Biggest election fear? A slowdown

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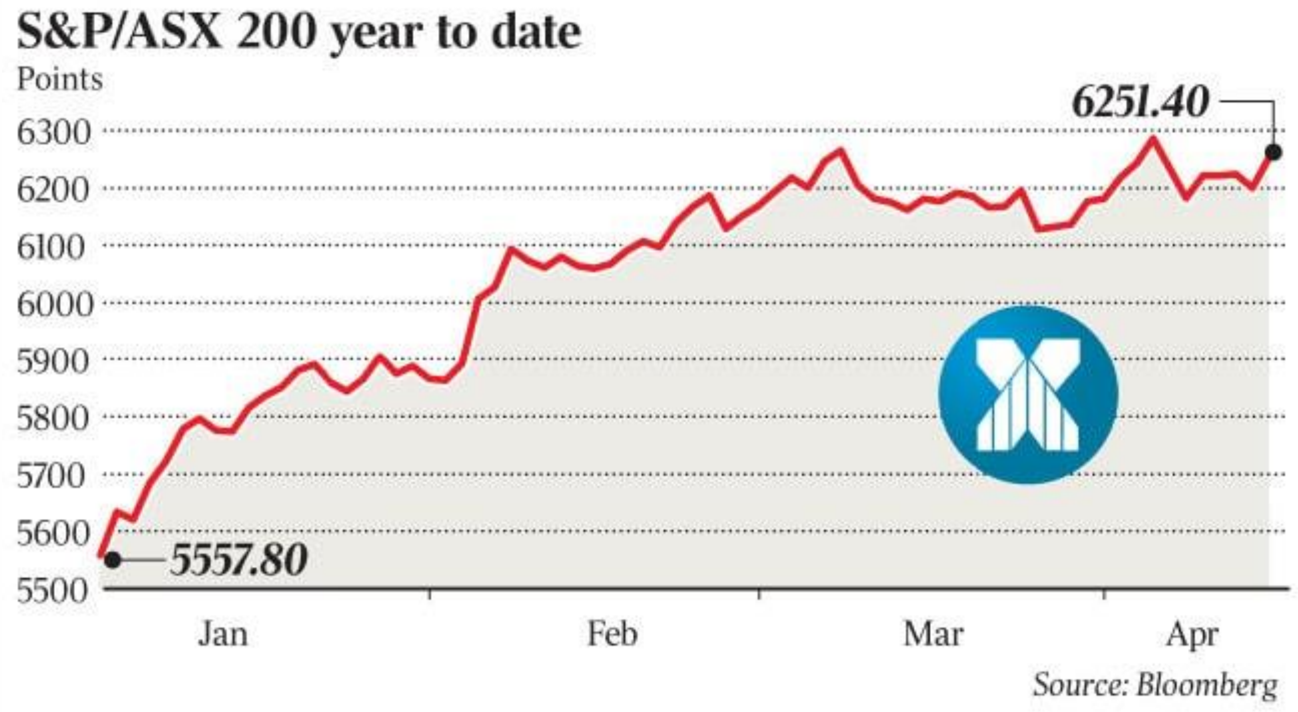
As the federal election draws nearer, potential tax changes have become a dominant point of discussion. However, it seems the biggest concern of all is that potential increased layoffs, when combined with a reduction in hiring based around the cost of labour, could have a significant effect on our overall economy.

In Australia, we have averaged 2.7 per cent growth over the past decade. If there is a slowdown, the economy may slow by more than most analysts anticipate. For 2019, they suggest we will see a below-average growth rate of 2.4 per cent — also well below global growth of 3 per cent.

I believe a US slowdown is more likely to gain momentum than not and therefore this is of concern — particularly for equities markets post the northern summer.

Bond markets are the canary in the coal mine. Traditionally, they have been a leading indicator for growth. While equities have had a spectacular start to 2019 here and overseas, bond markets are flashing concern. Yields on longer-dated US Treasuries are falling below those of shorter-dated Treasuries — the so-called inverted yield curve.

The yield curve has inverted ahead of every US economic slowdown in the past 50 years except for 1998. On every one of these occasions except 1998, the S&P 500 also fell in the preceding 12 to 18 months.



While I do see a pronounced slowdown in the US economy, I do not see a recession. Yet Australia is in a different situation and this, together with the potential political uncertainty that will come from new and untested policies, is keeping me up at night.

What's more, though markets generally ignore changes in government, this time the change on the political front might also exacerbate a decline for an already fragile macro environment in the domestic economy. The combination of the tax changes that will dampen consumption and overall investor confidence combined with increased costs for business is not sustainable.

Falling house prices as a theme has been well covered in recent months. They are not only weaker in the major markets of Melbourne and Sydney, but this week Moody's Analytics projected total price decreases for 2019 of more than 10 per cent in Melbourne and 9 per cent in Sydney. Meanwhile, dwelling approvals are off more than 28 per cent over the year.

Heuristic Investment Services research points to weak approvals data and a 5-10 per cent decline in residential construction over the next 12-18 months. Their research points to this at 6 per cent of GDP — it is a significant headwind.

It's not all doom and gloom, however. The strong performance of the equity market is continuing despite the ongoing weakness in the housing sector and the risks associated with the economic outlook.

Moreover, the Reserve Bank could well cut rates later this year to support a slowing economy. On February 7 it opened the door to cutting rates further, with the dollar experiencing its steepest one-day fall since August. Notably, the RBA has held its cash rate steady at 1.5 per cent since August 2016, and most economists are forecasting a further cut this year, which will also put downside pressure on the dollar.

Markets are now pricing in the prospect of a rate cut this year as the weakness in housing and concerns over high household debt levels and continued low wages growth is compounded by a more uncertain global outlook. Until recently, the correction taking place in house prices occurred against a backdrop of strong global growth. That view, too, is now being challenged.

This means asset allocation and respecting the economic cycle is more important than ever.

The election result next month will most probably result in a change of government and that may trigger a short-term reaction in local equity markets. Savvy investors know that reactions — both positive and negative — don’t last. Cycles mean that neither falls nor rises are forever and keen observers know to never trust a forecast that illustrates a straight line. As a result, whatever the second half of the year holds, the sensible investor must always keep that in mind.

I will continue to reduce exposure to equities in any rallies during the remainder of the year. (In other words, think about moving in the opposite direction to the pack.) It’s not about stock or bargain picking so much as about developing and maintaining a sound investment strategy — particularly when it comes to the highly popular asset class: Australian equities.

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