2017-18 financial year in review

4 July 2018

John Owen

Portfolio Specialist

While conditions deteriorated in the second half of the 2017-18 financial year markets still delivered good investment returns for investors.

A good year for investors despite rising trade tensions

The year to 30 June 2018 was generally a good one for investors. Global economic conditions strengthened as the year unfolded. This underpinned corporate earnings, especially in the US where the economy was resilient and substantial corporate tax cuts became law. Share market returns were broadly positive, including Australia's where high returns by the resources, energy and healthcare sectors helped offset subdued bank and telecommunication performances.

However, 2017-18 proved to be a year of two halves. Sentiment deteriorated after January with the US raising tariffs on a range of imports, especially from China, leading to reciprocal tariff measures taken by those countries the US targeted. The consequences for global trade and inflation are uncertain at this stage, as is the impact on markets of the continued withdrawal of monetary stimulus by key central banks.

Table 1: Mainstream asset class returns in Australian dollars – periods to 30 June 2018

Asset class	Returns*			
	1 yr	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)
Cash	1.8%	2.0%	2.2%	3.3%
Australian bonds	3.1%	3.4%	4.4%	6.1%
Global bonds (hedged)	1.9%	3.8%	5.0%	6.9%
Australian property securities	13.0%	9.7%	12.0%	6.0%
Global property securities (hedged)	6.4%	6.9%	8.8%	6.8%
Australian shares	13.0%	9.0%	10.0%	6.4%
Global shares (hedged)	10.8%	8.5%	10.8%	7.0%
Global shares (unhedged)	15.0%	9.6%	14.2%	8.6%
Emerging markets (unhedged)	12.3%	7.0%	9.6%	5.0%

* 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 Net Indices hedged and unhedged (net) in $A (global shares), and MSCI Emerging Markets Net Index (unhedged)

The global economy performed well

The global economy accelerated for much of the financial year with growth occurring in all the major economic zones. At year's end, global growth remains solid. However, notable differences in economic performance have occurred across the globe and there are some concerns with specific countries and regions, notably Italy and emerging economies.

The US economy continues to perform strongly. Economic activity grew at a solid rate and strong jobs growth has seen unemployment decline to just 3.75%, a 48 year low. Household spending has grown due to wages growth and income tax cuts. Business investment has also grown strongly. In expectation of sustained economic expansion, the US Federal Reserve (the Fed) raised interest rates on three occasions over the course of our financial year.

In Europe the broad-based improvement in economic conditions enabled the European Central Bank (ECB) to continue winding down its monetary stimulus measures. The ECB anticipates being able to suspend its monthly asset purchase program by the end of 2018. Predictably in a region as diverse as the Eurozone, country specific economic conditions differed. Italy's weak economy and the new Italian government's expenditure plans created market concerns late in our financial year.

Growth in Asia remained strong, helped by China's economy where growth stabilised at a 6.8% annual rate over the past year. Economic indicators were generally positive, with few surprises. China continues to manage a complicated transition in economic growth drivers from industrial activity and exports towards consumption. Industrial production has slowed and settled at a 6% pa growth pace while retail sales are growing at 9% pa. Recognising the need to protect the financial system by controlling rampant growth in bank lending and credit demand, China's central bank increased interest rates.

Elsewhere in Asia, Japan's economy continues to grow but at a sluggish pace relative to other economies.

Global shares also performed well (again)

Global shares returned 10.8% on a hedged basis while the unhedged return of 15.0% was higher because the Australian dollar weakened against the world's major currencies. When the Australian dollar decreases the value of overseas assets increases. Share market conditions were markedly different in the first and second halves of the financial year.

The global economy's strength and recovery in corporate earnings were important drivers for the first half of the year and into January with a number of markets reaching new highs. However, markets became more circumspect following the release of higher than expected US wages growth data which led to concerns the Fed would be forced to be more aggressive in raising interest rates. Markets were further unsettled by global trade tensions after the Trump administration imposed tariffs on a range of products and explicitly targeted Chinese imports.

In the US, the S&P 500 Index gained 13.7% (in local currency terms) and reached record highs in January 2018 following the successful passage of President Trump's corporate and personal tax cut reforms. US economic data was also very supportive, with solid jobs growth, lower unemployment and encouraging business survey results.

Despite the eurozone's economic upturn, growth in employment and improved consumer and business confidence, European markets delivered modest returns compared to global peers. Germany's DAX index fell 0.2% due to second half weakness caused by political uncertainty and trade protectionist action by the US, in particular the threat to impose tariffs on car imports. France's share market managed to rise by 7.4%.Continuing uncertainty about Britain's withdrawal from the European Union (EU) and its impact on the economy failed to adversely impact the performance of the FT100 index, which increased by 8.7%.

In Asia, Japan's Nikkei index rose 13.5% in response to the economy's improvement. After performing strongly in the first half of the year, China's SSE Composite index lost considerable ground and closed 10.8% lower for the year. The imposition of tariffs and fears of a trade war between China and the US were clearly adverse for the market. However, larger cap Chinese companies listed on the Hong Kong exchange performed better.

