December 2016

Outlook for Investment Markets

Global financial markets have been focussed on the implications of the Trump administration and, more recently, on the impact of the Fed's decision to start going further down the path to more normal interest rates. On balance, equities have benefitted, as investors have looked to somewhat improved global growth prospects, mostly down to likely faster growth in the United States. Income-oriented asset classes, however, have been badly hit as short- and long-term interest rates have risen, and there is likely more pain to come. In Australia, the economic outlook remains hard to read, with both positive and negative signals, but the most likely assessment is that the economy is still performing below par and does not yet have the momentum to deliver strong improvement in profits (outside the mining sector). Growth-related assets will also face headwinds as valuations are reassessed against higher bond yields.

Australian Cash & Fixed Interest — Review

Short-term interest rates have been steady: The Reserve Bank of Australia has been leaving the cash rate unchanged at 1.5% (most recently at its Dec. 6 meeting), and other short-term rates have followed suit, with the 90-day bank bill yield currently trading at a little over 1.75%. Long-term interest rates have continued to follow postelection U.S. bond yields upwards: The 10-year government-bond yield, which was 2.3% before the election, has risen steadily to its current 2.75%. This has caused sizable capital losses: In the December quarter to date, the S&P/ASX Australian Government Bond Index has lost 4.0%, and the year-to-date return has dropped to 2.2%. The Australian dollar has weakened in headline USD terms, from USD 0.77 just before the U.S. election to USD 0.742 currently, largely reflecting the global postelection rise in the USD: The widely followed DXY index of the USD's overall value is up 4.4% since the election. The AUD's overall value, however, is down only marginally (down 0.3%) over the period, and, for the year to date, the AUD is up 4.1%.

Australian Cash & Fixed Interest — Outlook

As has been the case for a while, the RBA's policy statements have said nothing about what the RBA will do over time (all they have said is that today's setting is OK for now). This has left room for a variety of forecasters' views, but in recent weeks they have tended to come together, and most of the big banks now think the RBA will leave the cash rate at 1.5% throughout next year. The futures market is also pricing in the same outlook, though with a hint of a possible small rise in interest rates toward the end of next year. NAB, however, has become concerned about potential near-term weakness in the economy (as noted in the "Australian Equities" section), and currently thinks the RBA will need to help things along with two 0.25% cuts to the official cash rate next year, bringing it down to 1.0%. Either way, investors in cash and bank deposits look likely to experience ongoing low returns for some considerable time yet.

Previous local forecasts for Australian bond yields have been left well adrift of actual developments–notably the 0.6% increase in the 10-year U.S. Treasury bond yield since the U.S. presidential election and the probability of further increases to come. Updating the previous views is still a moving feast, and most estimates still look on the low side: The 10-year Commonwealth bond yield is already up to the sorts of levels forecasters did not generally expect before the end of next year. Putting precise figures on likely local future yields is consequently somewhat problematic until U.S. conditions settle down, but the general direction looks clear. Bond investors are likely to facing further capital losses over the coming year, although the yield on new bonds will also become progressively more attractive: A yield in the low 3% would offer some reasonable inflation-adjusted value.

Forecasts for the AUD are also in the melting pot: Currently, the bank forecasters expect the AUD to continue to fall against the globally strong USD, and by the end of next year the AUD is expected to be somewhere between USD 0.68 and USD 0.72, but those views could well be adjusted a bit more towards a lower USD cross rate in coming months, especially as the USD has risen further in the wake of the Fed's interest-rate hike.

Australian & International Property — Review

The A-REITs have also borne the brunt of rising bond yields, with a sharp fall of close to 20% from their peak in early August, before the rising bond yield story started to have its impact, to their cyclical low point in mid-November. Since then, the A-REITs have shared to some degree in the global equity market rally, with prices up by close to 8% from the low point. The net effect is that the S&P/ASX200 A-REIT Index for the year to date has provided a capital gain of 4.6% and a total return including dividend income of 7.9%, results that are broadly in line with the performance of the wider sharemarket.

