December 2018

Taken from the CBA Global Markets Research report, 'December Month in Review'; first published on 2 January 2019

Summary: Financial Markets in December

- Money markets now pricing an RBA cut
- A strong risk off tone saw large rallies (falls in yields) in US and Australian bonds. There was widening in credit spreads.
- Falling underlying yields ensured credit finished the month with largely positive total returns.
- The US Dow Jones fell by 8.7 percent and the S&P 500 was down 9.2 per cent in December– their worst December performances since 1931 and biggest monthly losses since February 2009.

The dominant story of markets in December was the significant risk-off move - most obvious was the collapse in US equity prices. The US S&P Accumulation index was down 9.03% in December and that was after a strong recovery late in the month. (The intra-month result was as bad as -15% on 27 December.)

The Australian equity market outperformed massively by only falling 0.12% (accumulation) or 0.37%.

US bond markets reflected the risk-off tone and rallied strongly with yields falling.

On the FX side the risk-off move resulted in a 3.44% fall in the AUD against both the USD and an even larger fall of 4.11% on a trade-weighted basis.

The overall performance of commodities was relatively good (one reason that the materials sector could rise 5.29%) but oil prices fell sharply. Oil closed December at $US45.41 a barrel, down 10.84% on the month (and 40.6% from the peak in October).

Money Markets (Cash)

Market pricing for a move in cash rates by the Reserve Bank of Australia shifted course in December, as measured by Overnight Indexed Swap (OIS) rate. It's only small, but for most of December the OIS rates were pricing a small risk of a rate cut and by month end the priced expectation of a rate cut had risen to 40%. In November there was a 60% chance of a rate hike priced. At end-December there was a 40% chance of a rate cut.

The move was noteworthy that the market was pricing a risk of a rate cut despite the RBA insisting that they felt it was likely that the next move in rates was higher. The Australian data was on the weaker side in December, but not particularly poor. The weakest print was the GDP, which had been expected to rise 0.6% on the quarter but only managed 0.3%. That saw the annual rate fall to 2.8%. The labour force result was better, though not across the board. There were +37.0K jobs created but split as -6.4K full time and +43.4K part time. The unemployment rate ticked up to 5.1% on the back of an increase in the participation rate to 65.7%.

Australian and Global Fixed Interest

December was again a volatile month in markets.

While underlying economic developments were fairly typical, the US equity markets had two appalling weeks and one solid recovery very late in the month. Volatility was the order of the day, but the deterioration in sentiment was marked too. US bonds rallied each time there was a wobble in equity markets but have not sold-off far (if at all) in the late equity recovery.

There has also been major flattening pressure at some points.

The US 2Y yield closed the month at 2.52% which was a rally (fall in yields) of 29bp. The US 10Y closed the month at 2.725% which was a rally (fall in yields) of 29.5bp. The US curve finished the month unchanged, but had flattened abruptly mid-month (from 20bp to 10bp), only to recover back late in the month as the 2Y rallied to steepen the curve.

The second of the two large risk-off weeks appeared to be triggered (or at least worsened) by the FOMC's decision to raise interest rates on December 20.

The market behaved as if there were widespread fears the FOMC was making a policy mistake. The bond yields rallied (fell) on a rate rise that was only 75% priced.

The local market had to contend with a weak GDP result (only +0.3% compared to 0.6% expected) and a mixed labour force (+37K but a rise in unemployment to 5.1%). At the same time, the fall in house prices continues in multiple data series.

Australian rates have also rallied (yields fallen) and yield curve flattened. The 3Y physical bond has rallied 23.75bp to 1.8275%, while the 10Y physical has rallied 27.75bp to 2.3350%.

As well as the financial volatility there were still ongoing developments of a geopolitical nature that added to the movement in markets.

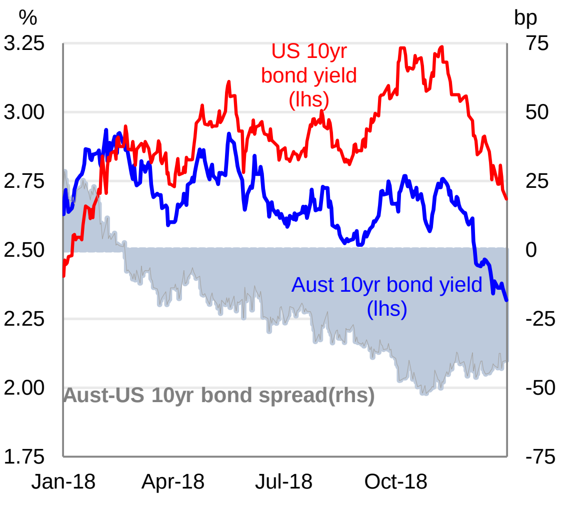
In Europe, UK Prime Minister May has failed to pass her Brexit legislation through parliament (yet). She survived a leadership challenge, but it seems very hard, at this point, to see how she can pass the deal she has made with the EU through the UK parliament. The other European story was the disagreement between the Italians and the EU about the Italian deficit. Negotiations were progressing well at month-end, but there was definite agreement yet.

