For institutional/adviser use only

Colonial First State
Global Asset Management

Global equity markets hit record highs

Market Watch

End-April 2019

Economics overview

- **US**: The US economy expanded at an annual pace of 3.2% in the March quarter; well ahead of even the most optimistic expectations.
- Sceptics suggested the result was unusually influenced by inventory build-up by producers against a background of ongoing trade tensions. An ex-inventory measure of GDP rose at a more moderate pace of 2.5%.
- Accordingly, there were suggestions that we might see a slowdown in headline GDP in the June quarter as inventory levels normalise. Time will tell.
- The employment picture remained undeniably favourable – nearly 200,000 new roles were created in March, taking the total number of newly employed Americans to more than half a million in 2019 to date.
- As the Federal Reserve made clear in March, policy settings are unlikely to be amended in the remainder of this year. The PCE Deflator – the central bank's favoured measure of inflation – continues to drift lower and remains well below target. This suggests there is a very low likelihood of unexpected interest rate hikes in the foreseeable future.

- **Australia**: Q1 2019 inflation data were released and came in well below consensus expectations. CPI was unchanged in the first three months of 2019 and the annual pace declined to 1.3%.
- The probability of interest rate cuts increased after the release. With inflation so far below the RBA's 2.0% to 3.0% target range, consensus expectations suggest borrowing costs will be lowered twice before the end of 2019. Markets currently indicate a 20% probability of a third interest rate cut by May 2020.
- The pace of Australian GDP growth has slowed in FY19, but growth in national income remains robust – partly due to elevated commodity prices. This has enabled the Government to propose stimulatory policies including tax cuts and higher infrastructure spending, at the same time as projecting a return to budget surplus. Following 12 years of deficit, the budget surplus is forecast to be $7.1 billion in FY20, or 0.4% of GDP.

- **New Zealand:** Like in other regions, inflationary pressures have moderated. CPI for the March quarter came in at 1.5% year-on-year; below expectations. Downward pressure from lower energy prices and a stronger NZ dollar more than offset a modest uptick in food prices.
- The subdued inflation print prompted increasing suggestions that the RBNZ might lower interest rates at its May meeting.
- There was a slight improvement in the labour market, with unemployment falling to 4.2%. Wages also grew 1.1% in the March quarter.

- **Europe**: The Eurozone economy expanded by 0.4% in the March quarter, from 0.2% in the prior three month period. In spite of the modest improvement in early 2019, it appears accommodative policy settings are not having the desired impact of stimulating activity levels in the region.
- Industrial production remains below levels from a year ago and inflation remains subdued. Consumer confidence also remains low, which does not augur well for retail sales and other discretionary expenditure.
- At the country level, there was a notable recovery in Italy. Europe's third largest economy slipped into recession in December, but grew 0.2% in the March quarter. This alleviated concerns of further political unrest for the time being.
- European leaders extended the deadline for the UK's exit from the EU to 31 October 2019. Efforts to agree withdrawal terms prior to the initial 29 March 2019 target proved unsuccessful.
- The UK has averted a potentially destabilising 'no deal' exit for now, but ongoing infighting among Members of Parliament suggests the delay might only serve to 'kick the can down the road' for six months ahead of further stalemate in October.
- Inflation in the UK remains slightly below the Bank of England's 2.0% target, although various other economic indicators surprised positively. The most recent retail sales, construction output and industrial production data, for example, all improved and came in ahead of consensus expectations.

- **Asia/EM:** Annual GDP growth in China remained at 6.4% in the March quarter, aided by the Government's pro-growth policies. These supported consumer demand, which helped offset the impact of ongoing tariff-related trade disruptions. Retail sales were 8.7% higher than in the corresponding period a year ago.
- In Japan, there was an uptick in inflation as food and transport costs stabilised. This is unlikely to be sufficient for the Bank of Japan to abandon its zero interest rate policy.
- Japanese markets are currently closed for 10 days for 'Golden Week' and the new Emperor's accession to the Throne; the longest ever closure for the Tokyo Stock Exchange.

Australian dollar

- The subdued inflation print for the March quarter brought forward expectations of an interest rate cut in Australia. At month end, money markets were implying a 36% chance of a rate cut in May, and a 72% probability of a cut by the end of June. A second cut has also been priced in by year-end.
- These evolving forecasts were reflected in currency movements relative to the US dollar. The AUD closed April at US$0.705, a depreciation of 0.7% over the month.

