Economic News July 2019

The 2019 financial year was a challenging period for investors. Investment markets still delivered good returns for the year but there were many periods of uncertainty. The global economy continued to grow, but it is currently showing signs of a sharp slowing. Central banks have shifted from threatening to raise interest rates to now promising to cut interest rates.

The rapid change in policy direction was most evident in the United States (US) where the US Federal Reserve (Fed) changed course three times. The Fed moved from raising US interest rates to then being on hold and finally to considering cutting interest rates. A marked economic slowdown in Australia, subdued wages growth, falling house prices as well as low inflation has prompted Australia's Reserve Bank of Australia (RBA) to reduce the cash interest rate to a record low 1.00%. Continuing trade tensions between China and the US, and fears that President Trump could target other countries, remain key concerns for the global economy and financial markets.

Trade tensions intensified

The new financial year began with the US imposing tariffs on Chinese imports totalling US $50 billion, prompting retaliatory action by China which targeted a range of US imports including aircraft, vehicles and agricultural products. The trade confrontation escalated in November 2018, when President Trump imposed a 10% tariff on a further $200 billion of Chinese imports.

There were hopes of a resolution after President Trump and China's President Xi agreed at the G20 summit in December to reopen trade discussions and delay further tariff changes. However, talks between the two countries eventually broke down. The 10% tariff on the $200 billion of imports from China was subsequently increased to 25% in May 2019 with the Trump Administration threatening further tariff action. Talks between Presidents Trump and Xi at the G20 in the last days of June resulted in another ceasefire that delayed additional tariffs and allows for the resumption of negotiations. However, there are considerable doubts whether this truce will be as successful as the last one. Consequently, the US may proceed to impose tariffs on the remaining US$300 billion of Chinese imports that are tariff free.

Despite the successful negotiation of a trade agreement with Canada and Mexico, the Trump Administration threatened to impose tariffs on Mexican imports in May 2019. This measure was designed to pressure Mexico to take steps to stem the flow of illegal immigrants into the US. While a compromise solution was quickly negotiated given that 90% of Mexico's exports are to the US, this was another reminder that President Trump is prepared to use trade policy to achieve domestic political goals. Concerns remain that the Trump Administration may target other trade partners such as Japan and Europe.

United States

The US economy performed well for much of the year. A clear sign of the US economy's strength was the progressive fall in the unemployment rate to a fifty year low of just 3.6%. The tight labour market has provided American workers with bargaining power to ask for higher wages. This has had a strong positive impact on US consumer confidence and spending. However, the US corporate sector has progressively become more cautious given that trade tensions with China are materially impacting their supply chain as well as foreign sales prospects.

Europe

Economic conditions in Europe softened as the year progressed with both local and global factors contributing to the slowdown. Unemployment levels remain elevated in many European countries such as Greece, Italy and Spain. The fragile state of the Italian economy, which is also burdened by excessive debt and a weak banking sector, remained an issue. Manufacturers in Europe (and Japan) are concerned the trade war between the US and China is hindering export opportunities for their products. A major risk that is affecting confidence is President Trump may impose tariffs on car exports to the US. This would have serious consequences for both German and Japanese car manufacturers who rely on the US as a key market for their vehicles. Given these negative global and local forces in play, the European Central Bank (ECB) is now considering whether further stimulus is required. With interest rates already at very low levels and the ECB presidency of Dr Mario Draghi ending in October, there is concern that the ECB lacks both the firepower and the will required to restore strong economic growth to Europe.

The United Kingdom

Intense negotiations to reach a Brexit arrangement acceptable to both the UK and the European Union continued throughout the year. The UK Parliament's failure to reach consensus has necessitated an extension to the Brexit date on two occasions. The latest exit date granted by the European Union is now 31st October 2019. Failure to achieve a Brexit strategy acceptable to Conservative Party members compelled Theresa May to resign as the UK Prime Minister. The Conservative Party is now set to elect a new Prime Minister on 22nd July 2019 and with Boris Johnson favoured to win, the risk of a no-deal Brexit has increased. The Brexit stalemate and consequent political instability has taken its toll on parts of the UK economy. However, labour market conditions remain strong with the 3.8% unemployment rate at a 45-year low.

