McGregor Asset Consulting

Economic and Market Commentary
July 2013

Global markets have stabilised after adjusting to the US Fed comments on the start to withdrawing ("tapering") the QE stimulus. Markets continue to be captive to Ben Bernanke's policy announcements and he is likely to shape investor expectations for the coming year. His message is a tapering of the stimulus is contingent on the economy improving in-line with forecasts and there is no pre-set timetable for withdrawing the stimulus.

The financial year has seen strong returns from growth investments in the order of 20% plus for Australian equities and 30% plus for global equities while cash and bonds have dropped below 5%. A major contributor to returns for Australian global investors has been the drop in the A$ which has contributed around 10% over the months of May and June. With the RBA still having an easing bias and a lower A$ should help drive a modest increase in growth.

US bond yields have risen resulting in capital losses over the past two months. 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 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 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 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 2.5% 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 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 recession and 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.

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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 has reacted positively to the large QE stimulus implemented by Prime Minister Shinzo Abe who is embarking on a strong growth strategy. He has now won control of 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 and Japan currently on track to achieve 4% growth this year. 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 will provide flexibility for the RBA to cut the cash rate (currently 2.75%) further over the coming months. This should be supportive for equities and other growth assets.

The upcoming companies reporting season (commencing end July) should provide the share market with direction for the remainder of year as the market looks for earnings guidance over the coming year. 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 current uncertainty for markets is the political impasse where the election date is unknown, thus creating a difficult 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.

Returns 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 in the short term 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 flat, despite the recent interest rate cuts.

- **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 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.
- **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

- The risk of sovereign debt defaults continues to remain high with 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 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 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.
- Increased social unrest within China is becoming an increasing issue as the country urbanises.
- 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	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12	Jan-13	Feb-13	Mar-13	Apr-13	May-13	Jun-13
Intl–MSCI ex A A$	-0.62	-1.56	4.50	2.11	-0.52	0.67	2.34	4.59	1.90	0.61	3.54	8.84	2.31
Aust - All Ords	0.25	3.74	2.12	2.13	2.97	0.27	3.43	5.08	5.18	-2.24	3.82	-4.39	-2.62
Aust – Small Coy	-4.78	-0.19	2.95	4.37	1.31	-2.43	3.23	4.20	0.87	-3.33	-4.65	-3.82	-7.15
Aust Property ASX	4.34	5.55	-0.13	1.20	5.32	-1.28	2.86	4.41	3.53	-2.58	8.16	-3.66	-0.97
Global Property	5.15	3.08	0.60	-0.21	1.11	1.03	3.09	3.58	1.72	3.46	5.94	-5.65	-2.76

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 30 Jun 13 %
Intl–MSCI ex A A$	0.64	2.66	-4.52	-5.34	0.69	-0.50	13.59	14.14	10.76	33.10
Aust – All Ords	4.80	12.17	-8.43	-11.43	-6.27	-7.04	13.36	18.84	17.80	20.67
Aust – Small Coy	13.49	16.41	-12.11	-21.43	-8.57	-14.61	3.83	6.58	-5.82	-5.32
Aust Prop – ASX	4.74	5.87	-6.29	-1.56	1.67	10.98	28.90	32.79	30.52	23.98
Global Property	24.78	36.60	1.06	1.94	8.40	6.93	30.54	26.29	22.57	15.46

Best Performing Asset Sectors for twelve months ended 30 June 2013

Sector	Market Index	Return
International Equities Unhedged	MSCI World Ex Aust Accum Index A$	33.10
Aust Listed Property	S&P/ASX Property Trusts Accum Index	23.98
International Equities Hedged	MSCI World Accum Index Hedged A$	21.83
Australian Shares	S&P/ASX All Ords Accum Index	20.67
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge $A	15.46
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged $A	3.84
Cash	Australian 90 Day Bank Accepted Bill	3.28
Australian Fixed Interest	UBS Warburg Composite 0 + Years	2.78
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	-5.32

Market Indices - Monthly Returns (%)