The View From The Outer

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Tim Rocks
Chief Investment Officer

Timothy Rocks

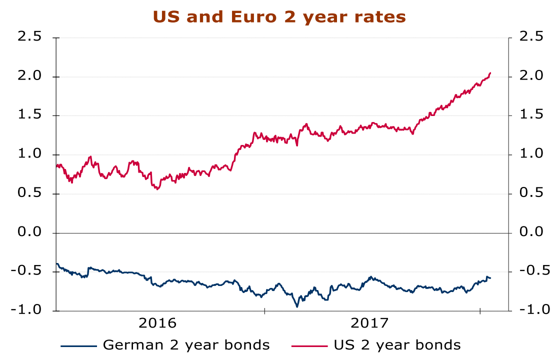
Central bankers called to action

We expect major changes in monetary policy this year across the globe, including from the RBA. We now assume two raise rates in Australia in 2018.

Some of the issues driving this are:

- The global inflation threat is rising as shown by a jump in producer prices.
- The balance of macro risks has changed particularly in Australia now that the mining sector has stabilised. Excessive credit growth and asset price bubbles from low rates are now the greatest threats.
- Central banks are starting to reconsider their inflation focus.

Markets are not fully positioned for hikes in Australia and Europe. These expectations are more aggressive that what is currently priced into markets. This is most extreme in Europe where two-year government bond rates are still negative.



Source: Thomson Reuters Datastream, Evans & Partners

Recommendations

As investors position for rate rises we expect a range of implications for markets:

- Higher rates will constrain global equity market performance but healthy earnings growth will be an offset. We expect Australian equities to underperform.
- Financials will benefit from rising margins. European banks have the most to gain. Australian banks will also benefit but to a smaller degree. Investors can gain exposure to European banks through ETFs or direct stocks.
- Interest rate sensitive equities will remain at risk.
- Corporate credit will be at risk as quantitative easing is unwound.
- RBA rate rises will create some upward pressure on the $A but overall we expect a lower $A over 2018 because it is overvalued at current levels and commodity prices could drift lower due to weakness in Chinese industrial activity.

Central bankers called to action

The big story for 2018 could be central bankers raising rates. There could be a shift in the approach to monetary policy and this is not priced into markets, particularly in Europe and Australia.

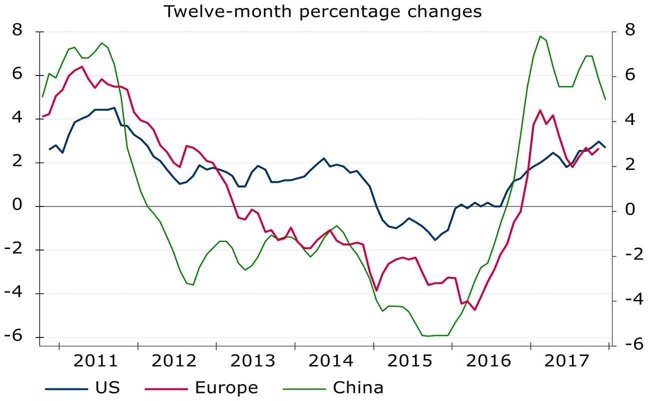
The spark for rising rates could be higher inflation but we are at the point that rates may now rise even if this does not occur. As the long shadow of the financial crisis finally fades, central banks are now in a position to revert to a more normal approach to setting rates.

Inflation might finally be on the horizon

Central banks will certainly tighten aggressively if inflation does finally begin to rise. Pricing power is beginning to become apparent at the manufacturing level. Manufacturers are starting to raise the prices they charge to retailers as shown by a rise in producer price indices in the chart below. This has been occurring to different degrees across the globe but is most pronounced in China. In fact this is one of the drivers of better global profits over the past year.

Producer Prices by Region

Twelve-month percentage changes



Source: Thomson Reuters Datastream, Evans & Partners

So far retailers have had to absorb these higher costs. Retailers have been stuck in the middle of generally weak spending and the threat from online competitors. However if retail spending continues to improve, retail inflation could return quite quickly.

The balance of risks for central banks

Central banks remain in crisis mode. Even though it is 10 years since the GFC, policy is still being set based on fears of a slide back into a financial crisis. They have been willing to accept the risk that very easy policy could lead to overheating in economies because another financial crisis has been their greatest fear. This is what Glenn Stevens called the "policy of least regret" during his time as RBA governor.

The US Federal Reserve was the first central bank to slowly move away from this approach and 2018 is likely to be the year that others follow. The crisis risk has clearly receded. It is not just that economies are stronger. Much more important is the progress in reducing financial risk through enhanced regulation and substantial balance sheet repair in the banking system.

