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Economic Update

Sydney | 24-07-18

July 2018

Outlook for Investment Markets

Markets in recent weeks have been upset by the potential threat to world economic activity from trade frictions between the United States and other major countries and trading blocs. There have been other episodes of concern over global growth since the current postcrisis global recovery set in, and risk assets have eventually ridden through them, but the current trade stand-offs are nonetheless worrying. On balance, the world economy looks like it may keep on growing at close to previous rates, but as the IMF and many others have said, risks to the outlook have risen, and investors may want to start thinking about taking some insurance against the trade disputes playing out badly. Interest-rate-sensitive assets have also struggled as monetary policy has started to turn less supportive, particularly in the US. At home, the local business cycle appears to be improving, and although there are still sectoral challenges for local risk assets, notably the weak outlook for financials, the uptick in growth should provide some selective opportunities.

Australian Cash & Fixed Interest — Review

Short-term interest rates are unchanged: The Reserve Bank of Australia has continued to hold the target cash rate at 1.5%, and other short-term rates have been correspondingly steady, with the 90-day bank bill yield currently 2.0. Local bond yields have uncoupled from their usual relationship with US bond yields: although the local 10-year Commonwealth bond yield followed its US equivalent higher earlier this year, more recently it has gone its own way, and at 2.63% it is currently trading lower than the 2.9% yield in the US market. The Australian dollar has been weak against other major currencies, particularly against the yen (-5.8%) and the US dollar (-5.4%). Year to date it has dropped by 2.8% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The most recent policy statement from the RBA, at its policy meeting on July 3, said that "the next move in the cash rate would more likely be an increase than a decrease," but also that "there was no strong case for a near-term adjustment in monetary policy. Rather, the Board assessed that it would be appropriate to hold the cash rate steady and for the Bank to be a source of stability and confidence while this progress towards higher inflation and lower unemployment] unfolds." Both the futures market and a range of forecasters have interpreted the statement to mean that the RBA will keep the cash rate on hold at least until the second half of 2019. It is possible that the current cyclical pickup could see the RBA bringing forward the date of an eventual rate hike, but whatever the exact timing low short-term rates look very likely in place for some time.

As noted in the international fixed-interest section, the more likely scenario is that the current global expansion will continue into 2019, taking global inflation and global months yields higher. There is an alternative scenario, currently less likely, in which geopolitical setbacks to the current world business cycle cause lower inflation and lower bond yields. On the more likely view, local bond yields could well revert to their previous relationship with US yields, and head higher as well. In the latest semiannual 'Scope' BusinessDay roundup of economic forecasts, the average pick of the forecasting panel was for a 10-year bond yield of 3% in a year's time.

Currencies are inherently problematic to predict, but the most obvious factor that may come into play is the likely widening of interest-rate differentials with the US dollar as the US Federal Reserve continues to raise interest rates while the RBA keeps local rates on hold. Given that the Australian dollar is sometimes regarded as "commodity backed," the recent softening of world commodity prices, if maintained, may also tend to push the local currency lower. Further Australian dollar weakness looks a plausible outcome, but as always with currency forecasting, a wide range of factors is in play. In the Scope survey, for example, the forecasters were evenly split between likely appreciation and depreciation, and the foreign exchange markets may choose to pay more attention to one factor than to another. On the

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Commonwealth Bank's latest forecasts, for example, the Aussie dollar could bounce back up to USD 0.76 in a year's time.

Australian & International Property — Review

The A-REITs have reacted in the same way as overseas property and other bondlike asset classes to concerns about potentially higher bond yields, with a sell-off early in the year which that reversed later as bond yields did not rise as feared. Slight falls in recent weeks have eroded some of the May/June recovery. For the year to date, the S&P/ASX200 A-REITs Index is up 1.8% in capital value and has delivered a total return of 4.5%.

Overseas, initial concern and a subsequent rethink about the outlook for bond yields have also driven the performance of listed property, with the result being little net movement in the FTSE EPRA/NAREIT Global Index, which has recorded a small 0.8% loss in terms of net return in US dollars. By region, Japan did best with a 7.7% net return; Germany also did well with 4.4%. The key US market showed little change, returning 0.7%. The UK market softened (-3.2%), and there were also patches of weakness in the eurozone (including Italy's -6.6%). Emerging markets were very weak, in line with emerging-markets equities and bonds, and returned a net loss of 11.8% (all regional returns in US dollars). In parts of the eurozone, listed German property returned 3.5% (all regional results in US dollars).

