

Market Overview

Australian Shares

- In a year that was friendly to most equity markets, returns for Australian shares have been good:
 - The S&P/ASX 200 Accumulation Index produced a total return of 14.09% for the Financial Year
 - Resources, which have weighed on performance previously, perked up, and returned 22.92%

International Equities

- World shares did well for the Financial Year, with the MSCI World Index up 20.8% for the year to date in the currencies of its component markets:
 - Australian investors achieved smaller returns in hand (14.74%), owing to the appreciation of the AUD against the USD
 - Among developed markets, the US (Dow Jones Industrial up 22.12%) and the eurozone (Germany's DAX up 27.32% and France's CAC up 23.60%) have led the way
 - Japan (Nikkei up 28.62%) and the UK (FTSE 100 up 16.92%) have also made strong gains

Australian Property

- The A-REITs have been strongly affected by investors' assessment of the outlook for bond yields:
 - For the A-REITs, however, the reassessment of relative value was particularly brutal in late June (and the first half of July), when investors finally decided that central banks were starting to change course
 - As a result, the Index produced a loss of 6.26% for the Financial Year

Australian Cash and Fixed Interest

- The RBA has kept monetary policy unchanged, which means that short-term rates have also shown little change, with the 90-day bank bill yield showing small day-to-day fluctuations around 1.75% (currently 1.71%):
 - Long-term yields have followed overseas rates upwards as many markets started to take a more serious view of the potential for world monetary policies gradually becoming less supportive
 - The 10-year Commonwealth bond yield is at 2.60%

International Fixed Interest

- Bond yields overseas have risen recently in the US, the eurozone and the UK:
 - In the US, financial markets have been adjusting to the prospect of less-supportive monetary policy
 - The target range for the federal-funds rate has already progressively been raised to its current 1.0%-1.25% (most recently on June 14), and the Fed has also said that it will soon start running down the large amount of bonds it had bought under its quantitative easing programme
 - As a result, the benchmark 10-year US Treasury yield has risen to 2.31%

Australian Dollar

- The Australian dollar has strengthened, particularly in the days after congressional testimony by the chair of the Federal Reserve, Janet Yellen:
 - The US dollar fell globally as a result, and the Australian dollar rose as a collateral beneficiary, with the AUD now up 8.0% for the year to date against the USD, at USD 0.781

Market Outlook for 2017/2018

The past 12 months have been a strong performance period for shares in Australia and around the world. The Financial Year to 30 June 2017 was a welcome contrast to the previous Financial Year when uncertainty was high and market returns were low. This was despite a lengthy list of things to worry about, including:

- Brexit vote and a messy election outcome in Australia, both just before the Financial Year started
- Concerns about global growth, profits and deflation a year ago
- Donald Trump being elected President in the US with some predicting a debilitating global trade war as a result
- Various elections across Europe feared to see populists gain power
- The US Federal Reserve resuming interest rate hikes
- North Korea stepping up its missile tests
- China moving to put the brakes on its economy amidst ever present concern about its debt levels
- Relatively modest economic growth in Australia along with perennial fears of a property crash and banking crisis

Despite these perceived risks, the Financial Year has been a rewarding one for investors and offers a classic reminder 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.

Looking ahead, we think the level of economic growth, the prospect of rising inflation and the direction of interest rates (particularly in the US, Europe and Japan), will have the most significant impact on the performance of financial markets in the 2017/18 Financial Year.

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Australian Shares

The Australian share market, represented by the S&P/ASX 200 Accumulation Index (capital appreciation plus dividends), posted a total return of 14.1% for the Financial Year, made up of a capital return of 9.3% plus a dividend yield of 4.8%. This was the Australian share market's third-best year post the GFC and was bettered only in 2013 and 2014 with returns of 17.3% and 12.3% respectively.

Most of the return was generated in the first half of the Financial Year, with the index returning 10.6% for the six months to December 2016, as investors flocked to resources and the cyclical sectors (banks and industrials) on the back of the election of President Trump and his promises of accelerating US economic growth.



