Monthly Economic Notes & Outlook **March 18**

Economic Overview

Ten years since the global financial crisis, investors can find differing signals in the market. On the one hand, there are signs that economic growth is becoming less dependent on stimulus from central banks. On the other hand, valuations appear to be stretched for most asset classes. History suggests that average economic cycles are about 6 years long, but this year will mark the tenth year since the start of the recovery. We must keep in mind that recovery from a banking crisis normally take longer than other forms of financial crisis. Nevertheless, an economic downturn therefore might be expected in the not too distant future. Central banks are likely to become net sellers of bonds in 2019, as the exceptional post-crisis measures are phased out. Could that mark a turning point in the cycle? Or will some other event be a catalyst?

US economic growth slowed slightly more than initially thought in the fourth quarter of 2017 after the strongest pace of consumer spending in three years depleted inventories and drew in imports as businesses struggled to produce enough goods and services. Gross domestic product expanded at a 2.5% annual rate in the final three months of 2017, instead of the previously reported 2.6% pace. That was a deceleration from the third quarter's brisk 3.2 percent pace.

Growth in consumer spending, which accounts for more than two-thirds of US economic activity, was unrevised at a 3.8% in the fourth quarter. That was the quickest pace since the fourth quarter of 2014 and followed a 2.2% rate of growth in the July-September period.

The US Conference Board said that consumer confidence rose from 124.3 in January to 130.8 in February, the highest level in 18 years.

Strong demand and record-low supply continued to push US home prices higher in December, far faster than income growth. US home prices increased 6.3% compared with December 2016. That is an increase from 6.1% annual growth in the previous month.

The Eurozone Purchasing Managers' Index, seen as a good overall indicator of growth for the euro zone, fell to 57.1 in February from January's 58.8. January's reading was a level not seen since June 2006. But the slight slip in February leaves the PMI well above the 50 mark that separates growth from contraction.

Euro zone inflation slowed to a 14-month low in February, underlining the European Central Bank's caution in removing stimulus. Inflation in the 19 countries sharing the euro slowed to 1.2% from 1.3% in January, in line with expectations but far from the ECB's long elusive target of 2%.

Japan's unemployment rate fell to 2.4% in January, the lowest in over 24 years. The data suggests companies are facing intensifying competition to secure workers as the economy enjoys its second-longest postwar economic expansion cycle. Tightness in the job market, however, has yet to fully translate into robust wage growth in Japan. The unemployment rate fell 0.3 percentage point from December to the lowest level since April 1993. It has stayed below 3% since June 2017. The jobs-to-applicants ratio, meanwhile, stood at 1.59 in January, unchanged from December, staying at the highest level since January 1974. This means there were 159 job openings for every 100 applicants.

Growth in China's manufacturing sector in February cooled to the weakest in over 1 1/2 years. The weakness was driven by disruption to business activity due to the Lunar New Year holidays and curbs to factory output from tougher pollution rules, but there are worries of a loss in momentum. The official Purchasing Managers' Index (PMI) fell to 50.3 in February, from 51.3 in January.

The International Monetary Fund revised up its forecast for world economic growth in 2018 and 2019, saying sweeping US tax cuts were likely to boost investment in the world's largest economy and help its main trading partners. However, the IMF, in an update of its World Economic Outlook, also added that US growth would likely start weakening after 2022 as temporary spending incentives brought about by the tax cuts began to expire. Economic gains from the tax cuts would be partially paid back later in the form of lower growth as temporary spending incentives, notably for investment, expired and as rising federal debt took a toll. The IMF now expects US to expand by 2.7% in 2018, much higher than the 2.3% the fund forecast in October. U.S. growth was projected to slow to 2.5% in 2019. The IMF forecasted Eurozone growth to 2.2% (+0.3ppt) and China to 6.6% (+0.1ppt). The IMF cautioned that higher inflation could prompt the Fed to raise its cash rates faster than expected, leading to a tightening in financial conditions around the world. Hence, policy makers should take steps to raise potential growth and increase resilience to shocks, such as reforms to lift productivity and proactive financial regulation.

Interest Rates & Currency

The new Federal Reserve Chairman Jerome Powell vowed to prevent the economy from overheating while sticking with a plan to gradually raise interest rates. Powell acknowledged the economy had strengthened recently, a remark that prompted investors to increase bets on four rate increases in 2018. The Fed's last round of economic projections in December pointed to three rate increases this year. Powell's overall tone, however, was one of continuity, as the Fed would balance the need to guard against excessive inflation with the benefits of allowing the economy to enjoy the "tailwinds" of tax cuts and strong global growth. He said the Fed was in a "process of discovering" how low unemployment could fall before inflation took hold. The US unemployment rate is at a 17-year low of 4.1%.

The European Central Bank (ECB) reaffirmed its ultra-easy policy stance, promising to keep rates steady until well after the end of its bond buys and maintaining a pledge to boost the purchases, if necessary. It kept rates at record lows, confirmed that monthly bond purchases would continue at 30 billion euros (US$37.16 billion) a month until the end of September, and said it stood ready to expand or lengthen its asset-purchase programme if the inflation outlook worsens.

The Bank of England (BoE) is likely to need to raise interest rates again to tackle inflation but will not do so aggressively, the central bank's chief economist said. The central bank raised interest rates for the first time in over a decade in November, and financial markets now see a roughly 70% chance of a further 25 basis point increase in May, which would take the BoE's main rate to 0.75%.

Bank of Japan (BOJ) Governor Haruhiko Kuroda said the central bank was ready to debate an exit strategy from ultra-easy monetary policy and communicate its plans to markets when the appropriate time to do so comes. But he stressed that it was premature to discuss an exit strategy now, as inflation remains distant from the BOJ's 2% inflation target. Kuroda was nominated by the government to serve another five-year term after the current one ends in April.

