Economic Update

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Outlook for Investment Markets

World equity markets, after recovering from February through to late April, have softened again more recently in another episode of uncertainty over global growth prospects, especially in the eurozone and Japan. While the global economic outlook remains modestly positive, it carries several downside risks, and recurrent outbreaks of anxiety may well feature during the rest of this year. Global bond yields have dropped to even lower levels again, and now look more likely to stay at these ultra-low levels for some time. Local equities have modestly outperformed global equities, as the latest data on the prospects for the Australian economy have generally been positive. The Reserve Bank of Australia, or RBA, looks likely to cut interest rates again, after its surprise cut earlier this month.

Australian Cash & Fixed Interest — Review

Short-term rates have fallen in recent weeks. Up to 27 April, they had been steady, with the 90-day bank bill yield at around 2.3% or a tad less (2.27% on 26 April). But on 27 April, the news came out that consumer prices in the March quarter had unexpectedly fallen, by 0.2%, and the money markets began to think about a consequential easing of monetary policy: the 90-day yield dropped to under 2.2%. It was, however, by no means certain the RBA, would cut rates. When on 3 May they did cut the cash rate from 2.0% to 1.75%, the 90-day yield dropped further, to just above 2.0%, and has stayed there since. Long-term interest rates have fallen, partly following overseas trends and partly reflecting domestic developments—the unexpectedly low inflation, the surprise easing by the RBA, and the possibility of further easing to come. The 10-year Commonwealth bond yield is now 2.3%, down 0.6% since the start of the year. The lower yields have translated into capital gains for bond holders: the S&P/ASX Australian Government Bond Index returned 4.1% and the S&P/ASX Corporate Bond Index returned 3.03% year to date, and both have comfortably outperformed the 0.78% return from the S&P/ASX Bank Bill Index. The Australian dollar has been weak, especially since the RBA's interest rate cut: the Australian dollar was trading at USD 0.76 the day before the cut, traded at USD 0.75 the day after, and has since weakened further to USD 0.73. Year to date the AUD is down 1.9% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The main reason for the RBA's surprise cut was lower than anticipated inflation. In the March quarter, the annual headline rate of inflation was 1.3%, and the "core" rate (the rate the RBA is particularly interested in) was 1.55%, well shy of the 2.0% economic forecasters had been expecting.

The RBA said "Inflation has been quite low for some time and recent data were unexpectedly low. While the quarterly data contain some temporary factors, these results, together with ongoing very subdued growth in labour costs and very low cost pressures elsewhere in the world, point to a lower outlook for inflation than previously forecast." Subsequently, the RBA updated its inflation forecasts to show it does not now expect inflation to get back up to 2% (the bottom end of the RBA's target range) before 2018.

Other forecasters, and the financial markets, have been making similar adjustments to their expected outlook, generally tending in the same direction—compared with their previous views, they now envisage lower inflation, lower short-term interest rates, less of an increase in bond rates (or none at all), and a weaker Australian dollar. The financial futures market, for example, expects another 0.25% cut from the RBA, which would take the 90-day bank bill yield down to 1.7% by the end of this year, and there could well be more—the most up-to-date forecaster at time of writing was the Commonwealth Bank of Australia, which had just issued an update expecting two further cuts in the cash rate, to 1.25%.

Bond yields are now expected to rise only modestly. Low inflation, easier local monetary policy, and less upward pressure from U.S. bond yields as interest rate expectations have been wound back in the U.S., all point

the same way. By the end of this year, the 10-year Commonwealth bond yield will have risen to 2.5% (the view of Commonwealth Bank), 2.65% (National Australia Bank) or 2.75% (Westpac Bank). Even these small forecast increases could be wound back, however, in the next round of forecast revisions.

