Colonial First State

Market View – March 2017

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Summary

The Reserve Bank of Australia (RBA) Board met on 7 March 2017 and as widely expected, left the official cash rate on hold at 1.5%. There has been no change in the official cash rate since August 2016.

The strength in the housing market was reinforced by March month end figures from CoreLogic showing capital city home prices rose 1.4% in March and up 12.9% per year with prices rising in all eight capital cities in March.

The S&P/ASX 200 Accumulation Index rose by 3.3% during March. The Australian dollar was weaker over the month, with falls in bulk commodity prices and higher official interest rates in the US leading to the falls. The AUD ended the month down 0.4% against the USD at $US0.7628.

Global developed equity markets had a more muted performance in March, after strong gains since the election of US President Trump.

In the US, the US Federal Reserve Open Market Committee (FOMC) raised the official Fed Funds target rate to 0.75% to 1.00%, a lift of 25 basis points and was widely expected by financial markets.

In the UK, Prime Minister Theresa May officially activated Article 50 on 29 March 2017, starting the clock on the two-year timeframe to negotiate the terms of the exit and a new deal with the EU.

Australia

The Reserve Bank of Australia (RBA) Board met on 7 March 2017 and as widely expected, left the official cash rate on hold at 1.5%. There has been no change in the official cash rate since August 2016.

There was little changed in the statement with financial markets roughly pricing in a small chance of a hike or cut by the end of the year. Most forecasters including ourselves expect no change by the RBA for a prolonged period of time, well into 2018.

The Australian Prudential Regulation Authority (APRA) announced on 31 March 2017 it was "initiating additional supervisory measures to reinforce sounds residential mortgage lending practices in an environment of heightened risks". This announcement follows the RBA's focus on these heightened risks at its early March Board meeting and subsequent minutes, and as a result, new measures were widely expected by the market but the specific measures announced were not expected.

These additional measures communicated to authorised deposit-taking institutions (ADIs) build on those announced in December 2014, with the new measures including: limiting the flow of new interest-only lending to 30% of total new residential mortgage lending (currently closer to 40%), as well as placing strict internal limits on the volume of interest-only lending at loan-to-value ratios above 80%, and ensuring strong justification and scrutiny for those above 90%. ADIs must also ensure lending to investors is comfortably below the previously announced 10% growth limit, as well as review and ensure serviceability metrics for current conditions.

The strength in the housing market was reinforced by March month end figures from CoreLogic showing capital city home prices rose 1.4% in March and up 12.9% per year with prices rising in all eight capital cities in March. Over the year, prices rose the most in Sydney (+18.9% per year) and Melbourne (+15.9% per year) and fell in Darwin (-4.4% per year) and Perth (-4.7% per year).

The February labour market report showed the unemployment rate rose to 5.9% from 5.7%, with a loss of 6,400 jobs in the month. This headline figures hides the large job losses in part-time (-33,500) and gains in full-time (27,100), which is opposite to the trend of the past 12 months. The labour market continues to be a weak point for the Australian economy, holding down wages and inflation.

US

On 15 March 2017, the US Federal Reserve Open Market Committee (FOMC) raised the official Fed Funds target rate to 0.75% to 1.00%, a lift of 25 basis points and was widely expected by financial

markets. This follows on from the Fed's lift in rates at its December 2016 meeting.

After a very slow start to its monetary policy normalisation process, with one rate hike in both 2015 and 2016, this latest hike signals a new, more active phase for monetary policy.

There was little change to the accompanying statement, highlighting continued strengthening in the labour market and moderate expansion in economic growth.

The Fed's own expectation for the future path of monetary policy, the "dot plot" for 2017 remained at three rate hikes in total - so two more expected this year.

Other news flow in March centred on the expected policy decisions and legislative timetable of President Trump. Over the month, Speaker Paul Ryan pulled legislation to repeal the Affordable Care Act ("Obamacare") from the House of Representatives, when it became clear there lacked consensus among Republicans on the legislation. This has prompted President Trump and Congress to turn to tax reform as the next big legislative push.

