Market Overview

Australian Shares

- Australian shares had stagnated for most of the year—at the end of September prices were still close to where they had started the year—but the past few months have seen a distinct improvement:
    - Much of the gains occurred in one large move in October, but there were also further smaller increases post this
    - The S&P/ASX200 Accumulation Index made 7.64% for the quarter
    - For the Calendar Year, the S&P/ASX200 Accumulation Index returned 11.80%, which includes the value of dividends
    - Resource stocks in did very well for the quarter (15.57%) taking the gain for the Calendar Year to 25.94%
    - The more modest overall result for the S&P/ASX200 Accumulation Index for both the quarter and Calendar Year, however, reflects the more subdued result from Industrials (5.97% and 9.00% respectively) as a consequence of the drag from the large Financials sector

International Equities

- In a year that started off coping with the major surprise of President Donald Trump's election, and that had to grapple with a serious geopolitical conflict (North Korea) as well as the dysfunction of American policymaking and the tortuous Brexit process, in hindsight global equities in 2017 performed remarkably consistently:
    - Although intermittent squalls along the way seemed important at the time, looking back with hindsight at global equity indexes shows more or less steady progress throughout the year
    - The MSCI World NR AUD Index was up 5.81% for the quarter and 13.38% for the Calendar Year

- Most of the major markets contributed for the Calendar Year:
    - In local currency terms, the US S&P 500 was up 21.83%, and the Japanese Nikkei was up 19.10%
    - Even the U.K. has managed to claw back previous Brexit-related share losses, with the FTSE100 Index up 5.02% for the quarter as some progress was made in the difficult exit negotiations.

- There have been even stronger performances from the emerging markets, where the MSCI Emerging Markets Index is up by 27.09% in Australian dollar terms:
    - By region, Asia was strongest
    - By country, the heavy lifting has been done by Brazilian and Indian shares, with a smaller contribution from China, but little change in Russia

Australian Property

- The S&P/ASX200 A-REIT Accumulation Index was up 5.72% for the Calendar Year:
    - Prices have recovered well from their July low point, with the Index producing a return of 7.90% for the quarter
    - The surprise news on December 12 that European mall owner Unibail-Rodamco had made an agreed takeover bid at a substantial premium for Westfield had a knock-on impact on the sector more generally
    - Westfield's share price shot up from $8.70 to $9.70

Market Overview

Australian Cash and Fixed Interest

- As expected, the Reserve Bank of Australia once again left monetary policy unchanged at its latest meeting on December 5, so short-term interest rates have been steady, with 90-day bank bill yields close to 1.75%:
  - Long-term bond yields have also shown little movement, with the 10-year Commonwealth bond yield at 2.58%.

International Fixed Interest

- The main event in the international fixed-interest space has been the Fed's decision to raise interest rates:
  - As widely expected, on December 13 it raised its target range for the fed funds rate by 0.25%, to a range of 1.25% to 1.5%
  - Financial markets had been well primed to expect the decision, and there was little reaction on the day
  - If anything, the latest inflation data, also released on December 13, and which showed inflation a tad lower than expected, had more of an influence, with U.S. bond yields dropping slightly
  - Overall, however, there has been little net movement in the benchmark 10-year Treasury yield, which at 2.40% is very close to where it was a month ago.

- There was also been minimal moves in other major bond markets over the month:
  - The 10-year benchmark bond yields in Germany (0.42%), Japan (0.05%), and the U.K. (1.19%) are all close to where they started

Australian Dollar

- The Australian dollar has been volatile throughout the year:
  - Recent weakness continued in early December, but the trend reversed in mid-month following the favourable employment report and improving iron ore prices
  - The Australian dollar closed the year at US$0.780 from US$0.724:
    - This is its best Calendar Year appreciation in seven years.

Market Outlook 2018

Despite the usual worry list relating to President Trump, North Korea, elections in Europe, an overheated domestic property market and the hype around bitcoin, 2017 was a very good year for investors.

This was primarily as a result of the following events that occurred during 2017:

- Strong global growth - global growth continued the acceleration seen through the second half of 2016 which helped drive strong growth in corporate profits. With global growth at around 3.6%, it is the best result in six years, with most major regions seeing strong growth.

- Benign inflation - underlying inflation stayed low and below target, surprising on the downside in the US, Europe, Japan and Australia.

- Rising commodity prices - better than expected global demand and a surprise fall in the $US helped commodity prices rise with constrained supply particularly in the case of oil.

- Politics - 2017 was a year defined by politics with many of the potential risks turning out less threatening than initially feared.

- Easy monetary policy – despite the synchronisation in global growth, there is little synchronisation in the monetary policies of global central banks. The U.S. Federal Reserve (Fed) is tightening, whilst the European Central Bank and the Bank of Japan are still printing money (quantitative easing), albeit at a slower rate, The Bank of China is slowing credit growth which will have implications on China's economic growth in 2018 and beyond.

- Domestically, the Australia economy is still growing, although fairly modestly, hitting 26 years without a recession. While housing construction started to slow and consumer spending was constrained, non-mining investment improved, infrastructure spending surged & export volumes were strong. Record low wages growth and low inflation kept the Reserve Bank of Australia (RBA) on hold with interest rates.

