View from the hill

OCTOBER 2018

Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **30 September 2018.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-1.3	1.5	14.0	12.1
Smaller companies	-0.4	1.1	20.3	17.0
International shares (unhedged)	0.6	7.4	20.8	12.4
International shares (hedged)	0.8	5.6	12.9	14.7
Emerging markets (unhedged)	-0.6	1.0	7.6	11.3
Property - Australian listed	-1.6	2.0	13.3	10.3
Property - global listed	-2.2	0.5	5.6	7.1
Australian fixed interest	-0.4	0.5	3.7	2.9
International fixed interest	-0.4	-0.1	0.9	3.2
Australian cash	0.2	0.5	1.9	1.9

Overview & Outlook

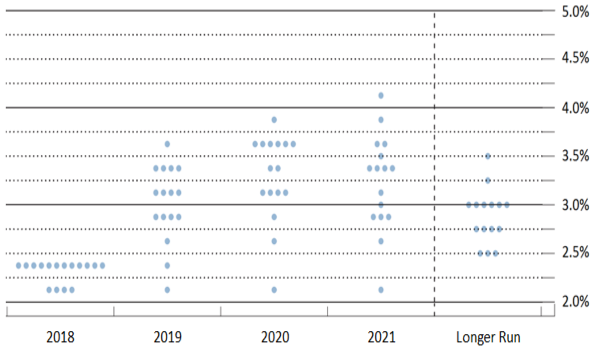
Trade tensions escalated in September as the U.S. put in place a 10% tariff on US$200bn of Chinese imports and Donald Trump flagged tariffs on another US$267bn, should China retaliate. China has added tariffs (5% and 10%) on US$60bn of goods imported from the US.

Concerns of a potential slowdown in economic activity in the U.S. continue with many commentators highlighting various indicators providing conflicting data. Interestingly, in China there are signs of the economy slowing with new home sales, a very sensitive indicator of economic activity and sentiment, falling 4% on the previous month.

In the UK little headway is being made with European leaders in relation to agreeing on terms for Britain's exit of the European Union (EU). British Prime Minister, Teresa May is coming under increasing political pressure as her proposed plan was again rejected by the EU. Issues around border control in Ireland, trade between the UK and EU members are a significant concern for the UK. The EU is concerned that the UK is trying to cherry pick the benefits of EU membership without all that comes with being part of the EU. Some in the UK feel the EU is being overly difficult and trying to chastise the UK for its decision.

The UK is scheduled to leave the EU on Friday the 29th March 2019 unless all remaining 27 members of the EU agree to an extension. If an agreement cannot be put in place before the exit, all treaties will cease to apply, and the UK would operate under World Trade Organisation rules. This would involve a range of tariffs on trade, customs checks for travellers and residency rights for UK citizens living abroad in the EU would be in jeopardy. None of these outcomes are desirable for the UK. This could have ramifications for global corporates operating in Britain and Britain's role as a global financial centre.

The US Fed increased the overnight rate for the third time this year by 0.25% as widely expected. This takes the Fed Funds rate to 2% – 2.25% and is now no longer being described as accommodative. The chart below shows the expectations of each Fed Reserve board member for 2019 and beyond. Clearly there is some uncertainty and the future economic data will determine the path of interest rates.



Source: US Federal Reserve

Share markets

Australian shares fell (-1.3%) over the month driven by continued concerns around the US/China trade war, coupled with valuation concerns impacting some of the more stretched areas of the market. Notable declines were recorded in Health Care (-7.7%), consumer discretionary stocks (-4.2%) and utilities (-3.3%). The Resources sector was a standout for the month (5.4%) with energy (4.3%) also performing well as underlying commodity prices helped stock prices rally.

The financial sector continues to be challenged by the prospective outcomes of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. With the release of an interim report on the last trading day of the month raising over 600 questions in relation to activities in banking, insurance, superannuation and financial advice, the challenges are not going away in a hurry as the final report is not due until 1 February 2019.

