McGregor
Asset Consulting

# Economic and Market Commentary
# January 2015

As we start to move into 2015, central banks are beginning to factor in deflationary conditions, especially in Europe. Deflation is an outcome of falling prices plus falling wages and falling asset prices. The US successfully used quantitative easing to pump more cash into the economy and promote growth, which has resulted in a stronger economy and growth in asset prices. Europe's ECB has announced a large €60 billion per month quantitative easing programme to be implemented from March until September 2016 in order to counter the risk of deflation and stimulate growth back into the Eurozone. This is a massive stimulus and should be supportive for growth assets. It will also lower the borrowing costs across the Eurozone. The risk for Europe is to find agreement amongst its 19 member countries, many with differing objectives but all with the common Euro currency. Japan which has suffered deflation in the past has been undertaking a massive programme of quantitative easing and is having limited success in stimulating its economy.

The IMF's forecast for global growth is 3.5% for this year, which is sufficient for under pinning economies and providing adequate asset growth. Growth is likely to range from 1% in the Eurozone and Japan, 3.5% in USA and 7% in China. Russia has been hit hard by the drop in oil and commodity prices as well as Western sanctions. The currency is in crisis falling 50% versus the US$ since the beginning of the year. This crisis could well set off a bank run in Russia as it increases interest rates, which are now at 17%.

Easy monetary conditions and uneven global growth are likely to set the conditions for 2015. Growth assets should continue to be the focus for investors with global shares, infrastructure and listed property providing opportunities. Markets are currently digesting the huge drop in the oil price where the price has declined over 50% since June 2014 to US$47 per barrel. Also, from Australia's perspective commodity prices led by iron ore have declined 50% from $130 per tonne to $68 per tonne. This is going to have a significant effect on Australia's national income over the coming year as the government seeks to manage this imbalance.

Currencies are likely to play an increasing role in the outcome of global recovery and we are starting to see a structurally stronger US $ v Euro, Yuan, Yen and now Australian $. The euro has dropped to an 11 year low versus US$ on the back of the Swiss National Bank abandoning its pledge to maintain the Swiss franc above 1.20 per euro. The A$ has succumbed to the lower oil and commodity prices, dropping to the 81 US cent level and is unlikely to rebound until commodities prices start to increase, which may not occur for a prolonged period of time. The fall in the $A should further help the economy avoid recession as mining investment slows. It also provides a boost to corporate earnings as each 10% fall in the $A adds around 3% to earnings.

The US economy continues to provide optimism for markets with growth running at 3.5%. Markets are placing greater emphasis on the Fed's guidance to a gradual return to higher interest rates, although not expected until late this year or into 2016. The US economy has generally been performing well and unemployment has steadily declined, now at 5.8% which is providing the catalyst for a return to higher interest rates. As a result, US equities markets now require underlying earnings to grow in order to support the equities valuations. Also, business confidence is providing a boost and the housing market recovery is still intact. Access to cheap funds and access to affordable energy is also supporting the improved sentiment in the US.

China and Indian equities markets are continuing to perform strongly, although from a low base. China's Shanghai Composite index is likely to be further boosted as it opens to foreign trading, which is seen as a significant advancement. While China has under gone a slowing over the past months, the leadership has responded by lowering interest rates and providing additional liquidity to spur growth by offering low interest rate loans to the small business and housing sectors. The Chinese leadership continues to step up the reform process as the country transforms from the export and investment phase to a consumption phase. This consumption phase is likely to generate marginally lower growth over the coming years as the transition to a broader based economy takes effect with less impact than the investment phase has had over the past five years. Positive signs are emerging for China and opportunities starting to emerge in its share market where values are attractive.

Selected emerging markets are showing signs of improvement and capital flows have turned positive. Fears are still high with many of the emerging markets such as Russia, Turkey, South Africa and Brazil

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underperforming as well as dealing with geo political uncertainties, social unrest and currency problems. Geo political risks remain at elevated levels and tensions between Russia and the West remain strained, where stronger sanctions have been put in place.

The Japanese equities market continues to be driven by the large stimulus as they continue to embark on an ambitious reflation strategy. The Japanese equities market has been responding. Abe is now likely to undertake more difficult reforms to re-energise Japan's economy. The aim is to continue to drive down the currency and boost export earnings, which is starting to occur although it will undergo periods of volatility.

Growth is likely to remain at subdued levels in the developed markets, but should continue to underpin company earnings and equities markets. While every cycle comes to an end and a return to normality in markets should eventually occur. However, the recent history of QE and the massive stimulus being undertaken in Japan and now being undertaken in Europe, suggests that “normal” may not occur across world markets for quite a while longer.

Returns for bonds, both global and domestic remain low and unappealing. With the easing of monetary conditions bond markets have rallied strongly with US 10 year rates trading around 1.8% and Australian 10 year bonds at 2.6%. This is now just 10 points above the cash rate of 2.5% and suggests the next move in cash rates is likely to be lower in order to stimulate a modest growth environment. This should continue to provide support to the housing market. Term deposits are also losing appeal with one year rates around 3%.

With lower returns from bonds investors are seeking higher yields from riskier assets, such as property, infrastructure and equities. Quality large cap companies that pay reliable dividends have benefitted the most. Inflation in developed countries is benign, resulting in bonds now generating positive real rates (US 10 year bonds 1.8% and inflation 0.8%).

In Australia, the focus is now on consumer and business confidence. Unemployment has increased to over 6%, both business and consumer confidence also have deteriorated since the July high, which is likely to flow through to lower growth forecasts in the near future. The government needs to be mindful not to retard the drivers of growth as we come off record terms of trade and a rapidly slowing resources sector. Current GDP growth forecast for 2014 is 3% and is below the long term growth of 3.5%.

Returns from fixed interest are harder to achieve as cash rates are generally well below long term levels and opportunities are now difficult to find. Commercial and retail property valuations are offering better value and long term investors are being attracted to the market. Listed REITs are attracting investors seeking yield.

- **International shares: [Overweight]** Sentiment in global equities markets remains positive providing opportunities for international shares to outperform in the coming year. An overweight unhedged position is appropriate for the sector. A weakening A$ should provide opportunities.

- **Australian shares: [Neutral] Australian Small Caps: [Neutral]** Increased pressure on the economy and particularly the mining sector is limiting opportunities. Investors need to be selective in this environment. Large cap stocks are 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 offering value although investors need to be selective in this sector.

- **Infrastructure: [Neutral]** Listed infrastructure securities provides opportunities in this 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 months. An underweight for the sector is appropriate. Corporate bonds should provide the best opportunities.

- **Cash: [Underweight]** The risk return profile of Cash and Term Deposits is less attractive.

## Risks

- The rapid fall in oil and energy prices is likely to affect the energy exporting countries significantly and may well result in destabilizing their economies. Russia will need to manage its currency and economy carefully.
- A major risk ahead for the global economy is the mismanagement of the QE stimulus programs currently in place and its repercussions on bond markets and rising interest rates.
- The European Union continues to face significant challenges in managing deflationary pressures as the region deals with low growth and large debt issues. A lack of discipline to control the predicament also remains an issue.
- The conflict with the Islamic State in Iraq and Syria has been elevated with a coalition of the West and is likely to contribute to global uncertainty. An escalation of the unrest may have negative implications for the countries involved as defence spending is impacted and global relationships may well be tested.
- Political unrest in Ukraine and Russia needs to be managed carefully in order to avoid a major conflict. If conflicts escalate, markets are likely to be effected, especially energy supplies into Europe.
- The Ebola virus outbreak has now killed over 8,600 people largely contained in West Africa but is putting all countries on alert.
- A number of the emerging market countries and parts of Asia need to manage their currency and economies closely in order to prevent a currency crisis.
- The Chinese leadership need to implement their economic reforms without stalling the economy which would have major flow on effects, especially for Australia. We are now starting to see defaults on loans in China where the government previously chose to bail them out, which may lead to a contagion effect.
- The risk of sovereign debt defaults continues to remain with large deficits being run by many countries. Investors need to be selective. Servicing debt is likely to be an issue when interest rates rise.

## Global Opportunities

- The Asian region continues to generate satisfactory GDP growth and should continue to be a major driver of world growth. India is likely to be a significant contributor and provide market opportunities.
- 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 Australian resources and agricultural sectors over the longer term. The China Free Trade Agreement with Australia should under pin trade. We are witnessing greater interest by China in our agricultural sector.
- The rise of the US energy industry to a point of becoming an exporter of energy (gas and oil) provides a platform for optimism.

## Fixed Interest, Property and Infrastructure

- Opportunities for higher returns from traditional fixed interest are limited. The market has largely factored in the lower rates.
- The listed property trust and infrastructure sectors are in good shape to participate in an improving investment cycle and low borrowing rates provide increased opportunities.