Despite the perceived risks, 2017 was a rewarding one for investors. As we have mentioned before, this offers a classic reminder that sometimes you need to turn down the noise on all the events swirling around investment markets and associated predictions of disaster, and how things can often surprise for the better.

Key themes for International and Australian shares in 2018

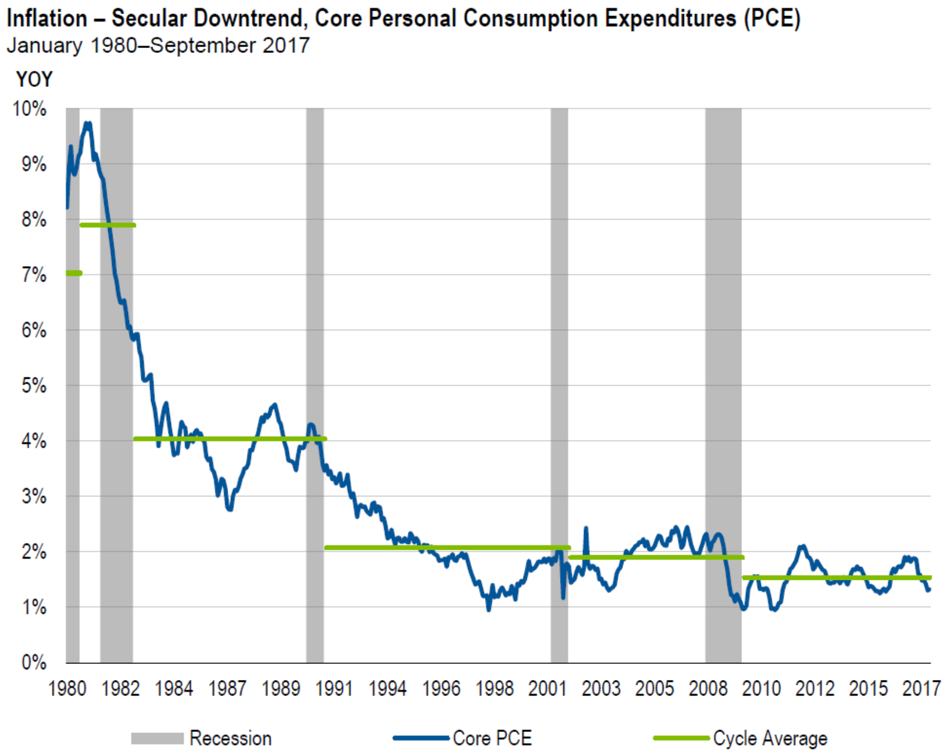
As we look into 2018, we expect it to be a potentially pivotal year for global equity markets. The reversal of quantitative easing (money printing) by central banks in both Europe and Japan as well as rate hikes and rising inflationary pressures in the US will be among the most impactful factors on global financial markets in the year ahead.

- **US inflation is starting to lift**

Perhaps most important among these factors is inflation, given its status as a driver of Fed policy, interest rates and other key variables. Whilst some inflation is healthy for an economy (such as wage inflation) as well as for asset prices, persistently high core inflation could spur rates to climb faster than anticipated. However the more likely scenario is for a modest uptick in inflation over the coming year.

Inflation has been persistently low as a consequence of several factors, primarily globalization and technology. Globalization has made a vast pool of labour available that has helped keep a lid on wage growth globally. At the same time, improvements in technology have resulted in the automation of various traditionally manual tasks.

Globalization and technology have kept a lid on US inflation



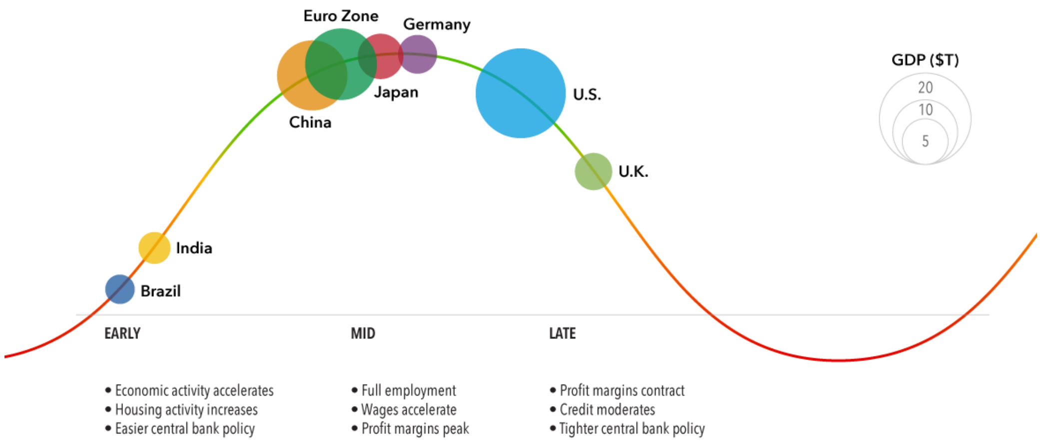
Source: FactSet, US Bureau of Economic Analysis

While the pace of globalization may have slowed recently, technology has not. As these impacts are unlikely to ease materially over the near term, core inflation may tick up, but unlikely to increase in dramatic fashion over the years ahead, providing a positive backdrop for equity markets into 2018.

