Market update

The table below provides details of the movement in average investment returns from various asset classes for the period up to **30 June 2016.**

Asset class (% change)	1 month	3 months	1 year	3 years (%pa)
Australian shares	-2.5	3.9	0.6	7.7
Smaller companies	-1.3	5.9	14.4	9.1
International shares (unhedged)	-3.8	4.4	0.4	14.8
International shares (hedged)	-1.2	1.7	-1.4	10.9
Emerging markets (unhedged)	1.2	4.0	-9.2	5.5
Property - Australian listed	3.5	9.2	24.6	18.5
Property - global listed	4.0	4.8	18.7	14.3
Australian fixed interest	1.3	2.9	7.0	6.2
International fixed interest	2.0	2.9	9.3	7.6
Australian cash	0.2	0.6	2.2	2.5

Overview & Outlook

June was characterized by heightened volatility as a result of the decision by UK voters to depart the European Union, a decision which was unexpected by markets. The initial sell-off in equity markets was severe however, as is often the case, once investors had time to examine the actual financial impacts of the decision, equities rallied sharply. One of the major impacts of the so-called Brexit vote was a sharp decline in the Pound (8.1%) which was a major boost to British exporters. This led to a strong rally in the UK FTSE equity index which rose 4.4% over June, making it the best regional performer for the month.

A second major impact of the Brexit vote was that markets, once again, reduced their expectations for a Fed interest rate hike this year. This was despite increased confidence in US/Chinese and global growth.

The heightened equity market volatility saw a number of trends that have been in place over the last few quarters as defensive assets and those that benefit from lower interest rates continue to recorded strong performance. Notable domestic bonds returned 1.3% while domestic listed property returned 3.5%, out-performing equities by 6.0%. Listed infrastructure also had a strong month due to its defensive qualities and returned 5.6%. Similar trends were evident amongst global assets and there was also a rally in safe haven assets such as the $US, Yen and gold.

Turning to the potential impacts of Brexit, the decision poses some risks for financial market stability and to European economic stability and these may linger for some time. However it is unlikely to cause the global economy to move into recession or have a major direct impact on Australia, but could have an indirect bearing via market volatility and confidence. By way of reference the UK is only 2.5% of the world economy and only takes 2.7% of Australia's exports.

For the UK economy the decision is bad news. Estimates from the UK Treasury estimate that the UK economy could be 5% smaller than otherwise in 15 years' time with heightened risk of recession in the short term as a result of the blow to business confidence and uncertainty around continued access to EU markets.

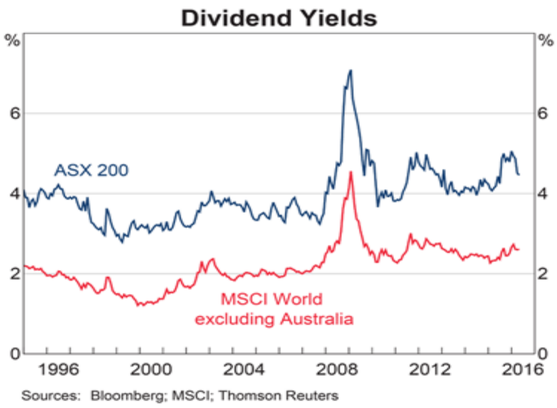
It is also important to note that in the short-term central banks have quickly acted to provide liquidity to markets and economies and as a result global monetary policy and interest rates will remain easier for longer. Over the medium-term Britain has only started the road to exit and currently still has all the benefits and obligations of a full EU member. It will be sometime before the negotiation process starts and this could last two or more years. Finally there still remains the possibility of another referendum.

Equity markets

International shares struggled in June, returning - 1.2% (hedged) and -3.8% for unhedged equities, as the $A rallied sharply against all currencies except the Yen. A factor that helped support markets during the heightened volatility was investors moving to factor in a lower global interest rate environment than was previously expected as a result of the Brexit shock.

