Economic Overview

Globally, we have seen weak economic growth, and increasing fears of a slowdown or a possible recession in the next few years. As such, central banks have taken action to support the economic expansion by reducing interest rates. With European, Japanese and Australian interest rates at either negative yields or very low yields, central banks have reached the limits of conventional monetary policy. This leaves them with unconventional monetary policy such as quantitative easing (i.e. buying bonds) to further reduce long-term interest rates. Increasingly, central banks have now said that it is up to governments to start introducing fiscal stimulus, e.g. tax cuts or increased government spending, to complement monetary policy. Among the major developed economies, only the US has a positive nominal interest rate at 1.8%, but as the US Federal Reserve continues to reduce interest rates, a fiscal policy response may also be required in the US if the economy deteriorates.

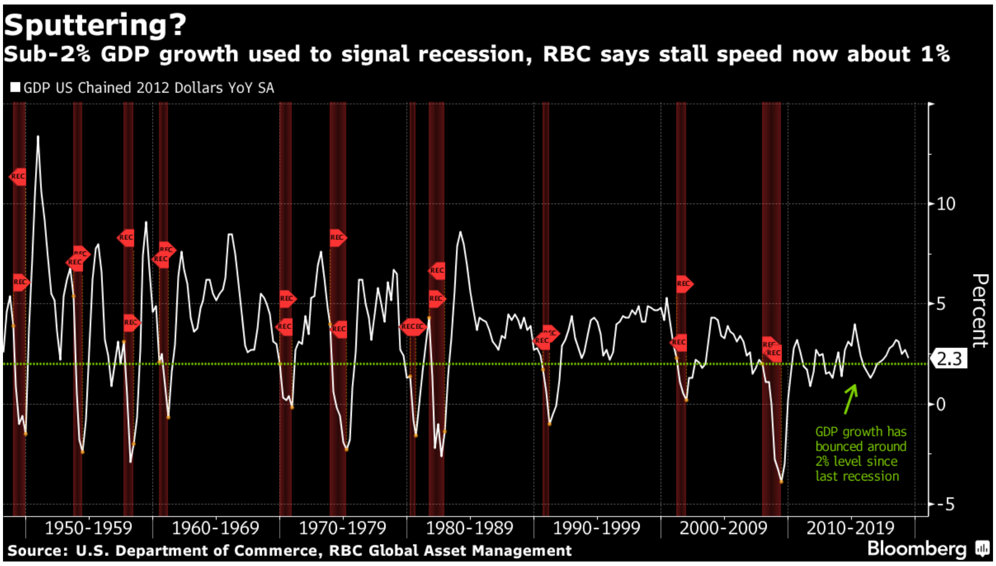
Leading indicators are suggesting an upcoming US recession. Several market and economic data warnings have been triggered, including US truck sales, jobless claim trends, manufacturing data and lending standards. Interest rates and bond yields will continue to fall as central banks reduce interest rates in response, and equities could fall. Asset allocation should be reviewed.

US manufacturing sector slowed again in September, falling to its lowest level since 2009, amid trade war worries. It was the second month in a row manufacturing has contracted, continuing a slowing trend underway since March. ISM's monthly manufacturing index fell to 47.8, a sharp drop from 49.1 in August. Any reading below 50 indicates contraction.

US business investment contracted more sharply than previously estimated in the second quarter and corporate profit growth was tepid. Business investment declined at a 1.0% annualised rate in the June quarter. That was the steepest decline since the fourth quarter of 2015. After-tax profits without inventory valuation and capital consumption adjustment, which correspond to S&P 500 profits, increased at a downwardly revised $59.7 billion, or 3.3% rate. Profits were previously reported to have advanced by $86.0 billion, or at a 4.8% rate in the second quarter.

US GDP increased at an unrevised 2.0% rate in the second quarter as the strongest consumer spending in 4-1/2 years offset weak exports and a slower pace of inventory investment. The economy grew at a 3.1% rate in the January-March quarter. It expanded 2.6% in the first half of the year.

The US economy’s growth rate is losing speed, prompting questions over how slow it can go and still avoid crashing into a recession. Whereas expansion below 2% used to almost guarantee the economy would subsequently contract, some economists now reckon the US can wobble around 1% to 1.5% without falling over. (See chart below) Whether the longest expansion in history remains intact may ultimately depend on whether consumers are able to maintain spending enough to offset the slump in manufacturing amid the US-China trade war.



Euro zone inflation slowed in September to near a three-year low because of cheaper energy although core inflation edged higher, highlighting the challenges facing the European Central Bank. Consumer prices in the 19 countries sharing the euro rose 0.2% month-on-month in September for a 0.9% year-on-year gain. The weaker than expected September number, the lowest year-on-year figure since November 2016, was mainly due to a 1.8% year-on-year fall in energy prices. Excluding energy and equally volatile unprocessed food, price growth accelerated to 1.2% in September from 1.1% in August. This number is called core inflation by the ECB which it monitors for monetary policy decisions.

