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Global economic perspectives

October 2018

Market summary

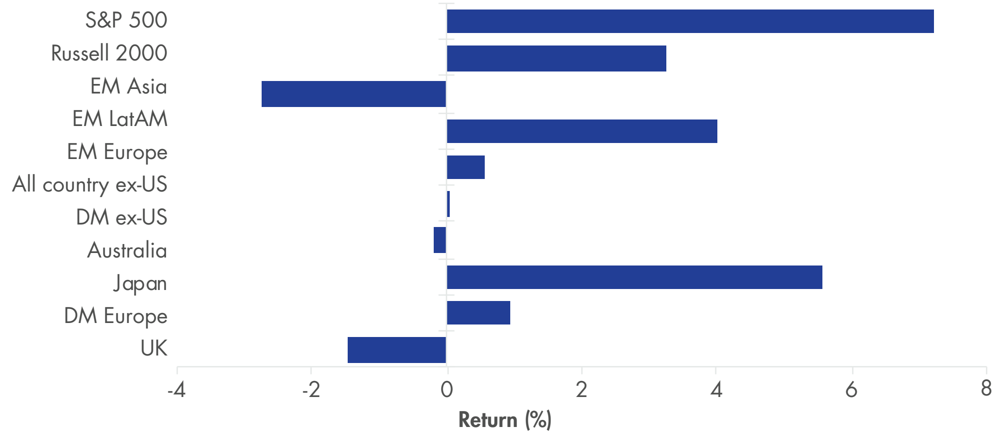
The September quarter again saw US markets outperform global equities in common currency terms as its economy continued to thrive. US second quarter gross domestic product (GDP) struck 4.2%, driven largely by consumer spending.

Global growth is still on track but less synchronised. European equities continued to suffer on the back of persistent political squabbling. The Japanese economy appears to be growing again with rising labour participation.

All eyes continue to be on the Fed and the shape of the US yield curve after a late September rate hike for a third time in 2018. Investors will also be examining upcoming mid-term elections.

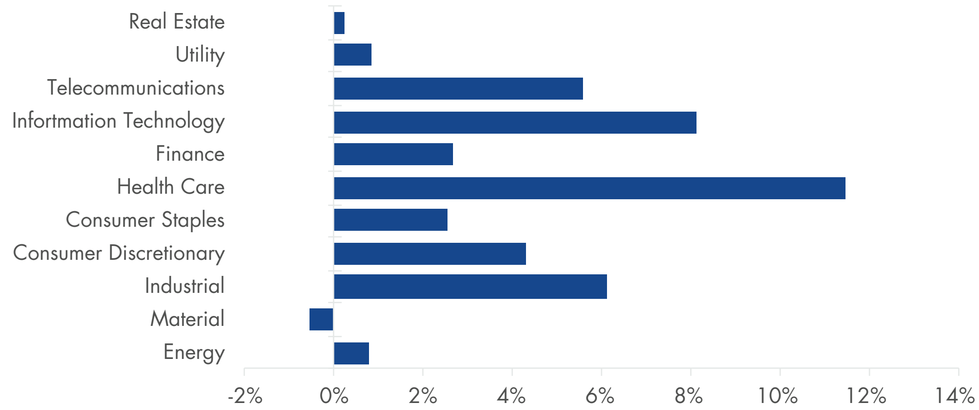
Emerging markets continued to experience setbacks; predominantly US-dollar strength and capital management challenges on the periphery. However, fundamentals for emerging markets are stronger now than in prior crises. Serious sustained contagion in emerging market countries is unlikely with opportunities arising after the sell-off. At a sector level, defensives outshined with healthcare outperforming. Technology companies continued to be the market darlings. Apple became the first company to reach a $1 trillion market capitalisation.

