COLONIAL FIRST STATE

MARKET SUMMARY

June 2018

Taken from the CBA Global Markets Research report, 'June Month in Review'; first published 2 July 2018

Summary: Financial Markets in June

- The overall risk-off tone saw a small fall in bond yields. The US Federal Reserve was hawkish, lifting interest rate expectations, but the European Central Bank (ECB) was dovish, pushing back market timing of interest rate hikes.
- Credit spread widening remained the theme through June as trade tensions weighed on offshore markets.
- Global share markets were mixed in June with ASX outperforming, assisted by the weaker AUD.
- On the currency front, the Australian dollar trade weighted index fell -0.3% in June.
- Commodity prices were broadly unchanged in June in US$ terms.

Money Markets (Cash)

The Australian data was moderate in June, but didn't affect near-term RBA expectations. The Q1 GDP on 6 June was strong, printing at +1.0% in the quarter and +3.1% on the year (above expectations of +0.9% and 2.8% respectively). However, the more timely labour force data on 14 June showed only a +12K change in jobs and a fall in full-time jobs (-20.6K). The unemployment rate fell to 5.4%, but the underlying details were weaker.

On 29 June, the well-established slow-down in credit continued with a fall in the growth of Private Sector Credit to 0.2% m/m and 4.8% y/y.

The focus in June was on the Bank Bill Swap Rate (BBSW), a short-term money market benchmark interest rate. It is used to provide a reference interest rate for the pricing and revaluation of Australian dollar derivatives and securities and a general measure of funding costs in AUD. The June quarter-end saw a major increase in BBSW alone.

Australian and Global Fixed Interest

The bond market was playing second fiddle to the funding markets (detailed earlier) for headlines in June.

The US 10Y sold-off (yields rose) sharply in the first week of June, only to slowly rally back (yields fell) over the rest of the month. The yield has closed 1.5bp lower at 2.855%.

The Australian 10Y followed a similar course, selling off in the first week of the month only to rally back over the balance of the month. The Aus-US 10Y spread inverted a further 2.5bp to -22.5bp.

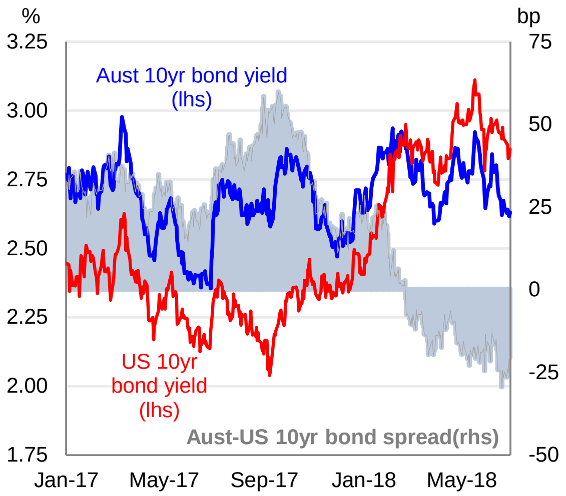
The rise in yields, globally, in early June was due to the improving circumstances in Italy and indications for hawkish movements from the US Federal Reserve and ECB. Locally, strong GDP data on 6 June (and the stronger partials in the lead-up) only added to the sell-off (higher-yields). The positive outcome to the US/North Korea summit also added to the early optimism.

However, the bond market then turned bullish (yields lower). The FOMC delivered a rate hike and an increase in the number of interest rate hikes expected on average this year. The ECB was on the Dovish side. Although the ECB announced the end of bond buying, the promise to keep rates unchanged "until at least summer 2019" was unexpected.

There was growing tension about a new round of US/China trade tariffs in the second part of June which also added to the bond rally globally.

