Economic and Investment Update – July 2014

Economic & Investment Commentary for quarter ended 30 June 2014

The global economic recovery stalled during the June quarter as United States and European economic data pointed to a slowing in economic conditions.

In the United States, while unemployment continued to fall, GDP growth for the March quarter was revised down to a 2.9% contraction, driven by weak investment, declining inventories and a negative export contribution. Despite ongoing monthly cuts to the US Quantitative Easing bond buying program, the US Federal Reserve signalled their intention to maintain near-zero short-term interest rates throughout 2014.

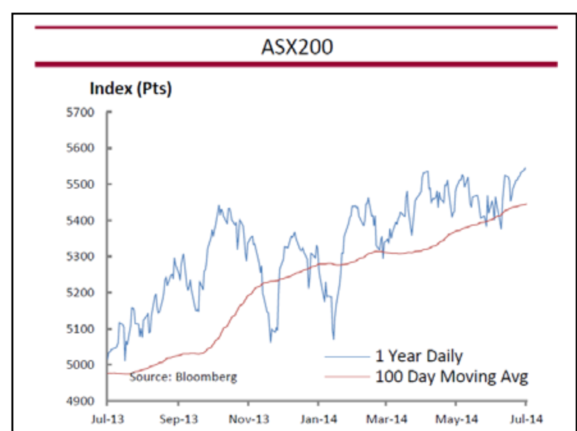
In Europe, while there were signs of a pick-up in activity in countries worst hit by the Eurozone's interlinked government debt and banking crises, activity slowed across the Eurozone's core, including Germany, Austria, and the Netherlands. In France, activity contracted.

In Asia, improved data and a series of mini-stimulus injections by the Chinese Government reduced fears that the Chinese economy would experience a significant slowdown due to a cooling property market. However, confidence in the Japanese recovery stalled, following a recent increase in sales tax.

The Australian economy lost some momentum during the June quarter, with the slowdown a result of a combination of factors, including negativity surrounding the Federal Budget, weakness in China, commodity prices and the stubbornly high Australian Dollar. Against a soft economic backdrop, the Reserve Bank left the cash rate unchanged at 2.5%, throughout the quarter.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index finished up 0.9% for the June quarter and 17.4% for the 2014 financial year.



During the quarter, while industrials finished modestly higher (+1.3%), subdued consumer sentiment (following the release of the 2014 Federal Budget) and a stronger local currency negatively impacted returns. Resources finished lower (-0.70%), as iron ore prices slipped below US$100 a tonne.

At a sector level, the best returns were generated by the utilities (+6.4%) and energy sectors (+5.2%). The materials (-3.3%) and consumer discretionary sectors (-2.3%) generated the lowest returns. Returns from smaller companies (as measured by the ASX Small

Ordinaries Accumulation Index) underperformed large companies, and finished down 2.3% for the June quarter, but up 13.1% for the 2014 financial year.

International equity markets continued to perform strongly with the MSCI World ex-Australia index up 3.8% for the June quarter and 19.6% for the 2014 financial year (in local currency terms). Increased geopolitical tensions and a rising oil price were outweighed by comments from the US Federal Reserve that they would keep interest rates low, and further monetary easing in Europe.

Within developed markets, the biggest quarterly gain was from the United States (+4.7%, S&P 500), whilst Japan (+2.3%, Nikkei 225) and Germany (+2.9%, DAX Index) generated more modest positive returns. Following a period of underperformance, most emerging markets rebounded strongly with the Indian (+13%), Chinese (+5.5%), Brazilian (+5.5%) markets all producing solid quarterly returns.

Domestic listed property performed strongly and rose by 9.3% for the June quarter and 11.1% for the 2014 financial year. While gains over the quarter were primarily driven by a decline in bond yields, recent merger and acquisition activity was also a positive influence. Returns from global listed property were also strong for the quarter (+8.0%).

