MARKET UPDATE

The global economy: March quarter 2015 review

Financial markets overview – equities and bonds

***All returns and yields are in local currency terms.**

It was a volatile and eventful first quarter of 2015, driven largely by central bank announcements. The European Central Bank (ECB) embarked on a large quantitative easing program, political risk re-emerged in Greece, the US Federal Reserve (the Fed) inched closer to the first rate hike, while concerns were raised over the slowdown in China. Commodity prices also continued to fall, particularly oil and iron ore, while the US Dollar (USD) continued its rally.

In Europe, the first surprise for asset markets was the Swiss National Bank (SNB) abandoning the cap on the Swiss Franc against the euro. This was unexpected and immediately led to a 30% rally of the Swiss Franc. The SNB also cut interest rates further into negative territory, lowering rates by 50bps to -0.75%. This was just prior to the widely expected announcement by the ECB of its Public Sector Purchase Program. The ECB did surprise the market by the size and scale of the plan, which will last through until at least September 2016 and amount to around €1.1trillion. Denmark and Sweden also eased monetary policy over the quarter, largely in response to low inflation and the move by the ECB.

Election results in Greece saw Alex Tsipras of the anti-austerity party, Syrzia, sworn in as Prime Minister. He pledged to renegotiate the country’s current bailout program with creditors. This reignited speculation of a Greek exit from the euro area if a new agreement could not be reached. To date, the current bailout program has been extended until the end of April after agreement on 20 February; although the terms of the agreement still need to be finalised. Mounting tensions between the two sides have raised the risk of a Greece exit from the euro area, with Greek 10-year yields rising from 9.75% to 11.63% over the quarter.

The Fed removed the word ‘patient’ from its policy statement at its March meeting, indicating it would now be dependent on the data in lifting the Fed Funds rate for the first time. This is despite US economic growth moderating in Q4 2014 and Q1 2015, driven by a stronger USD, poor winter weather, a slowdown in oil related capital expenditure and the west coast port strike. The USD continued to rally, with the US Dollar Spot (DXY) Index up 9% for the quarter, reaching its highest level since March 2003.

Volatility picked up slightly in the first quarter of 2015, although it is still relatively low despite recent events, particularly the increased concerns over a Greece exit from the euro. Volatility, as measured by the Chicago Board Options Exchange Volatility Index (the VIX) averaged 16.61 over Q1 2015, compared to 16.08 in Q4 2014 and it is expected volatility will continue to pick up as the first US Fed tightening comes closer.

A stronger USD and further monetary policy action by major central banks saw global equity markets record positive, albeit divergent returns. The MSCI World Index rose 1.8% in the quarter, led by strong gains in Europe and much of Asia. US markets underperformed. MSCI Emerging Market Index also rose, up 1.9% (led by Asia), while Latin America underperformed and produced a negative return. Asian markets were helped by a number of easing measures announced over the quarter, including China, India, South Korea, Indonesia and Thailand.

In the US, the S&P500 Index (+0.4%) rose but traded with significant volatility over the period, falling 3% in January, rising 5% in February and falling 2% in March. It reached an all-time record high on 2 March before retreating into quarter-end. Despite these loses, the S&P500 Index recorded its ninth consecutive quarterly advance, the longest run of quarterly gains since 1998. The Dow Jones fell (-0.3%) while the NASDAQ (+3.5%) gained ground.

In terms of sector performance, MSCI Energy (-4.6%) and MSCI Utilities (-5.6%) were the worst performing sectors given the continued weakness in the oil price. The best performing sectors were Healthcare (+7.8%) and Consumer Discretionary (+5.5%).

European equities had their best quarterly performance since 2009, assisted by the large scale quantitative easing program introduced by the ECB and the weakness in the euro. The euro had its worst quarter since it was introduced in 1999, falling 12.7% against the USD to end March at $US1.0731. Overall, the Euro Stoxx 50 Index rose 17.5%. In other equity markets, Germany (+22.0%), Italy (+21.8%) and France (+17.8%) rose sharply. Spain rose 12.1%, while the UK produced more muted returns, up 3.2%.

The Japanese equity market (Nikkei 225 Index, +10.1%) continued to rise over the first quarter of 2015, and is now up 31.4% over the past 12 months. Aggressive quantitative easing by the Bank of Japan (BoJ), and the consequent depreciation against the USD, which now totals 16.4% over the past 12 months, has helped the Nikkei significantly outperform the broad developed market equities index. Hong Kong (+5.5%) and Singapore (+2.4%) produced more modest returns.

