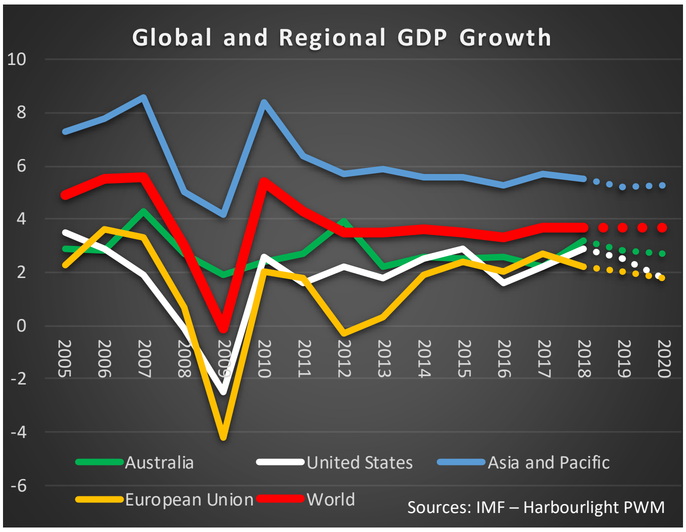
December 2018

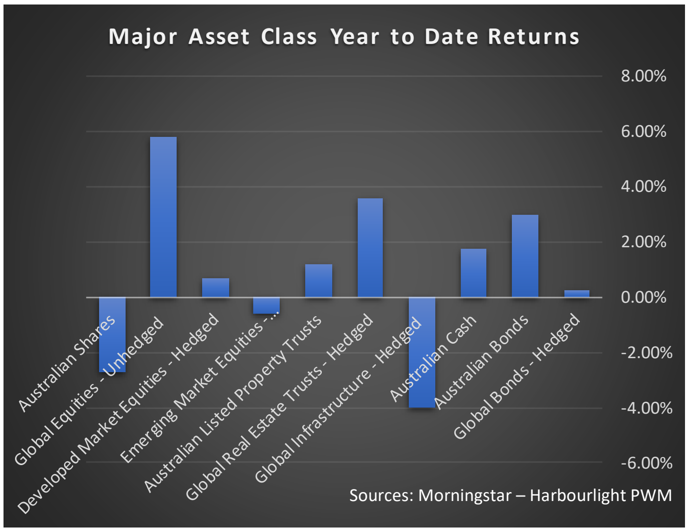
A Brief Review of Investment Markets and Broader Factors Affecting Clients in 2018 and 2019.

Macro-Economic and Asset Class

Investment markets opened 2018 on a positive note with most investors focused on geographically aligned global growth and an optimistic tone for financial markets. As the year progressed, political tension fuelled by the ongoing themes of international labour competition, populist politics and trade tension left the outlook looking more uncertain. Whilst GDP measures and forward projections published by the International Monetary Fund still show reasonably healthy expansion, uncertainty has come to the front of investors minds. Headlines continue to focus on Britain's pending exit of the European Union, an increased probability of a US recession and ongoing trade wars between China and the United States that look to alter global trade patterns.



As we approach year end, year to date returns for global growth assets are scattered between –4.00% and +5.82% with portfolio returns benefiting from unhedged offshore assets increasing in value due to a falling Australian Dollar. That's a very different picture to the end of the 3rd quarter, where the same year to date returns ranged between -2.2% and 14.2%. Commercial property and defensive stocks have held up better whilst energy, financial, consumer discretionary and technology stocks have suffered, highlighting the important role good defensive assets play in capital preservation and diversity.



Macro-Economic and Asset Class - Continued

So where does this leave us as we go into 2019? Financial markets and the media can make it hard to have an objective view, further allowing emotions to drive investment decisions frequently results in underperformance. A good place to start is to look at the actual current earnings coming from our investable universe, through this we can begin to have an educated view.

The table below shows the current earnings yield of various asset classes. Simply answering the questions of;

- What rate of earnings do the businesses we invest in via the stock market provide?
- What rental and development yield do the property and infrastructure investments we invest in provide?
- What rate of interest do our deposits provide?

