Economic and Investment Update – October 2016

Contrary to the negative aura created by world political news, the global economy is in reasonable shape. Global growth is expected to be around 3.1% in 2016. The US economy is stable, global interest rates are very low and central banks continue to provide additional liquidity in Europe, China and Japan. Inflation around the world is near zero.

The major focus at the start of the quarter was on the implications of the Brexit vote. Since Brexit, the Pound has fallen by over 15% against the Euro, yen and US Dollar. UK inflation expectations have shot up to 3.5%.

Continental Europe's gradual recovery has continued despite the Brexit vote. However, whilst GDP is expected to grow at 0.3% for the recent quarter, momentum is weakening in the face of political uncertainty ahead of elections in France and Germany and political risks in Italy and Spain. Quantitative Easing (QE) programs were maintained in Europe (and Japan) although the European Central Bank is rumoured to be mulling over the continuation of its QE program.

The US Federal Reserve kept rates unchanged but emphasised its intention to raise rates very gradually. This backdrop saw bond yields stabilise at low levels having dropped considerably through the first half of the year. The S&P 500 hit a new record high on 15 August. As we close in on the US Presidential Election on 8 November, expectations of heightened market volatility are diminishing as the polls swing against Donald Trump. Markets still expect that the Fed is more likely than not to lift interest rates in December.

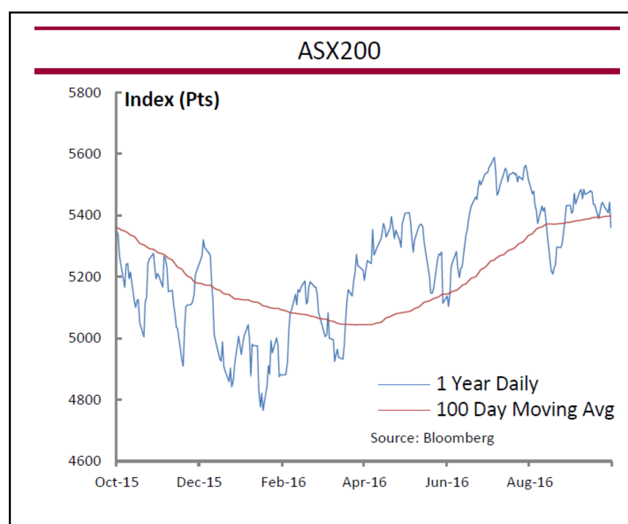
Risk aversion swept through global financial markets in the September quarter driven to some extent by the continued slowdown in China. However, ongoing economic slowdown was temporarily alleviated by a bout of rapid, credit fuelled growth in China's property market fuelling house price increases – 9.2% overall in the year to August and 31.2% in Shanghai.

Further conventional interest rate easing was delivered in Australia. However, the RBA modified their inflation objective, meaning the chances of another rate cut has diminished. Policy setting is already accommodative and the economy is performing reasonably well, although not quite as well as the 3.3% growth rate suggests. The RBA are concerned that the eventual downturn in residential construction occurs before we see any recovery in the mining related sector.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished 5.1% higher over the September quarter and up 13.2% over the past 12 months. The September quarter again saw gains in the Materials and Resources sectors up 13.9% and 12.9% respectively, however the telecommunication services sector fell 6.4%. Small cap stocks again outperformed larger companies and rose 8.5% for the quarter.

Internationally, the MSCI World ex-Australia Index returned 5.1% for the September quarter. Returns in Australian Dollar terms were 2.0% for the quarter as well as for one year with the stronger Australian Dollar offsetting gains.



During the September quarter, the best performing developed markets were Hong Kong (up 12.0%, as measured by the Hang Seng PR Index) and Germany (up 8.6%, as measured by the Deutsche Boerse AG Index). In the US, returns remained steady with the S&P 500 Index returning 3.3% for the September quarter and 12.9% for one year. A rally in tech stocks such as Apple, Alphabet (Google), Microsoft, Facebook and Amazon helped the NASDAQ close up 9.7% for the quarter.

Domestic listed property fell by 2.0% over the September quarter (but up 20.8% for one year). Global property finished higher, up 1.3% over the September quarter (14.0% for one year) but with the spectre of rising interest rates in the short to medium term.

