Mortgage Choice

Financial Planning

Quarterly Market Review – March 2016

Published: 15th April 2016

Contents

Please Note: Past performance is not a reliable indicator of future performance.

Overview

The hard yards

With company reporting season out of the way, the market is adjusting to the sluggish mood that overhangs global markets. Volatility has eased however markets remain unusually nervous and tentative about where the opportunities are going to emerge from the subdued trading conditions and soft demand background.

Commodity prices have improved somewhat from the lows seen in February 2016 which has added to the confidence level for the ongoing sustainability of industries relying on the growth in these sectors. It remains a waiting game to see support return longer term.

Central banks are still very much in control of the short term interest rate environment and liquidity but this has not yet resulted in adding a lot of confidence to either investor's, consumers or companies seeking signs of growth returning to the broader economy.

Economic data reveals the soft trend is continuing

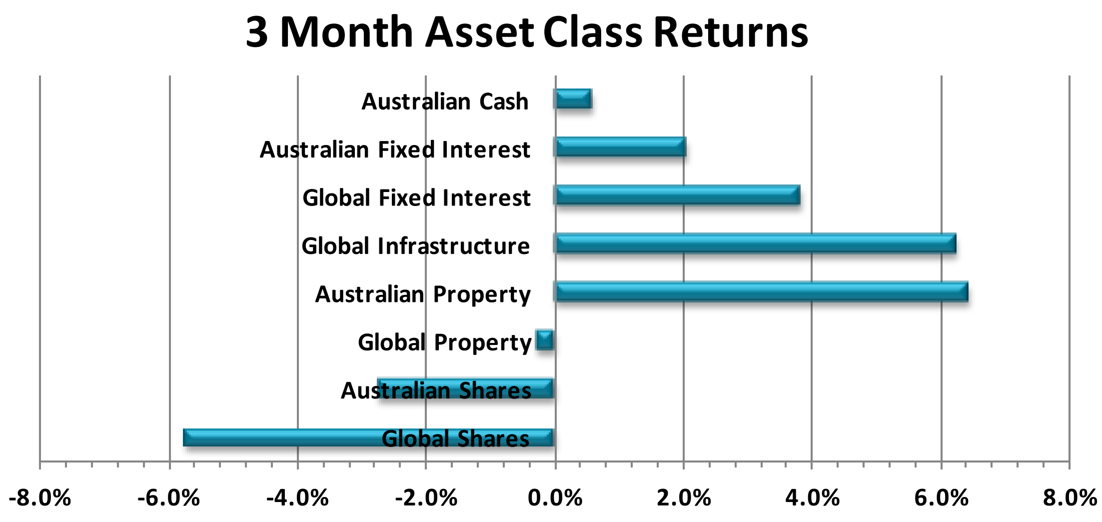
Markets remain nervous and are likely to continue to be sensitive to any news regarding signs of any softness in demand for key areas such as retail sales, employment and commodity prices. Regionally the economic data reveals the following:

- **USA**: The U.S. recovery is holding with the annual growth rate of GDP 2.0 %, slightly down from 2.1 % reported in the September quarter. On a positive note, unemployment weakened to 5.0% from 4.9 % in the previous month. The number of unemployed persons was little changed at 8 million;
- **China** GDP growth rate decreased to 1.6% over the December quarter with the annual growth rate easing to 6.8 % from 6.9% previously. The unemployment rate of 4.05% was unchanged and inflation appears to be steady at 2.3% p.a. for the month of March 2016;
- **Europe** also remains in the doldrums with GDP growth rate holding 0.3% in December 2015. Europe's unemployment of 10.3% was an improvement over the previous 10.4% however inflation is going backwards reporting a negative 0.1% for March 2016. The ECB is maintaining an accommodative stance to monetary policy and intends to keep interest rates low in the months ahead; and
- **Australia** GDP latest data from the December quarter revealed the annual growth rate bounced back to 3.0% from an upwardly revised 2.7% in the September quarter. Unemployment fell to 5.8% in February 2016 and inflation rose to 1.7% from 1.5% in September 2015.

