Financial Planning

Quarterly Market Review – December 2016

Published: 20th January 2017

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

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Overview

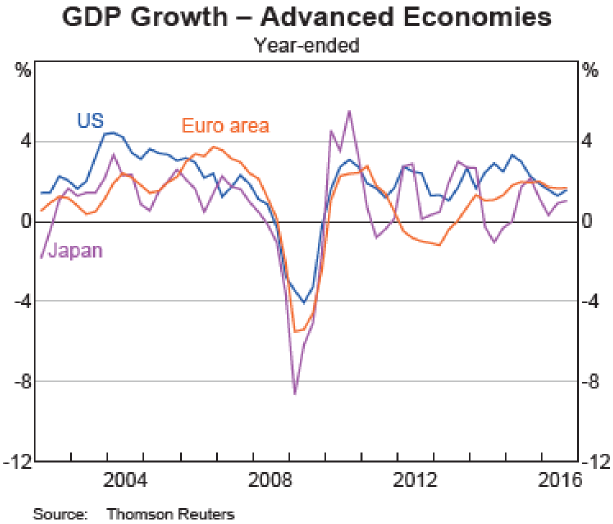
The world awaits President Trump

Much of the December quarter was focussed on the US Presidential elections and now that the outcome is clear, the markets have responded in a positive way, looking forward to a fresh approach to the US political and economic challenges that lie ahead. With President Trump seemingly looking at loosening fiscal measures to assist the growth cycle currently underway, the global share markets are upbeat on the potential outcome for their own economies on the back of any uplift in growth outcomes.

A much-anticipated move by the Federal Reserve Bank (Fed) in the US to raise interest rates by 0.25% to a target range of 0.50% to 0.75% did impact the fixed interest markets in a negative way and have led to a change in perception about the level of interest rates globally.

Global growth expectations are yet to reflect the optimism post the elections and the markets will await the next quarter results to get an early reading on any changes that are introduced by the new administration. The latest GDP data reveals:

Chart 1 & 2



Attention turns to Global Interest Rates

Most economists expect the Fed to retain the current monetary tightening bias and expect US interest rates to move higher over the medium term. They believe that inflation in the US will run around 2% over the next year and this will keep demand for capital tight.

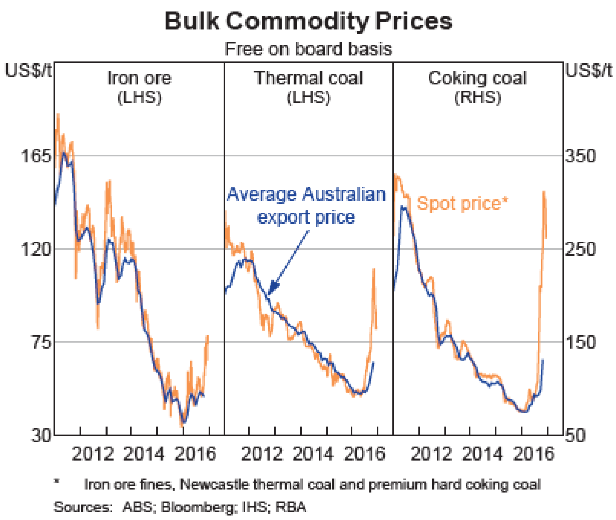
Economic activity expected to improve

The global markets have clearly changed gear and this fresh optimism has given a much-needed boost to growth expectations for 2017. Much depends on what changes are made in the US and how quickly these changes will be converted into company profits.

The "X" factor is likely to be Europe with "Brexit" gaining political concern. For their part, commodity markets continue to improve with iron ore (+40%) and oil (+15%) spot prices showing solid price rises over the quarter which are supporting the share prices in the resources sector.

