

# Interest rates – how low can they go?

## Market Watch

End-July 2019

### Economics overview

- **US:** At the end of the month, the Federal Reserve lowered US interest rates by 0.25 percentage points.
- While the move had been widely anticipated by investors, it was nonetheless quite a significant event for global financial markets. After all, this was the first time policy settings had been eased in the world's largest economy for more than a decade.
- Consensus expectations suggest US interest rates could be lowered further in the months ahead. Markets have already factored in a 60% probability of another cut after the Federal Reserve Board's next meeting in September.
- Economic growth in the US slowed in the June quarter, to an annual pace of 2.1%. Whilst below the 3.1%/yr rate seen in the March quarter, the reading was ahead of forecasts. A marked improvement in consumer spending supported growth; rising employment and a reasonable level of wage growth appear to have contributed to buoyant discretionary expenditure.
- These influences have also exerted upward pressure on prices. The Core PCE – the Federal Reserve's preferred measure of inflation – increased to 1.6%/yr in June, rising back towards the 2.0% target.
- **Australia:** The Reserve Bank of Australia lowered interest rates for a second consecutive month – the first back-to-back cuts since 2012 – moving the official cash rate to 1.00%.
- In a speech later in the month, the Governor of the Reserve Bank suggested it would be imprudent to lower Australia's inflation target (2% to 3%/yr) and affirmed that policy makers are willing to ease policy settings further, if required.
- Australia's Composite PMI – a reasonable barometer of activity levels in the manufacturing and services sectors – deteriorated slightly in July, but remained in 'expansionary' territory.
- Unemployment was unchanged at 5.2%. While new job adverts increased markedly in June, it is too early to suggest this is indicative of a meaningful improvement in the labour market.
- The residential property market appeared to stabilise. National home prices rose 0.1% in July; only a modest gain, but significant in that it followed 20 consecutive months of declines.
- **New Zealand:** Business confidence deteriorated in July, to its lowest level in a year. This does not augur well for growth.
- Inflation remained below target in the June quarter, but picked up to an annual pace of 1.7%. Some suggested this might result in the Reserve Bank of New Zealand leaving monetary policy settings unchanged when it meets on 6 August.
- That said, markets continue to suggest one or two rate cuts remain likely before the end of 2019.
- **Europe:** The Eurozone economy expanded just 0.2% in the June quarter, down from 0.4% growth in the first three months of the year. The German economy, Europe's largest, remained subdued, partly due to sluggish factory orders.
- There was no growth at all over the quarter in Italy, while the pace of growth decelerated in both France and Spain.
- These releases increased the probability that the European Central Bank will announce a new phase of Quantitative Easing; most likely in September.
- Core inflation dipped back below 1%/yr in July, which is likely to be another concern for policy makers.
- There was another deterioration in the Economic Sentiment Indicator, which is calculated based on business and consumer confidence surveys. More encouragingly, unemployment in the Eurozone continued to edge lower. At 7.5%, the jobless rate is at its lowest level in more than a decade.
- In the UK, Boris Johnson won the Conservative Party leadership contest and has been sworn in as the new Prime Minister.
- Johnson has talked openly about his willingness to pursue a 'no deal' Brexit in October if terms cannot be agreed with European officials. The increased probability of this potentially destabilising event resulted in sterling weakness and a sharp move lower in UK government bond yields following his election.
- **Asia/EM:** Economic growth in China fell to a 30-year low of 6.2%/yr in the June quarter. The slowdown appeared primarily due to trade tensions with the US, which are reducing export demand and affecting the manufacturing sector, in particular. China's trade with the US has declined 13.5% in the past year.
- A slowdown in Chinese imports is a separate concern, indicating weakness in the domestic economy. Accordingly, consensus Chinese GDP growth estimates for 2020 were lowered in July.
- Export demand has also tailed off in Japan. June data indicated exports were 6.7% lower than the corresponding period a year ago. Demand for semiconductors, auto parts and ships has been particularly weak recently.
- Consumer confidence levels in Japan have deteriorated to their lowest levels in more than five years. With demand weak, Core inflation remained anchored at 0.7%/yr, well below the Bank of Japan's 2.0%/yr target.

### Australian dollar

- The release of mixed economic indicators in Australia and stronger-than-expected GDP data in the US saw the 'Aussie' dollar depreciate against the US dollar.
- By the end of July, the Australian dollar had fallen back below the US\$0.70 level, closing below US\$0.69. This was a decline of 2.5% over the month.

