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September 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.

US employers added 151,000 workers in August following a 275,000 gain in July that was larger than previously estimated. The jobless rate and labour participation rate held steady, signalling continued strength in the face of lacklustre global growth. The climb in payrolls was less than the median forecast by economists.

Consumers took full advantage of extremely low mortgage rates and continued monetary policy inaction from the Federal Reserve, as new home sales unexpectedly soared to their highest point since October 2007. Sales of new single-family homes in July clocked in at an impressive annualised rate of 654,000 – up 12.4% over the month and 31.3% over the year.

US consumer spending increased for a fourth straight month in July amid strong demand for automobiles. The Commerce Department said that consumer spending, which accounts for more than two-thirds of U.S. economic activity, rose 0.3% in August after a 0.5% gain in July.

Manufacturing unexpectedly hit a rough patch in the US in August. The Institute for Supply Management's index fell by 3.2 points to 49.4 in August, the biggest drop in more than two years and signalling contraction for the first time in six months. Data in coming months will determine whether the pullback was an aberration or an early warning that manufacturing has not quite found its footing. The report raises the risk that a third-quarter growth rebound will be weaker than anticipated, and diminishes expectations that strength in the world's largest economy will broaden beyond household spending.

The euro-area economy maintained its momentum in August, with growth showing little sign of being curtailed by fallout from the UK's Brexit vote. A composite Purchasing Managers Index (PMI) for the 19-nation region was 52.9 in August from 53.2 in July. That is above the 50 level that divides expansion from contraction and marks the best reading in seven months. The increase was driven by an improvement in services, while manufacturing activity slipped.

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Britain's factories saw a strong rebound in output and new orders in August. A closely watched measure of factory activity swung to a 10-month high in August from a 41-month low recorded in July. But there were signs a weaker pound was stoking inflation, as it raised the cost of imported materials for UK factories and they passed those higher costs on to customers. The Markit/Cips UK Manufacturing PMI rose to 53.3 in August from 48.3 in July. That was the greatest month-to-month jump in the survey's nearly 25-year history.

Japan's economic growth ground to a halt in April-June as weak exports and shaky domestic demand prompted companies to cut spending. The world's third-largest economy expanded by an annualised 0.2% in the second quarter, less than the 0.7% increase markets had expected and a sharp slowdown from a revised 2.0% increase in January-March. Japan's consumer prices fell in July by the most in more than three years as more firms delayed price hikes due to weak consumption. The core consumer price index, which excludes volatile fresh food prices but includes oil products, fell 0.5% in July from a year earlier, the fifth straight month of declines. Japan's unemployment rate dropped to 3% in July marking the lowest level in 21 years. The number of employed persons was 64.79 million, an increase of 980,000 or 1.5% from the previous year. The number of unemployed persons in July, meanwhile, was 2.03 million, which is a decrease of 190,000 or 8.6% from the previous year.

Activity in China's manufacturing sector unexpectedly expanded at its fastest pace in nearly two years in August as construction boomed, suggesting the economy is steadying in response to stronger government spending. The official factory survey also highlighted growing lopsidedness in the world's second-largest economy, with larger firms expanding, likely thanks to government stimulus, while smaller manufacturers continued to struggle.

The official PMI rose to 50.4 in August from 49.9 in July, and above the 50-point mark that separates growth from contraction on a monthly basis. The Chinese economy is expected to grow 6.6% this year, with the inflation rate rising to 2%, the IMF said in a report after concluding its annual economic health check on the Chinese economy. *"We have a positive view of China's growth outlook as China continues to mobilise its very considerable resources and catches up with higher-income economies,"* the IMF said.

The 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.

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Interest Rates & Currency

The case for a U.S. interest rate hike has strengthened in recent months, US Federal Reserve Chair Janet Yellen said. Ms. Yellen did not say when the U.S. central bank would raise borrowing costs, and investors remained sceptical that such a move was imminent. But the Fed chief said the U.S. economy was creating a lot of new jobs and would likely keep growing moderately, despite data showing only sluggish growth in the second quarter. *"In light of the continued solid performance of the labour market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months,"* Ms. Yellen said, adding that the Fed still thinks future rate increases should be "gradual."

