	Price	5 Day % Change	3 Month % Change	1yr % Change
S&P/ASX300	57,353	-1.38%	-8.87%	-2.64%
MSCI World Ex-Aus. (Unhedged)	8,765	-0.51%	-9.93%	1.96%
MSCI World Ex-Aus. (Hedged)	1,573	-0.85%	-8.94%	-3.72%
Bloomberg AusBond 0+ Composite	9,466	-0.08%	1.16%	3.43%
BloombergBarclays Global Agg. (Hedged)	981	0.15%	0.87%	0.74%
S&P/ASX300 Property	49,099	-1.45%	-3.08%	3.06%
FTSE/Epra NAREIT (Hedged)	2,588	-1.34%	-1.64%	1.31%
S&P Global Infrastructure (Hedged)	4,712	0.58%	-2.07%	-4.71%
BarclayHedge Global Hedge Fund Index (USD)	5,562	N/A	-3.58%	-1.23%
AUDUSD	0.7172	-0.50%	0.27%	-6.44%
AUDEUR	0.6346	-0.24%	-3.01%	2.57%
AUDGBP	1.0557	-0.69%	3.43%	3.99%
AUDJPY	0.5703	-0.79%	-4.01%	0.08%
AUDNZD	81.3480	-0.17%	-1.47%	5.91%

Source: Bloomberg, S&P Dow jones, MSCI, FTSE/EPRA, Barclays, 16th December 2018

Equity markets continued to trade softer last week. There is no doubt that sentiment is depressed. But it is less clear to what extent this might be justified. This week we discuss some of the reasons behind the current weakness in global share markets, covering main the economic, political and central bank news. Coming up, the Federal Reserve will take centre stage on Wednesday night.

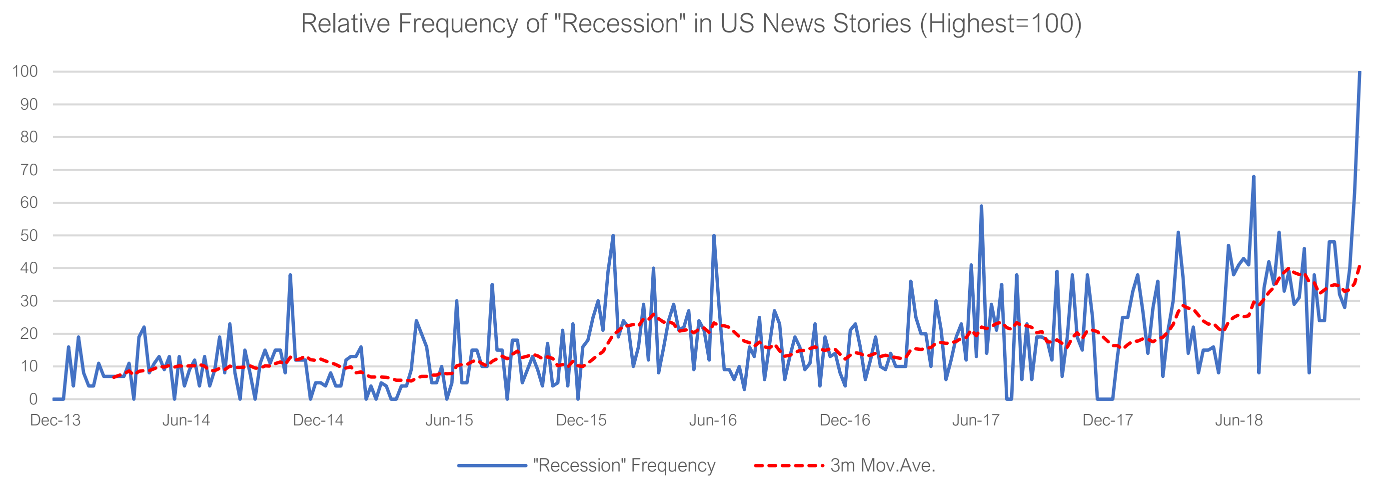
Source: Bloomberg, MSCI, 16th December 2018

US economic data this week was generally good. Monthly retail sales growth exceeded expectations at 0.2% with the prior month also being revised up from 0.8% to 1.1%. Industrial production – which is highly correlated with equity revenues and profits - was positive. Companies also continue to increase inventory to meet demand and job openings are rising. Capacity utilisation is close to a 3yr high.

