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August 2016

Market Overview and Outlook

Economic Overview

Following the economic crisis of 2008, government debt levels in many advanced economies rose as governments sought to rescue the financial system and boost demand, but the underlying issues of employment and stagnant incomes have remain unresolved creating a backlash against globalisation and international trade. Housing affordability has declined due to excess liquidity causing property values to rise. The inability of governments to deliver on promises to restore growth and prosperity is a factor causing the rise of populist movements and nationalism. Brexit, for example, is symptomatic of these pressures. Looking ahead, these same forces will be in the background for the US presidential election, and the German and French elections in 2017. Even if they are unlikely to gain power in their own right, far-right and far-left political parties or movements are reshaping agendas. The United Kingdom Independence Party (which has a single elected member in the U.K. House of Commons) was influential in June's EU referendum.

The US created 255,000 jobs in July, higher than the 180,000 jobs expected. The unemployment rate held steady at 4.9%. Hourly wages also moved higher at an annualised pace of 2.6%. Professional and business services led the way with 70,000 new positions, while health care rose 43,000 and Wall Street jobs increased by 18,000. Leisure and hospitality continued to be a big contributor to job growth, adding 45,000. Government added 38,000 to the total. Job losses came in mining and logging (-7,000), while construction added 14,000 and manufacturing grew by 9,000.

A 4.2% gain in US household consumption in the second quarter, among the largest of the current expansion, was the lone bright spot in an otherwise bleary picture as the US economy had its worst first half since 2011. Businesses hunkered down, trimming inventories and reducing outlays on equipment and construction projects, while government agencies also cut back. That limited the gain in GDP in the second quarter to a 1.2% annualised rate.

Purchases of new US single-family homes rose in June to the highest level in more than eight years, indicating a firm and resilient housing market. Sales increased 3.5% to a 592,000 annualised pace, the fastest since February 2008.

Euro-area GDP rose by 0.3% between April and June, in line with expectations but below 0.6% growth in the first quarter. Eurozone inflation rose to 0.2% in July from 0.1% in June as a result of higher food, alcohol and tobacco prices. Euro area unemployment stood at 10.1% in June, unchanged from the previous month, when the rate fell to the lowest level since July 2011. 16.269 million people in the euro area were unemployed in June 2016. This is 37,000 fewer people out of work than in May. Euro area unemployment levels thus continue their slow decent. Among the member states, the lowest unemployment rates recorded in June 2016 were in Malta (4.0%) and Germany (4.2%). The highest unemployment rates were observed in Greece (23.3% in April 2016) and Spain (19.9%). Although remaining at elevated levels, Spain also registered one of the sharpest decreases in unemployment, with the rate dropping from 22.3% in June last year.

Market Overview and Outlook

UK manufacturing shrank more than initially forecast in July, suffering its biggest drop in more than three years. The Purchasing Managers' Index slumped to 48.2. The index has only fallen below the 50 mark - which separates expansion from contraction - one other time since early 2013. The index was at 52.4 in June. This suggests that Britain's decision to leave the European Union may have a harsher impact on the economy than initially expected.

Japan will spend 6.2 trillion yen (US$61 billion) on infrastructure to help double the number of tourists visiting the country, speed up construction of a magnetic levitation line and aid building projects overseas. The spending is part of a 28 trillion yen stimulus package Prime Minister Shinzo Abe flagged to revive the world's third-biggest economy and speed its exit from deflation. The government will support expansion of ports to accommodate large cruise ships, boost airport capacity in the Tokyo area and regional economies, and strengthen transportation hubs. Japan is aiming to double the number of overseas visitors to 40 million by the time of the Tokyo Summer Olympics in 2020. The government will also provide loans to help bring forward the completion of a Nagoya-Osaka maglev link.

Growth in China's manufacturing sector contracted in July, with the official Purchasing Managers' Index (PMI) easing to 49.9 in July from 50.0 in June. Around 7.5% of China's industrial businesses are "zombie companies". "Zombie companies" are economically unviable businesses, usually in industries with severe overcapacity, kept alive only with aid from the government and banks. Zombie firms are more prevalent in underdeveloped western and northeastern China. State-owned enterprises and large and medium-sized companies have the highest ratio of zombie firms. Analysts said streamlining zombie companies could raise fears about employment in the short run, but killing them off is essential to China's long-term economic health.

The International Monetary Fund (IMF) cut its global growth forecasts for the next two years, citing uncertainty over Britain's looming exit from the European Union. The move included a nearly full percentage-point reduction in the UK's 2017 growth forecast. Cutting its World Economic Outlook forecasts for the fifth time in 15 months, the IMF said that it now expects global GDP to grow at 3.1% in 2016 and at 3.4% in 2017 -- down 0.1 percentage point for each year from estimates issued in April.

Interest Rates & Currency

The US Federal Reserve left interest rates unchanged in July while saying risks to the US economy have subsided and the labour market is getting tighter, suggesting conditions are getting more favourable for an increase in borrowing costs. *"Near-term risks to the economic outlook have diminished,"* the Federal Open Market Committee said in its statement, before repeating language from June that the panel *"continues to closely monitor"* inflation and global developments. Job gains were *"strong"* in June and indicators *"point to some increase in labour utilisation in recent months,"* the Fed said.

