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ECONOMIC UPDATE

Economic outlook is anything but 20-20

The past year was characterised by a global slowdown precipitated by increasing geopolitical uncertainty and heightened trade frictions. Central banks responded with coordinated monetary easing that buoyed equity markets despite the softening economic fundamentals, however, with monetary policy already nearing its limits, the efficacy of further cuts has been questioned with many central banks calling for fiscal policy-makers to open the taps and support growth. Fiscal stimulus will likely not be forthcoming and the outlook for 2020 continues to be soft with risks appearing tilted to the downside.

Global: A turning point seems optimistic

It has been a turbulent 2019 for global markets amidst what has been a relatively uninspiring global economic environment. Despite the uncertainty, several key global equity markets are heading into the final month of the year at or near fresh record highs – including Australia, the US and Europe. This performance comes just a few months after bond markets rallied and priced in peak levels of pessimism. Overall, investor sentiment has declined materially over the course of 2019. Reading these dynamics together it feels like the year can be adequately described as one in which there was plenty to be concerned about, but investors do not want to miss out on any market rally, and they are confident central banks will keep the stimulus coming.

Looking at global equities, it has been a year of two halves. After a material sell-off in late 2018, global equity markets staged a strong and synchronised rebound in the early part of 2019. This dynamic has flattered returns on an annual basis, but many of the gains up to mid-year merely represent

GRAPH 01 KEY DEVELOPED MARKETS EQUITY PERFORMANCE

Equity markets were choppy in late 2019 but finished strong



Sources: IFM Investors, Macrobond

» a recovery of lost ground for most advanced economy equity markets. The rise in the US S&P 500 from January to May 2019 was 17.5%, reversing the 14.3% decline from September 2018 to January 2019. Similarly, the Australian S&P/ASX 200 fell 12.5% in over the same period in 2018, only to rise 17.5% in the same time frame in early 2019. Performance over the remainder of 2019 has been much more measured, with the S&P500 up a solid 5.0% and the ASX200 rising 5.2% at the time of writing. Both markets have been characterised by more volatility.

The drivers of these moves were clear. In the first half of the year, markets were buoyed by the monetary policy pivot that several central banks made at the end of 2018. This led to the scenario whereby 'all boats rose on the incoming policy tide'. A shift that outweighed geopolitical concerns on US-China trade tensions, albeit only temporarily. However, these concerns gathered momentum as tit-for-tat tariffs on each country's exports progressively became more aggressive over the course of the year. The impact of these tensions was observable in the economic data flow, not only in global trade volumes but also in investment as businesses grew increasingly uncertain. News flow on US-Chinese negotiations drove markets, meaning the latter part of the 2019 year was punctuated by bouts of higher volatility. A more positive tone coming out of negotiations – at least on a 'Phase One' deal that would prevent the ratcheting up of further tariffs and perhaps wind existing ones back – saw a risk-on move late in the year. With these tensions having been diminished, it left markets only with additional monetary stimulus in place and a rally ensued. But this proved short-lived, as sentiment turned again. Our concern is that markets are seemingly being driven less by any real improvement of the growth outlook, but by the removal of perceived downside risks. Consequently, we assert that these stimulus-driven market gains are likely unsustainable without being backed by an improvement in underlying fundamentals.

Downside risks to the global economy are still evident for some investors, and this is being reflected in the bond market where a more circumspect narrative and further stimulus from central banks was quickly priced in. US 10-year bond yields tumbled in a relatively uniform fashion



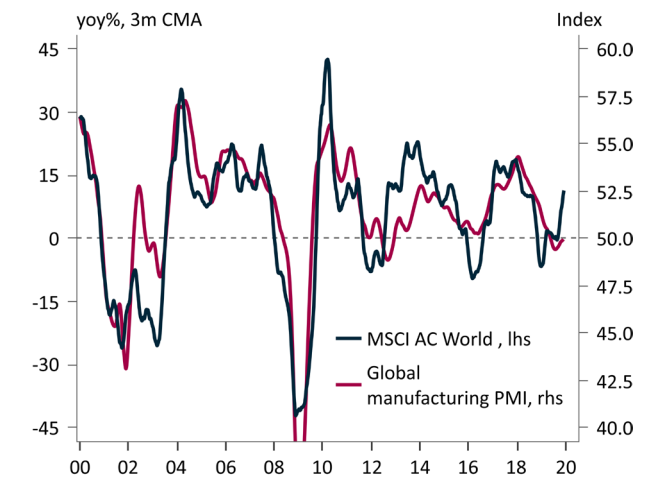
Stimulus-driven market gains are likely unsustainable without an improvement in underlying fundamentals.

