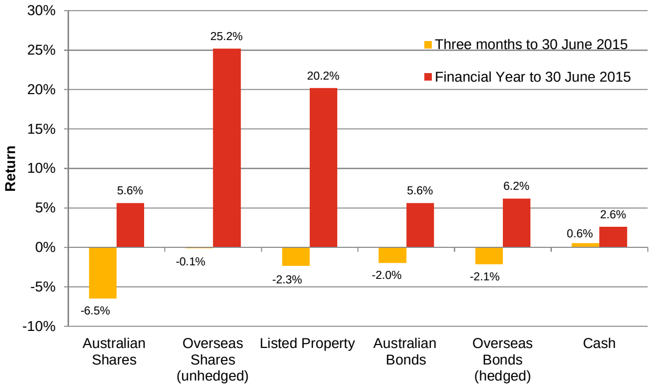
Markets take back some gains…

30 June 2015

June 2015 Quarter

This quarter saw a number of highs and then lows across most asset classes. The quarter started strongly on the back of the strong March quarter; however, markets retreated from that point with most indices ending lower for the three month period. Returns for a typical growth fund for the calendar year to date (around 4%) and the 2014/15 financial year (around 10%) are still quite strong.

Significant factors over the quarter were the RBA's 25bp rate cut from 2.25% to 2.00%, uncertainty on whether Greece would stay in the Eurozone, and the strong increase and then sudden decline in the China A shares market.



1. *All market returns shown above are before tax and before investment costs.*
2. *Indices used are outlined in the Disclaimer section of this newsletter.*

The US equity market was flat for the quarter. Optimism regarding growth in the US economy was dampened by concerns over interest rate increases, and market confidence was hampered by uncertainty within the European Union (EU) and China. Market optimism was boosted by an increase in corporate activity, with IPO's in the June quarter almost twice that of the March quarter.

The Japanese equity market was one of the best performing markets, returning 5.2%. This was primarily due to positive economic data following their monetary policy measures despite a weakened Yen versus the US Dollar. Financials was the best performing sector, with banks leading the charge returning over 18% for the quarter.

European markets had a tough quarter due to uncertainty surrounding the Greek sovereign debt crisis. Overall, the Europe ex UK index returned -4.4% over the quarter, while the UK market returned -2.8%. Following the start of the European Central Bank's €60-billion-a-month quantitative easing program, many countries within the EU have seen their sovereign bond yields fall below 0% for shorter dated bonds.

Australian equities returned -6.5%, largely due to weakening economic conditions and continued weakness in commodity prices, although the Australian Dollar strengthened marginally against the US Dollar over the quarter. All sectors delivered negative returns except for Energy which led the market, although only returned a meagre +0.3%. Financials (-9.0%) was one of the worst performing sectors, in particular the Banking sub-sector, due to increased capital regulations, as well as some banks reporting an increase in bad debt recognition.

Australian listed property returned -2.3% over the quarter, Australian bonds returned -2.1% and overseas bonds returned -2.0%, under-performing cash, which returned 0.6% over the quarter. Inflation increased in the June quarter, with CPI rising 0.7% and gives an overall inflation figure of 1.5% for the year.

Since 30 June 2015

The market volatility and uncertainty has continued into July, although at the time of writing there is some prospect that Greece's position in the Eurozone has been stabilised for the time being, and that Chinese markets have responded to the measures introduced by the Chinese government.

As at 24 July the US equity market has increased by around 1% and the Australian equity market is up by 2%. Unhedged global equity has been the best performer, returning 6% to date, due to a fall in the Australian dollar. Both Australian fixed interest and overseas fixed interest are up 1% at the time of writing.

Some longer term themes

Some key issues going forward include:

- **China equity market volatility** – The market correction on the Chinese Share market, which started from the middle of June has continued into July. The key aspects to watch are how the numerous policy measures implemented by the government play out over the short term. At the start of July, the government implemented a new policy almost daily in an attempt to slow the selling frenzy. Notable policy changes were surprise interest rate cuts, relaxed rules on paying back margin loans, suspended accounts from short selling, state owned funds purchasing in the open market, suspension of IPO's, increased funding lines to brokers from state owned corporations and almost doubling the Qualified Foreign Institutional Investor limits from $80b to $150b.
- **"Grexit"** – Monday 13th July 2015 saw the Eurozone reach agreement on further bailout support, keeping Greece in the Eurozone for the time being. The day of the news led to a boost in most global markets, particularly within Europe, and the announcement should hopefully boost market confidence in Europe over the short-term. A key aspect to watch is how this situation will play out is if Greece can implement further austerity measures and continue to pay their bailout instalments.
- **Falling CPI** – Currently many economies are experiencing a lack of economic growth, particularly within Europe, and some markets are experiencing deflation, whilst others like the United Kingdom have teetered around 0% CPI for most of 2015. Given interest rate movements commonly lag CPI movements, we may see further rate cuts globally if CPI continues to drop in these countries.