Exhibit 1: Index returns in September quarter (US$ terms)



Source: Bloomberg; to end of September 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 September quarter performance, MSCI All Country World Index (US$ terms)



Bloomberg to end of September 2018. Energy is MSCI World Energy Index, Materials is MSCI World Materials Index, Industrials is MSCI World Industrials Index, Consumer Discretionary is MSCI World Consumer Discretionary Index, Consumer Staples is MSCI World Consumer Discretionary Index, Health care is MSCI World Health Care Index, Finance is MSCI World Finance Index, Information Technology is MSCI World Information Technology Index, Telecommunications is MSCI World Telecommunication Services Index, Utility is MSCI World Utility index, Real Estate is MSCI World Real Estate index

A Narrowing Path Ahead

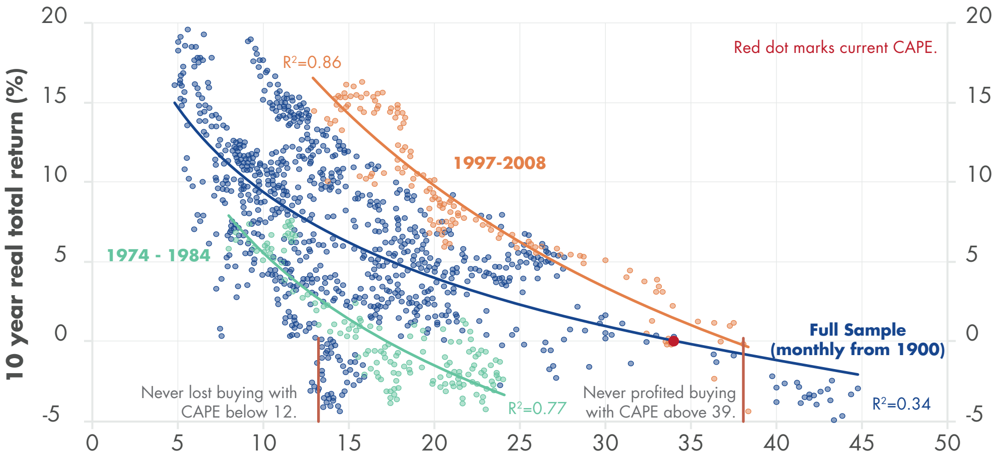
US equities again rose, taking most developed market (DM) equities with them. There have been valid reasons for this strong performance. Turbo charged by Trump tax cuts, the technology sector has led strong growth in US earnings.

But while macro conditions have been positive in 2018, the path to continued good market performance is narrowing. Risk is rising with valuations. In other words, looking forward, investors are being offered less reward to accept a rising level of risk.

Long run valuation measures such as the CAPE ratio (cyclically adjusted price earnings ratio) are reaching levels that suggest forward-looking returns are going to be, at best, subdued. At the same time, US and global growth prospects appear to be peaking.

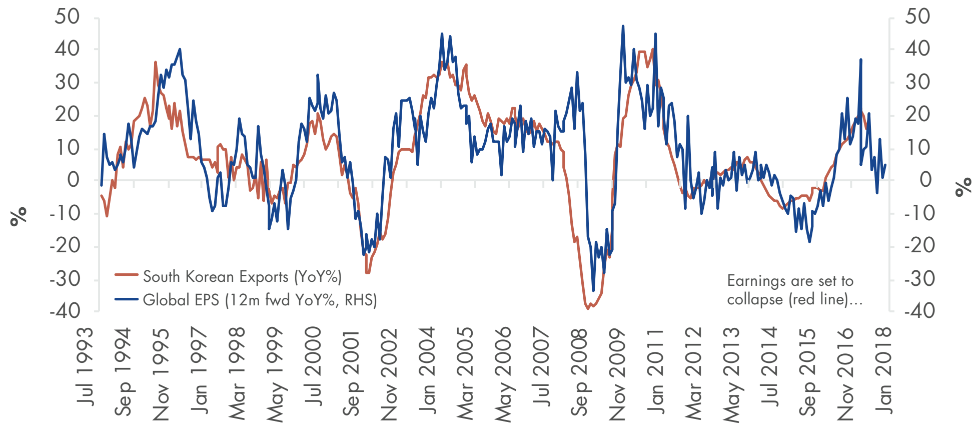
Korea is a highly open economy, embedded deep in global supply chains, especially in the technology sector. Korean exports have therefore been a bellwether for global growth, as well as corporate health. The current sharp slowdown in Korean exports points to weaker global earnings per share (EPS) in coming months. Rising US interest rates will crimp EPS, directly through rising interest costs and indirectly by denting the appeal of debt-funded share buybacks.

