Economic Update

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Outlook for Investment Markets

Cash and bond yields have dropped to new lows as central banks have sought to boost growth and inflation and as investors have sought safe assets like government bonds in a climate of high political risk from the US-China trade tensions. Lower yields have boosted the valuation attractiveness of equities, and income-oriented sectors like property and infrastructure have been in particularly high demand. Looking forward, the most recent analyses suggest the world economy can keep the current business expansion going into 2020, but against a background of sizeable downside risks, notably from the trade conflicts. In New Zealand, the economy has slowed down from 2018's pace of growth, and although the profit outlook for 2020 looks better, local equities are now expensive by both historical and international standards. They may continue to be supported, however, by further cuts in local interest rates.

New Zealand Cash & Fixed Interest—Review

Short-term interest rates are 0.4% lower for the year to date, reflecting an easing in monetary policy: the 90-day bank bill yield is now just under 1.6%. Long-term yields have followed the strong downward trend observed across many developed economies in recent weeks, and the 10-year government bond yield of 1.67% is now 0.7% below where it started the year. The New Zealand dollar has also moved lower, and for the year to date is down by 2.7% against the US dollar and by 1.9% in overall trade-weighted value.

New Zealand Cash & Fixed Interest—Outlook

The Reserve Bank of New Zealand cut interest rates on May 8, and the general expectation at the moment is that it will cut again: Inflation has persistently been running below the bank's target 2%, and some extra policy oomph will be needed to drive it higher. Futures pricing suggests another 0.25% cut by this time next year, but some economists see the bank cutting twice. Either way, returns from bank deposits are heading even lower.

Bond yields also look to stay at low levels. The current hunt for safe-haven assets looks likely to persist if trade frictions continue to worry investors and will lead to ongoing demand for government and other high-quality bonds. In the Budget on May 30, for example, the Treasury's forecast was that the 10-year bond yield would average 2.3% over the coming year.

If the Reserve Bank continues to cut interest rates faster than the US Fed looks likely to, then the New Zealand dollar is likely to remain on the weak side. The ANZ Bank, which was one of the earliest forecasters to pick that the RBNZ would be cutting rates, thinks that two more rate cuts could see the kiwi dollar drop from its current US 65.3 cents to 63 cents in a year's time. As well as the pressure from interest-rate differentials, market conditions like today's "risk-off" environment, where investors are concerned about geopolitical trade risks, also tend to see currencies like the kiwi dollar sold off as investors retreat to the safety of their home currencies.

New Zealand Property—Review

In a world where interest rates on cash and bonds have fallen to even more unusually low levels, it is not surprising that asset classes with relatively attractive dividend yields have been doing well. The S&P/NZX All Real Estate Index for the year to date has delivered a capital gain of 15.4% and a total return including dividends of 17.8%, modestly outperforming the (itself strong) wider share market.

New Zealand Property—Outlook

The latest index data from the MSCI/Property Council of New Zealand showed that the operating environment for real estate has been supportive. The total return (capital gain and income) across all property classes was 10.6% in the year to March 2019, slightly better than the 10.4% earned in the previous year. There was the usual tiering of returns, with industrial property to the fore (13.5%) and retail property returns bringing up the rear as retailing

continues to face the growing challenge of online commerce.

Since those data were compiled, the economy has slowed down somewhat, but not enough to make any large difference to operating conditions in the sector. Ex retail, tenant and investor demand remains strong and the availability of space (despite some new offices coming on stream in Auckland) is generally tight, particularly for industrial property. The combination of reasonably good operating conditions, and a 4.1% dividend yield when the 10-year bond yield is now well below 2.0%, suggests that the sector will remain in demand from investors, even though valuations are getting on the expensive side by historical standards.

Australian & International Property—Review

As with New Zealand listed property, the A-REITs have also been buoyed by lower yields on fixed interest. The S&P/ASX 200 A-REITs Index is up 18.8% in capital value and has returned 19.6% including dividends, again outperforming the wider share market.

It has been exactly the same story overseas, where global REITs have also outperformed by a modest margin. Including the taxed value of dividends, the FTSE EPRA/NAREIT Global Index is up 15.2% in US dollars, a bit ahead of the MSCI World Index's equivalent return of 14.4%. Other than in the emerging markets, which recorded a small loss, gains were widespread, led by the strong North American market (net return of 18.2%).

Australian & International Property—Outlook

The business outlook in many respects resembles the overall national economic outlook: patchy, with some areas doing well but others lagging. Top of the heap are industrial sectors everywhere, and the Sydney and Melbourne central business district office markets. As JLL noted in its latest Asia-Pacific property digest report, in the March quarter "Melbourne CBD vacancy tightened further to 3.7%, the lowest recorded rate in the market since 1988." Conditions in the residential development and retail sectors, on the other hand, are difficult. In the Sydney retail market, for example, JLL says that "Due to the increased competition from online and overseas retailing, leasing conditions should continue to be challenging over the next 12 months."

