



Economic and Investment Update – October 2015

Economic & Investment Commentary for quarter ended 30 September 2015

During the September quarter, while economic data releases were mixed, global macroeconomic uncertainty surrounding decelerating economic growth in emerging markets, including China and the timing of an eventual US interest rate hike, led to an increase in investor anxiety and overall risk aversion.

As a result, equity markets retreated, commodity prices fell, government bond yields tightened and credit spreads widened.

In China, economic readings released during the September quarter were softer than expected and implied that growth continued to slow, despite policy easing initiatives of Chinese authorities and a comparatively large depreciation of the yuan against the US dollar in August.

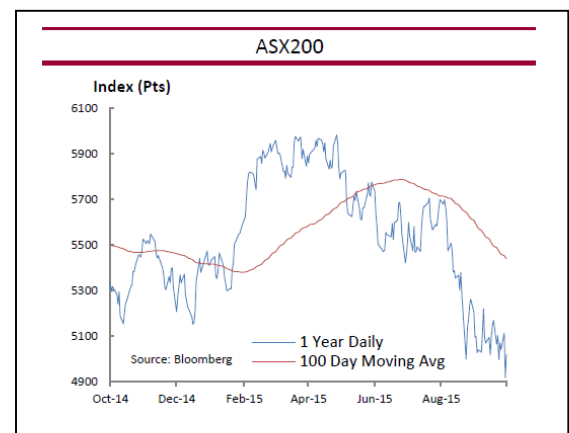
While US data releases pointed to continued improvement in the US economy, the US Federal Open Market Committee delayed an interest rate increase, citing concerns over heightened volatility in global markets. The US Federal Reserve's cautious tone and dovish comments from Chairperson Janet Yellen were interpreted to mean that the global economy was too fragile to withstand an interest rate rise – which weighed on market sentiment.

In Europe, economic data pointed to a slight improvement in economic conditions, with GDP growth higher than forecast and unemployment falling to its lowest level since February 2012. Potential short-term problems arising from the Greek debt negotiations also faded as the European Union and Greece came to an agreement about another bail out package.

In Australia, disappointing second quarter GDP growth (0.2% - the lowest quarterly growth in four years) raised concerns over the slowing pace of local economic growth and increased speculation over a recession. The Reserve Bank of Australia noted that a more 'moderate expansion' warranted ongoing accommodative monetary policy and kept rates at a record low 2% during the September quarter.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished down 6.6% over the September quarter and down 0.7% over the last 12 months. Sector-wise, energy (-21.6%) led declines over the quarter amid a fall in the oil price. Broader weakness in the commodities space also dragged materials (-11.1%) lower. The financials (-9.7%) were also hit following capital raising announcements by ANZ and CBA. On the other side of the coin, industrials (+4.3%) led the way higher with Qantas and Asciano both performing strongly.



Smaller company returns fared better compared to large companies but were still down 3.9% for the September quarter.

Internationally, the MSCI World ex-Australian Index returned -7.4% for the quarter and 1.3% over the last 12 months. However, returns in Australian Dollar terms were 0.4% for the quarter and 18.9% for the previous 12 months as a fall in the Australian Dollar offset share market falls over the quarter. During the September quarter, the best performing major market was the United States (-6.9%, as measured by the S&P 500). The Chinese A-share market produced the weakest return, down 28.4% for the September quarter.

Domestic listed property rose by 1.1% over the September quarter as investors focused on defensive earnings streams and stocks offering high liquidity, including Westfield Corporation, Scentre Group and GPT Group. Global property also finished higher, up 2.1% over the September quarter and 12.8% over the previous 12 months.

Australian Government and global bonds generated positive returns over the September quarter as market concerns around China and the US led to a fall in bond yields. Domestic bonds (as measured by the Bloomberg Composite Bond Index) returned 2.2% for the quarter whilst global bonds (as measured by the Barclays Capital Global Aggregate Index) returned 1.9%. However, credit securities underperformed bonds, as credit spreads widened. During the September quarter, both global investment grade and high yield credit securities posted negative returns. The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

