Market Overview and Outlook

Economic Overview

Global growth expectations are on the rise and there may be room for more upside surprises. Reflation[1] is becoming synchronised, with non-US economies contributing as much as the US to growth expectations. This marks a reversal from 2016, when the US was the locomotive. The global economic recovery is broadening and there is room for growth forecasts to ratchet higher as reflation gains traction. While some of the enthusiasm over Mr Trump's policies might have waned, real hard data is likely to accelerate. The five structural headwinds to global growth over the past four years are diminishing – fiscal tightening, the euro crisis, bank deleveraging, the decline in BRIC growth and the collapse in commodity prices, and US and euro area GDP growth may accelerate. The three locomotives of global growth; US, China and Europe, are for the first time since the financial crisis, all contributing to global economic growth.

US job growth slowed in May and employment gains in the prior two months were not as strong as previously reported, suggesting the labour market was losing momentum despite the unemployment rate falling to a 16-year low of 4.3%. Nonfarm payrolls increased 138,000 in May as the manufacturing, government and retail sectors lost jobs. The economy created 66,000 fewer jobs than previously reported in March and April. May's job gains could still be sufficient for the Federal Reserve to raise interest rates at its June 13-14 policy meeting. The economy needs to create 75,000 to 100,000 jobs per month to keep up with growth in the working-age population.

Euro-area manufacturing and services continued to expand at the fastest pace in six years, powered by growth in the region's two biggest economies -- Germany and France. A composite Purchasing Managers' Index held at 56.8 in May, unchanged from the previous month. Meanwhile, separate reports showed Italy and Spain, the third and fourth biggest euro-zone economies, continued to show strong momentum in May. Business activity and order books remained strong in Italy, while Spain saw further increases in employment for the month. France added 49,400 jobs in the first three months of the year. It was the seventh straight quarter of net new job creation in the private sector and pushed up the size of the labour force in metropolitan France to 16.23 million, the highest level since the GFC in late 2008. Unemployment in the Eurozone stood at 9.5% in March, down from 10.2% a year earlier.

Euro zone inflation eased by more than expected in May, reflecting dips in Germany and Spain among others and supporting European Central Bank policymakers wanting only slow adjustments to rates and monetary stimulus. Inflation in the 19 countries sharing the euro slipped to 1.4%, its lowest level since December, from 1.9% year-on-year in April.

German companies exported goods and services worth 118.2 billion euros (US$129 billion) in March - a gain of an impressive 10.8% compared with the same month a year ago. Imports climbed 14.7% over the year, hitting 92.9 billion euros, and also marking the best March figure on record.

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[1]Reflation is the act of stimulating the economy by increasing the money supply or by reducing taxes.

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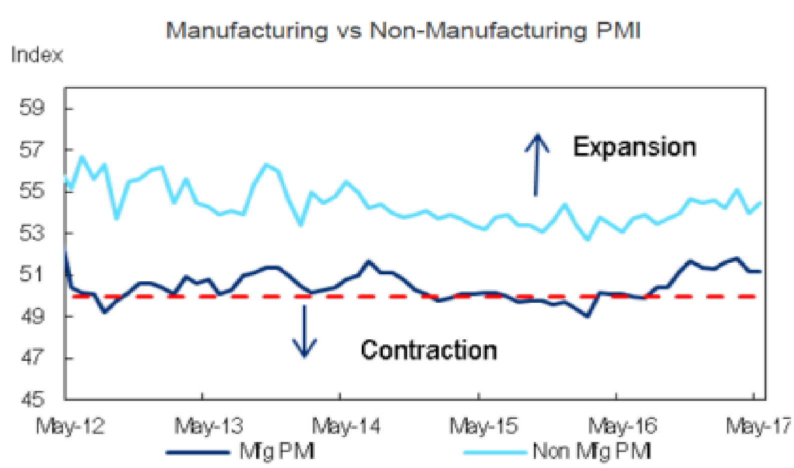
As a result, Germany's overall trade surplus grew to 25.8 billion euros in the month, continuing its upward trend that already widened the country's trade gap to an annual record of 253 billion euros last year. Due to mortgage interest rates of well below 2%, Germany has been experiencing a rapid transition towards home ownership in recent years. Housing prices, which were relatively cheap compared with other European countries in the past, have risen sharply. Real estate prices in cities like Berlin, Hamburg, Munich and Frankfurt have increased by more than 60% since 2010. For many well-off Germans with permanent jobs, renting no longer makes sense. Commerzbank, the country's second-largest lender, offers a mortgage with an ultra-cheap fixed rate of just 0.94% for a 10-year loan.

