	Price	5 Day % Change	3 Month % Change	1yr % Change
S&P/ASX300	58,155	0.22%	-6.78%	-1.19%
MSCI World Ex-Aus. (Unhedged)	8,810	-2.64%	-8.66%	1.23%
MSCI World Ex-Aus. (Hedged)	1,586	-3.97%	-7.51%	-2.43%
Bloomberg AusBond 0+ Composite	9,473	0.72%	1.05%	3.20%
BloombergBarclays Global Agg. (Hedged)	979	0.63%	0.60%	0.79%
S&P/ASX300 Property	49,821	4.48%	-0.13%	6.40%
FTSE/Epra NAREIT (Hedged)	2,623	0.62%	0.36%	3.68%
S&P Global Infrastructure (Hedged)	4,685	-0.08%	-2.03%	-5.70%
BarclayHedge Global Hedge Fund Index (USD)	5,576	N/A	-3.22%	-0.36%
AUDUSD	0.7208	-1.34%	1.42%	-4.03%
AUDEUR	0.6331	1.99%	-2.86%	0.79%
AUDGBP	1.0484	1.45%	3.74%	4.87%
AUDJPY	0.5658	1.27%	-2.80%	-1.47%
AUDNZD	81.2080	2.18%	-2.88%	4.60%

Source: Bloomberg, S&P Dow jones, MSCI, FTSE/EPRA, Barclays, 8th December 2018

Volatility continued to rile investors this week. Two major events dominated the headlines: the weaker than expected GDP number in Australia and the flattening of the US yield curve. This week we discuss each in turn and try to place them in context. We conclude that there is a danger in inferring an economic slowdown just because the yield curve is flat. We also highlight the upcoming Brexit vote in the UK on Tuesday, which may prolong the current volatility.

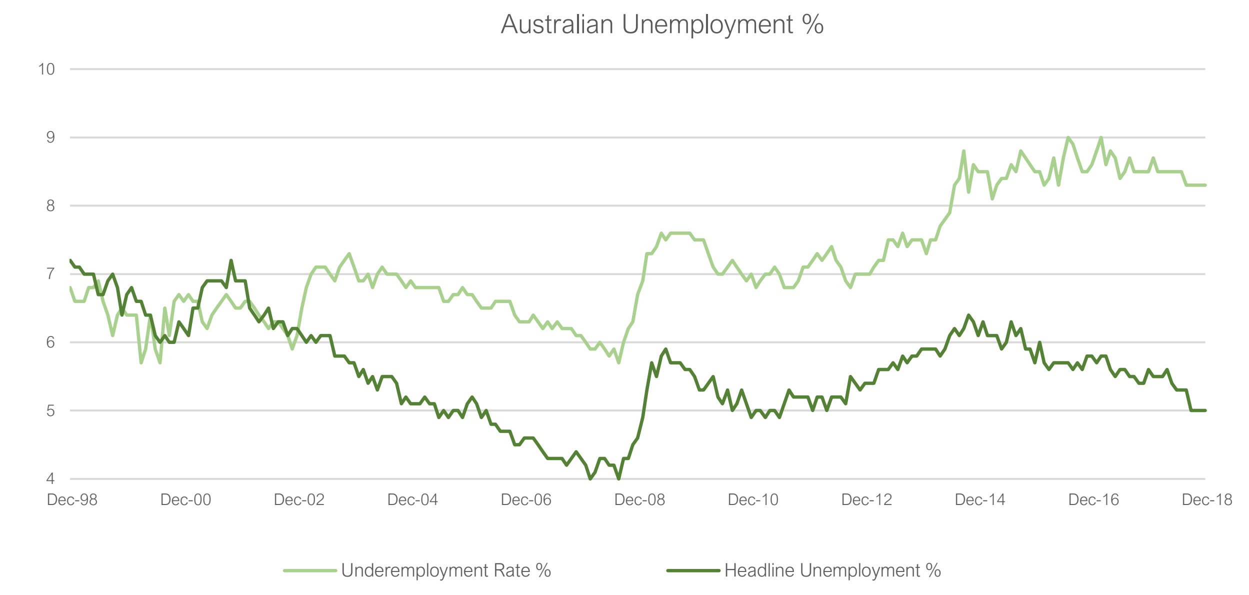
Last week was a particularly heavy week for data. Earlier in the week, the PMI surveys showed again that the global economy is slowing. Of particular concern are Europe and China. More positive momentum is beginning to gather in Japan, albeit off a very low trend.

