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# VanEck ViewPoint™

## Global economic perspectives

June 2018

# Market summary

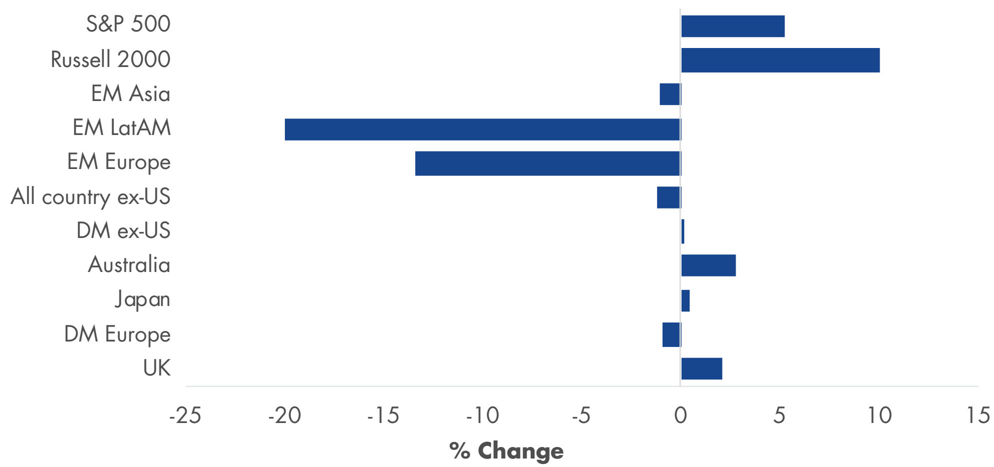
Equity markets remained volatile and returns were, compared to last year, patchy. However, the June quarter again saw US markets out-perform global equites in common currency terms. US out-performance reflected the continued strong returns from large-cap technology stocks (Exhibit 1).

There were notable set-backs in Europe and emerging markets. European equities have under-performed in part because of disappointing European economic data. Political risk increased later in the quarter due to the formation of a new coalition government in Italy. Italian bond yields spiked as Italian equities sold off.

Technology was the best performing global sector, recovering from corrections in the March quarter. Other cyclical sectors – energy, materials and consumer discretionary – also out performed. Defensive sectors continued to struggle, as they have since long-end yields troughed in mid-2016.

### Exhibit 1: Index changes in June quarter (US$ terms)

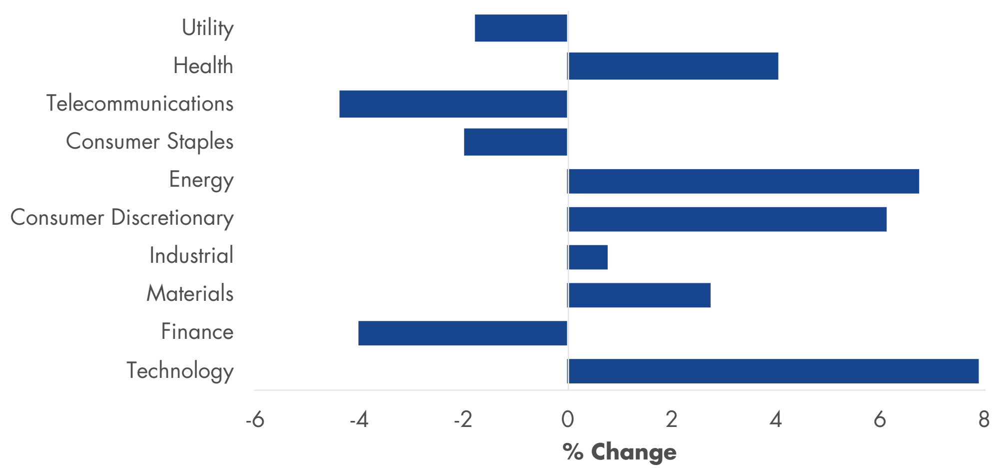
**June quarter equity returns**




Source: Bloomberg, Minack Advisors, to end of May 2018. EM Asia is MSCI EM Asia Index, EM LatAM is MSCI Latin America Index, EM Europe is MSCI Emerging Europe Index, All country ex-US is MSCI AC World ex-USA Index, DM ex US is MSCI World ex-USA Index, Australia is MSCI Australia, Japan is MSCI Japan Index, DM Europe is MSCI Europe Index, UK is MSCI UK Index.

