

Economic Update

Sydney | 15-11-18

November 2018

Outlook for Investment Markets

Although equities, overseas and at home, have been recovering from their sell-offs in October, they are still well below their previous peaks. Looking ahead, the global economy looks like continuing its already long post-GFC expansion into 2019, which should be supportive for growth assets, but equities remain overly dependent on the performance of American shares and the American economy, and there are risks (notably around trade wars and potential mistakes from accidentally overtightening monetary policy) which could derail the outlook. In Australia, the Reserve Bank of Australia, or RBA, has come out with a notably more upbeat forecast for business activity, but there is still a wide range of other views, and even on the bank's upbeat take, the 2019 economy may not translate into strong corporate profit outcomes.

Australian Cash & Fixed Interest — Review

Once again, short-term interest rates are unchanged, with the 90-day bill yield continuing to trade just below 2.0%. Steady rates reflect the unchanged stance of monetary policy. As expected, the RBA left the official cash rate (OCR) unchanged at its latest policy meeting on 6 Nov. Bond yields have been volatile in recent weeks though with little net overall change, and the 10-year Commonwealth bond yield of 2.72% is close to where it was a month ago. The Australian dollar has fallen in value this year, partly reflecting the global strength of the U.S. dollar. In overall trade-weighted value, the Australian dollar is down 3.1%, due mainly to its depreciations against the U.S. dollar (down 7.4%) and the Japanese yen (down 6.3%).

Australian Cash & Fixed Interest — Outlook

In its latest (9 Nov) quarterly monetary policy statement, the RBA said it "is expecting further progress in reducing unemployment and ensuring inflation is consistent with the target. If that progress is made, higher interest rates are likely to be appropriate at some point. However, given

the expected gradual nature of that progress, the Board does not see a strong case to adjust the cash rate in the near term." On current pricing, the futures market is interpreting the RBA's "at some point" to mean a 0.25% increase in the cash rate sometime in late 2019 or early 2020, which means that returns from short-term fixed interest investments will remain very low for some time yet.

Inflation is likely to gradually move up into the RBA's 2%-3% target range, with the RBA expecting inflation will be running at 2.0% to 2.25% next year and will continue at 2.25% throughout 2020. Higher inflation means it is likely bond yields will also have to head higher to preserve investors' "real" (above-inflation) returns. Another factor suggesting higher local yields is the likely rise in U.S. bond yields, as although the relationship appears to have become uncoupled in recent months, longer-term trends still suggest higher U.S. yields will have some local impact. National Australia Bank, for example, thinks a 10-year U.S. bond yield of 3.5% in a year's time will be one of the factors leading to the local equivalent also rising to 3.5%. Rising yields and the associated capital losses are likely to make for low overall returns from fixed interest over the coming year.

The RBA in its quarterly statement said: "Movements in the Australian dollar tend to be related to developments in commodity prices (and the terms of trade more generally) and interest rate differentials over time. Those two forces have been working in offsetting directions over recent years. The RBA Index of Commodity Prices has increased while Australian government bond yields have declined relative to those in major markets," with the downward impact of relative bond yields the stronger of the two forces.

Looking ahead, forecasters evidently believe the Aussie dollar has now fallen as much as it needed to. The latest (6 Nov) Reuters poll of a wide range of foreign exchange analysts found they expected the Australian dollar to be little changed over the next six months—they are picking

Economic Update

Sydney | 15-11-18

November 2018

USD 73 cents, close to its current USD 72.3 cents—and think there could be even be some modest appreciation back up to USD 75 cents in a year's time.

Australian & International Property — Review

Listed property has proved to be a usefully defensive asset through the past month's equity volatility. Although the absolute return has not been especially impressive, with the S&P/ASX 200 A-REITs index marginally down (by 0.2%) in capital value, and providing a modest 3.0% total return, the sector has outperformed the 1.7% return from the overall sharemarket. The outcome flatters the sector to a degree, as there was a burst of merger and acquisitions activity that somewhat fortuitously boosted the prices of the target A-REITs.

International property has not worked out quite as well as a defensive option. Year to date, the FTSE EPRA/NAREIT Global index is showing a 2.9% loss in terms of net return in U.S. dollars, a bit worse than the 1.9% loss from the MSCI World index on the same basis. The pattern of regional returns broadly matched that of the wider share markets, with the U.S. and Japan faring best, the eurozone and the U.K. doing poorly, and emerging markets falling sharply.

Australian & International Property — Outlook

Conditions are mixed across the subsectors of the A-REIT universe. Industrial remains in the strongest position, with e-commerce being an important driver. Colliers' latest Research and Forecast Report on the sector found "e-commerce retailers have been amongst the largest takers of industrial space over the past few years, spearheaded by Amazon's entrance to the market" and that "against the backdrop of the strong fundamentals in the industrial property market, investor demand has remained particularly buoyant. This strong demand, however, is being restrained by the lack of stock being available, particularly the lack of portfolio opportunities. As a result, yields have continued to compress [that is, fall, boosting

property valuations] across the board over the past 12 months."

