Market Overview and Outlook

Economic Overview

Investors have to acknowledge a new set of risks tied to socioeconomic concerns that go far beyond the realm of traditional geopolitical hazards and have the potential to roil economic activity and financial markets. The confluence of new and old political risks threatens to undermine progress made through globalisation and foster a rise in conflict between, as well as within, nations. That is the ominous conclusion of Citibank's team of analysts and the Carnegie Europe think tank. Such traditional geopolitical risks as armed conflict and newer socioeconomic risks like income inequality, threaten to intersect in an environment where global growth is stagnating while public expectations remain high and government capacity to effect positive change through reforms is low.

Case in point is the situation in Syria. An armed conflict has evolved into a sequence that could end up affecting politics throughout Europe following the settlement of millions of refugees. Thus far in 2016, however, traditional geopolitical tensions—notably, between Saudi Arabia and Iran—have not translated into meaningful financial market shocks. Accommodative monetary policy has kept financial markets from reflecting the brunt of geopolitical tensions. The stimulus deployed by the Federal Reserve and other central banks in the wake of the financial crisis had the effect of putting downward pressure on risk premiums. The danger is that the Fed is beginning to withdraw this accommodation at the same time political worries mount, which could amplify any declines in risk appetite.

In the US, warmer weather heated up housing activity at the end of 2015 to help make it the best year for sales of new single-family homes since 2007. But the overall sector's potential for growth in the new year is clouded by the prospect of higher interest rates, underwhelming wage gains and rising real estate costs. About 501,000 new homes were sold last year, which was up 14.5% from 2014 and the highest annual figure the domestic real estate market has seen in eight years.

Euro-area Purchasing Managers' Index (PMI) fell to 52.3 in January from 53.2. Unemployment decreased to a four-year low in December. The unemployment rate declined to 10.4% from 10.5% in November. That is the lowest since September 2011. Factories in the euro area slashed prices of goods by the most in a year in January, highlighting the deflationary risks. In its monthly manufacturing report, Markit Economics said price pressures remained on the downside and output charges fell for a fifth month. In addition, all countries in its survey reported declines, the first time that had happened in 11 months.

The Bank of Japan (BOJ) announced that it will charge banks that leave too much cash on idle deposit with the BOJ a 0.1% fee, effectively a negative interest rates. It hopes that will encourage commercial banks to lend more and also to push down the value of the Japanese yen to make exports more competitive.

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China's manufacturing PMI dropped to a three year low of 49.4 in January. The non-manufacturing PMI edged down to 53.5 last month from a 16-month high of 54.4 in December. The People's Bank of China (PBOC) cut the main interest rate six times from late 2014 to late 2015 to a record-low 4.35%. It also has made a series of reductions to the reserve-requirement ratio for big banks, allowing them to keep less cash locked up at the PBOC. China's capital outflows jumped in December, with the estimated 2015 total reaching US$1 trillion.

The International Monetary Fund (IMF) lowered its forecast of global economic growth over the next two years amid the deepening slowdown in emerging markets and a continued slump in oil prices. The IMF now projects the world economy will grow 3.4% this year and 3.6% in 2017. That pace would be faster than last year, but the projections are 0.2 percentage points lower than the IMF estimated in the third quarter of 2015. The IMF forecast that growth in China will further slow to 6.3% this year and fall to 6% in 2017 — below Beijing's official target for the pace of expansion.

Interest Rates & Currency

In its January meeting, the US Federal Reserve acknowledged that the US economy has slowed down but provided little guidance about when it would raise interest rates again. The central bank began increasing interest rates in December 2015 and signalled it anticipated increasing its benchmark rate four times this year. However, if the broader economic growth disappoints in the coming year, it may be doubtful whether the Fed will be able to put through four rate hikes this year.

European Central Bank (ECB) President Draghi said that fading growth and inflation prospects may force the ECB to review its policy stance in March. Global market turmoil, plunging oil prices and weaker growth across emerging markets are quickly increasing economic headwinds for Europe so the ECB will need to be ready to use any possible instrument as inflation risks turning negative and growth slows, Draghi said.

The Bank of England governor ruled out an early rise in interest rates, saying UK growth was still too weak and pointing to recent turmoil in the global financial markets. The governor said the UK faced "a powerful set of forces" that prevented policymakers from raising rates. *"The world is weaker and UK growth has slowed,"* he added.

Japan's sovereign bond yields slid to record lows across the curve amid the aftershock from the central bank's unexpected move to adopt a negative interest-rate strategy. Benchmarks 10-year yields touched 0.05%, 20-year yields reached an unprecedented 0.74% and two-year yields slid to a record -0.11% after the Bank of Japan unexpectedly cut the rate on excess reserves held by financial institutions at the central bank to -0.1%.