Global listed property shows the same pattern, rising strongly to an early August peak before suffering a sharp setback, and then recovering to a relatively modest degree in December. For the year to date, the FTSE EPRA/NAREIT Global Index in U.S. dollars has delivered a year-to-date net return of 3.9%. Among developed economies, the U.S. did best (net return of 6.0%), slightly ahead of Japan (4.1%). The eurozone returned a loss of 1.7%, with very mixed outcomes indeed ranging from a small 2.3% return from the relatively well-performing German market to the 21.2% loss from the financially distressed Italian market. U.K. property shares have also suffered heavily from the Brexit vote, with a loss of 23.6%. Emerging markets performed strongly: As with bonds, investors were hunting for better yields than those available in the developed world, and emerging-markets property equities were much in demand, returning 19.7%.

Australian & International Property — Outlook

The latest data from the Property Council/IPD Australian All Property Index (these days, part of the MSCI family of indexes) give a clear insight into the performance of Australian property. Total returns have been impressive: 12.2% in the year to September (13.4% for offices, 11.9% for industrial, 10.5% for retail). But the composition of the return is unusual. The income component (from rents, for example) has been gradually sliding in recent years, which partly reflects the limited ability of landlords to raise rents in a slower-than-usual economy. The capital component, on the other hand, has been steadily expanding: Over the past year, it made up roughly half of the overall return and reflected property revaluation gains as long-term interest rates fell.

The tide has started to turn, however, as bond yields have started to rise and the gusher of capital gains is being turned off. The A-REIT sector has already gone some considerable way to taking the new environment on board: The substantial slide in share prices from August through November meant that the sector largely got back to reasonable levels of valuation from its previously expensive pricing. As one example, the current yield from the sector (around 5.0%) offers a pickup of some 2.25% compared with the current 10-year Commonwealth bond yield, which is slightly above its long-term average. On present A-REIT pricing, investors are being offered reasonable value: The risk is that bond yields keep rising and require some further discounting of the A-REITs to restore relative valuation balance.

For global property, ongoing growth in the world economy, boosted a little more recently by prospects of faster economic growth in the U.S., is helpful and will provide some support for the sector. As Colliers International said in its recent report on the outlook for U.S. property next year, "Overall, we expect that economic fundamentals will keep property markets strong in 2017 and going into 2018. Interest rates are still low and many institutional investors are sitting on record levels of capital targeted to the property sector, all of which should maintain demand for the near term, despite policy uncertainties that may keep some capital on the sidelines."

The recent reaction of the sector to higher short-term and long-term U.S. interest rates, however, suggests that relative valuation reassessment is likely to be a bigger driver of sector performance than economic growth or pent-up demand for further property acquisition. There is still a reasonable gap between the yield on global property (around 3.8%) and the yield on global fixed interest (1.65%), but it has the potential to narrow further, as recent sharp rises in bond yields have shown. Global REITs may hold their own if bonds stabilise, but look vulnerable if, as seems more likely, bond yields edge up a bit further.

Australian Equities — Review

Australian shares have done reasonably well, and have followed overseas markets higher: The S&P / ASX200 Index is up by nearly 2% for the month to date, and the recent rise means the index is up 4.7% in year-to-date capital value and has provided a net total return of 9.2%. The sectoral pattern is as before: Ongoing and very large rises, from a depressed starting point, for the resource stocks, which are now up 55.5%; a drag from the large but weak financials sector (down 7.6%); and other sectors in between, with the industrial doing reasonably well (up 5.0%), mixed results from consumer stocks (discretionary, up 3.0%; staples, down 2.4%), and somewhat weaker IT stocks (down 3.9%).

Australian Equities — Outlook

The economy continues to give off mixed signals which, taken together, suggest that business activity is still growing at a relatively subdued rate.

The biggest item of news was the unexpectedly large drop (down 0.5%) in gross domestic product in the September quarter, which meant that the economy had grown by only 1.8% in the year to September. While there was a fortuitous bunch of things that all happened to go the wrong way in the same quarter, and the number consequently understated the true state of the economy, nonetheless it showed that the economy was not growing robustly enough to absorb assorted shocks around the country (such as weather-related setbacks to housebuilding).

