Economic Overview

After rebounding in Q2 to a new cycle high of 4.1%, global growth was more mixed in Q3, likely slowing a little below its recent 4% pace. US growth remained very strong, but eased to 3.0% pace. European growth slumped below 2%, while growth in China also eased modestly. Elsewhere, data across the UK, Japan and parts of the emerging markets were also less robust. A number of developments are increasingly challenging an otherwise solid outlook. This includes an intensification of political instability in Europe and the UK. The European Union (EU) continued to debate the new Italian Government's more stimulatory fiscal stance, while the UK once again is trying to make progress on Brexit. Middle East tensions have also risen between the US, Saudi Arabia and Iran.

The US federal budget deficit has blown out to US$779 billion in fiscal 2018, and this is 17% higher than the previous year. This fiscal deterioration has been driven by Trump's tax cuts. The deficit is expected to exceed US$1 trillion in 2019. On present trends, federal debt will balloon to 100% of GDP by the end of the next decade from 78% today. The Trump administration is attempting a massive peacetime stimulus and this has never been unleashed onto an economy that is already expanding at a healthy pace. In the past, such stimulus was provided during recessions or early recoveries. The implication is that if this fiscal spending coincides with an increase in inflation, there may be a breakout in inflation.

Growth remains strong in the US. After 4.2% in Q2, growth rose by an annualised 3.5% in Q3, lifting the annual pace to 3.0% (from 2.9%), its fastest in over three years. After jumping 270,000 in August, jobs growth softened, rising just 134,000 although unemployment fell sharply from 3.9% to 3.7%. Housing data has stayed weak, likely due to higher borrowing rates. At the start of Q4, October's purchasing managers' index (PMI), rebounded to 54.8 from 53.9, reversing its recent downtrend. Looking ahead, expectations for 2018 growth are at risk of being revised higher. But US tariffs at a higher-than-expected rate of 25% for 2019 could potentially see the growth outlook edge lower beyond this year.

UK Prime Minister Theresa May announced a Brexit deal on November 15. Following the announcement, a number of ministers resigned from their positions, including Minister of State for Exiting the European Union Dominic Raab and Secretary of State for Work and Pensions Esther McVey. Sterling was largely unchanged over the month. The UK government's 83-page document sets out a range of scenarios and makes a number of assumptions, reflecting the uncertain nature of the UK's future relationship with the EU and post-Brexit immigration policy. It makes comparisons with projected GDP growth if Brexit does not go ahead. In all the versions of Brexit considered by the government, the report concludes the UK economy would continue to grow. Brexit's effect is predicted to be a check on growth, rather than leading to a downturn. The biggest projected hit would happen under a no-deal Brexit, where GDP growth is predicted to be 9.3 percentage points lower over 15 years compared with a continuation of the status quo, again if migration from Europe is reduced to net zero.

Japan's industrial production posted the first month-on-month rise in two months in October, supporting the Bank of Japan view that production is returning to a moderate recovery path after the weak third quarter. Production in October rose 2.9% from September for the first month-on-month rise in two months and follows a 0.4% fall in September. Japan's nationwide consumer price index rose 1.0% year-on-year in October, unchanged on the previous month and Bank of Japan officials remain cautious about their inflation outlook. The inflation rate remains stubbornly slow in responding to a sustainable economic expansion and tight labour market conditions, with firms still cautious about raising retail prices.

China’s local governments may have accumulated 40 trillion yuan (US$5.8 trillion) of off-balance sheet debt, or even more, suggesting further defaults are in store, according to S&P. Much of the build-up relates to local government financing vehicles (LGFVs), which do not necessarily have the full financial backing of local governments themselves. Rising vulnerabilities among LGFVs occur against a backdrop of a record pace of defaults this year in China, which has sought to roll back a decades-old practice of implicit guarantees for debt.

China's official manufacturing Purchasing Managers' Index (PMI) for November was 50.0 and down from 50.2 in October. The 50-point mark is considered neutral territory, indicating no growth in activity or contraction on a monthly basis. Analysts had forecast the official gauge would hold steady from October's low level, suggesting marginal growth. New export orders shrank for a sixth straight month. Chinese manufacturers' import orders also shrank, reflecting weakening domestic demand.

The International Monetary Fund has cut its global growth forecasts as trade tensions between the US and trading partners have started to hit economic activity worldwide. The IMF said the global economy is now expected to grow at 3.7% this year and next year — down 0.2 percentage points from an earlier forecast, according to the fund's latest World Economic Outlook report released in October. The two economies in the centre of the ongoing tariff fight — the US and China — are also expected to grow slower than initially projected. The IMF maintained that the US and China will grow by 2.9% and 6.6%, respectively, this year but said both would slow more than expected to 2.5% and 6.2%, respectively, in 2019.

Interest Rates & Currency

Minutes from the Nov. 7-8 meeting of the Federal Open Market Committee, which sets interest rates, pointed toward the strong likelihood of another quarter-point adjustment in the central bank's benchmark rate target in December. The US economy has been growing solidly, with GDP increasing 3.5% in the third quarter and the unemployment rate at a generational low of 3.7%. Housing market weakness has been a drag on growth, though, and officials attributed the slowness to rising mortgage rates. Members also noted worry that companies might struggle to pass on rising input costs, again from tariffs, onto consumers and create detrimental inflation. More immediately, members reported that activity in the agricultural market is *"depressed"* due to *"the effects of trade policy actions on exports and farm incomes."* While affirming their commitment to a rate increase over the short term, members also noted that actions after that would be dependent on incoming data. *"Monetary policy was not on a preset course; if incoming information prompted meaningful reassessments of the economic outlook and attendant risks, either to the upside or the downside, their policy outlook would change,"* the minutes said.

