View from the hill

JULY 2018

Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **30 June 2018.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	3.3	8.5	13.0	9.0
Smaller companies	1.1	7.7	24.3	15.0
International shares (unhedged)	2.3	5.5	15.4	10.0
International shares (hedged)	0.3	3.6	11.5	9.8
Emerging markets (unhedged)	-1.9	-4.5	12.3	7.0
Property – Australian listed	2.3	9.8	13.2	10.0
Property – global listed	2.7	8.0	5.8	7.6
Australian fixed interest	0.5	0.8	3.1	3.4
International fixed interest	0.2	0.2	1.9	3.8
Australian cash	0.2	0.5	1.8	2.0

Overview & Outlook

Equity markets generally traded sideways as investors became more sanguine about geopolitical issues despite the trade-war concerns increasing sharply toward month-end and into July. The MSCI World ex Australia Index was up 0.3% (hedged), following a gain in May of 1.3%. This brought annual returns to 11.5%.

While several of the political issues that had been worrying investors for the past few months continued into June. Trade tensions ramped up over the quarter as steel and aluminum tariffs were imposed on Europe, Canada & Mexico and met with retaliatory tariffs on sensitive U.S. exports. A tariff of 25% will be applied to USD 34 billion of Chinese imports from 6 July, and Chinese authorities are expected to implement tariffs on an equivalent value of goods imported from the U.S.

The risks of a full-blown trade war increased during the month, with both the US and China threatening a cycle of counter-retaliatory measures; increasing the risk of an escalating tariff spiral. The US also increased its negative rhetoric with Europe, threatening to impose tariffs on European automotive imports which saw a sharp sell-off of European car and part maker shares from late May. Despite these concerns US economic data remains positive overall, with very low unemployment figures and supportive personal spending growth, improving business conditions, high consumer confidence and the US dollar remains strong.

The emerging economies are vulnerable to the current situation where the US dollar is strong and there are rising interest rates and oil prices, and in particular those with large current account deficits and high external funding requirements, such as Turkey and Argentina, have come under significant pressure reflected in sharp falls in both currencies and equity markets. Further interest rate rises from the Fed or a higher U.S. dollar could apply more pressure to those weaker emerging economies with the emerging market index off 16.6% since late January. However, investors have shown the ability to distinguish between those economies that are more or less vulnerable as opposed to treating the emerging markets as a single asset class, resulting in not all emerging markets registering declines. For example, Indian equities were higher over the quarter.

Chinese equities have been amongst the worst hit with the sell-off of the onshore Shanghai Composite Index recording a 20% decline from the peak. The weakness in China is not just about trade, as economic data has been softer than expected, thanks to tighter monetary and fiscal policies. The near-term pain is a symptom of the longer-term goal of financial stability and reduced leverage in China's financial system.

Markets will be driven by developments with respect to how the trade tariff situation progresses and earnings reports by US corporates for Q2 which will start toward the end of July. Also, critical will be further data that gives an indication of the outlook for US inflation and thereby bond yields.

Share markets

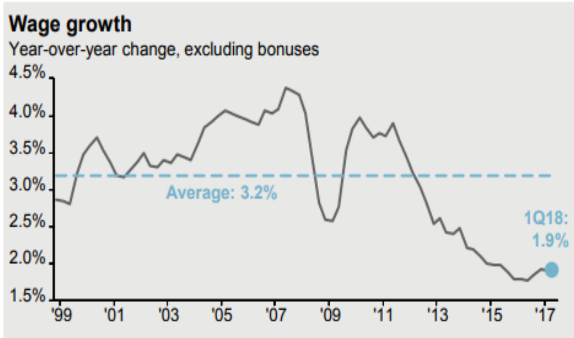
The ASX 200 Accumulation Index had strong June, up 3.3%, driven by very strong increases in the Energy sector up 7.7% as oil prices (WTI crude, the market benchmark prices) rose 10.6%. Equities also benefitted from the earnings kicker to exporters of a 2.2% decline in the $A against the $US over June. Telco's were the worst performing sector, due to a sharp decline in Telstra, which lowered market profit expectations for FY19. Notable has been the market's rotation into the high-yielding banks, which had fallen to levels not seen since 2016 and this saw the Financials (+4.1%) bounce. The strong run in the Australian equity market has pushed valuations higher. The forward price-to earnings ratio for the ASX 200 was 15.7x at the end of June, above its long-run average of 14.2x.

For the 12 months through June (FY18), the market had a strong year with the S&P/ASX 200 Index rising 13%, including dividends. The Telco sector was the worst performer of the fiscal year, dropping -34.9% with Energy (+38.2%) the strongest performer. Strong returns were also posted by Information Technology (+29.5%), Health Care (+25.4%) and Materials (+25.2%). The common thread among the best performing sectors was the expectation of strong earnings growth in a market where most companies were struggling to deliver earnings growth much above 5%. Utilities (-5.7%) and Financials (-3.9%) were the only other sectors in the red.

Interest rates

In Australia, cash rates continued at 1.5%. The RBA appears unconcerned about the rising risks of a trade war and has concentrated more on domestic fundamentals. A range of factors including stronger legislative restrictions on foreign buyers, rising levels of housing supply and perhaps most importantly tighter bank lending criteria for investors, buyers wanting interest-only loans and buyers with low deposits have all acted to reduce house price growth with Sydney and Melbourne recording price declines, albeit marginally. This is the first annual decline since October 2012 and the RBA has never had a set of circumstances in which rates were raised in the face of falling house prices in the two major capital cities.

In evaluating the factors that are being considered by the RBA accelerating business investment, both mining and non-mining, booming infrastructure spending and continued strong growth in export volumes are factors acting against a rate cut, while a peak in housing investment, weak consumer sentiment and high personal debt levels, allied with continuing low wage growth (see chart below) and inflation, point to a rate cut. The length of time since the last rate move allied with the neutral stance in the commentary of the RBA Minutes indicates the fine balance in these factors. The RBA appears comfortable to wait for a clear change in conditions prior to raising rates. Notably some commentators are now forecasting the first rate hike to only occur in 2020 with markets pricing in a rate hike in late 2019.



Source: JP Morgan Asset Management

In the United States a strong economy gave the Federal Reserve the confidence to raise interest rates again in June and signal two further hikes to come this year, followed by three more next year. Clearly the US has moved to rate hiking cycle that is aggressive compared to other major economies. This factor, combined with the move of $US back into the US by corporates, are the two major factors supporting the US currency and pressuring the $A.

Beyond the cash rate, Australian 10-year bond yields fell 4 basis points over the month to 2.63% in the absence of any significant new data however it was likely triggered by a flight to safety mentality as investors looked to reduce risk as trade war rhetoric increased. US bonds were unchanged at 2.86% but off recent highs of 3.05% in mid-May and then continued their decline into July. Investors appear to have shaken off concerns of a move to much higher bond yields, driven by fears of higher inflation and the sale of bonds to fund the Federal Budget deficit, at least in the short-term.

Property

The Australian AREIT sector continued its strong run in June, up 2.3%, largely due to dividend payments as opposed to higher share prices. The sector continued its rally in July up a further 1.7% by July 6th. The ongoing decline in long bond yields and solid rental conditions continued to support the sector. It is interesting to note that the US REIT sector has also rallied strongly since a recent low in late March to be up 13.7%, supported by the same factors as those noted above. The recent strength in the REIT sectors may be indicative of investors moving to the view, that at least in the short-term, fears of much higher bond yields have ameliorated and therefore the sector offers value, given the current buoyant rental conditions.