OCTOBER 2017

Investment Outlook Report

Lonsec

The *Investment Outlook Report* reflects Lonsec's latest views on investment markets and the economy, as well as providing dynamic asset allocation guidance against Lonsec's strategic asset allocation framework.

ISSUE 12

Lonsec

Economic Analysis

Growth on the up?

Index Returns as at 30 September 2017 (% p.a.)

	3 Months	6 Months	1 Year (% p.a.)	3 Years (% p.a.)	5 Years (% p.a.)
AUSTRALIAN EQUITIES	1.02	−0.53	8.53	7.3	10.08
GLOBAL EQUITIES	4.29	7.59	19.63	10.65	14.96
A–REITS	1.94	−1.17	−1.97	12.48	13.21
GLOBAL LISTED PROPERTY	1.04	3.15	1.94	8.67	10.56
AUSTRALIAN FIXED INTEREST	−0.07	0.94	−0.75	3.9	3.9
GLOBAL FIXED INTEREST	0.89	2.07	0.53	4.77	5.1
CASH	0.43	0.87	1.76	2.14	2.43
AUD/USD	1.89	2.69	2.22	−3.61	−5.47

MARKET INDICES:
S&P/ASX 300 ACCUMULATION INDEX
MSCI WORLD EX AUSTRALIA NR INDEX (AUD HEDGED)
S&P/ASX 300 A–REIT ACCUMULATION INDEX
FTSE EPRA/NAREIT DEVELOPED NR INDEX (AUD HEDGED)
BLOOMBERG AUSBOND COMPOSITE 0+ YR INDEX AUD
BARCAP GLOBAL AGGREGATE TR INDEX (AUD HEDGED)
BLOOMBERG AUSBOND BANK BILL INDEX AUD

Economic Analysis

The global economic recovery continues, and in a sign of increased optimism the IMF upgraded its growth forecasts for the first time in six years. The US and Europe currently lead the way, although China and Japan have generally exceeded expectations. While inflation continues to surprise to the downside, the improved growth picture has turned the focus on to the central banks, with the Fed in the early stages of monetary policy normalisation, and the ECB soon to follow.

In a sign of increased optimism the IMF upgraded its growth forecasts for the first time in six years

Although the September FOMC meeting indicated that a December Fed funds hike was quite likely, there is clearly some disagreement within the Fed over the outlook for inflation and the implications for future policy deliberations. While many participants thought an increase in rates later this year was warranted, many others believe that the recent low inflation readings may reflect more persistent drivers, and that patience was required in removing policy accommodation. For now, Fed chair Janet Yellen seems intent on normalising policy, perhaps reflecting confidence in the Phillips Curve relationship between tight labour markets and inflation, or perhaps in order to provide room for easing in the event of another economic downturn. Maintaining extremely easy policy settings also carries the risk of inflating asset prices to unrealistic levels, raising financial stability risks.

Meanwhile, ECB President Mario Draghi is paving the way for a policy tightening when he stated: “The economic expansion is now firm and broad-based across euro area countries and sectors. The ongoing recovery is, crucially, driven by domestic forces, and the labour market has notably improved … employment gains, together with increasing household wealth, are supporting the private consumption outlook. Moreover, investment is improving, buoyed by very favourable financing conditions.” Eurozone core inflation has risen from a low of 0.7% in early 2017 to 1.3% in August, and although it remains well below the 2% (or just under) inflation target, emerging price pressures can be gleaned from recent strong PMIs. In light of the growth and inflation outlook, the ECB is expected to announce at its 26 October meeting that it will cut its bond buying program from €60 billion to €40 billion a month, but will seek to keep interest rates at record lows.

The 19th National Congress of the Communist Party of China (CPC) kicked off on 18 October, and will lay out the country's direction and goals over the next five years, as well as appoint the top political leaders. It will provide some indication of the likely trajectory and risks around growth for the coming years. Having achieved a stabilisation in the economy over the past 12 months, many observers expect the authorities to use the initial phase of the next five years to engage in further economic and financial market reform while focussing on addressing financial stability risks. Recent growth has been slightly above expectations, capital flows have stabilised, and the yuan has strengthened, allowing the authorities to tighten credit conditions in some parts of the financial system. Meanwhile, perhaps most noteworthy over the past month was the move by the PBoC to cut the effective reserve requirement ratio for banks by 0.5% to 1.5% depending on the extent to which the bank lent to small business and rural borrowers.

In Japan, Prime Minister Abe called a snap election for 22 October. Abe is seeking to benefit from the threats from North Korea and, if successful, would ensure the continuation of the BoJ's efforts to stimulate inflation to the sustainable 2% level.

Finally, while the global economy enjoys a recovery in growth, the Australian economy continues to battle a combination of factors including low wages growth, high levels of household debt, and subdued consumer confidence. The tightening in lending conditions since April as a result of APRA and the RBA's focus on the growth in interest-only lending, together with rate hikes in these areas by the banks, has constrained household disposable income, in turn undermining consumer spending. In the October Financial Stability Review, the RBA noted that "household balance sheets and the housing market remain a core area of interest".

Quarterly Outlook

PETER GREEN, GENERAL MANAGER–EQUITIES

SHAILESH JAIN, SECTOR CO-LEAD–AUSTRALIAN SMALL CAPS

Australian Equities

Performance Summary

The Australian equity market continued to go sideways for the September quarter, with the S&P/ASX 300 TR Index (ASX 300) returning a measly 0.8%. This continues the trend from the June quarter, resulting in the six-month return for the ASX 300 being –0.9%. This is in stark contrast to the two preceding quarters, where the 'Trump-o-nomics' induced euphoria, along with better macro data out of China, had led to a period of more robust returns. Hence, the ASX 300 return for the rolling 12 months to 30 September 2017 is still a healthy 9.2%.

