



Report for the September 2018 Quarter

The US Federal Reserve lifted interest rates for the 8th time in September to 2.0%, a rate that is now higher than official interest rates in Australia. The US economy is growing strongly, with growth of 3.1% forecast for 2018, full employment and inflation on target at 2%. The Fed forecasts one more rate rise this year and three in 2019. Meanwhile, Australia's cash rate remains at an historic low of 1.5%. The growing differential between local and US rates pushed the Aussie dollar lower in September, down more than 2% to around US72 cents.

Locally, our economy continues to be in good shape. Australia's record period without a recession is now in its 28th year, with growth up 0.9% in the June quarter, 3.4% annualised, the strongest rate in 6 yrs. The Budget deficit fell to \$10.1 billion in 2017/8, the smallest in a decade, with more Australians in jobs and record company profits boosting tax revenues and reducing the welfare bill. Unemployment was steady at 5.3% in August. Consumer and business confidence continue to fluctuate on political uncertainty.

Higher interest rates (in the U.S.) and interest costs (locally) will make it harder for markets to go higher. Fundamentally, markets are driven by profitability and these additional costs will make it more difficult to continue to grow at current rates.

Headline statistics for the first 3 months of the financial year to September 30, 2018 are as follows:

- All Ordinaries: 6,325; up 36 points or 0.57%,
- Listed Property Accum. Index: 49,391.9, up 1.61%,
- 90 Day Bank Bills: 1.83%; down 0.21%
- FTSE 100: 7,510; down 1.38%,
- S & P 500: 2913; up 7.1%
- Dow Jones 26458; up 9.01%
- AUD vs U.S. Dollar; 0.72; down 2 cents or 2.70%

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Housing prices *off the boil*



The Australian housing market appears to have reached a turning point, with prices falling 2.2 per cent since peaking in September 2017. This is welcome news for first home buyers; not so much for sellers and investors.

As always with residential property, it's a tale of many markets with big differences between states, cities and even between suburbs. Before you make any property decisions, it's important to look beyond the national figures to understand what is happening to prices in your neck of the woods and why.

A tale of many markets

Price falls over the past year have been greatest in Sydney (-5.6 per cent), Darwin (-4 per cent), Perth (-2.1 per cent) and Melbourne (-1.7) per cent. The standout performer is Hobart (+10.7 per cent), followed by Canberra (+2.3 per cent), Adelaide (+1 per cent) and Brisbane (+0.9 per cent). Regional areas are still rising (+1.6 per cent) as buyers look beyond the big cities.ⁱ

There are a variety of factors at play. The Australian Prudential Regulatory Authority (APRA) has imposed tighter lending standards on the banks and encouraged them to restrict higher risk lending, which has slowed market activity.

There has also been a fall in foreign investment. Last year, Chinese investment in local residential property fell 25 per cent, although Australia still ranks second only to the US as a favoured destination.ⁱⁱ

With fewer buyers in the market and an oversupply of new apartments in Sydney and Melbourne in particular, sellers are having to drop their asking price to compete.

Mortgage rates on the rise

More recently, three of the big four banks and many smaller lenders have lifted mortgage interest rates due to the increased cost of funding. Lenders source much of their funding from overseas markets where interest rates are rising, unlike here where the cash rate remains at an historically low 1.5 per cent.

This raises the bar for first home buyers and puts added pressure on existing borrowers who are already stretched to the limit.

Rates on interest-only loans, used mostly by investors, have been increasing for some time. Interest-only loans typically have a term of 1-5 years after which they revert to principal and interest payments. This has raised concerns that investors who took out loans at the peak of the housing boom may struggle to meet higher principal and interest payments. Forced sales could lead to further price falls.

However, as Reserve Bank Assistant Governor, Michele Bullock, recently said, "borrowers have been transitioning to principal and interest loans for the past couple of years without signs of widespread stress".ⁱⁱⁱ

Affordability a worry

Despite falling prices, housing affordability remains an issue, especially for first home buyers in Sydney and Melbourne. The median home value in Sydney is \$855,287, almost twice as much as

Hobart (\$437,254) and more than twice the regional average (\$368,366).

