

## Economic Update

Sydney | 14-09-18

# September 2018

### Outlook for Investment Markets

The world economy is still growing, which is a generally positive background for risk assets, but investment outcomes have become overdependent on ongoing gains from U.S. equities. The most likely outlook is ongoing global expansion, though trade wars, monetary policy mistakes, problems in some emerging markets, and geopolitical shocks are all real risks to monitor. Bond yields in the U.S. have headed higher and have contributed to weak performance by global fixed interest and by global income-oriented assets like property and infrastructure; Australasian property markets, however, have been performing rather better. In the Australian economy, it looks as if the pace of business activity may be moving into a slightly higher gear, although the ongoing drag of the financials sector remains a concern for equity performance.

### Australian Cash & Fixed Interest — Review

The Reserve Bank of Australia continues to keep the cash rate at 1.5%, and other short-term interest rates are correspondingly steady, with the 90-day bank bill rate at a little under 2.0% (1.93% currently). Long-term rates fell up to early September, mainly reflecting lower U.S. bond yields: At its low point on 3 September, the 10-year Commonwealth bond yield was 2.53%. In recent weeks, however, U.S. bond yields have been on the rise and have taken local rates up with them: The 10-year Commonwealth yield is now a bit higher at 2.6%. The Australian dollar has depreciated: Likely reasons include the prospect of widening interest-rate differentials between the RBA and the Fed in the U.S. and the global strength of the U.S. dollar (up 4.1% in overall value since the start of this year). For the year to date, the Aussie dollar is down 5.5% in overall value and in particular down 8.9% against the strengthening U.S. dollar. In terms of the headline USD rate, it has dropped to 71 U.S. cents from 78 cents.

### Australian Cash & Fixed Interest — Outlook

Forecasters have generally agreed with the RBA's Statement on Monetary Policy in August that there is an interest-rate hike somewhere on the horizon but do not see eye to eye on when. For Westpac Bank, for example, the cash rate will be on hold all the way out to the end of 2020, and the current pricing in the financial futures market is broadly in the same camp, with a first rate hike not expected until late 2020. The other big banks, however, think the first rise will be earlier than that, most likely in the second half of next year. Either way, low rates on bank deposits will remain a fixture for some time yet.

The likelihood is that local inflation will gradually pick up more towards the middle of the RBA's 2.0% to 3.0% target and that U.S. bond yields will continue to rise. Both factors should lead to some rise in local bond yields, though there is quite a variety of views on how large the rise might be. The latest bank forecasts suggest an increase to around the 3.2% to 3.3% mark in a year's time. Rising yields will make it difficult for total returns from bonds to perform well.

Currency forecasting is a highly inexact science, and the latest forecasts from the banks consequently show a difference of views. Two of the banks (ANZ and Westpac) think the Aussie dollar in a year's time will be a little lower than it is today, at around 70 US cents. The other two (the Commonwealth and NAB) see the Aussie dollar appreciating back up to the 75 – 76 U.S. cent area. There are good arguments on both sides: Widening interest-rate differentials against U.S. rates, for example, would argue for the lower number, but an upbeat view on Australia's growth rate and world commodity prices would take you the other way. At least forecasters are, for now, reasonably agreed that further falls along the lines of earlier this year do not look likely.

### Australian & International Property — Review

The A-REITs have benefited from a winding back of expectations about the likely rise in bond yields. For the year to date, the S&P/ASX200 A-REITs Index is up 3.7% in

## Economic Update

Sydney | 14-09-18

### September 2018

capital value and has delivered a total return including dividends of 7.0%. The sector has narrowly outperformed the wider share market, where the equivalent figures are a capital gain of 1.8% and a total return of 5.2%. The sector has been enlivened by a pickup in M&A activity, with a bidding contest for the Investa Office Fund and (just announced at time of writing) a likely takeover move on the Centuria Industrial REIT.

Global property has not fared quite so well, and for the year to date the FTSE EPRA/NAREIT Global Index is showing a small 0.7% loss in terms of net return in U.S. dollars. While overseas property shares, like their domestic counterparts, had shaken off their worst fears about higher rates and had risen steadily from April through to mid-August, more recently share prices have slid again, dropping by 3% since 20 August. As with equities generally, what performance there has been reflects a relatively strong U.S. market: Ex the U.S., the net return would have been lower again, at 1.6%. Emerging markets have also performed very poorly, with the net USD return from FTSE EPRA / NAREIT index of emerging markets in Europe, the Middle East, and Africa showing a loss of 24.1%.