Friday's data out of China, the world's second largest economy was less positive. Yet slowing of growth was broadly in line with the multi-year readjustment that is taking place. Even if the data was a shade weak, industrial production is still growing at 5.4% yoy, and retail sales at 8.1% yoy. Fixed asset investment, fuelling commodity imports from Australia, slightly beat expectations at 5.9% ytd, yoy. Holders of Chinese and Australian assets should be encouraged by the readings. For the highly cyclical German economy that has strong trade links with China, the Chinese figures are showing up as a more pronounced industrial downturn, with other European nations not affected to the same degree.

Given that growth in the rest of the world is predominantly slowing, the focus on the US has intensified. The US tends to lead the global economic cycle in terms of economic growth, in terms of monetary policy, and in terms of stock market performance. If the world's largest economy were heading into recession, it would have major implications for stock prices. Capital Economics now place the chances of US recession in the next 12-18 months at roughly 30%.

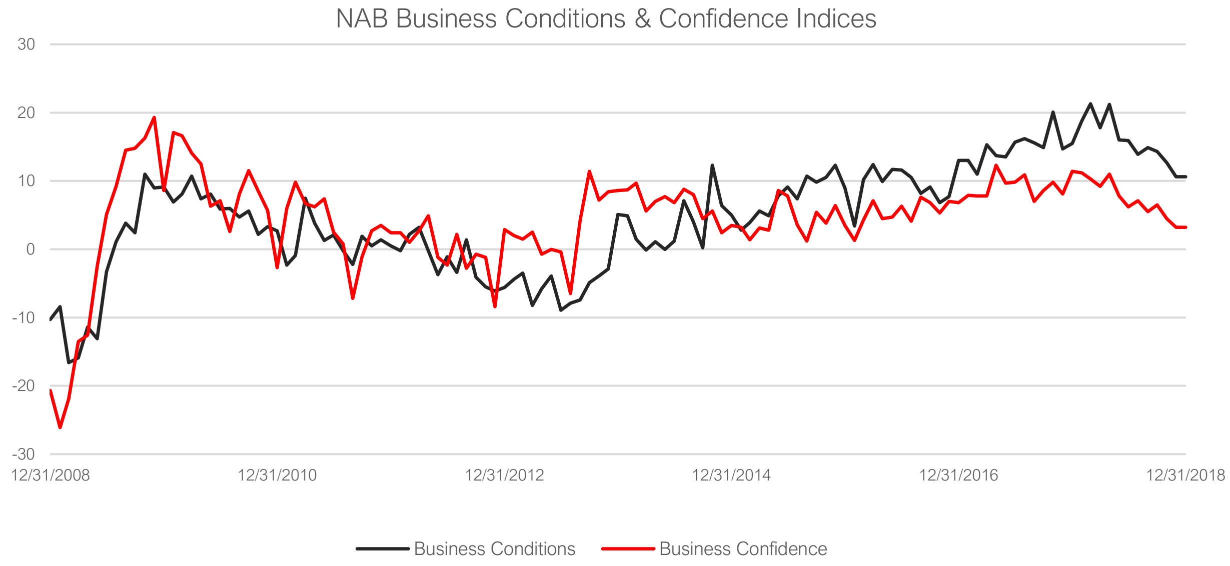
The chart below shows the relative number of times the term "recession" has been mentioned in US news articles over the last three years according to Google, clearly illustrating the recent rise in frequency. To a large extent, the news stories have been driven by the flattening to of the US yield curve. But an impending recession is not the only possible interpretation of the shape of the curve.



Source: Google Trends, 16th December 2018

Fund flows data out of the US show that holders of equity and corporate debt funds are switching some holdings back into cash. The Federal Reserve has increased the attractiveness of cash deposits and, as the earnings effect of tax reform fades, it would be perfectly sensible and logical for investors to take profits after such a long bullish streak. As previously noted, long-term inflation expectations have also fallen and increased the attractiveness of long-dated bonds. It would be very sensible again for investors to increase allocations to Treasuries to benefit from higher real yields. Given rising economic uncertainty, a better interpretation might therefore be that risk premia are rising, and investors are attaching more reasonable valuations to securities (as we believe). If so, this is a positive development in terms of the outlook for future returns.

Recessions are very difficult to predict. The data listed above are all examples of coincident data; data that indicate what is happening right now. GDP and inflation are lagging indicators that give a picture of the economy several months ago. To forecast the future direction of the activity, economists look to leading data such as the grants of building permits, loan approvals and confidence surveys. The NAB business conditions and confidence surveys released this week in Australia illustrate some of the difficulty. The forward-looking confidence survey tends to lead the current conditions survey, but it also tends to overshoot and show some volatility. This can reduce the predictive power, especially around turning points where you would look for signs of recession.