Japan raised its national sales tax to 10% from 8% on 1 October, risking short-term pain for the sake of the country's future financial stability as it copes with a fast aging and shrinking population. Previous tax increases, a 2-point increase to 5% in 1997 and another to 8% in 2014, brought on recessions. Prime Minister Shinzo Abe twice delayed the move out of fears it might derail the tenuous expansion of the world's third-largest economy. But he said this time it was unavoidable. *"We are pursuing social security reforms to ensure everyone is covered, that all generations from children to senior citizens can feel secure. This is going to be a first big step,"* Abe said.

The sales tax increase covers most goods and services from clothes, electronics to transportation and medical fees. But the government sought to soften its impact with tax breaks for home and car purchases, while launching a rewards program for credit card and other "cashless" purchases at small- to medium-size restaurants and other retailers through next June. One elderly woman, coaxed by a clerk into trying out her credit card at a Tokyo supermarket, appeared delighted with the 5% discount from her 905 yen ($8) grocery bill.

The Bank of Japan's quarterly Tankan business survey for September showed business sentiment, mainly amongst manufacturers, fell from three months ago, hit by the intensified trade tension and the slowing Chinese economy. But the survey also showed capital investment plans by major and smaller firms in this fiscal year were above historical averages. Japan's industrial output fell 1.2% in August, and more than expected. Output was weighed down by reduced production of iron and steel products, factory production equipment and cars.

China's official manufacturing PMI came in at 49.8 in September — the fifth straight month of contraction but slightly exceeding the 49.5 that analysts polled by Reuters had expected. The indicator was 49.5 in August. The trade conflicts between China and the US had a notable impact on exports, production costs and confidence of enterprises. Offsetting this, central policymakers have recently been emphasising the strong growth in the domestic market, with faster construction of infrastructure projects, better implementation of upgrading the industrial sector, and tax and fee cuts to offset the influence of the subdued overseas demand and soften the downward pressure on China's economic growth.

The People's Bank of China announced in September that it would cut its reserve requirement ratio – the amount of cash from deposits that banks must keep – by 0.5 percentage points, which would add US$185 billion to the financial system. Some banks will see their reserve ratio cut by 1 percentage point to promote lending to small businesses and private enterprises. Senior officials also indicated that they planned to loosen restrictions on local governments related to raising money for infrastructure projects. The central bank's move is its latest to ease monetary policy. China has long used the banking system to flood the economy with cash when growth starts to slow.

South Korea's consumer prices fell for the first time in September, underscoring the hit to domestic demand as the economy grapples with falling exports. Prices dropped 0.4% from a year earlier. Inflation was flat in August.

The World Trade Organization has slashed its forecast for trade growth this year by more than half, warning the slowdown could hit living standards and jobs. The WTO said it expected trade volumes to grow by just 1.2% in 2019, down from the 2.6% it predicted in April. It also cut its global economic growth forecast from 2.6% to 2.3%. It blamed the downgrades on slower growth in major economies, trade wars and ongoing uncertainty over Brexit.

Interest Rates & Currency

On Sep 18, the Federal Reserve cut interest rates by 25bps for the second time this year reducing its benchmark rate to 1.75% - 2.00%. US President Donald Trump, who wanted more aggressive cuts tweeted his dissatisfaction.

On Sep 12, the European Central Bank announced a comprehensive stimulus package comprising of 5 key measures, a rate cut, deposit rate tiering, a new round of open-ended QE, strengthened forward guidance and improved TLTRO-III (Targeted Longer-Term Refinancing Operations) terms. The deposit rate was cut by 10bps to -0.5%, in line with consensus as the ECB reintroduced tiered deposits starting 30 October. The significant dovish surprise was the reintroduction of a US$20bn Euro a month QE program. The ECB made it clear in advance that it would strengthen forward guidance expecting rates to *"remain at the present or lower levels".*

The RBA cut rates by 25 basis points to 0.75% at their October meeting, in line with market pricing and consensus. The RBA made an explicit statement that rate cuts also reflect global central bank easing. Specifically, *"The Board also took account of the forces leading to the trend to lower interest rates globally and the effects this trend is having on the Australian economy and inflation outcomes"*. This is consistent with a senior RBA official's recent comment that *"if [the AUD] would depreciate further, that would also be helpful for the macro economic outlook"*. UBS' view is *"Overall, the RBA cut 25bps & kept an easing bias, as we expected. This supports our more dovish than consensus/market view they cut to 0.25%. But they were so dovish we pull forward the next -25bp to this year (not Feb-20)."*

Goldman Sachs believes the RBA will have to buy $200 billion of Australian government bonds to achieve its unemployment and inflation goals once the cash rate is between 0.25% to 0.5%. This will be the introduction of quantitative easing in Australia and will be supportive of government bonds.

