Economic Update

Sydney | 20-02-13

February/March 2013

Outlook for Investment Markets

Investment markets have seen a global rotation out of income assets and into growth assets, as investors have become more confident about global growth prospects and less tolerant of very low cash and bond yields. Sharemarkets have consequently had a strong run, and bond prices have fallen. More of the same looks likely for the rest of the year, with the provisos that recent price rises may have taken some sharemarket valuations into expensive territory, and that it is still an open question whether bond yields will continue to rise.

Australian Cash & Fixed Interest – Review

Australian short-term interest rates have dropped a little, the 90-day bank bill yield falling from 3.07 percent at the end of last year to 2.90 percent. Longer-term interest rates followed the lead of offshore bond markets, the 10-year Commonwealth bond yield up from 3.27 percent at the close of 2012 to 3.56 percent. The $A has shown little overall change: it was US$1.038 at the end of 2012, is still around the US$1.03 mark, and has been trading in a US$1.02 - 1.06 range for the past six months. The $A was up a little (0.80 percent) in overall trade-weighted value for the year to date.

Australian Cash & Fixed Interest – Outlook

The minutes of the Reserve Bank of Australia's 5 February meeting stated that: "The inflation outlook, as assessed at this meeting, would afford scope to ease policy further, should that be necessary to support demand", although forecasters have mixed views about whether that further easing will in fact be needed. The National Australia Bank's economists have a weaker view than most of likely GDP growth this year (two percent), and predictably expect the Reserve Bank to swing into action with 0.75 percent of cash rate cuts and bank bills dropping to 2.40 percent by the end of this year. Westpac, expecting 2.50 percent growth, is going for one 0.25 percent cut, while the Commonwealth Bank, with relatively upbeat 3.20 percent GDP growth in mind, expects the Reserve Bank not to move at all. The market as a whole, going by futures pricing, is leaning towards one 0.25 percent cut in the first half of this year, which would see bank bills dropping to around 2.75 percent at the end of the year, before rising modestly in 2014.

The outlook for local bond yields depends very much on your view of overseas bond market developments. If, as in Westpac's current forecast, you do not expect a lot of movement in the US 10-year Treasury yield, then equally you do not expect much of a local move either. If, like the National Australia Bank's forecasters, you have US Treasuries going to 2.50 percent by the end of this year and 3.30 percent by the end of 2014, then you have local bonds going to 3.60 percent and five percent. As noted in the International Fixed Interest section, it is plausible that US bond yields are in fact heading modestly higher this year, in which case local yields are likely to do the same.

More confident global markets might normally be expected to translate into greater appetite for the $A, which tends to do better in a risk-on environment. While the $A continues to look overvalued from a fundamental perspective – the Reserve Bank has noted that it looks on the high side, given that commodity prices have eased back – forecasters in aggregate are not expecting much of a move this coming year.

Australian & International Property – Review

Australian listed property is showing a three percent capital gain for the year to date, and a total pre-tax return of 4.10 percent. This somewhat overstates the shape of the sector, however: while the sharemarket as a whole is still making good ground, the AREITs peaked on 6 February, and have fallen 2.20 percent from their peak.

Global property securities have tracked wider global sharemarkets, rising from mid-November through to the end of January and levelling out more recently. The EPRA/NAREIT Global Index is up 3.20 percent in $US since the start of the year, and the Global ex-Australia Index hedged back into $A up 4.50 percent. The US gained 5.20 percent (in $US terms), while the UK was up 3.20 percent (in sterling). Europe was predictably weaker, with a small (0.30 percent) decline in Euro terms. Japan had an especially steamy December, set alight by the prospect of new construction contracts from the incoming government, and the Japanese index rose 17.10 percent for the month. The euphoria has since subsided, and Japanese property share prices have risen by a more modest three percent over the year to date.

