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Global economic perspectives

2018 Outlook

2017 – The year that was

Synchronised global growth

2017 may be remembered as the year that the global economy finally moved on from the Global Financial Crisis (GFC). For the first time in the ten years since the crisis began, all 45 countries tracked by the Organisation for Economic Co-Operation and Development (OECD) experienced GDP growth at the same time. This had a number of knock-on impacts, most notably the announcement by the US Federal Reserve (the Fed) that it would begin to reduce the size of its balance sheet.

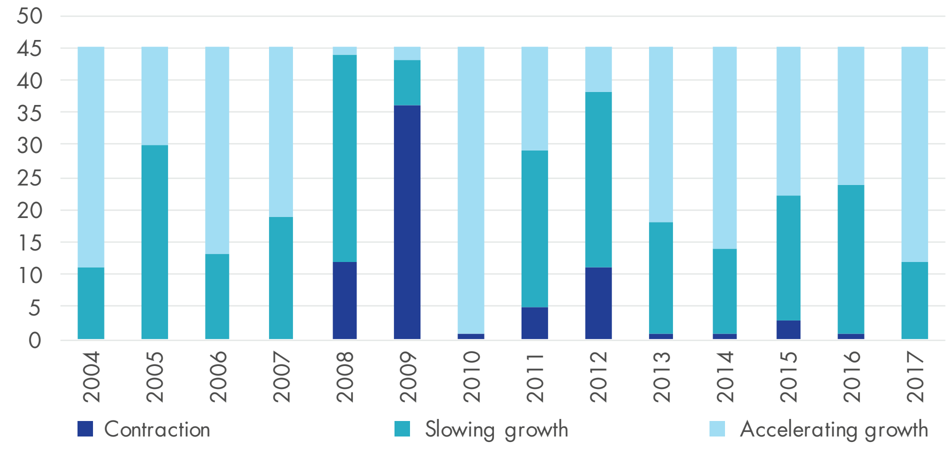
In Australia, the news was not all positive. While measures of business conditions and confidence reached all-time highs, consumers struggled under the weight of low wage growth, high debt levels and a slow-down in the housing boom. The major banks were hit by a focus on housing lending standards, anti-money laundering missteps and the announcement of Royal Commission into the entire banking industry in December. We believe these headwinds will persist into 2018.

Good performance for all asset classes

The US has lead most of the world in its recovery from the GFC thanks, we believe, in large part to the monetary policy enacted by the Fed. In 2017 the US took a back seat as European and emerging market (EM) equities lead the way. EM equities, that have lagged developed market (DM) equities, were helped by a weaker US dollar, the lack of a 'hard landing' in China, the end of a global resource recession and increased export demand. The improved consumer sector in emerging markets also helped to push technology and consumer discretionary stocks higher.

On the road to recovery

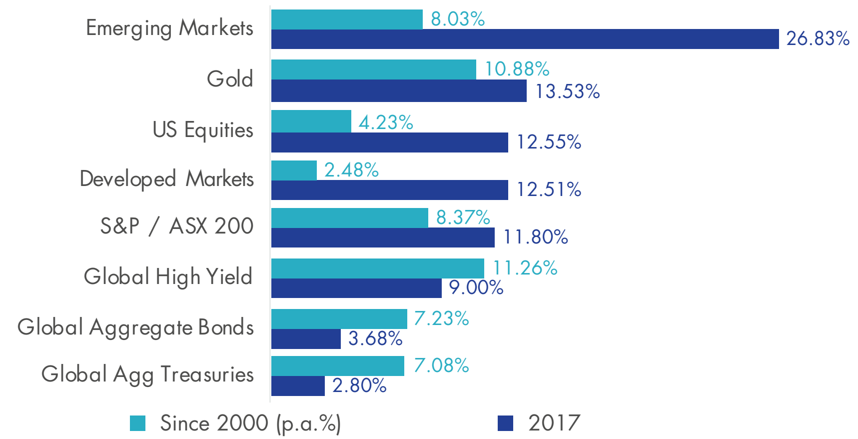
OECD countries economic growth profiles



Source: OECD

Everything looking positive

Major asset class performance (A$)



Source: Bloomberg*

*Gold = US Dollars Per Troy Ounce, Global Aggregate Treasuries = Bloomberg Barclays Global Aggregate Treasuries AUD Hedged Index, Global Aggregate Bonds = Bloomberg Barclays Global Aggregate Hedged AUD Index, Global High Yield = Bloomberg Barclays Global High Yield Hedged AUD Index, S&P ASX 200, Emerging Markets = MSCI Emerging Markets Index, DM = MSCI Europe, Australia & Far East, US Equities = S&P 500 Index. All returns in AUD as at Dec 29 2017.

No sight of volatility in 2017

2017 saw investors enjoy a slow grind higher in almost all asset classes. Despite threats of nuclear war between the US and North Korea, erratic tweets from the US president, rocky Brexit negotiations, political turmoil in Brazil, South Africa and Zimbabwe and dysfunction within the Saudi Royal family, markets remained eerily quiet. The S&P 500 Index, as an example, did not have a single down month for the entire year and volatility was well below its recent historic averages.

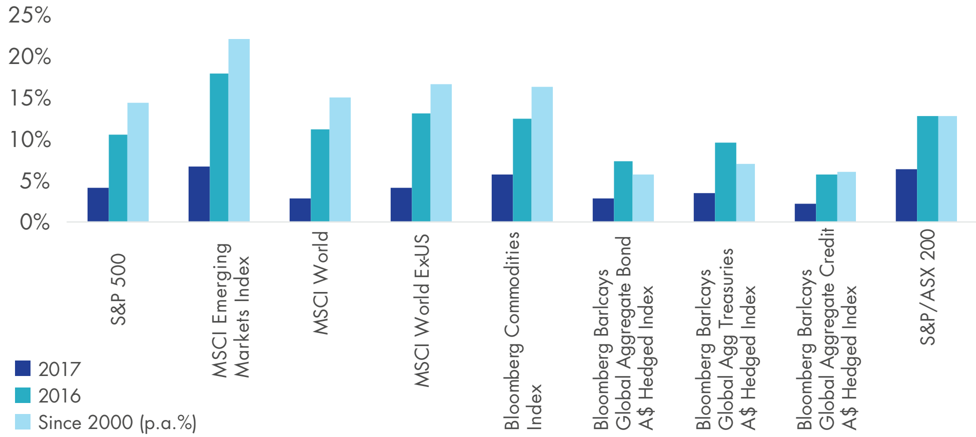
There were a few reasons for this. Despite the increased growth outlook, inflation remained muted. This kept real yields low and took away any re-rating of equity valuations caused by higher discount rates. The second is that central banks have become much better at communicating their plans to the market. The careful communication gave rise to sayings such as a 'dovish hike'. Third is the coordinated position of developed economy central banks. The US Federal Reserve (Fed), Bank of Canada (BOC) and the Bank of England (BOE) all raised short term interest rates during 2017. Added to this, the European Central Bank (ECB) has indicated that it will begin tapering its bond purchases in 2018 and the Reserve Bank of Australia (RBA) has stated that the next interest rate move will be to raise short term interest rates.

