Market Highlights – March 2015

Markets focus on the Fed

Share markets took a breather in March following February's strong gains as the focus swung to the outlook for US interest rates.

Ahead of the US Federal Reserve's (the Fed) meeting, the attention was on potential changes to its interest rate outlook. Given the continued strengthening in the US labour market, as seen in a decline in the unemployment rate to 5.5% in February, analysts expected that the Fed would remove reference to it 'remaining patient' before raising rates. This was seen as providing the Fed with flexibility in how it may respond to developments in the economy in the future.

As it turned out, the Fed did remove reference to remaining patient, noting instead that it didn't think rates would be raised at its next meeting. In doing so, it stressed that this did not imply a change to the Fed's outlook for interest rates which were driven by the economic outlook.

In a key development, the Fed lowered its inflation forecast for the next two years. Core inflation is now expected to remain broadly unchanged in 2015 before rising more modestly to 1.7% by the end of 2016, below its long-run target rate of 2.0%. Alongside downward revisions to growth, this prompted the Fed to lower its projections (known as its 'dot point forecasts') for the likely path of interest rates. The median projection for rates for the end of 2015 was revised to 0.50-0.75% (from 1.00-1.25%), while the projection for the end of 2016 was revised down to 1.50-1.75% (from 2.25-2.50%).

Fed forecasts validate fixed income pricing

The lowering of the Fed's interest rate projections brought it broadly in line with what financial markets were already expecting for the next two years. Nonetheless, alongside a run of weaker US economic data in recent weeks, it did prompt markets to further reduce expectations for the path of rates by around 25 basis points (bps) over the next two years, driving a modest decline in US bond yields.

Weaker data in the UK also saw UK bond yields fall as markets reduced expectations for rate rises, while many euro zone government bond yields fell as the European Central Bank (ECB) commenced the purchases of government bonds announced in January. The net result was that the global fixed income benchmark produced a solid return of 0.8% in the month, offsetting the modest negative return recorded in February.

In March, Australian fixed income produced a return in line with its global peers, with bond yields falling slightly as the market continued to expect further rate cuts by the Reserve Bank of Australia (RBA) as early as its April meeting.

Share markets consolidate recent gains

Global developed market shares posted a modest negative return of 0.2% on a hedged AUD basis after the 6% gain recorded in February. Weaker US economic data weighed on the US share market, with the S&P 500 index declining 1.7%. By contrast, signs of strengthening in their respective economies saw further solid gains in the euro zone and Japanese share markets. The German DAX share market has risen by 22% since the start of the year.

The Australian market also consolidated last month, with the ASX 300 index posting a broadly flat result on a total return basis. This followed a gain of more than 10% in the first two months of 2015. The flat result for the market, as a whole, masked significant differences between sectors. Continued weakening in commodity prices saw renewed weakness in resource stocks in March. This was offset by further strong gains in the broader market, supported by a decline in the Australian dollar (AUD) and market expectations for further cuts in domestic interest rates.

Emerging market shares performed in line with global developed market shares in March with a broadly flat return in US dollar (USD) terms. Chinese shares continued to rise strongly while Russian shares rebounded strongly following the weakness seen since the middle of 2014. However, the strong gains here were largely offset by weakness in shares in commodity producing countries reflecting the continued drop in commodity prices.

The AUD continues its steady fall against the USD

The combination of ongoing falls in commodity prices, particularly for iron ore which is Australia's largest export, and the markets assessment of possible further rate cuts in Australia saw the AUD continue to decline against the USD in March. The AUD fell 2.4% against the USD to finish the month at US76.4c. While this helped boost the returns of global shares on an unhedged basis for Australian investors, the benefit was offset somewhat by an appreciation of the AUD versus the Euro following the commencement of the ECB's program of purchasing sovereign bonds. This saw the Euro fall by more than 4% against the USD in March, bringing the decline in the Euro versus the USD to 22% since the start of 2015.

