FOX Wealth Management

Quarterly Market Review

September 2018

This review looks at the global investment markets and reports on some of the underlying asset class performance and influences.

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CONTENTS

OVERVIEW	3
WHAT HAPPENED IN THE MARKETS	4
ASSET CLASS REVIEW	5
GLOBAL SHARE MARKETS	5
DOMESTIC SHARE MARKETS	6
DOMESTIC & GLOBAL PROPERTY	6
DEBT MARKETS	6
CURRENCY	7
WHERE TO FROM HERE	7
KEY MESSAGE	8
DISCLAIMER	8
CONTACT DETAILS	9

Please Note: Past performance is not a reliable indicator of future performance.

Warnings and Disclosure: The contents of this review are general advice and do not relate to the acquisition or possible acquisition of classes of assets or financial product(s). Before making any investment decisions the reader should obtain and consider more information, including the Investment Statement or Product Disclosure Statement for each product and, where relevant:

The reader must consider whether it is personally appropriate considering his or her financial circumstances or should seek further advice on its appropriateness. This is not to be taken as personal advice and does not constitute a recommendation to purchase, hold, redeem or sell any product(s), and the reader should seek independent financial advice before investing in any product.

OVERVIEW

Interest Rates and Trade tariffs steal the limelight

The global markets started the new financial year with stiff headwinds mainly fuelled by the changing trade environment post implementation of the US tariffs but also the Federal Reserve's continuing tightening of monetary policy, pushing the target US interest rates above the 2% level. In response, US 10year bonds were sold off above the 3% level.

This activity has not tempered the advance of the global share markets which posted reasonable gains under the circumstances. **Historically there has been an inverse relationship between shares and interest rates (so if interest rates rise, shares fall and vice versa).**

Debt markets are feeling the squeeze with investors chasing the higher yielding US securities as they pushed above 3% in the 10year Government Bonds. The resultant capital flows are fuelling demand for the mighty US dollar which is starting to flex its muscles and strengthen against global currencies.

Big picture concerns were mostly:

- Rising global interest rate trends;
- Trade impacts post the US import tariffs;
- China's economy and signs of slowdown; and
- Global currency response to the interest rate differentials, especially in the US.

Share market volatility was again moderate despite the background noise. Analysts remain interested in the valuation impact of companies with unhedged debt.

Monetary Policy

The Fed Chairman, Jerome Powell raised the target range for the **US federal funds to 2.00%-2.25%** at the recent 25th – 26th September 2018 FOMC meeting.

The Bank of Japan maintained their Quantitative Easing (QE) programme the BOJ maintained its short-term interest rate target at minus 0.1% and a pledge to guide 10-year government bond yields around zero percent.

The European Central Bank however has changed tack and announced that refinancing interest rates will remain low (0.25% margin loans to -0.40% deposit facility) however, the Governing Council will reduce the €30 billion a month net purchases under the asset purchase programme (APP) after September 2018. The Governing Council will **reduce the monthly pace of the net asset purchases to €15 billion** until the end of December 2018 and anticipates that, subject to incoming data confirming the medium-term inflation outlook, net purchases will then end.

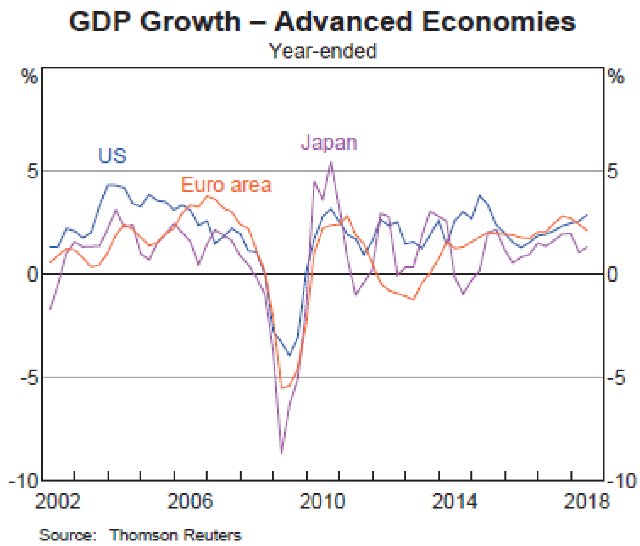
Growth and Inflation

The GDP data revealed that growth in the advanced economies continues to respond to the Central Bank efforts resulting in outcomes above 3%.

Globally, economists and Government officials are still looking for GDP growth of between 2% and 3% for the next fiscal year.