Commodities

- Commodity prices were mostly higher during April as concerns around US-China trade wars eased. Chinese policy support, via tax cuts and infrastructure projects, was also broadly supportive.
- Iron ore (+5.5%) prices rose, as lower port stockpiles in China signalled shortage concerns. Stockpiles are declining as the fallout from the dam disaster at Vale's *Feijao* iron ore mine in late January is now being felt at ports in China.
- Oil (Brent crude +3.8%) moved higher, driven primarily by OPEC-led supply cuts and robust demand.
- Industrial metals were mostly lower during the month. Zinc (+1.4%) and copper (+0.2%) edged higher, while lead (-3.2%), Aluminium (-4.3%), nickel (-7.1%) and tin (-7.3%) all lost ground.
- In the precious metals sector, gold (-0.7%) and silver (-1.1%) edged lower, while platinum (+4.3%) bucked the broader trend, posting relatively strong gains.

Australian equities

- An improvement in sentiment enabled the S&P/ASX 100 Accumulation Index to return 2.3% in April. A positive start to the US earnings season combined with increasingly dovish commentary from global central banks supported the performance of Australian shares.
- Consumer Staples was the best performing sector, adding 7.9% as all constituents registered positive returns.
- The Financials sector recovered from March weakness, rallying 4.3%. With the exception of Suncorp Group, all major and regional banks added value.
- Bond-proxy sectors including REITs and Utilities under-performed. A modest increase in bond yields reduced the appeal of yield-generating equities.
- Small caps outperformed their large cap peers, with the S&P/ASX Small Ordinaries Accumulation Index rising 4.1%.

Listed property

- Global listed property trailed broader equity markets, with most property markets posting negative returns for the month. The FTSE EPRA/NAREIT Developed Index returned -1.3% in USD terms and -0.4% in AUD terms
- New Zealand (+3.7%) was the best performing property market, while Japan (-3.6%) was the worst performer.
- In Australia, the S&P/ASX 200 A-REIT Index returned -2.6%. Office A-REITs (-1.3%) was the best performing sub-sector, followed by Industrial A-REITs (-1.4%). Retail A-REITs underperformed, returning -3.8%.
- Outperformers in Australia included Unibail-Rodamco-Westfield (+6.4%) and Mirvac (+4.0%).
- During the month, Unibail-Rodamco-Westfield announced it had entered into an agreement to sell Tour Majunga, an office building located in Paris, at a premium to book value. The company also released its financial information as at the end of March 2019, which highlighted tenant sales growth of 4.3% and footfall growth of 2.4% in its European shopping centres, while also reporting US specialty sales growth of 5.3% per square foot.
- Underperformers included GPT Group (-6.1%) and Scentre Group (-5.6%); both struggled following Q1 operating updates.

Global equities

- The MSCI World Index rose 4.6% in AUD terms, pushing global equity markets up to all-time highs. The weaker AUD helped to bolster returns, with the corresponding Index up 'only' 3.8% in local currency terms.
- The S&P 500 Index rallied 4.0% in USD, registering fresh record highs on the last day of the month.
- The increased prospect of interest rate cuts in the US, a more positive corporate earnings season than anticipated, a stronger energy sector driven by rising oil prices and reports that "substantial progress" is being made in the US-China trade talks all helped to drive US stocks – and global markets more broadly.
- Germany's DAX recovered from a weak March result to be the strongest performer over April, rising 7.1% in euro terms. Economic sentiment and unemployment numbers both improved in Germany and investors responded particularly positively to the reduced risk of an escalation in trade tensions.
- The Japanese Topix was a laggard for the second month in a row, managing only a 1.9% gain in yen terms. Investors were disappointed as industrial production and balance of payments numbers showed that the country's manufacturing sector was struggling as export demand faltered.
- Emerging markets enjoyed a sixth successive month of positive returns, with a 3.1% rise in AUD terms. Stocks in the EMEA region outperformed, supported by strong gains in South Africa ahead of the country's general elections in May.
- Latin America was the weakest EM region. Investors appeared to be losing faith in the new Brazilian president's ability to drive reforms through congress.

Global and Australian Fixed Income

- Global bond yields rebounded a little in April, having fallen sharply in the March quarter.
- Benchmark 10-year US Treasury yields closed the month 10 bps higher, at 2.50%.
- In Germany, yields clawed their way back into positive territory, closing 8 bps higher at 0.01%.
- Japanese yields remained negative, at -0.05%, despite rising 4 bps over the month.
- Among the most significant moves was in the UK, where 10-year yields rose 19 bps, to 1.19%. The gilt market remained affected by Brexit-related developments.
- In Asia, Chinese local currency bonds were added to the Bloomberg Barclays Global Aggregate Index. Over time this is expected to result in broad-based buying, although prices dipped immediately after the addition as yields rose sharply. Chinese 10-year yields closed April 33 bps higher, at 3.40%. Please refer to '*Chart of the Month'* overleaf for details.
- Australian CGS yields were almost unchanged in April, closing the month at 1.80%.