Prime offices in the biggest cities are also doing well. According to Cushman & Wakefield's latest *Office Leasing Trends & Outlook Report*, CBD office markets are now landlord markets in both Sydney and Melbourne, with Melbourne in particular seeing large increases in rentals this year. For example, Cushman & Wakefield estimate the increase to have been around 14%. Further rental increases of 5% to 10% are expected in 2019.

At the bottom of the heap, however, are retailing and housing development. Brick-and-mortar retailing, other than the "destination" megamalls, is on the receiving end of the move towards online shopping, while the housing sector is weak. CoreLogic's latest (end October) house price indexes showed national house prices are down 3.5% on a year ago, led by Sydney (down 7.4%) and Melbourne (down 4.7%). Various surveys have also shown the sector is also being cramped by tightened credit availability, one example being ANZ Bank's announcement this month of more rigorous checks on both owner-occupier residential and property investors.

Overall, the mixed conditions suggest the A-REITs do not currently stand out from the overall equity market. The sector may get some support as a defensive option if there is further significant volatility, but otherwise performance much in line with the wider market looks a plausible prospect.

Overseas, the ongoing global expansion is generally supportive of property operating performance. The Royal Institution of Chartered Surveyors' latest (September) Global Commercial Property Monitor found "sentiment in the real estate world, in general, remains fairly solid. This chimes with much other anecdotal evidence which is pointing towards actual transactional volumes at least as strong as last year and possibly a little bit firmer." The sector has nonetheless suffered as bond yields in the U.S. have risen and have reduced the previous appeal of

Economic Update

Sydney | 15-11-18

November 2018

property yields when other income options had offered unusually low returns.

By and large, the same high-level trends are still in play, though it is possible the prolonged underperformance of property is beginning to open up some bargain-hunting. Property specialists Green Street Advisors estimate that U.S. REIT prices are trading at a 5.6% discount to Green Street's assessment of their net asset value, which is well below the long-run pattern of prices trading at a modest (2.2%) premium to net asset value. Discounts have been larger again during U.S. recessions, so the current discount is not necessarily an unambiguous signal of good value if things were to go badly wrong.

If the U.S. economy continues to expand into 2019, however, there is a reasonable argument valuations have drifted down to the cheap side of fair value. The big institutional fund managers appear to be starting to think along those lines with the latest (November) Bank of America Merrill Lynch, or BAML, survey of the big managers found they had moved overweight to REITs. While these signs of increased investor interest are encouraging, it is early days, and it is not yet clearcut that valuations are attractive enough to encourage strong buying of the asset class.

Australian Equities — Review

The significant sell-off in October bottomed out on 26 Oct, at which point the S&P/ASX 200 index had dropped by 10.8% from its peak on 29 Aug. More recently, Australian shares, following the global pattern, have been recovering, though the index is still 6.5% below its previous peak level. Year to date, the index is down 2.0% in capital value, although dividend income takes the overall return into positive territory, for a small 1.7% total return.

The financials (down 9.7% in capital value) have severely affected the overall outcome, while consumer

discretionary stocks are down by 2.7%. More positively, the IT sector has been strong (up 13.2%), while consumer staples (up 6.4%) and the miners (up 3.6%) are also ahead. The industrials have shown little net change (formally down 0.3%).

Australian Equities — Outlook

There is still a widespread divergence of views on the outlook for business performance. The RBA's latest quarterly monetary policy statement was right down the upbeat end of the spectrum: the bank lifted its forecasts for economic growth and lowered its forecasts for unemployment. On GDP growth, it now thinks the Australian economy will grow by 3.25% this year (it had previously picked 3.0%), and it expects the unemployment rate will be 5.0% at the end of next year (previously 5.25%), and lower again (4.75%) in 2020.

More in the middle of the pack is the picture that emerges from National Australia Bank's business surveys. The latest (October) monthly survey, National Australia Bank said, "continues to point to a healthy business sector, with profitability and trading conditions remaining high, and forward-looking indicators still favourable ... Overall, the survey fits our view, that the labour market remains healthy, growth is solid, but that wage and price pressure remains subdued in the economy more broadly."

But there are also more downbeat perspectives. The Commonwealth Bank of Australia's monthly performance indexes of how businesses are faring in the manufacturing and services sectors have been on the weak side. Its October "composite" index across both sectors "signalled the joint-weakest rate of private sector output growth in the two-and-a-half-year survey history (on par with August) and reflected slower expansions in both manufacturing and service sectors."