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 September 2019					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.00%	1.00%	US Fed Funds Rate	1.83%	2.12%
90 Day Bank Bills	0.945%	0.973%	AUD/USD	67.49	67.18
180 Day Bank Bills	0.910%	0.987%	US 10 Year T-Bond	1.73%	1.50%
5 Year Govt Bonds	0.693%	0.702%	US 30 Year T-Bond	2.18%	1.96%
10 Year Govt Bonds	1.002%	0.930%	Japan 10 year yield	-0.155%	-0.266%

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

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

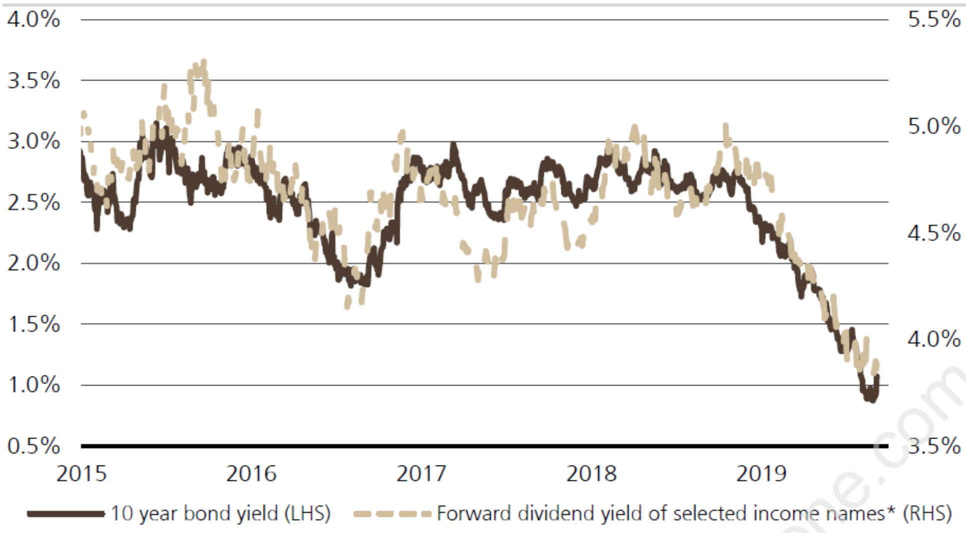
Australian Shares

According to UBS, *"We still like Defensive Income & Growth (DIG) stocks as we think the market is overlooking the ultra-low 1.9% longer-term 10y yield implied by 20y and 30y bonds. Although the DIG trade has run hard already, we think that, as analysts recalibrate their valuation models to use lower risk free rates, DIG stocks will benefit more than other stocks.*

We think the outlook for interest rates is extremely relevant for portfolio positioning. Firstly, low and falling interest rates can make income from equities attractive relative to lower-yielding equities and other assets. Secondly, lower interest rates mean the discount rate which should be used to value companies should be lower, thereby leading to higher valuations (all else equal). While a rising tide lifts all boats, there are two specific groups of stocks that ought to continue to outperform others if rates continue to decline (or simply stay low). They are defensive income stocks and growth stocks.

Based on the historical relationship between income stocks and bond yields; if 10- year bond yields fall to 0.5% by end-19, then defensive income stocks could deliver a c.10% total return over this time frame. However, if 10-year bond yield rises to 1.5%, then defensive income stocks could deliver a c.-4% total return."

Figure 9: Defensive income dividend yields may fall if bond yields trend lower



Source: FactSet, UBS, * Selected names are ALX, APA, CHC, DXS, GPT, MGR, SKI, SYD, TCL, WOW

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.

