## Economic Update

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# March 2019

### Outlook for Investment Markets

Many asset classes have done well for the year to date. Equities have continued to recover from their sell-off late last year; income-oriented asset classes like property (local and global) and infrastructure have been in strong demand; and bonds are also ahead for the year as bond yields have fallen. Looking ahead, the most likely scenario is that the world economy will "muddle through" with ongoing economic growth, though the likely pace of business activity now looks slower than previously expected. Cash and bond yields will remain low and could even fall further. Risks and uncertainty remain high, however, particularly around threats to world trade. In Australia, too, the likely immediate economic outlook is for slower growth than previously, with sharply lower house prices affecting an already cautious household sector. The big issue for businesses will be how to grow profits in a slower-growing economy.

### Australian Cash & Fixed Interest — Review

Short-term interest rates have dropped since the start of the year: The 90-day bank bill yield is down 0.24% to its current 1.85%. Long-term interest rates have dropped a bit more again: The 10-year Commonwealth bond yield started the year at 2.33% and is now just under 2.0%. The Australian dollar is slightly lower in overall trade-weighted value, having depreciated by 0.8% since the start of the year, with a mixed pattern of some gains (against the euro and the yen), some stability (unchanged against the U.S. dollar), and some losses (renminbi, pound, New Zealand dollar).

### Australian Cash & Fixed Interest — Outlook

Forecasters continue to walk back from their previous prevailing view that the RBA would eventually start tightening monetary policy. As one recent example, National Australia Bank, or NAB, has said on 12 March that "We now think that the RBA will make two rate cuts in 2019. Growth appears to have lost significant momentum, placing at risk further improvement in the labour market at a time when inflation poses little constraint on policy and financial stability risks have abated. We have pencilled in one 25bp cut to 1.25% in July and a further 25bp cut to 1% in November". The futures market is not (yet) quite on board with a series of cuts but currently expects one by the end of the year. Either way, short-term interest rates will remain very low for the next year or two.

Forecasters continue to reduce their expectations for bond yields in response to a number of developments—in particular, the lower track now expected for overseas bond yields, the potential of slower economic growth at home, and the possibility of easier domestic monetary policy. Westpac Bank, for example, now expects that the 10-year bond yield will not get back over 2.0% this year. That may be a minority view—the Commonwealth Bank thinks 2.4% is more likely for the end of this year, and National Australia Bank sees 2.6%—but even if yields do rise back over 2.0%, the scale of the rise is a lot less than expected only a few months ago. Investors in bonds who had been apprehensive of yields returning to more normal levels by historical standards, bringing capital losses in their train, may have lucked into a largely unexpected reprieve.

There is not a strong degree of consensus around the outlook for the Australian dollar. Among the big banks, you find takers for the view that the Aussie dollar will be a bit lower at the end of this year (Westpac), about the same (ANZ), a bit higher (Commonwealth), or quite a bit higher (NAB, with a 75 U.S. cents call compared with today's 70.5 cents). The latest (early March) Reuters survey of a wide range of forecasters leans towards the side of a gradually higher Australian dollar, with a median forecast of 72 U.S. cents in six months' time and 74 U.S. cents in a year's time.

### Australian & International Property — Review

The shape of the business cycle and increased demand for defensive assets have been big supports for Australian listed property. The A-REITs have handily outperformed



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equities as a whole, with the sector delivering a total year-to-date return of 12.0% compared with the wider market's 10.5%.

The same factors have underpinned strong performance for global listed property. For the year to date, the FTSE EPRA/NAREIT Global Index is up 12.3% in terms of net return in U.S. dollars, slightly more than the 10.6% net return from the MSCI World index. The key U.S. market returned 14.5%, led by the industrials sector (20.5%) and the office markets (19.4%). Even the out of favour retail sector returned 11.3%. Elsewhere, Asian markets returned 10.9%, though Japan was a laggard with 6.9%, and developed European markets returned 10.5%. There is evidence that investors started chasing formerly beaten-up markets like Italy (21.8%) and the U.K. (15.3%).

**Australian & International Property — Outlook**

The outlook continues to be very mixed by sector. At one end, as JLL points out in its latest review and outlook report on the office market, "The Australian CBD office market vacancy rate trended back into single digit territory in 2018 (8.6%)—the lowest level since 3Q12. The Sydney CBD (4.1%) and Melbourne CBD (3.7%) are two of the tightest office markets in the world." JLL says that demand has driven yields down to unusually low levels relative to bonds but that investors have been prepared to go along given that they are buying into the prospect of strong rental hikes. Industrial property is also popular: JLL says that "demand for industrial space will remain firm, and the scope for valuation upside will remain for quality industrial assets."

