View from the hill

SEPTEMBER 2018

Market update

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

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	1.4	6.2	15.4	11.5
Smaller companies	2.5	2.5	22.3	16.9
International shares (unhedged)	4.1	9.3	24.3	11.2
International shares (hedged)	1.5	5.0	14.7	13.1
Emerging markets (unhedged)	0.0	-0.3	8.9	10.7
Property - Australian listed	2.6	5.9	15.7	10.8
Property - global listed	1.8	5.5	7.9	8.7
Australian fixed interest	0.8	1.5	3.8	3.1
International fixed interest	0.3	0.5	0.8	3.5
Australian cash	0.2	0.5	1.9	2.0

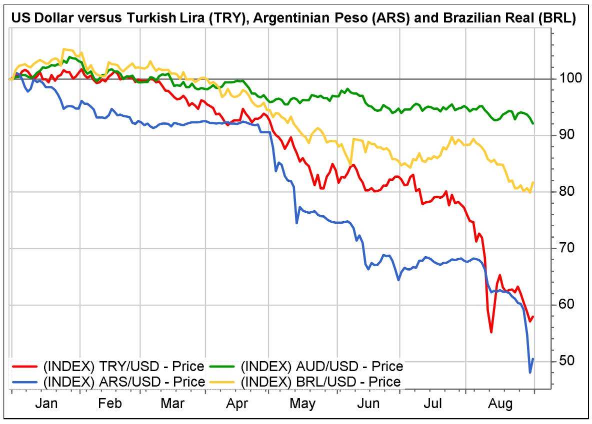
Overview & Outlook

US equities achieved a new milestone in August, the longest running bull market in US history 3,453 days since the low in March of 2009 and counting. If you don't think the 19.4% decline in 2011 counts, then since the market turned on 9th March 2009 the market has gained more than 300%. While this was assisted by significant stimulus from the US Fed, the fundamental backdrop has been progressively better over time and earnings have improved significantly. Despite this, on a range of metrics US equities do look stretched.

The US and China trade issues continue to provide concerns around the future for global trade and the flow-on to global economic growth. With pending US mid-term elections, negotiations between the US and China if not resolved very soon are not likely to recommence until late in 2018. Therefore, this will likely remain an overhang for the coming months.

The trade war does go beyond China with Trump declaring that he authorised the doubling of Turkey's tariffs on aluminium and steel to 20% and 50% respectively on the back of the depreciation of the Lira. The depreciation here was part of a larger emerging market concern.

Emerging market currencies (see chart) continue to be challenged, with Turkey seeing significant falls in the Lira and Argentina having its central bank raise interest rates from 45% to 60% to defend the Peso which has plunged to a record low versus the US dollar. Argentina has requested accelerated funding from the IMF as it endeavours to shore up its economy. South Africa, Mexico and Indonesia are also seeing pressure on their currency partly driven by US rate hikes.



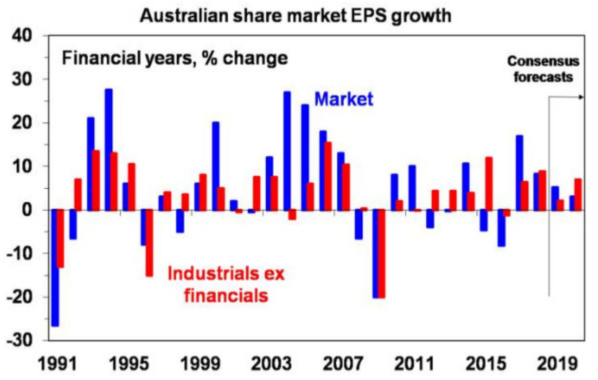
Source: FactSet, AMP - AUD provided for perspective

Australian political instability was reignited in August, firstly with a failed challenge for the Prime Ministership which was backed up a few days later with another failed challenge that none the less resulted in a change of Prime Minister. Peter Dutton was unsuccessful in his challenge for the role, with Scott Morrison emerging as Prime

Minister. Given an election will occur by 18 May 2019, the political situation may remain unsettled until then.