Japan

Despite years of substantial monetary stimulus by the Bank of Japan, Japan's economy remains subdued. With China a major export market, Japan is very exposed to the US-China trade dispute and global economic slowdown. Although Japan's unemployment rate at 2.4% is lower than the United States, there has only been modest growth in wages. This has contributed to slow consumption growth. With interest rates essentially at zero and government bond yields now negative, Japan's central bank seems to have little ammunition if the economy weakens further.

China

Trade tensions with the US and the global economic slowdown had obvious implications for China's economy, necessitating some targeted fiscal and monetary initiatives to help support growth. Economic indicators suggest that China's growth has slowed over the past year. Recent industrial production, exports and retail spending statistics have been disappointingly soft, placing considerable doubt on whether China's economy will achieve the government's 6% to 6.5% growth target.

Australia

Australia's economic performance weakened as the year progressed. Australia's economic growth slowed to an annual rate of just 1.8% for the year to March 2019. This is the slowest annual growth rate recorded since the GFC in 2009. The RBA reduced the cash rate to just 1.00% in response to the economic slowdown. The RBA may even reduce interest rates further in the coming months.

Jobs growth has been strong with 360,000 new positions created in the year to May 2019. However, considerable spare capacity remains as seen in the unemployment and underemployment rates. Low wages growth and high average household debt continued to constrain the retail sector. The Westpac-Melbourne Institute sentiment survey suggests that consumers are concerned about the outlook. A further sign of consumer caution has been the significant drop in new car sales which have fallen for 14 consecutive months (to May 2019). Australian housing prices also declined sharply during the year although the pace of decline has eased in recent months. Lower housing prices and tighter lending standards from the banks after the Royal Commission have translated into much weaker residential construction, especially for apartments. Apartment construction fell by 24% in the year to April 2019. Notably the RBA has expressed concern that further sizeable falls in housing prices could weaken retail conditions even further as consumers limit their spending.

The Australian Labour Party's (ALP) proposal to end cash refunds for excess franking credits prompted many companies in the lead up to the May 2019 Federal election to pay undistributed franking credits via special dividends or share buybacks. Investment markets responded favourably to the re-election of the Coalition Government as Labour's proposed capital gains, franking credit and negative gearing changes would not be implemented.

In a positive step, the Government has finally announced a drop in deeming rates for Age Pension recipients. The rate will decrease from 1.75% to 1% up to $52,000 for singles and up to $86,000 for couples and the upper rate of 3% for investments over that amount. This should result in an increased benefit for some pensioners who fall under the incomes test.

In uncertain markets, a defensive portfolio stance remains justified

We have believed for some time that the appropriate response to challenging investment markets is to conservatively position portfolios. Most portfolios are currently:

- holding more cash than normal
- remaining highly selective about the types of bonds to limit exposure if inflation or interest rates rise quickly
- retaining a high exposure to unhedged global shares to increase diversification
- employing currency and protection strategies to improve risk control, and
- including strategies that provide returns that are not reliant on share markets and help preserve capital in weak and volatile markets through private equity.

While this focus on managing risk may not prevent negative returns in weak share and property market conditions, it should provide a great deal of protection for investors.

We have attached an updated Financial services guide version 8 20/6/2019 for compliance purposes. There is nothing you need to do with this. If you have any questions or wish to discuss anything, please call us on 03 9544 1004.

All the best,

Andrew Shaw BBus, Grad Dip SIA, CFP
Principal NAB Financial Planning Mount Waverley Pty Ltd
ACN 603 130 963, ABN 80603130963
Authorised Representatives

Suite 30, 1 Ricketts Road Mount Waverley VIC 3149
T 03 9544 1004

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