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Colonial First State
Global Asset Management

Renewed trade-related fears drag share markets lower

Market Watch

End-August 2019

Economics overview

- **US**: Comments from President Trump regarding trade with China dominated attention and diverted investors' focus from actual economic data releases.
- Trump suggested further tariffs would be imposed on goods imported from China, reigniting growth fears globally.
- With the US and China ratcheting up tariffs on goods imported from one another, the fear is that global trade volumes – and, in turn, global growth prospects – could get even worse before they start to get any better.
- Further dialogue on the ongoing trade dispute will, therefore, remain a focus of central bankers and investors alike in the weeks and months ahead.
- In other news, wage growth ticked up to an annual pace of 3.2% in July. Combined with the prospect of interest rate cuts, this appears to be supporting consumer confidence and spending.
- US unemployment remains at 3.7%, close to a 50-year low.

- **Australia**: The Reserve Bank of Australia updated the market with its latest *Statement on Monetary Policy*. As expected, inflation forecasts were revised lower – CPI is not now expected to return above 2.0% until 2021. Time will tell whether the recent interest rate cuts see a re-emergence of inflationary pressures.
- Interest rates were left on hold at 1.00% following consecutive cuts in June and July. Policy makers will be keeping a close eye on economic data to see whether further cuts are required.
- With that in mind, it was notable that the Composite PMI – a gauge of activity levels in Australia's manufacturing and services sectors – deteriorated quite sharply in July.
- Australian money markets are indicating that interest rates are likely to be lowered again in October or, failing that, on Melbourne Cup Day in early November.

- **New Zealand:** Interest rates in New Zealand were slashed by half a percentage point, to 1.00%. This came as a surprise to investors; a quarter-point cut had been widely anticipated.
- Inflation in New Zealand is currently 1.7% year-on-year and officials have suggested they are keen to see it rise into the upper half of the 1.0% to 3.0% target range.
- The rate cut saw the New Zealand dollar depreciate by 3.5% against the US dollar. This was significant, as a weaker currency improves the price competitiveness of New Zealand produce and should help support export demand.
- The latest labour force data was encouraging. Unemployment fell to an 11-year low in the June quarter and an increase in the minimum wage level saw overall earnings growth pick up.

- **Europe**: The latest statistics confirmed that the German economy, Europe's largest, contracted slightly in the June quarter. The slowdown in China appears to have affected demand for German cars and other exported goods.
- Conditions in the German manufacturing sector are poor – industrial production is now around -5% below 2018 levels, which has weighed on business confidence. Consumer confidence is subdued too, which does not augur well for overall economic growth in the second half of 2019.
- A new word was added to the vocabulary of most UK investors, as Prime Minister Johnson requested a suspension of Parliament in September. Critics suggested Johnson intended the '*prorogation*' to reduce the time available for MPs to pass laws opposing his divisive Brexit plans. Johnson denied the claims, suggesting the move would merely allow the government to bring forward its "legislative agenda".
- It seems likely that Brexit will dominate attention in Europe ahead of the UK's revised 31 October EU withdrawal deadline.
- In economic news, the UK economy shrank in the June quarter. Inventory drawdown following March's original Brexit deadline was blamed for the deterioration.

- **Asia/EM:** Increasingly violent anti-government protests in Hong Kong dampened sentiment towards Asian shares. The Hang Seng Index fell 7.0% over the month in local currency terms.
- The prospect of an escalation in the US/China trade conflict also weighed on confidence, although a seemingly deliberate devaluation of the Chinese yuan was expected to partially offset the impact of further tariffs on goods exported to the US.
- Some observers are suggesting Chinese policy makers could look to ease policy settings later this year to help support the slowing economy.
- The outlook for Chinese manufacturers is particularly bleak. Growth in industrial production slowed to a 17-year low in July, partly reflecting lower exports to the US.
- Elsewhere, the Japanese economy grew 0.5% in the June quarter; well ahead of expectations. Encouragingly the private sector performed better-than-expected, complementing strong government spending.

Australian dollar

- The Australian dollar depreciated by -1.6% against the US dollar in August, closing the month at 67.3 US cents.
- The 'Aussie' also declined (-1.1%) against a trade-weighted basket of international currencies. The local currency performed particularly poorly versus the Japanese yen (-3.9%).
- Those overseas holidays keep getting more expensive!

