

Economic and Market Commentary March 2014

A major focus in recent months has been on emerging markets with investors withdrawing capital. Emerging markets equities fund outflows from 1st January to early March have been US\$34.7 billion and are higher than for the total of calendar 2013, US\$ 26.7 billion. Heightened volatility has been caused by concerns surrounding the emerging world, reflecting political and currency problems in a number of countries including Turkey, Argentina, Brazil, South Africa and the Ukraine as well as concerns about Chinese growth. The concerns largely reflect the unknown consequences of unwinding the US stimulus (QE3) which has had significant flow on effects to the developing economies.

Investment sentiment in 2014 continues to favour growth assets over defensive/income assets as record low interest rates in the developed economies and continued stimulus, although at a reducing level in the US should be the catalyst to support the "risk on" environment. This environment supports increased liquidity, which should continue to drive equities investing. Of increasing concern is that many of the markets are bordering on fair value to over-valued, which is likely to add to increased volatility over the year ahead. The US Fed is providing forward guidance of the strategy put in place by Bernanke, which is to withdraw the stimulus in an accommodative manner with interest rates remaining low for a considerable period. Growth markets are likely to rely on global growth increasing during the year, which should continue to underpin company earnings. The International Monetary Fund's latest forecast for global growth is for 3.7% for 2014.

While every cycle comes to an end and a return to normality in markets should eventually occur. However, the recent history of QE3 and the massive stimulus being undertaken in Japan and likely to be undertaken in Europe, suggests that "normal" may not occur across world markets for quite a while longer.

Parts of the emerging and Asian economies now need to adjust to the more volatile environment and are likely to underperform over the coming months. The Latin American region is undergoing a prolonged period of weakness largely due to softening commodity prices and higher inflation. Other emerging market countries are being embroiled in political issues with Ukraine, Russia and Turkey being the most affected.

China continues to be a major contributor to world growth. The Chinese leadership is starting to implement an ambitious reform agenda and is seeking to balance a transition from infrastructure investment spending to an increased consumption spending focus. This process is difficult to undertake while maintaining the required growth to drive the underlying economy. As a result they are placing more pressure on industries including steel/iron ore, cement and solar industries which is starting to have an effect on the Australian exporters where China now takes 37% of Australia's exports. The performance of China's economy directly impacts Australia.

The Japanese equities market continues to perform on the back of the large QE stimulus being implemented by Prime Minister Shinzo Abe who is embarking on an ambitious growth strategy. He is now undertaking 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 continue to drive down the currency and boost export earnings, which is starting to occur although it will undergo periods of volatility. Japanese equities also continue to attract large flows. A major fiscal reform is planned to be introduced in April where value added taxes are scheduled to be increased which should provide an indication as to the progress Japan is making in its recovery.

The Eurozone has been laying the foundations for recovery with most countries moving out of recession, although there is little growth being generated from the region. It is anticipated that growth is to be in the region of 1% for 2014. High debt burdens and high unemployment levels continue to be major issues for most Eurozone countries. The ECB is also watching for deflationary pressures as the region recovers.

The US economy continues to undergo recovery with promising signs of growth and increasing business confidence. Optimism is coming from a strengthening housing recovery, improving jobs market, access to cheap funds and a reinvigorated energy sector providing access to affordable energy. The housing recovery is likely to contribute strongly to US GDP in the coming year.

The quantitative easing programmes being undertaken by US, Europe and Japan continues to fuel the "risk on" approach by investors. However, markets are likely to remain volatile while uncertainty remains, with US bond

yields likely to increase in response to tapering. The Fed's message is "tapering of the stimulus is contingent on the economy improving in-line with forecasts, with no pre-set timetable for withdrawing the stimulus". The underlying fundamentals remain supportive for the US market and continue to support an overweight to global equities (unhedged).

Returns for bonds, both global and domestic remain low and unappealing. The RBA Cash rate remains at 2.5% and has provided strong support to the housing market. Rates are likely to remain on hold in order to stimulate a modest growth environment.

US 10 year bond yields have stabilised around the 2.8% region and with negative real interest rates for cash in most developed countries, this has led investors to seek higher yields from riskier assets, such as property, infrastructure and equities. Quality large cap companies that pay reliable dividends have benefited the most and are responsible for the strong returns seen across most equity markets of developed countries.

Inflation in the developed countries is benign, resulting in bonds now generating positive real rates (US 10 year bonds 2.8% and inflation 1%). The US unemployment rate is a major focus for the Fed and has now dropped below 7%.

In Australia, the construction industry has provided a boost to the housing sector with both the NSW and Victorian economies benefitting, whereas the resource states are being blunted by the wind back in mining sector capital expenditure. The combination of low interest rates and a lower A\$ is likely to drive a modest pickup in growth into next year. A lower trending A\$ is positive for exporters, manufacturers and tourism, which have suffered for the past few years. The Australian equities market has been boosted by a strong companies reporting period where earnings were generally in line or better than expectations, which is supporting the higher equities prices.

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 also offering better value and long term investors are being attracted to the market. Interest in listed REITs has also been solid as investors seek higher yielding investments.

- **International shares: [Overweight]** Sentiment in global equities markets remains positive providing opportunities for international shares to outperform in the coming year. A depreciating A\$ v US\$ (unhedged) is a further positive for international shares. An overweight position is appropriate for the sector. Japan also continues to provide opportunities. Emerging and Asian equities markets are not preferred in the current environment.
- **Australian shares: [Overweight] Australian Small Caps: [Neutral]** Opportunities are likely to arise over the coming year as the economy grows. 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 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 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 less attractive.

Risks

- 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.
- 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.
- 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 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 chose not 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.
- 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.
- With large US government debt levels (US\$17 trillion), strong political will is required to enact the necessary measures to reduce the debt levels. 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.
- 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. Chinese interest in Australian assets is increasing.
- 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.

Fixed Interest, Property and Infrastructure

- 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. Focus should be on the corporate bond sector.
- 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 Thirteen Months

Market Indices	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14
Intl-MSCI ex A A\$	1.90	0.61	3.54	8.84	2.31	7.45	-1.50	-0.06	2.55	5.69	4.44	-1.20	2.30
Aust - All Ords	5.18	-2.24	3.82	-4.39	-2.62	5.46	2.59	2.39	3.91	-1.38	0.92	-2.76	4.84
Aust - Small Coy	0.87	-3.33	-4.65	-3.82	-7.15	9.81	2.88	1.69	2.74	-5.23	2.55	-2.76	4.97
Aust Property ASX	3.53	-2.58	8.16	-3.66	-0.97	-0.70	-0.07	0.93	2.64	-2.73	-1.26	0.41	4.26
Global Property	1.72	3.46	5.94	-5.65	-2.76	1.18	-5.53	4.51	3.55	-3.59	0.16	2.45	4.75

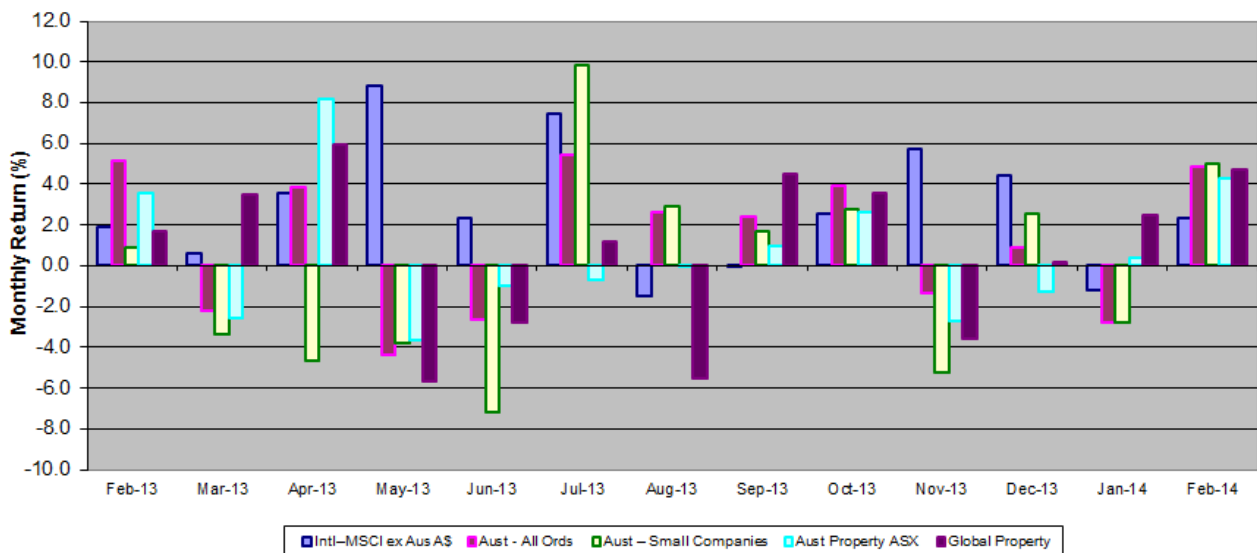
Annual Share Market Performance

Markets Index	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 30 Sep 13 %	1 Year to 31 Dec 13 %	1 Year to 28 Feb 14 %
Intl-MSCI ex A A\$	-5.34	0.69	-0.50	13.59	14.14	10.76	33.10	34.02	48.03	40.38
Aust - All Ords	-11.43	-6.27	-7.04	13.36	18.84	17.80	20.67	23.55	19.66	10.37
Aust - Small Coy	-21.43	-8.57	-14.61	3.83	6.58	-5.82	-5.32	1.42	-0.76	-3.62
Aust Prop - ASX	-1.56	1.67	10.98	28.90	32.79	30.52	23.98	16.39	7.27	3.90
Global Property	1.94	8.40	6.93	30.54	26.29	22.57	15.46	11.46	5.84	7.80

