October 2018

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

Summary: Financial Markets in October

- There was a sharp sell-off in global shares in October.
- US Bond markets sold-off (yields rose) early in the month, but rallied back (yields fell) in the risk-off tone late in the month. Australian bond yields fell on the month.
- In credit markets, A$ cash credit was resilient to offshore widening.
- Australia's trade-weighted index eased by 0.5% in October. AUD was mixed against the cross rates.
- In commodity markets, iron ore and coking coal prices rose in October.

There was a large fall in equities this month and the risk-off tone from that move dominated bond markets. The US SPX accumulation was down 6.84% while the Australian version lost 6.05%. The falls were widespread, with the financial sector losing 5.96% and the materials index lost 5.18%.

The risk-off tone caused rallies (yields fell) in bond markets.

In an unusual occurrence there has been rises in commodity prices (other than oil) and falls in the AUD.

Offshore credit spreads succumbed to widening pressure with US$ and EUR Corporate spreads both widened over the month. A$ spreads across both corporates and financials however held firm.

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, the RBA remains completely on hold.

The Australian data this month was a continuation of themes that have been clear for a while now. The Labour Force result on 18 October was fairly strong, with a fall in the unemployment rate to 5.0%. There was a small rise in jobs of +5.6K, but a large fall in the participation rate to 65.4%.

However the October 31 CPI confirmed that the RBA is on their hands for a good period yet. The headline CPI rose only 0.4% on the quarter and 1.9% on the year, while the underlying CPI recorded 0.35% on the quarter and 1.75% on the year.

The difficult month in equity markets was felt in bond markets (see below) but largely didn't affect the Australian money market.

Australian and Global Fixed Interest

The US bond market actually sold-off over October (yields rose). Although the latter part of the month was full of doom and gloom in equity markets and a major bond rally (yields falling), there had been a strong sell-off in the first week of October. Overall, US yields finished marginally higher, with the US 2Y selling-off 4bp to 2.865 and the US 10Y sold-off 9bp to 3.14%.

The Australian market didn't match the early sell-off in the US, so when the late-month rally got going the Australian yields have rallied overall on the month. The Australian 3Y and 10Y both fell to 1.99% and 2.63% respectively.

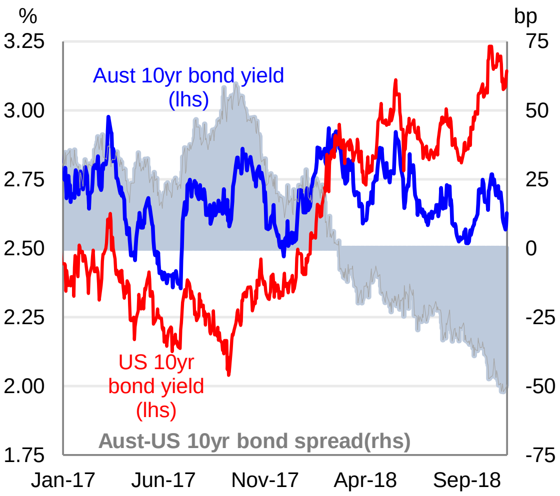
Not surprisingly, the Aus-US 10Y spread has continued to invert consistently and had reached -50bp at month-end (a 12bp inversion over the month).

For most of the month the bond markets were volatile, but largely at the whim of equity markets. The US S&P fell 6.9% over the month with a worse performance avoided thanks to a mild recovery in the last couple of days. The peak-to-trough loss was 11.4% between October 4 and October 30 (intraday).

The cause of the correction in US equities isn't entirely clear but is an amalgam of the following factors. In the US, the equity correction came after a major run-up in prices. The market has a growing fear that the FOMC will over-tighten and trigger a reversal of the US economy. The US-China Trade war has been simmering along in the background. Finally, the US mid-terms have been identified as a concern given the hyper-partisan US political situation.

