Economic Overview

The underlying fundamentals for the global economy remain solid, reflecting tight global jobs markets, low inflation and very low interest rates. However, China's new more aggressive negotiating position would portend further escalation in the US-China trade dispute, challenging the ability of the global economy to stabilise this year. Recent data suggest growth in the world economy slowed significantly in Q2 to 3.3% from its 4.3% pace just a year ago. The slowdown has been relatively evenly spread across both advanced and developing economies. Global growth remains well supported by historically 'easy' monetary policy and near-universally tight jobs markets. The US consumer remains robust, China is amid renewed stimulus and domestic growth in Europe and Japan is solid. Australia has likely passed the worst of its housing crisis and recent business investment plans are holding up well. However the risks have increased that the cacophony of geo-political noise could sufficiently crush global business confidence and capex plans, so as to undermine the otherwise strong jobs and consumer sectors that are currently supporting growth and company earnings across the world.

Americans spent more at retail stores and restaurants in July, a sign that concerns over weakening economic growth and a persistent trade war that have roiled financial markets have yet to dampen consumer confidence. Retail sales rose a healthy 0.7% in July after a 0.3% gain in June. Online retailers, grocery stores, clothing retailers and electronics and appliance stores all reported strong gains. Consumer spending, the primary driver of the US economy, appears healthy even as other sectors of the economy, such as business investment, have weakened amid growing uncertainty over the US-China trade conflict. Job growth is steady, the unemployment rate is near a 50-year low, and wages are rising modestly, which bolsters Americans' spending power.

US factory activity unexpectedly contracted in August for the first time in three years as shrinking orders, production and hiring pushed a widely followed measure of manufacturing to its lowest level since January 2016. The Institute for Supply Management's purchasing managers index fell to 49.1 in August, weaker than forecasts. Figures below 50 signal the manufacturing economy is generally contracting. The group's gauge of new orders dropped to a more than seven-year low, while the production index shrank to the weakest level since the end of 2015.

Economic confidence among US small firms fell in August to the lowest level since November 2012, according to a monthly survey of more than 670 small companies. The portion of respondents that expect the economy to worsen over the next 12 months rose to 40%, compared with 29% in July and 23% a year ago.

Higher trade barriers, including President Donald Trump's tariffs, are slowing the US economy and cutting household income, congressional budget experts warned. The nonpartisan Congressional Budget Office (CBO) said changes in US and foreign trade policies since January 2018 will reduce inflation-adjusted US gross domestic product by 0.3 per cent from what it would be otherwise by 2020. It also predicted that trade would reduce real income for the average US household by 0.4 per cent, or US$580. CBO also projected a deeper federal deficit of US$960 billion for fiscal year 2019, which ends on Sept 30, due in part to higher government spending. The deficit is projected to top US$1 trillion next year - two years sooner than expected - and average US$1.2 trillion between fiscal years 2020 and 2029. CBO data showed that annual deficits over the next decade would average 4.7 per cent of GDP, the highest since 2012 and significantly higher than the 2.9 per cent annual average of the past 50 years.

A strong majority, 74%, of US business economists appear sufficiently concerned about the risks of some of President Donald Trump's economic policies that they expect a recession in the US by the end of 2021. The economists surveyed by the National Association for Business Economics mostly did not share Trump's optimistic outlook for the economy, though they generally saw recession coming later than they did in a survey taken in February. 34% of the economists surveyed said they believe a slowing economy will tip into recession in 2021. That is up from 25% in the February survey. An additional 38% of those polled predicted that recession will occur next year, down slightly from 42% in February.

The German economy could slip into a technical recession in the third quarter after failing to recover over the summer, the Bundesbank said. The Bundesbank said falling industrial production and orders would likely lead to a continued shrinkage in the period from July to September, after Germany saw a fall of 0.1% in GDP from April to June. This would mean the economy would fulfill the definition of a technical recession, which is two consecutive quarters of negative growth.

Brexit has caused British companies exposed to Europe to cut investment plans significantly and has cut UK productivity by between 2 and 5 percent, according to Bank of England research. Real business investment has been flat since the 2016 referendum, which has been unusual at a time of high employment rates and lower than in other advanced economies. Other studies have compared the performance of the UK economy over the past three years with those of similar countries and have also suggested that Britain has lost between 2 and 3 percent of growth over the past three years.

The Japanese Manufacturing Purchasing Managers' Index (PMI) rose to a seasonally adjusted 49.5 in August from a final 49.4 in the previous month, but stayed below the 50.0 threshold that separates contraction from expansion for a fourth month. Japanese manufacturers turned pessimistic about business prospects for the first time in more than six years in August as the spectre of a global downturn looms large amid the escalating US-China trade war. The monthly poll, which tracks the Bank of Japan's (BOJ) closely-watched tankan quarterly survey, found manufacturers' mood slid for a third straight month to minus 4 in August from the prior month's plus 3. It was the weakest sentiment reading since April 2013, when it was minus 4.