Despite a weaker end to the quarter by the commodity sensitive sectors, due mainly to sharp falls recorded by the major commodities of oil, coal and base metals, the Materials (mining) sector remained the largest contributor to the overall market return, with strong returns also posted by Utilities, Healthcare and Information Technology.

While Australian bank shares were negatively impacted by the new levy announced in the Federal Budget, the sector still managed to record a very strong return for the year. Energy, although weak towards the end of the Financial Year still managed to post a positive return for the year.

However, the Telecommunications sector, led by Telstra, and A-REITs were the major underperformers, with both posting negative returns for the Financial Year.

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Returns for the Australian share market for Financial Year 2017

S & P Sector	12 Month % Change	S & P Sector	12 Month % Change
Materials	20.6%	Consumer Discretionary	3.1%
Utilities	14.7%	A-REIT (listed property)	-7.3%
Financials	11.9%	Telcos	-26.9%
Health Care	11.8%	Midcap 50	14.5%
Information Technology	11.4%	S & P/ASX 100	9.7%
Consumer Staples	11.1%	S & P/ASX 200	9.3%
Industrials	10.1%	Top 50 Leaders	9.1%
Energy	5.5%	Small Caps	7.01%

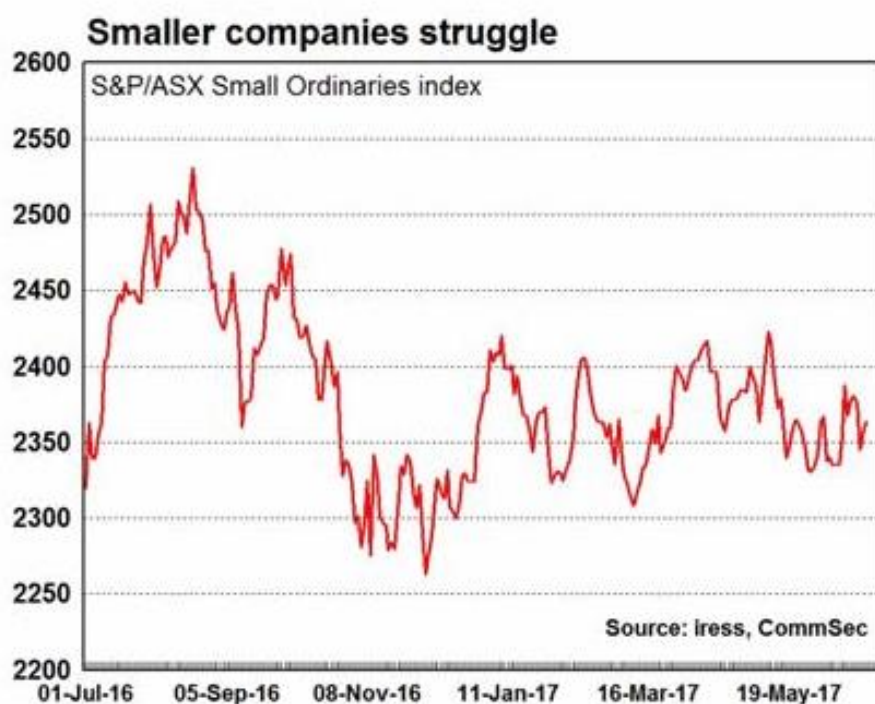
Source: IBES, Macquarie Research, July 2017

The MidCap50 sector was again the strongest size category in the Australian share market, with mid cap companies (50 to 100 by market capitalisation) up by 14.5%, outperforming their large cap top 50 rivals (9.1%) over the 2017 Financial Year.



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The small cap sector unfortunately struggled to some extent, up by only 7.01% for the 2017 Financial Year as investors moved to the supposed reliability of the larger companies in the market.



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 the 2018 Financial Year. As such we think that the small cap sector at this stage represents the best value in the Australian market.

