McGregor Asset Consulting

Economic and Market Commentary
August 2014

The very high returns from the global equities markets over the past two years are showing signs of slowing as they have tended to run ahead of the underlying economic growth, especially in the US. Market valuations are bordering on the upper band limits and need to see company earnings meet expectations. The Australian equities and listed property markets have had a strong start to the financial year both up over 4% for the month of July. The Australian companies reporting season has commenced with the markets focus now on the underlying earnings to support the market valuations.

Growth assets continue to reward investors in an environment of very low interest rates. Equities markets continue to be supported by the intent of central bankers willing to provide liquidity to the markets with Japan continuing to undertake a massive QE programme ($600 billion per year) along with Europe's ECB intention to be supportive. The US is well through the process of reducing QE as its economy recovers. The US has been removing $10 billion each month this year from the programme and plans to inject $25 billion in August. The US is on target to remove the stimulus by the end of 2014 and is providing guidance to the market of its actions with an expectation that interest rates are likely to remain at the current low levels until mid 2015. As a consequence of these actions volatility levels in equities and bond markets are at historical low levels, which has been the catalyst for positive sentiment to the markets. This QE unwinding process and interest rates rising are probably the most significant factors that are likely to impact markets over the next few years.

Investors who have followed the asset allocation overweight to growth assets versus fixed interest have benefited with very good absolute returns over the past two years.

China and Indian equities markets are showing strong recoveries. China's Shanghai Composite index increased 7.4% for the month of July. Indian equities are also responding to the decisive leadership of the recently elected Narendra Modi as he commences to implement major reforms and infrastructure spending. The Chinese leadership is stepping up the reform process as the country transforms from the export and investment phase to a consumption phase where the strong growth rates of the past have slowed but still remain at a sustainable pace. While the shadow banking system has grown in excess of 30% in the past five years and property market sales volume has grown 18% pa for the last 15 years, the leadership is making significant progress, especially reforming the State Owned enterprises and clamping down on corruption. Positive signs are emerging for China and opportunities starting to emerge in its share market where values are attractive.

Selected emerging markets are showing signs of improvement and capital flows have turned positive. Fears are still high with many of the emerging markets such as Russia, Turkey, South Africa and Brazil underperforming as well as dealing with geo political uncertainties, social unrest and currency problems. Geo political risks have heightened with increased tensions between Russia and the West, where stronger sanctions are now being put in place. The Iraq and Middle East (Israel/ Hamas) tensions also increase uncertainty for markets and further escalation may negatively impact global equities markets.

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. High debt burdens and high unemployment levels continue to be major issues for most Eurozone countries. The ECB is aggressively implementing a liquidity strategy with banks being forced to on-lend the liquidity rather than hold it on deposit in an attempt to stimulate growth. Banks are to receive a negative interest rate if they hold deposits with the ECB. The ECB is concerned about deflationary pressures. The strong action by the ECB is providing the catalyst for Europe's recovery and activity in the equities markets across the region.

Low interest rates in the UK and support by the Bank of England has driven a massive increase in housing prices. Top end luxury housing in London is now 50% higher than pre GFC levels and the UK housing market as a whole is 30% higher than pre GFC levels.

The Japanese equities market continues to be driven on the back of the large QE stimulus being implemented by Prime Minister Shinzo Abe who continues to embark on an ambitious growth strategy. The Japanese equities market has responded strongly over the past quarter, up 9.75%. Abe 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.

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. Growth is likely to remain at subdued levels in the developed markets during the remainder of the year, but should continue to underpin company earnings and equities markets.

While every cycle comes to an end and a return to normality in markets should eventually occur. However, the recent history of QE 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.

The US economy continues to undergo recovery, although at a low level. There are positive signs of an improving jobs market. US wages have bottomed and appear to be on the rise. Business confidence is providing confidence and the housing market recovery is still intact. Access to cheap funds and a reinvigorated energy sector providing access to affordable energy is supporting the improved sentiment in the US.

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. Term deposits are also losing appeal with one year rates around 3%.

US 10 year bond yields are now trading around the 2.4% 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 equities markets of developed countries. Inflation in developed countries is benign, resulting in bonds now generating positive real rates (US 10 year bonds 2.4% and inflation 1%).

In Australia, the focus is now on the companies reporting season and the outlook statements which should drive the equities market over the coming months. Although unemployment has increased to 6.4%, business and consumer confidence appears to be returning although from a low base. 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%. The A$ is likely to remain in the mid 90 cent range due to off shore investors seeking the higher relative interest rates on offer in Australia compared to close to zero rates in the US, Europe and Japan. The stimulus currently being under taken globally places upward pressure on the A$. The Euro is likely to devalue against the A$ and underpin the currency if it introduces significant QE stimulus.

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.

- **Australian shares: [Overweight] Australian Small Caps: [Neutral]** Opportunities are likely to arise over the remainder of the year as the economy grows. Investors who have been holding cash are likely to consider equities 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 months. 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 major 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 and rising interest rates.
- The unrest within Israel and Palestine, as well as Iraq is likely to contribute to global uncertainty as pressure builds on the oil supplies from the Middle East. An escalation of the unrest is likely to have negative implications for the US economy as defence spending is impacted and global relationships may well be tested.
- 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, especially energy supplies into Europe.
- 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.
- 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 Portugal, Greece, Italy and Spain with large debt issues and the lack of discipline to control the predicament remain an issue.
- With large US government debt levels, strong political will is required to enact the necessary measures to reduce the debt levels.

Global Opportunities

- The Asian region continues to generate satisfactory GDP growth and should continue to be a major driver of world growth. India is likely to be a significant contributor and provide market opportunities.
- 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. We are starting to witness greater interest by China in our agricultural sector.
- 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 may start to return as the bond market stabilises at these low levels. The market has largely factored in the lower rates and the 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

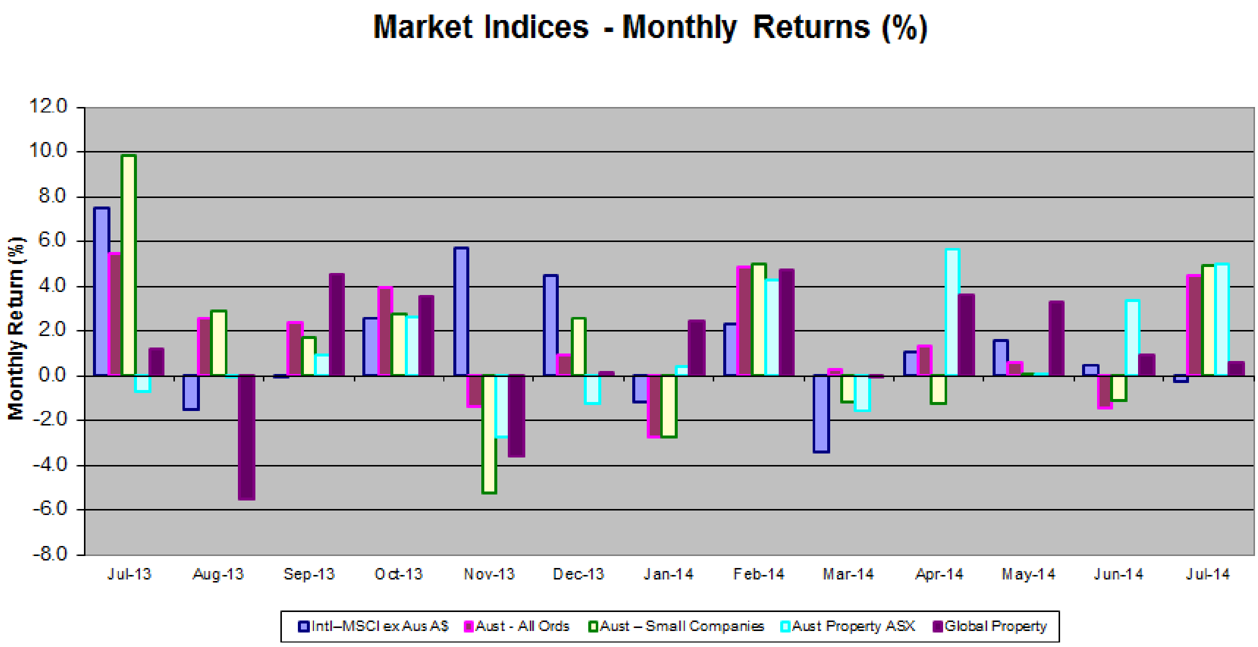
Market Indices	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14
Intl–MSCI ex Aus UH A$	-1.50	-0.06	2.55	5.69	4.44	-1.20	2.30	-3.43	1.03	1.54	0.44	-0.25
Aust - All Ordinaries	2.59	2.39	3.91	-1.38	0.92	-2.76	4.84	0.25	1.29	0.61	-1.41	4.49
Aust – Small Company	2.88	1.69	2.74	-5.23	2.55	-2.76	4.97	-1.16	-1.24	0.08	-1.11	4.91
Aust Property REITs	-0.07	0.93	2.64	-2.73	-1.26	0.41	4.26	-1.58	5.63	0.05	3.33	4.96
Global Property REITs	-5.53	4.51	3.55	-3.59	0.16	2.45	4.75	-0.02	3.64	3.30	0.89	0.62

Annual Share Market Performance

Markets Index	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 Jun 14 %	1 Year to 31 Jul 14 %
Intl–MSCI ex Aus UH A$	13.59	14.14	10.76	33.10	34.02	48.03	34.73	20.41	11.78
Aust - All Ordinaries	13.36	18.84	17.80	20.67	23.55	19.66	13.19	17.64	16.56
Aust – Small Company	3.83	6.58	-5.82	-5.32	1.42	-0.76	-1.46	13.11	8.07
Aust Property REITs	28.90	32.79	30.52	23.98	16.39	7.27	4.96	11.08	17.41
Global Property REITs	30.54	26.29	22.57	15.46	11.46	5.84	4.18	15.77	15.12

