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Colonial First State
Global Asset Management

Trade tensions dominate the headlines

Market Watch

June 2018

Economics overview

- **US:** The Federal Reserve raised interest rates by 0.25% as anticipated, to a new target range of 1.75% to 2.00%. Consensus expectations suggest rates could be increased twice more in the remainder of 2018, before four further hikes next year.
- Final GDP data confirmed the economy expanded 2.0% in the year ending 31 March 2018.
- The US employment market remains buoyant. Non-farm payrolls data showed a 223,000 increase in jobs in May. The official unemployment rate fell to 3.8%, the lowest level since the 1960s.
- Tighter labour market conditions have not resulted in significant wage pressure. Average hourly earnings rose 2.7% in the year to 31 May 2018; slightly below inflation. The Consumer Price Index – arguably the best indicator of prices for most households – rose at an annual pace of 2.8% in May, a six-year high.
- Core PCE – the inflation measure used by the Federal Reserve when setting interest rates – also rose, to the target 2.0%.

- **Australia:** GDP data showed the Australian economy grew by 3.1% in the year ending 31 March 2018. This pace was above consensus forecasts. The acceleration in growth was fuelled by a recovery in export volumes. Consumer spending was weak and funded by a savings rate that fell to its lowest level since 2007.
- Australian inflation remains below 2%. The Reserve Bank of Australia again left interest rates on hold at 1.50% against this background.
- The unemployment rate unexpectedly dropped to 5.4%, helped by a sizable gain in part-time employment.
- Other data released showed that the Australian population grew by 1.6% in 2017. Australia continues to see net positive overseas migration, with migrants accounting for over 60% of the growth.
- Victoria appears to be a particularly appealing destination, with the state population rising by 2.3%.

- **New Zealand:** GDP data for the first three months of 2018 showed the economy expanded at an annual pace of 2.7%, a slight deceleration from the December quarter.
- A dissection of the data highlighted that growth was driven by services sectors and rising production of dairy products. Conversely, there was a slowdown in the construction sector.
- The GDP data supports a view that the Reserve Bank of New Zealand is unlikely to raise interest rates until 2020. In fact, some observers are suggesting a cut is possible in the months ahead.
- Later, data showed that exports rose 10.4% in the year ending 31 May 2018, the second fastest pace on record. This was partly due to a 17% yoy rise in meat exports and strong lumber exports.

- **Europe:** The European Central Bank (ECB) announced an intention to withdraw its Quantitative Easing program by the end of 2018.
- Rather than removing the stimulus package at the end of September 2018 as originally planned, the Bank will halve bond repurchases – to a rate of €15 billion per month – for the final three months of the year.
- Official interest rates will remain zero until mid-2019 at the earliest. Investors are not expecting a hike until September 2019.
- The announcement came at a time when the European economy is showing signs of weakness. This prompted some observers to suggest that the move was based on political motivations rather than economic indicators.
- In the UK, 146,000 new jobs were created between February and April; more than economists had anticipated.
- The official UK unemployment rate remained at 4.2%, the lowest level since 1975. In spite of the buoyant employment market, wage growth eased to 2.8%, suggesting there remains some spare capacity in the economy.
- The Bank of England left interest rates on hold at 0.50%. Three of the nine-member Committee voted for an increase, however, raising the prospect of a hike in the months ahead.

- **Asia:** Unlike the ECB, the Bank of Japan (BoJ) remains committed to its own Quantitative Easing program.
- Currently at 0.7% yoy, inflation has been trending lower suggesting the program could remain in place for an extended period. In fact, the BoJ lowered its inflation forecasts during June.
- In China, some observers suggested that a prolonged trade conflict with the US could shave 0.5% from GDP growth.
- Escalating trade tensions between China and the US weighed on equity markets in the region. The Shanghai Composite Index, for example, is down 20.0% since January. China's currency also suffered its largest ever monthly fall against the US dollar in June.
- The much anticipated North Korea/US summit was held in Singapore in mid-June. This event attracted plenty of headlines, but did not affect equity or bond markets in the region.

Australian dollar

- The diverging outlook for interest rate policy in the US and Australia was reflected in foreign exchange markets.
- The Australian dollar depreciated by 2.2% against the US dollar in June, extending recent weakness.
- Since Australia Day on 26 January 2018, the 'Aussie' has lost more than 8% against the US dollar.