## Commodities

- Iron ore prices closed the month around US\$115 per tonne. There was a notable increase in stockpiles at Chinese ports, indicating demand could tail off in the near term. However, concerns about supply disruptions following Vale's fatal dam collapse earlier in the year remained supportive.
- Continued weakness in China's manufacturing activity saw a sharp decline in premium coking coal prices during the month.
- Oil prices weakened for much of the month and closed July around -2.0% lower. The demand outlook in a slowing global growth environment offset potential supply concerns as geopolitical tensions between the US, UK and Iran intensified. Disruptions in the Persian Gulf could affect a significant proportion of global oil supply.
- The gold price climbed a further 1.1%, adding to recent strength.
- The nickel price rose a further 17.8%, adding to gains earlier in the year. In fact, nickel has been the best performing industrial metal in 2019, benefiting from increased demand for electric cars.

## Australian equities

- Australian equities followed global equity markets higher as prospects of more stimulatory monetary policies both here and in the US drove Australian shares to all-time highs. The S&P/ASX 200 Accumulation Index rose 2.9% during the month.
- Sector performance was dominated by Consumer Staples, which rose an impressive 10.2%. Infant formula producer, a2 Milk leapt +23.6% following broker upgrades as stronger growth from both China and the US was factored in to forecasts.
- The Health Care sector (+6.2%) also fared well, supported by Resmed (+10.7%). The sleep disorder mask and medical device manufacturer announced a 13% increase in revenue in the June quarter and set an ambitious target for its user base to jump to 250 million by 2025.
- Materials (+0.4%) lagged in spite of rising iron ore prices. Mineral sands producer, Iluka Resources (-10.7%), suffered after it issued disappointing June quarter production results and as zircon prices declined. Iluka has also suffered operational problems at its Sierra Leone titanium dioxide projects, which may see a downgrade in scale.
- Australian small caps bounced back from the longer-term underperformance of their large cap counterparts (discussed further in our *Chart of the Month*). The S&P/ASX Small Ordinaries Accumulation Index rose 4.5%, driven by small gold stocks.
- Dacian Gold, Gold Resources and Ramelius Resources all added more than 30% as gold prices hit new all-time highs in AUD terms.

## Listed property

- Global listed property posted moderate gains for the month. The FTSE EPRA/NAREIT Developed Index returned 0.4% in USD terms and 2.2% in AUD terms.
- Europe (ex UK) was the best performing market (+2.5%), while Hong Kong was the worst performer (-5.1%) amid ongoing civil unrest in the territory.
- In Australia, the S&P/ASX 200 A-REIT Index returned 2.6%. Diversified A-REITs was the best performing sub-sector (+4.2%), followed by Retail A-REITs (+4.1%), which bounced back after three consecutive months of negative returns. The worst performing sub-sector was industrial A-REITs, driven by the underperformance of Goodman Group.
- Outperformers in Australia included Stockland (+9.6%), which announced a strategic capital partnership in its residential portfolio. Capital Property Group is acquiring a 50% stake in the Group's largest master planned community, Aura, at a 30% premium to book value. Stockland suggested this capital injection would help strengthen its balance sheet and provide flexibility to invest into other counter-cyclical residential opportunities.

## Global equities

- Global equity markets continued to establish new highs in July. The MSCI World Index edged up only 1.2% in local currency terms, but the weaker AUD helped to bolster returns in AUD terms to 2.3%. While momentum in US markets helped, the UK bourse was the strongest performer, with the FTSE 100 Index up 2.2% in local currency terms. UK stocks were up as much as 3.6% as sterling fell to two-year lows.
- German stocks struggled, with the Dax falling -1.7% in euro terms. At one stage, the index suffered its heaviest one-day fall since February as German inflation came in below expectations and well below the ECB's target. This added to the gloomy news earlier in the month that the manufacturing business climate index had fallen to its lowest level in almost a decade.
- Emerging markets have now underperformed their developed counterparts for six straight months as the MSCI Emerging Markets Index only rose 0.7% in AUD. Even this was thanks to the weaker AUD as the Index fell -0.9% in local currencies.
- MSCI EM Asia was the weakest regional index in AUD terms, rising only 0.3%. Both MSCI India (-5.5%) and MSCI South Korea (-3.9%) fell particularly heavily in local currency terms.
- The US/China trade conflict is hitting many Asian companies hard, but there is also an escalating trade disagreement between South Korea and Japan. Indian stocks fell sharply on market unfriendly budget proposals announced earlier in July.