Translated to stronger business confidence

The positive growth outlook has translated into business confidence. By almost any metric the outlook for business has been improving. To date this has not translated into wage growth which we believe is the major reason behind the slower than expected rebound in inflation and the disconnect between business and consumer confidence.

Absent volatility

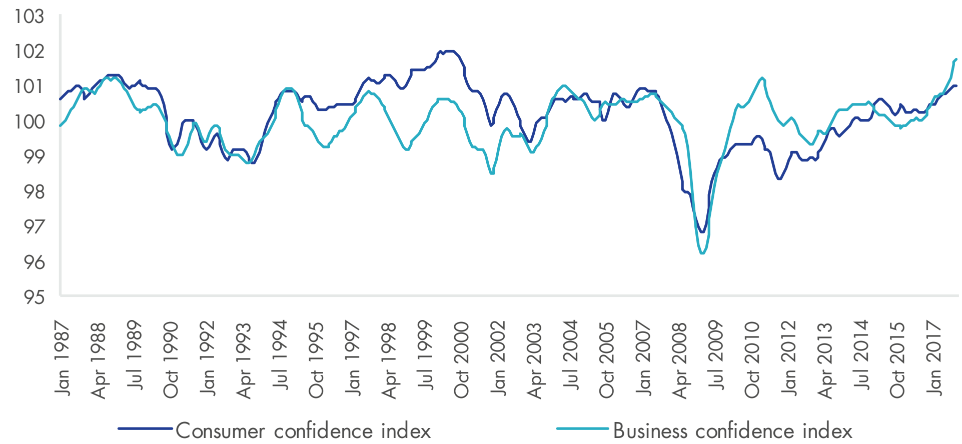
Historic volatility since 2000



Source: Bloomberg, VanEck

Animal spirits ignite

Developed consumer versus business confidence



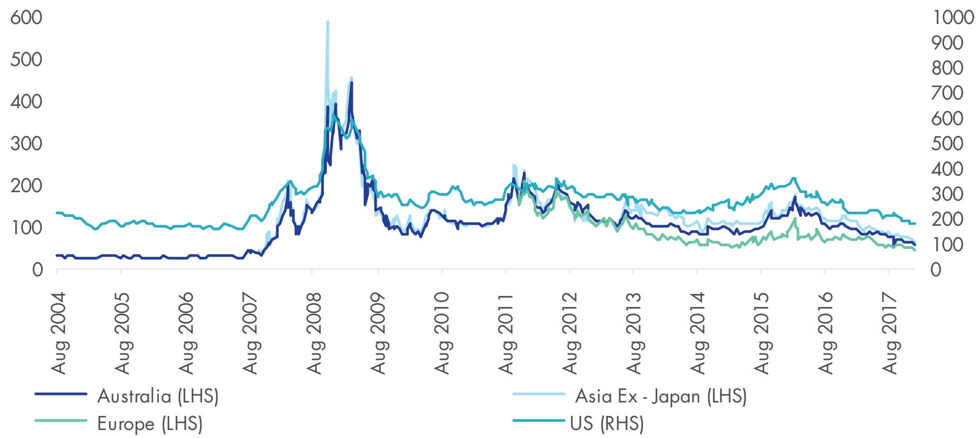
Source: OECD

Tighter credit spreads

It is said that equities tell you what is going to happen, bonds tell you what is happening and commodities tell you what happened. The bond market is reflecting the current positive macroeconomic environment. As a consequence of lower volatility and synchronised growth outlook, credit spreads between government and corporate credit have been steadily declining and are now at pre-GFC levels. For some this may be cause for concern however, it is also true that credit spreads were lower in 2005, so there is the still plenty of room to run and the potential for credit spreads to tighten even further.

Credit spreads down to pre-2008 levels

Major credit spread indicators 2004-2017



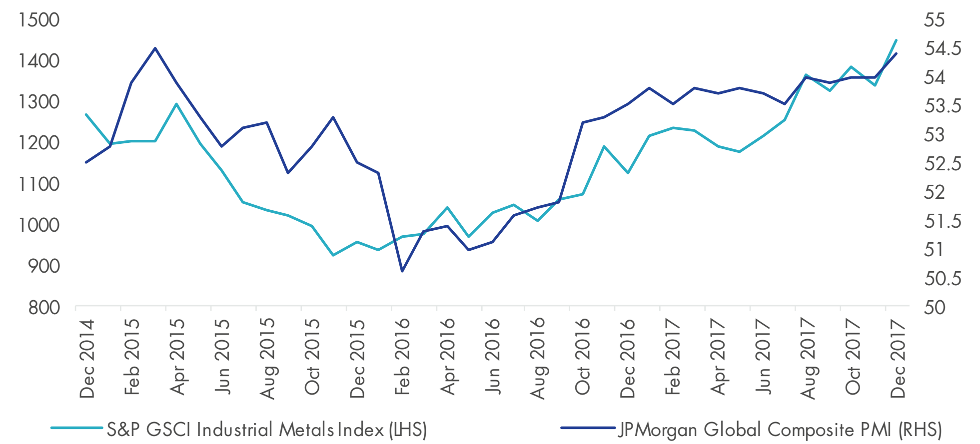
Source: Bloomberg, Markit iTraxx*

Rebound in commodity prices

Commodities, having bottomed broadly at the end of 2015, continued their push higher during 2017. The rise was led by industrial metals, which saw increased demand on the back of improved global capital spending and tracked Purchasing Manager's Indices (PMI's) higher. Oil joined the party in the second half of 2017 as OPEC production cuts reduced the supply glut. As we mentioned in Q2, the supply cuts and increased global demand outlook put a floor on oil prices at around US$50 per barrel as the focus on US shale output proved to be overdone.

