Economic Update

Auckland | 19-11-19

November 2019

Outlook for Investment Markets

While geopolitical risks remain high, at the moment investment sentiment has turned more positive on a potential (if only partial) resolution of the U.S.-China trade disputes. Growth assets have consequently benefited, while the prospect of a pick-up in world growth, and reduced demand for defensive boltholes, have led to sell-offs for bonds and bond proxies. Provided geopolitical risks do not re-emerge to disturb business and investor confidence, the central outlook is for ongoing global growth into 2020, albeit with the balance of risks loaded to the downside. In New Zealand, recent data has been modestly encouraging about the prospects for business activity, although several local asset classes continue to look expensive.

New Zealand Cash & Fixed Interest — Review

There has been little change to short-term interest rates, with the 90-day bank bill yield a little above 1% (currently 1.09%). Long-term yields continue to feel the impact of overseas trends: in the U.S. the 10-year Treasury bond yield has risen by 0.35% since early October, and its local equivalent has done much the same, from just over 1.0% in early October to 1.44% now. Although there is still a good deal of day-to-day volatility, in overall trade-weighted value, the New Zealand dollar appears to have broadly stabilised in recent months. Its weakness early in the year, however, means that year-to-date it is still down 3.6% in overall value.

New Zealand Cash & Fixed Interest — Outlook

Most forecasters had picked that the Reserve Bank of New Zealand, or RBNZ, would cut interest rates again at its Nov. 13 Monetary Policy Statement, but instead it elected to leave the official cash rate at 1%. While it is still open to the idea of cutting rates in the future, saying "We will add further monetary stimulus if needed", its own forecast for the cash rate suggests at most there might be one further 0.25% cut in the pipeline. Bank depositors can at least take some comfort from the fact that returns have, finally, gone as low (give or take) as they are going to, but there is unlikely to be any improvement from current low levels for some considerable time. The bank's forecasts suggest it will be late 2021 or early 2022 before rates start rising again.

Several local forecasts for bond yields have been left somewhat behind the run of play, as the recent rise in U.S. bond yields has helped local bond yields to rise to levels that forecasters had not been expecting this early in the piece. The RBNZ's latest (December quarter) survey of expectations has also been left rather high and dry for the same reason. Perhaps the best assumption to make for the time being is that U.S. bond yields will continue to rise (always assuming there is no big setback to the U.S.-China trade talks). Currently U.S. forecasters expect a rise of about 0.25% in U.S. yields in 2020, and local yields are likely to at least match that rise. Unusually, local yields have been trading below U.S. yields, and a correction back to normal relationships might see local bond yields having to rise faster than American ones.

The recent steadiness of the kiwi dollar may well persist in coming months. One downward pressure looks to have abated: with both the Fed and the RBNZ now likely to stop cutting rates, interest rate differentials are unlikely to widen against the kiwi dollar. Market opinion is now of the view the kiwi dollar will hang around its current levels. In the RBNZ's survey of expectations, respondents said they expect it to be around USD 0.63 and AUD 0.92 in September 2020, only slightly below current levels.

New Zealand Property — Review

Investors have had a very good run in listed New Zealand property. Year-to-date, the S&P/NZX All Real Estate index has made a capital gain of 22.4%, and delivered a total return including dividends of 26.0% (26.8% with imputation credits). The year-to-date return, while strong and ahead of the wider sharemarket, has eased back in recent weeks as prices have retreated from earlier levels with REIT prices dropping 5.5% since a recent high on Oct. 22.

New Zealand Property — Outlook

Operating conditions in the sector remain solid. Although the economy has been going through a softish patch, it has had little impact on demand and supply conditions in the property markets. Colliers' latest (September quarter) survey of commercial property investors shows that overall investor confidence remains strong, with Auckland industrial, and Auckland and Wellington office markets, particularly in demand. As in overseas markets, retail conditions are weaker, which is likely to be a result of the ongoing impact of e-commerce than any cyclical effect.