¹ As reported by CentralBankNews.info

from a 3.23% peak in November 2018 to a low in September 2019 of 1.45% (the lowest since July 2016). Yields have risen choppily since then – driven by the risk-on and risk-off moves that have pervaded equity markets – but still look more than likely to end the year well short of 2.0% (which still makes the US bond market 'high yield' compared to many other advanced economies). Other major debt markets mimicked the US 10-Year Treasury bonds move, with German and Japanese yields negative for much of 2019. In late August, when yields were at their lowest, around US\$17 trillion or 30% of the outstanding global bond supply had negative yields; a measure of just how risk averse some investors had become.

GRAPH 02 GLOBAL EQUITY AND MANUFACTURING

Equity market optimism precedes economic recovery



Sources: IFM Investors, IHS Markit, MSCI, Macrobond

Our view of the global economy as it enters 2020 is one of cautious optimism more characteristic of bond markets than equities markets. The latter seems to reflect a buoyancy stemming from two key factors. The first and most recent is that some of the positive tone from US-China trade talks will translate into materially better growth outcomes. The second is a faith that pre-emptive monetary policy action has removed downside risks to global economies and may prompt another growth and reflationary episode. This comes as, by Q3 2019, 60 central banks had cut policy rates 113 times by a cumulative 47.2ppts, offsetting the tightening that had characterised 2018 and collectively amounted to 43.4ppts.¹

Monetary policy stimulus is expected to see real economic growth accelerate in 2020 to 3.4%, compared to the expected 3.0% in 2019, according to the International Monetary Fund's (IMF) forecasts. The dynamic driving this is less an advanced economy recovery and more an emerging economy one, despite the significant policy easing in the former. This comes as the larger emerging economies, of Turkey, Argentina and Brazil, stage domestic rebounds. Growth in the Indian economy has strengthened as well and China's solid growth rate has slowed only modestly.

» Global trade tensions are key to this outlook, with no further deterioration being expected by economists rather than any material improvement.

Our view is that it will likely be some time before advanced economies benefit from the de-escalation of uncertainty with regard to trade tensions if it indeed occurs. And this will need to be a material and sustained improvement to prompt better trade conditions and investment. We believe the US-China trade tensions are just one symptom of broader concerns around intellectual property protection and market access that will extend well beyond the current situation. Furthermore, the US-China situation may well be replicated on a bi-lateral basis between the US and some other of its major trading partners so the potential for a protracted phase of weak global trade seems to be the risk. The OECD's forecast echoes this sentiment, with its expectation of global real GDP growth for 2019 sitting at 2.9% in 2019 and no improvement in 2020. It highlights not only the downside risks to US-China trade talks but the broadening of tensions globally, as well as the increase in corporate leverage in the US and a more material slowdown in China. The disruptive impacts of climate change, demographics and technological disruption are other medium-term factors that will further weigh on growth.

What is clear from 2019 is that monetary policymakers are willing to add further stimulus to the global economy and they will likely do so. But our view is they are less convinced than ever that their efforts will be effective as conventional policy options wear thin – and rightly so. And many of them, in concert with global institutions and market economists, continue to call for a greater role of fiscal policy. Unfortunately, we believe fiscal policymakers are unlikely to come to the fore in 2020 and will likely be unwilling or unable (or both) to meaningfully add stimulus to the global economy which would prompt a better outlook for growth.

Australia: Will RBA cuts work?