- **Global growth to remain strong**

After being narrowly driven by a few countries like the United States and China, we have seen the expansion of global growth broaden out, with greater participation from Europe, Japan and various emerging markets, which indicates that the cycle has further to run. Ample liquidity, potentially more supportive fiscal policy in a number of major economies and easing lending conditions should all help underpin global growth over the course of the coming year.

Global Economies - country position within the business cycle



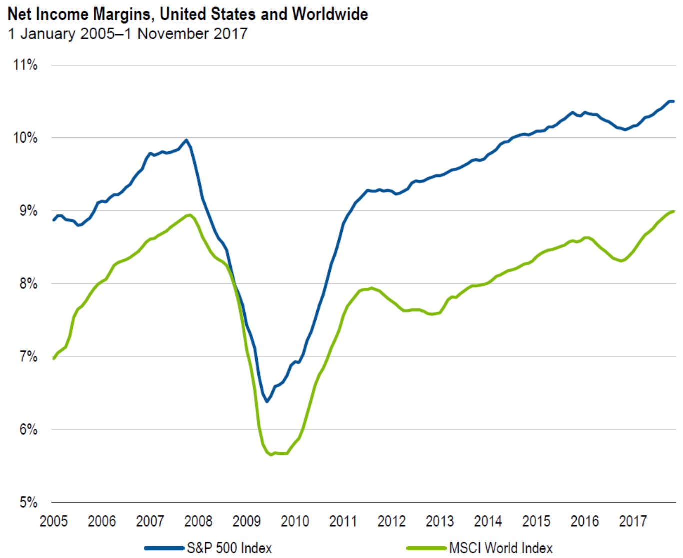
Source: Capital Group, FactSet

In fact the International Monetary Fund (IMF) recently raised its forecast for global growth from 3.7% in its October projections to now 3.9% for both 2018 and 2019. The focus was clearly on the US, with about half the upgrade attributed to the recent tax cuts. The IMF is projecting the US to expand at 2.7% for 2018, the Euro Zone to register 2.2% growth, Japan to grow 1.25%, and China to run at an impressive 6.6%.

This is the first time that global growth has gone through such a synchronized expansion since 2010 and as such the ongoing global economic recovery has the potential to continue for a few more years at least.

The extended period of generally low interest rates globally has also supported corporate profit margins which are still improving coming into 2018. The sustainability of corporate profits in a low interest rate environment should continue to provide a strong foundation for rising global equity markets in 2018.

Corporate profit resiliency amid low interest rates



Source: Thomson Reuters Datastream

- **Rise in interest rates and the return of volatility**

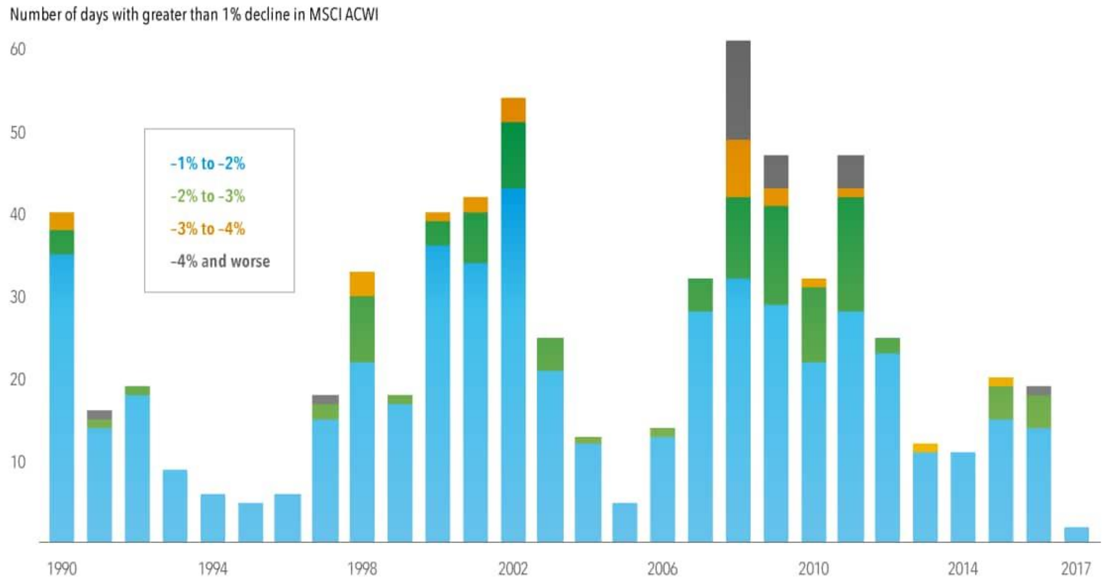
With a more durable economic recovery, a simultaneous move by certain central banks to begin to tighten monetary policy has begun as economic conditions have improved in a number of regions to the point that tighter policy is warranted.

With the recovery in the United States the most entrenched, the Fed is already farthest down the path toward policy normalization. A gradual rise in interest rates is expected over the year ahead, along with a continued unwinding of the Fed's massive balance sheet as the economic recovery continues and the labour market remains relatively tight.

The normalizing of monetary policy could see the potential for greater financial market volatility in 2018. In addition, any resurgence in market volatility could also be driven by various geopolitical factors. The US political environment remains a challenge, and several of the pro-growth economic policies touted by the current presidential administration have been slow to develop.

