Market Overview and Outlook

Economic Overview

Global growth is expected to remain fragile in 2016. Global trade and manufacturing activity will likely struggle, and additional growth scares should be expected. This will play out within the global macro economic themes of low inflation and global policy divergence. Across the developed world, deflation scares of 2015 are expected to give way to an environment of low, but no longer falling, inflation. The bulk of the oil price plunge has likely already occurred and the gradual fall in unemployment should stabilise or increase wage inflation, ensuring that deflation is less of a risk. The US Fed is expected to continue raising interest rates whilst other central banks continue stimulus. The US economy is expected to remain resilient and there would be continued expansion in Europe and Japan.

Home values in 20 U.S. cities rose at a faster pace in the year ended October as lean inventories of available properties combined with steadily improving demand. The S&P/Case-Shiller index of property values climbed 5.5% from October 2014 after rising 5.4% in the year ended September.

For the third quarter of 2015, US corporate spending on equipment advanced at a 9.9% annualised pace, the biggest gain in a year. Household purchases, which account for almost 70% of the economy, rose at a 3% annual pace. Steady payroll gains and cheap gasoline are helping support Americans. Payrolls have advanced at a 210,000 average monthly pace in 2015, compared with a 260,000 average for 2014 that was the strongest in 15 years. Costs at the gas pump are at their lowest since 2009, having fallen steadily for four months on a slide in global commodity prices. The average price of a gallon of regular gasoline was $2.00 as of Dec. 20, the lowest since March 2009. That compares with a daily average in 2014 of $3.34 per gallon. Cutbacks in public spending also will probably no longer hinder growth in 2016 after Congress and the Obama administration agreed to fund the government through September. Outlays at the federal level will grow 2.6% in 2016, the first gain since 2010. Prices tied to consumer spending excluding food and fuel rose at a faster pace in the third quarter than previously estimated, which may also alleviate concern with too-low inflation. The core consumption price index climbed at 1.4% annualised rate from July through September.

European Union inflation was unchanged in November at a weak 0.1%. This is well below the official target of near or just below 2.0%.

Britain's economic growth has slowed markedly. Hurt by slow demand for exports from a flagging global economy, GDP grew 0.4% in the third quarter, matching its lowest rate since late 2012, when Britain was still struggling to recover from the financial crisis. There was a sharper cut for growth in the second quarter, meaning the economy looks set to grow by 2.2% in 2015 as a whole, down from nearly 3% in 2014. Until a couple of months ago, the Bank of England was expected to raise rates quite soon after the U.S. Federal Reserve. But that was before wage growth slowed in Britain and the latest unexpected growth downgrade.

Confidence at big Japanese manufacturers held steady in the three months to December. The headline index for big manufacturers' sentiment stood at plus 12 in December, unchanged from three months ago, the Bank of Japan's quarterly "tankan" survey showed.

China's factories cooled in December for the fifth month running with the Purchasing Managers' Index edging up to 49.7 in December from 49.6 in November. The index was below 50, the point that separates expansion from contraction. After growing 7.3% in 2014, the economy is thought to have expanded by 6.9% in 2015 and the central bank has forecast that it may slow further in 2016 to 6.8%.

China's labour market saw deteriorating conditions in the fourth quarter, with job growth taking a significant hit amid shrinking labour supply. With employment being a key economic metric in China, the government will likely face increasing pressure to ramp up its policy response if weakness in the labour market persists. In October, the People's Bank of China cut interest rates for the sixth time in less than a year while lowering the amount of cash that banks must hold as reserves for the fourth time in the year, in a bid to counter a persistent slowdown in the world's second-largest economy. However, recent policy loosening may have been futile, as the percentage of companies borrowing slipped to a record low in the fourth quarter.

The OECD trimmed its global economic forecasts as slower growth in emerging markets spilled over into countries such as Germany and Japan. World output will expand 2.9% in 2015 and 3.3% in 2016, down from the 3% and 3.6% predicted in September. With Russia and Brazil in recession and China poised to deliver its weakest expansion in more than two decades, the economies that powered world growth in recent years are now slowing it down. The OECD barely changed its forecasts for Chinese output, pegging growth at 6.8% in 2015 and 6.5% in 2016.

