Economic and Investment Update – July 2015

Economic & Investment Commentary for quarter ended 30 June 2015

Economic and investment fundamentals took a back seat during the June quarter with the focus on the impasse between Greece and its creditors and a plunge in the Chinese A-share market.

The situation in Greece reached its climax on 29 June when the Greek premier, Alexis Tsipras, decided to hold a referendum on the bail out terms. After successfully obtaining a "No" vote from its citizens, the Greek Government caved in to European Union demands and accepted further reforms. These included improving VAT collection, broadening the tax base and reforming the pension system.

Despite increased volatility, European markets (in Australian dollar terms) were marginally positive for the quarter as the European Central Bank continued its Quantitative Easing (QE) programme, purchasing around EUR60bn of bonds each month.

In China, following a surge on the Chinese A-share market over the last 12 months, extreme volatility reared its head, with a 33% market fall over the last two weeks of June. While Chinese authorities responded with vigour, the sight of government intervention exacerbated the concerns of an already skittish market. Meanwhile, attempts to transition the Chinese economy away from its focus on investments and exports to a consumer led economy continue.

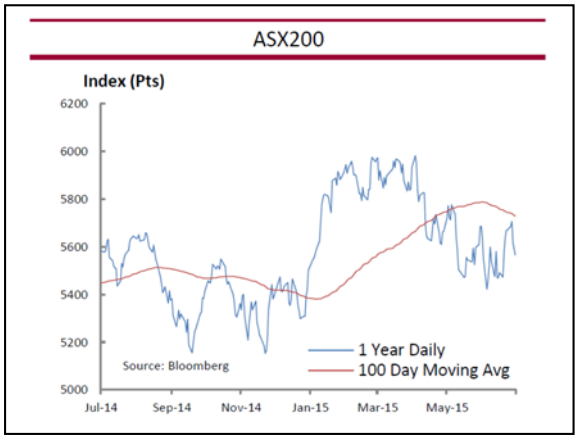
Economic data from the US was mixed with a strengthening US dollar increasing the pressure on US corporate earnings. This pushed back market expectations of a US interest rate rise to the latter half of this calendar year.

In Japan, the government maintained its stimulus policies, despite signs of stronger domestic growth. Japanese growth in the March quarter was revised up to an annualised rate of 3.9% as business investment and inventories were stronger than initially reported. However, inflation remained absent and the Japanese government revised down its assessment of the economy and overall business conditions.

The Australian economy continued to grow at below the long term average rate as the unemployment rate showed some signs of improvement and the inflation rate remained low. Consequently, to provide additional stimulus the Reserve Bank dropped official interest rates in May by 0.25% to a new record low of 2%.

MARKETS

The Australian equity market (as measured by the S&P ASX 200 Accumulation Index) finished down 6.6% over the June quarter but up 5.7% for the financial year. While the energy sector produced a positive return (+0.6%), following a rebound in the oil price, no other sectors were immune to the sell-off in absolute terms. With cyclical sectors underperforming, the weakest returns were generated by the consumer staples (-10.2%) and consumer discretionary (-9.5%) sectors. Smaller company returns fared better compared to large companies but were still down 4.0% for the June quarter.



Despite doom and gloom news from Greece and China, the MSCI World ex-Australian Index returned -0.04% for the quarter and 10.9% for the financial year. Returns in Australian Dollar terms were -0.1% for the quarter and 25.2% for the year. During the June quarter, the best performing market within developed economies was Japan (+5.4% in local currency terms). The US (as measured by the S&P 500) was flat with a June quarterly return of -0.2%. Despite the 33% fall in the Chinese A-share market in late June, the Shanghai Shenzhen Index still produced a return of 10.4% for the quarter.

Domestic listed property fell 2.4% over the quarter as rising bonds yields led to a pullback in this sector. Global property fared even worse, giving up all the gains of the previous quarter with a fall of 7.0%. Australian Government and global bond yields increased over the June quarter in anticipation of a lift in U.S. interest rates. This led to a sell off in domestic and global bonds with both down around 2% for the quarter.