As the recent price declines have shown, however, valuation issues are beginning to count more than operating conditions as a driver of sector performance. It is no coincidence the recent declines mirror rises in local bond yields as although there is still a comfortable differential between the yield on the sector and returns available from bonds, the tide has started to turn and yield-oriented support is not quite as strong as it was. It has not helped that the previous hunt for yield had driven prices to expensive levels (a premium of around 20% to the value of the properties owned by the REITs). The sector still has solid defensive appeal, but future performance looks likely to be more modest.

Australian & International Property — Review

The A-REITs have done well year to date. The S&P/ASX 200 A-REITs index is up 20.0%, and has returned 23.6% including dividends. The sector has slightly lagged the wider sharemarket with the total return from the S&P/ASX 200 at 25.1%.

Global listed property has also produced good returns, with the FTSE EPRA/NAREIT Global index in U.S. dollars up 16.5% in capital value and providing a total return including dividends of 20.5%. As with the wider equity markets the North American markets were strongest (25.3% return), while emerging markets (14.4%) and the Asia-Pacific region (13.9%) were the back markers.

Australian & International Property — Outlook

The latest (September quarter) National Australia Bank survey of commercial property showed "Confidence softened against a backdrop of below trend economic growth," although from a more positive perspective, the absolute level of sentiment is broadly in line with long-term averages. Respondents are saying that overall conditions are middling rather than outright poor.

The overall response cloaks very varied performance by sub-sector. The office and industrial sectors are the areas where capital growth and rental increases are expected to be strongest (albeit quite modest increases are expected even in those markets). Retail remains very difficult, with rents reported as falling over the past two quarters, and are expected to keep falling over the next two years. The NAB survey does not cover residential-oriented REITs, but it is likely that they are in a happier state in recent months given the ongoing recovery in house prices in the major cities. CoreLogic's data for October showed another rise in national house prices, which have now risen for four months in a row.

The main issue for the sector is valuation. So far, rising bond yields have only had a modest impact, with A-REIT prices trading sideways rather than falling (as they typically have in overseas markets), and investors still enjoy a decent yield pickup compared with bonds. But the combination of a gradual narrowing in yield pickup, high prices relative to the value of the properties owned, and the middling operating outlook suggests that future investment performance will be challenged.

Overseas, recent market analyses have principally focused on the impact of slower growth in the world economy. JLL's latest *Global Market Perspective*, for example, said "The synchronised slowdown in the global economy is starting to filter through to real estate market activity with a slight moderation in investment and leasing volumes expected, albeit from record levels."

In the same vein, the latest (September quarter) global commercial property monitor run by the Royal Institution of Chartered Surveyors said that "Although the key indices monitored ... have only edged lower in a modest way, there is still a sense from respondents that the real estate cycle is gradually moving into a downturn phase. In terms of the key group of markets that we focus on, more than half of all contributors are now suggesting that the sector is either in a downturn phase or approaching a floor for the cycle compared with roughly two-fifths previously too, it may be that we have passed the high water mark for income-oriented REIT demand."

Since those reports, the global outlook has perked up a bit on greater optimism about trade dispute resolution, which helps the sector, but on the other hand, bond yields have risen, and the global REIT index has consequently been dropping back from its early October peak. The cross-currents suggest the recent strong price rises will be difficult to repeat.

Global Infrastructure — Review

Year-to-date, the S&P Global Infrastructure index in U.S. dollars has delivered a net return (capital gain plus taxed dividends) of 21.4%, modestly underperforming the MSCI World's 23.4%. Hedging back into New Zealand dollars improved the return to 22.6%.

Global Infrastructure — Outlook

Like global listed property, infrastructure has been feeling some of the cold draught from rising bond yields: share prices have fallen in November. The asset class also carries the weight of expensive valuations from the peak of the "hunt for yield" period. At the end of October, the index was trading on an expensive 2.2 times its book value.

But despite the valuation overhang, the sector still has two sources of ongoing appeal for investors. One is that in a period of ongoing geopolitical risk, it is likely to continue to appeal as defensive insurance. As ASX-listed infrastructure vehicle Argo said in its latest (September) quarterly report, "This is because during periods of weakening economic growth and higher levels of market risk, investors tend to favour more defensive assets" such as essential utilities.

