View from the hill

JUNE 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 **31 May 2018.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	1.1	1.1	9.6	5.9
Smaller companies	3.7	4.1	25.4	11.6
International shares (unhedged)	0.4	2.6	9.8	8.1
International shares (hedged)	1.3	1.0	11.3	8.7
Emerging markets (unhedged)	-3.8	-2.9	12.2	6.6
Property – Australian listed	3.0	7.5	5.7	7.7
Property – global listed	2.8	8.4	3.7	5.1
Australian fixed interest	0.7	1.2	1.7	2.9
International fixed interest	0.4	0.8	1.5	3.4
Australian cash	0.2	0.5	1.8	2.0

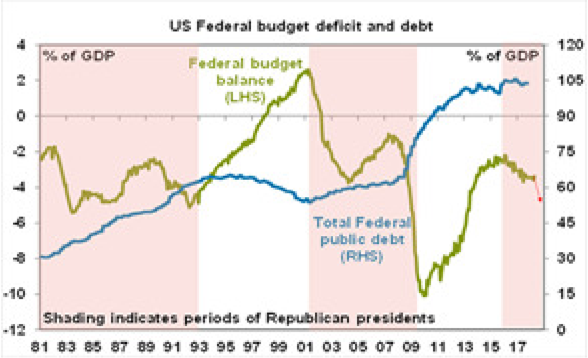
Overview & Outlook

Equity markets rose during May, despite concerns over an Italian exit from the Eurozone toward the end of the month, supported by lower bond yields and buoyant company earnings. Ongoing and rising geopolitical concerns were largely ignored. The MSCI World ex Australia Index was up 1.3% (hedged), following an increase of 2.0% last month. The US market which is 60% of the global benchmark was up 2.2% (USD), while Emerging markets fell 3.8%, impacted by a strong US dollar, higher oil prices and higher interest rates. Australian equities rose with the S&P/ASX 200 up 1.1%. This brought annual returns for the respective indices to 11.3% and 9.6%.

In April we discussed the concern among investors that there have been signals that global growth may be slowing from the strong conditions that prevailed at the end of 2017 and earlier this year. Our view was the growth should remain in place for some time. However, investors face other issues[1] that have the potential to derail markets and that needs to be monitored - we detail these below. The first is the increase in US debt. There are two aspects to this issue. The first is that the level of debt in US corporate has been rising (but is still below pre-GFC levels). Despite this US corporate spreads or the premium that investors are demanding to lend to companies (which are relatively riskier compared to government debts) are extremely low. This would indicate that investors are not factoring in the risks in the corporate sector as debt and leverage have increased. In the current economic environment characterized by strong growth and rising earnings there has been little impact on balance sheets or cash flows. However, as the cycle matures, and earnings growth becomes more scarce, investors are likely to start to price in default risk for corporates which will see their borrowing costs increase as cash flows come under pressure. This will be over and above further interest rate hikes from the Federal Reserve. These increases could see several companies come under significant financial stress. Credit standards for corporate are loose while defaults in personal and mortgage debt remain low at this point. Stresses may become evident as the Fed continues to raise rates.

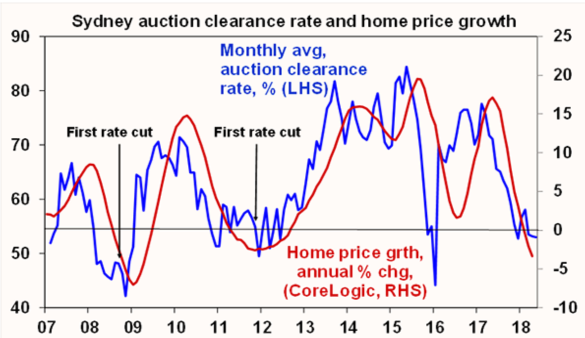
The second aspect of US debt is that of government debt which is forecast to increase sharply, and this will need to be funded externally. The increase in debt is due to both the tax cuts passed late in 2017 and the lift in government spending limits earlier this year. The combined impact of these policies will significantly increase the budget deficit which is almost certain to reach 5% of GDP over the next few years, from around 3% currently. This is of concern as the economy is currently recording strong growth and any downturn will significantly exacerbate the deficit. By way of comparison Australia's worst deficit was 4.1% immediately after the GFC.

[1] AMP Capital, 28 May 2018



Source: Reuters, FRED, AMP Capital

Domestically, a concern is that tighter lending standards and a strong likelihood of increased legislation after the Royal Commission could exacerbate the current downtrend in home prices driven by increased supply and reduced affordability reducing demand. While these changes will increase the soundness of the banking system over the medium term, in the short-term they could aggravate house price decline with knock-on effects to an already stressed consumer as well as increasing bad debts, currently at historically low levels, in the banking system.



Source: Domain, AMP Capital

Finally, there is the issue of higher commodity prices which could drive higher inflation most importantly in oil prices, although other commodity prices have also rallied. Should the oil price remain above $70 there is a risk of sharp increase in inflation which is not currently factored in by markets. Higher inflation would impact global growth and most likely lead to higher interest rates by Central banks looking to dampen the higher inflation. Each of the concerns noted are not major issues for markets currently however investors need to monitor these factors as each has the potential to significantly impact markets and cause downside volatility.

Share markets

The ASX 200 Accumulation Index was up in May (1.1%), led by very strong increases in the Healthcare and Consumer Discretionary sectors, up 5.6% and 4.9%. In Healthcare CSL (9.1%) lifted its profit outlook while in Discretionary, Seven West (47.8%) was up also on providing further profit guidance. The weakest sector was Telco's as Telstra fell 12.0% on announcing that pre-tax profit would be at the lower end of the forecast range. The market is up 9.6% on a rolling 12-month basis led by IT, Healthcare and Materials, with the first two sectors driven by investors looking for domestic growth companies.

Interest rates

In Australia, cash rates continued at 1.5% with some observers now looking at 2020 for the first increase in rates. The RBA appears unconcerned about share market volatility, the risk of a trade war and higher bank funding costs. Despite the recent strong data on GDP growth, up 3.1% year-on-year, largely driven by export volumes, notably coal, iron ore and LNG, wage growth and inflation remain soft.

In the bond market the 10-year yield ended the month down 10 basis points at 2.67%. There were number of conflicting factors impacting the bond market notably the delayed expectations for the next rate hike, a flight to safety driven by jitters over Italy and continued weakness in wage growth which implies inflation is unlikely to increase in the medium term.

Globally most bond markets saw their 10-year bonds end lower mostly driven by investor flight to safety because of jitters over a potential Italian exit from the Eurozone, although these concerns reduced toward month-end. Notable were German 10-year bond yields, which declined from 0.56% to 0.34%, i.e., by 22 bps or 40%.

Property

The Australian AREIT sector was up 3.0% in May, supported by a further decline in long bond yields (10 bps) and solid rental conditions. From June the sector composition will change significantly as Westfield has been bought by the French company Unibail- Rodamco. The new entity will trade as a stapled unit on the ASX, and depending on tradability, is likely to form a reasonable part of the AREIT index. The share will give investors an opportunity to invest in a large, global shopping centre entity (82% of assets) with sound management.

This will be the first time since September 1961 that a Westfield entity will not be traded on the ASX. Frank Lowy[2] is quoted as saying in a recent interview that "$1,000 that was invested with my dad in Westfield in 1960. At the end of this transaction, would be worth $440 million today. That is a 25.6% compound return every year for the last 57 years." The other interesting thing is that, Westfield shareholders have received some $47.7 billion of returns for dividends and capital returns over and above the equity that was raised.

[2] AFR, Dec 12, 2017