Monthly Market Review – As at 31 May 2017

How the different asset classes have fared:

(As at 31th May 2017)

Asset Class	10 Yr % p.a.	5 Yr % p.a.	3 Yr % p.a.	1 Yr %	YTD %	6 Mo %	3 Mo %	1 Mo %
Cash[1]	3.9	2.6	2.2	1.8	0.7	0.9	0.4	0.1
Australian Bonds[2]	6.3	4.5	4.9	2.5	3.2	3.0	2.4	1.2
International Bonds[3]	7.5	5.6	5.3	2.7	2.1	2.4	1.4	0.6
Australian Shares[4]	3.4	11.6	6.2	10.2	2.6	6.9	1.3	-2.6
Int. Shares Unhedged[5]	5.0	18.7	14.2	13.3	7.3	12.1	8.4	2.8
Int. Shares Hedged[6]	6.4	16.8	10.5	19.3	9.0	12.2	4.2	1.8
Emerging Markets Unhedged[7]	3.4	10.2	9.5	24.0	14.0	16.6	11.4	3.4
Listed Infrastructure Unhedged[8]	N/A	18.0	15.3	12.2	11.0	16.6	12.1	4.6
Australian Listed Property[9]	-0.1	16.3	15.2	2.3	1.5	8.3	2.2	-1.0
Int. Listed Pty Unhedged[10]	N/A	14.3	12.5	-2.0	-1.2	4.9	2.0	0.4

[1]Bloomberg AusBond Bank 0+Y TR AUD, [2]Bloomberg AusBond Composite 0+Y TR AUD, [3]Bloomberg Barclays Global Aggregate TR Hdg AUD, [4]S&P/ASX All Ordinaries TR, [5]MSCI World Ex Australia NR AUD, [6]Vanguard Intl Shares Index Hdg AUD TR, [7]MSCI EM NR AUD, [8]FTSE Developed Core Infrastructure 50/50 NR AUD, [9]S&P/ASX 300 AREIT TR, [10]FTSE EPRA/NAREIT Global REITs NR AUD

Overview

May was another broadly positive month for investors. Both defensive investments, like bonds, and growth investments, like shares, did well. The exception to this was Australian shares, where a rerating of bank shares led the local market lower.

International Shares

Developed Markets

International share markets continued to grind higher through May. Some of the initial market enthusiasm for President Trump has dissipated as implementation of tax reform and other policy changes proved to be somewhat harder than Trump and, apparently, the market expected.

Nevertheless, the US economy is continuing to show strong momentum. This seems to have been enough to keep US shares running even higher, despite stretched valuations.

European share markets also did well. Eurosceptic candidates in the Netherlands and France were resoundingly dispatched. Economic growth at last looked reasonably solid, and even stubbornly high unemployment rates have started coming down. European equities also represent relatively better value.

Hedged vs Unhedged?

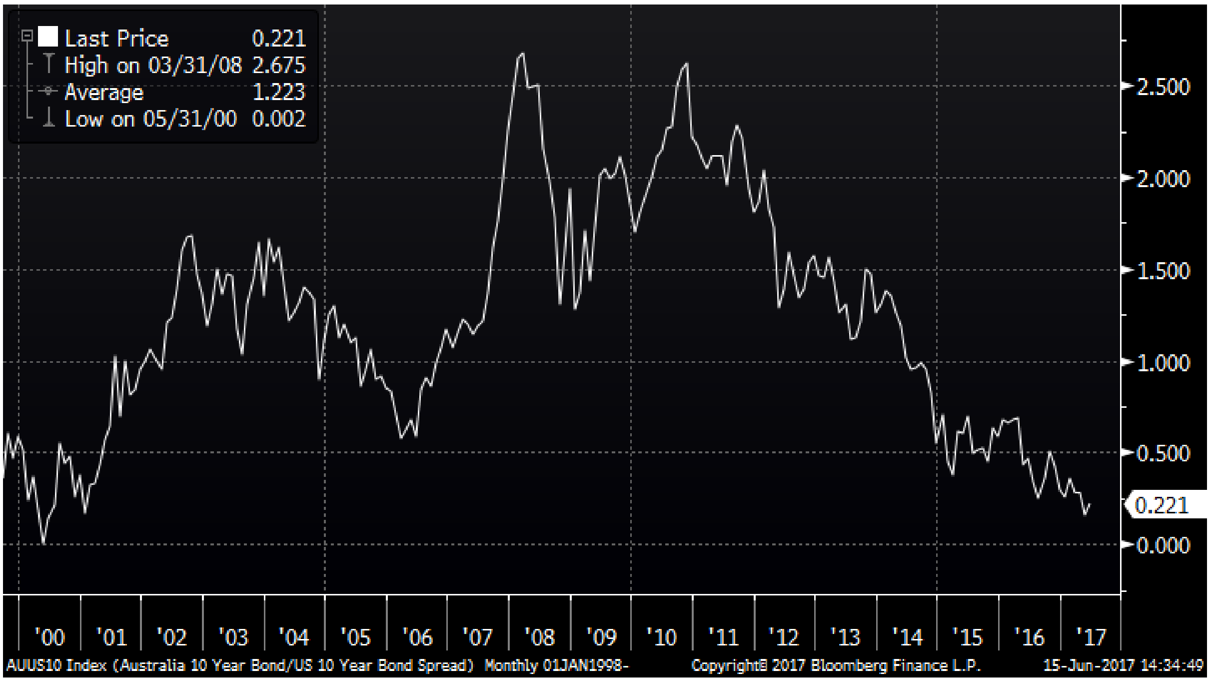
The Australian dollar softened slightly; resulting in currency unhedged international shares doing better than hedged. The fact it was just a softening, rather than a bigger fall is somewhat puzzling.

