McGregor Asset Consulting

Economic and Market Outlook
January 2014

The performance of Growth assets during 2013 was exceptional with International shares (unhedged) up 48% supported by a falling A$ v US$. Japan, US and Europe all returned in excess of 40% for the year. Australian shares were up 20%, infrastructure up 17%, global property up 6% and Australian property up 7%. These returns have largely been driven by the massive quantitative easing stimulus instituted throughout the developed countries combined with very low interest rates. Conversely, fixed interest markets have delivered poor returns of around 2% for the year.

As we enter 2014 the investment environment continues to favour growth assets over defensive/income assets. Extremely low interest rates in the developed countries and continued stimulus, although being reduced should continue to support investing in growth assets over defensive assets. This environment supports increased liquidity into, especially the equities markets which should continue to drive equities investing. Increasing investor sentiment continues to support investing in growth assets. This affect is negating the risk that many of the markets are bordering on fair value to over-valued, which is likely to provide the markets with increased volatility over the year ahead. The US Fed now led by Janet Yellen is focused on tapering the stimulus however, it is likely to be tapered in an accommodative manner with interest rates remaining low for a considerable period. Growth markets are likely to rely on global growth increasing during the year and underpin company earnings. The International Monetary Fund's latest forecast for global growth has been upgraded to 3.7% for 2014.

Emerging markets and Asia underperformed the developed markets during 2013 as it suffered a pull back in growth, although it still accounts for much of the global growth. The Latin American region is undergoing a prolonged period of weakness largely due to softening commodity prices and higher inflation. Other emerging market countries are being embroiled in political issues with Turkey and Egypt being the most affected.

China continues to be a major contributor to world growth. China's growth bottomed out in 2013 at 7.5%. The Chinese leadership is starting to implement an ambitious reform agenda and is seeking to balance a transition from infrastructure investment spending to an increased consumption spending focus. While the Chinese economy is large and complex, it is hard to predict as it lacks transparency.

The Japanese equities market continues to perform strongly (up 47% in 2013) on the back of the large QE stimulus being implemented by Prime Minister Shinzo Abe who is embarking on an ambitious growth strategy. He controls both chambers of Japan's parliament and is commencing more difficult reforms to re-energise Japan's economy. This has led to renewed optimism in Japan with deflationary pressures gradually receding. The aim is to drive down the currency and boost export earnings, which is starting to occur although it will undergo periods of volatility. Japanese equities also continue to attract large flows. A major fiscal reform is to be introduced in April where the value added taxes are to be increased and this should be a key indicator as to the progress Japan is making in its recovery.

The Eurozone is starting to lay the foundations for recovery with most countries moving out of recession, although there is little growth being generated from the region. It is anticipated that growth is to be in the region of 1% for 2014. France is undergoing political destabilization with a lack of leadership from President Hollande and his popularity dropping to extreme lows. High debt burdens and high unemployment levels continue to be major issues for most Eurozone countries.

The US economy continues to undergo a broadening recovery although from a low base fuelled by cheap funds (cash rates close to 0%), improving jobs market, improving housing and construction market and access to affordable energy. The housing recovery is likely to contribute strongly to US GDP in the coming year. All of these factors are providing a lift in confidence with the US economy continuing to produce positive growth although at low levels and a more upbeat corporate and banking sector. The quantitative easing programmes being undertaken by US, Europe and Japan continues to fuel the "risk on" approach by investors. However, markets are likely to remain volatile while uncertainty remains, with US bond prices likely to increase in response to tapering. The Fed's message is a tapering of the stimulus is contingent on the economy improving in-line with forecasts, with no pre-set timetable for withdrawing the stimulus. The underlying fundamentals remain supportive for the market into 2014 and continue to support an overweight to global equities (unhedged).

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Returns for bonds, both global and domestic have dropped to 2% for the year to the end of December. The RBA Cash rate remains at 2.5% and is now providing support to the housing market. Rates may stay on hold as the low rates start to encourage borrowing activity and stimulate a modest growth environment.

US 10 year bond yields have stabilised around the 2.8% region and with negative real interest rates for cash in most developed countries, this has led investors to seek higher yields from riskier assets, such as property, infrastructure and equities. Quality large cap companies that pay reliable dividends have benefitted the most and are responsible for the strong returns seen across most equity markets of developed countries. Emerging markets and Asia ex Japan have been weaker. The Eurozone is starting to attract equity investors as the first stages of recovery appear from a low base. Germany and UK, in particular are starting to provide further stability for the European region as it deals with low growth and the potential for a deflationary period.