Best Performing Asset Sectors for twelve months ended 28 February 2014

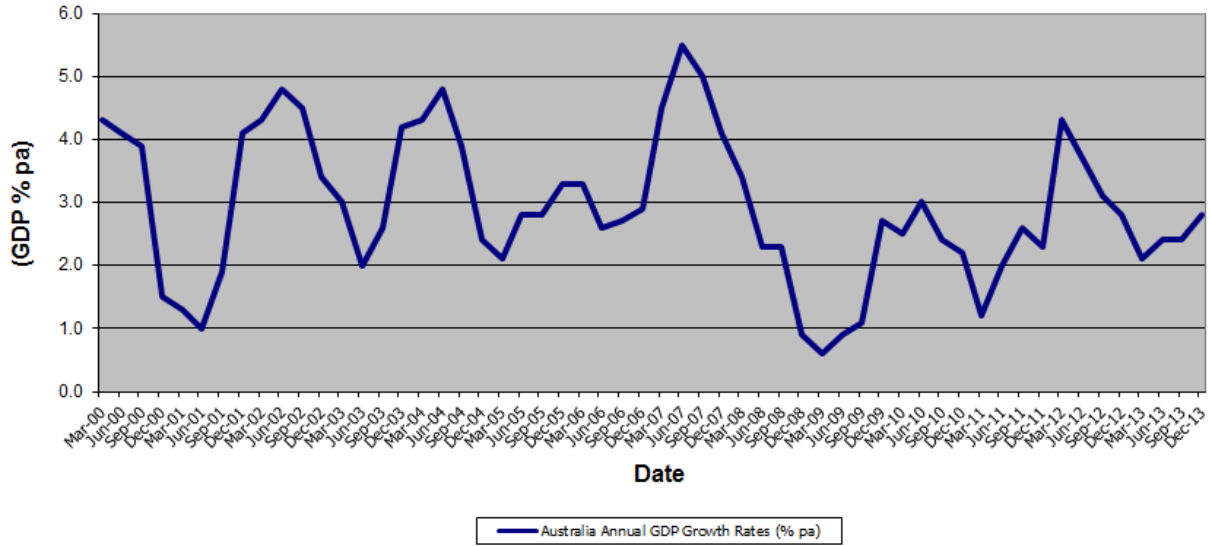
Sector	Market Index	Return
International Equities Unhedged	MSCI World Ex Aust Accum Index A\$	40.38
International Equities Hedged	MSCI World Accum Index Hedged A\$	24.99
Australian Shares	S&P/ASX All Ords Accum Index	10.37
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge \$A	7.80
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged \$A	4.02
Aust Listed Property	S&P/ASX Property Trusts Accum Index	3.90
Australian Fixed Interest	UBS Warburg Composite 0 + Years	3.07
Cash	Australian 90 Day Bank Accepted Bill	2.79
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	-3.62

Market Indices - Monthly Returns (%)

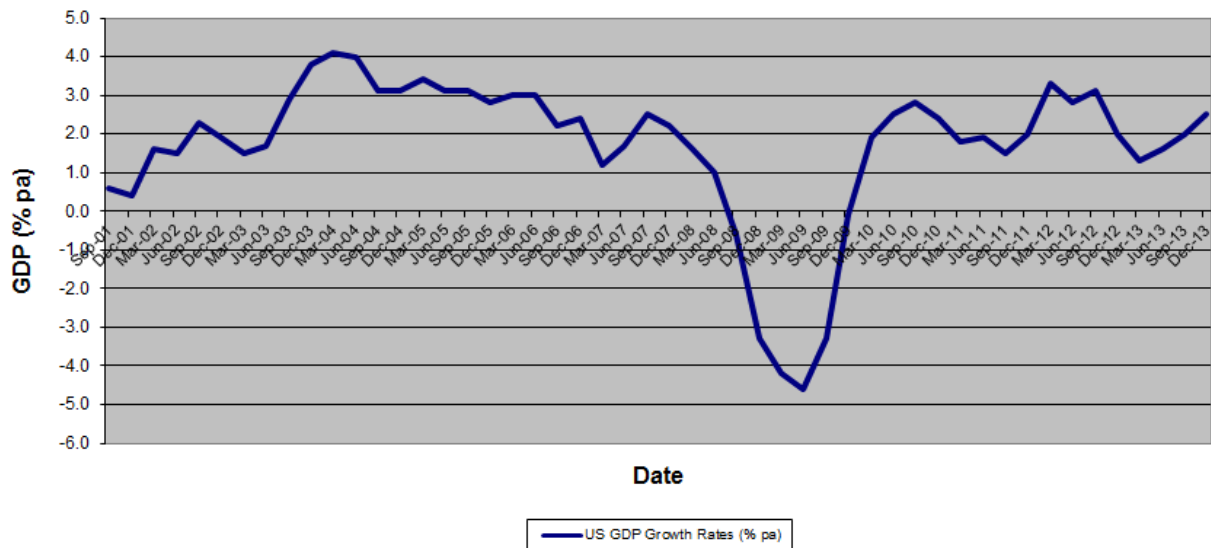


Major Economic Indicators

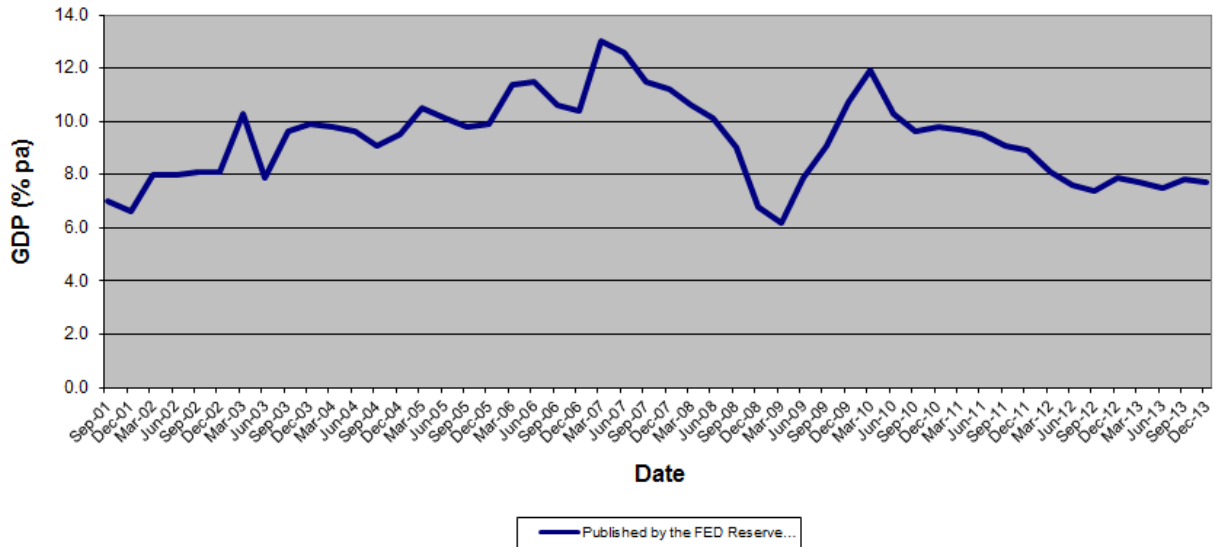
Australia GDP Growth Rates (%pa)