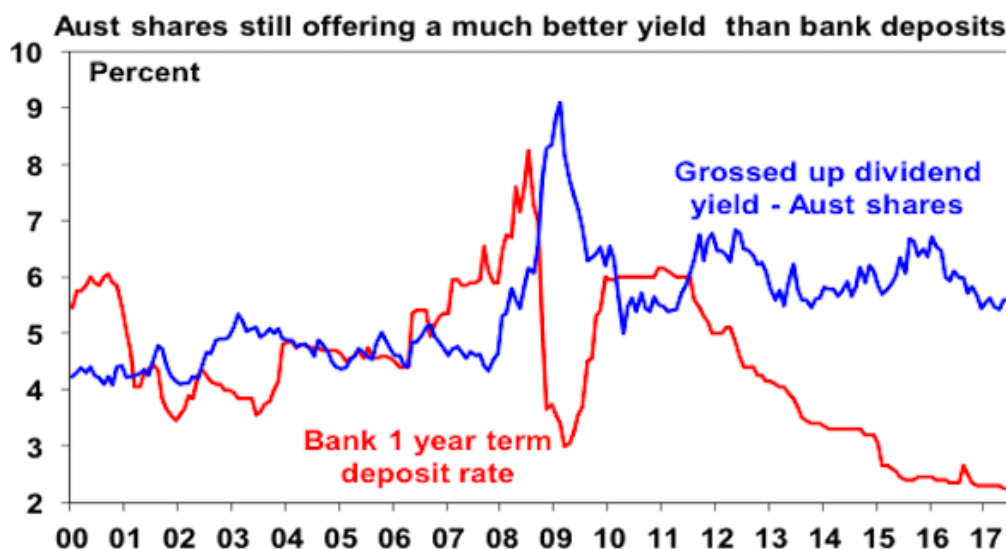
From a valuation (Price/Earnings) perspective, the Australian share market is trading only slightly above the longer term average PE of 15.7. However, most importantly it is still a long way from historical extremes and with high quality earnings, strong balance sheets and low interest rates there is an argument that the market should be trading well in excess of these long run averages.

PE Ratio for the Australian share market



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Australian shares also continue to be very attractively valued against other asset classes, particularly against cash and bonds. With the earnings outlook looking somewhat brighter and a significant gap between cash yields versus share dividends still existing (and likely to for the foreseeable future) there is scope for the Australian share market to continue to outperform.



Source: RBA, AMP Capital

Looking forward to the year ahead, the economic and financial metrics for Australia remain encouraging. The June RBA minutes confirmed that the central bank remains comfortable with its prior assessment of the economy – temporary drags in the March quarter reversing, an improving labour market, some easing in house prices and evidence that the global growth upswing continues.

It did however express a rising concern around the outlook for the consumer and still elevated debt growth, but recent ABS house price data provided some evidence that recent credit rationing by the banks and rising mortgage rate are starting to take heat out of the key Eastern seaboard cities.

Although economic growth is relatively modest at 1.7%, the cash rate is at record lows, inflation is under control, the Australian dollar is supportive and business conditions are near 9-year highs, all which should provide some impetus to the economy. And unemployment is at a 4-year low of 5.5%.

While it may be hard to match the strong market performance of 2016/17, all the major factors, including reasonable economic growth that should flow through to stronger corporate profits, are still very much in place to deliver investors relatively good returns from the Australian share market in 2017/18.

