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Colonial First State

Market View – July 2016

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Summary

The Reserve Bank of Australia (RBA) left the official cash rate on hold at 1.75% at its July meeting, as was widely anticipated by financial markets. The US Federal Open Market Committee (FOMC) met on 26 and 27 July and left rates unchanged. This was largely expected. The European Central Bank (ECB) met on 21 July and as expected no policy changes were announced. The Bank of England (BoE) met on 14 July and unexpectedly left policy unchanged, despite the market expecting a significant easing package to combat the expected post-Brexit economic weakness. The Bank of Japan's (BoJ) policy board met on 29 July and eased monetary policy, but by the barest of measures, disappointing markets.

Australia

The Reserve Bank of Australia (RBA) left the official cash rate on hold at 1.75% at its 5 July 2016 meeting, as was widely anticipated by financial markets. However in its 2 August 2016 meeting, the RBA cut the cash rate by 25 basis points to 1.50%. In the statement they noted that "prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by easing monetary policy."

The RBA stated that moderate growth in dwelling prices, considerable supply of apartments over the next couple of years and slowing growth of lending for housing purposes "suggests that the likelihood of lower interest rates exacerbating risks in the housing market has diminished."

The results of the Federal Election became more certain with the Coalition likely to win the 76 seats required to form government in the House of Representatives. The Labour Party will win 69 seats whilst the Xenophon Team, Greens and 3 independents will all now hold 1 seat each. Although still being counted, it appears that in the Senate both the Coalition and Labour Party will lose seats while it is likely that Pauline Hanson and Derryn Hinch will become senators. The preliminary results suggest that the smaller parties will again hold the balance of power in the Senate.

Q2 2016 Consumer Price Inflation (CPI) data was released and was in line with consensus. Headline CPI rose to 0.4% per quarter but was down to 1.0% from 1.3% per year in Q1. Drivers included increases in auto fuels (+5.9% per quarter) and medical and hospital services (+4.2% per quarter) which were largely offset by declines in domestic holiday travel and accommodation (-3.7% per quarter) and telecommunications equipment and services (-1.5% per quarter).

Underlying inflation, the RBA's preferred measure, rose to 0.5% per quarter, slightly up from 0.2% in Q1 2016. The annualised rate remained at 1.5% per year.

The June labour market report showed the unemployment rate increased by 0.1% to 5.8% with the participation rate increasing slightly to 64.9% from 64.8%.The number of people employed increased by 7,900, below the 10,000 expected whilst number of hours worked declined by 0.3%.

Retail sales increased by 0.2%. This was driven by an increase in food (0.7%) and other retailing (1.4%) whilst household goods (-1.1%) and apparel (-1.2%) declined.

US

The US Federal Open Market Committee (FOMC) met on 26-27 July and left rates unchanged. This was largely expected.

The statement was slightly more positive than previous releases with the FOMC stating that "near-term risks to the economic outlook have diminished."

The FOMC noted that the labour market had "strengthened" and the expectation was for inflation "to remain low in the near-term, in part because of earlier declines in energy prices, but to rise to 2 per cent over the medium-term." The FOMC reiterated its view that "economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate."

The first estimate of Q2 2016 GDP was released at 1.2% on a seasonally-adjusted-annualised-rate, lower than the expected 2.5%.

Growth in Q2 was driven by improvements in consumer spending (+4.2%) while weak business investment (-2.2%) and government spending (-0.9%) were the laggards.

Employment was stronger in June, increasing by 287,000 from 38,000 in May (+180,000 was expected). Payrolls average 147,000 over Q2 2016 compared to 196,000 in Q1 2016 and 229,000 over 2015. Despite this the unemployment rate increased by 0.2% to 4.9%.

Inflation remains subdued. Headline CPI remained at 0.2% in June and 1.0% per year, whilst core CPI increased 0.1% to 2.3% per year.

Energy (+1.3%) and transport (+0.6%) increased while apparel (-0.4% per year) and food (-0.1%) declined.

Retail Sales increased by 0.6% in June, greater than the 0.1% expected.

