Market Watch

First Sentier Investors

Interest rates cut again in Australia and the US

End-October 2019

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Economics overview

- **US**: The Federal Funds rate was lowered for the third time in as many months, as US officials responded to deteriorating economic indicators. The 0.25% cut had been widely anticipated by investors.
- The latest US manufacturing data was dismal, missing all expectations and falling to a three-year low. The downturn has been blamed on the trade conflict with China.
- Durable goods orders declined slightly more than expected in September. With global growth indicators deteriorating, it appears that non-essential business investment is being delayed or cancelled.
- Worryingly, weakness in the manufacturing sector appears to be spreading to services sectors. The latest gauge suggested activity levels declined to a three-year low during September.
- All that said, the slowdown in the overall economy was less bad than feared. US GDP rose at an annual pace of 1.9% in the September quarter, above consensus expectations.
- September employment numbers were slightly below expectations, but data for the prior month were revised higher. This resulted in the official unemployment rate falling to 3.5%, the lowest level in more than 50 years.
- US consumer sentiment rebounded a little from recent weakness, possibly on the back of interest rate cuts this year. The latest survey indicated that nearly 30 percent of Americans see their income outpacing inflation in the next 1-2 years – the highest number since records began in the late 1970s.
- Following three consecutive months of modest increases, US inflation was unchanged in September. Importantly, inflation is below the Federal Reserve's target, suggesting policymakers have room to lower interest rates again, if required.

- **Australia**: Australian interest rates were also lowered by 0.25%, taking the official cash rate to 0.75%. Most observers expect borrowing costs to be lowered further in the next few months.
- Officials confirmed they are "prepared to ease monetary policy further if needed" following three recent interest rate cuts. Like in the US, inflation is below target, providing policymakers with headroom to lower borrowing costs, if required.
- The latest reading of Australian consumer confidence fell unexpectedly sharply. This was a little surprising given generally buoyant labour market conditions and declining mortgage costs.
- Nearly 15,000 new jobs were created in Australia in September and the reading for August was also revised higher. As a result, the official unemployment rate ticked back down to 5.2%, from 5.3% previously.
- There has also been further evidence of an improvement in the Australian housing market. The latest survey suggested prices added 1.4% in October; the third consecutive month where prices rose by more than 1%.

- **New Zealand:** The value of exports was higher than expected in September, which supported New Zealand's trade balance. Imports were little changed from the prior month.
- Consumer confidence rebounded from very subdued levels – September's reading was the worst in more than four years.
- The RBNZ did not meet and interest rates were unchanged.

- **Europe**: Consumer confidence in Europe has deteriorated to its lowest level this year. This will likely be a concern to policymakers hoping that domestic demand will help offset sluggish export orders.
- The survey of economic expectations in Germany was less bad than had been anticipated, but still below zero (indicating expectations of economic contraction) for a sixth consecutive month.
- Germany's trade surplus fell sharply in August, primarily reflecting lower exports. Demand for European goods from China, for example, has fallen this year. While manufacturing and trade-related sectors are struggling, services sectors and construction appear to be faring relatively well.
- In the UK, the Brexit process was delayed yet again. European leaders agreed to a further three-month delay in the UK's proposed withdrawal from the European Union, extending the deadline to 31 January 2020.
- Subsequently, Members of Parliament voted to hold a general election in the UK on 12 December, effectively placing the fate of Brexit in the hands of the British public.

- **Asia/EM:** Two major surveys painted different pictures of conditions in the Chinese manufacturing sector. One suggested conditions have deteriorated even more significantly than had been feared. The other showed the strongest improvement for two and a half years and pointed towards higher production and new orders as export demand improved.
- Releases of factory production data will therefore continue to be closely scrutinised, to gauge how the ongoing trade conflict with the US is affecting manufacturing activity.
- Encouragingly, conditions remain reasonably buoyant in the Chinese services sector. This is important for the overall economic growth outlook.
- At 6.0%, the Chinese economy has slowed to its lowest rate of annual growth for around 30 years. The ongoing trade conflict with the US has had a particularly damaging effect on exporters and has hampered manufacturing activity.
- With that in mind, it was encouraging that reports indicated China was prepared to buy at least US$20 billion of US agricultural products next year, which prompted US authorities to suggest that potential import tariffs on some Chinese goods scheduled for December might be withdrawn.
- Export demand remains subdued in Japan too. The latest reading, for the month of September, confirmed that exports were running 5.2% below 2018 levels. Again, this is an important headwind for growth in the Asia Pacific region.

