McGregor
Asset Consulting

Economic and Market Commentary
May 2014

Growth assets continue to reward investors as we progress to the end of the financial year. Global and domestic equities continue to deliver strong returns compared to the low cash and fixed interest returns. Global equities (unhedged) has returned 30% for the year to 30 April and Australian equities 10% for the year. Emerging markets and Asian equities continue to underperform the broader global equities universe. Emerging markets equities have returned 10% for the year to 30 April and Asian equities 14%.

Uncertainty still overshadows the emerging world which reflects political and currency problems in a number of countries including Turkey, Argentina, Brazil, South Africa, Ukraine and Russia as well as concerns about weaker Chinese growth. The concerns largely reflect the unknown consequences of unwinding the US stimulus (QE3), which has had significant flow on effects to the developing economies.

Investment sentiment and the key drivers of the equities bull market remains intact for 2014 which favours growth assets over defensive/income assets. Record low interest rates in the developed economies and continued stimulus although at a reducing level in the US should continue to be the catalyst to support the "risk on" environment over the coming months. This environment supports increased liquidity, which should continue to drive equities investing. Of increasing concern is that many of the markets are bordering on fair value to over-valued, which is likely to add to increased volatility over the year ahead. The US Fed is providing forward guidance of the strategy which is to withdraw the stimulus in an accommodative manner with interest rates remaining low for a considerable period (possibly for another 12 months). Growth markets are likely to rely on global growth increasing during the year, which should continue to underpin company earnings. The International Monetary Fund's forecast for global growth is for 3.7% for 2014.

While every cycle comes to an end and a return to normality in markets should eventually occur. However, the recent history of QE3 and the massive stimulus being undertaken in Japan and likely to be undertaken in Europe, suggests that “normal” may not occur across world markets for quite a while longer.

Parts of the emerging and Asian economies are now adjusting to the more volatile environment and are likely to underperform over the coming months. 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 Ukraine, Russia and Turkey being the most affected.

While concerns have risen of the Chinese growth easing, it continues to be a major contributor to world growth. The Chinese leadership has commenced to implement an ambitious reform agenda and is seeking to balance a transition from infrastructure investment spending to an increased consumption spending focus. This process is difficult to undertake while maintaining the required growth to drive the underlying economy which has grown at a rapid rate over the past decade. As a result they are placing more pressure on industries including steel/iron ore, cement and solar industries, which is starting to have an effect on the Australian exporters where China now takes 37% of Australia's exports. The leadership is now placing a greater focus on reducing air and water pollution at the expense of industry.

The Japanese equities market continues to be driven on the back of the large QE stimulus being implemented by Prime Minister Shinzo Abe who is embarking on an ambitious growth strategy. He is now undertaking 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 continue to drive down the currency and boost export earnings, which is starting to occur although it will undergo periods of volatility.

The Eurozone continues 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. High debt burdens and high unemployment levels continue to be major issues for most Eurozone countries. The ECB is also watching for deflationary pressures. The strong support of the ECB is providing the catalyst for Europe's recovery and activity in the equities markets across the region.

The US economy continues to undergo recovery with steady signs of growth and increasing business confidence. Optimism is coming from a strengthening housing recovery, improving jobs market, access to

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cheap funds and a reinvigorated energy sector providing access to affordable energy. The housing recovery is likely to contribute strongly to US GDP this year. US GDP growth is forecast for 2014 at 2.8%.

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 yields likely to increase in response to tapering. The Fed's message is "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 US market and continue to support an overweight to global equities.

Returns for bonds, both global and domestic remain low and unappealing. The RBA Cash rate remains at 2.5% and has provided strong support to the housing market. Rates are likely to remain on hold in order to stimulate a modest growth environment.

US 10 year bond yields are trading around the 2.6% 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. Inflation in developed countries is benign, resulting in bonds now generating positive real rates (US 10 year bonds 2.6% and inflation 1%). The US unemployment rate remains a focus for the Fed which has now dropped to 6.5%.

In Australia, the focus has been on the Federal government's budget and what the flow on affects to the economy are likely to be. While there has been much political noise around the severity of the cuts, the budget can be assessed as a gentle fiscal repair budget with many of the savings being delayed and a number after the next election, which may not occur. The deficits over the remaining term of this government still remain at relatively high levels. The question to consider is should each generation pay for itself or is debt going to be passed to the next generation. The government needs to be mindful not to retard the drivers of growth as we come off record terms of trade and a slowing resources sector. Current GDP growth forecast for 2014 is 2.75% and is below the long term growth of 3.5%. Unemployment is also going to be a key indicator for the health of the economy over the year ahead.

Returns from fixed interest are 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 offering better value and long term investors are being attracted to the market. Listed REITs are attracting investors seeking yield.

- **International shares: [Overweight]** Sentiment in global equities markets remains positive providing opportunities for international shares to outperform in the coming year. An overweight position is appropriate for the sector. The European recovery should provide opportunities. Emerging and Asian equities markets are not preferred in the current environment.

- **Australian shares: [Overweight] Australian Small Caps: [Neutral]** Opportunities are likely to arise over the coming year as the economy grows. Investors who have been holding cash are likely to consider equities during the year as the return profile has become more attractive. Large cap stocks are preferred over small cap stocks.

- **Australian Listed Property: [Neutral] Global Listed Property: [Neutral]** Quality listed property securities delivering solid yields are likely to benefit from the focus on yield and suggest a neutral weighting to this sector. Quality direct property is also offering value although investors need to be selective in this sector.

- **Infrastructure: [Neutral]** Listed infrastructure securities provides opportunities in this environment as they provide both yield and defensive attributes. Governments globally are focussing on building infrastructure assets which should provide opportunities for the sector.

- **Fixed Interest: [Underweight]** With interest rates at historically low levels both globally and in Australia, opportunities for fixed interest are likely to be limited over the coming year. An underweight for the sector is appropriate. A cautious approach to global sovereign debt is required. Corporate bonds should provide the best opportunities.

- **Cash: [Underweight]** The risk return profile of Cash and Term Deposits is less attractive.

Risks

- A number of the emerging market countries and parts of Asia need to manage their currency and economies closely in order to prevent a currency crisis.
- Political unrest in Ukraine and Russia needs to be managed carefully in order to avoid a major conflict. If conflicts escalate, markets are likely to be effected.
- A potential risk ahead for the global economy is the mismanagement of the unwinding of the QE stimulus programs currently in place and its repercussions on bond markets.
- The Chinese leadership need to implement their economic reforms without stalling the economy which would have major flow on effects, especially for Australia. We are now starting to see defaults on loans in China where the government previously chose to bail them out, which may lead to a contagion effect.
- The risk of sovereign debt defaults continues to remain with large deficits being run by many countries. Investors need to be selective. Servicing debt is likely to be an issue when interest rates rise.
- The European Union continues to face challenges in managing member countries, especially Greece, Italy, Spain and Portugal with large debt issues and the lack of discipline to control the predicament.
- With large US government debt levels (US$17 trillion), strong political will is required to enact the necessary measures to reduce the debt levels. US politicians continue to defer making tough decisions.

Global Opportunities

- The Asian region continues to generate satisfactory GDP growth and should continue to be a major driver of world growth.
- A key factor for continued Asian growth is the increasing demand by China's consumers as they develop greater wealth and require ever increasing volumes of commodities and agricultural products, which should underpin the Australian resources and agricultural sectors over the longer term. Chinese interest in Australian assets is increasing.
- The rise of the US energy industry to a point of becoming an exporter of energy (gas) within 3-4 years and oil by 2030 provides a platform for optimism.

Fixed Interest, Property and Infrastructure

- Opportunities for higher returns from traditional fixed interest have largely disappeared with interest rates at record low levels. The market has largely factored in the lower rates and the risk now is for capital loss if rates rise. Focus should be on the corporate bond sector.
- The listed property trust and infrastructure sectors are in good shape to participate in an improving investment cycle and low borrowing rates provide increased opportunities.

Monthly Share Market Performance over the last Thirteen Months

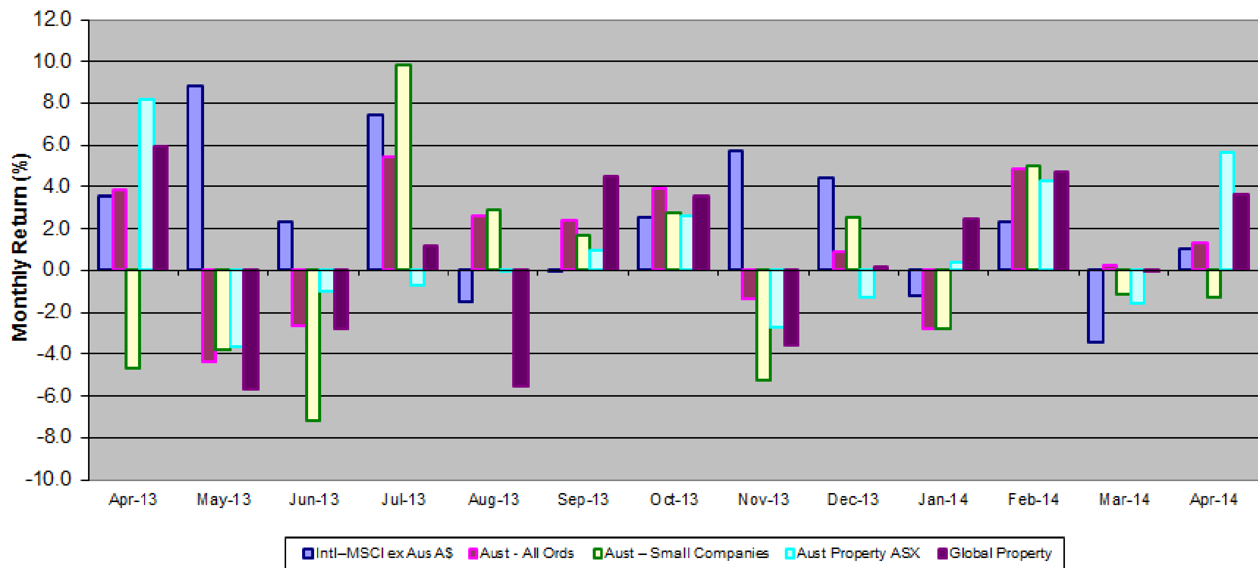
Market Indices	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14
Intl–MSCI ex Aus UH A$	8.84	2.31	7.45	-1.50	-0.06	2.55	5.69	4.44	-1.20	2.30	-3.43	1.03
Aust - All Ordinaries	-4.39	-2.62	5.46	2.59	2.39	3.91	-1.38	0.92	-2.76	4.84	0.25	1.29
Aust – Small Company	-3.82	-7.15	9.81	2.88	1.69	2.74	-5.23	2.55	-2.76	4.97	-1.16	-1.24
Aust Property REITs	-3.66	-0.97	-0.70	-0.07	0.93	2.64	-2.73	-1.26	0.41	4.26	-1.58	5.63
Global Property REITs	-5.65	-2.76	1.18	-5.53	4.51	3.55	-3.59	0.16	2.45	4.75	-0.02	3.64