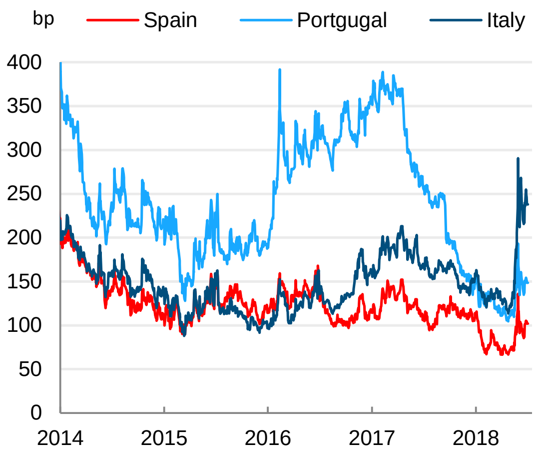
Along with the global factors, the Australian data turned weaker in the second half of June, with labour force in particular triggering yields to fall on 14 June.

Chart 1: Australian vs US 10Y bond yield



Source: Bloomberg, CBA

Chart 2: European spreads shopped widening



Source: Bloomberg, CBA

Global Credit Markets (Cash)

Credit spreads continued to drift wider in June with Financial and Corporate indices (>1 year) both +3 bps wider. The "Italian situation" was far less a concern in June than it was in May, though one or two sessions saw spikes. The main impact on global markets was trade tensions between US and China. Then for credit markets, there was also the matter of primary market indigestion coming in the second half of June via US$31bn of Mergers & Acquisition related issuance from Bayer and Walmart. In a historically slower month of the year, both US and European primary markets reached >100bn of their respective currencies.

For the first three weeks of the month crude oil prices were once again fairly steady, or even softer in Brent's case. But OPEC, US, Iran headlines led to a large price increase from 21 June. Brent rose 9% and WTI rose 13% in the last six trading days of the month, closing out month-to-date gains of +2% and +11% respectively. The stronger oil price is generally a net positive for the US High Yield sector, given this has been the main source of defaults over the last 3yrs.

Through the month, A$ credit spread widening again lagged the offshore moves (as usual) but the widening was universal across subsectors of Financials and Corporates.

Global Equity Markets

Global sharemarkets were mixed in June. Australian shares were notable outperformers, benefiting from a +2.8% fall in the Aussie dollar against the USD. Investor outflows from Asian emerging market equities and bonds also boosted Aussie shares. Central bank meetings served to highlight monetary policy divergences. Trade tensions between the US and China re-intensified. The much-anticipated US-North Korea summit took place in Singapore. And OPEC agreed to lift crude oil production in Vienna.

Major global sharemarkets began the month on the front foot as investors reacted positively to a strong US jobs report and robust ISM manufacturing data. The Dow Jones index rose by 2.8 %, the Nikkei 225 index increased by +2.4% and the S&P500 index rose +1.6% over the week to June 8. Twitter shares surged by +5.1% on June 5 after it was announced that the social media company would join the S&P500. Australian shares rose +0.9%, buoyed by the strongest quarterly (March) economic growth (GDP) report in six years. Resources shares outperformed.

Investor response to the Trump-Kim Summit was muted given the lack of detail around North Korea's denuclearisation plans. Markets were more concerned about the potential fall-out from the Trump Administration's latest list of US$50bn worth of 25% tariffs on Chinese imports (to be implemented July 6).

The Aussie sharemarket continued its relative outperformance against blue-chip US shares into the second week of the month, up by +0.8%. Aussie government bond yields fell, lifting interest-rate-sensitive telecom, utility and property-related shares. Only the tech-heavy Nasdaq index (up +1.3%) and German Dax index (up +1.9%) did better over that week.

In a week of central bank meetings, the US Federal Reserve lifted the Federal Funds rate by 0.25% to a 1.75% - 2.00% target range, maintaining its 'hawkish' policy stance. And the European Central Bank announced that it would halve its bond buying program to €15bn from September, before ending it completely in December. President Draghi signalled that interest rates would remain unchanged for at least another 12 months. The Bank of Japan announced no change to its ultra-accommodative policy.

