

OVERVIEW

Investment markets, particularly share markets, performed strongly through the first quarter of the year. This was in stark contrast to the final quarter of the 2018 calendar year where all markets (bonds, shares, real estate) were impacted by the sentiment that the US central bank, the Federal Reserve, would push the US economy into recession by raising interest rates throughout 2019. This concern has abated somewhat with the US now not likely to see any change to interest rates until 2020.

With parts of the developed world economy continuing to face economic challenges (e.g. Brexit implications for the UK and European growth and China's slowing growth trajectory), the direction and growth of the US economy seems more relevant than ever. As a result, events directly impacting the US economy such as quantitative tightening, any changes to interest rates and the conclusion of US/China trade deals are closely watched and influential for all investment markets.

The most recent Federal Reserve decision has interest rates on hold for 2019. Those following this in the media would notice President Trump's continued criticism of the Federal Reserve for raising rates too aggressively through 2018. Trump is now calling for both interest rate cuts and an end to quantitative tightening measures as a means to maintain US growth. This might be a step too far for the Federal Reserve to consider as there is evidence that US growth continues (196,000 new jobs created in March) while inflation remains steady/low.

Further to this, the Federal Reserve must continue to reduce post GFC liquidity/debt created by quantitative easing. Quantitative easing created new money supply which in turn was used by the Fed to create liquidity and ultimately support for US corporations. The Fed's focus has turned to quantitative tightening in recent times, often referred to as the Fed 'winding in its balance sheet'. While this is also a form of tightening for the economy, it is necessary to reduce this debt imbalance, particularly in corporate America.

For now, markets have improved on a weaker interest rate outlook and hopes of a resolution to US/China trade talks (unresolved at the time of writing) that are now well beyond Trump's initial 1 March deadline.

Overall, the bigger global issues that markets will be watching include:

- Growth prospects for the US and global economy,
- The corporate health of US and Chinese companies,
- Trade negotiations, particularly between the US and China/Europe and Brexit negotiations between the UK and Europe.

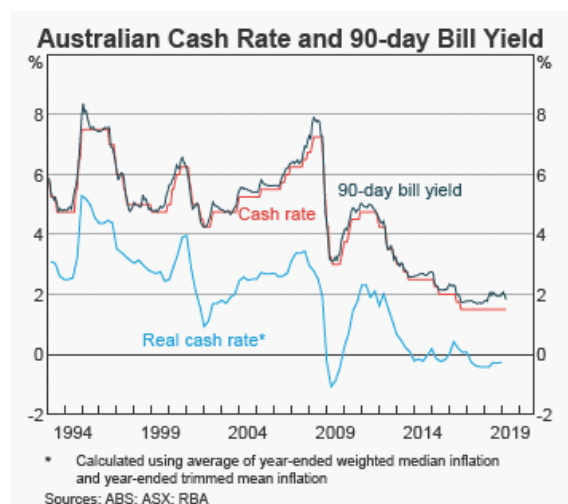
Closer to home, the local economy continues to face challenges with the housing led downturn and the negative 'wealth effect' of falling house prices weighing on consumer spending. This impacts household spending and consumption, offsetting the positive impacts of stronger mining exports and government infrastructure spending.

According to the NAB's March Monthly Business Survey, business conditions improved after a weakening trend over the prior six months. Business confidence (reflecting the expectations of conditions going forward), remains below average, however confidence is surveyed as highest in the mining, transport, utilities and construction sectors and weakest in the service and retail sectors. At the same time, the RBA has moved to a neutral setting for interest rates, likely reflecting the uncertainty of economic conditions and the ability for the RBA to either raise or lower rates subject to conditions.

Not surprisingly, the Government budget focused on fiscal relief, particularly for middle income earners and small business. Planned infrastructure spending increased by \$6 billion. Retailers may benefit from planned tax cuts for low-to-middle income earners, doubling from \$530 to \$1,080 p.a., while infrastructure and contracting companies such as Transurban, Boral and Cimic could benefit from the public transport related infrastructure boom.