Commodities

- Iron ore was the biggest loser in August, following news about the increase in trade tariffs between China and the US. This raised concern about the demand outlook and resulted in the price of iron ore falling to around US$91 per tonne, a drop of ~21%.
- Combined with the prospect of further US rate cuts, ongoing trade tensions saw the gold price rise 6.5% during the month. The price rose to a six-year high of more than US$1,500 per ounce.
- The oil price fell 5.9%. WTI crude traded around US$55/barrel at month end and Brent around US$60. Geopolitical tensions in the Middle East continue to threaten supply – Yemeni rebels attacked a major oilfield in Saudi Arabia in August, for example, but uncertainty over the demand outlook are dominating attention.
- Supply concerns caused nickel futures to surge 24.1%. Indonesia confirmed an export ban on the metal (and all mineral ore exports) would come into effect sooner than expected. Indonesia currently accounts for nearly a third of the world's supply of nickel ore.
- The September quarter has already seen premium coking coal spot prices decline more than 20%, reflecting demand concerns stemming from China's lower manufacturing activity. Slowing economic growth and weaker steel production in Europe is also contributing to the price weakness.

Australian equities

- Market positivity driving the S&P/ASX 100 to all-time highs at the end of July came to an abrupt end, as investors shunned equities globally in the first half of August. There was little to excite shareholders close to home, with a generally disappointing earnings season in Australia (see *Chart of the Month* overleaf). As the month progressed, investors became more comfortable with the global growth outlook. As a result, the S&P/ASX 100 Accumulation Index recovered from its initial ~6% decline to end the month -2.1% lower.
- At the sector level, returns were widely dispersed, with Materials (-7.5%) and Information Technology (+5.6%) at the extremes.
- In the Materials sector, most miners weighed on performance; both Iluka Resources (-25.7%) and Orora (-17.5%) saw double-digit declines after releasing results that were below market expectations. James Hardie (+13.4%) bucked the trend as its first quarter result showed positive performances across all regions, despite the uncertain economic backdrop. Management also provided FY20 profit guidance above market expectations.
- Better returns in the IT sector were supported by Afterpay (+15.9%) and WiseTech Global (+15.6%). Both stocks benefited from the release of FY19 results that showed strong revenue and earnings growth. Afterpay also highlighted the robust growth it has achieved in the US and UK as the number of users and stores available both rose substantially.
- Australian small caps resumed their longer-term underperformance trend (compared to Australian large caps) in August, with the S&P/ASX Small Ordinaries falling -3.9%.

Listed property

- Global listed property posted pleasing gains in August. The defensive nature of the asset class proved appealing given the 'risk-off' mood that permeated investment markets.
- The FTSE EPRA/NAREIT Developed Index rose 1.9% in USD terms and 4.3% in AUD terms; comfortably outperforming broader equity markets. Canada was the best performing market (+4.1%), while Hong Kong continued its miserable run (-9.4%) as demonstrations in the territory escalated.
- In Australia, the S&P/ASX 200 A-REIT Index returned 1.2%. Retail A-REITs continued to bounce back in August; this was the best performing sub-sector for the month (+2.8%), followed by Diversified A-REITs (+1.9%). Industrial A-REITs underperformed for the second consecutive month (-2.0%).
- The strongest performers in Australia were Charter Hall Long WALE REIT (CLW) (+14.0%) and National Storage REIT (NSR) (+11.9%), both of which released their full year results. Both announced an annual improvement in earnings and provided reassuring earnings guidance for FY20.

Global equities

- Having hit all-time highs in late July, US Fed Chairman, Jerome Powell, initially upset the global equity market party through his "mid-cycle adjustment to policy" comments, which doused hopes of additional monetary easing. President Trump further dampened investors' high spirits with tweets about additional import tariffs and when Chinese authorities responded by allowing the renminbi to depreciate to its lowest level since the Global Financial Crisis, equity investor party-goers started heading for the exit.
- By mid-August, the MSCI World Index had fallen -5.0% in local currency terms. The combination of renewed hopes for a trade deal and the weaker Australian dollar (AUD) saw a recovery in returns over the final weeks. The MSCI World Index finally eked out a positive return of +0.3% in AUD terms by month end.
- The UK was the weakest performer among major equity markets, with the FTSE 100 Index down -4.1% in local currency terms on raised prospects of a hard Brexit on 31 October. The S&P 500 Index in the US was the strongest performer, down 'only' -1.6% in USD terms after bouncing 3% from mid-August on the prospect of a favourable trade outcome.
- Emerging markets underperformed their developed counterparts for a seventh straight month, with the MSCI Emerging Markets Index falling -2.7% in AUD terms. Latin America was the weakest performing region. Brazilian stocks struggled reflecting the deteriorating trade outlook and falling commodity prices – particularly iron ore.