Paying governments for the privilege of lending to them

With bond yields at record lows, and the sovereign debt of 10 European countries now trading at a negative yield over short durations, it raises the question whether negative yielding bonds are worth the investment and who would invest in them.

Just the concept of paying to lend alone sounds absurd, and one would assume that such an investor has too much money to keep under their mattress! But there is some logic within the madness.

One aspect is that as the European Central Bank (ECB) continues its €60-billion-a-month quantitative easing programme, consuming the available debt in the market; which is likely to further increase bond prices, and lower bond yields. Therefore, investors are being forced to buy regardless of price given that the ECB is doing so. Typically many bond investors would buy bonds for income purposes, and therefore would opt for the highest yield available at their given level of risk. On the contrary, investors in negative yielding bonds expect that yields will continue to fall due to the quantitative easing from the ECB, and prices will continue to rise, allowing the investor to realise a capital gain by selling after yields fall further. These investors are willing to pay a small amount of yield for the potential price growth, over holding cash and making no return.

There is also the risk of deflation (i.e. negative inflation) in many countries, so given prices are falling, the negative yielding bond may still offer better upside potential than other investments.

Given the weak global economy, particularly within the European Union, negative yielding sovereign bonds look like they will continue to persist for the short term at least. Although the next question to ask would be if a negative yielding bond can still be classed as a defensive asset, or given 100% of upside potential is derived from price appreciation - a growth asset.

Chinese Share Markets

Looking at the China share markets is a little like opening a can of alphabet spaghetti, there are the A-shares, B-shares, H-shares, L-shares, N-shares, Red-chips, P-chips and S-chips, although typically most foreign investors only hear of the A-share and H-share markets. Currently access to the A-shares market for foreign investments is through approved Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII), which combined hold approximately 2% of the A-share market cap, with regulators considering increasing the quota to 15% over the next few years.

Due to the restricted access to the China A-shares market, they are not fully reflected in many World or Emerging Markets indices despite the significant market cap of Chinese equities. The China A Shares market is one of the largest in the world (second to the United States by market cap), although understandably many believe it is correct not to include them in indices fully, until global investors have better access to the underlying investments. The Chinese equities currently included in many global indices are typically those listed on the H-Shares index.

- **A-shares:** Public companies incorporated in mainland China and listed on the Shanghai or Shenzhen stock exchanges, priced in Renmimbi, and typically only available to mainland Chinese investors, QFII's and RQFII's.

- **B-shares:** Large cap companies incorporated in mainland China and listed on either the Shanghai stock exchange in US Dollars or the Shenzhen stock exchange in HK Dollars, these can be purchased by both Chinese citizens and foreign investors.

- **H-shares:** Mid-Large cap companies incorporated on mainland China and listed on the Hong Kong stock exchange in HK Dollars, these are open to all investors.

- **L-shares:** Small cap companies incorporated offshore (i.e. Bermuda, Cayman Islands, British Virgin Islands) and listed on the London stock exchange in GB Pounds, but have their main operations on mainland China. Open to all investors.

- **N-shares:** Any sized company, incorporated anywhere, listed on the New York stock Exchange or NASDAQ, but have their main operations on mainland China. Open to all investors.

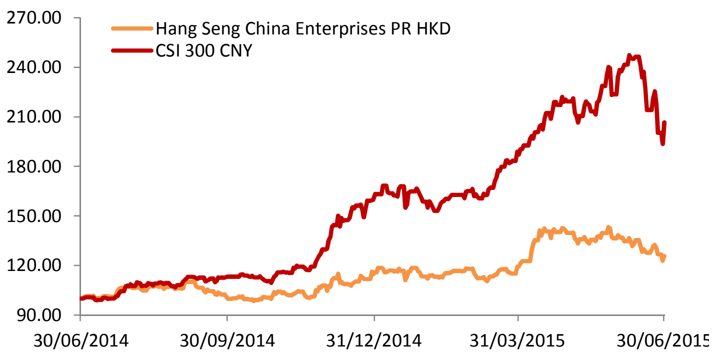
- **Red-chips:** Similar to H-shares, but the companies are either directly or indirectly controlled by the government.

- **P-chips:** Companies incorporated offshore, and listed on the Hong Kong stock exchange but have their main operations on mainland China. Owned by the private sector i.e. Chinese entrepreneurs and businessmen.

- **S-chips:** Small-Mid cap companies incorporated in Singapore or offshore, and listed on the Singapore stock exchange in SG Dollars, but have their main operations on mainland China.

