Economic Update

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May 2019

Outlook for Investment Markets

Both equities and bonds have continued to do well this year. Although U.S. - China trade tensions have weighed on equities in recent days, investors in both local and global equities are still well ahead for the year to date, while investors in domestic and international bonds have also benefited from the capital gains created by largely unexpected falls in bond yields. Bond proxies like property and infrastructure have also fared well. Looking ahead, the global business cycle still looks intact, though 2019 is shaping up to be a bit weaker than 2018. The major risk is geopolitical and hard to call: Nobody can be sure of the outcome of the U.S. - China trade talks, and the impact could be significant (on the upside and the downside). Standard portfolio protection tactics look advisable (diversification, bond insurance, defensive tilts). At home, the business cycle has weakened – the Reserve Bank is likely to respond with at least one interest-rate cut – and although the economy is still growing, listed Australian companies are likely to find it harder going to grow their profitability.

Australian Cash & Fixed Interest — Review

Although the Reserve Bank of Australia kept the cash rate unchanged at its latest policy meeting on 7 May, other short-term interest rates have continued to fall, and the 90-day bank bill yield is now 1.65%, down 0.4% since the start of the year. Long-term interest rates have also reached new lows, with the 10-year Commonwealth bond yield now only 1.75%. The Australia dollar has weakened slightly and is down 0.8% in overall trade-weighted value and by a similar 0.9% in terms of its headline rate against the U.S. dollar.

Australian Cash & Fixed Interest — Outlook

Forecasters had been split roughly 50:50 on whether the RBA would cut the cash rate at its May decision. With hindsight, it was always somewhat unlikely, as the bank would not have wanted to buy into a political argument over rate changes in the middle of a general election campaign, and one month's delay till the June decision avoided controversy. But at least one, and possibly two, 0.25% cuts now look likely in the second half of this year as the bank tries to boost a slowing economy and help get inflation up into its target 2% to 3% band. Savers will be receiving very low levels of bank deposit income for some considerable time to come.

The ongoing fall in bond yields to historic lows has one unexpectedly positive outcome: Bondholders have had some modest capital gains, with the S&P / ASX Index of government bonds up 4.5% for the year to date and the index of corporate bonds up 3.8%. It is possible that bond yields could fall even further again: The Reserve Bank of Australia, in its 10 May monetary policy statement, attributed the fall to very low short-term rates, lower inflationary expectations, less uncertainty about future interest rates, and the volume of bond buying from institutions such as pension funds which need to hold long-term assets. None of those factors looks like it is changing anytime soon: The plus is some further potential small capital gains, the negative is the increasingly low running yields, which will be upsetting the income expectations many investors had for their portfolios.

The Australian dollar rose in the immediate aftermath of the RBA holding rates steady when a good proportion of forecasters had expected a cut, and, as the RBA commented in the latest monetary statement, it is possible that rising commodity prices (good for the dollar) will offset the downward effect of lower Australian bond yields and help keep the dollar around current levels. But the likelihood of a couple of cash rate cuts in the pipeline suggests that the Australian dollar has the potential for further modest weakness in coming months. All guesstimates, however, remain subject to the wild card in today's financial markets: a good outcome from the U.S. – China trade talks would be likely to support the Australian dollar and conversely for a bad outcome.

Australian & International Property — Review

The search for yield has helped the A-REITs, which for the year to date are up 10.6% in capital value and have delivered a total return including dividends of 11.4%, a little behind the 13.3% total return from the wider sharemarket.

Overseas property shares have also done well. For the year to date, the FTSE EPRA / NAREIT Global Index is up 13.3% in terms of net return in U.S. dollars. Gains were widespread across most developed markets, with the key North American market returning 15.4% and European markets returning 11.6%. Asian markets returned a little less (10.6%), mainly because of the relatively small 6.2% gain for Japanese property shares.

Australian & International Property — Outlook

The economic fundamentals are not currently helpful for listed property. In National Australia Bank's latest (March) quarterly survey of commercial property, overall respondents' sentiment turned negative for the first time in four years, with particularly sharp falls in sentiment in the retail and central city hotel sectors. While the office and industrial sectors are still doing well, they too showed falls from previous levels of confidence. Expectations for capital gains and rental increases are modest even in the better sectors and are outright pessimistic for the retail sector: Respondents expect retail rents to drop by 2.7% nationally over the next year. The NAB survey does not cover the housing-oriented REITs, but if it had the results would have been a bit glummer again.