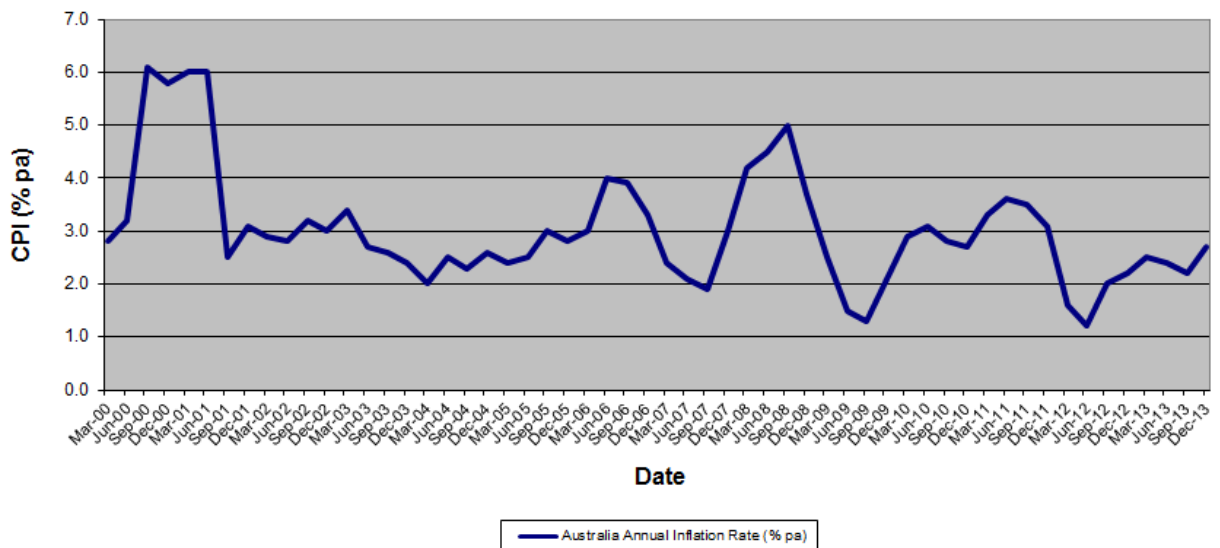
US GDP Growth Rates (%pa)

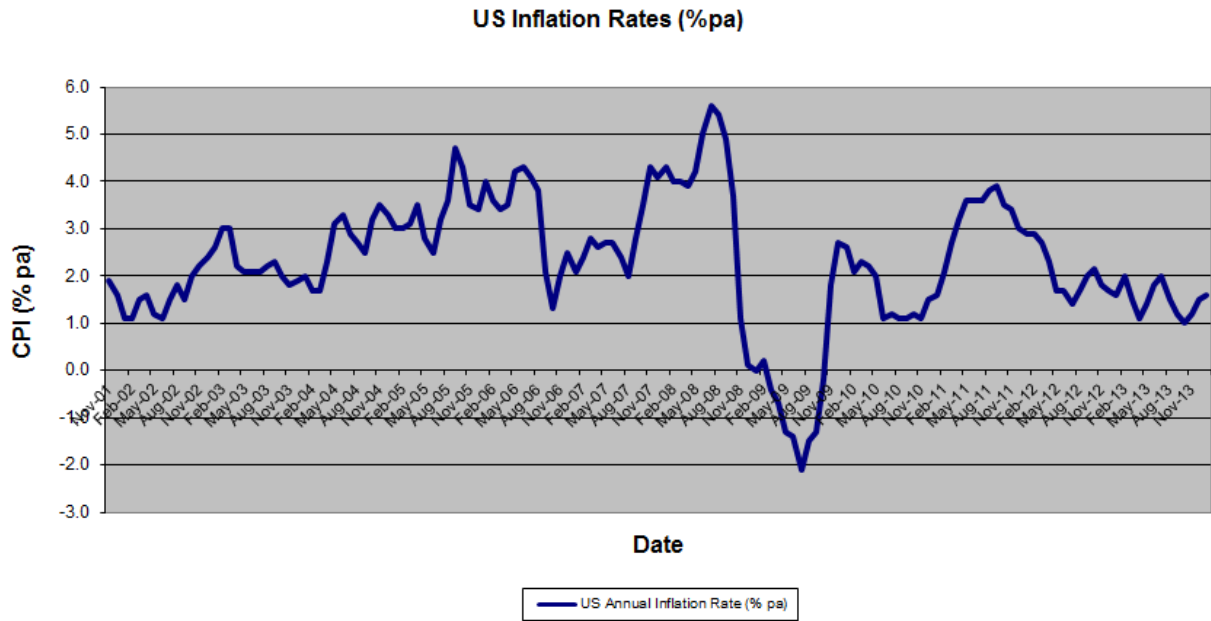


China GDP Growth Rates (%pa)

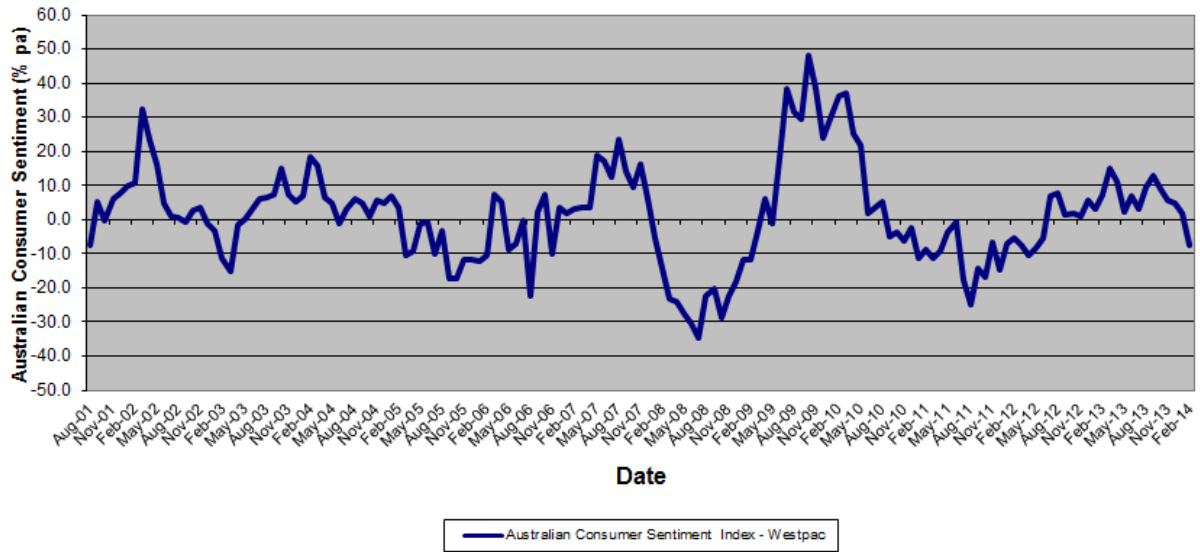


Australia Inflation Rates (%pa)