Annual Share Market Performance

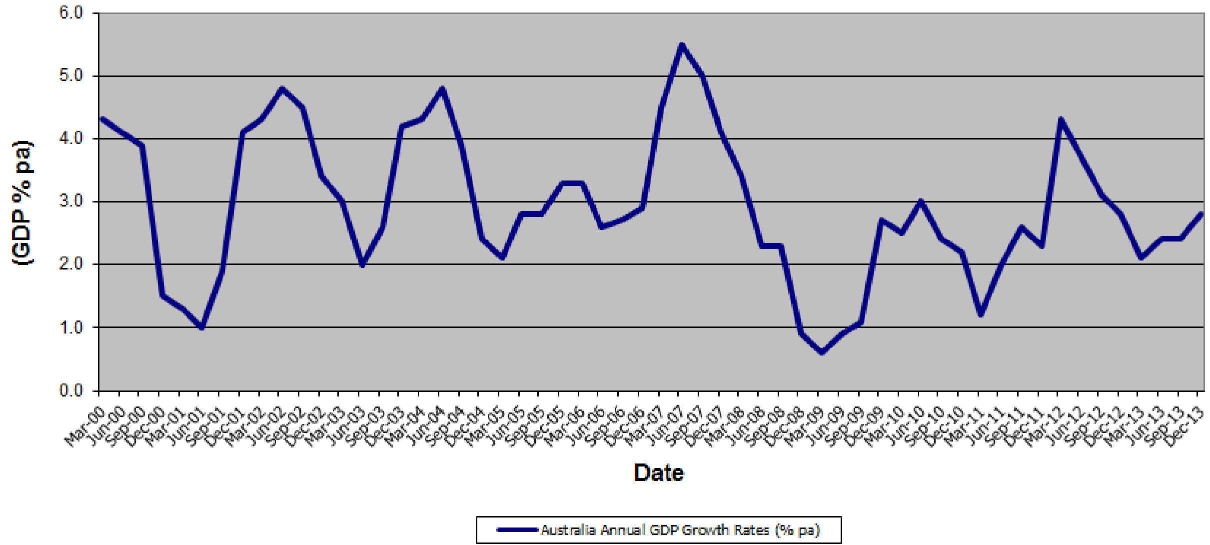
Markets Index	1 Year to 30 Jun 12 %	1 Year to 30 Sep 12 %	1 Year to 31 Dec 12 %	1 Year to 31 Mar 13 %	1 Year to 30 Jun 13 %	1 Year to 30 Sep 13 %	1 Year to 31 Dec 13 %	1 Year to 31 Mar 14 %	1 Year to 30 Apr 14 %
Intl–MSCI ex Aus UH A$	-0.50	13.59	14.14	10.76	33.10	34.02	48.03	34.73	31.47
Aust - All Ordinaries	-7.04	13.36	18.84	17.80	20.67	23.55	19.66	13.19	10.43
Aust – Small Company	-14.61	3.83	6.58	-5.82	-5.32	1.42	-0.76	-1.46	2.06
Aust Property REITs	10.98	28.90	32.79	30.52	23.98	16.39	7.27	4.96	2.51
Global Property REITs	6.93	30.54	26.29	22.57	15.46	11.46	5.84	4.18	1.92

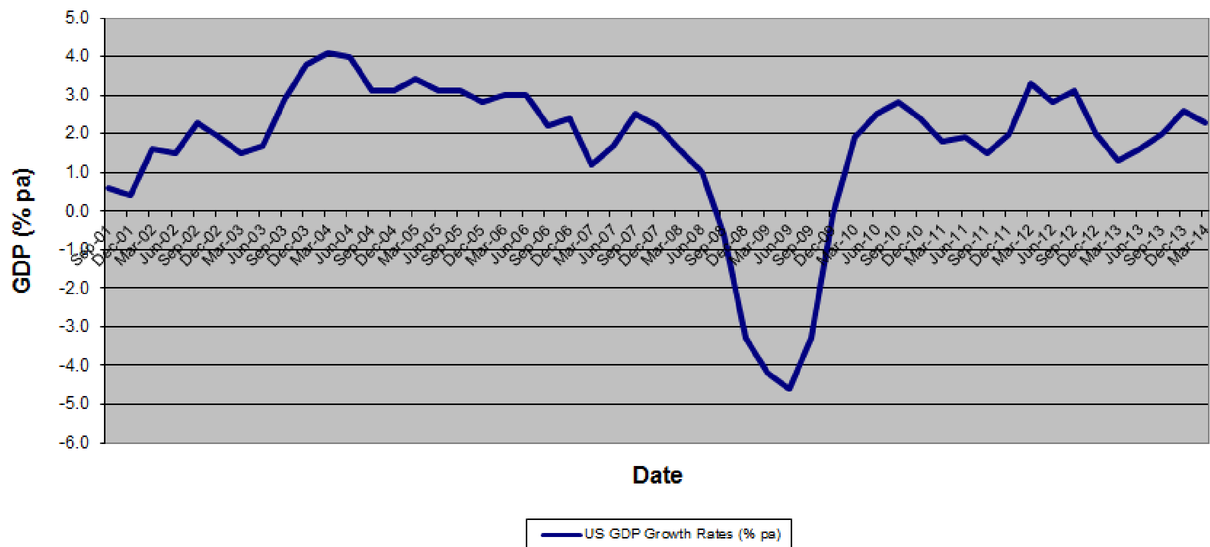
Best Performing Asset Sectors for twelve months ended 30 April 2014

Sector	Market Index	Return
International Equities Unhedged	MSCI World Ex Aust Accum Index A$	31.47
International Equities Hedged	MSCI World Accum Index Hedged A$	19.35
Australian Shares	S&P/ASX All Ords Accum Index	10.43
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged $A	2.90
Cash	Australian 90 Day Bank Accepted Bill	2.72
Australian Fixed Interest	UBS Warburg Composite 0 + Years	2.65
Aust Listed Property	S&P/ASX Property Trusts Accum Index	2.51
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	2.06
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge $A	1.92