News of a downturn in the China A-share market has dominated headlines since the middle of June, where the index has had significant volatility and a very sharp decline. The China A-shares market is unlike many other stock exchanges, where it is predominantly only invested in by domestic Chinese investors, as well as a few qualifying foreign investors. Most foreign investors looking to invest in Chinese equities would invest in the China H-share market, based in Hong Kong, which has performed in a similar fashion to the A-share market; however, with lower levels of volatility.

Unlike the China H-shares market, which is largely driven by economic fundamentals, the China A-share market has been largely influenced by speculation and debt driven expansion. In the period between 30 June 2014 and 30 June 2015 the CSI 300 index (the A-share version of the ASX 300) was up almost 150% at its peak, whilst comparatively the China H-share market was up 43% at its peak. Despite the CSI 300 index hitting a high on the 13th June and then falling 16% by the end of the month, it still returned +14% overall for the June quarter. The chart below shows the relative growth of the CSI 300 index and the Hang Seng China Enterprises Index (H-shares) over the year having been rebased to 100 at the start of the period.



Another issue for the China A-share market was that a significant number of investors bought on margin (i.e. borrowed to invest), which was becoming excessive as a percentage of the market cap.

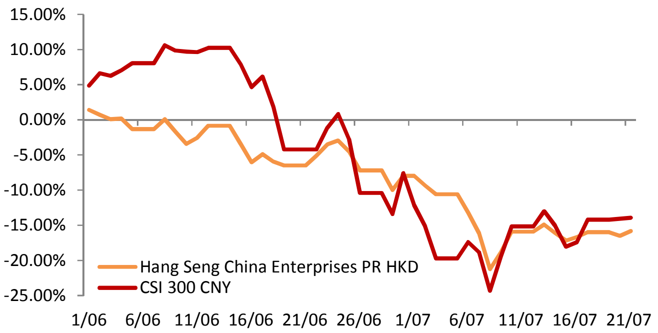
According to Morgan Stanley in a note from their China Equity Strategy Team, they state:

"We do note that the quantum of margin financing outstanding, one of our key concerns, has fallen by 22% from the peak at US$371bn on June 18 to US$289bn as of July 6. This reflects that the A-share market is going through a deleveraging process, which is encouraging, in our view."

With the unwinding of such a substantial amount of margin investing which is now occurring, we anticipate that there will be continued market volatility within China A-shares, which will also be felt in China H-shares, albeit at a much more muted level. Between the market down turn on the 13th June and the 27th June, the CSI 300 index fell by 18% due to the unwinding of margin loans, which induced a sell-off from other market participants.

To stem the falling index, Chinese authorities began to implement a quick succession of policies to boost markets, starting with a surprise interest rate cut and required reserve ratio cut. In July, further measures were taken almost daily, which included relaxing margin lending rules, allowing margin loans to be extended, suspension of selected short selling accounts, state funded purchases of index ETF's, suspension of IPO issuance, some fund managers pledged not to sell shares, whilst state owned firms were ordered not to sell shares, and for the benefit of foreign investment, QFII's had their overall quota raised from $80b to $150b.

The chart below shows the return of each index relative to 1 June 2015, where you can see the downturn of the CSI 300 Index on the 13th June, followed by both indices flattening out after the policy changes at the beginning of July.



Although the headlines portray the China A-share market as having fallen substantially, the bigger picture is that returns for the 2014/15 year are positive overall, with a 106% return on the CSI 300 index, whilst the H-shares delivered a 25% return. Leading further into FY 2015/16 further market deleveraging combined with monetary easing, should benefit the Chinese economy creating better quality growth activity within Chinese equities.

Greferendum

Greece has been relying on a series of financial bailouts by the European Union (EU) and International Monetary Fund (IMF) over the past six years to help manage the country's finances. The assistance from the EU and IMF was provided on the basis that Greece take austerity measures help the country to get its debt levels under control. However, the Greek government has not been strong enough on its austerity measures to improve the debt situation and for the IMF to extend its financial support it wants to see the Government taking stronger action. Speculation around a Greek exit (or Grexit) from the Eurozone led to a run on the banks and the imposition of capital controls in June 2015.

The fear was that if Greece leaves the Eurozone the country may revert to the drachma, and bank deposits would be converted to drachmas, presumably at a large discount to their current value. A decision by the Greek government to declare a referendum on 5 July on the terms of the latest bailout deal has taken the debt crisis to a new level, and resulted in Greece defaulting on its IMF debt.

This situation triggered a sell-off in equity markets as investors feared the flow on effects this would have on other countries like Italy, Spain and Portugal, particularly if it leads to Greece exiting the Eurozone. The sell-off resulted in a disappointing end to the financial year for equity market returns, with the S&P/ASX 300 Accumulation index falling 5.3% for the month of June.

