

Market Overview

Australian Shares

- The main factor behind the 4.82% total return from the S&P/ASX 200 Index was the impact of the global post-Trump equity rally:
 - The resource stocks, which had been strong in January and February, have weakened more recently and are now only up 2.29% for the year

International Equities

- The global post-Trump rally continued and although price rises have slowed in the last few weeks, the strong rises in January and February meant that world shares (in local currency terms) were well ahead for the quarter
- The U.S. has been the strongest of the developed markets, with the S&P500 up 6.07% for the year, but European shares have also been improving as the eurozone's economy has strengthened:
 - German shares were up 7.25% and French shares, despite the presidential election uncertainties, were up 5.51%
 - In Japan, however, little has happened since the turn of the year Trump rally
- Emerging markets have been stronger again, with the MSCI Emerging Markets Index up 5.78% in local currency terms:
 - Of the big four "BRIC" economies, India and Brazil did the heavy lifting, with a smaller gain in China
 - Russia, however, lost ground, principally in response to a lower world oil price

Australian Property

- A-REITs underperformed the wider share market in the opening weeks of the year:
 - Year to date, the S&P/ASX 200 A-REIT Index is down 0.28%

Australian Dollar

- The Australian dollar has been strong across the board:
 - In terms of its headline U.S. dollar rate, the Australian dollar has appreciated year to date by 5.52% to USD 0.764

Australian Cash and Fixed Interest

- There has been little effective change in short-term rates as monetary policy has remained on hold:
 - The Reserve Bank of Australia kept its target official cash rate at 1.5%
 - Long-term interest rates remain closely linked with U.S. bond yields—both rose in late 2016, but have not moved much since the start of this year and the current local 10-year Commonwealth bond yield is 2.70%

International Fixed Interest

- The key event for the asset class has been the Fed's clear indication that the era of exceptionally low American interest rates has come to an end:
 - On March 15, the Fed raised its target range for the federal-funds rate by 0.25%, to a range of 0.75% to 1.00%

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- Markets had been anticipating that the Fed was likely to move and had also observed a strengthening global economy which was leading to a gradual rise in global inflation:
 - Bond yields have consequently been moving up for some time with the low point for the 10-year U.S. Treasury yield back in early July last year and since then it has risen by over 1% (from 1.37% at its low point to 2.40% currently)
 - Negative bond yields, which had prevailed in some markets at the height of monetary policy ease, are becoming rarer:
 - In the most negative yield market of all, Switzerland, the 10-year government bond yield is now almost back to zero
- Bond yields (outside the U.S.) have not yet risen substantially:
 - Modestly higher bond yields mean the associated capital losses have also been modest, but they have helped to reduce the returns from fixed interest

Reporting Season Wrap

Australian Shares

The last 12 months have been stressful for Australian equity investors. Despite the S&P ASX 200 TR Index (capital appreciation plus dividends) actually ending up with a small positive return of 0.56% for Financial Year 2016, it has certainly been an emotional rollercoaster. The Financial Year started off with concerns of a hard landing in Chinese economy, December's Santa Claus rally turned into a brutal hangover in the New Year, the market then staged a recovery in March and May, before falling again in June due to the surprising outcome of the UK vote to leave the European Union.

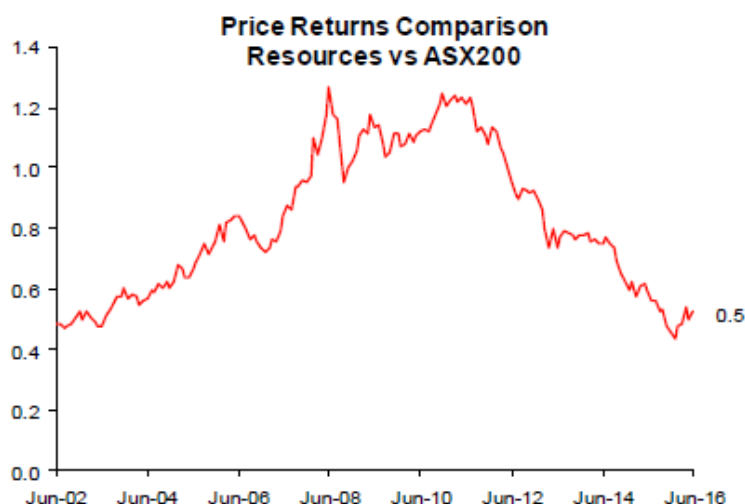
Returns for the Australian share market for Financial Year 2016 are seen in the table below.

S & P Sector	12 Month % Change	S & P Sector	12 Month % Change
Consumer Discretionary	19.7	Telecomm Services	-0.6
Consumer Staples	1.4	Utilities	24.4
Energy	-21.8	A-REIT (listed property)	24.57
Financials	-3.5	20 Leaders	-7.0
Health Care	21.1	50 Leaders	-2.6
Industrials	18.7	S & P/ASX 100	-0.4
Information Technology	3.8	S & P/ASX 200	0.6
Materials	-2.8	S & P/ASX 300	0.9

Source: IRESS, Macquarie Research, July 2016

The two top performing sectors within the Australian share market for FY2016 have been the "yield" sectors of utilities and listed property, which have benefited from the RBA rate cut to 1.75% in May and expectations that interest rates globally will remain close to zero for the near future.

