Economic Update

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August 2019

Outlook for Investment Markets

The past few weeks have been dominated by geopolitical uncertainty, particularly the prospect of a US-China trade war and its potential impact on global business activity: Equity markets have whipsawed as trade tensions have risen or receded. The other major development has been further declines in local and global interest rates to even lower levels. Looking ahead, investment outcomes remain hostage to Washington and Beijing: a deal could see the long post-global-financial-crisis world expansion carrying on into next year or even beyond, but there is a real risk that ongoing conflict triggers a cyclical setback either directly (though supply chain disruptions, for example) or indirectly (through reduced business and consumer confidence and hence lower capital investment and retail spending).

At home, while income-oriented buying has boosted equities, it is now getting harder to find attractive investment options. Interest rates have dropped sharply, and equities are on the expensive side given the subdued outlook for the local business cycle.

Australian Cash & Fixed Interest — Review

The Reserve Bank of Australia had been expected to leave the cash rate unchanged at 1.0% at its monetary policy meeting on August 6, and it did. Year to date lower short-term interest rates reflect the bank's earlier cuts in the cash rate: The 90-day bank bill yield is now 0.95%, down from 2.1% at the start of the year. Long-term interest rates have also dropped to even lower levels, partly reflecting similar falls in overseas bond markets and partly in response to the RBA's moves. The 10-year Commonwealth bond yield is now only 0.97%, down from 2.3% at the start of this year. The Australian dollar has weakened, particularly against the yen and the US dollar, and year to date has dropped by 2.8% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The RBA is ready to cut interest rates again if inflation continues to be a bit lower, and unemployment a bit higher, than the bank would ideally like. As it said after its August 6 meeting, the bank, "will ... ease monetary policy further if needed to support sustainable growth in the economy." The futures market is looking to at least another 0.25% cut, and possibly two, at some point in coming months. Returns from the likes of bank deposits are likely to drop even further.

The bank also indicated that it has been researching the unconventional monetary policy techniques, such as quantitative easing, or QE, that have been employed by central banks overseas when interest rates have been pushed as low as they can feasibly go. Employing them in Australia may still be some way off, but if they do eventuate, programmes like QE would likely mean that bond yields would fall even further again. Even without a QE assist, they could go lower in any event, if investors remain wary of the current risks to global growth.

Lower domestic interest rates have clearly weighed on the relative attractiveness of the Australian dollar. The RBA in its quarterly Monetary Policy Statement in August said that, "The depreciation over the past year is consistent with the decline in Australian bond yields relative to those in other major markets over that period." The median view, however, in the latest (early August) Reuters poll of currency forecasters is that the value of the Australian dollar will appreciate from its current US 67.6 cents to 70 cents in six months' time, and to 72 cents in a year's time. It may be that the analysts think all the bad interest differential news is already in the price, and forecasting is an imprecise exercise at the best of times, but in current unsettled market circumstances a stronger dollar looks a brave call.

Australian & International Property — Review

Listed Australian property has continued to perform strongly. with the A-REITs outperforming the wider share market. The S&P/ASX 200 A-REITs Index has registered a

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year-to-date capital gain of 20.1% and a total return including dividends of 23.1%, beating the 18.9% return from the overall market.

Overseas the relative performance picture has been a bit different. Global property shares have done well enough: The year-to-date net return (including taxed dividends) in US dollars from the FTSE EPRA/NAREIT Global Index is 13.8%. But it has lagged a little behind the 14.8% from the MSCI World Index, mainly because of particularly poor outcomes in the Brexit-affected UK (net loss of 2.4%) and in emerging markets in Europe, the Middle East, and Africa (net loss of 6.6%).

Australian & International Property — Outlook

The impact of slower economic growth means that Australian landlords have been having a harder time. The Royal Institution of Charted Surveyors, or RICS, which runs a suite of quarterly international property surveys, found in its latest (June) Australia survey that the commercial property market is, "showing signs of fatigue amid late-cycle signals … In the occupier market, survey participants flagged that availability of space to rent and inducements were rising at a faster pace than occupier demand."

That said, conditions vary markedly by sector and state. The RICS respondents, for example, expect some modest rent rises and capital gains for both prime offices and prime industrial property, mainly in Sydney and Melbourne. Expected conditions in the retail sector, however, remain poor. The RICS respondents expect rents and capital values to drop over the coming year, even for prime retail property, and there are especially difficult times ahead for secondary retail, where the RICS survey is indicating a 3.8% drop in rents and a 2.8% drop in capital value over the next year.

