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Colonial First State
Global Asset Management

Trade tensions front of mind ahead of G20 Summit

Market Watch

End-November 2018

Economics overview

- **US:** Early in the month there was a focus on midterm elections. The opposition Democratic Party won control of the House of Representatives, while the governing Republicans extended their majority in the Senate. The 'split' Congress suggests it could be more challenging for new legislation to be passed in the two remaining years of the current Presidential term.
- Employment trends remain encouraging. More than 250,000 jobs were created in October; well ahead of forecasts for an increase of around 200,000. The unemployment rate was unchanged, at 3.7% - levels we have not seen for almost 50 years.
- Even more positively, average hourly earnings growth picked up to 3.1%, the highest level since 2009.
- Buoyant employment conditions have supported services sectors of the economy, in particular. The non-manufacturing ISM survey moderated slightly in October, but remained close to its highest level in more than 20 years.
- The pace of retail sales growth has also been firm; averaging more than 5.0% yoy in 2018 to date.

- **Australia:** The Reserve Bank of Australia left interest rates on hold at 1.50% for a 25th consecutive meeting. It is likely that both inflation and wage growth will need to rise towards 2.5% before the Bank will raise interest rates for the first time since 2010.
- Labour force data surprised on the upside for October. The economy added 32,800 jobs, well ahead of the +20,000 estimate. The official unemployment remained at 5.0%; the lowest level since 2012.
- Business confidence deteriorated further, to the lowest level in more than two years. With a Federal Election likely in the next six months or so, it appears that political instability is affecting confidence levels.
- Data showed the value of new mortgages approved by lenders dropped sharply in September – see our attached *Chart of the Month,* outlining drivers of recent housing market weakness.

- **New Zealand:** Interest rates were again left on hold at 1.75%. The RBNZ Governor reiterated that there are no plans to amend monetary policy during 2019, unless inflation moves outside the 1% to 3% target range. In the September quarter, CPI quickened to 1.9% yoy, from 1.5% yoy in the previous quarter.
- Like the Australian dollar, the 'kiwi' dollar has weakened this year; supporting exporters and providing support to the economy.
- There was a further dramatic fall in the official unemployment rate in the September quarter, from 4.5% to 3.9%. The jobless rate has been steadily declining since 2012, when it hit 6.7%.
- Wages are also edging higher, rising 1.4% in the September quarter alone.

- **Europe:** Brexit headlines dominated attention. British Prime Minister May agreed terms of the UK's withdrawal from the European Union with EU officials. In December, she will try and obtain Parliamentary approval on the draft bill. This is not expected to be easy, suggesting the Brexit debacle could get worse before it gets better.
- Economic data in the UK has been quite sluggish. Inflation has come off the boil and most economists are anticipating a slowdown in economic growth in the December quarter.
- Business confidence has deteriorated, highlighted by a decline in investment. At the same time, growth in the services sector has slowed to a seven-month low and consumer confidence has been dampened by signs of house price weakness.
- Economic growth in Continental Europe has not picked up to the extent anticipated earlier in the year. A second estimate confirmed that growth in the Eurozone economy decelerated to an annual pace of 1.7% in the September quarter; the slowest since 2014. The German economy shrank slightly over the same period. These indicators will likely be a concern for policy makers as the European Central Bank prepares to withdraw its Quantitative Easing program at the end of this month.
- Manufacturing data also continued to deteriorate, likely reflecting lower activity following the introduction of tariffs on autos and certain other products.

- **Asia/EM:** Sentiment towards exporters in Asia and other emerging markets continued to be affected by trade-related concerns. The US has threatened to introduce tariffs on a further $250 billion of goods imported annually from China.
- Chinese data was a little contradictory – exports rose in October, while other indicators continued to soften; manufacturing and non-manufacturing PMI surveys both deteriorated.
- Retail sales have been firm, particularly around 'Singles Day' in China (the online discounting equivalent of 'Black Friday' in the US). Early reports suggest Chinese shoppers spent more online in one day than Australians spend online annually – this strong domestic demand is helping to offset export-related concerns.
- In Japan, inflation rose to 1.4% yoy – the first increase since February. This is unlikely to be a concern for the Bank of Japan, which currently maintains official interest rates at -0.1%. In fact the Bank has revised inflation expectations lower, suggesting years of monetary easing have failed to stimulate the economy.

