Market Watch

First Sentier Investors

"No guts, no sense, no vision…"

End-September 2019

For adviser use only

Economics overview

- **US**: The words above were used to describe Federal Reserve Chair, Jerome Powell, after he announced a quarter percentage point cut to US interest rates. Who would use such derogatory language about a senior official? In fact, it was US President Trump; describing the man he appointed.
- Trump was unhappy interest rates were not lowered more significantly. With the next Presidential Election little over a year away, Trump is keen to keep the US economy as buoyant as possible as he seeks re-election. After "Making America Great Again" since being elected, he will seek to "Keep America Great" in a second term.
- Indicators regarding the strength of the US economy have been mixed recently. The latest survey showed conditions have deteriorated markedly for manufacturers, for example. The ongoing trade dispute with China appears to be eroding confidence among US firms, affecting their investment plans.
- More encouragingly, the ISM non-manufacturing index came in well above consensus expectations, suggesting conditions are more resilient in the services sector.
- Consumer spending in the US is being supported by rising employment and solid earnings growth. Wages are rising at more than 3% a year, well above the pace in Australia.
- Despite the strong demand for goods and services, inflation remains slightly below target. This suggests policy makers will be able to lower interest rates again, if required.

- **Australia**: Interest rates were unchanged at the RBA's meeting in September. As anticipated, they were subsequently lowered by 0.25 percentage points on 1 October, to 0.75%.
- According to policymakers, easier monetary policy settings are required to support employment and income growth and, in turn, help drive inflation back up towards the 2% to 3% target band.
- Despite solid employment growth in this cycle, the local economy still has spare capacity and the RBA believes lower borrowing costs will help make inroads into that.
- Officials believe the unprecedented low level of interest rates, tax cuts following the recent Federal Election, ongoing infrastructure spending, signs of stabilisation in the Sydney and Melbourne housing markets and a brighter outlook for the resources sector will help support the growth outlook.
- Subdued consumer spending appears to be the main risk to the economic outlook. With subdued wage growth, households are seeing only modest increases in disposable income, even given lower mortgage servicing costs.
- Employment trends have been encouragingly strong, although the official unemployment rate has remained steady at around 5¼ per cent in recent months, as increased demand for labour has been met by more supply.

- **New Zealand:** Credit card spending data rebounded following the greater-than-expected interest rate cut in August. These early indications suggest the policy shift could be having its desired effect on consumer spending.
- Less encouragingly, exports declined to their lowest level for a year. Foreign demand for dairy products remains a key driver of the New Zealand economy.

- **Europe**: Investors were primarily focused on the European Central Bank's meeting in mid-month. As anticipated, officials announced a monetary stimulus package designed to stimulate activity levels in the Eurozone economy. The Bank will recommence asset purchases at a rate of 20 billion euros per month, which will inject liquidity into the financial system and should, in turn, promote lending and activity levels.
- Business sentiment in the Eurozone has fallen to its lowest level in six years, dragged down by ongoing uncertainty over how Brexit will affect European firms. Slower growth in China is also affecting demand for European exports, including cars and other manufactured goods.
- The closely watched survey of economic expectations in Germany improved, but remained negative. This suggests growth in Europe's largest economy could be slightly negative in Q3 and Q4, following a small contraction in Q2.
- In the UK, the ongoing Brexit debacle continued to dominate attention. Prime Minister Johnson's 'prorogation' of Parliament in August was deemed to have been unlawful, prompting renewed calls for his resignation. He refused of course, instead offering a general election. Johnson is seeking a larger majority, which may enable him to press ahead with his Brexit proposals.
- The opposition Labour Party refused the election request and so the Brexit stalemate went on…
- Theoretically, the UK is due to withdraw from the European Union within the next month. However, with MPs unable to agree on the best way forward, a further extension of the process appears possible. The Brexit can could be kicked down the road for a few more months yet, increasing the probability of recession in both the UK and Continental Europe.