#### Australian & International Property — Outlook

The latest (September quarter) ANZ Bank / Property Council of Australia survey of commercial property, with two exceptions, generally painted an upbeat picture of the outlook for the property sector. The industrial, office, hotels, and retirement living sectors are all more optimistic than they were a year ago, and all of them have high expectations for capital gains, particularly retirement living (everywhere), industrial property (everywhere), and offices (mainly Melbourne and Sydney).

The two exceptions are easily guessable. The retail sector has been under a cloud for some time, and although Colliers argues in its latest investment review of the sector that Australian retail is not as vulnerable to e-

commerce as elsewhere—"The relatively low supplied retail market in Australia contributes to strong catchment engagement and high footfall in our shopping centres" compared with more at-risk operations overseas—investors remain wary of the sector. More recently, the housebuilders are finding it tougher going. The ANZ / PCA survey found a sharp fall in business confidence in the sector in the latest quarter, and respondents now expect falls in house prices in New South Wales (mainly) and Victoria (less so) over the next year.

Retail and house construction apart, there is enough in the economic outlook to support the operating prospects of property, expectations of bond yield increases are now more modest than they used to be, and REIT prices remain reasonable on a price to net tangible asset backing basis. It is probably optimistic to expect the A-REITs to go on outperforming the wider share market, but there is still the potential for some further gains.

Overseas, the ongoing global business expansion is generally helpful for property, although as with the wider equity market (discussed later) there is a clear distinction between the U.S. and everywhere else. Market conditions in Europe, for example, are nowhere near as strong as in America. Knight Frank's latest quarterly review of European commercial property found that "The average European prime office rent fell by over 6% year-on-year, the steepest fall in ten years. The 30% rental increase in Berlin could not offset falls in Zurich, Geneva and Paris La Defense, where the current prime rent is below the 5-year average." The large U.K. listed property market is also at significant risk from a poor Brexit negotiation outcome. Investment opportunities outside the U.S. are necessarily more selective and tactical (Knight Franks mentioned Madrid and Prague, for example), rather than riding a strong economic cycle.

Overall returns from the asset class consequently ride on the U.S. Cushman & Wakefield's latest (September) macro forecast, which says that "By nearly every relevant metric, the economic backdrop pertaining to the property

**Economic Update**

Sydney | 14-09-18

**September 2018**

markets is in excellent shape.” The outlook for industrial property in particular is strong— “our forecast for overall industrial asking rents calls for a strong year in 2018, with a 6.5% growth rate and continued growth in 2019/20” - though retail is at the bottom of the totem pole, particularly lower-quality space. As Cushman & Wakefield colourfully put it, “The situation is increasingly dire for Class C properties, for many of which death spirals appear to be ramping up.”

The big issue is the threat from rising U.S. interest rates. Cushman & Wakefield argue that “The temptation is to say that if interest rates rise, then cap rates [used to value property] will rise—implying that values must fall. Although the higher cost of capital will put pressure on certain assets, the very fact that interest rates are rising signals that CRE [commercial real estate] values should go up, not down. Interest rates are rising because the economy is getting stronger. That means that all of the factors that drive net operating income (NOI)—those that lower vacancy, put pressure on rents, induce greater appetite for risk and debt - will support CRE values even in a rising interest rate environment.” Investors will have to hope the upbeat perspective is right: On the other hand, the recent decline in global REIT prices coincided with the U.S. 10-year bond yield getting back up to close to 3.0%. Investor sensitivity to bond yields may continue to outweigh the more positive economic fundamentals.

## Economic Update

Sydney | 14-09-18

# September 2018

### Australian Equities — Review

Australian shares are slightly ahead for the year, with the S&P/ASX 200 Index showing a small capital gain of 1.8% and a total return of 5.2%. By sector, the best returns have come from IT stocks (19.2% capital gain) and consumer staples (10.3%). The financials continue to drag on the market. Although the sector had recovered somewhat from the worst royal commission revelations of poor banking behaviour, more recently the spotlight has turned on the insurance companies, and the sector is now down 6.1% for the year. The miners have also subtracted from overall performance with a 3.0% capital loss.