Australian dollar

- The Australian dollar appreciated to a three-month high against the US dollar, reflecting optimism that a trade deal between the US and China might be close to being agreed.
- The local currency added 2.1% against the US dollar, closing the month at 68.9 US cents.
- The 'Aussie' appreciated on other exchanges too, adding 1.4% against a trade-weighted basket of international currencies.

Commodities

- Commodity prices were mostly higher during October, amid easing trade tensions between the US and China.
- Most industrial metals posted gains, including zinc (+8.1%), aluminium (+2.9%), copper (+2.5%) and lead (+2.2%).
- Nickel (-6.2%) was a notable exception, falling amid policy uncertainty around Indonesia's proposed nickel ore export ban.
- Iron ore (-10.5%) fell sharply, primarily on an improving supply outlook. Brazilian mining giant Vale continued to bring production back online following severe supply disruptions earlier in the year.
- Precious metals were mostly higher, including gold (+0.5%), silver (+3.1%) and platinum (+5.0%).
- Oil (Brent +2.8%) finished higher, as progress appeared to be made towards a resolution of the US/China trade war.

Australian equities

- The Australian share market started October with its worst weekly return in nearly a year.
- Reinvigorated fears of a weakening global economy, disappointing manufacturing data and ongoing Brexit uncertainty weighed on the index. The market since recovered, as Australian shares followed global peers higher following some reasonably solid corporate earnings numbers in the US.
- In the month as a whole, the S&P/ASX 100 Accumulation Index declined -0.4%.
- The 'risk-off' theme for much of the month saw defensive sectors, such as Health Care, Real Estate and Utilities, outperform.
- Health Care (+7.7%) benefited from the rally in sector heavyweight CSL, after the company reaffirmed its earnings guidance for FY20. Demand for blood plasma and recombinant products appears to remain strong.
- Sydney Airport helped drive a positive return from the Industrials sector (+3.4%) as a Productivity Commission report found that airports have not abused their market power and that the fees charged are within reasonable boundaries.
- At the other end of the spectrum was the Information Technology sector, which fell over -6%. A research report pushed WiseTech Global nearly -25% lower. It was alleged that the company had overstated profits, its organic growth and the performance of its European business. The firm provided a rebuttal to the report, which later helped alleviate investor concerns.
- Small companies (-0.5%) once again underperformed their large cap peers, extending their underperformance to -2.9% in 2019 to date.
- The S&P/ASX Small Ordinaries Accumulation Index was dragged lower by the drastic decline in Southern Cross Media (-33.6%) following a quarterly update that showed revenues had slumped -8.5%.

Listed property

- Global listed property was up modestly in October. The FTSE EPRA/NAREIT Developed Index returned 0.4% in AUD terms, performing in line with the broader global equity market.
- The UK was the best performing property market (+5.0%) for the second consecutive month as the perceived likelihood of a 'no deal' Brexit continued to wane.
- In Australia, AREITs returned 1.2% for the month, with the Diversified (+1.9%) and Industrial (+1.5%) sub-sectors leading the charge.
- Notable outperforming AREITs included Stockland (+7.5%) and Mirvac (+4.9%), both of which released their September quarter operational updates during the month.

Global equities

- Global equities maintained their upward momentum from September. Investors were heartened by the announcement of a "limited trade deal" between the US and China earlier in the month and a reasonably solid corporate earnings reporting season in the US.
- Together, these positive influences powered the S&P 500 Index in the US to new all-time highs.
- The MSCI World Index jumped 1.9% in local currency terms in October, also to a new high, although Australian dollar strength reduced the equivalent returns to just 0.4% for Australian-based investors.
- The Japanese Nikkei jumped over 5.0% in local currency terms and was the strongest market for a second consecutive month. This is the strongest two months for Japanese equities since late 2016. The weakness of the Japanese yen is supporting sentiment towards Japanese exporters.
- UK shares struggled with the ongoing Brexit shenanigans. Having been down as much as -4.4% in local currency terms, the FTSE recovered to be down just -1.9% by month-end as the probability of a 'hard Brexit' dissipated.
- The improved trade outlook helped emerging markets to outperform developed markets for the first time since January.
- The MSCI Emerging Markets Index rose 2.0% in AUD terms, led by particularly strong returns from Russian stocks.
- From a style perspective, value stocks went into the red again in October having enjoyed a relatively strong month in September. At the same time, growth stocks added value, registering their tenth month of outperformance relative to value stocks in the last 12. The recent rotation into value stocks appears to have been short-lived.