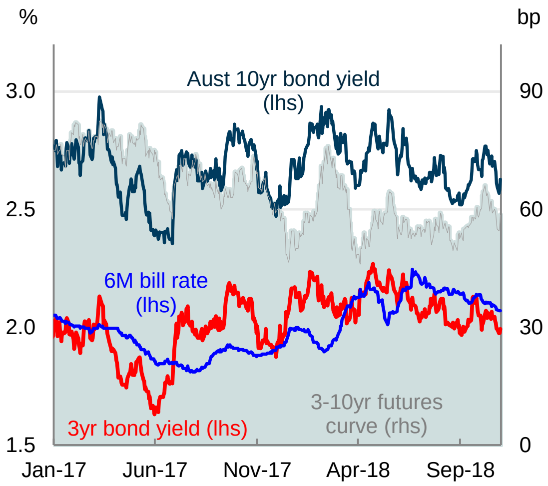
The global political situation continues to throw up market relevant stories. The global shift toward populism intensified in October with Brazil electing right-wing candidate Jair Bolsonaro and German Chancellor Merkel announcing she will not contest the next election. Brexit is closing in on the end-game with no clear resolution yet.

Chart 1: Australian vs US 10Y bond yield



Source: Bloomberg, CBA

Chart 2 – Main Australian Yields



Source: Bloomberg, CBA

Global Credit Markets (Cash)

October has always been a 'black cat' month for equity markets with many a crash through history occurring in the month that contains Halloween. October 2018 was not different. There was no new news flow per se, or any specific catalyst to trigger the sell-off, rather it was a culmination of themes and events coming together, causing investors to universally question the validity of valuations. Themes remain Brexit uncertainty, US vs China trade war, Italian fiscal policy, fear of Fed policy error, and upcoming US elections. The month was dominated by heightened volatility and a mini-correction across global stock markets, which saw key indices down 8% – 10%.

Offshore credit spreads succumbed to widening pressure with US$ and EUR Corporate spreads both +14 bps wider on the month. Financials offshore also widened some +7 bps and +13 bps across US$ and EUR respectively. Unlike the last equity volatility inspired spread widening in March earlier this year, this correction didn't come with a steady stream of primary activity. A saving grace that muffled spread widening pressure. A$ spreads across both corporates and financials however held firm, remaining resolutely unchanged over the month (plus or minus half a basis point).

Two thirds of US Q3'18 reporting season is behind us as at the end of October, with 65% S&P 500 companies now reported. Aggregate sales growth has reached just over 8.0% YoY, while aggregate earnings growth is north of 23.0% YoY. Most sectors at this stage are exhibiting solid sales and earnings growth momentum, however there is some doubt on growth sustainability without further stimulus - a contributor to recent market malaise.

Equity Markets

Global shares were sold down in October as investors reacted negatively to ongoing US-China trade tensions, rising US interest rates, slowing global growth and worse-than-expected September quarter earnings results of some US technology giants, prompting a reassessment of asset values.

Global sharemarkets began the month on the back foot. The new US-Mexico-Canada trade agreement was overshadowed by rising global bond yields. The US 10-year Treasury yield hit a 7-year high at 3.25 per cent during trading on October 5. The yield lifted by 17 basis points in the first week of October after US Federal Reserve Chairman Jerome Powell signalled that US interest rates "may go past neutral" – the point at which the rate neither helps nor hurts economic growth.

US economic data releases were mostly positive. The US unemployment rate fell to a 48-year low of 3.7 per cent and annual average hourly earnings rose by 2.8 per cent in September, supporting market expectations for a rate hike in December. Global sharemarkets generally fell by 1-3 per cent in the first week of October, led lower by the US Nasdaq (-3.2 per cent) on chipmaker cybersecurity concerns.

In the second week of October, risk sentiment deteriorated after the IMF downgraded its global growth forecasts for the first time in two years due to intensifying US-China trade tensions. And investors continued to fret about the impact of rising borrowing costs on economic activity and company profits. High-flying technology shares came under acute selling pressure after investors appeared to scale-back their expectations for continuing double-digit revenue growth in 2019.

Over the second week of October, US shares fell by 3.7-4.2 per cent. The Dow Jones lost 1,378 points and the Nasdaq fell by 409 points on October 10-11. Germany's DAX index was the worst performer, down by 4.9 per cent. The Japanese Nikkei (down 4.6 per cent), London FTSE (down 4.4 per cent) and Australia's ASX200 (down 4.7 per cent) indexes all declined.

