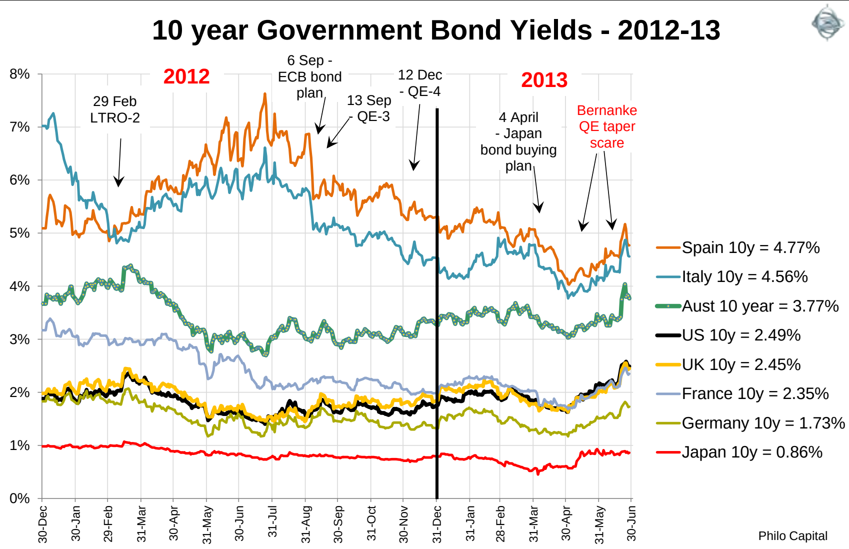
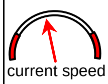
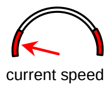
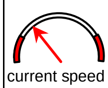
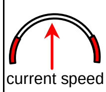
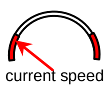


GLOBAL BOND YIELD SPIKE

The big story in global markets in June was the spike in bond yields. On 22 May US Federal Reserve Chairman Ben Bernanke suggested the US economy was recovering so well that it could be taken off life support after more than four years of trillion dollar deficits, zero interest rates and unprecedented "quantitative easing".

When he said: "we could, in the next few meetings….take a step down in our pace of purchases", investors panicked and sold down shares and bonds in the US and everywhere else in the world. He followed up on 19 June with his plan to "moderate" bond purchases later in 2013 and possibly end QE altogether by mid-2014 if inflation remained low and unemployment remained above 6.5%.