Asset Class Review

Market volatility rattled the global share markets early in the New Year with a major sell-off in January and February followed by a sharp rebound in March 2016. The asset class returns were as follows:

Chart 1



Source data: Morningstar, 31 March 2016

Growth Markets

The global shares rebounded in the month of March after a very sharp selloff, especially early February when most of the Asian markets were closed for the Lunar New Year but managed to recover and finish March on a positive note (+4.74) but disappointingly, in the red for the quarter. In contrast, the infrastructure and property sectors posted strong gains as investors retreated from the volatility of the share markets.

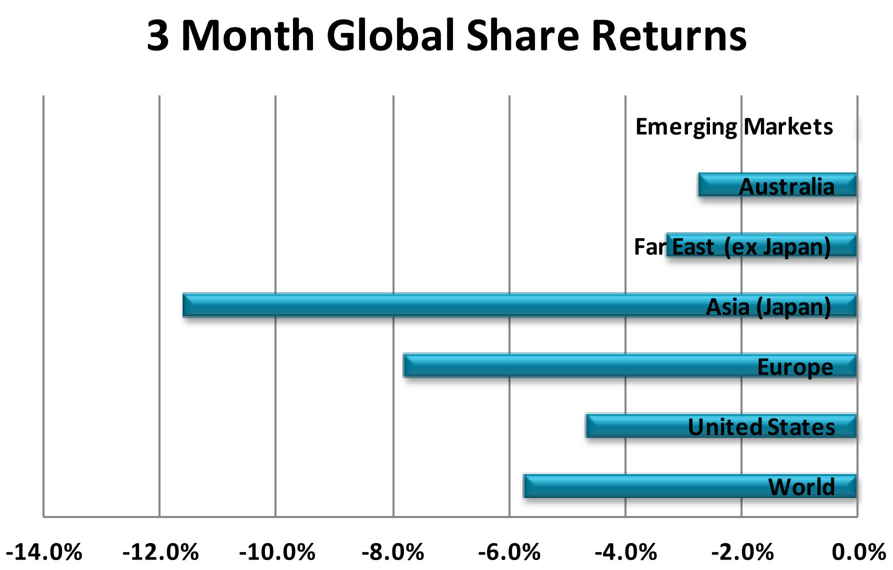
Defensive Markets

The fixed interest markets posted strong gains over the quarter as the Central Banks in Europe and Japan maintained their accommodative stance to monetary policy. European bond markets held steady as the European Central Bank intends to maintain easier monetary conditions for the region. The Federal Reserve in the US refrained from increasing interest rates further instead awaiting fresh economic data to see if any adjustments are necessary to control the rate of growth in their economy.

Global Share Markets

The global share markets experienced a large scale sell off early in the New Year which impacted both the thin holiday markets over the festive season, as well as, into the Lunar New year celebrations in Asia when markets were closed for about a week. The regional and country specific returns for the quarter were as follows:

Chart 2



Source data: Morningstar, 31 March 2016

Note: The above returns are reported in Australian Dollars. The AUD/USD exchange rate also added to the negative results of global holdings by firming from 0.7306 to 0.7657 over the quarter which represented a loss to offshore investor's of some 4.8% in USD terms. The S&P500 in USD terms returned a positive 1.18% for the quarter so you can see the impact that currency movements have on returns in Australia.

