Market Overview and Outlook

Economic Overview

US economic data has been surprising to the upside over the last couple of months. However, none of the structural headwinds that seem to have plagued the global economy in recent years (a mix of excessive indebtedness, deteriorating demographics, rising political uncertainty as well as the end of the China growth miracle and the commodity supercycle) have been resolved. According to Citibank, the following are some reasons to be concerned for global growth:

1. The Chinese stabilisation could be even more short-lived than currently expected. Much of China's growth has been reliant on increasing debt.
2. One contributor to the potential stabilisation in China's and emerging market activity has been the weaker US dollar and receding expectations of a US rate hike. The market may be under-pricing Fed rate hikes over the next two years.
3. A US downturn could threaten. While most US data has been decent recently, it has not been very strong. This leads to some caution, especially if there is more economic weakness to come.
4. Political risks in Europe are high and rising. This includes, Brexit, the refugee crisis, elections in Spain and extremist parties in a variety of European countries.

The US economy added just 38,000 jobs in May. This is far fewer than the 160,000 that economists had anticipated. The unemployment rate declined by 0.3 percentage points to 4.7%, but this can be attributed to people dropping out of the workforce. The number of workers who would like to work full-time but can find only part-time work increased by nearly half a million, to 6.4 million. US Consumer Price Index increased 0.4% in April, the largest gain since February 2013, after rising 0.1% in March. That took the year-on-year increase in the CPI to 1.1% from 0.9% in March. US consumer spending recorded its biggest increase in more than six years in April as households stepped up purchases of cars. Consumer spending, which accounts for more than two-thirds of US economic activity, surged 1.0% in April, the largest since August 2009.

The euro-area economy grew faster than previously estimated at the start of the year, driven by investment and a pickup in consumer spending. GDP rose 0.6% in the first quarter. After growing at the fastest pace in a year, the European Central Bank predicts the 19-nation economy will slow in the second quarter, with inflation rates likely to remain very low or even negative. Among the downside risks to the outlook were subdued prospects in emerging markets, slow progress in structural reforms, and the U.K.'s June 23 referendum on whether to remain in the European Union.

Euro-area consumer prices failed to increase for a fourth consecutive month, highlighting policy makers' struggle to stoke inflation despite multiple rounds of stimulus. Prices fell 0.1% in May from a year earlier and this follows a drop of minus 0.2% in April. The unemployment rate held at 10.2%.

U.K. companies are feeling the strain from the upcoming European Union referendum, with a gauge of services falling to its lowest level in more than three years. In April, the services PMI dropped to 52.3 from 53.7. While that is above the 50 level that divides expansion from contraction, it is the weakest since February 2013.

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The slump follows bigger-than-expected declines in manufacturing and construction surveys. The reports indicate growth of just 0.1% in April, down from 0.4% in the first quarter. U.K. inflation unexpectedly slowed in April to 0.3% from 0.5% in March. Inflation has been below the 2% target for more than two years, largely due to lower oil costs and a stronger pound.

Japan's economy dodged a recession last quarter as gains in government and consumer spending compensated for a slide in business investment. GDP expanded by an annualised 1.7% in the three months ended March 31. The October-to-December quarter was revised to a 1.7% contraction, worse than the previous estimate of a 1.1% drop. The core consumer price index, which excludes volatile perishables, posted the second straight year-on-year drop in April but the pace of decline remained at -0.3%.

China's manufacturing activity showed signs of steadying in May but remained weak amid soft demand at home and abroad. China's official factory activity gauge expanded for the third straight month in May, but only marginally. Factories continued to cut staff. The May Purchasing Managers' Index (PMI) was unchanged from April at 50.1, barely above the neutral 50-mark.

The World Bank cut its outlook for global growth as business spending sags in advanced economies including the US, while commodity exporters in emerging markets struggle to adjust to low prices. World GDP will grow by 2.4% this year, an "insipid" pace that is unchanged from 2015 and down from the 2.9% estimated in January. Growth will pick up to 2.8% in 2017. Downside risks have become more pronounced since the start of the year, with a range of challenges looming including deteriorating conditions in commodity-exporting economies, rising private-sector debt in large emerging markets and heightened policy and geopolitical uncertainties.

Interest Rates & Currency

Federal Reserve Chair Janet Yellen gave a largely upbeat assessment of the US economic outlook and said interest rate hikes are coming but, in an omission that stood out to some investors, gave little sense of when. Overall, Yellen said, *"I see good reasons to expect that the positive forces supporting employment growth and higher inflation will continue to outweigh the negative ones."* The Federal Reserve, mindful of unexpectedly weak job growth last month, has abandoned hope of raising interest rates at its June meeting, but Fed officials say they are still thinking seriously about raising rates in July or September. Ms. Yellen was generally upbeat assessment of economic conditions. While describing the May jobs report as "concerning," she also emphasised that it was just one piece of data and that other economic indicators, including wage growth, paint a considerably brighter picture.

