Economic Overview

The key theme for 2019 was the return of central banks, importantly the US Federal Reserve, which, in the absence of a recession, pushed the litany of geopolitical concerns (trade war, Hong Kong protests, Brexit, Middle East tensions, US presidential impeachment) into the background. It was, as a result, a much better year for investors across the board.

There are some important lessons from the 2019 experience. Firstly, that asset prices are systemically important and policy makers are not yet ready to withdraw or materially temper their support. Secondly, that in the absence of recession, liquidity eclipses growth. While the liquidity taps remain on, markets will be supported. Thirdly, geopolitics only really matter when they impact real economic outcomes, and not always in the way is naively expected. The accelerating trade tensions between the US and China did hurt industrial production and trade, but the fact that it relieved some pressure on a potentially overheating US economy and brought the Fed back to the table for another round of easing ultimately meant it had a net positive impact on markets.

US manufacturing closed out a tumultuous year with the weakest monthly performance since the end of the recession, with orders shrinking and factories continuing to dial back production. The Institute for Supply Management's purchasing managers' index fell to 47.2 in December from 48.1, the fifth straight month of contraction. It was the worst reading since June 2009 and marked the eighth decline in the last nine months. Readings below 50 indicate activity is shrinking. The deterioration was driven by the weakest gauges of new orders and production since April 2009.

Home prices in 20 US cities rose at the fastest pace in five months in October, posting a third straight acceleration as real estate markets showed fresh strength at the start of the fourth quarter. The S&P CoreLogic Case-Shiller index of property values advanced 2.2% from October 2018. Lower mortgage rates and a robust labour market have helped consumers remain upbeat, luring potential home buyers and helping to lift prices.

Confidence among US consumers climbed to the highest level in five months as Americans grew more optimistic about the economy and their personal finances. Bloomberg's index of consumer comfort rose 1.6 points, the most since June, to 63.9 in the week ended Dec 29. The gauge for the state of the economy also hit a five-month high and the reading for personal finances increased to the best level in three months. Comfort readings for those 65 and older, college graduates, home owners and those who are not employed were all at the highest levels since 2000.

Factories across the euro zone ended 2019 in poor shape with activity contracting for an 11th straight month. IHS Markit’s final manufacturing Purchasing Managers’ Index (PMI) has been below the 50 mark separating growth from contraction since February, and at 46.3 in December, it was below November’s 46.9. The index measuring new orders dipped to 46.6 from 46.7 and as they did all last year, firms turned to completing backlogs of work to stay active. Also indicating they do not expect an imminent improvement, purchases of raw materials were reduced and staffing levels cut.

The UK economy ended 2019 in stagnation, under pressure from long-term uncertainty, mounting business costs and a global economic slowdown, according to a business survey. The British Chambers of Commerce's (BCC) latest quarterly economic snapshot, based on a poll of 6,500 firms across the country in November, painted a gloomy picture of the economy at the end of the year. The service sector, which accounts for almost 80% of economic output, worsened in the final quarter of the year. Indicators for factories' export and domestic orders were negative for two consecutive quarters for the first time in a decade, and manufacturers' investment plans hit an eight-year low.

The BCC is forecasting a slowdown in economic growth to 0.2% in the final three months of 2019, from 0.3% in the third quarter. The Bank of England estimates growth of just 0.1% in the fourth quarter, when high street spending stalled and many firms put investment plans on hold before the election and due to Brexit uncertainty. The BCC estimates the UK economy grew by 1.3% in 2019. It predicts growth will slow to 1% in 2020, which would be the weakest performance since 2009.

Japanese manufacturing activity shrank at a faster pace in December than in the previous month as output slumped, underscoring growing pressure on businesses from sagging demand abroad and at home. The Jibun Bank Final Japan Manufacturing Purchasing Managers' Index (PMI) slipped to 48.4 on a seasonally adjusted basis, matching a more than three-year low last touched in October. It was down from a preliminary figure of 48.8 for December and compared with November's final reading of 48.9.

Japan's economy grew at a much faster pace than initially estimated in the July-September quarter thanks to stronger-than-expected spending by companies. The economy expanded an annualised 1.8% in the quarter, following 2.0% growth in the previous quarter, revised gross domestic product figures showed. That was much faster than the annualised 0.2% growth in a preliminary estimate from the Cabinet Office in November.

