Financial Planning

Quarterly Market Review – June 2017

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Contents

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

Overview

Markets disrupted by Geopolitical Risks

The global markets finished the year mixed over the last twelve months as shares did well but property finished in negative territory. Politics stole the limelight in the June quarter with investors sidelined, most likely distracted by the noise, which has tended to mildly disrupt the economic recovery underway. Much of the attention seemed to be focussed on:

- President Trump and the latest tweets;
- Korea's Kim Jong-un and the latest missile tests;
- The conflict in Syria;
- Theresa May and Britain's exit from the European Union; and
- The elections in France and the Nederland's.

With so much noise, who could blame investors for taking a breather and sitting back trying to make sense of how the real economy is tracking. When the dust settled, amazingly enough, investors have remained optimistic about the global recovery assisted by the lacklustre volatility which has remained relatively subdued throughout the period as global and domestic equities along with bond yields, traded within narrow ranges.

Monetary Policy

On the monetary front, the Bank of Japan retained their Quantitative Easing (QE) programme while the European Central Bank modified their programme by reducing the level of bond support from EUR80 billion per month to EUR 60 billion per month, both remain committed to stimulating growth in their respective economies. The Federal Reserve (Fed) in the US gently nudged their targeted cash rate higher.

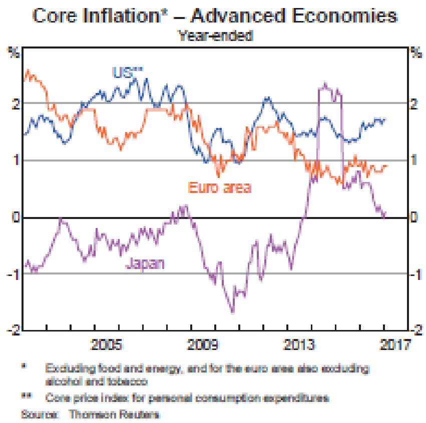
On the 14th June 2017, the Fed raised interest rates by another 0.25% to a target range of 1.00% to 1.25%. The central bank's decision comes after lots of signs that the U.S. economy is in good shape. The unemployment rate fell to 4.3% in May, its lowest level since 2001. The economy has added jobs for 80 consecutive months.

Global markets unsettled

With all the noise surrounding the issues mentioned earlier, markets experienced a late kick up in volatility towards the end of the financial year by some last-minute positioning that some analysts put down to tax loss selling and others to preparing for the cash distributions for trusts and ETF's that need to be paid out in cash post June 30. All in all, it was reasonably orderly and the market has since recovered somewhat.

The latest GDP and Inflation data reveals:

Chart 1 & 2



Economic activity expected to improve

The global markets finished the year mixed but over the year, shares were the best performer delivering returns of 14% plus despite the sell-off experienced in the June quarter. We expect the markets will track higher over the next two quarters and the dividends and distributions are re-invested. We will watch closely the company profits results expected over July/August to get a sense of what sectors are recovering best.

Commodity markets were mixed with spot prices for iron ore falling sharply over the quarter (-35.5%) but managing to finish in the black for the year (+12.66%) in USD terms. Oil also fell (-8.47%) over the quarter and ended up negative for the year (-5.58%) which resulted in mixed outcomes for the companies relying on the resources sector overall.

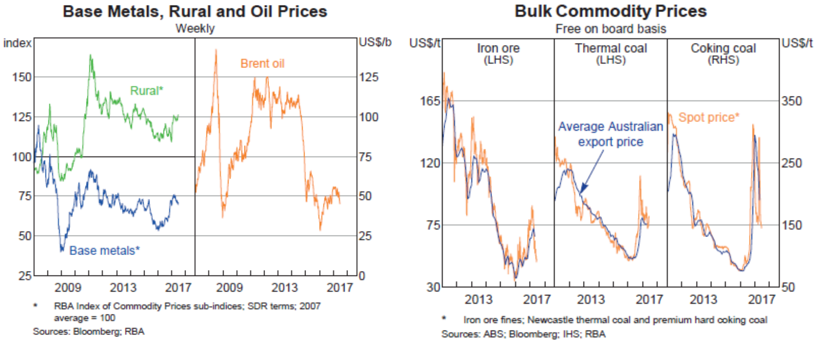
Regionally the economic data reveals the following:

- **United States of America**: The US economy in GDP terms to expanded by an annualized 1.4% in the first quarter of 2017. The unemployment rate fell to 4.4%% in June 2017 down from 4.5% in the previous quarter.
- **China** drifted lower over the quarter with the GDP growth rate coming in at 1.3 %. The annual growth rate year-on-year was 6.9 % with the unemployment rate showing further improvement to 3.97%;
- **Europe area** is maintaining the status quo with the GDP growth rate improving to 0.6% in March 2017 from 0.4% in the previous quarter. Europe’s unemployment rate improved to 9.3% for May 2017 which is encouraging, along with core inflation climbing by 1.1% in June 2017 slightly higher than 0.9% in May 2017; and
- **Australia’s** latest GDP data for the March quarter 2017 revealed the annual growth rate of 1.7% from 2.4% previously. Unemployment fell to 5.5% or 711,900 persons in May 2017 from 5.9% in March 2017. Core inflation lifted to 1.9% in March 2017.

Commodities

As mentioned earlier, commodity prices were mixed over the year with iron ore finishing close to US$58 per metric ton (+12.66%) and thermal coal at $81 per metric ton (+52.25%) over the year to June 2017 with demand still evident from global consumers such as China:

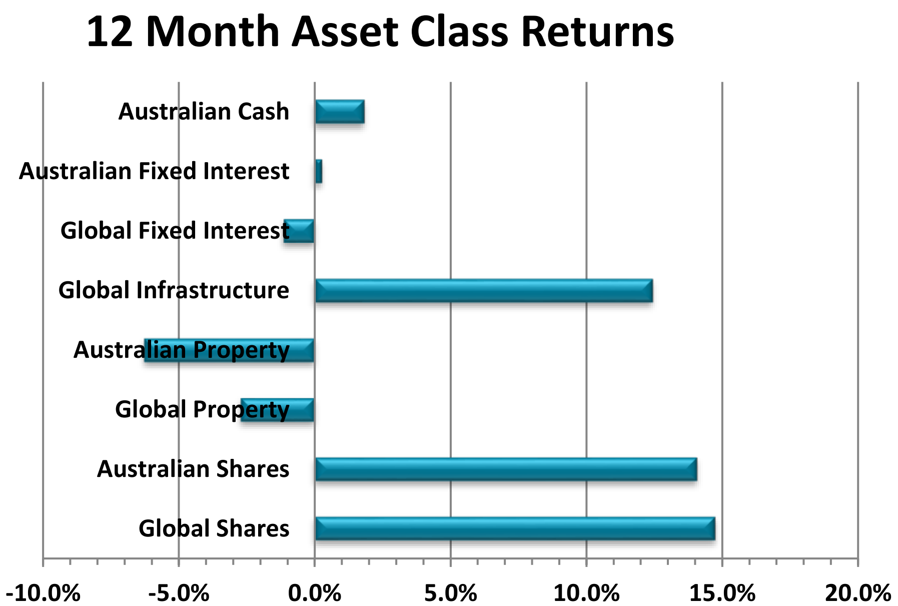
Chart 3 & 4



Asset Class Review

The global markets were mixed over the year with strong gains in shares and infrastructure assets however, the global property assets and the fixed interest assets were impacted by the fears of further rises in interest rates following the Fed's shift to a tightening bias. The returns achieved were as follows:

Chart 5



Source data: Morningstar, 30 June 2017

Growth Markets

The global share markets continued their advance on the back of improving economic conditions. Global Property was impacted by the rising commercial interest rates despite the efforts of the Central Banks of Japan and Europe to hold rates low for the time being.