Exhibit 3: CAPE vs subsequent 10 yr return



Source: Standard & Poor's, Robert Shiller, BLS, Bloomberg, Barclays. Dates refer to the returns (Not starting point CAPE).

Exhibit 4: Korean YoY exports vs global earnings per share 12 months forward



Source: Minack Advisors

Slack in the US economy is disappearing with wages picking up gradually which is keeping the Fed on a tightening path. But imbalances and policy risks are rising, with an unprecedented late cycle fiscal boost possibly pressuring inflation higher. Separately, escalating trade tensions may put pressure on global exports and therefore growth.

Market-implied measures of volatility remain at lows, even as policy volatility rises.

Markets continue to put a bullish spin on developments despite the US-China trade war escalating. While equities would rise further were tensions to abate, it's hard to believe valuations have not yet been damaged.

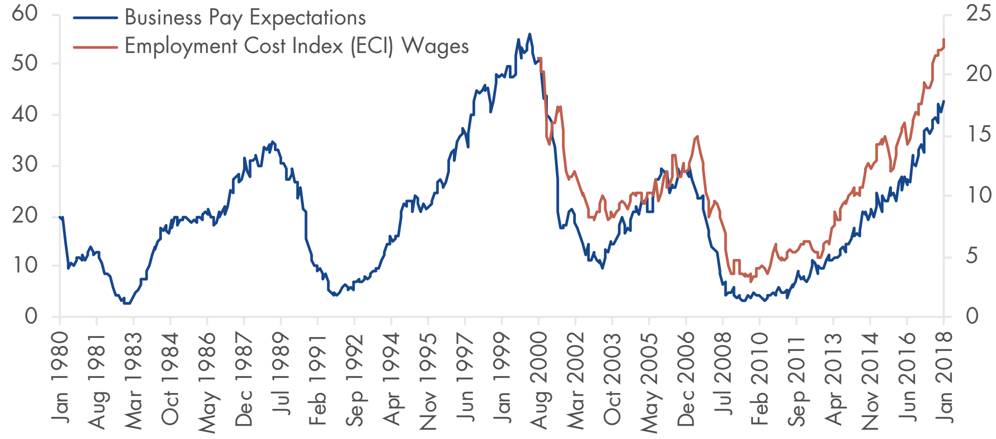
At the same time, increased trade risks are rising rapidly. The next round of US sanctions on China could include large amounts of consumer goods and China's retaliation may include restricting exchange rate and corporate and capital access.

This would, in turn, directly impact inflation as well as disrupt global supply chains. Up until now, excessive focus on the US versus China national scorecards has distracted from the corporate impact or globally disrupted supply chains. This would lead to lower output at higher prices and lower profit margins.

The Fed's round-up of corporate feedback, the Beige Book, has seen mention of 'tariffs' increase from 0 to 41 times between its March and September issues this year. Two thirds of businesses reported either actual or expected cost increases due to tariffs.

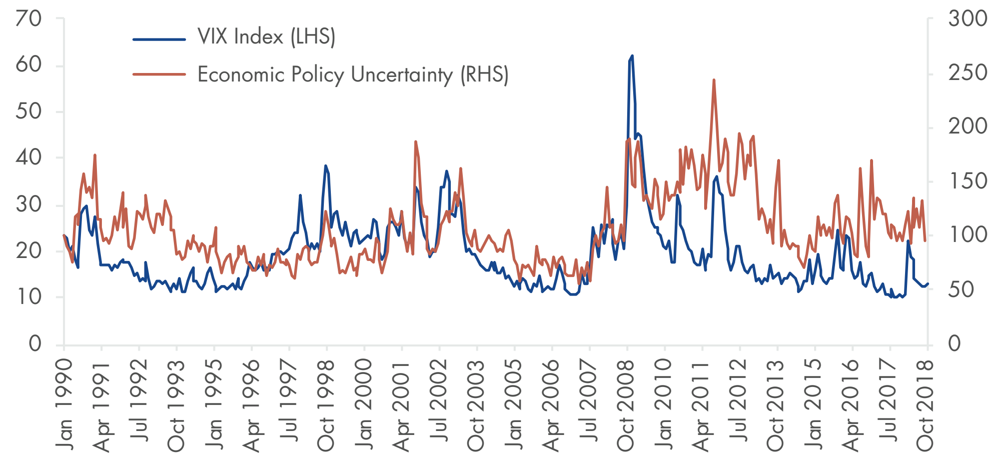
So a win for the US Government would not necessarily imply a win for US globalised corporates.

