## Economic Update

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# July 2019

### Outlook for Investment Markets

Interest rates have fallen to ever lower levels, benefiting both bonds (through capital gains) and equities (through improved absolute and relative valuation). Most of the impetus has come from central banks trying to get inflation to the levels they would prefer, but some (including in Australia) has also been insurance against potential economic slowdown. Looking forward, the global business cycle, while still intact, is showing some signs of slowdown and will need a favourable outcome from the currently quiescent U.S. - China trade hostilities if it is going to roll on into 2020 or beyond. At home, there is more evidence of a slowdown in domestic growth, and local equities are looking expensive against what looks (ex the miners) like an uphill road for local corporate profits.

### Australian Cash & Fixed Interest — Review

Interest rates across much of the developed world have fallen to even lower levels, and Australia has been no exception. At the short end, the 90-day bank yield is now 1.15%, down by nearly 1% since the start of the year, and at the long end, the 10-year Commonwealth bond yield is also down by almost 1% to 1.36%. While there has been volatility along the way, at the moment the Australian dollar is not showing much net change: For the year to date, it is marginally down (by 0.2%) in overall trade-weighted value, and at its current USD 70.65 cents is up a tiny bit (0.1%) against the U.S. dollar.

### Australian Cash & Fixed Interest — Outlook

As largely expected, the Reserve Bank of Australia cut interest rates by a further 0.25% in July following its earlier 0.25% cut in June. Forecasters reckon it is not finished yet: The ANZ Bank, National Australia Bank, and Westpac Bank all expect the cash rate to be cut by a further 0.25% to 0.75% in coming months, and the futures market agrees with them. Returns from cash in the bank look set to go even lower.

Local forecasters generally feel that, at current levels, bond yields may have bottomed out and that yields may track modestly higher over the next year. The Conversation, a website, runs a panel of 20 forecasters and their latest (end of June) view is that the 10-year bond yield will be back up to 1.5% by June of next year. That said, the recent history of bond yield forecasting (in Australia and everywhere else) has been poor, and yields could conceivably head even lower still. In any event, yields from local fixed interest look likely to stay very low by historical standards.

As ever, currency forecasting is a heroic exercise: The range of views among the Conversation forecasting panel is very wide, ranging from USD 63 cents to USD 75 cents next June, with an average of USD 68.5 cents, a tad lower than today's levels. Reuter's latest (July) monthly survey of currency forecasters, on the other hand, showed that the Australian dollar is expected to appreciate a little bit over the next year, to USD 72 cents. Averaging them out – probably no great move either way – is as plausible a view as any.

### Australian & International Property — Review

Listed Australian property has done very well, outperforming a share market that was itself in impressive shape. The S&P / ASX 200 A-REITs Index has delivered a year-to-date capital gain of 20.6% and a total return of 23.5%, 2.3% more than the return from holding the S&P / ASX 200.

Overseas listed property has not quite managed to keep pace with the MSCI World Index, but has been no slouch, either. The FTSE EPRA / NAREIT Global Index has had a net return (including taxed dividends) of 16.0% in U.S. dollars, a bit behind the 17.9% net return from the MSCI World Index. Asia (net return of 17.7%) and North America (16.3%) were the strongest markets, with emerging markets (6.1%) and the eurozone (7.4%) at the back of the pack.

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**Australian & International Property — Outlook**

The operating outlook for property remains mixed. Overall, the recent softening of the domestic business cycle does not help, but the impact varies by subsector. On the plus side, prime office and industrial properties remain in high demand and short supply, but the retail sector is under pressure. The latest (March quarter) commercial property survey from the Royal Institution of Chartered Surveyors showed that rents and capital values are expected to fall over the next year even for prime retail properties, with larger falls again for secondary retail. REITs involved in housing development, however, may be starting to turn for the better. The latest (June) CoreLogic house price data showed that house prices have stopped falling in Sydney and Melbourne.

The fundamental outlook is somewhat secondary, however, as investors flock into residual sources of yield in a low bond yield environment. The sector remains in high demand: J.P Morgan estimates that the A-REITs were comfortably able to raise AUD 2.1 billion in new equity in the first half of this year, more than it had issued in the whole of the previous two years. With the sector offering a yield pickup of nearly 3% (4.28% compared with 1.36% on the 10-year Commonwealth bond), it is likely to remain on yield-hunters' buy lists.

Overseas, the ongoing global expansion, even if now facing stronger headwinds, has been broadly positive for property performance. CBRE's latest report on the global prime office markets, for example, found that "Occupiers continue to seek higher-quality space in markets with robust infrastructure and social amenities, despite weaker global economic growth in Q1 2019 and worries about a U.S. / China trade war ... Combined with limited supply and moderate construction pipelines in most cities, prime office occupancy costs have risen to new heights". Of the 122 markets it covers, all but 15 had stable or rising rents, and the average increase was 3.6% in the year to March.

