2016 INVESTMENT MARKET UPDATE **JANUARY 2016**

COMMENTARY

The purpose of this note is to provide investment views on the outlook for markets and economies over the course of 2016. This information has been provided by Atrium Investment Management (Atrium) which provides investment services to Fitzpatricks.

As 2015 drew to a close, markets faced a number of variations on themes which we have discussed over recent years and which we expect will continue to have an impact on asset prices over in 2016; These themes included; weak growth in Europe, the US Federal Reserve Bank lifting interest rates off zero, weakening growth in emerging markets led by a slowdown in China, and a lack of inflationary pressure across the globe. Uncertainty relating to whether the US economy is on stable enough footing to begin to increase interest rates and whether the slowing Chinese economy can avoid a hard landing scenario has dominated risk appetite and market moves in late 2015 and early 2016. This has resulted in sharply elevated levels of volatility across investment markets which we expect will continue to again be a feature throughout 2016. This backdrop of low interest rates and uneven global growth coupled with the strong rise in asset prices over preceding years post the Global Financial Crisis has tempered our expectations for investment returns in the near term. Not unlike 2015, in such an environment we expect the ultimate return on offer for investors will be determined by the success of selective allocation of capital across a range of asset classes. We were delighted with the performance of the portfolios in 2015 which exceeded our investment objectives and delivered particularly strong returns for our investors while maintaining lower levels of volatility.

Our focus as a firm is to construct portfolios that help clients achieve their investment objectives. While we continue to stress that investors must always remember that the time frame we focus upon is over the medium to long term, it is nonetheless pleasing when market opportunity coupled with flexibility of approach allows for these objectives to be exceeded.

In many ways we expect 2016 to be largely more of the same and we remain singularly focussed on preserving and compounding capital to deliver our clients investment objectives.

	1 year	3 Years	5 Years	Return Objectives
Conservative	7.4%	6.9%	5.8%	Cash + 2.00%
Moderately Conservative	8.6%	8.4%	6.6%	Cash + 2.50%
Balanced	12.3%	12.4%	9.2%	Cash + 3.75%
Growth	13.5%	13.7%	10.0%	Cash + 4.50%
High Growth	14.0%	14.1%	10.3%	Cash + 5.00%

Source: Atrium. Portfolio returns based on the portfolios managed by Atrium and offered by Fitzpatricks for select clients within the Fitzpatricks managed discretionary account service. Past performance is not a reliable indicator of future performance. When we speak of our investment objectives, particularly for performance, it is very important to understand that these are not forecasts, promises or guarantees. They are simply our goals. The performance or success of an investment through our investment strategies is not guaranteed. You can lose as well as make money.

Later in this letter, we briefly summarise our thoughts on the US Federal Reserve. When the central bank with oversight over the world's largest economy and reserve currency enters an interest rate hiking cycle, markets across the globe are affected. Arguably, the step towards interest rate normalisation is unusual in that the Fed is hiking at a time when growth in the US is only moderate and the risks to inflation appear to be on the downside rather than the upside. The policy rate has been held at the emergency setting of effectively zero since late 2008, so there are likely to be significant impacts (some of which have no doubt already commenced) as US short rates rise and the US dollar strengthens. In our discussion of the various major economies, it is notable how important monetary policy is in terms of the expectation that it can resolve many of the post the Global Financial Crisis (GFC) weakness – perhaps it has hit its limits and the pressure will grow for other forms of structural reform to take up some of the slack. It is highly significant that the Fed is hiking when much of the rest of the world is still easing policy.

When we wrote six months ago, the International Monetary Fund (IMF) had just revised lower its forecasts for global growth. Yet again, growth expectations are being lowered, and in the first week of 2016 the World Bank again cut global growth forecasts, in what has now become a regular six-monthly event.

In the portfolios, we continue to hold a preference for offshore equities relative to domestic given our view on local currency valuations and we expect that the Australian dollar will likely continue to depreciate despite how far it has already fallen. This has been a major contributor to returns, and we expect this will continue to be the case in 2016.