Underlying performance overall is consequently likely to be mixed, but that is unlikely to deter investors from the A-REITs. As the currently busy volume of corporate activity shows, with bids for existing REITs and floats of new ones, interest in the sector is high, with the big attraction being the now wide differential between the yield on the A-REITs (4.5%) and the sharply lower 1.4% yield on a 10-year Commonwealth bond. Further gains look likely as investors chase yield, particularly as valuations, despite the recent price rises, are still reasonable. Standard & Poor's latest estimate is that the A-REITs are trading on an undemanding price/book ratio of 0.87.

Overseas, while it is true that the global business cycle has slowed somewhat this year, conditions are still reasonable. As Cushman & Wakefield's latest (June) global macro outlook puts it, "the global backdrop is still pretty good, just not as good. And property markets have performed just fine when growth was 'good but not great'–this time shouldn't be any different."

Even with slower growth, Cushman & Wakefield estimates that "job growth remains steady. The global economy is tracking to create close to 29 million net new jobs this year. That will translate into 79,000 new jobs per day and another 250 million square feet of office absorption in markets around the world. We can double that figure on the industrial-logistics side." And the lower interest rates that slower growth has helped bring about have been helpful for the sector, both through reducing interest costs and taking pressure off the "cap rates" used to value property.

As long as there is no major shock to the global economy–a big "if" in the current trade war environment–investors look likely to continue to support the sector, principally on the strength of the wide differential between the 3.9% yield from the sector and the very low (or even negative) returns now on offer in the major bond markets.

Global Infrastructure—Review

No prizes for guessing the recent performance of global listed infrastructure: It has been as buoyed by lower bond yields and the subsequent search for yield as other income-oriented asset classes. For the year to date the S&P Global Infrastructure Index in US dollars has returned 17.5% (including the value of taxed dividends), and slightly more (18.3%) when hedged back into New Zealand dollars.

Global Infrastructure—Outlook

Much of the recent popularity of the sector is clearly down to the enhanced relative attraction of the sector yield (4.3%) when compared with what little is now on offer from bank deposits and government bonds. It may also be the case that investors are opting for relatively defensive assets, in case the current global cycle succumbs either to old age or trade war (or other) shocks. As infrastructure manager Cohen & Steers argues, "global listed infrastructure has tended to deliver strong absolute and relative returns in late-cycle periods, outperforming global equities by an average of 5% annually."

There is also evidently a great deal of private equity money trying to get into the sector, while not enough investment opportunities are becoming available. Cohen & Steers estimates that there is "a record [US] $180 billion backlog of dry powder looking to buy infrastructure assets," which is likely to support the prices of existing assets and of the listed entities that hold them. With valuations on the sector still reasonable, despite the unspent money still looking to find an infrastructural home, the sector looks likely to continue to perform well.

Australasian Equities—Review

New Zealand equities have enjoyed a long run of good performance–over the 10 years to end May, the S&P/NZX 50 Index delivered a remarkable total return of 13.9% a year–and the good run has continued this year, with the index for the year to date up 14.3% in capital value and delivering a total return including dividends of 16.2%.

Australian shares have generally underperformed in recent years–at the start of this year prices were still roughly where they had been four years earlier–but the past few months have been a good deal better. With a local interest-rate cut and an unexpectedly business-friendly outcome from the general election, for the year to date the S&P/ASX 200 Index is up 16.1% in capital value and has returned 18.3% including dividends. While most sectors did well, there were especially large capital gains for miners (24.0%) and IT stocks (23.1%); consumer staples stocks (9.0%) were at the back of the pack.

Australasian Equities—Outlook

The latest indicators show a consistent picture of the New Zealand economy hitting a slower patch of growth. The Reserve Bank had cited slower growth when it cut rates in May, and the latest (May) business survey by the ANZ Bank found that "Most ANZ Business Outlook activity indicators were little changed in May, at levels consistent with the slower growth the economy is experiencing."

The current consensus is that business activity will pick up over the next year. In the Budget, for example, the Treasury said that "Real GDP growth is projected to pick up over the six months to December 2019 and peak around 3.0% in 2020, supported by solid growth in government spending, accommodative monetary conditions and rising investment."

Hopefully the pickup will do something to improve the outlook for corporate profitability, which up to now has been weak. The businesses responding to the ANZ Bank survey, for example, remained pessimistic about profits and have been downbeat ever since early 2018. The Budget data contained estimates that business profits will have been virtually static (recording a marginal 0.6% gain) over the June year just finishing.

