Economic Update

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August 2018

Outlook for Investment Markets

While the long post-global financial crisis global expansion is still intact and is providing fundamental economic support for risk assets, it is increasingly being challenged by downside risks, with trade wars and emerging-markets economies the latest worries. Risk asset classes have also become overdependent on the U.S. economy. All going well, the global and U.S. economies will continue growing through 2019, but the recent pattern of volatility looks set to become an established feature of what are now "late in the cycle" markets. In Australia, the economic data continue to blow hot and cold, though some forecasters, notably the central bank, believe a pickup in growth is not far away. The equity market has picked up, despite the drag of the financials, suggesting that it too may be feeling a bit more positive about the outlook for profitability, although various risks (notably falling commodity and house prices) could derail the prospect of faster growth.

Australian Cash & Fixed Interest — Review

Short-term interest rates are once again unchanged. The Reserve Bank of Australia continues to hold the cash rate at 1.5%, and other short-term rates are also unchanged, with the 90-day bank bill yield continuing to trade at a little under 2.0% (currently 1.96%). Local bond yields have drifted a bit lower, with the 10-year Commonwealth bond yield now just under 2.6%, marginally lower than at the start of this year. Part of the move likely reflects lower U.S. bond yields in August, as Australian yields over time tend to follow the American trend, though it is not always a strong pattern: Unusually, local yields are currently lower than their U.S. equivalents. The Australian dollar is also lower, particularly in the aftermath of rising investor concerns over trade wars and emerging markets: It dropped to 72.4 cents on Aug. 15 from 74.3 U.S. cents on Aug. 8. For the year to date, the Australian dollar is down 3.9% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

In its latest quarterly Statement on Monetary Policy on Aug. 10, the RBA said that "Higher interest rates are likely to be appropriate at some point, if the economy continues to evolve as expected", but both the financial futures market and the economic forecasters reckon that whatever eventual moves the RBA might have in mind are still some considerable distance away. The futures market, for example, thinks the first move will not be till late 2019 or early 2020. Investors will have to live with low rates on the likes of bank deposits for some time yet.

The likelihood is that local-bond yields will gradually track upwards over the next year, in part influenced by the likely rise in U.S. bond yields over the period. Local bank forecasters continue to expect the 10-year yield to be a bit over 3.0% in a year's time: The Commonwealth Bank and Westpac are picking 3.1% for September 2019, while National Australia Bank thinks it could go a bit higher again, to 3.4%. Bond forecasts, however, come with a larger than usual proviso that the world economy does not hit a reef, in which case capital preservation demand could support bond prices and keep yields down.

The currency outlook is, as always, a tough call: Looking at the current forecasts from big four banks, two have it lower in a year's time and two have it higher. On balance, the depreciation view looks stronger at the moment. The Australian dollar tends to weaken when (as now, with trade frictions) international investors' risk appetite has dropped off, and it also suffers when (again, as now) world commodity prices are under pressure. The prospect of an ever-widening gap with U.S. interest rates is also an argument for a weaker Australian dollar. It is possible–as NAB currency modelling indicates–that all these downside factors are already in the price: The bank thinks the Australian dollar is some 2% below what these factors would justify. In that case, it could stabilise or even recover from some of the selling overreaction. But NAB also makes the case that some of these downside factors could get worse again, in which case there could be further weakness in store.

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Australian & International Property — Review

The A-REITs have continued to recover from their sell-off earlier in the year, when valuations had been threatened by fears of an imminent sharp rise in bond yields. As noted earlier, expectations for higher bond yields have been wound back to more modest and gradual rises, and the A-REITs have benefited from the change in sentiment. For the year to date, the S&P/ASX200 A-REITs Index is up 3.1% in capital value and has delivered a total return of 6.4%: for the first time in a while; the total return has come close to matching the total return from the overall share market (7.0%).

There has been the same pattern overseas, except that the recovery in recent months has not yet been quite strong enough to recover from the sharp falls at the start of the year: For the year to date, the FTSE EPRA/NAREIT Global Index is showing a small 1.1% loss in terms of net return in U.S. dollars. As with the wider equity markets as a whole, the U.S. has supported the overall outcome: Ex the U.S., listed property in the other developed economies property returned a 2.5% loss. And, again like shares more generally, emerging markets have detracted strongly from performance, with the FTSE EPRA/NAREIT Index of emerging markets down by nearly 20% in terms of net U.S. dollar return.