Exhibit 5: Wages growth and business wages expectations



Source: Minack Advisors

Exhibit 6: Implied volatility versus actual volatility



Source: Bloomberg, Baker, Bloom & Davis, NBER

Widespread trade barriers are going to result in some combination of higher inflation (if corporates pass on costs) or lower earnings (if margins are squeezed). To the extent that costs are passed on and inflation rises, the response from the Fed will be aggressive.

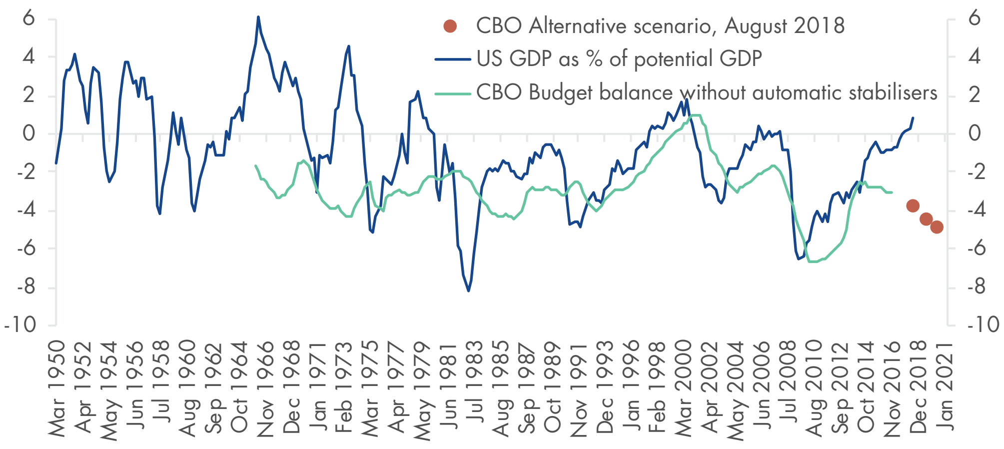
It seems likely too that Japan will be dragged into the trade dispute along with Europe. Canada and Mexico recently signed an agreement with the US.

If all the growth damaging fears come to naught, the US economy has little scope left for above-trend growth. Unemployment is back at its recent cycle lows, although the degree of 'hidden' slack is still an open question. Productivity and labour force growth is subdued so faster than potential growth may provoke higher costs.

Coupled with a pro-cyclical fiscal boost continuing into 2019, before dropping away in 2020, and the real Fed Funds rate still hovering around zero, there is little room for overheating without provoking an inflation pick-up and a draconian Fed response.

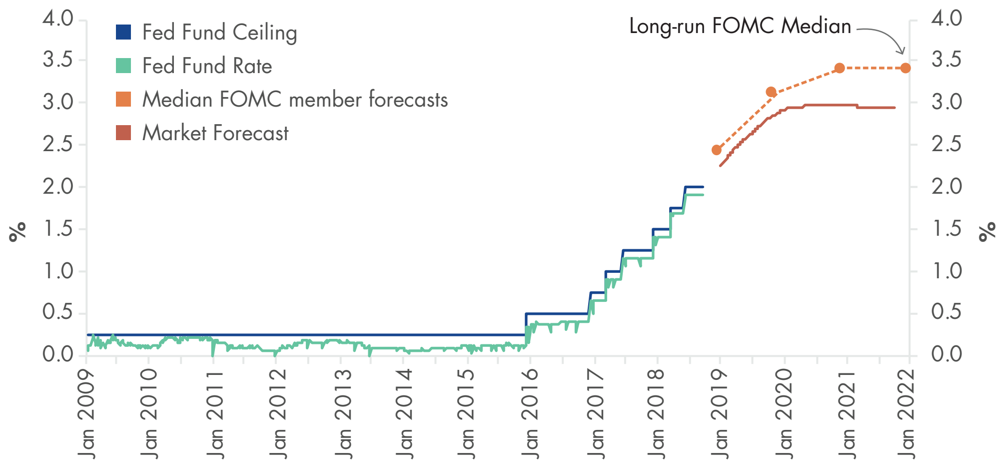
The Federal Open Market Committee's (FOMC) 'dot chart' (members' forecasts of where the Fed funds rate is going) currently has rates heading to near 3% next year and peaking at around 3.5% in 2020. This forecast assumes inflation and growth both hovering around 2% by 2020. Should the economy overheat, rates will be forced higher more quickly.