This time last year the Reserve Bank of Australia (RBA) appeared to have a hiking bias. At the time, economists were debating whether 2019 would see the cash rate rise. But a lot has changed. Now, with the cash rate being cut to an all-time low of 0.75% in October and market expectations of at least one additional cut in 2020, a more appropriate discussion is whether the RBA will be forced to use unconventional policy measures in order to stimulate the subdued Australian economy and whether recent and future monetary easing will have the desired effects.

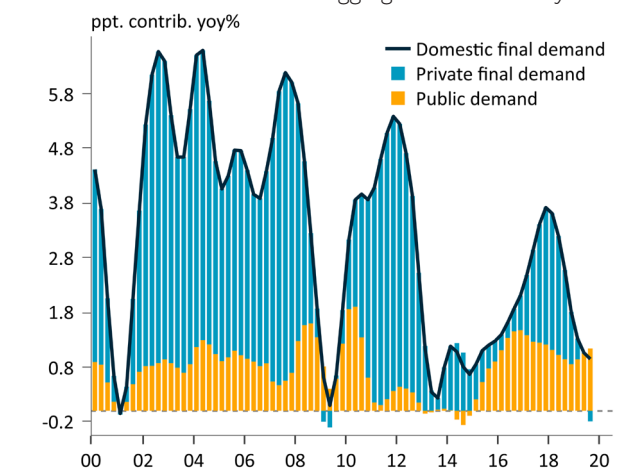
In terms of unconventional policy, the RBA Governor, Philip Lowe has highlighted that conventional policy is almost at its limits. Unconventional policy measures, specifically an Australian version of quantitative easing or QE, then becomes an option at a policy interest rate of 0.25%, when rates will effectively be zero given the corridor system the RBA uses. Lowe has emphatically ruled out negative interest rates as an option. In terms of the impact monetary easing may have on the economy, Lowe himself has noted that

monetary policy is less effective at these low rates (and especially so when central banks around the world are also easing). The RBA also does not seem optimistic given that it downgraded its forecasts in its November Statement on Monetary Policy. Notably, it is forecasting neither full employment nor a return to the midpoint of its inflation target over its two and a half -year forecast horizon.

The data flow for the Australian economy at the end of the 2019 year remains relatively soft, posing risks to the RBA forecasts. The unemployment rate hovered around 5.3% in the three months to November, edging away from the RBA's forecast path that bottoms out at 4.9%, and a long way from the estimated 4.5% natural unemployment rate in 2021. Labour market slack will likely continue and this is reflected in wages growth for Q3 2019: the measure was little moved at 2.2%yoy and is forecast to peak at 2.3%yoy by the RBA. Inflation has also remained below the 2-3% target band in the September quarter, with the headline measure at 1.7%yoy and trimmed mean at 1.6%yoy. This weak inflationary pulse sees the RBA no longer expecting it to reach even the bottom of its target band by the end of 2021.

GRAPH 03 AUSTRALIAN DOMESTIC FINAL DEMAND

Private sector weakness is dragging on the economy



Sources: IFM Investors, ABS, Macrobond

Areas where the RBA still seems a little more optimistic are on growth and consumption. Our view, however, is these positions seems somewhat at odds with the softening data: GDP is expected to grow 2.3%yoy in Q4 and lift to 3.1%yoy in Q4 2021; and household consumption is expected to lift to 2.7%yoy in Q4 2021, despite subdued wages. But Q3 national accounts data suggest this may be in question already: real GDP grew just 0.4%qqq and 1.7%yoy – the most gentle of turning points. Notably, household consumption remains soft at 1.2%yoy and the private sector overall is experiencing a growth lull. Indeed, it's the public sector still driving demand largely via government spending. While we note the lags in monetary policy transmission, we remain concerned that policy settings will do more for asset prices than the real economy.

