September 2018

Reproduced from the CBA Global Markets Research report, 'September Month in Review'; first published 2 October 2018

Summary: Financial Markets in September

- Bond markets had a decent sell off (yields rose).
- Another strong month of A$ credit issuance, the strongest September since 2009, spreads resilient.
- The Australian ASX200 fell by 1.8%.
- The US and Australia's major trade-weighted indexes ended September flat but AUD/USD was up 0.5%.

Geopolitical drivers persisted into month end with the US and China still squaring off over trade. Some progress was made with the US, Canada and Mexico coming to terms on their trade relationships, post month end. Emerging markets remain a concern and doubt is building over Italy's ability to pass its budget. The Fed abandoned use of the term 'accommodative' in its monthly statement and hiked rates as expected.

The US and China trade war dominated headlines during the month. The Trump administration slapped tariffs on US$200bn in Chinese goods. China responded with imposing tariffs on US$60bn of US products. The feud continued with China calling off trade talks with the US. China warned that it won't meet with US officials unless they stop threatening to expand tariffs. Trump has threatened that Chinese retaliation could see new duties on another US$267bn in Chinese imports. If Trump follows through on his threat, US tariffs would cover all the goods imported from China last year.

Brent crude traded above US$80/bl, its highest level in four years. The higher price is being driven by OPEC showing no urgency to boost output and loss of Iranian supply due to the looming US sanctions. Brent hit a high of US$82.20/bl. The OPEC and non-OPEC states, including top producer Russia, gathered in Algiers in late September for a meeting that ended with no formal recommendation for any additional supply boost to counter falling supply from Iran.

Talks between the EU and Britain soured during a summit in Salzburg over Brexit negotiations. Theresa May accused the EU of not treating the UK with respect and blamed EU leaders for the "impasse" in negotiations. The televised attack by Theresa May spooked the currency markets which saw the sterling fall 1.5% against the dollar, its biggest one day drop this year. European Council President Donald Tusk warned that the UK's proposal from Chequers "will have to be reworked and further negotiated" on issues such as the back stop for the Irish border and the post-Brexit economic relationship between UK and the EU.

Money Markets (Cash)

The pressure in short term funding markets eased slightly in September but remain very highly elevated compared to normal levels.

Once again, with the RBA firmly on the side-lines.

The data released in September was generally positive. There were no surprises from the RBA's 4 September meeting. The RBA left the cash rate at 1.50% and maintained a neutral policy stance. The RBA remained upbeat with respect to global and domestic economic conditions. In fact, Australian Q2 GDP grew more than expected in Q2 (actual: 0.9%, consensus: 0.7%).

On an annual basis, GDP expanded at an above - potential growth rate of 3.4% which is well ahead of RBA projections

The number of jobs rose by 44k in August, well above expectations for an 18k increase. The details were good with the majority of new jobs full - time (33.7k). Importantly, the underemployment rate fell to a four-year low of 8.1% in August, from 8.5% in May. Meanwhile, the language the RBA used in the Minutes to describe the labour market and the wages outlook appear more confident. The Minutes noted the "Australian labour market had continued to improve"

Australian and Global Fixed Interest

Bond markets have sold off (yields up) over the month on a strengthened macro backdrop, largely ignoring trade headlines which persisted for much of the month. Economic data was better than expected with US labour and wages data surprising versus consensus. Closer to home, we had better than expected GDP growth rates and also firming labour market conditions.

The general risk-on tone saw major markets sell off (bond yields rise). The US 10Y has sold off 20 bps over September to 3.061%. The

Australian 3Y has sold off 8 bps to 2.05% over September. The 10Y has sold off 15 bps to 2.69%. The slope steepened 7 bps to 60 bps.

China and the US continued to square off against each other on the trade front with President Trump threatening to go 'all in' and impose tariffs on all Chinese goods imported into the US. A further US$200bn of Chinese goods were hit with tariffs, with China retaliating with a more modest US$60bn of goods impact. China also walked away from the negotiating table, unwilling to return until Trump ceases his trade threats. With mid-term elections approaching in November progress is unlikely.

