Economic Overview

With the US moving into the later stages of the business cycle, the US Federal Reserve raising interest rates, and monetary and credit conditions diverging widely across the other major global economies, the potential for renewed volatility in both equity and fixed income markets remains high.

Employers added 312,000 jobs to the US economy in December — nearly double the 178,000 new positions economists had expected. Meanwhile, the unemployment rate ticked up from 3.7% to 3.9%, in part because 142,000 people quit their job and started looking for a new one. Both figures are a sign that the US economy remains strong despite recent stock market volatility over economic growth worries and a prolonged US trade war with China. The lingering problem, however, is that US workers have not seen their wages grow by very much. In December, private sector workers got an average US11-cent hourly raise, adding up to an average hourly pay of US$27.48. In the past 12 months, average hourly earnings have only increased US84 cents, or 3.2%.

US services sector activity slowed to a five-month low in December, but remained above a level consistent with solid economic growth in the fourth quarter. The Institute for Supply Management said its non-manufacturing activity index fell to 57.6 last month, the lowest reading since July, from 60.7 in November. Still the index stayed well above the 50 mark, suggesting expansion of the vast services sector.

Federal Reserve Chairman Jerome Powell is concerned about the ballooning amount of United States debt. *"I'm very worried about it,"* Powell said at The Economic Club of Washington, D.C. *"From the Fed's standpoint, we're really looking at a business cycle length: that's our frame of reference. The long-run fiscal, nonsustainability of the U.S. federal government isn't really something that plays into the medium term that is relevant for our policy decisions."* However, *"it's a long-run issue that we definitely need to face, and ultimately, will have no choice but to face,"* he added.

The Fed chief's comments came as the annual US deficit reaches new sustained highs above US$1 trillion, a fact many economists worry could spell trouble for future generations. Annual deficits have topped US$1 trillion before, but never during a time of sustained economic growth like now, raising concern about what would happen if a recession hits. Total US debt is about US$21.9 trillion, of which US$16 trillion is owed by the public. In part because of continued rate increases under Powell, the interest cost on that debt could start to become a bigger and bigger burden.

The Fed is raising rates while the government deficit increases as a share of GDP. Normally when the deficit is expanding, the Fed would be lowering interest rates. Interest rates on government debt may not reduce during a period of economic weakness if there is increased issuance of government debt.

US student loan debt outstanding reached a record US$1.465 trillion. This debt is raising fiscal risks. Over 90% of student loans are guaranteed by the US Department of Education, meaning that if a recession causes a rise in youth unemployment and triggers mass defaults, this contingent liability could prove burdensome for the US government budget. The record student debt level is more than double the US$675 billion outstanding in June 2009 when the recession ended. Many student loan borrowers face significant debt burdens. Over 2.7 million borrowers owe in excess of US$100,000, of which, about 700,000 owe US$200,000 or more, according to data from the U.S. Department of Education. One year earlier, 2.5 million owed in excess of US$100,000.

Euro zone headline inflation was at the European Central Bank target in November. Consumer prices in the 19 countries sharing the euro eased 0.2 percent month-on-month in November for a 1.9% year-on-year increase, revised down from the previously reported 2.0%. The ECB wants to keep headline inflation below, but close to 2% over the medium term.

Ireland last year gained more than 4,500 jobs stemming from Britain's decision to leave the European Union. More than 55 firms, including Bank of America and Morgan Stanley, confirmed new or expanded operations in Ireland during 2018. Britain is due to leave the EU on March 29 this year. UK financial services firms are opting to relocate staff and assets away from London to Europe, with around US$1.4 trillion in assets estimated to be transferred in anticipation of a Brexit decision, according to EY. The US$1.4 trillion of assets that are set to move is still a modest estimate given total assets of the UK banking sector is thought to be almost US$14.2 quadrillion. However, EY says the figure is likely to grow as Brexit creeps closer.