### Exhibit 2: Global equity sector performance, MSCI All Country World Index

**June quarter equity returns**



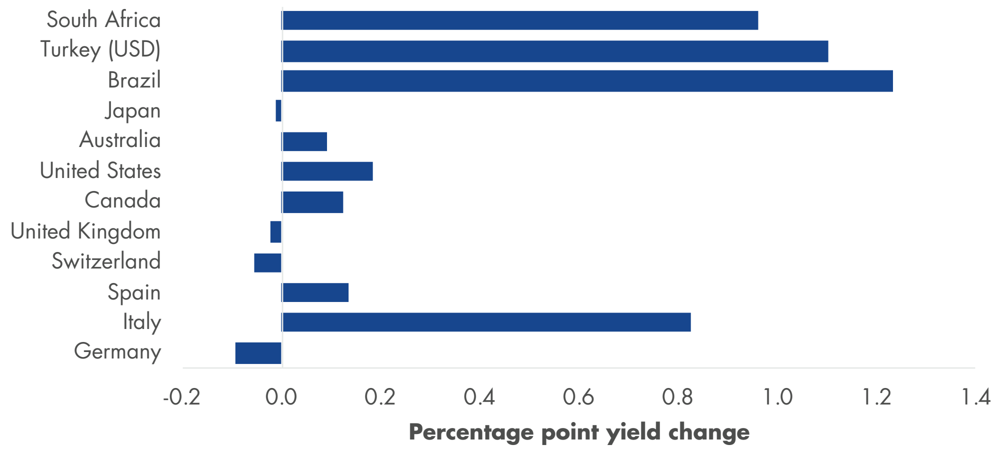

Source: Bloomberg, Minack Advisors, Data is MSCI AC World Index as at 31 May 2018.

Rising yields have also created some pockets of stress in emerging markets. There were idiosyncratic factors at work in some countries, but the bigger picture point is that rising US interest rates and a stronger US$ both work to tighten financial conditions throughout the emerging economies. The sharp increase in long-end yields in a number of markets through the quarter is a neat marker of stress levels (Exhibit 3).

Australia was relatively immune to these stresses, and with trade growth solid the local equity market generated reasonable returns. However, the domestic economy remains patchy, notwithstanding the solid 3.1% GDP growth reported over the year to the March quarter. Much of that growth was accounted for by net exports. While domestic demand did improve, real wage growth remains desultory and housing – which has been the engine of growth over the past three years – looks patchy.

**Exhibit 3: June quarter bond yield change**

**10 year sovereign bond 3 month yield change**




Source: Bloomberg, Minack Advisors as at 31 May 2018.

# US equities lead the way

US equities have handsomely out performed other markets since 2010. This has largely been an earnings story. The principal reason why earnings increased faster in the US than elsewhere was because US companies quickly restored their margins to peak levels after the GFC. In fact, forecast margins surpassed their pre-GFC level by 2014, while margins outside the US were well below prior peaks. Expected US margins again jumped after the Trump tax cuts. Importantly, however, forecast margins have continued to be revised higher even after taking account of the corporate tax cuts (Exhibit 4).

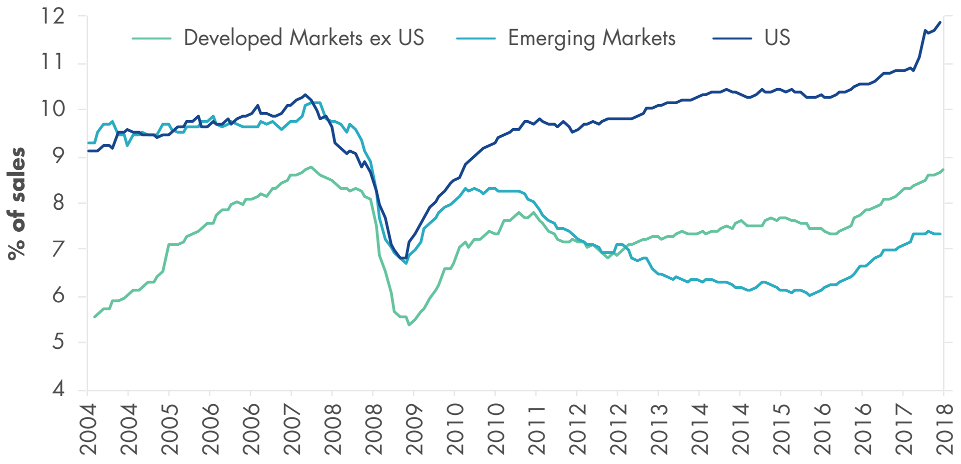
Most of the out-performance of US equities since 2010 has been due to better earnings growth. Exhibit 5 compares the forecast earnings of US equities versus forecasts earnings of other developed markets, and the relative performance of US equities versus other markets. Because the lines overlap in 2010 and again in 2016 it implies that all the out performance of US equities through that period was solely due to superior US earnings. While most equity markets re-rated through that period, the US equity market did not re-rate relative to other developed equity markets.

