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# VanEck ViewPoint™

## Global economic perspectives

October 2017

# Global expansion picks up steam

For the first time since the Global Financial Crisis (GFC), the June Organization for Economic Co-operation and Development (OCED) Global Economic Outlook pointed to synchronised growth in all 45 countries tracked by the OECD. After persistent downgrades, global growth forecasts are now being upgraded as economic activity rebounds in most parts of the world.

Despite global growth pickup and tighter labour market conditions, inflation has been muted. The Phillips curve which links inflation to employment looks to be broken or at least shifted, which has led to the question of whether low inflation is the new normal. This is because structural changes that have led to technological innovation, globalisation and weakening labour unions have reduced wage pressures over the last twenty years. These changes may mean that trying to achieve a 2% inflation target risks creating asset bubbles.

Currency strength or weakness is a product of inflation expectations as much as interest rate expectations. The US dollar weakness is consistent with prior US Federal Reserve rate hiking cycles and emerging market equities have performed particularly well as a result. On a valuations basis, emerging markets look to provide greater expected returns than developed markets. Gold has also benefited from the weaker US dollar and finally broke through the US$1,300 resistance level.

In Australia, business conditions and sentiment have risen to their highest levels since the GFC. Despite unemployment remaining steady and job creation exceeding expectations, wage growth remains non-existent as the underemployment rate has ticked up. The Australian economy is at a delicate point with risks remaining in the housing sector and the overall level of household indebtedness

## Synchronised growth

- The June OECD Global Economic Outlook pointed to synchronised growth in all 45 countries tracked by the OECD
- The International Monetary Fund (IMF) observed in July that the pickup in global growth anticipated in the April World Economic Outlook remains on track, with global output projected to grow by 3.5% in 2017 and 3.6% in 2018
- After persistent downgrades, global growth forecasts are now being upgraded
- Global manufacturing Purchasers Managers' Index (PMIs) and GDP growth point to positive trend growth

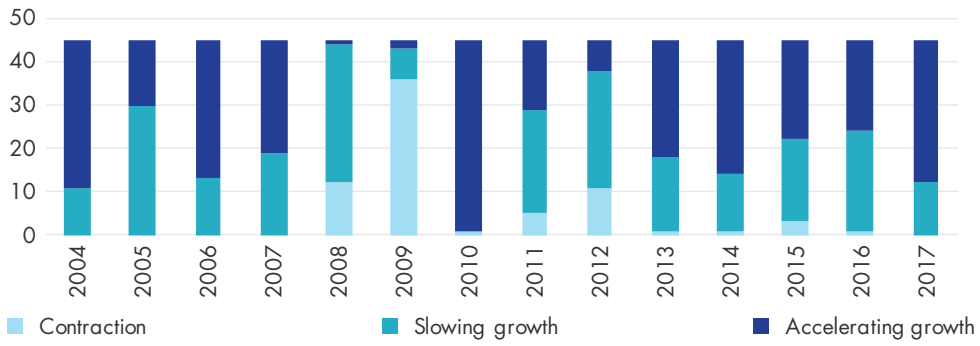
Q3 marked the 10 year anniversary of the beginning of the GFC. On the 9th of August 2007, BNP Paribas announced that it was ceasing activity in three hedge funds that specialised in US mortgage debt. This signalled that the trillions of dollars in derivatives backed by US mortgages weren't worth the paper they were written on.

For the first time since then, the June OECD Economic Outlook has reported that the world's major economies are growing in sync, with all 45 countries tracked by the OECD on track to grow this year[1]. More positively, 33 of them are poised to accelerate from a year ago.

The IMF also reported in July "the pickup in global growth anticipated in the April World Economic Outlook remains on track, with global output projected to grow by 3.5% in 2017 and 3.6% in 2018."[2]

### On the road to recovery

**OECD countries economic growth profiles**




Source: Bloomberg, Markit

1 OECD Interim Economic Outlook: Short-term momentum: Will it be sustained?, OECD, 20th September 2017, accessed 24th September 2017

2 IMF World Economic Outlook, IMF, July 2017, accessed 24th September 2017

Unsurprisingly, global GDP pickup has been on the back of an uptick in global manufacturing PMI. PMIs provide an indication of the economic health of the manufacturing sector.

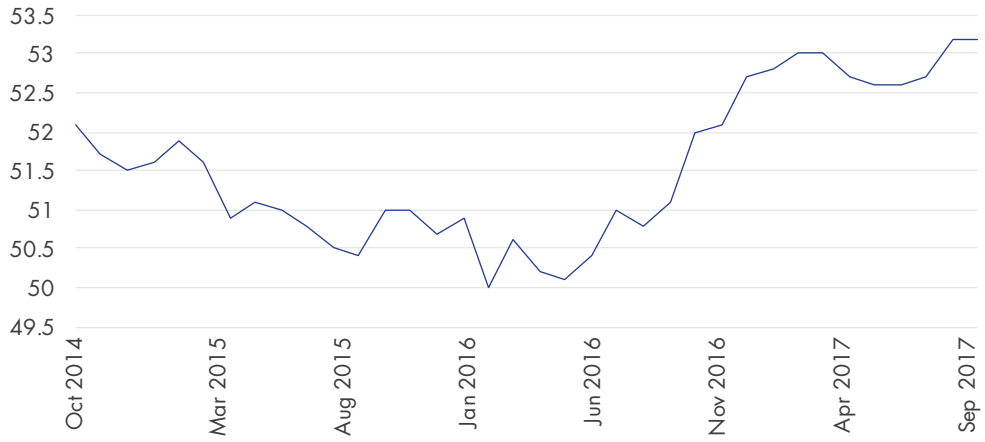
On the back of this pickup in economic activity, global growth forecasts are being revised up.