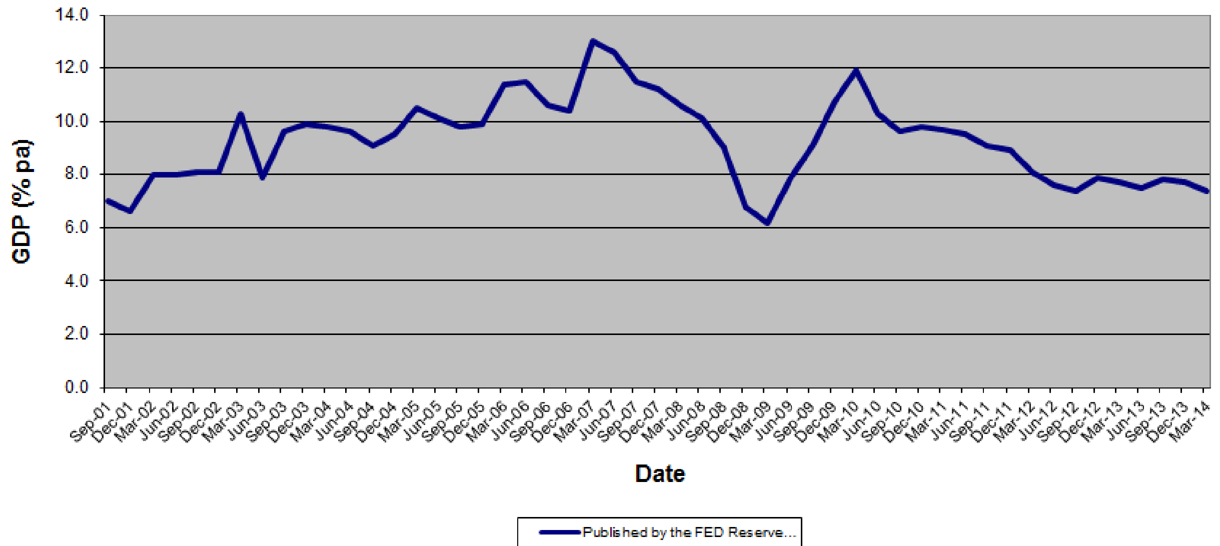


Major Economic Indicators

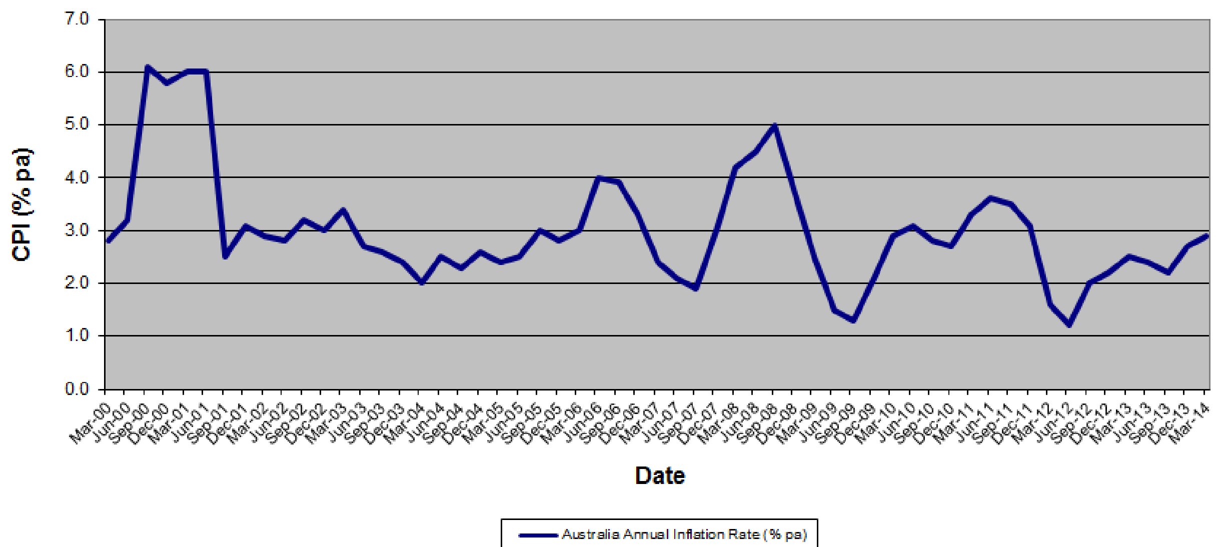


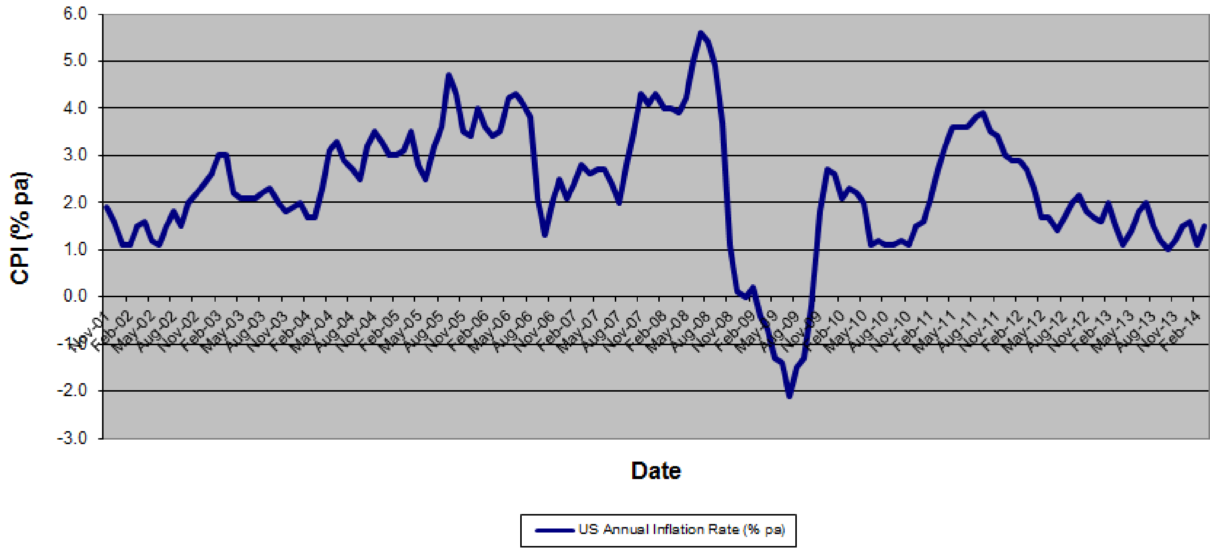


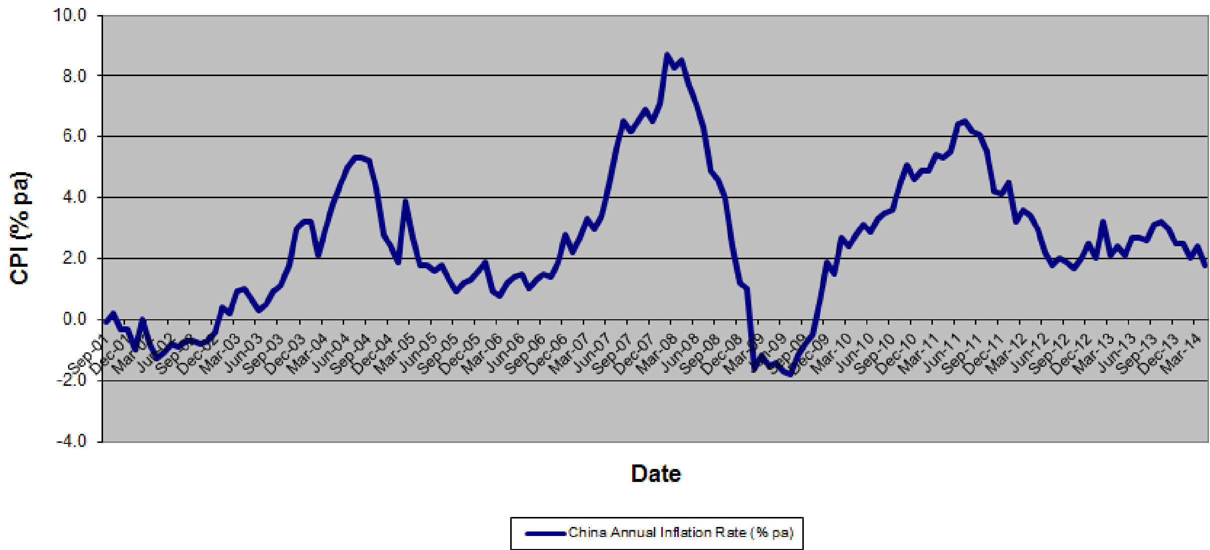
China GDP Growth Rates (%pa)

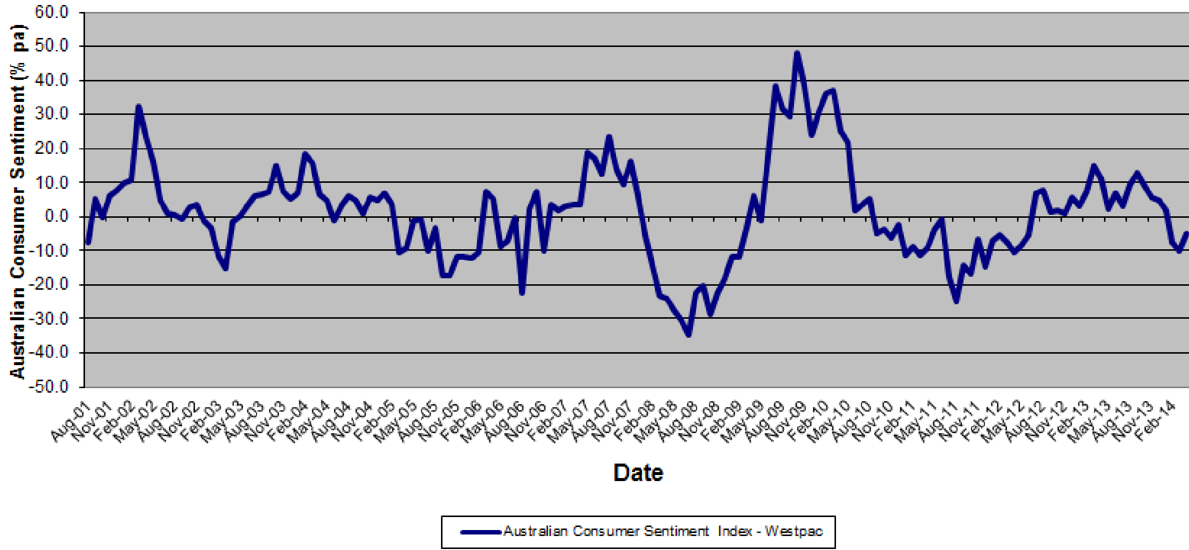


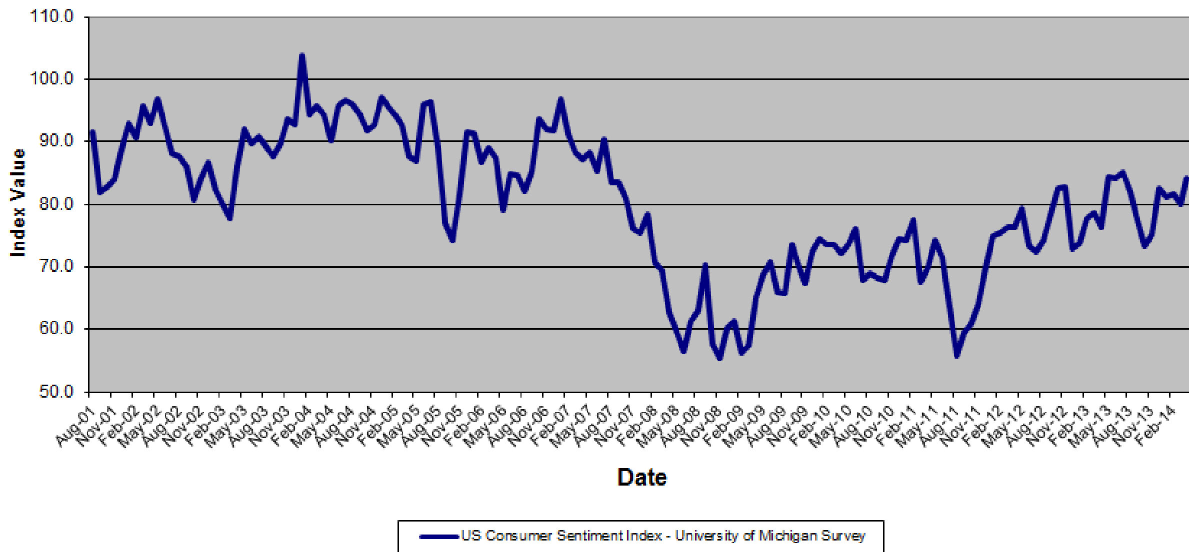
Australia Inflation Rates (%pa)