The US debt ceiling was automatically reset on 16 March 2017 to the current actual level of debt outstanding of $US19.9trn. This follows the US Congress "suspending" the previous debt ceiling of $US18.1trn in November 2015 to 15 March 2017. Theoretically, this means the US Treasury has no legal authority to borrow more money. However in practice, it will employ a number of "extraordinary measures" to keep under the debt ceiling for a number of months, when Congress will either have to raise the debt ceiling, abolish the debt ceiling or suspend the debt ceiling.

Employment was stronger than expected in February, increasing by 235,000 (from a revised 238,000 in January). The unemployment rate fell to 4.7% (from 4.8%). Average hourly earnings rose to 2.8% per year, up from 2.6% per year. The labour force participation rate also rose, up to 63%, from 62.9%.

Inflation data for February revealed an increase of 0.1% and 2.7% per year, the strongest since March 2012. This was largely driven by commodity prices, while rent and medical expenses continue to strengthen. The Fed's preferred measure of inflation, the Core Personal Consumption Expenditure Index, rose in March by 0.2% and 1.8% per year.

Retail sales growth softened, rising 0.1% in February after a 0.6% gain in January. Retail sales have risen 5.7% per year. Consumer confidence, as measured by the conference board survey, rose sharply in the month, continuing its elevated levels post President Trump's election. The consumer confidence index rose to 125.6 in March, up from 116.1 in February and the highest level since December 2000.

Europe

The European Central Bank (ECB) met on 9 March 2017 with no change to policy. The Governing Council continues to expect the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of net asset purchases.

The ECB retains its monetary policy stance to "secure a sustained convergence of inflation rates towards levels below, but close to, 2% over the medium term" and "supports the steadily firming recovery of the euro economy", with sentiment indicators suggesting the "cyclical recovery may be gaining momentum".

Inflation retreated in the month, with the annual rate slipping to 1.5% per year in March, down from 2.0% per year in February.

In politics the focus remained on the French Presidential elections, with polling over the month indicating a tight race between Marine Le Pen and the centrist candidate Emmanuel Macron. Currently Marine Le Pen is polling at 25%, slightly down on February's numbers, with Macron on 24%. At this stage, Macron is expected to win in the second round on 7 May 2017. The first round of the vote is 23 April.

UK

The Bank of England (BoE) met on 16 March 2017 and as widely expected, held policy unchanged. There was one dissent at this meeting, with Kristin Forbes considering it appropriate to increase the Bank Rate by 25 basis points.

Prime Minister Theresa May officially activated Article 50 on 29 March 2017, starting the clock on the two-year timeframe to negotiate the terms of the exit and a new deal with the EU.

As expected, the UK wants to reach agreement on a comprehensive new deal with the EU-27 in parallel with the terms of the exit by March 2019.

The EU-27 opposes this view, as detailed by EU Council President Tusk. The next steps are expected by 27 April, when the EU Council will convene to determine the broad framework for the negotiations, with detailed negotiations to start in June.

NZ

The Reserve Bank of New Zealand (RBNZ) met on 23 March 2017 and left the official cash rate on hold at 1.75%, where it has been since November 2016.

The RBNZ highlighted the 4% fall in the trade-weighted exchange rate since February, noting it "is an encouraging move, but further depreciation is needed to achieve more balanced growth". On balance, monetary policy will remain accommodative for a considerable period of time and given the numerous uncertainties, "policy may need to adjust accordingly."

Q4 2016 GDP data was released, with growth weaker than expected at 0.4% per quarter and annual growth of 2.7% per year, down from 0.8% per quarter and 3.3% per year respectively.

Japan

The Bank of Japan (BoJ) met on 16 March 2017 and left its policies intact, with the Policy Balance Rate on hold at 0% and 10-year yield target at -0.10%.

The jobless rate fell to 2.8% in February, down from 3% as the labour market continues to tighten.

The final Q4 2016 GDP data was released, indicating growth of 0.3% per quarter and 1.6% per year. This was up from 1.1% per year in Q3 2016.

