Economic & Investment Update – January 2020

The last three months have seen a turnaround in some of the major political themes that have haunted most of 2019. Phase One of the US/China trade agreement has been signed although the subsequent phases dealing with issues such as subsidies given to state owned Chinese companies may prove more problematic.

In the UK, the Conservative party won the election in a landslide 80 seat majority. The result allowed the government to pass its European Union withdrawal bill. However, the UK stockmarket has struggled relative to other countries given the significant potential economic impact, including within the banking sector.

Global markets were rattled by the US assassination of Iran's top military figure, General Soleimani and the tragic shooting down of a civilian airplane. The world's attention has also been drawn to Australia and our devastating bushfires. It is not yet clear what the full economic impact is, but the fires (which continue to burn) are likely to have created significant disruption to supply chains and infrastructure as well as harming industries such as tourism and farming.

Figures from the IMF show the global economy expanding in 2019 at 2.9%, down from 3.6% in 2018. Forecast rates for 2020 have also been lowered to 3.3% mainly because of lower growth in India.

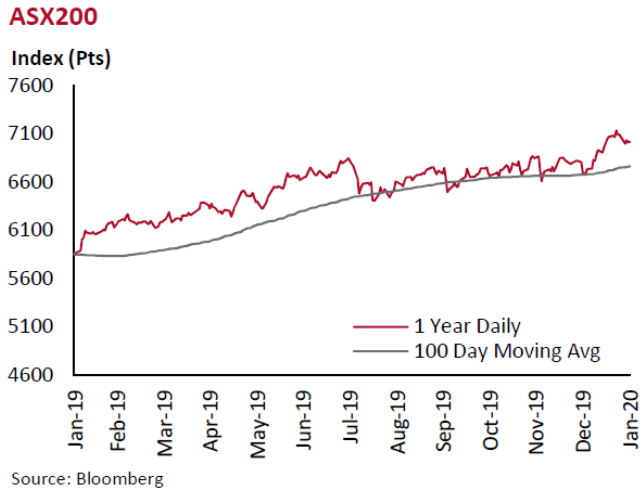
US official interest rates appear to be on hold for the immediate future. US GDP growth has fallen to 2.3% p.a. its slowest expansion of the post war period. However, recent US payroll data has been positive with the unemployment rate dropping to 3.5% and private sector wage growth of 3.1%.

Europe's manufacturing sector continues to decline in the face of the US China trade war. The German car industry is facing further challenges since the diesel scandal, given the push towards investing in electric cars.

Positive manufacturing numbers out of China together with the signing of the aforementioned trade agreement supports the view that a more significant downturn in Chinese growth is likely to be averted.

The Australian economy enters 2020 with low economic growth, excess capacity in the labour market and low inflation. The Australian Dollar strengthened over the quarter from US$0.68 to US$0.70 however has since weakened given that the bushfires may lead to a cut by the RBA in interest rates.

MARKETS



The Australian share market produced a flat result over the quarter of 0.7% in what was otherwise a stellar year for equities with the ASX 200 accumulation index returning 23.4% over the calendar year.

Health Care was the best performing sector for the quarter (+13.6%) followed by the Energy sector (+6.1%). The Financial sector fell 6.3% off the back of the non-reporting of Anti Money Laundering issues at Westpac and pressure on lending margins.

Global stocks pushed ahead over the quarter with the MSCI World ex-Australia Index (AUD Hedged) returning 7.5% for the quarter and 26.8% for the calendar year. With the Australian dollar strengthening over the past three months but weakening over the year, the return in Australian Dollar terms over the quarter were 4.3% and 28.0% over the calendar year.

Most major international equity markets produced results between 6 and 9% for the quarter. However, despite positive news regarding Brexit, the UK market as measured by the FTSE 100 PR Index GBP returned only 1.8% over the same period. Impressive annual returns were produced by China as measured by the Shanghai Shenzhen CSI 300 PR Index, up 36.1% for the calendar year and the US as measured by the S&P 500 PR Index USD, up 28.9% for the calendar year. Off the back of political turmoil in the UK and Hong Kong, share indices in these regions lagged, returning 12.1% and 9.1% respectively for the year.

Australian listed property fell 1.0% for the quarter but was up 19.4% over the calendar year as "lower for longer" monetary policy extended the cycle duration within the property sector. The outlook for residential housing improved following recent RBA rate cuts and APRA easing its credit lending guidelines. Globally, performance was stronger with Global Infrastructure up 3.1% for the quarter (26.5% over the year) and International Listed Property up 0.6% for the quarter (21.1% over the year).

