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Colonial First State
Global Asset Management

Markets refocus on fundamentals

Market Watch

April 2018

Economics overview

- **US:** Following a period where market sentiment was largely driven by geopolitical news flow and events, investors started to refocus on the outlook for growth and monetary policy globally. This was the primary driver of bond yields over the month.
- Equity investors focused on a favourable Q1 earnings reporting season in the US. In April, around half of S&P 500 companies announced their results for the first three months of 2018. Of these, more than three quarters beat consensus expectations and have reported earnings growth of 24.6%, more than double that expected according to Thomson Reuters.
- Data confirmed the US economy grew by 2.3% in the 12 months to 31 March 2018. This was a slowdown from the 2.9% yoy growth in the previous quarter, mainly attributable to more subdued consumer spending versus the hurricane-related replenishment spree of the previous quarter.
- Few observers seemed concerned about the slowdown, in the belief that consumer spending and growth will reaccelerate next quarter driven by tax cuts and the solid employment market.
- Unemployment in the US remained at a 17-year low of 4.1% in March 2018, where it has been for the past six months.
- There was a modest increase in US price pressures, with the core inflation measure most closely watched by policy makers – picking up to 1.9% yoy in March, the fastest pace in more than a year and approaching the Federal Reserve's 2.0% target.
- This supports the case for further increases in interest rates in the remainder of 2018 and beyond. Global markets continue to pay close attention to commentary released by Federal Reserve Board members regarding monetary policy.

- **Australia:** As anticipated, the Reserve Bank of Australia (RBA) left domestic interest rates on hold a 1.50%. Official borrowing costs have been at this level since August 2016 – the longest period that Australian interest rates have remained unchanged.
- CPI data confirmed that inflation ran at an annual pace of 1.9% in the March quarter; in line with the final quarter of 2017. With inflation under control, there appears to be a low probability of the RBA increasing interest rates in the near future.
- Employment growth appears to be coming off the boil. Just 4,900 jobs were added in March, well below the +20,000 forecast. Unemployment remains steady at 5.5%. Owing to net migration into Australia and the associated increase in the workforce, strong job growth over the past year or so has not had a significant impact on the official unemployment rate.
- Helped by solid bulk commodity exports – primarily coal and iron ore – Australia continues to enjoy a healthy trade surplus. Exports were $825 million greater than imports in February.

- **New Zealand:** Inflation fell to an 18-month low of 1.1% yoy in the March quarter. Lower education costs appeared to contribute, with the government having made the first year of tertiary education free to students.
- House construction prices rose 0.4%, the smallest since 2011.
- With inflation towards the lower end of the RBNZ's 1% to 3% target range, few observers are expecting interest rates to be increased from the current 1.75% level this year.

- **Europe:** European growth appears to have moderated in early 2018. French GDP growth decelerated in the March quarter.
- The European Central Bank has suggested any moderation in the pace of growth will prove temporary and that conditions remain supportive of a broad-based expansion.
- Economies in the EU continue to benefit from zero interest rates and an ongoing QE program. The latter is due to conclude later this year, but could be extended if required.
- UK GDP growth has also slowed from 2017. The economy expanded at an annual pace of 1.2% in the March quarter, below forecasts and the slowest pace in more than five years.
- UK inflation has also decelerated, to 2.5% yoy. This suggests the Bank of England might not need to amend policy settings – the previously anticipated interest rate hike in May now appears to be a possibility rather than a probability.

- **Asia:** Moderating food prices have fed through to lower overall inflation in Japan. Prices rose just 1.1% yoy to March 2018.
- The Bank of Japan is believed to be considering when and how best to remove its current QE program. The lower inflation reading suggests there may be no pressing need to do so.
- For now, official Japanese interest remain negative, at -0.10%
- In China, data showed the economy grew at an annual pace of 6.8% in the March quarter. The government continues to target 6.5% yoy economic expansion as the economy transitions towards domestic growth from export-oriented growth.
- In South Korea, the economy grew at an annual pace of 2.8% in the March quarter. April saw a historic meeting between the leaders of North and South Korea, with the two Heads of State agreeing to end the 65-year long Korean War and to complete a full denuclearisation of the Korean Peninsula.

Australian dollar

- The subdued inflation print – combined with stronger data in the US – saw the Australian dollar weaken nearly 2% against the US dollar. The Australian dollar fell by less against a trade-weighted basket of currencies, declining by just 0.3%.

Commodities

- Commodity prices were mixed in April, against a background of geopolitical uncertainty. Aluminium (+11.4%) was the standout performer after the US imposed sanctions on Russian aluminium giant Rusal. Nickel (+3.6%) and Copper (+1.1%) posted smaller gains, while Lead (-2.7%) and Zinc (-4.8%) declined. Coking coal had another poor month, falling -13.4%.
- WTI Crude continued its upward momentum, adding 5.6% to US$68.57 per barrel. Robust demand, coupled with sidelined supply and trade sanctions helped support prices.
- After sharp falls last month – on surplus concerns in China's steel market – iron ore prices steadied, edging 0.7% higher to US$65.30 per tonne.
- Gold fell -0.5% to US$1,315 per ounce on the back of a strengthening US dollar.

