Economic and Investment Update – January 2018

Brexit negotiations between the European Union and the UK have entered the second and decisive phase with the aim of an agreement being in place by October 2018.

Economic growth in the Euro zone continued to improve steadily, up 2.6% over the year. The recovery being broad-based across different countries and different sectors. The European Central Bank (ECB) responded by announcing in October that it will reduce its monthly bond purchases down to Euro 30bn.

Across the Atlantic, economic recovery in the US is much further advanced with the US Federal Reserve now unwinding its balance sheet of bonds and mortgage backed securities at a targeted monthly rate of US10bn. Furthermore, despite a benign inflation environment, the official interest rate rose 0.25% in the December quarter to 1.50% and is expected to rise up to a further three times over the 2018 year. President Trump's tax overhaul, a significant legislative victory, is expected to provide an additional boost to growth.

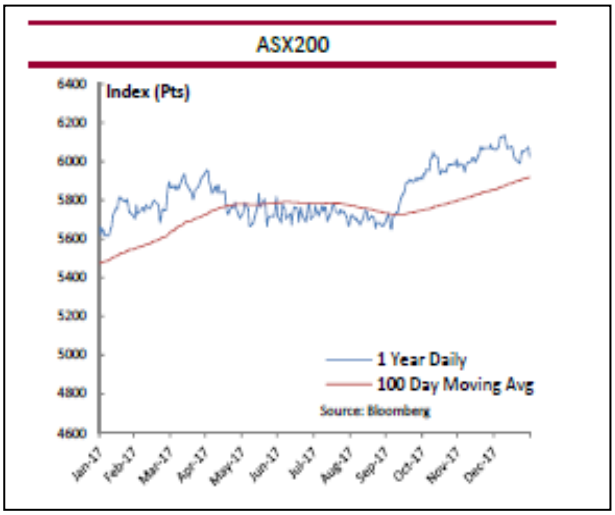
Chinese data, although strong relative to major developed economies, indicates a slight loss in momentum in recent months with a softening of industrial production and investment numbers.

On the domestic front, the Reserve Bank of Australia (RBA) kept rates on hold at 1.5% throughout the period (unchanged now for over a year) noting the low level of wage growth and the moderation in household spending. The unemployment rate remained steady at 5.4% however total employment improved due to an increase in the participation rate. The RBA's economic growth forecasts are for 2.75% in the current financial year, rising to 3.5% in 2018/19.

Given the broad based pick up in global growth, the International Monetary Fund raised expected global growth rates for 2018 and 2019 by 0.2% to 3.9%.

MARKETS

The Australian Equity market performed strongly over the December quarter with the ASX 200 rising 7.6%.



Resource stocks continued their rally with strong returns in Energy (up 18.3%) and Materials (up 13.1%) off the back of a 16.9% increase in the oil price. The IT sector was up 16.7% reversing the fall from the previous quarter. All other sectors showed positive returns with the weakest being Utilities (up 3.3%).

Small cap stocks produced stronger returns with the Small Ordinaries Index up by 13.7% for the quarter, now outperforming the ASX 200 for the financial year (20.0% v 11.8%).

Internationally, global stocks continued their upward momentum with the MSCI World ex-Australia Index returning 5.8% for the quarter and 13.4% for the past 12 months. The Australian Dollar was flat against the US Dollar over the quarter (although the Australian Dollar has since strengthened in January). In local currency terms, global stocks were up 5.5% for the quarter and by 20.0% for the year.

The best performing markets were again in Asia including Japan (up 11.8% as measured by the Nikkei 225 PR Index) and Hong Kong (up 8.6% as measured by the Hong Kong Hang Seng Index). US returns were also strong off the back of the legislated reduction in corporate tax rates with the Dow Jones Industrial Index up 10.3% although the broader based S&P 500 Index was only up 6.1%.

After a poor start to the 2017 calendar year, domestic listed property finished up 7.9% for the quarter and 5.7% for the year. International listed property also produced positive returns with 3.6% for the quarter and 8.2% for the year. Global Infrastructure produced a small positive return of 1.8% for the quarter but an impressive 15.4% for the year.

