

Economic and Market Commentary June 2013

Bond and equities market reacted swiftly to US Fed comments in mid-May on the start to withdrawing the QE stimulus. Markets have become captive to Ben Bernanke's policy announcements and he should shape investor expectations this month for the coming year. Focus is now on when and how the stimulus is to be withdrawn. The continued stimulus has delivered strong returns for the MSCI ex Australia, up 8.8% for the month of May and 23.6% for the six months to 31st May. A major contributor to returns for Australian global investors has been the drop in the A\$ which contributed 6% for the month of May. US bond yields have risen resulting in capital losses over the past month.

Negative real interest rates for cash in most developed countries have led to investors seeking higher yields from riskier assets, such as property, infrastructure and equities. Quality large cap companies that pay reliable dividends have benefitted the most and are responsible for the strong returns seen across most equity markets of developed countries. Emerging markets and Asia ex Japan have been weaker over these periods. Uncertainty within the Eurozone remains with France in recession and soft economic data coming out of Germany. This is likely to cause periods of volatility within markets.

The US is undergoing a broadening economic recovery although from a low base fuelled by cheap funds (cash rates close to 0%), improving consumer sentiment, improving housing and construction market and access to affordable energy. All of these factors are providing a lift in confidence. However, the US fiscal issues remain a hurdle to be overcome with politicians being required to still address the significant debt issues within coming months. The quantitative easing programmes being undertaken by US, Europe and Japan has fuelled the "risk on" approach by investors and with the US Fed now using language to indicate a winding back of the stimulus in the US, markets are likely to remain volatile while US bond prices increase in response.

Inflation in the developed countries is also declining resulting in bonds now generating positive real rates (US 10 year bonds 2.19% and inflation 1%) The US unemployment rate is a major focus for the Fed and has remained stubbornly high, although now easing below the 8% level to 7.5%. The US housing sector is generally showing good recovery signs with the foreclosure rates rapidly declining across the country. House prices have also experienced the biggest year-to-year advance since 2006. This should provide a strong boost to the economy as the leverage effect supports the wider economy and should provide a further boost to employment. The Fed has indicated that they are targeting a 6.5% unemployment rate before reducing their stimulatory stance although the language is suggesting this may happen sooner. It still appears that the QE programme remains entrenched for at least the coming year as the US growth rate remains around 2% and inflation is well contained. This supports a "risk on" environment.

The European Central Bank (ECB) continues to be proactive in providing a support mechanism to the region in the form of a bond purchase program, Outright Monetary Transactions (OMT) that allows member countries to off load distressed bonds to the ECB. They have further promised the Eurozone banks that they will provide as much liquidity as they need until at least July 2014 to assist lending to smaller companies, which have generally been starved of credit in many countries.

Whilst this action has improved investor sentiment and confidence, the Eurozone is still suffering from excesses of debt with potentially more countries requiring assistance over the coming year. Inflation in the euro area dropped to a three-year low of 1.2% in April and unemployment climbed to 12.1%, the highest since records began in 1995. In response, the ECB cut interest rates well below its target level to a record low of 0.50% and is "technically ready" to cut its deposit rate from the current zero percent into negative territory, meaning it would start charging banks for holding their money overnight. Such a move could encourage the banks to lend out money rather than hold it at the ECB.

In addition, Italy, Spain, Portugal, UK and France continue to deal with weakening economies, high debt burdens and high unemployment levels. These uncertain conditions are all leading to a long period of recession and low growth for the region and it dominates decision making. France's unemployment rate has crept over 10% placing the country into recession and further pressure on the government's finances. These issues can

have significant flow on effects for these countries and its people as it leads to social unrest and dislocation of the economy and recovery process.

Despite the US fiscal issues, the US economy continues to produce positive growth although at low levels and a more upbeat corporate and banking sector. A further positive for the US is the strong state of the energy market, which is anticipated to provide a strong boost to the economy over the coming years as they rely less on imported oil and gas, with an expectation of being an exporter of gas by 2015.

The emerging world is also suffering from a slowing in growth as it adjusts to the issues in the developed economies. However, it is still likely to account for much of the global growth in the year ahead. China remains key to world growth. The Chinese leadership is overseeing a slowing in growth now projected to decline in the region of 7-7.5% over the coming year. Managing the housing finance system is a priority as well as seeking to balance a transition from infrastructure investment spending to an increased consumption spending focus. China's share market is also underperforming. While the Chinese economy is large and complex it is hard to predict as it lacks transparency.

The Japanese equities market has been volatile over the past month as markets react to the large QE stimulus implemented by Prime Minister Shinzo Abe who is embarking on a strong growth strategy. He has formally adopted a 2% inflation target in conjunction with the Bank of Japan and is implementing a monetary easing stimulus of ¥10.3 trillion Yen (US\$116 billion) aimed at driving up economic growth. The aim is to drive down the currency and boost export earnings which is starting to occur.

So far, the expansionary policies of Shinzo Abe are delivering quick and tangible results. Japan's economy grew at a faster pace than expected with solid growth in consumer spending and exports. For the March quarter, GDP grew at an annualised rate of 3.5 percent and is the second consecutive quarter of growth. Japan has begun their climb out of recession with consumers more confident to spend and a weakening Yen, has led to export growth of around 3.8% for the March quarter.

The Australian share market has underperformed over the past month as investors focus on a slowing economy and wind back of the mining sector from its highs. The market has given back much of the gains from the beginning of the year. There is still a strong yield thematic with the move out of cash and term deposits into higher yielding growth investments. Resource companies are having to deal with more volatile commodity prices and a general outlook for lower prices over the year ahead. With the recent rapid depreciation in the A\$/US\$ from \$1.04 to \$0.94 and further downside projected, stock selection is likely to become more important as exporters begin to become more competitive.

The announcement of the latest budget deficit of \$20 billion for 2013-14 is likely to place more pressure on the RBA to cut the cash rate (currently 2.75%) further over the coming months. This is also likely to be supportive for equities and other growth assets. Inflation is not an obstacle with the rate declining (currently 2.5%). The lower interest rates are reducing the attractiveness of term deposits and are starting to stimulate flows into higher yielding assets. In addition the election date for 14th September is fast approaching which should provide a better environment for decision making by the business sector.

The weakening A\$ is a strong positive for exporters, manufacturers and tourism which have suffered for the past few years. This should help boost the economy over the coming year. A weakening A\$ is also benefitting investors holding international equities.

The high returns last year from fixed interest is becoming harder to achieve as cash rates are generally at well below long term levels and opportunities are now difficult to find. Australian bonds may offer better value than global bonds as rates are anticipated to be cut in Australia. Commercial and retail property valuations are also offering better value and long term investors are re-entering the market. Interest in listed REITs has also been solid as investors seek higher yielding investments. However, the outlook for the housing market still remains uncertain, despite the recent interest rate cuts.

- **International shares: [Overweight]** Sentiment in global equities markets is improving which provides opportunities for international shares to outperform over the coming year. A depreciating A\$ v US\$ (unhedged) should be a further positive for international shares. An overweight position is appropriate for the sector with the US preferred. Japan is also providing opportunities.
- **Australian shares: [Neutral]** **Australian Small Caps: [Neutral]** Opportunities are likely to arise from a stronger investment climate in the US. Investors who have been holding cash are likely to consider equities during the year as the return profile has become more attractive. Large cap stocks are currently preferred over small cap stocks.
- **Australian Listed Property: [Neutral]** **Global Listed Property: [Neutral]** Quality listed property securities delivering solid yields are likely to benefit from the focus on yield and suggest a neutral weighting to this sector. Quality direct property is also showing signs of recovery although investors need to be selective in this sector.
- **Fixed Interest: [Underweight]** With interest rates at historically low levels both globally and in Australia, opportunities for fixed interest are likely to be limited over the coming year. An underweight for the sector is appropriate. A cautious approach to global sovereign debt is required.
- **Cash: [Underweight]** The risk return profile of Cash and Term Deposits is becoming less attractive.

Risks

- The risk of sovereign debt defaults continues to remain high with the large deficits being run by many countries. They now need to manage carefully the wind back. Investors need to be selective.
- The European Union continues to face major challenges in managing member countries, especially Greece, Italy, Spain, Portugal and UK with large debt issues and the lack of discipline to control the predicament.
- A potential risk ahead for the global economy is the mismanagement of the unwinding of the QE stimulus programs currently in place and its repercussions on bond markets.
- Social unrest in Europe, Africa and the Middle East is becoming an increasing concern for governments.
- With large US debt levels (US\$16 trillion), strong political will is required to enact the necessary measures to reduce the debt levels. This is likely to be difficult as the US politicians continue to defer making tough decisions.
- Increased social unrest within China maybe an issue with the increasing urbanisation of the country.
- Poor policy decisions by the Australian Federal government in the lead up to the election may result in lower growth for the Australian economy.

