December 2012/January 2013

Outlook for Investment Markets

Sharemarkets have recovered from their November weakness as investors have become less concerned about the US 'fiscal cliff', the Eurozone's debt problems, and global growth. The risks have diminished rather than vanished, but the prospects are for a better 2013, which should benefit growth assets. The prospect of lower US interest rates until 2015 has triggered a surge of interest in bagging the income yields still available, and there's now little value left in some fixed interest and property markets. The important question locally is the scale and timing of a slowdown in activity as the resources sector comes off its peak and the potential impact on growth assets.

Australian Cash & Fixed Interest – Review

Short-term interest rates fell over the past month, the 90-day bank bill yield dropping from 3.30 to 3.10 percent, reflecting the Reserve Bank of Australia's 0.25 percent cash rate cut to three percent from 5 December. Longer-term interest rates edged up a little, in line with a slight uptick in overseas bond yields: the 10-year swap rate increased from 3.70 to 3.90 percent, and the 10-year Commonwealth bond yield from three to 3.35 percent. The $A strengthened over the month, up from US$1.035 to US$1.055, and recorded a 1.80 percent overall trade-weighted rise.

Australian Cash & Fixed Interest – Outlook

In its most recent policy decision, the Reserve Bank gave a clear explanation of the rationale for its latest interest rate cut – inflation on track, but the mining boom coming off its peak, so other parts of the economy need extra support to grow faster – but gave little hint of what it might do next. The futures market expects a 90-day yield of 2.90 percent in 2013, consistent with another 0.25 percent cut to the cash rate. The major forecasters are generally in the same camp, some picking an unchanged cash rate, some one more decrease, and a few picking that the expected slowdown in the Australian economy will be quite serious, and require significantly looser monetary policy.

Before the US Federal Reserve's recent announcement that it would keep monetary policy very supportive until unemployment dropped below 6.50 percent, local forecasters had been expecting a modest and gradual rise in local bond yields. The news that US interest rates are likely to stay ultra-low out to 2015 suggests that local bond yields may still rise, but very modestly and slowly.

While there is universal agreement that the $A is overvalued from an export competitiveness point of view, the likelihood of any substantial near-term drop looks low. Central banks in the US, United Kingdom, Eurozone, and Japan are all printing money apace; our Reserve Bank has not cut short-term rates to zero or thereabouts; and overseas investors' willingness to give the $A a go has increased with lower levels of Eurozone anxiety. A steady or even higher $A therefore looks plausible in current market conditions.

Australian & International Property – Review

Australian listed property shared in the wider recovery of the Australian sharemarket from its selloff in November, the S&P/ASX200 A-REIT Index up 3.20 percent over the past month.

International property also followed the global sharemarket recovery, the EPRA/NAREIT Global Index up 5.10 percent in $US for the month and the Global ex-Australia Index up a very similar five percent. Europe was the best-performing region for the month, up 6.60 percent, helped by a 7.90 percent rise in the

German market. The UK gained 7.30 percent. Asia was up 4.80 percent, Japan gained 3.10 percent, and US REITs rose by 3.60 percent.

Australian & International Property – Outlook

The macroeconomic backdrop is not greatly supportive for Australian listed property. As Jones Lang LaSalle recently pointed out: "the continued weak macroeconomic environment, subdued labour market, and softening of the mining boom" mean that tenants are likely to have negotiating leverage over rentals in the next few years. Surplus space has been coming onto the market except in Perth, through increased sub-leasing as more cautious companies cut back on rental commitments. On the other hand, the attraction of the income stream has increased in an environment where bond yields now look to stay very low for longer. In an income-scarce world, this is probably enough to attract and hold ongoing investor interest.

It's harder to make the same case for international listed property, where valuations in some markets have been driven up to expensive levels by investors desperate for something that yields more than a bank deposit or local government bond. This is especially true of the US, where the current income yield is only 3.60 percent. International property has some useful defensive qualities in a world where there are still significant uncertainties, and there are pockets of the market where property shares can still be found offering attractive yields, but at current overall yields not a lot of value is on offer.