The Bank of Japan's (BOJ) controversial march to the top of shareholder rankings in the world's third-largest equity market is picking up pace. Already a top-five owner of 81 companies in Japan's Nikkei 225 Stock Average, the BOJ is on course to become the No. 1 shareholder in 55 of those firms by the end of next year. The free float at Fast Retailing Co. (owner of the retailer Uniqlo), whose top weighting in the Nikkei 225 makes it a major recipient of BOJ money, is about 25% of shares outstanding. The BOJ owns about half the company's free float now, a proportion that will rise to 63% by year-end. While there is no sign that the central bank will use its holdings to influence how Japan's public companies are managed, some investors worry that BOJ purchases could give a free ride to poorly-run firms and crowd out shareholders who would otherwise push for better corporate governance.

Japan's biggest banks are running out of room to sell their government bond holdings, pushing the central bank closer to the limits of its record monetary easing. Japan Post Bank Co. and the nation's three so-called megabanks have almost halved their sovereign bond holdings to 114 trillion yen (US$1.1 trillion) since March 2013, the month before the Bank of Japan began buying the securities on an unprecedented scale to end deflation. Government notes held by the three megabanks are approaching the level where further reductions would involve securities they need as collateral. Banks are the first port of call as the BOJ seeks to boost its JGB holdings by 80 trillion yen annually. Record bond buying has already saddled the BOJ with more than a third of outstanding sovereign notes, draining liquidity from the market and making it more volatile.

The RBA held the cash rate unchanged at 1.50%in September, as widely expected, after they cut the cash rate by 25 basis points at the prior meeting in August and also cut 25 basis points in May. UBS' view is that *"Looking forward we still expect the RBA to hold rates steady."*

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.

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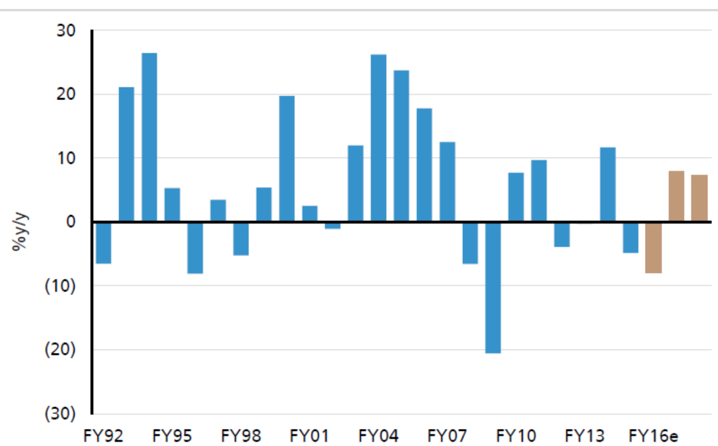
Closing Rates as at 31 August 2016					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	1.50%	1.75%	US Fed Funds Rate	0.4000%	0.4000%
90 Day Bank Bills	1.79%	1.89%	AUD/USD	75.14	75.22
180 Day Bank Bills	1.71%	1.82%	US 10 Year T-Bond	1.58%	1.48%
5 Year Govt Bonds	1.630%	1.525%	US 30 Year T-Bond	2.24%	2.20%
10 Year Govt Bonds	1.883%	1.843%	Japan 10 year yield	-0.063%	-0.137%

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

Australian Shares

UBS' view is, *"The Australian market appears to be pausing after a very strong July rally. The ASX200 has eased back to just under our year-end 5500 price target. Multiples still look demanding in an absolute sense (particularly in industrials ex financials) but the relative appeal of equities against very low interest rates can't be ignored. Aggregate earnings trends look set to improve in FY17 (after a weak aggregate FY16) due to a revival in commodity prices, though typical stock-specific earnings trends are steadier. On the negative side, we view the revival of the A$ presents something of a headwind for foreign currency earners, if sustained. "*

Figure 2: Australian Market Aggregate EPS Growth By FY



Source: Factset, UBS estimates

We think FY16 looks set to market the second consecutive year of negative EPS growth for the Australian market. We believe the drag from resources should reverse in FY17 albeit the degree of swing is still a function of commodity price outcomes.