China's official manufacturing Purchasing Managers' Index (PMI) for December was 49.4 and down from 50.0 in November. Activity in China's manufacturing sector contracted for the first time in more than two years. December's consumer inflation was 1.9%, and this is lower than forecast of 2.1%. China's central bank said it was cutting the ratio of cash that banks must hold as reserves by 100 basis points (bps), or 1 percent. The cut in banks' reserve requirement ratios (RRR) is the first in 2019 and the fifth in a year by the People's Bank of China (PBOC) as the economy faces its weakest growth since the global financial crisis and mounting pressure from U.S. tariffs. The reduction is being made in two equal stages, effective Jan. 15 and Jan. 25. The size of the move was on the upper end of market expectations. Further cuts in the RRR are widely expected this year.

The World Bank's semi-annual Global Economic Prospect report titled *Darkening Skies* has warned that the US/China trade war is already inflicting collateral damage and government and corporate debt is slowing down economic growth. The bank has predicted that growth will soften slightly over the year from 3% in 2018 to 2.9% in 2019 amid rising risks. Growth among advanced economies is predicted to drop to 2% this year while growth in emerging markets is predicted to hold steady at 4.2%. China's growth is

expected to slow down to 6.2% this year. The US is also predicted to slow down to 2.5% in 2019, down 0.4 percentage points from 2.9% in 2018. Meanwhile the Euro area is predicted to slow to 1.9%.

Interest Rates & Currency

US Federal Reserve officials acknowledged that the policy path ahead is “less clear” after approving an interest rate hike at their December meeting. Minutes released from the meeting showed the rate hike came with reluctance from a few members who thought the lack of inflationary pressures argued against another increase. The Fed hiked its benchmark rate a quarter point to a range of 2.25% to 2.5%, the fourth increase in 2018 and the ninth since policy normalization began in December 2015.

“With an increase in the target range at this meeting, the federal funds rate would be at or close to the lower end of the range of estimates of the longer-run neutral interest rate, and participants expressed that recent developments, including the volatility in financial markets and the increased concerns about global growth, made the appropriate extent and timing of future policy firming less clear than earlier,” the meeting summary stated. The indecision was reflected in rate forecasts among individual members. Officials cut their expected moves this year from four to two, citing a range of concerns about growth and volatility in the financial markets. Fed Chairman Jerome Powell said policymakers will be “patient” when approaching policy decisions.

The European Central Bank would end its 2.6 trillion euro (US$2.95 trillion) government bond purchase scheme started four years ago but would keep re-investing cash from maturing bonds for a long time after its first interest rate hike.

The RBA had previously shown little concern as recently as November 2018, upgrading GDP to a booming 3½% y/y in 2018 and 2019; and in October 2018 arguing *"Most borrowers do not take out the maximum loan possible & so the vast majority of prospective borrowers have not been affected by these [lending standards] changes"*. However, in December, the RBA turned in the dovish direction, amid material credit tightening. UBS’ view is *“Our base case remains 'Credit Tightening', which is already below consensus on the outlook & more dovish on the RBA with rates on hold through 2020. But, following much weaker than expected Q3 GDP, we cut our growth forecasts, and can't rule out the RBA cutting rates if weaker data continues in 2019. Looking ahead, the RBA will likely materially downgrade their GDP forecasts in their Feb 2019 statement, but for an actual rate cut to occur, we think they likely need to see slower than expected CPI & wages, & unemployment to stop falling. This will take more than one weak print.”*

No change in the RBA cash rate is expected in the near term, but there is a growing risk that the next rate move may be a cut to the cash rate. Our preference remains for both short dated fixed-rate and floating-rate securities of investment grade corporates.

