August 2018

Reproduced from the CBA Global Markets Research report, 'August Month in Review'; first published 4 September 2018

Summary: Financial Markets in August

- Bond markets had a moderate rally (yields lower), though there was little change in slope of the yield curve.
- The underlying drivers were generally geopolitical in nature. There was fear about the ongoing Trade Wars and the risk of issues in Emerging Markets spreading to a more global problem.
- There was a significant amount of A$ credit issuance with near record volumes.
- The record US sharemarket bull-market run extended to August and Aussie shares straddled 10½-year highs.
- The AUD fell reasonably sharply (down 3.07% against the USD and 2.05% on a Trade Weighted Index basis).
- Commodity prices were mixed in August with oil, aluminium and coking coal saw increases, while most other commodities finished slightly lower.

Money Markets (Cash)

The pressure evident in short-term funding markets in remained in August, lessened slightly but remains elevated compared to normal levels.

The Reserve Bank of Australia (RBA) is expected to be on hold for some time and there has been very little change in market pricing over August.

The data released in August was mixed. The Retail Sales printed strongly at +0.4%, above expectations of +0.3%. The Business Conditions index fell to 12 points, while the Confidence index rose to 7 points. The Consumer Confidence index fell 2.3% to 103.6 points. The Wage Price Index growth rate increased to 2.1% as expected. The labour Force result suggested that there were 3.9K jobs lost from the economy, but the unemployment rate dropped to 5.3% based on a fall in the participation rate to 65.5%.

There was some weakness late in the month via the Private Capital Expenditure print for the June quarter (-2.5%, against +0.6% expected). The Private Sector Credit print showed growth of +0.4% in the month and +4.4% in the year.

Australian and Global Fixed Interest

Bond markets have rallied moderately (yields lower) over August in most parts of the world. Economic data was largely a secondary consideration in August. Instead it was a collection of headlines regarding the ongoing US Trade Wars that were most likely to move the market, with a little help from Politics and Banks.

The general risk-off tone saw major markets rally (bond yields move lower). The US 10Y has rallied 10.5bp over August to 2.845%. The Australian 3Y has rallied 11.5bp to 1.97% over August. The 10Y has rallied 13.5bp to 2.52%. The slope flattened 2bp to 52.5bp.

There was plenty of carnage in the emerging markets however, with both Turkey and Argentina having periods of extreme market moves.

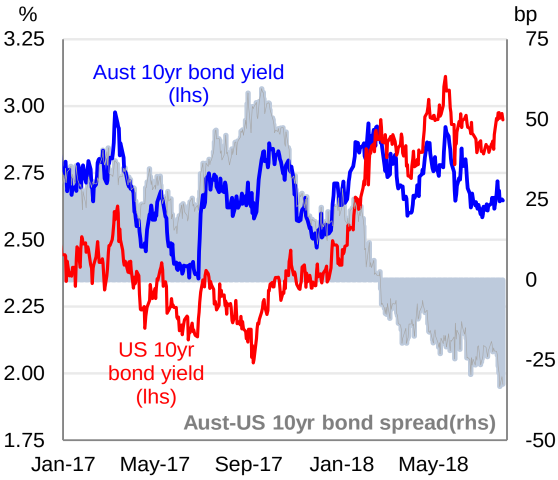
China and the US had looked like turning a corner in their trade war when negotiations resumed, but little tangible progress was made and there was a further $US16bn of goods subjected to tariffs, taking the total to $US50bn. The US and Mexico seemed to have formed the beginnings of an agreement, though Canada is seemingly still a long way from joining the agreement.

Australian politics also caused consternation as yet another Prime Minister was toppled by their own party. On 24 August Scott Morrison replaced Malcolm Turnbull as leader of the Liberal Party and, therefore, Prime Minister and a long and bruising period of instability. Markets took the instability poorly, with equities falling and bonds rallying (yields falling), though there was improvement when the final decision was announced.

Growth momentum in China moderated further in August. Key July economic data surprised to the downside. In particular, the sharp fall in infrastructure investment was a key drag in the Chinese domestic economy. July broad credit growth also came in slightly below market expectations. Despite a sharp rise in bank loan growth, shadow banking shrank again albeit at a slower pace.

