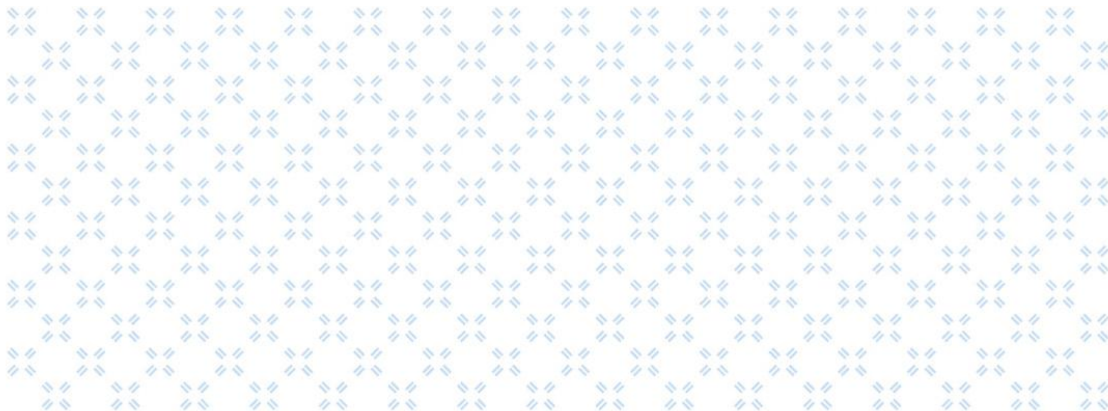
BT Investment Solutions

12 Month Outlook

July 2016



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12 Month Outlook

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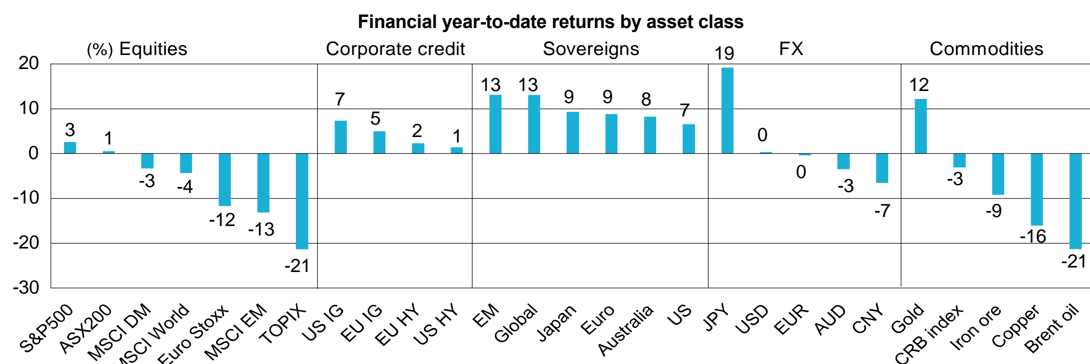
Head of Strategy and Research

It's been a volatile year for markets with investors being challenged at various times by Greek debt concerns, US Federal Reserve (Fed) tightening, capital flight from China and then Brexit. This has left share markets lower over the past 12 months, while resulting in a very strong year for bonds. Uncertainty seems set to dominate over the next year too and will constrain overall returns. However, this will also create opportunities that we will target in our portfolios.

The year started with angst over higher US interest rates, lower commodity prices and emerging markets. But concerns had mostly settled, with markets recovering by the time the Brexit debacle hit in the final week of the financial year. Uncertainty is expected to continue, which may create opportunities for our portfolios. As the year progresses, we expect solid fundamentals, strength in China and supportive policy to drive moderate returns for markets. The major themes we expect to influence markets are outlined in Chart 1.

Chart 1: Financial year-to-date returns by asset class



Source: Datastream

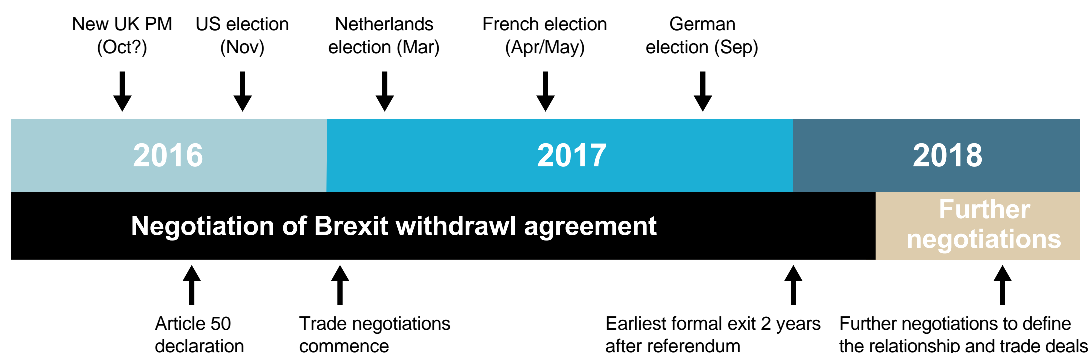
1. Elevated uncertainty

Our baseline assumption is the enduring impact of Brexit will be small. Responses by central banks will mitigate the broader economic impact. However, the impact on markets could be exaggerated and volatile in the short term as investors attempt to assess the economic and political implications. Volatility seems set to be higher throughout the year ahead and there is the prospect of more event risk episodes that will see sharp moves in markets.

Some of the particular issues from Brexit are as follows.

+ There will be an initial period of turmoil for a couple of months as the effects on consumer and business confidence are assessed. Economic data for July and August will be watched very closely. It may take a few months for this to be clear.
+ Key events in the Brexit process are likely to trigger sharp volatility including the appointment of the new UK Prime Minister, the declaration under Article 50, key negotiation dates and any further referenda.
+ Other political events in Europe are likely to receive heightened attention including elections in France, the Netherlands and Germany in 2017.