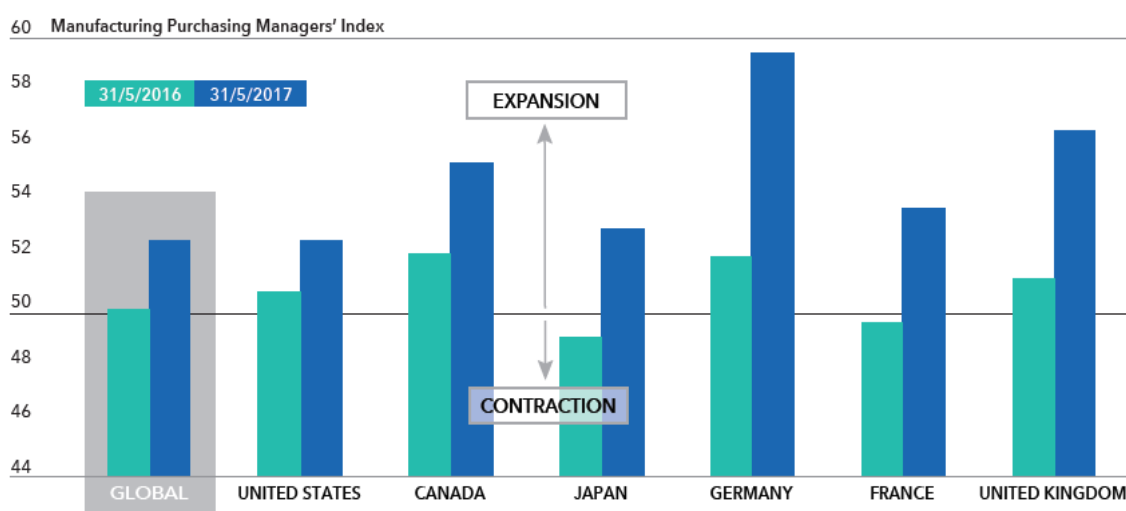
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International shares

On the surface the global outlook is certainly more positive than it was this time last year. For the first time in years, the world's major economies all appear to be on the road to recovery.

Once the missing link in the global recovery story, the industrial sector has bounced back this year, as can be seen in the graph below. Powered by improvements in the U.S., Germany, France, the U.K. and China, increasing demand and a gradually weakening dollar have acted as a tailwind for global manufacturing activity, while consumer spending has remained strong in many regions.

Industrial strength recovery: Survey points to expanding manufacturing activity all over the world



Source: FactSet, May 2017

United States

In the US, the S&P500 Index gained 17.2% in local currency terms and achieved record highs. President Trump's bold promises of corporate tax cuts, higher infrastructure spending and less regulation were supportive factors.

Over the course of the year, the US market moved away from the economically sensitive 'value' stocks back to quality growth areas like technology. In many tech stocks we saw an unusually strong level of earnings upgrades and positive revenue guidance. This is at least partly a reflection of the oligopolistic profits being made in many areas by companies that dominate their market segments like Facebook, Apple, Amazon, Netflix and Google (FAANGs).

Despite the FAANG stocks being responsible for a significant proportion of total index gains, the tech-heavy NASDAQ-100 Index is still trading on a price-to-forward earnings ratio modestly below its long-run average. If these companies can keep beating earnings estimates they should continue to support the US equity market going forward.

Market Outlook for 2017/2018



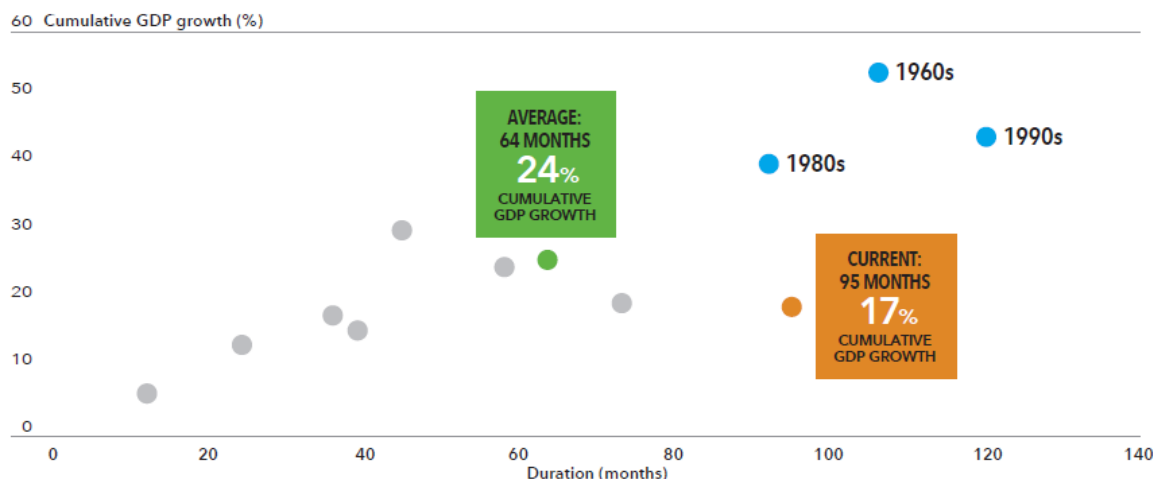
Source: Fidelity International, Thomson Reuters, June 2017

On the policy front, easing regulations, combined with prospective tax reform, should provide a further boost to growth.

