Economic Update

Market Highlights – November 2014

October was a tumultuous month for financial markets. While markets generally finished up strongly, there was a marked spike in volatility as share markets declined before recovering in the second half of the month.

The fall in share markets in the first half of October reflected the continuation of the same concerns which weighed on markets in September. Investors were also disappointed by the details of the European Central Bank's (ECB's) quantitative easing program as the ECB stopped short of purchasing sovereign bonds.

From its peak in early September to the middle of October, the MSCI world ex Australia share index in local currency terms fell more than 8%, erasing all the gains seen thus far in 2014. The Australian share market fell just over 9%. The scale of this correction was broadly in line with that seen in mid-2013 (the so called 'taper tantrum') and mid-2012.

A liquidity event in bond markets in the month, which saw US 10-year Treasury bond yields briefly drop sharply (by more than 30 basis points (bps) to 1.86%), its lowest reading in 17 months, before rebounding to around its prior level, also contributed to market anxiety. This highlighted the negative side effect of government regulations to strengthen the banking sector following the global financial crisis, which have significantly reduced secondary market liquidity in bond markets. Arguably these regulations, while safeguarding the banking sector, have inadvertently increased the liquidity risk for the financial sector more generally.

Concerns over global growth alongside signs of renewed disinflation in developed economies saw investors re-evaluate the prospects for inflation. Lower inflation expectations saw investors push back the timing of the first interest rate rise in the US and the UK, while also reducing the extent of rate rises in New Zealand over the coming year. This saw a return of the search for yield which saw listed property markets strongly outperform broader share markets and emerging market shares also hold up relatively well.

As the month progressed, the release of economic data in China which showed a rebound in industrial production and a stabilisation in the beleaguered housing market helped stabilise sentiment.

Meanwhile, with expectations having been revised down prior to the start of the US earnings season, company earnings reports generally beat expectations as economic data showed the US expansion remained resilient. Combined with the prospect that interest rates would remain even lower for even longer, this saw share markets recover strongly in the second half of the month.

In aggregate, despite weakness in European markets, the MSCI world share market index finished the month 1.3% higher on a hedged Australian dollar (AUD) basis. The recovery in global shares was especially noteworthy in the US, with the S&P 500 finishing up 2.3% at a record high. Shares were also boosted at the end of the month by the surprise decision of the Bank of Japan (BoJ) to significantly increase the pace and scope of its asset purchase program. This saw the Japanese TOPIX surge 4.3% on the last day, which left the market up 0.6% for the month as a whole. A rise in the AUD in the month, especially against the Euro and Yen, saw unhedged global shares record a broadly flat result.

The return of the search for yield thematic saw emerging market shares outperform developed shares, posting a solid 0.7% return on an unhedged AUD basis in the month. The rise was fairly broad based across the major markets with the exception of South Korea.

The Australian share market performed particularly strongly in October, with the ASX 300 index finishing up 4.3% on a total return basis. This was despite continued weakness in commodity prices weighing on the resources sector. The return of the search for yield, the positive impact to earnings from the earlier decline in the AUD and relatively cheaper valuations following September's decline in shares saw the rest of the market rebound strongly.

Fixed interest markets performed strongly in October as the prospect of lower inflation resulting in central bank rates remaining even lower for longer saw government bond yields fall (prices rise). Both the Australian fixed interest and global fixed interest market returned 1.0% in the month. Australian government bond yields fell on net by more than their global counterparts, with 3 year yields dropping by 14bps and 10 year yields falling 20bps to finish the month at 3.28%, its lowest level in 17 months. However, this was somewhat offset by a rise in corporate credit spreads in the month.

After falling sharply in September, the return of the search for yield in October saw the AUD move higher against most major currencies. While the rise in the AUD was relatively modest against the US dollar (USD), it was especially large versus the Yen following the BoJ's stimulus decision at the end of the month.

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Major asset class performance as at 31 October 2014 (%)

Sector	Index	1 month	3 months	12 months
Australian Shares	S&P / ASX300 Accumulation	4.3	-0.7	6.1
Global Shares (hedged)	MSCI World ex Australia (hedged)	1.3	3.5	15.1
Global Shares (unhedged)	MSCI World ex Australia (unhedged)	0.1	6.1	17.4
Global Emerging Mkts (unhedged)	MSCI Emerging Free Net in AUD (unhedged)	0.7	1.3	8.4
Global Small Companies (unhedged)	MSCI World Small Cap ex Australia	1.3	4.9	13.7
Global Low Volatility Shares (unhedged)*	MSCI World minimum volatility index ex Australia (unhedged)	0.4	4.7	na
Global Listed Property	FTSE EPRA/NAREIT Developed Index ex Australia (hedged)	7.3	4.5	15.8
Cash	UBS Bank Bill	0.2	0.7	2.7
Australian Fixed Interest	UBSA Composite Bond All Maturities	1.0	1.6	7.1
Australian Inflation Linked Bonds	UBS Government Inflation Index: All Maturities	1.0	1.3	10.0
International Fixed Interest	Barclays Global Aggregate Bond Index (hedged)	1.0	2.3	7.9

Source: JP Morgan & ANZ Global Wealth

* Returns for Global Low Volatility Shares are only available since the start of December 2013.