Global listed property delivered a hedged return of 6.4% for the year. Property market conditions in many countries remain favourable and the sector continues to grow earnings. However, other areas of the share market are experiencing better earnings growth prospects, especially in the US following last year's generous corporate tax cuts. This has constrained the performance of the global listed property sector as investors rotate into higher growth areas of the market. The distribution yield of the sector has also become less compelling as interest rates rise.

Conditions for emerging markets have been mixed

The emerging markets sector performed well for much of the financial year as the acceleration in global growth during 2017 benefitted emerging market exports and commodity producers. However, weakness emerged later in the year due to a number of headwinds. Fears of a trade war between the US and China plus growing protectionism have prompted some investors to move away from riskier investments such as emerging markets. The increase in US interest rates and expectations of further rate rises have also contributed to an outflow of capital from emerging economies, and currency weakness against the US dollar. In order to defend their currencies, central banks in countries such as Argentina, Turkey, Indonesia and Mexico have had to raise local interest rates. Country specific issues such as high inflation in Argentina, political uncertainty in Turkey and the economic impact of a truckers strike in Brazil added to the negative sentiment towards emerging markets.

Bonds generally delivered modest returns

Local and overseas bonds delivered low single digit returns in the financial year as many central banks continue to tighten policy settings, either by raising rates (as in the US, UK and China) or curtailing monetary stimulus measures (like the ECB).The first half of the year saw an upward move in yields as bond prices fell due to accelerating global growth, heightened inflation concerns and the Fed continuing to raise rates. Since January, yields have been stable to slightly lower. However, markets have taken some comfort from the gradual approach taken by the Fed and other major central banks to tighten monetary policy.

Global monetary conditions continue to tighten

Central bank policies in many parts of the world continue to shift from easing to tightening. The most obvious signs of this include numerous central banks either raising official interest rates, reducing their massive bond holdings following large scale purchases over a number of years or a mix of both. Central banks have done so cautiously and gradually to avoid undermining markets and preserve the economic recovery that has been successfully engineered.

The US is the most advanced in the withdrawal of monetary stimulus because its economic growth cycle has been the longest and it continues to outpace most of its developed peers. Despite benign inflationary pressures, the Fed still raised interest rates by 0.25% on three occasions during the year due to strong economic growth, a big increase in government spending and low unemployment. Having upgraded its economic growth forecast for 2018 to 2.8%, the Fed has projected two more rate rises totalling 0.5% before the end of the 2018 calendar year.

In Europe, the ECB responded to the broad-based improvement in economic conditions by signalling its intention to end its monthly bond purchase program by December 2018. However, it indicated it won't rush to raise interest rates because inflation remains low.

In contrast to the tightening bias in Europe and the US, Japan's central bank is continuing with its monetary stimulus program to tilt inflation towards its preferred 2% target.

Trade tensions and geopolitical risks worsened late in the financial year

While markets welcomed the successful passage of President Trump's large corporate and personal tax cuts late in December, their reaction to his decision to impose tariffs on a range of products (explicitly targeting Chinese imports) has been less favourable. After announcing in March that a 25% tariff would be imposed on imports of steel and aluminium, the Trump administration confirmed in June that tariffs would be levied on Chinese imports totalling US$50 billion, beginning 6 July. Not surprisingly, China responded in kind, targeting a range of US imports including aircraft, vehicles and agricultural products. The EU, Mexico and Canada also imposed tariffs on imported US goods in retaliation for the steel and aluminium tariffs.

The value of goods and services subject to the recent tariffs represent only a small percentage of total trade value at this stage. However, President Trump's threat to impose tariffs on another US$100 billion of imports if China retaliates; possible tariffs on automobile imports into the US; threats to withdraw from NAFTA; and the acrimony on display between the US and its allies at the G7 gathering in June suggests trade tensions will remain a risk for financial markets in the new financial year.

Results of elections held in key countries were largely in line with markets' preferred outcomes. Japanese Prime Minister Shinzo Abe achieved a solid victory in a snap election in October 2017. In Germany, Angela Merkel secured a fourth term as Chancellor, though the loss of seats by the Christian Democratic Union/Christian Social Union required a coalition with some minority parties to form a government. While this helped end months of political uncertainty, recent dissension within the government over Germany's immigration and refugee policy has threatened the stability of the coalition.

Political risk in Europe shifted late in the financial year to Italy where inconclusive election results in March ultimately led to the formation of a coalition government comprising the populist Five Star Movement and the conservative Lega, both 'euro-sceptic' parties. Market concerns centred on the new government's pledge to implement a range of fiscal stimulus measures, including income tax cuts, that may breach the EU's budgetary rules and spending constraints. Despite reassuring comments by key ministers in the government, which helped Italian government bonds and the euro recover some of their lost ground, Italian politics and the relatively poor state of the economy will continue to be a watch point for markets.

