

Last year we saw synchronised global economic growth for the first time since the global financial crisis (GFC). However, while the US economy is still growing strongly, a range of leading economic indicators point to a slower pace of growth in other regions. A stronger Euro and weaker Chinese demand have slowed down the pace of growth in Europe. However, the US economy is likely to keep growing at an above-trend pace, driven by President Trump’s fiscal stimulus of tax cuts and increased government spending.

After a number of strong years for share market returns, share markets have shifted gear since the end of 2017; moving into a more volatile, sideways trading range. We believe we are now stuck in a period of consolidation that may well continue through the balance of 2018. Emerging markets have been the laggard, underperforming most developed share markets. Australian shares have performed strongly over the prior 12 months but there are risks on the horizon, especially if the banking sector tightens credit conditions in the aftermath of the Royal Commission.

## How the different asset classes have fared (As at 30<sup>th</sup> June 2018)

Asset Class	10 Yr % p.a.	5 Yr % p.a.	3 Yr % p.a.	1 Yr %	YTD %	6 Mo %	3 Mo %	1 Mo %
Cash <sup>1</sup>	3.3	2.2	1.9	1.8	0.9	0.9	0.5	0.2
Australian Bonds <sup>2</sup>	6.1	4.4	3.4	3.1	1.7	1.7	0.8	0.5
International Bonds <sup>3</sup>	6.9	5.0	3.8	1.9	0.1	0.1	0.1	0.2
Australian Shares <sup>4</sup>	6.2	10.3	9.5	13.7	4.0	4.0	8.0	2.9
International Shares Unhedged <sup>5</sup>	9.2	15.0	10.1	15.4	6.3	6.3	5.6	2.2
International Shares Hedged <sup>6</sup>	9.2	13.1	10.1	11.7	1.4	1.4	3.8	0.3
Emerging Markets Unhedged <sup>7</sup>	4.9	9.3	6.6	12.2	-1.1	-	-2.9	-3.8
Listed Infrastructure Unhedged <sup>8</sup>	n/a	13.3	9.4	7.3	4.8	4.8	7.8	4.7
Australian Listed Property <sup>9</sup>	6.1	12.2	10.0	13.2	3.0	3.0	9.8	2.3
Int. Listed Property Unhedged <sup>10</sup>	n/a	10.9	7.1	8.4	6.1	6.1	10.2	4.8

<sup>1</sup>Bloomberg AusBond Bank 0+Y TR AUD, <sup>2</sup>Bloomberg AusBond Composite 0+Y TR AUD, <sup>3</sup>Bloomberg Barclays Global Aggregate TR Hdg AUD, <sup>4</sup>S&P/ASX All Ordinaries TR, <sup>5</sup>Vanguard International Shares Index, <sup>6</sup>Vanguard Intl Shares Index Hdg AUD TR, <sup>7</sup>Vanguard Emerging Markets Shares Index, <sup>8</sup>FTSE Developed Core Infrastructure 50/50 NR AUD, <sup>9</sup>S&P/ASX 300 AREIT TR, <sup>10</sup>FTSE EPRA/NAREIT Global REITs NR AUD

## Cash

The RBA once again left its benchmark cash rate unchanged at 1.5% for the twenty-third month in a row. Markets now price in the central bank remaining on hold well into next year. The RBA does not want to cut rates for fear of reigniting a cooling housing market. However, an indebted consumer makes the economy vulnerable to interest rate increases. With inflation subdued, the RBA can afford to continue to sit on its hands.

## Bonds

An increase in risk aversion in the second half of June pushed up a demand for bonds, which rose moderately. This has been the pattern so far this year. The US central bank, The Federal Reserve, continues to withdraw the liquidity it has injected into the system in response to the GFC and hike interest rates. This is negative for bonds. On the flipside, bouts of risk aversion driven by rising global tensions have pushed up demand for bonds. The net result of these opposing forces has been largely flat performance year to date.

Australian bonds have done better than those offshore in 2018 for a few reasons. Firstly, Australia is at a different point in the economic cycle with a central bank resolutely on hold. Secondly, short term interest rates in Australia are now below those in the US. International bond investments are (almost always) currency hedged. The negative interest rate differential means what used to be a hedging yield pickup is now a detractor.

## Australian Shares

Australian stocks had a good June. Investors saw value in the banks causing them to bounce by 4% after a period of sustained stock price weakness. Ongoing bank scandals, culminating in the Royal Commission; regulatory

pressures on residential lending standards; and high starting valuations relative to their peers offshore; have combined to see the sector out of favour this year. The Financials ex-REITS index is down -2.1% for the year to the end of June.

In contrast, mining companies haven't missed a beat. June was another positive month with the sector appreciating by just over 3%. So far this year they're up by 11%, and a whopping 41% over the last 12 months. Australia's world class lowest on the cost curve miners were oversold following the end of the mining boom. Chinese stimulus then led to renewed demand for iron ore. This, combined with operational cost efficiency programs and the end of large capital expenditure outlays (i.e. the mines are built), has seen the miners throwing off enormous amounts of free cash flow. Investors have cheered and the stocks have rerated accordingly.

### International Shares

The continuing easing in the Australian dollar meant currency unhedged international equities did better than hedged. This has also been the case year to date.

With European macroeconomic indicators disappointing, and renewed fears of Brexit; European stocks underperformed other developed economy share markets in June. US shares did the best with the Japanese share market taking out the silver medal position. This has also been the pattern for the year to date. US shares have added 9% this year, Japanese 7% and European 2% (all in local currency terms).

European stock markets have a heavy tilt to banks whereas US share markets are dominated by technology companies. Facebook, Amazon, Netflix, Google et al. continue to be priced on very high multiples by investors. In contrast, financials are not. Flat yield curves (long term interest rates are not much more than short term) mean banks' net interest margins are compressed. This is because a bank essentially borrows short term (in the form of the interest they pay on deposits) and lends long term (in the form of mortgages). The dominant sectors in each stock market is a big reason for diverging fortunes.

### Emerging Markets

Emerging markets continue to struggle for several reasons. Increasing US interest rates make emerging market assets relatively less attractive, leading to investors pulling their funds out. Some emerging market governments and corporates have borrowed in US dollars. Increasing US interest rates and dollar make these loans and bonds harder to repay. The higher oil price creates additional pressure, with many governments weaning their populations off fuel subsidies; and being forced to reverse course. This adds to the pressure on government finances. Finally, to cap things off, we now have an incipient trade war between the US and China. This caused Chinese shares, which has been relatively stable compared to the rest of the emerging markets, to sell off at the end of June and into July. Due to extended and complex global supply chains this impacted not just China, but much of emerging Asia.

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