Having previously hit all-time lows, domestic bond yields rose with the 10-year bond yield rising 0.35% over the quarter, resulting in falling bond prices. However, despite the Australian bond market (as measured by the Bloomberg Ausbond Composite All Maturities index) falling 1.3% for the quarter, a strong return of 7.3% was recorded over the twelve-month period. A similar pattern emerged overseas with US 10-year Treasury yield rising 0.25% over the quarter with international bond markets, as measured by the Bloomberg Barclays Global Agg TR Index (AUD Hedged) index, recording a return of -0.8% for the quarter and 7.2% for the calendar year. Albeit fairly flat, the US Treasuries yield curve is no longer inverted as was the case in August 2019.

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	0.7	23.4	9.0
	S&P/ASX Small Ordinaries TR (Accum) Index	0.8	21.4	10.6
International	MSCI World ex Aust NR Index (AUD)	4.3	28.0	12.2
	MSCI World ex Aust NR Index (AUD Hedged)	7.5	26.8	10.0
Emerging Mkts	MSCI Emerging Mkts NR Index (AUD)	7.3	18.6	8.9
Listed Property				
Australian	S&P/ASX 200 A-REIT TR (Accumulation) Index	-1.0	19.4	10.9
International	FTSE EPRA/NAREIT Dev NR Property Index (AUD Hedged)	0.6	21.1	6.8
Infrastructure				
Global	S&P Global Infrastructure TR Index (AUD Hedged)	3.1	26.5	8.6
Currencies				
AUD v USD	Against US Dollar	4.0	-0.4	-3.0
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-1.3	7.3	4.2
	Bloomberg Ausbond Credit All Maturities	-0.4	7.1	4.6
International	Bloomberg Barclays Global Agg TR Index (AUD Hedged)	-0.8	7.2	4.2
Commodities				
Gold	Gold – USD	3.0	18.3	5.1
Oil	WTI Oil $/b – USD	12.9	34.5	2.8

Economic & Investment Outlook

Trade wars have weighed on business sentiment and in particular impacted export sensitive regions such as Europe, Japan and China. Emerging markets remain in the passenger seat of the ongoing disagreements (not just the US and China trade war but also between South Korea and Japan). The signing of phase one of the US / China trade agreement should provide relief to investment markets after two years of tit for tat measures.

Economic growth in China may be slowing but it is still growing at over 6% p.a. However, the recent rapid spread of the coronavirus has the potential to slow Chinese growth even faster with the potential for a global knock-on effects across a range of sectors.

US corporate earnings growth has been challenged over the year with the likelihood of four consecutive quarters of negative growth. However, the outlook is positive with lower US interest rates, healthy consumer spending and record low unemployment.

This is in stark contrast to other parts of the world. The Eurozone remains anaemic, expanding at below trend rates. The impact of Brexit also appears to be catching up with the UK economy which has shown signs of contraction.

The outlook for the Eurozone is not all bad news with positive earnings growth expected after three consecutive quarters of declines.

Australian Shares

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

As previously reported, recent gains over the past year have been driven by factors such as global fiscal and monetary stimulus, the impact of low interest rates on valuations, the depreciating Australian dollar, a buoyant mining investment cycle and a recovering housing sector.

The forward Price to Earnings (PE) ratio is now trading at over 17x earnings, the highest it has been since 2001. However, the recent turnaround in house prices in Melbourne and Sydney is likely to have a positive impact on consumer sentiment and demand. "Lower for longer" interest rates should also maintain equity valuations and hence prices.

Global Shares

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

Market sentiment has improved given the positive recent news in respect of Brexit and the US / China trade agreement. Furthermore, interest rates appear to be on hold for the moment hence providing support to valuations. However globally, PE ratios remain well above long term average.

Within global equities, we retain our preference for emerging markets where valuations are more attractive given that these markets have underperformed in recent times relative to developed economies. However, the traditional driving forces of emerging markets, a weak US dollar and strong global growth, is lacking. The impact of the coronavirus may also provide some buying opportunities in the short term.

Property

We recommend investors hold a neutral position in property relative to their benchmark allocation.

Strong annual returns of 19.4% and 21.1% respectively have been records in the Australian and global REIT markets. This is a consequence of low interest rates driving down capitalisation rates.

However, we expect interest rates to remain stable for the short term, supporting valuations.

Both Australian and global REITs are trading at around a 2% discount to Net Asset Value. Caution should be exercised in the retail sector due to growing pressures on profit margins.

Fixed Interest

We recommend investors retain an underweight position to Australian Government Bonds and a neutral to underweight position to Global Government Bonds relative to their benchmark allocation.

The 10-year Australian Government bond rate remains close to 1%. We consider further significant falls unlikely, albeit that the RBA may still reduce rates due to the impact of the devastating bushfires and the coronavirus. We see more value in US 10-year bonds, which are trading closer to 2%. However the low rate does not offer much more than downside protection against falling equity markets.

Credit markets, especially overseas, are expensive and we therefore recommend a neutral to underweight position in these fixed interest classes.

Sources: Lonsec