

View from the hill

MARCH 2018

HILLROSS

Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **28 February 2018**.

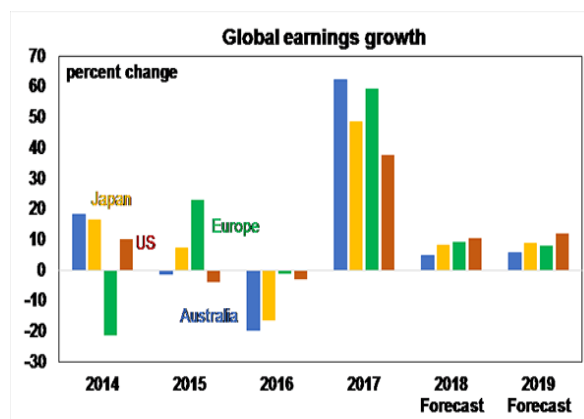
Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	0.4	1.7	10.1	5.1
Smaller companies	0.0	2.7	20.8	10.8
International shares (unhedged)	-0.4	-0.4	16.0	8.5
International shares (hedged)	-3.7	1.1	14.7	9.3
Emerging markets (unhedged)	-0.9	4.3	28.8	9.1
Property - Australian listed	-3.2	-6.2	0.5	5.0
Property - global listed	-6.3	-7.8	-5.3	1.2
Australian fixed interest	0.3	-0.5	2.9	2.4
International fixed interest	-0.2	-0.7	2.1	3.2
Australian cash	0.1	0.4	1.8	2.0

Overview & Outlook

Equities had a volatile month, but most global markets ended weaker in February with the MSCI World ex Australia Index down 3.7% (hedged), following January's gain of 3.8%. Notably, the S&P/ASX 200 rose 0.4% mostly due to dividends (for the half-year to Dec) rather than price growth. This brought annual returns for the respective indices to 14.7% and 10.1%. The relative strength of the Australian market can be attributed to its high dividend yield (by global standards), more reasonable valuations relative to global markets, and a reasonable corporate reporting season. Furthermore, the \$A has weakened by 4% against the \$US (as well as most other major currencies), subsequently contributing to improvements in Australian corporate competitiveness overseas as well as making the domestic market cheaper for foreign investors.

The initial driver for the sell-off was the higher-than-expected employment numbers and wage growth data in the US. The spike in bond yields which drove the market pullback stabilized and ended February slightly below their highs for the month at 2.90% and fell further to 2.84% during March. The stabilization of yields is surprising, given the very significant issuance over the next 12 months to fund the US budget deficit – which has been worsened by the recent corporate tax cuts. Higher issuances usually lead to lower prices and higher yields. The fact that rates have not continued to go higher is most likely attributable to a combination of US inflation, the safe haven buying

after the increase in equity market volatility, and lastly the higher US bond yields relative to other developed country bonds.



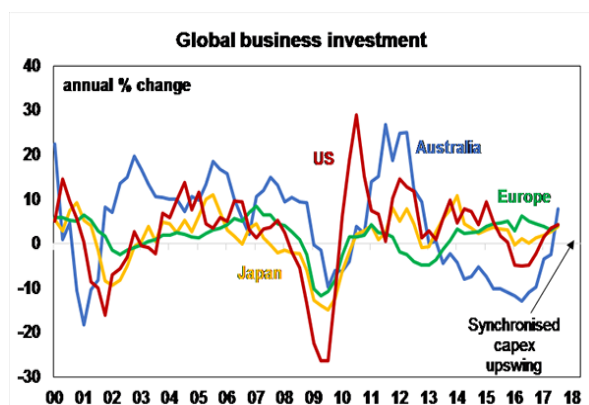
Source: Bloomberg, AMP Capital

Global equity markets have re-bounded strongly despite bond yields remaining around the same level that triggered the sell-off. In addition, there is no further data on inflation nor US wage growth – which are both key data points driving the recent sell off. More recently, the imposition of trade tariffs by the US on steel and aluminum imports as well as threats of retaliation by some trade partners have raised concerns that a trade war may develop between the US and its major trading partners. Critical factors in the outlook fall into two areas, first, the

path of interest rates and second, the outlook for corporate earnings. As noted, the outlook for earnings remain sound and these will only be significantly impacted by a recession – which given the length of the current upcycle is possible but does not look likely at this point.