Global Opportunities

- The Asian region continues to generate satisfactory GDP growth and should continue to be a major driver of world growth. Asia should continue to create opportunities for Australian investors although with periods of volatility like we have been experiencing.
- A key factor for continued Asian growth is the increasing demand by China's consumers as they develop greater wealth and require ever increasing volumes of commodities and agricultural products, which should underpin the Australian resources and agricultural sectors over the longer term.
- The rise of the US energy industry to a point of becoming an exporter of energy (gas) within 3-4 years and oil by 2030 provides a platform for optimism.

Australia

- Opportunities should continue as China and India evolve into stronger economies over the coming decade and demand for resources should be under pinned over the longer term.

Fixed Interest and Property

- Opportunities for higher returns from traditional fixed interest have largely disappeared with interest rates at low levels. The market has factored in the lower rates and the risk now is for capital loss if rates rise.
- The listed property trust sector is in better shape to participate in an improving property cycle.

Monthly Share Market Performance over the last Thirteen Months

Market Indices	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13
Intl-MSCI ex A A\$	-1.76	-0.62	-1.56	4.50	2.11	-0.52	0.67	2.34	4.59	1.90	0.61	3.54	8.84
Aust - All Ords	-6.90	0.25	3.74	2.12	2.13	2.97	0.27	3.43	5.08	5.18	-2.24	3.82	-4.39
Aust - Small Coy	-10.22	-4.78	-0.19	2.95	4.37	1.31	-2.43	3.23	4.20	0.87	-3.33	-4.65	-3.82
Aust Property ASX	-1.24	4.34	5.55	-0.13	1.20	5.32	-1.28	2.86	4.41	3.53	-2.58	8.16	-3.66
Global Property	-4.22	5.15	3.08	0.60	-0.21	1.11	1.03	3.09	3.58	1.72	3.46	5.94	-5.65

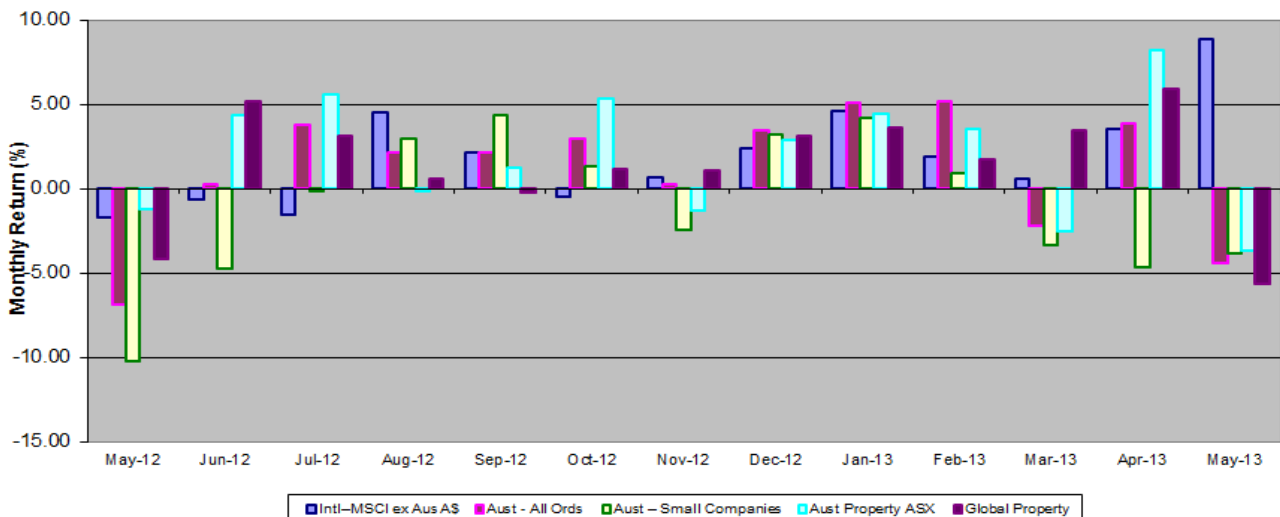
Annual Share Market Performance

Markets Index	1 Year to 31 Mar 11 %	1 Year to 30 Jun 11 %	1 Year to 30 Sep 11 %	1 Year to 31 Dec 11 %	1 Year to 31 Mar 12 %	1 Year to 30 Jun 12 %	1 Year to 30 Sep 12 %	1 Year to 31 Dec 12 %	1 Year to 31 Mar 13 %	1 Year to 31 May 13 %
Intl-MSCI ex A A\$	0.64	2.66	-4.52	-5.34	0.69	-0.50	13.59	14.14	10.76	29.30
Aust - All Ords	4.80	12.17	-8.43	-11.43	-6.27	-7.04	13.36	18.84	17.80	24.23
Aust - Small Coy	13.49	16.41	-12.11	-21.43	-8.57	-14.61	3.83	6.58	-5.82	-2.91
Aust Prop - ASX	4.74	5.87	-6.29	-1.56	1.67	10.98	28.90	32.79	30.52	30.62
Global Property	24.78	36.60	1.06	1.94	8.40	6.93	30.54	26.29	22.57	24.85

Best Performing Asset Sectors for twelve months ended 31 May 2013

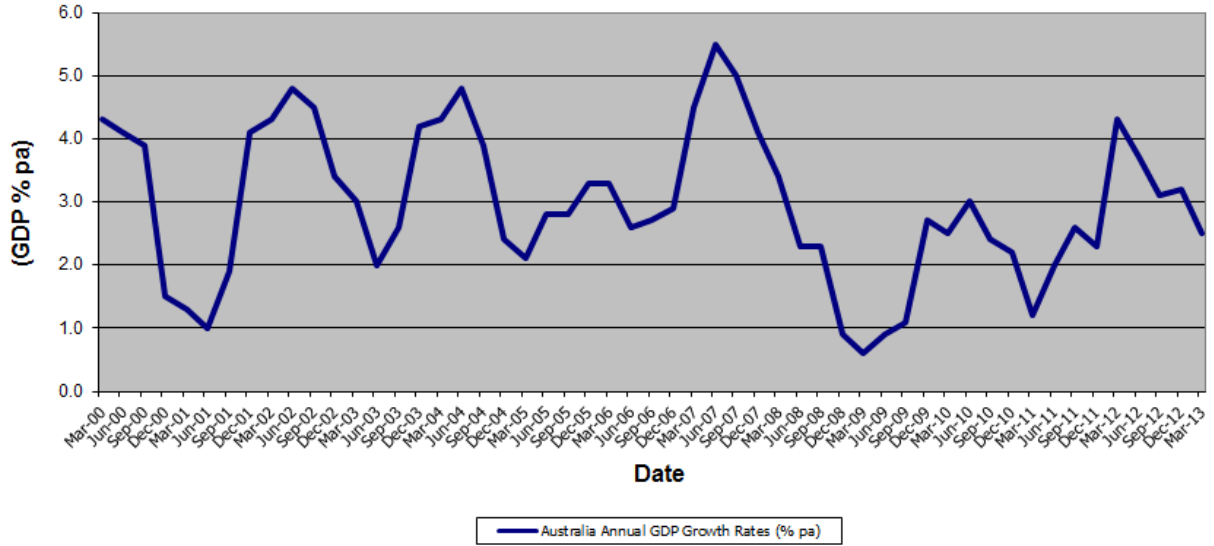
Sector	Market Index	Return
Aust Listed Property	S&P/ASX Property Trusts Accum Index	30.62
International Equities Hedged	MSCI World Accum Index Hedged A\$	30.32
International Equities Unhedged	MSCI World Ex Aust Accum Index A\$	29.30
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge \$A	24.85
Australian Shares	S&P/ASX All Ords Accum Index	24.23
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged \$A	4.75
Australian Fixed Interest	UBS Warburg Composite 0 + Years	3.69
Cash	Australian 90 Day Bank Accepted Bill	3.33
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	-2.91

Market Indices - Monthly Returns (%)