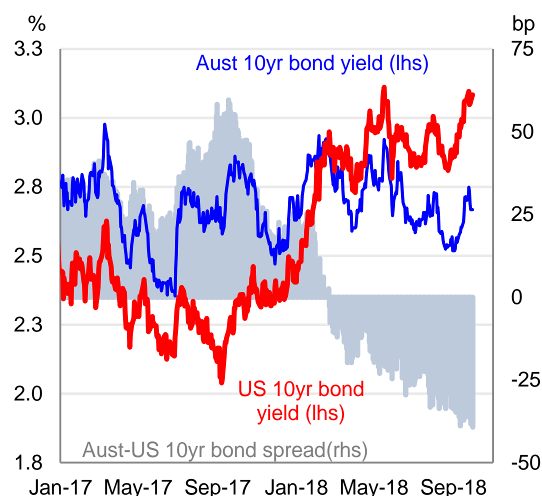
The US and Mexico formed the beginnings of an agreement, which Canada later joined (announced post month end).

The August Chinese economic data dump was mixed. Retail sales edged up slightly to 9%/yr, marginally better consensus expectations. Industrial production also inched higher by 0.1% to 6.1%/yr, in line with expectations. However, fixed asset investment growth continued to slow to only 5.3%/ytd –the slowest on records going back to 1999.

Chinese local government bond issuance jumped in August after top policy makers urged increased fiscal spending. By including strong local government bond issuance, annual credit growth increased marginally in August.

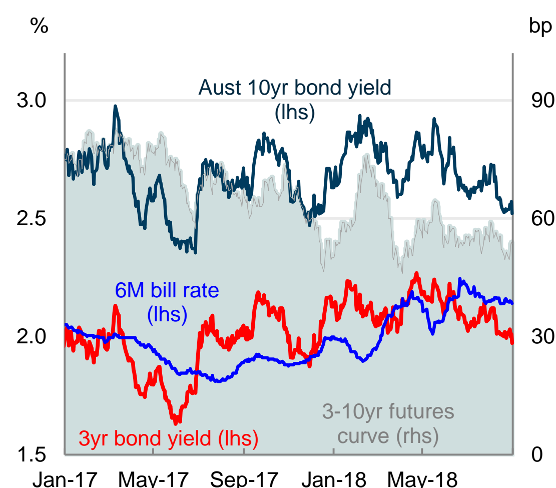
The main takeaways from the PBoC Q3 monetary policy meeting on 26 September is that the PBoC is aiming to maintain adequate liquidity in the interbank system to support fiscal stimulus and reasonable credit growth. On the currency front, the PBoC seems to anchor market expectations for the CNY around current levels.

Chart 1: Australian vs US 10Y bond yield



Source: Bloomberg, CBA

Chart 2 – Main Australian Yields



Global Credit Markets (Cash)

In terms of total return, the A$ credit index generated a total return of -0.11%, comprising a -0.11% return for Financials and -0.12% for Corporates. Underlying bond yields rose 6 – 14 bps across the curve, which dominated total return calculations. Spreads also were a negative contributor, printing +1.5 bps and +1.2 bps wider respectively over the month.

By credit rating, only the 'A' rated index delivered positive returns, +0.04%. Worst performing sectors were 'AA+' and 'AAA' with -0.29% and -0.27% respectively.

Equity Markets

The US-China trade war dominated investor attention over September. But investor sentiment wasn't overly dampened by the dispute with the US Dow Jones and S&P 500 indexes hitting record highs over the month. The US Federal Reserve lifted the federal funds rate as expected on September 26.

Global sharemarkets were weaker over the first week of the month. US economic news was generally positive. The ISM manufacturing index hit 14-year highs in August with the services gauge also higher in the month.

The US trade deficit rose by US$4.4 billion to US$50.1 billion in July with the deficit with China up 10%. And non-farm payrolls rose by 201,000 in August, ahead of expectation for a 191,000 lift in jobs. The measure of wages – average hourly

earnings – rose 2.9% over the year – the fastest rate in nine years.

In corporate news, on September 5, Facebook shares fell 2.3% with Twitter down 6.1% after executives from both companies testified before US Congress.

Global sharemarkets generally fell 2-3% in the first week of September although the US Dow fell just 0.2%.

In the second week of September, global sharemarkets clawed back some of the losses in the first week. Gains of up to 1.4% were recorded, except the out-performing Japanese Nikkei, up 3.5%. The US Dow rose for four straight days from September 11-14. Investors debated the wider implications on the US-China trade war. The Turkish central bank lifted rates by 625 points on September 13, lifting the lira by 4%. In the US, both the core measures of consumer and producer prices rose just 0.1% in August and retail sales also rose just 0.1%.