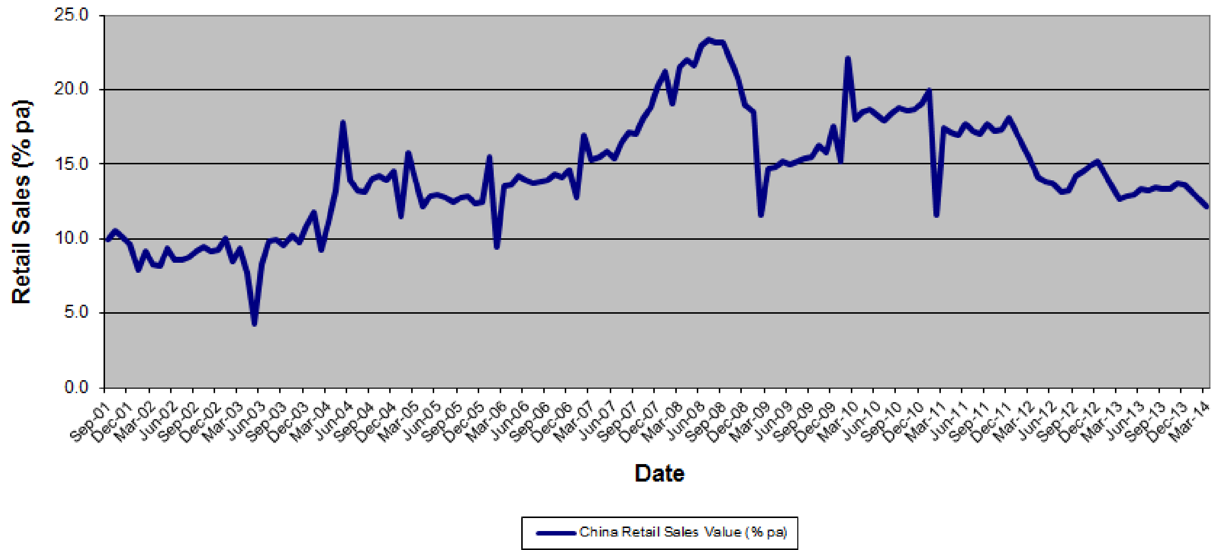



US Inflation Rates (%pa)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-2.0
-3.0
CPI (% pa)
Date
US Annual Inflation Rate (% pa)


China Inflation Rates (%pa)
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
CPI (% pa)
Date
China Annual Inflation Rate (% pa)


Australian Consumer Sentiment Index - Westpac
Australian Consumer Sentiment (% pa)
Date
Australian Consumer Sentiment Index - Westpac


US Consumer Sentiment Index - University of Michigan Survey
Index Value
Date
US Consumer Sentiment Index - University of Michigan Survey


China Retail Sales Value (%pa)
Retail Sales (% pa)
25.0
20.0
15.0
10.0
5.0
0.0
Sep-01
Dec-01
Mar-02
Jun-02
Sep-02
Dec-02
Mar-03
Jun-03
Sep-03
Dec-03
Mar-04
Jun-04
Sep-04
Dec-04
Mar-05
Jun-05
Sep-05
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Mar-07
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Mar-08
Jun-08
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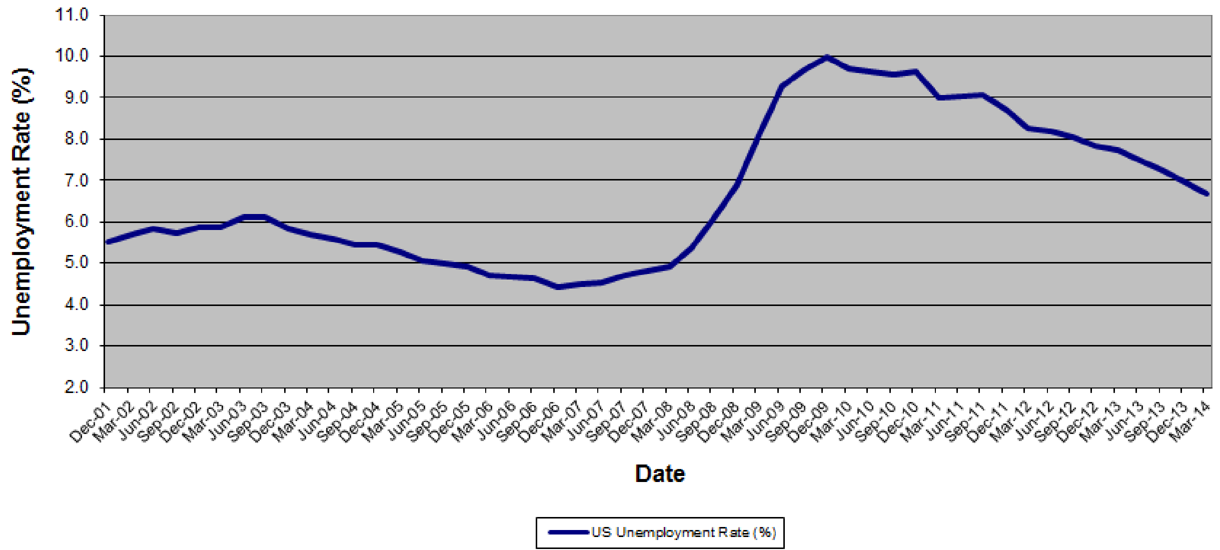
Mar-09
Jun-09
Sep-09
Dec-09
Mar-10
Jun-10
Sep-10
Dec-10
Mar-11
Jun-11
Sep-11
Dec-11
Mar-12
Jun-12
Sep-12
Dec-12
Mar-13
Jun-13
Sep-13
Dec-13
Mar-14
Date
China Retail Sales Value (% pa)