Australian dollar

- The 'Aussie' recovered partly from months of weakness against the US dollar, appreciating by 3.3% during the month.
- This reflected broader US dollar weakness, as investors pared back expectations for further hikes in the Federal Funds rate.

Commodities

- Commodity prices were mixed during November.
- Industrial metals were mostly higher, with lead (+4.8%), copper (+2.7%) and zinc (+1.5%) posting gains. Aluminium (-0.6%) edged slightly lower.
- Gold (+0.7%) continued last month's gains on 'safe haven' demand, although platinum (-4.9%) and silver (-0.7%) both fell.
- Iron ore (-9.9%) reversed its recent upward trend as steel prices fell. Thermal coal (-6.6%) and coking coal (-3.6%) also finished the month lower.
- Brent Crude (-20.8%) fell sharply to 12-month lows, reflecting record production in the US and Saudi Arabia.

Australian equities

- The Australian equity market started the month with renewed optimism, rallying more than 2% within the first two weeks. The momentum didn't last long, however, as a fresh wave of selling dragged the market lower mid-month – particularly in the Energy and Health Care sectors.
- Small Caps outperformed their larger cap peers. The S&P/ASX Small Ordinaries Index declined a modest -0.4%, whilst the S&P/ASX 100 Index declined -2.4%.
- Companies that contributed to small cap outperformance were G8 Education (+36.6%), Kidman Resources (+34.0%) and Appen (+30.6%). G8 Education rallied after the company announced improvements in centre occupancy during a trading update.
- For the large caps, the Energy sector was by far the worst performing sector, declining -10.4% as oil prices plummeted. Materials (-5.3%) also felt the impact of declining commodity prices, particularly metals.
- Cochlear (-4.7%) dragged the Health Care sector lower, after announcing it would invest up to AU$21m in Nyxoah – a medical device company that provides treatment for sleep apnoea.
- The Financials sector (+1.5%) provided the best returns, despite the ongoing Royal Commission, all four major banks added value. Clydesdale Bank (-25.8%) fell significantly, as management provided a cheerless outlook given the 'Brexit' negotiations.

Listed property

- The S&P/ASX 200 A-REIT Index returned -0.4% in November.
- Office A-REITs (1.6%) was the best performing sub-sector, followed by Diversified A-REITs (1.1%). Retail A-REITs underperformed, returning -2.0%.
- The strongest performers included Charter Hall Retail REIT (6.4%) and Shopping Centres Australasia (2.7%).
- Charter Hall Retail REIT offloaded a neighbourhood shopping centre in Queensland and a Woolworths supermarket in NSW, for $76.1 million, as part of the company's clearing of low-performing assets in its portfolio. Although at a modest discount to book value, these sales were welcomed by investors. They were also consistent with the REIT's strategy of divesting smaller assets and redirecting capital into larger, more dominant retail centres.
- Weaker performers included Unibail-Rodamco-Westfield (-7.1%) and Viva Energy REIT (-5.1%).
- Negative sentiment surrounding the timing and strategic risks of the Westfield transaction contributed to the sell-off in Unibail-Rodamco-Westfield. While the transaction appears strategically sound, investors appear concerned that it might present some short-term risks to the balance sheet and operations.
- Many major global property markets bounced back from last month's lows and generated positive returns. The FTSE EPRA/NAREIT Developed Index returned 3.8% in USD terms, outperforming broader equity markets.
- In local currency terms, Hong Kong (8.7%) was the best performing market, while UK (-4.5%) was the worst.

