



HAMILTON[®]
WEALTH MANAGEMENT

Investor Insight 79 – September 2019

August saw volatility return to investment markets as geo-political risk rose again creating the one thing that markets dislike...uncertainty!

As we have discussed regularly, the main driver of markets over the last few months has been interest rates. The Federal Reserve (Fed) cut the overnight cash rate to 2.25 per cent last month, the Reserve Bank of Australia (RBA) cut to 1.00 per cent and the European Central Bank (ECB) looks like following suit soon. The Fed and RBA are looking at additional cuts imminently. The Reserve Bank of New Zealand also cut its cash rate by a larger than expected 0.5 per cent to 1.00 per cent early in the month.

Government Bonds have continued to rally as a result, with the Australian Government 10-year bond breaking below 1.00per cent in August, closing the month at 0.88 per cent. Yield curves in Australia and the US continued to flatten and the 2yr/10yr curve in the US as well as Germany and the UK are now slightly inverted, often a signal of a recession 12-18 months in the future, *Capital Economics* in London feels most major economies will avoid a recession.

The rally in Government Bonds has probably gone a bit far, and our economic consultants *Capital Economics* forecast bonds will close 2019 slightly higher in yield than current levels, therefore not in bubble territory as many are forecasting.

The lower bond yields are however justified, given reduced inflation expectations, technological progress, globalisation, workers reduced bargaining power and slow productivity growth.

Whilst we may well continue to see short term spikes down in bond yields, the forecasts of another full 1.00 per cent reduction overall in the Fed Funds rate is perhaps overstated, with *Capital Economics* stressing that the Fed has never cut by as much as investors expect in the absence of a recession - and they are not anticipating a recession in the near term.

We do still expect interest rates to remain at or around these levels though, which will underpin the demand for risk-based assets.

The big rider to all this is what the next moves are in the ongoing US-China trade war. Market reaction to President Trump's decision to impose an additional 10% tariff on Chinese goods from September 1 – and China's immediate response of letting the Yuan depreciate - caused a quick equity market pullback. Deferring these additional tariffs has pushed the issue further out but has not resolved it. It is clear where the risks lie.

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The trade war is creating a benign roll back in globalisation according to Capital Economics, which is underpinned by technological change such as robotics and artificial intelligence.

As the current tensions remain limited to the US and China, this is not preventing economies elsewhere such as Europe and Asia seeking closer ties. It is however crimping some businesses desire to invest, and this is impacting on global growth.

The one thing the world does not want is to see it split in two around US and China led spheres of influence. If this was to be the case there would be graver economic and market consequences.

In the short term, equity markets will be volatile as investors try to digest President Trump's actions and how China retaliates.

Interestingly, Capital Economics in London estimate the trade war has decreased Chinese GDP by -0.5 per cent over the last year. China has nevertheless held its growth levels through the property sector offsetting the decrease in exports. The remaining tariffs the US has announced will hurt the US more than China, through increasing the prices the US consumer will pay. Indeed, the latest tariffs have concentrated on areas where China is the dominant supplier to both the US and globally.

Thus, the tariff war is having a negative flow through effect on Asia even though pound for pound for every new round of tariffs the effect is diminishing.

We visited Fund Managers in Hong Kong and Singapore in August the market sees the chances of a deal between China and the US as ever diminishing. Even though Trump needs the trade war as he heads into an election (and can thus announce a "great big deal"), he won't be able to back down. All those I spoke to were of the view that the Chinese will not give up much ground from here if any.

The importance of Asia in a global context is important to put into perspective, International Monetary Fund (IMF) estimates show that between 2017 and 2019, half of global economic growth originated in Asia, with China and India comprising 35.2 per cent and 8.6 per cent respectively. Many are projecting that up to 70 per cent of global growth will come from Asia over the next 20 years.

We have recently moved "underweight" Emerging Markets. Whilst recent sell downs precipitated by both the trade wars and the Hong Kong protests are providing opportunities for fund managers to buy, markets dislike uncertainty and that is what the trade wars are providing along with increased volatility.

Where we continue to watch equity, markets are around the profits of corporate America. Why?

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Corporate America drives US equity markets which in turn lead equity markets globally, with the S&P 500 operating earnings having grown by nearly 50 per cent over the last four years.

When US profits start to falter we do believe this will place pressure on the US equity market and therefore we see a target on the S&P500 of 2,500, albeit this is now more likely in the first half of 2020 rather than later this year.

We should stress though that this is a slowdown, not a recession, therefore equity markets will see a recovery afterwards.

With uncertainty dominating, diversification is crucial. We are concerned with “group think” that appears to have come to the forefront with Australian Equities managers.

Our Managing Partner, Will Hamilton, wrote an OpEd on this topic which was published in *The Australian* last month. For the year ended 30 June 2019 we have seen 83 per cent of active fund managers underperform their benchmark - some quite dramatically so.

This article can be accessed via <https://www.hamiltonwealth.com.au/2019/08/active-fund-managers-have-had-a-year-to-forget-the-aust-17-08-19/>. It is an unpopular stance to take but needs highlighting.

It's a truism that the domestic funds management industry is going through a shake-up. We have seen established players such as JCP, UBS and Janus Henderson all exit the landscape in the past twelve months.

Yet there are still many fund managers (some say too many) in what is a very small equity market. Indeed, it's a concern that some are trying to differentiate themselves by taking on too much risk.

While the performance numbers we saw for the full year to June 30, 2019 include the fourth quarter of 2018 where we saw a large equity market correction, it is unacceptable for such a large percentage of the industry to underperform.

Finally, we must again highlight one of our favourite topics: fees. The bottom line is that domestic Australian equity management expense ratios are higher than those of international developed markets. These fees must come down and the argument of paying for conviction doesn't hold water.

This has certainly been a very tough environment for Australian equity managers in the last twelve months. Unless we see an improvement in performance, we will experience further contraction in what is a very crowded market.

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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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