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VanEck ViewPoint™

Global economic perspectives

March 2018

Market Summary

Markets are interestingly poised at the moment. Most equity markets in the developed world look expensive from a valuation standpoint however underlying economic growth remains strong. They say that history doesn't repeat, but this year is shaping up to look very similar to 2017 with inflation and wage growth expectations falling.

In February, we saw a correction in equity markets that many market participants had predicted. However since then it has been back to the races, particularly in the US, where tech stocks have continued to power higher and the full impact of the 2017 Trump tax cuts have begun to work their way through the economy.

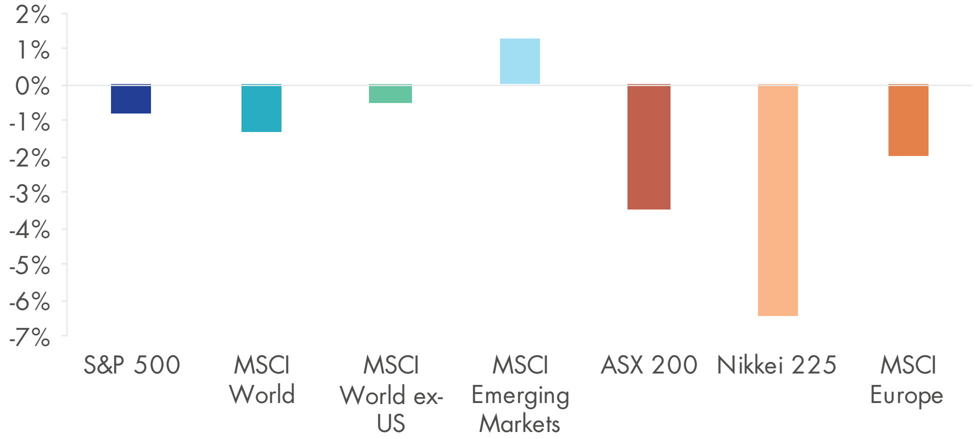
In Australia, we've continued to see both the equity market and general economic activity lag the rest of the developed world. Favourable business conditions and increased optimism has not fed through to consumers and the retail sector has continued to struggle. We like the prospect for earnings growth outside of the mega caps, particularly in healthcare and technology.

Elsewhere, economic conditions in Europe look positive as the ECB ponders when to begin removing emergency monetary stimulus, although the economic impact of Brexit remains to be seen. Japan looks to be moving in the right direction as we have seen steady increases in GDP growth for the past two years.

We are optimistic on the prospect for Emerging Market (EM) equities. Emerging markets now make up 50% of global GDP and the cyclical global expansion should benefit the producer economies in emerging markets. After lagging the developed world in equity performance for the last nine years, the opportunity to buy EM equities at current valuations is relatively attractive.

Key equity benchmarks

Year to date performance - 29 December 2017 to 30 March 2018



Source: Bloomberg, VanEck, Returns in US dollars.

Market volatility returns

As is often the case, the February market correction started in the US equity market and spread around the world to various degrees. The sell-off was triggered we believe by two elements:

1. Acceleration in US wage growth

The January employment data showed US average hourly wages growing at its fastest pace since 2009. This had a number of knock-on effects. As this was the first set of wage data since the introduction of the Trump tax cuts, the market interpreted the strong hourly wage growth to be the beginning of a return to inflation. This pushed bond yields higher and contributed to the sell-off in equities. One month on and another jobs report in, it appears the market may have gotten ahead of itself.

The January jobs report in the US is impacted by a number of seasonal factors. These are mostly muted because of the year-on-year growth measure however January 2018 had an unusual number of bad weather days. When the weather is bad, low paid workers are those that are first to stay home, meaning the average hourly earnings are pushed higher. We maintain that a number of structural factors are keeping wage growth down in the developed world.