Sceptics of the equity and bond bull markets that have been in existence since the end of the GFC have pointed to a lack of synchronised growth as evidence of economic fragility. Popular rhetoric has focused on the effect of global central bank intervention in keeping equity markets afloat as weak corporate earnings saw valuation multiples expand to levels only previously seen during the dot com bubble and in the lead up to the Great Depression. As the US Federal Reserve ended quantitative easing in 2014, there was a persistent narrative that gains would reverse and something akin to the taper tantrum of 2013 would rattle global markets as the weakness in the global economy would lay itself bare.

Three years since the end of quantitative easing and coming up on two years since the US Federal Reserve began raising short term interest rates, these fears are yet to be realised as the global economy has continued to expand and US equity markets have pushed to new all-time highs. It is said that the stock market leads the economy, with positive economic activity feeding into corporate earnings results months after it has taken place and been priced into the stock. This was particularly evident as Q2 results were reported, showing a broad rebound in corporate earnings.

## Economic activity trending upwards

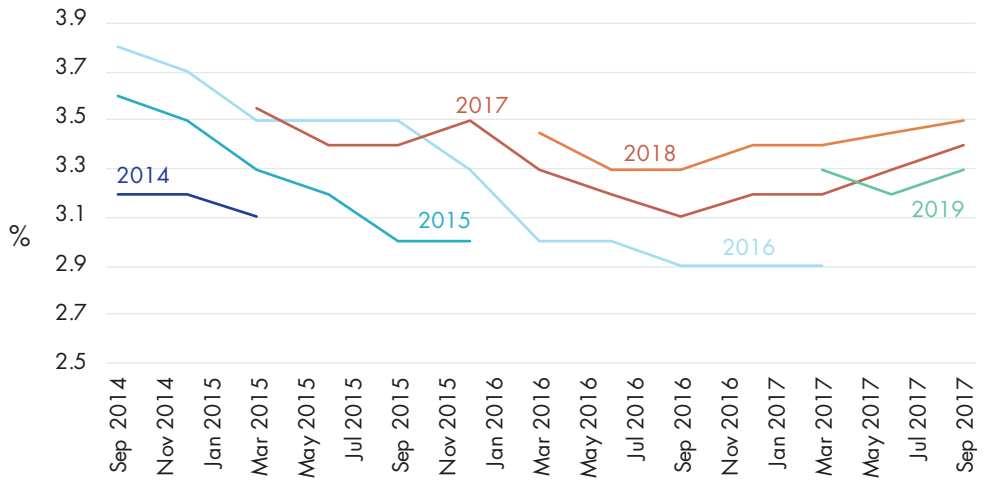
**JPMorgan Global Manufacturing PMI**




Source: Bloomberg, Markit

## Growth outlook turns positive

**World GDP Forecasts**




Source: Bloomberg

Our view is that the pick-up in economic activity we are seeing and the subsequent increased earnings should help to alleviate some of the valuation concerns. We expect that earnings growth will outstrip price growth over the next twelve months, as the 'E' of the 'P/E' increases at a faster rate than price. As a result of this, equity investors should expect lower returns, particularly from US equities.

## Where is inflation?

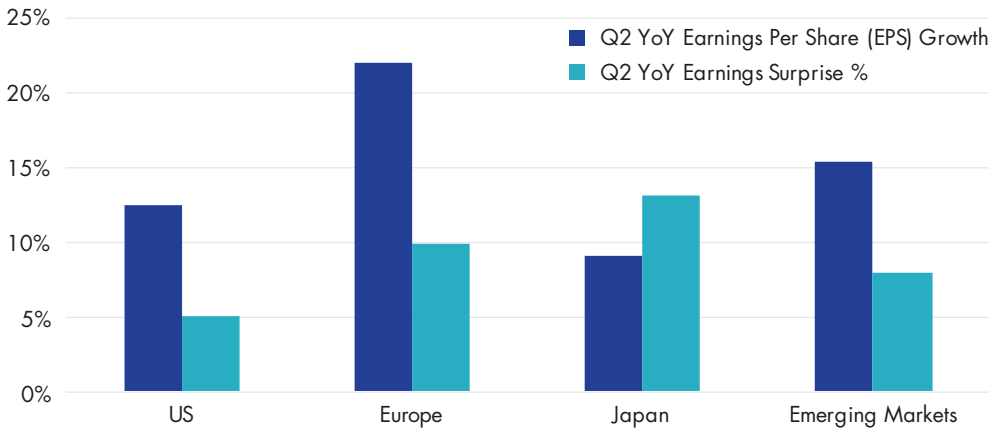
- Unemployment in developed world as a whole peaked in 2010
- Despite tightening labour market conditions, inflation has been falling
- The Phillips curve looks to be broken, or at least shifted, changing the game for global central banks
- Tighter labour market conditions in the US are not having the same impact on inflation as they have done in previous cycles

The pickup in global growth has had another tangible economic impact, an increase in business and consumer confidence.

Investors were relieved when results in Dutch, French and German elections saw the election of more moderate political parties, albeit with far right parties seeing an increase in voter support. As European political risks have subsided, 2017 has seen equity markets experience a prolonged period of low volatility. The lower risk environment has led to an increase in aggregate demand, which has decreased unemployment and taken some of the remaining slack out of the labour market. Conventional economic theory would dictate that inflation would increase as a result.