Australian & International Property — Outlook

The threat of rising bond yields has not lifted entirely from the sector. NAB's latest (June) quarterly survey of commercial property professionals included a special question about the impact of higher rates: The answer was, "If medium- to long-term interest rates continue to rise, 1 in 5 (18%) property professionals think this will cause property values to fall more than 10%, and 1 in 2 (51%) by less than 10%."

On the other hand, the scale and speed of increases in bond yields now looks far less threatening than appeared likely six months ago, and operating conditions for property (with the exception of large parts of the retail subsector) look reasonable and outright strong in some areas. JLL's latest (June quarter) Office Index, for example, estimated that, because of very tight demand/supply conditions, office rents in the Melbourne central business district rose by 12.8% over the past year, and capital values had appreciated by 12.3%. The corresponding figures for the Sydney CBD (12.5% and 10.9%) were almost as strong.

The respondents in the NAB survey expect that vacancy rates in the office and industrial sectors will fall over the next two years–even the previously shattered Western Australia office market, though still bad, is slowly coming good–and they expect modest increases in rents (1.7%) and capital values (around 2.0%) over the period. Retail conditions are significantly worse–vacancy rising, rents expected to fall virtually everywhere–but operating conditions in the rest of the sector look supportive of further equity gains.

Overseas, the ongoing global expansion has continued to assist property performance. The Royal Institution of Chartered Surveyors quarterly survey of commercial property measures both investor demand and occupier demand: Its latest (June) results showed that most markets are in the happy position of scoring well on both measures, with many European markets in particular enjoying good conditions. London, with its Brexit problems, is the major exception, with RICS finding that "Something in the region of three-quarters of respondents from the U.K.'s capital view the market as being in a downturn."

It is even arguable that the very weak outcomes in the retail REIT sector may have bottomed out. Knights Frank in its latest (June quarter) U.K. retail Monitor spoke for many retail markets when it said that "While retail occupier markets are not in meltdown, they are definitely in a state of limbo. Retailers are reluctant to commit to new sites and leases until they have greater clarity as to whether others are vacating or remaining on compromised terms, and the effect that this will have on

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pitches, footfall and rental tones." It may be premature to say that "there are some [investors] that are beginning to see retail as a potential counter-cyclical play," but it is looking more plausible that a lot of the adverse structural trends hobbling retail (notably e-commerce) may now be baked into REIT prices. In the U.S. market, for example, overall retail REIT prices have stopped falling (they are up by 1.0% for the year to date), although the malls are still out of favour (negative 3.8%).

While operating conditions remain helpful and retail may finally be pricing in its challenges, the major headwind for the sector is valuations. The RICS survey found that property is generally regarded by those in the industry as expensive, with particularly high "expensive" ratings in Germany and Japan. RICS rightly says that "the extended nature of the current real estate cycle could leave markets more vulnerable to any industry specific or macro shock.. Its own view is that in the more expensive markets "expectations for capital growth largely point to a soft landing rather than anything more damaging," but expensive valuations in the sector leave it rather exposed to any unexpected worsening of the global economic environment.

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Australian Equities — Review

Australian shares have done well by current global equity standards, and have been relatively unruffled by the concerns that have held back many other markets. The S&P/ASX 200 index is now showing a year to date capital gain of 4.4% and a total return of 5.8%. The strongest returns have come from the IT sector (up 15.3% in capital value) and from consumer staples (up 12.4%). The financial sector has continued to hold back overall returns, with the royal commission's exposure of poor banking practices keeping a critical spotlight on the sector, and is down 1.9% year to date, though optimists may prefer to focus on the 9.1% rise in the sector from its absolute nadir in mid June. The opposite is true for the miners – up year to date (by 3.3%), but well down (by 7.3%) from its peak back in May as trade frictions have weighed on the prospects for demand for commodities.