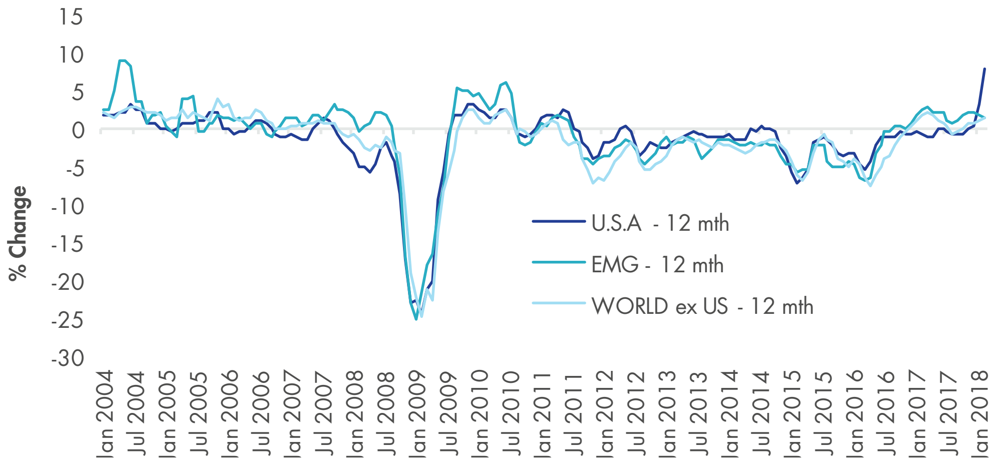
2. The blow-up of short volatility strategies

We wrote in our most recent ViewPoint about the historically low equity market volatility in 2017 and our expectation that these levels would not last. We were proven right at the start of February when the VIX went from 13.47 to 37.32 over the space of two trading days.

This saw the collapse of several short volatility strategies, most notably XIV which had $1.9bn in assets before collapsing almost overnight. The lesson from XIV is not that short volatility products as a whole are bad, but not all lessons from 2008 have been heeded.
XIV was a derivative of a derivative, betting on not just low changes in volatility but low changes in the volatility of volatility.

Tax cut expected to boost margins

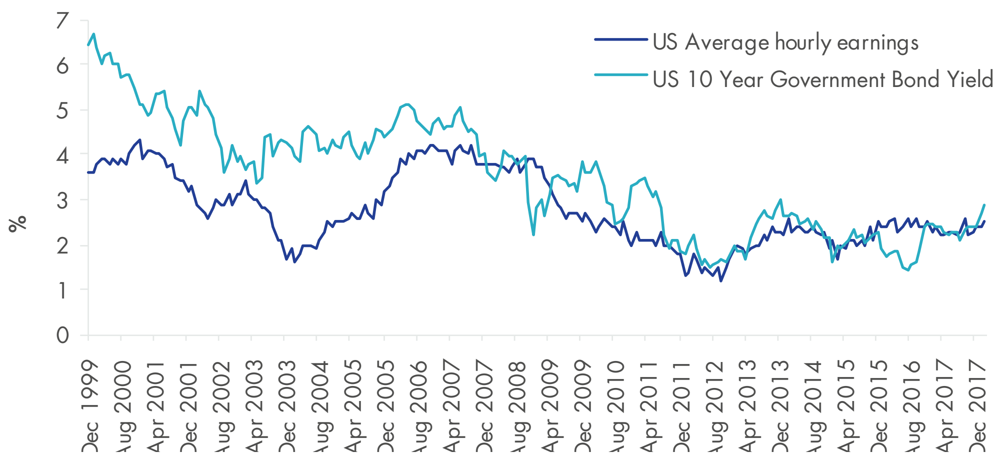
Revisions to consensus EPS forecast



Source: Bloomberg: USA in MSCI USA-12 MTH FWD 3 MTH change.
EMG in MSCI EMG 12 MTH FWD 3 MTH change. MSCI World ex US-12 MTH FWD 3 MTH change.

