Economic & Investment Update – October 2018

The US/China trade war continued to roll on with the imposition in late September of 10% tariffs on a further US$200 billion of Chinese exports to the US. This contributed to a downgrade in global economic growth projections by the International Monetary Fund from 3.9% to 3.7%.for the 2018 and 2019 years.

Conversely, the continuing strength of the US economy and uncertainty over the level at which the Federal Reserve regard as its "neutral rate" resulted in a surge in US 10 year bond yields. Yields pushed through the 3.0% mark before hitting 3.23% in early October, spooking equity markets. Further market volatility continued through to the end of October.

The ongoing gradual slowdown in Chinese growth and the negative impact of the escalating trade war saw the People's Bank of China cut reserve requirements for the fourth time this year, injecting further liquidity to stimulate bank lending. China has indicated that there is "plenty of room for adjustment" to further stimulate economic growth if required.

Despite evidence of slowing growth in Europe, unemployment continues to fall in most Eurozone countries and at 8.10% is edging closer to the low of 7.28% experienced just before the Global Financial Crisis. Significantly, most of the improvement has come from Germany.

With the 29 March 2019 date drawing closer, Brexit negotiations stalled with ongoing issues such as the proposed hard border in Ireland, threatening to bring down the UK Government.

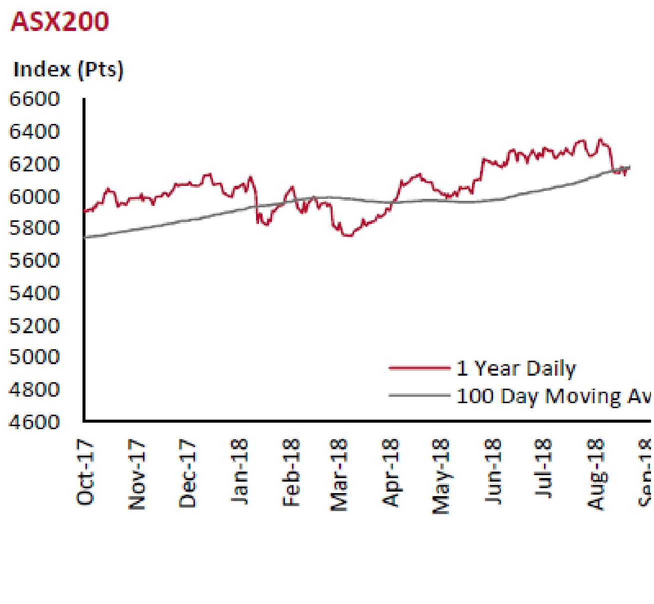
In Australia, the Reserve Bank of Australia (RBA) kept rates on hold at 1.5%, unchanged now for over two years. The RBA observed that the banks had recently tightened lending standards and that further tightening by the banks may be on the way as a result of the Royal Commission. Although wage growth and inflation are expected to pick up, there are concerns about the impact of a slowing Chinese economy, high levels of household debt and falling property prices.

The Australian dollar weakened further and is close to levels reached during the 2015-16 Chinese deflation scare. However, with commodity prices holding up, investors should not get too pessimistic about the Australian dollar.

MARKETS

Australian Equity market edged higher over the September quarter with the S&P/ASX 200 index up 1.5% (14.0% over 12 months).

The Telco sector rebounded by an impressive 25% over the quarter off the back of the proposed TPG / Vodafone Hutchison merger. The IT (+10.2%) and Health Care (+4.6%) sectors also delivered solid returns over the quarter. The Financial sector continued to disappoint (+0.2%) with Westpac down 4.8% after announcing a provision of $235 million in the wake of the Royal Commission. Other banks have similarly announced provisions and have experienced share price weakness.



Small cap stocks marginally underperformed the large cap sector, returning 1.1% for the quarter. However, , small cap stocks have returned 20.3% on a rolling one-year basis compared to the large cap sector return of 14.0%, primarily due to a rebound in small resource stocks.

Internationally, global stocks continued their upward momentum with the MSCI World ex-Australia Index (AUD Hedged) returning 5.6% for the quarter and 12.9% over the last 12 months. With the Australian dollar continuing to weaken, returns in Australian Dollar terms were slightly higher with a 7.4% return for the quarter and 20.8% for the financial year.

During the quarter, the best performing markets were Japan (up 8.1% as measured by the Nikkei 225 PR Index) and the US (up 7.2% as measured by the S&P 500 PR Index). Chinese shares finished down 2.0% for the quarter (as measured by the Shanghai Shenzhen CSI 300 PR Index) despite a 3.2% rise in the month of September.

Domestic listed property continued its upward revival returning 1.9% for the quarter and 13.2% over 12 months as retail landlords divest themselves of non-core assets. International listed property also produced positive returns of 0.5% for the quarter and 5.6% over 12 months. Global Infrastructure was down 1.3% for the quarter and flat over the past 12 months.

With little change in domestic yields, Australian bonds (as measured by the Australian composite index) produced a modest return of 0.5% for the quarter with slightly better returns coming from credit. The global composite bond index produced a negative return of 0.1% for the quarter as the US 10 year bond rate broke through the 3.0% barrier.

