> INVESTMENT STRATEGY & ECONOMICS

MARKET WATCH

In brief – June 2013

- While growth in emerging markets has slowed, it remains higher than developed countries.
- The tapering of quantitative easing in the US may be an uncomfortable adjustment but ultimately should be seen as positive.
- Positive steps have been taken to reinvigorate Japan's economy and end the 22 year long "lost decade".

Slowing growth doesn't equal decay

Jeff Rogers
Chief Investment Officer, ipac

Emerging market economies across Asia have become key drivers of world growth over the past decade. Businesses have been demanding low-cost merchandise and these economies have benefited from their ready supplies of lower cost labour backed by governments determined to advance their national prosperity.

WHILE THERE ARE CERTAINLY SOME CHALLENGES FACING EMERGING ASIAN ECONOMIES, THERE IS ALSO A REALITY THAT THEY ARE STILL GROWING AT MUCH FASTER RATES THAN THE REST OF THE WORLD. THIS IS LIKELY TO CONTINUE.

However, over the past year many of these economies have started to struggle to continue the same pace of growth due to reduced demand. Demand from Europe is less but also emerging economies have invested so heavily in building manufacturing capacity that their demand for raw materials has also declined.

The latter has upset the plans of some of Australia's miners but other developed economies have started to respond to these competitive challenges. Like Japan which has undertaken aggressive measures to restore its competitiveness.

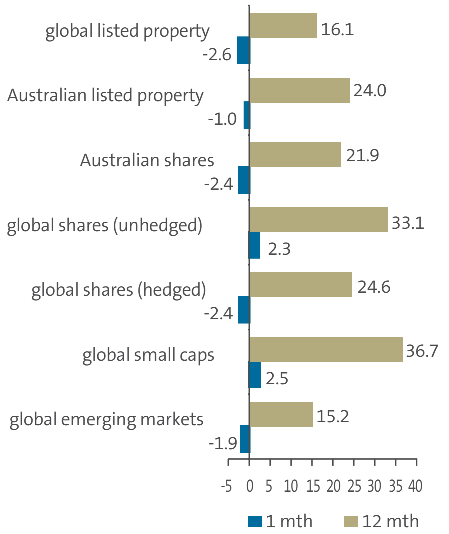
In addition, each of the emerging economies faces its own unique domestic challenges. China faces pressures from demands for better wages and conditions and from an appreciating currency. Also new leadership is focusing on tackling corruption in China and trying to control the rapid growth and unproductive use of credit that has supported excessive property price inflation.

China's government wants to move up the value-added chain by encouraging the development of higher value-add industries, and to reduce its reliance on exports and manufacturing by boosting its growth in more consumer and service-related areas.

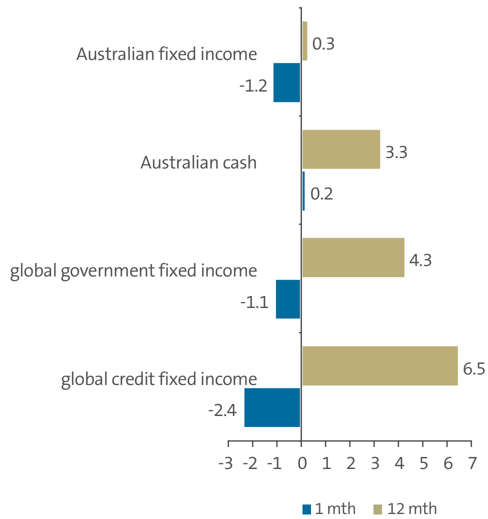
The degree of uncertainty surrounding the pathway of growth has left investors apprehensive and has negatively impacted emerging market shares and bonds especially as global investors sense an improvement in opportunities elsewhere, particularly the US. In our view, while share markets have fallen it is the short-term "tourist investors" who are leaving the emerging markets – when things don't look as good, you go home.

The story is a different one for longer term investors. Share market opportunities are far more dependent on corporate fundamentals and real economic growth. While the rate of emerging economic growth has slowed, they are still growing at higher rates than the rest of the world. In addition, a rise in economic growth in the US, improved stability in Europe and lower exchange rates will be advantageous to exporters in emerging economies.

