



Our Market Review

Q3. July –September 2016.

It was a generally positive quarter for financial markets with volatility across equities and fixed income markets considerably lower compared to recent quarters. Around the world, central banks are continuing their 'easy money' policies. At the same time, the US is (very slowly) trying to tighten monetary policy (raise interest rates).

The Australian share market gained 5.2% over the quarter, with these gains made largely in July. The top performing sectors over the quarter were Metals & Mining, Consumer Staples and Information Technology; while Telecoms, Listed Property Trusts and Utilities lagged. Mid cap and small stocks also continued to outperform, returning 7.1% and 8.5% respectively. We continue to favour these sections of the market due to higher growth profiles and market pricing inefficiencies resulting in opportunities to generate higher than index returns. Our exposures in these areas continue to deliver excellent results.

Meanwhile, despite a strong return in July of 5.30%, property securities delivered much weaker performance in August and September and lost 2% over the quarter. While this asset class looks expensive compared to history, attractive yields and a stable low interest rate environment remain supportive of the sector.

Expectations of slower interest rate rises in the US, an easing of Brexit concerns and firming commodity prices bolstered investor risk appetites. International equity returns were slightly positive in the quarter returning 1.9%. This return was heavily and negatively impacted by a strong Aussie Dollar which detracted 3% from performance.

The residential property market continues to benefit from low interest rates and a demand/supply imbalance. Most capital cities continued the recent positive price trend, with the notable exceptions of Perth and Darwin which continue to struggle – **As shown in the table below:**

CoreLogic RP Data Daily Home Value Index: Monthly Values - 30 September 2016									
City	All dwellings			Houses			Units		
	Month End Value	% Change Year on Year	% Change Month on Month	Month End Value	% Change Year on Year	% Change Month on Month	Month End Value	% Change Year on Year	% Change Month on Month
Sydney	1031.37	10.21 ▲	0.81 ▲	1122.31	10.62 ▲	0.75 ▲	743.89	8.26 ▲	1.07 ▲
Melbourne	843.23	8.97 ▲	2.30 ▲	896.73	9.39 ▲	2.34 ▲	543.89	5.19 ▲	1.92 ▲
Brisbane (Inc Gold Coast)	539.53	4.01 ▲	0.22 ▲	561.37	4.33 ▲	0.15 ▲	398.26	1.17 ▲	0.89 ▲
Adelaide	479.49	6.50 ▲	2.11 ▲	494.86	6.45 ▲	2.29 ▲	350.60	7.10 ▲	0.05 ▲
Perth	565.65	-7.04 ▼	-2.47 ▼	575.84	-7.13 ▼	-2.67 ▼	457.09	-5.87 ▼	0.38 ▲
5 capital city aggregate	781.58	7.12 ▲	0.98 ▲	817.60	7.28 ▲	0.95 ▲	598.79	6.01 ▲	1.18 ▲
Brisbane	526.72	3.03 ▲	0.07 ▲	543.75	3.29 ▲	-0.01 ▼	401.04	0.45 ▲	0.89 ▲
Darwin	477.18	-5.99 ▼	-2.21 ▼	503.16	-6.83 ▼	-1.04 ▼	389.37	-2.13 ▼	-7.02 ▼
Canberra	671.95	9.04 ▲	2.38 ▲	698.74	9.22 ▲	2.31 ▲	433.80	6.47 ▲	3.31 ▲
Hobart	358.16	8.72 ▲	0.14 ▲	362.13	8.84 ▲	0.29 ▲	324.01	7.63 ▲	-1.27 ▼

There has been much press lately regarding the oversupply of CBD apartments in both Melbourne and Sydney. We will be watching this space carefully, especially as new apartment developments complete, for any negative impact this may have on property prices.

Lending interest rates for housing continue to face downward pressure as banks and lenders compete aggressively for business. Discounts off standard variable rates are at all-time highs with variable interest rates under 4% easily attainable. However, these additional discounts seem to have topped out, meaning variable rates could be at their lowest, as we are seeing lenders reign in some of the discounting of recent months. **The interest rate outlook also suggests we are at/near the bottom of this cycle...**



Outlook

+ Interest Rates

It seems we have reached the bottom of the interest rate cutting cycle. The RBA has been clear in its belief that monetary policy is becoming less effective in boosting growth and additional measures are now showing diminishing reward, i.e. further cuts won't do much to help. The bond market, for the first time in a long time, is now pricing in higher interest rates over the coming 2 and 5 years.

We are also seeing the first hints of inflation coming through (inflation being the main determinant of interest rates). Significant increases in raw material prices over the last 6-12 months (oil, iron ore, coal etc.) are filtering through to higher producer prices – it can be expected that these prices will be passed on to consumers resulting in general price inflation. This would be a catalyst for future interest rate rises if prices rise too steeply. This is still a way off but it is significant in that we have been in a disinflationary (and reducing interest rates) environment for so long, and we may now have turned the corner and be heading back into an inflationary (rising interest rate) environment.

In the US, markets are now pricing in a 50% chance that the US Federal Reserve will increase its target cash rate in December.

+ Residential Property

The outlook for property remains sound in Melbourne and Sydney with low interest rates, limited supply and strong relative demand. Whilst demand has softened a little, this has been more than offset by a reduction in supply, particularly of quality dwellings. According to many market observers the impending supply of inner city apartments could be a destabilising factor going forward, though we have seen no evidence of this to date. Bank tightening on lending to foreigners is also cause for concern with evidence emerging of purchasers walking away from settlements due to not being able to source finance.

Lesser known, but having a meaningful impact on demand, has been the recent changes to stamp duty and the additional costs imposed on foreign buyers. From 1 July 2016, foreign purchasers must pay an additional duty rate of 7%, on top of the usual stamp duty of circa 5.5%, i.e. a total of 12.5% of the purchase price! Conversations with real estate agents suggest this is having a significant impact in some areas. Despite this, there remains abundant demand from domestic purchasers given the reduced supply.

+ Financial Markets

Excessive monetary easing by central banks has dampened volatility across financial markets and driven asset valuations to their highest level since the financial crisis. While this would normally be a cause for concern, we think that in an environment where interest rates are expected to remain low for longer, growth assets still remain attractive.

Looking ahead, high equity valuations mean we are likely in for a period of lower returns. However, in this low growth, low interest rate environment, we think investors are likely to continue to own growth assets as a source of income, even if they don't expect significant capital appreciation.

James Taylor
Managing Director