On the political front we had both the Democratic and Republican National Conventions where Hilary Clinton and Donald Trump officially accepted their party's Presidential nominations.

Europe

The European Central Bank (ECB) met on 21 July 2016 and as expected no policy changes were announced.

The statement acknowledged Brexit but noted that financial markets were seen to have weathered the news with "encouraging resilience", leaving financial conditions "highly supportive" of the economic recovery and the projected inflation pickup.

The ECB stated it will "very closely" monitor the incoming data and pledged to reassess the outlook "over the coming months".

Preliminary GDP data was released for the euro area showed growth of 0.3% per quarter, in line with expectations. Annual growth for Q2 2016 fell to 1.6% from 1.7% per year in Q1 2016. The only two large economies to release national GDP so far have been Spain (+0.7% per quarter) and France (+0.0% per quarter).

The first estimate of July CPI for the euro area was recorded at -0.2%, an increase from +0.1% per year in June.

UK

The Bank of England (BoE) met on 14 July 2016 and unexpectedly left policy unchanged. The market had been expecting a significant easing package from the BoE to combat the expected post-Brexit economic weakness after Governor Mark Carney's comments that more stimulus was "likely to be required" in the summer months.

The decision to remain on-hold seems to be driven by a desire to wait for the August inflation report and the opportunity to re-state the forecasts for growth and inflation as well as wait for further activity date post-Brexit.

Over the month, confidence surveys for business and consumers showed mixed results. Business confidence as measured by the Lloyds Bank Business Barometer rose to 29 from the post-vote low of 6, almost recovering to May's level of 32. Consumer confidence, however, fell more than expected to -12 from the post-Brexit reading of -9, compared to -1 before the vote.

Q2 2016 GDP was better than expected, increasing by 0.6%. The annual rate increased to 2.2%. Industrial production (+2.1%) showed surprising strength over the quarter while Services (+0.5%) remained supportive. Growth is expected to slow in H2 16 as the Brexit vote weighs on business investment and retail sales.

CPI data showed inflation increased by 0.2% in June, driven by the volatile transport services component. The annual rate of inflation increased to 0.5% from 0.3% while core inflation increased to 1.4% from 1.2%.

Japan

The Bank of Japan's (BoJ) policy board met on 29 July 2016 and as expected eased monetary policy, but by the barest of measures, disappointing markets.

The BoJ announced it would conduct a "comprehensive assessment" of the economy and its policy regime at the September meeting, suggesting the possibility of further easing or a change to monetary policy.

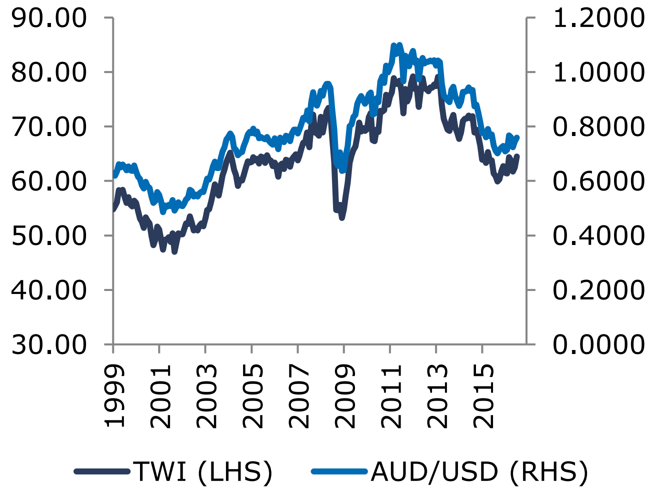
Headline CPI remained low at -0.4% over June while the core measure excluding food and energy fell to 0.4% from 0.6% per year in May, both well below the BoJ's 2% target.

Australian dollar

The Australian dollar strengthened against the major currencies in July. The AUD finished up 2.0% against the USD to $US0.7596. This was despite the soft Q2 CPI print and the expectation of further easing from the RBA in August.

The Australian dollar rose against the euro (+1.15%), the sterling (+2.30%), the yen (+0.89%) and NZ dollar (+0.95%) over the month of July.

