Economic Update

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Outlook for Investment Markets

2016 has started badly for many asset classes, with global equities of all kinds sold off heavily worldwide, but especially in the emerging markets. The main concerns have been the potential impacts of slower Chinese economic growth and falling commodity prices. Government bonds have benefited as investors have sought refuge from the equity sell-off, but lower-quality bonds have weakened as investors have become more risk-averse. Looking ahead, the most likely outlook is for continued modest global economic growth, which should provide some floor support to global shares, though there is a risk that investors could remain too anxious to invest and could set off a further cycle of self-fulfilling selling. Interest rates, both locally and internationally, now look likely to rise more slowly (if they rise at all). In Australia, the most recent data are inconclusive, and there is still no clear sign that the pace of business activity has picked up. There are ongoing risks as well, notably around commodity prices.

Australian Cash & Fixed Interest—Review

There has been no change to short-term interest rates, with the 90-day bank bill yield steady at 2.3%. Long-term bond yields have moved in line with the U.S. bond market, where safe-haven buying in the current equity market volatility has led to higher U.S. bond prices and lower yields: For the year to date, the 10-year Commonwealth bond yield has dropped to 2.7% from 2.88%. Lower yields have brought capital gains: For the year to date, the S&P/ASX index of Australian government bonds has returned 0.92%, and the S&P/ASX index of corporate bonds has returned 0.73%. The Australian dollar has been affected by global financial instability: On the Reserve Bank of Australia's trade-weighted index the AUD is down 4.8% for the year to date, and on the headline U.S. dollar basis it is down by 5.9%, to USD 0.6875 from USD 0.731.

Australian Cash & Fixed Interest—Outlook

Forecasters are of two minds about the outlook for short-term interest rates. Some believe the RBA will cut rates this year, possibly more than once: With inflation remaining moderate, there is room for the RBA to assist a still subpar economy with the stimulus of lower interest rates. The financial futures market is currently pricing in one 0.25% cut by the middle of this year. On the other hand, several forecasters think the RBA will keep the cash rate at 2.0% for the rest of this year: The recent drop in the value of the AUD has effectively eased monetary policy and reduced the need for interest-rate cuts to achieve the same effect. The latest strong jobs numbers would also indicate that the economy may not need the stimulus of lower interest rates.

The RBA is unlikely to do anything at its next meeting (the monetary policy decision on Feb 2), given that it is likely to want to wait and see how the current global financial market volatility plays out, but we may well get a clearer view of its intentions either at its Monetary Policy Statement on Feb 5 or at its next policy decision meeting on March 1. Whatever happens, local short-term interest rates look likely to remain low throughout this year.

Local inflation is tracking a little below the RBA's target, and falling energy and commodity prices mean that the inflation rate could well fall further in coming months. There is also the increasing likelihood that U.S. monetary policy tightening will be less than previously anticipated, which would lead to a slower rise in U.S. bond yields than forecasters were calling for. Before the latest market volatility, forecasters had typically been expecting a small rise in the 10-year Commonwealth bond yield during the course of this year. In the light of recent events, a more likely prospect is that local bond yields will remain around current levels, although, as with many other asset markets, much will depend on where the current market volatility ends up.

The AUD has weakened for a variety of reasons. Investors tend to shy away from taking foreign-exchange risk in currencies like the AUD when global uncertainty is high, and it has been very high in the opening weeks of this year: Investors have preferred to retreat back to their home currencies (the USD, for example, is up by 1.5% in overall value since the start of the year, on the *Wall Street Journal's* index). The dollar has also been bracketed with other currencies that are seen as 'commodity backed' (such as the Canadian and New Zealand dollars) at a time when commodity prices globally have been falling. And currencies in the Asian region have also been seen as relatively more vulnerable to a Chinese economic slowdown. Arguably the AUD has now fallen to levels that are sustainable from a longer-term export competitiveness point of view, but it remains vulnerable to ongoing investor anxieties.

Australian & International Property—Review

A-REITs have not escaped the equity market carnage completely unscathed but have strongly outperformed the share market as a whole (as they also did in 2015). For the year to date, the S&P/ASX200 A-REIT Index has delivered a loss of 1.3% in terms of total return, a good deal less than the 7.4% loss for the S&P/ASX200.

