# View from the hill

**SEPTEMBER 2017**

## Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 August 2017.**

| Asset class (% change) | 1 month | 3 months | 1 year | 3 years (%pa) |
|---|---|---|---|---|
| Australian shares | 0.7 | 0.9 | 9.8 | 5.1 |
| Smaller companies | 2.7 | 5.1 | 3.2 | 5.7 |
| International shares (unhedged) | 0.8 | -3.5 | 10.1 | 12.1 |
| International shares (hedged) | 0.2 | 1.9 | 17.1 | 9.5 |
| Emerging markets (unhedged) | 2.9 | 2.7 | 18.0 | 8.2 |
| Property – Australian listed | 1.5 | -3.2 | -6.7 | 10.3 |
| Property – global listed | -0.1 | 1.4 | -1.9 | 7.7 |
| Australian fixed interest | 0.0 | -0.7 | -0.7 | 3.9 |
| International fixed interest | 1.0 | 1.1 | 1.0 | 4.9 |
| Australian cash | 0.1 | 0.4 | 1.8 | 2.2 |

## Overview & Outlook

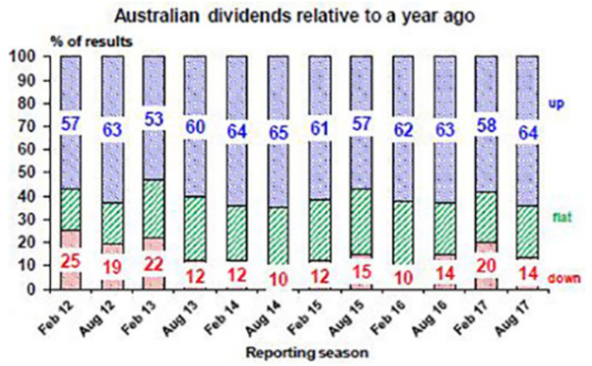
All asset classes recorded minimal change over August despite being impacted by a range of factors, both political and economic. Global markets dealt with increased turmoil in the White House, heightened political tension with North Korea and ongoing concerns that the US government may close toward the end of month if the debt limit was not raised. Domestically, key issues centred on the reporting season and ongoing political uncertainty for the government because of the “dual citizenship” issue. Offshore equity markets experienced a slight upward bias as investors continued to be impressed by the recovery in global growth and improved company profits. Bond markets were flat as inflation remained at very low levels with little indication of an uptick despite the growth environment.

The reporting season was enlightening regarding the outlook for both the economy and market sectors. Results created positive sentiment as profits and dividends are up, with 67% of companies reporting higher profits than a year ago while 64% increased dividends, which highlights the quality of earnings. Overall, earnings per share growth for 2016-17 where approximately 17.7%, a significant turnaround after two years of decline.

However, underlying the headline earnings were some concerning trends. The massive upswing in earnings was largely attributable to a 124% rise in resource sector profits. This is an impressive turnaround and the Resource companies have increased their dividends substantially to reflect this. However, profit growth, excluding Resources, is much more conservative at around 6%. In addition, only 39% of companies have surprised on the upside (which is less than normal and the weakest since 2013) and 31% of firms reported earnings lower than forecast. While the overall market was stable over the month there has been intense volatility with some very sharp declines in share prices for companies who disappointed (e.g., Domino’s, Telstra, Suncorp, QBE, BlueScope, Healthscope, Harvey Norman) either in terms of the result, outlook comments or dividends. This is attributed to PEs being relatively high when a significant amount of good news had already been factored in.

Other key themes from the reporting season include large caps outperforming small caps, constrained revenue growth with the domestic economy still not reflecting improved growth, housing construction still strong but mixed retail sales growth, some disappointment from foreign earners; dividends (ex-Telstra) (see the table over) continuing to roar ahead and indications of stronger business investment.

Earnings growth expectations for the current financial year have been revised down to 2.3%. Notably, profit growth for the market, excluding resources, is expected to remain relatively stable at around 4.3%.




Source: RBA

While profit growth of approximately 4% (ex Resources) is reasonable, this is less than rates in the US at 11% and in Europe and Japan at around 30% over more recent reporting periods. The differential in earnings growth over time partially explains the relative under-performance of Australian shares compared to international equities (see below). Expectations of a continuation of higher earnings growth offshore validates ongoing exposures to international equities.

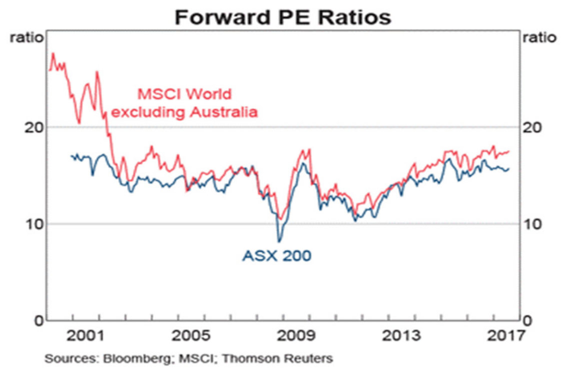

Source: AMP Capital

On global equity markets, the US S&P500 index ended the month 0.3% higher and 1.0% in Australian dollar terms, due to $A weakness. The MSCI World ex-Australia (hedged) rose 0.2% over the month as investors continued to factor in reasonable economic growth and higher corporate earnings.

## Share markets

The ASX 200 Accumulation rose 0.7% in July, but with a significant divergence in returns across the sectors. The market bounced off an Index low of 5690 five times and on the upside failed to break through 5800. Positive returns from Energy (3.0%), Materials (4.2%), Industrials (4.2%) and Staples (3.7%) contributed to market upside offset by weakness in Telco's (-9.7%), Insurance (-4.9%) and Banks (-3.4%). Telco's were impacted by the decline in Telstra which announced a dividend cut, while the insurers were pressured by weaker margins. Within Banks, CBA was notable as it fell 9.5% after it came under investigation by Austrac and APRA announced an inquiry into some of the banks' practices.

Australian stock valuations are still relatively high, with earnings multiples above the long-term average. This implies growth in corporate profits, which may be driven by commodities stocks. However, low wages growth and high levels of household debt are likely to constrain consumer spending, with retailers and the financial sector feeling the impact while the stronger $A will hamper exporter earnings.




Source: RBA

## Interest rates

In Australia, cash rates were held at 1.5% at the RBA's September meeting leaving rates unchanged for 13 months. Essentially, a rate cut is unlikely as RBA policy remains caught between strong business confidence and jobs growth, compounded by expectations for a growth pick up and concerns about reigniting the Sydney and Melbourne property markets. However, record low wages growth, low underlying inflation, the impending slowdown in housing construction, risks around consumer spending and the rise in the A$ argue against a rate hike. And so, the only logical option for the RBA is to leave rates on hold at 1.5% with this situation unlikely to change until late next year at least.

## Property

The Australian listed real estate market rose 1.5% in August with flat bond yields allowing investors to focus on earnings announcements. Mirvac, a large diversified real estate business recorded an 11% increase in earnings with strong forward guidance and set the tone for the sector. Three REITS announced new share buybacks and NTA's increased by 3.2%.

August saw reporting of the returns to unlisted property for FY2017 at 11.9% which included capital growth of 5.6% with valuations supported by the relatively attractive yields in the sector.