View from the hill

JANUARY 2016

HILLROSS

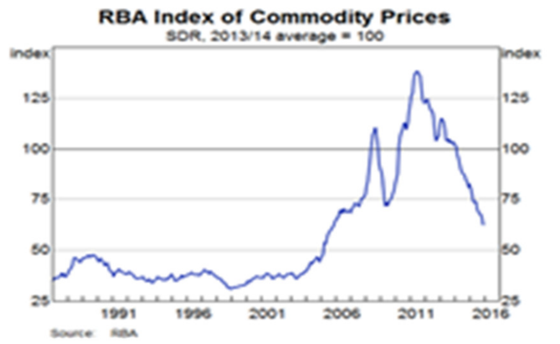
Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 December 2015.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	2.7	6.5	2.6	9.2
Smaller companies	3.9	11.3	10.2	1.7
International shares (unhedged)	-2.3	1.7	11.8	23.9
International shares (hedged)	-2.1	6.6	3.8	15.6
Emerging markets (unhedged)	-3.1	-3.3	-4.5	4.8
Property – Australian listed	4.0	6.0	14.3	15.9
Property – global listed	0.8	5.9	5.9	12.9
Australian fixed interest	0.3	-0.3	2.6	4.7
International fixed interest	-0.1	0.6	3.4	5.3
Australian cash	0.2	0.6	2.3	2.6

Overview & Outlook

Despite a reasonable economic backdrop, commodity prices continued to decline during December. The Reserve Bank Commodity Price Index fell 4.9%, with the annual decline 23.3%, led by falls in oil and iron ore.



Source: RBA

The $A, which is sensitive to commodity price movements, usually declines to offset the impact of lower commodity prices. However in recent months the $A has been stable and rallied in December against the $US, up 0.8% to U.S.72.87 cents. Despite recent stability the currency provided some relief to exporters as it fell 16.7% against the $US over 2015. For Australian resource companies, the combination of declining commodity prices and a firm currency is a very difficult environment, and this was reflected in Resource Index, which fell 24.9% over the year.

Despite slightly lower economic growth the Australian economy recorded strong employment growth for November with unemployment rate falling to 5.8%; well down from the recent high of 6.4% in January 2015. Sustained high levels of residential housing construction as well as strong growth in inbound tourism, with October year-on-year numbers up 8.8%, have contributed to the stronger employment growth.

The Reserve Bank of Australia (RBA) left the official cash rate on hold at 2% at on 2 December 2015, where it has remained since May this year. The bias looks to be toward another rate cut.

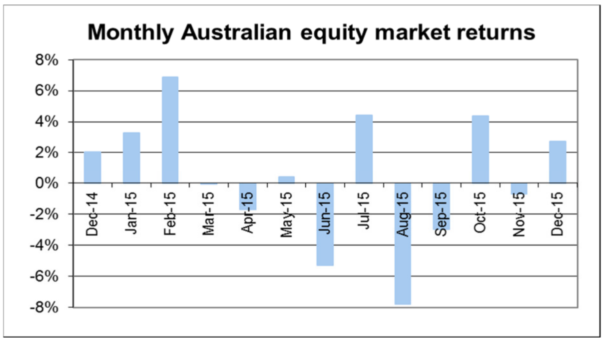
Globally, the US interest rate increase did not cause undue volatility in financial markets, which was not surprising given the amount of analysis that had preceded the increase. Markets will now move to focus on the path of US interest rate increases, which will be data driven. Manufacturing data in January, both in the US and China, has added some uncertainty to the global growth outlook.

Inflation globally remains benign with declining commodity prices adding downside to forecasts. This environment makes it likely that interest rates will move up very gradually.

Share markets

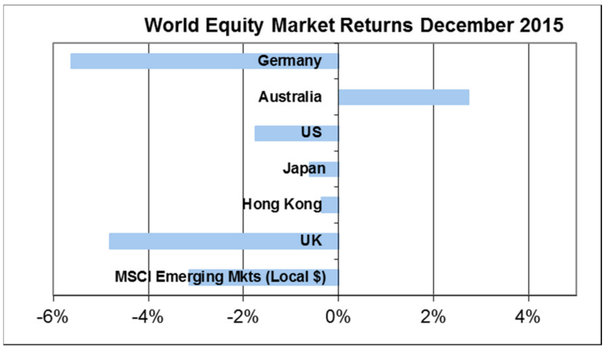
The Australian share market was volatile in December, with the S&P/ASX 200 Accumulation Index down around 5% at one point. A month end rally however, ensured the market recorded a positive return in both December (+2.7%) and the year as a whole (+2.6%). Consumer discretionary and Consumer Staples were stand-out performers for the month up, 6.3% and 7.1% respectively. On the negative side, energy stocks were notable falling 7.5%, reflecting oil and gas price weakness. The resource sector fell 2.0% for the month and was down 24.9% for the year.

The Small Caps Index rose 3.9% and was up 10.2% for the year, well ahead of the broader S&P/ASX 200 Index. The strength was attributable to a smaller weighting to resources as well as a generally better earnings outlook for the sector than is the case in the large cap sector.



Source: S&P ASX 200 Index

The MSCI World (ex-Australia) Index fell 2.3% in December in $A taking the annual return to 11.8%. While the US Fed rate hike did not impact markets, signs of slowing growth were not well received by equity markets as evidenced by sharp falls on the Chinese and US markets in January.



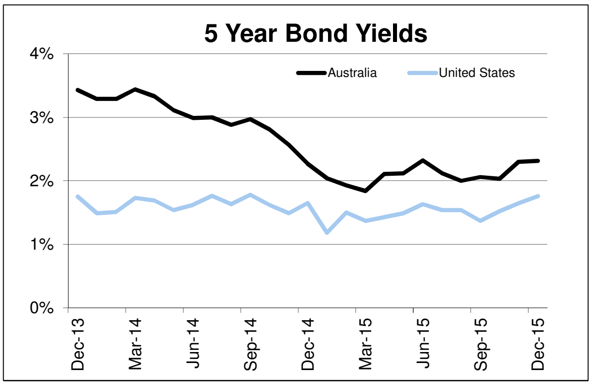
Source: MSCI Indexes.

Emerging markets were weak in December down 3.1% bringing the annual decline to -4.5% in $A. As has been the pattern for much of the past year, emerging markets were dragged down by weak economic growth, particularly in countries with commodity-dependent economies (e.g. Russia, Brazil, Chile and South Africa). Emerging markets are likely to struggle in 2016 due to rising interest rates and the strong $US, which increases the debt costs of a number of companies, many of which have high debt burdens, and this will drag on growth.

Interest rates

Global bond markets were again driven by central bank action in December however bond yields generally ended flat over the month. While yields in Australia were largely unchanged, the 10-year government bond yield traded in a range of 30bps, ending higher at 2.88%. Increased bond market volatility is likely in 2016 due to a number of factors, including lack of liquidity, central bank action and the potential for slowing economic growth and lower inflation, driven by declining energy prices.

Volatility continued in the US high yield credit market, with continued weakness from the Energy and Materials sector resulting in wider in spreads over the month. The Bank of America Merrill Lynch US High Yield index spread moved up sharply by 55 bps wider to 6.90% reflecting concerns in this sector. Australian credit spreads were barely changed over the month.



Source: Reserve Bank of Australia. US Federal Reserve.

Property

The AREIT sector performed well in December, with the S&P/ASX 200 Property Accumulation Index up 4.0%, bringing returns in 2015 to more than 14%; well above the performance of broader market. The strong commercial rental market and low bond yields are likely to continue to support the market.

Source: S&P ASX 200 A-REIT Acc Index.