View from the hill

OCTOBER 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 **30 September 2016.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	0.5	5.1	13.2	6.0
Smaller companies	1.5	8.5	29.2	7.1
International shares (unhedged)	-1.3	2.0	2.0	13.4
International shares (hedged)	0.3	5.1	11.8	10.2
Emerging markets (unhedged)	-0.5	6.1	7.2	6.3
Property - Australian listed	-4.3	-1.9	20.9	17.7
Property - global listed	-1.7	0.3	16.6	14.5
Australian fixed interest	-0.2	0.9	5.7	6.2
International fixed interest	0.1	0.8	8.2	7.3
Australian cash	0.1	0.5	2.2	2.4

Overview & Outlook

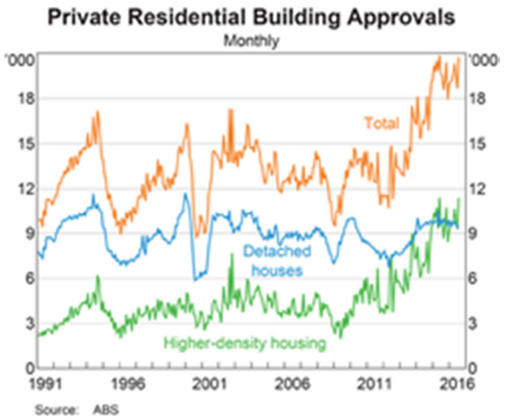
September was dominated by Central Bank positioning and statements and investor perceptions of these statements. Last month we wrote that "Uncertainty around the timing of the US Federal Reserve raising interest rates was contrasted with other developed economies looking to increase their accommodative 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. The market is currently factoring in December as the most likely timing for a raise by the Fed, if it eventuates at all in 2016." These comments remain valid.

What has changed is the announcement by the BoJ that its quantitative easing programme has only been partially effective. It was now moving to target interest rates across all time frames and to hold these at zero percent until inflation rises to 2% p.a. Given the strong deflationary forces in Japan the programme is likely to be in place for an extended period of time. This continuation and strengthening of stimulus by the BoJ indicates the stimulatory policy at a global level is likely to remain in place as central banks continue to adopt policies that target deflation, currently a far larger concern than any inflation pressures. However, the US is an exception, and investors are increasingly concerned that there is a risk of higher inflation in that country. Should the Fed not raise rates in December and inflation does increase, markets could become volatile as they factor in the higher inflation or an aggressive Fed response.

On the political front a concern is the outcome of US election. At the time of writing it appears that Trump is increasingly unlikely to win the November US election. However a Clinton win with a Republican Congress could see significant policy gridlock on a number of pressing issues, including tax reform.

In Australia, the RBA held the cash rate at 1.5% p.a. as it waited for further economic data to indicate economic strength as well as the impact of previous rate cuts. In addition there is a growing view that further cuts may have limited effectiveness in stimulating growth. Domestic growth for the second quarter recorded growth of 3.3% year-on-year. The major negative was the continuing and expected decline in mining investment. What is critical, looking forward, is the RBA that the two major headwinds in terms of economic growth, namely the terms-of-trade and mining investments, are starting to ease.

Residential housing continues to be a concern as rental yields are at record lows and building approvals remain near record highs and despite this some cities continue to record house price appreciation. The new RBA governor, Phillip Lowe, used his comments as a governor to express concern about people paying "so much for housing". This issue may become a more important factor in the RBA's rate setting than has been the case over the recent past.



Equity Markets

Global equity markets, supported by central bank policy and comments, fell slightly in September (-1.3%, unhedged). US economic data showed an improving trend with consumer confidence at its highest since 2007, while durable goods orders and new home starts were stronger than expected and jobless claims remained low. While there was some weaker data points the generally stronger tone of the economy and an uptick in inflation and oil prices, remain supportive of a December rate hike.

A negative for global equity markets, particularly he banks, was investor concern regarding Deutsche Bank. The main issues appear to relate to the size of a US Dept of Justice penalty relating to mortgage backed securities and whether the bank will require a capital raising to pay the penalty and preserve sufficient liquidity. This appears to be affecting sentiment around banks generally although reports that Deutsche Bank may settle for a far lesser amount than originally reported helped sentiment late in the week. It appears that whenever there are issues with banks investors fear a re-run of the GFC, but with all the tougher regulation and greater transparency now, the risk of this is lower.

The domestic market recorded some volatility falling 7% from their mid-August high on the back of a range of issues including nervousness about the Fed, a back-up in bond yields, political uncertainty and a perception the RBA's easing cycle was ending all had a negative impact on domestic shares. Despite a rally toward month-end sentiment remains uncertain.

We do not see the conditions in place for a recession which would be the critical factor leading to a meaningful bear market. First, bond yields are unlikely to rise meaningfully. The bond rally that has been in place since the early 1980s is likely to be bottoming out as central banks ease policy, fiscal austerity gives way to fiscal stimulus and rising commodity prices reduce deflationary fears. However rates are unlikely to increase in an environment of low global growth and low core inflation. Second, equity market valuations are not demanding in a low rate world, buoyant conditions in tourism and higher education and booming resource export volumes. The low likelihood of recession is important as most severe bear markets are usually associated with a recession.

Australian equities closed the month 0.5% higher with the Materials sector the best performer, up 5.7%, as commodity and energy prices continued to improve off their February lows. Given the concern around bond yields it was unsurprising that the worst sectors were AREITs, Telecomms and Utilities, all of the most rate sensitive sectors.

Fixed Interest

Global bond yields were flat over September however it was a relatively volatile month. In the domestic market, the bell-weather Australian 10 year bond yield rising slightly to 1.91% and off-shore US ten year rates rose marginally to 1.59%. German and Japanese 10-year government bond yields actually and ended the month at -0.12% and -0.09% 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. Against this backdrop, the US Fed continues to delay further interest rate hikes, despite stronger US growth.

Property

The AREIT market fell 4.3% in September following a decline of 2.7% in August. The sell-off was triggered by the volatility of the bond market and, given the valuations in the sector, any increase in yields was likely to see a decline in prices.

Retail property rent growth of around 3% over the year adds to the soundness of the sector. Leasing spreads are also generally improving (meaning lease renewals are negotiated at higher rents) and vacancy rates remain low. In commercial real estate, office remains the bright spot, especially in Sydney, where limited supply and strong demand are lowering vacancy rates and increasing rents. Lower interest rates and disciplined borrowing also reinforced the sector's attractions. Higher asset values have reduced gearing levels to around 28.5% (debt relative to gross assets).