Financial Planning

Quarterly Market Review – June 2016

Published: 28th July 2016

Contents

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

Warnings and Disclosure: The contents of this review are general advice and do not relate to the acquisition or possible acquisition of particular classes of assets or financial product(s). Before making any decision the reader should obtain and consider more information, including the Investment Statement or Product Disclosure Statement for each product and, where relevant, the reader must consider whether it is personally appropriate in light of his or her financial circumstances or should seek further advice on its appropriateness. This is not to be taken as personal advice and does not constitute a recommendation to purchase, hold, redeem or sell any product(s), and the reader should seek independent financial advice before investing in any product.

Overview

Enough of the politics

Finally, the political landscape has cleared somewhat at least as far as Australia is concerned. Now we are looking forward to some meaningful discussion around the business of Government for a change. Superannuation changes have been mooted so we are eagerly waiting what the actual legislation will look like. Once we know more of the detail we can start to develop forward looking plans for our clients.

Globally, Britain has stolen the limelight with the surprise exit of the United Kingdom from the European Union. While no major impact for Australia is expected short term according to most economists, there may be implications for the UK and its trading partners longer term.

Central banks are still dominating the short term interest rate environment and continue to provide sufficient liquidity to ensure the world financial markets continue to function smoothly. Consumer confidence remains subdued as investors and companies await signs of growth returning to the broader economy before committing fresh capital.

Economic data reveals the soft trend is continuing

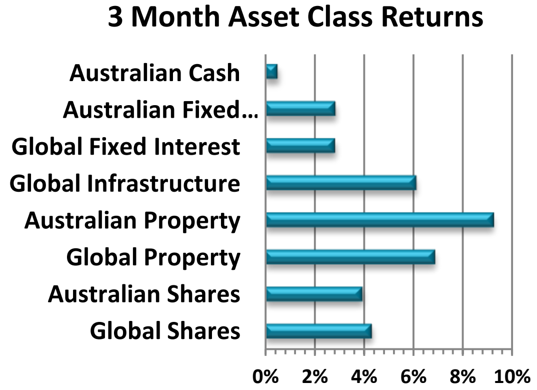
Markets remain cautious and are likely to continue to be sensitive to any news regarding signs of any continued slowdown in demand for key areas such as retail sales, employment and commodity prices. Regionally the economic data reveals the following:

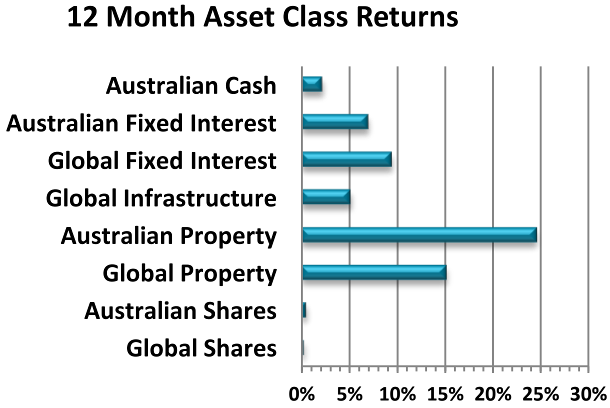
- **USA**: The most recent data from the U.S. revealed that the economy is slowing with the annual growth rate of GDP down slightly to 1.1 %, from 1.4% reported previously. The unemployment weakened to 4.9% in June 2016 from 4.7 % in the previous month. The number of unemployed persons was up 347,000 to7.8 million;
- **China** is showing signs of life with the GDP growth rate improving to 1.8% over the June 2016 quarter from 1.2% however, the annual growth rate was unchanged at 6.7 % and the unemployment rate was steady at 4.05%;
- **Europe** had shown signs of life prior to the Brexit announcement with the GDP growth rate edging higher to 0.6% in March 2016 from 0.3% previously. The annual growth rate was up slightly to 1.7% from 1.6% previously. Europe's unemployment in May 2016 of 10.1% was an improvement over the previous 10.2% however inflation was flat at 0.1% for June 2016; and
- **Australia's** latest GDP data for the June 2016 quarter revealed the annual growth rate rose to 3.1% from 3.0%. Unemployment rose to 734,200 persons or 5.8% in June 2016 up from 5.7% in March 2016 and inflation slipped to 1.0% in June 2016 from 1.3% in the March 2016 quarter.