## Global and Australian Fixed Income

- Fixed income markets remained dominated by expectations of interest rate cuts and other potential forms of monetary policy easing.
- Australian 10-year government bond yields closed the month 14 bps lower, for example, at 1.19% as Reserve Bank of Australia officials indicated that borrowing costs could be lowered further. Investors are speculating that Australian interest rates could fall as low as 0.50% in this cycle, effectively pricing in two further 0.25 percentage point cuts.
- Yields plunged even further into negative territory in Europe, with 10-year German bund yields closing July at a new record low of -0.44%. In the UK 10-year gilt yields declined 22 bps, to 0.61%, as markets factored in the prospect of a potentially disorderly withdrawal from the European Union.
- Bond markets were little changed in the US and Japan, with 10-year yields up a single basis point in both countries in the month as a whole.
- The net result of all these moves was another month of favourable returns from domestic and global bond funds.
- Moves in Australia and the US also resulted in new lows in the Australia-US spread. Local 10-year yields are now 83 bps below those in the US.

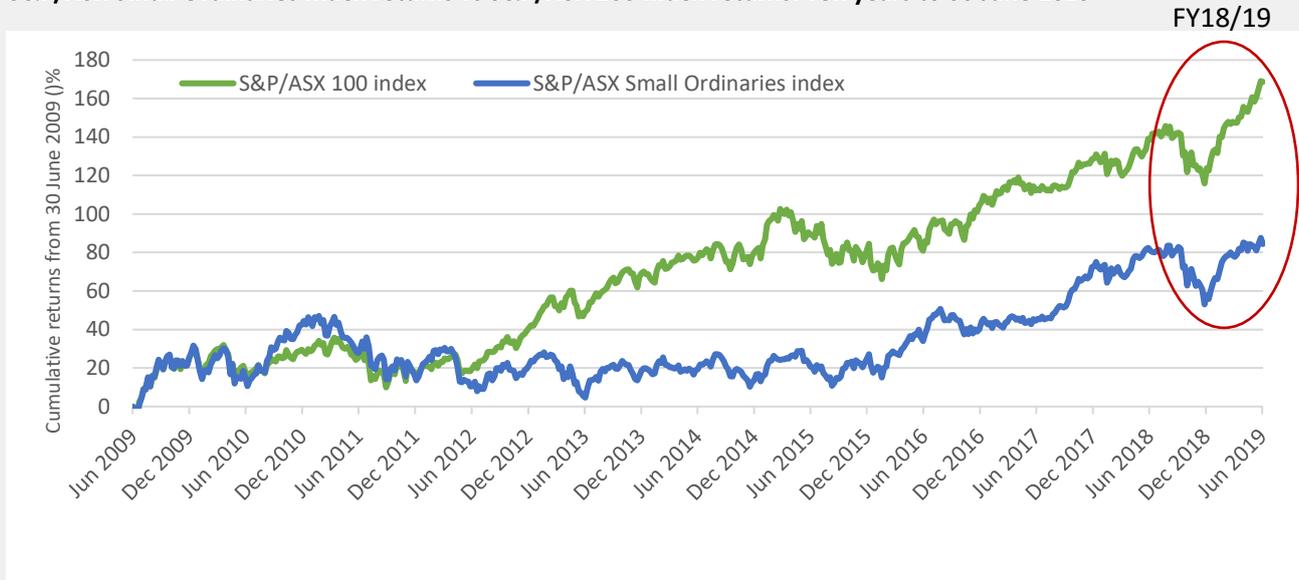
## Global credit

- Anticipation of interest rate cuts worldwide helped support sentiment towards global credit markets. All else being equal, lower borrowing costs make it easier for companies to service their debt repayment obligations by reducing the cost of new issuance.
- Around two thirds of US companies also released their quarterly earnings during July. Collectively, earnings increased by nearly 3.0% during the period, which was well ahead of consensus expectations.
- These positive factors saw spreads narrow in both the investment grade and high yield areas of the market, resulting in another month of positive returns from global credit portfolios.
- Australian credit markets also appreciated, benefiting from narrowing spreads and reflecting strength in the share market.

**Chart of the Month – the importance of being active**

*In these bulletins, we aim to share interesting observations from global investment markets. This month we look at the return profile of Australian small companies vs large companies, and why small caps continues to be an attractive investment option for investors, despite the story in the chart below.*

**S&P/ASX Small Ordinaries Index returns vs S&P/ASX 100 Index returns. Ten years to 30 June 2019**



Source Bloomberg, CFSGAM. Cumulative total returns 30 June 2009 to 30 June 2019

As shown in the chart, the 2018/19 financial year was a strong one for Australia’s largest companies, with the S&P/ASX 100 index adding 12.6%, compared to a relatively meagre 1.9% return from the S&P/ASX Small Ords index.

