The National Australia Bank is picking 3.0%, for example, while Westpac is predicting 3.4%. The outlook makes for likely poor performance, as increases of that order would imply capital losses that would outweigh the coupon income. A rise to 3.25%, for example, would lead to a capital loss of some 5% on the current 10-year benchmark bond.

There are mixed views on the outlook for the Australian dollar. On the bullish side, an optimist's take on commodity prices and overseas demand for the likes of Australian real estate could lead to the Australian dollar appreciating. The Commonwealth Bank, for example, sees the Australian dollar at USD 0.78 in a year's time, up 4 cents on today's level. However, most forecasters take a more bearish view. With interest rate differentials widening against the Australian dollar as the Fed raises rates while the RBA stands pat, and with some further relapse in key commodity prices such as for iron ore, the Australian dollar could well weaken, and the other three big banks see the

Australian dollar lower, at around the USD 0.68-USD 0.70 mark, in a year's time. Although one cannot put a lot of confidence in the call, from the perspective of local investors holding unhedged overseas assets, there looks to be a reasonable chance of some foreign exchange gains if the more mainstream view eventuates.

Australian & International Property — Review

Many listed property markets have underperformed year to date, compared with their wider overall equity markets, and Australia has been no exception. The A-REITs underdelivered compared with the ASX with the S&P/ASX 200 A-REITs Index providing a total return of only 0.5% versus the overall market's 4.5%.

It was same again for global listed property, with the net 4.2% return from the FTSE EPRA/NAREIT Global Index in U.S. dollars falling short of the 9.5% performance of the MSCI World Index on the same basis. Improving business conditions in the eurozone and a good outcome from the French presidential elections helped eurozone property shares to a 12.5% net U.S. dollar return, and U.K. property shares did the same, though the U.K. rise is from a previously highly depressed post-Brexit base. Asian markets also did well, with a 7.6% return. The poor performance of the overall sector was very much down to the weak outcome in the U.S., where shares delivered a 2.1% overall loss.

Australian & International Property — Outlook

An economy that is growing at a somewhat slower rate than usual is producing an overall mixed outcome for property. Some regions and sectors are doing very well indeed: Savills' latest "Quarter Times" report on the office markets, for example, shows that yields have fallen to particularly low levels in Sydney, where the yield on prime central business district offices is now down to 4.75% to 5.25% due to high demand and tight supply. In the latest (March quarter) survey of global commercial property from the U.K.'s Royal Institution of Chartered Surveyors, or RICS, Sydney featured as one of the world's strongest in terms of both investor interest and tenant demand. Melbourne offices, and industrial space in many areas (partly boosted by the logistics facilities needed to service e-commerce), are also doing well. But the two tier economy in the wake of the unwinding of the mining boom has also left some markets in a very weak place. On Knight Frank's latest estimate, "The Perth CBD vacancy rate increased to 22.5% as at January 2017 from 19.6% a year ago, the highest level recorded in 22 years."

On the plus side, the sector can look forward to ongoing reasonable, rather than boom-time, business conditions. But on the minus side, the A-REITs face a relative valuation threat from bond yields that look likely to increase over the coming year. The sector is reasonably well placed to face the challenge, as the sector is not currently on expensive valuations. REIT prices may be a bit on the expensive side, by historical standards, on a price/net tangible asset value basis, but on the other hand, the yield differential with bonds is modestly higher than usual, leaving the sector some room to cope with an erosion of the differential as bond yields rise. Even so, REITs, as the latest performance data show, typically tend to lag the wider equity market in a rising interest rate cycle, and it would not be a surprise to see more of the same during the rest of this year and into 2018.

The conflict between acceptable operating performance and the valuation risks from rising bond yields is starker overseas. The economic backdrop is certainly improving. As the latest RICS report said, business sentiment in the property sector is "improving (or becoming less negative) in the majority of markets reported on in this survey. This is broadly consistent with macroeconomic news flow which generally continues to surprise on the upside." The German market has been benefiting from a stronger eurozone economy, with Berlin, Frankfurt and Munich all reporting strong demand. They are in a group with the highest expectations for rental growth and capital appreciation over the next year, which also includes Bangalore and Mumbai, and some smaller European markets of Budapest, Dublin, and Lisbon.

