Economic Update

Sydney | 18-03-16

March 2016

Outlook for Investment Markets

Equity markets have staged a strong recovery from the sharp sell-off of January/February, although in most cases, the recovery has not yet clawed back all of the earlier losses. Investors appear to have become less nervous about a range of risks (the global economy, U.S. monetary policy, China, emerging markets, the impact of low oil prices, banking sector stress). Overall, the global outlook is for further slower-than-usual growth in the world economy, albeit with downside risks, which could yet provoke further periods of volatility. In Australia, there are signs business activity in the non-mining economy is picking up pace, while the miners have benefited from a turnaround in global commodity prices.

Australian Cash & Fixed Interest — Review

Short-term interest rates have remained steady year to date, with the 90-day bank bill yield trading at about 2.3% (currently just above, at 2.33%). Longer-term interest rates continue to reflect the influence of overseas markets, with yields falling—the 10-year Commonwealth bond yield has dropped from just under 2.9% at the start of the year to just under 2.6% currently. Year to date, the S&P/ASX Fixed Interest Index has provided a total return of 1.1%, with contributions from both government (1.2%) and corporate (0.6%) bonds. The Australian dollar has strengthened—year to date, it is up by 2.5% against the U.S. dollar, from USD 0.731 to USD 0.749, and by 1.4% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The Reserve Bank of Australia, or RBA, at its latest policy meeting on 1 March said "inflation is likely to remain low over the next year or two," and as a result "continued low inflation may provide scope for easier policy, should that be appropriate to lend support to demand." While the text would suggest the RBA may lean towards a rate cut this year, opinion remains split on whether it will actually do so. The ANZ Bank is confident it will, with its forecasters picking two 0.25% cuts are in the pipeline. However, it is on its own among the big four banks, with the other three inclined to believe the RBA will leave rates alone. The futures market is currently splitting the difference, with its pricing having 90-day bank bills 0.2% lower by the end of the year, which would be consistent with one 0.25% cut by the RBA.

Australia is relatively unusual among developed economies, in that inflation this year is widely forecast to be around 2% on a headline inflation basis, or a bit higher on an underlying basis (excluding volatile items like petrol). Other central banks have struggled to get their local inflation rates up to that level. There is a bit more underlying pressure towards higher bond yields in Australia as current bond yields barely offer a positive real rate of return (over and above inflation). That said, most forecasters expect any increase in yields to be quite modest, with Westpac Bank picking a yield a little above 3% at the end of this year, and the National Australia Bank picking 3.3%. On the other hand, forecast inflation in many developed economies has failed to materialise as anticipated, and the Commonwealth Bank's pick of unchanged bond yields this year may be closer to the mark.

The outlook for the Australian dollar remains enmeshed with the state of investor confidence. The Australian dollar was sold off during the period of high investor anxiety in January and early February—on 20 January, it got as low as USD 0.687. More recently, improved international investor sentiment has supported the Australian dollar, as has some modest improvement in export commodity prices (particularly iron ore and gold). The RBA has not been especially forthcoming with its analysis, for example: "The exchange rate has been adjusting to the evolving economic outlook" did not add much to the total sum of human knowledge. However, private sector economists currently believe

the Australian dollar's recent rise against the U.S. dollar has gone too far. All four big banks expect the Australian dollar to be lower by the end of this year, with the high USD 0.60s a popular pick. The odd one out is the ANZ Bank. Its view the RBA will take local interest rates 0.5% lower means it expects the Australian dollar to trade significantly lower, and to finish the year at about USD 0.64.

Australian & International Property — Review

Once again, the A-REITs have shown their defensive value, with a relatively limited sell-off during the January/February volatility, and a relatively quick and strong recovery, they have easily outperformed the wider sharemarket. The S&P/ASX 200 A-REIT Index has delivered a capital gain year to date of 4.5%, compared with the S&P/ASX 200 Index's capital loss of 2.4%, and a total return including dividend income of 5.5% compared with the S&P/ASX 200 Index's 1.2% loss.

Global listed property has behaved much the same as global equities: year to date, in terms of net return in U.S. dollars, the FTSE EPRA/NAREIT Global Index is down by 1.6%, compared to the 2.2% decline in the MSCI World Index (also in U.S. dollars). The result would have been considerably better but for a 14.2% decline in the U.K. market. As the managers of the TR Property Investment Trust (a U.K.-based REIT investing in European and U.K. property) commented, "it was the U.K. names—particularly the large caps and London-centric names who saw further aggressive selling pressure." Investors expect yield expansion (50 basis points is priced in) [higher yields mean capital losses] and worry about renewed supply (we don't) as well as the uncertainty around Brexit." Other markets have typically seen small year-to-date moves, with, for example, the U.S. market up 1.3%, Asia up 0.3%, and the eurozone unchanged.