Closing Rates as at 31 December 2018					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	2.40%	2.20%
90 Day Bank Bills	2.09%	1.95%	AUD/USD	70.58	73.16
180 Day Bank Bills	2.22%	1.95%	US 10 Year T-Bond	2.72%	3.05%
5 Year Govt Bonds	1.920%	2.213%	US 30 Year T-Bond	3.02%	3.33%
10 Year Govt Bonds	2.322%	2.617%	Japan 10 year yield	-0.001%	0.083%

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

Australian Shares

Commonwealth Bank economists echoed the view of many experts in its predictions for the markets this year saying that *"any forecasts for 2019 are contingent on the assumptions made for resolution of the (trade) dispute. We take the view that it is very much in the interests for both countries to have the dispute resolved. And while it may take a little longer than the March 1 data set for resolution, we believe enough progress will be made to provide optimism for investors".* The price earnings ratio is now at 14, which is well below its five-year average of 16.1 according to the CBA. The dividend yield is sitting at a more than two year high. Both these measures can deteriorate if earnings fall, but other than the banks, the prospects for corporate profits in Australia remain solid.

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 2018					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,709.4	5,749.3	AOX Earnings Yield	7.14%	6.94%
PE Industrials (2019)*	14.5x	15.3x	Div Yld Indust (2019)*	5.3%	5.0%
PE All Ords (2019)*	14.0x	14.4x	Div Yield All Ords (2019)*	5.6%	5.5%

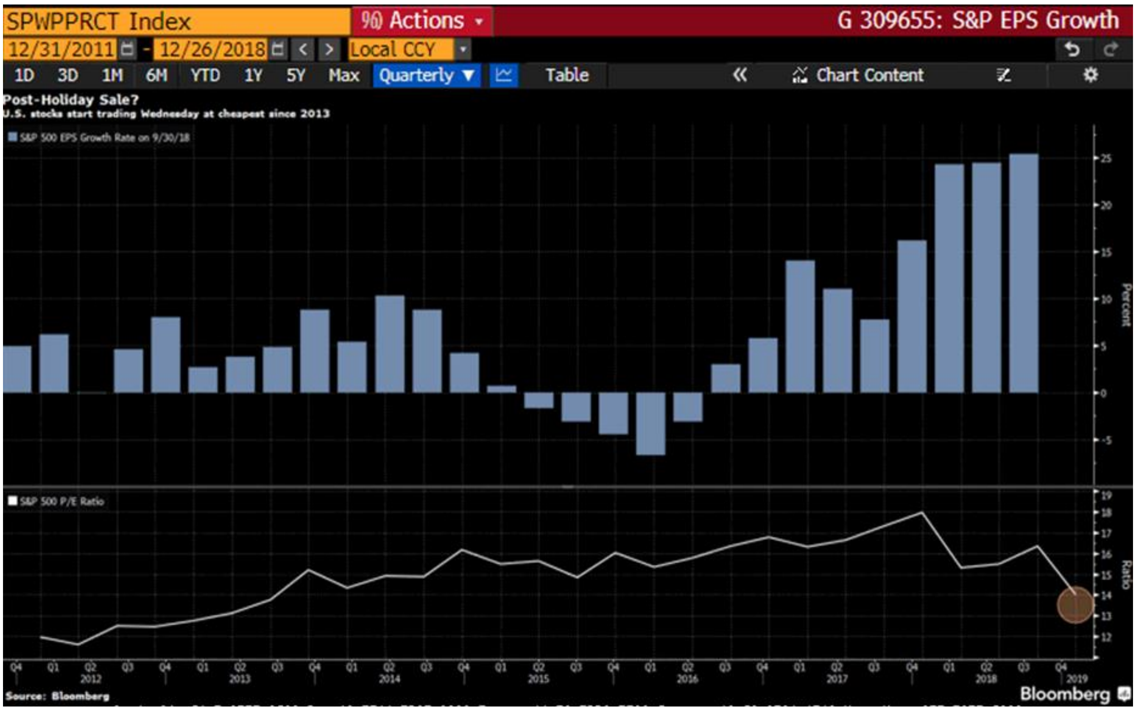
*Source – UBS

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.

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

International Shares

Analysts point out that markets are entering 2019 on some pretty reasonable valuations by historical standards. For example, the S&P 500 is the cheapest it has been since 2013 and growing at a much higher rate.



There is risk of a greater pullback, if the trade war further escalates, earnings growth disappoint or if inflation unexpectedly rises.