Elsewhere, the latest push for Catalonian independence in Spain is a reminder that Europe's economic recovery faces many potential future disruptions. Similarly, geopolitical hotspots such as North Korea could linger as a source of uncertainty and risk. As such there could be potential for rising volatility following an unusually quiet period for global financial markets.

Market volatility is low, but is it sustainable?



Sources: MSCI, RIMES

Looking at the graph above, global equity market volatility has fallen to historically subdued levels. The global share market declined by more than 1% on only two days in 2017, the fewest number on record. It also marked the first time since 2005 that there wasn't a single daily decline above 1.5%.

While subdued volatility may be welcome, it cannot continue indefinitely. Although it is important to guard against complacency, it is also important not to overreact to the inevitable bouts of market volatility should they occur.

- **Investment opportunities outside the US**

Most of the world's major equity market indexes achieved or neared multiyear highs in 2017, as investors set aside concerns about politics and focused on broadening expansion. European stocks had a strong run in 2017, rising 23% and outpacing U.S. shares for the first time since 2012. Emerging markets equities also outpaced the U.S., soaring 32%.

Valuations point to relatively attractive opportunities outside the U.S.

12-Month Forward Price-to-Earnings Ratios	U.S.	EUROPE	JAPAN	EMERGING MARKETS
9/30/17	17.9	14.9	14.3	12.4
10-Year Average	14.4	12.3	14.8	11.0

Sources: Capital Group, FactSet, MSCI, RIMES, Thomson Reuters

In fact, current market levels still suggest that better investment opportunities may be in non-U.S. markets. Consider that the U.S. share market accounts for 52% of global share market capitalization, near a historic high, and its market cap is 106% of its GDP. Also, the forward P/E ratio for the U.S. share market, at 17.9, is notably higher than other major markets. Conversely, the emerging markets share of global market cap appears relatively modest compared with its contribution to GDP, with emerging economies expected to contribute half of global GDP by 2021.

Strong economic growth in China and India is expected to feed through to better corporate profits across the region. Furthermore, China's emphasis on consumption over government investment and India's ongoing structural reform efforts may create conditions for continued economic and corporate earnings growth over both the short and longer terms.

- **What about Australian shares?**

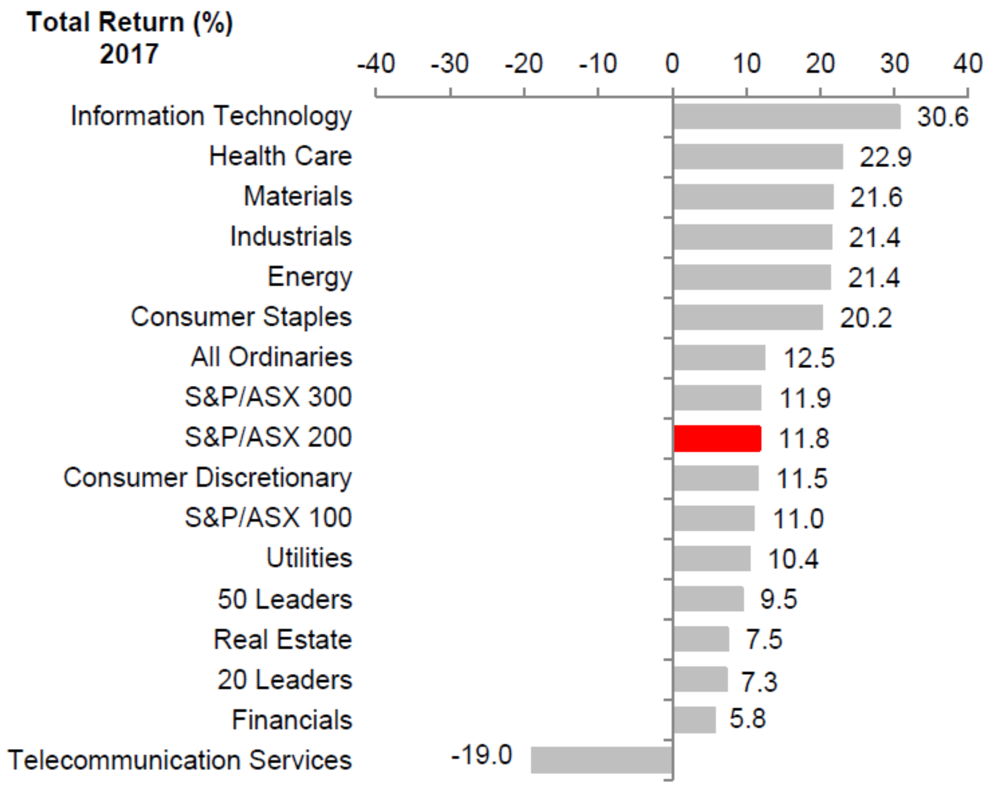
Australian equities had a strong finish to 2017 with broad based gains across both small and large cap sectors over the December quarter, mirroring the trend in global markets as the Trump tax cuts and continued strong growth data supported equity markets. The ASX200 posted a total return of 11.8% for the calendar year, made up of a capital return of 7% plus a dividend yield of 4.8%.

The standout sector in 2017 was Information Technology, followed up by a strong performance from Healthcare thanks largely to CSL and COH. Energy and Materials both posted their second consecutive year of double digit gains.

