Market Watch

ANZ Wealth Chief Investment Office

JUNE 2016

Market Highlights

- Share markets dropped sharply in the hours post Brexit and then rallied strongly
- Brexit is a medium-term challenge but has reinforced the long-standing trend of lower yields
- Market expectations have shifted towards US rates being on hold for an extended period

The post Brexit landscape

The vote by the UK to exit the European Union on 23 June (Brexit) drove a sharp share market correction followed by a solid rally, led by the US and the UK.

Brexit is clearly a medium-term challenge for the UK, and to some extent Europe, although the headwinds to global growth may be modest.

A key near term legacy of Brexit is to reinforce the long-standing 'lower for longer' trend of lower bond yields. This reflects market expectations that central banks will keep rates on hold or provide further policy support to aide growth and provide ample liquidity. Yields are now negative across many markets including Switzerland, Germany, Japan, and Sweden.

The share market rally was led by the US and UK

The market correction post Brexit was strongest in banks and financials as these sectors are generally supported by somewhat higher rates and yields.

Bond sensitive sectors that supported the rally were consumer staples, utilities, Real Estate Investment Trusts (REITs), gold and telecommunications.

Other sectors that rebounded, like energy and metals and mining, were partly supported by improved fundamentals and expectations that the US dollar (USD) would remain capped due to the US Federal Reserve (Fed) rate hikes being pushed out.

UK shares were propped up by the sharp decline in the pound sterling, favouring offshore exposures.

Through June the outlook for global economic growth, while remaining soft, continued to stabilise, including across Europe. The late 2015 sharp earnings downgrade cycle also consolidated, with further signs of an improvement in US earnings.

In China, the government's measures to boost credit growth continued to support the economy through a lift in residential construction and infrastructure investment. However, the impact of stimulus measures on commodity prices has now eased as commodity prices have levelled out following extra supply being brought on.

In Australia, the surprise dip in inflation (-0.2% in the first quarter of 2016) drew a rapid response from the Reserve Bank of Australia (RBA) with rates cut by 0.25% on 3 May, and prospects for further rate cuts factored in.

While the Australian dollar (AUD) initially dipped through the Brexit correction it has rallied strongly post-Brexit, partly reflecting market expectations that the Fed will keep US rates on hold for longer.

While Australian inflation and wages remained soft, GDP lifted strongly at 1.1% over the quarter and 3.1% over the year. This result suggests that the economy continues to weather the downturn in mining investment.

Solid consumer spending and strong growth in both housing construction and exports helped to offset the slump in mining investment. However, apartment approvals appear to be easing which suggests some softening in construction in 2017.

Shares

Brexit surprised markets and resulted in an initial sharp correction in global shares, and was followed by a strong rally in late June. This, in part, reflects expectations that central banks will continue to provide liquidity and support growth.

Following the higher market volatility global developed share markets were down 1.2% in USD terms. European shares were down 6.4% in local currency terms as concerns of contagion led to reduced risk appetite. US shares were flat over the month while the UK FTSE was up strongly. Meanwhile, Japan was down 9.7% as the higher yen dampened future prospects for earnings.

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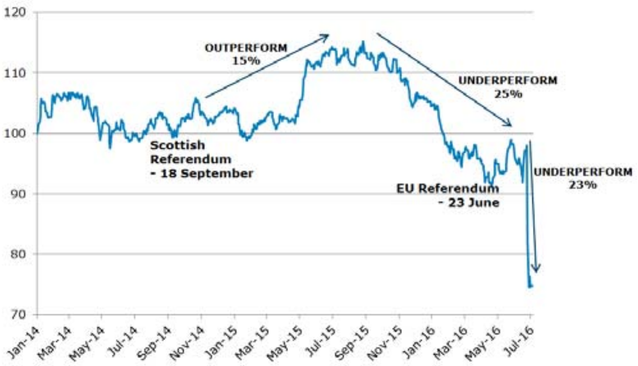
The Australian share market also recovered solidly in late June, although returns were still down 2.4% in the month. This time the resilience of the AUD resulted in lower returns on an unhedged basis.

Emerging market shares were up 3.3% in USD terms supported by US rate hikes being pushed out and lower bond yields. This was led by strong returns in Brazil where higher commodity prices benefited earnings growth.

Performance of UK domestic stocks relative to UK exporters



Source: Bloomberg, ANZ Wealth

Bonds

Support for bond returns reflected soft growth and inflation, possible further central bank support from the European Central Bank (ECB) and the RBA cutting rates. US 10-year yields fell to 1.47%, while core European longer-term bond yields fell sharply with many markets recording negative yields.

Developed market credit found support as spreads largely tracked down following the large rally in government bond yields. Across investment grade corporate bonds, central bank stimulus measures continued to support returns. This underpinned a strong return from corporate bonds which drove a 2.0% return from global fixed interest in June. Australian fixed interest performed strongly at 1.3% buoyed by further expectations for RBA easing.

Currencies

The 'risk off' environment favoured the USD and the Yen. The GBP fell sharply against the USD, down 8.3% in June. Elsewhere, expectations for a delay in Fed tightening have helped to anchor currency gains across emerging market currencies. In June the AUD was up 3.0% and the NZD up 5.5%.

Implications

While Brexit was a short-term shock to markets, it is a medium-term issue for the UK and Europe to resolve. The ultimate implications remain very unclear although the headwinds to global growth are likely to be modest. The post Brexit environment has reinforced the long standing trend towards lower yields and continued central bank policy support.

In Australia, following the 3 May rate cut we think a further decline in the RBA's cash rate is likely, as soft inflation and the continued drag from investment will continue to weigh on growth.

Overall, continued soft global growth with the US relatively advanced in its growth cycle continues to render the outlook vulnerable to large swings in investor sentiment. We continue in our cautious approach with an underweight to growth assets.

Major asset class performance as at 30 June 2016 (%)

Sector	1 month	3 months	12 months	5 Years
Australian Shares	-2.4	4.0	0.9	7.2
Global Shares (hedged)	-1.2	1.7	-1.4	11.3
Global Shares (unhedged)	-3.8	4.4	0.4	14.9
Global Emerging Markets (unhedged)	1.2	4.0	-9.2	3.5
Global Small Companies (unhedged)	-4.6	5.0	-0.9	15.3
Global Listed Property	4.1	4.6	18.3	12.7
Cash	0.2	0.6	2.2	3.1
Australian Fixed Income	1.3	2.9	7.0	6.7
International Fixed Income	2.0	2.9	9.3	7.8

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