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Colonial First State
Global Asset Management

June's rally closes out a strong year for risk assets

Market Watch

End-June 2019

Economics overview

- **US**: Federal Reserve Board members appear determined to sustain the ongoing economic expansion in the US. Investors have become increasingly sure that interest rates will be lowered to support activity levels in the economy. By the end of June, an 85% probability of a 0.25 percentage point rate cut in July had been priced in to markets.
- Inflation in the US remains well below the Federal Reserve's 2.0% target, which prompted one Committee member to vote for a rate cut at June's meeting.
- The unemployment rate remained at 3.6% – close to 50-year lows. More than 750,000 new jobs have been created in 2019.
- Elsewhere there remained a high level of scrutiny on comments from President Trump around trade – specifically whether or not he will be willing to make concessions with China after earlier talks appeared to stall in May.
- The ongoing trade dispute appears to be harming US firms – the ISM Manufacturing PMI survey has deteriorated in three of the past four months and is currently at its weakest level in nearly three years.

- **Australia**: As had been widely anticipated, Australian interest rates were lowered by 0.25 percentage points in early June, to 1.25%. Inflation remains well below the 2% to 3% target range, which prompted policy makers to reduce borrowing costs in an attempt to stimulate activity levels in the economy.
- This was the first time domestic monetary policy had been amended for nearly three years since interest rates were last cut in August 2016.
- The Chairman of the Reserve Bank of Australia suggested it is reasonable to expect further rate cuts this year.
- In other news, data showed more than 42,000 jobs were created in May; well ahead of expectations for a 16,000 increase.
- That said, underlying growth in employment might not be quite as strong as the headline numbers suggest. Almost all of the new positions were part-time, possibly reflecting a spike in casual employment around the Federal Election.
- In spite of the surge in employment, the unemployment rate remained at 5.2% as new entrants joined the workforce. The RBA has suggested an unemployment rate of closer to 4.5% will be required to revive inflationary pressures in the economy.

- **New Zealand:** Economic growth for the March quarter was revised higher, to an annual pace of 2.5%.
- Supported by infant formula and other dairy products, the value of exports increased to NZ$5.8 billion in May; a record high.
- Rates were unchanged at 1.50%, having been lowered in May.

- **Europe**: Encouragingly, unemployment in the Eurozone edged lower again in April, to 7.6%.
- Inflationary pressures remain muted, with the latest CPI for May printing at just 1.2% year-on-year.
- Industrial production in the Eurozone remains subdued and below levels from a year ago. Factory orders in Germany, for example, are currently around 5% below 2018 levels.
- Data showed that the UK economy shrank for a second straight month in April. Manufacturing output had been supported earlier in the year as companies prepared for the original 29 March Brexit deadline. Activity levels have since slumped – there was something of a bloodbath in the auto sector, for example, with production collapsing 24% in April.
- The UK's new Prime Minister faces a challenging period once appointed in late July. The new leader must address a worrying economic slowdown and seek to negotiate a revised Brexit deal before the revised deadline of 31 October 2019.

- **Asia/EM:** Industrial production indicators have worsened in Japan. Machine tool orders – a useful barometer of capital expenditure and production – are more than 25% below their levels from a year ago.
- In China, inflation rose to 2.7% year-on-year; its highest level in more than a year. This reflected soaring food prices and was noteworthy as it bucked the global trend; inflationary pressures are subdued or weakening in almost all other regions.
- There were rising geopolitical tensions in the Middle East, with Iran blamed for attacks on oil tankers in the region.
- Investors remained focused on the G20 summit in Japan late in the month. US President Trump went into the meetings threatening to add tariffs to US$300 billion worth of Chinese goods, but later suggested "I had a great meeting with President Xi… far better than expected. I agreed not to increase the already existing tariffs that we charge China while we continue to negotiate".
- Whilst encouraging, various key trade issues – specifically intellectual property rights and technology transfer – appear to remain unresolved between the two superpowers.

Australian dollar

- The Australian dollar fell as low as 68.5 US cents in mid-June – its lowest level in more than a decade – but regained some lost ground towards the end of the month to finish at 70.2 US cents, an appreciation of 1.2% over the month.
- Current drivers of the Australian dollar / US dollar exchange rate are covered in a research paper here.