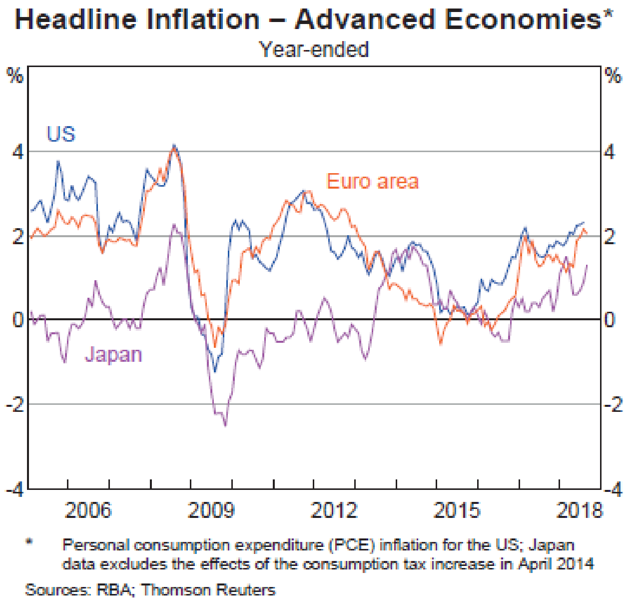
The latest charts for GDP and inflation data reveal:

Chart 1



Inflation is tracking higher in the US but seems to be struggling to gain any momentum in other regions. **Global inflation is expected to be 2.7%** in 2019 which reflects increased tariffs as well as a higher profile for oil prices next year. Gauging the effects of tariffs on inflation requires a view on currency moves and the degree of pass-through to final prices which can be difficult to accurately project.

Chart 2



Investment Climate

Investors are concerned about rising inflationary trends and the likely response via higher interest rates. The markets however, are convinced that the impact on share markets will be moderate as it will take some time for the current liquidity in the global economy to filter back into the Central Banks.

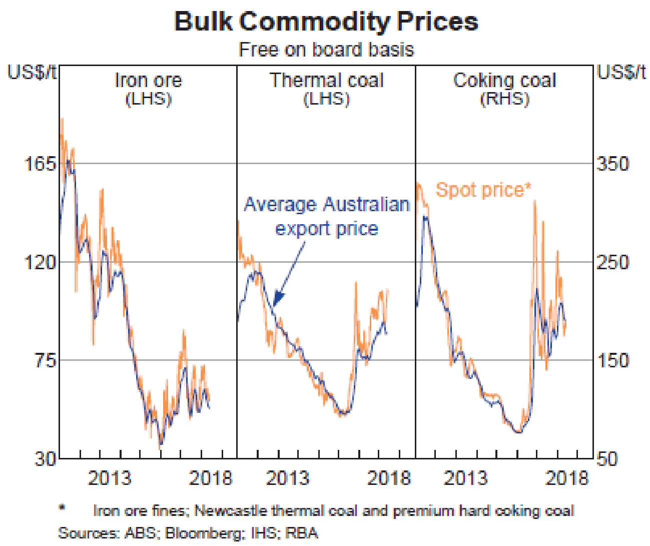
WHAT HAPPENED IN THE MARKETS

The global **share markets finished higher** as investor optimism continued to show support for a growing global economy brushing aside any negative expectations around tariffs. There will be a reaction to the trade tariffs when early data signals either a sharp slowdown or a muted response.

Debt markets were nervous as the US yield curve shifted higher in response to a strengthening US economy.

Commodity markets traded sideways to higher with Energy related markets enjoying a moderate bounce over the quarter with the WTI Oil price closing at US $70.12 a barrel which was a gain of 3.98% since June 2018 close of US$67.52 a barrel.

Chart 3



Iron Ore traded higher from US$65.04 a dry metric ton to close at US$68.44 in September 2018. This was a gain of some 5.23% over the quarter.

Economic Data:

Regionally, the economic data revealed the following:

- **United States of America**: The US economy in GDP terms, expanded by an annualized 2.9% in the second quarter of 2018, up slightly from the 2.6% in April 2018. The unemployment rate improved slightly to 3.7% in September 2018 down from 4.0% in June 2018. Inflation shifted marginally lower to 2.7% in August 2018.
- **China**'s GDP growth rate reached 1.8% in June 2018. The annual GDP growth rate year-on-year was unchanged at 6.7 % with the unemployment rate improving to 3.83% in the second quarter from 3.89%.
- **Europe area** GDP annualised growth rate was a little lower at 2.1% for the second quarter of 2018. Europe's unemployment rate improved to 8.1% for August 2018. Core inflation settled at 1.0% in August 2018; and
- **Australia's** latest GDP data for the second quarter of 2018 revealed an annual growth rate of 3.4% which was up again from the previous 3.1% in July 2018. Unemployment fell to 5.3% in August 2018, or 708,800 persons. The CPI Inflation rate finished higher at 2.1% in the second quarter of 2018.

