Economic Overview

For the first time since the global financial crisis, world GDP growth is increasingly strong and synchronous, although it has been supported by loose monetary and fiscal policy. Looking to 2018, we believe that the growth momentum will continue and this would be broadly supportive of growth assets. However, there are risks that will require close watching and they include a sharp and qunexpected rise in inflation, the unwinding of quantitative easing by central banks and how economies deal with potentially distorted asset prices as monetary policy is tightened.

Despite strong growth and tight (or tightening) labour markets, developed markets inflation remains low, and markets have gotten used to this. There are however increasing signs that inflation will continue rising in 2018. A faster than expected pick-up could surprise markets and lead to a sharp repricing of central bank rate rise expectations, which could be disruptive for risk assets.

The reduction of monetary accommodation could turn out to be too onerous for economies and asset markets that have become addicted to low interest rates. With markets having become used to and addicted to easy monetary policies, this turn in the tide of global central bank policies poses significant risks to markets and economies.

US created only 148,000 jobs in Dec, vs 190,000 jobs expected. The total was well below the November pace of 252,000, which was revised up from the initially reported 228,000. The unemployment rate held unchanged at 4.1%.

Beginning on January 1, workers in a large number of US cities and states should expect a pay bump as new minimum wage policies go into effect. Eighteen states and 20 cities are scheduled to raise minimum wages on the first day of the new year. As of January 1, California's minimum wage will increase to US$11 per hour from US$10.50 per hour for businesses with 26 employees or more. In New York City, larger employers will be required to pay employees a minimum wage of US$13 per hour as of Dec. 31, while minimum wage in the state as a whole will rise to US$10.40 on the same date. In Rhode Island and Hawaii, where campaigns have already been proposed to increase the minimum wage to US$15 per hour over the next few years, the minimum wage will be raised to US$10.10 during 2018. In New Jersey, the minimum wage will rise to US$8.60, and in Vermont to US$10.50. Later in 2018, three additional states will implement a wage hike. Walmart announced that it will raise entry level wages for US hourly workers by 10% to US$11. This could potentially be one factor to result in rising inflation, which has been low to-date.

Fuelled by high consumer confidence and a robust job market, US retail sales in the holiday period rose at their best pace since 2011, according to Mastercard SpendingPulse, which tracks both online and in-store spending. Sales, excluding automobiles, rose 4.9% from Nov. 1 through Christmas Eve, compared with a 3.7% gain in the same period last year. E-commerce continued to drive the gains, rising 18.1%.

President Donald Trump signed the Republican tax-overhaul bill, delivering a major tax cut to US corporations along with a package of temporary cuts for other businesses and most individuals. The bill slashes the corporate tax rate to 21% from 35% and cuts individual tax rates across the board, with the top income tax rate falling from 39.6% to 37%. Republican leaders say a “typical family of four” that’s earning US$73,000, the median family income in the US, would see a tax cut of more than US$2,000 under the bill.

Confidence in the euro area continued its advance at the end of 2017, capping what was probably the strongest year for the economy in a decade. The European Commission’s measure of sentiment touched its highest since late 2000 in December. The reading of 116 was above the median forecast of 114.8.

German exports in November increased by 4.1% month on month, the strongest surge in three years. Full order books and a high level of business confidence point to favourable cyclical developments in the months ahead. A large number of companies are already in the process of enlarging their production capacities. Four out of 10 industrial firms are putting more money aside for new machinery.

Germany is in a jobs boom with the number of people working has never been as high. Despite an ageing population, 600,000 more people were in work than in 2016, mainly thanks to a rise in immigration. In November, the unemployment rate in Germany also reached a new low since Reunification between the East and West in 1990, with a 5.3% unemployment rate.