Telcos were the only sector to fall in 2017, coming on top of a 7% decline in 2016. Bond yield proxies underperformed in 2017 with Real Estate and Utilities both posting below market returns and unwinding some of the relative outperformance from 2016. Perversely, this came despite bond yields falling during the year, with the 10-year yield declining from 2.79% to 2.64%.

The Banking sector rallied late in the year, back from the November (Royal Commission induced) sell-off, but finished the year lower, with all four majors in negative territory, but positive once dividends were included.

Australia Equity Market Performance (2017)



Source: MSCI, Datastream, Macquarie Research

The big underlying themes throughout the year were:

- The strong performance of building and construction related areas;
- Another strong year for commodity stocks, supported by global synchronised growth as well as increased demand. The continued decline of the US dollar against most global currencies also supported commodity prices.
- Continued re-rating in offshore exposed stocks (both industrial and healthcare); and
- Ongoing pressure on interest rate sensitive sectors as well as the banks (due to rising political risk rather than any meaningful deterioration in earnings fundamentals).

Our outlook on a few of the major sectors in the ASX 200 Index in 2018:

Banking Sector

Operating conditions remain challenging with the outlook for earnings and dividend growth under pressure despite recent better than expected economic news (GDP growth, building approvals, employment growth, business confidence and non-mining capital expenditures spend). In addition, widespread competitive funding and regulatory pressures continue to squeeze net interest margins. If margin pressure intensifies then loan repricing is more than likely to occur despite the increased political scrutiny of the upcoming Royal Commission.

In addition, even though credit growth is growing modestly at best, it is expected that good volume growth and a solid performance in cost management will support earnings growth for the major banks in 2018.

Despite increasing concerns from increased public and political scrutiny, we feel that the risks to the Banking sector are well contained and mostly priced in. Importantly, the major banks still have attractive income yields relative to alternatives of cash, term deposits and bonds with fully franked dividend yields between 5.5% and 6.7%, grossed up to 7.8%-9.5%.

Healthcare

Domestically, we expect the market to remain focused on three major areas:

- Government funding of the medical service benefits scheme (MBS);
- The issue of private health insurance participation levels; and
- Disruption to the pharmaceutical supply chain

Given the recent changes announced by the government, any changes to the MBS are expected to be minimal, which bodes well for pathology and radiology service providers. In addition with consultation underway around the treatment of private patients in public hospitals, it is expected that any curbing of this trend to prove positive for private hospital providers. Finally, clarity around pharmacy ownership rules should pave the way for participants in the supply chain to move into the retail frontline.

We retain our positive outlook on the healthcare sector, believing funding concerns weighing on the sector have been inflated. The ageing of the Australian population and the importance of the private sector's role in assisting to minimise the cost burden for government remains an important secular long-term driver of demand for healthcare names.

Commodities

Commodities strengthened late in 2017, fuelled by synchronised global growth and China pushing its traditional construction and industrial sectors for more growth. As China's economic growth becomes more reliant on further growth in investment, government funding continued to flow.

Supply-side disruption in China was a key driver in markets where it is a significant global supplier, with prices for several commodities now trading well above the marginal cost of production, including iron ore, coking and thermal coal, copper, alumina, aluminium, steel, and zinc.

In 2018, we expect Chinese government policy to continue to influence commodity markets, in particular, commodities where China is a substantial supplier such as coking and thermal coal, steel, and aluminium. Winter steel and aluminium production cuts may support buoyant margins for commodity processors over the shorter term but longer term, we think elevated coal and steel maker margins are unlikely to persist as Chinese government-induced supply constraints abate.

With the strong prevailing commodity and share prices, we think the sector is somewhat overvalued and expect commodity prices generally and earnings for the miners to pull back through 2018 and 2019.

Energy

Brent crude prices have mostly been on the rise for the past two years. The current US$65 mark is more than double January's 2016's sub-US$30 lows.

The most recent up-leg in crude prices was not market-driven, rather engineered by supply restrictions from OPEC and its partners. However as the source of global supply is reduced, U.S. shale producers are able to profitably fill the shortfall by increasing volumes in a US$60-US$65 Brent environment.

Once the cuts are lifted, full OPEC production coupled with rapidly growing U.S. output is likely to outstrip near-term demand growth and could easily tip the industry back into oversupply in 2018.

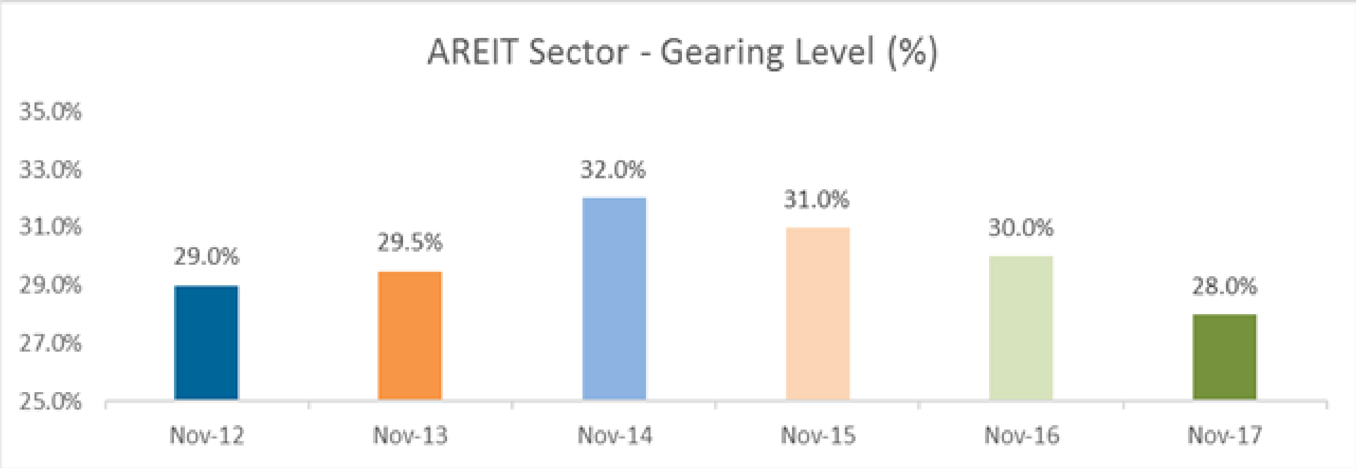
Australian Listed Property (REITs)

