View from the hill

APRIL 2019

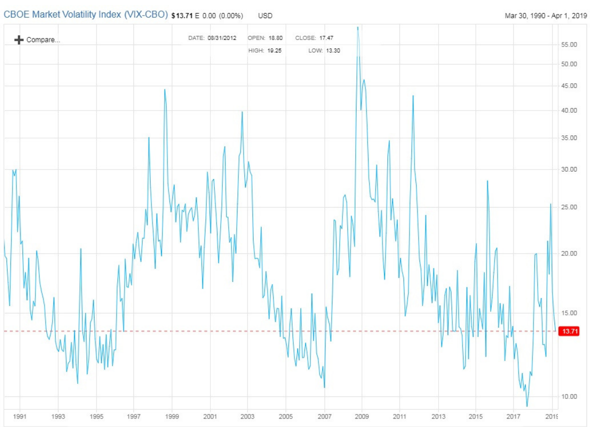
Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 March 2019.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	0.7	10.9	12.1	11.5
Smaller companies	-0.1	12.6	5.8	11.4
International shares (unhedged)	1.5	11.5	12.3	13.7
International shares (hedged)	1.7	12.6	6.5	12.0
Emerging markets (unhedged)	1.0	8.9	0.0	13.7
Property – Australian listed	6.0	14.4	25.9	10.2
Property – global listed	3.5	14.1	16.4	5.9
Australian fixed interest	1.8	3.4	7.2	4.2
International fixed interest	1.7	2.8	4.6	3.2
Australian cash	0.2	0.5	2.0	1.9

Overview & Outlook

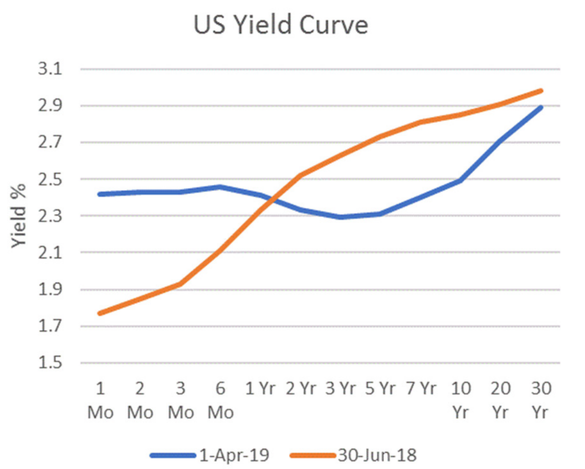
Conflicting signals between volatility in equity markets and bond yields who will be correct? Despite commentators suggesting volatility will remain high 2019 has seen volatility markets fall to rather low levels as can be seen by the fall in market volatility measure the VIX index in the chart below. This is suggesting all is well again.



Source: FactSet

The fall in volatility has been accompanied by a surge in listed property trusts and share markets globally and comes despite the continued uncertainty around Brexit, the unresolved situation with the US-China trade wars and many other aspects of Trump's administration. The key change has been the Fed's succumbing to pressures from markets and the White House to slow down (halt) the rate rises and ease off the quantitative tightening (selling down of assets by the US Fed). It appears that the weakening economic outlook in many parts of the developed world has put the brakes on Central banks' desire to normalise monetary policy.

The worrying sign is coming from bond markets and much has been made of the yield curve inversion in the US as a sign of recession on the horizon.



Source: US Department of Treasury, AMP Capital

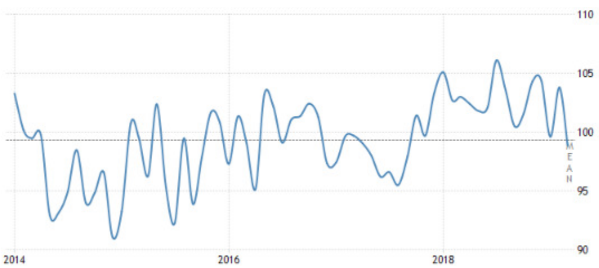
So, what is yield curve inversion? The yield curve is a line connecting the prevailing interest rate on government bonds over the various maturities. Lenders normally would expect higher interest rates for longer maturities to compensate for the added risk (the orange line in chart above). This is no different to term deposit holder wanting a higher rate for a five-year term deposit than they would for a 3-month deposit. However, when the market foresees economic weakness and likely cuts in interest rates this can result in shorter term yields being higher than longer term rate thus the ‘curve’ is inverted.