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	1.5	14.0	8.2
	S&P/ASX Small Ordinaries TR (Accum) Index	1.1	20.3	8.8
International	MSCI World ex Aust NR Index (AUD)	7.4	20.8	15.3
	MSCI World ex Aust NR Index (AUD Hedged)	5.6	12.9	12.6
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	1.0	7.6	9.1
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	1.9	13.2	12.4
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	0.3	5.6	8.6
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)	-1.3	-0.1	9.9
Currencies				
AUD v USD	Against US Dollar	-2.4	-7.8	-5.0
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	0.5	3.7	4.3
	Bloomberg Ausbond Credit All Maturities	0.9	3.9	4.6
International	Bloomberg Barclays Capital Global Agg TR Index (AUD Hedged)	-0.1	0.9	4.6
Commodities				
Gold	Gold – USD	-4.9	-6.9	-2.2
Oil	WTI Oil $/b – USD	-1.2	41.8	-6.5

Economic & Investment Outlook

Whilst global macro-economic conditions remain robust, politically driven factors continue to impact on the normal business cycle and investment markets.

Economic conditions in the US are strong, despite the trade war with China predicted to reduce economic growth by around 0.2%. However, fiscal stimulus (primarily from recent tax cuts) is likely to boost economic growth late in the business cycle, this being a time when typically Governments start running budget surpluses and a tightening agenda.

This has the potential for increased inflation given the environment of almost full employment. Increased US tariffs could also add further pressure to price rises.

A major consequence is rising interest rates, which although assisting to dampen economic growth, will impact investment markets. As witnessed at the start of October, equity markets were spooked then US Bond yields pushed through the 3.0% mark before hitting 3.23%.

Rising US interest rates and growing interest rate differentials has led to a stronger US Dollar against most currencies including against the Australian Dollar. Commodity prices continue to stabilise due to rising demand and this should provide support for the Australian Dollar going forward.

Japan is likely to be a benefactor of the strengthening US Dollar, further increasing demand for Japanese exports.

The outlook for the UK remains patchy given the political risks around Brexit. With the European Central Bank (ECB) looking to end its €30bn a month bond purchase program in December 2018, European markets will also have to deal with the prospect of declining liquidity within investment markets.

Although the trade war between China and US is impacting on Chinese economic growth, the ability of the centralised economy to provide swift targeted economic stimulation provides a significant buffer against US tariffs. As previously stated, China has indicated that there is "plenty of room for adjustment".

In Australia, rising household costs and falling house prices are placing pressure on household demand. RBA rhetoric continues to suggest the next interest rate 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 move to a neutral position in Australian Equities relative to their benchmark allocation.

Although the outlook for the Australian equity sector remains mixed, recent falls in October have resulted in valuations being fair. However, corporate earnings growth is expected to remain relatively benign with increased costs and rising house prices putting pressure on household demand.

Corporates sourcing earnings from overseas are expected to fare better including those that benefit from China's attempts to stimulate their economy. However, increased volatility is expected to prevail given economic and political conditions overseas. As recent history has shown us, falls in US equity markets almost always impact the Australian equity market whilst short term recovery in US markets don't necessarily flow through.

Global Shares

We recommend investors hold a neutral to underweight position in International Equities.

The rate of economic growth in the US is starting to challenge capacity given the low unemployment rate. Inflationary pressures are likely to impact on interest rates and long term US Treasury bond yields. This is expected to put pressure on not just US equities but also emerging market equities, as capital is diverted back to low risk US assets.

To counter this, US corporate earnings growth has been solid and, given continued fiscal stimulus, are expected to remain so, despite rising costs.

Short term value exists in places such as Japan where currency factors are supporting export markets. Further dips in global equity markets could also be seen as a buying opportunity for those with surplus cash holdings.

The Australian Dollar continues to depreciate against the US Dollar given the strengthening US economy and rising US interest rates. However, stabilising resource prices may add support for the Australian Dollar in the short to medium term so we may be close to seeing value in hedging international equity portfolios.

Property

We recommend investors hold a neutral position to domestic property and a neutral to underweight position to global property relative to their benchmark allocation.

Returns from "bond proxy" sectors such as property and infrastructure will continue to be buffeted by moves in US bond markets. However, valuations are fair at the moment and a falling Australian dollar and increased corporate takeover activity indicates more value in Australian domestic property.

As in previous reports, we prefer unlisted domestic property however higher property prices and falling yields have meant that opportunities in the unlisted space have reduced.

Fixed Interest

With the growing interest rate differential with US Treasuries now at about 0.5%, 10 Year Australian Government Bonds (at just over 2.5%) look expensive and closer to offering value at 3.0%.

As such, we recommend investors hold an underweight position to Australian Government Bonds and a neutral to underweight position to Global Government Bonds relative to their benchmark allocation.

Credit spreads remain fairly tight, especially in the high yield market, with valuations for Australia and Global credit fair to expensive. At this time, we prefer hybrid securities.

Sources: Lonsec.