



ANOTHER GREAT YEAR FOR 'RISK' ASSETS

The 12 month period to June 2014 was another very good year for 'risk' assets. Australian and global shares generated around 20% returns for the year, as they did in the previous 12 months to June 2013. We have been over-weight Australian and global shares in portfolios since early 2012 near the start of the global share rally that has accompanied the long, slow economic recovery in the main developed markets: the US, Europe, UK and Japan (while the main 'emerging markets' have slowed or stalled).

In the case of listed property we were also over-weight during much of the big rally in 2012-3, but we were slightly under-weight in the recent 2013-4 year, when listed property returns were still good, but not as good as shares.

The so-called 'defensive' assets (bonds, cash, bank deposits) did relatively poorly again in 2013-4. We were under-weight 'defensives' during the past two years. (We don't regard these as 'defensive' or 'safe' as they suffer worse drawdowns and take longer to recover than shares in real terms after inflation).

On the commodities front, gold recovered a little from the big losses in 2012-3, but iron ore kept falling and coal was flat. Most industrial metals were a little stronger in 2013-4, with Chinese demand still holding up relatively well.

MAJOR MARKETS

		Current position	Direction / Trend	Pace of growth
Australia	<p>Uncertainty over the Federal budget continues to hamper confidence and investment in Australia. Public support for the coalition appears to have collapsed as the opposition and minor parties now oppose around \$25 billion of the proposed budget cuts. Clive Palmer's party has now hijacked the carbon tax debate with his emission trading scheme proposal backed by Al Gore. The government's legislative and policy agenda will be hampered further by the new Senate from July, when micro parties and independents will hold the balance of power. There is even talk of a possible double dissolution election being threatened.</p> <p>The top personal tax rate has been raised to 49% (including the 'temporary' deficit tax) from July 2014. The corporate tax rate is due to be reduced to 28.5% from July 2015 but the government has not been clear on whether future dividends paid out of past profits on which 30% tax was paid will be franked at 30% or only 28.5%, and this is concerning many investors. The unemployment rate is flat at 5.8% but this benign headline rate masks deeper problems – declining job numbers, increasing numbers of unemployed and falling participation rates. Continuing declines in coal prices caused coal miners to announce mine closures and project cuts, including at the world's largest coking coal miner, BHP. Iron ore prices also dropped below \$90 for the first time since September 2012, but prices recovered slightly by month end.</p>	Below average growth rate	Growth slowing	
	<p>The big event in Europe for the month was the European Central Bank's cut in interest rates to record lows on 5th June. It now charges negative interest rates to banks for their central bank deposits, in an attempt to prevent hoarding and stimulate lending by the banks. The ECB pledged to do even more to fight deflation and hinted at possible 'quantitative easing'. In the words of ECB's Mario Draghi: "We aren't finished here". This follows Draghi's warning on 26 May that "low inflation, a weak recovery and weak monetary and credit dynamics" could cause a "pernicious negative spiral". These conditions have been good for both shares and bonds. In the 12 months to June, European stock markets are up 20-40%, and European bonds have also generated double digit returns thanks to declining yields and credit spreads. Lithuania is to become the 19th country to adopt the Euro. This is a far cry from the hysterical warnings over the past couple of years of the imminent collapse of the Euro system. On the political front, following the European elections in May which saw the rise of the radicals and extremists, there is now an acrimonious battle for Presidency of the European Commission. German Chancellor Angela Merkel favours the left-leaning, centrist ex-PM of Luxembourg, Jean-Claude Juncker, but leading the opposing camp is Britain's David Cameron, who is feeling pressure from across Britain and from within his own Tory Party for 'less Europe'.</p>	Still virtually Stagnant	Very slow Recovery	
US	<p>Echoing the political fragmentation in Europe, on 10th June the Tea Party engineered a shock defeat of Eric Cantor in the elections for Republican House majority leader. This came as a rude shock to Republicans in their preparations for the upcoming Congressional mid-term elections in November in which they were expecting to control both houses. The March quarter economic numbers for the US were revised downward to a steeper contraction, but that was mainly due to the unusually long and cold winter, and it is all in the past. Despite this setback, the US economy continues to recover slowly. The job market remains weak although the official unemployment rate remains on a steady downward path. The Fed has now shifted its attention from jobs to housing as the main indicator of demand and growth. The housing market remains positive and has been assisted by declining mortgage interest rates in recent months as long term bond yields have eased. Meanwhile the 'QE taper' plan also remains on track without scaring share or bond investors to date, although consumer price inflation has started to creep up in recent months.</p>	Below average growth rate	Recovery remaining slow	
Asia	<p>The Chinese economy is slowing but the government appears committed to boosting activity artificially to keep the official growth rates above 7% as promised. Housing prices and construction activity are softening. Over-supply and declining new housing prices are flowing through to weaker construction activity, and are now starting to affect secondary market prices. This could lead to a 'pernicious negative spiral' in some over-built markets in second and third tier cities. Also affecting housing prices are forced sales from developers as they come under pressure from their major funding source - the shadow banks. Chinese price inflation is also weak. CPI is running at just 2.5% for year to May (mainly propped up by food prices), while producer prices have been declining for more than two years, a sign that production excesses still exceed demand. The Chinese trade surplus is expanding, mirroring the widening trade gaps in the US and Europe as import demand grows with their recovering economies. Industrial commodities prices were mostly positive for the month as Chinese factory production continues to exceed demand.</p>	China: Cyclical slowdown	China: Lower structural growth trend	
	<p>Japan: Early recovery</p>	Japan: Stimulus improving exports, production & growth		

