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Colonial First State
Global Asset Management

Italy gives the world a fright

Market Watch

May 2018

Economics overview

- **US:** If labour market statistics are a fair gauge, the US economy remains in a healthy state. Unemployment fell to 3.9% in April, the lowest level since 2000.
- The latest data showed that inflation (core PCE measure) remained just below 2% in April, at 1.8%.
- Any further inflationary pressure is likely to prompt the Federal Reserve to raise interest rates. The Federal Funds Rate has already been increased once in 2018; most observers are expecting a hike in June and at least one more later in the year.
- Existing home sales have come off the boil, suggesting five interest rate increases in the past 18 months have started to affect the housing market.

- **Australia:** The 2018-19 Commonwealth Budget was released, but did not contain any major surprises and had no discernible impact on domestic financial markets.
- The 2018-19 budget deficit is expected to be $14.5 billion, or 0.8% of GDP. This was in line with consensus forecasts, but does represent a significant improvement on last year's position.
- The Government is forecasting a small budget surplus in 2019-20, a year earlier than previously anticipated. This would be a welcome development ahead of the next election.
- Australia's net debt is expected to peak this year, at 18.6% of GDP. Again, this is earlier than was previously anticipated.
- Shortly after the Budget was released S&P affirmed Australia's AAA sovereign rating, but also affirmed the negative outlook.
- The Reserve Bank of Australia left interest rates on hold at 1.50%. Futures markets suggest that offshore wobbles in May removed the likelihood of any interest rate increases this year.
- An increase in the participation rate saw the official unemployment rate edge up to 5.6%, from 5.5% previously. This masks reasonably buoyant conditions in the Australian labour market; the economy added 22,600 jobs in April.

- **New Zealand:** The country's bi-annual Financial Stability Report suggested lending restrictions first implemented in 2013 have had the desired effect on the housing market. After reaching a high of 15.0% in late 2015, annual house price inflation has fallen sharply. The Reserve Bank of New Zealand will monitor future pricing data to see if and when loan-to-value lending restrictions can be relaxed or withdrawn.
- Unemployment fell to 4.4% in the March quarter, the lowest level since the end of 2008. The buoyant conditions are attracting overseas workers – New Zealand continues to see net migration of around 5,000 people per month.

- **Europe:** Events in Europe were front and centre of attention in May. Italy's ongoing difficulty in forming a government and concerns that nationalist parties are attracting increased support prompted suggestions that Italy could review its membership of the European Union and euro single currency.
- These concerns sent shock waves through financial markets globally. Stock markets sold off, bond yields dropped sharply and credit spreads widened.
- Rising energy prices pushed European inflation estimates up to 1.9% yoy in May, the highest level in more than a year. There remains a fair degree of focus on inflation levels, as they may affect the European Central Bank's stated intention to withdraw its Quantitative Easing program later this year.
- Economic data was mixed. In Germany, for example, factory orders disappointed, but industrial production was ahead of expectations.
- In the UK, the Bank of England downgraded GDP growth and inflation expectations for 2018, 2019 and 2020, but is still entertaining the possibility of further gradual rate rises this year.

- **Asia:** There was a fair degree of focus on the region in May, mainly due to June's proposed meeting between US President Trump and Kim Jong Un, the Supreme Leader of North Korea. Trump announced he was withdrawing from the summit, but an official US delegation was nonetheless dispatched to prepare for the meeting, suggesting it may yet go ahead.
- It seems almost certain that there will be many more comments/threats from both sides before North Korea completes a denuclearisation program and/or the US lifts punitive sanctions on the country.
- In economic news, Japanese industrial production in April disappointed, suggesting the economy might be losing steam. The measure of factory output rose 2.5% from a year earlier, but that was well short of expectations for a 3.6% rise.
- Chinese manufacturing activity remained strong. The manufacturing PMI rose to 51.9 in May, exceeding consensus expectations. A strong non-manufacturing PMI print also suggested China's services sector is performing well.

Australian dollar

- The Australian dollar appreciated by 1.1% against a trade-weighted basket of overseas currencies.
- The 'Aussie' added 0.5% against the US dollar.
- Currency markets globally were quite volatile during the month, due to a combination of trade talks/friction between the US and China and political instability in Italy and its effect on the euro.

