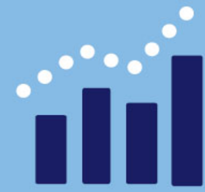
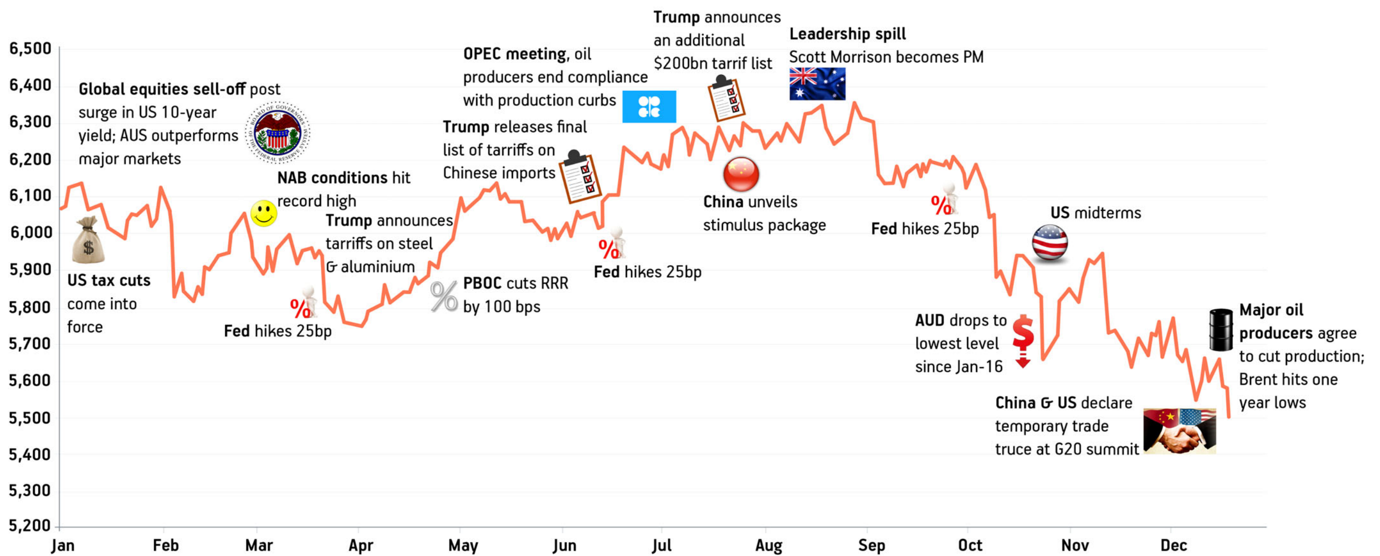
UniSuper

January 2019

Investment market update



2018 in (not so pretty) pictures



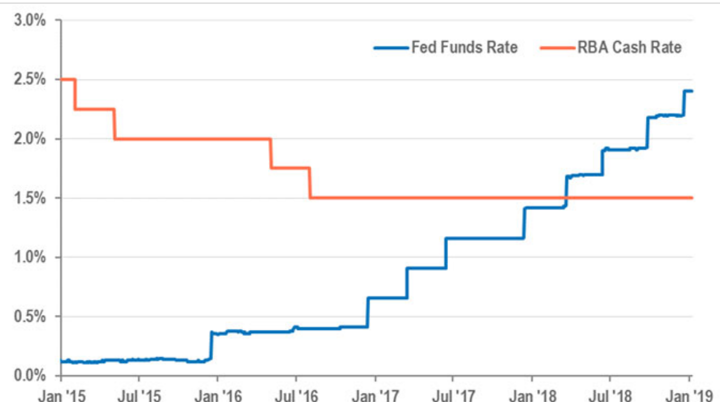
Source: JP Morgan

After hitting a peak of nearly 6,400 in September, the ASX200 (an index of the largest 200 companies in Australia) followed the swoon in global markets, finishing at 5,646. Despite the -6.9% fall over the year, most UniSuper members will see their account balances flat or slightly up in 2018. Our Balanced investment option—the default option for our accumulation members—eked out a small positive return of 0.9%.

As is typically the case over any 12 month period in financial markets, there were many twists and turns—although, generally speaking, the negative forces held sway. Here we attempt to capture the main drivers of market performance over the last year.

The US Central Bank ('the Fed') continued to increase its target rate

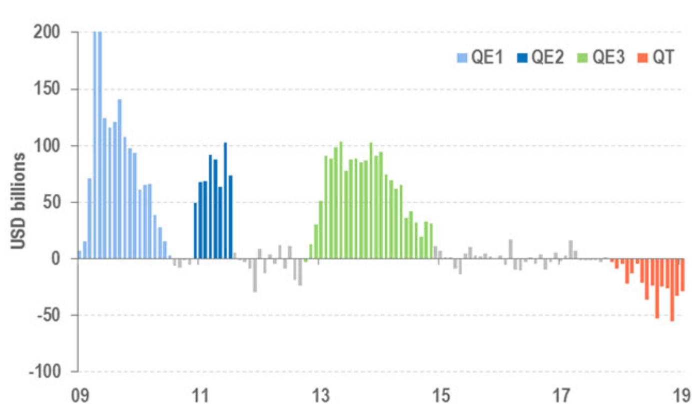
Arguably, the most important factor driving global financial markets over the past few years has been the rise in US interest rates from about zero to 2.50% at a time when other central banks were holding rates steady, or even cutting them (as was the case with the Australian Reserve Bank). This trend continued in 2018.



