

Coronavirus fears grip investment markets

End-January 2020

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Economics overview

- The outbreak of 'novel coronavirus' in China eroded sentiment towards shares and other risk assets in January.
- Some investors suggested the disease could hinder economic activity in China and other regions, adversely affecting the growth outlook for 2020. This pushed bond yields lower.
- Travel to and from China has been restricted and much of the country is in lockdown as authorities attempt to contain the virus.
- The impact of SARS – a similar epidemic in China in 2002-2003 – was not significant or lasting for the local or global economy.
- **US:** The pace of GDP growth in the US was unchanged in the December quarter. The world's largest economy expanded at an annual pace of 2.1%; the same as in the third quarter of 2019.
- There was a slowdown in consumer spending, however, which may be cause for concern given services sectors account for around three quarters of the overall economy.
- Policymakers will be hoping to see a rebound in discretionary spending in early 2020. It appears that Americans can afford it – wage growth continues to outpace inflation, meaning consumers have greater purchasing power.
- More than two million new jobs were also created in 2019, which took the unemployment rate to a 50-year low of just 3.5%.
- Interest rates were unchanged, with the target Federal Funds rate remaining between 1.5% and 1.75%.
- **Australia:** Headline inflation rose slightly more than expected in the December quarter. Prices rose 0.7% over the three-month period, the fastest quarterly increase in three years. This took the annual inflation rate to 1.8%.
- The increase was partly due to higher food prices, affected by disruptions to transportation owing to bush fires in November and December. Fruit prices rose nearly 7%, for example.
- Employment data for December was again strong, following a better-than-expected result in November.
- A further 28,900 new jobs were added, almost three times the 10,000 estimate. This lowered the unemployment rate to 5.1%.
- New jobs were again dominated by part-time positions, but the improvement was nonetheless quite pleasing for policymakers.
- Together, the stronger inflation and labour market data prompted the Reserve Bank of Australia to leave interest rates unchanged at 0.75% at its meeting in early February.
- **New Zealand:** Inflation also picked up in New Zealand. Consumer prices rose at an annual pace of 1.9% in the fourth quarter of 2019, compared with 1.5% in the prior three-month period and ahead of consensus forecasts.
- At 1.9%, inflation is close to the midpoint of the central bank's 2% to 3% target range and suggests current monetary policy settings are appropriate for now.
- According to a Reserve Bank spokesperson, the weaker NZ dollar is helping to moderate the impact of global headwinds.
- The kiwi economy should also be supported by a NZ\$12 billion infrastructure spending program. More than half of the expenditure is being brought forward, with various road and rail works set to commence later this year.

- **Europe:** The UK's withdrawal from the European Union occurred as planned at the end of the month, finalising the Brexit process that had been three and a half years in the making.
- UK policy makers can now focus on the domestic economy, which remains subdued. Industrial production is below levels from a year ago, inflation is well below target and the latest data suggested the economy contracted slightly in November.
- Consumer confidence has improved slightly following the recent general election, but remains fragile.
- Despite speculation regarding a possible cut, UK interest rates were left unchanged at 0.75% at Bank of England Governor Carney's last meeting.
- At the same time, officials lowered their GDP growth forecast for 2020, to 0.75% from 1.25% previously.
- In Continental Europe, surveys suggested some underlying improvement in sentiment in the manufacturing sector – a welcome development following months in the doldrums.
- Meanwhile, German inflation continued to pick up, indicating that activity levels in the Eurozone's largest economy may be improving. The latest data also showed that German retail sales were much stronger than anticipated in November.
- **Asia/EM:** Coronavirus-related news dominated attention in Asia. By month end, several airlines had suspended services to and from mainland China. This could affect tourism-related sectors worldwide, as Chinese tourists are estimated to account for around 30% of holiday spending globally. Around 1.5 million Chinese people visit Australia annually, for example.
- In mid-month, Chinese and US officials formally signed the 'phase one' trade deal that had been agreed in December.
- Official GDP data showed the Chinese economy grew at an annual pace of 6.0% in the December quarter, the same as in the September quarter. Growth is being supported by buoyant consumer spending domestically.
- Encouragingly, Chinese exports have risen from subdued levels earlier in the year. In December, exports were nearly 8% higher than in the corresponding month a year ago.
- In Japan, machine tool orders – an important barometer of economic activity levels – remained extremely weak. Industrial production is also running around -8% below 2018 levels.
- This reflects lower export demand, consistent with global trends.
- Japanese consumers remain frugal too. Nationwide department store sales were down -5.0% in December from a year ago.
- Unsurprisingly inflation remains very low, prompting the Bank of Japan to continue with very accommodative policy settings in an effort to stimulate activity.

Australian dollar

- The Australian dollar depreciated quite sharply, recording its worst monthly performance for more than two years.
- The currency lost nearly 5% against the US dollar, battered by coronavirus-related concerns. Australia's close ties with China means 'risk off' sentiment around the virus is affecting the Australian dollar more than most other currencies.
- A weaker currency may prove beneficial for Australian manufacturers, as it makes locally produced goods more competitively priced internationally.

