View from the hill

JUNE 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 May 2016.**

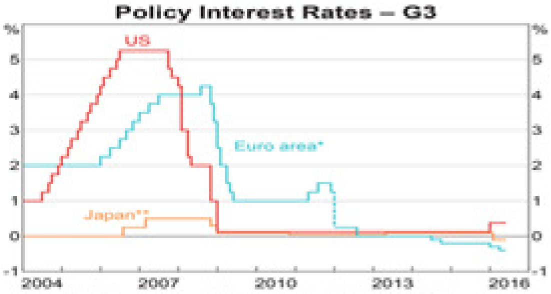
Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	3.1	11.6	-2.4	7.7
Smaller companies	4.1	13.1	6.9	6.9
International shares (unhedged)	6.0	7.5	1.6	17.2
International shares (hedged)	1.9	8.2	-3.0	10.4
Emerging markets (unhedged)	1.4	8.1	-13.0	4.4
Property - Australian listed	2.7	8.1	15.6	16.8
Property - global listed	2.0	8.5	9.1	11.8
Australian fixed interest	1.3	1.3	4.6	5.4
International fixed interest	0.6	1.8	6.1	6.4
Australian cash	0.2	0.6	2.3	2.6

Overview & Outlook

The majority of asset classes continued their positive returns in May as investors returned to their search for higher yielding assets. Commodities also continued their uptrend, with iron ore being one exception as it fell from recent high's, leading to the Resources Index falling 5%.

The $A weakened with the currency moving from US76.7c to US71.9c as the US dollar re-bounded on investor belief that the US Fed was likely to raise rates in the near-term. Markets appear relaxed about another Fed rate hike for a number of reasons. First, there is more confidence in US/Chinese and global growth; second, Fed caution and delays have provided confidence it is not going to be reckless; third, the global oil market is re-balancing, which is helping to stabilize the oil price and thereby reduce the risks for oil producers.

Policy Interest Rates – G3



* Main refinancing rate until the introduction of 3-year LTROs in December 2011; deposit facility rate thereafter

** Since April 2013, the Bank of Japan's main operating target has been the money base

Source: central banks

One of the factors that will weigh on market into June will be the vote by the UK on whether to stay within the European Union (EU), which is set to take place on June 23rd, the so-called "Brexit" vote. Initially it appeared that the vote would be strongly in favor of staying in the EU, however more recent polls are showing a far closer vote. Markets have factored in some fairly severe scenarios in the event the UK votes to leave however the actual outcome could be more benign.

First, even if there is majority support to leave it could be two years or so before the terms of the exit are agreed. Second, an exit vote would be seen as a negative for the UK given the threat it would pose to its access to EU markets, its financial sector and labor mobility. The size of this impact would depend on what sort of exit is negotiated with the EU but has been estimated at somewhere around 2% of UK GDP. This would adversely affect UK assets including the pound. Britain could in time agree a trade deal with the EU (like Norway has) but this would involve a loss of sovereignty as Britain would have to agree to EU rules with no say in setting them. On this basis of this downside, our view is that the vote will likely be to stay in the EU. For Australian investor's there is likely to be minimal investment impact although sentiment could be volatile.

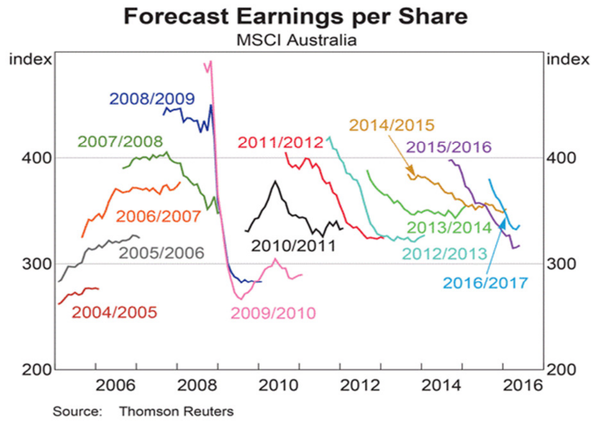
Equity markets

International shares performed well throughout May, up 1.9% (hedged) and 6.0% for unhedged equities, as the $A was declined sharply over May.

The Australian equity market rose 3.1% with the Resource sector notable as it declined 5.0% on profit taking after last month's strong rally. Mid-caps recorded strong performance up 5.7%, bringing their 12 month performance to 10.0%, well ahead of the overall market at -2.4%. The primary driver for the strength of these companies has been the higher earnings growth they have delivered and expectations that the profit growth out-performance will continue.

Other strong sectors were healthcare (9.4%) and telco's (5.0%). Healthcare was strong across the board as investors bid up the prices these companies as they have a reasonable earnings growth profile and are generally beneficiaries of the weak $A. Telco's moved up as investors moved back to the theme of searching for yield as interest rates continued to decline.

In terms of outlook global growth remains fragile and local companies are struggling to deliver sustained earnings growth as shown in the chart below. Aggregated corporate earnings to June 2016 are only marginally those to June 2006. However, beyond near term volatility, shares could trend higher this year helped by a combination of relatively attractive valuations, further global monetary easing and continuing moderate global economic growth.



Source: Bloomberg, RBA

Fixed Interest

Bond yields were generally stable, albeit at very low levels. Bonds across all yield maturities continued to decline into May, on the back of the weak March quarter CPI, with the bell-weather 10 year bond yield falling to 2.26%, from a high of 2.67% in April, whilst the 3-year bond was down 53 basis points, yielding 1.55%.

After the much lower than expected March quarter inflation the RBA lowered its inflation forecasts for this year to just 1-2%, and to 1.5-2.5% for 2017 and into 2018.

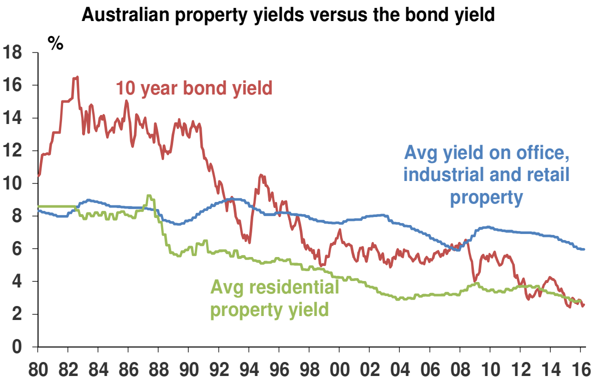
Given the downside risks around inflation and continued weak demand growth, we see a reasonable chance of another rate cut in the third quarter. The chart below shows 10-year bond yields continuing to fall as investor's factor in a sustained period of low inflation.

US Treasury yields rose as Fed speakers reiterated that June is a 'live' meeting and that economic data is not far away from where the Fed needs to see it in order to proceed with interest rate normalisation. Subsequent to this comment the May non-farm payrolls came in significantly lower than expectations with a rise of 38K jobs as compared to expectations of 160K. This very weak number led investors to re-assess their views that there may be a rate hike in June. The focus will now be on Chair Yellen's next speech in order to assess the Fed's reaction post this disappointing employment outcome.

The announcement that RBA Deputy Governor Philip Lowe will replace Glenn Stevens as Governor in September is no surprise and welcome. His expertise and experience at the RBA makes it's hard to see significant changes in the operation of monetary policy.

Property

The AREIT market maintained a positive month returning 2.7%, driven by lower interest rates. The AREIT sector is now trading on reasonably demanding valuations however it is difficult to see these moving back to fair value as long as the interest environment remains weak, particularly as property yields are well above that of 10-year bond yields (see chart below) indicating some valuation buffer.



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