

2018-19 financial year in review

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Markets fell sharply in the final quarter of 2018 but have made a remarkable recovery in 2019. This has seen longer-term returns for investors remain pleasing.

A challenging year for investors with many twists and turns.

The financial year to 30 June 2019 was a challenging period for investors. Australian and US shares, as well as Australian listed property, still delivered good returns for the year but there were many twists and turns along the way. The global economy continued to grow, but it is currently showing signs of a sharp slowing. Central banks have shifted from threatening to raise interest rates to now promising to cut interest rates. The rapid change in policy direction was most evident in America where the US Federal Reserve (Fed) changed course three times. The Fed has moved over the past year from raising US interest rates to then being on hold and finally to considering cutting interest rates. A marked economic slowdown in Australia, subdued wages growth, falling house prices and construction as well as low inflation has prompted Australia's Reserve Bank of Australia (RBA) to reduce the cash interest rate to 1.25%. Continuing trade tensions between China and the US, and fears that President Trump could target other countries, remain key concerns for the global economy and financial markets.

Despite this, Table 1 shows that returns across a range of asset classes are still pleasing.

Table 1: Mainstream asset class returns in Australian dollars – periods to 30 June 2019

Asset class	Returns*			
	1 yr	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)
Cash	2.0%	1.9%	2.1%	3.0%
Australian bonds	9.6%	4.2%	5.1%	6.0%
Global bonds (hedged)	7.2%	3.1%	4.8%	6.6%
Australian property securities	19.4%	8.4%	13.8%	14.0%
Global property securities (hedged)	8.7%	6.4%	8.5%	13.8%
Australian shares	11.5%	12.9%	8.9%	10.0%
Global shares (hedged)	6.2%	12.8%	9.4%	13.1%
Global shares (unhedged)	11.9%	14.5%	13.3%	12.3%
Emerging markets (unhedged)	7.0%	13.3%	9.1%	7.7%

* Annualised returns. Past performance is not a reliable indicator of future performance. Sources: FactSet, NAB Asset Management Services Limited.

Benchmark data: Bloomberg AusBond Bank Bill Index (cash), Bloomberg AusBond Composite 0+ Yr Index (Aust bonds), Bloomberg Barclays Global Aggregate Index Hedged to \$A (global bonds), S&P/ASX200 A-REIT Total Return Index (Australian property securities), FTSE EPRA/NAREIT Developed Index (net) hedged to \$A (global property securities), S&P/ASX200 Total Return Index (Aust shares), MSCI All Country World Indices hedged and unhedged (net) in \$A (global shares), and MSCI Emerging Markets (net, unhedged)

Conditions in the global economy moderated as the year progressed with signs of slower growth, most evident in Asia and Europe.

The US

The US economy performed well for much of the year, outpacing most of its peers. However, there have been recent signs that US economic growth is moderating. The benefits of the 2017 fiscal stimulus and tax cuts have faded and the Fed continued to raise interest rates into the first half of the financial year. A clear sign of the US economy's strength was the progressive fall in the unemployment rate to a fifty year low of just 3.6%. The tight labour market has provided American workers with bargaining power to ask for higher wages. This has had a strong positive impact on US consumer confidence and spending. However, the US corporate sector has progressively become more cautious given that trade tensions with China are materially impacting their supply chain as well as foreign sales prospects.

A sharp shift has occurred in US interest rate policy settings and market expectations during the financial year. The Fed raised US interest rates by 1% in the 2018 calendar year and signalled a willingness to raise interest rates further in 2019. This contributed to significant global share market weakness in the December quarter of 2018. The Fed then shifted to a neutral stance early in 2019 by putting US interest rates on hold. In June 2019, the Fed shifted further to suggesting it would consider lowering interest rates to counter weaker global conditions and persistently low US inflation. Global bond market yields have moved sharply lower in response with market expectations now favouring a 0.5% cut to US interest rates over coming months.