Source: UniSuper

The Fed has also transitioned from quantitative easing (QE) to quantitative tightening (QT).

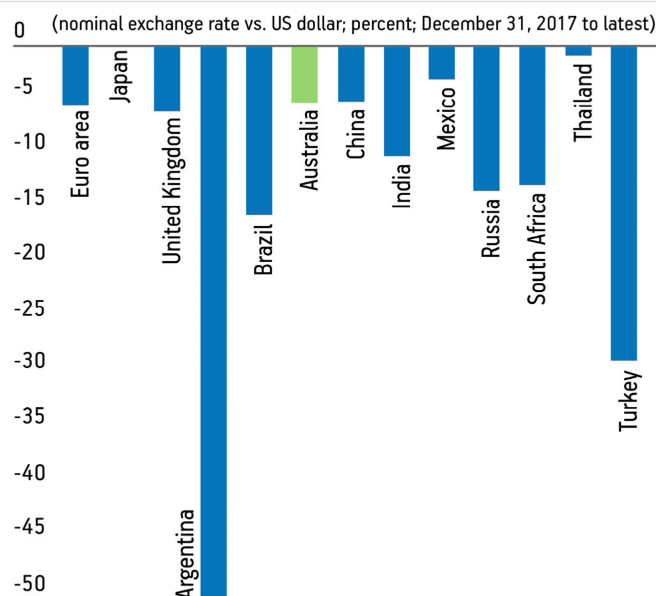
In addition to increasing the cost of US dollars (by raising rates), the Fed is also reducing the quantity of US dollars available. Quantitative tightening is a technical process whereby the Fed effectively transitions from being a buyer of bonds to a seller of bonds, putting upward pressure on interest rates. (As bond prices go down, bond rates go up).



Source: UniSuper

Tightening of US dollar liquidity has resulted in a stronger US dollar relative to other currencies

Changes in exchange rates are a key way in which changes in US interest rates are transmitted to the rest of the world. The impact is particularly large on countries with significant US dollar borrowings and weak fundamentals, such as Argentina and Turkey.

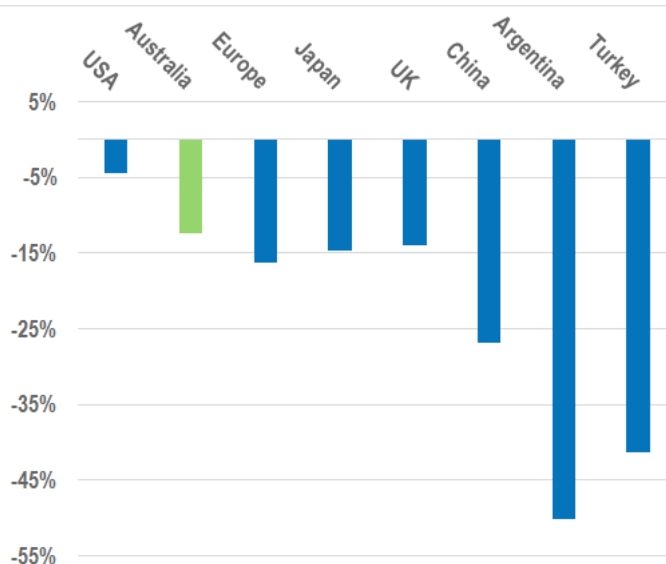


Source: IMF staff calculations

Tightening US dollar liquidity usually hurts asset prices and 2018 was no exception

All global share markets were down in 2018. The US share market was actually in positive territory until December when it recorded a 9.4% decline. This was the worst December on record for the US since the Great Depression!

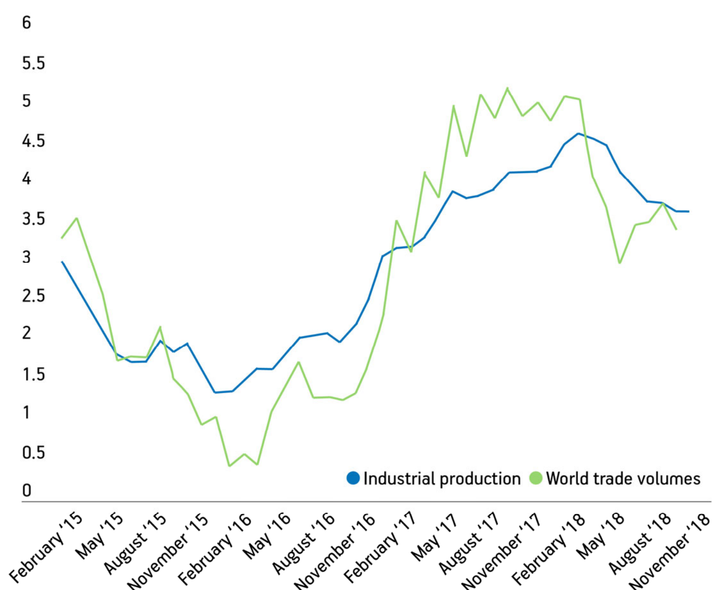
The graph is expressed in US dollar terms for consistent comparisons. Not surprisingly, Argentina and Turkey were two of the worst performers.



