Economic Overview

January's burst of equity-market euphoria has given way to fear of a trade war, a more hawkish Fed and the return of volatility. The challenge of late-cycle investing is that equity valuations are stretched, there are worries about the economy overheating and the Fed is taking away the punchbowl. At the same time, economic growth and earnings are strong. The added complications are that the US federal government has enacted substantial fiscal stimulus at a time when the economy is at full employment, and President Trump is imposing trade sanctions that could escalate into a major trade war. However, the tit-for-tat tariffs triggered due to US steel and aluminium import tariffs are trivial in size. All the other tariffs are just proposals, contingent on the US and China being unsuccessful in reaching a negotiated solution. Hence, so far it has been a phoney trade war between the US and China.

We are monitoring the impact of tighter monetary policy. To raise interest rates, the US Federal Reserve has taken action to reduce liquidity of the banking system, resulting in a reduction in the supply of credit. In the US credit growth has stalled since its peak in November 2017. At the same time, the Federal Reserve has continued to reduce its balance sheet. The tighter US monetary policy has resulted in overseas interbank lending rates to rise, including European and Australian rates.

US economic growth slowed less than previously estimated in the fourth quarter as the biggest gain in consumer spending in three years partially offset the drag from a jump in imports. Gross domestic product expanded at a 2.9% annual rate in the final three months of 2017, instead of the previously reported 2.5%. That was a slight moderation from the third quarter's brisk 3.2% pace. The upward revision to the fourth-quarter growth estimate also reflected less inventory reduction than previously reported.

The US unemployment rate for those ages 55 and over is 3.2% as of February 2018. That is lower than the current unemployment rate of 4.1% for the entire US population and 14.4% for teens. Many boomers facing retirement want to work because they fear they do not have enough money for retirement. More companies are hiring experienced senior workers in this tight labour market.

Spending on US general purpose credit cards surged 9.4% last year, to US$3.5 trillion. Card delinquencies are also rising. US household debt climbed in the fourth quarter at the fastest pace since 2007. The typical American might not notice much pain from rising rates –- at least for now. The vast majority of mortgages, auto loans and student debt are taken out at fixed rates, guaranteed for the life of the loan. New loans are linked to long-term rates, which have not risen along with short-term Libor and Fed funds rates. That leaves rising rates on credit card debt as the biggest financial worry for many US families. Card debt is typically based on a "prime rate" that is directly linked to the fed funds rate. If the Fed pushes through a quarter-point increase, the card's rate could go up by the same amount a

month or two later. Fewer than 40% of consumers say they "always" pay their credit card bills in full each month.

The final Eurozone manufacturing PMI was 56.6 in March, unchanged from the earlier flash estimate and down two points from 58.6 in February. Despite the third consecutive fall since December's series high, and the biggest decline posted since June 2011, the first quarter average of 58.2 pointed to solid growth.

Unemployment in the 19 countries that use the euro fell to its lowest level in a decade. The rate dropped to 8.5% in February from 8.6% in the previous month, marking the lowest level since December 2008. The number of people out of work fell by 141,000 to below 14 million. The Czech Republic registered the lowest unemployment rate in the EU (2.4%), with Germany and Malta both logging 3.5% rates. Greece found itself at the other end of the spectrum, with its jobless rate standing at 20.8%.

The EU27 leaders approved a Brexit transition period and guidelines for negotiations on a future relationship with the UK in just two minutes. Gone are the days when officials in Brussels were secretly hoping the UK would somehow reverse course. Now, nearly a year after the start of talks, even some of Britain's closest allies on the Continent, like the Netherlands and Luxembourg, are eager for Brexit to be over and done with. Rather than throwing up obstacles and putting pressure on UK Prime Minister Theresa May, at a time of maximum leverage in the negotiations, the EU27 leaders continued a pattern of helping to carry Britain to the door. Another EU diplomat rejected the suggestion that the 27 had rolled out a red carpet to the exit. *"No, it's not a red carpet, it's like runway lights,"* the diplomat said, *"to show them the way."* One motivation for not making life too awkward for May was to avoid sending the UK hurtling off the so-called cliff edge, creating an economic calamity for everyone.

Japan's household spending rebounded in January but workers' wages fell at the fastest pace in six months, in a worrying sign that consumption will lose momentum this year and weigh on an economy now enjoying its longest run of growth in 28 years. Household spending rose 1.9% in January from a year earlier, rebounding from a 0.1% drop in December. But the gain was driven mostly by higher costs for necessities, as unusually cold weather forced households to spend more on fuel and medical treatment. Separate data showed workers' wages after adjustments for inflation fell 0.9% in January from a year ago, marking the biggest decline since a 1.1% drop in July 2017. The decline suggests the government will struggle to convince large companies to raise wages by 3% or more this year at annual negotiations with unions. An index measuring big Japanese manufacturers' confidence fell by 2 points to plus 24 in March, the Bank of Japan's quarterly "tankan" survey showed. Both big manufacturers and non-manufacturers forecast business conditions would sour three months ahead, the tankan showed, reflecting looming uncertainty over the fallout from Trump's trade policy and a strong yen. Labour shortages also weighed on sentiment, as economic recovery and a dwindling working-age population push the jobless rate to a near 25-year low.