US Unemployment Rate (%)
Unemployment Rate (%)
11.0
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
Dec-01
Mar-02
Jun-02
Sep-02
Dec-02
Mar-03
Jun-03
Sep-03
Dec-03
Mar-04
Jun-04
Sep-04
Dec-04
Mar-05
Jun-05
Sep-05
Dec-05
Mar-06
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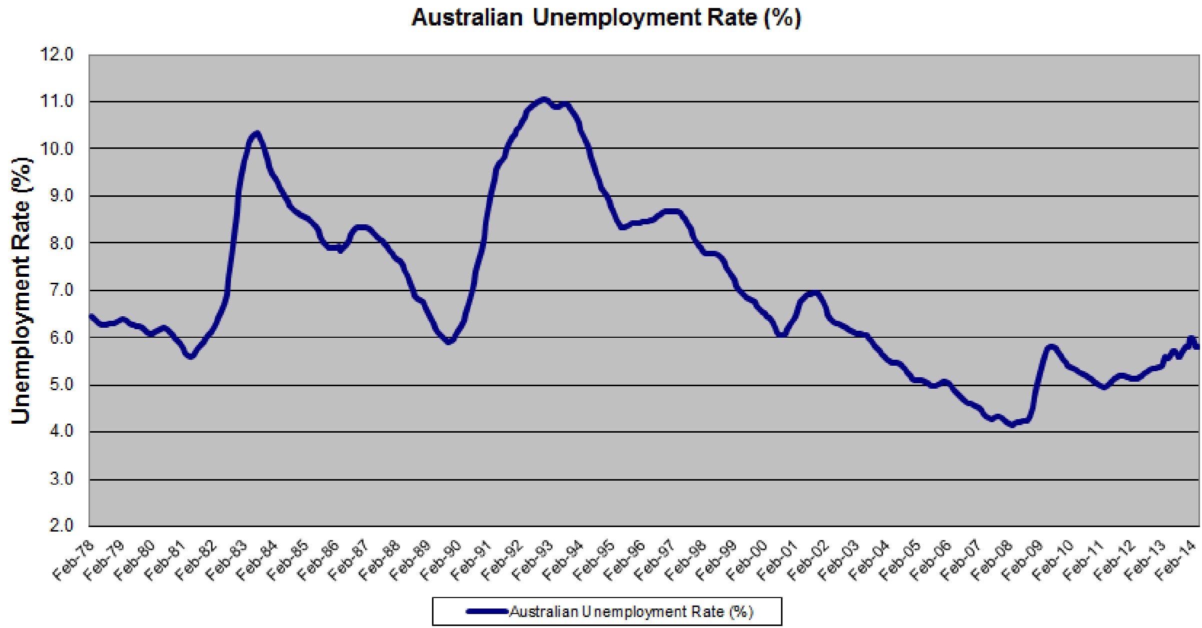
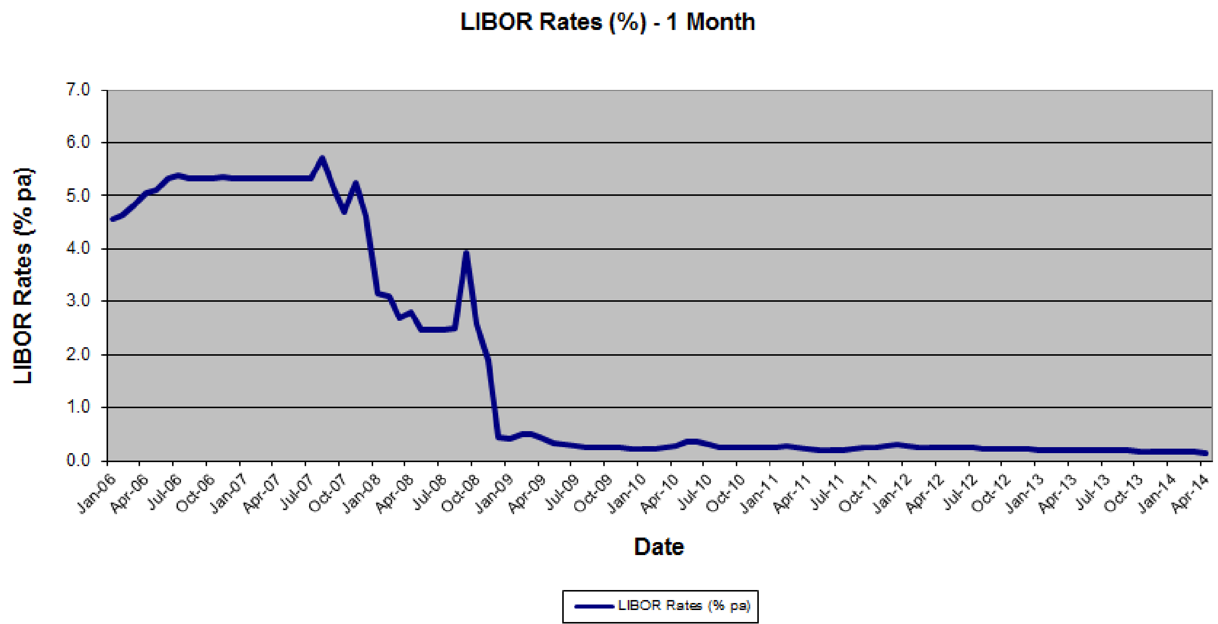
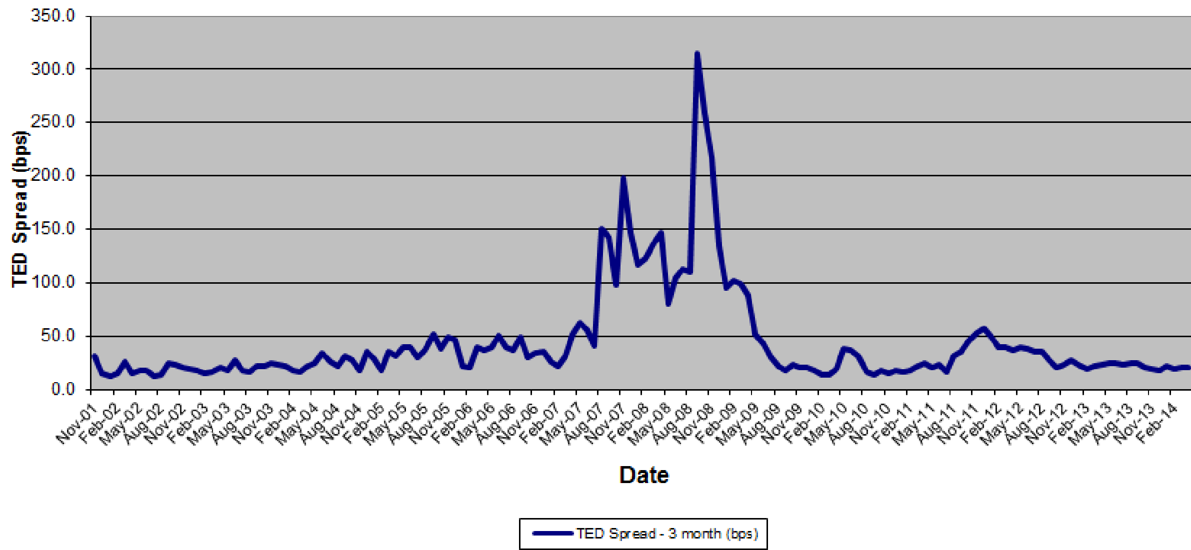
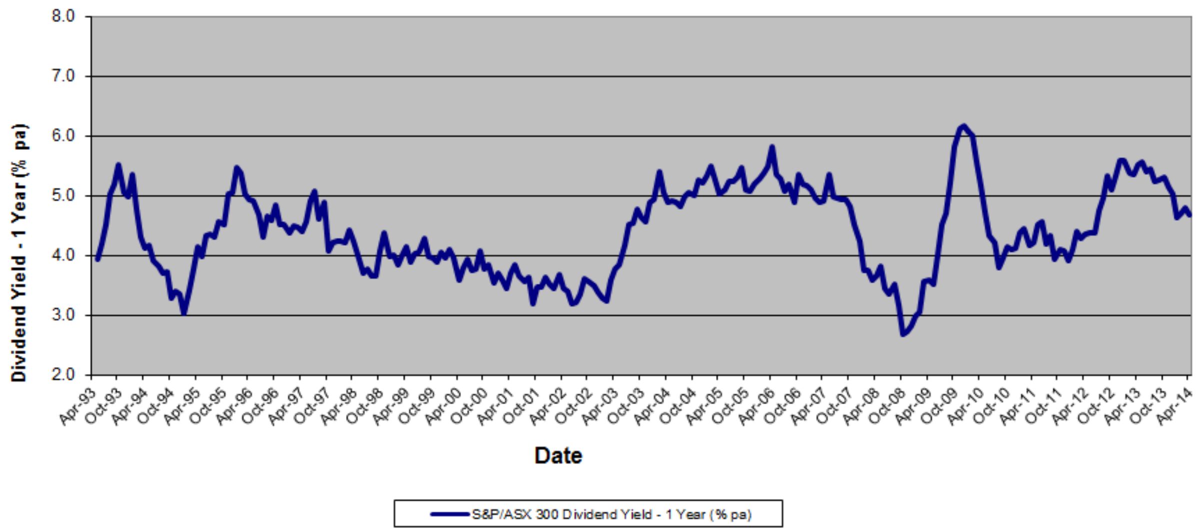
Jun-10
Sep-10
Dec-10
Mar-11
Jun-11
Sep-11
Dec-11
Mar-12
Jun-12
Sep-12
Dec-12
Mar-13
Jun-13
Sep-13
Dec-13
Mar-14
Date
US Unemployment Rate (%)


Australian Unemployment Rate (%)
Unemployment Rate (%)
12.0
11.0
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
Feb-78 Feb-79 Feb-80 Feb-81 Feb-82 Feb-83 Feb-84 Feb-85 Feb-86 Feb-87 Feb-88 Feb-89 Feb-90 Feb-91 Feb-92 Feb-93 Feb-94 Feb-95 Feb-96 Feb-97 Feb-98 Feb-99 Feb-00 Feb-01 Feb-02 Feb-03 Feb-04 Feb-05 Feb-06 Feb-07 Feb-08 Feb-09 Feb-10 Feb-11 Feb-12 Feb-13 Feb-14
Australian Unemployment Rate (%)

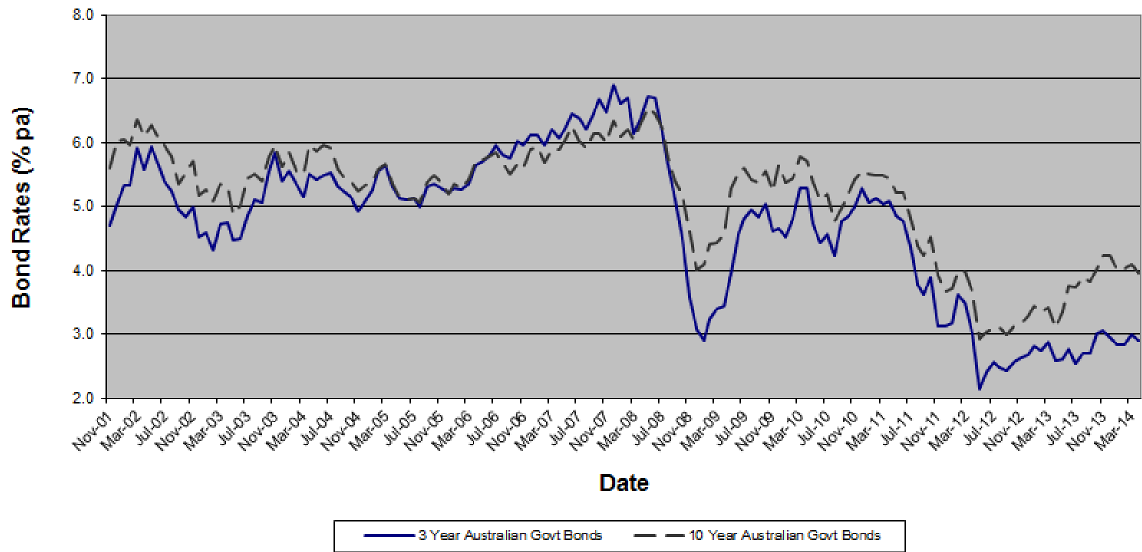

LIBOR Rates (%) - 1 Month
LIBOR Rates (% pa)
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Jan-06 Apr-06 Jul-06 Oct-06 Jan-07 Apr-07 Jul-07 Oct-07 Jan-08 Apr-08 Jul-08 Oct-08 Jan-09 Apr-09 Jul-09 Oct-09 Jan-10 Apr-10 Jul-10 Oct-10 Jan-11 Apr-11 Jul-11 Oct-11 Jan-12 Apr-12 Jul-12 Oct-12 Jan-13 Apr-13 Jul-13 Oct-13 Jan-14 Apr-14
Date
LIBOR Rates (% pa)