### Australian Equities — Outlook

Corporate profits have been doing well. The June reporting season was affected by some outliers—three big companies (BHP, Commonwealth Bank, and Telstra) reported lower profits—but overall, on broker CommSec’s estimates, profits were up 8.4% on a year ago. If you excluded the drag from the big three that went backwards, profits were up by a strong 20%, and for income-oriented investors a higher than usual proportion (90%) of companies paid a dividend, and in aggregate dividends rose by 13.6% on a year ago.

There was also a pleasant surprise when the June quarter GDP data were released. The economy grew at a faster than expected 3.4% in the year to June, well above the 2.9% that forecasters had been predicting, and the news extended the already record-breaking economic expansion to a full 27 years.

One quarter’s data may be neither here nor there, and in any event the June outcome is already a bit dated. But it was an encouraging signal, and more recent data have generally confirmed that business activity is going well. The latest (September) business survey from National Australia Bank, for example, found that “Business conditions regained some of the ground lost in recent months and have been well above average for some time.

In addition, the forward orders index saw a rebound as did capital expenditure. Capacity utilisation remains high and the profitability index remains well above average.”

The Commonwealth Bank’s performance indexes for August are not showing as strong a picture, especially for the services sector, but the bank reckons that the latest readings may be giving an overly pessimistic view of the true outlook: “...still high readings for business expectations about the year ahead suggest activity has hit a pothole rather than started a more serious decline.”

In sum, the RBA may be right when it said at its September policy meeting that its “central forecast is for growth of the Australian economy to average a bit above 3 per cent in 2018 and 2019.” That would provide a supportive base for corporate profitability growth, although there is still the important issue of whether equity prices are expensive relative to what lies down the track.

As CommSec said in its reporting wrap-up, “The Australian sharemarket is no longer cheap with the price-earnings ratio at 17, above longer-term averages near 15.5.” (Standard & Poor’s came out with a very similar 16.8 ratio, also on a historic basis.) High valuations mean more-limited prospects for capital gains: CommSec expects the end-year S&P / ASX200 Index to be in the 6,150 to 6,550 range. Taking the 6,350 midpoint, that would translate into quite a modest gain of some 3% between now and the end of the year.

### International Fixed Interest — Review

In the U.S. the key 10-year Treasury bond yield has risen in recent weeks. There was a brief period in later August when investor worries, over Turkey in particular and emerging-markets risk more generally, had spurred the buying of Treasuries as a safe-haven asset, and yields had fallen, with the 10-year yield dropping to close to 2.8%. More recently, however, yields have moved back up again, and the 10-year yield is now a whisker below 3.0% (2.97%).

## Economic Update

Sydney | 14-09-18

### September 2018

Although they are still very low in absolute terms, yields have moved up a little in other major markets as well, with (for example) the German 10-year government-bond yield up from 0.31% (when emerging markets were more of a concern) to 0.41% currently, while its Japanese equivalent has risen from effectively zero (0.03%) at the start of July to 0.11% now.

The increases in bond yields have been modest, but they have helped constrain the return from fixed-interest investments. The Bloomberg Barclays Global Aggregate Index in U.S. dollars has returned a loss of 1.8% for the year to date, with bigger losses where investors have been exposed to longer maturity bonds: The Bloomberg Barclays Long U.S. Treasury index is down 4.5%. The formerly popular “high yield” (low credit-quality) sector has also lost ground, with the index down 1.8%. Emerging markets, which were also a popular option at one point but which are now out of favour with investors, have done worse again, with the Bloomberg Barclays Emerging Markets Index down 3.8%.

#### International Fixed Interest — Outlook

The outlook for international fixed interest essentially splits into the U.S. market and everywhere else.

In the U.S., the most likely scenario is that interest rates will head higher. The Fed is charged with steering towards both full employment and 2% inflation, and on both scores its job to keep monetary policy very supportive until both targets are reached is now effectively achieved. The unemployment rate has fallen to 3.9%, and while economists differ on whether this is tantamount to “full employment,” it is low enough for the Fed not to have to worry about further stimulation of the economy. Low unemployment is also generating stronger wage growth—in the latest (August) data, hourly earnings were running 2.9% up on a year earlier—and inflation is now back up to (and indeed a little bit over) the 2%

inflation rate the Fed would like to see. Again, the Fed no longer needs to keep interest rates very low.