The other is that it offers exposure to some attractive longer-term themes in energy and the digital economy. As CBRE Clarion said in their latest (September quarter) market commentary, "There are also secular [long-term] themes we believe will support growth even in an uncertain economic environment, including most notably: (1) decarbonization in energy supporting renewable and natural gas infrastructure investments; and (2) rapid data growth globally resulting in organic growth for companies that facilitate transmission, processing and storage of data." While there may be a degree of trendiness to them, akin to the current high demand for logistics-oriented industrial property, they may well help to support investment outcomes.

Australasian Equities — Review

New Zealand equities have had a good year to date, with the S&P/NZX50 index year up 19.9% in capital value and returning 23.6% including dividend income (24.7% counting the value of imputation credits).

Australian shares have also done well. The S&P/ASX 200 index year to date is up 20.3% in capital value and has returned 25.1% including dividends. IT shares continue to do best, with a 35.5% capital gain, but most other sectors have also had a good outing, particularly consumer discretionary (up 28.3%) and the industrials (up 24.8%). The mining shares have gained 17.2%. The financials are the relative laggards, up 11.8% with recent challenges including the share price dilution from Westpac's planned

AUD 2.5 billion capital raising, as well as the impact of dividend cuts by National Australia Bank and Westpac.

Australasian Equities — Outlook

In New Zealand the latest business surveys suggest the economy may be picking up from a period of hesitancy. The October Bank of New Zealand/Business NZ surveys of manufacturing and services both improved from previous levels, and the BNZ commented: "Between the two of them, they now indicate annual GDP growth of closer to 2% than the 1% they portrayed just months ago."

The same picture of some modest improvement came through in the ANZ Bank October survey, which found that "firms' own activity expectations, profit expectations and employment investment intentions lifted a smidgen. Life on the prairie for the average business may not be stellar but it looks solid."

But how much of this modest turn for the better will flow through to corporate profits is debatable. In its November Monetary Policy Statement the Reserve Bank said "A theme that has come through in both business surveys and our business visits is that firms' margins are being squeezed. Firms are facing increased costs, but most feel unable to pass on these costs to consumer prices. The three main reasons cited for compressed margins were increased online competition, increased price transparency, and fixed-price contracts." While some of the big names in the S&P/NZX 50 index may be more sheltered behind protective moats, in general the current outlook is not strongly supportive of profit growth, and New Zealand shares continue to look expensive. The NZX 50 index is trading at 24.8 times expected profits on Standard & Poor's latest calculation.

In Australia, the economic indicators continue to point to ho-hum business conditions. The latest official data has been outright poor—retail sales in September were markedly weaker than expected, and the October jobs data showed a completely unexpected drop of 19,000 jobs when forecasters had been looking for a 15,000 increase. The unemployment rate rose a bit, to 5.3%.

Business surveys do not show as weak a picture, but they confirm a period of sluggish business activity. The results from the latest (October) National Australia Bank business survey "continue to point to only modest outcomes in the business sector, though forward-looking indicators have improved slightly and may be pointing to a stabilisation in conditions ... our read is that the survey continues to point to weak outcomes in the private sector, and that business' own outlook is for more of the same."

Along similar lines, the Commonwealth Bank's performance indexes are also underwhelming. Its index of the services sector in October showed that "subdued growth of the service sector occurred concurrently with the weakest increase in new business for seven months. Anecdotal evidence suggested the wider economy had lost some momentum and the business environment had become more challenging."

It is not the most congenial environment to expect strong corporate profit growth. The RBA in the November Monetary Policy Statement pointed out that what profit growth there has been recently was heavily concentrated in the mining sector, that profits in the financial sector were steady, but in other sectors "underlying profits for listed companies outside the resources and financial sectors declined slightly compared with the same period last year." The global firming in equity sentiment, and further cuts in local interest rates, may help sustain the recent solid performance of Australian shares, but there is some risk of an eventual disconnect between ever higher equity prices and the earnings results companies are likely to put in the window.