While asset prices are more fully priced today than they were 12 months ago, we remain confident of achieving client investment objectives over the medium term time frame. Our desire to avoid assets that are overpriced or offer inappropriate risk and return skews will be important if this is to be achieved. We will continue to avoid the approach taken in much of the industry where assets are allocated with reference to strategic asset allocation weights. We are not bound by neutral weights in an arbitrary benchmark, and we believe that the result to date have demonstrated the benefits of such an approach.

Kind Regards

Alex Hone

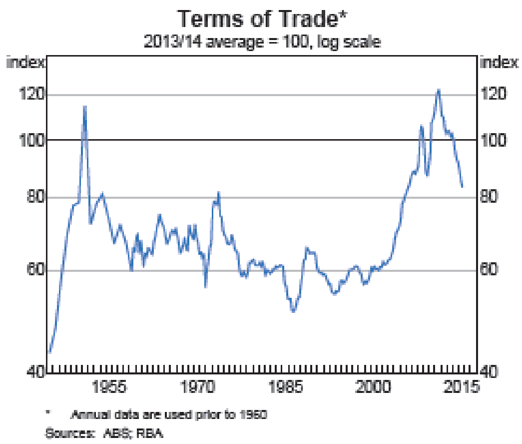
Chief Investment Officer
Atrium Investment Management

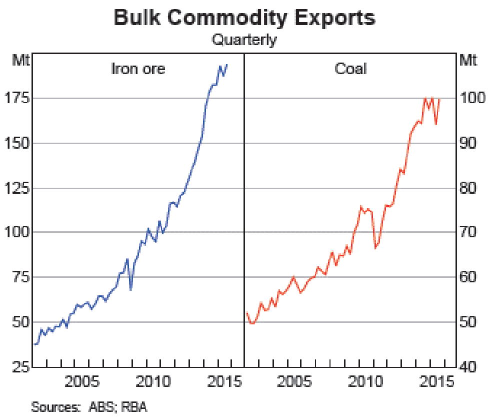
Markets and Macro

Australia

The story in Australia remains broadly unchanged since our 30 June update, however we have been pleasantly surprised as to how well the economy has performed given the slowdown in the resources sector. Australia has benefitted from low levels of interest rates, little inflation, and a significant decline in the value of the Australian Dollar (AUD). The Reserve Bank of Australia (RBA) lowered its overnight rate to 2.00% in the first half of 2015, where it remains at 31 December. The RBA gave a signal at its meeting on Melbourne Cup day that it was unlikely to ease further, although shortly after this in its Statement of Monetary Policy, it downgraded expectations for inflation, potentially leaving the door open for further cuts should they be needed. The lack of any inflationary pressure is a concern to the RBA, particularly given the currency has fallen so far, and the RBA feels it is prudent to retain room to ease further, should conditions deteriorate. Clearly the impact of commodity price falls (in AUD terms) reflected in the huge decline in our terms of trade, is offsetting any domestic benefit to consumers / businesses from the low overnight cash rate.

The decline in the AUD has had a major impact for the competitiveness of Australian products and services internationally, as alluded to continually by the RBA's Glenn Stevens; while the Iron Ore price fell 38% in USD terms for the year, increasing global affordability. The significant decline in the AUD meant a smaller 31% fall in Iron Ore in AUD terms. The decline in the price of Coal, despite grabbing many headlines only fell by 9% in AUD terms. The decline in the value of the AUD has also provided opportunities for the services sector, most notably tourism, where conditions have improved significantly. It seems from here, the key requirement for further easing by the RBA – which clearly retains an easing bias – will be a dramatic deterioration in the international sector, rather than anything in the domestic economy. Business conditions are felt to be above average, although business confidence is still weak; to some extent the better business conditions are reflecting part of the required transition away from a heavily export-reliant economy, to one which is more service-oriented, although there is a long way to go to pick up the excess capacity (particularly labour) in the mining sector. The manufacturing sector continues to shrink sharply. Even retail seemed to end 2015 on a better note, although this was partly buoyed by sales on the home improvements side, reflecting the strong growth seen in the housing segment of the economy. Consumer anxiety fell quite noticeably in the fourth quarter, no doubt assisted by the turnaround in the unemployment rate, which has now fallen from a peak of 6.4% in November 2014, to 5.8% 12 months later.