The ASX200 index reached 10½-year highs on June 21, supported by a weakening Aussie dollar, which fell to 18-month lows of US73.42 cents. A 'relief rally' for oversold Aussie banks led Financials higher. The paring-back of interest rate expectations pushed bond yields lower, supporting REITs and infrastructure shares. The passing of the Turnbull government's income tax cuts plan boosted consumer discretionary stocks. Trade war (potential auto tariffs) and immigration policy worries weighed on US and European sharemarkets. EU member states eventually agreed on a package of measures to deal with the flow of migrants on June 29.

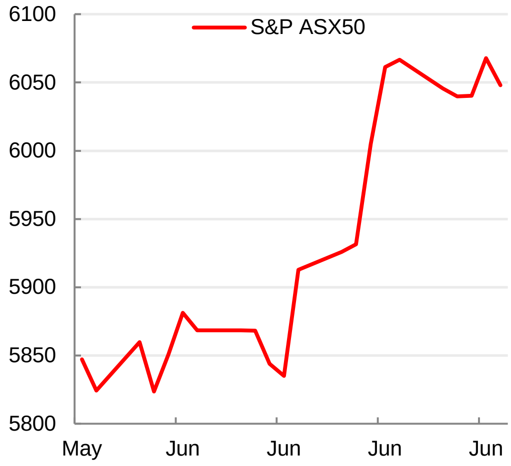
The oil price rose by +5.4% on June 22 as OPEC and Russia agreed to increase output by one million barrels per day (which after production constraints amounts to around 700,000 barrels per day) - less than had been expected by analysts.

Over June the US Dow Jones fell by -0.6%. The S&P 500 index rose by +0.5% and the Nasdaq lifted +0.9%. Across Europe the German Dax fell by -2.4% and the London FTSE was -0.5% lower. In Japan, the Nikkei rose by +0.5%.

In Australia, the ASX200 rose by +3.0% and the All Ordinaries increased by +2.7% during June. Over the June quarter, the ASX200 rose +7.6% and the All Ordinaries increased +7.2% – the best quarterly outcome since 2015. And in the financial year 2017/18, the ASX200 rose by +8.3% and the All Ordinaries increased +9.1%.

Only five of the 22 sub-industry sectors in Australia fell in June. Automobiles & Components (up +7.8%) was joint strongest performer, led by G.U.D Holdings (up +10.6%). Energy (also up +7.8%) increased due to the rising oil price. But Telstra (down -6.4%) dragged down Telecoms (down -5.8%). And larger companies outperformed with the ASX50 and ASX100 indexes up by +3.4% and +3.2%, respectively in June.

Chart 3: Larger companies surge…



Source: CommSec, Iress

Australian Dollar

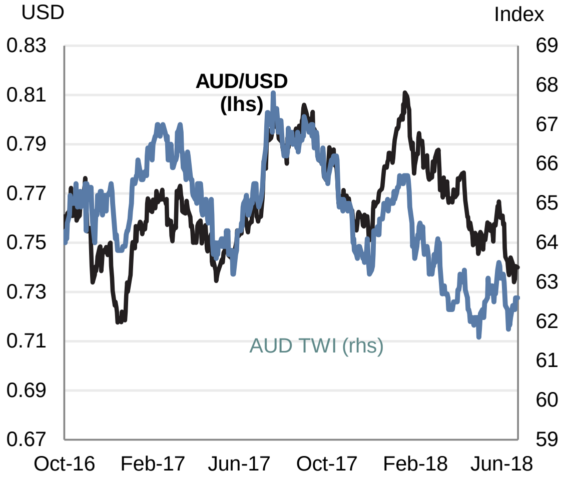
The Australian trade-weighted index fell by 0.3% in June. AUD/USD decreased by 2.2% in June, though most of the down-leg occurred in the second half of June.

