Economic Update

Sydney | 25-10-18

October 2018

Outlook for Investment Markets

World equities sold off in October, based on a range of concerns. The two most important were the potential impacts of higher bond yields, and the prospect of the U.S. or global business cycles running out of momentum. Higher bond yields have not only depressed returns from bonds but have also weighed on property and infrastructure. The likelihood is that both the U.S. and global expansions are still intact, but risk levels have risen at this late stage of the cycle, and further volatility can be expected. In Australia, the latest data suggests a reasonable rate of ongoing economic growth, though not at a pace that is likely to generate strong growth in corporate profitability.

Australian Cash & Fixed Interest — Review

Short-term interest rates have been steady, with the 90-day bank bill yield trading a little below 2.0%, reflecting the Reserve Bank of Australia's unchanged monetary policy. The cash rate was yet again held at 1.5% at the latest monetary policy decision on Oct. 2. Bond yields have moved up a bit from their recent low point in early September: the 10-year Commonwealth bond yield had got as low as 2.53% (Sept. 3) but at the time of writing is back up to close to 2.7%. The Australian dollar has been weak: year to date it has dropped 5.1% in overall trade-weighted value, mainly due to large declines against the Japanese yen (down 9.0%) and U.S dollar (down 8.9%).

Australian Cash & Fixed Interest — Outlook

The RBA has given no recent hints about its next monetary policy move, but current market expectations are that there will be some modest increase in the cash rate some time over the next year or two. Current pricing in the futures market says there is a reasonable chance of a 0.25% increase by the end of next year, and a high chance of one before the middle of 2020. But there is no strong pressure on the RBA, from either a growth or inflation perspective, to alter policy, and it could well leave rates where they are for even longer. For example, Westpac thinks the cash rate will still be 1.5% at the end of 2020. It is likely that short-term fixed interest investments will be offering low returns for an extended period.

Bond yields are likely to move higher. Current yields look rather low in an environment where inflation, at least over the next year or so, looks likely to be within the RBA's 2%-3% target band. U.S. bond yields, which tend to have some influence on local rates, also look likely to head higher. On a reasonable view of where U.S. yields may go (3.5% by the end of next year), National Australia Bank thinks the local 10-year yield will also be 3.5%, which looks as good a view as any, though forecasters with a lower track for U.S. yields will have a correspondingly lower track. Westpac for example has the end 2019 U.S. yield at 3.2% and the local equivalent at 2.8%, only slightly higher than today. Either way, however, the outlook for the asset class suggests some risk to capital values over the coming year.

Forecasters continue to hold diverse views on the outlook for the Aussie dollar over the next year, with takers for all options: the ANZ Bank expects a little more depreciation against the U.S. dollar; Westpac expects little change, and National Australia Bank expects a modesty stronger Aussie dollar. Given the high level of uncertainty, perhaps it makes some sense to average them out and to anticipate no great change over the next year. That would also be consistent with the business community's expectations in the latest National Australia Bank business survey: they expect little change over the next six months. In the very near term, however, there is a real chance further widening of the gap between U.S. and local interest rates could well drive the Aussie dollar a bit lower again.

Australian & International Property — Review

The listed property sector has been caught up in the wider equity market sell-off in October, but has nonetheless proved to be a relatively resilient defensive option. Year to date, the S&P/ASX 200 A-REITs index is

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only marginally down (0.8%) in capital value, and has delivered a small 2.5% total return, outperforming the S&P/ASX 200's 0.7% total return.

The same has not been true of international property, however, which has continued to underperform global equities. Year to date, the FTSE EPRA/NAREIT Global index is showing a 5.4% loss in terms of net return in U.S. dollars, significantly worse than the equivalent negative 0.8% return from the MSCI World index. By region, Japan and Germany have performed best, and emerging markets worst.

Australian & International Property — Outlook

Judging by the substantial level of M&A activity, there appears to be significant investor interest in the sector, but the outlook is not easy to square with the investor attention. Recent surveys have shown a deterioration in expected business conditions.

National Australia Bank's September quarterly commercial property survey, for example, said that "Confidence in commercial property markets fell to new Survey lows. It was weakest in Retail (new lows) and fell sharply (but positive) in the bouncy CBD Hotels sector. More moderate falls were noted in Office and Industrial property markets, and they are expected to be the best performing asset classes over the next 1-2 years." The survey included a special question to identify what respondents saw as the key risks. The result, for investors, "changing bank risk appetite is the biggest risk, followed by increased debt funding costs and domestic/international political uncertainty."

