

Market Overview

Australian Shares

- Australian shares have done reasonably well, and have followed overseas markets higher:
 - The S&P/ASX200 Accumulation Index was up by 5.18% for the quarter, and the recent rise means the Index provided a total return of 11.8% for the Calendar Year
- The sectoral pattern is as before:
 - Ongoing and very large rises, from a depressed starting point, for the resource stocks, a drag from the large but weak financial sector and other sectors in between, with the industrial doing reasonably well
 - mixed results from consumer stocks and somewhat weaker IT stocks

International Equities

- Soon after the surprise U.S. presidential election result, world share markets rose as investors realised that the largest short-term impact was likely to be a boost to the U.S. economy from looser fiscal policy, and world shares continued to rise during the rest of November:
 - Share prices rose more rapidly in the first week of December
- Although many markets have booked good price rises in December, in year-to-date terms gains have been heavily concentrated in the U.S. market
- Despite a good quarter, other developed markets shown little or no year gains for the Calendar Year
- Overall, emerging markets have done well, but, again, there have been strong regional divergences:
 - Investors needed to be in the strong markets of Brazil and Russia
 - The other key emerging economies did not deliver, with not much to show for the Indian market and an outright loss in China

Australian Property

- The A-REITs have borne the brunt of rising bond yields, with a sharp fall of to 13% from their peak in early August, before the rising bond yield story started to have its impact, to their cyclical low point in mid-November
- Since then, the A-REITs have shared to some degree in the global equity market rally

Australian Cash and Fixed Interest

- Short-term interest rates have been steady:
 - The Reserve Bank of Australia has been leaving the cash rate unchanged at 1.5% and other short-term rates have followed suit, with the 90-day bank bill yield currently trading at a little over 1.81%
- Long-term interest rates have continued to follow postelection U.S. bond yields upwards:
 - The 10-year government-bond yield, which was 2.3% before the election, has risen steadily to its current 2.79%

Market Overview

International Fixed Interest

- The rise in U.S. bond yields in November that followed the election of Donald J. Trump has continued into December and got a further small boost from the Fed's decision on Dec. 14 to raise short-term interest rates, with the target range for the Fed-funds rate being raised from 0.25% to 0.50% to a range of 0.50% to 0.75%:
 - As a result, the 10- year U.S. Treasury yield has risen
- Other major global bond yields have felt some modest impact, though ongoing easy monetary policy in the eurozone and Japan mean that bond yields there remain very low
- The impact of the U.S. move, however, has been big enough to take overall measures of the global bond market into negative territory
- Indeed, November was the worst month ever for global bonds, prompting one local pundit to coin the term "Bondcano"
- Why did this happen? In short, investors have been pricing in interest rate and inflation expectations that are just too low. Why this is important now is that it is becoming increasingly clear that Central Banks are starting to run out of puff with regard to their ability to provide monetary support, not to mention the impact on inflation should Trump be able to get all of his tax cutting and big spending policies through. Whilst you can never predict the timing or the catalyst of these things, the outcome itself is not that surprising because bonds were just too expensive.

Australian Dollar

- The Australian dollar has weakened in headline USD terms, from USD 0.77 just before the U.S. election to USD 0.724 currently, largely reflecting the global postelection rise in the USD

The Australian dollar continues to be driven by its relative position against the stronger USD, but supported by improvements in commodity prices and general expectations that the RBA interest rate cutting cycle is at an end.

Market Outlook for 2017

On many measures, 2016 was a good year for equity markets both here in Australia and around the world, however the ride throughout the year was anything but smooth – in fact, it looked at several stages throughout the year as though markets were headed for a negative return.

Significant events that occurred during the year were:

- A 20% fall in the Chinese share market over a fortnight in January
- Plunging oil prices, down to a 12-year low of US\$26 a barrel
- The UK voting to leave the European Union (Brexit)
- Donald Trump being elected US President
- The Italian referendum result going against the government, leading to Prime Minister Renzi's resignation
- The US Federal Reserve lifting interest rates only once in the year - in December for only the second time in almost a decade
- Towards the end of 2016, OPEC oil producers finally agreeing to restrict production in order to support prices
- The surprise recovery in iron ore and coal prices, particularly in the final quarter of 2016, as a result of China's program of closing unprofitable steel capacity and mines

Also, an extraordinary strategy note issued in early January by the Royal Bank of Scotland (RBS) saying it was time to "sell everything", did not help investors' confidence. RBS warned in the note of a "cataclysmic year" ahead for markets and advised clients to "sell everything except high-quality bonds."

But despite all the dire warnings, the biggest surprise for the year was how financial markets reacted to the various political and economic events - unambiguously positive, with strong returns generated in most markets around the world. Growth investments have outperformed since the Trump victory as investors flock to resources and cyclical sectors, believing Trump's proposals to lift economic growth and inflation will deliver and "Make America Great Again".

Looking ahead, we wait to see the likely content of Trump's policies after he was inaugurated on January 20. The effects of his policies on inflation and bond yields will be an important determinant to the performance of financial markets in 2017.

