Market Overview

Australian Shares

- The Australian market has recovered most of its losses for the calendar year to date
  - The S&P/ASX200 Accumulation Index returned 8.47% (after including dividends)
- Rising commodity and energy prices have lifted the likes of BHP, RIO and Woodside Petroleum
- CSL continues to go from strength to strength after lifting profit guidance in May
- On the flip side, financial stocks have not recovered from recent Royal Commission revelations
- For the Financial Year, the sectors that dragged down returns were the banks, telecommunications and utilities
  - Most other sectors of the market had a great year

International Shares

- A respectable corporate earnings season helped global equities rally off their February lows however sentiment remains vulnerable to inflation, higher bond yields and geopolitics:
  - The MSCI World Index was up by 5.62% for the quarter in Australian dollar terms
- Trade war tensions have re-surfaced, and possible bilateral tariffs between the US and China may see these escalate further
- A fractured G7 summit in early June saw the US at loggerheads with its G7 counterparts:

Australian Property

- AREITs posted strong returns recently despite rising bond yields:
  - For the quarter, the S&P/ASX200 A-REIT Index recorded a gain of 10.04% (after including dividends)
  - M&A and a relief rally in global malls may explain some of the recent strength
  - In M&A news Blackstone's $3.1 billion cash bid for Investa Office sent the stock soaring while Westfield ceased trading at the end of May following Unibail-Rodamco's successful bid for the company

Australian Cash and Fixed Interest

- The Reserve Bank of Australia left the cash rate unchanged at 1.50% in June.
- The RBA remains relatively upbeat on the prospects for global growth
  - Recent employment data has been slightly disappointing, and wages growth continues to underwhelm.
- The RBA's statement was little changed from previous months.

International Fixed Interest

- The US Federal Reserve increased interest rates in June as it pursues its normalisation of interest rate policy from ultra-low levels post the GFC
  - US Treasury yields are up sharply since December, reflecting an adjustment to stronger economic growth
  - A growing US deficit and signs of wage inflation earlier in the year accentuated the rise

Australian Dollar

- The Australian dollar has been weak against the US dollar, down 3.65%, as well as other major currencies.

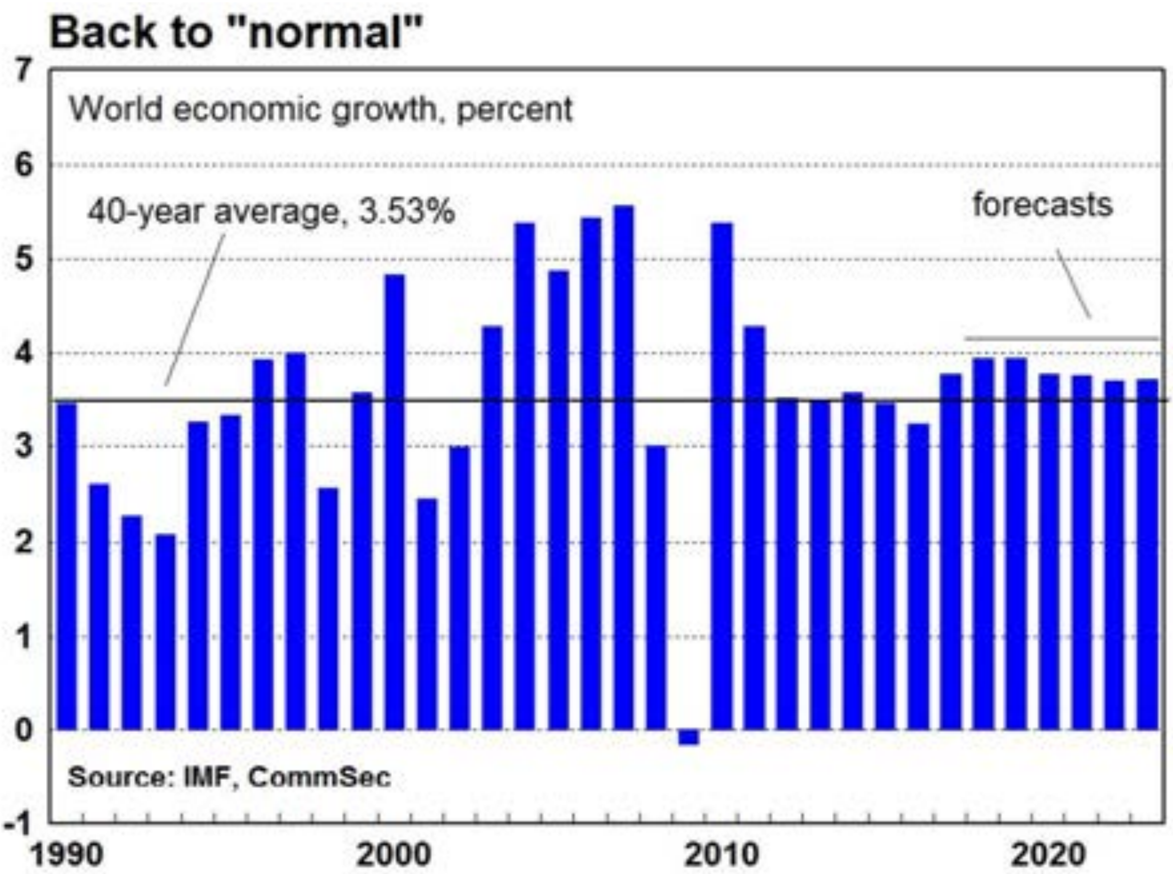
Market Outlook for 2018/2019

The past Financial Year saw solid returns for investors, but it was a story of two halves. While the December Half Year was buoyant as global share markets moved to factor in stronger global growth, the last six months saw heightened market volatility and more subdued returns as an increasing list of issues affected investor confidence.