The European Central Bank (ECB), which began buying corporate bonds in June, said it will not have to sell notes downgraded to junk as it fleshed out the latest expansion of a stimulus program. Securities can be retained even if their ratings fall below the criteria for purchase in the rebooted quantitative-easing plan. The decision to hold onto downgraded bonds may reflect the ECB's desire to avoid creating price swings in the market. The announcement in March that it would start buying corporate debt helped drive borrowing costs toward record lows and spurred a flood of issuance. The fact that the ECB will not be a forced seller is supportive for the market.

Negative interest-rate stimulus is half working in Japan, as lenders cut government bond holdings by the most in almost three years, only to hoard proceeds at the central bank. Japanese government bonds owned by banks fell 5.5% in April from a month earlier, as most yields slumped below zero Their deposits at the BOJ, where only a small part of reserves are charged fees, rose 3.4% per cent in the period. That does not bode well for loan growth now riding near a three-year low. A Toyota Motor Corp. unit sold yen bonds with the lowest coupon ever for a Japanese company, reflecting the plunge in borrowing costs. Toyota Finance Corp. issued 20 billion yen (US$186 million) of notes at a yield of 0.001%. That is the lowest coupon ever for a regular bond by a domestic company that is not backed by the government.

The RBA, at its June Board meeting, left the cash rate unchanged at its new record low of 1.75%, after May's 25bp cut, as widely expected. However, in contrast to expectations, the RBA did not clearly re-instate its easing bias, noting that "holding…policy unchanged at this meeting…[is] consistent with sustainable growth…and inflation returning to the target over time". UBS' view is that *"While the RBA has entered a 'wait & see' mode, we continue to forecast a final 25bp cut in August post a low Q2 CPI print"*.

Another reduction in the RBA cash rate is expected in the coming months. Our preference remains for both short dated fixed-rate and floating-rate securities of high investment grade corporates.

Closing Rates as at 31 May 2016

	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.75%	2.00%	US Fed Funds Rate	0.3700%	0.3700%
90 Day Bank Bills	2.02%	2.17%	AUD/USD	72.70	76.55
180 Day Bank Bills	1.97%	2.10%	US 10 Year T-Bond	1.88%	1.82%
5 Year Govt Bonds	1.845%	2.083%	US 30 Year T-Bond	2.67%	2.67%
10 Year Govt Bonds	2.322%	2.524%	Japan 10 year yield	-0.112%	-0.108%

Stance:	**Corporate**	**-**	**Positive variable rate and investment grade**
	Government	**-**	**Underweight**

[1] Previous rate or level represents the rate or level as at the end of the previous month.

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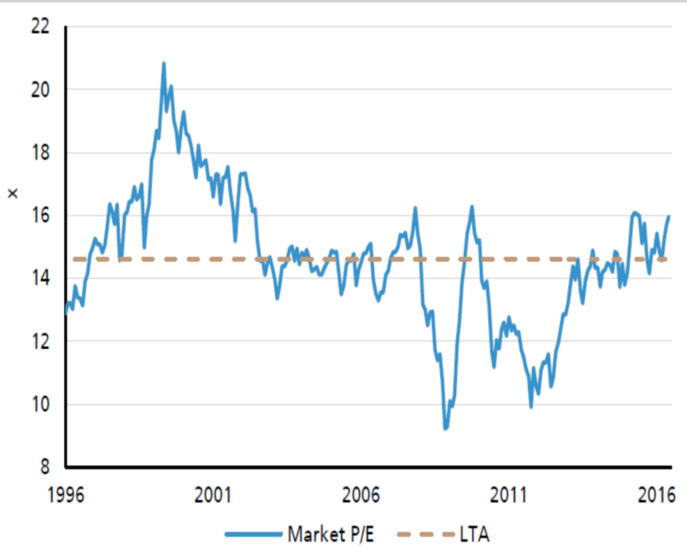
Australian Shares

UBS' comment is, *"The Australian market valuation, in aggregate, looks somewhat stretched at 16x 1 year forward consensus earnings. Breaking the market down into its four major sub-sectors reveals the following valuation picture:*

- ***Resources** are sitting on a notionally expensive 25x forward earnings. However, "below trend" commodity prices (most particularly the oil price) are depressing near-term earnings estimates.*
- ***Banks** are trading on just above 12x forward earnings, which in contrast to most sectors, is below the long-term average (albeit very marginally).*
- *The highly bond yield sensitive **REIT** sector is trading on 18x, well above its long-term average of 14x.*
- *Finally the **Industrials-ex-Financials** sector is trading just above 18x, well above the long-term level of around 16x.."*

Figure 1: Aggregate Australian Market P/E Multiple



Source: I/B/E/S, Factset

The overall market PE has pushed up to 16x forward earnings. This is in part being driven by depressed earnings in the resource sector but is also be driven by high PEs in the REIT sector and also the industrials ex financials sector.