### Positive suprises

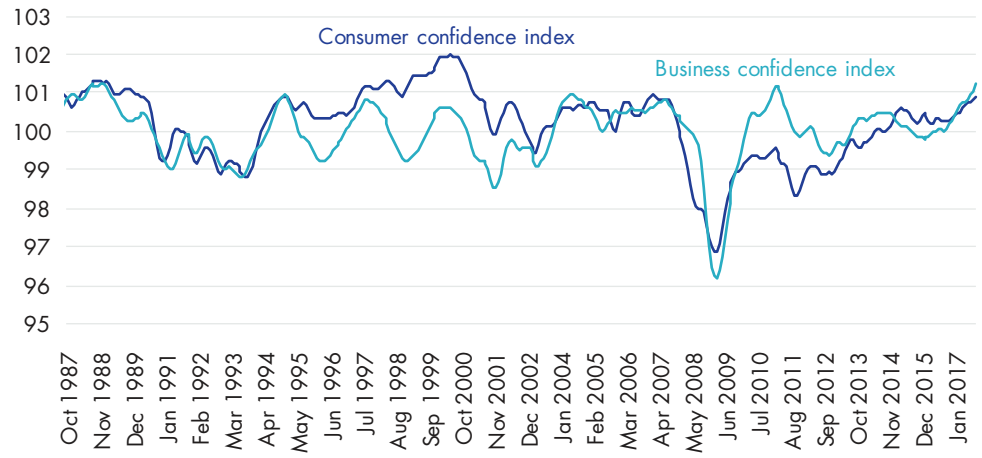
**Gobal equity Q2 results**




Source: Thomson Reuters Datastream, Riverfront; all data in US dollar, as of 31st August 2017, US = S&P 500 Index, Europe = MSCI Europe Index, Japan = TOPIX 500 Index, Emerging Markets = MSCI Emerging Markets Index

### Animal spirits igniting

**Developed economies consumer vs business confidence**



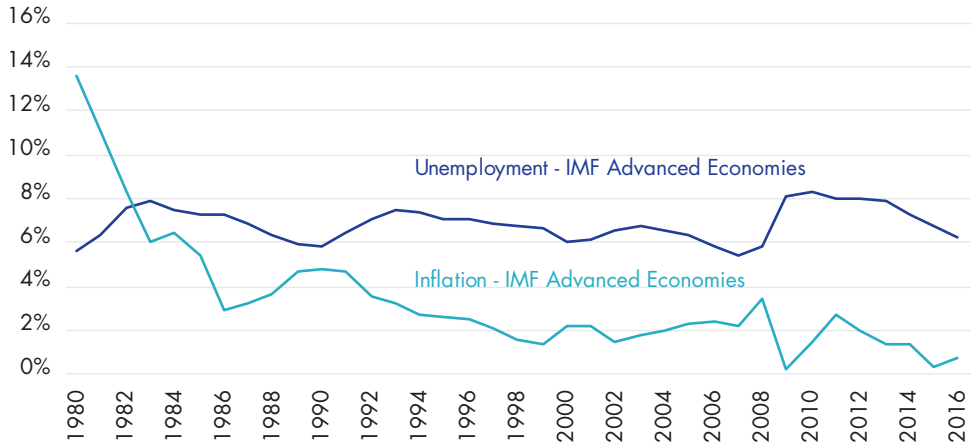

Source: OECD

The Phillips curve, named after New Zealand economist William Phillips, states that inflation and unemployment have an inverse relationship. As unemployment falls, workers have more bargaining power and can hold out for higher paying jobs as supply outstrips demand for employment. This pushes up wages earned which in turn pushes up discretionary spending. As consumer's can afford to spend more, businesses put up the prices of goods and services to take advantage of this, leading to an increase in the rate of inflation. Historically, this relationship has been fairly strong but since 2010 the slope of the curve, particularly in the US, has flattened.

This is not news to Federal Reserve Chair Janet Yellen or European Central Bank (ECB) Chair Mario Draghi. They are acutely aware of this issue, but the question remains whether this is simply a temporary supply shock or the sign of a more structural change. Our belief is that central banks have now become very concerned with the shift in the Phillips curve and are determined to move on a path to normalisation, whether target inflation is met or not.

## A broken Phillips curve?

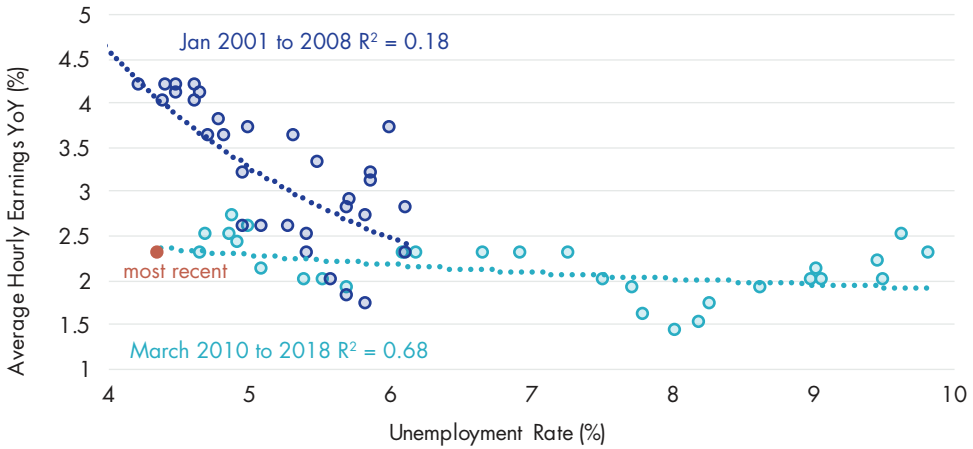
**IMF advanced economies unemployment rate vs inflation**




Source: IMF

## No sign of wage pressure

**US unemployment rate and wage growth**




Source: Bloomberg, Bureau of Labor Statistics

## The new norm of low inflation

- There is the possibility that in the developed world, low inflation is the new normal
- Structural changes that have led to technological innovation, globalisation and weakening labour unions have reduced wage pressures over the last twenty years
- If supply shock is not temporary, inflation targets needs to be reassessed
- The Bank of International Settlements (BIS) warns that trying to achieve 2% inflation in this environment risks creating asset bubbles

One possible explanation for the disconnect between strengthening growth, tighter labour market conditions and lower inflation is that in addition to stronger aggregate demand, developed economies have been experiencing positive supply shocks.

