Economic Overview

Worries over geopolitics and the slide in US inflation data are amply offset by the continued and synchronised pick-up in global growth. Despite the relative maturity of the US business cycle, recession risks remain muted and a combination of global earnings upgrades and loose financial conditions are supportive for shares and other risk assets. Globally, central banks remain in mostly dovish mood; and even with balance sheet normalisation in the US and tapering of quantitative easing in Europe set to start, policy around the world is still loose. Equity returns in late cycle are typically positive unless financial conditions tighten sharply. The slow pace of rate normalisation and lack of inflation pressure create a good environment for taking risk. Any deterioration in data, in particular employment, business confidence and consumer lending metrics, may trigger a review of holding risk assets.

President Donald Trump proposed the biggest US tax overhaul in three decades, calling for tax cuts for most Americans, but prompting criticism that the plan favours business and the rich and could add trillions of dollars to the deficit. Trump said his tax plan was aimed at helping working people, creating jobs and making the tax code simpler and fairer. But it faces an uphill battle in the US Congress with Trump's own Republican Party divided over it and Democrats hostile. Analysts were skeptical that Congress could approve a tax bill this year, but that is what Republicans hope to achieve so they can enter next year's congressional election campaigns with at least one legislative achievement to show for 2017.

The plan would lower the top individual tax rate, paid by the nation's top earners, to 35% from 39.6%. It would lower the top corporate income tax rate to 20% from the current 35%. The existing rate is high globally, but many US-based multinationals pay much less than the headline rate because of abundant loopholes and tax breaks. In a step to simplify tax returns, the plan would shrink the current seven tax brackets to three: 12%, 25% and 35%. That would raise the bottom tax rate on low-earning Americans to 12% from 10%, but analysts said other parts of the plan would still mean a net tax cut. The Committee for a Responsible Federal Budget, a Washington-based policy group, estimated the plan contained about $5.8 trillion of total tax cuts over a decade and would have a net cost of $2.2 trillion through 2027.

Target Corp. is raising its minimum hourly wage for its workers to US$11 in October and then to $15 by the end of 2020 in a move it says will help it better recruit and retain top-quality staff and provide a better shopping experience for its customers. Target quietly raised entry-level hourly wages to US$10 last year from US$9 from the previous year, following initiatives by Walmart and others to hike wages in a fiercely competitive marketplace. But Target's hike to $15 per hour far exceeds not only the federal minimum of $7.25 per hour but the hourly base pay at Walmart, the nation's largest private employer, and plenty of its other retail peers whose minimum hourly pay now hovers around $10. As part of its $2.7 billion investment in workers, Walmart Stores Inc. had raised its entry-level hourly pay for workers to $9 in 2015 and then to $10 in 2016. With Target's large influence in the retail, its hike could force some rivals to match the pay in order to compete.

Basking in increased domestic consumption, exports and investment, Germany is expected to grow by 1.9% this year and 2.0% in 2018, according to the latest forecasts, and this is up from estimates earlier this year, when the predicted gross domestic product (GDP) growth was 1.5% and 1.8% respectively. The upswing in the German economy had gained in strength and breadth. The strong global economy and especially the continuing upturn in the eurozone are stimulating exports. Even the current appreciation of the euro against other currencies would only have a limited braking effect.

The number of people out of work across the 19 countries sharing the euro currency edged down further in August, but that the overall unemployment rate remained unchanged at its lowest level since early 2009. The number of jobless fell by 42,000 to 14.75 million. Despite this, the unemployment rate held at 9.1% but is down from 9.9% in August 2016. The country with the lowest overall unemployment is the Czech Republic at 2.9%, followed by Germany and Malta. The highest unemployment rates were recorded in Greece and Spain. Youth unemployment — defined as those under 25 —remained high though. In the eurozone countries nearly 2.7 million youth were out of work, a decrease of 240,000 from the previous month. Here again Greece tops the list with the highest rate of youth joblessness at 43%, followed by Spain and Italy.