The energy and resource sectors were hardest hit during FY2016 (after also posting similar losses in FY2015) mainly on concerns of a hard landing in the Chinese economy. Interestingly though, commodity-linked stocks staged a recovery in later part of FY16 with iron ore up +27% and oil gaining +30%. In hindsight both oil and key minerals such as iron ore were probably sold down too aggressively over the last 2 years. Recently we have also seen better demand than expected out of China and some supply discipline from producers. Looking to the second half of 2016 it is hard to see these sectors continuing to outperform, but at least it is encouraging to see a turnaround in the sector's fortunes.

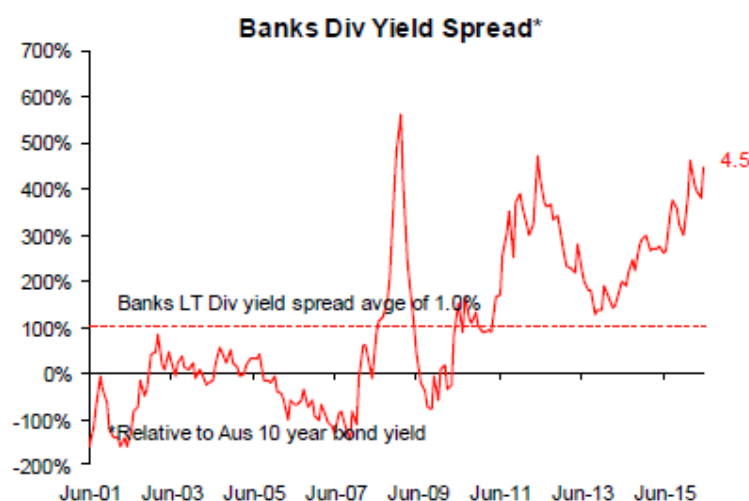


Source: Factset, Bloomberg, Macquarie Research, July 2016

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Financials have had a tough FY2016, in particular bank shares which have been sold off on concerns about higher bad debts and also the potential for additional capital raisings that may come out of the upcoming Basel IV standards on capital reserves for banks. With continued low revenue growth, banks are now turning their focus toward costs. Faced with ongoing margin pressure, Australian Banks will continue to protect margins by adjusting interest rates across their loan book, as and when required. We have already seen this across investment loans, owner-occupier loans, business loans and deposit rates.

Against a background of margin pressure, dividend growth for the banks is only going to be minimal in the coming years. There is some downside risk to bank dividends, as evidenced by the cut in ANZ's dividend, as pay-out ratios reach or exceed the top end of acceptable levels. ANZ lowered their payout to 60%-65% from about 70%. But even taking this into consideration, Australian banks currently offer an attractive dividend yield, especially relative to the yields on offer for cash or Australian 10 year government bonds.



Source: Factset, Bloomberg, Macquarie Research, July 2016

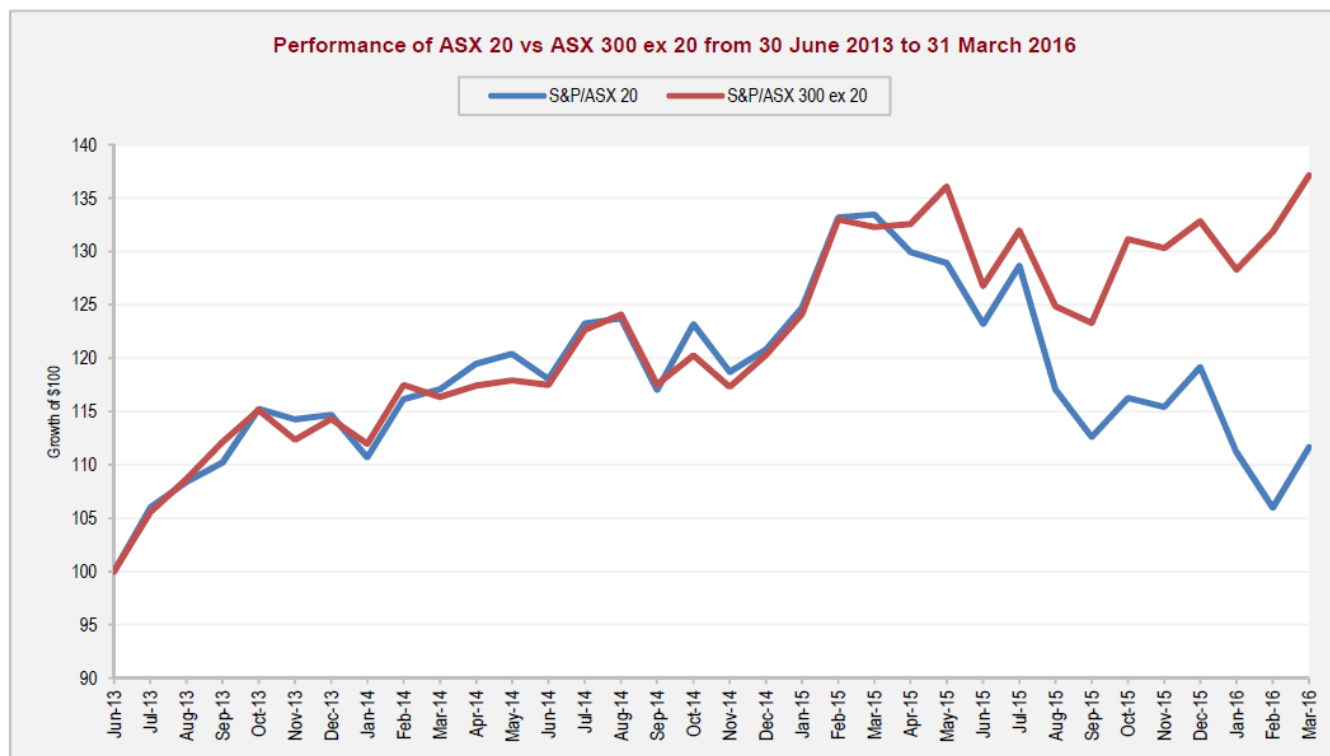
Whilst the larger capitalisation stocks have been buffeted by macroeconomic concerns, the mood is far more positive in smaller companies with the S&P ASX Small Ords TR returning 14.40% FY2016. The key drivers of small cap performance has been the strong share prices of the resource based stocks late in FY2016 along with the significant absence of a large exposure to financials which dominate the top 20 stocks on the ASX.

