Investment Pulse

Wealth Management Research

Global bonds yields rose after Janet Yellen indicated US rate rises are likely in the coming months

Summer holidays in the US, Europe and UK have made for quiet markets, with implied volatility falling to multi-year lows. Monetary policy easing from the Bank of Japan, Reserve Bank of Australia and Bank of England helped to calm tensions during August. US Federal Reserve members have guided markets to expect higher interest sooner rather than later as the US labour market continues to improve. The chart opposite shows US wage growth is accelerating, providing a positive backdrop for the consumer-led economy but also a leading indicator for inflation. Our US economist expects interest rate hikes to proceed at a gradual pace that will be supportive for risk assets. Our base case for the next rate hike remains December 2016, with the Federal Funds rate increasing by 50 basis points per year until the Federal Funds rate reaches two percent in 2019.

The intractability of Japan's economic malaise suggests it is stuck in a liquidity trap, where measures to increase the supply of funds to the banking system fail to produce the anticipated decline in interest rates. In a world of low inflation and low interest rates, real interest rates are not able to fall far enough to stimulate demand. The Japanese yen has rallied beyond our expectations and now presents a headwind for the fight against deflation. We expect the Bank of Japan (BoJ) to move further into negative interest rate territory, shifting from -0.1% to -0.2% in September and to -0.5% in December. While we do not expect further increases to the BoJ's monthly bond purchases, we estimate 85% of Japan's Government bonds will be owned by public institutions by 2020.

Economic growth in Australia remains resilient, particularly relative to global developed economies, but inflation is well below the Reserve Bank of Australia's (RBA) inflation target of 2% to 3%. This disconnect can be traced back to labour market trends which exhibit underemployment and historically low wage growth. Rekindling inflation in this environment will take time, particularly with the resurgent Australian dollar providing an unwelcome headwind. This combination of factors underpins our expectation of further RBA easing. With the economy in an income recession, the only question is that of timing. We expect the RBA will be on hold through the rest of 2016. The recent capital expenditure survey supports this view and we think the RBA will want to give some time for recent interest rate cuts to flow through the economy. We expect deteriorating inflation will ultimately see the RBA next cut the official cash rate in February 2017.

1. Macquarie Wealth Management recommended asset allocation

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Australian Equities		X			
International Equities				X	
Property			X		
Fixed Interest		X			
Alternatives			X		
Cash				X	

Source: MWM Research, September 2016

2. US wage growth: production & nonsupervisory workers

Source: MWM Research, Macquarie Securities, September 2016

Market performance August 2016

Australian equities

The Australian market was unable to hold July's high, with the S&P/ASX 200 Accumulation Index returning -1.6% in August. Over the course of the month, both the S&P/ASX 100 Accumulation Index and the S&P/ASX Small Ordinaries Accumulation Index lost 1.56%. The S&P/ASX Small Industrials outperformed the S&P/ASX Small Resources significantly, with the indices returning -0.8% and -6.4% respectively.

The Information Technology sector bucked the trend, returning 5.1% which was the strongest sector performance in the market. The best performing companies were Altium Limited (ALU, +26.1%) and Isentia Group (ISD, +21.3%). The worst performing sector was Telecoms (-6.6%), significantly impacted by Telstra (TLS, -6.2%) and Vocus Communications (VOC, -13.9%).

International equities

After a post-Brexit rebound in July, the performance of international equities in August was more subdued as markets waited on the outcome of the annual Economic Symposium in Jackson Hole, Wyoming. While volatility was slightly elevated on levels earlier in the month, it remains low by historical standards.

Both the S&P 500 Index (-0.1%) and Dow Jones (-0.2%) finished lower at 2,171 and 18,401 respectively. The Nasdaq on the other hand added 1.0% for the month.

The overall performance of European markets was broadly positive. The German DAX Index returned 2.5%, followed by Spain (IBEX 35 Index, +1.5%), UK (FTSE, +0.85%), and Italy (MIB 30 Index, +0.6%). However, France's CAC 40 Index finished August broadly unchanged.

Asian stock markets were amongst the strongest performers globally. Hong Kong's Hang Seng added 5.0%, followed by China's Shanghai Composite Index, which closed 3.6% higher for the month. Japan's Nikkei 225 Index also rallied, returning 1.9%.

