Investment Pulse

Wealth Management Research

The Federal Budget and lower interest rates boosted Australian business confidence while firming US wages suggest the Fed will need to lift rates by September.

Key points

US wage growth accelerated in May as 280,000 jobs were added to the economy. Headline wage growth increased 2.3% in the year to May, in line with previous expansions which have seen wages respond 6 to 9 months after the unemployment rate fell below 6%. US unemployment is currently 5.5% and dropped below 6% in August 2014 with the current wage response similar to the recoveries of 1994-95 and 2003-04. The Federal Reserve's Beige Book also reported skill shortages across numerous regions and industries with wage increases becoming more prevalent. We believe the US economy is approaching full employment with the US Federal Reserve likely to increase interest rates by September at the latest.

Eurozone leading indicators suggest the European Central Bank's (ECB) quantitative easing measures are flowing through to the real economy. European inflation increased 0.3% during May, having been flat in April and negative through early 2015, a deflationary trend which had driven many sovereign bonds to negative yields. The positive inflation data saw broad selling in German Bunds during May as deflation trades were unwound. Greece negotiations continue to dominate headlines with an International Monetary Fund (IMF) payment deferred in early June. We believe the risk of a third bailout being withheld and Greece exiting the Eurozone later in 2015 is high.

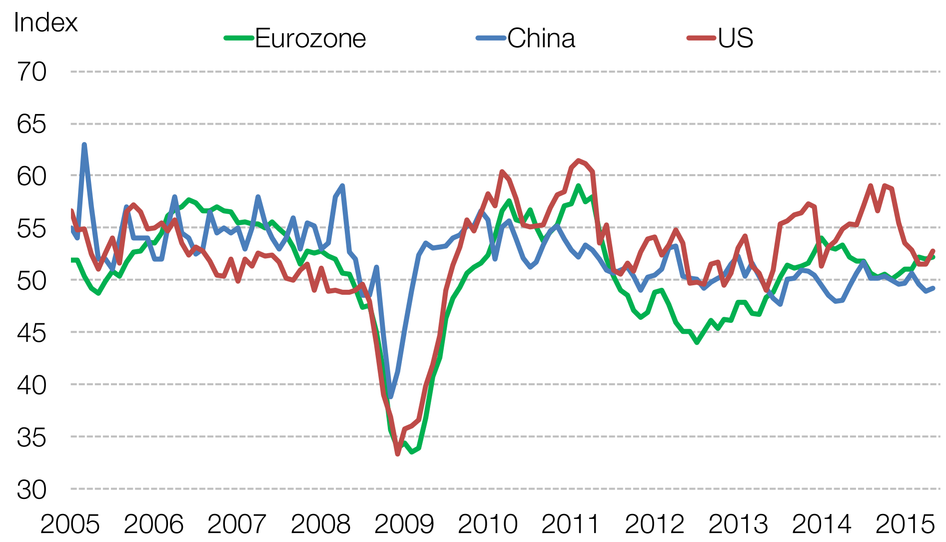
Australian business confidence jumped to the highest level since August 2014 in response to lower interest rates and a more positive Federal Budget. Australian gross domestic product was bolstered by resource exports and inventories, but domestic demand was flat with annual growth (+0.8%) running well below headline growth (+2.3%). Consumer spending (+2.6%) and residential construction (+9.2%) were the bright spots but offset by non-residential construction (-12.9%). Wage growth remains below historical averages but disposable income has risen due to lower interest rates with consumers opening their wallets – the household savings ratio is now at a six and a half year low of 8.3%. While the economy is likely to have a degree of positive momentum in the coming months, we believe a further decline in the exchange rate is required to stimulate the non-mining economy to deliver a more sustainable recovery.

1. Macquarie Wealth Management recommended asset allocation

	Underweight	Neutral	Overweight
Australian Equities		X	
International Equities			X
Property	X		
Fixed Interest	X		
Alternatives		X	
Cash		X	

Source: MWM Research, June 2015

2. Global manufacturing surveys



Source: MWM Research, June 2015

Market performance May 2015

Australian equities

The Australian market rose slightly during May with the S&P/ASX 200 Accumulation Index returning 0.4%. The S&P/ASX 100 Accumulation Index (+0.3%) underperformed the S&P/ASX Small Ords Accumulation Index (+2.3%) for the second month running as smaller gold companies performed strongly while (Sirius Resources, +30.7%) and Sirtex Medical (SRX, +25.6%) were standout performers.