Like the banks, Australian shares look reasonably priced, especially compared to cash and government bonds. Australian shares are very attractive for income seeking investors and may become more so as the prospect of weaker global growth will likely lead to further cuts in the RBA cash rate.

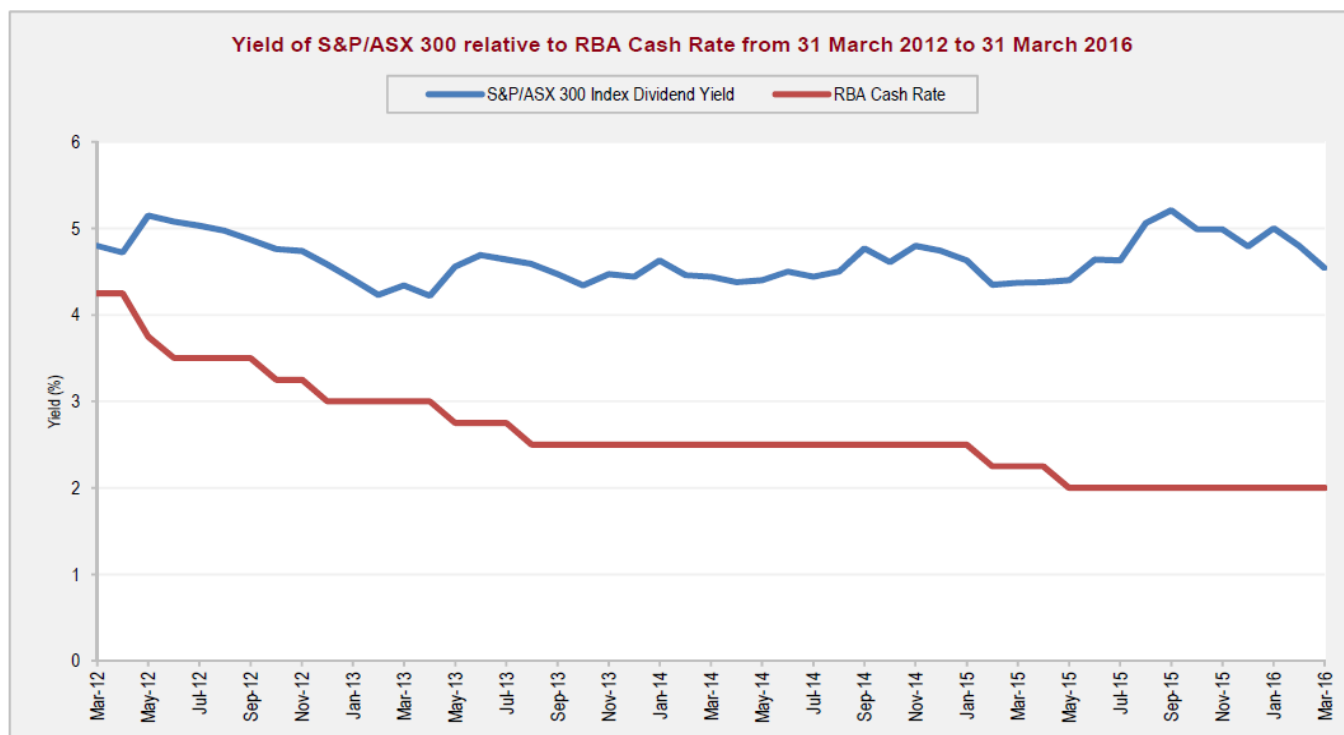
At present, the Australian share market is trading on a 2016 P/E ratio of 16.8 times and a prospective P/E Ratio of 14.9 times in 2017, relative to long term averages between 14.5 and 15.0 times. The S&P/ASX 200 is currently trading on a prospective 2017 dividend yield of 4.6% and 2018 dividend yield of 4.8%. Relative to the 15-year long run average of 4.3%, dividend yields are attractive. Investors will most likely continue their "search for yield", amid a backdrop of continued low government bond yields and a cash rate, which we expect will fall to 1.5% during the later part of 2016.

The combination of reasonable valuations, lower rates and possible further global stimulus leads us to believe Australian shares present reasonable value. The pressure on investors to switch money out of cash and into equities will continue to mount as it will be incredibly difficult to fund retirements with cash holdings alone when deposit rates are less than 2% and falling.