Global equities

- After a brief bounce at the end of October, markets resumed their negative momentum into November, setting this up as potentially the worst December quarter for markets since the GFC.
- Investors have fretted over plunging oil prices, endless Brexit negotiations, Italy's budget impasse and ongoing trade tensions between the world's two largest economies. The MSCI World Index finished the month down a further -1.8% in Australian dollar terms, bringing the quarter-to-date returns to -7.1%.
- A temporary trade truce negotiated between Presidents Trump and Xi in Buenos Aires over last weekend, however, may see markets bounce back in December.
- Germany was one of the worst performing developed markets. Shares of German auto makers suffered on news reports suggesting the US could soon impose a 25% tariff on imported vehicles. European auto stocks have lost over a fifth of their value in 2018 on trade concerns and anaemic consumer demand.
- The US S&P 500 bounced back in the final week of November, on perceived dovish comments by the Federal Reserve Chair.
- Amidst the gloom, emerging markets eked out positive returns in both Australian dollars and local currencies. The MSCI Emerging Markets Index rose 1.1% over the month, powered by MSCI Asia, which was up 2.1% (both in Australian dollars). The Chinese and Indian markets, in particular, performed well in local currency terms, with the MSCI China and MSCI India markets up 7.2% and 4.0% respectively. Higher risk emerging market currencies, like the Indian rupee, also bounced on the Fed Chair's comments – further boosting MSCI India's monthly return in Australian dollars.

Global and Australian Fixed Interest

- Bond yields were pushed lower by comments from the US Federal Reserve that suggested interest rates might not be increased as much in 2019 as had been anticipated previously.
- Fed Chairman Powell suggested rates are now "just below" neutral, which surprised investors. There were increasing calls for a pause in interest rate hikes – not least from the US President – with some commentators suggesting further tightening could prompt a significant economic slowdown, or even a recession.
- Ten-year US Treasury yields had risen in early November to an intra-month high of 3.24%, but fell back sharply to close the month just below 3%.
- The significant decline in oil prices also weighed on inflation expectations. This flowed through to global fixed income markets and helped to push yields lower.
- Australian CGS yields followed the US lead; rising sharply early in the month before losing all these gains later. The 10-year yield declined 3 ½ basis points during November, closing at 2.59%.

Global credit

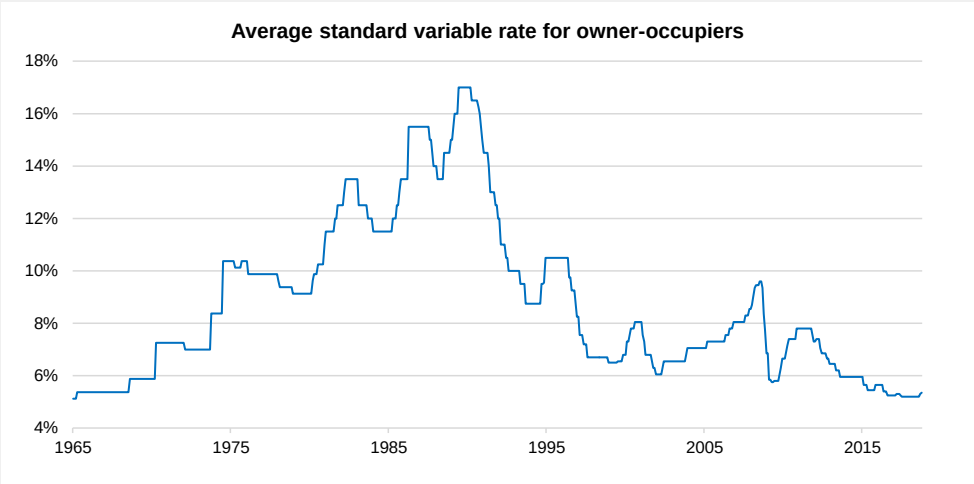
- Credit markets, which had been quite resilient against October's equity market weakness, destabilised in November.
- Investment grade credit spreads widened by 19 bps, to 1.43%. High yield spreads closed the month 39 bps higher, at 3.64%.
- There was a perception among investors that US corporate earnings may have peaked, following another quarter of strong growth in the three months ending 30 September 2018.
- Concerns about a potential escalation in the 'trade-war' also remained front of mind, with scepticism that the US and China would be able to diffuse rising tensions when they met as part of the G20 Summit in Buenos Aires in early December. *In the event some progress was made, with the US agreeing to delay the possible introduction of additional tariffs by 90 days.*
- New issuance was met with mixed demand, prompting some companies to postpone new offerings. Those with imminent funding requirements are now running out of time if they want to have deals completed before the end of the year.

Chart of the Month – Banks are to blame for house price weakness, aren't they…?

In these bulletins, we aim to share interesting observations from global investment markets. This month we're looking at the downturn in Australian house prices and, specifically, whether mortgage lenders might be responsible for it.