Global and Australian Fixed Income

- Government bond yields rose for a second consecutive month, resulting in negative returns from most fixed income markets.
- While economic data remained reasonably downbeat, hopes of a possible partial resolution to the US/China trade standoff saw yields edge higher.
- Bond market participants appear to be thinking that we have likely already seen most of the likely interest rate cuts worldwide and that further moves could be some time away.
- In the US, 10-year Treasury yields closed the month just 3 bps higher, at 1.69%, but there were larger moves elsewhere.
- Yields rose 16 bps and 14 bps in Germany and the UK respectively, for example, and by 8 bps in Japan.
- Ten-year Australian government bond yields closed October 12 bps higher, at 1.14%, despite the Reserve Bank of Australia's interest rate cut at the beginning of the month.

Global credit

- Corporate bonds eked out modest gains in October, partly reflecting ongoing strong inflows into the asset class and a limited amount of new issuance.
- In 2019 to date, we have seen US$246 billion of new money flow into the investment grade sector and a further US$23 billion into the high yield market. Spreads have narrowed against this background, resulting in favourable performance from credit.
- Overall, investors seemed comfortable with September quarter earnings reported by US firms. Around two-thirds of listed companies released their results during October. A modest deterioration in overall earnings was expected, but the declines were no worse than anticipated.
- Manufacturing-related businesses continue to face headwinds. Encouragingly, however, demand among US consumers for goods and services appears to remain intact.

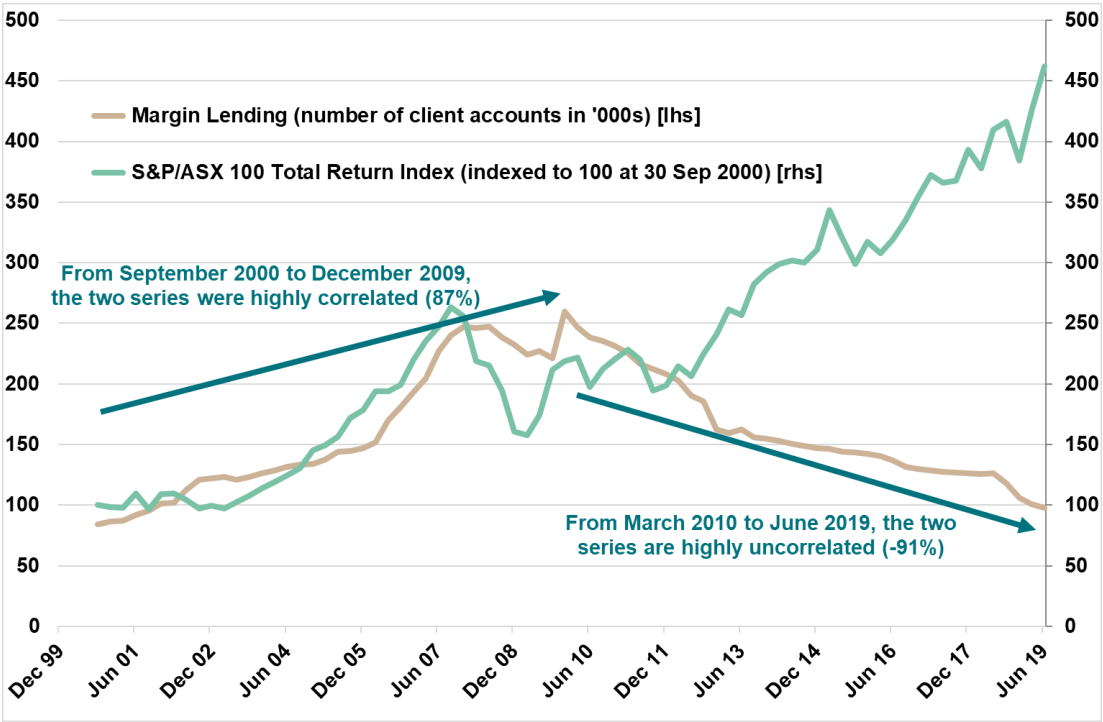
Chart of the Month – Margin lending… clients are leaving, in spite of a rising market

In these bulletins, we aim to share interesting observations from global investment markets. This month we highlight the dramatic decline in the number of client accounts engaged in margin lending.