## Monthly Share Market Performance over the last Twelve Months

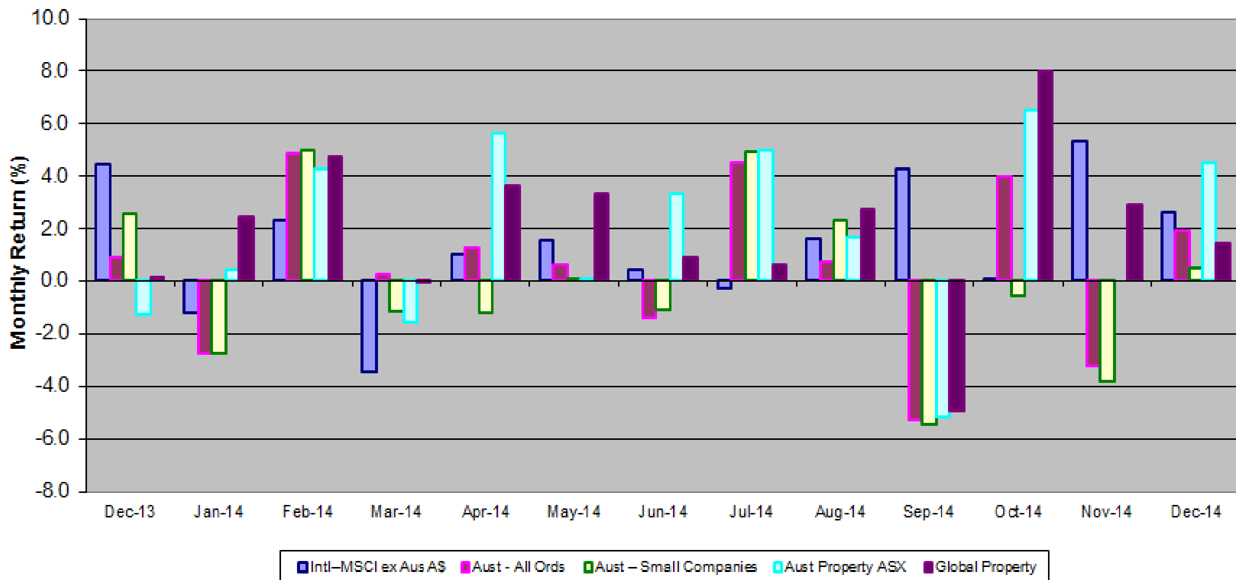
| Market Indices | Jan-14 | Feb-14 | Mar-14 | Apr-14 | May-14 | Jun-14 | Jul-14 | Aug-14 | Sep-14 | Oct-14 | Nov-14 | Dec-14 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Intl–MSCI ex Aus UH A$ | -1.20 | 2.30 | -3.43 | 1.03 | 1.54 | 0.44 | -0.25 | 1.63 | 4.30 | 0.05 | 5.32 | 2.63 |
| Aust - All Ordinaries | -2.76 | 4.84 | 0.25 | 1.29 | 0.61 | -1.41 | 4.49 | 0.72 | -5.26 | 3.96 | -3.20 | 1.93 |
| Aust – Small Company | -2.76 | 4.97 | -1.16 | -1.24 | 0.08 | -1.11 | 4.91 | 2.34 | -5.47 | -0.54 | -3.81 | 0.47 |
| Aust Property REITs | 0.41 | 4.26 | -1.58 | 5.63 | 0.05 | 3.33 | 4.96 | 1.68 | -5.14 | 6.53 | 0.00 | 4.49 |
| Global Property REITs | 2.45 | 4.75 | -0.02 | 3.64 | 3.30 | 0.89 | 0.62 | 2.75 | -4.91 | 7.97 | 2.89 | 1.46 |

## Annual Share Market Performance

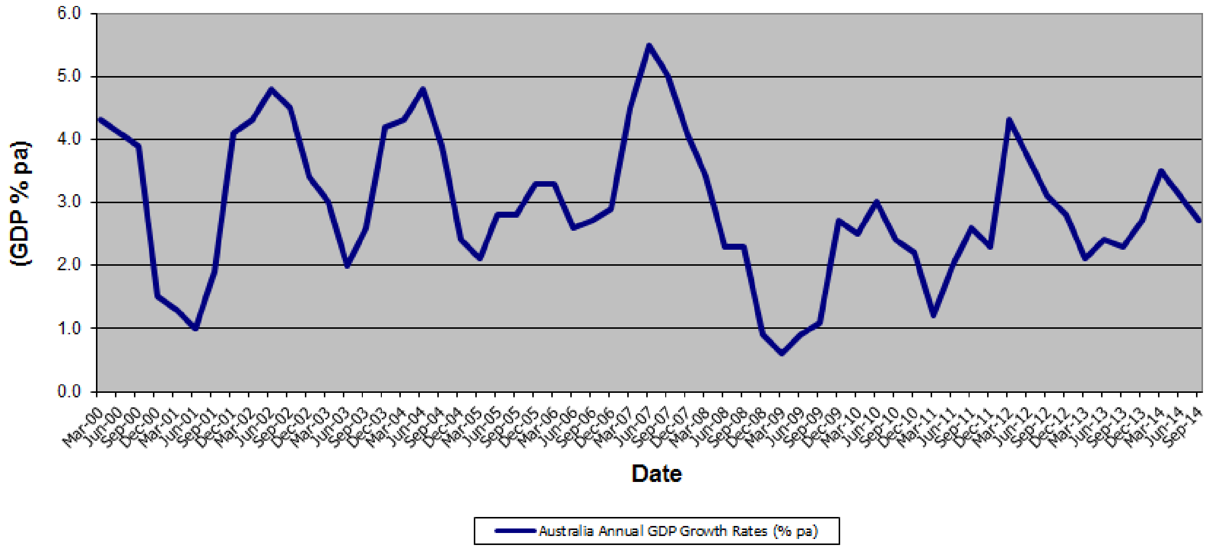
| Markets Index | 1 Year to 31 Dec 12 % | 1 Year to 31 Mar 13 % | 1 Year to 30 Jun 13 % | 1 Year to 30 Sep 13 % | 1 Year to 31 Dec 13 % | 1 Year to 31 Mar 14 % | 1 Year to 30 Jun 14 % | 1 Year to 30 Sep 14 % | 1 Year to 31 Dec 14 % |
|---|---|---|---|---|---|---|---|---|---|
| Intl–MSCI ex Aus UH A$ | 14.14 | 10.76 | 33.10 | 34.02 | 48.03 | 34.73 | 20.41 | 20.37 | 15.01 |
| Aust - All Ordinaries | 18.84 | 17.80 | 20.67 | 23.55 | 19.66 | 13.19 | 17.64 | 5.89 | 5.02 |
| Aust – Small Company | 6.58 | -5.82 | -5.32 | 1.42 | -0.76 | -1.46 | 13.11 | -0.07 | -3.81 |
| Aust Property REITs | 32.79 | 30.52 | 23.98 | 16.39 | 7.27 | 4.96 | 11.08 | 12.28 | 26.79 |
| Global Property REITs | 26.29 | 22.57 | 15.46 | 11.46 | 5.84 | 4.18 | 15.77 | 13.92 | 28.41 |

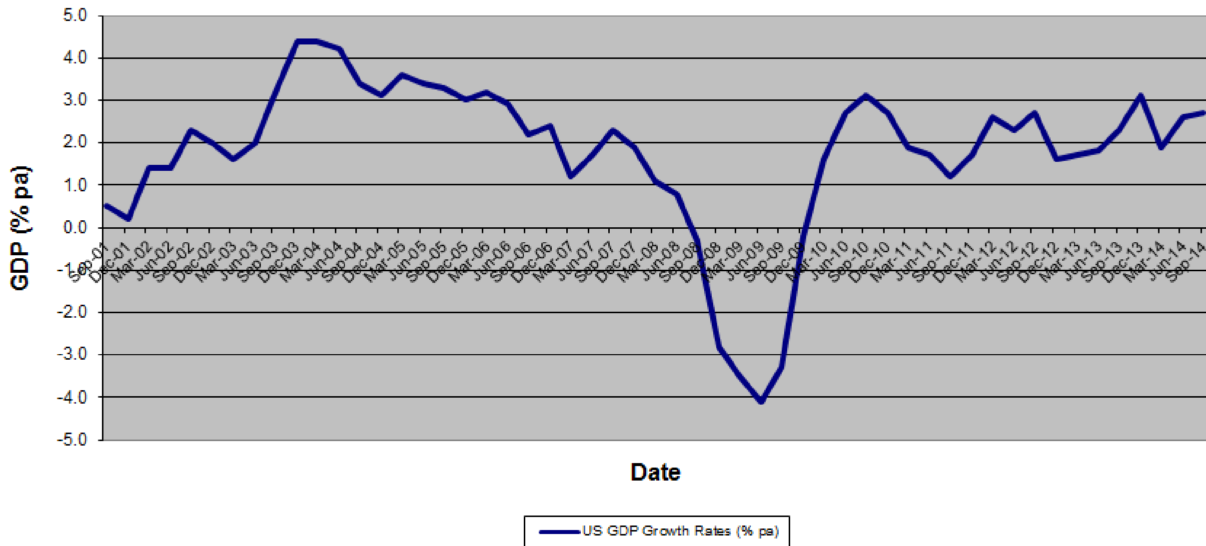
## Best Performing Asset Sectors for twelve months ended 31 December 2014