However, that started to change last year – a change that has continued this year. US earnings have outpaced other markets this year, but part of the US out performance over the past 18 months is due to US equities re-rating versus other developed equity markets.

At face value this is surprising. With margins already high, it seems that there is less upside potential for US corporates compared to companies in other markets. Moreover, the Federal Reserve is tightening monetary policy, which typically puts pressure on US equity valuations. In this cycle, however, Fed tightening has been associated with US equities re-rating in absolute terms, and re-rating relative to its global peers.

### Exhibit 4: Simply higher: US margins vs the Rest of the World

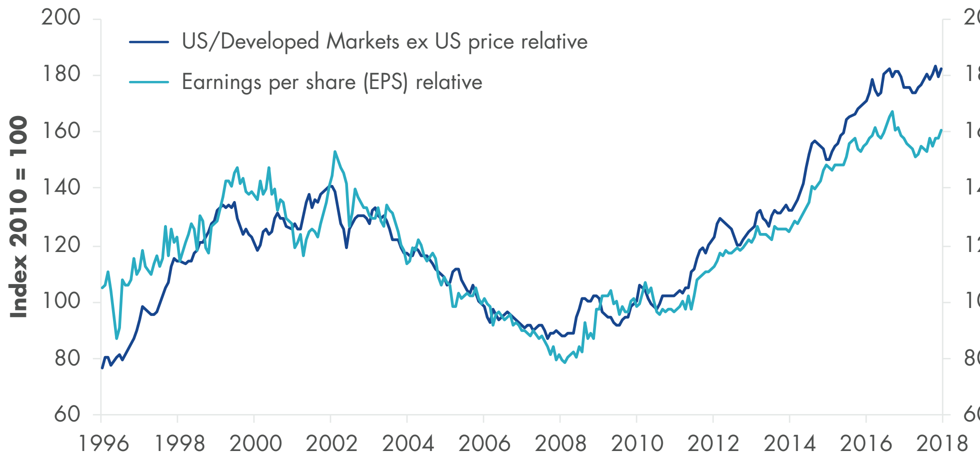
**Forecast profit margins**




Source: IBES/DataStream, MSCI, NBER, Minack Advisors. Index for Developed Markets ex US is MSCI World ex USA Index, Emerging Markets is MSCI Emerging Markets Index, US is MSCI USA Index.

### Exhibit 5: US Equities Now Re-rating

**US versus Developed Markets ex US**




Source: IBES/DataStream, MSCI, NBER, Minack Advisors. Index for Developed Markets is MSCI World ex USA Index, US is MSCI USA Index.

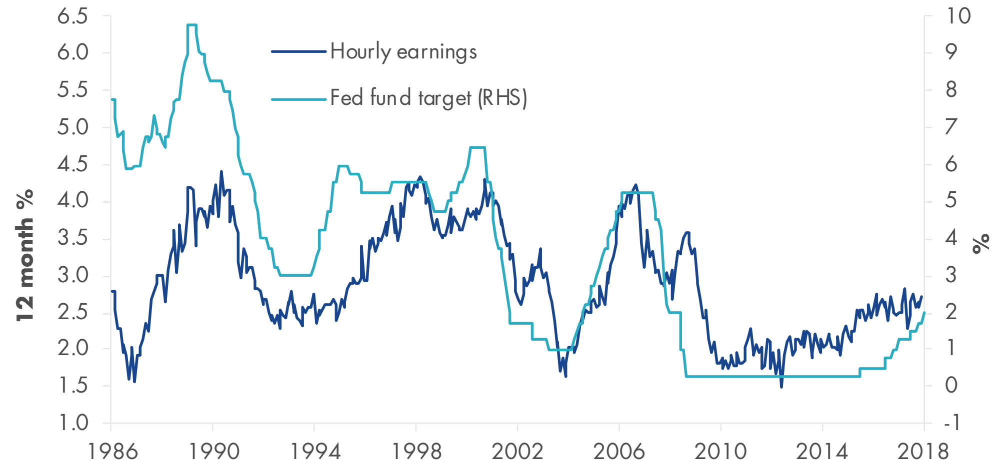
# Policy tightening & the dog that hasn't barked