Bonds yields react to wage pick-up

US real average hourly earnings growth



Source: Bloomberg, BLS

But it worked. XIV returned 41.24% p.a. since its inception in March 2013 to the end of January 2018 vs the return of the S&P 500 Index of 15.21% p.a[1]. But when it unwound, it unwound quickly. The problem with short volatility strategies is that as volatility increases, they need to sell more equities to reduce their risk exposure, increasing the volatility in the market and becoming self-fulfilling.

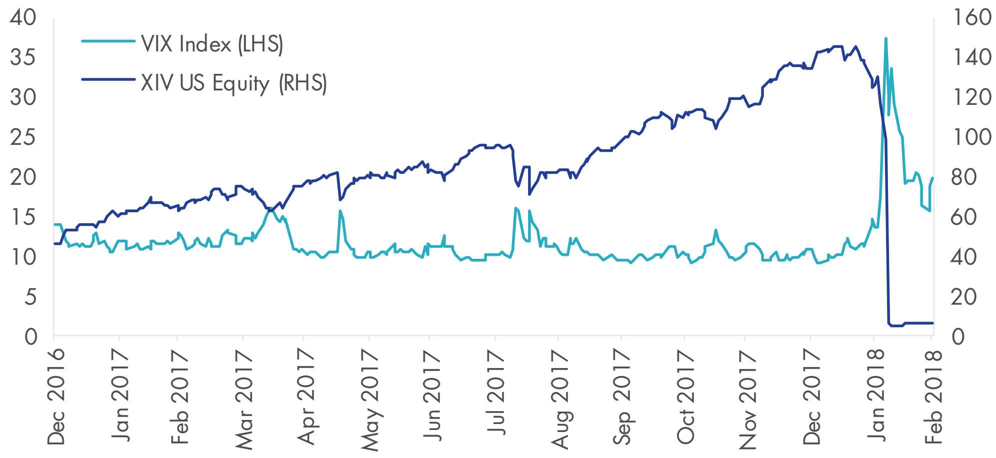
To the credit of the issuer of the product, they had foreseen this circumstance and had warned investors in the prospectus that "The long term expected value of your ETNs is zero"[2].

Trump gets his trade war

The major economic policy story so far in 2018 has been the proposed tariffs imposed by the Trump administration. Having campaigned on protectionist policies, the administration finally delivered the promises that the market had feared. Steel and aluminium tariffs were the opening shot across the bow but the news that the administration is planning on demanding China reduce its trade deficit by US$100bn and targeting China's intellectual property theft we see as having the biggest chance to cause a global trade war.

The collapse of short volatility

VIX vs XIV



Source: Bloomberg, CBOE

1 Source: Bloomberg, price returns in USD.

2 Velocityshares

Populism returns to Europe

The Italian elections provided a reminder that the economic rebound being felt by Europe has not translated to a pro-Europe stance. The results of the election saw Italy effectively split at the middle in what is being called the "most dramatic political shift in Italy since the founding of the republic after the Second World War"[3]. The entire Italian south went to the Five-Star Movement. Most of the North of the country went to a centre-right bloc led by the League, formerly the Northern League, which campaigned on fears of out-of-control immigration and economic distress. Both parties pushed populist agendas, although Five-Star Movement stresses that it is not a populist party, nor an EU-sceptic.

Undoubtedly, investors will be concerned what a move towards more protectionist policies in Europe's third largest economy will have on asset prices. Our view remains that despite a broad based swing to the right in European politics, the prospects for the current proposed US style protectionist policies are overstated.. A rising tide lifts all boats and we expect that the continued economic rebound in Europe will subdue any anti-Europe agendas. Brexit is the real test case, as for better or worse, politicians on the continent can point to Britain's post Brexit economic performance as a sign of what to expect.

Draghi keeps the market guessing

European Central Bank (ECB) chief Mario Draghi delivered one of his typically careful addresses after the February ECB policy meeting. The market's initial reaction to the meeting was to begin pricing in the withdrawal of ECB stimulus at the end of 2018, however in Draghi's subsequent press conference he pointed to slack in the eurozone economy being bigger than previously estimated.

