Economic and Investment Update – July 2017

Despite political turmoil in Washington, raising the risk that President Donald Trump and lawmakers would be unable to coordinate efforts to promote economic growth, economic conditions improved across most major economic regions.

In the US, while the Trump administration continued to draw attention, stronger annualised GDP growth (2.6%) and declining unemployment (4.3% in May – its lowest level since 2001) led to an interest rate rise on 14 June. However, lower than expected inflation in the US continued to surprise markets and the US Federal Reserve appeared to signal less confidence in achieving its 2% US inflation target.

In Europe, all major economies continued to grow at a respectable rate. However, a major theme that emerged was the ebbing of heightened political risk. Pro-EU Emmanuel Macron defeated anti-Euro populist Marine Le Pen in French presidential elections held over April and May while in June, the UK Conservative Party's shock loss of its parliamentary majority dampened equity gains. Towards the end of the quarter, central bank rhetoric out of Europe, shifted from a deflationary to an inflationary focus which triggered a late rally in global bond yields.

In Asia, Chinese growth remained solid at 6.9% despite a tightening in financial conditions while the Japanese economy benefitted from rising global demand for its exports and the enhanced ability to pass on price increases to customers.

On the domestic front, while unemployment fell to a four-year low in May (5.5%) and retail sales were much stronger than expected, domestic growth weakened with the 1.7% annual rate the lowest since the 2008 global financial crisis. With the Reserve Bank (RBA) grappling with the uncertainties associated with the improving labour market, anaemic wages growth and high levels of household debt, cash rates were left unchanged at 1.5% during the June quarter.

MARKETS

The Australian Equity market rally that had been a feature of the last 12 months started to wane in the June quarter with the market (as measured by the ASX/S&P 200 Accumulation Index) down 1.6% (but up 14.1% for the financial year). Falls during the June quarter were mainly off the back of a broad sell-off in the 'big four' domestic banks, following the announcement of a new bank levy in the Federal Budget, Wesfarmers (due to slower retail sales and concerns about increasing competition) and Telstra (due to a poor earnings outlook). Standout performers during the quarter were the Industrials (+8.7% for the quarter) and Healthcare (+7.1%) sectors with Qantas, CSL and Cochlear generating solid returns.

Small cap stocks produced mixed results, slightly outperforming larger companies during the June quarter (down 0.4%) but underperforming larger companies for the financial year (+7.0%).

Internationally, global stocks continued their upward momentum and the MSCI World ex-Australia Index returned 3.6% for the June quarter and 14.7% for the financial year. Returns in Australian Dollar terms were 3.2% for the quarter and 20.5% for the financial year. During the June quarter, the best performing markets were in Asia including Japan (up 6.0%, as measured by the Nikkei Index) and China (up 6.9%, as measured by the Hong Kong Hang Seng Index). In the US, returns were strong with the Dow Jones Industrial Index finishing up 3.3% for the June quarter while European markets were largely flat.

Domestic listed property fell by 3.4% over the June quarter and finished down 6.3% for the financial year. The large retail stocks (Westfield, Scentre and Vicinity) had the greatest negative influence on the sector primarily on concerns about Amazon setting up in Australia. Global property fared better and rose 2.1% over the June quarter (+2.2% over 12 months).

Australian Government and global bonds produced positive returns for the June quarter as bond yields edged lower. Domestic bonds (as measured by the Bloomberg Composite Bond Index) returned 1.0% for the quarter whilst global bonds (as measured by the Barclays Capital Global Aggregate Index) returned 1.2%. Interest rate spreads in the credit market also narrowed resulting in a small positive quarterly return.

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	-1.6	14.1	11.8
	ASX Small Ordinaries Acc Index	-0.4	7.0	5.7
International	MSCI World ex Aust Index (AUD)	3.6	14.7	18.2
	MSCI World ex Aust Index (AUD Hedged)	3.2	20.5	15.4
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	5.7	20.1	10.2
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	-3.4	-6.3	14.1
International	FTSE EPRA/NAREIT Dev Prop Index (Hedged)	2.1	2.2	11.4
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	3.1	12.2	10.8
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	4.0	13.4	13.8
Currencies				
AUD v USD	Against US Dollar	0.8	3.2	-5.6
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	1.0	0.3	4.3
	Bloomberg Ausbond Credit All Maturities	1.1	2.8	5.3
International	Barclays Capital Global Agg Index (AUD Hedged)	1.2	0.5	5.5
Commodities				
Gold	Gold – USD	-0.6	-6.1	-4.9
Oil	WTI Oil $/b – USD	-9.0	-4.7	-11.5

Economic & Investment Outlook

Based on recent data releases, the global economic outlook appears robust and economic sentiment is at a multi-year high. The International Monetary Fund (IMF) suggested that the global economy was enjoying the "broadest synchronised upswing" it has experienced in the past decade, with growth revised up for Japan, the euro area, China, and for Asian emerging and developing economies generally.