Structural shifts in the economy that have caused these supply shocks include:

- Globalisation, that allows companies to keep manufacturing costs down and allows consumers to purchase items from cheaper emerging markets,
- Weaker trade unions which has reduced workers bargaining power in negotiating on higher wages, and
- Technological innovation which has led to a cheaper cost of manufacturing

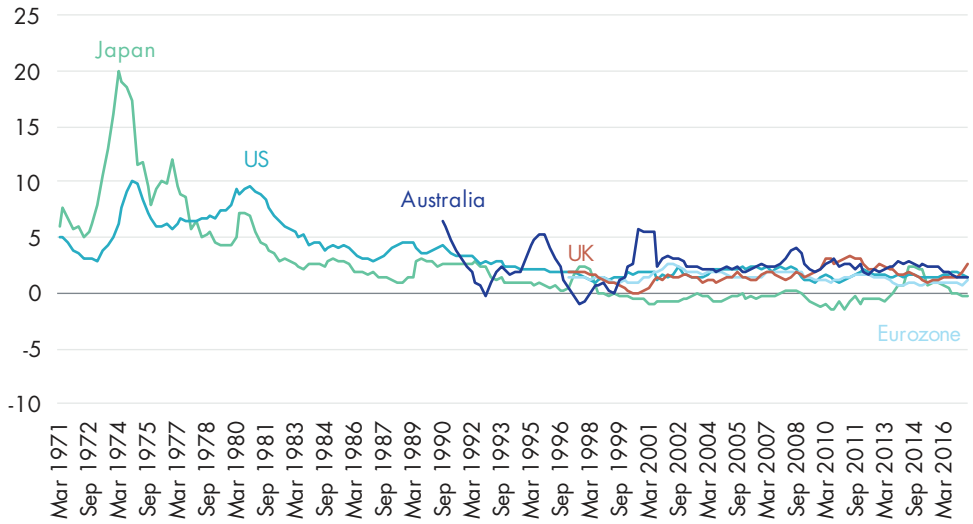
All of these factors have had their share of a disinflationary impact on developed economies.

Standard economic theory suggests that the correct monetary policy response to these sort of supply shocks depends on their persistence. In the case of temporary shocks, central banks should continue to normalise monetary policy, because eventually tighter labour markets will lead to a rise in inflation. Indeed this is the approach that the Federal Reserve has taken. The persistent message from the Fed since they began raising the Fed Funds Rate in 2015 has been that they expect inflation will begin rising in due course, despite slowing inflation and mixed economic data in early 2017.

In Europe, the ECB has announced that it expects to taper its bond purchases in 2018, under the assumption that stronger economic growth will lead to inflation at some stage in the future. In Australia, the RBA said in July that they see the neutral cash rate at 3.5%, 2% higher than the current level.

### Low inflation persists

**Selected country core inflation levels - 1971 to 2016**




Source: Bloomberg, Eurostat, US Bureau of Economic Analysis, UK Office of National Statistics, Japan Ministry of Internal Affairs and Communication, Australian Bureau of Statistics , Japan = Core CPI, US = Core PCE, Eurozone = Core CPI, UK = Core CPI, Australia = Core CPI

If however the shock is permanent and central banks continue to raise rates, the prospect of reaching their inflation targets becomes very slim. Our view is that central banks, while focused on inflation, are now opening up their focus to the prospect that easy monetary policy is creating asset bubbles and these supply shocks may possibly be permanent.

Economist Nouriel Roubini argued recently that if the shocks are permanent or more persistent than expected, normalisation must be pursued even more quickly, because inflation has already reached a 'new normal'. This is the view taken by the BIS, which argues that it is time to lower the inflation target from 2% to 0% – the rate that can now be expected, given permanent supply shocks. Trying to achieve 2% inflation in a context of such shocks, the BIS warns, would lead to excessively easy monetary policies, which would put upward pressure on the prices of risk assets, and, ultimately, inflate dangerous bubbles. According to this logic, central banks should normalise policy sooner, and at a faster pace, to prevent another financial crisis[3].

Despite the concerns of the BIS, we've begun to see signs of a pickup in inflation in the Eurozone and we expect inflation to rebound in Q4 2017 in the US. There are a number of leading indicators which point to an expected increase, in particular the yield on 2 year US Treasuries and weakness in the US dollar.

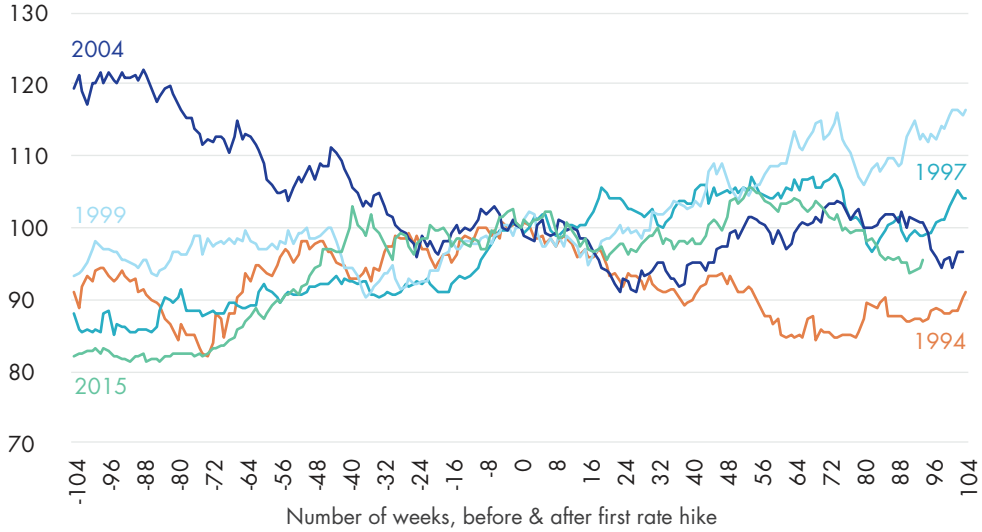
## Expect US dollar weakness

- Currency strength or weakness is a product of inflation expectations as much as interest rate expectations
- Historic performance of US dollar during Fed tightening cycles points to continued weakness
- Given the rebound of global growth, investment opportunities look to be more attractive outside of the US

After a strong run in 2H 2016 the US dollar has been weaker in 2017 versus almost all major currencies. Contrary to conventional wisdom, the higher Fed Funds Rate has not led to stronger demand for the US dollar with investors taking advantage of carry trade potential versus the Euro and the Japanese Yen. Looking at the last four US Federal Reserve rate hiking cycles, 1999 was the only time when the US dollar was markedly stronger versus a basket of currencies two years later.