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Source: Bloomberg



Source: Bloomberg

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International Shares

It was a reasonably tough year for global equity markets as the world continues to face a number of headwinds. Central banks continue to cut rates or add stimulus measures as they try to kick start growth and inflation. In June 2016, global uncertainty increased significantly following the Brexit vote. Overall, the MSCI World Index TR AUD returned 0.35% for the year.

The latest forecasts for world growth from the World Bank have downgraded the likely pace of global growth. Its latest (June) update of its Global Economic Prospects still has the world economy growing by 2.4% this year and by 2.8% next year, but these numbers are lower than the World Bank's previous set of forecasts in January (lower by 0.5% for this year and by 0.3% for the next year).

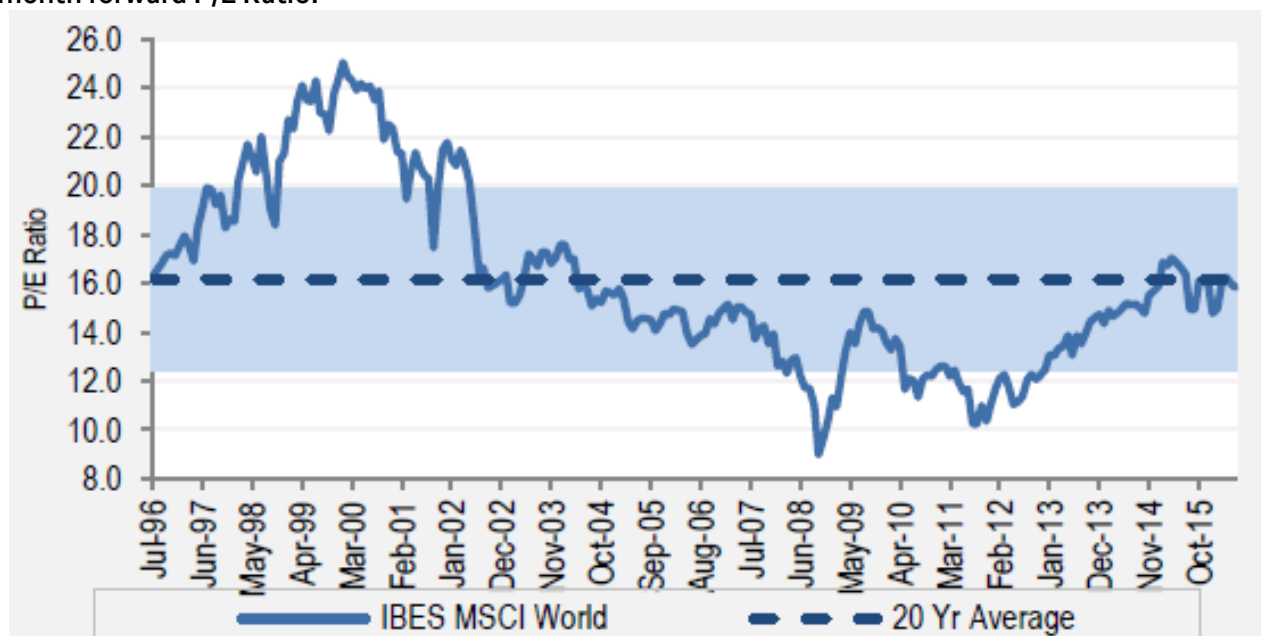
As a consequence, the US is expected to delay its interest rate hike plans, as uncertainty across the globe underpins the current low growth environment.

In our opinion, the outlook for International shares remains sound for the following reasons:

- Global policy makers have signalled easier global monetary policy for longer post Brexit.
- The decline in bond yields has further improved the relative attractiveness of shares.
- There doesn't seem to have been a surge in support for exiting the EU or Eurozone in other European countries post Brexit. In fact as highlighted by the Spanish election it may be the opposite. Note of course the rest of Europe always saw itself as far more "European" than the UK ever did.
- Global economic data has generally been good – there has been no sign of the much feared global recession
- US profits are showing signs of bottoming helped by a stabilisation in the US dollar and the oil price
- Investors have been more relaxed about the state of the Chinese economy and its currency (Renminbi or RMB)

Further supporting that outlook for International shares is that Price-to-Earnings ratio (PE) of the MSCI World Index is currently trading at average historical levels, indicating International shares are not expensive as per common perception.

