

Investment Perspectives: Issue 50

Further Stimulus Changes Outlook

The unconventional policies adopted by central banks over the last decade have flooded the global economy with liquidity. The success of this approach can be measured by the avoidance of deflation, the strengthening of employment conditions and incomes, and the maintenance of positive global growth, albeit at declining trend rates. Over the last 12 months the market has struggled with the intention of the US Fed to tighten USD liquidity by reversing its asset purchases. This has been reflected in a flat performance from the MSCI World equity index (local currency) for the 12 months to September. So the recent decision by the Fed and the ECB to re-start bond purchases, along with further rate cuts, should be regarded as positive for asset prices. While we remain cautious due to the extended nature of the current economic expansion and elevated valuations of some asset classes, we have reduced our underweight exposure to growth assets. We take profit on our overweight exposures to listed property and domestic bonds, and rotate the proceeds into Australian and global equities.

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Unintended consequences — global reach for yield

The unconventional but sustained policy of monetary stimulus has resulted in a global reach for yield. This has been demonstrated by the collapse and convergence in global debt curves, soaring PE's in higher yielding equity sectors, tight credit spreads between sub-investment grade and government bonds, and higher real estate prices. The structure of the global economy has changed and this is now reflected in the valuation of many asset classes.

The decision by the ECB and Fed to re-start asset purchases seems likely to cap any upside in long-term interest rates. Assets that have benefited from the collapse in interest rates should continue to do so, but the risks of lower future returns have increased.

Economic headlines dominating sentiment

Economic headlines continue to print negatively, especially around manufacturing, trade, freight activity and GDP data. While the IMF believes a synchronised slowdown is underway, the outlook for 2020 is less negative.

A key positive for investors is that market positioning has been in a 'defensive crouch' for some time, waiting for an economic contraction. With renewed stimulus from the Fed and ECB, and a relatively good chance of an acceptable 'Phase 1' trade agreement between the US and China, the market may get caught short by some rare good news.

This supports our decision to reduce our underweight exposure to growth assets.

Investment View — tactical asset allocation

Cash	Underweight
Fixed Income	Reduce overweight
Property	Reduce to underweight
New Zealand Equities	Neutral
Australian Equities	Increase to overweight
Global Equities	Reduce underweight

Macro Backdrop

Economic headlines reflect past or current conditions

The widespread doom and gloom that has been perpetuated by deteriorating economic headlines has been accentuated by a more volatile geopolitical environment. But, with markets being relatively efficient, the bad news that we keep reading about relates to current or past economic activity and is probably already priced into equity markets.

The World Bank and IMF have recently reinforced the negative messaging from the global economy. Of note is the downturn in manufacturing with global trade more or less at a standstill. Activity measures such as freight indices and the US Beige Book have also pointed to further weakness ahead. Despite the decline in earnings over the past few quarters, the key contributor to underlying activity — the global consumer — remains in relatively good shape.

With monetary and liquidity indicators about to expand again, and the possibility of an agreement between the US and China for a halt, or partial reversal, of their tariff war, the outlook for 2020 could be more positive than many currently think.

Reasons for less pessimism

While economic indicators are useful for telling you how the economy has been performing, they do not provide much value in telling you where the economy is going. Financial market liquidity, investor positioning and valuations are more important.

Some important financial signals tell us a recession is not imminent. These include:

- The spread between sub-investment grade credit and government debt remains relatively tight. Credit remains accessible for most borrowers and debt servicing costs are low. Tight spreads indicate very little stress across most sectors in the economy.
- Real borrowing costs are close to zero for many businesses and individuals. Consumption has held up and should continue to do so. The wealth effect of higher asset prices is underpinning the spending habits of many households. Capital investment may also increase if a positive return is expected, with the lower cost of funding setting a low hurdle rate.
- The Fed and the ECB have stopped shrinking their balance sheets and have indicated a re-start to asset purchases. The expansion of the central bank balances sheets, even at the margin, will have a positive impact on the markets.
- Interest rates and oil prices remain subdued. In the past, either one or both of these indicators have been rising sharply prior to a recession.
- Consumer and housing sectors remain strong in the US, generating economic upside surprises. US shoppers are charging ever-higher sums to their credit cards, while loan delinquencies remain close to historic lows. A stronger housing market (in the US and Australia) should result in a further boost to consumer activity due to the positive wealth effect.
- Consensus market positioning is overweight money market assets and bonds, and underweight equities. Over the past 12 months, equity and commodity inflows have declined by around -3.0% combined.
- China's 'goes it alone' policy is targeting increased domestic infrastructure investment, financed by special purpose bonds. Local governments have been given approval to front-load the costs of the infrastructure bonds to expedite new capital investment. While this is unlikely to reflate the global economy, it may help the slowdown in global growth to bottom out.
- The market does not appear to be positioned for any positive news around the trade war between the US and China, or Brexit. A 'Phase 1' trade agreement and détente in the tariff war could see a rebound in global manufacturing, and more importantly, overall sentiment.

Australian economy looking more stable

The Australian economy has been suffering from weak consumer and business sentiment, despite on-going record terms-of-trade that has boosted the national income.