Currently slow-growing business activity could of course strengthen as the RBA expects, but the Westpac-Melbourne Institute leading indicator is not detecting any acceleration signals. Westpac said it "expects momentum

Economic Update

Sydney | 15-11-18

November 2018

to slow to around 2.5% in the second half of 2018, which will be slightly below trend, with this slower pace to be sustained through 2019 at around trend of 2.7%, " which would be well adrift of the RBA's expectations. Westpac pointed to various headwinds: "an uncertain outlook for the consumer with ongoing weak wages growth; falling property prices in Sydney and Melbourne which will be associated with a negative wealth effect; and a slowdown in jobs growth as both political uncertainty and global volatility weigh on firm's employment decisions."

The RBA noted profits for the S&P/ASX 200 companies in the first half of this year were only 5% up on a year earlier, largely due to the resources sector, with the financials flat and other sectors only modestly ahead. Given the mixed views on the business outlook, more of the same modest profit growth looks the most likely outcome, although equity performance could surprise on the upside if the RBA's more upbeat scenario were to come to hand.

International Fixed Interest — Review

U.S. bond yields hit a new high on 8 Nov, when the 10-year Treasury yield closed at 3.23%, its highest close since May 2011. In the past few days, the yield has dropped back to its current 3.18%, but even so, the rise in U.S. yields year to date—the 10-year yield started 2018 at 2.4%—has meant holders of U.S. dollar bonds have suffered capital losses. Investors holding a portfolio of "long" Treasuries (20 years maturity and more), for example, and who have been most exposed to the impact of lower bond prices, are looking at a loss of 8.5% for the year.

Bond yields in most other major currencies have shown little net movement for the year—German yields are marginally lower, Japanese bonds marginally higher—which means the movement in U.S. yields has been the dominant influence on disappointing fixed interest outcomes. Year to date, the Bloomberg Barclays Global

Aggregate index of fixed interest is down by 3.5% in U.S. dollars. The higher running yield on lower credit quality bonds has partly protected investors in that neck of the fixed interest woods, but they too are currently facing losses, with the Bloomberg Barclays Global High Yield index down 1.9%. Emerging markets bonds have also done poorly (though not as poorly as emerging markets equities), and the Bloomberg Barclays Emerging Markets index is down 3.4%.

International Fixed Interest — Outlook

The outlook for international fixed interest remains difficult, principally because of the potential for further rises in U.S. dollar yields. The U.S. economy is doing well, unemployment has dropped to low levels, and inflation is up to the levels the Fed would like to see.

The Fed said after its latest policy meeting on 7-8 Nov that "the labour market has continued to strengthen and ... economic activity has been rising at a strong rate." On the inflation front, it has said "both overall inflation and inflation for items other than food and energy remain near 2 percent." While it left the federal-funds target rate at 2.0%-2.25% on this occasion, the Fed pointed to "further gradual increases in the target range for the federal-funds rate" and is very likely to raise the target range by 0.25% at its 18-19 Dec meeting.

The futures markets and private sector forecasters continue to expect further rises next year: current futures pricing suggests that two further 0.25% increases are the most likely outcome, though there are also reasonable numbers of takers for one increase, and for three.

The central outlook in sum is more of the same: further interest rate rises in the U.S., though probably not on the scale of the rises already in the bag, with generally little movement in other major market bond yields (although Brexit-related moves in U.K. bonds and budgetary issues in Italy could spring some surprises in those markets). The European Central Bank is tiptoeing towards less supportive monetary policy, and will be stopping its

Economic Update

Sydney | 15-11-18

November 2018

interest-rate-depressing policy of buying bonds at the end of this year, but it will take its time on any further tightening, not least because core inflation (1.1% in October) is still well below the European Central Bank's target. It will be well into 2019 at the earliest before it turns its mind towards raising rates, and any tightening in Japan is even further over the horizon again.

Ongoing low running yields on non-U.S. dollar bonds, and capital losses on U.S. dollar bonds, will likely make for further poor results from the asset class. Given the ongoing risks to global equities—notably the potential for trade wars, or for some shock to derail what is already a lengthy global business cycle—investors may however want to place some value on the portfolio insurance from bonds.

International Equities — Review

World shares have struggled to regain the ground lost since the sharp sell-off in October. At its current level, the MSCI World index of developed markets in U.S. dollars is still 7.8% below its recent peak on 27 Sept, and is 9.8% below its all-time high back on 26 Jan. Year to date the index is down 3.6% in capital value and by 1.9% adding in taxed dividend income, though local investors holding the index would have experienced a modest gain thanks to the 7.4% depreciation of the Australian dollar against the U.S. dollar.