There was a lengthy list of factors that had a significant impact on investment markets over the Financial Year. They included:

- A strong lift in global growth assisted by US tax cuts
- Low wage and price growth which resulted in low inflation in most world economies
- Productivity benefits from technological advances
- Benefits of globalisation
- Concerns around rising US interest rates
- Uncertainty around potential trade wars
- Renewed China and Emerging Market worries
- Falling home prices in Australia.

Looking ahead, we suspect returns are likely to slow but broadly remain positive. As shown in the graph below, global growth is forecast to remain strong, which should continue to underpin corporate profit growth. There are also minimal signs of economic excess that point to a peak in the global growth cycle.



The main threats to global growth include rising US inflation and interest rates, trade war fears and the risks around China and emerging economies.

Australian Shares

The Australian share market, represented by the S&P/ASX 200 Accumulation Index (capital appreciation plus dividends), posted a total return of 13.01% for the Financial Year, made up of a capital return of 8.30% plus a dividend yield of 4.71%. This was the sixth straight Financial Year of positive total returns, although the 2015/16 Financial Year was line ball following the commodities price collapse.

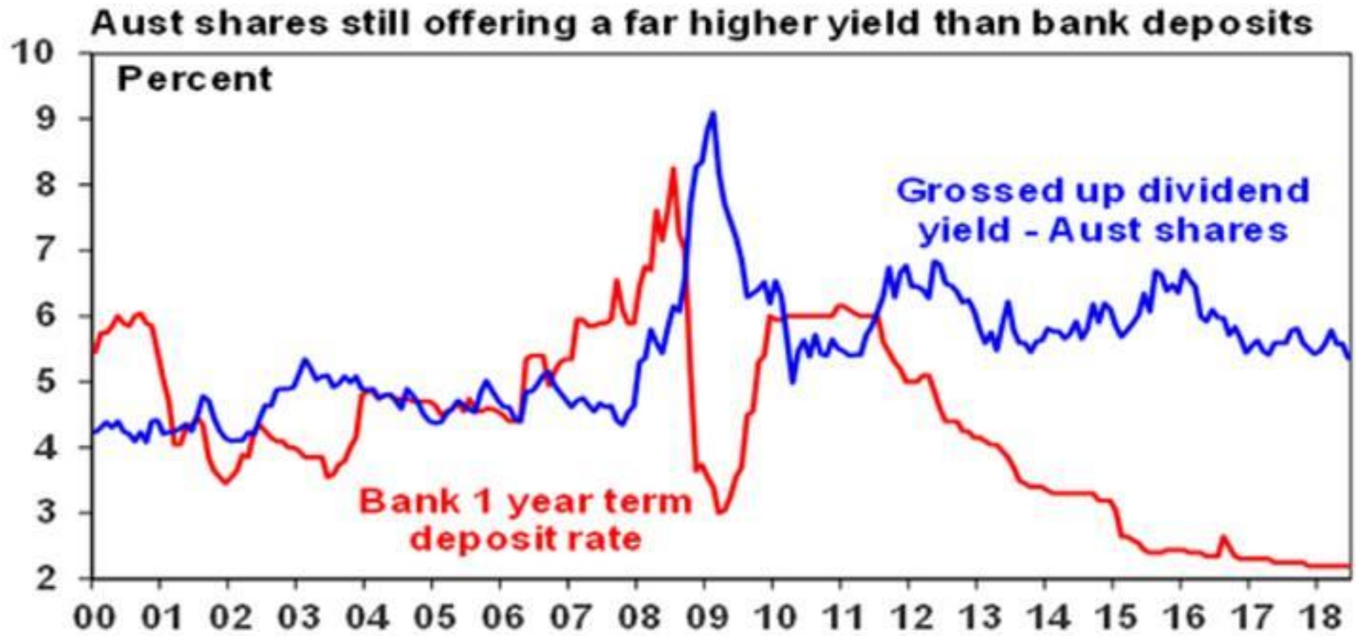
As can be seen in the graph below, most of the return was generated in the first half of the Financial Year, with the accumulation index returning 8.4% for the six months to December 2017. However, investor fear around some geopolitical issues saw markets pull back heavily in the March quarter but then quickly rebound as international events became less threatening.

Despite another solid year for the Australian share market, from a valuations perspective (Price/Earnings), the Australian market is trading only slightly above the long term average PE of 14.6. Most importantly, the Australian market PE 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 more than these long-run averages.

Australian equity market – valuation is not stretched

Australian shares continue to be attractively valued against other asset classes, particularly against cash and bonds. With the earnings forecasts of the market looking solid and a significant gap remaining between cash yields and share dividends, there is scope for the Australian share market to continue to perform solidly.

