

Letter from the CIO

December update



“Overall, we believe market returns in 2018 will be lower than in 2017 and market volatility will rise from the exceptionally low levels experienced last year. But to be sure, we continue to expect that investors in our diversified funds will be rewarded with attractive positive returns which are well in excess of the cash rate and that will serve to grow their purchasing power.”

Jeff Rogers, Chief Investment Officer, ipac

The year that was

2017 was a very good year for economies, markets, and client portfolios. The global economic expansion gathered pace with continued upgrades to growth forecasts throughout the year. Even though the cash rate in the US was raised three times during 2017, financial conditions remained supportive, investor confidence improved and business confidence surged. Major share markets delivered above-trend returns, while the combination of easy credit conditions and a weakening US dollar boosted emerging markets.

The big surprise for the year was that inflation remained subdued and in fact softened somewhat in the US. Bond yields traded in a narrow range and the long-anticipated bond market sell-off did not materialise. The environment could be best described as a real economic expansion rather than reflation (ie: a combination of a pick-up in both growth and inflation) as we had previously characterised it.

Accelerating economic activity supported a rise in expectations for company revenues. The combination of improved earnings together with low and stable bond yields represented an attractive backdrop for share markets. Late in the year, sentiment was boosted further by the passage of legislation in the US slashing the headline rate of corporate tax.

The year ahead

The global economy enters 2018 in excellent shape with synchronised growth at an above trend rate. This momentum is being reinforced by the shift in the fiscal stance of major economies. While growth is likely to decelerate later in the year there is little evidence of overheating. Given tentative signs that wage growth and consumer inflation will begin to rise to more normal levels, we can expect cash rates in the US to continue to rise at a measured pace and we are likely to see the gradual withdrawal of non-conventional monetary policy in several advanced economies. However, the risk of a recession in any of the major economies in the year ahead appears quite remote.

Operating conditions for companies exposed to the global investment cycle are expected to remain favourable. So, even though valuations in several markets are less attractive than their historical average, investors are likely to draw comfort from the strong earnings prospects in the economically sensitive sectors of the market.

The economic cycle in Australia is less advanced than in other developed economies. Activity remains subdued as housing investment moderates and consumers remain cautious on account of anaemic wages growth. Nonetheless, the preconditions for an improvement in growth are in place. Business confidence has improved and there is evidence of broad-based acceleration in business investment. At the same time, large public-sector transport infrastructure projects are beginning to ramp up.

The domestic economy should also benefit from a lower exchange rate which is likely to emerge as interest rates in the US are pushed up to levels above those in Australia. This downward pressure on the Australian dollar is likely to be reinforced by a modest decline in key commodity prices later in the year as activity in China moderates. While an abrupt slowdown in China would be quite negative for Australia, we remain confident that authorities have the capacity to deal with any issues associated with the build-up of debt in less productive parts of the economy.

The Australian share market isn't as well-positioned as many of its global counterparts to benefit from the cyclical pick-up in global growth due to its over-sized exposure to domestic financial companies. Nonetheless corporate cash flow should remain solid and dividends are likely to remain strong, providing a reasonably secure source of return.

The risks

Our optimistic view on the prospects for the economy and our constructive outlook for equity markets are currently shared by many other investors. So it is appropriate to consider what could go wrong.

There are ever-present geopolitical risks whose potential impact is hard to predict. At present, the major concerns are focussed on the threat of war on the Korean peninsula, political instability in Europe associated with the upcoming election in Italy and the prospect of a trade war if overt nationalist policies gained traction in important economies.

The major macro-economic risk for both bond markets and share markets is a surge in inflation which would provoke an aggressive interest rate reaction from central banks. Markets are priced on an expectation that inflationary pressures remain muted and interest rates persist at low levels for a considerable period, so a surge in inflation would force a material downward re-pricing of assets. We do know that employment growth has been strong for a quite some time. At some point in the future we should expect upward pressure on wages and inflation. If the amount of under-employment in the labour market is being materially over-estimated then prevailing asset prices would turn out to be unsustainable. While the probability of such an outcome appears low, it does require careful monitoring.

Central banks have been signalling for some time that as conditions improve they will progressively withdraw the asset buying programs established in the wake of the Global Financial Crisis. These programs may have contributed to elevated asset prices and certainly have served to suppress market volatility. So another potential risk is that investors or consumers turn out to not be adequately prepared for this policy normalisation. It is possible that the withdrawal of the asset buying program undermines some investment strategies whose effectiveness was over-reliant on easy monetary conditions. Closer to home, we are watching developments in the Australian housing market.

Conclusion

Overall, we believe market returns in 2018 will be lower than in 2017 and market volatility will rise from the exceptionally low levels experienced last year. But to be sure, we continue to expect that investors in our diversified funds will be rewarded with attractive positive returns which are well in excess of the cash rate and that will serve to grow their purchasing power. We also believe our investment managers are well-positioned to take advantage of the anticipated increase in market volatility. A larger portion of portfolio returns in the period ahead is likely to be sourced from the skill of our managers.

Important note

ipac asset management limited ABN 22 003 257 225 (ipac) AFS Licence No. 234655 is the responsible entity of the diversified funds referred to in this documents (Funds) and the issuer of the units in the Funds. To invest in any of the Funds, investors will need to obtain the current Product Disclosure Statement (PDS) for the relevant Fund from AMP Capital Investors Limited (ABN 59 001 777 591, AFSL 232 497) (AMP Capital). The PDS contains important information about investing in each Fund and it is important that investors read the PDS before making a decision about whether to acquire, or continue to hold or dispose of units in the Funds. Neither AMP Capital, AMPCFM nor any other company in the AMP Group guarantees the repayment of capital or the performance of any product or any particular rate of return referred to in this document. Past performance is not a reliable indicator of future performance. While every care has been taken in the preparation of this document, AMP Capital makes no representation or warranty as to the accuracy or completeness of any statement in it including without limitation, any forecasts. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. Investors should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to their objectives, financial situation and needs.

Level 5, 50 Bridge Street, Sydney 2000, Australia. Sydney Office Locked Bag No. 15 Grosvenor Place NSW 1220. Telephone: +612 9373 7000. Facsimile: +612 9373 7111.