MARKETS

Inflationary expectations have changed considerably over the quarter despite the current reading of inflation over the year sitting at 1.8%. The RBA official cash rate remained unchanged at the April meeting at 1.50%. Despite the RBA not changing rates, yields on Australian bonds fell reflecting cautious expectations for the Australian economy. This direction in yield continues to influence the returns available from cash and fixed interest investments. Cash and bank bill rates have moved lower over the quarter with the 90-day bank bill rate at 1.75% and 180 days at 1.81%. These rates are influential for the pricing of most fixed income investments including bonds and interest rate securities (Capital Notes and Preference Shares). Term deposits offer a margin above these bank bill rates but do not exceed 2.75% at best and have changed marginally over the quarter, with some Banks reducing rates offered in line with changes to Bank Bills noted above.



Government bond yields continued to pare back across January-March as prices rose (yields fall as prices rise). The yield for the Australian Government 10 year bond sits at approximately 1.89% (as compared to the 10 year US Treasury yield near 2.50%), and approximately 0.40% weaker over the quarter and a substantial 0.77% weaker over a year. Recent uncertainty over the pace of growth and inflationary expectations in Australia through the balance of this year explains the fall in yields.

10-year Australian Government Bond Yield



ASX listed hybrid securities such as Capital Notes and Preference Shares yield slightly lower than last quarter owing to price changes in some securities with income yields between 4.50 and 5.50% p.a. (gross) typical subject to the security type, issuer and timeframe to call/maturity.

With regard to the outlook for interest rates, the RBA is at a 'neutral' setting. The RBA expects tightening in the job market to lead to higher wages, prices/inflation, and ultimately higher rates. That said, if a weaker housing sector leads to unemployment or the global economy continues to slow, the RBA has the ability to cut rates depending on circumstances and how they may affect the local economy. The consensus of views seems to be leaning towards a rate cut as the next move, as reflected in falling yields for bonds.

Real estate investment trusts (REITs), continued to perform well on a relative basis benefiting from the weaker interest rate outlook. While prices were subject to general share market volatility through the last quarter, REITs produced a positive return of 14.4% for the quarter ended 31 March and 25.9% for the year to 31 March. This return is total return and inclusive of strong income returns between 4-6% (varies by REIT).

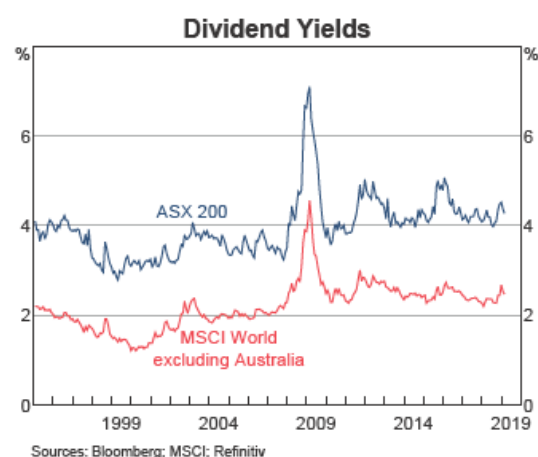
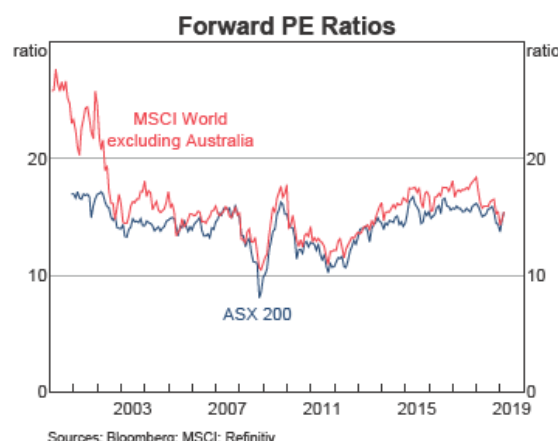
With regard to bond yields and REIT valuations, they are generally sensitive to movements in bond yields. As noted above, the Australian Government bond yield is now some 0.40% lower over the quarter. These conditions continue to be supportive for the Australian REIT sector.

