July 2018

Taken from the CBA Global Markets Research report, 'July Month in Review'; first published 1 August 2018

Summary: Financial Markets in July

- Bond markets were very little changed. Inflation data in Australia halted a rise in yields. The Bank of Japan (BoJ) tweaked monetary policy.
- Credit spreads drifted wider again in A$, but offshore a solid Q2 US reporting and light new primary issuance activity has halted widening.
- Global share markets rose in July, US and German indices outperformed the ASX200
- The Australian Trade Weighted Index rose by 1.4% in July on strength in Australian employment conditions and global economic activity.
- The CBA commodity price index decreased ~2.8% in July led by price falls in coking coal, industrial metals and oil.

Money Markets (Cash)

The pressure evident in short-term funding markets in June relented a little in July. There has been a clear tightening in spreads over July, but the spreads remain elevated in absolute terms.

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 July. The Labour Force data was stronger than expected on July 19, printing at +50.9K jobs and an unchanged 5.4% unemployment rate. The inflation data printed lower than anticipated at 0.4% q/q and 2.1% y/y, which was enough to put the slow the rise in yields. Overall, expectations of the RBA were very little changed in July.

Australian and Global Fixed Interest

There has been a very slow sell-off (rise) in Australian bonds over July.

There was a short-lived sell-off (yields higher) following the Labour Force data (which was very strong, +50.9K jobs) but couldn't sustain itself in the face of the weaker inflation print. Although headline inflation rose back into the band at 2.1% y/y it was under expectations for a 2.2% rise. Underlying inflation fell slightly to 1.9% on the year.

The US 10Y yield rose 9bp to 2.94% in July. The Aus-US bond yield spread went into negative territory (inverted) sharply at 10Y, dropping to a new low of -32bp in late July, before closing the month at 29bp inverted.

Trade wars remained on the agenda. On 6 July the first major wave of tariffs was activated in the China/US trade war. There were sporadic headlines over July regarding the possibility of further measures, but the market is becoming increasingly desensitised to these headlines.

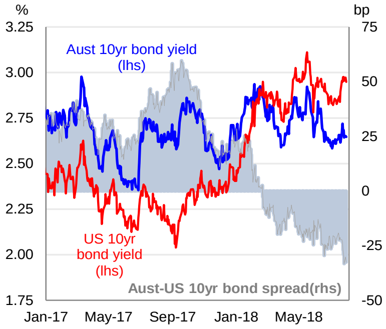
Markets spent the bulk of July closely watching developments in the funding markets and bond yields were able to, largely, stagnate.

There was a little bit more excitement on 31 July when the Bank of Japan (BoJ) reconfirmed their commitment to the 0% 10Y Japanese Government Bond (JGB) and added a commitment to keep rates low "for an extended period of time". The move was not the relaxation that markets had been anticipating and there was a large 5bp fall in JGB yields and a sharp 4bp fall in US 10Y bonds too.

Other than the BoJ inspired fall in yields on 31 July, international markets didn't have a great deal of influence on Australian over the month. For the record, European Sovereign spreads continued to tighten to German Bunds over July.

China's GDP eased to 6.7%/yr in Q2 2018, after three quarters of steady growth of 6.8%. The June economic data updates showed both industrial production and investment demand slowed in June amid continued deleveraging. However, a sharper than expected rebound in June retail sales alleviates some concerns over weakening consumption. Policy makers have shifted the tone towards an easing bias after a series of small measures. The People's Bank of China has loosened measures to support credit supply. The state council also said to ramp up proactive fiscal measures to support domestic demand.

Chart 1: Australian vs US 10Y bond yield



Source: Bloomberg, CBA

Global Credit Markets (Cash)

July was dominated by China / US trade tensions, however, Q2 reporting season also managed to provide a reminder to investors that the fundamentals remain solid. The last fortnight in US and Euro cash markets saw spreads halt the recent widening, and even begin to reverse some of it.

Offshore investors managed to put June's primary market indigestion behind them and in fact the post-quarter end reporting supply from US banks was absorbed without fuss. Truth be told, however, it was actually a light month in US$ markets, just US$58bn of Investment Grade issuance printing, which is the lightest July in 4 years and the lowest monthly volume YTD, by some distance. The light supply month firmed up the technical environment in US$, offering comfort to issuers, investors and dealers alike.

A$ Credit spreads lagged offshore price moves on the widening since February 2018, and it's therefore of little surprise to see A$ spreads lag on the stabilisation (and modest tightening seen recently). Credit spreads continued to drift wider in July.