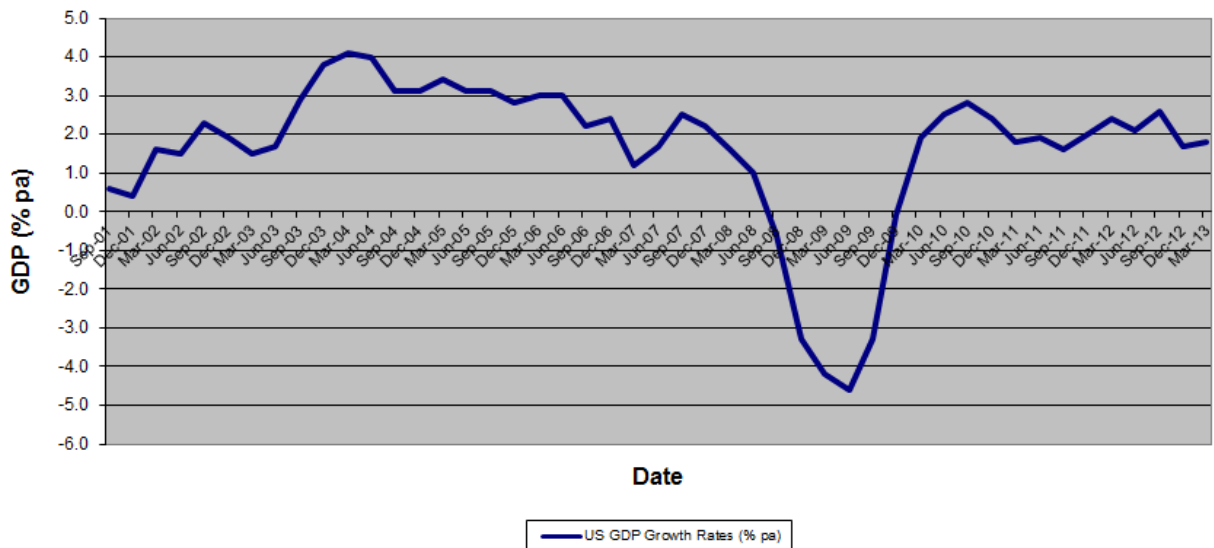


Major Economic Indicators

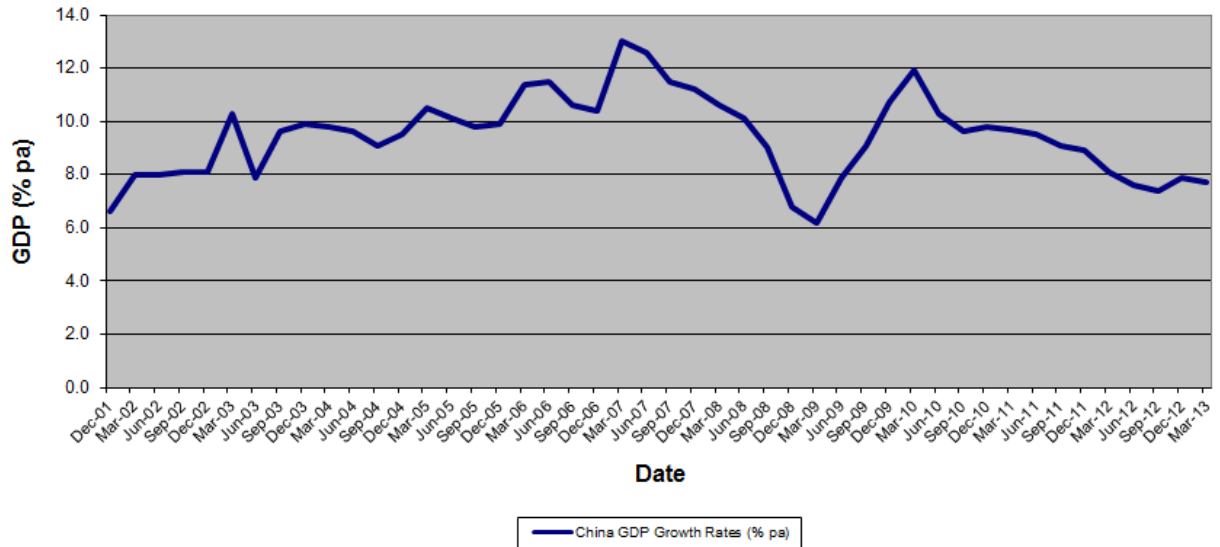
Australia GDP Growth Rates (%pa)



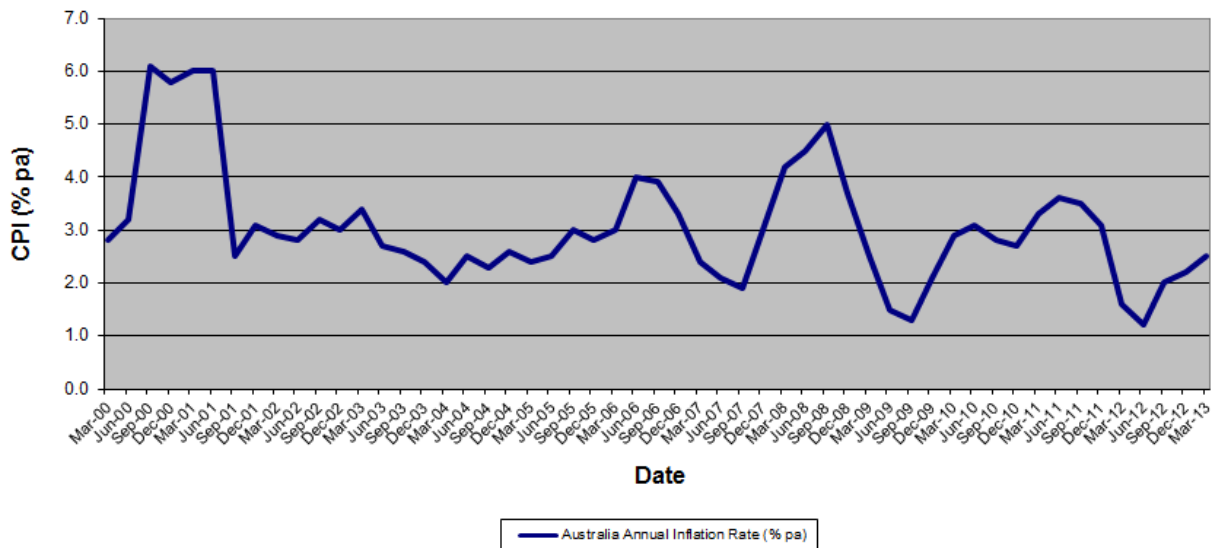
US GDP Growth Rates (%pa)



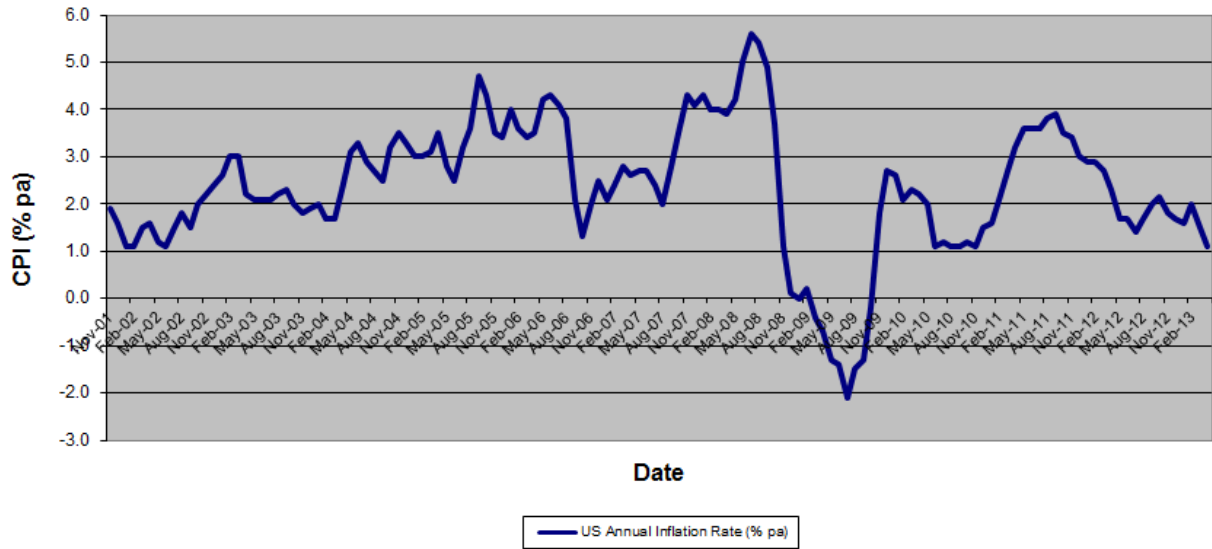
China GDP Growth Rates (%pa)



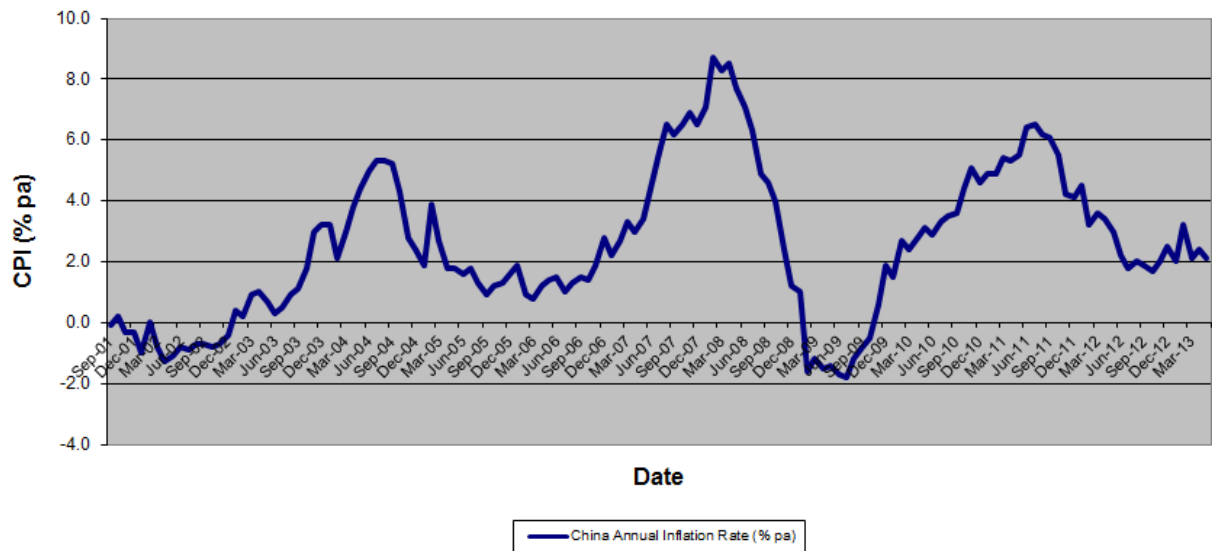
Australia Inflation Rates (%pa)