The franked dividend yield above the term deposit rate continues to provide support for equity valuations. With the falling cash rate, we believe there should be continued support for equity valuations and gross yields from equities.

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Closing Rates as at 31 May 2016	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,447.8	5,316.0	AOX Earnings Yield	5.43%	5.56%
PE Industrials (2016)*	16.2x	15.4x	Div Yld Indust (2016)*	4.8%	5.0%
PE All Ords (2016)*	18.4x	18.0x	Div Yield All Ords (2015)*	4.3%	4.3%

*Source – UBS

Stance: Neutral

International Shares

Ultra low and negative interest rates are supposed to boost business investment, but an analysis suggests easy money policies may be giving incentive to companies to do the opposite. The very low rates in the US have contributed to companies responding to yield-starved investors by returning more profits to shareholders via dividends and share buybacks. US dividend payout ratios rose to 36.9% in 2015, from 28.8% in 2007. The outcome has been that low and negative interest rates could be less influential in stimulating capital expenditure by firms, and result in lower productivity and lower economic growth.

US productivity, which measures hourly output per worker, contracted at an annualized rate of 0.6%. Unit labour costs, the price of labour per single unit of output, increased at a revised 4.5% pace in the first quarter. Low productivity growth means that companies still face significant labour costs for producing an extra unit of output. After-tax corporate profits fell 5.1% in 2015 and rose at only a 0.6% rate in the first quarter.

We expect geopolitical events occasionally giving rise to market volatility. Take advantage of market volatility and the elevated AUD to purchase international shares, but to be aware of the rising risks of a price earning ratio (PE) contraction in the US market.

Closing Rates as at 31 May 2016	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	17,787.20	17,773.64	Nikkei Dow	17,234.98	16,666.05
S&P 500	2,096.96	2,065.30	Hang Seng	20,815.09	21,067.05
FTSE 100	6,230.79	6,241.89	MSCI	1,674.6	1,670.8

Stance: Neutral with positive bias

[1] Previous rate or level represents the rate or level as at the end of the previous month.

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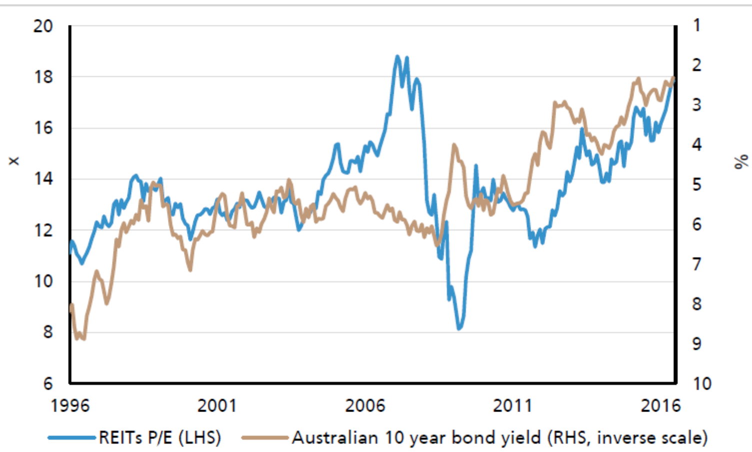
Property

Property surged 5% higher over the calendar year to date. Melbourne is the country's best performing city as dwelling values rose 13.9% over the 12 months to May 2016. Sydney came in second with an increase of 13.1% over the same period, followed by Brisbane increasing by 7.1%, Hobart by 6.1%, Canberra by 5.7%, and Adelaide by 3.9%. Perth recorded the greatest losses with dwelling values decreasing by 4.2%. Economists believe that the unexpected surge in house prices in May will not last because regulators may step in to tighten lending and the supply of new apartments will also slow down the increase in prices.

According to UBS, *"Interest rate sensitive sectors such as REITs and infrastructure have enjoyed large re-ratings with the decline in bond yields and would seem vulnerable to a significant back up in bond yields."*

Figure 16: Australian REIT PE and 10 Year Bond Yield



Source: Factset, Datastream

Australian REIT valuations have also followed declining bond yields in recent years.

The yield advantage in owning the REIT sector is narrowing as long term bond yields increase. Earnings per share growth will be key in determining whether distributions can grow.

Closing Rates as at 31 May 2016		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,437.1	1,400.2

Stance:

Commercial/Listed:	**Neutral and Trim if overweight**
Residential:	**Neutral, with a negative bias**

1] Previous rate or level represents the rate or level as at the end of the previous month.

IMPORTANT INFORMATION

Note that this is general advice that does not take into account the current financial circumstances or financial needs of any individual which should be considered when making investment decisions and in consultation with an appropriately qualified adviser.

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