

MARKET WATCH



October 2016

Market and economic overview

The Reserve Bank of Australia met on 1 November 2016 and, as widely expected, the cash rate was held unchanged at 1.5%. Q3 2016 Consumer Price Inflation data was released and was slightly above consensus estimates. The Australian dollar (AUD) strengthened against most major currencies over October. The AUD was down 0.7% against the US dollar (USD) to \$US0.7608. In the share market, the ASX/S&P 200 Accumulation Index lost 2.2% with most industry sectors finishing the month lower. Commodity prices were mixed, with metals varied and weakness in energy, except coal which saw significant increases.

Globally, cash rates were left unchanged. Share markets were mixed over the month, with weakness in the US and strength in Japan and European peripheries. Volatility continued as markets reacted to changes in the oil price, political concerns in the US and the prospect of a Fed rate hike in December.

Australia

The Reserve Bank of Australia (RBA) Board met on 1 November 2016, as widely expected, the cash rate was held unchanged at 1.5%.

The statement remained largely similar to the October statement, with inflation still described as “quite low” and “...expected to remain low for some time.”

The RBA did however, tilt slightly dovish on the commentary around the labour market, noting that “employment growth overall has slowed”. This was slightly tempered by the observation that “forward-looking indicators point to continued expansion in employment in the near term.”

Q3 2016 Consumer Price Inflation (CPI) data was released and was slightly above consensus estimates. Headline CPI rose 0.7% per quarter and 1.3% per year, from 1.0% per year in Q2. Key drivers included increases in fruit (+19.5% per quarter), vegetables (+5.9% per quarter) and electricity (+5.4 per quarter) prices, this was partly offset by falls in telecommunication equipment and services (-2.5% per quarter) and fuel (-2.9%.qtr).

Underlying inflation, the RBA’s preferred measure rose to 0.4% per quarter, slightly down from 0.5% per quarter in Q2 2016. The annualised rate fell slightly to 1.5% per

year from 1.6% per year. Both measures of inflation are still below the RBA’s 2-3% target band.

The September labour market report showed the unemployment rate decreased by 0.1% to 5.6%, driven by a 0.2% fall in the participation rate to 64.5%. The number of people employed fell by 9.8k below the +15k expected. The decrease was entirely driven by full time employment (-53k) while part time employment rose (+46k), continuing the recent trend towards flexible and part-time employment.

Consumer confidence increased over the month with the index up 1.1% to 102.4. The largest gains were seen in the Economy 1 year ahead (+5.8%) and consumer sentiment (+1.1%) components.

US

The US Federal Open Market Committee (FOMC) met on 1-2 November 2016 and as widely expected, left the official Fed Funds target rate unchanged at 0.25%-0.5%. While the November meeting was never considered “live” given its proximity to the US Presidential Election, we and the markets continue to expect a rate increase at the 13-14 December FOMC meeting.

In detailing the policy decision, the Fed statement was little changed from that released at the time of the September FOMC – with the Fed continuing to signal that a rate hike at the 14 December FOMC is the base case.

The Fed’s statement repeated the view that “near-term risks to the economic outlook appear roughly balanced” and that they will continue “to closely monitor inflation indicators and global economic and financial developments”. Given this, the Fed noted that “the Committee judges that the case for an increase in the federal funds rate has continued to strengthen but decided, for the time being to wait for some further evidence of continued progress towards its objectives.”

On inflation, the Fed upgraded their commentary a little, stating that inflation “has increased somewhat since earlier this year but is still below the Committee’s 2 percent longer-run objective, partly reflecting earlier declines in energy prices and in prices of non-energy imports” and that “market-based measures of inflation compensation have moved up but remain low.”

The first estimate of Q3 2016 GDP was released at 2.9% on a seasonally-adjusted-annualised-rate, better than the 2.6% expected and an improvement on 1.4% in Q2 2016. The better than expected print was helped by a recovery in net exports and an increase in soy bean exports which contributed 0.9% to the headline figure.

Growth in Q3 saw a slowing in domestic demand with consumption (+2.1%, down from 2.7% in Q2), business capital spending (+1.1%) and government spending (+0.5%) all weak or slowing.

