Economic & Investment Update – July 2018

Despite rising concerns about global trade protectionism and the possibility of a trade war, the global economy ended the 2018 financial year on a solid footing, with solid GDP figures from developed and emerging economies, low inflation, and positive business conditions favouring investment and employment.

The US economy continued to fire on all cylinders with growth in the second quarter tracked at 4.0%, helped along by a rebound in household spending, business investment and surprising strength in net exports. During the quarter, the US Federal Reserve continued raising interest rates (to a range of 1.75-2.00% - its highest level since 2008). The decision to raise rates came as the US unemployment rate hovered at 3.8% - the lowest rate in nearly two decades - and inflation, which lagged the Fed's 2% target for six years, finally hit the central bank’s goal.

However, trade tensions continued to ratchet up, dragging the US into escalating trade disputes with China, Canada, Mexico and Europe. On 6 July, US tariffs on US$34 billion worth of Chinese goods came into effect, with China responding in kind with tariffs on American soybeans, pork and electric vehicles. The major fear for markets is that this is merely the first of many tariff rounds in an escalating trade conflict.

In Europe, with an annualised growth rate of 2.3% and inflation at 1.2%, the European Central Bank (ECB) announced in June that it would end its €30bn a month bond purchase program in December 2018. In conjunction with this announcement, the ECB advised that it was keeping interest rates (currently zero) on hold for now and for as long as necessary to ensure that inflation remained in line with expectations.

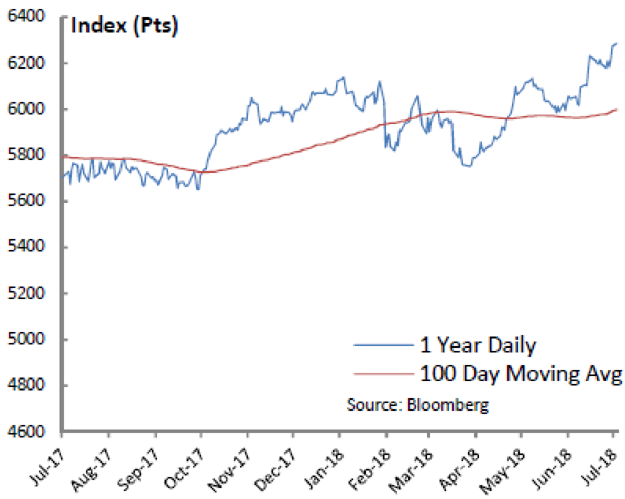
In Asia, growth in China eased back to 6.5%, with slowing credit growth and infrastructure spending. Chinese firms felt the pinch from the government’s measures to curb risky lending, which has resulted in higher borrowing costs and reduced access to funds for smaller companies. The People’s Bank of China (PBOC) responded by cutting reserve requirements for the major state-owned banks — the third such move in 2018.

In Australia, the Reserve Bank of Australia (RBA) kept rates on hold at 1.5% throughout the period (unchanged now for nearly two years). While there was some tightening in home lending, low wage growth and inflation remaining below the RBA target of 2-3%, GDP remained robust with a 1% gain in the March quarter and a 3.1% annual gain over the year. Employment data also surprised on the upside with almost 51,000 jobs added in June, taking the annual job gains to 339,000.

MARKETS

Following weaker returns during the March quarter, the Australian Equity market rebounded over the June quarter with the S&P/ASX 200 index rising by 8.5% (13.0% for the financial year).

ASX200



During the quarter, a sharp rise in oil prices spurred the Energy sector to solid gains (up 19.8%) while the Materials sector (up 11.4%) performed strongly as commodity prices recovered. BHP Billiton was a standout performer and returned 20.2% for the quarter. The Health Care (up 15.9%) and Consumer Staples (up 12.0%) sectors also delivered solid returns as CSL and Woolworths performed strongly.

The Telecommunications sector generated the only negative quarterly return (down 13.3%) as shares in Telstra, which lowered earnings forecasts, continued to fall in value.

Small cap stocks continued to generate solid returns with the Small Ordinaries Index up by 7.7% for the quarter and 24.3% for the financial year.

Internationally, global stocks continued their upward momentum with the MSCI World ex-Australia Index (AUD Hedged) returning 3.6% for the June quarter and 11.5% for the financial year. With the Australian dollar weakening, returns in Australian Dollar terms were slightly higher with a 5.5% return for the June quarter and 15.4% for the financial year.

During the June quarter, the best performing markets were the UK (up 8.2% as measured by the FTSE 100 PR Index) and Japan (up 4.0% as measured by the Nikkei 225 PR Index) while Chinese shares finished down 10.0% (as measured by the Shanghai Shenzhen CSI 300 PR Index) as trade tensions with the United States and worries about debt dimmed the outlook for China's economy. US returns for the June quarter were modest with the Dow Jones Industrial Index up by 0.7%, although the broader based S&P 500 Index finished up 2.9%.

Domestic listed property finished up 10.0% for the quarter and 13.0% for the financial year with the strong quarterly return driven by the redeployment of cash investors received from the recent Westfield merger, other merger and acquisition activity and the 10-year bond yield falling 10 basis points to 2.67%. International listed property also produced positive returns with 7.3% for the quarter and 6.4% for the financial year. Global Infrastructure returned 5.5% for the quarter but only 2.9% for the financial year.

