Monthly Economic Notes & Outlook **November 19**

Economic Overview

The two main developments in the past month are:

1. More strident commentary from the IMF and central banks that monetary policy (whether adopting low interest rates or quantitative easing policies) are becoming less effective to support economic growth as interest rates are already very low, and that fiscal policy (via increased government spending and lower taxes) will have to step in. However, most governments have been reluctant to adopt looser fiscal policies to-date, but this may change in the coming year.

2. Growing realisation in the US and China that the ongoing trade dispute and escalating tariffs are impacting the US and Chinese economies, with signs that tariffs may be wound back and a trade agreement could be signed.

US consumer sentiment pared gains from earlier in October while remaining elevated, suggesting Americans' spending will continue to support the economy despite weakness in manufacturing. The University of Michigan's October consumer sentiment index rose to 95.5 from September's 93.2. While consumer sentiment is still at a three-month high, the data showed Americans cooled on the economic outlook amid persistent trade tensions and global weakness. A measure of buying conditions for household durable goods matched the highest level this year. Americans' shopping is key to keeping the record-long US expansion going as business investment cools and job gains slow.

"The focus of consumers has been on income and job growth, while largely ignoring other news," Richard Curtin, director of the University of Michigan consumer survey, said in a statement. *"To be sure, the multiple sources of uncertainty will keep consumers focused on potential threats to their prevailing optimism."*

Despite a strong US economy, two-thirds of adults fear a recession could come next year, according to a CNBC survey. People who identify themselves as Republican are far less likely to agree, with 46% saying a recession is coming, compared with 84% of Democrats. Nobel Prize winning economist Robert Shiller said that *“People are fascinated by this idea of a business cycle, so they say that we’re overdue for a recession or they say that we’ve got an inverted yield curve. These are stories that have been amplified and they’ve gotten to the point where they may be self-fulfilling prophecies. The inverted yield curve causes a recession because people think it will.”*

US nonfarm payrolls rose by 128,000 in October, exceeding the estimate of 75,000 from economists. There were big revisions of past numbers as well. August’s initial 168,000 payrolls addition was revised up to 219,000, while September’s jumped from 136,000 to 180,000. The unemployment rate ticked slightly higher to 3.6% from 3.5%, still near the lowest in 50 years. The pace of average hourly earnings picked up a bit, rising 0.1% to a year-over-year 3% gain.

US homebuilding tumbled from more than a 12-year high in September, but single-family home construction rose for a fourth straight month, suggesting the housing market remains supported by lower mortgage rates even as the economy is slowing. Housing starts declined 9.4% to a seasonally adjusted annual rate of 1.256 million units in September as construction in the volatile multi-family housing segment dropped. The housing sector, which accounts for about 3.1% of the economy, continues to be hampered by land and labour shortages. The 30-year fixed mortgage rate has dropped more than 135 basis points to an average of 3.57%.

The US manufacturing purchasing managers index from the Institute for Supply Management came in at 48.3 in October, compared with a 47.8 reading in September. This is the third straight month of slowdown. However, the latest report also showed signs of recovery, making some on Wall Street believe the manufacturing slowdown would not be accelerating. New orders, employment and inventories all showed improvement in October.

The European Commission cut its growth forecast for the 19 countries that share the euro to 1.1% this year from 1.2% it expected in July, and to 1.2% in 2020 and 2021 from 1.4%. *"Economic growth has continued, job creation has been robust and domestic demand strong. However, we could be facing troubled waters ahead: a period of high uncertainty related to trade conflicts, rising geopolitical tensions, persistent weakness in the manufacturing sector and Brexit,"* Commission Vice President for the euro Valdis Dombrovskis said. *"I urge all EU countries with high levels of public debt to pursue prudent fiscal policies and put their debt levels on a downward path. On the other hand, those Member States that have fiscal space should use it now,"* he said.

The Commission forecast the euro zone's aggregate budget deficit would rise from an historic low of 0.5% of GDP in 2018 to 0.8% this year, 0.9% in 2020 and 1.0% in 2021, unless policies change. But pressure for higher fiscal stimulus is mainly on Germany and the Netherlands, referred to as countries that have fiscal space, because both have been running large budget surpluses for years and both of which have low public debt. Germany is to have a budget surplus of 1.2% of GDP this year and 0.6% in 2020, while the Netherlands is to have a surplus of 1.5% this year and 0.5% next year.

Japan's household spending rose at the fastest pace on record in September as consumers rushed to buy goods before a sales tax hike, though the test for the economy will be whether the higher tax will squeeze domestic demand in coming months. Household spending jumped 9.5% in September from a year earlier, the fastest pace of increase since comparable data became available from 2001 and stronger than the median forecast for a 7.8% gain. It was a tenth straight month of gains, the longest such streak since 2001.