The September quarter was again a tale of sectoral dispersion. On the positive side, cyclical sectors such as Resources (S&P/ASX 300 Resources TR Index 9.3%), Materials (6.7%) and Energy (7.1%) had very strong quarters on the back of a normalisation in commodity prices and sounder global economic data. Consumer staples also rallied, albeit off a low base, with the S&P/ASX 300 Consumer Staple TR Index returning 4.2%. This was offset by poor quarterly returns for the former market-darling 'bond proxy' sectors of healthcare (–5.2%), telecommunications (–15.1%), and utilities (–5.8%). The softness in Financials moderated slightly, with the quarterly return being 0.2%. The 'Big 4' banks continue to be in the political spotlight, with the AML story out of CBA enhancing negative sentiment, which followed the announcement of a bank levy during the June quarter.

At a stock level, Wesfarmers (ASX: WES) had a solid quarter and returned 5.8%. This follows WES announcing an increase in its dividend on the back of a positive earnings result. However, hidden in the good news was a fall in earnings for its key grocery unit, Coles (–13.5%). Three of the banks—NAB, WBC and ANZ—also posted gains of 3–6% on the back of solid earnings. This positive momentum did not extend to CBA which fell by nearly 7% on the back of civil proceedings launched by AUSTRAC due to concerns over CBA's management of its anti-money laundering obligations. CBA's poor quarter was dwarfed by Telstra, with the telecommunication giant being heavily sold off (–16.5%) following the announcement that its pay-out ratio going forward would be in the 70–90% range. The move follows a soft earnings result as increased mobile phone competition, in particular, started to hurt.

Rolling Three-Year Returns to 30 September 2017

SOURCE: LONSEC RESEARCH

Smalls vs Large

The September quarter has seen a continuation of a pattern that first emerged in the June quarter, where small caps have substantially outperformed large cap stocks. The S&P/ASX Small Ordinaries TR Index ('Small Ordinaries') returned 4.4% for the September quarter, compared to a paltry 0.4% return for the S&P/ASX 20 TR Return Index ('ASX 20'). The small caps return was also well in excess of the ASX 300 return. The main reason for the extent of the dispersion between the Small Ordinaries and the ASX 20 has been the poor 'bottom-up' driven outcomes for shareholders in TLS and CBA. However, the Small Ordinaries has also benefitted from the very strong rally in small resource stocks and associated industries such as mining services.

A cautionary tale: the fall of the Telstra dividend

A mainstay in many Australian equity portfolios over the last decade has been the Telstra dividend. While much has fluctuated in the investment realms, investors seemed to take it for granted that the Telstra dividend would at least hold up and eventually increase.

A look back through the 21st century highlights why the maxim that the TLS dividend was as 'safe as houses' was held. For instance, the full-year Telstra dividend rose from 28¢ in FY07 to 31¢ for FY17. To make things even better, this dividend has been fully franked throughout this period. It is fair to say that retirees simply loved that 'divvy'.

The shock was palpable when Telstra CEO Andrew Penn announced in August that one of the outcomes of Telstra's 'capital allocation strategy review' was to significantly alter the dividend policy. In particular, Penn announced that the Telstra Board had decided to revise the pay-out ratio from 100% to between 70–90% of 'underlying earnings', and that this was likely to reduce the FY18 dividend to 22¢ (a fall of over 30%). The share price reaction has been savage. Penn's reasons, however, are steeped in common sense. After the National Broadband Network transmission, Telstra is just another telecommunication company with the biggest swing factor in its earnings being its mobile business. Yet the outlook for mobile is competition and more competition, meaning Telstra will need to re-invest to stay relevant. A portion of its free cash-flow will be needed to fund this. Goodbye (and good riddance) to the 100% pay-out ratio.

Lonsec will continue to seek valuation driven opportunities to up its ASX allocation

The lesson for investors is to invest in companies that have certainty and a robust outlook for earnings. The long-term funding source for dividends is always earnings; for sustainable dividend growth, earnings need to be robust and on an upward trajectory. Also, companies that face industry head-winds, including increasing competition, must re-invest in their businesses to grow and maintain market share. In this dynamic, a 100% pay-out ratio is not sustainable unless a Board is willing to gear the balance sheet to fund this obligation. The Telstra Board was sensibly not prepared to imperil its balance sheet and hence the only other source is free cash. The rest is history.

PETER GREEN, GENERAL MANAGER–EQUITIES

ADRIAN HOE, SENIOR RESEARCH ANALYST

Global Equities

Global stocks continued the upward momentum first evident in Q2 with the MSCI AC World Index up 4.96%, in USD terms, over the September quarter. The markets were buoyed by the release of macroeconomic data showing major economies in a state of continued expansion. Positive macroeconomic data out of the United States, China and European countries dominated the quarter with declining unemployment figures, above-estimate economic growth and a recovery in crude oil prices helping to push equity markets higher. Concerns about escalating political tensions after North Korea's missile launch over Japan were fleeting as the market's attention shifted towards corporate earnings. The reporting season was largely strong, and the market duly rewarded.

A common theme arising out of the quarter was Central Bank rhetoric. The Chair of the Federal Reserve and the Bank of England's Governor all indicated the coming months would see an increased likelihood rates normalisation, with inflation likely to be in line with target bands. US 10-year Treasury Bond yields and 10-year Gilt yields both finished the quarter higher as a result. The omission of "downside risks" by the President of the European Central Bank (ECB), Mario Draghi, followed by the strong indication the ECB will commence winding down its €2.3 trillion bond purchase programme at the start of 2018 further supported the bullish market sentiment across the Eurozone.

Emerging markets reversed their mixed performance by generating a return of 8.04% in USD terms over the quarter. The continuation of strong economic growth in China coupled with a weakening US dollar helped drive EM equities higher. Brazilian equities were the strongest performer with the MSCI Brazil Index returning 22.95%, in USD terms, over the period as optimism over reforms to social and economic policies driving equities higher.

A suprise arrived near the end of the quarter as the Alternative for Germany (AfD) party won 1.3% of the votes in the German election, forcing Chancellor Angela Merkel to form a coalition government. On the US front, the inability to pass healthcare legislation and delays in taxation reforms will likely see this play out in 2018.