With around two thirds[1] of Australians owning their own home, it's unsurprising that the recent rollover in residential property prices has attracted a lot of attention. Sections of the mainstream media have suggested lenders are at least partly to blame for adverse price movements, by raising mortgage rates 'out of cycle' during a period where the Reserve Bank of Australia (RBA) has left official interest rates on hold.

A quick look at the data suggests these accusations might be misdirected.



Source: Reserve Bank of Australia, January 1965 to October 2018

The chart above shows the average standard variable mortgage rate (SVR) for owner-occupiers in Australia over the past 50+ years.

The average SVR has increased by 0.15% over the past three months as lenders have passed on higher short-term funding costs to borrowers. Nevertheless, mortgage rates remain extremely low by historical standards. In fact, they are close to their lowest level since the 1960s and are still below the level from two and a half years ago, prior to the RBA's official interest rate cut in August 2016. In short, borrowing costs haven't increased anywhere near as much as some of the recent media headlines might have you believe. It's also worth remembering that property prices were rolling over before any recent increases to SVRs were implemented.

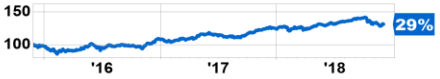
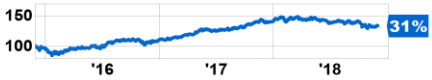
Instead, the moderation in prices appears to be attributable to a combination of:

- Higher supply – strong price appreciation in recent years underpinned significant new construction activity; building approvals grew at an annual pace of 8.5%[2] in the five year period between 2013 and 2017.
- Dampened confidence levels – in spite of declining unemployment, wage growth in Australia remains stagnant and affordability is an issue in Melbourne and Sydney, in particular. Buyers also appear to have become more cautious, owing to falling auction clearance rates and media headlines prophesising an imminent 'crash'. Many buyers appear to be adopting a 'wait and see' approach, removing the competitive bidding pressure that helped propel Australian property prices steadily higher for so long.
- Tighter lending standards – in general, new loan approvals are becoming more stringent as lenders have sought to improve the average credit quality of their loan books. The value of new loans being approved has fallen as a consequence, removing some potential buyers from the market.
- Moderating investor appetite – capital restrictions in China, the introduction of higher stamp duty on properties acquired by offshore buyers and rumoured changes to taxation for onshore investors has curbed demand.

Separately, there has been some speculation that lenders' mortgage rate increases have been a factor in the RBA's most recent decisions to leave official cash rates on hold at 1.50%. The broader falls in the SVR over the past two years and the modest extent of the increases recently would suggest this is probably not the case. Instead, the RBA will continue to monitor broader economic conditions and inflationary pressures as part of its monetary policy setting deliberations.

[1] 65.5%. Source: Australian Census 2016: includes homeowners that own their property outright (31.0%) and those paying off a mortgage (34.5%).
2 Source: Australian Bureau of Statistics, January 2013 to December 2017.

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 witholding tax, in AUD)	3,130.73	-1.79%	-6.57%	4.67%	8.83%	
MSCI Emerging Markets (AUD)	983.48	1.06%	-6.32%	-5.14%	9.53%	
ASX 200	5,667.20	-2.21%	-9.28%	-0.96%	7.69%	
ASX Small Ordinaries	2,573.80	-0.37%	-10.25%	-1.63%	10.39%	
S&P 500 (USD)	2,760.17	2.04%	-4.40%	6.27%	12.16%	
REITs						
ASX 200 A-REIT	1,376.80	-0.44%	-5.25%	1.45%	7.98%	
FTSE EPRA/NAREIT Developed (USD)	2,114.61	3.85%	0.64%	7.57%	3.52%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.50%	0.00%	0.00%	0.00%	-	
10-year yield Australia	2.59%	-0.02%	0.07%	0.09%	-	
10-year yield US	2.99%	-0.16%	0.14%	0.60%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	64.73	-10.54%	-3.56%	-4.97%	16.63%	
Brent crude oil (USD/barrel)	58.71	-22.21%	-24.17%	-7.65%	9.59%	
Gold (USD/ounce)	1220.20	0.65%	1.66%	-4.16%	4.61%	
AUD/USD	0.730	3.03%	0.97%	-3.81%	0.26%	

Source: FactSet, as at 30 November 2018

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