Commodities

- Commodity prices were mixed, with metals falling, energy prices rising and iron ore little changed.
- Zinc (-4.9%), aluminium (-4.5%), copper (-3.5%) and nickel (-1.9%) all fell, as trade concerns between the US and China cast a cloud over the economic growth outlook and the demand for industrial metals.
- Gold finished -3.8% lower amid ongoing strength in the US dollar. Silver (-3.1%), palladium (-3.1%) and platinum (-6.1%) also fell.
- Oil prices rose, with WTI Crude adding 10.7%. Prices were supported by ongoing OPEC supply restrictions.
- Coal rose for the second consecutive month, with coking coal and thermal coal adding 4.4% and 3.9% respectively.
- Iron ore edged 0.8% higher, as the drawdown of Chinese steel inventory continued on supply disruptions from China's pollution crackdown.

Australian equities

- The S&P/ASX 200 Index performed well in June, returning 3.3% and rising to a 10½ year high. This impressive performance was driven by a combination of a weakening Australian dollar, which fell to 18-month lows and a 'relief rally' in Australian banks.
- With the exception of Telecoms, all sectors registered positive returns. Energy (7.8%) and IT (6.3%) outperformed and helped drive a wedge between value and growth stocks (see Chart of the Month). Telecoms declined another -5.8% in June, closing FY18 as the laggard, falling -23.2%.
- All constituents of the Energy sector rose as higher oil prices provided a tailwind for the sector. Caltex Australia was the best performer, rising more than 10% after it released updated first half earnings guidance for 2018, which detailed a 49% annual improvement in net profit after tax.
- Small caps underperformed their large cap counterparts, with the S&P/ASX Small Ordinaries Accumulation Index rising 1.1%.
- Gateway Lifestyle, Amaysim Australia and Liquefied Natural Gas were among the best performers, each rallying more than 30%.
- June concluded one of the strongest three years of small cap outperformance since the inception of the Index in March 2000. In the three years ending 30 June 2018, small cap returns exceeded returns from the S&P/ASX 100 Index by 6.4% pa.

Listed property

- The S&P/ASX 200 A-REIT Index had a solid month in June, returning 2.2%. Industrials (4.5%) was the best performing sub-sector, while Diversified (0.5%) was the weakest.
- Merger and acquisition activity was a key driver, with Blackstone and Investa Office Fund entering a scheme of arrangement, and Hometown and Brookfield both making all-cash bids for Gateway Lifestyle.
- The strongest performers were Viva Energy REIT (9.8%), National Storage REIT (6.9%), and Charter Hall Long WALE REIT (6.4%). Viva Energy REIT benefited as its largest tenant and shareholder, Viva Energy, secured strong cornerstone interest for its upcoming IPO.
- The weakest performers were Mirvac (-3.0%), Stockland (-1.1%), and Unibail-Rodamco-Westfield (-0.3%). Mirvac fell heavily on concerns over the company's exposure to residential property developers in Sydney, who are facing lower prices amid tighter credit conditions.
- Globally, major property market returns continued to outpace broader equity markets. The FTSE EPRA/NAREIT Developed Index returned 1.6% in USD terms. In local currency terms, the US (4.2%) was the best performing market, while Hong Kong (-4.1%) was the worst.

Global equities

- Global equity markets had a bright start to the month, rising almost 4% on positive economic news in the US, before trade tensions undermined market confidence. The MSCI World Index slipped back to finish the month up only 2.4% in AUD terms.
- In FY18 as a whole, the Index added 16.0%, beating the return from FY17. However, market joy was not well spread. Financials and some defensive sectors were left behind and value stocks suffered their worst year since the GFC (see Chart of the Month).
- Among major markets, the S&P 500, FTSE 100 and Nikkei 1000 were all little changed, returning 0.6%, -0.2% and -0.9% respectively, in local currency terms. The German DAX lagged, down -2.4% in euro terms.
- Emerging Markets underperformed their developed market counterparts over both the month and the year. The MSCI Emerging Markets Index returned -1.8% in June and 12.7% in FY18 in AUD terms.
- Investors are particularly concerned by countries with widening current account deficits and/or high levels of USD denominated debt. These markets appear susceptible to a combination of rising US interest rates and a strengthening US dollar.
- Asia was the worst performing region over the month, however, with China suffering from a combination of a weaker equity market and a falling currency. Investors appear to be fleeing the deteriorating economic outlook – exacerbated by fears of further trade barriers being erected between China and the US.

Global and Australian Fixed Interest

- Global bond yields continued to trade in reasonably wide ranges, but closed the month little changed in most markets. In the US, 10-year yields rose towards 3.0% in early June, before reversing and closing the month unchanged at 2.86%.
- Japanese 10-year yields were also unchanged in June. UK 10-year gilt yields rose 5 bps, while 10-year yields in Germany and Australia closed 4 bps lower, at 0.30% and 2.63%, respectively.
- The increase in bond market volatility in 2018 is arguably attributable to the removal of liquidity by central banks.
- Investors have been able to shrug off negative news flow in recent years, safe in the knowledge that markets would be supported by global central banks' extremely accommodative policies. This sentiment is changing as policy settings are being reviewed, contributing to volatility in yields as investors digest economic and geopolitical news.