Domestic Share Market

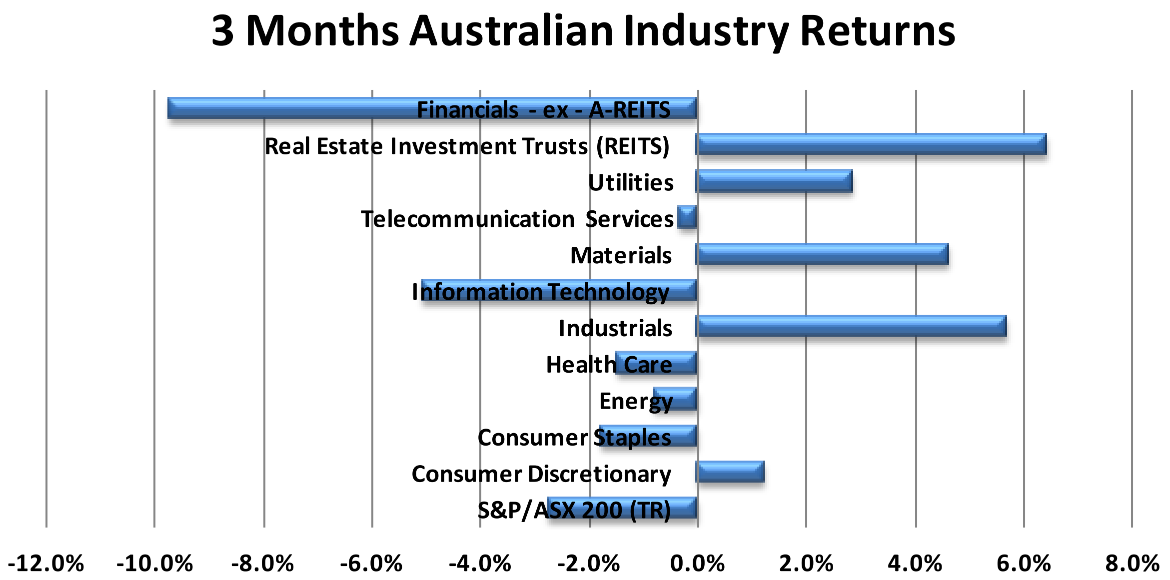
The Australian share market posted sharp losses over the quarter with the heavyweight **financial sector experiencing a major pullback**. The materials and energy sectors were again in the spotlight as expectations of ongoing lower oil and iron ore prices reversed with iron ore prices firming 24% over the quarter from US$42.90 to finish around the US$53.20 per a dry metric ton. Oil hardly moved and closed around the $37 a barrel.

The transition from a **"resources" based economy towards a "services"** based economy continues but it is a slow process and likely to take a little longer than first thought.

The economy, profitability, volatility, yield and liquidity remain key considerations for investor's and will most likely continue to dominate next quarter's return expectations.

The following table provides an industry breakdown of the composition of the S&P/ASX200 share market returns over the quarter:

Chart 3



Source data: Morningstar, 31 March 2016

The rebound in iron ore added much needed support for resource based companies although tempered by the rising Australian dollar. Banks became the focus as the housing market took a breather and investor's paused to reflect on what historically happens to bank profits when the housing market cools.

Overall the Australian economy remains sluggish with only pockets of growth emerging. Hopefully this will flow over into confidence for consumers to start to spend again.

Where to from here?

The market has changed focus from the falling commodity prices towards the possibility of loan defaults by the customers of the Banks. In defence of the Banks, they are very well regulated in Australia and hopefully have learnt their lessons from past property market booms and related slowdowns.

It is too early to call major losses from bad loans as any Bank borrower will readily point out how stringent their lending has become. APRA, the regulator of Banks in Australia, continues to monitor their activities and has implemented strong capital requirements over the Bank's lending activities to prevent the excesses of the past, in terms of leveraged balance sheets and easy credit.

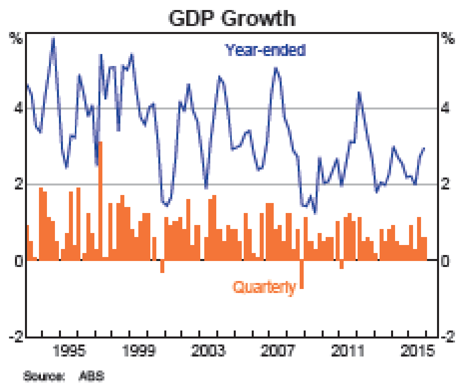
Analysts are closely monitoring the major Australian lending data to check on the Banks activities and gauge the profit/loss potential changes of the companies heading the sector. Factors of influence include:

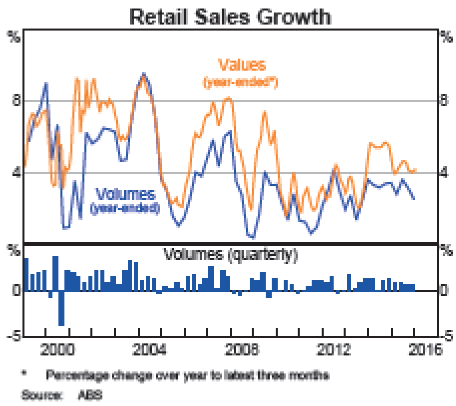
- The level of interest rates and the mix of fixed verses variable mortgages;
- The loan to valuation ratio (LVR) that banks will lend at for domestic housing (a LVR of 80% requires a deposit of 20%) ; and
- The Bank's profit margin – cost of wholesale borrowing rates (to raise capital) verses the credit margin that Banks charge for mortgages over and above this cost.