Calendar Year 2017 turned out to be a subdued year for A-REIT's with a total return of 5.72%. While overall returns from the A-REIT sector in 2017 were only fair compared to equity markets, A-REIT's have performed extremely well over the medium to long-term returning 11.00% per annum over the last 3 years and 13.23% over the last 5 years.

Overall, the 2017 reporting season for A-REIT's offered convincing evidence that the A-REIT sector remains an attractive option for income-focused investors. The reporting season delivered lower debt, lower servicing costs, higher hedging and higher quality portfolios across the sector.

Gearing and Cost of Debt

Since November 2012, the A-REIT sector's weighted gearing has remained relatively stable, within a range of 28% to 32%.



Source: JP Morgan (2017)

As at 30 November 2017, the AREIT sector's gearing was 28.0%, a fall of 2.0% from the previous year. The lower gearing of the sector is mainly attributable to positive property asset revaluations and debt reduction initiatives across the sector with many AREITs sensibly offloading lower quality assets at attractive prices, using the proceeds to lower debt.

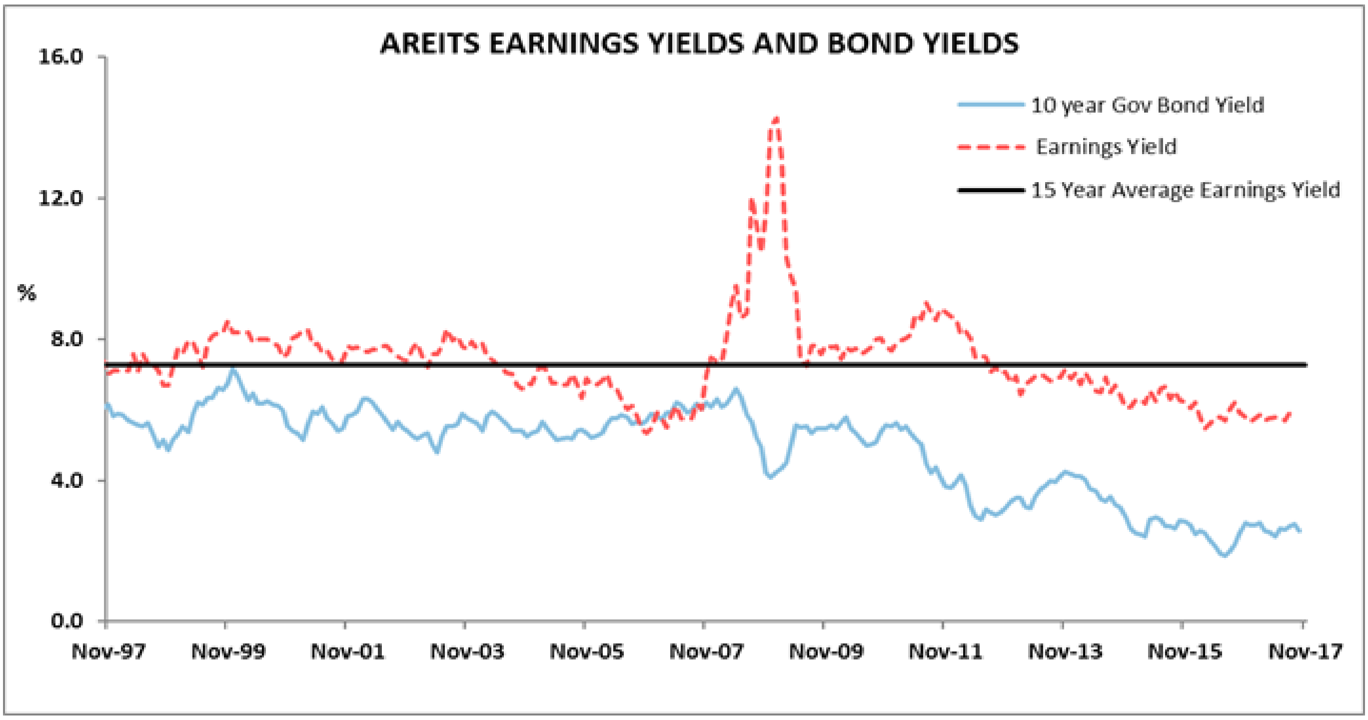
The sector's weighted average cost of debt meanwhile, sits at an incredibly low 4.4%. This was assisted by large-cap A-REIT's like Dexus Group and Mirvac Group, which managed to reduce their annual cost of debt by 0.7% p.a. and 0.20% p.a. respectively.

