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Colonial First State Global Asset Management

Trade relations take centre stage

Market Watch

March 2018

Economics overview

- **US:** As expected, the Federal Reserve raised the target range for the federal funds rate by 25 basis points, to 1.5%-1.75%. At least two further interest rate hikes in the US are anticipated in the remainder of 2018.
- More importantly, interest rate forecasts for 2019 and 2020 were increased in light of the strengthening economic growth outlook.
- Q4 2017 GDP growth data was revised upwards, to 2.9% yoy.
- Growth forecasts were also upgraded to 2.7% yoy for 2018 (from 2.5%) and to 2.4% yoy for 2019 (from 2.1%). The improved outlook is being supported by a firmer labour market.
- In other news, President Trump announced proposed new tariffs on around 1,300 products imported from China. Steel and aluminium, for example, will have tariffs of 25% and 10% applied, respectively. The moves are designed to reduce the price competitiveness of imports and, in turn, help protect US industries. The US administration is also trying to reduce the trade deficit with China, which reached ~US$375 billion in 2017.
- US imports from other countries – including Australia and EU countries – are unaffected for now, although talks are continuing and future tariffs remain a possibility.

- **Australia:** The Reserve Bank of Australia (RBA) left interest rates unchanged, at 1.5%.
- In the statement that followed the interest rate announcement, the RBA noted that higher commodity prices and tight labour markets are likely to see inflation pick up in the next two years. For now, Australian inflation remains low, with both CPI and underlying inflation running below 2.0%.
- The RBA also expects the domestic economy to grow faster in 2018 than it did in 2017, supported by buoyant business spending and public infrastructure investment.
- The latest statistics indicated an increase in unemployment, to 5.6%. We note, however, that this series has been a little volatile recently and do not believe a clear trend is in place.

- **New Zealand:** Running at an annual pace of 1.6%, inflation in New Zealand appears to remain under control.
- In its latest policy statement, however, the Reserve Bank of New Zealand suggested that inflationary pressures are starting to build owing to rising commodity and agricultural prices.
- An increase in CPI could prompt the Bank to consider raising interest rates. Policy was last amended in November 2016, when interest rates were lowered to a record low of 1.75%.
- Data showed that New Zealand had a trade surplus in February, with exports NZ$217 million ahead of imports. Food and lumber sales to China were particularly strong.

- **Europe:** Attention shifted towards EU growth rates in the March quarter, with the Bundesbank suggesting that the German economy continues to perform well. German factory orders appear to remain buoyant and household demand is being supported by rising wages and employment.
- For now, the Eurozone refinancing rate remains at 0.0% and the European Central Bank's $30 billion/month QE program continues.
- In the UK, there was a significant moderation in inflation, with CPI falling to 2.7% (from 3.0%). This was the lowest inflation reading for seven months.
- UK unemployment declined to 4.3%, the lowest level since 1975. Wage growth was above expectations, providing further encouragement.
- The Bank of England left UK interest rates unchanged at 0.5%, but reiterated that tighter monetary will be required to keep inflation under control and close to the 2.0% target.
- Accordingly, markets priced in an increased likelihood of a rate hike as early as May 2018. Two of the nine-member Monetary Policy Committee have already called for a rate hike.

- **Asia:** China responded to President Trump's proposed import tariffs on Chinese goods by imposing tariffs of its own on products imported from the US.
- A 'trade war' is unlikely to appeal to either country, suggesting there is scope for negotiation before the proposals are implemented.
- Meanwhile, Chinese inflation rose to 2.9% yoy, its highest level since 2013. This was primarily due to an increase in food prices.
- Japanese inflation also picked up to 1.5% yoy, the highest level in nearly three years. In spite of the increase monetary policy was unchanged, with negative interest rates (-0.1%) and an ongoing ¥60 billion/month QE program.
- The Japanese labour market has been improving markedly. The unemployment rate dropped to 2.4% in January; a 25-year low.

Australian dollar

- The Australian dollar declined -2.0% against a trade-weighted basket of currencies.
- A stronger US dollar, lower commodity prices and rising global trade tensions weighed on the AUD/USD cross and contributed to Australian dollar underperformance relative to other major currencies.
- The moderating Australian interest rate outlook also did little to support sentiment.

Commodities

- Most commodity prices declined, as escalating trade tensions between the US and China created market uncertainty.
- Iron ore (-18.7%) and coking coal (-16.9%) prices fell sharply, reflecting surplus concerns in the Chinese steel market. The build-up in Chinese steel stockpiles was partly the result of an unexpected increase in China's steel output during January and February. Markets were also concerned that a slowing property sector in China could curb demand.
- Thermal coal prices fell -13.6%, as recent shortage concerns eased. Chinese policymakers have looked to boost thermal coal imports and domestic supply, particularly in response to high prices and rising demand from the coal-fired power sector.
- Oil prices bucked the downward trend, rising 5.7% in March, as OPEC and its allies continued their program to restrict supply.
- Base metals were broadly lower, with Aluminium (-7.5%), Copper (-3.9%), Zinc (-4.8%) and Lead (-4.7%) all declining.
- Gold prices edged 0.6% higher, in line with a slightly weaker US dollar, and as the prospect of a trade conflict prompted 'safe haven' demand.