Asset Class Review

At last some respite for investors as the market price volatility eased back towards longer term averages. The global asset markets rebounded from the sharp falls experienced in the previous quarter with some solid gains across the board. The returns achieved were as follows:

Chart 1 & 2





Source data: Morningstar, 30 June 2016

Growth Markets

The global share markets had mixed results over the last quarter of the financial year as investors looked for mispriced opportunities leftover from the poor start to the year. Many of the underlying regions ended in negative territory with the broader market, in aggregate, finishing flat for the year. In contrast, the infrastructure and property sectors posted strong gains as investors chased yield and the relative protection of uncorrelated returns.

Defensive Markets

The fixed interest markets continued to deliver positive returns over the quarter as the Central Banks in Europe and Japan maintained their accommodative stance to monetary policy which tempered any interest rate hike concerns.

The downward drift in global growth overshadowed the interest rate markets as longer term yields continued to ease. The problem now is that, in some instances, sovereign debt is offering negative yields where losses are incurred if bonds are held to maturity, making it difficult for fixed interest investors needing income from the sector.

The Federal Reserve in the US refrained from increasing interest rates further instead deciding to await fresh economic data to gauge if there is any adjustment necessary in the rate of growth in their economy.

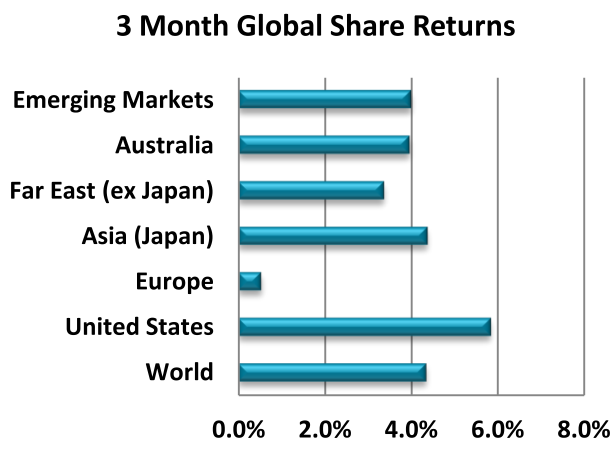
Global Share Markets

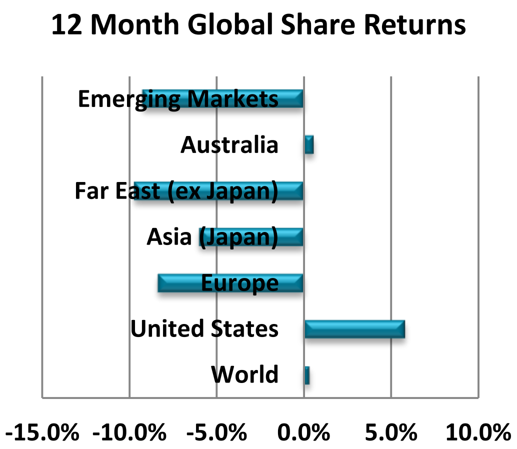
The global share markets ended the financial year on a positive note however, the returns for the underlying regions were mixed. In aggregate, the asset class disappointed most investors over the last 12 months.

Political uncertainty in Europe and weak growth expectations were the main factors hindering consumer and investor confidence despite the best efforts of the Central banks to rekindle a spark in their respective economies.

The regional and country returns for the quarter and the last 12 months were as follows:

Chart 3 & 4





Source data: Morningstar, 30 June 2016

Note: The above returns are reported in Australian Dollars. The AUD/USD exchange rate added to the returns of global holdings denominated in Australian Dollars by easing from AUD/USD 0.7657 to 0.7426 over the quarter which represented a benefit to offshore investors of some 3.02%. Over the year, this boosted returns by 3.31% (0.7680 to 0.7426).

