Economic Update

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Outlook for Investment Markets

World economic growth is still supportive for global equities, and fund managers currently expect equities to make further gains. But the outlook, particularly this late in a sustained global business cycle, is becoming more vulnerable to various risks, notably higher bond yields (especially in the U.S.) and various geopolitical risks. Bonds and bond proxies are likely to continue to struggle. In Australia, the latest forecasts are for some pickup in the rate of economic growth, but not on a scale that looks to deliver strong growth in corporate profits.

Australian Cash & Fixed Interest — Review

Short-term interest rates have been steady. The Reserve Bank of Australia, or RBA, held the target cash rate at 1.5% at its latest monetary policy decision on May 10, and the 90-day bank bill yield consequently continues to trade a little under 2.0% (1.92% at time of writing). Somewhat unusually, local bond yields have not followed their usual pattern and taken their direction from U.S. bond yields; instead, they have risen only modestly this year even as U.S. yields have climbed. The local 10-year Commonwealth bond yield (currently 2.91%) is up only 0.3% year to date, compared with the equivalent 0.65% rise in the U.S. The Australian dollar is weaker year to date, both in headline U.S. dollar terms (down 3.6%) and in overall trade-weighted value (down 3.7%). In part this reflects a stronger U.S. dollar, which had weakened in January and bobbled along at its late January levels until around mid-April, but which more recently has started an ongoing appreciation.

Australian Cash & Fixed Interest — Outlook

There is not a lot of disagreement about the outlook for short-term rates. Nobody expects any imminent move from the RBA, which said in the minutes of its latest meeting that the best idea would be leave things as they are. For now, "it would be appropriate to hold the cash rate steady and for the Reserve Bank to be a source of stability and confidence." Further out, the bank said "[RBA policymaking] members agreed that it was more likely that the next move in the cash rate would be up, rather than down." Whatever the next move is, it is unlikely to materialise before mid-2019 at the earliest and maybe not till a good deal later—Westpac, for example, expects no move before 2020. Either way, some small increases look some distance away, and current low rates on the likes of bank deposits look well entrenched.

The likelihood is that local bond yields will head higher over the next year or two, partly because local inflation is likely to be running at around 2% and partly because of some re-emergence of the traditional relationship with U.S. yields. Local forecasters have different views on the extent of the rise, from a modest rise in the 10-year yield to 3.1% by the end of next year—for example, Westpac and the Commonwealth Bank—to something rather larger such as National Australia Bank's expected 3.65%. Whatever the exact outcome, local bond markets are likely to face the same difficult outlook as their overseas equivalents.

Current currency forecasts are a mixed bunch, reflecting the fact that some factors, for example, interest rate differentials moving in favour of U.S. dollar assets, suggest a lower Australian dollar but others such as rising world commodity prices favour stronger commodity-backed currencies like the Australian dollar. Forecasters can reasonably emphasise one factor over another, and consequently there are quite different views in the marketplace for the headline U.S. dollar rate at the end of next year. Some see it a good deal lower, for example, ANZ Bank and Westpac see U.S. 70 cents; others see it a fair deal higher, for example, Commonwealth Bank's U.S. 83 cents. It could be that the various factors are a wash. National Australia Bank's view of not a lot happening, with the headline rate still around U.S. 75 cents at the end of 2019 could well be a realistic outcome.

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Australian & International Property — Review

The A-REITs have underperformed relative to the overall Australian sharemarket, with the S&P/ASX200 A-REITs index down 2.8% in capital value and down 1.9% in total return, compared with the 0.4% capital gain and 2.2% total return for the S&P/ASX 200.

It is the same overseas, where year to date the FTSE EPRA/NAREIT Global index has turned in a 2.6% loss in terms of net return in U.S. dollars, compared with the 1.7% net return from the MSCI World index. The loss was very largely down to poor performance in the U.S., where there have been very large losses in parts of the retail sector (particularly shopping centres); ex America, developed market REITs would actually have posted a small 0.8% net return. The pick of the markets outside the U.S. was Japan, with a net return in U.S. dollars of 9.3%, which helped Asian markets overall to a 2.0% gain.

