# 2017 financial year in review

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*'With the close of the 2017 financial year, it's time to review what's happened in investment markets this year and look ahead'.*

## A rewarding year for investors

The financial year to 30 June was a very welcome contrast to the previous financial year when uncertainty was high and market returns were low. Despite political risks featuring prominently through the year and higher interest rates in the US, the financial year has been a rewarding one for investors (see Table 1).

The global economy's improved performance over the past year and pick-up in corporate earnings were very supportive of share markets. Positive business surveys, rising consumer sentiment, solid jobs growth and lower unemployment have been evident across the US, Europe and Asia. This stronger global economic performance was sufficient to counter political uncertainty, especially in Europe where electoral success of anti-European Union parties was feared.

**Table 1: Mainstream asset class returns (%) in Australian dollars – periods to 30 June 2017**

| Asset class | Returns * | | | |
|---|---|---|---|---|
| | 1 yr | 3 yrs (pa) | 5 yrs (pa) | 10 yrs (pa) |
| Cash | 1.8% | 2.2% | 2.5% | 3.9% |
| Australian bonds | 0.2% | 4.3% | 4.3% | 6.2% |
| Global bonds (hedged) | 0.5% | 5.1% | 5.5% | 7.5% |
| Global high yield bonds (hedged) | 7.5% | 5.1% | 0.0% | 0.0% |
| Australian property securities | -5.6% | 12.2% | 14.2% | -0.1% |
| Global property securities (hedged) | 3.2% | 8.7% | 12.3% | 4.2% |
| Australian shares | 14.1% | 6.6% | 11.8% | 3.6% |
| Global shares (hedged) | 21.0% | 9.6% | 14.9% | 6.4% |
| Global shares (unhedged) | 15.9% | 12.9% | 17.8% | 5.3% |
| Emerging markets (unhedged) | 20.5% | 8.7% | 10.6% | 3.3% |

* Annualised returns. Past performance is not a reliable indicator of future performance.

Sources: FactSet, JANA Corporate Investment Services Limited.

Benchmark data include Bloomberg AusBond Bank Bill Index (cash), Bloomberg AusBond Composite 0+ Yr Index (Aust bonds), Barclays Global Aggregate Index Hedged to $A (global bonds), Composite benchmark of indices for MLC's high yield managers (global high yield bonds hedged), S&P/ASX300 A-REIT Accumulation Index (Australian property securities), FTSE EPRA/NAREIT Developed Index hedged to $A (global property securities), S&P/ASX200 Accumulation Index (Aust shares), MSCI All Country World Indices hedged and unhedged in $A (global shares), and MSCI Emerging Markets in $A.

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## Global shares are all “TRUMP-ed up” but risks are still evident

Global shares made robust returns over the past year, delivering 21.0% on a hedged basis. The unhedged return was lower at 15.9% because the Australian dollar (AUD) strengthened against most of the world’s major currencies. The AUD’s resilience was surprising given that the US central bank has been raising interest rates while Australia’s economic data has been unspectacular. However, the rebound in iron ore and metal prices was particularly supportive for our currency.

In the US, the S&P500 Index gained 17.2% in local currency terms and achieved record highs. President Trump’s bold promises of corporate tax cuts, higher infrastructure spending and less regulation were supportive factors. European share markets also made remarkable gains given positive economic activity and encouraging business surveys. Germany’s was up 27.3% for the year and the French market gained 24.8%. Despite the uncertainty created by the surprise Brexit vote and the Conservative Party’s recent loss of their parliamentary majority, the UK share market increased by 16.9% as the weaker currency will benefit UK companies with offshore earnings.

## Political risks were a major theme driving markets

Political risks featured prominently over the past year in terms of elections. Yet even with the dramatic headlines and surprising results, these elections have proven to be only temporary setbacks to risk taking.

Australia’s Federal Election in July 2016 started the political year of surprises with a narrow victory to the Turnbull Government. Turkey’s coup attempt in July 2016 caused some initial turbulence in emerging markets. The election of Donald Trump as US President in November 2016 was the major political event of the financial year. President Trump’s bold stimulus policy agenda inspired Wall Street.

Even concerns over European political stability have proven transitory. Italy’s constitutional referendum setback in December with the resignation of Prime Minister Matteo Renzi had minimal impact. The early stages of the French Presidential campaign did cause some angst given Ms Marine Le Pen’s pledge for France to have a referendum on European Union membership. However the election of the moderate pro-European candidate in Emmanuel Macron as French President in May 2017 provided considerable assurance to investors. Britain’s general election in June 2017 provided the final political surprise with the Conservative Party losing their parliamentary majority, compelling Prime Minister Theresa May to seek the support of the Democrat Unionist Party to maintain power. In March 2017, Britain finally triggered the start of a Brexit negotiation process. This political saga may have more surprising twists and turns ahead given the complex negotiations are due for completion in March 2019.

## Central bank policies remain a key influence

With the global economy’s improved performance over the year, the central banks have been closely watching the markets, particularly the US.

The US economy recorded strong consumer spending and job gains. Notably the US unemployment rate fell to 4.3%, which is its lowest level since early 2001. US price pressures have been reasonably contained with inflation running below the central bank’s 2% target. Given this healthy activity data, the US Federal Reserve (Fed) raised interest rates by 0.75% over the past year, which takes the Fed cash rate range to 1% to 1.25%. The Fed Chair Janet Yellen provided guidance that US interest rates should increase “a few times a year until the end of 2019”. This was welcomed by Wall Street.

In Europe, given the concerns over financial and political stability proved temporary, the European Central Bank has maintained low interest rates and the supportive asset purchase program. Europe’s unemployment rate fell to 9.3%, which is its lowest level since 2009.