The Governor of the Bank of England has warned that the major economic impact of Brexit has yet to be felt, but it was likely to spell a weaker economy, higher inflation and higher interest rates in the coming years. In his latest attack on Brexit, Mark Carney said that it should be seen as a prime example of "de-globalisation", adding that it was likely to dampen UK growth, and that any fall in migration numbers could also push up inflation and force the bank to raise borrowing costs. Mr Carney also said that while economic growth remained relatively resilient so far, it could take many years for the full impact of the transition to be felt by the UK economy, pointing out that any fall in the value of the currency could take as long as four years to feed into domestic prices.

The expansion of Japan's manufacturing sector is accelerating, with the September Manufacturing Purchasing Managers' Index hitting 52.6, a four-month high, up from 52.2 in August. Japanese exports and imports surged in August, with both beating expectations as a recovery in trade appeared to gain momentum. The Japanese economy grew at an annualised 2.5% in the second quarter, more than double its potential growth rate. But while a weaker yen has improved trade data, inflation remains well below the Bank of Japan’s 2% target. Exports to China, Japan’s largest trading partner, rose 25.8% from a year earlier. Shipments to the US increased 21.8%. Those to the EU climbed 13.7%.

China's official manufacturing PMI rose to 52.4 in September. Eight second-tier cities including Chongqing and Nanning in China have introduced new property curbs – some of which comprise banning home sales within two to three years after purchases, giving a strong indication that the Chinese government is not letting up in its drive to rein in escalating home prices in the country. The latest round of cooling measures add on to the numerous restrictive policies imposed by several first-tier cities over the last year, which has since resulted in home prices rising at the slowest pace in seven months in August this year.

The global economy is getting stronger and will grow at the fastest pace since 2011 this year, according to the Organisation for Economic Cooperation and Development. Expansion will accelerate next year, with the biggest economies all contributing, the OECD said in its Interim Economic Outlook. The OECD projects that the global economy will grow by 3.5% this year and 3.7% in 2018, with industrial production and trade picking up and further acceleration in the rebound of technology spending. The projections reflect modest improvements in the global economy since the previous Economic Outlook in June 2017. Growth among the major advanced economies remains on pace. In the United States, growth is estimated at 2.1% in 2017 and 2.4% in 2018, supported by stronger consumer spending and business investment. Job creation has remained strong, but the extent to which fiscal easing and regulatory reform may provide an additional boost in 2018 remains uncertain. The euro area is projected to grow at a 2.1% rate in 2017 and a 1.9% pace in 2018 – upward revisions from previous projections driven by stronger growth in key European countries. Growth in the major emerging market economies has improved overall, helped by a rebound in some commodity producers and public infrastructure investment in China, although growth remains subdued in a number of oil-exporting economies. Growth in China is revised upward, to 6.8% in 2017 and a more moderate 6.6% in 2018, as stimulus measures ease and efforts continue to stabilise corporate debt and rebalance the economy. The Interim Economic Outlook renews calls on policymakers to enact a rebalancing from monetary to fiscal and structural support for growth and wages. It calls for better use of tax and spending policies to achieve more inclusive growth and says increased structural reform efforts will be needed across all countries to boost productivity, wages and skills.

Interest Rates & Currency

US Federal Reserve chair Janet Yellen has confirmed that the central bank will begin winding down its purchases of US Treasury and mortgage-backed securities in October. The decision to begin reducing the Fed's balance sheet came as no surprise to financial markets, given it has been widely telegraphed for several months. The Fed's balance sheet reduction will start with asset sales of US$10 billion per month, and is expected to accelerate to US$50 billion per month over the next 12 months. If the assets sales go ahead as planned the Fed's balance sheet will reduce from its current US$3.5 trillion to US$3 trillion in three years' time.

Yellen said the Fed needs to continue gradual rate hikes and it would be imprudent to leave rates on hold until inflation reached the Fed's 2% target. Yellen's term as chair expires February 2018, and the view is that Yellen may move for an interest rate increase prior to her term expiring, so as to provide the new chair time to consider the next interest rate increase. Vice Chairman Stanley Fischer has said he will leave the Fed in October. In addition, there are two other Fed governor vacancies that need to be filled. Indications are that President Trump may not nominate Yellen for a second term.