Inflation in the developed countries is benign, resulting in bonds now generating positive real rates (US 10 year bonds 2.8% and inflation 1%). The US unemployment rate is a major focus for the Fed and has now dropped to the 7% region. The US housing sector is generally showing good recovery signs with the foreclosure rates rapidly declining across the country. House prices have also experienced the biggest year-to-year advance since 2006.

In Australia, consumer and business confidence is starting to improve which should flow to better investment sentiment although it has been blunted by the wind back in mining sector capital expenditure and the difficult manufacturing environment, with the demise of Holden and the general flow on across the manufacturing sector. The business sector is looking for more certainty from the Coalition government as it settles into office and starts to repair the government's finances and priorities.

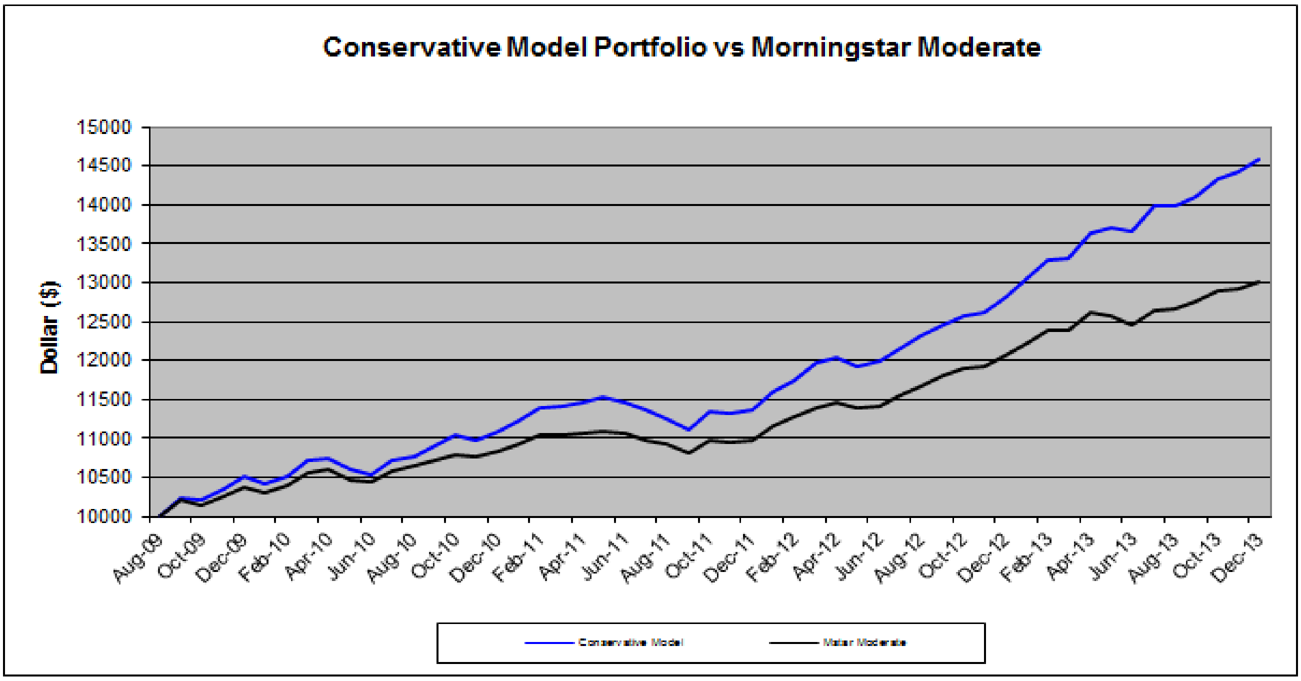
The combination of low interest rates and a lower A$ is likely to drive a modest pickup in growth into next year. A lower trending A$ is positive for exporters, manufacturers and tourism, which have suffered for the past few years. There is still a strong yield thematic by investors with the move out of cash and term deposits into higher yielding growth investments. The Australian equities market is now looking out to the reporting period, which commences in February for confirmation of earnings, which need to increase in order to support higher equities prices.