Also, maintaining rates near zero may now represent the greater threat to financial stability because it is leading to higher credit growth and bubbly asset markets. As central banks increasingly recognise this they could raise rates even if inflation remains below target.

The death of inflation targeting

There has also been some discussion in central bank circles that there has been too much focus on inflation.

Some of the arguments that have recently been made by central bankers in Europe and the US are:

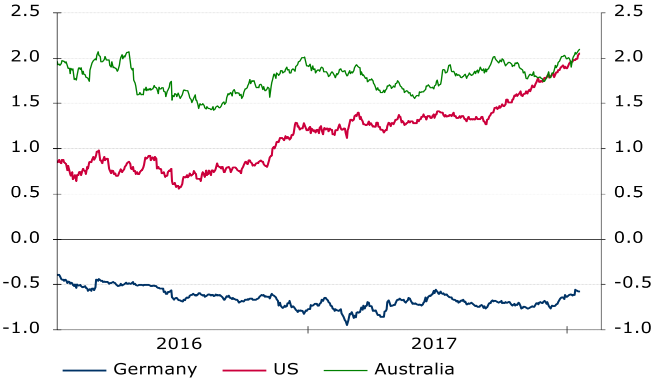
- Central banks' ability to control inflation is overstated due to globalisation and technological change. Globalisation means that domestic factors have less influence on inflation and have placed a cap on wage rises. Technological advances such as e-commerce are deflationary and may swamp the efforts of central banks.
- A narrow focus on inflation is at odds with the main lesson from the financial crisis which is that central banks should play a broader role in promoting financial stability and preventing systemic risks.
- Inflation targeting may be leading to financial instability because low interest rates are encouraging excess debt growth and higher asset prices.

If you cannot influence inflation, it is dangerous to attempt to do so. Low rates will only create distortions and financial instability rather than generate inflation. The Fed is leading the charge by raising rates even though inflation remains below target.

What is priced in?

US rate expectations have moved much further than those in Europe and Australia. For Europe this is most apparent from movements in the 2 year bond rates. Remarkably the European 2-year rate remains deeply negative (around -0.5%), implying that investors are positioned for rate cuts not hikes.

Government 2 year rates



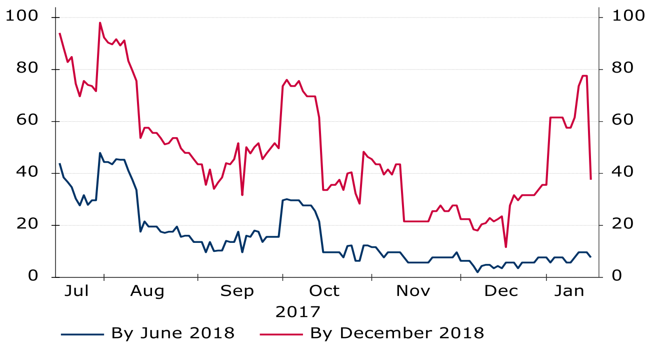
Source: Thomson Reuters Datastream, Evans & Partners

Given the macro data, and the other comments on central bank policy made earlier, European rate increases are increasingly likely over the next year. A critical consideration here is the end of Mario Draghi's term as governor. He has been the architect of ultra-easy policy and negative rates, and investors will become increasingly concerned about a change in approach as his term comes to an end. There is speculation that his successor in the second half of 2019 will be current Bundesbank president Jens Weidmann, who has been vocal recently about the need for a change in approach.

This is starting to creep into market pricing, and futures markets are now pricing an 80% chance of one ECB hike this year.

Probability of ECB rate hike

% probability of 25bp hike

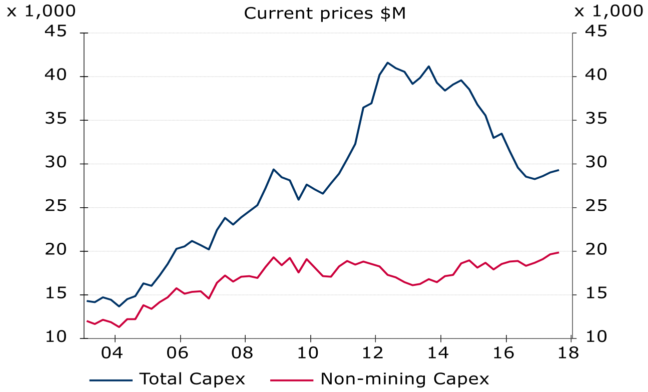


Source: Thomson Reuters Datastream, Evans & Partners

We are also changing our view on Australian rates and now expect the RBA to raise rates in 2018. Australia appears to be exiting the period of heightened macro risk that has existed since the peak of the mining boom in 2012. Mining investment is rising again and while housing activity is slowing there is little evidence of collapse. There has also been substantial job creation in new growth areas like tourism.