Australian & International Property — Outlook

Operating conditions for property mirror the national economy: ongoing economic growth in the non-mining economy has led to stronger performance in some subsectors, notably the Sydney and Melbourne central business district, or CBD, office markets, but the wind-down of the mining boom continues to drag on others. The Perth office vacancy rate is currently around the 20% mark, for example, and is still rising. Overall, National Australia Bank's recent quarterly survey of commercial property found property professionals were expecting only very modest increases in rentals in the still-subpar economy.

The modest underlying performance of the sector has, however, been more than counterbalanced by high levels of yield-driven demand, both domestically and from overseas.

CBRE's recent Investor Intentions Survey of Asian institutional cross-border property investors, for example, found Australia is now the most popular intended destination (displacing Japan, the 2015 favourite).

However, as in many other markets, the search for sustainable yield is pushing valuations to rather expensive levels. Colliers' latest research and forecast report on the CBD office markets, for example, quoted several investors who felt once-attractive investments were now pricey. One said "Australian property is becoming expensive, even relative to major cities such as London. Yields are still higher, however, once incentives (11% incentives for London prime office compared to Sydney at 30%) and interest rates are taken into account, the gap becomes minimal. A decade ago, this was not the case."

Both physical and listed property are now on the expensive side, with the A-REITs trading at a premium of about 25% compared to their net tangible asset backing; a valuation which is some 10% higher than their historical premium. But with cash and bond yields still unusually low, and investors also mindful of defensive options against further episodes of global

economic volatility, the A-REITs may well remain in demand.

Global listed property is a mixed bag, reflecting the mixed fortunes of the major economies, ranging from sustained expansion in the U.S. through to persistently sluggish conditions in Japan. Currently, many property investors are keen on Europe (and may be even keener following the European Central Bank's, or ECB's, latest stimulus). Many have come to the same conclusion that European property is in a "sweet spot," where occupier demand is starting to pick up, but new supply of space has yet to respond. Knight Frank's latest European Commercial Property Outlook report, for example, said, "Although improved occupier demand has, to date, resulted only in moderate office rental growth outside of hotspots such as Dublin and London, rental increases should become more widespread in 2016, supported by the diminishing availability of prime office space in European CBDs." In the same vein, Savills' latest German office market report found "The six largest office letting markets in Germany are enjoying an uptrend characterised by growing demand, rising rents and declining vacancy rates ... Owing to the sustained supply shortage, which may conceivably worsen, rental growth is likely to continue over the coming years. In (good) B locations, the rental growth may well even accelerate."

Another theme of these reports, however, is property investors remain concerned about the potential impact of global economic or financial setbacks, which explains why global listed property has been behaving very similarly to global equities. Although they themselves did not subscribe to the likelihood of a GFC rerun, CBRE noted in their recent report on the outlook for European property, "The big downside risk is that emerging-market debt problems turn into another financial crisis that affects occupiers and investors alike." The CBRE Asia Pacific Investor Intentions Survey 2016 similarly found "A greater number of respondents (58%) identified the domestic and global economy as the greatest threat to the Asia Pacific real estate market this year, compared to last year's 29%."

On the upside, the same forces supporting global equities are likely to carry global listed property with them. But on the downside, the likelihood in current circumstances is global listed property is unlikely to offer defensive protection should equity markets hit another squall.

Australian Equities — Review

Year to date, local considerations have been very much secondary to global trends. Although the Australian economy has been doing reasonably well, the local sharemarket was sold off, in line with global markets, up to mid-February. More recently, it has been a beneficiary of the global recovery in equity investor confidence, although the recovery from the market low on 12 February has not been quite strong enough to take the market into positive territory for the year. The S&P/ASX 200 Index is still down year to date by 2.4% in capital value and by 1.2% in terms of total return.

For once, the miners performed well, and are up 6.9% on the back of stronger world commodity prices. The industrials however haven't done so well, with a 3.6% loss. Consumer stocks are slightly down (staples down 2.0%, discretionary down 2.9%). Financials, which comprise a large portion of the S&P/ASX 200 Index have been a major drag on the index with a 5.5% loss, due to global worries about the financial sector. IT stocks have also fared poorly, with a 9.3% decline.