British shoppers tightened their belts over Christmas, leading to the first year-on-year fall in spending since 2012, and leading businesses aim to do the same over 2018. Visa, whose debit and credit cards are used for a third of payments in Britain, said British consumer spending fell by 0.3% last year, the first fall since 2012. Evidence of a consumer slowdown in Britain has mounted since official data showed the weakest household spending growth in five years earlier in 2017 against a backdrop of high inflation and worries about Brexit that weigh on business investment. British inflation unexpectedly rose to its highest level in nearly six years in November, tightening the post-Brexit vote squeeze on households. Consumer price inflation hit an annual rate of 3.1% in November, above the 2% inflation target. The UK economy shed jobs at the fastest pace in almost 2 1/2 years in the three months through October. The number of people in work fell by 56,000, exceeding consensus for a fall of 40,000. Basic wages rose 2.3% in the period, the most since January, but still well behind inflation.

The Japanese economy entered its 59th month of expansion in October, marking the second longest postwar growth phase and surpassing the "Izanagi" boom, which lasted 57 months between 1965 and 1970. Japan's inflation-adjusted GDP growth came in at an annualised rate of 2.5% in the July-September period. The seasonally adjusted unemployment rate fell to 2.7% in November, a 24-year low.

China’s manufacturing PMI for December fell slightly to 51.6 from 51.8 the month prior. The non-manufacturing PMI rose, to 55 from 54.8.

Chinese consumer and producer price growth decelerated in November. CPI rose 1.7% in November on an annualized basis, down from 1.9% in October, which was a highest since January. The November gain was lower than the 1.8% median forecast. Food prices dropped for the 10th month in a row on a year-on-year basis, helping to contain the overall consumer price index. Food prices dipped 1.1% in November compared with the same period a year ago, with the drop accelerating from the 0.4% decline in October. Non-food prices, on the other hand, accelerated to 2.5% y/y, 0.1 percentage point higher than October. The non-food gain was again led by medical care prices, which posted a rapid 7.0% y/y gain due in large part to the continued effect of the government's removal of price caps. Residence prices rose 2.8% for the third month in a row, while recreation and education prices rose 2.0%, and other articles and services rose 1.7%. In the first eleven months of the year, CPI grew 1.5%, slower than the 2% gain in the same period last year and half the government's 3% goal for the full year.

Since its last report in June, the World Bank has upgraded nearly all of its forecasts, with global economic growth now expected to come in at 3% for 2017, up from an earlier forecast of 2.7%. Growth is expected to hit 3.1% this year, and 3% in 2019. The brighter outlook comes as *"the global economy is experiencing a cyclical recovery, reflecting a rebound in investment, manufacturing activity, and trade"*, the World Bank said in its report. This means 2018 is on track to be the first year since the financial crisis that the global economy will be operating at or near full capacity, the World Bank noted.

Interest Rates & Currency

In December, US Federal Reserve officials followed through on an expected interest rate increase and raised their forecast for economic growth in 2018, even as they stuck with a projection for three hikes in the coming year. *“This change highlights that the committee expects the labour market to remain strong, with sustained job creation, ample opportunities for workers and rising wages,”* Chair Janet Yellen said. In a key change to its statement announcing the decision, the Federal Open Market Committee omitted prior language saying it expected the labour market would strengthen further. Instead, it said monetary policy would help the labour market “remain strong.” That suggests Fed officials expect improvement in the job market to slow.

The interest rate increase, the Fed’s third in 2017, raises the benchmark lending rate by a quarter percentage point to a target range of 1.25% to 1.5%. In another move that could tighten monetary conditions, the Fed confirmed that it would step up the monthly pace of shrinking its balance sheet, as scheduled, to US$20 billion beginning in January from US$10 billion.

The European Central Bank (ECB) may end its stimulus program this year if the euro zone economy continues to grow strongly. The ECB has said it will buy bonds at least until September and it is widely expected to wind down the 2.55 trillion-euro scheme, the centerpiece of its efforts to revive inflation in the euro zone, after that. The ECB's stimulus has helped pull the euro zone back from the brink of deflation, with price growth now comfortably above 1%.