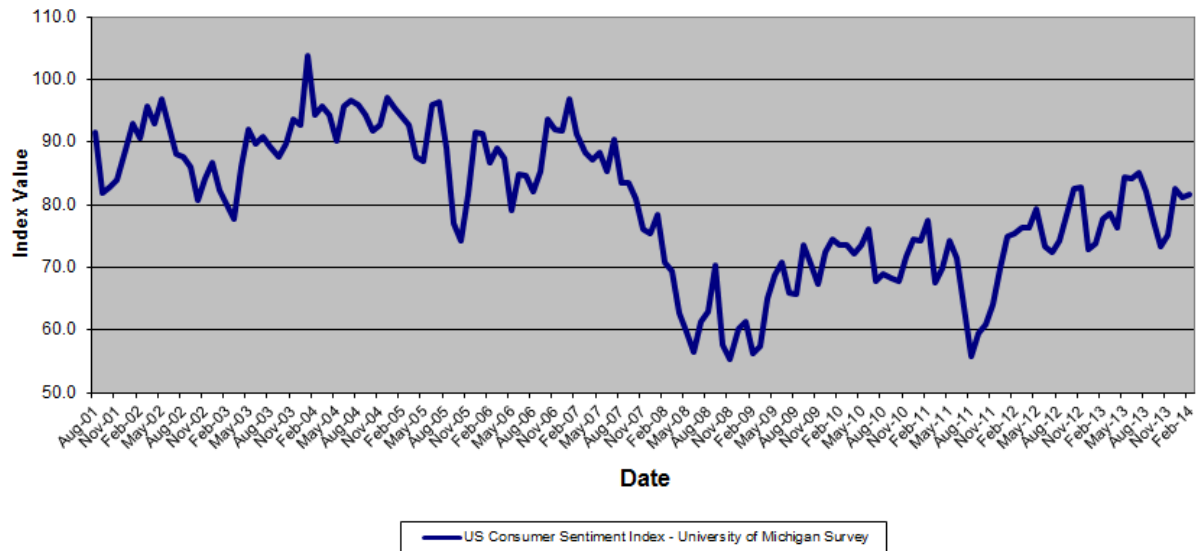




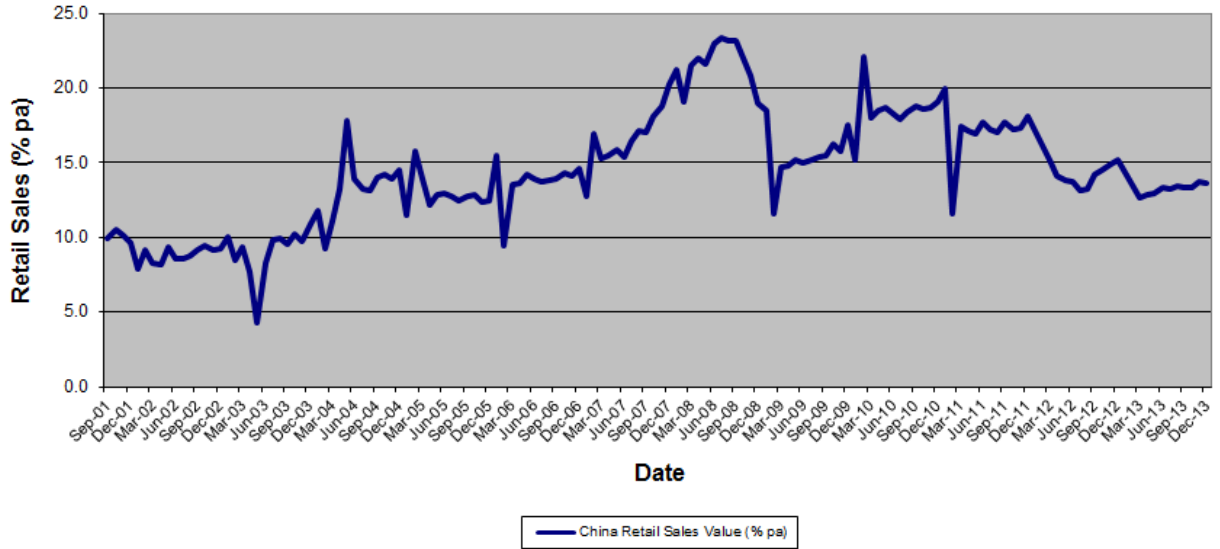
Australian Consumer Sentiment Index - Westpac



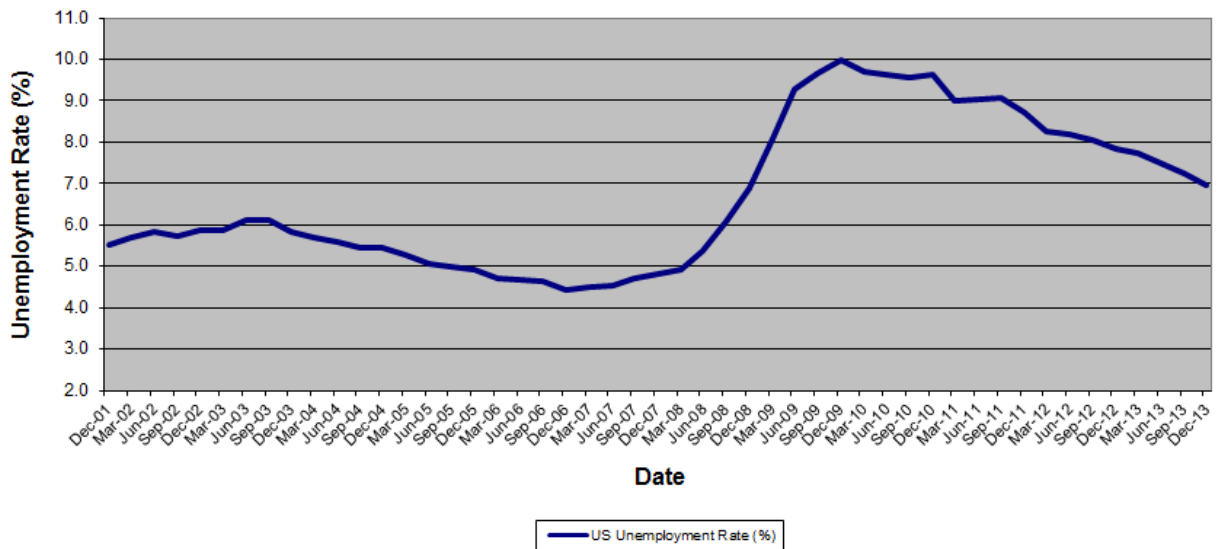
US Consumer Sentiment Index - University of Michigan Survey

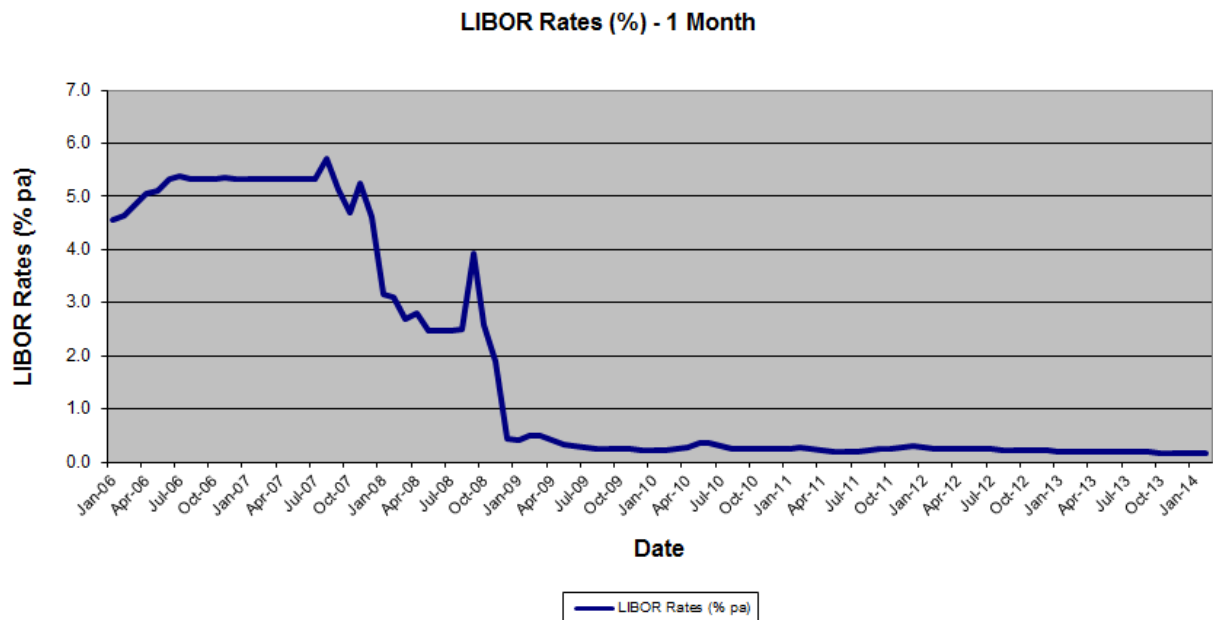
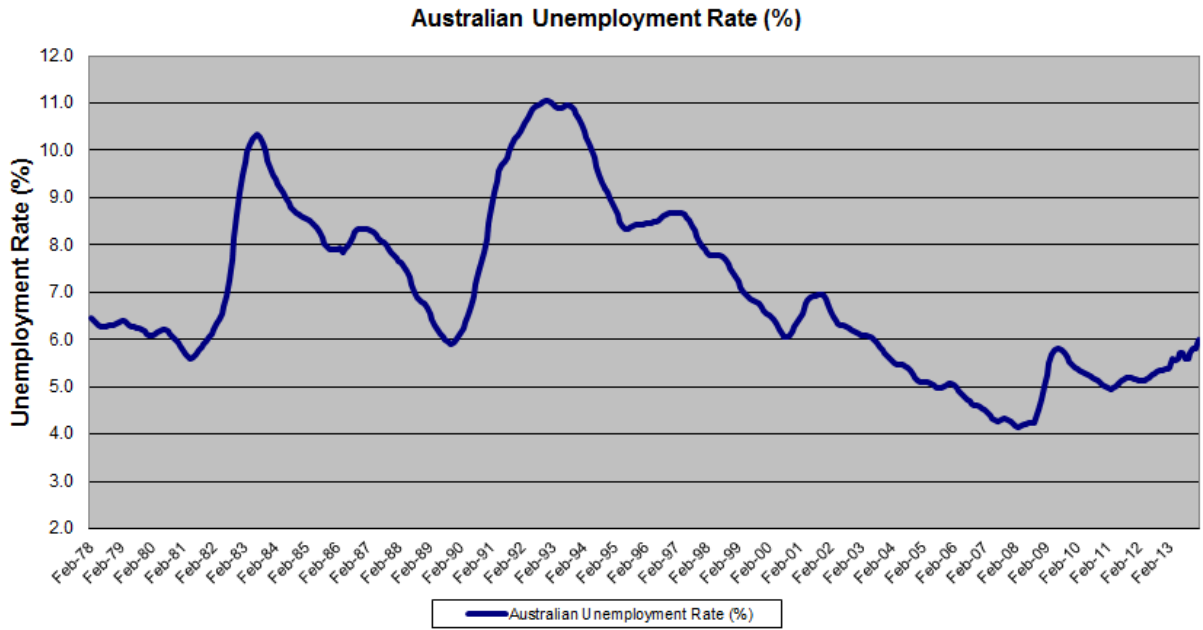