Australian & International Property – Outlook

The expected cyclical economic slowdown is not the best of environments for Australian listed property. Although consumer confidence has improved, this has yet to translate into stronger retail sales. Businesses are reluctant to hire, the labour market has been seeing modestly higher unemployment rates, and there is an unwinding of the resources investment boom. As the Property Council of Australia's latest (January) survey of the office market shows, for example, cumulatively these trends have led to rising vacancy rates in the office sector (from 7.30 percent in July 2012 to 8.10 percent in January 2013), with an outright fall in take-up of space in Perth as the resources sector cools down. The relative attraction of the yield (a little over five percent) is also not quite what it was. Even if Australian bonds do not keep rising, the earnings pickup from property has been eroded by 0.30 percent since the start of the year. This has been partly offset by lower yields from another income alternative to property, the banks' deposit 'specials', where rates on offer have been dropping and may fall further if the Reserve Bank cuts the cash rate again. All up, between the effects of a cyclical slowdown, a less compelling income proposition relative to bonds, and a change in investors' demand from a search for income to a more risk-tolerant search for capital gain, it's hard to see a strong year ahead for Australian listed property.

The economic backdrop for global listed property is more supportive. World economic activity is picking up in aggregate, and as the Royal Institution of Chartered Surveyors' latest survey of global commercial property noted, this has led to "broadly positive occupier and investment momentum across Asia, the United Arab Emirates, North America, and Russia; this is also reflected in a declining flow of distressed properties coming onto the market in these areas". Some previously devastated property markets (Ireland, the UAE) have even started to come right, and the only remaining outright area of weakness is the Eurozone, where the Dutch, French, Greek, Italian, and Spanish markets are all in poor shape. The improving economic outlook is a given, but whether investors are getting a good deal from global listed property is more debatable. The sector was bid up strongly in 2012 as investors chased pockets of yield, and has been bid up further in recent weeks as part of the global sharemarket rally. For a relatively defensive sector, valuations have now reached a point where further advances will be harder to achieve.

Australian Equities – Review

Australian shares have been tuned in to the global sharemarket rally, the S&P/ASX200 Accumulation Index up 8.90 percent year to date. The financials, helped by a good reporting season from the banks, delivered a strong 11.80 percent gain, and there were also good performances from consumer discretionary

(+13.40 percent) and consumer staples (+10.0 percent) stocks. Somewhat oddly at a time of growing optimism about the world economy, the resources stocks were relatively neglected, the S&P/ASX300 Metals and Mining Index up only 3.80 percent.

Australian Equities – Outlook

The key question in the outlook for Australian shares remains how the economy, and corporate performance, will fare during an ongoing transition from the 'two-speed economy' (boomtime in resources, weaker domestic non-mining sectors). The Reserve Bank is predicting a slowdown in GDP growth in 2013 to a slower than usual 2.50 percent (private sector forecasters on average have a similar view), with slowing resources investment, the high dollar, and fiscal tightening weighing more heavily in the mix than a strengthening housing market and, potentially, investment picking up in the non-mining economy. Recent data has tended to bear out this slower growth scenario, retail sales and the labour market on the weak side, although the latest Westpac/Melbourne Institute consumer confidence survey recorded a significant improvement in household sentiment, and particularly about the economic outlook.

This outlook of a modest cyclical slowdown, with some pick-up expected in 2014, is a decent but not strongly supportive backdrop for Australian shares. The latest profit reporting season has been going quite well, but it may be that the recent strong run in share prices and rather optimistic profit expectations investors appear to have are running ahead of what companies are actually going to be able to continue to deliver.

International Fixed Interest – Review

Global government bond yields in the major markets have risen since the start of the year, the key 10-year US Treasury yield up from 1.75 to just over two percent, with similarly-sized rises in Germany (from 1.30 to 1.65 percent), France (two to 2.30 percent), and Switzerland (from 0.45 to 0.77 percent). Japan, whose new government is set on an even easier monetary policy, was an exception, the 10-year yield dropping slightly from 0.80 to 0.75 percent. The more indebted Eurozone economies also benefitted from perceptions that their debt problems are being tackled, Ireland benefitting from a renegotiation of the interest rate on its bailout funding. Greek, Italian, and Spanish 10-year yields dropped, although less dramatically.