Source: Bloomberg, NAB, 16th December 2018

The current readings suggest that economic sentiment is weak in Australia, as well as equity market sentiment. This might be for a number of reasons, including falling house prices in Sydney and Melbourne, disappointing GDP figures, and softer energy export prices.

Politics also influence confidence. We are now certain to have an Australian general election within six months, and very likely a change of government. In other large economies, we are also at a point in the election cycle where domestic political mandates are weakening. Consider for example, the loss of House to the Democrats in the US, Merkel's decision to step aside before the next election in Germany, and the Gilets Jaunes protests in France. The court decision to overturn Obamacare on Friday, as well as disagreement over the border wall and the partial government shutdown, is likely to harden relations with the White House when the new Congress resumes in January. This will pose a serious obstacle for the President's agenda.

As domestic political mandates have been undermined, one consequence may have been a more conciliatory tone to international politics. China and the US are talking. China resumed purchases of US soya beans this week. But it is perhaps too early for markets to rebound decisively.

Theresa May in the UK is one leader that has bucked the trend. She has of course agreed, like Angela Merkel, not to lead her party at the next election. But in the intervening period she has consolidated her party mandate. On the surface, the cancellation of the Parliamentary vote on the Brexit deal this week might have appeared to be a humiliation. But the vote of no confidence that followed exposed the lack of support for the hard-line Brexiteers in her party. Boris Johnson and others cannot challenge her leadership for another twelve months and the hard Brexit avenue may have been closed off once and for all. The Prime Minister is in Europe this weekend, attempting to engineer further concessions for a Brexit that looks increasingly likely to have more "remain" than "leave" features. It is even reported in the Sunday Times today that some Conservatives are now pushing for a second Brexit referendum. Since the ECJ ruled this week that the UK is free to revoke the Brexit decision with little formality, that possibility looks much more likely than it did two weeks ago. We do not expect this saga to end anytime soon.

With mounting economic and political uncertainty, the most important question becomes whether Central Banks continue to tighten liquidity. Recent speeches from the RBA indicate a definite "no" in Australia. The ECB this week stated that the economic risks have shifted to the downside, but nevertheless decided to end its program of balance sheet expansion. Importantly, however, principal redemptions will continue to be reinvested and the balance sheet reduction will not begin until after interest rates begin to rise, in September 2019.

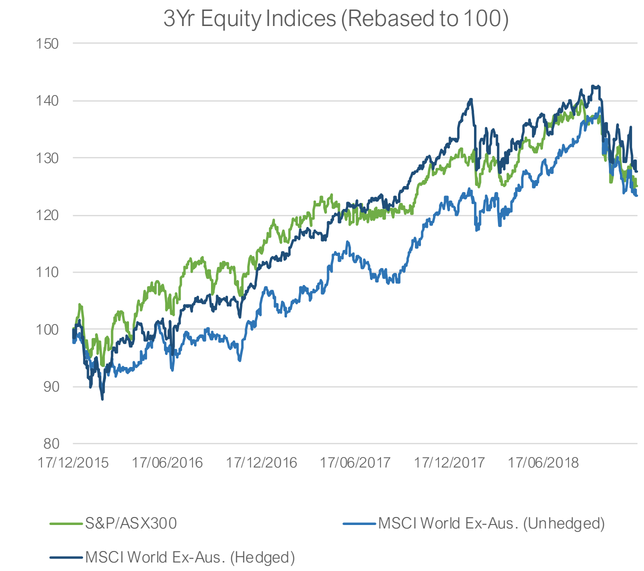
On Wednesday the Federal Reserve will hold one of the most eagerly awaited meetings for several years. Current expectations are for the Federal Reserve to raise rates by a quarter point to 2.25%-2.5% (72.4% chance[1]) or leave rates on hold (27.6% chance[1]). The market is likely to attach much greater importance to the accompanying statement. If the Fed indicates a pause in the tightening cycle in 2019, there is a good chance that the market could rally several percentage points. But market expectations probably lean in that direction, so if no pause is indicated, or we return to data-driven assessments, we expect more volatility. January is already often a volatile month. Christmas shopping figures are important, weather patterns can influence northern hemisphere economic activity, and the US earnings season begins in the middle of the month. If the Fed indicates further tightening, we should expect a major sell-off in equities, but given the movements in the yield curve, this last scenario appears to be the least likely of the three.