There were similarly lower results in the December quarter ANZ Bank/Property Council of Australia survey. The bank said that in the housing development sector, "Sentiment in the residential segment has fallen to the lowest level since 2012". Other commercial sectors were generally doing better, though sentiment had weakened over the past year across all sectors other than the e-logistics-boosted industrial sector. The retail sector, however, is deeply pessimistic, and expects shopping centre property values to fall over the next year, which was in line with the National Australia Bank survey where respondents expected falls in both retail rentals and retail property values. Again, respondents noted the impact of harder access to credit and expected increases in interest rates.

There are still strong sectors—industrial everywhere, and (at least for now) offices in Sydney and Melbourne—and some investors may benefit if they are lucky enough to be holding the next M&A target. But otherwise the outlook for the sector is looking weaker than previously.

Overseas, there still appears to be significant underlying demand for property. Deloitte's just-released "2019 Commercial Real Estate Outlook" report, for example, found virtually all (97%) of the 500 global institutional property investors plan to increase their investments in the sector next year, and by sizable amounts in some markets. The survey found investors expected to increase their investments in the U.S. and Germany by 13%, and in Canada by 12%.

Perhaps Deloitte's are right in saying, "most institutional investors are committed to the CRE [commercial real estate] industry over the next 18 months despite concerns around a flattening yield curve, various country tax reform initiatives, the potential of trade tariffs in the United States, and the uncertainty around the impact of Brexit in Europe." But if so, it would be bucking a well-established trend, where global listed property has been a prime casualty of the retreat from ultra-low cash and bond yields. With the prospect of higher U.S. bond yields, in particular, featuring prominently in investors' concerns at the moment, more of the same underperformance looks the more likely prospect.

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Australian Equities — Review

Australian shares have followed the global pattern—a gentle drift down from a peak in August or September (in Australia's case Aug. 29), followed by a sharp sell-off over the week of Oct. 5-12. Since then prices have stabilised, but have not recovered from the mid-October sell-off levels. Limited progress earlier in the year means the October losses have been the major driver of year-to-date performance. The S&P/ASX 200 index is currently down 2.6% in capital value for the year, although dividend income brings the total return marginally into the black, for a 0.7% gain.

The IT sector (capital gain of 11.1%) and the consumer stocks (staples up 4.1%, discretionary up 1.4%) are ahead for the year, as are the miners (up 3.0%). Rising world commodity prices in September and October helped insulate the resources sector from the wider sell-off. But the financials (down 11.7%), enmired in Royal Commission criticism, have continued to be a major drag on overall performance, while the industrials (down 2.3%) are also down year to date.

Australian Equities — Outlook

The Australian economy continues its world-record-breaking business expansion (now into its 28th consecutive year). While there have been hints from time to time of an acceleration in the pace of business activity—and these were validated by a clearly stronger-than-anticipated burst of GDP growth in the June quarter—the latest data points more to ongoing growth at a reasonable pace rather than to anything stronger.

The Commonwealth Bank's latest (September) performance of services indicator, for example, found "Business activity continued to expand in September, but the rate of increase remained relatively sluggish, picking up only slightly from August's recent low." In a similar vein, the latest (September) quarterly business survey from National Australia Bank found the pace of activity had slowed down from earlier this year, but was still respectable: "Business conditions have pulled back through the middle of 2018 after reaching very high levels earlier in the year. However, the latest monthly survey suggests that conditions have stabilised at a still high level...Overall, trading conditions, profitability and employment conditions remain quite favourable."

If there is a cloud on the horizon—apart from the ongoing travails of the financial sector—it is the risks around household spending and the health of the retail sector. Westpac's latest (October) "Red Book" analysis of household behaviour said that "The consumer sits front and centre of domestic risks to Australia's economic outlook. More specifically, the extent to which consumer spending is affected by ongoing weakness in wages, spillovers from the correction in house prices and a slowdown in job gains will have a major bearing on the wider pace of economic growth."

Provided the wealth and confidence effects of falling house prices do not derail it, the central outlook is for ongoing reasonable economic growth–the current consensus forecast from the *Economist*'s panel of forecasters is for 2.8% GDP growth in 2019–and reasonable though not buoyant growth in corporate profits. Crédit Suisse, for example, is picking 8% earnings per share growth for next year. That ought to be reasonably supportive for local equities (again, excepting the financials), but the outlook will need something extra to catalyse stronger equity performance. As things stand, Crédit Suisse see profit growth of only 2% in 2020, which is unlikely to enthuse investors.

International Fixed Interest — Review

As noted later in the "International Equities" section, the bond markets have been in the spotlight as the proximate cause of the past month's global equity market weakness.

