Financial Planning

Quarterly Market Review – December 2015

Published: 21st January 2016

Contents

Please Note: Past performance is not a reliable indicator of future performance.

Overview

Share correction still in play

Oversupply in the commodity markets, especially oil and iron ore, coupled with tepid industrial demand has resulted in a continuation of softening of commodity prices, which in turn, impacts on the projected revenues of the world's major resource companies. The anticipated lower company revenues point to potentially lower profits which are reflected in the softer share prices for much of the materials sector over the December 2015 quarter.

One hurdle that the markets seem to have climbed over without a major price impact was the end of the "Quantitative Easing" by the US Federal Reserve Bank (Fed). Liquidity was seen as a major concern post the event however so far, the markets appear to be managing without any undue intervention. The main focus remains on the weakening outlook for growth, especially in China. Emerging countries in the Asia region have also been hit hard given their reliance on the growth in the developed and developing markets to drive their economies forward.

Economic data remains subdued

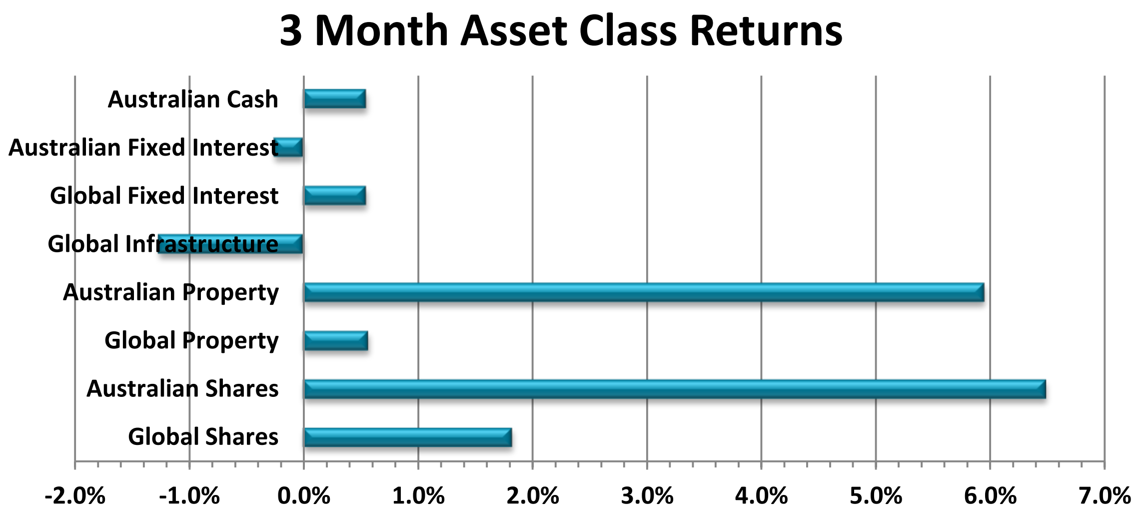
Markets remain unsettled and are likely to continue to be sensitive to any news regarding lower commodity prices and the anticipated continued slowdown in China:

- **USA**: The U.S. recovery is holding with the annual growth rate of GDP 2.1%, slightly down from 2.7 % reported in the June quarter. On a positive note, unemployment has strengthened to 5.0% from 5.1 % previously;
- **China** GDP growth rate increased to 1.8% over the September quarter with the annual growth rate easing to 6.9% from 7% previously. The unemployment rate of 4.05% was little changed from the previous 4.04% and inflation appears to be steady at 1.6% p.a. for the month of December 2015;
- **Europe** also remains on the sidelines with GDP growth rate easing to 0.3% from 0.4% in September 2015. Europe's unemployment of 10.5% was an improvement over the previous 11.0% however inflation is going nowhere and expected to be 0.2% for December 2015. The ECB is expected to push on with its bond purchasing program until September 2016 which will keep interest rates low;
- **Australia** GDP latest data from the September quarter revealed the annual growth rate bounced back to 2.5% from 2.0%. Unemployment improved to 5.8% in December 2015 and inflation remained steady at 1.5%. The Reserve Bank of Australia (RBA) has left the target cash rate at 2.0% at their meeting on 1st December 2015 with economists still looking at the possibility of future easing ahead in 2016 as the broader economy remains sluggish, apart from the growth in the domestic housing sector which is starting to show signs of slowing.

