Economic and Investment Update – April 2017

During the March quarter, politics continued to be the main focus of markets. The implementation of President Trump's plans were met with significant resistance; firstly his immigration orders were blocked by the courts, followed by Congress failing to pass the rewriting of the Obama healthcare legislation. The latter resulted in a six day losing streak on US markets as questions were raised about Trump's ability to implement proposed tax cuts.

The US Federal Reserve raised official rates in March to 0.75% off the back of better than expected economic growth and employment figures. Market expectations are for a further two rises this year although the Federal Reserve has expressed some caution.

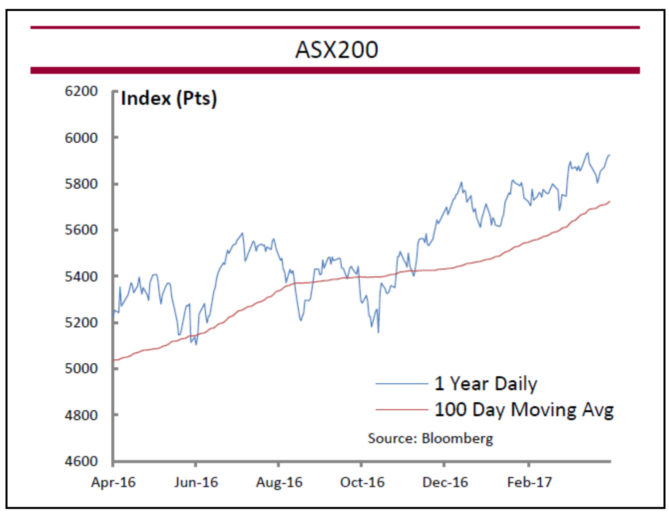
Across the Atlantic, on 30 March Britain formally invoked Article 50 in relation to the UK's exit from the European Union and Prime Minister May called a June General Election, in an attempt to strengthen her position prior to negotiations with Europe. The Dutch elections passed the markets by without much commotion. The first round of the French presidential election held on 23 April saw Emmanuel Macron outpoll Marine Le Pen of the National Front with the final round of voting due on 7 May 2017. A win by the more conservative Macron is expected to steady markets as the region moves through this tumultuous European election season.

Confidence grew in the Chinese domestic economy due to further Government stimulus although, high levels of debt is cause for concern.

On the domestic front, the Reserve Bank (RBA) held cash rates at 1.5%. The housing market continued to be a source of consternation with continued growth in the Melbourne and Sydney markets. The banking regulator responded with a number of measures including a limit on new interest only lending. Unemployment remained steady at 5.8%.

MARKETS

Despite political uncertainty, markets continued to post positive returns as risk appetite rose. The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished 4.8% higher over the quarter and by 20.5% over the past 12 months. The March quarter saw solid gains in Health Care, Utilities and Consumer Staples (all up 10.7%). However, Telecommunications finished lower (down 4.7%) as sector-heavyweight Telstra finished the quarter 5.6% lower. Small cap stocks underperformed larger companies and finished up 1.5% for the quarter and 13.7% for the year.



Internationally, the MSCI World ex-Australia Index returned 5.7% for the March quarter. Returns in Australian Dollar terms were 0.9% for the quarter as a stronger Australian Dollar reduced gains. The S&P 500 index (i.e. top 500 US stocks) is now trading at a cyclically adjusted PE ratio similar to those before the crashes of 1929 and 2000.

During the March quarter, the best performing developed market was Germany (up 7.3%, as measured by the Deutsche Boerse AG Index). In the US, returns were also strong with the Dow Jones Industrial Index finishing up 4.6% for the quarter.

Domestic listed property fell by 0.3% over the March quarter (but was up by 6.0% over 12 months). Global property rose 1.2% over the March quarter (+3.8% over 12 months).