Interest Rates & Currency

In December, the Federal Reserve raised interest rates for the first time in almost a decade, a widely telegraphed move that Chair Janet Yellen said would be followed by "gradual" tightening as officials watch for evidence of higher inflation. The Federal Open Market Committee unanimously voted to set the new target range for the federal funds rate at 0.25% to 0.5%, up from zero to 0.25%. Policy makers separately forecast an appropriate rate of 1.375% at the end of 2016, implying four quarter-point increases in 2016.

In December the European Central Bank (ECB) unveiled a package of measures to tackle too-low inflation, from a cut in the floor for interest rates to an expansion of its bond-buying program by at least 360 billion euros ($390 billion). The ECB will extend quantitative easing by six months until at least March 2017 at the current rate of 60 billion euros a month, and broaden the assets purchased to include local and regional debt. The Governing Council earlier reduced its deposit rate by 10 basis points to minus 0.3%.

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The ECB will keep monetary policy easy for as long as necessary in light of risks such as slower growth in emerging economies, its chief economist said. *"It (the ECB) will pursue an accommodative monetary policy for as long as is necessary. Without giving a date, this timescale is fairly long,"* said Peter Praet, who is also a member of the bank's executive board*. "Additional risks have arisen from the slowdown in the emerging countries, risks that are pretty significant for the euro area. There are also downward pressures on prices in the manufacturing sector as a result of surplus output and the very high unemployment level."*

Bank of England Governor Mark Carney said the economic developments required to justify the first increase in U.K. benchmark borrowing costs in eight years were not yet in place. Carney said his comments in July that a decision on rates would come into "sharper relief" around the end of 2015 were never a promise to hike.

Bank of Japan unveiled measures including purchasing exchange-traded funds that track companies which are *"proactively making investment in physical and human capital."* The central bank will spend 300 billion yen ($2.5 billion) a year from April buying such securities to offset the market impact as it resumes selling stocks purchased earlier from financial institutions. The central bank is aware such products are not yet available and in the meantime will buy ETFs tracking the JPX-Nikkei Index 400, a government-backed equity measure started last year that chooses companies based on return on equity and operating profit. The BOJ also already purchases ETFs linked to the Nikkei 225 Stock Average and Topix index and owns roughly half of the market for ETFs in Japan.

Unless economic conditions deteriorate significantly in Australia, it is unlikely the RBA will further reduce rates in the coming months. Our preference remains for both short dated fixed-rate and floating-rate securities of high investment grade corporates.

Closing Rates as at 31 December2015

	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	2.00%	2.00%	US Fed Funds Rate	0.3600%	0.1200%
90 Day Bank Bills	2.41%	2.29%	AUD/USD	72.96	71.89
180 Day Bank Bills	2.30%	2.24%	US 10 Year T-Bond	2.22%	2.23%
5 Year Govt Bonds	2.246%	2.310%	US 30 Year T-Bond	2.93%	2.99%
10 Year Govt Bonds	2.751%	2.849%	Japan 10 year yield	0.272%	0.303%

Stance: **Corporate - Positive variable rate and investment grade**
Government - Underweight

[1] Previous rate or level represents the rate or level as at the end of the previous month.

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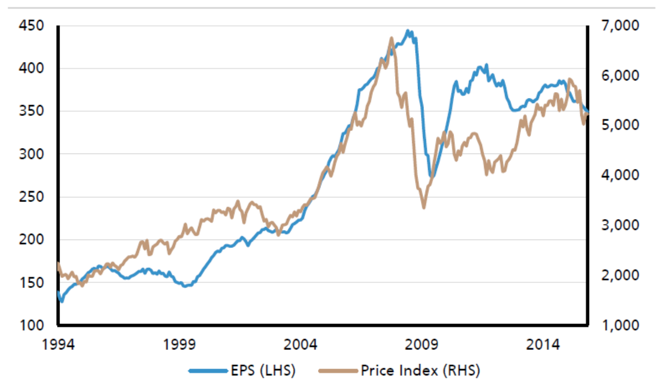
Australian Shares

UBS' view is, *"Aggregate market EPS growth is currently -4.3% for FY15 and -0.9% for FY16. The weaker earnings growth picture is being driven heavily by falling earnings in the resource sector and to a lesser extent by sluggish EPS growth in the bank sector. The market ex banks and ex resources EPS growth is a more respectable 8.9% for FY15 and 5.9% for FY16."*

Figure 30: Australian Market EPS versus Price Performance



Source: I/B/E/S, Datastream

The market's expected earning level is not growing largely due to the heavy decline of resource sector earnings estimates.

