McGregor
Asset Consulting

Economic and Market Commentary
August 2013

Growth assets have performed strongly over the past year with global equities outstanding with a return of 45% assisted by a depreciating A$ which is now trading around 90 US cents. This has provided a strong boost to returns that have been dominated by the US market and the supporting quantitative easing programs being undertaken by the major economies. Markets are now beginning to look ahead to the period where the US market starts to unwind (taper) the QE stimulus. Markets remain captive to Ben Bernanke's policy announcements as he shapes investor expectations for the coming year. His message is a tapering of the stimulus is contingent on the economy improving in-line with forecasts with no pre-set timetable for withdrawing the stimulus.

The strong returns over the past year include Australian equities with 23% for the last year, 45% for global unhedged equities and 16% for listed property trusts. Returns for bonds have dropped below 4% for the 12 months to the end of July. The RBA again cut the cash rate in July by 25 basis points to 2.5% and continues to maintain an easing bias with the aim of stimulating a modest growth environment.

US bond yields have risen resulting in capital losses over the past quarter. Negative real interest rates for cash in most developed countries has 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. Uncertainty within the Eurozone still remains with soft economic data coming out of France and Germany. The German elections are to be held in September.

The US is undergoing a broadening economic recovery although from a low base fuelled by cheap funds (cash rates close to 0%), improving jobs market, improving housing and construction market and access to affordable energy. The housing recovery is likely to contribute 1.5% to US GDP this year. All of these factors are providing a lift in confidence with the US economy continuing to produce positive growth although at low levels and a more upbeat corporate and banking sector. 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 US debt ceiling is fast approaching currently set at $16.7 trillion and is likely to be reached in September and is may well create uncertainty for markets as both the Democrats and Republicans indicate that agreement is unlikely to be reached quickly as cuts to the deficit are likely to be required. The quantitative easing programmes being undertaken by US, Europe and Japan continues to fuel the "risk on" approach by investors and as a result markets are likely to remain volatile while uncertainty remains. US bond prices are likely to increase in response to uncertainty.

Inflation in the developed countries is also declining resulting in bonds now generating positive real rates (US 10 year bonds 2.9% and inflation 2%). The US unemployment rate is a major focus for the Fed and has remained stubbornly high, although now easing below the 8% level to 7.4%. 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 affect supports the wider economy and should provide a further boost to employment.

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 (OTM) 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 has dropped to a three-year low and unemployment has climbed to 12%, 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%.

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 low growth for the region and it dominates decision making. 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.

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 bottom out 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 continues to react positively to the large QE stimulus implemented by Prime Minister Shinzo Abe who is embarking on a strong growth strategy. He now controls both chambers of Japan's parliament and is likely to undertake more difficult reforms to re-energise Japan's economy. This has led to renewed optimism in Japan with deflationary pressures gradually receding. The aim is to drive down the currency and boost export earnings which is starting to occur.

In Australia while the focus is on a slowing economy and wind back of the mining sector the combination of low interest rates and a lower A$ is likely to drive a modest pickup in growth into next year. There is still a strong yield thematic with the move out of cash and term deposits into higher yielding growth investments. With inflation likely to be low in the near term this should provide flexibility for the RBA to ease the cash rate further if required. This should be supportive for equities and other growth assets. The reporting season is providing mixed results with miners under pressure and banks out performing. The market is looking for direction for the remainder of year and is receiving mixed earnings guidance. Inflation is not an obstacle with the rate declining (currently 2.4%). The lower interest rates are reducing the attractiveness of term deposits and are starting to stimulate flows into higher yielding assets.

The focus on the upcoming election is creating uncertainty for decision making by the business sector and as a consequence a drop in confidence. A decisive result is required to reinvigorate the business community.
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.

Returns from fixed interest are becoming harder to achieve as cash rates are generally well below long term levels and opportunities are now difficult to find. Australian bonds may offer better value in the short term than global bonds as the easing cycle is still in play 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. The outlook for the housing market is showing signs of improvement as the recent interest rate cuts provide a boost to the sector.

- **International shares: [Overweight]** Sentiment in global equities markets is positive 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. 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.
- **Infrastructure: [Neutral]** Listed infrastructure securities provides opportunities in this volatile environment as they provide both yield and defensive attributes. Governments globally are focussing on building infrastructure assets which should provide opportunities for the 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

- 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.
- The risk of sovereign debt defaults continues to remain high with large deficits being run by many countries. Investors need to be selective.
- The European Union continues to face challenges in managing member countries, especially Greece, Italy, Spain and Portugal with large debt issues and the lack of discipline to control the predicament.
- Social unrest issues coming to the fore in significant emerging markets of Turkey, Brazil and Egypt are concern for this investment sector.
- 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.

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 record low levels. The market has largely 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	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13
Intl–MSCI ex A A$	-1.56	4.50	2.11	-0.52	0.67	2.34	4.59	1.90	0.61	3.54	8.84	2.31	7.45
Aust - All Ords	3.74	2.12	2.13	2.97	0.27	3.43	5.08	5.18	-2.24	3.82	-4.39	-2.62	5.46
Aust – Small Coy	-0.19	2.95	4.37	1.31	-2.43	3.23	4.20	0.87	-3.33	-4.65	-3.82	-7.15	9.81
Aust Property ASX	5.55	-0.13	1.20	5.32	-1.28	2.86	4.41	3.53	-2.58	8.16	-3.66	-0.97	-0.70
Global Property	3.08	0.60	-0.21	1.11	1.03	3.09	3.58	1.72	3.46	5.94	-5.65	-2.76	1.18

Annual Share Market Performance

Markets Index	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 30 Jun 13 %	1 Year to 31 Jul 13 %
Intl–MSCI ex A A$	2.66	-4.52	-5.34	0.69	-0.50	13.59	14.14	10.76	33.10	45.29
Aust – All Ords	12.17	-8.43	-11.43	-6.27	-7.04	13.36	18.84	17.80	20.67	22.67
Aust – Small Coy	16.41	-12.11	-21.43	-8.57	-14.61	3.83	6.58	-5.82	-5.32	4.16
Aust Prop – ASX	5.87	-6.29	-1.56	1.67	10.98	28.90	32.79	30.52	23.98	16.63
Global Property	36.60	1.06	1.94	8.40	6.93	30.54	26.29	22.57	15.46	13.34

Best Performing Asset Sectors for twelve months ended 31 July 2013

Sector	Market Index	Return
International Equities Unhedged	MSCI World Ex Aust Accum Index A$	45.29
International Equities Hedged	MSCI World Accum Index Hedged A$	29.10
Australian Shares	S&P/ASX All Ords Accum Index	22.67
Aust Listed Property	S&P/ASX Property Trusts Accum Index	16.63
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge $A	13.34
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	4.16
Australian Fixed Interest	UBS Warburg Composite 0 + Years	3.27
Cash	Australian 90 Day Bank Accepted Bill	3.24
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged $A	3.06