The same cannot be said for global listed property, which has behaved very much like the wider global equity market and which has recorded large losses. For the year to date, in terms of net return in USD, the FTSE EPRA/NAREIT Global Index is down 7.4%. The losses were widespread, relatively smaller in the U.S. (-5.2%) and Japan (-5.9%), larger in Asia as a whole (-7.9%) and the eurozone (-8.0%), larger again in the U.K. (-10.9%) and–as in the wider equity market–largest of all in the emerging markets (-15.4%).

Australian & International Property—Outlook

As might be expected in an economy growing somewhat more slowly than in previous years, the operating performance of property is fair rather than good. ANZ's commentary on the latest (March) quarterly ANZ/Property Council of Australia survey said that 'Leasing conditions across commercial property sectors have broadly improved in the past year, however Australian commercial property markets continue to reflect patchy economic conditions across regions and property grades.' The survey found mixed expectations about capital growth. People in the industry were strongly optimistic about higher property values in the retirement village market and quite positive about shopping centres and hotels, but they were only lukewarm about industrial property and slightly pessimistic about the office market.

The operational performance of property may be a secondary issue, however, if market conditions continue to be turbulent and investors continue to value its defensive characteristics relative to the broader equity market. It has also helped that the prospect of higher local bond yields has receded. While there is not a lot to choose between the yield on the A-REITs and the yield on the ASX200 (both currently a little above 5%), the A-REITs now look likely to maintain an appreciable yield differential over bonds. Income pickup and downside protection will remain attractive in current market conditions.

Global listed property, on the other hand, has been offering little or no defensive downside protection: the sector moved broadly in line with global equities in 2015 and has been just as badly sold off as equities more generally this year.

The main issue for the asset class has been that property valuations have been inflated by investors chasing yield in a low-interest-rate environment and that prices are at unsustainably expensive levels. Colliers International's *Global Investor Outlook* for 2016, which surveyed some 600 institutional investors in global property, shows both the scale of property demand in recent years and its impact on valuations, notably in the U.S. In 2013, 70% of the surveyed investors were planning to increase their investment in property, and although the proportion is dropping, it is still high (54% for this year). But the consequence has been that assets have become pricey: As Colliers said, a rising proportion of investors planning to be net sellers 'might signal a desire from some investors to take advantage of current pricing levels to cash-in and a view that in some markets the property cycle is nearing a turning point.' The market most at risk looks to be the U.S.: 'One fifth (21%) of investors expect to be net sellers this year, compared to none last year.'

The prospect of slower rises, or even no rises at all, in international bond yields has slightly improved the prospect for global property, but as one panellist at Morningstar's most recent Expert Asset Allocation Panel meeting said, the sector has 'gravity defying valuations.' So far this year, gravity has reasserted itself, and the fall may have further to go.

Australian Equities—Review

Australian shares have dropped sharply, with the S&P/ASX200 down 7.4% both in capital value and total return. (The measures come out the same because there is less than three weeks of data to date, so there has been little or no opportunity to accrue dividend income.) With investors preoccupied by falling commodity prices and the potential extent of China's slowdown, the miners were particularly weak: the S&P/ASX300 Metals and Mining Index is down 12.4%. Other than the A-REITs (discussed elsewhere), the various sectors of the ASX all registered substantial declines, ranging from the 5.2% decline for industrials and the 5.4% decline for consumer staples through to the 7.9% decline for financials.

Australian Equities—Outlook

In Australia, most of the key business and consumer surveys have yet to get going for 2016, but on the limited evidence of what is available, there have been mixed indicators that in aggregate suggest the economy is still growing at a slower than usual rate.

On the plus side, one especially positive development was the news that the labour market in December performed well. Forecasters had been expecting a loss of about 10,000 jobs, largely on the grounds that November's unexpectedly big 71,000 increase in jobs had been some kind of statistical anomaly that would unravel once updated data became available, but also for more fundamental reasons: The outsize jobs surge seemed larger than realistic in an economy growing at a moderate pace. In the event, there was almost no decline in December (the overall job count showed a tiny loss of only 1,000 jobs), and the composition of the loss showed that it was down to fewer part-time jobs: There were actually 17,500 more full-time jobs. It was also encouraging that the unemployment rate held steady at 5.8%.