Property

Australian REITS lost 2.8% in August, unable to hold onto strong returns from the previous month. That said, the S&P/ASX 200 A-REITs Accumulation Index has added 19.2% year-to-date. Mirvac Group (MGR) returned 5.5%, supported by a result which eased settlement concerns. Bunnings Warehouse Property Trust (BWP, -15.1%) suffered after Wesfarmers announced Bunnings will vacate up to seven of its existing warehouse premises owned by BWP.

Fixed interest and cash

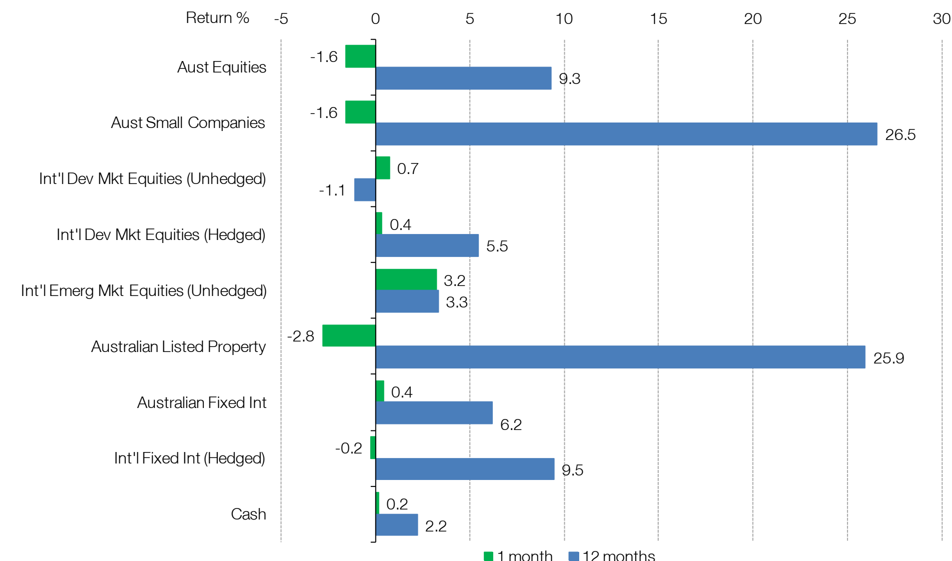
Australian fixed income continued to trade strongly with the benchmark 10-year government bond yield declining 2.6% to finish the month at 1.83%. However, the US 10-year yield increased 8.9% to end the month at 1.58% as Federal Reserve members provided firm forward guidance on the direction of US interest rates.

The Bloomberg Composite Bond Index added 0.4% for the month, with Corporate bonds and Government bonds returning 0.7% and 0.3% respectively. In terms of the maturity structure, short-term bonds (0-3 years) and long-term bonds (10+ years) returned 0.3% and 0.4% respectively.

Currency

The likely downward trajectory of Australian interest rates started to play out, with the Australian dollar depreciating against most major currencies. The A$/US$ finished August weaker (-1.1%, 0.7517), after touching a recent four-month peak of $0.7702. The local currency was also weaker against the New Zealand Dollar (-1.6%, 1.0367), Euro (-0.9%, 0.6739), and UK Pound (-0.4%, 0.5724). The only exception was the Japanese Yen, where the Australian Dollar appreciated by 0.2% to 77.75.

3. Market performance August 2016



Source: IRESS, Bloomberg and MWM Research, September 2016

Australian equities outlook

Australian equities retraced through August as reporting season delivered mixed results and global bond yields started to increase towards month-end. The S&P/ASX 200 declined 1.6% with telcos and industrials losing 6.6% and 5.2% respectively. The August reporting season was eventful as always. The chart opposite illustrates the percentage change in our FY17 earnings forecasts for a selection of larger companies.

Healthcare was a relative bright spot. Hospital operators Ramsay Healthcare (RHC) and Healthscope (HSO) both delivered solid results as hospital admissions recovered during 2H16. Australian pathology operators Primary Health Care (PRY) and Sonic Healthcare (SHL) reported resilient revenue growth with the sector's outlook also positive due to the expected implementation of collection centre rental reforms. Cochlear (COH) recorded impressive unit growth of +12.4% which helped lift net profit by 30%. CSL Ltd (CSL) was arguably the biggest disappointment with the recently acquired Seqirus flu business reporting revenue 16% below our forecast and management providing FY17 guidance approximately 14% below market expectations.

