Economic and Investment Update – April 2014

Economic & Investment Commentary for quarter ended 31 March 2014

Global headlines over the quarter centred around Russia's annexure of the Crimea, the hunt for flight MH370 and the extreme US winter weather conditions, rather than on the benign investment markets.

However, the slowdown in US Quantitative Easing (QE) and the potential for US interest rate rises is never far from the front pages with the Federal Reserve indicating that, subject to continued improvement in economic data, the QE bond buyback programme could be completely curtailed by the end of the year with potential interest rate rises a further six months behind. The US labour market shows continued signs of recovery with the fall in unemployment now due to the creation of jobs, rather than from people dropping out of the workforce.

Conditions in Europe continued on a positive trend with data suggesting that the Eurozone grew 0.5% in the quarter, the best result for three years. Even the previously written off economy of Greece showed positive signs with the parliament approving a structural reform package and managing to issue 3 billion euro of bonds at 4.95%. However, in reality, the Eurozone is still at the early stages of addressing their economic woes. Consideration is being given to a US style QE programme with an emphasis on credit flows to businesses.

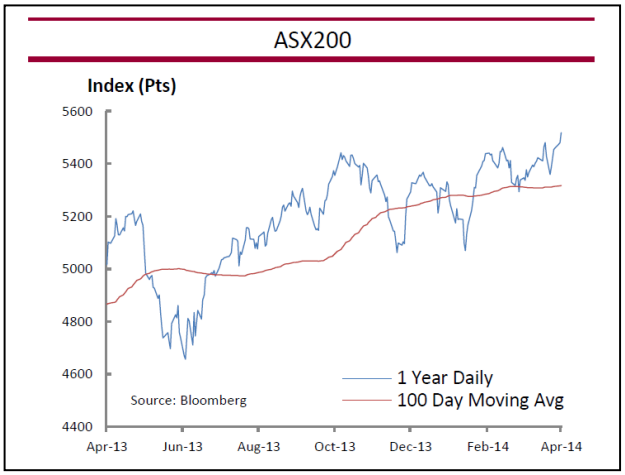
In Asia, confidence in the Japanese recovery has stalled, with question markets over domestic consumer demand in the period ahead, given the upcoming hike in sales tax. On the contrary, China announced tax breaks for small business and the speeding up of infrastructure spending to keep the growth rate from sinking below 7%.

Domestically, Australia is experiencing a hand over from the resources sector back to the general economy with retail sales, building approvals and employment all showing signs of improvement. Indeed, the improvements are in stark contrast to the headline grabbing closures announced by the likes of Qantas, Ford and Holden.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished up 2.1% over the March quarter and 13.5% over the last 12 months.

Industrials (+2.7%) more than offset falls in resource stocks (-0.8%). During the March quarter, the strongest returns were generated by the Information Technology (+6.5%), Utilities (+4.4%) and Financial (+3.8%) sectors.



Returns from smaller companies (as measured by the ASX Small Ordinaries Accumulation Index) underperformed large companies, finishing up 0.9% for the March quarter.

International equity markets took a breather from their recent strong performance with the MSCI World ex-Australia (Hedged) index up 0.5% for the March quarter and 16.5% over the past 12 months. However, with the Australian Dollar strengthening against most major currencies, this detracted from shorter term international equity returns in Australian Dollar terms - down 3.1% for the quarter but up 29.1% for the year.

The US (S&P 500 index) gained 1.3% over the quarter although significant losses were seen across Asia with Japan (Nikkei 225) down 9.0% and emerging markets as a whole down 3.9%.

The Chinese Shenzhen Composite index fell 1.7% for the quarter (up 12.1% for the year). Concerns continued around the slowdown in manufacturing and the level of debt (albeit relatively small by world standards) in the 'shadow banking' system.

Domestic listed property reversed its recent downward trend, gaining 2.1% for the quarter, however down 0.8% for the 12 months. Conversely, global listed property gained 3.6% for the quarter and was up 15.5% over the past 12 months.

Bond markets rallied over the quarter with US 10 year government bonds yields falling 0.31% to 2.72%. The Australian bond market followed suit falling 0.15% to 4.08%. Credit markets posted positive performance across both higher yield and investment grade bonds. The table below summarises the returns from a number of key market sectors.