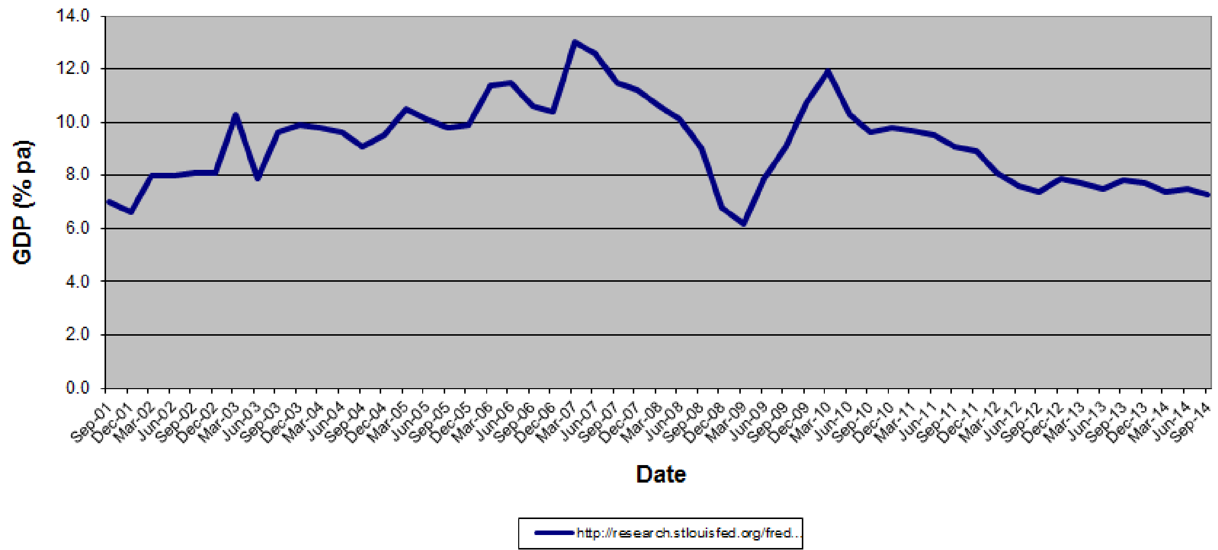
| Sector | Market Index | Return |
|---|---|---|
| Global Listed Property | UBS Global Real Estate Inv Ex Aust Idx Hedge $A | 28.41 |
| Aust Listed Property | S&P/ASX Property Trusts Accum Index | 26.79 |
| International Equities Unhedged | MSCI World Ex Aust Accum Index A$ | 15.01 |
| International Equities Hedged | MSCI World Accum Index Hedged A$ | 12.88 |
| International Fixed Interest Hedged | JP Morgan Gov Bond Accum Index Hedged $A | 11.25 |
| Australian Fixed Interest | UBS Warburg Composite 0 + Years | 9.81 |
| Australian Shares | S&P/ASX All Ords Accum Index | 5.02 |
| Cash | Australian 90 Day Bank Accepted Bill | 2.69 |
| Australian Smaller Companies | S&P/ASX Small Ordinaries Accum Index | -3.81 |

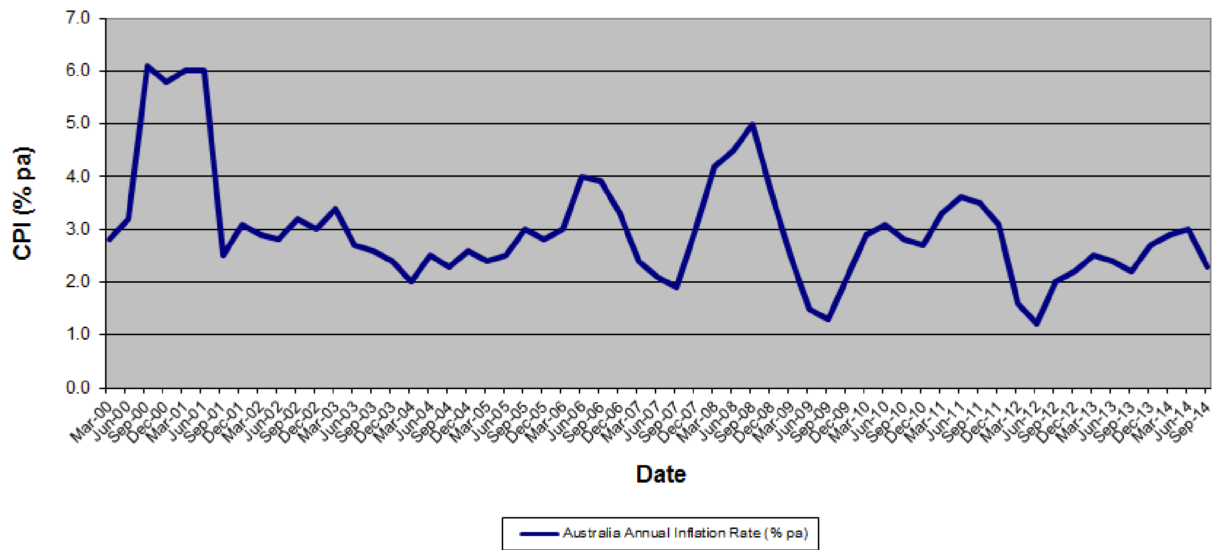


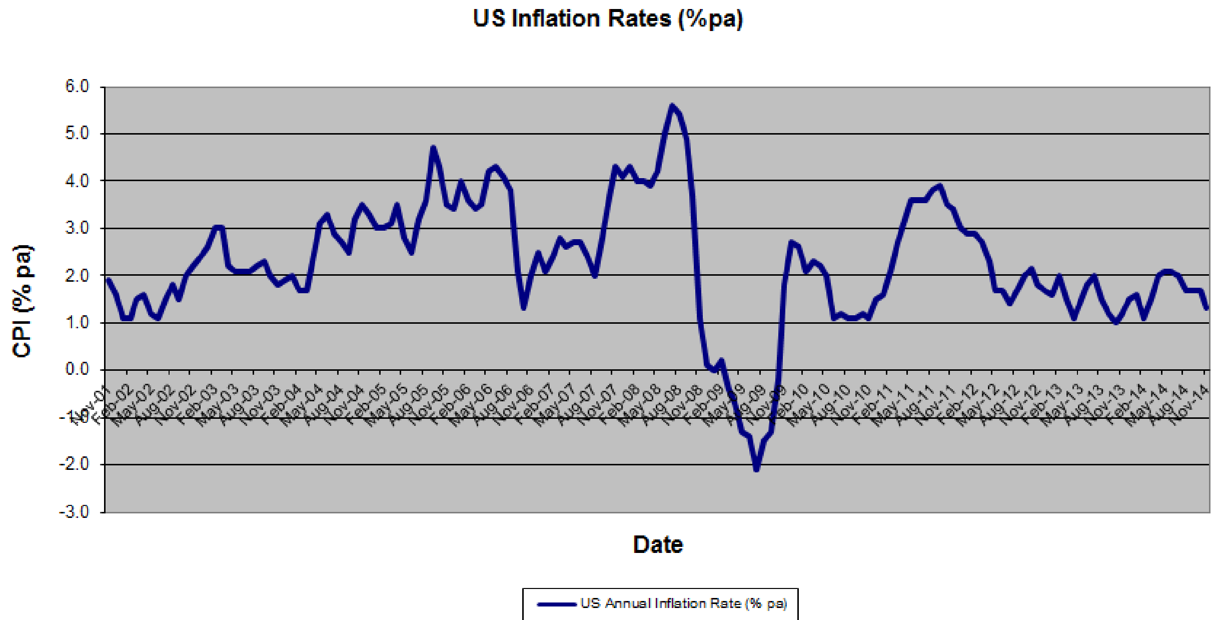
# Major Economic Indicators



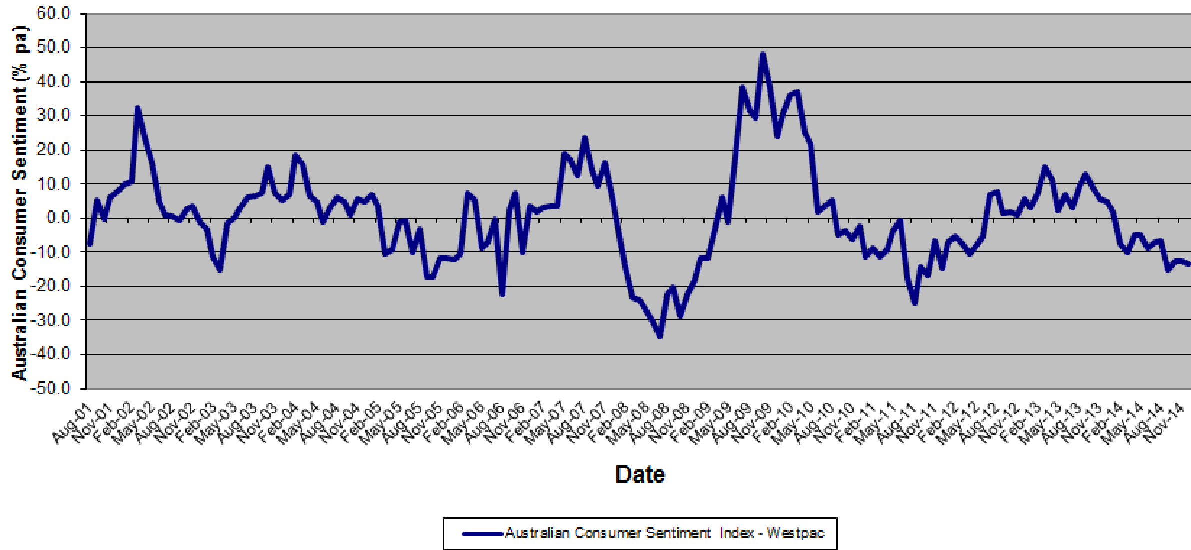



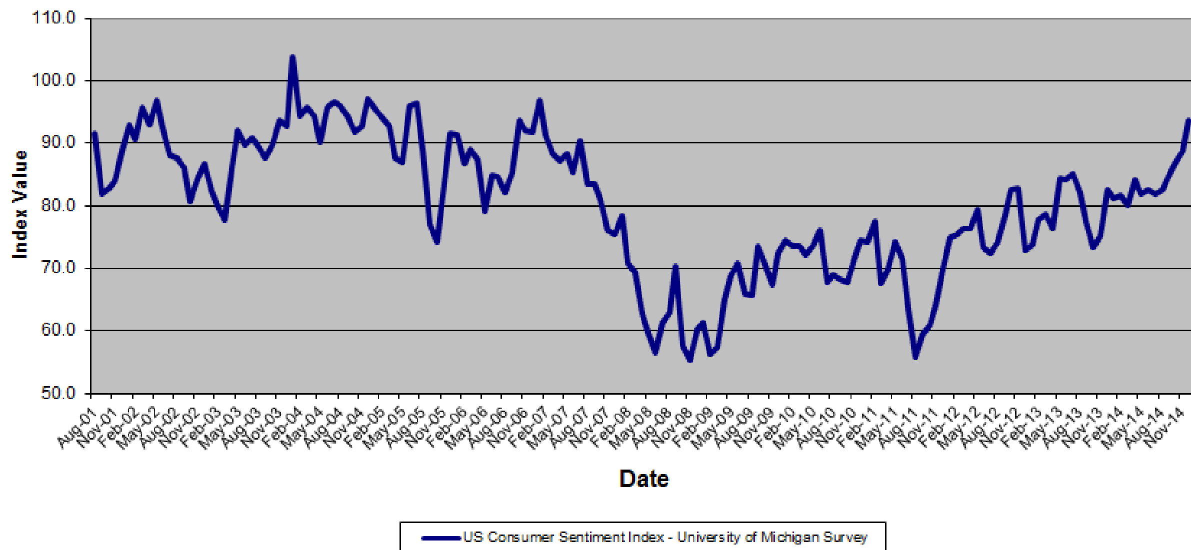

China GDP Growth Rates (%pa)
GDP (% pa)
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
Date
http://research.stlouisfed.org/fred...

