Economic Update

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Outlook for Investment Markets

Coronavirus has dominated discussion of the immediate economic outlook. At the moment, the consensus' view (as expressed by, among others, both Australia's and New Zealand's central banks) is a short, limited impact on local and global economic activity. But nobody can be sure. Equity markets have made gains regardless, but bonds have also gained as more worried investors have played it safe. Assuming the virus' effects are indeed modest, the global economy is in reasonable shape to support risk assets, while income-oriented sectors like property and infrastructure are likely to continue to benefit from ongoing low cash and bond yields. In Australia, the Reserve Bank has taken quite an upbeat view of the domestic business outlook; other analysts, however, reckon that corporates will continue to find it a challenge to boost profits.

Australian Cash & Fixed Interest — Review

Short-term interest rates are unchanged, reflecting the Reserve Bank's decision on Feb. 4 to keep the target cash rate steady at 0.75%. Ninety-day bills are yielding 0.9%. Year to date, longer-term yields have moved lower, closely following the coronavirus-influenced trend in the U.S. bond market: the local 10-year yield dropped from 1.4% at the start of January to a low of 0.93% in early February, and has risen more recently to its current 1.05%. The Australian dollar is lower, partly due to the impact of safe haven demand for U.S. dollars pushing it down against the greenback from 70.1 U.S. cents at the start of the year to 67.2 cents now. Overall the currency is down by 3.2% in overall trade-weighted value.

Australian Cash & Fixed Interest — Outlook

At its Monetary Policy Statement on Feb. 7, the Reserve Bank said that "monetary policy is very likely to remain accommodative for some time." Outside observers think that in the end, policy may need to become even more accommodative than it is today and are expecting at least one 0.25% interest rate cut. Of the 38 economists polled by Finder.com in their latest cash-rate forecast poll, for example, 26 of them think the cash rate will bottom out at 0.5%, and another five expect a further 0.25% cut. Returns from bank deposits are headed even lower again.

For longer-term yields, it is possible that the recent coronavirus linked decline in yields will unwind, and that slightly higher U.S. bond yields over the coming year could also carry local yields up with them. But given that the RBA is likely to be on a monetary policy-easing course, it is more likely that bond yields will follow short-term yields down. Both National Australia Bank and Westpac, for example, continue to predict that the 10-year yield will be only 0.8% at the end of this year.

The recent fall in the currency appears to be strongly related to coronavirus worries. Currencies like the Australian dollar are closer to Asia and as being relatively dependent on commodity prices at a time when virus concerns are sending commodity prices down. The Bloomberg Commodity Index, for example, is down 6.8% year to date in U.S. dollars. The Aussie dollar also tends to be sold down when global investors are relatively anxious, as they are now. However, the latest (early February) Reuters poll of currency forecasters found that they think the currency has now fallen as much as it is going to, to around the $0.67 mark. Ultimately, they think it will recover the virus-related losses, with a pickup to $0.68 in six months and to $0.70 a year out.

Australian & International Property — Review

The A-REITs have done very well year to date. The S&P/ASX 200 A-REITs index has delivered a total return of 9.3%, ahead of the overall share market's strong 6.7%.

Global property has also done well, and the FTSE EPRA/NAREIT Global Index in U.S. dollars is up 3.1% in capital value, the same as the gain for the MSCI World Index of global equities. As with the wider share market, much of the gain has been reliant on the U.S. market. ex the U.S. the global REITs gained only 0.7%. The gains in the U.S. followed the usual pattern, with infrastructure and

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industrial doing the best and retail REITs doing the worst. Investors in U.S. shopping malls and regional malls have lost around 4% year to date.

Australian & International Property — Outlook

There have been mixed results from the latest surveys of the sector. The December quarter Royal Institution of Charted Surveyors survey showed that investors had become more positive on the sector, though occupier demand remained flat. Rents were expected to increase modestly, by 1.1%, over the next year, with the usual tiering of prime offices (rents expected to rise by 3.2%) and prime industrial (2.6%) at the top and secondary retail (-2.2%) at the bottom. One outcome of the hot industrial sector is that an industrial REIT (Goodman) has now displaced the retail REIT (Unibail-Rodamco-Westfield) as the largest REIT by market cap.

The December quarter commercial property survey run by National Australia Bank was a bit more downbeat. Except what looked like an anomalous upwards blip in CBD hotel sentiment, it found that: "Overall confidence levels in commercial property markets were largely unchanged at below average levels. The 12 month measure stood at a pedestrian +13, and the 2 year outlook +18. We suspect confidence is being dampened by widespread expectations for below trend economic growth to continue." It confirmed the relative ranking of the RICS survey, with retail again at the bottom.

Overall, operating conditions are only fair, but as in other income-oriented asset classes, now the operating metrics take second billing behind relative yields. With the Australian 10-year bond yield around 1.0%, and little prospect of any recovery soon, the A-REIT yield of 4.5% is likely to continue to attract investor support.

