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Colonial First State
Global Asset Management

Gains in the US push global shares up to record highs

Market Watch

October 2018

Economics overview

- **US:** The Federal Reserve tightened monetary policy again in September, raising official US interest rates by 0.25 percentage points, to between 2.00% and 2.25%. This was the eighth time borrowing costs have been raised in the past two years.
- US interest rates are now at their highest level in more than a decade, but most observers suggest they will go higher still. Consensus expectations suggest the Fed Funds rate will be raised by a further 0.25 percentage points before the end of 2018 and by at least a further 0.75 percentage points in 2019.
- The ongoing improvement in economic conditions is being reflected in the labour market; more than 200,000 new jobs were added in August. At 3.9%, unemployment is close to its lowest level since the early 1970s.
- At the very end of the month, the US, Canada and Mexico agreed on a trade accord that will replace the former North American Free Trade Agreement.
- The new trade pact was well-received by financial markets, which had been concerned about a potential slowdown in activity – particularly in the US – if a new deal was not agreed.

- **Australia:** The latest data confirmed the Australian economy expanded by 0.9% in the June quarter, taking the annual pace of growth to 3.4%. This is the fastest rate since 2012.
- Growth data for the March quarter was also upwardly revised.
- These data releases provided some respite from recent currency weakness and helped push local bond yields higher.
- In spite of the favourable economic backdrop, business confidence has fallen to its lowest level in more than two years.
- This may reflect political uncertainty following the recent change of Prime Minster and in anticipation of a Federal Election within the next year.
- Consumer confidence has also declined recently, perhaps owing to rising mortgage costs and moderating house price data.
- Prices in Sydney and Melbourne have been falling for several months, but the national average has now dipped into negative territory too, following six years of unbroken growth.

- **New Zealand:** The New Zealand economy grew by 1.0% in the June quarter, taking the annual pace of growth to 2.8%.
- The improvement did not affect interest rate forecasts. Few observers are expecting borrowing costs to move before 2020.
- In spite of ongoing house price growth, consumer confidence levels have dipped to their lowest level in six years.
- Business confidence levels are also subdued, which could dampen activity levels in the medium term.

- **Europe:** Ongoing Brexit-related headlines continued to attract a fair amount of scrutiny. UK and European lawmakers are still yet to reach agreement on the UK's proposed withdrawal from the European Union.
- The UK's ruling Conservative Party and opposition Labour Party held their annual conferences during September, which helped keep Brexit and political considerations in the spotlight.
- In economic news, strong UK retail sales data brought forward expectations of the next increase in borrowing costs. For now, official interest rates are 0.75%, but consensus expectations suggest they will be raised again in mid-2019.
- UK inflation has come off the boil over the past few months, reducing the need for the Bank of England to consider more significant policy tightening.
- Headline inflation in the Euro Area has risen to 2.1%; the highest level in five and a half years. This is partly attributable to sharp increases in energy prices – the Core CPI measure, which excludes energy, actually moderated to an annual pace of 0.9%.
- The European Central Bank remains committed to withdrawing its Quantitative Easing program at the end of 2018. From there, investors will be keeping a close eye on inflation to gauge the likely timing of interest rate increases. For now, no movement is anticipated until the second half of 2019, at the earliest.

- **Asia/EM:** News flow in China continued to be dominated by trade; specifically how the introduction of import tariffs by the US might affect demand for exports and, in turn, the global supply chain.
- In September, the US introduced new tariffs on a broader range of goods imported from China – albeit at a rate of only 10%, versus the 25% feared. Semiconductors, chemicals, plastics and motorbikes are among cargoes that now face tariffs. China was also measured in its retaliation when imposing tariffs on goods such as steel and medical equipment imported from the US.
- In Japan, there was an unexpectedly sharp increase in inflation. Headline CPI quickened to an annual pace of 1.3% in August, driven by increases in food and transport prices. More persistent inflation might be required for the Bank of Japan to withdraw its stimulus program and consider raising interest rates above zero.
- Concerns about emerging markets receded in September, following extreme caution and widening credit spreads that had been seen in August.