Source: Ausbil, Citi, Factset



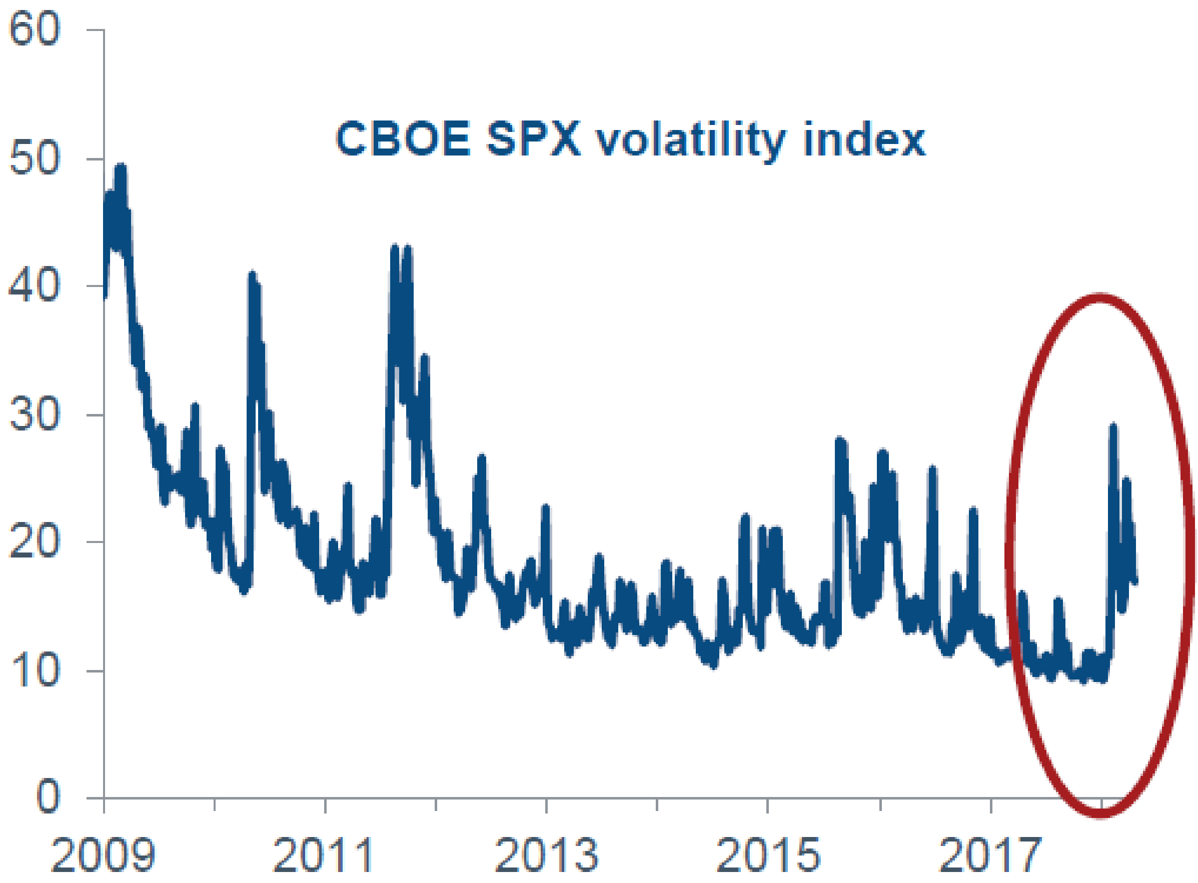
Australian economic growth is likely to remain between 2.5% and 3% with strong business investment and infrastructure spending helping boost growth but being offset by a housing slowdown and constrained consumer spending. This level of economic growth should continue to underpin solid profit growth of about 7% - 8% in corporate Australia.

While the Australian share-market is unlikely to match the strong market performance of 2017/18, all the major factors that should flow through to stronger corporate profits, being a weaker $A, low interest rates, falling unemployment and tax cuts, should deliver investors relatively good returns from the Australian share market in 2018/19.

International Shares

The broad outlook for the global economy remains positive, with the strong US economy underpinning momentum around the rest of the world. However, as mentioned earlier, we expect more frequent bouts of volatility, similar to the ones recently triggered by inflationary concerns in the US in early February and then around trade protectionism in March.

Investors will need to get used to higher levels of volatility in financial markets – as can be seen in the graph below, although volatility spiked in the March quarter, this rise in volatility is only back to relatively 'normal' levels after two years of a steadily declining trend.

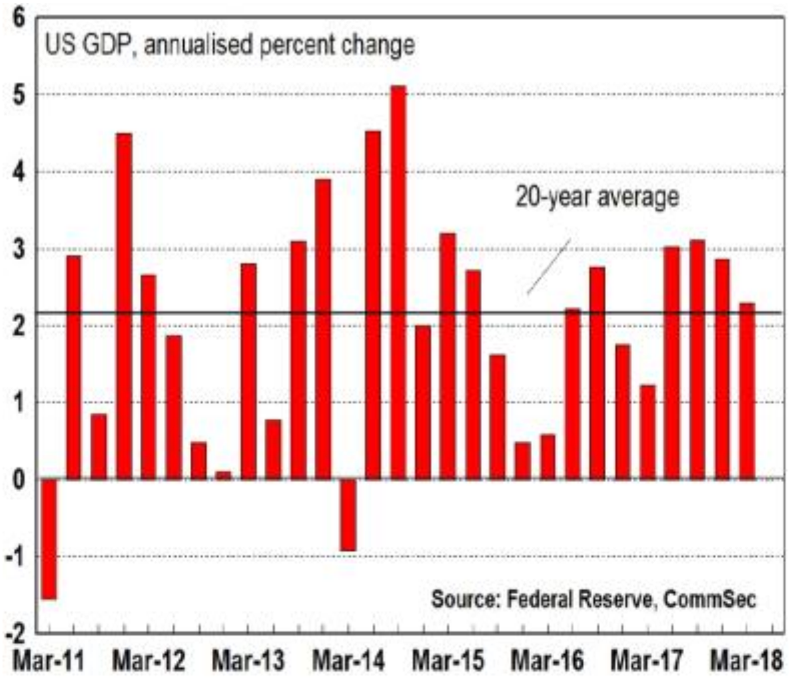


United States

The fundamental picture for the US economy appears healthy and can improve further over the rest of the year, as the potential stimulus from tax cuts and a more business-friendly regulatory environment should significantly boost US business confidence, and more than likely offset any headwinds from increases in energy prices and interest rates.