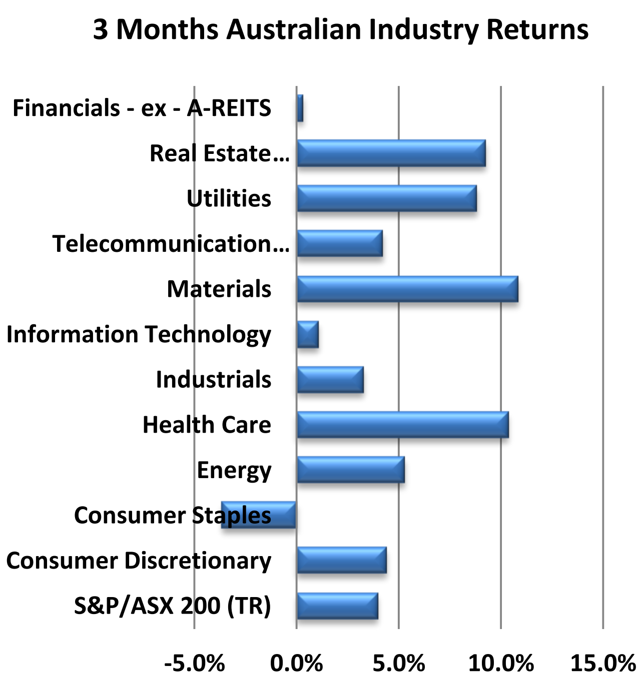
Domestic Share Market

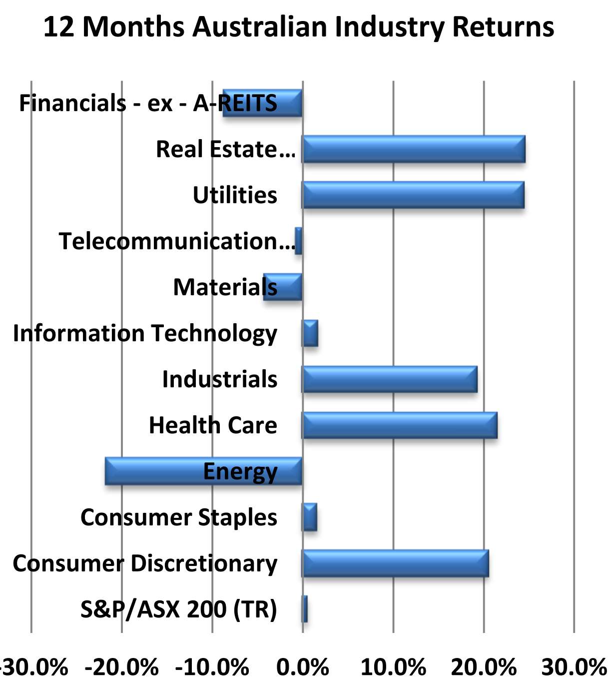
The Australian share market, in total, rebounded strongly over the quarter however, like the global markets, not all sectors contributed to the overall market gains. With commodity prices, in general, stabilising and iron ore prices settling around the US$50 a tonne, resource based companies found support during the June 2016 quarter aided by the falling Australian dollar. Companies in some sectors like Consumer Staples, (dominated by Coles & Woolworths) were put under the microscope as the retail food market became the focus of investor scrutiny. Profits are being squeezed by competition in the sector.

The economy, profitability, volatility, yield and liquidity remain key considerations for investor's and will most likely again 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 and the last 12 months:

Chart 5 & 6





Source data: Morningstar, 30 June 2016

Overall the Australian economy was on hold over the June 2016 quarter, distracted by the long winded federal election. Hopefully now that the results are known, the Government can focus on helping the economy to emerge from the recent stagnation.

Where to from here?