There is a belief among policy makers that indicators of inflation are beginning to show and that inflation will return, albeit slowly. The market does not agree with them. Euro denominated zero coupon inflation swaps have begun trending downwards, having peaked in February. Our view remains that inflation will remain low for an extended period of time, but this will not stop the ECB from removing monetary stimulus.

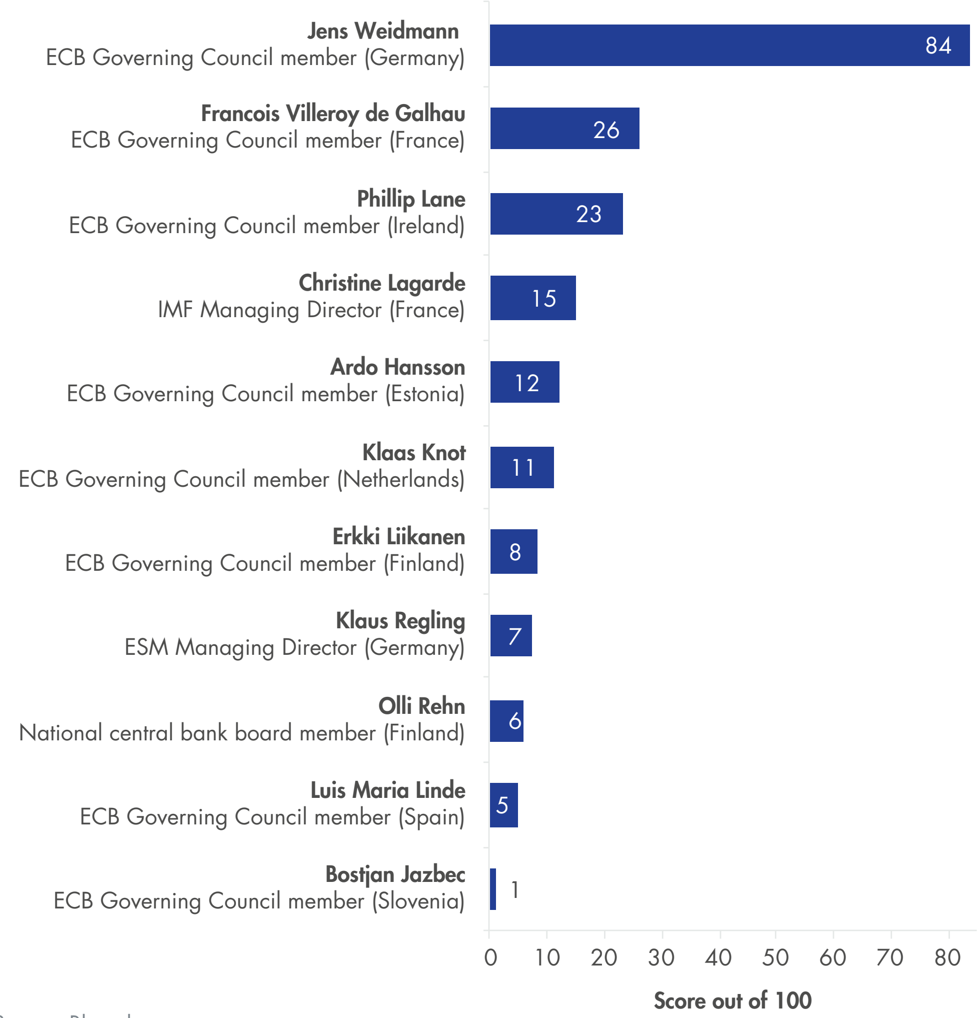
We believe that the approach the ECB is moving towards is a position similar to that of the US: of removing stimulus until the data tells them it is a bad move, rather than waiting for the data to meet its target. This makes sense in a world where inflation has disconnected from the broader economic environment but raises the risks of central bank missteps.

