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Colonial First State
Global Asset Management

Storm clouds brewing

Market Watch

End-May 2019

Economics overview

- **US**: Trade talks between the world's two largest economies stalled, with the US threatening to increase tariffs and China insisting there will be no more concessions. The focus then turned on tech stocks after Trump placed China's Huawei, the telecommunications equipment maker, on a trade blacklist. Tech companies in the US and Europe subsequently reported that they were suspending business with Huawei sending tech stocks on both sides of the Atlantic sharply lower.
- US Manufacturing PMI dropped to 50.6 in May; its weakest pace of expansion since September 2009. Despite weakening PMI data, the US unemployment rate fell to 3.6% in April; the lowest jobless rate since December 1969.
- As expected, the US Fed kept the federal funds rate target range at 2.25% to 2.50% during its May meeting, saying that economic activity has been rising at a solid rate and that the labour market remains strong. The Committee also reaffirmed its "patient" approach to "moving [rates] in either direction."

- **Australia**: The key event in Australia was the unexpected outcome of the general election, with the Coalition claiming victory. Markets cheered the defeat of Labor's wide-reaching tax and policy reforms, which were widely considered to be market unfriendly. Banks and private health insurers all rallied strongly as they were among the industries likely to face the most pressure from Labor's policy agenda.
- The Reserve Bank of Australia gave a strong indication towards month end that rates will be cut in June, noting, "A lower cash rate would support employment growth and bring forward the time when inflation is consistent with the target," This was on top of the RBA board meeting minutes that recorded its members had "considered the scenario where there was no further improvement in the labour market in the period ahead, recognising that in those circumstances a decrease in the cash rate would likely be appropriate."
- The result saw economists bringing forward and increasing the number of rate cuts this year and the market is now pricing in a stronger probability of rates going below 1% by year end.
- The CBA Composite PMI recovered a little in May to sit further above the critical 50 level that separates expansion from contraction. The improvement reflected a recovery in both the Services PMI and the Manufacturing PMI.

- **New Zealand:** The Reserve Bank of New Zealand lowered its official cash rate by 25 bps to a new record low of 1.5% at its May 2019 meeting, as widely expected. It was the first rate cut since November 2016. The RBNZ said it was necessary to support the outlook for employment and inflation consistent with its policy remit amid slower global economic growth.

- **Europe**: The European elections were held during May, which were notable for some unexpected results. Traditional centre-ground parties lost ground to the Greens and Liberals, but the pro-EU majority holds, if slightly fragmented. While right wing parties made some important gains in France and Italy, they still remain roughly a quarter of the European Parliament.
- The UK participated alongside other EU member states after an extension of Article 50. Nigel Farage's newly-formed Brexit Party was voted in with around 32% of the vote.
- The Brexit party is in contention to be the biggest single national party in the parliament. This might become a disruptive force in the determination of the bloc's top jobs – including the president of the European Commission and the head of the ECB.
- Outside of the elections, the German economy advanced a seasonally-adjusted 0.4% on quarter in 1Q19. The expansion was mainly supported by the fastest increase in household spending in eight years. This helped to drive a stronger than expected 1Q19 GDP read for the Eurozone, up 1.5% YoY, and defying IMF forecasts of precarious global growth as the three largest economic blocs (the EU, China and the US) have all reported 1Q19 GDP growth above expectations.
- The UK unemployment rate fell to 3.8% in the first quarter of 2019; its lowest level since 1974. In other positive data, UK GDP Growth reached 18 month highs, expanding 1.8% YoY in 1Q19.
- The unemployment rate in France also fell to multi-year lows, dropping to 8.7% in the March quarter; the lowest jobless rate in a decade.

- **Asia/EM:** In China, the economy advanced 6.4% in the three months to March 2019 (YoY), unchanged from the previous period and, although better than expected, it remains the lowest growth rate since the GFC amid intense trade conflict with the US, softening domestic demand and off-balance-sheet borrowings by local governments.
- The Japanese economy unexpectedly grew in Q1, rising by 0.5% quarter-on-quarter in the three months to March 2019, comfortably beating market expectations of a small contraction.

Australian dollar

- The Australian dollar was weaker against the USD and EUR, and stronger against the GBP. The Australian currency market priced in imminent rate cuts after the release of the RBA meeting minutes. Falling energy prices, which are seen as a negative for Australia's LNG export prices and the terms of trade, also weighed on the Aussie dollar.
- The AUD closed April at US$0.694, a depreciation of -1.5% against the USD over the month.

