Market Overview and Outlook

Economic Overview

The UK's momentous decision to leave the European Union brings long-lasting political and economic consequences. It is expected that European leaders will focus on fending off domestic populist movements emboldened by the British exit and on preventing the entire EU edifice from falling apart. This points to a tough negotiating stance toward the UK and less focus on much-needed structural reforms. It is expected attitudes on immigration to harden, and the risk of a protracted standoff feeding uncertainty.

The final estimate on first quarter US GDP growth was revised up from 0.8% to 1.1%. The result was supported by solid consumer spending (+1.5% in the first quarter). Case-Shiller home prices rose 0.5% in April to be up 5.4% on a year ago. US Conference Board consumer confidence rose from 92.6 to 98.0 in June.

The news on June 3rd that the US economy created a mere 38,000 new jobs in May—the lowest total since 2010—was a nasty shock. The consensus forecast was for about 160,000 new jobs in May. A labour-market slowdown that had seemed gentle now looks pronounced: between March and May, the economy created on average 116,000 jobs per month, compared with 222,000 in the year to February. The report, taken alone, was dire. But on the whole, there is much less cause for gloom. The American economy may have slowed, but remains fundamentally strong, as it is buttressed by a healthy consumer. Personal consumption, adjusted for inflation, is up by 3% in the past year. The University of Michigan's consumer-confidence index grew strongly in May. Even before that, confidence exceeded its average during the 2003-07 boom. According to a recent Fed survey, 69% of Americans say they are "doing okay" or "living comfortably", up from 62% in 2013. What is more, the rise has been most pronounced among those with only a high-school education. Rising wage growth helps explain consumers' cheer. Since early 2015 growth in average hourly earnings has perked up from about 2% to around 2.5%.

Italy is looking to pump capital into Banca Monte dei Paschi in what may become the lender's third bailout since the financial crisis. The government would invoke a European Union rule allowing temporary state aid if regulatory stress tests uncover a shortfall. An Italian bank rescue would evoke the taxpayer bailouts of the financial crisis as well as test the bailout rules, which took full effect this year, forcing bondholders and shareholders to share losses.

Ratings agency S&P cut the U.K.'s top credit rating by two notches from AAA to AA, citing the risk of a less predictable, stable, and effective policy framework in the U.K. The cut also "reflects the risks of a marked deterioration of external financing conditions". S&P left the U.K. on negative outlook, reflecting the risk to "economic prospects, fiscal and external performance". Fitch also cut the credit rate from AA+ to AA on the Brexit vote.

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Japanese companies' inflation expectations fell slightly in June from three months ago, adding to growing doubts over the Bank of Japan's (BOJ) argument that aggressive money printing will accelerate price growth to the 2% goal. The data on inflation expectations showed business confidence was subdued in the second quarter, heightening pressure on the BOJ to roll out yet more stimulus to ease the pain from a strong yen. Companies expect consumer prices to rise an average 0.7% a year from now, down 0.1 percentage point from three months ago and some way off the BOJ's 2% target.

Growth in China's manufacturing sector stalled in June, with the official Purchasing Managers' Index (PMI) easing to 50.0 in June from 50.1 in May and right at the 50-point mark that separates growth from contraction on a monthly basis. A similar survey showed activity in China's services sector picked up in June, which if sustainable would indicate progress in the government's bid to rebalance the economy.

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

The minutes of US Federal Reserve June meeting showed that policymakers were split over the near-term prospects for the economy. In particular the strength of the labour market was hotly debated, with many members believing that the pace of hiring had materially slowed. Overall the minutes clearly had a dovish tone, and given the June meeting took place before the surprise Brexit vote, it is unlikely the Fed will be looking to lift rates in coming months.

The yields on 10-year German bonds dipped below zero percent in June for the first time, meaning investors are essentially paying the German central bank to keep their money. The German 10-year bonds are just the latest to fall into negative territory, after those in Switzerland and Japan. Yields on German five-year bonds fell below zero last year.

In early July, the Bank of England (BoE) introduced the first round of policy easing post-Brexit. The BoE cut the countercyclical capital buffer for UK banks from 0.5% to 0% which is estimated to boost lending capacity by £150bn. The BoE expects the reduced buffer to be in place until "at least" June 2017.