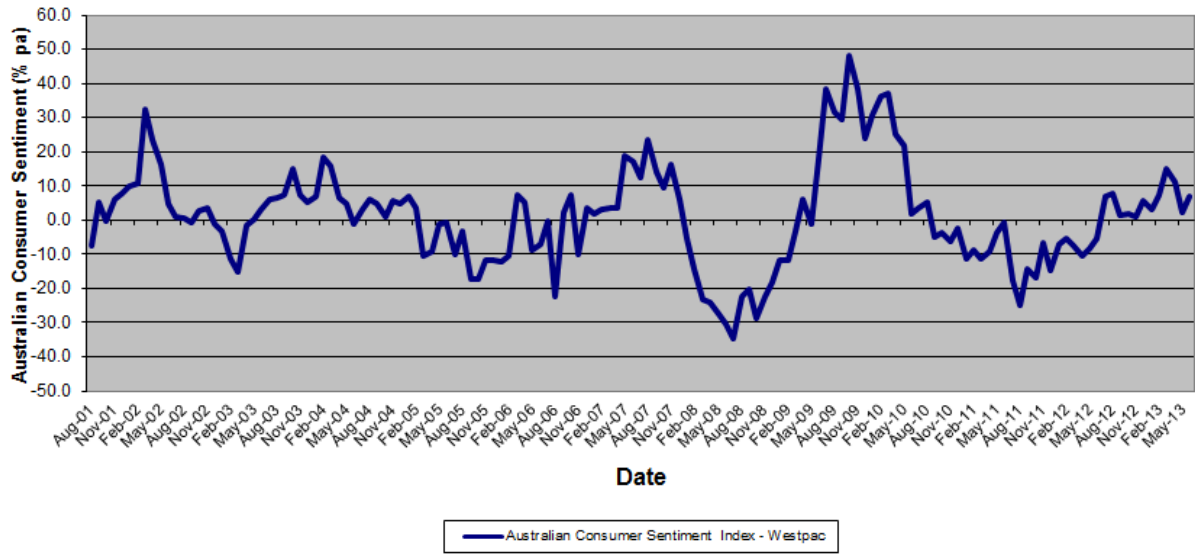
US Inflation Rates (%pa)



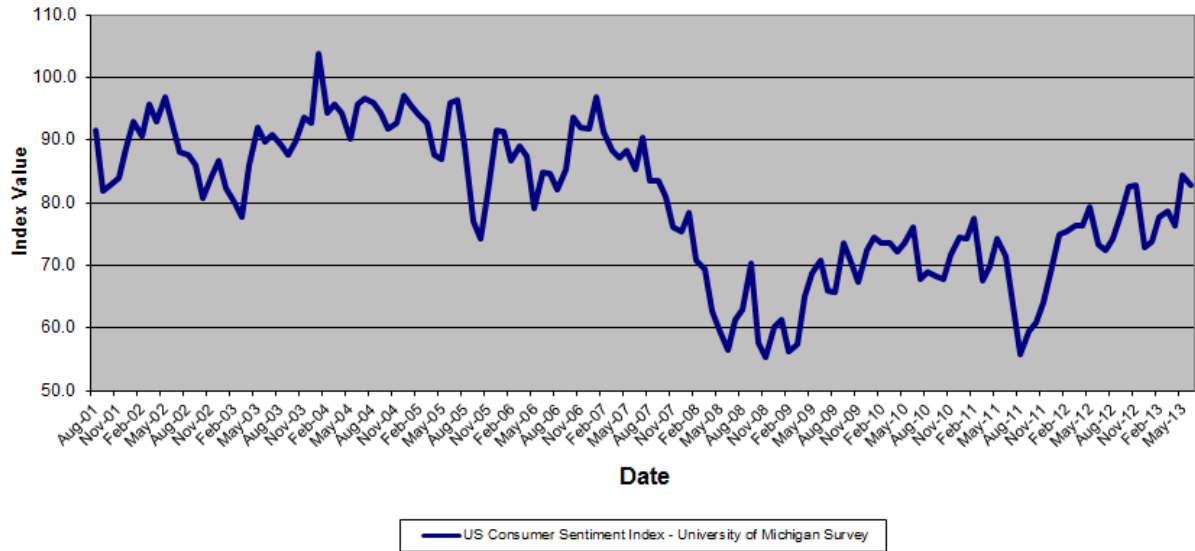
China Inflation Rates (%pa)



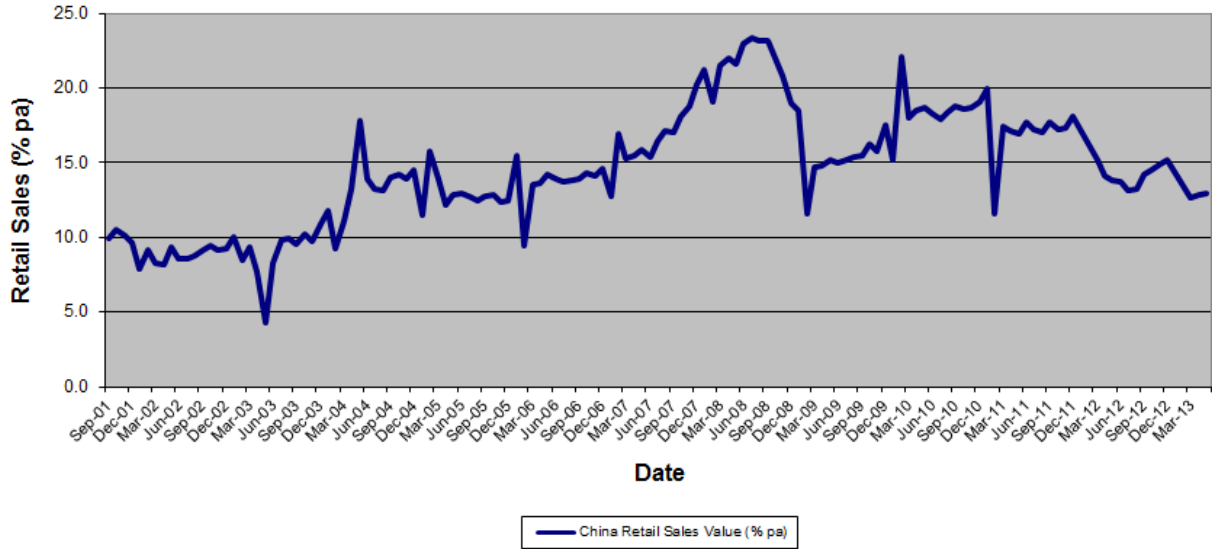
Australian Consumer Sentiment Index - Westpac



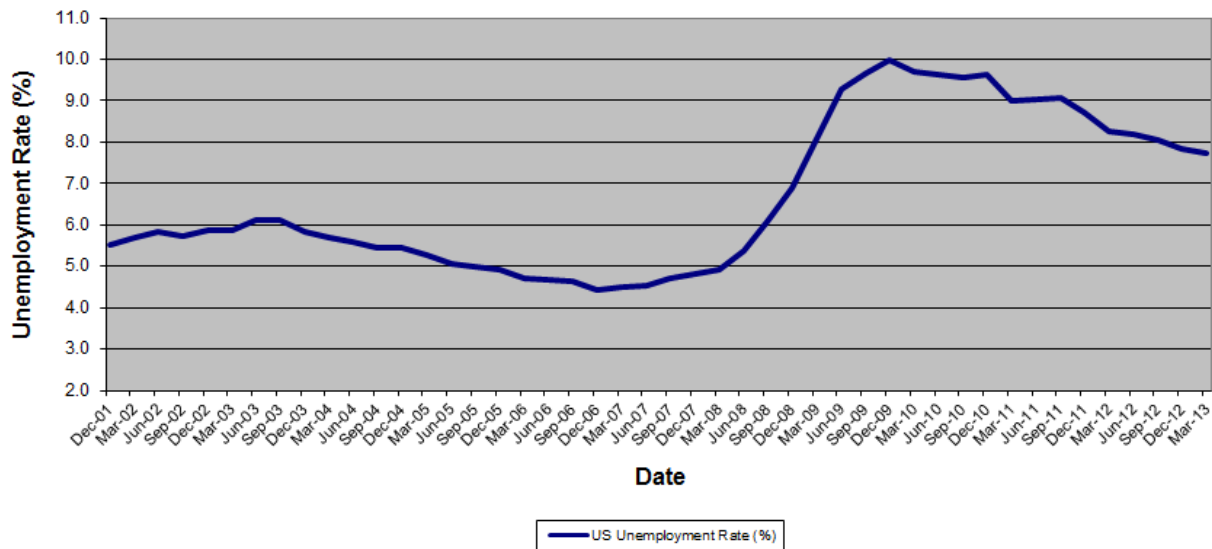
US Consumer Sentiment Index - University of Michigan Survey