Global credit

- Credit spreads tightened further, supporting corporate bond prices and enabling global credit markets to register a fourth consecutive month of positive returns.
- Credit investors appeared to remain confident that US and Chinese officials will be able to resolve their ongoing trade dispute, alleviating the risk of further damaging tariffs being implemented on imported goods.
- Economic releases were broadly supportive, particularly in the US where the pace of GDP growth rebounded back above 3.0% year-on-year in the March quarter.
- Investors' generally healthy appetite for global credit was met with a steady flow of new supply. Most notably, Saudi Aramco – the state-run oil company of Saudi Arabia – completed its inaugural corporate bond issue during the month.
- The offering was substantially oversubscribed, enabling the bonds to be issued at a lower yield than comparable Saudi Arabian sovereign bonds. The US$12 billion of new paper issued attracted more than US$100 billion of bids. This likely reflected the perceived security of the deal. With more than US$110 billion of earnings, Saudi Aramco was the world's most profitable company in 2018.

Chart of the Month – is the Chinese bond market becoming too big to ignore?

In these bulletins, we aim to share interesting observations from global investment markets. This month we focus on the Chinese bond market and why it is becoming increasingly important for global bond investors.

During April, renminbi-denominated Chinese bonds were added to one of the most widely tracked bond indices; the Bloomberg Barclays Global Aggregate Index. At this early stage, government bonds and those issued by policy banks – Export-Import Bank of China, China Development Bank and Agricultural Development Bank of China, for example – have been included as index constituents, though other Chinese issues may be added over time.

At just 0.3%[1], China's weighting in the Bloomberg Barclays Global Aggregate Index is currently low. For now, active global fixed income managers can choose not to invest in China without meaningfully affecting tracking error. That seems likely to change as the size and influence of the Chinese economy and bond market become too big to ignore. As shown in Chart 1, the size of the Chinese bond market has grown by ~17% per year over the past decade; by 2018 it was worth more than USD11 trillion. With this growth trajectory, China appears likely to surpass Japan as the world's second largest bond market within the next 12 months.

By the end of 2020, China's weighting in the Bloomberg Barclays Global Aggregate Index is forecast to be above 6%. This would likely result in more bond managers investing in the market. These fund flows could be significant – it is estimated that between USD2 trillion and USD2.5 trillion is currently invested in funds tracking the Bloomberg Barclays Global Aggregate Index alone. Assuming these funds invest in China around index weight, potential inflows into the Chinese bond market could be between USD120 billion and USD150 billion before the end of next year.

Additionally, it is likely only a matter of time before other providers add China to their own global bond indices. Specifically, markets are watching if and when Chinese bonds will be included in the FTSE Russell World Global Government Bond Index and/or the JPMorgan Government Bond Index – Emerging Markets; two other major global fixed income indices. A further USD2.7 trillion of assets track these two indices combined[2], suggesting total fund inflows could be as much as ~USD300 billion if China is included in all three indices.

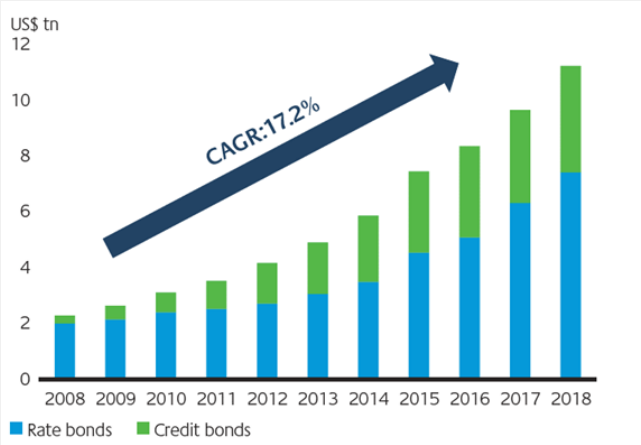
Higher yield, and potentially higher return

Chinese bonds currently offer appealing yields relative to peers. As highlighted in Chart 2, at the end of April 10-year Chinese government bonds yielded 3.40%; well above comparable US Treasuries at 2.50%, Japanese government bonds at -0.05%, German bunds at 0.01% and UK gilts at 1.19%. Chinese bond yields are also currently higher than Australian government bond yields (1.79%). While income for international investors will be eroded by currency hedging costs, the additional yield pickup seems likely to remain attractive.