Europe

Economic conditions in Europe softened as the year progressed with both local and global factors contributing to the slowdown. Unemployment levels remain elevated in many European countries such as Greece, Italy and Spain. The fragile state of the Italian economy, which is also burdened by excessive debt and a weak banking sector, remained an issue. European inflation remains persistently low and well below the European Central Bank's (ECB) 2% target. Manufacturers in Europe (and Japan) are concerned the trade war between the US and China are hindering export opportunities for their products. A major risk that is affecting confidence is President Trump may impose tariffs on car exports to the US. This would have serious consequences for both German and Japanese car manufacturers who rely on the US as a key market for their vehicles. The impact these concerns have had on confidence is evident in the Purchasing Managers Index (PMI) surveys which have fallen sharply over the past year.

Given these negative global and local forces in play, the ECB is now considering whether further stimulus is required. With interest rates already at very low levels and the ECB presidency of Dr Mario Draghi ending in October, there is concern that the ECB lacks both the firepower and the will required to restore strong economic growth to Europe.

The United Kingdom

Intense negotiations to reach a Brexit arrangement acceptable to both the UK and the European Union continued throughout the year. However, this has proven to be a stalemate rather than an amicable and practical separation. The UK Parliament's failure to reach consensus has necessitated an extension to the Brexit date on two occasions. The latest exit date granted by the European Union now stands at 31 October 2019. Failure to achieve a Brexit strategy acceptable to Conservative Party members compelled Theresa May to resign as the UK Prime Minister. The Conservative Party is now set to elect a new Prime Minister on 22 July 2019. With Boris Johnson favoured to win, the risk of a no-deal Brexit has increased.

The Brexit stalemate and consequent political instability has taken its toll on parts of the UK economy. The Brexit uncertainty and global growth slowdown has meant UK business investment spending fell through the year. However, labour market conditions remain strong with the 3.8% unemployment rate at a 45-year low.

Japan

Despite years of substantial monetary stimulus by the Bank of Japan, Japan's economy remains subdued. As one of the most significant export oriented economies in the world and with China a major export market, Japan is very exposed to the US-China trade dispute and global economic slowdown. Japan's domestic demand remains mediocre with inflation very low. Although Japan's unemployment rate at 2.4% is lower than America's, there has only been modest growth in wages. This has contributed to slow consumption growth. With interest rates essentially at zero and government bond yields now negative, Japan's central bank seems to have little ammunition if the economy weakens further.

China

Trade tensions with the US and the global economic slowdown had obvious implications for China's economy, necessitating some targeted fiscal and monetary initiatives to help support growth. Economic indicators suggest that China's growth has slowed over the past year. Recent industrial production, exports and retail spending statistics have been disappointingly soft, placing considerable doubt on whether China's economy will achieve the government's 6% to 6.5% growth target.

Trade tensions have intensified and remain a major concern

Trade tensions between America and China have been a major risk for financial markets and global businesses through the year. The new financial year began with the US imposing tariffs on Chinese imports totalling US \$50 billion, prompting retaliatory action by China which targeted a range of US imports including aircraft, vehicles and agricultural products. The trade confrontation escalated in November 2018 when President Trump imposed a 10% tariff on a further \$200 billion of Chinese imports.

There were hopes of a resolution after President Trump and China's President Xi agreed at the G20 summit in December to reopen trade discussions and delay further tariff changes. However, market scepticism that a lasting agreement could be reached proved to be well founded as talks between the two countries eventually broke down. The 10% tariff on the \$200 billion of imports from China was subsequently increased to 25% in May 2019 with the Trump Administration threatening further tariff action. Talks between Presidents Trump and Xi at the G20 in the last days of June resulted in another ceasefire that delayed additional tariffs and allows for the resumption of negotiations. However, there are considerable doubts whether this truce will be as successful as the last one. Consequently, the US may proceed to impose tariffs on the remaining US\$300 billion of Chinese imports that are tariff free.

