MORNINGSTAR®

Your Money Weekly

Forecast 2017–18

Global tightening – The punch bowl is removed. Market upside limited

At 30 June 2017, the half way mark of the calendar year, the S&P/ASX 200 index is up 9.3% from a year ago at 5,721. Including dividends, the S&P/ASX 200 Accumulation Index is up 14.1% at 55,759. All gains in the S&P/ASX 200 were achieved in the six months to 31 December with the benchmark at 5,719 at the halfway mark. The Accumulation Index 1H/2H contributions were +10.6%/+3.5%.

In the 15 December 2016 Forecast 2017, my bull case for the Australian market was for the S&P/ASX 200 to finish the year around 6,000, with a base case at 5,600 and a bear case 4,800. On the bigger stage the bull case for the S&P 500 was 2,600, base case 2,350 and bear case 1,750.

This time next year, I expect the annual returns will be much lower than those just posted. Morningstar's bottom-up view from our 200 plus company coverage suggests a median price/fair value ratio of 1.05 and the simple average 1.11, suggesting modest overvaluation.

While global equities markets could move higher in the short term, the concerted move by central banks to rein in accommodative settings and tighten monetary policy, will impact the course of equities markets over the coming year. While the U.S. Federal Reserve was, until recently a lone voice, the European Central Bank, the Bank of England and the Bank of Canada have recently stepped up their tightening monetary policy rhetoric. Bond yields responded, moving sharply higher.

The era of easy and cheap money and accommodative settings of central banks is over. The central banks have exhausted their reserve capacity, doing all the heavy lifting as fiscal policy went absent without leave for years. Markets and investors were addicted to this unusual phenomenon, leading to bubbles or overvaluation in some risk asset classes. San Francisco Fed president John Williams believes US equities markets are "running on fumes". Some of his companions have similar thoughts. The Investment Clock is showing 12.30. (Exhibit 1)

The early days of the Trump presidency saw investors embrace the pro-growth, deregulation, swamp draining promises of the election campaign and despite some setbacks with Congress, the benefit of the doubt still prevails. Risk-on strategies are in the ascendency as global indices push higher. However, more recently there is some recognition of stretched valuations, particularly in some major U.S. technology-related stocks.

The FAANGS, the anacronym, for the five big technology stocks – Facebook, Apple, Amazon,

Australia's Leading Independent Investment Newsletter Since 1973

Peter Warnes
Head of Equities
Research

This bi-annual feature is written on the premise of a subscriber asking what could be the key issues, trends and risks in the share market and economy over the next year. It will help you understand how we approach the issues and how we update them during the year in our Weekly Overview. We look at many trends both local and international that influence global financial markets. The goal is to provide investors with the necessary information and investment ideas to generate satisfactory long-term returns by the prudent management of a growing pool of investable funds.

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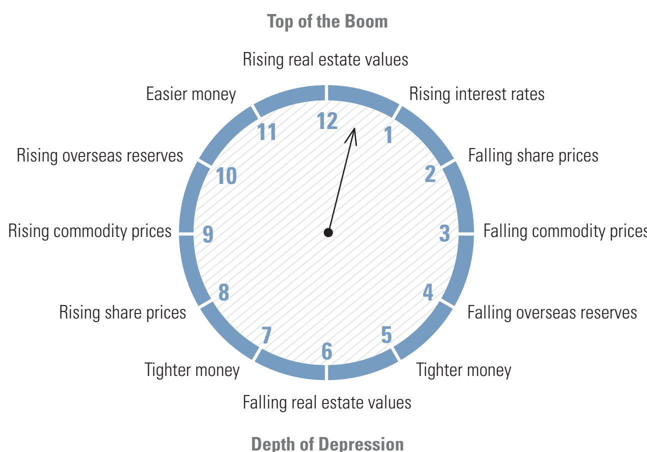
Exhibit 1: The Investment Clock



Source: Sharecafe/startrungrow

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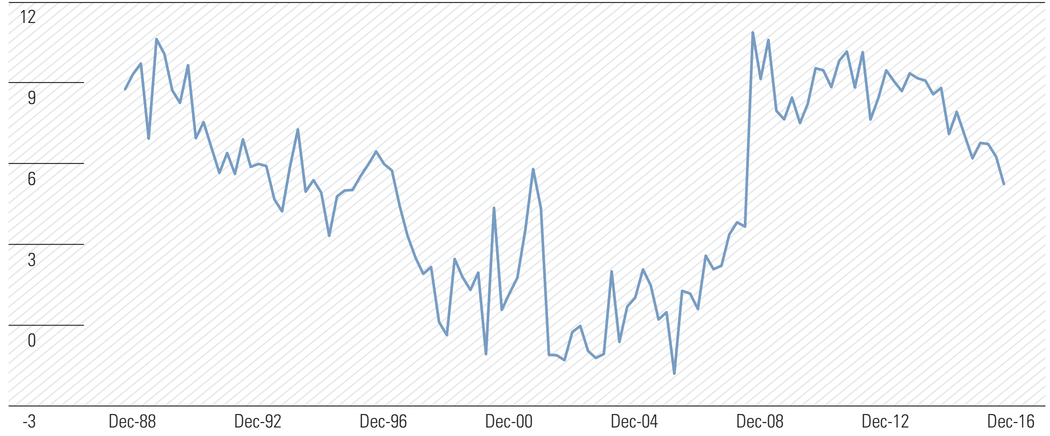
Key Terms
Buy: Significantly undervalued;
Accumulate: Modestly undervalued;
Hold: Fairly valued;
Reduce: Modestly overvalued;
Sell: Significantly overvalued.
CAGR: compound annual growth rate

Any feedback on this week's Overview is always welcome. Send your comments to YMW@morningstar.com. We'd love to hear from you.

