December 2018 Investment News

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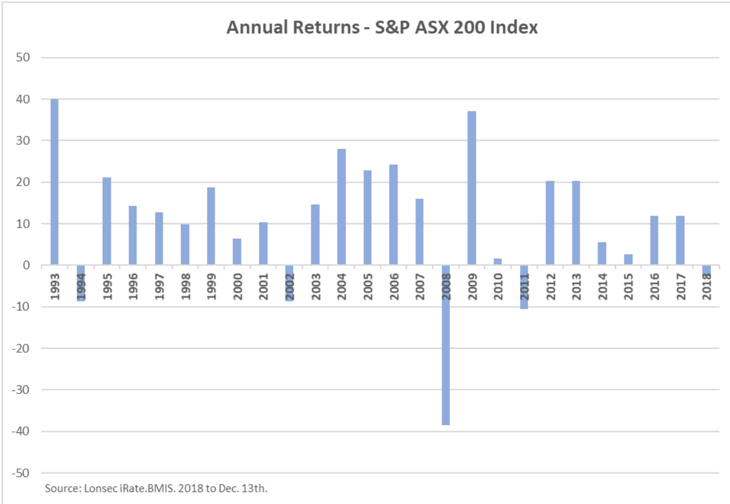
An end of year perspective on financial markets

After showing great promise throughout the year, 2018 has ended disappointingly for investors. As at mid-December, Australian and global share markets have produced returns of negative 2% to 3% (including dividends) for the calendar year. Cash and fixed interest returns have been moderately positive, ranging from less than 1% for global fixed interest to just over 3% for local investments. Listed property has also been positive, producing a gain of around 3% so far this year. The fall in the Australian dollar over the course of 2018 has provided one bright spot for investors holding unhedged global equity investments, with the lower $A pushing the value of equity investments held in overseas currencies higher by nearly 5%.



This year's likely negative return from equities is the first calendar year decline since 2011. Over the past 25 years, the Australian S&P ASX 200 Index has produced 20 positive calendar year returns and 5 negative years. As such, the small negative return in 2018 should not be considered highly unusual. From a medium perspective though, the Australian equity market's average annual return over the past 5 years of 6% is below the longer term 25-year average of 9%. It is also below the 10% per annum recorded by global equity markets over the past 5 years. The underperformance of the Australian market in recent years is consistent with the lower per person economic growth recorded domestically when compared with global averages. It also highlights the benefit in investors being geographically diversified. None-the-less, the 6% annual return (plus franking credits) generated by Australian equities over the past 5 years has still provided a reasonable premium over the risk free cash interest rate average of 2%.

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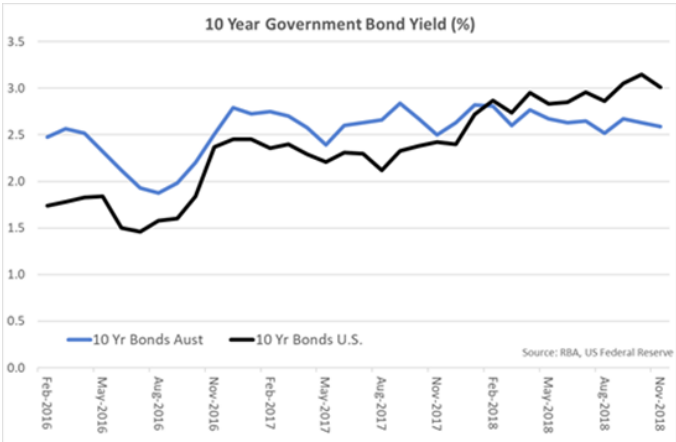
What drove share markets in 2018?

The year of 2018 was characterised by periods of very strong upward momentum in share markets spurred on by ongoing positive global economic growth. Over the course of the year, this growth became more and more United States centric, with the large U.S. Information Technology companies dominating growth momentum. The upward trajectory of markets was interrupted twice during the year. Firstly, over February and March share markets were sold off due to concerns that rising U.S. inflation and wage pressure would drive interest rates higher than expected. Notwithstanding some actual increase in U.S. interest rates, this fear gradually gave way to ongoing optimism around the outlook for company earnings which sent the U.S. stock market to a series of record highs. The positive sentiment that drove markets to these heights ended abruptly in October when share markets were sold off heavily, accompanied by a sharp increase in volatility over the December quarter. October's correction appeared to reflect a combination of concerns around the level of market valuations, some very selective signs of a deceleration in U.S. economic momentum as well the uncertainty produced by the U.S. mid-term elections, the U.S. / Chinese trade negotiations and the stalemate over the Brexit arrangements.