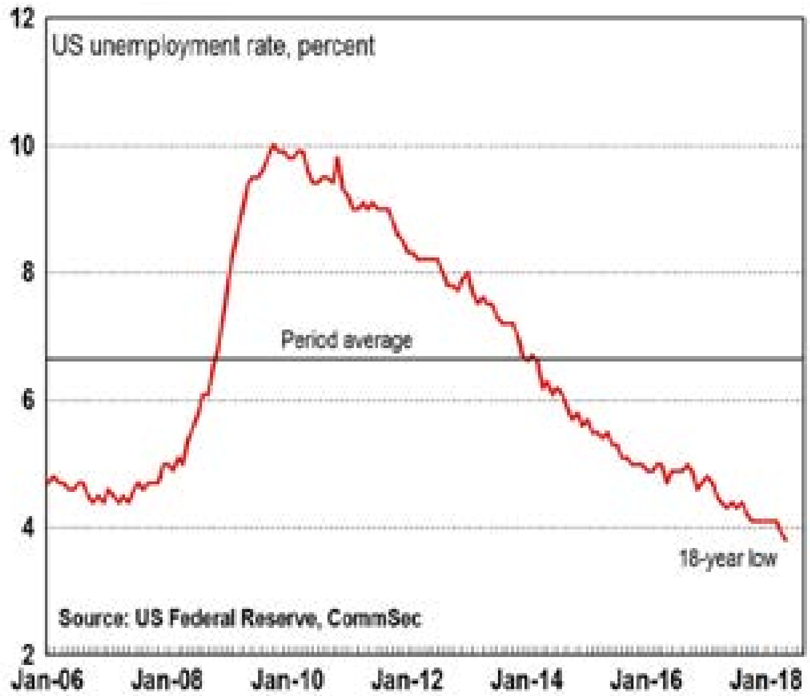
Having emerged from a soft patch earlier in the year, retail sales and consumer spending data have recovered. Also, surveys from business also generally struck a positive note, suggesting the economy's strong underlying momentum remains intact.

Above average US Growth



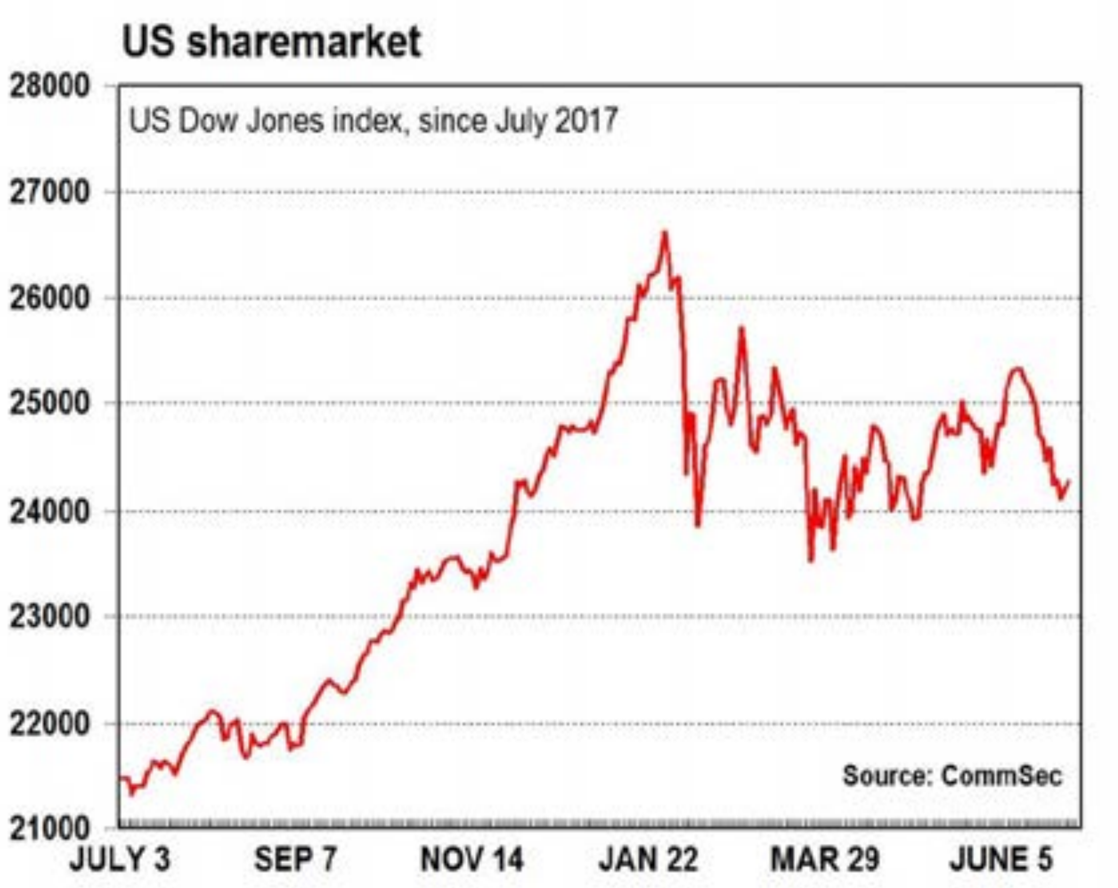
A recent manufacturing survey showed that companies were being squeezed by labour shortages and rising costs of raw materials, which may be inflationary on prices.

A buoyant labour market report for May provided another strong set of data with the unemployment rate reaching a new cycle low of 3.8% in May.



Despite the tightness of the labour market and hints of mounting pricing pressures on companies, inflation is increasing only moderately, and as such, the US Federal Reserve (Fed) should continue to raise rates only gradually over the year ahead, barring any unforeseen geopolitical events. This level of certainty on interest rate movements has been positive for financial markets.

Despite market sentiment have turned more cautious in 2018 as uncertainty grows, the strong earnings momentum, corporate tax cuts and fiscal stimulus will likely support the US share market over the coming Financial Year. As a potential upside, if the uncertainty around the aggressive US stance on trade lifts, financial markets could take a significant lift up.