Australian Government and global bonds again produced solid gains as bond yields fell. Australian 10 year bonds outperformed with 10 year yields falling 0.07% to 1.91%. All time lows were seen in US 10 year Treasury yields of 1.35% in early July before a modest retreat to 1.59% by the end of the quarter. Domestic bonds (as measured by the Bloomberg Composite Bond Index) returned 0.9% for the quarter whilst global bonds (as measured by the Barclays Capital Global Aggregate Index) returned 0.8%.
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	5.1	13.2	11.2
	ASX Small Ordinaries Acc Index	8.5	29.2	5.3
International	MSCI World ex Aust Index (AUD)	2.0	2.0	17.3
	MSCI World ex Aust Index (AUD Hedged)	5.1	11.8	15.9
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	6.1	7.2	8.1
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	-2.0	20.8	19.6
International	FTSE EPRA/NAREIT Dev Prop Index (Hedged)	1.3	14.0	16.2
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	2.6	12.1	10.1
Currencies				
AUD v USD	Against US Dollar	2.9	9.2	-4.5
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.9	5.7	6.0
	Bloomberg Ausbond Credit All Maturities	1.4	5.3	6.4
International	Barclays Capital Global Agg Index (AUD Hedged)	0.8	8.2	7.0
Commodities				
Gold	Gold – USD	-0.5	18.0	-4.1
Oil	WTI Oil $/b – USD	-0.2	7.0	-9.4

Economic & Investment Outlook

Current political developments have the potential to significantly impact investment markets. Despite polls having Hilary Clinton firmly in the lead over Donald Trump, the Brexit vote has taught us to be cautious in this regard. A Trump win is likely to increase volatility in both investment markets and world affairs.

Negotiations over the exit of the UK from Europe and the Italian referendum of constitutional reform are also likely to sway markets. Add to that the possibility of a "Frexit" as proposed by Marie Le Pen, President of the minority French National Front party.

However, central bank policy continues to play a more fundamental role regarding the direction of markets. It is likely that the current emphasis on monetary policy will continue to provide support to both the economy and investment markets. Countering this is the likely US Federal Reserve December rate rise that looms on the horizon.

Potential fiscal policy is also assisting investment markets. The 26 trillion yen promised spend in Japan on areas such as infrastructure has helped support the Japanese equity market, which has also been assisted by the announcement of further monetary policy support.

We remain cautious about the outlook for equity markets. Most asset classes are priced at fair value or look expensive.

In Australia, after a cut in August, official interest rates are likely to remain around about current rates for some time. Strong June quarter GDP and increased consumer and business confidence overshadowed an unexpected contraction in employment numbers.

Australian Shares

Following further gains over the quarter, we recommend investors hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

Against a backdrop of global political uncertainty, stock valuations such as price to earnings (currently 17.7 times for the current year) now exceed historic levels.

While small cap stocks have continued to outperform large cap stocks, a cautious approach to small cap stocks should be adopted going forward due to relatively high valuations.

Global Shares

The US S&P 500 is trading on a forward PE of 16.6 times which is above historic levels and hence on face value above fair value. Furthermore, risks to earnings remain with a higher US Dollar and continued instability in oil prices. After five consecutive quarters of falling corporate earnings, expectations of earnings growth will be treated as a bullish signal by markets.

Under the same metrics, European and Japanese markets look less expensive at 14 and 13 times respectively. However, this is explained by the deflationary conditions and poor growth prospects. Furthermore, the aftermath of Brexit and potential further political turmoil makes Europe less attractive.

On a forward PE ratio of 12.4, emerging market look relatively attractive.

Caution should be exercised regarding adding to international equity exposure prior to the US election on 8 November.

We maintain our recommendation for investors to hold a neutral to underweight position to International Equities relative to their benchmark allocation with a preference towards topping up underweight positions in emerging markets.

Property

Australian listed property is currently trading at a small 1% to 2% premium to net asset value against an historic 5% discount. However the distribution yield of around 4% to 5% looks attractive against a cash rate of 1.5% and 10 year bond rates around 2%. Fundamentals such as low vacancies and projected rental growth look strong.

Global listed property is also trading at a modest premium to net asset value, although divergences exist around the world (eg Europe 20% premium, UK 16% discount). US fundamentals appear good and are comparatively better than other developed markets.

Investors should however remain cautious given the likely impact that rising global interest rates will have on valuations. As such, we recommend a neutral to underweight position to Australian listed property and an underweight position to global listed property.

We recommend that investors instead consider alternative unlisted options in selected property sectors.

Fixed Interest

Global bond rates continued to rally over the September quarter with global bonds as a whole looking expensive on a valuation basis. Higher yield (emerging market) bonds continue to face headwinds, meaning exposure to the sector should be selective. Credit continues to offer some value.

As such, we recommend an underweight position to international sovereign bonds and a neutral exposure to international credit.

The RBA has cut rates twice this year and unless there is a strong case for a further cut, we expect rates to remain on hold for the time being. With 10 year bonds hovering around 2.25%, Australian bonds are viewed as fair value. We recommend a neutral to underweight holding in Australian sovereign bonds with a bias towards Australian credit to help obtain additional yield.

Sources: Lonsec, RBA, Schroder, Magellan.

Please note that the information above is general in nature and does not take into account your personal circumstances, financial needs or objectives. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation and needs. In particular, you should speak to Kevin Smith of The Professional Super Advisers on (02) 9955 5800 prior to acting upon this information.