Australian Equities — Outlook

In Australia, opinion continues to be divided between those who see some improvement in the business cycle and those who expect ongoing but sub-par economic growth. At the optimistic end, the RBNZ said in its August 10 quarterly statement on monetary policy that "Supported by accommodative domestic monetary policy and a positive international outlook, GDP growth is expected to be a little above 3 per cent in both 2018 and 2019, which will reduce spare capacity".

On that basis, the share market could do quite well: as the RBA put it, "Analysts' earnings expectations for coming years have been revised higher this year, driven by the resources sector. Expectations are that overall earnings will continue to rise, consistent with survey measures of business conditions, which
remain elevated".

"A little above 3 per cent" is the key moving part: that pace of growth would be enough to get the unemployment rate moving down, with the RBNZ forecasting that it will fall to 5.25% by the end of next year and to 5.0% by the end of 2020. Other forecasters think it is plausible: both the National Australia Bank and the Commonwealth Bank, for example, also expect growth around the 3% mark, and have unemployment falling a bit faster than the RBNZ expects (to 4.9% next year, on the Commonwealth Bank's view). In turn a stronger labour market would do wonders for hitherto cautious consumer spending, which has been a drag on business activity.

But a cheerier outlook is by no means a given. Westpac Bank, for example, doubts that growth will reach the magic 3.0%: it picks 2.5% for next year, which means that unemployment would rise a little, to 5.6%, and would prolong the wary stance of household budgeting. The drought, falling house prices in Sydney and Melbourne, and the potential impact of global trade wars on Australian commodity prices are all factors that could lead to an outcome down the slower end.

Recent data releases have not clarified the issues. There were pluses and minuses in the latest (July) NAB business survey - "Conditions remain well above the long-run average of +6 but have now eased notably since April" - as there were in the latest official statistics on the labour market, which showed an unexpected (though small) drop in jobs in July, but also a small fall in the unemployment rate. It was the same mixed story in the latest instalment of the ANZ – Roy Morgan consumer confidence survey, which found that "A sharp improvement in households' optimism regarding 'future financial conditions' was outweighed by deterioration in sentiment across the remaining subindices about the economy". Households appear to be getting a good deal more comfortable about the longer term outlook, but more worried about the immediate risks to getting there. As in many other markets, "Geopolitical issues may be weighing on sentiment. US-China trade tension was in the news again, supporting the view that they are unlikely to be resolved quickly", as the ANZ said.

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The recent resilience of Australian share prices could indicate that investors, on balance, are getting more confident about the local business cycle. But with geopolitics still fraught, any upturn will remain hostage to largely unpredictable events. At time of writing, for example, some key commodity prices (notably copper) were in free fall as fears of trade tensions had intensified.

International Fixed Interest — Review

Investors have been worried about the ongoing trade frictions between the U.S. and China, which the latest (August) Bank of America Merrill Lynch survey of fund managers showed ranks at the top of global fund managers' concerns. More recently, investors have been confronted by another worrying risk--Turkey's economic problems and the "contagion" risk they might pose to banks holding Turkish debt or to the financing capability of other emerging markets.

Investors faced with these risks would usually be expected to look for the relative safety of high-quality government bonds, and U.S bonds in particular. Bond prices would rise and yields fall. Thus far, however, there appears to have been limited "safe haven" buying. The 10-year U.S. Treasury yield has indeed dropped, but only slightly, to 2.87% on Aug. 10 from its recent high of just over 3.0% on Aug. 1. There was a similar modest fall in the eurozone, where the 10-year German government-bond yield dipped to 0.32% from 0.48% over the same period. At time of writing, the degree of alarm over Turkey's prospects appeared to be abating, and the U.S. yield had correspondingly risen a little, to 2.9%, and the German equivalent had also moved marginally higher.

Economic news had also helped send U.S. yields higher. The "core" inflation rate, which is consumer price inflation ex food and ex energy and which is the focus of the Fed's monetary policy, was 2.4% in July, slightly higher than the 2.3% forecasters had expected and above the Fed's 2% target level. Higher inflation is bad news for fixed interest assets: The current overall U.S. inflation rate (2.9%) means that investors are failing to earn a "real" return over and above the loss of their purchasing power.