The official PMI for China rose to 51.5 in March, from 50.3 in February, and was well above the 50-point mark that separates growth from contraction on a monthly basis. Economists are penciling China's growth to slow 6.5% this year, from 6.9% in 2017, due to a cooling property market and rising borrowing costs.

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.

<u>Interest Rates & Currency</u>

Federal Reserve officials, meeting for the first time under Chairman Jerome Powell, raised the benchmark lending rate a quarter-point and forecast a steeper path of hikes in 2019 and 2020, citing an improving economic outlook. Policy makers continued to project a total of three increases this year. *"The economic outlook has strengthened in recent months,"* the policy-setting Federal Open Market Committee said. Officials repeated previous language that they anticipate *"further gradual adjustments in the stance of monetary policy."* The vote to lift the federal funds rate target range to 1.5% to 1.75% was a unanimous 8-0. The latest set of quarterly forecasts showed that policy makers were divided over the outlook for the benchmark interest rate in 2018. Some officials projected at least four quarter-point hikes would be appropriate this year, while others expected three or fewer increases to be warranted.

European Central Bank chief Mario Draghi says the eurozone still needs significant monetary stimulus to help boost inflation. The bank is gradually reducing its bond purchase program but it may continue past September. *"Given the uncertainty surrounding the measurement of economic slack, the true amount may be larger than estimated, which could slow down the emergence of price pressures,"* Draghi said. *"This is particularly visible in the labour market."* The ECB reduced its bond purchase stimulus — a form of quantitative easing — from €60 billion a month to €30 billion a month at the start of this year. The bank has said the purchases will continue at least through September, and longer if necessary.

The Bank of England's monetary policy committee announced that it had kept UK interest rates at 0.5%, with economists expecting an increase in May. The committee voted 7-2 to maintain the bank rate at 0.5%, and voted unanimously to leave the bank's corporate bond and UK government bond purchases program unchanged. While the decision to keep interest rates unchanged was expected, the two minority votes to raise rates were highlighted by economists as a sign of a likely hike at the May meeting.

The Bank of Japan (BOJ) has surpassed overseas investors to become the largest net buyer of Japanese stocks since the launch of Abenomics in late 2012. The BOJ buys exchange-traded funds as part of its campaign to lift inflation to 2%. Its annual purchases have risen gradually from 1 trillion yen in 2013, just after the start of its massive monetary easing program, to a record 6.17 trillion yen in fiscal 2017. The central bank's ETF holdings stood at an estimated 24 trillion yen at fiscal year-end based on current market value -- nearly 4% of the total market capitalization of Japanese stocks. BOJ Gov. Haruhiko Kuroda has stressed that the ETF purchases have played a major role in bolstering the economy and inflation. But the stock market's growing reliance on central bank activity has some analysts worried about pricing distortions.

The RBA's April 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 *“The RBA still see improving global growth as supporting better Australian GDP & gradually higher CPI ahead. The only significant change was the RBA noting tightening of US financial conditions resulting in higher short-term market rates in Australia. We still expect the RBA to hold rates until 2019.”*

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 31 March 2018					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	1.6700%	1.4200%
90 Day Bank Bills	2.03%	1.785%	AUD/USD	76.65	78.47
180 Day Bank Bills	2.125%	1.83%	US 10 Year T-Bond	2.75%	2.90%
5 Year Govt Bonds	2.353%	2.373%	US 30 Year T-Bond	2.98%	3.16%
10 Year Govt Bonds	2.621%	2.793%	Japan 10 year yield	0.027%	0.047%

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.

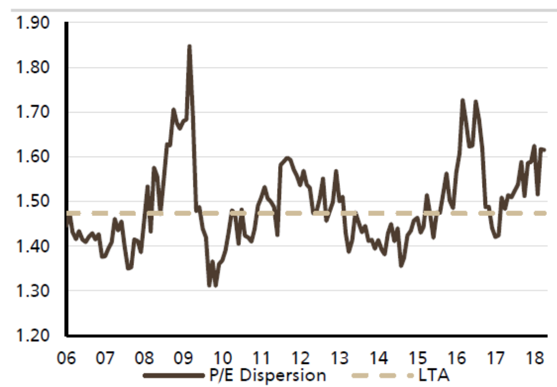
Australian Shares

UBS view is *"The 3 risks (inflation, trade wars and US tech) that have dragged global equities down in recent weeks of course cannot be discounted completely, but we see them more as risk scenarios. We judge the robust economic/earnings backdrop as the stronger and higher probability central force. We retain a constructive view on both global and the domestic equity markets, although we continue to think Australia underperforms somewhat on a 6 to 12 month view. We trim our year-end target to 6250 based on a PE of 15.0x (was 15.5x) and a steady trend for forward earnings estimates (estimates have edged up in the last 6 months). If the market PE was to hold current levels and earnings estimates were to remain unchanged our target would shift down to 6060."*

Figure 1: The market is now arguably cheap on a PE measure relative to its five-year average...