Australian dollar

- Favourable Australian economic data releases enabled the currency to arrest recent declines against the US dollar.
- The Australian dollar gained 0.5% again the 'greenback', after falling in value by more than 10% between the end of January and the end of August.

Commodities

- Commodity prices generally rose during September as concerns eased around the impact of US trade tariffs and the associated impact on global economic growth.
- Zinc (+2.8%) and Copper (+2.7%) both rose, while nickel (-4.1%), aluminium (-4.8%) and lead (-2.9%) finished lower.
- Oil rose 6.9% to four year highs on expectations of tightening supply ahead of US sanctions against Iran and major oil producers' decision not to increase production.
- Expectations of more stringent checks and controls on China's coking coal production during the winter season supported coking coal prices (+9.2%). Thermal coal (+2.4%) also rose.
- Iron ore (+6.5%) had another strong month amid elevated steel production levels and a rising Chinese steel rebar price.
- Precious metals were mixed. Gold (-0.7%) was lower on continued strength in the US dollar, while silver (+1.3%) and platinum (+4.2%) both rose.

Australian equities

- Australian equities declined for the first month since March 2018, with the S&P/ASX 200 Accumulation Index falling -1.3%.
- Eight of the 11 GICS sectors delivered negative returns; the only positive performers were Energy (+4.3%), Materials (+4.2%) and Communication Services (+2.7%).
- Most resources-related stocks rose; Whitehaven Coal (+14.3%) and Beach Energy (+10.3%) were among outperformers as energy prices rose.
- Materials stocks were boosted by Northern Star Resources (+20.0%) after the company announced the acquisition of the Pogo Underground Gold Mine in Alaska, partially funded by a capital raising. The issue was heavily oversubscribed, indicating the market's strong approval of the acquisition.
- Health Care stocks (-7.7%) struggled, driven by sector heavyweights CSL (-11.0%) and Cochlear (-6.3%) and the announcement of a royal commission into the aged care sector. Investors appeared to focus on CSL's and Cochlear's high price-to-earnings ratios and whether elevated valuations were justified.
- Small caps outperformed their large cap counterparts, but nonetheless lost ground (-0.3%). The Small Cap Health Care sector (+3.6%) performed well, driven by gains in Mesoblast (+31.1%) and Pro Medicus (+22.7%).
- Small Financials (-3.1%) underperformed, with insurance and brokerage companies caught up in the negative sentiment associated with the royal commission into banking behaviour and the potential for increased regulation into the future.

Listed property

- A-REITs had a weak month in September, returning -1.8%. Diversified A-REITs (+0.2%) was the best performing sub-sector, while Industrial A-REITs (-3.2%) was the weakest.
- Outperformers included Growthpoint Properties (+4.0%) and Investa Office Fund (+3.6%). While Growthpoint did not release any material news, it benefitted from recent M&A activity among peers. Canada's Oxford Properties is in a bidding duel with Blackstone for Investa Office Fund (IOF). The IOF Board is allowing Oxford Properties to begin due diligence on a potential takeover.
- The weakest performers were Scentre Group (-3.4%) and Vicinity Centres (-5.4%). Scentre Group was one of only two REITs whose June 2018 results were viewed as "credit negative" by credit ratings agency Moody's.
- Many overseas property markets struggled too. The FTSE EPRA/NAREIT Developed Index returned -2.0% in USD terms. In local currency terms, Japan (+3.3%) was the best performing market, while the UK (-2.5%) was the worst.