Australian & International Property — Outlook

Except for retail property, the operating conditions for most subsectors of the A-REIT market are reasonably good, and the recent evidence of some cyclical improvement in the economy suggests conditions will get better again in coming months. The latest (June) quarterly ANZ Bank/Property Council of Australia survey of the sector found high levels of confidence among industry participants (again, ex retail), and other reports also point to generally landlord-friendly conditions. JLL's latest research report on the office sector, for example, showed particularly tight markets in the two major markets of Sydney and Melbourne. In Sydney, JLL said, "growth in Sydney's CBD [central business district] prime office rent continues to be among the highest in the world, with double-digit growth in prime net effective rents over the past two years. Growth is currently at 26 percent ... Vacancy, at 5.5 percent has been stable over the past quarter, but the secondary vacancy rate of 4.9 percent is the lowest it has been since 2001."

As any number of research reports have said, retail, other than the very large "event" or "destination" shopping malls, continues to be overshadowed by the threat from online shopping. Knight Frank's latest (June) report on the Melbourne retail market, for example, said that "Competition to bricks and mortar retail will come from online retail, which is growing and is tipped to reach 10% of all retail trade by 2020. The growth of online retail could potentially be accelerated by Amazon which launched in early 2018, and by tactical marketing initiatives such as eBay's 'eBay Plus' offer which provides for unlimited deliveries and returns."

As with other property markets, the valuation threat from rising bond yields still lurks in the background, but absent any unexpectedly sharp rise in bond yields, improving operating conditions suggest that the A-REIT sector should be able to generate some further modest capital gains.

Overseas, in the key US market operating conditions have been very good. As property company Cushman & Wakefield put it, "Nearly nine years into the current cycle, the US economy is strong and getting stronger. The leading indicators that correlate well with the property markets are in excellent shape." There has been the usual pecking order of subsectors, with industrial at the top, office in the middle, and retail at the bottom. At the top, the demand for e-commerce logistics has done wonders for the likes of warehouse space: Cushman & Wakefield said that "Healthy demand combined with modest supply growth caused US industrial rents in the second quarter

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of 2018 to increase 7.2% from a year ago, rising in 58 of 79 markets; 18 markets reported double-digit gains." At the bottom end, however, "Closures of weakest malls and centres will ramp up in the second half of 2018." Cushman & Wakefield believe, perhaps overhopefully, that "The reinvention of these dying malls as mixed-use projects will gain momentum in 2019 and beyond," but even if some escape the chop, large parts of the sector face strong headwinds.

The offset to strong operating conditions in the US is that it is also the market where bond yields are likely to rise fastest. As the latest regional performance data show, the result has been a hard-fought draw. Elsewhere in the world property faces the opposite mix: not quite so buoyant in terms of rental growth and tenancy uptake, but also less exposed to normalisation of monetary policy. Again, the combo has translated into not much in the hands of investors. The rest of the year may see more of the same.

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Australian Equities — Review

After showing little net movement in the first half of the year, the Australian market has perked up over the past month, and the S&P/ASX 200 Index is now showing a year-to-date capital gain of 3.6% and a total return of 5.8%. This is despite the ongoing drag of the financial sector (down 2.2% year to date) and, since mid-May, a gradual slide in the resources sector, although the miners are still ahead for the year (up 3.6%). The globally in-demand IT sector is currently best in class for the year (up 14.0%) while defensive consumer staples stocks have also done well (up 11.5%).

Australian Equities — Outlook

The latest data suggest that the domestic economic cycle is gradually improving. There was, for example, a strong rise in employment in June--50,900 new jobs in the month, roughly treble what forecasters had expected--and the firming labour market has drawn out more people to look for a job now that the chances of finding one have improved (a rise in the participation rate, in economic jargon).

The same sentiment has been captured in the latest (July) consumer confidence survey run by Westpac and the Melbourne Institute. Confidence lifted in the month, and Westpac said that "the latest lift in sentiment is being driven by growing optimism about the economy. The 'economic outlook, next 5 yrs' subindex surged 9.8% in July to be up nearly 20% on a year ago. The 'economic outlook, next 12 months' subindex also posted a solid 3.9% rise to be up 13.5% [over the year]. Both subindexes are now well above their long run averages."

Similar optimism can be seen in the latest (June) quarterly business survey from National Australia Bank. Current conditions are quite good--"Overall, conditions remain favourable, and a pattern of broad-based strength remains evident at the industry level, with most industries at or above average in Q2," as NAB put it--and are likely to get better again. Business expectations about the coming year have been progressively improving for some time.

