Economic Update

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June 2018

Outlook for Investment Markets

The world economic expansion is still trucking along, although it has become a bit more dependent than previously on the U.S. economy, and should support some further equity gains, although against a background of rising political risks—especially the risk of trade wars. Fixed interest and other income-oriented asset classes continue to be challenged by the prospect of rising inflation and tighter monetary policy. In Australia, there have been some promising signs that the pace of business activity is picking up, although the benefits for growth assets are being held back by the ongoing weakness of the financial stocks.

Australian Cash & Fixed Interest — Review

Once again, there is little to report on short-term interest rates. While 90-day bank bill yields are up a bit year to date (currently 2.07%), this has reflected higher funding costs for banks rather than any formal tightening of monetary policy, which is still keeping down the general level of short-term rates. The Reserve Bank of Australia, or RBA, maintained the cash rate at 1.5% at its latest monetary policy decision on 5 June. It has been held steady since May 2016. Bond yields have been more volatile, and not as closely linked as usual to U.S. bond yields. On occasions, the local 10-year Commonwealth bond yield has yielded less than its U.S. equivalent, as is the case currently, with the local 2.71% below the U.S. 2.92%. The Australian dollar is weaker year to date, and is down 3.9% in overall trade-weighted value. Some of its weakness is down to depreciation against the Japanese yen (down 5.9%) and Chinese renminbi (down 5.8%), but in recent months, the key moving part has been the impact of a globally stronger U.S. dollar.

Australian Cash & Fixed Interest — Outlook

Short-term interest rates are very likely to remain around current levels over the next year. The RBA has said the next move is more likely up than down, but has given no signals about when it might start raising rates. Forecasters typically expect it will not be for some time with a general expectation of a 0.25% increase sometime in the second half of next year, though it could be later again. For example, Westpac thinks there will be no change before March 2020. Low rates on cash in the bank will be a feature of the local investing landscape for some time yet.

Bond yields look likely to head higher. Inflation is likely to be a little higher over the next year, with forecasters typically seeing it around 2.0%-2.5%, which means bond yields will have to rise to maintain the same real (after inflation) return. And while the relationship has not held exactly this year, there is also likely to be some impact from higher U.S. bond yields. Forecasters on average see the local bond yield around 3.5% in a year's time.

Currencies reflect a wide range of factors which often point in different directions, but at the moment, there is one factor, a particularly obvious divergence between the likely path of U.S. and domestic monetary policies, which is likely to dominate. The U.S. policy rate is already above the local rate, with the target U.S. federal-funds rate at a range of 1.75% to 2.0%, compared with the RBA's cash rate of 1.5%, and the gap is likely to widen further as the Fed raises rates again later this year while the RBA holds rates steady. While other factors could intervene—there could be a pickup in overseas portfolio investment into the equity or property markets, which would tend to support the Australian dollar, and the Commonwealth Bank, for example, sees the U.S. exchange rate rising to USD 80 cents in a year's time—at the moment, the forecasters picking a lower Australian dollar look to be taking the more realistic view. The ANZ Bank and Westpac, for example, see the dollar down in a year's time from its current USD 74.3 cents, with ANZ picking USD 70 cents and Westpac USD 72 cents.

Australian & International Property — Review

The A-REITs have struggled to recover the ground lost at the start of the year, when the sector (like its counterparts overseas) was hit by concerns over the potential impact of rising interest rates. Currently, however, the REITs have just managed to creep into the black for the year, possibly helped by reinvestment of cash from holders of Westfield with AUD 7 billion of cash paid out on 7 June as part of the Unibail takeover, and this may have supported the remaining names in the sector. The S&P/ASX 200 A-REITs index is now marginally ahead (0.1%) in capital value for the year and has delivered a total return of 1.1%, a little behind the 2.4% return from the wider sharemarket.

Overseas, listed property has also underperformed with the FTSE EPRA/NAREIT Global index showing a small 0.4% loss in terms of net return in U.S. dollars, compared with the 2.5% net return from the MSCI World index. The underperformance is largely down to ongoing poor results in North America (down 1.8%), and to a lesser extent, a sharp setback to emerging market REITs (down almost 10%, although they have only a small weight in the index). Losses in the U.S. and the developing world outweighed a 2.0% gain in Asia (Japan was up 8.8%) and in parts of the eurozone, where listed German property returned 3.5% (all regional results in U.S. dollars).