Higher yields have meant losses for most categories of fixed interest investment, as the capital losses have outweighed the interest income. Global government debt is down 2.90 percent and global corporate debt down one percent year to date. Global high yield (low credit quality) investments have done rather better, up 1.20 percent year to date.

International Fixed Interest – Outlook

The opening months of the year have been difficult for international fixed interest. Investors have become more confident about the economic and financial outlook, and less inclined to take out 'safe haven' insurance against uncertainty. The bigger question is whether the recent rise in the yields is the start of a longer-term march towards more normal levels of yield and ongoing capital losses.

Predictions of an eventual rise in bond yields have been a commonplace in the post-financial crisis years, but have repeatedly proven premature. Yields have stubbornly remained at unusually low levels for longer than virtually anyone expected. In addition, the major central banks remain committed to substantial bond purchases (keeping yields down), and there remains the possibility that there could be further market squalls that could prompt investors to scurry back into bonds. And for all their poor income value, bonds still offer a yield pick-up over cash, a situation that is not going to change for some time, with all the major central banks likely to keep short-term interest rates low well into the future. A case, in sum, can still be made that long bond yields will stay very low, or even return to last year's levels.

At the very least, though, the odds are rising that bond yields have started on the long road back to more normalised levels. Any rise in longer-term yields will be gradual and modest: the US forecasters surveyed by the *Wall Street Journal*, for example, currently expect the US 10-year yield to rise slowly to 2.40 percent by the end of this year and to three percent by the end of 2014. This looks like a reasonable prognosis, in which case the recent setback to returns may well become par for the course during the remainder of this year.

International Equities – Review

International equities rose strongly in the second half of November, in December, and again in January. The pace of increase has dropped off more recently, and in some markets prices have actually declined. The aggregate MSCI World Index rose 6.20 percent in January, but was up only 0.30 percent (month to date) for February. Most of this gain in foreign currency terms translated through into a solid performance in $A terms as well, the Aussie dollar only marginally firmer in overall value over the period.

The global rally has carried most national sharemarkets along with it, but there have been some relative winners and losers. Japanese shares have been especially strong on expectations of business-friendly stimulus from the new government: the Nikkei Index is up 29.0 percent since the global rally in world shares got underway in the middle of November. Chinese shares have also been powering along. At the weaker end, European shares have been slipping in recent weeks. In France, for example, the CAC40 Index had gained 13.30 percent between mid-November and 29 January, but it has since dropped 3.30 percent.

International Equities – Outlook

There have been good reasons for the improved performance of global equities. Monetary policy in the major economies has been set on 'ultra-easy' for some considerable time, the effects are accumulating, and investors are becoming more optimistic, as the fall of the gold price and the ongoing decline in the VIX volatility index have showed.

The US continues to grow at a moderate pace, confounding fears of a relapse into slower growth or even back into recession. Jobs growth was stronger in 2012 than first thought (181,000 jobs a month, rather than the 153,000 originally estimated), and has continued into 2013, with 157,000 new jobs in January. While not earth-shattering, this is consistent with a gradual pick-up in GDP growth in the US from 2012's 1.70 percent to 2.40 percent this year and 2.90 percent in 2014 (according to the latest *Wall Street Journal* forecaster poll).

Financial crises, particularly in the Eurozone, have been at least partially defanged – credit ratings agencies have recently upgraded Ireland, for example – and growth prospects in Asia in particular have been boosted. Investors had been worried about unexpectedly weak data, but this has come and gone. The Markit/HSBC Purchasing Managers Index, a good guide to the Chinese economic cycle, picked up again late last year, and latest official Chinese statistics have also been strong. As a result, China appears likely to avoid any significant slowdown from its previous eight percent-plus growth, and latest consensus forecasts have been revised up to 8.50 percent growth for this year. And in Japan, the new administration is determined to get the moribund economy growing at a faster rate. *The Economist*'s latest poll of international forecasters shows that they have lifted their estimate for Japanese GDP growth this year from 0.70 percent in the previous poll to one percent in the current one – again, like the outlook for US growth, not massively game-changing, but another bit of evidence that the world economy is turning for the better compared with previous investor expectations.