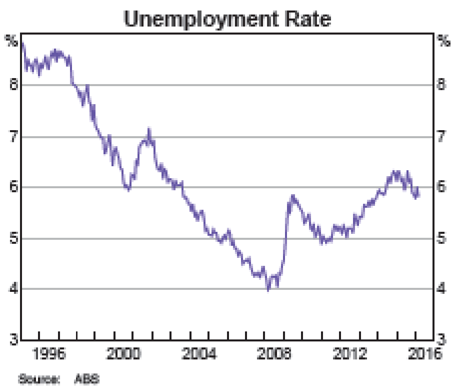
The economy remains a key focus with annual growth in GDP is running at 3% as at the end of December 2015 which is in line with GDP estimates for 2016. The economy continues to shuffle along with the domestic housing market still ticking along although the momentum is slowing.

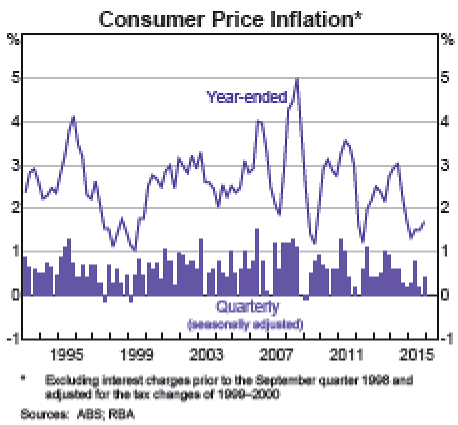
Other statistics revealed the following:

Charts 4, 5, 6 and 7









Economists see the share market gaining over 2016 with many indicating **ranges between 4,700 and 6,000 for the S&P ASX200**. This is approximately -9.76% and +14% respectfully from the closing price level of 5,158.80 for the S&P ASX200 Accumulation Index price as at the end of March 2016.

Global and Domestic Property

The Property sector continued to benefit from investor support driven by the continued lower levels of interest rates, lower levels of volatility and the yield available from rental returns. Property has become a safe haven for investor's concerned with the ongoing volatility of the share markets but like any market, **there is a cycle for when to buy and when to sell.** For long term investor's, property still remains a favourite given the low levels of correlation with the other asset classes and the reasonable rental returns available.

Global holdings are impacted by the level of the AUD which can erode returns if the AUD strengthens. From the table below you can see this impact despite the good returns that the sector historically has generated. Remember, past performance is not a reliable indicator of future performance but it is a measure that helps understand the cyclicality of the sector and the currency impact.

Table 1

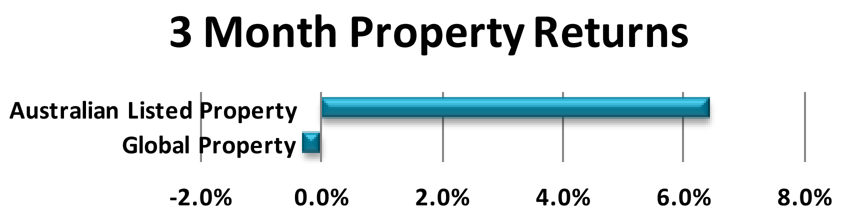
Property (months)	3	6	12	24	36
Global Property*	-0.29%	0.48%	0.56%	18.54%	13.56%
Australian Listed Property	6.43%	12.77%	11.26%	22.42%	16.31%
AUD/USD	7.24%	4.80%	9.23%	0.30%	-9.78%

Source data: Morningstar, 31 March 2016

*Note: Global property returns are reported in AUD terms. A positive return for the AUD/USD means that the Australian dollar has strengthened which will result in a negative valuation effect on the offshore holdings; hence the currency impact can be significant.

In Australia, for the moment, the slowdown in the domestic housing market has not impacted the professional markets with office, retail and commercial property assets well sought after.