Commodities

- Commodity prices were mixed during May, with industrial metals and oil mostly lower, and iron ore and gold higher.
- Escalating US-China trade tensions, new US tariffs on Mexico and an unexpected fall in China's manufacturing PMI in May weighed on the demand outlook for industrial metals. Zinc (-7.1%) was the worst performer, followed by copper (-6.8%), lead (-4.9%), tin (-3.1%) and nickel (-1.4%). Aluminium edged up 0.2%
- Iron ore (+5.4%) tracked higher through most of May on supply concerns and demand prospects. China's iron ore port stockpiles fell sharply in May, continuing a trend that began in early April.
- Oil prices (Brent -11.6%) weakened in May, particularly in the final days, as demand worries, emanating from trade tensions, outweighed supply disruption risks.
- Precious metals were mixed. Gold (+2.1%) was higher while silver (-2.5%) and platinum (-8.9%) both fell.

Australian equities

- The positive investor sentiment seen in April continued into May, with the S&P/ASX 100 Accumulation Index rising +2.1%. The majority of this market gain was experienced in the lead-up to and following the surprise outcome of the Australian Federal election, with the incumbent Coalition government returned with an increased majority.
- The Communication Services sector was the best performer this month given its +7.7% rise. This sector, along with the shares of other dividend favourites such the 'Big Four' banks and Listed Investment Companies all rallied with the removal of the threat of franking reform under a potential Labor government.
- Medibank Private (+15.7%) was the best performing Financials constituent as the Liberal election removed the downside risk of Labor's proposed 2-year 2% cap on premium rate increases.
- Consumer Staples (-3.5%) and Energy (-3.4%) were the worst performing sectors as energy stocks followed the oil price lower.
- Small caps underperformed their large cap peers in May with the S&P/ASX Small Ordinaries Accumulation Index declining -1.3%.

Listed property

- Global listed property substantially outperformed the broader market during the month. The FTSE EPRA/NAREIT Developed Index fell -0.2% in USD terms and rose 1.4% in AUD terms, markedly outperforming equities, which fell 5.7% in USD terms (MSCI World Index). Australia, as measured by the S&P 200 A-REIT (Sector) Index (+2.5%), was the best performing property market, while Hong Kong (-5.8%) was the worst performer.
- In Australia, Diversified A-REITs (+7.2%) was the best performing sub-sector, followed by Office A-REITs (+3.0%). Retail A-REITs underperformed, returning -1.6%.
- The strongest performers in Australia were Stockland (+17.5%) and Mirvac (+7.1%). Stockland rallied strongly following the Coalition's surprise federal election victory and after being upgraded by numerous research houses shortly thereafter. The outlook of the Group's residential development division has improved along with overall housing market sentiment - buoyed by APRA's proposal to scrap the existing 7% serviceability threshold on home loan applications, the government's recently announced new first home buyer scheme and the high likelihood of RBA rate cuts as soon as June.

Global equities

- Global equity markets suffered their first negative monthly returns for 2019 as fears over the escalation and broadening of the China/US trade dispute, and its ramifications for world growth, frightened investors away from equity markets in May and into safe haven assets like gold and bonds. Not even a weaker Australian dollar (AUD) could prevent the worst MSCI World Index returns since October 2018, as it fell -4.2% in AUD terms. And even with the market correction, growth stocks continue to outperform their value peers with the MSCI World Growth Index, -3.7%, outperforming its value counterpart, -4.7%, for the sixth straight month in AUD.
- The UK's FTSE 100 was the best performing of the major overseas markets, down only -2.9% in British pounds – notwithstanding the ongoing uncertainty over Brexit and the resignation of Theresa May as Prime Minister. Japanese equities were the worst performers for the third consecutive month as the rallying Yen, also seen as a haven asset, poses a further headwind to Japanese exporters. The Nikkei was down -6.7% in Japanese Yen. Emerging markets also struggled during May with the MSCI Emerging Markets Index down -5.8% in AUD terms. The strongest performing region was MSCI EM Latin America, which was down only -0.4% in AUD – largely driven by the recovering MSCI Brazil Index, up 0.8% in local currency terms. MSCI EM Asia was the worst performing region, down -7.3% in AUD, as MSCI China plummeted -13.0% in Chinese Renminbi. Investors are concerned over the trade war effects on the Chinese economy with disappointing retail sales, industrial production and manufacturing PMI numbers reported over May.