Although the Eurozone economy is recovering, it is not yet helping deliver a sustained adjustment in inflation levels towards the European Central Bank's target, Chief Economist Peter Praet said. *"While the euro area recovery remains solid, broad-based and resilient, the economy has yet to make sufficient progress towards a sustained adjustment in the path of inflation to levels that are consistent with the Governing Council's aim,"* Praet said. *"A very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up,"* he added.

In September, the Bank of England's monetary policy committee voted 7-2 in favour of holding interest rates at 0.25%. The Bank of England has raised the prospect of an interest rate rise as early as November, in an attempt to relieve the squeeze on living standards from surging prices and sluggish wage growth.

Bank of Japan policymakers said they should stick with their current policy framework and had reason to be optimistic about consumer prices because measures of inflation expectations have stopped falling, minutes of the central bank's July 19-20 meeting showed. The BOJ now expects inflation to reach 2% sometime in the fiscal year ending in March 2020. The BOJ has postponed the price target timeframe six times since Kuroda launched his massive asset-buying programme in 2013.

The Bank of Japan has continued to increase its presence in the Japanese stock market, replacing foreign investors as the biggest buyer in terms of accumulated purchases for the first time since the so-called Abenomics market started in November 2012. Foreign investors account for roughly 70% of trading in Japanese shares, but they tend to opt for near-term trading. In contrast, the BOJ holds on to the shares it buys. With the bank doubling the annual pace of ETF purchases to 6 trillion yen in July last year, the amount of ETFs it holds has steadily increased. The forecast is for the number of listed companies of which more than 10% is indirectly owned by the BOJ will increase to 29 in March 2018 from 12 in December 2016.

The RBA's October board meeting again held the cash rate at 1.50% as widely expected. RBA Governor said in an earlier speech that better global growth and higher interest rates do not necessarily mean rate hikes here. While he said *"the next chapter is a return to more normal monetary conditions globally"*, he argued *"A rise in global interest rates has no automatic implications… in Australia,"* albeit *"would, over time, be expected to flow through… just as the lower interest rates have"*. Lowe is also aware rate hikes could push up the currency, by arguing that *"Our flexible exchange rate though gives us considerable independence regarding the timing as to when this might happen"*. UBS view is *"Overall, we stick to our view the RBA will hold until 2H-18, and take some comfort from Lowe's speech which was on the dovish side of expectations. However, it remains clear that the risks have shifted to an* *earlier move in 1H-18, given the degree to which global growth has improved, and central banks have turned more hawkish."*

No change in the RBA cash rate is expected in the near term. Our preference remains for both short dated fixed-rate and floating-rate securities of high investment grade corporates.

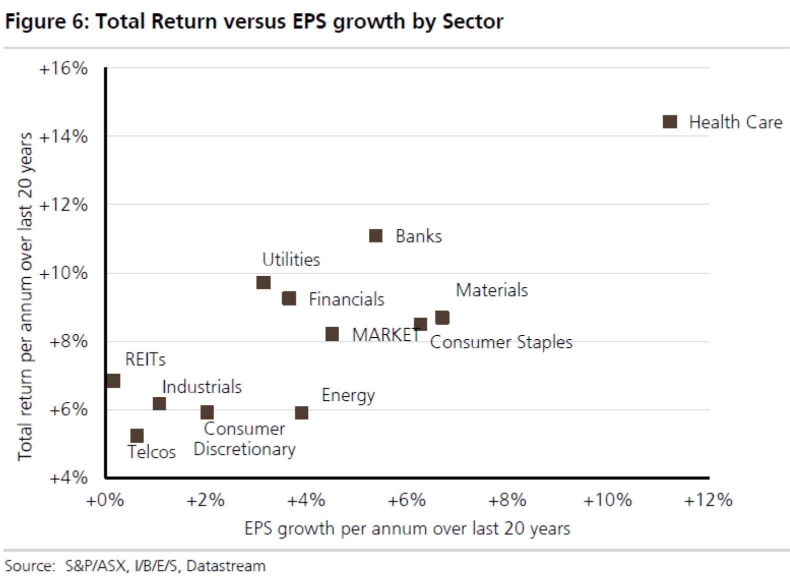
Closing Rates as at 30 September 2017					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	1.0600%	1.1600%
90 Day Bank Bills	1.73%	1.76%	AUD/USD	78.39	78.98
180 Day Bank Bills	1.76%	1.77%	US 10 Year T-Bond	2.35%	2.15%
5 Year Govt Bonds	2.370%	2.244%	US 30 Year T-Bond	2.88%	2.76%
10 Year Govt Bonds	2.847%	2.721%	Japan 10 year yield	0.075%	0.009%