And whilst the current economic growth cycle has been around for a long time (at 95 months it has been longer than the average) there are no obvious imbalances or excesses in the US economy today. Given the relatively modest pace of growth thus far compared to previous economic growth cycles, it could take some time for any imbalances to build up and with strengthening wage growth and retail sales, these conditions point to accelerating growth going forward.

This should continue to support corporate earnings and with the US Federal Reserve expected to take its time lifting interest rates back to more "normal" levels as inflation is well contained, this in turn should continue to support the US share market.

The current growth cycle is longer than average, but the growth rate has been lower than average



Source: National Bureau of Economic Research, U.S. Bureau of Economic Analysis, May 2017

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That said, questions remain about how much longer things can continue as they currently are given President Trump is now perceived as something of a loose cannon, whose ability to pass legislation hangs in the balance.

Eurozone

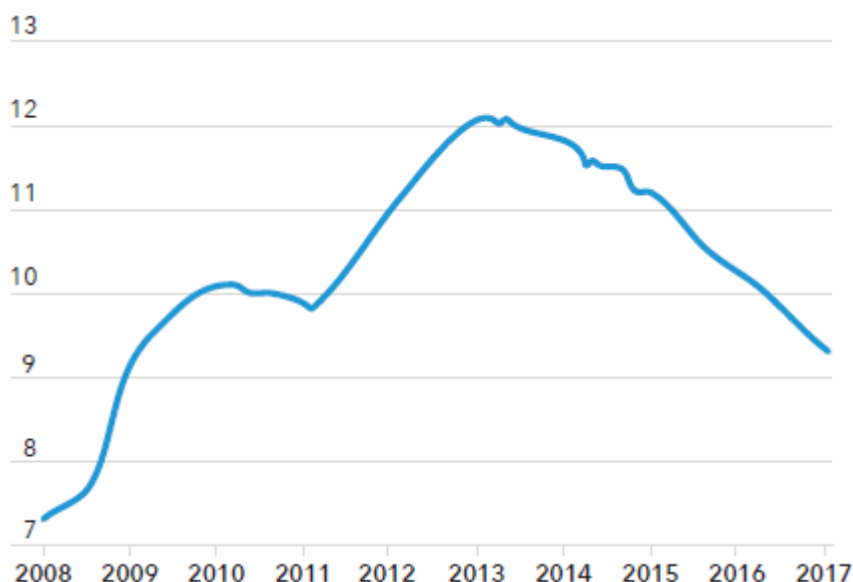
European share markets also made remarkable gains given positive economic activity and encouraging business surveys. Germany's share market was up 27.3% for the year and the French market gained 24.8%.

Despite the uncertainty created by the surprise Brexit vote and the Conservative Party's recent loss of their parliamentary majority, the UK share market increased by 16.9% as the weaker currency benefited UK companies with offshore earnings.

European equities are now showing signs of recovery after concerns around political risk, which have weighed on returns over the last year but have now eased following anti-EU party defeats in Dutch and French elections this year.

The improvement in the euro-zone's growth rate has been broad-based and supported by several factors, particularly an accelerating reduction in the unemployment rate and a rise in spending. Also Europe has been the beneficiary of a sharp improvement in global economic activity, particularly in the U.S. and China.

