View from the hill

NOVEMBER 2018

HILLROSS

Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 October 2018.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-6.1	-5.9	2.9	8.3
Smaller companies	-9.6	-7.7	2.6	10.5
International shares (unhedged)	-5.4	-0.9	9.6	8.2
International shares (hedged)	-6.9	-4.7	2.4	9.2
Emerging markets (unhedged)	-6.8	-7.3	-5.4	6.8
Property - Australian listed	-3.1	-2.1	7.3	7.4
Property - global listed	-2.6	-3.0	3.3	4.2
Australian fixed interest	0.5	0.9	3.1	2.9
International fixed interest	-0.2	-0.3	0.2	2.9
Australian cash	0.2	0.5	1.9	1.9

Overview & Outlook

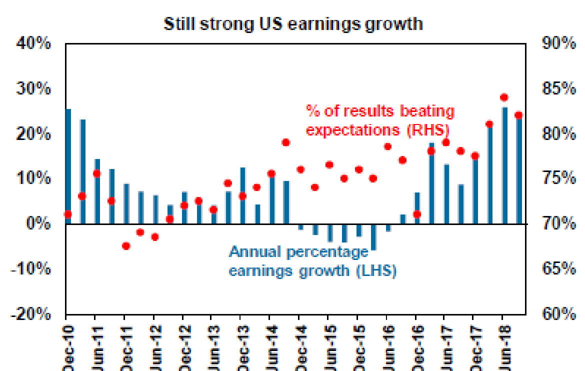
"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February." Mark Twain, Pudd'nhead Wilson. Firstly, we don't speculate and yes October was a poor month for investor returns but longer-term returns remain robust.

Concerns around slowing economic growth, Trump's trade wars and the outcome of the November US midterm elections as well as increasing interest rates from the US Fed all weighed on the market. With their stretched valuations, the brunt of the fall was seen in Tech stocks as the NASDAQ lost nearly 9% over the month.

While Trump said in an interview with the Wall Street Journal, "We don't even have tariffs. I'm using tariffs to negotiate." He has tweeted, "Billions of dollars are, and will be, coming into United States coffers because of Tariffs." This is also wrong as the tariffs are paid by the importers i.e. Americans not the Chinese so there is no new money coming into the US, just increased costs to the importing corporates in the US. To what extent these additional costs are passed onto consumers will depend on a range of factors but they either reduce the profit of the corporate or increase the cost to consumer or a combination of the two if not fully passed on.

Trump has imposed tariffs on $250 billion in goods from China, about half of all Chinese imports. He has also imposed tariffs on other products including steel and aluminium from Canada and other countries, and these tariffs range from 10% to 50%.

Adding to these geopolitical issues is the recent development where Chinese media has reported President Xi Jinping has told his military commanders to "concentrate preparations for fighting a war" as tensions continue to grow over the future of the South China Sea and Taiwan.



Source: Bloomberg, AMP Capital

The market weakness is despite the U.S. earnings season, which so far, has been strong. With over 80% of S&P 500 companies that have reported have been above analysts' earnings estimates driven by profit

margins that are exceptionally high. Higher input costs and slower economic growth may curb margins in the future and the outlook of weaker earnings into 2019 may be a factor weighing on sentiment.

Share markets

Australian shares (-6.1%) were a little better than global markets over the month driven by concerns mentioned above as well as declining house prices and political instability following the recent change in Canberra. The weakest returns were recorded in Info Tech (-11.2%), Energy (-10.5%) and Consumer Discretionary (-8.0%). The remaining sectors all lost ground to some degree with the highest return being in the Telco Services (-3.9%).

With weak building approvals and declining house prices there is potential for a negative feedback loop via the wealth effect to slow Australian economic activity which may be weighing on investors. There is a suggestion that the RBA may have to look to cut rates in the future.

Global equities (-6.9%) were weighed down by the general weakness in market driven by the Trump trade war with China and broader concerns in emerging markets. Emerging markets (-6.8%) were under pressure from a strong US dollar and slowing growth in China which has seen its slowest level of growth since the GFC. This was the worst month in emerging markets since August 2015 however with the forward price to earnings ratio around 10 times there does appear to be value in these markets.

While these types of market corrections are unpleasant for investors, they are normal. While the chart below doesn't show times before the GFC, these pullbacks did occur prior to the meltdown in 2008/09 from which we are still significantly impacted when we think of the monetary policies, government debt and central bank balance sheets around the globe.

Interest rates

Fixed interest markets struggled to provide the diversification benefits we look for with the broader global market down (-0.2%) for the month. However Australian fixed interest was able to rise over the month (0.5%) with government bonds and corporate bonds both contributing to the increase.

In Australia, inflation remains muted at 1.9% year-on-year, as such the RBA continues to maintain the cash rate at 1.5%. Australian Government 10-year Bond yields fell 5 basis points 2.62% and were steady at 1.93% for 1-year bonds with markets showing no concerns regarding inflation.

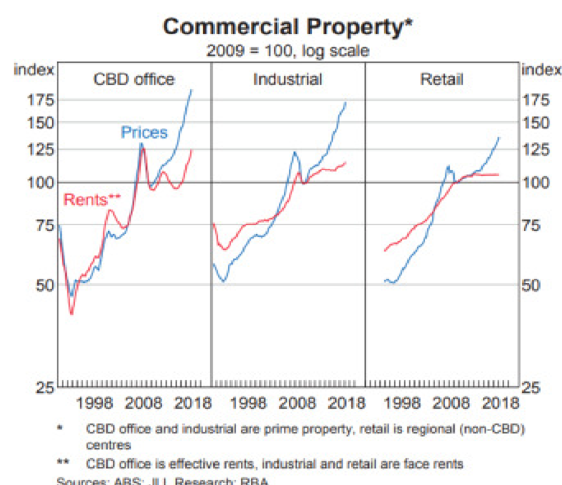
The US 10-year bond yields rose 9 basis points over the month to 3.16%. Inflationary pressures from US fiscal policy, tight labour markets, rising labour costs (3.1% wage growth y-o-y) and now potentially some impact from tariffs giving the US Fed little option but to continue to raise interest rates. Fed Chair Jerome Powell indicated that interest rates are "a long way" from neutral, and he said, "Interest rates are still accommodative, but we're gradually moving to a place where they'll be neutral," this is being played out in bond markets with yields continuing to rise.

With the increased indebtedness of global corporates, particularly those in the US, we continue to favour higher quality bonds. High-yield bonds spreads widened by 53bps in the US and 58bps in Europe and while now more reasonably priced, at this point in the cycle we would be cautious of investment in the sub-sector.

Property

Listed property markets have fared better than broader equity markets falling around half that of equities. Australian listed property trusts fell (-3.1%) while global real estate investment trusts declined (-2.6%).

Indications are that the underlying domestic commercial property continues to generate positive returns with industrial among the strongest sectors. Office continues to perform having high occupancy rate. The retail property sector remains challenged however the evolving makeup of the properties is providing some offset to that weakness. The 'experience focus' combined with dining and café offerings is helping to maintain significant foot traffic in shopping centres.



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