The low cost of debt has assisted A-REIT income returns, but the outlook is helped by the high level of hedging (67% of debt is hedged over the next five years) which will reduce over coming years. With GDP growth low and interest rates lower than they've ever been, the expiration of hedging facilities should allow A-REIT's to renegotiate debt at very attractive rates. Furthermore, no sizeable debt repayments are expected in the sector over the next 12 to 15 months.

A-REIT yields remain attractive

The 2017 reporting season offered convincing evidence that the AREIT sector remains an attractive option for income-focused investors, not only from a debt perspective but from an earning perspective as well.

At the end of November, the earnings yields (Earnings per share divided by the share price) exceeded the 10-year Australian government bond yield by 3.3%. This is higher than the long-term average of 2.7%. The premium over the bond yield increased by 0.2% during November 2017 reflecting a fall in 10-year Australian government bond yield.



Source: RBA, UBS (2017)

Forecast earnings yields for 2018 by property sector over the next year remain strong.

Sectors	Yield (%p.a)
Retail	5.8
Office	6.1
Industrial	5.4
Diversified	6.0
Total	5.9

Source: UBS

Underlying property asset yields range between 5.4% to 6.1% p.a. which remains incredibly attractive relative to the return available on cash or fixed interest.

Buybacks and corporate activity leading to strong growth in asset values

Buoyant transaction activity saw net tangible asset (NTA) levels increase by an average of 10%, allowing AREITs to book substantial valuation gains.

A booming office property market in Melbourne and Sydney are helping valuations. To 30 June 2017, effective rents were up 25.2% in Sydney and 16.2% in Melbourne with tenant demand extremely high.

During December, Unibail-Rodamco (Unibail) announced it had agreed to acquire all of the outstanding shares in Westfield Corporation. This is Australia's biggest ever acquisition, worth $32bn, and has given confidence to the beleaguered retail sector.

Also, a number of A-REIT's have announced they will be undertaking share buybacks. Capital management initiatives are typically a vote of confidence by A-REIT boards in the value of their portfolios. In an environment where earnings growth could easily be driven by debt-funded asset acquisitions, resisting this temptation and opting instead to reward shareholders through buy-backs is extremely reassuring for the sector.

Our expectation is that A-REIT's will deliver earnings growth of 5-6% and a total return of between 10-12% over the next 12 months.

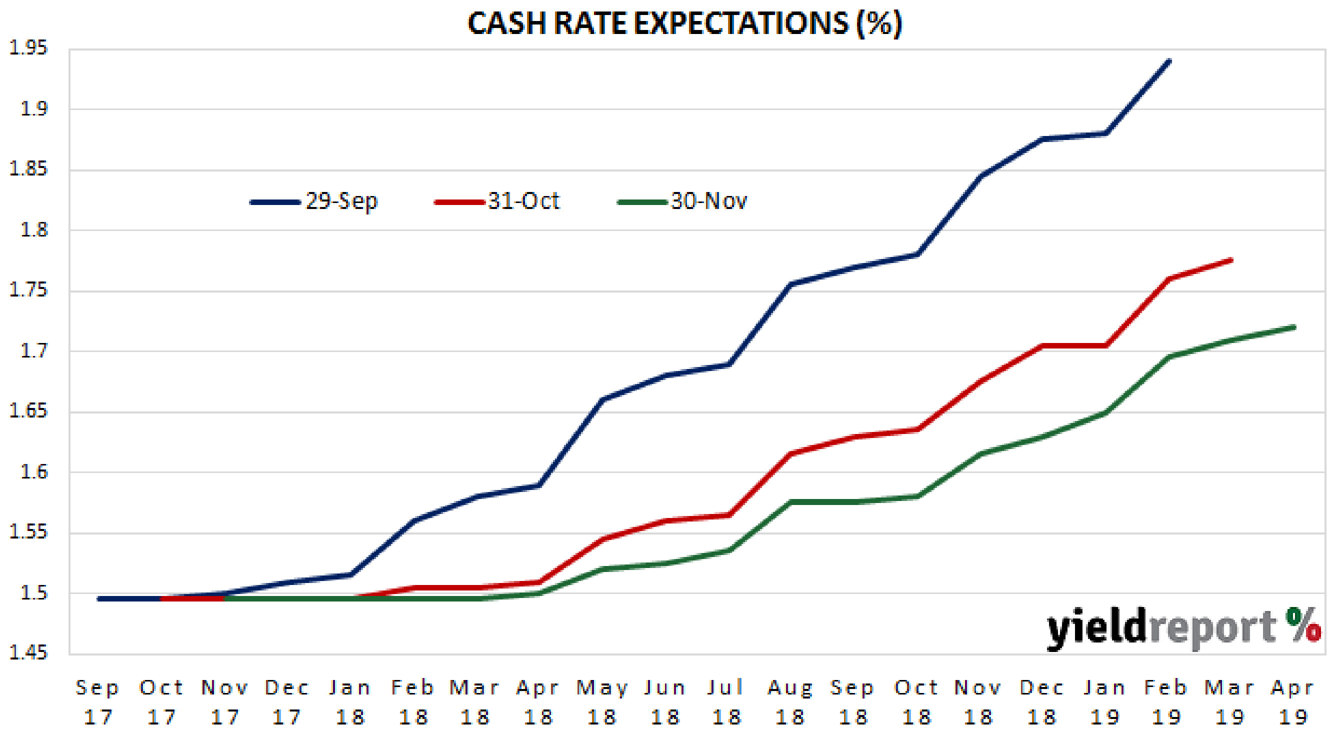
Australian and International Cash and Fixed Interest

It has been a relatively uneventful year in cash and fixed interest markets.