Australian & International Property — Outlook

The operating outlook for property (ex retail) is solid, particularly in Sydney and Melbourne. In the office sector, for example, there are tight supply/demand conditions in the CBDs of both cities, which are having knock-on benefits for the wider metropolitan (outside the CBD) office markets. As Colliers' first half of the year review of metropolitan offices found: "Some metro markets, such as Parramatta and the Melbourne City Fringe, are even more tightly occupied than the Sydney and Melbourne CBDs, and we expect them to stay this way until new supply starts completing around 2019/20."

Industrial property is also performing strongly with high demand but limited supply, largely but not exclusively driven by online shopping logistics. Colliers' half-year review said: "Although investment choices in logistic-type assets will remain dominant, particularly as e-commerce continues its exponential growth path, other industrial sectors have experienced positive employment growth over the past five years." Retail is the laggard, although the high end of the market, for example, large "destination" malls, appears to have better prospects against the online challenge than lower-tier shopping outlets.

A good operating outlook, improved by recent evidence that the pace of the economy has kicked on a gear, has not, however, appeared to offer a compelling proposition to investors who have been getting better capital gains from the wider market, and without sacrificing much yield. The A-REITs offer 4.6% compared with the overall market's 4.2% (on Standard & Poor's calculations). The prospect of rising bond yields is also an ongoing challenge. Further underperformance looks the most likely prospect.

Overseas, the key market is the U.S., which accounts for 45% of the benchmark FTSE/NAREIT index. On the plus side, the U.S. economy has been performing strongly, and while retail remains under the global shadow of e-commerce—U.S. retail-focused REITs are down 4.8% year to date, with shopping centres down 7.5%—other sectors have been doing well, particularly industrial (up 3.8%). Colliers' latest report on the industrial sector said: "The national industrial vacancy rate remained at an all-time low of 5.1% for the second consecutive quarter despite nearly 53 million square feet of new supply completing in the first quarter of 2018;" rents have risen by 5% to a new record high; and "growth in investor demand for industrial properties continues to surpass all other property types."

On the down side, however, the U.S. market is also the market most exposed to higher bond yields as American monetary policy tightens faster than in other major regions. So far, the contest between improving rental income and the prospect of lower capital values as interest rates rise has not worked out well for investors, and although there are some very strong property markets outside the U.S., overall listed property outcomes are likely to remain on the disappointing side until U.S. bond yields peak.

Australian Equities — Review

The Australian market is marginally in the black year to date. The S&P/ASX 200 index has made a 0.5% capital gain and delivered a total return including dividends of 2.4%. There have been marked divergences in sectoral performance. IT stocks (up 11.4%), the resources (up 9.7%), and defensive consumer staples (up 8.5%) have performed well. The overall modest outcome, however, reflects the heavy drag of the financials (down 8.9%) which have continued to weaken due to ongoing bad publicity at the Royal Commission and, more recently, from the news of criminal cartel charges laid by the Australian Competition and Consumer Commission.

Australian Equities — Outlook

While there has been a prolonged period of subpar performance by both the economy and the equity market, recent data suggests a modest turn for the better. The economy grew at a faster-than-expected 3.1% annual rate in the year to March. The official data on company profits showed they also had a good March quarter, and were up 5.3% on a year earlier. The labour market continues to improve, with the unemployment rate dropping on its latest reading from 5.6% to 5.4%, which is the lowest rate since late 2012.

The latest business surveys have also been encouraging. The latest (May) business survey by National Australia Bank, or NAB, was somewhat down from the very strong results in April, but as NAB commented: "Despite the easing in conditions, the survey continues to suggest a broad-based strength across industries and most states. Both business conditions and leading indicators continue to suggest a pick-up in economic growth and that, over time, jobs growth should see the unemployment rate fall towards 5%." Other business surveys show the same picture. The latest (June) Australian Chamber–Westpac quarterly Survey of Industrial Trends, for example, found that: "Expectations are positive, centred on new orders, output, backlog, overtime as well as renewed expansion in employment."