Regionally the economic data reveals the following:

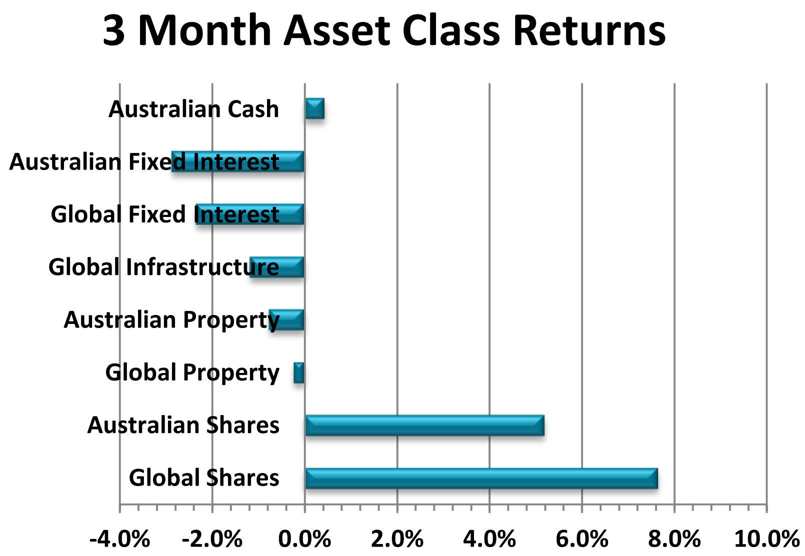
- **United States of America**: The US economy expanded an annualized 1.7% in the second quarter of 2016. The unemployment rate firmed to 4.7%% in December 2016 down from 5.0% in the previous quarter. The unemployment rate hit a nine year low of 4.6% in November 2016 which is likely to have influenced the Fed move;
- **China** flat lined over the previous quarter with the GDP growth rate stabilising at 1.8% over the September 2016 quarter. The annual growth rate was unchanged at 6.7 % with the unemployment rate showing further improvement at 4.04%;
- **Europe** is maintaining the status quo with the GDP growth rate holding 0.3% in December 2016 unchanged from 0.3% previously. Europe's unemployment rate improved to 9.8% for November 2016 which is encouraging along with core inflation up 0.90% in December 2016; and
- **Australia's** latest GDP data for the September 2016 quarter revealed the annual growth rate fell to 1.8% from 3.3% previously. Unemployment rose to 5.7% or 725,230 persons in November 2016 from 5.6% in October 2016. Core inflation remains low at 1.7% in September 2016. Commodity prices are still firm:
  Chart 3



Asset Class Review

The global asset markets ended mixed over the quarter with some solid gains across shares however, the global property and fixed interest assets were impacted by the rising interest rates following the Fed move. The returns achieved were as follows:

Chart 4



Source data: Morningstar, 31 December 2016

Growth Markets

The global share markets were the beneficiaries of capital flows from the rising interest rates and associated sell-off in bond holdings. As mentioned in the last market review, we expected that any sector sensitive to increases in global interest rates (such as bonds and property holdings that are geared) would start to feel the pinch as investors look to pre-empt potential changes in investor sentiment. Trump's surprise win has invigorated share investors as they anticipate an improving economic outlook for the US.