ASSET CLASS REVIEW

Growth assets apart from US shares, were subdued over the quarter. US investor confidence was very strong as the concerns about the impact of the trade war remained on the sidelines. Investors retain a positive outlook overall for the rest of 2018.

Defensive assets had mixed results over the quarter as bonds were sold off but buoyed by interest coupons attached to the securities. The main concern for bond holders remains the US QT (quantitative tightening) strategy of the Fed and the impact on liquidity and bond markets globally.

Table 1

ASSET CLASS	RETURNS	RETURNS	RETURNS
GROWTH	3 Months	6 Months	12 Months
Global Shares	7.48%	13.64%	21.49%
Australian Shares	1.53%	10.14%	13.97%
Global Property	0.20%	7.38%	5.24%
Australian Property	1.86%	12.08%	13.20%
Global Infrastructure	-1.31%	4.11%	-0.14%
ASSET CLASS	RETURNS	RETURNS	RETURNS
DEFENSIVE	3 Months	6 Months	12 Months
Global Fixed Interest	-0.59%	-0.43%	1.03%
Australian Fixed Interest	0.55%	1.37%	3.71%
Australian Cash	0.52%	1.00%	1.87%

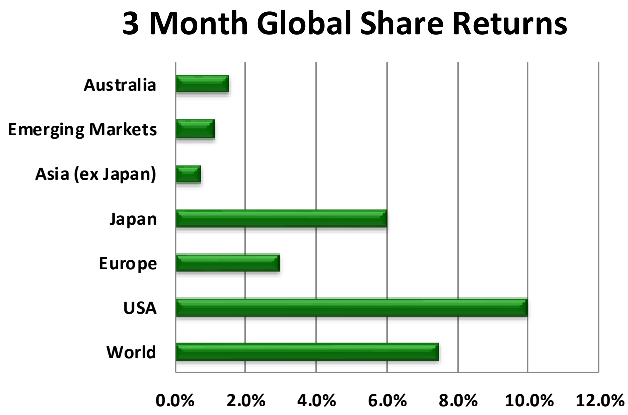
Source Data: Lonsec as at 30th September 2018

Note: The above performance returns reflect total returns in Australian Dollars (prices plus dividends assumed reinvested).

GLOBAL SHARE MARKETS

Global share markets were supported over the September quarter 2018 led by the US company reporting season that ended up broadly in line with most analyst expectations. The short-term impact of the trade flows is unknown as it is too early to accurately measure any results.

Chart 4



Source Data: Lonsec as at 30th September 2018

European share markets ended higher over the September 2018 quarter. While the ECB made changes to their monetary policy, the pace of economic growth in the euro zone was subdued. The ECB indicated it will reduce the EUR30 billion each month after September 2018 to EUR15 billion until December 2018.

Asia retreated somewhat following the nervousness surrounding the impact any trade war between the US, Canada, Mexico and China may have on the region.

Emerging markets continue to feel the brunt of the negative feelings regarding the trade concerns but now look oversold in Asia which, although not immune to the fallout, are in a region with high population density and continuing consumption needs.

China is still confident of hitting its economic growth target of around 6.5% this year despite views that it faces a bumpy second half as the trade row with the United States intensifies. We will watch the economic data for any impact.

In Japan, the stock market continues to perform returning just shy of 20% over the past year. The economy is growing with annual GDP growth rate of 1.0% reported in the second quarter of 2018 along with au unemployment rate of 2.4%.

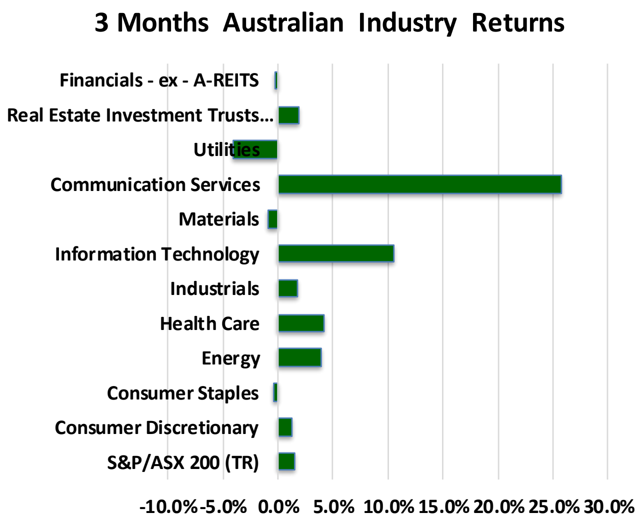
DOMESTIC SHARE MARKETS

The Australian share market (S&P ASX200) posted a modest rally over the September 2018 quarter ending up just 1.53%

The underlying sector performance was mixed with big gains in Communication Services (+25.79%) and Information Technology (+10.53) over the quarter.

