

Economic Update

Sydney | 20-12-18

December 2018

Outlook for Investment Markets

Equities have continued to be battered by two big fears for 2019: the potential damage from a U.S.-China trade war and the prospect of a U.S. economic slowdown. There has also been a slew of other worries, including slower eurozone growth and Brexit. However, relatively defensive sectors such as property have benefited as refuges from the market volatility. Bond investors have had some relief from previous losses, as U.S. bond yields have fallen (at least for now). Looking ahead, while all the recent focus has been on downside risks, a broader perspective should allow for the possibility that the long post-GFC economic recovery is still intact, although there is the potential for ill-advised political brinkmanship to derail the cycle. At home, the latest big set-piece—the government's midyear economic round-up—suggests Australia is on track for further economic growth of around 2.75% to 3% a year, but it may not be enough to spark a boost to corporate profits. The woes of the financial sector are also an ongoing headwind for equities.

Australian Cash & Fixed Interest — Review

A "steady as she goes" monetary policy stance means that, yet again, short-term interest rates have shown little change, with the 90-day bank bill yield still trading just below 2.0%. Long-term interest rates have followed the lead of the U.S. bond market, peaking in November and falling since, with the 10-year Commonwealth bond yield going a little over 2.75% on 9 Nov, but has since dropped back to just under 2.5%. The Australian dollar has risen against the U.S. dollar in recent weeks, and is now trading at USD 71.9 cents. This recent rise has not, however, made up for currency weakness earlier in the year, and the Aussie dollar is still down 4.2% in overall trade-weighted value for the year.

Australian Cash & Fixed Interest — Outlook

Although the Reserve Bank of Australia has not indicated at any of its recent monthly decisions what its next move

will be, it has said elsewhere its next move will likely be an increase. Forecasters and the futures markets generally agree, but also expect the eventual increase is still some distance away. The latest Reuters poll of forecasters, for example, found no increase is expected next year, and it could be late 2020 or even into 2021 before the bank makes its move. Returns from cash in the bank and similar investments look set to remain at very low levels.

Forecasters have generally been winding back their expectations for bond yields, partly in response to the recent fall in U.S. bond yields. While forecasters still expect bond yields to rise, they now typically expect quite modest increases from current levels. National Australia Bank, or NAB, and Westpac, for example, both expect that the 10-year bond yield will rise to 2.7% by the end of next year. While bonds offer protection against equity volatility, which is a useful feature given recent market conditions, investors otherwise do not have a lot to look forward to: gently rising yields meant modest capital losses, but still low income levels by historical standards.

Currency forecasting remains an uncertain exercise, but for what it is worth the latest Reuters poll of foreign exchange analysts sees the Australian dollar rising to USD 73.0 cents in six months' time and to USD 75.0 cents in a year's time. That would reflect the recent questions over the outlook for the U.S. economy, which have reduced the attractiveness of holding U.S. dollars. The "commodity backed" perception of the Aussie dollar, however, could be the factor that might upset the consensus view. Any setback to world trade, for example, from intensified China-U.S. trade frictions) would likely lead to even weaker commodity prices and the Bloomberg Commodity index is down 7.4% year to date.

Australian & International Property — Review

Listed property has handily outperformed the wider sharemarket for a variety of reasons. As equity markets

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became more nervous in October and November, investors shifted to more defensive sectors, and listed property got a further boost from the drop in bond yields from mid-November onwards. As a result, the S&P/ASX 200 A-REITs year to date is up by 1.0% in capital value and has delivered a total return of 4.3%, well ahead of the wider market's 3.8% loss.

International property has also outperformed global equities, although has not fully preserved investors' capital. Year to date, the FTSE EPRA/NAREIT Global index is down 2.1 % in terms of net return in U.S. dollars, a better outcome than the 5.9% loss from the MSCI World index on the same basis. The Japanese and North American markets did best, but there were poor returns from the eurozone (down 10.0%) and the U.K. (down 17.4% as Brexit issues multiplied). Emerging markets were even weaker again.

Australian & International Property — Outlook

BDO's annual survey of the A-REIT sector for 2018 showed that, unsurprisingly, industrial property led the field thanks to the increasing demand for e-commerce lined logistics facilities set against a shortage of industrial land, and BDO expected the same trends to continue into next year. Some office markets, notably Sydney and Melbourne, were also very strong and looked to stay that way: "With low vacancy rates in the larger markets likely to continue, office A-REITs should continue to benefit from smooth earnings growth."