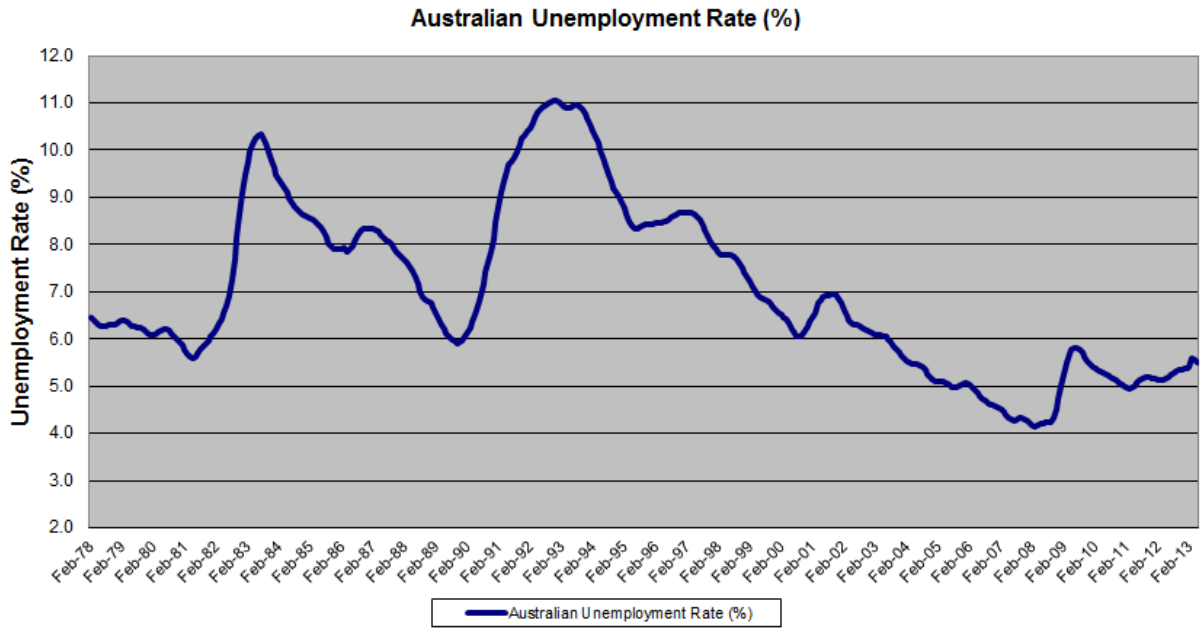


China Retail Sales Value (%pa)

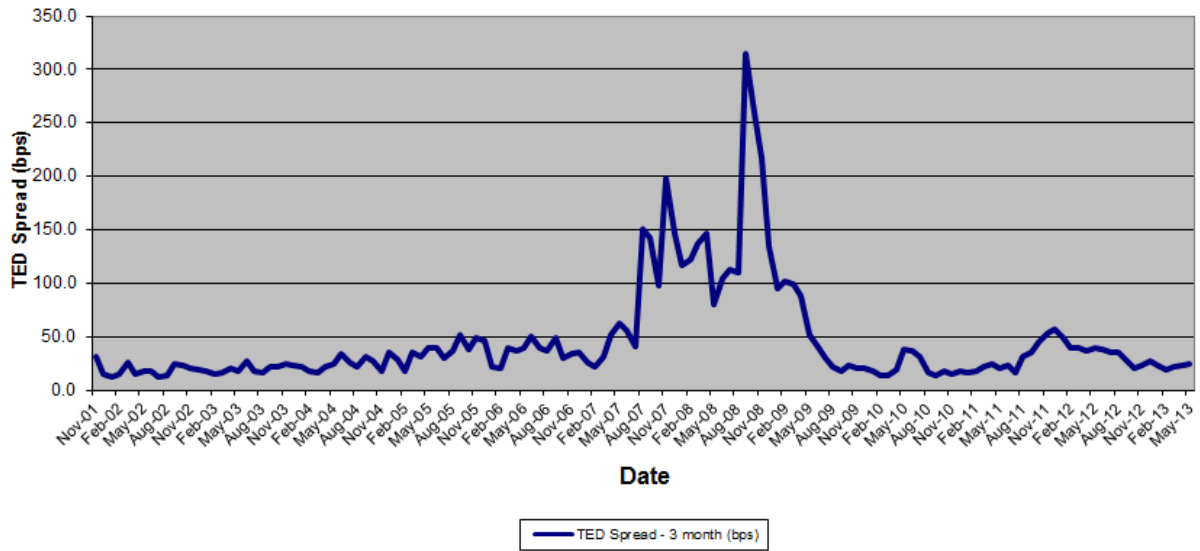


US Unemployment Rate (%)

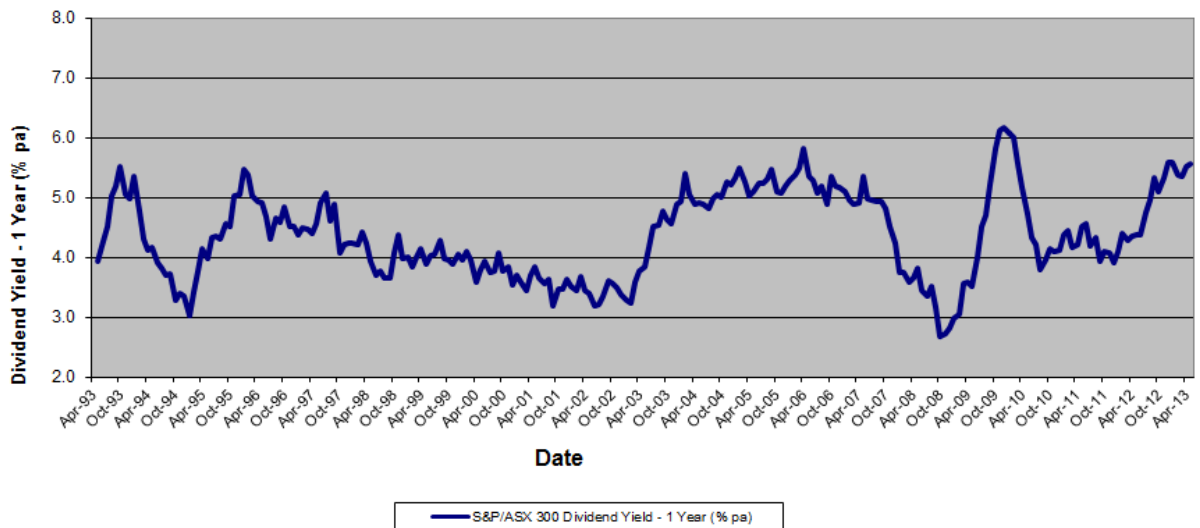




TED Spread - 3 Month



S&P/ASX 300 Dividend Yield - 1 Year (% pa)

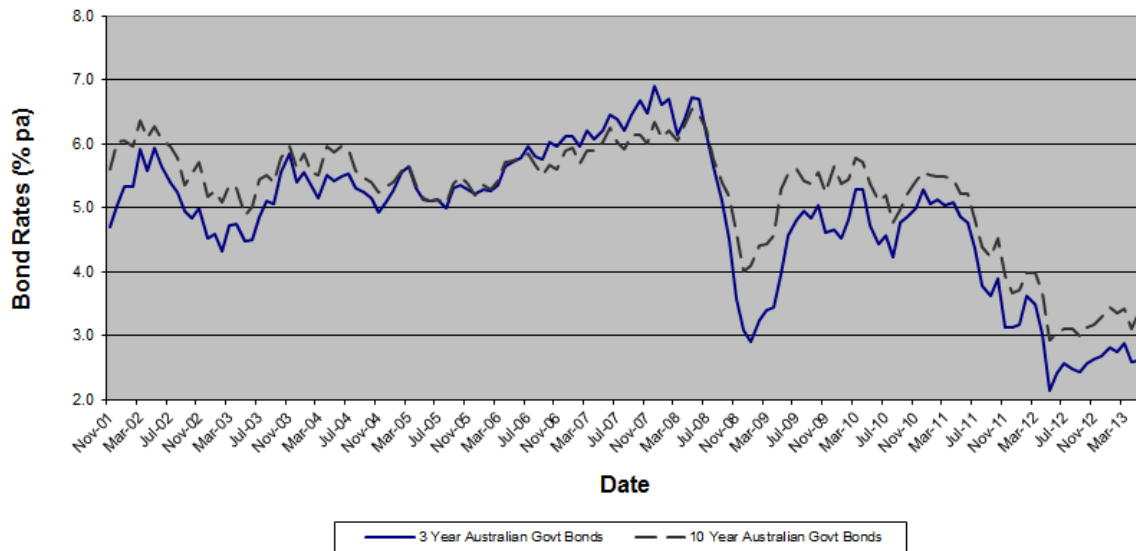


Australian Sharemarket Valuations (X)