The main contributors to the Communication Services performance result was the turnaround in Telstra (+21.76%) and the take-over activity surrounding TPG (+65.18) and Vodaphone. Technology shares were also volatile with APT Afterpay (+91.98%).

Chart 5



Source data – Lonsec as at 30th September 2018

For the rest of 2018 share analysts remain quietly confident of an improving economy and growing company profits with predictions for the S&P/ASX200 of reaching 6,780 (high 31st October 2007) by year end. With the S&P/ASX200 price closing at 6,207 for September 2018, this would put growth estimates for the last quarter of the year at 9.22%. This looks too ambitious and no doubt will be revised as the trade wars and interest rates cap growth expectations.

In terms of dividends, analysts expect defensive stocks to deliver around the 4.0 % p.a. which if fully franked at 100% (company tax at 30%) would deliver a yield of 5.71% grossed up.

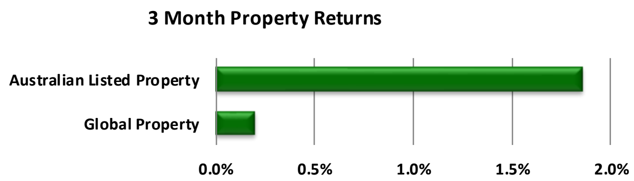
Remember this is a projection and subject to revision, **past returns are no guarantee of future returns**.

DOMESTIC & GLOBAL PROPERTY

Globally, the property sector experienced small gains (mostly dividend related) as the expectations for rising interest rates continue to weigh heavily on the sector.

Listed property in Australia was resilient posting gains of 1.86% over the quarter however, felt the interest rate pressure later in the month of September 2018 when the market fell some 1.77%.

Chart 6



Source Data: Lonsec as at 30th September 2018

As mentioned previously, most property funds have moderate gearing levels (circa 30% to 40%) with many opting for CPI indexed leases to help counter any future interest rate rises with additional revenue.

Many lock in their interest rate exposure which limits the impact of rising interest rates on cash flows.

DEBT MARKETS

The strengthening momentum for a major shift in direction for interest rates was felt in the September 2018 quarter with longer term bonds sold off leading to inferred higher interest rates globally.

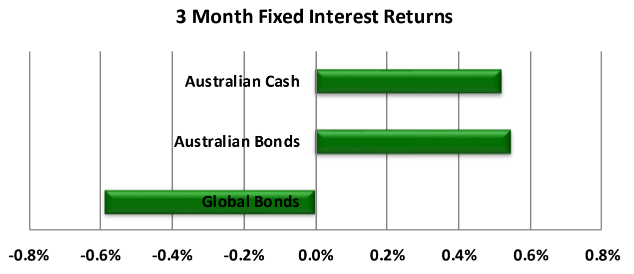
While the net effect was minor in terms of reported performance as coupons (interest payments) help mitigate the impact on capital losses the sector is anticipating further interest rate pressure which will keep investors nervous.

In the US, the Board of Governors of the Federal Reserve System voted to increase the federal funds target rate to 2.00% to 2.25% at their meeting on 26th September 2018.

The Committee commented that "the labor market has continued to strengthen, and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has stayed low. Household spending and business fixed investment have grown strongly. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent".

Source: FOMC Statement 26th September 2018.

Chart 7



Source Data: Lonsec as at 30th June 2018

The US 10-year Government bonds closed at 3.0625% for the quarter up in yield (0.21%) from the previous quarter close of 2.86%. The Australian Government 10-year bonds finished slightly higher in September 2018 at 2.68% up in yield from 2.66% in June 2018.