At the other extreme, retail continues to struggle against both the structural e-commerce headwind and the immediate cyclical outlook, where consumer spending is under a cloud, particularly given the loss of wealth effect of lower house prices on family spending. The latest (end February) CoreLogic data shows that house prices are now down 10.5% on a year ago in both Sydney and Melbourne. The weak housing sector also affects both the residential-linked A-REITs and the retirement village subsector. Overall, it looks as if demand for cyclically defensive assets is the prime driver of recent A-REIT returns and may remain so, but. given the issues facing some property subsectors. it is unlikely that the A-REITs can go on outperforming matching the wider equity universe.

Overseas, the economic outlook is reasonably. though not strongly. supportive. In the key U.S. market, an article on the U.S. REIT trade group website suggests, reasonably, that this year "is likely to be a good but not great one for commercial real estate and REITs, with some slowing of GDP growth but continued low inflation and low interest rates providing solid support for real estate markets." It also notes that investor demand is very strong, with the volume of real estate transactions almost back up to its peak level before the global financial crisis.

The key issue for the sector will be valuations. For now, the pretax yield on the FTSE/EPRA global index is just shy of 4%, which is comfortably clear of yields in the major bond markets. As the previous "craze for yield" that occurred after the global financial crisis showed, however, investors looking for sustainable income drove property valuations to unsustainably expensive levels. That has not happened yet but remains a risk. The more adventurous yield-chasers may already be pushing their luck: The demand for U.K. assets, for example, is very much at odds with their underlying operating performance.



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**Australian Equities — Review**

Local shares have continued to benefit from the globally equity-positive environment. The S&P/ASX200 Index is up 9.1% in capital value (10.5% including dividends) for the year to date. IT shares continue to star, with a capital gain of 19.3%, and the resources have also done very well (up 14.2%), while the industrials have gained 9.0%. Somewhat oddly, given concerns about a slowing economy, the consumer discretionary shares (up 9.8%) have substantially outperformed consumer staples (up only 3.2%), even though household staples might be expected to be in a better position to withstand cyclical setbacks. The financials continue to underperform relative to shares as a whole, though the better news is that they have maintained their post-royal-commission rally and are up 6.5%.

**Australian Equities — Outlook**

The data on the Australian economy have been blowing hot and cold for some considerable time, but the past few weeks have been consistently on the cooler side.

The official data on gross domestic product growth were weaker than expected (only 0.2% in the quarter, 2.3% year on year) prompting media descriptions of a "per capita recession" (in both September and December, GDP growth had failed to match population growth).

More-recent private sector indicators have also weakened. The Westpac/Melbourne Institute consumer confidence survey for March found that pessimists now slightly outnumber optimists: "All index components recorded falls in March but the biggest shift was in consumers' near term expectations for the economy," which is not surprising given the recent run of poor GDP data. And the National Australia Bank survey of business confidence for February was also downbeat: "Following the release of the national accounts for Q4 2018—which showed growth has materially slowed in the private sector, the business survey suggests that there has been little improvement in the first two quarters" of 2019." The slowdown may go on for a while yet: "Forward looking indicators point to an ongoing weakness in business conditions."

The latest Commonwealth Bank's performance of services index has also headed south: "February showed a deterioration in Australian service sector activity for the first time since the survey began nearly three years ago." It was enough to take the CBA's overall index of the economy (which includes manufacturing) into negative territory. The bank suggested that it may be just another of those weak patches that have been coming and going—"firms remained confident about the outlook from a longer-term perspective. Business expectations over the next 12 months remained buoyant, with 56% of respondents anticipating higher activity in the year ahead." In the interim, though, things may be bumpier, with CBA respondents in particular mentioning "further changes to banking sector regulations and upcoming federal elections."

In these conditions, profit performance has been understandably mediocre. CommSec's summary of the latest (end of December) reporting season said that "Overall companies have found it tough." Headline ("statutory") profits were up 15.3% on a year earlier, but they were heavily affected by very large reported profits at Wesfarmers and BHP. Excluding those two, CommSec calculated that profits at the other 136 reporting companies had fallen by 5.5%.