Total returns from Chinese bonds have also been favourable relative to other global investment markets. In 2018, the Bloomberg Barclays China Aggregate Index returned 3.5% in USD terms in a year where returns from US Treasuries and most major equity markets were negative[3]. Perhaps even more importantly, correlations between Chinese bonds and other major global asset classes have historically been low. As well as their income and total return potential, Chinese bonds are increasingly being viewed as useful portfolio diversifiers.

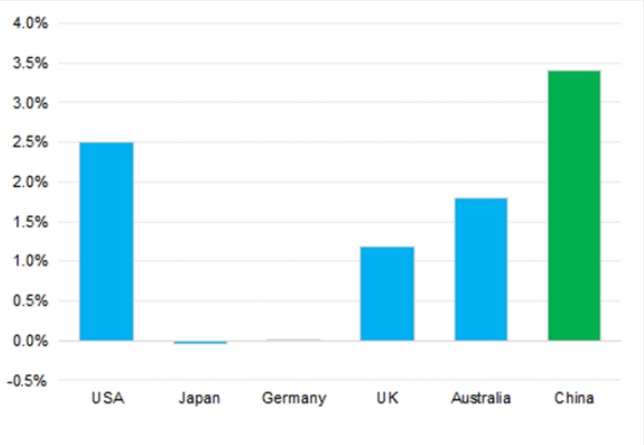
The opening up of the Chinese bond market is among the most significant developments in fixed income in the past 20 years. CFSGAM is one of few Australian entities licensed to invest in the market and our Asian Fixed Income team has extensive experience in the region. With this in mind, we welcome the opportunity to discuss the evolving investment landscape with investors interested in diversifying their investment portfolios through an investment in Chinese bonds. Feel free to contact your account manager to get the conversation started.

Chart 1: Growth of China's bond market



Source: HKEX, Bloomberg, CCDC, SHCH, data covers only the interbank bond market

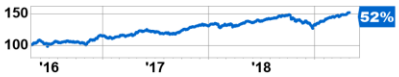
Chart 2: Global sovereign 10-year bond yields



Source: Bloomberg, as at 30 April 2019

[1] Source: Bloomberg, as at 30 April 2019
[2] Source: FTSE Russell, JP Morgan
[3] Source: Bloomberg, HKEX

MARKET WATCH DATA SHEET

		1 Month Return/Change	3 Month Return/Change	12 Month Return/Change	3 Year Annualised Return/Change	3 Year Chart
EQUITIES						
MSCI World (Gross of withholding tax, in AUD)	3,466.65	4.56%	12.14%	14.84%	15.08%	
MSCI Emerging Markets (AUD)	1,107.07	3.07%	6.95%	2.22%	14.71%	
ASX 200	6,325.50	2.37%	9.29%	10.41%	11.10%	
ASX Small Ordinaries	2,855.00	4.11%	11.04%	7.18%	11.79%	
S&P 500 (USD)	2,945.83	4.05%	9.48%	13.49%	14.87%	
REITs						
ASX 200 A-REIT	1,526.90	-2.56%	5.32%	17.68%	7.96%	
FTSE EPRA/NAREIT Developed (AUD)	3,199.41	-0.36%	5.92%	18.65%	9.42%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.50%	0.00%	0.00%	0.00%	-	
10-year yield Australia	1.80%	+0.03%	-0.43%	-0.98%	-	
10-year yield US	2.50%	+0.09%	-0.13%	-0.43%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	93.24	7.95%	22.64%	42.57%	16.10%	
Brent crude oil (USD/barrel)	72.04	5.34%	16.40%	-4.16%	14.39%	
Gold (USD/ounce)	1278.60	-1.11%	-3.11%	-2.86%	-0.27%	
AUD/USD	0.704	-0.92%	-3.47%	-6.76%	-2.66%	

Source: Factset, at 30 April 2019

Disclaimer

This document is directed at persons of a professional, sophisticated or wholesale nature and not the retail market. This document has been prepared for general information purposes only and is intended to provide a summary of the subject matter covered. It does not purport to be comprehensive or to give advice. The views expressed are the views of the writer at the time of issue and may change over time. This is not an offer document, and does not constitute an offer, invitation, investment recommendation or inducement to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any matter contained in this document. This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy or completeness of the information. We do not accept any liability for any loss arising whether directly or indirectly from any use of this document. References to “we” or “us” are references to Colonial First State Global Asset Management (CFSGAM) which is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124. CFSGAM includes a number of entities in different jurisdictions, operating in Australia as CFSGAM and as First State Investments (FSI) elsewhere. Past performance is not a reliable indicator of future performance. Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell. Reference to the names of any company is merely to explain the investment strategy and should not be construed as investment advice or a recommendation to invest in any of those companies. In Australia, this document is issued by Colonial First State Asset Management (Australia) Limited AFSL 289017 ABN 89 114 194311.