

MARKET WATCH

In brief – May 2014 edition

- > The National Commission of Audit – what is it and what does it mean to Australians?
- > In balance, we are in an investment friendly environment.
- > A health check on the residential housing sector.
- > Microsoft well-placed to reward investors.

National Commission of Audit – what it means

The independent National Commission of Audit (the Commission) was established by the Australian Government shortly after it was elected to office in September 2013. The purpose of the Commission is to “review and report on the performance, functions and roles of the Commonwealth government”. What does the review mean for Australians?

The bottom line is that Australia’s fiscal finances should be in much better shape than they are given the boom over the last decade. In addition, the budget outlook is unsustainable and the problem is structural, reflecting excessive long-term growth in spending particularly beyond 2017-2018 as the impact of the aging population drives up spending in areas like health, pensions and aged care.

Even if revenue rises to 25% of Gross Domestic Product (GDP) by 2024, which is 1 percentage point above its long-term average, the budget will still be in deficit because spending is projected to have increased to 26.6% of GDP, which will be its highest ever, and still rising. Relying on stronger economic growth simply won’t solve the problem.

To address this projected blow out in spending and ensure a return to surplus by 2020, the Commission recommends a combination of measures including:

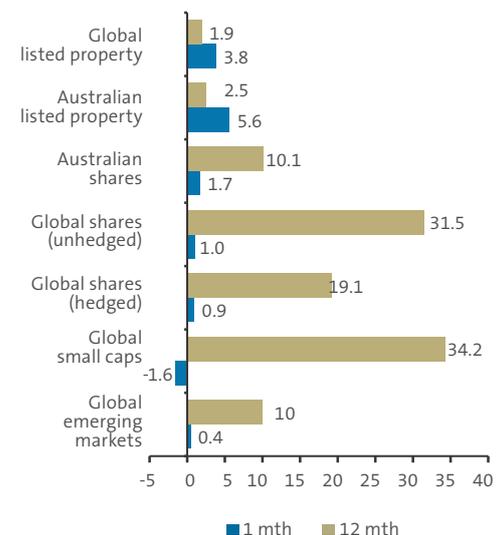
- > Tougher means testing for the pension including the value of the family home above \$500,000 for a single, slowing the indexation of the pension and increasing the retirement age from 2033;
- > Co-payments for Medicare services;
- > Abolishing Family Tax Benefit Part B;
- > Limiting industry assistance;
- > Reducing the number of government bodies; and
- > More privatisation.

Some of these are likely to be acted upon in the upcoming Budget. However, the focus has to be on measures to rein in spending growth over the longer term – right now the key is to put policies in place to bring long-term spending growth under control so a return to surplus is assured, without damaging the economy in the near term thereby making the deficit reduction task even more onerous.

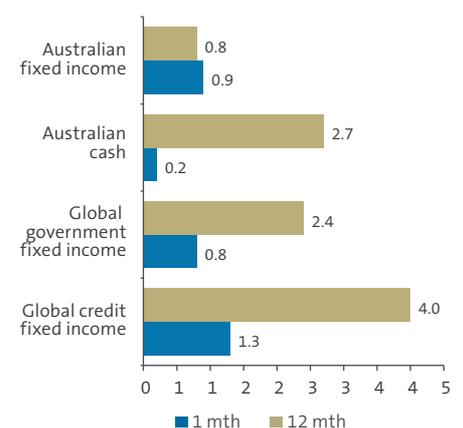
If Australia’s budget and public debt problems were on the same scale as those seen in recent years in the US and parts of Europe (where budget deficits hit 10% of GDP and public debt pushed up to around 100% of GDP) then an argument could be made for more drastic immediate action, but that is far from the case.

Either way, on the 13th of May all eyes will be on how the Coalition picks its way through the puzzle.

Growth markets (%)



Defensive markets (%)



An attractive investment backdrop



The widely-held consensus for 2014 is that share markets will rise with returns likely to be more muted in magnitude than last year. While conditions remain favourable for share markets we expect to see an increase in market volatility as any news that does not support the consensus view of markets could trigger a sharp price response. Nevertheless, in balance, we are in an investment friendly environment.

There are several points that, on balance, add up to an attractive investment backdrop:

Growth

- > The US is displaying good momentum after negative weather effects in early 2014;
- > On the whole business and consumer confidence are strengthening;
- > The economies of Europe and Japan are likely to benefit from the continuation, and likely extension, of accommodative monetary policy;
- > The ongoing political tensions in Ukraine and Russia are unlikely to destabilise the global economic recovery;
- > A pick-up in housing, non-mining investment after accommodating policy can help underpin positive economic developments in Australia;

Inflation

- > Currently inflation is benign across most developed economies with deflationary pressures remaining in the short-term in the Eurozone;
- > Emerging economies such as Brazil and India continue to face the challenges posed by high inflation and have been forced to raise interest rates to support their currencies and ease price pressures;

Monetary policy

- > The tapering of quantitative easing does not imply cash rates in the US will rise any time soon;
- > Interest rates are likely to remain low in Europe and Japan with further quantitative easing possible;
- > Australian interest rates likely to remain steady for some time;

Fiscal policy

- > Key focus will be on the ability of leaders to develop and then deliver credible policies.

Residential housing update

The residential housing story has improved given lower interest rates and foreign investment. Housing approval rates are up and capital-city auction clearance rates remain elevated. Strong capital into the sector has benefited Mirvac Group, Stockland Group and Australand Property Group which have exposure to the Australian residential market.

