View from the hill

FEBRUARY 2016

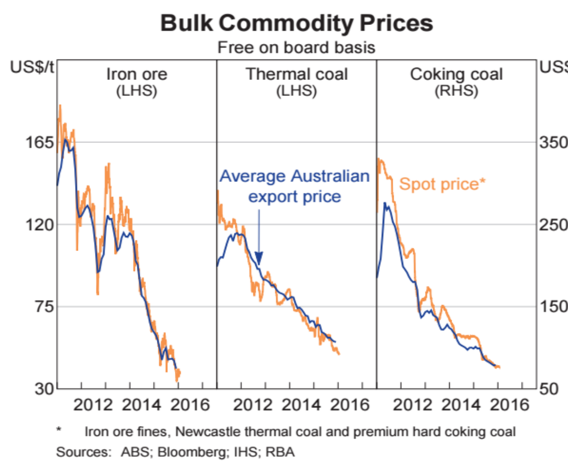
Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 January 2016.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-5.5	-3.6	-6.1	5.5
Smaller companies	-5.1	-1.4	3.6	-1.4
International shares (unhedged)	-3.2	-7.4	-4.9	20.8
International shares (hedged)	-5.4	-6.6	-1.2	11.5
Emerging markets (unhedged)	-3.3	-11.4	-12.9	3.3
Property - Australian listed	1.0	2.1	7.5	14.6
Property - global listed	-2.7	-2.5	-3.8	10.6
Australian fixed interest	1.2	0.7	2.2	5.2
International fixed interest	1.7	1.8	2.8	6.0
Australian cash	0.2	0.6	2.3	2.6

Overview & Outlook

Global equities had a very difficult start to the year falling 5.4% (hedged) over January, with the All Country World Index down 10.0% at the month's lows. Concerns that global growth was slowing and weaker energy prices were the primary drivers of the sell-off. The oil price was down 9.2% over the month. The Australian equity market fell 5.5% over the month due to the same factors but with the potential for a slowdown in China in particular adding to investor concerns.



Source: Reserve Bank of Australia

Domestic business conditions and confidence, as measured by NAB, remain reasonable but tending slightly lower over January. Consumer confidence, measured by Westpac, has been very volatile down 3.5% in January after falling 0.8% in December and increasing 3.9% in November. The recent declines are interesting as consumer confidence usually improves when fuel prices fall and job creation is strong.

The Reserve Bank of Australia (RBA) left the official cash rate on hold at 2.0% at its meeting on 2 February 2016, where it has remained since May last year. The bias continues to be toward another rate cut given that headline inflation at 1.7%, is below the RBA target range of 2-3%, and is likely to trend lower as the full benefit of lower fuel prices is yet to be reflected in the data.

Globally, the US Fed kept interest rates at 0.25% at its January meeting. It continues to balance the conflicting factors of a strong $US and low inflation, which favour stable rates against the reasonably buoyant job market, which supports further rate hikes. On balance, markets are now focusing on the path of US interest rate increases, which will be dependent on monthly employment data. However with annual inflation at 0.7% in January and ongoing weakness in energy prices, adding downward pressure to inflation, it is likely that interest rates will move up very gradually.

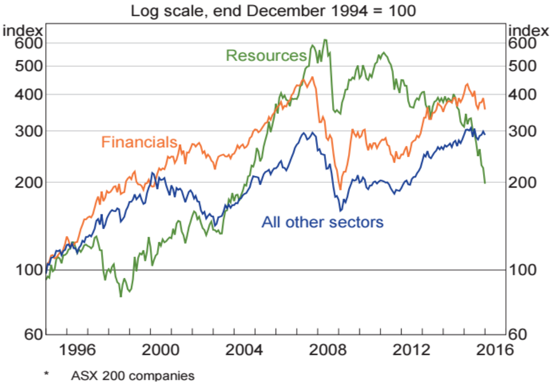
Share markets

The Australian share market was very weak in January, with the S&P/ASX 200 Accumulation Index down around 5.5%. The declines were led by the financials with ANZ notable as it fell 13.4% with the other major banks falling around 8.0%. The Material sector remained under pressure with bell-weather BHP falling 14.1%, reflecting a write-down of $7.0bn of its energy assets and the impact of weaker oil, base metals and iron ore prices. The resource sector fell 9.0% over the month and is down 30.8% over the previous 12 months.