- **Asia/EM:** The month got off to a promising start, with Chinese manufacturing data for August coming in ahead of expectations. The 50.4 reading was ahead of consensus forecasts and, importantly, was above the 50 level indicating expansion rather than contraction. Services data was also stronger than expected, resulting in a rebound in the Composite PMI reading.
- The reading was somewhat inconsistent with subdued export data. The effects of higher tariffs on goods exported to the US are affecting trade volumes and, in turn, factory output.
- Retail sales growth data were also below expectations. This was a little concerning - with export volumes tailing off, it is important that domestic demand remains firm.
- Like in other regions, Chinese authorities have been easing monetary policy settings in an attempt to support activity levels. The Loan Prime Rate – the key benchmark for lending to businesses and households – was reduced in September.
- In Japan, retail sales data rebounded more than expected but other leading indicators were little changed over the month.

Australian dollar

- The 'Aussie' strengthened against the US dollar, though not by a significant amount. At month end, one Australian dollar bought 67.5 US cents.
- The Australian dollar also strengthened against a trade-weighted basket of international currencies, performing particularly well against the Japanese yen.

Commodities

- After posting strong gains in recent months, Gold (-1.5%) finished lower, as US 10-year real yields rose during the month.
- Oil (Brent +1.4%) rose following disruption to Saudi Arabia's oil infrastructure. Saudi Arabia restored oil production capability faster than expected, however, tempering price gains.
- Iron ore (+2.2%) tracked higher on restocking demand in China, and optimism demand may remain strong during October.
- Industrial metals, including copper (+0.6%), lead (+1.4%) and zinc (+4.0%), finished mostly higher on easing US/China trade tensions.

Australian equities

- The increasing likelihood of interest rate cuts in Australia was sufficient to propel the S&P/ASX 100 Accumulation Index (+1.8%) into positive territory. The change in interest rate expectations occurred on the back of comments in the minutes of the RBA's latest meeting and mixed employment data.
- Constituents of the Energy sector (+4.9%) benefited from a recovery in oil and gas prices following the disruptions to Saudi Arabia's energy production capabilities.
- Financials (+4.0%) also performed admirably. The 'Big Four' banks provided support and offset weakness in CYBG (-18.4%).
- Underperformance from Telstra (-5.6%) weighed on the Communication Services sector (-3.9%). Telstra's guidance came under scrutiny as NBN Co's updated Corporate Plan guided to lower activation volumes in FY20.
- Both the Real Estate (-2.5%) and Health Care (-2.4%) sectors experienced a reversal of August's strength.
- Investors' 'risk-on' sentiment saw an increase in Australian bond yields during the month and a corresponding decline in equity substitutes.
- Small companies (+2.6%) outperformed their large cap counterparts throughout the month, albeit only modestly, while Australian 'value' stocks recovered from weakness in August and closed the gap on Australian 'growth' stocks in September.

Listed property

- Global listed property securities continued their strong year-to-date run and posted solid gains in September.
- The FTSE EPRA/NAREIT Developed Index rose 2.5% in USD terms and 2.4% in AUD terms, marginally outperforming the broader global equity market.
- The UK was the best performing listed property market (+6.9%), buoyed by the diminished likelihood of a 'no-deal' Brexit following numerous setbacks to Prime Minister Boris Johnson's agenda.
- Australia was the worst performing developed market (-2.7%).
- In Australia, Retail A-REITs outperformed for a second consecutive month (-1.3%), while Office A-REITs were the worst performing sub-sector (-5.8%).
- The strongest performers in Australia included Unibail-Rodamco-Westfield (+6.0%) and Cromwell Property Group (+4.8%). Both stocks rallied following the announcement of their latest results.