Global equities

- Global equity markets recovered from being more than -1% down on a deteriorating trade outlook at the start of the month, to end September in positive territory with the MSCI World Index up 0.6% in AUD terms.
- Solid economic data in the US and more measured tariff increases than initially feared helped both the S&P 500 and the MSCI World (in both local currency and AUD terms) out of the red and to establish all-time highs later in the month.
- The strongest performer, however, was the Nikkei 1000, which returned 4.7% in Japanese Yen. The improved trade outlook helped, as did Abe's re-election as leader of the ruling LDP party. This effectively gave Abe another three years as Prime Minister and the chance to become Japan's longest serving premier.
- Among major developed markets, Australia was among the weakest performers.
- Emerging market equities bounced back from being down as much as -3.5% mid-way through September, but not quite enough to get back into the black. The MSCI Emerging Markets Index ended the month down -0.5% in AUD terms.
- Having been the strongest performing region last month, the MSCI EM Asia Index sold off in September, down -1.7% in AUD.
- MSCI India was down -7.1% in local currency terms (and -9.1% in AUD) as a number of its financial stocks sold off heavily on concerns about further defaults in the sector and the Reserve Bank of India's order for Yes Bank's CEO to resign after finding that the bank had under-reported its bad loans.

Global and Australian Fixed Interest

- Bond market investors appeared to refocus on economic drivers, after emerging market risks had dominated attention in August.
- Global markets once again took a lead from the US, where the yield on 10-year Treasuries rose 20 basis points to 3.06%. The Fed Funds rate was increased by 0.25 percentage points to between 2.00% and 2.25%, as anticipated.
- More importantly, investors appeared to reassess their longer-term expectations for US monetary policy.
- There is some evidence that tightness in the labour market is being seen in wage growth, which is now running at a pace above Headline inflation; a trend the Federal Reserve will be watching.
- Government bond yields rose in other major markets, too.
- 10-year yields closed the month 15bps and 14bps higher in the UK and Germany respectively, for example, and by a more modest 2bps in Japan. As well as the upward move in US Treasury yields, there was optimism that UK and European lawmakers were making some progress in Brexit negotiations. Final details of the UK's proposed withdrawal from the European Union are yet to be finalised, but investors were reassured that both parties appear willing to negotiate.

Global credit

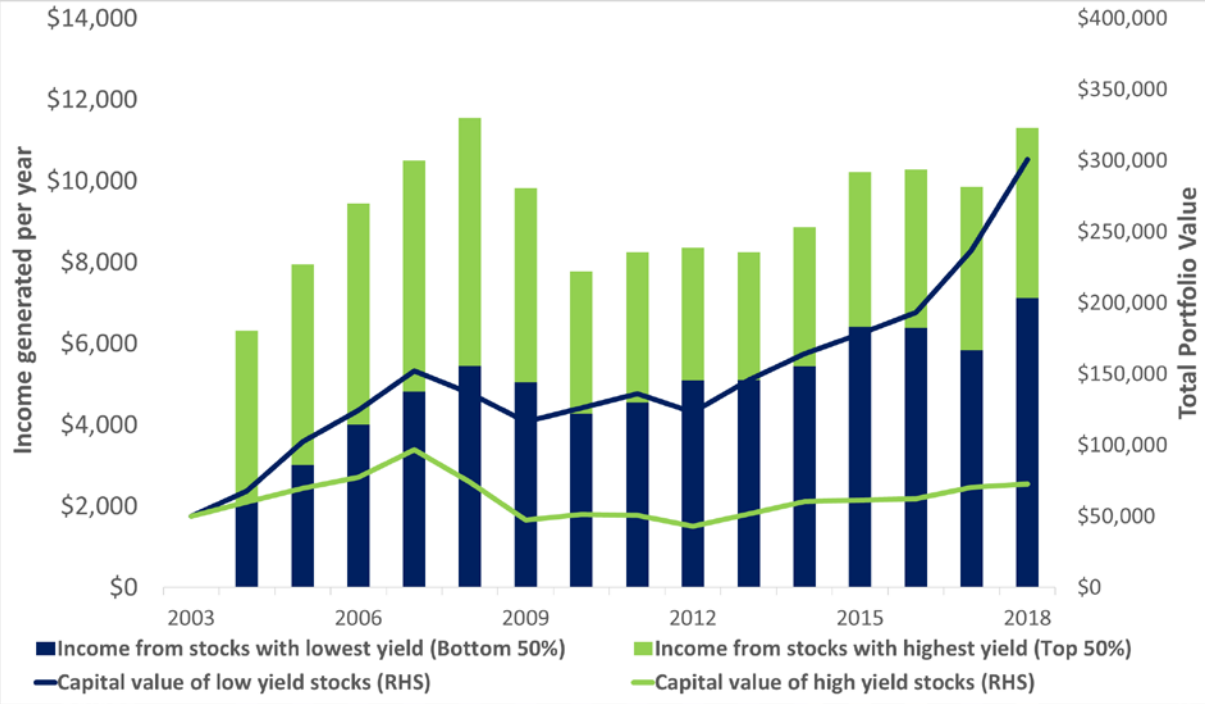
- Credit markets were supported by the general improvement in economic indicators and a healthy risk appetite among investors.
- Issuance increased as anticipated following the seasonal lull during the summer holiday season in the northern hemisphere. Encouragingly, this increased supply was met with solid demand and did not result in any spread widening.
- In fact, credit spreads narrowed in both the investment grade and high yield sectors. Energy-related sectors were among the best performers, buoyed by the rising oil price. It will be interesting to see how issuers in sectors are affected by persistently higher energy prices, specifically whether they are able to pass higher costs on to customers through higher prices, or whether they will be forced to accept narrower margins.