Exhibit 7: Fiscal vs output gap



Source: BEA, CBA, NBER

Exhibit 8: Fed expectations vs market



Source Bloomberg, Federal Reserve

The Case for Rotation - US versus Europe and Japan

The outperformance of US corporates, in terms of margin and profit growth, has both provoked and justified US equity outperformance.

But, for the reasons outlined above, it's harder to picture stellar US performance going forward. While challenges exist for Europe and Japan, remaining economic slack, improved capital efficiency and competitiveness suggest both economies are due for some catch-up outperformance.

In Europe, peripheral economies have rebuilt competitiveness, while retaining sufficient slack to allow a considerable period of above-potential growth. Of course, political risks remain in Europe. Italian politics are still fraught with a fractious coalition intent on pushing back against European Union strictures even though the Italian banking sector relies on ECB support.

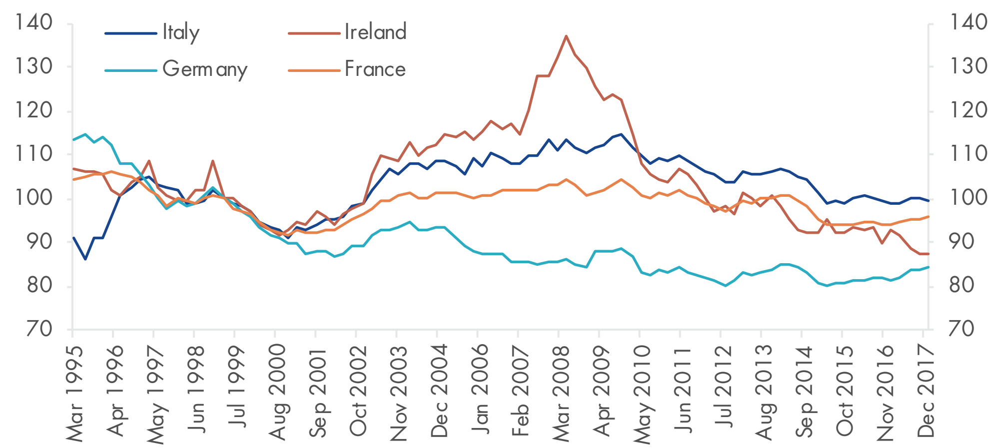
Perversely, the cost of European squabbling may be felt most keenly by the UK. While the EU will try to compromise with members, including Italy, it is likely to pursue a hard-line against the UK in a clear demonstration of carrot-and-stick for countries looking to push against EU discipline.

Japan is likewise in a position to outperform after its 'lost decades'.

Growth has recently surprised on the upside and deflation has given way to, at worst, sideways prices (depending on which price measure you use). Even land prices have turned up. At the same time, real labour compensation has risen, which should add to the sustainability of growth.