Commodities

- Optimism following the agreement of a 'phase one' trade deal between the US and China quickly gave way to demand and economic growth concerns stemming from the rapid spread of the coronavirus.
- Oil (Brent -13.3%) felt the uncertainty sharply, while industrial metals were also lower; copper (-9.5%), nickel (-8.4%) and aluminium (-4.8%) all posted sizeable losses.
- Iron ore (-10.1%) also fell on China-related demand concerns.
- Unsurprisingly, gold (+4.7%) posted solid gains on 'safe haven' demand amid the uncertainty. Please see our *Chart of the Month* overleaf for a detailed overview of the recent rise in the gold price.

Australian equities

- Halfway through the month, the Australian equity market looked like it would experience its best monthly return in five years. Sentiment was being supported by positive economic releases, such as surprisingly strong retail sales and positive employment figures, and the completion of the 'phase one' trade deal between the US and China.
- However, the outbreak of the coronavirus and its threat to Chinese and, hence, global growth, felt in Australia through the tourism and education sectors, worried investors and caused the market to drop slightly into month end.
- Despite these fears late in the month, the S&P/ASX 100 Accumulation Index delivered an impressive +5.1% return, the best January in 26 years. This helped the Index set new all-time highs in terms of price and total return.
- All Information Technology constituents helped push the sector +12.8% higher. Afterpay (+31.7%), Australia's leading 'Buy-Now-Pay-Later' company, benefited from a positive broker note that included improved customer base and sales expectations for Afterpay's half-year results.
- Given their bond-proxy nature, the Utilities sector lagged the market and provided a modest +0.6% return. The poor performance of AGL Energy (-2.8%) dragged on the sector following continued softness in forward electricity prices. The industry is expected to experience continued pricing pressure given expectations for more interconnectors, additional renewables and changes to state-based policies.
- Although Australia's small companies underperformed their large cap peers, the S&P/ASX Small Ordinaries Accumulation Index still delivered a solid +3.4% return. Mesoblast, an Australia-based regenerative medicine company, was the best performing constituent following a promising quarterly result and increased expectations that the US Food and Drug Administration will approve Mesoblast's Ryoncil product.

Listed property

- Global listed property kicked off the calendar year with solid gains in January. The FTSE EPRA/NAREIT Developed Index returned 2.2% in local currency terms and a more impressive 5.9% in AUD terms, reflecting the weaker Australian dollar.
- The sector was propelled by the easing of ongoing uncertainties, as the US and China officially signed a 'phase one' trade deal and the UK officially withdrew from the European Union. Falling interest rates also supported the sector.
- The Australian property sector led the charge as A-REITs returned 6.4% during the month.
- The sector was led higher by National Storage REIT (+17.2%), which received a takeover bid. Other outperformers included Charter Hall (+16.1%) and Goodman Group (+11.4%).
- Hong Kong (-7.8%) was by far the worst performing market. Sentiment towards equities in the region plunged in the second half of the month, as concerns around the coronavirus outbreak intensified in China and surrounding regions.

Global equities

- Momentum in global equities continued from 2019 early in the month, with the MSCI World Index establishing new highs in the first 20 days of January. The signing of the 'phase one' trade deal between the US and China, combined with increasing conviction of a gradual recovery in global growth helped support global share markets.
- That optimism was quickly snuffed out, however, on mounting fears over the coronavirus and its impact on Chinese, and hence global, growth.
- From 20 January, the MSCI World dropped -3.1% in local currencies, to end the month down -0.2%. The AUD's associated plunge helped insulate Australian investors in global shares from negative returns. In fact the Index ended the month up 4.4% in AUD terms, the strongest January return since 2013.
- Most major markets fell into negative territory in the latter half of the month. The best performing of these was the S&P 500 Index in the US, which closed January only marginally negative in USD. A Q4 US GDP growth rate that met expectations, the Federal Reserve keeping interest rates unchanged and a solid start to the US earnings season helped to offset the virus fears.
- With the MSCI Emerging Markets Index rising only 0.1% in AUD in January, emerging markets have now lagged in ten of the last twelve months, bringing up the worst 12 months of relative performance (-15.5%) since January 2016. Asia was the worst performing EM region (-3.9%) in local currencies, dragged down by China (-4.9%) and Taiwan (-4.0%). That said, Asia was the strongest performing EM region in AUD terms (+0.3%) given the 'Aussie's' depreciation against USD-linked Asian currencies.

Global and Australian Fixed Income

- The risk that coronavirus results in a prolonged economic slowdown was reflected in fixed income markets worldwide.
- Government bond yields were pushed sharply lower in all key regions. US and Australian 10-year yields closed the month 42 and 41 bps lower, respectively, resulting in positive returns from overseas and domestic bond markets.
- Moves in Europe were a little more modest, but were substantial nonetheless. In the UK, 10-year gilt yields dropped 30 bps, while German Bund yields closed January 25 bps lower. Japanese JGB yields also fell 5 bps.
- Essentially, any economic slowdown as a result of the virus is likely to push expectations of interest rate increases further out into the future. Moreover, it will likely result in calls for borrowing costs to be lowered even further to help support activity levels.