Japan's exports fell for a 10th straight month in September as trade tensions between the US and China hit demand for machinery and other manufacturing mainstays. The Finance Ministry said the trade deficit in September totalled US$1.1 billion, a third consecutive month of red ink. Exports fell 5.2% from the same month in 2018, with slower shipments of machinery, vehicles and auto parts. Imports dropped 1.5%. Japan's exports to the US dropped nearly 8% from a year earlier, as exports of vehicles sank 16%. Imports from the US declined 12%. The trade surplus with America fell 3.5% to 564.1 billion yen (US$5.2 billion).

China said its economy grew by 6% in the third quarter from a year earlier. It is believed to be China's slowest GDP gain in at least 27 years. In the second quarter of 2019, China's statistics bureau said the economy grew 6.2% from a year earlier. China's GDP has fallen sharply since the first quarter of 2018, when it gained 6.8% due to credit tightening and the country's trade dispute with the US.

China's Purchasing Managers' Index (PMI) fell to 49.3 in October, versus 49.8 in September. Factory activity in China shrank for the sixth straight month in October and by more than expected.

The IMF's latest World Economic Outlook shaved global growth this year by 0.2 percentage points and 0.1 percentage point next year, compared with the organisation's view from July. Global economic growth is expected to fall to 3% rate this year, the slowest pace since the 2008 financial crisis and down from a 3.8% pace seen in 2017. The IMF is growing even more pessimistic about the global economy, as higher import tariffs are impacting manufacturing activity and international trade. If global growth slows below a 2.5% rate, that would mean a recession.

Interest Rates & Currency

In October, the US Federal Reserve cut interest rates by 25bps for the third time this year reducing its benchmark rate to 1.50% - 1.75%. Federal Reserve Chairman said *"We took this step to help keep the economy strong in the face of global developments and to provide some insurance against ongoing risks. We see the current stance of monetary policy as likely to remain appropriate as long as incoming information about the economy remains broadly consistent with our outlook."*

The International Monetary Fund warned Europe to prepare emergency plans for an economic slump, as risks to the region's outlook spread and monetary policy has all but exhausted its arsenal. *"Given elevated downside risks, contingency plans should be at the ready for implementation in case these risks materialise, not least because the scope for effective monetary policy action has diminished,"* the IMF said in its Regional Economic Outlook for Europe. *"A synchronised fiscal response"* may be necessary, the fund said in the report, highlighting the dangers from trade protectionism, a chaotic Brexit and geopolitics.

The Bank of England voted 7-2 on November to keep interest rates on hold at 0.75%. Two policymakers voted for an immediate interest rate cut to support growth. Mark Carney, the governor of the Bank of England, said the Brexit deal had created *"the prospects for a pick-up in UK growth"*. The Bank expects the annual pace of growth to rise from around 1% at the end of this year to more than 2% by the end of 2022. Mr Carney said *"three-quarters of that rise in growth is driven by domestic factors - the most important of which is a reduction in uncertainty driven by an orderly transition to a new Brexit arrangement."* However, the Bank's Monetary Policy Report said a weaker global economy and its new assumptions about Brexit would knock 1% off UK growth over the next three years compared with its forecast in August.

Bank of Japan Governor Haruhiko Kuroda stepped into the global debate on the need for governments to do more heavy lifting to support their economies, saying that the ultra-low interest environment created by Japan's central bank makes fiscal spending more powerful. Mr Kuroda said that the BOJ was not planning to add to its stimulus in tandem with some form of government spending package, but acknowledged that a policy mix was more effective in stimulating prices and the economy than the central bank acting alone.

The RBA held the cash rate at 0.75%, as widely expected, at their November meeting, after cutting 25 basis point in October. Crucially, their comments keep alive the change of a cut in December. They repeated an explicit easing bias to *"monitor developments, including in the labour market, and is prepared to ease monetary policy further if needed to support sustainable growth in the economy, full employment and the achievement of the inflation target over time".* UBS remains dovish, seeing a 0.25% cash rate by mid-2020, with the next cut in December, but with risk of delay to February, and the view remains conditional on more global central bank easing and no US-China trade deal.