The dispute between the two economic superpowers escalated beyond trade with both countries targeting specific companies and industries via proposed sanctions and export controls. President Trump blocked the use of Huawei products in US networks on national security grounds while a US Commerce Department regulation barred US firms from selling technology to Huawei without government approval. The US is also examining whether there should be controls imposed on the export of critical technologies. China has considered similar controls on the export of rare earths metals to the US.

Despite the successful negotiation of a trade agreement with Canada and Mexico, the Trump Administration threatened to impose tariffs on Mexican imports in May 2019. This measure was designed to pressure Mexico to take steps to stem the flow of illegal immigrants into the US. While a compromise solution was quickly negotiated given that 90% of Mexico's exports are to the US, this was another reminder that President Trump is prepared to use trade policy to achieve domestic political goals. Concerns remain that the Trump Administration may target other trade partners such as Japan and Europe.

A reasonable year for global share investors

Share market sentiment moved from negative to positive as the year progressed. Global shares returned 6.2% for the year on an Australian dollar hedged basis while the higher 11.9% unhedged return largely reflected the 5.0% fall of the Australian dollar against the US dollar.

The December quarter was the most challenging period for investors with share markets losing considerable ground due to growing concerns about the intention of the Fed to continue raising US interest rates. The worsening trade dispute between the US and China, mixed news on the performance of the global economy and fears that the global corporate profits cycle had passed its peak also unsettled markets. Most markets reached their low point for the financial year in December with the US S&P500 Index falling 17.5% from its peak in September.

Markets recovered strongly in the second half of the financial year as the Fed softened its stance on raising US interest rates further. There was also some temporary reassurance with China and the US agreeing to defer further tariff changes to negotiate a settlement. However, for some share markets, the gains were insufficient to offset the falls in late 2018, with a number recording either negative or low single digit returns for the year.

Despite significant weakness in the December quarter, the US share market was one of the better performers with a record high in June eclipsing the previous high in September 2018. The S&P500 Index increased by 9.8% (in local currency terms) in the year. Expectations the Fed may reduce US interest rates in the coming months, modest inflation and better than expected corporate profit results for the March quarter boosted investor sentiment.

European shares delivered disappointing returns in response to subdued economic conditions and weak business surveys, which reflect concern that the US could extend its trade war with China to include European car imports into the US. Germany's market

was higher by just 0.8% while the French market was a better performer with a rise of 7.6%. The drawn-out Brexit process weighed on the UK share market with the FTSE 100 Index rising by just 1.5%.

Markets in Asia delivered mixed returns. China's share market was predictably weaker in response to the tariff dispute and its impact on parts of the economy with the MSCI China Index returning -1.8%. Japan's Nikkei index fell 2.6% over the year.

Our share market performed well compared to most global markets

Australian shares returned 11.5% in the financial year to 30 June, down marginally from the 13.0% return in the previous financial year. However, our market performed well this year compared to many offshore market peers which either lost ground or recorded modest returns.

The financial year was one of contrasting halves for Australian share investors. Our market fell 6.8% in the December half with most of the lost ground occurring in the final quarter of 2018 when the market was down by 8.2%, one of the worst quarters since the GFC. The deterioration in market sentiment in the first half of the financial year was due to growing concerns about the economic impact further US interest rate rises could have (as the Fed signalled at that stage it intended to continue tightening), mixed news on the global economy (notably on Chinese growth) and the worsening trade dispute between the US and China.

In marked contrast to the first half, Australia's share market rebounded in the second half with consecutive monthly gains, resulting in a rise of 19.7%. The substantial turnaround in sentiment was due to a combination of factors, some unique to our market and others of a global nature. Australia's economy slowed considerably during the financial year, leading to expectations that the RBA would reduce interest rates, which it did on 5 June. This was particularly favourable for the Australian share market.

The Australian Labour Party's (ALP) proposal to end cash refunds for excess franking credits prompted many companies in the lead up to the May 2019 Federal election to clear undistributed franking credits via special dividends or share buybacks. The market responded favourably to the re-election of the Coalition LNP Government as Labour's proposed capital gains, franking credit and negative gearing changes would not be implemented.

