Economic Update

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April 2019

Outlook for Investment Markets

It has been a good year for investors thus far, as unexpectedly lower bond yields have not only generated gains for fixed-interest investors but have also improved the perceived attractiveness of many other asset classes. It has helped that late-2018 nervousness about global growth has continued to dissipate. For now, the global economy is still likely to keep growing at a modest pace and should help underpin further investment gains. The major risks are excessive valuations (the other side of the low bond yield coin) and an unhappy outcome to the U.S. - China trade talks. In Australia, while recent indicators are pointing in different directions, on balance the outlook is for slower economic growth than previously expected, and the pace of recent asset price gains may not be sustainable against a modestly more downbeat backdrop.

Australian Cash & Fixed Interest — Review

Short-term interest rates have fallen since the start of the year: The 90-day bank bill yield is down 0.4% to just under 1.7%. Long-term interest rates have continued to fall: Remarkably, the 10-year government bond yield is currently just below 2.0% and has been as low as 1.74% (28 March). The Australian dollar is a bit higher, it has appreciated by 1.2% in overall trade-weighted value, with gains against the yen, euro, U.S. dollar, and New Zealand dollar outweighing losses against the U.K. pound and Chinese renminbi. On its headline U.S. dollar rate, the Australian dollar has appreciated this year to its current 71.8 U.S. cents from 70.6 cents.

Australian Cash & Fixed Interest — Outlook

Analysts have been fixated on one sentence from the minutes of the Reserve Bank of Australia's most recent monetary policy meeting on 2 April: "Members also discussed the scenario where inflation did not move any higher and unemployment trended up, noting that a decrease in the cash rate would likely be appropriate in these circumstances." The financial markets have generally come to believe that the next move will indeed be a cut in the cash rate, with (for example) both the National Australia Bank and Westpac Bank now expecting two 0.25% cuts to the cash rate in the second half of this year. Short-term interest rates look likely to remain very low for the foreseeable future.

On bond yields, some forecasters still cling to the idea that yields will climb back to more "normal" levels: NAB, for example, has the 10-year Commonwealth bond yield back up to 2.6% by next March. But given the evolution of bond yields overseas, it is likely that expectations will be lowered in coming months. Westpac, for example, is now of the view that the 10-year yield will stick around current levels for the next year.

On the currency front, the outlook looks partly dependent on which central banks move first in cutting short-term interest rates. If, for example, the RBA is faster to the draw than the Fed in cutting rates, as seems likely, a lower Australian dollar would look plausible. But there are also positives: The Australian dollar gained, for example, on the latest strong local employment data, and a positive outcome on the U.S. - China trade talks, which is currently a real possibility, would also buoy a currency that is widely seen as leveraged to China's growth prospects. With these cross-currents, forecasters don't see a lot in it either way. The latest (April) Reuters survey of currency forecasters found they were modestly supportive of the outlook for the Australian dollar and expect a 73 U.S. cents level in a year's time.

Australian & International Property — Review

Against the renewed "hunt for yield" backdrop, the A-REITs have done well. For the year to date, they have recorded a capital gain of 10.8%, matching the broader market's 10.9%, and delivered a total return including dividend income of 11.6%, just a little shy of the overall sharemarket's 12.3%.

Lower long-term bond yields have also enhanced the appeal of global listed property, and the FTSE EPRA / NAREIT Global Index is up 12.8% for the year to date in

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terms of net return in U.S. dollars. However, higher demand for property dividend yield was not strong enough to enable the sector to outpace the 15.4% net return from world shares more widely. Investors in the key North American market did best, with a 13.5% return, but overall performance was held back by lower returns in Asia (10.8%) and the eurozone (9.4%).

Australian & International Property — Outlook

The outlook for the A-REITs hinges largely on the continuance of investor demand for acceptable levels of yield, as the operating outlook is not otherwise strongly supportive.

The latest (June quarter) ANZ Bank / Property Council of Australia survey showed that sector confidence is on the wane, with the headline confidence measure dropping for four quarters in a row. Confidence still remains positive—an index reading of 115 where 100 is neutral—but tough conditions in the housing and shopping centre sectors have made a big dent in the readings, and even previously strong sectors such as offices and retirement villages are no longer quite as buoyant.

