Market Overview and Outlook

Economic Overview

Central bank policy intervention has dominated the investment landscape for the last eight years. Monetary policy intervention has certainly been helpful as it has steered the world economy from a global depression during the global financial crisis. With economic growth still stubbornly low in many regions, scepticism has grown about how effective monetary policy can be. The IMF forecasts world growth this year at 2.5%, which is the same as in 2015 and well short of the 3.7% average over the five years leading up to the global financial crisis. Quantitative easing, especially in the US, has been effective, but has come with consequences. For example through the encouragement of possible capital misallocation by favouring equities and property over cash and fixed interest, thus fuelling possible asset class bubbles.

US payrolls grew by 215,000 workers in March following a gain of 245,000 in February. The unemployment rate ticked up to 5% from 4.9% as people streamed into the labour force looking for work, and not all were successful. The gain in hiring shows businesses remain confident in US prospects even amid the slowdown in global growth and turmoil in financial markets. The labour force participation rate, which indicates the share of working-age people who are employed or looking for work, rose to 63%, the highest since March 2014. The rate has climbed by 0.6 percentage point over the past six months, the biggest advance over a similar period since 1992.

The Phillips curve relationship between tightening labour markets and inflation is proving to be more powerful in some US metropolitan markets like Minneapolis, where wage growth was 4.9%. With the US expansion approaching its seventh year in June, an increasing number of regional markets are battling to find workers. We are now in the part of the expansion where the labour markets get so tight in some areas that employers increasingly poach workers from each other. This reflects more quits, which results in more switches mainly for wage gains. The tighter the labour market, the more this happens and the bigger the wage gains. Some of the US's hottest labour markets are getting wage gains well in excess of the roughly 2% gains most Americans have been getting.

Euro-area unemployment retreated in February to the lowest since 2011, continuing its slow decline as the economy grows at a modest pace. The rate fell to 10.3% from 10.4% in January. While the unemployment rate in the currency bloc has been almost continuously above 10% for more than six years, national figures point to a divide in the region. In Germany, the jobless rate held at 4.3%. In contrast, it is 20.4% in Spain.

Big British firms are delaying deals and hiring decisions ahead of a referendum on the country's European Union membership, adding to signs that uncertainty around the vote is Weighing on the economy. Chief financial officers are increasingly in favour of staying in the EU, with 75% of the CFO's from FTSE 350 and other large private companies backed by Britain's continued membership of the EU in the first three months of this year, up from 62% in the fourth quarter of 2015. But the survey also showed 83% of CFOs thought the level of uncertainty facing their business was above normal, high or very high, a big jump from 64% at the end of 2015 and the highest level in over three years.

Japan's manufacturing activity contracted in March at the fastest pace in more than three years as new export orders shrank sharply. The Purchasing Managers Index (PMI) fell to 49.1 in March. Japan's major companies are giving lower wage increase next fiscal year. For example Toyota agreed to increase the monthly base salary by Yen 1,500 (US$18) in the year beginning April. That compares with a Yen 4,000 hike the previous fiscal year. The biggest reason companies are offering smaller pay increase is because profits are not rising as much as last year. Toyota's resistance is the latest indication that the virtuous cycle sought under Abenomics – in which wage growth, higher consumption and price hikes combine to drive sustainable economic growth – may be stalling.

China's manufacturing activity rebounded in March to its highest level since last August, thanks to the government's continued structural reforms. The PMI came in at 50.2 in March, up from February's 49. Chinese Premier announced a 6.5% to 7% growth target, down from an objective of 7% last year. China will need average annual growth of at least 6.5% in the next five years to reach its target of doubling per capita income from 2010 levels. The government would address "zombie" state firms via mergers and restructuring, while offering 100 billion yuan (US$15 billion) for employees laid off as part of that process. China aims to lay off 5-6 million state workers over the next two to three years as part of efforts to curb industrial overcapacity and pollution. The overall figure is likely to rise as closures spread to other industries and even more funding will be required to handle the debt left behind by "zombie" state firms. The "zombie" term refers to companies that have shut down some of their operations but keep staff on their rolls since local governments are worried about the social and economic impact of bankruptcies and unemployment.

The OECD cut its 2016 economic growth forecast to 3.0% from 3.3% owing to disappointing data, sluggish demand, weak investment and a high risk of financial instability. It trimmed its outlook for this year as growth slows in many emerging countries and advanced economies only expected to achieve modest recovery. In its November outlook, the OECD had already downgraded its initial 2016 estimate, citing stagnating trade amid a slowdown in China. But it said it felt compelled to make a further downward revision both for this year while also revising downward an initial November projection for 2017 to 3.3% from 3.6%.