Global equities

- Global equities bounced back in September as investor risk appetite returned.
- There were easing fears of further deterioration in the trade spat between the US and China and greater monetary stimulus in key regions – policy settings were eased in China, Europe and the US.
- The MSCI World Index jumped 2.4% in local currency terms, but an appreciating AUD pegged back the equivalent returns to 2.1% for Australian-based investors.
- Japan was the strongest performing market, with the Nikkei surging more than 5.0% in local currency terms; the yen sold off along with other 'safe-haven' assets. This helped boost the shares of Japanese exporters including carmakers and large electronics companies including Sony and Sharp.
- At the other end of the scale, Australian shares were among the laggards in developed markets.
- US stocks also underperformed, partly due to uncertainty around a possible impeachment of the President.
- The US S&P 500 Index returned 1.8% in local currency terms. This brought up the strongest nine-months to end September since 1997 and leaves the S&P 500 Index just 1.3% away from its all-time high.
- Emerging markets continued to drift away from their developed counterparts, underperforming them for an eighth straight month. The MSCI Emerging Markets Index rose 1.8% in AUD terms.
- The MSCI World Value Index has also lagged over 2019, though bounced back in September returning 3.9% in AUD terms versus a meagre 0.4% return from the Growth equivalent.
- This was the first time value stocks had outperformed growth stocks globally since November last year as investors rotated out of the winners in 2019-to-date – defensive and growth stocks – and into relatively unloved value stocks.

Global and Australian Fixed Income

- Major government bond markets generated negative returns in September, following several months of strong gains.
- Benchmark 10-year yields in the US, Europe and Australia all rose by between 10 and 20 basis points, although increases were more modest in Japan and the UK.
- Despite the increases, bond yields remained negative in many parts of the world (please refer to our *Chart of the Month* overleaf for details).
- While US interest rates were lowered during the month, a breakdown of Federal Reserve Board Member votes indicated some resistance to lower rates. Market expectations still suggest the next move in the Federal Funds rate will be downwards, but possibly not until 2020. This appeared to provide some support to Treasury yields and, in turn, those in other countries.
- In Australia, semi government spreads widened a little, resulting in negative returns from State Government bonds.

Global credit

- September saw a very large amount of new corporate bond issuance. In a two-week period alone, more than US$100 billion of new paper was issued, making it the biggest fortnight of new issuance ever.
- With Treasury yields so low and with credit spreads tightening, corporates are being incentivised to raise capital with historically low borrowing costs.
- Investment grade spreads continued to move lower, by 5bps during the month. In spite of the increasingly uncertain economic background, corporate profitability remains in reasonably good shape and default risk remains relatively low. The increased yields on offer in corporate bond markets are therefore proving appealing for investors in search of income.
- High Yield credit has performed well against this background and again outperformed the Investment Grade sector in September. High Yield spreads closed the month 20bps lower, at 3.13%.
- At 0.66%, Australian credit spreads were little changed over the month.

Chart of the Month – The negative bond yield plague

In these bulletins, we aim to share interesting observations from global investment markets. This month we highlight a table rather than a chart, showing current government bond yields in major fixed income markets around the world.

For much of this year, financial markets have focused on **negative bond yields**. To understand how this phenomenon has arisen and what it means for investors, it is perhaps worth revisiting '*Bond 1.01'* for a refresher on how fixed income securities work.

Effectively bond buyers are lending money to issuers, for a predetermined period. Bondholders receive predetermined interest – or *coupons* – at regular intervals, essentially earning income in return for lending the money. A 5-year, 1.5% coupon bond issued at $1,000, for example, will provide investors with income of $15 per year for five years until the bond matures and the $1,000 is repaid. It's a bit like putting your money in a savings account with a bank – by leaving it there, the bank will make regular interest payments, gradually increasing the size of your deposit over time.

Would you still put your money in the bank if the interest payments were negative? You'd effectively be paying the bank for it to look after your money… that doesn't sound so appealing.

With that in mind, *how can bond yields ever be negative?*

Like shares, bonds are actively traded on the open market. A bond issued at $1,000 can trade above or below the par value – the market price fluctuates over time, depending on a wide range of variables. The concept of negative yields arises when investors buy bonds for more than their issue price on the secondary market. As the price 'pulls to par' at maturity, there is a small capital loss for investors that have bought the bond above the issue price. If this is greater than the remaining coupon income prior to maturity, the bond has a negative overall yield. It's possible investors are not behaving rationally; we might look back at this period as a fixed income 'bubble' in hindsight. In any case, paying a government or a corporate for the privilege of lending them money is a bizarre market environment, at best.