Asset Class Review

Asset class returns ended the December quarter strongly with Australian shares and property posting much needed positive results. The asset class returns were as follows:

Chart 1



Source data: Morningstar, 31 December 2015

Growth Markets

The Australian equities and property sectors finished strongly at the end of the quarter. Infrastructure however was impacted by the changes to the interest rate policy of the Fed as it may imply higher borrowing costs for any project that relies on debt funding.

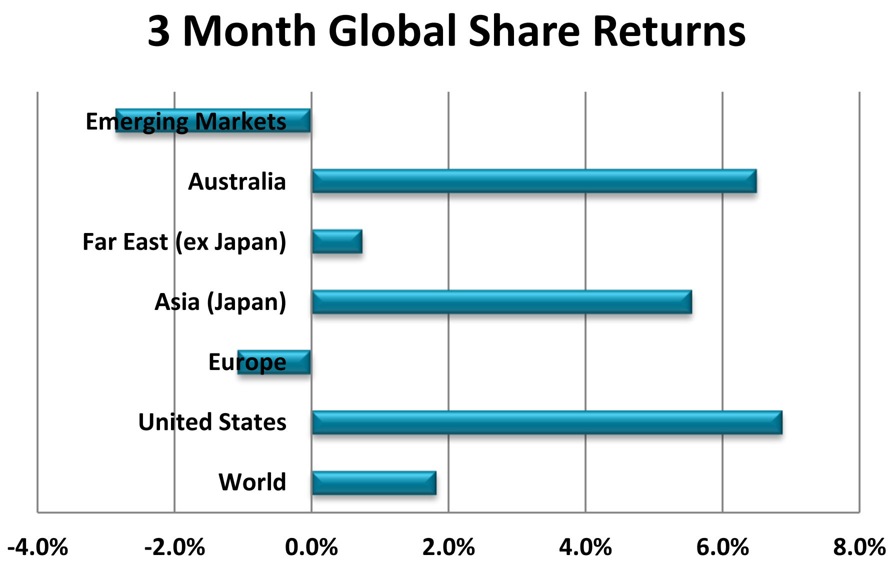
Defensive Markets

The Australian fixed interest markets were impacted by the tightening of monetary policy by the Fed in the US. While there were no real surprises in the upward move, markets did sell off marginally as the change in US monetary policy direction will impact future interest rate moves over time. European bond markets held steady as the European Central Bank intends to maintain easier monetary conditions for the region.

Global Share Markets

A relieving rally early in the quarter resulted in many of the global share markets posting a positive to flat returns for the quarter however, the downward correction continued to emerge in December which took the shine off the annual results. The regional and country specific returns for the quarter were as follows:

Chart 2



Source data: Morningstar, 31 December 2015

With the focus on liquidity, interest rates and the Fed moves to tighten monetary policy, equity markets were able to take a breather although not out of the woods just yet given the late selloff experienced towards the end of December 2015.

Domestic Share Market

The Australian share market posted modest gains over the quarter although the materials and energy sectors were impacted again by the lower oil and iron ore prices.