AUD/USD rose to a high of 0.7677 in early June supported largely by positive Australian economic activity. Retail sales increased at solid monthly pace of 0.4% in April and annual real GDP growth stepped up to an above-trend 3.1% in Q1. The Q1 GDP outcome was a bit stronger than the latest RBA forecasts contained in the May Statement on Monetary Policy (2.75%/yr at Q2 2018).

AUD/USD fell sharply mid-way through the month largely because of external economic developments. Monetary policy divergence between the US Federal Reserve and other major central banks generated a broad based rally in USD.

Meanwhile, worries of more protectionist global trade policy benefited USD largely against global growth sensitive currencies like AUD. On 15 June, the US and China announced they will begin to collect additional duties on US$34bn worth of imports from each other on 6 July. The European Union (EU) also implemented in mid-June tariffs on some US products (like motorcycles and whiskey) in retaliation to US tariffs on steel and aluminium imports from the EU.

Chart 4: AUD vs USD and the TWI



Source: CBA, Bloomberg

Commodities

Commodity prices were broadly unchanged in June in US$ terms but gained 2% in A$ terms.

Mining commodity prices split neatly into lower metals prices and higher energy prices: Oil prices gained as OPEC production, more by accident than design, fell more than they planned. Steaming and coking coal prices continue to benefit from demand growth and a generally higher energy price context. Metals prices fell as some questions about global economic growth that were overlaid on growing supply for several metals.

Agri-commodity prices were unchanged overall in June. The unchanged prices for the group though again included much larger (offsetting) moves for several agri-commodities: Cotton prices fell 8%, partly reflecting more sober assessments of supply risk, and partly reflecting worries about US-China cotton trade. Wheat prices fell by 5% because the US Dollar rally weighed on prices that then prompted investors to sell hefty long positions.

Cattle prices rallied 7% because, both, the Australian Dollar fell, and US pastoral regions enjoyed relief from dry conditions.

Australian house prices

Taken from the CBA Global Markets Research report, 'CoreLogic Dwelling Prices – June 2018'; first published 2 July 2018.

Dwelling prices in the eight capital cities fell by 0.3% in the month of June. This was the ninth straight monthly fall. Dwelling prices are down 1.6% over the year and by 2.2% from their peak in September 2017.

Unit prices haven't fallen by as much as house prices this cycle and are still up 0.4% over the year. House prices are down 2.2% over the year and 2.7% from their peak. The outperformance of units of late is explained by the fact that they didn't rise as far during the upswing. They also tend to be a little cheaper than houses which is attractive from an affordability perspective, and located close to public transport.

The falls in overall dwelling prices in this cycle are being driven by falls in Sydney and Melbourne. Prices in Sydney are now down 4.8% from their peak in July 2017. Prices in Melbourne are off 2.0% from their peak in November 2017. A drop off in investor interest following the APRA rule changes which limited lending on an interest only basis kicked off the price falls.

Dwelling prices are also still falling in Darwin and Perth. Prices are down 21.9% and 11.4% from their respective peaks in these states. These falls occurred against a backdrop of falling mortgage interest rates and may have been a lot larger if the RBA had not been cutting rates.

Dwelling prices in Hobart continued to rise in June, up 0.3% in the month and 12.7% over the year. There has been an increase in people moving to Tasmania from the other states which is driving up dwelling prices in Hobart.

Looking ahead we expect dwelling prices to continue to drift lower. We expect prices to fall around 2½% this year with a similar sized fall next year as well. The declines expected to be concentrated in Sydney and Melbourne. All up we think Sydney prices could fall around 10% from peak to trough with prices falling a little less than this in Melbourne. While falls of this size are decent a 10% fall from peak to trough in Sydney would only take prices back to where they were in late 2016. Similarly, a 7½% fall in Melbourne prices would take them back to levels seen in late 2016.

Auction clearance rates are trending lower and are back at levels last seen in late 2012. The auction clearance rate was 58.7% in the week to 24 June. An auction clearance rate of less than 60% is generally considered to be signalling that it is a "buyers' market".

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