Defensive Markets

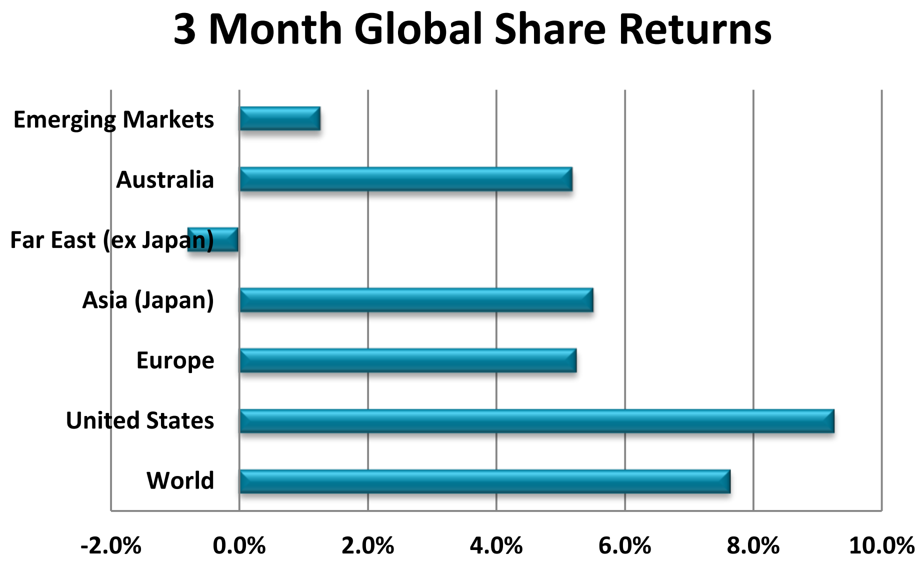
The fixed interest markets felt the brunt of the Fed move but also the change in investor sentiment for fixed interest returns. The Central Banks in Europe and Japan maintained their accommodative stance to monetary policy as their respective economies are yet to experience any real economic benefit from what is anticipated in the US political changes. Interest rate sensitive assets will be subject to periodic weakness if this is the start of a broader based sell off in the bond markets.

Global Share Markets

The global share markets finished strongly over the quarter as they benefitted from the anticipated fiscal changes that the new Trump administration is expected to roll out. Not all regions benefitted from the election result with the Far East markets impacted by talk of trade barriers and tariffs being back on the agenda in the US.

The regional and country returns for the quarter were as follows:

Chart 5



Source data: Morningstar, 31 December 2016

Note: The above returns are reported in Australian Dollars. The AUD/USD exchange rate boosted the returns of global holdings denominated in Australian Dollars by easing from AUD/USD 0.7630 to 0.7236 over the quarter which benefitted investors' offshore holdings in USD by some 5.16%.