Commodity upswing

JP Morgan Global Composite PMI and S&P/GS Industrial Metals Index



Source: Bloomberg, CME, Markit

*Australia = Markit iTraxx Australia Index; Asia Ex-Japan = Markit iTraxx Asis Ex-Japan Index; Europe = Markit iTraxx Europe Index, US = US Corp BBB/Baa - Treasury 10 YR Spread.

Australian equities: Large-caps underperform

Australian equities underperformed their global peers in 2017, with large-cap stocks dragging down strong performance from mid- and small-cap stocks. The story line was the growth of new economy stocks in Australia, particularly health care and IT. While investor focus remains on the large banks and miners, since 2006 healthcare and IT stocks have lead Earning Per Share (EPS) growth. In 2017, both sectors returned over 25% to lead all sectors on the ASX. Forward EPS estimates see this continuing, with improved technologies and increased demand driven by an aging population fueling growth in health care and equipment suppliers.

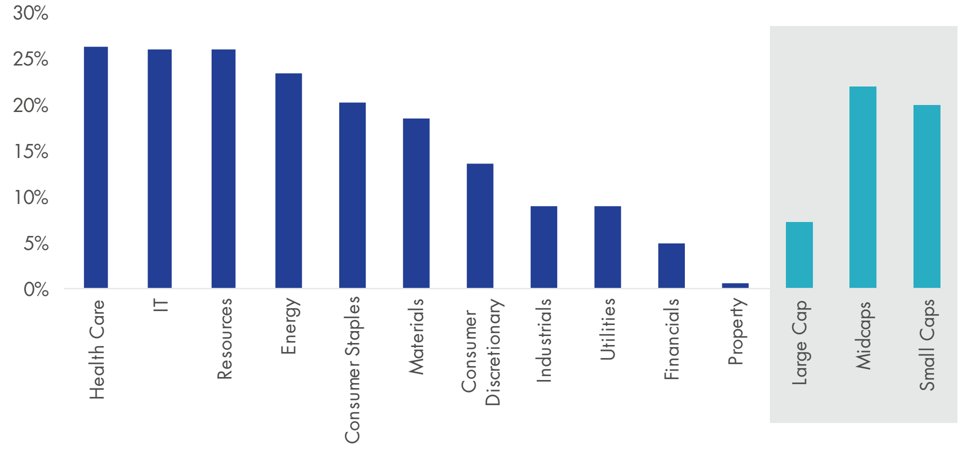
2017 proved to be a challenging year for Australia's big 4 banks. The average total return, including reinvestment of dividends, was just 1.73%, versus the S&P/ASX 200 Index return of 11.79%. Declining interest rates have put pressure on net interest margins and last year's triple whammy of APRA imposed 30% cap on interest only loans and focus on housing lending standards, anti-money laundering missteps and the announcement of a Royal Commission into the entire banking industry in December all combined to weigh heavily on share prices. Banks operate in mature markets and are struggling to achieve earnings growth in a low interest-rate environment. That's not likely to change anytime soon.

The big resource companies rode commodity prices higher in the second half of the year to enjoy strong gains. Having repaired their balance sheets and undertaken a renewed focus on operational efficiencies in the wake of the commodity bear market of 2014 and 2015, forward capital expenditure expectations look to have bottomed and are trending upwards in 2018. The electric vehicle revolution sweeping the auto industry saw some small-cap lithium miners enjoy extreme moves in price during 2017.

While we continue to see a positive outlook for resource companies in 2018, based on the improved prospects for global economic output, investors need to ensure they have diversified exposure to the growth potential of mid- and small-cap companies as the Australian economy continues to transition away from the dual booms in mining and housing construction.

Mid- & small-caps lead the charge

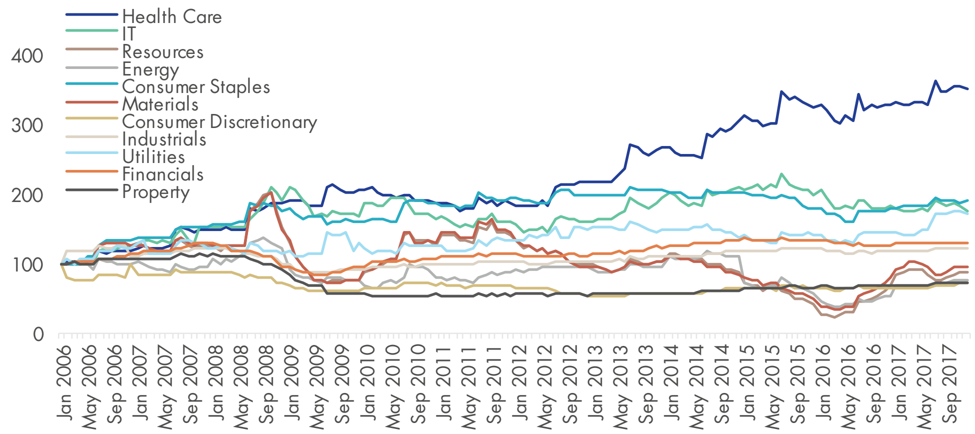
Australian Equity Sector and Size Performance 2017



Source: Bloomberg, GICS = Global Industry Classification Standards. Large Cap = S&P/ASX Accumulation 20 Leaders Index. Mid Cap = S&P/ASX Midcap 50 Index; Small Cap = S&P/ASX Small Cap Ordinaries Index.

Healthcare earnings consistently lead the way

Trailing earnings per share by sector 2006 - 2017



Source: Bloomberg

2018 – What lies ahead?