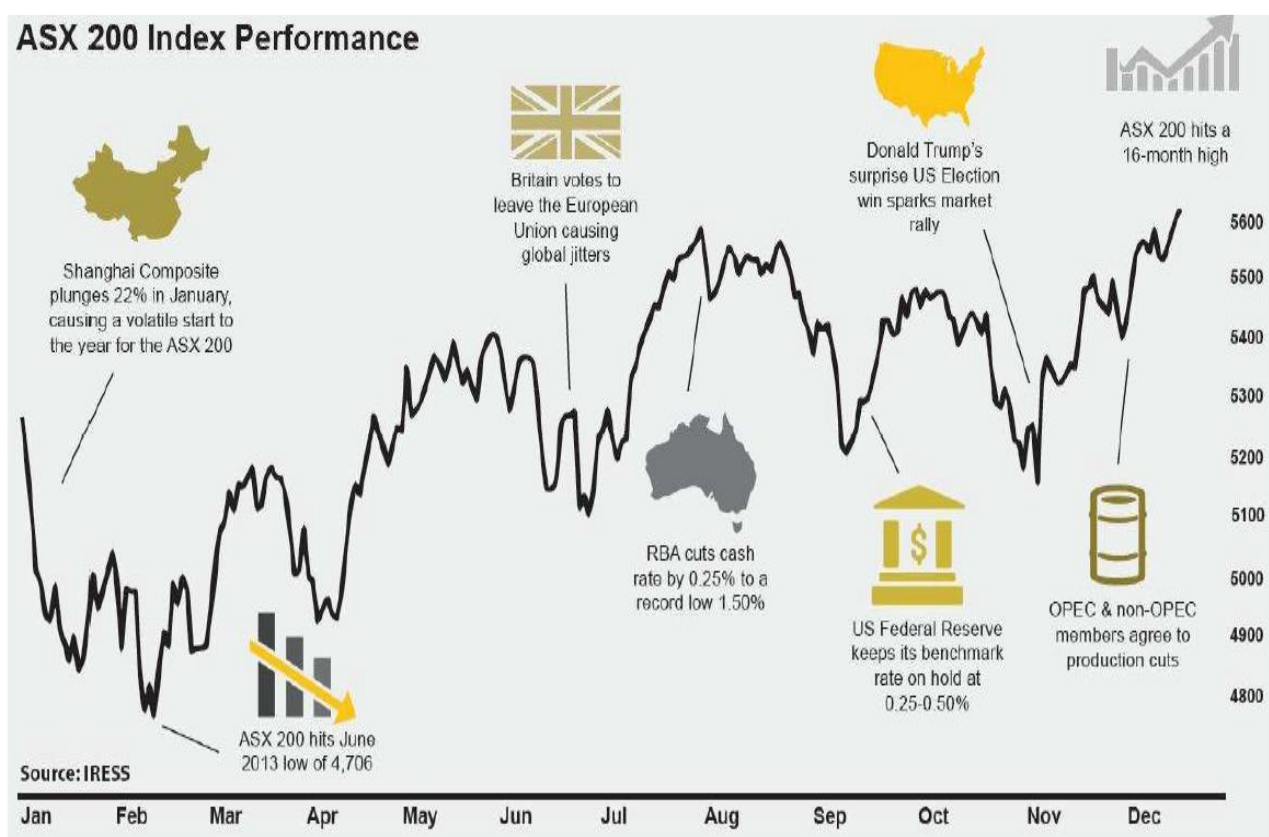
Market Outlook for 2017

Australian Shares

The Australian market exceeded many global benchmarks with the S&P/ASX 200 Accumulation Index posting a total return of 11.80% for the calendar year, made up of a capital return of 7% plus a dividend yield of 4.8%. This was the best calendar year performance in three years.

Most of the return was generated by Australian shares was in the second half of the year, with the index returning 10.59% for the six months to December, primarily driven by the rotation away from bond proxies such as listed property, infrastructure and utilities to the banks and resource companies.

Australian Sharemarket over 2016



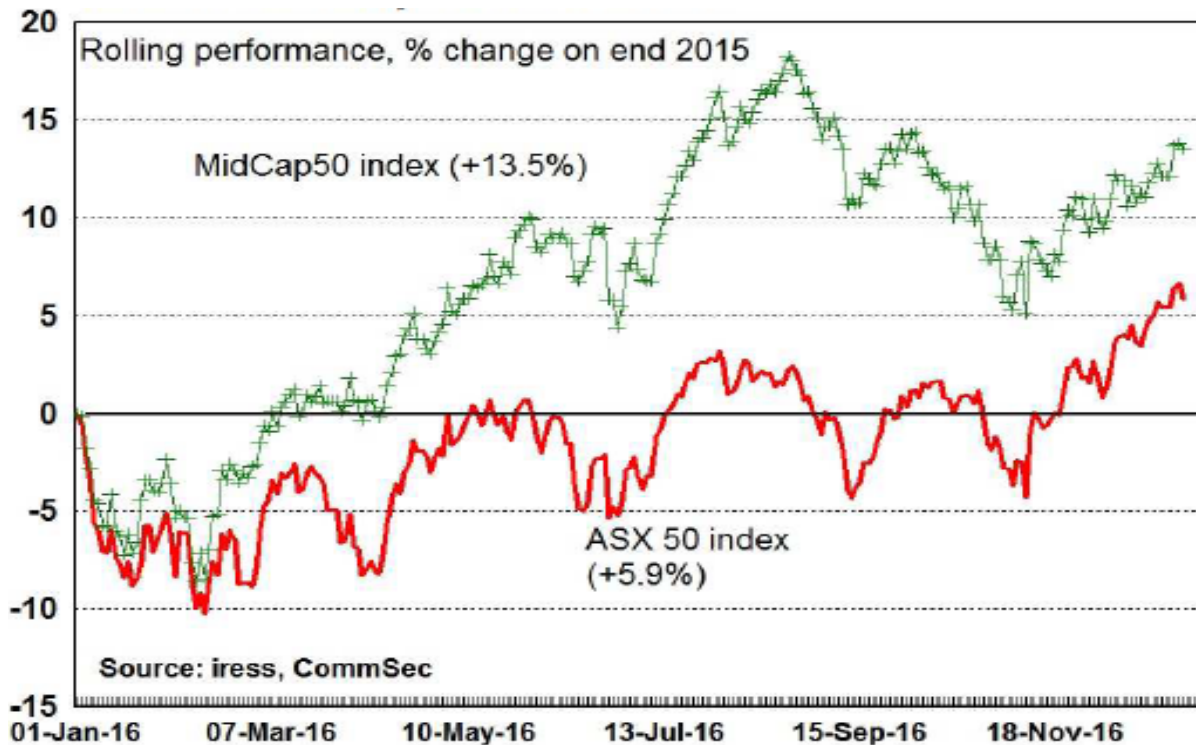
Source: CommSec

The best performing sectors on the Australian share market were the Capital Goods sector (companies involved in engineering and construction services as well as manufacturing and distribution of goods), up by 39.4%, closely followed by the Materials sector (metals and mining), up by 39.1% for the year. The Retailing and Consumer durables sectors also did well returning around 20% for the year.

The worst performing sectors were Telecommunications (-12%) as well as Media (-7.3%), Diversified financials (-3%), Transportation (-2.4%) and the Banks (only +0.7% but staged a strong rebound in the second half of the year).