As the table shows, there is now an enormous stock of negative yielding government bonds globally. In fact, almost all bonds issued by governments in Europe and Japan currently have negative yields. According to Bloomberg, the value of these outstanding bonds is now more than US$17 trillion. Traditional holders of bonds – retirees, for example – are effectively being starved of income. In some cases, they are being forced up the risk spectrum into more risky investment types in search of yield. This helps explain why asset classes such as equities and credit have performed so well this year, even though fundamental indicators have mostly been deteriorating.

	Official	Current Government Bond Yields								
	interest rate	6mth	1yr	2yr	3yr	5yr	7yr	10yr	15yr	30yr
Switzerland	-0.75%	-	-0.89%	-0.91%	-0.92%	-0.91%	-0.85%	-0.79%	-0.59%	-0.39%
Denmark	-0.75%	-0.80%	-0.84%	-0.82%	-	-0.75%	-	-0.55%	-	-
Sweden	-0.25%	-0.51%	-	-0.60%	-	-0.61%	-	-0.27%	-0.12%	-
Japan	-0.10%	-0.29%	-0.31%	-0.32%	-0.38%	-0.36%	-0.36%	-0.22%	0.01%	0.36%
Germany	0.00%	-0.68%	-0.70%	-0.77%	-0.82%	-0.78%	-0.74%	-0.57%	-0.45%	-0.07%
Netherlands	0.00%	-0.68%	-	-0.77%	-0.81%	-0.70%	-0.61%	-0.43%	-0.33%	-0.09%
France	0.00%	-0.64%	-0.63%	-0.70%	-0.73%	-0.64%	-0.50%	-0.27%	0.00%	0.54%
Finland	0.00%	-	-0.65%	-0.71%	-0.71%	-0.66%	-0.52%	-0.31%	-0.13%	0.15%
Austria	0.00%	-	-0.63%	-0.71%	-0.70%	-0.60%	-0.49%	-0.33%	-0.09%	0.24%
Belgium	0.00%	-0.62%	-0.64%	-0.69%	-0.70%	-0.56%	-0.47%	-0.26%	-0.02%	0.54%
Ireland	0.00%	-	-0.55%	-	-0.55%	-0.48%	-0.29%	-0.04%	0.24%	0.77%
Spain	0.00%	-0.52%	-0.51%	-0.52%	-0.47%	-0.30%	-0.08%	0.15%	0.57%	1.04%
Portugal	0.00%	-0.45%	-0.43%	-0.61%	-0.45%	-0.29%	-0.05%	0.16%	0.54%	1.07%
Italy	0.00%	-0.25%	-0.25%	-0.27%	-0.12%	0.21%	0.49%	0.82%	1.37%	1.91%
UK	0.75%	0.79%	0.47%	0.37%	0.30%	0.29%	0.27%	0.49%	0.72%	0.97%
Australia	0.75%*	-	0.82%	0.77%	0.73%	0.75%	0.87%	1.02%	1.25%	1.63%
New Zealand	1.00%	-	0.77%	0.80%	-	0.89%	0.99%	1.09%	1.28%	-
Canada	1.75%	1.67%	1.71%	1.58%	1.51%	1.40%	1.36%	1.36%	-	1.53%
USA	2.00%	1.81%	1.74%	1.62%	1.56%	1.54%	1.61%	1.66%	-	2.11%
China	4.20%	2.48%	2.55%	2.68%	2.75%	2.95%	3.15%	3.13%	-	3.74%