In retail, they found the usual two-tier market, with "non-flagship" assets (regional and high street retail) doing poorly but "flagship" assets doing well: "This has likely been driven by the ability of these assets to differentiate from the online experience," and BDO felt their prospects had been underestimated by investors fixated on e-commerce threats.

BDO concluded that "with the underlying metrics of sustainable income, occupancy and asset values remaining positive, A-REITs remain well placed as the go-to defensive asset for investors." That may be overstating the case somewhat. As a recent report from BIS Oxford Economics pointed out, recent returns from property have been unusually high, as property values enjoyed a one-off rise from post-GFC distress levels and valuations got an especially large boost from abnormally low interest rates. But even on their view that returns will not match those of recent years, returns look reasonably attractive. BIS Oxford expects Sydney offices to return 9.2% a year over the next five years, and Melbourne 7.7%, while (echoing BDO's findings) large format retail could also do well, with an expected return of 7.9% a year. At a minimum, the A-REITs look a comfortable place to ride out the current wider market volatility.

Overseas, the drop in U.S. bond yields has been a godsend for the sector. There is an argument that REITs perform well in the early stages of rising interest rates. Because the rising interest rates reflect a robust economy, the positive impact of strong activity outweighs the adverse effects of higher debt costs and higher cap rates (used to value property). But the reality was investors had been worried about a progressive tightening of monetary policy and about a narrowing of the yield differential between property and bonds. The relapse in U.S. bond yields was a welcome relief.

However, it may prove temporary. We are past the early stages of the global economic cycle, and monetary policy will, however gradually, be normalised, starting in the U.S. As the investment management arm of U.S. bank Wells Fargo says in its 2019 investment outlook report, "REITs ... are facing two strong headwinds—an aging economic cycle and rising long-term interest rates—which have historically slowed their performance. Some REIT fundamentals are beginning to show the signs of a

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maturing economic cycle." Wells Fargo think the FTSE EPRA NAREIT index could still eke out a "mid-single-digit" gain, but they also expect that this will trail behind the performance of the wider global sharemarket.

Australian Equities — Review

Australian shares have fared badly in recent weeks. On top of weak global equity sentiment, the financials have continued their horror run with further revelations from the Royal Commission of poor behaviour helping the financials to a 15.9% year-to-date capital loss. IT stocks (up 5.8%) are a rare example of a sector which is clearly ahead for the year, and the more defensive sectors have held up reasonably well (the REITs are up 1.0%, and consumer staples down by only 0.7%), but otherwise it has been hard going. The S&P/ASX 200 index is down 7.6% in capital value, with the loss reduced to 3.8% by dividend income.

Australian Equities — Outlook

The official data for GDP growth in September sprang a somewhat unpleasant surprise. Forecasters had expected the economy had grown by 0.6% during the quarter, but the actuality proved well short with only 0.3% growth, affected in particular by cautious behaviour by households, who increased their spending by only 0.2%. The numbers were hardly a disaster—year-on-year GDP growth was still an internationally respectable 2.8% and continued a 28-year uninterrupted run of expansion—but they raised the perennial question of whether the economy can pick up pace from what has been an extended period of steady but not strong growth.

Business surveys do not give a clear answer to the question. The latest (November) monthly survey from National Australia Bank, or NAB, leaned towards a slower outcome: "Declines in business confidence to below average levels also suggest businesses' outlook is for momentum to ease further. Indeed, forward orders (the

most reliable indicator of domestic demand) fell in the month and are now below average for the first time since late 2016." The Westpac-Melbourne Institute leading index was also in the slower camp: "With this latest slowdown, the Index growth rate continues to point to slowing momentum into the new year." But the Purchasing Manager Indexes, or PMIs, from the Commonwealth Bank looked more upbeat: "PMI readings for Q4 were above those for Q3. So the slowdown does not look like an ongoing slide. It also suggests that the weakness in Australian GDP growth in Q3 won't be repeated in Q4."

Perhaps the most authoritative take came in the government's Mid-Year Economic and Fiscal Outlook, or MYEFO, released on 17 Dec. The immediate outlook is not quite as strong as the government had expected back on Budget day in May, with GDP growth for the year to June 2019 likely to be 2.75% rather than 3.0%. But on the other hand, the economy is expected to perk up a bit in the year to June 2020, getting back up to a 3.0% growth rate. That would be enough to keep the unemployment rate at a reasonably low 5.0%.