Emerging markets and Europe recovery underway

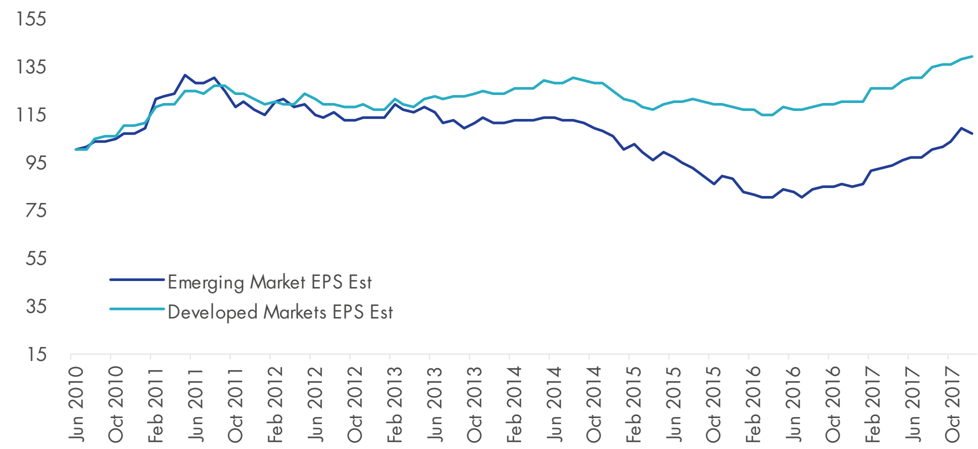
The scene is set for a strong equity run to begin 2018. Up to mid-January 2018, 26 companies in the S&P 500 have reported, with 62% subsequently raising Q1 EPS estimates. This is the first time in any quarter for the last six years that estimates are rising[1].

The current positive corporate sentiment tends to provide a short-term lead on EPS growth. Having lagged the US in its post-crisis recovery, we believe European and emerging market equities provide the greatest growth opportunities in 2018. The European Commission Manufacturing Confidence Index reached an all-time high in December[2] as the European economy has shrugged off geopolitical concerns from 2017 caused by elections, terrorist attacks and a refugee crisis.

In EM, we see a favourable backdrop of positive valuation metrics, a weaker US dollar, stronger commodities and increased export demand to drive equity values higher. Emerging markets, as a group, trade on a Shiller PE of 17.3 as opposed to 25.5 for developed markets[3] and 2017 saw EPS growth begin outstripping that of developed market equities. Add to this favourable structural benefits driven by increases in working age population and we see an environment where EM equities are poised to enjoy a period of cyclical outperformance.

Earnings outpace

Emerging Markets versus Developed Markets trailing EPS estimates 2010-2017



Source: Bloomberg, MSCI. EM = MSCI Emerging Markets. DM = MSCI World Index.

Paying less for higher return on equity

Emerging Markets versus Developed Markets (Return on Equity and Price to Book) 2010 - 2017

Source: Bloomberg, MSCI Emerging = MSCI Emerging Markets Index, Developed = MSCI World Index.

1 The Earnings Scout, January 15, 2018
2 European commission, Bloomberg
3 StarCapital research, January 16, 2018

Global expansion

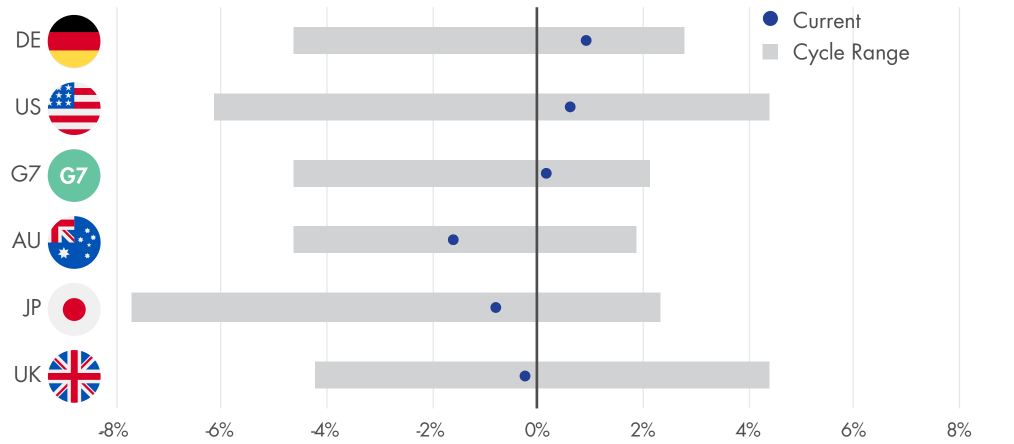
The road back from March 2009, where the global economy was being brought to its knees, has been long and painful. 2017 finally saw the global economy begin firing on all cylinders and confidence return to businesses. At present, consumer confidence is lagging but we would expect this to reverse as businesses begin to increase capital expenditures and invest in new projects. This will further reduce unemployment and put upward pressure on wages. An increase in wages should translate to improved consumer confidence and spending, pushing the global expansion further.

Capacity utilisation metrics, measuring an economy's output gap (difference between actual and potential GDP as a percentage of potential GDP), now show G7 economies running near full capacity. However, we still see plenty of room to run. Economies generally grow at above potential GDP towards the end of an economic cycle. Australia's output gap is forecast to shrink during 2018, but still ranks far below other developed market economies.

As this excess capacity is used up, we expect to see further revisions to global growth forecasts. Since the end of 2016, global growth forecasts have been consistently revised up, reversing a trend of downward revisions. Fiscal stimulus in the form of US tax cuts we believe will add further weight to the global expansion in early 2018.

