ADVANCE ASSET MANAGEMENT

ADVANCE ECONOMIC SPOTLIGHT ON

Tapering of Quantitative Easing (QE) by the US Federal Reserve Bank

The background

The US Federal Reserve (Fed) sought to mitigate the impact of the GFC and stimulate the economy through the implementation of quantitative easing (QE) when conventional policy rates were reduced to almost zero. QE is where the monetary authority buys not only government bonds but also mortgage backed bonds for its own account, which has the impact of:

1. increasing the supply of money in the banking system, and
2. reducing long term interest rates (cost of capital).

Post the GFC, and as US economic recovery continues, the Fed initiated a program of tapering or reducing the $US85 billion of quantity of monthly purchases of securities it buys for its own account at each Fed meeting this year to allow US fixed income asset prices to be more fundamentally determined by traditional market forces. Tapering is due to be completed in October of this year.

What scenarios and risks might occur as a result of tapering?

1. Economic performance may deteriorate, as interest rates move higher forcing the Fed to either halt or reverse tapering.

   What is the likelihood and outcome of this occurring?

   > Advance believes there is a low likelihood of this occurring, but if it does, we expect it would have a very positive impact to risky assets such as credit and equity market prices.

Economic performance remains stable and the market begins to normalise so the Fed continues tapering at the current pace of $10 billion each month until completion in October 2014.

   What is the likelihood and outcome of this occurring?

   > Market consensus and Advance's view is that this is the highest probability scenario.

   > Advance anticipates this would have a neutral to negative impact on equity markets and slightly negative impact on bond markets.

2. Economic performance deteriorates but tapering continues.

   What is the likelihood and outcome of this occurring?

   > Advance views this as being moderately unlikely, and if it occurs, it would suggest that excess liquidity from QE has generated significant asset bubble risks that the Fed needs to manage.

   > Advance expects this scenario to have a negative impact on equity markets, while being positive for sovereign bond markets.

How has Advance positioned its investment strategies to respond to this?

We believe QE has distorted financial asset market prices to the point where the discovery of the "true value" of an asset or the level of risk attached to such assets has been impaired. Having recognised the risks that unconventional policies have generated in financial asset markets and being aware of the excessive levels of gearing that QE has encouraged, we have gradually reduced the level of equities in our portfolios, and increased the allocation to other asset classes, such as REITs and alternative strategies. Factoring the potential for interest rates to rise, we have also reduced our allocation to fixed interest.

Aside from addressing the risk of tapering, we believe taking a conservative approach at this point in time in prudent given that absolute returns have been strong and other identified risks in markets have increased in number and probability of occurrence.

We view our responsibility to investors to "enhance and preserve" the value of investors' capital as paramount and will continue to assess the market behaviour and adjust positioning as required to reflect any identified opportunities in the market, or to manage any future risks.

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