September Quarter 2019 Review

NEWSLETTER

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Easing of interest rates placates equity markets

The lack of resolution to trade tensions between the US and China is beginning to impact business sentiment, with central bankers around the world pushing interest rates lower in response to a weaker growth outlook. Highlights for the quarter included:

- Central banks lowered interest rates in many of the major world economies, including Australia
- Global bond markets and interest rate sensitive assets performed well
- US and UK political turmoil continues
- China/US trade tensions continue to weigh on financial markets and the economic outlook

International Equities

Following a strong June quarter, the past three months saw global equity markets facing more challenging times, with a short but sharp correction in early August. Concern over global economic growth has seen more than 30 central banks cut interest rates so far this year. However, most major equity markets recovered quickly from the August losses and posted positive returns (bar Hong Kong) this quarter.

Asset Class Return	3 Months	Annual
Australian Equities	2.4%	12.5%
Global Equities - Unhedged	4.4%	8.9%
Global Equities - Hedged	1.3%	1.9%
Australian Listed Property	1.1%	18.9%
Global Listed Property	5.6%	13.9%
Global Listed Infrastructure	2.3%	14.1%
Australian Fixed Interest	2.0%	11.1%
Global Fixed Interest	2.3%	9.8%
Cash	0.3%	1.7%

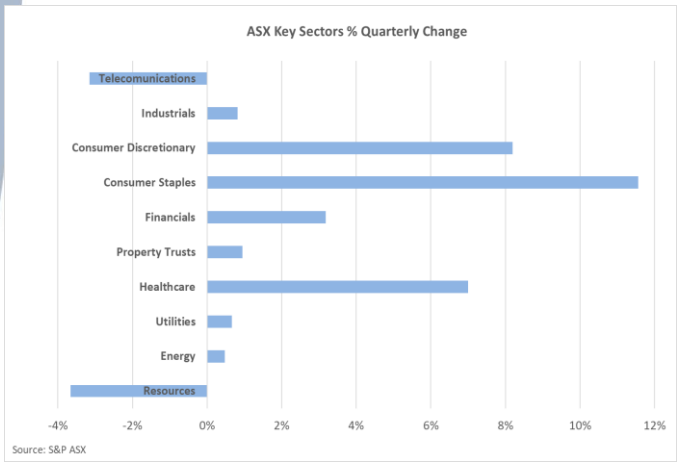
The end of September saw the US economy enjoying 123 months of uninterrupted growth, the longest run since records began in 1854. It is more than twice as long as the average post-WWII expansion. However, markets were concerned the ongoing trade war between the US & China is taking its toll on business confidence and the economy. The widely watched ISM Index, a gauge of the health of US manufacturing, fell again in September to 47.8, the weakest reading since June 2009 (an index below 50 signifies a contraction). Nonetheless, falling interest rates once again provided a source of support for the equity market with the US S&P 500 Index returning 1.7% for the quarter.

For China, the trade war has come at a challenging time. Growth slowed to 6.2% (annualised) in the second quarter, the slowest growth in 27 years. However, the Government is attempting to stimulate the economy, allowing a lower Yuan (local currency) as well as injecting $185 billion into the financial system. In addition, it announced an of

easing of restrictions on foreign purchases of stocks and bonds. The local market (Shenzhen CSI 300) rose marginally, up 0.9%. The Hong Kong market (Hang Seng) was the worst performing market falling 7.5%, impacted by pro-democracy demonstrations. There seems little relief in sight in spite of the leader, Carrie Lam, finally announcing the withdrawal of the China extradition bill that initially set off the riots.

In Europe, the central bank announced a return to looser monetary conditions, with a further cut to existing negative interest rates. The new official interest rate is now negative 0.5%. In addition, they will recommence their quantitative easing program, looking to pump 20 billion Euros back into the economy through a bond purchase program. The German (DB DAX) market was flat over the quarter, returning 0.2%. In the UK, Boris Johnson became the new Prime Minister with the task of seeking to take the UK out of the European Union. His strategy to do so has not gone to plan, resulting in financial markets none the wiser as to when and how Brexit occur. The uncertainty has had a dampening effect on the UK Pound and, as a consequence, many UK companies have benefited when converting their offshore earnings. The UK market managed a return of 0.9% over the quarter.