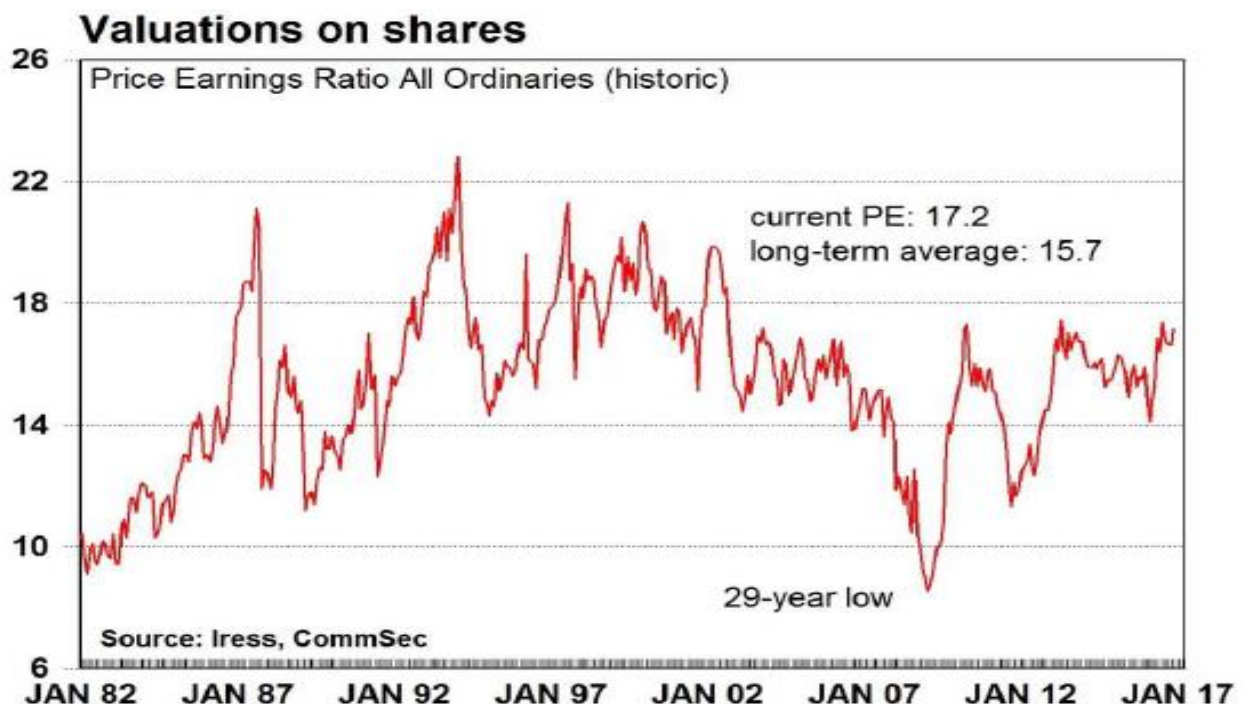
The MidCap50 sector was the strongest category in the ASX 200, with mid cap companies 50 to 100 by market capitalisation (+13.5%) outperforming their large cap top 50 rivals (+5.9%) over 2016.

Market Outlook for 2017



Although we are strongly in favour of mid-cap exposure in client portfolios, it is difficult to see such a significant outperformance occurring again in 2017 between the two groups of the ASX 200.

From a valuation perspective, the Australian share market remains on the fuller side of fair value but, importantly, it is still a long way from historical extremes. Despite a modest domestic growth outlook, we expect slightly more upside for the share market in the short term, with positive momentum as the driving force.



Market Outlook for 2017

In addition, with the earnings outlook looking somewhat brighter and a significant gap between yields on bonds versus equities still existing, there is scope for the stock market to weather potentially higher interest rates.

The main focus which will likely dictate the direction of the Australian share market in 2017 is the USA and the economic direction of the new Trump administration, as well how the reforms and the restructuring of the Chinese economy are handled by its government.

Our view on a few of the major sectors in the ASX 200 index:

Banking Sector

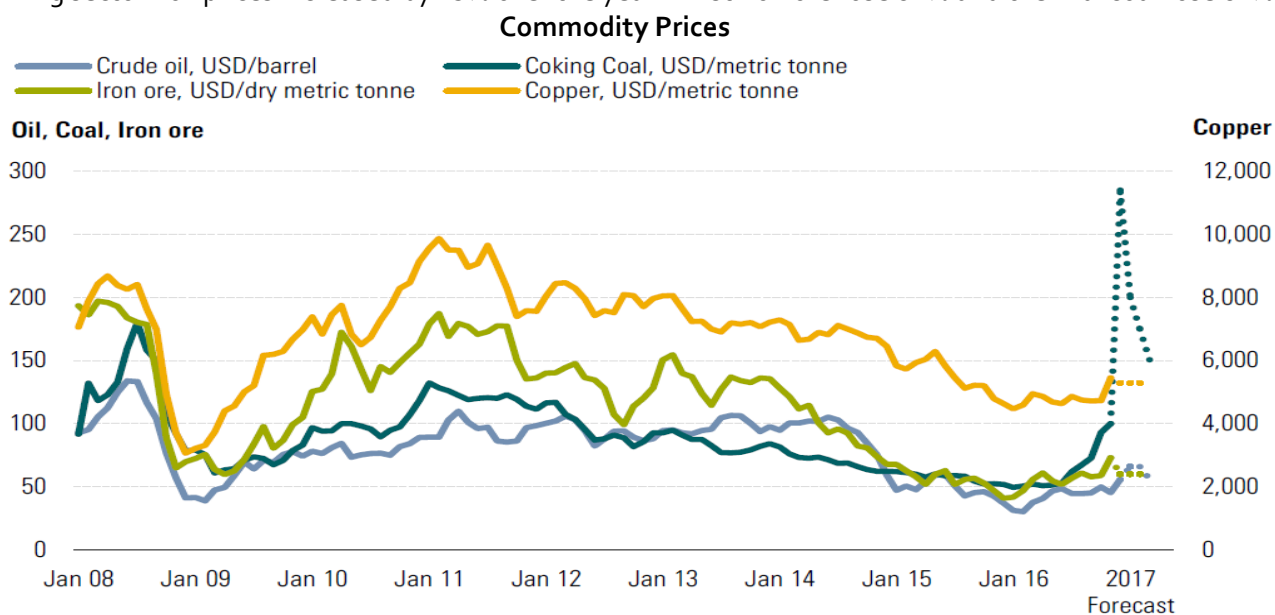
Operating conditions will remain challenging for the banking sector with the outlook for earnings and dividend growth under pressure following recent weaker than expected economic news (GDP, building approvals, wages and credit growth). In addition, widespread competitive funding and regulatory pressures continue to squeeze net interest margins, but recent loan repricing, particularly on investment loans, has partially offset the margin reduction. Further loan repricing is more than likely if margin pressure intensifies despite the increased political and public scrutiny.

Nevertheless, we believe the major banks' pricing power will ensure return on equity is maintained above the cost of equity with recent loan repricing evidence that the negative impact to interest margins can be managed.

In addition, the major banks all generate fully franked dividend yields of between 5.5% and 6.6% (grossed up to 7.8% – 9.5%). This is still very attractive relative to the alternatives of cash, term deposits and investment-grade bonds.