### Scope to weaken

**USD Index to 100 at beginnng of hiking cycle**




Source: Bloomberg, US Federal Reserve

3 The mystery of the missing inflation, Project Syndicate, 13th September, 2017, accessed 14th September 2017

Our belief is that the weakness of the US dollar, despite the higher interest rate that can be earned on the currency, is caused by three factors:

1. Real yields are more indicative of the rate of return on the currency than nominal yield. The US, despite its low levels of inflation, is still outstripping Europe and Japan with inflation expectations being higher in the US than elsewhere. This decreases the attractiveness of the US dollar.

2. In the economic cycle that has existed since the end of the GFC, the US has led the rest of the world in its rebound in economic activity. In the US, unemployment rates have fallen and GDP have grown at a faster rate than other reserve currencies. However this has begun to change. As we have seen economic growth pick-up outside the US, we have seen the strength of the US dollar diminish. At the moment quite simply there are better growth opportunities outside of the US and this is driving demand for other currencies.

3. The US terms of trade looks to have peaked in late 2016 and we have seen the US dollar fall since that time.

We expect the US dollar weakness to continue into Q1 2018. The more recent developed market manufacturing PMIs continue to tell a story of fundamental divergence between the US and the Eurozone. While the Eurozone's PMIs beat expectations in September by a wide margin, their US counterparts failed to maintain their upward momentum. Recent economic data releases suggest that the growth trajectory in the Eurozone might strengthen further in Q3 and indicate that the underperformance of the US dollar should continue for now.

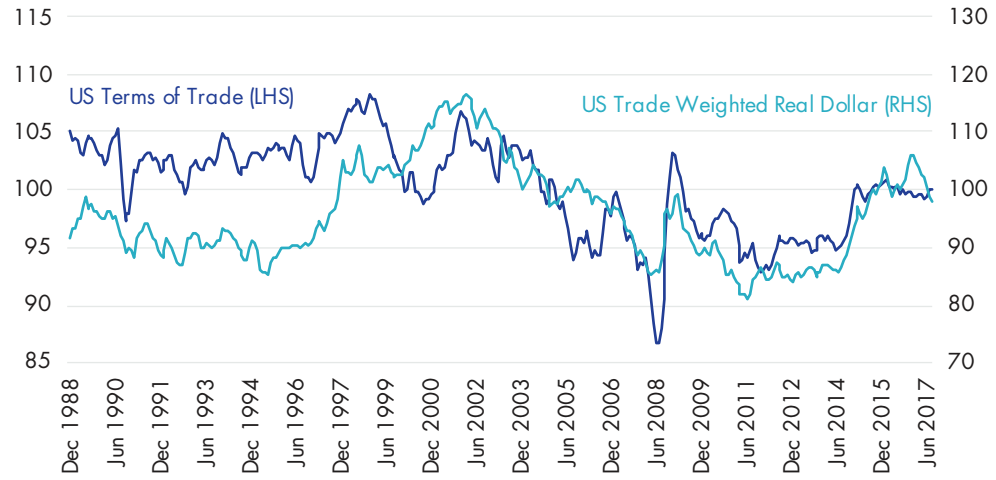
## Emerging market equities look relatively cheap

- Emerging market equities have been outperforming most developed markets since the US dollar bull market began in 2016
- US dollar weakness acts as a further tailwind to performance of commodity focused emerging market economies
- On a valuations basis, emerging markets look to provide greater return opportunities than developed markets

Not surprisingly, the weaker US dollar has seen strong performance from Emerging market equities so far in 2017.

### Tracking the trade

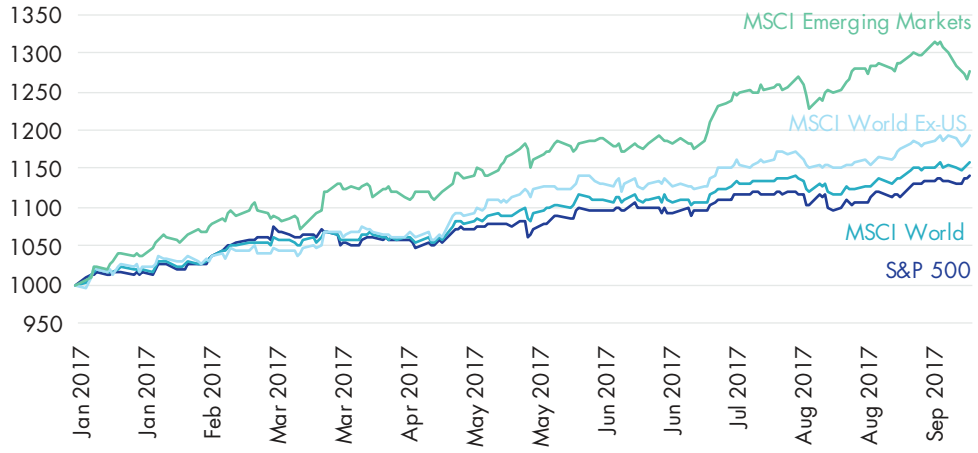
**US terms of trade and trade weighted US$**