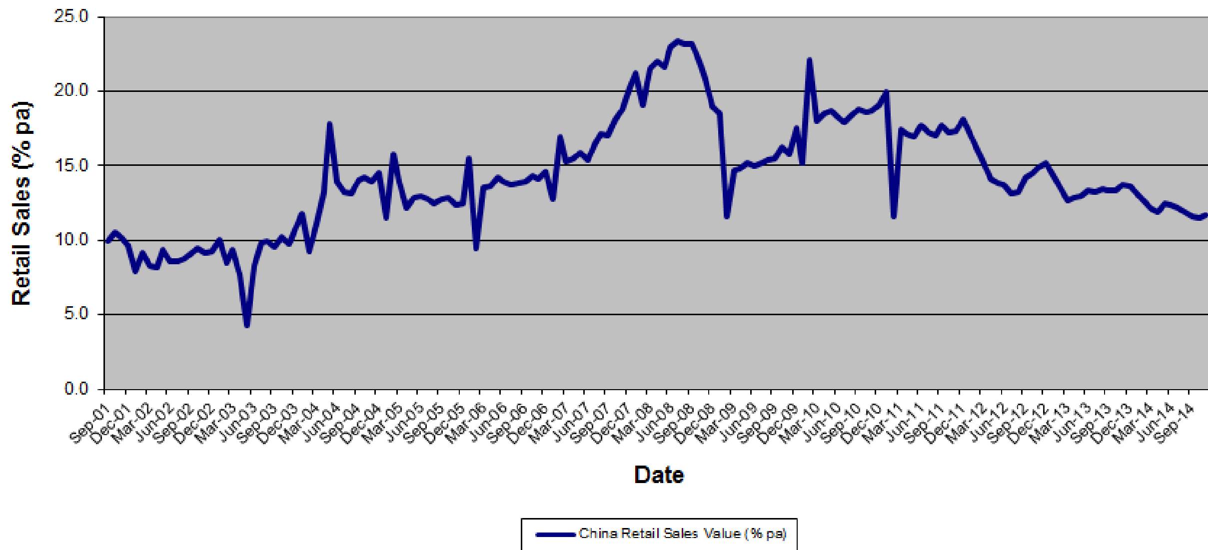

Australia Inflation Rates (%pa)
CPI (% pa)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Date
Australia Annual Inflation Rate (% pa)

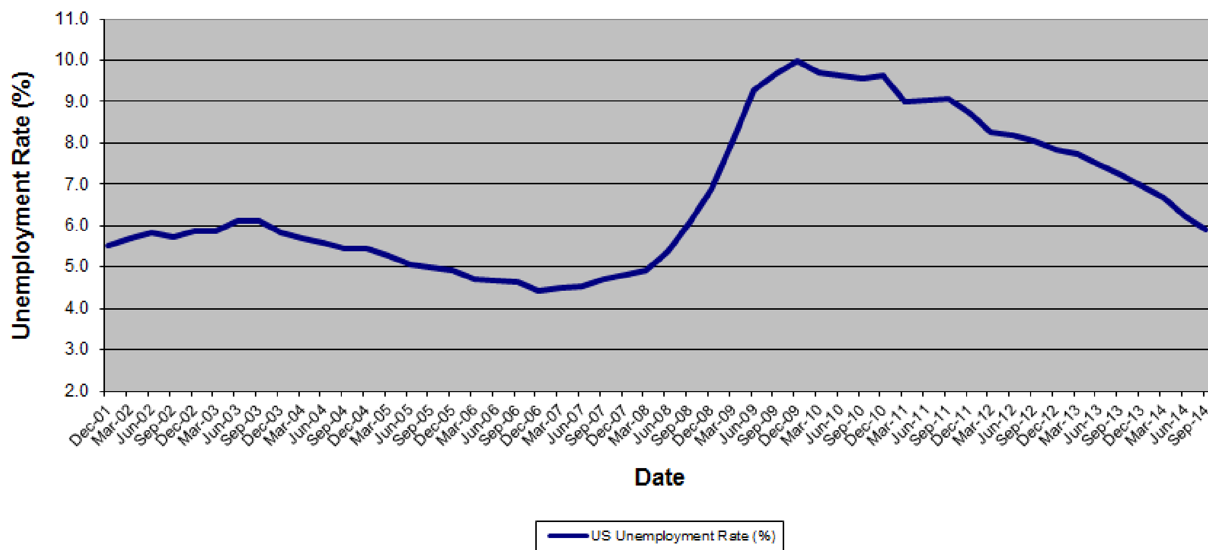

US Inflation Rates (%pa)
CPI (% pa)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-2.0
-3.0
Date
US Annual Inflation Rate (% pa)

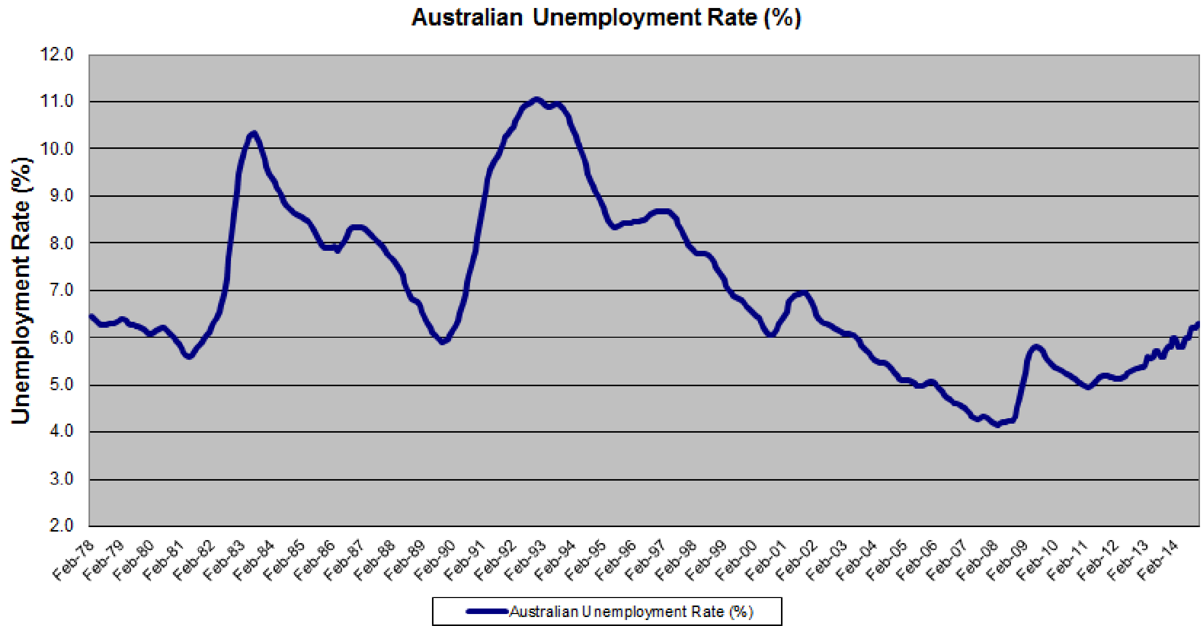
China Inflation Rates (%pa)
CPI (% pa)
10.0
8.0
6.0
4.0
2.0
0.0
-4.0
Date
China Annual Inflation Rate (% pa)


Australian Consumer Sentiment Index - Westpac
Australian Consumer Sentiment (% pa)
60.0
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
-30.0
-40.0
-50.0
Aug-01 Nov-01 Feb-02 May-02 Aug-02 Nov-02 Feb-03 May-03 Aug-03 Nov-03 Feb-04 May-04 Aug-04 Nov-04 Feb-05 May-05 Aug-05 Nov-05 Feb-06 May-06 Aug-06 Nov-06 Feb-07 May-07 Aug-07 Nov-07 Feb-08 May-08 Aug-08 Nov-08 Feb-09 May-09 Aug-09 Nov-09 Feb-10 May-10 Aug-10 Nov-10 Feb-11 May-11 Aug-11 Nov-11 Feb-12 May-12 Aug-12 Nov-12 Feb-13 May-13 Aug-13 Nov-13 Feb-14 May-14 Aug-14 Nov-14
Date
Australian Consumer Sentiment Index - Westpac


US Consumer Sentiment Index - University of Michigan Survey
Index Value
110.0
100.0
90.0
80.0
70.0
60.0
50.0
Aug-01 Nov-01 Feb-02 May-02 Aug-02 Nov-02 Feb-03 May-03 Aug-03 Nov-03 Feb-04 May-04 Aug-04 Nov-04 Feb-05 May-05 Aug-05 Nov-05 Feb-06 May-06 Aug-06 Nov-06 Feb-07 May-07 Aug-07 Nov-07 Feb-08 May-08 Aug-08 Nov-08 Feb-09 May-09 Aug-09 Nov-09 Feb-10 May-10 Aug-10 Nov-10 Feb-11 May-11 Aug-11 Nov-11 Feb-12 May-12 Aug-12 Nov-12 Feb-13 May-13 Aug-13 Nov-13 Feb-14 May-14 Aug-14 Nov-14
Date
US Consumer Sentiment Index - University of Michigan Survey