Global credit

- Credit spreads had tightened sharply in late 2019, resulting in favourable returns from both investment grade and high yield corporate bonds.
- In January, however, concerns associated with the virus outbreak – specifically how a slowdown in activity levels might affect corporate earnings – saw spreads retrace some of this earlier movement.
- A slowdown in China could have broader reaching implications for companies in other regions. Remember, China now accounts for around 16% of global GDP.
- Unsurprisingly, issuers in Asia were among the worst performers. Chinese property companies with exposure to Wuhan, for example, fared particularly poorly.
- Spreads widened elsewhere too, although from a regional perspective European issuers held up the best.
- The European Central Bank continued with its €20 billion/month asset purchase program. So far, around a quarter of the total has been channelled into corporate bond markets, providing significant support to credit valuations in the region.

Chart of the Month – Gold fever: Will it keep its shine?

In these bulletins, we aim to share interesting observations from global investment markets. This month we look at what drove the surge in gold prices in 2019 and whether prices will stay as high during 2020.

Gold prices hit all-time highs in AUD terms



Source: FactSet. Data as at 31 January 2020.

In January, gold prices reached all-time highs in Australian dollar (AUD) terms, surging over 40% since the September quarter last year. This may come as no surprise given that the yellow metal is seen as an attractive store of wealth during periods of uncertainty. Over the last year, many safe haven assets have rallied given concerns about trade wars, Brexit negotiations and, more recently, drone strikes and virus outbreaks. Without discounting the significance of these events, we argue that there has been another key factor driving gold prices higher – falling real interest rates.

As shown from the chart, there has historically been a strong negative relationship (a correlation of -0.8 since 1 January 2009) between real interest rates, nominal interest rates adjusted for inflation, and gold prices – i.e. gold prices benefit when real interest rates move lower. Real interest rates can be low for two reasons, high inflation or low interest rates. Investors view gold as a 'safe-haven', with no default or inflation risk. So gold becomes increasingly attractive as returns on other 'safe-haven' assets (e.g. government-backed securities) are eaten away by high inflation. However, gold's allure can also rise when interest rates are low because the opportunity cost of investing in gold (a non-yielding investment) is reduced.

During 2019, deteriorating economic releases and concerns of lower global growth saw central banks quickly switch to a 'dovish' interest rate regime. With the US Federal Open Market Committee delivering three interest rate cuts over the year, real interest rates contracted into negative territory. The negative real interest rate environment reinforced demand for the yellow metal as investors opted for assets that would offer a hedge against the growing stream of geopolitical risks.

Another safe-haven asset that appreciated last year was the US dollar. The associated depreciation of our currency against 'the greenback' helped to enhance the value of gold in AUD terms.

So far, we have focussed on the demand for gold. However, another influence on the gold price is supply, with some industry participants suggesting that we have reached peak gold production. They point to a declining rate of gold mine discoveries and the falling average grade of new gold deposits. If they are correct, this may further support gold prices. Talk of peak gold production is nothing new and even though the World Gold Council observes that there is 54,000 tonnes¹ of reserves below ground, about 28% of above ground stocks, it acknowledges that the "upward trend [in gold production] in recent years ... is likely to level off". However, if gold prices were to rise over the longer term, previously uneconomic lower-grade deposits would become financially feasible and add to supply. Improved mining/extraction technologies have also seen production levels extend beyond prior 'peaks'.

So can gold prices continue to rise? Over the short term, fears over the coronavirus certainly appear to be rising rather than falling. With a gradually recovering global economy, interest rates may have stopped falling, but they are likely to remain low for a while. So gold prices may well remain inflated. But predicting commodity prices is never an easy game – former US Federal Reserve chairman Ben Bernanke highlighted the challenge with the statement "*Nobody really understands gold prices, and I don't pretend to understand them either*".

¹ <https://www.gold.org/about-gold/gold-supply/gold-mining/how-much-gold>

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)	3,918.71	4.39%	8.41%	28.96%	16.88%	
MSCI Emerging Markets (AUD)	1,145.73	0.11%	5.37%	13.51%	12.92%	
ASX 200	7,017.20	4.98%	6.08%	24.72%	12.36%	
ASX Small Ordinaries	2,995.50	3.38%	4.69%	18.84%	12.12%	
S&P 500 (USD)	3,225.52	-0.04%	6.72%	21.68%	14.54%	
REITs						
ASX 200 A-REIT	1,667.70	6.36%	4.01%	19.57%	13.22%	
FTSE EPRA/NAREIT Developed (AUD)	4,012.63	5.92%	3.24%	21.91%	14.10%	
CASH and FIXED INCOME						
Official Cash Rate Australia	0.75%	0.00%	0.00%	-0.75%	-	
10-year yield Australia	0.95%	-0.42%	-0.19%	-1.29%	-	
10-year yield US	1.51%	-0.41%	-0.18%	-1.12%	-	
Foreign Exchange						
AUD/USD	0.669	-4.77%	-2.83%	-8.19%	-4.10%	

Source: Factset and Bloomberg, at 31 January 2020

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