## Economic Overview

The increasing breadth of the global economic expansion suggests the global expansion is sustainable and will last longer, with the US demonstrating the most advanced recovery in the current economic cycle. This has resulted in inflation picking up in the US but moving sideways at low levels in the Eurozone, supporting monetary policy divergence. Steady growth is supporting subdued market volatility, and this is supportive of growth assets. Geopolitical risks have the potential to disrupt markets, with the North Korean missile and nuclear weapons program a major threat to regional stability. However, an all-out war is a low probability event as the costs are too high on all sides.

The US economy's growth rate last quarter was revised upward to 3.3%, the fastest in three years, on stronger investment from businesses and government agencies than previously estimated. Consumer spending, which accounts for about 70% of the economy, continues to be the main driver of growth. The biggest improvement came in business investment, which made a 1.2 percentage-point contribution to growth, up from 0.98 point in the initial estimate a month ago. In addition to greater spending on transportation equipment, the data also reflected more software spending.

US consumer confidence unexpectedly improved in November to a fresh 17-year high of 129.5, the best since November 2000, from 126.2 in October, a sign Americans are growing more confident about the economy and labour market. Consumer expectations advanced to 113.3, the strongest reading since September 2000. US purchases of new homes unexpectedly advanced in broad fashion in October by 6.2% month-on-month, reaching the strongest pace in a decade since October 2007 and offering an encouraging signal for residential construction.

The US added 261,000 jobs in October as the job market began to recover from job loss caused by the hurricanes. The unemployment rate edged down to 4.1% from 4.2% in September.

A massive overhaul of the U.S. tax system looks set to get the green light by Christmas. But whether it will translate into a boost for President Donald Trump over the longer term remains to be seen. House and Senate lawmakers have begun wrangling over a tax reform plan that reconciles versions from both chambers. Sticking points have arisen, from a corporate tax rate to estate taxes. Still, Congressional Republicans hope to get a bill to Trump's desk by Christmas.

The Senate bill would cut the corporate tax rate to 20% from a top rate of 35%. For individuals, it would make tax cuts temporary and create seven income tax brackets, with a bottom rate of 10% and a top marginal rate of 38.5%, down from the current rate of 39.6%.

The 19-nation euro-zone bloc is already enjoying the strongest growth in a decade and now economists are forecasting a golden period of low-inflationary expansion. The European Commission raised its 2017 growth forecast to 2.2% from a 1.7% estimate in May. The improvement has plenty of room to run according to economists. After more than four years into the current expansion, most indicators signal the euro-zone economy is still somewhere around mid-cycle, and several more years of economic growth are expected.

The Eurozone core CPI was 0.9%, which is below the 2% target. For October unemployment, Eurozone was slightly lower at 8.8% than forecasted. In Europe, the final reading of November composite PMI (57.5) and services PMI (56.2) were both in line, with the former at a six year high.

The German economy grew at a healthy pace of 0.8% in the third quarter. This was stronger than the consensus forecast of 0.6% and marked an increase from the 0.6% logged in the previous quarter. Figures showed Germany's GDP rose by 2.3% when compared with the same period last year.

British shoppers cut back their spending in October at the fastest pace for any October since 2008, a reminder of the strain on household budgets even before the Bank of England raised interest rates. Retail sales declined by an annual 1.0% on a like-for-like basis.

Amid concerns that Britain may exit the European Union in 2019 without a new trade deal, some 50 London-based banks have approached eurozone banking regulators about relocating key services within the revised bloc. 20 financial services providers have already applied for a eurozone banking license.

The potential exodus is not limited to financial services as some London-based law firms have also enquired about moving their headquarters to Dublin. Management Consultants Oliver Wyman have estimated that as many as 75,000 banking and insurance jobs could leave Britain in case of a so-called hard Brexit, where no new trade deal with Europe is finalised. It estimated that, in a worse-case scenario, British-based banks would lose 40-50% of total revenue from selling financial services to the EU.

The Nikkei Japan Services Purchasing Managers' Index, or PMI, rose to a 26-month high of 53.4 in October from September's 51.0, backed by an increase in new orders.

China’s manufacturing PMI for November rose slightly to 51.8 from 51.6 the month prior. Expectations had been for a modest decline. The non-manufacturing PMI also rose, to 54.8 from 54.3.

