View from the hill

FEBRUARY 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 January 2017.**

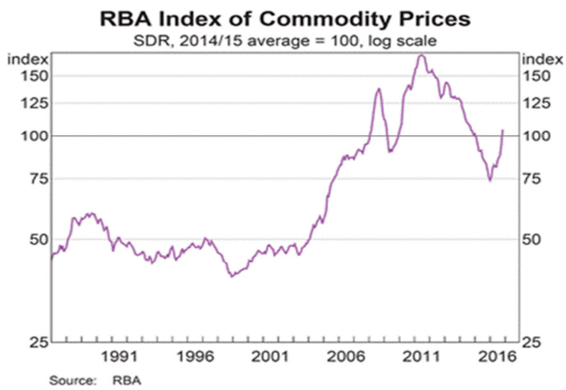
Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-0.8	6.7	17.3	7.4
Smaller companies	-2.4	-0.1	16.4	6.4
International shares (unhedged)	-2.4	6.6	8.9	11.1
International shares (hedged)	1.4	7.3	18.3	10.5
Emerging markets (unhedged)	0.6	1.1	16.9	6.3
Property – Australian listed	-4.7	2.5	6.8	15.9
Property – global listed	-0.9	1.8	9.0	12.0
Australian fixed interest	0.6	-1.0	2.3	4.9
International fixed interest	-0.3	-1.5	3.3	5.6
Australian cash	0.2	0.5	2.0	2.3

Overview & Outlook

January was dominated by economic and political news from the United States with President Trump leading with a range actions including withdrawing the US form the Trans-Pacific Partnership (TPP) and placing a travel ban on travel from seven countries as well as moving toward approving the Dakota and Keystone XL pipelines and speeding up approvals for high priority infrastructure projects. The TPP is an agreement between 12 nations, bordering the Pacific and aims to promote economic growth and reduce tariff and non-tariff barriers to trade. The two pipelines noted above are used to transport oil and gas across the US to refineries and tank farms and have delays on environmental concerns.

His statements have also included the possible imposition of a 20% tax on imports from Mexico which may lead to the introduction of a wide-ranging Border Tax Adjustment policy to help fund a reduction in the US corporate tax rate of 35%, which is high by global standards.

Since the US election last November US and global shares have rallied around 8% with Australian shares up 12%, supported commodity prices which have been buoyant (See chart below). In addition, the US dollar has been stronger as have bond yields. These rallies have largely been driven by President Trump's infrastructure plans which would boost growth but would also add to inflationary pressures given that the US economy is nearing full employment. These concerns have driven higher bond yields.



Some caution in terms of the infrastructure spending may be warranted. For example, infrastructure projects need highly trained workers, however due to the 2008 recession, which caused an estimated 25% of construction jobs to vanish, their numbers have declined and therefore a new round of projects could experience significant issues in terms of completion delays and increased costs.

In addition, the stimulus from the infrastructure package risks further budget deficits and increases in an already high level of public debt. For example, when President Reagan took over in 1981 US public debt was 30% of

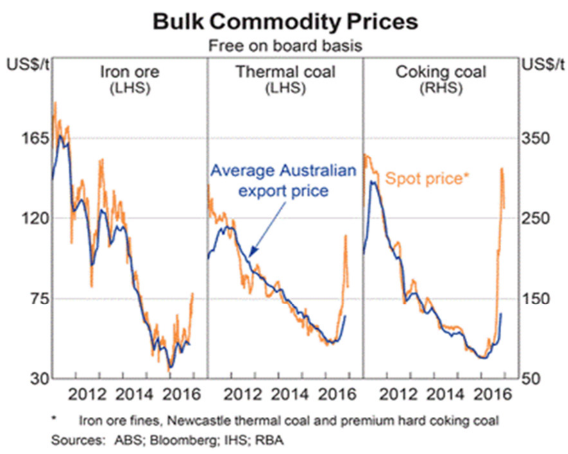
GDP however it has now risen to over 100%. By way of comparison Australia's public debt is around 20% of GDP. The budget deficit is already under pressure going forward due to the pressures of an aging population.

Looking ahead the strong rally in global share markets as well as the US dollar is likely to see these markets trade sideways or pull-back as investor sentiment has been become very buoyant. Over the year improved earnings, supported by stable to higher global growth, easy monetary conditions and rising profits will likely see equities trend higher.

In Australia, the notable data over January was the strength of the $A, driven largely by improved commodity prices, notable coal and iron ore, and the release of the Q4 CPI which came in at 1.5% year-on year. The higher commodity prices as well as the continuing growth in export volumes as completed mining and energy projects record higher production saw the trade surplus move to a record $A3.5bn in December.

Share markets

The local equity market fell 0.8% over January despite an improved earnings outlook dragged down by AREITs (-4.7%) and Industrials (-4.4%) while Materials, up 4.8% was the strongest sector supported by significant rallies in resource prices (see chart below). Key out-performers were Blue Steel, Fortescue and Rio.



Source: RBA

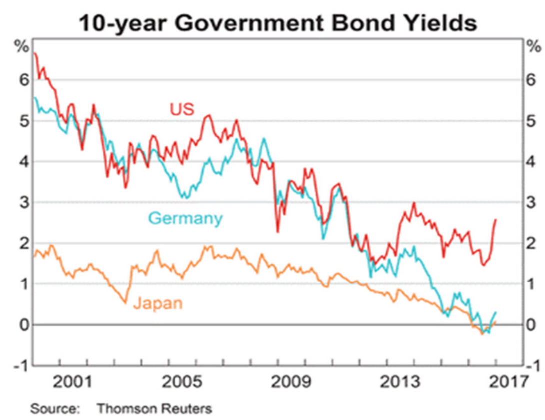
Financials were negative as the banks fell with performance reflecting profit-taking as opposed to any deterioration in fundamentals. Also notable in this sector was a wide-ranging sell down of fund managers as markets weakened.

Overall business conditions finished 2016 on a strong note supported by improved profits and firm order books. However other barometers of the economy such as hiring intentions, labour costs and pricing power remain weak. In terms of listed company earnings expectations for 2016/17 earnings growth are now 17% from around 7% last September. Resource company profits are expected to double, albeit off a very low base, with profit growth across the rest of the market likely to be around 5%. Key themes will be the resource earnings turnaround, low revenue growth for banks and industrials and an ongoing focus on dividends.

Global markets, unhedged, fell 2.4% over the month however when stripping out the strength of the $A, they rose 1.4%. Despite the lack of clear policy initiatives from Washington, US equities (+1.8%) were supported by solid business conditions, house price gains as well as consumer confidence and increased personal spending. Also notable was that 74% US companies reporting for the December quarter have beaten expectations and earnings are expected to be 6% higher on a year-on-year basis.

Interest rates

Bond yields, both locally and globally, were largely flat over January as investors considered whether the rapid increase in bond yields in the last half of 2016 (see chart below) were sufficient to capture the expected increase in inflation. The RBA held rates at its February meeting as the improved commodity prices are supporting economic activity and reducing the pressure for further rate cuts with the strength of $A and continuing surge in credit growth to property investors as well as a strong start to the year in home prices in Sydney and Melbourne added to concerns that property markets was too buoyant.



Source: RBA

Property

The sector fell sharply after a strong run-up before going ex-div in December, supported by foreign buying. Despite flat bond yields sectors sensitive to yields fell sharply in January. The sector is likely to be supported by ongoing rental growth particularly in the Sydney office market. Despite significant office rental construction this market is also still recording rental growth as there is significant withdrawal of office space as this is converted to residential accommodation.