In a speech to The Economic Club of New York in late November, US Federal Reserve Chairman made some observations which included the following statement. *"Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy; that is, neither speeding up nor slowing down growth."* Observers immediately picked up on the apparent change from interest rates being a "long way" from neutral to "just below" neutral, and effects were seen in the markets for bonds, cash futures and currencies. Expectations regarding US Fed monetary policy also moved. A 25bps rise in December is still on the cards; the implied probability of a December rate increase firmed from 73% to 77%. However, the probability of an additional increase in March fell back from 47% to 42% and, if it falls further, will signal a likely slow-down in future rate rises. Futures markets suggested that rather than three rate hikes in 2019, there may only be two.

The European Central Bank will continue to wind down €2.6 trillion in bond buying, despite data pointing to an economic slowdown in the eurozone. Monetary policy will nonetheless remain loose if the ECB affirms a decision to end quantitative easing during a December meeting, President Mario Draghi says.

China's central bank will keep monetary policy flexible and adjust it appropriately according to changes in the country's economic situation, bank Governor Yi Gang said. Yi's comments come amid widespread expectations that the central bank will ease policy further in coming months to support China's economic growth, which has cooled to the weakest pace since the global financial crisis. The Chinese central bank has already slashed banks' reserve requirements four times this year and brought down market interest rates to relieve funding strains on cash-strapped companies.

The Bank of Canada raised its overnight benchmark rate by a quarter point to 1.75% at the end of October, the third hike this year and fifth since it began increasing rates in 2017. It acknowledged for the first time in more than a decade that it expects to completely remove monetary stimulus from the economy.

The RBA's December meeting held the cash rate at 1.50% as widely expected. Their policy outlook remains 'near-neutral' as 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"*, & 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 through 2020, given credit tightening, 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 November 2018					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	2.20%	2.20%
90 Day Bank Bills	1.95%	1.91%	AUD/USD	73.16	70.85
180 Day Bank Bills	1.95%	1.92%	US 10 Year T-Bond	3.05%	3.14%
5 Year Govt Bonds	2.213%	2.179%	US 30 Year T-Bond	3.33%	3.39%
10 Year Govt Bonds	2.617%	2.630%	Japan 10 year yield	0.083%	0.126%

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

Australian Shares

According to Crestone, *"After a decade of flat returns, the resources sector has delivered stellar growth, outperforming industrials by 93% since early 2016. While commodity prices (up more than 51% since the beginning of 2016) were the main driver, restrained capex, a*

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

lack of headwinds from the Australian dollar, solid cost control and higher pay-out ratios have also contributed. Although demand has moderated in 2018, driven by diverging and decelerating PMIs, stimulatory with data expected to evidence this in Q4 2018 and 2019. Uniquely, the strong commodity backdrop has also come with a weaker Australian dollar, providing an unusual tailwind to Australian dollar earnings for Australian-domiciled commodity companies. Resources are now offering a near 10% true yield (ex-franking) over the coming year, with AUD 19 billion in dividends expected and at least AUD 11 billion in buybacks."

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 2018					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,749.3	5,913.3	AOX Earnings Yield	6.94%	6.99%
PE Industrials (2019)*	15.3x	15.3x	Div Yld Indust (2019)*	5.0%	5.1%
PE All Ords (2019)*	14.4x	14.3x	Div Yield All Ords (2019)*	5.5%	5.1%

*Source – UBS

Stance: **Neutral, and to purchase Australian shares (with a preference for mid-cap shares) if currently underweight Australian shares. To review direct banking share exposure.**

International Shares

According to Antipodes, *"The key question for 2018 and beyond remains to be: to what extent can the benign environment persist? Putting aside trade wars and policy missteps, while the US growth environment is unlikely to accelerate much from here, the combination of fiscal stimulus and the easiest US financial conditions since the Global Financial Crisis should sustain growth at current levels for longer. However, we believe the unusually favourable goldilocks-combination of accelerating growth and tepid inflation experienced in 2017 will not repeat. Instead, normalisation of interest rate policy will likely upset the rhythm with more volatile and less forgiving markets."*

Notwithstanding the recent pullback, 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 greater pullback, if the trade war further escalates, earnings growth disappoint or if inflation unexpectedly rises.

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

Closing Rates as at 30 November 2018					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	25,538.46	25,115.76	Nikkei Dow	22,349.70	21,920.46
S&P 500	2,759.62	2,711.74	Hang Seng	26,506.75	24,859.16
FTSE 100	6,970.78	7,128.10	MSCI	2,041.4	2,022.0

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

<u>Property</u>

The fall in home values across Sydney and Melbourne has continued to accelerate the slump in the Australian housing market, according to the latest data from CoreLogic. According to CoreLogic, property prices dropped by 0.7% nationwide in November, the weakest month-on-month change since the global financial crisis, with national values now down 4.1% year-on-year. The national decline was driven by a 0.9% fall across Australia's combined capital cities. Sydney and Melbourne have continued to drive the slump in home values, with drops of 1.4% and 1%, respectively, with prices also dropping in Perth (0.7%). Since the peak of the market in July 2017 and Sydney property prices have fallen by 9.5%.

The general view among investors was to not own REITs when interest rates were rising is based on the view there was a negative correlation with the performance of REITs in such cycles. However, there is research suggesting that there was in fact a much stronger correlation between falling interest rates and REIT performance, then when rates were rising. A key indicator that REITs would perform well even when interest rates are going up is when the increase was due to rising economic activity and rising inflation rather then because of poor economic performance, when interest rates went up as a means to increase the risk-free premium.

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 2018		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,376.8	1,382.9

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 of Australian Financial Complaints Authority