Financial Planning

Quarterly Market Review – March 2017

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

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Overview

Markets continue to show support for Trump

The global markets continue to favour the potential for growth outcomes post the new President Trump administration in the US. Analysts are focussed back on economic fundamentals rather than responding to political events which have dominated the previous quarter's market direction and are optimistic about what lies ahead.

While President Trump forges a new agenda for policy in the US, the Central Banks in Europe and Japan have retained their Quantitative Easing (QE) programmes committed to stimulating growth for their own economies.

The Fed continues tightening bias for Monetary Policy in the US

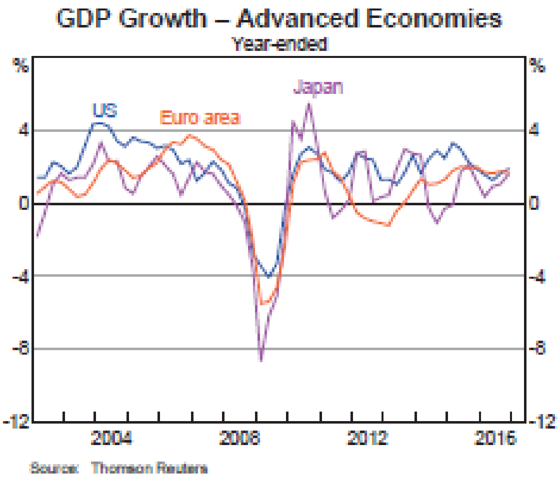
The recent moves in March 2017 by the Federal Reserve Bank (Fed) in the US to raise interest rates by another 0.25% to a target range of 0.75% to 1.00% failed to influence fixed interest markets adversely as the move was largely expected and did not result in any dramatic shift in interest rates or the investment appetite for shares.

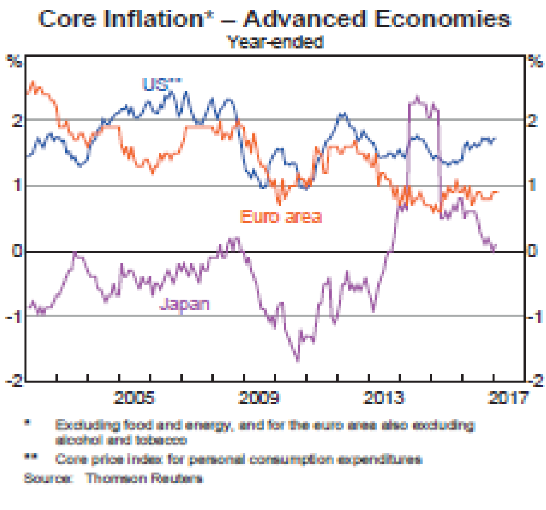
Global markets hold steady

With the conflict in Syria a distraction, it is probably too early to see a trend developing post the US elections for global growth and/or inflation as there has been little time to react however, analysts are watching closely any economic data updates to gauge how each region and more importantly, the underlying industry sectors, are progressing.

The latest GDP data reveals:

Chart 1 & 2





Economic activity expected to improve

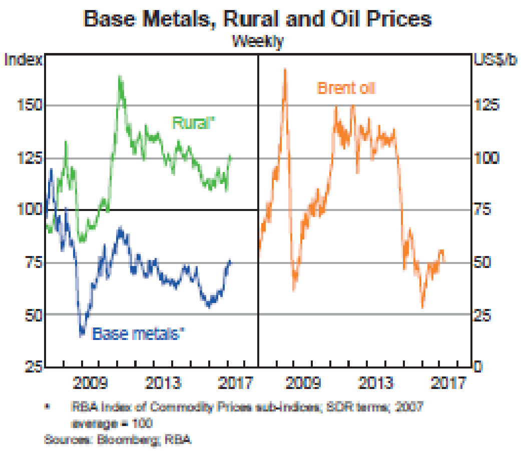
The global share markets have responded positively to what was broadly a reasonable company reporting season by drifting higher in most sectors. Time will tell if there are going to be any surprises in the future direction for US policy but globally the "X" factor is still likely to be Europe with "Brexit" and the fallout for the United Kingdom a concern.