Source: RBA, RBS, Atrium

Australian equities saw significant divergence between sectors, which really highlighted the problem with taking a broad exposure to the index, rather than an active approach to managing equities. For the full year of 2015, the ASX 200 Accumulation index (ie including dividends) returned 2.6%. However, the headline masks this divergence. Within the index, Energy was down 21%, Materials (ie: resource companies) down 8%, and financials were down 2%. On the other hand, Consumer Discretionary (+10%), Health Care (+7%) and Consumer Staples (+7%) saw strong positive returns.

With the fall from grace of the resource sector, the Australian banking sector remains under close scrutiny, with the four major banks at approximately 30% of the equity market index. In line with offshore regulatory initiatives Australian banks have all raised capital, and / or reduced risk weighted assets, and profitability (as measured by return on equity) will remain under pressure, although recent out of cycle hikes to the mortgage rates will help. We remain underweight the major banks, and have no exposure to the mining sector, as we believe the unwinding of the commodity "super cycle" has a number of years to run. We continue to hold a preference for international equities over Australian equities, given our views on local currency valuations and as a result of our expectation of further falls in the Australian Dollar against the US Dollar. Given how far it has fallen to date, the benefit from a falling AUD to our portfolios may be lower than in recent years. While currency is managed as a separate variable within the portfolios, we take this exposure into account in allocating to international equities, and as the AUD moves towards fair value we may increase Australian equity exposure at some point. The additional return provided by franking of dividends in Australia is certainly another supporting factor for the local market.

Equities	6 Months	1 Year
Australia (S&P ASX 200 Accum)	-0.5%	2.6%
ASX Australian Small Companies	7.0%	10.2%
ASX Australian Listed Property	7.2%	14.4%
ASX Resources	-23.9%	-25.2%
USA (S&P 500)	-0.9%	-0.7%
Germany (DAX)	-1.8%	9.6%
China (Shanghai Composite)	-17.3%	9.4%
MSCI World Ex Australia Accum (AUD)	2.1%	11.8%
MSCI World Ex Australia Accum (Local)	-3.3%	-0.6%
Currencies	**6 Months**	**1 Year**
Australian Dollar	-5.3%	-11.1%