During the third week of October, US investors focused on corporate earnings results. The Dow Jones surged by 548 points on October 16 after banks Morgan Stanley and Goldman Sachs' profits beat market expectations. Health care companies Johnson & Johnson and UnitedHealth also posted better-than-expected earnings. Global share markets finished the week broadly flat, but the Nasdaq fell 0.6 per cent and the ASX200 was up 0.6 per cent.

Global shares continued to fall in the final week of October following the release of the weakest annual Chinese economic growth data in 9½ years in the September quarter (6.5 per cent). But annualised US economic growth remained strong, up by 3.5 per cent in the September quarter.

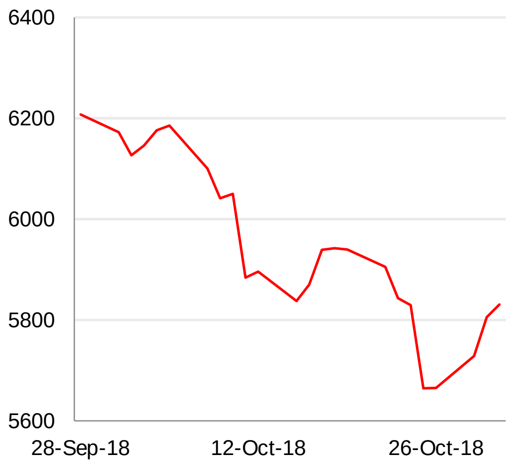
Sharemarket volatility increased amid mixed US earnings results. Over the week, global shares fell by 1.6-4.6 per cent. The ASX200 was the worst performer falling to its lowest level in 12 months on October 25. The Nasdaq fell by 329 points on October 24 – its biggest decline since November 24 2008.

To-date, almost half (48 per cent) of the companies in the US S&P 500 have reported earnings for the third quarter. Of these companies, 77 per cent have reported actual Earnings per Share above the mean estimate, which is above the five-year average of 71 per cent, according to FactSet.

In October, the US Dow Jones fell by 5.1 percent and the S&P 500 lost 6.9 per cent – its biggest monthly fall since September 2011. And the US Nasdaq Composite posted its worst monthly pullback since November 2008, down by 9.2 per cent. In Asia, Japan's Nikkei fell by 9.1 per cent and the Australian ASX200 fell by 6.1 per cent – the biggest monthly drop since August 2015. In Europe, the German Dax fell by 6.5 per cent and the London FTSE declined by 5.1 per cent.

All 22 sub-industry sectors in Australia fell in October. Media fell by the most (down 16.2 per cent) from Auto & Components (down 12.1 per cent). Transportation was the best performer (down 2.5 per cent). The Small Ordinaries underperformed, down by 9.7 per cent.

Chart 3- Under pressure: S&P/ASX200 Index since Sept 2018



Source: CommSec, Iress

Australian Dollar

Australia's trade-weighted index eased by 0.5% in October. AUD was mixed against the cross rates.

AUD/USD dropped by about 2 US cents in the first week of October. More evidence the RBA is in no rush to raise the cash rate weighed on AUD. In its post-meeting statement, the RBA highlighted that "credit conditions are tighter than they have been for some time". Softer global economic activity also weighed on AUD/USD. The global manufacturing PMI fell to near a two-year low in September. And the IMF cut its global GDP growth outlook in its October World Economic Outlook.

Also weighing on AUD was increased volatility in emerging market asset prices. The Australia-US two year interest rate spread decreased heavily to 90bps in early October, the most negative since October 1997.

AUD/USD consolidated in the middle of October before mounting a modest recovery. Firmer commodity prices helped AUD. Iron ore swaps increased almost continuously in October from

$US68 per ton at the start of the month to $US73 per ton by the end of October. But capping the recovery in AUD were falls in global equity markets.