The US election will also be a critical event during the second half of this year. The table below shows the critical events on the horizon. There are likely to be a number of other Brexit-related events but their timing is unclear.



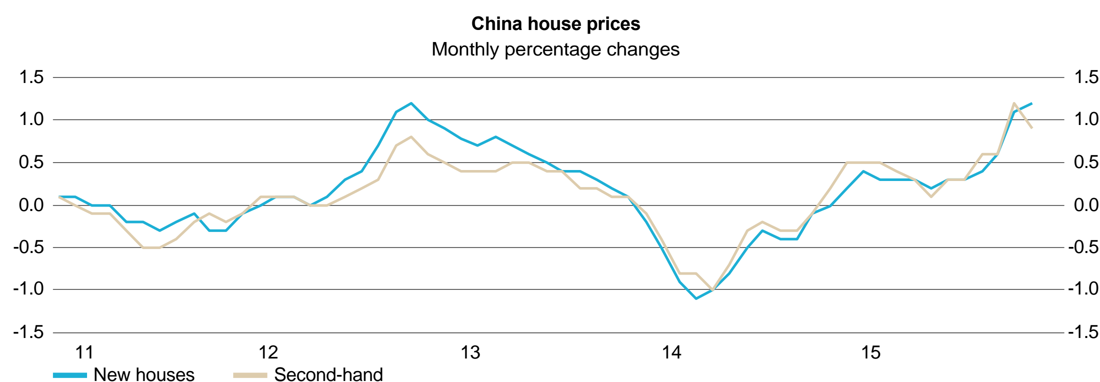
2. China stimulating again

The Chinese government has changed its priorities to soften the hardline reform agenda and refocus on solving problems in the property sector, along with lifting economic growth. The impact has been immediate, starting a pipeline of activity that should continue well into 2017.

+ The People's Bank of China (PBoC) has lowered reserve requirements for Chinese banks, allowing them to lend more. Indeed, credit growth has picked up sharply. There has also been a substantial increase in local government bond issuance due to an easing in rules late last year.
+ A range of measures have been introduced to assist the property market directly. Mortgage rates have been lowered, residency rules have been changed and down-payment rules have been relaxed in most markets.
+ Fiscal spending is set to ramp up. The Government has stated its intentions to fast track a number of large-scale infrastructure projects in 2016.

These policies are starting to have an impact. House prices have been rising across the country (as shown in Chart 2) and developers have begun planning new projects. This will have a positive impact on a number of assets including Australian resource companies, commodity prices and emerging market assets.

Chart 2:



Source: Datastream

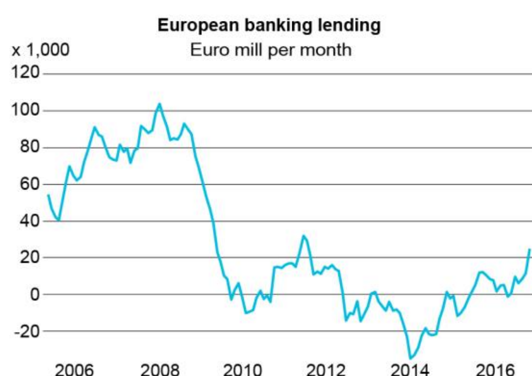
3. Old world slowly rehabilitating

Trend global growth has been lower since the financial crisis. Global growth has averaged around 3.5% since 2012, compared with closer to 5% in the five years to 2008. A large number of issues have contributed to this, including adverse demographics, Chinese reform, previous overinvestment, deleveraging and the constraints of tightening bank regulation.

However, the better news is some of these pressures are starting to ease allowing for more solid outlooks in the US and Europe over the next few years even with heightened political risk. The health of the European banking sector has improved, which has allowed the banks to start lending again (see Chart 3). Europe has taken longer to recover from the financial crisis, partly because the banking sector was hamstrung by the sovereign debt crisis, increases in banking regulation and rising capital requirements. But banks are now lending again and Europe's economy should now catch up to the US, provided political risk does not increase too much.

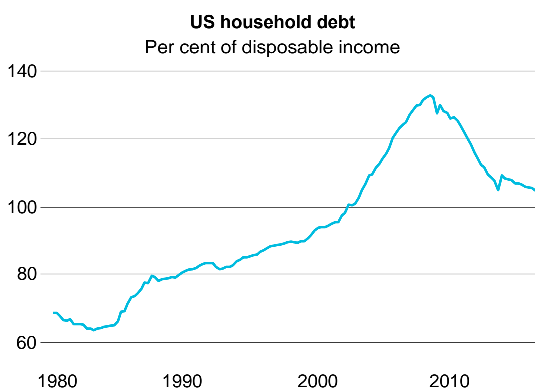
US household debt has also fallen, suggesting the process of deleveraging is well advanced (see Chart 4). One of the reasons the US economy has disappointed in recent years is US households are still focused on reducing debt rather than spending. A slowing in this process of deleveraging should free up more money for consumers.

Chart 3:



Source: Datastream

Chart 4:



Source: Datastream

4. Policies still continue to be a major support for economies

Aggressive central bank action, particularly in Japan and Europe, was an important circuit breaker to weak markets earlier in the year. We expect central banks will now step in again in the wake of the economic and political uncertainty created by the Brexit vote.

At the same time, governments are becoming more comfortable in expanding fiscal policy. European spending has lifted significantly in response to the refugee crisis and as Eurozone rules have been eased. There is also the prospect that government spending will rise in the US next year after the new president is elected.

Policy makers have been able to provide more policy support because inflation remains well below target. There have been powerful deflation forces at work since the financial crisis. A decade of overinvestment leading into the crisis has left the world with too much capacity and an absence of pricing power. For example, Chinese factory prices have been falling for four straight years. There is also an absence of wages pressure, even though labour markets have tightened in some countries like the US. Inflation expectations continue to fall and have hit a record low in the US. This will help embed the low inflation outlook.