Australian and international fixed interest investments finished higher for the June quarter, as a result of the decline in global bond yields. Over the quarter, Australian 10 year government bond yields fell by 54 basis points, to 3.54% while US 10 year government bonds finished down 19 basis points, to 2.53%. Credit markets also saw healthy rises, driven by the combination of the low interest rate environment and tightening credit spreads. The table below 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	0.9	17.4	11.2
	ASX Small Ordinaries Acc Index	-2.3	13.1	3.4
International	MSCI World ex Aust Index (AUD)	3.0	20.4	11.5
	MSCI World ex Aust Index (AUD Hedged)	3.8	19.6	12.3
Emerging Markets	MSCI Emerging Mkts (Net Div) (AUD)	4.7	10.8	5.9
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	9.3	11.1	14.3
International	UBS Global REITS Ex-Aust (AUD Hedged)	8.0	15.8	22.7
Direct Property				
Australian	Australian Mercer Unlisted Property (pre tax)	2.2	9.6	7.2
Currencies				
AUD v USD	Against US Dollar	1.8	3.2	3.2
Fixed Interest				
Australian	UBS Warburg Composite All Maturities	3.1	6.1	6.9
	UBS Warburg Credit All Maturities	2.5	6.7	7.8
International	JPMorgan WGBI ex Aus (AUD Hedged)	2.4	7.2	7.7
Commodities				
Gold	Gold – USD	3.4	7.5	7.4
Oil	WTI Oil $/b - USD	3.7	9.1	8.6
Base Metals	RBA Index Base Metals (weighted currency)	6.4	0.9	-0.2

Source: van Eyk

Economic & Investment Outlook

Following the release of lower than expected economic data from a number of developed markets, many analysts expect that economic activity will continue to be modest over the remainder of 2014. In line with this thinking, the International Monetary Fund (IMF) recently lowered its 2014 global growth forecast, from 3.6% to 3.4%, as expansion weakens in China, the U.S. and other major economies, and military conflicts raise the risk of a surge in oil prices. The IMF noted that 'Global growth could be weaker for longer, given the lack of robust momentum in advanced economies'.

However, authorities in developed economies are expected to continue to utilise stimulatory monetary policy settings in order to promote growth and macroeconomic stability through 2014 and 2015.

While the US Federal Reserve continues to cut back the pace of asset purchases in measured steps (US$10 billion per month), the ratcheting up of US interest rates is unlikely until at least the middle of 2015. Any rate increase is likely to remain contingent on improved labour market conditions or a rise in inflation.

In Australia, while the economy appears to have lost some momentum in recent months, higher 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 2015.

Australian Shares

While the domestic economy remains largely lacklustre, equity market conditions remain benign on the back of accommodative monetary policy.

With recent gains propelling the Australian Equities market to a six year high, the domestic equities market now appears to be fully valued on a Price to Earnings basis. For the market to advance further, earnings growth expectations may need to improve. However, earnings growth is expected to be lower with downgrades driven primarily by mining sector earnings (mostly iron ore slippage) and to a lesser extent, downgrades in the industrials (ex-financials) sector.

Accordingly, we remain cautious about adding to Australian Equities holdings in the short term and recommend a neutral position.

Global Shares

While International Equities appear fully valued, following strong gains over the last 24 months, a continuation of stimulus programs in major offshore economies is likely to further support global equity markets. However, with many global indices at all-time highs, and company valuations at the upper band of historic limits, many believe that markets may now be susceptible to a correction.

We therefore suggest that investors hold a neutral to underweight exposure to International Equities, with diversification across both developed and emerging markets. As we anticipate that the Australian

Dollar will weaken in the medium to long term, we also prefer International Equity holdings to be unhedged in order to enhance returns.

Property

While recent falls in bond yields have propelled property returns (due to the widening of the gap between bond and property yields), the outlook for the listed property sector remains relatively positive. Domestically, the sector is priced on a 2014 financial year dividend yield of 5.5% and a Price to Earnings ratio of 15.4 times earnings. Earnings and balance sheets are also stable with sector gearing currently at 29%.

However, the short to medium performance of both domestic and international property will largely be dependent on movements in long term bond yields. Following recent falls in bond yields, we recommend an underweight position to the property 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

Government Bonds in Australia and major developed international markets are currently unappealing, following the recent fall in bond yields. A low ongoing yield, together with the risk of a capital loss (should bond yields rise again), make this sector of the fixed interest market unattractive.

While limited opportunities now exist across the fixed interest spectrum, some value can potentially be extracted by absolute return managers who can exploit anomalies in the fixed interest market place.

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

Sources: VanEyk, Schroders and UBS

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.