Australian equities

- The Australian equity market delivered another lacklustre performance in March, with the S&P/ASX 200 Accumulation Index declining -3.8%.
- Bond proxy sectors, such as Real Estate and Utilities, were the best pest performers, only falling -0.2% and -0.8% respectively.
- For the second month in a row, Telecoms (-6.1%) was the worst performing sector. Telstra (-6.3%), TPG Telecom (-10.1%) and Vocus Group (-9.4%) dragged the sector down.
- Financials (-5.8%) struggled, with the ongoing banking Royal Commission increasing investor concerns. Several regional banks including Bank of Queensland (-13.2%) and Bendigo & Adelaide Bank (-10.4%) helped drag the sector lower, along with Perpetual (-10.3%) and Insurance Australia Group (-8.8%).
- The Materials sector fell -4.3%, with the majority of constituents generating negative returns. Heavyweights BHP Billiton (-5.2%) and Rio Tinto (-7.8%) both weighed significantly on performance as commodity prices declined through the month.
- Energy (-2.5%) also declined, despite rising oil and gas prices.

Listed property

- The S&P/ASX 200 A-REIT Index was little changed, returning 0.1%. Industrial A-REITs (2.7%) was again the best performing sub-sector. Office A-REITs (1.4%) also performed well, while Retail A-REITs (-1.2%) continued their underperformance from February to again be the weakest sub-sector. A-REIT performance was supported by falling Australian bond yields.
- The strongest performers were Iron Mountain (7.3%), Cromwell Group (6.5%), and Shopping Centres Australasia (4.0%). Iron Mountain continued its strategy of expanding into new geographies and businesses, with the acquisition of US art transportation company Artex Fine Arts Services.
- The weakest performers were Vicinity Centres (-2.8%), Westfield (-2.7%), and Charter Hall Group (-2.1%). Vicinity continues to be hurt by deteriorating sales metrics and structural and cyclical headwinds in the retail sector, while Westfield faces some lingering uncertainty around the Unibail takeover.
- Global property market returns were relatively strong, against a weak broader market. The FTSE EPRA/NAREIT Developed Index returned 2.5% in USD terms. In local currency terms, the UK (4.3%) was the best performer, while Hong Kong (-2.5%) was the worst.

Global equities

- Fears of a trade war between the US and China and speculation that the Trump administration is considering a crackdown on Chinese investments in the technology sector weighed on global equity markets. The MSCI World Index ended the month -2.1% lower in USD terms, completing the poorest March quarter return since the end of the GFC.
- Japanese stocks struggled (-2.7%). The yen rose to a 16-month high and fallout from the cronyism scandal undermined confidence in Prime Minister Abe's Government.
- The German DAX Index was one of the better performers, but was still down -1.9%. The German Social Democrats (SPD) endorsed their party leadership's decision to renew the Grand Coalition and delivered greater political stability.
- Emerging markets fell -1.8%. The MSCI EM Latin America Index was the strongest performer of the regional benchmarks (-0.9% in USD terms). Mexico performed relatively well (+0.8% in USD terms); the peso and stocks rallied on US President Trump's decision to exempt Mexico and Canada from new steel and aluminium tariffs. MSCI EMEA (-4.9%) lagged, with Greece down -9.9% in USD terms as its banks increased provisions for bad loans.