Our forecasts now incorporate a further cut in the European deposit rate, accelerated asset purchases in the UK, Europe and Japan and a further delay in the Fed tightening cycle. We now only anticipate one Fed rate hike in the pipeline but do not expect this until 2017. There is also the prospect of even more aggressive action from the Bank of Japan (BoJ), including outright central bank financing of infrastructure projects.

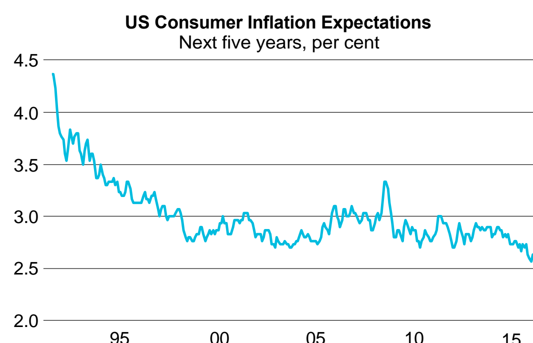
A noticeable acceleration in inflation could change this policy outlook. Central banks would no longer be able to provide more stimulus as required and instead may be forced into an aggressive reversal. We expect this would have a material effect on share valuations.

As a result we continue to monitor inflation trends closely. So far, US wages remain in the range of 2-2.5% growth, well below historical trend growth of 3-4%, and longer term inflation expectations continue to fall (as shown in Charts 5 and 6). Chinese factory prices also continue to fall, suggesting broader deflationary pressures are still strong.

Chart 5:

Source: Datastream

Chart 6:



Source: Datastream

Macro forecasts

These themes have generated more uncertainty than usual for the outlook. However, our baseline is that the global economy will have a reasonably solid year. Our forecasts are broadly similar to the outcomes of the past year, based on our assumption for continued accommodative policy to offset the European uncertainty. The table below shows our macro forecasts for the major regions.

Economic & Market Forecasts to end June 2017

	Real GDP (%)		Core CPI (%)		Policy rate (%)		10yr bond yield		FX/USD	
	Latest	Jun- 17	Latest	Jun- 17	Latest	Jun- 17	Latest	Jun- 17	Latest	Jun- 17
US	2.0	2.2	1.6	1.9	0.375	0.625	1.51	1.8	na	na
Australia	3.1	2.8	1.6	2.1	1.75	1.25	2.0	2.1	0.75	0.73
Euro zone	1.7	1.5	0.8	1.2	-0.40	-0.50	-0.12	0.3	1.11	1.08
China	6.7	6.7	1.6	1.8	4.35	3.70	-	-	6.64	6.90

Growth in the US is expected to strengthen moderately with the domestic part of the economy proving more resilient than the external sector. Specifically, we anticipate stronger consumption and housing activity will help to offset subdued business investment. The external sector should be supported by reasonable global growth; however, an expected appreciation of the US dollar will limit the impact. We anticipate underlying inflation will gradually move higher to be just under the Fed's 2% target. Despite this, we expect the Fed will only increase interest rates once over the coming year with a hike in the first half of 2017. The Fed will tread cautiously given increased global uncertainties.

Chart 7:

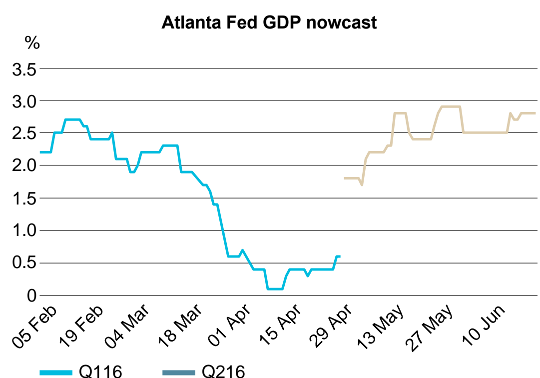


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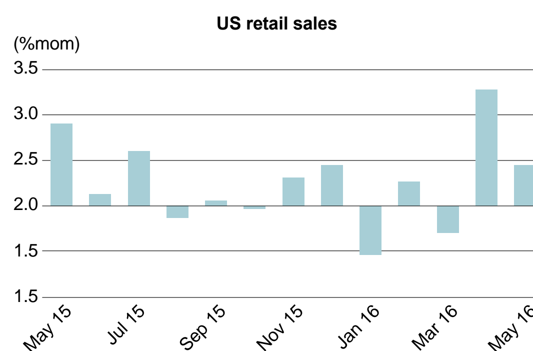
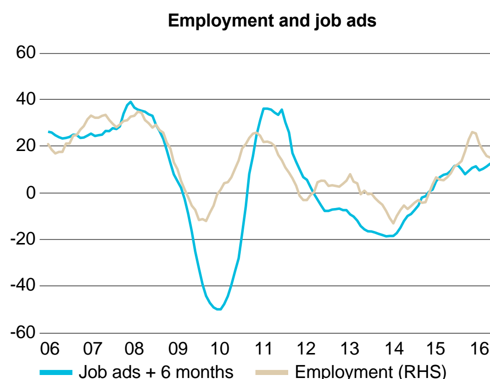
Chart 8:



Source: Datastream

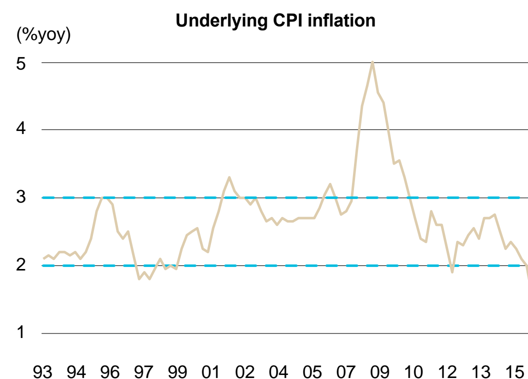
The Australian economy will remain weak relative to long-term averages. While the consumer sector has been the key support over the past year, it is looking more vulnerable due to subdued household income growth and high debt levels. The outlook for business investment remains weak but the worst of the fallout from the end of the mining boom is likely behind us and investment should improve from here. Underlying inflation will likely move up gradually to the bottom end of the RBA's target range, supported by stronger import prices from previous falls in the Australian dollar. We anticipate the RBA will cut rates twice more as insurance against further falls in inflation.

