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Economic Update

Sydney | 28-01-20

January 2020

Outlook for Investment Markets

The global economic outlook has improved, partly because of reduced geopolitical risks from trade wars and Brexit, although there is still uncertainty around the coronavirus outbreak (which has triggered a hopefully temporary flight to safety into bonds). Assuming the virus does not have major consequences, risk assets could perform well: Global fund managers think the equity market will not peak before the September quarter this year. Risks have not gone away completely, however, and relatively defensive assets such as REITs will also be worth holding, especially as their yields remain attractive relative to ongoing low levels of fixed interest income. In Australia, some recent indicators have also perked up, but it is still not clear that the economy has decisively turned the corner from a sluggish 2019, and the Reserve Bank is still expected to have to come to the party with further interest-rate cuts.

Australian Cash & Fixed Interest — Review

With no central bank decision meetings over the holidays, short-term interest rates have shown little change, and the 90-day bank bill rate remains around 0.9%. Long-term interest rates have fallen, mainly reflecting a decline in U.S. yields, and the local 10-year Commonwealth bond yield is down by almost 0.3% to 1.1%. The Australian dollar is down across the board against other major currencies and so far this year is down 2.2% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

The Reserve Bank has been struggling with an economy that has been too soft for its liking. Most forecasters were therefore convinced that the bank would continue to cut interest rates in 2020. That confidence took a bit of a knock after better than expected employment data for December, but even so, forecasters still lean towards the idea of lower rates in the pipeline. The ANZ, National Australia Bank, and Westpac, for example, expect two 0.25% cuts by the bank this year, while the futures market expects one. Low returns from money in the bank will likely head even lower.

The recent decline in bond yields looks to be partly a one-off, linked to global safe-haven demand for bonds (and for U.S. bonds in particular) in the middle of the current coronavirus scare. But that said, there are also other factors keeping bond yields low: The Reserve Bank will likely be cutting interest rates and may even embark on a bond buying policy, and the economy (despite the December data) still looks on the lacklustre side. Bond yields could well remain very low indeed or even nudge lower: Both National Australia Bank and Westpac, for example, think that the 10-year yield will have dropped to 0.8% by the end of this year.

The recent fall in the currency to its current 68.5 U.S. cents is also mostly down to safe-haven factors, as investors have headed for currencies such as the U.S. dollar and have avoided off-piste forays into currencies like the Aussie dollar. The latest Reuters poll of currency strategists indicates that, in the next three months, the Aussie might continue to be under modest selling pressure – the poll expects a further 0.7% drop against the U.S. dollar – but the selling is then expected to abate, with the forecasters expecting a recovery back to around 70 U.S. cents by the end of this year.

Australian & International Property — Review

Australian shares had a very strong start to the year, but the A-REITs did even better again, with the S&P / ASX 200 A-REITs Index notching up a remarkable 7.1% capital gain (and total return), outpacing the itself boisterous 6.1% return from equities overall.

Global property has also started the year positively, though it came nowhere near the A-REIT outcome.
The FTSE EPRA / NAREIT Global Index in U.S. dollars is up 3.0% in terms of total return. The result was heavily dependent on the strong U.S. market: Ex the U.S., the index was unchanged. In the U.S., the REITs have gained 24.6% over the past year: The star performer continues

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to be the red-hot industrial property sector (return of 6.1% in January to date, and of 44.5% over the past year). Data centres, infrastructure, and residential development have also been strong. The tail ender continues to be retail, up only 5.1% over the past year: The "regional mall" subcategory, in particular, has been devastated, dropping by 16.0% over the past 12 months.

Australian & International Property — Outlook

The robust start to the year for the A-REITs reflected a combination of factors: a generally equity-friendly period after global trade frictions eased, lower bond yields in the wake of the coronavirus scare, and some improvement in the economic indicators (notably retail sales and job growth). It helped that operating conditions appear to have been improving in any event. The latest (March '20 quarter) ANZ Bank / Property Council of Australia survey was conducted in mid-November through early December, before the U.S. - China trade deal and the coronavirus-linked fall in bond yields, and it showed generally improving conditions. A strong turnaround in the residential development sector played a part as house prices have recovered, but it was sectorwide: As ANZ commented, "Confidence in Australia's commercial property industry edged higher in the March quarter survey. The improvement was broadly based, with sentiment higher in all states bar Victoria."

Ongoing performance on January's scale looks implausible, but investor demand is likely to remain supportive given that the Reserve Bank of Australia is likely to be cutting interest rates this year, and bond yields are likely to remain low for an extended period. The yield from the A-REITs of some 4.5% will continue to look attractive when the 10-year bond yield could well be still below 1.0% in a year's time.