China's central bank said it would reduce the portion of deposits commercial banks are required to set aside as reserves, releasing billions of dollars to the financial system to help boost economic growth. The People's Bank of China said that it would lower its reserve requirement ratio for all banks by 0.5 percentage point, effective Jan. 6, injecting more than 800 billion yuan (US$114.9 billion) into the financial system. The official reserve requirement ratio for most large banks will fall to 12.5% from 13% after the cut takes effect, while the ratio for smaller lenders will drop to 10.5% from 11%. Beijing has in recent months stepped up efforts to boost a weakening economy by pouring more funds into infrastructure, among other measures.

The purchasing managers' index for China's manufacturing sector was unchanged at 50.2 in December from November. This marks the second straight month of expansion.

The global economy is growing at the slowest pace since the financial crisis as governments leave it to central banks to revive investment, the OECD said in an update of its forecasts. The world economy is projected to grow by a decade-low 2.9% this year and next, the OECD said in its Economic Outlook, trimming its 2020 forecast from an estimate of 3.0% in September. A concern is that governments are failing to get to grips with global challenges such as climate change, the digitalisation of their economies and the crumbling of the multilateral order that emerged after the fall of Communism. It would be a policy mistake to consider these shifts as temporary factors that can be addressed with monetary or fiscal policy; they are structural, OECD said.

Interest Rates & Currency

US Federal Reserve policymakers agreed in their final policy meeting of 2019 that interest rates were likely to stay on hold for "a time" as the central bank set its sights on a new articulation of its monetary policy framework.

The Fed's meeting minutes often lay out opposing camps in the discussion of whether to shift its stance of monetary policy at that meeting. But not the minutes for its last meeting, a reflection of the firm consensus at the central bank at the end of 2019 that it had done enough to shield the economy from a downturn by cutting rates several times that year.

"Participants judged that it would be appropriate to maintain the target range for the federal funds rate," according to the minutes. Similarly, the minutes noted that policymakers regarded the current rate stance *"as likely to remain appropriate for a time"* as long as the economy stays on track.

European government bonds could be supported as investors buy the securities to sell on to the European Central Bank (ECB) under its latest asset-purchasing program. The ECB relaunched its quantitative easing operation in November, at a pace of 20 billion-euro (US$22 billion) per month, increasing the demand for regional debt, and this would be very supportive for the smaller markets such as Ireland and Portugal.

In December, the Bank of England (BoE) kept interest rates steady. Two of the BoE's nine policymakers voted for a second month in a row for a cut to borrowing costs due to fears that Britain's jobs boom is deteriorating. But the majority took a wait-and-see approach at the penultimate rate-setting meeting for Governor Mark Carney, who is due to stand down on Jan. 31. *"There was no evidence yet about the extent to which policy uncertainties among companies and households had declined following recent domestic policy developments,"* the BoE said in a statement.

Sweden's central bank ended five years of negative interest rates in December when it raised benchmark borrowing costs by a quarter point to zero. The increase from -0.25 per cent makes the Riksbank the first of the central banks that pushed rates below zero to inch its way back to what was long considered the floor for interest rates. Rates are still negative in the euro zone, Japan, Denmark, Switzerland and Hungary, and with the exception of Hungary, are expected to remain so for some time to come. Riksbank Governor Stefan Ingves said negative rates had worked well, boosting inflation and the economy. *"But it is a completely different question what would happen in an economy if you had negative rates for a very long period,"* he told reporters.

The RBA's December meeting held the cash rate at 0.75%, as widely expected (after last cutting 25bps in October). Crucially, they retained an explicit easing bias, and concluded *"The Board 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 comments are *"UBS remain more dovish than consensus, still seeing a 25bp rate cut at the RBA's next board meeting in Feb-20 as likely, & then another 25bps cut to 0.25% by mid-20; albeit the latter remains conditional on more global central bank easing & no material fiscal stimulus in the government's Mid-Year Economic and Fiscal Outlook (MYEFO)."* UBS economists have stated it was still too early to know the full impact of the bushfires, but that the crisis would be a drag on GDP growth in the short term. Consumers are likely to hold back on their spending in the coming months due to higher food prices – from the drought and bushfires – and rising insurance premiums. *"Overall, we think this makes a rate cut from the RBA in February more likely,"* UBS said.