Australian & International Property — Outlook

The March quarter Royal Institution of Chartered Surveyors, or RICS, Australian Commercial Property Monitor confirmed what earlier surveys from the ANZ Bank/Property Council of Australia and from National Australia Bank had shown: investor demand for commercial property remains high, though tenant demand has eased back a little. As in overseas markets, there are pronounced sectoral differences with prime office space expected to do best (largely down to tight vacancy conditions in Sydney), as is prime industrial (buoyed by e-commerce logistics demand), with retail, and especially secondary retail space, expected to fare worst. In the secondary retail sector, RICS respondents expect outright falls in rents and property values over the next year.

The generally positive outlook for tenant and investor demand is expected to translate into modest gains in rents (1.0%) and property values (1.3%) over the next year. A-REIT valuations are also undemanding, with measures such as the ratio of REIT prices to the value of the properties they own ("price/net tangible assets") on the cheap side by historical standards. But neither the positive operating outlook nor reasonable valuations may be enough to counter the current investor mood of wariness of income-oriented asset classes as bond yields threaten to rise further.

Overseas, the outlook is best split into the outlook for the U.S., which has been hit hardest by fears of higher interest rates, and everywhere else, where normalisation of monetary policy is less advanced.

In the U.S., as recent commentaries on NAREIT.com, the U.S. REIT trade organisation, have pointed out, interest rate rises can be symptomatic of the good times rolling for property owners. As one article put it, "when interest rates increase because of strengthening macro demand conditions, real estate investors have tended to benefit from rising occupancy rates, rent growth, property values, and lease income." But this is only up to a point. As another said, "Higher interest rates could also pressure cap rates [the rates used to value property], which, if interest rates rose fast enough and far enough, could cause property prices to fall." The author felt that the U.S. REIT market could cope with gradual rises, but so far investors appear more concerned about the downside aspects of higher interest rates, and the U.S. sector may continue to lack support until investors are more comfortable that interest rates have stopped rising.

Elsewhere, however, fears of rising interest rates are lower, and growth prospects (particularly in emerging markets) are stronger. The latest (March quarter) RICS Global Commercial Property Monitor shows there is a wide range of markets, predominantly in Europe (including eastern Europe) and Asia where property professionals expect to see strong rises in rents and capital values over the next year. Investment vehicles exposed to these promising markets could do well, but overall headline performance of the sector will continue to be held back by the drag of the U.S.

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Australian Equities — Review

Most equity markets have struggled to show any decent gains year to date, and the Australian sharemarket is no exception, with a small 0.7% capital gain for the S&P/ASX 200 index and a total return of 2.2%. Once again, the outcome has been held back by the financial sector, which delivered a capital loss of 6.0% as it continues to reel from the evidence at the Royal Commission and the potential for corrective regulation. On the plus side, the miners have done very well (up 10.3%) on the back of higher world commodity prices, and local IT stocks (up 8.4%) have been as popular as their global counterparts.

Australian Equities — Outlook

The outlook is for the economy to pick up in the near term and for the current expansion—which now dates back to the early 1990s—to continue for the next few years. But there are some question marks over how much of the ongoing economic growth will flow through into share prices.

Both the economic data and the business surveys have been positive. Employment continues to grow (22,600 more jobs in April), and the business surveys have generally been supportive. Although both the Australian Industry Group, or AIG, and Commonwealth Bank, or CBA, performance indexes showed slight declines in April, the performance levels remained high, and on some other measures, businesses may be doing even better than the AIG/CBA numbers show. The April business survey from National Australia Bank found that business conditions (what has actually happened to profits, sales and hiring) were at their equal highest level since the survey began back in 1997, and NAB commented: "The record high ... simply reinforces what has been evident since the middle of last year, that business activity in Australia is robust."

In the 8 May Budget, the Australian Treasury forecast that growth will pick up a bit, from 2.75% in the current June 2018 year, to 3% a year over the next two years, which fits with the picture shown by the strengthening business surveys. But the pickup does not necessarily translate into strong corporate profit growth. On Treasury's estimates, the best is behind us, with corporate profits rising 7% in the June year nearly over and will drop to rather slower gains of 3.25% in the year to June 2019 and 4.5% the year after. That could well be enough to support some modest equity gains, probably including ongoing relative outperformance from the miners and underperformance from the financials but does not look enough to power a stronger outcome.