There are mixed views on the immediate economic outlook (as discussed in the Australian equities section), but in this survey the respondents had a clear opinion: They became markedly more pessimistic about likely levels of business activity. The only shining light is the industrials sector, which has been very strong in recent quarters and became even more so this time around.

In the current yield-sensitive environment, underlying operating fundamentals may have to take a back seat as yield-focused investors drive A-REIT prices higher. But the valuation limit to yield buying may be getting closer: While the sector still offers a useful pickup over bonds, there is now very little difference between the yield on the A-REITs (4.45%) and equities more generally (4.35%, both Standard & Poor's calculations), and investors may come to question the benefits of sector-dependent yield.

Overseas, the unexpected falls in interest rates have also given strong support to the sector. Industry forecasts had been expecting higher rates: As Knight Franks' *Global Outlook 2019* report had said, "Higher interest rates and the end of quantitative easing means we are reaching the end of the 'everything bubble'. For the past decade it was enough for investors to buy property in major gateway markets and the generosity of central banks would help ensure strong returns."

In any event, the central banks have generously kept the liquidity taps flowing, and the global growth worries that had bothered investors in late 2018 have also eased, leading to better prospects for property tenancy take-up and rental increases. As with other income-oriented asset classes, however, the challenge will be valuations. Yields have not yet been pushed to their limit—at just under 4.0%, the yield on the index still provides a useful yield differential over global bonds—but overexuberant chasing of property yields could leave expensive prices exposed to macroeconomic or other shocks.

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Australian Equities — Review

Australian shares have been doing well, though the bulk of the gains occurred in January and February and prices have not pushed on a lot since then (and in recent days have fallen in the case of the miners). Nonetheless, the strong start-of-year gains mean that the overall year-to-date performance shows substantial gains. The S&P / ASX200 Index is up 10.9% in capital value and up 12.3% including the dividend yield. The IT sector remains highly popular (capital gain of 23.4%), and the miners (up 16.3% despite falls recently) and consumer discretionary stocks (up 13.7%) have also done well, with the industrials (up 12.3%) close behind. The relative laggards were consumer staples (up 8.5%) and, inevitably, the still-under-a-cloud financials (up 7.7%).

Australian Equities — Outlook

Recent indicators do not give a clear reading on the outlook for business activity. At one extreme, sharply lower housing prices look to be a major issue. On CoreLogic's March estimates, Sydney house prices have fallen by 10.9% over the past year and are down by 9.8% in Melbourne, which one might expect to have strong ramifications for consumer confidence. But at the other extreme the latest employment data have been strong: There were 25,700 extra jobs in March, well above what forecasters had been expecting, while the makeup of the total was encouraging. The 25,700 total was made up of a 22,600 drop in part-time jobs, replaced by a very large 48,300 increase in full-time jobs.

If the business surveys are taken as the key predictors of where we go next, then the immediate outlook may be for slower growth than previously. The latest (March) quarterly business survey run by National Australia Bank was downbeat: The bank said that "Business conditions continued to ease in Q1 suggesting the loss in momentum through 2018 has continued into 2019. Conditions are now only just above average and negative confidence and forward orders suggest the outlook remains weak." In particular, businesses turned marginally negative about the outlook for profitability, where they had been modestly positive in previous surveys. (The last time they were net pessimists was back in 2013-14.)

The Commonwealth Bank of Australia's latest (March) set of purchasing managers indexes showed exactly the same picture. On the overall index (which aggregates services and manufacturing), the bank said that "Softer economic conditions experienced over the second half of 2018 have continued into the first quarter of 2019 ... Relatively weak demand conditions has led to softer business sentiment, with confidence around the 12-month outlook the lowest since June 2016."

But there are also optimists who reckon the business surveys may be painting too gloomy a picture and that the high-profile setbacks to house prices are not the only moving part to keep track of.