Market Overview and Outlook

European Central Bank (ECB) corporate bond purchases have helped companies reduce borrowing costs and their reliance on bank financing. The ECB said its March policy announcement can be credited with 11 of a total 16 basis points decline in the spreads of euro area investment-grade corporate bonds. March's policy package included the launch of a corporate sector purchase programme under which the ECB has bought Euro 13.21 billion in bonds between the start of the programme on Jun 8 and July 29, the latest reporting date.

The Bank's interventions also had a notable impact on the credit spreads of bonds that the ECB does not target under its programme. In particular, it shows an impact of 25 basis points on high-yield bonds, i.e. bonds with a rating lower than investment grade, and an impact of 5 basis points on corporate bonds issued by financial institutions.

The Bank of England (BoE) cut interest rates to a historic low of 0.25%, and launched a £70 billion programme of quantitative easing, including an unprecedented £10 billion dedicated to buying investment grade bonds from companies with substantial UK operations. The Bank launched the Term Funding Scheme to make sure that the lower levels of interest rates now set by the BoE are reflected in the costs commercial banks charge households and companies to borrow funds. The Bank said it does not expect the scheme to lead to significantly faster aggregate loan growth, but to offset any hit to lending from a cut in official interest rates closer to zero. Eligible institutions will be able to borrow four-year central bank reserves for an initial period of 18 months at rates close to the Bank Rate. The lowest cost of funding, the 0.25% Bank Rate, will be for banks that maintain or expand net lending to the economy and the BoE will charge a penalty rate if banks reduce net lending.

The RBA, at its August Board meeting, cut the cash rate by 25 basis points to 1.5%, a new record low, as widely ex*pected.* UBS' view is that *"we believe already accommodative policy, firm growth data, a likely trend lower in the AUD and concern about financial stability will see the RBA on-hold at 1.5% for the foreseeable future."* However, the market is pricing in the possibility of further interest rate cuts in the coming months.

Another reduction in the RBA cash rate is possible 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 July 2016

	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.75%	1.75%	US Fed Funds Rate	0.4000%	0.4100%
90 Day Bank Bills	1.89%	2.00%	AUD/USD	75.22	74.26
180 Day Bank Bills	1.82%	1.92%	US 10 Year T-Bond	1.48%	1.47%
5 Year Govt Bonds	1.525%	1.665%	US 30 Year T-Bond	2.20%	2.27%
10 Year Govt Bonds	1.843%	2.012%	Japan 10 year yield	-0.137%	-0.230%

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

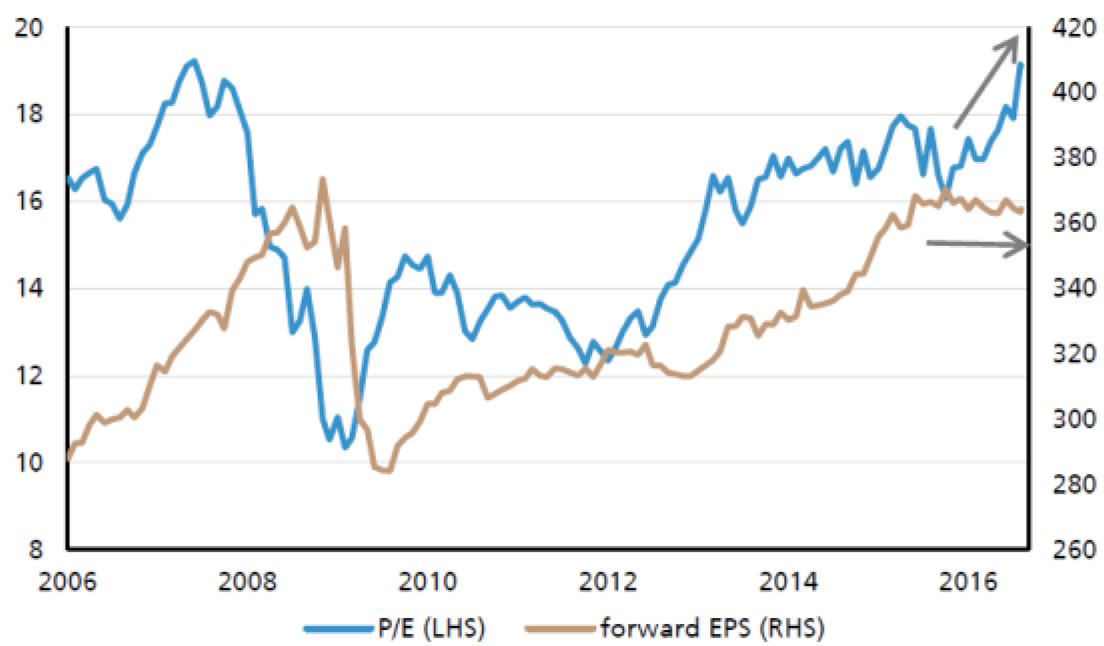
Market Overview and Outlook

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

Australian Shares

UBS' view is, *"While the market's valuation at over 16x looks stretched in an absolute sense, we think "dispersion" of valuation is still the bigger story. Defensive growth and defensive income are trading well above historical valuation levels while cyclical/risky areas of the market are trading seemingly cheaply. We keep our year-end ASX200 target unchanged at 5500. We see a risk that the relative valuation argument carries equities to new highs, but demanding absolute valuations and low levels of risk aversion against a still somewhat rocky macro backdrop in our view suggest a degree of caution"*