The MSCI EM (Emerging Markets) Index rose 1.9% in Q1 2015 after falling 4.5% in Q4 2014. There were significant regional differences in performance, with the MSCI Emerging Markets Latin America Index underperforming in USD terms, falling 10.1% over Q1 2015. Sharp falls in commodity prices and the stronger USD have impacted this region. The Brazil IBOVESPA Index fell 15.5% in USD terms, hindered by lower oil and iron ore prices while the central bank lifted its official cash rate and the SELIC rate by 50 bps to 12.75% in March. This is in direct contrast to a number of easing measures by central banks over the quarter.

The oil price continued to fall over the quarter, with the price of West Texas Crude falling 10.6% to $US47.6 a barrel, while the price of Brent fell 3.8% to $US55.1 a barrel. Rising supply out of the Middle East and no production cuts from OPEC continued the weakness. Late in the quarter, rig counts in the US begun to fall and there were some signs of lower production and capital expenditure plans in the US.

Australian equities performed well in the March quarter of 2015, with the S&P/ASX 200 Accumulation Index rising in value by more than 10%. With the exception of the Energy sector, all areas of the market registered solid gains. Most ASX-listed companies published their results for the six or 12 months ending 31 December 2014 during February. As anticipated, few companies announced significant revenue improvements. There remains a heightened focus on cost control among Australian businesses, which is supporting a modest level of earnings growth in the market as a whole. Dividends remained reasonably high and some companies used balance sheet strength to return cash to shareholders.

Over the first quarter of 2015, longer-dated government bond yields fell across the US, the UK and Europe. All major developed bond markets were volatile and trading ranges increased. The US 10-year treasury yield ended the quarter down 25bps, closing at 1.92% despite the first lift off date for the Fed inching closer and changes to the policy outlook with the removal of "patient". Treasuries posted the longest stretch of quarterly gains since 1998, driven largely by lower inflation, and equated to five straight quarters of falling yields.

In Europe, the announcement of a large scale quantitative easing program and the uncertainty in Greece post the election result saw 10-year German bond yields end the quarter 36bps down to 0.18% and the 2-year yield falling further to a negative yield of -0.25%. Italian 10-year yields fell 65bps to 1.24%, French 10-year yields fell 35bps to 0.48% and Spanish 10-year yields fell 40 bps to 1.21%. In contrast, Greece 10-year yields rose 189bps to 11.63% on the election of the anti-austerity party Syrzia and heightened concern of the renegotiation of the bailout package or a potential default.

The 10-year UK Gilt yield fell by 18bps to 1.58% during the March quarter, with expectations that the Bank of England (BoE) will delay the first rate rise to late 2015 or early 2016 on low inflation. Japan was the only major developed market to see their 10-year government bond yields rise, albeit only 7bps over the quarter.

Longer dated Australian bond yields mirrored the direction of global yields and fell through the quarter. The yield on the benchmark 10-year government bond fell by 49bps to 2.32%. The Reserve Bank of Australia (RBA) cut interest rates by 0.25% to 2.25% in February, a move not fully anticipated by the market given stimulatory effects

of the falling oil prices and falling Australian Dollar (AUD). The shift from acknowledging the below trend GDP growth, higher unemployment rates and inflation and the lower end of the target range, towards monetary policy easing indicated the view that domestic growth had been delayed

Details of key events during the March quarter for the G4 major economies as well as Australia, New Zealand and China are as follows:

United States

The Fed; from "patient" to "not impatient"

The US Federal Open Market Committee (FOMC) made no changes to policy over the quarter, but did make substantial changes to its policy statement in March 2015. The Fed removed the word "patient" from the statement, which had indicated they would be patient before lifting rates. This change essentially makes every meeting live to begin the "lift off" process for interest rates.

However, the Fed did specifically rule out tightening at the 29 April FOMC meeting, with the FOMC stating it will be appropriate to raise the target rate for the federal funds when it has seen further improvement in the labour market and is reasonably confident that inflation will move back to its 2% objective over the medium-term.

The Fed statement also acknowledged that "economic growth had moderated somewhat" in early 2015.