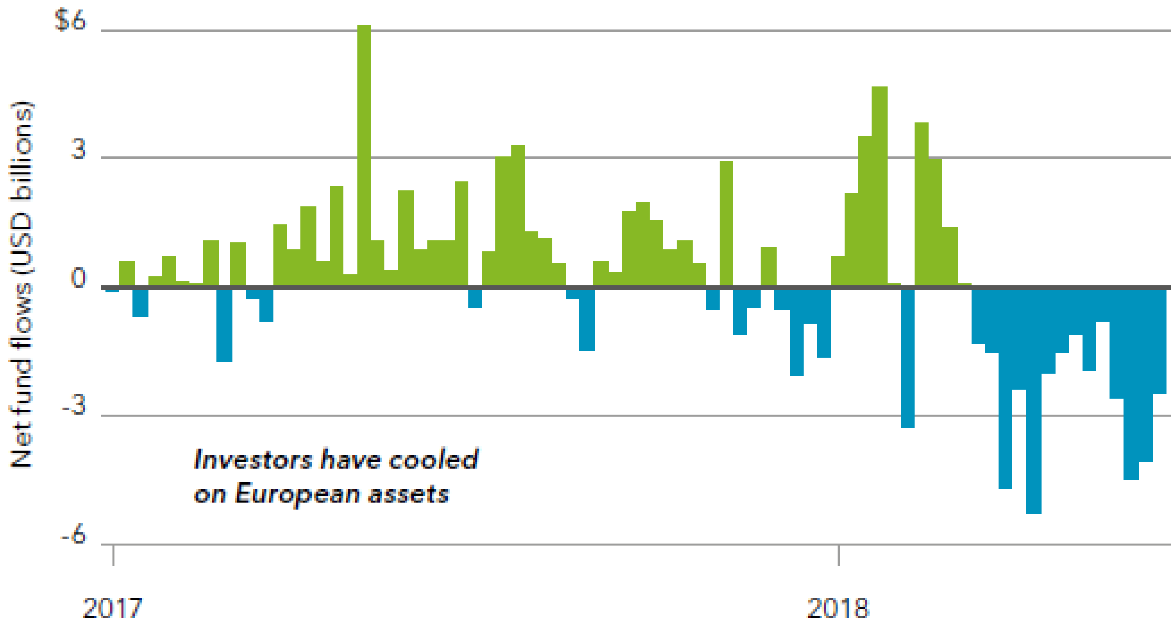
Eurozone

Unfortunately, the outlook for European assets has to some degree turned for the worse.

Europe's growth has been stronger recently, but its longer-term potential is hindered by structural problems such as labour market inefficiencies, lack of private and public investment and different levels of competitiveness between the core and peripheral countries.

These issues, along with Italy's new anti-establishment government, has upped the risk of European fragmentation, which has in turn seen investor sentiment turn sour.

Net fund flows to European equity funds, 2017-2018



Source: BlackRock Investment Institute

The fear is that Italy will break EU rules on fiscal spending and tension on migration with the EU have deteriorated. Banks continue to be a source of worry, still grappling with shaky balance sheets, rising US dollar-funding costs and limp loan demand.

These risks and sluggish core inflation are likely to keep the European Central Bank (ECB) on its slow path to normalisation. The ECB is set to wind down its bond buying this year but hold off on rate rises until after mid-2019. Financial fragilities also make the risk of a policy misstep acuter.

It is expected that Europe will muddle through this year, with no breakup but also dim prospects for further improvement in the near term. All this is not very positive for financial markets in the region.

China

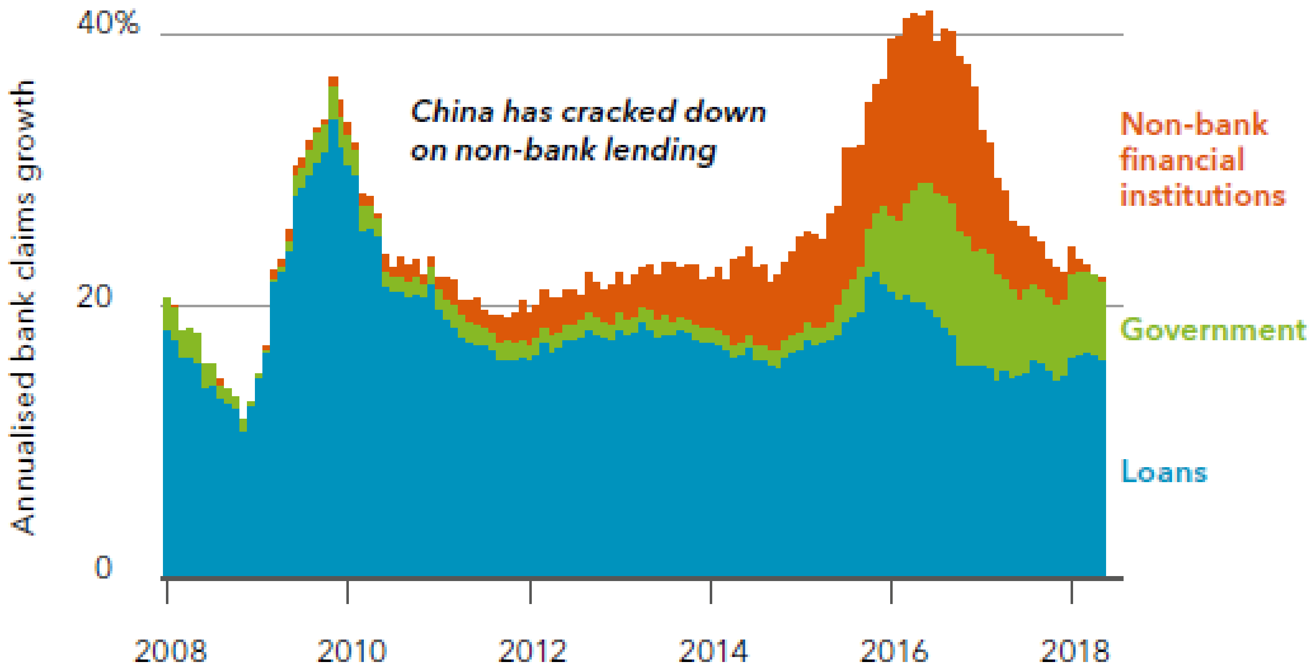
Despite trade tensions with the US and elevated domestic debt levels, China's near-term outlook remains resilient.