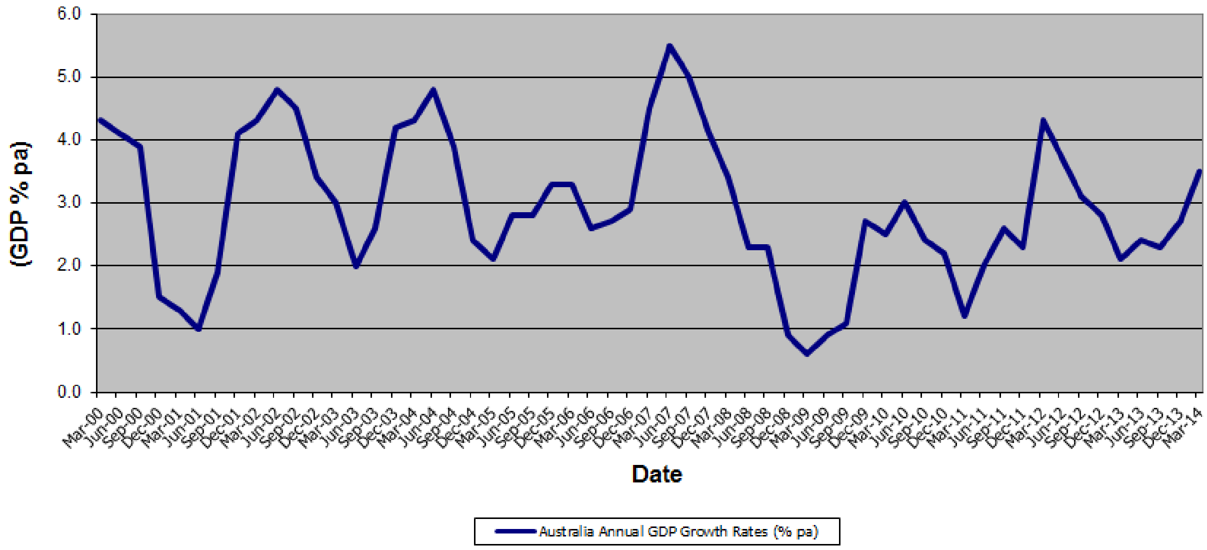
Best Performing Asset Sectors for twelve months ended 31 July 2014

Sector	Market Index	Return
International Equities Hedged	MSCI World Accum Index Hedged A$	18.03
Aust Listed Property	S&P/ASX Property Trusts Accum Index	17.41
Australian Shares	S&P/ASX All Ords Accum Index	16.56
Global Listed Property	UBS Global Real Estate Inv Ex Aust Idx Hedge $A	15.12
International Equities Unhedged	MSCI World Ex Aust Accum Index A$	11.78
Australian Smaller Companies	S&P/ASX Small Ordinaries Accum Index	8.07
International Fixed Interest Hedged	JP Morgan Gov Bond Accum Index Hedged $A	7.24
Australian Fixed Interest	UBS Warburg Composite 0 + Years	5.49
Cash	Australian 90 Day Bank Accepted Bill	2.66

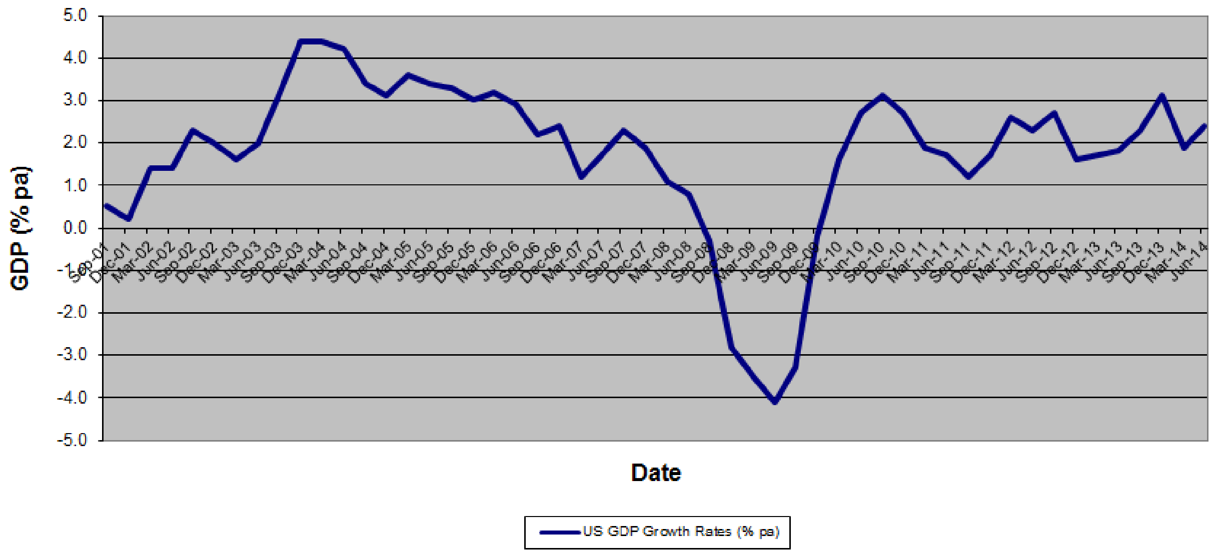


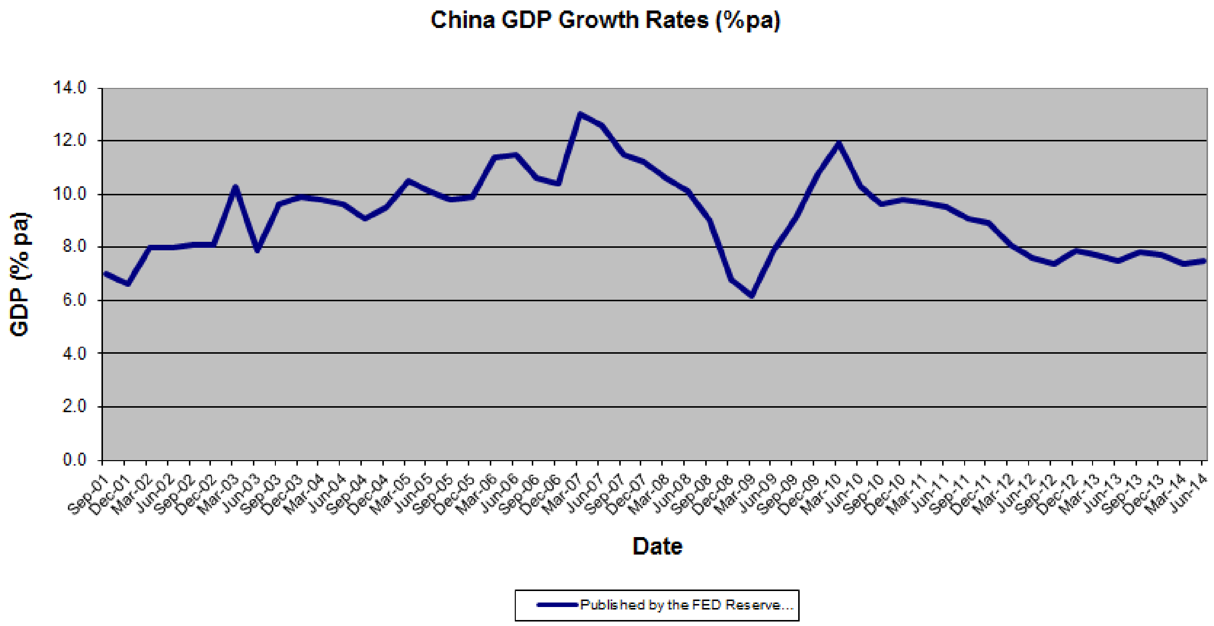
Major Economic Indicators

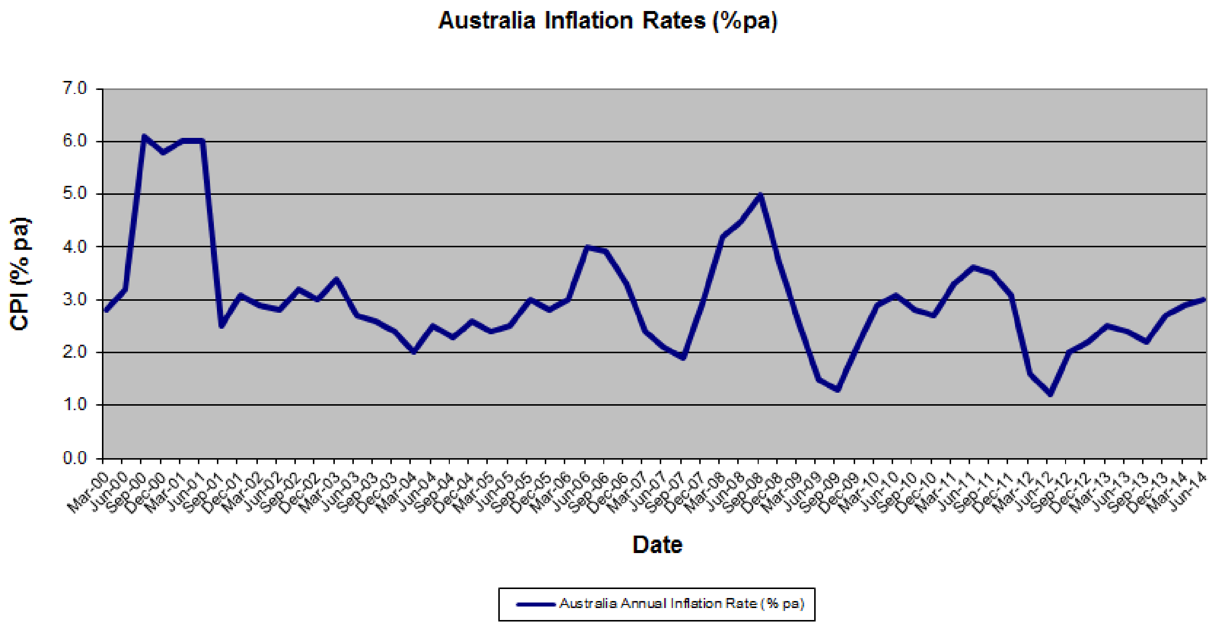
Australia GDP Growth Rates (%pa)