Importantly, the Fed's dot plots, where each member expects the Fed Funds rate to be in the years ahead, were meaningfully lowered, further pushing out the timing and pace of rate rises being forecast by the bond market. This market continues to under-price the timing and size of potential rate rises.

The median forecast for the Fed Funds rate was lowered by 50bps from 1.13% to 0.63% for the end of 2015.

Growth moderates and downgrades for 2015

After a strong Q3 2014, with growth of 5% recorded on a seasonally adjusted annualised rate, the US economy slowed into the fourth quarter of 2014. The third estimate of Q4 2014 GDP recorded growth of 2.2% on a seasonally adjusted annualised rate. Consumer spending grew at its fastest pace in eight years, while net exports, business investment and inventories disappointed. For the whole of 2014, the US economy expanded by 2.4%, the strongest since 2010 and follows a 2.2% expansion in 2013.

Following on from a slower Q4 2015, there have also been downgrades to growth expectations for Q1 2015. These downgrades have been driven by a range of factors including the USD strength, the west coast port strike, poor winter weather and the fall in energy capital expenditure due to the lower oil price.

Inflation eases

The lower oil price and the rising USD saw inflation ease considerably over the March quarter. Headline inflation eased from 0.8% per year in December 2014 to just
-0.1% per year in March 2015. Falling gasoline prices contributed to the decline. While there are tentative signs core inflation (ie ex food and energy) prices are rising. Core inflation is running at 1.8% per year in March (the largest annual rate since October 2014), assisted by price gains for medical-care services, housing and clothing. The Fed's preferred measure of inflation, the Core Personal Consumption Expenditure Index (Core PCE), was 1.4% until the end of February 2015, where it has roughly remained since November and continues to be, below the Fed's 2% target.

Employment has mixed results

The unemployment rate fell to 5.5% at end of March 2015, down from 5.6% at end of December 2014. However, the pace of employment gains did slow, with 591,000 jobs added in Q1 2015 compared to 973,000 in Q4 2014. Cold weather, a stronger USD, the lower oil price and the west coast port strike all contributed to slower job gains.

Earnings have also failed to meaningfully move higher with average hourly earnings for all employees rising to 2.1% for end of March 2015, compared to 1.8% per year for end of December. Given falls in the unemployment rate, it would usually be expected for wages to have accelerated by this point in the cycle. Changes to the composition of

job gains and the fact that wages didn't fall during the worst of the job shedding between 2009 and 2012 have capped wage gains to date. It is expected that the Fed would have to see some upward wages pressure before lifting interest rates.

Europe

Greece…again

Greece elected a new Prime Minister Alexis Tsipras on 25 January 2015 from the anti-austerity party, Syriza. This development set off a new wave of concerns that Greece would leave or be forced out of the euro area. This follows a campaign by Syrzia to back-track on previously agreed reforms and budget measures. At this stage, the current bailout program has been extended until end of April, however the process has not been smooth and Greece still needs to provide the rest of Europe with a detailed list of reforms and budget measures.

The other difficulty is Greece is rapidly running out of money with tax receipts falling, given the state of uncertainty in Greece and the weaker economy. Greece did meet a repayment to the International Monetary Fund (IMF) in early April, however concerns remain of the next repayments due in May.

The European Central Bank delivers

At its 22 January meeting, the ECB announced an expanded asset purchase program as widely expected. Under this expanded program, monthly bond purchases will total €60billion and be carried out until at least the end of September 2016. Its success will be measured by a sustained adjustment in the path of inflation, which is consistent with our aim of achieving inflation rates below, but close to, 2%.

Based on monthly purchases of €60billion between March 2015 and September 2016, the total size of the program is around €1.1trillion. ECB purchases will include bonds issued by euro area central governments, agencies and European institutions. The ECB will be limited to 20% of losses, with the National Central Banks sharing the remainder. Securities will be purchased with a maturity of 2 years and 30 years.

The asset purchases started in early March and by the end of March had totalled €47.4 billion, with securities purchases in 16 of the 19 eligible countries. No securities were purchased in Greece, Estonia or Cyprus.

