View from the hill

JUNE 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 May 2019.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	1.7	4.9	11.1	10.6
Smaller companies	-1.3	2.7	2.1	9.8
International shares (unhedged)	-4.4	1.4	8.8	10.6
International shares (hedged)	-6.0	-0.7	0.6	10.0
Emerging markets (unhedged)	-5.8	-2.0	-0.3	11.5
Property - Australian listed	2.3	6.0	17.2	8.2
Property - global listed	0.2	3.0	10.1	5.4
Australian fixed interest	1.7	3.9	9.0	4.3
International fixed interest	1.4	3.1	6.0	3.4
Australian cash	0.2	0.5	2.0	1.9

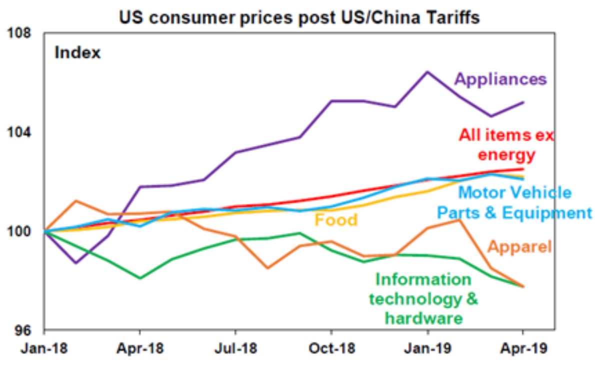
Overview & Outlook

Share markets may see further declines in the short term due to the imposition of tariffs from both China and the US along with further market uncertainty as negotiations continue around trade. China has hinted it may stop exports of rare earth minerals to the US and may establish a blacklist of companies that hurt Chinese interests. This would impose significant challenges to the US economy given China supplies around 80% of rare earth minerals to the US and are essential in the defence and electronic sectors. Since US companies have many suppliers in China and Mexico, any further tariffs will cause deep uncertainty around supply chains as businesses wonder which suppliers will be disrupted.

Investors were not surprised when the Reserve Bank cut the cash rate to an all-time low of 1.25%. Given the RBA has not met its inflation targets and is combating other fiscal factors such higher unemployment, we expect another cut by 0.25% in July or August and with potentially more to come if the economic indicators of inflation, unemployment and, to some degree, GDP growth do not move toward the desired levels.

Lower interest rates pull down all yields resulting in lower returns for bonds however government bonds remain an excellent option for portfolio diversification. The lower cash rate, will also reduce the rate financial institutions can offer on bank deposits as the return banks get on fund held with the RBA reduces. Term deposit rates have already come down in the expectation of the recent move by the RBA, this was done to allow banks to cut the lending rates on home and other loans and maintain their margins.

Given the increase in tariffs on Chinese imports, US Consumer prices have increased however the impacts have not been significant thus far. The chart below shows that the US inflation rate is currently at 2% (excluding energy) which is not significantly different to the level of a year ago. It is estimated that the potential tariffs imposed on the imports of consumer goods from China will have a direct impact on prices and is likely to add about 0.3% to annual inflation.



Source: Bureau of Labour Statistics, AMP Capital

Australia's average capital city house prices are likely to continue to fall due to tighter credit conditions, and a significant supply and demand mismatch with foreign investors having largely pulled out of the market. However positive factors such as the anticipated further rate cuts, First Home Loan Deposit Scheme, removal of the threat of a loss to negative gearing and the CGT discount as well as the loosening of the mortgage rate serviceability test, all may assist a stabilisation of the housing market and provide broader support to economic activity.

Share markets

Global share markets fell during May due to growing concerns of the escalating US-China trade war which could have consequences on economic growth. This is exacerbated by stalls in the negotiation processes and is made worse by Trump's decision to impose a 5% tariff from June 10 on Mexican imports, rising to 25% by October, unless the country stops illegal immigration.

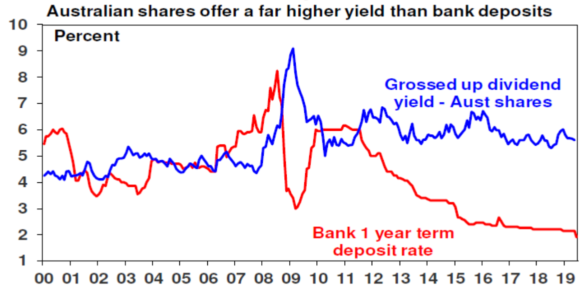
International shares fell by 6% during the month on a currency hedged basis. Factors attributed to this include the US raising tariffs on USD$200 billion of Chinese imports from 10% to 25% and China retaliating by imposing USD $60 billion on American imports.

However, Australian shares countered this trend, returning 1.7% during May. This out-performance was attributed to a more optimistic domestic outlook after an unexpected Coalition win at the Federal election, APRA easing lending standards on mortgage serviceability and expected cuts in the cash rate by the RBA.

Communication Services was the highest performer during May (+7.1%), followed by Healthcare (3.5%) and Materials (3%). Detractors include Consumer staples (-4.2%), Energy (-3.8%), and Information Technology (-3.1%).

The top performer was Evolution Mining (+21.3%). Despite gold prices increasing by only 2% last month, gold stocks saw increases due to increases in demand as investors flocked to perceived safety of gold stocks and to leverage a rising gold price. The worst performers included IOOF (-18.3%) and Pendal (-18.3%). IOOF was impacted by breaches in licence conditions and the delayed sale of OnePath to ANZ thus resulting in delayed synergies. Pendal's underperformance was due to lower fee margins than expected.

Given that Australian interest rates are likely to remain low for some time, the pursuit for yield and return will likely continue to drive commercial property, infrastructure and shares that offer sustainable high dividends. The chart below demonstrates how grossed up dividend yields on Australian shares far exceed the yields earned on a regular bank deposit. This may result in retirees taking on more risk to offset the lost interest on defensive assets.



Source: RBA, Bloomberg, AMP Capital

Interest rates

Australia's cash rate was reduced to a record low of 1.25% at the June RBA meeting, the first change in just under 3 years. This was primarily driven by higher unemployment rates and sustained low inflation below the Reserve Bank's target of 2-3%.

Factors driving low inflation include weak demand, intense competition, technological innovation, softer commodity prices, the economy having higher levels of spare capacity and the underutilisation of workers. Much of which, arguably, the RBA's target rate has little effect on.

Source: Reserve Bank of Australia, June 2019

The Australian 10-year bond yield decreased to a record low of 1.48% while in the US the 10-year yield fell to 2.13% and may fall further if monetary policy eases as signalled by Chair of the Federal Reserve Jerome Powell.

The Australian Fixed Interest Market returned (1.7%) in May while slightly higher returns were to be found in Australian Government Bonds which earned (1.9%.) International Fixed Interest (1.4%) was slightly below Australian fixed interest due to weaker returns in credit.

Property

Listed Property Markets had overall positive performance with Australia (2.3%) outperforming Global Listed Property (0.2%). This is reflected by continued strong demand for REITs with Australia's largest REITs having raised $2.1 billion so far in 2019, which was more than the total capital raised in 2017 and 2018. The majority of those funds were raised by Dexus ($964 million) and Mirvac ($750 million).