In CommSec's view, "CommSec expects the economy to lift once [the 18 May] election uncertainty is removed. The job market remains in strong shape, with wages trending higher – growing at a faster rate than inflation. The Federal Budget is providing stimulus at a time of softness in the global economy. And while the rebalancing of housing markets is occurring across the country, the infrastructure boom continues."

AMP Capital also recently argued that "The combination of improving growth, okay valuations and still relatively easy monetary policy globally should see this year as a good one for shares, notwithstanding the risk of a short-term correction or pull back in markets - both globally and also in Australia."

It is hard to come to strong conclusions, but on balance forecasters are currently leaning to a more cautious view. The early April poll of forecasters run by Reuters found that the economy is now expected to grow by only 2.2% this year, compared with the 2.7% expected in the previous poll. A reasonable view might be that, in these

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equity-friendly conditions, Australian shares will continue to gain but may not perform as strongly as equities overseas given the domestic uncertainties.

International Fixed Interest — Review

Yields in all the major bond markets have moved lower since the start of the year. In the key U.S. Treasury market, for example, the 10-year yield is now 2.56%, down from 2.68% at the end of 2018, and is now well below its recent peak (3.26% last September). The bellwether of abnormally low global bond yields remains the Swiss market: There, an already negative yield (negative 0.25%) in January has become a tad more negative again (negative 0.29%).

Falling yields have generated capital gains, and the Bloomberg Barclays Global Aggregate Index in U.S. dollars has returned 1.7%, with government bonds up 0.8% and corporate debt up 4.3%. The fall in yields at the very creditworthy end of the asset class has encouraged strong demand for lower-quality bonds: The Bloomberg Barclays Emerging Markets Aggregate is up 5.6%, and their Global High Yield (that is, low credit quality) index has returned 7.2%.

International Fixed Interest — Outlook

With hindsight, it is not too hard to fathom why bond yields have fallen, against earlier expectations of a rise back to historically more normal levels: A number of central banks have come to the conclusion that their economies are not in fact robust enough to absorb the impact of higher interest rates. Planned increases in short-term interest rates are consequently being cancelled or unwound, and (as in Europe) policies of "quantitative easing" to keep bond yields low are also being maintained instead of being wound down.

Current expectations are that the interest-rate tightening cycle in the U.S. is finished. The latest (April) Bank of America Merrill Lynch survey of fund managers, for example, showed that respondents now think the Fed is done, whereas in the previous month they had thought not. Surveys of forecasters, and the pricing in the futures markets, also point to the likelihood of the Fed standing pat for the rest of this year, with the futures market also pointing to a one-in-three chance of a rate cut. In Europe, the European Central Bank will be required to go on providing monetary policy to a weak eurozone economy, and in Japan there is also no sign of any turn away from very supportive low interest rates and robust levels of bond purchasing to keep yields low.

This has all been very welcome news for corporate treasurers, who have been issuing bonds in record volumes, and investors have also been spared the higher yields and associated capital losses that had earlier looked likely. Now, the main issue looking ahead is how to react to very low ongoing levels of running yield. So far, the reaction has been to reignite the "hunt for yield": Investors have flocked to the riskier end of bonds and into income-oriented asset classes, which offer better-than-bonds yields.

Investors will need to take care: The *Financial Times* in the U.K. recently reported that "Greek debt touches lowest yield since 2005." Partly, that reflects investor recognition of some efforts at reform of the Greek economy, but it also likely shows that, if investors are offered Greece's 3.27% yield, they are becoming none too fussy about the credit risks being run to earn it.

International Equities — Review

World shares have extended their strong recovery from the sell-off of late 2018, when investors had become nervous about the global economic outlook.

For the year to date, the MSCI World index of developed markets is now up 14.9% (in the various markets' local currencies) and by 14.7% in U.S. dollar terms. Including the value of taxed dividends brought the total return up to 15.4% in U.S. dollars. Australian investors experienced slightly lower returns, with the Australian dollar

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appreciating by 1.8% against the U.S. dollar over the period.