Major asset class performance as at 31 March 2015 (%)

Sector	Index	1 month	3 months	12 months
Australian Shares	S&P / ASX300 Accumulation	-0.1	10.3	13.9
Global Shares (hedged)	MSCI World ex Australia (hedged)	-0.2	5.2	16.7
Global Shares (unhedged)	MSCI World ex Australia (unhedged)	0.9	9.6	29.1
Global Emerging Markets (unhedged)	MSCI Emerging Free Net in AUD (unhedged)	1.0	9.5	21.9
Global Small Companies (unhedged)	MSCI World Small Cap ex Australia	2.7	12.0	26.1
Global Low Volatility Shares (unhedged)	MSCI World Minimum Volatility Index ex Australia (unhedged)	0.6	9.5	29.1
Global Listed Property	FTSE EPRA/NAREIT Developed Index ex Australia (hedged)	1.0	6.8	25.6
Cash	Bloomberg Bank Bill	0.2	0.7	2.7
Australian Fixed Income	Bloomberg Composite Bond All Maturities	0.8	2.7	11.1
Australian Inflation Linked Bonds	Bloomberg Government Inflation Index: All Maturities	0.7	4.6	17.4
International Fixed Income	Barclays Global Aggregate Bond Index (hedged)	0.8	2.6	10.3

Source: JP Morgan & ANZ Global Wealth

Economic highlights by region

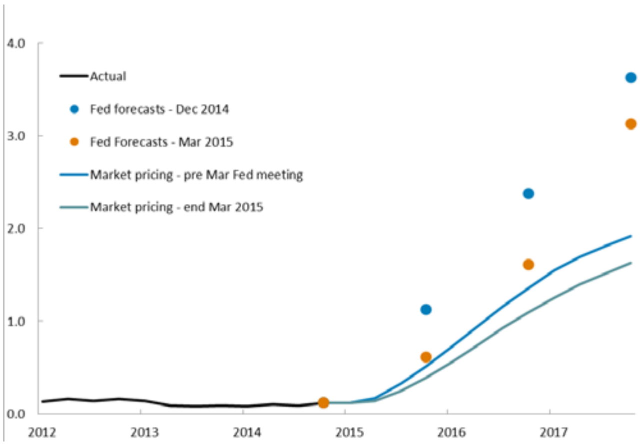
US

Economic momentum showed further signs of slowing in March from the strength seen around the middle of 2014. This slowing appears to partly reflect the impact of the strengthening USD on manufacturing activity. That said, this slowing appears to have been accentuated by a re-occurrence of poor winter weather. Survey measures of services activity remain consistent with robust growth in the domestic economy while a continued downward trend in claims for jobless benefits points to an ongoing fall in the unemployment rate.

Changes to the Fed’s interest rate outlook dominated headlines in March. As has been the case over recent years, the Fed lowered its expectations for growth and unemployment over coming years. More importantly, the estimate for the level of unemployment the Fed is aiming to achieve has been lowered from around 5.5% to 5%.

Along with a weaker inflation outlook, the Fed’s median projection for the path of interest rates was reduced over coming years. If realised, this would imply one of the slowest pace of interest rate increases undertaken by the Fed over at least the last 50 years.

US Fed Interest Rate Projections (%)