3 The Atlantic

A key focus now is who the successor to Draghi will be. Jens Weideman is the overwhelming favourite among Bloomberg surveyed economists and the German is seen as dovish, being one of the most vocal critics of the slow normalization of the ECB's monetary policy.

The most-likely nominees to succeed Draghi as ECB President

Ranking based on a Bloomberg survey of economists



Source: Bloomberg

EM equities continue their outperformance

EM equities have continued on from their strong end to 2017. We continue to see the backdrop for EM equities as positive for the year ahead. From a valuation standpoint, EM equities remain cheap relative to developed market equities. Added to this, the continued improvement we expect to see in global economic output bodes well for EM equity earnings.

The growth in forward earnings per share estimates closely tracks the total global export value and while global growth may slow in the second half of 2018, we expect that EM will continue to offer better real growth opportunities than their developed market counterparts.

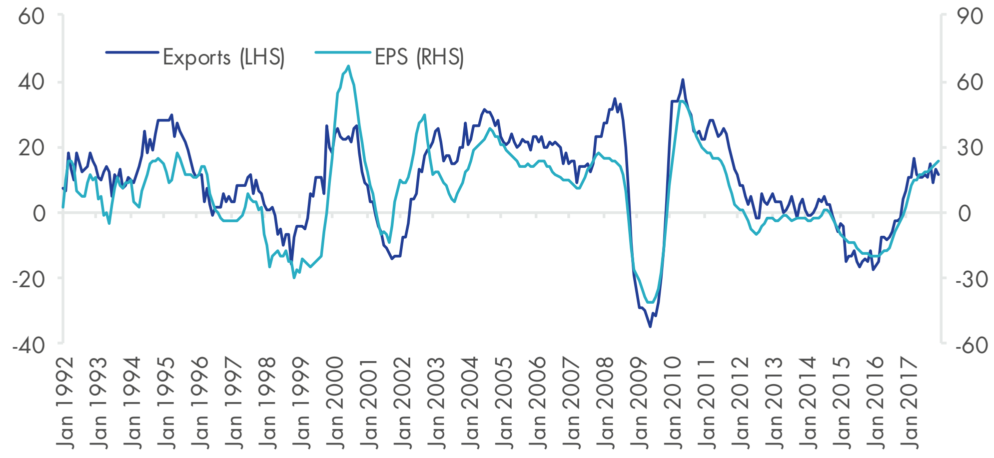
China back to the future

In March, the decision by the Communist Party of China (CPC) to abolish presidential term limits will allow Xi Jinping to remain in power indefinitely. This is seen in many quarters as President Xi tightening his grip on power and returning China, after three decades of opening up to the outside world, to be more inward focused. Our view remains that this is a careful orchestration of the China 2025 plan, the ambitious initiative to comprehensively upgrade Chinese industry. The Center for Strategic and International Studies states that the guiding principles of China 2025 are to have manufacturing be innovation-driven, emphasise quality over quantity, achieve green development, optimise the structure of Chinese industry and nurture human talent. The goal is to comprehensively upgrade Chinese industry, making it more efficient and integrated so that it can occupy the highest parts of global production chains. This is why we believe the imposition of US steel tariffs is misguided.

The Chinese want the high skilled manufacturing jobs that are further up the supply chain. This allows them a strategic advantage as they transition their economy into a modern world, and move away from the stereotypical view of the large smoke stacks to a more technology focused "new" economy. The ten year presidential term limit for Xi would have been up in 2023. Removing the limit allows him to see the China 2025 plan through to its completion. China is a controlled economy and Xi knows that it is Chinese domestic issues that will cement his legacy, not how China performs on the world stage. A smooth transition into modernity would cement the CPC's long-term authority and ensures Xi's legacy as modern China's most significant leader. But challenges remain, not least how to deal with the current hukou (household registration) system. This is the arrangement that allows migrants from rural areas to work in cities across China, but does not afford them the same rights as those born in cities. We are confident that the prospect of a hard landing in China is subsiding, but we expect growth to slow as the economy becomes more mature.