Table 1 – Australian dollar moves - October

	AUSTRALIAN DOLLAR		
	End Sep 28-Sep-18	End Oct 31-Oct-18	M/M % Change
AUD-USD	0.7224	0.7073	-2.1
AUD-JPY	82.13	79.89	-2.7
AUD-EUR	0.6224	0.6253	0.5
AUD-GBP	0.5544	0.5541	-0.1
AUD-CHF	0.7090	0.7133	0.6
AUD-CAD	0.9322	0.9306	-0.2
AUD-NZD	1.0910	1.0854	-0.5
TWI	62.2	61.9	-0.5
Month High		0.7238	2-Oct-18
Month Low		0.7021	26-Oct-18

Source: Bloomberg, CBA

Commodities

Commodity prices finished mostly lower in October as demand concerns escalated on the back of falling global equity markets and rising US China trade tensions. A strengthening US dollar also weighed on commodity prices. Iron ore, coking coal and gold were notable exceptions.

Iron ore prices rose significantly through October as rising steel prices encouraged steel mills to purchase the steel making ingredient. Mills also looked towards medium grade ores (62% Fe) as higher grade ores (65% Fe) proved too expensive. Steel prices lifted on the back of actual and proposed cuts to steel output as policymakers look to ensure cleaner air. Steel mills in northern China are facing potential output restrictions from 1 October 2018 to 31 March 2019. While the restrictions are expected to be more severe and widespread than last year, authorities have chosen to be more selective in their capacity cuts. Mills, for instance, that have met environmental standards should be exempt from any curtailments. In any case, iron ore prices will likely be supported over the next few months, like they were when the cuts were enacted last year.

Stronger steel prices prompted coking coal prices higher too, but to a lesser extent than iron ore.

The lift in the gold price was a surprise last month as it occurred alongside a rise in the US dollar. Over the last year, the strengthening US dollar has proven the most accurate predictor of falling gold prices. We think safe haven demand, triggered mostly by falling equity markets, helped keep gold prices supported more than otherwise.

Oil prices declined over 10% in October as demand concerns combined with oversupply fears. Compliance with an accord to sideline 1.8% of global supply amongst OPEC and allies fell to its lowest level in September. That is expected to only have worsened in October. Saudi Arabia and Russia have led production higher, in hopes of offsetting lower production in Iran, Venezuela and Angola. US production also looked stronger than expected, with rising US crude oil stockpiles signalling oversupply.

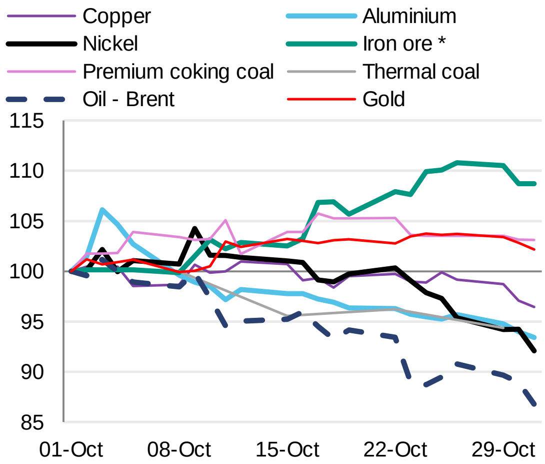
In the agriculture commodity space:

- Wool prices, continue to fall in October, by about 7%, but still leaves prices at very high levels;

- Cattle prices jumped 10% because rainfall in some dry weather stoked some optimism about more feed being available; and

- And, in the largest move, sugar prices jumped 27% as the worst fears of a heavily oversupplied market receded and investors exited their hefty short futures positions.

Chart 4: Commodity price performance in October



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 – October 2018'; first published 1 November 2018.

Dwelling prices in the eight capital cities fell by 0.6% in October. Prices have fallen for 12 straight months and are down 4.6% from their peak.

The falls were driven by Sydney (-0.7%), Melbourne (-0.7%) and Perth (-0.8%) (see table 2). Prices were flat or higher in the other capital cities. Hobart was the standout with prices up 0.9% in the month and 9.7% over the year. Sydney dwelling prices are now down 8.2% from their peak in mid-2017. This takes prices back to where they were in late 2016. Prices in Melbourne are down 4.9% from the peak in November 2017, taking prices back to early 2017 levels.