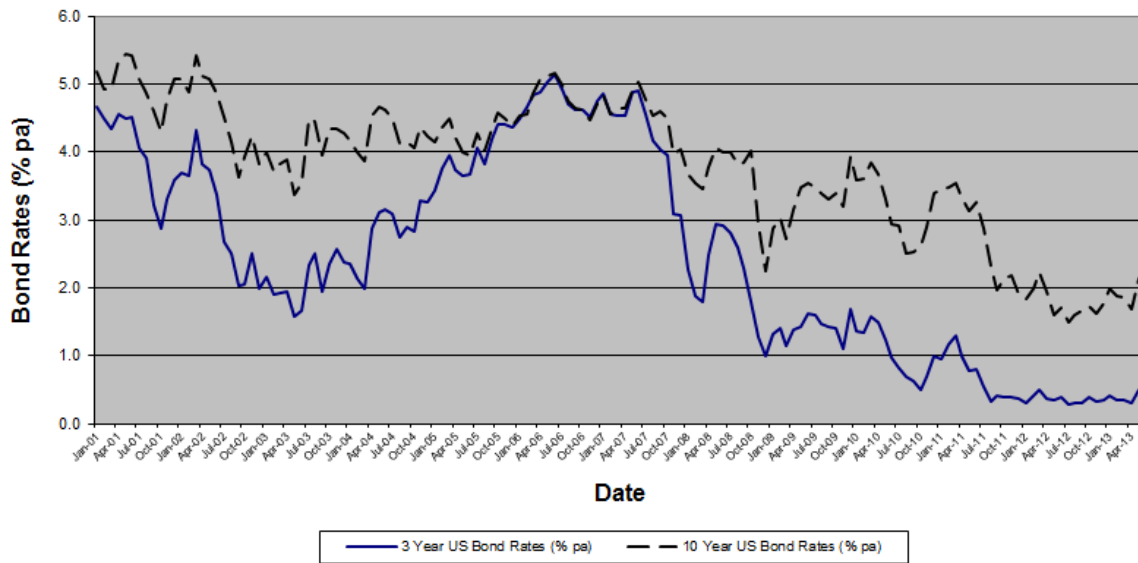


Source: UBS Australia and Reserve Bank of Australia as at 17 June 2013.

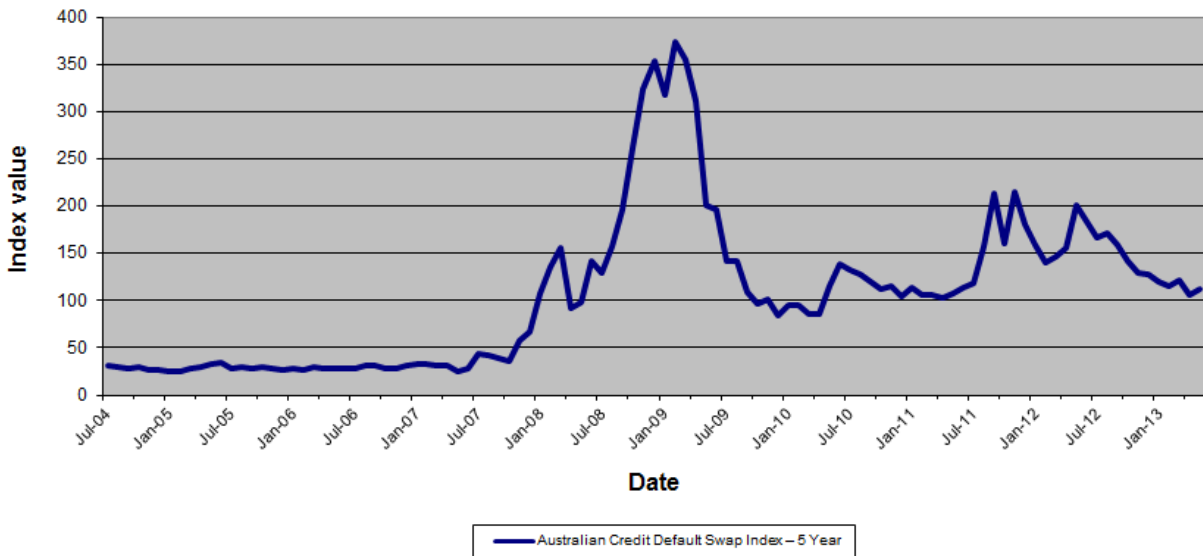
3y and 10y Australian Bond Rates (%)



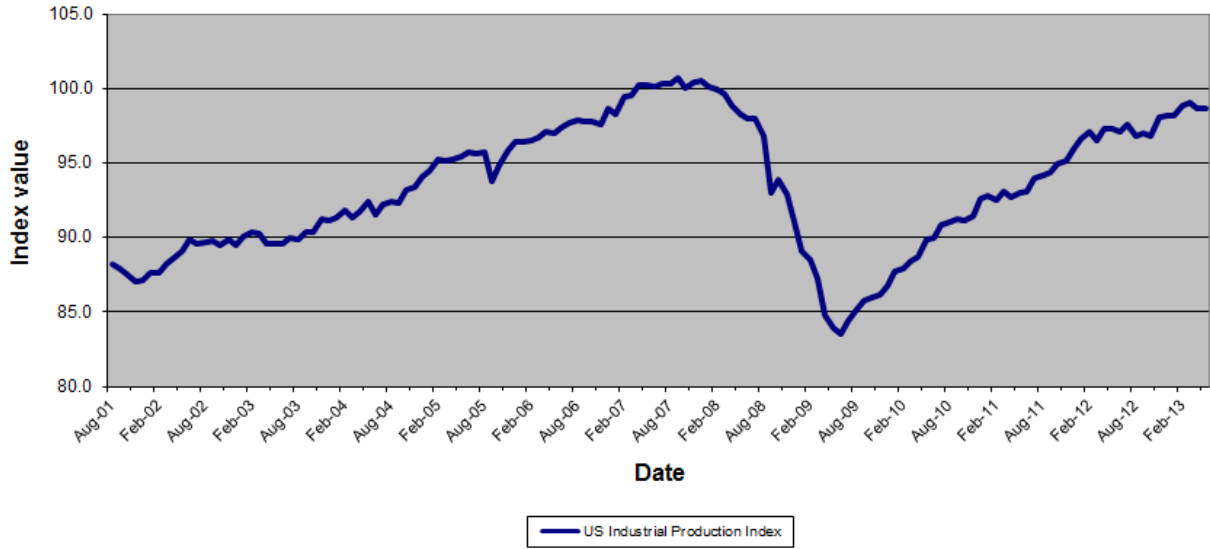
3y and 10y US Bond Rates (%)



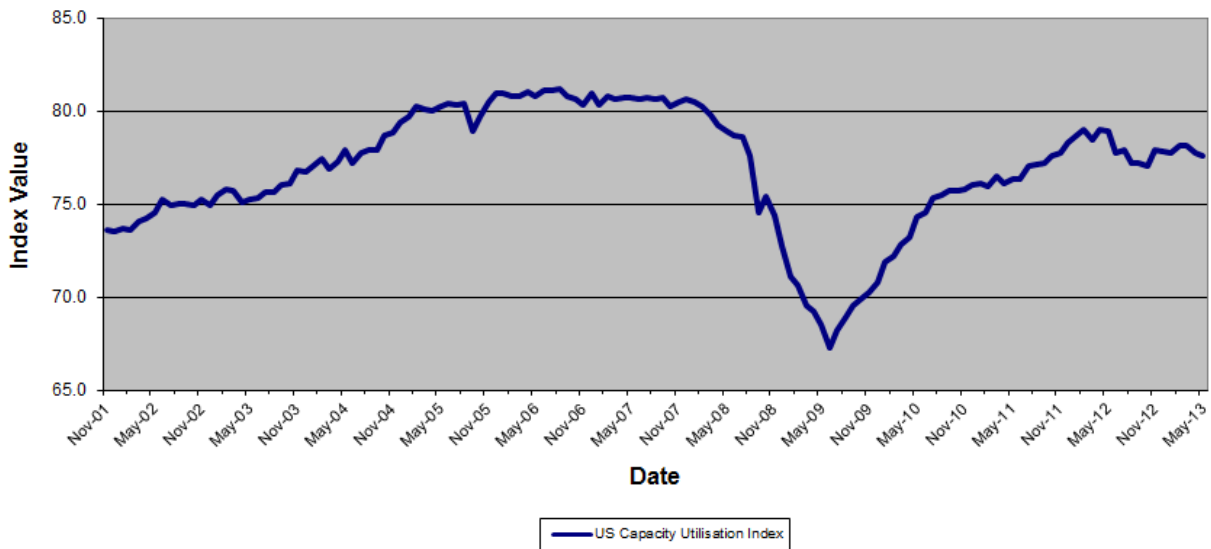
Australian Credit Default Swap Index – 5 Year