Rolling Three-Year returns to 30 September 2017

SOURCE: LONSEC, DATA SOURCE: LONSEC/FINANCIAL EXPRESS

United States

US equities powered through the quarter with the S&P 500 delivering a strong return of 4.5% in USD terms over the period buoyed by positive macroeconomic data. The US economy grew 3.1% (annualised) over Q2 which was the fastest since Q1 2015 and considerably outpaced the 1.2% (annualised) figure of Q1 2017. Growth in consumer spending (3.3%), and business expenditure (8.8%), drove US GDP which exhibited the quickest increase in almost two years. Further, the unemployment rate declined to 4.2% in September while nonfarm payroll employment decreased by 33,000 for the month of September after consecutive increases in July (138,000) and August (169,000). The decline in nonfarm payroll for September is considered transitory with the majority of the downward revision in employment concentrated in the food services industries impacted by hurricanes Irma and Harvey.

The Federal Open Market Committee (FOMC) indicated in their latest minutes from the September meeting that it plans to normalise its US $4.5 trillion balance sheet. This is to commence in October at initially US $10 billion per month. Though the market is pricing in an increase in the Federal Funds Rate in December based on the Fed's hawkish tone in their latest minutes, concerns still persist within the Fed and the broader market about the lack of inflation. The Fed's preferred gauge shows inflation at about 1.4%, below the 2% target. Nonetheless, discourse continues on whether there are ephemeral factors distorting current inflation figures. The likelihood of a further rate increase and the normalisation of the Fed's balance sheet highlights the Fed's view of the strength of the economy, with near-term risks to the economy, due to balance sheet reduction, being approximately balanced.

US equities powered through the quarter with the S&P 500 delivering a strong return

The reflation trade that began in November 2016 faded in Q1 and Q2 2017 after the failure to repeal the Affordable Care Act (ACA), known as 'Obamacare'. However, the 'Trump Bump' looks to be recommencing with outlined fiscal policy providing a slight increase to growth in small caps. Underpinning this is the framework of tax reform which, if passed, will see a reduction in the corporate tax rate from 35% to 20% and the top individual tax rate from 39.6% to 35%. At this stage, amendments to US taxation laws and infrastructure spending looks to be delayed until 2018. Geopolitical concerns were unable to dampen the appreciation in US equities, with increases in volatility short-lived after tensions with North Korea escalated after the nation's most recent missile launch which crossed over Japan.

Amid positive macroeconomic data underpinning the strength of the US economy, a strong earnings season also helped lift major US equity indices to all-time highs largely led by the Information Technology and Energy sectors. Driving this strong growth in corporate earnings are offshore earners with large cap companies sourcing approximately half of their revenues from abroad. As mentioned, the Technology sector outperformed all other sectors and finished the quarter up 8.3% to take its year-to-date performance to 26%. Tech was followed by Energy which grew 6.0% for the quarter partly driven by a recovery in crude and brent oil prices which have substantially recovered from their close-to-bear-market June lows. The global oil market has come back into balance, with global inventory gradually reducing through the course of the quarter from 234mb to 195mb over the five-year average. Conversely, performance laggards for the quarter included the bond proxy Consumer Staples while Consumer Discretionary continued its struggles, gaining only 0.8% with disruption rife in the sector.

World ex US

European shares continued their advance for the year, albeit at a tempered pace, as the MSCI EMU Index (European Economic and Monetary Union) returned 4.3% for the quarter in EUR terms. European equities appreciated on the back of positive macroeconomic data showing seasonally adjusted GDP rising by 0.6% in the Euro area (EU19) and the EU28 during the second quarter, topping the 0.5% in the first quarter. By way of contrast, the US grew at 0.6% for Q2, 2017.

Economic conditions have continued to improve across Europe and, in comparison to the same quarter last year, seasonally adjusted GDP rose by 2.2% in the Euro area and 2.3% in the EU28, an increase of 0.3% and 0.2% respectively. Favourable jobs data provided further fuel and helped pushed equities higher throughout Q3, with the unemployment rate decreasing to 9% at the end of August. This represents the lowest level of unemployment since February/March 2009. Despite economic growth providing a strong tailwind for European equities, this decrease in unemployment has seen an appreciation of the EUR/USD. As Eurozone companies approximately source 50–60% of their revenues abroad this has resulted in a hit to bottom lines, particularly from Q3 onwards.

Rolling 12-month (%p.a.) returns to 30 September 2017

SOURCE: LONSEC. DATA SOURCE: LONSEC/FINANCIAL EXPRESS

The appreciation of the Euro was further stimulated through the hawkish tone by ECB President, Mario Draghi. Q3 saw Draghi indicate that the ECB intends to start winding down its €2.3 trillion bond purchase programme at the start of 2018. Markets have continued to hone in on the ECB President's language which has seen a softening of his tone in relation to "downside risks" over the Eurozone's economic outlook. The majority of the ECB's decision in relation to its €60 billion-a-month quantitative easing programme will be decided in October.

UK equities rose modestly over the quarter generating a return of 2.14% in GBP terms, partly driven by the Resources sector performing well after positive Chinese GDP figures for the first half of 2017. As noted, the rebound in crude oil prices drove the Oil and Gas Sector which helped contribute to gains. Conversely, diversified defensive names detracted from performance caused largely by the appreciation in the Sterling over the period. The BoE has suggested it could normalise or raise rates as early as November which has partly contributed to the appreciation of the sterling. However, given debt-laden consumers and businesses, the principal risk to the economy which needs to be balanced with risks arising from Brexit.

Japanese equities finished the quarter up 4.7%, in JPY terms, with the majority of gains occurring in September after lacklustre performance in July and August. Equities pushed higher on the back of increased crude oil prices, which drove the appreciation in oil and mining stocks, and strong corporate earnings results which surpassed expectations. Positive macroeconomic data released also contributed to positive market sentiment with an increase in GDP of 4% (annualised) over Q2 versus expectations of 2.5% and core CPI at 0.7%. The Bank of Japan kept rates unchanged throughout the quarter. Looking forward, the political landscape will be of close attention as Q3 saw Japan's Prime Minister Abe call a snap election to be held in October on the back of renewed popularity following relatively recent scandals. Abe will be pitted against the Democratic Party and the Tokyo Governor, Yuriko Koike's newly formed party which has gathered momentum over the preceding weeks.

