Economic Snapshot

July 2016 – 2017 FYE & outlook

In summary

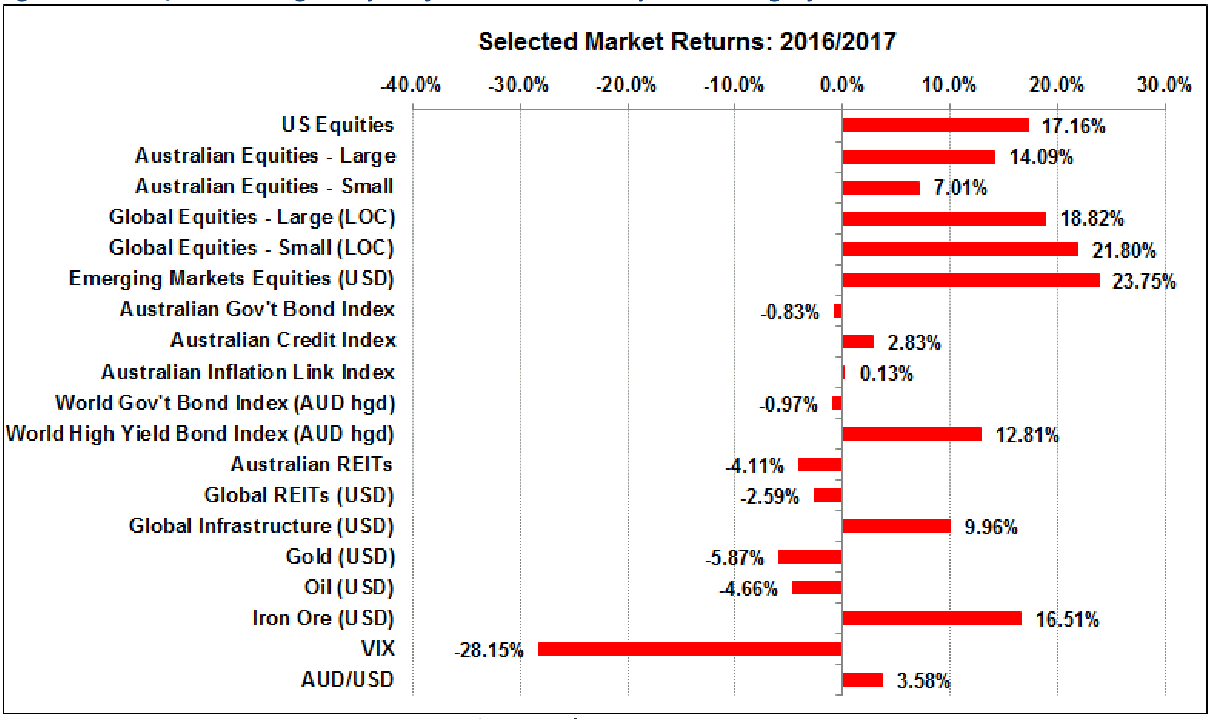
If ever investors wanted proof that uncertainty and political events in markets is a fuse to volatility but that economic fundamentals win, 2016/17 would be a good case study. Despite fears of an uncertain geo-political world results were strong in all equity markets – the area volatility excels.

Financial markets commenced 2016/17 in the wake of the Brexit result just a few days before and offered a frightening outlook. At the same time we had looming elections in Europe, where extremist candidates seemed to be making headway, as well as an unheralded US Presidential election with Clinton vs Trump. As things turned out, the European elections proved more benign than feared, the US election delivered one of the most startling results in decades and markets responded favourably through economic policy stimulus. Who would have imagined that?

After all the turmoil, global equity markets commenced a sustained rally that delivered strong double digit gains for the year as a whole. Other risk (equity) assets, such as high yield bonds, also performed very well. However, government bond markets had a poor year and bond-sensitive equities, such as AREIT's [Australian Listed Property], underperformed with negative returns. In general these developments were driven by investors chasing the "reflation trade" – that is, a view that the world economy was finally entering a period of better growth with moderate inflation.