Rightly or wrongly, inflation-targeting central banks typically see labour costs as the best single leading indicator of inflation. Consequently, monetary policy cycles are often synchronised with, or led by, the cycle in labour costs. Exhibit 6 shows the historical correlation between the Fed funds target rate and hourly earnings growth.

This suggests that the single most important unknown for monetary policy in the US – and elsewhere – is the responsiveness of labour costs to signs of labour market tightening. To the surprise of policy makers in many economies, labour costs have been slow to increase as labour markets have tightened. Put another way, the Phillip's curve – the relationship between unemployment and wages – has flattened. Exhibit 7 shows the flattening Phillip's curve in the US.

### Exhibit 6: The Fed cycle and the wage cycle

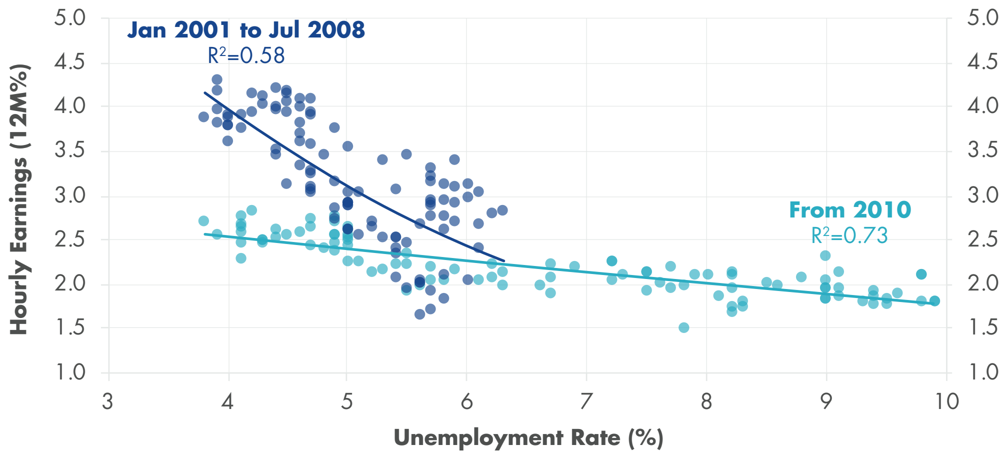
**Hourly earnings and Fed funds target**




Source: BLS, Bloomberg, NBER, Minack Advisors

### Exhibit 7: Wages not responding the usual way

**US unemployment rate and wage growth**



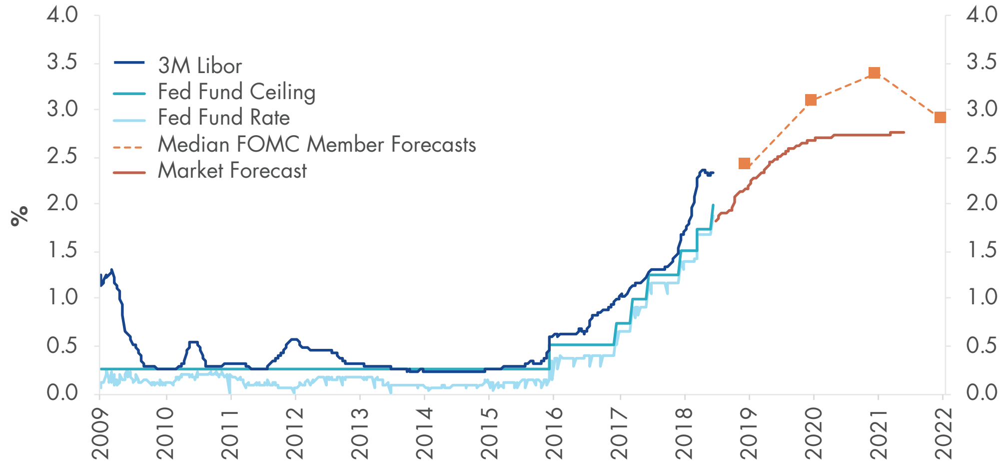

Source: BLS, Minack Advisors

This is a remarkable outcome. Coming out of the GFC the Fed seemed to think that wages would start to accelerate once unemployment fell below 6½% – that is, the natural rate of unemployment was over 6%. Unemployment is now below 4% with only modest signs of wage acceleration.

