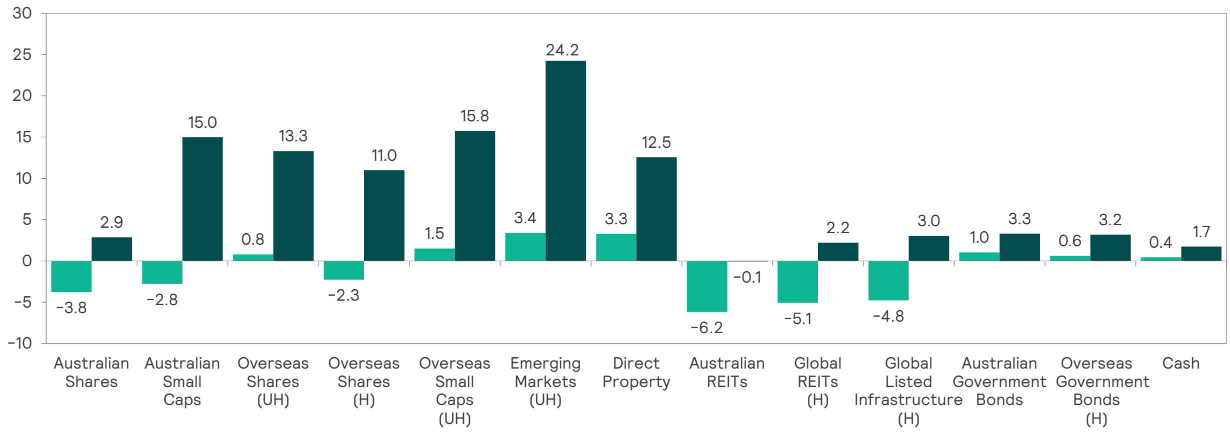
Q1 2018

MARKET AND ECONOMIC CONDITIONS

SELECTED MARKET INDICATORS COMMENTARY

ASSET CLASS RETURNS (%) AS AT MARCH 2018 QUARTER



Data source: Thomson Financial Datastream; MSCI. Data provided 'as is'

■ MARCH 2018 QUARTER ■ 12 MONTHS TO MARCH 2018

Global equity markets began the quarter in a risk-on atmosphere following President Trump's tax package in late 2017 and continued economic growth across major economies. This was not to last, however, as equity market volatility picked up following steeper rate hike fears in the US which was then followed by President Trump's controversially imposed trade tariffs on China in early March. This sparked fears of a global trade war; impacting market movements further. Consequently the MSCI World ex Australia Index fell 2.3% in hedged A$ terms over the quarter.

European markets were similarly affected by activity in the US, but also experienced political uncertainty with Brexit negotiations beginning between British parliament and European leaders, and mixed results coming out of the German and Italian elections. In local currency terms, the UK (-7.3%), France (-2.0%), Switzerland (-6.0%), Germany (-5.9%) and Spain (-4.0%) MSCI country indices all fell over the quarter.

As anticipated by markets, and following higher than expected rates of inflation in the US, the US Federal Reserve (Fed) decided to raise its benchmark interest rate by 0.25% to a range from 1.5% to 1.75%p.a in its March meeting. The hike puts the US rate ahead of the RBA cash rate for the first time since 2000. The rate increase supports strong realised labour market conditions and a solid return to 2% inflation for the US.

Major bond yields increased off this news, also influenced by expressed commitment to a tightening of monetary policies from central banks in Europe, Japan and the US, but were pulled back late in the quarter by the effects of increased market volatility and political (in particular trade) uncertainty. We saw a distinct flattening of the US Treasury yield curve over the quarter, as investors may be adjusting their growth expectations and/or pricing in greater volatility.

Domestic markets also experienced a weak quarter, as the S&P/ASX 300 fell 3.8%. Healthcare and IT were the strongest performing equity sectors over the period. The Australian dollar (AUD) depreciated over the quarter, from US$0.782 in December to $US0.767 in March. Sentiment weakened against the backdrop of the dramatic trade tension, and was also not improved by the first round of hearings from the Royal Banking Commission. The commission was rife with controversy and disappointment, bringing to light immoral behaviour and illegal practices undertaken by the major Australian banks. Information that has been uncovered so far may indicate that banks and mortgage lenders could be more exposed in an economic downturn than previously anticipated.

