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Colonial First State
Global Asset Management

Bond yields plunge as economic outlook deteriorates

Market Watch

End-March 2019

Economics overview

- **US**: Mid-month, the Federal Reserve indicated US interest rates are unlikely to change in the foreseeable future; moving away from previous forecasts of two hikes in 2019. In a press conference, Federal Reserve Chairman Powell commented "We don't see data coming in that suggest that we should move in either direction … we should remain patient and let the situation clarify itself over time. It may be some time before the outlook for jobs and inflation calls clearly for a change in policy."
- Having digested these comments, few forecasters are now anticipating any change in US interest rate policy in 2019 and the market is pricing in a high likelihood of cuts before year-end.
- Employment growth slowed in February, but the unemployment rate nonetheless dropped to 3.8%; slightly above the 3.7% level from late 2017, but still close to 50-year lows.
- A combination of rising employment and quickening wage growth is supporting consumer confidence, which remains close to its highest level since the early 2000s.

- **Australia**: Data showed that Australian GDP grew just 0.2% in the December quarter; slightly lower than anticipated. The annual rate of 2.3% was also below consensus expectations.
- Whilst acknowledging that economic activity moderated in the second half of 2018, the Reserve Bank of Australia reiterated its 3.0% year-on-year GDP growth target for FY19. This suggests existing monetary policy settings are appropriate for now and helps explain the apparent reluctance to make any adjustments.
- Officials continue to point towards household consumption as the primary threat to the target being met. Wage growth remains subdued and residential property prices are falling quite sharply, suggesting discretionary spending could come under pressure.
- There was a modest decline in the unemployment rate in February, to 4.9%, although only 4,600 jobs were created during the month. There was a skew towards part time positions; the number of full time employees actually fell slightly.

- **New Zealand:** GDP grew 0.6% in the December quarter, an acceleration from the 0.3% growth in the prior quarter. The pickup in activity was focused in the construction and services sectors.
- In spite of the improvement, the annual pace of GDP growth declined to 2.3%; the weakest since 2013.
- Interest rates were unchanged at 1.75%. Policy makers indicated the next move in rates is likely to be downward, reflecting the weaker global economic outlook and sluggish domestic spending.
- In spite of improving exports of milk powder and lamb – particularly to China – New Zealand posted the widest annual trade deficit since 2006. The value of imports has been driven up by higher fuel prices.

- **Europe**: The European Central Bank announced a new round of stimulus measures in response to the slowing economy.
- The assistance package will include new loans to banks and was a little surprising, coming just three months after the ECB's previous Quantitative Easing program was withdrawn.
- Regional GDP growth forecasts were reduced to 1.1% for 2019, down from 1.7% just three months ago. Other European data has been concerning too; German manufacturing data was particularly weak in February, for example, deteriorating to six-and-a-half year lows.
- The ECB continues to argue that a recession in the Eurozone is unlikely, citing the improving labour market, rising wages and healthy consumption. That said, a more subdued growth outlook suggests rate hikes are unlikely in the remainder of this year.
- The UK remained mired in Brexit-related uncertainty. For now, the UK remains in the European Union as politicians were unable to agree on details of the exit deal prior to the proposed 29 March 2019 exit date.
- Brexit-related instability appears likely to continue to hamper activity levels in the UK until there is a resolution to the impasse. A general election may be required to move forward and a second Brexit referendum also remains a possibility.

- **Asia/EM:** China lowered its GDP growth target for 2019 to between 6.0% and 6.5%. The lower end of the range would represent the slowest rate of growth in nearly 30 years.
- Policymakers also announced tax cuts worth around US$300 billion for the year in an effort to stabilise the slowing economy.
- Chinese exports declined by -16.6% year-on-year in February, reflecting the influence that US import tariffs are having on activity levels.
- Indicators are subdued in Japan too. Inflation remains very low, even though the economy continues to be supported by stimulus from the Bank of Japan.
- There was a positive surprise in the labour market, where the unemployment rate unexpectedly dropped to 2.3% (from 2.5%). There was no change to the jobs to applicants ratio.
- The quarterly Tankan survey showed a sharp deterioration in sentiment among Japanese manufacturers – the decline in the survey was the sharpest since the December quarter of 2012.