LIBBY NEWMAN, GENERAL MANAGER – FIXED INCOME AND MULTI-ASSET

Cash and Fixed Interest

Fundamentals remain mixed for interest rate markets. Domestic inflation remains at the bottom of the RBA target range while US inflation remains perplexingly softer than Fed Chair Yellen expects. European inflation has seen a slight uptick and Japanese inflation stubbornly low also.

Global GDP has edged up driven by improvements in the Euro zone and US. Despite unemployment rates in many major advanced economies being at or below levels that could be associated with a build-up in wage pressures but Draghi for one, continues to believe that labour market and not a structural change in the nature of inflation is the chief culprit behind low prices.

In Australia, the RBA has kept rates on hold at its October meeting, a stance expected by most market participants to be maintained for the balance of 2017, though talk has shifted to the next move being a rise. The market (as observed in the short-term interest rate futures market) is pricing in at least one hike in early 2018. However, with inflation stubbornly low, some pockets of softer auction results and reports of mortgage stress, any rate hikes are likely to be reasonably measured. Further, the impact and 'pain point' are likely to be more acute than previous cycles.

Australian Fixed Interest

The 2017 rally in yields was sharply reversed in July and has range traded over the quarter around the 2.75% mark. While bond prices have retraced from expensive territory and again offer an attractive term premium relative to their cash anchor, relative to history and fair value estimates, they are still viewed as expensive.

Credit metrics remain reasonably positive and an overweight to credit is a popular method of extracting some additional yield. Spreads reflect the popularity of this trade, having continued to grind tighter from their 2016 highs to be tracking below their five-year average at time of writing. Australian investment grade is viewed as fair to expensive.

Against this backdrop of fair to expensive credit, there has been strong interest in passive floating rate credit products with the launch of two floating rate credit ETFs (BetaShares QPON and the slightly punchier Van Eck FLOT)

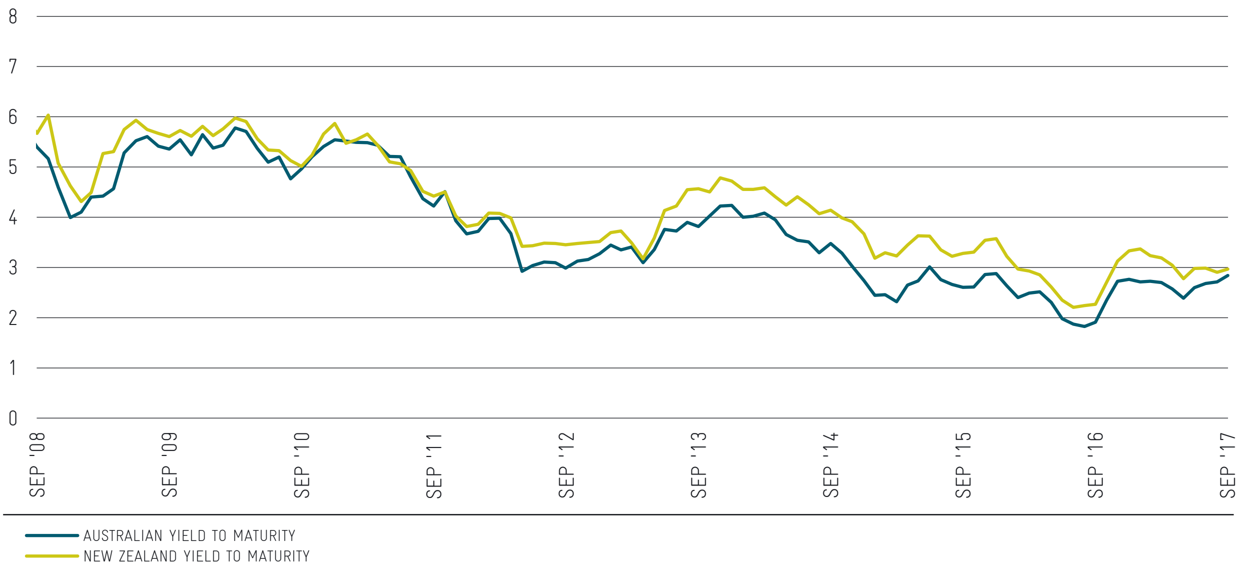
The opportunity set in Australia is relatively narrow and active managers have had a tough time of it in recent years. However, pleasingly active managers have added value over the course of 2017.

Quarterly Outlook

Rolling Three-Year Returns (p.a.) to 30 September 2017

SOURCE: LONSEC, DATA SOURCE: LONSEC/FINANCIAL EXPRESS

Australian and New Zealand 10-Year Bond Yield



SOURCE: BLOOMBERG

Further, investors making the switch to passive management should be aware that the underlying index duration continues to lengthen. Low yields in an historical context and long duration make bonds even more sensitive to capital price fluctuations for a given move in yields.

We favour managers who continue to view fixed interest as a more defensive asset class. Some variation in what constitutes defensive has been observed amongst the rated universe, most starkly in the unconstrained bond group. To some it means minimising the chance of losing money from rising yields (hence have adopted short duration stance). To others it means being negatively correlated to equity markets in a portfolio context. Both can be valid depending on the mix of other risk assets in the portfolio. However, we are mindful that chasing the credit market spreads to the bottom (which can bolster meagre performance returns relative to peers in low volatility environments) may result in high correlation to equity beta asset classes.

Global Fixed Interest

The case for active management is more compelling in global fixed interest, where the opportunity set is broad. A flight to quality rally early in the quarter on the back of banter between the North Korean leader and the US president saw Australian bonds lag global counterparts. However, in August, bond yields retraced, when the Canadian central bank surprised with a rate hike and the BoE (while not raising rates) flagged a hike as soon as November. US yield curves are also steeper than Australia, offering a greater pick up for longer bonds than the domestic market when hedged back to AUD.

In the US, the Fed's task of navigating rate rises while simultaneously unwinding its massive balance sheet and the prospect of tax reform, continue to be a focus. The composition of the Federal Reserve Board itself (in a post-Yellen era) and the doves/hawks balance will likely impact the pace of balance sheet unwind in the coming years.