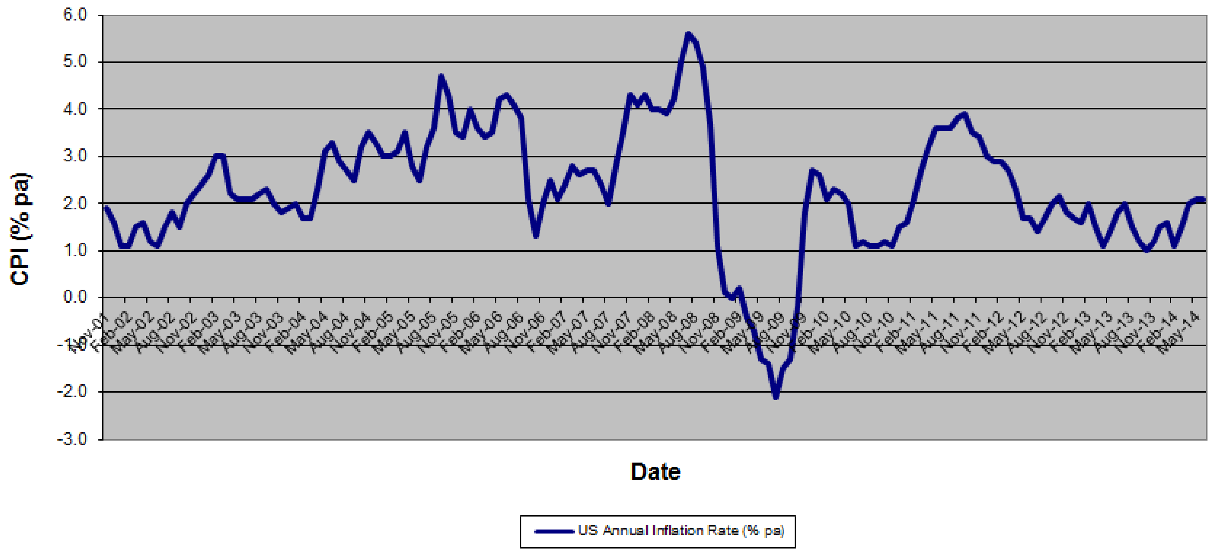
US GDP Growth Rates (%pa)



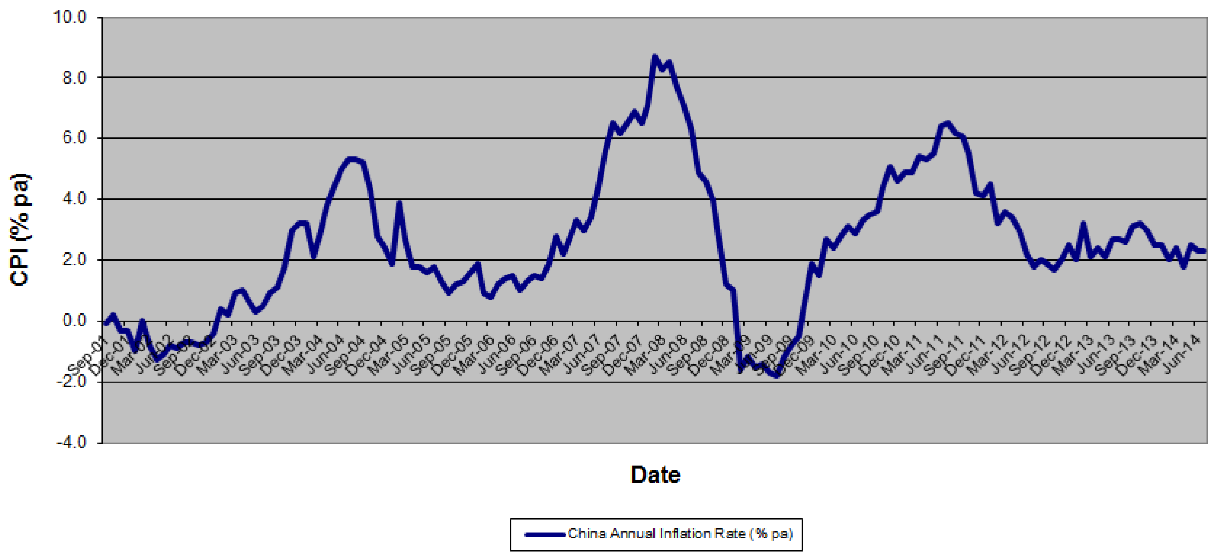

China GDP Growth Rates (%pa)
GDP (% pa)
Date
Published by the FED Reserve...

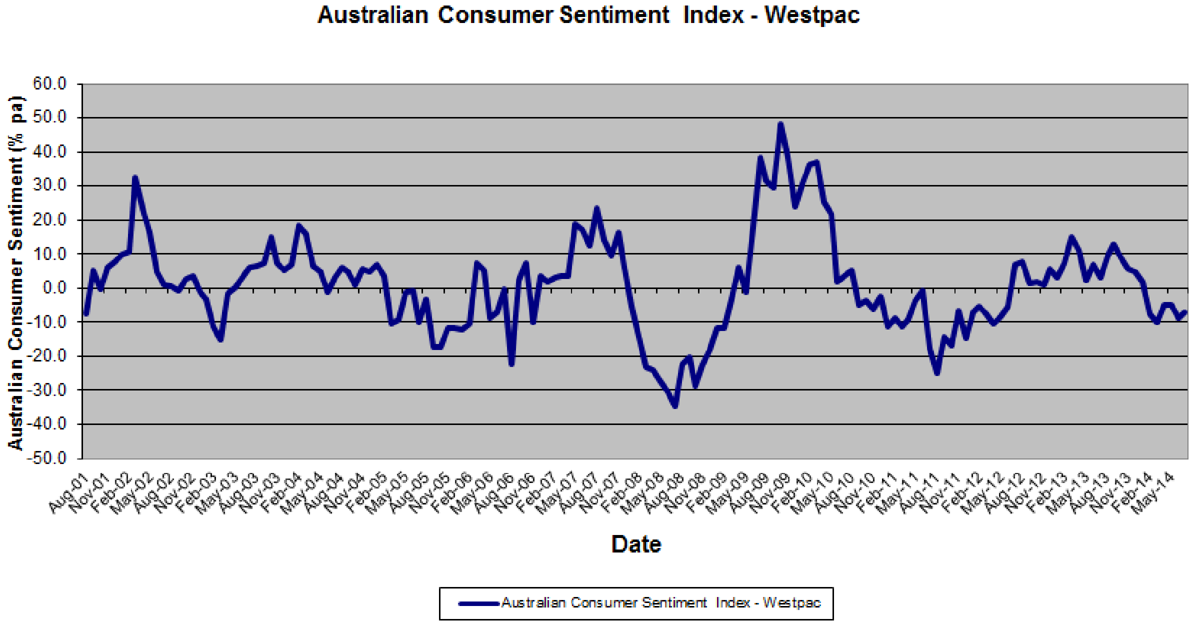

Australia Inflation Rates (%pa)
CPI (% pa)
Date
Australia Annual Inflation Rate (% pa)

US Inflation Rates (%pa)



China Inflation Rates (%pa)




Australian Consumer Sentiment Index - Westpac
Australian Consumer Sentiment (% pa)
60.0
50.0
40.0
30.0
20.0
10.0
0.0
-10.0
-20.0
-30.0
-40.0
-50.0
Aug-01
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
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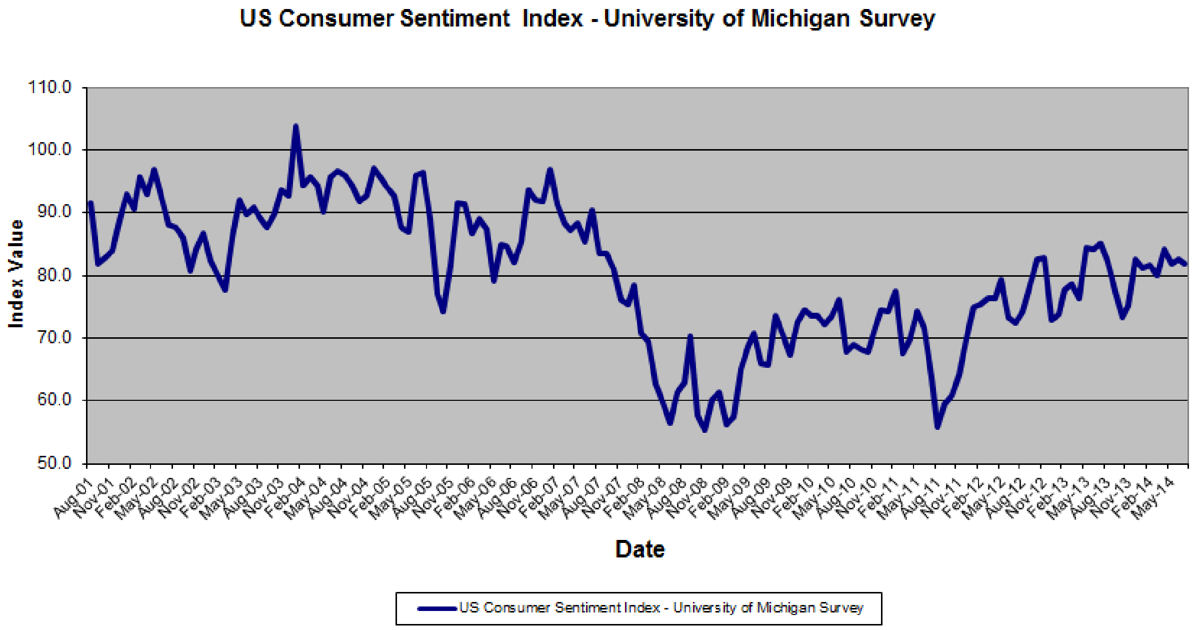
Nov-13
Feb-14
May-14
Date
Australian Consumer Sentiment Index - Westpac