Australian Capital Expenduture

Current prices $M



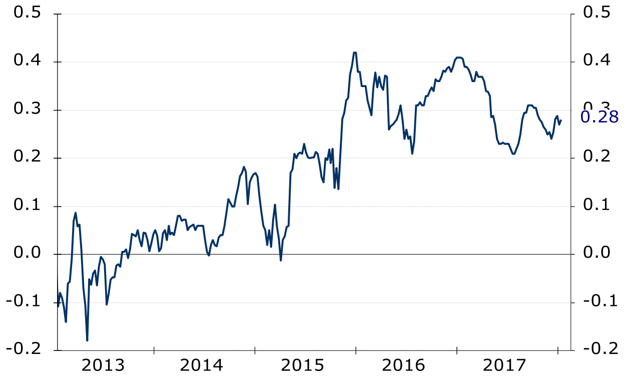
Source: Thomson Reuters Datastream, Evans & Partners

There are still areas of concern such as weak wages growth and consumption but the RBA is likely to consider that a change in the balance of risks has occurred. Further, in line with our previous comments on evolving views on inflation targeting, we no longer expect the RBA to wait for inflation to rise before acting. As a result we are now forecasting the RBA to raise rates twice this year and by more in 2019.

Australian markets are currently forecasting one rate rise so more will need to be priced in.

RBA Forecast Rise in cash Rate

Next 6 months



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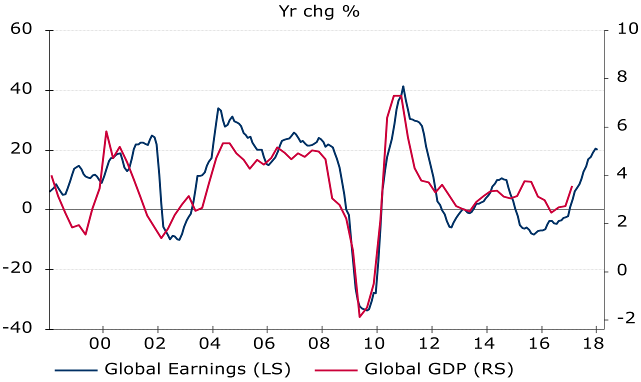
Rate hikes and equities

Changes in rate expectations will have some important implications for markets.

For overall equity markets, changing views on interest rates will dampen equity returns but this effect may not be significant if the better economic environment means stronger earnings. In fact, the pricing power that will lead to inflation may also lead to upgrades to profits and this will be an important offset for investors worrying about the impact of higher rates.

Global GDP and Earnings Growth

Yr chg %

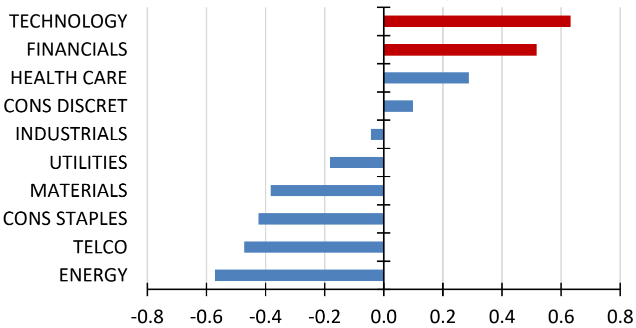


Source: Thomson Reuters Datastream, Evans & Partners

Instead the major implication for equity markets might occur at the sector level. The chart below looks at the correlation between changes in interest rate expectations and relative sector performance in the US since 2009.