Bank of England (BOE) policy makers said the breakthrough in Brexit negotiations in December could prove to be positive for the UK economy, which has lagged behind many of its international peers. The BOE made the comments as it announced that its key interest rate will remain at 0.5%. The Monetary Policy Committee, which raised the benchmark in November for the first time in a decade, reiterated that "further modest increases" would probably be needed over the next few years if the economy performed as expected, without providing additional detail on the timing.

Bank of Japan kept monetary policy steady in December and its governor said economic improvements alone would not trigger a withdrawal of stimulus, reassuring markets it will lag well behind its overseas peers in ending crisis-mode easing. Governor Haruhiko Kuroda stressed the need to "patiently" maintain ultra-loose policy, with inflation still distant from the BOJ's 2% target despite a strengthening economy. As widely expected, the BOJ kept its short-term interest rate target at minus 0.1% and the 10-year bond yield target around 0% - wrapping up a year in which the central bank made no change to policy.

UBS view on the RBA's next interest rate move is *"UBS has long held a below-market view that the consumer would slow ahead – rather than pick-up as consensus and the RBA expected. This has been a key driver of our relatively dovish view of a downward wage-price spiral seeing the RBA keep rates on hold until at least late-2018. Indeed, our view has been strongly reinforced by the subsequent slump in retail sales growth over recent months to under 2% y/y. Amid the lagged impact of macroprudential tightening, UBS banks team now see home loans falling in coming years, seeing housing credit growth drop from >6% to ~3%, causing house prices to weaken to ~flat in 2018 (revised down from 0 to +3%), & probably fall in 2019 (0 to -3%). Hence, the prior large boost to consumption from the 'household wealth effect'/collapsing household savings rate is likely to fade ahead, & spending will slow towards income. Hence, we also now see the RBA on hold for even longer until 2019 (was Q4-18)."*

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 31 December 2017					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	1.4200%	1.1600%
90 Day Bank Bills	1.795%	1.77%	AUD/USD	78.37	75.85
180 Day Bank Bills	1.80%	1.76%	US 10 Year T-Bond	2.41%	2.39%
5 Year Govt Bonds	2.368%	2.141%	US 30 Year T-Bond	2.74%	2.83%
10 Year Govt Bonds	2.666%	2.508%	Japan 10 year yield	0.047%	0.036%

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

Australian Shares

Explaining the Australian equity's underperformance compared to international equities in 2017, UBS said, *"From a top-down perspective we can decompose Australia's underperformance into three drivers: 1) relatively weaker EPS growth, 2) relatively weaker EPS revisions and 3) relative P/E de-rating as Australia's P/E remained static while the World P/E rose. From a sector perspective the reason for Australia's underperformance in 2017 is that the Australian equity market is heavily overweight banks and heavily underweight tech."*

Figure 1: Australia Versus Key Regions – Key Metrics (local currency returns)

	P/E 12 mth fwd	EPS growth CY17	EPS growth CY18	EPS revision CY18, YTD	Total Return YTD
World	17.0	+12.7%	+9.9%	+2.5%	+18.4%
US	18.4	+10.9%	+11.4%	-1.4%	+20.8%
Europe	14.9	+12.4%	+8.9%	+9.5%	+13.2%
Emerging Markets	12.3	+22.4%	+13.2%	+12.0%	+27.9%
Asia ex Japan	12.9	+23.7%	+12.9%	+17.3%	+33.3%
Japan	14.8	+13.8%	+21.8%	+10.9%	+21.4%
Australia	15.5	+10.4%	+4.6%	+0.0%	+10.6%

Source: Datastream, I/B/E/S

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

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 31 December 2017					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,167.3	6,057.2	AOX Earnings Yield	6.29%	6.25%
PE Industrials (2018)*	16.7x	16.4x	Div Yld Indust (2018)*	4.6%	4.6%
PE All Ords (2018)*	15.9x	16.0x	Div Yield All Ords (2018)*	4.5%	4.4%