China

The Chinese government set their economic targets during the month, with economic growth target at "about 6.5%" in 2017, slightly lower than last year's 6.5% to 7% target. The inflation target has been set at 3%, fixed asset investment target at 9% and retail sales at 10%. There were reductions in the target of Total Social Financing credit growth to 12%, implying slower credit growth to 2016, and a tightening bias.

The People's Bank of China has been guiding market interest rates higher in recent months, as China's interbank liquidity has been tightened.

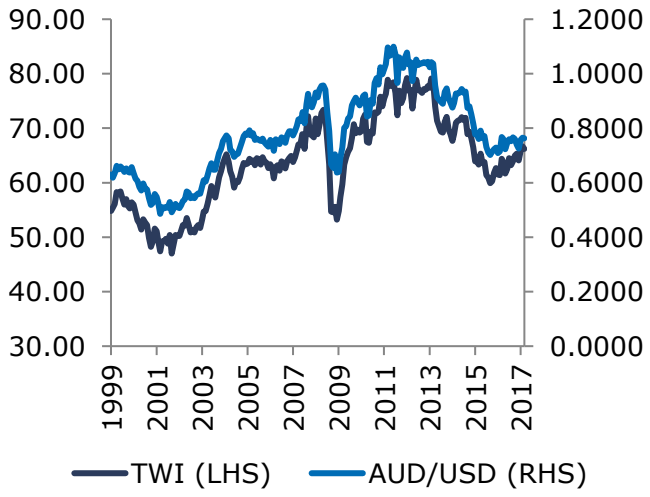
Inflation data released in March showed an easing of pressures that had built up at the start of the year. Inflation for the year to February was 0.8% per year, down from 2.5% per year to January, with food price inflation retreating. Producer Price Inflation strengthened again, rising to 7.8% per year, up from 6.9% per year and the fastest pace since September 2008.

Australian dollar

The Australian dollar was weaker over the month, with falls in bulk commodity prices and higher official interest rates in the US leading to the falls. The AUD ended the month down 0.4% against the USD at $US0.7628, with the AUD reaching as high as $US0.7731 and as low as $US0.7506.

The AUD was also weaker against the GBP (-1.7%), EUR (-1.1%) and the Yen (-1.6%), while it rose against the NZD, up 2.3%.

AUD WEAKENS WITH BULK COMMODITIES AND HIGHER US INTEREST RATES



Source: Bloomberg as at 31 March 2017

Commodities

Commodity prices were mixed in March, as oil prices retreated. Oil prices had been relatively steady in the three months prior to March, but fell this month with reports that OPEC compliance production cuts had slipped and there were further signs of an increase in US inventories.

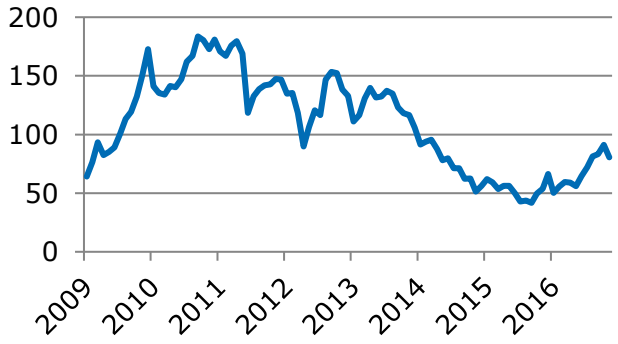
The price of West Texas Intermediate (WTI) Crude oil finished the month at $US50.6 per barrel, down 6.3%. The price of Brent Crude oil was down 5.8% to $US53.53 per barrel.

Gas prices reversed the move seen in February, with the US natural gas Henry Hub futures price up 23.3% to $US3.10 per million British Thermal Unit (MMBtu).

Iron ore prices retreated in the month after gaining ground since October 2016. The spot iron ore contract (Qingdao 62% Fe fines) fell by 11.9% to $US80.75/t in March, but is still up 49.6% over 12 months. There are still signs higher cost Chinese producers are switching to higher grade Australian iron ore, but the general expectation is the price of iron ore will continue to soften over 2017. Coal prices also weakened over the month.