There is less unanimity on the direction of the Australian dollar. Most forecasters expect the lower interest rate track now likely in Australia will translate into a lower track for the Australian dollar. At best (Westpac's view), the Australian dollar will still be around current levels (USD 0.73) at the end of this year, but then drop modestly to around USD 0.70 by the middle of next year. On this lower-Australian dollar view, the depreciation could be rather more: National Australia Bank thinks the Australian dollar will be worth USD 0.68 in a year's time, and ANZ Bank reckons USD 0.66. But not everyone is in the "lower Australian dollar," and it is possible that other factors (such as commodity prices, Chinese growth, or the dividend attraction of Australian equities or listed property) could outweigh the impact of lower local interest rates. It is a minority view, but the Commonwealth Bank, for example, sees the potential for the Australian dollar to appreciate, to USD 0.78 by the end of this year and to USD 0.80 in a year's time. As ever, currency forecasting remains a highly problematic exercise.

Australian & International Property — Review

The A-REITs have performed strongly year to date, with the S&P/ASX 200 A-REIT Index recording a capital gain of 10.9%, and a total return including dividend income of 11.9%, substantially in excess of the 0.6% capital gain and 2.4% total return for the wider S&P/ASX 200 Index.

Global listed property has also outperformed global equities, though not quite as spectacularly. Year to date, the FTSE EPRA/NAREIT Global Index in U.S. dollars has delivered a net return (including the taxed value of dividend income) of 4.5%, compared with the negative 0.7% net return from the MSCI World Index. The returns were strongest in regions where monetary policy has been most stimulatory, with lower bond yields leading to stronger demand for property income and to upward property valuations. The German market returned 11.0% and the French market 10.4%, although the overall eurozone return of 7.0% was dragged down by a 7.5% loss in Italy. Japan also saw the effect of very easy monetary policy, returning 8.6%. The U.S. market returned 5.7%, while the U.K. market was affected by "Brexit" worries, and had a net loss of 7.9% (all regional returns are on a common, net return in U.S. dollars, basis).

Australian & International Property — Outlook

The latest of National Australia Bank's comprehensive reviews of the commercial property sector, for the March quarter, shows an operating environment that is middling at best and which is likely to translate into only very modest increases in rents and capital values. Over the next year, for example, office rents are expected to move only 1.1% higher (largely due to an expected 3.2% increase in New South Wales), industrial rents are expected to rise by only 0.5% (mostly due to Victoria and New South Wales), while retail rents are expected to drop very slightly, by 0.1% (mostly down to a weak Western Australia market). There are equally modest expectations for capital growth.

As with many other listed property markets, however, investors may not be too concerned about operational performance, or about the relatively expensive valuations of the REITs by historical yardsticks such as price/net tangible asset value. All that appears to matter in current market conditions is that the REITs continue to offer an acceptable pickup in yields over bonds, and the current yield of 4.6% compares well with the current 2.3% on 10-year Commonwealth bonds. The sector will continue to outperform if investors remain heavily focused on income differentials, and remain prone to look for less defensive equity sectors in periods of equity market volatility.

The outlook for global listed property is rather akin to that for global equities as a whole: overall, ongoing modest global economic growth is tending to support property performance, but there are marked regional differences

and higher-than-usual levels of political and economic risk. The March quarter Royal Institution of Chartered Surveyors, or RICS, survey of global commercial property showed "sentiment across developed economies in general remains solid, with occupier and investment demand for commercial real estate increasing. Meanwhile, the softness in commodity prices continues to place financial pressure on many emerging markets heavily reliant on exports and this is being reflected in a rather downbeat near-term outlook for the commercial property sector."

The hottest markets in the RICS survey, from a combined perspective of tenant and investor demand, are in Europe (Germany, Ireland, Hungary and Portugal in particular) and Japan; with the U.S., which dominates international listed property indices, also doing reasonably well. The weakest are markets most exposed to any Chinese slowdown, to commodity prices, or facing political risks, with some countries fitting into multiple boxes (Brazil, Indonesia, Russia).

The diverse prospects for regional markets likely offer opportunities for active property fund managers who are prepared to head off the beaten benchmark track, but that is likely to be a sideshow to the main event. The principal driver of the sector has been, and looks set to remain, the income differential between the 3.6% yield on the FTSE EPRA/NAREIT Global Index and the 1.33% yield on the Barclays Global Aggregate Bond Index. Both yields are abnormally low, and both asset classes look very expensive, but as long as the differential persists, income-oriented investors are likely to continue supporting global property.

