Economic and Investment Update – January 2014

Economic & Investment Commentary for quarter ended 31 Dec 2013

The global economic recovery continued during the December quarter as United States and European economic data pointed to an improvement in economic conditions.

In the United States, economic growth accelerated while employment growth gained momentum toward the end of the year. On the back of more positive economic news, the US Federal Reserve announced that it would begin tapering its quantitative easing program in January 2014. While equity markets treaded cautiously and credit spreads widened prior to this announcement, the implied confidence in the momentum and sustainability of US growth brought buoyancy back to the financial markets.

In Europe, sovereign debt and banking concerns faded, while manufacturing activity in the euro area trended upwards. However, the Eurozone core inflation rate fell to 0.7%, the lowest reading since the series began, raising fears of deflation.

In Asia, China struggled under the burden of difficult export market conditions, a crack down on speculative residential property construction and attempts to curtail the 'shadow' banking sector. Japan's adoption of ambitious economic reflation policies in April 2013 resulted in a strong rebound in economic growth.

Australia's economic growth was reduced to a sub-trend pace in December due to slowing resource related investment activity and the absence of a pickup in other sectors of the economy. Despite this, the Reserve Bank left the cash rate unchanged as the Board continued to monitor the impact of interest rate cuts in May and August.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished up 3.4% over the December quarter and 20.2% for the 2013 calendar year.

While both industrials (+3.8%) and resources (+1.7%) made reasonable gains, the faltering performance of gold explorers and mining service businesses held back the resources sector. During the December quarter, the strongest returns were generated by the banking (+6.1%), telecommunications (+5.9%) and healthcare (+5.4%) sectors. A rebound in the consumer discretionary sector (+3.3%), highlighted expectations of stronger retail demand over the Christmas period.

Returns from smaller companies (as measured by the ASX Small Ordinaries Accumulation Index) underperformed large companies, and finished down 0.2% for the December quarter.

International equity markets performed strongly with the MSCI World ex-Australia index up 8.2% for the December quarter and 26.7% for the calendar year. Driving returns was the continued stimulus from central banks around the world and improving economic data out of Europe and the United States.

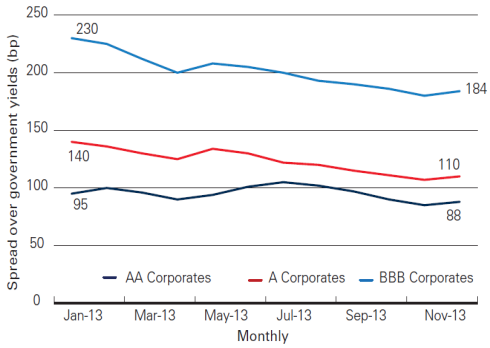
The fall of the Australian Dollar against most major currencies enhanced international equity returns in Australian Dollar terms (up 13.3% for the quarter and 47.9% for the year).

For the December quarter, the biggest gains were from developed markets including Japan (+12.7%, Nikkei 225), Germany (+11.1%, DAX Index) and the US (+9.5%, S&P 500). Emerging markets underperformed as some emerging economies struggled with the initial effects of the reduction in US quantitative easing, slowing economic growth and rising inflation.

Domestic listed property fell 1.5% for the December quarter but gained 7.1% for the calendar year. Declines over the second half of 2013 were primarily a result of an increase in the 10 year bond yield (up from 3.26% to 4.26%), however recent capital raisings and Initial Public Offerings also led to selling pressure across the sector. Returns from global listed property were flat for the quarter (+5.8% for 12 months).

Australian and international fixed interest investments finished slightly higher for the December quarter, despite rising bond yields. Over the quarter, Australian three and 10 year government bond yields rose by 24 and 43 basis points, to 2.95% and 4.24% respectively.

Global credit markets continued to perform well over the quarter, as positive economic data out of the US and strong investor demand for yield led to the continued contraction of credit spreads. Relative spreads between higher and lower investment graded securities also tightened during the calendar year, leading to outperformance from BBB rated securities.



The table below summarises the returns from a number of market sectors.