Factory activity in China shrank in August for the fourth month in a row. The Purchasing Managers' Index (PMI) fell to 49.5 in August versus 49.7 in July, below the 50-point mark that separates growth from contraction on a monthly basis. Export orders fell for the 15th straight month in August, although at a slower pace. Total new orders – from home and abroad – also continued to fall, indicating domestic demand remains soft, despite growth-boosting measures over the past year.

The International Monetary Fund trimmed its forecast for global economic growth again as the U.S.-China trade war continues, Brexit worries linger and inflation remains muted. The global economy is expected to expand by 3.2% in 2019. The revised economic growth figure is 0.1 percentage points lower than the IMF had forecast in April and is 0.3 percentage points below the fund's growth estimate at the start of the year.

Interest Rates & Currency

Federal Reserve Chairman Jerome Powell said the US economy is in a favourable place but faces "significant risks" as growth abroad slows amid trade uncertainty. *"Trade policy uncertainty seems to be playing a role in the global slowdown and in weak manufacturing and capital spending in the United States,"* Powell said to central bankers gathered at the Kansas City Fed's annual symposium in Jackson Hole, Wyoming. *"We will act as appropriate to sustain the expansion, with a strong labour market and inflation near its symmetric two per cent objective."*

Citing slowing global growth and muted inflation, the Fed cut interest rates in July for the first time in more than a decade, reducing its target range by a quarter-percentage point to two per cent-2.25 per cent. Powell described the rate reduction at the time as "a mid-cycle adjustment to policy,'' telling reporters on July 31 that it was not the beginning of a long series of cuts.

But in his recent remarks, he noted that events since that meeting "have been eventful." *"We have seen further evidence of a global slowdown, notably in Germany and China. Geopolitical events have been much in the news, including the growing possibility of a hard Brexit, rising tensions in Hong Kong, and the dissolution of the Italian government. In principle, anything that affects the outlook for employment and inflation could also affect the appropriate stance of monetary policy, and that could include uncertainty about trade policy,"* Powell said. Investors have fully priced in another quarter point reduction when the Federal Open Market Committee meets on Sept. 17-18.

Germany's central bank's view is negative-rate mortgages are fine. The bank considers such loans conceivable and would not intervene against them. Five years of sub-zero rates in the euro area have left lenders scraping for ways to offset the hit to their earnings. Paying home buyers to borrow money might be a lesser evil, because parking money at the ECB may cost more. In addition, a negative interest rate on retail bank deposits would cause savers to withdraw their money from the bank and to keep cash at home, and this makes a negative interest rate on retail bank deposits not a realistic option. In August, a bank in Denmark became the first to offer negative interest rates on mortgages.

ECB policy makers expect borrowing costs to stay at present levels or lower through at least the first half of 2020 and have raised the possibility for a September reduction in the deposit rate from the record low of minus 0.4%. They have also signaled they will restart their bond-buying program if needed.

The RBA held the cash rate at a record low 1.00% at its September meeting, as widely expected, after cutting 25 basis points in both June & July. The RBA reiterated 'forward guidance' that *"It is reasonable to expect an extended period of low interest rates".* Their policy outlook also kept an explicit 'easing bias'. UBS' view is *"While we acknowledge a risk they 'look through' the Q2 GDP data, & instead cut in November, we still expect the RBA to cut rates by 25bps at their next meeting in Oct-19. We also expect another cut in Feb-20 to 0.50%."*

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 31 August 2019					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.00%	1.00%	US Fed Funds Rate	2.12%	2.40%
90 Day Bank Bills	0.973%	1.005%	AUD/USD	67.18	68.94
180 Day Bank Bills	0.987%	1.025%	US 10 Year T-Bond	1.50%	2.05%
5 Year Govt Bonds	0.702%	0.853%	US 30 Year T-Bond	1.96%	2.58%
10 Year Govt Bonds	0.930%	1.194%	Japan 10 year yield	-0.266%	-0.155%