SIGNIFICANT DEVELOPMENTS

- The RBA decided to leave the cash rate unchanged again in its early March meeting at 1.50%p.a. RBA Governor, Philip Lowe, noted that the global economy has strengthened over the past year, with many advanced economies experiencing above-trend growth rates and low unemployment rates. In Australia, the economy grew by 2.4% over last year, which was lower than the central bank's forecast of 3%. The RBA's forecast remains for faster growth in 2018. Investment and business conditions in non-mining sectors and increased levels of public infrastructure investment support a positive future outlook. High debt levels and low household consumption continue to provide uncertainty, however consumption growth picked up towards the end of 2017. Housing markets in both Sydney and Melbourne have slowed, with measures of housing prices experiencing little change over the last six months. During 2017, employment rose in all Australian states, along with a significant rise in labour force participation. Low wage growth is likely to continue, although the stronger economy could help to improve wages over time. Underlying inflation remains low at just under 2%, due to low growth in labour costs and strong retail competition. The RBA is forecasting CPI inflation to reach just over 2% in 2018. Consequently, the RBA believed it was appropriate to leave the rate unchanged, taking into account current progress in reducing unemployment, the expectation that inflation will return to target and the view that low interest rates will continue to support the Australian economy.
- Australian seasonally adjusted employment increased by 17,500 positions in February, below expectations for a 20,000 rise while January increased by 12,500 positions (revised), below expectations for a 15,000 increase. The unemployment rate increased from 5.5% in January to 5.6% in February, above market expectations. The participation rate increased to 65.7% in February. Part time jobs decreased by 47,400 in February, after increasing by 65,600 (revised) in January. Full time jobs increased by 64,900 in February, and decreased 53,200 (revised) in January.
- Australian house prices increased by 1.0% in the fourth quarter 2017, but rose 5.0% from a year earlier, above expectations for 0.0% QoQ and 3.9% year on year (YoY). Meanwhile building approvals decreased 6.2% month-on-month (MoM) and were down 3.1% for the year to February, below both expectations for a monthly 5.0% decrease and yearly 0.3% increase. In trend terms, building approvals decreased 0.1% for February, and were 5.5% higher than a year earlier.
- US Non-Farm Payrolls increased by 103,000 in March, whilst expectations were for an 185,000 increase. February was the strongest month for US employment in the quarter, rising 326,000 (revised) over the month. January also saw an increase of 239,000 (revised) for the month. The unemployment rate remained unchanged at 4.1% in the March quarter, consistent across all months. The participation rate increased to 62.9% by the end of March, from 62.7% level by the end of December.
- The Institute for Supply Management (ISM) Manufacturing Index decreased to 59.3 in March, below consensus for 59.6, and below the 60.8 recorded in February. Of the 18 manufacturing industries, Fabricated Metal Products, Plastics & Rubber Products and Computer & Electronic Products were the top contributors while Apparel, Leather & Allied Products reported a contraction in growth during March.

- The ISM Non-Manufacturing Index decreased to 58.8 in March, below consensus for 59.0, and below the 59.5 for February. The top performers were Mining, Transportation & Warehousing and Agriculture, Forestry, Fishing & Hunting with Educational Services and Information being the only industries to report contractions during February.
- US GDP assumption was revised for Q4 2017 to 2.9% QoQ annualised, above expectations for 2.7%, and below the 3.2% growth recorded in Q3 2017.
- US headline consumer price index (CPI) decreased to 0.2% MoM and increased to 2.2% YoY in February, in line with expectations, and both below the 0.5% MoM and above the 2.1% YoY movement experienced in January. Core CPI decreased to 0.2% MoM, in line with expectations, and remained at 1.8% YoY, also in line with expectations, in February, from 0.3% MoM and 1.8% YoY in January.
- The Caixin Manufacturing purchasing managers' index (PMI) in China recorded 51.0 in March, below expectations for 51.7. The indicator continues to show positive improvements in China's manufacturing industry, despite falling to a four month low.
- Chinese GDP increased 6.8% YoY in Q4 2017, above expectations of 6.7% and in line with 6.8% recorded over the year to Q3 2017. Seasonally adjusted GDP increased 1.6% QoQ for Q4 2017, below expectations of 1.7% and below Q3 2017 level of 1.8% (revised) QoQ.
- European Core CPI estimate recorded 1.0% over the year to March, below expectations for 1.1%. The unemployment rate decreased to 8.5% in February, below 8.6% for January, while MoM CPI increased to 0.2% in February.
- The Eurozone composite PMI decreased to 55.2 in March, below expectations for 55.3, but maintained an expansionary signal for the fifty-seventh month in a row. Output expansion declined in Germany (8-month low), Italy (14-month low) and Spain (3-month low). France saw its output growth fall to a 7-month low and Ireland continued its decline to reach 53.7, a 57-month low for the nation.
- Eurozone seasonally adjusted GDP remained in line with 2.7% for year-on-year, and also remained constant at 0.6% QoQ for Q4 2017.

