Economic Overview

The synchronised global expansion of 2017 has long receded. Growth has not only plateaued, but it has also become more uneven across regions this year. Increasing economic divergence and different performance of various asset classes are typical of an ageing expansion. The consensus is that we are currently in late-cycle of the current economic expansion. However, it does not necessarily lead to the conclusion that a recession is immediately imminent. In fact, a late-cycle expansion can last if excesses and major policy mistakes are avoided. A recession over a three- to five-year horizon is quite likely, but it is not currently visible in the immediate horizon.

The three significant issues for the next few months are:

- Whether the US Federal Reserve tightens for the fourth time this year at the December meeting, and how hawkish it sounds
- How aggressively President Trump pursues his trade war agenda
- The amount that China stimulates its economy

A December US Federal funds rate hike is looking likely with increased pressure on wages. More important will be the message that investors take from the December statement. Markets are pricing in additional tightening with one more interest rate increase in December 2018 and a further three or four hikes in 2019. This would take the federal funds rate to 3.3%. A shift to a more aggressive outlook would put upward pressure on the US dollar and Treasury yields. It also would add to the stresses in emerging markets. The risks are shifting towards a slightly more aggressive Fed than the market is pricing.

President Trump has implemented a further US$200 billion in tariffs against China at a 10% rate. He has threatened to increase this to a 25% rate and further threatened tariffs on an additional US$267 billion, which would cover the entirety of China's exports to the US. An escalation in trade wars is a threat to emerging markets and global trade.

Chinese President Xi Jinping is focused on deleveraging and structural reform in China, but he also needs to implement policy stimulus to counteract the impact of US tariffs. Some stimulus has already happened, most notably the 9% depreciation in the renminbi since April. More stimulus is coming in a mix of fiscal spending and credit easing.

The US economy expanded at a 4.2% annual rate in the second quarter, the fastest pace in four years. Durable goods orders rose 4.5% in August, the most in six months, driven primarily by a jump in aircraft demand. Durable goods are items that are expected to last three years or more. Strong durable goods orders are a signal of a solid economy, as businesses and individuals are only willing to shell out the money for big-ticket items when they are confident in their economic prospects. However, the solid reading was primarily due to an increase in orders for aircraft, cars and other transportation equipment. Excluding these items orders increased only 0.1%. US manufacturing is expanding at a solid pace, with orders up 9.2% year-to-date.

Amazon.com Inc announced it would raise its minimum wage to US$15 per hour for US employees from November. The increase pushes Amazon’s lowest wage above that at Walmart Inc and Target Corp. The online retailer also said it would now lobby in Washington D.C. for an increase in the federal minimum wage and urged its competitors to follow its lead as the union-led “Fight for Fifteen” movement pushes for higher remuneration. The pay increase will benefit more than 250,000 Amazon employees in the United States as well as over 100,000 seasonal employees who will be hired across the country this holiday season, the company said. At US$7.25, the federal minimum wage is a seen as a poverty wage. Amazon currently pays around US$11 per hour. Analysts said the raise would cost it US$1 billion or less annually but would be offset by a recent US$20 increase in the cost of its Prime memberships.

Automakers endured a bumpy month in September as car sales withered and overall demand could not match the levels from last year, when Americans rushed out to replace vehicles destroyed by Hurricane Harvey. Ford, Toyota, Nissan and Honda reported sales declines of 11.2%, 10.4%, 12.2% and 7%, respectively. Despite the car struggles, the overall sales rate for the auto industry remains at relatively high levels as SUV sales remains strong. The strong job and housing markets are keeping consumers relatively confident about buying big-ticket items. Rising interest rates and the fear of tariffs may have nudged some shoppers to buy vehicles early in recent months. The average annual interest rate on a new vehicle in September was 5.8%, up from 4.8% a year ago. Those increases stem from the Federal Reserve's recent interest-rate hikes, which are pegged to the strong economy. Only 5.6% of buyers are getting 0% interest-rate loans now, down from 10.1% a year ago. Vehicle prices continue to rise. Prices averaged US$35,742 in September, up 2% from a year earlier.

German inflation unexpectedly accelerated to a four-month high, suggesting the rate in the euro area will rise further above the European Central Bank’s goal. Consumer prices rose an annual 2.2% in September. Inflation in Germany has been slightly stronger than in the currency bloc in recent years, supported by a robust labour market and solid domestic growth. The latest pick-up -- boosted by rising energy costs -- is likely to add to discontent in Europe’s largest economy about continuously loose monetary policy and amplify calls for higher interest rates.