China Retail Sales Value (%pa)
Retail Sales (% pa)
25.0
20.0
15.0
10.0
5.0
0.0
Sep-01 Dec-01 Mar-02 Jun-02 Sep-02 Dec-02 Mar-03 Jun-03 Sep-03 Dec-03 Mar-04 Jun-04 Sep-04 Dec-04 Mar-05 Jun-05 Sep-05 Dec-05 Mar-06 Jun-06 Sep-06 Dec-06 Mar-07 Jun-07 Sep-07 Dec-07 Mar-08 Jun-08 Sep-08 Dec-08 Mar-09 Jun-09 Sep-09 Dec-09 Mar-10 Jun-10 Sep-10 Dec-10 Mar-11 Jun-11 Sep-11 Dec-11 Mar-12 Jun-12 Sep-12 Dec-12 Mar-13 Jun-13 Sep-13 Dec-13 Mar-14 Jun-14 Sep-14
Date
China Retail Sales Value (% pa)


US Unemployment Rate (%)
Unemployment Rate (%)
11.0
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
Dec-01 Mar-02 Jun-02 Sep-02 Dec-02 Mar-03 Jun-03 Sep-03 Dec-03 Mar-04 Jun-04 Sep-04 Dec-04 Mar-05 Jun-05 Sep-05 Dec-05 Mar-06 Jun-06 Sep-06 Dec-06 Mar-07 Jun-07 Sep-07 Dec-07 Mar-08 Jun-08 Sep-08 Dec-08 Mar-09 Jun-09 Sep-09 Dec-09 Mar-10 Jun-10 Sep-10 Dec-10 Mar-11 Jun-11 Sep-11 Dec-11 Mar-12 Jun-12 Sep-12 Dec-12 Mar-13 Jun-13 Sep-13 Dec-13 Mar-14 Jun-14 Sep-14
Date
US Unemployment Rate (%)


Australian Unemployment Rate (%)
Unemployment Rate (%)
12.0
11.0
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
Feb-78
Feb-79
Feb-80
Feb-81
Feb-82
Feb-83
Feb-84
Feb-85
Feb-86
Feb-87
Feb-88
Feb-89
Feb-90
Feb-91
Feb-92
Feb-93
Feb-94
Feb-95
Feb-96
Feb-97
Feb-98
Feb-99
Feb-00
Feb-01
Feb-02
Feb-03
Feb-04
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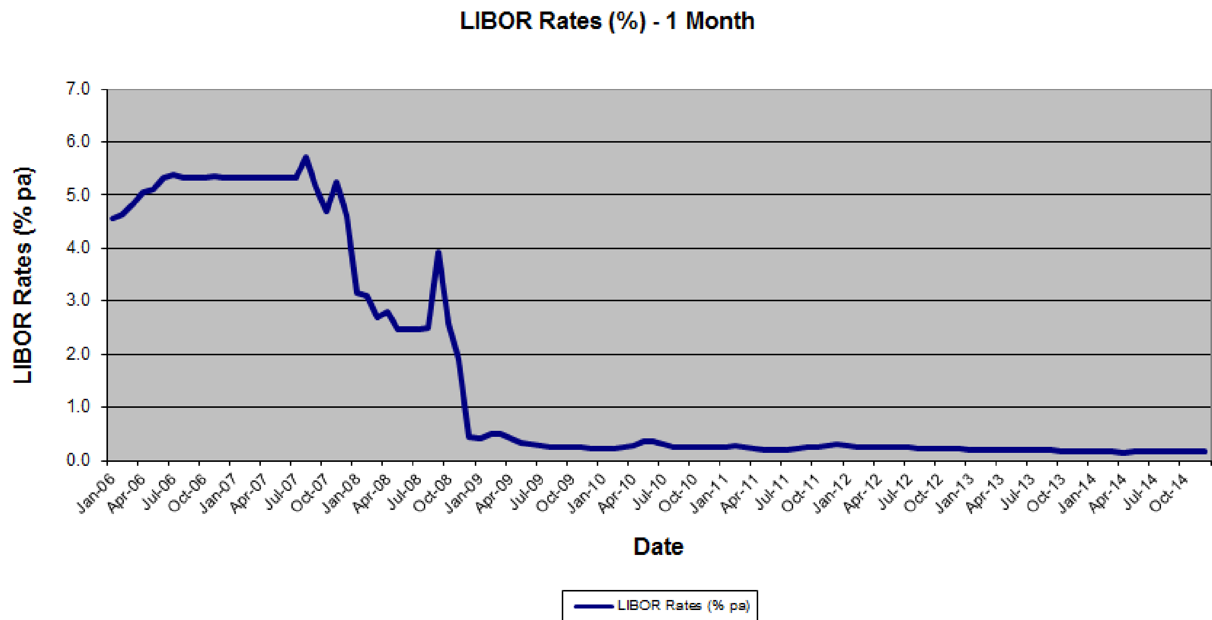
Feb-08
Feb-09
Feb-10
Feb-11
Feb-12
Feb-13
Feb-14
Australian Unemployment Rate (%)


LIBOR Rates (%) - 1 Month
LIBOR Rates (% pa)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Jan-06
Apr-06
Jul-06
Oct-06
Jan-07
Apr-07
Jul-07
Oct-07
Jan-08
Apr-08
Jul-08
Oct-08
Jan-09
Apr-09
Jul-09
Oct-09
Jan-10
Apr-10
Jul-10
Oct-10
Jan-11
Apr-11
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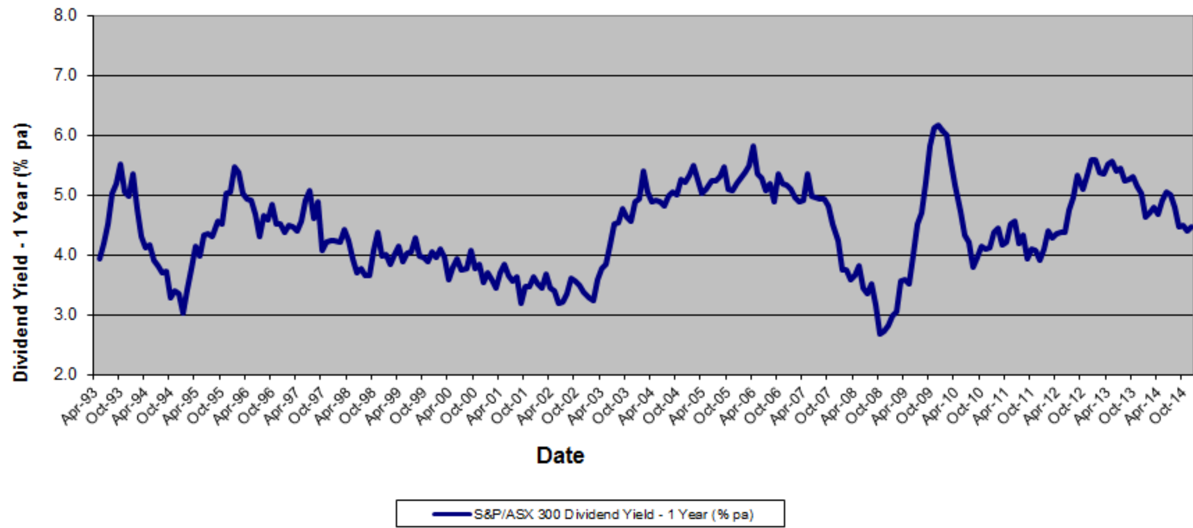
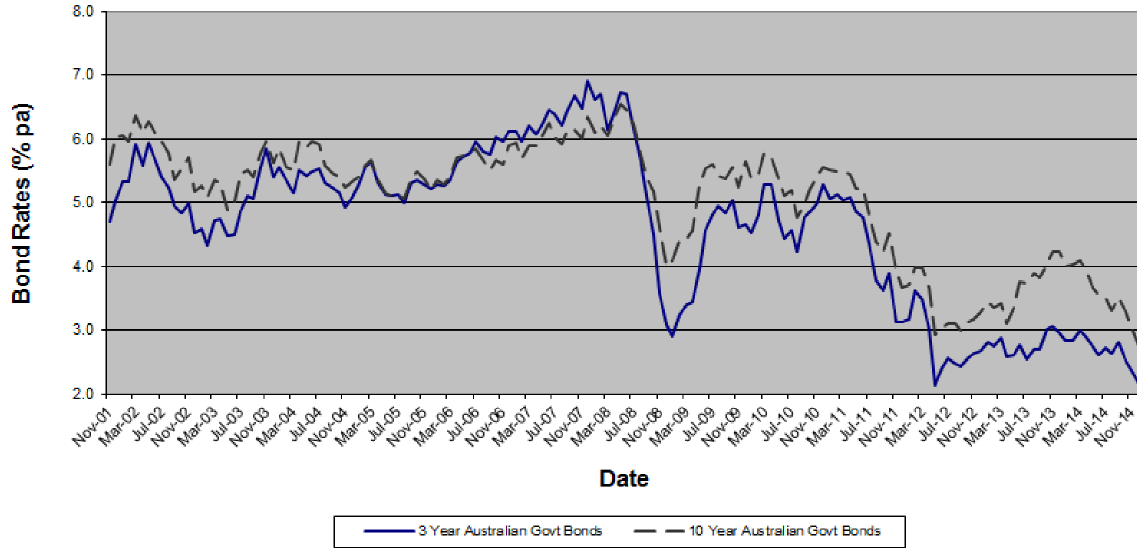
Oct-11
Jan-12
Apr-12
Jul-12
Oct-12
Jan-13
Apr-13
Jul-13
Oct-13
Jan-14
Apr-14
Jul-14
Oct-14
Date
LIBOR Rates (% pa)