Base metals were mixed with the London Metals Exchange (LME) Index down by 1.0%. Nickel was down 8.7% after strong gains in February. Elsewhere aluminium (+2.0%) and lead (+3.7%) gained momentum, while copper (-2.3%) and zinc (-1.9%) were weaker. The spot gold price was relatively flat in March, up just 0.1% to US$1,249.35/oz.

IRON ORE FALLS AFTER A STRONG RUN



Source: Bloomberg as at 31 March 2017

Australian shares

The S&P/ASX 200 Accumulation Index rose by 3.3% during March. Returns were broad based, with Utilities (+6.3%), Health Care (+5.5%), Consumer Staples (+5.4%), Consumer Discretionary (+5.0%), Energy (+4.8%), Industrials (+4.4%), IT (+4.1%) and Financials (+3.9%) all posting strong gains. Telcos edged +0.2% higher on a total return basis, buoyed by Telstra's interim dividend.

Utilities were led higher by strong performances from AGL Energy, APA Group and AusNet Services. Health Care was boosted by double-digit gains from Ansell and Sirtex Medical, while sector giant CSL had another strong month. The 'big four' banks performed well, as investors welcomed out-of-cycle rate rises. Elsewhere in the financial sector, Diversified Financials and Insurers both posted heathy gains. Materials endured another difficult month and suffered from heavy sell-offs in Resolute Mining, Fletcher Building and OZ Minerals.

Listed property

The S&P ASX 200 A-REIT index increased 0.6% in March in AUD terms, led by the office REIT sub-sector which gained 2.7%. Retail A-REITs lagged, reflecting concerns that online competitors may erode spending levels in the 'bricks and mortar' retail format.

The best performing A-REITs included Charter Hall Group (+4.9%) and GPT Group (+4.5%). Property management company Charter Hall Group continued its run of strong performance following a positive earnings result announcement in February. GPT Group didn't make any material news announcements, but continued to benefit from its high quality, diversified property portfolio, with a focus on the robust Sydney and Melbourne markets.

The worst performers included retail A-REIT Vicinity Centres (-2.1%) and diversified A-REIT Stockland (-1.7%), whose property portfolio includes a number of shopping centres. Both stocks were impacted by concerns about potential headwinds facing the retail sector.

Listed property markets offshore declined in March. The FTSE EPRA/NAREIT Developed Index (TR) dipped by-1.4% in US dollar terms. Hong Kong was the best performing market, with a gain of 3.2%. The worst performing market, Japan, finished the month -3.4% lower.

Global shares

Global developed equity markets had a more muted performance in March, after strong gains since the election of US President Trump. The failure to pass the repeal of the Affordable Care Act, with the vote being pulled from the House of Representatives led to questions within the market of the ability of President Trump to enact

his ambitious legislative agenda and ability to lift the potential economic growth rate in the US.

Global economic data, particularly in Europe continued to perform well, and equity markets had little reaction to the US Federal Reserve lifting the Fed Funds rate mid-month.

The MSCI World Index was up 0.8% in US dollar terms in the month and 1.2% in Australian dollar terms.

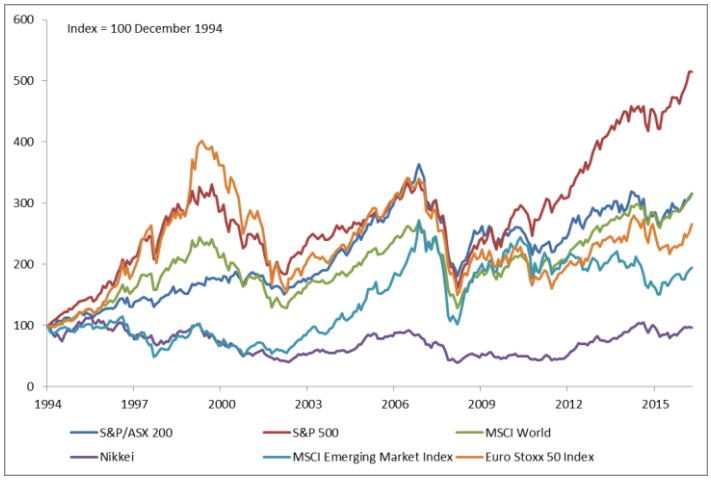
The VIX Index, a market estimate of future volatility of the S&P500 Index finished the month at 12.37 and had the lowest average quarter since Q4 2006, despite the rising geopolitical risks in the US.