Profit growth has been hard to come by: CommSec said "the fact that fewer companies were able to lift profits, accords with survey evidence. In fact only around half of all companies managed to lift profits compared with a year ago."

Further price gains for Australian shares consequently look more likely to come from continuing to coast on the back of positive global sentiment than from any strong improvement in local corporate performance. That's not to



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be sneezed at: Assuming things go well globally, CommSec reckons the global tide could take the S&P/ASX200 Index into the 6,350–6,650 range by the end of this year, which at its midpoint would be a useful 5% gain from current levels. Ultimately, however, further gains will need a stronger cyclical outlook than looks likely at the moment.

**International Fixed Interest — Review**

Bond yields in the major bond markets have fallen slightly for the year to date. While they rose at the start of the year—at one point (18 January), the U.S. 10-year Treasury yield got as high as 2.79%—more recently they have generally been heading lower, albeit with quite a degree of volatility. The benchmark U.S. yield is now 2.63%, down 0.07% since the start of the year. There has been a larger fall in eurozone yields, where the equivalent yield has dropped to virtually nothing (0.07%) from 0.24%. Negative bond yields have re-emerged in Japan, where the benchmark yield is now negative 0.05%, and even more so in Switzerland, where the 10-year yield has dropped to negative 0.31%.

Modest falls in government bond yields, and the resultant step up in demand for alternative sources of income in the bond space means that investors have enjoyed positive returns for the year to date. The Bloomberg Barclays Global Aggregate Index in U.S. dollars is up 1.3%, with government bonds up 0.7% and corporate debt up 3.0% as corporate credit spreads reduced from their alarmed levels of late last year. Emerging-markets debt has also done well, with the Bloomberg Barclays Emerging Markets Aggregate up 4.3%.

**International Fixed Interest — Outlook**

The likelihood that the pace of growth of world economy is slowing down is the main reason for lower bond yields. Slower growth reduces inflationary pressure in a world where central banks were already concerned that inflation was lower than they would like. In response, major central banks have been required, at a minimum, to stop raising interest rates any further in order to support growth and to boost inflation.

In the U.S., Fed chair Jerome Powell said in a recent speech that with "nothing in the outlook demanding an immediate policy response," the Fed had opted for "a patient, wait-and-see approach to considering any alteration in the stance of policy." The financial markets have read this as meaning that the fed-funds rate will be kept on hold for the rest of this year. According to the Chicago Mercantile Exchange's "FedWatch" tool, which is based on futures prices, the futures market now thinks there is a 78% chance of no change to monetary policy. There are no takers anymore for a rate hike, and there is now a 20% chance of a rate cut.

Given the more downbeat cyclical outlook and the Fed's stance, U.S. forecasters have pared back their expectations for bond yields. The average forecast from *The Wall Street Journal*'s latest (March) survey of American forecasters is that the 10-year Treasury yield will not now get back over 3.0% this year: They see it reaching 2.93% by the end of the year. It would not be surprising if expectations are further wound back in coming months.

In the eurozone, where the cyclical outlook has weakened more than in the U.S., the central bank has had to go further and actually reverse track. It had decided to stop buying more bonds for its "quantitative-easing" stockpile: The bond buying had been designed to keep long-term interest rates down. Faced with a weak eurozone economy, however, the European Central Bank has had to backtrack and reintroduce a programme of cheap loans to banks ("Targeted Longer-Term Refinancing Operations") that it had last used three years ago.

There are mixed implications from these moves for investors. On the plus side, holders of bonds are not now facing yield increases and capital losses, and ongoing easy monetary policy in the U.S. and the eurozone takes



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the risk of a too-tight monetary policy mistake off the table. On the downside, the lower track for bonds is a symptom of the world economy not travelling quite as well, and investors will also have to be resigned to yet another prolonged period of unusually low levels of income off their bond holdings. Finally, although investors in high yield (low credit-quality) bonds have done very well for the year to date (a gain of 5.8% in U.S. dollars for the year to date), fishing in these risky waters could prove perilous if the world economy hits another squall along late-2018 lines.

**International Equities — Review**

World shares have continued to recover from the sell-off that occurred late last year. For the year to date, the MSCI World index of developed markets is now up 11.2% (in the markets' own currencies) and also by 11.2% in U.S. dollar terms (11.6% including taxed dividends).