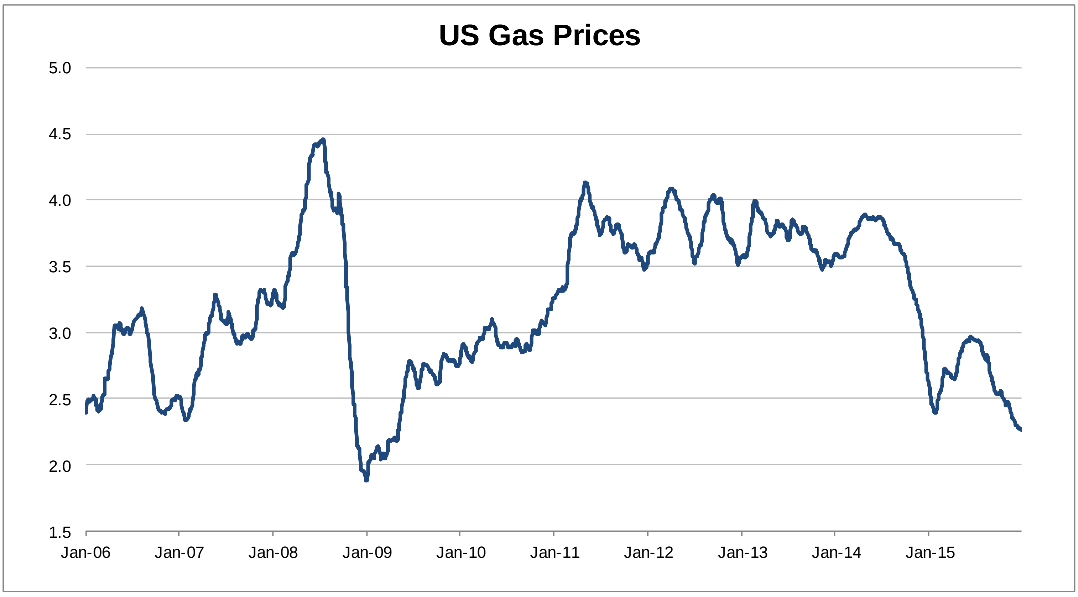
Source: Atrium,Bloomberg, IRESS

US

Despite the ongoing improvement in the US economy over 2015, US equities ended flat for the year albeit with considerable volatility throughout. As discussed at the end of this note, the improving US economy has seen the US Federal Reserve hike policy rates for the first time in 10 years, raising from the level of effectively zero. Adjusting for inflation, real rates have been negative for a number of years and this has had an impact in terms of assisting the economy to recover. The labour market in particular has improved, with job growth in the fourth quarter being impressive. Despite the growth in jobs and lowering of the unemployment rate, what this has not done is lead to any wage pressure. In an ordinary recovery this may be taken as a positive. However with inflation risks still skewed to the downside despite all of the post-GFC stimulus, the Fed and perhaps markets would prefer to see some signs of price pressure. The Fed's preferred measure of inflation, the core-PCE, closed the year around 1.3%, well short of the 2% "target". Headline measures of inflation are much lower as a result of the significant declines in oil prices, however the Fed (and most investors) tend to look through the more volatile headline inflation measures, as oil needs to reach around $10 to get a similar flow through to inflation in 2016, as what was the case in 2015.

In addition to wages and inflation, the one other possible area of concerns in the US is in manufacturing. Although manufacturing as a share of the US economy has declined very significantly over the past quarter of a century, at present manufacturing appears to have declined for two consecutive months perhaps partly due to the strength in the USD.

Overall however, the US economy appears to be in much better health than at any point in the past 7 years. The housing market – the cause of much of the GFC woes – has improved, and the consumer is benefiting from low mortgage rates, and low gas prices (see chart). The improvement seen in the US implies a very gradual tightening of monetary policy over the coming years.



Source: Bloomberg, Atrium

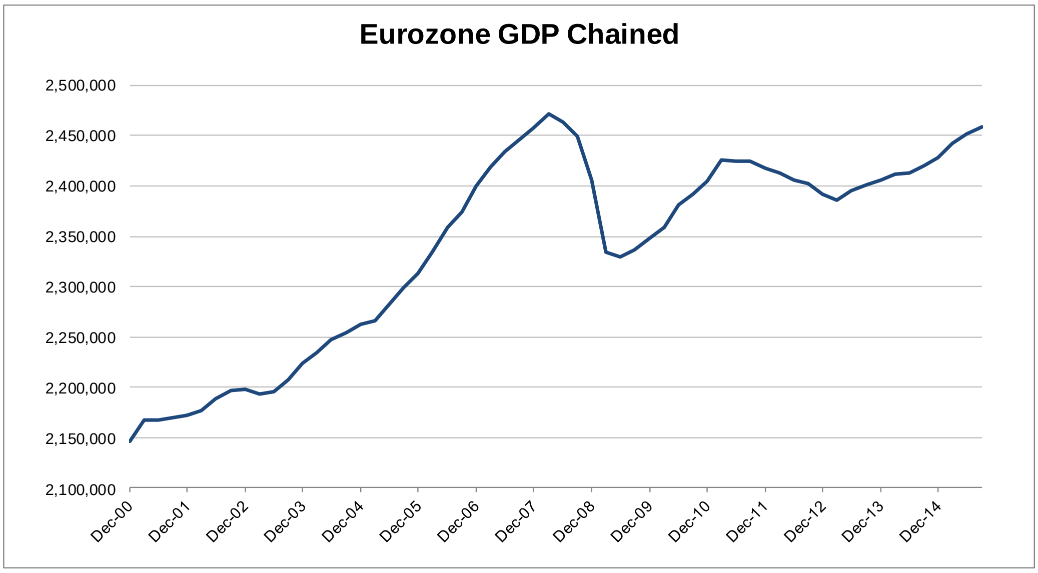
One additional note of caution, and something we are monitoring closely, is the state of credit markets in the US (and therefore globally given the relatively high correlation between markets). Much of the weakness in the US High Yield market reflects specific concerns around the energy and materials sectors which are large borrowers in the high yield market, but we have certainly seen a similar price movement across into the investment grade markets where spreads have also widened appreciably. It is important to monitor as it was in the credit markets in 2007 that the first rumblings of the GFC were felt, well ahead of equity markets. However in the absence of a recession (which we clearly do not expect in 2016), we would expect credit markets to rebound during the year.