As 2017/18 starts, risk assets are looking less attractive than a year ago and markets are facing up to the end of the global interest rate easing cycle. **From here on, interest rates go up rather than down, with implications for all asset classes, but most especially bonds and currencies.** At the same time, the pace of global growth looks set to slow down, thereby providing less support for profits and cash flows. Given all this, equity markets sitting on high valuations look vulnerable to many analysts**.**

Figure 1: 2016/17 was a great year for risk assets - equities & high yield bonds



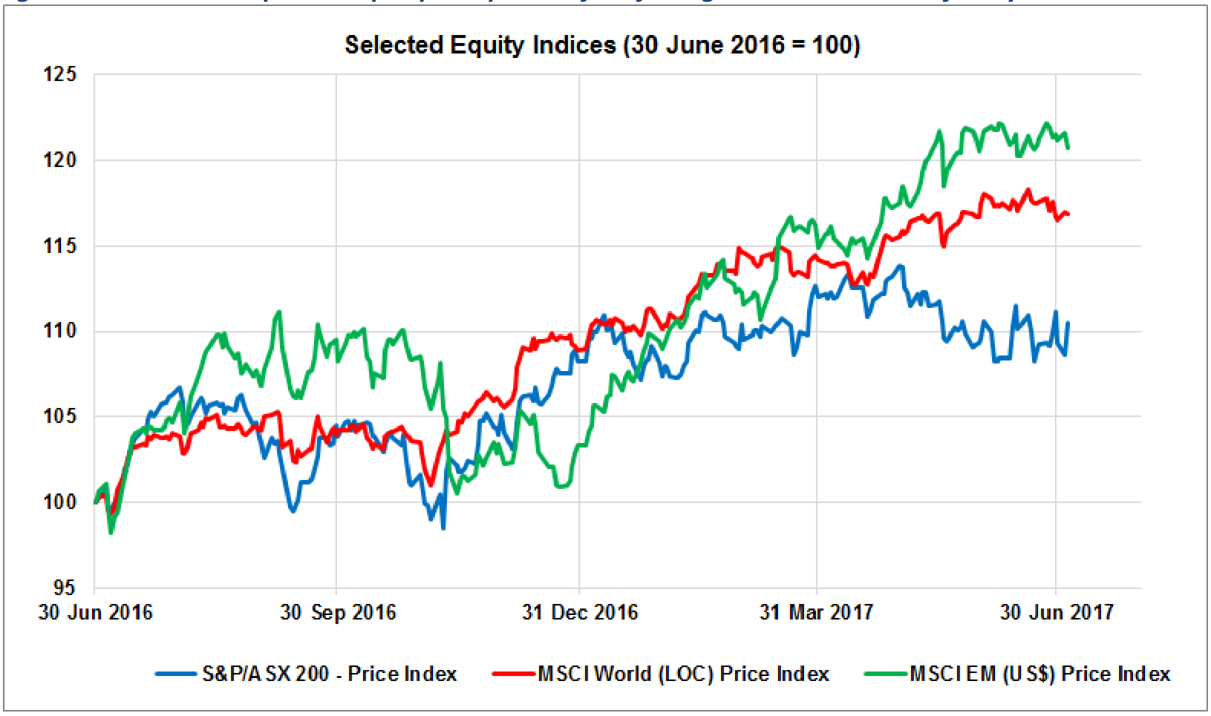
Source: Thomson Reuters

The reflation trade that drove equities higher (see Figure 2) was partly in response to President Trump's election on the back of promised fiscal stimulus for the economy, and partly because the price of oil continued to recover, which was a good sign for the US oil industry. Most importantly, Chinese economic growth also accelerated sharply as the government stimulus program kicked in. This in turn flowed through to the rest of the world, boosting growth in the US, Europe and here in Australia.

At the same time inflation appeared to be picking up and fears of deflation were dissipating. In the US, the unemployment rate fell through 5% and there were signs that both wage and price inflation would accelerate. This, combined with the US Federal Reserve saying it intended to keep lifting the cash rate as part of its policy to "normalise" monetary policy, helped push bond yields up.

