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CONSULTANTS

Market Review – December 2019

2019 Year in Review

2019 can be considered once more as the year of the bankers. Bankers have managed to reinflate financial markets by easing monetary policies, implemented through reductions in interest rates (e.g. US and Australia), or in the case of the Eurozone, through expansion in the central bank 's balance sheet.

Investors started 2019 with anxiety after a sharp decline in share markets in the last quarter of 2018. In early 2019 Chairman Powell signalled that the US Federal Reserve (the Fed) has pivoted from tightening bias to a more neutral, "data dependent" policy stance. The Fed subsequently reduced policy rates by 75 basis points to a target range of between 1.5% and 1.75%. Other central banks followed suit. The Reserve Bank of Australia (RBA) reduced the target cash rate by 75 basis points to 0.75%. The European Central Bank (ECB) brazenly announced that it had reduced the interest rate on deposit facility by 10 basis points to negative 0.5% and would resume net asset purchases at a monthly pace of 20 billion Euro per month. It also wrote an open cheque by announcing that the asset purchase program would remain for as long as necessary.

Easing monetary policy comes amid deteriorating economic conditions, especially in manufacturing sectors. The Purchasing Managers' Index (PMI) suggested that the manufacturing sectors in the US, Europe and China were all experiencing recessionary conditions by the end of 2019.

As the tide of central banks' lifted all asset classes, investors have been richly rewarded for taking risks in 2019. The year-to-date returns of the main asset classes are shown in Table 1 – all of which returned positive numbers. Australian bonds returned just over 7.3% as the RBA reduced policy rates three times during 2019. Global sovereign bonds (hedged) also delivered a very solid 7.2% to investors – impressive considering around 1/3rd of the global sovereign bonds universe comprises negative-yielding bonds. Further out on the risk curve, listed real estate assets benefited from falling bond yields and generated returns above 20%. Both global and Australian shares performed strongly despite concerns about economic recessions, lower earnings growth and expensive valuations, while emerging market shares have been a relative laggard.

However, the high one year returns masked considerable volatility in markets, which were often driven by macro headline news on US-China trade tensions, Brexit and developments in the Middle East. The S&P 500 fell by 6.8% in May and by 5.8% in the first week in August. The US equity market recovered strongly and quickly after those falls. One of the factors supporting the recovery is the fall in US 10 year bond yield, which started the year at close to 2.7% and was around 1.92% in December.

2020 Outlook

Expect much more of the same in 2020.

Interest Rates

Interest rates or rather how low can they go, how long will they stay there and will we get unconventional monetary policy measures will be the continued key point of focus for 2020.

This is unlikely to change this year as central bankers across the globe continue to play an outsized role in the shape of the global economy.

Some economists expect two more cuts in Australia to take the cash rate to an unprecedented 0.25% by the middle of 2020. Possibly the first cut to be delivered in February.

There is also the possibility that the RBA will then launch quantitative easing where it will begin issuing new currency and buying bonds from banks, increasing money supply in a bid to encourage more lending and investment. However, the RBA may hold off on a bond-buying program if the Federal Government pushed through a new round of tax cuts at the May Budget, but unlikely given its commitment to a surplus.

Shares

The Australian share market notched up its best year in a decade in 2019 in a run which added close to $340 billion to the value of the nation's biggest listed companies. All up the S&P/ASX 200 Accumulation Index was up 23.4% for the year.

This expected continued low interest rate environment will prompt investors to persist in piling into high-quality companies which are paying good dividends and have clear growth potential.

Any move by the RBA to launch quantitative easing is also likely to cause the Aussie dollar to fall against its US counterpart, this would be supportive of companies earning income from overseas.

Market expectations for 2020 Australian share market is for a rise of between 5% to 7%.

Property

The sharp bounce back in house prices was one of the few areas of the Australian economy which surprised to the upside in 2019.

House prices peaked in Melbourne and Sydney in mid to late 2017 before falling 11% and 15% respectively. They bottomed out in both cities in the middle of 2019 as interest rates were slashed to record lows, stress tests for new home loans were relaxed and a surprise federal election result removed uncertainty about the future of negative gearing. Prices have since bounced back and in a far quicker fashion than most economists had tipped.

Based on expected further interest rate cuts strong growth in house prices is set to continue in 2020 especially when there is pent up demand and the level of housing stock on the market is still relatively low.

It is predicted that house prices in Melbourne and Sydney are set to rise by 10% in 2020, as low interest rates and a more relaxed approach to lending by banks entices buyers.

The Economy

RBA governor Philip Lowe says the economy appears to have reached "a gentle turning point". Some economists are not so sure.

In 2019 the Australian economy was a best described as sluggish. Economic growth slowed from 2.3% to 1.7% over the year. That took growth to its lowest level since 2009 as the unemployment rate ticked up from 5.1% to 5.3%. However, it is expected economic growth to recover to between 2% to 2.2% by the end of 2020, but still well below the 2.75% the RBA is forecasting.

It is predicted that the domestic economy will not get any worse but there are no strong signs that the economy will get better in 2020.