Performance varied across industry sectors. Energy (-5.9%) was the only sector to fall. Despite escalating tensions in the Middle East and production disruption in Venezuela and Libya caused by civil unrest, the price of oil (Brent crude) fell 16.2% over the year.

The Materials sector increased by 19.4% as iron ore producers BHP Billiton, Rio Tinto and Fortescue Metals Group benefitted from the 68.5% surge in the price of iron ore after the collapse of a tailings dam at a major mine in Brazil caused supply disruptions.

With Australian bond yields reaching historic lows, yield seeking investors were attracted to the Australian Real Estate Investment Trust (A-REITs) sector, which increased 19.4% over the year. Information Technology (up 19.4%) was another strong performer, though it is a very small part of the Australian market. The Communication Services sector was the best performing sector, rising by 40.8% after being the worst performer with a 30.9% fall in the previous financial year. Concerns the proposed merger of TPG Telecom and Vodafone Hutchison Australia would increase competition in the industry and adversely impact company profits eased after the Australian Competition and Consumer Commission blocked the merger.

The Financials ex-AREITs index returned 8.3%. The Banking, Superannuation and Financial Services Royal Commission released its final report in February. Fears that banks' profits will be under pressure due to substantial remediation and compliance costs as well as the weaker housing sector caused most of the major banks and AMP in particular to underperform the market return.

Another mixed report card for Australia's economy

Australia's economic performance weakened as the year progressed. After beginning the new financial year with the Australian economy recording annual growth of 3.4%, Australia's economic growth slowed to an annual rate of just 1.8% for the year to March 2019. This is the slowest annual growth rate recorded since the GFC in 2009.

The RBA reduced the cash rate by 0.25% to 1.25% in June in response to the economic slowdown and numerous indicators of spare capacity in the Australian economy. This was the first interest rate adjustment since August 2016. In the Statement of Monetary Policy released in May, the RBA cut its economic growth forecast for 2019 by 0.75% to only 2.0%. The RBA also lowered their inflation forecast to just 1.75% by the end of 2019, which is significantly below its preferred 2-3% target band. With economic growth well below potential and subdued inflationary pressures, the RBA appears set to reduce interest rates further in the coming months.

Australia's labour market gave mixed signals during the year. Jobs growth has been strong with 360,000 new positions created in the year to May 2019. However, considerable spare capacity remains as seen in the unemployment and underemployment rates.

After falling to 4.9% during the year, Australia's unemployment rate finished the year at 5.2%. This remains above the RBA's revised estimate of full employment which is 4.5%. The underemployment rate, which measures the part-time workers who want to work longer hours, also remains high at 8.5%. This spare capacity in the labour market continues to constrain wages growth. While private sector wages growth has improved from 1.9% to 2.3% over the year, it remains low in historical terms.

Low wages growth and high average household debt continued to constrain the retail sector. Consumer spending growth slowed to just 1.8% for the year (to 31 March) with spending on discretionary items under pressure. The Westpac-Melbourne Institute sentiment survey suggests that consumers are concerned about the outlook. A further sign of consumer caution has been the significant drop in new car sales which have fallen for 14 consecutive months (to May 2019).

Australian housing prices also declined sharply during the year although the pace of decline has eased in recent months. National housing prices fell 8% with price declines of nearly -10.0% in Sydney and -9.0% in Melbourne. The strengthening of bank lending practices has resulted in tighter housing credit conditions.

Lower housing prices and tighter lending standards have translated into much weaker residential construction, especially for apartments. Apartment construction fell by 24% in the year to April 2019. Notably the RBA has expressed concern that further sizeable falls in housing prices could weaken retail conditions even further as consumers limit their spending.