More broadly, while Australia has managed the transition from the mining boom to more balanced growth, which now includes the tourism and education sectors, ongoing equity market impacts from slower growth post-boom are likely to be felt in the form of falling dividends, lower interest rates and a lower $A exchange rate.

Australian Share Price Indices*

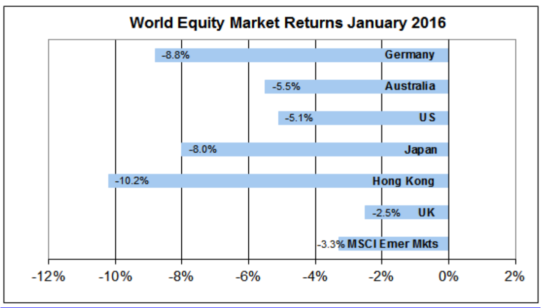
Log scale, end December 1994 = 100



Source: Bloomberg, Reserve Bank of Australia

The MSCI World (ex-Australia) Index fell 3.2% (un-hedged) in January taking the annual return down to 4.9%. Signs of slowing global growth, especially in manufacturing, and concerns around the impact of lower commodity prices on emerging markets saw investors sell down these markets, which fell 3.3% bringing the annual decline to -11.9% in $A. The stand-out market was Chinese Shanghai Composite Index which fell 22.6% over January. Emerging markets are likely to continue to struggle in 2016 due to rising interest rates, weak commodity prices and the strong $US.

Similar to the Australian market, the worst performing sectors in the global indices were MSCI Materials at -10.2% and MSCI Financials at -9.9%.



Source: MSCI Indexes.

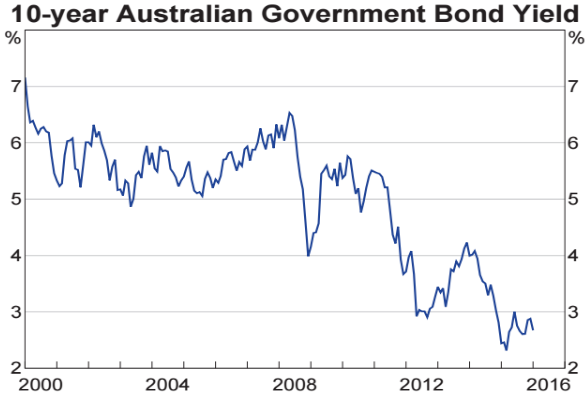
Interest rates

Global bond markets were again driven by uncertainty in central bank actions as globally policy started to diverge as the US moved to a rising interest rate regime while Europe and Japan remained with zero (or negative) rate regimes. The difference in central bank policy was highlighted when, in a surprise announcement, the Bank of Japan dropped its policy rate to -0.1%. The Bank adopted this policy in an attempt to increase inflation, which is around 0.2% pa currently.

US 10-year bond yields were down 35 bps to 1.92% while German 10-year bonds almost halved falling 30 bps to 0.35%. Australian long bonds followed the global trend falling 25 bps to 2.64%. These declines reflect investor concern with the potential for deflation in a number of economies.

Volatility continued in the US high yield credit market, with continued weakness from the Energy and Materials sector resulting in wider spreads over the month with the Bank of America Merrill Lynch US High Yield index spread increasing by 82 bps to 7.77%, reflecting the increased distress in these sectors.

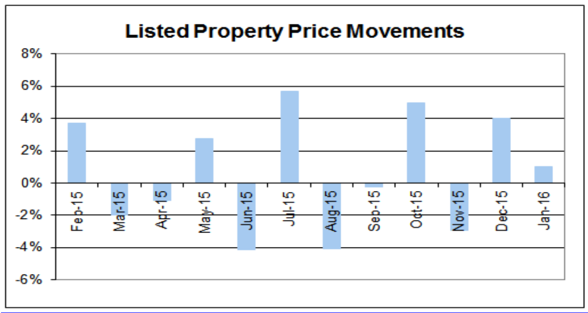
10-year Australian Government Bond Yield



Source: Reserve Bank of Australia.

Property

The A-REIT sector performed well in January, with the S&P/ASX 200 Property Accumulation Index up 1.0%, well ahead of the equity market. The upward re-valuation of commercial property and declining bond yields supported the market.



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