Economic Update

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Outlook for Investment Markets

Overseas and domestic equity markets have continued to recover from a loss of confidence in January/February. The outlook is for continued global growth at a relatively slow rate, with a range of downside risks, and with only modest prospects for global corporate profits. Many asset classes look expensive against this backdrop, largely due to cash and bond yields remaining very low and now looking to stay at very low levels for longer than previously thought. There is some recent evidence that the Australian economy may be picking up speed, which would help justify somewhat expensive valuations for local equities.

Australian Cash & Fixed Interest — Review

There has been little change to short-term interest rates in recent weeks, with the 90-day bank bill yield at about 2.3% (currently 2.29%). Year to date, the yield is also unchanged, reflecting the unchanged stance of monetary policy from the Reserve Bank of Australia, or RBA. Longer-term interest rates have shown little change in recent weeks, but year to date, the 10-year Commonwealth bond yield, at 2.53%, is down 0.35% since the start of the year following the trend towards lower yields in overseas bond markets. The Australian dollar is up significantly against the U.S. dollar year to date, having appreciated by 5.5% from USD 0.731 to USD 0.771. The move in the headline rate partly reflects the global weakness of the U.S. dollar. On the *Wall Street Journal's* index of its overall global value, the U.S. dollar is down 4.3% year to date and somewhat exaggerates the underlying strength of the Australian dollar, but even so, the Australian dollar has also strengthened, by 3.2% year to date, on an overall trade-weighted index basis.

Australian Cash & Fixed Interest — Outlook

The major forecasters are of the unanimous view the RBA will leave interest rates where they are for the rest of this year, on the basis that (unlike many overseas central banks) the RBA will not need to take any policy action to work inflation back up to a higher level. The latest Reuters poll of Australian economists found inflation this year is expected to be 1.9%, only marginally below the RBA's 2% to 3% target range, and is expected to be well within the range next year, at 2.4%.

On the other hand, the financial futures market is leaning towards the view the RBA will cut again this year—the market expects the 90-day bank bill yield to be 2.1% at the end of this year, which would be consistent with a 0.25% cut by the RBA. One possibility is the RBA might cut rates in order to work the currency lower after its recent (and unwanted, by the RBA at least) appreciation of the Australian dollar. The RBA said in the minutes of its 5 April meeting that "an appreciating exchange rate could complicate progress in activity rebalancing towards the non-mining sectors of the economy." The RBA has left the door open for a future cut saying, "Continued low inflation would provide scope to ease monetary policy further, should that be appropriate to lend support to demand."

There are conflicting influences on the direction of bond yields. A gradual but modest rise in U.S. bond yields would tend to pull local bond yields up with it, as would local inflation heading over 2%, but on the other hand, there is a chance the RBA will indeed cut interest rates, which would tend to limit or even prevent any increase. Currently, forecasters are still in the general area of expecting modestly higher bond yields by the end of this year, but, as in the U.S., forecasters' views are gradually being pared back. As views are reassessed, there is a realistic chance local bond yields may remain around current levels for the rest of this year.

The currency is also being pushed in different directions. Stronger investor confidence after the recovery in financial markets from the sell-offs of January/February helps push the currency higher, as overseas investors are keener to take positions in foreign currencies like the Australian dollars when they are less anxious about the

global financial climate. Local bond and dividend yields are also relatively generous by international standards.

On the other hand, a possible impending cut in interest rates would reduce the attraction of the Australian dollar, and most local analysts reckon, while the Australian dollar is well down from its previous peaks, it is still somewhat on the high side from an export competitiveness point of view. As a result, forecasters typically have the Australian dollar dropping to the high USD 0.60s by the end of this year. However, it is unlikely to be a smooth decline. The Australian dollar currently tends to be seen as a commodity play, and/or as a play on China's growth rate, and will remain hostage to the flow of news (good and bad) on commodities and China's prospects.