US Consumer Sentiment Index - University of Michigan Survey
Index Value
110.0
100.0
90.0
80.0
70.0
60.0
50.0
Aug-01
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
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Feb-11
May-11
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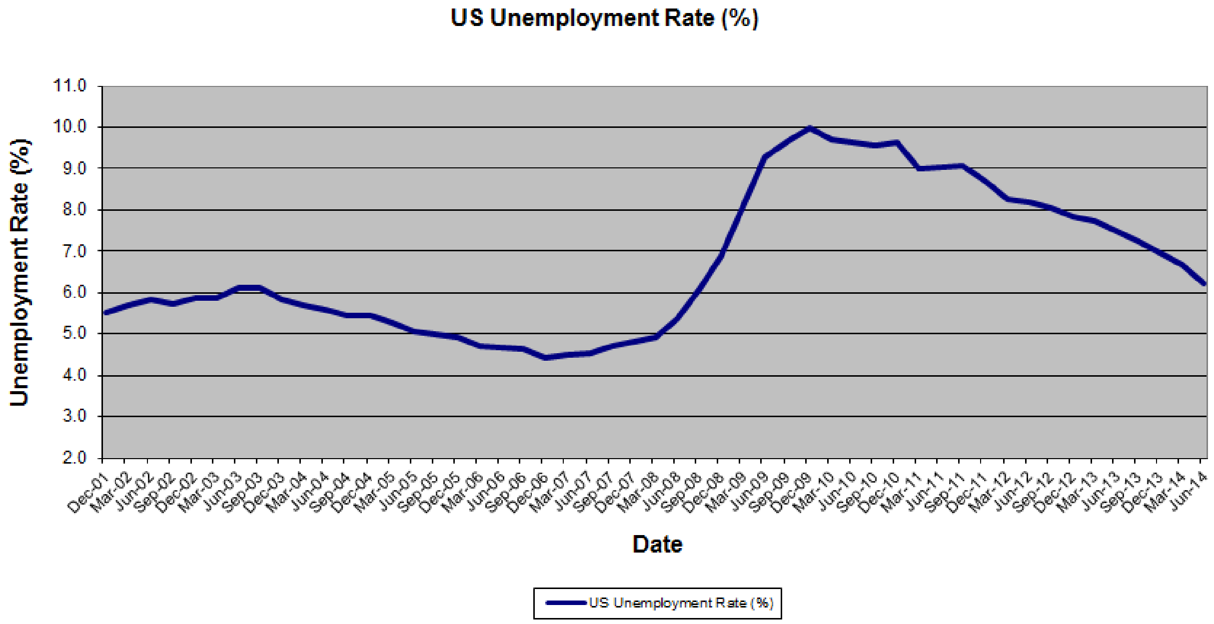
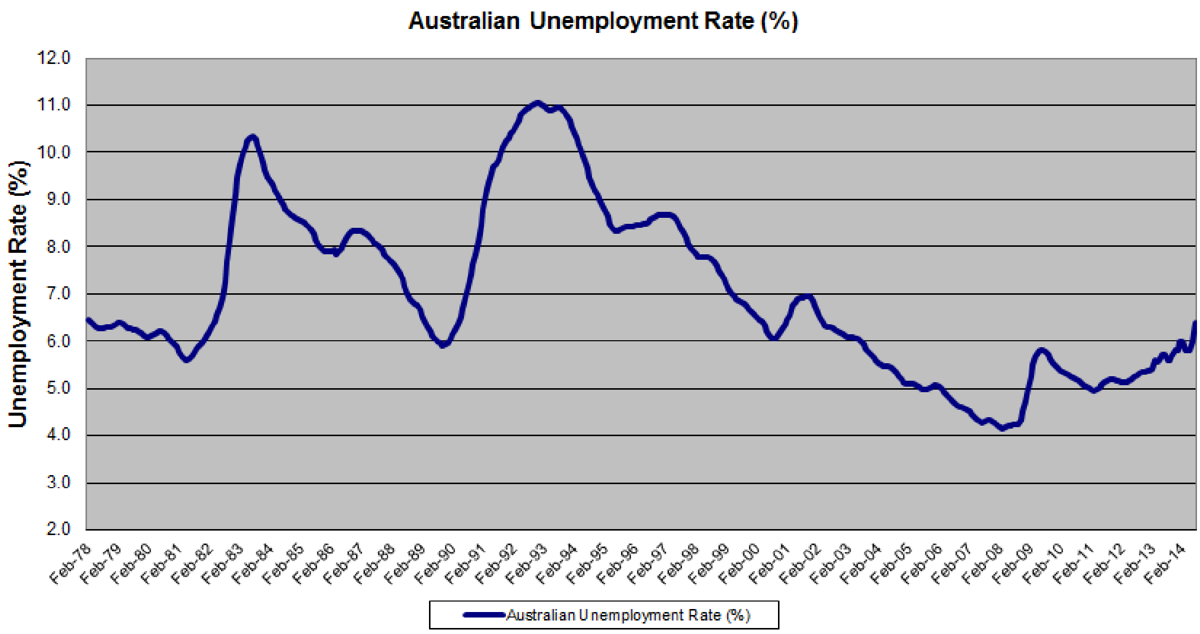
Feb-12
May-12
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
May-14
Date
US Consumer Sentiment Index - University of Michigan Survey


China Retail Sales Value (%pa)
Retail Sales (% pa)
Date
China Retail Sales Value (% pa)


US Unemployment Rate (%)
Unemployment Rate (%)
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
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Feb-91
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Feb-01
Feb-02
Feb-03
Feb-04
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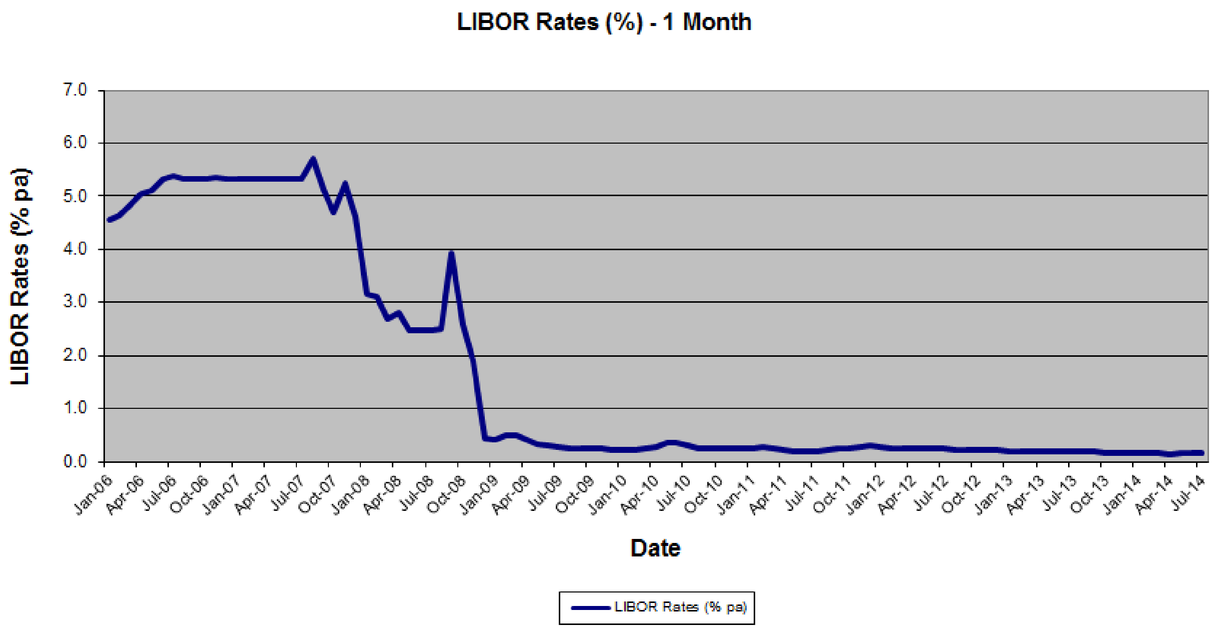
Feb-09
Feb-10
Feb-11
Feb-12
Feb-13
Feb-14
Australian Unemployment Rate (%)