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 December 2019					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	0.75%	0.75%	US Fed Funds Rate	1.55%	1.55%
90 Day Bank Bills	0.922%	0.885%	AUD/USD	70.06	67.77
180 Day Bank Bills	0.90%	0.88%	US 10 Year T-Bond	1.92%	1.81%
5 Year Govt Bonds	0.991%	0.738%	US 30 Year T-Bond	2.39%	2.24%
10 Year Govt Bonds	1.372%	1.097%	Japan 10 year yield	-0.012%	-0.045%

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

Australian Shares

Fund managers and strategists expect more modest returns from Australian shares in 2020 after they delivered a large 18% return (excluding dividends) in 2019, which is the best annual performance in a decade. Many of the tailwinds that lifted stocks in 2019 are

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

already priced in. Analyst expect S&P/ASX 200 companies to deliver earnings per share growth of just 2% in 2020.

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 December 2019					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	6,802.4	6,948.0	AOX Earnings Yield	5.65%	5.78%
PE Industrials (2020)*	20.2x	20.2x	Div Yld Indust (2020)*	4.0%	4.0%
PE All Ords (2020)*	17.7x	17.3x	Div Yield All Ords (2020)*	4.2%	4.3%

*Source – UBS

Stance: Neutral. To review direct banking share exposure.

International Shares

The CEOs of America's biggest companies say they expect to hire fewer people and invest less in the next six months owing to lingering worries about the economy. The Business Roundtable said an index that measures CEOs' outlook for the economy fell for the seventh quarter in a row. The index slipped 2.5 points to 76.7, a bit below its historic average. The index had hit an all-time high of 118.6 in the first quarter of 2018, shortly after the passage of President Trump's tax cuts for individuals and businesses.

In a separate question, nearly half of all top executives polled said labour is their biggest cost pressure, reflecting an environment of extremely low unemployment in which companies have to offer higher wages to compete. Some 14% cited regulations and 11% pointed to higher costs of raw materials and other supplies.

Signs of a US-China trade deal has boosted the US equity market. The possibility of a recession is a threat to the outlook for international equities.

Closing Rates as at 31 December 2019					
	Level	Level (Prev) [1]		Rate	Rate (Prev)
US Dow Jones	28,538.44	28,051.41	Nikkei Dow	23,656.62	23,293.91
S&P 500	3,230.78	3,140.98	Hang Seng	28,189.75	26,346.49
FTSE 100	7,542.44	7,346.50	MSCI	2,358.5	2,292.26

Stance: Neutral and to reduce exposure if overweight

Property

Australian home prices ended 2019 with the biggest quarterly rise in a decade, a remarkable return to boom from bust that promises to support consumer wealth and, perhaps, spending. Data from property consultant CoreLogic showed that home prices across the nation rose 1.1% in December, from November when they climbed 1.7%. That brought the gains for the three months to December to 4%, the steepest rise since late 2009.

The resurgence was again led by the major cities with values in Sydney up by 1.7% in December and 6.2% for the quarter. Melbourne likewise boasted gains of 1.4% and 6.1% respectively. The median Sydney home was now worth A$840,072, compared to the national value of A$537,506. It was the sixth straight month of price gains and a decisive end to a two-year price slump.

With interest rates and government bond yields at current low levels, A-REITs will again be supported by investors chasing higher yields backed by secure rental income from blue-chip tenants. The yield spread of A-REITs to bonds, at between 3 to 4%, is still attractive. Moody's has a "stable" 2020 outlook for A-REITs, which the rating agency says reflects modest net operating income growth expectations of around 3% over the next 12-18 months.

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

Closing Rates as at 31 December 2019		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,568.0	1,667.4

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.

NEWELL PALMER SECURITIES PTY LTD

Address:	**Suite 101, 270 Pacific Highway CROWS NEST NSW 2065**
Mail:	**PO Box 1680 CROWS NEST NSW 1585**
Phone:	**(61 2) 9906 8066**
Fax:	**(61 2) 9906 8080**
Website:	**www.newellpalmer.com.au**
Email:	**info@newellpalmer.com.au**

ABN 89 050 040 232
Australian Financial Services Licence No. 229264

Member of Australian Financial Complaints Authority