Economic & Investment Update – April 2019

In preparation for the May 18th Federal Election, the Australian Federal Budget was handed down a month before the regular budget season, presenting tax measures to please key voter groups, a further boost to infrastructure spending and the much-vaunted return to surplus. However, the economy is slowing with annualised GDP growth at just 1.0% in the second half of 2018 compared with the 4.0% pace during the first half. With core inflation remaining below target, the shift in RBA policy bias from tightening to neutral seems totally justified.

The slowdown in US growth in the early months of 2019 followed a sharp downturn in the last quarter of 2018. Total job cuts over the March 2019 quarter amounted to 190,410, which is the highest quarterly total since September 2015 and the highest first quarter total since 2009. With inflation slipping back below the Federal Reserve's target, markets dramatically shifted their expectations for the next interest rate move, with a cut to the US Federal Reserve funds rate firming as a possibility.

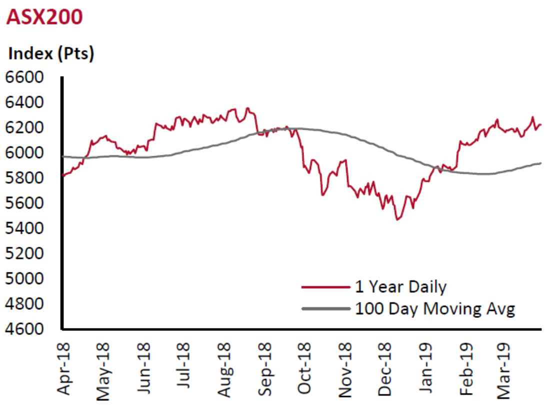
The ECB cut its expectations for growth sharply from 1.7% to 1.1% for 2019 and from 1.7% to 1.6% for 2020. However, the euro area is being supported by a strong labour market and gradually rising wages.

UK Prime Minister May's Brexit deal was convincingly rejected by the parliament three times. Britain's exit from the EU has now been delayed further to 31 October 2019 with the option of an earlier exit if the British Parliament can, in the meantime, agree on a solution that is acceptable to the rest of the EU.

The news out of China was slightly more positive with March manufacturing and service figures improving and retail sales growth stabilising. A surge in overall credit reflected the stimulus measures put in place by the Chinese government. Furthermore, Chinese shares have been more upbeat, rising 28.6% over the quarter.

MARKETS

Following significant falls over the December quarter, Australian share market rallied over January and February before flattening out over March. By 31 March 2019, the ASX 200 accumulation index had recovered the December quarter losses in full - up by 10.9% for the quarter, 1.7% for the six months and 12.1% over the year.



Source: Bloomberg

All market sectors finished the quarter higher. The IT sector was the best performing sector (20.0%) closely followed by Resources (18.8%) and Telco Services (17.9%).

Despite Bellamy rocketing 36.2% higher in March, the Consumer Staples sector was the worst performing sector for the quarter (5.0%), followed by Financials (5.9%) and Health Care (6.7%).

Small cap stocks outperformed the large cap sector over the quarter (12.6%) led by a rally from the resources sector. The rebound over the quarter led to an annual return of 5.8% to the end of March.

Although not fully recovering from the significant falls over the December quarter, global stocks also rebounded with the MSCI World ex-Australia Index (AUD Hedged) returning 12.6% for the quarter and 6.5% over the last 12 months. With the Australian dollar strengthening since December, returns in Australian Dollar terms over the quarter were slightly lower at 11.5% (although 12.3% for the year).

The top performer was the Chinese market (as measured by the Shanghai Shenzhen CSI 300 PR Index RMB), up 28.6% for the quarter off the back of stimulus announcements and progress in trade talks. However, over the year the market was down (-0.7%). The US market (as measured by the S&P 500 PR Index USD) also rebounded strongly up 13.1% over the quarter and 7.3% for the year. Apple shares were up 9.7% over March as investors saw the upside in the company's services and wearable segments, despite falls in iPhone revenue.

The best performing Australian sector was listed property, up 14.8% for the quarter and 26.2% for the year with investors attracted by the promising outlook in earnings and distributions, despite significant headwinds facing the retail sector. International listed property produced similar results over the quarter (+14.5%) with a16.2% gain over 12 months. Global Infrastructure also performed strongly, up 14.2% for both the quarter and over the 12 month period.

While equity markets stabilised, bond markets sounded alarm bells for investors as falls in long-term yields resulted in an inverted yield curve (historically a signal that a recession is on the way). In Australia, the 10-year yield declined nearly 60 basis points during the March quarter. This resulted in Australian bonds (as measured by the Australian composite index) producing a solid return of 3.4% for the quarter and 7.2% for the year. Credit securities produced slightly lower returns at 2.9% for the quarter and 6.0% for the year. The global composite bond index produced a return of 2.8% for the quarter and 4.6% for the year.