Chart 9:



Source: Datastream

Chart 10:

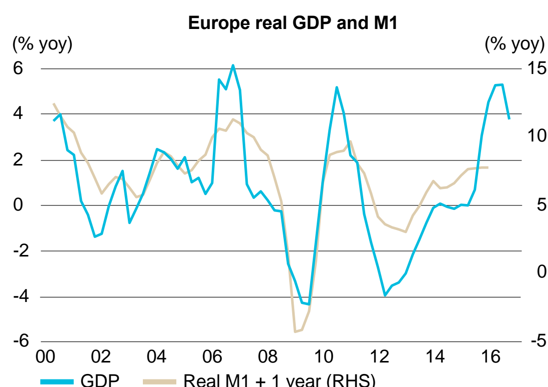


Source: Datastream

The outlook for the Eurozone is now more uncertain given the political backdrop but we still expect a solid outcome and only a small deceleration from last year. Consumption should be stronger based on an improved labour market outlook and a recovering housing market even if confidence takes a hit. Business investment was beginning to brighten based on solid domestic demand and easier bank lending standards. We do not expect a significant hit to continental investment from the political uncertainty. Government spending is lifting to meet the demands of the refugee crisis. The ECB will play a critical role in assuaging the political concerns and we now expect a further cut in the deposit rate and an extension of its asset purchase program. We expect a small rise in inflation over the coming year – although it will remain well below the ECB's target of 2%, and not inhibit the prospect of further easing.

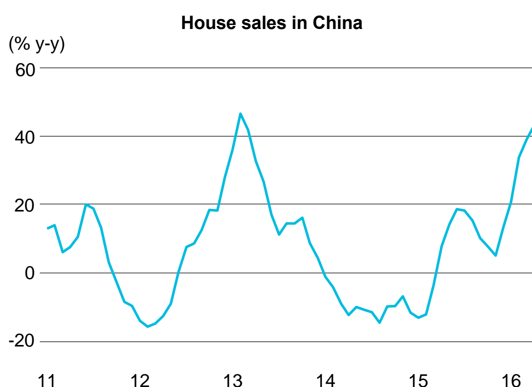
We expect China's economy will continue to grow around its current pace of 6.7% over the coming year, supported by continued easier monetary and fiscal stimulus. The impact will continue to be most felt in the property sector, with investment, construction and prices remaining well supported. The impact on business investment and consumption will improve as other supportive policy measures (infrastructure approvals and incentives) play out. Credit growth may be stronger than official numbers suggest due to increased local government bond issuance and internet financing meaning overall growth could surprise on the upside. This may make the economy more vulnerable to shocks as debt to GDP levels rise even further.

Chart 11:



Source: Datastream

Chart 12:

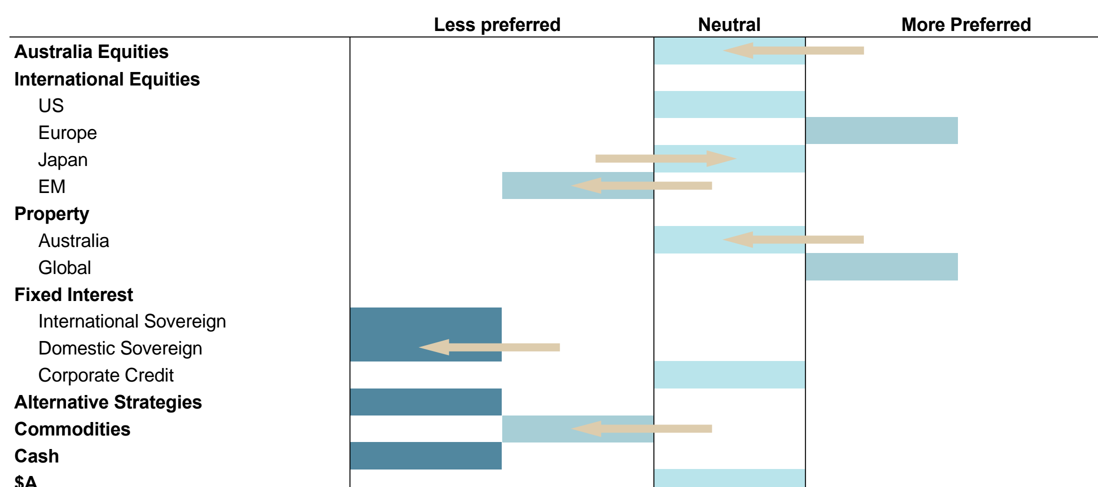


Source: Datastream

Market forecasts and positioning

We continue to prefer risk assets over fixed interest in our asset allocation, but are less aggressive with shares due to more stretched valuations and global event risks ahead. The table below shows our preferences and recent changes in view. We have moved Australian shares and property back to neutral, and reduced our view on Australian bonds and commodities. Europe is our preferred share exposure.