Source: Bloomberg, US Federal Res

### Emerging Markets shine

**US equities vs Rest of World 2017**



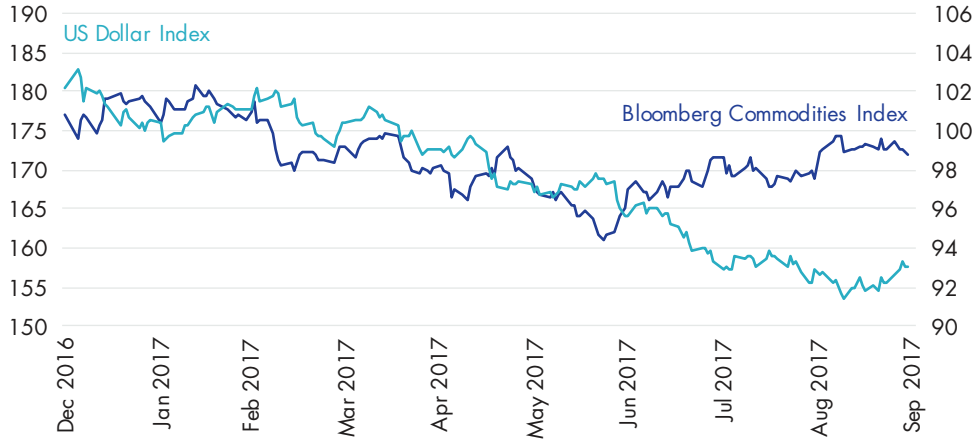

Source: Bloomberg, all in USD, as at 30 September 2017, above indices rebased to 1000

The performance of emerging market equities has traditionally been inversely correlated with the US dollar. A weaker US dollar increases the price of commodities. For countries such as Brazil, Russia and Indonesia that rely in large part on exporting commodities for economic growth, the increase in commodity prices improves the country's terms of trade and GDP growth. It also decreases the debt burden on corporations that have US dollar denominated debt obligations and are earning revenue in local currency.

Despite the recent uptick in the equity performance of emerging markets, these countries remain cheap on a valuations basis compared to other developed nations, where central bank intervention has seen large asset price increases. Much has been made of the elevated level of the Cyclically Adjusted Price to Earnings (CAPE) Ratio in the US, which ended September at 29. This marks the CAPE levels in this expansion as the third highest period of all time. This is compared to a CAPE of just 15.4 for emerging markets equities.

## Inverse correlation

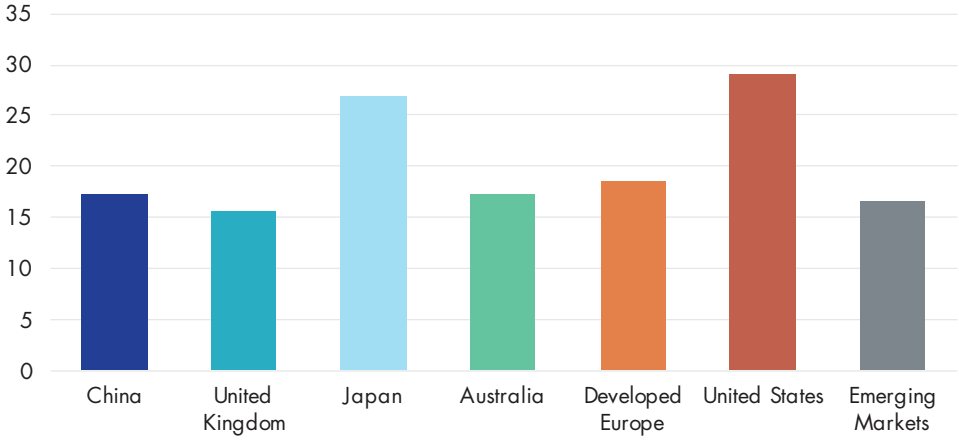
### US dollar vs commodities




Source: Bloomberg

## Valuations are compelling for emerging markets

### Cyclically Adjusted Price to Earnings Ratio (CAPE)




Source: Thomson Reuters Datastream (Worldscope/IBES), StarCapital

We maintain that high valuations in and of themselves aren't a cause for concern for investors, particularly when the level of leverage in the economy is not at the level it was in the lead up to the GFC. Higher valuation levels simply reduce the future expected return on the asset. They do not guarantee that there will be a market crash as there was in the lead up to the Great Depression and the dot com bubble where PE ratios were this elevated. Based on current equity valuations, future return opportunities in emerging markets look more attractive at the present time than US equities.

## US dollar weakness and geopolitical risks act as tailwind for Gold

- Q3 saw Gold finally break and hold above technically significant US$1,300 level
- US dollar weakness and geopolitical risks provide support for the Gold price into the end of 2017

During August, the price of Gold finally broke through the US$1,300 price level, after testing it three prior times. It moved all the way up to US$1,352 per ounce on the 8th of September after a confluence of events at the end of August worked to push the price higher.

First, Fed Chair Yellen spoke on 26th of August at the annual Kansas City Fed event in Jackson Hole and made no mention of rates or guidance, leading the market to believe the Fed would not meet earlier guidance of three rate increases in 2017.

Second, continued geopolitical tensions with North Korea pushed investors into the traditional safe haven asset.

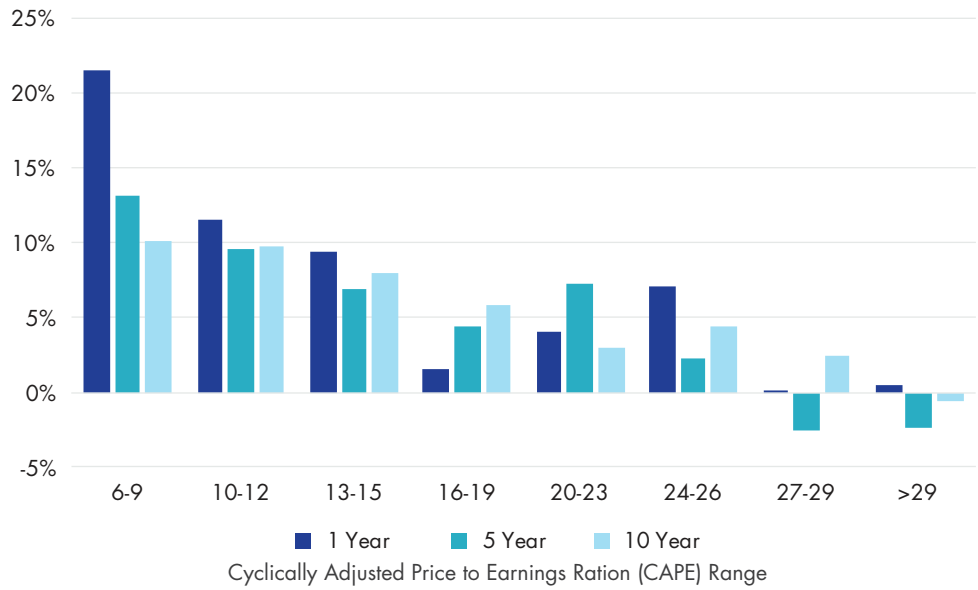
Thirdly, Hurricanes Harvey, Irma and Maria will likely be the most costly natural disasters ever and create a drag on US GDP growth over the coming quarters. All of this hit the US dollar which provided further strength to Gold.

