View from the hill

SEPTEMBER 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 August 2016.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-1.6	2.1	9.3	6.6
Smaller companies	-1.6	5.5	26.6	7.1
International shares (unhedged)	1.3	-0.6	0.5	13.9
International shares (hedged)	0.6	3.6	7.7	11.5
Emerging markets (unhedged)	3.6	7.9	5.5	7.0
Property - Australian listed	-2.7	6.2	26.0	19.8
Property - global listed	-2.6	6.1	21.3	16.7
Australian fixed interest	0.4	2.5	6.2	6.5
International fixed interest	0.1	2.8	9.0	7.7
Australian cash	0.2	1.1	2.2	2.5

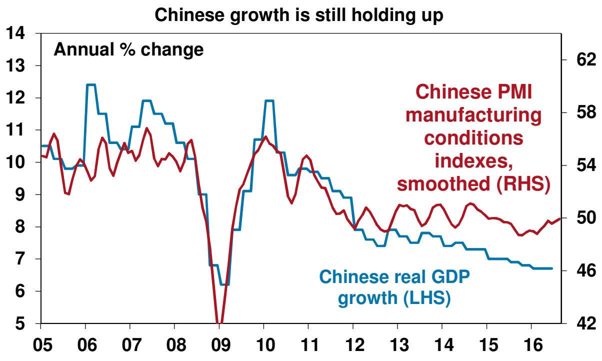
Overview & Outlook

Conflicting direction regarding global government economic action came into focus during August. Uncertainty around the timing of the US Federal Reserve raising interest rates was contrasted with other developed economies looking to increase their accommodative policy measures. The environment was further complicated by concerns that global monetary policy has not been effective and may need to be supported by additional stimulatory fiscal measures or government spending. Fed Chair, Janet Yellen, noted in her speech at Jackson Hole that the case for a US rate hike had strengthened in recent months, but that any movements were likely to be gradual. The market is currently factoring in December as the most likely timing for a raise, if it eventuates at all in 2016. However, any increase will remain data dependent and there is no certainty that economic conditions will be sufficiently supportive by year end. The Fed's focus is firmly on payrolls or effectively unemployment and less on economic growth per se.

While there's still few signs of an upturn in global growth, consensus growth forecasts have come down sharply in past six months. Investors want to see more consistent data coming out of the US and resilience in China, before pushing markets higher.

On the political front another concern is the outcome of US election. At this point is does not appear that Trump is likely to win the November US election, however, given the surprise Brexit vote, investors are cautious of a Trump victory. A potentially more inward-looking and protectionist US is negative for global growth, however, significant uncertainty over Trump's actual policy agenda and ability to get these through Congress do reduce concerns.

In Australia, the RBA rate cut was to ensure that sub-target inflation does not become entrenched and to try and alleviate upwards pressure on the Australian dollar, as the Federal Reserve looks likely to delay a rate increase. The RBA's August statement on monetary policy saw no significant changes to its forecasts of approximately 3% GDP growth and 1.5-2.5% inflation, over the next two years. In this statement, the RBA expresses a view that as inflationary pressure is currently low and is likely to remain so.



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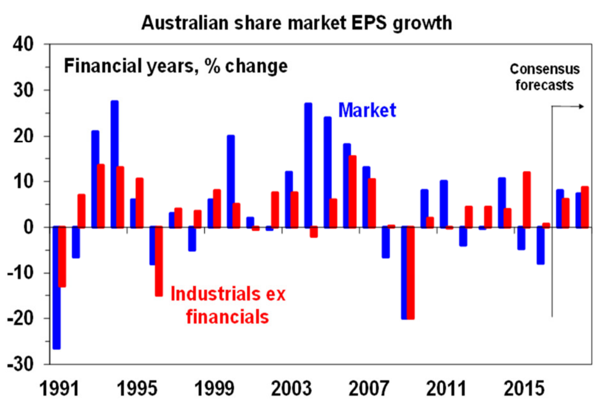
Equity Markets

Global equity markets, which remain supported by central bank activity, posted small gains in August (up 1.3% as measured by the MSCI World ex Australia Net Index, unhedged). Toward the end of the month Yellen's Jackson Hole speech reinforced that the US Fed) is increasingly confident about their domestic economy and can resume measured rate hikes. These words pulled investors in different directions. Given the extremely low rates prevailing, raising interest rates may counter-intuitively serve to actually increase general confidence (as well as increasing income for recently retired investors) and, therefore, actually provide some stimulus.

