HAMILTON
WEALTH MANAGEMENT

Investor Insight 75 – May 2019

As we near the Federal Election there are two questions that are dominating discussion:

1. Are we at the start of a global slowdown in growth?
2. Where is Australia positioned if we see a global slowdown?

Before we get to the stage of a slowdown dominating discussion, we could well see a melt up in equity markets. This is on the back of the "dovish tilts" being adopted by central banks, leading to talk of possible interest rate decreases in the United States, Australia, Canada and New Zealand.

A melt up in equity markets is what we experienced in the 3rd quarter of 2018. Momentum takes over and we see equity markets perform exceptionally well, defying fundamentals.

This is common at the advanced stage of an economic cycle and is why we talk about fading the equity market rallies.

We do believe a US slowdown will gain momentum as a point of discussion and concern for markets post the northern summer.

The canary in the coal mine we believe is the bond market. Bond markets have traditionally been a leading indicator for growth, and whilst equities have had a spectacular start to 2019, bond markets are flashing concern, with yields on longer dated US Treasuries briefly falling below those of shorter dated Treasuries, creating an inverted yield curve.

What this tells us is that bond markets are concerned about the direction of the US economy and are anticipating that the Federal Reserve will need to loosen interest rate policy in the future to support a slowing economy.

Of course, this market signal could be wrong, but the yield curve has inverted ahead of every US economic slowdown in the past 50 years except for 1998. In every one of these occasions except 1998, the S&P500 also fell in the following twelve to eighteen months.

Even if the signal is correct, this tells us nothing about timing and recent data in China, together with a generally good US earnings season, suggests the bears may have to wait a little while yet. To reiterate what we have been saying for the last few months, whilst we do see a pronounced slowdown in the US economy we do not see a recession.

The situation is different in Australia and this is where we have more immediate concerns.

Investor Insight 75 – May 2019, continued

Whilst we don't like the "R" word and we don't see a global recession, we do think Australia faces more complex challenges.

For all of 2018 the Reserve Bank of Australia (RBA) adopted a tightening bias, expecting wages growth to pick up and for GDP growth to be 3 per cent or more. Noting the risks posed by China, the domestic housing market and high levels of household debt, the RBA has now adopted a neutral position on rates.

Whilst markets generally ignore changes in government, this time change on the political front might also exacerbate an already fragile macro environment for the domestic Australian economy.

The ALP has widely signalled their intentions on taxation and it has created a lot of debate, but we point out that any changes must get through the Senate. This may well be a problem for a Labour government, the crossbench with the exception of the Greens already signalling its objections to the ALP's tax policies.

We spent time in April meeting with senior business leaders. Whilst there is concern regarding the proposed tax changes and the effects on both the housing market and overall consumption, there is greater concern over wage increases.

These business leaders indicated to us that this would result in reduced investment in Australia, increased investment offshore and potential increased layoffs. This could have a significant effect on our economy.

In Australia, we have averaged 2.7 per cent growth over the past decade. We expect our economy to slow by more than most anticipate and for 2019 we see below-average growth rate of 2.4 per cent, well below global growth of 3.0 per cent.

Household debt has risen from 160% of income in 2012 to 190% presently. Housing loans are a record-high share of bank assets. Hence, we are seeing a credit squeeze as witnessed by the slump in home loan approvals. The latest private credit data shows lending for housing is up just 4.4% over the year with housing investor credit up only 1%.

Falling house prices as a theme has been well covered in recent months. They are weak in all markets and during April Moody's Analytics projected total price decreases for 2019 of more than 10 per cent in Melbourne and 9 per cent in Sydney. Meanwhile, dwelling approvals are off more than 28 per cent over the year.

Heuristic Investment Services research points out that weak approvals data will lead to a 5-10 per cent decline in residential construction over the next 12-18 months, and they point out that at "at 6 per cent of GDP, this is a significant headwind".

Investor Insight 75 – May 2019, continued

9.5 per cent of total workers are currently employed in construction, against a long-term average of 7 per cent, however many of these jobs are in infrastructure which is a large employer in Melbourne and Sydney.

For now, the Australian equity market continues to perform well despite the ongoing weakness in the housing sector and the risks associated with the economic outlook.

On 7 February the RBA opened the door to cutting interest rates further, with the AUD experiencing its steepest one-day drop since August. The RBA has held its cash rate steady at 1.5 per cent since August 2016 and insists that any future rate moves remain data dependent but most economists are now forecasting a cut this calendar year. This would put downside pressure on the AUD.

We remain very cautious regarding the domestic Australian outlook. Whatever the election result later this month the economy will face headwinds which may impact investors further.

Markets are now pricing in the prospect of a rate cut in 2019 as the weakness in housing and concerns over high household debt levels and continued low wages growth is compounded by a more uncertain global outlook. Until recently, the correction taking place in house prices was occurring against a backdrop of strong global growth. That backdrop is now being challenged.

The importance of asset allocation and respecting the economic cycle could not be more important as we look into and beyond the second half of 2019. Cycles mean that neither falls nor rises are forever, never trust a forecast that illustrates a straight line, and the sensible investor always keeps that in mind when planning for the future.

We have a strategy and we will continue to fade the rallies during the remainder of 2019.

Hamilton Wealth Management is a Fee for Service, Wealth Management business and as such our advice is built around the conviction to our process and philosophy and our strong belief in diversification.

We would be happy to discuss this further with you, please don't hesitate to contact us.

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