Euro-area unemployment has reached its lowest level since 2009



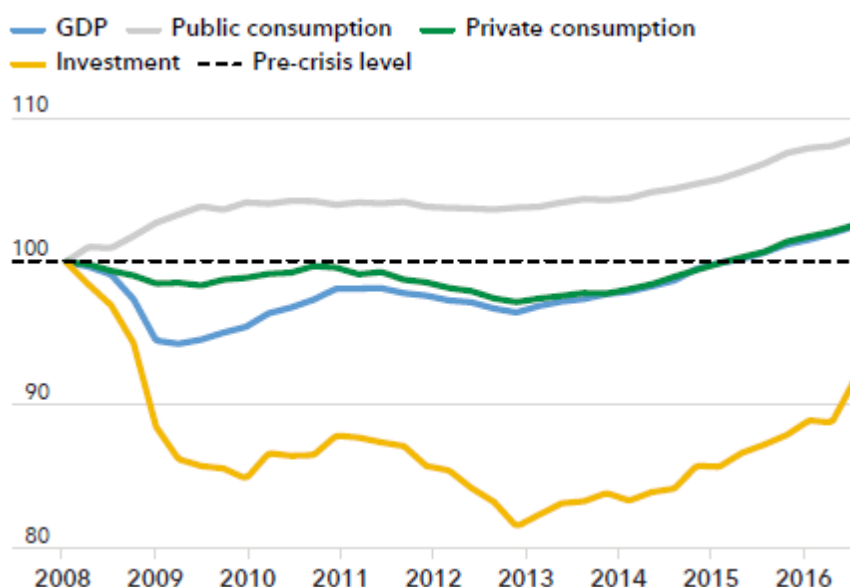
Source: Thomson Reuters Datastream, June 2017

Meanwhile, the European Central Bank has maintained an extremely accommodative monetary stance, with low interest rates coupled with a relatively weak euro. Fiscal policy has become less of a drag on growth as austerity has been lifted.

Finally, there are signs that credit demand is picking up as households and companies start to spend, and banks have become more willing to lend.

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Spending is on the rise



Source: Thomson Reuters Datastream, June 2017

While these factors all contribute to a positive outlook for Europe's economy, there is still the potential for global macroeconomic instability to adversely affect the European economy, particularly with the tone of Brexit negotiations and the upcoming Italian elections, which could throw up concerns around potential financial and political risks.

China and the Emerging markets

The positive tone in developed markets extended to the emerging world with the MSCI Emerging Markets Index making a sharp recovery over the year, returning 20.5% on an unhedged basis.

China's share market gained 9% in response to the economy's solid performance, which was driven by a large infrastructure spending stimulus program and a robust housing market.

After a few disappointing years, earnings momentum has turned firmly positive. It has been the best start to the earnings cycle in the last five years in terms of upward revisions. As long as the US Fed rate doesn't raise interest rates too quickly and the pace of its stimulus reduction is gradual, the outlook for the region remains positive.

Specifically for China, we see a managed slowdown to growth levels of around 6.5%. The government is aiming to deleverage the financial system, improve transparency and curb a credit bubble by clamping down on 'shadow banking' activities. The fundamentals of China's economy therefore remain positive for the long term, which should support investment sentiment.

Corporate profits are picking up too, which historically has been good for share prices. In aggregate, earnings for companies in China and other emerging markets are estimated to increase 21% in 2017.

Significantly, strong earnings are expected from the technology sector which is undergoing remarkable growth, with market leaders like Alibaba forecasting revenue growth of 49% this year. Also the shift to online is happening at a rapid rate in China with companies like Alibaba and Tencent innovating at a frenetic pace and embracing new technologies like artificial intelligence. Both companies are also investing in cloud technology and the significant

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mobile payments market, which makes up 56% of web traffic in China versus only 30% in Germany and 23% in France.

Valuations on China and emerging markets thus appear relatively attractive amid earnings turnaround and a reform drives in the region.

Australian Dollar

The Aussie dollar has proved to be far more resilient than expected, rising around 3.22% over 2016/17. The Aussie started the year around US74.51 cents and ended at around US76.91 cents.