The best returning S&P/ASX 200 sectors were Industrials (+5.6%) and Information Technology (+5.5%) with the best performers in the Industrials sector being UGL Limited (UGL, +33.0%) and Mineral Resources (17.4%) while Carsales.com (CAR, +10.7%) topped Information Technology.

The worst performing sectors were Consumer Staples (-2.2%) and Financials ex-Property (-1.7%) Consumer Staples were weighed down by Woolworths (WOW, -5.0%) following a disappointing strategy day while the major banks dragged down the Financials sector for the second month running with Commonwealth Bank (CBA, -4.3%) and Westpac (WBC, -5.4%) the weakest.

Australian REITs increased 2.9% during May. Sector heavyweights Westfield Corporation (WFD, +2.4%) and Scentre Group (SCG, +5.6%) pushed the sector higher while the best returns were from BWP Trust (BWP, +8.9%) and Dexus Property Group (DXS, +8.5%).

International equities

The MSCI World Index (Hedged in $A) increased 1.1% in May as Japan's Nikkei 225 index increased 5.3% with the Yen weakening further. The S&P 500 Index (+1.0%) and Dow Jones (+1.0%) finished higher at 2,107 and 18,011 respectively while the Nasdaq (+2.6%) set fresh highs.

In Europe's equity markets, Germany (DAX Index, -0.4%), Spain (IBEX 35 Index, -1.5%) and France (CAC 40 Index, -0.8%) were weaker while UK (FTSE, +0.3%) and Italy (MIB 30 Index, +2.0%) moved higher. Greek negotiations continued to preoccupy investors although economic data is incrementally improving throughout the region.

Chinese equities continued their move higher, adding 3.8% during May, but the pace was well off the returns from April (+18.5%) and March (+13.2%) as investors began to question the sustainability of the rally and regulators looked to limit margin lending.

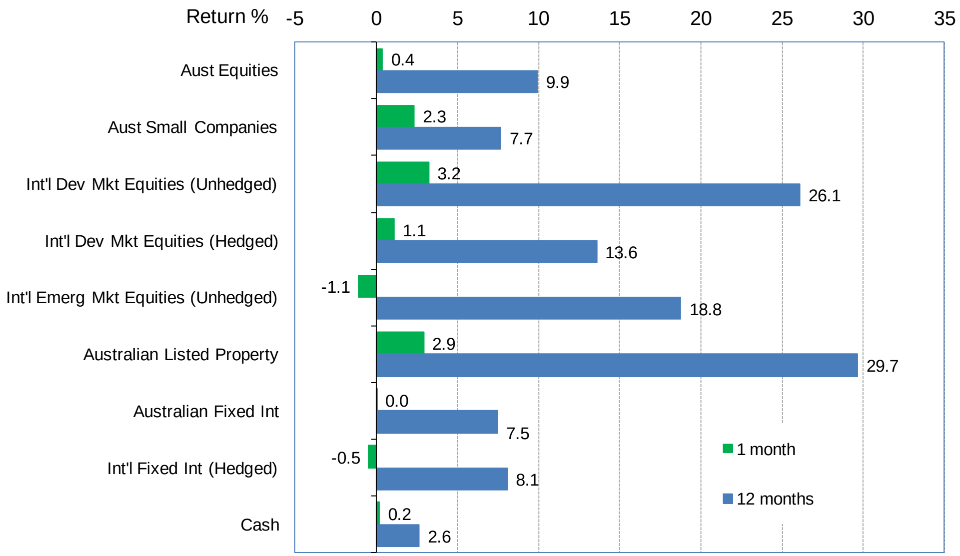
Fixed interest and cash

Australian fixed interest returns were positive for the month as Australian bond yields rose with the 10 year yield increasing +3.1% to finish the month at 2.7%. The Bloomberg Composite Bond Index returned +0.04% with government bonds (-0.1%) underperforming corporate bonds (+0.3%) with short-term (0-3-year) and long-term (+10-year) bonds returning +0.3% and -1.0% respectively.

