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Colonial First State
Global Asset Management

Progress on US/China trade negotiations helps markets

Market Watch

End-February 2019

Economics overview

- **US:** US GDP data for the December quarter were released towards the end of the month.
- The world's largest economy grew 2.9% in 2018 as a whole, an acceleration from 2.2% growth in the prior year.
- This was a creditable performance, but investors are more interested in the outlook; specifically how growth and inflation might affect the Federal Reserve's interest rate policy.
- For now business and consumer confidence levels in the US remain quite buoyant, supported by tax cuts and solid employment growth.

- **Australia:** The Reserve Bank of Australia left interest rates on hold at 1.50% at its meeting early in the month, but there were increasing calls for an interest rate cut.
- There has been a subtle change in Reserve Bank rhetoric; officials now acknowledge the possibility of policy settings being eased if economic conditions do not improve.
- Economic data were mixed. Building approvals statistics were released and showed December approvals -22.5% below levels from a year ago. The number was considerably worse than consensus forecasts and suggests developers are holding back on projects given the uncertain outlook.
- Retail sales also declined from 2017 levels in December in the critical pre-Christmas shopping season. In fact, a gauge of conditions in the services sector as a whole slumped by the most since 2014 in January. This was attributed to the slowdown in building activity and weaker consumer spending.
- More encouragingly, Australian employment increased by 39,100 in January. More than 65,000 new full-time jobs were created, although a decline in part-time positions dragged down the overall number. The official national unemployment rate remained unchanged at 5.0% in January, but broke below 4.0% in New South Wales for the first time in modern history.
- Other data showed that nationwide wage growth remained flat at 2.3% yoy in the December quarter.

- **New Zealand:** Unemployment rose to 4.3% in the December quarter, up from 4.0% in the previous period and above consensus expectations. Unemployment among 15-24 year olds saw the greatest increase.
- In spite of the subdued employment picture, wages in New Zealand rose 1.0% in the December quarter.
- The trade deficit widened to its largest level since 2006 in January, reflecting moderate exports and an increase in the value and volume of imports.
- The Reserve Bank of New Zealand left interest rates unchanged at 1.75% – no changes are anticipated in the foreseeable future.

- **Europe:** Growth in Europe has slowed quite alarmingly. The Eurozone economy expanded by just 1.2% in 2018.
- Industrial production growth was negative in December and retail sales are rising at an annual pace of less than 1.0%.
- Industrial production in both Germany and France is below levels from a year ago.
- On a brighter note, ratings on Italian debt were reaffirmed during February. This provided some relief as some investors had been concerned that the sovereign rating might be downgraded.
- In the UK, Brexit-related issues continued to dominate attention.
- Politicians appear no closer to agreement over terms of the UK's proposed withdrawal from the European Union. Time is running out; the exit is currently scheduled for 29 March 2019, although Prime Minister May has opened the door to a possible extension of the deadline if a deal cannot be agreed.
- The Brexit focus diverted attention from subdued data releases – the UK economy grew by just 1.3% in 2018 and export growth in the December quarter came in below expectations.

- **Asia/EM:** In Japan, data showed the economy grew at an annualised rate of 1.4% in the December quarter. This followed a -2.6% contraction in the prior three month period.
- The improvement was supported by higher private and public demand following a series of natural disasters that had affected output in the September quarter.
- Japanese data was not universally positive; the manufacturing PMI survey declined to 48.9 in February, a decline of nearly 4 points in the past two months alone.
- Elsewhere in Asia, there were signs of progress in trade talks between the US and China. Proposed tariffs due to be implemented on 1 March 2019 have been delayed pending further negotiations.
- This was an encouraging development as existing trade tariffs appear to be having a significant adverse impact on trade volumes and, in turn, manufacturing activity globally.
- In South Korea, for example, February exports were -11.7% below levels from a year ago and imports were -17.3% lower.
- More importantly, GDP growth in China has decelerated to its slowest level in nearly a decade – economic growth of 6.4% in 2018 was below the government's target of 6.5%.

Australian dollar

- The Australian dollar reversed some of its January strength against the US dollar, falling in value by 2.5%.
- At 28 February 2019, the Australian dollar bought US$0.709.
- The Australian dollar also weakened against the Japanese yen and against a trade-weighted basket of international currencies.