Chart 13:

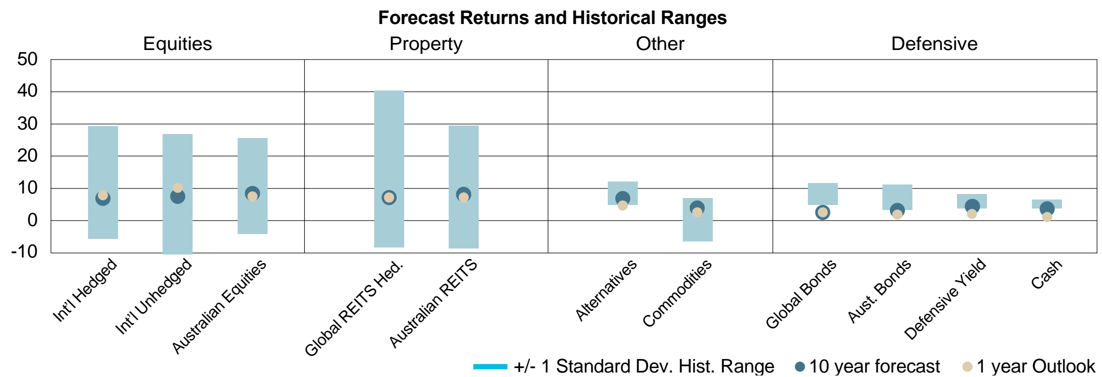


Source: BT Investment Solutions

Our year ahead return forecasts are generally lower than a year ago. Our share returns are broadly in line with 10 year forecasts and our bond forecasts are below. These are consistent with a balanced fund delivering a return of 6.5% over the next 12 months. Some of these forecasts are detailed below.

+ We have lowered our projections for Australian shares, Australian REITs, and Australian and international fixed interest.
+ We have raised our projections for Japanese shares and the Australian dollar.
+ European shares are expected to outperform the US, Australia and Japan despite higher political concerns.
+ Sovereign bond returns are forecast to be low, given low starting yields.
+ We expect the Australian dollar to move sideways, the US dollar to appreciate, and the euro and Japanese yen to fall.

Chart 14:



Source: Datastream, BT Investment Solutions

Shares

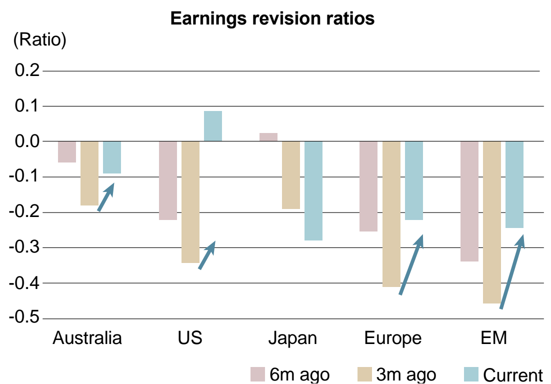
We would regard any significant pullback as a new buying opportunity despite the dampened short-term outlook for shares from the Brexit and its associated political risks. We are forecasting global share markets to generate high single digit total returns over the next year, comfortably outperforming global bonds.

As valuations have rerated back to normal levels, further upside to shares will require a pickup in earnings growth. There has been a continuation of downgrades, with Earnings Per Share (EPS) growth revised down from 7% at the start of the year to 1%. This was particularly acute in January and February. But since then, the pace of downgrades has eased. Our macro forecasts are consistent with a return to positive EPS growth over the next year, especially in Japan and Europe. Meanwhile, valuations should also remain well supported given low global bond yields.

Chart 15:

Source: Datastream

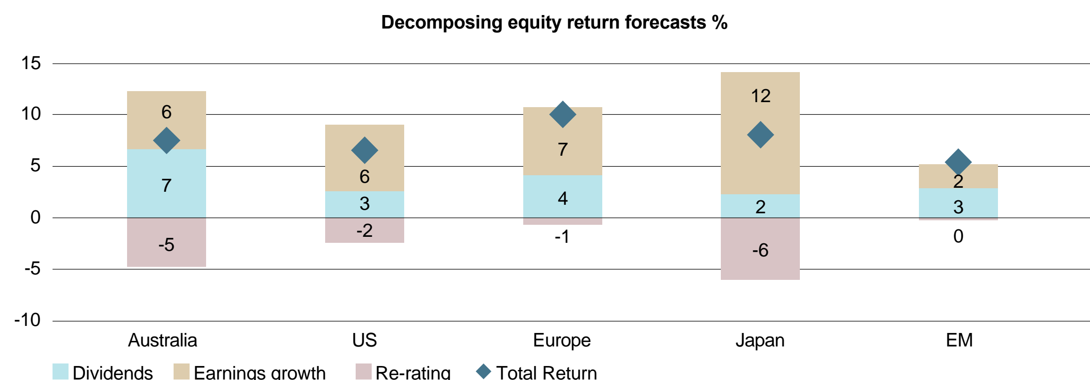
Chart 16:



Source: Datastream

We do not think it is particularly difficult for shares to see high single digit returns this year. Chart 17 decomposes our equity total return forecasts into contributions from dividends, earnings growth and changes in valuations. Given we see a return to earnings growth this year, our forecasts are not dependent on Price-to-Earnings (PE) ratios rising materially higher from current levels. In fact, we assume PE ratios will be lower in all markets except for Europe.

Chart 17:

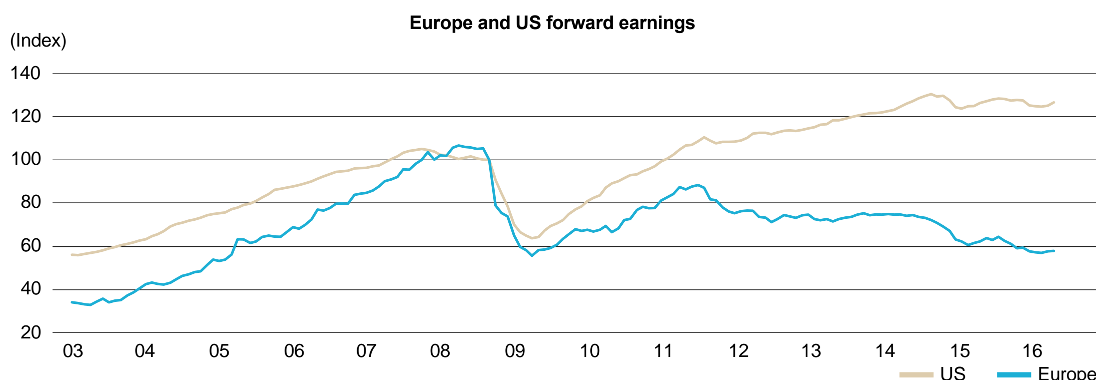


Source: Datastream, BT Investment Solutions

In terms of regional preferences, we have a preference for European shares, we are neutral on Australia, Japan and the US, and least prefer emerging market companies.

