Markets Summary - February 2019

Taken from the CBA Global Markets Research report, 'February Month in Review'; first published on 1 March 2019.

Highlights in February

- Bonds yields fell in Australia as the Reserve Bank of Australia (RBA) switched to a more neutral bias.
- January's equity strength continued into February.
- The Australian dollar (AUD) weakened over February with the RBA moving to say the next move in the cash rate could be up or down.
- The CoreLogic data showed that dwelling prices continued to fall in February, with a 0.9% fall across the eight capital cities.

Cash

Australian short term money market rates have moved to price in a full rate cut on around a 12 month horizon. There is some scope for a May rate cut priced and a very significant chance for an August rate cut. The movement in RBA pricing followed a run of communicating from the RBA in which they completely remodelled their guidance. Throughout 2018, the RBA focussed on 'the next move is more likely to be up than down'. This was changed to outline that there was an equal chance of the next move in the cash rate being higher or lower.

The actual Australian economic data in February has been strongly mixed. There is clear weakness along the housing and household sector while clear strength in labour markets remains.

Australian and Global Fixed Interest

For the second consecutive month, Australian bond yields finished the month lower, with the local market outperforming the US. As mentioned above, the RBA's change of tone delivered a strong performance by bonds, with yields falling. The 10-year Australian bond yield fell 20 basis points (bp). Market based expectations for cuts continued to consolidate with a near full rate cut now priced in over the next 12 months.

Over the month, the US 2-year yield saw a range of 2.38% to 2.615%, closing 2bp higher at 2.515%. The 10-year traded between 2.625% and 2.725%, closing 3bp at 2.715%, making the monthly range the tightest since the 1970s.

While the backdrop in global markets was generally supportive, as leading indicators softened, Australia outperformed in this environment.

The difference between Australian and US 10-year bond yields narrowed to -62bp, a level not previously reached. The move reduces the attraction of Australian government bond yields against the US.

Global Credit

February saw a broad continuation of the themes that emerged in January. A more optimistic tone permeated through markets, underpinned by rising hopes that sanity will prevail in the US vs China trade war and that a deal is possible in the foreseeable future. The US government remained open and Trump declared a national emergency to get his wall funded - although that is being contested. Either way, this was not market moving. Brexit remains a 'dog's Brexit', chasing its tail with furious conviction. Nevertheless, in recent days there seems to be some degree of progress, with the odds of a hard Brexit moderating.

February is typically local reporting season. At month end the bulk of reporting is done (>90% of the ASX 200) and it's been a soft season. Aggregate sales were down 2.5% on the same period last year with Consumer Services (-16.3%) and Telcos (-10.6%) the two main drags on the broader market. Despite the drop in aggregate sales, 71% of companies reported sales growth. In earnings, it was a little softer again with aggregate earnings down -1.5% on the same period last year and six out of ten sectors all down. Only 49% of companies reported earnings growth. Telcos (-29.6%) and Consumer Services (-8.9%) again the two main drags. Despite softer results, most of which missed expectations, the ASX 200 ended the month +5.2%, outperforming the S&P 500 (+3.3%) and STOXX (+4.4%).

January saw aggressive credit spread moves both onshore and off, mainly a retracement of the wild swings wider at the end of last year (mainly offshore). February saw spreads cool their jets somewhat with more modest tightening (spreads narrowed).

Global Equities

After their worst December performances since 1931, US share markets posted their best returns in January since 1987. And the comeback continued in February, with shares up by 18-21 per cent from Christmas Eve lows. In fact, the Dow Jones index rose by 11.1 per cent, posting the best two-month start to a year since 1987. Further progress on US-China trade talks and a shift by global central banks from a tightening bias to a more neutral ("patient") monetary policy stance drove the share market rally as financial conditions eased.

The Dow Jones commenced February strongly, driven by a bumper January jobs report. But market sentiment soured after US President Trump said that a meeting with Chinese counterpart Xi Jinping would not occur before the March 1 tariff deadline. Weak manufacturing activity gauges and downgrades to Eurozone and UK growth forecasts also weighed on bourses. Over the first week of February, US markets rose by up to 0.5 per cent, while European shares fell (German Dax was down by 2.4 per cent). That said, Aussie shares outperformed with the ASX 200 index up by 3.6 per cent. The Reserve Bank's shift to a neutral interest rate stance, rising iron ore prices and a lift in bank shares supported the broader market.