*Source – UBS

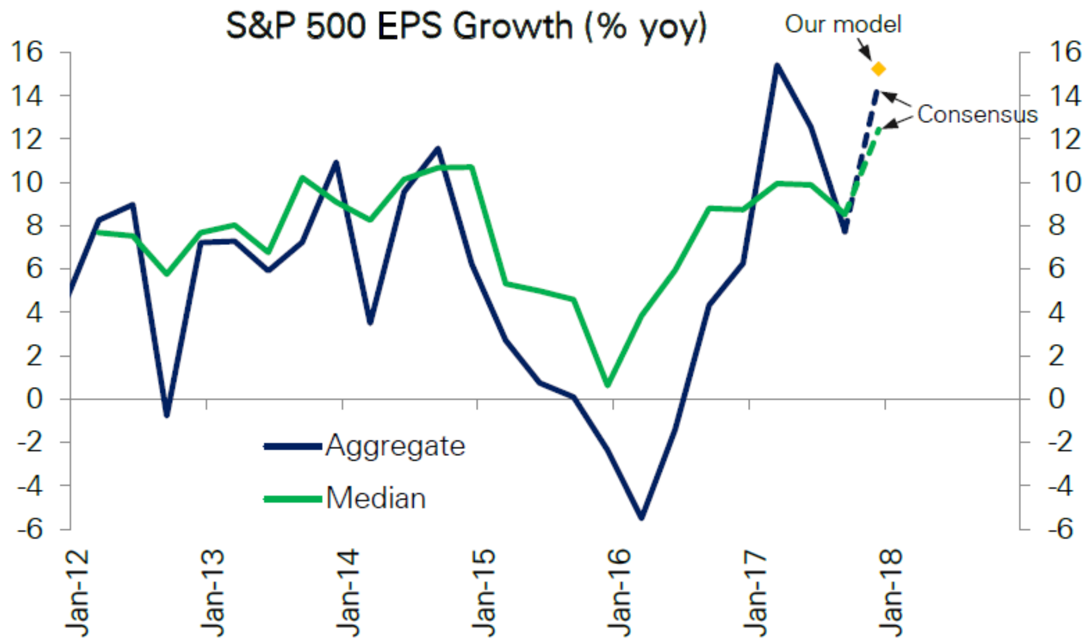
Stance: Neutral

International Shares

Deutsche Bank's view on US shares is *"S&P 500 Q4 EPS growth is expected to bounce back sharply (14.6%). The bottom up consensus (11.0%) combined with a typical beat (3.4%) points to a strong bounce back in earnings growth from Q3 (7.8%). This would take EPS growth back up to near the six year high seen in Q1 2017 (15.4%) though that performance was off a low base. Cut in corporate tax rate is expected to lift 2018 S&P 500 EPS significantly. We estimate the aggregate S&P 500 effective tax rate should fall from 27% to 19%, raising EPS growth in 2018 by 11%. Changes in tax rates have not had a long run impact on the level of EPS which have grown around a clear and steady trend of 6.5% over the last 80 years. With cyclical growth alone poised in our view to take EPS back up to the long term trend level in 2018, the cut in the corporate tax rate would raise them well above (+11%). Above normalized levels earnings tend to be discounted and we see the multiple derating to 18.5x in response. In turn we raise our forecast for 2018 S&P 500 EPS by 11% from $146 to $162 and our S&P 500 target by 5% from 2850 to 3000 (10% above current levels)."*