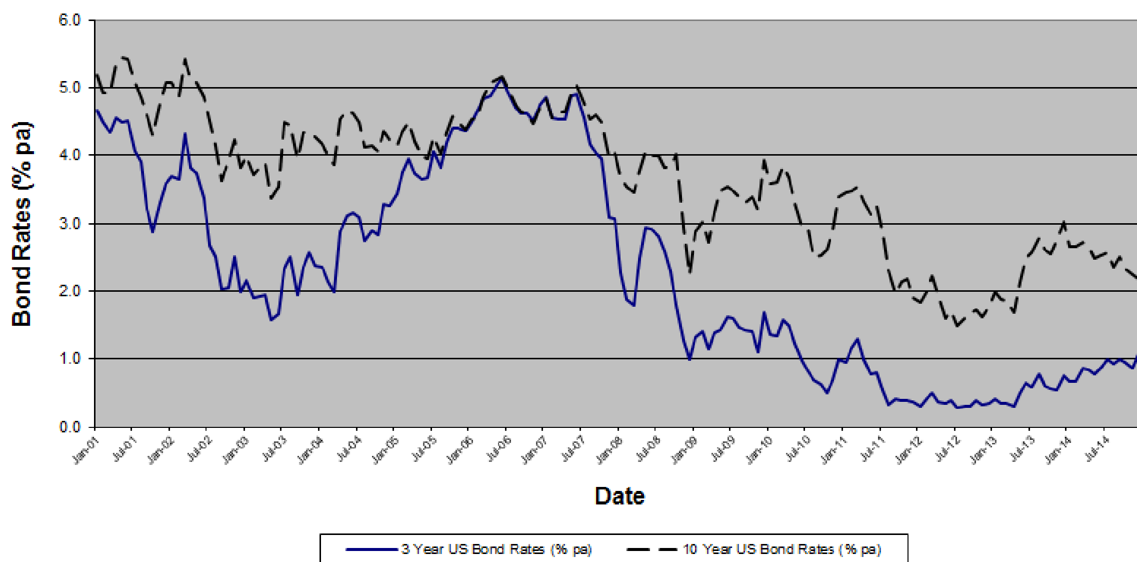


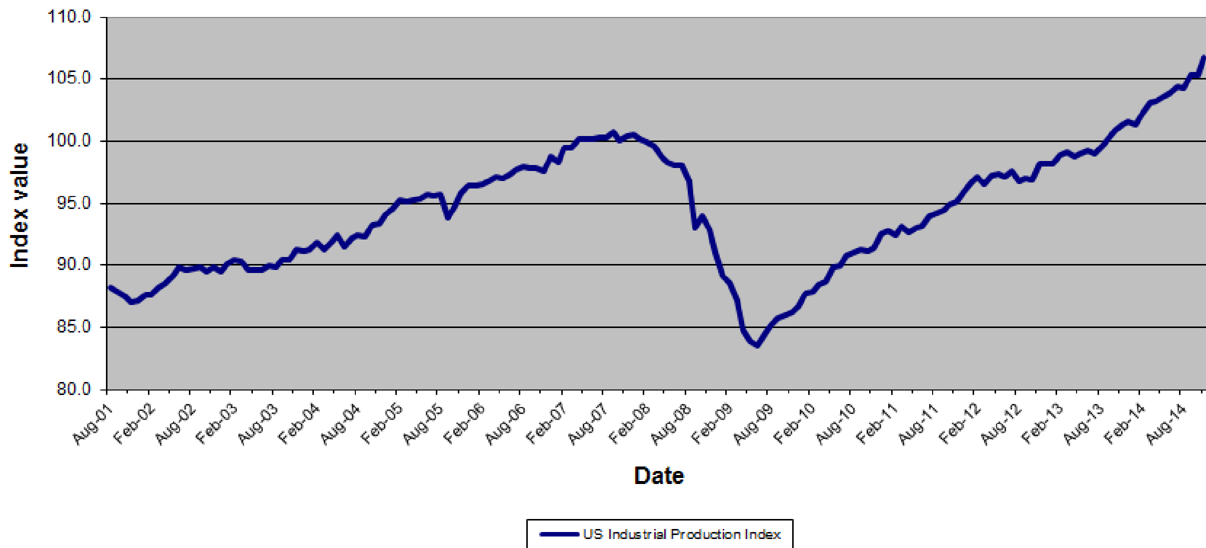
Source: UBS Australia and Reserve Bank of Australia as at 19 August 2014.

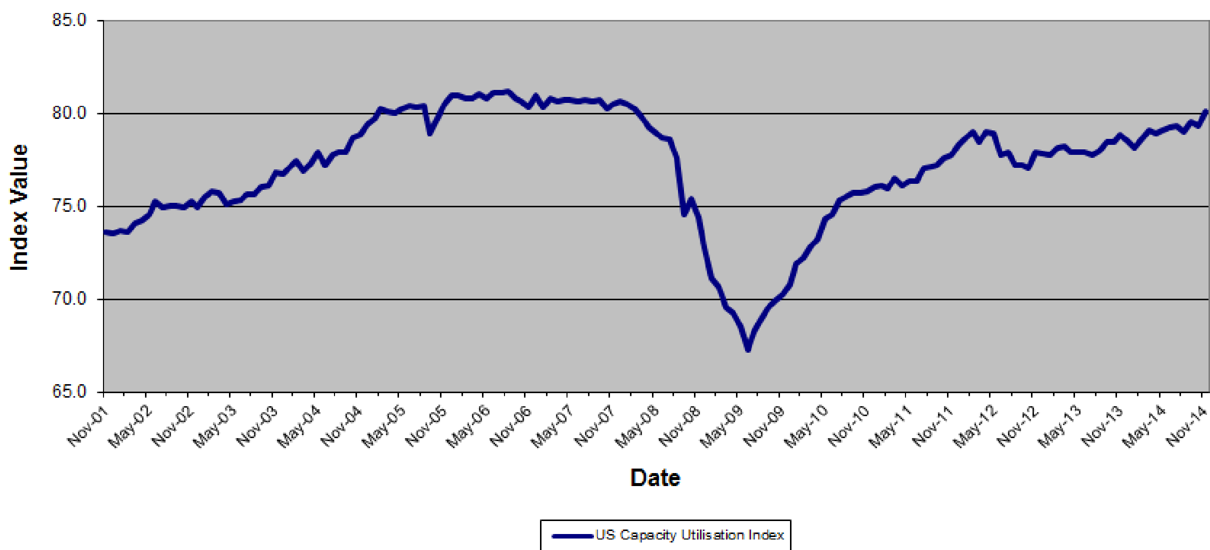
3y and 10y Australian Bond Rates (%)




3y and 10y US Bond Rates (%)




US Industrial Production Index
Index value
110.0
105.0
100.0
95.0
90.0
85.0
80.0
Aug-01
Feb-02
Aug-02
Feb-03
Aug-03
Feb-04
Aug-04
Feb-05
Aug-05
Feb-06
Aug-06
Feb-07
Aug-07
Feb-08
Aug-08
Feb-09
Aug-09
Feb-10
Aug-10
Feb-11
Aug-11
Feb-12
Aug-12
Feb-13
Aug-13
Feb-14
Aug-14
Date
US Industrial Production Index


US Capacity Utilisation Index
Index Value
85.0
80.0
75.0
70.0
65.0
Nov-01
May-02
Nov-02
May-03
Nov-03
May-04
Nov-04
May-05
Nov-05
May-06
Nov-06
May-07
Nov-07
May-08
Nov-08
May-09
Nov-09
May-10
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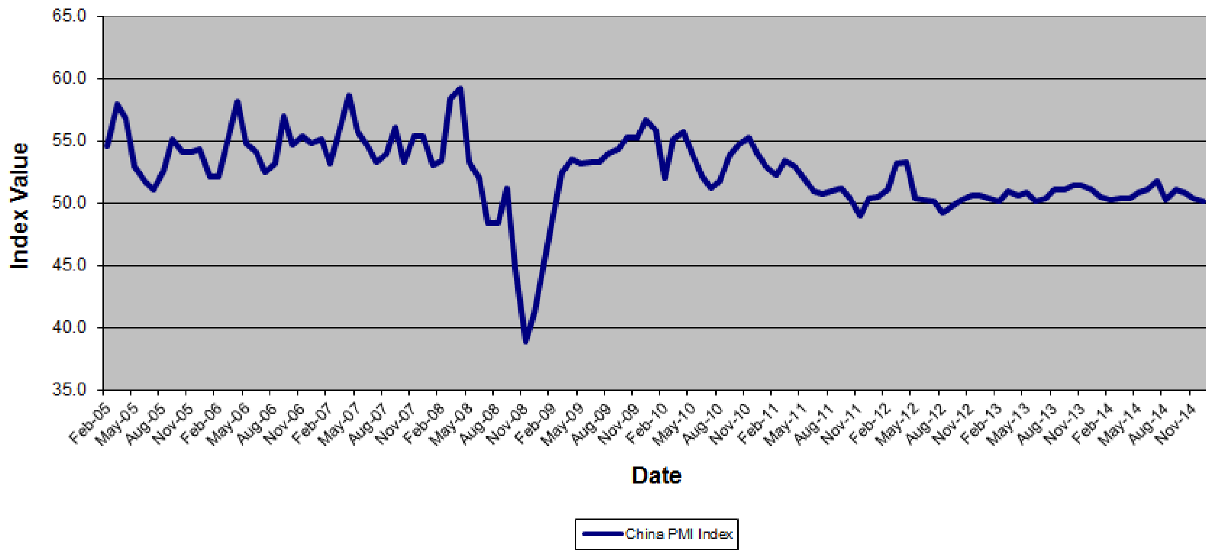
Nov-12
May-13
Nov-13
May-14
Nov-14
Date
US Capacity Utilisation Index


