Economic and Investment Update – October 2014

Economic & Investment Commentary for quarter ended 30 Sept 2014

During the September quarter, mixed economic data indicated that activity has hit a soft patch in the global economy.

The Eurozone continued to struggle despite low (and even negative) interest rates. Inflation fell to near zero and German industrial production experienced is largest decline since January 2009. The European Central Bank is moving towards a policy of printing money to fuel the ailing economies. However, the plan to buy covered bonds and asset backed securities from October 2014 is seen in some quarters as too little, too late.

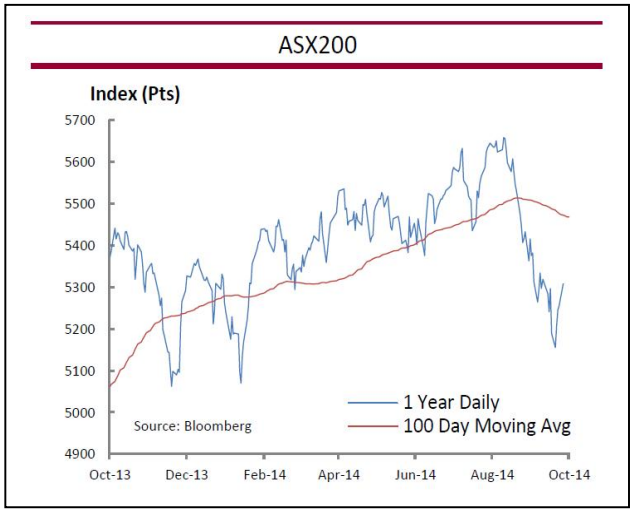
The Chinese economy continued to slow down (ie a "soft" rather than "hard" landing) with growth slowing to 6.9% p.a., the lowest rate since the GFC.

On the positive side, the US economy is showing solid growth with a fall in unemployment to 5.9%. The Federal Reserve's QE programme is coming to an end and speculation is now focussed on when official interest rates in the US will start to rise.

Meanwhile, in Australia official cash rates remained on hold, as they have been all year. The RBA continued to adopt a wait and see approach given conflicting signals. A softening economy (fuelled now by the property market as opposed to the mining sector) suggests that the next rate move could be down. This would also aid the RBA's desire for a further weakening of the Australian Dollar. However, as inflation edged ominously higher and the RBA raised concerns regarding property prices, the next rate move is more likely to be up.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished down 0.6% for the Sept quarter but up 5.9% over the last 12 months.



Profit taking from offshore investors impacted heavily on banking stocks, sending the sector down 7.6% in September and 4.5% for the quarter.

At a sector level, the best returns were generated by the Healthcare (+9.4%) and Telecommunication Services (+5.5%). The Materials (-2.8%) and Financials sectors (-2.0%) generated the lowest returns. Returns from smaller companies (as measured by the ASX Small Ordinaries Accumulation Index) outperformed large companies, finishing up 1.5% for the quarter, but flat over the last 12 months.

Returns over the quarter from international equity markets were respectable, with the MSCI world index (hedged) gaining 0.5% for the period. The long expected weakening of the Australian Dollar (a fall of 7.3% against the USD but generally not against other currencies) resulted in an unhedged return of 5.1% for the quarter.

Overall, markets were impacted by a range of issues including the global economic recovery (particularly in Europe), the timing of increases in US interest rates, the impact of the appreciating US dollar on a US recovery and other world events, such as the hostilities in Iraq.

From a country perspective, the biggest quarterly gain in local currency terms was from China (+21.6%, Shenzhen Composite) whilst Japan (+6.7%, Nikkei 225) also generated good returns. In stark contrast, the Hong Kong Index in local currency fell 1.1% over the quarter and was further impacted in October by pro-democracy demonstrations.

Domestic listed property was relatively flat, rising 1.0% for the quarter and 12.2% for the 12 month period. There was a sell off in September (as the index fell over 5%) given overseas investors concerns with the Australian Dollar and valuations. Returns from global listed property were weaker over the quarter (-1.7%) but stronger over the 12 month period (13.9%).