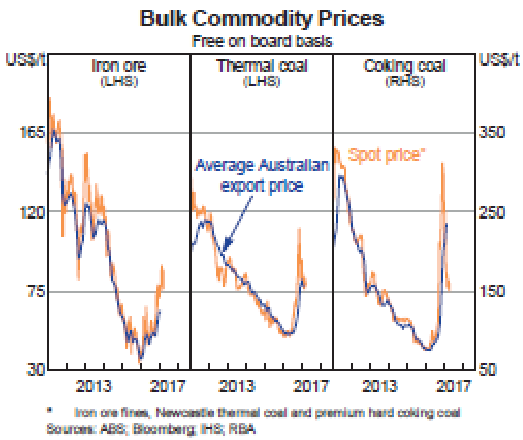
Commodity markets were mixed with spot prices for iron ore (+8.89%) and oil (-9.52%) over the quarter which resulted in mostly neutral returns for the resources sector.

Regionally the economic data reveals the following:

- **United States of America**: The US economy expanded an annualized 2.0% in the fourth quarter of 2016. The unemployment rate fell to 4.5%% in March 2017 down from 4.7% in the previous quarter. The unemployment rate was the lowest jobless rate since 2007 which may have added weight to the Fed move;
- **China** held steady over the previous quarter with the GDP growth rate stabilising at 1.7 % over the December 2016 quarter. The annual growth rate year-on-year was 6.8 % with the unemployment rate showing further improvement to 4.02%;
- **Europe area** is maintaining the status quo with the GDP growth rate improving slightly to 0.4% in December 2016 from 0.3% previously. Europe's unemployment rate improved to 9.5% for February 2017 which is encouraging however core inflation only up 0.7% in March 2017 slightly lower than December 2016; and
- **Australia's** latest GDP data for the December 2016 quarter revealed the annual growth rate of 2.4% from a revised 1.9% previously. Unemployment rose to 5.9% or 748,100 persons in February 2017 from 5.7% in January 2017. Core inflation however drifted lower to 1.6% in December 2016. As mentioned, commodity prices were mixed:

Chart 3 & 4

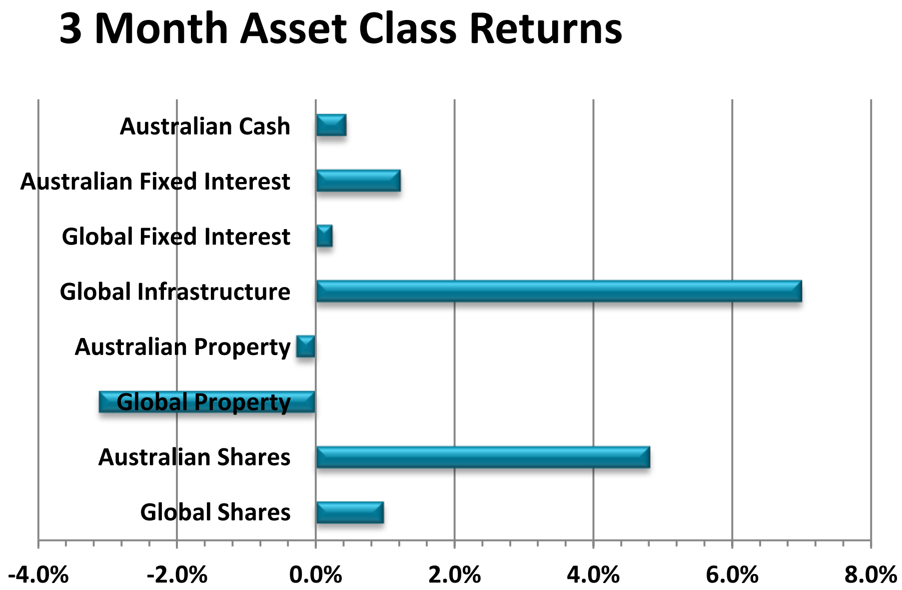




Asset Class Review

The global asset markets were mostly positive over the quarter with modest gains in fixed interest, shares and infrastructure however, the global property assets were impacted by the potential for further rises in interest rates following the Fed move. The returns achieved were as follows:

Chart 5



Source data: Morningstar, 31 March 2017

Growth Markets

The global share markets responded well to the more upbeat company reporting season and a period of low volatility and relative stability on the political front. Global Property saw profit taking emerge partially influenced by the potential for higher borrowing costs post the Fed move. The Dow Jones Industrial Average (DJIA) reached a record high of 21,115 on the 1st March 2017 following President Trump's first address to a joint session of Congress.