+ Europe is our most preferred region. European shares have been particularly hard hit following the Brexit referendum, especially financials. Markets are ratcheting up the probability that another vote on EU membership will be held. We think this is an overreaction. More broadly, the ECB has been supporting the outlook for corporates through cutting rates and purchasing corporate bonds, which will put downward pressure on the cost of capital. European firms have substantial earnings upside given the economic recovery in Europe has also lagged other regions.

Chart 18:



Source: Datastream

+ US shares have continued to outperform in recent months, supported by the recent fall in the US dollar. Any increase in market stress as the year progresses will ensure US shares will remain well bid. But we fail to get too excited in an environment of peak US profit margins and stretched valuations.
+ We have downgraded Australian shares to neutral on the back of less supportive valuations. The outperformance of the ASX200 in recent months has meant valuations are now stretched, particularly in the core market. Whenever the market PE has moved above 16x, this has usually not been a good signal for forward returns.

Chart 19:

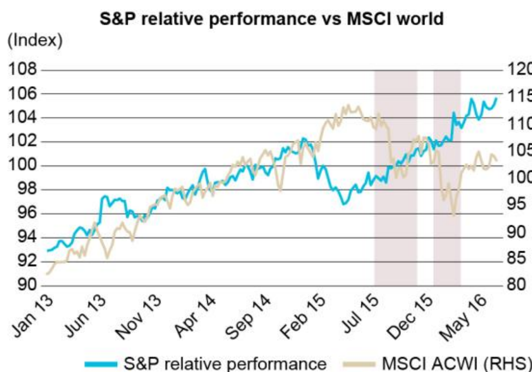


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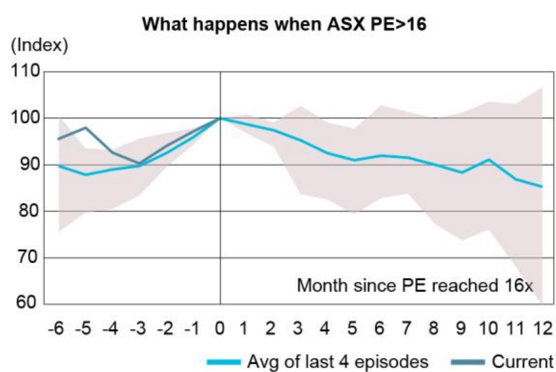
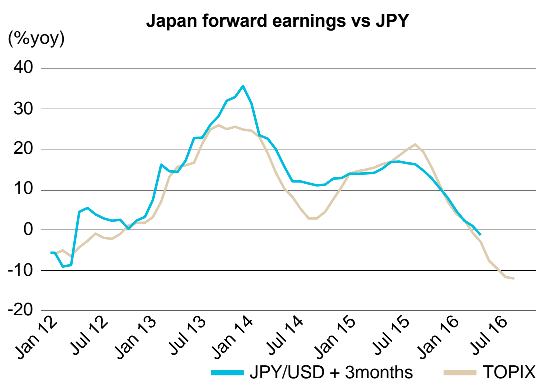
Chart 20:



Source Datastream

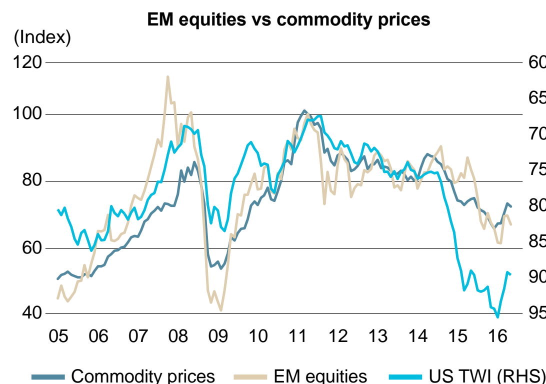
+ We have moved Japan to neutral given its underperformance since the start of 2016. There are still some negatives for Japanese shares, including the appreciation of the yen, and questions around the effectiveness of BoJ policy and Abenomics. But the risk of a large fiscal expansion by the government in the second half of 2016 and relatively attractive valuations make us more comfortable on the outlook.
+ Emerging markets are our least preferred region given the persistence of macro headwinds. We expect commodity prices to remain broadly stable and the US dollar to move higher. Deleveraging in many emerging market economies is also yet to occur. But longer-term, emerging markets represent an attractive buying opportunity as GDP growth strengthens relative to developed economies.

Chart 21:



Source: Datastream

Chart 22:



Source: Datastream

Meanwhile, global property is expected to deliver strong returns over the next year and perform in line with broader equity markets as income growth and yields remain healthy. REITs continue to enjoy a favourable landscape as the global economy is growing, albeit at a lacklustre pace, while easy monetary policy boosts the demand for defensive income streams. A number of positive occupier market trends – including low supply, falling vacancy rates and upward pressure on rents – point towards improved prospects for real estate income growth.

Fixed interest

We maintain our tepid outlook for sovereign bonds as risk/return dynamics continue to deteriorate. We forecast total returns to be below 3% in Australian dollar terms across our four key regions, weighed down by two factors. First, headline yields remains close to, or at historical lows, especially in Japan and in Europe. Second, we expect US yields to rise over the next year which will lower returns.

The downside risks in sovereigns have increased. The average duration for benchmark sovereign indices has continued to lengthen, implying the sensitivity of bond prices to change in yields has increased. The risks to bond yields also lie to the upside. In the US, the Fed continues to reduce its share of the sovereign market and there is scope for a new Government to increase infrastructure spending after the election, which should be inflationary. In Japan, the market is anticipating the possibility of a stimulus package after the upper house elections. The BOJ will also potentially run out of bonds to purchase in 12 to 24 months' time given that they currently own ~40% of the market.

