View from the hill

JANUARY 2017

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 December 2016.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	4.4	5.2	11.8	6.6
Smaller companies	3.6	-2.5	13.2	6.2
International shares (unhedged)	4.5	7.7	7.9	11.5
International shares (hedged)	2.9	5.2	10.3	8.9
Emerging markets (unhedged)	2.3	1.3	11.7	4.6
Property - Australian listed	6.8	-0.7	13.2	18.0
Property - global listed	4.4	-2.9	7.0	13.3
Australian fixed interest	-0.2	-2.9	2.9	5.1
International fixed interest	0.4	-2.2	5.2	6.3
Australian cash	0.2	0.4	2.1	2.4

Overview & Outlook

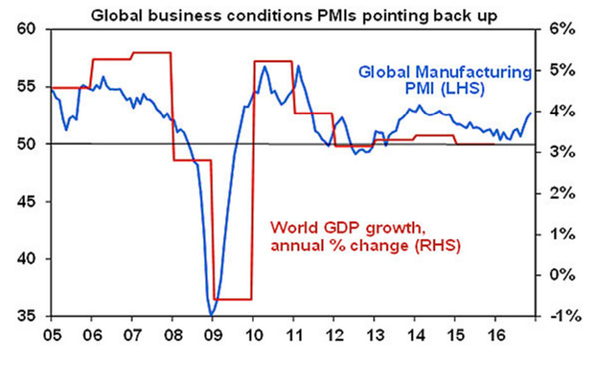
2016 was a notable year for investors as it started with a sell-off and poor sentiment driven by concerns around global growth and deflation and ended with all major asset classes delivering solid returns. This was all the more surprising as bond yields rose and Australian growth disappointed. The best performing asset class was Australian listed property, recording a return of 13.2%, followed by Australian equities at 11.8%. Small caps returned 13.2% to lead the large caps over the year while fixed interest returns were low but positive despite the increase in yields toward year-end.

The year was marked by a global economy that delivered 3.0% growth, helped by stronger US growth and a stabilization of the Chinese economy. Deflation concerns, a topic of much discussion early in the year, faded as commodity and energy prices rallied and spare capacity was reduced by ongoing economic growth. Perhaps the biggest surprise was in politics as the Brexit vote and the US presidential election highlighted rising support for populist economic policies and the outcomes of these votes surprising almost all investors. Domestically, the surprises included a very low inflation rate which allowed for further interest rate cuts and the economy recording negative growth in the third quarter.

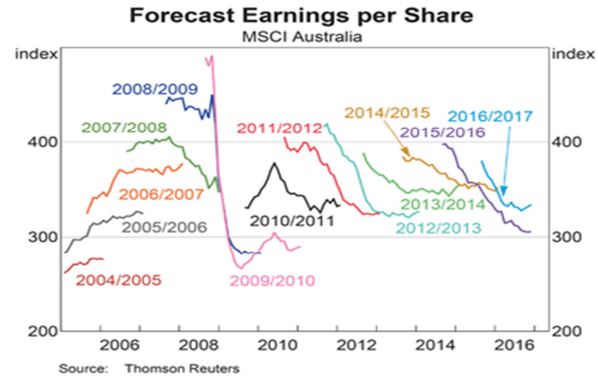
Turning to 2017, the outlook at this point appears more positive due to several factors; first, leading growth indicators have accelerated after a slowdown in 2015/16 and are signaling that growth is likely to be higher than the 3% recorded last year. This is a sound starting point for equity returns (see chart pg 2).

Second, there are few signs of imbalances, either in economies or financial markets, that usually lead to recessions or sharp market declines. There are no global bubbles in commercial property or business investment (if anything this is below average), inflation remains low, as do global interest rates. While the Fed is likely to raise rates over 2017 the economic impact may be offset by fiscal stimulus from the Trump administration as part of its expected infrastructure package. Currently the expectation is for two or three 0.25% hikes however the strength of the $US may temper the Fed. $US strength reduces import prices and thereby inflation as well as acting as a headwind to US exports. The rest of the world still has low interest rates and with little signs of any increase likely in the Eurozone or Japan although China may see a change to a tightening phase.