Australian Equities – Review

Australian shares followed the global pattern of a weak period up to mid-November followed by a solid recovery since. The S&P/ASX200 Accumulation Index was up 5.50 percent for the past month, all sectors participating. Metals and mining was the most volatile sector, dropping most to mid-November, but also gained most on the rebound. The Industrials were up 5.80 percent, financials 4.60 percent, consumer discretionary stocks 5.20 percent, and consumer staples 3.90 percent.

Australian Equities – Outlook

The key question for the Australian sharemarket is the extent and duration of a slowdown in economic activity. The latest official data showed that the economy grew by 0.50 percent in the September quarter. While a reasonable outcome by developed economy standards, this was slower than the June quarter (+0.60 percent), and slower than forecasters had expected, and resulted in the annual growth rate falling from 3.80 percent in June to 3.10 percent.

There are more recent signs that the economy has cooled appreciably since the September quarter. The latest National Australia Bank Business Opinion Survey was downbeat: 'business conditions', a mix of firms' own trading conditions, profitability, and employment, remained in quite poor shape. Profitability fell further, and forward orders – a clue about the likely shape of 2013 business activity – also went backwards. Nor is it just businesses who are feeling glum. The Westpac/Melbourne Institute index of consumer confidence dropped in November, a surprising result given the recent interest rate cuts.

The news has not been uniformly poor. More jobs were created in November than predicted (13,900, when analysts had been picking no growth), a repetition of the similar positive surprise in October. But clearly the economy is in transition from a higher rate of growth to something slower. If the slowdown works out as forecasters currently expect – 2.80 percent growth next year is the current consensus forecast – then the sharemarket may do reasonably well. Potential pluses include ongoing (if slower) growth, appeal as an indirect Chinese growth play, and the attractiveness of the dividend yield. But the tone of the latest business and consumer confidence readings suggests that there is more downside risk to this outlook than existed two or three months ago.

International Fixed Interest – Review

US bond yields were slightly higher over the past month, the 10-year US Treasury yield up from 1.60 to 1.70 percent, but remained within the 1.60 – 1.75 percent trading range of recent months. The other major government bond markets were largely unchanged, with no change in Germany (1.35 percent), Japan (0.73 percent), or Switzerland (0.46 percent), and UK yields only slightly higher at 1.87 percent.

After much wrangling, an agreement was concluded to lend Greece €34.0 billion, about half earmarked to recapitalise the Greek banks. This was welcomed by investors, and borrowing costs in the larger European economies fell. The biggest impact was felt in the more indebted peripheral economies. Greece's 10-year borrowing cost dropped five percent to just under 13.0 percent, and Portugal's 1.70 percent to 7.10 percent. Ireland's borrowing cost was unaffected: it had already dropped sharply (to 4.75 percent) as investors liked its fiscal austerity and other reforms.

Corporate credit spreads continued to narrow, particularly for lower-quality borrowers, the yield on global 'high yield' (junk) debt down to just under 6.20 percent. Global corporate bonds have returned 10.90 percent (in $US) over the year to date, and high yield bonds a remarkable 19.10 percent. In Europe, where investor worries about the Eurozone crisis had been especially high, the recent improvement in sentiment has contributed to a 13.0 percent gain for all European corporate bonds, and a 27.40 percent gain for pan-European high yield debt.

International Fixed Interest – Outlook

The major recent development has been the US Federal Reserve's announcement that it would keep monetary policy low for "an extended period", and short-term interest rates near zero until the US unemployment rate has dropped below 6.50 percent. The Fed also upped its quantitative easing program of buying Treasury and mortgage securities to US$85.0 billion a month – over US$1.0 trillion at an annual rate.

This latest explanation of the Fed's intentions means that exceptionally low government bond yields are likely to last even longer than forecasters had expected. This might provide some comfort to holders of government bonds worried about sharp rises in yields (and concomitant capital losses) from currently ultra-low levels. Equally, though, the Fed's approach is still storing up a major government bond market setback down the track. As one fund manager memorably put it in the *Financial Times* on 12 December: "The analogy I would use... is that of a balloon being held under water. When the Fed withdraws from the market and allows interest rates to find their economic level, the balloon will inevitably ascend."

Risks have also increased in the corporate bond area as the extra yield from holding corporate debt has been bid away. The extra return from holding BBB rather than AAA-rated US corporate bonds has dropped from around 135 basis points in September to 100 basis points. The recent substantial acceleration in corporate bond issuance is also suggestive: corporate treasurers clearly believe current market conditions represent an unusually cheap funding opportunity. But for investors, that translates into an unusually bad buying environment.