Miners continued to benefit from aggressive cost-out initiatives and volume growth. While BHP Billiton's (BHP) weak net profit dominated headlines, the underlying result beat our estimate primarily due to improved cost management with the benefits expected to continue into FY17 (see chart opposite). Fortescue Metals (FMG) delivered a solid operational result which supported a dividend that was well ahead of analyst forecasts. FMG's cost performance and expected volume uplift resulted in a 9% increase to our FY17 earnings estimate and we also believe the company is on track to be upgraded to an investment grade credit rating.

Energy was one of the weaker sectors. Santos (STO) reported a first half net loss that was 9% below our expectation due to high one-off costs and a large impairment, which saw the 1H dividend cancelled. Origin Energy (ORG) downgraded its profit guidance and also scrapped its dividend which, when combined with ongoing divestments, will allow the company to manage its significant debt pile ahead of an expected ramp up in cash flows from its Australia Pacific LNG project.

Portfolio positioning

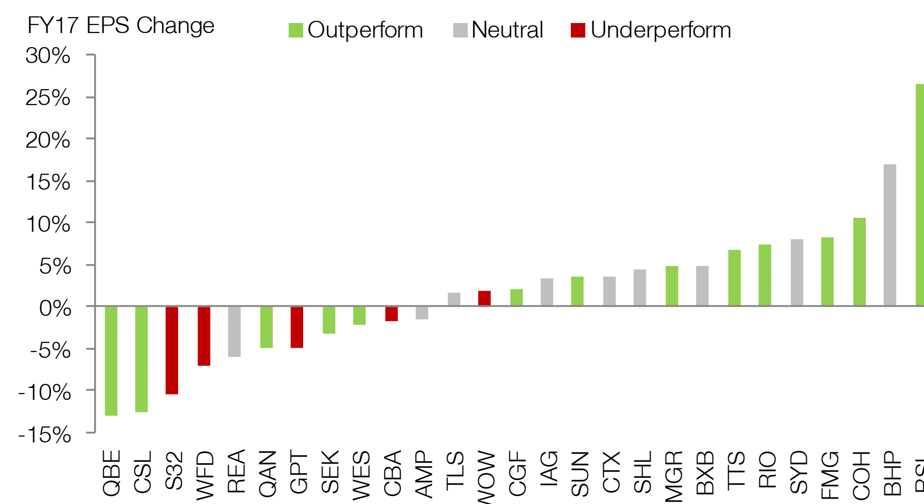
We continue with our underweight to Australian equities. The major banks will be a drag on earnings growth in the year ahead due to soft revenue growth and margin pressure, although valuation support limits downside. Australian equities still look expensive on a 12-month forward price/earnings ratio of 16.7x for the S&P/ASX 200. While earnings estimates have been revised higher, this has primarily been from the volatile resources sector. Our sector positioning is relatively defensive with a preference for earnings certainty and defensible yield. Structural growth stories expected to perform well through the cycle, with little reliance on cyclical dynamics, will trade at significant market premiums given weak support from the broader economy.

4. Macquarie Wealth Management Australian equity sector tilts

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Energy					X
Materials				X	
Industrials				X	
Consumer Disc.	X				
Consumer Staples				X	
Healthcare	X				
Financials ex REITs		X			
Property Trusts			X		
Info Tech	X				
Telecom Services				X	
Utilities				X	

Source: MWM Research, September 2016

5. Reporting season changes to our FY17 earnings forecasts



Source: MWM Research, Macquarie Securities, September 2016

International equities outlook

Global equities were remarkably calm in August, with volatility dropping to multi-year lows as the US, European and UK markets took summer holidays. The annual Economic Symposium at Jackson Hole, Wyoming, saw markets pause for thought as US Fed officials turned hawkish with upcoming meetings now clearly 'in play'.

The US second quarter company reporting season is now complete. Positively, 71% of S&P 500 companies delivered earnings that were above consensus analyst expectations. The chart opposite illustrates how each sector of the S&P 500 performed relative to analyst expectations. Information technology and health care stocks dominated the scorecard with 85% and 84% of companies, respectively, beating consensus earnings estimates in those sectors. Technology businesses with rapidly expanding operations in software, social media, application platforms and cloud-computing services are experiencing rapid revenue and earnings growth. Facebook is benefiting from high demand for mobile ad services while Amazon's profit was driven by growth in cloud services sales. After missing analyst estimates in Q1, Alphabet (formerly Google) also beat consensus expectations in Q2 with strong results in mobile ad sales and cloud revenues.