Currency

The $A/$US decreased 3.3% to $0.7646 as disappointing business investment data pushed the Australian dollar down. Consequently, the $A was weaker against UK Pound (-2.8%, 0.5002) and Euro (-1.2%, 0.6956). However, the $A was stronger against the Japanese Yen (+0.6%, 94.91) and New Zealand dollar (+3.6%, 1.0754) as speculation mounted New Zealand's Reserve Bank will cut interest rates further.

3. Market performance May 2015



Source: IRESS, Bloomberg and MWM Research, June 2015

Australian equities outlook

Australian equities were marginally positive in May with the S&P/ASX 200 accumulation index increasing 0.4% while the price index declined 0.2%. An acute global bond selloff gathered steam through early June, pulling the S&P/ASX 200 back below 5,500 and reversing all gains for the index made since January. Weakness in the banks was a continuing theme as a focus on capital requirements and residential investor lending combined with three major banks going ex-dividend.

The May Federal Budget had a more positive tone this year, evident in the higher consumer confidence reading which followed, although this was quickly reversed in the June survey. We expect the small business package, which provides an instant tax write off for items up to $20,000, will combine with recent rate cuts and a booming Sydney housing market to support retail sales over the next few months. June is expected to be particularly strong with retailers expected to capitalise on the small business instant asset write off as the end of financial year approaches.

Electronic retailers will benefit from the end of fringe benefits tax on portable electronic devices for small businesses with upside to the computer category. JB Hi-Fi (JBH) is our preferred electronics retailer while Harvey Norman (HVN) is more leveraged to the housing market given its larger weighting to home furnishings. Wesfarmers (WES) is also well placed via its Bunnings and Officeworks businesses.

Portfolio positioning

We downgrade our Energy sector recommendation to neutral. Our global oil strategist is bearish on crude for the remainder of 2015 with global oversupply expected to remain till late 2016. Oil Search (OSH) is our preferred exposure given its favourable cost position and organic growth opportunities.

We also reduce our Materials sector recommendation to underweight, from neutral, reflecting our expectation the iron ore price will move lower in 2015 as further Australian supply enters the seaborne market. We recommend BHP (BHP) over Rio Tinto (RIO) for its more diversified asset base and see less risk to its dividend.

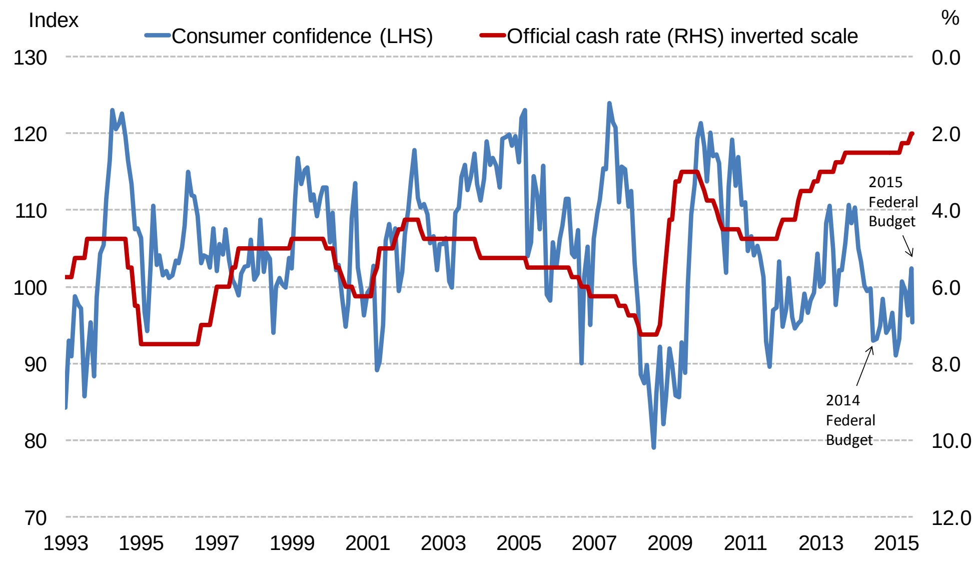
Australian equity valuations remain above historical averages despite the recent pullback. We have a preference for companies exposed to offshore growth opportunities and a lower Australian dollar. Defensive sectors will be vulnerable to a correction in long-term bond yields with recent bond movements evidence of how quickly markets can adjust.

