Economic Update

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Market Highlights – January 2015

Central banks and inflation dominate markets

After months of speculation, the European Central Bank (ECB) extended its program of asset purchases to include euro zone government bonds in January. The program is essentially open-ended, with the ECB tying it to the achievement of its inflation objective, which makes it greater in size than financial markets expected. Other central banks, most notably the Bank of Canada, also eased policy in January while the Swiss National Bank abandoned its currency peg against the euro. The Swiss franc subsequently jumped 15% versus the euro.

Continued falls in oil prices drove further declines in inflation across most developed economies. In particular, the euro zone moved into deflation, with the extent of declines in headline prices intensifying at the start of 2015. Meanwhile, US wages growth weakened, which, alongside signs of slowing US growth, saw markets reduce their expectations for rate rises by the US Federal Reserve (Fed) over the coming two years.

All up, the drop in inflation and additional stimulus by central banks reinforced expectations that official interest rates would be held at a low level for a long period of time. This saw an intensification of the search for income (yield) as the main driver of financial market returns.

Fixed income continued to perform strongly

The international fixed income market returned 2.2% in January. The combination of lower inflation, central bank actions and signs of softening in the US economy drove further falls in government bond yields across most developed economies. This was especially the case in the US, where 10-year bond yields fell 53 basis points (bps) to 1.64%, a 20 month low, as markets reduced expectations for rate rises by the Fed. The market now expects just one rate rise in 2015 and a Fed funds rate of only 1% by the end of 2016, around half the Fed's most recent guidance. Meanwhile, the ECB's announcement saw a significant fall in all European yields.

The Australian fixed income market returned 1.6% as global factors saw strong demand for Australia's relatively higher yielding bonds. The Bank of Canada's decision to cut rates also saw markets move to price in more aggressive easing by the Reserve Bank of Australia (RBA) given the perceived similarities between both countries as significant commodity producers. Australian government 10-year bond yields fell 30bps to 2.44%, below the official cash rate, while 3-year yields dropped 18bps as markets priced in more than two rate cuts by the RBA.

ECB action boosts European shares, US lags

Global share markets totalled a negative return of 0.5% in local currency terms. This was mainly a reflection of the 3% decline in the US S&P 500 index where falling oil prices raised concerns about the earnings of energy producers and the rising US dollar (USD) was seen as limiting earnings more generally. This was somewhat offset by a sharp gain in European shares, with the Euro Stoxx 50 index jumping more than 7% after anticipating the ECB's bond-buying program and it being larger than expected when announced.

The weakness in developed market shares was more than compensated, for unhedged investors, by the continued weakening in the Australian dollar (AUD), particularly versus the USD. While the AUD rose against the euro following the ECB's announcement, the combination of falling commodity prices and expectations for rate cuts by the RBA saw it drop against most other major currencies, including a 5% decline against the USD to US77.6c. This saw global developed market shares return 3.2% on an unhedged AUD basis in the month.

The Australian share market performed well in January with a total return of 3.2%. This was despite weaker commodity prices, including a further 13% drop in iron ore prices, continuing to weigh on the resources sector which fell 1.2% in the month. As happened in December, investors were attracted by the higher yield of the Australian market, especially of the financial sector and property trusts, while the broader market was also supported by expectations for rate cuts by the RBA and the falling AUD.

Emerging market shares outperformed developed shares with a 0.6% return in USD terms. The rise in shares was fairly broad based across the major markets, with the exception of Brazil which was held back by falling iron ore prices. Indian shares continued to perform

especially well in local currency terms with a 6.4% gain, continuing the strong run of the past year which has seen the market gain more than 30%. On an unhedged AUD basis, emerging market shares returned 5.7% in the month.

Finally, listed property trusts posted extremely strong returns in January as investors were attracted by their relatively higher yield. Australian REITs posted a gain of 7.4% while global REITs gained 6.5%. Meanwhile, the recent rise in volatility saw low volatility shares achieve a 6.4% gain on an unhedged AUD basis versus a 3.2% return by the broader global share market on an unhedged AUD basis.