China Retail Sales Value (%pa)

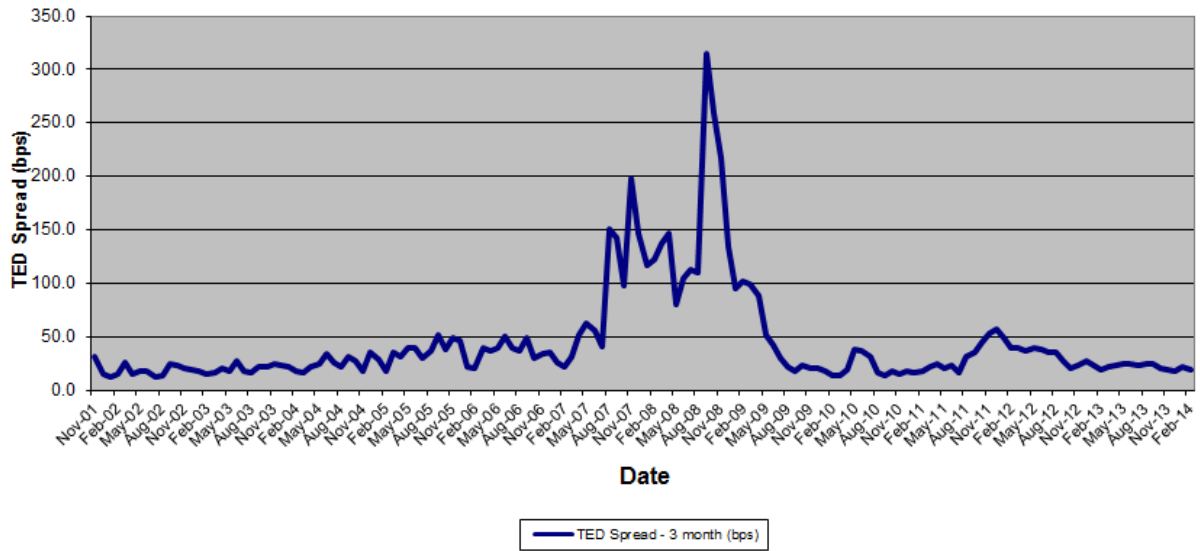


US Unemployment Rate (%)

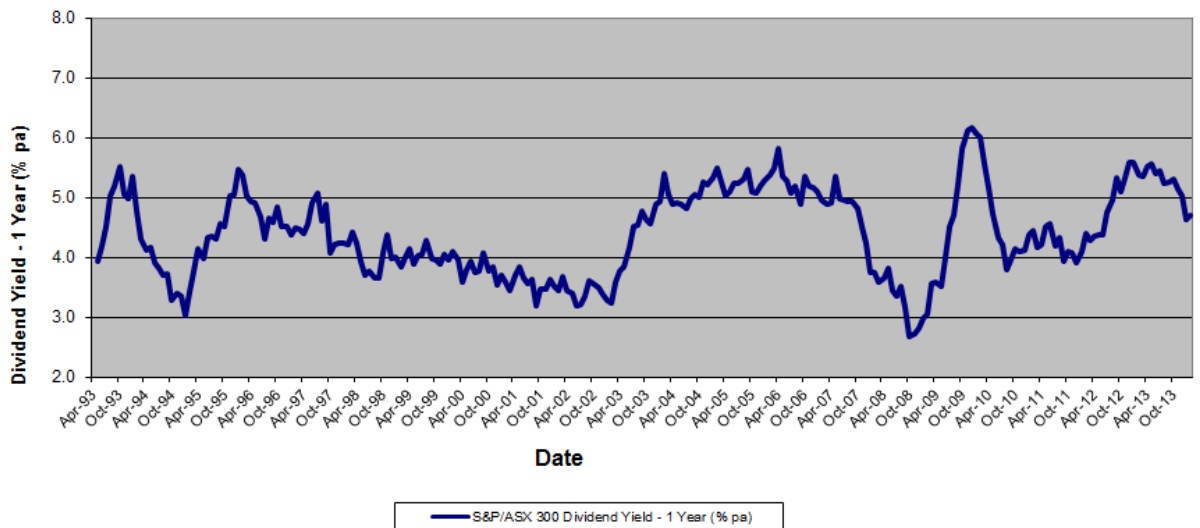




TED Spread - 3 Month



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

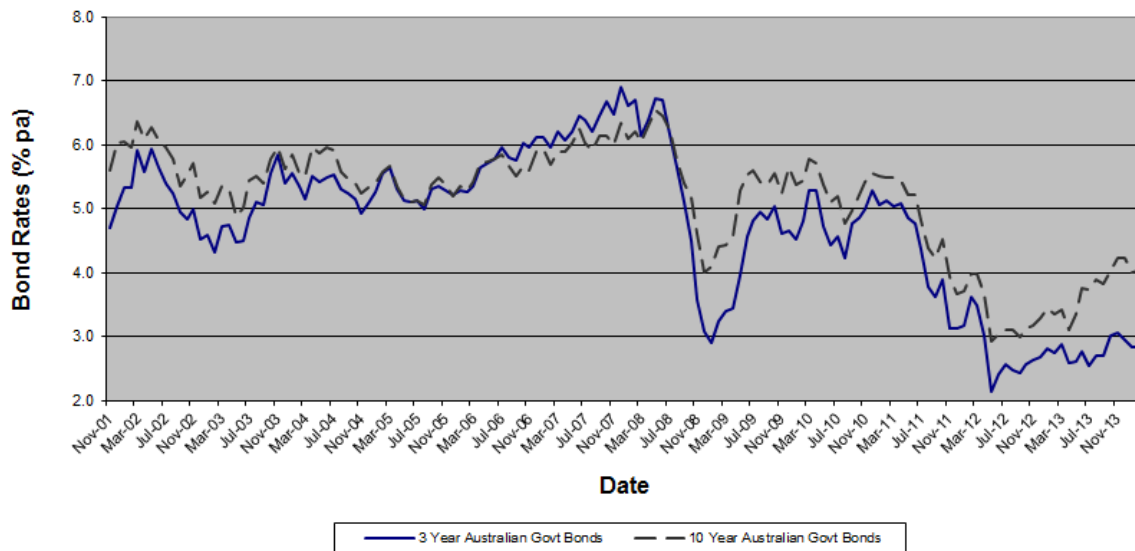


Australian Sharemarket Valuations (X)

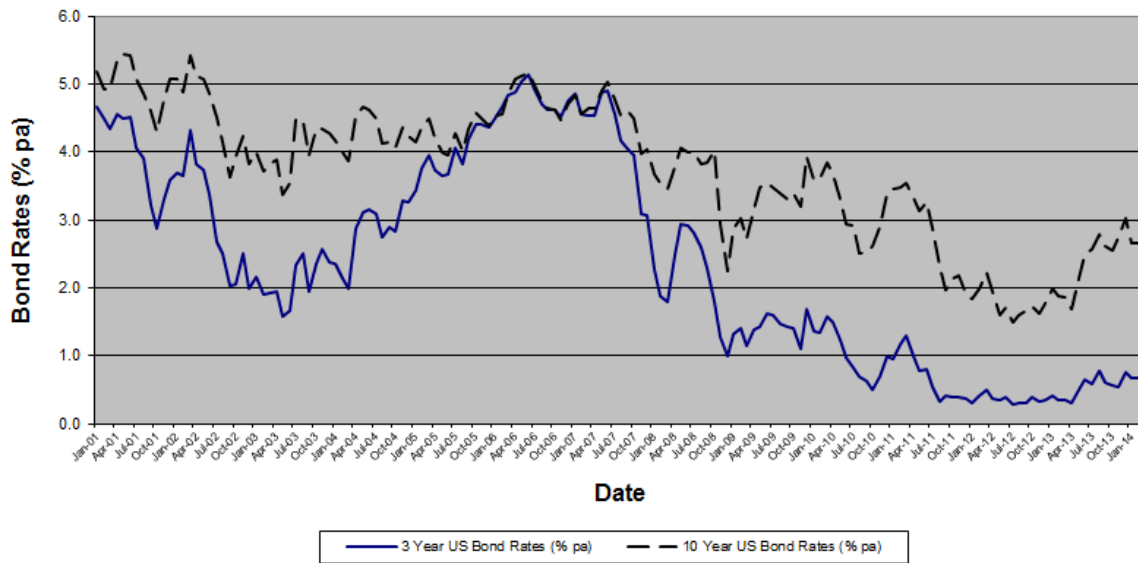


Source: UBS Australia and Reserve Bank of Australia as at 7 March 2014.