With regard to share markets, the November and December correction to world share markets led by the US (the S&P500, a measure of the top 500 stocks in the US, ended the quarter at -14%), was answered with stronger share markets through the quarter. International markets responded to conditions that point to easier monetary policy settings posting a total return for the quarter of 11.5%. Australia followed suit and posted a return of 10.9% for the three months ended 31 March (S&P ASX200 TR). The 12 month return for the international and Australian share markets to 31 March were 12.3% and 12.1% respectively.

Within the local market resources companies continued to outperform, while defensive sectors such as utilities and infrastructure also outperformed the more cyclical sectors (e.g. Banks, building and discretionary retail). The February reporting season was mixed with a generally cautious tone from businesses reflecting uncertainty on the economic front. With regard to earnings growth expectations, this was trimmed to around 5% for the 2019FY, a slight reduction from previous estimates.

Following the recent appreciation in prices this leaves the market trading broadly in line with its long-term average price/earnings or P/E ratio of 15.5 times. The market is still offering a relatively attractive dividend yield of approximately 4.1% p.a. on average or approximately 5.50% p.a. in gross terms. Low interest rates, and falling bond yields over the quarter, continue to highlight the relative attractiveness of financially stable higher yielding stocks.

On the valuation front, measured by the forward price earnings ratio for the ASX top 200 (see chart below), this suggests valuations in the Australian market now represent fair value i.e. market prices a fair reflection of intrinsic value. A price/earnings ratio of approximately 15 times compares to 16 - 17 times at the beginning of the December quarter and now largely in line with the historical average at 15.5 times. With regard to valuation, earnings are a key factor and while the earnings outlook remains reasonable, forward expectations have again moderated with estimates of approximately 5% annual earnings growth (as noted above).



Dividend yields available from Australian shares continue to retain their advantage over shares listed on overseas (global) share markets (measured by the MSCI World excluding Australia) in the above chart.

To summarise quarterly movements and highlight the current position or valuation of markets and possible prospective returns (including income and growth components of total return on a per annum basis and over a ten year period), the below table highlights that:

- The Australian share market now represents fair value compared to some international markets, the US in particular. The Australian share market has moved upward of the first quarter of 2019 and now, at approximately 6,200 to 6,300 points, represents fairer value i.e. prospective returns for monies invested now may have the potential to achieve approximately 7.0 - 8.0% p.a. over the next ten years.

- The fair to full pricing position for developed markets equities (shares) remains largely attributable to the US market which is considered to have moved back into overpriced territory at the time of writing (S&P500 Index at 2890 points). Developed market equities (shares) outside of the US (Japan, China, Europe, and UK), measured by the FTSE All World Ex US Index, remain less expensive than other markets and may provide better prospective returns as a result (forecast return is approximately 8.0% p.a. over a ten year period as compared to the US market at approximately 2.5% p.a. over the same timeframe).
- ASX listed real estate trusts (A-REITs column in the below), at 1,530 points (ASX 200 REIT Index) represents fair value. Total return expectations have moderated owing to strong upward price movements to 6.5 - 7.0% p.a. over a ten year period at today's market prices.

Australian Equities			Developed Market Equities		
All Ords 6,314.0	10 yr F'cast return	Status	FTSE DM 306.9	10 yr F'cast return	Status
9250	2.1%	Overpriced	390	2.8%	Overpriced
9000	2.5%	Overpriced	380	3.1%	Fully priced
8750	2.9%	Overpriced	370	3.4%	Fully priced
8500	3.3%	Fully priced	360	3.7%	Fully priced
8250	3.7%	Fully priced	350	4.1%	Fully priced
8000	4.1%	Fully priced	340	4.4%	Fully priced
7750	4.6%	Fully priced	330	4.8%	Fully priced
7500	5.1%	Fully priced	320	5.2%	Fully priced
7250	5.6%	Fair value	310	5.6%	Fair value
7000	6.1%	Fair value	300	6.0%	Fair value
6750	6.7%	Fair value	290	6.4%	Fair value
6500	7.2%	Fair value	280	6.8%	Fair value
6250	7.9%	Fair value	270	7.3%	Fair value
6000	8.5%	Cheap	260	7.8%	Fair value
5750	9.2%	Cheap	250	8.3%	Cheap
5500	9.9%	Cheap	240	8.9%	Cheap
5250	10.7%	Cheap	230	9.4%	Cheap