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
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Apr-09
Jul-09
Oct-09
Jan-10
Apr-10
Jul-10
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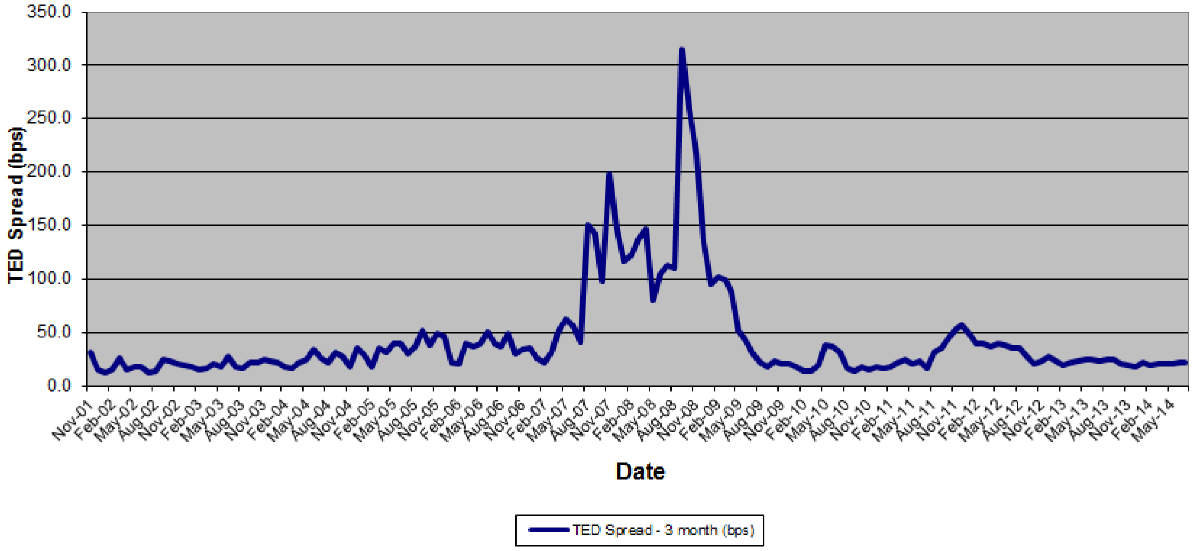
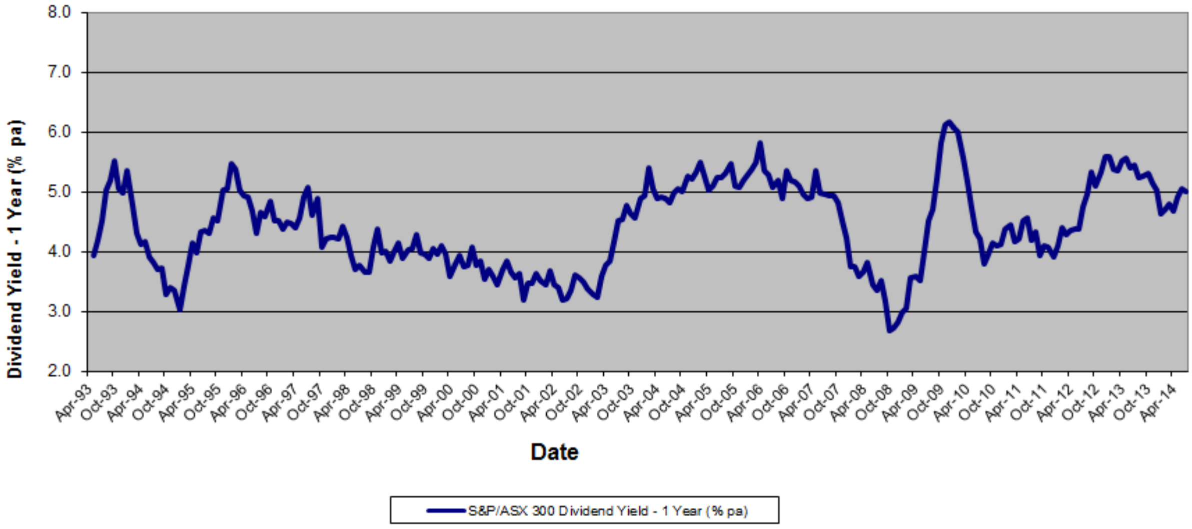
Apr-13
Jul-13
Oct-13
Jan-14
Apr-14
Jul-14
Date
LIBOR Rates (% pa)

