Economic & Investment Update – October 2019

The September quarter saw the continuation of geopolitical risks with the ongoing US/China trade dispute, growing tensions in the Middle East, the threat of Donald Trump's impeachment, protests in Hong Kong and the ongoing Brexit saga. A drone attack on a major Saudi Arabian oil facility in September wrought short term havoc on oil markets.

US/China trade talks broke down in September and it is estimated by the IMF the dispute will have reduced the level of global growth (GDP) by 0.8% by 2020.

Whilst Central Banks remain divided on monetary policy, the US Federal Reserve again cut rates in September. This was the second time this cycle with the potential for a further cut at the end of October. The manufacturing sector is bearing the brunt of the downturn in global trade with the ISM manufacturing index recording its worse reading in a decade. However, US inflation again came in above expectations with an annual rate now of 2.4%.

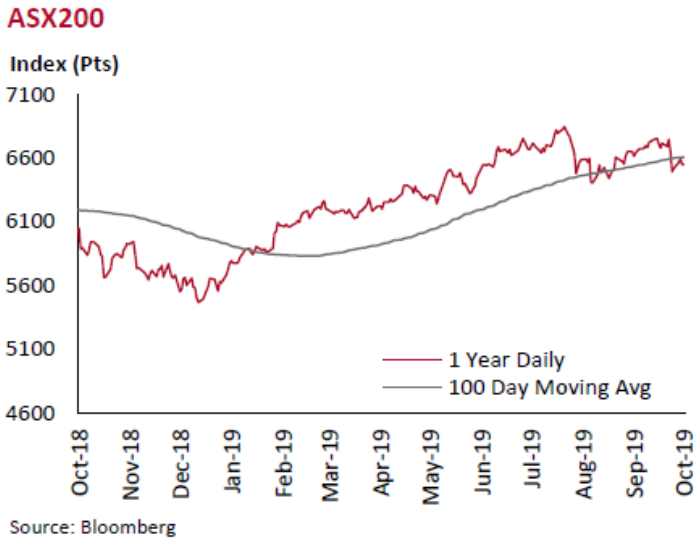
A similar slump was seen in the European manufacturing sector (particularly in Germany where there was a sharp drop off in exports), although this was offset by growth in the services sector. There is growing pressure in Europe to introduce fiscal stimulus (Government spending etc) to work alongside existing monetary policy (including a restart of quantitative easing in November).

In China, GDP growth continued to slow with industrial production growth the weakest in 17 years amid ongoing trade tensions. The Government boosted infrastructure spending and monetary policy is being applied via a reduction in the Loan Prime (interest) rate and an easing of the bank reserve requirement ratio.

Australia's economy appears stagnant with the per capita GDP growth rate in the year to June at 0.2%. This is the worst result since the global financial crisis. The RBA lowered official cash rates at its June, July and October meetings to a record low of 0.75% citing risks to international trade posed by the US /China trade dispute. Wage growth and unemployment levels remained flat.

MARKETS

The Australian share market produced a solid but volatile return over the quarter off the back of US and domestic interest rate cuts. For the September quarter, the ASX 200 accumulation index returned 2.4% (12.5% over the last 12 months) despite a fall of 4.3% in the first week of August, as US/China trade negotiations again broke down.



Consumer Staples was the best performing sector (+11.6%) followed by the Consumer Discretionary sector (+8.9%). The Telecommunications Services sector gave up some of its recent gains, falling 6.8% over the quarter, with the Resources and Materials sectors down 3.6% and 3.5% respectively. Small cap stocks reversed a recent trend, slightly outperforming the large cap sector over the quarter (+3.1%).

Global stocks produced a small positive return over the quarter with the MSCI World ex-Australia Index (AUD Hedged) returning 1.3% for the quarter, albeit with a return of only 1.9% for the year. With the Australian dollar continuing to weaken against major global currencies, the return in Australian Dollar terms over the quarter were higher at 4.7% (9.1% over the last 12 months).

The worst performer, given ongoing unrest, was the Hong Kong Hang Seng PR Index down 8.6% for the quarter (-6.1% over the last 12 months). Their Chinese counterpart fared much better with the Shanghai Shenzhen CSI 300 PR Index down by just 0.3% (up 10.9% for the year). Most country stock indices were relatively flat for the quarter although Japan, as measured by the Nikkei 225 PR Index, reversed a recent trend and finished up 2.3% for the quarter (but down 9.8% over the last 12 months).

Recent rate cuts by the RBA (0.25% at each of the June, July and October meetings) failed to add much fuel to the interest rate sensitive Australian property and infrastructure sectors with interest rate falls effectively already priced in over previous quarters. Australian listed property was up 1.0% for the quarter and 18.3% over the last 12 months. Globally, performance was stronger with Global Infrastructure up 2.5% for the June quarter (17.9% over the last 12 months) and International Listed Property up 5.6% for the quarter (13.5% over the last 12 months).

Having already hit all-time lows, domestic bond yields continued to fall in July and August before seeing a reversal in September, resulting in a return of 3.7% for the quarter and 10.4% for the 12 months to 30 September 2019. A similar pattern emerged overseas with US 10 year Treasury yield rising significantly in the first half of September before giving up all the gains by early October. An inversion from at the long end of the US yield curve is raising concerns of a possible US recession.