This combination of stronger growth and rising inflation offered the prospect of a better environment for corporate cash flows and profits. Investors responded by buying equities and credit rather than government bonds. Commentators dubbed this the "reflation trade" which became one of the big investment themes for 2016/17. Figure 2 illustrates the sustained rally in equities after the US election in early November 2016. Emerging market equities did especially well, benefitting from the higher commodity prices associated with the surge in global growth. Australian equities kept up the pace until Q2 2017 when they started to slip back. Within the Australian equity market, resource stocks and banks performed very well in the first half of the year, but less so in the second half. The Federal Budget's major banks levy, combined with further regulatory pressure to dampen speculation in the housing market, weighed on bank stocks. Bond-sensitive AREIT's underperformed earlier in the year as bond yields rose and never managed to recover all of that lost ground.

Figure 2: Australian equities kept up the pace before fading towards the end of the year



Source: Thomson Reuters

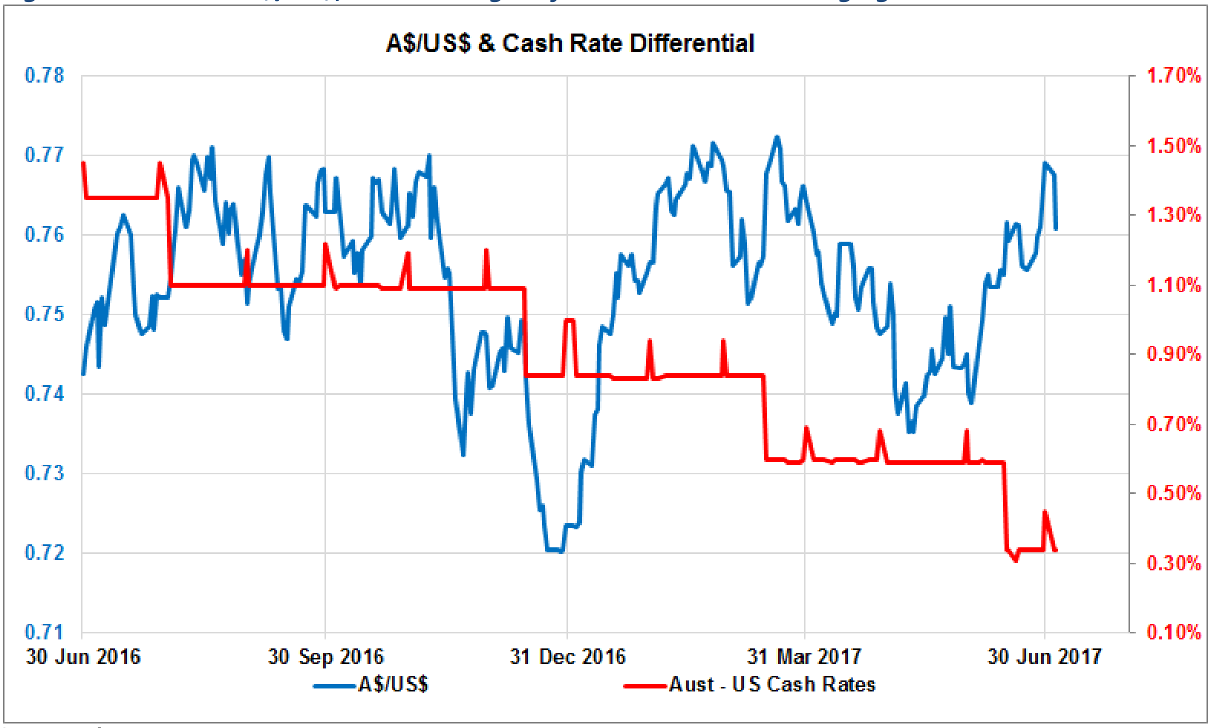
The other big investment theme to emerge in 2016/17 was central banks' efforts to normalise monetary policy. This refers to two things: first, the need to lift interest rates above the emergency levels in place since the GFC and second, the need to remove the excess liquidity pumped into the global economy. Although it is not prudent for these policy settings to remain in place indefinitely, the central banks need to be very careful how they unwind them so as not to upset the financial markets. The US Federal Reserve is in the forefront of the normalisation program, followed by the Bank of Canada and the Bank of England, with the ECB and the Reserve Bank of Australia somewhat further back in the process. A look at how some of these economies have fared over the past 12 months helps explain this.