Overseas, the real estate sector looks to be in a comfortable position. The coming year is shaping to be a somewhat better one than 2019, but the global economy is not likely to recover strongly enough to lead to marked rises in bond yields, which would threaten the yield attractiveness of the sector. Commentators on the key U.S. market, in particular, are upbeat about its prospects. CBRE, for example, in its real estate market outlook for 2020, says that "A combination of resilient economic activity, strong property fundamentals, low interest rates and the relative attractiveness of real estate as an asset class are the primary drivers supporting our view that 2020 will be a good year for [U.S.] real estate."

There are two wrinkles in the outlook. One is that the long boom in industrial property may be peaking, at least in the U.S. Analysts reckon that new industrial supply outstripped new industrial uptake in 2019. Leasing conditions still remain righter than normal, and industrial rents consequently still look likely to rise, but the outright boom times look to be winding down. The other risk is that investors may see the firming global economy and decide that more growth-oriented stocks look like the equity of choice, rather than opting for more-defensive sectors like the REITs, which appeared more of a safe-haven choice in the riskier environment of 2019.

Australian Equities — Review

Australian shares have rocketed out of the starting gate. The S&P / ASX200 Index is up 6.1% in capital value and also in terms of total return. There were particularly large rises for consumer staples (10.7%) and IT stocks (10.2%). As usual, the financials sector was the slow coach, with a smaller 3.0% gain.

Australian Equities — Outlook

The rollicking start to the year in Australia, while welcome, looks unjustifiably exuberant. On the plus side, it clearly reflects some genuine good news: Over and above the fillip to many markets from at least a partial resolution to international trade frictions, there has been some good domestic economic news. November retail sales were a lot stronger than expected, as was the December employment report, and some business surveys have turned more positive. The March quarter business expectations survey from illion (formerly Dun & Bradstreet), in particular, was very strong, "sparking

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hopes the new year will be a stronger one for the economy. The expectations index soared to an all-time high, while actuals recovered from a rocky previous quarter, lifted by noteworthy turnarounds in the retail and construction sectors."

But there are counterarguments to the bullish view. The November retail bounce may have been an artefact of "Black Friday" discounting. The rise in jobs in December was entirely due to new part-time roles – nothing wrong in itself but not the full shilling either. The bushfires are likely to inflict significant costs and disruption. And other business surveys don't echo the illion finding. The Commonwealth Bank's purchasing manager index survey for January looks to be capturing an entirely different economy: "The start of 2020 pointed to a third successive monthly decline in business activity in the Australian private sector," although there was also some positive signs from new orders, which may lead to better business activity down the track.

The economists polled by Reuters in January may have the right end of the stick: There is indeed some momentum improvement on the business horizon, but it is not dramatic. The economists think 2019 will have recorded distinctly modest gross domestic product growth of only 1.8%, will pick up to 2.3% this year, and will pick up a bit more again to 2.5% in 2022. If it eventuates, it will be a welcome acceleration and will help provide fundamental support for corporate profits, but it is still shy of the 2.75% (or better) that would translate into clearly lower unemployment and a genuinely robust business climate. Investors will gladly pocket January's gains, but they are rather unlikely to see ongoing performance on that scale unless the business outlook turns markedly more positive than currently seems likely.

International Fixed Interest — Review

Somewhat surprisingly, global bonds have started the year with capital gains as yields, particularly in the U.S., have fallen. So far this year, the Bloomberg Barclays Global Aggregate in U.S. dollars has returned 0.4%, though without the contribution of the U.S., bondholders would have recorded a small loss of negative 0.3%.

International Fixed Interest — Outlook

In theory, bonds face a more difficult year. Although the global economic outlook remains uncertain, at the moment it looks likely that 2020 will be a better year for global business activity than 2019, and a strengthening business cycle is not usually helpful for bonds. Inflation, for example, tends to rise in stronger economic conditions: The IMF in its latest economic forecasts expects that inflation in the advanced economies will be 1.7% this year, up from 1.4% last year. This does not sit well with the current level of global bond yields: On J.P Morgan's estimates, the yield on global governments bonds is only 0.92%. Holders of bonds will be incurring real (that is, after inflation) losses of purchasing power.

The business cycle theory, however, has been temporarily derailed by the coronavirus outbreak. Investors have been heading for safe havens as a hedge against the potential risks to world trade, and their assets of choice have been the U.S. dollar and U.S. government bonds. So far this year, the U.S. dollar has gained 1.1% in overall value (on *The Wall Street Journal*'s index), while demand for the benchmark U.S. 10-year Treasury bond has seen its yield decline from just over 1.9% to just under 1.7%.