Figure 6: Industrials Ex Financials PE and Earnings



Source: Factset

Market Overview and Outlook

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 31 July 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,644.0	5,310.4	AOX Earnings Yield	5.38%	5.59%
PE Industrials (2016)*	16.5x	15.5x	Div Yld Indust (2016)*	4.7%	5.0%
PE All Ords (2016)*	18.6x	17.9x	Div Yield All Ords (2016)*	4.1%	4.4%

*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%. 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?"

1] Previous rate or level represents the rate or level as at the end of the previous month.
2]Foxconn is a contract manufacturer most well known for manufacturing Apple iPhones and iPads.

Market Overview and Outlook

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 July 2016

	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	18,432.24	17,929.99	Nikkei Dow	16,569.27	15,575.92
S&P 500	2,173.60	2,098.86	Hang Seng	21,891.37	20,794.37
FTSE 100	6,724.43	6,504.33	MSCI	1,721.8	1,653.3

Stance: **Neutral with positive bias**

Property

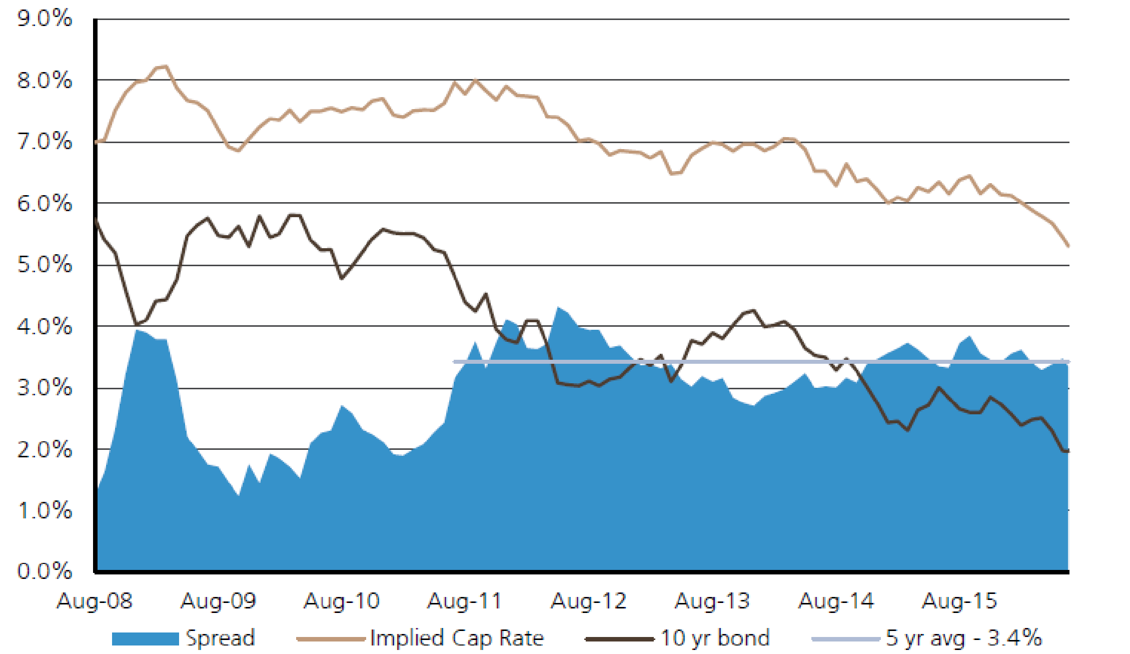
Sydney and Melbourne house prices have risen 61.3% and 42% respectively since the boom started in 2012, but the rate of growth has slowed, according to Corelogic. Nationally, housing prices grew 0.8% for July, while Sydney and Melbourne were up 1.3% and 1.1% respectively. While the rate of growth was slower, the cooling or falling prices expected after the end of last year has not materialised. The show stopper for housing price growth could be housing affordability. First-home buyers comprise a record low 10.4% of all new owner occupier housing finance commitments in NSW. In Sydney, while annual housing price growth is 12.1%, incomes were only growing 4.5% annually.

According to UBS, *"AREIT sector currently trading on a 5.3% initial property yield and 10x EBIT multiple. The spread of implied cap rate to bonds is 3.4% which is in line with the 5 year average. Throughout this period the range has been 300 to 400bps above the 10 year bonds. Assuming a 2% bond rate and a spread of 300bps would imply upside of 8% for the sector. Or assuming a 400bps spread vs the 10 year bond implies a downside scenario of 18%."*

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

Market Overview and Outlook

Figure 1: Implied Cap Rate vs Bonds (spread ranges from 3% to 4% since 2011)



Source: UBS estimates, Factset

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 31 July 2016		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,546.4	1,467.2

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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