AMP CAPITAL

Interest rates likely to remain on hold until economic growth improves


Dr Shane Oliver
Head of Investment Strategy and Economics and Chief Economist

There is little chance the Reserve Bank of Australia will hike interest rates in the next six months, even though property prices are at record highs in some markets, according to AMP Capital Head of Investment Strategy and Chief Economist Shane Oliver.

"I can understand why people think maybe they should," says Oliver. "But I think it's a 2018 story, not until probably late in 2018 before the Reserve Bank starts raising rates."

The reason he predicts rates will stay on hold is simple. The background economic data is just not strong enough.

"We've still got pretty sub-par economic growth, we've got high levels of under employment, we've got inflation below target, we've got record low wages growth," says Oliver. "More recently we've seen this break higher in the Australian dollar and that will act as a constraint on Australian growth and also on inflation."

The Australian dollar has spiked above US80 cents in recent weeks, for the first time since 2015. A hike in interest rates would add further pressure to the upward momentum of the dollar and further dampen demand economic growth.

The economic story is a big factor, says Oliver, in why the Australian share market has been under-performing against international equities.

"Global shares had a good run through the June quarter, and so far in the September quarter that has continued," he says. "The global economy has been improving, there's been very low interest rates, monetary policy remains very stimulatory, and that combination is resulting in higher profits whether you look at the US, Europe, Japan, even in the emerging world you are seeing profits rising."

By contrast the Australian share market has been a bit of a laggard. However, Oliver predicts the broad rising trend in Australian shares to resume.

"On a six to 12 month view I do see the Australian share market rising," Oliver says. There are several reasons. The global backdrop will be reasonably positive, global growth is on the mend and that's helping profits, which should flow through to the Australian share market."

"We've still got pretty sub-par economic growth, we've got high levels of under employment, we've got inflation below target, we've got record low wages growth," says Oliver.

Aussie equities still remain a good long-term bet


Tom Young
Portfolio Manager,
Australian Equities

Australian equities have been getting bad press with some investors warning they are significantly overvalued and even dangerous. The narrative goes that we're in the midst of a housing bubble that will blow up and take the share market down with it.

Like every story there are elements of truth to this, but if you silence the noise and take a long-term view – as most investors should – Australian equities remain a strong investment choice.

No housing bust

But the biggest concern for Aussie equities bears is a possible housing market bust. Young says the housing market is a bit frothy and could fall. Sentiment is already switching to negative. But he notes that while the market is softening, "we don't see the market blowing up."

A housing bust will only be triggered by a surge in unemployment and high interest rates. "At the moment unemployment is looking alright and interest rates are stable and probably going to remain stable," Young says.

Relative strength

And while Aussie shares may be trading at healthy valuations, relative to other investments – particularly when it comes to yield and income - Australian equities look strong.

Australian equities are yielding 4.5 per cent; add franking credits and that increases to 6 per cent. The Australian 10-year Government bond, by contrast, is yielding just 2.5 per cent.

"The income from Australian equities remains pretty attractive relative to bonds at this point in the cycle," Young says.

Australian equities are particularly good options for income investors that aren't so worried about volatility. Since 2010, the Australian market's total return was 60 per cent. Over half that has

been due to dividends. "We're pretty confident that yield [of around 4.5 per cent] will continue," Young says.

A long-term view

Most investors will hold Australian equities in their portfolio for 20 to 30 years or even longer. A 20-year-old who lives to 90, could be invested in Aussie equities for 70 years! Even a retiree at 65 who lives to 90, will hold them for 25 years.

The Australian market might have some risks, but given its long-term potential it's riskier not being invested in it.

"On average, the Australian equities market goes up," Young says. "If you own the market for a long period of time you should make money."

Why listed real estate faces Amazon-like disruption

Kristen Le Mesurier
Senior ESG Investment Researcher

Investors have recently focussed on the impact of Amazon's plan to roll out its full retail offering in Australia on local retailers. But fewer investors have been considering the impact of Amazon-style disruption - and other global social trends - on real estate. We have identified 3 major trends that are particularly redesigning real estate as an investment.

