Economic and Investment Update – July 2016

The June 2016 quarter was again dominated by share market volatility. During a roller-coaster quarter, a recovery in oil and iron ore prices saw energy and material stocks drive equity markets higher in April. Markets continued to climb during May, as solid US housing data and a robust oil price buoyed sentiment, before sliding in June on the result of the United Kingdom referendum on European Union membership.

In Europe, while the European Central Bank implemented a corporate sector purchase program from June to bolster monetary policy and inflation rates, the region was dominated by the United Kingdom's vote to leave the European Union. The immediate reaction included sharp falls in sharemarkets in the UK, the European Community, Japan and the United States, together with falling bond yields and heightened volatility in currency markets. Reflecting the uncertainty created by Brexit and in anticipation of further monetary easing by the European Central Bank, Germany became the first Eurozone country to sell 10-year government bonds at a negative yield.

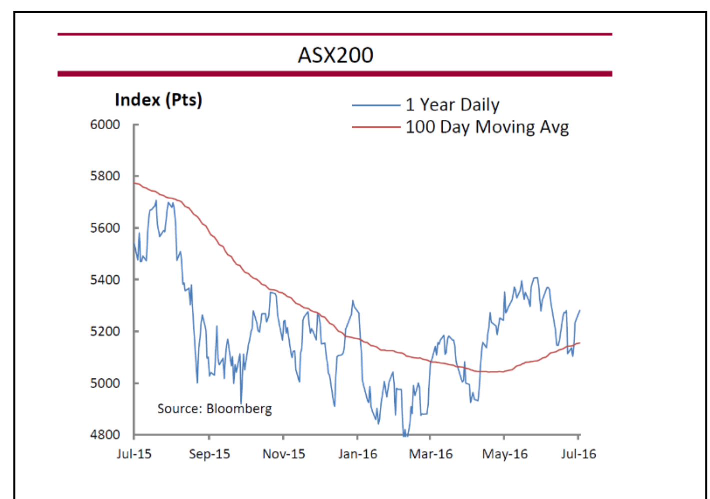
In the US, despite the release of encouraging economic data and hawkish comments from the US Federal Reserve, interest rates were held constant. Federal Reserve Chair Janet Yellen cited ongoing concerns over business investment, the US labour market and the fragile global environment. Consumer confidence indexes increased, although manufacturing data continued to disappoint.

In Asia, the Bank of Japan surprised markets by maintaining cash rates at -0.1% and has not ruled out additional liquidity measures. Pressure on the Bank of Japan increased as investors seeking a safe haven post-Brexit pushed up the price of the Yen. However, there are growing concerns about the effectiveness of monetary policy, with the central bank rapidly exhausting its options without material improvement in the Japanese economy. In China, 1st quarter growth slowed to 6.7%, while inflation fell to 2%. The Peoples Bank of China devalued the RMB to 6.6375 against the US dollar, although this largely went unnoticed by markets.

In Australia, the Reserve Bank lowered the cash rate in May by 25 basis points to a historic low of 1.75%. The decision to lower the cash rate was made in light of weak inflation data (1.5% for the 12 months to 31 March), below the RBA's targeted 2-3% range. The Australian dollar was surprisingly resilient, despite the cut in the cash rate and finished the quarter down only 2c vs the USD, closing the quarter at $0.74.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished 3.9% higher over the June quarter and up 0.6% for the financial year. At a sector level, Materials (11.5%) was the top performer, as commodity prices strengthened during the beginning of the quarter, while Health Care (10.3%) also generated solid returns. Consumer Staples (-3.9%) underperformed, as sector heavy weights (Woolworths and Wesfarmers) face challenged margins.



Smaller company returns outperformed large companies and finished up 5.9% for the June quarter (+14.4% for the financial year).

Internationally, the MSCI World ex-Australia Index returned 1.7% for the June quarter and -1.4% over the last 12 months. Returns in Australian Dollar terms were 4.4% for the quarter and 0.4% for the financial year as movement in the Australian Dollar enhanced returns, particularly over the last three months.

During the June quarter, the best performing developed market was the UK (up 5.3%, as measured by the FTSE 100 Index) whilst falls were recorded in Japan (down 7.1%, as measured by the Nikkei Index), Germany (down 2.9%, as measured by the Deutsche Boerse Index) and China (down 2.0% as measured by the Shanghai Shenzhen CSI 300 Index). In the US, returns were modest with the S&P 500 Index returning 1.9% for the June quarter (largely driven by the energy sector, +10.8%) and 1.7% for the financial year.

Domestic listed property rose by 9.3% over the June quarter (24.6% for the financial year), supported by falling bond yields and strong overseas demand. Global property also finished higher, up 3.7% over the June quarter (12.3% for the financial year).

Australian Government and global bonds produced solid gains as bond yields fell. The US and Australian 10 year bonds were the stand outs over the June quarter with US Treasury bond yields down 30 basis points to 1.47% and Australian 10-year bond yields down 54 basis points to finish the quarter at 1.98%. Domestic bonds (as measured by the Bloomberg Composite Bond Index) returned 2.9% for the quarter whilst global bonds (as measured by the Barclays Capital Global Aggregate Index) also returned 2.9%.