Source: Factset, UBS

Figure 2: ...but PEs remained dispersed, with the market paying up for defensive growth and discounting sectors with perceived structural (& cyclical) headwinds



Source: Factset, UBS

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 March 2018					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,868.9	6,117.3	AOX Earnings Yield	6.62%	6.06%
PE Industrials (2018)*	15.9x	16.7x	Div Yld Indust (2018)*	4.8%	4.6%
PE All Ords (2018)*	15.1x	16.5x	Div Yield All Ords (2018)*	4.8%	4.4%

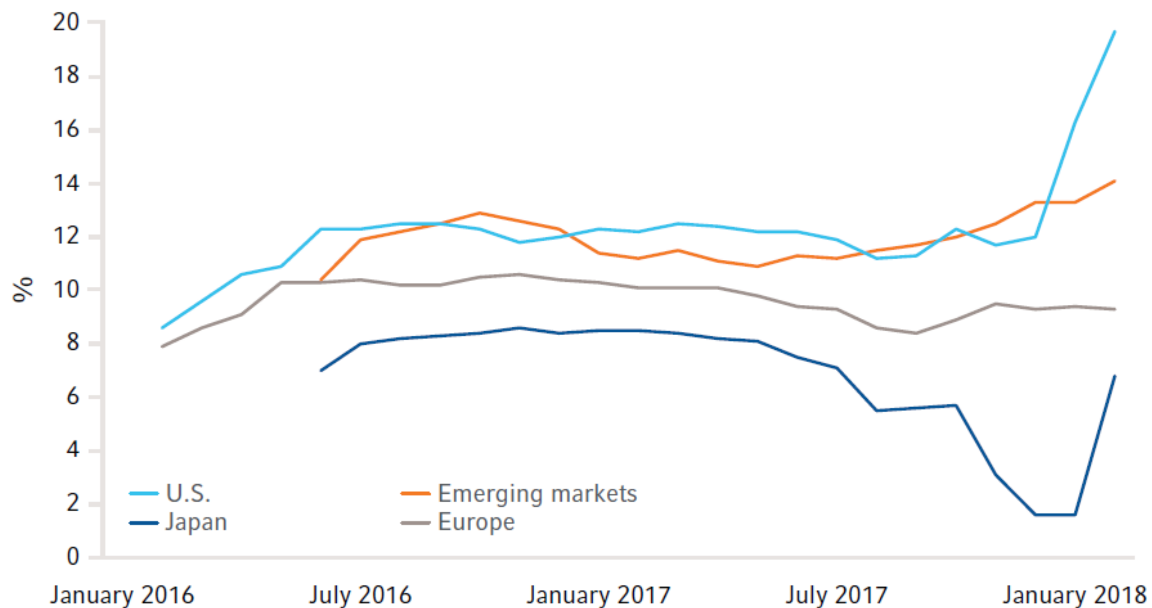
*Source – UBS

Stance: Neutral

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

International Shares

According to Russell Investments, *"Our view is that, for now, the cycle tailwinds from synchronised global growth, strong earnings-per-share (EPS) gains, and fiscal easing, all combine to outweigh the growing headwinds from monetary tightening and inflation pressures. The outlook for corporate profits this year is particularly robust. The chart shows the regional industry consensus forecasts for EPS growth in 2018, which are aggregated from the individual company forecasts by brokerage house analysts. The stand-out is the upgrade in the U.S. EPS growth forecast to nearly 20%. Four to five percentage points of this can be attributed to the impact of the corporate tax cuts, but even accounting for this, the surge in profit expectations is impressive. EPS forecasts are also robust for the rest of the world. Japan looks the laggard at 5% growth, but this follows more than 30% EPS growth in 2017."*



Source: MSCI and Institutional Brokers' Estimate System (IBES), as of February 2018. Markets reflected by the MSCI USA Index, MSCI Japan Index, MSCI Emerging Markets Index and MSCI EMU Index. Indexes are unmanaged and cannot be invested in directly.

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 March 2018					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	24,103.11	25,029.20	Nikkei Dow	21,454.30	22,068.24
S&P 500	2,640.87	2,713.83	Hang Seng	30,093.38	30,844.72
FTSE 100	7,056.61	7,231.90	MSCI	2,066.80	2,117.99

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

Property

Home prices across Australia's major cities slipped for a sixth straight month in March, with Sydney leading the falls, but the worst may be over for the city's property owners. Sydney home prices dropped 0.3% in March, leaving values down 2.1% on the year, according to property consultant CoreLogic. But CoreLogic believes the Sydney property market is showing signs of stabilising, with the 0.3% monthly fall its slowest rate of decline since late last year. If the trend towards an improving rate of decline persists, the Sydney housing market may have already moved through its peak rate of decline.

Citibank's view is that the recent contraction in bond yields could boost the performance of the REIT sector. The yield curve for Australian bonds is flattening again and the impact could be bullish for local REITs. In the last five years, the analysts at Citibank have identified three major flattening periods. In two of those periods, the REITs outperformed the broader index by around 25%.

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

Closing Rates as at 31 March 2018		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,302.90	1,302.80

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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