Affordability is measured by the share of income required for mortgage repayments. In June 2018, for borrowers with a 20 per cent deposit, the repayment required on the average mortgage amounted to 36.3 per cent of gross household income. Ten years ago, it was 51 per cent. That's due largely to mortgage interest rates almost halving over the same period.^{iv}

What does it mean for me?

For first home buyers, the biggest stumbling block is often saving a deposit as rising prices push desirable properties further out of reach. But with prices expected to fall over the next couple of years, time is on your side.

Homeowners planning to downsize have an opportunity to sell now near the market peak and buy a smaller property in a falling market. What's more, if you are over 65 you can put up to \$300,000 of the sale proceeds into your super for a significant tax saving.

Families looking to upsize to a larger home also need to weigh up whether it's better to sell and buy now or wait and see if prices of larger homes fall further.

If you are looking to buy or sell a home or an investment property and would like to discuss your options, give us a call.

i <https://www.corelogic.com.au/news/augusthomevalueindexresults>

ii <https://thenewdaily.com.au/money/property/2018/09/11/foreign-investment-real-estate/>

iii <https://www.rba.gov.au/speeches/2018/sp-ag-2018-09-10.html>

iv <https://www.corelogic.com.au/housingaffordability>



Plugging in to TECHNOLOGY stocks

On August 2, Apple became the world's first company to reach US\$1 trillion in market value. It took 42 years to get there from humble beginnings in an LA garage, but a handful of younger technology companies collectively known as the FANGs – Facebook, Amazon, Netflix and Google – are already nipping at its heels.

What do they have in common? All have used innovative technology to create new markets, often beginning with a single product or service. Think Apple's early desktop computers, Amazon's online book retailer, Netflix's streaming service, Facebook's social network and Google's search engine.

According to Forbes magazine, these tech giants have become so much a part of everyday life that their products or services are regarded almost as utilities, as essential to modern living as power or water.ⁱ They have also used technology and digital transformation to redefine customer experience in a way that is leaving traditional companies behind.

While their products and services may be cutting edge, their investment appeal is old school. Legendary investor Warren Buffett has been a major Apple shareholder for some time. He is known to look for stocks with reliable, long-term earnings at an attractive price with a strong 'moat'. A moat might be a brand name, key products or high barriers to exit. Switch your iPhone for another brand for example, and you lose your iTunes music library and countless apps you downloaded.

China unleashes BATs

While Apple and the FANGs are US-based, they face stiff competition in the global tech stakes from China's BATs. Baidu, Alibaba and Tencent may not

be household names in Australia, but they deserve to be on investors' radar because they are a dominant market force not just in China but increasingly elsewhere as well.

Hong Kong-listed Tencent Holdings is known as China's equivalent of Facebook. Tencent was the first Asian company to reach the US\$500 billion stock market valuation mark. It's WeChat social media platform recently reached an eye-popping one billion members, and it's also involved in online gaming, music, e-commerce and smartphones.

Alibaba (China's Amazon plus eBay) is the world's biggest retailer. It's New York Stock Exchange (NYSE) listing in 2014 was the world's biggest and this year it became the second Asian company to be valued at more than US\$500 billion.

Baidu (China's Google) is the second most widely used search engine in the world. It's also moving into mapping, artificial intelligence and autonomous vehicles. And these are just the biggest of many emerging Chinese tech stocks.

Opportunities and challenges

The tech giants are also beginning to expand into new business areas such as cloud storage, music and video streaming. Some are also growing by acquisition, with Facebook buying What's App and Microsoft buying LinkedIn.

Yet big does not necessarily deliver success. Facebook's share price recently fell 19 per cent in a day. The sell-off was due partly to concerns about the company's ability to deal with privacy issues, but also to a flattening out of user numbers. China's BATs also face challenges from the worsening trade dispute with the US.

So how can Australian investors participate in the dynamic technology sector without getting burnt?

Getting down to business

Diversification is the key to investing in the world's leading tech stocks, while minimising the risk of individual companies performing poorly. The simplest way to gain exposure is via a traditional managed fund or an exchange-traded fund (ETF) which can be bought and sold on the Australian Securities Exchange (ASX) like individual shares.