With the RBA continuing to signal that interest rates are on hold, Australian fixed interest investments finished around 1% higher for the September quarter. Overseas returns were more positive with the JP Morgan Broad WGBI Hedged Index rising 2.1% for the quarter.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	ASX/S&P 200 Accumulation Index	-0.6	5.9	6.8
	ASX Small Ordinaries Acc Index	1.5	-0.1	-0.3
International	MSCI World ex Aust Index (AUD)	5.1	17.1	8.1
	MSCI World ex Aust Index (AUD Hedged)	0.5	13.5	9.5
Emerging Markets	MSCI Emerging Mkts (Net Div) (AUD)	4.1	11.5	4.6
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	1.0	12.2	8.6
International	UBS Global REITS Ex-Aust (AUD Hedged)	-1.7	13.9	15.9
Direct Property				
Australian	Australian Mercer Unlisted Property (pre tax)	2.6	9.6	8.9
Currencies				
AUD v USD	Against US Dollar	-7.3	-6.1	-0.2
Fixed Interest				
Australian	UBS Warburg Composite All Maturities	1.0	6.0	6.7
	UBS Warburg Credit All Maturities	1.1	6.1	7.5
International	JPMorgan WGBI ex Aus (AUD Hedged)	2.1	8.0	7.6
Commodities				
Gold	Gold – USD	-9.0	-9.1	3.7
Oil	WTI Oil $/b - USD	-13.5	-10.9	5.2
Base Metals	RBA Index Base Metals (weighted currency)	6.9	9.1	-2.2

Source: van Eyk

Economic & Investment Outlook

The sell off in world equity markets in September continued into October with some significant falls in the first fortnight. The market has since recovered and at the time of writing the Australian Sharemarket was back above its September close.

Speculation in the US continues as to when official interest rates will rise. This will be dependent upon the continued improvement in labour market data and other economic indicators. The US Dollar has already started to strengthen against major currencies and this trend is expected to continue over the coming year.

The European economy offers far greater uncertainty. The lack of unity within the Eurozone makes it much harder to implement reforms compared to say, the US. We wait to see the extent to which the new stimulus package fuels growth in the region. However, the weakening Euro will help the export sector and consequently corporate earnings.

The structural reforms in Japan, such as the recent introduction of a consumption tax, continue to be implemented. However, although offset to some extent by a weakening yen, headwinds exist such as the reduced growth (and hence consumer demand) from Europe.

The Chinese are orchestrating a soft landing of their economy with growth slowing to under 7% p.a. However, initiatives such as the new clean energy investment plans should help economic activity. Concern around property prices are being managed with the property sector experiencing a mild correction. The pending launch of the Shanghai – Hong Kong Connect program will give foreign investors unprecedented access to mainland Chinese shares.

There is some evidence of an improvement in the Australian economy, although the slow down in the mining sector off the back of the Chinese economy means that our economy remains weak. The RBA's policy of low interest rates looks set to remain for the time being.

Australian Shares

The recent profit reporting season was positive with earnings growth generally in line or ahead of expectations. Although the economy remains weak, recent falls in the Australian equity market over the past two months has resulted in more value appearing.

As such, we are comfortable with clients maintaining a neutral position against the benchmark holding. There is more uncertainty in the current environment with smaller companies and as such a tactical underweight to this sector should be maintained.

Global Shares

Again, the recent sell off in global markets has led us to conclude that there is significant value on offer in global equities. While the brightest economy, record equity prices in the US have meant that

valuations have been stretched. A strengthening US dollar will boost the returns of unhedged holdings.

We believe that the European market offers greater value with the positive impact of the forthcoming ECB policy intervention not priced into the market. As such, we expect to see European stocks recover back toward their long term valuations.

Emerging markets are expected to face a tougher time with the end of the QE stimulus package in the US this month, although the Chinese market is expected to retain its recent buoyancy.

Property

Our view on listed property has not changed. The market has been supported over the past few years by the global hunt for yield. Although some of this money was withdrawn during the recent mini correction, there are still signs that overseas buyers (primarily Asian) are paying over market prices for office buildings in Australia.

However, the short to medium performance of both domestic and international property will largely be dependent on movements in long term bond yields.

We continue to 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 remain unappealing. 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.

Value has started to appear in global high yield investment grade credit given the widening of spreads (ie inherent interest rates). Furthermore, 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 very low interest rate environment.

Sources: VanEyk, Blackrock

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.