In a side-meeting at the G20 Presidents Trump and Xi agreed a 90 day cease-fire in the US China trade war. The Chinese have also de-emphasised some of the elements of the Made in China 2025 policy that were causing the most consternation in the US. However, the overall stability of the Trump Presidency remained in question throughout the month as the potential Government Shutdown dominated news. The potential became the actual and the Government shut on 21 December. At month-end, there was no clear sign of the Government re-opening.

The Democrats take control of the House on 3 January following last November's election.

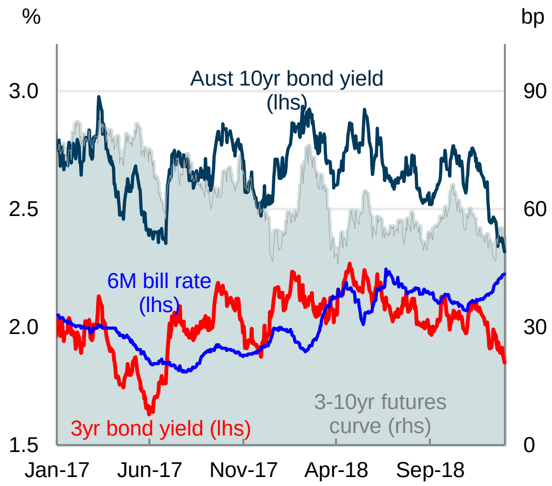
The Federal MYEFO on December 17 showed a significant fall in the budget deficit of $9bn and an improved trajectory across the forward estimates.

Chart 1: Australian vs US 10Y bond yield



Source: Bloomberg, CBA

Chart 2 – Main Australian Yields



Source: Bloomberg, CBA

Global Credit Markets (Cash)

The December G20 meeting ended on a positive note with China agreeing to purchase a substantial amount of products from the US in exchange for the US not to increase tariffs in January. Yet there is a general lack of confidence that a meaningful deal will be reached by the end of the agreed 90 day ceasefire period. The arrest of Huawei CEO on US criminal charges was seen by markets as a signal that the US will not back down easily from its campaign against Chinese tech firms seeking global dominance.

US non-farm payrolls expanded by only 155,000 in November vs consensus of 198,000, but growth in average hourly earnings met expectations of 3.1% YoY. Despite weak data and market jitters, the Fed hiked rates at the December FOMC meeting and signalled another two hikes in 2019. A deadlock over funding for the wall on the US/Mexico border led to a partial shutdown of the US Federal government with the second half of the month witnessing heightened market volatility with VIX spiking at 36%.

Offshore credit spreads continued to widen, although US$ spreads across Financials and Non-Financials were the standout underperformer, +18 bps wider on the month. EUR Financials and Non-Financials were +1 bps and +3 bps respectively wider. A$ credit spreads continued to feel widening pressure from offshore, +5 – 6 bps across Non-Financials and Financials. Liquidity was subdued because of the holiday season, which exacerbated widening pressures.

Equity Markets

In 2018, global sharemarkets recorded their worst annual performance since the Global Financial Crisis. The US Dow Jones (-5.6 per cent), S&P500 (-6.5 per cent) and Nasdaq (-3.9 per cent) indexes all fell. In Europe, Germany's Dax (-18.3 per cent) and the UK FTSE (-12.5 per cent) bourses tumbled. In Asia, Japan's Nikkei fell by 12.1 per cent and the Australian ASX200 index was down 6.9 per cent – its worst year since 2011 – led lower by Telecom (-17.4 per cent) and Banks (-15.5 per cent) shares.

Global equities commenced December positively after US President Donald Trump and Chinese President Xi Jinping agreed to a trade war truce at the G20 summit in Buenos Aires. However, investors quickly became pessimistic that a broader trade agreement would be secured in the 90-day period beginning January 1. Such a broader agreement is necessary to stop President Trump's threat to raise tariffs on US$200 billion worth of Chinese goods from 10 per cent to 25 per cent. And the arrest of Huawei's chief financial officer Meng Wanzhou in Canada on allegations that she violated US sanctions against Iran lowered market expectations for a trade deal even further. US sharemarkets were down by as much as 4.9 per cent in the first week of December, but the Aussie ASX200 index was up by 0.3 per cent.