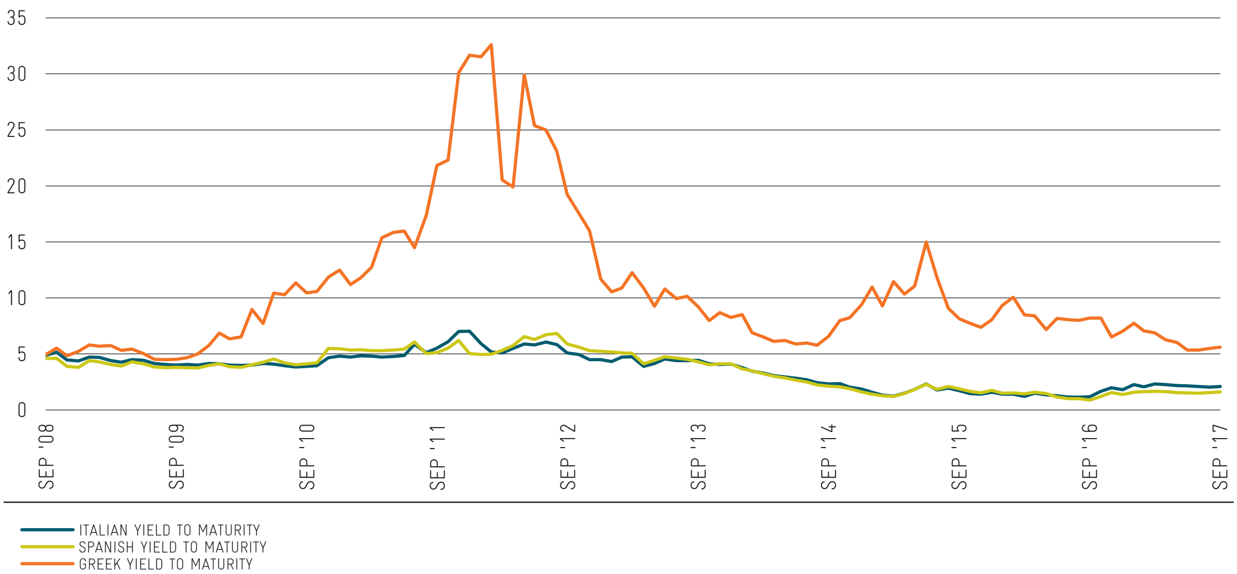
Many global managers have begun to take pause and derisk in the late stages of the credit cycle. For many, mortgage backed securities in various forms continue to be a popular source of lower risk returns. The trade-off for the extra yield against a backdrop of better housing market metrics than Australia is liquidity. While the amortising nature of such securities provides a regular source of income, these securities tend to be tightly held, trade less frequent and may for periods exhibit less market price volatility.

Like their Australian counterparts, we have observed an increased use of emerging market debt and currency in the armoury of global fixed interest managers. This has exhibited mixed results, with currency markets subject to quite different characteristics to mortgage backed securities—high levels of liquidity and commensurately higher price volatility.

US, German and UK 10-Year Bond Yield

SOURCE: BLOOMBERG

Italian, Spanish and Greek 10-Year Bond Yield



SOURCE: BLOOMBERG

Credit

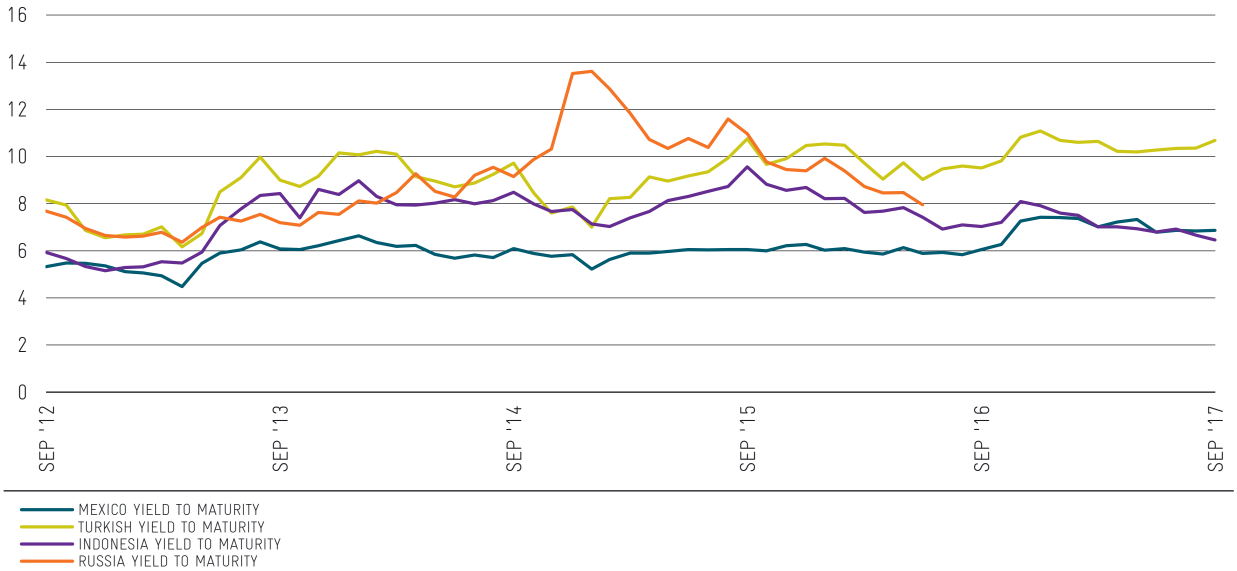
Investment grade spreads are continuing to offer attractive carry, though are not expected to experience gains from further spread compression. High yield, however, has remained in relatively expensive territory from a spread perspective with the global thirst for yield continuing to dominate. A repeat of the very strong performance of 2016 is not expected. Historically the prospects for consecutive years of strong returns from high yield credit (particularly with spreads at current levels) are not high and while fundamentals remain supportive and corporates have taken the opportunity to term out their debt, we are cautious of late cycle yield chasing behaviour.

Emerging Markets

With credit markets in the US (particularly high yield) appearing fully priced by historical standards, investors are increasingly turning to Emerging Markets to satisfy their thirst for yield. This has been a popular and rewarding trade in 2017 and was a consistent theme observed by our fixed income team on their mid-year trip to visit UK, American and Asian managers. The strong issuance pipeline from Emerging Markets has been more than met by investor demand. However, the transition of leadership in China and the broader impact of rising US rates are some of the near-term risks.

