Client Newsletter

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Summary of Key Views

Emerging markets on the front line

June was a relatively strong month for markets with the exception of emerging market equities, which continued to retreat following a sharp pullback in May. Despite this, annual end of financial year returns for key asset classes were strong, with equities leading the way, posting double digit returns.

As discussed in previous months, we believe we are heading into an environment of increased volatility. This in itself is not a negative thing for astute investors, as it can bring up investment opportunities in a market where most assets have been priced at fair to expensive value territory in recent years.

The increase in volatility in emerging markets is a good example how a mix of various factors when combined can contribute to a rise in volatility. The emerging markets sector experienced a significant outflow of foreign investment in May (approximately US $12 billion), which was the largest in 18 months. The outflows were driven by idiosyncratic events such as the recent re-election of Turkey's incumbent conservative president Recep Erdogan for another 5-year term, and ongoing concerns of a trade war between the US and China. These issues were compounded with the strengthening of the US dollar, which has had an adverse impact on emerging markets.

While we expect volatility to rise, key economic indicators such as the unemployment rate, PMIs and consumer confidence indicators across key economies remain conducive to growth in the near term. We are watching the shape of the yield curve, which has flattened. Historically, inverted yield curves have been a precursor to recessions, which tend to follow six to twelve months after the yield curve has flipped. Asset class valuations remain fair to expensive, however the increased volatility in some sectors has created some early signs of valuation support.

Market developments during June 2018 included:

Equities

The S&P/ASX 200 Accumulation Index rose 3.3% in June, led by the Energy (+7.8%) and IT (+6.3%) sectors. A late rally in oil prices saw oil refiner Caltex (+10.6%) gain, solidified by the announcement of a long-term wholesale food supply agreement with Woolworths (+7.2%). Machine learning tech provider Appen (+31.0%) saw the biggest price gain in June, and has surged 235.1% over the past 12 months, with investors seeing a potential wave of demand from global tech giants for artificial intelligence data.

Over the past year to June, the ASX 200 has returned 13.0%, with Australia's top 20 largest shares proving the laggards, returning 11.3%.

Meanwhile, the S&P/ASX Small Ordinaries Index, the benchmark for small-cap shares, has returned a remarkable 24.3%, with themes such as technological disruption, Chinese demand, and the commodity rally driving valuations higher. Growth shares continued their winning streak through the first half of 2018 and are currently the main drivers of market returns, among them consumer staples shares like a2 Milk Co (+5.9% in June and +179.8% over 12 months), as well as big names like CSL (+3.6% in June and +39.5% over 12 months).

Global developed market shares, measured by the MSCI World Ex Australia Index, returned 2.3% in Australian dollar terms and 0.3% in local currency terms, reflecting lacklustre US performance, ongoing European weakness, and a softer Australian dollar. The US S&P 500 Index returned 0.6%, with the Consumer Staples (+4.2%) and Consumer Discretionary (+3.5%) sectors the biggest gainers. Twenty-First Century Fox A shares (+28.9%) jumped during the month as Disney (+5.4%) bested Comcast (+5.2%) in a tense bidding war for the Murdoch owned entertainment conglomerate, offering US$71.3 billion in cash and shares. Industrials (-3.4%) was the worst performing US sector in June, dragged down by American Airlines Group (-12.8%) and Caterpillar (-10.7%).

In Europe, the STOXX Euro 600 Index fell 0.6%, with trade uncertainty weighing on major auto stocks like Volkswagen (-11.6%) and Daimler (-10.6%). Other trade sensitive sectors took a hit during the month, including the pan-European basic resources (-3.8%) sector, while retailers (+1.9%) managed to keep their heads above water. In Asia, Japan's Nikkei 225 Index rose 0.7%, Hong Kong's Hang Seng fell 4.5%, and China's CSI 300 Index fell 7.0%. Emerging market shares fell 1.8% in Australian dollar terms, while small caps remain the superior performers over one year, returning 19.2%.

Fixed Interest

Australian bonds returned just under 0.5% in June, with Australian corporate debt returning 0.3% and government debt returning just over 0.5%. Long-term government bonds (with a maturity of ten years or more) returned 1.1%. Globally, the Bloomberg Barclays Global Aggregate Bond Index (AUD hedged) returned 0.2% as geopolitical tensions forced yields lower.

In the US, the flat shape of the yield curve continues to worry investors (a negative-sloping curve is historically a predictor of future recessions). The spread of 2-year over 10-year treasury yields converged to around 290 basis points during the month, threatening to invert for the first time since 2007.

At the same time, the US Fed is gradually raising the funds rate while the government is bringing ever more

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short-term debt to the market to finance its tax reform package, which has helped to raise the shorter end of the yield curve.

In Europe, Germany's safe-haven Bunds underwent further yield compression, with the 10-year yield falling from 0.34% to 0.30%, while the 5-year yield pushed further into negative territory, from -0.28% to -0.31%.

REITs (listed property securities)

The S&P/ASX 200 A-REIT Accumulation Index rose 2.2% in June as yield contraction lifted the sector during the month. Viva Energy REIT (+9.8%) was the top gainer, with parent company Viva Energy Group announcing its long-awaited IPO. Shopping centre leasing giant Scentre Group (+5.0%) continued to push higher, supported by favourable conditions in the retail market. High-yielding shares like National Storage REIT (+3.8%) also gained, providing an attractive income alternative to banks and telcos. Meanwhile, the prospect of falling house prices did nothing to help home and apartment builders Mirvac Group (-5.7%) and Stockland (-4.3%).

Globally, developed market property rose 2.0% on a hedged basis in June. In the US, REITs enjoyed their fourth consecutive month of gains after suffering a sharp correction earlier in 2018. The Bloomberg US REIT Index rose 4.0%, led by shopping centres (+7.3%) and self-storage (+6.2%), while hotels (-2.8%) were down.

Alternatives

Preliminary estimates for June indicate that the index decreased by 0.2 per cent (on a monthly average basis) in SDR terms, after decreasing by 0.5 per cent in May (revised). The rural and base metals subindices increased in the month, while the non-rural index decreased. In Australian dollar terms, the index decreased by 0.6 per cent in June.

Over the past year, the index has increased by 6.6 per cent in SDR terms, led by higher thermal coal, LNG and oil prices. The index has increased by 9.9 per cent in Australian dollar terms. Consistent with previous releases, preliminary estimates for iron ore, coking coal, thermal coal and LNG export prices are being used for the most recent months, based on market information. Using spot prices for the bulk commodities, the index increased by 2.7 per cent in June in SDR terms, to be 16 per cent higher over the past year.

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