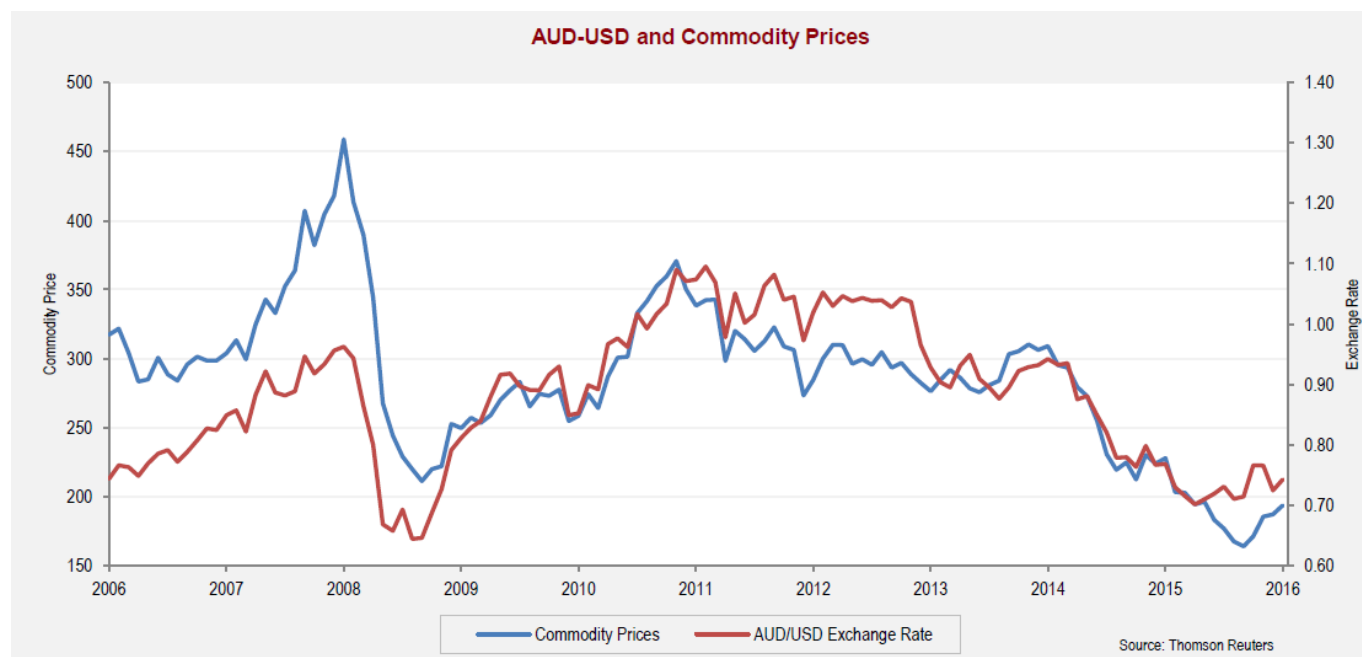
12 month forward P/E Ratio:



Source: Thomson Reuters

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The Australian Dollar (AUD) fell by 3.8% over FY2016. The Aussie started the year at US76.8 cents and ended the Financial Year at US73.88 cents. Historically movements in the AUD have closely correlated with movements in commodity prices, however in FY2016 this was not the case.



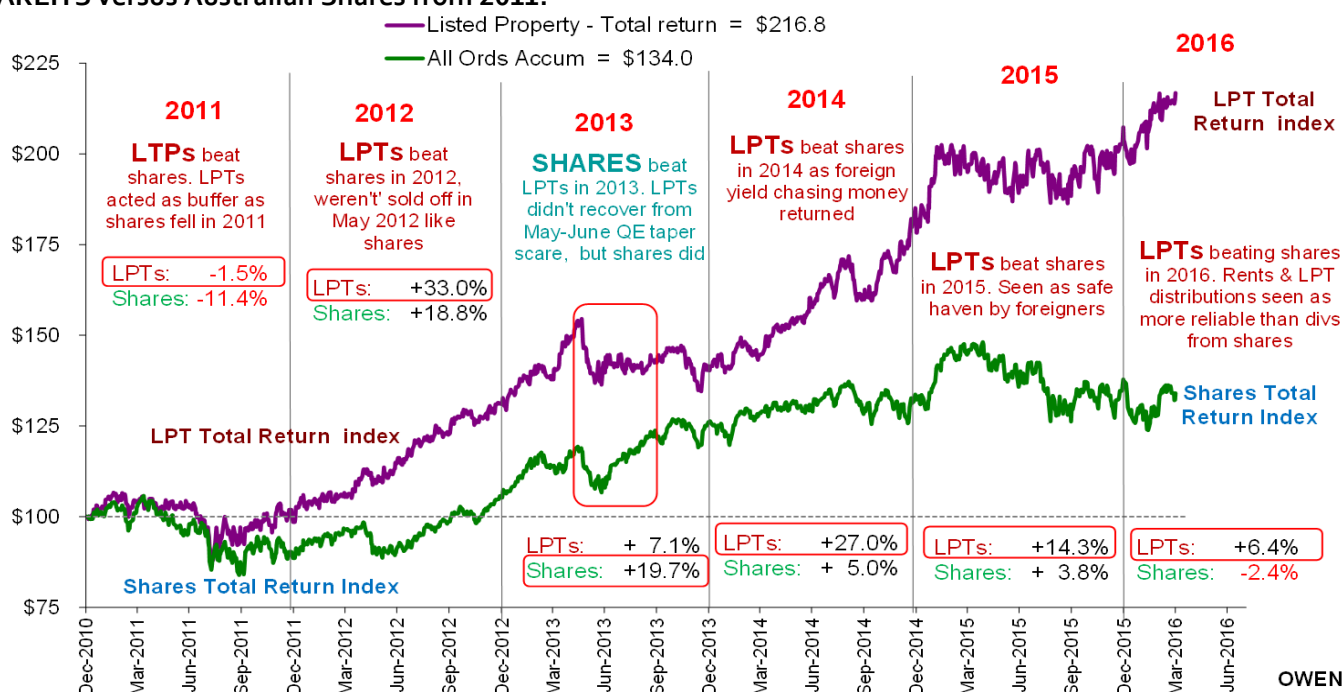
The Australian dollar is still higher than it should be and a longer term downtrend looks likely to continue as the interest rate differential in favour of Australia narrows as the RBA continues cutting and the Fed eventually resumes hiking, and commodity prices remain in a secular downswing. We continue to recommend our clients be unhedged with their International share investments.