At least until the coronavirus outbreak arrived, the global economic outlook was looking good for property. As RICS commented on its December global commercial property survey, "An improving macroeconomic and geopolitical backdrop, combined with more supportive credit conditions, has placed the sector on a slightly firmer footing." Within the overall improvement, RICS also noted difficult structural conditions for retailing and also pointed to marked regional differences—some European markets (notably Germany) are in very strong shape while some Asian markets (particularly Hong Kong, but also Beijing, Shanghai, and Dubai) are struggling.

RICS found that investor demand was stronger than occupier demand, a feature also picked up in JLL's latest (February) *Global Market Perspective*. It said that investor demand was clearly the stronger: "Momentum in global leasing has moderated from the peak levels in 2018, while investment volumes have registered new records." The reason was straightforward: "real estate continues to offer a healthy premium to most other asset classes despite yields being at record lows. The volume of capital raised by funds targeting real estate has reached all-time highs and investor conviction in the sector remains strong." It looks plausible that the global REITs will remain supported while bond yields continue to maunder at current low levels.

Australian Equities — Review

Australian shares have shadowed the global pattern of a strong start to the year, followed by a coronavirus setback in late January and early February, and then a more recent revival, which has taken shares back above their pre-coronavirus highs. The only difference is that local prices have not returned to above the pre-virus peak on Jan. 19. The S&P/ASX200 Index is up 6.7% in capital value and in terms of total return (dividend payouts are still very low this early in the year). The IT sector (up 12.8%) led the way. At the other end, the miners (down -0.3%) have particularly felt the impact of the virus threat to world trade. For once the financials (up 8.6%) made a decent showing after a pronounced period of underperformance.

Australian Equities — Outlook

The Reserve Bank has taken a relatively upbeat view of the business outlook. It acknowledges that there will be

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short-term impacts from the bushfires, which will knock 0.1% off GDP growth in both the December '19 and March '20 quarters, and from the coronavirus, which will knock around 0.2% off growth in the March quarter. But then, it says, "growth should recover relatively quickly, to be around 3 per cent over 2021." That would be strong enough to make a decent dent in the unemployment rate, which would head below 5.0% by the end of next year.

While equity investors would welcome such a clear acceleration in business activity, quite a few commentators reckon that the RBA's take is too optimistic. Westpac for example says that "We continue to have a more downbeat view on Australia's economic prospects for 2020 with growth expected to be around 2% rather than the RBA's expectation for an around trend 2.75%." National Australia Bank has a similar view, saying that "our forecasts are very different—in 2020—from those recently published by the RBA ... we fear the RBA forecasts will be proved overly optimistic very soon."

The most recent business surveys support the more cautious views. Even before the coronavirus concerns, the December Westpac/Melbourne Institute leading indicator was pointing to "weak economic momentum continuing in the first half of 2020." NAB's January business survey found that "Conditions were unchanged in the month, continuing their below average run ... Overall, forward looking indicators continue to imply weak business conditions ahead." The Commonwealth Bank's purchasing manager indexes for January showed that the economy had picked up a bit from December, but was showing a very subdued level of growth.

There are some pluses, notably support from monetary policy, a more competitive Australian dollar, and the recovery in the housing sector, but at the moment (assuming no drastic deterioration in the virus outlook) 2020 is looking more like another subpar year for businesses and does not appear to be strongly helpful for corporate profits. Credit Suisse, for example, thinks that profits per share will grow by 8% this year, but that is very largely down to the miners, and will unwind in 2021, when they expect no overall profit growth (though with some pockets of strong performance, notably in IT and healthcare).

But as in many other markets right now, profits may take second place to yield differentials. On the RBA's figures in January, investors going for the specials offered by the banks were earning only 1.1% on their deposits. With the S&P/ASX200 yielding near 4%, there could well be further support even against the middling outlook for corporate performance.

International Fixed Interest — Review

The main driver of global fixed-interest returns has been concern over the coronavirus outbreak. Investors went for the safety of U.S. bonds. The yield on the 10-year U.S. Treasury bond dropped from around 1.9% at the start of January to around 1.5% at the end of the month. The yield backed up a bit in February (currently a little over 1.6%) but the overall year-to-date drop in yields means that the Bloomberg Barclays U.S. Aggregate Index is up 1.9%, and has helped the Bloomberg Barclays Global Aggregate notch a small positive return of 0.4% in U.S. dollars. Ex the U.S., however, the global index has returned a small 0.8% loss.

International Fixed Interest — Outlook

Bond yields across the developed world remain below the rate of inflation, meaning that investors who hold them are losing purchasing power (even before paying tax). The average yield on global government bonds, according to the J.P. Morgan Index, is only 0.87%. And in some countries (notably Switzerland, Germany, and the Netherlands) bond yields, on average, across all maturities are negative, meaning that investors are paying borrowers.

However, there is little sign that these peculiar circumstances are going to turn around anytime soon. Central banks everywhere will likely keep monetary policy

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at least as supportive as it is now and may even ease further.

Even in the U.S., where the central bank has been reasonably successful in getting inflation back close to its 2% target, the current likelihood is that an interest rate cut looks more likely than not. Going by the FedWatch tool, which uses the current interest rate futures prices at the Chicago Mercantile Exchange, the chance of the Fed holding its target rate by June are only fifty-fifty, and there is better than an 80% chance of at least one rate cut by the end of this year. Presumably the market reckons either that the Fed, like other central banks, may be tempted to take out some virus insurance, or, alternatively, may see weaker American economic conditions ahead in 2021.