In conclusion: The weaknesses in the Australian economy can be attributed to a mix of weak consumer spending, driven by low wage growth and the wealth effect from corrections in house prices, and deteriorating corporate sentiments. It is anticipated that more accommodative monetary policy, the reduction in income tax in July 2019 and the recovery in house prices seen in the second half of 2019 may stabilise the economy, helping Australia maintain its record of uninterrupted economic growth since the early 1990s.

The modest recovery in economic growth could benefit equities. However, given most share markets are currently trading at around fair value through measures such as forward price/earnings and price/book, investors should expect modest returns in the single digits.

Table 1: Market Performance – Periods to 31 December 2019

Sector	1 Month %	3 Months %	1 Year %	3 Years % pa	5 Years % pa
Australian Shares	-2.2	0.7	23.4	10.3	9.0
Australian Shares Small Cap	-0.3	0.8	21.4	10.0	10.6
International Shares Ex-Aus (Unhedged)	-0.9	4.3	28.0	13.8	12.2
International Shares Ex-Aus (Hedged)	2.4	7.7	27.4	11.8	9.2
Emerging Markets (Hedged)	5.7	9.5	18.1	11.5	7.5
Emerging Markets (Unhedged)	3.4	7.3	18.6	12.7	8.9
Australian Listed Property	-4.4	-1.0	19.4	9.1	10.9
International Listed Property ($A)	-3.1	-2.2	23.5	10.4	9.7
Australian Direct Property*	0.8	1.7	7.0	10.8	11.7
Australian Fixed Interest	-1.6	-1.3	7.3	5.1	4.2
International Fixed Interest (Hedged)	-0.3	-0.8	7.2	4.1	4.2
Cash (BAUBIL)	0.1	0.2	1.5	1.7	1.9
		Change over the month			
Australian Govt. 10 yr Bond Yield	1.03%	0 bps			
AUD/USD	$0.69	$0.01			

*as at 30 September 2019

Australian Shares (S&P/ASX 200 Accumulation Index)

The S&P/ASX 200 Accumulation Index dropped -2.2% in December but finished the year with a gain of +23.4%. Resource sector comfortably outperformed Industrials over the month returning +1.7% versus -2.9%.

By sector, Materials (+1.5%), Utilities (+0.8%) and Energy (-1.5%) outperformed in Australia, while Consumer Staples (-8.1%), Communication Services (-5.8%) and IT (-4.6%) underperformed the most.

The top three moves within the S&P/ASX 200 Accumulation index included Silver Lake Resource (+20.7%), Gold Road Res Ltd (+18.5%) and Northern Star (+17.9%).

The bottom three moves were Jumbo Interactive (-27.3%), Smart Group Corp (-23.1%) and Perenti Global Ltd (-16.7%).

At the end of December, the index finished trading at a P/BV of 2.1x and a P/E Ratio of 18.3x and equity yield (dividend) of 4.0%.

The VIX was at 14.61 (the average since 01.10.2010 is 16.4) indicating below average level of market volatility.

Australian Shares Small Cap (S&P/ASX Small Ordinaries Index)

As a collective, Australian small caps (stocks 101-300 in the ASX) benefit from low interest rates, a low currency and availability of equity capital. Add a modest improvement in demand (high employment and some wage inflation) and there is reason to expect some growth.

The Small Ords Accumulation index fell -0.3% in December outperforming the broader index by +1.9%.

At the end of December, the trailing P/E Ratio was at 19.7x at the end of the month, P/BV is at 2.1x and equity yield (dividend) of 3.0%.

International Shares (MSCI World ex Australia Index, Net AUD and the MSCI World ex Australia Index, Net LCL)

The MSCI World ex Australia Index (Unhedged) -0.9% for December whilst the MSCI World ex Australia Index (Hedged) returned +2.4%.

Global equity markets enjoyed a Santa rally in December as optimism returned to the global trade outlook, policies from central banks remained supportive and investors took the view that ultra-low interest rates would remain in place for longer. US markets performed strongly, wrapping up one of their best years on record in 2019. US stocks were buoyed by hopes that an interim trade deal between the US and China was still on course to be signed in January.

Among MSCI developed world GICS sectors, Energy (+5.4%), IT (+4.2%) and Materials (+4.1%) outperformed the most, while REITs (+0.6%), Industrials (+1.0%) and Communication Services (+2.0%) underperformed the most.

At the end of December, the index ended trading at a forward P/E Ratio of 20.1x and P/BV of 2.5x and equity yield (dividend) 2.3%.

US market: The US equity market reached fresh highs in December to cap one of the best years of the past decade.

US equity market gains were led by energy and tech stocks. Energy stocks were boosted by a month-long bounce back in the price of oil. Brent crude, the international benchmark, reached its highest level since mid-September when Saudi Aramco oil-processing facilities were attacked by drones, sparking fears of supply shortages. Tech stocks continued their rally into the year end, buoyed by Amazon shares, after it reported a bumper Christmas holiday season, and Apple, amid enthusiasm for its foray into streaming video subscriptions and fading concerns that iPhone demand was lagging.