Employment was slightly weaker than expected in September increasing by 156K, but still more than enough to cover the estimated natural increase in the labour force. Despite this, the unemployment rate increased to 5.0%, from 4.9% driven by a 0.1% increase in the participation rate to 62.9%.

Inflation has picked up slightly. Headline CPI was up 0.3% in September, with the annual rate increasing to 1.5% per year. Core CPI increased 0.1% with the annual rate falling 0.1% to 2.2% per year. Inflation continues to be driven by shelter and medical costs, with energy (+2.9% per month) also contributing to the increase in headline CPI.

The Fed's preferred measure of underlying inflation, the Core Personal Consumption Expenditure, was stable at 1.7% per year in September, around the level it has remained for most of 2016.

Europe

The European Central Bank (ECB) met on 20 October 2016 and left monetary policy unchanged, as largely expected.

ECB president Draghi dampened expectations that asset purchases would be tapered and reiterated the forward guidance that QE would continue at the monthly pace of EUR80bn until there was a sustained increase in the path of inflation consistent with the ECB's objective.

The market is expecting an extension of the ECB's QE program which is due to end in March 2017 at the December meeting.

The first estimates of CPI for the euro area in October showed an increase of 0.5% per year, the fastest since 2014. Core CPI was stable at 0.8% per year still well below the ECB's 2% target. Inflation was aided by the increase in oil prices over the last year with energy prices down -0.9% per year in October compared to -3% per year in September. Services remain the main driver of inflation at +1.1% per year.

The political deadlock in Spain ended over the month with Mariano Rajoy of the centre right Peoples Party sworn in a PM after winning a confidence vote, ending a 10 month period with no government.

UK

The Bank of England (BoE) Monetary Policy Committee did not meet in October; the next meeting is scheduled for 3 November 2016.

Over the month it was confirmed that the BoE governor Mark Carney would leave his role in 2019, before the end of the full 8 year term (2021), but long enough to see the UK through the Brexit. The decision appears to be due to personal/family reasons and not political pressure as speculated.

Q3 2016 GDP was better than expected increasing by 0.5% per quarter with no sign yet of a "Brexit" slowdown. The annual rate increased to 2.3% per year. Growth was entirely driven by service (+0.8% per quarter), while industrial production (-0.4% per quarter) and construction (-1.4% per quarter) slowed.

CPI data showed inflation increased by 0.2% in September, driven in part by rising oil and core goods inflation. The annual rate of inflation increased to 1.0% per year from 0.6% per year while core inflation increased to 1.5% per year from 1.3% per year. Rising oil prices and a lower currency are expected to continue driving inflation higher over the next year.

NZ

The Reserve Bank of New Zealand did not meet over October; the next meeting will be held on 10 November 2016.

Q3 2016 CPI was stronger than expected at 0.2% per quarter and 0.2% per year, down from 0.4% per year in Q2 2016 and still well below the RBNZ's target of 1-3% on average over the medium term.

Canada

The Bank of Canada left rates unchanged at 0.5% at their 20 October 2016 meeting.

September CPI increased by 0.1% while the annual rate rose to 1.3% per year from 1.1% per year. Core inflation was stable at 1.8% per year.

Japan

The Bank of Japan's met on 1 November 2016 and left monetary policy unchanged as widely expected.

China

The People's Bank of China left monetary policy unchanged during the month with no rate cuts or reserve requirement ratio easing.

Q3 2016 GDP released in October showed growth once again stable at 6.7% per year, the middle of the 6.5%-7% target band where it has remained for all of 2016.

Inflation increased in September for the first time since February, rising to 1.9% per year from 1.3% per year in August. Food price inflation continues to be the major driver of inflation, rising to 3.2% per year in September from 1.3% per year in August.

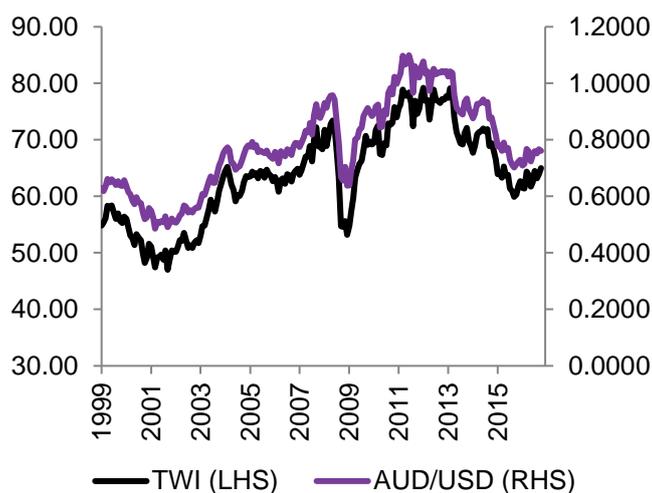
Chinese producer prices as measured by the PPI increase 0.1% per year in September, the first increase since 2012 and up from -5.9% per year one year ago.