4. Macquarie Wealth Management Australian sector allocation

	Underweight	Neutral	Overweight
Energy		X	
Materials	X		
Industrials			X
Consumer Discretionary			X
Consumer Staples		X	
Healthcare			X
Financials ex Property	X		
Property Trusts	X		
Info Tech		X	
Telecom Services		X	
Utilities	X		

Source: MWM Research, June 2015

5. Consumer confidence and official cash rate



Source: FactSet, MWM Research, June 2015

International equities outlook

The MSCI World Accumulation Index (hedged in A$) increased 1.1% through May while the equivalent unhedged index returned 3.2%. We have made several changes to our global equity market recommendations this month.

We have upgraded both Europe and UK to an overweight recommendation. This follows evidence the ECB's quantitative easing measures are positively influencing retail sales and inflation expectations, reversing deflationary expectations that were prevalent only a few months ago. Europe's composite leading indicator appears to have reached a trough (figure 7), a positive sign for earnings across the region. The Sentix Economic Sentiment Index also indicates Europe is in the midst of an economic recovery, but the index has retraced in recent months as the Euro and bond yields have rebounded while Greek negotiations dominated headlines.

The ECB is receiving decent leverage for its quantitative easing program as the US has finished its equivalent stimulus measures. This has seen the Euro depreciate against the US dollar from 1.36 to 1.13 currently, having dipped to 1.05 during March. The lower exchange rate is spurring growth across the region, lowering the risk of bank-related issues flaring up again.

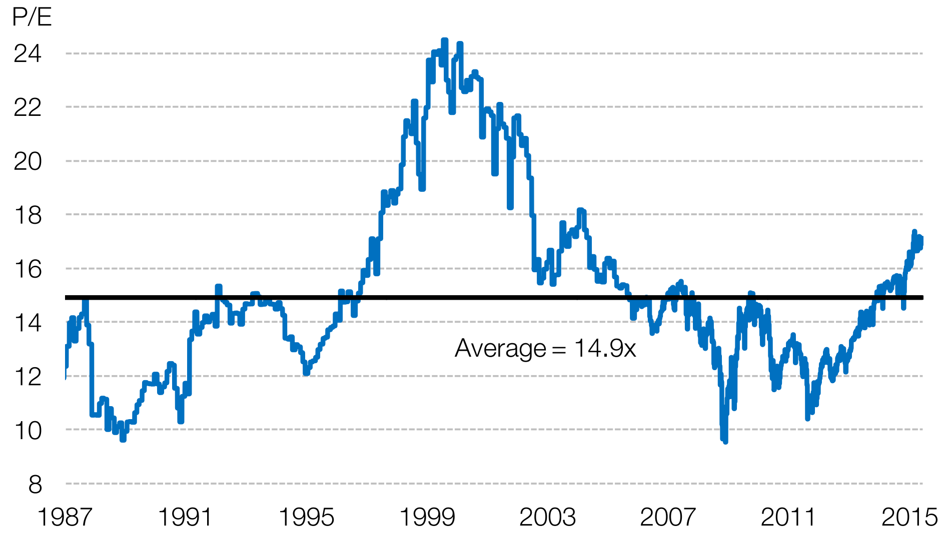
We downgrade our recommendation for Asia ex-Japan from overweight to neutral. Chinese equities have surged relentlessly in recent months. We view the rally as detached from fundamentals with the MSCI China index running well ahead of key leading indicators. Peripheral Asia is also suffering as capital is shifted out of the region and into China.

Portfolio positioning

We continue to favour global equities over Australian equities. We are overweight USA, Europe and UK while remaining underweight Japan and Latin America. We prefer cyclical to defensive exposures with the latter likely to come under pressure as global bond yields continue to rise.