Defensive Markets

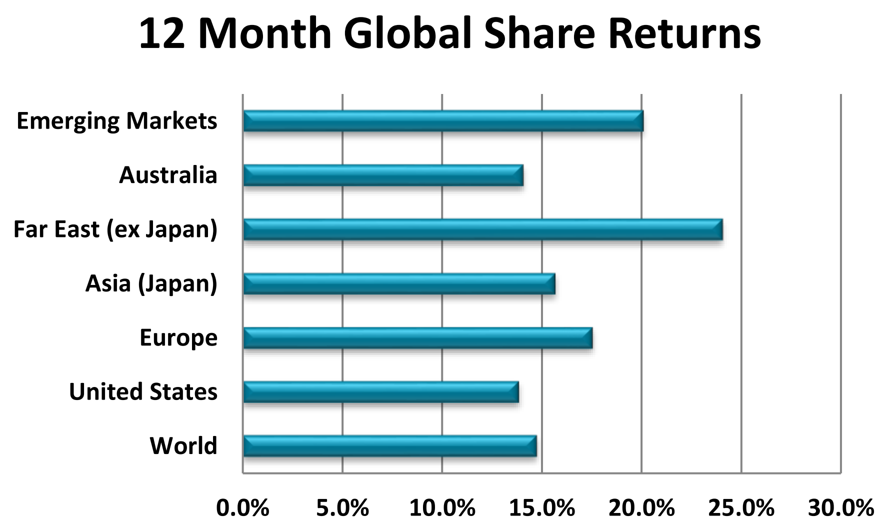
The fixed interest markets began to feel the impact of the Fed's tightening of monetary policy and the creep in interest rates. Despite the efforts of the Central Banks in Europe and Japan, commercial demand for capital is improving and along with it the level of interest rates. Interest rate sensitive assets will remain under pressure and be subject to periodic weakness as the bond markets adjust to the changing credit conditions.

Global Share Markets

The global share markets finished the year in positive territory but suffered a sell off late in June partially due to what some analysts believe to be tax loss selling and balance sheet adjustments prior to financial year end. Emerging Markets and the Far East (China) featured well in what was a solid result across the asset class mirroring the economic sentiment.

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

Chart 6



Source data: Morningstar, 30 June 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 0.7426 to 0.7692 over the year which cost investors' some 3.58% in returns.

