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Colonial First State Global Asset Management

New year optimism abounds

Market Watch

January 2018

Economics overview

- **US:** For a few days in mid-month, politics overshadowed economic news. A number of government departments had to shut down as Congress failed to pass a new funding deal. A temporary solution was subsequently agreed, enabling investors to refocus on economic data releases.
- Corporate earnings were also announced by around a quarter of companies in the S&P 500. As ever, these releases attracted a great deal of scrutiny.
- In spite of the improvement in economic conditions in the US over the past year, inflation appears to remain under control. Annual CPI of 2.1% was announced for calendar year 2017. Higher employment, improving confidence and buoyant retail sales have not yet resulted in significant inflationary pressure.
- The recovery in US manufacturing continues. Industrial production rose 1.8% in 2017, the first gain since 2014.
- The employment picture also remains encouraging. December's jobs report was broadly in line with expectations, with 148,000 new jobs being created. Wage growth also continued to edge higher.
- Towards the end of the month, investors focused on the release of employment statistics for January, which were released in early February. Data showed that a further 200,000 jobs were added in January, which was well above expectations.
- Average hourly earnings also rose 2.9% yoy in January; the fastest pace of growth since 2009. This prompted some commentators to suggest that the labour market could be showing signs of overheating.

- **Australia:** Employment continued to rise in December, with a further 34,700 jobs being created. In 2017 as a whole, more than 400,000 new jobs were created in Australia, providing a significant boost to the economy.
- Consumer confidence has risen to its highest level in more than four years on the back of the improving labour market conditions.
- Higher confidence levels are being reflected in spending habits. November retail sales grew at the fastest monthly pace since February 2013, for example, and new car purchases are at record highs.
- In spite of the higher spending, inflation remains slightly below the Reserve Bank of Australia's 2% to 3% target range. This suggests there is a limited likelihood of interest rate increases in the near term. Official interest rates were left on hold at 1.5% at the Bank's last meeting in December.

- **New Zealand:** CPI data for the December quarter highlighted annual inflation of 1.6%. This was well below expectations and was the lowest quarterly reading in the whole of 2017.
- The subdued reading was attributed to moderating food prices, although selected other sectors including education and utilities continued to see quite strong price increases.
- The lower overall inflation reading affirmed investors' existing view that the Reserve Bank of New Zealand is unlikely to raise interest rates from the current 1.75% throughout 2018.

- **Europe:** Euro area GDP rose 2.5% in 2017 as a whole; the best performance in the past decade.
- Improved conditions have resulted in rising new job vacancies and have seen the unemployment rate fall to 8.7%. While this remains high by Australian standards, it is well below the 12%+ rate seen around five years ago.
- The employment picture has also improved in the UK, where the overall number of people in work is now higher than ever before. The official unemployment rate (4.3%) is the lowest in more than 40 years.
- Encouragingly, UK exports are rising and the manufacturing sector is performing well. Negotiations over 'Brexit' continue; this has the potential to derail the economy in a worst-case-scenario outcome for the UK.

- **Asia:** Data confirmed that the Chinese economy expanded 6.9% in 2017; ahead of the government target of 6.5%. The performance in 2017 was also an improvement on the 6.7% growth witnessed in 2016, which was the country's lowest growth reading for more than 25 years.
- Elsewhere in Asia, Japanese inflation quickened to its fastest pace since early 2015, driven by rising food prices. In spite of the spike, official interest rates remain below zero (-0.1%).
- The Japanese government forecasts economic growth of 1.4% this year, which could result in inflation of around 2% in 2019.

Australian dollar

- The Australian dollar appreciated by more than 1% against a trade-weighted basket of currencies in January.
- The dollar performed particularly well versus the US dollar, rising to its highest level since May 2015 (US$0.8136). The move was supported by general weakness in the US dollar and a more positive outlook for global economic growth. Buoyant Australian economic activity was also supportive.
- The Australian dollar lost ground against the British pound, partly reflecting the release of favourable UK economic data.

Commodities

- Commodity prices were mixed during January, although most were supported by a weaker US dollar and growing optimism regarding the global growth outlook.
- Coking coal saw the most noticeable change, falling -18%. A restocking cycle that helped prompt coking coal prices higher at the end of December was unwound in January, as stockpiles grew sharply. Iron ore tracked mostly sideways, as demand for higher-grade ores remained strong (see our Chart of the Month on the following page), despite evidence of easing restocking demand in January.
- Base metals were mixed. Nickel (+10.6%) and Zinc (+8.5%) rose, while Copper (-0.8%) and Aluminium (-0.8%) edged lower.
- Gold continued its strong momentum, adding 2.5% on a weaker US dollar.
- Oil (+7.0%) continued its march higher, reaching three-year highs. Strong demand, OPEC production cuts and positive IMF economic growth forecasts all helped to support the oil price.