The global cycle has not lifted all boats. The retail sector everywhere is challenged by e-commerce, and Green Street Advisers recently calculated that at the bottom of the U.S. shopping centre market, the 'D' rated malls have an occupancy rate of only 67%. But with good conditions in the office markets and strong conditions in the industrial sector, there is enough capital value certainty for investors to feel confident about exploiting the income differential between the yield on the sector (3.9%) and the very poor yields from bonds. Provided bond yields do not move back up, global listed property will likely remain favoured.

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### Australian Equities — Review

Australian shares have more mirrored the global trend, with little net movement in July after strong rises earlier. For the year to date, the S&P / ASX200 Index is up by 18.7% in capital value and by 21.2% including dividend income. By sector, the resources (up 27.8%) and IT stocks (up 27.4%) have been the stars, while the financials (up 14.0%) have been relative laggards.

### Australian Equities — Outlook

The latest evidence generally points to a cyclical slowdown and suggests that the Reserve Bank's back-to-back 0.25% interest-rate cuts were timely.

National Australia Bank's June quarterly business survey, for example, found that "Business conditions (an average of trading conditions/sales, profitability and employment) continued their downward trend, decreasing by 3pts to +1 - just below the long-run average of +2 index points. Trading, profitability and employment all declined in the quarter", with the declines broad-based across industries and states. Businesses have steadily been downgrading their profit expectations, from clear optimism about profitability in early 2018 to their current mid-2019 pessimism.

The latest (July) survey of consumer confidence was also discouraging. The Westpac / Melbourne Institute survey found that "The fall in sentiment this month is troubling as it comes against what should have been a supportive backdrop for confidence. The last month has seen a further 25bp interest rate cut from the RBA, the Federal government's tax package pass through Parliament, more signs that the Sydney and Melbourne housing markets are stabilising and even some more improvement in the US-China trade dispute. Despite these positives, Australian consumer confidence has fallen to a two year low. The main driver continues to be deepening concerns about the outlook for the Australian economy and prospects for family finances".

Forecasters have consequently had a downshift in expectations. The Conversation's forecasting panel now think that GDP growth will be only 2.1% in the year to June 2020, well below the 2.75% that Treasury, for example, had been expecting in the April Budget.

Profit growth (outside the resources sector) will consequently be difficult to achieve for many forms this year. It may not matter too much if ongoing global pro-equity sentiment carries Australian equities along with it, and it is a help that they are not especially expensive: On Standard & Poor's calculations they are priced at 16.7 times expected earnings, which is cheaper than the 18 times expected earnings of the American S&P 500. But unless the domestic economy outlook improves enough to signal a better profit track, the odds are not great that Australian equities can maintain their recent year-to-date performance. The Conversation panel thinks the slower economic outlook will translate into only a 2.5% gain for the ASX 200 over the coming year.

### International Fixed Interest — Review

World bond markets have continued to confound expectations, with already very low bond yields falling even further. In the U.S. market, the benchmark 10-year Treasury bond now yields only 2.05%, down 0.6% since the start of the year, and at one point in early July it was trading below 2.0% (it reached a low of 1.95% on July 5). Other bond markets have followed suit: The benchmark German government offered a small positive yield of 0.24% at the start of this year but is now on negative yield of negative 0.32%. The developed economy trophy for lowest 10-year yield continues to be held by Switzerland, now at negative 0.61%.

The resulting capital gains mean that bond indexes are showing positive year-to-date returns, with the Bloomberg Barclays Global Aggregate Index in U.S. dollars up 5.4%. As yields on benchmark government bonds have shrivelled, investors have flocked into riskier areas, chasing either duration or credit premiums (or both). On the Bloomberg Barclays numbers, 'long' U.S. Treasuries (those with maturities of 20 years or more) are up 10.2%, while 'high yield' (low credit quality) bonds are up 9.5%, and emerging-markets bonds are up 9.9%.

**International Fixed Interest — Outlook**

The recent falls in bond yields reflect three factors. One is unexpectedly low inflation. As a generalisation, central banks have not been able to get inflation up to the 2% they are typically aiming for: The U.S. is nearly there, but the eurozone and Japan are well adrift, and lower-than-target inflation has also been an issue for both the Australian and New Zealand central banks. Monetary policymakers have responded by cutting interest rates to try to move inflation higher and may cut them further again.

A second factor is central banks' anxiety about potential economic slowdown. While the world economy is currently still growing at a modest rate, the outlook as suggested, for example by recent global business surveys, is fragile. Central banks have also been cutting rates as a preventative measure to prevent any further deceleration.

And the third factor has been investor anxiety, which has resulted in precautionary buying of safe-haven assets like bonds as insurance against trade wars (or other risks) derailing the world economy.