Australian & International Property — Review

The A-REITs have had a solid start to the year. They held up relatively well during the January/February market volatility, and recovered relatively quickly and strongly. To date, the S&P/ASX 200 A-REIT Index has delivered a capital gain of 4.5%, and a total return including dividend income of 7.3% compared with the S&P/ASX 200 Index's 1.3% loss. The major item of corporate activity in the sector, the DEXUS bid for Investa Office Fund, fell over at a late stage in the 18-month proceedings, though Investa (or parts of it) may still be in play for other suitors.

Global listed property has also done well, and has outperformed global equities as a whole. 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 5.3%. Emerging markets recorded a startlingly strong 17.5% return, largely down to Brazil where both equities and the Brazilian currency, the real, have risen strongly on hopes of political change for the better. In the major developed markets, Japan (up 10.1%) and Asia in general (up 8.6%) led the way, followed the eurozone (up 7.4%) and the U.S. (up 4.9%). The property sector has struggled in the U.K., however, in the shadow of the forthcoming "Brexit" referendum, and U.K.-listed property is down 10.1% (all regional returns on a common, net return in U.S. dollars, basis).

Australian & International Property — Outlook

Operating conditions for property across all markets in Australia were good in 2015. The latest data from the Property Council of Australia/IPD Australia All Property Index showed directly held property produced a total return of 14.0% for the year ended 31 December 2015, though the return was boosted by the cyclical fall in interest rates. This reduces the "cap" rates that are used to value property and boosts their capital value, and was largely responsible for the 6.8% capital gain component of the total return.

The aggregate outcome, however, conceals two important subtrends. One is that performance has been extremely diverse. The office markets in Perth and Brisbane, for example, are in dire shape, and still deteriorating as new supply commissioned in the heady days of the mining boom is coming onto an already glutted market. Sydney and Melbourne have been doing much better. As the chief executive of the Property Council of Australia said about recent trends, "Demand for offices in Sydney and Melbourne is roaring along."

The other trend is that property prices have been bid up to very high levels. Investors have been hoovering up any outstanding yield opportunities in a world of extremely low cash and bond yields. The result, as the RBA said in its latest *Financial Stability Review*, is "commercial property yields have compressed across a range of market segments and there are some questions over their sustainability at these levels once global interest rates normalise." The bank was thinking of the potential risk to banks which have lent against commercial property, but its general point also stands as a warning bell for investors that the current strong investor support for A-REIT yield will not last forever.

The point is even stronger for international property, where yields have been driven even lower again. The yield

on the FTSE EPRA/NAREIT Global Index is 3.6%, a rate which would not normally be regarded as an adequate return on property other than in a world where the yield on global bonds is only 1.35% (the yield on the Barclays Global Aggregate Index).

There is some fundamental support for global property: the world economy is growing, and demand for commercial property space is rising. The latest (April) half-yearly consensus forecast from the Urban Land Institute, or ULI, in the U.S., for example, shows ongoing economic growth in the U.S. is expected to lead to generally falling vacancy rates and rising rentals over the forecast 2016–18 period. It also shows that physical property prices, and U.S. REIT performance, have surged well beyond what will be manageable in coming years. U.S. commercial property prices, for example, rose by 16.1% in 2013, by 16.5% in 2014, and by a further 12.7% last year. The ULI panel of forecasters expects some further price appreciation, and improved REIT performance, but the increases will be much slower than previously experienced. For example, US REITs are expected to provide a total return of 5.0% this year and 7.0% next year, which would be well below the long-term performance of the U.S. REIT sector (12.9% a year over the past 20 years). It looks like a realistic call.

Australian Equities — Review

Australian shares have picked up from their January/February selloff, but the year to date gains has not yet been large enough to return investors to the winning circle. The S&P/ASX 200 Index is still 2.6% below where it started the year, and has returned a small year to date loss of 1.3% after adding the value of dividend income.

By sector, in terms of capital gains, the miners have done best, on the back of at least temporarily improved commodity prices: world prices (on the RBA's index) rose by 2.1% in February and by 5.3% in March, and mining shares are up 16.8% year to date. The industrials are up 5.0%. But there the good news ends: apart from the A-REITs (discussed elsewhere), other sectors are in the red. The biggest drag has been the financials (down 7.2%), but there have also been declines for consumer stocks (staples down 3.7%, discretionary down 2.1%) and for IT shares (down 4.9%).