EM earnings track exports higher

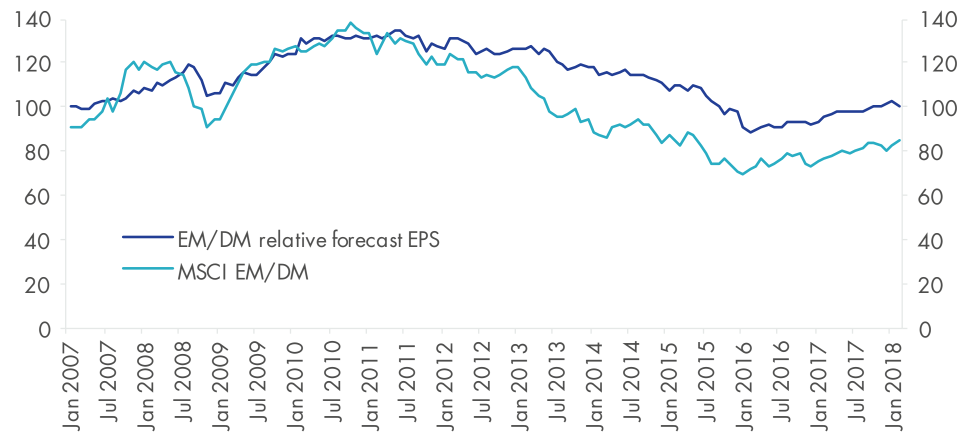
EM Market Exports & Forecast Earnings per Share (EPS)



Source: CPB, IBES/DataStream, MSCI, NBER

EM outperforms

Emerging Market/Developed Market relative performance and Earnings per Share (EPS)



Source: MSCI, IBES/DataStream, NBER

Australian earnings reflect positive back drop

Australia's earnings season for the second half of calendar year 2017 provided an interesting insight into the health of the Australian economy. Having experienced record highs in business conditions in 2017, earnings reported in February reflected this positive backdrop. 81% of companies reported increased revenues and overall analyst forecast future earnings were revised upwards for 60% of the ASX 200. This is important because the most often cited valuation metric, the Price-to-Earnings (P/E) ratio, uses analyst consensus 12 month forward earnings expectations as the denominator. Upwardly revised earnings expectations lead to the valuation metric of a share market declining.

Banks pressure weighing on market

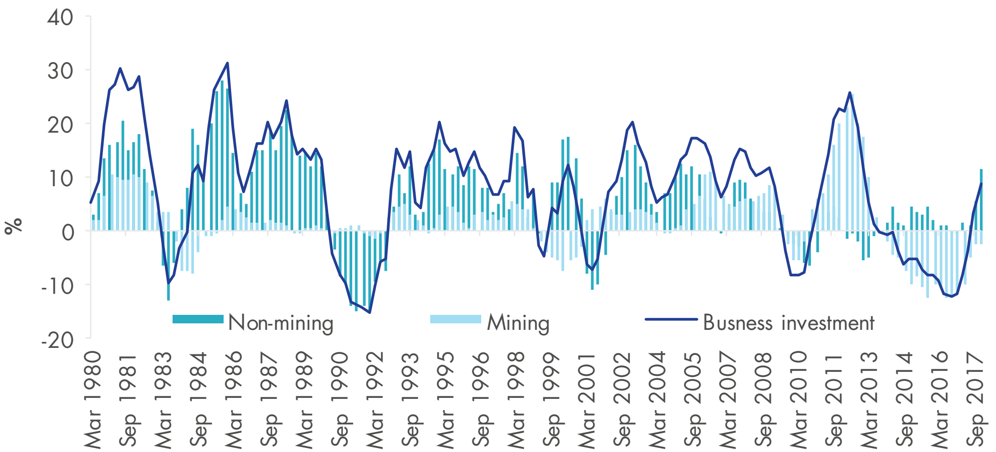
The challenges remain in the mega caps. With commodity prices softening as the US dollar strengthens and we retreat back from the top of the commodity cycle, resource stocks have been challenged. Australia's big 4 banks continue to struggle. We maintain our view that 2018 will be a tough year for banks in Australia. There are the dual pressures from the Banking Royal Commission and stresses in the Australian property sector. Added to this, as USD LIBOR OIS begins to widen, PIMCO, one of the world's largest Fixed Income managers, began selling the bonds of Australian banks.