Interest Rates & Currency

In March, the US Federal Reserve announced that it did not plan to raise interest rates four times this year as announced previously in December, and indicated there will be two rate hikes this year. The Fed also cut its forecast for US economic growth from 2.4% to 2.2%. *"Since the turn of the year, concerns about global economic prospects have led to increased market volatility and tighter financial conditions in the United States,"* Fed

Chairperson Janet Yellen said. The Fed emphasised that any future rate increases will likely be *"gradual"* moves. She said that *"policy is not on a pre-set course"* and will change because the *"economy will surely evolve in unexpected ways."*

The European Central Bank reduced the rate on cash parked overnight by banks by 10 basis points to minus 0.4% and lowered its benchmark rate to zero. Bond purchases were increased to 80 billion euros a month from 60 billion euros, and corporate bonds will now be eligible. A new series of long-term loans to banks will begin in June. It would effectively pay commercial banks money to borrow central bank funds. The offer means banks that participate would pay back less at the end of the four-year loan than they borrowed. Banks will qualify for the money only if they lend it on to consumers and businesses, i.e. the real economy. And there are other conditions as the money cannot be used for mortgages, for example.

The Bank of England policymakers voted to keep the U.K.'s interest rates at 0.5% in March. The vote was unanimous and comes after the British government revised its 2016 growth forecast for the country's economy down to 2% from 2.4%.

While the Bank of Japan (BOJ) kept policy unchanged in March, Governor Kuroda underscored a readiness to move on any of three fronts: a reduction in the present minus 0.1% rate to as low as minus 0.5%, an acceleration in boosting the monetary base or an expansion in purchases of riskier assets. With the BOJ far from its 2% inflation goal and economic growth stalling, most analysts predict that additional stimulus is just a matter of time.

The RBA at its April Board meeting kept the cash rate unchanged at a record low of 2.00%. This was widely expected. Overall, the RBA's post-meeting statement was little changed. UBS' view is *"There's now little doubt the RBA views some of the rise in the AUD, due to easier monetary policies elsewhere in the world, as unhelpful. This does not signal an imminent cash rate cut, particularly given the ongoing moderate growth in the global economy, Australia's 2015 growth pick-up, better global financial market sentiment and the rise in commodity prices."*

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.

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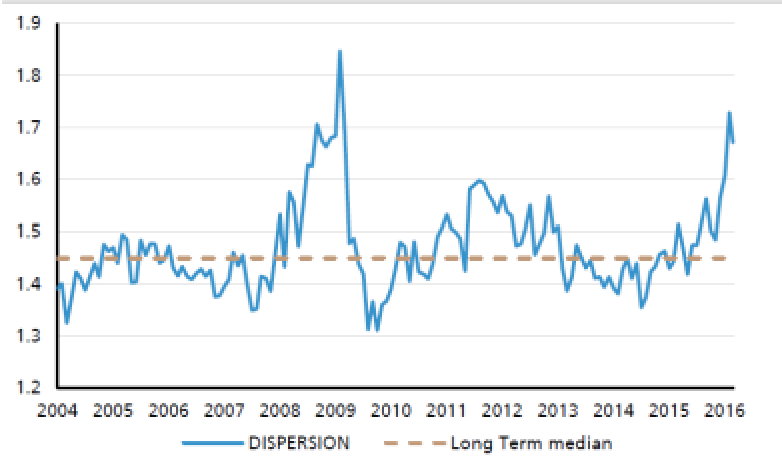
Closing Rates as at 31 March 2016					
	Rate	Rate (Prev)[1]		Rate	Rate (Prev)
Cash	2.00%	2.00%	US Fed Funds Rate	0.2500%	0.3700%
90 Day Bank Bills	2.30%	2.33%	AUD/USD	76.51	71.40
180 Day Bank Bills	2.23%	2.20%	US 10 Year T-Bond	1.76%	1.74%
5 Year Govt Bonds	2.083%	1.962%	US 30 Year T-Bond	2.59%	2.61%
10 Year Govt Bonds	2.4474%	2.409%	Japan 10 year yield	-0.076%	-0.058%

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

Australian Shares

UBS' comment is, *"The market P/E dispersion (defined as the ratio of the 80th percentile P/E divided by the 20th percentile P/E) remains well above average despite having re-traced somewhat in recent weeks. We note that the dispersion has had a reliable tendency to mean revert over the past 15 years. This mean reverting tendency suggest some caution on the high P/E end in our view, even though the growth environment appear constrained. It is interesting that at the high P/E end, even though EPS growth is on average better than the broader market, we are observing some slippage in terms of EPS downgrades."*

Figure 1: Market P/E Dispersion* (ASX100 Ex Resources)