On the other hand, consumer confidence has been sliding. Households are not outright unhappy–although the latest weekly readings from the ANZ/Roy Morgan consumer confidence survey have been falling, they have only dropped to around their long-term historical average–but they are clearly of two minds. They are happier about their own financial situation, which likely reflects a mix of a stronger labour market, lower mortgage costs, and cheaper petrol. But they are increasingly concerned about the longer-term outlook for the economy. The part of the survey that asks about the economic outlook over the next year has been falling since last November and took an especially large dive in the latest survey (for the week ending Jan 17), following new concerns about China and the global and domestic share market declines. Ongoing declines in Australia's export commodity prices are also weighing on the downside.

International forecasters remain of the view that Australia's growth rate will pick up only slowly this year: In the *Economist*'s latest (January) poll, they expect GDP growth of 2.5% this year, compared with 2.3% in 2015. If so, then share market returns will likely be modest. Dr. Shane Oliver, head of investment strategy at AMP Capital, for example, is picking a total return of 7% from Australian equities this year (which would equate roughly to a modest 2.0%-2.5% capital gain plus a 4.5%-5.0% dividend yield). If the pace of economic activity does, finally, accelerate out of the slow-growth patch caused by the unwinding of the mining investment boom, however, then returns could be a lot higher. Macquarie Bank in a recent report said that investors could well become more confident about the domestic economy in the second half of this year, and their increased propensity to take on equity risk could see the market deliver a total return of around 17%.

The outlook in sum is dependent on a resolution of the current global market volatility, which has been inimical to Australian equity performance; evidence that the economy could be definitively emerging from the post-mining slowdown; and, at a minimum, some stabilisation in commodity prices.

International Fixed Interest—Review

International bond markets have been strongly affected by investor anxiety over the international economic and financial outlook, resulting in sharply contrasting outcomes in different subsectors of the asset class.

Safe-haven buying by worried investors has meant strong demand for government bonds in the most creditworthy countries. In the U.S., the 10-year Treasury yield has dropped this year to 2.06% from 2.27%, and 10-year yields have also fallen in Germany (to 0.48% from 0.63%) and Japan (to 0.22% from 0.27%). The Barclays Capital global government bonds index in USD has consequently returned 1.09%.

More risk-averse investors have shunned the less creditworthy fixed-interest sectors. The Barclays index of global corporate bonds in USD terms is down marginally, with a negative 0.01% return. But the high-yield (low credit quality) end of the corporate market has been heavily sold off, with the Barclays global high-yield index in USD showing a year-to-date loss of 2.6%, a large loss considering it has occurred over a span of scarcely three weeks.

The other fixed-interest casualty in current market conditions has been emerging-markets debt, partly because of generalised higher risk aversion and partly because of ongoing bad news from some of the major emerging markets (their equity markets have also been very weak). The Barclays index of emerging-markets government bonds in USD terms is showing a year-to-date loss of 2.1%.

International Fixed Interest—Outlook

There has been a marked change in recent weeks in forecasters' expectations for U.S. monetary policy. Global volatility has been focussed on downside risks to economic activity, meaning that analysts now feel the U.S. Federal Reserve would be unwise to press on with further interest-rate increases after its first 0.25% hike in the federal-funds rate in December. And inflation virtually everywhere has been turning out to be lower than expected, well below the target rates the major central banks are aiming for: It consequently makes little sense for central banks to press on with interest-rate increases when the inflation data indicate that, if anything, lower rates are needed.

One key component has been oil prices, which have continued to fall: At the time of writing, the price of Brent crude had just dropped below USD 28 per barrel, its lowest level since the end of December 2003. The latest drop reflects not only the ongoing attempt by Saudi Arabia to drive American fracking-derived oil out of the market by pushing world prices below the cost of production for fracking, but also the prospect of increased supply from Iran as it returns to international markets after the ending of sanctions related to its nuclear programme. The traditional oil well producers in the Organisation of Petroleum Exporting Countries are optimistic that they can restore their control of the global oil price this year by driving frackers away. The latest monthly report from OPEC said that 'Non-OPEC marginal barrel production'–fracking–'in the next six months will be sensitive to sustained low oil prices.' But in the next few months prices look set to stay low or even go lower again.