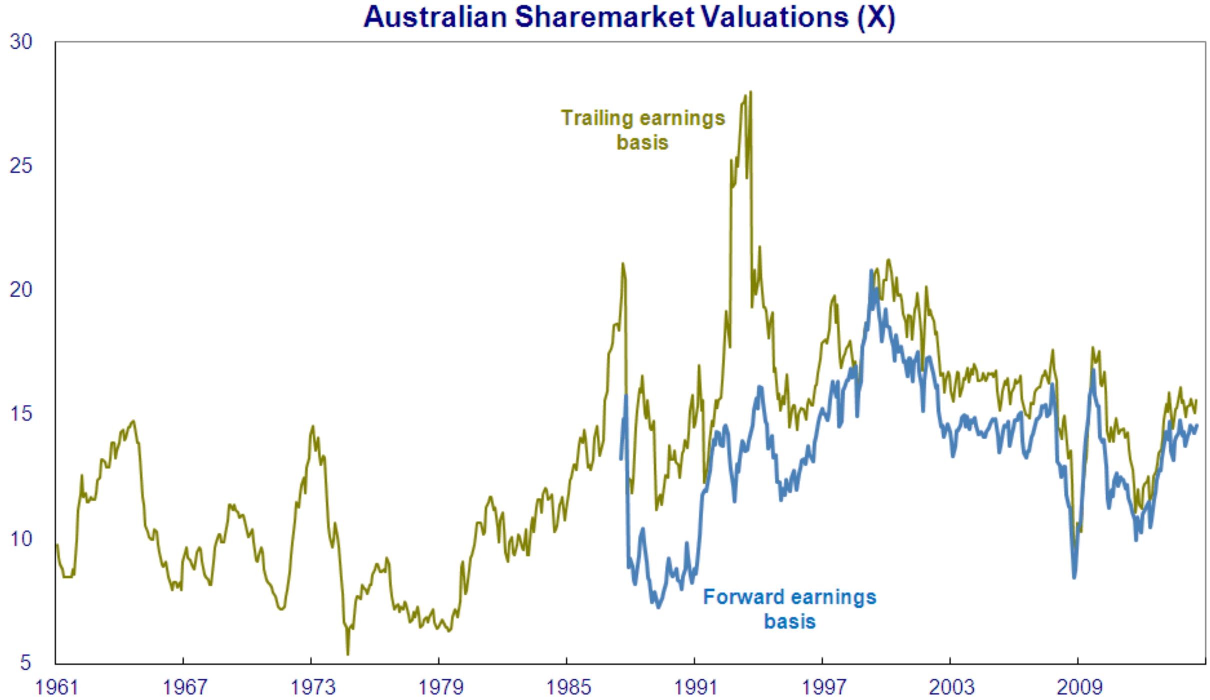
TED Spread - 3 Month



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

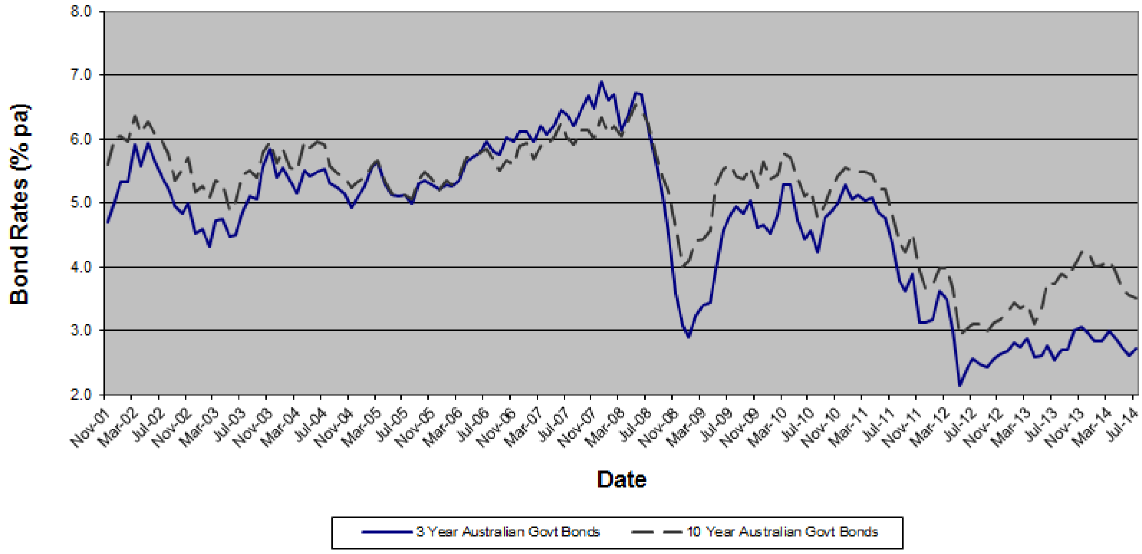


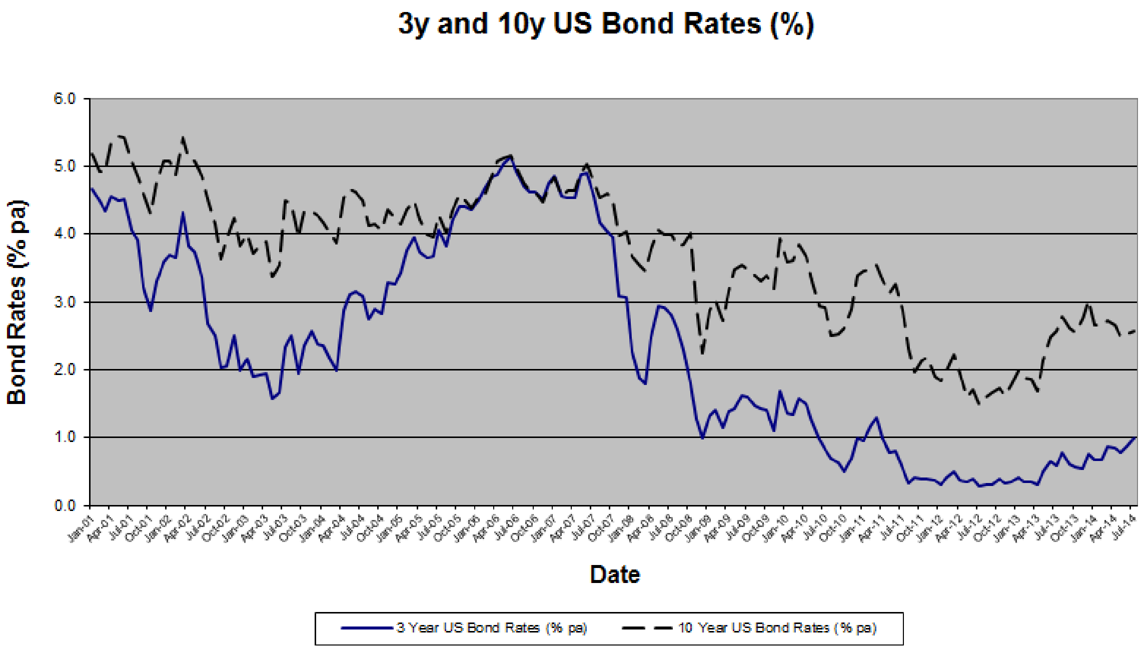
Australian Sharemarket Valuations (X)

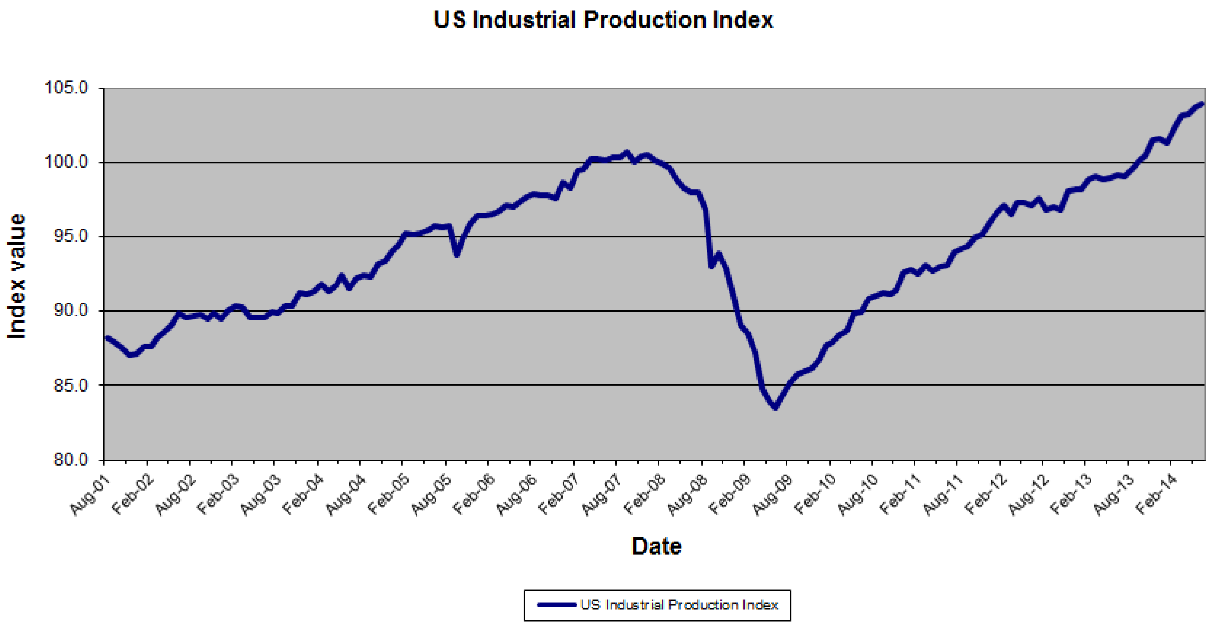


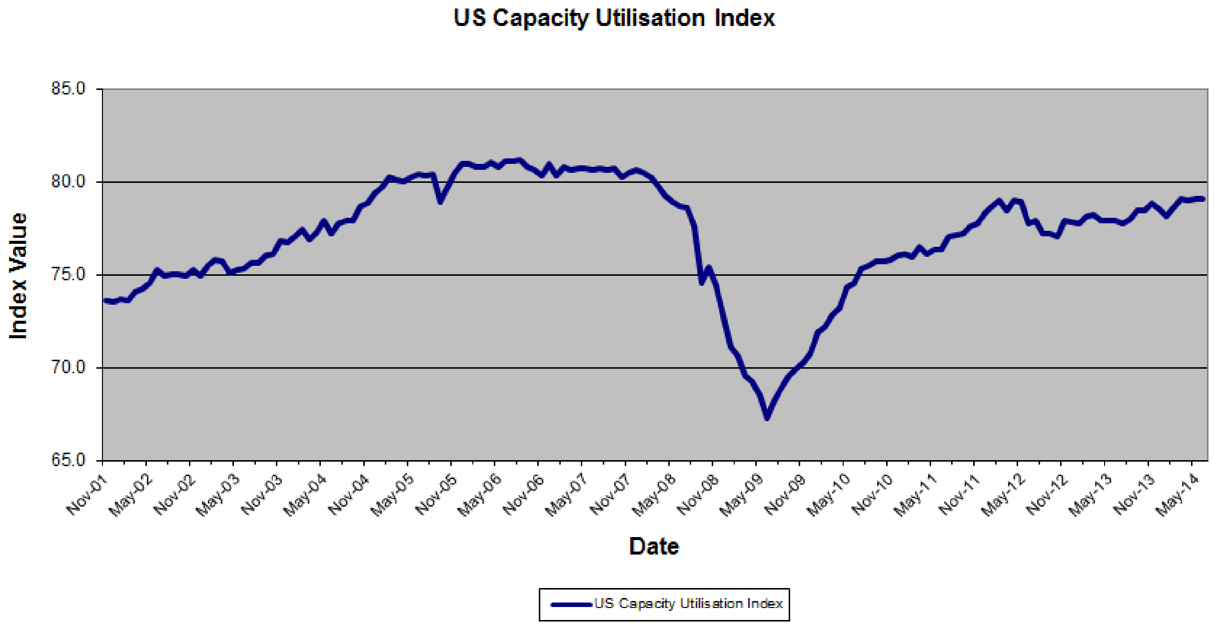
Source: UBS Australia and Reserve Bank of Australia as at 15 July 2014.

3y and 10y Australian Bond Rates (%)




3y and 10y US Bond Rates (%)
Bond Rates (% pa)
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Date
3 Year US Bond Rates (% pa)
10 Year US Bond Rates (% pa)


US Industrial Production Index
Index value
105.0
100.0
95.0
90.0
85.0
80.0
Aug-01
Feb-02
Aug-02
Feb-03
Aug-03
Feb-04
Aug-04
Feb-05
Aug-05
Feb-06
Aug-06
Feb-07
Aug-07
Feb-08
Aug-08
Feb-09
Aug-09
Feb-10
Aug-10
Feb-11
Aug-11
Feb-12
Aug-12
Feb-13
Aug-13
Feb-14
Date
US Industrial Production Index


US Capacity Utilisation Index
85.0
80.0
75.0
70.0
65.0
Index Value
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
May-14
Date
US Capacity Utilisation Index


