

View from the hill

JULY 2017

HILLROSS

Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **30 June 2017**.

| Asset class (% change) | 1 month | 3 months | 1 year | 3 years (%pa) |
|---------------------------------|---------|----------|--------|------------------|
| Australian shares | 0.2 | -1.6 | 14.1 | 6.6 |
| Smaller companies | 2.0 | -0.4 | 7.0 | 7.1 |
| International shares (unhedged) | -2.6 | 3.6 | 14.7 | 13.0 |
| International shares (hedged) | 0.1 | 3.2 | 20.5 | 9.7 |
| Emerging markets (unhedged) | -2.0 | 5.7 | 20.1 | 8.3 |
| Property - Australian listed | -4.5 | -3.1 | -5.6 | 12.2 |
| Property - global listed | 0.6 | 1.4 | -0.8 | 8.6 |
| Australian fixed interest | -0.9 | 1.0 | 0.3 | 4.3 |
| International fixed interest | -0.2 | 1.2 | 0.5 | 5.1 |
| Australian cash | 0.1 | 0.4 | 1.8 | 2.2 |

Overview and outlook

The financial year ended 30 June 2017 was very good to well-diversified, growth-orientated investors. Equities enjoyed well above average returns, whereas property and fixed income were far more subdued (particularly A-REITs whose annual returns were mostly driven by the results for the single month of June). That's great news for accumulation investors, but far less so for those looking to generate income.

In the year ahead, this looks like continuing, as a combination of rising interest rates in the US and the Eurozone, strengthening economic recoveries and ultimately, rising inflation, make for more favourable conditions for risk assets over bonds.

In the US, the Federal Reserve recommenced the normalisation of the cash rate (lifting by 25 bps to 1.25%) and indicated it will look to shrink its balance sheet later this year. It expressed some optimism on US employment and expectations for higher inflation were reigned in. Further stimulus in the form of cheaper oil can now be added to the mix, as OPEC appears to have failed in its efforts to decrease global production of oil.

However, geopolitical issues dominated the month of June. In the US, the administration pulled out of the Paris Climate Accord, a decision that is likely to further complicate global ties and relationships. This, coupled with sanctions on the Russian Nord Stream 2 gas pipeline, which is a key part of sustaining Northern European energy security, increased

diplomatic friction. In France, the election of Macron was generally seen as supportive for the European market, providing a platform for pro-business reforms in France. On the other hand, the Conservatives had a pyrrhic victory in the UK election poll, adding to the concerns over Brexit. In Italy, the European Central Bank (ECB) identified that two Italian banks were failing, forcing the government to initiate their orderly wind-up. This heightened political instability in Italy due to sensitivity over the relationship with the ECB.

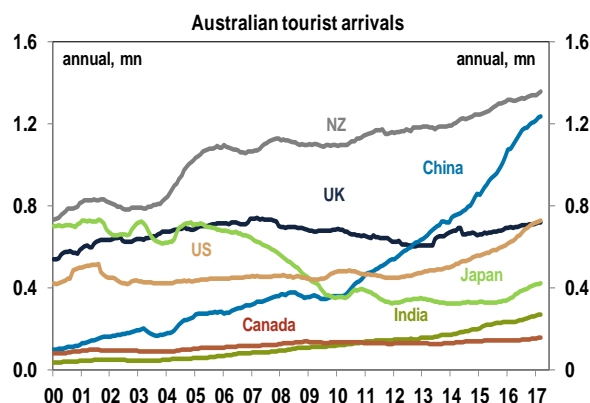
Even so, the actual economic data released for the month was positive for global economic growth. Japanese services conditions, as measured by the Purchasing Managers Index, have improved, adding to confidence. In China, both import and export levels beat expectations, although their CPI has shown upward pressure, the producer prices have fallen following the higher commodity prices of a year ago. In Europe, the ECB kept rates unchanged and inflation remained in check. Economic optimism increased when the expected Eurozone GDP was revised upwards to 0.6% from 0.5%, reinforcing other indicators and pointing to stronger growth.

