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Colonial First State
Global Asset Management

A new year, but little change on the economic front

Market Watch

December 2017

Economics overview

- **US:** As expected, US interest rates were raised by a further 0.25% (to 1.5%); the third hike of the year.
- At 2.2%, inflation appears to be under control and is unlikely to prevent the Fed from increasing interest rates further in 2018.
- The labour market also remains in a healthy state, underpinning solid GDP growth.
- The economy may be further boosted by President Trump's tax legislation overhaul which cleared Congress and was signed by the US President just prior to Christmas.
- The encouraging tone of recent data releases, combined with the potential boost from the new tax legislation, suggests that interest rates will be increased further in 2018. Indeed, most observers are suggesting the federal funds rate will rise by a further 0.75% in the coming 12 months.
- It is worth remembering, however, that a new Chairman will shorty take over at the Federal Reserve. Jerome Powell is perceived to be one of the more dovish members of the current Board, suggesting future rate hikes might be less aggressive than some commentators are forecasting.
- Recently released board meeting minutes also highlight uncertainty across Federal Reserve board members on the economic impact of the tax cuts.
- Elsewhere, there were mixed signals on the consumer front. Confidence dipped to a three-month low in November, although retail sales growth picked up in the same month following strong sales during the 'Black Friday' period.

- **Australia**: GDP growth data was released for the September quarter. While quarterly growth of 0.6% fell slightly short of consensus expectations, the annual pace of growth picked up to 2.8%, from 1.9%.
- Economic activity is being supported by a strong uptrend in employment. In November, more than 60,000 new jobs were created and there were positive revisions made to the statistics for previous months. The unemployment rate remains 5.4%, but appears to be under downward pressure.
- Yet wage growth has not kept pace with employment growth.
- In spite of subdued wage growth, the improved employment backdrop appears to be supporting consumer confidence. Retail sales rose 0.5% mom in October; an encouraging indicator ahead of the important pre-Christmas trading period.
- The RBA left interest rates on hold at 1.5%, as expected.

- **New Zealand**: The pace of economic growth slowed slightly in the September quarter, declining to 2.7% yoy from an upwardly revised 2.8% yoy in the June quarter.
- Activity in the construction sector rebounded following subdued performance in the June quarter, helping to buoy the overall GDP growth reading.
- The September quarter mining sector contribution also improved markedly following a negative reading in the prior period.
- As expected, the RBNZ left interest rates unchanged at a record low of 1.75%. The rate was unchanged throughout 2017 and no policy amendments are anticipated in the near term.

- **Europe:** Inflation in the UK rose to 3.1% in November, the fastest pace of price increases for nearly six years. This appeared to support the recent decision to raise interest rates.
- The Bank of England has been vague regarding further possible changes to monetary policy, only suggesting that any further tightening will be "gradual" in pursuing its 2.0% inflation target.
- In Continental Europe, the economy continues to recover steadily. Growth in the September quarter was the strongest since the first quarter of 2011, supported by improving conditions in Germany and Italy.
- The European Central Bank has recently raised its inflation forecast for 2018, but has thus far been unwilling to raise interest rates above 0%.

- **Asia:** The Japanese economy expanded for a seventh consecutive quarter in the three months ending 30 September 2017. Economic growth has accelerated to 2.5% yoy, stronger than the initial estimate for the period and well ahead of consensus expectations.
- Business spending has improved markedly and an increase in export demand has further boosted activity levels.
- In spite of the improved conditions, official interest rates remain negative, at -0.1%, and the yield target on 10-year government bonds remains zero.
- In China, attention is turning towards the release of Q4 2017 GDP data in mid-January. Consensus expectations suggest the economy grew at an annual pace of 7.0%. This would be the fastest pace of growth since mid-2015.

Australian dollar

- Recent weakness in the Australian dollar continued in early December, but the trend reversed in mid-month following the favourable employment report and improving iron ore prices.
- In the month as a whole, the dollar appreciated by around 2% against a trade weighted basket of currencies.
- The Australian dollar closed the year above US$0.78 from ~US$0.72 - its best calendar year appreciation in seven years.

Commodities

- Most major commodity prices rose. The standout performer was coal, buoyed by strong Chinese demand. This was in spite of a broad reduction in industrial activity to reign in pollution during China's winter 'heating season'.
- Iron ore had another strong month, rising 12.5%. China's pollution controls have also increased demand for Australia's cleaner, higher-grade ores - now trading at significantly higher premia to their lower grade counterparts than 6-12 months' ago.
- Nickel (+8.5%) continued its recent strength on hopes that the rise in lithium-ion batteries will increase demand for the metal.
- Gold finished the month higher, adding 2.6% to US$1306/oz, despite the US interest rate hike.
- WTI Crude rose 5.2% to US$60.36 per barrel – its highest level since mid-2015. Prices benefiting from supply disruptions and continued production cuts by OPEC and allied oil producers.