Exhibit 2: Household savings ratio – now falling (% income)



Source: ABS, Westpac Economics

Netflix and Google parent Alphabet, have accounted for 40% of the increase in the market capitalisation of the S&P 500 in 2017. IT companies, dominated by the FAANGS, now account for 20% of the S&P 500.

No one wants a recession. Most of all the U.S. Federal Reserve (The Fed) and Wall Street. I am not suggesting a recession is on the cards, but extending the normal economic cycle can have unpredictable consequences. The lack of cohesion between monetary and fiscal policy over the past seven years drove central banks to empty their armoury. Risk assets are the beneficiary, but an all-out fiscal splurge comes too late in the piece.

The arm wrestle between The Fed and Wall Street and bond markets is on in earnest. The former predicting or hoping for a strong rebound in GDP growth and higher inflation, while the bond market is unconvinced on both fronts. The flattening of the bond curve is teasing the former and sowing elements of doubt in the minds of investors.

Geopolitical tensions continue to bubble on several fronts and concerns over China's debt and lack of reform still lurk as potential destabilising issues.

Australia – Economic outlook sombre – Households hold the key

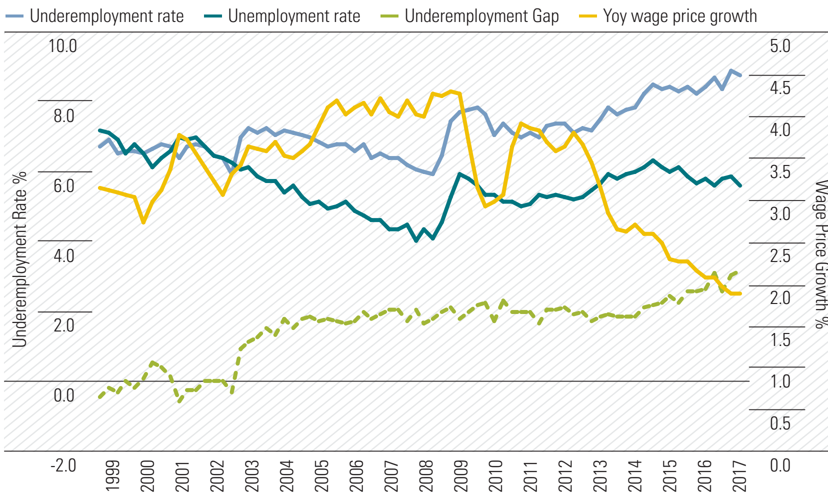
The Reserve Bank of Australia (RBA) and Treasury remain optimistic on the growth outlook for the Australian economy. Others, including myself are yet to be convinced. Undisputedly, household consumption is the main driver of GDP growth and it is restrained. The major influencing factor affecting consumption is income and in the household's case, wages and salaries. In both a macro and micro sense, this is determined by the number of hours worked and the hourly wage rate.

Wages growth remains below trend and a catalyst to jolt it back to trend, let alone above trend, is difficult to pin point. Wages growth in the March quarter was just 1.9% with the private sector increasing at 1.8% and the public sector by 2.4%. The lack of wages growth and therefore household income is of concern, particularly as the real cost of living, not measured by headline or core inflation, is increasing at multiples of both wages growth and any measurement of inflation. Non-employment creating household expenses are increasing rapidly. Rising energy, insurance, education and health, not to mention mortgage repayments, are sapping employment-creating demand for goods and services. Households are being forced to dip into an already depressed level of savings. (Exhibit 2)

There has been a secular change in the composition of employment in recent decades. The share of part-time employment has increased from around 10% in the early 1970s to over 33% at present. This is relatively high by international standards and is the main cause of increasing underemployment. While the decision to work part-time was one of choice, especially for students, primary carers – mostly women, and those transitioning to retirement, the lack of opportunities for full-time work is also an influencing factor. There is little doubt there is a meaningful degree of spare capacity in the labour market when the underemployed and genuine unemployed are combined. This will tend to be a drag on wages growth for some time, although as is always the case skilled trades will be sought after. (Exhibit 3)