Equity Markets

Global sharemarkets began the second half of the year positively, shrugging off escalating trade concerns. Instead, investors focused their attention on positive underlying fundamentals including solid US and European earnings results. US economic data releases were robust with the June quarter GDP growth rate of 4.1 % the strongest in four years. The IMF retained its global growth forecast of 3.9 % for this year, but acknowledged some concerns over the impact of tariffs on global growth.

Markets lifted in the first week of July despite thp Trump Administration's confirmed implementation of 25 % tariffs on US$34 billion (with a further US16 billion under review) worth of Chinese imported goods. Over the week to July 6, the Dow Jones index rose by 0.8 %; the S&P500 and German Dax indexes both rose 1.5 %; the Nasdaq was up 2.4 %; ASX200 index lifted 1.3 %; but the Nikkei was down 2.3 %.

The trade war intensified into the second week of July after China slapped retaliatory duties of 25 % on US imports. US President Trump responded by announcing a proposal to add tariffs to another US$200 billion worth of Chinese imports, subject to a consultation process.

On the data front, US and Chinese consumer and business inflation both lifted. Aussie consumer confidence rose to its highest level in 4½ years in July. The Bank of Canada increased interest rates by 0.25 % to 1.5 %. The Nikkei index rebounded by 3.7 %, the Dow Jones index increased by 2.3 %, but the ASX200 index edged lower by 0.1 %, but breached the 6,300 point level for the first time in 10½ years on July 9.

In the middle of the month China released its June quarter economic growth data. As expected, the annual GDP growth rate slowed by just 0.1 % to 6.7 %. The June activity data was mixed. A US$74 billion liquidity injection into the financial system by the People's Bank of China raised hopes that China would ease policy to support growth.

The ASX200 index outperformed during the week ended July 20, supported by lifting industrial, financial and consumer shares. Australia's unemployment rate fell to 5½ year lows of 5.37 %. The ASX lifted by 0.3 %, ahead of the Dow Jones index which was up by 0.2 % and the S&P500 index which was flat.

On July 26 President Trump said the US and EU had agreed to "work together toward zero tariffs" on non-auto industrial goods, while the EU would import more American natural gas and soybeans. And agriculture-focused shares, Deere and Caterpillar, gained on reports that the Trump Administration plans to offer US$12 billion in emergency aid to farmers hit by tariffs.

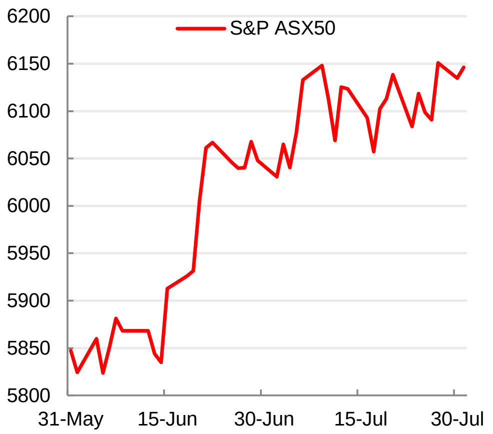
As at July 31, 60 % of the companies in the S&P 500 had reported their results with 82 % of companies reporting Earnings Per Share (EPS) growth above estimates. Shares of Facebook fell on July 26 by 19 % after disappointing revenue and declining monthly user numbers, wiping off $119 billion in market capitalisation. The Nasdaq index fell by 1.1 % over the week ended July 27. The Dow Jones was up by 1.6 % and the ASX200 index was up by 0.2 %.

Over July the US Dow Jones rose by 4.7 %. The S&P 500 index rose by 3.6 % and the Nasdaq lifted 2.2 %. Across Europe the German Dax rose by 4.1 % and the London FTSE was 1.5 %

higher. In Japan, the Nikkei rose by 1.1 %. The ASX200 rose by 1.4 % and the All Ordinaries increased by 1.2 %.

Fourteen of the 22 sub-industry sectors in Australia rose in July. Telecommunications (up by 7.9 %) was strongest performer, led by gains from TPG Telecom (up by 11.4 %). However, Consumer Durables & Apparel (down by 7.6 %) was the biggest laggard, with Michael Hill International down by 2.1 %. And larger companies outperformed with both the ASX50 and ASX100 indexes up by 1.6 %.

Chart 2: ASX large caps continued outperformance…



Source: CommSec, Iress

Australian Dollar

The Australian trade-weighted index rose by 1.4% in July. AUD/USD traded within a 0.7300-0.7500 range during the month despite Australia-US 2-year swap spreads reaching their most negative level in over 18 years

Favourable global economic activity and solid Australian employment conditions supported AUD/USD. The International Monetary Fund (IMF) made no changes to its global growth projections in its July 2018 World Economic Outlook (WEO) Update. The IMF still expects the world economy to grow at an above trend pace of 3.9% in 2018 and 2019. But the IMF warned that escalating and sustained trade actions could derail the global economic recovery.

