Monthly Economic Notes & Outlook **July 19**

Economic Overview

The consensus is that we are currently in a late cycle environment with risks elevated, but also with the potential for markets to further rally. The risks include the inverted yield curve signalling a potential recession in the next two years, trade war uncertainty and weakness in global growth. However, with major central banks across the world currently easing, more China stimulus and the potential of a US-China trade deal, these factors could trigger a rally in markets. There is a risk of a "melt-up", i.e. strong rally, in equity markets as central banks continue to reduce interest rates. But the economic background is weakening with lower growth. Thus, caution is warranted at this stage of the cycle, but to recognise that growth assets can continue to perform in the short term.

The US economy grew at a healthy 3.1% rate in the first three months of this year, but signs are mounting that growth has slowed sharply in the second quarter amid slower global growth and a confidence-shaking trade battle between the United States and China. Economists believe growth has slowed sharply in the April-June quarter to around 2%. They expect similar meagre gains for the rest of the year. Last year's strength was powered by the implementation of a US$1.5 trillion tax cut, President Donald Trump's signature domestic achievement, and billions of dollars in increased government spending on the military and domestic programs Congress approved in early 2018. However, the impact of the tax cuts and the higher government spending are expected to fade this year, leaving the economy growing very close to the 2.2% average seen over the 10 years of the current expansion.

The US budget deficit widened to US$738.6 billion in the first eight months of the fiscal year, a US$206 billion increase from a year earlier, as expenditures climbed faster than revenue. The shortfall was 38.8% more than the same period a year ago. So far in the fiscal year that began Oct. 1, a revenue increase of 2.3% has not kept pace with a 9.3% rise in spending. The budget gap has continued to increase under President Donald Trump, driven by a combination of Republican tax cuts that will add up to about US$1.5 trillion over a decade, and increased government spending. The deficit is forecast to reach US$897 billion this fiscal year, from US$779 billion last year, and rise to more than US$1 trillion in fiscal 2022. The White House has said the tax cuts will pay for themselves by creating more revenue through faster and sustainable economic growth.

Spending on US construction projects fell in May, the first drop in six months, as home building fell for a fifth straight month. The Commerce Department reported that spending fell 0.8% in May, the first decline since a 1.3% drop in November. The weakness in May was widespread with spending on single-family homes and apartments down 0.6% while non-residential construction fell 0.9%. Spending on government projects also dropped 0.9%, led by a decline in construction spending by the federal government.

US consumer confidence fell to a two-year low in June. It fell to 121.5 in June from a 131.3 in May. That is the lowest level since September 2017. The escalation in trade and tariff tensions appears to have shaken consumers' confidence. Despite unemployment hitting a 49-year low, plus low interest rates and inflation, people are feeling skittish. 78% of adults are losing sleep over work, relationships, retirement and other worries, according to a study by personal-finance site Bankrate.com. Over half (56%) of Americans are worrying about money. Americans are concerned over retirement (24%), health care and/or insurance bills (22%), the ability to pay credit-card debt (18%), mortgage/rent payments (18%), educational expenses (11% versus 26%) and stock-market volatility (5%).

Nearly half — 45% — of US workers require a side hustle to make ends meet, and even middle-aged workers are feeling the pinch. This includes 48% of millennials, 39% of Generation Xers and 28% baby boomers. Side hustlers make an average of US$1,122 per month from their part-time work. That's up from US$686 last year. And approximately 40% of millennials who do work a job on the side say that gig brings in half of their monthly income. A lot of people are working side hustles because even though the economy is strong, wages are stagnant. For a lot of Americans, expenses are rising, but there are no raises at work.

European businesses are increasingly anticipating a recession in the near future as bad debt losses showed a marked increase in 2018. Companies reported 2.31% in bad debt losses in 2018 as a share of total revenues, an increase from 1.69% in 2017. Half of European companies stated that a recession is imminent within five years, while just 30% believe no recession will occur in their country in the foreseeable future. Meanwhile 18% of companies believe that their country is already in recession.