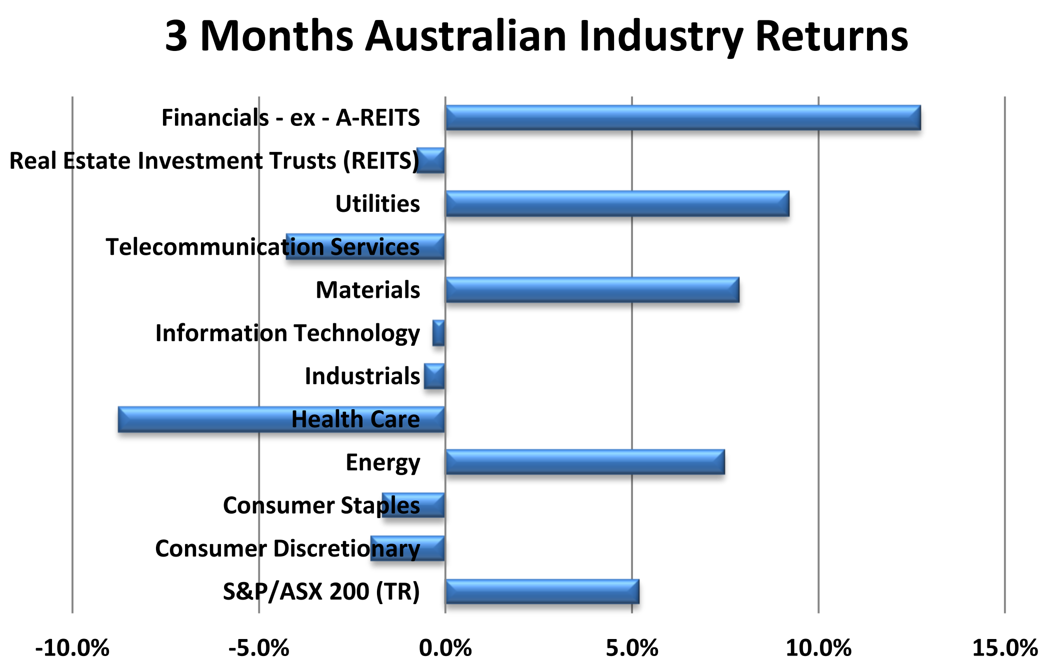
Domestic Share Market

The Australian share market, in total, rebounded 5.19% over the quarter however, not all sectors experienced gains. With commodity prices firming and spot iron ore hitting close to US$80 a tonne, resource based companies were again in demand. In the Materials sector, BHP rallied by 11.97% and RIO put on 16.06% over the quarter. Banks were well supported with CBA up 13.83%, NAB 10.05%, WBC 10.47% and ANZ up 10.10%.

The Healthcare sector was subject to a pullback following a cautious trading update by a minor healthcare company that seemed to impact the share prices in the rest of the sector. The sector is dominated by CSL Ltd (the old Commonwealth Serum Laboratories) which fell 6.16%, Ramsay Healthcare which fell 13.68% and Cochlear which retreated some 13.08%. Most analysts believe the healthcare sector will bounce back as the fundamentals have not changed.

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

Chart 6



Source data: Morningstar, 31 December 2016

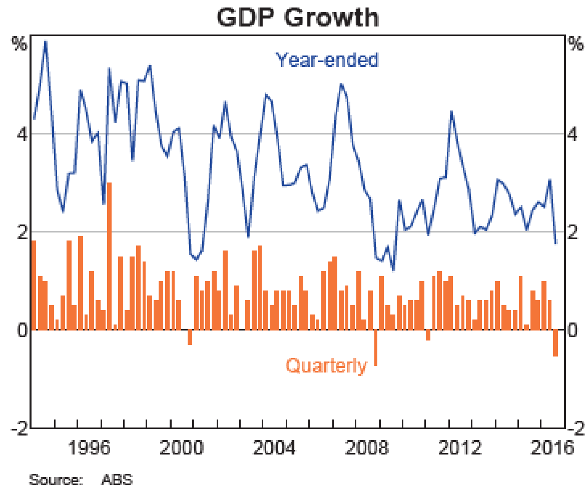
Overall the market signs were very positive leading up to the end of the calendar year and anticipate a solid start to the New Year. More will be known about the short-term direction for the share market when companies start reporting their results for the last six months which are due out shortly.

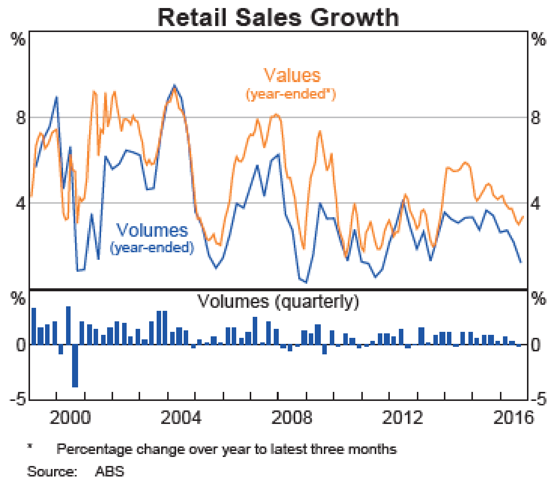
Where to from here?