The big question is how much of the cyclical improvement will flow through to higher share prices. There are still likely to be some sectoral headwinds: While bank shares have fallen to undemanding valuations, the outlook for bank profits remains unclear, and the banks are likely to remain under intense regulatory scrutiny, which may continue to deter investors. And the resources sector remains exposed to global trade shocks: The main indexes of world commodity prices have been falling since late May as trade tensions have risen. But elsewhere there are likely to be selective opportunities as domestic growth picks up: Credit Suisse, for example, reckons that profits in the industrials sector (ex BHP) will pick up by a tad more than 10% next year.

International Fixed Interest — Review

World bond markets have been a difficult class for investors for the year to date: the Bloomberg Barclays Global Aggregate Index is down 1.4% in US dollars. Investors in global government bonds are down by 0.9%, while investors in global corporate debt are down by 2.7%, owing to both higher base US interest rates and a widening in corporate credit spreads.

Some investors are ahead: Yen-based investors in yen debt are up 0.8%, for example, as are euro-based investors in eurozone debt, up 0.3%--as much of the adverse effects have been felt in US-dollar-denominated debt. The 10-year US Treasury bond yield has risen to 2.9% from 2.4%, whereas yields have shown little net change in other major bond markets. The Bloomberg Barclays US Aggregate Bond Index, for example, is down 1.5%, and the Long Treasury index, where the capital impact of higher bond yields is largest, is down 2.6%. The troubles facing some emerging markets, and the consequent spread of investor caution to the wider emerging-markets asset class, have also played a part; the Bloomberg Barclays Emerging Markets Aggregate Index is down 2.6% in US dollars.

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International Fixed Interest — Outlook

The outlook for the asset class--on the more likely scenario of two main alternatives--remains problematic.

The more likely outlook is that the world economic expansion remains intact, that global inflation pressures gradually rise so that more central banks achieve inflation nearer their targeted levels (usually 2%), that monetary policy settings are gradually readjusted to be less supportive than previously, and that rising bond yields lead to ongoing capital losses.

Recent data, other than on the relatively unpredictable geopolitical front, tend to support this scenario. The chair of the Fed, Jerome Powell, confirmed in evidence this month to a US Senate committee, that the Fed would go on raising interest rates, and both the futures market and economic forecasters continue to expect a series of increases to the fed funds rate and a rise in the US 10-year bond yield over the next year.

Other major central banks are also inching closer to the starting line for normalisation of monetary policy. According to a July Bloomberg survey of European economic forecasters, the European Central Bank will (as it has indicated) stop its bond purchasing programme at the end of this year. Although the ECB has not indicated when it might move on interest rates, the forecasters expected some announcement on policy direction by next March, and the first actual increase by September: admittedly only a tiny increase, to -0.2% from -0.4%, in the deposit rate the ECB offers to banks, but nonetheless the start of a gradual process.

Remarkably, there has even been some speculation that the Bank of Japan, which is still on an aggressively supportive monetary policy stance, might even tweak back its support to something more sustainable. The most recent inflation data, however, may have scotched the idea, as consumer inflation ex food and energy, the bank's preferred target measure, was only 0.2% in June, lower than expected and far below the 2% target level.

Elsewhere, though, the likelihood is that global inflation will pick up and interest rates rise accordingly. As the latest (June) IHS Markit global business outlook survey found, "inflation expectations remain elevated by historical standards. The net balance of global firms predicting greater cost burdens is the second-highest recorded in over five years, while that for selling prices is the second highest since February 2014. Companies worldwide envisage that currency fluctuations, trade wars, tariffs, higher prices for oil and other commodities will push up input costs." This sort of higher inflation world is uncongenial for bonds.

An alternative scenario, however, cannot be ruled out completely. In that scenario, the world business cycle takes a knock, most likely from the direct and collateral damage of protectionist trade policy, and central banks are forced to backpedal from what would then be a misguided removal of monetary policy support. As part of the process, ongoing geopolitical tensions would also raise demand for safe-haven assets, again leading to lower bond yields and higher bond prices.

On balance, the view of ongoing global growth still looks more likely. As surveys of fund manager allocations have shown, managers are hedging their bets a bit: The alternative scenario is more likely than previously, and in the latest (July) Bank of America Merrill Lynch fund manager survey respondents have slightly increased their allocation to bonds. But a very large net 46% of respondents are still underweight to bonds: That is well down on the record net 69% underweighting recorded in February this year, but it is still a very substantial majority picking further difficult times ahead for bonds.

International Equities — Review

World shares have continued to struggle, particularly in the face of rising trade war tensions, and the MSCI World

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Index for the year to date is up by only 2.6% in the currencies of its constituent markets and by 1.7% in US dollars (2.9% including taxed dividends). Equity prices remain 2.6% below their 26 Jan peak.