Australian Equities — Review

Australian equities shared in the general global strength of February through April, and although they dipped briefly in late April in line with global markets, more recently, they have been rising again whereas global markets have continued to weaken. In terms of capital value, the S&P/ASX 200 Index is now 0.6% ahead of where it started the year, and has provided a total return including dividends of 2.4%.

Other than the REITs (discussed in their own section), the top performing sectors were the miners (up 16.7% in capital value) and the industrials (up 10.1%). Shares linked to discretionary consumer spending also gained, by 3.7%. Australian shares would have done rather better but for the drag of the financials, which have a large 45.7% weighting in the index and which lost 5.0% in capital value, with investors concerned about the potential for rising levels of bad debts and the sustainability of current dividend levels. Performance was also held back, to a lesser extent, by falls in IT shares (down 1.4%) and consumer staples (down 1.1%).

Australian Equities — Outlook

Recent data shows an economy that is either continuing to grow at a reasonable rate, though still suffering the side-effects of lower mining investment, or even picking up a bit from its recent rate of growth. Although the RBA's cut in interest rates on 3 May might at first suggest the economy needed some stimulus, the move was very largely focused on unexpectedly lower inflation rather than on any serious slowdown, with the RBA saying "the available information suggests that the economy is continuing to rebalance following the mining investment boom" and "Indications are that growth is continuing in 2016, though probably at a more moderate pace" than in late 2015.

In any event, the RBA's cut has had an immediate impact on consumer confidence, which rose very strongly in April on the Westpac/Melbourne Institute Consumer Sentiment measure. In particular, households have become markedly more optimistic about the economic outlook on both a one-year-out and a five-years-out basis.

Business surveys also show ongoing growth. The latest (April) Australian Industry Group sectoral indices show manufacturing has been expanding for 10 months in a row, construction has just moved into expansion mode, and the services sector, which has been a drag on growth, has

improved and is now only just below the 50% level that would show it too, is growing. And National Australia Bank's latest (April) business survey showed business conditions (what is actually happening to firms' trading, employment and profits) are holding up well saying, "Business conditions eased back to +9 points in April, but this was still an above-average result that is consistent with an ongoing recovery in the non-mining economy."

However, once again, the key issue for investors is whether share prices are aligned with the likely profit outlook from this reasonably promising economic backdrop. As it happens, we got a good steer on likely profits growth in the 3 May Budget—Treasury included its latest forecasts of growth in pre-tax and pre-depreciation corporate profits (it prepares them because it needs to forecast the company tax take). Treasury expects GDP to have grown by 2.5% in the current fiscal year to June 2016, by 2.5% again in the year to June 2017, and by a faster 3.0% in the year to June 2018. It expects this GDP growth to translate into corporate profits growth of 5.25% in the year to next June, and by 5.75% in the year to June 2018, with ongoing modest growth thereafter (5.25% in the year to June 2019, 4.75% in the year to June 2020).

Currently, the sharemarket is priced at 16.7 times expected earnings (on Standard & Poor's estimates), which is arguably down the expensive end. It is, for example, close to the 17 times forward earnings ratio of the S&P 500 Index in the U.S., which is itself regarded by analysts as richly valued. Data provider FactSet, which has a similar estimate of the forward U.S. ratio (16.6 times), notes it is above its longer-term five-year average of 14.3 times earnings.

The valuation of the Australian market also does not leave room for much to go wrong on commodity prices. Until recently, commodity prices have been recovering: iron ore futures, for example, rose strongly from mid-January to mid-April, and the shares of the miners have benefited as a result. In recent weeks, however, the likes of iron ore futures have dropped off again, and it is possible the earlier price rises may have been boosted by high levels of speculative trading in China in commodities such as copper and iron, and may not have reflected genuine long-term improvement in demand.

Even so, with the economy in reasonable shape, and an internationally attractive dividend yield of 4.5%, the Australian market could well defy its valuation and continue to outperform its overseas equivalents.