Australia

In Australia business conditions and manufacturing capacity utilisation improved in 2016/17 as the China growth impulse came through via our exports. The housing market continued to boom with prices moving ever higher, although there are clear signs the boom in dwelling construction on the back of house price inflation is now over. Business investment remains muted and household spending is being constrained by ever-higher mortgage repayments. Most importantly, there has been little progress on inflation and unemployment. The unemployment rate drifted down from 5.75% at the start of the year to 5.53%, while core inflation troughed in the December Quarter before lifting slightly to 1.9%, just below the Reserve Bank's 2% - 3% target range.

Despite the weight of interest differentials moving further and further against it, the A$/US$ proved more resilient than many had expected and kept gravitating back to the US$0.77 level (see Figure 3). The resilience of the A$ has provided an on-going drag to the local economy which the RBA is not comfortable with. That, plus the fact that the RBA hasn't cut the cash rate to zero, like other central banks, means the RBA can be in less of a hurry to start lifting the cash rate again. The RBA cut the cash rate to a record low 1.5% in August 2016 and has left it there ever since.

Figure 3: A resilient A$/US$, but the weight of interest rates is moving against it



Source: Thomson Reuters

United States

Looking at the United States economy, key indicators of growth surged from late 2016 to levels not seen for many years. The labour market continued to improve with solid employment growth and an ever-declining unemployment rate, which started the year at 4.9% and ended up at 4.3%. This is clearly below the level the Fed regards as safe for not creating too much inflation pressure. As late 2016 unfolded, financial markets expected US inflation to keep rising with lower unemployment pushing up wages, but this did not happen. Wages growth did not keep accelerating as unemployment fell and core inflation actually declined in the first half of 2017. As a result, the markets decided the Fed would not be able to lift the cash rate much, if at all, and the US$ slipped, thereby adding to the upward pressure on the A$/US$.

Once again, geopolitics was important in 2016/17 but it introduced upside not downside results. After the surprise result in the US election, the European elections proved more benign than feared, with extremist parties not gaining enough seats to take power. However in the UK the surprises kept coming with the June general election delivering a terrible result for the incumbents. Although the Brexit process will continue, it is unlikely to be as smooth as hoped and further political instability in the UK seems inevitable.

In the Middle East, progress is being made in rolling back ISIS but as that happens the terror group is exporting more of its operations into attacks in key European cities. It is no coincidence that attacks occurred in the lead-up to European elections and for that reason Germany may well become a target later this year. Relations between Saudi Arabia and Iran were tested through the year, culminating in the ultimatum delivered to Qatar to curb activities connected with Iran and state sponsored terrorism.

Tensions also rose between Russia and the West (principally but not exclusively the US) over cyber-hacking and interfering with elections, while North Korea and China's program of island-building add to regional concerns.

Looking ahead….the crystal ball gazing

With thanks and acknowledgement to our support partner Caravel Consulting, Snapshot has again presented an outlook on asset classes in the near future. ***Our natural disclaimer on this is no one can accurately predict the future but economic fundamentals imply the below outcome is feasible. It is also important to recognise these views are not representative of a personal recommendation for investors.***

As we move into the new financial year the reflation trade and normalisation themes are still very much in play. However, while reflation was the dominant theme in 2015/16, normalisation is likely to the dominant theme in 2017/18. Financial markets are now faced with:

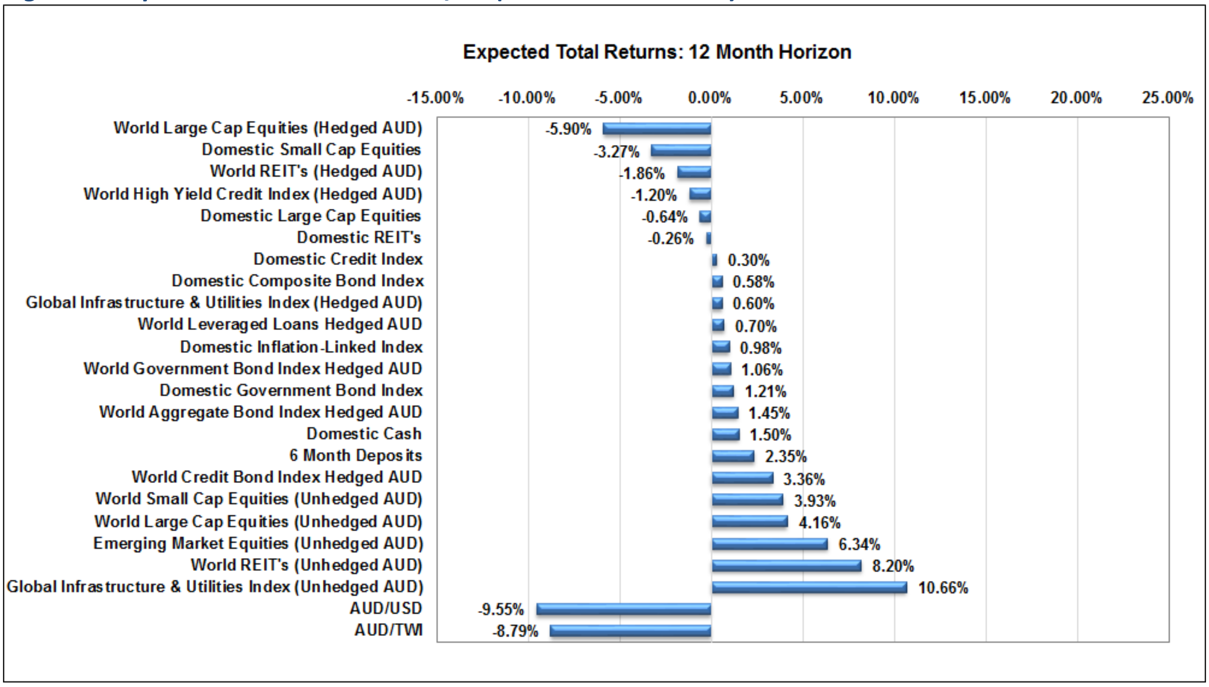
- risk (equity) assets sitting on high valuations, with the prospect of rising inflation and interest rates threatening those valuations;
- slowing economic growth (though no recession) over the coming year; and
- an unusually high degree of investor complacency about equity risk.

This situation is compounded by the fact that markets seem to be underestimating just how much tightening the Federal Reserve is likely deliver in the next 12 months. The markets currently expect no more US rate hikes in 2017 and only one in 2018. The Reserve has indicated it would like to do four rate hikes in that period. The markets' more cautious view is based on the belief that inflation in the US is not going up enough to justify what the Reserve wants to do. However, just as the markets overestimated inflation a year ago, the risk is they are underestimating it now. The markets are also ignoring signals from the Reserve that they really want to get on with normalising monetary policy despite low inflation.

Putting all this together, it is difficult to foresee an attractive set of returns across the asset classes (see Figure 4 below). These 'expected' returns are much lower than we have just seen in 2016/17 (see Figure1). The only meaningful positive expected returns come from further depreciation of the A$/US$ as the Reserve tightens and the RBA leaves the cash rate at 1.5% through the year.

Currency depreciation means that unhedged international equities are the most attractive asset classes, even though the prospects for the underlying equities are less attractive than a year ago.

Figure 4: Expected returns over 2017/18 (base case scenario)



Source: Caravel Consulting

Other key aspects of the outlook include:

- ***Bonds and bond-sensitive assets like REIT's are likely to find the coming year challenging as the global interest rate structure edges higher;***
- ***Resource stocks may be vulnerable to further retracement as the growth impulse fades;***
- ***Geo-politics will continue to worry markets and cause bouts of volatility from time to time;***
- ***Equity markets have become increasingly vulnerable to a pull-back in order to restore value;***
- ***Portfolio diversification will be even more important than ever in the face of a challenging set of expected returns*.**

Finally, as investors we often observe a myriad of confusing and contradictory statements around the economy, markets and asset class movements. The one discipline that creates steady outcomes is diversification. Notwithstanding the outlook at the beginning of 2016, equities performed against the odds. As we enter the 2017/18 the outlook remains as challenging as ever – yet diversification remains intact as a safeguard for not capitulating to forecasts or past returns.