Stance: Corporate - Positive variable rate and investment grade
Government - Underweight

Australian Shares

According to UBS, *"Health Care stands out as the best performing Australian sector by a wide-margin and has outperformed its global peer group, driven mostly by strong earnings growth and P/E multiple expansion to a lesser extent. However, the Health Care sector's current high P/E may pose some risk for sector performance going forward. Beyond Health Care, both long-term performance and earnings growth tends to drop away quite sharply and show a lot less consistency. Banks have performed reasonably well over the long-term. Earnings growth (5.4% pa) for the sector has been well above market, though it has lagged system credit growth (9% pa). The large shortfall between the credit growth backdrop and delivered EPS growth may call into question sector growth prospects as we move into a period of much lower system credit growth. The lack of earnings growth achieved in most sectors over the long-term, against a backdrop of relatively good economic conditions, is somewhat sobering. The challenge for Australian companies will be to improve the conversion of moderate economic growth into earnings per share growth. We believe that this bolsters the argument for not just sector-selection but quite a focussed bottom-up stock-picking approach to the Australian market, alongside higher global equity allocations in a broader context."*

[1] Previous rate or level represents the rate or level as at the end of the previous month.



Total returns are also well correlated with earnings growth, though the impact of dividends/dividend yield is also apparent.

The franked dividend yield above the term deposit rate continues to provide support for equity valuations. With the low cash rate, we believe there should be continued support for equity valuations and gross yields from equities.

Closing Rates as at 30 September 2017					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,744.9	5,776.3	AOX Earnings Yield	6.49%	6.41%
PE Industrials (2018)*	15.5x	15.7x	Div Yld Indust (2018)*	4.8%	4.7%
PE All Ords (2018)*	15.4x	15.6x	Div Yield All Ords (2018)*	4.5%	4.4%

*Source – UBS

Stance: Neutral

International Shares

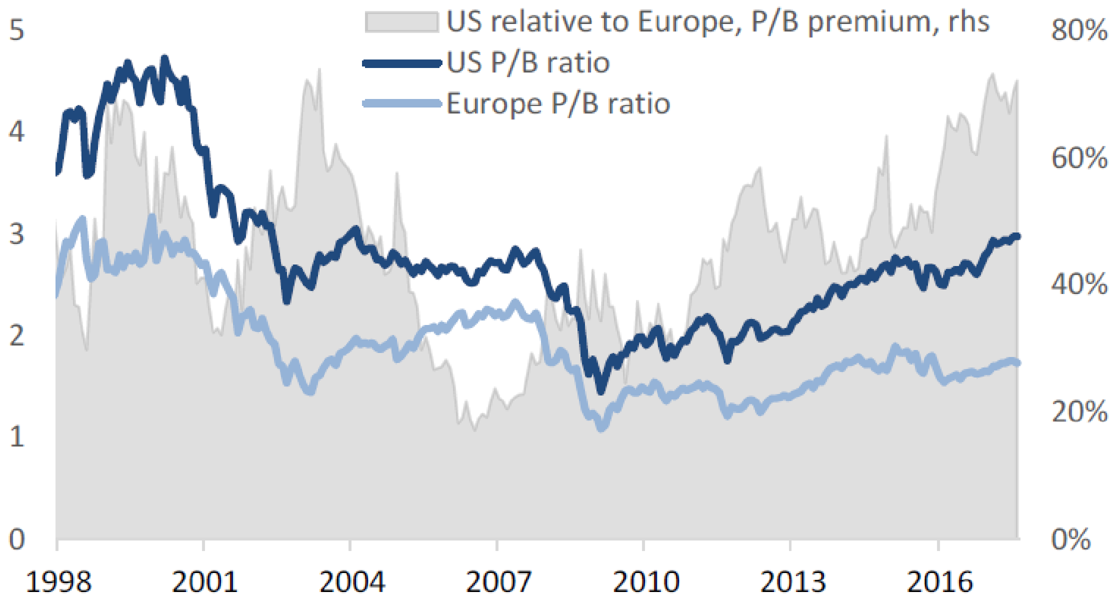
Deutsche Bank's view is *"Over the past two decades investors have bestowed a persistent valuation premium on corporate America relative to European companies. Many longstanding structural factors, such as higher profit margins and tax policy, explain this transatlantic gap. However, investor behaviour over the past few years has driven the valuation differential to near record-highs. Even if the structural differences remain intact in*