The small fall in interest rates in August has helped the performance of bonds as prices have risen, but for the year to date the outcome from the asset class continues to disappoint, largely because of the rise in U.S. yields: The 10-year Treasury yield started the year at 2.4%. As a result, the Bloomberg Barclays Global Aggregate Index in U.S. dollars is down 2.3%. Emerging-markets bonds, like emerging-markets equities, have been especially weak, with the Emerging Markets Aggregate in U.S. dollars down 3.7%.

International Fixed Interest — Outlook

The outlook for the asset class remains difficult. It remains likely that the U.S. Fed will continue to raise short-term interest rates from the levels that were appropriate in the aftermath of the global financial crisis, when inflation was unusually low and unemployment too high. Now, inflation is already back up to the 2% target that the Fed would like to achieve, and the economy is in strong shape. Long-term rates will also track upwards, again in response to inflation and ongoing economic growth.

In terms of numbers, the U.S. futures market (going by the Chicago Mercantile Exchange's "FedWatch" indicator) expects that it is a near certainty (96% probability) that the Fed will raise its target range for the fed-funds rate by 0.25% at its next meeting on Sept. 26. It also believes that there are further rises to come–very likely another 0.25% increase at the Dec. 19 meeting and a 50:50 chance of another by the middle of next year.

The U.S. economic forecasters surveyed by *The Wall Street Journal* are in the same place, predicting a series of monetary policy tightenings. The latest (August) survey also showed that they expect a gradual rise in the 10-year U.S. Treasury yield to just shy of 3.5% by the end of next year. They are not expecting further rises beyond that–they think the 10-year yield will plateau around 3.5%

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through 2020—but even the modest rise they see in the cards would be enough to prolong the poor performance of global fixed interest.

Fund managers in the latest (August) Bank of America Merrill Lynch survey also expect higher bond yields and remain heavily underweight to bonds, with a net 54% taking a dim view of their prospects. They are also significantly overweight to the banking sector, as they expect rising interest rates will be good for the banks.

Other central banks are not as advanced as the Fed in moving to reduce the degree of monetary policy support—the U.K., for example, has been mired in Brexit problems, the eurozone has been growing quite slowly, and inflation still remains very low in Japan—but the general trend towards more-normal monetary conditions will in time extend to them as well (though very late in the piece in Japan's case). In the U.K., for example, the Bank of England raised the Bank rate by 0.5% to 0.75% on Aug. 1 and said that "were the economy to continue to develop broadly in line with its Inflation Report projections, an ongoing tightening of monetary policy over the forecast period would be appropriate." The European Central Bank had previously said it was getting closer to winding down its bond-buying programme, which had been designed to keep bond yields very low.

Bonds might yet provide some insurance value if some financial stress or geopolitical event were to undermine the current global expansion, with the U.S. forays into protectionism the most obvious possibility at the moment. But on the more likely scenario of global growth continuing into 2019, the asset class faces further headwinds.

International Equities — Review

It has been heavy-going for world shares. Investors have been alarmed by the trade tensions between the U.S. and China and in recent days have also had to cope with the potential ramifications of Turkey's problems and with some disappointing earnings results from high-profile American tech companies.

The MSCI World Index for the year to date is up 2.2% in terms of its component local currencies but up by only 0.6% in U.S. dollars (1.9% including the taxed value of dividends). What little capital gain was available was very largely due to the U.S. market, where the S&P 500 is up 5.4%: Ex the U.S., the MSCI World would have recorded a capital loss of 6.7%. Other major markets weakened in local-currency terms: Germany was down 5.8%, the U.K. down 2.5%, European shares in general down 2.9%, and Japan down 2.5%.

Things were worse again in the emerging markets, where the MSCI Emerging Markets Index is down 6.6% in terms of the emerging markets' own currencies and by a substantial 11.7% in U.S. dollars. The core BRIC (Brazil, Russia, India, China) economies were down 11.1% in U.S. dollars. Unsurprisingly, China has done especially badly, with the Shanghai Composite down 17.6% in yuan terms. Much of the recent angst has been caused by extrapolation of risks from events in Turkey, where the local benchmark index (the Borsa Istanbul 100, or BIST 100) is down 17.6% for the year in local lira terms, while the currency has slumped by over 36% against the U.S. dollar.

