Economic Update

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October 2019

Outlook for Investment Markets

Global financial markets have continued to be choppy as investor sentiment has reacted to the twists and turns in US-China trade relations and to the flow of data on the outlook for the global economy. Latterly, the trade war news has been modestly better, benefiting equities but triggering a sell-off in bonds. The central outlook remains for modest growth in the world economy—the IMF, for example, thinks 2020 will be a bit better than this year—but with significant risks to the downside. So, while growth assets have economic support, investors are likely to experience further volatility along the way as risks loom larger or withdraw. In Australia, the turnaround in house prices in the big cities is welcome news, but otherwise recent business and other surveys have generally been downbeat. While 2020 could see some modest pickup in business activity, at this point, it looks unlikely to drive significant improvements in corporate profitability.

Australian Cash & Fixed Interest — Review

Short-term interest rates have moved a bit lower, and are trading below the 1% mark: the 90-day bank bill yield is currently 0.9% in the wake of the Reserve Bank of Australia's latest cut in interest rates. The RBA lowered its target for the cash rate by 0.25% to 0.75% on 1 October. Long-term interest rates have followed the global trend with the local 10-year Commonwealth bond yield hitting a low point in early October (0.86% on 7 October) before rising to its current 1.1%. The Australian dollar has weakened, and year to date is down 2.0% in trade-weighted value. It is down 3.2% in terms of its headline rate against the US dollar.

Australian Cash & Fixed Interest — Outlook

The RBA said at its October rate cut decision that it would "ease monetary policy further if needed to support sustainable growth in the economy and the achievement of the inflation target over time," and there is a very widespread consensus that further interest rate cuts are indeed on the way. The *Australian Financial Review*'s September quarterly round-up of forecasters found forecasters had expected the 1 October cut, and anticipated another one by the middle of next year. The outlook is for even lower returns from bank deposits.

Forecasting of bond yields, both in Australia and overseas, has been very difficult in recent years, but the current assessment is that overseas bond yields may have troughed, and in the case of the US may start heading up over the next year. The US forecasters polled in October by the *Wall Street Journal* expect the 10-year Treasury yield in the US to rise from 1.75% now to 1.9% by the end of next year. If so, local yields could well follow. Some of the latest local forecasts have been left behind a bit by events, and yields have already risen faster than the banks had generally been expecting, but Westpac's view of a 1.25% yield by the end of next year is still standing, and looks as good a pick as any. The only major proviso is the possibility the RBA might embark on a "quantitative easing" programme of bond buying, which would keep bond yields low.

On the currency front, local short- and long-term interest rates look like remaining comfortably below their US equivalents, and are likely to keep the Aussie dollar weak. Recurrent flurries of investor anxiety about the global economic outlook are also unhelpful, as currencies like the Aussie dollar tend to do better when potential investors are in a more risk-taking frame of mind. The latest (October) Reuters survey of forecasters expects little change over the next six months, with the Aussie dollar expected to be around USD 68 cents close to its current USD 68.3 cents.

Australian & International Property — Review

Year to date, the A-REITs have broadly matched the returns from the wider sharemarket. The total return (capital gain plus dividends) from the S&P/ASX 200 A-REITs index is 20.9%, a tad behind the 21.9% from the S&P/ASX 200 index.

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Global listed property has done a bit better, and modestly outperformed global equities as a whole. The net return (including taxed dividends) in US dollars from the FTSE EPRA/NAREIT Global index is 21.3%, ahead of the equivalent 18.5% from the MSCI World index.

Australian & International Property — Outlook

The latest (9 October) report from rating agency Moody's on the A-REITs showed mixed operating conditions across the subsectors. Industrial remains very strong. Moody's said, "The A-REITs plan to increase their weighting to the sector over next 2-3 years on e-commerce, infrastructure and population growth," and recent capital raisings in the sector have been strongly supported. Offices have also been buoyant, though the boom times look set to ease as more supply comes on stream beyond 2020. Residential is "challenging" although house prices now look as if they are starting to recover. And retail remains "difficult", thanks to a mix of cyclical factors (such as low consumer confidence) and structural issues (mainly the impact of e-commerce on retail brick and mortar).