ASSET CLASSES			Current position	Long term returns (1)
Shares	Australian shares	June was yet another very quiet month for Australian shares, with the All Ordinaries index hovering in the 5,400's range. Among the larger stocks the main move of note was Worley Parsons (in our portfolios) up 8% on higher oil prices. Newcrest (not in our portfolios) was also up 8% in a minor comeback in the gold price. The other major stocks were more or less flat for the month, including the big banks and big diversified miners. For 2014 year to date the overall market has returned a very modest 3% including dividends, and has lagged most other major global markets. However for the 12 months to June 2014 the Australian market has returned a very healthy 18%, mostly coming in the first half, and mostly from the big mining, energy and bank stocks. This 18% return for the 12 months to June 2014 is virtually the same as the return for the previous 12 months to June 2013. We have been over-weight Australian shares in portfolios since early 2012, near the start of the current rally.	Around fair value	Around average long run returns
	Developed markets shares	June was another very quiet month for developed markets, with all markets either up or down by just a per cent or so. The US market was up 2% for June bringing it to 22% for the 12 months, even better than the 18% in the previous 12 months to June 2013. Consistent with the European rebound theme, European markets dominate the winners table for the 12 months to June. The leaders were Denmark, Spain and Italy (up 40% or more), followed by Norway, Luxembourg, Canada, Belgium and the US (up 20% or more), with Australia lagging near the bottom of the table. We have been over-weight global shares since early 2012, favouring developed markets over emerging markets.	Mixed – US over-priced on long term measures, but other markets varied	Around average long run returns, but currency gains expected (2)
	Emerging markets shares	Emerging markets also edged up a little in June. Brazil and other Latin American markets were up, with the minor up-tick in iron ore prices. Argentina lost its appeal in US courts over its liability to repay principal and interest on bonds it defaulted on back in 2001. Despite Argentina's on-going debt and default woes, Argentina's stock market index was up another 2% in June, making it 46% up for the year to date. Russia was up strongly for the month with rising oil prices due to the worsening civil war in Iraq, but most other Eastern European markets were down. Chinese markets had a flat month and are still under-water for the year. Share prices there are holding up reasonably well in the face of widening talk of economic slowdown and declines in property prices. For the 12 months to June, India (up 31%) was the best of the major markets, mostly coming in the last couple of months due to optimism over Narendra Modi's BJP election win. Brazil just scraped into double digits, while China and Russia were barely positive. As usual, some of the markets in turmoil generated astronomical returns for brave speculators – eg. Venezuela (up 84%), Argentina (up 165%), Egypt (up 73%).	Hard to value. Many appear inexpensive to fair value, but are reliant on fickle global sentiment	Above average long run returns, but high volatility (2)