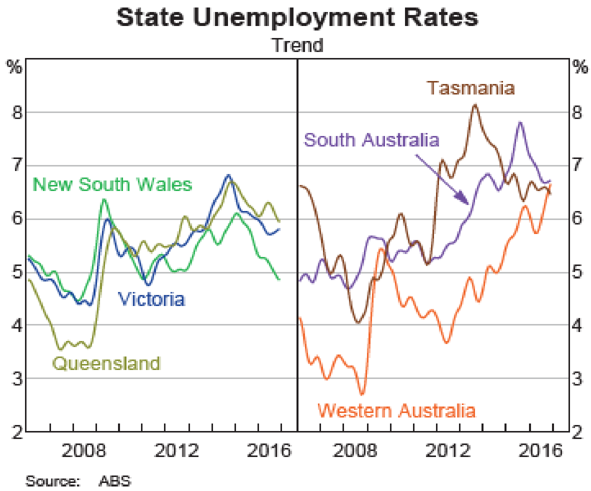
For Australia, the domestic economy remains a key focus as our economy does appear to be out of step with the recovering US market. Measures such as the annual growth in GDP falling to 1.8% and unemployment holding around the 5.7% reveal a soft side to our economic recovery. We do appear to be held back by growth in the region which is under a cloud given the potential change in foreign policy that may be on the agenda in the US. Time will tell how the Trump administration will impact growth down under.

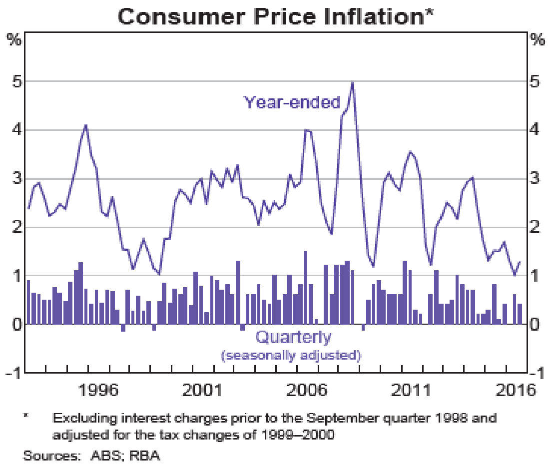
Other economic statistics for Australia revealed the following:

Charts 7, 8, 9 & 10









Economists are in the process of reassessing the view for the next 12 months for the local share market with most anticipating gains for 2017 with early indications seeing the **S&P ASX200 price index trading between 5,150 and 6,250**. This is approximately +/- 9.6% from the closing price level of **5,699.10** for the S&P ASX200 Accumulation Index price as at the end of December 2016.

This seems logical for the upside expectations as GDP growth is expected to be around 2.5%-3% and inflation around 1.5%-2% so by adding company dividends of around 4.5% it gives you a **target of 8.5%-9.5%** for the year. Let's hope we can do better than that.

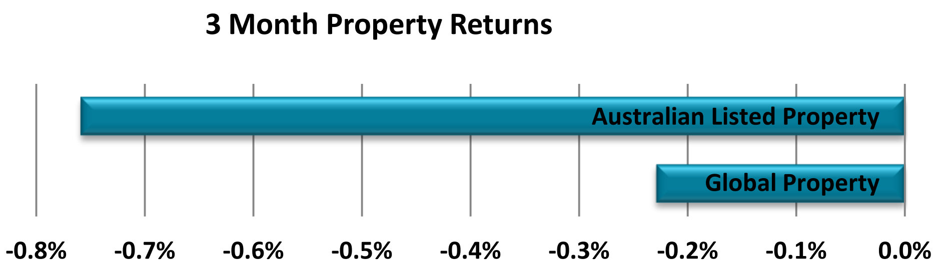
Global and Domestic Property

The Property sector suffered a minor pullback in prices essentially driven by ongoing concern of investors that see the sector as being sensitive to interest rate rises. Most property funds do carry a reasonable level of debt ranging from 20% to 60% which leaves unhedged funds exposed to rising interest rates. In Australia, the listed property sector has returned a respectable 13.14% over the last year.

For long term investor’s, property remains a key element of their growth portfolio exposure given the low levels of correlation with the other asset classes however, with the trend in the US shifting to rising interest rates, the sector may undergo a period of consolidation.