Australian dollar

The Australian dollar (AUD) strengthened against most major currencies over October. The AUD was down 0.7% against the USD to \$US0.7608, but rose against the euro (+1.85%), the sterling (+5.42%), yen (+2.90%) and NZ dollar (+1.18%).

Improving commodity prices and terms of trade over the month supported the currency.

THE AUSTRALIAN DOLLAR STRONGER (EXCEPT AGAINST THE USD)



Source: Bloomberg as at 31 October 2016

Commodities

Commodity prices were mixed over October with metals varied and weakness in energy, except coal which saw significant increases.

The price of West Texas Intermediate Crude finished the month at \$US46.86 per barrel down 2.9%, while the price of Brent was down 4.2% to \$US48.61 per barrel. Oil prices rose early in the month, around optimism that a potential OPEC deal would reduce excess supply. Before falling in the last week of October as the market realised any production cuts would be difficult to achieve and would likely exclude key OPEC producers (Iran, Iraq, Nigeria and Libya).

Increasing activity in the US energy sector also weighed on markets with US rig counts now up nearly 40% from the lows reached in May this year.

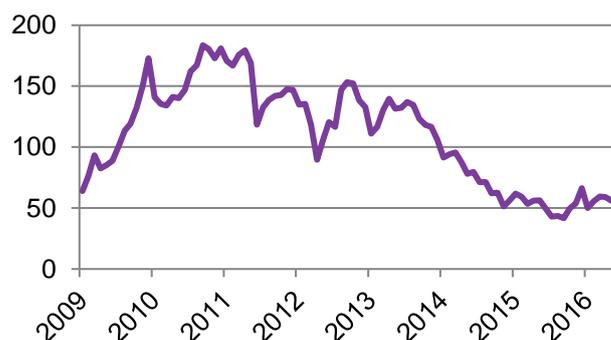
Gas prices were mixed with the US Henry Hub spot price down 7.9% to \$US2.79/MMBtu while the UK natural gas price was up 18.5% over August.

Iron ore prices were stronger over October, up 15.3% to \$64.38/metric tonne, as measured by the benchmark price of iron ore delivered to Qingdao China, the highest level is May 2015.

Coal was the best performing commodity over the month with increasing demand from China, due to domestic mine closures, pushing prices higher. The price of Newcastle thermal coal increased 50.4% to \$108.6 per metric tonne over the month.

Zinc (+3.4%) and Aluminium (+3.6%) rose over October while Nickel (-0.9%), Lead (-2.8%), Gold (-3.3%) and Copper (-0.2%) were all weaker.

IRON ORE UP WITH CHINESE DEMAND



Source: Bloomberg as at 31 October 2016

Australian shares

The ASX/S&P 200 Accumulation Index lost 2.2% during October, with most industry sectors finishing the month lower. Health Care (-8.3%) was among the worst performers, dragged lower by industry heavyweight CSL.

Bond proxy sectors continued September's decline, as the market reacted to rising bond yields and a potential rise in US interest rates. AREITs (-7.9%) and Utilities (-3.0%) once again underperformed the broader market.

Energy (-2.3%) started the month strongly, but finished lower as doubts surfaced around OPEC's commitment to cut production. Whitehaven Coal had another strong month on the back of rising coal prices, adding to the 333% share price appreciation since the start of 2016.

Materials (1.3%) outperformed the market with strong performances from Fortescue Metals and Rio Tinto, which benefitted from a strengthening iron ore price.

Financials (0.7%) edged higher, led by banks as sentiment towards the sector improved. Banking stocks typically enjoy investor interest during October, as three of the big four banks go ex-dividend in the first half of November.