China’s economic growth target for 2018 will reflect new changes in the economy as the government put more emphasis on higher quality development, the State Council Information Office said. Policy sources have said that China’s leaders are likely to maintain this year's growth target of "around 6.5%" in 2018. The economy grew 6.7% in 2016, a 26-year low, but has expanded 6.9% in the first three quarters of 2017.

China's financial system is becoming significantly more vulnerable due to high leverage, according to central bank governor Zhou Xiaochuan, who has made a series of blunt warnings in recent weeks about debt levels in the world's second-largest economy. Latent risks are accumulating, including some that are *"hidden, complex, sudden, contagious and hazardous,"* even as the overall health of the financial system remains good, Zhou wrote. *"High leverage is the ultimate origin of macro financial vulnerability,"* wrote Zhou, 69, who is widely expected to retire soon after a record 15-year tenure. *"In sectors of the real economy, this is reflected as excessive debt, and in the financial system, this is reflected as credit that has been expanding too quickly."*

**The OECD's latest Economic Outlook forecasts 3.6% global growth this year, up from 3.1% in 2016. Growth is forecast to reach 3.7% in 2018, close to the 1990-2007 average. The only member of the Group of Seven big economies whose growth this year is not expected to be higher than in 2016 is the UK. Growth is accelerating in China, the US, Japan, Europe and many emerging economies. The OECD monitors 45 economies that generate 80% of global output. Not one is forecast to contract in 2017, 2018 or 2019.**

## <u>Interest Rates & Currency</u>

Four of the world's top central bankers promised to keep openly guiding investors about future policy moves as they slowly withdraw the huge monetary stimulus rolled out during the financial crisis. After pumping some US$10 trillion into financial markets since the 2008 crisis, the Federal Reserve, European Central Bank, Bank of England and Bank of Japan are now trying to wean investors off easy money without causing an upset. To do this, words will be key, the heads of the four central banks said. It is called forward guidance in banker-speak, essentially warning gently of what is coming.

*"Forward guidance has become a full-fledged monetary policy instrument,"* ECB President Mario Draghi said. Draghi and his three counterparts are at very different stages in roll-back process. The Fed is looking at its fifth rate increase and the BOE raised its own rate for the first time in 10 years. But the ECB is merely reducing the pace of its bond purchases, and the BOJ is still printing money at full speed, although it has signalled that no additional stimulus is likely.

While the US economy has experienced a solid recovery since the global financial crisis, stagnant wages and low inflation have baffled economists. But according to the Fed's latest Beige Book, this may be turning around. The Beige Book noted that employment growth has increased since the previous report in October, and the labour market continued to tighten with Americans finally starting to see their wages increase. Many Fed districts said that employers were raising wages and increasing their use of signing bonuses and other nonwage benefits to retain or attract employees. Wage increases were most notable for professional, technical and production positions that remain difficult to fill.

Jerome Powell, in a statement to the Senate Banking Committee ahead of his confirmation hearing as the next US Federal Reserve Chairman, signalled broad support for how the Fed operates, regulates and guides the economy. *"Our aim is to sustain a strong jobs market with inflation moving gradually up toward our target,"* Powell said in the text of his remarks. *"We expect interest rates to rise somewhat further and the size of our balance sheet to gradually shrink."* That keeps Powell firmly in line with the trajectory for monetary policy set out by current Fed Chair Janet Yellen, whom he would succeed in early February if he is confirmed. Under Yellen, the Fed has raised rates just four times in two years and put its US$4.5 trillion balance sheet on a very gradual path of slimming down.

Fed officials are scheduled to meet Dec. 12-13 in Washington and are widely expected to raise their benchmark interest rate by a quarter percentage point.

The Bank of Japan (BOJ) is slowing the supply of money, raising speculation that it is paving the way for a trimming of its ultra-easy monetary policy. The supply of funds to the market in November showed an increase of 51.7 trillion yen (US$458 billion), effectively the smallest annual pace of growth since the BOJ introduced easing in April 2013. The central bank is steadily shifting the focus of its easing policy to controlling interest rates, away from "quantitative" measures. Interest rates, if kept around zero, serve as a strong credit-easing measure. The BOJ is thus set to make its monetary policy sustainable by cutting the money supply, while keeping interest rates around zero. Fortunately for the BOJ, its reduced purchases of government bonds are not being taken as a "retreat" from monetary easing, for the moment. Although the cutback could have grave effects on prices and economic activity if it results in a stronger yen and falling stock prices, there are no such moves for now.