Two of the main drivers of AUD are the terms of trade (i.e. how much we get for our exports vs how much we pay for our imports) and yield differentials (i.e. what an investor can get here for their money vs off shore).

Both seem to be pointing towards a much lower A$.

The former has deteriorated markedly in the last few months: iron ore fell from above $US90 a tonne in March to the low $50s in June. Yield differentials also are weakening as a support for the AUD.

The chart below shows the yield (in %) a holder of 10-year Australian Government Bonds receives less the yield a holder of 10 year US Government Bonds receives:



The spread between the two is almost as narrow as it has ever been.

Yet, despite these two supports for the AUD being pulled from under it, the AUD is seemingly defying gravity and has hardly budged. Needless to say, we believe investors should continue to hold the international equities portion of their portfolio currency unhedged.

Emerging Markets

Emerging markets again had a good month, and are the best performing asset class this year. As is often the case, this is the opposite of what was supposed to happen according to most market pundits at the start of the year.

The argument then was that rising US interest rates and a rising US dollar would be bad for Emerging Markets. The idea being that companies in the emerging world had borrowed in US dollars; whilst their revenues were in their own local currency. Consequently, when things reversed and US interest rates and consequently the US dollar rose, the sum of their debt would increase and they would struggle to service it. There were also significant concerns about rising levels of protectionism in the US.

As it turned out Trump's bark was a lot worse than his bite. His summit with the Chinese leader, Xi Jinping, led to a softening in stance as the focus switched to getting the Chinese to take a harder line with North Korea.
Doubts about the actual implementation of Trump's stimulatory tax and infrastructure spending plans; along with fairly lack lustre "hard" economic indicators out of the US, such as inflation and GDP growth, saw the US

dollar rally fizzle. Finally, plain old fashioned value attracted buyers to emerging market equities. In a world where most markets look fair to expensively valued, emerging markets seemed to be one of the few where any potential bad news was at least somewhat priced in.

Australian Shares

In contrast to off shore share markets, Australian equities did not have a good month. A logical reason for this, one would think, was the fall in iron ore; which could potentially lead to weakness in the resource companies that are one of the two sectors that dominate the ASX.

While one might think this...one would be wrong. The ASX 200 Resources sub sector index actually had a positive month: advancing by 1.2%. It was actually the other dominant ASX sector, the banks, that was behind the poor result. The ASX 200 Financial sub sector index returned -7.7% for the month.

The banking regulator in Australia (APRA) has been gradually tightening the screws on bank lending over the last 12 months. The Federal Government also got in on the act, with the bank levy announced in the budget. This in turn drove increased debate over the sustainability of continued strong housing price increases on the East coast. A final factor in the downward rerating of the banks by the markets is the high valuation placed on their shares. The Australian big four banks are some of the most expensive banks in the world. With conditions likely to be less favourable in the past, investors took profits on their bank holdings.

Bonds and Cash

After the initial bond selloff late last year; bond markets have recovered, seeing positive returns this month, and indeed over all time periods. Some doubts have set in with the reinflation hypothesis. Despite the rosy US labour market, US inflation remains stubbornly low.

In cash markets the RBA continued to remain on hold, leaving the cash rate at 1.5%. The Federal Reserve (the “Fed”), however, chose to press ahead with rate hikes despite the inflation data; arguing that the US was at full employment and this would find its way into wage inflation, and eventually, general inflation. Given the lags in the effects of changes in monetary policy on the economy the Fed believes it has to act now to avoid the economy overheating.

While it attracted less attention than the rate hike, the Fed also announced that it was going to gradually shrink its balance sheet over the next 3 - 5 years to around half the current size. This marks the start of the attempted reversal of the grand quantitative easing (QE) experiment put in place in the wake of the GFC. The withdrawal of this massive amount of liquidity has never been attempted before, so the Fed, and markets, are watching how this will unfold with interest.