Our reasoning here is that none of the usual factors associated with the top of the cycle are evident. Notably, while business and consumer confidence has improved it is not excessive. Economies remain largely in balance with little sign of excesses such as over-investment (see chart below), there have not been significant increases in debt (except US and Chinese corporates), and monetary policies (i.e., interest rates) are not tight despite the tightening cycle of the US Fed¹.

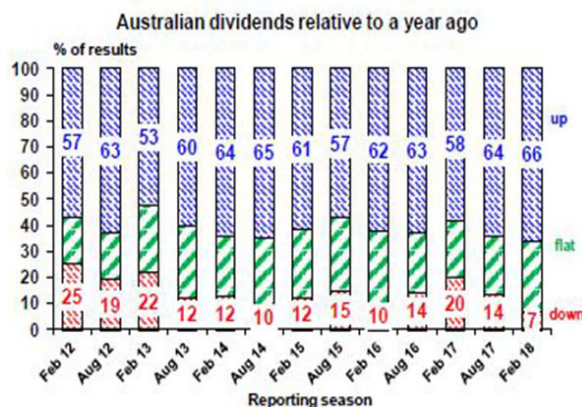
Turning to interest rates, markets are moving to the view that will be three (rather than two) rate hikes in 2018. However, should the current growth see US inflation move up more sharply than expectations (potentially due to the growth impact of the corporate tax cuts), four rate hikes are possible. The primary driver here would be higher inflation which is moving slightly higher across developed markets as growth improves and spare capacity (particularly in the labour market) is used up. Firm commodity prices are also increasing pressure on prices. While core inflation trends are a bit softer, our positive outlook on growth in 2018 means that we see some risk of inflation lifting higher than currently expected – particularly in the US.



Source: Bloomberg, AMP Capital

Share markets

The ASX 200 Accumulation Index was essentially flat over February (+0.4%), despite a significant sell down earlier in the month. Solid profit growth across a number of sectors, despite this growth being lower than offshore markets. For the December half of the reporting season, 74% of companies had profits above those of 12 months ago, and 66% of companies increased their dividends (and 26% kept dividends flat) – signaling confidence in the outlook for profits.



Source: AMP Capital

Strong sectors were Healthcare again (7.0%), driven by solid earnings growth, notably by CSL, and Info Tech (1.7%). The weakest sectors were Telco's (-8.0%) and Utilities (-2.7%), both pressured by the upward moves in long-bond yields earlier in the month.

EPS growth expectations are now around 5% for 2018-19 and this outlook, combined with a benign interest rate environment, will be supportive of the equity market. However, over the short term, domestic equities will be driven by US equity market volatility.

Interest rates

In Australia, cash rates continued at 1.5% with the outlook for unchanged rates likely to continue for some time. While the growth outlook domestically has improved, still low wage growth has tempered expectations for a rate hike until late this year at the earliest. Australian 10-year bond yields were largely unchanged over the month at 2.87% in the absence of any significant new data impacting investor outlook. US bonds rose 16 basis points to also end at 2.87%.

Continuing Fed rate hikes and US fiscal stimulus in 2018 will place upward pressure on global bond yields which will constrain returns. With the Reserve Bank of Australia (RBA) unlikely to follow the Fed though until late 2018, investor's may wish to over-weight Australian bonds relative to global bonds.

Property

The Australian AREIT sector fell again in February, down 3.2%, despite flat bond yields. A number of AREIT's are trading at or below NTA and therefore investors are not attributing any value to the management companies. The retail trading landscape remains difficult and the environment continues to challenge retailers with inefficient platforms, products, and structures. However, those AREITs that own premium shopping malls are now seeing some investor interest after the recent declines.

¹ AMP Capital, 21 Feb 2018