In Australia, employment surged by 50.9k in June compared to the consensus estimate of 16.5k. The bulk of the jobs added in June were full-time positions (41.2k).

As was widely expected, the RBA left the cash rate at 1.50% and maintained a neutral policy stance on 3 July 2018. There was no material changes to the RBA's post-meeting statement. The RBA remained upbeat with respect to global and domestic economic conditions and reiterated "inflation is likely to remain low for some time".

In fact, inflation pressures in Australia were soft in Q2 2018 and weighed on AUD/USD. Headline inflation quickened at an annual pace of 2.1% in Q2 2018 from 1.9% the previous quarter. This was a bit below consensus expectations of 2.2%. Also, underlying inflation (average of trimmed mean and weighted median) remained below the RBA's 2-3% target at 1.9%.

Table 1 – Australian dollar moves in July

AUSTRALIAN DOLLAR			
	End Jun 29-Jun-18	End Jul 31-Jul-18	M/M % Change
AUD-USD	0.7405	0.7424	0.3
AUD-JPY	82.01	83.02	1.2
AUD-EUR	0.6337	0.6351	0.2
AUD-GBP	0.5607	0.5657	0.9
AUD-CHF	0.7334	0.7353	0.3
AUD-CAD	0.9725	0.9656	-0.7
AUD-NZD	1.0930	1.0891	-0.4
TWI	62.6	63.5	1.4
Month High		0.7484	9-Jul-18
Month Low		0.7311	2-Jul-18

Source: Bloomberg, CBA

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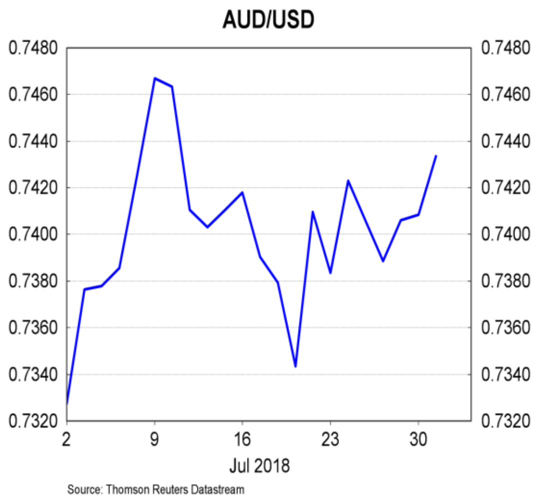
Chart 3: AUDUSD move in July



Commodities

Commodity prices finished mostly lower last month, led by coking coal. Iron ore and thermal were the exceptions, rising through July. The downward bias in commodity prices last month broadly reflected growing demand concerns as the US-China trade war deepened. While the tariffs in isolation are not expected to slow down growth in US or China, the potential disruptions to global supply chains and investment cycles are weighing on the global consumption outlook.

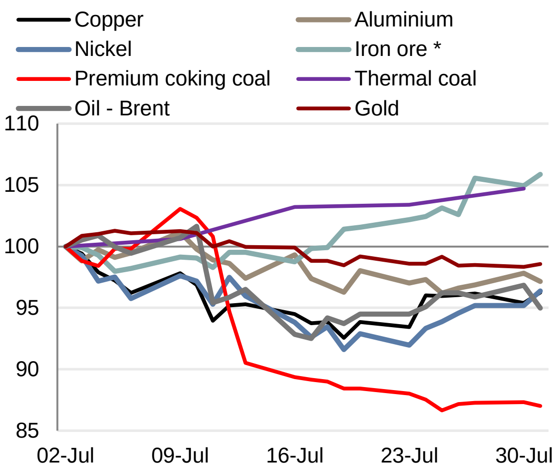
Coking coal prices declined in July as demand for imported coking coal in China fell on port restrictions and as the falling renminbi kept buyers at bay.

Iron ore prices lifted ~5% last month as stronger steel prices encouraged steel mills to boost output and procure more iron ore. The 62% Fe benchmark saw particular support later in the month as the high grade premium (65% Fe over 62% Fe) proved too high, eventually seeing renewed demand for 62% Fe ores. July saw the high grade premium peak at new highs as China's anti-pollution push creates a structural preference for high grade ore.

Thermal coal prices lifted in July as warm weather boosted demand in China. On the supply side, Chinese policy has proven a key driver, with environmental checks keeping domestic Chinese output subdued. Policymakers also re imposed coal import restrictions (in place since April) at southern and eastern ports, exacerbating a domestic supply shortage.