In Australia, the GDP announcement on Wednesday was met with dismay. The third quarter number of 2.8% was a seemingly big miss from the expected 3.3% yoy. Q2 growth has also been revised down to 3.1%, from an initial release at 3.4%.

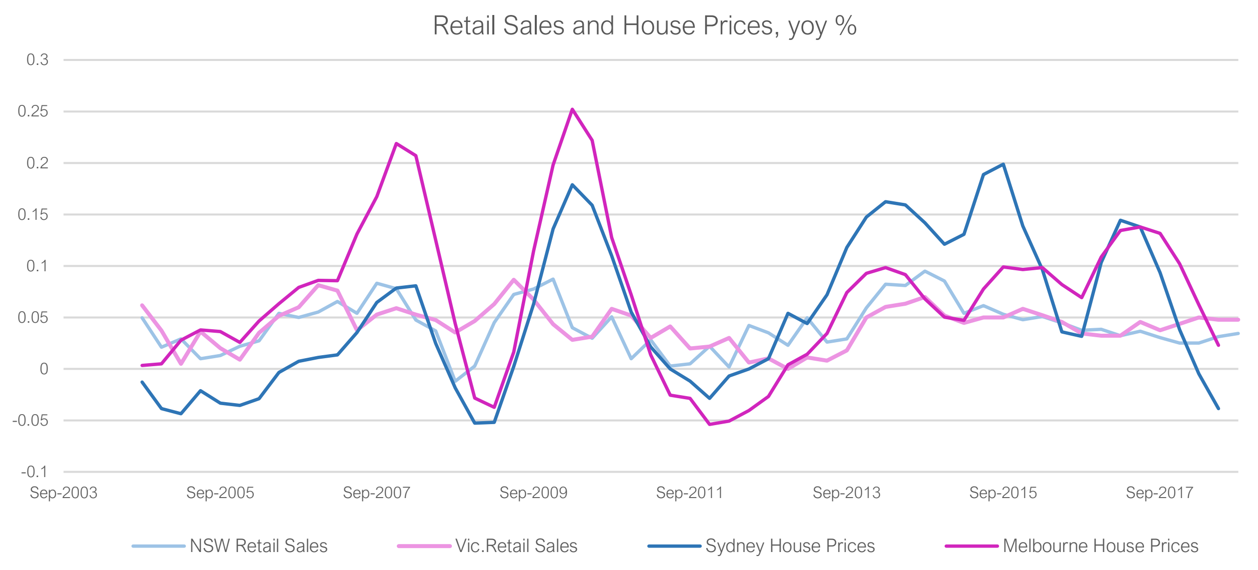
The figures shocked many since the general narrative from both the Federal government and the press had been positive; employment, wages, trade and the Federal Budget were all seemingly exceeding expectations. However, some of the detail behind the headlines data reveals some weakness that tallies better with the GDP results. For example, headline unemployment is falling. But underemployment - the unemployment number that is left unadjusted by the participation rate - remains stubbornly high compared to other recoveries (see chart below).

Given the very high ratio of house prices to incomes, it is not surprising that there is some correlation falling prices and the retail sales numbers that came out on Thursday. However, retail sales did manage to post a 0.3% increase nationally, while house prices in Sydney and Melbourne are falling much more dramatically. Longer-term time series show that there is a general relationship. House prices are more volatile, most likely due to leverage. But it is perhaps a little too much to blame weaker retail sales on falling house prices and the “wealth effect”. Both house prices and retail sales respond to conditions in the labour market, as well as the availability and cost of mortgage finance. As they say, correlation does not imply causation.

We believe that the RBA is correct to suggest that high leverage in housing undermines the resilience of the Australian economy to an external shock. This week the RBA suggested further that a key risk is the unwillingness of banks to lend, but there appears little they can do to reverse this through policy. Together, this has pushed general expectations that interest rates will remain on hold out to the end of 2019, with a very small number of economists now calling for a cut.