The fine detail, however, is likely to continue to take a back seat to the ongoing attraction of the A-REITs' yield differential over bonds. The yield on the 10-year Commonwealth bond has dipped below 1%, while the yield on the A-REITs remains around 4.4%. That calculation will likely continue to play out in the A-REITs' favour for a while yet.

Overseas, there are clearly rising risks, but the current combo of modest ongoing global growth and significantly lower interest rates has been broadly positive for commercial property. As JLL's latest (August) *Global Market Perspective* put it, "Despite slowing economic momentum and geopolitical tensions, the consequent monetary loosening policies by several central banks are flowing through to commercial real estate markets. Risk-free rates continue to plummet, lowering financing costs and widening spreads to property at a time when investors are hungrier than ever for yield. Although prices are elevated across many markets, fundamentals remain sound, underwriting is disciplined, and debt levels are generally modest."

The same picture of reasonable though not strong conditions, overlaid with some rising risks, emerged from the June quarter RICS global survey: "The overarching picture ... is one in which sentiment across the real estate world remains resilient for now. However scratching beneath the surface, there are just a few signs of concern, whether it is the ongoing trade dispute between the US and China ... or the softer macro picture in Europe."

While shocks to the world economy could yet derail the operating outlook for property, the current consensus of ongoing modest growth looks solid enough to give investors enough confidence to keep chasing the yield pickup from the sector. With global government bonds now yielding only 0.83%, while the yield on the FTSE EPRA/NAREIT Global Index is still 4.0%, global listed property looks likely to remain in demand.

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Australian Equities — Review

Australian equities have conformed to the international pattern in recent weeks: they dropped in early August and have not regained the lost ground. Even so, the strong gains earlier this year mean that the year-to-date performance is still respectable. The S&P/ASX200 Index is up 16.3% in capital value and has returned 18.9% including dividend income. Excluding the REITs (discussed elsewhere), the big sectoral winners were the industrials (capital gain of 21.0%) and IT stocks (20.2%), while the main laggard was the financial sector (12.2%).

Australian Equities — Outlook

The immediate outlook remains somewhat difficult to call. The central bank's assessment at its latest monthly policy meeting and in its subsequent quarterly Monetary Policy Statement was that there are stronger economic conditions ahead, but assorted other indicators are pointing to greater caution.

The RBA said at its August 6 policy meeting that "The central scenario is for the Australian economy to grow by around 2 1/2 per cent over 2019 and 2 3/4 per cent over 2020. The outlook is being supported by the low level of interest rates, recent tax cuts, ongoing spending on infrastructure, signs of stabilisation in some housing markets and a brighter outlook for the resources sector."

But again, business surveys do not point as confidently to any imminent acceleration. National Australia Bank's latest (July) monthly business survey found that, "Broadly the picture from the business survey is unchanged from last month—the key message being that the business sector has lost significant momentum since early 2018 and that forward looking indicators do not point to an improvement in the near term." In particular, businesses were distinctly lukewarm on their profitability (there were equal numbers of optimists and pessimists).

Other indicators also point more to ongoing subpar growth rather than to clearly better times ahead. The Westpac/Melbourne Institute's leading indicator picked up a little in July, but is still signalling slower than usual growth in coming months, and Westpac believes that by later this year the RBA will have discovered that, "It has made little progress in its objective of a significant reduction in the unemployment rate."

It is entirely possible that dividend-oriented buying or a revival of global equity investment sentiment may continue to support the market, but otherwise the economic fundamentals are not currently strongly helpful. As the RBA noted in the August Monetary Policy Statement, when valued against expected earnings Australian equities overall are now a bit more expensive than usual, and nonresource and nonfinancial stocks are considerably more expensive than usual.

International Fixed Interest — Review

Just when it had seemed that world interest rates could go no lower, they dropped even further again. In the US, for example, the yield on the benchmark 10-year Treasury note had been trading a bit above 2% for much of July, but then dropped sharply from the end of July onwards, reaching a low of 1.65% on August 12, and is still there or thereabouts (currently 1.68%). It is now a full 1% below where it started the year.