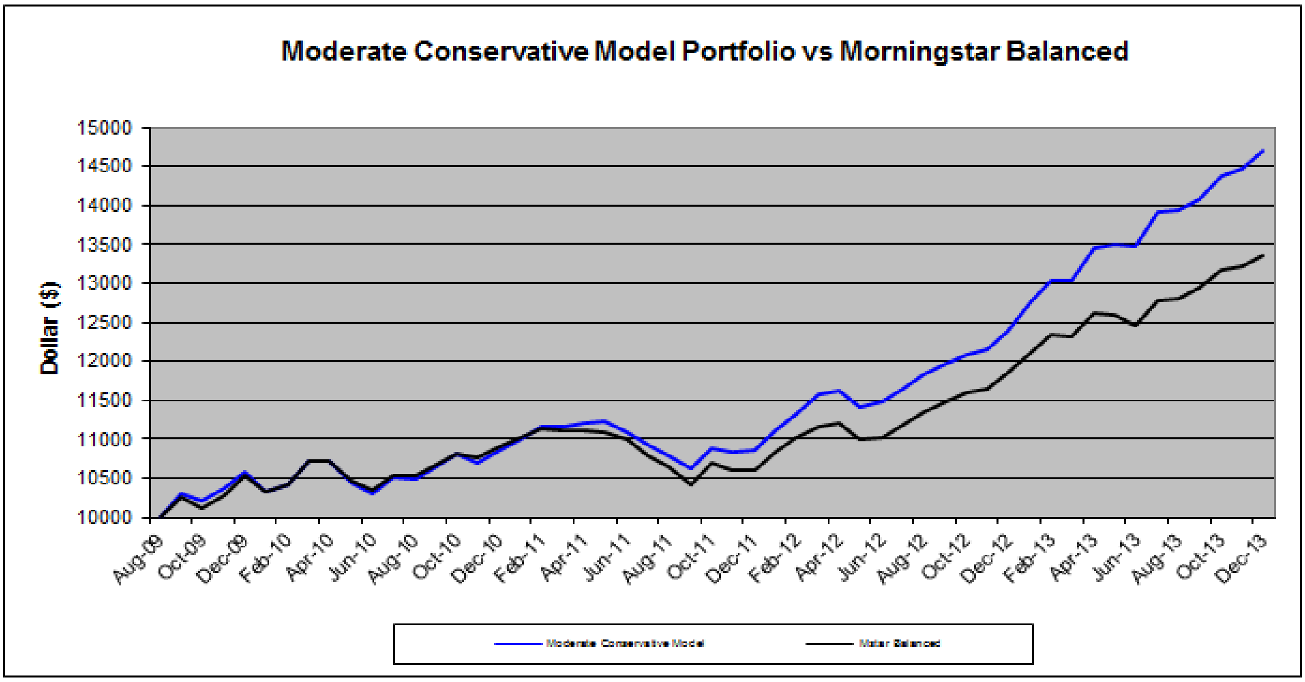
Returns from fixed interest are becoming harder to achieve as cash rates are generally well below long term levels and opportunities are now difficult to find. Commercial and retail property valuations are also offering better value and long term investors are re-entering the market. Interest in listed REITs has also been solid as investors seek higher yielding investments. The outlook for the housing market has improved markedly as the recent interest rate cuts provide a boost to the sector.

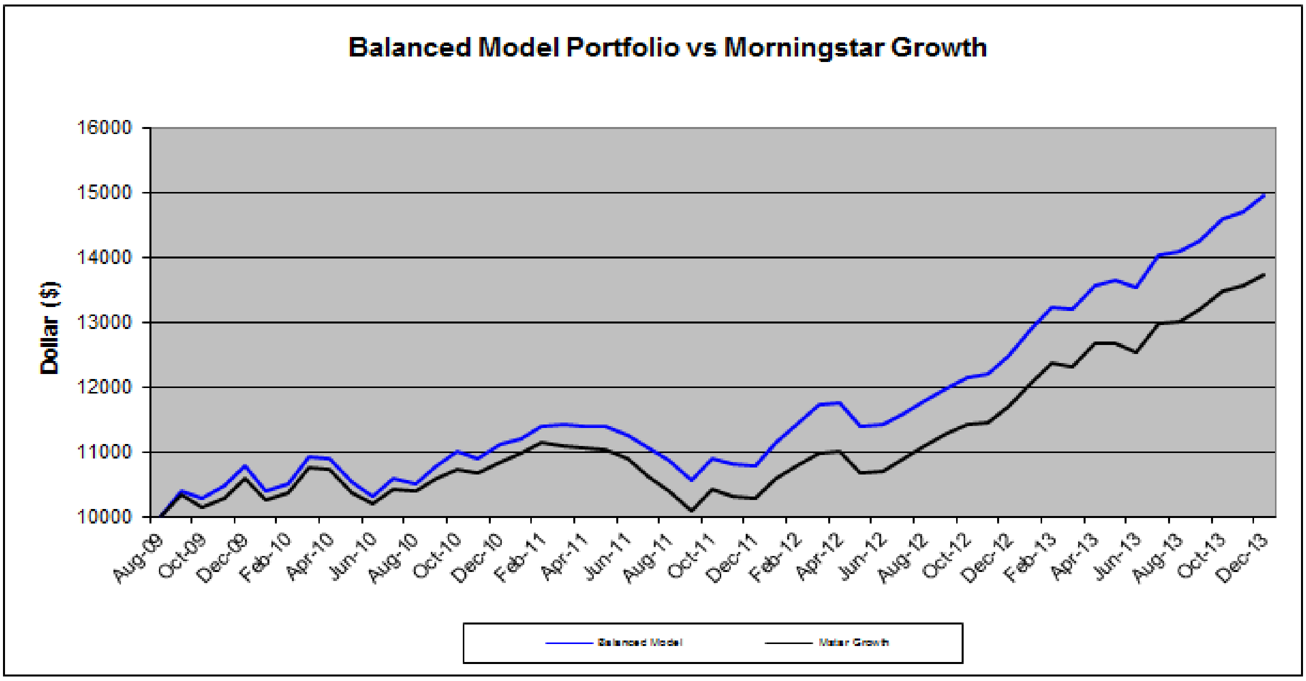
Best Performing Asset Sectors for twelve months ended 31 December 2013