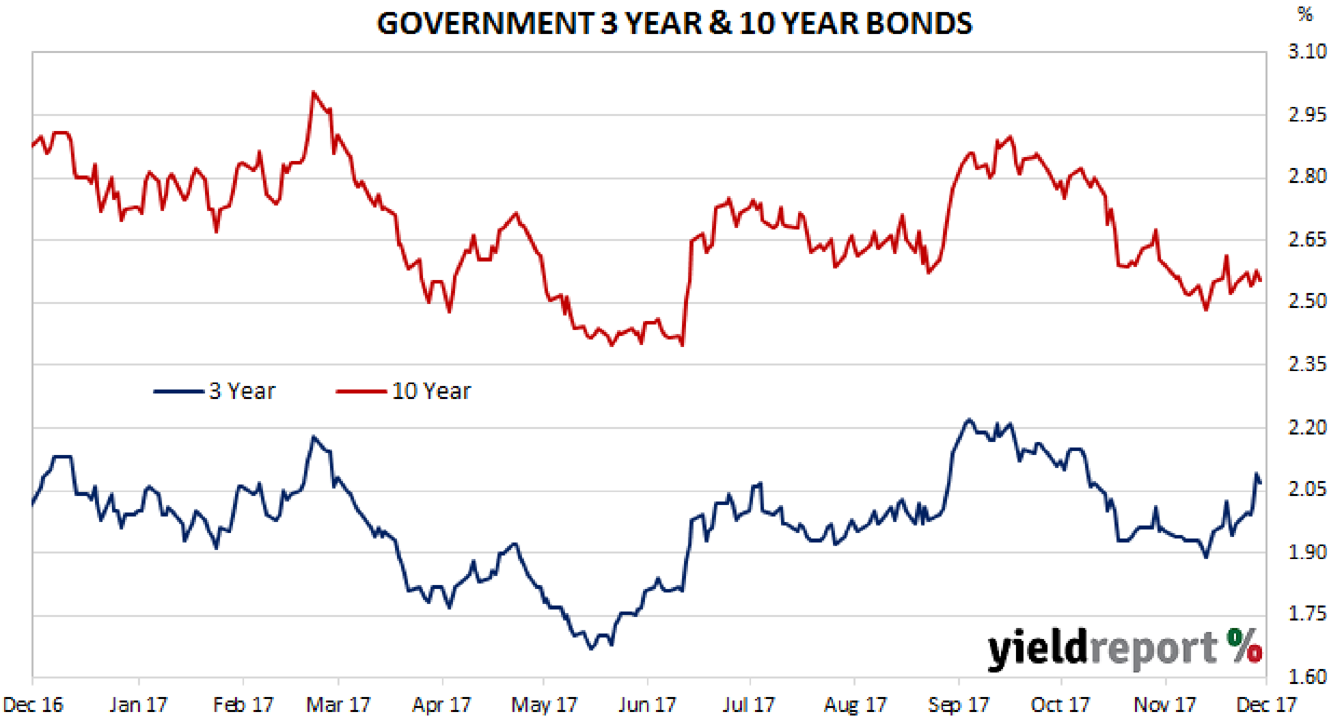
The RBA started calendar year 2017 with no official conditional bias, however with the consensus global growth was improving and domestic economic conditions were likely to remain stable, most analysts were convinced that interest rates had bottomed and RBA would keep the official cash rates stable during 2017. This eventuated with the RBA leaving the cash rate during 2017 unchanged at 1.50%.

The expectation is that the Australian economy should muddle along in 2018. Weak Consumer Spending continues to drive a mixed domestic economic picture for 2018 as all-time high household debt levels and below-trend wages growth heighten consumer caution and subsequently reduce discretionary spending. Any downward shock in the stronger business and public sectors will drag GDP growth lower and place further pressure on households as they again adjust their spending. Consumer spending represents approximately 60% of GDP, so without any pickup, we won't see much of a pickup in GDP growth.

Weak wage price inflation will continue to be at the forefront of discussions of the RBA. Our expectations are for the domestic cash rate to remain flat at 1.50% for the duration of 2018. However, upside to rate movements is more of a probable scenario based on the consensus view of continuing strong global growth and increased domestic Government spending.



Government bond yields here in Australia remained relatively stable through 2017, but with a weakening towards the end of 2017 due to weak retail sale figures. In Australia, the 10 Year Australian Government Bond yield started the year at 2.79% before finishing the year at 2.64%.



It is expected that there will be a gradual shift higher in bond yields in 2018. As the U.S. Federal Reserve continues their tightening policy, it is expected U.S. sovereign yields to move up in sync slowly, and with them domestic sovereign yields. While U.S. interest rate futures are pricing in two to three increases this year, anything beyond that could temporarily destabilise global bond and equity markets, sending bond yields higher and equity prices lower.