Australian Equities — Outlook

The RBA's assessment of the economy (released on 15 March in the minutes of their 1 March policy meeting) was that "the domestic economy had continued to grow at a slightly below-trend pace. There had also been further signs of a rebalancing of activity towards non-mining sectors of the economy, aided by the low level of interest rates and the depreciation of the exchange rate over the past couple of years."

This official assessment of "more of the same," as the non-mining economy does reasonably well while the mining investment boom winds down, may, however, be a bit on the downbeat side, as recent business surveys show a somewhat stronger picture. The Australia Industry Group, or AIG, sectoral indices for February, for example, were quite positive. Manufacturing has been growing for the eighth month in a row, the services sector turned around from contraction to expansion. AIG noted "New orders recovered from a four month contraction ... This promising reversal suggests that sales could pick up further, later in 2016." Although construction remained weak, it did not get any worse than previously.

The latest monthly National Australia Bank business survey was noticeably strong. The National Australia Bank team commented "The Australian economy appears to be performing better than many had expected, and this month's business survey gives no signs that this is wavering. The NAB Business Survey showed a notable improvement in business conditions during February, jumping to +8 points, more than unwinding the decline from last month, which was primarily driven by Australia's mining states...Forward indicators were more positive as well." Actual business "conditions" (as opposed to business "confidence") are a composite of firms' actual trading, employment, and profitability. National Australia Bank have looked at how this correlates with GDP, and at current levels of business conditions, the Australian economy could well be growing at about a 3.5% annual rate, a clear step up from the 2.8% year-on-year growth recorded in the December quarter.

This should be a decent, though not spectacular environment for corporate profitability. Unfortunately, it is not easy to get a clear handle on what is happening to underlying profitability, as the aggregate numbers have been distorted by sharp falls in the miners' profits, and by large one-offs (notably Woolworths' write-down of its Masters hardware stores). On the data collected by share broker CommSec, for the companies that reported six-monthly profits for the December 2015 half-year, reported profits almost halved (down 46.6%) compared with the previous half-year. Ex BHP Billiton, the drop in profits was only 6.4%. Ex BHP Billiton and fellow miner South32, profits actually rose, by 2.1%. And ex BHP, ex South32, ex Woolworths/Masters, profits rose by 13.4%.

A fair summary is that, behind some of the alarming headline numbers on aggregate corporate profits, many companies quietly did reasonably well in 2015 and are in a good position for some further growth in profits in 2016. On Credit Suisse's latest forecasts for earnings per share, for example, and excluding further expected profit falls in the energy and materials sectors, S&P/ASX 200 Index companies are expected to see profit growth of some 5.75% this year. While there have been previous instances of the domestic cycle appearing to pick up only to relapse into subpar growth, and while international volatility could spring unpleasant surprises (if, for example, the recent turnaround in commodity prices fails to hold), the backdrop could well be coming together for Australian equities.

International Fixed Interest — Review

World government bond yields had been falling sharply (and prices correspondingly rising) up to the second week of February. Investors had become concerned about a range of potential risks to the world economy, and had been buying government bonds as insurance against potential global setbacks. They had also been selling lower-quality corporate debt, which had looked especially vulnerable to any adverse shocks.

Over the past month, however, investors' anxieties appear to have diminished. This has had a particularly strong effect in the U.S. bond market: the 10-year Treasury yield, which had dropped as low as 1.66% on 11 February, at the height of investors' concerns, has

now risen back to very nearly 2% (currently 1.98%). Yields have not moved in the same way in the eurozone or Japan; however, even if investors had turned less wary about the global outlook, bond yields remained low because of an increased degree of monetary policy stimulus by the ECB at its meeting on 10 March, and ongoing vigorous monetary policy support from the Bank of Japan. Remarkably, the 10-year Japanese government bond yield turned negative on 9 February, and even though it briefly turned positive again as investors became less worried, it has since relapsed into negative territory, and is currently trading at negative 0.01%.

The net effect is that in the past month, investors no longer feel quite the same need to buy government bonds, and are less fearful of corporate debt. The yield on the Barclays Capital Global Treasury Index has risen a little, from 0.89% to 0.93%, and the yield on the Barclays Capital Global Corporate Index has dropped a little, from 3.11% to 2.94%. Overall, the yield on the Barclays Capital Global Aggregate Index is up very slightly, from 1.53% to 1.55%. The reduction in investor anxiety is particularly evident from the sharp fall in yields investors had been demanding on "high yield" (low credit quality) debt. A month ago, the yield on the Barclays Capital Global High Yield Index was 8.3% more than the yield on global government bonds, whereas at the time of writing, it has dropped to 6.85%. Rising oil prices played a large part—investors had been especially concerned about the impact of very sharp falls in oil prices on oil producers and on sectors (such as banks) exposed to the oil producers' problems.