Filling Up

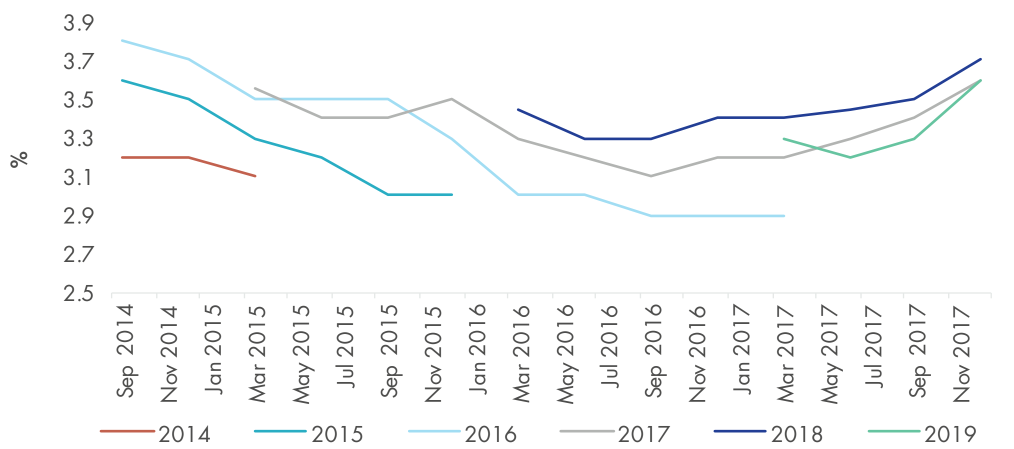
G7 Output gaps, 1980-2017



Source: OECD

Growth outlook turns postiive

World GDP forecasts



Source: Bloomberg

Post quantitative easing era - North America and Europe

Fed chairwoman Janet Yellen retires having presided over the stable transition from emergency monetary stimulus to monetary tightening. Her replacement, Jerome Powell, is publicly seen as a continuation of the status quo. We expect the US Fed to raise rates by 0.25% three times during 2018. This is as it allows bonds to roll off its balance sheet as they mature. The market is currently only pricing in two rate hikes during 2018, as it did for most of 2017 when the Fed hiked three times. Our view has long been that the Fed views the current environment of full employment without inflation and wage growth to be transitory, and as long as there are no exogenous shocks to the US economy, the path back above a Fed Funds rate of 2% will continue in 2018.

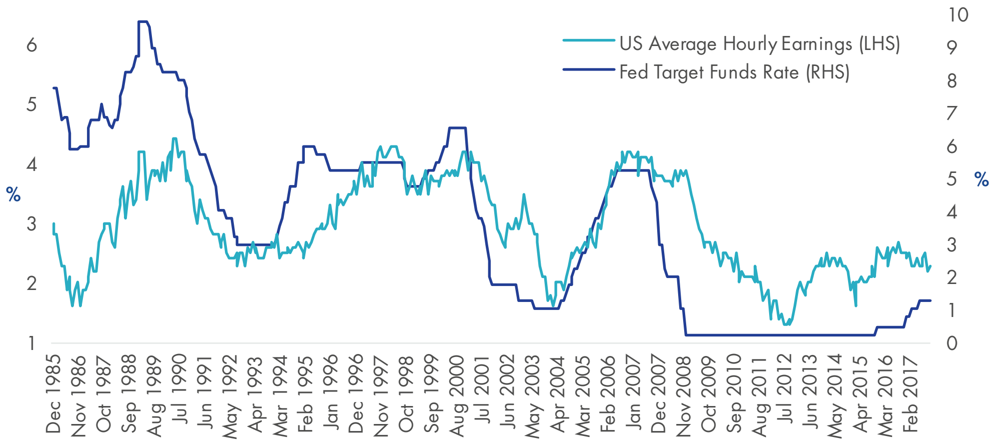
At the ECB, speculation about tapering of its bond purchasing plan after September 2018 was escalated after ECB Governing council member Ardo Hansson indicated that they could possibly remove all bond purchasing in one action.

Both the BoC and the BoE increased rates during 2017, joining the US and other developed nations to begin the process of unwinding the extraordinary monetary easing that occurred post GFC. In Canada, the central bank sought to put a lid on runaway house prices that threaten the stability of the Canadian economy while in the UK, the BOE reacted swiftly to inflation that had more than doubled post Brexit to 2.6% year on year.

In Australia, we don't expect the RBA to raise rates during 2018. Australian Prudential Regulatory Authority (APRA's) focus on mortgage lending standards in 2017 looks to have taken the air out of the housing market, what we saw as the major motivation for the RBA to raise rates. With excess slack in the labour market we don't see wage growth putting any pressure on inflation in 2018. Inflation expectations have been falling in Australia since October.

Tightening ahead of wage growth

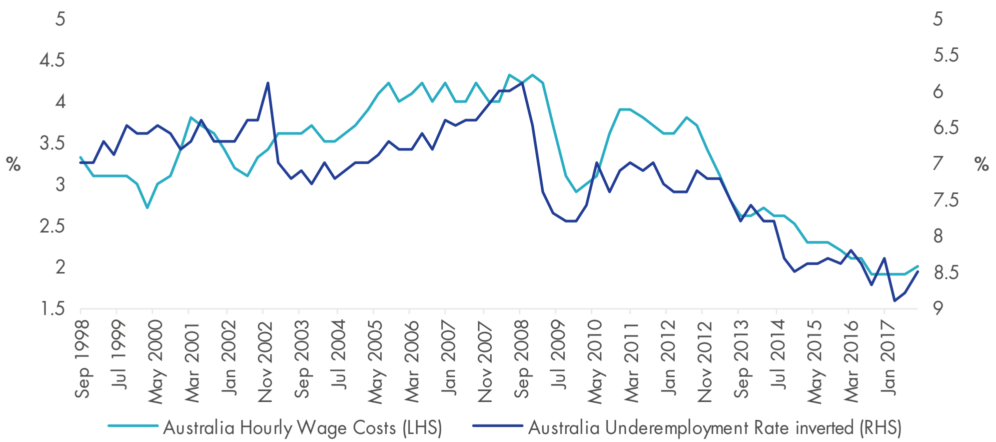
US average hourly earnings and Fed funds target rate



Source: Bloomberg, Bureau of Labor Statistics, Federal Reserve Bank.

Excess capacity holding back wage growth

Australia hourly wages costs versus underemployment rate



Source: Bloomberg, Australian Bureau of Statistics

Yields on the rise

Much has been made of the rise in bond yields in the first trading days of 2018, with Bill Gross[4] calling this the beginning of a bond bear market and the Chinese government signalling that it may rein in purchases of US treasuries. In reality, the top of the bond market (bottom in yields) occurred in the middle of 2016, when benchmark yields in Australia, USA, Japan, Germany and the UK reached all-time lows. Since then, yields have been rising but at a slow pace.