Since then, there has been remarkably good news from the labour market: There were 39,100 new jobs in November, well above the 17,500 or so that forecasters had expected, and they were all full-time rather than part-time jobs. Even if the unemployment rate rose by a tick, to 5.7% from 5.6%, that in itself reflected the fact that more people had decided to enter the labour force, which is usually taken as a sign of people's confidence that there are jobs to be had.

But on the other hand there was also an unexpectedly bad outcome from the latest (December) Westpac/Melbourne Institute survey of consumer confidence. As part of the survey, consumers are asked about their recall of recent news, and clearly the surprise fall in GDP is part of the answer: Perhaps consumers will feel more upbeat as that impact wears off. But for now, they have turned more pessimistic on every single subcomponent of the survey, with a clear drop (for example) in their expectations for the performance of the economy over the next 12 months.

Business surveys show a mixed picture. The Australian Industry Group sector indexes are reasonably good: On the latest readings, manufacturing and services are growing, though construction is contracting. The National Australia Bank (NAB) survey, however, is markedly more downbeat: Commenting on the November readings, the bank said that "We are becoming increasingly concerned about the underlying momentum in the economy as evidence mounts that the non-mining economy is losing steam. The downward trend in business conditions and signs of weakness in the Q3 National Accounts – beyond one-off influences such as poor weather – lend further support to this view".

In sum, the data are not showing any clear signs that corporate profitability is likely to accelerate anytime soon. Official statistical data on company profits in the September quarter showed very little or no growth in profits outside the mining sector; the NAB's survey measure of profitability, while still positive, has been sliding all year. As it stands, investors in Australian equities are paying a reasonably expensive price–16.3 times projected earnings, on Standard and Poor's calculations–for a distinctly modest profits outlook. The economy needs to show some improvement on current performance if equities are to progress from current levels.

International Fixed Interest — Review

The rise in U.S. bond yields in November that followed the election of Donald J. Trump has continued into December and got a further small boost from the Fed's decision on Dec. 14 to raise short-term interest rates, with the target range for the Fed-funds rate being raised from 0.25% to 0.50% to a range of 0.50% to 0.75%. As a result, the 10-year U.S. Treasury yield has risen from 1.86% before the election count started to its present 2.58%.

Other major global bond yields have felt some modest impact, though ongoing easy monetary policy in the eurozone and Japan mean that bond yields there remain very low. The 10-year German government bond yield is still only 0.3%, compared with the 0.2% before the U.S. election, and its Japanese equivalent is marginally positive (0.08%) compared with its marginally negative yield before the election.

The impact of the U.S. move, however, has been big enough to take overall measures of the global bond market into negative territory. The Barclays Global Aggregate Index in USD, for example, is down by 0.4% for the month to date, with U.S. Treasuries, in particular, responsible for much of the decline. At the longest end of the Treasury market, for example, where the capital impact of rising yields is felt most strongly, the Barclays index of Treasuries with maturities of over 20 years is down 2.2% this month.

For the year to date, the Barclays Global Aggregate in USD has returned 2.2%, with government bonds returning 1.9% and corporate bonds 3.9%. In a year where there has been precious little yield on offer from developed economy government bonds and high-quality corporate bonds, investors have been piling into alternative fixed-interest assets: The two big beneficiaries have been emerging markets (the Barclays USD Emerging Markets Index has returned 9.3%) and "high yield" (lower credit quality) bonds, which have returned 14.0%.

International Fixed Interest — Outlook

The Fed's increase was widely expected, as interest rates clearly no longer needed to be as low as they have been. On the Fed's latest forecasts, the U.S. economy is likely to be growing at only a modest rate (2.1% next year), but this will be enough to keep the unemployment rate acceptably low (at 4.5%) and for inflation to get back to where the Fed wants it to be (a 1.9% inflation rate for personal consumer spending).

The Fed signalled that it is currently minded to raise interest rates three more times next year, which would bring the Fed-funds target range up to 1.25% to 1.50%. The immediate reaction of market analysts was that the Fed had overestimated the likely extent of rate increases this year and might still be on the high side for potential rises next year, but either way the period of near-zero short-term interest rates in the U.S. looks well and truly at an end.