While over two thirds of S&P 500 companies beat analyst expectations, year-on-year earnings growth remains in negative territory at -3.2%, representing the fifth consecutive quarter of negative annual earnings growth. This is the longest stretch of negative earnings growth since 2009 reflecting the rout in energy companies. This stagnation is true of the S&P 500 regardless of whether energy stocks are included in the calculation.

Third quarter guidance suggests the trend is set to continue with annual earnings growth of -2.1% expected. Energy is expected to be the main drag on the index with -62% earnings growth forecast in the year to September, although this will start to wash through in the year ahead reflecting the oil price recovery.

More positively, seven out of ten sectors are expected to deliver positive annual earnings growth in the third quarter. Technology is one of the few sectors that continues to offer strong returns as secular trends and consumption patterns are able to overcome cyclical and structural forces, particularly in businesses that capitalise on the growth of software and cloud services.

Portfolio positioning

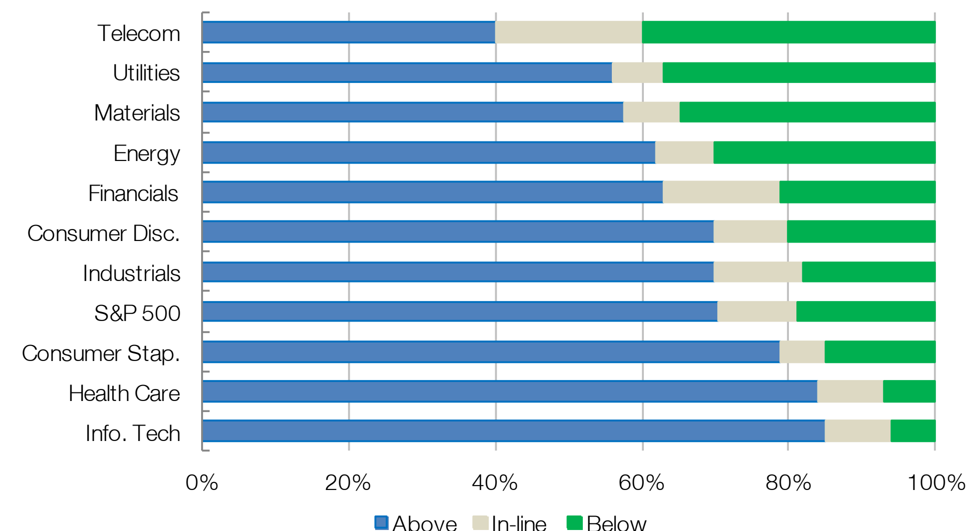
We continue to focus on regions where fundamentals are positive. We have a preference for European equities given monetary policy support and cheaper valuations. US equities offer better earnings momentum but valuations are more demanding. We expect yield sectors to remain in demand although some volatility is to be expected in the coming months. We remain most bearish on emerging market equities.

6. Global Matrix

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Australia		X			
US				X	
Europe				X	
China		X			
Japan			X		
Asia ex Japan / China	X				
Latin America	X				
Commodities - Oil				X	
Commodities - Metals				X	

Source: MWM Research, September 2016

7. S&P 500 - 2Q16 sector earnings relative to consensus



Source: MWM Research, FactSet, September 2016

Property outlook

The office sector was the bright spot in the August reporting season and residential held up well. Industrials were generally weak, while retail conditions are expected to deteriorate from here. Net tangible asset (NTA) growth was 10% year-on-year with the expectation that cap rates continue to fall modestly. Developers including Mirvac (MGR) and LendLease (LLC) as well as fund managers including Goodman Group (GMG) are best placed for earnings growth.

The office sector, particularly Sydney CBD, continues to improve, underpinned by limited supply and robust demand. This is reflected in the net effective rental growth in Sydney office (refer chart 8). Incentives have also fallen from 32% in March 2015 down to 28% in June 2016, which will benefit adjusted funds from operations (AFFO) initially and then underlying EPS growth. Barangaroo has not been a headwind to premium CBD tenant demand as expected. Conversely, Perth and Brisbane remain in negative territory.

