View from the hill

AUGUST 2018

Market update

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

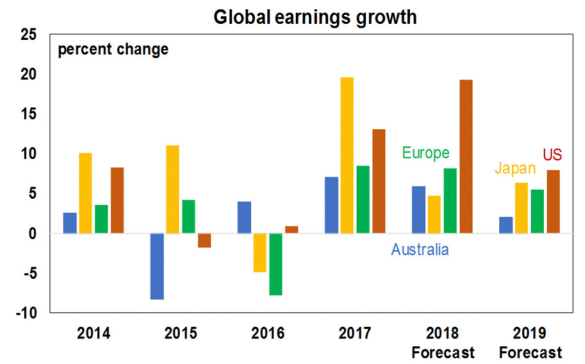
Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	1.4	5.8	14.6	8.0
Smaller companies	-1.0	3.7	22.6	14.0
International shares (unhedged)	2.5	5.3	20.3	8.5
International shares (hedged)	3.2	4.9	13.4	10.0
Emerging markets (unhedged)	1.6	-4.1	12.1	8.5
Property - Australian listed	1.0	6.3	14.5	8.3
Property - global listed	1.0	6.6	5.9	6.1
Australian fixed interest	0.2	1.3	3.0	3.0
International fixed interest	0.0	0.6	1.5	3.4
Australian cash	0.2	0.5	1.8	2.0

Overview & Outlook

Equity markets appreciated largely supported by strong earnings growth in US while investors tended to ignore geopolitical issues despite the trade-war rhetoric deteriorating sharply over the month. The MSCI World ex Australia Index was up 3.2% (hedged), bringing the annual returns to 13.4%.

Several of the political issues that had been worrying investors for the past few months continued. Trade tensions increased, at least in terms of rhetoric. Both the US and China started to talk of additional tariffs to potentially be imposed on selected imported good. Currently the US is threatening to impose tariffs of 25%, up from 10%, on $US200bn of Chinese imports. The Chinese have announced a list of $US60bn of US imports that will be subject to tariffs if the US proceeds.

The US Chamber of Commerce has warned that tariffs will increase input costs to companies and result in job losses. Notable here is that President Trump and the Republican party face mid-term elections in November and each increase in the tariffs threat appears to be supported by many Trump voters. This makes it unlikely the current situation will improve until at least after the US elections. Despite these concerns the US equity market has delivered growth year-to-date supported by the strong earnings growth of US companies reporting for the June quarter. At the time of writing around 80% of S&P 500 companies had reported with earnings up a very strong 26% year-on-year (see chart below). The major drivers for this growth are tax reform, lower prices, and improved operating margins.



Source: Bloomberg, AMP Capital

US economic data continues to be positive with a very low unemployment rate of 3.9%, personal spending growth, improving business conditions and high levels of consumer confidence. In addition, investors continue to be (pleasantly) surprised by the persistence of very low inflation and little evidence that this will increase soon. It appears that the long-run forces holding inflation, globalization, and technology, will continue to exceed the cyclical pressures of low unemployment, at least for now.

Markets will likely be driven by developments of the trade tariff situation and with US reporting season now ending investors may now turn their attention to focusing on the impact of the tariffs already in place on the US. Any further escalation in the situation will add to investor concern. Another concern is whether the US economy is facing a recession, with the bond market starting to indicate this could occur in late 2019 or 2020 although the timing is very difficult to predict. US recessions cause large market declines as profit margins decline sharply. However as noted above and discussed previously, the economy remains strong and, aside from bond yields, there are none of the other usual signs associated with over-heating.

Share markets

The equity market had a strong July, up 1.4%, with the notable sector being Telco's (7.6%), bouncing back from the sell-down over the last few months. Company reporting season is kicking off and earnings expectations are buoyant and the strong run in the Australian equity market which has pushed valuations higher, indicates that investors are expecting a sound reporting season. Earnings growth for FY2018 is expected to come in at around 9.0%, driven by a tick-up in resource earnings of around 25%. The sector has been supported by stronger commodity prices as well as growth in volumes. The forward price-to earnings ratio for the ASX 200 is 15.8x, above its long-run average of 14.2x, making the market very sensitive to any earnings disappointments.

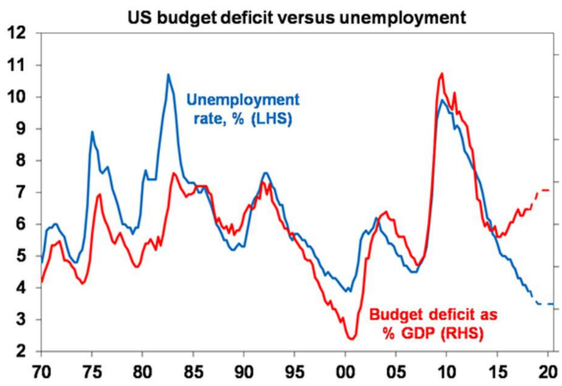
Interest rates

In Australia, cash rates continued at 1.5% having been at this rate for a record 24 months. Despite reasonable economic growth, the low inflation rate and weaker housing prices, among others, continue make it likely that the RBA will not act to increase interest rates for some time, possibly into late 2019 or 2020. Some commentators have noted the recent buoyancy in commodity prices are potentially the factor that may see rates increased. As higher commodity prices feed into company inputs, rising prices may see central banks raise rates faster than expected, which would be a headwind to equities.

Currently inflation is running at 2.0% p.a. using the latest data, which is right at the bottom end of the RBA's target band of 2% to 3% p.a. Notably the dominant upward pressure in prices is coming from government regulated prices like education and utilities. Most other components that make up the inflation basket are still running at low levels while the price of imported goods shows prices continue to fall.

A notable factor in interest rate markets is that US bond yields are now higher than those of Australia, a situation that has not prevailed since 2000. This is attributable to two major factors. First, the fact that the US economic cycle is more advanced in Australia and thus investors are more cautious about inflation and therefore demanding higher yields to invest on bonds. Second, is that the US government has markedly increased its budget deficit and therefore issuing more bonds as it borrows to cover the larger budget shortfall.

The budget deficit is now expected to be around $US 1tn (trillion) on an ongoing basis from 2019. This amounts to around 5% of GDP, by comparison the deficit in Australia is around 1% of GDP and declining. Also notable is that these deficits are in place during a buoyant economy and, as shown in the chart below, can be expected to significantly deteriorate in a recession. There are concerns around both the level of debt as well as the rate of increase and investors are requiring higher yields to buy US government bonds, although the impact is likely to be gradual.



Source: Bloomberg, AMP Capital

As investors moved US yields higher, the 2-year bond yield has moved up to 2.0% p.a. This is in line with the current dividend yield on the US equity market and the fact that investors can move to a risk-free income instead of relying on dividends may see a change in flows into the equity market.

Beyond the cash rate, Australian 10-year bond yields were largely flat over the month at 2.65% in the absence of any significant new data. US bonds were up 10 basis points to 2.96% but are gradually moving to the 3.0% level that was of concern to the market at the end of last year. The strength of US corporate earnings as well as the fact that yields have taken some time to reach 3.0% appears to have significantly ameliorated investor concern around the impact of higher bond yields on equity markets.

Property

The Australian AREIT sector continued its winning ways, up 1.0 % for the month ending July. The recent strength in the REIT sector may be indicative that investors are pricing the current buoyant rental conditions to continue for some time.