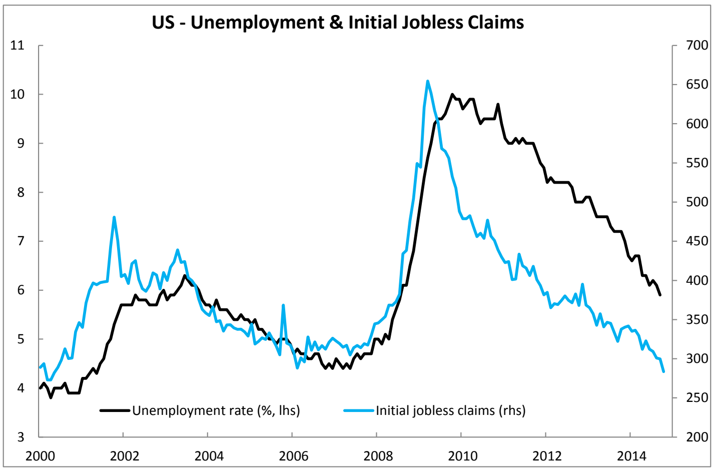
Economic highlights by region

US

While economic data in the US was weaker on balance in October, in aggregate it still pointed to an economic expansion that remains on a firm footing. The overall economy expanded by an annualised 3.5% in the September quarter, with growth buoyed by a strong contribution from net exports and increased Government spending. While domestic private demand grew at a more modest pace, a continued improvement in the labour market, with the unemployment rate falling below 6% and jobless claims trending lower, positive business confidence and a pickup in consumer confidence point to stronger domestic demand growth over the period ahead.

The Federal Reserve (Fed) ended its quantitative easing program as expected at its latest meeting. While the Fed continued to note it would be a considerable period before it commenced raising rates, the Fed's communication stressed that the decision as to when it raises rates was entirely dependent on the evolution of the economy

US - Unemployment rate (%) & initial jobless claims



SourceThomson Reuters & ANZ Global Wealth

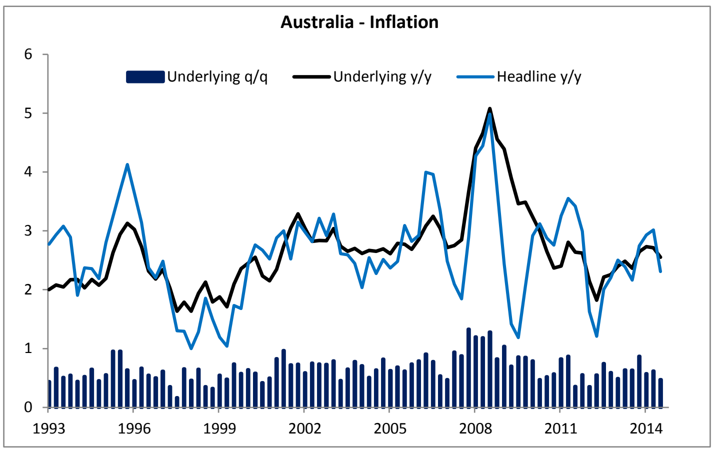
Australia

The key development in Australia in October was the release of consumer prices for the September quarter. The repeal of the carbon tax saw headline inflation ease lower to the bottom half of the Reserve Bank of Australia's (RBA) target range. Meanwhile underlying inflation was softer than expected, with annual growth slowing to around 2½%, the middle of the target range.

The activity data, meanwhile, was patchy, indicating the economy is still struggling to make the transition away from mining investment led growth. An earlier softening in consumer sentiment weighed on spending in the month, while business conditions fell, albeit to a still modestly positive level. The labour market was in focus after the Australian statistical agency acknowledged that limitations in its survey were impacting the integrity of the published figures. The unemployment rate continued to move slightly higher, while partial indicators such as job advertisements pointed to some improvement in the demand for labour. Against this back drop the RBA left rates on hold whilst continuing to point to rates remaining at their current stimulatory level for some time.

Australia – Inflation (%)

Source: ABS & ANZ Global Wealth



Europe

European industrial production dropped sharply in the latest month, however much of the weakness appears to have reflected temporary factors, most notably the shutdown of German auto production for annual maintenance. On a more positive note, there was stabilisation in business conditions outside of Germany after they had trended lower in earlier months. Elsewhere, the latest ECB stress tests of European banks revealed that 25 banks were under capitalised, though most of these banks have already moved to raise the required capital. Meanwhile, the latest bank lending survey showed that lending standards of European banks are finally beginning to ease following the significant tightening in credit availability of recent years. It also showed increased demand for loans from the private sector which suggests that private demand may be more positive moving forward than recent indicators suggest.

The ECB revealed details of its long awaited quantitative easing program, announcing it will commence purchases of covered bonds and asset-backed securities starting in late October. The ECB has ruled out, for now, purchasing sovereign bonds. While the initial intention is to return the ECB's balance sheet to the levels seen in early 2012 (an increase of up to €1 trillion from its current level), President Draghi's comments indicate a willingness by the ECB to continue asset purchases until inflation is in line with its target.

Euro area – Economic confidence & PMI

Source: Bloomberg, Thomson Reuters & ANZ Global Wealth

Asia

Economic growth worries eased in China in October. Though the pace of growth did ease lower in the September quarter, the extent of the slowdown was not as great as feared as industrial production rebounded from its August weakness. At the same time, there were signs that policy measures implemented by Chinese authorities were helping to stabilise the beleaguered housing market, with the rate of decline in housing transactions among China's largest cities easing.

In Japan, the BoJ surprised the market by announcing a significant increase in its quantitative easing program at the very end of October. The Bank announced it would increase the pace of growth in the monetary base to ¥80 trillion per annum, equivalent to 16% of gross domestic product (GDP), an increase of ¥10-20 trillion from the previous pace. This will be achieved by increasing the pace of annual purchases of Japanese government bonds (JGBs) to ¥80 trillion per annum and increasing its purchases of exchange traded funds and Japanese real estate trusts. The BoJ will also lengthen the average remaining maturity of its JGB purchases to between 7-10 years (from the current 7 years maximum) in an effort to encourage a decline in interest rates across longer maturities.