In 2018, as prospects of global growth accelerate and inflation expectations rise we expect to see a faster rise in yields than what 2017 brought. Breakeven yields, a measure of inflation expectations that subtracts the real yield of inflation linked bonds from nominal government bonds, have been steadily rising for most developed countries since mid-2017. As we see these inflation expectations continue to accelerate, we expect to see a further sell-off in bonds.

Volatility to return

Since mid-2016, rolling 12 month volatility in global indices has been trending downwards. The S&P/ASX 200 Index trailing 12 month volatility was between 11% and 16% in 2015 and 2016. It ended 2017 at 6.37%, almost half the average 12 month volatility since 2001. The S&P 500 Index went the entirety of 2017 without a down month.

We expect 2018 to be a year of mean reversion. The volatility in returns of major indices in 2017 was 50 to 70% below their averages since 2001. We expect 2017 to be the bottom in this cycle and increased volatility to come in 2018 on the back of continued geopolitical risks, tighter monetary policy in the US, rising bond yields and stretched equity valuations in developed markets.

4 The Washington Post, Gundlach May Be Right, But His Timing's Another Matter: Gadfly, accessed 12th January 2018

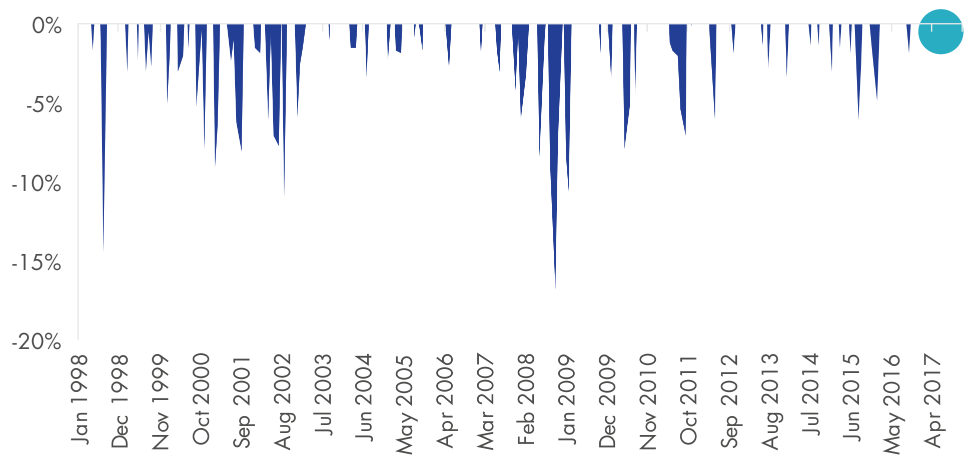
Yields point to rising inflation

US, Germany, Australia and UK breakeven yield

Source: Bloomberg

No negative months in 2017

S&P 500 monthly drawdowns over the past 20 years



Source: Bloomberg, VanEck

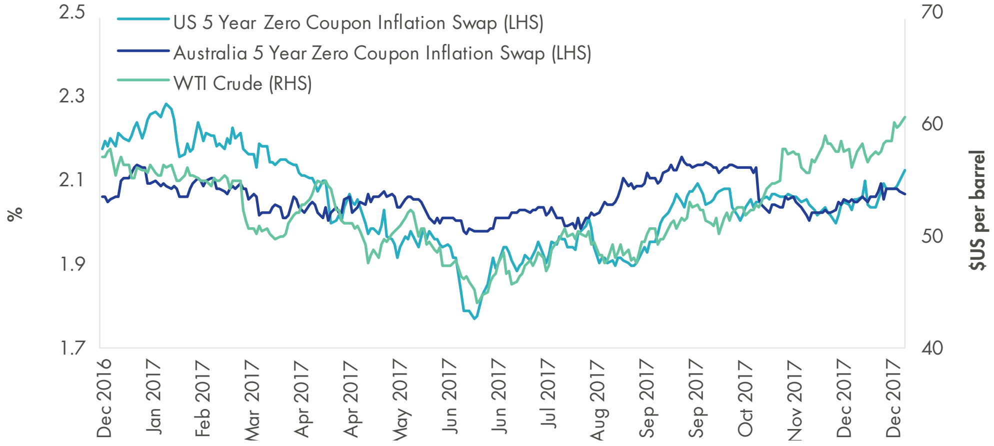
Commodity price momentum

The improvement in global growth in 2017 lifted commodity prices across the board. Industrial metals tracked PMI's higher and in the second half of the year, Organisation of the Exporting Countries (OPEC) supply cuts began to take affect and the price of Brent Crude rose over 40% from US$46.78/bl to end the year at US$66.87/bl[5]. Almost by stealth the gold price ended the year above US$1,300, up 13.1%

We continue to see tailwinds for commodity prices in 2018 in the form of a weaker US dollar and a positive global growth outlook. Gold has continued the trend of the prior two years, with weakness going into a year-end Fed rate hike and strength coming out of it. We expect 2018 to see continued strength in the gold price. Both the general strength of commodities and its appeal as portfolio insurance against an adverse geopolitical outcome, the risks of which are heightened by the unconventional foreign policy of the current US administration, bode well for gold bullion and gold equities in 2018.

Oil rise indicates rising inflation expectations

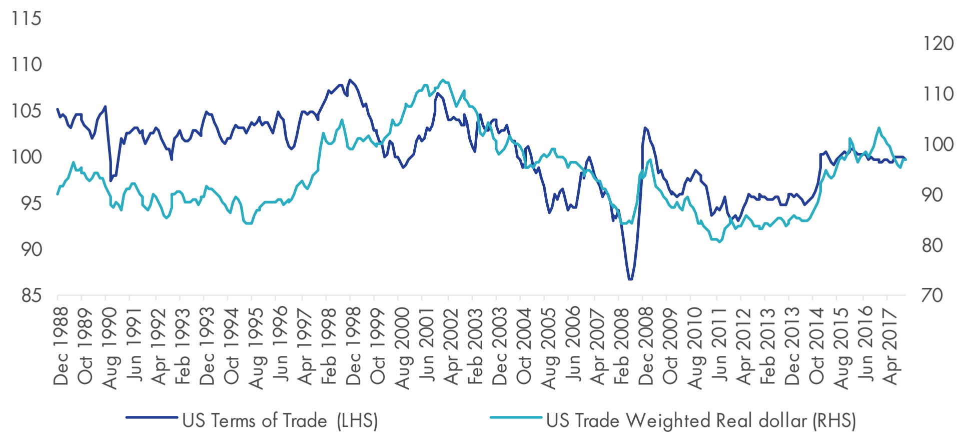
US and Australian inflation expectations 2017



Source: Bloomberg, New York Mercantile Exchange.