In a short period in early October, the 10-year Treasury yield in the U.S. went from 3.065% (Oct. 2) to 3.23%

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(Oct. 5). The rise was driven by further evidence of a strong U.S. economy, with the unemployment rate in September dropping to the lowest rate (3.7%) since December 1969. This year, the American labour market has generated an average of 211,000 new jobs a month, a pick-up from the 182,000 a month of 2017. Although yields dropped back a little in the subsequent equity market volatility—the 10-year yield closed at 3.15% on Oct. 11—more recently, the yield has returned to 3.2%.

The rise in U.S. yields has been the dominant influence on poor overall returns form the asset class, as yields in most other major markets have shown little net change. An exception is Italy, but it too has contributed to the weak outcome. Investors have been concerned about the economic policies of the current coalition government: the Italian 10-year government fund yield started the year at 2.1%, and is now 3.6%. As a result, the Bloomberg Barclays Global Aggregate index in U.S. dollars has shown a loss of 3.2% year to date. Emerging markets have been out of favour in the bond markets as well as in equity markets, and the Bloomberg Barclays Emerging Markets index is also down by 3.2%.

International Fixed Interest — Outlook

The minutes of the latest Fed policy meeting on Sept. 25-26, when it had raised short-term interest rates by a further 0.25% said that "participants generally anticipated that further gradual increases in the target range for the federal-funds rate would most likely be consistent with a sustained economic expansion, strong labor market conditions, and inflation near 2 percent over the medium term." Markets currently anticipate there will be three 0.25% increases in the federal-funds target range over the next year.

Importantly, while risks to the global economic outlook have risen, "The balance of risks to the short-term global growth forecast has now shifted to the downside" as the IMF put it in its latest *World Economic Outlook* update—the American outlook looks stronger. The Fed's minutes said "risks to the [U.S.] outlook appeared roughly balanced". On the potential upside, for example, "participants variously noted that high consumer confidence, accommodative financial conditions, or greater-than- expected effects of fiscal stimulus could lead to stronger-than-expected economic outcomes."

If indeed events pan out as the Fed expects—the cash target at 2.76% to 3.0% in a year's time, the economy still doing well, and inflation settled at around 2%—then it is likely bond yields will move a bit higher again. *The Wall Street Journal*'s panel of forecasters think the bond yield will settle around the 3.5% mark in the second half of next year.

At the moment, it is hard to see any offsetting declines in yields in prospect in other markets that might offset the likely capital losses from rising yields in U.S. dollar markets. There was a time when unusually low inflation in the developed world and the need to support recovery from the GFC warranted very supportive monetary policy and abnormally low bond yields: the IMF estimates that inflation across the developed world was only 0.8% in 2016. But it now looks (on the IMF's forecasts) that developed economy inflation will be 2.0% this year, and 1.9% in 2019, and the post-GFC world economy is in stronger shape. This is no longer compatible with global bond yields remaining at very low levels, and the outlook for the asset class remains challenging. Investors will need, however, to balance the likely weak investment outcome against the potential for an insurance pay-off from bonds if the world economy were to run into an unanticipated setback.

International Equities — Review

Undoubtedly, the biggest development in financial markets in recent weeks was the sharp fall in equity prices in the first half of October. In the U.S., for example, the S&P500 index had been drifting gently downwards in any event—at its close on Oct. 9, it was down 1.7% from its peak on Sept. 20—but this was followed by a sharp

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decline of 3.3% on Oct. 10. Although there have been some rallies since then, notably a 2.1% gain on Oct. 16, they have not lasted, and at time of writing, the S&P500 index is still below the level it dropped to following the big sell-off on Oct. 10.

The upshot is that year to date the latest weakness has unwound the gains made earlier in the year, and the MSCI World index is now down by 1.0% in capital value (in the overseas markets' own currencies) and by 2.4% in U.S. dollars. Fortunately, the 8.9% depreciation of the Australian dollar against the U.S. dollar has protected local investors from the worst effects of the overseas weakness.

By region, the U.S. continues to be by far the strongest. The S&P500 is still ahead for the year with a 3.1% gain, and the tech-heavy NASDAQ index is still up 8.2%, despite the big tech names taking some heavy hits in the latest volatility. Without the U.S. performance, world equities would have done significantly worse: the MSCI World in U.S. dollars, ex the U.S., is down 10.2%.

Among other major markets, only Japan has been relatively unscathed, with the Nikkei index marginally lower (down 0.7%) for the year. U.K. and European stocks have been weak, with, for example, the FTSE Eurofirst 300 index down 7.5%. Emerging markets, which had experienced a sell-off of their own even before October's setbacks, have been very weak, with the MSCI Emerging Markets index in U.S. dollars down 15.2% and the core BRIC economies (Brazil, Russia, India, China) down 14.7%.