AUSTRALIAN DOLLAR STRONGER DESPITE EXPECTATION OF FURTHER RBA EASING



Source: Bloomberg as at 31 July 2016

Commodities

Commodity prices were mixed in July with oil weaker but most metals stronger.

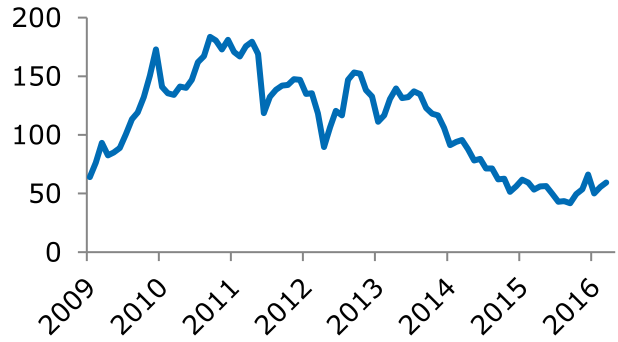
The price of West Texas Intermediate Crude finished the month at $US41.6/bbl, down 13.9%. Signs of continued oversupply, especially in US gasoline, weighed on markets along with five weeks of increasing rig counts suggesting supply may decline less than expected.

Gas prices were mixed with the US Henry Hub spot price up 1.5% to $US2.94/MMBtu while the UK natural gas price was down 3.0% over June.

Iron ore prices were higher in July, up 6.7% to $59.37/metric tonne, as measured by the benchmark price of iron ore delivered to Qingdao China.

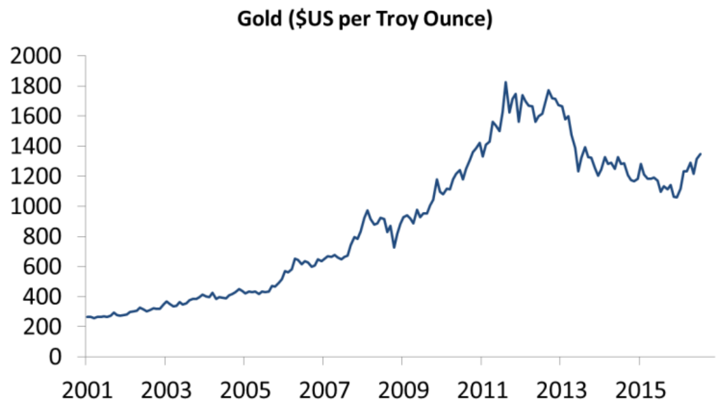
Gold (+2.3), Zinc (+6.6%), Copper (+1.7%) Nickel (+12.5%) and Lead (+2.0%) all rose over July while Aluminium (-0.3%) was slightly weaker.

IRON ORE REBOUNDS ON BETTER CHINA OUTLOOK



Source: Bloomberg as at 31 July 2016

GOLD RISES ON INCREASED POLITICAL UNCERTAINTY



Source: Bloomberg as at 31 July 2016

Australian equities

Following a period of uncertainty surrounding the Brexit vote in June 2016, the Australian equity market performed well during July, with the S&P/ASX 200 Accumulation Index adding 6.29%.

Most areas of the market performed well, with Consumer Discretionary, Consumer Staples and Materials among the best performers. The Energy sector lagged the broader market, but still posted a positive return despite the oil price losing around 13%.

Aside from Woolworths announcing almost AUD$100m in pre-tax restructuring costs as part of its operating model review, there was limited company news released during the month.

Most companies are in 'blackout' ahead of the release of their earnings for the six or 12 months ending 30 June 2016. Most of these results will be released during August.

The Federal Election was held in early July and, as expected, had little influence on the Australian share market. Investors remain focused on overseas events, particularly how 'Brexit' plays out and the likely timing and trajectory of future interest rate increases in the US.

Listed property

The Australian listed property sector rose by 5.4% in July as low bond yields remained supportive of the sector. News flow from the sector was relatively quiet over the month ahead of the sector's financial year earnings announcements in August.