Commodities

- Commodity prices were mostly higher during June, with iron ore and gold prices reaching multi-year highs.
- Iron ore (+18.2%) touched five-year highs as China's iron ore port stockpiles fell sharply, continuing a trend that started in early April. Declining stockpiles are primarily a result of supply disruptions that have shaken the market this year, most notably Vale's *Feijao* mine disaster in late January.
- Gold (+8.0%) reached US$1,409/oz, marking the highest gold price since late 2013.
- Gold rose on the increased prospect of US interest rate cuts, falling US 10-year real yields and a softening US dollar. Safe haven demand also provided support amid increasing tensions between the US and Iran.
- Industrial metals were broadly positive, led by lead (+6.8%), nickel (+5.4%) and copper (+3.0%). Aluminium (+0.4%) and tin (0.0%) were largely flat, while zinc (-3.9%) finished in negative territory. Oil (Brent +2.4%) stemmed May's sharp falls as demand concerns subsided and as Middle East tensions resurfaced.

Australian equities

- Expectations of lower interest rates, combined with rising commodity prices, provided support to Australian shares and enabled the S&P/ASX 100 Accumulation Index to return +4.0%.
- Within the Materials sector (+6.7%), more than two-thirds of constituents rose during the month. Gold producers Northern Star Resources and Newcrest Mining were the top performers, being beneficiaries of surging gold prices.
- Industrials (+5.7%) outperformed, thanks to the strong returns provided by infrastructure companies such as Sydney Airport (+11.1%), Atlas Arteria (+10.7%) and Transurban (+7.9%), all of which benefited from sector-specific news flow, such as positive traffic data, and the likelihood of lower interest rates.
- Consumer Discretionary (-1.0%) was the worst performing sector with all but one constituent, Aristocrat Leisure, declining over the month. JB Hi-Fi was the largest underperformer, declining on concerns of slowing sales growth and the threat of online competitors resurfaced.
- For the third month in a row, Australian small caps underperformed their large cap peers with the S&P/ASX Small Ordinaries Accumulation Index managing only a meagre positive return (+0.9%). With the heightened level of global economic uncertainty, it is likely that investors were attracted to large cap companies with relatively higher earnings stability.

Listed property

- Global listed property securities posted modest gains for the month. The FTSE EPRA/NAREIT Developed Index rose 1.7% in USD terms and 0.4% in AUD terms, underperforming broader equity markets. Singapore was the best performing market (+9.0%), while Developed Europe (excluding the UK) was the worst performer (-3.5%) and the only developed market to post a negative return for the month.
- In Australia, the S&P/ASX 200 A-REIT Index returned 4.2%. Industrial A-REITs was the best performing sub-sector (+13.3%), followed by Diversified A-REITs (+4.3%). Retail was the only A-REIT sub-sector to post negative returns for the month (-0.1%).
- The strongest performers in Australia were Goodman Group and Abacus Property Group. Goodman Group re-affirmed its corporate strategy and provided positive regional updates. Abacus Property Group and Charter Hall created a special purpose entity to acquire a 19.9% interest in in Australian Unity Office Fund for around $95 million. Having acquired this minority stake in the fund, the consortium has since submitted an unsolicited, indicative and non-binding proposal to acquire the remaining 80.1% for around $380 million.

Global equities

- It was a jubilant June after a miserable May; the S&P 500 Index enjoyed its strongest June performance since 1955, powering markets to all-time highs. The MSCI World Index rebounded 5.3% in AUD terms. Returns were even stronger in local currency terms, but AUD strength over June tempered overseas equity returns.
- The S&P 500 was the strongest performer in local currency terms across the major developed markets, delivering 7.0% in USD terms. Investors appeared to overlook trade tensions and cheered the prospect of interest rate cuts before year-end.
- The weakest performer for the fourth straight month was Japan's Nikkei index, which rose 2.6% in yen terms. Disruptions from US-China trade tensions and a subdued global automotive sector have affected sentiment towards manufacturers in Japan. Exacerbating their difficulties has been the ongoing strength of the Japanese yen, which is perceived as a safe haven currency.
- Emerging markets underperformed their developed counterparts, but the MSCI Emerging Markets Index still managed to rise by a very respectable 5.0% in AUD. The broader index was pulled down by the MSCI Europe, Middle East and Africa Index, which was the weakest emerging market region. The weakest market within that region was South Africa, which is suffering its worst economic downturn since the "GFC". Severe power shortages are devastating output in the power-intensive mining and manufacturing sectors.

