View from the hill

DECEMBER 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 November 2016.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	3.0	1.3	10.0	5.4
Smaller companies	-1.2	-4.4	13.5	5.9
International shares (unhedged)	4.5	1.7	1.0	11.5
International shares (hedged)	2.8	2.6	5.0	8.7
Emerging markets (unhedged)	-1.8	-1.5	6.4	4.0
Property - Australian listed	0.8	-11.0	10.3	14.9
Property - global listed	-1.7	-8.5	3.4	11.7
Australian fixed interest	-1.4	-2.9	3.4	5.3
International fixed interest	-1.6	-2.5	4.8	6.0
Australian cash	0.1	0.4	2.1	2.4

Overview & Outlook

The election of Donald Trump as the next President of the United States saw markets initially fall and then rally strongly with the Dow Jones Industrial Index subsequently rallying to an all-time high. Other global equity markets also rallied as did Australian equities.

The reversal in equity markets was mirrored in bond markets where yields rose while the $US rallied as did commodities. Most investors were surprised by the strength of the reversal and the rally was attributed to a conciliatory victory speech and markets turning their attention to the stimulatory aspects of Trump's election platform. These included a package of tax cuts, both personal and corporate, deregulation and increased defense and infrastructure spending. On the assumption that this package would pass Congress, investors also forecast higher inflation and thus higher interest rates, with this last factor also buoying the $US. Noticeable in the US equity market rally were the sectors likely to benefit e.g., industrials, financials and energy while the yield sensitive sectors such as REITs and utilities struggled.

On the negative side, Trump was elected on a populist agenda which has aggressive protectionism as a core policy which, if followed through would be negative for global growth and productivity. Also, flowing from his policies of higher infrastructure spending and any measures to reduce inequality in the US is the potential for somewhat higher inflation leading to higher US interest rates, which the market has already partially factored in.

Finally, an interesting outcome of the Trump policy will be the move to use fiscal policy (budget spending) to increase economic growth as opposed to using low interest rates to achieve this goal. It appears that there is increasing awareness by Central Banks and governments that low interest rates are not the best way to stimulate growth as we discussed last month.

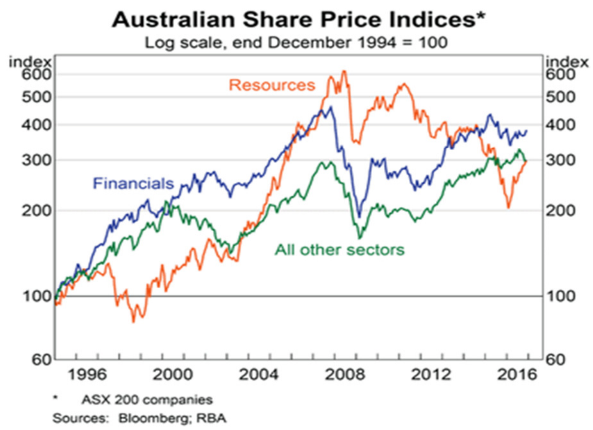
Currently markets are moving sideways and this is likely to continue until there is more certainty on Trump's policies and, more importantly, his ability to get policies through Congress, which may be challenging. The US already has reasonably high levels of government debt and is running a meaningful budget deficit which limit policy flexibility.

In Australia, the most notable economic data was the announcement of negative growth in the third-quarter at -0.3%. The decline was somewhat unexpected with the primary drivers being a decline in business investment, lower residential spending, reduced government expenditure and slower export growth. This negative growth rate is expected to reverse in the fourth-quarter.

Equity Markets

Global equity markets recorded a strong rally over November (4.5%, unhedged) as markets factored the potential for higher US economic growth driven by the policies expected from President-elect Trump. Improving US economic data, low unemployment and higher oil prices, make a December rate hike by the Fed likely.

The Australian equity market rose 2.8% over the month, driven by the global equity rally although the move weakened by month-end as the market still had to contend with higher bond yields, poor corporate announcements and a perception that the RBA's easing cycle was ending. The best sector was banks, up 6.0%, as they benefitted from higher yields and surprisingly, Utilities, which bounced back after the recent sell-off.



Source: RBA

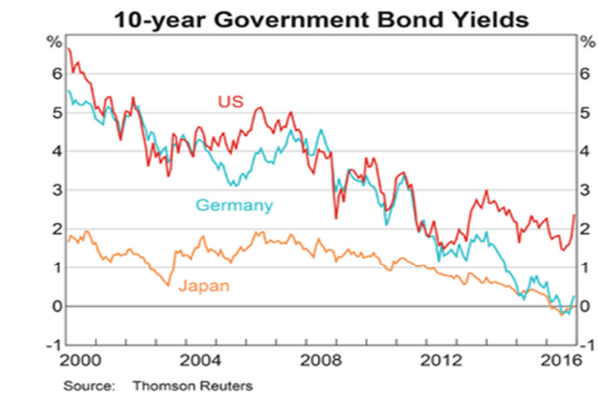
Fixed Interest

Most global bond yields rose again in November, following similar rises in October. In the US, 10-year yields hit a six-month high and closed the month at 2.39%. UK yields were also up, while domestically the bell-weather Australian 10-year bond yield rose sharply, up 38 basis points, to 2.74%.

Critical to investors over the medium term is whether bond yields have reached the end of their 35-year bull market which started in Sept 1981 with US 10 year yields at 15.5% p.a. This ongoing decline in bond yields since then, albeit interrupted over shorter time frames, has been a major tailwind for equities and therefore, if bond yields are moving to an environment of gradual but sustained increases, this will be negative for equities.

While the recent increases in bond yields have been very sharp, off a very low base, they represent a very small increase when measured in a historical context. For example, Australian bond yields rose 2% in 2009 before resuming their downtrend. The critical issue is to understand why yields are rising now and there are several factors; global growth is stronger than previously forecast, the likelihood of a US recession has declined, the threat of deflation has diminished as commodity prices have risen and wage pressure (at least in the US) has moved off lows and the potential for Trump's policies to move to growth driven by government spending could also add to inflation. Until recently these concerns have also seen investors move out of equities into bonds, further reducing bond yields.

Considering the above factors, investors have re-assessed whether current very low bond yields are sustainable. Given that over the long-term bond yields tend to be in line with nominal economic growth, current yields are still very low. By way of example Australian 10 yr bond yields are currently at 2.74% while long-term economic growth is around 4.75% p.a. and are therefore well below levels that are reflective of long term fundamentals.



Source: RBA

While yields may have bottomed and are likely to move up from here the increase is likely to be gradual, largely because it is expected to take some time before growth and inflationary expectations move up meaningfully. Should some of the President-elect's policy be enacted and the US Federal Reserve raise rates faster than the market is currently expecting, they are still likely to be gradual as fiscal policy takes time to impact the economy and any $US strength will slow the Fed.

In this environment investors need to be aware that fixed rates bonds may suffer capital losses as rates grind higher. Second, rising yields will hamper returns from equities although his impact will be reduced by higher earnings if growth improves. The high-yield sectors of the equity market are likely to remain under pressure, with AREITS and Utilities the most impacted.

Property

The AREIT market rose in November, up 0.75 %, following the sharp decline of 7.7% in October. After the recent sharp declines the sector is likely to be more stable as valuations have improved markedly. Notably the AREIT market was one of the few listed property security markets globally to record a positive return.