Chart 23:

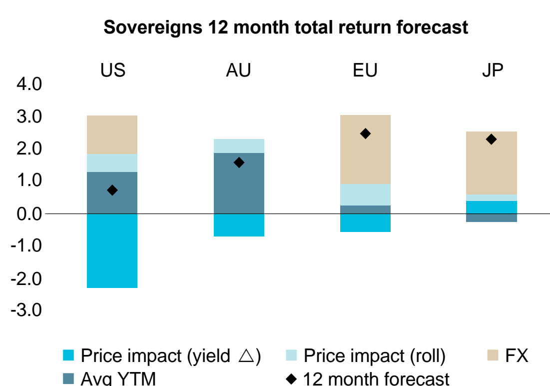


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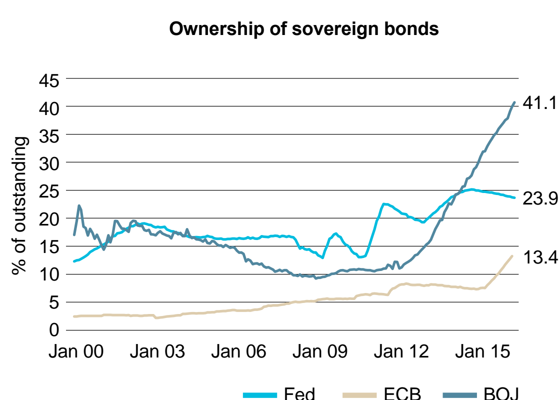
Chart 24:



Source: Datastream

We maintain our neutral outlook on corporate credit as corporate yields are well placed to absorb upward pressure from rising sovereign bond yields. Historically, higher bond yields have coincided with tightening credit spreads as they are both consequences of an improving macro outlook and this time will be no different. We forecast for ~3-4% total returns in investment grade credit in Australian dollar terms.

One key issue we are paying close attention to is the turn in the US credit cycle. As our base case, we forecast benign default rates in the US high yield sector, accommodative central bank policies and high (albeit deteriorating) corporate interest coverage. But this cycle is in its seventh year, with deteriorating corporate fundamentals, tightening lending standards and softening macro momentum. This makes us question whether the credit cycle may be a bit long in the tooth.

Chart 25:

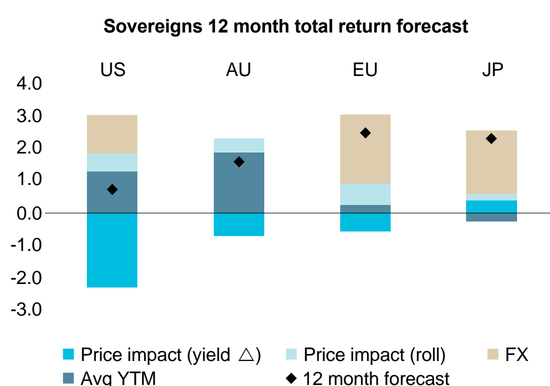


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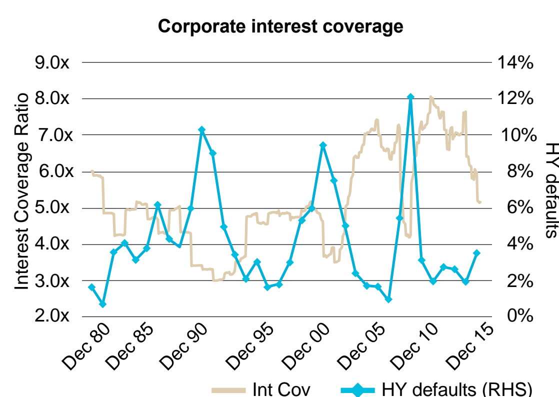
Chart 26:



Source: Datastream

We have downgraded our outlook on Australian fixed interest and see better risk-adjusted opportunities in Europe, especially in corporate credit. The ECB is effectively underwriting the market through its purchases. This should limit upward moves in bond yields, push spreads tighter and limit downside risk in a bear scenario. Returns in European fixed interest have also become more attractive for Australian investors on a fully hedged basis.

Our return forecasts for Australian sovereigns and credit have also concurrently been pared back over the past six months as bond yields rallied on looser monetary policy and as credit spreads have compressed.

Chart 27:

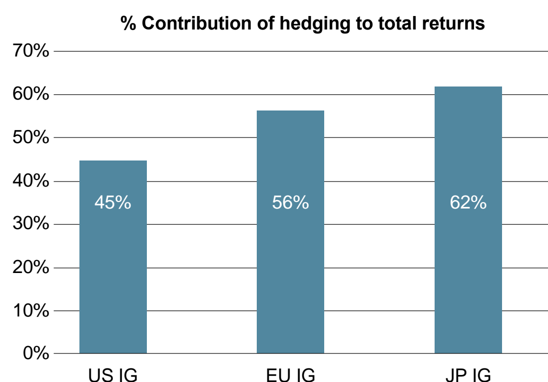


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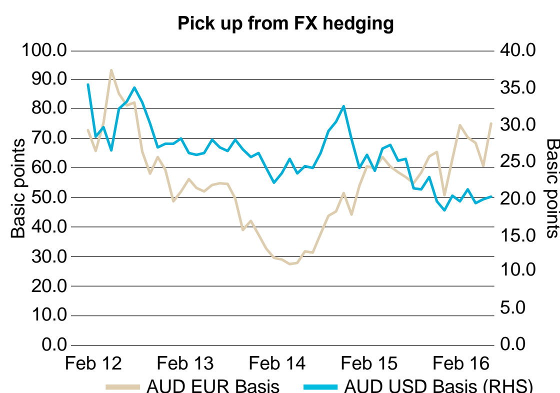
Chart 28:



Source: Datastream

Currencies

We have reaffirmed our views on currencies over the next 12 months. We expect the US dollar to appreciate slightly in line with rising bond yields, improving activity and labour market indicators, and higher official interest rates. We also see modest upside in the Australian dollar due to the effects of Chinese stimulus on commodity prices.

