Economic and Investment Update – October 2017

Economic recovery continued around the world, led by the ongoing turnaround in the US with US GDP growth to September 2017 in excess of 3% p.a. Despite the reported disruptions in the wake of Hurricane Harvey, US manufacturing production and new orders remained strong with the unemployment rate falling slightly to 4.2%. However core inflation remains low and the Federal Reserve left interest rates on hold, with the market expecting a rise of 0.25% at the December meeting.

The revival in the Euro zone continued to lag the US with estimated annual growth of 2.4% to September 2017. However, the International Monetary Fund (IMF) predicted growth of only 1.7% for the 2017 calendar year. Economic improvement is now being experienced across more European countries and across different sectors. Unemployment remains high at just over 9% with President Draghi of the European Central Bank (ECB) stating that interest rates are expected to remain at current levels "for an extended period of time and well past the horizon of the net asset purchases".

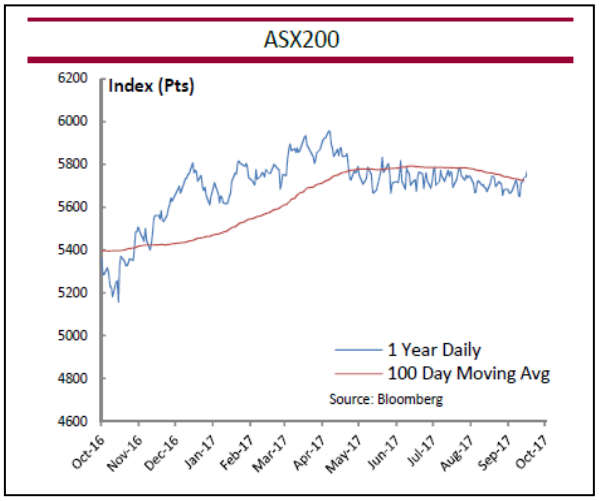
On the political front, the German federal election saw Chancellor Merkel lose ground with the continued global trend towards populism. Immigration again was a key concern. Political instability between the US and North Korea also came to a head during the quarter with China now taking a more active role in respect of the enforcement of economic sanctions.

China reported a 6% p.a. growth rate in August 2017, this being enough to ward off fears of a slowdown. Meanwhile, emerging markets such as Russia were boosted by higher oil prices.

On the domestic front, whilst wage and consumer price growth remained stubbornly low, the Australian economy appears stable. The unemployment rate is steady at 5.6% with participation rates high in historic terms. The Reserve Bank of Australia (RBA) kept rates on hold at 1.5% throughout the period noting the continued improvement in non-business investment as well as positive business sentiment. This is in contrast to the Westpac Melbourne Institute Index of Consumer Sentiment with surveys showing that pessimists still outnumber optimists, with concerns around housing affordability and rising energy prices.

MARKETS

The Australian Equity market remained relatively flat with the ASX 200 rising 0.7% over the September quarter.



A rebound in resource stocks on the back of a recovery in the iron price saw positive returns in the Energy sector (up 7.0%) and Materials (up 6.7%). This was countered by a large fall in Telecom Services -15.1% with Telstra returning -15.2%, after announcing a long-anticipated cut to its dividend in August. There were also falls in the Utilities (-5.8%), HealthCare (-5.2%) and Consumer Discretionary (-2.2%) sectors.

Small cap stocks produced stronger returns with the Small Ordinaries Index up by 4.4% for the quarter. However, they underperformed the ASX 200 for the financial year (3.0% v 9.3%).

Internationally, global stocks continued their upward momentum and the MSCI World ex-Australia Index returned 2.5% for the quarter and 15.4% for the past 12 months. However, returns were impacted by the strengthening Australian Dollar, up 1.9% against the US Dollar over the quarter. In local currency terms, global stocks were up 4.3% for the quarter and by 19.6% for the year.

During the quarter, the best performing markets were again in Asia including Hong Kong (up 6.9% as measured by the Hong Kong Hang Seng Index) and China (up 4.6% as measured by the Shanghai Shenzhen Index). US returns were strong with the S&P 500 Index up 4.0% for the quarter whilst the German market was up 4.1% (the Deutsche Boerse DAX 300 index).

Domestic listed property rebounded from the previous quarter finishing up 1.7% for the quarter. Global Infrastructure produced very similar quarterly returns however Global property returns were slightly flatter at 1.0.