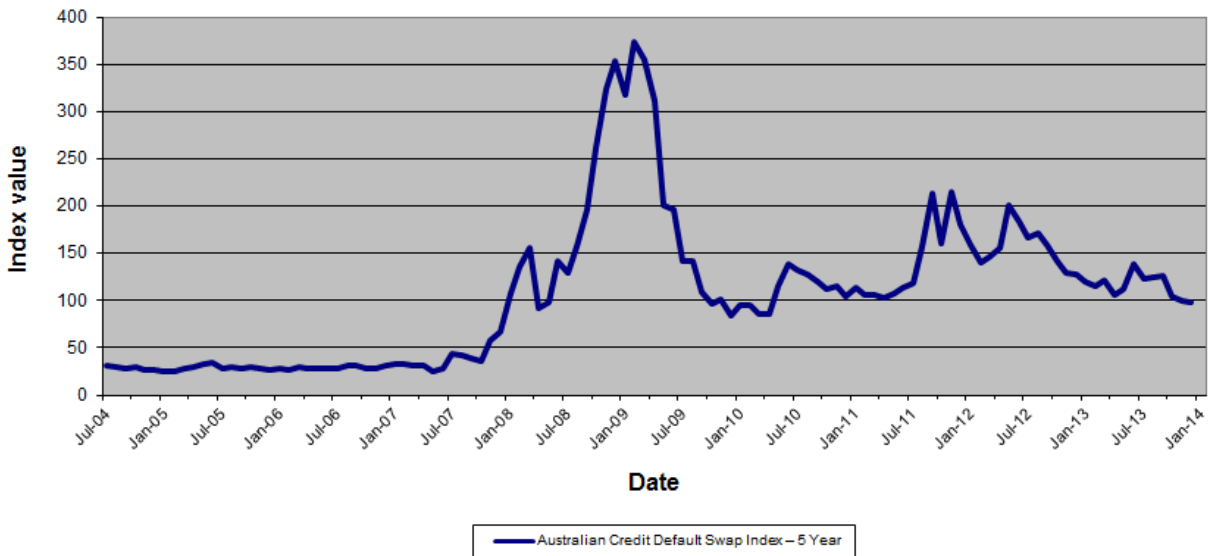
3y and 10y Australian Bond Rates (%)



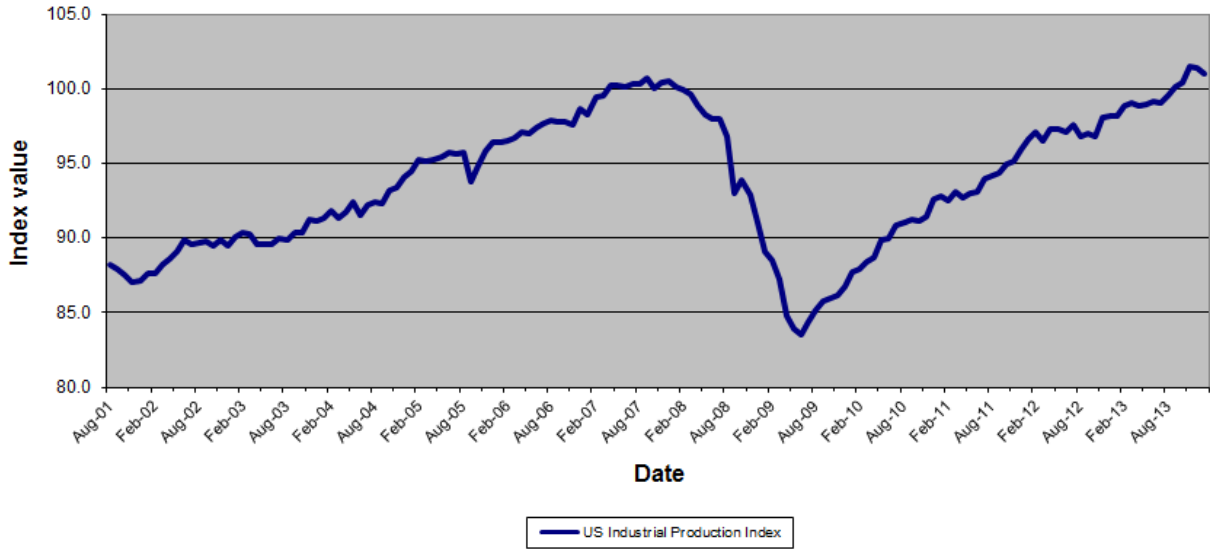
3y and 10y US Bond Rates (%)



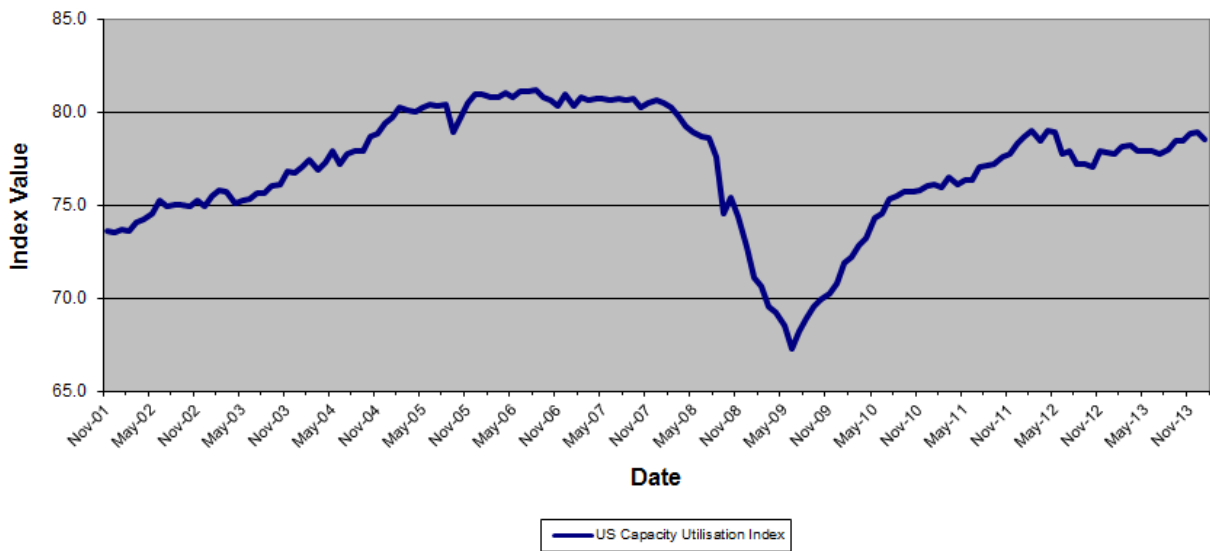
Australian Credit Default Swap Index – 5 Year