International Fixed Interest — Review

Outcomes for investors in international fixed interest have deteriorated markedly in recent weeks. A month ago, in the previous edition of this update, the Bloomberg Barclays Global Aggregate index had still been showing a marginally positive outcome, with a 0.6% return in U.S. dollars. Now, the year-to-date outcome is a 1.8% loss in U.S. dollars. The pain was shared both by investors in global government bonds (down 1.1%) and global corporate debt (down 3.3%).

There have been a number of drivers of the result. First and foremost, U.S. bond yields have continued to rise, breaking through one of those "big numbers" that markets sometimes get preoccupied with. The 10-year U.S. Treasury yield narrowly went over 3% on 24 April, and although it dropped back again for much of May, more recently, it has again moved above 3%, peaking at 3.11% on 17 May and trading at 3.06% at the time of writing. Emerging market yields have also risen in response to adverse developments in Argentina and Turkey in particular, with the Bloomberg Barclays Emerging Markets index now down 3.85% in U.S. dollars year to date. And there have been a variety of other smaller issues, including a sharp rise in Italian bond yields in response to the likely formation of a radical governing coalition.

International Fixed Interest — Outlook

More of the same looks likely. Although there has been a variety of factors behind the recent outcomes, the main driver, normalisation of monetary policy in the U.S., and to

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a lesser degree elsewhere, is intact, and has further to run.

The likelihood is that the U.S. Federal Reserve will go on raising short-term interest rates and withdrawing its previous programme of buying bonds, which had helped keep longer-term interest rates low. The Fed's current target rate for the federal-funds rate is 1.5% to 1.75%. Currently, the futures market regards it as a certainty that the range will be lifted by 0.25% at the Fed's 13 June meeting. After that, opinion is split about further increases, with prices suggesting it is a 50:50 call between one and two more 0.25% increases by the end of this year.

Economic forecasters agree about further tightening of short-term rates—in the latest (May) poll by the *Wall Street Journal* they have the federal-funds rate at 2.3%, and they also expect longer-term rates to rise further. They see the 10-year Treasury yield reaching 3.2% by the end of this year, and going on to 3.5% by the end of next year. This would align with the likelihood that the Fed will have finally worked inflation back up to its 2% target level. In fact, the forecasters see inflation running a little above 2.0% out to the end of 2020.

It has been a long time coming, it is happening more and faster in the U.S. than elsewhere, and it could be overtaken by some future shock that might require central banks to loosen monetary policy again, but the odds are that the era of globally ultra-low interest rates is winding down.

This was always going to be a difficult process for bond investors, and will also have knock-on effects for other asset classes. The yield on holding cash (as measured by the yield on 90-day Treasury bills) in the U.S., for example, has risen from virtually zero to match the dividend yield on the S&P500—they are now both 1.91%, and the cash yield has further to rise. And the fund managers in the latest (May) Bank of America Merrill Lynch, or BAML, survey said they are likely to start cyclically rotating out of equities and back into bonds when the yield hits 3.6%, which it is likely to do (there or thereabouts) by late next year.

As noted in the "International Equities" section, at some point, the current long global business cycle will weaken or falter, and one or more of the assorted financial and geopolitical risks that the BAML respondents worry about will sheet home. In those circumstances, bonds may well re-emerge as the safe haven asset of choice. But those risks look some time away, and in the meantime, bond markets are likely to continue to be difficult.

International Equities — Review

The good news is that faced with a trio of worries in rising interest rates, trade wars and other geopolitical tensions, and in recent weeks some suggestion that the world economy may not be growing as rapidly as expected—world shares are slightly up for the year. The bad news is that they have yet to regain the ground lost from the two big sell-offs in January and March which occurred when investors first started to take these concerns more seriously.

Year to date, the MSCI World index of developed markets is up 1.3% in the markets' own currencies, and up 0.8% in U.S. dollars (1.7% including the taxed value of dividends). Few of the major markets have stood out from the pack, with most registering small increases in local currency terms. In the U.S., the S&P500 is up 1.5%; in Japan, the Nikkei has gained 1.2%; and in Europe, the FTSE Eurofirst 300 index is up 1.2%, with the French market a rare example of a larger gain (CAC40 index up 5.7%).