Sector	Index	3 mths (%)	1 year (%)	5 years (% p.a.)
Equities				
Australia	ASX/S&P 200 Accumulation Index	-6.6	5.7	9.7
	ASX Small Ordinaries Acc Index	-4.0	0.4	1.4
International	MSCI World ex Aust Index (AUD)	-0.1	25.2	15.4
	MSCI World ex Aust Index (AUD Hedged)	0.0	10.9	17.0
Emerging Mkts	MSCI Emerging Mkts (Net Div) (AUD)	0.1	16.5	5.7
Listed Property				
Australian	ASX 200 Prop Trust Accumulation Index	-2.4	20.3	14.3
International	UBS Global REITS Ex-Aust (AUD Hedged)	-7.0	9.1	15.1
Direct Property				
Australian	Australian Mercer Unlisted Property (pre-tax)	2.4	10.1	9.9
Currencies				
AUD v USD	Against US Dollar	0.6	-18.6	-1.9
Fixed Interest				
Australian	Bloomberg Ausbond Composite All Maturities	-2.0	5.6	6.4
	Bloomberg Ausbond Credit All Maturities	-0.7	5.4	7.1
International	Barclays Capital Global Aggregate Index (AUD Hedged)	-1.7	5.6	7.3
Commodities				
Gold	Gold – USD	-1.0	-11.7	-1.2
Oil	WTI Oil $/b - USD	24.9	-43.6	-4.7
Base Metals	RBA Index Base Metals (weighted currency)	-3.8	-3.6	-1.0

Economic & Investment Outlook

Despite financial market turbulence in China and Greece, overall world growth is expected to be 3.3% in 2015 and 3.8% in 2016 according to the International Monetary Fund.

In the US, signs of economic strength have renewed the focus on the timing of the first interest rate rise in more than a decade. While the US Federal Reserve has stated that the timing of rate rises is data dependent, expectations are for one increase before the end of the calendar year followed by further increases next year.

Despite the news grabbing headlines from Athens, the European economy appears now to have hit a sweet spot with improved growth and inflation figures and declining unemployment. This has been aided by a weak Euro, lower oil prices and the Quantitative Easing programme. Although growth looks positive in the short term, long term growth is more questionable given issues around productivity and the regions aging workforce. Greek debt relief will also need to be addressed at some point in time given Greece's burgeoning level of debt and shrinking economy.

Volatility in China and emerging markets may continue, fuelled by the uncertainty surrounding US interest rate rises and weakness in global market sentiment.

Japan's unemployment rate continues to fall unchecked and its QE stimulus programme and falling yen is expected to continue to provide a boost to the economy and to equity markets.

In Australia, iron ore prices lost 30% in June and added to the pessimism surrounding the mining sector. Hope is for a property led recovery with new dwelling approvals nearing record levels and up 17.6% over the year. However, housing finance has been trending lower which may reflect a reduction in respect of 'off the plan' purchases. While the RBA has maintained a bias towards further reductions in interest rates, recent falls in the Australian Dollar may limit further interest rate cuts.

Australian Shares

We are optimistic about the Australian share market. The earnings growth outlook remains reasonable and if the 6.1% earnings per share growth forecast in the current financial year is achieved, a Price Earnings (PE) valuation of 15 appears to be fair value.

A falling Australian Dollar should assist with export growth as well as encouraging investment from overseas, hence increasing the likelihood of further corporate activity. Although the fundamentals look sound, risk remains through increased volatility from overseas markets including the US and China.

Overall, we are comfortable with investors maintaining a neutral position against their benchmark holding.

Global Shares

Global earnings growth for 2015 is estimated at 3.5%, equating to a Price to Earnings (PE) valuation of 17 times; in line with the 45 year average.

Our views in respect of the US market remain unchanged, with the equity market having already fully priced in the economic turnaround. Risks are that a market trading at a premium will weaken over the short term as mixed economic data unfolds.

We have a preference for a bias towards Japanese stocks. Although this market has shown significant gains over the last year, we believe that there is more room for improvement given the improving economic situation and the QE programme. However, the yen is likely to remain under pressure so exposure to the currency should be minimised.

We believe that there is still value in both Europe, despite the adverse news about Greece, and the Chinese share market. As discussed in previous reports, the QE programme and improving economic metrics provide an incentive for investors.

Property

Listed property trusts have been trading at a premium to their Net Asset Value. In the past, there has been slightly better value overseas as compared to Australia. However, bond yields are expected to rise, especially in the US. This will put downward pressure on overseas listed property prices. As such, we recommend that investors remain cautious in this sector.

Unlisted property trusts have in the past offered better value. However, offshore buyers have pushed prices up in this area, so we advise investors to be wary and only invest in areas where good value is apparent.

Better value exists in infrastructure assets with higher yield acting as a protective mechanism during deflationary periods.

Fixed Interest

Within the fixed interest markets, relative value exists in Australian Government bonds as well as global and domestic credit. Although we recommend an underweight position to fixed interest, investors should consider some investment in fixed interest, particularly in those markets discussed above.

Sources: Lonsec, Blackrock, Schroders, Franklin Templeton, RBA