Tracking the trade

US terms of trade and trade weighted US dollar



Source: Bloomberg, Citi Group Global Markets, Federal Reserve Bank.

5 ICE Futures Europe Commodities, Bloomberg

Headwinds for the Australian economy

We expect 2017 to be the year Australia's housing boom ended. The RBA and APRA spent much of 2017 jawboning Australian house prices, hoping to be able to deflate the bubble without pricking it. It appears their measures have been successful. December figures released by Corelogic showed month on month growth of house prices in Australia has declined every week since October 2017. The clamp down on investor and interest only lending has reduced the growth of investor borrowing and slowed down runaway house prices.

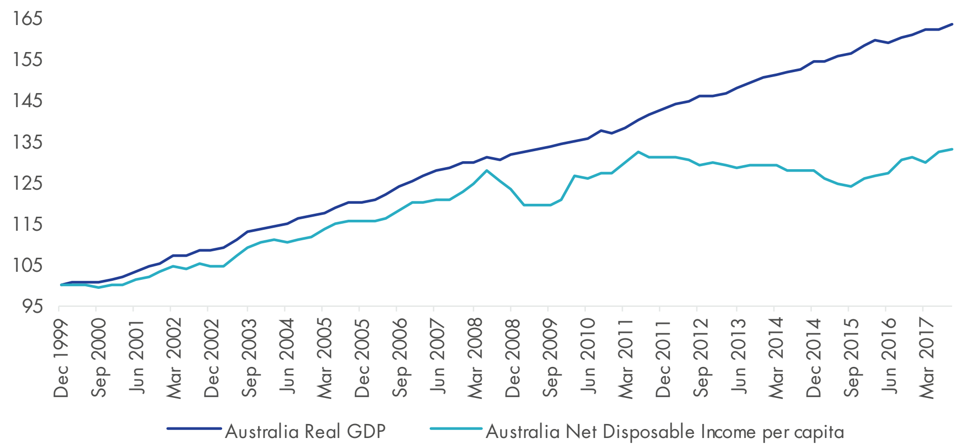
The downside to this for the Australian economy is the impact slowing house price growth will have on household savings rates and following this, consumer spending. We have seen a positive impact on GDP from a reduction in savings rates from 7.5% in 2015 to 3.2% in September 2017[6] caused by the wealth effect of increased house prices. This translated to increased consumer spending even as net disposable income per capita remained stagnant. As house price growth slows, the reversal in this trend will be a drag on GDP growth.

The upside for the Australian economy is the condition of Australian businesses. Following on from a rise in business confidence and conditions throughout 2017, we are now seeing an uptick in capital expenditure expectations and hiring plans. Given the remaining slack in the Australian labour market as reflected by the underemployment rate, we expect that increased hiring will not translate to meaningful wage growth. This will keep a lid on inflation and lead the RBA to keep rates on hold for 2018.

6 Australian Bureau of Statistics, Bloomberg

Stagnant spending power

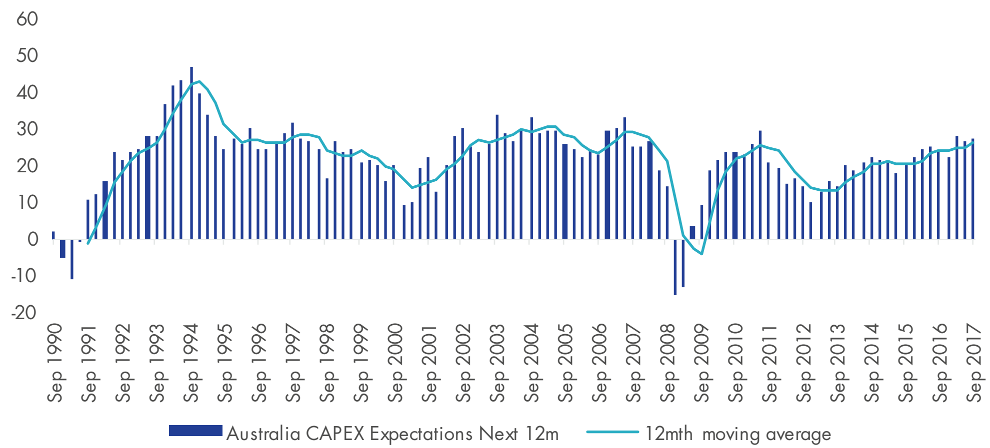
Australia Real GDP vs Disposable Income



Source: Bloomberg, VanEck, Australian Bureau of Statistics.

Business investment accelerates

OECD countries economic growth profiles Australia CAPEX expectations next 12 months



Source: Bloomberg, NAB, VanEck

2018 – What are the major risks?

Geopolitical

Geopolitical risks are generally the most difficult for market to hedge against. This is because they often affect sentiment rather than fundamental data. As Europe was in 2017, the US will be the focus of geopolitical risks in 2018. The ongoing investigation into the Trump administration's ties with Russia, tensions with North Korea and the US mid-term elections are hot-spots to watch for in 2018.

Upside surprise in inflation

With the US providing tax cuts to corporations at a time when the economy is operating at full employment, the risk that this leads to a spike in core inflation are heightened. Runaway inflation would cause the Fed to act swiftly to raise rates and most likely lead to higher bond yields, putting pressure on equity valuations in the form of higher discount rates in the world's largest equity market.

