View from the hill

JUNE 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 May 2017.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-2.8	1.5	11.1	6.0
Smaller companies	-2.1	0.3	3.6	6.0
International shares (unhedged)	2.8	8.4	13.3	14.2
International shares (hedged)	1.8	4.1	19.0	10.2
Emerging markets (unhedged)	3.4	11.4	24.0	9.5
Property – Australian listed	-1.0	2.3	2.3	15.2
Property – global listed	0.2	-1.0	2.6	8.7
Australian fixed interest	1.2	2.4	2.5	4.9
International fixed interest	0.6	1.4	2.7	5.4
Australian cash	0.2	0.5	1.8	2.3

Overview & Outlook

After several months with international issues dominating investor attention, it was domestic issues that focused investor attention over May. Two issues dominated, first, was the (very) unexpected imposition of a six-basis point levy on bank deposits. Second, was increased concerns over the outlook for the bank sector given rating downgrades, record levels of personal debt and continued house price appreciation. The potential for APRA to further increase bank capital requirements over the next few months added to negative sentiment. This would require the banks to raise equity either through rights offers, dividend re-investment or retained profits.

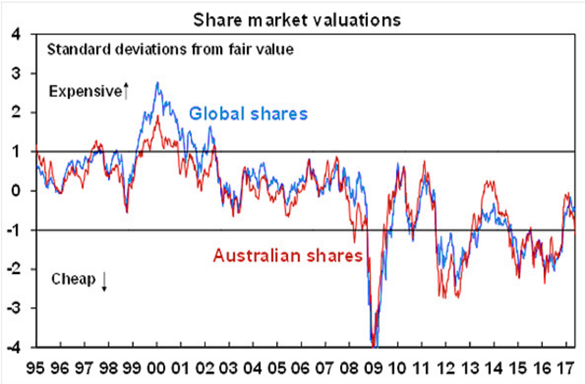
As noted, banking sector concerns saw ratings agency, S&P, downgrade a number of financial institutions, however the long-term credit ratings of the five largest banks remained unchanged. At the same time the agency maintained Australia's AAA sovereign rating but with a negative outlook warning that this could only be maintained if there was a significant moderation in house price growth.

Global equity markets remained buoyant with the US indices reaching all-time highs. Economic data was supportive and company earnings showing reasonable growth. European equities also moving higher on the outcome of the French election and some improvement in the Eurozone economic growth outlook.

Equities have had significant gains since their global growth scare, "bear market" lows, back in February last year to their recent highs. Global shares have risen 31% and Australian shares up 25% with year-to-date to gains of 7% and 5% respectively as at the end of May.

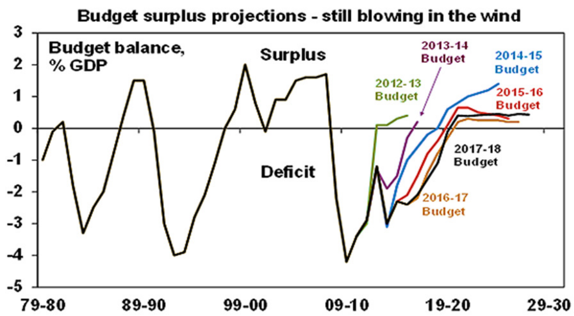
Given the strength of equity markets they are arguably due for a correction as some investor complacency has set in. The latest scandals around Trump along with other risks – North Korea and the potential for further Fed rate hikes – could be the trigger. These factors, domestic issues raised earlier and seasonal influences i.e., the best time for shares is from November to May, indicate some short-term caution may be warranted. However, over the medium-term, there are supportive factors for equity markets. Valuations for most share markets are not onerous. While price-to-earnings multiples in some markets are slightly above long-term averages, these are supported by the low inflation environment. Valuation measures that allow for low bond yields show shares are not as cheap as a year ago but they are still not expensive.

Also profit growth is strong with US profits are up 14% year-on-year while Japanese profits are up 15% and Eurozone profits up 24%. Australian profits look set to rise 20% this financial year, driven by a strong rebound in profits from resource companies. Finally, as discussed last month, global growth and the overall interest rate environment remain supportive of equity markets.



Source: AMP Capital

The government budget, was well received, however the risks around the projected return to surplus remain significant as there is still a budget deficit problem. Government spending surged 25% between 2006-07 and 2008-09 to combat the GFC and this has not been unwound. The Budget is now projecting a 12 -year run of deficits i.e., since the last surplus, totaling 27% of GDP. This is significantly larger than the deficits of the 1980s and 1990s, which were characterised by the severe recessions of the early 1980s and 1990s. While Budget forecasts still project a return to a small surplus by 2020-21, it is based on optimistic assumptions and the expected surplus could easily move back into deficit.



Source: AMP Capital

Share markets

Australian equities decline sharply in May, with the S&P/ASX 200 Accumulation Index falling 2.8%, dragged down by Banks (-9.8%), Retail (-9.3%) and Healthcare (-2.4%) while gains came from Industrials (+4.7%) and Telcos (+3.4%). The decline was driven by a correction in Banks, following the announcement of a Bank Levy in the Federal Budget and reinforced by rising concerns on the sustainability of house prices.

The chart below shows that domestic equities have been under-performing global equities since the end the GFC. Much of the relative underperformance of the Australian share market versus global shares since 2009 reflects relatively tighter monetary policy in Australia, the Australian dollar above parity and a mean reversion of the 2000 to 2009 out-performance. At this point the Australian share market looks likely to continue under-performing reflecting the weaker growth prospects in Australia.

Source: AMP Capital

Global markets rose in May, with the MSCI World ex-Australia up 2.8% on an unhedged basis. The US market was again weaker than other global markets, up 1.4% for the S&P500.

Interest rates

In Australia, cash rates were held at 1.5% at the RBA's June meeting. Current rate settings are likely to remain in place until the second-half of next year as the Bank continues to balance the buoyant housing market in Sydney and Melbourne and higher national income against low underlying inflation, a strong $A, tepid wage growth and high levels of under-employment.

Bond yields, both locally and globally, declined again over May as inflation concerns continued to abate. Australian yields fell with 10-year yields ending down 19 bps at 2.39% and 3-year also falling sharply by 17 bps to 1.63%. These lower bond yields were also reflected globally with the US 10-year bond yields falling 37 bps to 2.21% with smaller declines elsewhere.

Property

The Australian listed real estate market posted a negative return during May (-1.0%), out-performing the wider Australian equity market. The sector was dominated by takeover news and also the sharp decline in long bond yields, a primary driver of AREIT valuations. Sentiment was however dampened in the retail sub-sector as another retailer was placed into voluntary administration (TopShop), very weak wage growth (which feeds into retail sales), and ongoing concerns around the impact of the arrival of Amazon. The difficulties in the sector are reflected by the growing number of retailers who have collapsed including David Lawrence, Herringbone and Rhodes, Pumpkin Patch, Payless Shoes and Beckett and Marcs.