The Bank of England cut its growth forecast for Britain's economy to zero in the second quarter of 2019 and highlighted risks from global trade tensions and growing fears of a no-deal Brexit. The central bank also highlighted a growing disconnect between the "smooth" Brexit that underpins its forecasts and the market pricing in a much more chaotic exit from the EU that would hurt Britain's economy and probably mean rate cuts.

A closely watched quarterly survey by Japan's central bank showed declining confidence in the economic outlook among major manufacturers as trade tensions between the US and China add to worries over regional and global growth. The Bank of Japan's weak "tankan" reading was the second straight quarter of deterioration amid worries over trade tensions and a regional slowdown. The survey's index for major manufacturers fell to 7 in June from 12 in the March survey. But while the tankan reading for large manufacturers was worse than expected, conditions for non-manufacturers improved slightly, while the "all industry" index slipped to 10 from 12. *"Given that the change rather than the level tends to be the best guide to GDP growth, that suggests the economy may have passed its low point,"* according to an economist.

China's manufacturing industry remained weak in June, with the official purchasing managers' index suggesting factory owners are still downbeat about their prospects as the pressures of the trade war continue to mount. The purchasing managers' index (PMI) for the month, was unchanged from May at 49.4. The PMI is a gauge of sentiment among factory operators, with 50 points being the demarcation between expansion and contraction in activity. As in May, the June figure was the lowest since February's 49.2, after signs of expansion in March and April.

The World Bank cut its 2019 global growth forecast, citing a slowdown in trade growth to the weakest since the financial crisis a decade ago and a drop in global investment. The bank forecast that the world economy will expand 2.6% this year, compared with a projection of 2.9% it made in January and easing from an estimated 3% last year, the bank said in its twice-yearly Global Economic Prospects report. The bank also warned that risks are skewed "firmly" to the downside, citing reignited trade tensions between the U.S. and China, financial turbulence in emerging markets and sharper-than-expected weakness in advanced nations, particularly Europe. The bank downgraded its forecast for the euro area to 1.2% in 2019 and 1.4% in 2020, down 0.4 percentage point and 0.1 percentage point respectively from January's forecast. It highlighted weakening exports and investment as drivers of weakness in the region. The bank left this year's outlooks for the US and China unchanged. US economic growth is seen slowing to 2.5%, and further decelerating to 1.7% in 2020 and 1.6% in 2021 as the fiscal stimulus peters out, the bank said. China's economy is expected to expand by 6.2% this year before slowing to 6.1% next year, down 0.1 percentage point from the bank's earlier forecast.

Interest Rates & Currency

A divided Federal Reserve held the line on interest rates in June and indicated formally that no cuts are coming in 2019. The decision came amid divisions over what is ahead and still leaves open the possibility that policy loosening could happen before the end of the year depending on how conditions unfold. The central bank predicts one or two rate cuts in its set of economic predictions, but not until 2020. Despite cautious wording in the post-meeting statement, markets are still betting the Fed cuts, as soon as July. Powell opened the door to that possibility in a press conference following the statement, saying, *"Many participants now see the case for somewhat more accommodative policy has strengthened."* In a decision closely watched by financial market participants clamouring for multiple cuts, central bank officials on the Federal Open Market Committee voted 9-1 to keep the benchmark rate in a target range of 2.25% to 2.5%, where it has been since December's quarter-point increase. St. Louis Fed President James Bullard voted to reduce the rate.

The Bank of Japan (BOJ) kept monetary policy steady in June but Governor Haruhiko Kuroda signaled readiness to ramp up stimulus as global risks cloud the economic outlook, joining US and European central banks in dropping hints of additional easing. Seeking to dispel concerns the BOJ has run out of ammunition, Kuroda said the central bank could combine interest rate cuts with bigger asset buying if needed to keep the economy on track to achieve its elusive 2% inflation target.