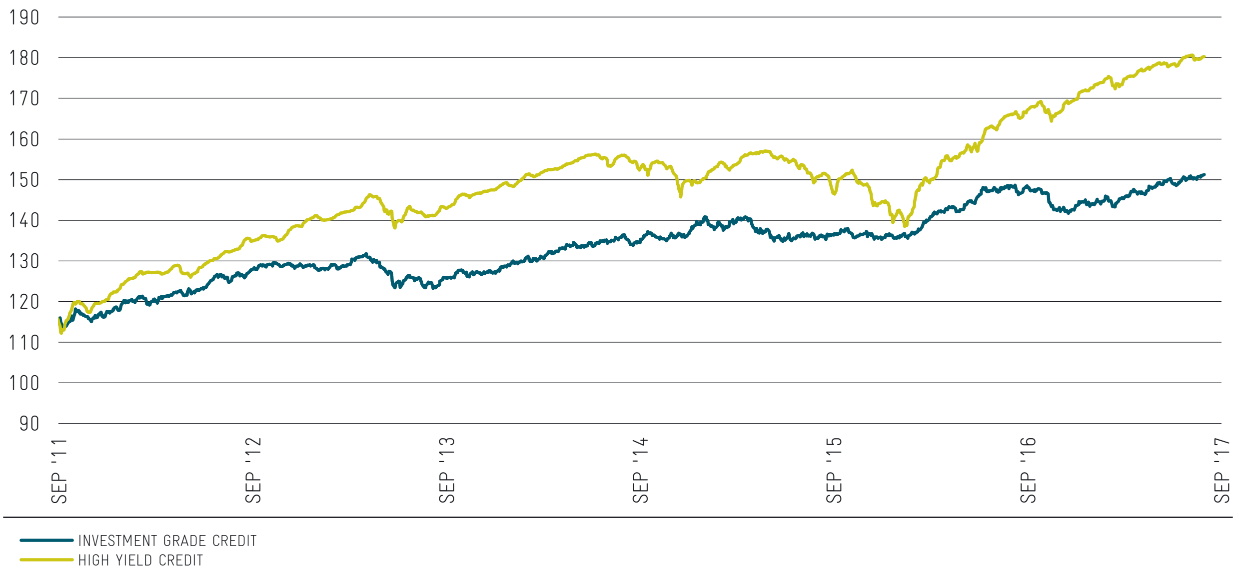
Quarterly Outlook

Mexican, Turkish, Indonesian and Russian 10-Year Bonds



SOURCE: BLOOMBERG

Investment Grade and High Yield Credit Returns



SOURCE: BLOOMBERG

KEVIN PROSSER, MANAGER – DIRECT ASSETS RESEARCH

Property and Infrastructure

A-REITs

The A-REIT sector managed to slightly outperform the broader market during the September quarter 2017 (ASX Property 300 Accumulation Index 1.9% total return compared to the ASX 200 Accumulation Index 0.7%). For the calendar year 2017, equities are still well ahead (3.9%) of A-REITs (–1.2%).

The large Retail stocks (Scentre and Westfield) continued to drag on the sector overall (35% of total), although Vicinity bucked this trend. Specialised, Industrial, Healthcare and Residential sectors lead the property index performance, with Diversified, Office and Retail underperforming.

The Amazon influence was discussed in the last issue, but the recent profit results showed that retail property earnings in Australia are currently holding up well despite softness in department store sales. The impact from on-line will be gradual and the example of Canada shows that Amazon took a decade to establish itself, although the speed of technological impact will no doubt compress this time period in Australia.

Benefiting on the other side of the Ecommerce trend, Industrial/Logistics property has been a consistent performer in recent years.

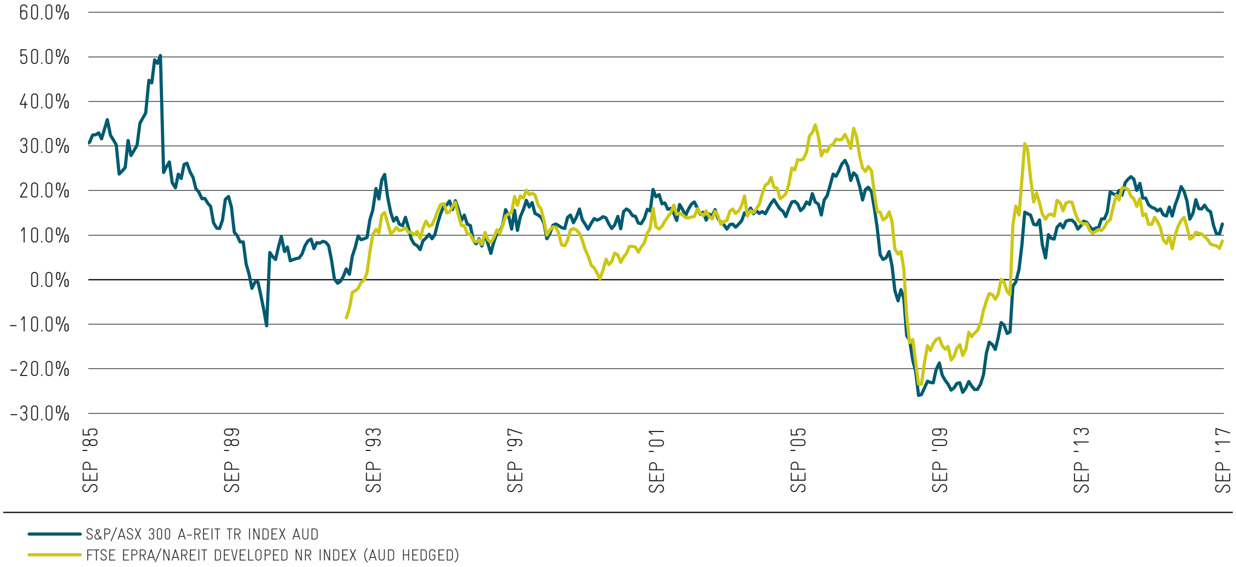
Office vacancy levels in the most major CBD office markets continue to tighten (Sydney 6% and Melbourne 7%) with strong employment growth underpinning demand and supply being taken out of the market in Sydney. Face rents are growing and incentives being wound back. Even Perth leasing activity has improved and vacancy is edging down but still above 20%.