The probability is that the economy is heading into a better period of business performance with the RBA, for example, saying at its latest policy decision that it expects "GDP growth to pick up, to average a bit above 3 per cent in 2018 and 2019." It is not a certainty, particularly given the still-cautious behaviour of households. Westpac, for example, commented on its latest Westpac–Melbourne Institute consumer confidence survey that confidence "remains well below the levels typically associated with a robust consumer," and expects GDP growth to fall short of the RBA's expectations.

But overall there is enough in the recent data to suggest that, outside the financial sector and parts of retailing, other sectors of the equity market may finally to start to benefit from the long-awaited pickup in business activity. While profit outcomes this year are likely to be somewhat exaggerated by the ongoing turnaround in the miners' fortunes, nonetheless, the likelihood is that other sectors will also see some of the benefit from faster GDP growth flowing through to improved equity performance.

International Fixed Interest — Review

Global bond markets have continued to be difficult for investors. The Bloomberg Barclays Global Aggregate index year to date is down 1.7% in U.S. dollars. Both investors in global government bonds (down 1.0%) and global corporate debt (down 3.2%) have lost ground as bond yields have risen and corporate credit spreads have widened.

As well as further tightening of monetary policy in the U.S., two other issues have contributed to the losses. Emerging market debt has been sold off as investors have become more aware of emerging market risk, sparked in particular by unpleasant surprises out of Argentina and

Turkey, and the Bloomberg Barclays Emerging Markets Aggregate index is down 4.0% in U.S. dollars. And in the eurozone, investors were alarmed by the formation of an unlikely and economically radical coalition in Italy, which reawakened older fears of eurozone financial stress for holders of Italian government debt. The 10-year Italian government bond yield, which had been around 1.75% before the election result, spiked to 3.1% on 8 June, and at its current 2.6%, is still well up on its pre-election level.

International Fixed Interest — Outlook

The macroeconomic currents continue to run against bonds as an asset class. While it has taken a much longer time than expected, a sustained global economic expansion, helped by monetary policy left on multiyear ultrasupportive settings, has finally got inflation moving back up to the levels that central banks would like to see. In the U.S., for example, the latest (May) reading on core inflation was 2.2%, and in its latest forecasts, the Fed has said it expects core inflation to stay at 2.1% in both 2019 and 2020. Progress towards more normal inflation rates has generally been slower outside the U.S. but even in the formerly deflationary eurozone and Japan, prices are rising faster. The latest (June) *Economist* poll of international forecasters expects inflation to be 1.6% this year in the eurozone, and 1.3% in Japan.

This has two consequences for bond yields. Inflation leads investors to demand higher yields to preserve their "real" (after inflation) return. And inflation back nearer the central banks' targets means they can remove the previous degree of monetary stimulus. On 13 June, the Fed raised its target range for the federal-funds rate by another 0.25%, to 1.75%–2.0%, and indicated there are likely to be two more 0.25% increases this year (one more than markets had been braced for). And on 14 June, the European Central Bank said it would slow down its bond purchase programme (which had been keeping bond yields down) from September, and is aiming, provided there are no economic surprises, to wind it down completely by the end of this year. Interest rate increases, however, still look some distance away, for example, according to the ECB, late 2019.

As these processes work through, bond prices will remain under pressure. It is unlikely to be a rout. U.S. forecasters in the latest (June) poll run by the *Wall Street Journal* expect the 10-year U.S. Treasury bond yield to peak at 3.6% by the end of next year, and to stay around that level in 2020. That is also the level (according to their June responses) at which the fund managers surveyed by Bank of America Merrill Lynch, or BAML, would consider rotating back into bonds from equities. But until yields have plateaued, capital losses will be constraining returns from the asset class, and fund managers are unsurprisingly steering clear, with a 49% underweight allocation in the BAML survey. Major geopolitical or financial surprises might reignite safe haven demand for bonds, but absent shocks, the economics does not look like playing out well for the asset class.