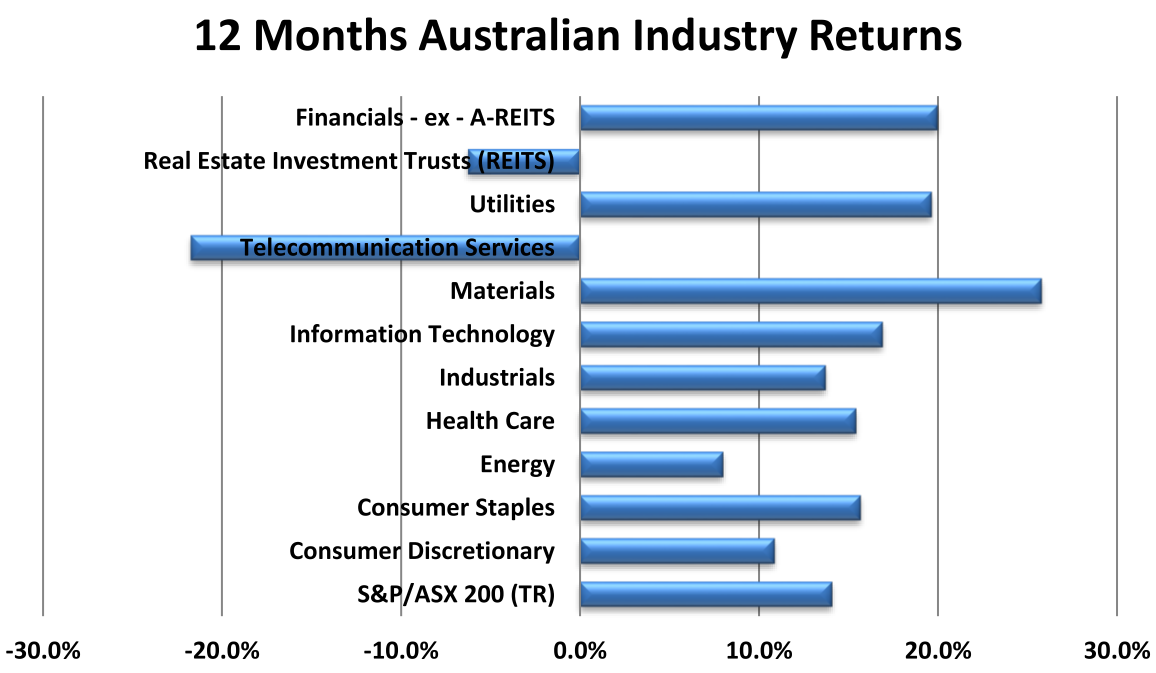
Domestic Share Market

The Australian share market lost 1.58% over the June quarter however, in total, gained 14.09% over the year. Not all sectors experienced gains with Telecommunication stocks taking a tumble as trends in mobile and fixed-line broadband hit home which is reflective of the heightening competitive pressure evident across all companies in that sector. REITS (listed property) were also impacted by interest rate expectations as mentioned previously.

Commodity prices ending mixed for the year however, resource based companies were back in favour adding an impressive 25.79%. Financial stocks added 19.98% along with utilities 19.64% featured strongly with impressive support from investors.

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

Chart 7



Source data: Morningstar, 30 June 2017

Overall the share market has a positive bias and investors are now looking forward to the year ahead with some optimism.

Where to from here?

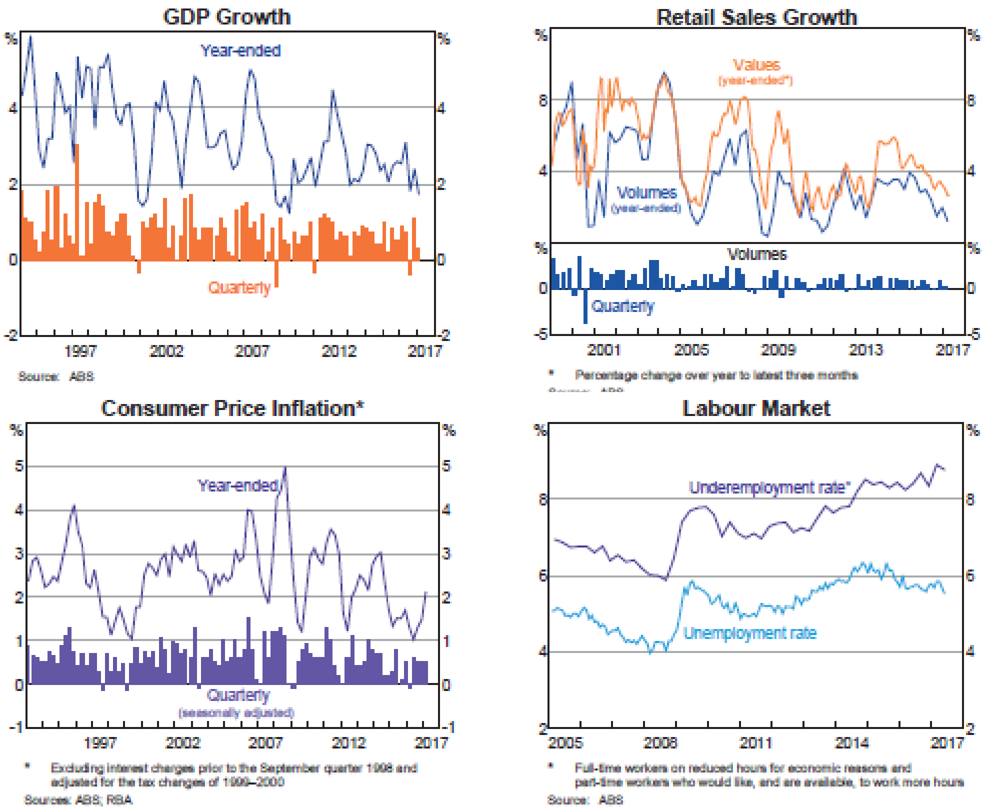
With the Government more interested in political infighting, the economy will look for a lead from offshore, especially what is happening in the US, Europe and China. Infrastructure spending is expected to support industry with jobs longer term with most of the optimism coming from the buoyant domestic housing market.

