View from the hill

JANUARY 2019

HILLROSS

Market update

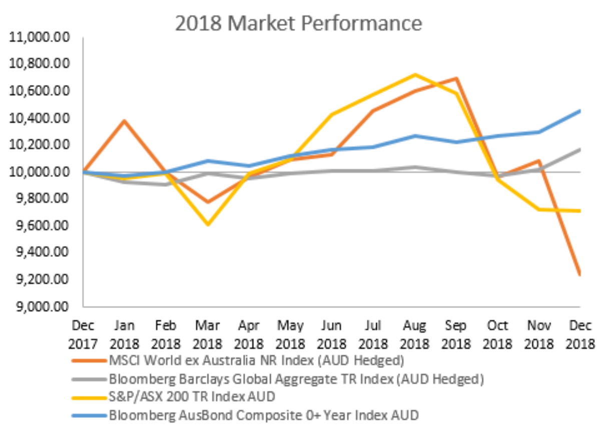
The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 December 2018.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-0.1	-8.2	-2.8	6.7
Smaller companies	-4.2	-13.7	-8.7	7.5
International shares (unhedged)	-4.3	-11.1	1.5	7.5
International shares (hedged)	-8.3	-13.6	-7.6	7.0
Emerging markets (unhedged)	1.0	-4.9	-5.1	10.5
Property - Australian listed	1.7	-1.7	3.3	7.6
Property - global listed	-6.5	-6.0	-4.0	2.9
Australian fixed interest	1.5	2.2	4.5	3.7
International fixed interest	1.4	1.7	1.7	3.5
Australian cash	0.2	0.5	1.9	1.9

Overview & Outlook

December failed to produce the much hoped for Santa rally and was yet another challenging month in what turned out to be a difficult year for investors. Persistent concerns around weakening economic conditions in the US, China, Europe and elsewhere as well as Fed tightening, trade issues and Brexit among other geopolitical issues have all been highlighted as drivers of weakness in markets.

Pleasingly, diversification provided some benefit over both the year and the month with fixed interest markets helping to offset the weakness seen in domestic and global equities. Australian fixed interest incrementally added value to portfolios through the year.



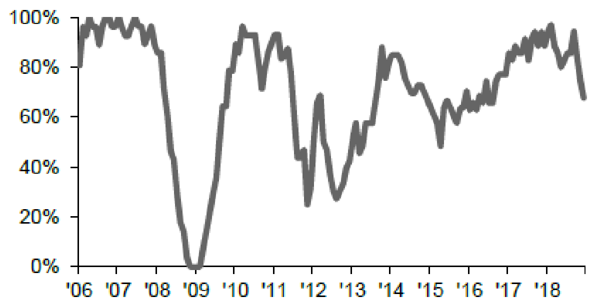
Source: Morningstar, AMP

Volatility which was particularly low in 2017 steadily increased through 2018 and peaked around Christmas. This was driven by some mixed messages from the Fed and concerns that US interest rate policy may be missing the mark and be contributing to an economic slowdown.

The mixed messages from US President Trump and Beijing made the hope for a trade resolution wax and wane. There is some hope remaining that an agreement will be hammered out by the end of the first quarter 2019.

Similarly, the on then off again Brexit deal contributed to volatility in both UK and European markets as a UK vote was cancelled at the last minute in December. A vote on Prime Minister May's agreed exit deal with Europe, is now expected around the 14th/15th of January with the chance of a no-deal exit now peaking as opponents of the solution remain unhappy with the situation for the Irish border. More details on specific measures for North Ireland are expected from Mrs May in the coming days.

Investor concerns are still in contrast to much of the economic data which remains quite positive. Unemployment remains low in the US and continues to fall in Europe and while now just above 8% has come down from over 12% in 2014. Some indicators are showing signs of slowing growth in particular the PMIs (purchasing manager index), an indicator of future activity, are suggesting a slowdown in industrial production growth in the US and Europe, while in the UK the PMI index actually improved in December to its highest level in twelve months. The chart below shows the percentage of countries that have manufacturing PMIs in expansionary territory which has dropped sharply which means nearly 40% of countries look like they will see a contraction in manufacturing in 2019. Some important export countries to now show contraction in manufacturing is likely to include China, Korea and Taiwan.