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The RBA, at its July Board meeting, left the cash rate unchanged at its new record low of 1.75%, after May's 25bp cut, as widely expected. UBS' view is that *"Household wealth fell in Q1. This, combined with the RBA focus on low inflation and low wage growth, as well as a weaker global growth outlook, means that we still expect the RBA to cut rates by 25bp in August."*

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 30 June 2016					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.75%	1.75%	US Fed Funds Rate	0.4100%	0.3700%
90 Day Bank Bills	2.00%	2.02%	AUD/USD	74.26	72.70
180 Day Bank Bills	1.92%	1.97%	US 10 Year T-Bond	1.47%	1.88%
5 Year Govt Bonds	1.665%	1.845%	US 30 Year T-Bond	2.27%	2.67%
10 Year Govt Bonds	2.012%	2.322%	Japan 10 year yield	-0.230%	-0.112%

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

Australian Shares

With regards to the UK 'Leave' vote and its impact on Australian Equities, UBS' comment is, *"Our central case is this is a passing phase of risk aversion, not a precursor to a bear market. Investors could also refocus back on the Australian market as a relative safe haven particularly given its attractive yield characteristics and still fairly benign macro backdrop. Further to this line of reasoning, domestically focussed stocks may gain interest due to what appear to be relatively benign fundamentals. Banks appear to tick both boxes in terms attractive yield and exposure to still a benign domestic macro backdrop. Consumer discretionary stocks may also attract renewed interest given the still reasonable earnings backdrop against considerable global uncertainty."*

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

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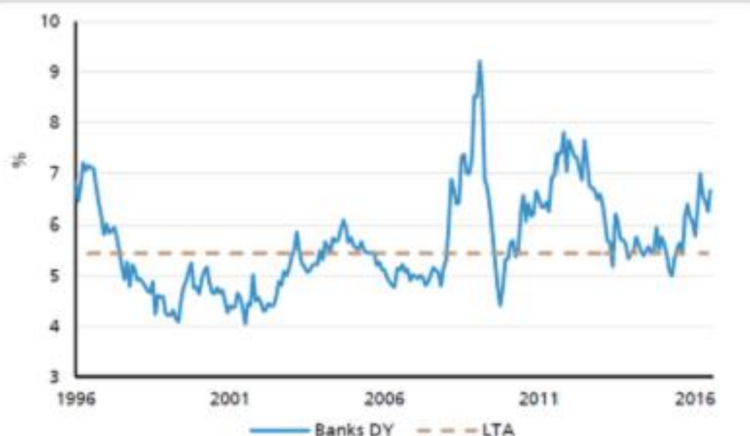

In a world of low yields the bank sector dividend yield of 6.6% (pre-franking) looks a reasonable risk return proposition in our view.

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.

Closing Rates as at 30 June 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,310.4	5,447.8	AOX Earnings Yield	5.59%	5.43%
PE Industrials (2016)*	15.5x	16.2x	Div Yld Indust (2016)*	5.0%	4.8%
PE All Ords (2016)*	17.9x	18.4x	Div Yield All Ords (2015)*	4.4%	4.3%

*Source – UBS

Stance: Neutral

International Shares

Deutsche' view is that *"One of the primary challenges today for global companies is revenue growth. At the beginning of the year, consensus expected only 17% of companies to see revenue declines, but today that number has risen to around 40%.*

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

This follows a weak 2015 where almost 1 in 2 companies posted falling revenues. The aftermath of the financial crisis is perceived as the likely culprit for this tepid growth. However, the US cleaned up its act some time ago. US companies are also seeing consensus downgrades, and for once a stronger dollar may not be to blame. One answer is the phenomenon of economic growth being increasingly driven by the few. Amazon has a market cap of US$341 bn and employs around 230,000 people; whereas Wal-Mart's is US$222bn but employs 10 times as many people. Technological advancement may bring many positives, but it is also disruptive to many. And ensuring the replacement of resulting job casualties is one of the primary challenges for a developed economy. Foxconn[2] announced that it would replace 60,000 of 110,000 employees with robots. Volvo driverless lorries are scheduled to make their first appearance in mines and drone technology is making its first home deliveries. If humans are ultimately no longer needed to do most of their old jobs, who will be able to afford technology-driven services?"