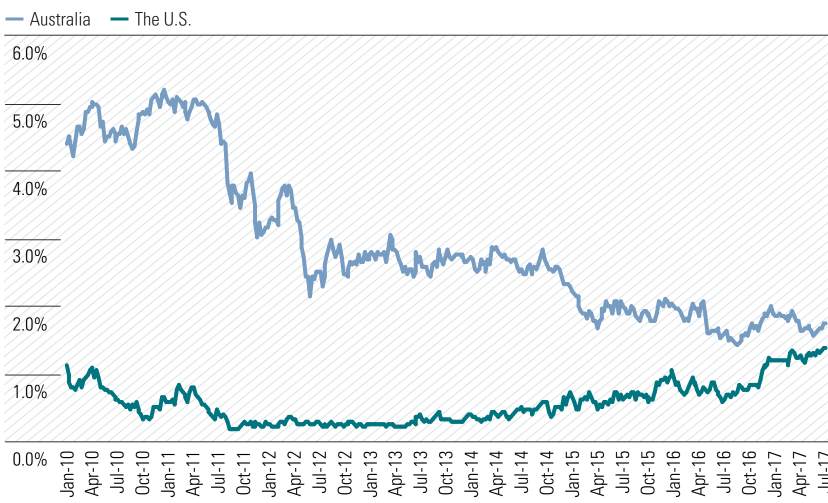
The east coast residential boom has been a useful contributor to GDP growth over the past few years and has now peaked and while the pipeline is still very healthy, the contribution to future growth will weaken. The terms of trade improved in 2016 as

Exhibit 3: Underemployment wage price growth yoy



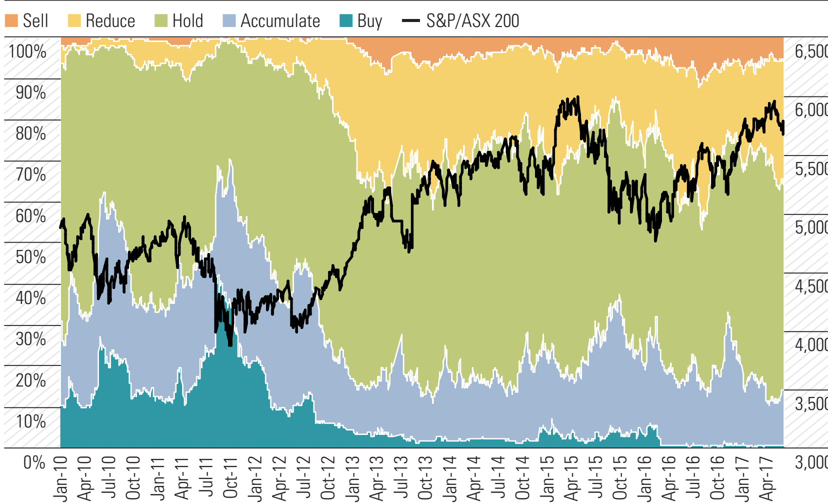
Source: Australian Bureau of Statistics

Exhibit 4: 2-year Government Bond Return: Australia versus the U.S.



Source: Reuters

Exhibit 5: Equity Research Overview - recommendation dispersion - 7 June 2017



Source: Morningstar

China-facing commodity prices, particularly iron ore and coking coal, surged and Gladstone-based ramp-ups boosted LNG exports. The December trade surplus was a record $3.7bn, but in April was $555m mainly due to sharply lower coal exports after cyclone Debbie. Iron ore and coal prices have retreated from late 2016 levels, while LNG exports will continue to lift. Overall the terms of trade will reduce the contribution to 2017 GDP growth.

Australia's terms of trade and the contribution net exports make to GDP growth are tied to Chinese fixed asset investment. Already there are signs this has peaked, with the rate of growth slowing. It will become increasingly difficult for Australian export volumes of steel-making commodities to increase from current levels. Consequently, export revenue will be dependent on price rather than volume. Price will invariably rely more on supply-side discipline – an attribute hard to maintain in a competitive environment. The scenario of reduced demand for Australia's resource exports and the flow-on effect in the trade balance and terms of trade is in tandem with China's burgeoning debt issues and the impact of reining in credit.