Global and Australian Fixed Income

- Government bond yields in most regions declined to record lows in July, but fell even more precipitously in August as the economic outlook deteriorated and as investors factored in the likelihood of further interest rate cuts worldwide.
- Worsening economic indicators and increasingly hostile trade-related rhetoric from US and Chinese officials increased the probability of a downturn in economic growth globally.
- In the US, 10-year Treasury yields plummeted 52 bps, closing the month at 1.50%. The Treasury yield curve 'inverted' during the month, with 2-year yields rising above 10-year yields. This was a concerning development for investors, as such a move has historically been indicative of a possible future recession.
- Yields fell even further into negative territory in Germany in Japan, closing August at –0.70% and –0.28%, respectively.
- In the UK, 10-year gilt yields closed 13 bps lower, at 0.48%, partly reflecting further Brexit-related uncertainty.
  Domestically, 10-year Australian government bond yield yields closed August at 0.89%, a drop of 30 bps over the month.

Global credit

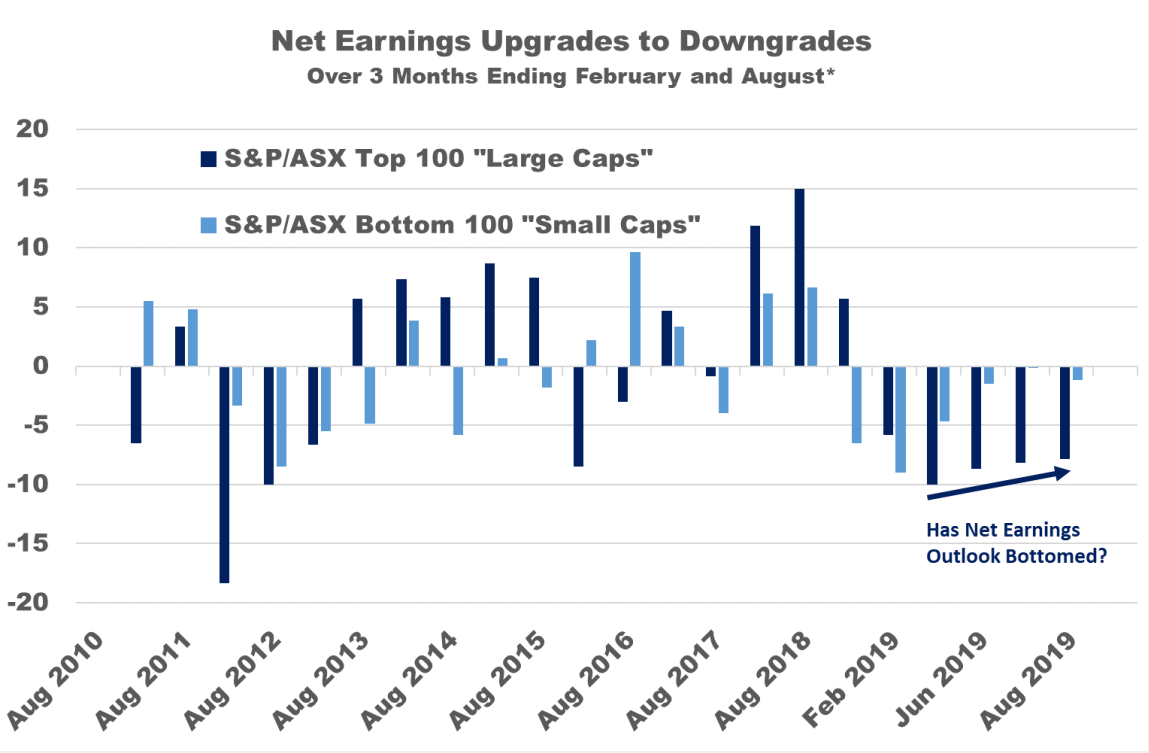
- Both investment grade and high yield credit spreads spiked in early August, reflecting the 'risk off' mood in global financial markets at that time. Thereafter, spreads were range-bound for the remainder of the month.
- June quarter corporate earnings releases in the US were mixed, but positive on the whole. On average, US firms' revenues and earnings were ahead of consensus expectations.
- There are competing forces at play in corporate bond markets. On one hand, the prospect of slower global growth is a worry for the earnings outlook. On the other, investors' ongoing appetite for yielding assets as risk-free rates decline globally is providing support for the asset class.

Chart of the Month (COTM) – Australian Earnings Season – Are We Through the Worst of It?

In these bulletins, we aim to share interesting observations from global investment markets. This month we again draw on our 10 million+ data points in our database[1] *to see what we have learned on the state of our larger companies over earnings season.*

Coming into the earnings season the Reserve Bank of Australia observed that "the financial health of [Australian] businesses looks sound"[2], while conceding that some individual sectors, such as domestic retailing, and regions do face challenges. Most of the RBA's analysis drew on data compiled *prior to* the May federal election, the back-to-back interest rate cuts over June/July, the reduced income tax package in July and a 5% depreciation in the Australian dollar since February 2019. The August earnings season represents a good opportunity to gain a bottom-up update on the financial health of Australian businesses given some of these developments.