Australian equities

- The S&P/ASX 200 Accumulation Index rose 3.9%, benefiting from heightened takeover activity. All sectors posted positive returns with Energy (+10.8%), Materials (+7.6%) and Health Care (+7.4%) the best performers.
- Energy and Materials stocks rallied reflecting rising commodity prices. Santos benefited further from the receipt of a takeover proposal from Harbour Energy, which valued Santos at A$6.50, more than a 28% premium to the previous close.
- Similarly, the Health Care sector benefited from a strong performance from Healthscope after it received a bid from a consortium of financial investors for an indicative price of A$2.36, representing a 16% premium to the previous close.
- In the Utilities sector (+2.3%), Infigen Energy delivered the largest return as Brookfield Asset Management's sudden purchase of a substantial holding sparked takeover speculation.
- The Financials sector (+0.2%) delivered the lowest return in April as several acts of market misconduct were brought to light through the Royal Commission.

Global equities

- The MSCI World Index recovered from trade dispute induced intra-month lows of -1.4% (in USD terms) as investors started to focus instead on an encouraging earnings season in the US. The index was up as much as 2.9%, before reports that global smartphone sales might have peaked saw technology stocks tumble. The broader index recovered to finish April up 1.2%.
- Despite delivering more than double the earnings growth expectations, the S&P 500 Index was one of the weaker markets. Some investors are now questioning whether earnings growth can improve any further, particularly with a further three US interest rate increases anticipated for this year. The UK FTSE 100 Index was one of the stronger markets, as a depreciating pound propelled the UK bourse to its highest level in almost three months. The Index finished up an impressive 6.8% in local currency terms.
- Value stocks edged ahead of their growth counterparts in April. Large cap stocks also outperformed small caps, with a rallying energy sector helping to offset the hit to large cap US technology stocks mid-month.
- The deteriorating outlook for smartphone sales also contributed to the MSCI Emerging Markets falling -0.4% in USD terms.
- Taiwan Semiconductors, one of Apple's largest suppliers for iPhone manufacture, fell almost -10% after warning shareholders of "weak demand" from the mobile phone sector.
- In fact Taiwan was one of the weakest markets, down -4.6% in USD terms. Russian stocks also struggled, down -7.4% as sanctions and diplomatic tensions over the recent spy poisoning in the UK triggered a run on Russian-related assets.

Listed property

- The S&P/ASX 200 A-REIT Index performed strongly in April, returning 4.5%. Industrials (+7.6%) was again the best performing sub-sector. Retail A-REITs (+5.2%) turned around their recent run of underperformance to be the next strongest, while Office A-REITs (+1.8%) lagged.
- A-REITs performed well despite significant increases in bond yields in both the US and Australia.
- The strongest individual performers were Westfield (+8.0%), Goodman Group (+7.6%), and Iron Mountain (+6.5%). Westfield shareholders are scheduled to vote on the proposed takeover by Unibail-Rodamco in late May, and with no competing bidders, the deal is expected to be completed in June.
- The weakest performers were Viva Energy REIT (+1.0%), Vicinity Centres (+1.2%), and Dexus (+1.8%).
- Viva Energy REIT underperformed despite a lack of company-specific news, while Vicinity Centres struggled on concerns over soft retail sales metrics.
- Overseas property market returns were solid too and again outperformed broader equity markets. The FTSE EPRA/NAREIT Developed Index returned 2.0% in USD terms. In local currency terms, Japan (+5.5%) was the best performing market, while the US (+1.3%) was the worst.

Global and Australian Fixed Interest

- Sovereign bond yields continued to trade in reasonably wide ranges during April. Overall market volatility dissipated a little from the elevated levels seen in February and March, but investors then refocused on fundamental drivers of fixed income markets (such as higher US official interest rates). During February and March, in particular, there had been a greater focus on geopolitical developments and risks.
- Following a reversal over that period, yields resumed their uptrend in April supported by generally favourable economic conditions in the US.
- Treasury yields rose as investors digested the modest increase in US CPI data releases. The likelihood of future interest rate hikes increased accordingly.
- Monetary policy expectations did not rise as significantly in other markets. 10-year government bond yields rose 7 bps and 6 bps in the UK and Germany respectively, and by 1 bp in Japan.
- Australian yields increased consistent with offshore moves, reversing some of the declines seen in March. The 10-year Australian bond yield closed the month at 2.77%, an increase of 17 bps from the end-March level. The curve steepened as longer-dated yields were pushed significantly higher.