The high for the AUD in 2016/17 was US77.78 cents in November 2016 and the low was US71.52 cents in December 2016 – with the AUD having tracked over a US6.25 cent range against the greenback over the year, this has been the least volatile year in 27 years.

Although it may push up into the low US80 cents in the short term given some US dollar weakness, the downtrend in the AUD is likely to resume at some point in the next 12 months. We therefore continue to recommend our clients be unhedged with their International share investments.

Heading into the new Financial Year, clarity is improving on many fronts, but questions remain:

- Can U.S. markets sustain their winning streak?
- Will Europe finally turn the corner?
- What will rising interest rates mean for investors?
- Can the Chinese made significant progress on their debt problems?
- Will the Sydney and Melbourne property markets experience a sharp downturn, which could threaten Australian growth?
- And will the politics, particularly around Trump's policy agenda and North Korean tensions upend everything?

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Australian Property

Over the last Financial Year it was a tough period for A-REIT's with the S&P/ASX 200 Property Trust Accumulation Index falling -6.26%. The short term negative performance of A-REIT's shouldn't be a concern to long term investors in A-REIT's who have had a stellar run. Over the last 3 years the S&P/ASX 200 Property Trust Accumulation Index has returned 11.98% per annum and over 5 years 14.14% per annum. It was almost inevitable a negative return for the A-REIT sector was due.

Much of the negative return for A-REIT's in the last 12 months can be attributed to the headlines of Amazon's arrival in Australia and the structural shifts in retail required during a period which retail does appear to be suffering. The fear is that the arrival of Amazon will destroy Australian retail. Amazon is a giant bundler offering low prices, incredible range and astonishing distribution. That seems to spell trouble for retailers and, by extension, shopping centres.

Retailers lacking a point of difference with online competitors are at the greatest risk. Credit Suisse found that Amazon's arrival will most affect Myer, Harvey Norman, JB Hi-Fi, Supercheap Auto, Rebel, Amart Sports, Big W, Kmart and Target. The question for investors in shopping centres is whether malls can adapt to what is likely to be reduced demand for floor space from troubled retailers. Certainly the returns of the shopping Centre operators has suffered with Westfield (-21.5%), SCentre (-13.4%) and Vicinity (-17.3%) weighing heavily.

The good news is that the big shopping malls have responded to the online threat by offering a much larger variety of retailers and entertainment brands which makes the best shopping centres more attractive as leisure-based destinations. Certainly there appears to be a plethora of overseas brands queuing up to take the place of the retailers most at risk.

Whilst all the noise of the A-REIT sector is currently focused on plight of the retail sector, it is important to look at the bigger picture with A-REIT's. In our opinion the most attractive feature of investing in A-REIT's is its simplicity. By focusing on the key financial metric of net operating income growth, occupancy and valuation you generally get a sound picture of the prospects of the sector.

At present, each key metric is strong as can be seen in the table below:

Metric	1H15	1H16
Earnings Per Share (EPS) growth	5.4%	5.3%
Net Tangible Asset (NTA) growth	5.3%	5.3%
Net Operating Income (NOI) growth:		
▪ Office	1.5%	1.9%
▪ Retail	2.7%	3.0%
▪ Industrial	2.3%	0.7%
Occupancy	97.1%	97.2%
Vacancy rate	2.9%	2.8%
Cap rate	7.1%	6.5%
Gearing	29.5%	28.5%

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In particular, low vacancy rates and the trajectory of Net Tangible Asset (NTA) growth remains extremely sound albeit we expect capital growth to be less than in recent years.

The yield on offer for A-REIT's also remains attractive. In a low interest rate environment, the current 5% - 6% running yield will continue to appeal to genuine long term investors that want a secure, stable income.

Most importantly, defensive A-REIT structures and the strategies they're employing imply a lower risk outlook. Most A-REITs have strong balance sheets (low levels of well managed debt), low levels of active (or risky, non-rental style) earnings and low offshore exposures. This is good for the long term prospects of the sector.

We would expect the return of A-REIT's to return back to normality in the coming 12 months with a likely return of somewhere between 6% - 10% underpinned by strong fundamentals.