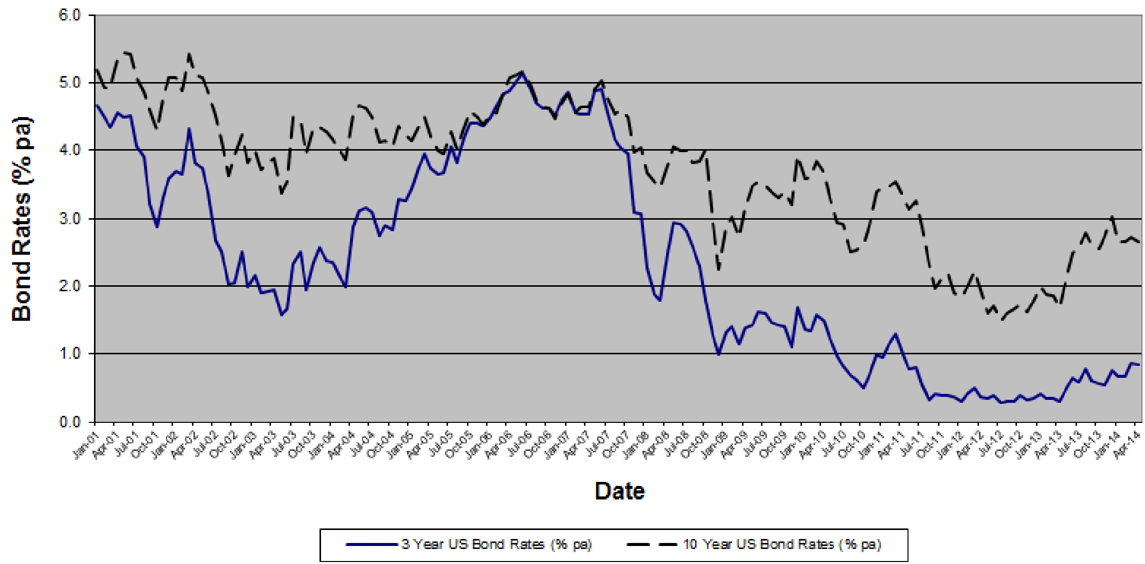

TED Spread - 3 Month
TED Spread (bps)
Date
TED Spread - 3 month (bps)

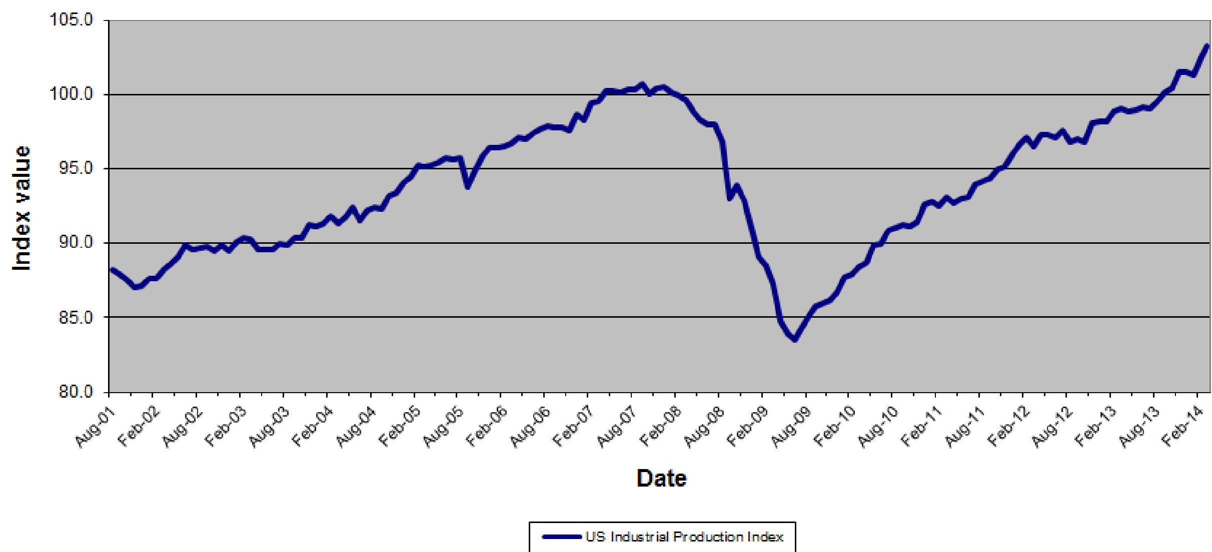

S&P/ASX 300 Dividend Yield - 1 Year (% pa)
Dividend Yield - 1 Year (% pa)
Date
S&P/ASX 300 Dividend Yield - 1 Year (% pa)

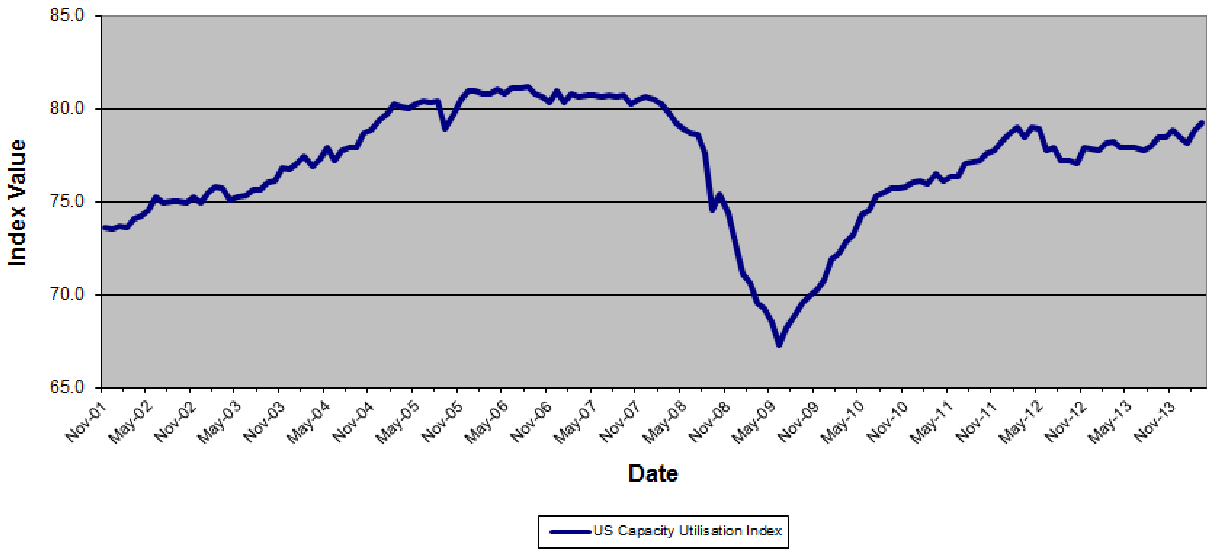
Source: UBS Australia and Reserve Bank of Australia as at 28 April 2014.

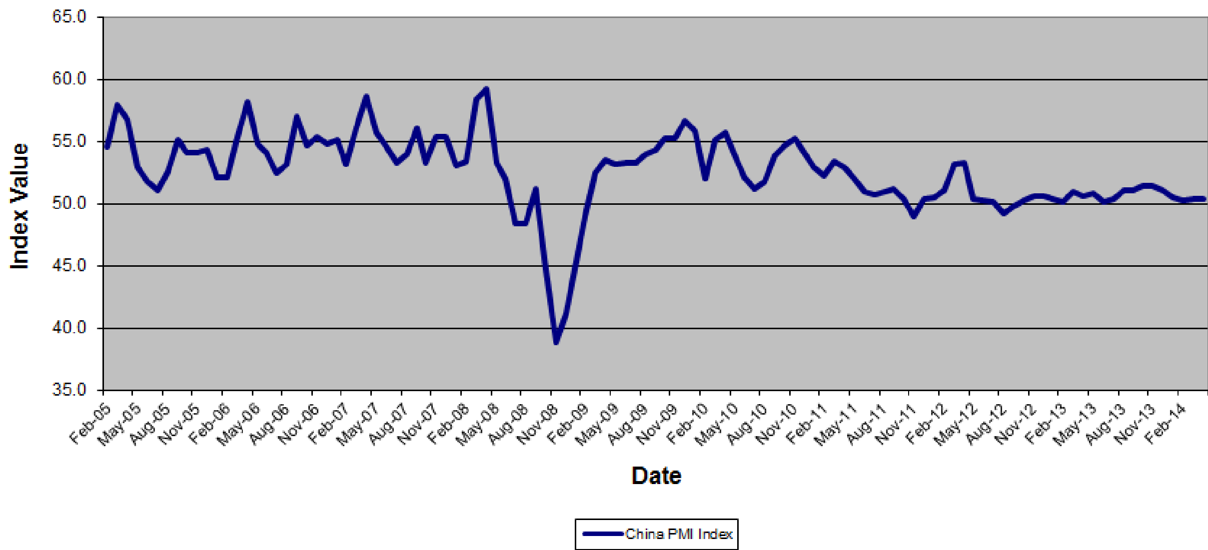
3y and 10y Australian Bond Rates (%)




3y and 10y US Bond Rates (%)
Bond Rates (% pa)
Date
3 Year US Bond Rates (% pa)
10 Year US Bond Rates (% pa)


US Industrial Production Index
Index value
Date
US Industrial Production Index


US Capacity Utilisation Index
Index Value
85.0
80.0
75.0
70.0
65.0
Nov-01
May-02
Nov-02
May-03
Nov-03
May-04
Nov-04
May-05
Nov-05
May-06
Nov-06
May-07
Nov-07
May-08
Nov-08
May-09
Nov-09
May-10
Nov-10
May-11
Nov-11
May-12
Nov-12
May-13
Nov-13
Date
US Capacity Utilisation Index