Australian equities

- The S&P/ASX 200 Accumulation Index posted solid gains, rising 1.8% and finishing the calendar year 11.8% higher.
- At a sector level, Energy and Materials were the standout performers, returning 6.4% and 6.2% respectively. These sectors were buoyed by rising commodity prices.
- Telcos (+5.5%) performed strongly, with mid-cap players TPG Telecom and Vocus Group once again posting strong gains. Sector giant Telstra reversed last month's losses, but ended the year almost 25% lower.
- Consumer Discretionary finished 3.5% higher, led by Ardent Leisure Group, which rallied on news it had sold its Bowling & Entertainment division. Consumer Staples (+1.6%) was supported by Woolworths and Wesfarmers. Metcash also rallied following better-than-expected H1 results.
- Bond proxy sector Utilities (-4.5%) was the main laggard during the month, affected by rising Australian Bond yields.
- Returns elsewhere in the market were more subdued, with Financials, Property Trusts and Healthcare little changed.

Listed property

- The S&P/ASX 200 A-REIT Index returned +0.2% in December. Retail A-REITs (+3.6%) outperformed, while Industrial A-REITs (-1.6%) and Office A-REITs (-3.3%) underperformed.
- The best performing A-REITs included Retail A-REIT Westfield Group (+13.3%), which rose strongly following the announcement that the company would be sold to European giant Unibail-Rodamco for A$32 billion. Unibail-Rodamco is the biggest commercial property landlord in Europe.
- The worst performers included Specialised A-REIT Iron Mountain, which fell 8.3%. The shares dipped after the company announced the acquisition of IO Data Centres' US operations for ~US$1.3 billion. With the transaction, Iron Mountain will acquire land and buildings associated with four data centres in the US.
- Globally, all major property markets rose in local currency terms, enabling the FTSE EPRA/NAREIT Developed Index (TR) to add 1.4% in USD terms.
- The UK (+8.2%) was the strongest market in local terms, followed by New Zealand, which rose 5.1% in NZD terms.
- The Japanese market lost ground, reflecting a fourth consecutive month of increasing Japanese bond yields.

Global equities

- Global equity markets continued their steady upward progress, with the MSCI World Index registering its 14th consecutive monthly gain (+1.4% in USD terms).
- Markets initially suffered from some rotation out of the strongly performing tech stocks and concerns over the direction of the probe into Russia's interference in the 2016 US presidential election. Increasing confidence in global growth and the prospect of tax reform in the US saw global equity markets steadily recover from being down almost 1% early in the month.
- The UK was the strongest performer in local currency terms, with the FTSE 100 up over 5%. The recovery in commodity prices supported large resources stocks, many of which are listed on the London bourse. One of the weaker performers was the German DAX, which was down -0.8%, partly reflecting a disappointing fall in the Ifo Business Climate Index.
- For the second month in a row, there was little difference across style segments; there was little to separate the USD returns of MSCI World Growth (+1.3%), MSCI World Value (+1.5%), MSCI World Small Cap (+1.6%) and MSCI World Large Cap (+1.3%).
- MSCI Emerging Markets strongly outperformed developed markets, rising 3.6% in USD terms, finishing off a year in which emerging markets outperformed their developed counterparts by almost 15%. This was the strongest relative performance by emerging markets since the Chinese fixed asset investment induced boom of 2009.
- Once again, this was an Asian led result. The MSCI EM Asia Index was up 43.3% over the year, driven primarily by MSCI China (up 54.3%) and, despite the geopolitical issues to its north, MSCI Korea (up an impressive 47.8%) – all in USD terms.

Global and Australian Fixed Interest

- There was little in December to surprise investors. The main drivers of bond yields – i.e. US tax reforms and the interest rate hike – were already largely priced in to markets. Indeed, most bond markets continued to trade in historically narrow ranges.
- In Australia, there was an outsized move in 10-year government bond yields, relative to the US, on the back of the US tax reforms in mid-month. While it is unclear what drove the sell-off, some of it was likely 'give back' after a sharp spread compression in prior months. The spread between Australian and US 10-year government bond yields is examined in this month's *Chart of the Month*.
- In Europe, bond yields rose on the back of slightly more hawkish commentary from some of the European Central Bank Governing Council. Rates remain on hold for now as asset purchases continue to be used to regulate the economy.
- The net impact of events in the month saw 10-year government bond yields flat in the US (generic 10-year yields at 2.41%). Yields rose in Germany (+6 bps) and Australia (+13 bps), but were down in the UK (-14 bps) on the back of Brexit concerns. Japanese government bond yields added 1 bp in the month.

Global credit

- Global investment grade credit spreads maintained a tightening trend as risk assets in general outperformed.
- The Bloomberg Barclays Global Aggregate Corporate Index average spread closed the month 3 bps narrower, at 0.94%. US credit also moved 3 bps narrower, with the average spread closing at 0.89%. In Europe, the spread on the Bloomberg Barclays European Aggregate Corporate Index was 2 bps narrower, at 0.86%.
- US high yield credit spreads finished wider, the Bank of America Merrill Lynch Global High Yield index (BB-B) out 6 bps to 2.86% by month end. The high yield market continues to be affected by downgrades, particularly in the energy and mining sectors.
- Demand for higher yielding securities saw record global issuance of US$2.2 trillion in 2017 as corporates took advantage of low global interest rates.

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