Europe

We discussed Greece in some detail in our 30 June report, although it is fair to say that in the second half of 2015 Greece played a minimal role in terms of influencing global markets. We noted that Europe appeared to have avoided – for the moment – the deflationary concerns of early 2015. Indeed, this continued to be the case in the second half of 2015, where core [1](CPI) across the Eurozone clearly turned up from around 0.6% to close at 0.9% at year end. Headline CPI continued to fleet with outright declines, and has fallen in trend terms from a 2.5% to 3.0% range in 2011, to around 0.2% at the end of 2015. Clearly headline inflation is being impacted globally by what is going on with oil prices, and hence core is the more relevant measure. Despite this improvement in core CPI, Mario Draghi, of the European Central Bank, remained concerned

[1] CPI or Consumer Price Index is a measure of Inflation in the economy.

about deflationary risks. The Euro continued to weaken in 2015, although not nearly at the same pace as the prior year. Signals given by Mario Draghi in October showed his concerns around the risks to deflation, and hence his desire to potentially add further liquidity via an increased quantitative easing program. Such a program should have the impact of preventing a reversal of the weakening of the Euro, which would itself reignite deflationary fears. A look at total output in the Euro zone highlights why deflation is still the key risk facing the euro zone; more than seven years after the peak in total output, this looks like recovering the previous peak in December 2015. A loss of output growth for 7 years clearly places downside risks to inflation, and highlights why the ECB has been focussed on further easing measures. (The US had regained its pre GFC economy size by June 2011).



Source: Bloomberg, Atrium

In fact, as the ECB has taken further measures to add liquidity, rates in much of the German bond market are negative. It is still the case that one can fund the German Government and pay to do so. The ECB continues to ease policy although on 3 December, the ECB significantly disappointed markets, by cutting the interest rate on the deposit facility by 10bps to -0.3%, and extending QE[2] by six months rather than twelve months as markets had expected. This disappointment saw a significant move higher in the Euro and lower in European equities, highlighting fears that there may no longer be an ability to convince all ECB members of the need for additional stimulus, which had been strongly hinted toward at the previous meeting.

In terms of European equities, the European market was a strong outperformer against Australia and the US in the first four months of the year, although most out the outperformance was given back in the subsequent months, as first Greece then the ECB continued to warrant caution. We believe that the European markets are attractively priced and the sizeable ECB stimulus program launched in early 2015 will provide a buffer and support growth albeit at low levels over coming years. We continue to hold a material component of our international equity exposure in the region, although given the impact on interest rates of the ECB's stimulus initiatives we are not as positive on the Euro, and have hedged this into US dollars. This view is also in line with our view on the UK market, although we are more positive on the British Pound than the Euro, partly reflecting the thought that the Bank of England, at some stage, will be in a position where it is able to increase interest for the first time post GFC (almost certainly well ahead of the ECB).

[2] QE or Quantitative Easing is a form of economic monetary policy stimulus used by central banks.

Emerging Markets

Perhaps one factor above all others has the potential to drive markets and lead to a considerable increase in volatility; China. We highlighted at 30 June the severe volatility seen in the Chinese equity market. This actually accelerated in July and August as investors sought to reduce leveraged equity exposure in any way possible, given the locking up of large parts of the market. As much of the move in equities had been fuelled by leverage, it is unsurprising perhaps that on some measures, the market was seen as quite overvalued. Perhaps of greater concern to global markets was the move to weaken the Chinese currency in early August. The People's Bank of China effected a 1.9% depreciation in the yuan on 11 August, and while the quantum was not particularly large, it gave a worrying signal in terms of the growth trajectory, and whether this may be the start of an ongoing devaluation of the currency. Such a policy may reflect an internal view that growth in China was weakening at a much faster pace than that which was comfortable for authorities.

China is in the midst of a multi-year / decade shift in the composition of growth, to move gradually away from an over-reliance on exports, manufacturing to support these exports, and infrastructure spending, to more of a consumer / service oriented economy as it matures. Purchasing Manager Indices within China highlighted the downward pressure on manufacturing and the latest reading showed a manufacturing sector in contraction; clearly not consistent with the stated desire to achieve 6.5% - 7.0% growth in the current year. Markets will continue to watch the yuan closely, and the forward markets have considerable further devaluation priced in over the coming 12 months; this would not be taken well by markets as it again heightens the risk of a further deflationary shock on the globe and potentially causes major issues for some of the other Asian (and other emerging market) economies.