Source: Bloomberg, as at 30 September 2019. * As at 1 October 2019

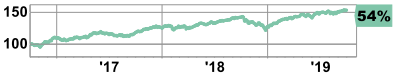
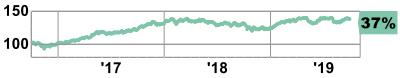
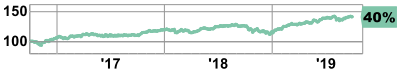
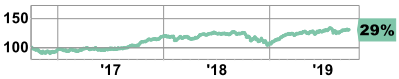
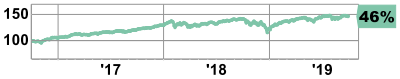
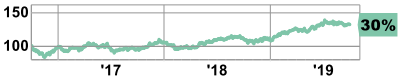
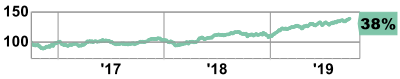
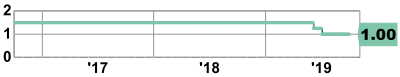
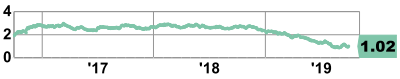
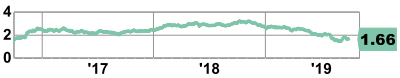
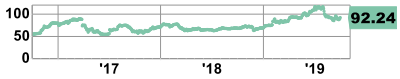
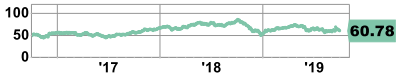
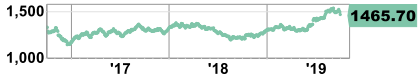
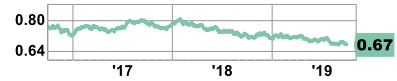
By holding negative yielding bonds until maturity, investors are guaranteed to make a capital loss. *So, why do it?* If investors are behaving rationally, they are most likely doing so for one of three reasons.

1) They are speculating that bond yields will fall even further into negative territory. Given the inverse relationship of bond yields and prices, bonds will appreciate if yields continue to fall. The holder could then sell the bond and lock in a capital gain.
2) They expect inflation will be negative, meaning the negative yield earned on a bond could actually represent a positive 'real' yield.
3) They are willing to pay a premium for the capital security and liquidity offered by government bonds. Even in a deteriorating economic environment, the credit risk of governments is generally very low – investors can feel reasonably confident that bonds will not default and that they will be repaid the par value at maturity. In addition, since government bond markets are among the most liquid in the world, holders can typically sell bonds quickly and easily, providing access to capital, if required.

Continuing to invest in bonds despite the negative yields on offer suggests investors see few other safe places to invest their assets. Perhaps their anticipated returns from other investment types are even worse?

Either way, these are extraordinary times for fixed income markets. At First Sentier Investors, we are fortunate to have more than our fair share of experienced fixed income professionals to help our clients navigate these uncharted waters.

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)	3,619.99	2.07%	4.73%	9.88%	15.59%	
MSCI Emerging Markets (AUD)	1,071.57	1.84%	-0.22%	5.53%	10.95%	
ASX 200	6,688.30	1.84%	2.37%	12.47%	11.88%	
ASX Small Ordinaries	2,894.30	2.61%	3.11%	3.95%	8.80%	
S&P 500 (USD)	2,976.74	1.87%	1.70%	4.25%	13.39%	
REITs						
ASX 200 A-REIT	1,609.80	-2.73%	0.95%	18.25%	9.19%	
FTSE EPRA/NAREIT Developed (AUD)	3,912.08	2.35%	9.11%	22.41%	11.33%	
CASH and FIXED INCOME						
Official Cash Rate Australia	1.00%	0.00%	-0.25%	-0.50%	-	
10-year yield Australia	1.02%	+0.13%	-0.30%	-1.65%	-	
10-year yield US	1.66%	+0.17%	-0.34%	-1.40%	-	
COMMODITIES and CURRENCIES						
Iron ore (USD/tonne)	92.24	1.46%	-15.52%	34.21%	17.66%	
Brent crude oil (USD/barrel)	60.78	0.58%	-8.67%	-26.52%	7.40%	
Gold (USD/ounce)	1465.70	-3.52%	3.97%	23.01%	3.73%	
AUD/USD	0.674	0.10%	-3.89%	-6.79%	-4.12%	

Source: Factset and Bloomberg, at 30 September 2019