The overall outcome has continued to depend disproportionately on the U.S. market, where the S&P500 index is up 2.0% year to date: ex the U.S. the MSCI World index is down by a substantial 11.3% in capital value. Japanese shares have been least bad, with a 2.2% fall in the Nikkei index, but European shares have been weak, with the FTSEurofirst 300 index down 6.9%. German shares have been among the weaker of the major European markets, with the DAX index down 12.3%. The U.K. has also struggled, with the FTSE100 index down 8.3%, although at time of writing there were some

potentially hopeful signs that the Brexit negotiations might be reaching a negotiated conclusion rather than the "hard" Brexit that has been worrying the U.K. equity market.

Emerging markets have been worse again after initially specific worries about Argentina and Turkey spread to the asset class as a whole. The MSCI Emerging Markets index in U.S. dollars is down 16.6% year to date, and the core BRIC component (Brazil, Russia, India, China) is down by a similarly large 15.6%.

International Equities — Outlook

The dependence of the overall asset class on U.S. performance has been understandable: profits have been booming in the U.S. but have been harder to come by elsewhere. According to U.S. data company FactSet, the S&P500 companies will have increased their earnings per share by 20.6% in 2018. While the overall number is somewhat inflated by a doubling of profits in the energy sector, profit growth has been widespread, and is at double-digit rates in eight of the 10 sectors FactSet breaks out, and is reasonable in the other two (consumer staples, up 8.8%, and real estate, up 8.0%).

There is still no clear indication that the U.S. economy has run out of profit-generating steam. Profit growth in 2019, according to the sharebroker analyst forecasts that FactSet collates, is expected to be 9.2%. The analysts believe that this will be enough to carry the S&P500 up to 3,181 in a year's time, which would be a 16.7% rise from current levels.

Interestingly, the fund managers surveyed in the latest BAML survey said they think the S&P500 will peak at 3,056, not as bullish as the FactSet analysts but still on track to what would be a solid gain from current levels of some 12%. Not everyone in the fund manager community is convinced—30% of respondents believe the peak for the S&P500 is already behind us, a significant rise on the 16% who had thought so in the October survey—but

Economic Update

Sydney | 15-11-18

November 2018

there are reasonable grounds to expect the U.S. economy and its equity market will hold up well.

The fund managers continue to be overweight to the U.S. market. So far, the economy is living up to their expectations as the U.S. economy continues to do well. The October employment report showed for example that there were 250,000 extra jobs in the month, more than the 190,000 that forecasters had been expecting, and the unemployment rate remained at a low 3.7%. There are risks: the current fiscal stimulus will progressively run down (and will not be renewed with now-divided control of Congress between Democrats and Republicans); there are more questions being asked of the prospects for the big tech stocks, which up to now have been a disproportionate source of U.S. equity gains; and the recent sharp drop in world oil prices brings the expected profits of the U.S. "fracking" industry under a new spotlight. But all that said, there is a reasonable prospect of U.S. gains supporting the outlook for the asset class.

Elsewhere, the good news is that the global economy looks set for ongoing expansion, but the bad news is that the rate of growth looks like slowing down. It would be nice if the latest (October) reading from the J.P. Morgan/IHS Markit Global Composite PMI [purchasing manager index], which measures the momentum of global business activity, was the harbinger of more good news to come: in September the Composite PMI had shown unusually slow world growth, but in October it perked up again. J.P Morgan said: "The start of the final quarter saw a modest improvement in the rate of expansion of global economic output, as a stronger performing service sector offset the ongoing slowdown at manufacturers."

It is somewhat more likely, however, that 2019 will not be quite as good a year for global business activity as 2018. The BAML fund managers certainly feel that way: 44% of them think the world will be growing more slowly in 2019, though only 11% think the outlook will

deteriorate all the way into recession. Somewhat oddly, the fund managers have fancy expectations for non-U.S. equities in these conditions: they think non-U.S. equities will be the best-performing asset class in 2019, well ahead of the S&P500 and commodities as their next best bets. Perhaps one answer is that they expect the last leg of the S&P500 gains to occur over the next few months, with non-U.S. equities kicking in later. Another possibility is that fund managers regard some of the non-U.S. markets to have been oversold in the recent decline—in September, for example, the fund managers had been a net 10% underweight to emerging markets, whereas in this latest November survey, they are now a net 13% overweight.

The past few months have been trying for international equity investors, and there are still significant risks to be faced with the top three, for the BAML respondents: trade wars; monetary policy mis-steps; and a slowdown in China (much the same trio that they have worried about all year). But (absent unpredicted geopolitical shocks) there is still a reasonable chance the ongoing world business cycle will muddle through over the coming year, and provide some fundamental economic support for better equity performance.

Performance periods unless otherwise stated generally refer to periods ended 12 Nov 2018.

Economic Update

Sydney | 15-11-18

November 2018

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Morningstar.com.au subscribers

Tel: 1800 03 44 55

Email: help.au@morningstar.com

Advisers/Institutions/Others

Tel: +61 2 9276 4446

Email: helpdesk.au@morningstar.com

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