Despite global trade concerns and slower global growth, Australia's terms of trade (the ratio of export prices to import prices) surprisingly improved through the year. An important contributor was the substantial 68.5% rise in the price of iron ore in the second half of the year. This iron ore price surge followed a tragic tailings dam collapse in Brazil which curtailed global supply at a time of rising Chinese demand. The substantial iron ore price rise may prove to be fortuitous for the Federal Government which has promised that the budget will return to a surplus in 2019-2020.

The higher iron ore price did little to prevent the Australian dollar from falling against all major currencies. Our dollar was down 5.0% against the US dollar and lower by 2.6% and 7.6% against the euro and yen respectively. Expectations that the RBA will continue to cut the cash interest rate has put pressure on the Australian dollar.

Bond market conditions changed markedly during the year

The past year saw a marked shift in economic outlook. The financial year opened July 2018 on a more promising note with a gradual strengthening of global growth and improved labour market conditions. This was accompanied by a winding back of monetary policy support and gradual tightening of financial conditions, most notably in the US but also in Europe. However, over the last nine months signs of economic weakness and geopolitical risks have seen global growth disappoint to the downside.

US government yields for a 10-year maturity hit a high of 3.2% in October 2018 as the Fed continued to raise interest rates. While the US unemployment rate continued to fall, US inflation remained stubbornly below the Fed's 2% target. Financial markets then judged in late 2018 that the Fed was over-tightening, resulting in a sharp sell-off in share markets. The Fed quickly changed course, first indicating that rising interest rates were no longer on the agenda, then in June 2019 suggesting the possibility of the next move being an interest rate cut. The result of all these policy twists and turns has been a sustained rally in government bonds, with the US government 10-year yield closing the financial year at a much lower 2% level.

Beyond the US, a similar pattern has occurred. In Europe, the ECB finally ended its quantitative easing program in late 2018 and was looking for the opportunity to raise interest rates out of negative territory. However, the weakening global economy and political issues (trade wars, Brexit, Italian budget negotiations) have combined to make the ECB consider that further stimulus may be required. For Australia, a stubbornly high unemployment rate, persistently low inflation and a weak housing market has led to the RBA cutting interest rates for the first time since August 2016. Further RBA cuts are expected in 2019.

The pivot by central banks towards a lower interest rate stance has helped support the continued extension of the credit cycle. After a sharp sell-off in the final quarter of 2018, credit markets have recovered their losses in 2019. Corporate default rates remain well below historical averages and profits remain healthy, so the outlook for credit is still relatively favourable. Emerging markets have also had a reasonable start to 2019 after a very difficult 2018. The fall in global government bond yields and prospective interest rate cuts in Europe and the US has again started to spur demand for higher yielding assets.

In terms of index performance, global government bonds delivered high single digit returns, with investment grade corporate bonds slightly higher over the year in Australian dollar (hedged) terms. Australian bonds (9.6%) outperformed global (7.2%) as Australian yields fell further than other major markets, and local credit spreads remained relatively stable. High yield bonds (3.3%, hedged) delivered low-single digit returns, outperforming floating rate bank loans. Australian inflation-linked bonds returned 5.4%.

In uncertain markets, a defensive portfolio stance remains justified

MLC has believed for some time that the appropriate response to the challenging investment environment is to defensively position our multi-asset portfolios – the MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios. Decisions we've made include:

- holding more cash than normal
- remaining highly selective about the types of bonds we invest in to limit exposure to securities that will fall in value if inflation or interest rates rise quickly
- retaining a high exposure to unhedged global shares to increase diversification
- employing innovative currency and option protection strategies to improve risk control, and
- including non-benchmark aware strategies that provide returns that are not reliant on share markets and help preserve investors' capital in weak and volatile markets.

In the MLC Inflation Plus portfolios we've also employed defensive strategies such as our Defensive Australian Shares Strategy. This unique strategy has helped reduce the impact of risks specific to the Australian market, such as the high exposure to banks.

While our focus on managing risk in our multi-asset portfolios may not prevent negative returns in weak share market conditions, it should provide some insulation for investors.

How does MLC's investment process deal with an uncertain outlook?

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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