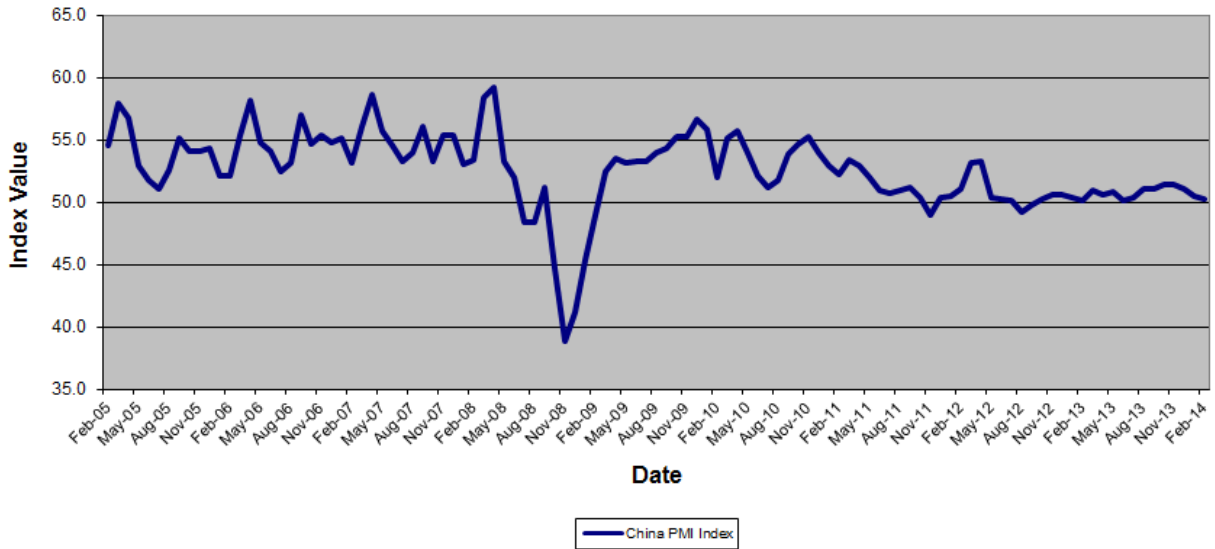
US Industrial Production Index



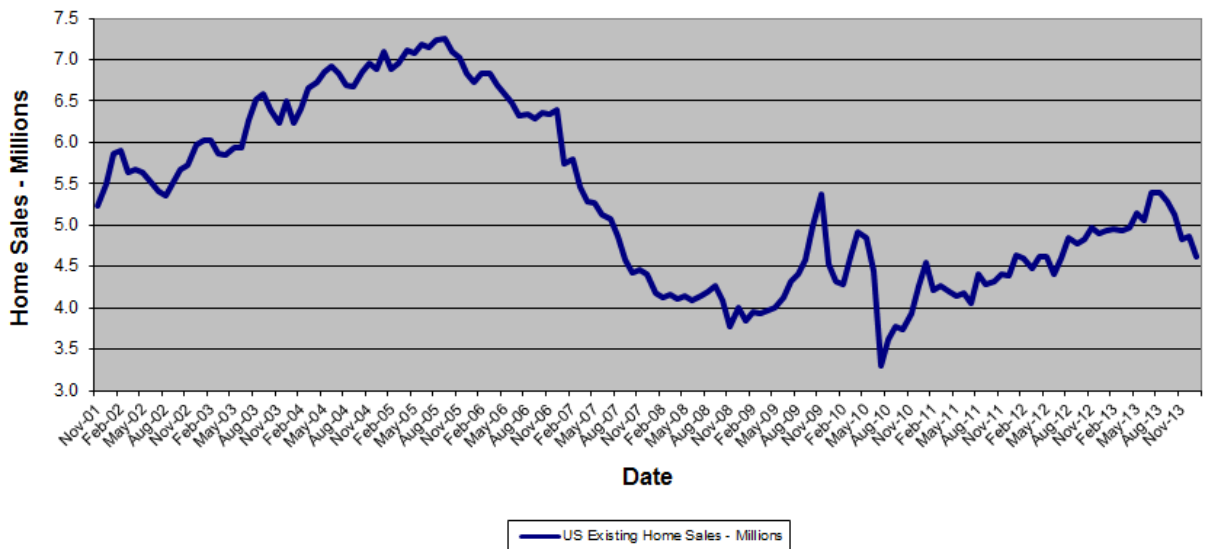
US Capacity Utilisation Index



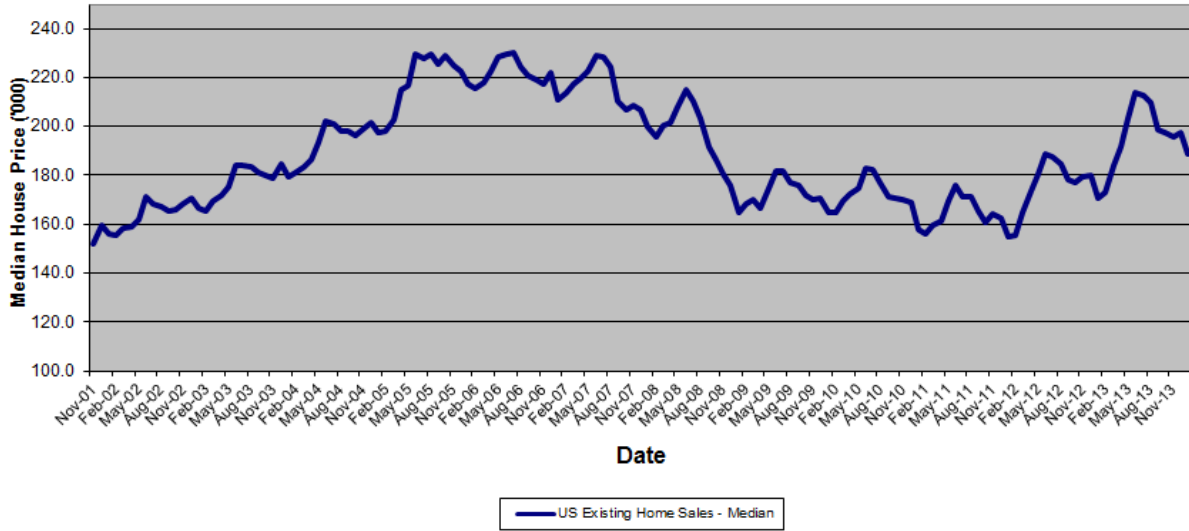
China Purchasing Managers Index (PMI)