None of this necessarily makes a positive outlook for international shares in 2013 a certainty. The US economy could be derailed by the shambles that is its fiscal policymaking. The 'fiscal cliff' was bodged with a Band-Aid, the next crisis (automatic spending cuts if nothing better is agreed) will potentially kick in from 1 March, and there is the issue of the Federal Government's debt ceiling after that. The Eurozone may be less likely to spring a sovereign default or banking system crisis, but its structural growth challenges are formidable – particularly in France, Italy, Spain, and Holland – and recent data has been very poor. Eurozone GDP fell 0.60 percent in the final quarter of 2012, a worse than expected outcome. Chinese political and financial developments are relatively opaque to outside investors, and in Japan the new government is summoning up policies that reached their use-by date in the 1980s.

More fundamentally, there is the risk of herd behaviour driving share prices to levels beyond what might have been justified by a genuinely improving economic and financial outlook. This 'great rotation' out of bonds into equities, as it has been dubbed, could mean that the recent strength of world shares more reflects a global wall of money looking for a new home than any sustainable lift in expected corporate profitability. The share price gains are still real enough, but they could be losing touch with the fundamentals of corporate performance.

From that perspective, the slowdown in share price appreciation in February after January's sharp gains isn't necessarily all bad news: a more measured response to an improved outlook is more likely to bank longer-term gains. Looking ahead, there is enough positive news to support further gains, but investors are increasingly going to have to satisfy themselves that valuations are not getting out of synch with reality. M

Performance periods refer to the month and three months to 18 February 2013.

Copyright, Disclaimer & Other Information

Limited Financial Services Guide

Morningstar Australasia Pty Ltd ('Morningstar') ABN: 95 090 665 544, AFSL: 240892 (a subsidiary of Morningstar, Inc.) of Level 36 Australia Square 264 George Street Sydney NSW 2000 is the provider of the general advice ('the service') provided in this report. The service is provided through research including the profiling and rating of managers and products. Morningstar does not receive commissions for the service and does not charge companies to be rated. Where Morningstar provides the service through the provision of research it is remunerated by subscribers paying a subscription fee. This fee is variable depending on the subscription and will vary depending upon the individual's specific requirements, particularly to the ongoing use and distribution of the service. Subscriptions are paid as agreed with individual clients. Morningstar representatives are remunerated by salary and do not directly receive any commissions or fees. They may be eligible for an annual performance payment which is discretionary and based on reaching agreed performance levels.

Please refer to our Financial Services Guide (FSG) for more information www.morningstar.com.au/fsg.asp

Copyright

Trademarks

Morningstar and the Morningstar logo are registered trademarks of Morningstar, Inc.

Disclaimer

All care has been taken in preparing this report but to the extent that it is based on information received from other parties no liability is accepted by Morningstar for errors contained in the report or omissions from the report. Morningstar gives neither guarantee nor warranty nor makes any representation as to the correctness or completeness of the information presented. Morningstar determines ratings on the basis of information disclosed to Morningstar by investment product providers and on past performance of products. Past performance is no guarantee of future performance.

Disclosure

If you wish to obtain further information regarding our services, we recommend you visit www.morningstar.com.au. Morningstar may provide product issuers with research or consulting services for the standard fee. In relation to consulting services, Morningstar may provide product issuers with advice in relation to asset allocation information. Morningstar uses quantitative data and qualitative research opinions as its methodology when preparing ratings opinions and research in respect of financial service providers. The methodology weighs the relative strengths and weaknesses of each manager/product relative to its peers.