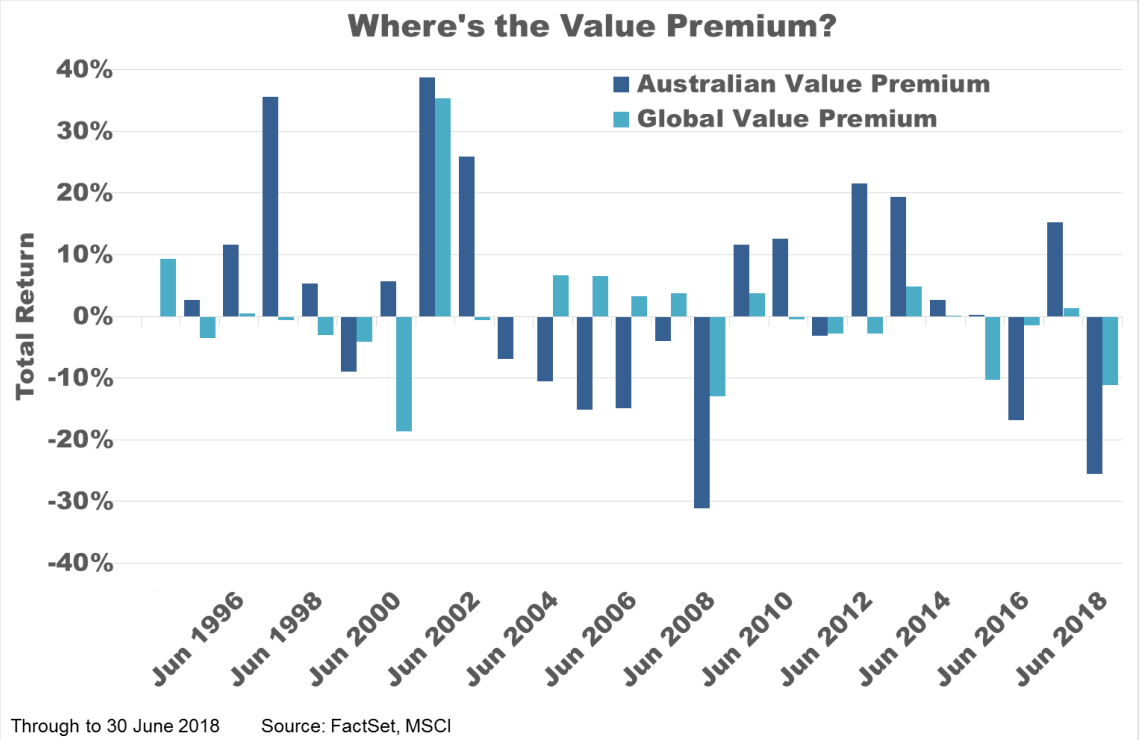
Global credit

- Credit markets were hampered by trade concerns, with the US and China each implementing new tariffs on a wide range of goods imported from one another.
- Thus far, investors have tried to estimate the likely impact on individual issuers. German car maker Daimler, for example, has suggested that lower Chinese sales of Mercedes vehicles manufactured in the US will result in lower profitability.
- These concerns saw investment grade credit spreads widen by 7 bps, to their highest level since late 2016. High yield spreads also closed the month 7 bps wider. Asian issuers performed particularly poorly, reflecting trade concerns.
- There was a reasonable level of issuance ahead of a seasonal slowdown during the northern hemisphere summer holiday season. Issues of around US$15 billion from both German healthcare giant Bayer and US retailer Walmart were among sizeable deals that came to market in June.
- Collectively, global corporates still have significant funding requirements in the remainder of 2018. The pace of new issuance is expected to pick up again in September.

Chart of the Month – Where's the value premium?

In these bulletins, we aim to share interesting observations from global investment markets. This month we look at the 'value premium' since the inception of the MSCI Australia Value and Growth indices. We conclude that you might be better off with a balanced exposure to both styles rather than endure the return volatility of a single style bias.