China Purchasing Managers Index (PMI)
Index Value
65.0
60.0
55.0
50.0
45.0
40.0
35.0
Feb-05
May-05
Aug-05
Nov-05
Feb-06
May-06
Aug-06
Nov-06
Feb-07
May-07
Aug-07
Nov-07
Feb-08
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May-12
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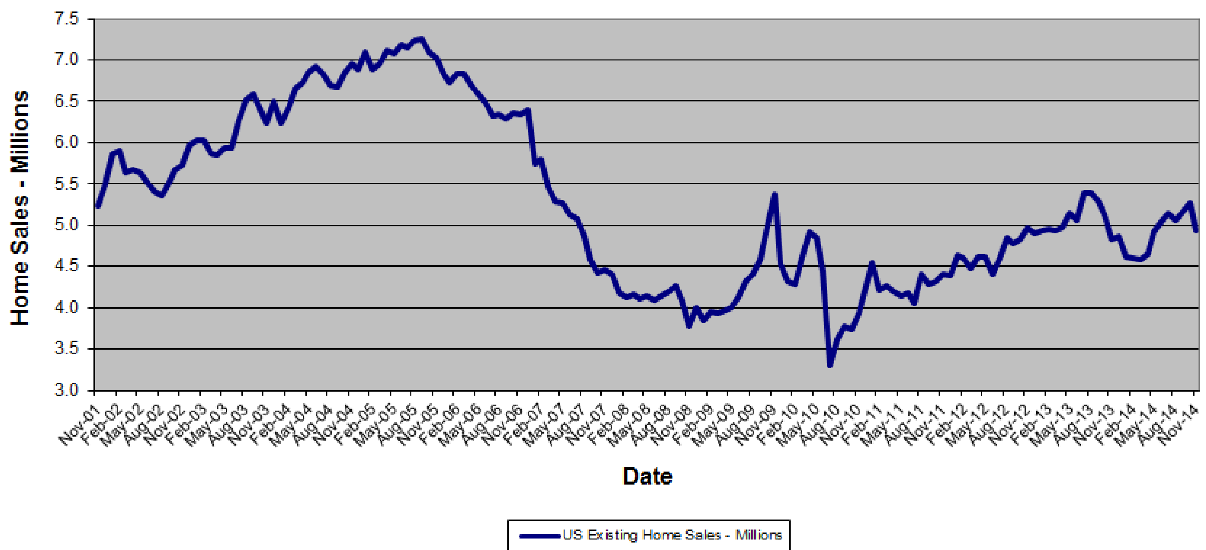
Nov-14
Date
China PMI Index


US Existing Home Sales - Millions
Home Sales - Millions
7.5
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
Nov-01
Feb-02
May-02
Aug-02
Nov-02
Feb-03
May-03
Aug-03
Nov-03
Feb-04
May-04
Aug-04
Nov-04
Feb-05
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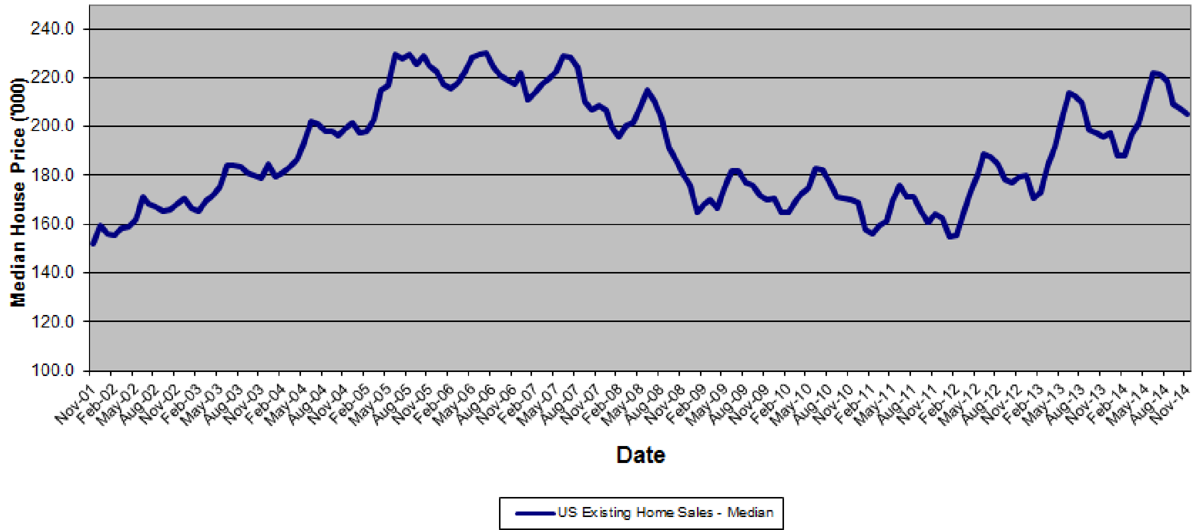
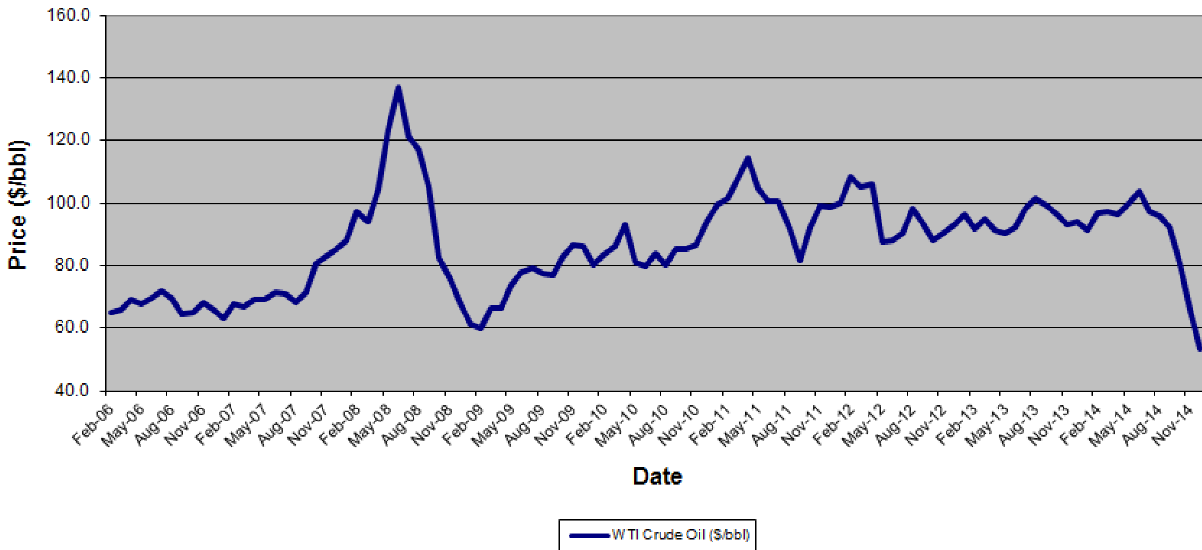
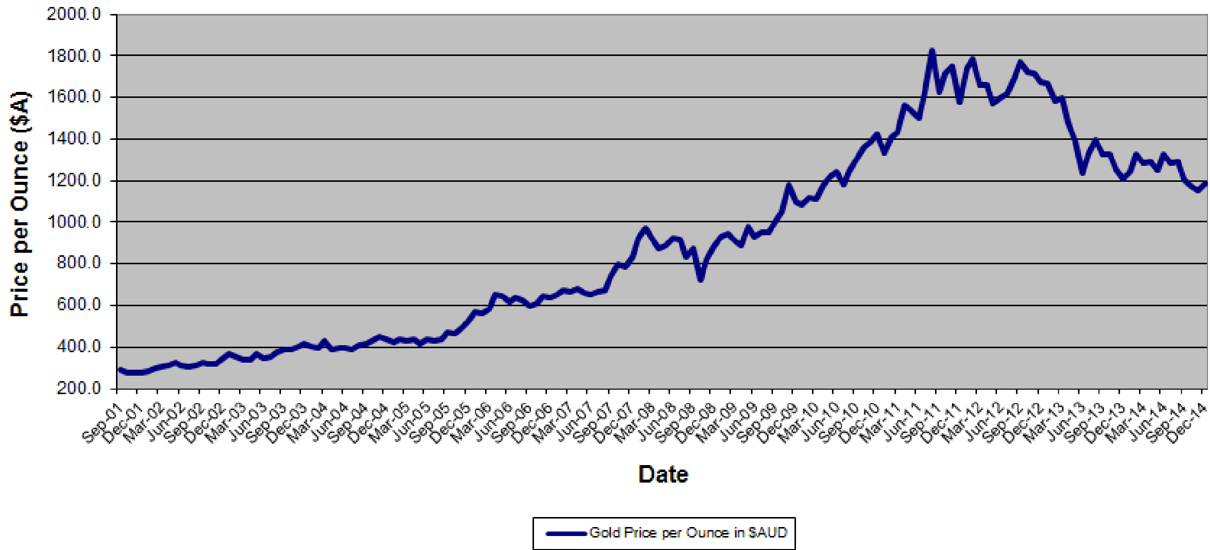
Feb-13
May-13
Aug-13
Nov-13
Feb-14
May-14
Aug-14
Nov-14
Date
US Existing Home Sales - Millions