| | | 3 mths (%) | 1 year (%) | 5 years (% p.a.) |
|------------------------|------------------------------------------------------|---------------|---------------|---------------------|
| <u>Equities</u> | | | | |
| Australian | ASX/S&P 200 Accumulation Index | -6.6 | -0.7 | 6.5 |
| | ASX Small Ordinaries Acc Index | -3.9 | -4.9 | -2.5 |
| International | MSCI World ex Aust Index (AUD) | 0.4 | 18.9 | 15.8 |
| | MSCI World ex Aust Index (AUD Hedged) | -7.4 | 1.3 | 13.1 |
| Emerging Mkts | MSCI Emerging Mkts (Net Div) (AUD) | -10.2 | 0.6 | 2.8 |
| <u>Listed Property</u> | | | | |
| Australian | ASX 200 Prop Trust Accumulation Index | 1.1 | 20.3 | 13.7 |
| International | FTSE EPRA/NAREIT Developed Prop Index (Hedged) | 2.1 | 12.8 | 13.2 |
| <u>Direct Property</u> | | | | |
| Australian | Australian Mercer Unlisted Property (pre-tax) | 2.9 | 10.5 | 10.1 |
| <u>Currencies</u> | | | | |
| AUD v USD | Against US Dollar | -8.6 | -19.7 | -6.2 |
| <u>Fixed Interest</u> | | | | |
| Australian | Bloomberg Ausbond Composite All Maturities | 2.2 | 6.9 | 6.6 |
| | Bloomberg Ausbond Credit All Maturities | 1.5 | 5.8 | 7.1 |
| | Barclays Capital Global Aggregate Index (AUD Hedged) | 1.9 | 5.7 | 6.9 |
| <u>Commodities</u> | | | | |
| Gold | Gold – USD | -4.9 | -7.7 | -3.1 |
| Oil | WTI Oil \$/b - USD | -24.2 | -50.5 | -10.8 |
| Base Metals | RBA Index Base Metals (weighted currency) | -10.1 | -18.7 | -5.4 |

Economic & Investment Outlook

According to the International Monetary Fund (IMF), world growth is expected to slow to 3.1% in 2015 and 3.6% in 2016. While a modest pickup in growth is expected to occur in developed economies, emerging markets are predicted to slow, primarily reflecting weakness in several large emerging economies and oil exporting countries.

Three major issues were noted by the IMF as impacting prospects for future global growth. Firstly, China's economic transformation - away from export and investment led growth and manufacturing, in favour of a greater focus on consumption and services; second, and related, the fall in commodity prices; and third, the impending increase in U.S. interest rates, which may have global repercussions and add to market uncertainty.

In the US, the relatively dovish global economic commentary accompanying the US Federal Open Market Committee's September meeting were removed at the October meeting and there are now expectations that an interest rate increase will occur in December. Regardless, speculation of the timing of any rate hike could continue to drive further near-term volatility.

Data suggests that Eurozone financial conditions and labour markets are improving. However political uncertainty, a slowing global economy and rising tensions with Europe's refugee crisis will continue to drag European growth down.

In Australia, while the broader economy remains sluggish, a combination of a weaker currency, a reasonable housing sector, and the scope for further rate cuts should keep growth above stall speed in the near term.

Australian Shares

While the recent sell-off in Australian shares resulted in a decline in the price to forward earnings ratio to 14.5 times earnings, a market recovery since 29 September has again pushed this ratio up to 15.8 times earnings - well above the markets long dated average of 13.5 times earnings.

In light of recent weakness in commodity prices and continued global economic uncertainty surrounding US interest rates and the Chinese economy, the challenging outlook for domestic equities is expected to persist.

With recent analyst estimates for earnings growth also revised down, due in large part to the continued weakness in the resources and financial sectors, market volatility is also expected to continue over coming months.

We therefore suggest that investors maintain a neutral position in Australian Equities relative to their benchmark allocation.

Global Shares

We also suggest that investors maintain a neutral position to International Equities relative to their benchmark allocation.

However, with many of the issues and uncertainties that affected global markets in previous months yet to be resolved, heightened volatility in global equities is expected to continue. With market valuations high for a number of emerging countries, we prefer developed markets over emerging markets.

From a regional perspective, our preference is Japanese and European stocks over US stocks, partly due to more favourable valuations and partly due to the impending contrast in the trend in monetary policy settings between the US Federal Reserve relative to the European Central Bank and Bank of Japan.

Property

While lower bond yields have driven property returns, due to the gap between bond and property yields, the general fundamentals for the listed property sector remain positive. Domestically, the sector is priced on a 2016 financial year dividend yield of 5.3% and a Price to Earnings ratio of 16.3 times earnings. Earnings and balance sheets are also stable with sector gearing currently at 29%.

However, future returns from both domestic and international property are expected to be dependent on movements in long term bond yields. Following recent falls in bond yields, we recommend that investors take a cautious approach and maintain a neutral to underweight position to this sector.

While unlisted property trusts have provided investment opportunities, offshore buyers have pushed prices up in this area. We therefore advise investors to be wary and only invest in unlisted options where good value is apparent.

Fixed Interest

Within fixed interest markets, we remain cautious as most fixed interest securities are now considered expensive. However, some relative value exists in Australian Government bonds as well as global and domestic investment grade credit.

Although we recommend an overall underweight position to fixed interest, investors should consider an investment in the above fixed interest markets.

Sources: Lonsec, RBA

Please note that the information above is general in nature and does not take into account your personal circumstances, financial needs or objectives. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation and needs. In particular, you should speak to Kevin Smith of The Professional Super Advisers on (02) 9955 5800 prior to acting upon this information.