The British economy is 2.5% smaller today than if the UK had voted to remain in the European Union, according to the Centre for European Reform. It says the UK suffers a £26 billion blow to the economy annually, equivalent to £500 million a week, without yet having formally left the bloc. The study notes that the UK is the slowest-growing advanced economy among its peers. *“The UK has grown by 3.1% over that period [since 2016]. Compare that to the average of the 22 most advanced economies: 5.2% — which amounts to a 2.1% gap, not far away from our estimate of the cost of Brexit,”* the report says.

Japan's services sector grew at its slowest pace in two years in September due to heavy rains, flooding, and earthquakes. The Markit/Nikkei Japan Services Purchasing Managers Index (PMI) fell to 50.2 on a seasonally adjusted basis from 51.5 in August. The index just barely held above the 50 threshold that separates expansion from contraction, the 24th consecutive month of growth albeit the weakest rate in this period. A tight labour market and gradually rising wages are likely to support future consumer spending, which should contribute to a healthy expansion in services companies.

Japanese business sentiment among large manufacturers worsened for the third straight quarter amid concerns over increased trade friction and the impact of natural disasters, according to the Bank of Japan's tankan survey. The key index measuring confidence among companies such as automobile and electronics makers stood at plus 19 in the September survey, down two points from June.

The Chinese official manufacturing purchasing managers index stood at 50.8 in September versus 51.3 in August. Indexes for retail, telecommunications, IT and financial industries in the PMI report were all above 55, showing robust activity, whereas the transportation and real-estate-services readings signaled contraction. Construction activity quickened noticeably. That construction uptick, if sustained, could be a sign that the measures aimed at boosting infrastructure investment are starting to kick in.

China will cut import tariffs on goods including machinery, paper, textiles and construction materials from Nov 1, in a move that would lower costs for consumers and companies as a trade war with the US deepens.

International Monetary Fund said that trade disputes and tariffs are starting to dim the outlook for global growth, calling on countries to resolve their differences and reform global trading rules. In July, the IMF projected 3.9% global growth for 2018 and 2019. The outlook has since become less bright, and the IMF will be reducing the growth forecast. A key issue is that rhetoric is morphing into a new reality of actual trade barriers. This is hurting not only trade itself, but also investment and manufacturing as uncertainty continues to rise. While the United States is growing strongly because of tax cuts and easy financial conditions, there are signs of slowing in the euro area and Japan. China is also showing signs of growth moderation.

Interest Rates & Currency

US Federal Reserve officials raised interest rates in September and cemented expectations for another hike this year as they reaffirmed that a strong US economy will probably warrant further gradual increases well into 2019. The quarter-point hike boosted the benchmark federal funds rate to a target range of 2% to 2.25%.

The European Central Bank is halving its monthly asset purchases from 30 billion euros (US$34.71 billion) to 15 billion euros from October, marking the penultimate step of its plan to terminate the bond-buying program at the end of the year. Though a key backstop for European debt markets, the reduction of quantitative easing is unlikely to send bond investors in Europe, let alone those in the US, into a panic. Changes to the ECB’s signature bond-buying program would only affect the bond market when the central bank’s overall holdings are reduced. With the central bank promising to reinvest all of the proceeds from maturing securities in its portfolio at least through the summer of 2019, its balance sheet will remain steady.

The RBA's October board meeting again held the cash rate at 1.50% as widely expected. Its policy outlook remains ‘neutral’, concluding holding is *“consistent with sustainable growth in the economy and achieving the inflation target over time”*. The RBA remains unlikely to be pre-emptive given *"further progress in reducing unemployment and having inflation return to target is expected, although… gradual"*, and this is predicated on *"low… rates… continuing to support the Australian economy"*. UBS’ view is *“We still have a more dovish view than consensus, and see rates on hold until 2020 given weakening housing & low inflation continuing.”*

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 30 September 2018					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	2.18%	1.9100%
90 Day Bank Bills	1.94%	1.96%	AUD/USD	72.22	72.49
180 Day Bank Bills	1.94%	1.976%	US 10 Year T-Bond	3.07%	2.86%
5 Year Govt Bonds	2.227%	2.24%	US 30 Year T-Bond	3.21%	3.02%
10 Year Govt Bonds	2.671%	2.59%	Japan 10 year yield	0.131%	0.100%

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

Australian Shares

According to Crestone, *“Results for the 2017-2018 financial year generally met expectations, with earnings growth of the S&P/ASX 200 index up around 9%. This was against expectations of a 7% gain. The weighted average was a little lower, held back by banks and telecommunications. Resources and energy companies continued to perform strongly with earnings up over 20%, while the rest of the market saw growth around 5%. Dividend growth exceeded earnings growth, propelling the market to decade highs at end August before*

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

succumbing to profit taking in September, amidst a rotation away from high valuation stocks. Solid balance sheets and restrained growth capital expenditure allowed directors to allocate more free cash flow to shareholders via dividends and share buy-backs."