Whether it is enough of an acceleration to generate a gush of corporate profits and a boost to share prices remains questionable, however. Even on the government's projections, corporate profits are facing headwinds. Treasury's MYEFO estimates that profits will grow by 7.5% in the year to June 2019, and while this looks impressive, it is down to a recovery in commodity prices which is now unwinding and which the MYEFO thinks will carry on out to 2021-22. The upshot is that overall profits are expected to show no growth at all in the year to June 2020, and to grow by only 2.75% the year after.

The Australian sharemarket has been an underperformer for some time: capital gains in particular have been hard to come by, with the S&P/ASX 200 index recording only a 1.3% a year gain over the past five years. While reasonable

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though not robust economic growth will provide some support, the headwinds from a cautious consumer, weakening commodity prices, falling house prices, and the still under-pressure financial sector look likely to lead to another period of subdued performance.

International Fixed Interest — Review

Developments in the asset class continue to be dominated by what is happening in the U.S. bond market with interest rate movements much more modest in both the eurozone and Japan.

In the U.S., bond yields rose up to the first half of November: the 10-year Treasury yield got as high as 3.24% on 8 Nov. Since then, however, yields have fallen markedly. The 10-year yield had dropped back to just under 3.0% on 30 Nov, and continued on down to 2.85% on 7 Dec. Since then it has picked up a little, to just under 2.9%, but the earlier falls meant that U.S. bondholders enjoyed some useful (if unexpected) capital gains.

The recent gains, however, have not been enough to make up for the larger capital losses earlier in the year. Year-to-date, the Bloomberg Barclays Global Aggregate index of fixed interest is still showing a loss of 2.6% in U.S. dollar terms. The higher risk end of the asset class is also underwater for the year, with the Global High Yield index down 3.2%, while emerging markets bonds have been as out of favour as their equity counterparts, and are down 2.7%.

International Fixed Interest — Outlook

The turnaround in the U.S. bond market reflects increased doubts about the outlook for the U.S. economy. As explored more fully in the "International equity" section, investors have become more worried about the strength of the U.S. business cycle. This has led them to look more favourably on bonds as a hedge against the downside risks

of an economic slowdown, and has also led to a reassessment of the likely actions of the Fed.

Until recently, the consensus had been that the Fed would raise the target range for the federal-funds rate from its current 2.0% to 2.25%—initially by 0.25% at its 19 Dec policy meeting, and subsequently by a further three 0.25% increases during the course of 2019. This would have resulted in a target range of 3.0% to 3.25% at the end of next year. Going by the Chicago Mercantile Exchange's FedWatch tool, which backs out target range expectations from futures prices, these expectations have been unwound quite significantly.

The December 0.25% increase still seems likely (a futures probability of 77%) but the three increases pencilled in for 2019 have been wound back to a 50:50 toss-up between one or two. The probability of only one by the end of next year is currently 36.5%, and of two is 36.9%. The chance of three is now a low 15%. Surveys of forecasters show the same reassessment: the latest Reuters poll of economic forecasters taken over 6-13 Dec has also wound back its view to two increases in 2019.

While the outlook for the asset class is not as challenging as it was before the recent revisiting of the U.S. economic outlook, likely returns still look to be unpromising (barring an unexpectedly early or large setback to the U.S. economy). Bond yields still look set to rise in the U.S. with the latest (December) consensus forecasts from *The Wall Street Journal's*, or WSJ's, panel of U.S. economic forecasters seeing the 10-year yield around 3.25% by mid-2019 and a little higher again at 3.35% at the end of next year. At some point too, the European Central Bank will start chipping away at its previously ultra-easy monetary policy. It has confirmed it will stop its bond-buying programme at the end of this year, although any interest rate increases are still some distance away (not before mid-2019, according to the bank).

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There is likely, in short, to be some drag on overall returns as gradually rising yields impact on bond capital values. With risks rising in the equity markets, however, investors may well feel the relative stability of fixed interest is worth consideration.