Source: ABS, Bloomberg, 8st December 2018

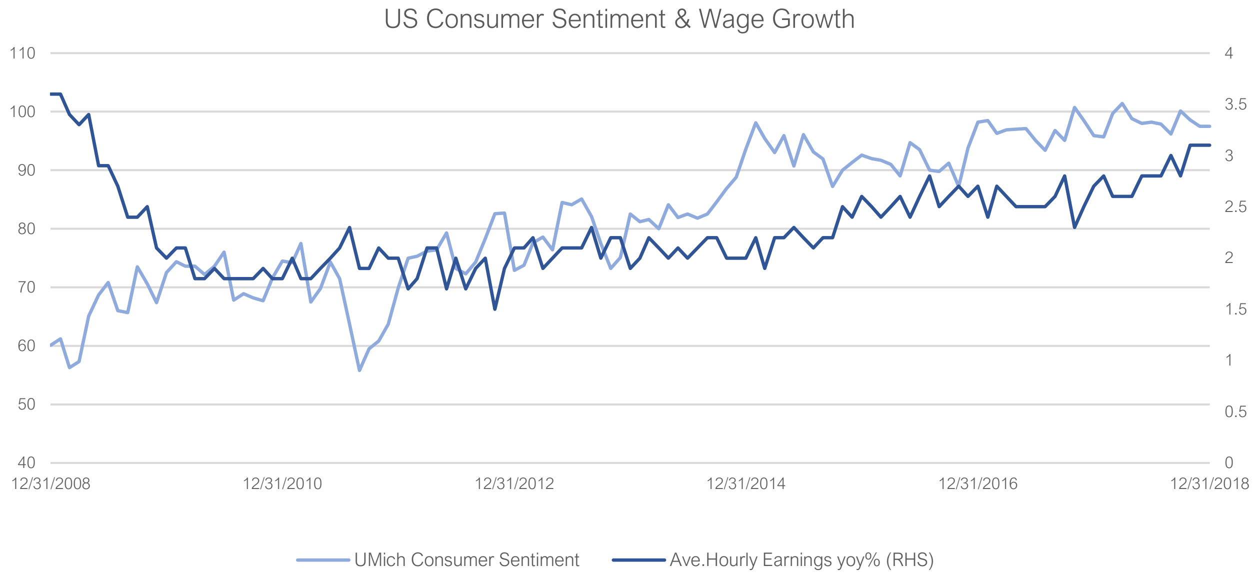


Source: ABS, 8st December 2018

The logical question for Australians is perhaps then "what chances of an external shock". Much fuss was made this week about the flattening of the US yield curve. But we believe that the fears are overdone.

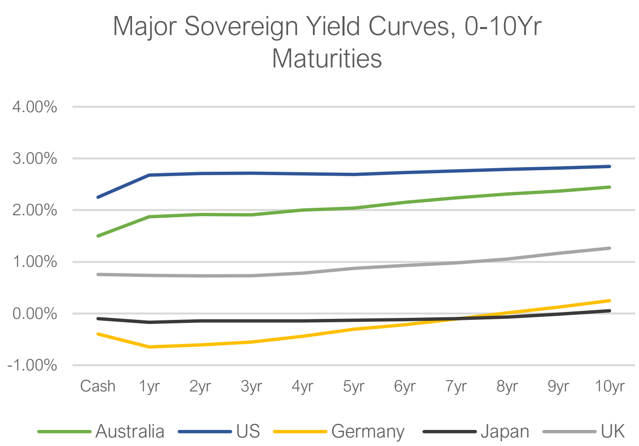
US economic growth remains very robust. 3rd quarter GDP growth was 3.0%, against 2.3% a year ago. Friday's labour report showed that 155,000 were added to the US economy in November. Unemployment held firm at 3.7% and, in contrast to Australia, the unadjusted underemployment rate has come down from a high of 17.1% in 2010 to 7.6%.

Average hourly earnings are growing at 3.1% yoy and tending to rise. Looking forward, consumer sentiment is close to the highs of the cycle and businesses are continuing to invest significantly in inventory to meet expected future demand. So why the doom and gloom?



