View from the hill

OCTOBER 2017

Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **30 September 2017.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-0.02	0.68	9.25	7.08
Smaller companies	1.31	4.41	2.98	8.15
International shares (unhedged)	3.44	2.53	15.38	11.82
International shares (hedged)	2.49	4.29	19.63	10.65
Emerging markets (unhedged)	0.68	5.47	19.43	8.78
Property – Australian listed	0.57	1.94	-1.97	12.48
Property – global listed	-0.08	0.71	-0.34	9.43
Australian fixed interest	-0.31	-0.07	-0.75	3.90
International fixed interest	-0.43	0.89	0.53	4.77
Australian cash	0.14	0.43	1.76	2.14

Overview & Outlook

Global equities were the notable asset class in September continuing their steady uptrend over the month, up 2.49% on an hedged basis. The primary driver was the robust economic growth being recorded globally and the flow-on to company profits. However, on the geopolitical front markets faced a number of uncertainties including ongoing political tension with North Korea and the outcomes of the German and Catalan elections.

Another issue adding to uncertainty and that has not received much attention is that the US Fed Chair, Yellen, is up for reappointment (and the decision will be made by President Trump) as well as the five Fed board seats becoming vacant that need to be filled. The Fed Vice-Chairman Fisher is also retiring. It is likely that President Trump will adopt a pragmatic approach to his appointments and lean toward a "low interest Fed." Ongoing concerns that the US government may close toward the end of September if the debt limit was not raised have declined in the very short term as President Trump reached an agreement with Democrats to raise the ceiling so that it would not be breached until December. Domestically, key issues centered on energy market "re-balancing.

On fixed interest markets, bond yields rose despite weak inflation however investors started to factor in rate rises both domestically and in the US. The move by the US Fed from quantitative easing to quantitative tightening, or QT, as it has become known, is likely to move interest rates higher. We discuss QT in detail below.

The move to QT has been well flagged and represents a very significant change in Fed policy and reflects how much the US economy has strengthened over the last few years. At the time of the GFC the Fed reduced cash rates to 0%. However, to reduce the interest rates paid by borrowers over longer time frames, say 5 years, it bought US govt bonds (largely), which act as the benchmark cost of borrowing. This process was known as quantitative easing or QE. These purchases pushed up bond prices and reduced bond yields which was the aim of the program. The program saw purchases of bonds from 6 months to 30 years maturity, reduced the cost of borrowing and assisted the economy in recovering from the GFC.

Naturally the process of purchasing bonds led to the Fed ending up with a large portfolio ($US4.5trillion) of bonds. As these bonds matured the Fed would re-invest the proceeds back into the market. Interest payments received on the bonds were similarly re-invested. In late 2014 QE was stopped and Fed only bought bonds to the value of maturities and interest received. As the Fed moves to QT, the above processes will reverse. The Fed will reduce its balance sheet, not by selling bonds, but by slowing the reinvestment of maturing bonds.

QT is likely to result in some upward pressure on bond yields over time as it will become a less active buyer over over time and its portfolio of bonds will decline. Notably the Fed has stated that it will stop its QT program if there is a marked deterioration in the economic outlook so the program is discretionary.

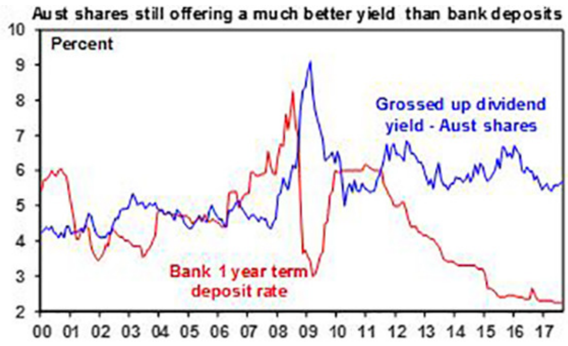
In terms of the Fed's interest rates expectations they are looking for one more rate hike this year, most likely in December, and three more hikes in 2018. They have stressed that rate hikes will be gradual and dependent on economic conditions. Market expectations of US interest rates are still well below those expected by the Fed, and this could lead to some volatility in markets as "unexpected" rate hikes occur.

In terms of investment implications, we would note the following, first, returns from bonds will be lower as yields slowly resume their rising trend, assisted by QT. Second, shares should be able to withstand the rising rate cycle just as they have the last four rates hikes. Shares remain cheap relative to bonds and the tightening is in response to improved economic growth which leads to improved company earnings and should support shares prices. Also rates remain very low as opposed to being at levels that are restrictive to economic growth. Third, bond-sensitive yield trades like AREITS and listed infrastructure could be relative under-performers. Finally, higher interest rates in the US are likely to see a stronger $US and therefore a weaker $A, which is positive for the domestic economy.

Share markets

The ASX 200 Accumulation fell 0.02% in September, trading in a very narrow band of 100 pts. Positive returns from Energy (1.0%) and Healthcare (0.9%) contributed to market upside offset by weakness in Telco's (down 4.8% for an annual decline of 32%) and Utilities (-4.1%). Resources struggled amid lower resource prices. Equities have traded between 5600 and 5950 pts on the S&P/ASX 200 Index since the end of 2016 as the market remains caught between high valuations, weak earnings growth and negligible wage growth on the one side and low interest rates and high dividend yields that remain very attractive to other yield instruments.

Global equities were notable with the S&P500 up 2.49% or 3.44% higher in $A terms, due the weakness of the $A. Also notable were European stocks which ended September up 4.5%.



Source: AMP Capital

Interest rates

In Australia, cash rates were held at 1.5% at the RBA's September meeting with rates now unchanged for 14 months. Over the month, some commentators were looking for a rate hike in the first quarter of 2018 on the back of stronger economic activity as the global growth strengthens. The RBA's post-meeting statement continues to imply a neutral short-term bias for the reasons we have noted over the last few months. The Australian 10-year bond yield ended 13 basis higher at 2.84% on the back of generally improving domestic data which saw investors start to price in a rate rise toward the end of next year.

Source: RBA

Globally bonds moved higher with the bell-weather US 10-year bond yield leading the way rising 21bps to 2.33% as the market increased the probability of a December Fed rate hike. Improving US economic data supported this view. German and Japanese 10 -year bond yields also rose.

Property

The Australian listed real estate market rose 0.57% in September despite higher bond yields as noted. The direct property market's stronger occupier demand saw improved rentals continue to support the Sydney and Melbourne markets. Yields continue to compress however should bond yields continue to move up gradually, yields are likely to expand and put downward pressure capital values.