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 30 June 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	17,929.99	17,787.20	Nikkei Dow	15,575.92	17,234.98
S&P 500	2,098.86	2,096.96	Hang Seng	20,794.37	20,815.09
FTSE 100	6,504.33	6,230.79	MSCI	1,653.3	1,674.6

Stance: Neutral with positive bias

Property

Across the nation's capital cities, dwelling values reached a record growth rate of 8.3% year-on-year to reach a median of $580,000. Melbourne remains the country's top-performing city, with dwelling values rising 11.5% in the 12 months to 30 June 2016. Sydney rose 11.3% over the same period, followed by Hobart which increased by 6.2%, Brisbane by 5.3%, Canberra by 3.9% and Adelaide by 2.2%. Perth recorded the biggest loss as dwelling values decreased by 4.7%, while Darwin's dwelling values fell 1.1%. Sydney's home values have been rising for four years and have increased by a cumulative 59% over this time frame.

Melbourne dwelling values have been rising for the same length of time and have moved 41% cent higher over the growth cycle to date.

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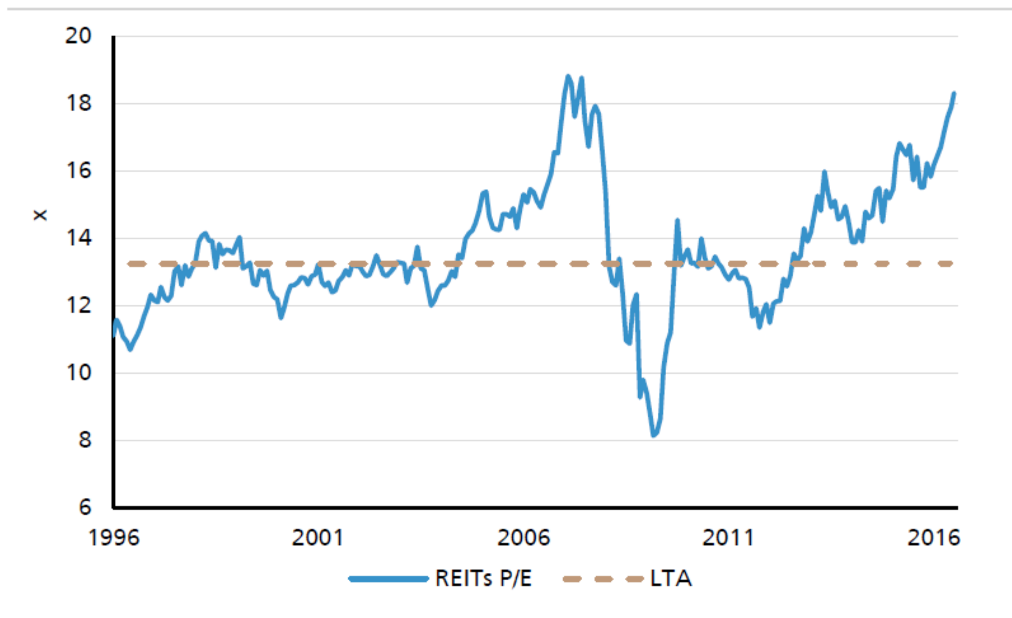
[2]Foxconn is a contract manufacturer most well known for manufacturing Apple iPhones and iPads.

According to UBS, *"Low bond yields are propelling defensive yield areas such as REITs higher. It is difficult to envisage an imminent circuit breaker given the current global backdrop."*



The REIT sector continues to be supported by falling long term bond yields. Earnings per share growth will be key in determining whether distributions can grow.

Closing Rates as at 30 June 2016		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,467.2	1,437.1

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.

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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.

NEWELL PALMER SECURITIES PTY LTD
Address: **Suite 101, 270 Pacific Highway CROWS NEST NSW 2065**
Mail: **PO Box 1680 CROWS NEST NSW 1585**
Phone: **(2) 9906 8066**
Fax: **(61 2) 9906 8080**
Website: ***www.newellpalmer.com.au***
Email: ***info@newellpalmer.com.au***

ABN 89 050 040 232
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