Sector		3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	ASX/S&P 200 Accumulation Index	2.1	13.5	13.4
	ASX Small Ordinaries Acc Index	0.9	-1.5	8.8
International	MSCI World ex Aust Index (AUD)	-3.1	29.1	8.8
	MSCI World ex Aust Index (AUD Hedged)	0.5	16.5	14.7
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	-3.9	10.9	8.1
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	2.1	-0.8	8.7
International	UBS Global REITS Ex-Aust (AUD Hedged)	7.3	4.2	26.1
Direct Property				
Australian	Australian Mercer Unlisted Property (pre tax)	1.7	8.9	5.9
Currencies				
AUD v USD	Against US Dollar	3.9	-11.1	6.0
Fixed Interest				
Australian	UBS Warburg Composite All Maturities	1.5	3.3	6.0
	UBS Warburg Credit All Maturities	1.5	5.1	7.6
International	JPMorgan WGBI ex Aus (AUD Hedged)	2.8	3.4	7.1
Commodities				
Gold	Gold – USD	6.5	-19.7	6.9
Oil	WTI Oil $/b - USD	3.2	4.5	15.4
Base Metals	RBA Index Base Metals (weighted currency)	-3.9	-11.9	2.5

Source: van Eyk

Economic & Investment Outlook

The economic recovery in the US continues to broaden, supporting recent cuts in the pace of asset purchases. However, the provision of additional liquidity into the financial system has done little to fuel growth or inflation, with the money lodged by domestic banks with the central bank.

Consequently, Europe is designing their own form of Quantitative Easing with the aim of getting credit flowing directly to business, hence fuelling growth and inflation. However, the spectre of deflation still looms.

The economic outlook in Australia looks positive, with escalating job ads over the past 6 months. Improving economic data and the rise in house prices, suggests a rise in the official cash rate, however the strength of the Australian Dollar and the transition of the economy away from the resources boom suggests otherwise. The RBA currently has a neutral stance on the cash rate with the current level looking as if it may remain unchanged (at 2.5%) for the remainder of the calendar year.

Australian Shares

The upcoming 2014 Federal Budget is expected to deliver a significant tightening in fiscal policy and hence may constrain future growth. This headwind is enhanced by the wind back of QE in the US and the slowdown in the Chinese economy.

Australian Equities are considered to be trading at or slightly above fair value (on the basis of forward looking Earnings per Share). Accordingly, we continue to remain cautious about adding to Australian Equities holdings and recommend a neutral position.

Global Shares

The recent underperformance of developed equity markets relative to other investments such as bonds can be seen as the market taking a "breather" after a strong rally. This is a positive when compared to the potential of a continued rally, followed by a sharp drop.

More importantly, the strong correlation of the US S&P 500 index to the level of Federal Reserve asset purchases suggests a levelling off of market returns as the QE tapering program is implemented.

Emerging markets offer some value however the relative price potentially does not fully compensate for the risk premium, considering the potential impact of the tapering of QE on these regions.

The 4% rise in the Australian Dollar against the US dollar over the quarter negated the fall in the previous quarter. The rise was supported by the differential in interest rates (current and projected)

and better than expected commodity prices. The expectation is for the Australian Dollar to weaken over the short to medium term and hence provide additional returns for unhedged portfolios.

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 that returns may be enhanced by currency movements.

Property

Both the domestic and international listed property markets strengthened over the quarter. However, they have been buoyed in recent times by their attractive yield compared to bonds. As bond yields are predicted to rise, we recommend an underweight exposure to this sector.

We suggest that better value may exist in infrastructure assets, with their defensive characteristics of a high yield and as a beneficiary during deflationary periods.

Fixed Interest

Recent falls in bond yields lead us to the conclusion that domestic and overseas Government Bonds remain unappealing, given the low yield and risk of a capital loss.

In fact, little value exists across the fixed interest spectrum, especially in the area of high risk / high yield. In particular, new Australian hybrid issuances are being floated at rates that don't truly reflect their increased risk. A yield of around 8% would be more appropriate than the current 6% on offer.

Some value can however be extracted from the fixed interest market, especially by absolute return managers who can exploit anomalies in the market place.

As such we recommend an underweight position to fixed interest. Investors should consider some investment in this area via absolute return managers as well as the safety of cash, albeit in a historically low interest rate environment.

Sources: VanEyk, Schroders

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.