

Market Watch

ANZ Wealth Chief Investment Office

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Market Highlights

- Bond yields rise on higher inflation risks
- Share markets moved lower as bond proxies such as REITs and utilities were dumped
- The markets are pricing around 70% probability for a US rate hike in December

Market jitters

Bond markets re-priced some inflation risk following rising headline inflation on the back of stronger commodity prices. In turn, bond yields rose sharply. Share markets fell, largely driven by a re-calibration of sectors within the market. Sectors which are a proxy for the defensive nature of bonds rather than yields, such as REITs and utilities, lost favour to industries linked to higher bond yields and higher economic growth, such as banks and consumer discretionary stocks, such as retail stocks.

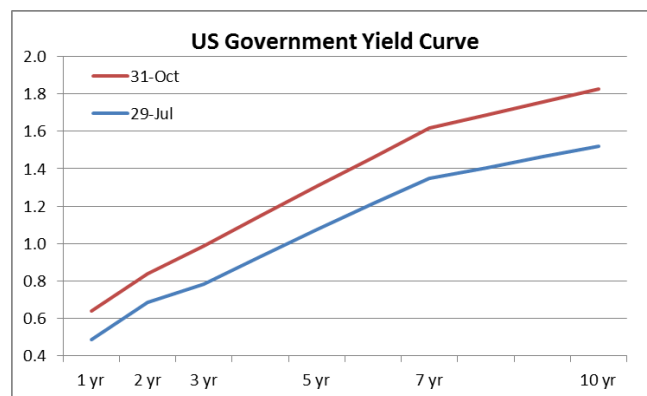
In the US, economic data remained stable as labour market indicators and industrial activity continued to improve. The market is now pricing in about a 70% chance for a US rate hike in December, however this may change due to market jitters related to the US presidential election, and its outcome.

Share markets have fallen on higher bond yields

In Europe, growth indicators continued to pick up as business sentiment improved. In Germany, the IFO Business Climate Index survey reached the highest level this year as consumer activity and growth continued to increase. In Japan, our forward-looking indicators such as the Purchasing Manager's Index (PMI) revealed new manufacturing orders have continued to improve but inflation has remained soft.

In China, third quarter (Q3) Gross Domestic Product (GDP) remained at 6.7%, in line with analyst expectations. Improved tertiary sector growth was the main contributor, driven by easier credit conditions, a stronger property market and firmer confidence. Industrial growth remained stable, but some of the earlier rounds of government stimulus are starting to subside.

Steeper US bond yields



Sources: Bloomberg, ANZ Wealth.

In Australia, the release of the Q3 inflation report continued to soft underlying core inflation, which is likely to see the Reserve Bank of Australia (RBA) maintain their easing bias. From a growth perspective, higher spot commodity prices, such as coking coal and iron ore, will likely boost the terms of trade and national income. The property outlook continues to be stable as auction clearance rates remain high, especially in Sydney and Melbourne despite declining building approvals.

Shares

Share markets fell in October following the increase in bond yields. Global developed share markets were down 0.5% in hedged Australian dollar (AUD) terms. European shares were up 1.1% in local currency terms following improved business activity and growth. The UK market (FTSE index) rose by 0.8% led by post-Brexit traction and following improved Q3 GDP growth. In the US, the share market fell following soft revenue growth in company reporting and on Presidential election jitters. On an earnings per share basis however the US share market still performed well over the month.

The Australian share market underperformed its global counterparts, falling 2.2%. REITs were the main detractor of performance, falling 15% from their peak. Telecommunications and utilities were also down due to earnings downgrades and rotations away from these bond proxy sectors. Resources continued to perform well given higher spot commodities and banks were modestly higher. Emerging market shares outperformed developed markets in US dollar (USD) terms. This comes as the hard data continued to improve in the region following stable Chinese growth, higher commodity prices and better investor sentiment.

Bonds

Bond yields moved sharply higher in the month as headline inflation expectations increased due to rising oil prices. The US 10-year bond yield closed the month at 1.83%, a 23 basis point increase. In Europe, bond yields also rose, but most prominently in the UK where yields rose 51.4 basis points. Fixed income returns were down 0.9% in the month, with Australian fixed income underperforming global at -1.3%. The 10 year Australian government bond yield rose by 44 basis points as the market priced in expected further interest rate cuts. This strong easing bias is largely due to ongoing soft core inflation in Q3.

Across credit markets spreads declined as sentiment improved. High yield credit continued to improve following firmer commodity prices and strong investor demand. Flows into emerging market bonds were strong following better macro-economic conditions.

Major asset class performance as at 31 October 2016 (%)

Sector	1 month	3 months	12 months	5 Years
Australian Shares	-2.2	-3.2	6.3	9.0
Global Shares (hedged)	-0.5	-1.4	3.0	13.9
Global Shares (unhedged)	-1.4	-1.4	-5.4	16.8
Global Emerging Markets (unhedged)	0.8	3.9	2.5	7.5
Global Small Companies (unhedged)	-3.1	-2.1	-2.7	18.1
Global Listed Property	-5.2	-9.0	4.5	13.0
Cash	0.2	0.5	2.1	2.9
Australian Fixed Income	-1.3	-1.1	4.0	5.8
International Fixed Income	-0.9	-0.8	6.7	6.8

Source: JP Morgan & ANZ Wealth

Indexes: Australian Shares - S&P / ASX300 Accumulation, Global Shares (hedged/unhedged) - MSCI World ex Australia, Global Emerging Markets - MSCI Emerging Free Net in AUD (unhedged), Global Small Companies (unhedged) - MSCI World Small Cap exAustralia, Global Listed Property - FTSE EPRA/NAREIT Developed Rental Index exAustralia (hedged), Cash - Bloomberg Bank Bill, Australian Fixed Income - Bloomberg Composite Bond All Maturities, International Fixed Income - Barclays Global Aggregate Bond Index (hedged).

Please note: Past performance is not indicative of future performance

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Currencies

The US dollar strengthened in the environment which favoured lower risk assets. The AUD was down 0.7% with higher commodity prices providing some support. The Euro and Pound were down 2.3% and 6.0% respectively. Emerging market currencies held up better, but were down 0.5% as concerns of a Donald Trump US Presidential victory weighed on market sentiment.

Implications

Bond yields rose this month as inflation expectations increased due to higher oil prices. This has led bond prices lower with share markets also impacted. In our view, this will not mirror the sharp impact we saw on bond markets during 2013's temper tantrum, as this time around low economic growth is compressing prices. Within share markets, valuations appear more balanced, even though bond proxy sectors such as REITs and utilities have de-rated.

We remain cautious towards growth assets due to political upheaval but the macro environment appears to favour markets more linked to a cyclical recovery such as Australia and emerging market shares. We are overweight defensive assets, and neutral Australian bonds, as further RBA rate cuts may eventuate in the face of low inflation. We hold an underweight position to international bonds, with an overweight position in cash.