Its leadership under the current President is showing a clear sense of direction. The goal is that by 2049 (100th anniversary of the founding of the People's Republic), China will be a fully developed, rich and powerful country with a GDP per capita similar to Germany's today. Three additional policy priorities over the next several years are to eliminate poverty, reduce pollution by imposing tough environmental standards and control risk in the financial system.

The country also aims to improve the quality of its growth, not just the quantity. It is pushing for more consumption and less investment as a share of economic activity. All of this comes amid reform progress, financial de-risking and slower credit growth.

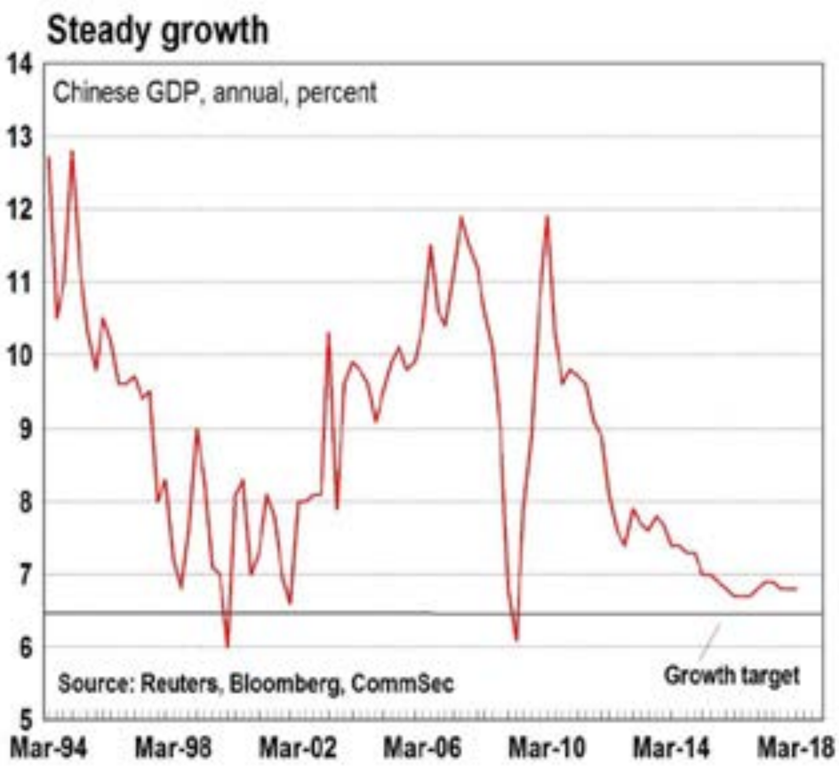
As shown in the graph on the next page, non-bank lending has slumped as a result of the credit crackdown. This is a step in the right direction, but the stability of China's opaque financial system remains a medium-term risk.

Credit crackdown – annual growth in China bank claims as a share of GDP, 2008-2018



Source: BlackRock Investment Institute

Getting this transition right is tricky, and any missteps could lead to bursts of volatility in Chinese asset prices.



The People's Bank of China is likely to keep injecting liquidity into the economy to offset the economic drag from deleveraging. Growing monetary policy divergence with the US is likely to push down on China's currency.

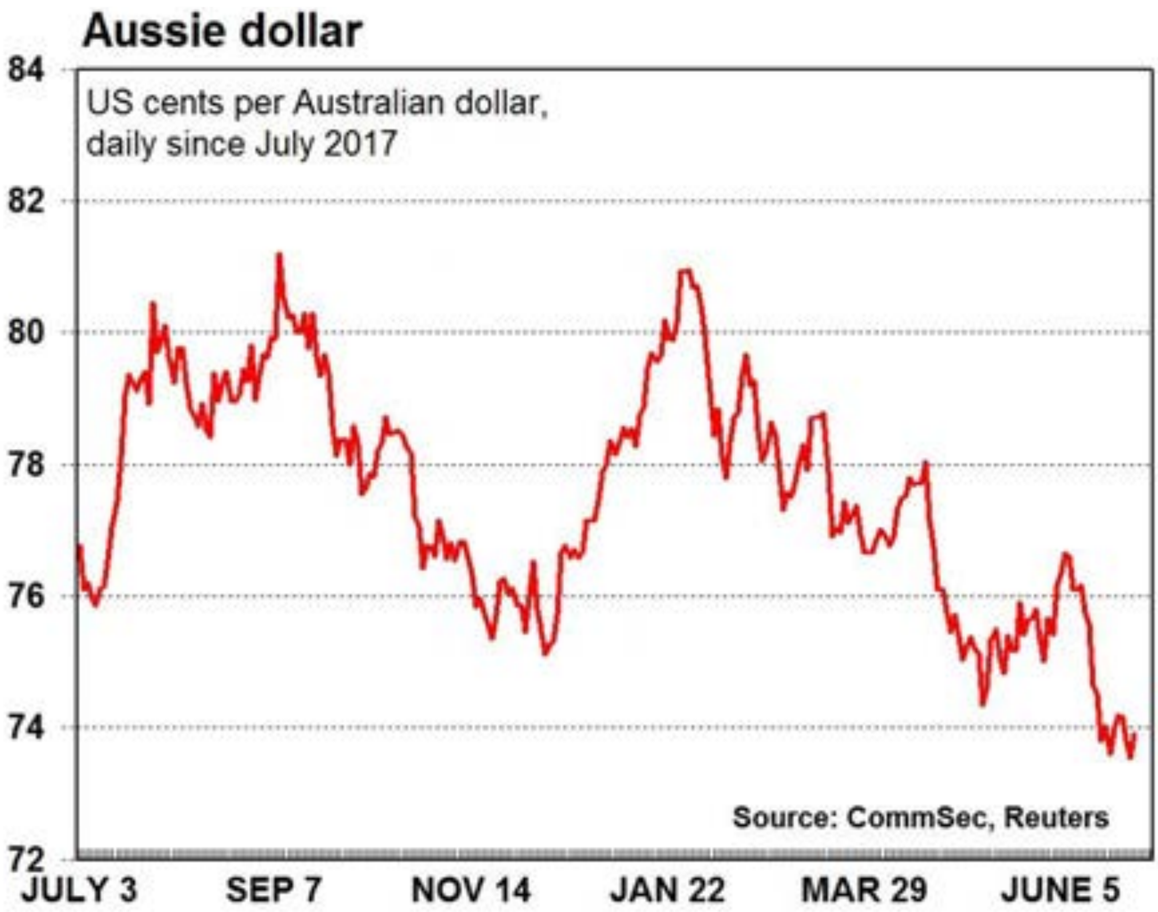
A weaker currency may ease the trade-off between deleveraging and growth – but also could become a major sticking point in trade talks and a catalyst for capital outflows. China's equity and debt markets are slowly opening up. The gradual addition of China A-shares to global indexes is a key step that will offer investors broader exposure to China's share-market.