Source: J.P. Morgan Economic Research

While the outlook is according to many not great at this point, it doesn't appear to be gloomy either. While this is usually the case before a significant event in economies and markets, the issues in Europe, China and the US have clearly had less impact on domestic markets.

So, 2019 commences with many challenges. The global recovery post the GFC has matured and is now considered late-cycle with the risk of recession in the US and elsewhere now rising. The bull market which commenced in March 2009 is struggling and may be at an end, for some it ended during 2018. But as the chart and data on the previous page show, diversification continues to provide benefit.

Share markets

In December Australian shares (-0.1%) fared relatively well recovering some lost ground in the last few trading days of the year. The weakest returns were recorded in Info Tech (-4.0%), Telecom Services (-3.2%) and Financials (-3.1%). Some solid returns came from Material (5.3%) and Health Care (2.9%) with Resources, a subset of Materials, (5.1%).

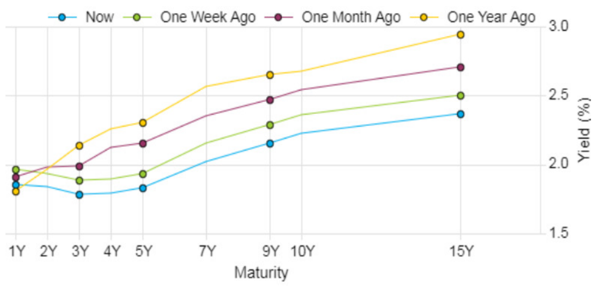
Over the twelve months to December Australian shares (-2.8%) fared well compared to international shares (-7.6%) on a currency hedged basis.

In December International shares (-8.3%) saw significant weakness as volatility surged. Particularly weak was the tech sector with the NASDAQ (the US's predominantly Tech based market) entering into bear market territory for the first time since the GFC. This was driven by weakness in Apple which lost 8.4% after falling 20.5% in November. Tech stocks were looking expensive earlier in 2018 and have come under significant pressure as global challenges continued to emerge through the year. Emerging markets (1.0%) unhedged was an area of strength in global equity markets. A significant fall in the Australian dollar provided some diversification benefit for unhedged international exposure and nearly halved the December loss of International shares (-4.3%) and enabled a slight positive (1.5%) return for the year.

Interest rates

Who said bond rates must rise? The concerns over global economic conditions and growth in the US saw bond yields shift down in a meaningful way in December. The US ten-year bond yield fell 32 bps to 2.67% while the Australian ten-year bond yields fell 27 bps to 2.32% its lowest level since October 2016. This resulted in solid returns in International (1.4%) and domestic (1.5%) fixed interest markets for the month. So, despite the concerns around long-dated developed market sovereign bonds (duration) in a rising rate environment, globally they delivered (1.7%) and domestically (4.5%) to help offset the losses seen in risk asset (shares and property).

The chart below highlights how the yield across different maturities in Australian government bonds has continued to move down over the last year. While a US version of the chart does show that yields increased over 2018 the end of the year did see a meaningful fall in yields across all maturities.



Source: FactSet 7 Jan 2019

Property

Listed property markets continue to be mixed with a stark contrast in performance between domestic and international listed property. The Australian listed property market (1.7%) managed to avoid the selling seen generally in risk assets. This is likely due to the high yields that are available and the desire for Australian investors to maintain income. Globally however listed property (-6.5%) was sold down in December along with other risk assets such as shares. Similarly, the contrast in property market returns, was also reflected in the returns for the 12 months to December. Australian listed property (3.3%) as compared to global property (-4.0%).

Australian assets fared well through 2018 and in December due to the very consistent economic data points with unemployment remaining low, interest rates having been kept on hold for 29 months and economic growth remaining buoyant.