In the US the S&P500 was flat, with the Dow Jones falling 0.7%, while the NASDAQ rose 1.5%, ending a strong run since the election of President Trump.

Equity markets in Europe performed well as geopolitical risks eased in the month. The outcome of the Dutch elections rejected the rise of populism while Chancellor Merkel's party had a sound result in a state election. In France, Emmanuel Macron continued to improve in the polls against Marine Le Penn. The large cap Euro Stoxx 50 Index rose +5.5%. The best performing major EU market was Spain (+9.5%). Italy (+8.4%), France (+5.4%) and Germany (+4.0%) all rose. The FTSE100 rose 0.8% with the activation of Article 50.

Asia markets were mixed, with the Japanese Nikkei 225 down 1.1%. The other major markets performed a bit better over the month with Hong Kong (+1.6%), Singapore (+2.5%), Korea (+3.3%) and Taiwan (+0.6%) all making gains.

EQUITY MARKETS MIXED IN MARCH – THE US TAKES A BREATHER



Source: Bloomberg as at 28 February 2017

Global emerging markets

Emerging market equities continued to recover their post-election losses, with the MSCI Emerging Market Index up 2.4% in USD terms and 2.8% in AUD terms.

An improving global economic environment and a weaker USD has helped emerging markets.

MSCI EM Latin America (+0.4%) and MSCI EM Asia ex Japan (+3.3%) both gained 3.3% over the month. This was despite falls in the Shanghai Composite Index, down 0.6% as monetary conditions continue to tighten.

The MSCI EM Europe, Middle East and Africa were down slightly with Russia, Poland and Hungary all weaker.

Global and Australian developed market fixed interest

Markets in the month were driven by central bank policy changes, specifically the rise in rates in the US, and by continued concerns around whether the Trump administration will be able to deliver on its pro-growth policy agenda.

Largely bond yields moved little over the month as a whole, but trading ranges intra-month reflected the continued volatility in markets. European elections and speculation around ECB monetary policy changes impacted European bonds and will continue to be a localised factor impacting German bund yields and peripheral markets.

Against this backdrop, bond yields in Europe moved the most in the month with 10-year German bunds up 12 bps. As noted above for the US, 10-year yields traded in a 29 bps range but ultimately were unchanged in the month. UK 10-year gilts were 1 bps down. Japanese bond yields rose 2 bps in the month as they continue to trade notably range bound.

Australian 10 year yields (whilst trading in a 30 bps range) ultimately ended the month roughly where they opened, with the 10-year yield down 2 bps to 2.70%.

Global credit

Global investment grade credit spreads reversed the recent tightening trend and moved marginally wider in the month reflecting the lack of conviction in the Trump administration. European political event risk remains a potential headwind (albeit recently reduced) for credit spreads. Investment grade credit continued to provide opportunity for investors with sustained robust supply in the month.

Specifically the Bloomberg Barclays Global Aggregate Corporate Index average spread 1 bps wider to 1.20%. US credit moved 2 bps wider, with the Bloomberg Barclays US Aggregate Corporate Index average spread closing at 1.12%. In Europe, the spread on the Bloomberg Barclays European Aggregate Corporate Index was 6 bps narrower to 1.18% on the back of the comments from the ECB. US high yield credit spreads reacted notably to the stalled growth potential in the US with the spread on the Bank of America Merrill Lynch Global High Yield index (BB-B) widening by 13 bps to 3.12%.

Australian credit spreads consistently ground tighter in the month, catching up with the global tightening of last month and largely ignoring the volatility in outright yields. Specifically the average spread on the Bloomberg Australian Corporate Index moved 6 bps tighter to 106 bps.

Want more information?

Please speak with your financial adviser or visit our website at **colonialfirststate.com.au**. Alternatively, you can call us on 13 13 36.