# All good things come to an end

## Market Watch

**February 2018**

### Economics overview

- **US:** In early February, stronger than expected wage data in the US was released. This prompted investors to revisit their inflation expectations and, in turn, suggest that US interest rates could be increased more quickly than previously anticipated.
- This sentiment took its toll on equity markets, both in the US and overseas. In mid-month, the US stock market was trading more than 10% lower from end-January levels, although it did regain some of this lost ground in the remainder of the month.
- The S&P 500 Index (-3.9%) recorded its worst monthly return for more than two years. The sell-off a reminder that stock markets can be volatile after a record period of unbroken monthly gains.
- The data also affected bond markets; unsurprisingly resulting in higher US Treasury yields. In fact, 10-year government bond yields in the US rose above 10-year Australian government bond yields for the first time since 2000.
- With both sectors selling off heavily over the month – it is clear that their longer term tendency to not move together is not at all stable (see Chart of the Month).

- **Australia:** As had been widely anticipated, the RBA left Australian cash rates unchanged at 1.50% in February, but warned that “inflation is likely to remain low for some time”. This description of inflation did not appear in December’s post meeting statement.
- February’s RBA Statement on Monetary Policy (SMP) showed the forecast profile for both inflation and growth are unchanged from the November SMP. Specifically, the RBA still suggests that underlying CPI will reach 2.0% in Q2 2019. This measure is thought most relevant when monetary policy is being set.
- Consistent with consensus expectations, employment rose by a further 16,000 in January. This helped set a new record for the longest run of consecutive monthly job gains (16 months in a row). The official unemployment rate dipped to 5.5%.
- While higher employment is clearly positive, there is some concern over the split between full time (-49,800) and part time (+65,900) roles.
- Retail sales in December were 0.5% lower than the previous month and below expectations of a -0.2% fall.
- In general, consumer confidence remains weaker than business confidence. This might partially reflect disappointing wage growth. Earnings rose 0.5% in the December quarter, taking the gain in 2017 to 2.1%. Increases largely came in the public sector; private sector wage growth remains subdued.

- **New Zealand:** Data showed that the unemployment rate declined slightly in the December quarter, to 4.5%.
- This appeared to support consumer confidence levels, which rose more strongly than had been expected.
- Retail sales data also surprised on the upside.
- In spite of these encouraging indicators, there remains a low probability that interest rates will be increased from the current 1.75% level in the foreseeable future.

- **Europe:** Following earlier preliminary estimates, final GDP data was released for the December quarter of 2017. The economy grew at an annual pace of 2.7% for the period, slightly below the 2.8% yoy growth seen in the September quarter.
- Growth in 2017 as a whole was the fastest since 2007.
- Among constituent countries, there were positive contributions from France and the Netherlands. The pace growth pace also fell in other countries including Germany, Italy and Spain.
- For now, the European Central Bank remains committed to its asset repurchase program. The support is expected to be withdrawn later this year.
- The UK GDP growth rate also slowed in the December quarter, reflecting lower household spending and business investment.
- At 3.0% yoy, UK inflation remains at the upper end of the Bank of England’s target range, suggesting further interest rate rises.

- **Asia:** Data in Japan was disappointing, on the whole. Preliminary statistics suggested the economy only grew 0.5% in 2017, well below forecasts of 1.0% growth.
- Industrial production data for January also came in below expectations and the pace of retail sales growth has slowed.
- Chinese PMI data released towards the end of February was weaker than expected. With interruptions associated with Chinese New Year celebrations, it is currently harder than ever to get an accurate picture of the economic picture in China.

### Australian dollar

- The dollar weakened by 3.0% against a trade-weighted basket of overseas currencies. Weakness was most significant against the Japanese yen.
- The RBA’s cautious inflation outlook and firmer US dollar weighed on the AUD/USD cross.
- The positive impact on the dollar from favourable employment conditions has been offset by the underwhelming wages data.

### Commodities

- Iron ore and coking coal prices rose steadily during February, adding 7.4% and 9.7% respectively, on renewed restocking demand. This was driven by the Chinese New Year holiday period and as steel mills in northern China readied themselves

for fewer output restrictions by mid- March. Output restrictions have been applied during the heating season (mid-November to mid-March) to reduce air pollution.
- Oil prices (-4.8%) finished the month lower on concerns that rising US supply could lead to surplus risks emerging later this year. Prices still remain well supported on demand hopes, which reflect forecasts of synchronised economic growth this year. Stronger compliance with oil production cuts among OPEC and allied oil producers has also meant that around 1.8% of global supply has been sidelined in recent months.
- Precious metals weakened, with gold (-1.8%), silver (-4.6%) and platinum (1.5%), all lower in line with a stronger US dollar.