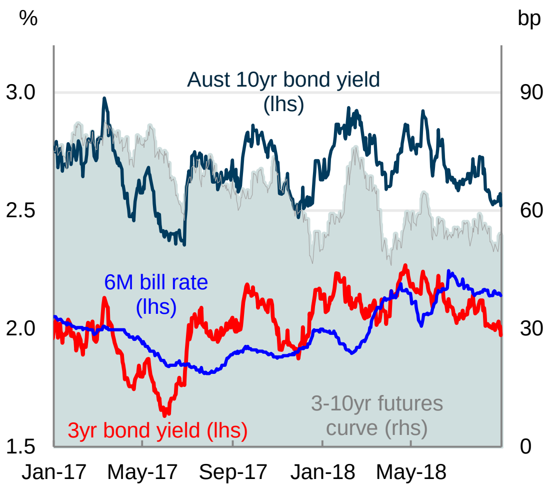
The PBoC has injected liquidity into the market. The PBoC has also re-introduced the counter-cyclical factor to slow down the yuan depreciation amid financial crisis in emerging markets. Policy makers called on 'more' proactive fiscal policy to support infrastructure projects. The personal income tax cuts are expected to come into force partially in Q4 2018 and fully in 2019. Overall, the near-term focus has shifted to support growth amid escalating trade frictions with the US.

Chart 1: Australian vs US 10Y bond yield



Source: Bloomberg, CBA

Chart 2 – Main Australian Yields



Global Credit Markets (Cash)

Once again, trade dominated headlines through the month with some progress made between the US and Mexico, while there appears to still be some hurdles in getting a deal done with their northern neighbour. Markets were hopeful Canada could be done as well, but not so. Trade negotiations with China around the middle of the month produced nothing meaningful in the way of progress. In this environment, Turkey and emerging market risk seemed to fade into the background and was having less of an influence on markets as the end of the month rolled around. But then Argentina reared up, well the Peso plunged, bringing EM back to the spotlight.

Sentiment was broadly constructive in equities and synthetic credit markets (CDS) for most of the month, however late developments (or lack thereof) in trade took a bit of the glow out of markets. Offshore cash credit markets were weighed down by technicals (supply), while A$ cash remained range bound despite a strong month of issuance, particularly the latter half. A$ Credit spreads moves were muted relative to offshore moves, which is normal behaviour.

Equity Markets

Global investors dealt with generally positive economic data and earnings results in August but also trade tensions and a crisis in Turkey. Aussie shares straddled 10½-year highs, despite political uncertainty, performing well during a solid corporate reporting season. Brexit uncertainty and currency strength weighed on the UK FTSE 100.

US shares began August positively, supported by healthy company earnings results, a lift in technology shares and strengthening jobs growth. The US Federal Reserve left interest rates unchanged but pointed to a "strong" economy for the first time since 2006. However, resources-focused sharemarkets like Australia's ASX200 index fell (down 0.7 %) on escalating trade tensions. The Trump Administration announced plans to lift its proposed tariffs on US$200 billion worth of Chinese imports from 10 % to 25 %.

Global shares generally fell over the first full week of August due to concerns over the crisis in Turkey. European sharemarkets were particularly hard hit given sizeable Eurozone bank exposures to Turkish debt (German Dax fell by 1.5 %). The ASX200 index performed well, lifting by 0.7 %, supported by the weaker Aussie dollar, rising iron ore prices and confirmation that the Reserve Bank would retain record low interest rates for a second successive year.

Into the middle of the month, reports that a Chinese trade delegation was being dispatched to Washington boosted investor sentiment on hopes for a resolution in the ongoing trade war. Chinese July economic activity data came in below consensus forecasts amid continued deleveraging and capacity constraints due to environmental controls. However, robust US retail spending signalled that the US economy remained on a solid footing.

US shares gained 1.4 % (Dow Jones) for the week ended August 17. And Aussie shares rose 1 % (ASX 200), however, German (Dax) shares lost 1.7 %, the UK FTSE fell 1.4 % and Japanese Nikkei shares fell 0.1 %.