Global and Australian fixed income

- Global bond yields fell sharply over May, with risk aversion pushing investors to the safety of high quality government debt.
- Benchmark 10-year US Treasury yields closed the month 38 bps lower, at 2.12% as inflation remained low and escalating trade tensions spooked investors concerned about the impact on global trade and ultimately, growth.
- Central banks have, in general, turned more dovish globally seeing markets price in easing in 2019. This is a stark reversal to 2018 where cash rate hikes continued to be priced in.
- In Germany, yields moved back into negative territory, their lowest on record, closing 22 bps lower at -0.21%.
- Japanese yields pushed further negative from -0.05% in April to -0.10% by end of May.
- In the UK, the Brexit impasse worsened with the announcement of an impending change of Prime Minister. 10-year gilt yields fell 31 bps to 0.88% during the month.
- Australian CGS yields were down substantially during the month from 1.80% to 1.45%, as the prospect for a June rate cut increased following RBA Governor Lowe's speech on 21 May.

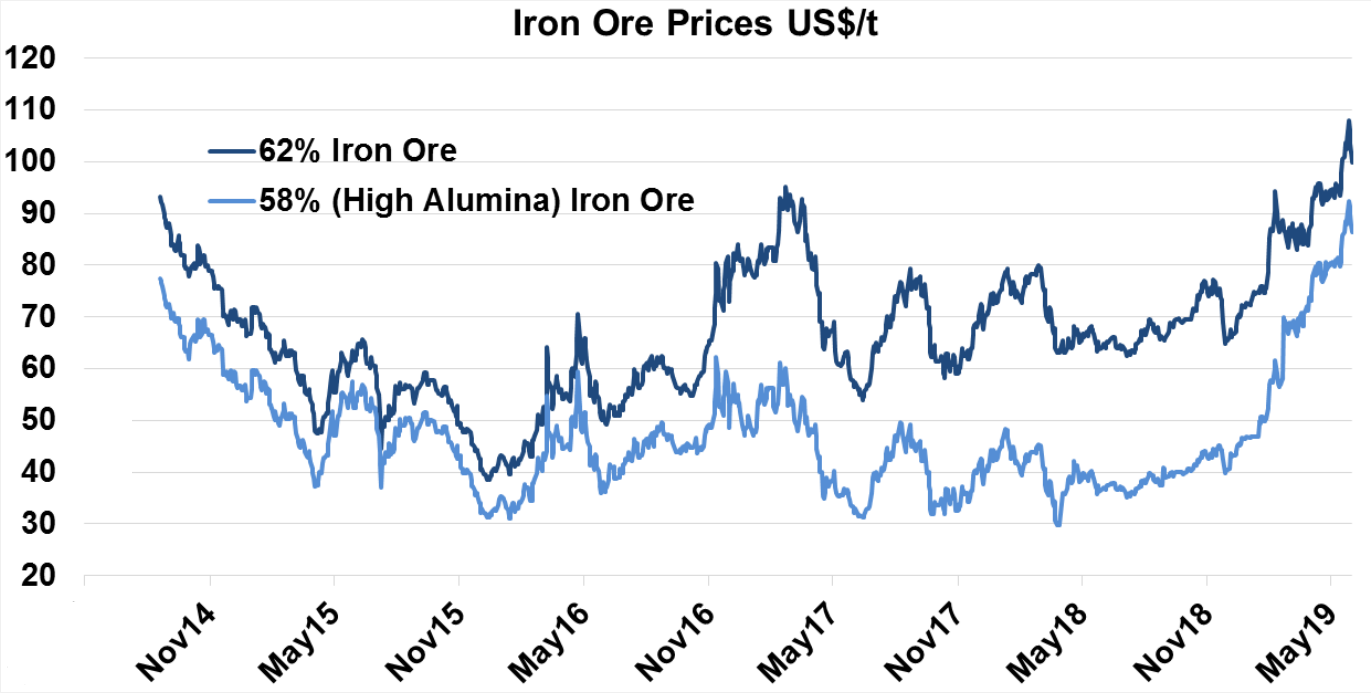
Global credit

- Credit spreads widened during the month after a previously strong 2019. The re-emergency of geopolitical risk saw risk assets unwind some of this year's gains.
- Investors were increasingly concerned with the escalation of trade tensions between the US and China along with intensification of pressure on some other US trading partners towards the end of the month including Mexico and India.
- Economic releases were on the softer side with mixed results in the US and most other developed markets seeing weaker manufacturing survey results.
- Sentiment in US credit markets has been negatively affected by escalating US-China trade tensions, with investors starting to consider the negative financial consequences of a prolonged stand-off. In Europe, continued Brexit uncertainty and heightened political risk in Italy have weighed on valuations and contributed to the general economic downside in Europe.
- Higher beta, lower quality names underperformed during the month as fund flows turned negative.
- Corporate bond issuance was generally light versus expectations due to the weaker macro environment.

Chart of the month – US$100/tonne or(e) bust

In these bulletins, we aim to share interesting observations from global investment markets. This month we focus on the recent rally in iron ore prices, with a focus on the diminishing discount between high and low quality ores, and our expectations for the market going forward.