Within large caps, the Financial Services sector was back in favour following the somewhat benign recommendations from the royal commission. The Materials sector benefitted from strong iron ore and record gold prices in Australian dollar terms. Health Care was supported by CSL, which had a stellar year on encouraging progress in its influenza vaccine business. Even Telstra had a good year. Within small caps, small IT companies, aka WAAAX, were among the star performers during the year. However, as is often the case in the small ordinaries index, negative returns from numerous low-quality companies eroded the value created from more successful businesses.

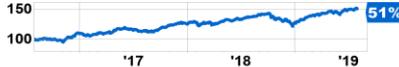
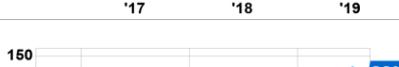
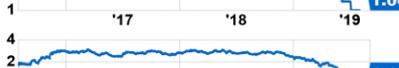
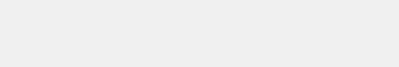
History shows that the larger cap S&P/ASX 100 index regularly outperforms the S&P/ASX Small Ordinaries index, and with less volatility. Looking at the chart above, no investor would favour investing in small caps over their large cap counterparts. However, the comparison of returns from the S&P/ASX 100 index and S&P/ASX Small Ordinaries index is too simplistic for one important reason; the index returns ignore the impact of ‘alpha generation’ – or outperformance – that active managers can produce, which can be particularly significant in small caps.

For example, the median small cap manager has outperformed the benchmark index by 7.4% p.a. over ten years, compared to the median broad-based manager who has outperformed by just 1.1%. This ‘alpha generation’ has resulted in the median small cap manager more than compensating for the lower returning small ords index, to generate higher absolute returns than their broad-based peers over 5, 7 and 10 years per annum (source: Mercer survey, June 2019).

Most stocks in the large cap S&P/ASX 100 Index are extensively researched by the professional investment community. They are mostly well known, mature companies with a large shareholder base. Investors like to hold large, mature companies because they are generally considered to be more predictable and less risky than their small cap counterparts.

In contrast, small companies tend to be less well researched and understood. This provides the opportunity for skilled small cap managers to identify – through their own extensive research, resources and experience – companies that have the potential to be future leaders, and companies that have the propensity to fail. By picking the winners and avoiding the losers there is potential for significant alpha generation and risk mitigation to help redress the risk/reward imbalance at the broader index level.

### MARKET WATCH DATA SHEET

		1 Month Return/Change	3 Month Return/Change	12 Month Return/Change	3 Year Annualised Return/Change	3 Year Chart
<b>EQUITIES</b>						
MSCI World (Gross of withholding tax, in AUD)	3,554.52	2.35%	3.24%	12.40%	14.71%	
MSCI Emerging Markets (AUD)	1,086.28	0.65%	-0.42%	5.92%	12.43%	
ASX 200	6,812.60	2.94%	8.58%	13.26%	11.68%	
ASX Small Ordinaries	2,961.40	4.51%	4.15%	7.61%	9.27%	
S&P 500 (USD)	2,980.38	1.44%	1.69%	7.99%	13.36%	
<b>REITS</b>						
ASX 200 A-REIT	1,644.20	2.57%	9.54%	21.22%	7.15%	
FTSE EPRA/NAREIT Developed (AUD)	3,689.87	2.22%	4.07%	16.62%	7.43%	
<b>CASH and FIXED INCOME</b>						
Official Cash Rate Australia	1.00%	-0.25%	-0.50%	-0.50%	-0.75%	
10-year yield Australia	1.19%	-0.14%	-0.60%	-1.46%	-	
10-year yield US	2.01%	0.01%	-0.49%	-0.95%	-	
<b>COMMODITIES and CURRENCIES</b>						
Iron ore (USD/tonne)	114.33	4.72%	22.62%	68.95%	26.40%	
Brent crude oil (USD/barrel)	65.17	-2.07%	-10.48%	-12.23%	15.35%	
Gold (USD/ounce)	1426.10	1.16%	11.17%	16.54%	1.87%	
AUD/USD	0.689	-1.78%	-2.07%	-7.28%	-3.21%	

Source: Factset and Bloomberg, at 31 July 2019

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