Sector		3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	ASX/S&P 200 Accumulation Index	3.4	20.2	12.5
	ASX Small Ordinaries Acc Index	-0.2	-0.8	8.1
International	MSCI World ex Aust Index (AUD)	13.3	47.9	9.4
	MSCI World ex Aust Index (AUD Hedged)	8.2	26.7	12.0
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	6.5	13.0	9.2
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	-1.5	7.1	8.6
International	UBS Global REITS Ex-Aust (AUD Hedged)	0.0	5.8	17.5
Direct Property				
Australian	Australian Mercer Unlisted Property (pre tax)	2.2	9.6	4.8
Currencies				
AUD v USD	Against US Dollar	-4.3	-14.2	4.8
Fixed Interest				
Australian	UBS Warburg Composite All Maturities	0.4	2.0	5.7
	UBS Warburg Credit All Maturities	0.8	4.3	7.3
International	JPMorgan WGBI ex Aus (AUD Hedged)	0.5	2.0	6.6
Commodities				
Gold	Gold – USD	-9.3	-28.0	6.6
Oil	WTI Oil $/b - USD	-3.8	7.2	17.2
Base Metals	RBA Index Base Metals (weighted currency)	-0.3	-11.8	3.1

Source: van Eyk

Economic & Investment Outlook

Following the recent release of encouraging economic data from a number of developed markets, many analysts expect that economic activity will continue to improve over 2014. In line with this thinking, the World Bank recently revised its 2014 global growth forecast, from 3.0% to 3.2%, as developed economies picked up pace.

It is expected authorities in the developed economies will to continue to maintain stimulatory monetary policy settings in order to promote growth and macroeconomic stability in 2014.

In the United States, the US Federal Reserve has continued cutting back the pace of asset purchases in measured steps (US$10 billion per month). However, further cuts are expected to be contingent on a supportive economic outlook and continued improvement in labour market conditions.

Emerging markets are likely to continue to struggle as falling currencies, rising domestic inflation and rising interest rates impact on future economic growth.

In Australia, while economic growth remains below trend, surprisingly high inflationary data has reduced the likelihood of further interest rate cuts in the current easing cycle. However, markets do not expect the cash rate to start rising again until the end of 2015.

Australian Shares

While Australian Equities are considered to be trading at fair value (on the basis of forward looking Earnings per Share), the ability of companies to meet or exceed earnings expectations will be an important factor in underpinning recent market performance. As much of the rally during 2013 was predicated on expectations of improved earnings, the market will need to see those expectations met to advance further.

External factors could also lead to increased volatility in the domestic sharemarket, with Chinese economic data releases and the impact of the scale back of US Federal Reserve stimulus on growth and growth expectations key variables. We are therefore continue to remain cautious about adding to Australian Equities holdings and recommend a neutral position.

Global Shares

While International Equities appear fully valued, following gains over the last 12 months, a continuation of stimulus programs in major offshore economies is likely to continue to support global equity markets.

However, as equity market gains in 2013 outpaced underlying corporate earnings, growth in corporate earnings must continue to avoid stocks coming under selling pressure. To date, corporate earnings results in the US have been modest.

Heightened volatility within emerging markets is expected to continue as the impact of the scale back of US stimulus measures continues to flow through the financial markets. Opportunities may materialise in China and Japan as a result of recently announced reform packages.

As we anticipate that the Australian Dollar may weaken further in the medium to long term, we recommend that investors maintain a neutral to overweight exposure to International equities, with sufficient diversification across markets. We prefer International Equity holdings to be unhedged in order to enhance returns.

Property

While a rise in bond yields has dented recent property returns (due to the narrowing of the gap between bond and property yields), the outlook for the Australian listed property trust sector remains relatively positive.

The sector is priced on a 2014 financial year dividend yield of 5.8% and a Price to Earnings ratio of 14.1 times earnings. Earnings and balance sheets are also stable with sector gearing currently standing at 29%.

Despite the sector now trading around the underlying book value, and supportive funding costs and cost cutting likely to drive earnings, the performance of the sector in the medium term will be dependent on movements in long term bond yields. As these are predicted to rise, we recommend an underweight exposure to this sector.

In relation to global property, while valuations of global listed property investments are slightly more attractive than domestic property, we recommend that investors retain an underweight position to this sector due to the risk of a rise in bond yields.

Fixed Interest

Despite recent rises in bond yields, Government Bonds in Australia and major developed international markets overseas remain unappealing. A low yield, together with the risk of a capital loss (should a sell-off in bonds take place), makes this sector relatively unattractive.

In relation to credit securities, credit spreads have now compressed significantly such that corporate debt is now losing its appeal. Recent hybrid issues have also looked less appealing, with the headline yield providing insufficient reward for the risk of conversion to equity in extreme circumstances.

Sources: VanEyk, Macquarie Group and RBA Board Minutes