Our economic recovery has remained soft with the lead still coming from the US market and the recent signs of life in Europe. The investment activity in the Emerging Markets (EM) has resulted in improving market conditions on the back of the developed markets recovery.

For Australia, the domestic housing market is still driving economic activity which is supporting the mild recovery in the jobs market with unemployment showing signs of improvement. Monetary policy is on hold with low growth in wages offset by the high prices being achieved for residential housing.

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 5,200 and 6,265**. This is approximately +/- 9.5% from the closing price level of **5,721.50** for the S&P ASX200 Accumulation Index price as at the end of June 2017.

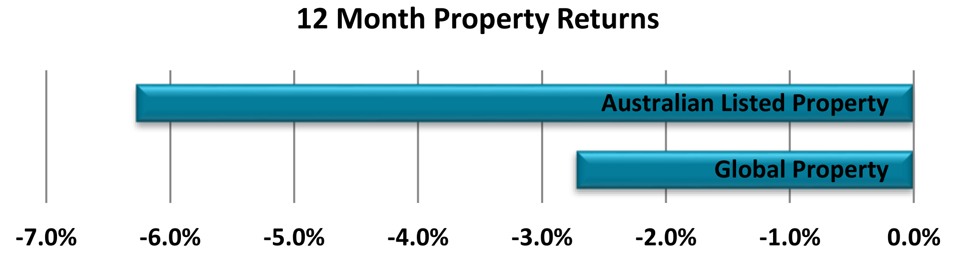
Global and Domestic Property

The Property sector struggled to gain any momentum higher plagued by the belief that the market is sensitive to interest rate rises. Most property funds do carry a reasonable level of debt ranging from 20% to 60% which means that for variable rate loans, rising interest rates will impact returns by reducing the rental pool available to pay dividends with the higher interest costs being incurred. Global property returns would have also been impacted by the strength of the AUD/USD over the quarter (+0.63).

As mentioned previously, 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, in a rising interest rate environment, the asset class may undergo periods of valuation weakness.

The falls in prices over the June quarter (-3.41) hurt the sector confidence however, concerns about future interest rate rises will continue to be a background factor for investors. The annual performance is as follows:

Chart 12



Source data: Morningstar, 30 June 2017

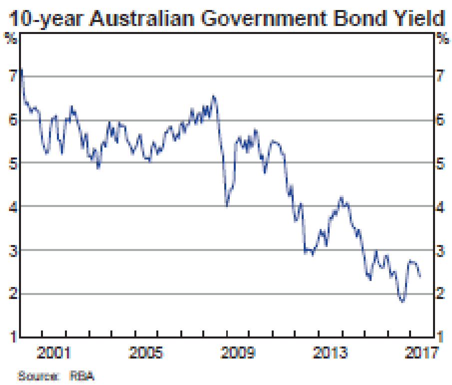
As mentioned previously, rising interest rates will have a negative impact on the sector unless the borrowing costs have been locked in (hedged) or fixed for a defined period.

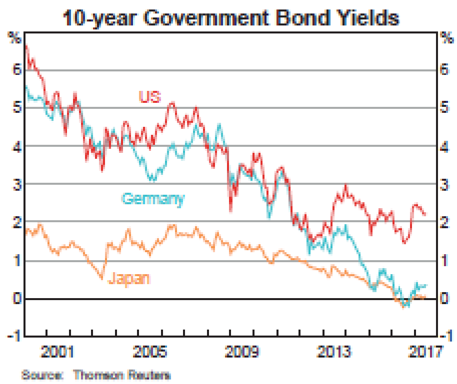
Global and Domestic Debt Markets

Global debt markets managed a small positive outcome over the quarter (+1.01%) as price falls offset the income received from bond coupons resulting in a negative result over the year (-1.15%).

The 10-year US Government Bonds firmed to 2.30% from 2.39% and in Australia, the 10-year Government bonds followed suit easing to 2.60% for the June 2017 quarter down from 2.72% at the end of March 2017.