The small falls in prices over the quarter still appear to be profit taking and not a serious correction in the sector however, concerns about the sharpness of the interest rate rises will continue to be a background factor for investors. The recent performance is as follows:

Chart 11



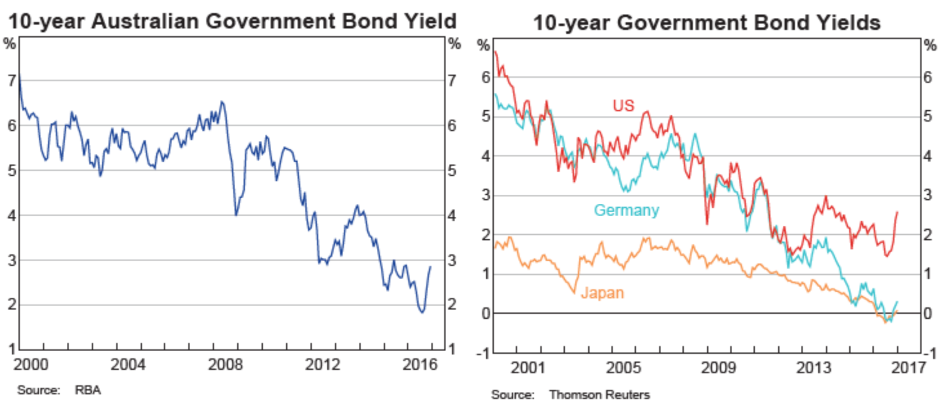
Source data: Morningstar, 31 December 2016

As mentioned previously, rising interest rates will have a negative impact on the sector unless the borrowing costs have been locked in (hedged) or fixed for a defined period.

Global and Domestic Debt Markets

It has been a long time since we have seen such moves in the long-term bond markets which suffered a sharp selloff resulting in negative returns for Fixed Interest markets. In the US, the 10 year US Government Bonds jumped sharply post the election rising to 2.45% from 1.60% and in Australia, the 10-year Government bonds followed suit rising to 2.79% for the December 2016 quarter up from 1.99% at the end of September 2016.

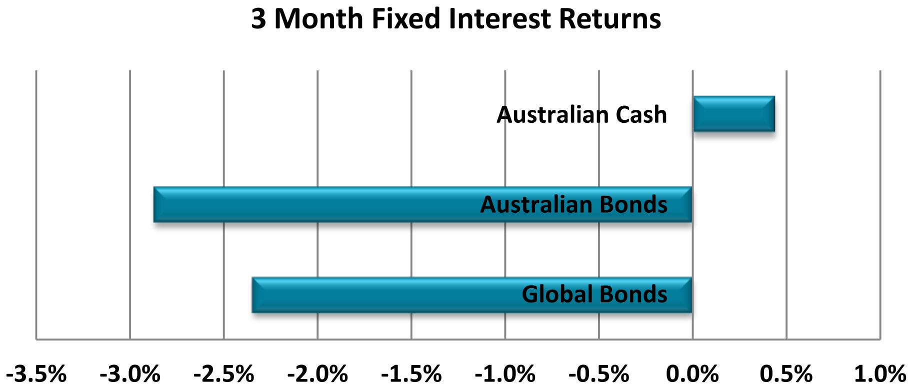
Chart 12 & 13



Source data: RBA, 31 December 2016

The following charts show the impact on the Fixed Interest returns over the quarter:

Chart 14



Source data: Morningstar, 31 December 2016

The Reserve Bank of Australia (RBA) left the target cash rate at 1.5% at the 6th December 2016 meeting. Economists are mixed in their views on the future direction of interest rates with the majority still looking at the possibility of future easing ahead in 2017 if the economy does not start to show signs of growth.

Bond investors will remain nervous as bond prices do not appear to be waiting for the cash rate to change direction instead are being influenced by what is happening offshore, primarily in the US. As demand for capital heats up, so will interest rates.

The AUD has come under pressure from the rising interest rates as speculators anticipated the falling margin between yields in Australia and those in the US finishing the December quarter 2016 at AUD/USD 0.7236. The currency fell sharply from AUD/USD 0.7630 at the end of September 2016 to finish 5.16% lower for the quarter. This assisted the returns for offshore investors and exporters but imports were expected to be more expensive. The currency is expected to trade within the **range of AUD/USD 0.6500 to 0.8500** medium term.