The franked dividend yield above the term deposit rate continues to provide support for equity valuations. With the falling term deposit rate, we believe there should be continued support for equity valuations and gross yields from equities.

Closing Rates as at 31 December2015					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,295.9	5,218.2	AOX Earnings Yield	6.45%	6.37%
PE Industrials (2016)*	15.1x	15.1x	Div Yld Indust (2016)*	5.0%	4.9%
PE All Ords (2016)*	15.5x	15.7x	Div Yield All Ords (2015)*	5.2%	5.2%

*Source – UBS

Stance: Neutral – Underweight portfolios should look to add

[1] Previous rate or level represents the rate or level as at the end of the previous month.

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International Shares

Had it not been for a small group of nifty companies such as Facebook, Amazon, Netflix and Google, 2015 would have entered the history books as a terrible year for the US stock market. The return for the S&P 500 for 2015 was flat, whilst the nifty companies gained more than 60% for the year. Such a narrowing of the market is a classic symptom of a lengthy rally that is coming to an end. In addition, the earnings of S&P 500 companies fell slightly in 2015 due to falling revenues at energy companies and the strong US dollar. However, the hope is that the narrow US market will not tip over into a bear market because of the US economy. The US economy is robust, with the US consumers showing signs of spending more with increasing employment and falling petrol prices.

We expect geopolitical events occasionally giving rise to market volatility. Take advantage of market volatility, more reasonable valuations and better industry diversification compared to Australian shares to purchase international shares.

Closing Rates as at 31 December2015					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	17,425.03	17,719.92	Nikkei Dow	19,033.71	19,747.47
S&P 500	2,043.94	2,080.41	Hang Seng	21,914.40	21,996.42
FTSE 100	6,242.32	6,356.09	MSCI	1,662.8	1,694.4

Stance: **Neutral with positive bias**

Property

Sydney property prices fell for the second consecutive month, dropping 1.2% in December, according to CoreLogic RP Data, but price rises in Melbourne and Perth kept the overall national dwelling prices across the month flat. Despite the softening in the Sydney and Melbourne markets, the two largest capital city housing markets still recorded much stronger annual gains than all other capital cities, 11.5% in Sydney and 11.2% in Melbourne.

Atchison Consultants says A-REITS look attractive on a yield play, with their spread to 10-year government bond rates high and widening. Across the S&P/ASX 200 A-REIT index, yields average 5.7%, with some trusts exceeding 6 and 7%, compared with 10-year Australian government bonds at 2.65% and US bonds at 2.15%. *"Dividend yields have not followed bond yields down, the margin has been widening,"* Atchison says.

[1] Previous rate or level represents the rate or level as at the end of the previous month.

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"Bond rates would have to rise quite a lot to make it discouraging to invest in A-REITs." While a recent report by Aberdeen Asset Management said current asset pricing was unsustainable and the commercial property market – especially office property – faced a looming price correction, the consensus appears to be that the bull market has further to run locally.

The yield advantage in owning the REIT sector is narrowing as long term bond yields increase. Earnings per share growth will be key in determining whether distributions can grow.

Closing Rates as at 31 December2015		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,291.2	1,261.1

Stance:

Commercial/Listed:	**Neutral and Trim if overweight**
Residential:	**Neutral, with a negative bias**

IMPORTANT INFORMATION

Note that this is general advice that does not take into account the current financial circumstances or financial needs of any individual which should be considered when making investment decisions and in consultation with an appropriately qualified adviser.

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1] Previous rate or level represents the rate or level as at the end of the previous month.