Markets Monthly

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Risk Warning Statement :
Investment involves risks. Past performance is not indicative of future performance.
Investors should not make an investment decision based solely on this document

ANZ

The Sun continues to rise

We expect the Japanese market to climb higher on the back of an improving economy, prospects of higher wages and increased buying from Japanese pension funds.

While the record levels of the S&P500 and Nasdaq have grabbed newspaper headlines recently, the Japanese Topix has quietly risen by close to 8% (In USD terms) year to date to become one of the best performing developed share market this year. We moved to overweight the Japanese market in November last year. This shift was triggered after the Bank of Japan (BoJ) signalled its commitment to end deflation by significantly increasing the amount of bonds it will purchase under its quantitative easing (QE) program.

We remain positive on the Japanese market over the next 6-12 months, although investors may want to hedge their yen exposure. The economy is gradually exiting its tax-induced recession and the outlook for business investment has brightened as spare capacity diminishes and profit margins improve. Meanwhile, wages remain key for the inflation outlook. On this front, the annual wage negotiations that are currently taking place could finally deliver decent wage increases. After all, the labour market is tight. See Figure 1. A meaningful lift in wages is needed for a sustained growth in spending, which should boost the economy.

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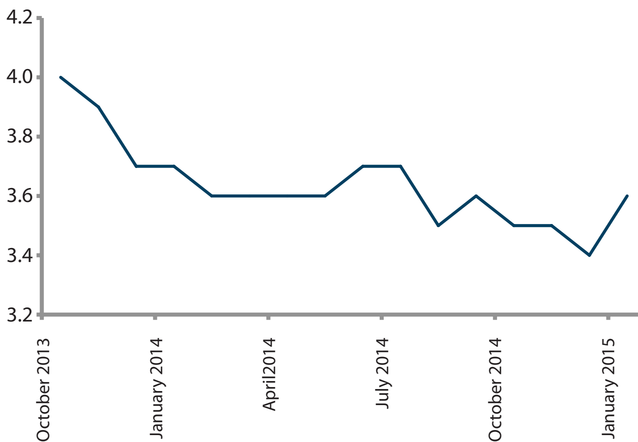
Figure 1. Japanese unemployment rate (%)



Source: Bloomberg. March 2015.

In addition, the Japanese market remains attractively valued. The weak yen has boosted earnings prospects and earnings upgrades continue to outpace downgrades. Structural changes are also afoot in Japan. The Japanese Government Pension Investment Fund (GPIF) announced plans to change to its asset allocation last year and is expected to gradually increase its investments in domestic shares. In fact, it is estimated that the GPIF bought JPY1.7tr of domestic shares in the fourth quarter of 2014. Other pension funds are expected to follow suit and the combined buying of Japanese shares by Japanese public pension funds may accelerate in the coming year.

Investment Summary

Last month, while we expressed continued confidence in our base case of stronger global economic growth, we highlighted the unsettling nature of the strong rally in bond yields, in particular the increased emergence of negative bond yields. A month later, the trend in economic data and the rise in bond yields have moderated some of these concerns.

Economic momentum has improved, most notably in Europe and share markets have reacted very positively to this improving trend. Fed tightening will be a major issue for markets going forward. We expect the Fed to be cautious in lifting rates in order to sustain the economic recovery, which is consistent with further gains in share prices.

For now, we maintain our moderate overweight to share markets. However, given recent market strength at the point of writing, investors who do not want to sit through the near term volatility can consider protecting some of their gains. On the other hand, those who do not have sufficient exposure to share markets will have the opportunity to buy on market dips.

Asset Allocation	3-12 month view
Growth Assets/Shares	**Moderate Overweight**
Global Shares	Moderate Overweight
Emerging Market Equities	Moderate Underweight
Global REITs	Neutral
Global High Yield Debt	Moderate Underweight
Defensive Assets	**Moderate Underweight**
Global Fixed Income	Moderate Underweight
Australia Fixed Income	Moderate Underweight

Source: ANZ Global Wealth. March2015.

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Shares

We expect the European market to outperform within developed markets. Encouragingly, leading economic indicators in the Eurozone are strengthening, albeit from low levels.

