Economic & Investment Update – July 2019

During the June quarter, global growth momentum slowed as most major economies progressed towards more advanced stages of the business cycle.

The deceleration in global industrial production continued, with the share of major countries with expanding manufacturing orders dropping below 50% for the first time since 2015. Global trade growth also moved into recessionary territory, weighed down by both the manufacturing slowdown and trade-policy friction, particularly between the US and China.

In response to the weakening global economic backdrop, the world's major central banks shifted their tone more clearly toward an easing bias which led to further falls in government bond yields but also a rally in global equity markets.

In the US, while unemployment remained close to 40-year lows, wages growth and inflation did not pick up as expected. In response to a combination of a slowing US economy and consistently low inflation, together with weaker global growth and trade uncertainties, the US Federal Reserve signalled its intention to cut interest rates at the July meeting.

In Europe, growth and business confidence remained very weak. French 10-year bonds joined German bonds to yield a negative rate of return, reflecting expectations of slowing growth and prompting ECB president Mario Draghi to reiterate that the central bank had "considerable headroom" to seek to stimulate the economy. The region also had to contend with prolonged Brexit uncertainty as the April 12 deadline for the UK to leave the European Union was extended until 31 October.

In China, while policy stimulus continued to stabilise the economy, GDP growth for the June quarter slowed to 6.2%, the lowest level since 1992. However, service sector and retail sales growth were better than expected. Credit growth remained subdued, implying that high debt levels were inhibiting the policy response and US trade uncertainty remained a headwind.

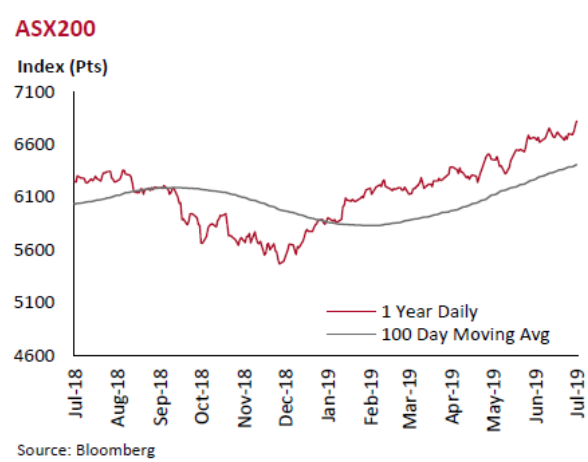
Australia's economy also continued to slow, with gross domestic product of 0.4% for the March quarter coming in below market consensus of 0.5%. On an annual basis, the economy grew just 1.8%; the economy's worst yearly performance since the global financial crisis. As widely predicted, the RBA cut rates in June by 25 basis points, followed by another cut in early July, with the cash rate now sitting at an historical low of 1.00%. With low inflation and spare capacity in the labour market key issues, the RBA also signalled that there was still some room for further action if required.

MARKETS

During the June quarter, US markets led by financial-sector stocks and long-term bonds spearheaded a broad-based appreciation in equity and fixed income assets around the world.

The Australian share market produced a strong return during the quarter on the back of a rallying US market and domestic interest rate cuts. For the June quarter, the ASX 200 accumulation index returned 8.0% (11.6% for the financial year), finishing above 6,600 points and close to its 2007 record high.

All but one market sector finished the quarter higher.



Telecommunications was the best performing sector (+13.2%) followed by Healthcare and Financials (+9.4% and +8.1% respectively), with the latter helped by Scott Morrison's election victory. The Energy sector was the biggest laggard, losing -0.6% over the quarter, with Utilities also soft, up +1.4%.

Small cap stocks underperformed the large cap sector over the quarter (+3.8%) led by lower returns from small resources and weakness among some of the larger index-weights, including Costa Group and Graincorp.