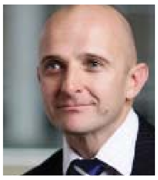
Growth markets (A$)



Debt markets (A$)



Potential opportunities in a normalising economy



By Matthew Hopkins
Senior Portfolio Manager, Multi-Asset Fund

The last few years have focused on the US's fight to reflate their economy. We recently saw a change of tone from the US central bank. Matthew Hopkins, Senior Portfolio Manager talks us through the shift and what opportunities lie ahead.

The US Federal Reserve's (Fed) bond buying programs have kept cash and bond rates historically low and affected asset markets in many different ways. In this period the obvious beneficiaries have been bond markets themselves with falling yields translating into higher and higher bond prices. The US share market has also benefitted, generating a cumulative return of over 95% since the end of 2008 and currently standing well above its previous 2007 highs. In contrast other parts of the market have languished. Share markets in peripheral European countries, struggling under austerity programs and heavy debt burdens, have underperformed dramatically over the same time period and sit around their lowest levels from 2008.

Some of the good share performance can be contributed to how lower rates have helped companies maintain profitability through cheaper borrowing and refinancing to buy back shares. Therefore, the Fed's announcement that it would start reducing its bond purchases, as long as everything was moving along okay with jobs and inflation, creates some concern. However, the tapering of this stimulus is ultimately signs of good things.

If an economy is strong enough to withdraw central bank support, this is a positive signal of a more normal environment. A stronger economy typically equates to stronger employment and demand, which help support corporate fundamentals; however, there are risks of an uncomfortable adjustment for bond holders as rates reset higher. And likely, there will be a period of transition for those other parts of the market that benefitted abnormally from the lower rates.

While there is likely to be a period of transition over the next year we see several opportunities presenting themselves in Europe, US bonds and emerging markets.

In Europe, Italy and Spain, previously hurt by very high borrowing costs and high debt levels, are already improving budget deficits forecast and their growth rates are improving at a faster rate than Germany's. These are signals of regions where headwinds are subsiding and could offer potential opportunities.

A second opportunity will be in US bonds where at some point after the tapering transition is digested we will have a less expensive and defensive asset that is providing a much more attractive yield than currently on offer. An opportunity that is compounded when hedged back into Australian dollars as the US dollar is also likely to be much stronger by the time tapering actually begins.

A third opportunity is emerging markets where at present some markets are in the midst of a storm of concerns over credit growth, falling commodity prices, and in some cases inflation concerns. The share markets of these countries are pricing in a lot of pain. The share market in Russia, for example, is showing a valuation level consistent with a depression. As the broader investment environment normalises on a path to growth and as investors worst fears in emerging markets are not realised, these regions are well place to offer a rise in valuations.

A positive start to Japan's awakening

Twenty five years ago Japan was acclaimed as a global economic powerhouse and technological leader. However, the share market bubble burst in 1991 and the period since has been referred to as Japan's 'lost decade'. The fact that the 'lost decade' has now lasted 22 years is testimony to how profound the collapse had been.

Japan's position as a leader in technology has been increasingly challenged by other nations as Japan has been unable to grow its economy. Consequently, its share of global output has shrunk and it has struggled with persistent asset price deflation.

After half-hearted efforts to boost growth and the need to rebuild after the devastating disasters that hit the country, Japan's new government has set out a bold new plan to awaken its economy. Under the leadership of Prime Minister Shinzo Abe, Japan has begun to implement a mix of strategies to reflate the economy, increase government spending and open closed industries in an effort to re-animate the economy.

The efforts to reinvigorate Japan are showing early signs of success. Since Abe was elected the local share market has risen by over 50% and first quarter growth has risen to an annualised rate of 3.5%.

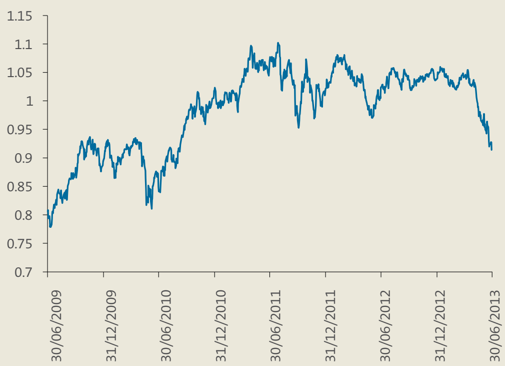
A more prosperous Japan would be a strong source of global demand. It will be interesting to see what the central bank and new Japanese government's bold reflationary and reformist policies can deliver in regards to its economy, especially following this month's upper house elections which could deliver a majority to Prime Minister Abe.