The Budget predicted that business profits will recover significantly, and forecast profit growth of 7.6% in the year to June 2019 and of 6.3% in the year to June 2010. That may be on the optimistic side, but whatever the exact outcome turns out to be, some decent-sized rise in profits needs to materialise to go some way to validate the current expensive valuation of New Zealand equities. On Standard & Poor's calculations, shares are trading on a historic P/E ratio of 21.4 times earnings and a prospective ratio of 23.4 times expected earnings (significantly more expensive ratings than either Australia or the US). The risk is that after their multiyear strong run, share prices may now be unusually vulnerable to earnings disappointments.

In Australia, the economic indicators continue to be mixed. If you went by the latest (May) Commonwealth Bank performance indexes of manufacturing and services, you would be reasonably cheery about current business conditions. The bank said that overall its indexes are "signalling a return to growth of private sector business activity. The latest reading reflected a stronger expansion in services and a return to growth of manufacturing production."

If the National Australia Bank May business survey is to be believed, however, "Business conditions weakened further in the month and are now well below average–the key message remains that the private sector continues to lose momentum. The goods distribution industries (especially retail–which is clearly in recession) remain particularly weak, and manufacturing is not far behind."

In similar vein, some of the other indicators have been stronger than expected–notably the much better-than-expected 42,300 extra jobs in May–while others have disappointed. Consumer confidence (as measured by Westpac and the Melbourne Institute) is also a tad weaker, while their leading index is also falling. Westpac said that "The index growth rate has been consistently negative over the last five months, a clear signal that economic growth through the three quarters of 2019 is likely to be below trend."

Overall it looks as if the economy is still growing at some modest rate: It is certainly not growing as fast as the Reserve Bank would like. Its rate cut (and probably more to come) is aimed at picking up the tempo of growth and driving unemployment down to 4.5% or below, compared with today's rather soggier 5.2%.

The immediate outlook for corporate profits in this lacklustre environment is not strong. Credit Suisse, for example, expects that while earnings per share at the ASX 200 companies will grow by 9% this year, the profit growth is entirely down to the mining sector (where profits are expected to be up 38%), while every other sector will be going backwards.

Credit Suisse think 2020 will be rather better (11% profit growth, again somewhat flattered by a further 14% gain for the miners). Upbeat profit forecasts need approaching with a degree of caution at the moment, given the international trade risks and the various ramifications of sharply lower Australian house prices, but if anything like Credit Suisse's expectations comes to hand, then there could be further buying support for Australian equities.

International Fixed Interest—Review

There have been remarkable developments in world bond markets. The key move has been the sharp drop in US bond yields, where the 10-year Treasury yield is now only 2.08%, down 0.6% since the start of this year. Yields in

other major markets have also dropped. The yield on the 10-year German government bond, for example has turned negative (currently negative 0.25%), and already negative yields in Japan and Switzerland have become even more so. Otherwise lucid investors are now paying the Swiss government 0.48% a year to hold its 10-year bonds.

Bond investors have benefited from the associated capital gains, and for the year to date the Bloomberg Barclays Global Aggregate Index in US dollars has returned 4.2%, with government bonds up 3.7% and corporate bonds up 6.3%. The higher-risk end of the asset class has done especially well, with both global "high-yield" (low credit quality) and emerging-markets debt returning 7.8% in US dollars.

International Fixed Interest—Outlook

With hindsight, it is possible to figure out the main reasons bond yields have dropped so much. One was that the Fed had indicated that it might reverse course and work interest rates back down again. Another was that investors were desperately keen to find safe assets as global trade frictions intensified. Even without the trade worries, some investors were also in all likelihood taking out early insurance against the late-cycle risks of the US or world economies weakening.

But that is looking backwards: In real time analysts were largely blind-sided by the latest developments. In May, for example, the large group of US forecasters polled by the *Wall Street Journal* had expected the US bond yield to be 2.6% in June, and the Fed to leave interest rates unchanged this year and next. They were out by a full 0.5% on the bond yield, which for an interest rate a month away is a large error by forecasting standards, and have hurriedly changed their expectations for both bonds and Fed policy. They now think the 10-year bond yield will rise to just 2.5% by the end of next year, and they expect the Fed to cut interest rates at least once. The US futures markets are also picking either one or two 0.25% cuts this year.

How much reliance investors can place on the latest views is debatable, however. They look plausible enough: The Fed has not got inflation definitively back to the 2% it would like to see, so perhaps interest cuts are a possibility, especially as the US economy looks to be slowing down next year and could do with a bit more monetary policy support. And bond yields have fallen to such low levels that investors are losing money on an after-tax after-inflation basis and should arguably move a bit higher to offer a more reasonable return.