Chart of the Month – Yield and income – same, same, but different

In these bulletins, we aim to share interesting observations from global investment markets. This month we look at the relative merits of targeting income versus yield in an equities strategy. While many investors might understandably believe they are the same, pursuing one over the other can deliver surprisingly divergent and apparently counterintuitive results.

In recent years, expected returns and income from traditional income asset classes have been low following years of global yield compression. As a result, investors have increasingly looked towards growth assets, like equities, to meet their income requirements. The standard strategy has been to target an equities mix that tilts towards higher yielding investments to match the desired portfolio yield target. This simple approach is often adopted because the terms yield and income are habitually used interchangeably when describing investment strategies - yet there are important differences!

In the chart below, we have split the attractive long-term income stream generated from Australian shares into two groups depending on their grossed-up dividend yield at 30 June 2003. We then look at the level of dollar income (the absolute level of income delivered in dollar terms) generated across the two groups since then. The green bars show the dollar income generated from stocks with the highest yields (top 50% of stocks), while the blue bars show the dollar income generated from the bottom 50% of stocks.



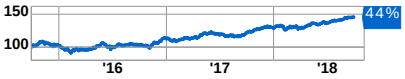
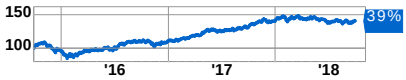
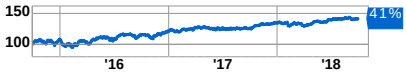
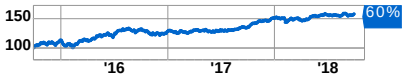
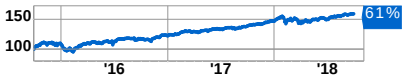
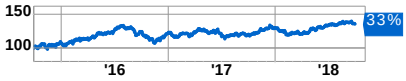
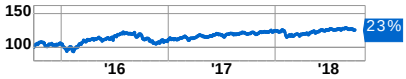
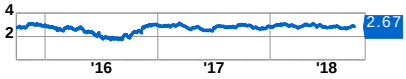
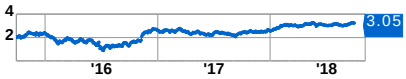
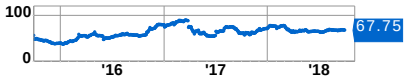
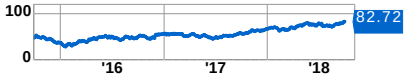
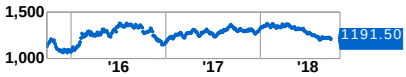
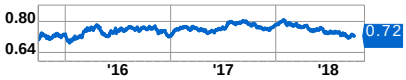
Source: Colonial First State Global Asset Management, FactSet.
Income and capital over 15 years calculated assuming a total investment of $100,000 equally weighted across all index constituents of the S&P/ASX 100 index as at 30 June 2003 that have the required 15 year price and dividend history (57 stocks). Data to 30 June 2018.