Change in market sentiment

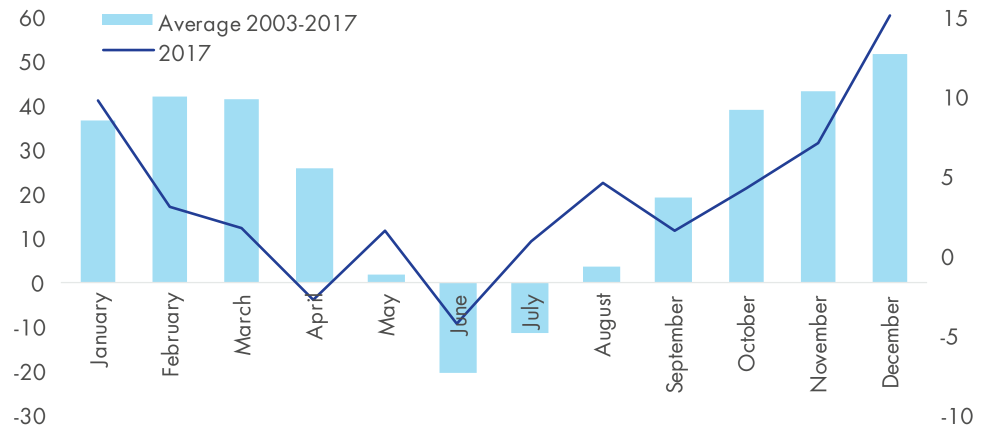
A major risk that we see in 2018 is the impact of economic releases that undershoot expectations. Global economic surprise indices show that releases are cyclical, tending to miss expectations in May to August. In an environment where investors are paying a higher price for taking on risk in both equity and bond markets, any miss in expectations may have an outsized impact on asset prices.

Central bank missteps

Central banks have become experts at signalling to the market their intentions, allowing markets to parse the information as it is received and generally absorb this into asset prices. With a new Fed chair and central banks generally looking to reduce the growth in their balance sheets, the potential for a misstep is increased. As mentioned in our previous point, a wrong move at increased valuation levels could have disastrous consequences for markets.

Economic surprises are cyclical

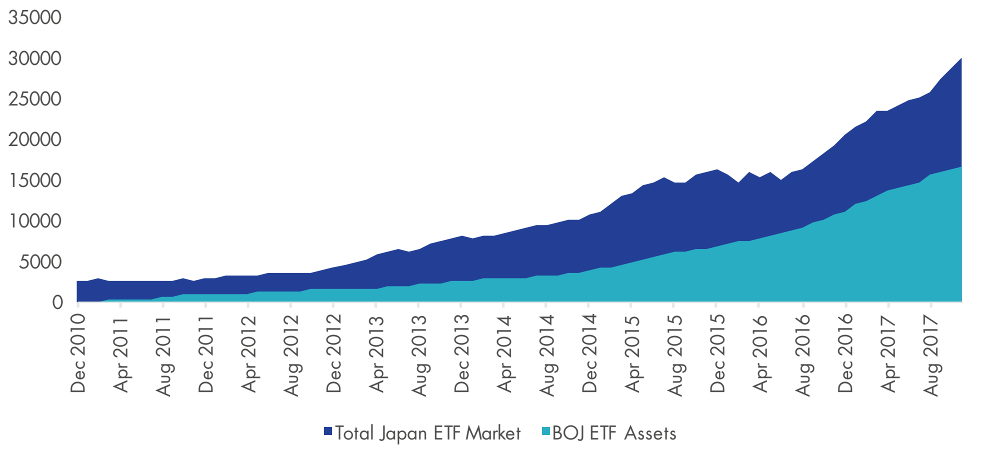
Citi Global economic surprise index



Source: Bloomberg, CITI

Japan's largest ETF investor

Bank of Japan ETF asset ownership



Source: Bloomberg, Bank of Japan, VanEck

A key question to us is what the Bank of Japan (BOJ) will do. Where other central banks have been purchasing various fixed income instruments, the BOJ now holds over 50% of Japanese ETF assets. This is not a position that is as easy to unwind as Treasuries were for the Fed, where they could simply allow them to mature. If and when the BOJ decides to sell its ETF assets, the impact on equity markets will be significant.

Measuring what the major risks are for any particular year can be a circular argument.
If we can identify the risks, then we can hedge against them and they no longer become risks.
We continue to believe that investors should maintain a globally diversified portfolio. A portfolio that is diversified across sectors and asset classes provides the best opportunity to take advantage of investment opportunities and traverse various pitfalls.

Range of VanEck Vectors Exchange Traded Funds (ETFs) on ASX

ETF Name	ASX code	Index	Management Cost (% p.a.)
Australian Broad Based			
VanEck Vectors Australian Equal Weight ETF	MVW	MVIS Australia Equal Weight Index	0.35%
VanEck Vectors S&P/ASX Franked Dividend ETF	FDIV	S&P/ASX Franked Dividend	0.35%
Australian Sector			
VanEck Vectors Australian Banks ETF	MVB	MVIS Australia Banks Index	0.28%
VanEck Vectors Australian Property ETF	MVA	MVIS Australia A-REITs Index	0.35%
VanEck Vectors Australian Resources ETF	MVR	MVIS Australia Resources Index	0.35%
Australian Small and Mid Companies			
VanEck Vectors Small Companies Masters ETF	MVS	MVIS Small-Cap Dividend Payers Index	0.49%
VanEck Vectors S&P/ASX MidCap ETF	MVE	S&P/ASX MidCap 50 Index	0.45%
International			
VanEck Vectors ChinaAMC CSI 300 ETF	CETF	CSI 300 Index	0.72%
VanEck Vectors Morningstar Wide Moat ETF	MOAT	Morningstar Wide Moat Focus Index™	0.49%
VanEck MSCI World ex Australia Quality ETF	QUAL	MSCI World ex Australia Quality Index	0.40%
Global Sector			
VanEck Vectors FTSE Global Infrastructure (Hedged) ETF	IFRA	FTSE Developed Core Infrastructure 50/50 Index Hedged into AUD	0.52%
VanEck Vectors Gold Miners ETF	GDX	NYSE Arca Gold Miners Index	0.51%
Australian Fixed Income			
Australian Corporate Bond Plus ETF	PLUS	Markit iBoxx AUD Corporates Yield Plus Index	0.32%
Australian Floating Rate ETF	FLOT	Bloomberg AusBond Credit FRN 0+Yr Index	0.22%

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