This dynamic is already evident. The much discussed

slump in house prices has been upended by a jarringly sharp upturn: prices went from a decline of 1.3%mom in December 2018, the largest fall in circa 35 years, to a rise of 2.0%mom in November 2019, the largest rise in circa 16-years. The RBA has some faith that the rise in asset prices will aid consumption, via the wealth effect – however, we remain skeptical. Looking ahead, the RBA is expecting growth to pick up to 3.0%yoy by mid-2021, an aspirational forecast in our view. From our perspective, we would like to see 2020 be the year the Federal Government comes to the fore to assist the RBA in generating growth via fiscal stimulus and reforms – particularly as monetary policy is at the limits of its effectiveness and the global environment remains uncertain.

US: Keeping on with growth

Economists spent much of 2019 concerned about whether we had seen the best of US growth and whether a recession could be expected. Such concerns were exacerbated by the inversion of the bond yield curve in August 2017 – a much-loved ‘predictor’ of US economic downturns for a long time. The growth narrative in the US clearly faded as fiscal stimulus has been wound down throughout 2019. Yet a proactive Federal Reserve has pulled policy rates well back into accommodative territory and this has provided confidence that the cycle can be extended through 2020.

The trade and technology ‘war’ with China will continue to be a key source of uncertainty for the US economy next year, as it is for China and the global economy more broadly. Relations between the two superpowers on trade issues appear to have improved in the three months to December, after a marked escalation in tensions in prior months. Both countries have signaled an intent to sign a limited Phase One deal. Current expectations are that it is increasingly unlikely the deal will be signed before a scheduled tariff hike from the US is due on 15 December. Economists will watch and wait, as 2019 highlighted that we are, as always, just a few tweets away from the game changing once more.

Despite trade tensions, increasing uncertainties, and slower global growth, the US economy continues to track relatively well. Growth for Q3 was recorded at 2.1%yoy. Emphasising this, the US Federal Reserve’s (Fed) October Federal Open Market Committee (FOMC) minutes suggest members see the economy in a relatively good place after two more ‘insurance’ cuts (25bps in September and another 25bps in October to 1.50-1.75%) that were seen as necessary, given more pronounced downside risks. The data would now have to justify a “material reassessment of the economic outlook” for further cuts. The key drivers of the Fed’s optimism are the strong US labour market and robust domestic consumer. An average of 205,000 jobs were added to the economy each month from September to November, with the unemployment rate between 3.5-3.6% for this period, which is near 50-year lows.

This has supported reasonable wages growth of 3.0%yoy in October and a commensurate increase in household consumption in Q3 of 2.5%yoy; but has failed to put upward

GRAPH 04 US UNEMPLOYMENT RATE

An increase in unemployment would be concerning



Sources: IFM Investors, U.S. CBO, Federal Reserve, U.S. BLS, Macrobond

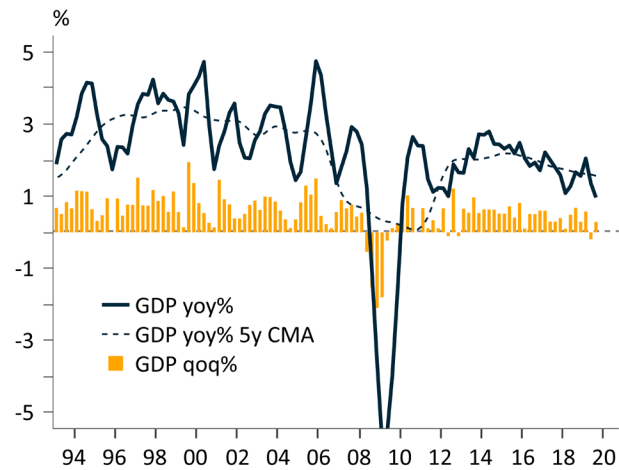
pressure on inflation, which broadly softened over the three months to October seeing most measures sit below the 2% target. Business investment continues to be a key concern given the uncertain global backdrop. For Q3 the measure fell 0.1%qoq and rose just 0.6%yoy. Industrial production has also taken a hit, falling 1.1%yoy in October after trending down since late 2018.