In the second week of December concerns over the lingering US-China trade dispute, weaker Chinese economic activity data and continued flattening of the US Treasury yield curve (often considered a US recession indicator) dampened market sentiment. Reports that China was considering removing US car tariffs, watering down its 'Made in China 2025' plan and re-starting US soybeans purchases, failed to sway sceptical investors. US sharemarkets fell by up to 1.3 per cent. However, the London FTSE lifted by 1.0 per cent as British Prime Minister Theresa May survived a leadership challenge over her proposed Brexit deal.

The sell-off in global shares intensified during the third week of December. US shares fell by up to 8.4 per cent, led lower by the technology-focused Nasdaq index. And the US S&P500 index posted its worst weekly performance since August 2011, down by 7.1 per cent. The US Federal Reserve's interest rate hike, the looming US government shutdown over budget funding and weaker US company earnings forecasts dragged shares lower. The European Commission reached a deal with Italy over the 2019 budget. And China's annual Economic Work Conference signalled additional fiscal and monetary stimulus in 2019. But Germany's Dax (down 2.1 per cent), Japan's Nikkei (down 5.7 per cent), the UK FTSE (down 1.8 per cent) and the ASX200 (down 2.4 per cent) all fell.

There were more declines for global sharemarkets ahead of the Christmas holiday period as the US government was partially shutdown. US shares fell on Christmas Eve as investors were rattled after US Treasury Secretary Steven Mnuchin announced that he had called US bank heads in attempt to shore up confidence in the US financial system. US President Trump also tweeted that the US Federal Reserve was "raising interest rates too fast", increasing investor concerns that Federal Reserve chair Jerome Powell could potentially be fired. The S&P500 index fell by 2.7 per cent, dipping within a couple points of a bear-market correction. Japan's Nikkei index fell by 5 per cent on Christmas Day.

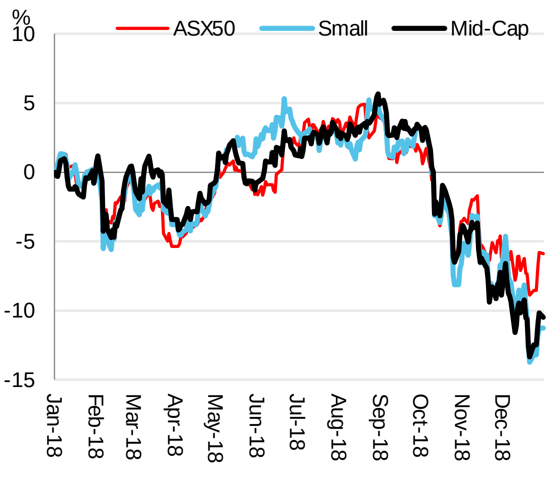
US sharemarkets, however, posted their biggest post-Christmas Day rally ever and best day in nearly a decade with the Dow Jones up by 1,086 points on Boxing Day – its largest one-day gain in history. The S&P500 (up 5.0 per cent) and the Nasdaq (up 5.8 per cent) both lifted by the most since March 2009. The S&P500 retailing index rose by 7.4 per cent after data released by Mastercard showed that holiday sales were the best in six years. Amazon shares rose 9.5 per cent after it sold a record number of items. The Dow rose by 449 points in its final three trading sessions of the year.

In December, the US Dow Jones fell by 8.7 percent and the S&P 500 was down 9.2 per cent – their worst December performances since 1931 and biggest monthly losses since February 2009. The US Nasdaq Composite declined by 9.5 per cent. In Asia, Japan's Nikkei fell by 10.5 per cent, but the Australian ASX200 fell by just 0.4 per cent. In Europe, both the German Dax (-6.2 per cent) and the London FTSE (-3.6 per cent) declined.

For the December quarter, the US S&P 500 and Nasdaq dropped 14.0 per cent and 17.5 per cent, respectively, their worst quarterly performances since the fourth quarter of 2008. The Dow Jones recorded its worst period since the first quarter of 2009, falling 11.8 percent. The ASX200 was down by 9.0 per cent.

In December, seven of Australia's 22 sub-industry sectors posted gains. The Materials sector rose most (up 5.3 per cent) from the Pharmaceutical & Biotech sector (up 3.9 per cent). But the Media sector fell by 10.9 per cent and Automobile & Components fell by 9.6 per cent. The ASX50 index was up by 0.3 per cent, while the Small Ordinaries fell by 4.5 per cent. Smaller companies were the worst performer in 2018, with the Small Ordinaries down by 11.3 per cent.

Chart 3- Smaller Companies underperformed: Rolling performance: percentage change, Annual 2018



Source: IRESS, CommSec

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