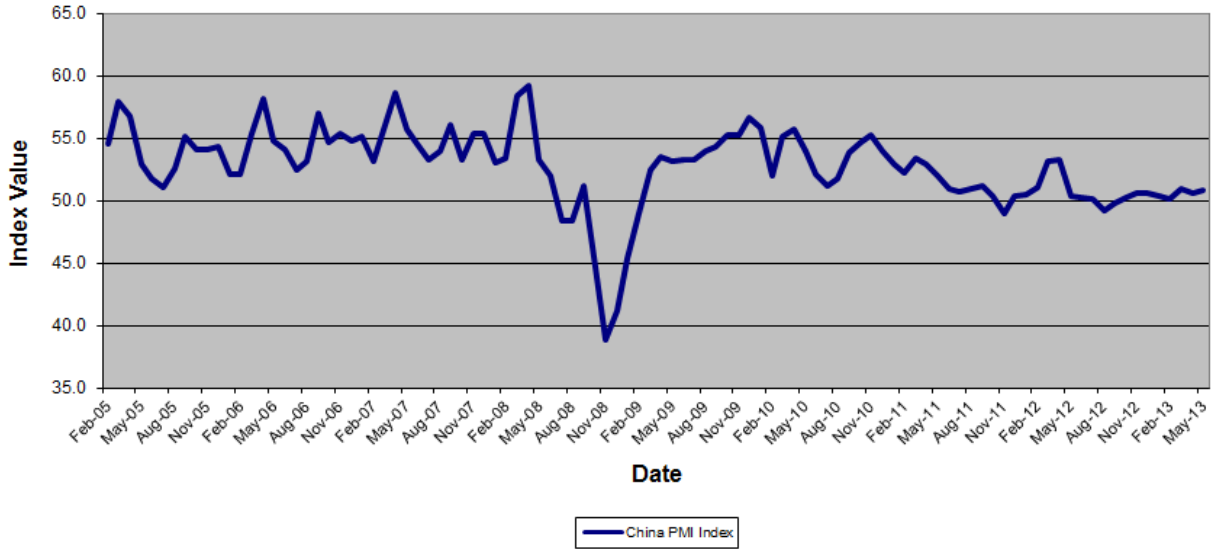
US Industrial Production Index



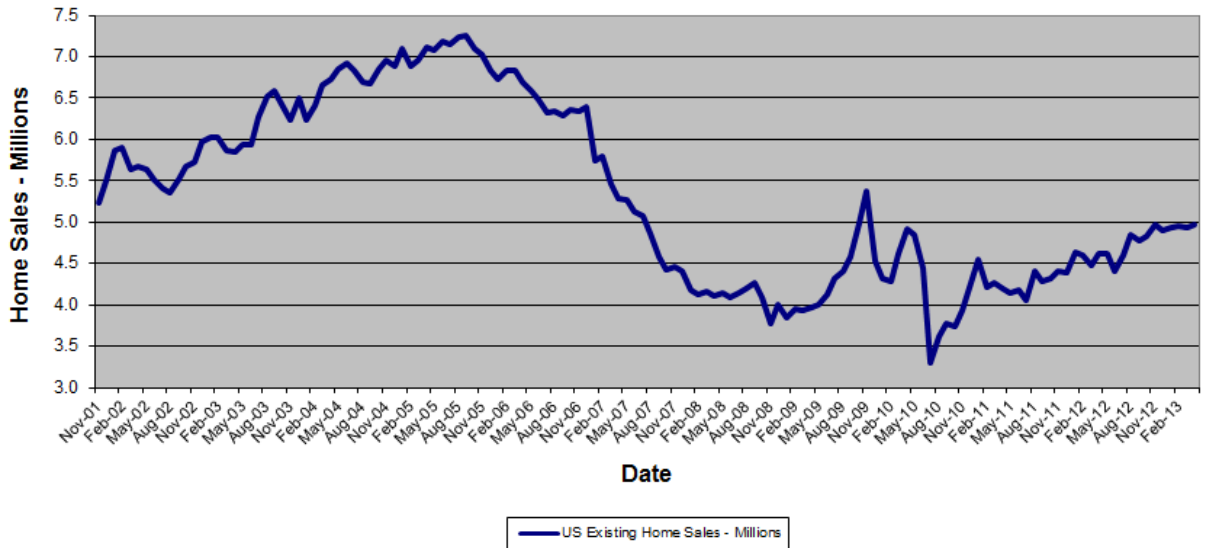
US Capacity Utilisation Index



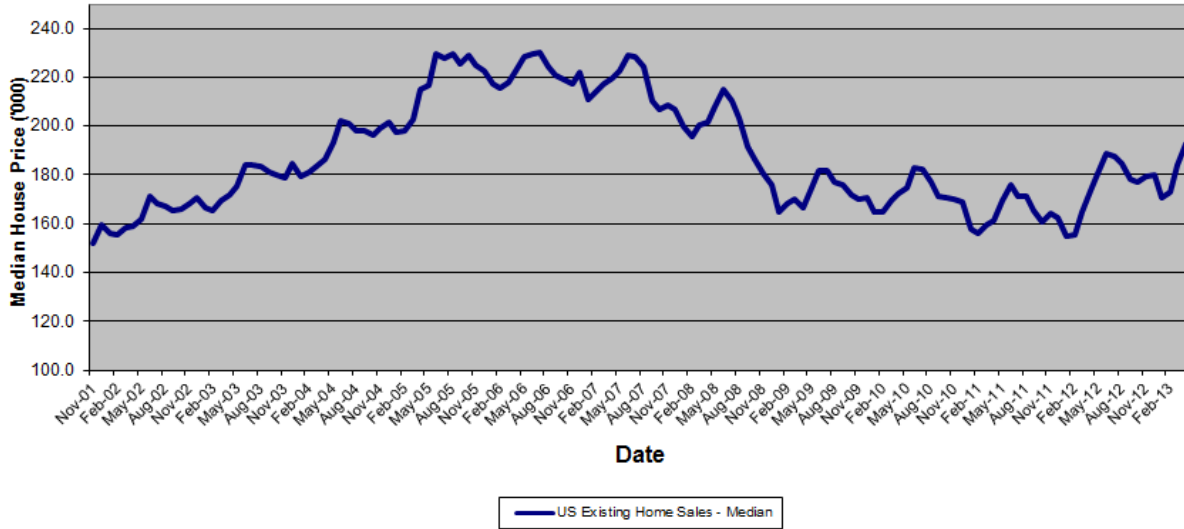
China Purchasing Managers Index (PMI)