ECB President Mario Draghi in June raised the prospect of a renewal of its asset-purchase program if inflation fails to accelerate. Other ECB policy makers all signalled that more stimulus may be needed to combat flagging price rises.

Despite dovish signals from the US Federal Reserve and the European Central Bank, the Bank of England (BoE) has stuck to its message that rates will need to rise in a gradual and limited way if Britain manages to exit the European Union with a transition deal to absorb the economic shock. BoE Governor Mark Carney acknowledged the widening differences between that position and the more pessimistic view of investors, who are now expecting a rate cut, especially after Boris Johnson and Jeremy Hunt - the candidates to replace Theresa May as prime minister - said they were prepared to leave the EU without a deal if necessary. Mr Carney said the central bank was working on the assumption that both candidates would achieve their stated aim of reaching a deal with the EU. If that happened, the outlook for Britain's economy could improve quickly, which is why the BoE has not changed its main message about the outlook for rates. *"In the UK, the combination of the relatively strong initial conditions – including a tight labour market and inflation at target – and the prospect of greater clarity emerging in the near term regarding the UK and EU's future relationship argues for a focus on the medium-term inflation dynamics,"* Mr Carney said.

In July, the RBA cut rates another 25 bps to a record low 1.00%, the first back-to-back rate cuts since 2012. UBS had expected the RBA to wait until August, given Governor Lowe's reiteration *"we're not cutting because things are getting worse, we're cutting because we want things to be better"*. However, the first back-to-back cuts since 2012 suggest the RBA is more willing to ease than their 'tone' suggests. UBS view is *"we still expect at least another 25 bps cut by November, but with a material risk of August if needed, especially if the Fed cuts in July and puts upward pressure on the AUD, or unemployment fails to fall."*

The universe of negative-yielding government bonds grew after dovish messages from central banks in Europe and the US, pushing the total past US$13 trillion for the first time. Joining the club of government debt with 10-year yields below zero were Austria, Sweden and France. Some 40% of global government bonds are now yielding less than 1%. In the investment-grade corporate bond market, negative-yielding debt now comprises almost a quarter of the total. The implication is that assets that can generate a yield will continue to be supported in such a low interest rate environment.

The RBA cash rate is expected to be reduced further in the coming months. Our preference remains for investment grade corporate bonds, and to incorporate government bonds in portfolios for duration exposure.

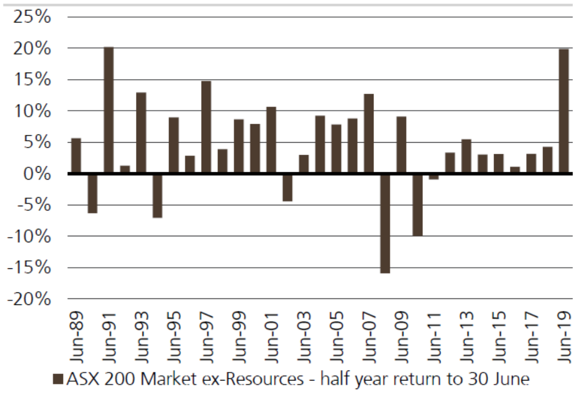
Closing Rates as at 30 June 2019					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.25%	1.50%	US Fed Funds Rate	2.38%	2.39%
90 Day Bank Bills	1.2046%	1.415%	AUD/USD	70.14	69.16
180 Day Bank Bills	1.14%	1.414%	US 10 Year T-Bond	2.03%	2.10%
5 Year Govt Bonds	1.036%	1.185%	US 30 Year T-Bond	2.55%	2.55%
10 Year Govt Bonds	1.0350%	1.496%	Japan 10 year yield	-0.147%	-0.093%