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	S&P/ASX 200 TR (Accumulation) Index	2.4	12.5	9.5
	S&P/ASX Small Ordinaries TR (Accum) Index	3.1	4.0	9.6
International	MSCI World ex Aust NR Index (AUD)	4.7	9.1	13.0
	MSCI World ex Aust NR Index (AUD Hedged)	1.3	1.9	9.3
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-0.4	5.1	7.8
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	1.0	18.3	13.6
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	5.6	13.5	9.0
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	2.5	17.9	8.9
Currencies				
AUD v USD	Against US Dollar	-3.9	-6.6	-5.1
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	2.0	11.1	5.3
	Bloomberg Ausbond Credit All Maturities	1.8	9.0	5.2
International	Bloomberg Barclays Capital Global Agg TR Index (AUD Hedged)	2.3	9.8	5.0
Commodities				
Gold	Gold – USD	4.5	23.6	4.0
Oil	WTI Oil $/b – USD	-7.5	-26.2	-9.9

Economic & Investment Outlook

The International Monetary Fund downgraded its projection for 2019 global GDP growth again, this time to 3%, after having previously downgraded to 3.3% in April 2019

Against this backdrop, the US announced it was suspending a tariff hike of US$250 billion of Chinese imports set to take effect in mid-October, whilst China agreed to buy US$40 to US$50 billion in US farm products. We wait in anticipation for the ratification of these concessions, the potential wind back of existing tariffs and a satisfactory conclusion to the protracted trade war which has now been going for over 15 months.

The trade exposed manufacturing and investment sectors globally have borne the brunt of the economic slowdown with the US protected somewhat given that the service sector represents 85% of the economy. US job gains are currently averaging 161,000 per month albeit, this is the slowest growth in jobs since 2010. The market expects further cuts to US interest rates over the next year, putting pressure on the US Dollar.

Chinese GDP growth slowed to just 6%, its lowest growth in almost 30 years. Recent stimulus to date has largely avoided dramatic increases in government spending, instead turning to monetary policy such as cuts to the reserve requirement ratio. The fear is that this may be too little too late to prevent a more serious downturn in the Chinese economy albeit, there is sufficient capacity for further fiscal and monetary policy.

The IHS Markit Eurozone Composite PMI (Purchasing Managers Index) suggests activity in the Eurozone will be lucky to have grown 0.1% in the September quarter. The German manufacturing sector looks particularly grim given its reliance on exports, a troubled car industry and inertia created by Brexit. Industrial production has fallen 7% from the peak in November 2017. Given constitutional and political factors, further monetary policy is likely to have to carry most of the burden. There may be some light at the end of the tunnel for Brexit given the recent successful vote in Parliament in respect of the new deal with Europe.

The Reserve Bank of Australia (RBA) cut rates to a record low 0.75% in early October. The economy's response to the easing cycle and Government tax cuts has been subdued to date. The upswing in the commodities industry and in the housing market provides room for optimism. However, with little room for further falls in interest rates, the heavy lifting may need to come from fiscal policy in a climate where the Government is keen to at first bring the budget back into surplus.

Australian Shares

We recommend investors maintain a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

Recent gains over the past year have been driven by factors such as global fiscal and monetary stimulus, the impact of low interest rates on valuations, the depreciating Australian dollar, a buoyant mining investment cycle and a recovering housing sector.

Following recent gains, valuations are stretched, with the forward Price to Earnings (PE) ratio still trading at over 16x earnings, 15% higher than the long term average. Furthermore, the pressure on bank profits means that bank profit growth is expected to be low to moderate.

Global Shares

We recommend investors hold a neutral to underweight position in International Equities, but with a tilt from developed markets to emerging markets.

Performance in the short term is heavily dependent on geopolitical factors such as the US / China trade talks. However with valuations considered stretched and earnings momentum waning, a conservative approach is recommended.

Within global equities, we retain our preference for emerging markets where valuations are more attractive. The current easing cycle by the US Federal Reserve may also lead to a weakening of the US Dollar, thus reducing the risk of capital outflows from emerging markets.

Property

We recommend investors hold a neutral position in property relative to their benchmark allocation.

Falling capitalisation rates driven by lower interest rates have supported the strong growth in property prices over recent years. However any future growth is more likely to be derived from earnings growth rather than from declining capitalisation rates.

Despite trading at a 6% premium to Net Asset Value, with an average yield of 4.7% and potential 2-3% earnings growth, listed Australian REITS still offer a relative attractive proposition.

Global REITS are trading at a slightly lower 2% premium to Net Asset Value (with US REITS currently trading at a 10% premium against a long term average of around 2%).

Fixed Interest

We recommend investors retain an underweight position to Australian Government Bonds and a neutral to underweight position to Global Government Bonds relative to their benchmark allocation.

Local investors have seen strong gains as the 10 year Australian Government bond rate has been driven down close to 1%. We consider further significant falls unlikely, albeit that the RBA is still in an easing cycle. We see more value in US 10-year bonds, which are trading closer to 2%.

Credit markets and the Australian hybrid market are expensive and we therefore recommend a neutral to underweight position in these fixed interest classes.

Sources: Lonsec