Third, headline inflation is likely to tick upwards as higher commodity and more importantly, energy prices feed into the production chain reducing deflation fears. Finally, the earnings recession has ended with the US and Australian equity markets likely to see sound earnings growth.



Source: AMP Capital



Source: RBA

In terms of headwinds, it is likely that bond yields will continue to increase gradually although there may be some decline in the short term given the strength of the recent increase in yields.

The domestic economy is likely to continue its long running rebalance from mining investment with the ongoing increase in resource export volumes and housing backlog all likely to see the economy record growth over the year after the weak third quarter data.

What are the implications for investors of the economic environment outlined above? Reasonable global growth and improving corporate profits is a positive environment for growth assets. Global shares are likely to trend higher over the year but may see some short term weakness given the recent sharp rally. Australian shares are likely to record sound returns assisted by a strong recovery in resource stock prices as bulk commodity prices have rallied as well as a general recovery in corporate profits as growth rebounds from the recent weakness. Expectations are for the overall market to record approximately 10% profit growth (see next chart) with valuations supported by low interest rates.

Bond returns are likely to be muted driven by a combination of low yields and some capital losses as yields rise while cash and term deposits are likely to continue to provide low returns with term deposits averaging 2.5%. Commercial property and infrastructure are likely to continue to benefit from the search for yield.

Equity Markets

Global equity markets continued their strong rally into December (4.5%, unhedged) as investors factored in the President-elect Trump's pro-growth policies and also drawing confidence from the Fed's decision to raise rates. In the UK, the FTSE rose 5.3% to record highs, while the DAX was up 7.9% and the Japanese Topix 3.5%.

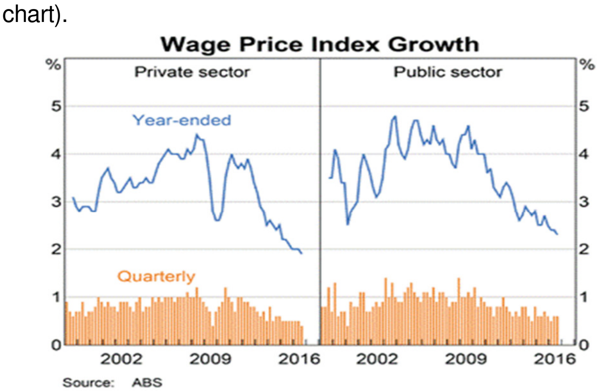
The Australian equity market rose 4.4% over the month, driven by the global equity rally, flat bond yields and an improved earnings outlook. The best sector was Utilities, up 8.7% and Energy which rose 6.1%.

Fixed Interest

Yields continued to rise through December, following November's increases, on the back of expectations of higher inflation and rotation into equity markets. The benchmark US 10-year Treasury yield rose from 2.38% to 2.45%, reaching a high of 2.60% following the Federal Reserve's decision to increase rates by 25 bps.

Notable US economic data was the announcement of a 0.4% rise in average hourly earnings, which pushed annual wage growth to a cycle high of 2.9%, which may lead to some inflationary pressure over time. US prices rose by an annual rate of 1.7% in November, still below the Fed's inflation target but building steadily recently.

Minutes from the RBA's December rate decision revealed that labor market underutilization remains a key concern, as well as the slower than expected pace of wage growth, currently around 2.0% in the private sector (see chart).



Source: RBA

Property

The S&P/ASX 300 A-REIT Accumulation Index gained 6.8% in December, partly reversing the significant losses over the three months to the end of October when the sector fell 14%, dragged down by rising bond yields. December showed the underlying strength of Australian listed property, which is still seen by investors as having solid fundamentals.