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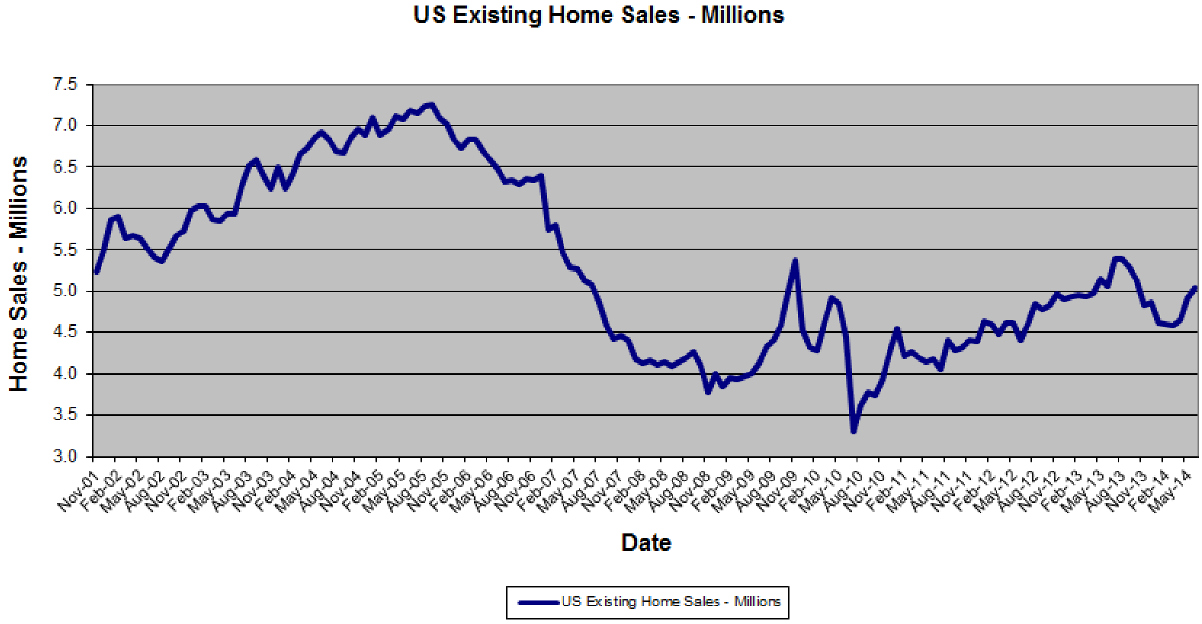
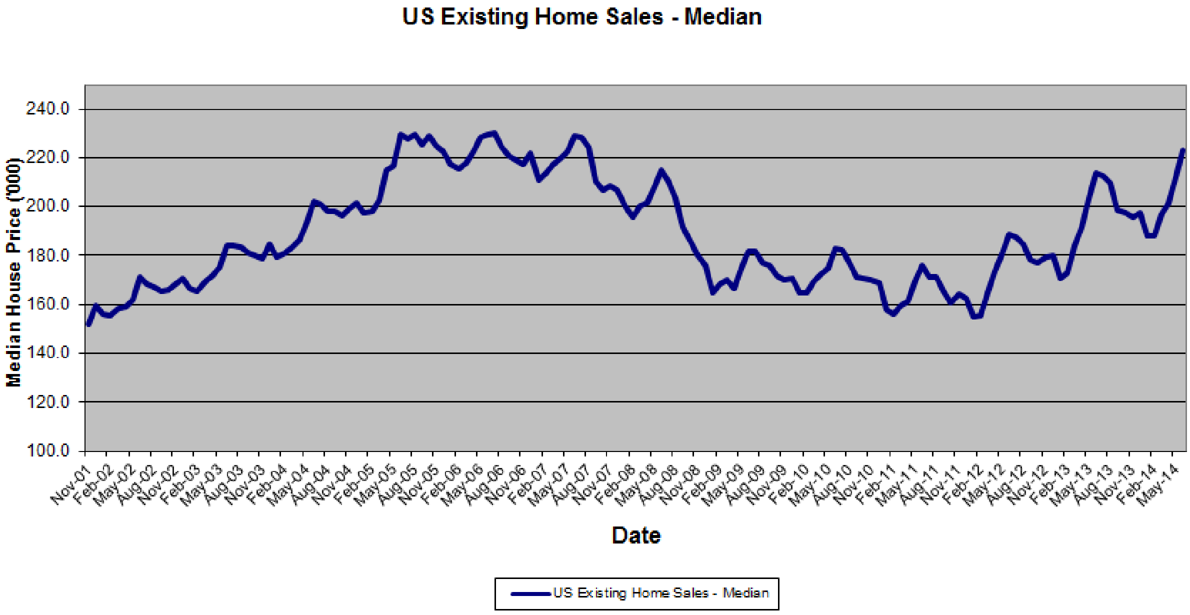
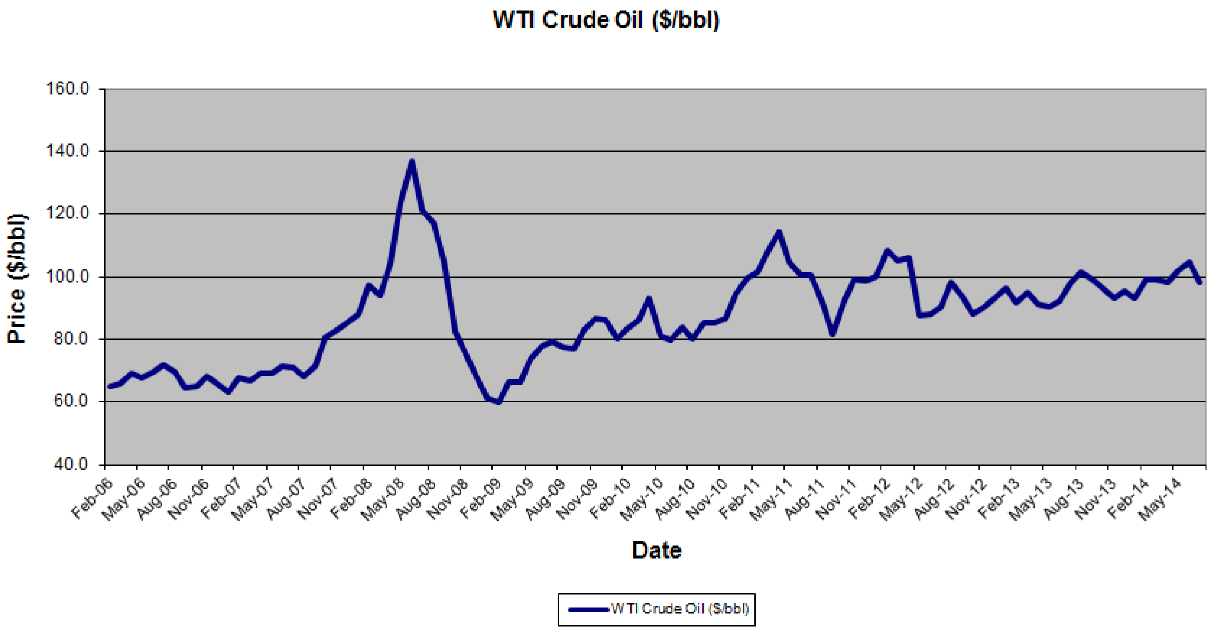
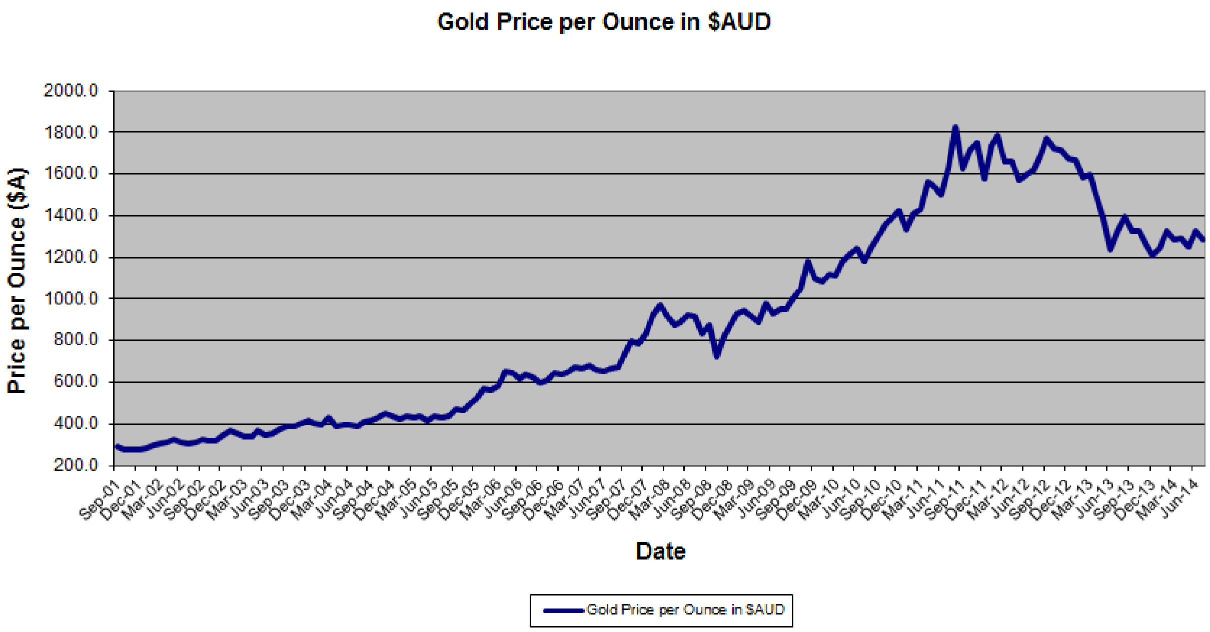
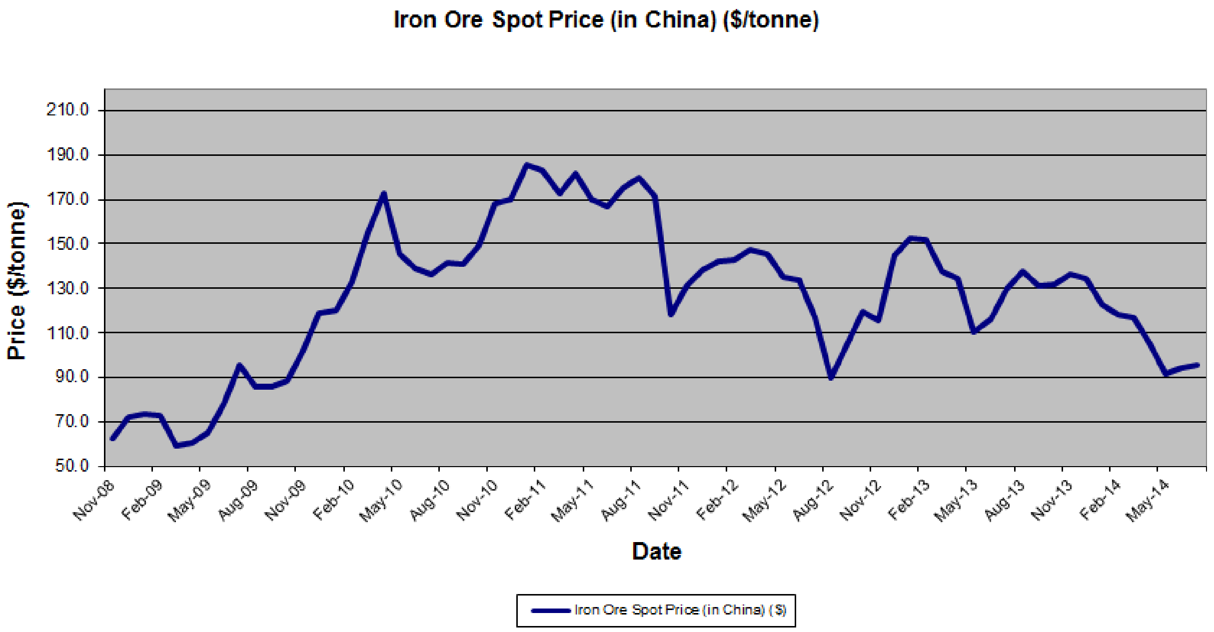
Aug-12
Nov-12
Feb-13
May-13
Aug-13
Nov-13
Feb-14
May-14
Date
China PMI Index