Margin lending was a popular way to gain leveraged exposure to equities in the early 2000s. As the chart shows, the number of margin loan accounts rose with the market pre-GFC and then through 2009.

Since then, a consistent decline in account numbers has occurred, even as the share market moved higher. The rate of decline accelerated in 2018/19, possibly a response to Labor's plan to limit negative gearing, potentially stopping the offset of investment losses against salaries. Given the series is quarterly, any bounce post the Coalition victory may be masked by losses in April/May.

The deteriorating relationship between margin lending popularity and share market performance



Source: RBA quarterly study and Bloomberg/S&P/ASX

Assuming an investor is comfortable with the higher risk/return profile of a leveraged exposure to the share market (a topic we address in an upcoming white paper), there are other ways to gain such exposure without the day-to-day margin/loan management issues, higher interest costs and tax policy uncertainty associated with gearing through margin loans.

Geared share funds can provide leveraged exposure to both market returns and franking credits (up to almost 60%) and pass on scale economies so that interest costs may be around a third of those associated with margin loans[1].

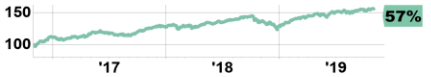
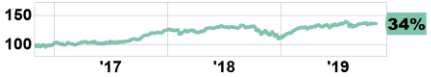
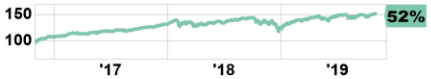
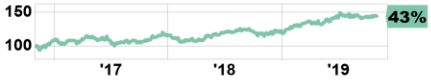
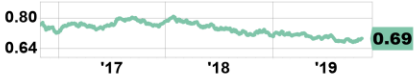
By also drawing on the resources of a professional equities team, who manage both the share portfolio and the margin calls/loan repayments, investors can still enjoy potentially high mid-teen returns over the long term[2], without having to deal with the numerous margin calls during down markets. With geared share funds, there is typically no recourse to the unit-holders as such obligations are met within the fund.

Furthermore, super funds (including SMSFs) ***can invest*** in geared share funds, whereas margin lending is prohibited owing to borrowing restrictions.

[1] The Colonial First State Wholesale Geared Share Fund borrowing costs are the Three Month Bank Bill Swap Rate (BBSW) plus 1% to 1.2% - so currently ~2%, versus the average of the cheapest 10 margin loans in the Canstar survey of 6.1% (amounts of $100,000). Source: https://www.canstar.com.au/margin-loans 30/10/19

[2] First Sentier Investors manages the Colonial First State Wholesale Geared Share Fund, which returned 14.7%pa (net of fees) from Aug 1997 (inception) to Sep 2019. Past performance is no indicator of future performance.

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)	3,630.78	0.41%	2.76%	16.61%	16.28%	
MSCI Emerging Markets (AUD)	1,091.97	2.03%	1.15%	15.52%	11.39%	
ASX 200	6,663.40	-0.35%	-0.91%	19.28%	12.56%	
ASX Small Ordinaries	2,875.10	-0.50%	-1.84%	14.41%	10.38%	
S&P 500 (USD)	3,037.56	2.17%	2.43%	14.33%	14.91%	
REITs						
ASX 200 A-REIT	1,629.80	1.24%	-0.36%	23.56%	12.67%	
FTSE EPRA/NAREIT Developed (AUD)	3,921.28	0.37%	7.14%	24.94%	13.31%	
CASH and FIXED INCOME						
Official Cash Rate Australia	0.75%	-0.25%	-0.25%	-0.75%	-	
10-year yield Australia	1.14%	+0.12%	-0.05%	-1.49%	-	
10-year yield US	1.69%	+0.03%	-0.32%	-1.45%	-	
CURRENCIES						
AUD/USD	0.689	2.15%	-0.04%	-2.79%	-3.26%	

Source: Factset and Bloomberg, at 31 October 2019