But the value on offer is not attractive. The latest yield on the FTSE/EPRA NAREIT Index is only 3.75%, and even a modest and gradual rise in global bond yields will put pressure on sector valuations. Ongoing underperformance looks like the most likely prospect.

Australian Equities — Review

This year has generally been equity-friendly, and the Australian sharemarket has also been a beneficiary. Australian shares have followed world shares upwards, but the scale of the gains has been more modest, due mainly to still subpar growth in the economy and the impact of lower commodity prices on the previously strong resources sector. Year to date, the S&P/ASX 200 Index is up 3.0% in capital value and has returned 4.5% including dividend income. The industrials (9.9% capital gain) have done very well, as have IT shares (8.0%), and consumer staples stocks (7.8%), but the resources sector has lost ground (down 3.3%) and the financial sector has made only limited gains (1.9%), not helped by the new tax on the big banks announced in the May 9 Budget.

Australian Equities — Outlook

There have been a couple of big set-piece forecasting exercises in the past few weeks. In the May 9 Budget, Treasury said that in the fiscal year ending this June, the economy grew by a distinctly subpar 1.75%, but it predicted that it will pick up to 2.75% growth in the June 2018 year, and to 3.0% the year after that, which would be fast enough to get the unemployment rate down a bit, to 5.5% in 2019. Earlier in the month, the latest quarterly *Statement on Monetary Policy* from the RBA had come to the same broad conclusions, with growth expected to pick up (on the midpoint of the RBA's forecasts) from 2% in the fiscal year just finishing to 3.25% in each of the coming two years.

The latest business surveys also give some cause for optimism. National Australia Bank's latest (April) monthly survey "posted another strong result in April, with both business conditions and confidence improving—pointing to ongoing strength in business activity in the near term. In addition, to elevated levels of business conditions, improvements appear to have become increasingly broad-based (across states and industries)."

However, it is not as straightforward as it looks to translate what looks like a potential pickup in economic activity into unambiguously good news for the equity market. There have been various false dawns in recent years that did not in the event lead to permanently faster growth, and some forecasters think the latest official forecasts will again disappoint. Westpac, for example, believes in, compared with the Budget view, "a significantly sharper downturn in dwelling investment; ongoing soft consumer spending; and no real uplift in non-mining investment in 2018/19", and it also takes a significantly dimmer view of the prospects for commodity prices.

Even if the rosier RBA and Treasury views prove correct, they may not translate into a gush of corporate profits. In the details of the Budget documents, Treasury's estimates for corporate profits (predepreciation) show distinctly modest, rather than strong, growth. Treasury calculates that corporate profits grew by 14.25% in the June fiscal year just finishing, an amount that (while real) is distorted by the large impact of higher commodity prices on the profits of the resources sector. For the coming fiscal year, Treasury is picking 5.25% profits growth, which is a bit faster than the 4% growth expected for the overall economy in nominal, that is, money terms, but then it sees profits growth slowing down markedly, to only 2.75% in the 2018-19 fiscal year, which will be slower than the 4% growth of the money economy.

The Australian sharemarket, at around 16 times prospective earnings, is not as expensively priced as some overseas markets, but it is on the expensive side of its own historical average, which is around 14 times expected earnings. It will require confirmation that the more optimistic views on the economy and on growth in corporate profits over the coming year are, finally, coming to hand, to justify current pricing and to see share gains start to match those achieved overseas.

International Fixed Interest — Review

Politics has been behind much of the recent movements in global bond yields. In the U.S., Treasury bond yields have tended to fall when investors have taken a dimmer view of the Trump administration's likely ability to get its economic stimulus ideas implemented. Slower growth puts less upward pressure on inflation and bond yields. The 10-year yield reached a recent low of 2.18% on April 18 when investors were especially disillusioned with the administration's inability to repeal "Obamacare." More recently, investors have begun to think that the administration might be getting some traction with its tax cut agenda, and yields rose again, to a recent high of 2.42% on May 10. In the last few days, however, the controversy over the firing of the head of the F.B.I. has again raised issues about the administration's effectiveness, and the 10-year yield has dipped back to 2.33%.