Materials Sector

The real surprise packet of 2016 was the strength of the recovery in commodity prices in the wake of unexpected strength in Chinese demand and supply disruptions. Commodity prices lifted with some notably sharp increases in the mining sector - oil prices increased by 45% over the year whilst iron ore rose 86% and thermal coal rose 87%.



Market Outlook for 2017

Although commodity prices are likely to hold up reasonably well in the near term as China continues to expand infrastructure spending, we don't expect another strong year in 2017 as many commodities are trading well above the marginal cost of production, notably copper, thermal coal and iron ore. Coking coal is at peak China-boom prices.

China's demand remains the key as its leading share of the world consumption of commodities means small demand changes have significant impact on commodity prices. We expect demand growth to soften in 2017 as China's fiscal stimulus abates.

Healthcare Sector

For the healthcare sector we expect the market to be focused on the results of a raft of government reviews over the next 6 to 12 months spanning funding of the Medicare Benefits Schedule, private health insurance affordability and the pharmacy sector. As such an increased risk of more aggressive healthcare reforms being pursued by the government could impact the sector in the coming 12 months.

However we expect offshore growth and geographical diversification to continue to offer domestic healthcare companies a buffer against regulatory risk. In addition the projected strengthening of the U.S. dollar should benefit U.S. facing businesses reporting in Australian dollars.

Despite the potential negative implications of funding reviews for healthcare providers, we see an ageing Australian population and the importance of the private sector's role in contributing to the cost burden for government as underpinning the defensive nature of the sector.

Market Outlook for 2017

International Shares

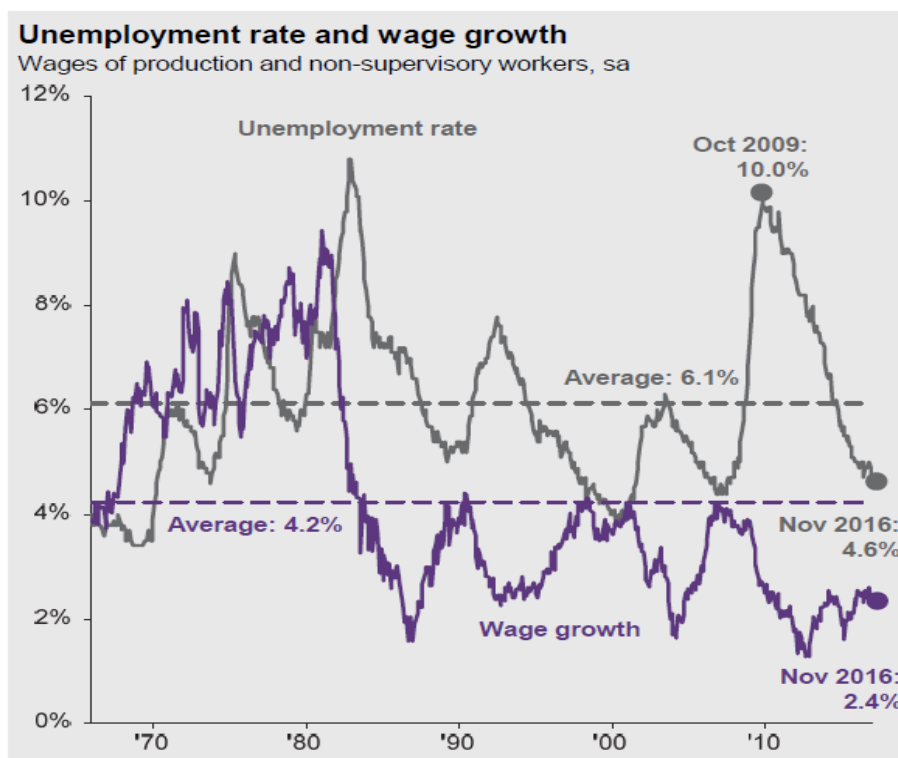
The outlook for the three major world economies over the next three years is for a continued recovery in the USA with modestly rising inflation, a continued slowdown in China, but not a financial crisis or hard landing and an improvement in the economic outlook for Europe.

United States

In spite of a rocky start to 2016, and even recession fears, the U.S. economy remains firmly on a long-term growth path of at least 2% a year. We maintain our view of resiliency for the USA economy, albeit with some headwinds.

The USA economy is driven by households, with consumption comprising around 69% of the country's GDP. The household sector has been buoyed by strengthening labour markets, rising house prices, lower debt, a strengthening USA dollar and low interest rates.

Average weekly earnings increased by 2.9% over the year and the number of people employed is now 152 million – over five million more than the previous peak in November 2007.

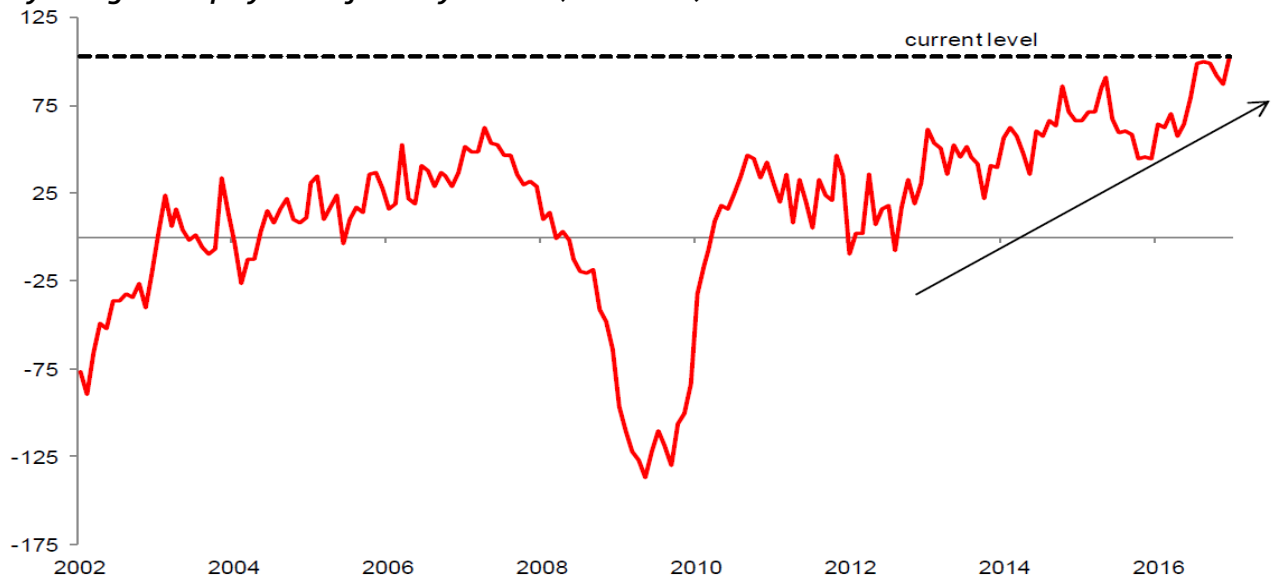


The outlook for wage growth at the start of 2017 is also fairly robust. On January 1st minimum wages were hiked in 19 states representing nearly 50% of USA employment. The weighted average amount of these increases was 6%, creating a meaningful positive impulse for wage growth over the next few years.