Looking at these measures we can see a current earnings yield of 2.3% to 8.3% across our selected asset classes below. It's important to note this is a current number and doesn't reflect future growth in corporate earnings or rental payments.

Current asset class earnings rates before growth forecasting

Asset Class	Income measure	Primary Income Yield	Secondary Yield (Dividend)
Australian Equities	Earnings Yield	7.0%	4.5%
US Equities	Earnings Yield	5.4%	1.9%
International Equities Ex US	Earnings Yield	7.9%	3.2%
Emerging Market Equities	Earnings Yield	8.3%	2.9%
Australian Listed Property	Earnings Yield	6.3%	4.9%
International Listed Property	Earnings Yield	6.8%	4.1%
International Infrastructure	Earnings Yield	6.5%	3.4%
Australian Govt Bonds	Yield to maturity	2.4%	
Australian Corporate Bonds	Yield to maturity	3.1%	
International Bonds	Yield to maturity	2.3%	
International Credit	Yield to maturity	2.9%	

Sources: RBA – Morningstar - Vanguard - Harbourlight PWM

The table paints a story of lower interest rates and a good selection of growth assets offering broadly acceptable returns (neither cheap nor expensive) with the exception being the US where higher valuations are providing lower current rates of earnings. This picture starts to become more complicated as you address matters that could alter rates of growth, such as some of the risks mentioned earlier. Though we think it's a good way of starting whilst remembering GDP growth is on your side (in most countries).

Our Views for 2019

We believe we are approaching the later part of the investment cycle in most growth assets and support broadly diversified portfolios positioned to benefit from the themes shaping our world. From an asset allocation perspective we support slight overweights to shorter dated corporate bonds, Asian, Australian and European equities with lower weightings to US equities. We are also moving clients to slightly more conservative yet well invested portfolios and from currency un-hedged to half-hedged in their international equity portfolios.

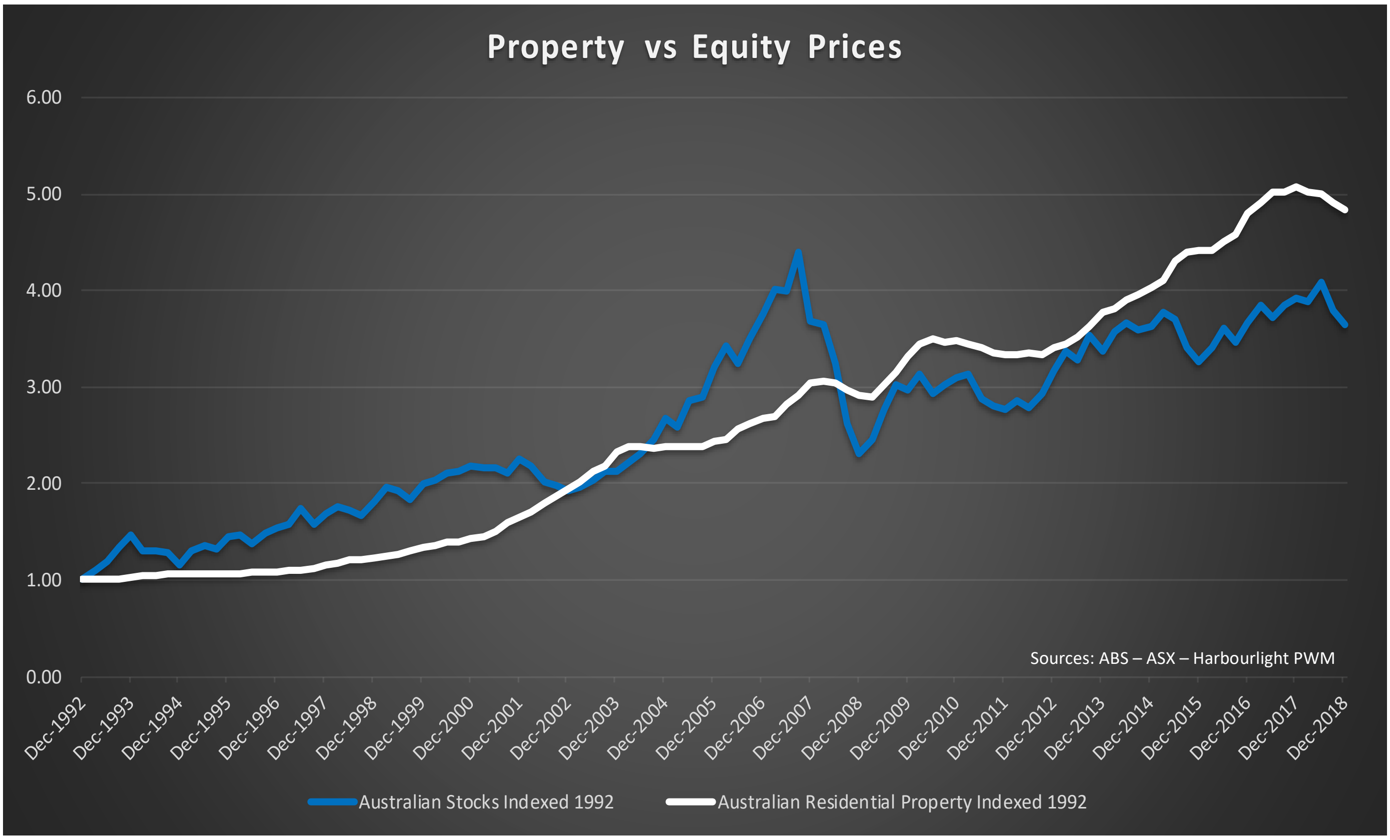
Australian Shares vs Property – A Hotly Discussed Topic.