Fixed Income	Australian Fixed Income	Market yields on treasuries declined by about 10 basis points (0.10%) across all maturities from one year and longer as the outlooks for local economic growth and inflation softened. Yields on 10 year benchmark bonds are now down 70 basis points for the year, but are still around 80 basis points higher than the recent low reached in July 2012. Credit spreads are still at unsustainably low boom-time levels, epitomised during the month by ANZ being able to borrow 3 year fixed rate US dollars at just 1.25%, 40 basis points above the US 3 year treasury note yield. We have been under-weight domestic bonds in portfolios as we expect yields and credit spreads to expand in the medium term.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Bank TD rates declined during 2013 as underlying market yields on bonds were rising, and they have kept on declining in 2014 as bond yields have fallen back. We have favoured 'breakable' TDs over bonds this year as they have provided superior return for risk. However they are likely to be modified or restricted with the new bank liquidity regulations flowing from the 'Basel-3' banking reforms.	Rates below long run average	Below average long run returns
	Global Bonds	Bond yields in the US and UK lifted a fraction in June as outlooks improved for the US and UK economies and their central bankers started experimenting with words that would prepare the market for future rate rises without alarming investors. Japanese yields remained flat, but European yields fell back further, especially in France, Italy, Spain & Greece as fears of default are now well and truly a distant memory in the eyes of the market. June was another month of very low volatility and small, steady gains on global bond indexes. We hold global bonds in most portfolios but we remain underweight due to their over-priced levels. They are providing modest returns and they also usually provide a useful counter-balance when share prices fall, as they did in 2008 and 2011.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The Reserve Bank's target cash rate remains at 2.5% where it has been since August 2013. The RBA has shifted its interest rate bias from downward to upward over the past couple of months. It would like to cut rates further to help bring down the dollar, but that would probably increase housing speculation even further, and this is also worrying them.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market was dominated by the proxy battle for the restructure of the Westfield entities. The deal finally scraped through unit-holder polls, and the two new entities Westfield Corp (with operations outside Australia/NZ) and Scentre Group (Australian/NZ assets) replaced the old Westfield Group and Westfield Retail. The deal favours Westfield Group (in our portfolios) at the expense of Westfield Retail (not in portfolios). The overall listed property trust index was up a fraction in June. It returned 11% for the 12 months to June, compared to 18% from the broader Australian stock market. We have been virtually neutral on property trusts but over-weight shares.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	In the major cities the middle markets (up-graders) still appear to be relatively strong, but the bottom end (first home buyers) and top end are relatively weak. Demand for investment units still appears strong despite over-supply, rising vacancy rates and declining rents in many markets. Australian housing prices are still amongst the highest in the world on several measures and the Reserve Bank and Australian Prudential Regulatory Authority (which regulates banks) have been warning lenders about declining credit standards on housing lending.	Varies by market and by property	Varies by market and by property
	Australian dollar (AUD)	The AUD had another quiet month, drifting up a little, mostly against the weaker US dollar. The AUD fell against a stronger Sterling which rose on talk of possible rate hikes in the UK to quell their property bubble. The AUD was also weaker against the NZ dollar, also because of rate hikes in NZ to counter its property bubble. The Chinese RMB continued to rise for the second month after its controversial policy-induced slide earlier this year. We see the AUD as still being over-valued on fundamentals and we remain un-hedged for global shares.	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