US economists Fama and French are credited with first identifying the premium associated with investing in value stocks over the longer term. Using the MSCI Australia Large Cap Value and Large Cap Growth indices, we have looked at the relative performance of value and growth stocks each financial year since the inception of these indices in May 1994. The chart shows that there have been years in which the MSCI Australia Large Cap Value Index has strongly outperformed its growth counterpart – particularly during the "Tech Wreck" of 2000/2001 when Australian value stocks outperformed by almost 40%. Global value stocks were also outperforming strongly at this time. But you don't have to be a Nobel Laureate to also know that what goes up – also tends to go down and during the depths of the Global Financial Crisis (GFC) over 2007/08, value stocks in Australia underperformed growth stocks by just over 30%.



*: The Australian Value Premium is the difference between the MSCI Australia Large Cap Value Index and the MSCI Australia Large Cap Growth Index.
**: The Global Value Premium is the difference between the MSCI World Value Index and the MSCI World Growth Index.

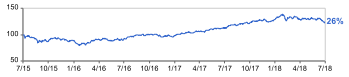
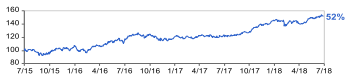
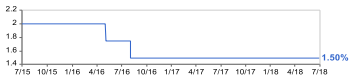
The value premium in Australia over the last 24 years has certainly been volatile, but if you have been patient and able to withstand the extreme swings in relative returns, you would have enjoyed a premium of 3%pa by investing in value stocks (as represented by the MSCI Australia Large Cap Value Index) as opposed to growth stocks (represented by the equivalent growth index). However, the benefits appear to have been eroding over time. In the second half of the period covered by the chart – from June 2006 to June 2018, the value premium had fallen away to a meagre 0.2%pa and over the last five years, that premium has turned around to become a deficit – ***growth stocks*** have outperformed by 0.4%pa.

Have investors been bidding up value stocks too much as they seek the premium identified by Fama and French? Or was there ever a premium at all? Jack Bogle, founder of the Vanguard Company, one of the largest asset managers in the world, has argued that no such premium exists and that Fama and French's results are period dependent. Looking at the equivalent results across global stocks, one might agree with Mr Bogle. Global growth stocks have outperformed their value counterparts over 24 years (albeit by a paltry 0.1%pa), over 12 years (by almost 3%pa) and over the last five years (by 0.3% pa). Indeed 2017/18 has been the worst financial year for value stocks here and overseas since the GFC.

What do we conclude from this? Our Realindex team, which seeks to gain exposure to a variety of styles, including value, would point to the extreme underperformance of value over the last year and observe that these stocks are looking very cheap – offering an opportunity to benefit from the inevitable recovery. Meanwhile, our Australian Equities Growth team argues the notable outperformance of their highest conviction growth stocks merely reflects strong recent earnings growth and the market's forward year expectations of their future growth being more than double that of the S&P/ASX 200[1]. Both arguments have merit, but one may be better off with a mix of value and growth as the benefits of exposure to one style alone appear to be outweighed by the volatility you have to endure in waiting for that single style premium to materialise.

[1] The Growth team's extensive broker database shows the weighted average earnings growth of stocks in their concentrated strategies are 24.56% (latest 12 months) and 9.04% (FY1 estimate) versus the equivalent for the S&P/ASX 200 being only 17.20% and 4.49% respectively.

MARKET WATCH DATA SHEET

		1 Month Return/Change	3 Month Return/Change	12 Month Return/Change	3 Year Annualised	3 Year Chart
EQUITIES						
MSCI World (Gross of witholding tax, in AUD)	3,166.95	2.40%	5.82%	15.96%	9.26%	
MSCI Emerging Markets (AUD)	1,045.13	-1.78%	-4.34%	12.73%	7.87%	
ASX 200	6,194.63	3.27%	8.47%	13.01%	9.04%	
ASX Small Ordinaries	2,859.03	1.06%	7.67%	24.25%	15.01%	
S&P 500 (USD)	2,718.37	0.62%	3.43%	14.37%	11.93%	
REITs						
ASX 200 A-REIT	1,409.35	2.19%	10.04%	13.04%	9.70%	
FTSE EPRA/NAREIT Developed (USD)	2,076.70	1.56%	11.08%	4.24%	5.05%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.50%	0.00%	0.00%	0.00%	-	
10-year yield Australia	2.64%	-0.01%	+0.06%	+0.04%	-	
10-year yield US	2.85%	+0.02%	+0.11%	+0.56%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	64.80	-0.12%	-0.14%	15.69%	5.53%	
Brent crude oil (USD/barrel)	79.44	2.38%	14.57%	65.78%	7.70%	
Gold (USD/ounce)	1251.30	-3.75%	-5.41%	0.85%	2.22%	
AUD/USD	0.739	-2.35%	-3.68%	-3.68%	-1.31%	

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