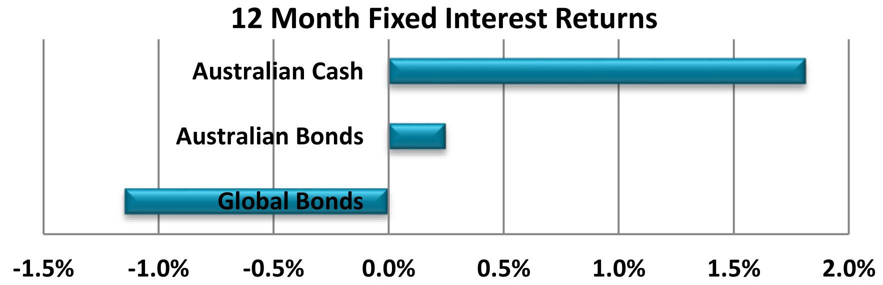
Chart 13 & 14





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

Chart 15



Source data: Morningstar, 30 June 2017

The Reserve Bank of Australia (RBA) left the target cash rate at 1.5% at the 6th June 2017 meeting. Economists believe we are in for a period of flat low interest rates with any talk of easing put on hold given the strength of the domestic housing market.

Bond investors are bracing for the impact on domestic interest rates given the rising interest rates offshore, primarily in the US. Corporate demand for capital is rising also and if inflation kicks in then, further interest rate rises are expected.

The AUD rallied as commodity prices rebounded strongly and export earnings jumped finishing the June quarter at AUD/USD 0.7692 up from 0.7426 at June 2016. 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?

The Federal Open Market Committee (FOMC) continued to **tighten US Monetary Policy** and lifted the target range 0.25 basis points for the federal funds rate to 1.00% to 1.25% in June 2017. The Fixed Interest markets had factored the rise into the future bond prices which in yield terms, have risen sharply over the year from 1.45% to 2.30% (-56.2%).

Given the sharp rise last year and the resultant impact on the US economy, the Fed may elect to mitigate the rate of change over the year ahead so that it does not slow the growth in the economy too much.

In contrast, no change for monetary policy targets in Japan however, the European Central Bank has reduced **their quantitative easing** policy in April 2017 to EUR60 billion per month from EUR80 billion previously.

What lies ahead for domestic interest rates?

For Australia, given the rising US interest rate climate, 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 year. We expect **no change to the cash rate** in the near term.

The major Australian Banks continue to restrict investment loans due to balance sheet limitations imposed by the regulator, APRA as they try and slow the pace of housing price rises. 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

Fixed Interest: In the short term, interest rates will follow the global trend and drift higher along with demand pressures from a growing economy. The domestic housing market continues to benefit from low interest rates despite the efforts of the regulators to restrict investment lending. The non-bank lenders appear to be stepping up and catering to this new source of business so the housing uptrend continues.

Shares: The share market is expected to continue its strong run as it is the beneficiary of an improving global economic climate. As markets move higher, rebalancing within your portfolio may be required to remove any unintended bias that may have been incurred via valuation drift.

Medium Term – 1 year to 3 years

Fixed Interest: In the medium term, tactical tilts towards alternative defensive assets away from traditional fixed interest positions, towards credit, should be considered.

Shares: 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 given the trend and level of interest rates.

Longer Term – 3 years to 10 years

Economic Outlook: 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 will remain the "X" factor for this year.** 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 half year as confidence builds.

Key Messages

Check cash levels: Surplus cash should be put to work to match your optimum risk profile without any unintended risks. Being underinvested in a rising market will impact your returns. Fixed Interest holdings should reflect your strategic weights with potentially a move towards an underweight position on the cards to protect capital, given the direction of interest rates.

For Australia - Consider Industry Changes: We will look for guidance from the upcoming company reporting season to see what industries are doing better in this sluggish economic environment and consider what changes are possible to the portfolio holdings that may provide stronger returns over the next period. Should changes be required to your portfolio we will contact you direct.

For Global exposures – Add to Emerging Markets: US shares remain well supported however the valuations look high. We will consider adding to Emerging Markets (EM) exposure to capture more of the global economic recovery. Europe is now starting to benefit from the low interest rates and is recovering well. The AUD/USD strength over the year did impact returns and switching to an element of hedged products may be a medium term option.

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Data Sources

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