Despite the overall optimistic outlook, risks remain skewed to the downside over the medium term. Monetary policy normalisation in advanced economies, could trigger a faster than anticipated tightening in global financial conditions while, given rich valuations and very low volatility in an environment of high policy uncertainty, there is the danger of a financial market correction.

According to key economic indicators, the US economic outlook remains healthy with the GDP growth rate expected to be between 2% and 3%, unemployment to remain low and inflation to stay below the 2% target rate. While interest rates are expected to rise in the US, recent weakness in inflation may force the US Federal Reserve to temper its apparent enthusiasm for tightening.

In Europe, solid economic activity and reduced risks have focussed attention on the European Central Bank's loose monetary policy stance and a number of analysts are speculating that a tapering its Quantitative Easing (QE) program will be on the Bank's agenda. However, despite positive economic activity, inflationary pressures remain low due to moderate wage growth and receding oil prices, complicating the Bank's next move.

The outlook for China remains positive with growth expected to be maintained between 6% and 7%. Further tightening in financial conditions are expected next year as the authorities use the opportunity presented by a more stable domestic and global growth environment to tackle financial stability risks.

In Australia, the RBA is projecting growth above 3% in 2018 based on solid consumer spending, an end to the mining-related downturn, positive contributions from LNG exports and housing and a modest recovery in business investment. While the interest rate loosening cycle appears to be over, a combination of out-of-cycle rises by the banks, together with weak wages growth and poor inflation readings, suggests that official interest rates will not be raised until next calendar year.

Australian Shares

Following small gains since 30 June, we recommend investors hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation. Rising household debt levels together with increasing pressure on household disposable income over the 2018 financial year are expected to weigh on consumer confidence and the overall growth outlook for the market.

Current earnings growth expectations for the 2018 financial year remain at around 3.5%, reflecting the lack of growth in the market's two largest sectors (banks and resources). While the growth profile does improve markedly outside these two sectors, valuation metrics remain elevated reflecting the scarcity of high quality earnings growth.

Key events for equity markets during the September quarter will be APRA's update on bank capital requirements; the local reporting season; central bank meetings in the US and Europe; and the upcoming German elections.

Global Shares

We maintain our recommendation for investors to hold a neutral to underweight position to International Equities relative to their benchmark allocation and maintain our recommendation for a bias away from the US towards European and Emerging Markets.

While the global economic outlook is improving, valuations appear somewhat stretched and there are numerous global geopolitical risks that have the potential to generate considerable volatility for equity markets over the 2018 financial year. The most significant of these is the escalation of tensions between the US and North Korea. Further market risk arises from the unpredictable nature of the Trump administration and whether it has the ability to deliver campaign promises. The potential for further diplomatic disputes to weigh on markets worldwide also remains a persistent threat.

Property

On fundamentals, Australian listed property currently looks relatively attractive with the sector trading at a 10% discount to Net Asset Values (against a long-term average of a 5% discount), annualised dividend yields of around 5%, low vacancies and strong projected average earnings growth (estimated at 6.0% per annum over the next four years). However, we are also mindful that a rise in long term bond yields could lead to falls in the value of property holdings.

We therefore suggest that investors hold a neutral position to domestic property relative to their benchmark allocation. 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 suggest an underweight to neutral holding relative to benchmark allocations. 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

With government bond yields continuing to remain in expensive territory by historical standards and the likelihood of interest rate rises increasing, we recommend that investors maintain a neutral to underweight position relative to benchmark allocations. However, any sell-off in government bonds may provide opportunities to reallocate to this sector during the 2018 financial year.

Within credit markets, while spreads remain tight and gains from further yield compression are expected to be limited, credit securities continue to offer greater relative returns when compared to bonds. However, with stretched valuations more acute in the lower rated high yield market, the reward for risk is becoming less compelling.

Sources: Lonsec