Regional Share Markets	
US	Neutral
Europe	Moderate Overweight
Japan	Moderate Overweight
Emerging Markets	Moderate Underweight
Asia ex Japan	Neutral

Source: ANZ Global Wealth. March 2015. Tilts are within a total portfolio context.

US - On the macro front, US economic growth momentum appears to be slowing, although this is expected to be only temporary. With personal consumption making up nearly 70% of US GDP, low oil prices are expected to boost spending and in turn, the US economy. However, the US share market looks expensive relative to Europe and Japan. With the strengthening US dollar, the risk return profile of the US share market looks less attractive.

Europe - We expect the European market to outperform within developed markets. Encouragingly, leading economic indicators in the euro zone are strengthening, albeit from low levels. We believe that the region can achieve double-digit earnings growth on the back of volume growth and high operating leverage. Indeed, analysts have been revising their earnings forecasts higher as they start to factor in the impact of a weaker euro and improving economic momentum. While the recent rally in European shares have raised valuations, the market is still cheaper than the US.

Japan - Japan is another of our favoured markets. Notwithstanding the lower than expected 4th quarter GDP reading, the economy is gradually exiting its tax-induced recession. However, as analysts have been very quick to factor in the positive impact of a weaker yen on earnings, we expect the positive trend in earnings revision to moderate slightly. We see the market climbing higher as the inflation outlook improves and Abe continues to press on with his structural reforms.

With bond markets pricing in only a limited amount of Fed tightening, the start of the Fed's rate hike cycle could increase volatility in the Emerging markets (EM). Low commodity prices coupled with an expected pickup in developed market growth appears favourable for Asia.

EM growth appears to have weakened at the start of 2015. In particular, Asian exports appear patchy and exports to its key trading partners with the exception of the US, continue to trend lower. The export picture to date may be distorted by the timing of the Chinese New Year and we should get more clarity in the months ahead. We expect Asian exports to pick up modestly as developed market growth lifts. We also expect investors to be more discerning within EM as we approach the Fed's rate hike. We continue to favour Asia within EM given their stronger fundamentals.

Within Asia

Taiwan – We remain positive on Taiwan as it continues to be the only market in Asia (excluding Japan) to enjoy upward earnings revisions. Taiwan's exports and export orders are expected to remain healthy as demand for electronics stay upbeat. Inflation will see another month of soft print due to low fuel prices, despite price increases during the Chinese New Year. Despite the disinflationary environment, we do not expect the central bank to cut interest rates as the economy remains on track to a recovery. That said, low inflation environment will provide room for the central bank to maintain on hold for some time.

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Korea – We are neutral on the Korean market but are monitoring developments closely. The market is now slightly cheap and although earnings continue to be revised lower, the pace has moderated significantly over the last 12 months. Going forward, earnings will be affected by the strength of the global recovery, as well as by the level of the KRWJPY. Consumer confidence is currently even lower than that in the second and third quarters of 2014,when sentiment was hit hard by the Sewol ferry accident. We expect the central bank to respond by cutting interest rates eventually, which will be supportive of the market.

China – We are neutral on the China market on a 3-12 month outlook, although we do not rule out the possibility of periodic rallies. The economy continues to slow further and the authorities are trying to stabilise growth with cuts to the interest rates and the reserve requirement ratio. We expect more easing to come, as rising capital outflows have tightened financial conditions.

However, in order for any rally to be sustained, we will probably need to see China's growth stabilise and greater progress on state-owned enterprise (SOE) reforms and further debt deleveraging.

Hong Kong – We are not overly bearish on the Hong Kong market despite the prospects of higher interest rates as the Fed prepares for lift off. In 2014, a red-chip listed company in Hong Kong acquired the main operating unit of its China-based parent. This could be the start of a wave of China's next round of SOE reform, benefitting Hong Kong. As a result, we may see increased new issuances, which may help to boost the Hong Kong market.

India – India remains one of our favoured markets in Asia. Although valuations are expensive, we expect the market to be underpinned by positive news flow and improving fundamentals. While the recent budget failed to deliver any big bang reforms, some positives include the proposed higher spending on infrastructure, plans to reduce the corporate tax rate over the next four years, as well as other measures to increase the ease of doing business.