**Australian equities**

- Most ASX-listed companies reported earnings during February. Overall it was a satisfactory reporting season, with around 33% of companies delivering 'beats' versus 16% delivering 'misses'. The S&P/ASX 200 Index returned 0.4%.
- Health Care was once again the standout performer, adding 7.0%. The sector was led higher by CSL, which posted strong gains on solid H1 earnings and FY18 guidance.
- Consumer Staples added 2.2%, despite poor performance from sector giant Wesfarmers, which reported accelerating losses at its troubled Bunnings UK business. Woolworths finished higher, while mid-cap a2 Milk Company rallied almost 50%.
- Telecoms was the main laggard, falling -6.0%. Telstra's disappointing run continued, with its share price hitting five-year lows. Energy fell -3.7%, led lower by Woodside Petroleum and Whitehaven Coal. Interest rate sensitive sectors also lost ground, with Property (-3.3%) and Utilities (-1.7%) both falling.
- Consumer Discretionary fell -1.2%, masking the considerable divergence of individual company performance within the sector. The share price of Myer and Domino's Pizza fell sharply after they posted disappointing results.
- Most other sectors, including Financials (+0.7%), Materials (+0.4%) and Industrials (-0.4%), were little changed.

**Listed property**

- The S&P/ASX 200 A-REIT Index doubled its losses for this calendar year, falling a further -3.3% in February.
- Industrial A-REITs (1.5%) had a positive month, reversing January's weakness. Office A-REITs declined -2.3%, but Retail A-REITs (-4.3%) were by far the weakest performers.
- Earnings results season was viewed as slightly positive, with most positive surprises in stocks with residential exposure and improving fees from assets under management. Asset revaluation gains were typically strong.
- National Storage (2.0%), Goodman Group (1.5%) and Cromwell Group (1.0%) performed well. National Storage reaffirmed its guidance – implying strong growth over the next six months – while Goodman Group upgraded guidance as the expansion of e-commerce continues to help its biggest client, Amazon.
- Vicinity Centres (-7.8%), Iron Mountain (-5.9%) and GPT Group (-5.4%) underperformed. Vicinity reported deteriorating sales metrics; the retail sector faces structural and cyclical headwinds.
- Major overseas property market returns disappointed in February, with the FTSE EPRA/NAREIT Developed Index (TR) falling -6.6% in USD terms. The US (-7.3%) was again the weakest property market, following a poor January.

**Global equities**

- After a strong start to 2018, global equity markets fell in February. The MSCI World Index dipped as low as -7.6%, before recovering to close the month -4.1% lower in USD terms.
- Weakness largely followed the lead of the US market, which struggled as investors suggested the Federal Reserve could raise interest rates more aggressively than previously expected.
- The initial rout subsided after encouraging results in the US earnings season. Of the ~90% of companies in the S&P500 that have reported results, 74% reported positive earnings surprises.
- Value companies continued their run of underperformance. Indeed, the MSCI World Value Index fell -5.0% in USD terms, compared to -3.2% for the MSCI World Growth Index.
- MSCI Emerging Markets (-4.6%) also struggled, albeit only underperforming their developed counterparts by 0.5% in USD terms. Asian stocks performed particularly poorly. Chinese stocks fell -6.4%, with investors appearing to take recent profits ahead of the long Lunar New Year public holidays.
- Brazil was one of the stronger Emerging Market countries (+0.6%), supported by higher iron ore prices.