Unfortunately, the overall results for the S&P/ASX 200 do not look great, with this being the worst August reporting season since 2012 with respect to the extent that both earnings and dividend downgrades are outnumbering upgrades. On the brighter side, as shown in the chart below, the overall August results are at least better than the half-year results in February. If we look at the breakdown across the Top 100 stocks "Large Caps" and the Bottom 100 stocks "Small Caps" of the S&P/ASX 200, there has already been a marked turnaround for the small caps, which are back in positive territory – more than compensating for the further deterioration across the large caps. And yet small caps share prices have underperformed their larger cap counterparts over August and the last six months. As Dawn Kanelleas, Senior Small Caps Portfolio Manager observes, "A number of high-quality, globally-exposed companies which met expectations were sold down against a backdrop of Brexit, trade tariffs and Hong Kong protests. The longer-term growth prospects for these quality companies, however, remain intact." Large caps are also showing some signs of improvement - albeit gradual.



*: To August 2018, we then show December 2018, February, April, June, July and August 2019 to highlight recent trends
Source: CFSGAM and S&P/ASX. Shows number of firms enjoying earnings upgrade levels in upper tertile of results since the inception of our database in August 2010 less the number of firms suffering earnings downgrade levels in the bottom tertile of results over the same period.

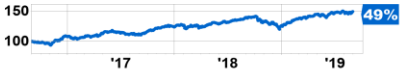
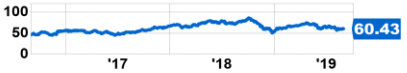
"One of the surprises last month was the market's positive reaction to the results from speciality domestic retailers such as JB Hi Fi and Super Retail Group. This showed that while the retail sector as a whole is priced for recession, there exists investment opportunities in more differentiated players.", notes Raelene De Souza, Senior Portfolio Manager, Realindex Australian Shares fund, which holds both stocks owing to their solid valuation characteristics.

There was also hope for the housing sector as Australia's leading online real estate classifieds company, REA Group, reported a 19% increase in monthly searches - indicative of a recovery in the housing market according to management – and rallied appreciably in spite of marginally missing expectations. Two other stocks to enjoy significant earnings upgrades over the month were the fast-growing tech stocks Afterpay and Wisetech, which are both taking share in their respective global markets. Head of Australian Equities Growth, Dushko Bajic, holds these three companies in his Concentrated and Ex-20 strategies. "It is beneficial to maintain an open mind to investing in this kind of environment", he notes, "We remain continuously inquisitive and do not ignore stocks trading at a given valuation metric or because their businesses are subject to near-term volatility or too new or complex."

[1] Our Australian equities teams are able to draw upon our proprietary collection of market statistics drawn from 10-12 brokers on a monthly basis over the last 8+ years. It has 100 data types on ~400 stocks over a minimum 5 year time frame.

[2] "Financial Stability Through the Lens of Business" Michele Bullock, Assistant Governor (Financial System), Reserve Bank of Australia, 8 August 2019.

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)	3,554.77	0.26%	8.03%	8.24%	14.33%	
MSCI Emerging Markets (AUD)	1,054.83	-2.66%	2.85%	3.06%	10.09%	
ASX 200	6,604.20	-2.36%	4.23%	9.04%	11.38%	
ASX Small Ordinaries	2,837.30	-3.85%	1.41%	0.95%	8.41%	
S&P 500 (USD)	2,926.46	-1.58%	6.87%	2.92%	12.70%	
REITs						
ASX 200 A-REIT	1,655.70	1.18%	8.16%	19.42%	8.59%	
FTSE EPRA/NAREIT Developed (AUD)	3,837.52	4.28%	7.05%	17.11%	9.42%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.00%	0.00%	-0.50%	-0.50%	-	
10-year yield Australia	0.89%	-0.30%	-0.57%	-1.63%	-	
10-year yield US	1.50%	-0.52%	-0.64%	-1.35%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	90.91	-21.32%	-7.01%	35.36%	16.71%	
Brent crude oil (USD/barrel)	60.43	-7.27%	-6.30%	-21.95%	8.71%	
Gold (USD/ounce)	1519.10	6.52%	16.33%	26.56%	5.14%	
AUD/USD	0.674	-2.25%	-2.76%	-6.84%	-3.58%	

Source: Factset and Bloomberg, at 31 August 2019

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