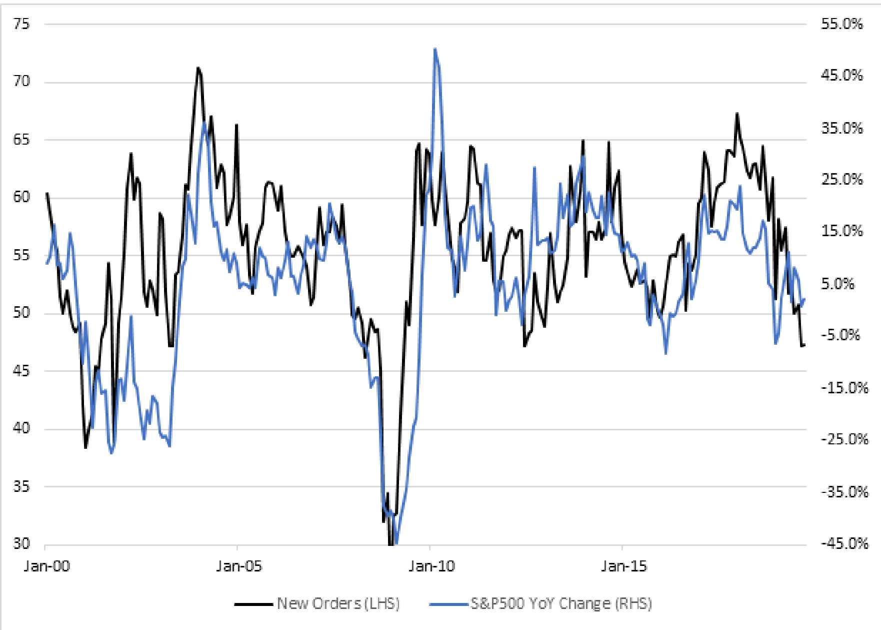
Closing Rates as at 30 September 2019					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,800.6	6,698.2	AOX Earnings Yield	6.06%	6.33%
PE Industrials (2020)*	19.3x	19.0x	Div Yld Indust (2020)*	4.0%	4.1%
PE All Ords (2020)*	16.5x	15.8x	Div Yield All Ords (2020)*	4.4%	4.6%

*Source – UBS

Stance: Neutral. To review direct banking share exposure.

International Shares

The ISM New Orders index correlates with the year-on-year change in the S&P 500 index (see chart below). The latest US ISM New Orders has come in at 47.3, which is contractionary. The upcoming earnings season is very important and is trending negatively, with 82 of the 113 S&P 500 companies issuing negative EPS guidance.



The chart below shows the ISM New Orders Index correlates with EPS growth. 50% of Small Caps, which are domestically focussed and very sensitive to economic conditions, already have forward earnings growth that are negative.

Source: FactSet, UBS

With the contractionary ISM New Orders Index and negative EPS growth signalling further economic weakness, there is risk of a pullback in the US equity market.

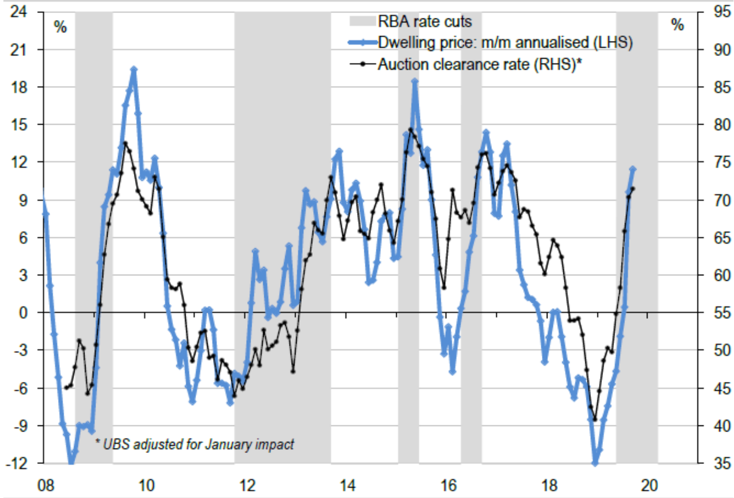
Closing Rates as at 30 September 2019					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	26,916.83	26,403.28	Nikkei Dow	21,755.84	20,704.37
S&P 500	2,976.74	2,926.46	Hang Seng	25,954.81	25,724.73
FTSE 100	7,408.21	7,207.18	MSCI	2,180.0	2,138.50

Stance: Neutral and to reduce exposure if overweight

Property

Home prices lifted >10% annualised in recent months, suggesting the risk is to the higher end of a possible 'mini-boom' forecast range of 5-10% for the year ahead, especially with the RBA likely to keep cutting. UBS view is that this ‘mini-boom’ would not be like previous home price increases, with limited leverage evident by record low credit growth; as well as little recovery in new housing, with residential building approvals collapsing to a >6-year low of 154,000.

Figure 2: Aug/Sep home prices boomed >10% m/m a.r., ~consistent with auction clearance rates spiking >70%



Source: CoreLogic, RBA, UBS

According to UBS, *"FY19 results season highlighted once again the diverging performance of various sectors in Australian real estate. The operating metrics for retail deteriorated with no catalyst in sight while office, logistics and funds management kept pace with lofty expectations. The residential outlook remains cautious despite lending growth rebounding. Overall, UBS funds from operations (i.e. cash flow) estimates were revised lower for retail and upgraded for funds management while we are yet to see material earnings revisions for lower debt costs."*

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

Closing Rates as at 30 September 2019		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,609.8	1,655.7

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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