Economic update

As the economy continues to improve another rate cut appears to be off the cards. Concerns remain over how smooth the transition will be from mining to non-mining driven demand, the potential risk of a hard landing of China and the resurgence in the value of the Australia dollar which are all likely to culminate in deterring future hikes in the official cash rate for some time. In addition, inflation remains within the target range of the Reserve Bank of Australia (RBA) further reducing the likelihood the RBA will initiate a rate hike.

The impact of the Federal Budget

If the Federal Budget includes a budget deficit levy and large cuts to the public sector this would decrease household incomes and diminish consumer sentiment, which will negatively impact the retail sector.

Higher taxes could have a softening effect on the residential housing market. This may actually be a positive as it will see housing growth move to more sustainable levels after a period of very strong growth driven by low interest rates.

A window into Microsoft

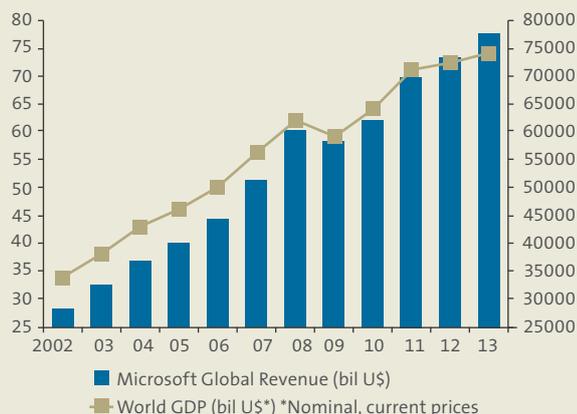
High quality technology companies, like tech giant Microsoft, which has strong product penetration and brand recognition around the world are well placed to benefit from an improved global economic outlook.

Aggregate demand for the hardware and software services that Microsoft sells is correlated to global macroeconomic factors (see chart). This is due to Microsoft's ability to capitalise on upgrades to computers in developed economies and improved discretionary spending in emerging economies.

In 2013 approximately 65% of Microsoft's revenue came from Windows operating systems purchased by original equipment manufacturers and pre-installed on the devices they sell.

This means that when consumers purchase a computer from other well respected brands such as Samsung or Asus, they also receive Microsoft products. In addition, Microsoft has made significant advances in mobile and cloud services and has strong sources of revenue from computer accessories, gaming consoles and online advertising.

While Microsoft is a more mature company than glamorous counterparts such as Facebook and Twitter, in its middle age it is now well-positioned to reward its shareholders with cash dividends from current earnings rather than the hope for capital gains from future earnings.



Economic indicators

Gross domestic product (annual rate %)*	Latest	Current	Previous	1 year ago
World (IMF/OECD)	2013	2.8	n/a	3.3
Australia	Dec-13	2.8	2.4	2.8
China	Mar-14	7.4	7.7	7.9
European Union	Dec-13	0.5	-0.3	-1.0
United States	Mar-14	2.3	2.6	1.3
Inflation (annual rate %)*	Latest	Current	3 months ago	1 year ago
Australia	Mar-14	2.9	2.7	2.5
China	Mar-14	2.4	2.5	3.2
European Union	Apr-14	0.7	0.8	1.2
United States	Mar-14	1.5	1.5	1.5
Official interest rates (%)*	Latest	Current	3 months ago	1 year ago
Australia	Apr-14	2.50	2.50	3.00
China	Apr-14	2.50	4.43	2.83
European Union	Apr-14	0.25	0.25	0.75
United States	Apr-14	0.25	0.25	0.25
Bond yields (%)	Latest	Current	3 months ago	1 year ago
Australia 3Y	Apr-14	2.90	2.84	2.59
Australia 10Y	Apr-14	3.95	3.99	3.09
United States 2Y	Apr-14	0.41	0.33	0.21
United States 10Y	Apr-14	2.65	2.69	1.67

Exchange rates

Official interest rates (%)*	Latest	Current	3 months ago	1 year ago
Australian Dollar / Chinese Renmimbi	Apr-14	5.7996	5.2874	6.3999
Australian Dollar / Euro	Apr-14	0.6682	0.6470	0.7874
Australian Dollar / Great British Pound	Apr-14	0.5487	0.5309	0.6670
Australian Dollar / Japanese Yen	Apr-14	94.6471	88.9863	101.1213
Australian Dollar / United States Dollar	Apr-14	0.9266	0.8725	1.0381

Share market analysis

Sharemarkets (in local currency)	5yrs (%pa)	3yrs (%pa)	1yr (%)	3 months (%)	1 month (%)
Australia : ASX 300 Accum	12.3	8.8	10.1	6.9	1.7
Germany : DAX	15.0	8.7	21.3	3.2	0.5
global emerging markets : MSCI in AUD	6.0	1.7	10.0	0.6	0.4
Japan : Nikkei	10.1	13.2	3.2	-4.1	-3.5
United Kingdom : FTSE 100	9.8	3.7	5.4	4.1	2.8
United States : S&P 500	16.6	11.4	17.9	5.7	0.6

**Data is most current available

+Rates are expressed as 1 Australian Dollar (IMF/OECD) purchasing-power-parity

Indices: Global shares: MSCI World ex AU Accumulation, Asian shares: MSCI AC Far East ex JP Accumulation, Emerging market shares: MSCI Emerging Markets Accumulation, Australian Shares: S&P ASX 200 Accumulation Index AUD, Global bonds: Barclays Global Aggregate Index Hedged AUD, Australian bonds: UBS Composite All Maturities Index AUD, G-REITs: UBS WARBURG Global Investors Index Accumulation Hedged AUD, A-REITs: S&P ASX 200 A-REIT Accumulation Index AUD, Direct Property: Mercer Unlisted Property Index, Cash: UBS 90 Day Bank Bill Index AUD.

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