Although the government pushed back its timeline for fiscal consolidation, we don't think this will deter the Reserve Bank of India from cutting rates further this year as the central bank is likely to view the increased focus on infrastructure spend in a positive light. In addition, low inflation over the next couple of quarters is expected to provide room for further easing.

ASEAN –Within Asean, we are most cautious on the Thai market as it is expensive and experiencing large downward revisions in earnings forecasts. The economic recovery in Thailand is likely to be uneven. The removal of rice subsidies will dampen growth and with prices of Thailand's key agricultural commodities (e.g. rice and rubber) languishing at 10-year lows, this is likely to weigh on personal incomes and domestic demand. We will probably see divergent performances between domestic-related sectors versus those which may benefit from lower energy costs and higher tourist arrivals.

Meanwhile, the outlook for the Indonesian market appears most positive within Asean. The recent budget was passed without significant opposition, despite earlier concerns that President Jokowi's coalition only accounts for 44% of parliamentary seats. The budget reflects a clear shift in priorities towards infrastructure, particularly public works, transport and agriculture, and away from fuel subsidies. The government is also injecting about US$5.1bn in stimulus funds to 44 state enterprises to spur investment. After an investment slump over the previous two years, a revival in investment spending in 2015 would be positive for growth. Unfortunately, this positive backdrop is partially offset by expensive valuations and concerns over the currency.

Within Asia	3-12 month view
China	Neutral
Hong Kong	Neutral
India	Positive
Korea	Neutral
Taiwan	Positive
ASEAN	Negative

Source: ANZ Wealth Asia. March 2015.

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Janet Yellen lays the groundwork for the first rate increase in the US, although the timing will be dependent on the health of the US labour market.

Global bond returns, measured by the Barclays Global Aggregate Index, were negative in February as well as year to date (USD terms). Relative to equities, bonds appear less attractive as valuations look very stretched from a long run perspective.

In the US, Janet Yellen laid the groundwork for the start of the first Fed rate hike. The likely removal of the "patient" language in the Fed communication in the March meeting will give the Fed flexibility to react to economic data. While we are still at least 3 months away from any Fed move, the pace of normalisation is more important than the timing. Given that the global recovery is likely to remain patchy and inflation subdued, the pace of interest rate hikes will probably be very gradual.

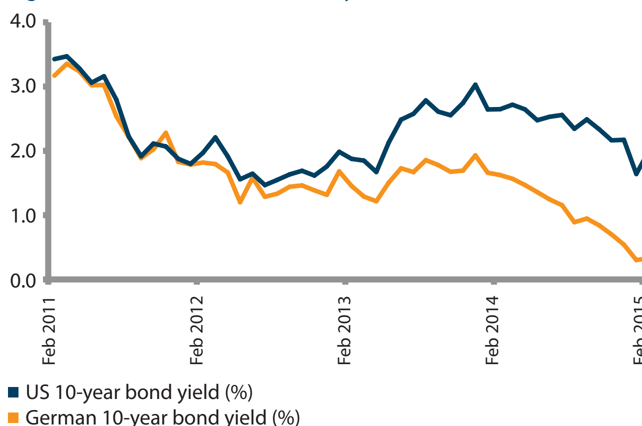
Bond markets have already priced in a "new normal" of structurally lower global growth rates. As such, further significant falls in yields are unlikely unless the growth outlook deteriorates, which we do not expect. Rather, with the US unemployment rate below 6%, a gradual move higher in yields over the medium term is expected. We believe that tightening labour market conditions in the US will, at some point, see at least a moderate acceleration in wages growth together with inflation.

Within global fixed income, we retain a preference for investment grade credit over government bonds. As long as the global expansion, albeit modest, remains intact, investors may want to enjoy the additional yield offered by high quality corporate bonds.

Over in Europe, the current gap between the German and US 10-year bond yields is at a historical high. See Figure 2. For the gap to narrow, US bond yields need to decline or German bond yields need to rise. The former will need economic conditions in the US to be weaker than what we expect.

Meanwhile, although the European economic recovery is still fragile, we believe that the region will avoid deflation and be able to record positive growth. While this backdrop suggests that German bond yields can move higher, bond purchases by the European Central Bank (ECB) is likely to cap any increase. After all, the ECB will probably find it challenging to purchase over a trillion euros worth of fixed-income securities at a time when there is already a shortage of high-quality euro zone bonds. Indeed, almost 30% of the continental European bond market is currently trading in negative territory, and the ECB hasn't even started buying yet. We have been positive European Investment Grade credits and European Financials for some time. Investors with existing exposure can potentially look forward to further, albeit modest gains.