Oil prices edged lower in July on oversupply concerns. Those worries were triggered by sharply rising Saudi Arabian production after OPEC and Russia decided to add back more supply to balance oil markets in late June. Over compliance has reduced meaningfully from 44-62% in May to 19-29% in June and is expected to have fallen even lower in July. We expect OPEC and Russia to add ~0.75mb/d (~0.75% of global output), but that may be as high as ~1mb/d given how quickly Saudi Arabia is adding supply to the market.

Chart 4: Commodity price performance in July



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 – July 2018'; first published 1 August 2018.

Dwelling prices in the eight capital cities fell by 0.6% in July. This was the tenth straight monthly fall. Dwelling prices are now down 2.4% over the year and by 2.8% 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 and Melbourne. Both capital cities posted falls this month. Sydney prices have been falling for a year now and are down 5.4% from their peak in mid 2017. The pace of decline in Sydney dwelling prices is looking very similar to previous downturns (see dwelling price cycle chart). 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 2.9% from their peak in November 2017. The current decline was quite mild to begin with but is now gathering steam. Like Sydney, we expect further falls, with a peak to trough decline of around 8%. Strong population growth in Melbourne is supportive of dwelling prices. But the supply of housing has lifted too. A rise in the number of residential building approvals in recent months suggests that there will continue to be plenty of new supply over the next couple of years.

Perth dwelling prices are yet to bottom out with a solid 0.8% decline in the month of July. Prices are now 12.1% below the peak in mid 2014. Construction of new dwellings is slowing back towards more normal levels, vacancy rates have eased and the jobs market has improved. These developments are supportive of dwelling prices and we expect to soon see the bottom of the downturn in Perth.

The most expensive properties continue to be hardest hit in this cycle. The most expensive 25% of properties fell by 0.8% in the month and are down 3.7% from their peak. In contrast, the cheapest 25% of properties are still rising in value. The variation in prices changes between expensive and cheap properties is largest for Sydney and Melbourne. Prices for the most expensive properties grew much more quickly than cheaper properties over recent years, which helps explain the larger correction now.

In terms of monetary policy the RBA seem comfortable with how the downturn in the housing market is playing out so far. While house prices are falling in Sydney and Melbourne we haven't seen any slowdown in consumer spending in these States. Nationally, consumer spending looks on track to post a solid increase in Q2. A cooling housing market means there is no pressure for the RBA to raise interest rates. We expect the RBA to remain on the sidelines until at least Q1 2019.

Table 2: CoreLogic Median Dwelling (Houses and Apartments) Prices – July 2018

	Sydney	Melbourne	Brisbane	Adelaide
Level $000s	863.8	709.6	494.6	438.2
%chg mth	-0.6	-0.9	0.1	-0.1
% ann chg	-5.4	-0.5	1.2	0.7
% chg from peak (peak)	-5.4 (July 17)	-2.9 (Nov 17)	na	na

	Perth	Hobart	Darwin	Canberra
Level $000s	457.3	435.8	439.6	590.2
%chg mth	-0.8	0.0	0.4	0.2
% ann chg	-2.3	11.5	-6.2	2.4
% chg from peak (peak)	-12.1 (June 14)	na	-21.7 (Apr 13)	na

Chart 5 – Annual Dwelling Price Change

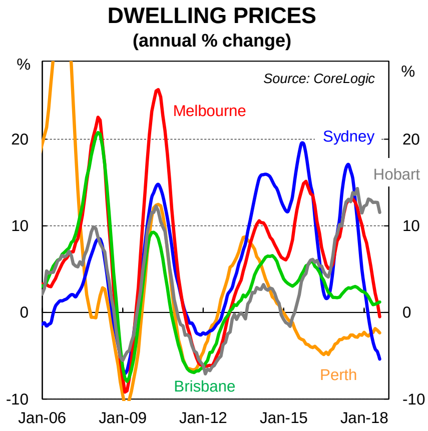


Chart 6 – Sydney Dwelling Price Cycles

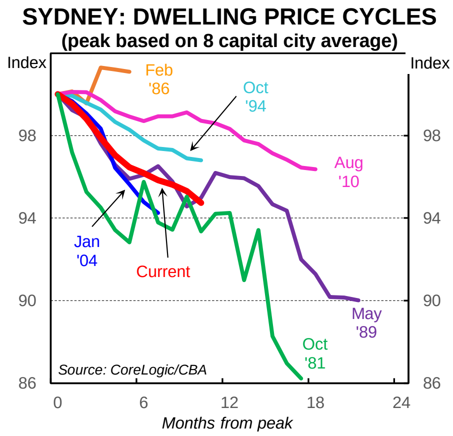


Chart 7 - Melbourne Dwelling Price Cycles