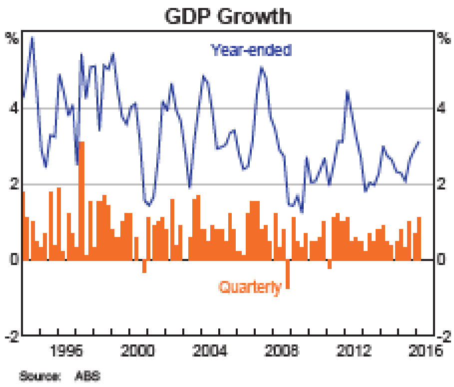
The economy remains a key focus with annual growth in GDP is running at 3.1% as at the end of June 2016 which is in line with GDP estimates for 2016. The economy however is patchy as evidenced by the latest CPI data which revealed that annual inflation is running at just 1%.

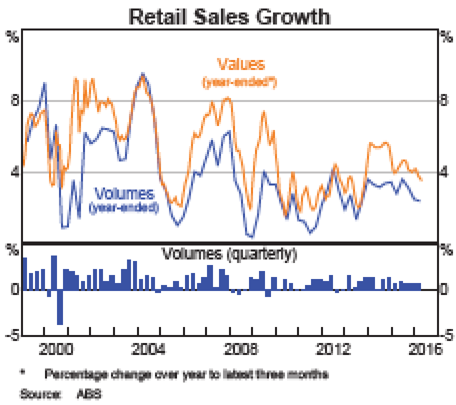
This may prompt further action by the Reserve Bank to reduce the cash rate currently sitting at 1.75% in an attempt to help kick start the economy.

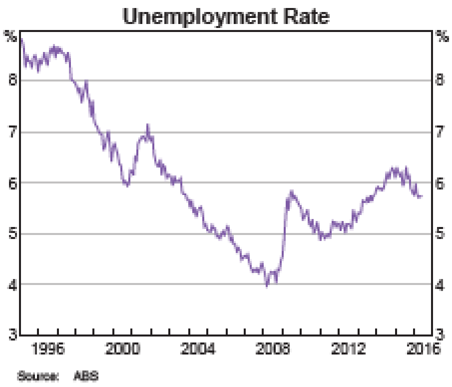
The company reporting season is just around the corner which will be closely watched by analysts for evidence of further slowing in the broader economy. The Federal election usually results in a flat period as people await the outcome. This election was a little longer than most so we are not expecting anything special from the reported results.

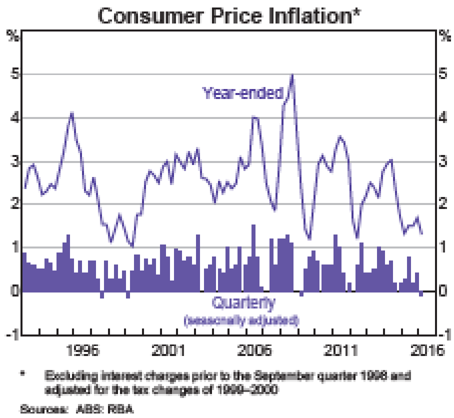
Other economic statistics revealed the following:

Charts 7, 8, 9 & 10









Economists see the share market gaining over 2016 with many indicating index price **ranges between 4,700 and 6,000 for the S&P ASX200**. This is approximately -11.49% and +12.99% respectfully from the closing price level of 5,310.40 for the S&P ASX200 Accumulation Index price as at the end of June 2016.

Global and Domestic Property

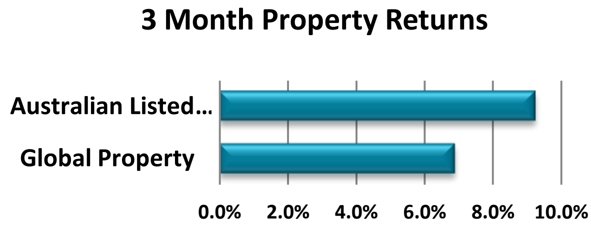
The Property sector continued to benefit from investor support driven by the continued lower levels of interest rates, lower levels of volatility and the yield available from rental returns. Property has become an important 'go to' exposure for investor's concerned with the ongoing volatility of the share markets.