Global stocks also performed well during the June quarter with the MSCI World ex-Australia Index (AUD Hedged) returning 3.4% for the quarter and 6.2% for the financial year. With the Australian dollar weakening against major global currencies, returns in Australian Dollar terms over the quarter were higher at 5.2% (12.0% for the financial year).

The top performer was European markets (up 7.6% for the June quarter, as measured by the MSCI AC European Index) as trade war rhetoric did not crystallise in actual policy measures and the European Central Bank remained supportive of a further easing in interest rates. US markets also performed well with the S&P 500 Index and Dow Jones Industrial Index returning 3.8% and 2.6% respectively for the June quarter as markets gained on expectations of US interest rate cuts. Chinese markets finished lower for the June quarter (down 1.2%, as measured by the Shanghai Shenzhen CSI 300 PR Index RMB) as trade tensions with the US weighed on sentiment.

Australian listed property, up 4.1% for the June quarter and 19.3% for the financial year, continued to produce solid returns as the RBA's rate cuts spurred investor interest in the promising outlook in earnings and distributions, especially within the office and industrial sectors. International listed property produced a weaker result over the June quarter (-0.5%) but still finished up 7.7% for the financial year. Global Infrastructure performed strongly, up 4.9% for the June quarter and 13.6% for the financial year, boosted by the expectations for lower bond rates and interest rates.

Within the fixed interest sector, falls in domestic bond yields (to all-time lows) led to a return of 3.1% for the June quarter and 9.6% for the financial year (as measured by the Australian composite index). Yields fell on the back of the two RBA interest rate cuts as weakening economic data spooked local investors. Credit securities also performed well, returning 2.7% for the June quarter and 8.1% for the financial year. Falls in global bond yields led to a return of 2.7% for the June quarter and 7.2% for the financial 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	8.0	11.6	8.9
	S&P/ASX Small Ordinaries TR (Accum) Index	3.8	1.9	9.3
International	MSCI World ex Aust NR Index (AUD)	5.2	12.0	13.3
	MSCI World ex Aust NR Index (AUD Hedged)	3.4	6.2	9.3
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	1.8	6.6	8.8
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	4.1	19.3	13.6
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	-0.5	7.7	7.5
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	4.9	13.6	8.5
Currencies				
AUD v USD	Against US Dollar	-1.1	-5.2	-5.7
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	3.1	9.6	5.1
	Bloomberg Ausbond Credit All Maturities	2.7	8.1	5.1
International	Bloomberg Barclays Capital Global Agg TR Index (AUD Hedged)	2.7	7.2	4.9
Commodities				
Gold	Gold – USD	9.1	12.5	1.2
Oil	WTI Oil $/b – USD	-2.8	-21.2	-11.1

Economic & Investment Outlook

Following increases in US/China tariffs in May, continued Brexit-related uncertainty, softening inflation and rising geopolitical tensions, the global growth outlook is likely to remain subdued. In the July 2019 update from the IMF, growth projections for 2019 were downgraded slightly to 3.2%, from 3.3% back in April 2019, while the growth forecast for 2020 was also downgraded.

However, despite pessimism about slowing global growth, recently released US second quarter GDP figures beat expectations (2.1% annualised growth v. 1.8% expected). While a strong labour market buoyed US consumer confidence, the lack of wages growth and a soft international climate have raised expectations that the US Federal Reserve will shortly cut interest rates by 25 basis points. The unknown is whether the rate cut is just an "insurance cut" or the start of a full easing cycle.

In Europe, many expect upcoming growth figures to disappoint with longer-term inflation expectations falling. Should this occur, more interest rate cuts and a new round of bond purchases may be considered, despite some doubts about how much room there is left for both tools. In the UK, the recent appointment of Boris Johnson as Prime Minister has increased the possibility of the UK leaving the European Union without a transition deal (hard Brexit) which may lead to heightened volatility in the lead up to the 31 October deadline.