Share markets

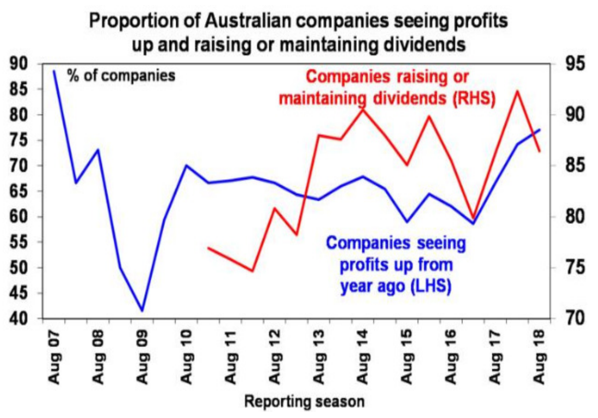
August saw the end of the Australian reporting season for companies with a June period end. The results were satisfactory with earnings growth roughly in line with expectations at around 8.0%, year-on-year. Impressively 77% of companies have seen rising profits despite the overall level of growth being weaker than the prior year.



Source: UBS, AMP Capital

Equity markets performed well again, with Australian shares gaining 1.4% and Global equities up 1.5% on a currency hedged basis. In Australia, Information Technology was a standout (12.3%) while telecommunications continued its recent strong performance (10.9%). Materials (-5.3%) was the weakest sector driven by commodity price declines and concerns around rising costs and the impact of US tariffs.

Capital management amongst Australian corporates was a key feature of the reporting season with the number of companies surprising the market, with dividends being higher than anticipated. A negative was the number of companies in August downgrading 2019 earnings forecasts being greater than those that upgraded their forecasts. The result is lower growth for the market is now expected for 2019 than was previously the case.



Source: AMP Capital

Interest rates

In Australia, the RBA has maintained the cash rate at the record low level 1.5% for the 25th month. Despite no change in Australian rates, rising off-shore funding costs for banks has reached a point where they have increased mortgage rates. Westpac was first, raising their standard variable rate by 14 basis points followed by ANZ's 16 basis points and CBA's 15 basis point increase. This followed smaller lenders some of which have raised their rates by as much as 25 basis point which is equivalent to a normal increase from the RBA.

Mortgage rate rises combined with very low wage growth and increasing non-discretionary costs are likely to constrain household spending and act as a drag on Australian economic growth and make it likely that the current low inflation will continue.

Bond prices generally rose with the US 10-year falling from 2.96% to 2.86% in what a fairly sharp fall across the longer end of the curve has been. This was driven in part by ongoing trade tensions and the escalating risks in emerging markets, and these concerns more than offset the strong US GDP growth of 2.9% year on year.

US corporates have geared up significantly since the GFC, driven by exceptionally low interest rates. This may be sensible in terms using more debt while rates are low, however current levels of debt are creating risks as interest rates increase. Currently US corporate BBB 5-year bond are yielding a slender 1.59% above US Treasuries, the risk-free benchmark and this does not, in our view, sufficiently account for the increasing risk. We see high-yield bonds as 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.

Fixed interest markets have delivered low returns over the last year. Global fixed interest generated just 0.8% over the last 12 months and Australian fixed interest providing a 3.8% return. Returns going forward will, most likely, continue to be muted.

Property

As is being well reported Australian residential property has delivered negative returns and recent mortgage rate increases will not help. The commercial space is however performing better with IPD releasing figures in August showing that direct property returns were 11.7% for the year end June 2018. Both global and Australian REITs performed strongly through August gaining 1.8% and 2.6% respectively. Retail focused REITs continue to struggle in Australia with weak wage growth, slow retail sales growth and strong online growth, all working against the brick and mortar retailers shopping centres. Office and industrial markets continue to deliver sound returns.