Recent headlines[1] have pointed to iron ore prices "busting above" US$100 a tonne for the first time in five years. But not all grades of iron ore have risen above $100 a tonne ... yet! As the chart below shows, low-grade iron ore (58% fines, high alumina) remains below the $100 level even though it has recently risen at a faster rate than high-grade iron ore (62% fines) equivalent. Clearly not all ores are borne equal! Indeed, in our Chart of the month of January 2018, we highlighted the growing discount between low and high grade iron ore, but predicted that the discount would likely narrow over time as steel industry profitability normalised in China. However, this adjustment has occurred earlier than expected owing to unanticipated and significant industry supply disruptions.



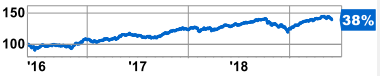
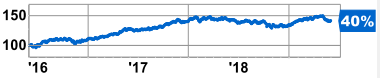
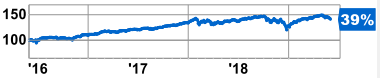
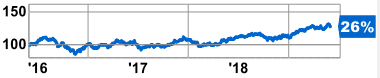
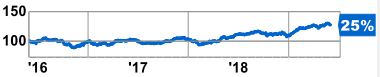
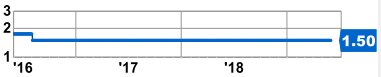
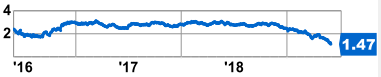
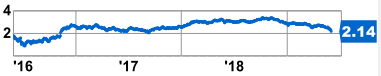
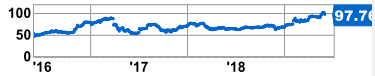
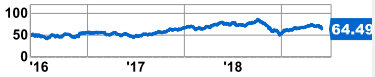
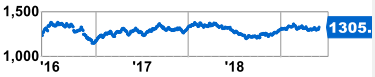
Source: Credit Suisse. Data as at 31 May 2019.

The major event that impeded market supply was the tragic tailings dam failure in Brumadinho, Brazil in January this year. The failure triggered Brazilian mining giant Vale to close several mines, resulting in around 90mt of iron ore being removed from the market. Closer to home, high grade producers Rio Tinto and BHP Group also experienced production difficulties in April 2019 as a result of cyclone Veronica, meaning supply in the higher-quality iron ore market has been universally tight. This supply disruption means steel producers are chasing all available ore they can get their hands on – leading to a greater appreciation for the lower grade ore, given its wider availability, and a significant decline in its relative discount. So will the discount continue to close and will 58% fines rise above US$100 per tonne?

The shortage of iron ore is likely to continue in the short term and it is estimated that it will take Vale a couple of years to get back to their full run rate. In the meantime, BHP and Rio are remaining disciplined and focussing on "value over volume", so iron ore prices could well enjoy ongoing strength over the coming months. At the same time, however, higher prices are enticing more marginal iron ore producers back into the market so the supply of lower quality iron ore could also be on the rise. In the medium to long term, the supply of high quality iron ore will increase if Vale's production resumes to normal levels. The price differential between high and low quality ores is likely to widen again over the medium term, as steel producers favour the efficiency and environmental benefits associated with higher grade iron ores.

[1] "How the iron ore price busted above $US100 a tonne" Patrick Commins, *The Australian Financial Review*, May 20, 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)	3,307.62	-4.18%	1.73%	9.51%	11.26%	
MSCI Emerging Markets (AUD)	1,039.99	-5.75%	-1.87%	0.10%	11.94%	
ASX 200	6,396.90	1.71%	4.88%	11.08%	10.60%	
ASX Small Ordinaries	2,816.70	-1.25%	2.69%	2.06%	9.84%	
S&P 500 (USD)	2,752.06	-6.35%	-0.67%	3.78%	11.72%	
REITs						
ASX 200 A-REIT	1,564.70	2.47%	6.06%	17.00%	7.90%	
FTSE EPRA/NAREIT Developed (AUD)	3,199.41	1.38%	4.87%	18.50%	7.72%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.50%	0.00%	0.00%	0.00%	-	
10-year yield Australia	1.47%	-0.33%	-0.63%	-1.18%	-	
10-year yield US	2.14%	-0.36%	-0.57%	-0.69%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	97.76	4.85%	19.67%	50.68%	21.51%	
Brent crude oil (USD/barrel)	64.49	-11.41%	-2.33%	-16.88%	9.08%	
Gold (USD/ounce)	1305.80	1.79%	-0.53%	0.44%	2.44%	
AUD/USD	0.693	-1.56%	-2.61%	-8.43%	-1.48%	

Source: Factset, at 31 May 2019

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