The residential cycle in Australia is expected to continue the run for another 12 to 24 months given the extended lower interest rate environment, slowing dwelling approvals and potential net migration in the next few years following the Brexit vote. Both LLC and MGR defied the sceptics, delivering solid results in an environment of tightening credit conditions. The default rate for both groups has remained low at less than 1%, although there has been a three to four week delay in settlements as foreign buyers access alternative sources of funding following the introduction of bank restrictions.

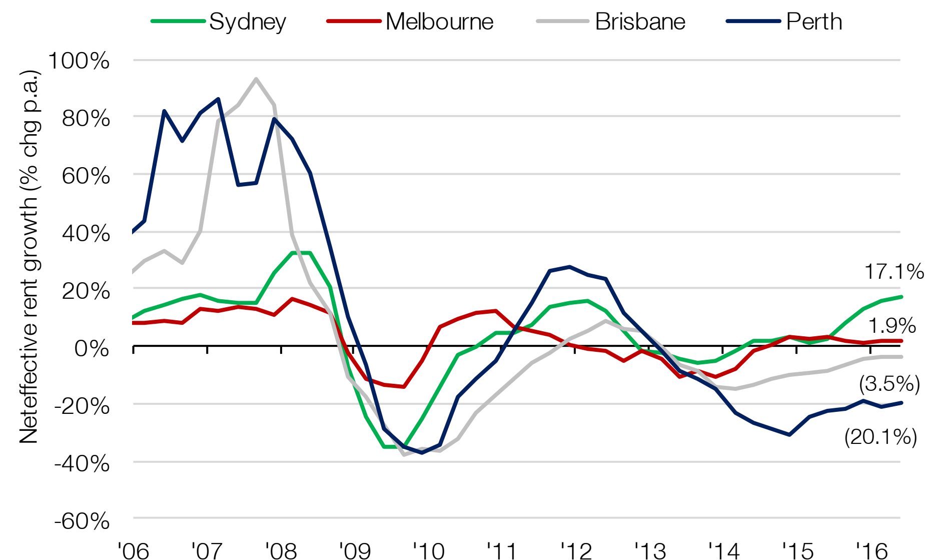
Macquarie Research remains of the view that the longer term outlook for residential remains fundamentally challenged, with a forecast of low single digit growth. The demand side for residential will continue to face headwinds due to stretched affordability (primarily Sydney but also Melbourne), regulatory overhang impacting buyer sentiment and slowing foreign investor segment over the longer term.

As far as retail is concerned, the prospects remain challenging for retailers and consequently landlords as re-leasing spreads are compressed by impacts of a weaker Australian dollar, and margin pressures across various retailer sub-categories.

Portfolio positioning

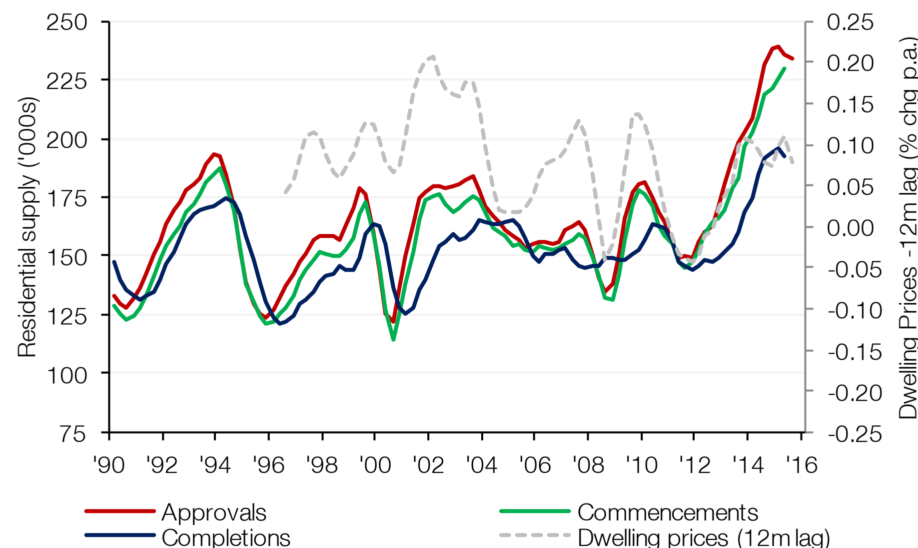
We are neutral on the listed property sector, preferring to be selective in what is an expensive section of the market. REITs are expensive on bottom-up valuations with most trading at significant premiums to net assets. From a macro perspective, global bond yields will continue to drive the sector with the calendar year to date correlation strongly negative at -0.8. Our property analysts downgraded Westfield (WFD), GPT Group (GPT) and Dexus Property Group (DXS) during reporting season and made no recommendation upgrades. As such, the key picks in the sector are Goodman Group (GMG), Mirvac Group (MGR) and LendLease (LLC).