The election of Emmanuel Macron as French president has also had an impact. The difference between French and German 10-year government bond yields had widened as France went into a presidential campaign that featured some potentially dramatic changes to French economic policy. A "hard left" candidate, for example, came a close fourth in the first round, and the National Front's Marine Le Pen won through to the final round. In the end, markets relaxed after Macron's win, and the differential between French and German yields dropped back to more normal levels. Overall, however, bond yields have moved a little higher since the start of the year on growing evidence of an improving eurozone economy.

There is a political element in the U.K, too, where Brexit uncertainties are high. The Bank of England, for example, is currently using the operating assumption (as stated at its May 10 policy meeting) that "the adjustment to the United Kingdom's new relationship with the European Union is smooth," but clearly there is significant potential for an unpleasant divorce.

Compared with their levels at the start of the year, there has not been much net movement in bond yields, with some capital gains from modestly lower U.S. yields offset by capital losses from modestly higher eurozone yields. Year to date, the Bloomberg Barclays Global Aggregate Index in U.S. dollars has returned 2.6%.

International Fixed Interest — Outlook

Although the short-term direction of U.S. bond yields is at the mercy of volatile shifts in investor sentiment, the longer-term outlook is clearer. The likelihood is that the Fed will continue to tighten monetary policy by raising interest rates, which will affect the shorter end of the yield curve, and will also move to reduce its bond buying programme, which will affect the longer end of the yield curve.

In both cases, the rationale is clear: the U.S. economy has continued to progress, with the rate of unemployment now down to only 4.4%, which means the economy no longer needs aggressive monetary policy support, and inflation has risen close to where the Fed would like it to be, so it too needs little or no further boost. The key measure for the Fed is the "core personal consumer expenditure deflator," which on its latest reading (1.8% in March) was effectively at the Fed's 2% target level.

The upshot is that the Fed will very likely continue to raise the federal-funds rate from its current 0.75%–1.00% target range, most likely starting with another 0.25% increase at its June meeting, and probably raising it by another 0.25% by the end of the year.

In addition, the Fed is likely to stop reinvesting in bonds as its quantitative easing, or QE, holdings mature, and instead will let its outstanding holdings gradually run down over a long period of time. The timing is still uncertain, but market surveys suggest that bond investors think the Fed will stop reinvesting in bonds sometime next year, and will have the effect of taking a major bond buyer out of play. Reduced demand is likely to lead to lower bond prices and (equivalently) higher bond yields.

The outlook for U.S. dollar bonds is consequently challenging. Assuming nothing happens to derail the U.S.

or global economies and to reignite "safe haven" bond buying, the latest consensus estimate (from the *Wall Street Journal*'s May poll of forecasters) is that by the end of 2018, the 10-year U.S. Treasury yield will be a full 1% higher, at 3.3%, than it is today, which would imply a capital loss of some 8% on the benchmark Treasury.

There is likely to be less pressure on still ultra-low bond yields in other major markets, but they too will face some headwinds: a combination of the knock-on effect of higher U.S. yields and the eventual prospect of normalisation of their own monetary policies. For the time being, the European Central Bank is still in full stimulus mode, including adding to its QE hoard of bonds, but the progressively strengthening eurozone economy will likely lead to a change of course some time next year. And the Bank of England has also said that it might have to raise rates a bit earlier than the markets currently expect, though its timing looks to be more like 2019 rather than 2018. Only in Japan does it look likely that bond yields will be kept very low for the indefinite future.

While bonds always carry some useful insurance value—and as noted elsewhere, investors in the equity markets appear to be ignoring potential risks, so some insurance against nasty surprises may well be worthwhile—overall, the economic fundamentals are running against the asset class.

International Equities — Review

After a quiet period in March and the first half of April when world shares traded sideways, shares have risen in late April and month to date, helped by a rally in eurozone equities after the first round of the French presidential election on April 23, and by ongoing high investor confidence in the U.S. As a result, at the time of writing, the DAX index in Germany, and both the S&P500 and Nasdaq indices in the U.S., had reached all-time highs.