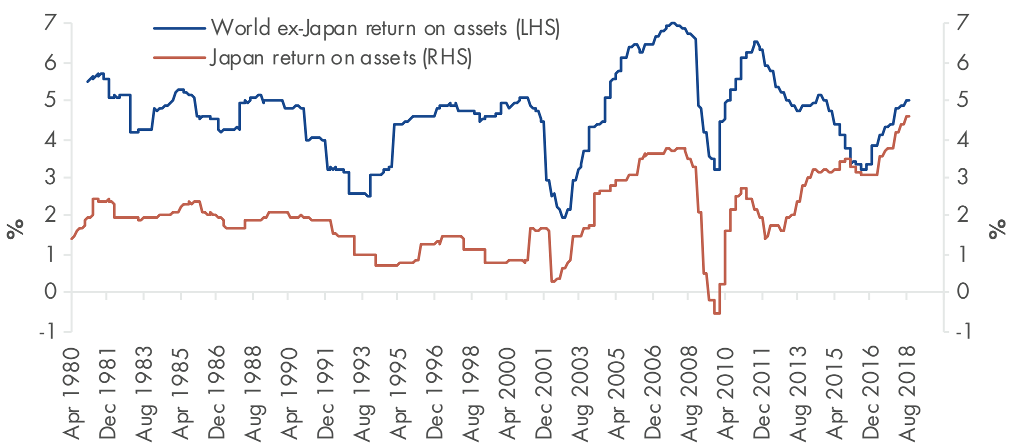
Finally, and most persuasively, return on assets has caught up with the rest of the world.

Exhibit 9: Unit labour costs by country



Source: Eurostat, CEPR

Exhibit 10: Non financial return on assets - Japan vs Rest of the world



Source: DataStream/Worldscope, NBER

Australia - the best of times?

Australia's annual growth rate picked up in the June quarter to 3.4%, the strongest growth for six years as consumers spent strongly and the post-mining boom drag continued to fade.

With inflation heading back towards the RBA's target band and unemployment falling towards acceptable levels, this would normally suggest the RBA would be considering raising interest rates to more 'normal' levels.

However, this scenario is unlikely to play out any time soon.

First, wage pressures, and hence inflation, are not a threat despite the falling unemployment rate. Underemployment remains higher than normal and employees have been emasculated by industrial relations laws. As a result, industrial disputes remain at generational lows.

Second, current growth looks to be 'as good as it gets.'

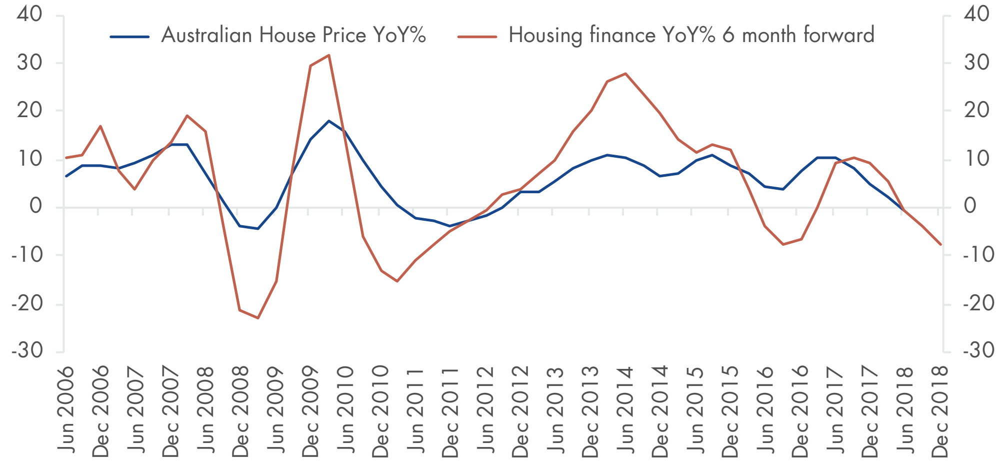
Housing prices continue to retreat. These falls look likely to continue with tighter credit standards unlikely to abate soon and demand falling away.

Employment growth is likely to moderate after a surge in public infrastructure spending and the National Disability Insurance Scheme (NDIS) build-out boosted jobs over the past 18 months.

Consumer spending has been maintained by a plunging savings ratio. With no wage acceleration in sight, and high debt levels, consumer sentiment can be expected to soften. That would slow the pace of consumer spending and moderate overall economic growth.

