View from the hill

DECEMBER 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 November 2017.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	1.6	5.7	14.6	8.7
Smaller companies	3.9	11.6	20.5	13.4
International shares (unhedged)	3.2	11.4	20.5	12.6
International shares (hedged)	1.7	7.0	22.1	10.6
Emerging markets (unhedged)	1.2	7.9	29.3	10.4
Property – Australian listed	5.3	8.3	13.5	12.9
Property – global listed	2.8	2.3	9.6	6.7
Australian fixed interest	0.9	1.7	4.0	3.8
International fixed interest	0.2	0.2	3.8	4.3
Australian cash	0.1	0.4	1.8	2.1

Overview & Outlook

Equities continued their appreciation over November with the MSCI World ex Australia Index up 3.2% on an unhedged basis and the domestic S&P/ASX 200 gaining 1.6%. Global growth remained the primary factor driving markets with many sentiment factors also contributing to market upside. These factors included the expected passage of the tax reform program through the Senate[1], the appointment of the new Chair of the Federal Reserve, Jerome Powell, and in the US stronger business investment and consumer confidence now at its highest level since 2000. It is important to note the impact of the tax reform and reduction in corporate tax rates can be over-emphasized. Some estimates[2] are that it may add around 0.1% to US economic growth p.a. over ten years, which is not meaningful.

Inflation continues to surprise in that it continues to remain at low level levels, despite buoyant economic activity. US CPI for the year-ended October was 2.0% while in Australia CPI for the year-ended October was 2.0% while in Australia it was 1.8% for the quarter-ended September.
Elsewhere the Bank of Japan continued with its very lax monetary policy despite some signs of accelerating economic growth as manifested by improving wages growth and Tokyo office vacancies falling to 3%. In Europe economic sentiment is at its highest level since 2001 while growth is rising at its fastest rate since 2011.

Given that it is the holiday season we thought we would discuss the related issues of sentiment and bitcoin. The surge in bitcoin has led to significant comment by a wide range of leading market commentators, fund managers and economists with opinion widely divergent on the outlook from here and whether this is a bubble or fad, or the bitcoin price is showing that blockchain, which uses bitcoin as its primary currency, is the start of something meaningful as a technology. Over the last five years the price of a bitcoin has increased from $12 to $8,000, with the 'currency' up 760% this year alone. At the time writing there were reports that it had traded up to $14,600, up almost 50% over the week.

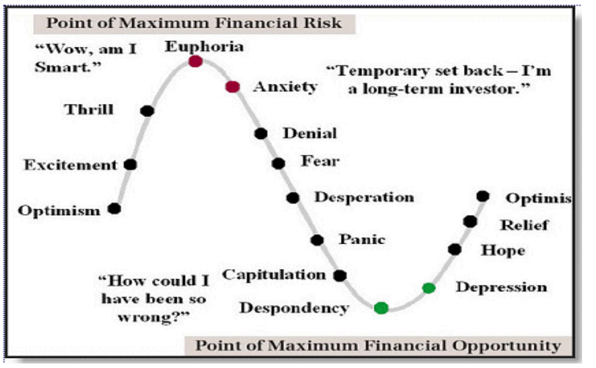
To understand the magnitude of this appreciation, the following chart illustrates the major global asset bubbles of the last four decades. What is important to note is that the first four "bubbles" shown have a range from 1 to 12, on the left, while the appreciation of bitcoin requires a scale that ranges from 1 to 1500, on the right.

[1] This Bill was passed in early December although the equity market then declined.

[2] AMP Capital

Source: Thomson Reuters, Bloomberg, AMP Capital

While the psychology of individual investors as well as that of crowds is now well understood and goes a long way to explaining why rampant speculation occurs this does not mean that asset bubbles do not occur. The chart below is well-known in terms of how it explains market cycles and it can be argued that in the case of bubbles the peaks and troughs are just more extreme.



Source: tradingcommonsense.com

Examples of bubbles that investors can identify with are the Japanese equity bubble of the Eighties and ending in 1989, Internet boom that peaked in early 2000 and more recently the US housing boom ended by the GFC in 2008. In Australia the most recent example is the commodity and mining boom that rolled over in 2012/13. It can be argued that, on the chart above, global equity markets are around the point marked by optimism as investor sentiment is well up on last year. Importantly there are few indicators that investors are at the euphoria stage which is typically when markets roll over.

Cryptocurrencies, led by bitcoin, and blockchain technology have the potential to be significant technology disruptors, notably in financial services, due to its anonymity and ability to provide a low cost way of facilitating business at a small fraction of what a bank would charge. However there remain many concerns around the investment issues for bitcoin. Perhaps most important is that because it has no income or yield it is very difficult to value. Another factor is that while the number of bitcoins is limited i.e., it may have scarcity value, there are many other competitor currencies. In fact, there are now over 1000 at last count and it is very difficult to see why one would be favored over another. A further issue is that governments and regulators may move to limit or halt their use.

An interesting anecdote is a recent article from Bloomberg entitled "A bitcoin frenzy like no other is gripping South Korea"[3]. The article notes that in South Korea investors are paying a 23% premium to the overseas bitcoin price to invest. Notably 21% of all trading on fee-charging bitcoin exchanges were in Korean currency. The Korean economy is about 1.9% of the global economy.

Circling back to the investment sentiment issue the rate of price increase would tend to indicate that bitcoin now has the all the characteristics of a bubble asset. Given the media time it is now receiving the bubble may continue to increase for some time before equilibrium is restored. Timing the exact point at which a sentiment reverses and the bubble bursts is impossible.

Share markets

The ASX 200 Accumulation rose 1.6% in November, bringing the annual increase to 14.6%. Across the sectors, Telcos (1.6%) was the only negative, financials were flat while on the positive side, real estate (5.3%), IT and energy stocks were strong. Banks under-performed into December on the announcement of the Royal Commission into the financial services industry. Notable over the month was the voluntary administration of Oroton, an upmarket retailer and this was a further reminder of the impact of a very tough retail environment and the low wage growth.

Interest rates

In Australia, cash rates were held at 1.5% at the RBA's November and December meetings with rates now unchanged for 17 months. As noted, inflation has been lower than expected and debt markets continue to see the next rate hike as still some period away. Australian bond yields continued to move lower, with the bell-weather 10-year bond down 17 basis points to 2.50% at month-end. Globally bond yields were largely unchanged.

Property

The Australian AREIT was strong over November, up 5.3% with lower bond yields again the primary driver, although improving sentiment around growth supported the outlook for rental growth. The most recent data[4] for the direct property sector saw total returns for this asset class to end-September at 12%, a very creditable return, with continued demand from offshore capital underpinning the firming of capitalisation rates over the last quarter.

Kindly note that the January View from the hill will be published in the week starting January 2018.

[3] Bloomberg LP, accessed 7/12/2017

[4] IPD Property Index