Yields on 10 year US treasuries shot up above 2.5% for the first time since the US credit downgrade crisis in August 2011. Yields also rose significantly in all markets globally except in Japan, the largest debtor nation.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	During June the March quarter GDP growth figure came in flat at 0.6%. This brought annual growth to 2.5%, a slowdown from the 3.2% growth in 2012. Unemployment is now at 5.5% having drifted up from below 5% two years ago, and not far below the GFC peak of 5.8% reached in mid-late 2009. Work force participation rates are declining, meaning more people are giving up the search for work. We are expecting unemployment rates to rise further as governments and businesses continue their cost cutting drives. This is likely to keep consumers hoarding cash instead of spending or buying major items or housing, and this may lead to more sub-trend economic growth over the coming quarters. All eyes are now on the new-old PM Kevin Rudd and whether he calls an early election so that voters are finally given a chance to end the uncertainty in Canberra.	Below average growth rate	Growth slowing	
Europe	Europe remains in recession while the government/bank debt crisis grinds on slowly. For example the banking union plan that was promised at the June 2012 summit is well behind schedule and has been watered down significantly. Germans are still very nervous about writing blank cheques to bail out foreign governments. In addition the German constitutional court is still wrestling with the legality of Germany supporting the OMT (Outright Monetary Transactions) program which is central to the PIIGS bail-out plan. One positive development was the IMF's admission on 6 June that its Greek bailout deal was too harsh as it gravely underestimated the negative growth impact of the austerity conditions. The Greek economy is still shrinking after 6 years and unemployment has risen to near 30%. This change of approach for the IMF echoes the May G7 meeting that advocated more positive support for deficit spending and delayed budget deficit targets. Offsetting this positive news, the global rise in bond yields will place even more pressure on heavily indebted governments when refinancing their debts.	Contracting	Remaining very weak	
US	There was a steady stream of mostly positive economic news from the US, confirmed by credit rating agency S&P's removal of its negative outlook for the US. (S&P had downgraded US debt on 5 August 2011 in the deficit ceiling crisis). The continued strengthening in the US economy prompted Ben Bernanke's 19th June statement on the planned exit from QE, confirming his 22 May statement. The unwinding of QE is conditional on unemployment and inflation targets being reached. Inflation is still very low at 1% to 1.5% pa, and has been declining from near 2% in late 2012 and 3% in 2011. The unemployment rate remains around 7.6% (down from 8.2% a year ago and 10% in late 2009) but participation rates are now improving, meaning more people are returning to the workforce and looking for work as confidence improves. House prices are rising, but this is mainly in the cities that fell most in the bust, and recent activity has been driven largely by investors. Ordinary families haven't yet been lured back in big numbers, so the Fed will be keen to keep mortgage interest rates low with QE. All of this means that the Fed bond buying program may well remain in place for some time yet. Meanwhile the budget deficit is contracting as tax revenues rise and the sequester cuts take effect.	Below average growth rate	Recovery remaining slow	
Asia	In the past couple of months we have seen concrete evidence of the new Chinese government's tougher stance on fiscal policy in its scaling back of infrastructure spending. In June we saw a big shift in monetary policy, which is conducted primarily through the banking system. On 20 June Chinese banks suffered a severe inter-bank credit squeeze when the Peoples' Bank of China (PBOC) unexpectedly refused to support banks during an otherwise normal cash drain over the Dragon Boat holiday season. The 7-day interbank repo rate shot up from 4% to 12% and 1-day rates in the shadow market reached 30%. The PBOC belatedly gave limited support after making its point - that it was finally getting serious about reining in credit growth in the big banks and also tackling the unrestrained and unregulated growth in the shadow banking sector. The Chinese economy continued to slow, with lower growth rates in industrial production, manufacturing, exports and imports. Imports of Australian iron ore and coal are holding up relatively well on relatively strong volumes, but on lower prices. In Japan Prime Minister Shinzo Abe revealed his much awaited "third arrow" of reforms on 5th June. The first two arrows were fiscal policy (deficit spending) and monetary policy (asset purchases). The "third arrow" was a flop as it didn't tackle the big issues required to bring about large scale reform. It failed to stop share prices falling and the yen rising after the 22 May reversal in the markets.	China: Cyclical slowdown Japan: Very slow	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	The local stock market fell a couple of per cent in June but is still ahead for 2013 to date - up 3% in price terms and up 5% including dividends. For the 12 month financial year to June the broad market returned a rather healthy 23% despite declining aggregate earnings. Our portfolios have been over-weight Australian shares over this time and our internal and external funds have also added significant value above the market indexes. During the month there were several more announcements of scale-backs in mining projects. There were also a number of big profit downgrades but most were from unrealistic profit outlooks to start with. The Newcrest selective leak to analysts ahead of its downgrade made headlines and will probably be in the courts for years. Then of course there was the great split-up for News Corp and also for Rupert and Wendy. So far the sum of the parts is worth more than the whole. But for Rupert and Wendy the sum of the parts will probably be shared by lawyers all round.	Around fair value	Around average long run returns