## Emerging markets enjoyed a sharp recovery…

The positive tone in developed markets extended to the emerging world with the MSCI Emerging Markets Index making a sharp recovery over the year, returning 20.5% on an unhedged basis. China’s share market gained 9% in response to the economy’s solid performance, which was driven by a large infrastructure spending stimulus program and a robust housing market.

There were also some very encouraging results for other key emerging markets. Brazil’s share market surged higher despite the political corruption scandals and the central bank aggressively cutting interest rates. India’s economic growth modestly slowed after the currency note swap (which invalidated India’s two biggest banknotes) in November 2016. However India’s falling inflation and lower interest rates were supportive of India’s share market. Even Russia’s economy appears to be emerging from recession with the benefit of lower interest rates and despite the fall in oil prices which is Russia’s key commodity export.

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## …while commodity prices experienced a rollercoaster ride

It was a turbulent year however for commodity prices. Better global economic activity data, China's infrastructure spending program and President Trump's promises of accelerating US economic growth saw commodity prices surge initially. Also notable was the agreement between the Organization of Petroleum Exporting Countries (OPEC) and Russia to reduce oil production. This was the catalyst for oil prices to surge towards US$55 per barrel.

However this commodity rally faded by mid-2017, with the realisation that excess global supply outweighed the potential pickup in global demand. Accordingly there were sharp falls recorded for the major commodities of oil, coal and base metals in the closing months of the financial year.

Iron ore also had a volatile performance during the year, rising strongly from US$55 to US$94 per tonne in February 2017, before fading back to US$65 per tonne in June 2017.

## Bonds generally delivered modest returns

Global and Australian government bonds delivered modest returns as yields increased, due in part to higher US interest rates. The rise in bond yields dampened the return of sectors such as listed property trusts, which until recently were favoured by yield seeking investors.

However there was some positive news in that global high yield bonds (hedged) had a very strong year with a return of 7.5%. Rising corporate profits as well as the promise of lower US corporate taxes saw credit spreads sharply narrow and corporate bond values rise.

## Australia's share market was a solid performer

Australia's share market was stronger with the ASX200 Accumulation index rising by 14.1%. Favoured sectors were the resources laden Materials index which increased 25.8% and Utilities which was up 19.6%. While Australian bank shares were negatively impacted by the new levy announced in the Federal Budget, the Financials (ex-Australian Real Estate Investment Trusts, A-REITs) sector still managed to record a positive return of 20% for the year.

Australia recorded mixed economic data over the past year. Australia's annual economic growth at around 2% was subdued judging by historical measures. Despite better jobs growth, both the unemployment rate at 5.5% and underemployment rate at 8.8% remain high. Given this spare capacity in the labour market, wages growth remains subdued. Consumers have also been very cautious with their retail spending even though intense retail competition has constrained prices. Accordingly, Australia's annual inflation has been sedate at 2.1% in the year to March 2017. In response to these mild wage and price pressures, Australia's central bank cut the official cash rate from 1.75% to a historic low of 1.5% in August 2016.

In Sydney and Melbourne, lower mortgage rates have served to both extend the boom in residential property prices and support robust apartment construction. Australia's business survey results have also been encouraging with the National Australia Bank survey showing strong gains for both confidence and conditions. The recent Federal Budget initiatives to raise infrastructure spending and cut small business tax rates have also been seen as beneficial by the corporate sector.

## A 'defensive' portfolio stance is still justified

From a portfolio perspective, we have believed for some time now that it's appropriate to be defensively positioned where possible in our MLC Horizon, Inflation Plus and Index Plus portfolios. Our view hasn't changed. Markets are complacent despite the presence of numerous risks while valuations are stretched and expensive, so risk management remains foremost in our minds.

We've been concerned that very low interest rates and large asset purchases by central banks have been the main driver of market returns, rather than economic fundamentals. President Trump's promises of lower corporate taxes and higher infrastructure spending have simply added more fuel to this appetite for risk with investors chasing returns.

Our defensive positioning is a function of these multiple risks, notably the continuing excessive level of debt in a number of countries, complacent market pricing, extreme monetary policy settings as well as limited room for policy manoeuvring in response to shocks.

This defensiveness has been achieved in a number of ways. We have maintained a low exposure to Australian shares. Our portfolios are holding more cash than is normal, including those managers we have appointed who have the discretion to hold cash to manage risk. We've maintained the allocation to alternative strategies which we believe will help preserve investors' capital in

volatile markets by providing potentially better returns. We have also taken steps to diversify the currency hedging in our multi-asset portfolios and we remain very selective of the type of fixed income we own in our portfolios.

In the MLC Inflation Plus portfolios, which have more asset allocation flexibility, we've also introduced a defensive Australian shares strategy. The new strategy enables us to increase our exposure to Australian shares – and benefit from the potential returns from this asset class – while carefully controlling the risk of these assets.

While these positions may not prevent negative returns in weak share market conditions, our caution should provide a degree of insulation.

## How does MLC deal with uncertainty?

At MLC, we focus strongly on risk management. We believe managing risk for our investors is the sustainable way of generating returns for them – and in this unpredictable investment environment, it's more critical than ever.

As a result, we design and manage our multi-asset portfolios to be resilient in a wide range of possible market conditions. Using our market-leading investment approach, we constantly assess how our multi-asset portfolios are likely to perform in many potential market scenarios, both good and bad. We can then adjust our portfolios to manage possible risks and take advantage of potential return opportunities.

This careful analysis means our portfolios are widely diversified, risk-aware and positioned for many market environments.

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