Since the Gold bear market ended in December 2015, the Gold price has been forming a base. Gold's recent advance through US$1,300 per ounce helps solidify this, which we believe is a prelude to a new bull market that may take shape in the coming months or years.

Despite retreating from this high in the second half of September as the US dollar took a pause from its down trend, we believe the fundamental factors in place for a gold bull market remain. We believe geopolitical tension, US dollar weakness and financial system risks associated caused by central banks keeping interest rates artificially low for the past decade, will provide a tailwind for the gold price into 2018.

### Low returns expected

US equity average forward returns at different CAPE levels




Source: Yale University, VanEck

## Aussie Corporates drive recession proof Australia

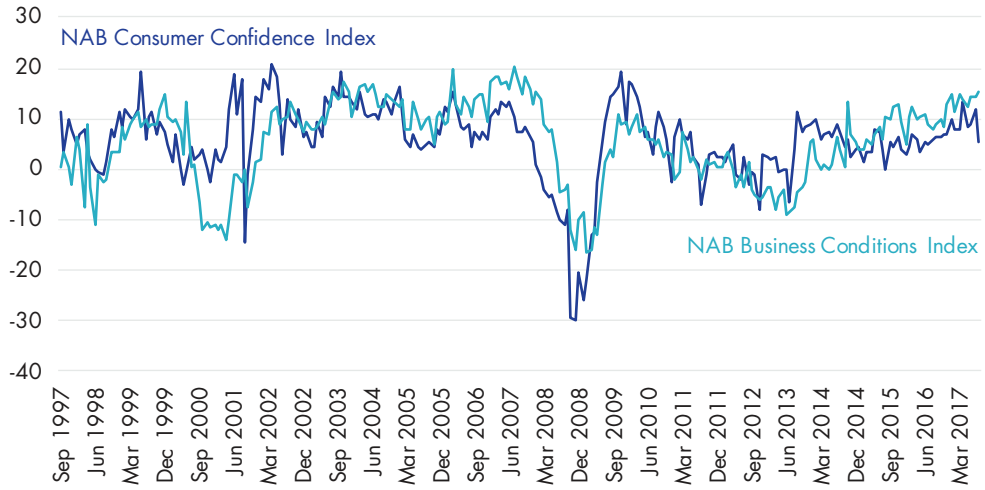
- Australia has now gone 26 years without a recession
- Business conditions and sentiment have risen to their highest levels since GFC
- Despite unemployment remaining steady and job creation exceeding expectations, wage growth remains non-existent
- Risks remain in the housing sector and the overall level of household indebtedness
- Australia is at a delicate point as economic expansion without wage growth could lead to increased debt servicing costs and inhibit the ability to meet requirements

Q3 saw Australian business conditions reach their highest level since 2007. Australia has now gone twenty six years without a recession as a smooth economic slowdown since the end of the commodity boom has cushioned the country from the potentially severe impacts of a sharp downturn. Unemployment has remained steady around 5.7% and we have seen a pick-up in the last 12 months in hiring as business conditions have improved.

Despite this fact, we've seen consumer confidence fall recently as the effects of a prolonged period of wage growth stagnation have begun to bite. Wage growth has been falling since 2012 and while nominal wage increases are low, real household disposable income has not grown since 2008.

### Weary consumers

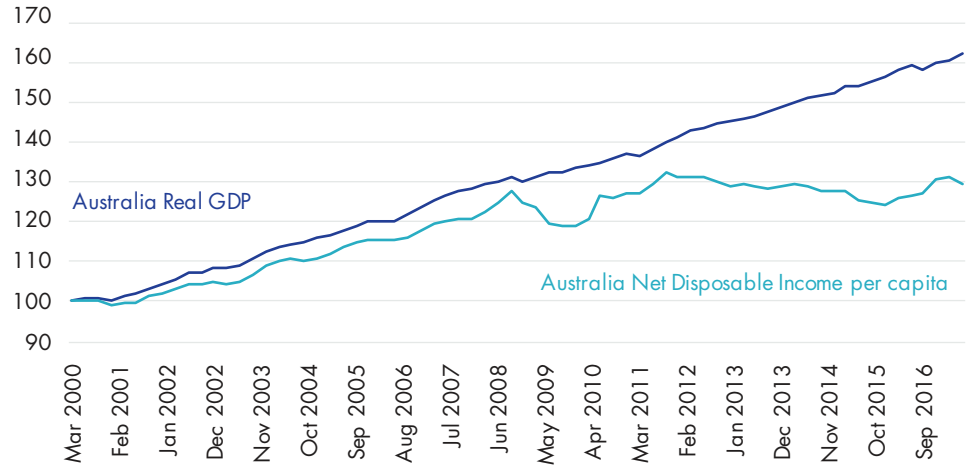
**Australia Business Conditions and Consumer Confidence**




Source: Bloomberg, National Australia Bank

### Stagnant spending power

**Australia Real GDP vs Disposable Income**




Source: Bloomberg, Australian Bureau of Statistics, rebased to 100, Australian Net Disposable Income Per Capita

For wage growth to occur, a prolonged period of higher job creation will be required to remove the remaining slack in the labour market. While the unemployment rate has been falling, the underemployment rate has generally been rising since 2010. Wage behaviour is consistent with the degree of slack in the labour market, with an inverse relationship existing between the underemployment rate and the rate of wage growth.

