Market Watch

ANZ Wealth Chief Investment Office

SEPTEMBER 2016

Market Highlights

- Central banks continued to support investor sentiment
- Share markets moved higher as bond yields remained low
- The US Federal Reserve (Fed) kept rates unchanged in September

Markets in a see-saw

At the start of the month share markets were weighed down by concerns that central banks may be withdrawing stimulus with bond yields increasing and prices dropping. However, these concerns were put to rest following the decision by the Fed to keep interest rates unchanged, along with communication from the European Central Bank (ECB) and the Bank of Japan (BoJ) reaffirming their asset purchase programs.

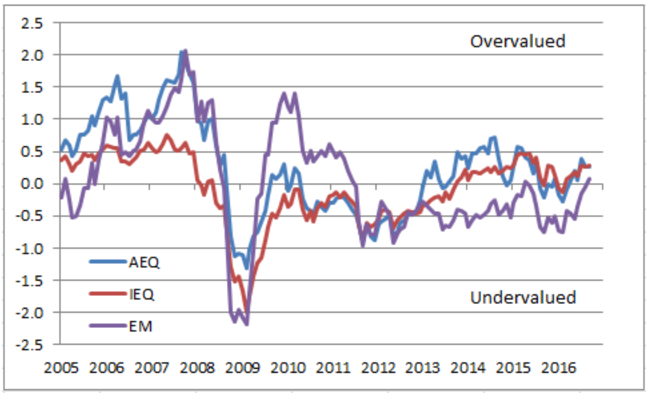
In the US, economic data remained soft following a decline in lead manufacturing indicators and industrial production. Retail sales were also soft but inflation measures were generally stronger. Despite the Fed leaving rates unchanged in September, members of the Federal Open Market Committee (FOMC) were generally more upbeat on the underlying strength of the economy as better labour market growth supports a rate hike in December.

Central banks continued to support markets

In Europe, growth indicators continued to pick up as business sentiment improved. Consumer activity remained strong but this was offset by softer industrial production. In the UK, the political front stabilised following the re-election of labor leader, Jeremy Corbyn, but there was limited discussion on implementing Brexit. In Japan, the BoJ reaffirmed its commitment to asset purchases after conducting its comprehensive monetary policy review, but with a focus towards providing steepness across the yield curve.

In China, weaker data flow in August saw the State Council (China's central body for fiscal policy implementation) commit to bring forward public works investments which supported industrial activity and steel prices. Measures of private sector investment remained soft, while rampant credit growth caught the attention of Western media.

Share markets in overvalued territory (composite indicators)



Sources: Bloomberg, ANZ Wealth.

In Australia, the Reserve Bank of Australia (RBA) is now armed with greater flexibility to meet its medium-term inflation target following a review of monetary policy by new RBA governor, Dr Philip Lowe. The net effect has been reduced market expectation of further rate cuts, in spite of soft underlying momentum across the economy. In particular, forward-looking industrial indicators have declined along with housing finance. Consumer confidence also edged lower but this was offset by continued labour market strength. Service sectors, including tourism and health care, continued to perform well.

Shares

Share markets rose moderately after a weak start to the month. Global developed share markets were up 0.3% in hedged Australian dollar (AUD) terms. European shares were up 0.1% in local currency terms as sentiment remained strong given easy monetary conditions. That said, concerns over Deutsche Bank and the broader banking sector highlight some risk factors in the region. Earnings growth remains challenged but is starting to follow improvements in lead indicators.

The UK market (FTSE index) rose by 1.7% as political stability and better growth prospects encouraged investors. In the US, the share market rose as investor sentiment improved, although the upcoming election may cause some pockets of volatility down the track.

The Australian share market performed well, up 0.5% which was in line with developed markets. Banks performed better as the outlook for interest rates looked more balanced, and the resources sector outperformed following better economic data in China and rising commodity prices.

Emerging market shares outperformed developed markets, up 1.1% in US dollar (USD) terms as fund flows increased due to improved sentiment thanks to reduced Fed rate hike expectations and stronger commodity prices.

Bonds

Bond yields remained low despite moving slightly higher at the start of the month. The US 10-year bond yield finished flat at 1.59%. In Europe and Japan yields were unchanged which produced a return of 0.1% across international fixed income. Australian fixed income underperformed international fixed income down -0.2% as rate cut expectations fell, with the 10-year bond yield rising by eight basis points (bps) in the month.

Across credit markets spreads declined as sentiment improved following central bank actions, with both investment grade and high yield spreads below their long-run average.

Currencies

Across currency markets the USD fell against most majors driven by the benign outlook for the Fed. The Australian dollar (AUD) rose by 2.0% following better data from China impacting unhedged returns for the month. However, narrowing interest rate differentials should see the AUD fall from here.

Implications

Share market valuations continued to rise as investor sentiment firmed in the face of ongoing central bank support. Our investment strategy favours caution in the near term, as share market pricing is out of step with the environment of somewhat softer economic growth, tepid corporate earnings and rising event risks towards the end of the year.

While central bank support via monetary stimulus and low interest rates can support the market, it's also becoming increasingly difficult to identify catalysts for further market appreciation. This has resulted in rising complacency and low volatility.

Within defensive assets, our preference is to hold a neutral position in Australian bonds, as further RBA easing in the wake of softening inflationary pressures may benefit yields. We hold an underweight position in international bonds given how low bond yields are, even with a delayed risk of Fed tightening. We hold an overweight position to cash.

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

Sector	1 month	3 months	12 months	5 Years
Australian Shares	0.5	5.2	13.5	11.0
Global Shares (hedged)	0.3	5.1	11.8	15.9
Global Shares (unhedged)	-1.3	2.0	2.0	17.3
Global Emerging Markets (unhedged)	-0.5	6.1	7.2	8.1
Global Small Companies (unhedged)	-0.4	4.3	4.5	19.3
Global Listed Property	-1.5	0.6	16.6	16.4
Cash	0.1	0.5	2.2	2.9
Australian Fixed Income	-0.2	0.9	5.7	6.0
International Fixed Income	0.1	0.8	8.2	7.0

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