In Asia, tensions resulting from North Korea's nuclear missile testing program subsided towards the end of the year, culminating in separate meetings between the US and South Korean leaders with North Korean Leader Kim Jong-un.

Positives and negatives for the Australian economy

After an extended period in the slow lane, Australia's economy picked up speed as the financial year progressed. The economy expanded by 1% in the first quarter of 2018 (up from 0.5% in the previous quarter), bringing the annual growth rate to 3.1% for the year to March 2018 (the most recent quarterly result available.) Exports were a major contributor to the growth pickup, accounting for half of the 1% growth in the March quarter GDP. The improvement in export performance and our terms of trade suggests Australia is finally benefitting from the acceleration in global growth and the weaker Australian dollar. An added stimulus for the economy continues to be spending on infrastructure by state and federal governments.

Australia's jobs market also strengthened over the past year (to May 2018) with over 300,000 new jobs created. The unemployment rate fell to 5.4%, the lowest reading since 2012. However, considerable spare capacity remains in the labour market as the underemployment rate, which measures part-time workers wanting to work more hours, remains high at 8.5%. Combined with those unemployed, having nearly 14% of the workforce underutilised has constrained annual wages growth to just 1.9%, a 20 year low.

With low wages growth, high household debt and sharply higher utilities costs, many Australian households are under pressure. Not surprisingly, annualised growth in retail spending is down to 2.6%. This has occurred at a time when there are signs the eastern seaboard housing market has softened. Despite good growth in lending to owner-occupiers, regulatory restrictions on lending to residential property investors and higher interest rates for investor loans have caused Sydney and Melbourne house prices to fall or stagnate over the year. The Reserve Bank of Australia (RBA) expressed concern that an easing in house price growth could influence households' consumption and saving decisions.

This overall tightening of credit availability plus concerns about the potential oversupply of apartments in Brisbane, Sydney and Melbourne has cooled the pace of residential construction after years of substantial construction activity. Allowing for the current pipeline of planned construction still to be done, the housing sector is a key downside risk for the economy over coming years.

Price pressures are still subdued with annual inflation at 1.9% for the March quarter. This has allowed the RBA to keep the cash interest rate on hold at 1.5%. Having already left the cash rate unchanged for a record 22 months, recent commentary by RBA officials suggest it will remain on hold well into 2019 unless the labour market tightens and wages growth picks up.

Australia's share market underperformed global peers

Australian shares posted a positive return of 13.0% for the financial year but with a very mixed performance across industry sectors. The Health Care sector recorded an exceptionally strong 27.7% return as many companies have superior profit momentum. Sharply higher global oil prices and a takeover offer for Santos benefitted the Energy sector which increased by 41.6%. The resources laden Materials index also performed strongly with a 29.9% rise as prices for metals and bulk commodities such as iron ore strengthened in line with the global economy's growth.

In contrast, the Telecommunications sector was very weak, falling 30.9% due to competitive pressures in the sector which forced Telstra to flag lower earnings and dividends. The Financials Ex-AREITs sector returned just 1.6% due to numerous headwinds for the major banks such as competitive pressures and low prospective earnings growth. The commencement of the Royal Commission into misconduct of banks and other financial services entities added to the negative sentiment. AMP shares lost considerable value following damaging revelations at the Royal Commission, which lead to the resignations of the Chairman and CEO.

The risky environment justifies a defensive portfolio stance

MLC has believed for some time that the environment we are in requires us to defensively position our MLC multi-asset portfolios. We have been concerned for some time that markets and investors have been complacent and under-appreciate the risks and uncertainties that exist. The era of substantial monetary stimulus that has been beneficial to markets is fast coming to an end. It is being replaced by monetary tightening, especially in the US where the process of removing stimulation via higher interest rates and balance sheet reduction is already well advanced.

It's highly uncertain how this policy reversal will affect financial markets and the real economy, yet share markets have until recently been behaving as if artificially low interest rates and loose monetary policy by central banks will remain in place. This is occurring at a time of heightened uncertainty about the impact that higher tariffs will have on the global and Australian economies. The inflationary consequences of higher tariffs, especially in the US where wages continue to rise, represent an added risk. All this is occurring at a time of stretched valuations in shares and parts of the bond markets.

Our defensive positioning has been achieved in a number of ways. We have maintained a low exposure to Australian shares. In the Inflation Plus portfolios, the Australian shares exposure that we do have is defensive in nature to reduce the impact of risks specific to the composition of the Australian market, such as the high bank exposure. Our portfolios are holding more cash than usual, as are those of our investment managers who have the discretion to hold cash to manage risk. We've maintained allocations to alternative strategies which we believe will help preserve investors' capital in volatile markets. After extensive research, we have implemented new currency and derivatives strategies to expand the number of investments generating returns and to carefully manage risks in our multi-asset portfolios. And we remain highly selective about the types of bonds we invest in, limiting exposure to securities that will fall in value if interest rates rise quickly.

While these positions may not prevent negative returns in weak share market conditions, our caution should provide some 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.

Important information

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