International Fixed Interest — Outlook

The most likely outlook is U.S. bond yields will rise this year, although more slowly than previously thought, but yields in the eurozone and Japan will remain extremely low.

In the U.S., the Fed's plans for higher short-term interest rates had been one of the ingredients in the January/February meltdown of investor confidence. Now, however, it looks like the Fed will be more cautious about the speed and extent of interest rate hikes. The Chicago Mercantile Exchange's "FedWatch" indicator, which calculates the futures market's implicit probability of Fed moves, expects no change at the March or April meetings, and less than an even chance of a 0.25% increase at the June meeting. The FedWatch calculation also suggests the most likely outcome (with a 40% probability) is only one 0.25% increase by December, with roughly equal chances (around 25% each) of no change at all, or two 0.25% increases. Either way, the market's previous worry the Fed would raise rates four times this year now looks unlikely.

Ongoing low inflation, and a smaller-than-previously-expected rise in short-term interest rates, means yet again, forecasters have been winding down their expectations of bond yield rate rises in the U.S. The latest (March) poll of U.S. forecasters by the *Wall Street Journal* is forecasting a 2.4% 10-year Treasury yield at the end of this year, an increase of only 0.4% from its current level, followed by a further 0.5% increase in 2017.

In Europe and Japan, the likelihood is bond yields will remain around current rock-bottom levels, and may even fall in some sectors. In Europe, the ECB has made short-term interest rates even more negative, increased the amount of bond-buying "quantitative easing" it will do, and widened the range of assets it is prepared to buy to include high quality corporate bonds. The upshot is yields on eurozone corporate bonds are likely to fall. Indeed, according to reports in the *Financial Times*, investors have been falling over themselves to buy new corporate bonds currently in the marketplace (notably from Valeo, a French maker of car parts, and Ferrari, the Italian car manufacturer)

before the ECB's corporate bond buying sends them even lower again.

Modestly higher U.S. yields mean the prospect of modest capital losses; and steady eurozone and yen yields mean capital stability, but pitiful levels of income. On its face, the asset class does not offer a strong value proposition (other than pockets of better value in corporate credit), but as the opening weeks of the year demonstrated, investors may nonetheless see enough insurance value in bonds (and especially government bonds) to continue to favour the asset class. Even as investors have become less nervous about the global outlook, the bond gains they made in the time of maximum uncertainty have been useful contributors to portfolio performance: the Barclays Global Aggregate year to date, in U.S. dollar terms, has delivered a total return of 3.8%.

International Equities — Review

The good news is world equity markets, after a sharp fall in January and into the second week of February, have staged a strong recovery since. The bad news is the recovery has not yet clawed back all of the earlier losses—year to date the MSCI World Index is down 3.2% in the currencies of its constituent markets, and down 2.2% in U.S. dollar terms. In Australian dollar terms, local investors are a bit worse off again, due to the Australian dollar's 2.5% appreciation against the U.S. dollar.

Among the major developed markets, the U.S. (S&P 500 down 1.1%) and the U.K. (FTSE100 down 1.6%) have been the most resilient. European markets have not recovered as strongly, with the French CAC 40 still down 3.1% and Germany's DAX down 8.5%. Although, at time of writing, the eurozone markets were still in the early days of reacting (positively) to the latest monetary policy support from the ECB and look likely to close the gap with the U.S. and the U.K. performance. Only Japan, where there have been ongoing concerns about economic growth and deflation, is still showing a substantial year-to-date loss, with the Nikkei Index down 11.0%.

The news is a little better from the emerging markets, with the MSCI Emerging Markets Index back to its opening year level, in the emerging markets' currencies, and has made a small (0.9%) gain in U.S. dollar terms. Russia has been the big winner, with the FTSE Russia Index up 10.7% mainly on the back of higher oil prices. Brazil also benefited, with the benchmark Bovespa Index up 1.4%. But the other two "BRIC" markets did badly. India's Sensex Index is down 5.4% on growing scepticism about the current administration's economic reform credentials, and in China, the Shanghai Composite Index is down 20.6%. Although Chinese share prices have been gently rising in recent weeks, the modest gains have been nowhere near enough to make up for the 27.3% fall in the index between late December and late January.