Correlation to Changes in Rate Expectations

Correl between 2 yr rate and sector relative performance



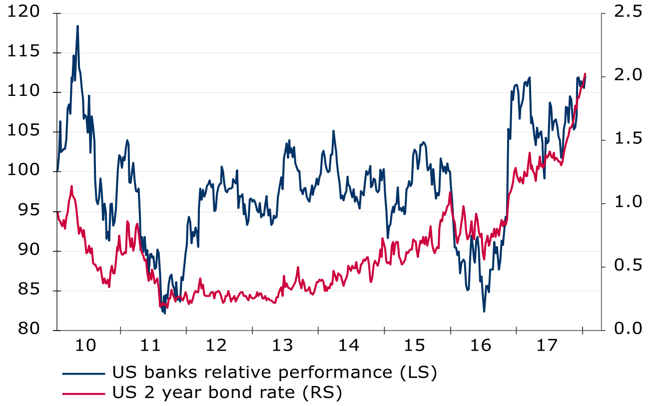
Source: Thomson Reuters Datastream, Evans & Partners

The major winners from higher rate expectations are financials and technology. Financials, particularly banks, benefit from a boost to profits because higher interest rates allow for margin expansion as banks will raise lending rates more than deposit rates. Technology has also benefitted in a more indirect way; the better macro environment has made investors feel more comfortable in paying higher multiples for tech companies.

At the other end consumer staples and telcos tend to underperform partly because they are bond proxies and because investors generally prefer more cyclical stocks in periods when rates are rising.

US banks were major beneficiaries of the major shift higher in interest rate expectations that occurred through 2016.

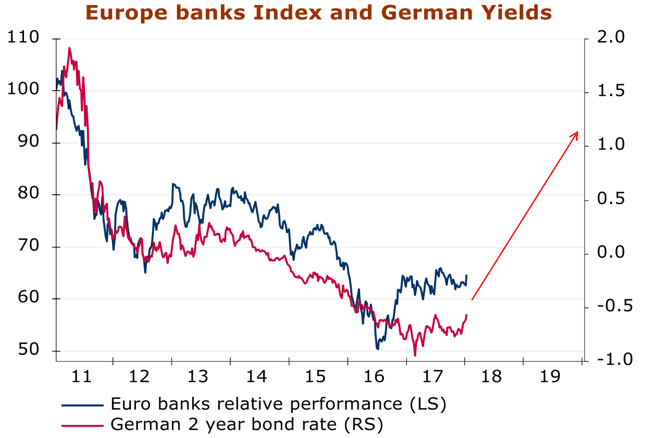
US banks Index and US Yields



Source: Thomson Reuters Datastream, Evans & Partners

This is still ahead for European banks. Given how much interest rate expectations still have to move in Europe, we expect a major rise in European banks is still ahead. The chart below shows that banks' performance has been tightly correlated with German two-year rates and these could move by as much as 1.5 percentage points over the next year or so.

Europe banks Index and German Yields



Source: Thomson Reuters Datastream, Evans & Partners

Rate impact in Australia

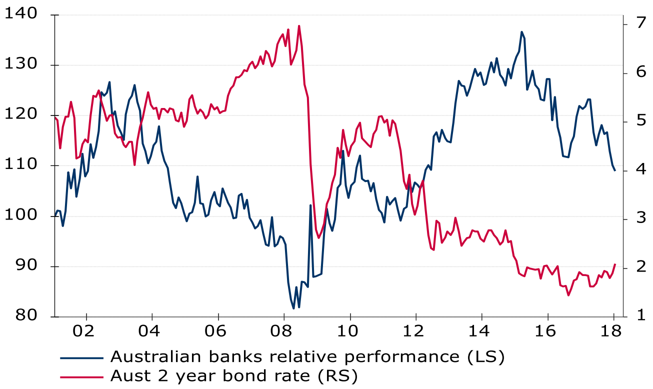
We expect rate rises by the RBA to have different impacts in Australia than the rest of the world. We expect the overall impact on the Australian economy and equity markets to be larger for a number of reasons:

- Australian equity valuations are more stretched than those offshore;
- Australian companies may not get the same offset from improving profits; and
- Australian consumption will be more sensitive to rate rises given recent increases in household debt and higher debt accumulation in recent years.

As a result we expect rates rises in Australia to lead to further market underperformance. In terms of the impact on individual sectors, some thoughts are:

- The benefit to Australian banks will be less than for offshore banks. Australian banks will use the opportunity of rising rates to lift their own margins primarily by raising mortgage rates by more than the official rate. However the effect will not be as much in Australia because the impact on margins will not be as large and there is also the risk that higher rates will increase asset quality concerns.

