View from the hill

NOVEMBER 2017

HILLROSS

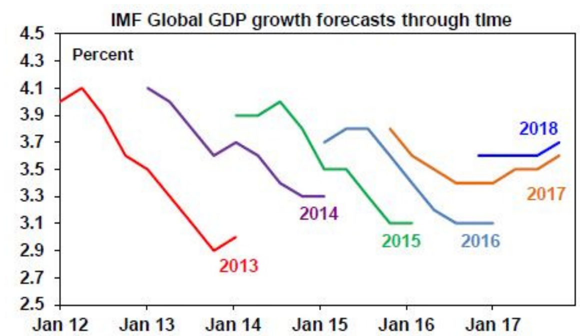
Market update

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

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	4.0	4.7	16.1	6.9
Smaller companies	6.0	10.3	14.6	10.5
International shares (unhedged)	4.3	8.7	22.0	13.4
International shares (hedged)	2.7	5.5	23.5	11.2
Emerging markets (unhedged)	5.9	9.7	25.5	10.6
Property – Australian listed	2.3	4.4	8.6	11.0
Property – global listed	-0.4	-0.6	4.9	6.7
Australian fixed interest	1.1	0.8	1.6	3.9
International fixed interest	0.5	1.0	1.9	4.6
Australian cash	0.2	0.4	1.8	2.1

Overview & Outlook

Equities had a very strong month over October with all markets recording solid gains. The MSCI World ex Australia Index (hedged) was up 2.7% while the domestic S&P/ASX 200 Accumulation rose 4.0%. The primary drivers for this buoyancy was an ongoing improvement in global growth as well as increase in forecasts for growth into 2018. Also important was that despite this strong growth there were no signs of rising inflation, which would place upward pressure on interest rates and slow the economy. A sound US earnings season which beat expectations also helped. Therefore equity investors were expecting improved company earnings and had minimal concerns around rising rates. Bond markets, the best indicator of inflationary expectations, saw yields flat to lower, further substantiating the low inflation outlook.



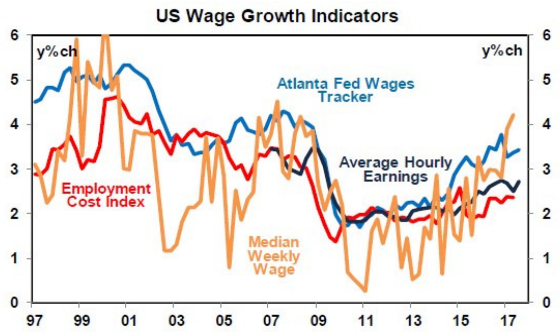
Source: RBA

Other positive factors that impacted markets were the nomination of the new Chair of the US Federal Reserve, Jerome Powell, who will replace Janet Yellen in February next year when her term expires, assuming the Senate approves his appointment. Powell has been a Governor of the Federal Reserve since 2012 and has been supportive of the Fed's approach to monetary policy and interest rates and is seen as non-ideological and pragmatic as well as a consensus builder. As a result he is unlikely to alter current policy settings in terms of reducing the Fed balance sheet and the expected path of interest rates. Currently expectation is for three rate hikes next year. For these reasons, markets were positive on the Powell nomination as well as the fact that it removed a significant uncertainty in terms of investor outlook for 2018.

The second positive factor was investor expectations around corporate tax reforms and cuts in the US. Key components of the reforms included cutting the corporate tax rate from 35% to 20%, lowering of the small business tax rate, repatriation of overseas profits and accelerated depreciation of new capital investments. At the time of writing the chance of the tax reforms occurring look mildly positive. However the timing of the actual passing of legislation may be longer than expected due to the complexities of achieving real reform.

The impact of tax reform on the economy is difficult to estimate and depends on the final details and how it is funded. In terms of the impact on corporate profits, the impact could be a boost of 5% to 10%[1], with improvements for companies with high effective tax rates.