Source: University of Michigan, Bureau of Labor Statistics, Bloomberg, 8st December 2018

Markets appear to be focussing on the 2yr-10yr spread, rather than the entire curve. The shorter end is upward-sloping, suggesting that shorter-term inflation risks are to the upside. But given the fact that the Federal Reserve has raised rates from 0.25% to 2.25% and inflation is still incredibly benign, the market is now beginning to believe that lower inflation may be more structural than cyclical. If labour markets can be this tight, and wages grow at over 3%, how come there is no inflation? The Fed appears to be asking the same question. In essence we can see from longer-term pricing that inflation expectations beyond 5yrs into the future have come down quite sharply in recent weeks. Lower inflation expectations imply higher real yields at the long-end of the curve. In other words, long-term yields begin to look very attractive after factoring in inflation, and investors begin to buy long-dated bonds, hence the flattening. The key is that the curve is not inverted. So, to infer an imminent recession seems a little too much.



Relative pricing is also important. Comparing the US curve to other major sovereign curves, US yields are significantly higher. German and Japanese yields are even negative up until 8yrs and 10yrs into the future respectively.

Rising wages in the US, on the other hand, are beginning to cause concerns for profit margins – a major contributor to equity market volatility. Investors would need a good reason not to own some US Treasuries in the current market.

For Australian investors, the yield curve also offers opportunity. Inflation risks are well-contained here too, while the upward slope offers additional roll yield. Trimming some equity risk in portfolios in favour of US and Australian bonds seems very sensible.

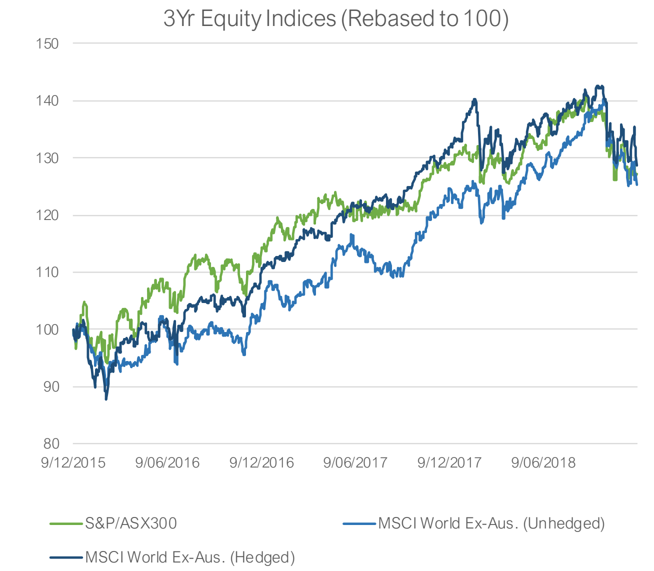
Source: ABS, Bloomberg, 8st December 2018

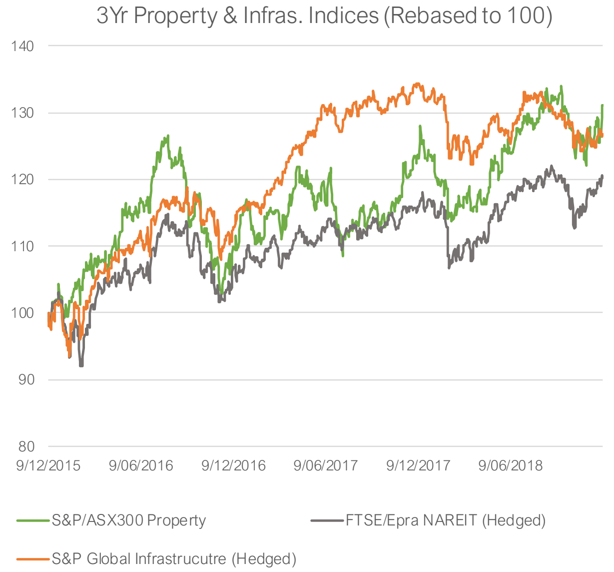
OPEC agreed to cut oil production cut by 1.2m barrels a day on Friday. The oil price initially rallied 5% but fell back to a more modest gain as it became apparent that supply is unlikely to tighten in the global market until late in 2019.