This lack of wage growth exacerbates the risks in the housing market. Currently 25% of households are suffering from mortgage stress, where household income is not covering outgoings[4]. This is in an environment where the RBA reports that the standard housing loan mortgage rate is only just above its all-time low[5], unemployment remains low and the economy has gone twenty six years without a recession. Australians have taken advantage of a period of prolonged low interest rates to pour money into the housing market, with Australian household mortgage debt now over 136% the average income. Digital Finance Analytics estimates that if interest rates were to rise by just 2%, 50% of mortgaged households would come under stress[6].

The RBA and APRA now have a delicate challenge to try and ensure that house price growth moderates through levers beyond the use of the RBA Cash Rate. A rise in the cash rate has the potential to de-stabilise the economy, given the size of Australian household debt and wealth that is tied to residential property.

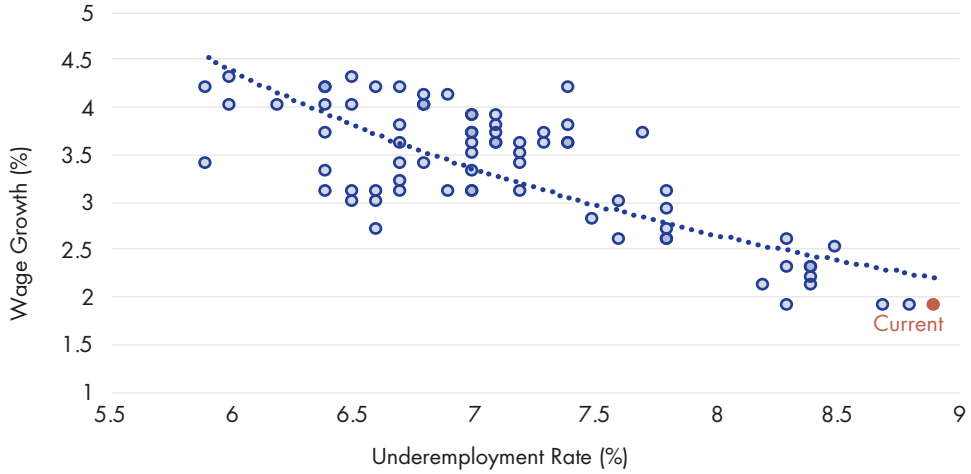
All this aside, we believe there are positive signs on the horizon for the Australian economy. On the back of the spike in business conditions, businesses have been revising up their investment plans. The NAB Investment Capital Expenditure Outlook for the next 12 months, which has previously been a reliable leading indicator of business investment, has been trending upwards since the end of 2015.

The Australian economy has proved resilient in the face of challenging economic conditions over the last two and a half decades. The Asian Financial Crisis, dot com bubble and GFC all failed to push the economy into recession. Undoubtedly risks remain, particularly those posed by household leverage, but we are positive that the current global economic growth environment will see a pickup in GDP growth in Australia for Q4 2017 and into 2018.

4 Mortgage stress hotspots revealed, ABC News, 23rd August 2017, accessed 21st September 2017
5 Source: Bloomberg, RBA, 15th August 2017
6 Mortgage stress hotspots revealed, ABC News, 23rd August 2017, accessed 21st September 2017

## Room for improvement

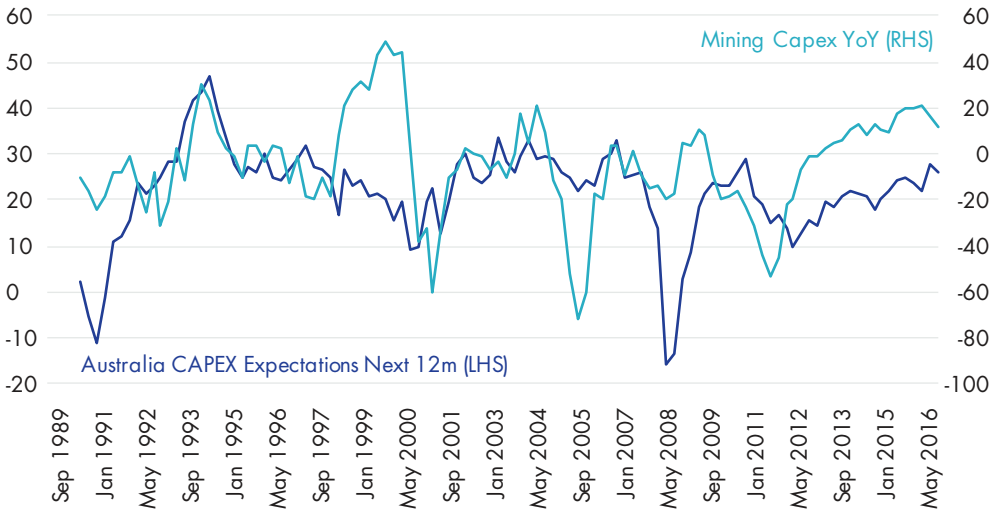
**Australia wage growth and underemployment**




Source: Bloomberg, Australian Bureau of Statistics

## Investment on the rise

**Non-mining investment and investment plans**




Source: Bloomberg, NAB, Australia Bureau of Statistics

## 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 Index | 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 Vectors 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** | | | |
| VanEck Vectors Australian Corporate Bond Plus ETF | PLUS | Markit iBoxx AUD Corporates Yield Plus Index | 0.32% |
| VanEck Vectors Australian Floating Rate ETF | FLOT | Bloomberg AusBond Credit FRN 0+Yr Index | 0.22% |

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