Defensive Markets

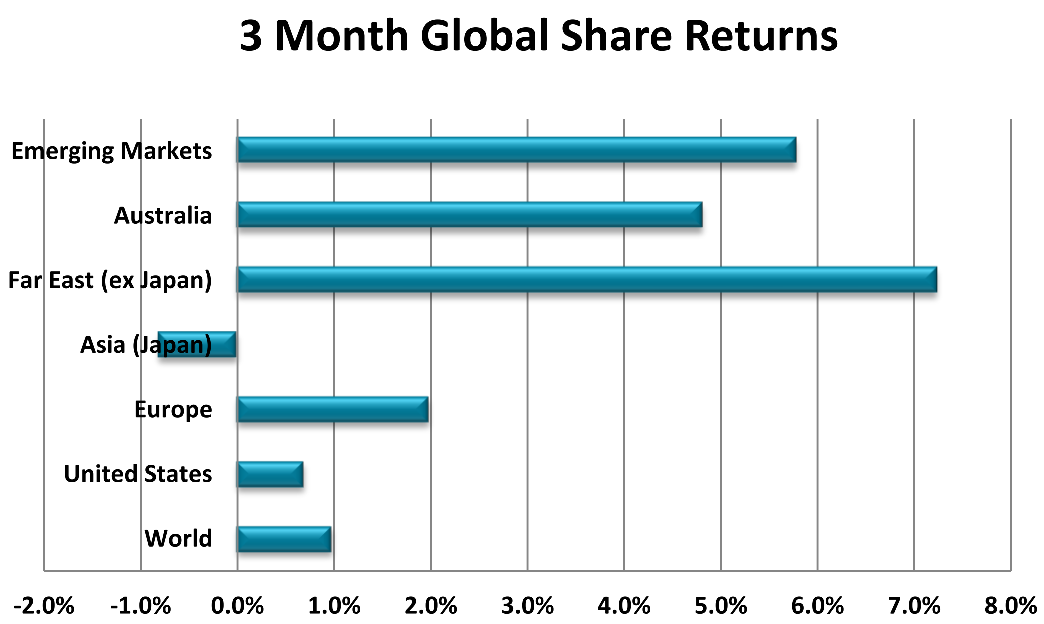
The fixed interest markets weathered the Fed move in its stride as the move was largely expected. The Central Banks in Europe and Japan maintained their accommodative stance to monetary policy as their respective economies are yet to experience any real economic benefit from what is anticipated in the US political changes. Interest rate sensitive assets will remain under pressure and be subject to periodic weakness as the bond markets digest the Fed moves.

Global Share Markets

The global share markets mostly finished strongly over the quarter as investors focussed on the beneficiaries of growth namely the Emerging Markets and the Far East (China). Not all regions benefitted from growth expectations with Japan impacted by their end of the financial year with offshore investors taking profits and selling down some of their holdings before the end of the Japanese financial year.

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

Chart 6



Source data: Morningstar, 31 March 2017

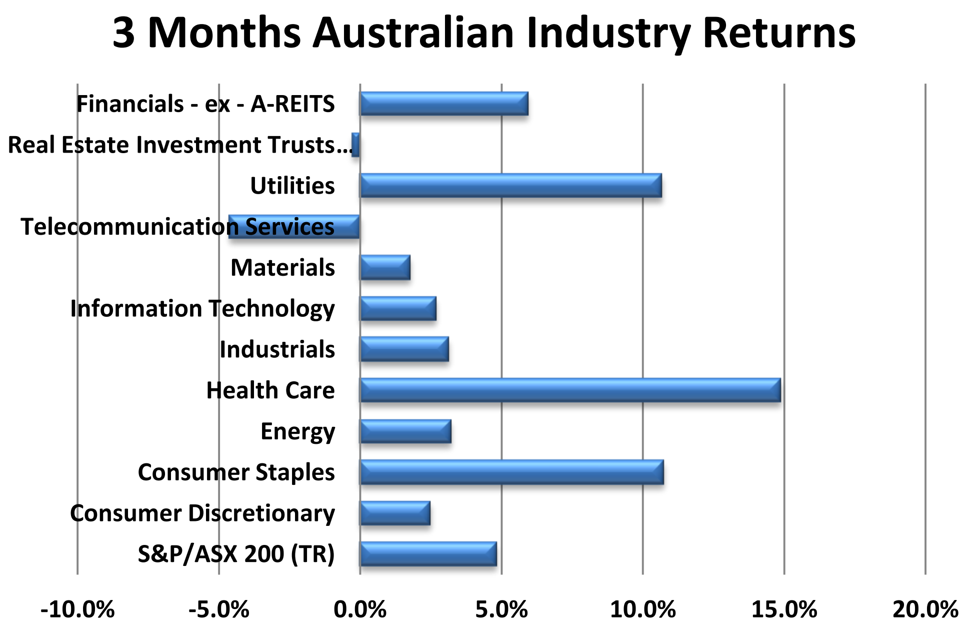
Note: The above returns are reported in Australian Dollars. The AUD/USD exchange rate hurt the returns of global holdings denominated in Australian Dollars by strengthening from AUD/USD 0.7236 to 0.7644 over the quarter which cost investors' some 5.64% in returns.