China Purchasing Managers Index (PMI)
Index Value
65.0
60.0
55.0
50.0
45.0
40.0
35.0
Feb-05
May-05
Aug-05
Nov-05
Feb-06
May-06
Aug-06
Nov-06
Feb-07
May-07
Aug-07
Nov-07
Feb-08
May-08
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May-11
Aug-11
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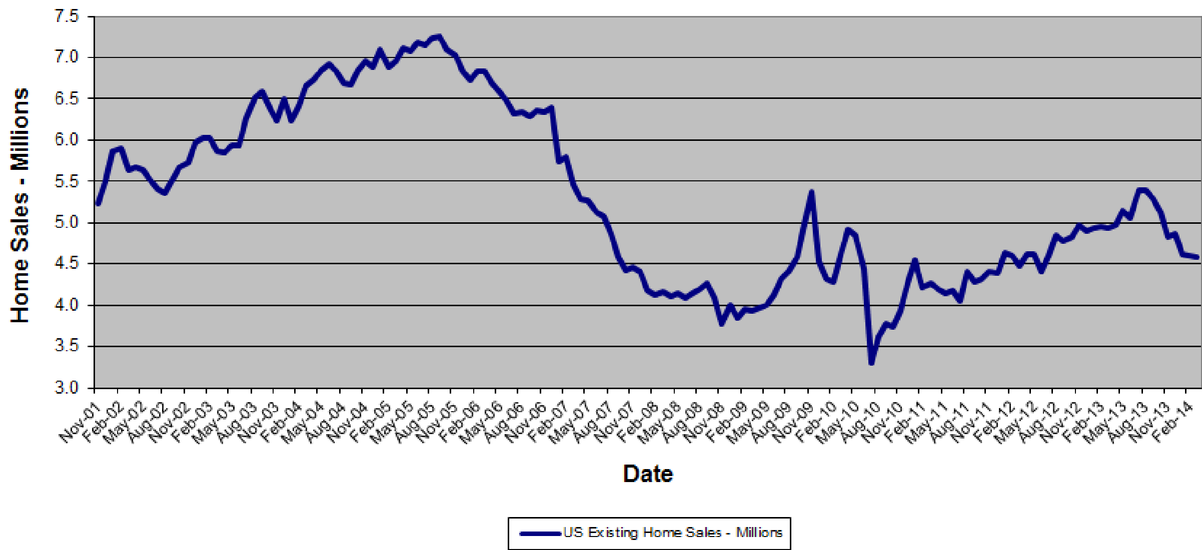
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
Date
China PMI Index


US Existing Home Sales - Millions
Home Sales - Millions
7.5
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
Nov-01
Feb-02
May-02
Aug-02
Nov-02
Feb-03
May-03
Aug-03
Nov-03
Feb-04
May-04
Aug-04
Nov-04
Feb-05
May-05
Aug-05
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May-10
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Nov-10
Feb-11
May-11
Aug-11
Nov-11
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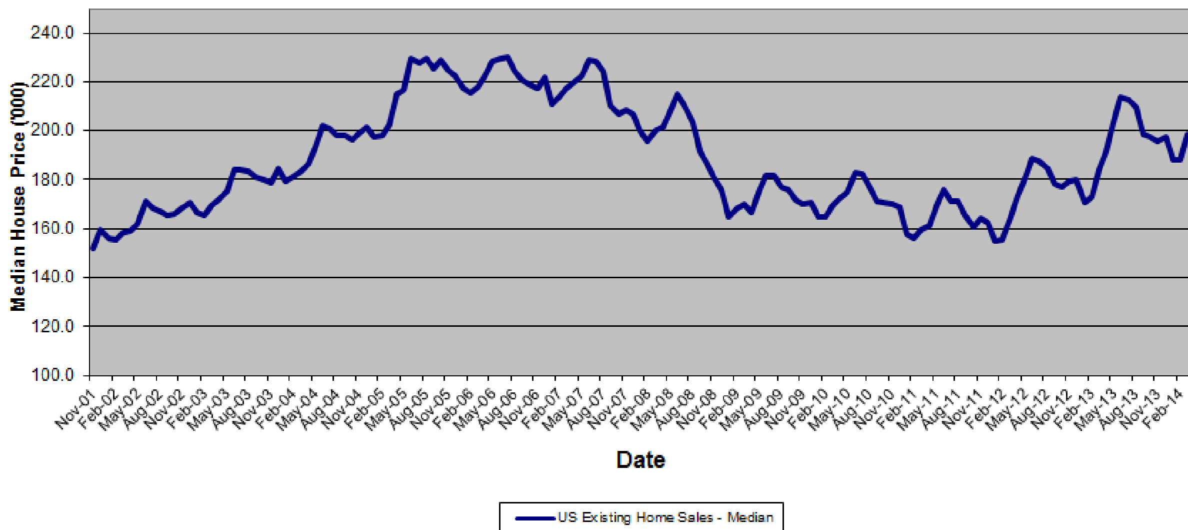
Feb-13
May-13
Aug-13
Nov-13
Feb-14
Date
US Existing Home Sales - Millions


US Existing Home Sales - Median
Median House Price ('000)
240.0
220.0
200.0
180.0
160.0
140.0
120.0
100.0
Nov-01
Feb-02
May-02
Aug-02
Nov-02
Feb-03
May-03
Aug-03
Nov-03
Feb-04
May-04
Aug-04
Nov-04
Feb-05
May-05
Aug-05
Nov-05
Feb-06
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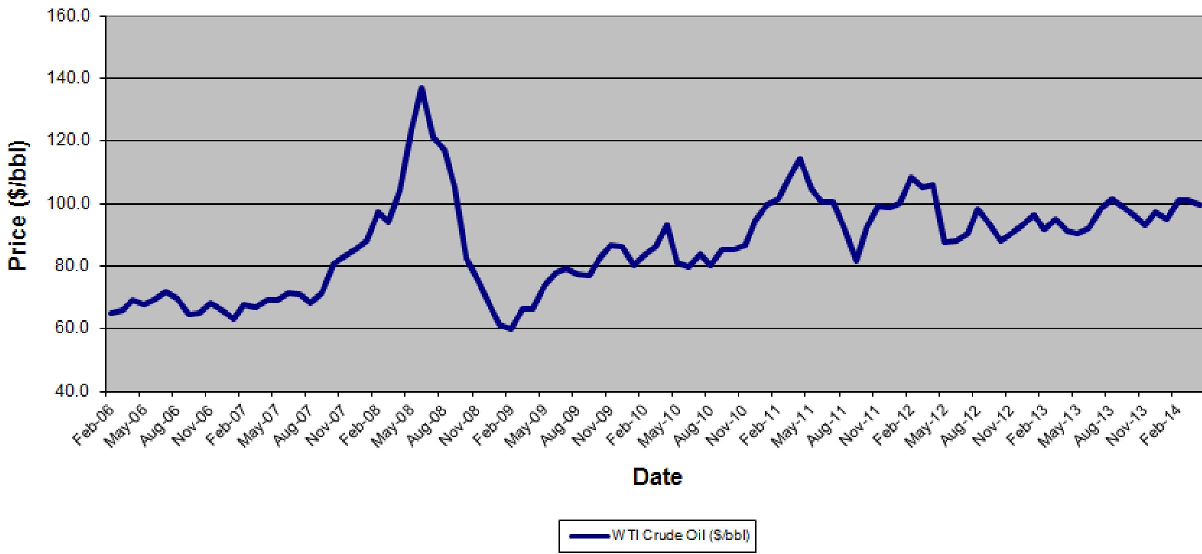
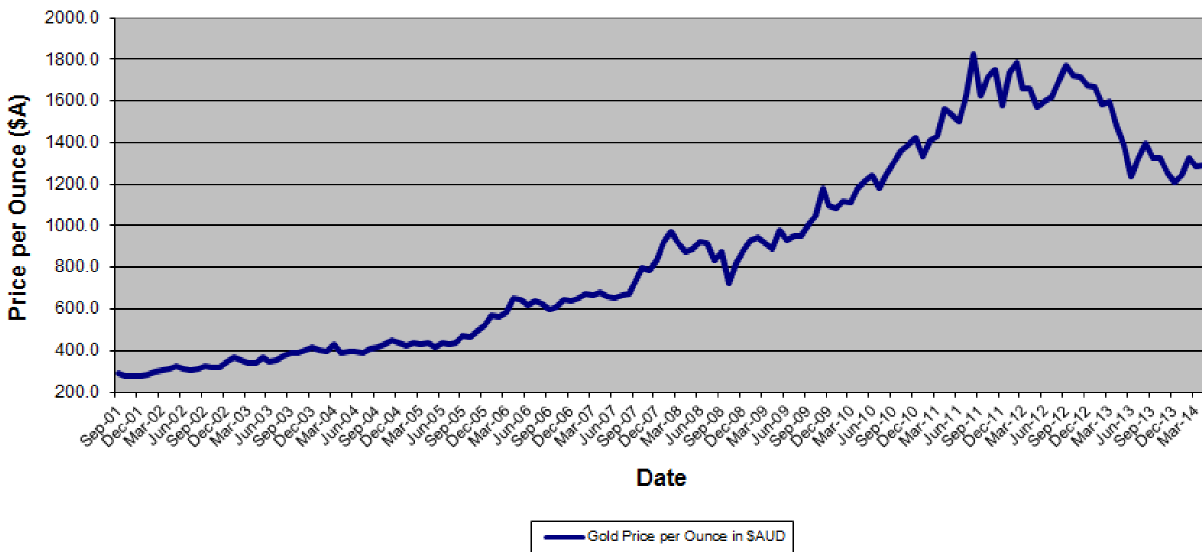
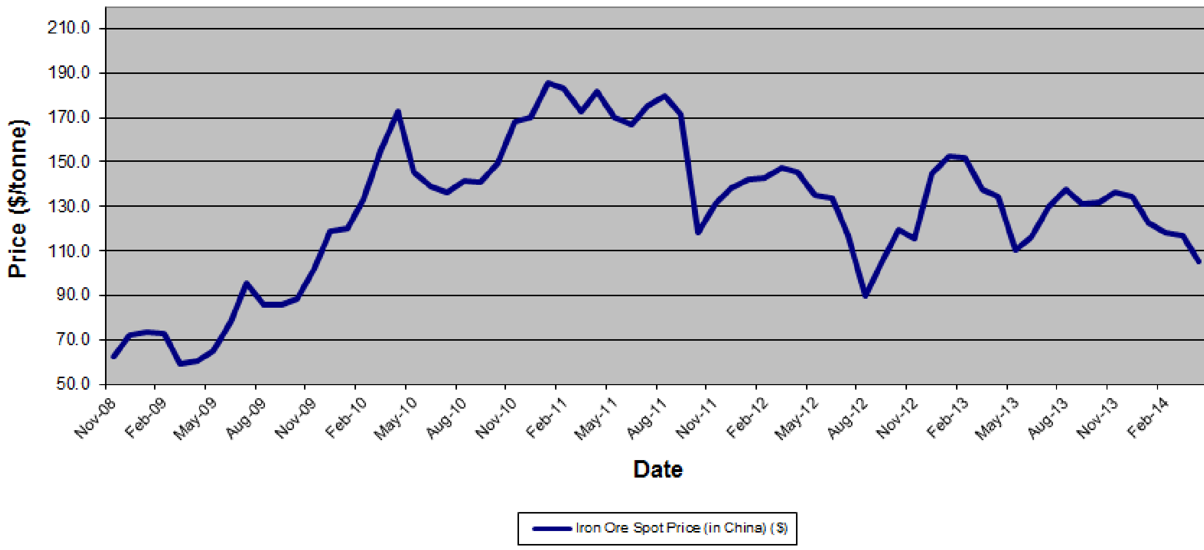
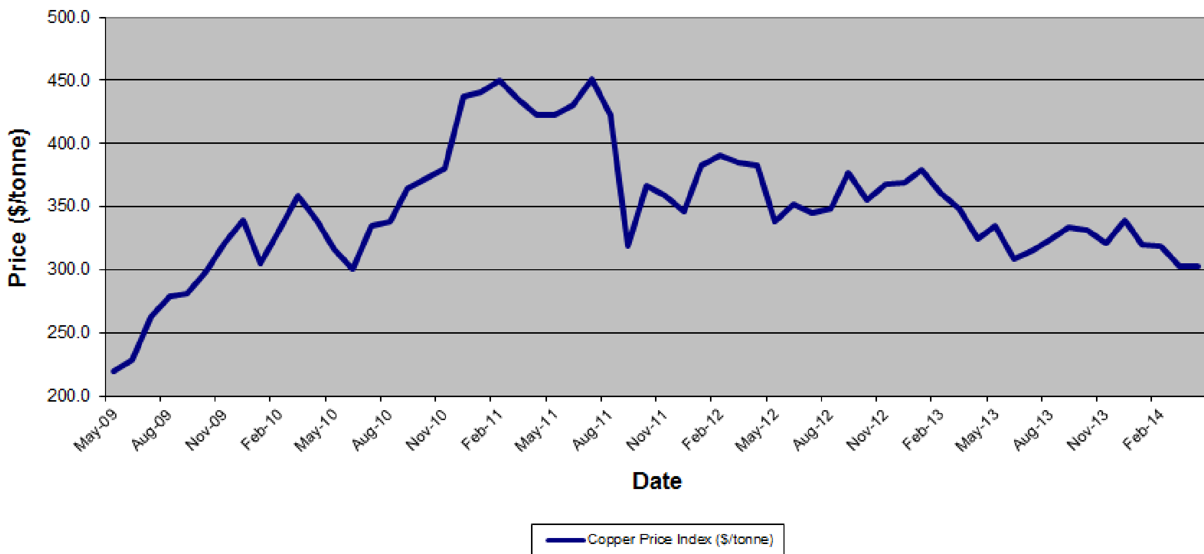
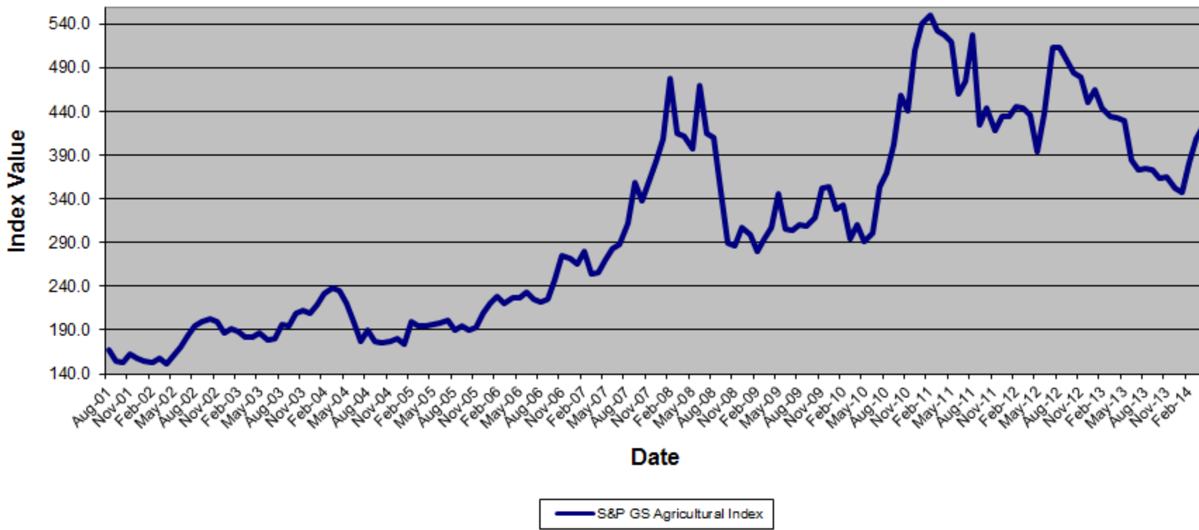
May-11
Aug-11
Nov-11
Feb-12
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
Date
US Existing Home Sales - Median