International Equities — Outlook

Recent geopolitical tensions have taken some toll on world economic activity, though the likelihood is that the post-global financial crisis expansion is still intact and will continue into 2019.

The latest (July) global J.P. Morgan composite index of world manufacturing and services activity, built up from the individual IHS Markit country surveys, found that "the rate of global economic expansion slowed to a four-month low, with rates of increase losing traction in both the manufacturing and service sectors." There was an especially sharp drop in new orders in the metals and

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mining sector, which is particularly sensitive to potential setbacks to world trade.

But J.P. Morgan also felt that better economic conditions ahead "should hopefully provide a platform for global GDP growth to revive later in the year," and forecasters generally continue to expect ongoing global economic growth this year and next. The *Economist*'s August poll of international forecasters found that they expect all 25 countries surveyed to continue growing in 2018 and 2019, with growth next year anchored by strong growth in India (7.4%) and, despite the trade issues, in China (6.3%). The latest BAML survey of major fund managers found that they had become slightly more optimistic about global profits.

Overall, the global economic outlook looks reasonably supportive for equities, though, at this late stage in the long post-global financial crisis recovery, the best period may be behind us. BAML's chief investment strategist, commenting on the latest survey results, said that "With investors telling us they are long the U.S., the Fed and cash, our view remains: peak profits, policy and returns."

Investors must also hope that the U.S. economy and share market continue to deliver, given that for the year to date they have effectively carried the overall international equity class on their shoulders.

On the economic front, the American data continue to be good. The latest employment data, for example, showed that the unemployment rate dropped even further in July, to 3.9%, and business and consumer surveys are strong. The latest (June) survey of small business run by the National Federation of Independent Business trade group, for example, found that "Since December 2016, the Index has averaged an unprecedented 105.4, well above the 45-year average of 98 and rivalling the all-time high of 108.0 in July 1983," and a net balance of 33 per cent of respondents expect better times ahead. The latest (July) University of Michigan consumer sentiment survey was also upbeat: "Despite the expectation of higher inflation and higher interest rates during the year ahead, consumers have kept their confidence at high levels due to favourable job and income prospects."

On the share market front, barring some high-profile tech companies that missed ambitious profit expectations, corporate profits have been robust. According to data company FactSet, which collects both actual profit outcomes and share analysts' profit forecasts, profits have been very strong. Although not all June quarter results are in yet, results to hand show that profits for the S&P 500 companies were up 24.6% on a year earlier. Analysts also have upbeat expectations for the full year–they are picking that a profit gain of 20.5% is on the cards for 2018 as a whole–and for a further 10.3% profit rise in 2019. They currently reckon that the S&P 500 will be at 3,148 in a year's time, which would be an 11.7% increase from its latest close.

A generally positive economic outlook may not be enough, however, to turn around the recent lacklustre performance of world equities. Among the main challenges the asset class faces are the overdependence on the American economy and, within that dependence, the further overreliance on the IT sector; high valuations even allowing for ongoing U.S. growth, with FactSet noting that "The forward 12-month P/E ratio for the S&P 500 is 16.6. This P/E ratio is above the 5-year average (16.2) and above the 10-year average (14.4)"; and the tricky issue of central banks (mainly in the U.S. but also in the U.K. and, not too far away, in the eurozone) removing their previous support without accidentally compromising the global expansion.

There are also geopolitical risks and the potential for emerging markets to spring some kind of financials sector shock. There appears to be no sign of any settlement or compromise between the U.S. and China or between the U.S. and other countries and regions it has been targeting with trade impediments. As the Michigan consumer survey said, "Resolution is critical to forestall decreases in

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consumer discretionary spending as a precaution against a worsening economy." Trade war impacts remain the key risk for the fund managers in the BAML survey. And while Turkey is not in itself a huge player in the world economy, its issues could lead to a reduction in investors' willingness to finance emerging markets in general.

In sum, more volatility looks the likeliest outcome. Investors will be navigating between still supportive global macroeconomics and a variety of challenges, led by protectionism, that might finally derail the global business cycle. A happy–if at this point unlikely–resolution of trade issues might see global growth underpin stronger equity performance, but the more likely outcome looks like further lacklustre gains against a background of rising risk.

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