Commodities

- Commodity prices finished mostly higher, led by industrial metals, coal and oil. Iron ore bucked the trend, declining -1.5% to US$64.3/tonne on concerns surrounding elevated stockpiles.
- Thermal coal prices rose 10.8% in May, reflecting robust demand and declining coal stockpiles at Chinese mines and power plants.
- Brent Crude (+4.6%) rose through most of May, as sidelined OPEC supply continued to drive deficit concerns. In addition, more supply may be involuntarily cut. Investors observed some risk in Venezuela, where oil production collapsed economic and debt crises mount. The US also announced sanctions against Iran, which has the potential to further reduce global supply.
- Industrial metals were mostly higher, led by nickel (+11.5%) which was buoyed by strong demand and falling stockpiles. Lead (+5.4%), aluminium (+1.5%) and copper (+1.1%) also rose, while zinc (-0.9%) and tin (-3.2%) declined.
- Among precious metals, gold fell -1.2% to US$1,300/ounce amid continued strength in the US Dollar.

Australian equities

- The S&P/ASX 200 Accumulation Index added 1.1%, despite an increase in macroeconomic and geopolitical tensions offshore.
- Most sectors delivered positive returns, with Health Care (5.6%) and Consumer Discretionary (5.1%) outperforming.
- The Health Care sector benefited from a strong rally in Mayne Pharma, after it announced that the US Food and Drug Administration had accepted its application for a new drug that will help with the treatment of systemic fungal infections.
- In the Consumer Staples sector, Seven West Media provided an upbeat presentation to the market while rumours of a possible merger between it and Fairfax circulated.
- Telecoms (-10.2%), Consumer Staples (-0.4%) and Financials (-0.2%) were the only sectors to retreat in May.
- Telecoms stocks struggled as sector heavyweight Telstra weighed on sentiment. Telstra declined significantly in the second half of the month after announcing that it expects earnings will be towards the lower end of guidance in FY18 and that it expects challenging trading conditions to persist in FY19 – raising doubts over whether it would be able to fund its dividend.
- Small caps outperformed their large cap counterparts, with the S&P/ASX Small Ordinaries Accumulation Index rising 3.7%. More than two thirds of constituents delivered positive returns.

Listed property

- The S&P/ASX 200 A-REIT Index (TR) had another strong month in May, rising 3.1%.
- Office A-REITs (5.4%) was the best performing sub-sector, while Retail A-REITs (2.8%) was the weakest. Westfield de-listed over May, following approval of its acquisition by Unibail-Rodamco, while the demerged OneMarket (the ex-Westfield technology business) and new Unibail CDIs began to trade on the ASX.
- The strongest performers were Investa Office Fund (15.0%), Vicinity Centres (9.4%), and Charter Hall Group (8.0%). Investa Office Fund received an all-cash takeover offer from Blackstone at $5.25, which the board will recommend to shareholders in the absence of a superior proposal.
- The weakest performers were Iron Mountain (-3.2%), National Storage REIT (-0.9%), and Cromwell Property Group (0.0%).
- Globally, major property market returns again outperformed broader equity markets. The FTSE EPRA/NAREIT Developed Index (TR) rose 1.7% in USD terms. In local currency terms, the US (4.8%) was the best performing market, while Singapore (-4.4%) was the worst.

Global equities

- Global equity markets broadly ended the month in the black. The MSCI World limped to a return of 0.7% (in USD terms) having been up as much as 2.6% mid month. This benign outcome hides some relatively disparate returns across and within markets. IT stocks powered the US bourse, which was the strongest performer among major developed markets and drove a wedge between growth and value stocks.
- The S&P 500 finished up 2.4% in local currency, having been up as much as 3.4%. Apple drove the IT sector markedly higher, reaching a record high during the month. The smartphone manufacturer reported strong sales, a robust outlook and dispelled April's fears over weaker iPhone sales. The US energy sector also had a solid month as oil prices rallied.
- The Japanese Nikkei, down -1.7% in local currency terms, was the weakest of the major markets. Geopolitical uncertainty on the Korean peninsula, disappointing factory output and a possible global trade war contributed to market weakness.
- Value stocks suffered their worst month against growth stocks since the 'green shoots recovery' began in February 2009. The MSCI World Value Index fell -1.2% in USD terms, while the MSCI World Growth Index added 2.6%, helped by IT stocks.
- Emerging Markets also underperformed, down -3.5% in USD terms. Latin America was pulled down by both Brazil, (-16.4% in USD) and Mexico (-13.6% in USD). Both countries face the prospect of higher interest rates as central banks seek to defend their currencies against higher US rates and a stronger US dollar.