Australian Equities — Outlook

Recent news has mostly been on the positive side, but not so positive as to signal a definitive emergence from an extended period of subpar growth. In particular, the latest labour market news was also encouraging. There were 26,100 new jobs in March, a bit better than the 17,000 forecasters had been expecting beforehand, and the unemployment rate, far from ticking up to 5.9% as the forecasters expected, actually dropped to 5.7% instead. There was the odd niggle in the data—all the new jobs were part time, with a 9,000 drop in full-time employment—but even so it was a strong result.

The latest business surveys also show some pickup in activity. The March survey from National Australia Bank found that "This NAB Business Survey revealed a significant improvement in both business conditions and confidence, suggesting the domestic business environment not only remains favourable but appears to be strengthening further ... All three components of conditions (trading, profits and employment) improved during the month, with the employment index particularly encouraging (the highest read since mid-2011), and indicative of ongoing labour market strength."

However, offsetting the mostly good news has been weaker consumer confidence. The Westpac-Melbourne Institute Consumer Sentiment survey found consumer sentiment weakened in March, with pessimists now slightly outnumbering optimists. While households were aware that the jobs market was improving—the unemployment expectations component of the survey improved—they have become less confident about the economy as a whole: "There was also concern about the economic outlook, the component tracking views on economic conditions over the next 12 months" down

5.5% and the component tracking expectations for "economic conditions over the next 5 years" down 5.9%."

Overall, it looks as if the economy will continue to grow at a subpar two-point-something pace rather than the stronger three-point-something pace that was manageable before the mining investment boom started to wind down. The latest Reuters poll of economists, for example, is picking that the economy will grow by 2.6% this year and by 2.9% next year.

Arguably, shares are on the expensive side for this reasonable, but not outright strong, outlook. On Standard & Poor's calculations, the benchmark index is trading on a historical P/E ratio of 24.1 times earnings, and on a prospective P/E of 16.5 times expected earnings.

On the other hand, overseas investor support for Australian equities appears to be strengthening, because of relatively high dividend yields by international standards. Credit Suisse, reporting on their latest annual Asian Investment Conference in Hong Kong in early April, found "back in 2015, conference attendees were clearly Underweight Australian equities, but now they are Overweight." Overseas investors were wary of two of the bigger sectors on the ASX (financials and resources), but were nevertheless prepared to invest "because the currency is expected to appreciate further and the dividend yield is the highest in the region." Valuations may be expensive, but they could be maintained by ongoing dividend-oriented foreign buying in the current low yield world.

International Fixed Interest — Review

Global bond yields have moved lower year to date, partly due to looser monetary policy in the eurozone and Japan, and partly due to investor demand for government bonds during the financial instability of the opening weeks of the year. In U.S. dollars, the Barclays Capital Global Aggregate Index has provided a total return of 6.6%. Easier monetary policies, and safe haven demand, have meant global government bonds have performed best, with an 8.3% return, compared with the 5.1% from global corporate bonds.

The yields now on offer are remarkably low. The yield on the global government bonds in the Barclays index is now only 0.78%, and at the time of writing, the Japanese 10-year bond yield has just dropped to a new low of negative 0.11%. Corporate bonds yield 2.6%, and the low credit quality "high yield" end of the market yields 7.2%.

International Fixed Interest — Outlook

The outlook for the international fixed interest asset class essentially divides into two: the U.S., where there is some prospect of a modest rise in interest rates this year; and the other major developed economies, where interest rates look set to remain at very low levels, or even drop a bit further again.

The U.S. is virtually the only major economy where inflation is behaving as it "ought to" in the wake of strongly supportive monetary policy. The latest official statistics show the "core" consumer price inflation rate (that is, excluding volatile elements like energy and food) was 2.2% in March, and has been gradually rising since the first half of last year.