Until very recently, the emerging markets had been handily outperforming their developed economy counterparts, but they have faltered in recent weeks, with the MSCI Emerging Markets up only 0.7% in the emerging markets' currencies and making a 1.8% loss in U.S. dollars. Investors who stayed in the key BRIC markets of Brazil, Russia, India, China, fared relatively well, with the MSCI BRIC index up 0.9% in U.S. dollars, but anyone off

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the main beaten path ran into trouble. Two countries in particular suffered big losses: the MSCI Turkey index dropped 25.9% in U.S. dollar terms, and the MSCI Argentina index (strictly speaking classed as a "frontier" rather than "emerging" market) fell by 24.8%. It was a reminder that, while growth prospects are higher, and valuations less expensive, in the emerging markets, they pose their own significant risks. Other emerging markets to weaken in U.S dollars included Indonesia (down 18.75%), the Philippines (down 15.1%), Poland (down 13.2%), and South Africa (down 10.5%).

International Equities — Outlook

The global economic outlook remains solid. As the April JP Morgan Global Composite performance index found: "The start of the second quarter saw a modest acceleration in the rate of expansion of global private sector economic activity. Although growth failed to recover and match the highs seen around the turn of the year, it remained solid and was in line with its long-run trend." It helps that the implausible contraction in the global technology sector that had mysteriously shown up in the March data reversed with a bang in April, with the sector having its best performance since September 2014.

At the edges there has been the occasional hint growth may not be quite as strong as investors have been expecting. Eurozone data, in particular, has been on the weaker side of expectations. Japan's GDP unexpectedly dropped by 0.2% in the March quarter. And the international economists polled in May by the *Economist* magazine generally tweaked back their forecasts for 2019 (other than slightly more upbeat views of Canada and South Africa). Overall, though, the economic outlook is still a good fundamental base for equity performance.

But there are growing risks. The global economic cycle is getting long in the tooth although as both forecasters and fund managers believe, it does not look as if it is going to fall over imminently. In the May BAML fund manager survey mentioned earlier, a large majority (76%) believe equities have not peaked yet. But we are likely to be somewhere down the late stage of a long cycle, where risks of derailment are accumulating. In the BAML survey, there was only a very small majority (1%) favouring the idea that the world economy can continue strengthening over the next year, though managers are roughly evenly split over whether the eventual slowdown will happen in 2019 (41% think so) or 2020 (the pick of 43%).

Valuations are also an issue, particularly in the U.S. and particularly, as noted in the "International fixed interest" section, when rising U.S. interest rates are upsetting the previous basis of relative equity valuations. World equity prices have risen by 12.75% in U.S. dollars over the past year, even after the sell-offs in January and March this year. That reflected a large price response to an acceleration in the world economy which had been given a further nudge along by big tax cuts in the U.S. But that was then, and this is now, and further gains of that order do not look likely when the odds now suggest an eventual slowdown rather than further unexpectedly good news.

The BAML respondents also identified the risks they are most concerned about. In order, they were potential monetary policy mistakes by either the Fed in the U.S. or the European Central Bank in the eurozone, the fall-out from trade wars, and geopolitical risks that might send the oil price as high as USD 100 a barrel.

So far, none of those risks has materialised. If anything, the rise thus far of the oil price has helped overall share prices rather than challenged them. There have been strong gains this year for energy companies (both for conventional oil and gas and for alternative energy).

All these torpedoes could yet go on missing their targets, and at the time of writing, the negotiations between the U.S. and China over potential trade concessions had, apparently, staved off at least the immediate threat of trade sanctions. But realistically world equity markets cannot expect to dodge all the bullets, especially as more

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of them are being fired by a U.S. administration that has been more comfortable with confrontation (with Iran and North Korea, for example, as well as with China) than previous administrations. If the global economic cycle were the sole determinant, the equity outlook would be reasonable, though unlikely to match the gains when optimism on growth was at its height. But risks, accidents and politics look as if they could have a spoiling role.

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