Global and Australian Fixed Interest

- May was a month of two halves for global bond markets.
- Yields moved steadily higher early in the month. 10-year US Treasury yields rose through 3%, then 3.05%, then 3.10%. Trade concerns were abating, with the US delaying the implementation of tariffs on steel imports from Europe, Canada and Mexico. With yields rising, breaking out of long-term trading ranges and with the oil price appreciating, investors suggested we could finally be about to see a significant and sustainable move higher in yields globally. Then, in just a few sessions, sentiment was turned on its head as events in Italy started to unravel.
- The catalyst for global markets to go into a tailspin in mid-May was a coalition seemingly formed with parties that had campaigned against European Union policies or even Italy's ongoing membership of the Union.
- Risk appetite nosedived as it emerged that a second election – possibly sometime in the next few months – could see populist parties attract increased support and potentially win power. Bond yields dropped sharply as investors absorbed the news flow.
- Events in May saw 10-year US Treasury yields fall 9 bps, to 2.86%. Japanese 10-year JGB yields declined 2 bps, to 0.03%. In the UK, 10-year gilt yields closed 19 bps lower, at 1.23%.

Global credit

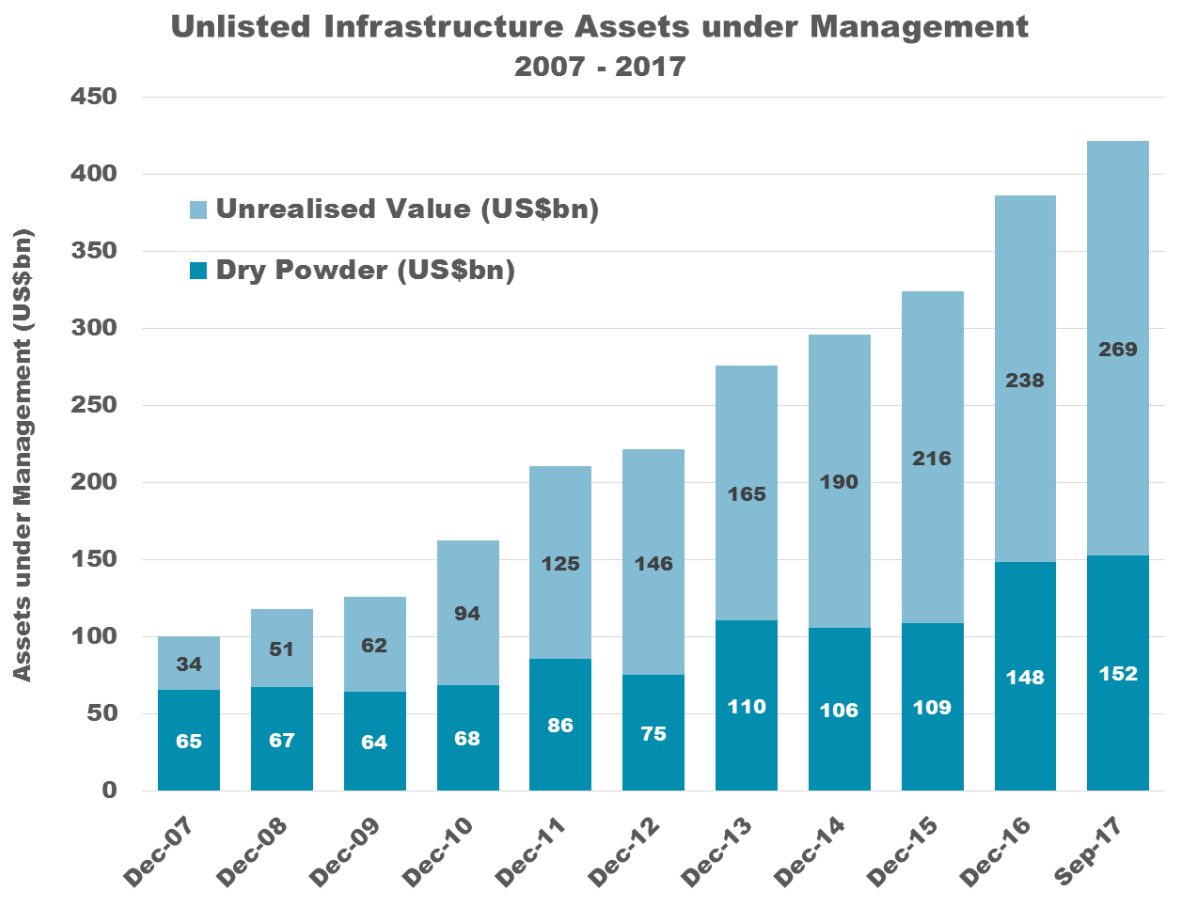
- Like other risk assets, sentiment towards corporate bonds was affected by uncertainty in Italy and the flow-on effects on risk appetite more broadly. Global investment grade credit spreads widened by 13 bps, to 1.18%.
- The 'risk off' backdrop was also reflected in the US high yield market, where spreads widened 22 bps, to 3.17%.
- Issuance slowed in the second half of the month, in particular. With deteriorating risk appetite pushing spreads wider, corporates appeared to hold off issuing until markets calmed.
- While Italy-related concern had abated by month end, sentiment towards credit remained fragile. Investors remain wary of trade tensions and the potential impact protectionist policies could have on corporate profitability in the US, in particular.