In the third week of September, both the US Dow Jones and S&P 500 indexes hit record highs. The Dow only fell on only one day between September 17 and 21. The gains came despite the US announcing 10% tariffs of US$200 billion of Chinese goods. China announced tariffs of 5-10% on US$60 billion of Chinese goods. The tariff increases were smaller than expected, providing hope that the trade dispute was nearing an end game. Global shares generally rose in the third week of the month except the US Nasdaq (-0.3%). But the Japanese Nikkei again out-performed, up by 3.5%.

In the final week of September global shares were mixed but the US Nasdaq out-performed as investors favoured technology stocks and the Japanese Nikkei rose again.

Global shares fell on September 24 after China cancelled planned trade talks with the US. But the oil price rose on the same day after OPEC oil ministers agreed not to lift output further. Energy stocks rose in response.

On September 26 the US Federal Reserve lifted the federal funds rate by 25 basis points to 2.00-2.25%. US shares fell on the day, dragged lower by banks, on the belief that the central bank target rate was getting close to "normal" or "neutral". Bank stocks tend to rise on expectations of higher rates with investors believing that it gives them greater scope to widen margins.

The US Dow and the S&P 500 finished September up 1.9 percent and 0.4% respectively. Despite gains late in September, the US Nasdaq Composite eased by 0.8%. The Japanese Nikkei rose by 5.5% in response to a weaker currency. The Australian ASX200 fell by 1.8%. In Europe, the German Dax fell by 0.9% while the London FTSE lifted by 1.0%.

Over the September quarter, US and Japanese markets out-performed. The Dow rose by 9% with the Nasdaq up 7.1%. Japan gained 8.1%. But the ASX 200 rose just 0.2% while the UK lost 1.7% and Germany lost 0.5%.

Only four of the 22 sub-industry sectors in Australia rose in September. Energy rose the most (up 4.0%) from Capital Goods (up 3.7%), Telecom (up 2.9%) and Materials (up 2.7%). Household and personal products fell the most (down 19.4%). The Small Ordinaries out-performed, down just 0.9%.

Over the September quarter, 10 sectors rose, led by Telecom (up 23.1%) and Commercial services & supplies (up 13.7%). But Autos & components fell by 8.1%. The MidCap 50 out-performed, up by 2.2% in the quarter.

Chart 3- Telecom back in favour: Telecom share index

Source: CommSec, Iress

Australian Dollar

Australia's trade-weighted index ended September flat but AUD/USD was up 0.5%.

AUD/USD fell to a low of 0.7085 (lowest level since February 2016) early in the month largely because US President Donald Trump insinuated in an interview of a potential trade issue with Japan. A wider Australian Q2 current account deficit (equivalent to about 2.9% of GDP), lower business confidence in August and the decision by two major Australian commercial banks to raise the interest rates on residential mortgages by 15-16bps also weighed on AUD.

There were no surprises from the RBA's 4 September meeting. The RBA left the cash rate at 1.50% and maintained a neutral policy stance. The RBA remained upbeat with respect to global and domestic economic conditions. In fact, Australian Q2 GDP grew more than expected in Q2 (actual: 0.9%, consensus: 0.7%). On an annual basis, GDP expanded at an above-potential growth rate of 3.4% which is well ahead of RBA projections. Table 1 – Australian dollar moves in September.

AUD/USD recovered mid-way though the month supported in part by a solid Australian August employment report and encouraging RBA September meeting Minutes.

The number of jobs rose by 44k in August, well above expectations for an 18k increase. The details were good with the majority of new jobs full-time (33.7k). Importantly, the underemployment rate fell to a four-year low of 8.1% in August, from 8.5% in May. Meanwhile, the language the RBA used in the Minutes to describe the labour market and the wages outlook appear more confident. The Minutes noted the "Australian labour market had continued to improve".

S&P's decision to reaffirm Australia's sovereign credit rating at AAA but change the outlook on the rating from 'negative' to 'stable' further underpinned AUD/USD. But AUD/USD paired back some of its gains in the last week of the month after the Chinese government cancelled trade talks with the US, raising concerns over an escalation in US-China trade tensions.