Australian Government bonds produced a negative return of -0.3% for the quarter. The positive return of 0.7% from credit resulted in a flat return (0.0%) for the Australian composite index. The global composite index fared much better increasing by 0.9% for the quarter led by High Yield bonds which rose by 2.4% due to the contraction of interest rate spreads.

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	0.7	9.3	10.1
	ASX Small Ordinaries Acc Index	4.4	3.0	5.1
International	MSCI World ex Aust Index (AUD)	2.5	15.4	17.7
	MSCI World ex Aust Index (AUD Hedged)	4.3	19.6	15.0
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	5.5	19.4	10.0
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	1.7	-2.8	13.0
International	FTSE EPRA/NAREIT Dev Prop Index (Hedged)	1.0	1.9	10.6
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	3.0	13.0	11.3
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	1.7	12.3	13.2
Currencies				
AUD v USD	Against US Dollar	1.9	2.2	-5.5
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.0	-0.8	3.9
	Bloomberg Ausbond Credit All Maturities	0.7	2.1	4.9
International	Barclays Capital Global Agg Index (AUD Hedged)	0.9	0.5	5.1
Commodities				
Gold	Gold – USD	3.1	-2.7	-6.3
Oil	WTI Oil $/b – USD	12.2	7.1	-10.9

Economic & Investment Outlook

The global economic recovery continues, and in a sign of increased optimism, the IMF recently upgraded its growth forecasts for the first time in six years.

A key indicator of the economic health of the manufacturing sector, the Purchasing Managers' Index (PMI), continued to rise in key economies including the US, Europe and Japan. Positive signs in Australia include strong non-mining business investment although low wage growth and falling housing affordability act as a drag on consumer confidence.

Improving economic conditions have led to the wind back of monetary policy with Europe reducing its Quantitative Easing program and the US now on the path to normalising interest rates. However, the rate of change may be slower than first envisaged. US interest rate rises have stuttered this year and rate rises in Europe are not expected in the foreseeable future.

The potential slower rate of change offers a doubled edged sword. On the negative side, it indicates that economic improvement is not as fast as expected although on the positive side, it provides more stability especially in investment markets where increasing bond yields have a significant negative impact on most asset classes.

The outlook for China appears positive. Having achieved stability in the economy over the past 12 months, the power obtained by President Xi Jinping at the recent 19th National Congress provides a platform for further economic and financial market reform over the coming five years.

In Japan, Prime Minister Abe called and won a snap election seeking to benefit from the threats from North Korea. Newly elected, the prime minister can now focus on the ongoing stimulation of Japan's economy.

In Australia, the RBA has now held interest rates steady for more than 12 months although the firm expectations are that the next move will be up. Again, any rise is likely to be slow as the RBA balances economic recovery with high levels of household debt.

Australian Shares

Despite the ASX 200 taking a breather (producing flat returns) over the past six months, we recommend investors continue to hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

Whilst headwinds from the domestic economy and the earnings outlook are expected to weigh on the ASX300, valuations have started to look slightly more attractive.

Caution must however be exercised in respect of buying stocks mainly for their dividend. As the recent 30% fall in the Telstra dividend demonstrated, significant capital losses can materialise if the dividend levels are not maintained.

Global Shares

We have upgraded our recommendation for International Equities to Neutral and maintain our recommendation for a bias away from the US towards European and Emerging Markets.

Stretched valuations in the US provide a potential risk particularly if President Trump fails to pass his reform packages including the proposed large tax cuts. Furthermore, the potential threats from North Korea could cause significant market volatility.

In our view, the trifecta of improving economies, continued monetary stimulus and more attractive stock valuations, provide better value for investors in European stocks. Whilst it is noted that significant stock market gains have been recorded in the region over the past year, we expect this to continue. Similarly, we expect the significant stock market rises to continue in China as strong economic growth continues through the economic and monetary reform package.

Property

Australian listed property remains an attractive sector with robust earnings supported by strong property market fundamentals. However, we continue to be mindful that a rise in long term bond yields could lead to falls in the value of property holdings.

We therefore suggest that investors continue to 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 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

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 hold an underweight position to both Australian and International Government Bonds.

Within credit markets, credit securities continue to offer greater relative returns when compared to bonds, with floating rate securities providing the added protection against yield expansion.

Sources: Lonsec