Financial Services Partners Pty Ltd
Level 23, 242 Pitt Street, Sydney, NSW 2000, Australia
ABN 15 089 512 587 AFSL 237590
T 1800 006 216 W www.fspadvice.com.au

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Economic highlights by region

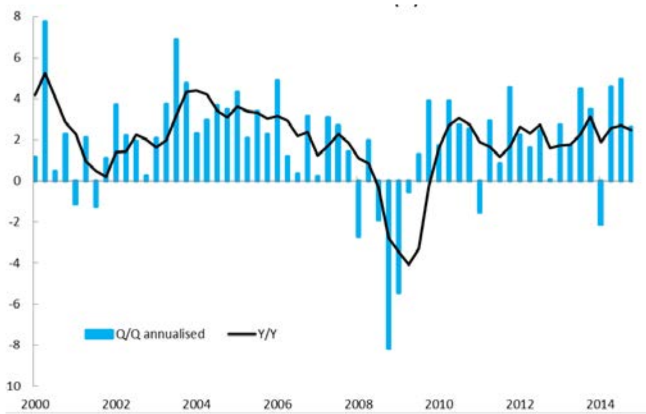
US

In January, economic data in the US pointed to a reduced pace of expansion following the very strong growth recorded around the middle of 2014. After averaging almost 5% (annualised) in the prior two quarters, growth slowed to 2.6% in the December quarter reflecting a fall in government defence spending, stronger import growth and slower business investment. This masked an increase in consumer spending to the fastest pace of the current expansion. While partial indicators point to this slower pace of overall growth being maintained into early 2015, there is nothing in the data which suggests a worrying slowdown in growth is occurring.

Inflation remained low in the month, with the Fed's preferred measure of core inflation easing to 1.4%, below its 2% target rate. Wages growth also waned suggesting that inflationary pressures were largely absent given the weak lead globally. While the Fed has clearly left the door open for an increase in rates after removing the statement "rates are likely to remain at their current low level for a considerable period", reference to international developments playing a role in the

Fed's deliberations was seen by markets as implying less rate rises were likely this year.

US - Real GDP growth (%)



Source: Thomson Reuters Datastream

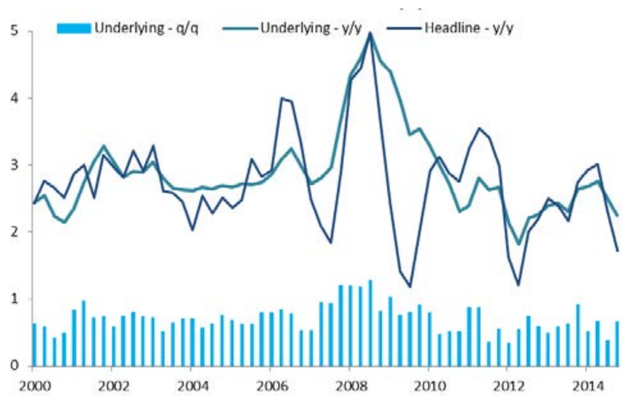
Australia

Labour market and inflation data took centre stage in Australia in January. Continued strength in employment saw the unemployment rate surprisingly ease back from its recent 12-year high, while several partial indicators point to continued robust demand for labour. Despite falling petrol and fruit and vegetable prices holding down headline consumer prices at the end of 2014, the RBA's preferred measures of underlying inflation rose on average by 0.7%, above expectations and annualising in the upper half of the RBA's target band. This did little to deter expectations for rate cuts by the RBA in 2015, with markets now expecting more than a 50bps fall in rates over the coming year. The RBA subsequently cut rates by 25bps to a record low of 2.25% at its meeting in early February citing weak domestic demand and a desire for a further decline in the currency.