Chart 8



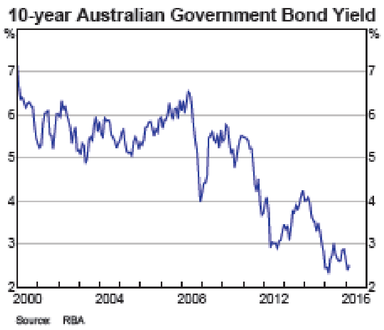
Source data: Morningstar, 31 March 2016

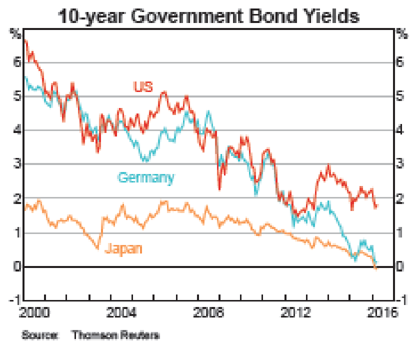
As mentioned previously, most property investment has an element of gearing (borrowing) which makes the prices of the property assets sensitive to interest rate moves. Rising interest rates will have a negative impact on the sector unless the borrowing costs have been fixed.

Global and Domestic Debt Markets

Fixed Interest markets strengthened over the quarter as bonds firmed and interest rates fell. The 10 year US Government Bonds firmed from 2.26% to 1.77% and in Australia, the 10 year Government bonds finished at 2.49% for the March quarter down from 2.88% at the end of December 2015.

Chart 9 & 10

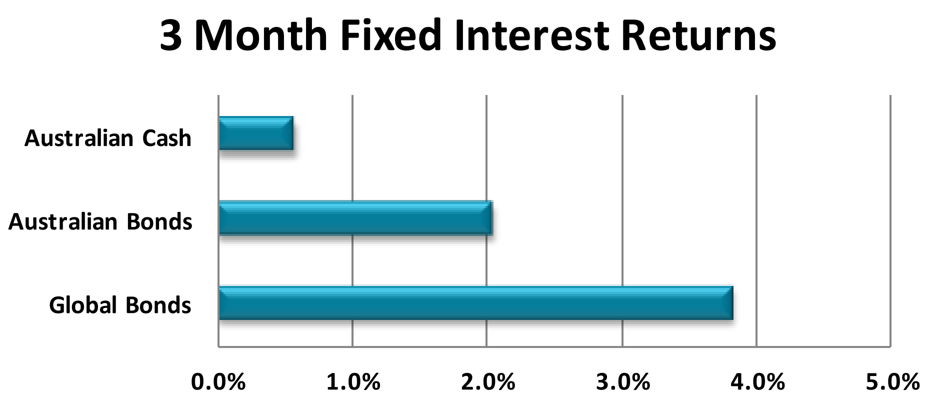




Source data: RBA, 31 March 2016

The following chart shows the returns from cash and fixed interest markets over the quarter:

Chart 11



Source data: Morningstar, 31 March 2016

The Reserve Bank of Australia (RBA) left the target cash rate at 2.0% at their meeting on 5th April 2016 with economists still looking at the possibility of future easing ahead in 2016 as the broader economy struggles to grow and the previously **buoyant housing sector starting to show signs of moderating**.

Most analysts see only a minor fall of 0.25 basis points from 2.00% to 1.75% if required and the full fall is **unlikely to be passed on to borrowers** by the Banks as credit is becoming harder to price (i.e.: investors are demanding a higher risk premium to lend).

Bond investors remain cautious about the Central Bank support for the bond markets in Europe and Japan and are watchful of any inflationary pressures that may evolve. For the moment, **no major changes to monetary policy** are expected over the next quarter.

What lies ahead for global interest rates?

The Fed has backed away from continuing the tightening of monetary policy short term and has left the targeted cash rate raised interest rates. The **Federal Funds Rate** is the interest rate which banks charge one another for 1 day (overnight) lending. This American base rate is set by the market and is not explicitly laid down by the Fed.

By withdrawing or adding funds to the money supply the Fed tries to bring the effective federal funds rate into line with the interest rate that it is striving for. If the Fed's monetary policy alters the base rate that usually affects the interest rate on various products such as mortgages, loans and savings. The fixed interest markets **expect further tightening of monetary policy in the US** to emerge over the course of this year and into 2017.