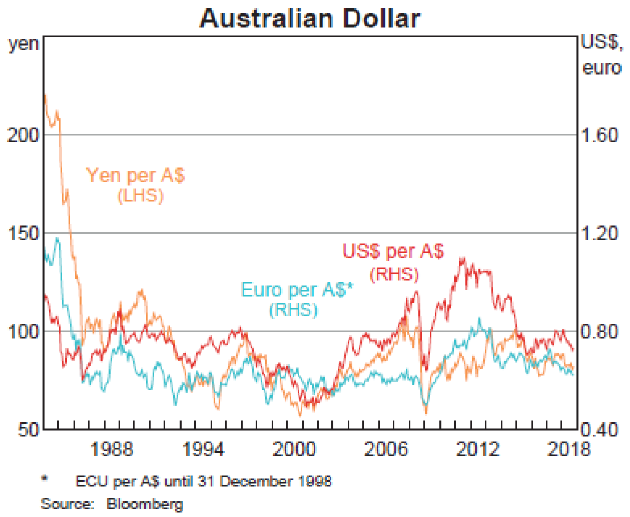
The Reserve Bank of Australia retained its monetary policy stance leaving the target cash rate unchanged at 1.5% at the recent 4th September 2018 board meeting.

Most domestic economists are expecting **little to no change** in the official Australian cash rate in the medium term however, the market is thinking that by mid-2019 inflation and growth may bring about a policy change.

CURRENCY

The AUD finished the September 2018 quarter lower at AUD/USD 0.7222 compared to 0.7391 at the start of the fiscal year, a fall of 2.29%. Currency forecasters see the AUD/USD range between 0.6500 and 0.8500 cents in the medium term.

Chart 8



The Australian dollar has been sold down off the back of the shift higher in US interest rates resulting in a stronger US dollar. There is a 0.38% interest rate differential in the AUD/USD 10year bonds in favour of the US. This gap has jumped 89% in the last quarter.

WHERE TO FROM HERE

The trade war impact on global growth is top-of-mind for investors. Any resultant slowdown in global demand for manufactured goods will impact China directly and will have repercussions across the globe.

We are seeing the change in perceptions now as the tariffs are in full swing. Much will depend on consumer behaviour going forward and any change in sentiment is likely to see markets quickly respond.

For **Australian share investors**, we play a waiting game as the US tariffs and restrictions for our key export markets take a toll. Given the fall in the AUD/USD, corporate earnings for the resource companies are likely to be aided by the lower currency and mildly higher commodity prices, especially oil.

We expect the market volatility to increase this time of the year however, we expect company earnings and profits to remain within guidance and support a mild increase in share prices over the year ahead despite periods of volatility.

For **Australian Bond investors**, the fixed rate bond markets remain the "hot spot" for **potential capital losses**, particularly the long-dated issues. The inflation numbers in Australia remain largely subdued around 2% and now that the residential property market is retreating, there is little momentum to push the cost of goods higher in the lead up to calendar year end hence, inflation should track sideways.

The bigger picture threat is rising global interest rates and credit spreads widening. We expect Australian bond yields will increase mildly over the year ahead but official cash rates to remain on hold.

KEY MESSAGE

Global trade imbalances, interest rates and growth expectations will weigh heavily on markets over the next quarter.

Globally we expect to see more volatility across all asset classes. While this is not the time to radically change strategic asset allocation exposures in terms of risk and return, there is the potential to tactically re-think how to mitigate any potential downside risks other than going to cash. More diversification using strategies involving **smart beta** can provide better risk/return outcomes.

For Australia, the economy is tracking along, held to ransom to a degree by the trade games. We expect the export markets will remain supported given the softer AUD/USD and firming commodity prices.

For growth: inflation, wages and retail spending will be closely watched however, leading up to the festive season, activity will be heightened which should trigger an improvement in consumer sentiment and add a boost to retail sales activity.

Looking further ahead, we expect that **over the medium term, shares will continue to experience earnings growth and the markets will maintain an upward bias despite the price volatility**.

DISCLAIMER

Note: The data used in this review was sourced from LONSEC, http://www.lonsec.com.au accessed on the 12th October 2018.

Benchmark	Country/Asset Class
MSCI World ex Australia TR Index AUD	Global Shares
MSCI Europe TR Index AUD	European Shares
S&P 500 TR Index AUD	United States Shares
MSCI Japan TR Index AUD	Japan Shares
S&P/ASX 200 TR Index AUD	Australian Shares
S&P/ASX Small Ordinaries TR Index AUD	Australian Small Companies
FTSE EPRA/NAREIT Developed ex Australia NR Index (AUD Hedged)	Global Property
S&P/ASX 200 A-REIT TR Index AUD	Australian Listed Property
S&P Global Infrastructure TR Index (AUD Hedged)	Global Infrastructure
Citi World Government Bond Index (AUD Hedged)	Global Bonds
Bloomberg AusBond Composite 0 Year Index AUD	Australian Bonds
Bloomberg AusBond Bank Bill Index AUD	Australian Cash
MSCI Emerging Markets TR Index AUD	Emerging Markets
Reserve Bank of Australia	Currency

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