However more importantly for the USA economy, employment gains continue to accelerate for 25-34 year olds. Both wage growth improvements and strengthening employment gains in the 25-34 age group are supportive of household spending, which has a positive flow on effect for residential investment, credit growth, and auto sales.

Market Outlook for 2017

Monthly change in employment of 25-34 year olds (thousands)



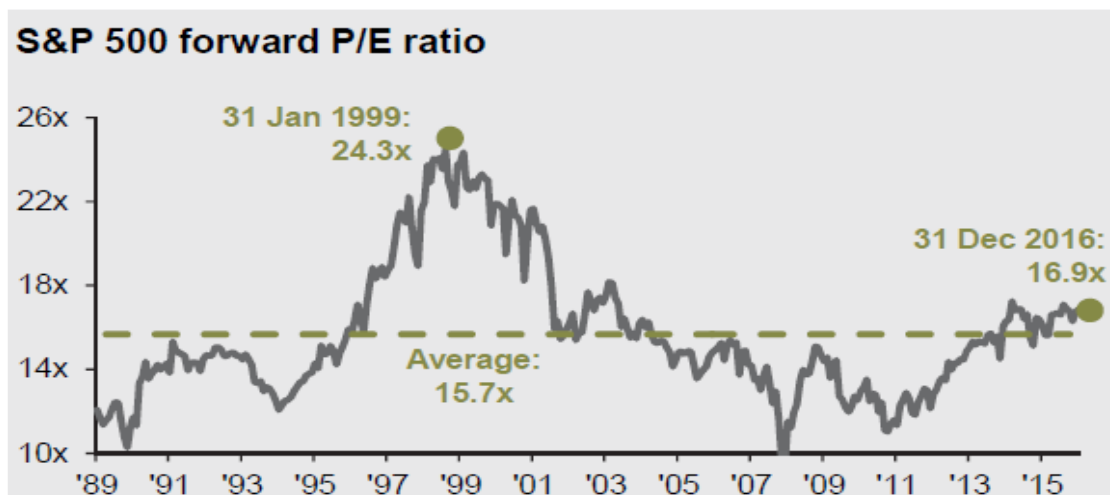
Source: Macquarie Research

After eight years of monetary stimulus which failed to generate satisfactory economic growth in the US and reignite inflation, Donald Trump has promised to unleash significant fiscal stimulus to "Make America Great Again." The subsequent strong performance of global equities since Trump's election win sees all major US stock market indices at all-time highs.



However from a valuation perspective the US share market is only slightly above fair value, still a long way from historical extremes. This is because higher goods and services consumption by households, as a result of wages growth and lower unemployment, is supporting a growing corporate sector and rising corporate profits.

Market Outlook for 2017

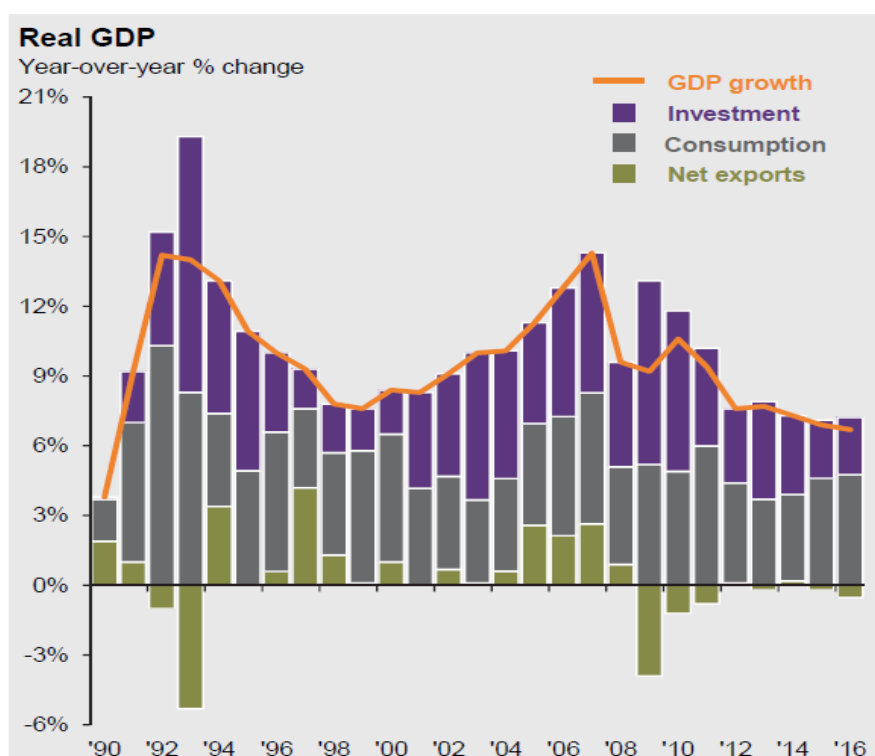


Source: FactSet, Standard & Poor's

Overall, we expect the US economy to continue along its path of a steady recovery over the next few years, barring unforeseen events. This should continue to support equity markets, although great uncertainty on Trump's actual policy platform will most likely lead to bouts of elevated market volatility during 2017.

China

On the back of the aggressive credit extension and infrastructure spending in 2016, economic growth in China has stabilised somewhat at around 6.7%, led by a modest recovery of the "old economy" such as mining and real estate. As such the transition from an economy driven by production/exports to one driven by consumer spending is still in progress but taking time.



Source: FactSet, NBS China

Market Outlook for 2017

Nonetheless, the protracted slowing trend of recent years is unlikely to be reversed any time soon, given secular and structural drags including industrial overcapacity, an ageing population, and falling productivity growth.

Despite a slight slowdown in economic growth, a financial crisis or hard landing is unlikely, unless the debt situation implodes. The means of achieving growth is likely to change with more focus on reform and restructuring and less on fiscal stimulus. More attention will be given to the now more important services sector, which represents 55% of China's GDP.

The Chinese leadership appear to be aware of the current problems with credit and property excesses in its economy and more importantly have the policy tools needed to stabilise the economy. Most of China's debt is held domestically, which makes it easier for the Government to manage large scale defaults. Also the huge pool of foreign exchange reserves and a large current account surplus make China resilient to external financial shocks.