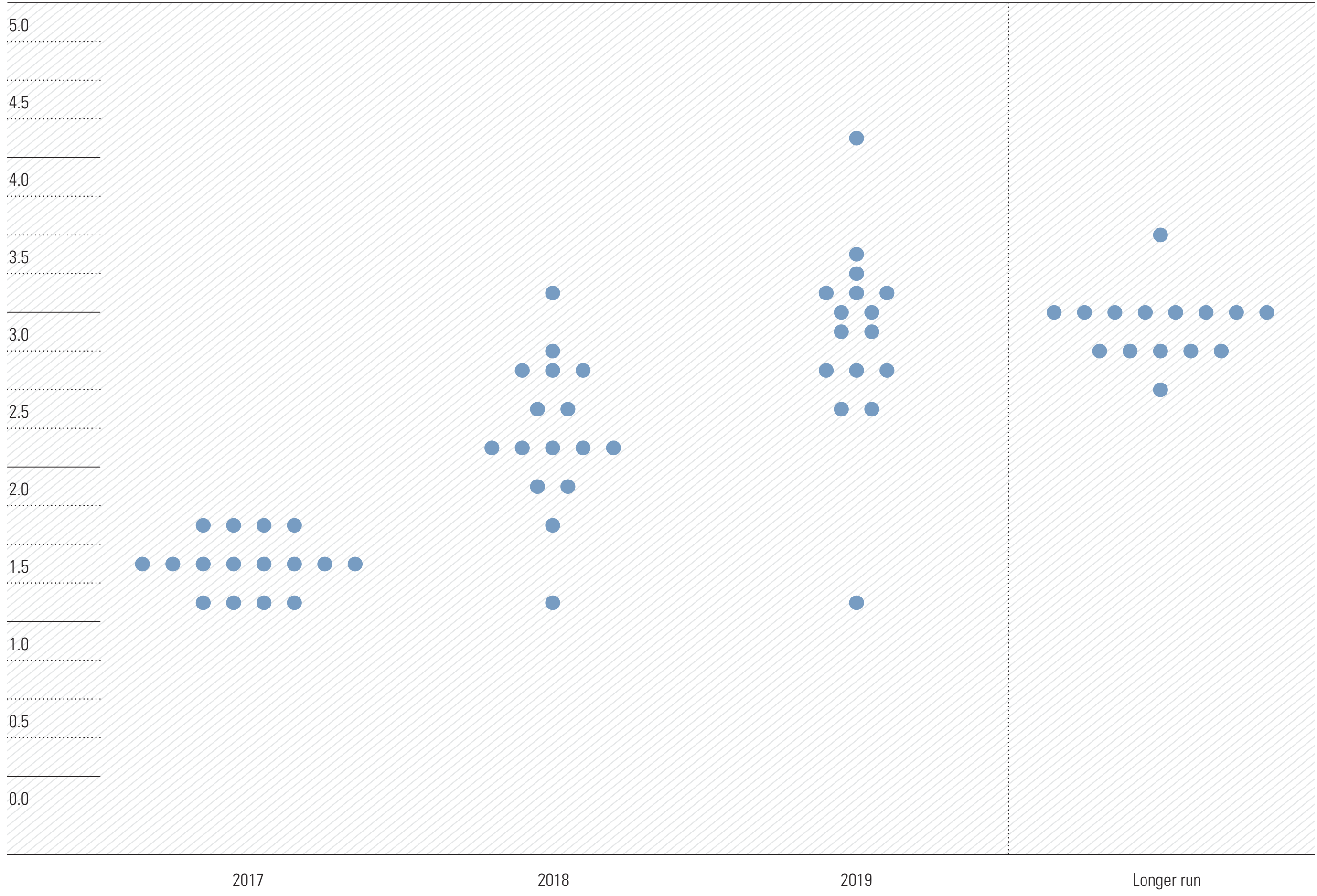
The underlying fundamentals suggest the A$ is overvalued. Monetary policy tightening in the U.S. and interest rate differentials moving is favour of the US$ suggests the A$/US$ rate should weaken from the current 0.765 mark. (Exhibit 4) But, near-term commodity-based currencies could garner support. Over the next six to 12 months the A$/US$ rate is likely to be closer to 0.70. Australian companies with US$ earnings should benefit, including undervalued counters Brambles, CSL, QBE Insurance and Westfield Corporation.

The record household debt to income ratio will make it difficult for the RBA to aggressively lift official interest rates. Out-of-cycle increases driven by macroprudential measures have already increased sensitive investor and interest-only rates. The housing price cycle is topping but the RBA is very aware of the finely balanced situation. A sharp fall in housing prices would almost certainly push an already struggling economy into contraction, and possibly recession.

Best ideas in a valuation-stretched market

Morningstar's research methodology is based on determining the long-term fair value of companies. The market will drive individual company recommendations. When the market valuation appears stretched the number of

Exhibit 6: FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate (%)



Source: Federal Open Market Committee (FOMC)

positive recommendations will reduce and conversely when the market appears undervalued the number increases. (Exhibit 5)

Our Best Ideas include Brambles (BXB), Contact Energy (CEN), Hotel Property Investments (HPI), Platinum Asset Management (PTM), Ramsay Health Care (RHC), Santos (STO), Vocus Group (VOC), Westfield Corporation (WFD) and Westpac Banking Corporation (WBC).

United States - The Federal Reserve's strategy - Tiptoe tightening

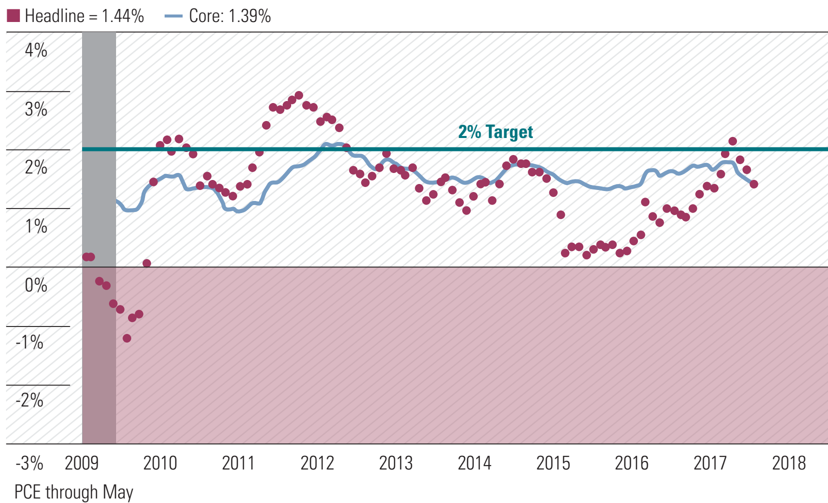
"Inevitably, you will end low interest rates too soon or not soon enough. If you worry too much about ending them too soon, it's too late. The easy part is easing; the hard part is tightening." **Paul Volcker – one of the best Governors of the U.S. Federal Reserve.**