	Developed markets shares	Global stock markets fell 3% in June but this was more than offset by the 4% fall in the Australian dollar, leaving the AUD index up 1% for the month (as we are unhedged in portfolios). The global AUD index is ahead by a healthy 19% for 2013 to date and 27% for the 12 months to June. Most of the major markets are down by 5-10% since the 22 May turnaround, with Japan the worst with a 13% decline. However the Nikkei index is still up 32% for 2013, making it the best of the major developed markets. Next was the US (up 12%) and the major European markets up by single digits. We have been over-weight global equities in portfolios over the past year and have benefited both from the strong rises in markets and the falling Australian dollar.	Mixed – US is moderately over-priced on long term measures, but most other markets are under- priced to fairly priced	Around average long run returns, but currency gains expected (2)
	Emerging markets shares	Rising unrest among the middle classes dominated the news in June. This time it was in Brazil and Turkey, triggered by slowing growth, stalling of reforms and government corruption. June also saw renewed violence in Xinjiang, China. The big emerging stock markets were all down for the month. Not only are their economies slowing but foreign investors are fleeing in droves. China was once again the worst of the big markets, down 14% in June with escalating concerns over the health of its banking system.	Extremely hard to value. Many appear inexpensive to fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Bond yields in June shot up at the long end as foreigners fled in the great QE exit panic. Hardest hit were inflation linked bonds, as implied future inflation fell below 2.5% for the first time in a year. In most sectors the losses from rising yields in June merely offset the gains made from declining yields in April, leaving returns flat for the June quarter and also flat for the year to date. We have been under-weight bonds in portfolios, with small holdings mainly for liquidity purposes.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Although bank TD rates remain low in historical terms we have been favouring them over bonds for fixed income exposure. We have also been staying at the short end as we have been expecting long term interest rates to rise. Despite market yields on 3 and 5 year bonds rising by 0.30% and 0.40% over the month, TD rates have lagged. If bond yields stay on the rise they should flow through into higher TD rates in the coming months.	Rates around long run average	Around average long run returns
	Global Bonds	Global bonds sold off virtually across the board in June on the news of the Fed's plan to scale down its bond buying. Although yields are still relatively low historically, the initial sell-off from 22 May has probably been over-done. The Fed is likely to be under heavy pressure to keep mortgage rates low (which are mostly tied to long term bond yields), and the ECB will be under similar pressure in Europe to support growth. Japanese bonds were the only ones that didn't sell off, despite the dramatic upturn in growth and even the first signs of inflation (although Japanese bond yields did rise a little in May). So far in 2013 the global bond index (in hedged AUD) has been dead flat. We remain under-weight as we see yields rising further in the medium term.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA's target cash rate remains at 2.75% since the last cut on 7 May but short term treasury bills have stayed below the cash target, indicating further cuts are possible. The RBA may cut further if unemployment rates continue to rise as long as inflation remains benign. But the lower dollar could start to raise inflationary pressures from imported traded goods.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts have also been sold off since the 22 May turning point. Yield-chasing foreign investors have been the main force driving prices higher over the past year, and they were the first to retreat in the QE exit. The market is still up 8% for the year so far (including distributions), and 23% for the 12 months to June. We hold neutral weights on the sector, having been over-weight during much of last year's strong rise.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	With the slowing of the mining construction boom, policy makers have been banking on housing construction to fill the void. Low interest rates are helping, but banks are yet to let loose and embark on another wild lending spree. Nor is there any competition from non-banks or foreign lenders that might trigger the next credit boom. New construction activity and housing loan approvals remain slow in most areas, and we are yet to see a broad based return of first home buyers. First home buyers are critical as they are the ones who go on to drive spending on furnishings, white goods and other household items that boost the broader economy.	Varies by market, but over-valued overall	Below average to average long run returns
Australian dollar		The AUD fell further in June (mainly against the stronger US dollar and yen) in the global sell-off of emerging market or "risk" currencies. (In the GFC The AUD also sold off more than almost all other currencies and this has been the pattern again in the recent sell-off). Our un-hedged stance has significantly boosted returns on global shares thanks to the AUD's decline. Even after the recent falls, the AUD remains over-valued.	AUD above fair value	Currency gains for Australian investors as the AUD falls

(1) Expected "long term" returns refers to periods of 10+ years (looking through economic cycles) starting from the current position
(2) Returns for non-Australian assets are in AUD terms – ie including any profits/losses from hedging or currency movements