AUSTRALIAN EQUITIES

Australian equities were negative over Q1 as the S&P/ASX 300 Index returned -3.8% for the period. There were negative movements across the market cap spectrum, with the best performer being the S&P/ASX Mid Cap 50; returning -2.2% for the quarter while the worst performer was the S&P/ASX 50; returning -4.2%. The best performing sectors were Healthcare (+6.6%) and IT (+1.9%) while the weakest performing sectors were Telecommunication Services (-11.3%) and Utilities (-6.6%). The largest positive contributors to the return of the index were CSL Limited, A2 Milk and Qantas with absolute returns of 10.4%, 55.5% and 16.0% respectively. On the other hand, the most significant detractors from performance were CBA, Westpac and Telstra with absolute returns of -7.6%, -7.3% and -11.8% respectively.

GLOBAL EQUITIES

The broad MSCI World ex Australia (NR) Index was down 2.3% in hedged terms and up 0.8% in unhedged terms over the quarter, as the AUD depreciated against the major currencies over the period. The strongest performing sectors were IT (+5.4%) and Consumer Discretionary (+3.8%), while Telecommunication Services (-4.0%) and Energy (-3.5%) were the worst performers. In AUD terms, the Global Small Cap sector rose 1.5% and Emerging Markets (NR) rose 3.4%.

Over the March quarter, the NASDAQ increased 2.3%, the S&P 500 Composite Index decreased 0.8% and the Dow Jones Industrial Average decreased 2.0%, all in USD terms. European markets experienced negative returns across the board, with the FTSE 100 United Kingdom (UK) decreasing 7.2%, the DAX 30 (Germany) decreasing 6.4% and the CAC 40 (France) also down 2.5% over the period. Majority of equity returns were negative across Asia as the Japanese TOPIX decreased 4.7% and the Indian BSE 500 decreased 5.8%. The Hang Seng Index increased 0.9%, while the SSE Composite (China) decreased 4.2%.

REAL ASSETS

Global and Domestic property experienced negative results over the March quarter. Domestic Real Estate Investment Trusts (REITs) were down 6.2% and Global REITs also decreased by 5.1% on a fully hedged basis. The unlisted property sector (NAV) rose 3.3% over the quarter, on a one month lagged basis. Meanwhile, Global Core Listed Infrastructure 50/50 index decreased 4.8% for the quarter in hedged terms.

FIXED INTEREST

Global sovereign bonds produced moderate returns over the March quarter for hedged Australian investors. Ten-year bond yields increased in the US (+33 basis points (bps) to 2.75%), in the UK (+13bps to 1.35%) and Germany (+7bps to 0.50%), and decreased slightly in Japan (-1bp to 0.04%). Two-year bond yields increased in the US (+39bps to 2.27%), Germany (+2bps to -0.64%), Japan (+1bp to -0.13%) and in the UK (+38bps to 0.82%). In terms of Global Bond indices, the Barclays Capital Global Aggregate Bond Index returned -0.1% and the Citigroup World Government Bond (ex-Australia) Index returned 0.6% over the quarter, both on a fully hedged basis.

Domestically, Australian 10-year bond yields decreased 3bps to 2.60% while five-year (-3bps to 2.31%) bond yields also decreased and two-year (+3bps to 2.02%) bond yields increased. Bloomberg Ausbond indices were positive over the quarter, with the highest being Bloomberg Ausbond Treasury index, returning 1.0%. The Bloomberg Ausbond Composite Bond index returned 0.9%.

CURRENCY MARKETS

The AUD depreciated against major currencies over the March quarter, finishing at US$0.767 with a Trade Weighted Index of 62.3. It depreciated 1.9% against the USD, 7.2% against the Yen, 6.1% against the Pound Sterling and 4.8% against the Euro. On a trade-weighted basis, the local currency decreased 4.0% over the quarter.

COMMODITIES

TThe S&P GSCI Commodity Total Return Index increased 3.7% over the quarter. Gold prices finished the quarter at US$1,323.43 per ounce for a 1.5% rise over the period. The oil price increased over the March quarter, by 5.2% to $70.09 per barrel. Iron Ore prices decreased over the March quarter, to $65 per metric tonne for a 12.2% decrease.

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