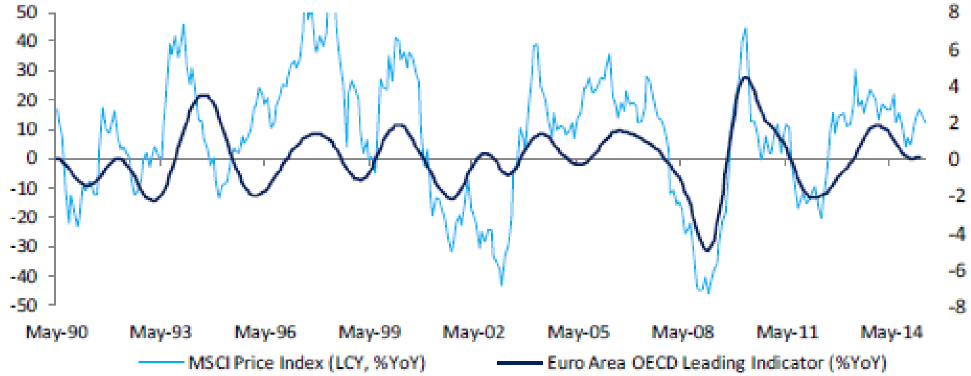
Within the US we have a preference to cyclical sectors such as machinery, electronics and residential construction which can be expected to outperform in a gradually rising rate environment.

6. US S&P 500 Price / Earnings ratio



Source: MWM Research, Macquarie Research, June 2015

7. Europe's leading indicator has troughed



Source: Macquarie Research, June 2015

Property outlook

Retail trading conditions have improved through early 2015 with lower interest rates and higher property prices improving the outlook for consumers. This year's Federal Budget small business package is also expected to flow through to retail sales in the coming months.

Retail sales started 2015 positively for the domestic retail landlords. Total centre comparable sales increased 1.9% in the year to March with specialty sales also improving 3.4%. The electronics category has seen very strong trading conditions, primarily due to the iPhone 6 release, with GPT reporting mobile phone sales increased 31.7% in the year to March. However, department stores continue to struggle with excess space as competition from international retailers weighs with Myer selectively closing underperforming stores.

Our analysis of correlations between comparable total centre and specialty sales growth rates against the total shareholder returns of retail property trusts shows the relationship between sales results and shareholder returns is inconsistent. Our analysis indicates the sector has historically been more correlated to long-term bond yields, a relationship we expect will hold going forward.

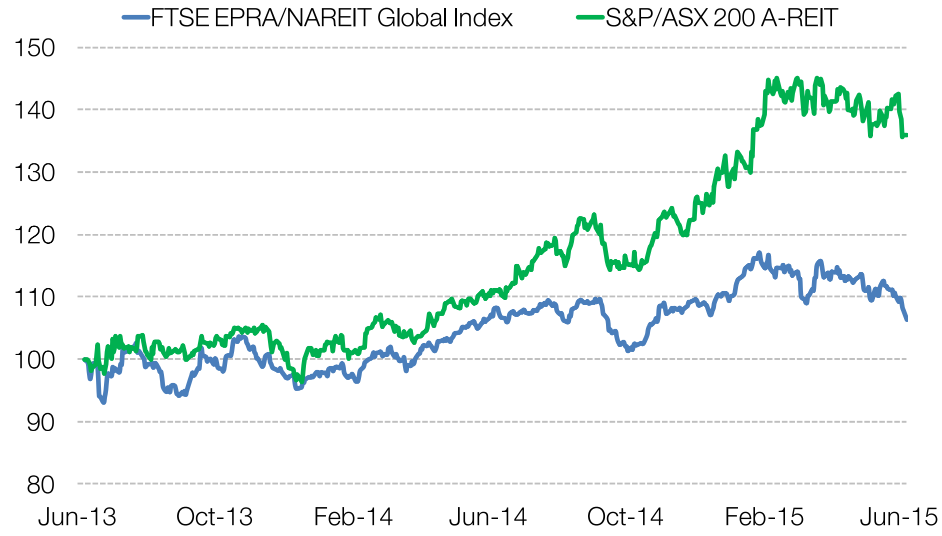
From a landlord perspective we are cautious relative to our more positive view on discretionary retailers. Elevated levels of supply are still to come onto the market (figure 9) and we expect re-leasing spreads to remain generally negative. Overall, we recommend buying the tenant and not the landlord.