Ex industrial, the overall fundamentals do not make for a compelling investment proposition, and it is evident the performance of the sector has been heavily reliant on the attraction of the sector yield differential over bonds and cash in the bank. The yield differential is still there—the dividend yield on the A-REITs is some 4.2%, a good 3% clear of the 1.1% yield on the 10-year government bond, but the sector now looks more vulnerable to a valuation rethink if, as is possible, bond yields have troughed and start moving back from their unusually low levels.

Overseas, too, it may be that we have passed the high-water mark for income-oriented REIT demand. in its third-quarter review of the unlisted property sector (managed funds and the like), data company Preqin found that while 2019 as a whole is likely to have seen a record volume of successful fund raising, just recently investor demand appears to be easing off. Preqin said "Investor confidence in real estate may have dampened in recent months", and it surmised that "Either investors are demonstrating a cautious approach to minimize risk in the face of a potentially imminent market correction, or they are nearing the fulfilment of their target allocations".

Another contributing possibility is the recent rise of US bond yields which also appears to be affecting demand. The latest (October) survey of global fund managers by Bank of America Merrill Lynch found that the managers had made a notable downshift in their allocation to global REITs. The sector may still do reasonably well if the global economic expansion continues into 2020 and beyond, but the strong yield-driven support in the period of ultra-low bond yields may be easing off.

Australian Equities — Review

A rise in global equity prices in recent weeks has been mirrored in Australia. Year to date the S&P/ASX 200 index is up 17.81% in capital value and has returned 21.9% including the value of dividend income. The IT sector has been the strongest all year, with a 27.9% capital gain; consumer discretionary (up 24.6%); and the industrials (up 20.7%) have also been strong. Back of the pack, as usual, are the financials, although investors will not be too unhappy with a 14.6% gain. The sector continues to struggle in relative terms, however, with the latest headwinds being the RBA's latest cut in interest rates and a competition authority inquiry into the banks' mortgage pricing.

Australian Equities — Outlook

The immediate cyclical outlook in Australia is not strongly supportive. The business surveys are generally on the weak side. National Australia Bank's September quarterly survey, for example, found, "Growth has slowed with a weak consumer and a fall in housing investment while price pressure remains weak. While we expect [interest] rate cuts to help, that will take time (mainly in 2020). Tax cuts to date are not really helping the consumer (who have largely used them to reduce debt and/or increase

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their liquidity).” Businesses on balance remain net pessimists about the outlook for profits.

The Westpac Bank-Melbourne Institute leading indicator is also signalling slow growth. In September, Westpac said, “The growth rate is now materially below trend and is signalling that growth through the first half of 2020 is likely to remain below trend.”

Consumer confidence has also gone backwards. The Westpac-Melbourne Institute survey took a knock in September, possibly (the bank surmised) because investors were more alarmed than comforted by the RBA’s interest rate cuts: “despite the rate cut, assessments for the economy overall plunged by 6% (the twelve month outlook) and 9.1% (the five year outlook). Consumers are looking behind the reason for the rate cut and, arguably, the absolute level of rates and getting nervous.”

The outlook is far from doom and gloom. Some measures are showing a more upbeat picture, notably the Commonwealth Bank’s September survey of the services sector. It found that “The Business Expectations Index rose to a 13-month high, with firms expecting improved economic conditions, an anticipated recovery in the housing market, as well as increased promotional activities and new service offerings to drive business activity over the next 12 months.” In particular, the housing market improvement the bank mentioned is a clear turnaround from the previous sharp setbacks: house prices are still well shy of where they had been at their peak, but on CoreLogic’s data, Sydney house prices have risen by 3.3% in the past two months, and Melbourne prices by 3.2%.