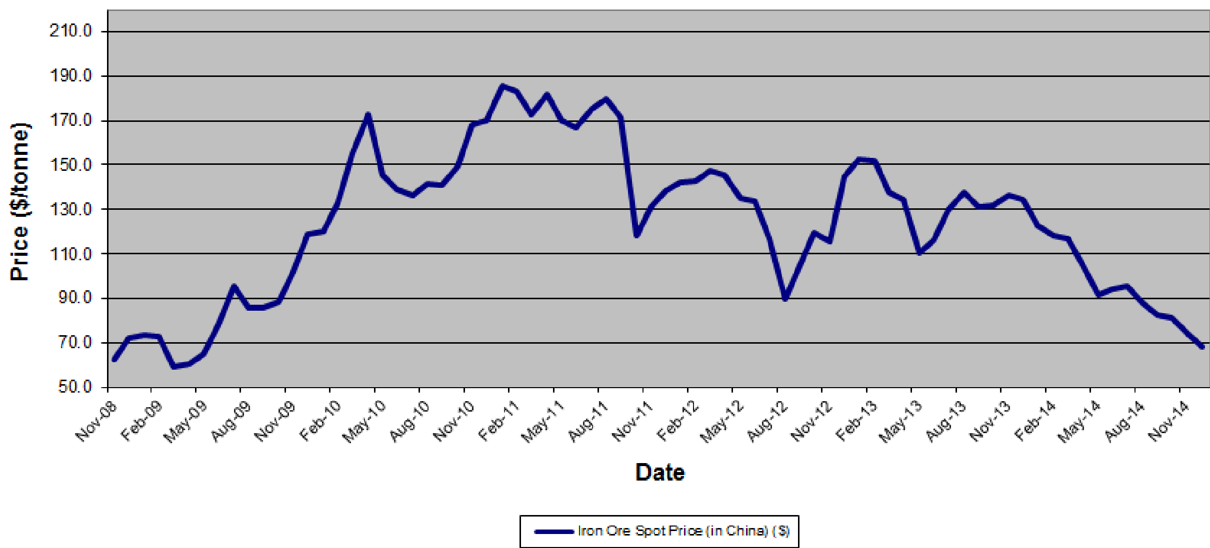
US Existing Home Sales - Median

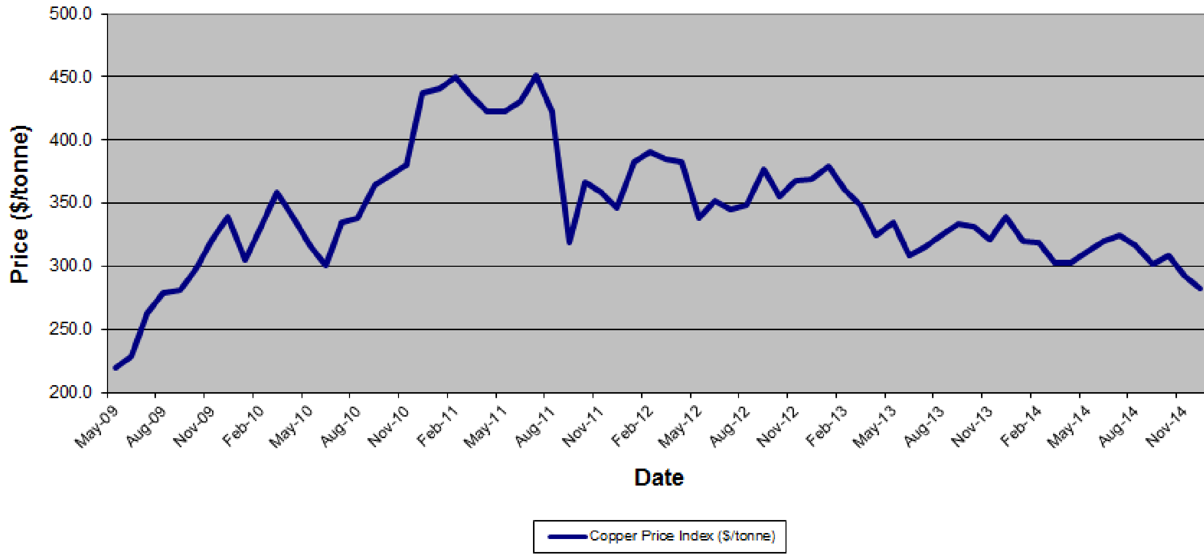


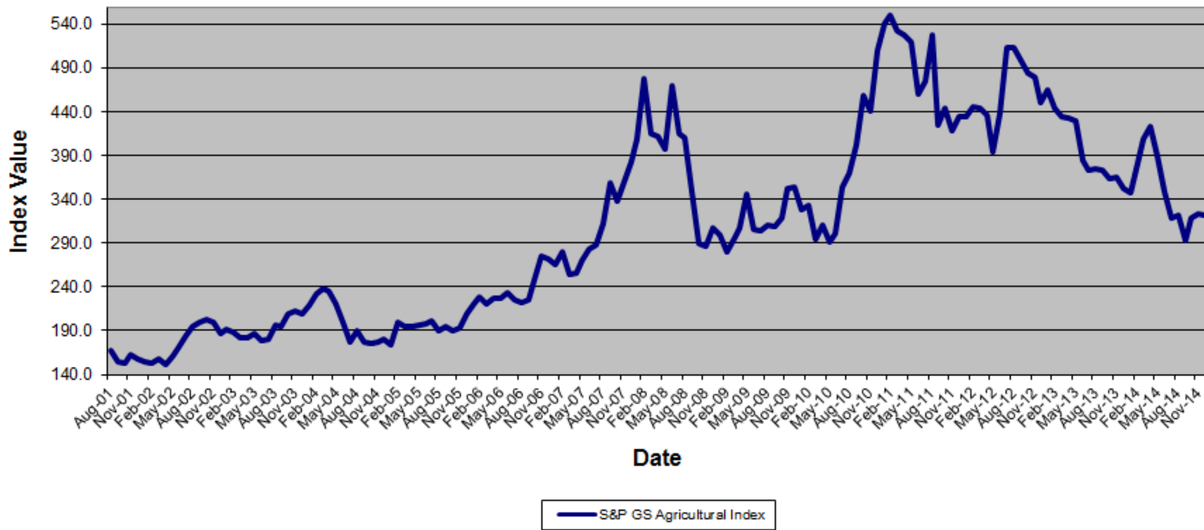

WTI Crude Oil ($/bbl)

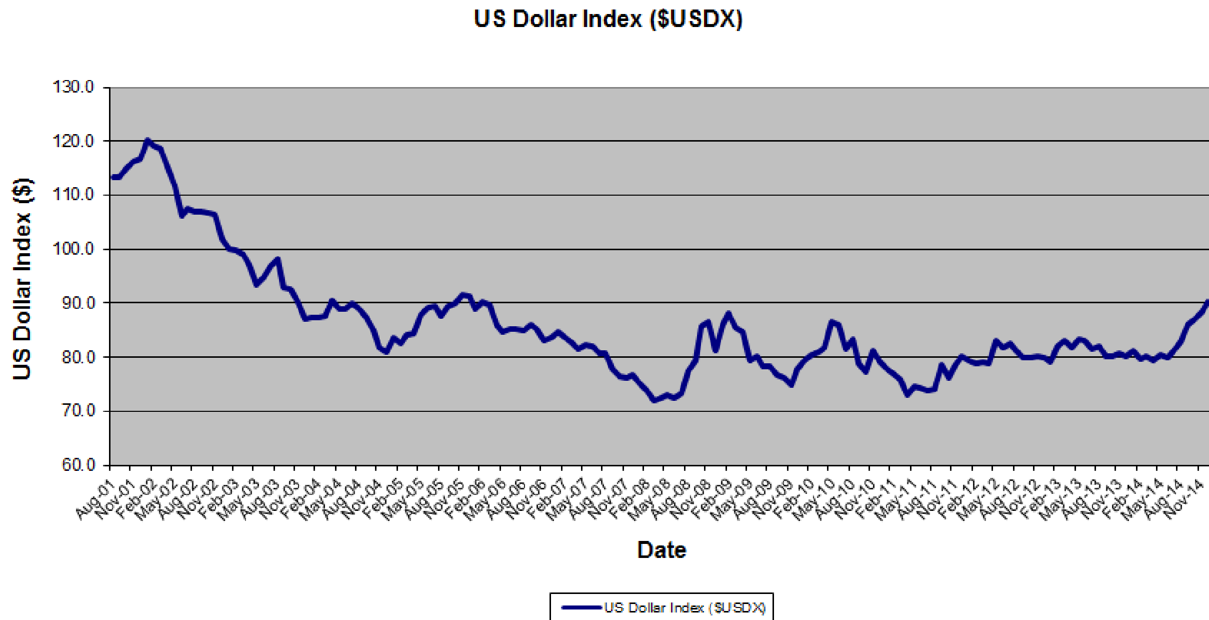



Gold Price per Ounce in $AUD
Price per Ounce ($A)
2000.0
1800.0
1600.0
1400.0
1200.0
1000.0
800.0
600.0
400.0
200.0
Date
Gold Price per Ounce in $AUD


Iron Ore Spot Price (in China) ($/tonne)
Price ($/tonne)
210.0
190.0
170.0
150.0
130.0
110.0
90.0
70.0
50.0
Nov-08
Feb-09
May-09
Aug-09
Nov-09
Feb-10
May-10
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
May-14
Aug-14
Nov-14
Date
Iron Ore Spot Price (in China) ($)


Copper Price Index ($/tonne)
Price ($/tonne)
500.0
450.0
400.0
350.0
300.0
250.0
200.0
May-09
Aug-09
Nov-09
Feb-10
May-10
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
May-14
Aug-14
Nov-14
Date
Copper Price Index ($/tonne)


S&P Goldman Sachs Agricultural Index
Index Value
540.0
490.0
440.0
390.0
340.0
290.0
240.0
190.0
140.0
Aug-01
Nov-01
Feb-02
May-02
Aug-02
Nov-02
Feb-03
May-03
Aug-03
Nov-03
Feb-04
May-04
Aug-04
Nov-04
Feb-05
May-05
Aug-05
Nov-05
Feb-06
May-06
Aug-06
Nov-06
Feb-07
May-07
Aug-07
Nov-07
Feb-08
May-08
Aug-08
Nov-08
Feb-09
May-09
Aug-09
Nov-09
Feb-10
May-10
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
May-14
Aug-14
Nov-14
Date
S&P GS 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%).