Global and Australian Fixed Interest

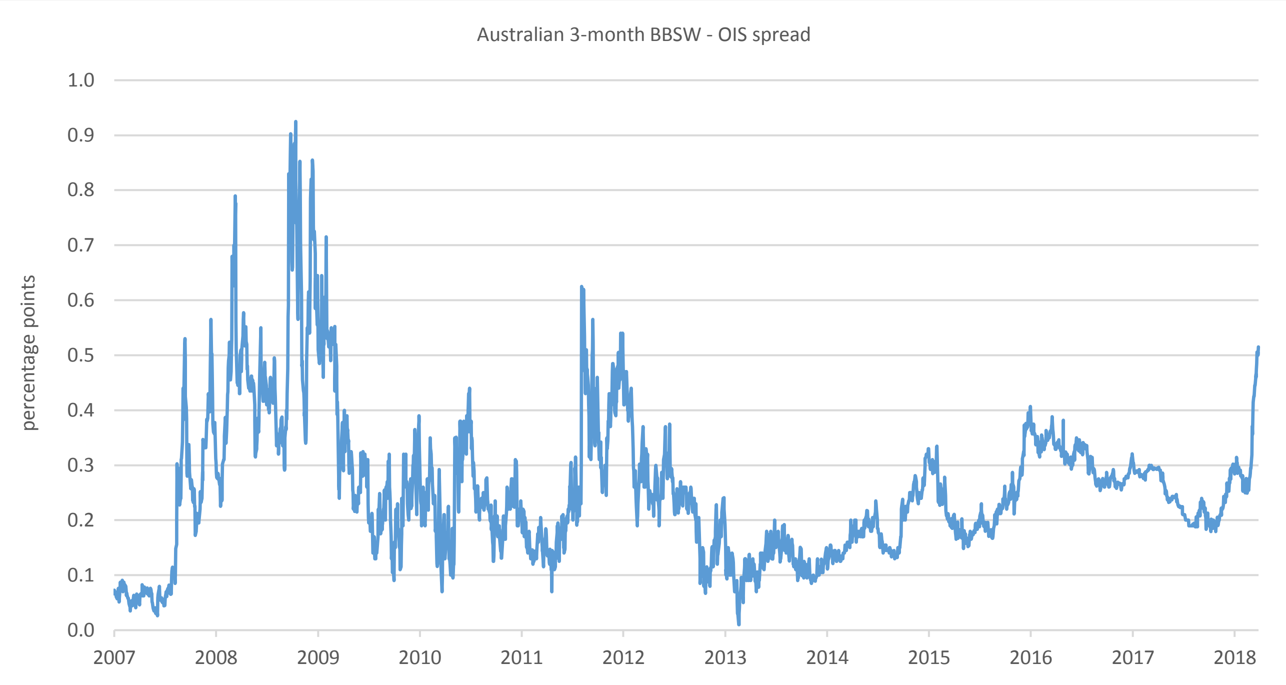
- Bond markets rallied, with generic 10-year government bond yields falling 12 bps in the US, 15 bps and 16 bps in the UK and Germany respectively, and 21 bps in Australia. Yields traded in unusually wide ranges (>20 bps) in most major bond markets
- LIBOR (the rate used to calculate interest payable on short-term loans that banks make to one another) increased in the US. Arguably the more interesting moveis the spread between LIBOR and Overnight Indexed Swap rates; commonly referred to as the 'TED' spread. In the US, 3-month TED spreads increased to their widest level since 2009. We examine the Australian equivalent spread in our 'Chart of the Month' on the following page.
- Australian government bonds continued to outperform US Treasuries, with the 10-yr yield differential declining to -14bps.
- Interestingly, the correlation between equity and bond markets continued to fall. During March, sessions where global equity markets sold off aggressively typically saw limited movement in bond yields. It will be interesting to see whether the historic correlation reasserts itself in the June quarter and beyond, or whether bonds and equities will continue to be driven by their own unique factors.

Global credit

- Credit spreads widened given rising short-term funding costs for corporates and associated equity market weakness.
- Investors' lower risk appetite was most clearly reflected in the US high yield market, where spreads widened significantly.
- As well as rising funding costs, short-term technical factors have been unsupportive of global credit. Significant issuance in early 2018 resulted in a sharp increase in supply, which coincided with a period of moderating demand. We have seen outflows from credit markets in Europe, for example, and Asian buyers appear to have stepped back from the market in recent weeks.
- In other news, the Q4 earnings reporting season in the US concluded with the last few remaining companies releasing their results. On the whole, earnings were in line with – or, in some cases, marginally above – consensus expectations and outlook statements highlighted general optimism. The financial implications of US corporate tax changes appear to have fully filtered through to consensus expectations and no longer appear to be an important driver of valuations.

In these bulletins, we aim to share interesting observations from global investment markets.

This month we examine the recent significant widening in spreads between BBSW (the rate used to calculate interest payable on short-term loans that Australian banks make to one another) and domestic cash rates. The 3-month spread blew out by more than 20 basis points in March alone, rising above 0.50%. This was the widest level since 2011.



Source: Bloomberg, to 31 March 2018

Rather than being an Australia-centric move, the rise in funding costs has been a global phenomenon. The key question for investors is whether the global moves are indicative of pressure in credit markets and bank funding. These concerns follow experience from mid-2007, when spreads widened significantly prior to the GFC the following year.

We do not believe the recent moves are credit-driven, but do acknowledge there is some risk that tighter funding conditions spill over and impact the Australian credit market more broadly. This is a risk that we are monitoring closely.

For now, it appears that the global moves are more technically driven. Some of the apparent drivers include the following:

- Ongoing monetary policy tightening by the US Federal Reserve – both higher cash rates and the unwinding of Quantitative Easing measures.
- Significant recent issuance of short-dated Treasuries after the US debt ceiling was raised in February 2018, to fund corporate tax cuts and higher government spending.
- Corporate bond sales in preparation for the US dollar repatriation of cash, following changes to the US corporation tax regime.
- Recent increase in longer-term Treasury yields, causing investors to move along the curve in pursuit of longer duration and higher carry.
- Investors rebalancing their equity exposure following the recent sell-off in share markets.

These drivers appear unlikely to go away in the foreseeable future, suggesting the spread could remain higher than average for the foreseeable future.

It is worth noting that higher cash and BBSW rates are likely to support performance in portfolios indexed to bank bills or BBSW, as their total returns should benefit from movements in the short end of the yield curve.

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