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The RBA at its February Board meeting kept the cash rate unchanged at a record low of 2.00%. Overall, the RBA's post-meeting statement was modestly more dovish. UBS' view is *"We continue to see the RBA on hold this year at 2.00%, but as we expected, recent events have encouraged the RBA to keep an open mind."*

Unless economic conditions deteriorate significantly in Australia, it is unlikely the RBA will further reduce rates 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 January 2016

	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	2.00%	2.00%	US Fed Funds Rate	0.3800%	0.3600%
90 Day Bank Bills	2.29%	2.41%	AUD/USD	71.00	72.96
180 Day Bank Bills	2.18%	2.30%	US 10 Year T-Bond	1.93%	2.22%
5 Year Govt Bonds	2.136%	2.246%	US 30 Year T-Bond	2.75%	2.93%
10 Year Govt Bonds	2.628%	2.751%	Japan 10 year yield	0.070%	0.272%

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

Australian Shares

UBS' view is, *"Australian equities remain weighed down by global macro concerns in relation to the global macro backdrop, namely 1) China growth, 2) the weak oil price and its associate stresses and 3) rising concerns over the US economy/stock market. Despite benign macro dataflow in recent months, Australia has shown no resilience to these macro concerns, largely because of our perceived place as a China proxy. The poor earnings picture at the overall market level is also not helping Australia's cause at present. Growth is more resilient/benign on an ex-resources basis and is presenting stock pickers with opportunity."*

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

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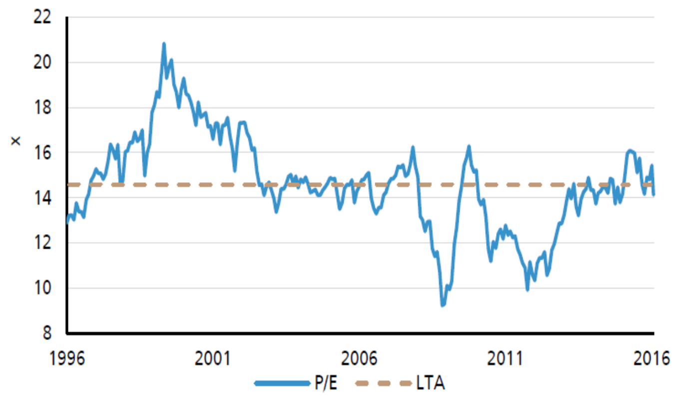
Figure 8: Australian Market Forward P/E



Source: Factset

The Australian market at 14.1x times looks moderately cheap.

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

Closing Rates as at 31 January 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,056.6	5,295.9	AOX Earnings Yield	5.99%	6.45%
PE Industrials (2016)*	15.0x	15.1x	Div Yld Indust (2016)*	5.0%	5.0%
PE All Ords (2016)*	16.7x	15.5x	Div Yield All Ords (2015)*	5.0%	5.2%

*Source – UBS

Stance: Neutral – Underweight portfolios should look to add

International Shares

Had it not been for a small group of nifty companies such as Facebook, Amazon, Netflix and Google, 2015 would have entered the history books as a terrible year for the US stock market. The return for the S&P 500 for 2015 was flat, whilst the nifty companies gained more than 60% for the year. Such a narrowing of the market is a classic symptom of a

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

International Shares (Contd)

lengthy rally that is coming to an end. In addition, the earnings of S&P 500 companies fell slightly in 2015 due to falling revenues at energy companies and the strong US dollar. However, the hope is that the narrow US market will not tip over into a bear market because of the US economy. The US economy is robust, with the US consumers showing signs of spending more with increasing employment and falling petrol prices.

We expect geopolitical events occasionally giving rise to market volatility. Take advantage of market volatility, more reasonable valuations and better industry diversification compared to Australian shares to purchase international shares.

Closing Rates as at 31 January 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	16,466.30	17,425.03	Nikkei Dow	17,518.30	19,033.71
S&P 500	1,940.24	2,043.94	Hang Seng	19,683.11	21,914.40
FTSE 100	6,083.79	6,242.32	MSCI	1,562.2	1,662.8

Stance: Neutral with positive bias

Property

After three years of increasing property prices in Sydney, house prices have fallen by the largest quarterly drop on record. Sydney's median house price dropped 3.1% over the December quarter 2015, the first drop since June 2012, the Domain House Price Report shows. Over the past three years, Sydney house prices are up 52.6%, with house prices up 14.8% over 2015.

According to UBS, *"REITs have been one of the key beneficiaries of the related themes of 'safety' and falling long bond yields. Sector-specific negatives in the yield-driven Banking and Telco sectors in 2015 have also likely contributed to REIT sector outperformance. Bottom up we are positive on selected real estate names including Westfield Corporation, Mirvac and Stockland, though top-down the expensiveness of the sector against the broader market keeps us underweight the sector. A significant rise in bond yields remains the key big picture risk for the sector though this appears reasonably remote at the current junction."*

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

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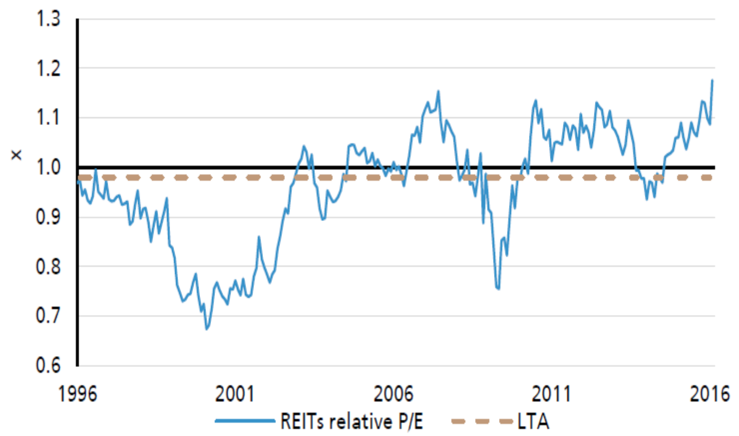
Figure 32: REIT Sector Relative* P/E



Source: Factset

...toward the top of its relative PE range

* Relative to Market-ex-Resources P/E

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 January 2016		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,304.6	1,291.2

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.

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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: **(61 2) 9906 8066**
Fax: **(61 2) 9906 8080**
Website: ***www.newellpalmer.com.au***
Email: ***info@newellpalmer.com.au***

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