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AREITs (Australian Real Estate Investment Trusts)

Financial Year 2016 proved to be another stellar year for AREITs with a total return of 24.27%. Over the last 5 years the AREIT Index has now returned a phenomenal 18.07% pa, the best performed asset class of the last 5 years. In fact, AREITs have outperformed the broader Australian share market in four of the past five Financial Years and it looks likely A-REITs will outperform the broader share market again in calendar year 2016, making it five of the last six years AREITs have outperformed on a calendar year basis.

AREITs versus Australian Shares from 2011:



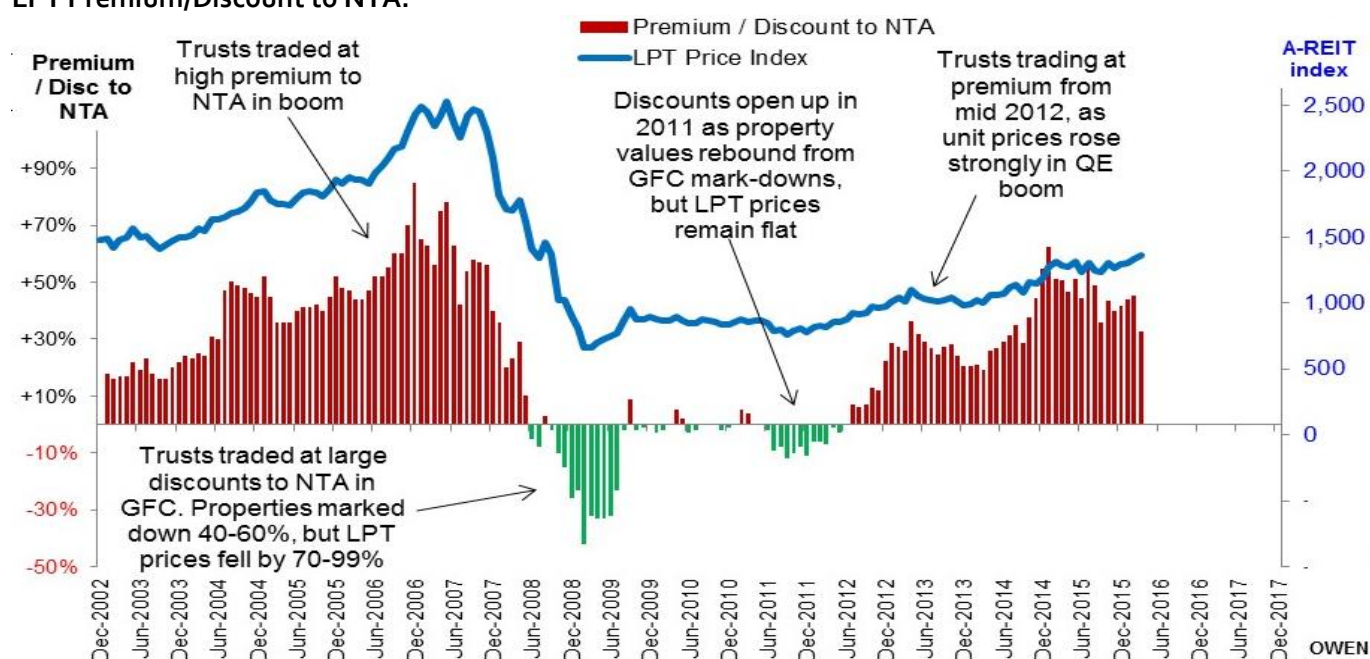
The "lower for longer" interest rate environment has served as a massive tailwind for the AREIT sector with strong price increases. This refers to the expectation that global growth and inflation will be low for an extended period. The "lower for longer" argument is also having a big impact on long term government bond yields, which have hit record lows. With global interest rates heading towards zero and in some cases going negative, investors seem more willing to pay up for yield. With term deposits and Australian government bonds paying around 2% p.a., the AREIT sector's forecast dividend yield of 4.80% p.a. for Financial Year 2017 is attractive.

The major question now is whether the rally in AREITs can continue or in fact are AREITs now expensive? If interest rates continue to fall, then it is highly likely the rally in AREITs will continue. However, if you look at the most commonly used valuation tool for AREITs, which is comparing the share price of AREITs to their Net Tangible Assets (NTA), this would indicate valuations *are* expensive, with AREITs now trading at a premium of 35.6% above their NTA's (as at 31st May).

However, the NTA valuation tool can be a distorted figure due to the impact of stocks like Goodman Group and Westfield Corporation, which include significant amounts of corporation earnings – those delivered by property development activities rather than rents. These stocks trade at significant premiums to NTA (as much as 70%-100%) and represent around 26% of the AREIT sector, distorting the overall market premium to NTA. Moreover, AREITs are liquid assets not liable for stamp duty and legal expenses, which can be as much as 6% of an asset's value. A 'neutral' 10-15% premium to NTA isn't unreasonable. Exclude Goodman and Westfield, and the sector's premium to NTA is 24%, indicating AREITs are only slightly overvalued at current prices.