With little change in domestic yields, Australian bonds (as measured by the Australian composite index) produced a modest return of 0.8% for the quarter with similar returns across Government Bonds and credit. The global composite bond index produced a slightly lower gain of 0.2% for the quarter.

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	8.5	13.0	10.0
	S&P/ASX Small Ordinaries TR (Accum) Index	7.7	24.3	11.6
International	MSCI World ex Aust NR Index (AUD)	5.5	15.4	14.9
	MSCI World ex Aust NR Index (AUD Hedged)	3.6	11.5	12.9
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	-4.5	12.3	7.0
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	10.0	13.0	12.0
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	7.3	6.4	8.8
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	2.4	12.9	11.7
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	5.5	2.9	11.4
Currencies				
AUD v USD	Against US Dollar	-3.6	-3.9	-4.1
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.8	3.1	4.4
	Bloomberg Ausbond Credit All Maturities	0.7	3.8	4.8
International	Bloomberg Barclays Capital Global Agg TR Index (AUD Hedged)	0.2	1.9	5.0
Commodities				
Gold	Gold – USD	-5.5	0.9	0.3
Oil	WTI Oil $/b – USD	14.2	61.1	-5.1

Economic & Investment Outlook

Global macro-economic conditions are currently the best they have been since the global financial crisis and we expect that this will continue, with global growth primarily driven by the United States.

While analysts are expecting the US Federal Reserve to continue to raise interest rates (an additional two hikes are expected this calendar year, which would bring the range to 2.25–2.50%), the flow on effects from the recent corporate tax cuts are expected to continue to aid US growth in the short term.

However, there are risks to US economic growth and the tit-for-tat tariff war with major trading partners could prove a drag on growth, putting pressure on supply chains and possibly undercutting business investment. At the very least, the cloud of uncertainty created by rising trade tensions is likely to weigh on global market sentiment, given the interdependencies of a global economy.

Continued strength in the US dollar, arising from rising US interest rates and optimism about US economic growth, may also lead to volatility in global currencies and the equity markets of emerging economies, as investors pour money into US Dollars.

In Europe, while growth is expected to continue, the European Commission recently cut its forecast (from 2.3% to 2.1%) citing trade tensions and rising oil prices as the major reasons. With the European Central Bank (ECB) looking to end its €30bn a month bond purchase program in December 2018, markets will also have to deal with the prospect of declining liquidity within investment markets.

In China, the outlook for the Chinese economy appears robust but external threats have arisen. At a time when the economy is slowing and a trade conflict with the US is intensifying, Beijing has signalled that it is prepared to soften its campaign to rein in debt in order to support the economy. However, this could further increase vulnerabilities within the Chinese economy.

In Australia, given weak inflationary pressures and the continued concern of policy makers over the impact of interest rate rises on the household sector, especially given current low wages growth and high levels of household debt, the RBA seems certain to keep the interest rates at 1.5% for the foreseeable future. RBA rhetoric continues to suggest the next move is up, but it will prefer to wait until the household sector is better positioned before embarking on the policy normalisation process.

Australian Shares

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

We believe that we are in a market of relatively low returns, given that there seems little scope for valuation re-rating and that Australian corporate earnings growth, in aggregate, are running at around mid-to-low single digits (consensus 4.2% for the 2019 financial year). This, in combination with significant challenges to long-established business models and industry structures, provides a challenging back drop for the market.

Following recent market gains, led by a partial reversal in recent bank sector weakness, commodity prices and strong support for domestic companies with global earnings, the Australian Equity market is currently trading on a 12-month forward price to earnings ratio of 15.7 times (against a long-term average of around 14.0 times earnings).

Global Shares

We recommend that investors hold a neutral to overweight holding in International Equities with a bias away from the US.

Asset valuations remain at elevated levels with the US market looking the most expensive based on traditional valuation measures such as Price to Earnings ratio and book-to-price metrics, however valuations in certain sectors continued to be supported by strong earnings. As previously noted, 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 and the possibility of a trade war, we expect the Chinese stock market to recover from recent falls.

Property

We suggest that investors hold a neutral to underweight position to domestic property relative to their benchmark allocation. While the listed Australian Real Estate Investment Trust sector is offering a dividend yield of 5.2% and balance sheets are stable with sector gearing at 27%, Australian listed property is currently trading on a Price to Earnings multiple of 17.0 times earnings, well ahead of its 27-year average of 13.4 times.

From a sector perspective, while office and industrial sectors are expected to continue to perform well, underpinned by low vacancy levels and recent transaction evidence, the retail sector may underperform. 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 suggest an underweight to neutral holding relative to benchmark allocations, due to the sensitivity of global property to rising bond yields.

Fixed Interest

With the likelihood of interest rate rises increasing, especially within the US, we recommend that investors hold an underweight position to both Australian and International Government Bonds. However, further rises in bond yields may provide opportunities to reallocate to this sector during the 2019 financial year.

Within credit markets, despite the recent widening of credit spreads, the sector overall remains expensive. Reduced market liquidity, in part due to a withdrawal of central bank stimulus, will also lead to increased volatility in markets. At this time, we have a preference for Australian corporate debt and hybrid securities.

Sources: Lonsec, Schroder

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.