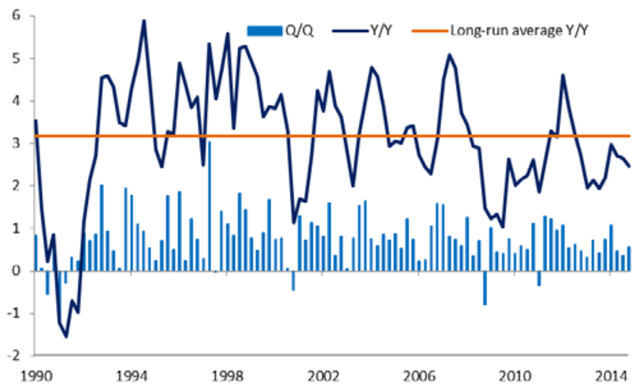
Source: US Federal Reserve

Australia

The Australian economy grew at a below trend pace of 0.5% in the December quarter, with annual growth over the year slowing to 2.5%. This compares to a long-run average economic growth of around 3.25%. Growth continues to be held down by a fall in mining investment following the boom of prior years, with business investment falling by 6% over the past year. This was offset by strong growth in exports as new mines commenced production. Pleasingly, there have been signs of a pickup in consumer spending in response to both lower rates and oil prices. However, declining business confidence and lacklustre consumer confidence suggest that uncertainty remains over whether the economy will successfully transition to more balanced growth in the face of a continued drop in commodity prices and national purchasing power.

In response to the economic data, the RBA, while leaving rates on hold in March, stated a clear bias to ease rates further. The market is expecting at least a further 50bps in cuts to a low of 1.75% over the remainder of 2015. The RBA also noted that an even lower AUD was needed to aid the transition of the economy.

Australian Real Economic Growth (%)



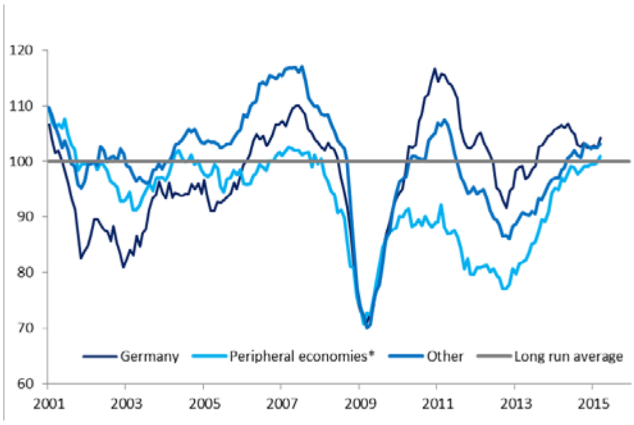
Source: ABS, ANZ Global Wealth

Europe

The clear signs of euro zone improvement in recent months continued throughout March. In response to the ECB's plan to purchase sovereign bonds and the resulting sharp decline in the euro exchange rate since the start of the year, key business surveys continue to post strong gains with many rising to their strongest levels in four years. Many of these surveys are now at levels consistent historically with growth of around 2%. Pleasingly, this growth appears to be increasingly broad based across the region, with growth picking up across peripheral European economies. Crucially for the medium term outlook, there are signs that efforts to clean up the banking sector with last year's stress tests and the ECB's efforts to increase its balance sheet are now feeding into a gradual increase in lending growth in the region.

On a less positive note, the failure of Greece to negotiate an easing in its debt bailout terms with the International Monetary Fund, ECB and European governments (known as the Troika), along with its reluctance to sign up to the tough reforms demanded by these creditors has raised the possibility of an eventual exit of Greece from the single currency euro zone. This has had little impact on markets outside of Greece, however, reflecting the ECB's stimulus measures as well as the fact that most of Greece's debt is now owned by the Troika and not by European banks.

Euro zone Economic Sentiment Index



Source: Thomson Reuters Datastream, ANZ Global Wealth
*** Greece, Spain and Portugal**

Asia

Chinese activity indicators showed weakness in the early part of the year. Growth in industrial production and investment in the first two months of 2015 slowed from the pace seen at the end of 2014. While this data is likely impacted by the timing of the Lunar New Year holiday in late February, purchasing managers surveys in March remain consistent with a slowing pace of growth. The Chinese Government lowered its growth objective for 2015 to around 7% (from 7.5% in 2014), with an increasing focus on achieving better quality and more balanced growth (i.e. characterised by stronger consumption and weaker investment growth). Nonetheless, policy makers continue to take steps to ensure a more worrying slowdown in growth does not eventuate, with the People's Bank of China (PBoC) cutting interest rates by 25bps in March. This followed a 40bps cut in interest rates in late 2014 and a 50bps reduction in February to the percentage of reserves banks are required to hold for lending.

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