International Equities — Outlook

Fingers have been pointed in many directions for potential factors behind the recent sell-off. The likeliest explanation is that a number of factors came together, with two in particular to the fore.

As noted earlier, U.S. bond yields rose quite quickly in October, and investors were clearly concerned that higher yields had the potential to upset the relative valuation of equities, especially at a time when U.S. equities are on expensive valuations by historical standards. If bond yields stabilise, or rise quite slowly by modest amounts, equities may well be able to cope with the challenge. In the latest (October) Bank of America Merrill Lynch, or BAML, survey of global fund managers, the 10-year U.S. yield would need to rise to 3.7%, a full 0.5% up from current levels, before fund managers started to seriously consider rotating back into bonds from equities. But rising interest rates remain a risk with a monetary policy mistake by the Fed, in tightening too quickly, rated by the BAML respondents as their second-highest concern.

A second prime factor was an interlinked series of issues around global growth—the ongoing dependence of equity performance on the success of the U.S. economy, the likelihood of the U.S. corporate sector being able to keep on delivering rapid profit growth, and the maturity of the current global business cycle.

On the plus side, the U.S. economy is still doing well. The latest (October) consensus forecast from *The Wall Street Journal*'s panel of U.S, forecasters is for GDP growth of 3.1% this year, and the unemployment rate, which has dropped to the lowest level in almost 50 years (3.7%), is expected by the panel to go a little further lower again. But the issue for investors is whether these impressive results can be kept going for much longer. The good news thus far has been reliant on a big boost from U.S. fiscal policy, via tax cuts. But that impetus will run out, and the WSJ forecasters see U.S. GDP growth progressively slowing to 2.4% in 2019 and to 1.8% in 2020—still well away from any recession, but not the strong environment which has been so congenial for U.S. corporate profits.

According to data company FactSet, the S&P500 companies will have increased profits by 20.2% this year, and are expected by sharebroking analysts to book a further rise of 10.3% in 2019. According to the

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sharebrokers, this would be enough to take the S&P500 onwards and upwards to 3260 in a year's time, which would be an 18.3% rise from current levels. Investors would be very pleased if this upbeat scenario came to hand, but equally—as October demonstrated—the equity market may be very unforgiving if these expectations are disappointed.

Questions are also being asked about a potential slowdown in the global business cycle. The J.P. Morgan/IHS Markit Global Composite PMI [purchasing manager index] which measures the momentum of global business activity has been slowing down since the start of the year, with September's results dropping to a two-year low. And the latest BAML respondents were also notably downbeat about the global economic outlook. A record 85% believed the world economy is in the late phase of an economic cycle; a net 38% think the global economy will decelerate over the coming year, the highest level since November 2008.

That was the "glass half empty" version. The "glass half full" version is the IMF's latest set of forecasts, in the October update of its *World Economic Outlook*. On this view, there may be some modest slowdown in the advanced economies with the IMF thinking they will grow by 2.1% next year, compared with 2.4% this year, but the world as a whole will largely sail on at much the same pace, with GDP growth of 4.7% expected both this year and next. India, China, and the bigger ASEAN economies in particular are expected to power along (2019 growth forecasts of 7.4%, 6.2%, 5.2%, respectively).

As with the rosy U.S. scenario, investors would be heartened if the forecasts come to hand. But the risks are that they may not. As the IMF said, "The balance of risks to the global growth forecast has shifted to the downside in a context of elevated policy uncertainty ... Meanwhile, the potential for upside surprises has receded, given the tightening of financial conditions in some parts of the world, higher trade costs, slow implementation of reforms recommended in the past, and waning growth momentum." Again, while the central scenario of ongoing growth is still a viable runner, the equity markets are likely to react badly to any outcomes that fall short of expectations.

In sum, there is still a reasonable chance of ongoing global business expansion and profit growth into 2019, or even beyond, which would form a usefully supportive backdrop for world equities. But it has become a more fragile prospect, vulnerable to a wider degree of risks. The BAML fund managers' biggest concern was trade wars, but it is easy to think of others—the drag on energy consuming economies of sharply higher oil prices, for example, or the potential for shocks from the unsettled state of geopolitics between the major powers. While the global economy has managed to pick its way through a variety of challenges since emerging from the GFC, and all going well will repeat the performance and keep growing over the coming year, at a minimum October 2018 has shown that there is now less margin for error.

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