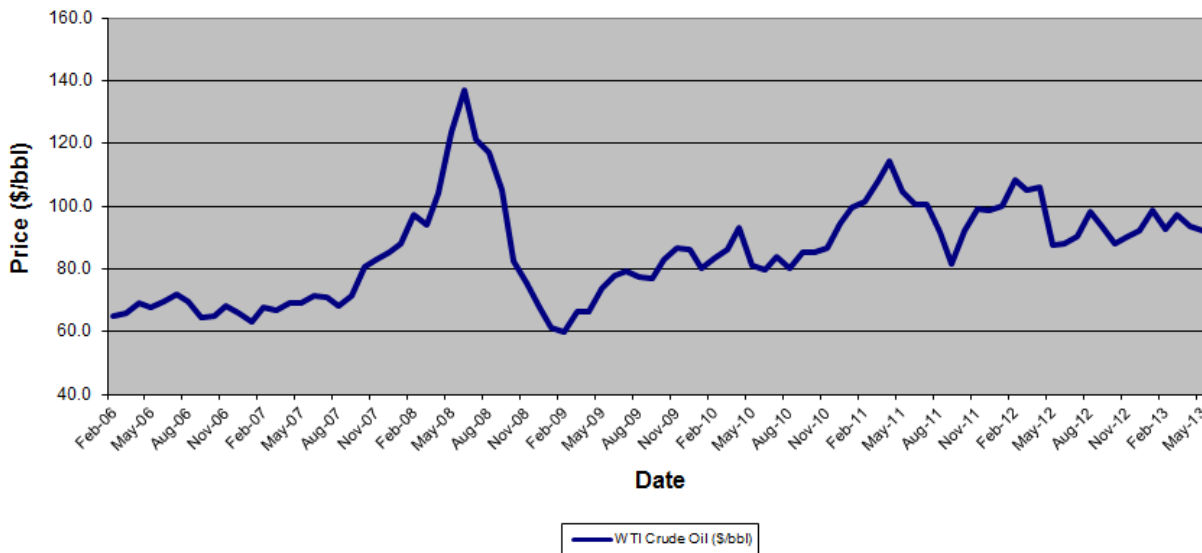
US Existing Home Sales - Millions



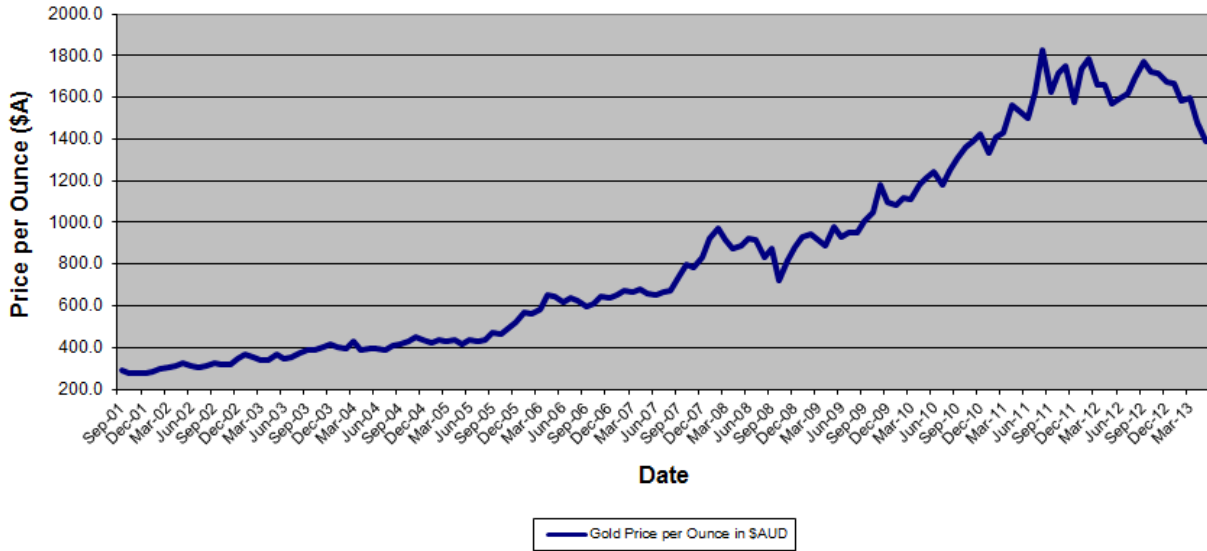
US Existing Home Sales - Median



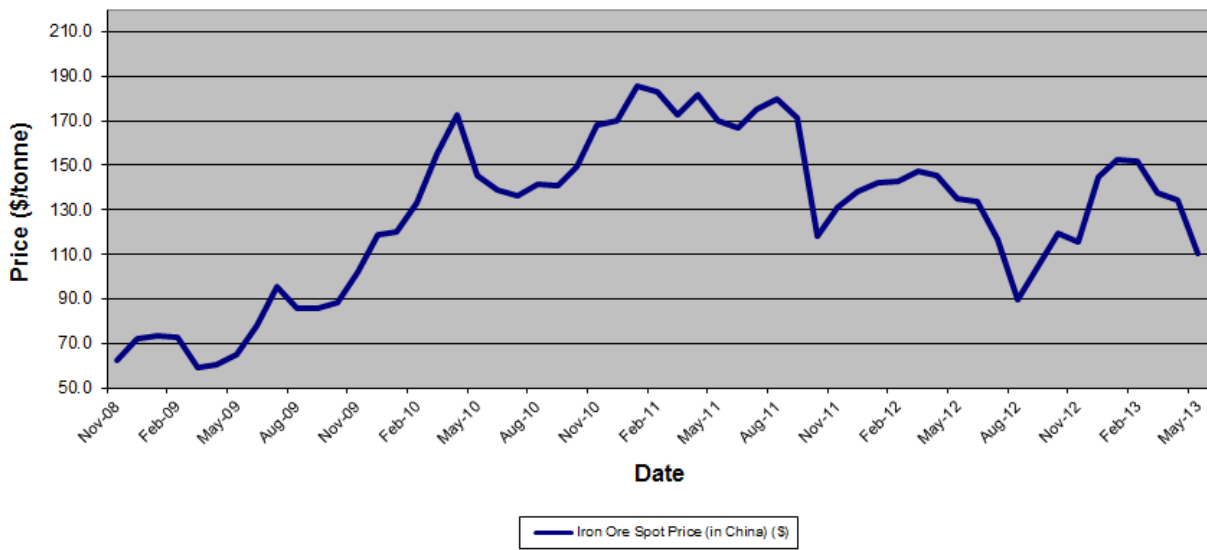
WTI Crude Oil (\$/bbl)



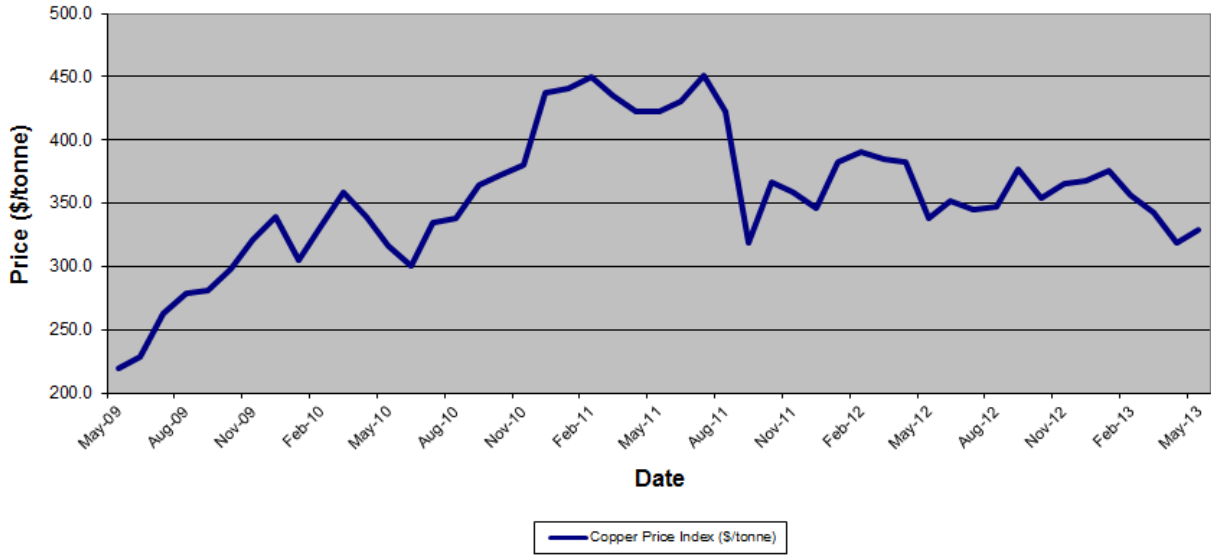
Gold Price per Ounce in \$AUD



Iron Ore Spot Price (in China) (\$/tonne)

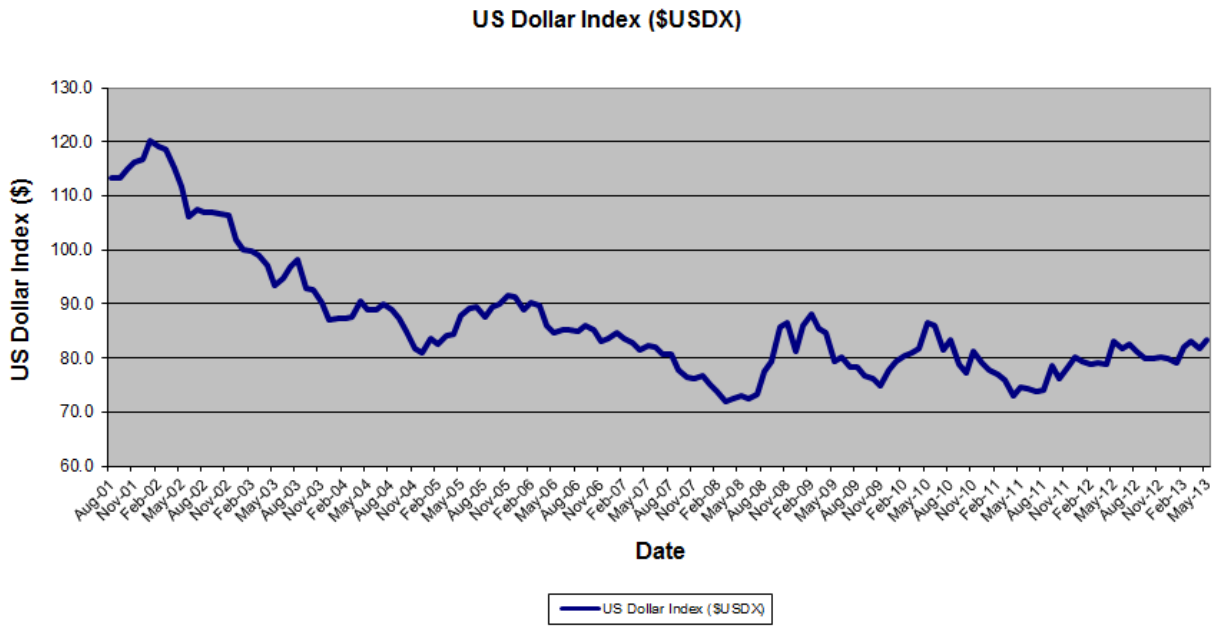


Copper Price Index (\$/tonne)



S&P Goldman Sachs Agricultural Index





The DXY is a weighted index of some of the major trading partners of the United States. The components of the DXY Index are (by weighting): Euro (57.6%), Japanese Yen (13.6%), Great Britain- Pounds Sterling (11.9%), Canadian Dollar (9.1%), Swedish Krona (4.2%), and Swiss Franc (3.6%).