Commodities

- Commodity prices finished broadly higher in February, led primarily by some supply concerns and easing US-China trade tensions.
- Industrial metals were mostly higher, led by copper (6.6%), nickel (4.5%) and tin (3.9%). Aluminium (-0.1%) finished the month slightly lower.
- Gold (-0.6%) lost some momentum after a run of strong performance on 'safe haven' demand amid weakness in global equity markets.
- Silver (-2.9%) also fell, while platinum (5.9%) posted strong gains.
- Oil (7.8%) was stronger on OPEC-led supply cuts, particularly from Saudi Arabia.
- Iron ore (1.8%) rose sharply in early February on supply concerns following the tragic dam collapse at Vale's *Feijao* mine in Brazil. Iron ore prices gave up some of these gains towards month-end, however, on reduced Chinese steel demand.

Australian equities

- January's optimism continued in February with investor positivity overriding a fairly ordinary 'earnings season' (discussed further in *Chart of the Month* overleaf). This positivity, evidenced by the S&P/ASX 100 Accumulation Index rising 5.9% in February, suggests investors were surprised by the resilience of company earnings given the ambiguous economic backdrop and ongoing geopolitical uncertainty.
- The Financials sector recovered from its weakness in January and provided the strongest return (9.0%). Asset management businesses such as IOOF Holdings (35.9%), Magellan Financial (25.0%) and Janus Henderson (17.4%) were among the best performers for both the sector and index.
- Major banks also performed well post the release of the Royal Commission's final report early in the month, whose recommendations were less punishing than the market had feared.
- Defensive sectors, such as Consumer Staples (-1.1%), Health Care (0.7%) and Real Estate (2.1%), generally under-performed. All but one constituent of the Consumer Staples sector, a2 Milk Company (14.0%), fell with newly listed Coles Group (-9.4%) declining the most.
- Small cap stocks outperformed their large cap counterparts for the second month in a row, with the S&P/ASX Small Ordinaries Accumulation Index closing 6.8% higher.

Listed property

- The S&P/ASX 200 A-REIT Index returned 1.8% in February.
- Industrial A-REITs (9.8%) was the best performing sub-sector, followed by Office A-REITs (4.6%). Retail A-REITs lagged, returning -2.1%.
- The strongest performers in February were Goodman Group (9.9%) and Mirvac (7.1%). Both Goodman Group and Mirvac performed strongly after releasing FY19 first half results.
- Weaker performers included Unibail-Rodamco-Westfield (-8.1%) and Stockland (-7.9%). The market reacted negatively to 1H FY19 results reported by both companies.
- Globally, most major property markets delivered modest positive returns, following extraordinary returns seen in January.
- The FTSE EPRA/NAREIT Developed Index returned -0.1% in USD terms and 2.4% in AUD terms.
- In local currency terms, Canada (3.8%) was the best performer, while Developed Europe excluding-UK (-3.2%) was the worst.

Global equities

- Global equity markets powered on in February, adding to January's solid showing. The MSCI World Index returned 5.6% in AUD terms in February and is now up 9.9% in 2019 to date – the strongest start to a calendar year since 1992.
- US and Chinese stocks have fared particularly well in the year to date, with the S&P500 and MSCI China up 11.5% and 15.0% respectively in local currency terms. Both indices rose in February reflecting "substantial progress" made in trade discussions and US President Trump's subsequent decision to extend the deadline for the introduction of US$200bn of Chinese imports beyond 1 March 2019.
- Having been up as much as 4.3% in sterling terms in mid-month, the FTSE 100 Index fell away in the final week to be one of the weaker markets, gaining 2.3%. Worries over Brexit continued to undermine sentiment towards UK-listed companies.
- Emerging markets' run of outperformance in AUD terms extended to a fourth month. Buoyant Chinese stocks pushed the MSCI Emerging Markets Index up 2.7%. Asia was the strongest performing region, rising 4.2%.
- Having been the strongest performing region over the prior two months – largely on the strength of Brazilian shares and the Mexican peso – the MSCI Latin America Index fell -1.3% in AUD terms. The Mexican central bank became the latest in a series of organisations, including the IMF, to slash forecasts for Mexico's GDP growth in 2019. The MSCI Mexico Index subsequently fell and closed the month -2.9% lower in local currency terms.

Global and Australian Fixed Income

- US bond yields traded in a fairly narrow range, which set the tone for a quieter month in global fixed income markets.
- Ten-year US Treasury yields rose 9 bps in February as a whole, closing the month at 2.71%. Government bond yields also edged higher in the UK and Europe – by 8 bps and 3 bps respectively. Japanese government bond yields closed the month 3 bps lower, at 0.03%.
- There was a fair amount of focus on the US GDP data release towards month-end, although investors are more interested in the outlook; specifically how growth and inflation might affect the US Federal Reserve's interest rate policy.
- In Australia, we saw increasing calls for an interest rate cut even though official policy was unchanged. There has been a subtle change in Reserve Bank rhetoric; officials now acknowledge the possibility of policy settings being eased if economic conditions do not improve.
- Consensus expectations suggest interest rates will be lowered towards the end of 2019. These evolving expectations exerted downward pressure on domestic bond yields; the 10-year CGS yield closed the month 14 bps lower, at 2.10%.