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 September 2018					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,325.5	6,427.8	AOX Earnings Yield	6.53%	5.86%
PE Industrials (2018)*	16.5x	17.0x	Div Yld Indust (2018)*	4.7%	4.11%
PE All Ords (2018)*	15.3x	17.0x	Div Yield All Ords (2018)*	4.7%	3.99%

*Source – UBS

Stance: Neutral

<u>International Shares</u>

According to Russell Investments, *"The S&P 500 Index has been the best performing regional equity market this year, but US equities remain very expensive, with a Shiller cyclically adjusted price-to-earnings ratio of 33 times as of mid-September. While we see momentum as continuing to favour US equities, some of our contrarian over-bought indicators are beginning to trigger."*

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 the trade war further escalates, earnings growth disappoint or if inflation unexpectedly rises.

Closing Rates as at 30 September 2018					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	26,458.31	25,964.82	Nikkei Dow	24,120.04	22,865.15
S&P 500	2,913.98	2,901.52	Hang Seng	27,788.52	27,888.60
FTSE 100	7,522.05	7,432.42	MSCI	2,184.01	2,175.50

Stance: Neutral, and to purchase international shares if currently underweight international shares

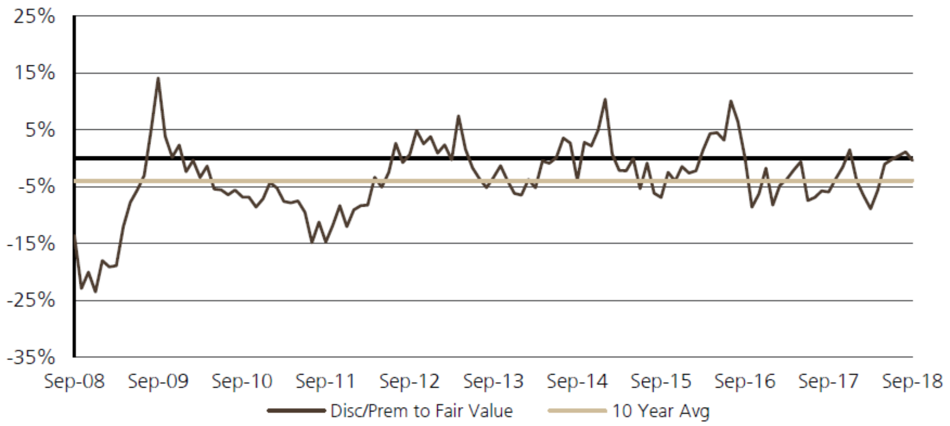
[1] Previous rate or level represents the rate or level as at the end of the previous month.

Property

Australian home prices are likely to fall over the next couple of years, reflecting the impact of tighter lending standards and the prospect of higher official interest rates from the RBA placing downside pressure on prices, says ANZ Bank's Australian economics team. However, unlike some more pessimistic forecasters, the bank says the downturn is likely to be modest and elongated in nature, rather than an outright price crash. ANZ expects nationwide housing prices to decline by 4% in 2018, and a further 2% in 2019. ANZ expects the Sydney and Melbourne-led national downturn will persist in the coming year. ANZ anticipates price declines of around 10% peak to trough in these two cities.

UBS' view for the Australian REIT sector is *"The sector is trading at a 0.4% discount to our blended NAV/DCF price targets, a 19% premium to NTA, and FY19e DPS yield of 5.2%."*

Figure 15: UBS fair value estimates vs AREIT prices (premium/discount)



Source: UBS estimates, FactSet

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 30 September 2018		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,427.4	1,453.52

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.

NEWELL PALMER SECURITIES PTY LTD

Address:	**Suite 101, 270 Pacific Highway CROWS NEST NSW 2065**
Mail:	**PO Box 1680 CROWS NEST NSW 1585**
Phone:	**(61 2) 9906 8066**
Fax:	**(61 2) 9906 8080**
Website:	**www.newellpalmer.com.au**
Email:	**info@newellpalmer.com.au**

ABN 89 050 040 232
Australian Financial Services Licence No. 229264

Member Financial Ombudsman Service Limited