The ASX200 index underperformed (-1.4 %) during the week ended August 24, as a leadership crisis engulfed the ruling Liberal Party. Scott Morrison was elected Prime Minister –and investors reacted favourably to the former Treasurer's elevation after the leadership ballot on August 24. In the US, the Dow Jones index rose by 0.5 %; the S&P500 index lifted 0.9 % and the Nasdaq surged 1.7 % as investors appeared unfazed by the legal turmoil engulfing the White House.

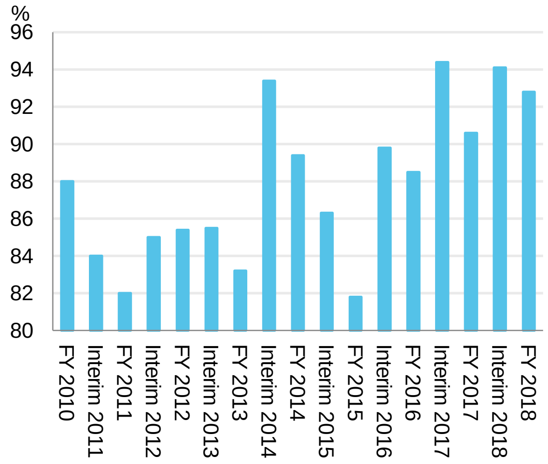
The S&P500 index marked its longest ever bull market run of 3,453 days during August. And the S&P500 index breached 2,900 points for the first time ever during trading on August 28, supported by news of a free trade deal between the US and Mexico. The Nasdaq index also reached an all-time record high above 8,000 points in late August.

The Australian listed corporate reporting season was positive. Results were broadly in-line with market expectations, led by the industrials sector, driven by better margins. Most companies have opted to return cash to shareholders with around 93 % producing a profit and 90 % electing to pay a dividend. Globally-focussed companies were amongst the key winners, keying off strong economic conditions.

The US Dow and the S&P 500 finished August up 2.2 percent and 3.0 percent respectively, with their best August gains since 2014. The Nasdaq Composite clinched its best August since 2000, ending the month up over 5.7 %. The Japanese Nikkei rose by 1.4 %. And the ASX200 rose by 0.6 %. But the German Dax lost 3.4 % and the London FTSE fell by 4.1 %.

Sixteen of the 22 sub-industry sectors in Australia rose in August. Consumer durables and apparel rose the most (up 26.4 %) from Pharmaceuticals & biotech (up 15.4 %). Materials recorded the biggest fall (down 5.3 %). The Small Ordinaries and the MidCap50 out-performed, both up by 2.2 %.

Chart 3- Most are making money: Proportion of ASX 200 companes producing a profit



Source: CommSec, Iress

Australian Dollar

The Australian trade-weighted index eased by 2% in August. AUD/USD was hit in the first half of August by the large sell-offs in select emerging market currencies. AUD typically eases when emerging market currencies fall because both Australia and emerging market economies are partly dependent on global growth expectations. AUD/USD showed little reaction to the RBA's August monetary policy statement. The RBA left interest rates unchanged at 1.50% in August, and made no major surprises in their commentary. Nevertheless, a delay in expectations for the start of the RBA's tightening cycle weighed on AUD. Australia's Wage Price Index rose by only 0.6% in Q2. The soft Q2 wages growth in Australia reinforced the view that the first move higher in the RBA's official cash rate is some time off. Helping support AUD in August was a small lift in commodity prices.

Table 1 – Australian dollar moves in August

AUSTRALIAN DOLLAR			
	End Jul	End Aug	M/M %
	31-Jul-18	31-Aug-18	Change
AUD-USD	0.7424	0.7189	-3.2
AUD-JPY	83.02	79.82	-3.9
AUD-EUR	0.6351	0.6197	-2.4
AUD-GBP	0.5657	0.5548	-1.9
AUD-CHF	0.7353	0.6967	-5.2
AUD-CAD	0.9656	0.9376	-2.9
AUD-NZD	1.0891	1.0868	-0.2
TWI	63.5	62.2	-2.0
Month High		0.7453	9-Aug-18
Month Low		0.7176	31-Aug-18

Source: Bloomberg, CBA

Source: CBA, Bloomberg

Commodities

Commodity prices were mixed in August. Oil, aluminium and coking coal saw increases, while most other commodities finished slightly lower. The mixed outcome partly reflects the topsy-turvy movements in the US dollar last month. For the most part, commodity prices managed to weather the storm of growth and contagion fears in emerging market economies prices and rising US-China trade tensions in August.