Portfolio positioning

We continue to recommend an underweight allocation to listed property trusts. The sector remains fully priced with most A-REITs trading above their net asset backing, reflecting the broad shift into yield sectors of recent years. Historically the sector has had a negative correlation with long-term bond yields which we expect will continue, particularly once the US Federal Reserve begins lifting the Fed funds rate.

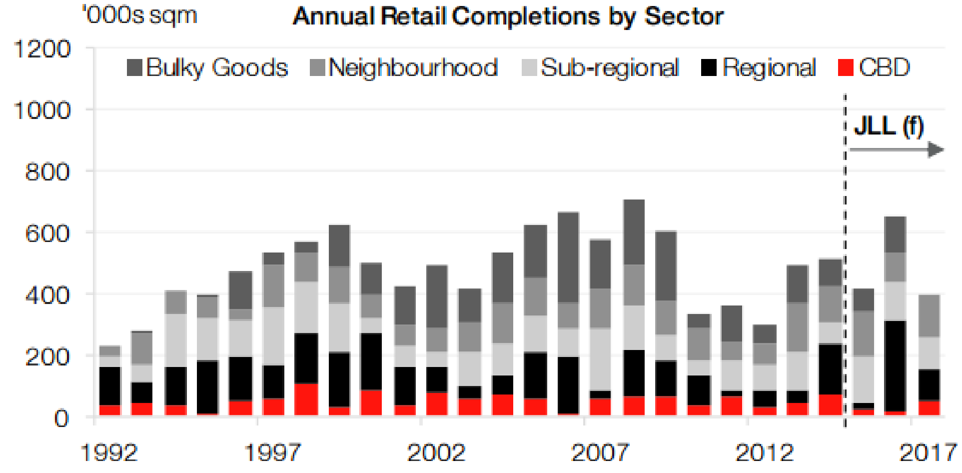
The sector's fundamentals are relatively weak (with the exception of residential) and we expect companies will focus on cost-outs and pursue acquisitions in order to drive earnings growth. While we believe the sector is fundamentally fully valued, we remain positive on stocks with leverage to a lower Australian dollar or compelling earnings profiles including Westfield Corporation (WFD), Goodman Group (GMG) and GPT Group (GPT).

8. Australian and global REITs



Source: MWM Research, IRESS, June 2015

9. Retail supply pipeline a risk



Source: Macquarie Real Estate Strategy, JLL Research, June 2015

Fixed interest and cash outlook

The global bond volatility which began in late April continued through May before accelerating in early June as the economic outlook improved in Europe. Signs that inflation is returning, albeit at a gradual pace, indicate quantitative easing measures are working and deflation is less of a threat than previously priced in.

The RBA left the official cash rate (OCR) unchanged at its June Board meeting, as broadly expected. The Board expects Australia's economy will be "operating with a degree of spare capacity for some time yet" given weakness in business capital expenditure, both mining and non-mining, which the RBA believes will continue through the remainder of 2015.

