Economic and Investment Update – January 2017

Amid the distractions of the US election, the global economy finished 2016 on a reasonable note with major regions experiencing an increase in economic activity, modest increases in inflation and slightly higher interest rates.

In the US, against a backdrop of significant improvements in key economic indicators including consumer confidence, manufacturing and retail sales, the Federal Open Market Committee (FOMC) raised growth forecasts. Revisions to third quarter GDP were also positive with the annualised metric raised to 3.5% while employment growth was also healthy. As a result, the FOMC increased interest rates by 0.25% to 0.75% during the December quarter.

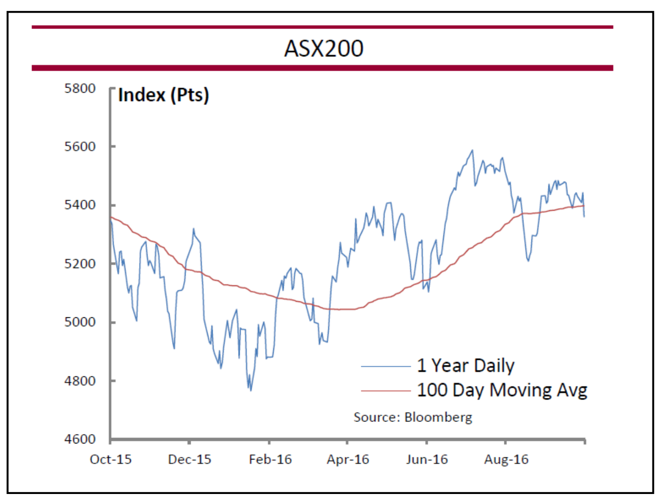
Across the Atlantic, the European Central Bank announced plans for its Quantitative Easing programme with the central bank to reduce the size of purchases by 20 billion Euros each month. With scope for adjustments if required, the outcome was perceived as supportive. Investors in the region also felt relief after the Italian referendum proved a non-event and concerns over the health of their banking system faded. In the UK, the wave of global optimism offset "Brexit" implementation fears.

In Asia, the Bank of Japan appeared more optimistic on the outlook for the country's economy as industrial output surged, boosted by increased exports. In neighbouring China, data was perceived as reasonably strong with improvements in manufacturing data and producer prices hitting five year highs.

Domestically, while Australia's terms of trade improved with higher commodity prices, the economy hit a soft patch with lower wages growth, negative September GDP and sluggish inflation. However, recent indicators point to a rebound in activity. The RBA left the cash rate unchanged at 1.50% after a 0.25% interest rate cut in August.

MARKETS

Despite improvements in the global economy, risk sentiment swung dramatically during the December quarter as pre-election concerns were replaced with global optimism as investors re-evaluated Donald Trump's pro-growth, pro-inflation policies. As a result, most key equity markets posted strong positive returns, underpinned by a rotation away from traditional 'defensive' sectors in favour of more cyclical sectors such as resources and materials, while bonds were sold-off.



The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished 5.2% higher over the quarter and up 11.8% over the calendar year. The December quarter saw solid gains in the Financials (+12.7%), Utilities (+9.3%), Energy (+7.4%) and Materials (+7.4%) sectors, however the more defensive Health Care (-8.8%) and Telecommunication Services (-4.2%) sectors finished lower.

Small cap stocks underperformed larger companies and finished down 2.5% for the quarter.

Internationally, the MSCI World ex-Australia Index returned 5.2% for the December quarter. Returns in Australian Dollar terms were 7.7% for the quarter as a weaker Australian Dollar enhanced gains.

During the December quarter, the best performing developed markets were Japan (up 16.2%, as measured by the Nikkei 225 Index) and Germany (up 9.2%, as measured by the Deutsche Boerse AG Index). In the US, returns were also strong with the Dow Jones Industrial Index finishing up 8.3% for the December quarter.

Domestic listed property fell by 0.8% over the December quarter (but was up by 13.2% for the calendar year). Global property was also lower, down 2.4% over the December quarter (+6.0% during 2016) as rising bond yields impacted on returns.