In this environment, the earlier assessment that the U.S. Federal Reserve would gradually raise interest rates this year is looking increasingly questionable, as is the view that the Bank of England in the U.K. would follow suit later in the year. At the time of writing, the governor of the Bank of England had just delivered a speech saying that, despite the U.K.'s relatively good economic performance by current developed economy standards, it was not robust enough to withstand an interest-rate hike.

The upshot is that ultralow cash rates in the major economies now look likely to last for longer than previously thought. The Chicago Mercantile Exchange's 'FedWatch' indicator, for example, which uses futures prices to calculate the futures market's implicit probability of Fed moves, is currently suggesting that it is essentially a 50:50 bet whether the Fed leaves the federal-funds rate at the target range of 0.25%-0.5% in the first half of this year or raises it to 0.5%-0.75%.

Less monetary policy tightening, and lower inflation than expected, also mean that bond yields now look less likely to increase this year. The most recent (December) poll of U.S. forecasters by the *Wall Street Journal* found that the 10-year Treasury yield had been expected to rise to nearly 2.9% by the end of this year. It is likely that the next poll will see bond yield expectations pegged back to a smaller and slower rise.

Within the overall asset class, there is likely to be ongoing divergence between subsectors. In the short run, government bonds will continue to attract investor interest while equity markets are unsettled, but in the longer run–assuming some eventual return to more normal market conditions–the yields are likely to prove unattractive: The current yield on the Barclays index of government bonds is only 1.05%.

Emerging-markets debt may well remain out of favour. At one point it had been a favoured vehicle for investors hunting for pockets of yield in a generally low-interest world, but more recent data show strong capital outflows from the emerging markets. With a wide range of the major emerging markets (Argentina, Brazil, Russia, and Venezuela) facing serious challenges, investors may well continue to reduce their involvement.

The outlook for corporate bonds is more complex. Credit spreads have widened; for some, this is a warning sign. A Barclays credit strategist, for example, was quoted in the *Wall Street Journal* on Jan 19 saying that 'Spreads in European corporate bond markets are at levels consistent with a recession,' the logic being that investors start to ask for higher credit spreads when it looks as if economies are running into trouble and the risk of corporate bond defaults is rising.

An alternative explanation, however, is that investors' general level of anxiety has risen: Investors may not be specifically expecting a eurozone or U.S. recession, but they are at least temporarily spooked by global uncertainty. In that case, higher corporate bond spreads have their attractions, and at Morningstar's latest (January) Expert Asset Allocation Panel, panellists continued to favour corporate bonds over government bonds, given the improved running yields. In the short term, however, high levels of investor anxiety have the potential to lead to further widening of credit spreads and to associated capital loss.

International Equities—Review

World share markets have had a torrid start to 2016. For the year to date, the MSCI World Index is down by 8.2% in the currencies of its component markets and by 8.6% in USD terms. Local investors have been relatively sheltered from the worst of the impact, because of the 5.9% decline of the AUD against the USD, but are also looking at losses.

None of the major developed markets escaped unscathed. In the U.K. the FTSE 100 was down 5.9%, France's CAC Index was down 7.9%, the S&P 500 in the U.S. was down 8.0%, Europe as a whole was down 8.8% on the FTSEurofirst300 Index, Germany's DAX was down 10.0%, and in Japan the Nikkei was down 10.4%.

There were worse results again in the emerging markets. Overall, the MSCI Emerging Markets Index was down 7.8% in terms of the emerging markets' own currencies but down 10.0% in USD terms as those currencies dropped against the USD. Many investors are likely to have their emerging-markets exposures in the principal 'BRIC' economies (Brazil, Russia, India, and China): There, the news was worse again, with the MSCI BRIC Index down 12.0% in USD terms since the start of the year. India was the best of a bad lot, with the Sensex Index down by a relatively small 5.1%, but the other three BRIC economies all delivered substantial losses. Worst of all was Russia: the FTSE Russia Index fell by 15.6% in rouble terms, exacerbated by a 9.5% decline in the rouble against the USD, for an overall loss in USD terms of 22.9%.

International Equities—Outlook

The economic fundamentals for global business activity remain fair rather than strong, with reasonable rather than robust growth ahead for the developed world offset by patchy performance and rising risks in major emerging markets. The overriding issue remains whether investors are paying a reasonable price for global growth that is running a bit slower than usual.