International Fixed Interest — Review

Global interest rates have generally headed a little lower in recent weeks. From one perspective, this has been somewhat surprising. Bond yields had dropped to remarkably low levels in February as investors had fretted over the global economic outlook and had sought the relative safety of bonds. With investor confidence recovering in recent months, less "safe haven" buying (and hence higher bond yields) might have been expected to follow, and at first that seemed like the most likely outcome. In the U.S., for example, the 10-year Treasury yield rose from its early February low point of 1.66% to 1.98% on 11 March, and as recently as 26 April, it was still 1.93%. In more recent weeks, however, as equity markets have weakened, bond demand has picked up, the yield has started to drop again, and is now down to 1.71%.

As well as reflecting some greater equity disquiet, the recent drop also reflects changed expectations around U.S. monetary policy: the U.S. Federal Reserve is now expected to raise interest rates by less, and later, than previously thought. Easier monetary policy elsewhere has also contributed. In the eurozone, stepped-up monetary stimulus from the European Central Bank, or ECB, has helped push bond yields down, both directly through its impact on eurozone interest rates, and indirectly, as investors have moved from eurozone markets to other bond markets (such as the U.S.) which still offer a higher running yield. The German 10-year government bond yield has dropped from 0.3% on 26 April to its current 0.15%. And in Japan, although the Bank of Japan unexpectedly did not increase the scale of its already enormous monetary stimulus at its latest policy meeting, the markets still

expect some further easing in coming months, and the 10-year Japanese government bond yield has become even more negative, and is currently negative 0.11%.

The headline news has been that many government bond yields have turned negative. According to a recent report from ratings agency Fitch, there is now USD 9.9 trillion worth of negative yield government debt globally, USD 6.8 trillion being bonds and USD 3.1 trillion shorter-maturity bills. More surprisingly, some corporate bond yields have also turned negative. Yields on euro-denominated corporate bonds, for example, became negative for the best names (those rated A to AAA) in mid-January and have remained negative since (at around negative 0.2% for 1- to 10-year issues, on the Bank of America Merrill Lynch Index).

The result of lower government bond yields, and lower credit premia on corporate bonds, is fixed interest has performed well as an asset class, year to date. The Barclays Capital Global Aggregate has returned 6.7% in U.S. dollar terms, with global government bonds returning 8.2% and global corporate bonds 5.85%. Global "high yield" (low credit quality) bonds returned 7.2%, partly because of the higher running yield (7.0%) and partly because of investors' increased willingness to take on more credit risk to generate higher levels of income when yields on high-quality bonds are extremely low. The yield on the global government bonds in the Barclays index, which have an average maturity of just under eight years, is only 0.78%.

International Fixed Interest — Outlook

There are a mix of positive and negative influences affecting the outlook for international fixed interest.

On the positive side, any moves in the U.S. towards less supportive monetary policy and higher interest rates are likely to be modest and gradual, especially in the wake of the latest jobs data which showed a slower than expected number of new jobs. Economic forecasters (going by the responses to the latest, May *Wall Street Journal* poll of U.S. forecasters) reckon there is a decent chance the Fed will raise rates at either its June or September meetings, but in this instance, it is probably better to adopt a "follow the money" assessment. The Chicago Mercantile Exchange's "FedWatch" indicator, which calculates the financial futures market's implicit probability of Fed moves, currently sees virtually no chance of any near-term move, is betting against a September move, and sees the chance of an increase at the Fed's December meeting as no better than evens. In turn, this is leading forecasters to wind back their expectations for U.S. bond yields: the latest *Wall Street Journal* poll expects the 10-year U.S. Treasury yield to rise to only 2.24% by the end of this year.

Monetary policy elsewhere in the developed world is expected to remain ultra-supportive. In the eurozone, for example, the ECB has increased its "quantitative easing" programme of bond buying, and next month, will extend it to corporate bonds, and the Bank of Japan is also expected to up the scale of its monetary policy support. The situation is less clear in the U.K.—the "Brexit" vote is on 23 June—but if the U.K. remains in the European Union, current futures pricing indicates monetary policy is expected to remain at its current supportive level out to 2019. However, if "Brexit" occurs, there is a chance rates might have to be cut to offset the downside economic impacts of departure.