In the second week, global share markets posted decent gains on optimism about US-China trade negotiations and solid, if not spectacular, US earnings results. President Trump signed-off on a spending and border security plan to keep the US government running through to September 30, averting another partial shutdown. On the data front, US industrial production and retail sales (the weakest in nine years) releases were notable, but business conditions in Australia improved. The Dow Jones rose by almost 780 points over the five days, up by 3.1 per cent, while the Dax rose by 3.6 per cent, ahead of the ASX 200, which fell by 0.1 per cent.

Global markets recorded more gains in the third week, but the UK FTSE index trailed (down 0.8 per cent) after the release of poor earnings results from energy supplier Centrica, defence company BAE Systems and consumer goods giant Reckitt Benckiser. Ongoing political turmoil associated with Brexit saw several politicians defect to the newly-formed 'Independent Group'. The US Federal Reserve's January meeting minutes signalled a 'patient' approach to rate hikes, given economic 'crosscurrents', but inflationary expectations also remained 'front of mind'. Over the week, US shares lifted by 0.6-0.7 per cent. But the ASX200 rose by 1.7 per cent on the back of a stronger-than expected employment report and cautious commentary on the housing market from Reserve Bank Governor Philip Lowe.

In the final week of February most share markets were mixed as political developments dominated trading. US President Trump delayed a tariff increase on Chinese imports (previously scheduled for March 1), citing 'substantial progress' in trade talks between the two nations. President Trump met with North Korean President Kim Jong-Un in Vietnam for their second summit. And tensions between India and Pakistan escalated in Kashmir. Shares were down by up to 1.4 per cent (UK FTSE), but the Dax (up 0.5 per cent) and the Nasdaq (up by 0.1 per cent) eked out gains. The ASX200 was flat.

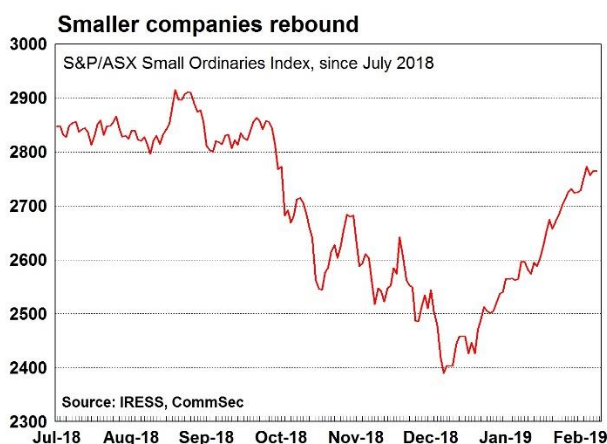
The US and Australian corporate reporting seasons both drew to a close with decidedly mixed results amid a more challenging global backdrop for corporates. According to FactSet, over 90 per cent of the companies in the S&P 500 reported December quarter results with almost 70 per cent announcing earnings above estimates, below the five-year average. In the

Australian half-year reporting, CommSec estimated that business revenues rose by 4.8 per cent; expenses rose by 5.6 per cent; profits lifted by 15.3 per cent; dividends lifted by 11.7 per cent and cash rose by 5.0 per cent since a year ago.

Over February, all major share markets were higher. The US Dow Jones rose by 3.7 per cent with the S&P 500 up by 3.0 per cent and Nasdaq up by 3.4 per cent. In Europe, the German Dax rose by 3.1 per cent and UK FTSE rose by 1.5 per cent. And in Asia, Japan rose by 2.9 per cent while the ASX 200 lifted by 5.2 per cent – the best monthly gain since July 2016.

In February, 19 of Australia's 22 sub-industry sectors posted gains. The Consumer Durables & Apparel sector rose the most (up 43.4 per cent) from Diversified Financials (up 11.2 per cent) and Automobiles & Components (up 10.2 per cent). But Household & Personal Products lagged (down 27.7 per cent). The Small Ordinaries outperformed, up by 6.5 per cent, with big companies (ASX50) up by 5.2 per cent and mid-cap stocks up by 4.1 per cent.

Chart 1 - Smaller Companies underperformed: Rolling performance: percentage change, Annual 2018



Source: IRESS, CommSec

Australian Dollar

The Australian trade weighted index decreased by 1.5% in February.

AUD/USD weakened by more than 2½ cents in the first week of February. The move down occurred because of a speech by RBA Governor Lowe that changed the RBA's forward guidance. Governor Lowe stated *"looking forward, there are scenarios where the next move in the cash rate is up and other scenarios where it is down. Over the past year, the next-move-is-up scenarios were more likely than the next-move-is-down scenarios. Today, the probabilities appear to be more evenly balanced."* In previous speeches, Governor Lowe had stated *"the next move in interest rates is more likely to be an increase than a decrease"*. Governor Lowe also indicated the RBA Board focussed on assessing *"the shifts in the global economy and the strength of household spending"*.