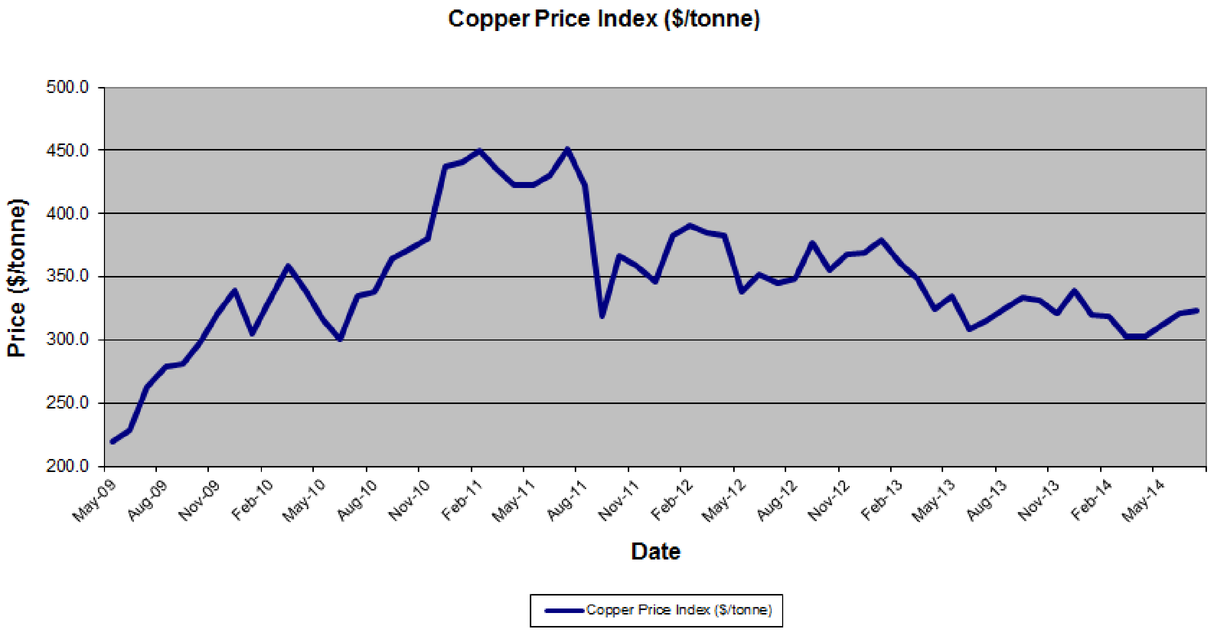

US Existing Home Sales - Millions
Home Sales - Millions
7.5
7.0
6.5
6.0
5.5
5.0
4.5
4.0
3.5
3.0
Date
US Existing Home Sales - Millions

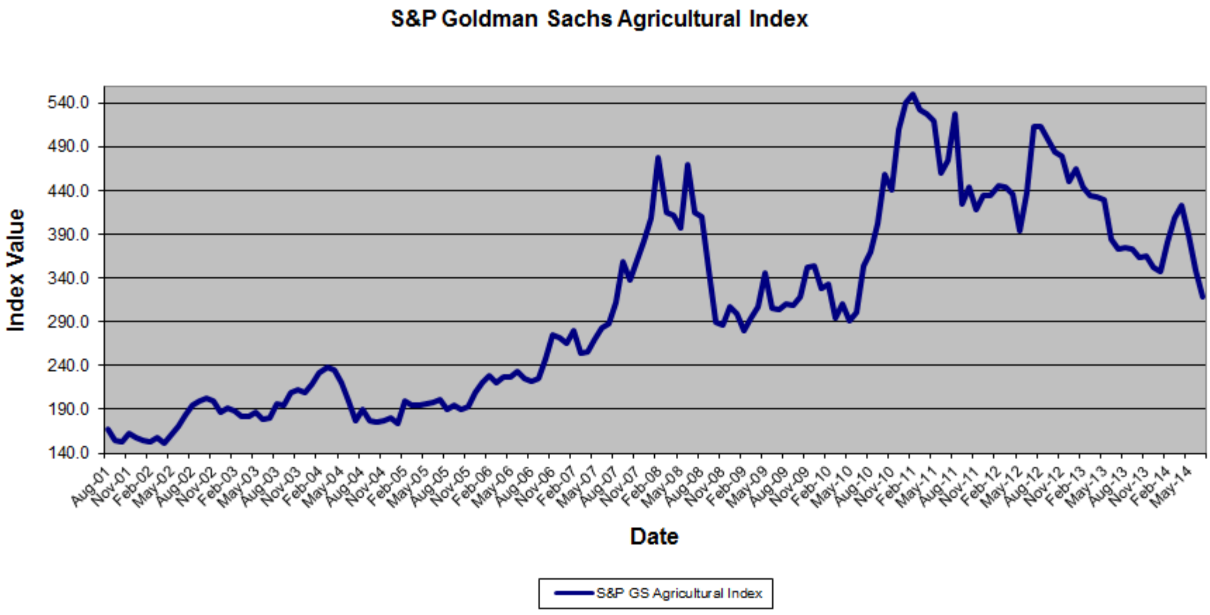

US Existing Home Sales - Median
Median House Price ('000)
240.0
220.0
200.0
180.0
160.0
140.0
120.0
100.0
Date
US Existing Home Sales - Median

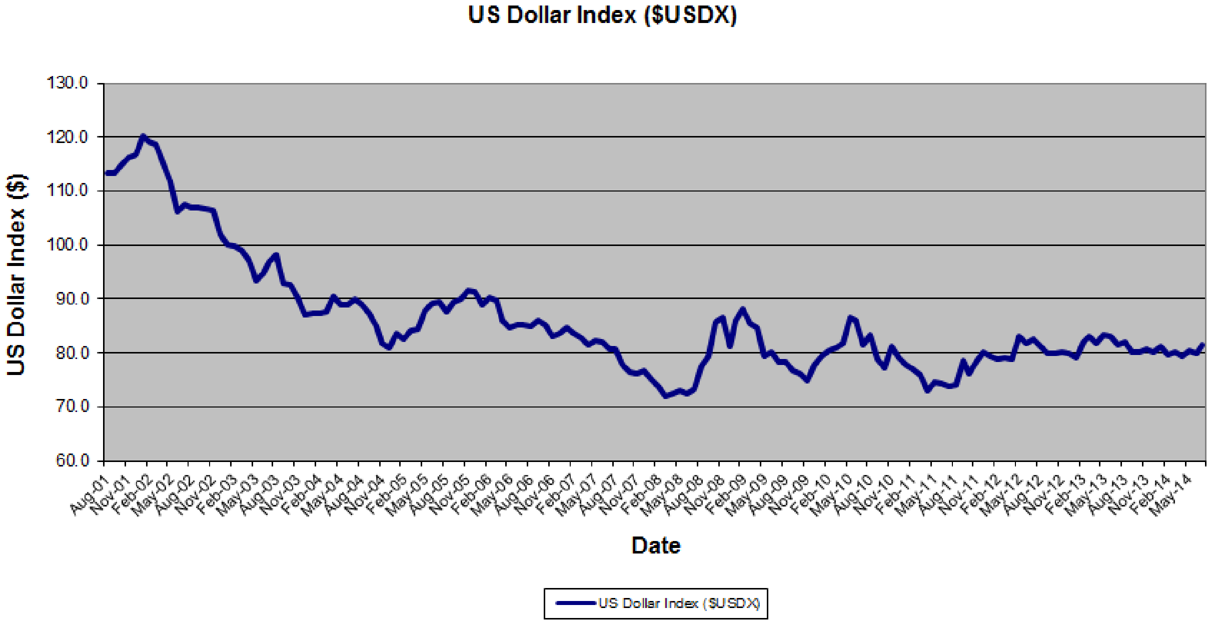

WTI Crude Oil ($/bbl)
160.0
140.0
120.0
100.0
80.0
60.0
40.0
Price ($/bbl)
Feb-06 May-06 Aug-06 Nov-06 Feb-07 May-07 Aug-07 Nov-07 Feb-08 May-08 Aug-08 Nov-08 Feb-09 May-09 Aug-09 Nov-09 Feb-10 May-10 Aug-10 Nov-10 Feb-11 May-11 Aug-11 Nov-11 Feb-12 May-12 Aug-12 Nov-12 Feb-13 May-13 Aug-13 Nov-13 Feb-14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


Gold Price per Ounce in $AUD
2000.0
1800.0
1600.0
1400.0
1200.0
1000.0
800.0
600.0
400.0
200.0
Price per Ounce ($A)
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 Jun-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
May-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
May-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%).