July 5th saw the Greek referendum take place and a 'No' vote cast, by a 61% majority, against the latest draft bailout proposal. In the week following the vote further discussions commenced between EU officials in the lead up to the EU summit scheduled for Sunday 12 July. The EU summit ended up being a marathon 16 hour negotiation in Brussels, between EU officials and Greece, which resolved in Alexis Tsipras' agreement to further Greek austerity measures and economic reforms, in return for a third bailout package of up to €86b. The week following the 'all-night' EU summit led to a reshuffle within the Greek parliament, before further voting by the Greek government on a second set of reforms, which were approved on 23 July. So it appears at this stage that the immediate threat of a Greek exit from the Eurozone may have been averted.

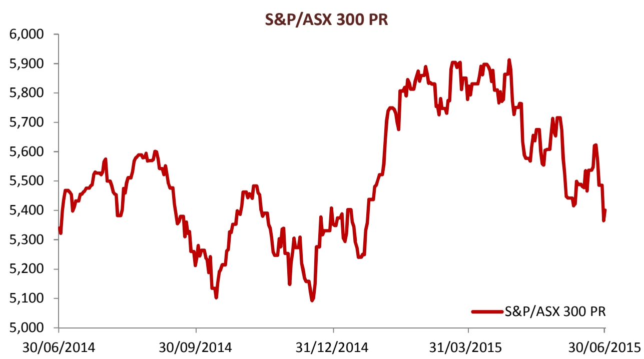
While these Greek risks exist, they have been known for a number of years, so European banks now have minimal exposure to Greek debt and the European Central Bank has actions available to deal with any potential contagion if required, such as expanding its quantitative easing program if financial conditions tighten too much. As a result we believe investors will eventually behave more rationally as they settle on the true level of risk that remains and we may have seen this with the rebound in equity markets in July.

Financial Year 2014/15 world markets round-up

The past 12 months have been a roller-coaster ride across many economies and many asset classes. The fall in the oil price was one of the first large events that rocked the boat, with prices tumbling from over $100 USD per barrel to lows of $50 USD per barrel.

Increased geopolitical tensions, particularly in the Middle East, have made headlines throughout the year and have the ability to cause further disruption to global markets. There has been increased quantitative easing in many regions, providing economic stimulus packages to boost growth and evade deflation, which proved successful in the United States.

In Australia, for the first 6 months of the year the S&P ASX 300 provided many bullish and bearish signals; however, overall there were little gains to be made, with the market returning 2.4% for the period.



The second half of the year saw a dramatic turn, with both January and February posting substantial gains. These gains were retained throughout March and most of April, with the ASX300 peaking at over 5900, before a rapid decline during the tail end of the June quarter, to end the year up 5.6%.

The Australian Fixed Income sector provided solid returns for investors, delivering 5.6% for the year. In both February and May, the Reserve Bank of Australia cut the cash rate by 0.25%, ending the year with a cash rate of 2.0%.

International Equities, in particular unhedged equities, had a significant year, delivering a return of 25.2%. Unhedged returns were significantly increased by the steady decline of the Australian Dollar over the course of the year. Throughout the year there has been steady optimism with regards to the US economy, and increased speculation as to when the Federal Reserve may begin to increase interest rates, following their announcement in the September quarter that they will cease their quantitative easing. US Equities remained strong over the year, with indicators that the market is now overvalued.

European equities had a relatively flat first half to the year, the region was fraught with weak economic growth, high unemployment rates and increased deflation speculation, leading to a European stimulus package being delivered at the beginning of March. The EU QE programme was well received in the March quarter with European equities ex UK increasing 15.2% over that quarter. But leading into the June quarter, increased "Grexit" woes fuelled by their sovereign debt crisis caused markets to decline, even though many countries are showing signs of increased economic activity. European bond markets have been hit by the Greek debt crisis, particularly in Greece, where the uncertainty of the Greek bailout has caused the yield on Greek short-term bonds to increase substantially, whilst the impact of the ECB's QE programme has caused other countries short-term sovereign debt yields to turn negative.

Australian listed property was one of the best performing asset classes over the past year, delivering double digit returns in the December quarter, followed by a strong March quarter, returning 11.3% and 9.2% respectively. The June quarter showed a slight retrace in the market, returning -2.3% to finish the year up 20.2% overall.

Indices Used:

Australian Shares: S&P/ASX300 Accumulation Index

Overseas Shares (unhedged): MSCI World(Ex Australia) Index in Australian Dollars

Overseas Shares (hedged): MSCI World(Ex Australia) Index (hedged)

Listed Property: S&P/ASX300 Property Trust Accumulation Index

Australian Bonds: Bloomberg AusBond Composite Bond Index (All Maturities)

Overseas Bonds (hedged): Citigroup World Government Bond (Ex-Australia) Index (Hedged)

Cash: Bloomberg AusBond Bank Bill Index

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