Figure 2. US versus German bond yield



Source: Bloomberg. February 2015.

We remain relatively cautious on Emerging Market (EM) bonds. While valuations of USD-denominated EM bonds currently look attractive compared to their long term averages, the region could be vulnerable to a reversal in capital flows as USD liquidity decreases. That said, we recognise that the fall in oil prices has helped improved the current account deficits of some countries in Asia. Nevertheless, for investors who are able to tolerate higher volatility, we prefer maintaining exposure to other growth assets such as developed market shares given their better liquidity characteristics.

We also advocate a cautious stance towards global high yield bonds even though valuations have become more reasonable following last year's correction. High yield bonds sold off in the second half of 2014, as the sharp decline in oil prices hurt the energy sector which makes up around 20% of the high yield bond market. At the same time, liquidity concerns and rising volatility also increased risk aversion towards the sector. While the current economic backdrop is supportive of high yields, with rate rises expected in the US this year, we continue to favour quality growth assets while limiting exposure to higher risk and less liquid assets. Meanwhile, investor positioning is a risk as surveys show that high yield bonds are currently the second most crowded trade in the financial market.

Within Asia, the risk-return profile of the BBB space appears attractive. We continue to like the higher quality Indian corporate bonds as well as Indonesian sovereigns plus quasi sovereigns. At the point of writing, the Reserve Bank of India (RBI) has surprised with an inter-meeting rate cut of 25 basis points. The RBI now expects inflation in January 2016 to be 'below' 6% rather than 'around' 6%. As such, we believe this leaves the door open for another 50 basis points of rate cuts which are likely to be positive for Indian credits. While the recent budget disappointed mildly for its lack of big bang reforms, we feel that the realistic revenue expectations and the focus on infrastructure spending coupled with the containment in subsidies underscore the quality of the budget, which is positive for bonds.

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The outlook for commodities for the rest of the year appears lacklustre.

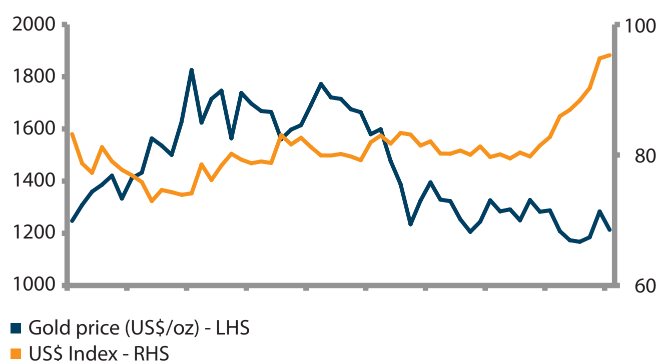
Commodity markets have started 2015 in a choppy fashion with most of the volatility seen in the gold and energy markets. Meanwhile the outlook for the rest of the year appears lacklustre. Supply and demand factors will continue to be important in 2015. Supply for oil remains high while seasonal demand is expected to fall.. While China's PMI may rebound slightly in March and April, the authorities continue to prioritise structural reforms over government-assisted growth.

Gold may trade lower in the near term although its long run appeal remains intact.

While it will be challenging to see gold rallying significantly in the face of a rising USD, there are also enough reasons for investors to want to hold some safe haven assets. For one, growth remains lacklustre outside of the US while the political situation between Greece and the rest of Europe are far from being resolved. This suggests that the long run appeal of gold remains intact.

In the current cycle of USD strength, the USD has risen 31% since bottoming in 2011. Gold has fallen 35% over the same period, suggesting that the two are now largely in sync. See Figure 3. As such, gold is now at a critical juncture. Given the recent upside break in the USD following better than expected US payrolls, we think that gold will likely trade lower in the near term.

Figure 3. Gold prices vs USD index



Source: Bloomberg. March 2015.

We expect oil prices to head lower in coming weeks, potentially reaching US$43/bbl over the next few months.