The immediate outlook for global activity has improved a little. The latest (November) global performance indices from JPMorgan/Markit showed 'a further step in the right direction for the global economy,' and the compilers said that 'If faster increases in new orders and employment translate into a further bounce in the pace of expansion in December, fourth quarter [global] GDP growth should come in a shade higher than that registered during Q3.'

Official data support a modestly upbeat outlook. Recent economic data in the U.S. in particular has been positive—its labour market continues to perform well. The much-larger-than-expected 271,000 new jobs figure in October has since been revised up to an even larger 298,000, and the strong October jobs numbers were followed by a substantial 211,000 further new jobs in November. The unemployment rate has remained at 5.0% despite an increase in the labour force as more people have become encouraged enough about the labour market to look for jobs.

The eurozone grew by 0.3% in the September quarter, much the same as the 0.4% recorded in the June quarter. Even though the pace of growth is still quite slow, it also means that the eurozone is gradually turning for the better. The latest (December) forecasts from the European Central Bank, for example, say that the eurozone economy will have grown by 1.5% this year, up from only 0.9% in 2014, and will grow slightly faster (1.7%) next year, and a little faster again (1.9%) in 2017.

In Japan, while there had been talk of a "technical recession" (two successive quarters of declining gross domestic product), the latest revised estimates showed that, rather than GDP contracting at an annual 0.8% rate in the September quarter, the reality was that the economy was growing at an annualised 1.0%. The data are unusually unreliable for a large economy, and the latest numbers may also be off the true mark.

Even so, it is now probable that the underlying reality was a good deal better than 'recession,' particularly as the new numbers reflected stronger business investment than previously thought, which is a sign of growing producer confidence.

If there is reasonable, but far from stellar, growth in the developed economies, the global outlook is complicated by difficult economic conditions in a number of important emerging markets, notably Argentina, Brazil, Russia, and Venezuela. A combination of the lower oil price, poor governance, and political risk have produced recessions in all but Argentina, and even in Argentina expected growth is marginal (only 0.3% in 2016, according to the *Economist* magazine). More positively, China's growth prospects appear to have steadied after official moves to stabilise the previous plunge in Chinese equity markets and to provide monetary stimulus to the wider economy; China is now expected (in the latest, December, poll of international forecasters by the *Economist*) to grow by 6.4% in 2016.

The big question remains whether investors are paying a reasonable price for a fair-to-middling business outlook, and one which comes with a bundle of risks that mostly look tilted towards the downside.

In the U.S., for example, data company FactSet tracks analysts' profit forecasts. The analysts' latest forecasts are for U.S. companies to grow their sales by 4.4% in 2016 and their profits by 8.1%. While an 8% increase in profits would be a good outcome, the issue is that the prices U.S. equity investors are paying for access to it is on the expensive side. On FactSet's calculations, today's price compared to the expected profits results in a forward P/E ratio of 16.1 times earnings: 'The P/E ratio of 16.4 for the index as a whole is above the prior 5-year average forward 12-month P/E ratio of 14.3, and above the prior 10-year average forward 12-month P/E ratio of 14.2.'

The relatively expensive valuations are, significantly, spread across nearly all sectors of the S&P 500: 'The Telecom Services (11.9 vs. 14.7) sector is the only sector with a forward 12-month P/E ratio below the 10-year average.' One explanation is that valuations in the U.S., and in other markets where central banks have been pursuing very supportive monetary policies, have been bloated by the very low rates of return available on other assets in a world of virtually free liquidity. The Fed has made an effort to prepare investors for rising U.S. interest rates, but the reality is that the equity markets are in the very early stages of coming to terms with altered valuation calculations.

Another issue is that many international investors are all invested in broadly the same set of trades. Particularly after the very strong jobs numbers in the U.S. in October, the big institutional investors have clustered around a similar set of core ideas. As the latest (November) BofA Merrill Lynch survey of the big investors showed, they are banking on ongoing U.S. growth, monetary policy support in the eurozone, weak conditions in some of the major emerging economies, and further falls in commodity prices. But when the bulk of the managers' bets are already in place on those ideas, there are few investors left over to drive them forward. Commenting on the latest survey, Michael Hartnett, the chief investment strategist at BofA Merrill Lynch Global Research, said, 'With consensus very clustered in QE [quantitative easing] and strong dollar trades, asset price upside appears limited until an "event" curtails the Fed hiking cycle, as in 1994.'