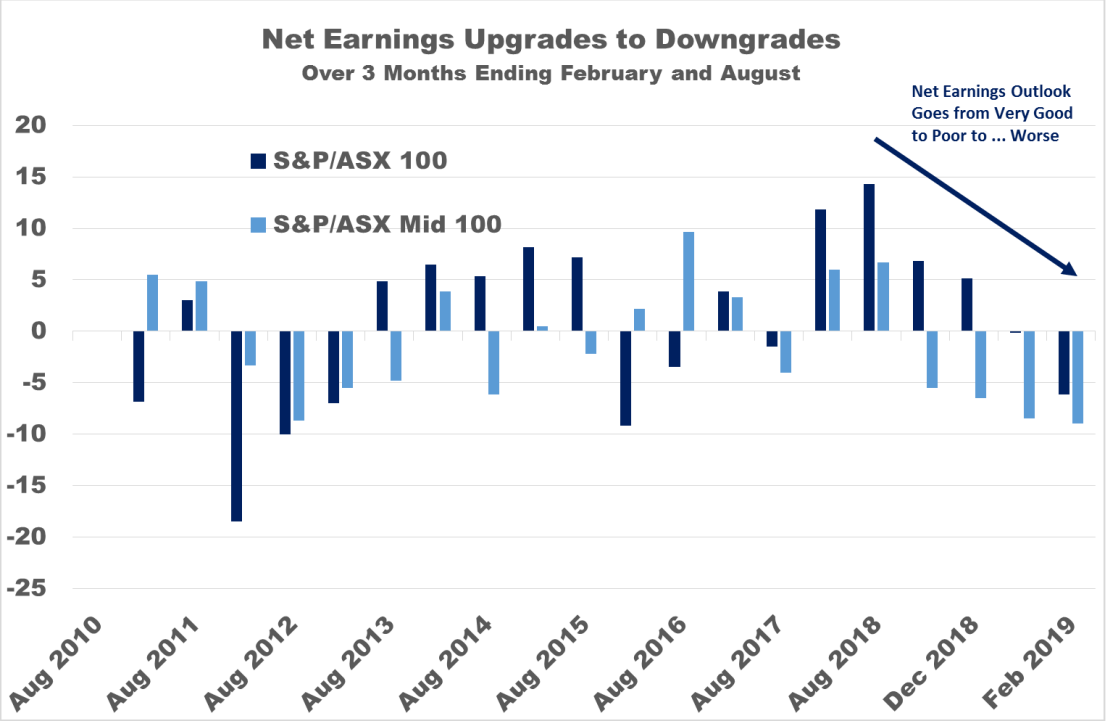
Global credit

- Global credit markets continued to recover in February. Spreads in both the investment grade and high yield sectors continued to narrow, consolidating gains made in January.
- The spread on the Bloomberg Barclays Global Aggregate Corporate Index declined 9 bps, to 1.27%. This is close to the level from mid-November, prior to the year-end rout in global credit markets. The Bank of America Merrill Lynch Global High Yield Index (BB-B) spread narrowed 42 bps, to 3.24%.
- Like in January, sentiment towards credit markets was supported by expectations that US monetary policy might not be tightened much further in 2019, following nine increases in interest rates over the past three and a half years.
- Another solid set of quarterly earnings reports from US-listed companies also helped support demand for corporate credit.

Chart of the Month – Australian Earnings Season – Is This Trend a Friend?

In these bulletins, we aim to share interesting observations from global investment markets. This month we go back to our 10 million+ database[1] *to more thoroughly examine the downward trend in earnings upgrades over the last six months.*

Below we have updated the Net Earnings Upgrades to Downgrades chart that we presented in our Chart of the Month last August. Back then we happily highlighted the largest gap favouring upgrades over downgrades for stocks in the S&P/ASX 200 since we have been collecting the data. How things have changed over the last six months! As the chart below illustrates, we are now seeing the worst ratio of upgrades to downgrades for the S&P/ASX 200 since 2012 – and this is occurring across both the S&P/ASX 100 and the S&P/ASX Mid 100. As this downward trend has played out, the S&P/ASX 200 fell -10.6% from the end of August last year to the end of December 2018. Since the end of the year, however, the stock market has leapt 9.3% - including a 'world-beating' 6.0% return in February[2] even though the ratio of upgrades to downgrades has continued to fall.