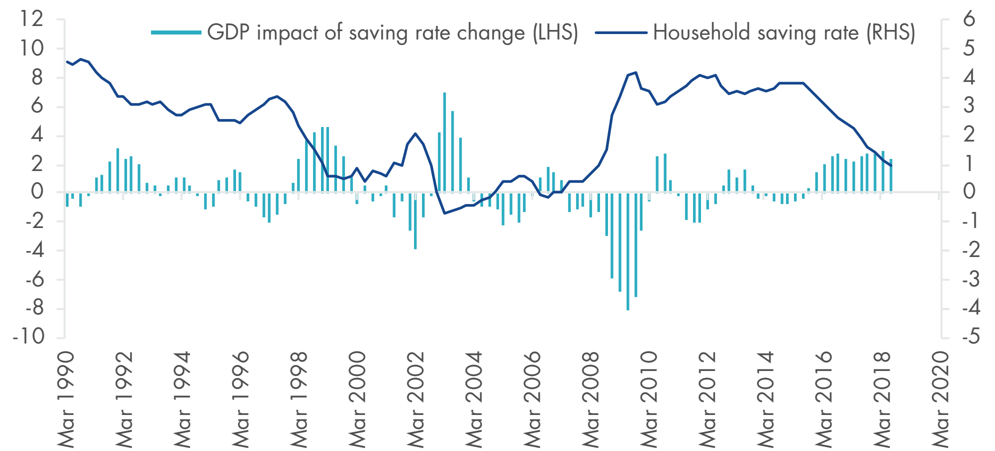
Growth moderation, wages and price stability, and an uncertain global outlook should be enough to keep the RBA on hold for another six to 12 months. Across the Tasman, growth has also surprised on the upside. With this strong growth and policy on the accommodative side, RBNZ Governor Orr's determination to resist hikes may soon be tested.

Exhibit 11: House prices



Source: RP Data

Exhibit 12: Household saving rate versus consumption



Source: ABS, Melbourne Institute

China Outlook

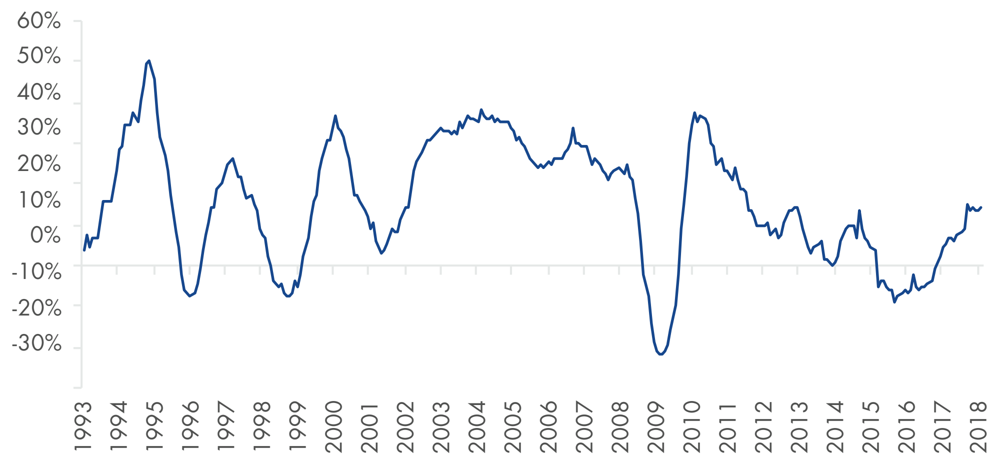
China has passed through a policy inflection point. After a period where the prime policy objective was shaking out excessive unofficial credit growth, the so-called shadow banking sector, and the consequent resource misallocation, China has now passed into a growth supportive phase. The Chinese Government will now be keen to protect industry and employment from the trade war fallout.

This has seen a relaxation of reserve requirements (with early signs of an uptick in credit growth) and a gentle easing of fiscal stance. So far, exports have picked up, though this likely reflects a rush to beat tariffs. As exports slow, expect more fiscal response.

Do not expect an early capitulation on trade. The Chinese Government views this as a hegemonic clash, driven by US antipathy to China's tech sector ambitions. China fully intends to be a tech sector superpower and has the scale as well as the science and engineering grunt to do so.