Table 1 – Australian dollar moves in August

AUSTRALIAN DOLLAR			
	End Aug	End Sep	M/M %
	31-Aug-18	28-Sep-18	Change
AUD-USD	0.7189	0.7224	0.5
AUD-JPY	79.82	82.13	2.9
AUD-EUR	0.6197	0.6224	0.4
AUD-GBP	0.5548	0.5544	-0.1
AUD-CHF	0.6967	0.7090	1.8
AUD-CAD	0.9376	0.9322	-0.6
AUD-NZD	1.0868	1.0910	0.4
TWI	62.2	62.2	0.0
Month High		0.7315	26-Sep-18
Month Low		0.7085	11-Sep-18

Source: Bloomberg, CBA

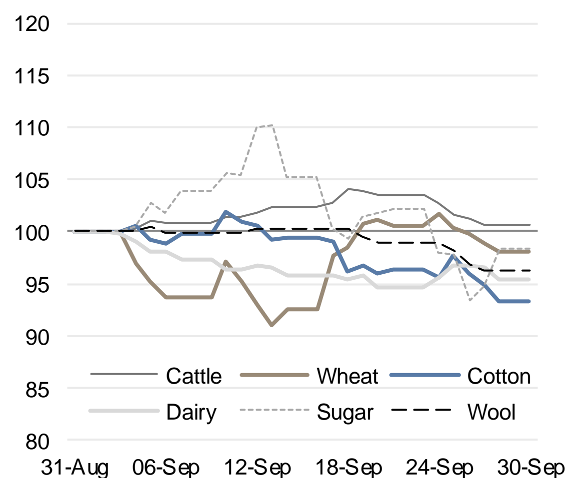
Source: CBA, Bloomberg

Commodities

Agri-commodity prices mostly fell during September. The major movers were:

- Wool prices, falling about 4%, but doing so from record highs;
- Cotton prices falling 7% from high levels, because the worst of prospective supply cuts are behind us; and
- Dairy prices falling 6% as seasonal pressures from the NZ supply weighed on prices.

Chart 4: Agri Commodity price performance in September



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 – September 2018'; first published 2 October 2018.

Dwelling prices in the eight capital cities fell by 0.6% in September. This was the 12th straight monthly fall. Dwelling prices are now down 3.7% over the year which coincides with the peak in September 2017.

Table 2 shows the details of dwelling price movements. The current downturn in dwelling prices is being driven by falls in Sydney, Melbourne, Perth and Darwin. Prices in Sydney have been falling for 12 months, Melbourne for ten months while Darwin has been falling since June 2017. Growth in Perth dwelling prices has also been in negative territory since June 2014.

In contrast, other capital cities have been holding up and recording positive price gains. Brisbane

dwelling prices rose by 0.2% in September and are up by 0.8% over the year. Rising net interstate migration is helping demand for housing. Prices in Hobart were up 0.4% in the month and 9.3% over the year, albeit off its recent strength. Strong population growth and relative housing affordability has helped the market in Hobart.

One key thematic playing out is the divergent performance of dwelling prices across the price spectrum. Prices for the most expensive 25% of homes are falling at a faster pace than the lower-middle quartiles. This divergence is contained largely to Sydney and Melbourne and mainly centred on houses and not units (Perth is the exception). In Sydney, the upper quartile of dwellings have fallen by 8.4% over the year, mid quartiles are down by5.3% and the lower quartile down by 3.3%. The figures in Melbourne are 6.6%, 1.4% and a gain of 4.1% respectively. This is not surprising as more expensive properties rose faster during the 2012-2017 boom. First home buyers are supporting the lower quartile.

Further declines are likely over the next year due to weaker investor demand, rising apartment supply, less foreign demand and more rational price expectations for would-be buyers. While we see price weakness as largely demand driven, the factor that is receiving the most attention at present is the impact of tighter lending standards on the supply of credit to would be dwelling buyers. Our price model shows a strong correlation between housing credit and dwelling prices, six months in advance. So any restriction on credit supply could put further pressure on dwelling prices.

Tighter lending standards are not new. The process has been underway for three years and has taken a number of different forms. The current focus is on household expenditure measures and if they are too low. More accurate expense collection could be lengthening the loan approval process and resulting in lower maximum borrowing amounts. The degree of tightening, though, depends on whether households were borrowing the maximum amount they were offered. Our view is they were not. This would soften the impact on credit growth from here and on the overall impact on dwelling prices. Of course there will be exceptions to this.