Clients frequently ask about property prices and Australian shares, logically as property and equities often represent some of their largest and important assets.

If you live in Australia, you would be accustomed to an incredible amount of media interest in falling house prices and comparisons to other developed nations who have seen major property crashes in the last decade. If you're based in Europe, looking over your shoulder from periods that saw property prices in Spain and Ireland halve in five years, this is an understandable thought process too. There are some important points to consider here though. Australia currently has neither the employment issues, nor the mortgage arrears that appeared in Europe. What it does have is a significant rise in leverage, house prices and increases in migration due to a favourable lifestyle, employment prospects, a stable legal system and temperate climate conditions.

Not to say the issues faced by Europe couldn't appear in Australia but without a larger employment or interest rate oriented shock there is hope for a slow and steady stabilisation. Tightening lending conditions and a central bank conscious of the economic sensitivity caused by interest rate rises may help to facilitate a softer price landing.

Australian property prices have doubled in the last 12 years with particularly breakneck speed in Sydney and Melbourne followed by a year of price declines as demonstrated in the chart below. This has been against the backdrop of equity prices which are still below the level they were 10 years ago, suggesting a pretty low likelihood that Australian residential property will keep up with other growth assets over the next few years.



Other Regulative Matters

- The federal opposition continues to propose an end to the refunding of unused franking credits and an increase to the rate of capital gains tax across assets.
- We might see two Federal Budgets in 2019. The Coalition government has now announced that the 2019 Federal Budget will be held on 2 April 2019, with the federal election to be held shortly thereafter. If there's a change of Government, the ALP may release their budget just a month later.
- Senate continues to consider primary residence capital gains tax exclusions for expatriates who sell their homes whilst offshore. (To be delayed and further debate in senate in 2019).
- Superannuation regulation continues to evolve as the superannuation system matures and provides a higher degree of retirement savings for Australians. We have seen the maximum level of Superannuation contributions continue to decrease to $25,000 for concessional and $100,000 Non-concessional contributions. The Transfer Balance Cap applying to commencing retirement income streams remains at $1.6m.
- Incentives continue to be provided for those who have had less time to contribute to super, with the largest being a $300,000 non-concessional allowance for those aged over 65 who are downsizing their premises held for over 10 years.
- Superannuation Guarantee Contributions remain at 9.5% with a scheduled increase to 10% in 2021

Please feel free to contact us if you wish to discuss any of these matters.

Best wishes for the Festive Season and 2019.

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