The good news, in sum, is there is little imminent risk of bond rates heading back to more normal levels and inflicting capital losses in the near term. There is also a school of thought that believes we could be moving into a new era of permanently slower growth and lower inflation, which would reduce the risk of higher bond yields and capital losses over the medium to long term as well. And as market moves year to date have shown, bonds have proven an effective asset to hold through episodes of equity market volatility.

However, there are also significant risks. Current exceptionally low yields are predicated on the global economy growing very slowly and generating very little inflation, and are very vulnerable to any improvement in the

global economy. Any signs the major central banks have, in fact, started to work inflation back up to the target levels they would like to see—generally around the 2% mark—would leave bond yields exposed as incongruous.

The second main risk is that, as yields on standard higher-quality fixed interest assets such as 10-year government bonds have dropped to ever-lower levels, investors have taken two routes to try to maintain income levels. One is to extend their maturities: governments have found ready demand for ever longer maturities. Latvia, for example, has just issued its first 20-year bond, while Switzerland has issued 42-year debt, France and Spain have issued 50-year debt, and Belgium and Ireland have even managed to place 100-year debt with investors. The other route is to take on more credit risk and to venture into sub-investment-grade assets.

Both of these tactics have their dangers. Mathematically, for any given interest rate rise, longer-maturity debt is more exposed than shorter-maturity debt to capital loss, while credit risk premia for lower-quality debt are there for good reason as they need to compensate for the risks of default. Currently, those risks are rising. On the latest count by ratings agency Standard & Poor's, there have already been 62 defaults this year, the highest year-to-date number since the late global financial crisis period of 2009.

At the moment, corporate and government treasurers are issuing huge quantities of debt, at ever longer maturities and ever lower yields. Investors are buying them, because that's all there is available to generate income without running the equity volatility of dividend income. But the treasurers think this is an unusual window of opportunity to raise exceptionally cheap funds. The treasurers' view looks the better one.

International Equities — Review

World sharemarkets had a strong recovery from mid-February through to late April, as investors regained confidence after doubts at the start of the year about the strength of the global economy. In more recent weeks, however, shares have eased back from their late April highs as investors have again started to wonder about the prospects for global corporate profits.

The net effect of the various shifts in mood has been world shares are now slightly down on where they started the year. In the currencies of the various overseas markets, the MSCI World Index is down 3.1% in capital value year to date, and down 1.6% in U.S. dollar terms. For local investors, the outcome was effectively the same, with the 0.1% depreciation of the Australian dollar against the U.S. dollar making little difference.

Among developed markets, uncertain economic prospects in Japan and the eurozone have been the major drag on year-to-date performance. In Japan, the Nikkei is down 13.8%, and in Europe the FTSEurofirst 300 Index is down 8.5%, with Germany's DAX Index down 7.4% and France's CAC down 6.8%. The U.K. had a relatively small decline, with the FTSE 100 Index down only 1.7%, while the U.S. was the only major market to show a gain, and even then, it was only a marginal 0.1% increase for the S&P 500 Index.

Emerging markets are effectively all square for the year, with the MSCI Emerging Markets Index formally up 0.2% in U.S. dollar terms, but its major components had strongly contrasting outcomes. Russian shares rose strongly, with the FTSE Russia IOB Index up 20.3% as world oil prices recovered, and Brazilian shares also did very well, with the Indice Bovespa gaining 19.5% on hopes of political change for the better. Chinese shares, however, have remained very weak, with the Shanghai Stock Exchange Composite Index down 20.1%, while Indian shares have not shown much net movement this year—the BSE Sensex Index is down slightly, by 2.4%.

International Equities — Outlook

The global economic outlook continues to be middling rather than strong. As the J.P. Morgan Global Services Business Activity Index (produced with Markit) for April showed, the world economy is growing, but "the rate of expansion remains weak by historical standards." The U.S.

looks the best out of the major developed economies, with more uncertain prospects for the eurozone, Japan and the U.K. As an overall group, the emerging markets look set for rather more substantial rates of economic growth, albeit with very large differences at an individual country level, and with higher degrees of political risk involved for investors minded to access their better economic prospects.