Chart of the Month – Responding to the insatiable appetite for infrastructure

In these bulletins, we aim to share interesting observations from global investment markets. This month we look at the ever increasing appetite for unlisted infrastructure and how investors are responding to any resulting valuation pressures.

Unlisted infrastructure has great appeal to certain investors. The fact that it is illiquid and traded infrequently brings two immediate benefits – its returns have low correlations with listed investments over the short term and there is an illiquidity premium that investors can enjoy if they can afford to have assets locked up for up to 10 years or more. This is an ideal outcome for the large institutional investors that enjoy net cash inflows and have long-term liabilities that need matching.

However, there are signs that the sector might be over-loved. As these larger investors have sought to access the diversification benefits and illiquidity premia, combined with the steady income associated with infrastructure projects, the asset class has grown rapidly over the last decade. As shown in the chart, assets under management (AUM) held by unlisted infrastructure fund managers has quadrupled over this period – from US$99bn in 2007 to US$421bn in 2017.



Source: Preqin

The expansion of the industry has brought with it noticeable challenges - the amount of capital held by managers has also been rising, with dry powder levels hitting a record high of US$152bn last year. The increased amounts "waiting on the sideline" to be invested has increased competition for new investments and rising valuations. According to Preqin's research "Valuations have yet again emerged as the number one concern among fund managers in our survey". Preqin has also reported, however, that unlisted infrastructure fund managers have been deploying their dry powder ever more quickly since 2013 – the ratio of 'Year End Unlisted Infrastructure Dry Powder' to 'Prior Year Capital Called' was at 2.5 years at the end of 2016 compared to 3.8 years in 2013.

What are the implications for investors? Our Unlisted Infrastructure team has responded to increased competition for deals by sourcing assets in better valued pockets of the market, such as smaller and bolt-on deals rather than chasing elephants / trophies in the large cap space. By adopting this approach, they have been able to deploy capital quicker than the market as a whole (last year their Dry Powder to Prior Year Capital Called was less than a year – well below the broader industry). Along with our Global Listed Infrastructure team, they also point to the enormous investment needed globally with the traditional public providers of infrastructure challenged by deteriorating fiscal positions and, therefore, less equipped to fund the estimated US$57+ trillion of investment required to keep GDP at current levels[1]. This suggests that demand will be more than sufficient to soak up the current (and growing) supply.

[1] Required global investment 2013-2030 US$trillion, Constant 2010 dollars. Source: McKinsey & Co.

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