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LPT Premium/Discount to NTA:



The good news for AREITs is that their balance sheets look very healthy, as can be seen from the table below. Debt is now lower and better managed, with a greater diversity and longer tenure. Asset value increases during Financial Year 2016 have reduced gearing levels from around 29.5% (debt relative to gross assets) to around 28.5%, meaning the ability of AREITs to service their debts has also increased. The sector is currently trading on a forecast 4.8% yield for the year. Remove Westfield Corporation (WFD) from the calculations and that figure increases to 5.1%.

Metric	1H15	1H16
Earnings Per Share (EPS) growth	5.4%	5.3%
Net Tangible Asset (NTA) growth	4.5%	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%	2.9%
Cap rate (movement)	7.1%	6.5%
Gearing	29.5%	28.5%

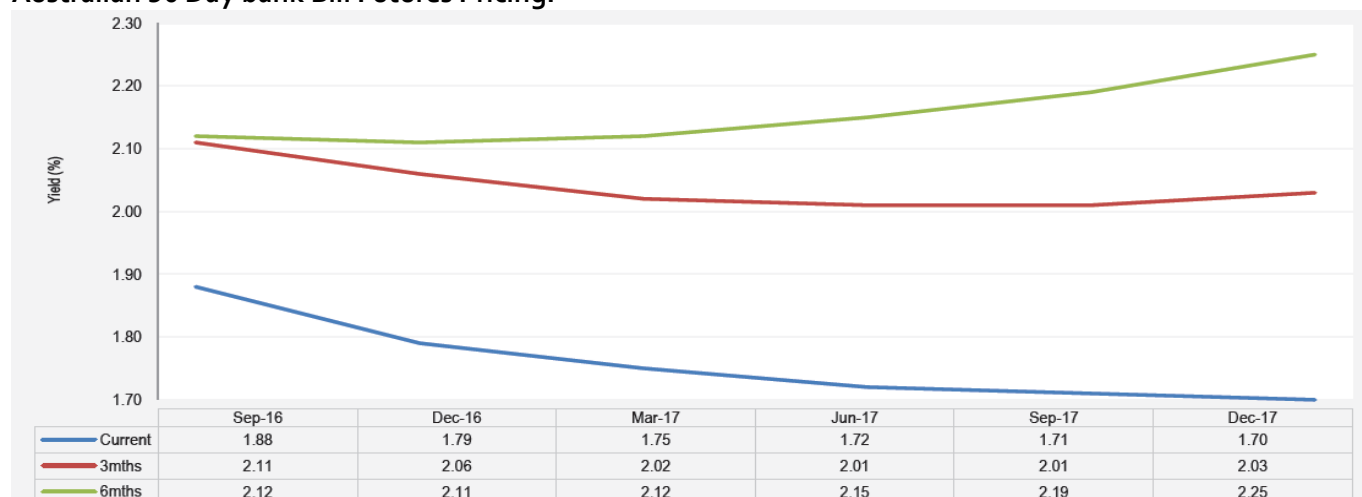
It is also possible mergers and acquisitions could be a major theme in AREITs in the coming years. GPT Metro Office Fund (ASX: GMF) is currently being pursued by two suitors and it is likely the sector will see more of this kind of activity.

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Cash & Fixed Interest

With general consensus global growth is slowing and domestic economic conditions being benign, the RBA shaved 25 basis points from the cash rate during Financial Year 2016 with the cash rate finishing the Financial Year at 1.75%. The RBA starts Financial Year 2017 with no official conditional easing bias, however, analysts are convinced the RBA will drop the official cash rate over the coming 6 months with cash markets pricing in a cut as a 5 in 6 chance. The current Australian 90 Day Bank Bill Futures pricing are also pointing to the likelihood of at least another 25 basis points cut.

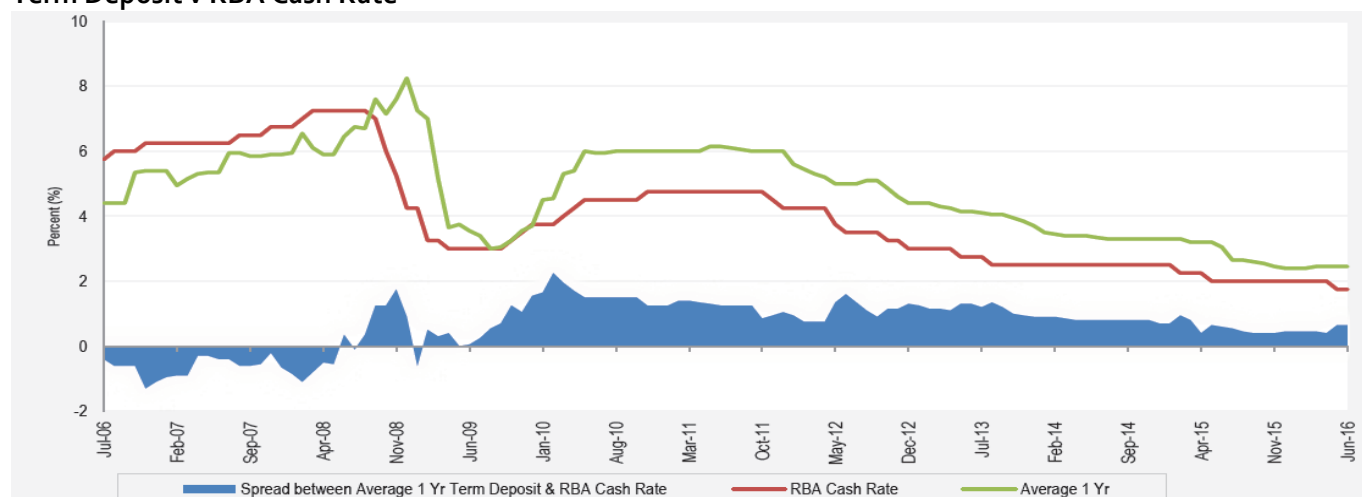
Australian 90 Day bank Bill Futures Pricing:



Source: Thomson Reuters

Australian Fixed interest rates are at all-time lows with yields from cash and fixed interest currently between 2% - 2.5% per annum. During the current RBA easing cycle, investors have benefited from our banks appetite for capital by offering a margins on high interest bank accounts and term deposits of up to 2% above the RBA cash rate. The current margin on high interest bank accounts and term deposits is now 1% above the RBA cash rate and it is expected this margin will tighten further. Investing in cash now is not attractive barely producing a return above inflation.

Term Deposit v RBA Cash Rate

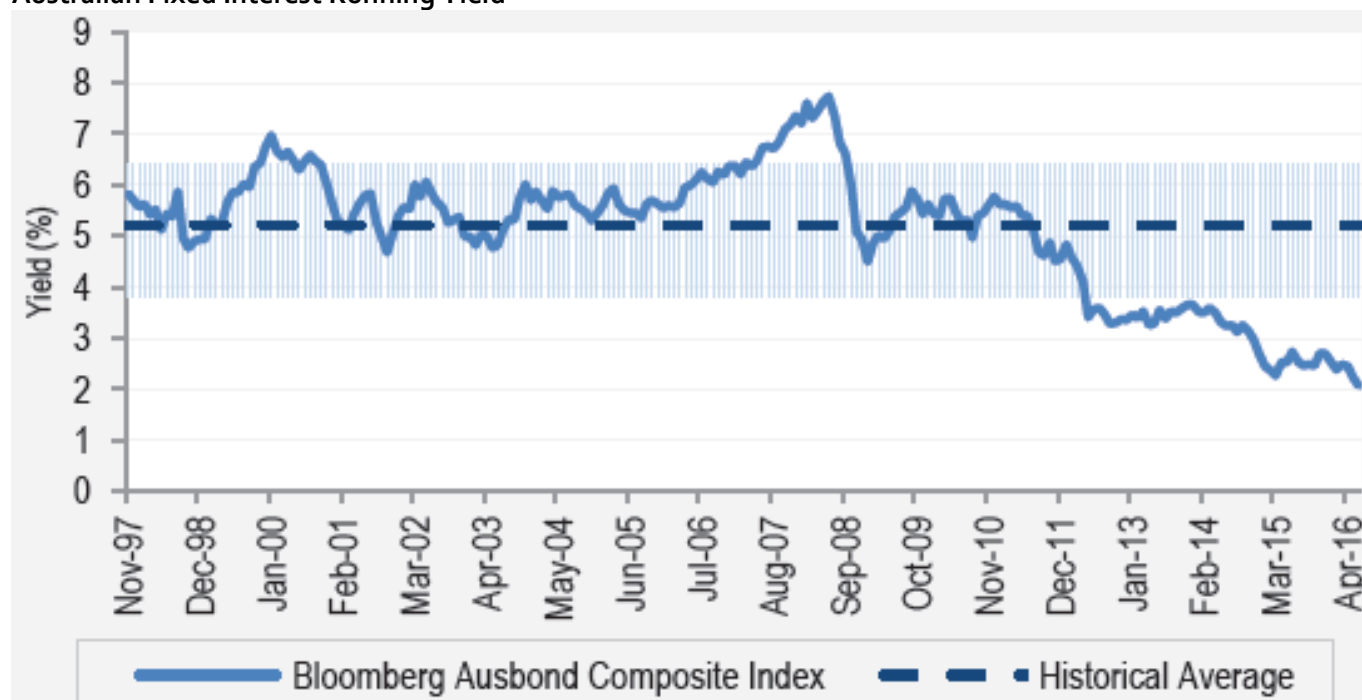


Source: Thomson Reuters

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Government bond yields around the world hit record lows during June. Unbelievably, the yield on Japanese bonds out to 40 years was only 0.10%, and yields on German and US bonds made new lows as did Australian Government 10 year bonds which closed out Financial Year 2016 at 1.99%. During July Australian Government 10 year bonds fell even further.

Australian Fixed Interest Running Yield



Source: Thomson Reuters

We continue to warn there is significant downside to bond prices with yields at all-time lows. Our preference within fixed interest is to own shorter duration corporate bonds and hybrids rather than longer-dated government bonds. At the right pricing, bank hybrid securities do look a very good alternative away from term deposits and other fixed interest investments. The cash yield on high quality bank hybrids is currently 5.5% – 6%. This is far more attractive than investing in Government bonds yielding less than 2% or current term deposit rates around 2.5%.