U.S. economic data has ranged from mixed to good. The most important statistic for the financial markets at the moment is the jobs numbers, and the latest data (for April) were a mix of good and bad. On the plus side, there were new jobs (160,000), but not quite as many as the forecasters' consensus had expected (200,000), and the unemployment rate was steady at 5.0% rather than declining a bit to 4.9% as forecasters anticipated.

Many analysts drew the "glass half empty" conclusion that the U.S. economy was not quite strong enough to cope with a series of interest rate increases by the Fed, but more recent data is more consistent with a "glass half full" view. Retail sales increased by a strong 1.3% in April, a much larger increase than expected, and the data was still impressive even after correcting for the volatility that car sales and petrol prices cause: ex cars and petrol, sales were up a solid 4.4% on a year ago. There was also a very strong rise indeed in the May consumer sentiment index compiled by the University of Michigan, where "Consumer sentiment rebounded in early May due to more frequent income gains, an improved jobs outlook, and the expectation of lower inflation and interest rates." It was notable there was an especially large rise in households' expectations about the coming year, which bodes well for economic growth in coming months.

The outlook in the eurozone and Japan is less upbeat. The latest data in the eurozone has not been strong: German industrial production, for example, unexpectedly dropped in March (negative 1.3% compared with expected negative 0.2%), and year on year was up only 0.3% compared with the 1.1% expected in a Bloomberg economists' poll. France has also underperformed against expectations with a year to year with 0.8% drop in industrial production in March, compared with the 0.5% gain forecasters had been picking. The European Commission's latest (May) set of forecasts says the eurozone will grow this year and next, but at rather modest rates, with eurozone GDP growing by 1.6% this year, and by 1.8% in 2017.

Japan's prospects are unclear. In theory, the economy should be benefitting from easier fiscal and monetary policy, and from "structural reform" aimed at making its industries perform more effectively. In practice, the payoffs have appeared distinctly modest: the Japanese economy did not grow at all in 2014, and grew only marginally in 2015. Forecasters are uncertain whether this year will be much better with the range of views in the *Economist*'s latest (May) poll of international forecasters ranging from a GDP fall of 0.4% to an increase of 1.0%, with an average forecast of modest 0.5% growth.

The outlook for emerging markets is mixed. China has assorted problems, notably high levels of corporate debt and a shaky financial sector more generally, but is still expected to grow (on the consensus view in the latest *Economist* poll) by a substantial 6.5% this year and by 5.9% next year. The forecasters also expect India to do very well with 7.5% growth this year, 7.1% in 2017, and this year's recessions in Argentina, Brazil and Russia are expected to turn around to modest growth next year. But there are also some very weak economies, notably Venezuela, which is close to economic collapse, and some seriously underperforming economies. South Africa, for example, saw its unemployment rate rise to 26.7% in the March quarter, worse than forecasters had expected.

Even if the overall economic performance of the emerging markets delivers for investors, the level of political risk remains high. A good example is Brazil where the currency, the share market and local bond yields have experienced dramatic day-to-day levels of volatility in the wake of the twists and turns in the ongoing impeachment process of President Dilma Rousseff.

The outlook for international equities is for a slowly growing world economy with modest overall growth in corporate earnings. But this outlook is expensively priced, mostly because ultra-easy monetary policies have inflated the values of all kinds of financial assets, and comes with what the European Commission's forecasters called "considerable downside risks." They were particularly concerned about "the risk that slowing growth in emerging market economies, particularly China, could trigger stronger spillovers or turn out worse than currently forecasted remains particularly significant for growth in Europe and the world," and they also mentioned high levels of geopolitical tension, and potential adverse surprises from commodity prices or financial shocks. We could well see the year-to-date pattern of equity markets persisting in coming months: shares do well for a time, but are subject to recurrent reality checks as investors reconsider the likelihood of downside risks eventuating.

Performance periods unless otherwise stated generally refer to periods ended 13 May 2016.

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