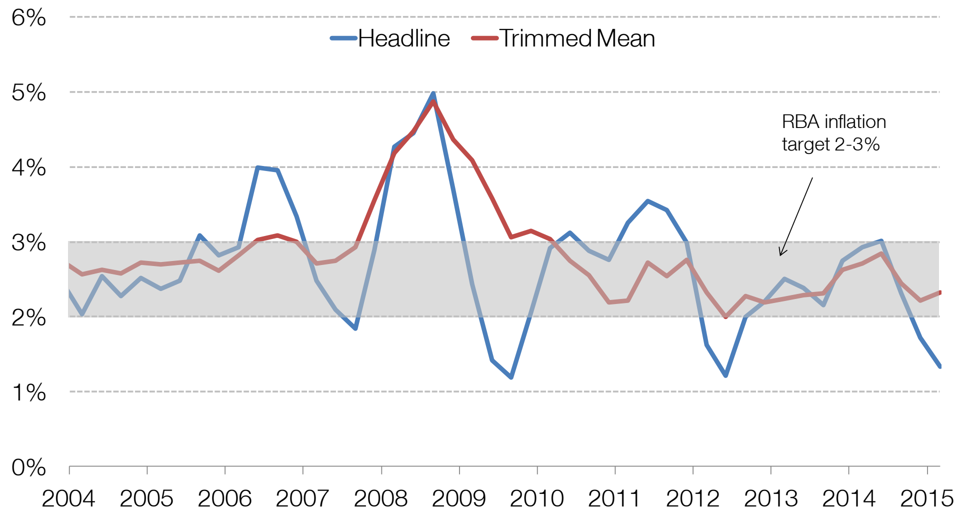
Labour costs will likely remain contained as the economy grows at a below trend pace. The RBA expects inflation will "remain consistent with the target over the next one to two years, even with a lower exchange rate". As such, we believe the risk of a rate rise is limited with further monetary easing the more likely scenario. We expect the RBA will remain on hold in the short-term given the economy has a degree of positive momentum following recent rate cuts and a more positive Federal Budget. The Australian dollar has remained below $0.80 for most of 2015 but will need to move lower to provide a more meaningful boost to the local economy. We forecast the RBA will cut the OCR in November which should result in a more substantial A$ depreciation if the Fed has commenced lifting interest rates.

Portfolio positioning

We maintain an underweight position in fixed interest. The US labour market is showing signs of improvement, both in jobs and wages, increasing our confidence the Fed will commence 'lift-off' by September at the latest. Meanwhile, signs of recovery in Europe have seen increased volatility in sovereign bonds. While we expect the RBA to continue cutting interest rates, the long end of the Australian yield curve can be expected to move in line with global yields. Australian government bonds (10+yr, -2.0%) have underperformed our preferred exposure of short-term corporate bonds (0-3yr, +1.6%) in the year to date.

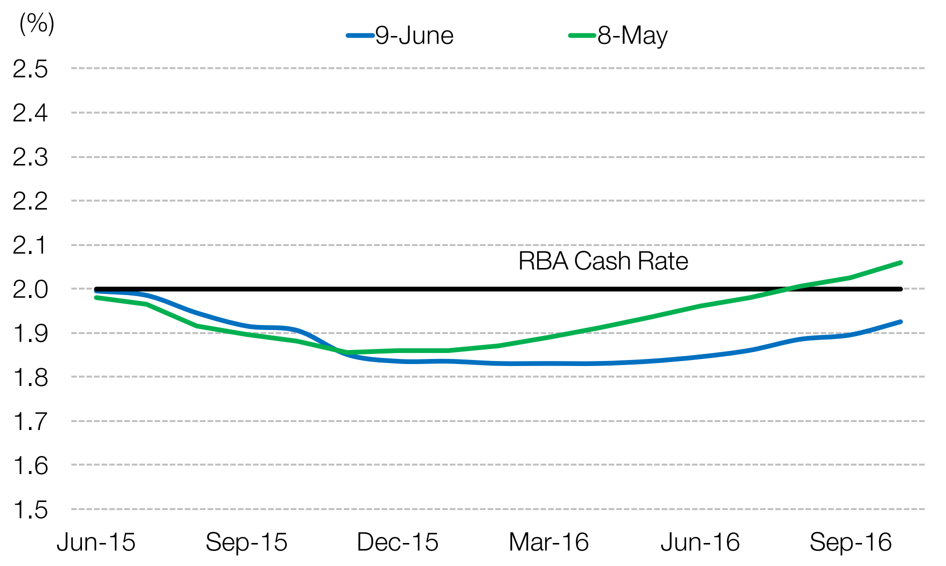
We have upgraded our recommended asset allocation for cash to neutral. Term deposits offer historically low returns which are unlikely to improve given our expectation of further rate cuts later this year. However, both equity and bond markets have rallied strongly in recent years with volatility increasing lately as investors begin to price in the Fed lifting interest rates. There is potential for positive correlation between these two asset classes and we prefer cash to fixed interest as a means of capital preservation given our expectation of capital losses in bonds.