Away from China, there have been major moves in emerging market currencies, partly reflecting the strong US dollar, but also highlighting the reliance on commodity exports. Latin American currencies – probably the EM region most exposed to commodity price moves – have performed particularly poorly, with the Brazilian Real down 33% in the year, and the Colombian Peso and Chilean Peso both falling hard. The Argentine Peso was devalued by 36% post the late 2015 election, although this reflects the build up of pressure under the previous regime, rather than a specific commodity price / capital outflow story. It is particularly noteworthy that the Mexican Peso has weakened to multi-decade lows; Mexico and Canada are both seen as countries which benefit from a normalisation of the US economy given the export focus, although with Canada having been forced to cut twice this year (to within 25bps of the all-time low seen post the GFC), energy prices amongst other things are seriously impacting both economies. Outside China, of all the major EM economies, perhaps Brazil faced the most difficult year. The economy is in a deep recession, and yet is one of the few major countries at present with an inflation problem (inflation is running around 8%). The overnight cash rate in Brazil was raised numerous times in 2015 by the Bank of Brazil, to above 14%. With a scandal involving the formerly state-owned Petrobras, which has pulled in politicians and wealthy business identities, it is difficult to see things improving significantly ahead of the Olympics in Rio later this year. Brazil's equity market, the Bovespa, fell 13% for the year. Two of the major rating agencies downgraded Brazil's sovereign rating to below investment grade.

In Asia, the Malaysian Ringgit was a notable underperformer, weakening 23% during the year, partly reflecting a political scandal, and the cost of insuring credit default risk on the sovereign increased noticeably as a result. The Bank of Thailand cut rates further during the year to 1.5%, and the Monetary Authority of Singapore eased policy via the currency (in the face of mild deflation). Vietnam was forced to devalue numerous times in August following the initial move in China. Inflation in India has moderated sharply to around 5%, allowing the highly regarded BOI Governor Rajan, to cut the policy rate on numerous occasions, supporting growth.

Source: CEIC Data, RBA

Emerging market equities overall fell 17% for 2015.

Policy Rates in the US – likely to be the other major focus in 2016

As the US economy continues to heal following the recession of 2008/09, the US Federal Reserve Bank met in December and raised its policy rate from effectively zero, to a range of between 25 and 50 basis points. This was the first hike in rates in the US for almost 10 years, and reflects the first step towards an extraction from emergency policy settings implemented at the height of the Global Financial Crisis in late 2008.

A US hiking cycle is often a major issue for markets, and 2015 had the potential to be more so, as global growth remains tepid relative to pre-GFC levels, and it marks the start of a divergence in policy direction from other developed economies. The European Central Bank and Bank of Japan, along with many other central banks, added liquidity or cuts rates in 2015 in the face of this weaker growth. One notable outcome of this divergence, which Fitzpatricks has actively reflected in the portfolios for well over 12 months, is a continued strengthening US dollar. This has implications across markets, from commodities which tend to get priced in USD, to emerging markets where a hiking US Federal Reserve tends to see funds flow out and back into the US dollar.

Going into the December FOMC policy meeting, markets were less concerned about whether or not the Fed hiked rates, but rather looking for guidance for the future path of hikes beyond the initial move. The Fed had given clear signals that they intended to hike in December, and Fitzpatricks had advised clients that we expected an initial upward move in interest rates, and that the lack of a hike would have been more disruptive for markets. The Fed had signalled that the US economy was improving, particularly headline measures of the labour market, and that the time had come to remove the emergency accommodation of zero rates.