8. Sydney office shows strong rental growth



Source: MWM Research, Macquarie Securities, September 2016

9. Supply response is beginning to soften



Source: MWM Research, Macquarie Securities, September 2016

Fixed interest and cash outlook

The benchmark Australian 10-year bond yield declined 2.6% to finish the month at 1.83%, the fourth consecutive monthly decline. The yield on US 2-year bonds rallied 22% to close out the month at 0.8% as investors priced in upside to US interest rates following explicit forward guidance from senior Fed officials.

Global sovereign yields ticked up during August as investors increasingly priced in the risk that the Bank of Japan (BoJ) has reached the limits of monetary policy. While aggressive bond market intervention has been standard practice for the BoJ in recent years, it will eventually come to an end.

Our global economics team forecasts the ECB and BoJ to begin tapering their bond purchases in the coming years. Recent employment data in Europe has been positive (+1.5% year on year), suggesting Europe will follow the US in an employment led recovery. However, we expect Europe will take longer to exit its stimulus programme than the US given its sluggish economic growth. By 2018, we expect the ECB to start reducing its bond purchases, and expect purchases to cease altogether by 2020. Our expectation for stimulus withdrawal supports our view for a mild strengthening in the Euro currency against the US dollar from 2018 to 2020.

We expect Japan to maintain bond purchases for a much longer period, potentially decades. Interestingly, the BoJ is effectively the only buyer of Japanese Government Bonds (JGBs) in the current market. We expect ongoing monthly bond purchases will lift the BoJ's ownership of JGBs to 51% by 2020, or 83% for the broader public sector. While the BoJ is likely to start tapering its bond buying programme in 2018, we do not see an end to bond purchases in the next decade. Specifically, the current annual bond purchases of ¥80tn in JGBs is likely to be reduced from 2018 but is unlikely to fall below ¥30tn per annum in the next ten years.

Portfolio positioning

Domestic fixed interest will continue to benefit from the downward trajectory of RBA monetary policy with short yields to remain suppressed in this environment. While the long end of the domestic yield curve will continue to be highly correlated with global yields, we see scope for the 10-year premium to US bonds to further compress given the increasingly divergent outlook for monetary policy and inflation.

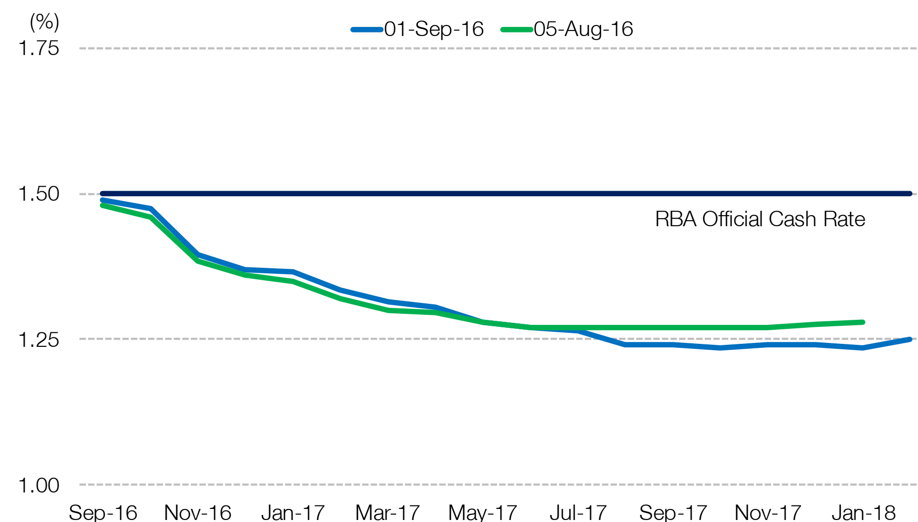
Our preference is to Australian treasuries for the relatively high yield on offer and upside from further RBA cash rate cuts. Overall, we prefer cash as a store of value than a broad exposure to fixed interest, particularly with competition for deposits increasing as the banks adjust to new capital requirements.