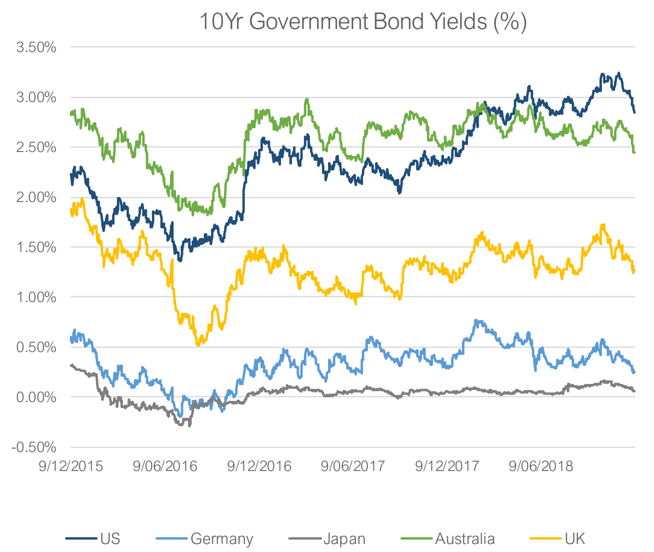
Lastly, next week sees the UK Parliament vote on the Brexit deal. As it stands, Theresa May has already lost two preliminary votes in the House of Commons. The deal is far from certain to go through, meeting resistance from both Remainers and Brexiteers alike. A failure to secure Parliament's approval on Tuesday would leave no clear future path. Given London's position in financial markets, such a result would have necessary consequences. It is difficult to determine what that might be, since the market is probably expecting the deal not to go through. A knock to the pound looks inevitable. Some spill-over into global equity market volatility, perhaps. But given that risks are tilted towards failure, it might be that the bigger moves follow a surprise passing of the bill. The contents of the deal are quite nebulous. There is much talk of future aims and cooperation, with relatively few concrete provisions to point to. The one area of clarity appears to be, ironically, a solidifying of the terms of the future trade relationship. Many Brexiteers are up in arms that leaving the arrangement included in this deal would be harder than leaving the EU in the first place. But for that same reason, a passing of the bill would almost certainly be well-received but the market. Even though the whole concept of the UK leaving the EU might be economically negative, accepting the deal would offer more certainty than the market currently expects, and a basis for avoiding the worst economic scenarios. The UK vote is likely to dominate the headlines in the northern hemisphere this week.

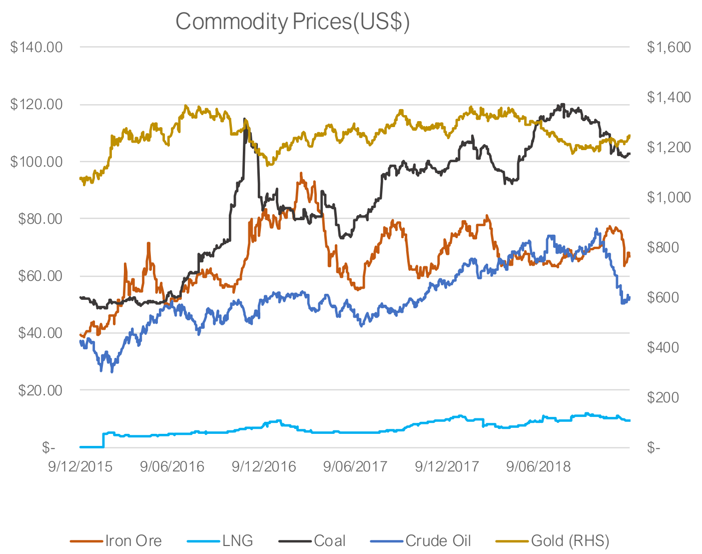
Significant Upcoming Data:

	Monday	Tuesday	Wednesday	Thursday	Friday
Australia	Home Loans	NAB Business Confidence/Conditions, ANZ Roy Morgan Weekly Consumer Confidence	Westpac Consumer Confidence		CBA PMI
US	JOLTS Job Openings	NFIB Small Business Optimism	Mortgage applications, PPI, CPI		Retail Sales, Industrial Production, Capacity Utilisation
Europe	Industrial Production - UK, Italy, Finland, Greece; Swiss unemployment	German ZEW survey, UK Unemployment, UK Parliamentary Vote on Brexit deal.		ECB Meeting, German French CPI	Finland, Spain - CPI
Japan	Q3 final GDP	Money stock, Machine Tool Orders	PPI, Core Machine Orders		Tankan Survey, Nikkei PMI, Industrial Production, Capacity Utilisation
China	China Trade data				Retail Sales, Industrial Production, Fixed Asset Investment









Source: Bloomberg, S&P Dow jones, MSCI, FTSE/EPRA, 8th December 2018

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