Economic and Strategy Review

Monthly Report as at 31 December 2013

US economic and political developments were favourable enough to give the Fed the confidence to gradually begin removing monetary accommodation.

Economic and Policy Trends: US economic and political developments were favourable enough to give the Fed the confidence to gradually begin removing monetary accommodation. On the data front, the US economy grew by a solid 0.9% over the September quarter while the US labour market continued to improve with the unemployment rate falling to 7% in November, the lowest level since November 2008.

On the political front, US politicians delivered the Bipartisan Budget Act of 2013 which funds the US government for the 2014 and 2015 fiscal years. While providing around $63 billion in sequester relief over the next two years, gains elsewhere via budget savings and non-tax revenue increases are expected to total around $85 billion and reduce the budget deficit by around $22 billion. The only fly in the ointment remains the US debt ceiling limit which will need to be extended once the debt limit suspension bill expires on 8 February 2014 and before the Treasury runs out of cash, most likely sometime in March.

Against this improving backdrop, the Fed announced on 18 December, that beginning in January it would modestly reduce the pace of its asset purchases from $85 billion per month to $75 billion per month. This will be achieved by reducing treasury purchases from $45 billion to $40 billion and MBS purchases from $40 billion to $35 billion. Further incremental cuts are expected over 2014, data permitting. Conventional tightening remains a story for 2015 but the unemployment rate will need to fall well below 6.5% according to the FOMC statement.

In Australia, the narrative of a re-balancing economy delivering patchy sub trend growth remained intact with the economy growing by only 0.6% over the September (2.3% year on year). There remains the promise of a lift in the interest rate sectors of the economy, with October retail trade lifting 0.5% over the month and October building approval data slipping only 1.8% after a massive 16.9% gain in the previous month. Labour force data for November was mixed, with the positive news of total employment lifting by 21,000 slightly soured by a lift in the unemployment rates to 5.8%.

The Coalition government released its first Mid-Year Economic and Fiscal Outlook (MYFEO) in which it signalled a sharp deterioration in the near term fiscal outlook and stepped away from its initial target of a budget surplus by 2016/17. From the starting point of a $47 billion budget deficit in 2013/14 (3% of GDP) the government committed to returning the budget to a sustainable surplus of at least 1% of GDP by 2023/24. Most of the downgrade to the fiscal outlook came from parameter shifts, including downgrades to real and nominal growth forecasts. Treasury are now looking for real GDP growth of 2.5% over both 2013/14 and 2014/15.

Equity Market Trends: The generally positive tone of global data helped equity markets weather the Fed's decision to commence tapering operations. In the US the S&P500 rose by 2.4%, while in Japan, the Nikkei powered ahead by 4.0%. In contrast, the Euro STOXX 50 was more subdued, gaining 0.7%. Further falls in the Australian currency helped boost the MSCI World ex-Australia Accumulation Index in Australian dollars by 4.4% over the month. For 2013, sector returns rose by a thumping 48%. In Australia, the S&P/ASX 300 Accumulation Index rose by 0.82% over December and by a very healthy 19.7% over the calendar year.

Bond Market Trends: Yields began the month trending higher but then reversed direction on a more subdued domestic economic outlook. After peaking at 3.13% and 4.43%, three and ten year government bond yields ended the month at 2.95% and 4.24%. For the month, the UBS Composite Bond Index rose by 0.53%, while the cash sector, as measured by the UBS Bank Bill Index, rose by 0.21%.

Investment Strategy: Under our valuation metrics, the Australian share market remains at the upper end of our fair value band. Therefore, multi sector funds continue to hold benchmark exposures to the sector.

The Australian fixed interest sector continues to show up as being fairly valued under our valuation approach and accordingly multi sector funds continue to hold benchmark weightings.

Frank Uhlenbruch, Investment Strategist

Tactical Asset Allocation Summary (as at 31 December 2013)

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

Signatory of: PRI Principles for Responsible Investment