The table below (sourced from Lonsec) summarises the returns from a number of market sectors.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	ASX/S&P 200 Accumulation Index	3.9	0.6	7.7
	ASX Small Ordinaries Acc Index	5.9	14.4	1.0
International	MSCI World ex Aust Index (AUD)	4.4	0.4	14.9
	MSCI World ex Aust Index (AUD Hedged)	1.7	-1.4	11.3
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	4.0	-9.2	3.5
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	9.3	24.6	18.1
International	FTSE EPRA/NAREIT Dev Prop Index (Hedged)	3.7	12.3	12.0
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	1.6	12.4	10.1
Currencies				
AUD v USD	Against US Dollar	-3.2	-3.1	-7.0
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	2.9	7.0	6.7
	Bloomberg Ausbond Credit All Maturities	2.3	5.3	6.7
International	Barclays Capital Global Agg Index (AUD Hedged)	2.9	9.3	7.8
Commodities				
Gold	Gold – USD	7.2	12.8	-2.5
Oil	WTI Oil $/b – USD	26.1	-18.7	-12.7

Economic & Investment Outlook

Despite the market's recovery from the shock of Brexit, the potential for more global equity market volatility exists, given the degree of uncertainty spawned by the United Kingdom's (UK) vote to leave the European Union (EU). Questions remain over when Article 50 will be triggered, starting the two-year countdown to withdrawal, and the ultimate shape of the economic relationship between the UK and EU. Beyond this, there are geopolitical implications; does Scotland leave the UK? Do other countries leave the EU? These questions are likely, at different times over coming years, to assume importance in the eyes of the market and cause further bouts of volatility.

In Europe, the European Central Bank (ECB) stands ready to step in following the UK's decision to exit the EU. Rates have been left on hold, with inflation (0.1%) well below the targeted 2% and unemployment (10.1%) marginally improving. The outlook for the EU is uncertain, with a downturn anticipated across Europe as the UK begins the process of exiting the EU.

In the US, the economy appears to be gaining some momentum entering the second half of 2016. With US inflation pressures gradually building, the US Federal Reserve is expected to tighten interest rates further this year. With the US economy sensitive to a rising US Dollar and interest rate rises together with global economic environment fragile, a cautious approach is expected to be adopted by the US Federal Reserve.

In Japan, in an attempt to revive the economy, further stimulus measures are expected. In late July, Prime Minister Shino Abe announced plans for more than US$355 billion in economic spending in an attempt to speed up the nation's exit from deflation.

In Australia, while business conditions remain favourable, employment, household income growth and inflation remains weak. Headline inflation rose by 0.4% in the June quarter and by 1% over the last 12 months (the weakest pace of inflation in 17 years). However, with underlying inflation (which excludes volatile items) of 1.5%, slightly higher than forecast, analysts' expectations of a further interest rate cut in early August have decreased to a 50% probability.

Australian Shares

Following strong gains since 30 June 2016, we recommend investors hold a neutral to underweight position in Australian Equities, relative to their benchmark allocation.

Against a backdrop of subdued growth and earnings, equity valuations currently appear expensive (the market's price to earnings ratio is currently 16 times forward earnings). However, the relative high valuations are not untoward in an environment where interest rates are expected to remain lower for longer. In any case, equity markets are likely to endure another year of event-driven volatility.

While small cap stocks have continued to outperform large cap stocks, a cautious approach to small cap stocks should be adopted going forward due to the increased risk of volatility, especially following recent strong gains.

Global Shares

We maintain our recommendation for investors to hold a neutral to underweight position to International Equities relative to their benchmark allocation.

Following a rally in global equities in July, on speculation central banks would boost efforts to contain the fallout from the Brexit vote, valuations recently reached an 11-month high. On valuation measures, we continue to favour European and Japanese equities over US equities.

As emerging market valuations remain high, we retain our preference for developed markets.

Property

Following recent strong gains, we recommend that investors trim back overweight positions to Property relative to their benchmark allocation, by taking profits.

While the domestic property sector is currently trading at a Price to Earnings ratio of 17.9 times, (close to a 26 year high), the global macroeconomic environment remains supportive with record low bond yields and interest rates. As such, property continues to offer some short to medium term attraction with the domestic property sector currently priced on a 2017 dividend yield of 4.5%.

Investors should however remain cautious with respect to Property investments. As previously noted, any rise in long term bond yields will reduce the relative attractiveness of the sector and may lead to falls in the value of Property holdings.

Fixed Interest

Global bond rates rallied over the June quarter. With further interest rate cuts expected, we recommend that investors hold a neutral position to this sector, relative to their benchmark allocation.

Australian sovereign bonds and global credit appear most attractive within this sector, albeit that market volatility and economic uncertainty pose a risk to investors.

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.