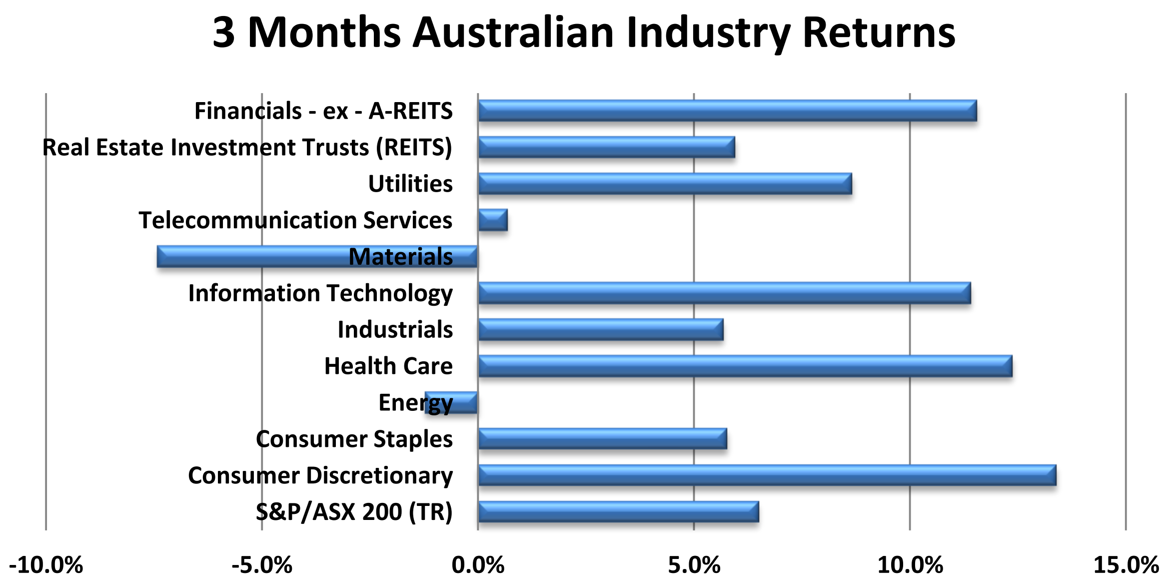
The transition from a "resources" based economy towards a "services" based economy is proving difficult. The current state of affairs with Australia's main commodities remaining under price pressure, interest rates low and the rest of the world in differing stages of economic reform and/or recovery, **there is little incentive to take on more equity risk** over and above what investors currently have allocated.

Analyst's are keen to see evidence of any emerging growth and have been favouring smaller companies over the larger more established companies in order to source returns. The Australian smaller company's accumulation index has returned some 11.3% over the quarter however the returns from this sector are quite cyclical in nature.

Volatility, yield and liquidity remain key considerations and will most likely dominate the next quarter's return expectations.

The following table provides an industry breakdown of the composition of the S&P/ASX200 share market returns over the quarter:

Chart 3



Source data: Morningstar, 31 December 2015

Oil prices started the quarter at US$45.06 and finished at US$37.13 (-17.6%). Growth in the Australian economy remains subdued although the gains over the quarter are encouraging.

The **Materials sector** includes companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, and metals, minerals and mining companies, including producers of steel and make up some 11.4% of all the top 200 companies listed on the ASX. The top 5 companies that dominate the sector include: BHP 3.7%, RIO 1.3%, Amcor (AMC) 1.1%, Newcrest Mining (NCM) 0.8% and James Hardie (JHX) 0.5%.

Where to from here?

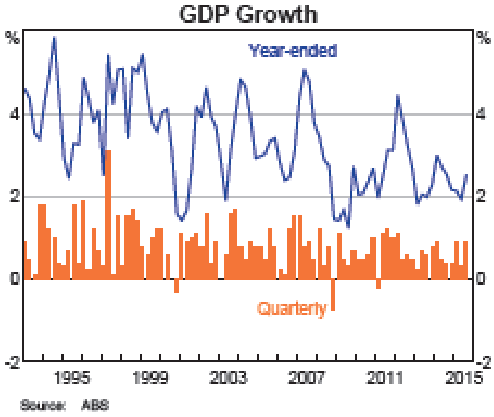
The market is fixated with the key commodity prices which are having what appears to be an undue influence over the whole Australian market. Analysts are closely monitoring the major Australian export markets especially, oil, gas, iron ore and coal in order to gauge the profit potential of the companies involved directly in the sector. Factors of influence include:

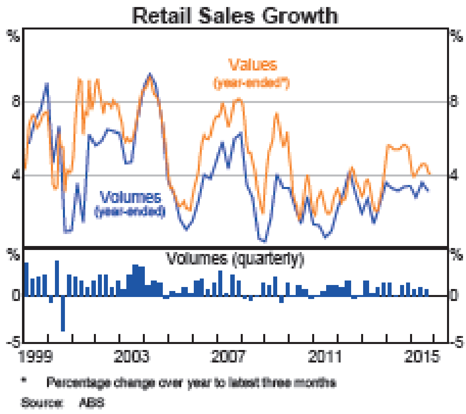
- The level of the AUD/USD: The AUD/USD strengthened from 0.7010 to 0.7306 (+4.22%) over the quarter but has since fallen back to under 0.70 cents early 2016;
- The price of the commodity: Oil has fallen from US$45 to US$37 (-17.6%) and Iron Ore has fallen from US$56 to US$43 (-24.0%);
- The company's profit margin – cost of mining verses cash received from spot sales.

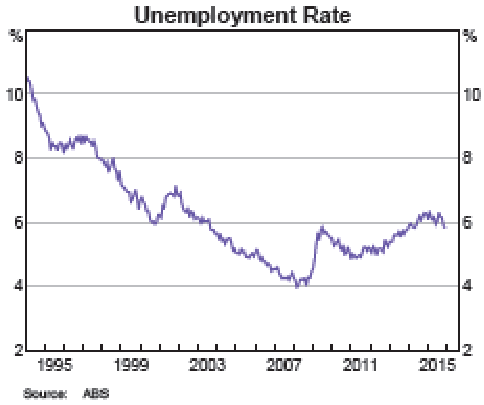
The annual growth in GDP is running at 2.5% as at the end of September 2015 which is in line with GDP estimates for 2016. The economy continues to drift sideways with the domestic housing market providing a bright spot for growth.

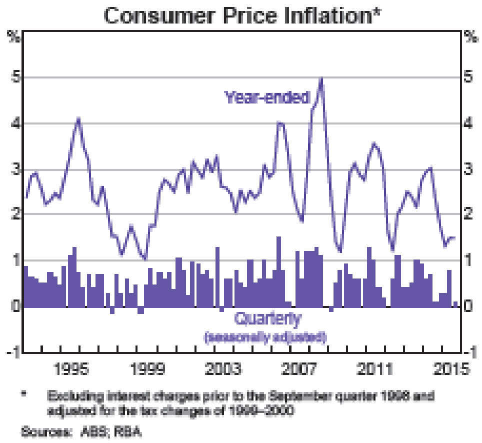
Other statistics revealed the following:

Charts 4, 5, 6 and 7









Market fundamentals indicate that this current softness in the share market is still just a correction and not a bear market. Investors need to be mindful that markets will be impacted by the holiday season when key decision makers may be away from the office.

The upcoming company reporting season for the previous 6 months trading will provide further evidence on the underlying state of the economy.

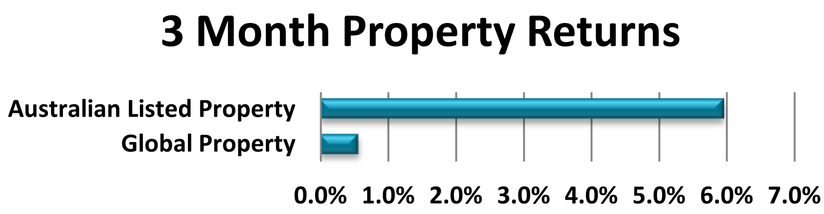
Economists see the share market gaining over 2016 with many indicating ranges between 4,700 and 6,000 for the S&P ASX200. This is approximately +/-12% from the closing price level of 5,295.86 as at the end of December 2015.