The Federal Open Market Committee (FOMC) increased the federal funds rate range by 25 points from 0.75% - 1.00% to 1.00% - 1.25% at the June meeting. The dot plot chart released after the meeting revealed the members median target by the end of 2017 was 1.25% - 1.50%, indicating one more increase for the year, probably in December. The longer-term target remains at 3%, well below the average 5.8% over the 45 years from 1971 to 2016. (Exhibit 6)

In addition to lifting the federal funds rate, the Committee outlined how it intends to gradually shrink the Fed's US$4.5 trillion balance sheet, built up via several asset acquisition quantitative easing programs over the past eight years. Initially it intends to reduce the reinvestment of the principal payments it receives, as bonds mature. The cap on payments of principal received from maturing U.S. Treasury's will be US$6bn per month, increasing by US$6bn at three monthly intervals over a year, until it reaches US$30bn per month. The cap on other agency and mortgage-backed securities will be US$4bn per month and similarly increased at three monthly intervals over a year, until it reaches US$20bn per month. This will see an outflow of cash from the economy to the Fed at a peak rate of US$50bn per month and will have a modest tightening effect.

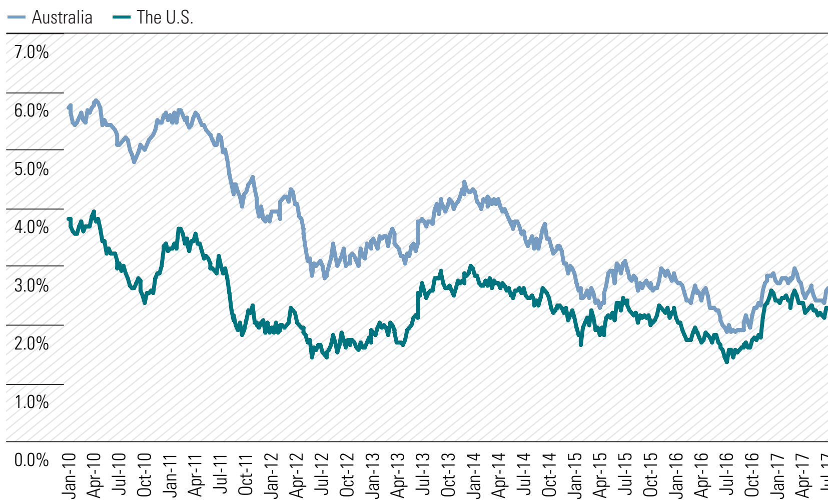
I believe the tightening process will be long and tedious. Normally tightening is effected through the

Exhibit 7: PCE price index



Source: AP Viewpoint

Exhibit 8: 10-year Government Bond Return: Australia versus the U.S.



Source: Reuters

interest rate mechanism – interest rates are increased at an appropriate rate, having regard for the implications on economic growth and inflation. The central bank's balance sheet is not usually an issue. But, this time the process needs to accommodate the need to shrink the Fed's bloated US$4.5 trillion balance sheet which requires both reducing the reinvestment of principal payments and possibly selling government and other securities, purchased in quantitative easing programs post the GFC.