There have been broad-based gains. The U.S. has been to the fore—the S&P 500 is up 15.9%, and the tech-focussed Nasdaq Composite index is up 20.5%—but many other developed markets have also done well. European shares (as measured by the FTSE Eurofirst 300 Index) are up by 15.8%, thanks in large part to gains in France (CAC index up 18.0%) and Germany (DAX up 15.8%). And, although not quite as robust, the U.K. market, despite Brexit, has managed a decent 10.9% gain, while Japanese shares are also up, with the Nikkei gaining 10.4%.

The emerging markets have also come storming back after being one of the worst affected casualties of last year's outbreak of nervousness. The MSCI Emerging Markets Index is up 13.0% in U.S. dollar terms, and the key BRIC economies (Brazil, China, Russia, India) are up 16.6%. China and Russia have been the big movers: In China, the Shanghai Composite Index started the year quietly but has made up for it since, with sharp rises since mid-February, and is now up 30.3%, while the FTSE Russia Index (which is U.S.-dollar based) is up 18.2%.

International Equities — Outlook

The global economic outlook remains reasonably supportive for equities. *The Economist*'s forecasting unit, for example, expects that virtually every significant economy (ex Argentina) will be growing this year. The U.S. leads among the major developed economies, with likely gross domestic product growth of 2.3%, while the eurozone (1.3%), Japan (1.0%), and the U.K. (1.0%) will be growing more slowly. Fortunately, the overall global economy will continue to benefit from the extraordinary rates of growth likely in the major emerging markets, led by India (7.2%) and China (6.3).

In the key U.S. market, data company FactSet's latest collation of share analysts' forecasts shows that ongoing GDP growth is expected to translate into modest profit growth for the S&P 500 companies of 3.4% this year. It doesn't look much, but the total is (yet again) affected by the volatile fortunes of the energy sector, which on this occasion depress the headline number. Sector by sector, there are decent prospects ahead for the U.S. financials (expected profit growth of 7.0%), consumer discretionary and utility shares (both 6.8%) and industrials (5.8%). Looking ahead, and although it is early days, the analysts think S&P 500 profits will increase by a further 11.5% next year, and their target price for the S&P 500 in a year's time is 3,121, which would be a gain of around 7.5% from its current level.

Fund managers are also reasonably comfortable with the international equity outlook. The latest BAML survey showed that they are far from being outright upbeat—a clear majority (two thirds) expects a global environment of slow growth and low inflation—but they do not expect any imminent recession (that's not expected before the second half of next year at the earliest), and they have consequently been prepared to go more overweight to equities, with emerging markets the most popular pick and U.K. equities the least.

Their two big worries are potential setbacks to Chinese growth and a bad outcome from the U.S. - China trade talks. So far, neither of these most feared risks look like they will materialise. The latest GDP figures out of China, for example, showed that the economy grew at an annual rate of 6.4% in the March quarter, slightly better than forecasters had expected and in line with the December outcome. Although Chinese statistics are squishy, it appears that recent stimulatory policies are keeping growth rolling along.

The trade war risks may also be receding. As far as anyone can tell from the outside, the U.S. - China trade talks appear to be making progress. On April 17, for example, *The Wall Street Journal* reported that "The U.S.

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and China are planning two rounds of face-to-face meetings as they seek to wrap up a trade deal, with negotiators aiming for a signing ceremony in late May or early June, according to people familiar with the situation ... The talks continue, and the negotiators have a history of missed deadlines, but the provisional plan for face-to-face meetings suggests optimism; recent talks have been conducted via videoconference."

These (or other) geopolitical risks could yet derail the equity rally but as of now are not looking like deal-breakers. A greater vulnerability may be valuations: As noted earlier, investors have been mightily cheered by the prospect of interest rates lower than previously expected, and their enthusiasm risks pushing shares into too-expensive territory. FactSet's latest earnings roundup found that "The forward [U.S.] 12-month P/E ratio is 16.8. This P/E ratio is above the 5-year average of 16.4 and above the 10-year average of 14.7." If all continues to go well on the economic and political fronts, valuations may not be an issue. But anything that challenges the current optimism could spark the sort of re-think that saw shares sell off late last year.

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