Global and Domestic Property

The Property sector continued to benefit from investor support despite the changes to interest rates announced by the Fed. Under normal circumstances, property would be impacted from any increase in interest rates as the listed vehicles are generally a geared investment. For the moment, the changes in interest rates may be contained in the US as they do not appear to have impacted returns overall in the sector.

As mentioned previously, most property investment has an element of gearing (borrowing) which makes the prices of the property assets sensitive to interest rate moves. Rising interest rates will have a negative impact on the sector unless the borrowing costs have been fixed.

Chart 8



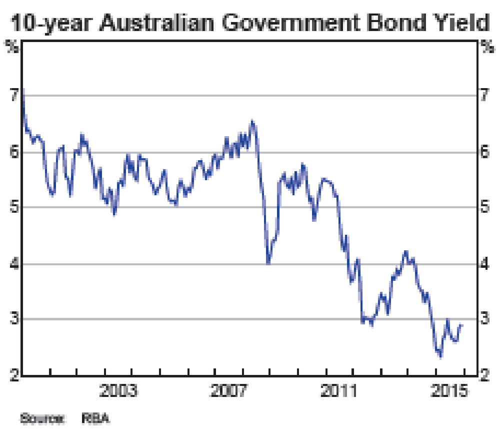
Source data: Morningstar, 31 December 2015

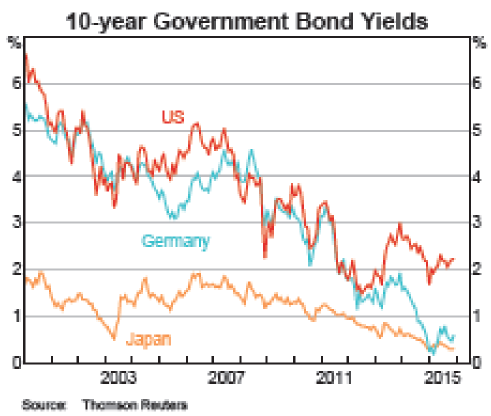
While residential property prices appear to be coming off their highs in Sydney, the listed property market remains well supported by institutional investors.

Global and Domestic Debt Markets

Fixed Interest markets were weaker over the quarter in response to the shift in policy by the Fed. The 10 year US Bonds responded by slipping from 2.03% to 2.26% and in Australia, the 10 year Government bonds finished higher at 2.88% for the December quarter up from 2.60% at the end of September.

Chart 9 & 10

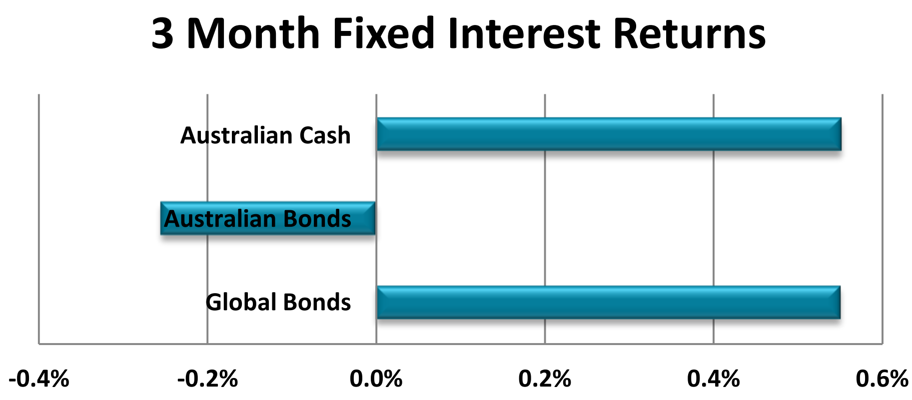




Source data: RBA, 31 December 2015

The following chart shows the returns from cash and fixed interest markets over the quarter:

Chart 11



Source data: Morningstar, 31 December 2015

The RBA held the target cash rate steady at 2.0% with no change since May 2015 citing in the recent media release (6th October 2015) that "monetary policy needs to be accommodative. Low interest rates are acting to support borrowing and spending. Credit is recording moderate growth overall, with growth in lending to the housing market broadly steady over recent months".