Interestingly, investors that targeted above-average yield stocks would actually have been worse off from a dollar income received perspective over the long term, even after accounting for the benefit of franking credits. Those with a keen eye might have observed that the high yield cohort produced higher levels of income in the first few years of the investment. That's true, and it's understandable that some investors prioritise this given the immediacy of their income needs. But the investment challenge for most investors is longer term in nature, including the generation of income over potentially long time periods in retirement.

What has produced this counterintuitive outcome? As the blue line in the chart shows, the lower yielding cohort collectively rewarded shareholders with a much higher level of capital growth. The lower yielding stocks' delivery of greater long-term dividend income was not attributable to their dividend policy or yield, but rather their significantly higher total return, comprised of both dividend income and capital growth. Importantly, when it comes to income generation from shares, each year's capital return provides the base upon which the following year's income return is generated. This is the key to long-term dividend income growth. In short, strong total returns drive attractive income from equities over time. As noted by Rudi Minbatiwala, CFSGAM's Head of Equity Income, "Maximising income and after-tax total returns from equities over the long term requires investors to consider ***yield and growth together***, rather than focusing on yield alone."

Stock examples might help to reinforce this message. Had an investor bought $100,000 worth of 'high yield' Telstra shares in June 2003 they would have received $136,201 in dividend income (including franking credits) over the following 15 years to June 2018. If instead they had purchased $100,000 worth of 'low yield' CSL shares in June 2003, the investor would have received $333,312 in dividend income. Why? Because CSL's capital return has been 27.45%pa versus Telstra's meagre -3.19%pa – helping to build a much larger base over time from which a lower yield can still derive a superior level of dollar income.

Does all this imply that the dividend yield concept is flawed? Certainly not. Dividend yield is designed to be a valuation metric that should be used in combination with other valuation metrics. The concern is that investors instinctively rely just on dividend yield as a proxy for future cash flow generation, despite the fact that it is the interaction of both income and growth that drives income from equities over time.

		1 Month Return/Chang	3 Month Return/Chang	12 Month Return/Chang	3 Year Annualised	3 Year Chart
EQUITIES						
MSCI World (Gross of witholding tax, in AUD)	3,380.52	0.55%	7.32%	21.29%	13.05%	
MSCI Emerging Markets (AUD)	1,045.66	-0.55%	1.15%	7.97%	11.65%	
ASX 200	6,207.60	-1.26%	1.53%	13.97%	12.11%	
ASX Small Ordinaries	2,863.40	-0.35%	1.10%	20.32%	16.97%	
S&P 500 (USD)	2,913.98	0.57%	7.71%	17.91%	17.31%	
REITs						
ASX 200 A-REIT	1,427.40	-1.77%	1.86%	13.20%	9.97%	
FTSE EPRA/NAREIT Developed (USD)	2,071.78	-1.86%	0.37%	6.48%	5.75%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.50%	0.00%	0.00%	0.00%	-	
10-year yield Australia	2.67%	+0.15%	+0.03%	-0.17%	-	
10-year yield US	3.05%	+0.20%	+0.20%	+0.75%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	67.75	0.70%	4.37%	11.56%	6.27%	
Brent crude oil (USD/barrel)	82.72	6.85%	4.13%	43.76%	19.59%	
Gold (USD/ounce)	1191.50	-0.73%	-4.78%	-7.02%	2.22%	
AUD/USD	0.724	0.05%	-2.07%	-7.79%	1.00%	

Source: FactSet, as at 31 September 2018

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