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	10.9	12.1	7.4
	S&P/ASX Small Ordinaries TR (Accum) Index	12.6	5.8	8.0
International	MSCI World ex Aust NR Index (AUD)	11.5	12.3	12.8
	MSCI World ex Aust NR Index (AUD Hedged)	12.6	6.5	9.7
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	8.9	0.0	9.3
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	14.8	26.2	14.8
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	14.5	16.2	9.2
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	14.2	14.2	9.2
Currencies				
AUD v USD	Against US Dollar	0.7	-7.6	-5.2
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	3.4	7.2	5.1
	Bloomberg Ausbond Credit All Maturities	2.9	6.0	5.0
International	Bloomberg Barclays Capital Global Agg TR Index (AUD Hedged)	2.8	4.6	4.8
Commodities				
Gold	Gold – USD	0.8	-2.5	0.13
Oil	WTI Oil $/b – USD	32.4	-7.4	-10.0

Economic & Investment Outlook

With both Australian and global equity markets posting double digit returns over the quarter, the latest recovery points to either a late cycle market rally or simply markets rebounding from a poor December quarter, off the back of news of the US Federal Reserve (Fed) keeping interest rates on hold. The Fed have downgraded its growth forecast and removed the projection of further rate hikes in 2019.

In the April 2019 update from the IMF, growth projections for 2019 were downgraded to 3.3% from 3.65% back in October 2018. Growth forecasts for 2020 were only slightly downgraded to 3.6% from 3.7%. The IMF believes the risks are skewed to the downside, reflecting risks on the trade and tariff front (eg the US/China trade war) and the prospect of a disorderly Brexit.

The European Central Bank substantially revised down growth expectations on weaker than expected economic data. The ECB now expects growth of 1.1% in 2019 (down from 1.7%), 1.6% in 2020 (from 1.7%) and an unchanged 1.5% in 2021.

Meanwhile, the Chinese economy appears to be responding to the stimulus put in place over the past 12 months. The March 2019 quarter GDP growth rate recorded 6.4%, in line with the previous quarter and beating expectations.

In Australia, retail sales were surprisingly strong off the back of a disappointing Christmas and New Year period, with consumers seemingly prepared to spend despite the negative wealth effects from the housing slump. The current Australian economic environment is one of low unemployment, solid employment growth, strong exports, improving business investment, a vastly improved fiscal position and low inflation. However, with the Australian economy slowing and core inflation remaining below target, evidence suggests that the Reserve Bank might be in a position to ease interest rates at some stage in 2019.

Australian Shares

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

The slowdown in the housing sector is expected to continue in the short term given a number of factors including tighter lending standards. Although retail sales have held up well in recent months, the negative wealth impact from falling property prices, together with lacklustre wage growth, is anticipated to keep a lid on consumer spending.

The upcoming Federal Election is adding to uncertainty specifically around potential personal tax changes, including changes to negative gearing. Increased uncertainty normally leads to many businesses and individuals deferring major items of capital expenditure pending the election results. This is in addition to the continued uncertainty in the global economic and geopolitical environment.

Furthermore, a continuing slowdown of the Chinese economy will create downside risks for the resources sector and other sectors heavily reliant on exports to China. However, these may be partly offset by a further decline in the Australian dollar.

Given the recent rally in the Australian share market (leading to shares being priced slightly above fair value on a PE basis) together with a slowing economy, we recommend that investors take profits from the recent rally.

Global Shares

We recommend investors hold a neutral to underweight position in International Equities, but with a tilt from developed markets to emerging markets.

Valuations are looking stretched as the world economy continues to slow. Although the tailwinds from US tax cuts are subsiding, a positive conclusion to both the US/China trade war and the UK Brexit issue may help to keep markets buoyant. However, market volatility is expected to continue.

Whilst we acknowledge the potential issue that a slowing Chinese economy has on emerging markets, the sector offers compelling valuations commensurate with the risks. The announcement from the US Federal Reserve that it would keep interest rates on hold has put the brakes on a strengthening US Dollar, thus reducing the risk of capital outflows from emerging markets.

Property

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

Given the recent rise in the prices of Australian listed property trusts, valuations are now at around a 10% premium to Net Asset Value. There are differences between sectors, with the retail and residential markets trading at a discount whilst the office and industrial sectors are trading at a premium.

Despite the premium, we see value in Australian listed property. The dividend yield looks very attractive in a low interest environment and the potential for a fall in official interest rates provides potential uplift in capital values.

We are still of the view that global property markets are in the mature part of the cycle, although tail winds are being extended while inflation and interest rate pressures are kept at bay.

Fixed Interest

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. While bond markets produced relatively strong returns over the March 2019 quarter, as a result of a reduction in bond yields, we believe that future returns, especially in Australia, will be modest.

Credit markets remain expensive and the Australian hybrid market is potentially impacted by the proposed changes to the refunding of franking credits should a Labor Party be elected and implement their tax reform policies. We therefore recommend a neutral to underweight position in other fixed interest classes.

Sources: Lonsec

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.