Barring some unexpected shock to the U.S. economy, short-term rates are consequently highly likely to be raised further. The current target range for the fed funds rate is 1.75% to 2.0%: The U.S. economists surveyed monthly by *The Wall Street Journal* currently expect the range will be 2.25% to 2.5% by the end of this year, and they expect two or three more 0.25% increases during the course of 2019.

Long-term U.S. yields are also likely to head north: Treasury bond yields cannot sustainably remain where they are if inflation has risen to over 2%, as it would mean tax-paying investors were receiving little or no real (above inflation) return from holding them. The likely rise will be modest, however: Investors have been deprived of yield for so long that they tend to emerge from the woodwork in large numbers whenever a yield close to 3% becomes available, as it did at the Treasury’s latest auction of 10-year bonds on 12 September. Their pent-up demand for decent returns boosts prices and damps yields. Even so, the trend is towards somewhat higher bond yields: *The Wall Street Journal* panel expects the 10-year yield will be approaching 3.2% by the end of this year and will rise further to 3.5% by the end of 2019. Modest and gradual increases of that scale are unlikely to spook the equity markets, unlike the situation at the start of this year when investors worried that bond yields were set to rise substantially and quickly, and equity markets dropped sharply.

Elsewhere, the other major central banks are unlikely to make any significant near-term changes to monetary policy. In the U.K., the byword is likely to be caution ahead of the sizable risk of a “hard” (no deal) Brexit, and the governor of the Bank of England has agreed to extend his term to help provide policy stability through what could well be a rocky period. In the eurozone, the European Central Bank is sidling up to reducing its “quantitative easing” bond buying. The plan is to reduce

## Economic Update

Sydney | 14-09-18

## September 2018

its monthly asset purchases from 30 billion euros a month to 15 billion and to stop buying any more bonds from the start of next year. But the ECB remains some distance away from raising interest rates or from starting to sell down its accumulated stock of bonds. In Japan, ultra-supportive monetary policy looks set to be maintained at least throughout next year.

In sum, higher U.S. dollar interest rates, steady rates elsewhere. U.S. dollar bond prices will be under downward pressure, and while nondollar bonds will not face capital losses, the other side of that coin is that they will continue to offer pitifully low yields. Bonds have insurance value, and in a climate where (as noted later) investors may be too blasé about risks, insurance may be worth having, but otherwise the fundamental drivers of fixed interest are running against the asset class.

### International Equities — Review

World shares have made a small gain for the year to date. The MSCI World Index is up 3.4% in terms of its various local component currencies and up 2.3% in U.S. dollars (3.8% including taxed dividends). The outcome continues to rely on the U.S. performing strongly: The MSCI World index ex the U.S. has actually recorded year-to-date capital loss of 6.2%.

International equity investors have been fortunate that the U.S. market has scored several milestones in recent weeks. On 24 August, when it closed at 2874.7, the S&P500 surpassed its previous all-time record, which had been set on 26 January (2872.9), just before global shares went into a tumble on fears of rising interest rates. The tech-heavy Nasdaq index went over 8,000 for the first time (on 27 August) and earlier in the month Apple had become the first U.S. listed company to be worth a trillion U.S. dollars. And while opinions vary on exactly what constitutes an uninterrupted bull market, the current one is now arguably the longest in U.S. history, having passed the previous 1990-2000 record on 21 August.

Other major markets have largely been missing in action. Apart from a tiny 0.4% rise in the French market, the other major bourses are down for the year in their own currency terms, ranging from a marginal loss for the Japanese market (negative 0.7%) to larger losses in Europe (U.K. negative 4.9%, Germany negative 6.9%).