Australia – Inflation* (%)

Source: ABS, ANZ Global Wealth

*** Excludes introduction of GST in 2000.**



Asia

Economic data in China was surprisingly positive in January. Industrial production rebounded by more than expected in December from the weakness in November. This was consistent with the view that at least some of the earlier weakness reflected a shutdown of factories in Beijing ahead of the APEC leaders' summit in November. This saw the overall economy grow by 7.3% in the December quarter, unchanged from the prior quarter and slightly ahead of expectations.

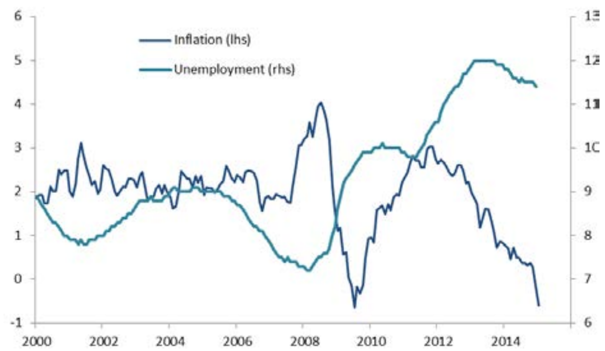
However, forward looking data continued to point to a weakening in growth momentum heading into 2015. The official manufacturing PMI fell below 50 for the first time since September 2012, with the details suggesting further weakness in industrial profits and a further run down in inventories in the near term. This paints a somewhat softer picture for industrial production over coming months.

Europe

Data momentum in the euro zone continued to show some improvement in January. After rising a little in December, following a period of decline since the middle of 2014, key business surveys posted further gains in January, with the purchasing manager's index (PMI) rising modestly in January to its highest level in five months. While the signs of improvement are encouraging, these surveys are currently only consistent with modest growth across the euro zone. With unemployment in the region elevated, deflation became more marked in January, with headline consumer prices declining over the past year by 0.6%, equal to the low point seen at the height of the GFC.

Against this backdrop, the ECB announced an expansion of its existing asset purchase program to include bonds of euro zone central governments, agencies and European institutions. The total size of asset purchases would amount to €60 billion a month, an additional €50 billion over and above the previous pace. Purchases of government bonds will be made by national central banks under the direction of the ECB in accordance with the average of the population and GDP weights of each country in the euro zone. Crucially, while the program will run from March until the end of September 2016, it is effectively open-ended as it is tied to the achievement of the ECB's inflation objective.

Euro zone – Unemployment and inflation



Source: Thomson Reuters & ANZ Global Wealth

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

Sector	Index	1 month	3 months	12 months
Australian Shares	S&P / ASX300 Accumulation	3.2	1.9	12.1
Global Shares (hedged)	MSCI World ex Australia (hedged)	-0.5	2.1	15.5
Global Shares (unhedged)	MSCI World ex Australia (unhedged)	3.2	11.5	20.1
Global Emerging Markets (unhedged)	MSCI Emerging Free Net in AUD (unhedged)	5.7	7.2	17.9
Global Small Companies (unhedged)	MSCI World Small Cap ex Australia	3.2	12.3	14.5
Global Low Volatility Shares (unhedged)	MSCI World Minimum Volatility Index ex Australia (unhedged)	6.4	14.7	24.2
Global Listed Property	FTSE EPRA/NAREIT Developed Index ex Australia (hedged)	6.5	10.3	29.9
Cash	UBS Bank Bill	0.3	0.7	2.7
Australian Fixed Interest	UBSA Composite Bond All Maturities	1.6	4.6	10.4
Australian Inflation Linked Bonds	UBS Government Inflation Index: All Maturities	1.8	6.5	15.4
International Fixed Interest	Barclays Global Aggregate Bond Index (hedged)	2.2	4.1	10.9

Source: JP Morgan & ANZ Global Wealth