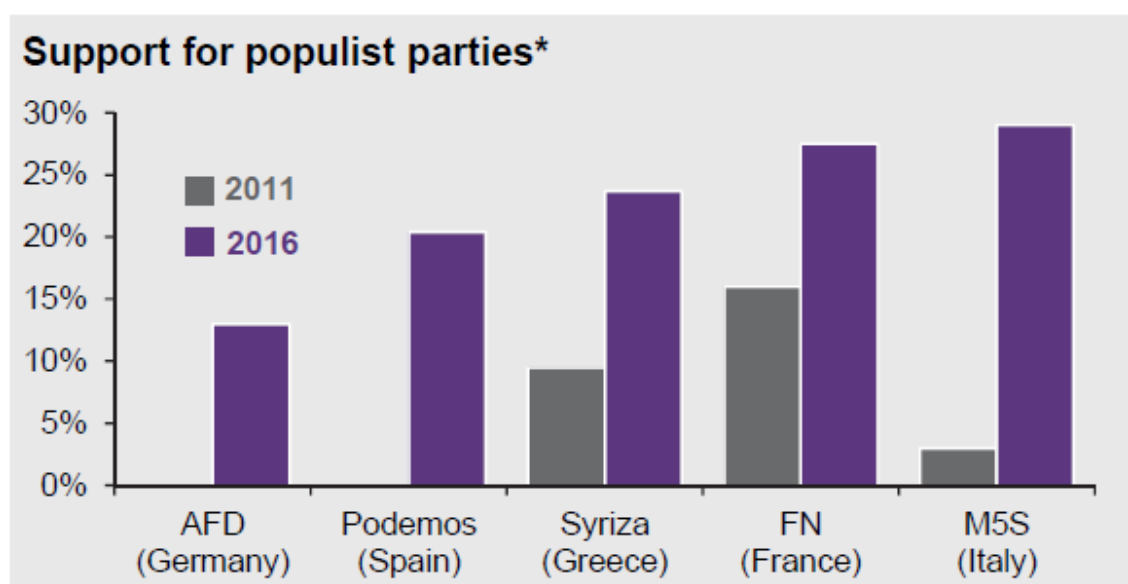
Investing in China and the rest of the Asian region is never plain sailing. Investors need to be cautious as there can be volatility in share market returns along the way. However we generally remain positive on Chinese and other Asian equity markets given the expectations of continued earnings recovery and fiscal stimulus to maintain growth in the region.

We are also positive on investment opportunities in India given its recent monetary and fiscal reforms, which have been a significant positive for its long-term economic outlook.

Eurozone

After the surprise of Brexit in June 2016 and the "No" vote in the Italian Referendum, there is much uncertainty surrounding the Eurozone. The Netherlands have a general election in March, France chooses a new president in May and later in 2017 Germany goes to the polls with Angela Merkel seeking a fourth term.

The anti-elitist movements that delivered Brexit and a Donald Trump presidency are at work throughout Europe and there is little doubt the EU and possibly the euro are under increasing threat.



Source: IFOP, J.P. Morgan Asset Management

Market Outlook for 2017

Despite all of the uncertainty, real GDP growth in the Eurozone was quite firm at around 2% for the year, surprisingly above trend for the region. A number of the periphery economies are continuing on their recovery path. Spain and Ireland's annual growth rates remained strong at 3.2% and 6.6% p.a. respectively, while Greece recorded its highest rate of annual growth since mid-2008 of 1.6% p.a. However, there are risks from Italy's ongoing economic malaise, undercapitalised banking system, tightening credit conditions and political uncertainty.

The Eurozone as a whole is likely to continue benefiting from a weaker currency, a stronger US economy, and an improvement in borrowing conditions and credit flows in an environment of ultra-low interest rates. However, the pace of growth is likely to remain modest for the foreseeable future as high levels of government debt, unresolved banking system issues, political uncertainty, and poor demographics hold back the economy.

With inflation hovering around and below zero and the deflation risk rising, the European Central Bank has had to act and decided to extend the quantitative easing program of EUR 60 billion per month from March to December 2017, adding another EUR 540 billion to the program!!! The ECB has stated that it will continue with quantitative easing until inflation is back to target of around 1.5%.

Overall, we expect a continuing gradual recovery in the Eurozone, but remain cautious about material downside risks and generally we are avoiding the region.

Market Outlook for 2017

Australian Property

A-REIT's (Australian Real Estate Investment Trusts)

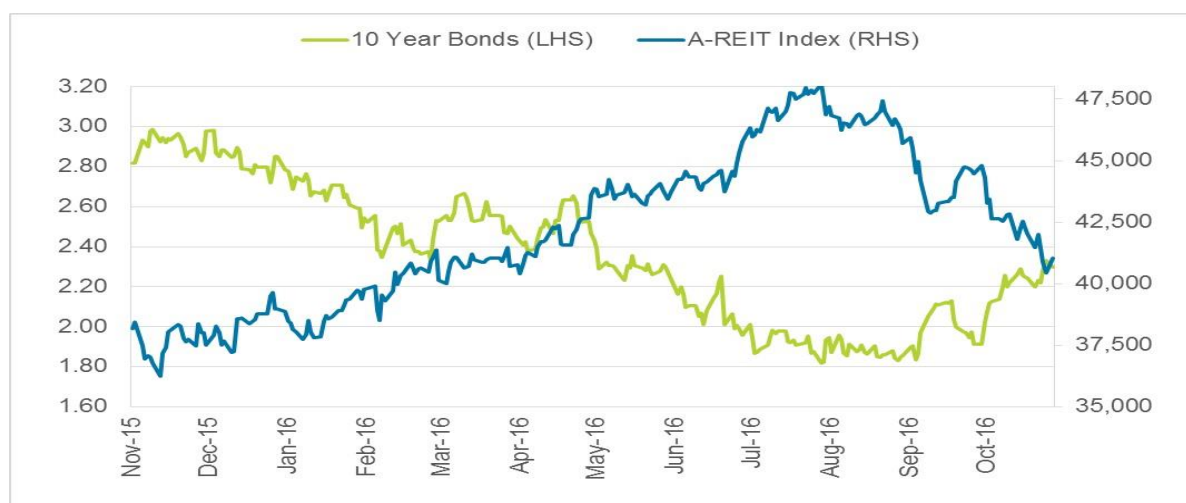
Calendar Year 2016 turned out to be another solid year for A-REIT's with a total return of 13.16%. Whilst overall returns from the A-REIT sector in 2016 were pleasing, during the second half of 2016 the movement in A-REIT prices became quite volatile. From August through to early November A-REIT's declined approximately -13% in value but recovered strongly from late November eventually only declining -2.68% for the second half of 2016.