But none of this may make much difference to investors' ongoing appetite for A-REIT yields. With the 10-year Commonwealth bond yield now only 1.75%, the 4.6% yield on the A-REITs is likely to remain on investors' radar.

Overseas, the current global expansion is very regionally differentiated, and operating conditions for property differ quite markedly from one country to the next. Overall, however, operating conditions are reasonably helpful: The Royal Institution of Chartered Surveyors found in its latest (March) quarterly survey that "The feedback provided to the Q1 RICS Global Commercial Property Monitor remains generally quite upbeat despite ongoing macro concerns ... Significantly, for around two-thirds of countries covered in the survey both the headline RICS Occupier (OSI) and Investor (ISI) Sentiment Indices are still in positive territory". The strongest markets are in Central and Eastern Europe, India, and parts of Asia, while London and New York are the main weak spots.

The RICS survey also picked up, however, that many property markets are now expensively valued. The survey asks whether respondents regard their local markets as expensive, fair value, or cheap: In a wide range of markets including Switzerland, Germany, France, Japan, Canada, Hong Kong, and the U.S., a majority of respondents opted for 'expensive', and there were few takers anywhere for 'cheap' (even in Brexit-affected Britain).

As in many other income-oriented asset classes, however, the only valuation yardstick investors currently appear to be focused on is yield differentials relative to bonds. The pretax yield on the FTSE EPRA / NAREIT global index is 3.9%, which still provides a useful yield pickup relative to global bonds. The asset class, although beginning to push its valuation luck on other metrics, will likely continue in favour while investors remain in yield-hunting mode.

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Australian Equities — Review

The global backdrop of higher trade tensions has had an impact on Australian shares, which have drifted down from their recent peak on 26 April. The past weeks' declines have been modest, however, set against the scale of the gains earlier this year, and the S&P / ASX200 Index is up 11.8% in capital value and up 13.3% including the value of the dividend yield. The IT sector remains far and away the success story of the year with a capital gain of 28.1%, and, somewhat oddly given weak consumer spending, the next strongest sector has been consumer discretionary (up 14.8%). The industrials (up 14.6%) and the miners (up 13.1%) have also done well. The financials have brought up the rear with a relatively modest 9.1% gain.

Australian Equities — Outlook

The most recent business indicators have been lacklustre. The Commonwealth Bank's performance indexes for manufacturing and services in April showed that both sectors were barely growing. The very similar indexes compiled by Australian Industry Group showed much the same picture: Manufacturing may have picked up in April, but the (much larger) services sector was going backwards and the construction industry was worse again.

The latest official statistics on retail sales were also poor. In real (adjusted for inflation) terms, retail sales had been unchanged in the December quarter and dropped (by 0.1%) in the March quarter, the first decline since 2012. Household purse tightening is hardly surprising given the shock to family balance sheets from lower house prices. The rate at which prices are falling appears to be slowing down, but that is little comfort for homeowners in Sydney and Melbourne: On CoreLogic's April numbers, prices are down 10.9% on a year ago in Sydney and 10.0% in Melbourne.

The bottom for housing prices may not be too far away. A recent (10 May) market update from AMP Capital for example argued that "Our base case is for national capital city house prices to fall another 5% or so into 2020 on the back of tight credit, rising supply, reduced foreign demand, price falls feeding on themselves and uncertainty around the impact of tax changes under a Labor Government. An earlier rate cut could bring forward the bottom in house prices as in the last two cycles they bottomed four months or so after the first rate cut". In the meantime, however, the direct and indirect ramifications of the weak housing market are contributing to a patch of slower than usual growth.

One consequence is that the RBA now thinks that 2019 will be a weaker year than it had earlier reckoned. It is picking gross domestic product growth of 2% this year, compared with the 2.75% it had expected when it last ran the numbers back in February. By macroeconomic forecasting standards this is a large adjustment of view in just three months.

It could be that the equity markets will look more to the prospect of stronger growth in 2020 – the RBA is forecasting a pickup to 2.75% growth – and there are other currents flowing that may also help keep the recent rally going, notably positive global equity sentiment and the increased attractiveness of equity dividends as interest rates continue to fall. But equally the downbeat outlook for domestic economic activity over the next six months, and the ongoing remediation required in the financials sector – exemplified most recently in early May by National Australia Bank cutting its interim dividend – mean there is a greater likelihood of corporate earnings disappointments than of pleasant surprises.

