2018 YEAR IN REVIEW

PERPETUAL PRIVATE INSIGHTS

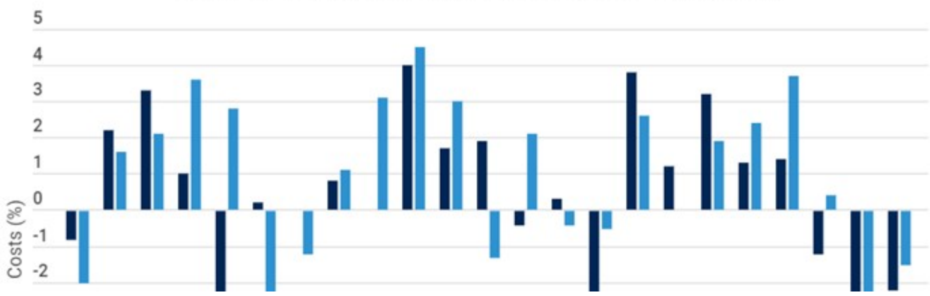
16/12/2018

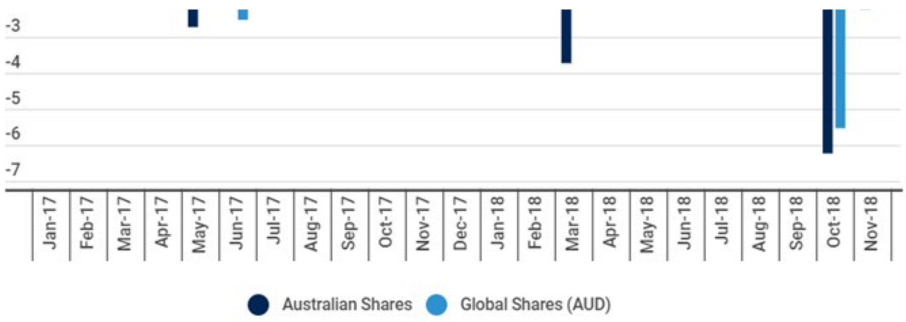
It looks like 2018 will close with both disappointing market returns *and* higher correlations between asset classes. The question is “what happens now?”

Calendar 2018 started off with synchronised global growth across key economies, however, within a few months, it became clear that growth trajectories were diverging.

Higher inflation and interest rates in the US created a rising US dollar. This, combined with a US-China trade war, saw emerging market economies sold off. Geopolitical events such as the Brexit wrangle and more Italian political instability, plus slowing growth in Europe and Asia sparked significant market sell-offs during October and November. This has continued into the early part of December, effectively giving back returns earned throughout the year.

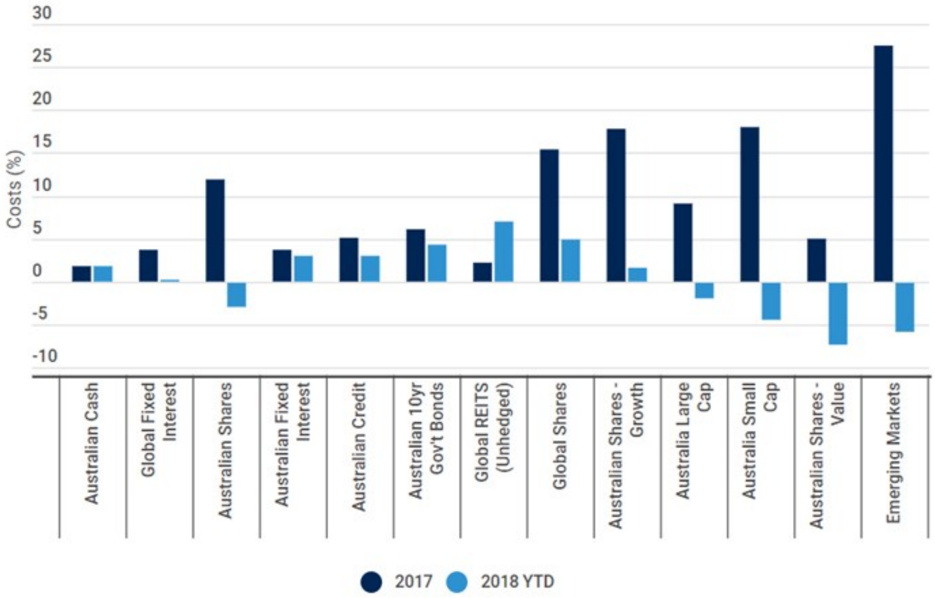
Graph 1: Monthly sharemarket performance (total return)





The stark contrast between 2017 (light blue bars) and the 11 months to the end of November 2018 (dark blue bars), can be seen in the chart below.