Our view is that real US GDP growth is likely to decelerate modestly in 2020 to an around trend rate of 1¾%. What will be important is whether this rate can generate enough jobs to keep the unemployment rate low. In what will likely be a relatively benign inflation environment, we believe the Fed will likely seek to ensure this outcome with some further modest easing of monetary policy. Key ongoing risks will be US-China tensions and the possibility of broadening trade rifts globally. Domestically, the key area of uncertainty will be the US presidential election in November. We expect an air of uncertainty may pervade the US economy as the election date draws nearer and markets and corporates seek to unpack the potential implications for the US and global economies.

UK: Brexit awaits

The outlook for the UK economy in 2020 rests almost entirely on the outcome of Brexit, which, after an extended period, is finally coming to a head. The politics of Brexit has been a key focus for the UK over recent months with multiple votes, debates, and negotiations in October culminating in the Brexit deadline being pushed beyond 31 October and a general election scheduled for 12 December. Polls at the time of writing have Boris Johnson’s Tories as likely to win a majority over Jeremy Corbyn’s Labour Party. Such an outcome would provide certainty that the UK would finally be able to ratify the withdrawal agreement on or before the 31 January deadline. However, attention will then turn to the transition period and progress would be important to remove

GRAPH 05 UK GDP GROWTH

Brexit uncertainty takes a toll on growth

Sources: IFM Investors, ONS, Macrobond

the uncertainty that has plagued the UK economy since the July 2016 vote. But as we know polls have been wrong before and the prospect of a minority government lingers and would clearly impede any material progress on Brexit occurring in an orderly manner.

Political uncertainty has been taking a toll recently and UK economic activity data has continued to be soft: Q3 GDP growth disappointed at 1.0%yoy, the slowest growth in nearly a decade; and business investment continues to be a key concern after falling 0.6%yoy in the quarter, the 6th consecutive fall. Survey data are also concerning. The manufacturing PMI fell to 48.9 in November 2019 and the services PMI has trended down over the past few months to 48.6 in November, the lowest level in 40 months. Against this tide, the labour market continues to perform relatively well – as has been the case through much of the year – despite softness in other areas of the economy. The unemployment rate ticked down to 3.8% in the three months to September and wages continue to grow strongly, with September quarter average weekly earnings (ex bonuses) up 3.6% on the same 3-month period last year. Despite robust earnings, consumption has recently softened, with Q3 household consumption up just 0.4%qoq and retail sales ex-automotive fuel down 0.5%qoq in November. Inflation has also been remarkably subdued given the recent labour market tightness and wages growth in the UK, with both headline and core measures trending down since early 2018 and averaging 1.7%yoy in the three months to October. These dynamics have left the Bank of England (BoE) with little to do but watch and wait for a Brexit outcome, leaving rates at an accommodative 0.75%.

As 2020 begins, our expectation is that UK economic growth will continue to decelerate as households and businesses search for clarity on where the UK is headed post-Brexit. Some modest fiscal stimulus from an incoming conservative government would likely be supportive through

the year. However, the question will be if businesses are able to gain enough confidence to resume investment and continue to employ. A near-term deceleration and then subsequent recovery of growth seems the most likely outcome in the UK, but growth would likely remain relatively weak overall at around 1¼% for the year. This is the BoE's expectation and, although it is poised to lend support to the economy through 2020, our view is that it will likely not need to do so. Our view is predicated on the quite large caveat that some political clarity comes from the imminent election. If not, the outlook may be considerably more bleak.



Our expectation is that UK economic growth will continue to decelerate as households and businesses search for clarity.

Eurozone: Will 2020 be better?