International Fixed Interest — Review

As has been the case for some time, international bond and equity markets have been very responsive to changes in sentiment about global growth. Over the past month, sentiment has improved significantly, mainly in response to signals the U.S.-China trade frictions might be reaching at least a provisional truce on some of the items in dispute. Respondents to the latest (November) Bank of America Merrill Lynch, or BAML, survey of big fund managers reported a dramatic improvement in expectations. A large majority (a net negative 34%) had been pessimistic in October, but this changed to a small optimistic majority (positive 6%) in November, which was the largest month-on-month change in sentiment in 20 years.

Bond yields have consequently risen: the 10-year Treasury yield in the U.S. is now 1.83%, well up on its recent cyclical low below 1.5% in early September. Yields have also risen in other major bond markets. In Japan, for example, the 10-year yield was nearly negative 0.3% in early September, and is now negative 0.07%.

However, the recent increases have not been large enough to make much of a dent in the capital gains recorded earlier in the year when bond yields had fallen sharply, and the asset class is still ahead for the year to date. In U.S. dollars the Bloomberg Barclays Global Aggregate index is up by 6.1%.

International Fixed Interest — Outlook

Increased optimism about the global economic outlook has been the key driver of higher bond yields, and (providing there is no sharp setback on the U.S.-China trade talks), is likely to lead to further rises in yields in coming months.

Another contributory factor pointing towards higher yields is the indication from the Fed that it has stopped easing monetary policy. On Oct. 30, the Fed cut its target range for the federal-funds rate by 0.25%, to a 1.5% to 1.75% range, but made it clear that this third cut is the last in the current easing cycle, provided the economic outlook remained in reasonable shape. The futures market agrees, seeing little near-term chance of further easing. The Chicago Mercantile Exchange's FedWatch tool, based on futures prices, currently shows the most likely outlook is for the Fed to hold interest rates steady out to mid-2020, with some chance of a 0.25% cut later in 2020.

Forecasters in the latest (November) poll run by the *Wall Street Journal* expect U.S. bond yields to rise modestly in coming years, by about 0.25% in both 2020 and 2021. Monetary policy still on ultra-easy settings militate against similar rises in the eurozone and Japan, but even there the recent trend to (at least) less negative interest rates looks likely to travel further.

Provided the world economy does not hit a reef—and the trade wars could still take it onto the rocks—it looks as if the global macroeconomy may be slowly shifting back up from ultra-low yields. Bonds will still have insurance value—not to be discounted going into the U.S. presidential election campaign, in particular—but the economic backdrop is running against them.

That is certainly how the BAML managers are positioned. They overwhelmingly believe equities will be the best performing asset class over the next year, with very few takers for bonds to do well, and over the past month they have increased their underweight allocation to fixed interest. It is also interesting that "a bond bubble" is their second most picked investment risk (after trade wars). Between investors chasing yield at almost at any price, and central banks pursuing aggressive (and unconventional) monetary policy ease, bond prices had got to unsustainable levels. A gradual unwind of overvaluation looks a likely outcome.

International Equities — Review

It has been a good month for world shares, which have been heartened by the Fed's latest interest rate cut and by signs of progress on the U.S.-China trade dispute. Much of the media attention has focused on the S&P 500 index in the U.S. hitting new record highs. It hit a new peak on Oct. 21 and has moved higher since. World shares have got less notice, but they too have moved into all-time record territory. In the MSCI World index of developed markets in U.S. dollars hit an all-time high on Nov. 1 (going past its previous peak on Jan. 26, 2018) and has also progressed further since then.

Year-to-date, the MSCI World index of developed markets is up 21.2% in U.S. dollars. Performance continues to be boosted by the U.S. markets—ex the U.S. the World index is up by 15.6%—as the S&P 500 (up 24.3%) and the Nasdaq index (up 28.6%) have performed particularly strongly. Eurozone and Japanese shares have also done well, and among major markets, the only clear laggard is the U.K., where Brexit uncertainties have held the FTSE 100 to a relatively small 8.5% gain.