International Equities — Outlook

The recent recovery in world shares reflects better-than-expected developments on most of the issues that had caused the selloff in January and early February.

Prominent among them was falling commodity prices. Although in principle, lower oil prices, for example, created winners as well as losers—Japan, for instance, is a large energy importer—the financial markets had been worried the impact on the losers could have various unwelcome ramifications, including on banking systems exposed to the energy sector. In the event, oil prices have picked up: a barrel of Brent crude, for example, cost less than USD 30 in January but is now just shy of USD 40. Other commodity prices have also recovered, with the Thomson Reuters/ Jefferies CRB Index currently up 11.2% from its low point on 11 February. Some of these gains may not hold—the recent rise in the oil price, for example, has been partly based on expectations a political agreement to curb production can be reached among

some of the major oil exporters, but equity markets are no longer as concerned about crises in commodity markets and their potential spillovers.

China was also at the forefront of investors' concerns, but equity markets have come to a less anxious conclusion about China's prospects. In early March, the Chinese government said it intended to aim for 6.5% to 7% GDP growth this year, has already eased monetary policy, and is in the process of moving to a modestly more supportive fiscal policy. Exactly what is happening in China is still rather unclear, and there is still potential for various financial stresses (property speculation, the losses of the state-owned enterprises) to spring unpleasant surprises, but earlier fears of an immediate sharp slowdown in Chinese growth now look overblown.

The global economic outlook was also one of the markets' larger concerns, but again the outlook now looks more likely to be one of ongoing, if slow and risk-beset, global growth rather than a stall or a recession.

In particular, the U.S. jobs data has been strong. In February, there were 242,000 new jobs created, more than even the most optimistic forecaster had picked (217,000) and well above the consensus forecast (190,000). Previous months' outcomes were revised up, and the participation rate—the proportion of people who say they are in the labour force either working or looking for work—also increased. This was encouraging, as the participation rate tends to rise when people believe the labour market is improving. Retail sales in the U.S. have also been going well. In February, household spending in the shops, excluding cars and petrol (which distort the underlying picture because of the large drops in petrol prices) was up 4.5% on a year earlier. In addition, the prospect of excessive or premature tightening of U.S. monetary policy has receded as the Fed now looks to take a more measured approach.

Outside the U.S., the outlook is less robust: overall, the global economy appears to be growing quite slowly. JP Morgan and Markit produce a global measure of all-industry output, based on aggregating individual countries' purchasing managers' indices, or PMIs. In February, it showed (according to the JP Morgan commentary) "The PMIs point to sluggish output gains in both the manufacturing and service sectors, while the upturn in new business softened." The surveys were taken before the ECB's most recent stimulus to the eurozone economy, and it is probable the eurozone's contribution to global economic activity in coming months will be a bit better. Either way, the macroeconomic background for equity performance is likely to be ongoing global growth, although at a slower-than-normal pace.

Slow growth in the world economy is modestly supportive for global equities. It is not an environment in which companies are likely to be gushing profits. It was noticeable, for example, in the latest U.S. profits reporting season, that higher profits were hard to come by in 2015. On data company FactSet's calculations, corporate profits at the S&P 500 companies dropped by 1.1% last year, although that was heavily influenced by a very large (60%) decline in profit at energy companies, while a range of other industries (notably telecoms, healthcare and consumer discretionary stocks) did well. The outlook for 2016, according to FactSet's collation of share analyst forecasts, is for a modest 2.6% growth in S&P 500 profits, with the overall number again dragged down by energy (another 60% contraction) but offset by better profit prospects for the utilities, consumer discretionary shares, healthcare, and the financials.

A modestly supportive economic outlook should see equities continue to recover from their crisis of confidence in the opening months of the year, as should improved absolute and relative valuations. The gross dividend yield on the FTSE World Index, for example, is currently 2.6%, a full 1% higher than the

1.55% available on the Barclays Capital Global Aggregate Index of fixed interest yields. But there is also ample scope for further episodes of volatility along recent lines, with the usual suspects as the most likely potential catalysts: global growth prospects, a Chinese slowdown, adverse shocks in other important emerging economies, and financial sector vulnerabilities.

Performance periods unless otherwise stated generally refer to periods ended 11 March 2016.

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Email: help.au@morningstar.com

Advisers/Institutions/Others
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