The Residential property sector is another area that gets more than its share of press coverage, but represents a small part of the A-REIT index. Lately the Retirement & Aged Care sector REITs have garnered some adverse media due to the spotlight being shone on some sub-standard practices at Aveo (stock price has dropped 28%). Notwithstanding the complexities of these sectors, we believe that there are good long-term growth opportunities (on the back of the ageing population) for A-REIT fund managers to seek out.

1 Not part of the A-REIT indices

Quarterly Outlook

Rolling Three-Year Returns (p.a.) to 30 September 2017



SOURCE: LONSEC. DATA SOURCE: LONSEC/FINANCIAL EXPRESS

While these and other specialised sectors (e.g. Student Housing) may have limited ASX-listed vehicles at present, there is much activity at the property level. Similarly, recent discussion forums have been centred on the possibility of the Residential Rental sector being securitised in Australia, in a similar vein to the well-developed Multi-Family Residential Sector in the USA. However, draft legislation by the Australian government on Trusts owning residential property is causing some angst amongst existing operators.

Relative weakness in the A-REIT sector has led to a pick-up in corporate activity. 360 Capital has snared 70% of Australian Pacific Data Centres, but tenant NextDC holds a blocking 30% stake. Propertylink is the centre of another battle, with suitor Centuria also being targeted by overseas investors. Cromwell has however terminated its offer and sold their almost 10% stake in Investa Office Fund to Investa Property Group.

With positive revaluations filtering through over the August reporting season, the sector is offering value, trading at around a 10–12% discount to Net Asset Values (long-term average of 0–5% discount). Current year dividend yields are 5.0%, offering a 2.2% premium to bond yields (above long-term average of 1.9%[2]) and sector gearing remains very reasonable around 30%.

2 Source: Cromwell Phoenix.

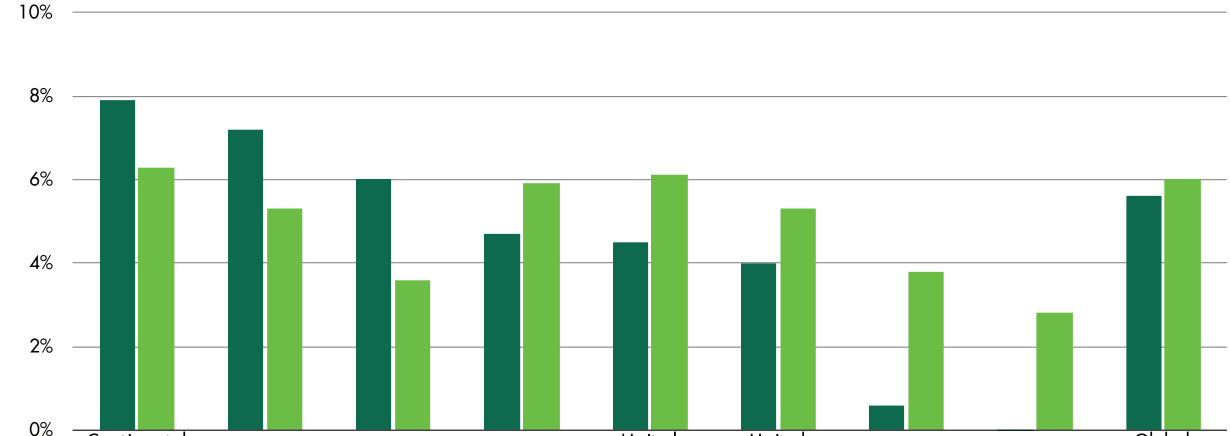
Global REITs

For the September quarter 2017, Global REITs (AUD Hedged) again recorded modest positive gains (1%) and further underperformed against the broader global equity market (4%). The one year underperformance is now out to a whopping –17% pts (2% versus 19%).

Geographically, Europe led the way again (5.6% in USD terms), followed by Asia-Pacific (2.1%) and North America lagging (0.9%). In the US, relatively good performance continued from the Industrial (winners from the 'e-tailing' trend), Data Centres (especially those with assets as hubs for international connectivity) and Self-Storage sectors. The weakness in the Retail sector abated (1.2% for the September quarter), with Healthcare recording the largest negative returns followed by Office and Residential sectors.

The equity markets have shifted focus from sectors that have benefited most from lower bond rates (property and infrastructure), although the physical property market is still buoyed by capital looking for more attractive and stable yields. However, changes in Chinese government capital regulations are beginning to have an impact on various markets as some of the more aggressive buyers retreat. The pull-back in property-related equities usually points to eventual corrections in direct property asset values.

Regional Earnings Growth Forecast



	Continental Europe	Hong Kong	Japan	Australia	United States	United Kingdom	Singapore	Canada	Global Average
2017f	7.9%	7.2%	6.0%	4.7%	4.5%	4.0%	0.6%	-0.7%	5.6%
2018f	6.3%	5.3%	3.6%	5.9%	6.1%	5.3%	3.8%	2.8%	6.0%

SOURCE : CBRE CLARION GLOBAL REAL ESTATE MARKET COMMENTARY

Globally, economic growth in Europe is expected to improve backed by continuing accommodative monetary policy. In the UK, property values continue to be supported by foreign capital flows even though office property fundamentals are clouded by the implications of Brexit with market rents continuing to fall, even though vacancy is at low levels and current employment levels are solid. Retail malls are showing falling sales, no doubt partly attributable to the rise of purchases made on-line. With Japan's central bank policies unchanged (zero to negative rates) reflecting a sluggish economy, office property vacancy is surprisingly tight and the increase in supply over the next year or two is not expected to lift vacancy much from these low levels.