With government bond yields in other major markets also falling, bondholders have enjoyed significant capital gains. Year to date the Bloomberg Barclays Global Aggregate Index in US dollars is up 7.1%. With government bonds on ever lower yields, investors have been stampeding into other bond markets where there has been some residual yield pickup. The Bloomberg Barclays Index of global corporate bonds, for example, has now returned 10.8% in US dollars year to date, and while equity investors have been wary of emerging markets, bond investors have had no such compunction, with the Bloomberg Barclays Emerging Markets Index up 10.3%, also in US dollars.

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International Fixed Interest — Outlook

The recent developments have been remarkable. Global government bonds now yield only 0.83%, according to the J.P. Morgan Global Government Bond Index. At the very extreme end, the yield on the 10-year Swiss government bond is now down to negative 0.68%, and overall roughly one fourth, or some USD 14 trillion, of all global bonds are now trading on a negative yield.

The reasons have been various. Central banks everywhere have been unable, for reasons not well understood, to get inflation up the target levels they would like (usually 2% or so), and have been cutting interest rates to try and move inflation higher. The most prominent has been the Fed, which cut its policy rate, the fed funds rate, by 0.25% on July 31, taking it down to a target range of 2.0%-2.25%.

There are likely further cuts in the pipeline from the Fed. Currently the futures market sees a high probability (81%) of another 0.25% cut at the Fed's September 18 meeting and a reasonable likelihood (64%) of another one at the October 30 meeting. There could well be a third cut at the December 11 meeting, with the market putting equal probabilities (41% each) on the Fed pausing and a further 0.25% cut (the probabilities come from the Chicago Mercantile Exchange's "FedWatch" tool). Other central banks will, at a minimum, be maintaining their own low rates and may even follow the Fed towards even more-stimulatory settings.

The other major influence has been investors' buying safe assets against a background of heightened risks to global growth (mainly stemming from the US-China trade tensions). Once the bond buying started and capital gains started to build up, the move into bonds took on a degree of self-fulfilling momentum. Sharply lower bond yields meant that yield curves risked becoming "inverted" (long maturity interest rates below short maturity ones). That is often taken as a signal of a potential recession, further increasing demand for the safety of bonds. According to Morningstar data, nearly half a trillion US dollars flowed into bond funds in the first half of 2019, over three times as much as bond funds had attracted in the first half of 2019. Equity funds, on the other hand, suffered a small net outflow.

For what it is worth, the US forecasters polled by the *Wall Street Journal* this month on average thought that the US 10-year yield would be 2.0% by the end of this year and would be back up to 2.2% by the end of next year. If so, some of the recent capital gains would unravel. That would be consistent with the trade clouds lifting from the current economic outlook.

But forecasting where yields might go next has repeatedly proved to be a fruitless exercise, and investors can be excused if they put this latest view to one side with all the previous ones. If the world economy were indeed to hit a rough patch, with (for example) a full-scale trade war, bond yields could sink even further again and bonds would provide further portfolio insurance.

International Equities — Review

World share prices had gone sideways for much of July but at the end of July and into the first week of August prices fell sharply. The immediate reason was an unexpected intensification of trade tensions between the US and China, with President Donald Trump threatening higher tariffs from September on USD 300 billion of imports from China. Tensions worsened further after the US Treasury Department later designated China as a "currency manipulator," after the Chinese currency had dropped below CNY 7 against the US dollar.

At time of writing the US had just announced that the new tariffs would be delayed to December on just over half of the Chinese imports, and equity markets had a relief rally, but not enough to repair the earlier damage: the MSCI World Index of developed markets is still 3.7% below its July 26 peak.

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Even so, strong price rises earlier in the year mean that world shares are still well ahead for the year to date, with the MSCI World up 13.7% in the overseas markets' currencies and up by 13.3% in US dollars (14.8% including taxed dividends). Performance continues to hinge on the US market, where the S&P 500 is up 16.7%. Excluding the US, the MSCI World is up by 7.3%. European shares have been the best of the other major markets, with the FTSE Eurofirst300 up 10.1%. Surprisingly, given Brexit uncertainty, in the UK the FTSE100 is up 7.8% (in sterling—investors will also have had to wear the impact of a weaker pound, down 5.4% against the US dollar). Japan's market has been the back marker, with a rise of only 2.2% in yen, although currency movements mean many investors will have done better (the yen is up 2.8% in US dollars).