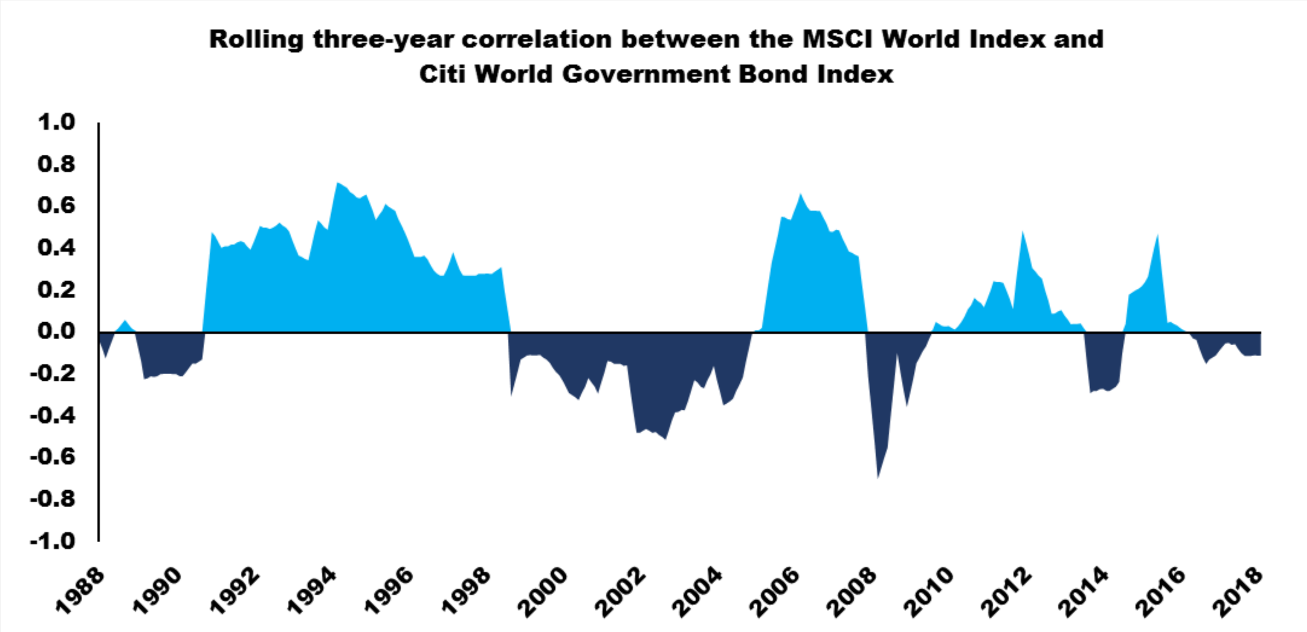
**Global and Australian Fixed Interest**

- Following optimism in January, markets flipped into 'risk-off' mode in February.
- Treasury yields in the US rose 4 bps, reflecting speculation that the Federal Reserve will raise interest rates by more than the planned three times this year. Indeed, markets began fully pricing in the three planned and even started pricing in a fourth.
- Optimism returning with strong US inflation and wages data.
- In the UK, investors suggested the Bank of England could also raise interest rates as soon as May.
- Elsewhere, minutes from the European Central Bank's January meeting showed inflation is picking up at a faster pace than predicted. Some market participants briefly interpreted this to mean that monetary stimulus could be withdrawn earlier than expected. A speech by a key ECB policy maker towards the end of the month, however, remained consistent with earlier comments regarding ongoing monetary accommodation.
- Australia government bond yields ended the month flat.

**Global credit**

- Global investment grade credit spreads broke from the long-held tightening trend, as risk assets were affected by the stock market correction. The impact was not significant, however, with spreads only moving marginally wider.
- The Bloomberg Barclays Global Aggregate Corporate Index average spread finished the month 9 bps wider, to 0.94%. US credit also moved 9 bps wider, to 0.91%. In Europe, spreads widened 6 bps, to 0.80%.
- Corporate bond issuance remained reasonably strong in February, albeit slightly below January's level and short of the 2017 average.
- Short term funding costs have spiked in the US. This is attributable to a combination of expected repatriation of offshore earnings (a number of large companies announced they would use cash held overseas to repay debt, rather than refinancing) and increased issuance of short-dated US Treasuries. Both of these factors are expected to see reduced demand/funds available for short-dated corporate funding relative to Treasuries; a trend that is likely to persist for some time.
- US high yield credit spreads finished notably wider, moving out 19 bps to 2.78%. The market continues to be affected by downgrades, particularly in the energy and mining sectors.

In these bulletins, we aim to share interesting observations from global investment markets. This month, we examine the correlation between global equities and global bonds.




Through to 28 February 2018
Source: MSCI, Citi, Bloomberg

Long-held assumptions that stock and bond prices are lowly correlated cannot necessarily be relied upon.

Over the past 30 years, the average rolling three-year correlation between equities and bonds has been low, <0.1. This does, however, mask periods of high positive (>0.7) and negative correlations (-0.7).

High quality government bonds are perceived to be among the best asset classes to own during recessions, but other scenarios could see both bonds and equities falling simultaneously (e.g. rising inflation or heightened bond volatility).

Traditional asset allocation works best when historical returns, volatilities and correlations are stable. These periods appear to be becoming fewer and farther between. Consequently, in multi-asset portfolios there is a greater requirement for dynamic asset allocation amendments, enabling investors to take advantage of short-term market dislocations.

In fact, correlations between equities and bonds have increased over the last few weeks, with prices moving up and down together to a greater degree. It will be interesting to see whether this trend is sustained and whether correlations become less negative in the remainder of 2018.

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