The RBA's March board meeting again held the cash rate at 1.50% as widely expected. Its policy outlook remains 'neutral', keeping the 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"*. UBS view is *"We still expect the RBA to hold until 2019, given we think the RBA wants faster wages before hiking."*

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 investment grade corporates.

Closing Rates as at 28 February 2018					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	1.4200%	1.4200%
90 Day Bank Bills	1.785%	1.775%	AUD/USD	78.47	80.73
180 Day Bank Bills	1.83%	1.77%	US 10 Year T-Bond	2.90%	2.71%
5 Year Govt Bonds	2.373%	2.410%	US 30 Year T-Bond	3.16%	2.96%
10 Year Govt Bonds	2.793%	2.800%	Japan 10 year yield	0.047%	0.085%

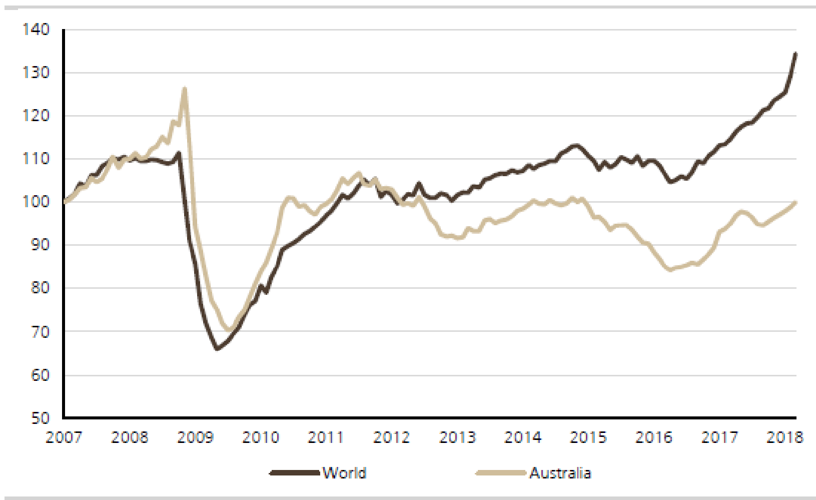
Stance: Corporate - Positive variable rate and investment grade
Government - Underweight

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

Australian Shares

UBS view is *"2018 is likely to involve an ongoing tug of war between two competing forces, inflation/rate jitters versus robust growth, with emerging trade tensions adding fuel to a volatile mix. We still see the primary trend for equities as up (due to a rising earnings base) but not as conclusively as was the case in 2017 and likely with a lot more volatility. We retain our ASX200 year-end target of 6275."*

Figure 6: Australia's Expected EPS Relative Global Equities



Source: I/B/E/S, UBS

Australian earnings are growing, but continue to lag the global earnings boom

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 28 February 2018					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,117.3	6,146.5	AOX Earnings Yield	6.06%	6.21%
PE Industrials (2018)*	16.7x	16.5x	Div Yld Indust (2018)*	4.6%	4.6%
PE All Ords (2018)*	16.5x	16.1x	Div Yield All Ords (2018)*	4.4%	4.4%

*Source – UBS

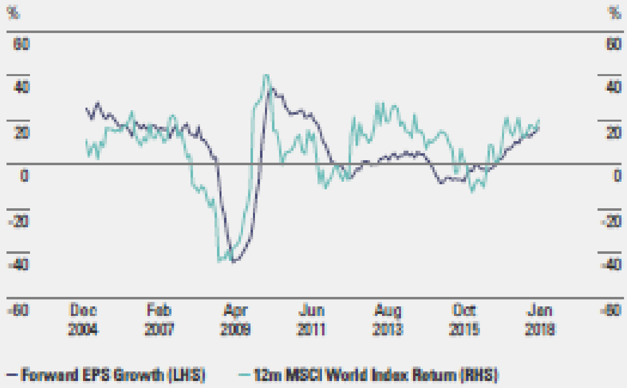
Stance: Neutral

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

International Shares

According to State Street, *"Strong economic fundamentals set the conditions for 2017's equity-markets rally, alongside record-low volatility. Even though macro uncertainties remain in the background for 2018, we expect similar conditions to support equity markets into 2018. Recent tax-relief legislation in the US may provide a further boost, but we remain watchful for signs of unexpected inflation, which could lead to market reactions similar to recent events."*

Figure 1: Earnings have been the Primary Driver of Returns in the Past Year



Source: MSCI, Thomson Reuters/DataStream, State Street Global Advisors. As of December 31, 2017. Returns and earnings measured in local currency. Index returns reflect capital gains and losses, income and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

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 28 February 2018					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	25,029.20	26,149.39	Nikkei Dow	22,068.24	23,098.29
S&P 500	2,713.83	2,823.81	Hang Seng	30,844.72	32,758.73
FTSE 100	7,231.90	7,533.55	MSCI	2,117.99	2,213.2

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

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

Property

Australian housing values have slipped for the fifth straight month. In the month of February alone, dwelling values fell 0.1%. In the past three months, Sydney property values fell by the most (-2.4%), while Hobart was by far the strongest performer (+3.2%). Sydney values have fallen 3.7% since its peak.

UBS view on the REIT sector is *"The sector is trading at a discount to UBS valuation of 8%. Rising bond yields, a tough consumer environment and a housing market past its peak suggest the REIT sector is in for a difficult year. However, it's not all bad news. The valuation discount, combined with the sector potentially returning $7bn capital (c$1.5bn reinvested) if the Westfield transaction completes (on top of buybacks announced and underway), and direct asset values also continue to strengthen. "*

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 28 February 2018		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,302.80	1,358.1

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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