In these circumstances bond yields are unlikely to move up much from today's levels. Even in the relatively high-inflation, low-unemployment U.S. economy, the forecasters in the latest (February) *The Wall Street Journal* poll think the 10-year U.S. Treasury bond yield will still be just below 2.0% by the end of this year.

Bond-yield increases are even more unlikely in other regions. There is little or no chance of the European Central Bank or the Bank of Japan tightening their monetary policies, given their relatively weak economies. The only major central bank where the policy outlook is more up in the air is the Bank of England. In theory (as it said at its Jan. 29 policy decision announcement) it could go either way. In practice, its policy is based on the questionable assumption of "an immediate but orderly move, at the beginning of next year, to a deep free trade agreement between the United Kingdom and the European Union." It too may find itself doing some further easing to help its economy along.

The positive for investors is that the risk of capital loss on bonds looks low, at a time when precautionary bond holdings look like a useful hedge against immediate downside coronavirus risks. The negative is ongoing pitiful levels of running yield, with little chance of an improvement on the horizon.

International Equities — Review

World equity markets started the year strongly up to mid-January, but subsequent fears about the impact of the coronavirus outbreak led to a sell-off in the second half of January and into early February. More recently the markets have become more optimistic (whether this is a good or bad thing remains to be seen), and share prices have risen back above their previous mid-January peak.

Year to date, the MSCI World Index of developed markets in U.S. dollars is up 3.1%, although the outcome was heavily dependent on the strong U.S. market: ex the U.S. the index was marginally lower, by 0.2%. The emerging markets have been especially leveraged to both world trade and commodity prices, which are both at risk from the virus, and have been relatively out of favour. The MSCI Emerging Markets Index in U.S. dollars is down 0.7% year to date.

While Chinese share prices sometimes appear to have little connection to the economy's underlying performance, on this occasion they have behaved as you would have expected, with the Shanghai Composite Index dropping sharply in late January. Although they have recovered somewhat since, the index is still down 4.4% year to date.

International Equities — Outlook

While the coronavirus has overshadowed most other issues, it is worth remembering that, before the virus emerged as a threat, the world economy was in good shape. The latest J.P. Morgan Global Composite Purchasing Managers Index, which aggregates a wide variety of national business surveys, found that "The rate of global economic expansion accelerated to a ten-month high in January, as growth strengthened in both the manufacturing and service sectors. With new order intakes and business optimism also improving, companies were sufficiently encouraged to raise employment for the

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third straight month." There are areas of distinctly modest growth in the developed economies (notably the eurozone and Japan) but overall, pre-virus, the 2020 global economy was shaping up to be a bit better than 2019.

With global-share performance strongly influenced by the U.S. market, it is also helpful that the actual and projected performance of U.S. corporates is supportive. Earnings at the S&P 500 companies had been expected to be a bit lower in 2019 than in 2018, partly due to a plunge in energy and mining profits. At the time of writing, not all S&P 500 companies had posted their 2019 results, but based on the 77% that had, data company FactSet reckons that profits will have marginally increased (by 0.9%).

FactSet also collects share analysts' forecasts for profit growth in 2020 and 2021. They show that the S&P 500 companies are expected to increase profits by 8.0% this year and by 11.2% in 2021. These may be on the high side, for two reasons. In the near term, coronavirus impacts are probably undercounted: As FactSet notes, "Given the large number of companies that did not update or modify guidance due to the impact of coronavirus, it is possible that there will be an increase in the number of companies issuing negative guidance later in the first quarter as these companies gain clarity on the impact of the coronavirus on their businesses." And in the longer term, 2021 may not be as strong of an economy as the analysts think. When the economists in the latest *The Wall Street Journal* poll of forecasters were asked when they expect the next American recession to start, 35% picked 2021 (another 30% picked 2022). All that said, however, the current consensus—even if on the optimistic side—suggests that U.S. markets can continue to underpin global equity performance.

A final positive element is that China and the U.S. have started to deliver on the actions agreed upon in their phase-one trade deal. Few believe the spectre of trade frictions is gone for good, but at least in the interim the protagonists are rolling back some of the tit-for-tat tariffs they had imposed. Geopolitics as an issue is on the back burner, if only for now.

But in the meantime, the virus is centre stage. As J.P Morgan said when releasing the latest Composite index, "We brace ourselves for a much weaker outcome this quarter as the outbreak of the nCoV virus disrupts activity in China and potentially around the world."

At the moment, the forecasting consensus appears to be that the virus will have a limited global impact, both in magnitude and duration, but nobody can be sure. Some will no doubt think that previous alarms around the likes of SARS and bird flu exaggerated the eventual outcome, and will be feeling like the villagers in Aesop's Fable when the shepherd once again cried "Wolf!" However, in the fable, there was indeed a wolf in the end. The best investors can do in these circumstances is be prepared through diversification, and investors overweight to emerging markets might consider taking some risk off the table.

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