While the Fed seems committed to increasing rates another one or two times in 2018, it seems unlikely that it would deliver the rate increases it's now forecast for 2019 without wage growth accelerating from current levels. That, for now, seems to be what markets are expecting: futures markets are pricing in Fed rate hikes for this year, but are sceptical that the Fed will deliver on its forecasts next year (Exhibit 8). If wage growth accelerates, validating the Fed's 2019 rate forecasts, then it would likely force market rates higher, particularly at the short end of the curve. If long-end rates remain well-anchored, then this is a scenario where the curve will flatten, and would likely invert (short rates higher than long rates) later this year.

### Exhibit 8: Markets don't believe the Fed for 2019

**Fed funds target, market and FOMC forecasts**




Source: Bloomberg, NBER, Minack Advisors

# A pause that refreshes in Europe?

European macro data have been falling well short of forecasts in recent months. This is partly due to poor weather in the European winter, partly due to stretched expectations after European growth persistently surprised on the upside through 2017. While European data have been patchy, aggregate data point to a moderate turn in growth, not a sharp deceleration (Exhibit 9).

But regardless of the cycle, the stress in Italy underlines (again) the structural flaws in the euro construct: the problems created by the competitive mis-match within the Eurozone. Put simply, the European periphery used to be able to stay competitive with the Germanic core by periodically devaluing their currencies; ever since that option was removed by the euro's introduction there has been two distinct European economies.

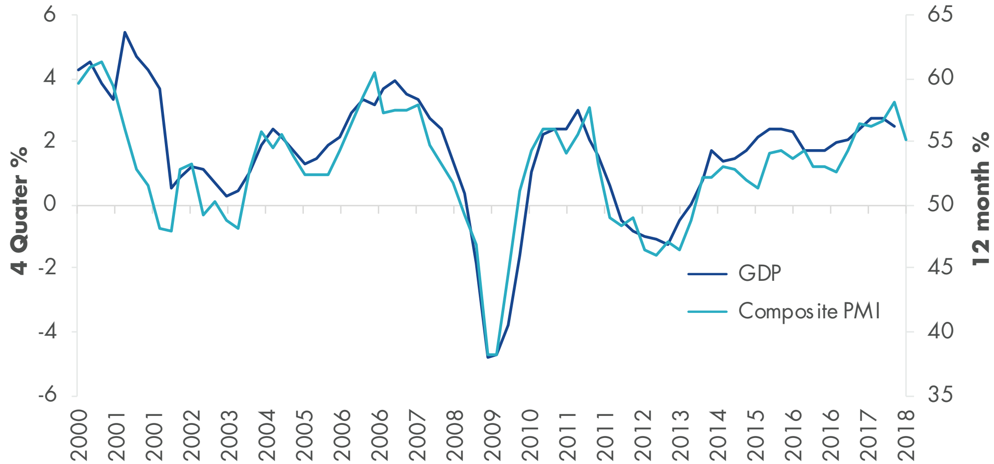
The disparity is reflected in most macro data series, but most importantly in unemployment rates: German unemployment is at multi-decade lows while unemployment elsewhere remains at double digit levels (Exhibit 10).

This is barely tenable now. It will become intolerable if the tightness in the German labour market accelerates German wage growth. How does the ECB respond under that scenario? To not tighten would threaten a significant lift in German inflation – undoubtedly to Germany's disgruntlement – while tightening monetary policy Europe wide with unemployment in double digits outside Germany risks policy backlash in the periphery.

While the pace of US wage gains will likely dictate the pace of Fed tightening, it may be that the pace of German wage gains will determine the risk of another existential Eurozone crisis.