Listed property

The S&P ASX 200 A-REIT index continued its recent decline, falling by -7.9% in October. Higher bond yields dampened sentiment towards REITs and other income-oriented investments.

Office A-REITs held up relatively well on the view that robust leasing demand from the financial services, legal and technology sectors would support Sydney and Melbourne's office markets.

The best performing A-REITs were Charter Hall Retail REIT (-1.9%), which stabilised following steep declines in August; and Dexus Property Group (-2.3%), which held an investor day and provided a first quarter update.

The worst performing A-REITs were Iron Mountain (-12.1%) and Scentre Group (-10.4%). Although neither company announced material news, broader sector underperformance weighed on both stocks.

Listed property markets offshore also dipped in October. The FTSE EPRA/NAREIT Developed Index (TR) fell by -5.7% in US dollar terms. Despite ending the month lower, Hong Kong (-1.3%) was the best performing region for a third consecutive month, followed by Japan (-1.4%). Property securities in Continental Europe and the UK lagged.

Global shares

Global share markets were mixed over October with weakness in the US and strength in Japan and European peripheries. Volatility continued over the month as markets reacted to changes in the oil price, political concerns in the US and the prospect of a Fed rate hike in December.

The MSCI World Index was down 2.0% in US dollar terms in the month of October and -1.3% in Australian dollar terms.

In the US, the S&P500 (-1.9%), the Dow Jones (-0.9%) and the NASDAQ (-2.3%) were all weaker, driven by broad market weakness. While earnings largely beat (reduced) expectations, the results were more "less bad" than good.

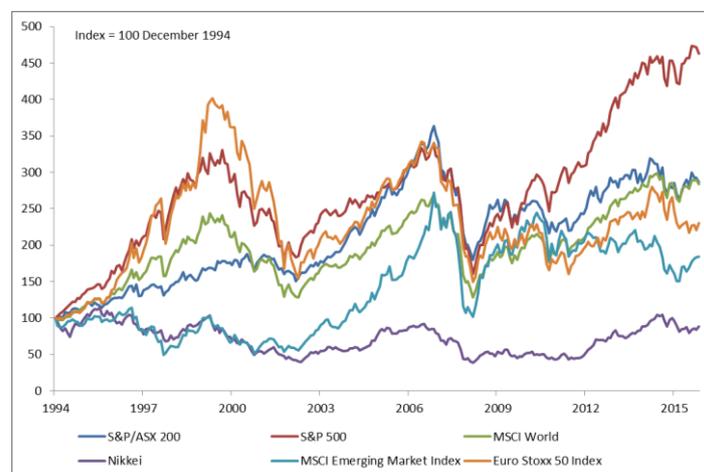
US markets also stumbled at the end of the month as it was revealed the FBI had found more Clinton emails in a separate investigation.

On a sector basis, MSCI Financials (+2.13%) was the best performer, as bank stocks climbed with rising yields. MSCI Health Care (-6.94%) was the worst performer as political noise around drug pricing and earnings concerns of medical device companies carried over to the rest of the sector.

Share markets in Europe were stronger over the month. The large cap Stoxx 50 Index rose 1.8% driven by strong performance in the periphery, with Greece (+4.5%), Italy (+4.4%) and Spain (+4.1%) all stronger. Elsewhere the UK FTSE100 (+0.8%), France (+1.4%) and the German DAX (+1.5%) all rose.

Asia markets were mixed with the Japanese Nikkei 225 (+5.9%) and Taiwan (+1.3%) up while Singapore (-1.9%) and Hong Kong's Hang Seng (-1.6%) fell.

EQUITY MARKETS REACT TO UNCERTAINTY



Source: Bloomberg as at 31 October 2016.

Global emerging markets

Emerging market shares were almost flat over October in USD terms with the MSCI Emerging Market Index up 0.2%, outperforming DM equities.

Despite the 3% rally in USD index and higher US yields emerging markets performed well in local currency terms aided by the pick-up in key commodity prices.

MSCI EM Latin America was the best performing region over the month rising 9.72% in USD terms with a strong rebound in Brazil (+11.2%) driven by positive political developments

MSCI EM Europe, Middle East and Africa (-0.28%) and MSCI EM Asia (-1.54%) underperformed.

The Shanghai Composite Index was stronger, up 3.2% on stable Chinese growth and stronger domestic consumption.

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