The annual reporting season for Australian companies is now complete, with equities finishing down by 1.55% (as measured by the S&P/ASX 200 Accumulation Index). 2015-16 was not great for listed company profits with earnings per share down around 8% driven by a 47% slump in resources profits and a 4% fall in bank profits. But it is notable that 62% of companies have seen their profits rise on a year ago and the typical or median company has seen profit growth of around 4%. Overall, the amount of companies that exceeded their earnings expectations was slightly lower than normal. Unsurprisingly, resource companies particularly struggled for earnings amid secularly-low, though recently improving, commodity prices. Most companies held or increased their payout ratios, which while good for an individual investor's cash flow, points to a tough environment for increasing internal profitability and reinvesting those earnings within a business. 86% of companies increased or maintained their dividends indicating that the median company is actually meeting expectations.

The chart below shows the slightly improved earnings outlook for Australian corporates over the next two years. If history is any guide these forecasts will decline slightly but the outlook has improved. In these terms, shares could trend higher this year helped by a combination of relatively attractive valuations, very low interest rates globally and moderate global economic growth.



Source: RBA

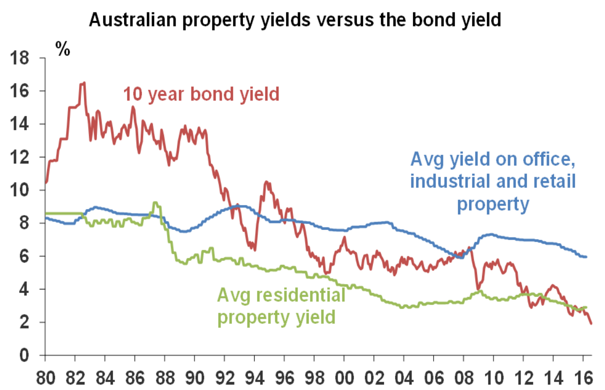
Fixed Interest

After a long period of declines, global bond yields rose in August, albeit from extremely low levels. In our rates market, the bell-weather Australian 10 year bond yield rising slightly to 1.89% from 1.86% the previous month-end. It is notable that the ten year bond also traded at an all-time low of 1.82% during the month, displaying the volatility in the market, as their perceptions changed. US, German and Japanese 10-year government bond yields all ended the month higher at 1.58%, -0.09% and -0.06% respectively.

The recent increase in the volatility of bond prices is likely to continue, as economic data globally continues to create a mixed picture of economic activity. In addition, political risk will increase ahead of the US elections in November and with a number of elections across Europe in the next few months. Against this backdrop, the US Fed continues to delay further interest rate hikes, despite stronger US growth, as it continues to be concerned about the strong US$, its impact on emerging economies, and the fragile nature of economic growth.

Property

The AREIT market had a weaker August falling 2.7%, after July's strong rebound post the Brexit vote, with no notable drivers. Within the sector relative weakness occurred despite most earnings results over the reporting season being in line with expectations. The market focused on earnings quality, identifying potentially non-recurring income streams such as those from trading profits and asset sales. In addition to this, asset re-valuation continued to be a theme for some trusts. This comes at a time of a 'lower for longer' interest rate environment, which may support further compression. Gearing in the sector remains around the historical average, although the cost of debt has fallen due to well bid interest rates for property owners. Global REITs also had a weak August, in part driven by US rate hike concerns.



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