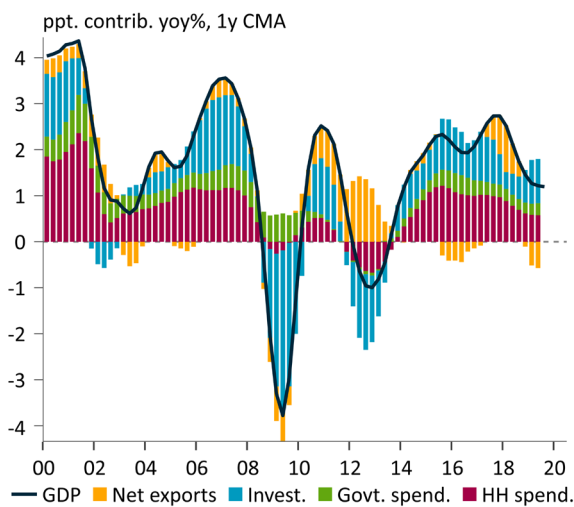
The Eurozone economy spent much of 2019 decelerating, with its major economies in or teetering on the edge of recession. Italy officially entered a shallow recession through the year and Germany narrowly averted one. Aside from some domestic uncertainties, it was the manufacturing slowdown driven by global trade uncertainty that took its toll on European growth. While this downturn has stabilised, it has not, as of the time of writing, turned around, and it will be the fortunes of this cycle that will likely drive the delta on Eurozone economic growth.

As 2019 comes to an end, our view of the Eurozone economy is that it continues to look distinctly fragile. Outgoing European Central Bank (ECB) President Mario Draghi in his final press conference emphasised “the protracted weakness in Euro area growth dynamics, the persistence of prominent downside risks and muted inflation pressures” facing the bloc. Indeed, Q3 growth figures were modest, with growth tracking sideways from Q2 at 0.2%qoq and 1.2%yoy through the year. This was, however, a better outcome than expected and also saw Germany narrowly avoid a technical recession in Q3, with growth of 0.1%qoq (-0.1%qoq was expected) after Q2 GDP fell 0.2%qoq. Given these uninspiring circumstances, the ECB decided to materially ease monetary policy in September: the deposit rate was cut 10bps to -0.5%; forward guidance was strengthened; tiered deposit rates were announced; the terms of the targeted longer-term refinancing operation (TLTRO) III facility were improved; and a new quantitative easing programme of €20bn per month was started on 1 November. This easing was the final act of Draghi in his capacity as ECB President and incoming President Christine

» Lagarde will likely leave these settings unchanged for an extended period, particularly as the effectiveness and imbalances being created by the current ultra-easy stance of such policies are increasingly being questioned. Lagarde will likely continue the ECB's push for member countries to do more on fiscal policy in order to support monetary policy, but this still seems unlikely to be forthcoming in a material way unless the outlook deteriorates.

GRAPH 06 EUROZONE GDP CONTRIBUTION BY COMPONENT

External sector important in stabilising the economy



Sources: IFM Investors, Eurostat, Macrobond

In some good news for the ECB, inflation has been moving in the right direction recently. Core inflation has risen for four consecutive months to 1.3%yoy in November, the fastest rate of growth since October 2015. But the headline measure remains more subdued, ticking up to 1.0%yoy for November. Also positive is that the unemployment rate has been edging lower, despite hovering at around decade lows of 7.5-7.6% since May 2019. Arguably, the continent's most important survey data is suggesting the outlook for the Eurozone's beleaguered manufacturing sector may be improving; the manufacturing PMI rose for two consecutive months, the first time since the end of 2017, to be at 46.9 in November, despite still being well in contractionary



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territory. However, the services PMI unexpectedly fell to 51.3 in November, suggesting that the protracted manufacturing slowdown continues to spill over into the previously robust services sector, with little evidence of industrial production recovering after falling an average of 2.1%yoy each month in the three months to September.

The European Commission (EC) is not overly optimistic on its economic outlook, downgrading forecasts in its Autumn 2019 Economic Forecast with growth expected to be 0.1 ppts slower to 1.1%yoy in 2019 and 0.3ppts slower to 1.2%yoy in 2020. While we have no material disagreement with this, we see risks skewed to the downside. These include the Brexit fallout, from which the Euro economy will not be immune; an escalation of US-China trade tensions or indeed tariffs being imposed on the Eurozone by the US, including on the auto sector; and ongoing political uncertainty, particularly in Italy.