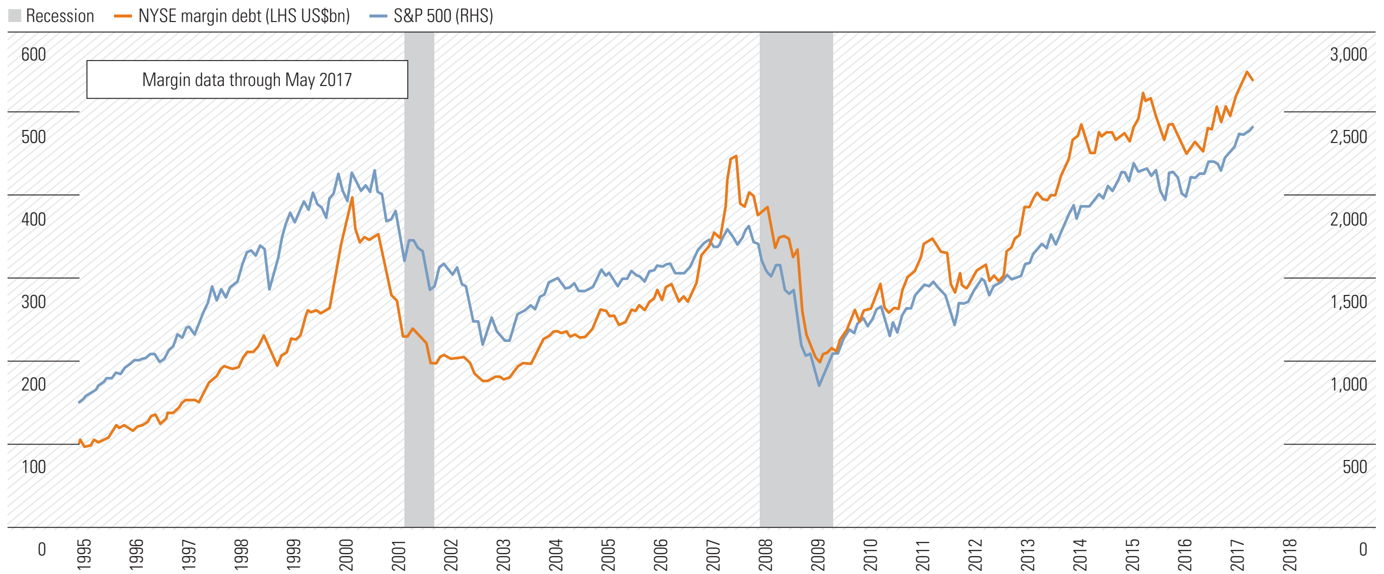
Simplistically, the unwind could take up to eight years for the Fed's balance sheet to normalise – closer to 2025 than 2020. The quantitative easing asset purchase programs targeted the short end of the bond curve – bonds and mortgage-backed securities with maturities less than 10 years. The Fed has capped the run rate of payments received from maturities at US$50bn per month (US$30bn from Treasuries and US$20bn from other assets). This peak run rate of US$50 per month, if started in July, would be reached in the September quarter of 2018. Annual maturities of US$600bn would reach US$4.2 trillion over seven years, effectively normalising the balance sheet. Mission complete, if not interrupted in 2025. But, it is difficult to see the normalising process proceeding without an unexpected interruption.

The FOMC remains quite upbeat about the prospects for GDP growth and inflation. The bond market is not yet convinced, despite the recent sharp jump in yields. Growth is inconsistent and inflation refuses to join the party. After surging from 1.80% before the Trump victory in early November 2016 to 2.60%, the yield on the U.S. 10-year bond has retreated, touching a 2017 low at 2.11% mid-June, before jumping to 2.35% on 3 July. The fall in oil, iron ore and coal prices is putting downward pressure on producer price indices and will feed, with a lag, into consumer price indices. The CRB Commodity Index struggles at 176 - the peak 371 in April 2011 the low 156 in February 2016. The Federal Reserve's preferred inflation indicator, core personal consumption expenditure (PCE) price index fell in May to 1.4%, comfortably below the 2.0% target. A modest rebound is likely to 1.7% later in the year, but core PCE is expected to remain below target for some time. (Exhibit 7)

Bond yields should reflect the combined expectations of the two driving forces – inflation and GDP growth. In May U.S. core inflation increased at 1.7% on May 2016. 1Q17 GDP growth finally came in at 1.4% at the third revision. The initial official 'guess' was just 0.7%. As is normally the case, there are expectations of a solid rebound in 2Q17 and the June ISM manufacturing index raised hopes. FOMC members wish for 3% annual growth, but in the bond market, where transactions in the billions occur daily, the 10-year yield remained stubbornly below 2.2% until recently. The disconnect between the FOMC and the bond market is both palpable and intriguing. If the bond market is on the money, the equities markets are in for a meaningful realignment. (Exhibit 8)

The Fed is in tightening mode and realises low interest rates have created asset bubbles in property and equities and sovereign bond markets. But policy makers are unsure at what point

Exhibit 9: NYSE margin debt and the S&P 500 real values (adjusted to present-day dollars)



Source: AP Viewpoint

tightening will trigger downward asset re-pricing, potentially damaging confidence. A more hawkish stance, favoured by some members could result in a greater correction and the possibility of another rescue mission, but with little ammunition in the arsenal – the bear case scenario.

Market valuations stretched

With the two major indices – S&P 500 and Nasdaq Composite – recently making new highs, valuations are stretched. The rush to passive investment vehicles, mainly Exchange-traded Funds (ETFs) and record levels of NYSE margin debt, both actual and inflation adjusted, combined with low interest rates are responsible for the surging markets. While corporate profitability is solid, valuations metrics are well above long-term trend. US corporate debt is at record levels, led by energy, utilities and materials companies. (Exhibit 9)

Currently the forward P/E multiple of the S&P 500 is 18, an earnings yield of 5.55%. With the 10-year bond yield at 2.35% the equity risk premium is a slim 3.20%. Despite a recent return to increased volatility, complacency levels are high. But, with investors becoming increasingly disappointed with the lack of fiscal easing promised during the election campaign and subsequently, to fuel economic growth, the landscape can change rather quickly. Markets have been pumped by significant inflows over the past six months and any change in sentiment through continued non-delivery could see market-leading high P/E multiple stocks pull back. Growth stocks look expensive and the possibility of rotation into value counters can't be ignored.