### Exhibit 9: Europe Slowing, Not Crashing

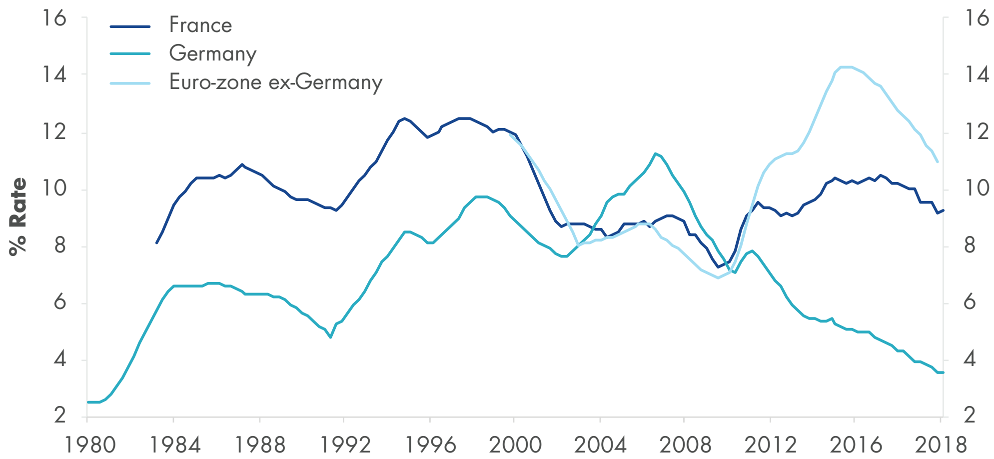
**Eurozone GDP and Purchasing Managers Index (PMI)**




Source: Eurostat, Markit, CEPR; Minack Advisors

### Exhibit 10: Can One Policy Size Fit All?

**Unemployment rates**




Source: Eurostat, CEPR, Minack Advisors

# Japan goes unrewarded

Japan proves that equity markets are not the economy. Whatever Japan's economic problems – and they seem to be exaggerated by some – they increasingly are not reflected in the performance of Japanese corporates.

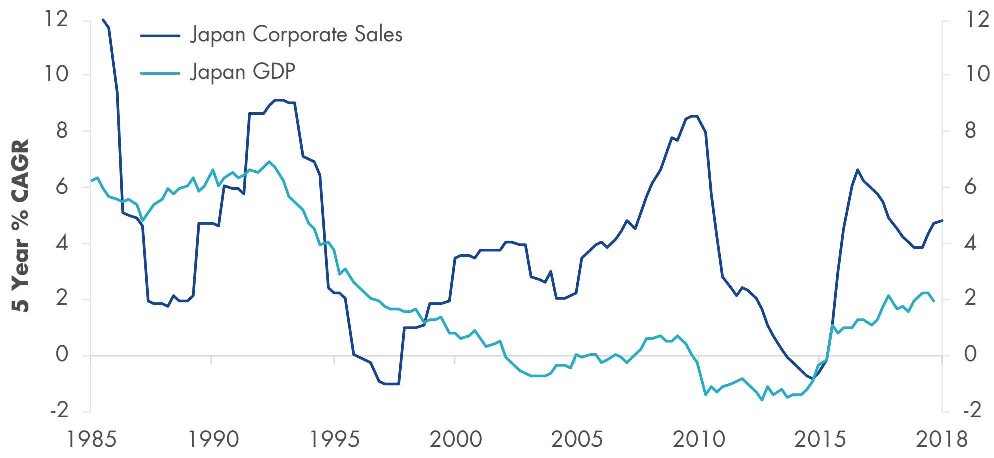
Consensus forecasts for Japanese corporate earnings have been significantly upgraded through the first half of 2018 even as Japanese GDP unexpectedly fell in the March quarter. But this disconnect has a long tradition: the growth of Japanese corporate sales has long ago disconnected from the growth in Japan's nominal GDP. Exhibit 11 shows the trend growth in both reported sales and nominal GDP.

The disconnect between Japanese GDP and Japanese corporate sales is part of the story of corporate Japan's structural improvements. Through the bubble era – which popped in 1990 – Japanese corporates were exceptionally valued, with exceptional leverage, and exceptionally low returns. The result of that poor combination was two decades of equity under performance. Over the past decade, however, structural change has seen Japanese corporates reduce leverage, increase returns and, as a result, produce earnings growth that has significantly out-paced earnings growth in other developed markets (Exhibit 12).