Source: UniSuper. Past performance is not an indicator of future performance

Trump's trade wars didn't help

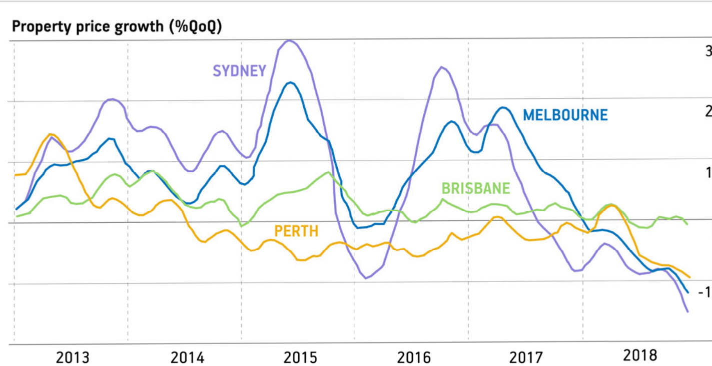
Despite higher rates, share markets were generally holding up OK until it became clear that Trump was going through with his threat to start a trade war. This immediately hit confidence, and industrial production and trade volumes have noticeably declined. Forecasts for global growth in 2019 have been revised down to about 3% from about 3.75%.



Sources: CPB Netherlands Bureau for Economic Policy Analysis; Haver Analytics; and Markit Economics

Australia has had its own problems, particularly falling house prices

House prices in Australia have been caught in a perfect storm. Starting from an overvalued position (particularly in Sydney and Melbourne), they have succumbed to lower foreign buying and tighter lending conditions arising from the fallout from the Royal Commission and APRA restrictions.



Source: Corelogic, Morgan Stanley

Impact on investment returns

A poor year for higher-risk assets caused an almost 180 degree turnaround in the relative performance of UniSuper's investment options. Whereas global strategies were our best performers in 2017, in 2018 they were our worst—with the notable exception of Global Companies in Asia (which had negligibile exposure to companies listed in the underperforming emerging market countries). Conversely, the Australian Bond option climbed to the top of the ladder in 2018 after being the second worst performer in 2017. The Cash option (1.8%) outperformed the Balanced option (0.9%) in 2018, representing the first time that has happened since 2011.

Best and worst performing investment options

2017	(%)	2018	(%)
Best performing			
Global Environmental Opportunities	20.12	Australian Bond	4.08
Global Companies in Asia	19.26	Global Companies in Asia	3.41
International Shares	17.24	Listed Property	2.65
Worst performing			
Diversified Credit Income	3.55	High Growth	-1.26
Australian Bond	2.86	Global Environmental Opportunities	-2.94
Cash	1.71	International Shares	-3.76

Past performance isn't an indictor of future performance. The information in this article is of a general nature and doesn't take into account your individual objectives, financial situation or needs. You should consider the appropriateness of the information for your personal circumstances and consider consulting a licensed financial adviser before making an investment decision based on the information contained in this article.

Is there light at the end of the tunnel?

Given that most share markets around the world have experienced their worst year since the global financial crisis, investors are generally engulfed in gloom. With a number of markets having fallen 20% from their peaks, we now hear talk of being in a 'secular bear' market. We feel there shouldn't be too much attention paid to such predictions. Markets could indeed fall further but there's nothing particularly special about a 20% fall as distinct from, say, a 15% or 25% fall. In fact, if an investor bought every time a market fell 20%, they would far more often than not be in front within 12 months.

In terms of catalysts of a more positive tone to markets, top of the list are:

1. A clear indication from the Federal Reserve that they're close to the end of this tightening cycle. In this regard, the latest comments from Fed officials have been encouraging and January is off to a more positive start. The firm market consensus is that we're closer to the end than the beginning of the cycle, and some commentators are even suggesting the possibility that the next move in official rates will be down.
2. Resolution to the China/US trade war. In global finance, there are really only two countries that matter—the US and China—so it's absolutely essential that they arrive at a workable truce. How this plays out is anyone's guess, although we can take some heart from Trump's recent tweets that talks are progressing well. Let's hope it's not fake news.
3. For Australian investors, it's hard to see a broad market rally without support for the banks. Assuming that the bad news from the Royal Commission has already been factored in, we now need stabilising house prices, particularly in Sydney and Melbourne. Unfortunately, given political uncertainty and tighter lending conditions, it's hard to see this happening any time soon. But it will happen… housing cycles never die.

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