Oil prices have recently been boosted by reports of capital spending cuts and a drop in drill rig activity. However, as the producers have only shut down poor yielding wells, US oil supply continues to climb. In fact, reports show that US oil output hit a record high in mid-February.

Meanwhile, refinery demand for crude oil is likely to be weak over the coming month, as refiners enter their seasonal maintenance period. As such, record level inventories are going to climb even higher in the face of healthy supply and weak demand.

Investors may become increasingly frustrated with the delay in supply cutbacks in the US despite the significant drop in drill rig activity. Speculators have increased their exposure to oil throughout December and January, and there is risk that they may liquidate their positions should further price upside does not materialise.

Against this backdrop, we expect oil prices to head below US$50/bbl in coming weeks, potentially reaching US$43/bbl over the next few months.

With large low cost iron ore expansions still coming on stream, key industry players are likely to accept a lower floor price.

High iron ore prices in 2010 and 2011 triggered a wave of new supply, which is currently struggling in the weak demand environment. Notably, three of the four largest iron ore producers in the world had committed to large expansions over a 4-5 year period and added 100 million tonnes to Australian iron ore exports in 2013 – three times the yearly addition over the previous decade. Even though iron ore prices have more than halved since 2011, the bulk of the capital expenditure has already been sunk, which gives these producers little incentive to pull back activity. Therefore, even if the smaller producers were to cut output, it is unlikely to have much impact on prices given their relatively small market share (~25%).

To date, the inelastic supply response from Chinese iron ore producers has surprised the market. Typically, higher cost Chinese supply tends to fall quickly in the face of sharp price declines. However, this time around, it appears that lower local government taxes have helped to lower overall costs, thereby supporting supply. At the same time, most of the large state-owned and privately run steel mills own domestic iron ore mines, absorbing the loss-making iron ore capacity.

Finally, despite the 60% drop in iron ore prices over the last 12 months, 85% of the seaborne industry is still profitable. This has come about on the back of increased productivity, lower energy and freight costs. The depreciation in the currencies of key iron ore exporting countries such as Australia and Brazil has also improved their competitiveness.

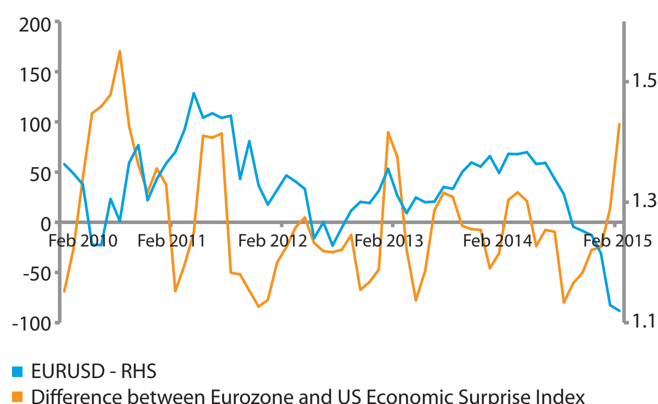
The euro could consolidate in the short term as Greece-related tensions subside and a modest upswing in the euro zone emerges.

USD – We remain comfortable with our strong USD view. In the last 6 months, factors driving the USD included easing by the BoJ as well as expectations of ECB easing. While these factors may have abated, we believe there are underlying forces which will support the dollar going forward . For one, the USD is still a beneficiary of a widening in interest rate differentials, although to date, the widening has occurred from easing in other countries, and not Fed tightening.

Meanwhile, there is also substantial anecdotal evidence that US-based investors have become more active in hedging their foreign currency exposure, which will sustain demand for the dollar. It was reported that more than half of the inflows into Exchange Traded Funds (ETFs) this year were into currency-hedged products.

EUR – There are nascent signs of a modest cyclical upswing in the euro area, spurred by lower oil prices, a weaker euro and easing monetary policy settings. Notably, the divergence between the EURUSD and the relative economic surprise index for the US and the euro area is at a historical wide, suggesting that the EURUSD looks oversold on this measure. See Figure 4.

Figure 4. Economic surprises vs euro



Source: Bloomberg. March 2015.

However, the start of the ECB's QE program is likely to be a headwind to any recovery in the euro. If euro area banks were to sell European fixed income to the central bank and buys US Treasuries instead, then the euro may extend its weakening trend over the medium term. In fact, the recent break of the euro below 1.10 opens the way for a move towards 1.05, and possibly even parity.