The AUD slowly lifted about 1½ cents during the rest of February. It recovered some of its recent losses in line with stronger global equity markets and higher oil prices, and more positive news on US-China trade negotiations. The strong January Australian labour report also gave AUD/USD a boost mid-month. Employment lifted by a robust 39,100 (consensus: 15,000). Full-time jobs growth of 65,400 drove net employment growth and the under-employment rate fell from 8.3% to 8.1%.

Table 1 – Australian dollar February performance

AUSTRALIAN DOLLAR			
	End Jan 31-Jan-19	End Feb 28-Feb-19	M/M % Change
AUD-USD	0.7273	0.7095	-2.4
AUD-JPY	79.19	79.07	-0.2
AUD-EUR	0.6353	0.6238	-1.8
AUD-GBP	0.5548	0.5350	-3.6
AUD-CHF	0.7231	0.7081	-2.1
AUD-CAD	0.9543	0.9339	-2.1
AUD-NZD	1.0519	1.0419	-1.0
TWI	61.6	60.7	-1.5
Month High		0.7284	1-Feb-19
Month Low		0.7054	12-Feb-19

Source: Bloomberg, CBA

Commodities

Commodity prices finished mostly higher in February, led by copper, coking coal and oil. Commodity specific supply factors were mostly at play. However, demand hopes also helped commodity prices generally. These demand factors were primarily easing US-China trade tensions and rising Chinese credit. Iron ore was a key underperformer last month, after outperforming earlier in February. Thermal coal saw the biggest decline amongst the major commodities as stockpiles held by Chinese utilities surged.

Iron ore prices rose sharply in early February after Vale and Brazilian regulators flagged that ~70Mtpa or ~4.5% of seaborne iron ore supply was being sidelined following the fatal dam collapse at Vale's Feijao mine. Prices retreated sharply following the Lunar New Year holiday as Chinese steel mills were reluctant to purchase seaborne iron ore at elevated price levels given subdued margins. Mills preferred to draw down on their own iron ore stockpiles and those held at ports. Steel mill reluctance to engage with the seaborne market persisted through February. End user steel demand concerns also weighed on iron ore prices, particularly with steel rebar stockpiles rising to the highest level since April 2018. Finally, restrictions on sintering (processing iron ore fines) in the steelmaking city of Tangshan from 25 February to 3 March also weighed on iron ore demand. Tangshan accounts for ~11% of China's steel production capacity. The current sintering restrictions – which are stricter than previous arrangements – are in place to improve air quality that is forecast to remain poor.

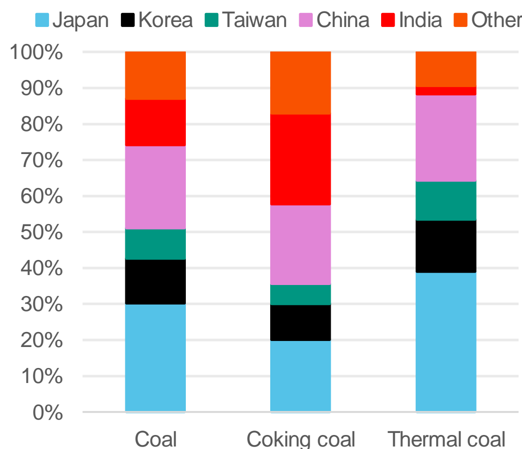
Copper prices gained mostly on supply concerns last month, but demand hopes did provide a helping hand. A suspension of an Indian smelter, a truck strike in Peru and reduced production plans in the Democratic Republic of Congo have sparked copper supply concerns this year. LME copper stockpiles declined to the lowest level since 2005.

Oil prices were on track to outperform other commodities last month, but pulled back in late February. Like most other commodities, demand hopes helped oil prices move higher in February. But OPEC-led supply cuts remained the dominant driver, particularly from Saudi Arabia. The kingdom is cutting oil production more than it pledged under an OPEC-led supply deal in order to balance oil markets as quickly as possible. Unplanned outages in Libya, Venezuela and Iran – countries exempt from the OPEC led supply accord – are also adding to the bullish sentiment in oil markets. Oil prices lost some of its gains in late February after US President Trump tweeted "oil prices are getting too high. OPEC, please relax and take it easy. World cannot take a price hike – fragile." Saudi Arabia seemed unfazed by Trump's comments, even expressing hope to extend OPEC led production cuts into 2H19 due to 'brimming' US oil stockpiles.