Some improvement in the growth outlook

Over the quarter, the growth outlook brightened in Europe. Q4 2014 GDP was recorded at 0.3% per quarter and 0.9% per year. Germany recorded growth of 0.7% per quarter, with retail sales data also improving in Q1 2015 and unemployment rate reaching a post-unification low of 6.4%. Elsewhere, Spain (+0.7%) and Portugal (+0.5%) recorded solid growth, while France (0.1%) and Italy (flat) and Greece (-0.4%) disappointed in Q4 2014.

United Kingdom

Inflation remains low

UK CPI was flat for the year to March 2015, down from 0.5% to December 2014 and 1.6% per year for the year to March 2014. Low petrol prices and an ongoing supermarket war are keeping inflation at extremely low levels.

Core inflation, which excludes energy food, alcohol and tobacco, slowed to 1% per year to March 2015 and was the lowest level since July 2006. This low inflation has so far kept the BoE on the sidelines after previously signalling a need to begin to raise interest rates, with concerns this low inflation could creep into wage negotiations and begin a lower wage lower inflation spiral. The unemployment rate fell to 5.6% in February, down from 5.8% three months earlier.

However, like in the US, there are only tentative signs of wages growth, running at 1.8% per year; the same rate as three months earlier. These factors are likely to continue to keep the BoE on the sidelines as concerns over inflation and the output gap remain.

UK economy still performing well

GDP growth for Q4 2014 was recorded at 0.6% per quarter and to 3.0% per year. Growth was driven by net exports and the consumer, with net exports contributing the most to growth since Q1 2013.

General election due 7 May 2015

The opinion polls ahead of the UK election are currently showing that the gap between the Conservatives and the Labour Party has narrowed considerably with the Conservatives at 34% and Labour at 36% in the YouGov poll from April.

At this stage, there are a whole range of possible outcomes including, the most like outcome of a hung Parliament, or a coalition government involving some combination of the Conservatives, the Liberal Democrats or the UK Independence Party, or Labour with one or more of these parties or the Greens. The Scottish Independence Party could also play a role, with large growth in its support in Scotland.

Japan

Bank of Japan leaves policy on hold

The BoJ left policy on hold over the first quarter of 2015. At this stage the BoJ left its qualitative and quantitative easing (QQE) program at an annual increase of ¥80trillion to its monetary base, after increasing the program in Q4 2014. There is some expectation that the BoJ will, at some point, expand its qualitative and quantitative program again given a lack of inflation pressures and disappointing growth data.

There was one dissenter at the meeting in April, with BoJ policy board member Mr Kiuchi proposing to lower the annual pace of expansion of the monetary base to ¥45trillion, but this was rejected by the rest of the board.

GDP growth disappoints

Q4 2014 GDP data was recorded at 0.4% per quarter, annualising at 1.5% per year.

The Japanese economy has failed to improve since the 1 April 2014 consumption tax hike from 8% and 10%, which tipped the Japanese economy into recession.

Inflation was 2.2% per year to February 2015, falling 0.2% per month. The BoJ's preferred measure, which excludes fresh food, fell 0.1% per month in February and hit a fresh low of 2%. Base effects should mean that inflation trends lower from here, as the consumption tax hike is removed from the year-on-year numbers. The question is: how low will inflation have to go before the BoJ expands its stimulus efforts?

China

Growth target officially reduced to 7%

The National People's Congress took place in early March with the 2015 GDP growth target lowered to 7% from 7.5%. The urban jobs target was maintained at 10 million, with the balance maintained between economic and social stability.

Premier Li called for "more forceful" fiscal policy and "appropriate" monetary policy to stabilise growth. As expected, there will be a focus on the continued development of the services.

China joins the party and eases monetary policy

The People's Bank of China lowered benchmark interest rates for the second time in this easing cycle on 28 February 2015. The 1-year lending rate was cut by 25bps to 5.35% and the deposit rate was cut by 25bps to 2.50%. This follows on from an interest rate cut in November and a Reserve Requirement Ratio (RRR) cut effective 5 February 2015.

There was also easing measures announced in the property market. The government announced a cut to both China's mortgage down payment requirement and property transaction tax policy today. One of these measures was the down payment requirement for all second mortgages has been lowered from 60% - 70% to 40%.

Lower interest rates and a lower RRR should act to improve both debt servicing burdens but also inject liquidity into the system.