China is currently in a balancing act of aiming to deleverage without a big hit to economic growth. Financial stability also remains a key risk for China in the medium term. The rest of the world will need to adjust to a slower but more sustainable Chinese growth rate, but the transition could be hard if China's growth slows more sharply than markets expect.

Currency

The US dollar is aided by attractive interest rate and growth differentials versus other economies. Higher short-end US rates also make the US dollar appealing just as geopolitical uncertainty has investors more willing reduce risk and sit tight in cash.

The US currency is probably looking a little expensive at the moment, which should limit its upside but there is a chance that it be bid up in any global risk-off episode sparked by risks such as a global trade war.



As such, the downtrend in the $A against the $US is likely to continue over the next 12 months despite an increase in commodity prices. We, therefore, continue to recommend our clients be unhedged with their International share investments.

Australian Listed Property (REITs)

Financial Year 2018 turned out to be a good year for A-REIT's with a total return of 13.04%. While overall returns from the A-REIT sector for Financial Year 2018 slightly outperformed the broader Australian share market (S&P ASX 200 TR AUD), it took a surge in returns in the June quarter (10.04%) for A-REIT's to outperform the broader market. A-REIT's continue to be a model of consistency returning 9.70% per annum over the last three years and 12.01% over the last five years, again outperforming the broader market over these time periods.

For a majority of Financial Year 2018, the A-REIT sector was plagued by concerns of a rising US bond yield which jumped by around a third, prompting a fall in A-REIT prices. In fact, in the first two months of the last Financial Year, the A-REIT sector's total return declined by 7.0%. But after a strong reporting season, in which the retail, office and industrial sectors each delivered positive comparable net income growth of between 2.3% to 3.4% for the period to 31 December 2017, the fundamentals of the sector finally shone through. This strong net income growth, combined with high occupancy levels and rising A-REIT book values prompted investors to re-rate the sector in the June quarter.

The following is an update on each sector of the A-REIT market:

Retail

- Retail asset valuations increased by 4.2% to 31st December 2017, driven by some property sales.
- At this stage, net property income growth in retail continues to keep pace with GDP growth.
- High-quality malls remain sound, attracting profitable and growing retailers. Smaller shopping centres are doing it tougher with leasing activity more subdued.
- Total sales growth – as represented by Moving Annual Turnover (MAT) – improved slightly over the half year, coming in at 2.0%.
- However, sales growth for specialty retailers slowed modestly, but at this stage, there are no signs of tenant weakness from arguably the most fundamental of measures – rental arrears. Of the major retail landlords surveyed, each reported tenant debtors remained in line with historical averages.

Office

- The story of strong rental growth in the office sector continues in the eastern-seaboard markets of Sydney and Melbourne, the cities in which most A-REIT office landlord portfolios are concentrated. To 31st December 2017, effective rents were up about 20% in Sydney and 10% in Melbourne while Brisbane and Perth remained weak.
- Net property income growth in the office market was 2.7% in the first half of the 2018 Financial Year, a decline on the prior period. But, this isn't anything to worry about. One-off tenant movements and expiries impacted some major office landlords.
- Occupancy levels in the office market remain well above long term levels, however, with the office sector traditionally having a long Weighted Average Lease Expiry (WALE) profile, landlords in Sydney and Melbourne will have to wait before marking their leases to market rents, but it will happen. This will be positive for the sector over the next couple of years.

Industrial

- Compared with previous periods, net property income growth in industrial was the highest across the major A-REIT sectors at 3.4%. This occurred despite subdued economic activity and a rising Australian dollar making life difficult for exporters.
- Landlords enjoyed the benefits of tightening occupancy levels and strong market rental growth driven by expanding e-commerce and third-party logistics tenant demand. High-quality industrial space located in urbanised metropolitan markets remains in tight supply, which will boost demand for such assets.

Looking forward, we continue to see value in A-REITs, particularly in the Office and Industrial sectors.

For retail assets, modest growth in retail sales is the worry. Many commentators put this down to Amazon's arrival and poor retail management. However anaemic wage growth is likely a better explanation of modest retails sales. We remain cautious of the retail sector.