While thermal and coking coal prices diverged last month, both markets were impacted by reports of restrictions on Australia's coal exports to China. Custom clearance times for Australian coal shipments to China have increased since early February, but authorities have yet to confirm reports of a ban by Dalian Customs on Australian coal shipments. Australia exports just under a quarter of its coal to China, highlighting significant downside risks to Australian coal

export volumes and prices if China restricts coal imports from Australia. Input costs into China's steel and power sectors are also expected to rise if China commits to restricting Australian coal imports.

Chart 2 - Export share of Australian coal shipments



Source: Bloomberg, CBA

Australian Residential Property Market

The decline in national dwelling prices continues. Dwelling prices declined by 0.9% in the eight capital cities over February. But it remains fundamentally a Sydney, Melbourne and Perth story. Dwelling prices are little changed in Brisbane and Adelaide over the year while prices are still rising in Hobart. Notwithstanding, the size of Sydney and Melbourne relative to the other capital cities means that the national figures are heavily influenced by Australia's two most populous cities.

CoreLogic reports that dwelling prices dropped by 1.0% in both Sydney and Melbourne over February. Houses in both capital cities fell more than units. The moves aren't surprising given what the leading indicators of property prices have suggested. That is, monthly lending to owner-occupiers and investors has declined, auction clearance rates are at levels commensurate with prices deflating, foreign residential demand has waned and the house price expectations index from the WBC/MI Consumer Sentiment survey has been falling.

Sydney dwelling prices are now down from their July 2017 peak by 13.2%. Prices in Melbourne sit 9.6% down on their November 2017 peak. The fall in prices has been met with a rise in yields. That is, dwelling rents are outperforming prices in Sydney and Melbourne.

Turnover has declined markedly in Sydney and Melbourne as prices have adjusted downwards. This is normal in a downturn. But it means lower stamp duty receipts for the NSW and Victorian State Governments.

Last year the RBA seemed relatively relaxed about the fall in dwelling prices, primarily because the economic data was decent, employment growth was strong and the unemployment rate was trending down. In short, they viewed the economy as largely divorced from the housing market. More recently, however, there has been a clear shift in their communication with respect to the housing market.

In the February Board Minutes it was noted that, *"from a longer-run perspective, members assessed that, following such large increases in housing prices, the effect of the recent price falls on overall economic activity was expected to be*

relatively small. However, members observed that if prices were to fall much further, consumption could be weaker than forecast, which would result in lower GDP growth, higher unemployment and lower inflation than forecast."

It looks increasingly like the housing market will influence the RBA's forecasts for growth, inflation and unemployment and by extension the outlook for monetary policy. To date consumer confidence has not been negatively impacted by the fall in dwelling prices. Indeed consumers as a collective are more optimistic today around the economic outlook than they were a few years ago when prices were rising briskly. The improvement in the labour market has had a profoundly bigger impact on household perceptions of the economy than changes in dwelling prices. In that context, if employment growth remains decent, as the leading indicators continue to indicate, households can remain reasonably upbeat even if dwelling prices continue to deflate. After all, a third of households rent. And for would-be buyers, falling dwelling prices are a positive.

Chart 3 – Annual change in dwelling prices

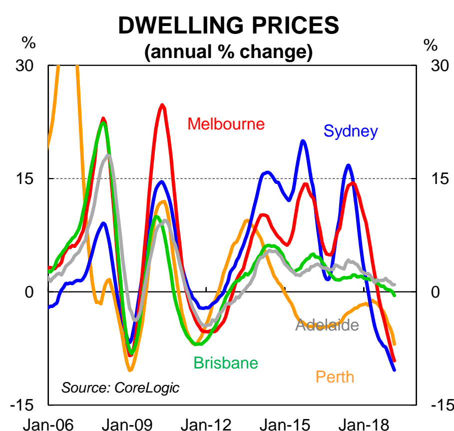


Table 2: CoreLogic Median Dwelling (Houses and Apartments) Prices – February 2019

	Sydney	Melbourne	Brisbane	Adelaide	Perth	Hobart	Darwin	Canberra	Capital cities
%chg mth	-1.0	-1.0	-0.3	0.0	-1.5	0.8	-1.7	-0.2	-0.9
% ann chg	-10.4	-9.1	-0.5	1.0	-6.9	1.1	-5.3	3.4	-4.2
% chg from peak (peak)	-13.2 (July 17)	-9.6 (Nov 17)	-1.0 (Apr 18)	na	-17.5 (June 14)	na	-26.6 (May 14)	na	-8.6 (Sep 17)

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This information was first made available to CBA clients on 1 August 2018 in a CBA Global Markets Research report publication titled, 'July Month in Review'.

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