Australian equities

- Following a strong December, the Australian equity market (S&P/ASX 200 Accumulation Index) edged -0.4% lower.
- Bond proxy sectors Property Trusts and Utilities weighed on the broader market, with both falling appreciably (-3.3% and -4.5%, respectively) amid rising bond yields.
- There was some divergence of stock performance within the Industrials sector (-2.1%), with Macquarie Atlas Roads (-8.7%), CIMIC Group (-8.4%) and Aurizon (-5.7%) among the underperformers.
- Health Care was the best performer, adding 3.2%. The sector was boosted by gains in Sirtex Medical, which surged 66.1% after agreeing to a $1.6 billion takeover by US firm Varian. ResMed (+15.0%), Sonic Healthcare (+4.3%) and CSL (+3.6%) also outperformed.
- Materials (+0.5%) and Energy (-0.5%) took a breather after both added 23% in 2017. Financials finished -0.8% lower, as the ‘big four’ banks all lost ground.
- Within Consumer Staples (-0.1%), a2 Milk had another stellar month, adding 14.6%, bringing its gains for the past 12 months to 294%. This was insufficient, however, to offset weakness in sector giants Wesfarmers (-1.4%) and Woolworths (-1.3%).
- In the Consumer Discretionary sector, strong gains in JB Hi-Fi (+17.2%) and Flight Centre (+15.4%) were offset by losses in Retail Food Group (-20.9%) and Fairfax Media (-9.0%).

Listed property

- The S&P/ASX 200 A-REIT Index fell -3.3%.
- Retail A-REITs (-2.3%) and Office A-REITs (-2.3%) were the stronger performers, while Industrial A-REITs (-3.9%) lagged.
- All stocks lost ground in January. The worst performers included specialised A-REIT, Iron Mountain and diversified A-REIT, Abacus Property Group. Iron Mountain suffered for the second month in a row, having fallen more than 8% in December after announcing the acquisition of the US operations of IO Data Centers. The deal was subsequently closed in January. Abacus Property Group fell over the first half of the month, in particular, after announcing the retirement of its Managing Director, who had been with the Group for more than 21 years, with 11 years as MD.
- Scentre Group and Vicinity Centres outperformed peers, although neither company released any meaningful news.
- The global FTSE EPRA/NAREIT Developed Index (TR) was flat in USD terms. In local currency terms, Japan (+7.8%) was the strongest property market, while the US (-4.2%) underperformed.

Global equities

- Global equity markets had a happy start to the new year. The MSCI World Index surged 5.3% in USD terms, having been up 7.2% before profit-taking and higher bond yields saw a weaker finish in the final week. Markets continued to set new records over the month in terms of both index levels and the sustainability of the recent rally. Investors even shrugged off some jitters over the potential for broader government shut-downs in the US, with the Senate threatening to block a funding bill. Markets were also supported by favourable economic data and solid earnings results in the US and Europe.
- The US market was the strongest performer in local currency terms, with the S&P 500 up an impressive 5.7%. Of the 24% of S&P 500 companies that announced results in January, 81% reported sales above consensus estimates.
- The FTSE 100 was one of the weaker performers, down almost 2%. Investors remain nervous over the potential outcome of ‘Brexit’ negotiations. Additionally, the resources-heavy UK bourse contains few information/bio technology companies that have been driving markets in the US and Asia.
- Growth companies outperformed their value peers. MSCI World Growth was up +6.3% in USD terms, versus MSCI World Value, which added +4.3%. There was a similar gap in favour of large caps, with the MSCI World Large Cap Index (+5.5%) outperforming the MSCI World Small Cap Index (+3.6%).
- MSCI Emerging Markets (+8.3%) also continued to strongly outperform their developed counterparts in USD terms, helped by the weakness in the US dollar. Latin American indices performed particularly well, with the resources-rich Brazilian bourse leading the way (+11.6%).

Global and Australian Fixed Interest

- Buoyant investor sentiment towards risk markets in early 2018 resulted in a strong upward move in global government bond yields. US 10-year Treasury yields rose to their highest level since April 2014.
- Market optimism was bolstered by US tax reforms passed at the end of 2017 and announcements that many US companies would be awarding pay rises and bonuses.
- CPI remains below target in most countries, there was also a marked increase in market expectations for inflation worldwide.
- Global central banks are also pulling back on asset purchases, most notably the European Central Bank (ECB). The ECB has started to talk about the possibility of lifting interest rates once its asset purchase program ends later this year.
- Continued discussions on the North American Free Trade Agreement also exerted upward pressure on bond yields, with suggestions that the US, Canada and Mexico are nearing an agreement on trade talks. Other geopolitical issues were more subdued in the month, with limited developments on the ‘Brexit’, North Korea and President Trump impeachment fronts.