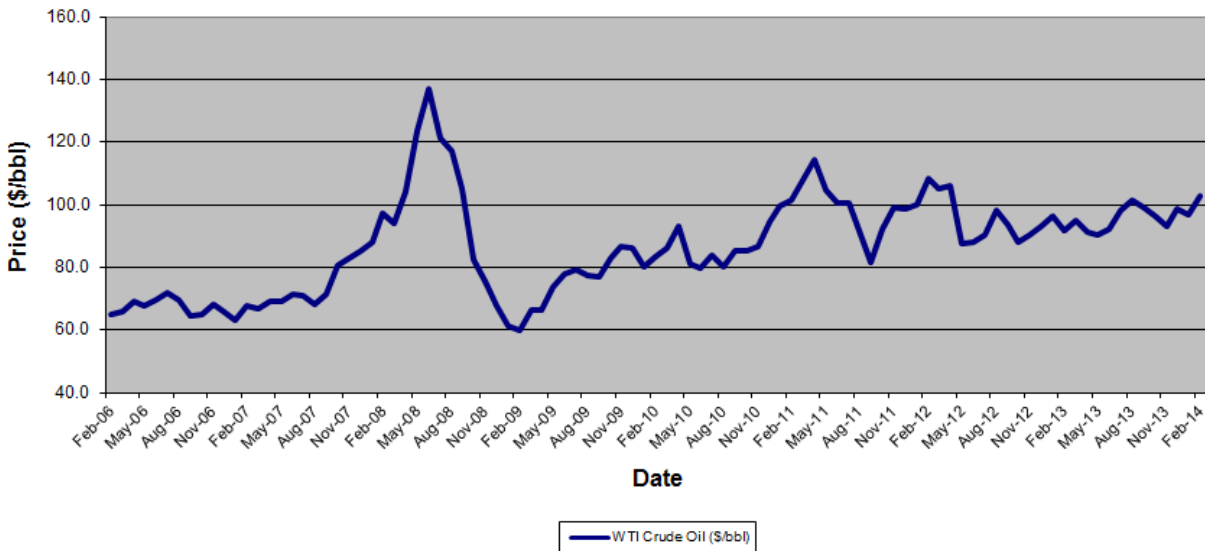
US Existing Home Sales - Millions



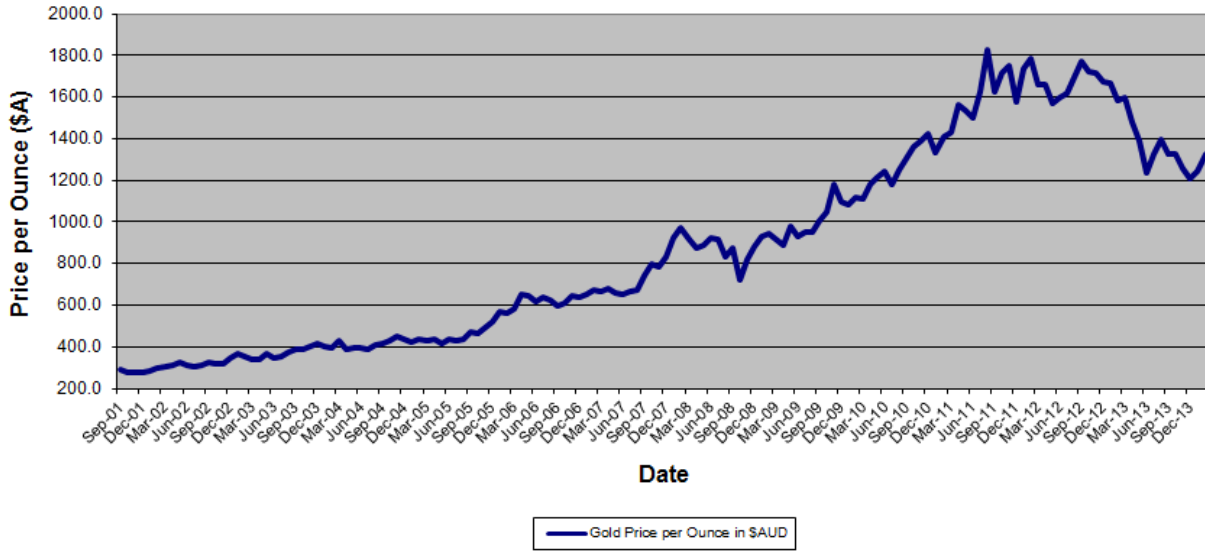
US Existing Home Sales - Median



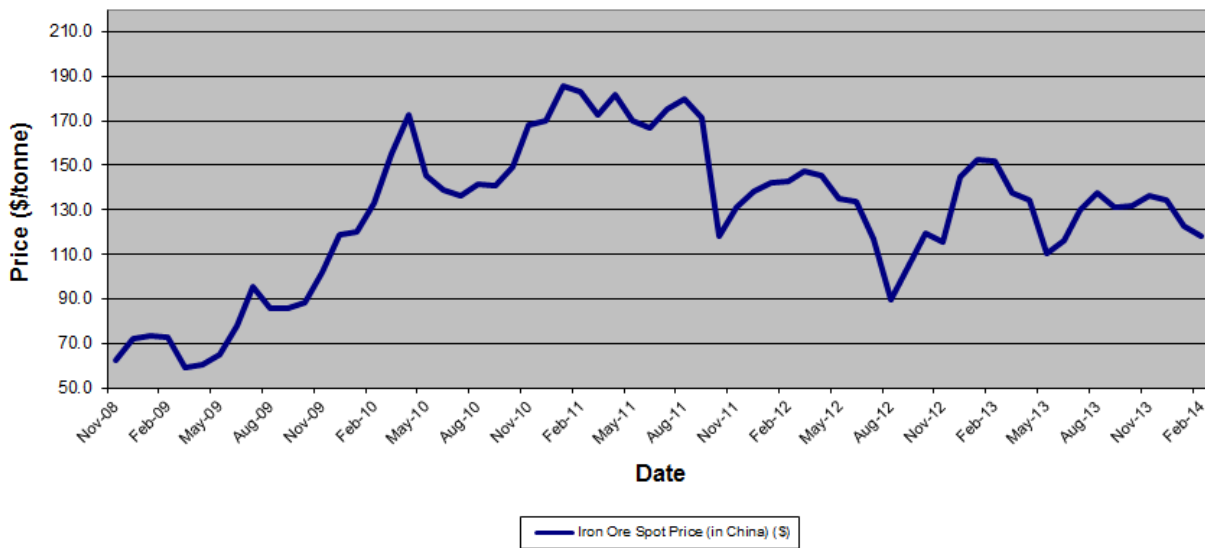
WTI Crude Oil (\$/bbl)



Gold Price per Ounce in \$AUD



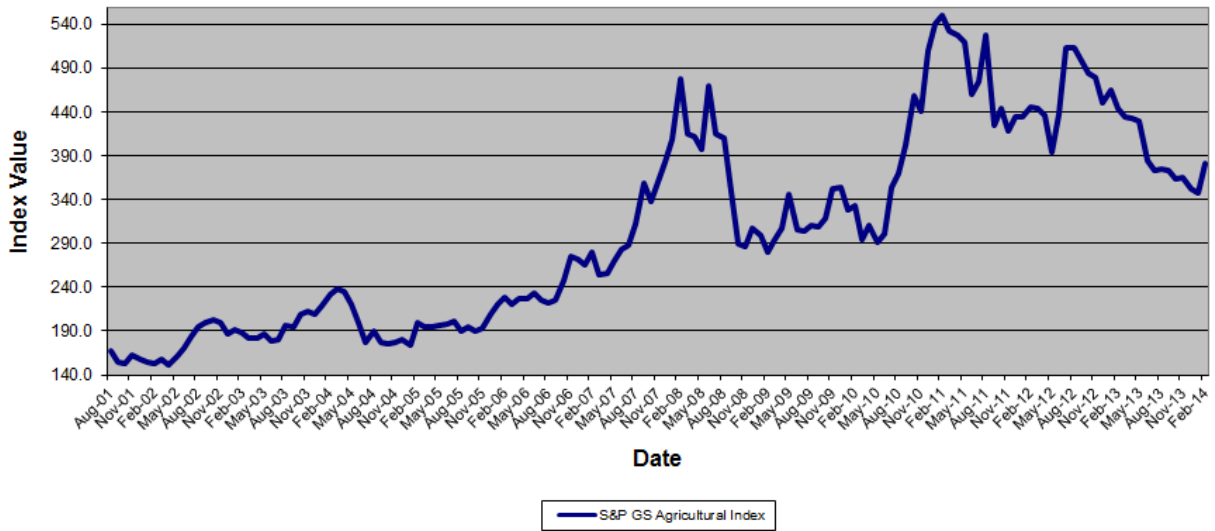
Iron Ore Spot Price (in China) (\$/tonne)

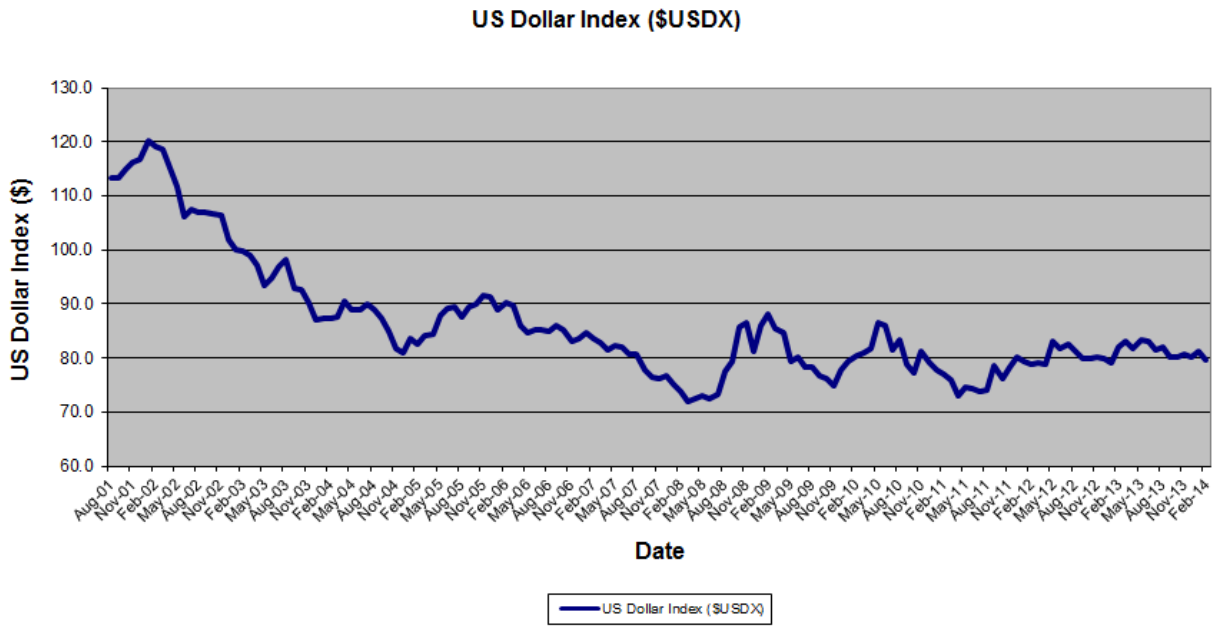


Copper Price Index (\$/tonne)



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%).