Economic and Strategy Review

Monthly Report as at 31 August 2014

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Economic and Policy Trends: As the US economy continues to heal, policy makers' focus is shifting to understanding just how much slack there is in labour markets and how much "space" they have to run very accommodative monetary policies before jeopardising inflation targets. In her comments at the Jackson Hole Symposium, the Fed's Yellen noted that while there had been substantial improvement in the US labour market, as measured by the fall in the unemployment rate, there was still a meaningful level of underutilisation. Understanding the rate at which any slack will be absorbed is clouded by the interaction of complex structural and cyclical factors whose relative importance is not completely understood. The Fed is well aware of the trade-offs involved and appears to be taking a pragmatic view indicating that if the slack was disappearing faster than expected, it would bring forward conventional tightening and delay it further if the opposite was occurring.

On that note, the latest Fed minutes appear to be laying the groundwork for what "lift off" or policy normalisation would look like. They reiterated that the Fed funds rate would remain the key policy rate and that moves would be in increments of 25 basis points. On the Fed's balance sheet, they agreed that it should be reduced gradually and predictably to as the lowest level consistent with the effective implementation of monetary policy. The majority thought reinvestment should end sometime after the first conventional tightening. They also promised more detail to come in advance of the first tightening, which we look for around mid-2015.

The true state of the labour market in Australia was also a dominant theme with the unemployment rate jumping to an unexpected 6.3%, though the level of employment was largely unchanged. While the ABS noted that technical changes accounted for a chunk of the lift, the RBA's view appears to be that the labour market conditions will remain subdued as the economy continues to grow at a sub trend pace. According to the latest Statement on Monetary Policy, the RBA have the economy growing at 2.5% over 2014/15 before growth lifts to 3% the year after. Sustained labour market improvement is not expected until 2016. The Governor also noted in comments to the House of Representatives that should "animal spirits" return, their current projections could prove to be on the conservative side. We continue to look for the RBA to remain on hold until late 2015 when a modest tightening cycle is expected to commence.

Equity Market Trends: Offshore equity markets were again buffeted by the waxing and waning of geo-political events in the Middle East and on the Ukraine border. However, improving economic conditions in the US and ongoing central bank policy support helped provide a strong counter. In the US, the S&P500 ended the month 3.8% higher while in Europe, the Euro STOXX 50 gained 1.8%. In Japan, the Nikkei fell 1.3%. The MSCI World ex-Australia Accumulation Index in Australian dollars gained 1.6% over August, with a modest gain in the Australian currency a drag on sector returns. In Australia, the S&P/ASX 300 Accumulation Index gained a modest 0.6% against the backdrop of a lacklustre reporting season.

Bond Market Trends: Offshore demand for higher yielding safe haven government securities appears to have been a factor behind the fall in local yields. Nevertheless, commentary from the RBA suggests that the cash rate will remain on hold at 2.50%, rather than be cut again. While economic readings were mixed over the month, they suggest a lift in the pace of activity in Q3 after a subdued Q2. Three and ten year government bonds ended the month 8 and 22 basis points lower at 2.63% and 3.29%. As a result of these moves, the sector experienced solid capital gains with the UBS Composite Bond Index gaining 1.0%. The cash sector, as measured by the UBS Bank Bill Index, rose by 0.23%.

Investment Strategy: Under our investment process, the Australian equity market is showing up as being at the cheap end of our fair value band, with the sector looking most attractive on a relative value basis given the low level of government bond yields. Multi sector funds are maintaining benchmark exposures to the sector.

Multi sector funds continue to hold a benchmark weighting to Australian fixed interest but maintain a strong bias to move underweight following the recent rally in longer term government bond yields.

Frank Uhlenbruch, Investment Strategist

Tactical Asset Allocation Summary (as at 29 Aug 2014)

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

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

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