Market Watch

ANZ Wealth Chief Investment Office

JULY 2016

Market Highlights

- Share markets bounced strongly despite the rise in geopolitical events
- Bond yields remained well supported by central bank policies
- Slowdown in US growth disappointed expectations for a second quarter rebound

Edging higher

In July share markets shrugged off the volatility which followed geopolitical events including Brexit and the failed coup in Turkey. The US share market (S&P 500 index) reached a record high of 2175 as investor risk appetite returned.

All this occurred in a month where the economic environment was generally soft, led by disappointing growth in the US. The US economy grew at an annualised rate of 1.2%, well below the market consensus of 2.6%.

Share markets shrugged off geopolitical events

Despite a strong lift in personal consumption, which rose at an annualised pace of 4.3%, private domestic investment and inventories dragged growth lower. The US Federal Reserve (Fed) also opted to keep rates on hold as a slowdown in economic momentum justified a more cautious stance towards tightening monetary conditions.

Elsewhere in Europe, growth drivers continued to show a pace of gradual expansion with second quarter GDP for the region at 1.6%. In the UK, measures of consumer sentiment and business confidence deteriorated as the consequences of the Brexit point to a slowdown in economic momentum.

Across in Japan, economic data remained soft as indicators of inflation continued to slide back. This prompted the government to announce further fiscal stimulus - ¥28 trillion over the next several years.

In China, credit growth remained strong, continuing to provide support to the industrial sector of the economy. Second quarter GDP growth of 6.7% (year on year) exceeded market expectations as government policies took effect. That said, the economy is continuing to progress towards allowing consumption and service sectors to hold a greater share of growth. The government remains committed to cutting excess capacity in materials production.

In Australia, the dataflow was generally softer as measures of consumer sentiment, building approvals and credit slowed. The prospects of a hung parliament eased when it became clear the Turnbull government could form an absolute majority.

Weaker inflation pressures followed the release of second quarter core measures of inflation which showed it to be rising at an annual pace of 1.5%, well below the RBA's target band of 2-3%. This prompted the RBA to cut interest rates by 0.25% in August in a bid to restore inflation and support underlying growth, especially at a time when the housing market appears to be easing.

Shares

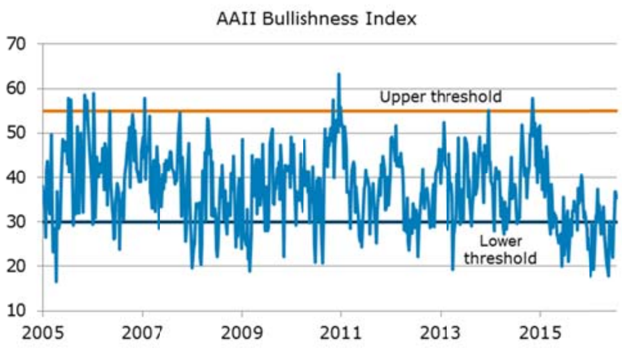
Share markets responded well to the improved risk environment and continued central bank support. Global developed share markets were up 4.1% in US dollar (USD) terms. European shares were up 5.1% in local currency terms as concerns of Brexit contagion were eased by the prospect of possible intervention by the European Central Bank. That said, concerns of an undercapitalised Italian banking sector still highlight some risk factors in the region.

The UK market (FTSE index) rose by 3.4% as a depreciation of the British Pound (GBP) favoured companies with offshore earnings. In the US, a solid reporting season resulted in most companies beating guidance which took the US market to new highs.

In Japan, the market rose 6.2% on increasing prospects for the Bank of Japan to announce further economic support. The Australian share market outperformed other developed markets, up 6.4% in the month as a strengthening in bulk commodity prices including iron ore and thermal coal drove the resources sector sharply higher.

Emerging market shares were up 4.7% in USD terms supported by the Fed remaining on hold for longer. An improvement in sentiment also resulted in a return of investment flows back towards this region. Commodity producing countries like Brazil and South Africa continued to benefit from higher bulk commodity prices.

Investor sentiment returns to more neutral levels



AAII - American Association of Individual Investors Sentiment Survey.

Sources: Bloomberg, ANZ Wealth.

Bonds

Bond yields generally remained low as central banks continued to favour monetary easing over tightening. A lower growth outlook, and with it inflation, has been priced into the lower yield dynamic. US 10-year bonds fell 0.2% to 1.45%. Core European longer-term bond yields continued to fall as many markets recorded negative yields.

Global fixed income returned 0.7%. Australian fixed income performed in line with global bonds this month as expectations of further monetary easing resulted in a strong return of 0.7%.

Currencies

The 'risk on' environment generally saw a softening in the USD against most major currencies, particularly as the Fed showed their preference to keep rates on hold for longer. Emerging market currencies continued to find support in this environment. The Australian dollar (AUD) rose by 2.0% which hurt returns from unhedged investments. The NZD was up 0.9% following a bounce in milk prices.

Implications

Share markets have reached higher levels of valuation in the wake of Brexit but risks remain high in an environment of uncertainty. Our investment strategy favours more caution in the near term as share market pricing is not commensurate with the environment of lower growth and ultimately tepid corporate earnings growth.

We acknowledge that central bank support via monetary stimulus and the policy of low interest rates can support the market, but it becomes increasingly difficult to identify catalysts for further market appreciation.

Within defensive assets, our preference is to hold a neutral position in Australian bonds as further RBA easing looks likely in the wake of a softening inflationary pressures and a slowdown in the key growth drivers in the housing market. We hold an underweight position in international bonds given how low bond yields are, even with a delayed risk of Fed tightening which could result in a sharp selloff. We hold an overweight position to cash.

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

Sector	1 month	3 months	12 months	5 Years
Australian Shares	6.4	7.0	2.9	9.4
Global Shares (hedged)	4.1	4.9	-0.1	12.7
Global Shares (unhedged)	2.0	4.0	-3.9	16.4
Global Emerging Markets (unhedged)	2.9	5.6	-4.1	4.7
Global Small Companies (unhedged)	3.2	5.0	-1.9	17.2
Global Listed Property	4.7	11.0	17.4	13.7
Cash	0.2	0.5	2.2	3.1
Australian Fixed Income	0.7	3.4	6.4	6.5
International Fixed Income	0.7	3.3	8.8	7.6

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