Down but not out for the Australian dollar

The Australian dollar fell to US$0.91 in June. The strengthening economy in the US and comments by the Federal Reserve concerning the time horizon over which they would contemplate scaling back stimulus measures influenced the fall. Other global factors that weakened investor appetite for the Australian dollar included apprehension surrounding China's growth path given China's importance as Australia's largest trading partner.

Closer to home, the lower interest rates impacted the fall as the Reserve Bank of Australia continued to hold interest rates at 2.75% in June while suggesting there was scope for lower interest rates.

While the falling Australian dollar may mean we'll be a little thriftier on our overseas holidays, the dollar's decline coupled with lower interest rates should help stimulate areas of the economy such as retail, tourism, education and manufacturing. This, in turn, could help fill some of the gap left by lower mining investment which has been dragging down performance of Australian shares.



Economic indicators

Gross domestic product (annual rate %)*	Latest	Current	Previous	1 year ago
World (IMF/OECD)	2012	3.2	n/a	4.0
Australia	Mar-13	2.5	3.2	4.4
China	Mar-13	7.7	7.9	8.1
European Union	Mar-13	-1.1	-0.9	-0.1
United States	Mar-13	1.6	1.7	2.4
Inflation (annual rate %)*	**Latest**	**Current**	**3 months ago**	**1 year ago**
Australia	Mar-13	2.5	2.2	1.6
China	Jun-13	2.7	2.1	2.2
European Union	Jun-13	1.6	1.7	2.4
United States	Jun-13	1.5	1.7	2.7
Official interest rates (%)*	**Latest**	**Current**	**3 months ago**	**1 year ago**
Australia	Jun-13	2.75	3.00	3.50
China	Jun-13	4.94	2.83	3.60
European Union	Jun-13	0.50	0.75	1.00
United States	Jun-13	0.25	0.25	0.25
Bond yields (%)	**Latest**	**Current**	**3 months ago**	**1 year ago**
Australia 3Y	Jun-13	2.75	2.88	2.40
Australia 10Y	Jun-13	3.76	3.09	3.04
United States 2Y	Jun-13	0.36	0.24	0.30
United States 10Y	Jun-13	2.49	1.67	1.64

Exchange rates

Official interest rates (%)+	Latest	Current	3 months ago	1 year ago
Australian Dollar / Chinese Renmimbi	Jun-13	5.6177	6.4784	6.5136
Australian Dollar / Euro	Jun-13	0.7042	0.8119	0.8077
Australian Dollar / Great British Pound	Jun-13	0.6035	0.6865	0.6536
Australian Dollar / Japanese Yen	Jun-13	90.9167	98.0159	81.7927
Australian Dollar / United States Dollar	Jun-13	0.9153	1.0425	1.0251

Share market analysis

Sharemarkets (in local currency)	5yrs (%pa)	3yrs (%pa)	1yr (%)	3 months (%)	1 month (%)
Australia : ASX 300 Accum	2.7	8.3	21.9	-2.8	-2.4
Germany : DAX	4.5	10.3	24.5	2.6	-4.3
United Kingdom : FTSE 100	2	8.1	11.6	-3.1	-5.6
global emerging markets : MSCI in AUD	0.5	0.6	15.2	4.7	-1.9
Japan : Nikkei	0.3	13.4	51.9	10.3	-0.7
United States : S&P 500	4.6	16	17.9	2.4	-1.5

*Data is most current data available
+Rates are expressed as 1 Australian Dollar
(IMF/OECD) purchasing-power-parady

Indices: **Australian shares**: S&P/ASX 300 Accum Index: **International Shares** (Unhedged): MSCI World Ex Australia Index in AUD: **International Shares (Hedged):** MSCI World Ex Australia Index (Hedged) in AUD: **Global Emerging Markets:** MSCI Emerging Markets Index in AUD : **Australian Listed Property:** S&P/ASX 300 A-REIT Index: **Global Listed Property:** UBS Global Investors Index (Hedged) in AUD Australian Cash: UBSA Bank Bill Index **Australian Fixed Interest:** UBSA Government/Treasuries: **Global Government Fixed Interest:** Barclays Global Aggregate Govt (Hedged) in AUD **Global Credit Fixed Interest:** Barclays Global Aggregate Credit (Hedged) in AUD