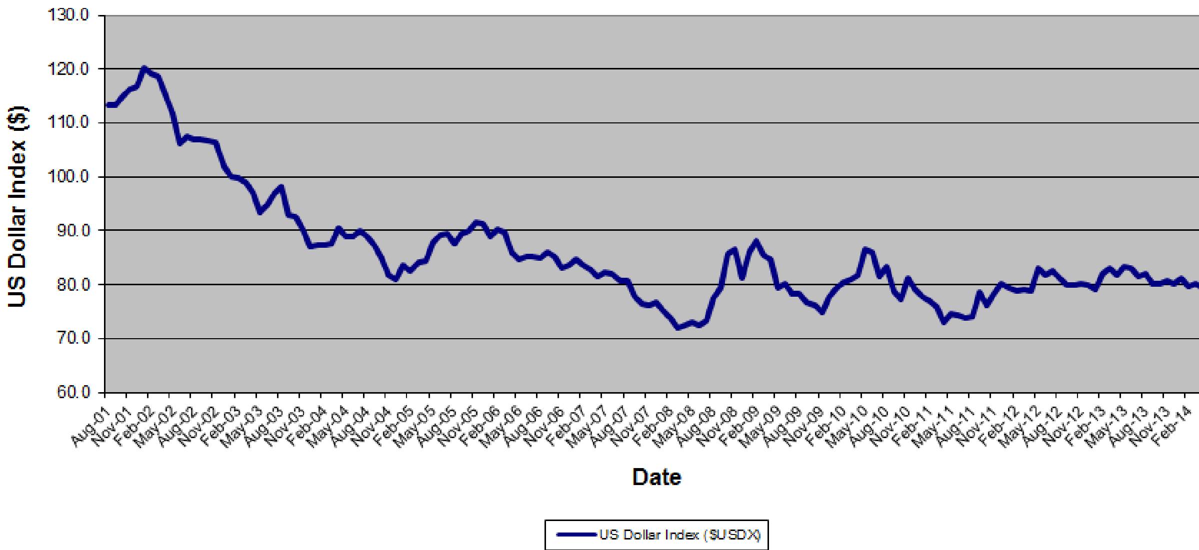

WTI Crude Oil ($/bbl)
Price ($/bbl)
160.0
140.0
120.0
100.0
80.0
60.0
40.0
Feb-06 May-06 Aug-06 Nov-06 Feb-07 May-07 Aug-07 Nov-07 Feb-08 May-08 Aug-08 Nov-08 Feb-09 May-09 Aug-09 Nov-09 Feb-10 May-10 Aug-10 Nov-10 Feb-11 May-11 Aug-11 Nov-11 Feb-12 May-12 Aug-12 Nov-12 Feb-13 May-13 Aug-13 Nov-13 Feb-14
Date
WTI Crude Oil ($/bbl)


Gold Price per Ounce in $AUD
Price per Ounce ($A)
2000.0
1800.0
1600.0
1400.0
1200.0
1000.0
800.0
600.0
400.0
200.0
Sep-01 Dec-01 Mar-02 Jun-02 Sep-02 Dec-02 Mar-03 Jun-03 Sep-03 Dec-03 Mar-04 Jun-04 Sep-04 Dec-04 Mar-05 Jun-05 Sep-05 Dec-05 Mar-06 Jun-06 Sep-06 Dec-06 Mar-07 Jun-07 Sep-07 Dec-07 Mar-08 Jun-08 Sep-08 Dec-08 Mar-09 Jun-09 Sep-09 Dec-09 Mar-10 Jun-10 Sep-10 Dec-10 Mar-11 Jun-11 Sep-11 Dec-11 Mar-12 Jun-12 Sep-12 Dec-12 Mar-13 Jun-13 Sep-13 Dec-13 Mar-14
Date
Gold Price per Ounce in $AUD


Iron Ore Spot Price (in China) ($/tonne)
Price ($/tonne)
210.0
190.0
170.0
150.0
130.0
110.0
90.0
70.0
50.0
Nov-08
Feb-09
May-09
Aug-09
Nov-09
Feb-10
May-10
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
Date
Iron Ore Spot Price (in China) ($)


Copper Price Index ($/tonne)
Price ($/tonne)
500.0
450.0
400.0
350.0
300.0
250.0
200.0
May-09
Aug-09
Nov-09
Feb-10
May-10
Aug-10
Nov-10
Feb-11
May-11
Aug-11
Nov-11
Feb-12
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
Date
Copper Price Index ($/tonne)





The DXY is a weighted index of some of the major trading partners of the United States. The components of the DXY Index are (by weighting): Euro (57.6%), Japanese Yen (13.6%), Great Britain- Pounds Sterling (11.9%), Canadian Dollar (9.1%), Swedish Krona (4.2%), and Swiss Franc (3.6%).