Ironically, Japanese equities out performed throughout the 1980s when the equity market's fundamentals were deteriorating, and has broadly under performed over the past decade as the fundamentals have improved. However, the combination of earnings out performance and index under performance has transformed the relative valuation of the Japanese market: it has switched from exceptionally expensive to now relatively cheap.

## Exhibit 11: Japanese corporate sales dsconnect from GDP

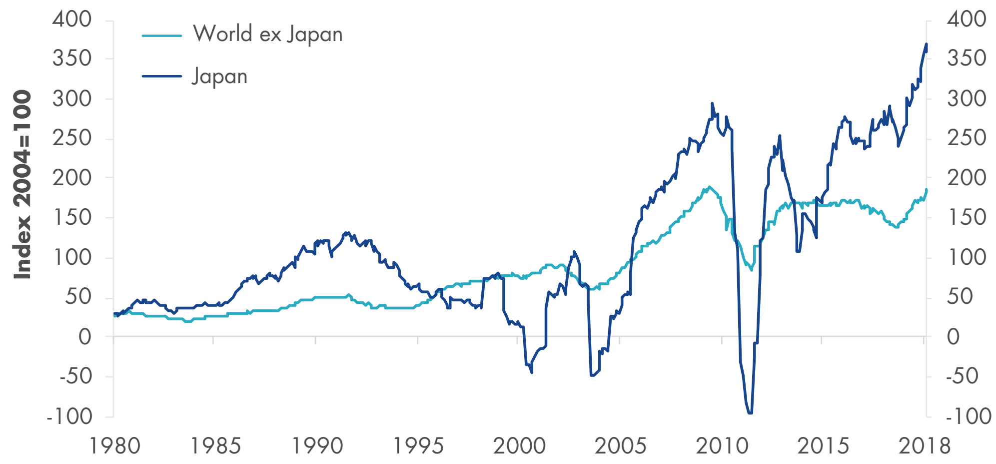
### Nominal GDP and corporate sales growth




Source: DataStream/Worldscope, ESRI, Minack Advisors

## Exhibit 12: Japanese corporates' strong EPS growth

### Trailing US$ EPS, by market




Source: MSCI, NBER, Minack Advisors. Index for World ex Japan is MSCI World ex Japan Index and for Japan is MSCI Japan Index.

# Australia's low calorie expansion

Australia's GDP growth remains solid. Real GDP growth has averaged 2½% since 2013, and was 3.1% over the year to March 2018. But Australia's economic growth is flattered by the strength of population growth – which is the fastest of any major developed economy, now running at just over 1½%. More importantly, with the labour participation rate rising, the labour force increased by 2¾% over the past year. The result is a major gap between aggregate macro growth rates and growth on a per capita basis. Australian GDP has grown steadily through the past few years, while per person income has stagnated (Exhibit 13).

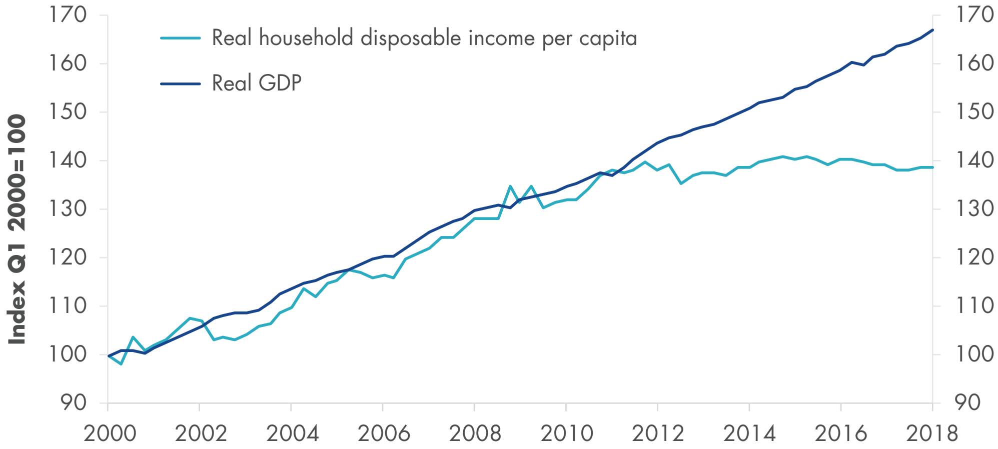
The weakness in per person income growth explains many of the features of the Australian economy. Domestic demand growth remains anaemic in nominal terms. The sharp increase in labour supply has kept wage growth in check. The result is muted domestic inflation pressures and on hold monetary policy.