Australian bonds (Australian composite index) produced a steady return of 1.4% for the quarter with similar returns across Government Bonds and credit as yields tightened. The global composite bond index produced a slightly lower gain of 0.9%, again with Government Bonds and credit returning about the same.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	ASX/S&P 200 Accumulation Index	7.6	11.8	10.2
	ASX Small Ordinaries Acc Index	13.7	20.0	7.4
International	MSCI World ex Aust Index (AUD)	5.8	13.4	18.4
	MSCI World ex Aust Index (AUD Hedged)	5.5	20.0	15.4
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	7.8	27.1	10.4
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	7.9	5.7	13.2
International	FTSE EPRA/NAREIT Dev Prop Index (Hedged)	3.6	8.2	9.8
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	3.8	13.6	11.7
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	1.8	15.4	12.9
Currencies				
AUD v USD	Against US Dollar	-0.3	8.3	-5.6
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	1.4	3.7	4.2
	Bloomberg Ausbond Credit All Maturities	1.5	5.1	4.8
International	Barclays Capital Global Agg Index (AUD Hedged)	0.9	3.7	4.9
Commodities				
Gold	Gold – USD	1.8	13.5	-4.9
Oil	WTI Oil $/b – USD	16.9	12.5	-8.0

Economic & Investment Outlook

The global economic backdrop is arguably the best we have seen since 2010 resulting in the International Monetary Fund raising expected global growth rates for 2018 and 2019 by 0.2% to 3.9%.

Earnings growth has picked up whilst labour costs and inflation remain in check. This has allowed the commencement of the reversal of Quantitative Easing and other monetary policy initiatives in the USA and to a lesser extent in Europe.

Investors in US equities remain bullish with the passing of tax reform legislation providing an anticipated boost to corporate cashflow and investments. President Trump utilised the victory in Congress as a springboard to announce at the annual World Economic Forum that the USA is "open for business". This is however against a backdrop of increased protectionism in the USA as the Trans-Pacific Trade Agreement talks progress without the USA and Canada as parties.

The decision on the number of US interest rate rises in 2018 by the Federal Reserve under its new chair, Jerome Powell, may have a significant impact on both bond and equity markets. Rising bond yields have a negative impact on bond and equity market valuations as well as yield type investments such a property and infrastructure.

Economic confidence in Europe is now at its highest since 2001 despite uncertainty over Brexit, Catalonia and the makeup of the new German government coalition.

In China, President Xi Jinping has laid out priorities over the next five years focussing more on issues such as innovation, distribution of wealth and quality of life rather than on the strict 6.5% to 7% growth target.

The above trend growth outlook in Australia of 3.25% p.a. over 2018 and 2019 may come under pressure from lower wages growth, household indebtedness and weaker housing prices. The RBA are expected to keep interest rates on hold for the time being.

Australian Shares

The ASX has produced strong positive returns over the quarter which have continued into January. We recommend investors continue to hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

The recent increase in prices, in particular in small cap stocks, have seen valuations starting to get more expensive whilst headwinds from the domestic economy and the earnings outlook are expected to weigh on the ASX300.

Global Shares

We have maintained our recommendation for International Equities at Neutral with a bias away from the US towards European and Emerging Markets.

Although the passing of President Trump's tax reform legislation has produced a fillip for markets and the economy, the expected rise in US bond yields will have a negative impact on valuations. The signing of the Trans-Pacific Trade Agreement without the US and Canada will have an impact on selected parts of the US economy.

As previously highlighted, the trifecta of improving economies, continued monetary stimulus and more attractive stock valuations, provide better value for investors in European stocks.

Similarly, despite the change in focus away from a strict growth target, we expect stock market rises to continue in China as strong economic growth continues.

Property

We recommend a neutral to underweight holding to the Australian listed property sector given the recent strong returns and expected rise in long term bond yields. As part of a diversified portfolio, we also continue to suggest that investors consider alternative unlisted options in selected property sectors, where available.

In relation to global property, we continue to recommend an underweight to neutral holding relative to benchmark allocations. As previously indicated, with global interest rates having started to head upward, global property markets are coming to the end of the current capitalisation rate tightening cycle.

Fixed Interest

Bond markets produced relatively strong returns over the quarter as a result of the small reduction in bond yields and the tightening of credit spreads. However the new calendar year has seen a rise in bond yields. With the likelihood of interest rate rises increasing, we recommend that investors hold an underweight position to both Australian and International Government Bonds.

Within credit markets, the tightening of credit spreads have made the sector expensive and, as with our view on Government bonds, we have moved to recommending an underweight position.

Sources: Lonsec, Franklin Templeton, Schroder