Global credit

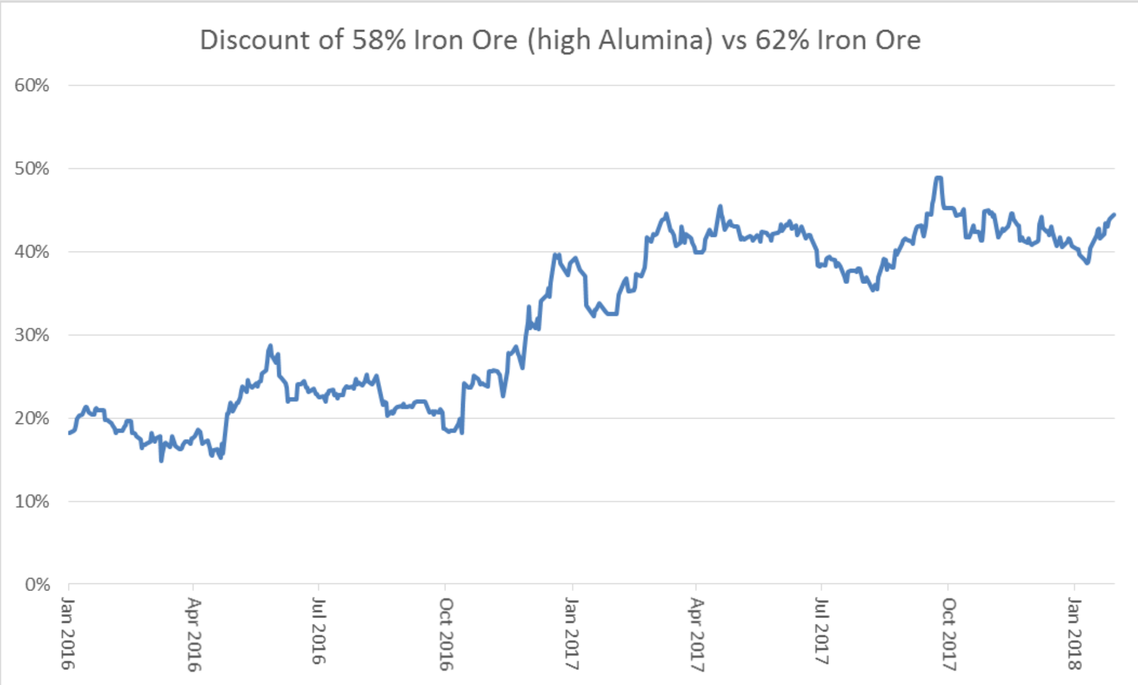
- Global investment grade credit spreads continued on the long-held tightening trend, reflecting ongoing optimism towards risk markets.
- Issuance remained strong, with a number of global investment grade bond issues being met with demand as the hunt for yield continued.
- Average credit spreads closed the month 9 bps narrower, at 0.85%. US credit moved 7 bps narrower, to 0.82%. In Europe, spreads closed January 12 bps narrower, to 0.74%.
- US high yield credit spreads widened 27 bps, to 2.59%. The high yield market continues to be impacted by downgrades, particularly in the energy and mining sectors.

Chart of the month

This month the chart shows the discount between low-grade, high-impurity iron ore, (58% ore, high alumina) and high-grade iron ore (62% ore). The discount has increased from 20% to 45% over the past two years.

China's steel industry is undergoing a period of structural reform, which is being enacted by the Government. The industry had previously built up excess capacity due to the abundance of capital. This resulted in very low steel margins and profitability. The steel industry became heavily indebted and, as a result, the Government forced the closure of outdated and illegal capacity. This has driven capacity utilisation higher and resulted in higher steel prices, driving profitability and making for a more sustainable industry. As utilisation rates increased, the mills have chased higher-grade iron ore (at the expense of the lower grade material) to ensure they can achieve maximum steel output. This has resulted in the discounts widening. Also, as coking coal prices have risen, the mills have had a preference for lower-impurity grade ores which use less coke in the mill.

The increased demand has benefitted many Australian miners, including BHP and Rio Tinto, which produce high-grade, low-impurity iron ore. The discount may narrow over time as the steel industry profitability in China normalises. However, it is likely to take some time, as the Government wants to ensure that profitability in the steel industry remains robust to repay debt.



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