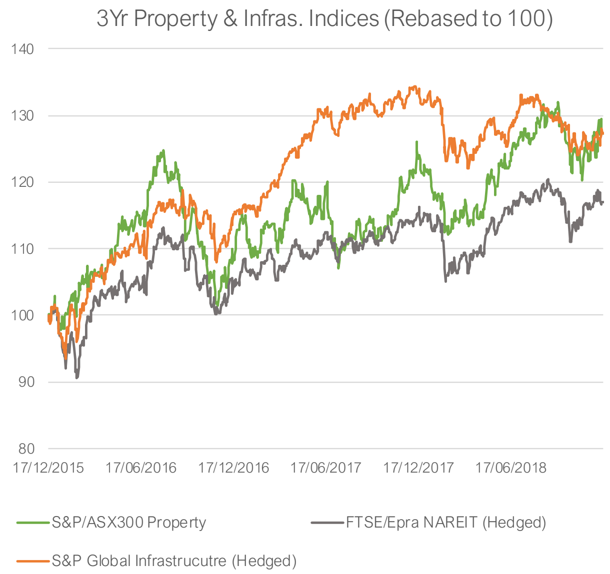
There is a fully-charged calendar of data this week. The importance of the Fed ensures that we will continue with another update next week, but we hope that everyone is enjoying the Christmas season and getting ready to enjoy the break.

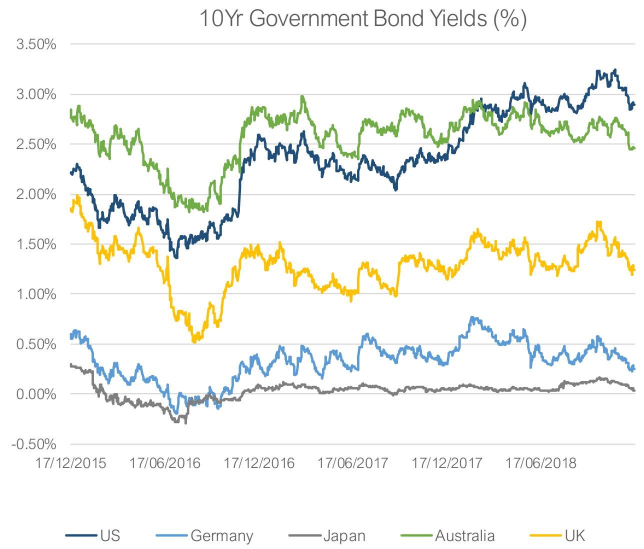
[1] Bloomberg, 16th December 2018

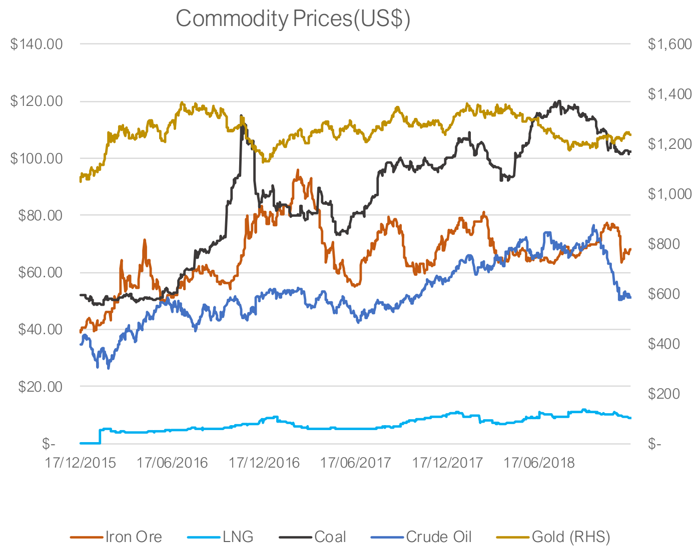
Significant Upcoming Data:

	Monday	Tuesday	Wednesday	Thursday	Friday
Australia		**RBA Minutes**, ANZ Roy Morgan Weekly Consumer Confidence	Westpac Leading Indicators	**Employment data**	
US		Empire Manufacturing	FOMC Rate Decision, Housing Starts, Building Permits, Mortgage Applications, Current Account, Existing Home Sales	Phili.Fed Survey, Leading Index	Durable Goods, Consumer Spending, PCE Inflation, UMich Consumer Sentiment, 3rd GDP estimate Q3,
Europe	**Eurozone Trade and CPI**	**German IFO survey**	UK CPI	**Bank of England Meeting,** Riksbank Meeting, ECB Current Account, UK Retail Sales	**Eurozone consumer Confidence**, French and Italian Manufacturing Confidence,
Japan					**CPI**
China					









Source: Bloomberg, S&P Dow jones, MSCI, FTSE/EPRA, 16th December 2018

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