Global credit

- Spreads were little changed, meaning government bond yields were the main driver of corporate bond returns over the month.
- Improving profitability from the US earnings season to date supports issuers' ability to service their repayment obligations and should continue to support a low level of defaults globally.
- Many corporates remain highly leveraged, potentially causing some concern as funding costs increase.
- A number of US issuers appear to be considering M&A, deploying excess capital being repatriated to the US under the revised corporate taxation regime. Some have also noted increasing cost pressures, particularly relating to rising energy prices. Strong corporate profitability and low unemployment have not yet been reflected in significantly higher wages.

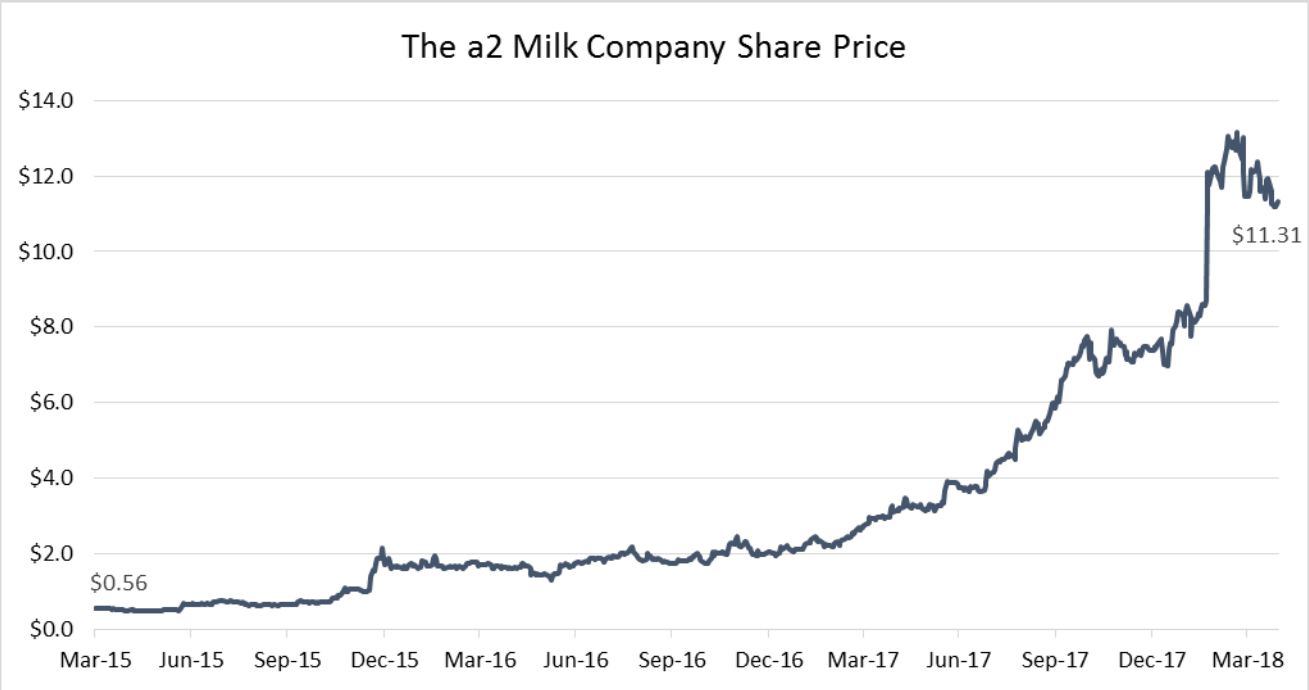
Chart of the Month – can a2 Milk's extraordinary growth continue?

In these bulletins, we aim to share interesting observations from global investment markets. This month, we examine the extraordinary success of the Australian share market darling, the a2 Milk Company (A2M) and whether it can continue.

Operating in a populated market, the A2M has experienced exceptional success with its differentiated product offering. Since listing on the Australian Securities Exchange on the 31st of March 2015, A2M's share price has risen over 1900% (as of 30th April 2018). The company's marketing slogan of 'feel the difference', as well as the 'clean and green' perception of Australia and New Zealand, have been key contributors to the company's success. Today, A2M holds a 9% share of the fresh milk market and >30% share of the infant formula market in Australia.

However some investors are, understandably, starting to question whether A2M's share price is now overvalued given its substantial rally. In response, our Australian Equities Growth team argues that continued market share gains in infant formula sales in China, both via cross-border channels and MBS (Mother & Baby Stores) is going to continue to be a primary driver of profit growth going forward. They also believe that the recently announced partnership with Fonterra will help drive the company's plan to expand further into South East Asia and the Middle East. While competitors such as Nestle have announced their intention to expand into A2 only products, this highlights the major impact A2M has had on the global market. The growing acceptance of the health benefits associated with A2-only dairy products will, in the opinion of our Australian Equities, Growth team, likely increase A2M's exposure. A2M's expected product expansion into adult nutrition and other dairy products would provide yet another avenue of growth for the company and may well be the beginning of a new global trend in dairy consumption.

Our Australian Equities, Growth team do not believe that these next waves of growth are being fully reflected in the share price and continue to hold the stock.



Source: Factset, to 30 April 2018

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