All the major markets have done well. The tech-oriented Nasdaq market is up 15.2%, and the U.S. market overall is up 12.1%. In Europe, the FTSE Eurofirst300 Index is up 10.9%: the French CAC Index is up 12.2%, and the German DAX is up 9.6%. In Japan, the Nikkei has gained 6.8%, and, even in the Brexit-hobbled U.K., the FTSE100 Index is up 6.4% in sterling, with a 4.5% rise in the pound against the U.S. dollar as a cherry on the top.

Emerging markets have also been strongly on the mend. The MSCI Emerging Markets Index is up 8.8% in U.S. dollar terms, and the core BRIC economies have been stronger again, with a 13.2% rise. Of the four core countries, three (Brazil, Russia, China) recorded strong rises, led by China, where the Shanghai Composite Index is now up 21.4% for the year. The fourth (India) managed only a smaller 4.7% gain.

**International Equities — Outlook**

The fundamental economic outlook for global equity performance has not changed, with the prospect of ongoing modest growth for the global economy, albeit overshadowed by considerable uncertainty.

The latest (6 March) flagship forecast report from the OECD expects that the current global expansion will continue through this year and next. It is predicting that the world economy will grow by 3.3% this year and by something very similar (3.4%) in 2020. This is a bit slower than the OECD had expected last time it did the numbers, in November last year, but makes sense. It takes account of likely slower growth in the eurozone and the U.K. in particular compared with how things stood late last year.

The OECD's forecasts are also a good reminder that while media attention is heavily focussed on the advanced economies, and in particular on the U.S. (where the OECD is picking growth of 2.6% this year and 2.2% next year), the global outlook is being underpinned by very strong rates of GNP growth in the major emerging markets. The OECD expects that India will grow by 7.2% this year and 7.3% next year, and there are similarly strong numbers expected for China (6.2% and 6.0%).

The likelihood is that the long post-global-financial-crisis global expansion will carry on "muddling through," although not as strongly as seemed likely six months ago. Somewhat lowered activity expectations are being taken on board by the professional investment community. At the start of this year, for example, share analysts (on the forecasts compiled by data company FactSet) were expecting that profits at the S&P500 companies would increase by 7.3%: now they are picking 3.9%, although the extent of the downward revision is somewhat misleading. There have been sharp declines in expected earnings from the energy and raw materials sectors, which have exaggerated the size of the rethink. Expectations remain broadly positive for most U.S. sectors (especially healthcare, communications, and financials), though wound back from the overoptimistic expectations at the start of the year.



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At one point, it looked as if the latest big news out of the U.S.—a much smaller than anticipated rise in jobs in February—was a sign of an unexpected sharp slowdown. That looks a premature call: It is probably better to consider the January outcome (a surprisingly large 311,000 extra jobs) and the February one (only 20,000) as a combo and average them out. But it is nonetheless true that a slowdown, to some degree, is in the pipeline.

Despite the OECD's relatively modest cutbacks to its growth forecasts, the slowdown could be reasonably material. At the bearish end, for example, the latest (February) IHS Markit Global Business Outlook, based on its business surveys around the world, found "Worldwide confidence surrounding the outlook for business activity in the year ahead has waned further in 2019. February data indicate that worsening sentiment in developed markets underpins the gloomiest global picture for almost two-and-a-half years, while developing markets' optimism has improved to a one-year high."

How weakish growth in the developed markets and stronger growth in emerging markets plays out could mean some modest slowdown (as per the OECD view) or something glummer (IHS Markit), but whether any of these scenarios gets to play out interrupted remains in the hands of the politicians. As IHS Markit said, "Anecdotal evidence shows ongoing anxiety about trade tensions, national security and lingering political uncertainty, particularly in Europe." The OECD came to the same view, saying that "Uncertainty is weighing on confidence, trade, investment and employment prospects."

The OECD's recommendation was that governments should play nice—or in its words, "Intensify multilateral dialogue globally and in Europe to reduce policy uncertainty"—but investors looking at the Brexit omnishambles or the Trump/China trade brinkmanship might well conclude that the likelihood of smiles all round is not high. There is a small chance that the some of the big geopolitical issues might turn out all right—markets would certainly welcome a happy ending to the trade wars—but a safer approach is to 1) hope that the politicians do not do too much damage to the world business cycle and 2) use traditional tools (diversification, relatively defensive options within asset classes) to help mitigate the current uncertainties.

*Performance periods unless otherwise stated generally refer to periods ended March 13, 2019.*



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