Domestic Share Market

The Australian share market, in total, gained 4.81% over the quarter however, not all sectors experienced gains. With commodity prices ending mixed, resource based companies took a back seat with the Healthcare sector taking the lead and gaining 14.88% over the quarter retracing most of the previous quarter's losses.

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

Chart 7



Source data: Morningstar, 31 March 2017

Overall the market negotiated the reporting season without too many surprises and is now looking forward to the year ahead with some optimism.

Where to from here?

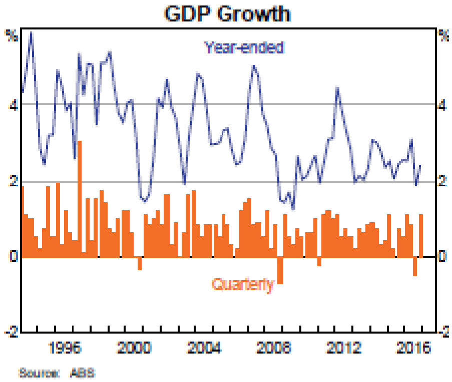
With the Government Budget just around the corner, much of the political focus is on revenue and controlling the level of Government spending. With much discussion around tax, super and negative gearing, the broader market is likely to be distracted until we get a better handle on what is being proposed. Changes to the company tax rate would be helpful but where does the money come from?

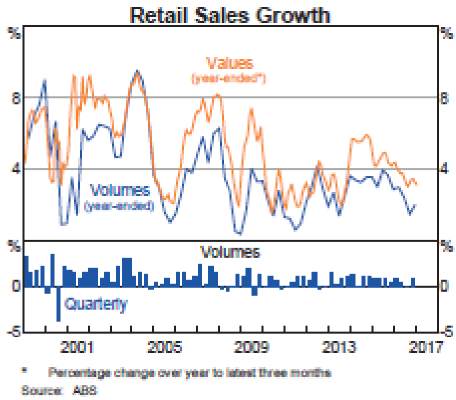
Our economic recovery does appear to be out of step with the US market and more closely linked to Japan and China than Europe. The investment activity in the Emerging Markets (EM) seems to point to an expected improvement in the growth prospects of the developed markets as the EM economies depend heavily on what is happening within these centres of influence to prosper.

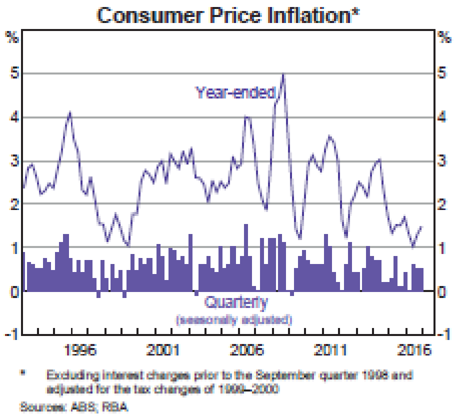
Unemployment is expected to rise near term to 6.0% as demand for part time employment outpaces full time employment. Ideally monetary policy would continue to be used to help provide a low-cost environment for businesses to borrow and expand however, with the high prices of residential housing, the Authorities are reluctant to move in that direction for fear of an asset bubble emerging.