They are concerned about the banks' exposure to risks in the property sector. As if things couldn't get worse for Australian banks, the Bank of International settlements (BIS) noted in a recent research paper that Australia's debt-service ratio, household debt-service ratio and cross-border claims are coded amber. This means they exceed a threshold that points to a high risk of a banking crisis in the coming years. Australian banks are among the most well capitalised in the world and we believe the prospect of a banking crisis in Australia is slim. However the likelihood of continued underperformance through the middle of 2018 is high.

Positively, on the economic front a mixed CAPEX report for Q4 2017 which showed private new CAPEX down 0.2% quarter on quarter, revealed green shoots on the horizon. Plant and equipment spending rose solidly and the drag from the decline in mining investment, which has persisted since the end of the commodity super cycle in 2014, is ending.

Business investment on the rise

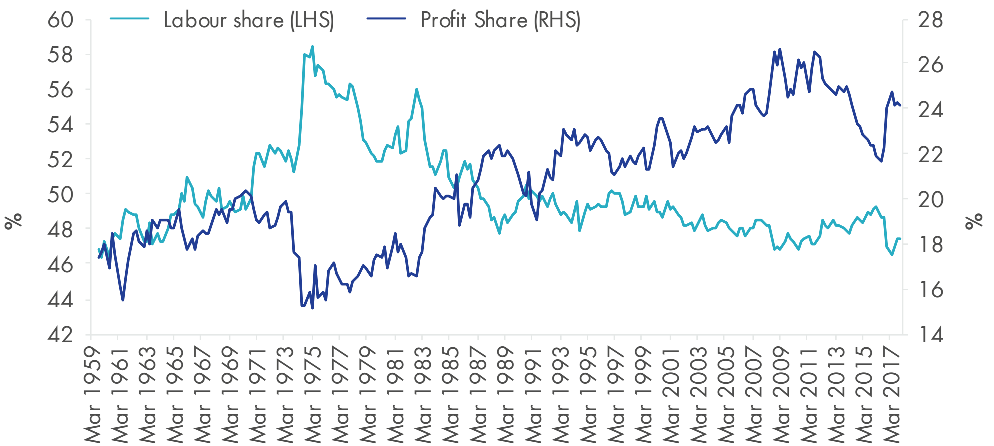
Australian Capital Expenditure (capex)



Source: ABS, Melbourne Institute, Minack Advisors

Businesses taking a greater share of the pie

% share of GDP



Source: ABS, Melbourne Institute, Minack Advisors

The outlook for capital spending remains positive, with a solid non-mining investment pipeline stemming from urban infrastructure investment to support Australia's population growth providing optimism that the Australian economy may be bottoming out in this current cycle. The main issue for the Australian economy remains the anaemic growth in real wages and the corresponding flattening of the Phillips curve. The slowdown from the mining boom has been starkly felt by workers, with labour share as a percentage of GDP falling to its lowest level since 1960 and profit share on the rise. Until we see wages begin to rise, we will continue to see poor consumer spending and low inflation.