Australian Government and global bonds produced positive returns for the March quarter as bond yields drifted downwards after a sharp rise in the previous quarter. Domestic bonds (as measured by the Bloomberg Composite Bond Index) returned 1.2% for the quarter whilst global bonds (as measured by the Barclays Capital Global Aggregate Index) returned 0.7%. Interest rate spreads in the credit market continued to narrow resulting in stronger returns compared to government bonds.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	ASX/S&P 200 Accumulation Index	4.8	20.5	11.1
	ASX Small Ordinaries Acc Index	1.5	13.7	2.3
International	MSCI World ex Aust Index (AUD)	0.9	15.6	16.4
	MSCI World ex Aust Index (AUD Hedged)	5.7	18.8	13.8
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	5.8	18.2	7.2
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	-0.3	6.0	16.9
International	FTSE EPRA/NAREIT Dev Prop Index (Hedged)	1.2	3.8	11.5
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	3.0	11.8	10.6
Currencies				
AUD v USD	Against US Dollar	5.8	-0.4	-5.9
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	1.2	2.1	5.1
	Bloomberg Ausbond Credit All Maturities	1.7	4.1	5.8
International	Barclays Capital Global Agg Index (AUD Hedged)	0.7	2.2	5.8
Commodities				
Gold	Gold – USD	8.9	1.3	-5.6
Oil	WTI Oil $/b – USD	-5.8	32.0	-13.3

Economic & Investment Outlook

Market momentum in the US dissipated over the quarter given softening economic data and doubts as to the President Trump's ability to implement reform especially in the area of tax cuts. Furthermore, political tension has increased given the ratcheting up of its war footing particularly in Syria and North Korea.

The US economy strengthened further with US unemployment in March falling to 4.5% - the lowest jobless rate since March 2007. As the US economy moves towards the top of its economic cycle, potential fiscal stimulus will increase pressure on wages and inflation. The Federal Reserve hints it will take a cautious approach in order not to snuff out "animal spirits".

Better than expected economic data has led the European Central Bank (ECB) to upgrade their 2017 and 2018 growth and inflation targets although fears about Greece continue to linger with many believing they will be forced to leave the Eurozone. The ECB has extended its Quantitative Easing (QE) program to the end of end of 2017 albeit at a lower rate.

The outlook for China remains positive given government stimulus measures aimed at helping corporate profitability and the health of the country's banking sector. Elevated levels of debt remain a concern with debt reaching 256% of Gross Domestic Product (GDP). However, growth in the use of credit is predominantly attributable to state owned enterprises hence the issue is the extent to which these loans are being used productively in respect of infrastructure and related projects or merely being used to prop up loss making ventures.

Despite concerns over housing affordability and the level of household debt, the cash rate in Australia remains at 1.5%, with core inflation a focus for the RBA. Expectations are for rates to be kept on hold at least until towards the end of the calendar year.

Australian Shares

Following further gains since 31 March, we recommend investors hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

Global and domestic markets have continued to price in prospective business and economic reform within the US despite the political uncertainty of policy implementation. Together with uncertainties around Australia's housing sector and correlation to overseas markets, this conveys a sense of uncertainty that warrants a level of caution.

A similar cautious approach to small cap stocks should also continue to be adopted.

Global Shares

We maintain our recommendation for investors to hold a neutral to underweight position to International Equities relative to their benchmark allocation and recommend a bias away from the US towards European and Emerging Markets.

Momentum indicators have been very strong given the post Trump election rally. However, markets appear to have got ahead of themselves having priced in the gains from the Trump election promises despite question marks over his ability to deliver campaign promises.

US equity markets look increasingly expensive on traditional valuation methods such as the cyclically adjusted prices earnings ratio. Contrast this to European markets, where further QE stimulus is expected to continue to buoy equity markets.

Emerging market valuations remain relatively supportive versus developed markets, albeit at heightened risk given volatile commodity prices and global trade protectionist agendas. A stronger US Dollar will also likely weigh on Emerging Markets.

Property

Recent updates to property valuations has resulted in the Australian listed property sector trading at a 4% discount to Net Asset Values. Low vacancy and rental growth especially in the Sydney and Melbourne markets remain supportive. Bond yields remain the key driver of future performance with capitalisation rates set to rise (and values fall) should bond yields rise. We maintain our neutral to underweight recommendation in this sector with a bias towards alternative unlisted Australian property.

The cycle of increasing interest rates heightens the risk around US property valuations. Across in the UK, London property values have fallen 15% based on a "hard Brexit". Consequently, we maintain our underweight position to global listed property.

Fixed Interest

Global Government Bonds still do not offer a particularly attractive yield with the prospect of capital losses in an environment of future interest rate rises. However, they do offer protection and the potential for gain in the scenario where investors rotate out of equities into bonds.

Although more attractive given the higher yield and flatter interest rate environment, Australian Government Bonds still do not offer a relatively high return.

The continued yield compression both globally and in Australia has resulted in credit securities becoming less attractive for the level of risk.

Sources: Lonsec, Schroder, Platinum