Outlook for the year ahead

Global share markets have tended to perform well over recent years due to the combination of steady predictable economic growth with maintained low inflation and low interest rates. Should this type of environment continue, then there is a reasonable probability of a return to positive returns from share markets. However, as was the case at the start of 2018, the threat that strong economic growth and tight labour markets, particularly in the U.S., will push inflation and interest rates above current expectations presents the greatest risk to equity markets. All else being equal, higher interest rates reduce the relative attractiveness of prospective equity market returns; and, as a result, share prices may have a tendency to fall in order equalise future risk adjusted return outcomes. However, the events of the past few months may have softened underlying inflationary risks somewhat, with the sharp drop in oil prices providing at least one deflationary force to offset inflationary pressures. This appears to be the conclusion of global bond markets, where the upward trajectory in yields has been partially reversed over recent weeks.



In addition to the risk that the "goldilocks" combination of solid economic growth with low inflation is disrupted, the geopolitical environment presents somewhat heightened risks. The U.S. / China trade situation remains the most significant of the potential threats. Of additional concern is that across the U.S., Europe and the U.K., the position of incumbent governments appears increasingly tenuous, which may not be conducive to sound economic management in the immediate future. However, in the case of the U.S. / China trade dispute, both parties have a strong incentive to negotiate a workable outcome, which, if forthcoming, could actually prove to be a source of support for share markets over 2019.

Australia is not immune to the political risks presented globally and a likely change of government here provides an additional source of uncertainty. Much of the domestic focus of markets will be on residential housing and ascertaining the impact of falling prices on banks and the broader economy. Continued underperformance of the Australian share market is possible until the bottom of the housing price cycle is known, and the impact can be assessed.

Key Opportunities

Investment strategies that appear relatively well positioned for the period ahead are described below:

- **Emerging markets**, such as much of Asia and South America, have underperformed the markets of developed economies over recent years. These markets have been subjected to bouts of capital outflow as a strengthening U.S. dollar and rising U.S. interest rates triggered a switch in investor preference to U.S. assets. With the exception of Argentina and Turkey, the emerging economies have held up well and generally shown to be prudentially sound whilst operating at above average rates of economic growth. Share market valuations appear cheap on a relative basis. The ratio of share prices to annual earnings in emerging markets is currently 12 times compared with a PE ratio of 18 times for developed markets.

- **Currency** exposure can be both a source of risk management and return. A decline in the value of the $A acts to boost the value of investment assets held in non $A currencies. Notwithstanding the decline in the $A that has already taken place (and the fact that currency movements are notoriously difficult to predict over the shorter term), the likely lack of any interest rate increase in the Australian economy in the months ahead may continue to create downside vulnerability for the Australian dollar. With the underlying growth trajectory of the Australian economy weaker than that of overseas economies, the prospects for interest rate increases globally are greater. A widening differential between Australian and global interest rates may subsequently reduce investor support for the $A.

- 2018 was a relatively difficult year for **active investment managers**. Those periods in which equity markets were rising strongly tended to be characterised by strong price momentum trends, rather than fundamental factors such as valuation, determining price movements. In the periods in which equity markets fell, selling was often seen as being indiscriminate with minimal consideration for stock specific factors. This recent pattern of price movement may have now created increased opportunities for professional active “stock picking” managers who can benefit from mispricing of securities and the ultimate reversion of share prices to align with the underlying fundamentals of companies.

Maintaining a focus on the long term

At this time of year, there is typically a strong focus on annual performance and the outlook for the year ahead. Whilst reflection and the assessment of future risk and opportunities are healthy investment activities, a one year time horizon is generally too short for any meaningful assessment or prediction. For longer term share market investors, the appropriate question to be asking at any time of year should be *"is there a reasonable prospect that the companies listed across global share markets will improve their earnings over the longer term?"* History suggests that the answer to this question is invariability "*yes*" and that ultimately share prices and dividends will follow earnings.

Important Information

The following indexes are used to report asset class performance and calculate the benchmark returns for this model portfolio: ASX S&P 200 Index, MSCI World Index ex Australia net AUD TR (composite of 50% hedged and 50% unhedged), FTSE EPRA/NAREIT Developed REITs Index Net TRI AUD Hedged, Bloomberg AusBond Composite 0 Yr Index, Barclays Global Aggregate ($A Hedged), Bloomberg AusBond Bank Bill Index, S&P ASX 300 A-REIT (Sector) TR Index AUD, S&P Global Infrastructure NR Index (AUD Hedged).

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