Global and Australian Fixed Income

- By the end of May, global bond yields had fallen to record lows. During June they fell further still, resulting in another month of positive returns for investors.
- Ten-year US Treasury yields closed the month 12 bps lower at 2.00%, having briefly traded below the 2% threshold. Consensus expectations suggest the Federal Reserve will lower US interest rates before the end of 2019, possibly in July.
- Yields fell even further into negative territory in Japan and Europe; 10-year JGB and German bund yields closed the month at -0.16% and -0.33%, respectively.
- Domestic bond yields also declined, to the lowest levels on record. Ten-year CGS yields closed June 14 bps lower, at 1.32%. Some implications of this move are outlined overleaf in our "*Chart of the Month*".
- Australian bond yields drifted lower as investors continued to revise down their interest rate forecasts. By the end of June, markets had priced in a 75% probability of a rate cut in July and further easing is anticipated within the next 12 months. With consumer confidence not appearing to improve meaningfully following June's rate cut, further stimulus may be required.

Global credit

- Credit spreads tightened during June, resulting in favourable returns from corporate bonds.
- Following concerns in May about a breakdown in trade dialogue between US and Chinese officials, there was some optimism that Presidents Trump and Xi would progress with discussions when they met as part of the G20 summit.
- A resolution to the ongoing dispute could help underpin trade volumes and, in turn, support corporate profitability. This issue has therefore been an important driver of sentiment towards corporate bonds over the past few months.
- Improved sentiment extended across the full credit spectrum, with both investment grade and high yield issuers performing well – both appreciated by more than 1.0% during the month, extending gains in the FY19 year as a whole to around 9% and 13%, respectively.

Chart of the Month – The rising 'yield premium' of Australian shares

In these bulletins, we aim to share interesting observations from global investment markets. This month we focus on the widening gap between domestic equity and bond yields and, more importantly, what it might mean for income-seeking investors.

With the S&P/ASX 200 Accumulation Index returning more than 11%, the 2018/19 financial year was a pleasing one for most Australian equity investors. Around two thirds of the return was from share price appreciation and the remainder from the receipt of dividend income.

Given the reasonably strong capital return, it is interesting that there has been no erosion in the prospective dividend yield from Australian shares for the 2019/20 financial year. Consensus expectations suggest stocks in the S&P/ASX 200 Index will collectively provide dividend yields of ~4.4% in the next 12 months[1]. That's almost identical to what was anticipated this time last year, for FY18/19.

When share prices rise and dividends remain unchanged in dollar terms, a stock's dividend yield will fall. The fact that forecasted dividend yields are unchanged therefore indicates equity analysts expect listed Australian companies to increase their dividend payments in the year ahead. To achieve this, analysts must be expecting the companies to grow their earnings, enabling them to reward shareholders with steadily rising dividend payments over time. While there are no guarantees, the resilient forward dividend yield suggests brokers are reasonably confident about the earnings growth outlook for Australian companies.

With the recent election result also ensuring that there will be no immediate changes to the franking/imputation credit system, companies might also be more confident that investors will continue to attach the same value to franked dividends as they have historically, potentially (re)orienting their dividend policies accordingly.