The modest overall gain for the developed markets has come largely through good performance in the US, where the S&P 500 is up 4.8%: without the US contribution, the MSCI World Index would have dropped by 3.2% in US dollars. Other developed markets have made little progress year to date: in Japan the Nikkei is down by 0.3%, while in Europe the FTSE Eurofirst300 Index is down 1.2%.

Emerging markets have done badly; the MSCI Emerging Markets Index in US dollars is now down 7.6% since the start of the year. The asset class has fallen markedly out of investor favour. While originally its problems were concentrated in two countries--the MSCI Argentina Index in US dollars is down 40.3% and the MSCI Turkey Index is down 37.2%--investor nervousness has become more generalised, particularly as trade war tensions have risen. Even investors who have stayed within the core BRIC portfolio (Brazil, Russia, India, China) are now looking at a year-to-date loss of 6.2% in US dollars, with Chinese shares especially weak in the environment of tit-for-tat trade retaliation with the US. The Shanghai Composite Index is down 14.5% since the start of the year.

International Equities — Outlook

The recent outperformance by US equities reflects a number of positive US-specific factors. The American economy continues to be supported by a strong boost from fiscal policy in the wake of large tax cuts. Profit expectations are consequently high: According to US data company FactSet, share market analysts expect profits for the companies in the S&P 500 to rise by 20.4% this year (partly influenced by a doubling of profits in the energy sector) and by a further 10.1% in 2019. Analysts think that the S&P 500 will be 3104 in a year's time; this would be a 10.8% rise from its latest close. The US is also home to many of the big names in the hot IT sector, in particular the FAANGs (Facebook. Amazon, Apple, Netflix, Google), which have been in very strong demand.

Conversely, the global economy has been somewhat under a cloud as fears over protectionism have risen. The latest (June) global business outlook survey run by IHS Markit found that "Businesses globally have pared back their expectations of growth since earlier in the year, citing concerns over political uncertainty and the potential impact of escalating trade wars. In the face of escalating trade wars, only two countries--the US and India--saw manufacturers grow more optimistic about the business outlook. Similarly, only three countries--Ireland, Japan, and Russia--saw their service sector outlook improve."

Trade wars are also on investors' minds. As the latest (July) BAML fund manager survey found, a trade war is now seen as by far the biggest risk facing the equity markets (in June, it had been only a little ahead of the next two big risks, a Fed or ECB policy mistake, and a debt crisis somewhere in the eurozone or the emerging markets).

On the positive side, the long global expansion that set in as the world recovered from the global financial crisis has to date successfully weathered a varied assortment of risks that had seemed significant at the time, notably including eurozone area financial stress, potential economic slowdown in the China, and fears of a rapid rise in US interest rates. This time may be no different, and as IHS Markit said, although global optimism has taken a recent knock, it is still quite strong: "The resilient degree of global optimism suggests worldwide GDP will see a similar rise in 2018 to the 3.3% gain seen in 2017."

On the other hand, that is not how fund managers see it. They have clearly turned more bearish in the BAML survey. In the June survey, they had been slightly positive (a net balance of +12) about faster economic growth: in July that had turned to slightly downbeat (a net balance of -11), the lowest level of optimism since early 2016.

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They have also become pessimistic about the outlook for profits over the next year, with a small majority now expecting a slowdown rather than an increase.

There are also risks around the tech sector: the US FAANGs and their Chinese counterparts, the BATs (Baidu, Alibaba, Tencent) may have a more solid underpinning than the "dot-bombs" that exploded in the tech wreck of the early 2000s, but it is not easy in the middle of a boom to differentiate between great underlying business models and an investor-led bubble.

And while at one point it had seemed that some sort of compromise might have been achievable between the US and China, at time of writing it appeared unlikely, with the US threatening to apply tariffs on all USD 500 billion of Chinese exports to the US.

On balance, the global economy may well continue to stumble through this latest challenge. The IMF, in its latest (July) update to its *World Economic Outlook* forecasts, still believes the world economy will grow by 3.9% this year and again by 3.9% next year. But as the IMF said, "the balance of risks has shifted to the downside in the near term ... The possibility for more buoyant growth than forecast has faded somewhat ... Downside risks, on the other hand, have become more salient, most notably the possibilities of escalating and sustained trade actions, and of tighter global financial conditions." It has been a volatile year to date, and more of the same looks likely while the interplay between ongoing expansion and protectionist policy works its way through.

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