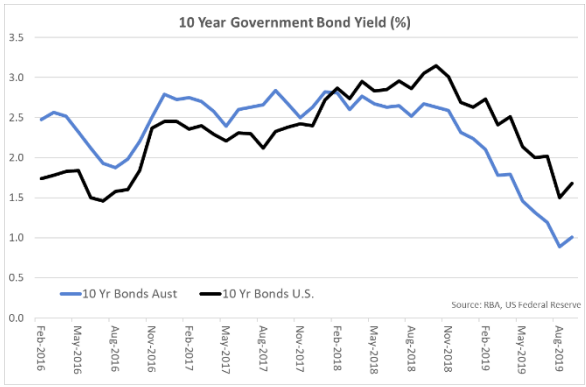
Australian Equities



In July, the ASX 200 Index finally crossed its pre-GFC all time high of 6828.7 set on November 1, 2007. However, the market failed to maintain the high, finishing the quarter up 2.4% at 6688 points. Results from the 2019 earnings seasons were somewhat disappointing, with 36% of companies beating market expectations, while 37% failed to meet them. Management generally painted a rather cautious outlook for the year ahead. The best performing sectors for the quarter were Consumer Staples (up 11.6%) and Consumer Discretionary (up 8.2%), with some positive surprises in retail store profit results. Healthcare also performed well (up 7.0%). Resources was the worst performing sector (down 3.7%) as iron ore prices came off recent highs. Energy was somewhat stronger (up 0.5%) possibly due to the attacks on two Saudi Arabian oil facilities in September, which pushed oil prices higher.

Fixed Interest & Currencies

The Reserve Bank of Australia (RBA) has cut interest rates three times (including the cut on October 1st) from 1.5% to 0.75%. Ongoing concern over the outlook for the domestic and global economies, and further interest rate cuts by overseas central banks, placed pressure on the RBA to provide the stimulus. The RBA has indicated it may undertake additional measures to stimulate the economy, but is also encouraging the Federal Government to undertake some of



the additional "heavy lifting" (fiscal stimulus). Ten-year bonds fell sharply over the quarter, reaching new all-time lows before recovering slightly to finish September yielding 1.01%. The Australian dollar was also weaker at 67.5 US cents, from 68.9 cents the previous quarter. US bond yields also fell over the quarter, with the US Federal Reserve lowering official rates twice. US 10 year Treasury bond yields dropped 0.32% to finish the quarter at 1.68%.

Outlook and Portfolio Positioning

The substantial fall in longer term bond yields recorded over the September quarter has further reduced the attractiveness of holding longer dated bonds, which are generally yielding below current inflation rates. Variable interest rate linked investments are preferred, as they provide less risk of capital loss should bond yields revert upwards. However, it remains inappropriate to substitute bond yield related risk with higher levels of credit risk, as the yields available on credit markets also provide investors with minimal return compensation for the risk taken.

Although equities are not excessively overvalued, a cautious approach to share market exposure remains warranted. Valuations have been supported by continued declines in interest rates, and if bond yields do revert from exceedingly low levels, then share prices may come under downward pressure. In addition, evidence of declining rates of global economic growth and the escalating levels of US and Chinese tariffs is likely to ultimately impact on company earnings, which creates a challenging environment for equities.

Given the risks associated with both bonds and equities, overweight positions to cash and assets with alternative return profiles appears appropriate.

Our portfolio positioning around holding unhedged foreign currency exposure across global share investments has been beneficial in recent months. This was particularly the case in August, when a lower $A offset some, if not all, the fall in global equity values. A bias to holding unhedged currency positions remains preferred, due to the possibility that the $A will continue to decline should the growth environment deteriorate further.