Limits on lending for very high debt-to-income loans have also been tightened. This tightening may be a factor behind the larger price falls for more expensive houses. More accurate collection of data showing a borrowers total debt could also impact loan sizes offered.

Housing credit growth has slowed marginally since the peak in dwelling prices twelve months ago, but not dramatically compared to previous cycles. This cycle is also different with credit growth starting at a much lower rate and the slowdown therefore looks less severe as Chart 8 shows. The RBA will be watching housing market development closely. To date we have not seen an impact on consumer spending in the states that have experienced dwelling price deflation (NSW and Victoria).

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

	Sydney	Melbourne	Brisbane	Adelaide
Level $000s	847.9	697.5	495.5	438.6
%chg mth	-0.6	-0.9	0.2	-0.2
% ann chg	-6.1	-3.4	0.8	0.7
% chg from peak (peak)	-6.2 (July 17)	-4.4 (Nov 17)	na	na

	Perth	Hobart	Darwin	Canberra
Level $000s	452.1	443.7	436.9	598.3
%chg mth	-0.6	0.4	-0.4	0.3
% ann chg	-2.8	9.3	-3.7	2.0
% chg from peak (peak)	-13.2 (June 14)	na	-22.1 (May 14)	na

Chart 5 – Annual Dwelling Price Change

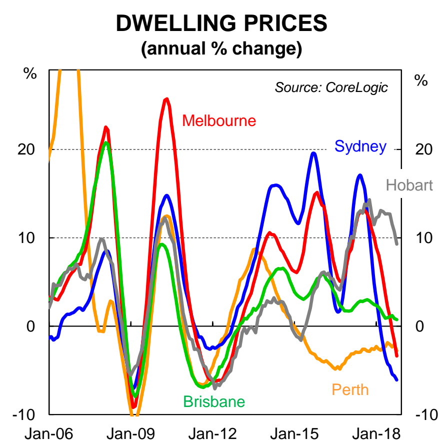


Chart 8 – Housing credit growth by cycles

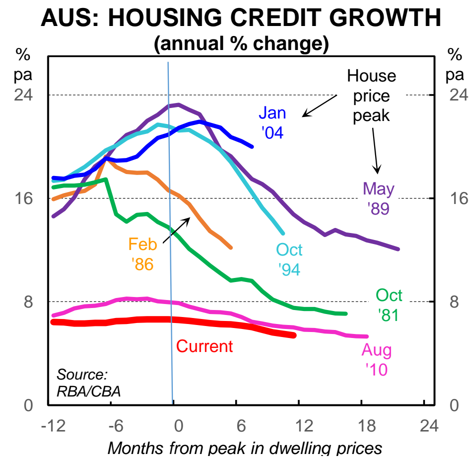


Chart 6 – Dwelling prices by quartiles

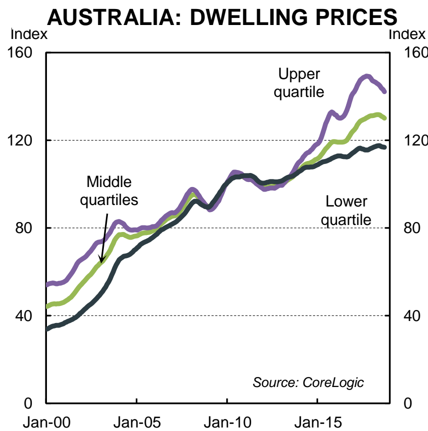
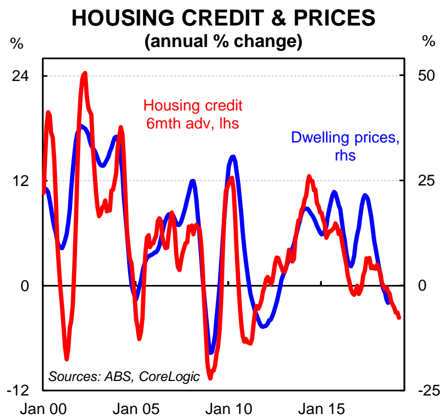


Chart 7 – Housing credit and prices



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