International Fixed Interest — Review

Bond yields everywhere have continued to fall. In the U.S. market, the initial impulse was the news that the Fed would not, in fact, embark on a series of monetary policy-tightening moves, which would have seen short- and long-term yields head north, but at a minimum would hold rates where they are and even cut them if inflation continued to stay too low or the U.S. economy showed signs of slower growth. In recent weeks, bond yields have also fallen as a side effect of the increased risks around a trade war between the U.S. and China: Investors have bought the insurance of bonds against heightened equity uncertainty.

The upshot is that the key U.S. Treasury 10-year yield is now 2.47%, down by almost 0.25% since the start of the year. Lower U.S. yields have flowed through to other major bond markets to the extent that the benchmark 10-year yields in both Germany and Japan are now marginally negative (negative 0.04% in both markets). The trophy for the most negative government-bond yields continues to be held by Switzerland, where the 10-year yield is now negative 0.37%, even lower than the negative 0.25% prevailing at the start of this year.

Lower yields have translated into modest capital gains, and for the year to date, the Bloomberg Barclays Global Aggregate Index in U.S. dollars has returned 2.3%. Government bonds were up 1.6%, but the real action was in corporate bonds, which gained 4.7% as investors looked for higher yields than are now available on government paper. The same hunt for yield boosted the low credit-quality end of the market, and the Bloomberg Barclays Global High Yield (that is, low credit quality) Index has returned 6.9% and also fed demand for emerging economies' debt, which returned 5.9%.

International Fixed Interest — Outlook

The latest indication of the Fed's intentions came after its 1 May policy meeting, when Fed chair Jerome Powell said that "our baseline view remains that, with a strong job market and continued growth, inflation will return to 2 percent over time and then be roughly symmetric around our longer-term objective".

On its face, this suggests that the Fed is in a good place with no great pressure to move in either direction and that is indeed what the economists polled in the latest (May) *Wall Street Journal* survey of U.S. forecasters expect. They think the fed-funds rate will be around 2.35% to 2.4% right out to the end of 2020, which is consistent with the Fed sticking with its current target range for the fed-funds rate of 2.25% to 2.5%.

Economists' views are all very well, but on the adage that it often pays to follow the money, it is worth noting that the futures markets have a different view and expect some interest-rate cuts. Going by the Chicago Mercantile Exchange's FedWatch tool, which figures out the probabilities of interest-rate moves from futures pricing, the futures market thinks there is only a 37% chance of the Fed sticking with its current target range for the rest of this year. There is a greater probability (42%) that by December the Fed will have lowered the target range by 0.25% and even a chance (18%) that the Fed will have made two 0.25% cuts.

Either way, the likelihood of the Fed tightening now looks completely off the table: There are currently no takers at all in the futures market for the idea. The prop given to global equity prices from the Fed walking away from earlier ideas of tightening looks likely to stay in place.

A lower-than-expected track for monetary policy interest rates also looks likely to feed through to a lower track for bond yields. Currently, *The Wall Street Journal* forecasting panel believes the U.S. 10-year bond yield will creep back up towards 2.75% by the end of this year and stay around that level throughout 2020, but that is looking a bit adrift of reality. The panel (like a lot of other forecasters and fund managers) has systematically overestimated the actual movement in bond yields: Six months ago, for example, it had thought the 10-year yield would be 3.4% this June, which is likely to be a full 1% higher than the actual outcome. A more plausible view is that bond yields will stay near current levels, though the uncertain outlook for the U.S. - China talks could complicate matters. A very bad outcome, for example, could further boost 'safe haven' bond demand and drive yields even lower again; the opposite would happen if the trade talks go well and investors reduce their levels of insurance cover.

Outside the U.S., monetary policies look likely to remain on a highly supportive setting for some considerable time. The latest (April) policy decision from the European Central Bank, for example, repeated that the bank "expects the key ECB interest rates to remain at their present levels at least through the end of 2019". The Bank of Japan is facing the same problem of inflation proving hard to nudge upwards and will also be keeping interest rates very low for a considerable time. And it would not be surprising if the Bank of England needed to give further support to a British economy likely to take some hit from Brexit (assuming a second referendum does not flag away the whole idea).

Low short- and long-term rates look well dug in for the rest of this year (at least). Income from fixed-interest portfolios is likely to be well adrift of what investors had imagined, and a key issue for investors will be to resist taking on excessive credit or duration risk to make up the yield shortfall.