Stance: **Corporate - Positive but selective**
Government - Neutral

Australian Shares

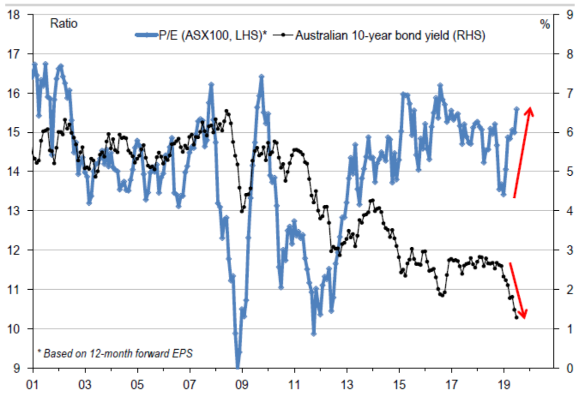
According to UBS, *"The ASX 200 has now recorded its strongest half year rally since 1991 (Figure 9), driven in part by the dramatic fall in bond yields over recent months (Figure 10). Lower bond yields have also pushed up PE dispersions to the highest level since the GFC (Figure 11) and the valuation of the Market (ex-Resources) is now at its highest level since 2001 (Figure 12). While Australian equities are pricing lower rates, the fall in bond yields should have pushed PEs even higher, all else equal. Using a dividend discount model, we estimate that the observed change in the forward PE multiple implies the market has priced lower future growth assumptions relative to 2018, in-line with lower actual GDP growth. Since the start of the year, the Market (ex- Resources) PE has increased from 13.8x to 16.8x, but if we plug in the implied 2018 average growth rate we arrive at a higher c.20x forward PE."*

Figure 9: The ASX 200 has recorded its strongest half year rally since 1991…



Source: FactSet, Datastream, UBS, All Ords used when ASX 200 not available

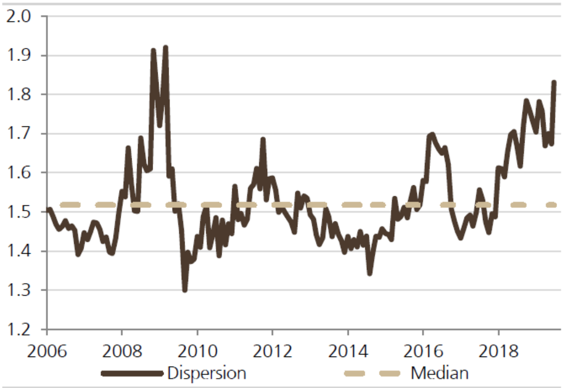
Figure 10: …driven in part by the dramatic fall in bond yields over recent months



Source: Datastream, I/B/E/S, UBS

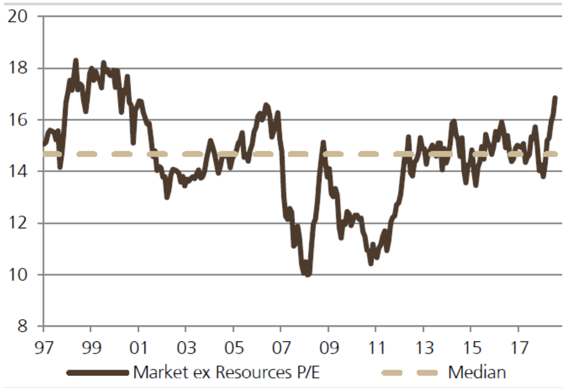
[1] Previous rate or level represents the rate or level as at the end of the previous month.

Figure 11: Lower bond yields have driven PE dispersions (80th percentile PE / 20th percentile PE) to a cycle high…



Source: FactSet, Datastream, UBS, Market ex-Resources

Figure 12: …and the valuation of the Market (ex-Resources) to its highest level since 2001



Source: I/B/E/S, UBS

The franked dividend yield above the term deposit rate continues to provide support for equity valuations. With the low and falling 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 June 2019					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,699.2	6,491.8	AOX Earnings Yield	6.10%	6.37%
PE Industrials (2019)*	18.6x	18.0x	Div Yld Indust (2019)*	4.4%	4.5%
PE All Ords (2019)*	16.4x	15.7x	Div Yield All Ords (2019)*	5.1%	5.3%

*Source – UBS

Stance: Neutral. To review direct banking share exposure.