Oil prices rose in August on concerns that US sanctions against Iran could see 0.7-1% of global supply displaced from the market. The sanctions are expected to come into full effect by November 4, but Iranian oil exports have already declined as buyers have switched early. Falling US crude oil stockpiles also helped oil prices higher, particularly in the second half of August.

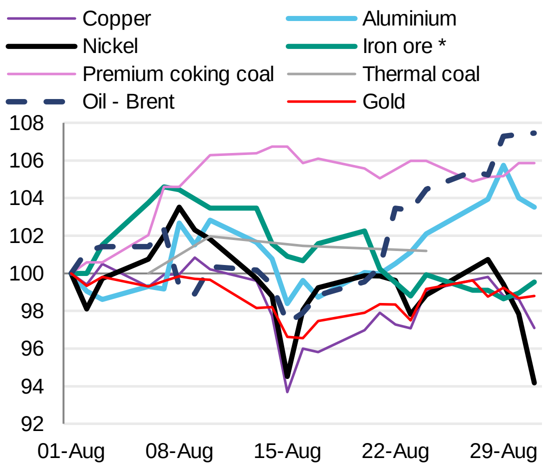
Aluminium prices rose strongly on increasing cost pressures as Chinese alumina prices lifted to the highest level since December. Alumina prices have lifted recently on supply constraints in Australia, reflecting a strike at Alcoa's refineries in Western Australia and maintenance at South32's Worsley refinery. Alcoa's refineries currently on strike account for ~7.5% of global alumina supply, while Worsley accounts for ~3.5% of global alumina output.

Iron ore prices started the month strongly, before sliding lower. Stronger steel prices, driven by concerns that Chinese policymakers will implement steel capacity cuts earlier than expected, initially helped iron ore prices higher. However, steel prices later fell as output cuts failed to eventuate as the market had feared. Iron ore prices declined as a result. High grade ore (65% Fe) premiums rose again in August as mills bought high-grade ore to boost productivity and lower emissions.

Stronger steel prices also prompted coking coal prices higher in early August. However, unlike iron ore, coking coal remained well bid in the second half of August. Expectations of more stringent checks and controls on China's coking coal production during the winter season helping coking coal prices.

Agri-commodity prices fell about 2% in US$ terms in August. As usual, there was considerable variation across the different commodities: Wool prices gained about 2% as structurally tight supply continued to see prices bid higher. Cotton prices fell 9% from very high levels, partly because investors cashed-in long futures trades; and wheat prices fell 6% when momentum stalled and then momentum investors sold their long positions.

Chart 4: Commodity price performance in August



Source: The Steel Index, Metals Bulletin, LME, COMEX, ICE,, Bloomberg, CBA estimates

Australian house prices

Taken from the CBA Global Markets Research report, 'CoreLogic Dwelling Prices – August 2018'; first published 4 September 2018.

Dwelling prices in the eight capital cities fell by 0.4% in August. This was the 11th straight monthly fall. Dwelling prices are now down 2.9% over the year and 3.1% from their peak in September 2017.

Table 1 shows the details of dwelling prices movements. The current downturn in dwelling prices is being driven by falls in Sydney, Melbourne and Perth. All three capital cities recorded falls in August. Prices in Sydney having been falling for a year now, Melbourne prices have been lower for nine months while Perth have been lower for the better part of four years.

There are a number of factors at work leading to lower dwelling prices. Reduced affordability, tighter lending standards, lower investor and foreign demand and higher inventory levels have collectively lowered demand for dwellings. The Auction clearance rate is currently below 60%, compared to above 70% a year ago. As a result sales volumes are falling. The Spring selling season is expected to be a big test for the housing market as will be headlines of higher mortgage rates.

In contrast, first home owner demand is rising. This is supporting demand for lower price dwellings as can be seen in the chart 7. Over the past twelve months, prices for the cheapest 25% of dwellings has risen by 1.2%, while the most expensive 25% of properties has fallen by 3.9%. The middle 50% has seen a rise of 0.7%. More expensive dwellings did perform better in prior years, but high debt-to-income ratios and tighter lending conditions are now weighing on this sector.