The UK economy slowed more sharply than initially estimated in the first quarter. GDP rose 0.2%, less than the 0.3% published earlier and down from 0.7% at the end of 2016. Exports fell 1.6% and consumer spending weakened, with household activity adding the least to the economy since 2014. The sharper-than-anticipated slowdown is another sign that Brexit is hitting the economy as accelerating inflation coupled with muted wage growth puts the squeeze on households.

Japan's current account surplus for fiscal 2016 soared to pre-Lehman shock levels, backed by steady exports to Asia and a fall in crude oil prices. Japan logged a current account surplus of 20.2 trillion yen (US$176.9 billion) in the year ended March 31, a 13.1% increase from the previous year and the highest since 2007. The figure was the third largest ever, and marked the third straight year of growth.

China’s official manufacturing PMI stayed unchanged at 51.2 in May, beating expectations for a decline. Non-manufacturing PMI rebounded to 54.5, suggesting services activity expanded at a faster pace. Even though the pace of GDP growth has moderated, it is still on track to exceed the 6.5% target.



Source: CEIC and Citi Research as of 30 May 2017.

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The global economy is set to post solid growth this year, amid improving trade and better performance by large emerging markets, the World Bank said. Yet rising trade protectionism and policy uncertainty, primarily in the United States, are important caution signals for the outlook. Nonetheless, the bank expects the global economy to grow by 2.7% for 2017, rising to 2.9% in 2018 and 2019. Growing confidence and a recovery in industrial activity has coincided with a pick-up in global trade, after two years of marked weakness.

The seven largest emerging market economies - China, Brazil, Mexico, India, Indonesia, Turkey and Russia - remain the key engine for the world economy. As a group, emerging market and developing economies are expected to grow 4.1% this year, led by India, which is expected to expand by 7.1%, and China at 6.5%. Meanwhile, Russia and Brazil are expected to again return to growth after contracting for the past two years. Advanced economies are continuing to grow but at a more modest pace, with the United States expected to expand by 2.1% this year and the euro area by 1.7%.

Interest Rates & Currency

Federal Reserve officials were in broad agreement in their May meeting to shrinking the bank's massive balance sheet. The Fed does not want to sell the assets on its US$4.5 trillion balance sheet, preferring to let it shrink as the securities mature. At the moment, the central bank is reinvesting the principal of the maturing securities to hold the balance sheet steady. The minutes show nearly all Fed officials said they were content with a plan to end the reinvestment of principal of maturing securities in slow, ever-increasing, stages, rather than ending the reinvestment all at once. Under the approach, only a small of securities would be allowed to roll off at first, but the amount would increase in regular increments. The caps would be set at initially at low levels and then be raised every three months. Officials said that this approach would be on auto-pilot, unless there was a major deterioration to the economic outlook. Fed officials said the process should start this year. While not set in stone, the fact that there was consensus behind a plan could suggest the Fed may be ready to start shrinking the balance sheet sooner than its December meeting.

The European Central Bank is likely to keep to its current normalisation plan, which foresees rate increases only well after asset purchases have been tapered. The quantitative easing program is currently scheduled to run at 60 billion euros a month until at least the end of the year. The four-year inflationary campaign has so far failed to put price growth on a self-sustaining path toward the ECB's goal of just under 2%. If anything, there are hints that the target is receding further into the future. Core inflation is slated to slow to 1%. The Eurozone recovery is becoming "increasingly solid" but central bank support is still needed to bring inflation back to target level, ECB President Mario Draghi said.

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In May, the Bank of England kept UK interest rates on hold, with only one member of the Monetary Policy Committee voting for an increase in rates. However, despite the solid vote for no change on the cost of borrowing, the minutes of the meeting relayed that some members still thought that it would take relatively little further upside news on the inflation outlook for them to support an immediate monetary tightening. The Bank also said that policy could be tightened by a somewhat greater extent than markets have recently been expecting.

The Bank of Japan's assets apparently exceeded 500 trillion yen (US $4.49 trillion) as of the end of May. The BOJ's balance sheet began expanding at a rapid clip after Governor Haruhiko Kuroda launched unprecedented quantitative and qualitative easing in April 2013.

At around 93% of GDP, the scale of the Japanese central bank's assets in proportion to GDP has no close match. Latest data shows that the US Federal Reserve held roughly US$4.5 trillion in assets, which is equivalent to 23% of the country's GDP. The European Central Bank's balance sheet, at about 4.2 trillion euros (US$4.71 trillion) is larger than the BOJ's, but it still sits at around 28% of the eurozone GDP.