JPY – The Japanese government pension fund is likely to continue to reallocate its assets into overseas markets, which will continue to put some upward pressure on the USDJPY. That said, with the JPY having weakened significantly following the BoJ's actions in late October, further depreciation is likely to be more tempered.

GBP – The backdrop for the sterling appears positive in the medium term. On the macro front, a range of indicators suggest that spare capacity in the economy is diminishing. For example, the unemployment rate is at its lowest since 2008 and surveys suggest that it can trend lower going forward. Firms are operating at above-average levels of capacity utilisation while employees are increasingly more confident over their work and wage prospects.

However, as we approach the upcoming election in May, elevated political uncertainty could cap the sterling's rise in the near term. Non-traditional parties appear to be gaining popular support creating uncertainties over the election outcome and the economic policies that will be pursued.

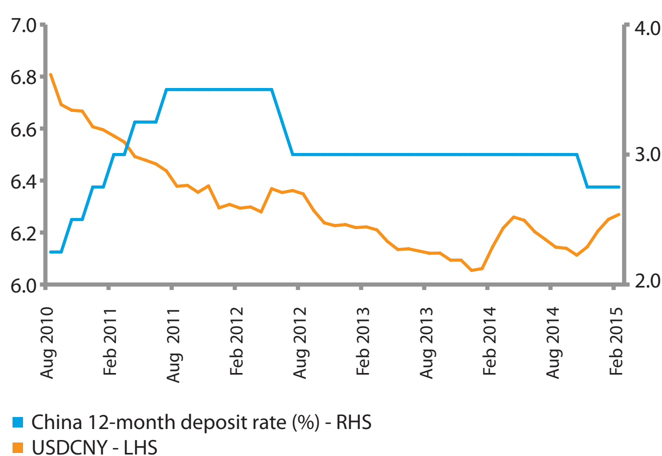
AUD – The earlier than expected rate cut by the Reserve Bank of Australia in February prompted investors to focus on the deterioration in the Australian economy. With the central bank putting more weight on growth over inflation, the lack of a tangible growth recovery in the near term has opened up the scope for greater than expected easing. Historically, the AUD tends to fall in an easing cycle.
Separately, while we do not think that Australia will lose its AAA rating, the fact that this was discussed in the media suggests that Australia's appeal as a destination for fixed income investments may be eroding.

NZD – We believe there are four conditions that need to be satisfied before the Reserve Bank of New Zealand will consider easing policy. These include very low inflation readings, further weakness in New Zealand agriculture prices, NZD strengthening and weak global growth. As such, the hurdle for rate cuts appears to be high. While an attractive yield and a healthy economic outlook should help support the NZD, the rising attractiveness of the USD is likely to keep the currency capped.

The scope for further easing from selective Asian central banks this year is likely to lead to further weakness in Asian currencies.

CNY – The Chinese government is expected to try to stabilise growth by cutting interest rates and the reserve requirement ratio further this year. Historically, the CNY tends to weaken following the rate cut, but recovers once easing has been priced in and the easier monetary conditions start to boost growth prospects. See Figure 5. We expect the CNY to respond in a similar fashion this time around and believe that the market is in the midst of pricing in additional easing.

Figure 5. China 12-month deposit rate and USDCNY



Source: Bloomberg. March 2015.

IDR – Following February's surprise rate cut, we expect a further 50 basis points of cuts this year. While the cuts will continue to keep Indonesian bonds attractive, the boost to growth and the increase in capital imports may worsen the current account deficit. This may weigh on the IDR. Notably, post the rate cut in mid-February, the IDR weakened 1.3% against the USD, despite a strong rally in the local bond market.

INR – We continue to see the rupee as an outperformer in the region, underpinned by improving fundamentals. INR is an exception where interest rate cuts bode well for portfolio flows and the currency. At the point of writing, the RBI has surprised with a 25 basis points inter-meeting cut. With the RBI expecting inflation in January 2016 to be 'below' 6% rather than 'around' 6%, we think there is room for another 50 basis points cut during the year.