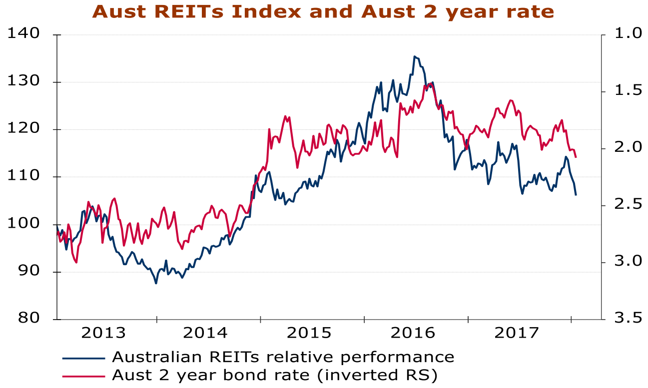
Aust banks Index and Aust Yields



Source: Thomson Reuters Datastream, Evans & Partners

- The nascent recovery in consumer stocks could prove short lived as rates rise. Rises in mortgage rates would eat into household finances.
- Bond sensitive sectors would be vulnerable. The chart below shows the tight correlation between short term rates and REIT performance, but this would also effect infrastructure, telcos and utilities. This effect is already underway but could continue.

Aust REITs Index and Aust 2 year rate



Source: Thomson Reuters Datastream, Evans & Partners

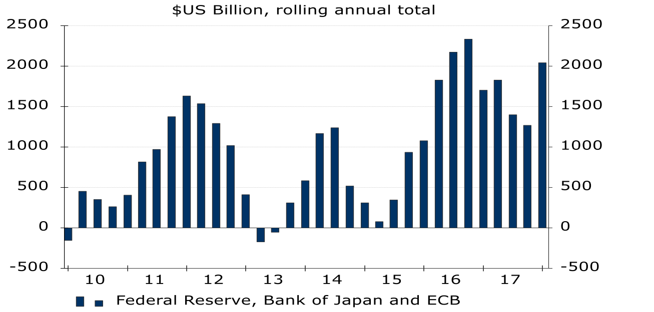
QE and credit

While we have been focussed on rate rises, the other important factor is changes in quantitative easing. Central banks are already set to tighten financial conditions in 2018 as the Fed reduces its balance sheet and the ECB slows down its asset purchases. Total central bank buying of debt securities was around $US2 trillion over the past year and the impact on markets has been significant, particularly for corporate credit. Over the next year net purchases may be close to zero depending on the pace of unwinding by the Fed and tapering by the ECB.

It is increasingly likely that the ECB will finish its purchases around September of this year while the Bank of Japan and the Federal Reserve have already begun to reduce their balance sheets.

Central Bank Asset Purchases

$US Billion, rolling annual total



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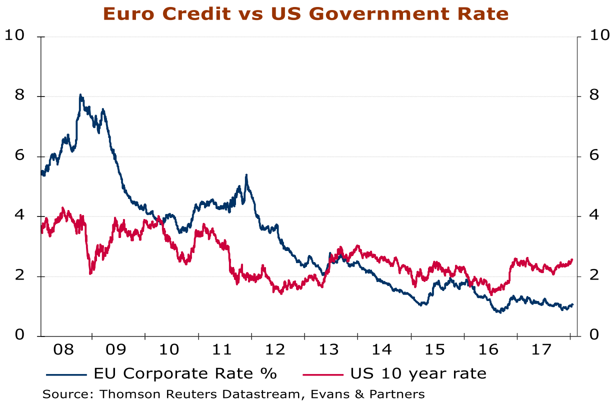
The end of the quantitative easing may have the largest impact on credit markets. ECB purchasing of corporate bonds has driven a major distortion in markets. It has pushed European corporate credit rates below the level of US government rates. Even though the largest impact on credit will be in Europe there could be flow on effects to credit instruments in other markets.



Market implications

Bringing this together, our strongest conviction view as we enter 2018 is that central banks will be more aggressive on raising rates than is currently priced into markets. This will be most pronounced in Europe and Australia.

Our recommendations are:

- Higher rates will constrain global equity market performance but healthy earnings growth will be an offset. Pricing power is high which means that that earnings outlook should stay healthy. However we expect this to lead to underperformance by Australian equities
- Financials are the stand out sector to benefit from this, particularly European banks. Higher interest rates will boost earnings of banks through increasing margins and insurance companies through increasing returns on reserves. Australian banks will also benefit but to a smaller degree.
- Interest rate sensitive equities are vulnerable, particularly those where revenues are not linked to inflation. Toll roads, which typically have inflation linked prices, will likely perform better that utilities, where the link to inflation is not as tight.
- Fixed income securities will be vulnerable to changing views on monetary policy. Corporate credit will particularly be at risk as quantitative easing occurs. Investors could also consider inflation linked bonds as protection against rising inflation.
- RBA rate rises will create some upward pressure on the $A but overall we expect a lower over 2018 because it is overvalued at current levels and commodity prices could drift lower over the year due to weakness in Chinese industrial activity.

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