All going well, the benign scenario that the big institutional investors expect will indeed materialise, and world shares will make gains next year. But equity markets are clearly vulnerable to any surprises that upset the current set of widely shared expectations—many investors trying to get through the same door at the same time can lead to sharp price volatility.

The recent weakness in world equity prices has had a variety of causes, including concern that higher interest rates in the U.S. might have been a misstep if the U.S. economy was not in fact robust enough to cope with it; a drop in U.S. retail sales in December gave some support to this view. Another strand of the anxiety related to the adverse impacts of falling commodity prices: Low oil prices, for example, were one of the main reasons for the exceptionally poor performance of Russian equities. Largely, however, the recent fragility of markets has focussed on China.

Given the global market emphasis on the outlook for China and its likely implications for world financial markets, Morningstar's January Expert Asset Allocation Panel meeting had discussed it at some length. Panellists were, on balance, inclined to the view that world markets could be over-reacting to a Chinese slowdown; it had been abundantly clear for a considerable time that China, for a variety of reasons, was not going to be able to maintain its previous breakneck pace of economic development. A slowdown in Chinese growth, in the panel's view, should not have come as shocking news to the financial markets.

Since then, there has been a series of official statistics released showing that, while there has been some further slowdown in the Chinese economy, it is still growing at a rapid rate. According to the official data released on Jan 19, China's economy grew at a year-on-year 6.9% rate in 2015, exactly in line with economists' consensus forecasts and only a bit slower than the 7.3% achieved in 2014. Retail sales grew by 10.7% after 12.0% growth in 2014. And industrial production was up by 6.1%, compared with 8.3% in 2014. In any other country, these would be regarded as remarkably strong numbers.

It is true that in China's case some investment plans (such as mining projects) may have been made on the overoptimistic basis that Chinese growth would continue at 7%-8% rates for some years yet. Markets are right to be worried about the ramifications of decisions that relied on the continuance of a commodity price 'supercycle' of many years of higher-than-usual prices held up by endlessly booming Chinese demand.

It is also true that investors have been confused about the direction of Chinese economic policy and about the abilities of the Chinese authorities to cope with problems. On the policy front, for example, markets appear to have worried that China might have been embarking on a 'currency war' of competitive devaluation. This would have raised geopolitical tensions, especially in the U.S., where suspicion about potential Chinese currency manipulation was already high. It also might have been a signal that China's economy was weak and needed the boost of a devaluation. While China's foreign exchange-rate setting process is not transparent, in reality it seems more likely that China was, if anything, trying to hold the renminbi more or less steady against a basket of currencies. On the competence front, investors have also been worried about the authorities' ability to cope with potential financial stresses in the equity, property, and banking sectors. The clunky 'circuit breaker' mechanism, which had stopped equity trading and which has since been junked, was one example.

In current market conditions, however, investors seem in no great mood to recognise still strong economic data or to see much potential upside to Chinese policy. Indeed, they seem to be jittery on a wide front, which has the potential to lead to a self-fulfilling vicious circle. The IMF, in the just-published update to its *World Economic Outlook*, saw a risk of 'a sudden rise in global risk aversion, regardless of the trigger, leading to sharp further depreciations and possible financial strains in vulnerable emerging market economies. Indeed, in an environment of higher risk aversion and market volatility, even idiosyncratic shocks in a relatively large emerging market or developing economy could generate broader contagion effects.' The World Bank said much the same in its January update of its *Global Economic Prospects*.

That said, the IMF's forecast for the world economy, even with risks predominantly on the downside, is that the world will manage slightly faster economic growth this year: 3.4% this year compared with last year's 3.1%. The World Bank came to the same conclusion, albeit with somewhat lower numbers: Their estimate of global growth last year was 2.4%, which they expect to pick up to 2.9% this year. Morningstar's Expert Asset Allocation Panel was of the same view.

Behind the current volatility, there may be more fundamental support for global equity performance than is apparent in the current low-confidence climate. The risk that currently low confidence will mutate into something with permanent impact cannot be discounted, and there may be a prolonged focus on the losers from low energy and other commodity prices (such as Russia) rather than on the beneficiaries (such as Japan). But the global economy is not necessarily doing as badly as the current share market declines might suggest.

Performance periods unless otherwise stated generally refer to periods ended 19 Jan 2016.

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