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

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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 August 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,529.4	5,644.0	AOX Earnings Yield	5.92%	5.38%
PE Industrials (2017)*	15.6x	16.5x	Div Yld Indust (2017)*	4.9%	4.7%
PE All Ords (2017)*	16.9x	18.6x	Div Yield All Ords (2017)*	4.4%	4.1%

*Source – UBS

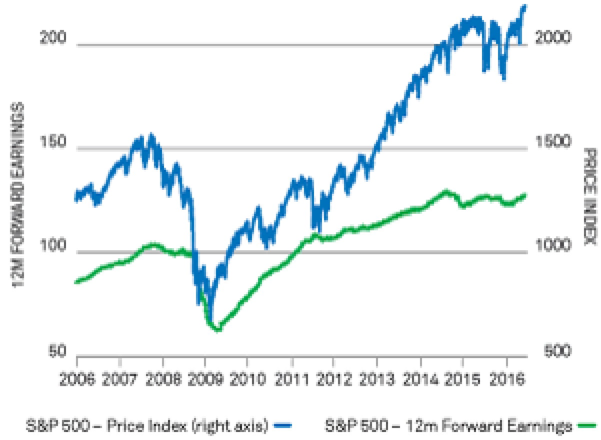
Stance: Neutral

International Shares

There is a misconception that US companies are swimming in cash. They may actually be drowning in debt. Of the US$1.8 trillion in cash that's sitting in U.S. corporate accounts, half of it belongs to just 25 of the 2,000 companies tracked by S&P Global Ratings. Outside of Apple, Google and the rest of the top 1% of corporates, cash has been falling over the last two years even as debt has been rising. Cash now covers only $15 of every $100 they owe, less than it did even during the financial crisis in 2008. The number of companies that have defaulted so far this year has already passed the total for all of last year, which itself had the most since the financial crisis. Even among companies considered high-quality, or investment grade, credit-rating agencies said a record number are so stretched financially that they are one bad quarter or so from being downgraded to "junk" status.

Blackrock's view is *"US economic activity is mixed, earnings are lackluster and stock prices remain elevated. Slower Fed tightening could support the asset class."*

U.S. EQUITY PRICE AND EARNINGS



Sources: Thomson Reuters Datastream, IBES, MSCI, BlackRock Investment Institute, 8/10/16.

S&P 500 DIVIDEND YIELD VS. 10-YEAR TREASURY YIELD

Sources: Thomson Reuters Datastream and BlackRock Investment Institute, 8/4/16.

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

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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 August 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	18,400.88	18,432.24	Nikkei Dow	16,887.40	16,569.27
S&P 500	2,170.95	2,173.60	Hang Seng	22,976.88	21,891.37
FTSE 100	6,781.51	6,724.43	MSCI	1,719.5	1,721.8

Stance: **Neutral**

<u>Property</u>

Sydney and Melbourne house prices have surged again in August, with Sydney prices up 1.5% while Melbourne prices grew 1.4% during the month. Year on year, Sydney's price growth was 9.4%. Melbourne's price growth was 9.1%.

The real estate investment trusts (REITs) delivered in 2016, with distributions coming in as promised. Gearing remained conservative and the property portfolios were generally in good shape. But after a year of strong outperformance, the REITs underperformed the broader ASX as the numbers came in, for two reasons. One, because the prices have run so hard; and two, because the earnings outlook, whilst secure, was subdued. Based on guidance for fiscal 2017, investors should expect a modest bump up in their payouts in 12 months' time with stronger earnings growth likely to be limited by a patchy economy, and the low-inflation environment, which will crimp operating income for those trusts that rely on CPI-indexed rent increases.

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 August 2016		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,492.7	1,546.4

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.

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