There are still reasons to hold international fixed interest – notably as insurance against fiscal cliffs or Eurozone-style financial issues – but at current yields and corporate credit spreads, the outlook for the sector has become decidedly less rewarding and more risky than before.

International Equities – Review

The sharp slide in world share prices in the first half of November has been well and truly reversed: the MSCI World Index rose 5.90 percent in overseas currency terms between its low point on 15 November and 17 December. $A appreciation ate up some of the gains in local investors' hands, but it's clear that global equities have been in much better shape over the past month.

Just as the November selloff had been pretty universal, so was the recovery. German (DAX +9.40 percent) and Japanese (Nikkei +8.90 percent) shares were especially strong, but there were also rises in Europe (FTSEurofirst 300 +6.10 percent), the UK (FTSE100 +5.50 percent), and the US (S&P500 +5.20 percent). Emerging markets chipped in with a 6.10 percent gain, spread evenly across Asia (+6.50 percent), Latin America (+6.0 percent), and Eastern Europe (+5.70 percent).

International Equities – Outlook

The recent rise in world shares reflects increased optimism about key risks that had been preying on investors' minds – the 'fiscal cliff' looming in the US, resolution of the Eurozone's debt issues, and a patchy world economic outlook. These risks have not gone away, but look more manageable than before.

The markets had been right to worry about the fiscal cliff in particular, because the stakes are high. All the forecasters polled in the *Wall Street Journal*s December survey felt that triggering the cliff would cause significantly lower share prices. Conversely, a deal avoiding the cliff would be positive. The prognosis was looking reasonably hopeful at the time of writing. Three-quarters of the *Wall Street Journal*s forecasters expected that some sort of agreement would be cobbled together. According to media reports, the Republicans had offered some increases in tax rates on the wealthy – previously off-limits for discussion – while the Democrats appeared to be more flexible on possible spending cuts.

Investors have also been more encouraged about the prospects of a relatively orderly resolution of the Eurozone's fiscal and debt issues. New lending to Greece will enable it to recapitalise its banks, help pay for ongoing deficits, and pay for Greece's buyback of half the debt it owed to private creditors at sharply discounted prices. More important than the details was the demonstration that the European countries could actually come to definitive agreements, after weeks of fruitless wrangling between the Eurozone members, the European Central Bank, and the International Monetary Fund.

On the outlook for global business activity, the major questions continue to be around the pace of US recovery and the state of the Chinese economy. On both fronts, the news has been quite good. The US economy continues to create reasonable numbers of new jobs, 146,000 in November, and a small drop in the unemployment rate to 7.70 percent. Assuming the economy does not topple off the fiscal cliff, the outlook remains for a gradual but persistent strengthening.

Uncertainties over the outlook for China have also lightened. The latest statistics paint a consistent picture: the slowdown has come to an end, and the local sharemarket clearly agrees, the Shanghai Composite Index finally coming out of its prolonged tailspin with a 7.20 percent rise over the past month. Industrial production in November was up 10.10 percent year-on-year, and retail sales were up 14.90 percent.

On the other hand, the Eurozone and Japan will struggle. Eurozone GDP is still falling, and next year isn't going to be a lot better, the European Central Bank picking that the outcome will lie somewhere between further recession (an 0.90 percent fall in GNP) and the slightest of recoveries (+0.30 percent). The outlook in Japan also remains weak. The latest quarterly survey by the Bank of Japan of large manufacturers showed a further slump in business confidence, with only a very small minority prepared to describe business conditions as 'favourable'.

The outlook remains a mixed picture. There are outstanding political risks (notably around the fiscal cliff), potential financial fragilities (Eurozone debt, perhaps some new mutation of the global financial crtisis), and patches of economic sogginess. Overall, though, world economic activity looks set to firm up gradually. The European Central Bank estimates that the world economy beyond the Eurozone will have grown by 3.70 percent this year, but will pick up to 3.80 percent next year and 4.50 percent in 2014. This should support corporate profitability and sharemarket performance, while the Fed's clarification that very low cash and bond rates are likely to persist out to 2015 will also make share dividends more attractive to investors. M

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