The Fed has already started on a path to making monetary policy a bit less supportive, with a rise in its target range for the federal-funds rate last December from 0–0.25% to 0.25–0.5%, and the likelihood is that it will raise the target range a little more at some point this year. The Fed has recently indicated, however, that it is going to raise rates more slowly than previously thought, and the current futures market pricing indicates that, at most, only one more 0.25% increase is in the offing, and it will not happen till late in the year. The Chicago Mercantile Exchange's "FedWatch" indicator, which calculates the futures market's implicit probability of Fed moves, currently sees no chance of any near-term move, and around a 50:50 chance of an increase at the Fed's last meeting of this year, on 21 December.

This very gradual and modest approach to tightening monetary policy is reflected in a similarly gradual and modest path expected for bond yields. The April *Wall Street Journal* poll of U.S. economic forecasters found they expected the 10-year Treasury yield to rise to just above 2% by June and to 2.3% by the end of the year. If anything, these forecasts may be revised down a bit more in coming months. In the last nine polls in a row, the forecasters have lowered their consensus estimates for the 10-year rate.

Elsewhere, ultra-low yields look likely to remain entrenched. In Europe, for example, inflation is nowhere near the 2% level the European Central Bank, or ECB, wants to see. In March, the annual rate of inflation across the eurozone area (and indeed across the wider 28-country European Union, or EU, as well) was zero. Even after taking out food and energy (which are volatile) and alcohol and tobacco (where tax changes can complicate the picture), the core inflation rate across both the eurozone and the EU was only 1.0%, still below the ECB's target. Japan, too, has been struggling to work inflation higher, and the Bank of Japan has recently indicated that it is minded to step up its already extremely loose monetary policy a bit further again.

All this leaves bond investors in a difficult place. Government bonds proved to be an effective hedge against global financial instability in January/February, but it is an expensive form of insurance to carry. Government bonds offer very little running yield, and in the U.S., some prospect of modest capital loss. Inevitably, some investors are being driven into higher yielding subsectors in the fixed interest space, such as emerging market government bonds and lower quality corporate debt, but there are real risks down the lower credit quality end of the spectrum. To date, 46 bond issues have defaulted, on Standard & Poor's, or S&P's, count, with half of them occurring in the energy and commodity sectors. S&P expects around 4% of subinvestment grade U.S. corporate bonds to default this year, twice the proportion of last year.

In the emerging markets sector, risks are also significant. At time of writing, for example, investors were apparently prepared to buy a massive new bond issue, reported to be around the USD 15 billion mark, from Argentina. Media reports said there were bids amounting to around USD 50 billion, with the attraction being an expected yield on the 10-year tranche of around 8%, or a bit less. It might end happily: the Argentinian government is trying to reform the perpetually-underachieving Argentinian economy. But it still has substantial ongoing issues (economic and political), and has previously defaulted on its external debt. Investors nonetheless appear prepared to funnel very large sums to what is at best (on Moody's rating) a borrower with a single B credit rating. (With "obligations rated B considered speculative and are subject to high credit risk.") The hunt for fixed interest yield is taking some investors into dangerous territory.

International Equities — Review

World shares, which had slumped in January and early February, recovered in later February and March, and have continued to rise modestly in the first half of April. In their own currencies, the MSCI World Index of global sharemarkets has not quite got back to its opening year level—it is still 1.2% below where it started the year—but in U.S. dollar terms is now slightly back in positive territory, with a year to date capital gain of 0.5%. In Australian dollar terms, however, global equities are down 4.7% due to the 5.5% appreciation of the Australian dollar against the U.S. dollar.

The U.S. market has been an important contributor, with the S&P 500 Index gaining 1.8% year to date: ex the U.S., the MSCI World Index in U.S. dollars was down 0.9%. Most European markets did relatively poorly: the FTSEurofirst 300 Index is down 6.1% in euro terms, with both German (DAX down 6.4%) and French shares (CAC down 3.1%) lower. Somewhat surprisingly, given the financial uncertainties over a potential "Brexit" vote, U.K. shares are up slightly, with the FTSE100 gaining 1.6% in sterling terms. The Japanese market remains the worst major market. The Nikkei Index has been sliding since the

middle of 2015 —it hit a high of 20,868 on 24 June last year, but is now at 16,848—and year to date, has logged a capital loss of 11.5% (in yen terms).