Bond investors remain cautious post the Fed move and are watchful of any inflationary pressures that may evolve. For the moment, **no major changes to monetary policy** are expected over the next quarter.

What lies ahead for global interest rates?

The Fed has shown its hand and raised interest rates. The market response has been muted which has pleased the authorities as the mood around the change in policy has been nervous but well telegraphed over the last year. The fixed interest markets **expect further tightening of monetary policy in the US** to emerge over the course of this year and into 2017.

In contrast, Japan and the European Central Bank are **maintaining their quantitative easing** policy that has worked so well to date, holding interest rates low, in their attempts to rekindle growth in their economies. This trend is likely to continue in the near term.

For Australia, the next round of economic data releases will influence the monetary policy settings however, from all accounts, the market expects **no real change in the RBA monetary policy** although the banks may act independently and continue to reprice credit risk given their capital adequacy needs, the demand for residential housing and the current economic climate.

Summary

Short Term – now to 1 year

In the short term, **markets are expected to correct** along with periods of price volatility. While there are price pressures on the core commodity markets, investors will wait patiently for the inevitable bounce before adding to their positions. For Australia, the lower AUD/USD will help boost tourism and the exporters of our natural resources will be more competitive as commodity prices stabilise near term.

Medium Term – 1 year to 3 years

In the medium term, experienced investors remain focussed on opportunities emerging from any **rotation of capital**. Emerging markets and countries less reliant on the sale of natural resources are of interest. The volatility within these investment markets and the fluctuating currency flows add an additional level of risk for investors.

For Australia, **commodity price falls are moderating** however, the flow on affects are for diminished profits which is pressuring the prices of resource stocks. As mentioned, the Material sector now only accounts for some 11.4% of the top 200 Australian stock market participants compared to 16.9% back in March 2014. Financial stocks (excluding Property Trusts) make up over 40% of the market now.

Longer Term – 3 years to 10 years

The global economy is still encountering headwinds on the growth front due to political, economic and consumer sentiment. Investor confidence has been battered by this latest bout of sustained commodity price falls and related softness across all the share markets. Avoiding price volatility whilst maintaining access to good sources of returns (with liquidity) remain key themes with investors.

The **markets will experience further bouts of volatility while global demand remains soft**. Oversupply of key resources will eventually benefit manufacturing however this will also add to the downward price pressures on goods and services.

Key Message

Patience: the markets will recover in 2016 and the lower price levels create opportunities for resource hungry industries. For consumers, this can only mean cheaper goods and that cannot be all bad.

Low currency, low interest rates and stabilising commodity prices offer a platform for growth over the months ahead. With the RBA keen on maintaining an accommodative to easing monetary policy, **the stage is set for an economic recovery** the only problem is over what timeframe it will occur.

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Data Sources

Where indicated in this review, the underlying data was sourced from Morningstar on the 19th January 2016.

Benchmark	Country/Asset Class
MSCI World ex Australia (Net TR) AUD	Global Shares
MSCI Europe NR AUD (AUD)	European Shares
S&P 500 (TR) USD	United States Shares
MSCI JAPAN (Net TR) AUD	Japan Shares
S&P/ASX 200 TR AUD (AUD)	Australian Shares
S&P ASX Small Ordinaries AUD (TG) AUD	Australian Small Companies
FTSE EPRA/NAREIT Developed NR AUD (AUD)	Global Property
S&P/ASX 200 Property Trusts Accum Index (AUD)	Australian Listed Property
S&P Global Infrastructure NR Hdg AUD (AUD)	Global Infrastructure
Citi WGBI Hdg AUD (AUD)	Global Bonds
Bloomberg AusBond Composite 0+Y TR AUD (AUD)	Australian Bonds
Bloomberg AusBond Bank 0+Y TR AUD (AUD)	Australian Cash
MSCI EM NR AUD (AUD)	Emerging Markets