The household sector has responded negatively to falling house prices and weak income

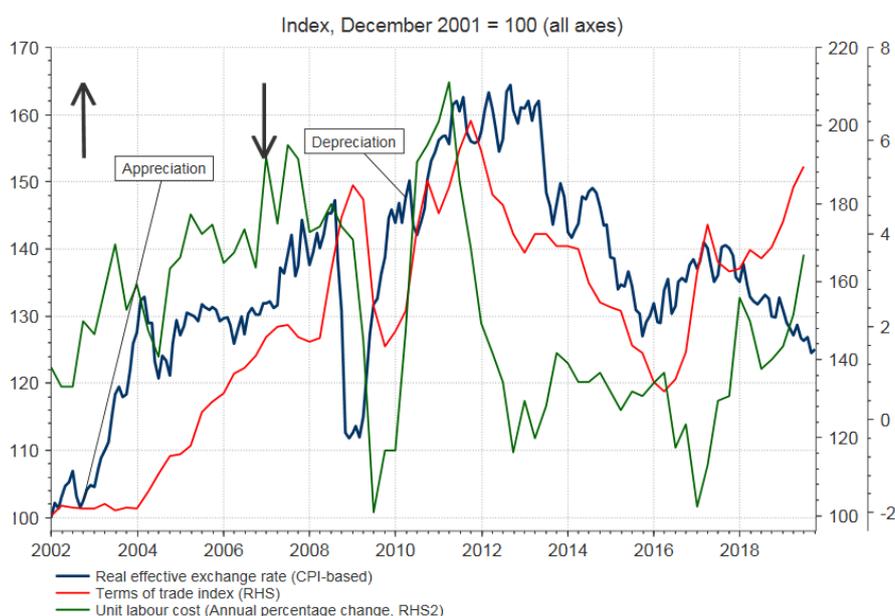
growth. The business sector has also kept spending and investment in check while the global uncertainty increased. Structurally, the industrial and resources sector are in good positions, with strong balance sheets and opportunities to attract inbound capital for investment. The financial sector remains under a regulatory cloud but earnings growth is still solid. Net inward migration remains high which is boosting underlying activity and demand for housing.

The slowdown in the housing sector looks to have bottomed, with rents starting to increase and a forecast shortfall in housing by mid-next year. As prices become more stable, and start to lift, the positive wealth effect should provide an upside tilt to domestic demand.

The government's accounts are now in surplus, after 11 years of deficits, boosted by the strong terms of trade. While increased fiscal spending is being called for, the current government appears reluctant to 'spend the kitty', unless a major downturn eventuates. This appears unlikely in the short term.

The AUD is in a tug of war between the historically high terms of trade, and historically low interest rates — so is probably around fair value. The key variable is what happens to the USD, and how successful China is in reflating its own domestic demand. The risks seem tilted to the upside for the AUD from current levels.

Figure 1. Australia real exchange rate and terms of trade



Source: Forsyth Barr analysis, Thomson Reuters DataStream

Tactical Asset Allocation

Cash and fixed income

With the ECB and Fed expanding their monetary bases again, cutting rates and buying assets, the upside in interest rates is negligible. By recommending monetary stimulus at this stage of the cycle, it is likely to be many years before the market will accept higher rates. **Stay underweight cash offset by a long bond exposure.** Get used to 10-year bonds fluctuating around 1.0% or lower in most developed markets for the foreseeable future. The overweight domestic bond exposure also provides the portfolio diversification protection should the reflation policies fail to deliver as expected.

Australian equities

China is looking to stimulate its domestic market via targeted infrastructure investment, and a bottoming in the Australian housing market looks to be underway. If so, the Aussie householder may start to feel more optimistic. While a capex strike is also holding back Australian industrial growth, and the current drought is expected to subtract -0.25% from GDP, a more optimistic Australian consumer and increasing demand from China could supplement the already record Australian terms of trade, lifting overall aggregate

demand. Australian net equity yields are comparable to New Zealand's (gross imputations), but the outlook is more stable based on a settled political environment and effected tax cuts already flowing through the economy. **We are lifting exposure to Australian equities (to overweight), to capitalise on a probable lift in cyclical stocks due to the impact of low bond yields, increasing domestic demand, and a possible lift in demand for commodities.**

New Zealand listed property

New Zealand listed property returned +35% over the 12 months to September. This extraordinary return was predominantly driven by cap rate compression and multiple expansion. While rental increases and quality assets have boosted revaluations, this sector is now trading at a premium to the broader market, which is also arguably expensive relative to other global markets. While we increased exposure to property slightly in August 2019, the sector has since appreciated sharply. **We are now taking profits on the interest rate driven returns over the past year or so. We reduce exposure to underweight.**

New Zealand equities

New Zealand equities are expensive relative to global equities. But in a market where bond yields are ~1% and investors still require income, the dividend yield for many of New Zealand's largest companies (with imputation) remains compelling, particularly for domestic investors with a home market bias. 12-month gross dividend yields in excess of 6.0%, for relatively stable companies, contribute to demand and current valuations. While we wouldn't rule out a correction in any overvalued market, the changing structure of the global economy plus the additional monetary stimulus provided by the major central banks suggest high yielding markets will continue to find support. **We retain a neutral exposure to New Zealand equities.**

Global equities

As the world shifts between globalisation and regionalisation, the macro environment becomes more volatile. However, a more accommodating Fed should underpin a liquidity driven surge in sentiment and activity, particularly if accompanied by a signed trade agreement, however narrow, between the US and China. Because of the defensive nature of global investors, **we are taking a more contrarian view and slightly increasing exposure to international equities.** We remain underweight overall, but are less pessimistic than following the previous review.

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