Stance: Corporate - Positive but selective
Government - Neutral

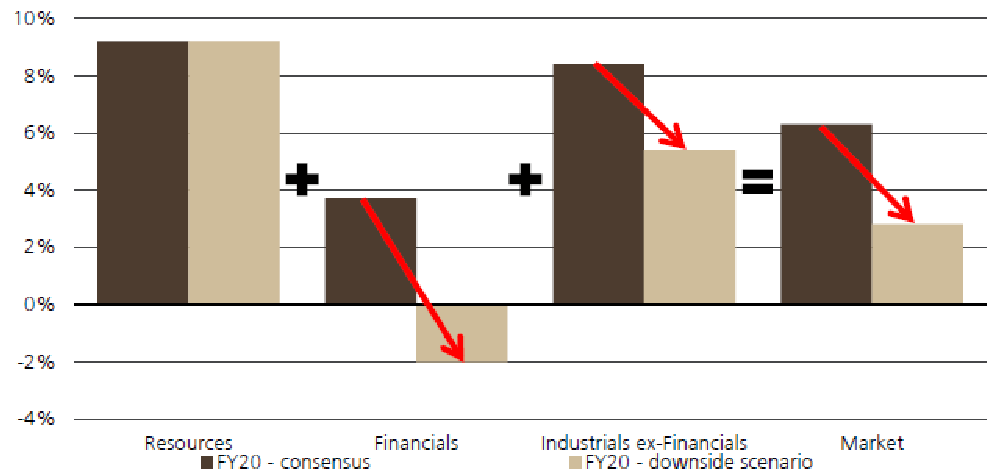
Australian Shares

According to UBS, *"Reporting season is now over. FY19 results were generally weak, with the beat-to-miss ratio at 0.8 (well below average). Guidance was also very soft, with the upgrade-to downgrade ratio coming in at 0.6, the worst in five years. However, the typical stock's price bounced after reporting, despite materially negative FY20E earnings revisions to more than half of the ASX 100. ASX 100 FY20 EPS was revised down by 2.5% to a growth rate of 6.3% in reporting season (albeit still greater than the 1.3% growth in FY19). There was broad-based weakness, with Industrials ex-Financials FY20E EPS revised down 2.4% to a growth rate of +8.4%, Resources revised down 4.2% to a growth rate of +9.2%, and*

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

Financials revised down 1.7% to a growth rate of +3.7%. However, we think consensus estimates for the Financials remain too optimistic, and if ex-Financials EPS is revised down modestly, actual EPS growth could come in at just c.3% in FY20E (Figure below). Nonetheless, ultra-low rates are overshadowing lacklustre growth by supporting PEs."

Figure 11: If Financials EPS is revised down to UBSe & Industrials ex-Financials EPS is revised down 3%, then FY20E EPS growth could come in at just c.3%



Source: FactSet, 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 31 August 2019					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,698.2	6,896.7	AOX Earnings Yield	6.33%	5.88%
PE Industrials (2020)*	19.0x	19.4x	Div Yld Indust (2020)*	4.1%	4.2%
PE All Ords (2020)*	15.8x	17.0x	Div Yield All Ords (2020)*	4.6%	4.9%

*Source – UBS

Stance: Neutral. To review direct banking share exposure.

International Shares

According to Crestone for the US equity reporting season, *"One-year forward EPS growth estimates declined moderately from 4.2% in June to around 2.5% now. This compares with around 20% at the end of last year. Significantly, forward earnings before interest and tax*

(EBIT) estimates are now in negative territory at -0.5%." Insights from the reporting season include:

1. 28% of S&P 500 companies cited the word "tariff" during earnings calls (up by 21% from the Q1 earnings season). 10 out of 11 sectors witnessed an increase in tariff references.
2. There have been more beats than misses and the share of companies reporting actual EPS above estimates (75%) is above the five-year average. Actual sales growth is still a bit below average.
3. Despite actual earnings mostly beating, EPS growth has slowed to -0.4%, the first consecutive negative result since H1 2016. There are now 137 companies in the S&P 500 with negative EPS growth (it was 68 at end-2018).

Crestone adds that *"Overall, the Q2 reporting season reveals a US economy that is reasonably firm, but one that has slowed. Conditions have clearly become more difficult, particularly for those importing inputs, while exporters have clearly fared less well than domestically focused companies who have benefited from a solid domestic US economy, particularly the consumer. The negative earnings growth also flags the risk that there is more slowing in the economy ahead."*

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 August 2019					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	26,403.28	26,864.27	Nikkei Dow	20,704.37	21,521.53
S&P 500	2,926.46	2,980.38	Hang Seng	25,724.73	27,777.75
FTSE 100	7,207.18	7,586.80	MSCI	2,138.50	2,187.56

Stance: Neutral

Property

The Reserve Bank's back-to-back interest rate cuts have super-charged the Sydney and Melbourne property markets with house values in the nation's two largest cities surging in August. The monthly CoreLogic report on the national property market showed house values in Sydney lifted by 1.5% in August. Over the past three months, values have climbed by 1.6%. There is a similar situation in Melbourne where house values increased by 1.3% in August to be 1.6% higher over the past three months.

UBS's view is *"We still expect the RBA to cut rates 25 basis points in Oct & Feb, given an ongoing 'per capita recession' & global weakness; but if house prices continue at this pace, regulators may need to reinstate macro prudential tightening."*

According to UBS in mid July, *"We estimate the market is pricing in a 2% 10yr bond, which compares to the spot rate of 1.3%. We estimate for every 100bps decline the valuation of the sector improves 10%. This incorporates a 60bps slowing in the terminal growth rate which is what we found the market prices in our empirical study. We see more downside risk to the 10yr bond."*

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

Closing Rates as at 31 August 2019		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,655.7	1,644.2

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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