Overall, though, the business outlook is only fair to middling. The latest Reuters poll of forecasters found they have lowered their GDP growth expectations to 1.9% for this year, down from 2.1% in the previous survey, and they expect 2.5% next year. While the pickup would be welcome, it remains shy of Australia’s longer-term performance, and also below what would be needed to make a serious dent in the unemployment rate. The most likely outlook is that businesses face limited opportunity for strong growth in profits. On the plus side, investors are not being asked to pay a lot for these modest prospects—16.25 times expected earnings according to Standard & Poor’s—but on the other hand, the middling outlook does not look supportive of ongoing double-digit growth in share prices.

International Fixed Interest — Review

Both bond and equity markets have continued to be very sensitive to changes in investor sentiment about the outlook for the world economy, and in particular about how trade frictions will play out. Over the past month there has been some limited progress in the US-China trade talks, and for investors this has translated into less demand for the relative safety of bonds, and yields have risen. At its recent low point, the 10-year US bond yield got to 1.53% on 8 October, but in the more positive trade environment since then, it has risen back up to 1.8%.

The latest rise in US and other major bond market yields is modest, however, set against the large falls earlier in the year, which means the earlier capital gains continue to drive the year-to-date performance of the asset class. The Bloomberg Barclays Global Aggregate index in US dollars is up by 6.6%: investors brave enough to take on long duration have done well, with the Bloomberg Barclays Long US Treasury index up 17.2%. Global high yield (low credit quality) has returned 9.5%, and emerging markets debt has returned 11.0%.

International Fixed Interest — Outlook

The outlook depends on an interlinked set of drivers – the outlook for inflation and growth in the major economies and the likely responses of their central banks, the prognosis for trade frictions (or other shocks to the global economy), and subsequent investor reactions.

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On the monetary policy front, inflation is generally still too low for central banks' liking, and growth is also less than ideal, so monetary policy looks likely to remain very supportive or become even more stimulatory. The eurozone has just stepped up its monetary policy support, Japan looks likely to, and in the U.K., it would not be surprising if the Bank of England had to rally round to assist whatever emerges from the Brexit process. Other countries are also generally easing. For example, this month Singapore eased policy for the first time since 2016, and a number of other Asian economies have also eased monetary policy. In the key US markets, both forecasters and the futures markets firmly expect the Fed to cut its target range for the federal-funds rate by 0.25% at its 30 October policy meeting, to a range of 1.5% to 1.75%.

Whether monetary policy will—or can—go much lower is debatable, however. In the US, both forecasters and the financial markets think there is still some chance of a further 0.25% cut, but either way, the Fed looks close to the limit of its easing. In the eurozone, there has also been pushback from some of the European Central Bank decision-makers about pushing ever further into negative interest rate territory. We look to be approaching "peak ease" for monetary policy, and any number of policy analysts have been arguing that enough is enough, and that getting inflation and growth moving along at a faster clip will from here depend more on fiscal rather than on monetary policy.

In the short run, monetary policy may contribute to keeping interest rates low, but the longer-term outlook for fixed interest looks more problematic. Bonds will still have insurance value, particularly as the US-China trade conflict is far from being resolved going into a US presidential election year, and geopolitics could spring other unsettling surprises, as we have seen this month in the Middle East with Turkey's move against the Kurds. But from an economic fundamentals point of view, if the global economy evolves as the big forecasting institutions expect—bumbling through, though at a slower than usual growth rate—bonds look poor value. In the latest (October) Bank of America Merrill Lynch survey of global fund managers, the BAML team found that the managers are net slightly overweight to equities, but a net 38% are underweight to bonds.

Then fund managers might be wrong. Global bond yields to date have fallen further, and stayed there for longer, than practically anyone expected. But with the yield on global government bonds only 0.92% (on J.P. Morgan's estimate), outside doomsday scenarios, it is hard to make a case for the value on offer in fixed interest.

International Equities — Review

Some progress on the US-China trade disputes has helped shares make progress in recent weeks. Year to date, the MSCI World index of developed markets is up 16.7% in the currencies of its component markets, and up by a very similar 16.5% in US dollars.