Trump's pro-growth initiatives in the slow lane

After bouncing out of the blocks with the rush of Usain Bolt, things have quietened down to a whimper. The big fiscal initiatives of slashing the corporate tax rate and getting the 10-year US$1 trillion infrastructure program started are not making headlines. Instead the administration's focus has been distracted by geopolitical and conspiracy issues, blindsiding any new effective legislation. This has not stopped U.S. equities markets from making new highs, but patience will be tested, particularly if GDP growth for 2Q17 does not meet 3% plus expectations in many quarters.

The International Monetary Fund recently cut its growth forecasts for the US economy. It questions the delivery of tax cuts and higher infrastructure spending and the ability of the administration to deliver a sustainable annual growth rate of 3%. This is an "extremely optimistic growth assumption". The IMF expects U.S. GDP growth of 2.1% in 2017 and 2018 and forecasts growth will steadily fall over the next five years to 1.7%. With expectations much higher, if this scenario played out, a correction of 10% plus from current levels is possible.

The Eurozone – Readying to taper

After 16 consecutive quarters of economic growth it is clear the prolonged financial stimulus is working. With improving economic data, including stronger business and consumer confidence and employment, and political uncertainty fading, the European Central Bank (ECB) is moving closer to taper its aggressive stimulus program. The asset buying program is due to expire in December, with

some suggestions it may end earlier. I suspect not. But, while the outlook has improved, GDP growth is expected to exit 2017 at around 2% and at best flat-line in 2018. Germany will lead, but others may struggle including France and Italy.

The expected recovery is unlikely to put upward pressure on inflation given the still meaningful spare capacity in the labour market. Some degree of stimulus needs to continue for the time being as inflation dynamics remain muted, although hopes for reflationary forces to return spring eternal. ECB president Mario Draghi has reiterated the central bank will have to be prudent as it gradually adjusts monetary stimulus. An increase in interest rates is unlikely until late 2018 early 2019. The conservative Swiss are in no hurry to tighten, distancing themselves from Draghi's recent comments.

China – Treading carefully

China's 2017 growth target of 6.5% looks achievable although momentum is likely to wane. The consumer-related components remain relatively robust given the base continues to expand at near double-digit rates. Growth of fixed asset investment is trending lower and the changing mix in economic drivers toward increasing household consumption is likely to see reduced demand and lower prices for steel-making commodities. This is a headwind for the A$.

The One Belt One Road initiative could replace some fixed asset investment and the political transition later in the year may see added government support should underlying growth start to weaken. The property sector is likely to soften as credit conditions tighten. Authorities continue to push for further financial deleveraging in the economy without causing stress in the more highly leveraged sectors. Getting the balance right is imperative, as any meaningful downturn would have significant repercussions globally, particularly as central bank have little ammunition with which to counter a global contraction in economic activity.

Morningstar research forecasts slowing economic growth as demographic change ushers in a reshaping of the Chinese economy. The extraordinary growth of the past 30 years was aided by a change in demography, which supported an increasingly investment-heavy economic model. Rapid urbanisation and productivity gains driven by an apparent endless supply of "surplus" rural labour will dry up over the next 10 years. The demographic will be a drag on growth rather than drive it. The working-age population will contract as the senior population surges. The support ratio – the number of working-age adults for each child and senior – will fall, draining the savings pool. This will impact investment outlays, but stabilise consumption growth as the overall economy slows and the components of growth change. There will be opportunities for companies tied to the Chinese consumer growth story, such as in healthcare.

Muted outlook for commodities

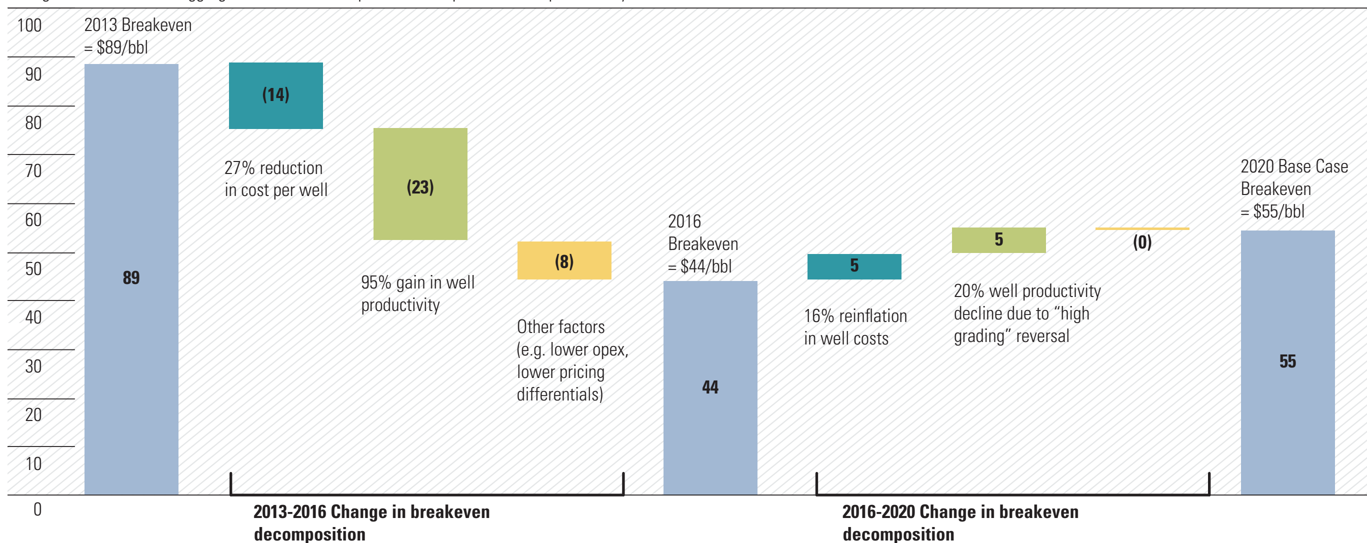
With few exceptions, we continue to see mined commodity and mining company share prices as overvalued. After a very strong start to the year, the markets for mined commodities have generally softened. The benchmark S&P/ASX 200 resources index is down about 10% from the late January peak. Market attention has turned from the tailwind of last year's fiscal stimulus in China and enthusiasm around Trump, to the headwind posed by structural change and the reduced importance of fixed asset investment for China's future economic growth.

