View from the hill

AUGUST 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 July 2017.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	0.0	-2.6	7.3	5.1
Smaller companies	0.3	0.2	-1.1	5.6
International shares (unhedged)	-1.7	-1.6	10.6	12.4
International shares (hedged)	1.5	3.4	17.5	10.5
Emerging markets (unhedged)	1.8	3.2	18.9	7.7
Property – Australian listed	-0.2	-5.6	-10.6	10.4
Property – global listed	0.9	1.7	-4.3	8.7
Australian fixed interest	0.3	0.5	-0.2	4.2
International fixed interest	0.4	0.8	0.1	5.1
Australian cash	0.2	0.4	1.8	2.2

Overview & Outlook

Central bank cash rates and their outlook were the major features impacting markets over July. Overseas most central banks, except Japan, indicated that monetary conditions and interest rates had bottomed and were likely to tighten, albeit gradually, from here. In Australia, the RBA noted that the neutral cash rate is around 3.5% p.a., or some 200 basis points above the current cash rate. The neutral rate is the rate at which the RBA views interest rates as neither stimulating or dampening economic activity. Therefore, if the neutral rate is 3.5%, this implies that current rates are very stimulatory and more likely to move up than decline from current levels. All markets, debt, equity, and foreign exchange markets initially reacted sharply to this view however further comment by the RBA saw markets take a more relaxed view on the implications of the neutral rate statement.

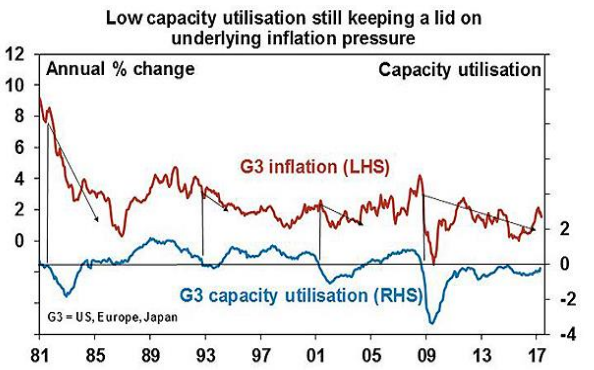
Also important in the domestic context, and discussed previously, APRA further increased bank capital requirements to ensure that Australian banks were "unquestionably strong". The capital ratio broadly indicates the amount of capital the banks carry to cover losses on their loan book, before needing to resort to other capital raising measures. However, the required increases in capital were less than the market was expecting and bank shares rallied on the announcement. Amongst the big four banks, most have capital reserves above current prudential requirements and therefore only need to raise relatively small amounts of capital to meet the new requirements

On global equity markets the US share market reached an all-time high again in late July, supported by benign domestic economic data, and positive earnings announcements. The US S&P500 index ended the month 2% higher, although lower in Australian dollar terms, due to currency movement. The MSCI World ex- Australia (hedged) rose 1.5% over the month as investors continued to factor in reasonable economic growth and higher corporate earnings.

Returning to global central bank announcements, Fed Chair Yellen continued to re-iterate that it was appropriate to raise rates gradually and that the Fed would look to start an orderly run down of its balance sheet shortly. Specifically, this means that the Fed will look to sell back into the market the bonds that were bought as part of its QE programs in place since the GFC. However, in the same way as purchasing these bonds placed downward pressure on bond yields, selling these bonds will place upward pressure on bond yields. Therefore the Fed will need to be very careful about how it manages this sell-down to ensure rates do not move up sharply.

In Europe ECB President Draghi commented that "the threat of deflation is gone and reflationary forces are at play" and that monetary policy will need to adjust once inflation rises. Bank of England Governor Carney also indicated that "some removal of monetary stimulus is likely to become necessary" if risk continue to diminish. The BOJ was an exception to the above announcements, with inflation stuck at zero and the bank continuing quantitative easing it is likely to be some years before rates rise in Japan.

In light of the above statements, it was surprising that global yields were broadly stable in the US, UK, Germany and Australia. This may be attributable to the fact that bonds have already rallied a long way since bottoming in July last year. What are the medium-term implication of increased bond yields and Central Bank outlook for investors? First, the change in Central bank outlook reflects the improvements in global growth over the last few quarters as well as the receding risk of deflation and is therefore positive for investors. Second, with underlying inflationary pressures very low, tightening is likely to be very gradual. The two factors keeping downward pressure on inflation are spare capacity, which limits pricing power, and structural factors including technological innovation. Third, even though global policy has gradually tightened because of the four hikes by the Fed, it remains a long way from tight levels that would end the bull market in equities.



Source: AMP Capital

Share markets

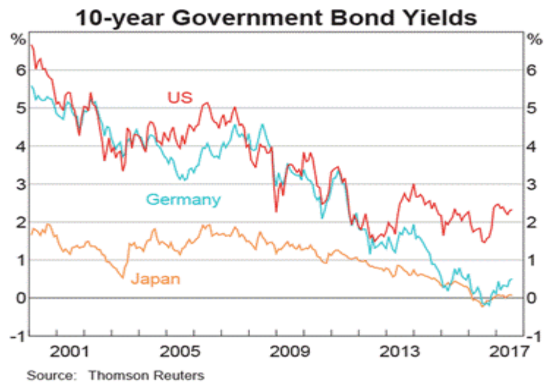
The ASX 200 Accumulation finished flat in July, having traded in a tight range throughout the month. Positive returns from banking stocks and a resurgent commodities sector were offset by weak healthcare, utilities and telecommunications stocks. Top performers were BHP Billiton, Fortescue and South 32, which rallied on strong commodity prices in July. CSL fell 8.7%, reversing recent gains, partly due to the headwind of the rising Australian dollar. Other companies with substantial foreign earnings also took a hit, with Aristocrat, Brambles and Amcor all lower over the month. Telstra fell 4.6%, on fears that it may not be able to sustain its dividend.

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. Global markets declined in July, with the MSCI World ex- Australia down 1.7% on an unhedged basis but up 1.5% on a hedged basis.

Interest rates

In Australia, cash rates were held at 1.5% at the RBA's August 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 against low underlying inflation, a resurgent $A, tepid wage growth and high levels of under-employment.

Bond yields globally were broadly stable over July on the back of Central Bank commentary with the US 10-year bond yields stable around 2.30% p.a. and Gernan yields moving from 0.47 to 0.53% p.a.



Source: RBA, Thomson Reuters

Property

The Australian listed real estate market was lower being down 0.2% in July as 10-year Australian bond yields rose from 2.60% to 2.69%. Notable was the ongoing weakness in retail businesses which have underperformed the wider market for most of 2017 as investors became cautious about the impact of online shopping on traditional retail business models and tight competition compressing margins.

In the office sector, the latest vacancy rate statistics released by the Property Council of Australia in July highlighted strengthening city office markets with vacancy rates firming to 10.5% (from 10.9%), as additional new supply is absorbed by the market. Vacancy rates have fallen to 5.9% in Sydney's central business district, Melbourne's central business district vacancies are stable at 6.5%, while vacancies in the Brisbane central business district rose to 15.9%.