The Australian equity market fell 2.5% with the IT (-7.6%) and financial (ex-AREITS) sectors recording sharp falls. The IT sector was hurt by two companies which had exposures to the UK while financials were impacted by the sharp fall in a UK-based fund manager and the big four banks which reported disappointing results. Into July the banks were further pressured by concerns that they would need to come back to the market for more capital.

Other strong sectors were Utilities (5.6%) and Materials (0.6%) on stable commodity prices and very strong performances by gold producers as the $US gold rallied 8.8% on safe-haven buying post-Brexit. In terms of outlook, shares could trend higher this year helped by a combination of relatively attractive valuations, global monetary easing and continuing moderate global economic growth. The chart below demonstrates the reasonably high yields on domestic equities compared to long-term averages.

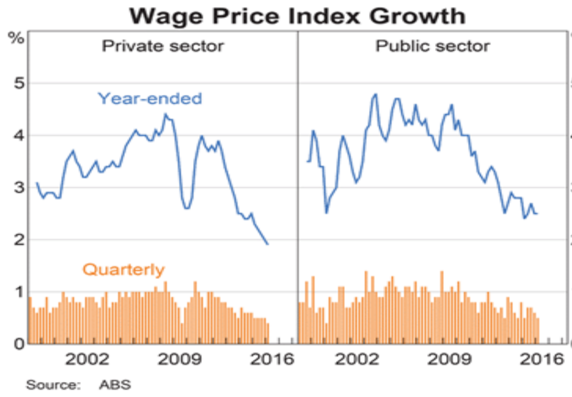


Source: RBA

Fixed Interest

Bond yields declined sharply across all global markets, as investors bought defensive assets post-Brexit and on the view that the Fed was unlikely to raise rates for even longer than previously forecast. Bonds across all yield maturities continued to decline in June, with the bell-weather 10 year bond yield falling to 2.02% from 2.32%.

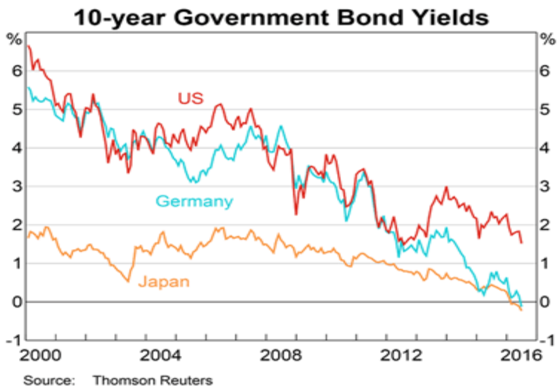
The RBA kept the cash rate at 1.75% at both the June and July board meetings. Despite reasonable economic growth recorded in Q1 (3.1% p.a.) the RBA noted the large declines in business investment and expectations of ongoing low inflation as the major reasons for holding rates.



Source: RBA

Given this outlook and the stronger $A there remains a reasonable chance of another rate cut this year. The chart above shows wage growth, an important driver of inflation over the medium-term, falling to the lowest levels on record.

At a global level, monetary conditions remains very supportive and major Central Banks will not withdraw easy policy conditions until they are comfortable that global economic growth is likely to be sustained and the risk of deflation declines sharply. This outlook has seen global bond yields fall to record lows partly driven by a flight to defensive assets as well as the weak nature of global economic growth. At current yields, bonds do not offer value and are likely to trend gradually higher over time should growth remain around current levels, detracting further from returns. However in the current environment an allocation to investment grade bonds can play a valuable role in providing positive returns in times when sentiment to equities is very negative as was the case over June.



Source: RBA, Thomson Reuters

Property

The AREIT market continued its strong run returning 3.5% over June, driven by lower interest rates. This ongoing rally has seen the sector out-perform the Australian equity market by 24.0% over the last year. The AREIT sector is now trading on reasonably demanding valuations however it is difficult to see these moving back to fair value as long as the interest environment remains weak.