Overall, year to date, the MSCI World Index is up 7.4% in capital value in the currencies of its component markets, and up 8.6% in U.S. dollar terms (9.5% including the taxed value of dividends). Among the developed markets, the best performers have been the big eurozone economies, with the DAX up 11.5% and France's CAC index up 11.4%. The S&P500 is up 7.3%, while there were lesser contributions from the U.K. (FTSE100 up 4.4%) and Japan (Nikkei up 4.0%).

Emerging markets have been outperforming the developed economies all year, with the MSCI Emerging Markets Index year to date up 12.7% in the emerging markets' own currencies, and by 17.2% in U.S. dollar terms. Once again, the biggest gains arose in India, where the Sensex was up 13.9% and the rupee appreciated by 6.1% against the U.S. dollar, and in Brazil, where the Bovespa index rose 13.7% and the Brazilian real rose by 4.9%.

International Equities — Outlook

In the U.S., the latest data has been a mixed bag. Although the single most-watched indicator, new jobs, has been doing well (211,000 new jobs in April, at the upper end of expectations), and consumer confidence has been rising, both April's retail sales and April's inflation rate came out a little lower than expected, hinting that the economy may not be running as strongly as anticipated. Even so, the latest data look more like a wobble than a shock, and forecasters remain confident about the outlook. The *Wall Street Journal* panel of forecasters is picking that the U.S. economy will grow by 2.0% to 2.5% this year and in 2018 and 2019, and it is also becoming less worried about downside risks with the panel putting only a 15% possibility of a recession within the next year, down from 20% a year ago.

The news from the rest of the world is also good, particularly in the formerly sluggish eurozone where a wide range of indicators are pointing to an acceleration in economic activity. The latest IHS Markit eurozone "composite" surveys (taking in both manufacturing and services) "portray an economy that is growing at an encouragingly robust pace and that risks are moving from the downside to a more balanced situation."

Markit aggregates its national and regional purchasing manager surveys into a global aggregate, the J. P. Morgan Global All-Industry Output Index, and it too is travelling well, with the latest (April) reading showing that "Growth of global economic output was maintained at a solid clip at the start of the second quarter." When sliced by industrial sector, the global survey shows that, remarkably, every single sector is currently in expansion mode, with the strongest rates of growth being seen in technology, the industrials, and healthcare.

The economic backdrop for corporate performance consequently looks reasonably good. In the U.S., for example, share analysts (on the data compiled by data company FactSet) expect that profits for the S&P500 companies will increase by 11.8%. While the figure is distorted by a massive turnaround in the energy sector (where profits are expected to soar by 45%, due to higher energy prices), most sectors (excepting real estate, the utilities, and telco services) look set for solid profit growth.

But, as has been the case for some time, the positive outlook needs to be tempered by noting expensive equity valuations and potential investor overoptimism. Valuation concerns are especially severe for the U.S. market—while, as noted, investors expect strong profit growth, they are also paying substantially more for it than they normally would. Estimates of the forward-looking price/earnings ratio vary in detail—the ratio is around 17.5 times expected profits, give or take—but agree that whatever the exact number is, it is well above normal. Some of this reflects the world of unusually low interest rates, where investors have been prepared to pay more for nonbond assets, given the very poor value on offer on fixed interest. But that support is on the turn as bond yields threaten to rise. All may yet turn out well, but a combination of pricing for corporate performance perfection and a deterioration in relative equity-bond value makes the future going rather harder.

The other potential issue is investors' apparent disregard of potential risk. The most widely publicised example is the unusually low level of the VIX, the measure of investors' expected volatility from holding the S&P 500 Index, and which has headed even lower in recent days. But going by similar indices for other asset classes, investors are also expecting unusually little turbulence in, for example, European equities, global bond markets, and foreign exchange markets.

Again, events might pan out just fine, and there have even been some pleasant upside surprises, notably the French presidential election result, but investing is a road with bumps in it, and investors expect to be compensated for the risks they run. Currently, they may be underestimating the likely potential for unexpected upsets, and consequently paying too much for assets that carry more risk than they are allowing for.

Performance periods unless otherwise stated generally refer to periods ended May 15, 2017.

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