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Despite political risks featuring prominently through the year, the financial year has been a rewarding one for investors. The global economy's improved performance over the past year with the United States (US) markets hitting record highs and an increase in corporate earnings translated into strong investment returns. Rising consumer sentiment, solid jobs growth and lower unemployment have been evident across the US, Europe and parts of Asia. This stronger global economic performance was sufficient to counter the political uncertainty, especially in Europe where electoral success of anti-European Union parties was feared.

Global shares perform well but risks are still evident

Political risks featured prominently over the past year in terms of elections. Yet even with the dramatic headlines and surprising results, these elections have proven to be only temporary setbacks. President Trump's bold promises of corporate tax cuts, higher infrastructure spending and less regulation were supportive factors for the US share market. There is however, no guarantee President Trump will be able to pass corporate tax cuts as promised.

In the United Kingdom (UK), despite the uncertainty created by the surprise Brexit vote and the Conservative Party's recent loss of their parliamentary majority, the UK share market increased as the weaker pound sterling currency benefits UK companies with offshore earnings. In March 2017, Britain triggered the start of the Brexit negotiation process. This may have more surprising twists and turns ahead given the complex negotiations are due for completion in March 2019.

Central Bank policies remain a key influence

With the global economy's improved performance over the year, Central Bank governors have been closely watching economic data, particularly in the US. The US economy recorded strong consumer spending and job gains. Notably the US unemployment rate fell to 4.3%, which is its lowest level since early 2001. US price pressures have been reasonably contained with inflation running below the Central Bank's 2% target. Given this strong data, the US Federal Reserve (Fed) raised interest rates by 0.75% over the past year. The Fed Chair, Janet Yellen stated that US interest rates should increase "a few times a year until the end of 2019". This was welcomed by Wall Street.

In Europe, the Central Bank has maintained low interest rates and the supportive asset purchase program. Europe's unemployment rate fell to 9.3%, which is its lowest level since 2009.

Emerging markets enjoyed a sharp recovery

The positive data in developed markets extended to the emerging world with markets making a sharp recovery over the year. China's share market gained 9% in response to the economy's solid performance, which was driven by a large infrastructure spending stimulus program and a robust housing market.

Brazil's share market surged higher despite the political corruption scandals and their Central Bank aggressively cutting interest rates. India's economic growth modestly slowed after the currency note swap (which invalidated India's two biggest banknotes) in November 2016. Even Russia's economy appears to be emerging from recession with the benefit of lower interest rates, despite the fall in oil prices which is Russia's key commodity export.

Australia's share market was a solid performer

Australia recorded mixed economic data over the past year. Australia's annual economic growth was subdued by historical measures. Despite better jobs growth, both the unemployment rate at 5.5% and underemployment rate at 8.8% remain high. Given this spare capacity in the labour market, wages growth remains subdued. It seems employers are either replacing their better paid, often older employees with younger ones or cutting back on wages by using contractors and temporary staff.

Consumers have been cautious with their retail spending even though retail competition has constrained prices. As a result, Australia's annual inflation was 2.1% for the year. In response to these mild wage and price pressures, the Reserve Bank of Australia cut the official cash rate from 1.75% to a record low of 1.5% in August 2016.

In Melbourne and Sydney, record low interest rates have served to both extend the boom in residential property prices and support high levels of apartment construction. Australia's level of household debt is the highest in the world and our share market is dominated by the big four banks. This suggests it will be difficult to see how bank share prices can continue to grow in value whilst maintaining their strong dividend payments.

Investment issues going forward

Looking ahead, there are many issues in Australia and overseas that could play out in various ways. Some of these issues are outlined below:

- China's approaching political leadership change may increase the focus on debt control as opposed to continually growing their economy.
- In the US, there are early signs of rising wage pressure but political uncertainty is undermining confidence in the US economy and economic policy.
- There is heightened uncertainty and challenging global tensions with North Korea and continuing issues in the Middle East.
- Issues of inequality in the developed world have also come to the fore.
- Most asset classes are expensive and there is a lack of viable safe haven investment options given low interest rates.
- Japan has strong growth but labour shortages with an ageing population are encouraging corporate change.
- In the UK, Brexit uncertainties remain unresolved.

A 'defensive' portfolio stance is still justified

We have believed for some time that it is appropriate to be conservatively invested. Preserving capital should remain the top priority for investors.

Our overall view of investment markets remains the same. Markets contain numerous risks while valuations are stretched and expensive, so risk management remains the key. It seems that record low interest rates and large asset purchases by Central Banks have been the main driver of market returns, rather than the growth of economic fundamentals. President Trump's promises of lower corporate taxes and higher infrastructure spending have added to already stretched investment valuations.

In taking this conservative stance, most portfolios have maintained a lower exposure to Australian shares and are now holding more cash than usual. Portfolios have maintained allocations to alternative strategies which we believe will help preserve investors' capital in volatile markets by providing potentially better returns.

While these positions may not prevent negative returns in weak share market conditions, this cautious approach should provide a good degree of insulation. Also insulating portfolios have been recent strong investment returns increasing portfolio balances to provide a buffer against any future market downturns. Investment portfolios are well positioned to manage possible risks and take advantage of potential return opportunities. Consequently, portfolios are widely diversified, risk-aware and positioned for different market environments.

If you have any questions or wish to discuss anything please call us on 03 9544 1004.

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