Car sharing and self-driving cars

Car ownership already seems to be falling as the young and affluent, particularly, turn to car sharing. In 2015, 15 per cent of adults used ride-sharing cars. The University of Calfornia, Berkeley, estimates that for every ride-sharing car, there are 9 to 14 fewer cars on the road. But an even bigger trend looms: Driverless cars.

Driverless cars, for a start, could mean the value of billboards may decline if fewer drivers are looking out the window in traffic. And if access to public transport is no longer as crucial, residential real estate with great transport links may not attract the premium it does today.

Automating the last mile

Large warehouses are too remote from consumers expecting extremely fast delivery. So retailers are experimenting with various solutions.

Buyers often aren't home when a delivery arrives so retailers are trying to make it more efficient to leave packages. But retailers also want more buyers to pick up their own goods through the likes of 'click and collect'. The most radical, futuristic delivery experiment, however, is the drone. Amazon, logistics player DHL, and drone tech start-ups, Matternet and Flirtey, all have drone trials underway. Safety and operational concerns will limit adoption for urban delivery, but drones may well form part of a large warehouse/distribution centre in roles just like robots are fulfilling today.

Multi-channel retail

Multi-channel means retailers need to provide more 'click and collection' centres where shoppers can order online and then pick up their goods in person. To attract shoppers and compete against the ease of online buying, stores will also have to become more experiential wow 'destinations', akin to showrooms, much like Apple's iconic store on New York's Fifth Avenue.

And multi-channel will also mean fewer stores. (Some 15 per cent of the 1,050 shopping malls in the US will close in the next decade, according to the World Economic Forum, with lower-grade malls most at risk.)

A new real estate model

Some listed real estate managers, such as AMP Capital, are deeply integrating the impact of these social trends into their investment process and asset selection. In this dynamic and disrupted environment, those asset managers with a deep understanding of the likely winners and losers will be best placed to construct an attractive, resilient investment portfolio. And they will be able to ensure that global listed real estate continues to deliver strong income streams and returns as it has in the past.

Key lessons from a recent US utilities trip

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We travelled to the US to attend several conferences, industry events and visits to company headquarters, to develop a better understanding of the key issues for the US utilities sector and its outlook. In a busy ten days we met with 35 companies as well as many other industry experts and participants.

What we found was a positive overall outlook for utilities' fundamentals, as well as signs of risk mitigation, in the following key areas:

1. Value creation from efficiencies

Utilities have been increasingly focused on improving the efficiency of their cost base. This likely began from what was a relatively high base, and significantly more potential remains. We expect this to be an important driver of cash flow growth going forward.

Most companies are now pointing to a flat evolution of their cost base, or at least below the level of inflation. Some even suggest that it will be possible to reduce costs year-on-year over

3 to 5-year periods, providing the opportunity for companies to create significant value.

2. Investment drivers

All three of the utility subsectors – electricity, gas and water – have seen a rapid growth in investments in recent years. One of the main drivers is infrastructure replacement, which will continue to be a driver going forward.

Each subsector has different drivers, but we expect rate base (the value of a utility's assets on which it can earn a return) growth over the next three to five years of 4 to 6 per cent for electric utilities, 5 to 7 per cent for gas utilities and 6 to 8 per cent for water utilities.

3. Regulation

Regulators set an 'allowed return on equity (RoE)' for utilities according to their view of the prevailing rates in the market. In recent decades, allowed RoEs have fallen as the US 10-year bond rate has declined, though not to the same extent. A large spread between US 10-year bonds and allowed RoEs has emerged.

Management teams we met with are confident that allowed RoE should remain at least flat or hopefully increase.

4. M&A activity

M&A activity has also become common in the utility industry over the years and particularly of late. Much of the M&A has been based on sound industrial logic and delivered meaningful synergies. The industry has been historically fragmented. The very low cost of debt has made acquisitions more appealing and many utilities have been able to take advantage of that to expand their service territory.

A strong outlook

Overall, our trip highlights the benefits of investing in an asset manager with a research team that can conduct detailed on-the-ground research into fundamental factors in complex sectors.

But it also highlights our thesis that global listed infrastructure is well positioned to weather future challenges and continue to provide advisers and investors with strong returns.