The resultant stampede into fixed interest - to capture capital gains, grab the last available yield opportunities, or avoid risks in the equity markets – means that, according to the latest (July) Bank of America Merrill Lynch fund manager survey, being long U.S. government bonds is now the "most crowded" global investment idea (and investment-grade corporate bonds were the third most crowded).

This rather suggests that the push towards ever lower yields may have reached its peak of bond-buying demand. The latest (July) consensus forecasts gathered by *The Wall Street Journal*, for example, show that the 10-year yield is expected to rise modestly from current levels, to 2.2% by the end of this year and to 2.4% by June '20. The forecasters have been wrong before and could be wrong this time round too, if (for example) some of the bigger downside risks to the global outlook materialise, but some modest rise from current abnormally low levels looks to be a plausible call.

**International Equities — Review**

World shares have plateaued in recent weeks, but strong performance earlier in the year means that markets are still showing substantial year-to-date gains. The MSCI World index is up 16.5% in U.S. dollars. Global equity performance has continued to be partly dependent on a strong U.S. market, where the S&P 500 is up 18.7%: Without it, the world index would have 12.3%. Eurozone shares have done surprisingly well, given the weak eurozone economy, with the FTSE Eurofirst 300 index up 14.4%, while even the rising prospect of a 'hard' no-deal Brexit has failed to prevent U.K. equities from recording an 11.6% gain. The laggard among the major markets has been Japan, where the Nikkei index is up 7.3%.

Emerging-markets shares are also ahead but have not matched the developed markets: The MSCI Emerging Markets Index is up 9.5%, with the key BRIC, or Brazil, Russia, India, China, countries up 12.6%. By far, the strongest of the BRICs has been Russia, where the FTSE Russia Index in U.S. dollars is up 33.4%.

**International Equities — Outlook**

The impact of more supportive monetary policy, the global economic outlook, the U.S. corporate reporting season, and the outlook for global trade tensions will remain the key drivers of equity performance in coming months.

Looking at the factors in turn, so far, the impact of monetary policy has been dominant: Equities have

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benefited strongly, through a variety of channels, from lower interest rates. But the scope for further interest-rate-related gains may be running out of impetus: At one point, for example, the equity markets had convinced themselves that the U.S. Fed was going to implement two 0.25% interest-rate cuts, but now only one looks more likely.

The global economic outlook is still positive, but fragile. On the latest readings from the J.P. Morgan global composite indicator, which aggregates a wide range of national IHS Markit business surveys, business activity in May and June was still growing but at a slower than usual rate.

J.P. Morgan said that "Market conditions and international trade flows will need to stage a revival if the current lacklustre picture is to brighten up in the second half of the year", but at the moment that pickup is not at all evident. IHS Markit runs business outlook surveys three times a year: The latest one (June) was notably downbeat. It found that "Worldwide optimism for business activity and corporate profits in the year ahead has fallen to its lowest since the global financial crisis, accompanied by reduced expectations for employment and investment spending". The latest BAML survey of large fund managers had found similar pessimistic expectations, with a net 30% of the managers expecting slower economic growth over the next year.

In the U.S., it is still early days in the June quarter reporting season, but overall it is not especially supportive for investors hoping that the U.S. equity market will continue to underpin global equity outcomes. At the moment, with only 16% of the results in, profits are not doing well. Going by the results to date, plus estimates for what the ones still to come will look like, U.S. data company FactSet thinks profits in the June quarter will turn out to be 1.9% lower than a year ago. For 2019 as a whole, the share analyst forecasts that FactSet collects are pointing to only a small (2.3%) increase in profits at the S&P 500 companies. The better news is that 2020 is expected to be substantially stronger, with share analysts picking a 10.9% rise in S&P 500 profits.

All of these factors remain hostage to the biggest single uncertainty overshadowing the equity market – the temporarily suspended trade wars. The fund managers in the BAML survey rated it their greatest fear, ahead of central bank impotence to boost growth and any slowdown in China. BlackRock's midyear investment outlook update also fingered the trade tensions as the key issue: "The key change in our outlook is that we now see trade and geopolitical frictions as the principal driver of the global economy and markets. This leads us to downgrade our growth outlook further and take a modestly more defensive investing stance".

So far, the equity markets have been pleasantly surprised that the worst did not eventuate and that a sharp rift between the U.S. and China has been avoided. Equally, though, there has been no definitive resolution, either, and both governments are capable of deliberately or accidentally causing serious disruption to global supply chains.

On balance, despite the various uncertainties, the most likely outlook is for modest ongoing global growth, albeit with the preponderance of risks tilted towards the downside. That is certainly how the surveyed BAML managers are inclined to play it: They remain modestly overweight to global equities, with a preference for emerging markets in particular, where valuations are less demanding.

*Performance periods unless otherwise stated generally refer to periods ended July 19, 2019.*

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