Australian dollar

- The dollar was almost unchanged against the US dollar in March, closing at US$0.71. The exchange rate traded in a narrow range, within US$0.01 of this level for the entire month.
- There was also little change against a trade-weighted basket of currencies, or versus others in the Asia Pacific region.

Commodities

- Commodity prices were mixed, with commodity-specific factors mostly at play. Broader influences on global demand, such as improved prospects of a US-China trade deal, more accommodative monetary policies and Chinese policy assistance via tax cuts and infrastructure projects, were also supportive.
- Iron ore (-1.9%) tracked slightly lower during the month, as markets continued to adjust to the likely supply disruption from Vale's *Feijao* dam disaster at the end of January.
- Oil (WTI +5.2%) moved higher, driven primarily by OPEC-led supply cuts. Saudi Arabia is cutting oil production by more than it agreed under the deal, while Russia is moving closer to complying with its reduced supply commitments.
- Industrial metals were mixed, with zinc (+7.4%) posting strong gains and aluminium (+0.4%) edging higher. Nickel (-0.2%), copper (-0.8%) and lead (-6.1%) all finished in negative territory.
- Precious metals were mostly lower, with gold (-1.3%), silver (-3.4%) and platinum (-2.4%) all losing ground.

Australian equities

- The market has tread water since February's 'earnings season' as investors focused on economic and geopolitical uncertainty. These tensions have hampered returns, even as expectations rose for an interest rate cut in 2019. The S&P/ASX 100 Accumulation Index added a modest 0.8% in March.
- Defensive sectors such as Utilities and Health Care performed positively, climbing 1.4% and 1.3% respectively.
- The poor performance of Australia's 'big four' banks weighed on the Financials sector (-2.5%). Investors are worried about a further deterioration in credit growth and/or house prices, either of which could pose potential headwinds to future bank earnings.
- Energy was the worst performing sector, declining -4.1% and partially reversing February's strong rally. All sector constituents lost ground, reflecting declining LNG prices and an announcement from Norway's sovereign wealth fund that it will divest investments in oil and gas exploration companies.
- Recent small cap outperformance of the S&P/ASX 100 Index came to an end, with the S&P/ASX Small Ordinaries Accumulation Index declining -0.1%.

Listed property

- Global listed property fared well; all major developed markets rose in local currency terms, propelled by lower bond yields.
- The FTSE EPRA/NAREIT Developed Index returned 3.7% in USD terms and 3.8% in AUD terms, outperforming broader equity markets. Asian markets (6.5%) outperformed, while the UK (0.1%) was the worst performer amid the ongoing Brexit saga.
- In Australia, the S&P/ASX 200 A-REIT Index returned 6.2%. Diversified A-REITs (8.2%) was the best performing sub-sector, followed by Retail A-REITs (5.9%). Industrial A-REITs underperformed, returning 4.3%.
- The strongest performers in Australia in March were Charter Hall (+16.7%) and Stockland (+10.0%). Charter Hall outperformed during the month after reporting strong results in February, which highlighted exceptional growth in its funds under management (+22%). Stockland announced the divestment of an additional $143 million of retail assets as part of its $400 million non-core retail divestment strategy. The proceeds of the sale will reportedly be reinvested into the business and to buy back shares.