[1] Previous rate or level represents the rate or level as at the end of the previous month.

the near future, the impending withdrawal of quantitative easing presents a test for the endurance of America's super-sized equity valuations.

Much of the significant price-to-book premium that US companies enjoy comes down to corporate America delivering higher returns on equity thanks to higher margins. In addition, US companies also benefit from a lower cost of equity because of the appeal of dollar assets for international investors, lower realized volatility, and lower effective tax rates on payouts to shareholders. What might cause an increase in the cost of equity for US companies? One possible catalyst would be the withdrawal of quantitative easing and further rate hikes by the Federal Reserve if this leads to a reduction in investors' appetite for cash payouts from companies. Over the past five years, the cost of equity for US companies has declined from 10.5% to 8%. This drop was driven by companies in America boosting their shareholder payouts – including dividends and buybacks – from 50% of net income to 75% even as their return on equity remained largely unchanged. If investors' fascination with cash-income delivering stocks were to diminish in the post-QE world, the drop in US companies' cost of equity could reverse – and their price-to-book multiple go down correspondingly."

Figure 2: Over the past 20 years, US stocks have consistently traded on a large price-to-book premium to their European peers



Source: MSCI, IBES, DB Research

US equities have risen based on earnings growth, PE expansion and having priced in tax cuts and better business conditions. There is risk of a pullback, if earnings growth disappoint or if the tax cuts or additional infrastructure spending do not eventuate as initially proposed.

Closing Rates as at 30 September 2017					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	22,405.09	21,948.10	Nikkei Dow	20,356.28	19,646.24
S&P 500	2,519.36	2,471.65	Hang Seng	27,554.30	27,925.22
FTSE 100	7,369.39	7,430.60	MSCI	2,000.55	1,959.7

Stance: **Neutral, and take advantage of stronger AUD to purchase international shares if currently underweight international shares**

<u>Property</u>

CoreLogic dwelling price growth continued a sharp slowing in recent months, rising only 0.2% m/m in Sep-17, after flat m/m in Aug-17. This dragged the y/y to 8.0%, the equal slowest since Jan-17 (after 8.9% in Aug), down from May's high of 10.4%. Indeed, Q3 moderated to only 0.6% q/q, the weakest q/q since mid-16.

For the REIT sector, Moody's Investors Service has projected aggregate comparable net operating income growth to "increase slightly" to 3% over the next 12-18 months, up from 2.6% over the past year. *"This growth will be broadly in line with the past 12 months, driven by contracted rent increases on existing leases and broadly steady vacancy rates,"* according to Moodys' latest report. *"The small pick up from the 2.6% income growth of the last 12 months is attributable to good demand for office space in Sydney and Melbourne, and strong industrial dynamics for Sydney."*

The REIT sector has been impacted by rising long term bond yields. Earnings per share growth will be key in determining whether distributions can grow.

Closing Rates as at 30 September 2017		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,319.4	1,315.9

Stance:

Commercial/Listed: **Neutral**
Residential: **Neutral, with a negative bias**

[1] Previous rate or level represents the rate or level as at the end of the previous month.

IMPORTANT INFORMATION

Note that this is general advice that does not take into account the current financial circumstances or financial needs of any individual which should be considered when making investment decisions and in consultation with an appropriately qualified adviser.

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