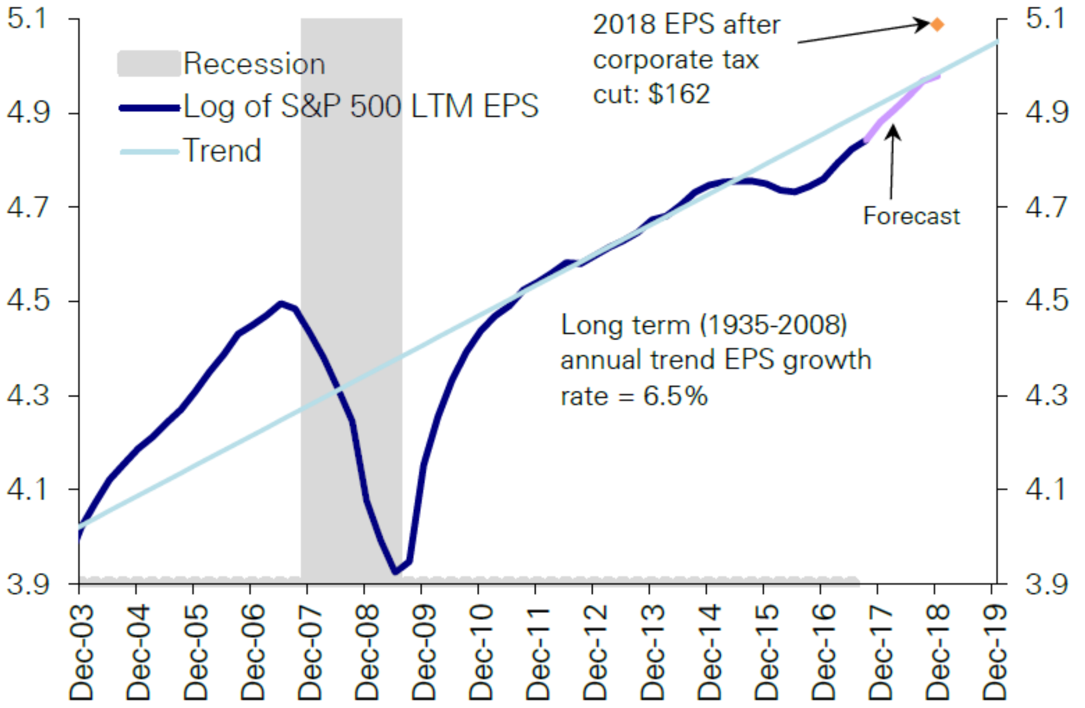
[1] Previous rate or level represents the rate or level as at the end of the previous month.

Figure 2: S&P 500 Q4 EPS growth expected to bounce back up sharply



Source: Factset, Haver, Bloomberg Finance LP, Deutsche Bank

Figure 18: The cut in tax rates should see earnings rise well above trend



Source: Haver, Bloomberg Finance LP, Factset, Deutsche Bank

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 inflation unexpectedly rises.

Closing Rates as at 31 December 2017					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	24,719.22	24,272.35	Nikkei Dow	22,764.94	22,724.96
S&P 500	2,673.61	2,647.58	Hang Seng	29,919.15	29,177.35
FTSE 100	7,687.80	7,326.70	MSCI	2,103.47	2,077.4

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

Property

National property markets ended 2017 with a whimper, with half of Australia's capital cities recording falling house prices in December. These declines are likely to continue over 2018, according to research house CoreLogic. Sydney's home prices dropped by almost 0.9% in the last month of the year, making it the joint-weakest capital with Darwin. Over the quarter, Sydney house prices were down 2.1%. Its property prices are now 2.2% below the market's peak in August 2017.

Managers of Australia's commercial real estate are under pressure to perform this year with the cycle reaching its peak. This makes deals harder to do and potentially opening the door to cashed-up foreign raiders who have the extra capacity. Analysts believe the new floats of real estate companies are unlikely to happen and instead major offshore investors will look to privatise listed REITs. Already in the past few months we have seen significant cross-border activity, including Unibail-Rodamco proposing a takeover of Westfield.

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.

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

Closing Rates as at 31 December 2017		
	Level	Level (Prev) [1]
S&P/ASX 200 A-REIT	1,404.90	1,422.80

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