Emerging market equities have bounced back well from their previous sharp sell-off, and year to date, the MSCI Emerging Markets Index is up by 3.8% in the emerging markets' currencies and by 6.6% in U.S. dollars. Brazil, where the Bovespa Index is up 22.8%, and Russia, where the FTSE Russia is up 18.8%, were the main contributors. Shares dropped slightly in India (Sensex Index down 1.9%) and are still well down on than their opening year level in China (Shanghai Composite down 13.0%).

International Equities — Outlook

At its April meeting, Morningstar's Expert Asset Allocation panel "reiterated its longstanding view of a global economy continuing to grow, but at a slower than usual pace, and with pronounced regional differences. As a result, the global economic backdrop is one which is consistent, at best, with only modest growth in corporate profits."

Nothing in recent weeks has upset that scenario. There have been some negative surprises. For example, one of the issues that had worried global markets at the start of the year was the impact of very low oil prices on countries and companies heavily dependent on oil income. In recent days, the oil price has been falling again due to a breakdown in the recent talks in Doha about an agreement to restrict output and boost prices. On the other hand, China's latest year-on-year rate of economic growth came in at 6.7% for the December 2015 quarter, in the middle of its government's 6.5% to 7% target range, and has helped allay fears about a "hard landing" for the Chinese economy. However, doubts were raised when the quarter-on-quarter figures were subsequently released which pointed to an annualised rate of only 6.3%.

Modest global growth remains the most likely scenario. The IMF's latest (early April) update to its authoritative *World Economic Outlook* (WEO) showed it expects ongoing growth in the world economy, if not quite at the rate it was expecting in its preceding (January) WEO. It is expecting global output growth this year of 3.2% (0.2% lower than its January prediction). This is expected to pick up a little to 3.5% in 2017 (a marginal 0.1% lower than its previous forecast), with the developing economies making most of the running (4.1% growth this year), and the more advanced economies growing more slowly (1.9% this year).

The IMF also compiled a list of what it called "significant downside risks." They included: further financial market volatility along March quarter lines; stresses in some of the major emerging markets; China, which the WEO said is "navigating a momentous but complex transition toward more sustainable growth based on consumption and services"; the possibility the world is moving to a period of permanently slower GDP growth; adverse political developments in the U.S. and UK (such as "Brexit"); the downside for producer economies of a protracted period of low oil or commodity prices; and, to cap it all, "Shocks of a noneconomic origin—related to geopolitical conflicts, political discord, terrorism, refugee flows, or global epidemics—loom over some countries and regions, and, if left unchecked, could have significant spillovers on global economic activity."

Against that background, one could be forgiven for wondering how the IMF had got to a forecast of positive global growth in the first place, given the accumulation of challenges and hazards facing it. It is also not surprising that when the economists in the latest *Wall Street Journal* poll were asked about the greatest risks to the U.S. economic outlook, roughly half of them picked "global risks," far ahead of other options.

That said, the IMF does a sensitivity analysis around its forecasts, and even on the worst outcome, it sees the global economy continuing to grow through all of these challenges. The worst outcome would be the global economy growing by around 1.5% in 2017. Other

forecasters agree. Reuters ran a poll in April among several hundred economists worldwide, and they came in with almost exactly the same outlook as the IMF: 3.0% global growth this year, and 3.2% next year.

The macroeconomic outlook for global equity markets remains one of modest economic growth, with associated modest prospects for growth in corporate earnings. As one example, the latest forecasts, collated from share analysts by U.S. data company FactSet for the profits of the S&P 500 companies is for profit growth of only 2% this year, with better prospects in some sectors (utilities, consumer discretionary, healthcare) largely offset by weak prospects in others (particularly energy, but also telco services and materials). Investors are also paying reasonably expensive prices for modest earnings growth, a consequence of ultra-low interest rates which have inflated valuations across all other asset classes. Global equities are no bargain, but have some modest upside on ongoing global growth, and also offer investors to a foreign exchange exposure which should ultimately benefit from a lower Australian dollar.

Performance periods unless otherwise stated generally refer to periods ended 15 April 2016.

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