It could have been worse. Although consumer spending growth has been modest, it has far outpaced consumer income growth. Exhibit 14 shows the growth in real consumer spending in Australia and how it has been funded, either by income growth or saving changes. The past two years have seen a significantly contribution from saving rundown.

Australians have been willing to reduce saving in part because household wealth has been rising. The key to rising household wealth has been rising house prices. Arguably the largest uncertainty in the outlook is what happens to house prices now that credit conditions are tightening, and how will any given decline in house prices affect consumer saving behaviour. There is genuine uncertainty on both points: how any credit tightening translates into house price change, and how any house price change affects saving.

**Exhibit 13: Great in aggregate, not so good per capita**

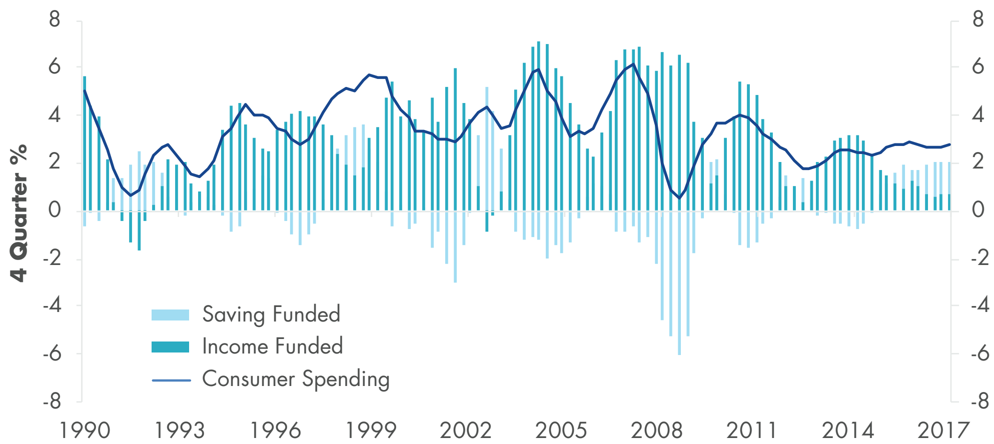
**Per capita household income & real GDP**




Source: ABS, Minack Advisors

**Exhibit 14: The decline in saving funds consumer spending**

**Consumer spending: income & saving**




Source: ABS, Melbourne Institute, Minack Advisors

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

| ETF Name | ASX code | Index | Management costs (% p.a.) |
|---|---|---|---|
| **Australian Broad Based** | | | |
| Australian Equal Weight ETF | MVW | MVIS Australia Equal Weight Index | 0.35% |
| S&P/ASX Franked Dividend ETF | FDIV | S&P/ASX Franked Dividend | 0.35% |
| **Australian Sector** | | | |
| Australian Banks ETF | MVB | MVIS Australia Banks Index | 0.28% |
| Australian Property ETF | MVA | MVIS Australia A-REITs Index | 0.35% |
| Australian Resources ETF | MVR | MVIS Australia Resources Index | 0.35% |
| **Australian Small and Mid Companies** | | | |
| Small Companies Masters ETF | MVS | MVIS Small-Cap Dividend Payers Index | 0.49% |
| S&P/ASX MidCap ETF | MVE | S&P/ASX MidCap 50 Index | 0.45% |
| **International** | | | |
| ChinaAMC CSI 300 ETF | CETF | CSI 300 Index | 0.72% |
| MSCI Multifactor Emerging Markets Equity ETF | EMKT | MSCI Emerging Markets Diversified Multiple-Factor Index (AUD) | 0.69% |
| Morningstar Wide Moat ETF | MOAT | Morningstar Wide Moat Focus Index™ | 0.49% |
| MSCI World ex Australia Quality ETF | QUAL | MSCI World ex Australia Quality Index | 0.40% |
| **International Sustainable Investing** | | | |
| MSCI International Sustainable Equity ETF | ESGI | MSCI World ex Australia ex Fossil Fuel Select SRI and Low Carbon Capped Index | 0.55% |
| **Global Sector** | | | |
| FTSE Global Infrastructure (Hedged) ETF | IFRA | FTSE Developed Core Infrastructure 50/50 Index Hedged into AUD | 0.52% |
| 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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