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.

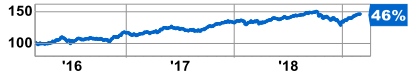
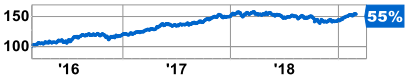
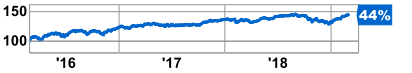
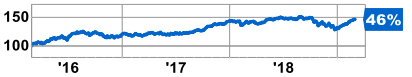
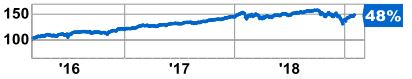
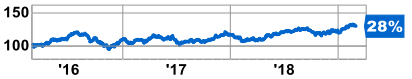
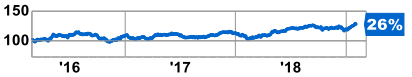
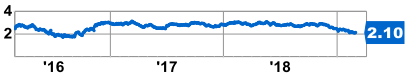
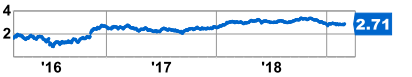
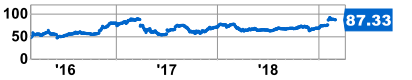
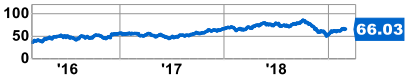
There are a number of potential explanations for this apparent inconsistency between stock market returns and the earnings results. Firstly, the stock market performance over the last quarter of 2018 might have more than anticipated the coming earnings downgrades. A number of commentators have observed that "Results were not as bad as feared."[3] As Dawn Kanelleas, our Senior Small Caps Portfolio Manager, observes: "The magnitude of some share price movements during 'reporting season' is often more attributable to market sentiment, rather than the underlying quality of a particular company's earnings or outlook. Our risk-aware approach and focus on quality companies and downside protection, have seen us end the month in positive territory despite the heightened volatility."

Unlike most relief rallies, however, growth stocks were recovering from last quarter's underperformance rather than value stocks rallying. According to Andrew Francis, Chief Executive of Realindex Investments, which targets a variety of styles, but primarily value, "There were no strong style influences in February, but small companies growth was the place to be. In this environment Realindex Australian shares kept pace with the market for February, whilst its small companies underperformed given the growth headwind."

Another reason for hope was the bias in the *levels* of upgrades versus downgrades. So while there have been more downgrades this year, the average level of upgrades was 2.4% - almost triple the average level of downgrades at -0.9%. There was also the improved prospects for global growth given "substantial progress" in the US/China trade discussions. David Wilson, Deputy Head of our Australian Equities Growth Team notes that: "The earnings results, like the Australian economy, were okay but not exceptional. It confirms our current preference for firms that are successfully growing earnings offshore and have less exposure to the Australian economy. We agree that the earnings outlook is deteriorating and see increasing cost and regulatory headwinds for domestic firms. Hence we are likely to maintain our bias towards offshore earners for the time-being".

[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] See Marketwatch February commentary on Australian Equities and Global Equities.
[3] Deutsche Bank Strategy Update, 2 March 2019; Goldman Sachs Portfolio Strategy Research, 17 February 2019; "ASX defies global fears, slowdown" Patrick Commins, Page 1 of *Australian Financial Review*, 1 March 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)	3,283.48	5.62%	5.42%	10.63%	13.43%	
MSCI Emerging Markets (AUD)	1,066.54	2.73%	9.00%	-0.92%	15.62%	
ASX 200	6,169.00	5.98%	9.95%	7.05%	12.91%	
ASX Small Ordinaries	2,764.60	6.78%	8.01%	3.48%	13.44%	
S&P 500 (USD)	2,784.49	3.21%	1.42%	4.68%	15.28%	
REITs						
ASX 200 A-REIT	1,477.90	1.75%	9.86%	18.86%	8.56%	
FTSE EPRA/NAREIT Developed (AUD)	3,495.02	2.39%	7.57%	23.81%	7.14%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.50%	0.00%	0.00%	0.00%	-	
10-year yield Australia	2.10%	-0.13%	-0.49%	-0.68%	-	
10-year yield US	2.71%	+0.08%	-0.30%	-0.16%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	87.33	14.86%	34.83%	13.20%	22.13%	
Brent crude oil (USD/barrel)	66.03	6.69%	12.47%	0.38%	22.44%	
Gold (USD/ounce)	1312.80	-0.52%	7.59%	-0.21%	2.09%	
AUD/USD	0.71	-2.43%	-2.57%	-8.70%	-0.13%	

Source: Factset, at 28 February 2019

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