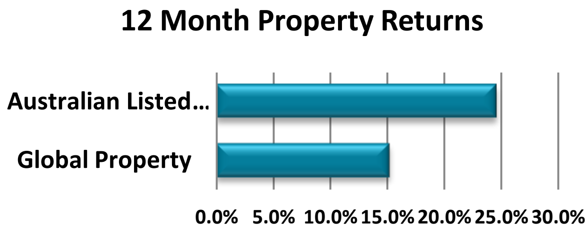
For long term investor's, property remains a cornerstone of their growth portfolio exposure given the low levels of correlation with the other asset classes and the market level of rental returns available from the sector. Liquidity has always been a concern.

Global holdings are impacted by the level of the AUD which can both benefit or erode returns. If the AUD/USD strengthens this hurts unhedged investment returns and vice versa, if the AUD/USD weakens, this benefits unhedged holdings. The AUD/USD is expected to trade within the **range of AUD/USD 0.6500 to 0.8500** medium term.

In Australia, for the moment, the domestic property market activity, along with an anticipated softening in residential house prices, has not overly impacted the professional markets with office, retail and commercial property assets well sought after.

Chart 11 & 12





Source data: Morningstar, 30 June 2016

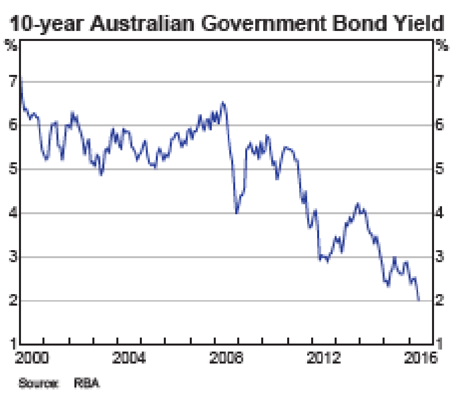
As mentioned previously, most property investment has an element of gearing (borrowing) which makes the prices of the property assets sensitive to interest rate moves. Rising interest rates will have a negative impact on the sector unless the borrowing costs have been locked in or fixed for a defined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

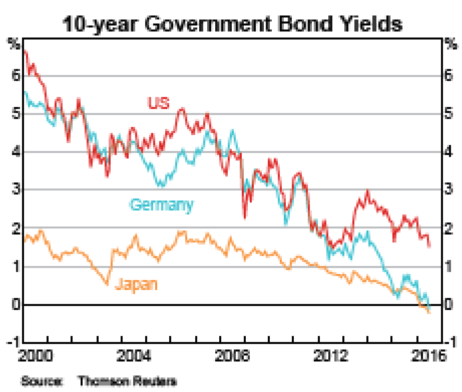
Global and Domestic Debt Markets

Low inflation, central bank asset purchases and the uncertainty following Britain's decision to leave the European Union (known as Brexit) have all resulted in a further drop in global bond yields. A significant proportion of European sovereign bonds now offer negative yields, or another way of putting it, losses for investors holding the bonds until maturity.

Fixed Interest markets did benefit over the quarter as bonds firmed and interest rates fell. The 10 year US Government Bonds firmed to 1.47% from 1.77% and in Australia, the 10-year Government bonds finished at 2.01% for the June 2016 quarter down from 2.51% at the end of March 2016.

Chart 13 & 14

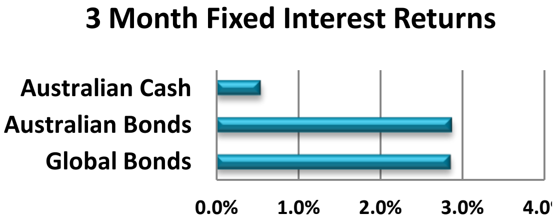


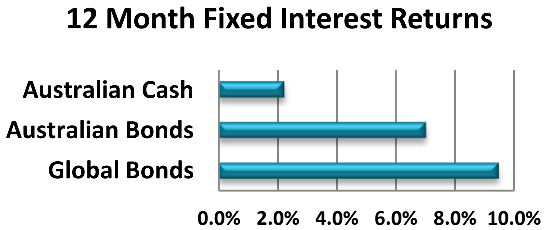


Source data: RBA, 30 June 2016

The following charts show the returns from cash and fixed interest markets over the quarter and the last 12 months:

Chart 15 & 16





Source data: Morningstar, 30 June 2016

The Reserve Bank of Australia (RBA) reduced the target cash rate to 1.75% at their meeting on 4th May 2016 with economists still looking at the possibility of future easing ahead in 2016 as the broader economy remains subdued.