At its June board meeting, the RBA held the cash rate unchanged at 1.5% as widely expected. UBS' view is that RBA will be on hold. *"Overall, the RBA stayed broadly 'neutral'. They remained comfortable with their view that an improving global backdrop will lead to better domestic growth. So despite some signs of slowing housing, the RBA stuck to its bullish 3%+ outlook. Overall, we continue to expect the RBA to stay on hold ahead, and assess the impact of recent macroprudential policy tightening."*

No change in the RBA cash rate is expected in the near term. Our preference remains for both short dated fixed-rate and floating-rate securities of high investment grade corporates.

Closing Rates as at 31 May 2017

	Rate	Rate (Prev)[2]		Rate	Rate (Prev)
Cash	1.50%	1.50%	US Fed Funds Rate	0.9100%	0.9100%
90 Day Bank Bills	1.78%	1.77%	AUD/USD	74.50	74.75
180 Day Bank Bills	1.70%	1.73%	US 10 Year T-Bond	2.23%	2.29%
5 Year Govt Bonds	1.929%	2.129%	US 30 Year T-Bond	2.90%	2.97%
10 Year Govt Bonds	2.405%	2.583%	Japan 10 year yield	0.047%	0.014%

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

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

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<u>Australian Shares</u>

According to UBS, *"The absence of a domestic recession for more than 25 years, alongside a progressive decline in interest rates, has created a fertile backdrop for Australian banks to significantly outperform both global banks and the broader Australian market. Bank earnings have been relatively stronger and relatively less volatile than both global banks and the broader Australian market. However, headwinds are building. 1/ Housing seems to be peaking, 2/ additional macro prudential requirements on "interest only" lending has allowed banks to re-price their way to some short-term margin widening but it will also likely slow credit growth medium-term, 3/ the major bank "liability levy" is expected to cause a 4-5% hit to earnings (assuming no pass through via re-pricing) and 4/ bad debts continue to be very low but the medium-term risk on provisioning is skewed to the upside in our view. Banks appear a "market performer" at best from here, although still benign domestic macro conditions and the "relative appeal" argument suggest against being overtly bearish right now. However, headwinds and clouds seem to be accumulating."*

Figure 1: Performance of Australian Banks versus World Banks

Source: Datastream, MSCI, S&P/ASX

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

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

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June 2017

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Closing Rates as at 31 May 2017					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,761.3	5,947.6	AOX Earnings Yield	6.71%	6.58%
PE Industrials (2017)*	16.7x	17.2x	Div Yld Indust (2017)*	4.6%	4.4%
PE All Ords (2017)*	14.9x	15.2x	Div Yield All Ords (2017)*	4.6%	4.5%

Source – UBS

Stance: Neutral (Change from 'Neutral, and Trim if Overweight')

International Shares

State Street's view is *"Looking from different angles across our investment teams, we see encouraging signals suggesting that improving European fundamentals are not another flash in the pan, but could be sustained and support further equity gains. As investors' biggest electoral fears have so far been averted, the headwinds of political risk have also receded.*

After a long drought since the 2011 collapse in profitability, European profits seem to be finally turning a corner, with revisions to analysts' earnings estimates across a broad range of sectors moving into positive territory."

Figure 2: Europe Trades at 33% below US on Sector-Adjusted Price/Book Basis

Source: Worldscope, MSCI, FactSet. Data through December 31, 2016.
SD = Standard Deviation, a statistical measure of historical dispersion.

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

US equities have priced in tax cuts and better business conditions, with share prices rising. The risk of a pullback is rising, especially if the tax cuts or additional infrastructure spending do not eventuate as initially proposed.

Closing Rates as at 31 May 2017					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	21,008.65	20,940.51	Nikkei Dow	19,650.57	19,196.74
S&P 500	2,411.80	2,384.20	Hang Seng	25,675.84	24,615.13
FTSE 100	7,519.95	7,203.94	MSCI	1,911.7	1,878.3

Stance: Neutral, and Trim if Overweight

Property

For first home buyers, the NSW government has unveiled a comprehensive package that will abolish stamp duty on new and existing homes up to $650,000 and provide stamp duty relief for homes up to $800,000. Insurance duty on lender's mortgage insurance will also be abolished, while the government will provide a $10,000 grant for builders of new homes up to $750,000 and purchases of new homes up to $600,000. Meanwhile, the surcharge on stamp duty for foreign buyers will double to 8% and the surcharge on land tax will increase from 0.75% to 2%. The measures will take effect from 1 July this year.

The REIT sector has been impacted by rising long term bond yields. Earnings per share growth will be key in determining whether distributions can grow.

Closing Rates as at 31 May 2017		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,400.1	1,415.6

Stance:	**Commercial/Listed:**	**Neutral**
	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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