Economic and Strategy Review

Monthly Report as at 31 May 2014

Offshore central banks remain focussed on supporting growth and ensuring inflation remains within targeted bands.

Economic and Policy Trends: Offshore central banks remain focussed on supporting growth and ensuring inflation remains within targeted bands. The main development over the month was the ECB signalling further monetary accommodation, most likely to come in early June via cutting the refinance rate, a negative deposit rate, ending Securities markets program (SMP) sterilization and some form of targeted longer term refinancing operations (LTRO) focussing on the small to medium size enterprise sector. Given heightened expectations, there is the risk that actual ECB measures may disappoint.

In China, policy makers appear to be responding to a softening in conditions via a 'mini stimulus'. Recent measures include increased spending on infrastructure and affordable housing, Reserve requirement ratio (RRR) cuts for county-level rural financial institutions, tax breaks for small businesses, and the relaxation of curbs on the property market in some regions. Central bank liquidity actions have helped the 3 month SHIBOR rate fall by around 50 basis points over the month. The PBoC also appears to have altered its FX policy with the renminbi depreciating over the month. Central bank policy bias, along with the rally in longer dated government securities over the globe should help global growth momentum improve over the remainder of the year.

In Australia, data releases remain mixed but it appears as though the interest rate sensitive sectors of the economy are beginning to lose some momentum after a strong start to the year. Building approvals fell 1.5% in March while retail sales inched ahead by 0.1% over the period. Scaremongering ahead of the Budget and poor articulation of the Budget's laudable medium direction led to a severe decline in consumer sentiment. The risk is that a negative feedback loop develops between falling levels of confidence and the real economy. Both the Treasury and the RBA released updated forecasts for the Australian economy. While both expect the economy to grow by 2.75% over 2013/14, Treasury have growth slipping to 2.5% in 2014/15 while the RBA are looking for 2.75%.

We continue to look for a period of sub trend growth ahead and have pushed back our expectations of the timing of the first rate hike by the RBA into H2 2015. We suspect that the RBA will look through choppy near term data and be encouraged by early signs of improving capital expenditure plans in the non-mining sectors of the economy.

Equity Market Trends: Offshore equity markets benefitted from signs that global growth was rebounding and pro-cyclical central bank actions. In the US, the S&P500 ended the month 2.1% higher while in Europe, the Euro STOXX 50 rose 1.4%. In Japan, the Nikkei rebounded 2.3% on signs that activity was rebounding after April's VAT hike. The MSCI World ex-Australia Accumulation Index in Australian dollars gained 1.5% over the month, with a relatively steady Australian currency having little impact on sector returns. In Australia, the S&P/ASX 300 Accumulation Index rose by 0.65% over April.

Bond Market Trends: Yields rallied over the month resulting in capital gains that helped lift the UBS Composite Bond Index by 1.37% over the month. The shorter end continued to benefit from patchy economic readings and a sharp fall in consumer confidence following a poorly articulated Budget. While longer dated securities benefitted from these factors, they also benefitted from a global search for higher yields against the backdrop of prospective ECB monetary easing. Three and ten year government bond yields ended the month 16 and 29 basis points lower at 2.74% and 3.66% respectively. The cash sector, as measured by the UBS Bank Bill Index, rose by 0.22%.

Investment Strategy: Our investment metrics have the Australian equity market starting to migrate from being fairly valued to offering value. The key driver has been a 50 basis point fall in the yield on a 10 year government bond since early April. Multi sector funds are maintaining benchmark exposures to the sector but have a strong bias to move overweight.

Multi sector funds continue to hold a benchmark weighting to Australian fixed interest but have a strong bias to move underweight following the recent rally in local yields.

Frank Uhlenbruch, Investment Strategist

Tactical Asset Allocation Summary (as at 31 May 2014)

Asset Class	Multi Sector Trusts*
Australian Shares	Benchmark
Australian Fixed Interest	Benchmark
Cash	Benchmark
International Shares	Benchmark fixed
Australian Listed Property	Benchmark fixed
Global Listed Property	Benchmark fixed

* Multi-sector Trusts may have differing asset class weights, including no exposure to a particular asset class