10. Fixed interest – tactical asset allocation active weights

	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Australian Treasury				X	
Australian Credit		X			
Global Treasury			X		
Global Credit		X			
High Yield			X		
Emerging Markets		X			

Source: MWM Research, September 2016

11. ASX 30-Day Interbank Cash Rate Futures Implied Yield Curve



Source: ASX, MWM Research, September 2016

31-August-16	1 month %	3 month %	1 year %	3 year %pa	5 year %pa
Australian Shares					
S&P/ASX 200 Accumulation	-1.55	2.07	9.30	6.59	9.68
S&P/ASX 200	-2.33	1.01	4.34	1.90	4.81
All Industrials Accumulation	-1.90	0.95	10.33	9.71	15.29
All Resources Accumulation	0.58	9.30	3.35	-7.06	-7.82
All Industrials	-2.75	-0.22	5.15	4.71	9.74
All Resources	0.23	8.92	-0.19	-10.40	-10.75
S&P/ASX 20 Accumulation	-2.00	-0.16	1.37	3.07	8.68
S&P/ASX 50 Accumulation	-1.79	1.16	5.70	5.14	9.66
S&P/ASX 100 Accumulation	-1.56	1.80	8.15	6.49	10.07
International Shares					
MSCI World Index Hedged in AUD	0.35	3.04	5.46	9.18	11.87
MSCI World Index (AUD Unhedged)	0.74	-1.24	-1.08	11.39	15.12
MSCI Emerging Markets (AUD Unhedged)	3.21	6.46	3.32	4.41	4.26
Regional Markets (local currency returns):					
Dow Jones	-0.17	3.45	11.33	7.50	9.64
S&P 500	-0.12	3.53	10.08	9.96	12.24
Toronto Comp	0.10	3.78	5.33	4.88	2.71
Nikkei	1.92	-2.02	-10.60	8.05	13.53
Dax	2.47	3.22	3.25	9.34	12.86
FTSE 100	0.85	8.84	8.54	1.88	4.68
Hang Seng	4.96	10.39	6.03	1.88	2.27
NZSE 50	0.66	4.74	25.44	12.61	12.13
Property					
S&P/ASX 200 Property Trust	-2.78	6.12	25.92	19.85	19.55
Cash and Bonds					
Bloomberg Composite Bond All Maturities	0.42	2.50	6.19	6.46	6.21
Citigroup World Govt Bond Index Hedged	-0.23	2.64	9.45	8.03	7.38
Citigroup World Govt Bond Index	0.25	-0.39	3.60	8.18	7.60
Bloomberg Bank Bill Index	0.17	0.51	2.22	2.46	2.99

	31-Aug-2016	31-Aug-2015	1 month %	3 month %	1 year %
Exchange Rates: AUD vs.					
USD	0.752	0.711	-1.10	3.94	5.68
NZD	1.037	1.122	-1.63	-3.03	-7.61
EUR	0.674	0.635	-0.88	3.72	6.21
GBP	0.572	0.464	-0.41	14.61	23.46
JPY	77.75	86.25	0.22	-2.91	-9.86
TWI	63.20	60.90	-0.16	2.43	3.78
Commodities					
Oil WTI (USD/bbl)	44.8	48.0	8.16	-8.27	-6.67
Gold (USD/oz)	1,309	1,135	-3.11	7.72	15.33
Copper LME (USD/tn)	4,603	5,095	-5.16	-2.07	-9.67
Zinc LME (USD/tn)	2,328	1,793	3.77	20.97	29.81
Aluminium LME (USD/tn)	1,601	1,550	-0.93	3.42	3.32

Interest Rates	Australia	US	Japan	German	UK
Cash (current)	1.50	0.25-	-0.10	0.00	0.50
90 Day Bank Bills	1.74	0.33	-0.28	-0.72	0.37
10 Year Government Bonds	1.82	1.58	-0.07	-0.07	0.54

Sources: MWM Research, Macquarie Research, IRESS, Bloomberg, September 2016

Investment Pulse September 2016 was finalised 2 September 2016.

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