International Equities — Review

World equity markets have gone through various minicycles in recent months, with periods of investor pessimism alternating with periods of renewed optimism. Cumulatively, however, negativity has been dominant, and after October's large sell-off shares have dropped a bit further again in recent weeks. Year-to-date, the MSCI World index of developed markets in U.S. dollars is down 7.6% in capital value and by 5.9% including taxed dividend income.

Until very recently, the overall return from the asset class had been kept up by ongoing gains for American shares, but this unravelled over the past month as investors started to fret about the U.S. economic outlook. The S&P500 is now down 2.8% for the year. A setback to the previously high-flying tech sector did not help, though for the moment the tech-heavy NASDAQ Composite index is still marginally ahead (0.1%). Other major markets lost ground, with Japan's Nikkei down 6.1% and eurozone shares down 10.3% on the basis of the FTSE Eurofirst300 index. The U.K. remains embroiled in Brexit problems, and the FDTSE100 index has lost 11% in value this year.

Emerging markets, which had been weak in any event even before this latest setback to the developed markets, have continued to struggle. The MSCI Emerging Markets index in U.S. dollars is down 16.1% year to date, and the key BRIC economies of Brazil, Russia, India, China are down by 13.9%.

International Equities — Outlook

The recent weakness of global equities reflects two large concerns that have come to the forefront of investors' attention: the prospect of economic disruption from an intensified tariff war between the U.S. and China, and the potential for the U.S. economy to slow down in 2019 as the fiscal boost from the Trump tax cuts drops away. There has even been speculation that an outright recession in the U.S. is not far away.

It has not helped that the latest worries came against a background where investors had already been fretting about the potential for the Fed to make a too-tight monetary policy mistake, and when U.S. share valuations were quite expensive by historical standards, leaving little room to withstand disappointed expectations. The latest sell-off was also abetted by a variety of other factors, including an unwind of speculative exuberance in the tech sector, weak economic data from the eurozone, slower than expected growth in China, and the fall-out from the Brexit negotiations.

The recent equity weakness is understandable, but looking ahead the case for equities is not as uniformly pessimistic as the headline alarm might suggest.

While the outcome of the U.S.-China trade frictions is hard to predict, it may turn out better than investors currently anticipate. Previous investor alarm over unexpectedly confrontational U.S. policies—notably against North Korea and the NAFTA free trade agreement—ended up less bad than feared.

The U.S. slowdown also needs to be viewed in perspective. Currently, the consensus forecast for the U.S. economy, from the WSJ forecasting panel, is that it will still grow by 2.3% in 2019, and as noted earlier fears that the Fed would precipitate something worse are being revised. The Fed is now expected to be more cautious about interest rate

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hikes. The U.S. profit machine has not yet stalled: the latest consensus forecast from sharemarket analysts, as collated by data company FactSet, is that profits for the S&P500 companies will grow by 8.3% in 2019.

There are, it is true, good reasons to expect that both the U.S. and the global economies will grow more slowly in 2019. The latest (November) J.P. Morgan IHS Markit global composite indicator found that "Forward-looking indicators for the survey raised some potential headwinds regarding the outlook for output growth ... Business expectations regarding the outlook for economic activity during the year ahead dropped to the lowest level since September 2016."

But in the current climate, worried investors are finding it hard to distinguish between a slowdown and a collapse. The outlook for the global economy may not be as strong as previously, but is not outright poor. The *Market Outlook 2019* forecast from Bank of America Merrill Lynch, or BAML, for example, expects the world economy will grow by 3.6% next year, which would be only slightly slower than this year's 3.8%.

Some of the other concerns also look overwrought. London's *Financial Times*, for example, reported that "[November] Retail sales grew at the slowest pace in 15 years in November in China, while factory output was the weakest in nearly three years." While correct, the actual numbers remained remarkably strong—retail sales were up 8.1% on a year earlier, and industrial production was up 5.9%.

In the current climate, however, news is being read from a bearish perspective, and investor anxiety may continue to rule the market for some time yet. BAML itself plans to be careful through this period: "We expect to turn tactically risk-on in late spring, but to start 2019 with a bearish asset allocation of 50 percent stocks, 25 percent bonds and 25 percent cash." However, while there are clearly a series of

near-term challenges, notably including the impulsiveness of U.S. of economic and foreign policy, there is still a reasonable chance that in the background, the long post-GFC global business expansion is still intact.

Performance periods unless otherwise stated generally refer to periods ended 14 Dec 2018.

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