Most analysts see the probability of more cash rate reductions by the RBA as high should growth in the broader economy remain sluggish in the months ahead. Some economists are calling cash rates as low as 1.0% if the economy fails to respond to the low interest rate environment. The latest CPI data suggests that further falls in the cash rate are possible given that inflation is sitting at 1% at the end of the June 2016 quarter.

Bond investors are happy to hold on to their current investments while demand for yield keeps prices favourable but remain cautious about any signs of inflationary pressures that may emerge as they do not want to incur capital losses if interest rates rise.

What lies ahead for global interest rates?

The Federal Reserve Bank has indicated that monetary policy would remain accommodative to support further improvement in labour market conditions and a return to their targeted 2% inflation. In particular, the Federal Open Market Committee (FOMC) maintained the target range for the federal funds rate at 0.25% to 0.50%. Looking ahead, the FOMC expects that economic conditions will warrant only gradual increases in the federal funds rate.

In contrast, Japan and the European Central Bank are **maintaining their quantitative easing** policy, holding interest rates low, in their attempts to rekindle growth in their economies.

What lies ahead for domestic interest rates?

For Australia, given what is happening globally, there is a high likelihood that the RBA will **consider further reductions** in the cash rate should the next round of economic data releases reveal signs of a continued slowdown in economic growth. The problem remains that **low interest rates alone will not solve the consumer sentiment and consumption issue**.

Summary

Short Term – now to 1 year

In the short term, **markets will remain cautious** and are likely to experience periods of price volatility as the markets respond to global conflict and take time to reassess what the latest developments mean to investor confidence and more importantly, company profits.

It is also a good time to **review the asset allocation of portfolios** and make any adjustments to the asset class or sector weights in order to re-position portfolios back to within the strategic or tactical targets that underpin the targeted risk profile. Any **excess cash** held in the portfolio from dividends or distributions received, **needs to be invested**.

Medium Term – 1 year to 3 years

In the medium term, experienced investors remain focussed on opportunities emerging from any rotation of capital. For example: **adding further diversification** to portfolios may help generate uncorrelated returns. For income focussed investors, asset classes such as Infrastructure may offer an alternative to shares as markets take time to recover.

Longer Term – 3 years to 10 years

The global economy is still encountering headwinds on the growth front due mainly political, economic and consumer concerns. Investor confidence, battered by a prolonged period of commodity price falls, volatility and the ongoing political unrest, is starting to **focus more on the recovery** of markets and where the investment opportunities are emerging.

Commodity prices are looking more stable as demand picks up however; they are not out of the woods just yet and are bound to experience bouts of volatility as **markets adjust to the changed short term demand influences**. The recovery cycle for commodities will drive investment back into the sector but for the moment, this is likely to be muted until clear evidence emerges that the trend is sustainable.

Key Message

Invest Surplus Cash: With cash yielding next to nothing, investors should ensure that any surplus cash is put to good use and actively invested.

Await Company Data: For Australia, opportunities will emerge this quarter as the company reporting period nears. For existing holdings, any signs of weakness in future earnings or expected profits will need to be closely examined.

Keep an eye on the economy: Low interest rates, moderating house prices and improved commodity demand offer a platform for growth. Now that the political playing field has been determined, the issue remains how quickly we can see evidence of the promised jobs and growth emerging.

Contact Details

Graham Fox
Financial Adviser
Mortgage Choice Financial Planning Pty Ltd
Authorised Representative No: 404026
Phone: 02 4331 9999, Fax: 02 4365 0901, Mobile: 0410 882 860
Suite 1, Karalta Connect, 18 Karalta Road, ERINA NSW 2250
MortgageChoice.com.au/fp/graham.fox

Data Sources

Where indicated in this review, the underlying data was sourced from Morningstar on the 26th July 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