The best performing stocks were diversified property owner and manager Charter Hall Group (+10.3%) which was buoyed by robust general demand for property securities, and diversified REIT Mirvac Group (+8.9%). Mirvac announced it would adopt a new earnings reporting structure, which aims to increase transparency and cost accountability at a business unit level.

The worst performing stock in July was self-storage operator National Storage REIT (-1.5%), following the completion of a AUD$260 million equity raising.

Listed property markets offshore also rose in July. The FTSE EPRA/NAREIT Developed Index (TR) increased by 5.1% in US dollar terms. Hong Kong (+11.7%) was the strongest performing region, followed by Continental Europe (+7.9%). Japan lagged, but still delivered a positive return of 0.9%.

Global developed market equities

Global equity markets rebounded strongly in July after the post-Brexit weakness. Signs of support from central banks along with the realisation that the Brexit would not be a 'Lehman' event improved sentiment towards risk assets.

The MSCI World Index rose by 4.1% in US dollar terms in the month of July and by 2.2% in Australian dollar terms.

In the US, the S&P500 (+3.6%), the Dow Jones (+2.8%) and the NASDAQ (6.6%) all rose, with the NASDAQ performing particularly well on improving sentiment towards technology stocks.

MSCI Information Technology (+8.13%) was the best performer in July, driven by significant earnings beats from Alphabet (Google) and increased sales from Facebook. MSCI Energy (-2.07%) was the worst performer over the month as energy prices fell and sentiment turned against the sector.

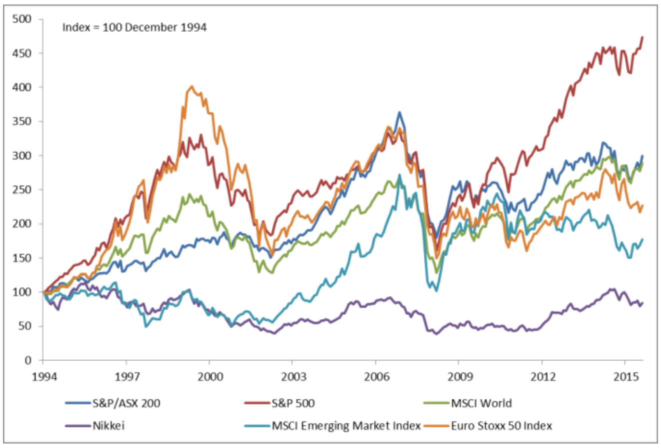
Equity markets in Europe took back some of their post-Brexit losses. The German DAX (+6.8%), France (+4.8%), Italy (+4.0%) and Spain (+5.2%) all rose along with the large cap Stoxx 50 (+4.4%).

UK equity markets continued their post-Brexit rally. The internationally focused UK FTSE 100 was up 3.4% and is now 5.6% above its pre-vote level, likely driven by the sharp fall in the Pound. The more domestically focused mid-cap FTSE 250 was up 6.2%, now almost unchanged from its pre-vote level.

Asia followed the global trend with Singapore (+1.0%), Taiwan (+3.7%) Honk Kong Hang Seng (5.3%) all up.

The Japanese Nikkei 225 (6.4%) was also stronger on the expectation and announcement of further ETF purchases by the BoJ and a large fiscal stimulus package.

EQUITY MARKETS RECOVER AFTER BREXIT VOLATILITY



Source: Bloomberg as at 31 July 2016.

Global emerging markets

Emerging market equities were up in June with the MSCI Emerging Market Index up 4.7% in US dollars.

Continued dollar weakness and easier monetary policy, along with record investor flows into EM Debt and Equity markets, supported markets.

Once again the Latin American region recorded the best performance with the MSCI EM Latin America up 5.38%, driven by Brazil (+11.2%). The MSCI EM Europe, Middle East and Africa was also up 4.88% in US dollar terms.

MSCI Asia Ex Japan was up 4.61%, with strength in Thailand (+5.5%) and Indonesia (+4.8%). The Shanghai Composite Index (+1.7%) also rose.