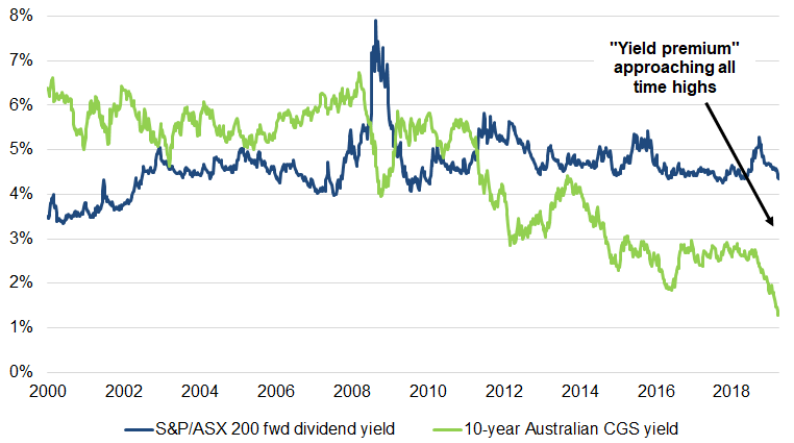
Another interesting aspect of Australian shares' buoyant dividend yields is how they compare to fixed income yields and, in turn, prospective income returns from Australian bonds (as well as term deposits and bank accounts). Bond yields have fallen sharply in the past few months – both in Australia and overseas – primarily reflecting expectations that the Reserve Bank of Australia and other global central banks will lower official interest rates.

By the end of June, 10-year Australian bonds were yielding just 1.32%. Let that sink in... Buyers of these instruments are effectively suggesting they are satisfied with income returns of ~1.3%pa for the next 10 years with no prospect of capital growth. Remember, bonds are designed to repay their par value at maturity; nothing more, nothing less. The Australian Government is one of few borrowers worldwide with an 'AAA' credit rating[2] and it is almost inconceivable that it will default on its debt. As a result, investors are almost certain to get their principal back when the bonds mature, but will receive relatively meagre annual income until that time. Further, the eroding effect of inflation – which currently sits at 1.3% versus a long-term average of more than 5%[3] – means real returns from Australian bond investments may be closer to zero.

With equity dividend yields stable and bond yields falling so dramatically, the gap between the two has rarely been wider. This may support the appeal of Australian shares for income-seeking investors. Only during the GFC period – when the S&P/ASX 200 Index dividend yield shot up to almost 8% as share prices collapsed – have we seen such a divergence in equity and bond yields.

It is important to note that both asset classes have important roles to play in a diversified investment portfolio and that their varying risk/return characteristics will appeal to different types of investors. Nonetheless, it is unusual to see such a wide divergence in the two yields and it will be interesting to see how the relationship evolves in FY20.

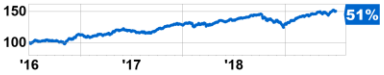
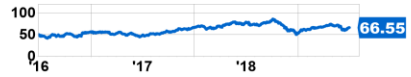
The Australian equity 'yield premium' has increased towards record highs



Source: Bloomberg and Factset, 1 January 2000 to 30 June 2019

[1] Source: Factset
2 S&P, as at 30 June 2019
3 Source: Bloomberg, 70 years ending 31 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)	3,476.50	5.28%	5.48%	12.59%	14.63%	
MSCI Emerging Markets (AUD)	1,085.30	4.97%	1.97%	6.98%	13.28%	
ASX 200	6,618.80	3.70%	7.97%	11.55%	12.88%	
ASX Small Ordinaries	2,834.60	0.92%	3.75%	1.92%	10.66%	
S&P 500 (USD)	2,941.76	7.05%	4.30%	10.42%	14.19%	
REITs						
ASX 200 A-REIT	1,604.80	4.22%	4.07%	19.32%	8.13%	
FTSE EPRA/NAREIT Developed (AUD)	3,617.56	0.42%	1.43%	14.39%	7.72%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.25%	-0.25%	-0.25%	-0.25%	-	
10-year yield Australia	1.32%	-0.14%	-0.45%	-1.31%	-	
10-year yield US	2.00%	-0.12%	-0.40%	-0.86%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	109.18	11.68%	26.41%	68.49%	27.20%	
Brent crude oil (USD/barrel)	66.55	3.19%	-2.69%	-16.23%	10.24%	
Gold (USD/ounce)	1409.70	7.96%	9.03%	12.66%	2.26%	
AUD/USD	0.702	1.28%	-1.21%	-5.02%	-1.96%	

Source: Factset and Bloomberg, at 30 June 2019

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