In Australia, employment data surprised on the upside, with aggregate unemployment down to its lowest level since early 2013. The table below shows the disparity between the various states across many economic variables and illustrates the reversing of the two-speed economy, from resources to more services-based growth.

State of the states, annual % change to latest

| | Retail Sales | Building Approvals, trend | Real State Final Demand | Home prices | Employment | Unemployment % | Rank |
|-------------------|--------------|---------------------------|-------------------------|-------------|------------|----------------|------|
| NSW | +2.6 | -11.3 | +1.9 | +11.1 | +0.6 | 4.7 | 5 |
| Victoria | +4.2 | -8.8 | +4.5 | +11.5 | +3.8 | 6.1 | 1 |
| Queensland | +4.1 | -19.7 | +1.6 | +2.3 | +1.4 | 6.3 | 7 |
| WA | -0.1 | -17.5 | -6.6 | -3.8 | +0.7 | 5.9 | 8 |
| SA | +4.0 | -13.4 | +3.3 | +2.9 | -0.5 | 7.3 | 6 |
| Tasmania | +2.7 | -0.5 | +2.4 | +5.8 | +1.9 | 5.9 | 2 |
| NT | +0.6 | -53.0 | +10.0 | -6.4 | +6.9 | 3.5 | 4 |
| ACT | +3.7 | -32.1 | +5.0 | +5.7 | +1.5 | 3.6 | 3 |

Although the outlook for the Australian economy is dominated by the global demand for our exports, approximately a third of which is taken by China, this relationship is diversifying. With a relatively low AUD and a rising middle class, Chinese interest in Australia is broadening.



Source: AMP Capital

Share markets

Australian equities held their ground in June and were matched by international equities, with the S&P/ASX 200 Accumulation Index up a modest 0.2% and the MSCI World ex-Australia Index (AUD hedged) up 0.1%. With some strength in the Australian dollar, the unhedged international index was down 2.6%.

The domestic market was most noticeable in the dispersion of returns across the GICs sectors. Healthcare was up 6.5% for the month, while Energy was down 6.9%, due in part to the prospect of government imposing export limits. Banks regained 1.6% following a weak May and Materials rose 0.6%, on stronger commodity prices. Small Caps even outperformed the All Ords, but failed to substantially make up their poorer relative performance over the last twelve months.

Over the last twelve months, global equities markets have risen strongly, especially in tech stocks (NASDAQ Comp

+28.6%), continental Europe (MSCI Europe ex-UK in +24.3% in USD terms) and Japan (Nikkei 225 in JPY +28.6). This demonstrates investors' expectations of growth in these markets and how the Chinese are not necessarily always the driver of investment returns.

Interest rates

At the RBA's July meeting, cash rates were kept at 1.5%, with the guidance that they are likely to remain at this accommodative level until the AUD falls. Demand for our commodities has virtually undone the benefits of the US lifting the Fed Funds rate, thereby reducing the yield differential and the rationale to buy AUD. With the retail banks tempering their lending to investors, the Sydney and Melbourne property markets are expected to ease, giving the RBA more scope to address a lack of wage growth and higher levels of under-employment.

Local Commonwealth bond yields reversed the May rally, with 10-year yields ending up 21 bps at 2.60% and 3-year yields rising sharply by 29 bps to 1.94%. Elsewhere, US 10-year bond yields rose 10 bps to 2.31%, while in Germany, the benchmark 10-year Bund rose 17 bps to 0.47%.

Property

The Australian listed real estate market posted a second consecutive monthly negative return in June (-4.5%), underperforming the wider Australian equity market. The outlook for the sector has been poor for retailers, driven by low wages growth and the potential impact of Amazon's arrival, and more broadly, negative for long-duration assets from rising bond yields. This sentiment is not new and effectively carries over from previous months. This does not appear to explain the extent of the selloff in A-REITs. A more plausible explanation is that, as of the 30 June, the Vanguard Australian domiciled diversified index funds no longer carry an exposure to either A-REITs or G-REITs (where the latter's impact is far more subdued). In fact, in June, G-REITs rose 0.6%.