An interesting feature of the latest dwelling price decline is that prices are falling much faster at the top end of the market. Prices for the most expensive quarter of properties are down 6.9% from their peak late last year. Prices in the middle quartile are down 1.7% from their peak in April and the prices for the least expensive quartile are down just 0.9%. An increase in first home buyer activity is supporting the lower end of the market. The fact that cheaper property prices are falling less than the most expensive is a positive for consumer spending. Households in cheaper properties tend to have lower incomes and their spending is more sensitive to dwelling price falls.

Sales volumes have dropped off sharply since late last year. Sydney sales volumes are back at levels last seen in the early 1990s. This is weighing on state government stamp duty revenues. The auction clearance rate has fallen sharply too and is currently just under 50%.

The RBA don't seem too concerned about the falls in dwelling prices so far. The falls are occurring alongside a favourable backdrop of above trend global growth and a falling unemployment rate. In a speech earlier this week, Assistant Governor Michele Bullock suggested that steady falls in dwelling prices over a year or more, as we are currently experiencing, is preferable to a short and sharp drop. So far households are taking things in their stride and we haven't seen signs of a pullback in spending.

In terms of monetary policy, below target inflation and falling dwelling prices mean that the RBA is in no hurry to raise interest rates. CBA economists don't expect a rate rise until November 2019.

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

	Sydney	Melbourne	Brisbane
Level $000s	833.9	665.0	491.9
%chg mth	-0.7	-0.7	0.0
% ann chg	-7.4	-4.7	0.4
% chg from peak (peak)	-8.2 (July 17)	-4.9 (Nov 17)	na

	Adelaide	Perth	Hobart
Level $000s	431.6	451.1	445.7
%chg mth	0.2	-0.8	0.9
% ann chg	1.8	-3.3	9.7
% chg from peak (peak)	na	-14.2 (June 14)	na

	Darwin	Canberra	Capital cities
Level $000s	433.8	589.4	625.2
%chg mth	0.0	0.0	-0.6
% ann chg	-2.9	4.3	-4.6
% chg from peak (peak)	-23.6 (May 14)	na	-4.6 (Sep 17)

Chart 5 – Annual Dwelling Price Change

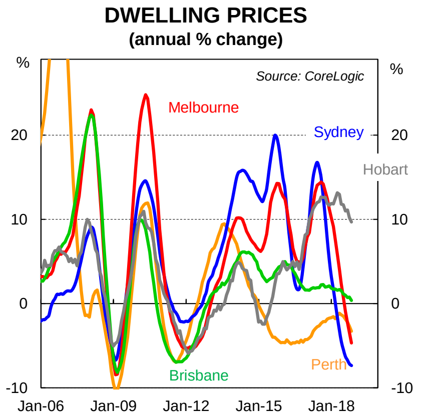


Chart 6 – Dwelling prices by quartiles

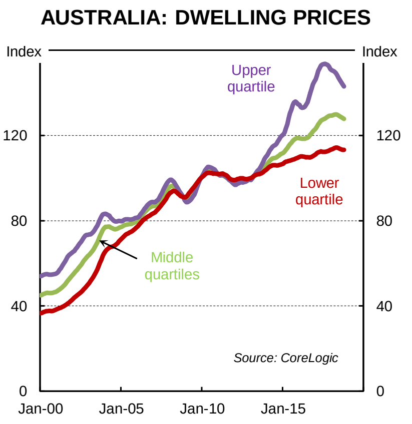
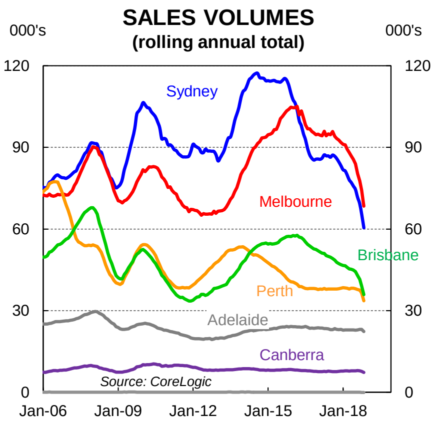


Chart 7 – Sales Volumes



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