The other drag on overall asset-class performance has been the emerging markets. The MSCI Emerging Markets Index in U.S. dollars is down 13.3% for the year to date: Within the overall outcome the key BRIC economies (Brazil, Russia, India, China) are down 14.5%. The two countries that have done most in recent months to alarm investors about emerging markets risk have done especially badly, with the MSCI Turkey index down 53.3% and the MSCI Argentina down 53.8% (both in U.S. dollars)

### International Equities — Outlook

The outlook for global shares continues to hang on the same handful of factors as previously: the performance of the U.S. economy, the wider performance of the global economy, the potential impact of trade wars, the tension between expensive share valuations (particularly in the U.S.) and rising bond yields, and the lurking risks of geopolitical issues.

In the U.S., corporate profits have been rising remarkably strongly. On data company FactSet's calculations, profits for the S&P500 companies in the June quarter were 25% up on a year earlier, and on FactSet's compilation of brokers' forecasts U.S. companies are expected to record 20.6% growth in profit for 2018 as a whole. Analysts expect further good news for 2019, with profits expected to grow by a further 10.3%. While the numbers have benefited from some one-offs (rising energy prices, U.S. tax cuts) that will wane over time, this is nonetheless an impressive performance.

The latest economic news has also continued to be reassuring. The key statistic is jobs: There were 205,000

## Economic Update

Sydney | 14-09-18

### September 2018

more jobs in August, much as economists as expected, and the unemployment rate stayed at a low 3.9%. As noted earlier, wages started to grow rather more strongly during the month, at a 2.9% annual rate, the fastest rise in almost 10 years. Remarkably, there are now more job vacancies in the U.S. (6.94 million) than there are officially unemployed people (6.28 million), a situation that first emerged in March and has become more pronounced since then.

The rest of the world is nowhere near as buoyant but is also growing. The latest (September) consensus forecasts from the *Economist* magazine's panel of international forecasters show that the eurozone is picked to grow by 1.8% next year, the U.K. by 1.4%, and Japan by 1.2%. These are self-evidently not tremendous growth rates, and they are vulnerable to even quite modest adverse shocks. But all going well, the major developed economies will continue to contribute to the ongoing post-GFC business expansion.

Although the financial and other problems facing some emerging markets have dominated the news, it is also worth noting that all the key BRIC economies will be growing next year. In the case of the two biggest, growth is likely to be very strong, with India expected by the *Economist* panel to grow by a very substantial 7.3% and China not far behind with a strong 6.3%. Both Brazil and Russia have had their issues, but they, too, are expected to grow next year (Brazil 2.2%, Russia 1.7%).

The central scenario remains one of ongoing global growth. But it could be disrupted. The key issue (as revealed by recent surveys of large fund managers) is the threat of protectionism, largely driven by the U.S. against its trading partners, but there are also other potential trade-disrupting developments, notably Brexit. They may yet turn out to be manageable. At time of writing, the U.S. appeared to be putting out feelers to China to try to prevent escalation of their tit-for-tat rounds of tariff

increases, although there is less room for optimism around the omnishambles of the U.K.'s Brexit negotiations. Even if trade issues eventually become less alarming, however, it is worth bearing in mind that protectionist outcomes range from bad to less bad: All of them put barriers in the way of global trading growth.

There is also the slumbering issue of potential monetary policy mistakes. Faster-than-optimal normalisation of monetary policy could adversely affect economic growth and would also upset the relative valuations of equities and bonds at a time when equities, especially in the U.S., are expensive. The historic P/E ratio on the S&P500 is 24.2 times earnings, and the prospective ratio is 17.8 times. The equivalent ratios for the tech-oriented Nasdaq index are even higher, at 25.75 and 21.4. Valuations leave little room for earnings disappointment, valuation reassessment, or adverse shocks out of the blue.

There is also the risk that investors have once again become too relaxed about the true level of potential risk, especially when the tenor of much "tenth anniversary of the GFC" commentary has been that finance still has the potential to spring further unpleasant surprises. The VIX index of the volatility investors expect to encounter from holding the S&P500 has once again dropped back to low levels, consistent with investors seeing no especially worrying risks on the horizon. This does not ring especially true, considering the range of financial, economic, and geopolitical risks that might yet trip up the global economy.

While risks abound, the post-GFC world economy and global equity markets have found a way to muddle through, and some further modest gains remain the most likely scenario.

*Performance periods unless otherwise stated generally refer to periods ended 12 September 2018.*

## Economic Update

Sydney | 14-09-18

## September 2018

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