So what caused the volatility in A-REIT returns in the second half of 2016?

Over the past few years A-REIT returns have been exceptionally strong. As at 31st December 2016, A-REIT's have returned 18.01% pa over the last 3 years and 18.54% pa over the last 5 years. Of course, nothing goes up in a straight line forever and we did warn in our June 2016 market outlook that returns of this nature were not sustainable especially in a sector known for its stability and income-driven focus.

Exceptionally low bond rates, and a declining interest rate environment was the major catalyst for the strong performance of A-REIT's until recently. 10 Year Australian Government Bond yields hit an all-time low of 1.82% on August 1, 2016 which, not coincidentally, was also the recent high of the A-REIT sector index. Since then, bond yields have risen in Australia due to an increase in US bond yields, a result of slightly stronger growth and the delivery of a December rate increase in the US. A change in bond yields has a direct relationship with sector value. Higher bond yields normally mean lower A-REIT values, which can be seen in the graph below:



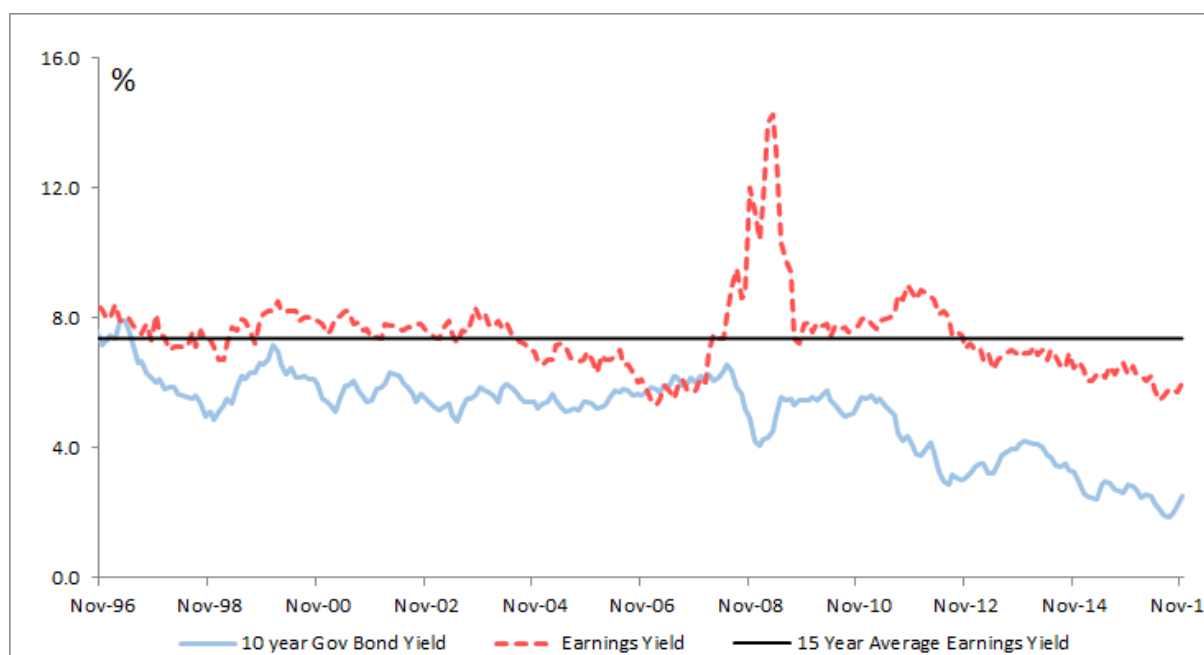
Market Outlook for 2017

The expectation is that US rates are likely to continue to increase during 2017, but not at a dramatic rate. The sell down in A-REIT's due to an increase in Government Bond yields from August through to early November was overdone and the recovery in A-REIT prices late in the year was evidence of this overreaction. In December alone the A-REIT sector rebounded 6.81%.

Looking into 2017 we remain cautiously optimistic for A-REIT returns. Each sector of the A-REIT market is in reasonable shape. The better quality retail properties (large shopping centres) that feature in the A-REIT sector are structurally sound, with high barriers to entry and low vacancy rates of around 1%. Commercial office is also particularly strong, especially in the prime markets of Sydney and Melbourne with low vacancies as well.

It also does not appear valuations are overstretched. Although Net Tangible Assets (NTA) currently show a high premium price to last valuations, this is not always a perfect measure of valuation as it doesn't account for the distorting impact corporate earnings has on share prices. Net Asset Value (NAV) and Discounted Cash flow Valuations (DCV's) are usually a more reliable measure, and these valuation metrics suggest the sector is currently trading at fair value.

Another supporting factor indicating that A-REIT's are not overpriced is that the earnings yield spread for the A-REIT sector is above the 10-year government bond yield (currently 3.7%). This is higher than the long term average spread (15 years to 30 November 2016) of 2.6%.



It is also important to appreciate the sell-off which occurred in A-REITs had taken place without any erosion in the underlying operating fundamentals within the sector. This means the distribution outlook of A-REIT's has not fundamentally changed and investors can continue to look forward to the distribution yield they have come to expect in the next 12 months of 5% - 6% per annum, which is attractive in this low interest rate environment.

We expect returns for A-REIT's for the coming 12 months to normalise at somewhere between 6%- 8%, but it is possible the volatility of the sector will continue with sensitivities to the movement of interest rates.

Market Outlook for 2017

Australian and International Cash and Fixed Interest

It has certainly been an interesting year in cash and fixed interest markets.