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 October 2019					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	0.75%	1.00%	US Fed Funds Rate	1.82%	1.83%
90 Day Bank Bills	0.93%	0.945%	AUD/USD	69.26	67.49
180 Day Bank Bills	0.96%	0.910%	US 10 Year T-Bond	1.78%	1.73%
5 Year Govt Bonds	0.846%	0.693%	US 30 Year T-Bond	2.26%	2.18%
10 Year Govt Bonds	1.138%	1.002%	Japan 10 year yield	-0.138%	-0.155%

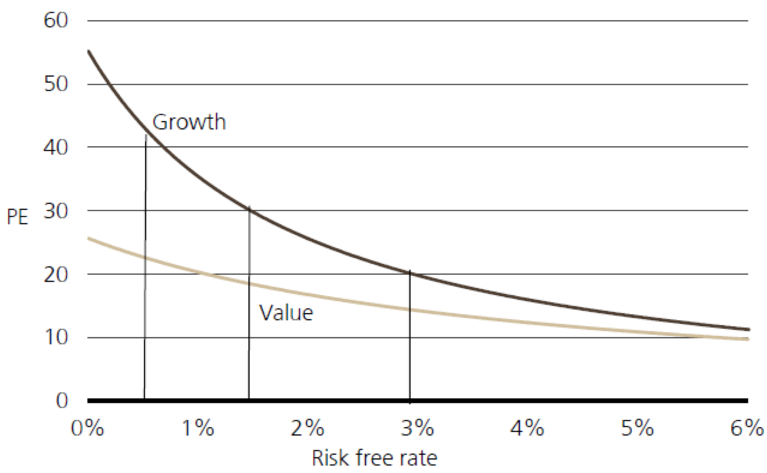
Stance: **Corporate - Positive but selective**
Government - Neutral

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

Australian Shares

According to UBS, *"Consensus expects the Industrials ex Financials are set to grow earnings by c.8% in FY20. Despite a number of FY20 earnings downgrades in the latter half of reporting season, some Industrials stocks remain a bright spot in the overall earnings outlook for the Australian market. Ultra-low rates also favour growth stocks because the bulk of their cash flows are expected to occur further into the future (Figure 5). Lower rates are also generally reflective of lower expected growth, and high dividend payout ratios across the market indicate a lack of growth opportunities. As a result, growth stocks are likely to continue to command a premium and could trade higher, in our view."*

Figure 5: Growth stocks benefit more from lower rates



Source: 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 October 2019					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,772.9	6,800.6	AOX Earnings Yield	5.99%	6.06%
PE Industrials (2020)*	19.4x	19.3x	Div Yld Indust (2020)*	4.1%	4.0%
PE All Ords (2020)*	16.7x	16.5x	Div Yield All Ords (2020)*	4.4%	4.4%

*Source – UBS

Stance: **Neutral. To review direct banking share exposure.**

International Shares

JPMorgan's view is "*Our portfolio managers remain somewhat more cautious than usual. At the company level, corporate profits are growing, but at a slower pace than last year. We also expect more downward revisions in earnings expectations, particularly in more economically exposed sectors, as global economic growth appears below trend, the manufacturing economy is weak, and persistent US-China trade tensions pose an ongoing risk for markets and firms. Still, all is not bleak for equity investors. The best growth companies are continuing to deliver remarkable profitability and cash flow, while prospects for value-oriented stock pickers, as measured by the divergence between cheap and expensive stocks, look very interesting. And unlike in some other asset classes, valuations for equities are mostly well within historical norms and investors are still compensated in real terms for holding stocks. In sum, we find many reasons to recommend staying invested.*"

A US-China trade deal could boost the US equity market further. The possibility of a recession is a threat to the outlook for international equities.

Closing Rates as at 31 October 2019					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	27,046.23	26,916.83	Nikkei Dow	22,927.04	21,755.84
S&P 500	3,037.56	2,976.74	Hang Seng	26,844.25	25,954.81
FTSE 100	7,257.70	7,408.21	MSCI	2,233.53	2,180.0

Stance: Neutral and to reduce exposure if overweight

Property

Sydney and Melbourne house prices surged through October with prices in some parts of the country now growing at their fastest rate in a decade. CoreLogic's closely watched home value index showed house prices in Sydney jumped by 1.8% in October while in Melbourne they bounced by 2.4%. Melbourne's house values have increased by 5.7% over the past 3 months or by almost 23% at an annualised rate. Sydney is not far behind, with prices there up 5.3% through the quarter or 21.1% at an annualised rate.

According to UBS, *"Given we prefer defensive income as a style in an ultra-low rate environment, we are positive on the REIT sector. In our view, REITs are likely to outperform on the back of higher stock market volatility and lower bond yields due to their stable cash flows and relatively attractive dividend yields. We prefer industrial and diversified REITs to those with retail exposure given reduced spending across services and dining, and the rise of online shopping."*

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

Closing Rates as at 31 October 2019		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,629.9	1,609.8

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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