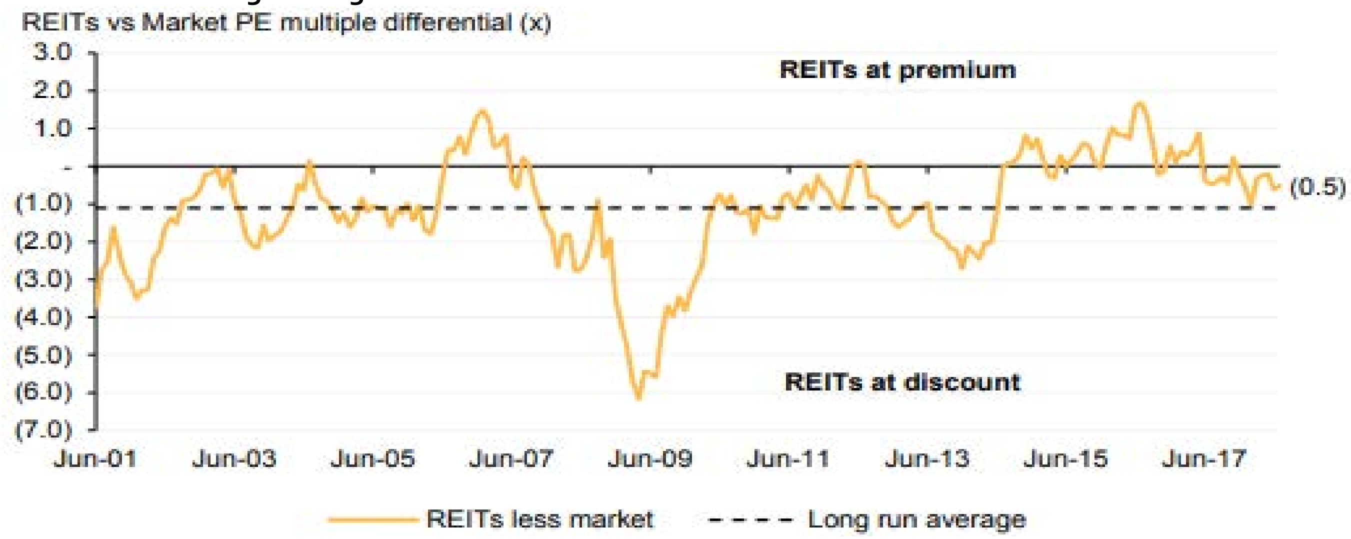
Although many factors can impact the price to Net Tangible Assets (NTA) of A-REIT's such as funds management and property development activity, NTA is usually a good reference point for the relative valuations of A-REITs. At present, the A-REIT sector is trading at a slight discount to NTA.

REITs are now trading at a ~1% premium to NTA ... NTAs set to rise

Source: Macquarie Research

In fact, price to earnings multiple of A-REITs is currently trading a slight discount to the overall Australian share market.

A-REITs now trading at a slight discount to the market



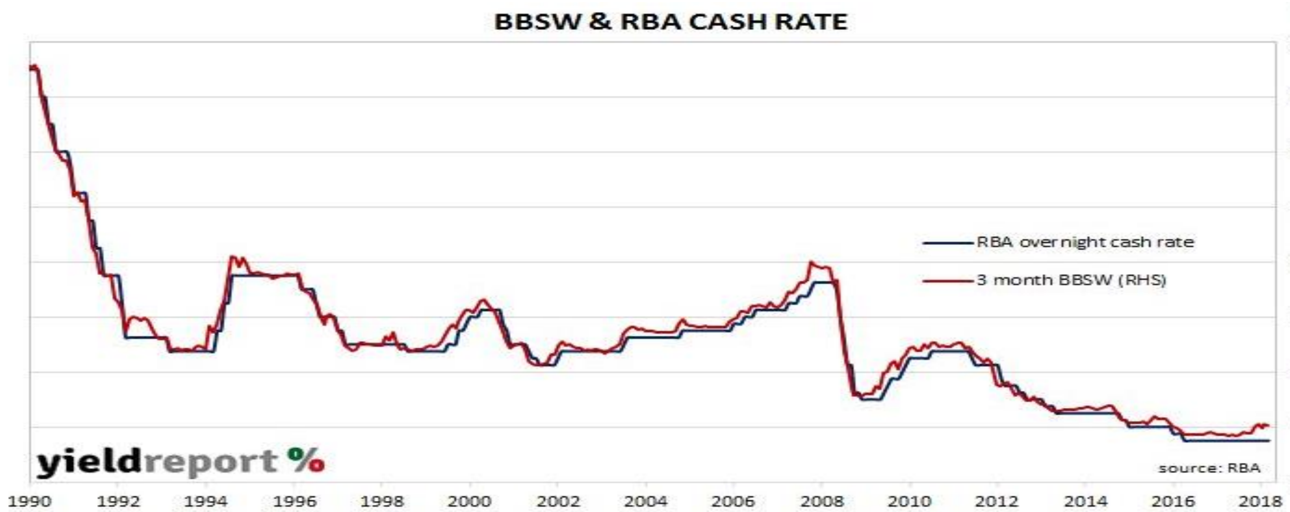
Source: Macquarie Research

With A-REIT's currently trading at a discount to NTA and a slight earnings discount to the broader Australian share market, we see A-REIT's as reasonably sound value and expect total returns of between 6-10% over the next 12 months.

Australian and International Cash and Fixed Interest

It remained an uneventful year in cash and fixed interest markets, much like the last couple of years. The RBA started the Financial Year 2018 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 the Financial Year. This eventuated with the RBA leaving the cash rate during 2017/18 unchanged at 1.50%.

The RBA has now been on hold since August 2016. At this point, the RBA has not shown any indication it is about to take the same path as the US Fed (by increasing the official cash rate), although it has indicated the next rate change is likely to be an increase. Recently, interest rate speculation had centred on the RBA's potential view of the forces driving the recent increase in short-term funding costs. The 90 day Bank Bill Swap Rate (BBSW) increased from around 1.80% at the end of March to 2.07% at the 30th June. As BBSW is the benchmark for interest rates on billions of dollars of loans and other financial instruments, its recent increase in the absence of higher official interest rate rises has provoked some discussion why.



As it turned out, the RBA provided little commentary on the increase to the BBSW, but the general sentiment is that increase in the BBSW is a pre-cursor to interest rates increasing sooner rather than later. It is also expected that there will be a further shift higher in bond yields over the coming 12 months. 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.