10. Australian inflation outlook is subdued



Source: ABS, MWM Research, June 2015

11. ASX 30-Day Interbank Cash Rate Futures Implied Yield Curve



Source: ASX, MWM Research, June 2015

31-May-15	1 month %	3 month %	1 year %	3 year %pa	5 year %pa
Australian Shares					
S&P/ASX 200 Accumulation	0.40	-1.37	9.93	17.43	10.31
S&P/ASX 200	-0.22	-2.56	5.18	12.33	5.46
All Industrials Accumulation	0.38	-1.32	14.88	23.07	14.79
All Resources Accumulation	0.55	-1.68	-9.96	-1.28	-3.40
All Industrials	-0.37	-2.43	9.80	17.32	9.04
All Resources	0.55	-3.29	-13.50	-4.45	-6.07
S&P/ASX 20 Accumulation	-0.80	-3.24	7.06	18.78	10.84
S&P/ASX 50 Accumulation	-0.01	-2.12	8.99	18.31	10.85
S&P/ASX 100 Accumulation	0.26	-1.56	10.12	18.26	10.77
International Shares					
MSCI World Index Hedged in $A	1.11	1.65	13.58	20.14	14.06
MSCI World Index ($A Unhedged)	3.24	2.40	26.09	24.33	12.67
MSCI Emerging Markets ($A Unhedged)	-1.10	3.46	18.77	12.12	3.61
Regional Markets (local currency returns):					
Dow Jones	0.95	-0.67	7.74	13.27	12.18
S&P 500	1.05	0.14	9.56	17.16	14.11
Toronto Comp	-1.38	-1.45	2.81	9.25	5.00
Nikkei	5.34	9.39	40.53	34.02	16.05
Dax	-0.35	0.11	14.79	22.14	13.86
FTSE 100	0.34	0.54	2.04	9.59	6.13
Hang Seng	-2.52	10.48	18.81	13.76	6.77
NZSE 50	0.68	-2.20	8.00	13.60	8.57
Property					
S&P/ASX 200 Property Trust	2.92	-0.32	29.66	21.81	15.07
Cash and Bonds					
Bloomberg Composite Bond All Maturities	0.04	-0.32	7.47	5.09	6.93
Citigroup World Govt Bond Index Hedged	-0.48	-0.10	8.07	6.39	7.49
Citigroup World Govt Bond Index	0.63	-0.16	11.81	5.68	3.32
Bloomberg Bank Bill Index	0.20	0.59	2.65	2.89	3.69

	31-May-15	31-May-15	1 month %	3 month %	1 year %
Exchange Rates: $A vs					
$US	0.765	0.931	-3.27	-2.09	-17.88
$NZ	1.075	1.096	3.58	4.18	-1.91
EUR	0.696	0.683	-1.24	-0.32	1.86
GBP	0.500	0.556	-2.85	-1.15	-9.99
JPY	94.91	94.77	0.59	1.61	0.15
TWI	63.70	71.50	-2.45	-0.62	-10.91
Commodities					
Oil WTI (USD/bbl)	60.3	102.9	0.85	22.04	-41.38
Gold (USD/oz)	1190.2	1249.0	0.50	-1.89	-4.71
Copper LME (USD/tn)	6088.5	6995.5	-2.51	3.54	-12.97
Zinc LME (USD/tn)	2212.5	2074.0	-6.07	7.38	6.68
Aluminium LME (USD/tn)	1705.5	1823.5	-10.68	-4.96	-6.47

Interest Rates	Australia	US	Japan	German	UK
Cash (current)	2.00	0-0.25	0-0.1	0.05	0.50
90 Day Bank Bills	2.14	0.00	0.13	0.18	0.55
10 Year Government Bonds	2.73	2.12	0.39	0.49	1.83

Sources: MWM Research; Macquarie Research, IRESS; Bloomberg; unless otherwise indicated.

Investment Pulse June 2015 was finalised 11 June 2015.

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