Sydney prices are now down 5.6% from the peak. The pace of decline is in line with previous cycles. We expect Sydney dwelling prices will continue to fall with a peak to trough decline of around 10%. This would take prices back to where they were in late 2016.

Melbourne dwelling prices are down 3.5% from their peak in November 2017. Like Sydney we expect further falls. Weaker demand, some tighter lending conditions and more supply of dwellings are impacting prices.

Perth prices also continue to fall. Prices peaked in June 2014 and are down 12.6% from this level. Prices had appeared to have stabilised earlier in the year, but have now started falling again. The strongest markets are Adelaide, with prices up 0.3% in August and 1% over the year and Hobart, which is 10.7% higher. The lower level of prices in these cities is supporting demand. Brisbane prices are up 0.9% for the year.

In terms of monetary policy, the RBA seem comfortable with how the downturn is playing out and have been at pains to point out that dwelling prices cannot rise forever. The main concern would be any impact on the consumer. However, the RBA appears to have softened their view on the risks around the consumer recently. Lower dwelling prices also means the RBA is in no hurry to raise rates. We expect the RBA to remain on hold till November 2019.

Table 1: CoreLogic Median Dwelling (Houses and Apartments) Prices – August 2018

	Sydney	Melbourne	Brisbane	Adelaide
Level $000s	855.3	703.2	493.9	438.5
%chg mth	-0.3	-0.6	-0.2	0.3
% ann chg	-5.6	-1.7	0.9	1.0
% chg from peak (peak)	-5.6 (July 17)	-3.5 (Nov 17)	na	na

	Perth	Hobart	Darwin	Canberra
Level $000s	454.0	437.3	439.7	593.9
%chg mth	-0.6	-0.1	0.1	0.5
% ann chg	-2.1	10.7	-4.0	2.3
% chg from peak (peak)	-12.6 (June 14)	na	-21.8 (May 14)	na

Chart 5 – Annual Dwelling Price Change

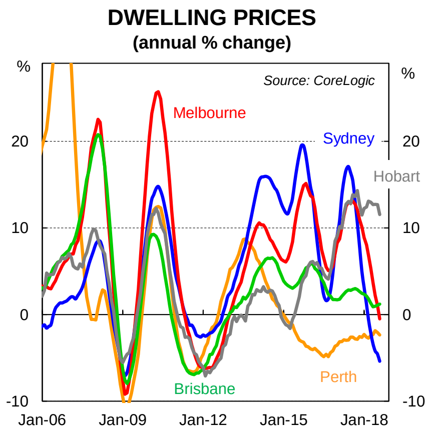


Chart 6 – Sales volumes

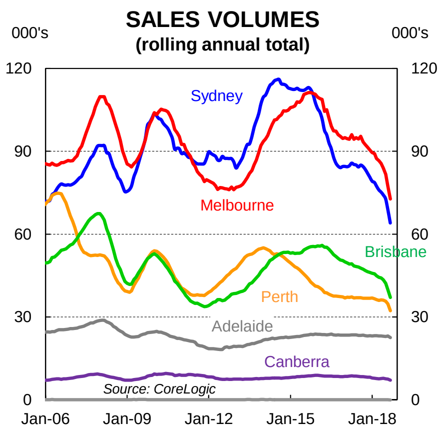
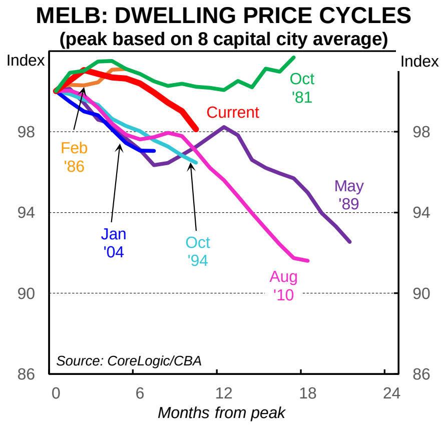


Chart 7 – Dwelling prices by quartiles



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