What lies ahead for global interest rates?

All eyes are on the US with the new President Trump expected to rein change on the US economy in line with his mandate for office. Most of the change being touted throughout the election is to do with fiscal policy, tariffs and immigration.

In line with the Federal Reserve Bank tightening monetary policy bias, the Federal Open Market Committee (FOMC) voted to lift the target range for the federal funds rate to 0.50% to 0.75% just before the elections. This move was anticipated but felt it may be delayed by the elections, no so.

In contrast, no change for Japan and the European Central Bank who are **maintaining their quantitative easing** policy, holding interest rates low, in their attempts to rekindle growth in their economies.

What lies ahead for domestic interest rates?

For Australia, given the now clear direction for rising US interest rates, there is a likelihood that the RBA will put its monetary policy plans on hold rather than consider further reductions in the cash rate.

The problem remains that the RBA may have to maintain the low cash rates to help the economy grow however, the wholesale credit markets have a different agenda and are responding to global demand pressures for capital.

Many of the Australian Banks rely heavily on funding any shortfall in their lending needs from offshore sources. The cost of this capital is rising and these costs will be passed on to borrowers via higher interest rates.

Summary

Short Term – now to 1 year

In the short term, **interest rates will be the focus** and are likely to experience periods of price volatility as the bonds yields rise. This can potentially benefit the local share market but cause problems for companies carrying high levels of debt.

The mood change in interest rates is an early signal that **the asset allocation** of client portfolios may need to reflect strategic targets for Fixed Interest investments and potentially, tactically tilt towards underweighting the at-risk asset class. Small companies or Infrastructure exposure may provide the alternative to large cap shares. Any **excess cash** held in the portfolio from recent dividends or distributions received, should be invested.

Medium Term – 1 year to 3 years

In the medium term, with the shift away from overweight fixed interest positions the problem is where will the growth opportunities emerge? In Australia, mid cap and small cap stocks have done much better than the large cap stocks over the past year and **diversification across the sector** may provide such opportunities. The larger companies look expensive when compared to some smaller companies in similar industries. Again, the debt level of the companies (large or small) will need to be considered.

Longer Term – 3 years to 10 years

The global economy is expected to be patchy with many placing big bets on the recovery underway in the US. The risks here are that the new Trump administration is unable to make the desired changes quickly enough to satisfy the expectations of investors. Europe is still under a cloud with Brexit now starting to impact the broader EU support. It will be interesting to see if the US recovery can provide the catalyst to help kick-start the global economy. Fingers crossed it can.

Key Message

Check Fixed Interest Exposure: With interest rates in the US rising, global markets will also be drawn into the mix as competition for capital heats up. Portfolio exposure to the Fixed Interest rate markets should reflect a client's strategic weights with potentially a move towards an underweight position on the cards should interest rates start to show signs of ongoing softening (rising interest rates).

Consider adding to Growth Assets: For Australia, opportunities will emerge as the six-monthly company reporting period starts and updates are received regarding guidance, in terms of their underlying earnings and profitability. We are reviewing cash holdings along with company results in each industry to consider where the opportunities may lie and if any changes to the current investment strategy are required, we will communicate these direct.

For Global exposures, Emerging Markets (EM) exposure remains on the radar especially with the currency holding neutral territory around the AUD/USD 0.7500 level. The diminishing interest rate differential between Australia and the US may also weigh on the AUD which will benefit investments in AUD/USD offshore. One of the risks for EM exposure is that any protectionism measures considered by the US may hinder growth prospects for some to the emerging countries that are directly linked to providing outsourced manufacturing.

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Data Sources

Where indicated in this review, the underlying data was sourced from Morningstar on the 26th January 2017.

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
AUD/USD	Australian Currency

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