Emerging markets have not done as well as the developed economies: the MSCI Emerging Markets index in U.S. dollars is up 8.6%, and the core BRIC markets (Brazil, Russia, India, China) are up 10.5%. Russia has been the key contributor, with the MSCI Russia index up 34% in U.S. dollars. The asset class threw up some reminders of the relative political instability of the asset class, notably widespread protests in Chile, which until recently had been regarded as a relatively rare example of good economic management in Latin America. The MSCI Chile index is down 18.1% in U.S. dollars year to date.

International Equities — Outlook

The outlook remains much the same as before. Even if the Fed has signalled it is going no further for now, share valuations are still being supported by generous liquidity from the world's central banks, and by the prospect of ongoing modest growth in global business activity. This scenario is however unfolding against a background of ongoing high levels of risk, including geopolitical risk that remains very difficult to analyse.

The business outlook remains moderately supportive. The main concerns have been about the impact of the trade frictions on the U.S. and China.

The good news is that neither of the two principal parties seems to be hugely impacted so far. In the U.S., the latest data on jobs, wage growth and consumer spending have all been positive. In China, there looks to be a greater impact, with the latest statistics showing slower rates of growth than previously, but the absolute levels of growth are still quite strong. Industrial production in October was 4.7% up on a year earlier, and fixed investment up 5.2%.

The downside however is that the uncertainty over the trade spat and its potential collateral damage has spread beyond the two main protagonists. The latest (October) J.P. Morgan Global Composite index, which adds up a wide variety of local business surveys (including ones in New Zealand and Australia) shows that world business activity is still growing, but only slowly: "The global economy made a weak start to the final quarter. The rate of output growth slowed to its joint second weakest during the current seven-year sequence of expansion. New order inflows also rose at a weaker pace, while job losses were registered for the first time in almost a decade."

Three times a year, data company I.H.S. Markit (organiser of the country surveys in the J.P. Morgan index) also produces a global business outlook poll. It found that "Businesses around the world have become gloomier about their prospects...Sentiment has worsened continually since peaking in early-2018, with the latest surveys showing a further erosion of confidence amid trade war tensions, wider geopolitical uncertainty and worries about slowing economic growth or recessions."

While the businesses polled fell short of picking an impending recession—a modest net positive balance of respondents picked ongoing growth—it is evidently not a great environment for corporate profits. Respondents still expect a small increase in profits, but they are much less optimistic than usual: "The outlook for profits had already slipped sharply in the June survey and edged further lower in October, with the net balance of positive 6% running below any levels previously recorded since the GFC and down sharply since peaking at positive 24% in early-2018."

As for the main uncertainty overshadowing business confidence, at time of writing equity markets had risen on expectations that at a minimum a stop-gap "phase one" agreement appears on the cards: as noted earlier, the prospect of some sort of settlement had a dramatic effect on fund manager optimism in the latest BAML survey. The core element appears to include increased Chinese purchases of U.S. goods (particularly soybeans) is exchange for a halt or a rollback of some U.S. tariffs.

But, despite the fund managers' high hopes, the situation remains very unclear. It is not (apparently) settled that there is indeed a quid pro quo agreement, and even if there is, it could unravel if other important points at issue (such as protection of U.S. intellectual property) lead to a breakdown in the negotiations. Both sides also have political considerations high on their agenda, and economic analysis of what might be a reasonable outcome may get sidelined by a tussle for geopolitical advantage.

So far, however, both the global economy and the world's bourses have dodged the bullet, as they have through previous "crises" in the current long post-GFC expansion. It remains a reasonable investment view to expect more of the same. But the ongoing level of risk and uncertainty also makes it advisable to continue to build protection into portfolios (through overall diversification and through more defensive positioning within asset classes) against the real risk that the global equity market's long run of good fortune comes to an end.

Performance periods unless otherwise stated generally refer to periods ended Nov. 15, 2019.

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