A surge in online purchases boosted US retail sales over the festive season, underlining the strength of consumer spending even as a sharp decline in bricks and mortar footfall points to the challenges facing physical stores and shopping malls in the year ahead. US retailers announced 9,300 store closures in 2019, according to Coresight, the most since the group began tracking the data in 2012. That is more than double the number of openings and is up sharply from the 5,844 closures announced last year.

UK market: December provided a positive return, capping a strong calendar year for the UK equity market. The market rallied sharply on news of a Conservative majority government mid-December, boosted by the prospect of an end to the political impasse and a period of stability.

European markets: European equity markets finished the year strongly, buoyed by the combination of a convincing UK general election result and news of a Phase One trade deal between US and China. Against this backdrop, investors were happy to adopt a ‘risk-on’ stance with ‘cyclical’ parts of the market (companies whose performance is linked to the business cycle) outperforming ‘defensive’ areas. Financials, energy and materials made the largest gains at a stock level. At the other end, communication services and consumer staples were the biggest laggards against the broader market.

Chinese market: Chinese equities were among the best performing markets in the region in December. China's economic data for November came in ahead of expectations, showing a broad improvement across industrial production, industrial profit and retail sales.

Emerging markets: Emerging equity markets registered broad gains during December to cap off a successful year for the asset class as investors responded positively to news that the US and China had reached agreement on Phase One trade negotiations. The easing in trade tensions represents the first tariff rollback since the inception of the trade war in July 2018.

Emerging Markets Shares (MSCI Emerging Markets Index, Net AUD)

Emerging market equities rallied significantly during the final month of the year as the US and China negotiated the first phase of a trade deal. The MSCI Emerging Markets Index (Hedged) rose +5.7%. North Asian markets were partially responsible as China, South Korea and Taiwan rose +8.3%, +8.9% and +7.5% respectively.

Macroeconomic data remains encouraging across the region. Latin America, Brazil also performed well, rising +12.2% as the central bank cut rates by a further 50 basis points to 4.5%. In the CEEMEA region, Russia was up +8.4% as the central bank also cut interest rates by 25 basis points to 6.25%, further supporting the equity market.

The MSCI World Emerging Markets Index (Unhedged) returned +3.4% for the month.

At the end of December, the index ended trading at a forward P/E Ratio of 14.2x and P/BV of 1.9x and equity yield (dividend) 2.7%.

Australian Listed Property (S&P/ASX 200 A-REIT Accumulation Index)

The S&P/ASX 200 Property Accumulation index returned -4.4% in December, underperforming the S&P/ASX 200, which returned -2.2%. For 2019, A-REITS returned +19.4% underperforming the market, which returned +23.4%. S&P/ASX Office AREITS returned -2.5% in December, S&P/ASX Retail A-REITS returned 3.0%, &P/ASX Diversified A-REITS returned -4.1% and S&P/ASX Industrial A-REITS returned -8.5%.

The best A-REIT performers over the month were Ingenia Lifestyle Communities (INA) at +5.5% and Rural Funds Group (RFF) at +4.1%. Key underperformers were Goodman Group (GMG) at -8.8% and Centuria Metropolitan REIT (CMA) at -6.9%.

At the end of December, the index was trading on a dividend yield of 4.5% with a P/BV 1.2x and a P/E Ratio 13.9x.

International Listed Property (FTSE EPRA/NAREIT Developed ex-Australia Index, AUD)

Globally, REITs were up +1.4% this month (USD terms). Hong Kong was the top-performing region (+5.2%). The worst-performing region over the month was the United States (-1.2%).

At the end of December, the index was trading on a dividend yield of 3.8% with a P/B 1.7x and a P/E Ratio 20.8x.

Australian Direct Property (Atchison Consultants Unlisted Property Funds Index)

Australian direct property posted a return of +1.7% over the September 2019 quarter. Capitalisation rates across property sectors continued to trend downwards. Cap rates across office, industrial and retail properties range are 5.1%, 5.6% and 5.0% respectively.

Australian Fixed Interest (Bloomberg AusBond Composite Bond Index)

Australian fixed interest rose by -1.6% over the month. Australian government 10-year bond yields increased by 36bps to 1.39%. At this point, 10-year Australian bonds yields were 53bps below US 10-year yields while 3-year single A corporate credit spreads tightened from 0.840% to 0.76%.

International Fixed Interest (Barclays Global Aggregate TR Bond Index, Hedged to AUD)

International fixed interest returned -0.32% over the month (Bloomberg Barclays). The 10-year US government bond yield increased by 14bps to 1.92% while the US corporate investment-grade credit spread tightened from 1.44% to 1.30%.

Contact Details

To obtain further information, please contact Atchison Consultants.

Jake Jodlowski
Principal
Atchison Consultants
Phone: +61 3 9642 3835
Email: jake.jodlowski@atchison.com.au

Alex Wong
Senior Investment Analyst
Atchison Consultants
Phone: +61 3 9642 3835
Email: alex.wong@atchison.com.au