Japan: Slow growth ahead

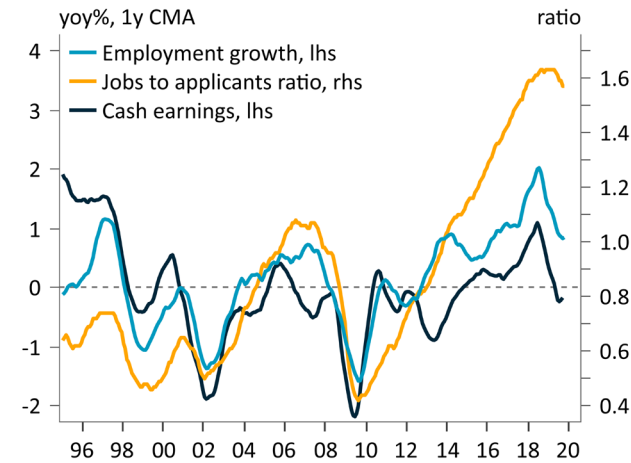
Japan's economy was also impacted by global trade tensions, with the external sector weighing on overall growth. Against this backdrop, 2019 will represent another relatively subdued economic expansion in Japan, likely under 1% (below potential growth). And the country will likely end the year with more of a fizz than a bang, with a strong expectation of negative growth in Q4 because of the impact of the sales tax hike and natural disasters in October.

Japan implemented its long-delayed value-added tax hike to 10% on 1 October, despite a subdued outlook for the economy and concerns that the policy would hit consumption, as it has in the past. Indeed, consumption was impacted more than expected: retail sales jumped 7.1%mom in September and fell 14.4%mom in October, the biggest fall in over two decades. As well, household spending for September jumped 9.5%yoy, the biggest increase in the measure in comparable data stretching back to 2001. Such is the pull forward and pay back characteristic of a VAT increase.

Household spending will likely level out to a relatively modest rate of growth through 2020. Wages growth continues to be relatively subdued. Despite labour cash earnings jumping materially in September by 0.9ppts, it nonetheless recorded still anaemic growth of 0.8%yoy. Further improvement is unlikely given tentative signs of increasing spare capacity in the labour market: the unemployment rate unexpectedly ticked up in September to 2.4%; the 'jobs to applicants' ratio has been trending down; and employment growth has been slowing recently. These observations increase risks to near-term consumption and Q4 growth; and are concerning given that Q3 GDP slowed by 0.3ppts to 0.1%qoq. The modest rate of growth in the economy will be unlikely to generate any meaningful acceleration of inflation with core inflation not getting above 1.0%yoy in 2019, let alone overshooting the Bank of Japan's 2.0%yoy target. This continues to be evident in the data flow as headline, ex-fresh food, and ex-fresh food and energy inflation for October were again far from the BoJ's 2% target at 0.2%yoy, 0.3%yoy, and 0.7%yoy, respectively. Yet despite

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GRAPH 07 JAPANESE EMPLOYMENT AND WAGES

Labour market strength may be faltering

Sources: IFM Investors, CaO, SBJ, Macrobond

this weak inflationary pulse it seems unlikely at this stage that the BoJ will undertake any further easing in 2020.

A cessation of hostilities between the US and China on trade will be important for the Japanese economy in 2020. The negative impact of the deterioration in global trade continues to reverberate through the Japanese economy.



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Trade data in October showed that exports were down 9.2%yoy (-7.5%yoy expected, the biggest fall in three years) and imports down 14.8%yoy (-15.2%yoy expected). This marks the 10th and 6th months of consecutive falls in exports and imports respectively. Industrial production has fallen for five consecutive months, plummeting -7.4%yoy in October, which was the biggest year-on-year fall since February 2013. The outlook for manufacturing continues to be subdued, with the PMI for November at 48.9 (still in contractionary territory) and the services PMI falling 2.9pts to 50.5 over the three months to November.

Our view is that a return to even potential growth is likely more than can be hoped for in Japan for 2020, with growth at around ¼-½% with an accelerating trend towards the back half. Some boost (and perhaps hangover) is expected from the hosting of the 2020 Olympic Games and some fiscal policy stimulus on infrastructure in response to the expected VAT-related slowdown should be supportive. However, it is the stabilisation of the global trade environment that would likely most benefit the Japanese economy in 2020. ■

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