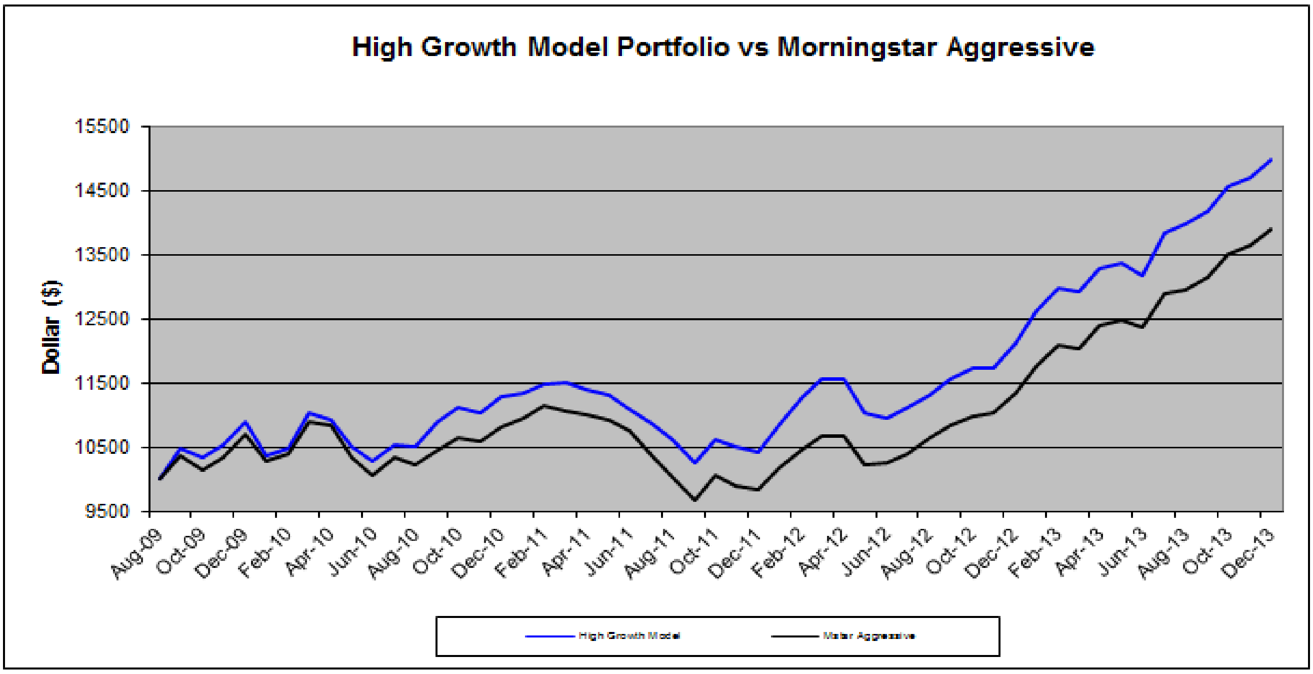
Sector	Market Index	Return
International Equities Unhedged	MSCI World Ex Aust Accum Index A$	48.03
International Equities Hedged	MSCI World Accum Index Hedged A$	32.72
Australian Shares	S&P/ASX All Ords Accum Index	19.66
Aust Listed Property	S&P/ASX Property Trusts Accum Index	7.27
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hdg $A	5.84
Cash	Australian 90 Day Bank Accepted Bill	2.87
Australian Fixed Interest	UBS Warburg Composite 0 + Years	1.99
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged $A	1.96
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	-0.76

Actual Model Portfolio Performance - Examples









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