International Equities — Review

It has been a volatile year for global equities. It started with strong rise in January, a substantial decline in late January and early February, followed by a recovery that never took proper hold—by early April, prices were back to their early February lows. More recently, there has been a slow rise in prices, but the recent gains have barely been enough to generate a year-to-date capital gain. The MSCI World index of developed markets is up only 2.3% in the overseas markets' currencies and by only 1.5% in U.S. dollars (2.5% including the taxed value of dividends). Prices remain below their late January peak, with the MSCI World still 3.0% adrift of its 26 January level.

Among the major markets, the U.S. has been doing best as its growth prospects have improved relative to other regions. The S&P500 is up 4.0% in capital value year to date, while the tech-heavy Nasdaq index is up a strong 12.2% on the back of good performance by an in-demand sector. Other major markets have shown little net movement, with Japan's Nikkei up 0.4%, and the

FTSEurofirst 300 Index of European shares down slightly (0.6%). In the U.K., shares are also down a little (0.7%).

The emerging markets have been weak in the wake of sharp setbacks in Argentina and Turkey which have sensitised investors to the risks of the emerging markets more generally. The MSCI Emerging Markets is down 3.9% in U.S. dollars, although the key BRIC markets (Brazil, Russia, India, China) did better than most (largely attributable to China). The two countries that sparked investor alarm have continued to struggle, with MSCI Argentina index down 35.4% and the MSCI Turkey index down 34.9% (both in U.S. dollars).

International Equities — Outlook

The world economy is still enjoying a largely synchronised business expansion. Virtually every sector is growing, according to the IHS Markit Purchasing Managers Index (PMI) measure which is based on aggregated single country PMIs. In May, it showed that all seven broad sectors it monitors were doing well, led by the industrials and technology, and nearly all of the 22 subsectors were also expanding, with the sole exception of mining.

It is a similar picture when the world economy is looked at regionally, although there have been some recent shifts in relative performance. The May JP Morgan Global Composite performance index, also based on the same country PMIs, "signalled a further uptick in the rate of global economic growth ... Robust inflows of new work, rising employment and positive business sentiment should all support further output growth during the coming months."

The latest uptick, however, owed a lot to the U.S., where faster growth has made up for steady growth in China and slower growth in the eurozone, Japan, India, and Russia. In the U.S., the latest data showed the unemployment rate dropped to a new low of 3.8% in May, and the economy generated rather more new jobs (223,000) than forecasters had expected. Share analysts believe the strength of the U.S. economy will translate into substantial rises in U.S. corporate profits. On the latest analyst forecasts collated by data company FactSet, profits for the S&P500 companies are expected to rise by very nearly 20% this year, and by a further 10% next year.

The new relative pecking order has not gone unnoticed by fund managers. As the June BAML survey showed, they have moved to a slight overweight allocation to U.S. equities for the first time since March 2017. The increased allocation has been funded by less overweight allocations to the eurozone (where economic data have been on the weaker side of expectations) and to emerging markets (where as noted earlier, risks have risen in a number of developing economies).

The economic fundamentals are still supportive of equity price gains, especially in the U.S. The analysts polled by FactSet think the S&P500 will reach 3,090 in a year's time, a gain of some 11%, while the fund managers surveyed by BAML see the index peaking at around 3,040, which would be a gain of around 9%.

But there is no denying that the global expansion is now getting on in years, and the odds of an interruption to the expansion at some point in the next year or two are rising. In the BAML survey, for example, respondents were evenly split over whether or not the world economy will be stronger in a year's time.

As well, the risks are rising and mutating. At the time of writing, the trade dispute between the U.S. and China had worsened, with President Trump threatening to impose tariffs on an additional USD 200 billion worth of Chinese goods, on top of the USD 50 billion previously targeted (and to which China had responded with a similar-size tariff package of its own). Confrontational protectionist policies raise a real risk of disruption to the global economy, and the BAML managers now rate trade wars as the single most worrying risk, ahead of a monetary policy mistake by either the Fed or the ECB, and the risk of a eurozone financial crisis.

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If the economics prevail, world equities should be able to make further gains. But protectionism, in particular, and the potential for other policy mistakes and geopolitical shocks, mean that gains, if they come to hand, will be achieved in choppy markets, and the volatility seen year to date is likely to remain a feature of the markets.

Performance periods unless otherwise stated generally refer to periods ended 15 June 2018.

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