China striving to be included in the IMF's Special Drawing Rights in 2015

China is aiming to have its currency included in the IMF's 4-currency basket of the Special Drawing Rights (SDR). This is a reserve asset created by the IMF and is used as a notional currency to value IMF member quotas. This would help recognise China as a key economic player and help confirm and promote further capital account liberalisation plans underway. In order for the Renminbi to be used, the currency has to be deemed to be "freely usable" (ie widely used and traded). This is likely to be a work in progress over 2015, but signals China's desire to increase the usability of its current and aim to liberalise its capital account as a priority.

Australia and New Zealand

The RBA surprises and cuts rates

After holding interest rates unchanged through all of 2014, only the third year it has done so in the inflation-targeting era that began in 1993, and signalling in December 2014 that "the most prudent course is likely to be a period of stability in interest rates", the RBA eased monetary policy by 25bps in early February, taking the cash rate to a new all-time low of 2.25%.

The RBA stated that "taking into account the flow of recent information and updated forecasts, the Board judged that, on balance, a further reduction in the cash rate was appropriate". The RBA's move followed a number of easing moves by other central banks in the early stages of 2015, including Europe, Japan, Switzerland, Denmark, Canada, India and Singapore.

In its February *Statement on Monetary Policy*, the RBA downgraded its growth and inflation forecasts. GDP growth is forecast in 2015 between 1.75% and 2.75% and between 2.75% and 3.75% in 2016 (ie growth will now take longer to return to above trend).

The RBA then proceeded to leave rates unchanged in March and April; although expectations of both money markets and economists are that a further rate cut is expected. The RBA also continued to express their concern over the strength of the housing market, with investor demand strong in parts of Sydney and Melbourne leading to price gains and gains in investor credit growth. However, at this stage the RBA is working with other regulators to "assess and contain risks that may arise from the housing market".

Australian economy slows

The RBA rate cut in February was vindicated with the release of soft GDP data for Q4 2014. GDP grew by 0.5% per quarter. This took the pace of annual economic growth down to 2.5% per year – the slowest pace of growth since Q4 2013. Australia's annual growth rate has now been below the trend level of around 3% per year since Q3 2012.

Growth in Q4 2014 was driven by a strong contribution from Net exports (+0.7%/pts) and Final consumption spending (+0.6%/pts). This was partly offset by a decrease in Inventories (-0.6%/pts), while an increase in dwelling construction was roughly offset by a decline in non-dwelling construction.

The Terms of Trade continued to fall, reinforcing weak income growth for the Australian economy. The Terms of Trade fell 1.7% per quarter and 10.8% per year and has now fallen 26% since its peak in Q3 2011. Weak income growth is hindering the Commonwealth Government's Budget due in May, with the income side of GDP growing 1.7% per year, compared to the production side of the economy growing at 2.5% per year.

Iron ore price collapses

The iron ore price fall sharply over Q1 2015, with the price of iron ore delivered to Qingdao China 62% Ferrous Content falling 28% in the quarter to $US51.35 / metric tonne. Softer Chinese demand and a sharp increase in global supply led by Australia and Brazil drove the price lower.

Over the whole of 2014, iron ore export volumes rose 24% and will rise a further 10% through 2015.

Australian dollar falls sharply

With lower iron ore prices and the US economy improving compared to the Australian economy, the AUD fell sharply in the March quarter, down by 6.9% to finish at $US0.7607. This is its lowest level since May 2009. The AUD is now in line with its post-float average of $US0.76 and well below its 10-year average of $US0.88

New Zealand economy still firing, RBNZ back to a neutral bias

Q4 2014 GDP data was released showing the NZ economy grew by 0.8% per quarter and 3.5% per year, roughly in line with expectations.

Growth was driven by strong domestic demand and also spending from tourism, which rose 15% over the quarter. Tourism has been strong from China, the UK and the US.

One other key area of growth was residential construction, helped by strong net migration, competitive mortgage rates and good employment prospects.

Despite continued strong growth, the RBNZ moved back to a neutral bias in its cash rate outlook over Q1 2015 stating "future interest rate adjustments either up or down, will depend on the emerging flow of economic data". The RBNZ left the cash rate on hold at 3.5% at each meeting over the quarter and highlighted the challenges to growth over the coming year, including drought conditions in parts of the economy, fiscal consolidation, reduced dairy incomes and the high exchange rate. Positives include, lower petrol prices helping to increase household purchasing power and lower the cost of doing business, strong employment and construction activity, high net immigration and supportive monetary policy.

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