In contrast, Japan and the European Central Bank are **maintaining their quantitative easing** policy that has worked so well to date, holding interest rates low, in their attempts to rekindle growth in their economies. This trend is likely to continue in the near term.

Returns from global bond investors benefit from the interest rate differential of the underlying country exposures and the domestic interest rates in Australia. With bond rates in Europe close to zero in some maturities, **global bond exposures are usually fully hedged back to Australian dollars** and investors pocket the advantage. As you can see from the returns available, this can work in investor's favor as Australia's interest rates are broadly higher than the underlying bond exposures.

What lies ahead for domestic interest rates?

For Australia, the next round of economic data releases will have a bearing on monetary policy settings however, from all accounts, the market expects **no real change in the RBA monetary policy** settings over the next quarter.

Financial institutions may act independently of the RBA and increase interest rates for borrowers as they continue to reprice credit risk given their balance sheet needs and the cost of raising capital offshore.

Summary

Short Term – now to 1 year

In the short term, **markets will continue to stabilise** but are likely to experience periods of price volatility as the dust settles. While commodity prices are bouncing off the lows, investors are closely watching the economic data to provide evidence of a longer term trend before having the confidence to add to their positions in a meaningful way.

Medium Term – 1 year to 3 years

In the medium term, experienced investors remain focussed on opportunities emerging from any rotation of capital. It is a good time to **review the overall tactical asset allocation** and make any adjustments to the sector mix in order to re-position portfolios back towards anticipated growth opportunities.

For Australia, **evidence of demand returning for the core commodity prices** will provide much needed relief for resource companies that have been sold down heavily on the back of expected lower profit margins. Now that this scenario may not go to plan, changes to the trend or sector bias embedded in client's portfolio may be necessary.

Longer Term – 3 years to 10 years

The global economy is still encountering headwinds on the growth front due to political, economic and consumer concerns. Investor confidence, battered by commodity price falls, volatility and the ongoing political unrest, are starting to **focus more on the recovery** of markets and where the investment opportunities are going to emerge. It may be a little early to make wholesale changes to investment strategy however, being prepared never hurt anyone.

Commodity prices are not out of the woods just yet and are expected to experience bouts of volatility as **markets adjust to the changed short term demand for resources**. The recovery cycle for commodities will drive investment back into the sector but this is likely to be muted until clear evidence emerges that the trend is sustainable.

Key Message

Be Proactive: the share markets are attempting to recover from the early 2016 losses, especially now that threads of demand are emerging for the core commodities. For Australia, opportunities need to be explored but bear in mind, we are nearing the **traditional tax planning period (May/June)** where tax loss selling may distort the short-term value of these opportunities.

Low interest rates, moderating house prices and improved commodity demand offer a platform for growth over the months ahead. As mentioned last review, the RBA is maintaining an accommodative stance to monetary policy, so **the stage is set for an economic recovery** the only problem remains is over what timeframe it will occur.

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Data Sources

Where indicated in this review, the underlying data was sourced from Morningstar on the 14th April 2016.

Benchmark	Country/Asset Class
MSCI World ex Australia (Net TR) AUD	Global Shares
MSCI Europe NR AUD (AUD)	European Shares
S&P 500 (TR) USD	United States Shares
MSCI JAPAN (Net TR) AUD	Japan Shares
S&P/ASX 200 TR AUD (AUD)	Australian Shares
S&P ASX Small Ordinaries AUD (TG) AUD	Australian Small Companies
FTSE EPRA/NAREIT Developed NR AUD (AUD)	Global Property
S&P/ASX 200 Property Trusts Accum Index (AUD)	Australian Listed Property
S&P Global Infrastructure NR Hdg AUD (AUD)	Global Infrastructure
Citi WGBI Hdg AUD (AUD)	Global Bonds
Bloomberg AusBond Composite 0+Y TR AUD (AUD)	Australian Bonds
Bloomberg AusBond Bank 0+Y TR AUD (AUD)	Australian Cash
MSCI EM NR AUD (AUD)	Emerging Markets
AUD/USD	Australian Currency