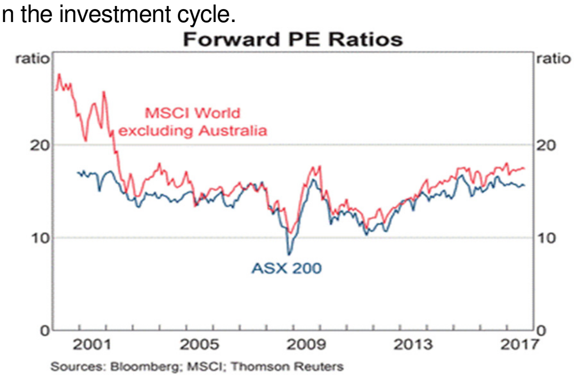
As the US accounts for around 25% of the global economy the outlook for growth there remains critical for the global growth outlook. Currently the US economy is in its eighth year of economic expansion and growth of around 2.5% to 3.0% looks achievable. This growth is supported by a number of factors including a positive consumer outlook, supported by a very low unemployment rate of 4.2%, and some pick up in wage growth (see chart below), an ongoing slow recovery in housing construction and some improvement in business investment (which will be boosted if the proposed business tax reform package passes).



Source: AMP Capital

The above factors point to growth being sustained but importantly for investors may, over the medium term, lead to slightly higher inflation. This would be driven by wage growth and capacity shortages in some sectors of the economy. As long as the inflation rate does not increase sharply, or move well ahead of investor expectations, markets are unlikely to be overly concerned.

Currently, the combination of high earnings multiples (see chart below) notable in the US, and low levels of volatility suggest that a degree of complacency exist in some markets. Given the strength of markets over the last 12 months, with the S&P 500 Total Return up 23.6% in local currency terms, US shares are overdue for a correction, but beyond short term issues, equities remain in the sweet spot in the investment cycle.



Source: RBA

[1] AMP Capital estimates

Share markets

The ASX 200 Accumulation rose 4.0% in October, its best monthly increase in 2017. Returns were hampered by Retail (-0.7%), which was the only sub-sector to suffer a decline, Real Estate (1.4%) and Telcos (2.8%), while on the positive side, healthcare (5.5%) and energy (5.8%) delivered notable returns. Banks (2.8%) underperformed the broader market through October despite reasonable returns from CBA (3.2%), WBC (3.4%) and NAB (3.7%). Since month-end domestic equities have continued their upward momentum, largely due to strength in the mining and energy sectors.

Global commodity markets, and therefore domestic mining companies, also benefited from an ongoing upswing through October with the majority of industrial commodities recording another strong month as evidence of stronger global growth recovery providing a strong tailwind for growth sensitive commodities. This supported the Materials Sector which rose 4.4%.

Three key themes can be discerned in the commodity markets – electric vehicles and battery demands (lithium & cobalt), supply side reform in China which has continued to take capacity out of traditional industry (i.e. steel and aluminium) to reduce pollution, and strength in oil prices as investors factor in additional OPEC production cuts into 2018. This factor as well as political issues in Saudi Arabia have seen crude oil prices move strongly above US$60/bbl into November.

Interest rates

In Australia, cash rates were held at 1.5% at the RBA's November meeting. Rates are now unchanged for 15 months. Inflation for the September quarter was lower than expected and when allied with weak retail sales data has seen the market now move to fully factoring in a rate hike as late as early 2019.

Australian bond yields moved lower, supported by the weak September inflation data, and the bellwether 10 year bond yield fell 14 basis points to 2.70% and into November yields had fallen further to 2.59% at the time of writing. Globally bond yields were largely unchanged. As noted, bond markets continue to remain unconcerned that inflation is likely to move ahead of current expectations.

Property

The Australian listed real estate market rose 2.3% in October with lower bond yields the primary driver, although improving sentiment around growth supported the outlook for rental growth and reduced vacancies.