The US market continues to lead the way: the S&P 500 is up by 19.1% and the Nasdaq up by 21.9%. Eurozone shares have confounded local economic sluggishness, with the FTSE Eurofirst 300 index up 15.3% in euros. Japan has also contributed, with the Nikkei index up 12.4% in Japanese yen. The U.K. has unsurprisingly been at the back of the pack, with the FTSE 100 up by 6.3% in British pounds.

Although they have not matched the developed markets, emerging markets are also ahead for the year, and the MSCI Emerging Markets index in US dollars is up 6.0%. The key BRIC markets (Brazil, Russia, India, China) are up 8.7% in US dollars, helped by a particularly strong performance from Russian shares: the FTSE Russia index is up 36.2% in US dollars.

International Equities — Outlook

It would be easy to take fright at the IMF's latest update to its World Economic Outlook report, and many people

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did, pointing to the downward revisions made since its previous (April) take.

"The global economy", the IMF said, "is in a synchronized slowdown, with growth for 2019 downgraded again—to 3 percent—its slowest pace since the global financial crisis. This is a serious climbdown from 3.8 percent in 2017, when the world was in a synchronized upswing. This subdued growth is a consequence of rising trade barriers; elevated uncertainty surrounding trade and geopolitics; idiosyncratic factors causing macroeconomic strain in several emerging market economies; and structural factors, such as low productivity growth and aging demographics in advanced economies."

It does not help that measures of the current state of the world economy show growth running even slower than the IMF's 3% expectations. Going by its historical relationship with global GDP growth, the latest (September) J.P. Morgan Global Composite PMI (purchasing managers index, an aggregation of a wide number of individual country ones) suggests the world is growing at more like a 2% pace, with near-recession in manufacturing the main drag; services industries are faring rather better.

Respondents to the PMI surveys are not happy campers, either, about the immediate outlook. As J.P Morgan said, "The Global Composite Future Activity Index posted 57.4, remaining close to August's series-record low of 57.2. Optimism was at, or close to, respective record lows in the manufacturing and service sectors respectively." The fund managers in the BAML survey were also downbeat about near-term growth prospects.

Yet it is worth pointing out nonetheless that the central scenario from the IMF was for the global business cycle to pick up next year, to 3.4% growth. The pickup is modest, dependent on a range of emerging markets recovering from previous difficulties, and subject to a variety of significant downside risks. The IMF said for example that: "Further escalation of trade tensions and associated increases in policy uncertainty could weaken growth relative to the baseline projection," and trade wars were also the top risk identified in the BAML survey.

It is certainly true the trade wars have not gone away. The progress on the trade frictions in October has been modest: it was only "phase one", as President Trump described it, of an overall resolution to the issues. The main measures in October included a potential postponement of planned US tariff increases and increased Chinese products of agricultural exports (historically the main item has been soybeans), and there was reported progress, though no clear outcomes, on other contentious issues including currency manipulation, intellectual property, financial services. It is easy to see how there might yet be a falling out, that would do further damage to manufacturing in particular.

But for all the uncertainties, the IMF's central scenario is that 2020 could work out a bit better than 2019 has. That is how US sharemarket analysts see it playing out. According to the earnings forecasts collated by data company FactSet, profits at the S&P 500 companies will essentially have been at a standstill this year (up 0.7%) but will grow by 10.4% next year. The overall number is affected by a big expected turnaround in the energy sector (a 26.4% fall in profits this year, a 26.6% gain next year), but broad swathes of the rest of the market are also expected to do well, led by the industrials, materials, and consumer discretionary stocks.

Recent international equity performance has been a bumpy ride, particularly in late 2018 when sentiment turned deeply pessimistic about global growth. But there is still a reasonable chance of the current global expansion carrying on into next year, although at the same time, investors are likely to want to carry adequate portfolio insurance against the various risks that might derail it.

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