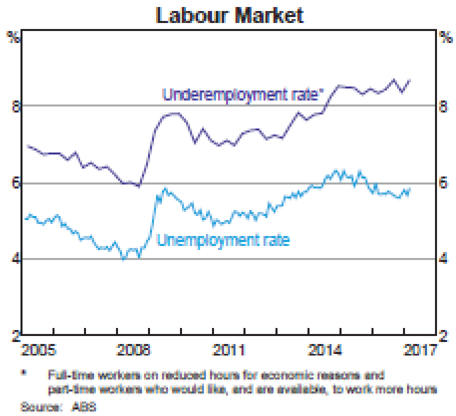
Other economic statistics for Australia revealed the following:

Charts 8, 9 10 & 11









Based on the historical volatility of the Australian share market, expectations are for the **S&P ASX200 price index to trade between 5,300 and 6,475**. This is approximately +/- 9.5% from the closing price level of **5,864.90** for the S&P ASX200 Accumulation Index price as at the end of March 2017.

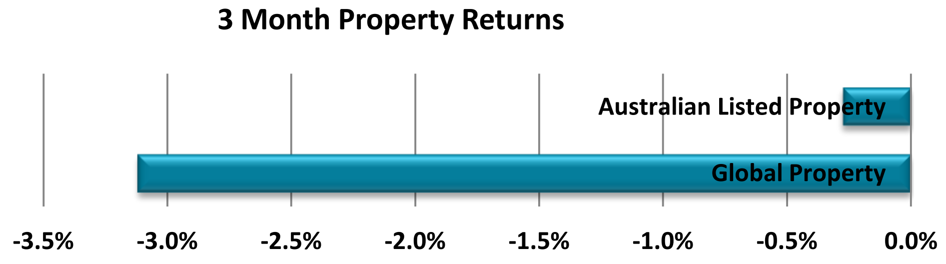
Global and Domestic Property

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. Global property returns would have also been impacted by the strength of the AUD/USD over the quarter.

Property is a long-term investment strategy which remains a key diversifier within an investors growth portfolio given the low levels of correlation with the other asset classes however, with the rising interest rate environment in the US, the asset class may undergo a period of consolidation and potential weakness although the yield may improve.

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 12



Source data: Morningstar, 31 March 2017

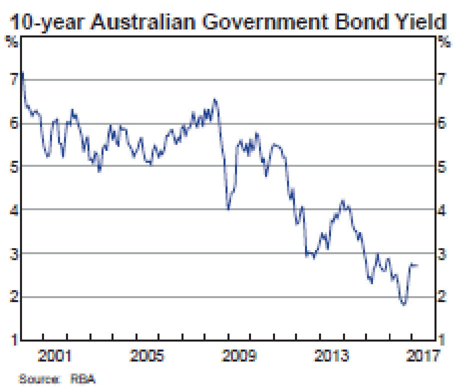
As mentioned previously, rising interest rates will have a negative impact on the sector unless the borrowing costs have been locked in (hedged) or fixed for a defined period.

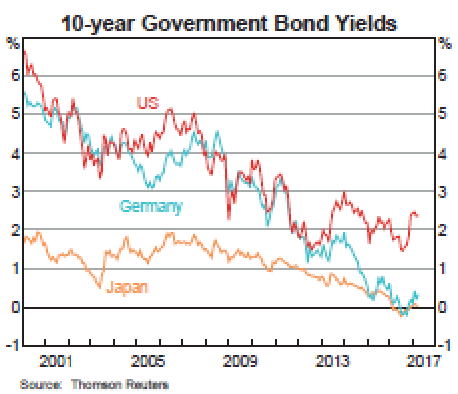
Global and Domestic Debt Markets

Global debt markets stabilised and managed a small rally over the quarter after the sharp sell-off in the December quarter 2016. The sell-off in December was in response to the expectations for enhanced growth and rising inflation post Trump. We think the markets got ahead of themselves as it will take time to gauge the impact of the policy moves but investors appear to be backing the delivery of his early election promises.

The 10 year US Government Bonds firmed to 2.39% from 2.45% and in Australia, the 10-year Government bonds followed suit easing to 2.72% for the March 2017 quarter down from 2.77% at the end of December 2016.