The RBA's December board meeting again held the cash rate at 1.50% as widely expected. Overall, their policy outlook remains 'neutral', keeping an identical conclusion that *"holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time"*, prefixed by the *"low level of interest rates is continuing to support the … economy".* This still shows a lack of urgency to hike rates given they do not have an explicit 'tightening bias'. UBS' view is *"Looking ahead, we still expect the RBA to keep the cash rate on hold until Nov-18, but with the risk of a later move if consumption weakens and drags on the inflation outlook."*

**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.**

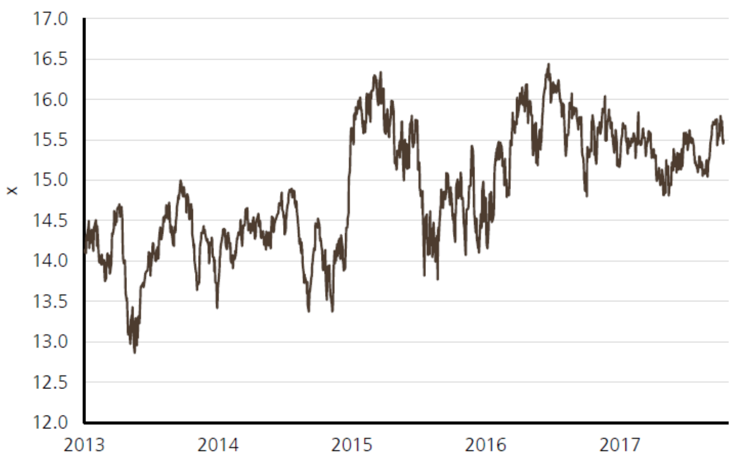
| Closing Rates as at 30 November 2017 | | | | | |
|---|---|---|---|---|---|
| | Rate | Rate (Prev)[1] | | Rate | Rate (Prev) |
| Cash | 1.50% | 1.50% | US Fed Funds Rate | 1.1600% | 1.1600% |
| 90 Day Bank Bills | 1.77% | 1.74% | AUD/USD | 75.85 | 76.73 |
| 180 Day Bank Bills | 1.76% | 1.72% | US 10 Year T-Bond | 2.39% | 2.36% |
| 5 Year Govt Bonds | 2.141% | 2.190% | US 30 Year T-Bond | 2.83% | 2.87% |
| 10 Year Govt Bonds | 2.508% | 2.673% | Japan 10 year yield | 0.036% | 0.067% |

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

## Australian Shares

According to UBS, *"Our global colleagues covering the US, Europe and Asian equity markets are looking for the bull market to extend through 2018 with another year of above-average returns driven by above-trend EPS growth. Under this scenario we continue to see Australia as a laggard (on a local currency basis) though the market appears capable of posting another trend-like return (8-10%). Once again Australia's key relative headwind is likely to be comparatively sluggish EPS growth relative to what UBS expects to be posted globally and regionally."*

**Figure 2: Australian Market P/E Multiple**




Source: Factset

**The Australian PE at 15.5x is above the long term average of around 14.7x but in the trading range of the last few years (i.e. since early 2015).**

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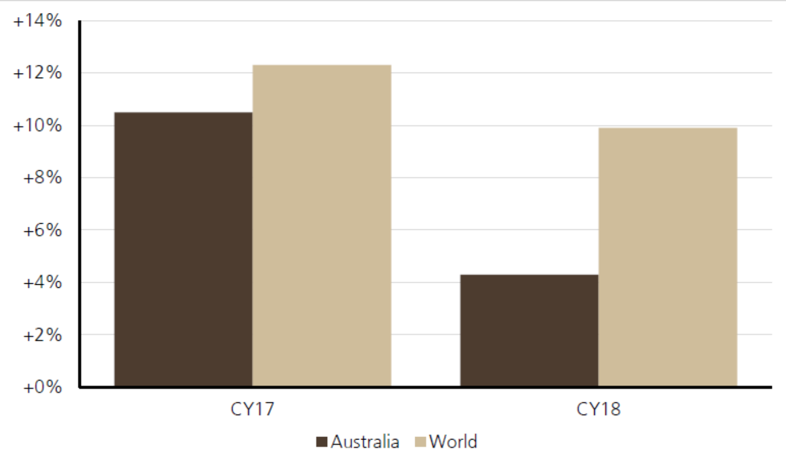
[1] Previous rate or level represents the rate or level as at the end of the previous month.

