View from the hill

AUGUST 2016

Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **31 July 2016.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	6.3	6.9	2.4	8.0
Smaller companies	8.6	11.5	22.3	8.7
International shares (unhedged)	2.0	4.0	-3.9	12.8
International shares (hedged)	4.1	4.9	-0.1	10.6
Emerging markets (unhedged)	2.9	5.6	-4.1	5.4
Property - Australian listed	5.4	12.0	24.2	20.9
Property - global listed	4.7	11.0	17.8	15.7
Australian fixed interest	0.7	3.4	6.4	6.2
International fixed interest	0.7	3.3	8.8	7.6
Australian cash	0.2	0.5	2.2	2.5

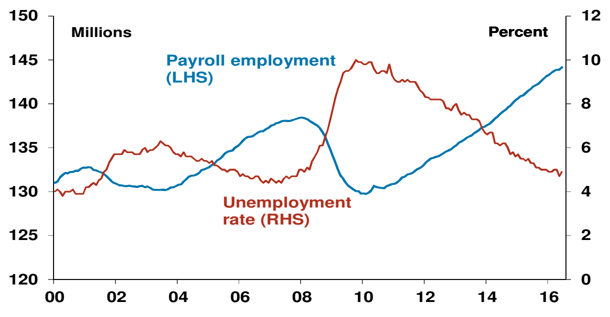
Overview & Outlook

Equity and bond markets moved up over July continuing the rally that started last month after the Brexit vote in the UK. It is unusual for both these asset classes to move in tandem as a strong equity market usually indicates an improving economy while a buoyant bond market is usually associated with a slowing economy, or a recession. Most commentators attribute the anomaly to the high levels of central bank stimulus and very low interest rates which are tending to support all asset markets.

Central Bank stimulus continued into July with the Bank of England cutting rates 0.25% and introducing a significant scheme to buy government and corporate bonds. The Bank of Japan further eased monetary conditions and is buying ETF's on the stock exchange. Easier monetary conditions were also reflected in Australia as the RBA cut rates again in August to a record low 1.5%.

After last month's severe initial equity market sell off after the Brexit vote it appears that the impact on the real economy of any slowdown will be contained to the UK where manufacturing indicators fell to recessionary levels, however Eurozone indicators were stable. The full benefit of the weaker Pound to exporters has yet to be fully reflected in the economy and may ameliorate the downturn.

Globally economic data was reasonable with the strength of the US economy a notable standout. June payrolls were much higher than expected while slightly higher inflation and wage growth indicated the broad nature of the US growth. In addition both the manufacturing and service sector surveys reflected expansionary conditions. Other positive indicators were retail sales and consumer sentiment. The chart below shows the ongoing strength of US employment growth (blue).



Source AMP

Looking forward global growth is likely to be around 3.0% in 2016 and 2017 but it is uneven, with a key theme the divergence between developed and emerging economies. The latter economies are struggling with structural weakness including high levels of debt and significant dependence on commodities to generate export revenues. This has led to cyclical pressures from the slowdown in global trade and lower commodity prices.

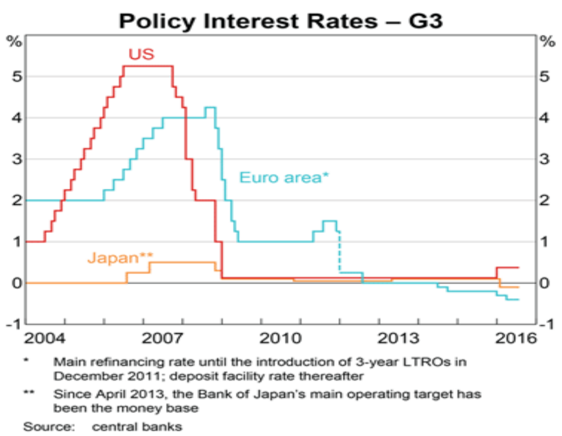
Equity markets

International shares recorded strong performance in July, returning 4.1% (hedged) and 2.1% for unhedged equities, as the $A rallied against all currencies. The rally was supported by easier monetary policy and generally better than expected economic data although earnings growth remains weak.