Chart 29:

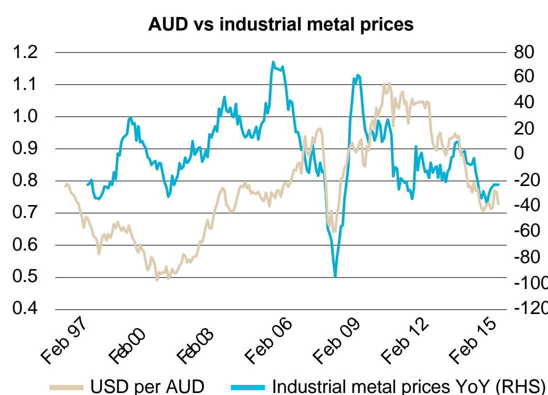


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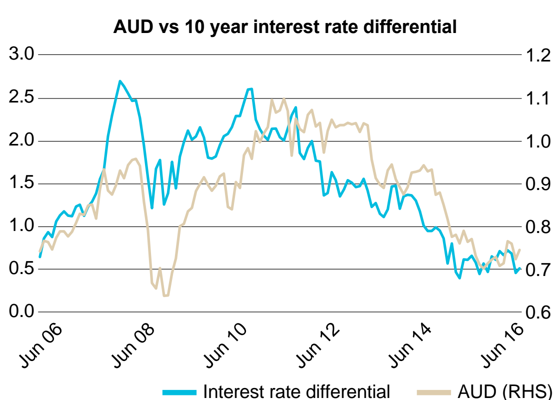
Chart 30:

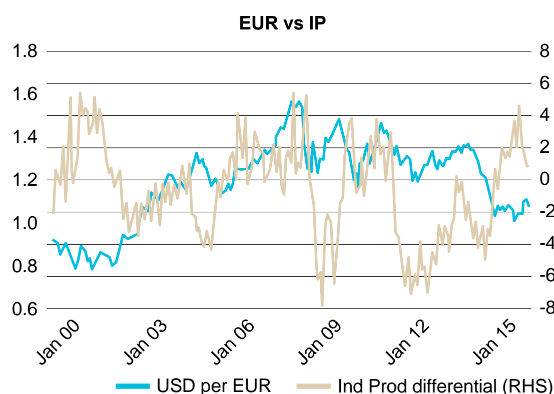


Source: Datastream

Although the euro has recovered some of its losses from the Brexit vote, we expect some downward pressure on the currency as geopolitical issues to dominate and other member countries mull over the possibility of leaving. Looking through the volatility, we forecast a modest depreciation over the next year on the back of widening interest rate differentials relative to the US and expectations for a stabilisation in oil prices.

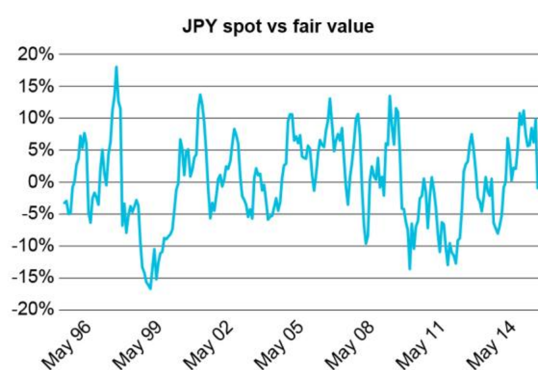
We remain bearish on the Japanese yen. Given rich valuations and softening data, especially on the inflation front, we expect the BoJ to move to ease the pressure on the currency through either cutting short term rates or actively intervening in fixed interest markets.

Chart 31:



Source: Datastream

Chart 32:



Source: Datastream

Commodities and Alternatives

We are less positive on commodities as an asset class. Commodity markets have had a solid start to 2016 on the back of Chinese stimulus measures and improving fundamentals for oil markets. However, we are forecasting a rising US dollar over the next year which is typically negative for commodities. Overall, we anticipate low single digit gains for most commodities, with a preference for energy and precious metals over industrial metals and softs.

On Alternatives more broadly, we are significantly underweight in our portfolios. Hedge funds will continue to struggle with a reduced opportunity set from poor market liquidity and dampened volatility.

Risks to our portfolio

As part of our risk assessment process, we developed a number of alternative macro scenarios. Some of the major foreseeable risks we have considered are outlined below.

+ Less accommodative central bank policy, particularly in the US

  We have run a number of different scenarios involving different outcomes for growth, inflation and interest rates in the US. Our conclusion is our current portfolio will perform well in most scenarios except if the Fed raises rates sharply and the economy slows. This would most likely occur if wages growth accelerated and forced the Fed to keep raising rates despite a slowing economy.

+ Rising financial strains in China

  Whether growing debt concerns in China would impact on markets depends on contagion to financial systems in the developed world. If the crisis does not cause systemic risk, then the impact will not be great. There is a higher degree of resilience today due to a greater focus on financial stability and increased oversight by central banks since the 2008 crisis.

+ Higher political risk particularly from Europe

  The major events will probably be major European elections over the next year, the US election and key milestones in the Brexit negotiations. We will look to take out portfolio protection around each of these key events. There is also the risk of further political flare-ups in Syria and Iraq or the impact of ongoing activities related to the ‘war on terror’.

We will monitor a number of indicators throughout the year to assess whether the economic momentum is shifting from our central case scenario of normalisation to one of the other paths, and whether we need to make adjustments to our portfolios to reflect this. The indicators we see as most important here include the US labour market, US inflation and Chinese growth and financial indicators.

BT Investment Solutions

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