The initial reaction to the move was muted, and one the Fed would have been very comfortable with, given its unwillingness to shock markets, and this really reflects that the markets had come around to fully expecting and pricing the move. The shift of 25 basis points did not concern markets, which were more focussed on the guidance in the statement, and the post-meeting press conference. The statement indicated that the Fed will be "gradual" in shifting policy rates higher, seen as more cautious language than the last hiking cycle 10 years ago, when the Fed used the language of hiking at a "measured pace". The other key piece of language in the statement was a focus on actual inflation rather than the expected path for inflation, as guiding the Fed in terms of subsequent hikes. Inflation is one area where the Fed has been missing its mandate, where inflation has been printing well below the 2% target. Some members of the Fed's policy-making committee, the

FOMC, have noted concerns about inflation being too low, and hence markets continue to price further hikes but at a slower pace than what the Fed itself expects to be able to deliver. The post meeting press conference highlighted a number of times that low inflation is being driven by transitory factors, and therefore should start to gradually rise.

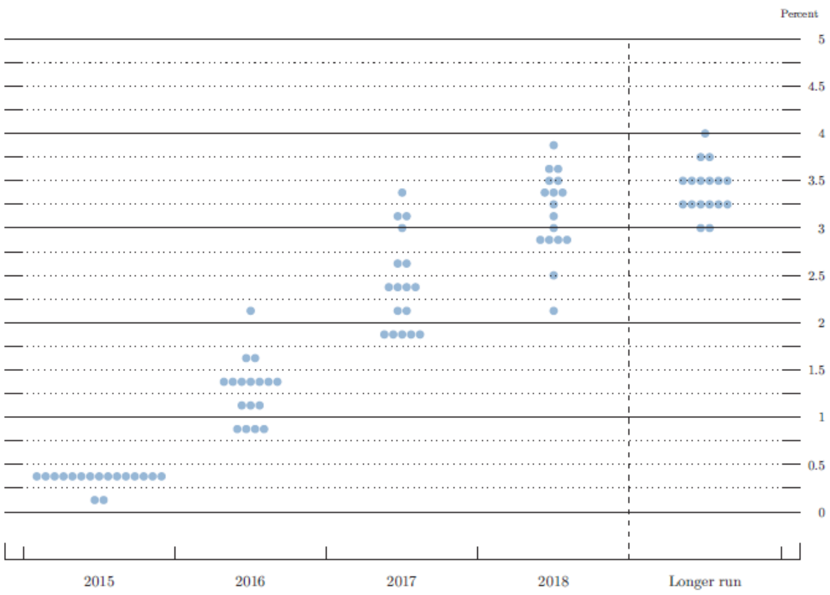
December's move did not surprise us. We have positioned for a rising US dollar for some time. We have not taken material duration in our fixed income portfolios, on the expectation that we would see a gradual rise in yields particularly at the short end of the yield curve (and that this will have flow on effects to other bond markets, particularly Australia). Equities were not initially shaken by the move, although we believe there is the potential for winners and losers and increased volatility. Stock selection is key in such an environment, and increased volatility is an environment in which our portfolio of alternative managers should continue to demonstrate their ability to add value as dispersion grows within their opportunity set.

The slow process of removing extreme policy accommodation following what is hopefully a once-in-a-century event – the GFC - has commenced and will proceed over a number of years. We continue to expect yields to rise gradually, the USD to appreciate, and dispersion in markets to remain elevated, providing opportunities for the alternatives managers in the portfolio. These are some of the ways we have looked to add value to the portfolios ahead of the move, and how we expect to protect the portfolios in the face of a slow and gradual move higher in yields and the US dollar over the coming year.

What remains fascinating is that markets continue to expect a much slower pace of subsequent hikes than that which the Fed has indicated. The Fed members overall expect 4 hikes to be appropriate over 2016. Markets have two hikes priced. This state of affairs is not new, and in fact one of the regional Federal Reserve Banks has published research on why this has been the case for the past 5 years or so. However when one looks at the Fed's legislated dual mandate (interpreted as inflation around 2% and full employment), the Fed has missed to the downside on inflation since the GFC, so arguably further stimulus could be required to generate some inflation, rather than tightening policy to push rates higher. We are of the view that the Fed will move more cautiously than what it has outlaid in the so-called "dot plots" in the chart below[3]. A move in line or faster than that indicated may require us to look at US earnings more closely (given the impact of a stronger USD on non-US earnings of US corporates with global operations) and commodity markets, so we will be watching this closely as we move through 2016.

[3] The Dot Point chart is an estimation of the trajectory of interest rates by the members of the FOMC.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Source: FOMC

Please feel free to contact us with any queries.

Regards,

Fitzpatricks Private Wealth Team

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