SGD – The Monetary Authority of Singapore lowered the slope of the appreciation path for the SGD in an unusual, inter-meeting announcement in January. Weak inflation readings weaken the rationale for SGD appreciation and potentially open the door for further easing at the next meeting in April. Notably, headline inflation fell 0.4%yoy in January, representing the third consecutive month of deflation and the weakest in five years. Importantly, core inflation also fell in January, to its lowest reading since March 2010.

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Returns

Country Equity Markets	YTD	1-Yr	3-Yr
ASX 200	9.6%	9.6%	38.9%
FTSE 100	5.8%	2.0%	17.4%
Hang Seng	5.2%	8.7%	17.0%
India Sensex	6.3%	39.2%	67.5%
Jakarta Comp	4.3%	19.3%	41.2%
Korea KOSPI	3.7%	0.4%	-0.3%
Malaysia KLCI	3.4%	-0.6%	16.8%
Nikkei 225	7.7%	26.0%	95.1%
S&P 500	2.2%	13.5%	53.9%
Shanghai-A	2.3%	61.7%	35.3%
Singapore ST	1.1%	9.9%	15.5%
Taiwan Weighted	3.4%	11.4%	20.9%

Regional Equity Markets	YTD	1-Yr	3-Yr
MSCI World	3.7%	5.9%	30.7%
MSCI Europe	6.1%	-4.7%	22.5%
MSCI BRIC	5.4%	5.3%	-13.8%
MSCI Emerging Market	3.6%	2.8%	-6.3%
MSC AP ex Japan	4.5%	5.6%	10.1%

Fixed Income	Yield	1-mth chg	YTD chg
Aust Govt (10Y)	2.46	2	-28
Bunds (10Y)	0.33	3	-21
Gilts (10Y)	1.80	47	4
JGB (10Y)	0.34	6	1
NZ Govt (10Y)	3.29	11	-37
SG Govt (10Y)	2.23	35	-5
US Trsy (2Y)	0.62	17	-5
US Trsy (10Y)	1.99	35	-18

Currencies	Level	1-mth chg	YTD chg
USD-JPY	119.63	-1.8%	0.1%
EUR-USD	1.12	-0.8%	-7.5%
AUD-USD	0.78	0.6%	-4.5%
USD-SGD	1.36	-0.6%	-2.8%
NZD-USD	0.76	4.2%	-3.0%
GBP-USD	1.54	2.5%	-0.9%
USD-CAD	1.25	1.7%	-7.7%
USD-TWD	31.46	0.2%	0.6%
USD-IDR	12932.00	-2.1%	-4.4%
USD-INR	61.84	0.1%	1.9%
USD-KRW	1098.00	-0.4%	-0.6%

Source: Bloomberg. As of 27 Feb 2015.

Commodities	Level	1-mth chg	YTD chg
Copper	5895	7.3%	-6.4%
Gold	1213	-5.1%	2.4%
WTI Oil	50	3.2%	-6.6%

Forecasts

Precious Metals (US$/oz)	Jun-15	Sep-15	Dec-15
Gold	1110	1150	1225
Platinum	1360	1400	1450
Palladium	805	810	815
Silver	19.1	19.5	20

Energy (US$/bbl)	Jun-15	Sep-15	Dec-15
WTI Nymex	43	51	55

Currencies	Jun-15	Sep-15	Dec-15
USD-JPY	118	119	120
EUR-USD	1.12	1.15	1.15
GBP-USD	1.54	1.56	1.56
AUD-USD	0.76	0.75	0.74
NZD-USD	0.74	0.73	0.72
USD-SGD	1.37	1.38	1.39
USD-IDR	12950	13150	13250
USD-INR	64	64.5	65

Cross Rates	Jun-15	Sep-15	Dec-15
AUDNZD	1.03	1.03	1.03
AUDSGD	1.04	1.04	1.03
NZDSGD	1.01	1.01	1.00
EURSGD	1.53	1.59	1.60
SGDJPY	86.13	86.23	86.33
GBPSGD	2.11	2.15	2.17
AUDIDR	9842	9863	9805
NZDIDR	9583	9600	9540
EURIDR	14504	15123	15238
JPYIDR	110	111	110
GBPIDR	19943	20514	20670

Source: ANZ Economics & Markets Research. As of 9 Mar 2015. Forecasts are quarterly averages.

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