In China, while recent policy stimulus has stabilized China's economy, a material economic reacceleration there is unlikely. The impact of tariffs imposed by the US on China will continue to cloud China's outlook for the remainder of the year. While markets are anxiously looking for signals of any escalating policy support, policy makers have stressed their commitment to moderate, targeted stimulus measures in order to avoid inflating asset prices.

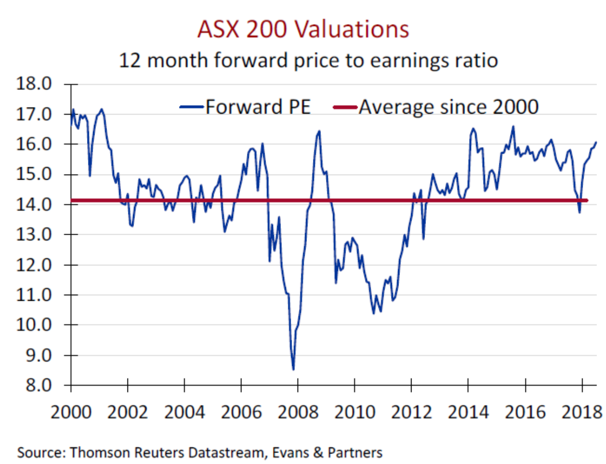
In Australia, the housing market is showing signs of stabilisation. However, concerns remain in other areas of the economy. Retail conditions remain weak and a range of labour market indicators are pointing to a deterioration in the outlook. These include hiring intentions from business surveys and surveys of job vacancies. The Reserve Bank of Australia (RBA) pointed to jobs as a critical part of its recent decision to reduce interest rates in the month, and it seems likely that further cuts will follow.

Australian Shares

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

Following recent gains, valuations are now stretched, with the forward Price to Earnings (PE) ratio trading at around 16x – close to the highest level in recent years.

A lot of the recent support for Australian equities has come from investors shifting out of other assets, in order to continue to receive an attractive income return. While the low interest environment is likely to provide continued support, it may not be sufficient to prevent market weakness if investors are disappointed by earnings.



Global Shares

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

The ongoing strength in global equity markets is at odds with weakness in economic data, earnings cuts and rising political risk. This points to the upcoming US reporting season as being particularly important. US earnings have been resilient to date, but there have been a number of profit warnings recently and pressures are growing from a softening macroeconomic environment, rising costs and complications from the trade war. Given elevated valuations, any disappointment could have an outsized effect.

Within global equities, we have a preference for emerging markets where valuations are better, and we expect more support to earnings from improving economic conditions in China and India in particular. The announcement from the US Federal Reserve that it would look to lower interest rates may also lead to a weakening of the US Dollar, thus reducing the risk of capital outflows from emerging markets.

Property

Where investors have overweight positions, we recommend, where possible, taking profits but retain a neutral position to domestic property relative to their benchmark allocation.

Following recent gains in the price of Australian listed property trusts, valuations are now at around a 10% premium to Net Asset Value. Despite this premium, we see benefits in retaining a neutral exposure to Australian listed property. The FY20 dividend yield of 4.7% on offer from the sector remains attractive in a low interest rate environment and the potential for further interest rate cuts should support capital values.

However, caution should be exercised as a decrease in the current valuation premium within the sector may lead to a fall in returns. Differing return expectations from the various property sectors also remains and non-dominant discretionary shopping centres with high specialty occupancy costs are expected to fall in value in the short to medium term.

In relation to global property, we continue to suggest a neutral holding against benchmark allocations, due to the relative attractive yields on offer relative to global bond yields.

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.

Bond markets produced strong returns over the June 2019 quarter as a result of a fall in bond yields. However, future returns, especially in Australia, are expected to be modest. The sharp fall in US government bond yields during the quarter was notable, but in comparison to domestic bond yields, they remain more attractive from a relative valuation perspective.

Credit markets and the Australian hybrid market are expensive and we therefore recommend a neutral to underweight position in these fixed interest classes.

Sources: Lonsec