Japan emerging

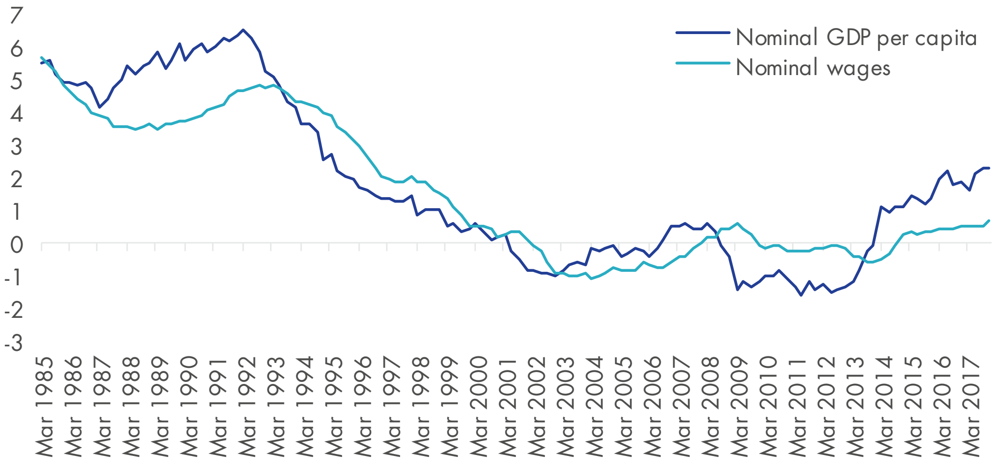
After two decades of stagnant GDP growth, the Japanese economy has begun trending higher. Despite economic growth slowing somewhat in the most recent quarter, compensation of labour has started showing meaningful signs of life over the past three years. A falling growth rate in the working age population is helping to boost GDP per capita. The policy changes introduced by the Abe government that require companies to invest more and increase workers' pay by at least 3% to be able to take advantage of a corporate tax cut we believe is the most likely reason behind the wage growth, not reduced slack in the labour market.

Contrasted with Australia, where the working age population is growing by over 2% per year due to population growth, the falling working age population in Japan means that on a per capita basis the Japanese economy is performing well. Despite an unemployment rate of 2.73%, the tight labour market and increased wages has not translated to higher inflation. This is because as wages have begun to rise, households have boosted their savings rates.

We are positive on the outlook for the Japanese economy, believing the worst years are behind them. What is significant is the time and extreme monetary and fiscal accommodation it has taken to get to this point. The structural disadvantages that a shrinking working age population brings are now showing benefits in the form of per capita improvements.

Shrinking Population

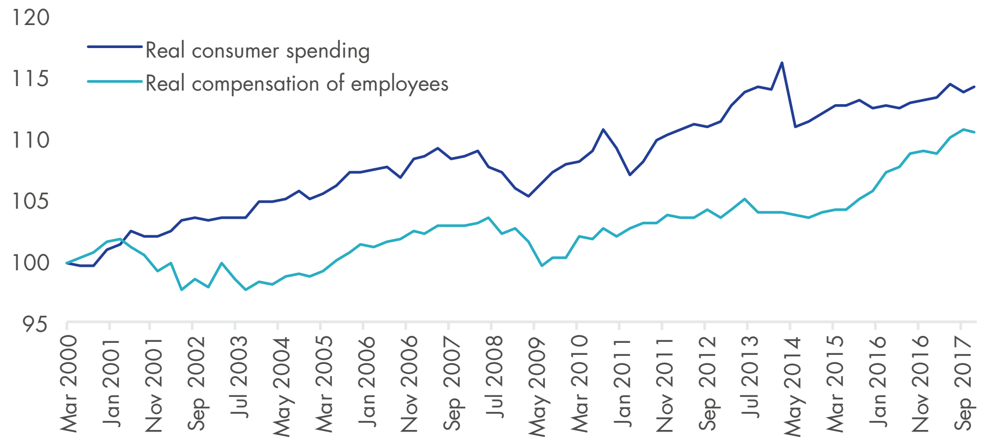
Average monthly pay (ministry of Health, Labour and Welfare)



Source: MHLW, MIAC, Minack Advisors

Increased wages not translating to spending

Consumer spending vs compensation



Source: OECD, ESRI, MIAC

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

ETF Name	ASX code	Index	Management Cost (% 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%
Sustainable Investing			
MSCI International Sustainable Equity ETF	ESGI	MSCI World ex Australia ex Fossil Fuel Select SRI and Low Carbon Capped Index	0.55%
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%
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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