We can see in the previous chart that the curve has partially inverted and that economic weakness is being seen with rates expected to fall for a period, starting in around 12 months. The expectation of recession is far from a fait accompli and this type of inversion has provided false signal in the past. Furthermore, even if correct the timing may be wrong and could be as far out as two years away. There are a range of reasons this may be a false indication, importantly we have not seen the sort of excess (overinvestment, rapid debt growth, inflation, tight monetary policy) that normally precedes recession. We suspect that the indications from equity markets is closer to the mark for the time being.

Share markets

Australian shares continued rising gaining 0.7% for the month. Telecom services (5.7%) was the strongest sector with consumer staples (3.9%) and materials (3.5%) also performing well. Energy (-4.1%) was the weakest sector as Norway’s Government Pension Fund Global said it will phase out pure oil and gas stocks from its investable universe, to reduce vulnerability to a permanent oil price decline. Weakness in financials ex REITs (-2.7%) resulted as investors refocussed on the challenges for the sector and moved past the initial response to the Hayne Royal Commission final report.

Despite consumer staples’ good performance in March the sector has been the weakest thus far in 2019. In March, consumer confidence fell to its weakest level since September 2017 and with falling property prices, anaemic wage growth and significant inflation in non-discretionary item such as energy there are challenges for consumer driven businesses. However, these may be off-set to some degree by tax cutting and spending by the election winner.



Source: Tradingeconomics.com, Westpac, Melbourne Institute

International shares (1.7%) on a currency hedged basis performed better than the local market. With the S&P 500 up 1.9% for the month seeing the end of the best quarter since 2009 up 13.7% including dividends. Stimulus in China and a rebound in the forward-looking manufacturing PMI index, the stall in US rate rises and improved global liquidity combined to see emerging markets shares (1.0%) continue to see recovery.

While the risks of the trade war with China escalating, has reduced the risk of the UK exiting the EU without a deal has arguably risen. So, the last three months’ market moves make it clear that equity markets have placed significantly more emphasis on the US Fed’s decisions than other risks. The decision to halt interest rate rises and walk back from the quantitative tightening that the Fed had been embarking on to normalise its balance sheet is a reflection of weakening economic conditions but is also seen as a positive for equities.

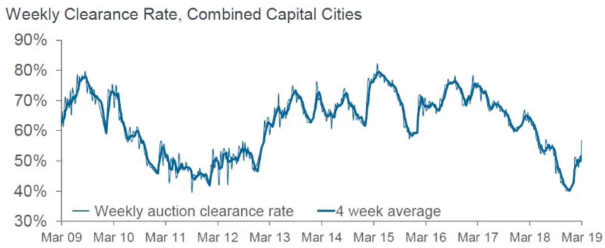
Interest rates

Australia’s cash rate has been kept at 1.5% by the RBA and the tone of the Board has become much more dovish. Falling bond yields means prices of bonds rose and as such Australian fixed interest (1.8%) was a strong performer in March and a little ahead of international fixed interest (1.7%) and the bond market continue to see economic weakness on the horizon and the need for rate cuts in the future.

Driven by weakening economic conditions and increasing likelihood that the next move by the Reserve Bank is a cut in interest rates, the Australian 10-year bond yield fell 32 bps to 1.79% and is now at record lows. In the US the 10-year yield also fell sharply 30 bps to 2.41%.

Property

Listed property markets were particularly strong significantly outperforming the broader share markets. Australian REITs (6.0%) outperformed the international counterpart (3.5%) on a currency hedged basis. This strength reflects the defensive nature of investors who have bought into bonds and generally more defensive investment such as property. This may also be a factor in more recent higher auction clearance rates in the residential property market with Sydney’s clearance rate hitting a 12-month high in March.



Source: CoreLogic