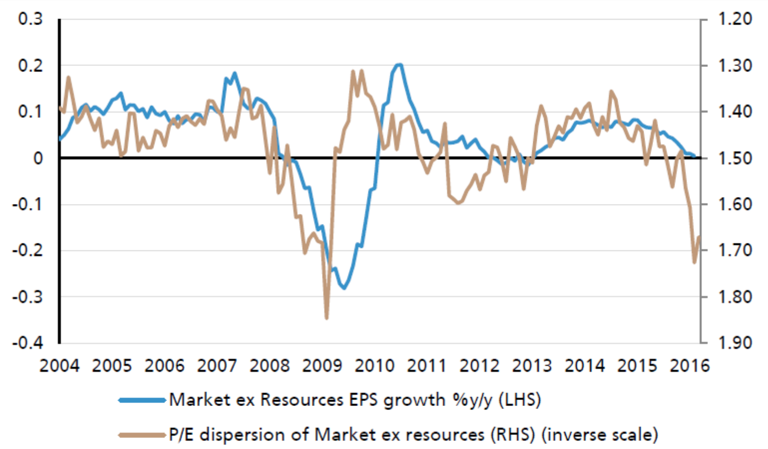


Source: Factset, UBS

The PE dispersion is well above average and has retraced a little recently.

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

Figure 3: Market P/E Dispersion (Inverted) versus Market Earnings Growth



Source: Factset, UBS, Datastream

PE dispersion (inverted) appears to show a link to EPS growth… or lack thereof.

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 March 2016					
	Level	Level (Prev)[1]		Rate	Rate (Prev)
All Ordinaries	5,151.8	4,947.9	AOX Earnings Yield	5.75%	5.99%
PE Industrials (2016)*	14.9x	14.4x	Div Yld Indust (2016)*	5.1%	5.3%
PE All Ords (2016)*	17.4x	16.7x	Div Yield All Ords (2015)*	4.5%	4.7%

*Source – UBS

Stance: Neutral – Underweight portfolios should look to add

International Shares

Qato Capital Analytic's chart on America's S&P500 share index shows US corporate operating earnings are heading south after five years of robust growth. Note how the share index responds to turning points in earnings.

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

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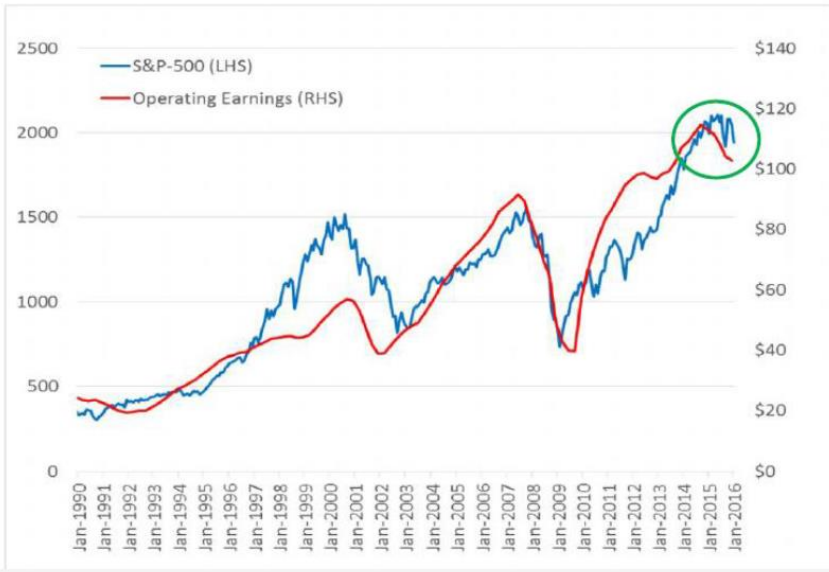
S&P-500 Operating Earnings have continued to fall over the past four quarters, commencing Q1-2015.



Source: Qato Capital Analytics, 24.2.2016

We expect geopolitical events occasionally giving rise to market volatility. Take advantage of market volatility and the appreciation of the 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 March 2016

	Level	Level (Prev)[1]		Rate	Rate (Prev)
US Dow Jones	17,685.09	16,516.50	Nikkei Dow	16,758.67	16,026.76
S&P 500	2,059.74	1,932.23	Hang Seng	20,776.70	19,115.32
FTSE 100	6,174.9	6,097.09	MSCI	1,648.1	1,547.2

Stance: **Neutral with positive bias**

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

Property

Australia's property market is showing signs of cooling, with prices up just 0.2% in the December quarter, while the Sydney market fell. The modest increase in the Australian Bureau of Statistics' residential property price index slowed the overall annual increase to a still robust 8.7%, but down from the 10.7% recorded in the September quarter. Sydney was one of the worst performing markets, falling 1.6% for the quarter, only marginally less than the 1.8% drop in Darwin. It is the first decline the Sydney market has suffered since the March quarter in 2012.

According to UBS, *"The REIT sector is currently trading on a 5.0% FY17 DPS yield, 16.2x forward PE and an implied cap rate of 6.0%. Key themes include 1) Positive sentiment towards regional retail is starting to wane, 2) Office cash flow poor, 3) Residential markets have moderated, 4) Funds Management is driving supernormal growth, 5) Capital position very strong and 6) NTA up 8.6% across the sector."*

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 March 2016		
	Level	Level (Prev)[1]
S&P/ASX 200 A-REIT	1,362.0	1,330.5

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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