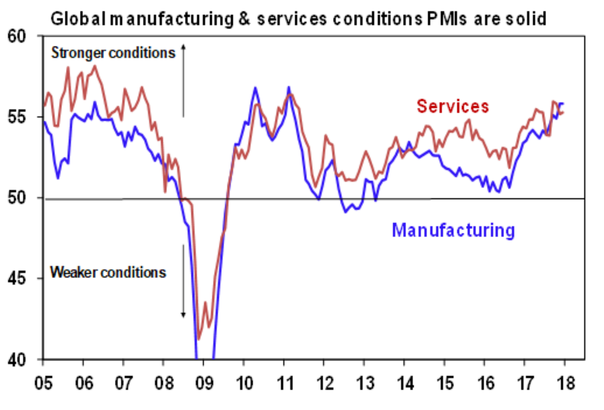
Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 December 2017.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	1.8	7.6	11.8	8.6
Smaller companies	3.2	13.7	20.0	14.4
International shares (unhedged)	-1.7	5.8	13.4	11.0
International shares (hedged)	1.1	5.5	20.0	11.2
Emerging markets (unhedged)	0.5	7.8	27.1	10.8
Property – Australian listed	0.1	7.8	6.4	11.3
Property – global listed	1.0	3.4	6.1	6.4
Australian fixed interest	-0.5	1.4	3.7	3.1
International fixed interest	0.2	0.9	3.7	4.1
Australian cash	0.1	0.4	1.8	2.1

Overview & Outlook

Equities continued to dominate investors' attention with the MSCI World ex Australia Index up 1.1% (hedged), following November's gains of 3.2%, with the domestic S&P/ASX 200 gaining 1.8% in December. This brought annual returns for the respective indices to 20.0% and 11.8%, very good returns considering the low expectations that were prevalent earlier in the year. Global growth continued to be the primary factor driving markets assisted by the passage of the tax reform program through the US Congress. The chart below demonstrates the strength of business conditions, both in services and manufacturing.



Source: Bloomberg, AMP Capital

The tax package will likely boost investment due to the lower corporate tax rate (of 21%) and accelerated depreciation, as well as boosting already strong consumer sentiment due to the tax cuts which would benefit a reasonable number of households. Over the next twelve months the tax package could add around 0.5% to US growth although, as discussed last month, the longer-term impacts are far smaller. Looking forward, growth is expected to move up to 3.7% over 2018.

The strength of this growth has seen equities record very strong gains in January, with the US S&P 500 up 3.5% (USD) since the beginning of January, as investors upgraded company earnings forecasts as business conditions and economic growth remain buoyant. However, this is likely to be the peak of global profit growth and this will likely temper market upside. The peak in earnings growth, allied with demanding market valuations notably in the US, as well as the strength of the recent increase are likely to see a correction in markets. The trend is likely to remain broadly upward as the very low interest rate environment will continue to offer support.

One notable risk is that while inflation and interest rates will likely continue to be very low, the US Fed will continue to raise interest rates as it looks to "normalise" rates. Normalise here means interest rates that are neither stimulative or restrictive for the economy. Markets have factored in a further two rate hikes in 2018, however should the current growth see inflation move up more sharply than expectations the Fed could increase rates three or four times. Should this occur markets would experience heightened volatility and some downside. Currently there are few signs of inflation although the risk are to the upside as labour markets are tight, which could see higher than expected wage growth, and energy prices are showing strength. Important to note here that investors are expecting some increase in inflation from current levels, and the risk is that it moves sharply above these expectations.

Source: Bloomberg, AMP Capital

Share markets

The ASX 200 Accumulation rose 1.8% in December, bringing the annual increase to 11.8%. Materials and telecommunications stocks did particularly well, while the defensive sectors of utilities and health care were slightly down over the month.

Over 2017, the ASX has been a relative laggard to other developed markets with global markets up 20.0% (hedged) and Asian shares up 31.2% (AUD) by way of comparison and this strength has continued into January. The lower returns recorded by domestic equities reflect the long-term issues of very weak domestic wage growth allied with very high household debt and a relatively strong currency, which combine to make revenue growth difficult and therefore earnings growth remains reasonable but still only around the 5% level. There is some upside over the medium term driven by strong infrastructure spending and an improving outlook for business investment, excluding mining, after a very long period of decline. Improving export volumes will also assist resource sector profit growth and exporters may get a further boost from a weaker $A. Expectations for the Australian market return over 2018 are for an 8.0% total return.

Interest rates

In Australia, cash rates continued at 1.5% with the outlook for another rate rise still only likely toward year-end as there are few factors likely to pressure a rate increase. Australian bond yields moved up over the month, with the bellwether 10-year bond up 13 basis points to 2.63% with no particular factors impacting the market. Globally, bond yields were again largely unchanged.

Over 2018, bond yields are likely to move slightly higher as inflation concerns, driven by global growth and low unemployment, impact investor sentiment to the asset class. This will constrain returns from fixed interest assets.

Property

The Australian AREIT sector was flat over December, with slightly higher bond yields offsetting positive outlook for rental growth. The return for the year was 6.4%.

One of the factors that has been impacting the retail sub-sector, which is 44% of the AREIT Index, is how online shopping and specifically, the entry on of Amazon, will impact the medium-term outlook for retail property assets in Australia. Although the sector is facing significant challenges from these issues, there are a number of important factors that ameliorate initial concerns.

First, the concern over the decline of conventional retailing is being driven by the US experience, which is quite different from other countries. The US has more than twice the retail floor space per capita, almost twice the department store space per capita and more than four times the vacancy rate of Australia where vacancy rates of between 0.5% and 1.0% are usual in the top-end mall assets[1]. Using the US retail experience and then drawing a line to Australia is not a useful indicator. It could be argued that Australia leads the world in the quality of its shopping centres, while the US could be said to lag it.

Second, online sales are not growing at very high rates. Evidence suggests the rate of growth of online sales in Australia is slowing. Notable also is that the main drivers of these sales are media and food, which tend not to compete with shopping centres. It is estimated that only around 6% of US online sales compete with shopping centres, which is likely to be similar to Australia's experience.

Third, is that conventional stores still work well for products that customers prefer to experience prior to purchase. Amazon recently spent $18 billion on purchasing Wholefoods, a US bricks and mortar retailer, and global retailers like H&M, Uniqlo, Apple and Zara continue to roll out stores across Australia. Clearly, like Amazon, these leading global brands see a solid future for conventional retailing. Related to the above is that shopping centres are transforming into 'experiential' environments, i.e., they are looking to deliver services that cannot be easily replicated online.

[1] Drawn from APN Group

This newsletter is provided by Hillross Financial Services Limited (ABN 77 003 323 055 & AFSL No. 232705) an AMP Group Company. It is of a general nature only and any advice is not based on your objectives, financial situation or needs. Accordingly, you should consider the appropriateness of any advice to your personal circumstances before acting on the advice. Before you make any investment decision, you should read the current Product Disclosure Statement available from Hillross or your financial adviser. Although this information was obtained from sources considered to be reliable, we do not guarantee it is accurate or complete. The information in this publication is current as at 11 January 2018, and may change over time. Hillross is part of the AMP group of companies. No additional remuneration or other benefits are paid to us or our related companies or associates in relation to the advice provided on this page. If you decide to purchase or vary a financial product, your financial adviser, Hillross and other companies within the AMP Group or associates of Hillross will receive fees and other benefits, including fees calculated as a percentage of either the premium you pay or the value of your investment. Further details are available from your adviser or Hillross. Past performance is not a reliable indicator of future performance.