Emerging Market Equities			A-REITs		
FTSE EM 686.7	10 yr F'cast return	Status	ASX REIT 1515	10 yr F'cast return	Status
1000	1.7%	Overpriced	2100	2.3%	Overpriced
950	2.3%	Overpriced	2000	2.9%	Overpriced
900	3.0%	Overpriced	1900	3.6%	Fully priced
850	3.7%	Fully priced	1850	4.0%	Fully priced
800	4.4%	Fully priced	1800	4.4%	Fully priced
775	4.8%	Fully priced	1750	4.8%	Fully priced
750	5.2%	Fully priced	1700	5.2%	Fully priced
725	5.6%	Fair value	1650	5.6%	Fair value
700	6.1%	Fair value	1600	6.1%	Fair value
675	6.6%	Fair value	1550	6.5%	Fair value
650	7.1%	Fair value	1500	7.0%	Fair value
625	7.6%	Fair value	1475	7.3%	Fair value
600	8.1%	Cheap	1450	7.5%	Fair value
575	8.7%	Cheap	1425	7.8%	Fair value
550	9.3%	Cheap	1400	8.1%	Cheap
525	10.0%	Cheap	1375	8.4%	Cheap
500	10.7%	Cheap	1350	8.6%	Cheap

US Equities			World ex US Equities		
S&P500 2804	F'cast return	Status	World ex US 261	F'cast return	Status
3000	2.1%	Overpriced	480	2.2%	Overpriced
2900	2.5%	Overpriced	460	2.7%	Overpriced
2800	2.9%	Overpriced	440	3.2%	Fully priced
2700	3.4%	Fully priced	420	3.7%	Fully priced
2600	3.8%	Fully priced	400	4.3%	Fully priced
2500	4.3%	Fully priced	380	4.9%	Fully priced
2400	4.8%	Fully priced	360	5.6%	Fair value
2300	5.3%	Fully priced	340	6.3%	Fair value
2200	5.9%	Fair value	320	7.0%	Fair value
2150	6.2%	Fair value	310	7.4%	Fair value
2100	6.5%	Fair value	300	7.9%	Fair value
2050	6.8%	Fair value	290	8.3%	Cheap
2000	7.1%	Fair value	280	8.8%	Cheap
1950	7.4%	Fair value	270	9.2%	Cheap
1900	7.8%	Fair value	260	9.8%	Cheap
1850	8.1%	Cheap	250	10.3%	Cheap
1800	8.5%	Cheap	240	10.8%	Cheap

Cheap	Fair Value	Fully Priced	Overpriced
Forecast 5%pa or more above TDs	Forecast 2.5% to 5.0%pa above TDs	Forecast 0% to 2.5%pa above TDs	Forecast return lower than TDs

SUMMARY

Both bond and share markets have rallied over the first quarter of the year i.e. prices of bonds, shares and A-REITs have increased over this period. This has implications for future returns as outlined above. Notably, the outlook for yields that might be achieved on cash, deposits and other forms of fixed interest investment at current prices has lowered reflecting expectations for a more challenging economic and market environment.

With this as the backdrop, we continue to believe a diversified approach to investment across major asset classes, and incorporating an appropriate allocation to cash/deposit according to your risk profile, will likely continue to provide the best risk adjusted returns over the longer term (5 - 7 years plus). The challenges of a low interest rate environment remain and this is supportive of staying invested in a diversified portfolio in line with your risk tolerance, as we have seen over the first quarter of this year.