Global equities

- Global equity markets ruled off the quarter with their third positive month in a row and, after a March monthly return of 1.5% in Australian dollar (AUD) terms, the MSCI World registered its strongest start to the year since 1998; up 11.6%.
- In spite of a series of economic data pointing to a global slowdown, equity investors were buoyed by the prospect of further progress on a US/China trade deal. The more accommodative stance on monetary policy from central banks around the world was also positive – particularly the about-face by the US Federal Reserve on the 2019 interest rate outlook.
- UK stocks led the way, up 4.3% in GBP in mid-month as the likelihood of a hard Brexit on 29 March appeared to have diminished. Those gains were pared back to 3.3% by month end, as the House of Commons rejected three Brexit proposals. The UK now risks leaving the EU in mid-April without a deal.
- The two trade protagonists – the US and China – also enjoyed positive returns in March. The S&P 500 Index added 1.9% and the MSCI China Index rose 2.4%, both in local currency terms.
- Germany's DAX was tracking other developed markets until late in the month, when a manufacturing survey revealed the sharpest contraction in Europe's manufacturing powerhouse since July 2012. This sparked a global equities sell-off and the DAX ended the month flat, up only 0.1% in euro terms.
- The Japanese Topix also struggled given global growth fears. The Index traded in tight range until falling into the red over the last couple of days, closing March down -1.0% in Japanese yen.
- Emerging Markets extended their stretch of positive returns in AUD terms to a fifth month (1.0%) with Chinese stocks driving the MSCI Emerging Markets Index higher.
- Latin America was the weakest emerging market region for the second month in a row, down -2.4% in AUD. Investors were wary of the political turmoil in Brazil, with important economic reforms struggling to get through Congress.

Global and Australian Fixed Income

- Bond yields were pushed lower as investors pared back their expectations for global growth, inflation and interest rate hikes.
- The yield on 10-year Treasury notes fell 31 bps, closing March at 2.41%; the lowest level in more than a year.
- Benchmark 10-year yields fell globally too. Bund yields closed the month 25 bps lower at -0.07%; the first time German yields have traded below zero since late 2016. Gilt yields moved 30 bps lower, closing at 1.00%. Japanese yields slipped further into negative territory, closing the month 6 bps lower at -0.09%.
- Australian government bond yields were also pushed sharply lower. Yields broke through the 2.00% threshold with little resistance, closing the month 33 bps lower at 1.78%; the lowest level on record. The move lower reflected increasing expectations that the Reserve Bank of Australia will lower official interest rates later this year.

Global credit

- It was a relatively quiet month for global credit markets following several months of heightened volatility. After narrowing sharply in January and February, credit spreads were little changed in March – the spread on the Bloomberg Barclays Global Aggregate Corporate Index narrowed by just 3 bps, to 1.24%.
- The high yield market was similarly placid – the Bank of America Merrill Lynch Global High Yield Index (BB-B) spread closed the month just 4 bps wider, at 3.28%. It was a little surprising that credit markets were so resilient given the deterioration in economic indicators globally and as investors moderated their expectations for global growth.
- While spreads were little changed, global credit returns were supported by the substantial move lower in Treasury yields.
- Regionally, European issuers fared reasonably well despite the release of some unsettling economic releases.

Chart of the Month – How to run a railroad

In these bulletins, we aim to share interesting observations from global investment markets. This month we take a look at developments in the North American freight rail industry that are driving efficiency gains across the sector.

The North American freight rail sector is a core component of the continent's transportation system; and a key part of the global listed infrastructure opportunity set. From hauling consumer products, industrial products, agricultural produce or bulk commodities, freight railways connect with many parts of the economy and provide an essential service.

Freight rail firms must maintain track networks that stretch for tens of thousands of kilometres, making them highly capital intensive businesses. A key metric for the sector is the Operating Ratio (OR) – defined as operating expenses as a percentage of revenue. This is a measure of how efficiently the company is working. The lower a company's OR, the better.

The implementation of Precision Scheduled Railroading (PSR) across the sector is driving exceptional improvements in freight rail ORs – and company profitability. Key PSR components include:

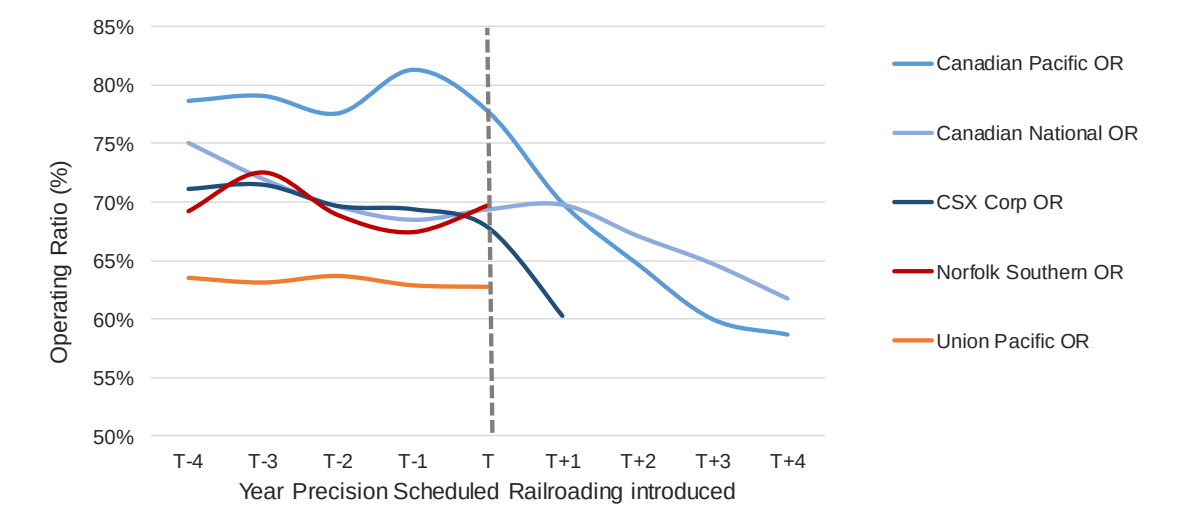
- Reducing the number of trains but increasing their length, which leads to increased speed and lower dwell times
- Reducing assets (locomotives, cars, hump yards) as the network becomes more efficient
- Reducing travel time and increasing certainty, which leads to increased customer satisfaction and premium pricing
- Reducing headcount as the railroad is run more efficiently

Our *Chart of the Month* illustrates dramatic OR reductions from the year where PSR was first introduced at three of North America's largest freight rail companies: Canadian National (from 2002), Canadian Pacific (from 2012) and CSX Corp (from 2017).

In light of these achievements, two other US freight railroads – Union Pacific and Norfolk Southern – announced in 2018 that they would also implement PSR across their rail networks.

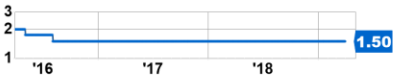
The CFSGAM Global Listed Infrastructure strategy currently holds positions in both Union Pacific and Norfolk Southern, on the view that PSR has the potential to prove similarly effective at these two companies. For those interested in further details on PSR, please refer to Senior Analyst Jessica Johnson's insightful Travel Diary from a recent research visit to North America.

Freight rail: getting more efficient



Operational Ratio by calendar year. T = the calendar year-end in which OR was first implemented at each company.
Source: Company reports, CFSGAM.

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)	3,323.09	1.54%	11.64%	12.96%	14.30%	
MSCI Emerging Markets (AUD)	1,075.48	1.01%	8.97%	0.36%	14.08%	
ASX 200	6,180.70	0.73%	10.89%	12.06%	11.46%	
ASX Small Ordinaries	2,744.70	-0.12%	12.59%	5.78%	11.40%	
S&P 500 (USD)	2,834.40	1.94%	13.65%	9.50%	13.51%	
REITs						
ASX 200 A-REIT	1,567.00	6.22%	14.75%	26.17%	9.90%	
FTSE EPRA/NAREIT Developed (AUD)	3,199.41	3.82%	13.83%	23.46%	9.42%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.50%	0.00%	0.00%	0.00%	-	
10-year yield Australia	1.77%	-0.33%	-0.55%	-0.83%	-	
10-year yield US	2.42%	-0.30%	-0.27%	-0.32%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	87.15	-1.10%	24.81%	33.10%	15.87%	
Brent crude oil (USD/barrel)	68.39	3.57%	27.12%	-1.37%	19.98%	
Gold (USD/ounce)	1293.00	-1.51%	1.15%	-2.25%	1.56%	
AUD/USD	0.710	-0.15%	0.90%	-7.39%	-2.62%	

Source: Factset, at 31 March 2019

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