Australian Government and global bonds produced negative returns for the December quarter as bond yields rose. In Australia, 3-year government bonds finished 46 basis points higher at 1.94% while 10-year bonds finished 83 basis points higher at 2.77%. In the US, 2-year government bonds climbed 43 basis points to 1.19% while 10-year bonds rose 85 basis points to 2.44%. Domestic bonds (as measured by the Bloomberg Composite Bond Index) returned -2.9% for the quarter whilst global bonds (as measured by the Barclays Capital Global Aggregate Index) returned -2.2%. Credit securities outperformed government bonds as global economic news supported credit markets.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	**Index**	**3 mths (%)**	**1 year (%)**	**5 years (% p.a.)**
Equities				
Australia	ASX/S&P 200 Accumulation Index	5.2	11.8	11.9
	ASX Small Ordinaries Acc Index	-2.5	13.2	4.9
International	MSCI World ex Aust Index (AUD)	7.7	7.9	18.6
	MSCI World ex Aust Index (AUD Hedged)	5.2	10.3	15.2
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	1.3	11.7	8.6
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	-0.8	13.2	18.5
International	FTSE EPRA/NAREIT Dev Prop Index (Hedged)	-2.4	6.0	14.1
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	4.2	12.4	10.5
Currencies				
AUD v USD	Against US Dollar	-6.0	-1.1	-6.7
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-2.9	2.9	5.0
	Bloomberg Ausbond Credit All Maturities	-1.4	3.8	5.8
International	Barclays Capital Global Agg Index (AUD Hedged)	-2.2	5.2	6.1
Commodities				
Gold	Gold – USD	-13.0	8.1	-6.0
Oil	WTI Oil $/b – USD	11.4	45.0	-11.5

Economic & Investment Outlook

Following Donald Trump's inauguration as US President, the world is now focussing on policy implementation in his first 100 days. Trump's early moves reflect the President's desire to quickly make good on his campaign promises. But they also encapsulate the pitfalls of an administration largely operated by officials with scant federal experience. As a result, continued heightened market volatility is likely as further policy details are released.

Apart from US internal policy, common themes remain for investors, including monetary stimulus and its longevity, changing regulatory environments, US external policy, Chinese economic policy and geopolitical tensions. The growth outlook, as well as the longevity of the economic cycle and how it affects interest rates, will also be important in 2017.

These themes will play out not only in the market prices of various asset classes, but also in the various global currencies relative to each other, and most importantly to the Australian Dollar.

In the US, there is a growing belief that the US Federal Reserve will be more emboldened to raise rates following Trump's election win with FOMC officials estimating that they will would raise interest rates three times in 2017. In Europe, with the ECB set to reduce Quantitative Easing, data trends signal respectable economic prospects.

In China, strong money growth has revived the economy but has contributed to property speculation and currency weakness, and is now feeding through to a pick-up in inflation. An interest rate hike in early 2017 would surprise markets, but could relieve downward pressure on the Chinese currency.

In Australia, the Reserve Bank is expected to look through recent weakness and leave the cash rate unchanged over 2017, given the outlook for around trend rates of growth and subdued inflation. The balance of risks remain tilted toward further easing over the second half of the year as the housing sector begins to cool from cyclical highs.

Australian Shares

Following recent gains, we recommend investors hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

Against a backdrop of global political uncertainty, stock valuations such as price-to-earnings exceed historic levels and consequently, the domestic market appears expensive.

With a number of high profile earnings downgrades across small and mid-cap stocks reversing the strong small cap outperformance of recent years; along with an improved outlook for resource earnings and the banking sector driving a recovery in large cap growth expectations, a cautious approach to small cap stocks should continue to be adopted.

Global Shares

We maintain our recommendation for investors to hold a neutral to underweight position to International Equities relative to their benchmark allocation.

Despite the recent rally in global equities, on the back of rising optimism over the health of the US economy and corporate profit, we believe that global markets do not provide compelling value. In the US, the S&P 500 is trading at 26 times the past year's earnings, while the long-term average is 16 times earnings. We also feel that equity markets are not factoring in the uncertainty surrounding future US policy.

The direction of the US Dollar will also continue to be a particularly important variable with further strengthening likely to detract from the strength of Corporate America as it diminishes the contribution from offshore subsidiaries. A stronger US Dollar will also likely weigh on Emerging Markets.

Property

Australian listed property is currently trading at a 5% premium to net asset value against an historic 5% discount. However, the distribution yield of around 4% to 5% looks attractive against a cash rate of 1.5% and against 10-year bond rates of around 2.8% and continues to attract local and institutional investors. Fundamentals such as low vacancies and projected rental growth remain strong.

Global listed property is trading at a modest 4% discount to net asset values, with larger discounts in Asia and Europe and small premiums in the US.

Investors should however remain cautious given the likely impact of rising global interest rates. As such, we recommend a neutral to underweight position to Australian listed property and an underweight position to global listed property.

We continue to recommend that investors consider alternative unlisted options in selected property sectors.

Fixed Interest

While valuations look more attractive, following a steepening in domestic and global yield curves during the December quarter, the prospect of rising interest rates may place added pressure on fixed interest markets. We therefore continue to recommend that investors take a cautious approach to bond investments and suggest an underweight position within this sector.

While credit continues to offer some value, we suggest a neutral exposure to credit securities in order to obtain additional yield. However, credit spreads reflect the popularity of this approach and are now tracking below their five-year average.

Sources: BT, Lonsec