International Equities — Review

Up to early May, world shares had continued their recovery from the sell-off of late 2018. At that point, however, cautious optimism about the outcome of the U.S. - China trade talks turned bearish after anti-China tweets from President Trump were followed by higher tariffs on a range of Chinese exports and by Chinese retaliation with new tariffs of their own. Despite this recent setback, the strong gains earlier in the year mean that year-to-date returns remain substantial. The MSCI World index of developed markets is up 12.9% in U.S. dollars.

With the U.S. economy continuing to do well, the S&P 500 is up 14.9% and the Nasdaq Composite is up 19.3%. European shares, although also well into positive territory for the year, have not quite matched the American markets, with the FTSE Eurofirst300 index Ip 11.3%. The U.K., despite its Brexit problems, is also ahead, with the FTSE 100 Index up 7.1%, while Japanese shares have been least strong, with a 6.6% gain for the Nikkei index.

Emerging markets have also done well, with the MSCI Emerging Markets Index up 7.0% in U.S. dollars and the core BRIC economies (Brazil, Russia, India, China) up 10.2%. This was despite a substantial setback to Chinese shares as trade war expectations worsened: The Shanghai Composite Index dropped by 12.8% between 19 April and 9 May. Although formally the index is up 17.9% for the year to date, the performance reflects the sunnier expectations prevalent in the January – March period more than the more recent downbeat views.

While the recent share-price rises have been impressive and welcome, it is worth noting for perspective that they have not quite regained all the ground lost in late 2018. In U.S. dollars, the MSCI World is still 3.3% below its peak (21 Sept last year).

International Equities — Outlook

The fundamental outlook is much the same. The year 2019 looks like it will not be as good a year as 2018 for global business activity. But the outlook remains for ongoing growth at a reasonable, though not strong, rate this year and next, with pronounced regional variations and considerable geopolitical uncertainty.

The most recent (April) reading from the J. P. Morgan Global Composite purchasing managers index, a gauge of world business activity, showed that the world economy is still growing, but at a slower rate than before, and continuing a pattern of gradual deceleration that extends back to early 2018. Some parts of the global economy are doing well: Notably, this is true for India and China, and the U.S. has been strong among the developed

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economies, with the unemployment rate falling to just 3.6%, the lowest in almost 50 years. Slower growth in other areas (notably the eurozone, Japan, and the U.K.) is constraining the overall outcome.

Other analysts have come to the same conclusion about a somewhat subpar 2019. The latest of the big international institutions to weigh in with its global forecasts is the European Commission. It has also taken a dimmer view of the prospects for this year: In this latest (Spring) set of forecasts, it thinks world GDP will grow by 3.2% in 2019, which is less than 2018's 3.6% and also less than the 3.5% the EC had expected in its previous Autumn 2018 set of forecasts.

But it is optimistic that 2019 is the low spot for growth and that 2020 will be a bit better, with 3.5% growth pencilled in. In the commission's view, "Over the course of 2019, a number of factors should help the global economy bottom out. Following the sharp tightening of financing conditions in the second half of 2018, the reappraisal of monetary policy by major central banks and the move towards a more accommodative monetary policy stance is expected to support a rebound in growth rates, especially across emerging market economies. In addition, significant policy stimulus has been deployed in China, which should help to stabilise activity in the country, while also supporting activity in Asia".

The commission finished its assessment, however, with the proviso that "it is assumed that prospects for at least a temporary solution of US – China trade tensions have improved". Unfortunately, this has not proved to be the case.

At time of writing, the prognostications for the trade outlook remained uncertain. The *Financial Times* in the U.K., for example, was pointing to some potential progress and the possibility that Trump would meet with Chinese President Xi Jinping at the G20 meeting next month to sign off on a deal. *The Wall Street Journal* also thought the meeting might be fruitful but was not overly optimistic given the track record so far: "Bridging the trade rift may ultimately depend on the personal chemistry between President Trump and President Xi and their willingness to push matters forward after months of negotiations that have been full of positive intentions but thwarted by miscalculations, accusations of backtracking and unfulfilled expectations".

From the outside, it is impossible to know how the geopolitics will play out. If there is a good or semi-good outcome, equities will benefit; if not, then recent history shows that investor concerns about global growth can lead to ugly sell-offs, as in late 2018. Hopefully, the outcome will not be pigheaded enough to imperil the base scenario of ongoing global expansion, but with these levels of hard-to-read uncertainty, the best preparation is likely to be extensive portfolio diversification to limit the impact of whatever the politicians deal to us.

Performance periods unless otherwise stated generally refer to periods ended May 10 2019.

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