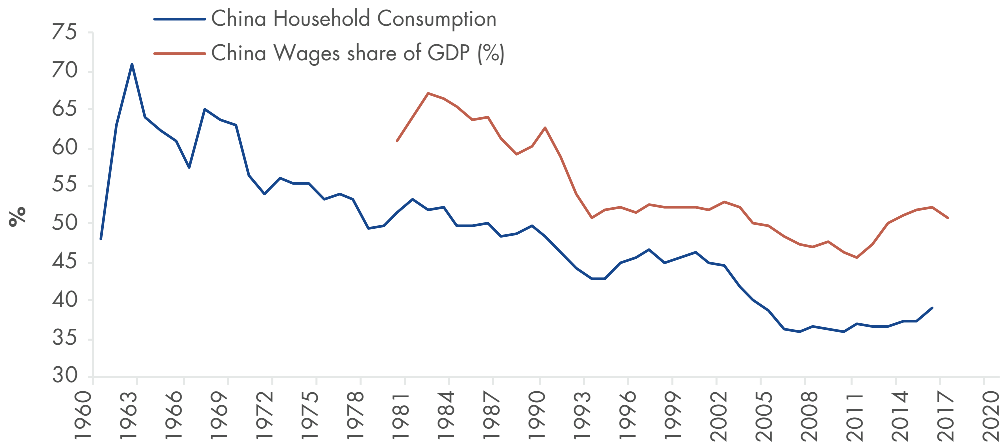
Current relative market pricing seems to reflect a view that the US can skate through the trade war unscathed while Chinese growth and companies get battered. This seems unlikely. China looks to be in a good position to generate domestic demand either through fiscal support or through solid household income growth.

Exhibit 13: Exports YoY (%)



Source: Federal Reserve Economic Data

Exhibit 14: Income vs consumption



Source: Bloomberg

Emerging Markets - Crisis or no Crisis?

As the US has moved steadily away from emergency rate settings, accompanied by a Chinese credit squeeze, the environment for emerging market (EM) economies has become more challenging.

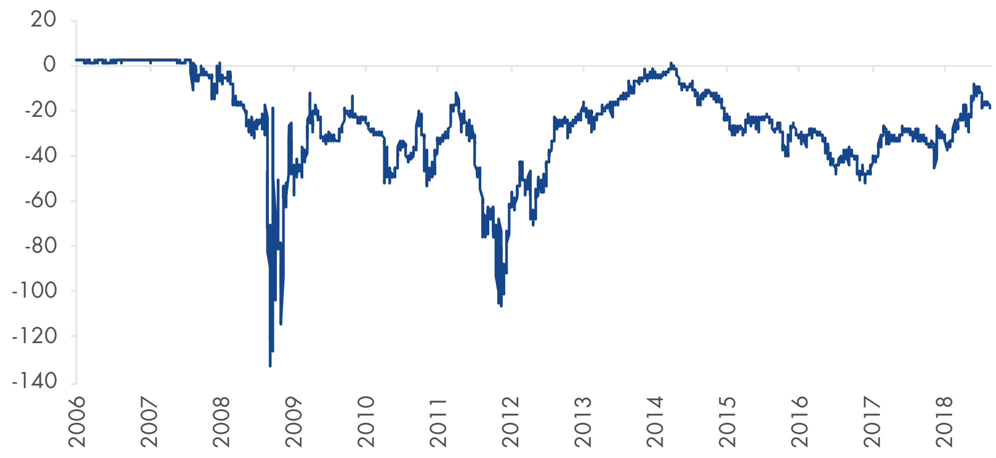
While the steady rise of US rates looks set to continue, the Chinese credit contraction already appears to be abating. Second, unlike earlier EM crises, there hasn't been across-the-board contagion. There is no sign of a US dollar drought, indeed dollar liquidity was tighter at the end of last year and earlier this year when tax reform repatriation flows were running strongly.

Most EM economies currently have reasonable macro settings:

- acceptable trade and fiscal deficits,
- manageable debt levels; and
- diversified funding sources and debt maturities.

The economies that have been hit hard have failed on these tests and, in cases like Turkey, have added idiosyncratic domestic and international policy risks. But of course, a world trade and growth collapse would see a broad hit to EMs.

Exhibit 15: US cross currency swap



Source: Bloomberg

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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