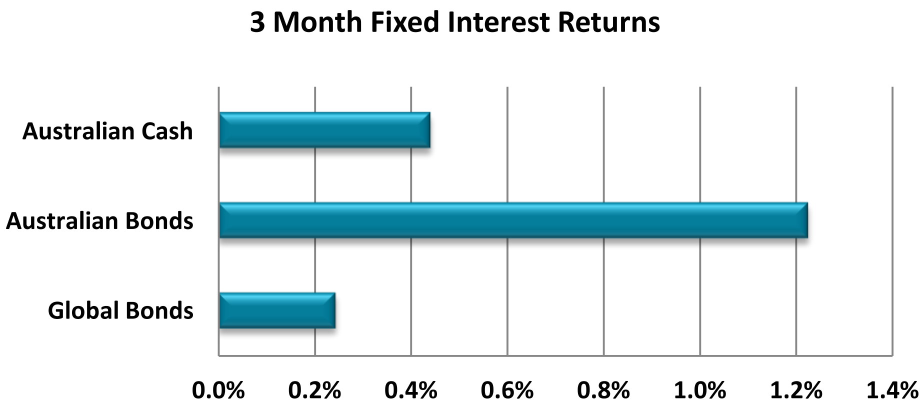
Chart 13 & 14





The following charts show the returns of the Fixed Interest asset class over the quarter:

Chart 15



Source data: Morningstar, 31 March 2017

The Reserve Bank of Australia (RBA) left the target cash rate at 1.5% at the 7th March 2017 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 with interest rates offshore, primarily in the US. As demand for capital heats up, so will interest rates.

The AUD rallied as commodity prices rebounded strongly and export earnings jumped finishing the quarter at AUD/USD 0.7644 up from 0.7236 at December 2016 quarter end. 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?

In line with the US Fed monetary policy bias, the Federal Open Market Committee (FOMC) continued to **maintain their tightening bias** and lifted the target range for the federal funds rate to 0.75% to 1.0% in March 2017. The Fixed Interest markets held their ground and consolidated as most of this move was factored into the current bond prices. We expect much of the same sideways move this next quarter but the trend now is for higher interest rates longer term.

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, the RBA has put its monetary policy plans on hold rather than consider further reductions in the cash rate preferring to wait and see how the economy responds over the next quarter. We expect **no change to the cash rate** in the near term.

Many of the Australian Banks are restricting investment loans due to balance sheet restrictions imposed by the regulator, APRA as they try and slow the pace of housing prices. Investment loan interest rates have risen but the non-bank lenders are still open for business and appear to be fulfilling this gap in demand for property buyers.

The cost of capital is rising and eventually these costs will be passed on to borrowers via higher interest rates which will also have an impact on housing affordability.

Summary

Short Term – now to 1 year

In the short term, interest rates will continue to respond to **the demand pressures of the domestic housing market.** Moves by the regulators **to restrict investment lending to housing will push certain loan rates higher.** This can potentially benefit the local bank share prices as their lending margins improve.

The consolidation in interest rates over the quarter is deemed to be temporary and the trend now is shifting towards a bear market in bonds. Some rebalancing may be required to remove any unintended bias in your asset allocation in your portfolio. Any **excess cash** held from recent dividends or distributions received, **should be invested**.

Medium Term – 1 year to 3 years

In the medium term, tactical tilts towards alternative defensive assets away from traditional fixed interest positions towards credit should be considered. 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 asset class** may provide opportunities to capture this growth. 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 and regionally diverse with much of the interest focussed on what happens next in the US. **Political conflict may be the "X" factor this quarter as the conflict in Syria heats up.** Let's hope common sense prevails.

Europe is still in recovery mode with Brexit a distraction. Like Australia, the EU region is also out of step with the US recovery however conditions are slowly improving. Look for the share markets to show the way in the next quarter.

Key Messages

Check cash levels: With share markets achieving new highs and interest rates in the US rising, portfolio asset allocation should be reviewed to ensure the underlying exposure reflects your risk profile **without any unintended risks**. Fixed Interest holdings should reflect your 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 are emerging post the company reporting season with results now known as to the underlying profitability and guidance on future earnings. Analysis is underway of the various industries and expectations for the year ahead. Should changes be required to your portfolio we will contact you direct.

For Global exposures: As expected, US shares remain well supported along with Emerging Markets (EM). Europe is showing signs of life but progress is slow. The AUD/USD strength over the quarter did take the wind out of the returns but this is not expected to cause problems longer term.

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.

To counter this, the optimism for the sector gives confidence **that investors see strength in the developed markets** who are the prime movers when it comes to EM productivity and growth prospects.

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Data Sources

Where indicated in this review, the underlying data was sourced from Morningstar on the 10th April 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