Figure 4: EPS Growth Forecast – Australia versus World




Source: Factset

**Australia is lagging the global earnings growth revival. We believe this was the main reason Australia underperformed in 2017 and is likely to present a headwind for relative performance in 2018e.**

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

| Closing Rates as at 30 November 2017 | | | | | |
|---|---|---|---|---|---|
| | Level | Level (Prev)[1] | | Rate | Rate (Prev) |
| All Ordinaries | 6,057.2 | 5,976.4 | AOX Earnings Yield | 6.25% | 6.33% |
| PE Industrials (2018)* | 16.4x | 16.2x | Div Yld Indust (2018)* | 4.6% | 4.6% |
| PE All Ords (2018)* | 16.0x | 15.8x | Div Yield All Ords (2018)* | 4.4% | 4.4% |

*Source – UBS

**Stance: Neutral**

## International Shares

UBS' view on US shares is *"2017 has been a year of better and more synchronized US/global growth, as financial conditions have remained easy and earnings have grown 10%. Accordingly, about half of the S&P 500 rally year-to-date has been from earnings and half from PE ratio expansion. In our view, the markers for the end of a bull market are largely absent and the drivers for further upside are still in place. We target 2900 for the S&P 500 for the end of 2018.*

1. *Production is still rebounding. Inventories are low and new orders are high, suggesting that growth can continue short-term. S&P returns averaged 12% in the 12 months following similarly low levels of inventory as we are seeing now.*

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

2. *Earnings can grow. S&P 500 EPS is still below trend levels following the energy/ industrial recession and USD surge of 2015-16. Margin drivers are supportive; productivity can turn up after it has lagged wages/hr by 17% since 2007.*
3. *Valuations are cheaper than you think. The S&P 500 P/E is 1-5x below the level implied by macro drivers, not 2-4x above fitted like at the end of bull markets. EPS volatility is less than half the levels prior to the financial crisis, supporting the fall in volatility and pointing to lower equity risk premiums.*
4. *Positioning is still supportive. Equity allocations are 5-10 percentage points below prior cycle highs and the year-to-date rally has been driven by short covering (+US$83bn flow), with US equity ETF+Managed Fund outflows (-US$17bn). Active fund managers are slightly overweight."*

**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 November 2017 | | | | | |
|---|---|---|---|---|---|
| | Level | Level (Prev) [1] | | Rate | Rate (Prev) |
| US Dow Jones | 24,272.35 | 23,377.24 | Nikkei Dow | 22,724.96 | 21,992.77 |
| S&P 500 | 2,647.58 | 2,575.26 | Hang Seng | 29,177.35 | 28,271.18 |
| FTSE 100 | 7,326.70 | 7,493.08 | MSCI | 2,077.4 | 2,036.8 |

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

**<u>Property</u>**

Dwelling values in Sydney have dropped by 0.7% in November, bringing the overall drop in values to 1.3% over the quarter. New data from CoreLogic's November Home Value Index shows that the median value of homes in Sydney fell to $904,041 as at 30 November 2017, a 0.7% fall on the prior month. According to CoreLogic head of research Tim Lawless, the drop in values over the quarter marks the greatest decline over a three-month period since March 2016. However, he outlined that while the rate of value decline *has "gathered some momentum"*, it remains *"extremely modest"*. The only other state capital to record a drop in value was Darwin, which saw values drop by 0.4% in the month (or 2.7% over the quarter) to $432,774.

Australian real estate investment trusts have struggled this year. But long-term, the asset class has performed well, with the index returning 10.31% return over three years and a five-year performance of 13.35%. A rising interest rate environment is not necessarily

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

negative for A-REITs if rate rises are slow and anticipated by the market, as the yield distributed by REITs will increase as rate increases are passed on in the form of higher rental yields.

**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 November 2017 | | |
|---|---|---|
| | Level | Level (Prev)[1] |
| S&P/ASX 200 A-REIT | 1,422.80 | 1,351.6 |

**Stance:**

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

*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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