International Shares

Russell Investment's view on the US is *"We are late cycle and fading fiscal stimulus is likely to slow the economy relative to its breakneck pace of 2018. The trade war re-escalated in May and this uncertainty is likely to challenge US and global capex. The outlook crucially hinges on what happens with Sino-American trade policy. For now, we assume a downside risk bias given the asymmetry of what a negative outcome could mean for US equities. The warning signals from the yield curve and the Business Cycle Index model are instructive in this regard. Our momentum indicators have turned higher with the strong equity market rally thus far in 2019. Our behavioural, contrarian, indicators suggest the market is neither panicked nor euphoric."*

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 30 June 2019					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	26,599.96	24,815.04	Nikkei Dow	21,275.92	20,601.19
S&P 500	2,941.76	2,752.06	Hang Seng	28,621.42	26,901.09
FTSE 100	7,425.63	7,161.71	MSCI	2,178.3	2,046.2

Stance: Neutral

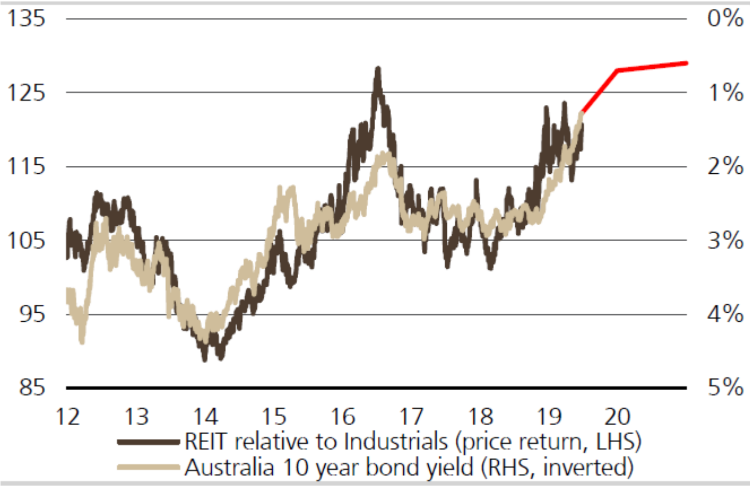
Property

Property values across Sydney and Melbourne have lifted for the first time since 2017 amid signs the re-election of the Morrison government and cuts to official interest rates have boosted confidence in the housing sector. But the turnaround in the nation's two largest property markets has yet to spread to the rest of the country with the CoreLogic measure of values showing sharp falls in Brisbane, Adelaide, Perth and Canberra. Nationally, property values dipped by 0.2% in June to be down by 1% over the past quarter and by 6.9% over the past year.

In Sydney, values lifted by 0.1%, the first increase since June 2017. The lift was driven by the apartments' sector with the value of units across Sydney up by 0.3% through the month. Values of houses were flat. In Melbourne, values lifted by 0.2% with houses up by 0.1% while apartments jumped by 0.5%. Elsewhere, house values fell in Brisbane (0.5%), Adelaide (0.5%), Perth (0.7%), Darwin (1.7%) and Canberra (0.9%).

According to UBS, *"Historically, bond yields have been the key determinant of the relative performance of the REITs. Hence, we view REITs as likely to outperform in a trade war. If earnings forecasts are left unchanged and the yield assumption is reduced to the current 10 year bond yield, there is much more than 50% upside to valuations for most REITs. However, part of the fall in Australian yields reflects lower growth expectations, and to be aware of growth headwinds when estimating the extent of re-ratings in PEs."*

Figure 58: The REITs are likely to outperform in a trade war given lower yields…



Source: Datastream, UBS, red is trade war escalation bond yield forecasts

The REIT sector has benefitted from a falling interest rate environment.

Closing Rates as at 30 June 2019		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,604.8	1,564.7

Stance:

Commercial/Listed: **Neutral, positive long WALE REITs, negative retail REITS & property index, which has 34% in retail REITS**

Residential: **Neutral**

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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