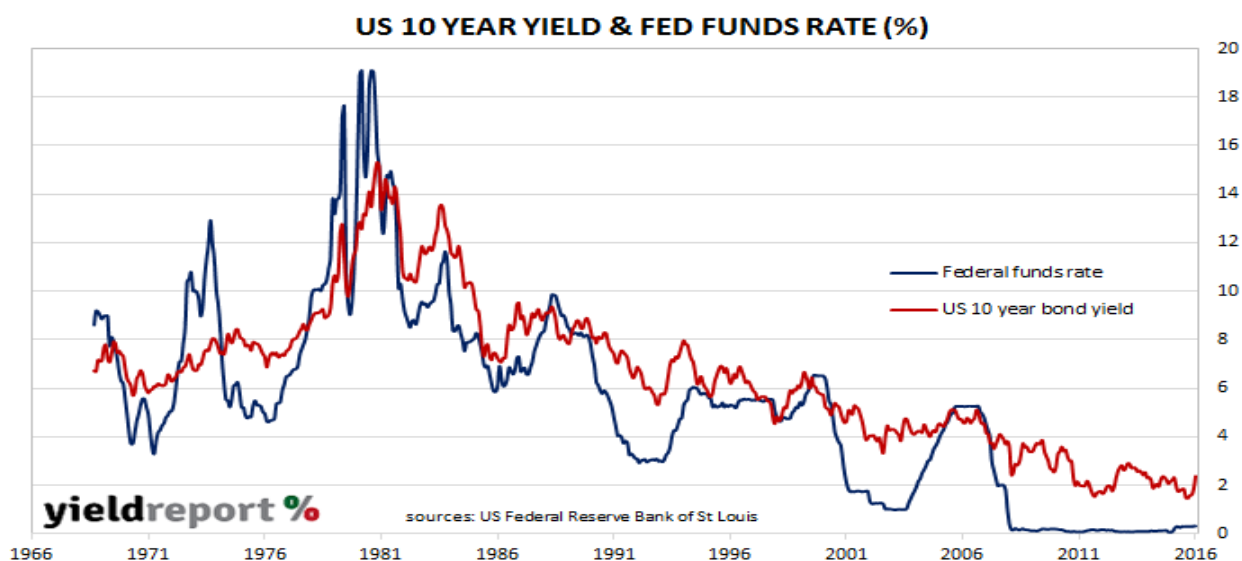
The RBA started calendar year 2016 with no official conditional easing bias, however with the general consensus global growth was slowing and domestic economic conditions were likely to be benign, analysts were convinced the RBA would drop the official cash rates during 2016. This eventuated with the RBA shaving 50 basis points from the cash rate during 2016 with the cash rate starting the year at 2.00% and finishing at 1.50%.

Likewise, cash yields around the world have been falling since 2008 as central banks maintained what amounted to unprecedented price support activities as economies in Europe, the US and Japan grew at rates less than trend with next-to-no inflation.

Government bond yields both here in Australia and around the world also hit record lows in August. In Australia the 10 Year Australian Government Bond yield started the year at 2.85% and hit an all-time low of 1.82% on August 1, before finishing the year at 2.79%. Similarly in the US, 10 Year Government bond yields reach an all-time low in July 2016 of 1.31% before finishing the year at 2.45%.

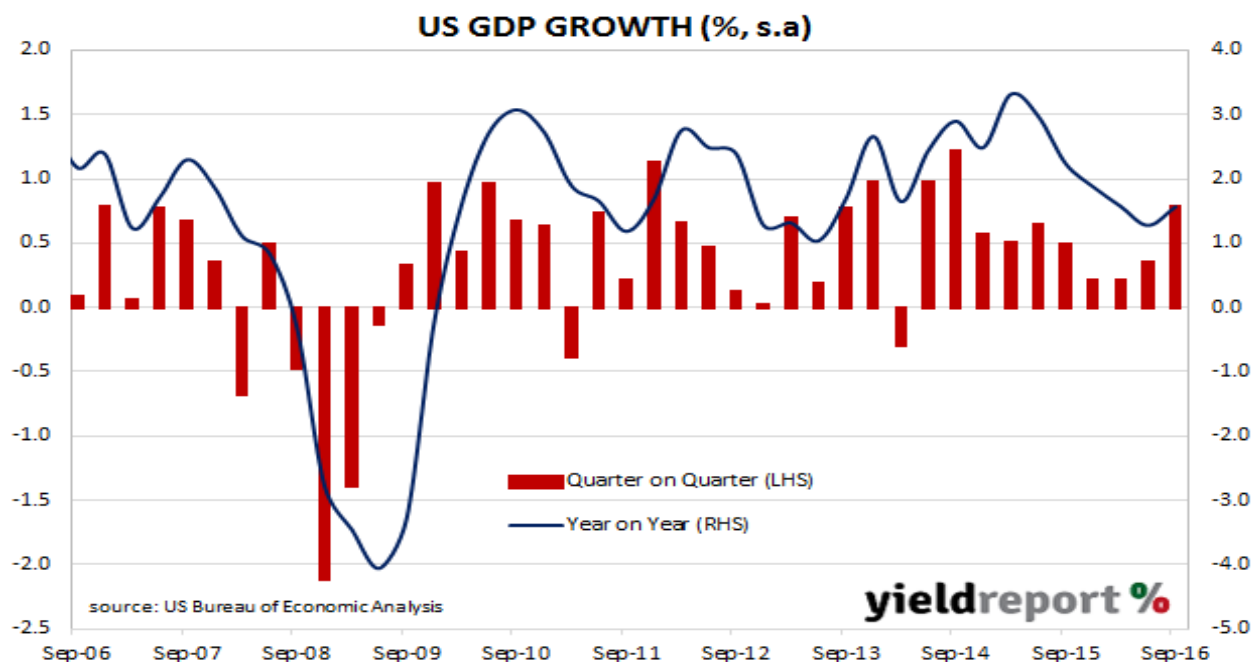
There were many reasons why Government Bond yields finally started to increase in the second half of 2016, including:

- Following the initial shock reaction to the Trump election result and contrary to the preceding message from various doomsayers, the new Trump administration has been received overwhelmingly positively by financial markets so far. Investors are accepting the Trump promises of a growth agenda, including tax cuts, new infrastructure investments and financial deregulation, at near face value. This combination of stronger growth confidence and rising inflation expectations on the back of debt-financed fiscal stimulus has seen government bond yields surge dramatically in response
- The US Fed also raised its official interest rates for a second time, one year after its last rise in December 2015. The Fed's interest rate setting committee, known as the Federal Open Markets Committee (FOMC) raised the Federal Funds target rate from its 0.25% to 0.50% range to a range of 0.50% to 0.75%. US bond markets again surged and Australian bonds followed suit



Market Outlook for 2017

- Better GDP figures in the US, UK and even in Europe



- Talk of a tapering of bond purchase programmes by the European Central Bank and a change to the Bank of Japan's 10 year bond yield policy.

With the increase in Government Bond yields and a renewed enthusiasm for US economic growth, it now appears we may have reached the bottom of the interest rate cycle both here in Australia and around the world. The US bond market is especially important, as it is the largest and its prices act as a benchmark for interest rates globally. Rising bond yields in the US signal a number of things, as for example higher expected inflation rate which puts upward pressure on interest rates. As a consequence, for the first time in a significant period, fixed interest markets are predicting the next rate move will likely be up, but this is not anticipated to occur until at least late 2017 if not early 2018.