Graph 2: Investment market performance (total return)

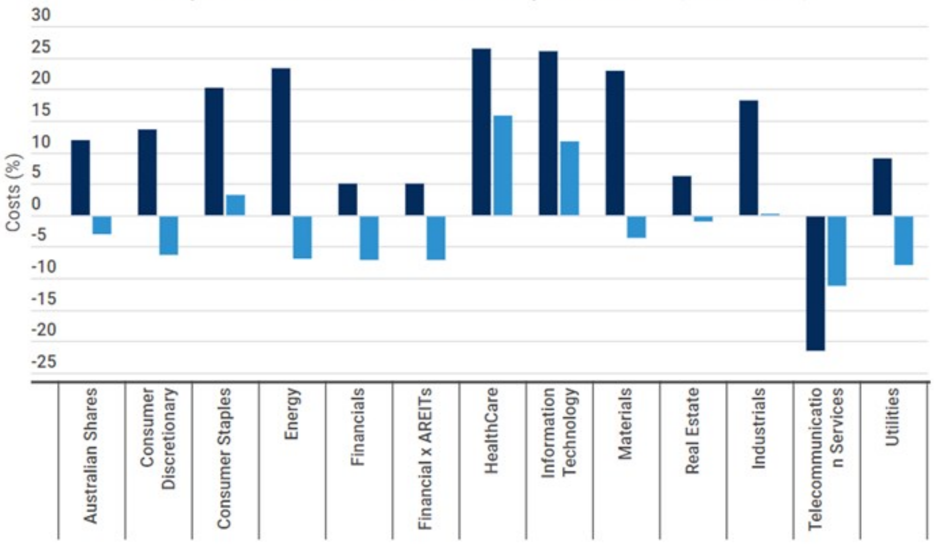


This is the year that was

The Australian sharemarket (ASX300) posted a -2.8% total return for the 11 months till November. It's Global shares (MSCI AC World) counterpart rose 4.9% in Australian dollar terms, though this was almost exclusively due to depreciation of the AUD, with underlying sharemarket performance basically flat. Looking a layer down, the flat result saw modest returns from US equities offset falls in European, UK and Japanese equities.

Large companies in Australia outperformed small companies over 2018 to date. This reverses 2017's result and the trend of the last five years as investors shunned the cyclicality and less diversified revenue streams inherent in smaller businesses.

Graph 3: Australian shares - sector performance (total return)



2017 2018 YTD

However, despite the weak returns we've seen in 2018, investors have still realised strong returns over 3 years in both Australian equities (averaging 7.7%p. a) and Global Equities (8.3%). These returns are in line with Perpetual Private'slong-term return expectations for those asset classes.

So now what?

Looking into 2019, we believe the global growth cycle has likely peaked, as has both US and Australian economic growth. US growth was spurred on by tax cuts but these effects will likely be swamped in 2019 by the growth drag from higher interest rates and the effects of current and proposed tariffs.

Australian growth is unlikely to reaccelerate above 3% for any meaningful period in 2019.

Aussie mates' rates

The Reserve Bank of Australia may very well make it three calendar years in a row with no change to the Cash Rate of 1.50% during 2019. A slowing Chinese economy, crumbling residential property market and slow wage, inflation and household consumption growth mean the RBA is likely to be in no hurry to make money more expensive.

In short, we are getting into the late stage of the global economic cycle, though most recession indicators in the larger economies are not yet flashing red and there are few signs of the excesses that typically presage cycle ends. Corporate earnings growth globally and in Australia is still solid (consensus forecasts have global earnings growing at 8% in 2019), though can be expected to slow somewhat as 2019 progresses.

Your plan is *the* plan

Thanks to the recent pullback in financial markets, most risk asset classes appear fairly valued. The exceptions are US equities and Government bonds in a number of advanced economies, which are somewhat expensive.

Emerging market equities are one of the asset classes looking clearly attractive from a value viewpoint - though as 2017 and 2018 have shown, the return path can be bumpy.

Whilst the cycle is maturing, we believe investors still need some risk exposure in their portfolios in 2019. Trying to time peaks and troughs is fraught with danger. It's very hard to find consistently successful short-term market timing strategies that meaningfully add to returns or reduce risk. For those with long investment horizons, modestly leaning into/away from the more extreme undervalued/expensive asset classes may increase your chances of adding to returns over the longer term.

For all investors, keeping your portfolio well diversified and broadly aligned to your risk profile is what maximises the chances of meeting your financial goals.

The Investment Research team here at Perpetual Private will remain focused on ensuring the individual securities we select and fund managers we invest with are well positioned to both limit the downside and increase the growth of our clients' portfolios, whatever market environment eventuates in 2019.

As always, should you have any questions regarding your investment portfolio, or investment markets more generally, please don't hesitate to contact your Perpetual Adviser.

*Please note we will be providing clients with our usual detailed review of the December 2018 quarter in our next Quarterly Market Update due out mid-January 2019.

Graph 1 Source: Lonsec/Morningstar, Australian shares is the ASX300 TR Index, Global Shares is the MSCI AC World TR Index AUD.

Graph 2 Source: Lonsec/Morningstar, Australian Cash is the Bloomberg AusBond Bank Bill Index, Global Fixed Interest is the Bloomberg Barclays Global Aggregate TR Index (Hedged), Australian shares is the ASX300 TR Index, Australian Fixed Interest is the Bloomberg AusBond Composite Index, Australian Credit is the Bloomberg AusBond Credit Index, Australian 10yr Government Bonds is the Bloomberg AusBond Govt 10yr Index, Global REITs is the FTSE EPRA/NAREIT Developed Index (Unhedged), Global Shares is the MSCI AC World TR Index (AUD), Australian Shares – Growth is the MSCI Australia Growth TR Index, Australia Large Cap is the MSCI Australia Large Cap TR Index, Australia Small Cap is the MSCI Australia Small Cap TR Index, Australian Share – Value is the MSCI Australia Value TR Index, Emerging Markets is MSCI Emerging Markets TR Index (AUD).

Graph 3 Source: Lonsec/Morningstar. Sector Data is from MSCI.