The coronavirus has shown the portfolio insurance value of bonds, and for all we know, the insurance may still be needed: The latest news out of China is not encouraging, and there are more cases being reported around the world. There could still be the possibility of a globally significant episode along the lines of the 1918-20 Spanish flu.

Hopefully, however, coronavirus will play out more like the SARS outbreak of 2002-03, which had limited global economic impact. If so, the underlying fundamentals will re-emerge and bond yields, particularly in the U.S., will eventually face upwards pressure. The Fed is close to the

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end of its monetary policy easing cycle: Economic forecasters and the futures markets both think there is some chance of a final 0.25% cut in the Fed funds rate, but the Fed could also leave rates where they are for the rest of this year. In the latest (January) poll of forecasters run by *The Wall Street Journal,* the pick is that inflation in the U.S. will be running close to 2.0% this year, and bond yields will need to rise. It will, however, be a slow and gradual process. The consensus view is that the 10-year yield will be 2.0% by the end of this year and 2.25% by the end of 2021. In other regions, any rise is even further off: The European Central Bank is currently conducting a review of how it operates, but whatever the outcome, the bank is still likely to be in supportive low interest-rate mode for a considerable time. The Bank of Japan is in the same boat.

Even if it only occurs in the U.S. this year, eventual rises in yields are likely to make portfolio insurance more expensive. In 2019, it was helpful that the Bloomberg Barclays Global Index returned 6.8%, so there was no absolute cost to hedging against the global risks (albeit there was a large opportunity cost relative to equities). This year, the going is likely to be a bit more difficult.

International Equities — Review

The strong performance of global shares in 2019 carried on into most of January, though in recent days concerns about the potential impact of the Chinese coronavirus have been a setback. The MSCI World Index of developed economies in U.S. dollars had gained 2.4% from its end '19 level when it peaked on Jan. 17 but has since dropped back by 0.8%, cutting the year-to-date gain to 1.6%.

This early in the year, the regional breakdown does not contain a lot of meaningful information, but for the record the recent pattern of global performance shows that some of 2019's key trends are still in place. Overall performance remains significantly dependent on the U.S.: Although the key eurozone markets of Germany and France have started the year well, ex the U.S., the World Index is up only 0.5%. And developed economies continue to outperform the emerging markets, where the MSCI Emerging Markets index is up only 0.4% so far.

International Equities — Outlook

The outlook for global equities has improved. First and foremost, there has been at least a truce in the U.S. - China trade wars, removing, at least for now, one of the main geopolitical concerns that had periodically rattled investor confidence through 2019 and which also had contributed to difficult business conditions for the manufacturing sector globally. It has also helped that Brexit issues have crystallised, even if the final shape of U.K. – EU relations is yet to be determined.

The reduction in geopolitical risk means that 2020 should be modestly better than 2019. The IMF, in its January update to its *World Economic Outlook* forecasts, thinks that the world economy will grow by 3.3% this year and by a little faster again (3.4%) in 2021. The forecasts are a bit less upbeat than its last go at the numbers in October last year, but the revised view mainly reflects slower expected growth in India than any wider reassessment of the global outlook.

It is even possible that the recent string of good news could set off a self-reinforcing positive cycle. The IMF said that "These early signs of stabilization could persist and eventually reinforce the link between still-resilient consumer spending and improved business spending." But while the risks to the downside are less, there are still quite a few around. The IMF listed "rising geopolitical tensions, notably between the United States and Iran, intensifying social unrest, further worsening of relations between the United States and its trading partners, and deepening economic frictions between other countries."

At least for now, however, global fund managers are strongly of the view that the upside potential will prevail over the downside risks. The first Bank of America Merrill Lynch fund manager survey of 2020 showed that they

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have become much more positive about the outlook for corporate performance.

A net 36% of the managers are bullish about the outlook for the world economy, the highest level since early 2018, although they are not being carried away by overoptimism: The net 36% is still below the peak optimism levels that occur at the top of the cycle. A net 27% of managers think corporate profits will rise over the next year, again the best reading since early 2018. And they are putting their money where their views are: The managers have shifted from being a net 12% underweight to global equities back in August of last year to a net 32% overweight equities now. Technology stocks and eurozone equities are at the top of their current buying list. Downside risks could yet derail the renewed optimism, but the fund managers currently reckon the international equity cycle has a fair way to go yet: They think the equity market will not peak till the third quarter of this year.

Performance periods unless otherwise stated generally refer to periods ended Jan. 24, 2020.

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