Higher short-term rates, the prospect of ongoing U.S. economic growth and easier fiscal policy, and, especially, the likelihood that U.S. inflation will be running at around a 2% rate over the next few years have already combined to lead to a strong rise in U.S. bond yields, and further rises look likely: A 10-year Treasury yield of 2.6% does not look sustainable if inflation does indeed average 2.0%. Forecasters' expectations for U.S. bond yields are consequently being revised: In November, *The Wall Street Journal*'s panel of U.S. forecasters had been picking that the 10-year U.S. yield would be 2.5%, but this month the consensus estimate has been hiked to 2.8%, and further revisions upwards are to be expected in coming months.

The outlook for international bond returns will remain challenging, although the extent of bond price weakness will be limited by ongoing easy monetary policy outside the U.S. The European Central Bank said on Dec. 8 that it will continue its very easy policy setting at least to the end of 2017, though it will scale back the extent of its "quantitative easing" buying bonds (to keep prices high and yields low) from April of next year. Similarly, the Bank of

Japan, immediately after the Fed rate hike, said that as well as keeping the 10-year Japanese government bond yield around zero, it would also be buying longer-maturity bonds to keep 15- to 30-year yields low as well.

That said, bonds were always due for some eventual normalisation from their exceptionally low post-global-financial-crisis levels, and even if the catalyst has come from a quarter that very few people had expected and has taken longer to happen than most people thought, it now looks under way. There is still a portfolio insurance case for global fixed interest–as Brexit, the Trump election, and the Italian referendum have shown, there is still a good deal of geopolitical uncertainty, and plenty of room for further upsets (the French presidential election, for example, or an Italian banking crisis). In uncertain times, bonds can often be an effective safe haven. But global economic fundamentals are currently running against the asset class and against the "bond surrogates" (infrastructure, property, high dividend equities) that investors had been accumulating in the previous era of ultra-low bond yields.

International Equities — Review

Soon after the surprise U.S. presidential election result, world share markets rose as investors realised that the largest short-term impact was likely to be a boost to the U.S. economy from looser fiscal policy, and world shares continued to rise during the rest of November. Share prices rose more rapidly in the first week of December and at time of writing had risen a bit more again: For the year to date, the MSCI World Index in USD terms is now up 6.7% in capital value and has provided a net return (including the value of taxed dividends) of 8.8%. In AUD terms, however, some of the net return was eroded by the 2.6% rise of the AUD against the USD this year.

Although many markets have booked good price rises in December, in year-to-date terms gains have been heavily concentrated in the U.S. market: The MSCI World ex U.S. is showing only a marginal 0.9% capital gain in USD terms for the year to date. In the U.S., the S&P500 is up 11.1%, and the Dow has flirted with cracking one of those iconic round numbers that markets from time to time get excited about. In any event, it has not quite cracked the 20,000 mark. At its highest, it closed at 19,966.43 on Dec. 14, and has dropped back a little since after the Fed's interest-rate increase.

Despite a good December to date, other developed markets have shown little or no year-to-date gains. European shares are down 1.7% (going by the FTSE Eurofirst 300 Index), a loss worsened by local-currency appreciation against the euro, with Germany (DAX up 5.0%) the best of the big euro economies. Japanese shares are up slightly in yen terms (Nikkei up 1.1%) and have also booked a slight local-currency gain. In the U.K., the FTSE100 may be up 11.6% in capital value in sterling terms, as the U.K. economy has been weathering the Brexit surprise better than expected, but local investors have been hit by the sharp fall in the pound (the NZD is up 22.9% against the pound for the year to date).

Overall, emerging markets have done well, with the MSCI Emerging Markets Index in USD terms up 10.5% in capital value, but, again, there have been strong regional divergences. Investors needed to be in the strong markets of Brazil (Bovespa, 36.7%) and Russia (FTSE Russia, 59.4%). The other key emerging economies did not deliver, with not much to show for the Indian market (Sensex, 2.2%) and an outright loss in China (Shanghai Composite negative 10.9%).

International Equities — Outlook

The latest data out of the U.S. have been mixed. The key indicator for financial markets is currently the jobs numbers, and they have been solid, but both November retail sales (up a marginal 0.1%) and industrial production (down 0.4%) fell short of analysts' expectations.

