Client Newsletter March 2014

Summary of Key Views:

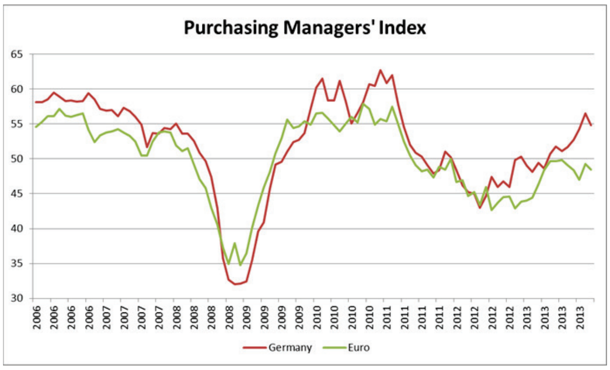
Come on Germany… come on!

It is encouraging, not intimidating, that many stock markets are at record highs. New stock market highs do not necessarily foreshadow the end of a bull market. Indeed, we remain bullish on stocks and bearish on bonds.

Economic statistics in the US suggest that the private sector is strong enough to sustain economic growth as the Federal Reserve continues to 'taper'. The US economy grew by 1.9% in 2013, compared to an increase of 2.8% in 2012. Severe weather has dampened economic activity early in 2014, however, we believe the year will be more like 2012 as consumption, investment and employment pick up. The US Purchasing Managers' Index (PMI) for February rose to its highest level in four years as both new orders and the employment components expanded. In addition, businesses are now investing, encouraged by the low cost of capital, rising earnings and increasing confidence as the policy uncertainties of recent years fade. Aggregate payrolls (hours worked times hourly earnings) at 4% are rising comfortably ahead of 1.6% inflation. Debt service ratios are at record lows and house prices are up around 13% from a year ago. In short, there's little evidence that recent economic weakness is anything but temporary with businesses and households in good financial shape, dormant inflation and employment conditions improving. All this is consistent with our economist's baseline scenario of 2.8% growth this year; a moderate growth rate historically, which we believe can be sustained for several years. As of mid-January earnings were expected to be up around 5% year-over-year. By the end of February (after most companies had reported), expectations had jumped to over 9%. This supports our estimate of earnings growing by around 10% this year, which underpins our positive valuation and expectations for the US market.

Australia's economy expanded faster than most economists expected in the fourth quarter of last year. The economy advanced 0.8% from the previous three months. Compared with a year earlier, the economy expanded by 2.8% against a median forecast of a 2.5% rise. In a statement by the Reserve Bank coinciding with its decision earlier this month to leave interest rates on hold, Governor Glenn Stevens said: "…..resources sector investment spending is set to decline significantly and, at this stage, signs of improvement in other sectors are only tentative". Meanwhile, the unemployment rate has climbed to a ten year high of over 6% in February, and seems destined to rise further.

While European equities have enjoyed strong gains and the Euro has rallied, economic conditions in Europe remain difficult. The average employment rate for the PIGS (Portugal, Italy, Greece and Spain) remains well over 20%. In contrast, Germany's 6.8% unemployment rate is the lowest seen in several decades. Given this dichotomy, it seems natural that Germany would want a 'hawkish' monetary policy while most of Europe would prefer a 'dovish' policy. While Germany may be able to fend off the European 'doves' when the overall growth rate is steady, this is unlikely to be the case should economic growth start to slip. There have been two periods since the 2008 financial crisis in which the European Central Bank (ECB) printed money and both came after economic growth had peaked. This can be seen by the Purchasing Manager Indexes (PMIs) which show economic contraction in 2008 and 2011. Currently we are seeing the likelihood of a third peak in economic growth.



Unlike in 2011 when the ECB expanded its balance sheet, there is far more reason for the ECB to aggressively print money today. Unemployment rates have risen dramatically since 2011 in every country except Germany. Additionally, the current inflation picture is far more supportive of monetary easing than it was in 2011 when inflation rates in Europe were at five-year highs. Currently, most of Europe is on the verge of seeing outright deflation with the Eurozone annual inflation rate at a meager 0.8%. The stage may be set for the ECB President Mario Draghi to aggressively loosen monetary policy in the weeks and months ahead to combat faltering growth. Based on what occurred in 2011 when the ECB last engaged in quantitative easing, we might expect global stock markets to rally while commodities could suffer under a strong US dollar.

SUMMARY

1. We remain bullish on stocks and bearish on bonds.
2. In the US the private sector seems strong enough to sustain economic growth as the Federal Reserve continues to 'taper'.
3. In Australia signs of an improvement in the non-resource sectors remain tentative.
4. The stage seems set for the European Central Bank to loosen monetary policy.
5. We believe there won't be a major armed conflict in Ukraine.

Market developments during February 2014 included:

Equities

Equity markets rebounded in February after a very poor start to the year. Markets surged against a backdrop of an improved economic outlook and extremely low interest rates. The US equity market reached new highs, despite ongoing uncertainty around growth momentum and Fed tapering.

Some peripheral European markets and several Asian markets experienced strong performance while Eastern Europe was undermined by developments in Ukraine and Russia.

Economic data presented a picture of ongoing recovery in Europe while weak US data was attributed to extreme weather conditions. Most Japanese indicators continued to improve although markets have become increasingly sceptical over the ability of "Abenomics" to lift Japan out of deflation.

The MSCI World ex-Aust Net Div (AUD) Index rose 2.29% in February. The year-on-year return hit 40.38%. The MSCI

World ex-Aust Net Div LC Index rose 4.19% during February, bringing the year-on-year return to 21.97%.

The S&P/ASX 300 Accumulation Index has returned 10.19% year-on-year.

Fixed Interest

Bond markets were relatively steady in February although peripheral European spreads and corporate spreads continued to narrow.

Australian 10-year yields began and ended the month close to 3.95% although they did reach 4.15% in mid-February.

Bonds were well-supported at the 4.25% level and now sit on the critical 200-day moving average.

A further rally from this level requires either slower domestic and global growth or an escalation of events in Eastern Europe.

Australian fixed interest returned 0.2% for the month and 2.7% for the financial year-to-date, slightly outperforming cash which returned 1.8% over the same period.

REITs and Infrastructure

The property sector returned 4.3% in February, taking the financial year-to-date return to 3.3%. That was below the broader equity market return and not much above bonds.

As an interest rate-sensitive sector the performance of REITs has been closely tied to developments in the bond market. Signs of improvement in the domestic economy should also flow through to earnings for the sector.

The improvement in the residential property market has certainly flowed through to the sector. An index of residential property trusts was up almost 6% in February and more than 20% in the financial year-to-date. The retail property sector has lagged, producing returns of 2.1% for the month and -5.4% for the FYTD.

Alternatives

Initial estimates for February indicate that the RBA Commodity index declined by 1.3% (on a monthly average basis) in SDR terms. This follows a 1.6% decline in January.

The major contributors to the fall were a drop in the prices of iron ore and coking coal, which was partially offset by an increase in the price of gold. The prices of many rural commodities rose while the base metals sub-index fell in February.

Over the past year, the index has declined by around 12% in SDR terms. The prices of most commodities in the index have fallen over this period. The index has risen by 1.8% in Australian dollar terms over the past year.

Commodity prices lifted almost 6.8% in February. Nickel, tin and zinc rose 7% while gold continued to rally, reaching US$1329 by end-February. Copper has generally lagged while iron ore prices have declined 10% this year to fall below $US120 a tonne for the first time since July 2013.