# View from the hill

## NOVEMBER 2016

## 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 2016.**

| Asset class (% change) | 1 month | 3 months | 1 year | 3 years (%pa) |
|---|---|---|---|---|
| Australian shares | -2.2 | -3.2 | 6.1 | 3.9 |
| Smaller companies | -4.7 | -4.8 | 14.9 | 4.4 |
| International shares (unhedged) | -1.4 | -1.4 | -5.4 | 11.9 |
| International shares (hedged) | -0.5 | 0.4 | 3.0 | 8.6 |
| Emerging markets (unhedged) | 0.8 | 3.9 | 2.5 | 5.4 |
| Property - Australian listed | -7.7 | -14.0 | 6.4 | 13.6 |
| Property - global listed | -5.4 | -9.3 | 4.4 | 11.1 |
| Australian fixed interest | -1.3 | -1.1 | 4.0 | 5.8 |
| International fixed interest | -0.9 | -0.8 | 6.7 | 6.6 |
| Australian cash | 0.2 | 0.5 | 2.1 | 2.4 |

## Overview & Outlook

At the time of writing the US election outcome was tending toward a Trump victory. If the vote is close there may be a call for a recount or the losing candidate may not concede defeat. However it does not matter from an electoral outcome perspective. It is Congress who certifies the electoral college vote and the candidates are not involved in this process.

Post-election markets will most likely turn to consideration of an interest rate by the US Fed. Most economists see a December rate hike as likely however there are a number of factors that make for a more muted market response than that of January/February this year.

First, the outlook for global growth has improved, as lower oil prices have boosted the global economy. Second, commodity prices have risen off their lows and are unlikely to be impacted by the poor supply/demand fundamentals and strong $US as was the case earlier. The higher commodity prices are adding confidence that profit growth in both the US and Australia has ended. Third, the increase in bond yields is likely to remain gradual, given low inflation. Fourth, while defensive yield equity sectors may see more downside, cyclical sectors are likely to strengthen with this rotation already evident.
The Fed's last meeting minutes also reinforced the impression that they are on track to hike rates in December. The minutes make reference to the fact that there are few signs of emerging inflation pressures. In addition, Fed Chair Yellen has made dovish comments regarding the case for allowing the economy to run hot for some time to help repair damage to the economy from the GFC. This statement contributes to the view that rates rises will be gradual.

What was also notable over the month was that there was some comment by Central banks that they were starting to have concerns around their current approach of very low rates and bond buying. Concerns have been voiced around the effectiveness of this policy as lower rates have not assisted the real economy but have been good for financial markets. In addition, the side-effects of this policy in terms of increasing inequality and instability of the financial system (as low rates and increased regulation have reduced bank profits) have also been criticized. It is likely over time that Central bank policy setting will become more aware of these issues.

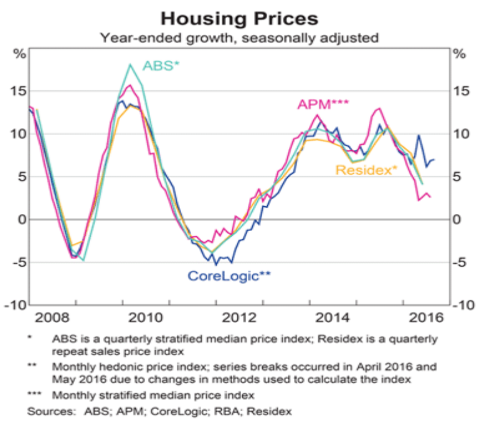
In Australia the RBA continues to hold rates at 1.5% p.a. The slightly higher inflation number for the September quarter at 1.3% p.a. and the stronger-than-expected Q3 economic growth is likely to see rates continue to remain on hold. The $A remains very strong around the US76c and the RBA is wary of putting more upward pressure on the currency through the market expecting higher domestic cash rates.

## Equity Markets

Global equity markets displayed little volatility over the month, and fell slightly (-1.4%, unhedged) as markets awaited the US election result and a potential Fed rate hike. US economic data showed an improving trend with jobless claims remaining very low while home sales and industrial production rose. The stronger tone of the economy and an uptick in inflation and oil prices, remain supportive of a December rate hike by the Fed. Although the path of projected rate hikes is likely to be gradual, due to soft wage growth.

In addition, the US September quarter profit reporting season has come in better-than-expected. It appears the trend of lower profitability for the S&P 500 has ended. Of the companies that had reported by end-October (299 companies) 78% had reported earnings above expectations and 59% had exceeded sales expectations. Profits are expected to be up 4% on the June quarter and above the 2014 high and driven by higher by sales growth.

The domestic equity market fell 2.2% over the month on the back of a range of issues including the back-up in bond yields, poor corporate announcements and a perception that the RBA's easing cycle was ending. Investor focus was on company AGM's and their updated earnings guidance. Another notable feature over the month was a sharp rally in some resource companies driven by significant increases in selected commodity prices (notably coal, where the price of metallurgical coal has more than doubled). Iron ore prices also remained firm. BHP and Rio rallied as did some of the focused resource companies e.g., Whitehaven Coal up 23.7%. Overall the materials sector was up 1.2%. Banks did well despite higher bond yields, though concerns remain round their exposure to the very strong housing market (see chart below) and their ability to weather a downturn should this occur. Mergers were also a theme as gambling companies Tatts and Tabcorp announced their intention to merge, pending regulatory approval.

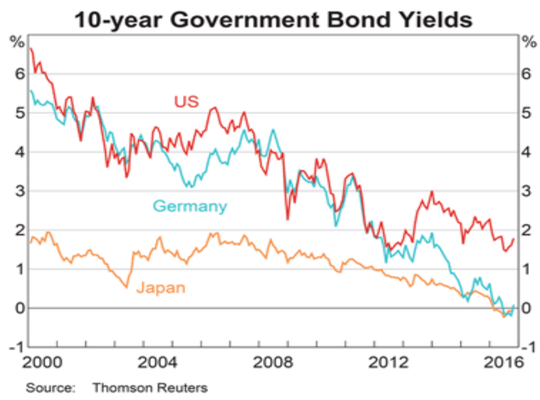



Source: RBA

Australian equities have been notable as relative under-performers, down 5% from their August high, while global peers have been range-bound reflecting the impact of higher bond yields on the domestic market. The reversal of the bond rally which had boosted the valuation of the higher dividend-paying Australian shares until mid-year, led to a sell-off of these stocks. The sell-off had significant impact particularly on the defensive sectors including Utilities (-5.3%), Infrastructure and AREITS (-7.8%). However further increases in bond yields are likely to be gradual in an environment in which inflation is still low and global growth remains weak.

## Fixed Interest

Most global 10-year bond yields rose in October, including in the US, were 10-year yields hit a six month high closing at 1.85%. In the UK yields rose very sharply, up 51 basis points to close at 1.26%. In the domestic market, the bell-weather Australian 10 year bond yield also rose sharply, up 44 basis points, to 2.35%. German and Japanese 10-year government bond yields followed the upward trend, ending the month at -0.04% and 0.17% respectively. The recent increase in bond yields is likely to continue as investors move to reflect the potential for some higher inflation and the view that Central Banks are more likely to reduce their intervention in bond markets over time, with the exception of Japan.




Source:RBA

## Property

The AREIT market fell sharply in October, falling 9.2%, following a decline of 4.3% in September. The sell-off was driven by the steep increase in bond yields and the overall volatility of the bond market. Notably the AREIT market was also the worst performing of all the global listed real estate markets. The higher bond yields saw investors pursue growth rather than yield strategies that prioritise income.