Emerging markets were lagging in any event, but a recent unwelcome electoral surprise in Argentina has further dented the wider asset class. Month to date the MSCI Argentina Index has lost one third of its US dollar value as the incumbent president looked likely to lose to a challenger committed to less-responsible economic policy. The MSCI Emerging Markets year to date is up by only 2.2% in the emerging-markets' own currencies, and scarcely at all (up 0.3%) in US dollars. The core BRIC markets (Brazil, Russia, India, China) are up 4.0% in US dollars, though the figures are somewhat flattering. On paper, the statistics appear to show that the Chinese market has done well: The Shanghai Composite is up 12.2% year to date. While formally true, all the performance relates to the period up to late April. As one would expect, the trade conflict has weighed heavily on the index since then, and it is currently 14.5% below its April 19 peak.

International Equities — Outlook

The unusually low levels of global interest rates (as discussed earlier) have the potential to provide ongoing support to world shares through their impact on the relative valuations of bonds and shares and through the resultant hunt for dividend income. The major central banks will be keeping monetary policy at supportive levels for some time.

Beyond ongoing monetary policy help, the outlook for world shares depends heavily on two other factors. One is the outlook for the world economy, and in particular the outlook for the US economy, which has been responsible for more than its fair share of global equity performance. The other is the potential economic and financial impact of political uncertainty, very largely around the prospects for the US-China trade conflict but also encompassing a variety of other issues (Brexit, Hong Kong, emerging-markets governance, and general geopolitical uncertainty).

So far, the world economy has continued to muddle through. The latest (July) reading from the J.P. Morgan Global Composite Index, which aggregates a large number of national business surveys, shows that the global economy is still growing, with stronger services industries making up for weaker manufacturing. In the latest (July) update to its *World Economic Outlook*, the International Monetary Fund still reckons that while 2019 is shaping up to be a bit slower than last year—global gross domestic product growth of 3.2% compared with 3.6% in 2018—the world economy looks likely to pick up a bit next year and grow by 3.5%. Although the advanced economies are expected to slow down a bit, from 1.9% to 1.7% growth, the ball will be kept in the air by the emerging markets, which are expected to pick up from 4.1% growth this year to 4.7% next.

In the US, the outlook is also for ongoing growth, though at a slower rate. The American economy grew at an annual rate of 2.1% in the June quarter, but according to the latest (August) consensus forecast from the *Wall Street Journal*'s panel of US forecasters the economy will slow down to around 1.75% growth over the next year. Corporate profits may do quite well even if macroeconomic growth slows down. Profits were slightly

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down year over year in the June quarter reporting season, but on FactSet's latest compilation of share analysts' forecasts, they are expected to increase by 9.9% in the year to June 2020.

While otherwise broadly supportive of equity performance, the big issue for global equities is that this scenario may not be allowed to play out due to political shocks. As the late July/early August sell-off and the more recent relief rally showed, equities remain hostage to the unpredictability of the US-China trade conflict. The J.P. Morgan indicator, for example, found that uncertainty appears to be weighing heavily on business confidence about the near to medium term: "The outlook also became less positive, with the Future Output Index falling to its lowest level in the series history." Sectors most exposed to supply chain disruption are doing especially badly. The sectoral breakdown of the J.P. Morgan data shows that production of cars in particular, but also of industrial goods and technology equipment, is in a downturn.

The IMF also stressed that while its central scenario is for ongoing global growth, "The principal risk factor to the global economy is that adverse developments—including further US-China tariffs, US auto tariffs, or a no-deal Brexit—sap confidence, weaken investment, dislocate global supply chains, and severely slow global growth below the baseline." Beyond the direct effects, a bad outcome on the trade front could well spill over into sentiment in the financial markets: "A risk-off episode [i.e. when investors are especially worried], depending on its severity, could expose financial vulnerabilities accumulated during years of low interest rates as highly leveraged borrowers find it difficult to roll over their debt and as capital flows retrench from emerging market and frontier economies."

Investors should not necessarily overreact to the alarmism of the headlines—in recent years world equity markets have survived an assortment of "crises" that appeared to be important at the time. Even the current trade frictions may end up with resolutions that do not derail the global economic cycle. But at the moment, the geopolitical outlook does not look especially encouraging, and while hoping for a benign outcome that favours further equity gains, many investors may well conclude that this is a good time to be thinking hard about diversification and portfolio insurance.

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