But there are such high levels of uncertainty around the trade disputes in particular that even reasonably plausible scenarios for US bond yields may be swept away by the geopolitics. An ugly outcome to the US trade tensions could see investors even more worried, sending the benchmark US bond yield below 2.0%. Equally a benign outcome could see the current flight to safety unwind, perhaps as sharply as it developed. Yields outside the US look a little easier to call, at least as far as monetary policy goes: The central banks in the eurozone, the UK and Japan all look set to keep interest rates at their current very supportive levels.

Unattractive as fixed-interest yields appear, perhaps the best course for investors through the current trade uncertainties is to hold a reasonable level of insurance against further trade dispute volatility while avoiding disproportionate exposure to the lower-quality end of the asset class. The quality of debt issuance has been deteriorating, and the credit premium for holding it has become insufficient for the underlying credit risks.

International Equities—Review

World shares have performed well in June but have not yet retaken all the territory lost when fractious US trade disputes with China, and more recently Mexico, threatened to disrupt global economic growth.

Fortunately, the good spell of share performance before the trade talk setbacks, added to the past few weeks' gains, mean that for the year to date the MSCI World Index of developed markets is up 13.1% in US dollars (14.4% including taxed dividends).

In the developed markets, gains have been dependent on the US market, where the S&P 500 is up 15.2%: ex the US, world shares would have gained a more modest 9.4%. European shares have done better than the European economic outlook might suggest, and the FTSE Eurofirst 300 Index is up 12.0%, while UK shares have managed a 9.2% gain despite the hash its politicians are making of Brexit. The weakest of the major markets has been Japan, where the Nikkei is up 5.5%.

Emerging markets' potentially large exposure to global trade shocks means that equity gains have been considerably more subdued than in the developed world. The MSCI Emerging Markets Index in US dollars is up 5.1% for the year to date, with the core BRIC economies (Brazil, Russia, India, China) up 7.8%. Investors needed to be relatively adventurous to earn BRIC returns: By far the largest gain was in the volatile Russian market, with the FTSE Russia Index up 29.8% in US dollars.

International Equities—Outlook

Looking ahead, the most likely outlook–absent trade war setbacks–is that the world economy will continue to provide some fundamental backdrop support for equities, which will also be boosted by the increased attractiveness of equity dividends in the new low-bond-yield environment.

Over the past month two of the big international forecasting institutions came out with their latest predictions. The World Bank thought that 2019 isn't turning out as well as it had previously expected: It now thinks the world economy will grow by 2.6% this year rather than the 2.9% it had picked in its previous set of forecasts.

But the better news is that it thinks the current global business expansion is still intact and that the world economy will keep growing, by 2.7% next year and by 2.8% in 2021. These modest rates of growth are, however, contingent on the wheels not falling off: As the bank put it, "Risks are also firmly on the downside, in part reflecting the possibility of destabilizing policy developments, including a further escalation of trade tensions between major economies; renewed financial turmoil in EMDEs [emerging markets and developing economies]; and sharper-than-expected slowdowns in major economies."

The same conditionally guarded modest optimism emerged from the Organisation for Economic Cooperation and Development. It agrees that there has been a slowdown this year and also agrees that next year could be a bit better. But it too lists a catalogue of possible upsets: "a prolonged period of higher tariffs on trade between the United States and China; further steps to raise new trade barriers, particularly additional tariffs on trade between the United States and the European Union; a failure of policy stimulus to prevent a sharper slowdown in China; continuing policy uncertainty and prolonged sub-par growth in Europe, including lingering uncertainty about Brexit; and financial vulnerabilities from high debt and deteriorating credit quality."

On the plus side, though, the OECD is also open to the idea that some of these risks could yet play out well: "decisive actions by policymakers to reduce policy-related uncertainty and strengthen medium-term growth prospects, including measures that reduce barriers to trade, would improve confidence and investment around the world."

If the economics is left to play out, equities could continue to make further gains, and (as noted in various places earlier) the more income-oriented and defensive end of the equity spectrum has been doing particularly

well and looks likely to continue to benefit from the search for yield in a low-interest-rate world.

But it is a big "if" whether the economics will prevail or whether the "wholesale weaponisation of economic tools," as the *Economist* recently described the Trump administration's policies, will derail the expansion. The magazine said that "the risk of a clumsy mistake that triggers a financial panic is high": all investors can do is hope that the global expansion rolls on for a while yet, despite the risks, while building in adequate levels of portfolio insurance against worse eventualities.

Performance periods unless otherwise stated generally refer to periods ended 14 June 2019.

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