Global equities (0.8%) performed a little better despite the issues around Brexit in Europe, the Trump trade war with China and broader concerns in emerging markets.

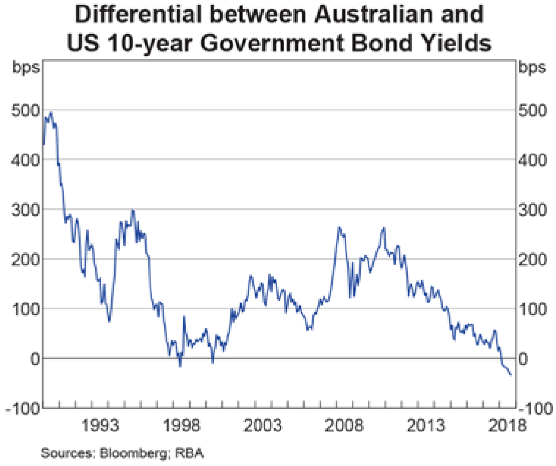
Emerging markets (-0.6%) have struggled with slowing conditions in China combining with the malaise in South America. The Chinese purchasing managers index (PMI) dropped to 50.8 in September which suggests minimal growth is likely over the three to nine months. Brazil has political issues, while Argentina's is struggling to contain inflation and has very high interest rates to support the currency.

Interest rates

Fixed interest markets fell in September with the broader global market down (-0.4%) for the month. Australian fixed interest was also down (-0.4%) with government bonds falling (-0.5%) over the month and corporate bonds (-0.1%) faring a little better.

In Australia, the RBA continues to maintain the cash rate at 1.5% where it has been for 26 months. Despite no change in Australian interest rates, Australian Government 10-year Bond yields were up 14 basis point to 2.67% while the 1 year's yield was down 4 basis points. These rates continue to oscillate around historically low levels.

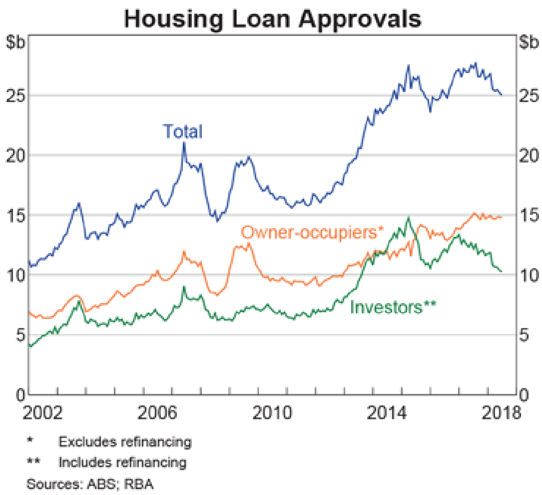
While Australian yields continue to bump along the bottom the US 10 Year yield is at the highest level since mid-2011. The latest US Fed Rate hike has seen the US 10-year bond yield rise 21 basis points over the month to 3.07%. The yields in the US continue to be higher than those in Australia as seen in the chart below for the first time since 2000.



With the increased indebtedness of global corporates, particularly those in the US, we continue to favour higher quality bonds. High-yield bonds are generally expensive and while at security level there are always opportunities, at this point in the cycle we would be cautious of investment in the sub-sector.

Property

Australian residential property continues to be challenged particularly in the Sydney and Melbourne markets. This is clearly having a flow-on effect with residential building approval falling 9.4% in August as compared to July and 13.6% year-on-year. This signals that future construction is likely to decline. We can see in the chart below that home loan approvals are falling across the market and investor home loan approvals are seeing a sharp decline.



Australian (-1.6%) and global (-2.2%) real estate investment trusts (REITs) lost ground over the month. The retail sector continues to be challenged by weak sales growth and online competition. The industrial sector in Sydney continues to show strength with tight vacancy rates. The Office sector continues to see good rental growth driven by low vacancy rates in Melbourne and Sydney.