The Australian equity market rose sharply in July, up 6.3%, with a common theme being the strength of higher dividend yield stocks. The renewed interest in searching for yield was not surprising as the RBA has cut the cash rate twice in recent months. Across the sectors, banks were notable as well as the Materials sector which was assisted by some improvement in commodity prices.

Another theme that continued over July was the out-performance of small caps compared to large cap companies, with the Small Ordinaries up 8.6% brining annual out-performance to 19.9%. Small caps have generally out-performed on the back of higher earnings growth than the larger companies and while this trend is likely to continue small cap valuations are now looking extended.

In terms of outlook, shares could trend higher this year helped by a combination of relatively attractive valuations, very low interest rates globally and continuing moderate global economic growth. The chart below demonstrates the negative rates prevailing in Japan and the Eurozone and the still very low rates in the US.

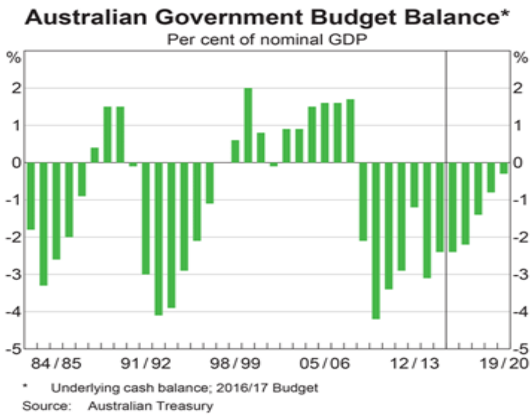


Source: RBA

Fixed Interest

Bond yields continued to decline across all global markets continuing the sharp falls recorded in June. The declines were across all maturities, with the bell-weather Australian 10 year bond yield falling to 1.87% from 2.02%. The primary driver of the ongoing decline in global yields was investor perceptions that the US Federal Reserve would again delay further interest rate hikes despite stronger US growth as it did not want to put at risk the fragile nature of economic growth and was still aware of the potential for deflation.

In July Standard and Poor's (S&P) revised Australia's sovereign credit outlook from stable to negative. The rating was maintained at AAA. S&P noted that "the prospects for improvement in budgetary performance have weakened following the recent election outcome." This reflected the risk of further budget slippage and was of little surprise to investors who had largely discounted the announcement. The chart below shows the long run of budget deficits recorded to date by the government.

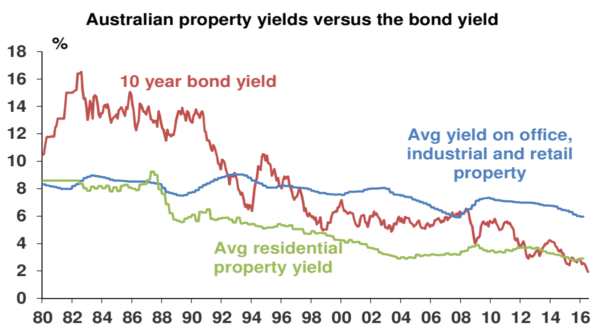


Source: RBA

It appears that it was the broad based weakness of inflation that led the RBA to cut rates in August particularly because inflation forecasts are well below the RBA target band. In addition, the ongoing strength of the $A which is negative for growth and the rebalancing of the economy after the mining boom appears to have also contributed to the decision to cut the cash rate.

Property

The AREIT market continued its strong run returning 5.4% over July, driven by lower interest rates. Within the sector the office and diversified companies performed strongly. Notable office vacancy in the Sydney and Melbourne CBD's fell to 5.6% and 7.0% respectively while in Perth it rose to 21.8% reflecting the two-speed economy that has developed as commodity prices have fallen since 2012. The AREIT sector is now trading on reasonably demanding valuations however it is difficult to see these moving back to fair value as long as the interest environment remains weak. The chart below shows the reasonable yields still available on commercial property.



Source AMP