KEVIN PROSSER, MANAGER – DIRECT ASSETS RESEARCH

Infrastructure Securities

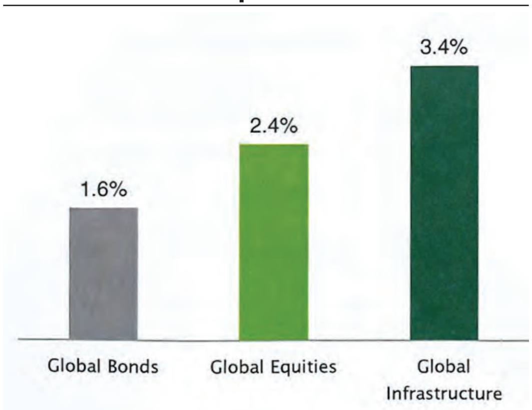
In contrast to the property securities sector performance over the last year (A-REITs -2.8% and Global REITs AUD hedged 1.9%), global infrastructure securities (AUD hedged 11.8%[1]) have not been impacted greatly by the anticipation of higher bond rates especially in the US.

Nevertheless, infrastructure has also lagged the broader equity markets over the last 12 months and this continued into the September quarter 2017 (AUD hedged 1.9%[1] versus MSCI World NR Index AUD hedged 4.2%).

However, the recent underperformance is off the back of an index increase of 9.3%[1] p.a. over the last ten years to September 2017 (broader Equities 6.6% p.a.), as real asset values benefited from the trend of lower bond rates. The longer-term outperformance of Infrastructure can be substantiated over the past 15–20 years.

Part of this relative performance can be traced to the superior and stable income characteristics of infrastructure assets and securities, with the latter still offering a 1% distribution yield advantage over global equities. According to CBRE Clarion research, "listed infrastructure cash flows and dividends benefit from contractually driven inflation-linked revenue growth... and 84% of listed infrastructure has the effective means to pass through the impact of inflation to shareholders."

Dividend Yield Comparison



SOURCE: CBRE CLARION SEPTEMBER 2017

Recently, **transportation** has been the strongest sector globally, with both European and Japanese stocks doing particularly well.

Airports have also performed well on the back of strong tourism numbers, with strategically placed assets (like Sydney Airport) harnessing growth from the rise of the middle-class traveller in Asia. Valuations though are more in line with that of sporadic private transactions, with good quality assets being tightly held.

1 FTSE Global Core Infrastructure 50/50 NR Index (A$ Hedged)

The US market has built-in expectations of a boost to infrastructure spending from the Trump administration. However, there has been little progress on this policy front with the political climate difficult for Trump to push through an agenda entailing significant spending. Even in **pipelines**, where Trump initially made executive decisions to cut ‘red-tape’, there have been political and administrative delays. The pipeline sector has been a poor allocator of capital and there are already signs that may lead to a surge in assets, which is likely to drive down operating returns.

Other trends include the growth in wireless technology and expanding data requirements of industry and consumers. Investment managers are positioned in **Communications** stocks to benefit from additional infrastructure needed to support this.

Renewable Energy infrastructure is another secular trend driving the relative performance within the wider **Utilities** sub-sector, with major technological changes improving the economics of large scale wind-power generation towards parity with traditional energy sources.

2 Earnings Before Interest, Tax and Depreciation
3 Source: CBRE Clarion

DANIAL MORADI, SENIOR EQUITIES STRATEGIST, LONSEC RESEARCH

Direct Equities

The Australian equity market recorded modest gains in the September quarter, delivering a total return of 0.7%. Stronger performances were seen from Energy (7.3%), Materials (6.5%) and Consumer Staples (4.4%) sectors, while the Telecommunication (–15.4%), Utilities (–5.9%) and Healthcare (–5.2%) sectors were the major underperformers. Small caps outperformed large caps over the quarter, with Small Resources gaining an impressive 12.8%, aided by rising commodity prices, particularly base metals, with aluminium, copper, nickel and zinc hitting multi-year highs during the quarter on optimism around the global economy and a weakening US dollar.

The main event during the September quarter was the FY17 reporting season in August, where company profit results were broadly in line to slightly below expectations. The Resources sector, as expected, displayed strong year on year earnings growth, however this was from a cyclically low base in FY16 when commodity prices were particularly weak. Mining & Metals stocks, such as BHP, RIO, FMG, etc. grew EPS by 170% over FY16 levels, while the Energy sector saw a 31% lift. This contributed to an overall market weighted EPS rise of 18%, an impressive outcome in isolation, however excluding the cyclical Resources component, EPS rose a more modest 6% for the Industrials portion of the index.

At the company level, Bendigo & Adelaide Bank, Flight Centre, IOOF Holdings, JB Hi-Fi, Orora and Sydney Airport reported better than expected results, whilst Challenger, BlueScope Steel, Domino's Pizza Enterprises, Healthscope, Telstra and QBE Insurance Group reported weaker than expected results.

Looking ahead, the strong growth in earnings in the Resources sector is unlikely to be repeated in 2018 with commodity prices expected to drift lower over the year. Consensus market earnings growth for FY18 currently sits at around 3%, reflecting the lack of growth in the market's two largest sectors with earnings growth expectations for the Resources sector currently at 0% and Financials at c. 3%. The growth profile does improve as we move outside Banks and Resources with 6% EPS growth forecast for Industrials, however, valuation metrics remain fairly to fully priced at a prospective FY18 PER of 15.4 times reflecting the scarcity of high quality earnings growth.

Looking ahead, we continue to retain an overall cautious outlook, with high household debt levels together with increasing pressure on household disposable income over FY18 expected to weigh on consumer confidence and the overall growth outlook for the market. Whilst we expect the RBA to remain on hold for the balance of FY18, the Australian dollar is expected to retreat from current levels against most major currencies. Accordingly, we expect companies with substantial offshore earnings to outperform over 2018 compared to their more domestically oriented peers. Our preferred sector exposures remain biased towards Healthcare, global Industrials, Insurance and Infrastructure, whilst retaining an underweight exposure to Banks, Resources, Telcos and Consumer Discretionary.

Lastly, the key events for the equity markets in the December quarter include: The outlook for the US economy and timing of interest rate rises (rate hike expected in December); The appointment of the next Chair of the Federal Reserve; Progress on tax reform plans in the US; Upcoming AGM season where we get our first formal update on FY18 earnings trends, and China's 19th National Congress in October to (re)elect leaders and set the economic agenda for the next five years.

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Investment Outlook Report

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