Closing Rates as at 31 December 2018					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	23,327.46	25,538.46	Nikkei Dow	20,014.77	22,349.70
S&P 500	2,506.85	2,759.62	Hang Seng	25,845.70	26,506.75
FTSE 100	6,728.13	6,970.78	MSCI	1,883.9	2,041.4

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

Property

Property prices fell by 4.8% in 2018 when compared to the previous calendar year, marking the weakest housing market conditions since the global financial crisis, according to CoreLogic. The December quarter saw the largest quarterly decline of 2.3% since the same corresponding period in 2008, with Sydney the weakest performing city (-3.9%) and Hobart the strongest performing city (+2.0%) in the last quarter.

Table 1 below shows the performance of the AREIT sector for various periods ending 30 November 2018.

Table 1

	1 Month (%)	3 Months (%)	6 Months (%)	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)
Total Return	-0.4	-5.2	0.4	1.4	8.0	11.6
Volatility		*4.6*	*7.9*	9.2	11.6	12.1

Table 2 below shows the income performance of AREITs for various periods ending 30 November 2018.

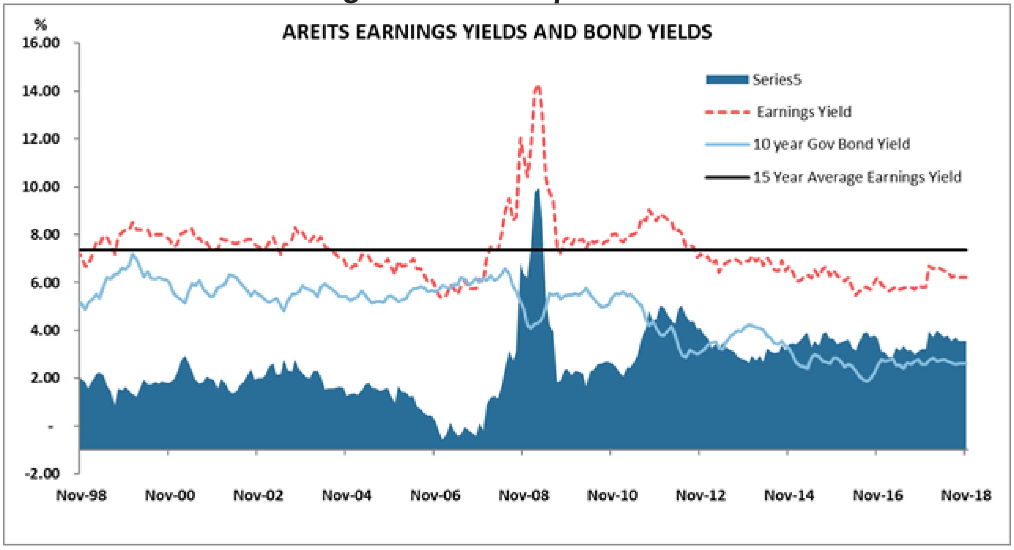
Table 2

	1 Month (%)	3 Months (%)	6 Months (%)	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)
Income Return	0.0	0.0	2.3	4.8	4.9	5.1
Volatility		*0.0*	*2.4*	2.2	2.1	2.3

The volatility associated with the income return was 2.2% on an annual basis, which is low when compared with other asset classes.

Currently, the earnings yield of the AREIT sector is at 6.2% which is higher than the yields of both cash and bonds. The premium to Australian 10-year government bonds is 3.6% which is higher than the average premium of 2.8%. The change over time of the spread between the AREITs earnings yield and the 10-year government bond yield is shown in Chart 1.

Chart 1: AREITS Earnings Yields Compared to Bond Yields



Since early November, US 10-year bonds have fallen on growing expectations US economic growth may begin to stall as recent rises in official interest rates start to impact. It could be a signal for a pivotal turning point for the AREITs market, which over the past 12 months has been negatively impacted by concerns that rising US rates will lead to higher domestic interest rates.

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 31 December 2018		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,375.30	1,376.8

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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