In the current state of sentiment, however, the markets have been less concerned about near-term indicators and more focussed on possible changes to policy – particularly personal and corporate tax cuts and increased infrastructure spending–which have the potential to boost

GDP in 2017 and beyond and improve the outlook for corporate profitability. There may also be moves to address the problem of the very substantial profits U.S. companies have been holding overseas (because of the relatively high U.S. corporate tax rate) and which would also have various positive effects if encouraged to repatriate.

The improved outlook for the U.S. economy is evident in a number of areas. *The Wall Street Journal* panel of forecasters has upped its latest estimate of GDP growth next year to 2.4% (previously 2.2%) and will likely raise it further in coming months. And the first postelection business survey run by the National Federation of Independent Business, an industry group representing small businesses, showed sharp rises in expected business conditions: Before the election, business owners had been mildly downbeat on the outlook (the survey had shown a net balance of negative 6), but postelection business confidence had jumped up to 38.

The latest expectations for U.S. profit growth (collated from share analysts' estimates by U.S. data company FactSet) are also encouraging. The currently expected 11.4% profit growth in 2017 for the S&P500 companies is distorted by a massive turnaround in energy company profits, but looking at the detail of other sectors, a good 2017 lies ahead for most of them (ex especially interest-rate sensitive sectors, such as the U.S. REITs and the utilities). Expected profit growth ranges from 4.3% for industrials and 6.9% for consumer staples, at the lower end, to a robust 10.7% for financials and 10.9% for IT. Again, these numbers are probably going to be revised higher in coming months as the exact shape of the incoming administration's policies becomes clearer.

Outside the U.S., the economic outlook in the main developed economies is less robust. In the U.K., conditions have been artificially boosted by the sharp fall in sterling, which has markedly improved exporters' competitiveness, but the U.K. has yet to experience the reality of what is likely to be less favourable post-Brexit access to the eurozone. The latest data (on October jobs) showed that total employment dropped by 6,000 against an expected 50,000 increase, which may be an early signal that the immediate postreferendum pickup in activity may already be losing oomph. In the eurozone, conditions remain generally weak. Industrial production, for example, unexpectedly dropped in October by 0.1%: It had been expected to pick up after a 0.9% fall in September. And in Japan, the latest "tankan" business survey showed some modest improvement, but it was largely concentrated in the energy sector, and there is no clear sign that the overall economy is managing to accelerate.

Overall, a stronger outlook for the U.S., strong growth in some emerging markets (especially China and Russia), and little change to the subdued outlook for the eurozone and Japan add up to better prospects for global corporate profitability. In the latest (December) survey of institutional fund managers run by Bank of America Merrill Lynch, the respondents had turned markedly more positive about the outlook for global activity and for global corporate profitability (expectations are at a six-and-a-half-year high). Their asset allocations have correspondingly been adjusted towards equities (towards Japan in particular, which is seen as offering good value, but also towards the U.S., while the eurozone has been cut back) and away from bonds.

There is consequently something of a tailwind behind global equities, and it may persist well into the New Year as investors continue to reassess the outlook, with in all probability progressively higher expectations for the U.S. economy yet to be factored in.

At the same time, the new bullishness needs to be tempered, as there are various wild cards that could derail the rally. One is progressively higher cash and bond yields: Equity valuations still contain some froth from relative valuation calculations based on historically unusual low cash and bond rates. Another is the absolute valuation of U.S. equities: After the recent rises, the S&P 500 is now trading on a trailing P/E ratio of 24.9 times earnings, a degree of expensiveness that could leave shares vulnerable to earnings disappointments. Another is geopolitical uncertainty: While investors have been quick to bank what they see as the economic upside of the Trump administration, there is still no clarity around its foreign policy intentions or how they will mesh with existing hot spots (in Syria, for example). Finally, there is the prospect of the eurozone blowing a political or financial gasket, which was the biggest worry mentioned by fund managers in the BofA Merrill Lynch survey. Cautious optimism may well be warranted, but the "cautious" element needs keeping front of mind.

Performance periods unless otherwise stated generally refer to periods ended December 13 2016.

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