For the broadest exposure there are global technology funds. A popular way to access the FANGs plus Apple, Microsoft and others is to choose a fund that tracks the Nasdaq 100 Index. Although the US-based Nasdaq exchange is home to a wide range of companies, it is well known for tech stocks.

Tech companies are often seen as exciting, but investors would do well to follow Buffett's lead and make sure that the fundamentals are sound, looking at their financial health and ability to deliver sustainable returns. If you would like to talk about your investment strategy, give us a call.

ⁱ 'Apple and the rise of the trillion dollar firm', 6 August 2018, <https://www.forbes.com/sites/dantedisparte/2018/08/06/apple-and-the-rise-of-the-trillion-dollar-firm/#6eecd0c631d>



Making the most of a falling Aussie dollar



One of the major themes for local investors in 2018 is the fall in the Australian dollar, and it's not just Aussie travellers heading overseas who are affected. Currency movements can have a big impact on your investment returns, but where there's risk there's also opportunity.

The Aussie dollar has dropped from a high of US\$1.10 in January to recent levels around US\$0.74, its lowest in 18 months. So, what's behind this decline and will it continue?

The interest rate gap

The US dollar has been rising against most other currencies this year, including ours. Part of the reason for this is the increasing interest rate differential between the US and the rest of the world.

The US Federal Reserve has lifted rates seven times since late 2015 from near zero to a range of 1.75-2.0 per cent. Federal Reserve chairman, Jerome Powell has said he expects to do so twice more this year and three times in 2019 due to solid growth in the US economy.ⁱ

By comparison, Australia's official cash rate has fallen over the same period and sits at an historic low of 1.5 per cent. Commentators expect the next move will be up, but possibly not until late next year.

Higher US interest rates relative to Australia make the US a more attractive destination for yield-seeking investors. As foreign money flows into the US market, demand for the US dollar increases and its value rises.

Threat of trade war

Also weighing heavily on the Aussie dollar are the threat of an escalating trade war between the US and China and falling commodity prices, notably iron ore.

The tit-for-tat tariffs placed on imports by the world's two biggest economies has the potential to impact the Australian economy more than most. Australia is viewed as a resources-based economy and any rise or fall in commodity prices tends to be reflected in the value of our currency.

When the first salvos in the trade dispute were fired in July, iron ore was trading at around US\$63 a tonne down from a high of US\$78 earlier this year and a peak of US\$197 back in 2008. Australia is the world's biggest exporter of iron ore, most of it headed to China for steel production.

China's growth eased slightly in the June quarter to 6.7 per cent, the slowest in 21 months. If tariffs put a dent in China's economic growth and demand for iron ore, our dollar could head lower.

While currency movements are just one factor influencing investment returns, it pays to understand the impact of a falling dollar to capitalise on the benefits and reduce currency risk.

Managing currency risk

For local share investors, a drop in the Australian dollar is good for exporters and companies with offshore operations because it improves their competitiveness in overseas markets.

The currency effect can also increase the appeal of global shares. Local investors

who own 'unhedged' global shares have already enjoyed the double benefit of rising international share prices and a falling Aussie dollar. Hedged returns perform better when the Aussie dollar is rising or flat while unhedged returns do better when the dollar is falling.

To illustrate the impact of hedging, Vanguard's International Shares Index Fund (hedged) returned 11.46 per cent in the year to June 2018 while the same fund unhedged returned 15.44 per cent.

Avoiding the cash trap

While currency risk can be a challenge for share investors to manage, one of the biggest risks when the Aussie dollar is falling is to leave all your cash in the bank. At a time when historically low interest rates have already reduced the amount you receive from cash investments, your purchasing power is further reduced when you buy overseas goods.

While investment decisions should never be based on currency factors alone, understanding the impact of a falling dollar can help you minimise currency risk and make the most of opportunities.

If you would like to discuss your investment strategy, give us a call.

ⁱ 'US Fed raises interest rates, expects 2 more hikes this year', by Akin Oyedele, Business Insider Australia, 14 June 2018, <https://www.businessinsider.com.au/federal-reserve-fomc-statement-and-interest-rate-decision-june-2018-2018-6?r=US&IR=T>