We broadly expect iron ore to continue to weaken through the remainder of 2017 as additional supply is introduced, particularly from Vale and Hancock Prospecting, and demand growth likely weakens as the benefit of last year's stimulus peters out. Longer term, the demographic challenge of a falling working age population and reduced rates of urbanisation will provide a headwind for steel demand, particularly for construction and machinery. In addition, as China's stock of steel matures – as cars, followed by machines and later buildings and bridges reach the end of their useful lives and become obsolete – its ability to meet steel demand from recycled scrap will grow.

In the nearer term, we do not expect the market to decline in a straight line. Recent price action for iron ore shows the market is susceptible to changes in sentiment, particularly among the steel mills purchasing iron ore. The expectation of rising prices, fuelled by government rhetoric, can quickly lead to large swings in short term prices as steel mills restock. This is despite the market being oversupplied, as seen in the growth in iron ore port stocks in China. However, we see these restocking events as cyclical noise around a longer term declining trend. Total steel in China's economy continues to rapidly accumulate as the country consumes at much faster rates per capita than its middle-income peers. Though not expected, further stimulus could improve the near-term outlook for steel

Exhibit 10: Minimal reinflation in shale well costs will put a cap on shale breakevens, hence oil prices ($/bbl)

Change in breakevens disaggregated into three components: cost per well, well productivity, and other factors



Source: Morningstar, EIA, Rystad

making materials, but this will effectively be at the expense of future demand as more of China's steel runway is used up. At current consumption rates, China's per capita accumulation of steel in its economy will reach Western world levels in a decade.

Like steel, China accounts for approximately 50% of global copper demand, and of China's copper demand, 80% reflects investment driven spending, which we expect to rapidly slow. China's surplus of savings provided a pool of cheap funds to fuel the investment boom, however, with the decline in the working age population in China, there will be a significant reduction in funds available. Weak jewellery demand for gold has shown modest signs of improvement. However, the market remains reliant on robust investor demand. Outsized investor demand means gold is vulnerable to changes in sentiment, either positive or negative, such as in 2013 when ETF's sold off. Gold trades only modestly above our long-term forecast, as elevated geopolitical concerns have fuelled investor demand. However, short term volatility driven by concerns about global stability would not surprise and could provide opportunities for investors. Currently gold is hostage to hawkish central bank sentiment. - *Mathew Hodge, CFA Senior Equity Analyst, Metals and Mining*

Energy

Because of U.S. shale's marginal position on the global oil cost curve, shale break-evens are a key determinant of our unchanged below-consensus long-term oil price expectation of US$60 per barrel Brent. In contrast to others, who point to shale cost re-inflation as a key driver of higher oil prices, we think shale cost gains will be more muted. Shale break-evens have fallen sharply, from about US$90 per barrel (West Texas Intermediate) in 2013 to about US$44 in 2016, and we project them to rise no higher than US$55 by 2020. Sustainably lower shale break-evens mean the era of lower-cost oil is here to stay, but we expect it to move moderately higher from sub-US$50 levels. OPEC attempts to support pricing via quotas are likely only to encourage shale production and further entrench its position as the swing player.

Several Australian energy names, like Santos, are regardless attractively priced in a lower cost oil environment. Woodside, Santos and Oil Search are all materially exposed to Asian gas prices following completion of new LNG export infrastructure in recent years. Our fair value estimates still assume most LNG contracts retain the approximate 80% price link to oil parity, that is US$8.50 per million British thermal units (mmBtu), or 20% above US$ 7.00/mmBtu spot. That's despite recognising the growing importance of US gas prices on export LNG markets. Even were the long-standing oil-LNG pricing mechanism to erode faster than anticipated, we still think strong Asia-Pacific demand growth will support US$8.50 LNG prices on a cost basis. US gas is cheap, but considerably more expensive to ship to Asia than for well-placed Australia exports. Otherwise our mid-cycle Australian domestic gas price assumption remains A$7.60, important for Santos and juniors like AWE, where lower pitched domestic contracts are rolling-off. - *Mark Taylor, Senior Equity Analyst, Oil & Gas and Mining Services*