Markets Summary – May 2019

Taken from the CBA Global Markets Research report, 'May Month in Review'; first published on 3 June 2019

Highlights in May

- Australian interest rate markets are now looking for around three rate cuts by mid 2020
- Over May, global sharemarkets fell but Australian sharemarkets rose
- The Australian Dollar (AUD) fell in May because of disappointing economic data, increased expectations of a June RBA rate cut and lower commodity prices (except iron ore)
- Bond returns in May were strong and this was largely to the fall in bond yields (prices rose)
- The CoreLogic data showed that house prices continued to fall in May but the pace of the falls has now moderated

Cash

In what was a repeat of April, Australian interest rate markets continued to move lower in yield over May, driven in part by global events but also by a more explicit stance from the Reserve Bank of Australia (RBA) that rates would be reviewed in June. Yields dropped in response to the rise in the April unemployment rate to 5.2%, which also showed a rise in underemployment, even though the participation rate rose and the jobs number remained solid. The RBA subsequently cut the cash rate to 1.25% on 4 June.

Financial market pricing for RBA interest rate cuts dropped below the 1% expectations to come close to three rate cuts by mid-2020. As the month finished, a full cut was priced for the June meeting as expected, while a second cut was priced for the September meeting.

Australian and Global Fixed Interest

The April drop in yields continued into May, with Australian yields touching record lows across all yields to maturities and the 10year Australian government bond yield falling below the RBA cash rate for the first time in several years. Global yields were also lower, helping markets extend the rally. The concerns over trade wars ramped up towards the end of the month.

Chart 1 – Australia and US 10-year bond yields

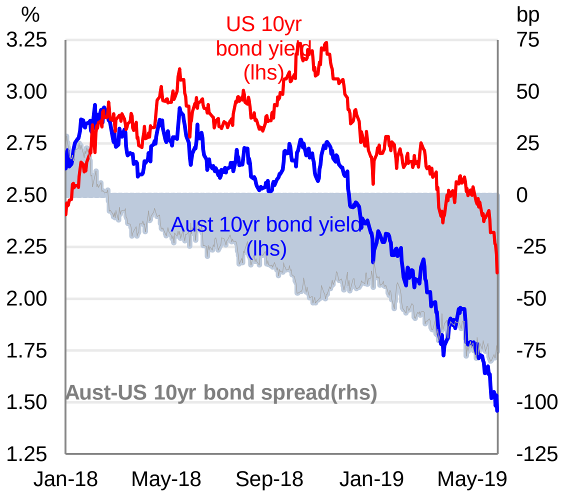
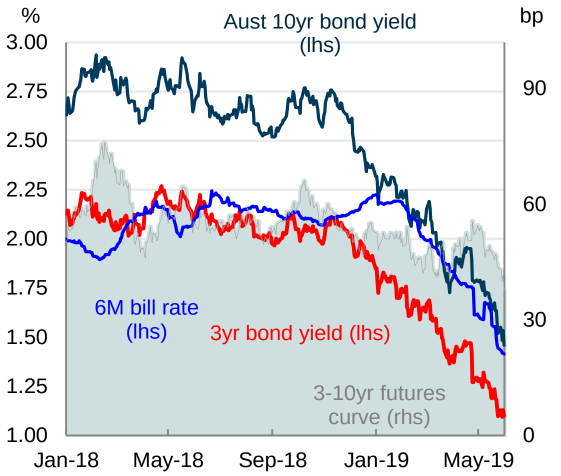


Chart 2 – Main Australian yields



Global Credit

April saw credit spreads (the difference between government bond yields and the yield on a corporate bond) continue to move lower as Australian government yields fall to record lows post weaker than expected quarter 1 Consumer Price Index (CPI) and the lift in the unemployment rate. Financial markets have priced close to three rate cuts by the RBA.

The Standard and Poors (S&P) 500 had its worst month year to date, falling more than 6.5% since 5 May, when US president Donald Trump reignited trade war fears by threatening to impose 25% tariff on all imported goods from China. Washington blames Beijing for reneging on already agreed provisions. China retaliated by imposing tariffs on US$60bn of US imports and accused the Trump administration of including "*mandatory requirements concerning China's sovereign affairs*".

The White House also threatened to slap tariffs on all goods imported from Mexico, starting at 5% and gradually stepping up to 25% by 1 October. In addition, the US will also terminate India's designation as a developing nation effective 5 June, which means the country will no longer be able to export goods to the US duty-free.

In Australia, the Coalition government claimed election victory in the 2019 federal election which means the risk of changes to negative gearing and dividend imputation are now off the table. The Australian Stock Exchange (ASX) 200 was one of the very few stock indices that delivered positive performance in the month, up about 1 percent.

Global Equities

Global sharemarkets weakened over May as investors re-assessed the outlook following a stalling in US-China trade talks. Australian shares bucked the trend, lifting over 1 per cent in May.

US sharemarkets eased over the first week of May. A key factor was the Federal Reserve rates decision on 1 May.. While the federal funds rate was left unchanged, there was a less 'dovish' stance from the Federal Reserve chair Jerome Powell (a dovish stance favours lower interest rates). The Federal Reserve chief said that some 'transitory' factors had been holding down the inflation rate. But strong jobs data (jobless rate hit a 49-year low of 3.6 per cent) lifted the Dow Jones by 0.8 per cent on 3 May. The US Dow Jones fell 0.3 per cent over 1 – 3 May while Aussie shares rose 0.2 per cent.

In the second week of May, the US Dow fell on three of five days, losing 2.1 per cent. Australian shares slipped 0.4 per cent. On 7 May the Dow slid 473 points or 1.8 per cent on concerns about a breakdown in China-US trade talks. On 10 May the US raised tariffs on $200 billion of Chinese imports from 10 per cent to 25 per cent, with President Trump saying that China *"broke the deal".*

The third week of May began with the US Dow Jones losing 617 points or 2.4 per cent on 13 May. China retaliated against the US by imposing tariffs on US$60 billion of US imports. Shares in Apple lost 5.8 per cent with Boeing down 4.9 per cent.

There were more conciliatory comments from the US President on 14 May, saying *"When the time is right we will make a deal with China".* US sharemarkets clawed back most losses over 14-16 May 16 before easing again on 17 May. The US Dow Jones lost 0.7 per cent over the week.

But the Australian and European markets actually lifted in the third week of May. The UK FTSE rose by 2.0 per cent after falling by 2.4 per cent in the prior week with the German Dax up 1.5 per cent. The US President delayed a decision on auto tariffs. And the Australian ASX 200 was up 0.9 per cent. Over 16-17 May, iron ore prices rose 5.6 per cent.

In the fourth week of May (20-24 May) Australian shares out-performed as investors responded to the Federal Election result. The ASX 200 lifted by 1.4 per cent while US and European shares fell. The US Dow Jones fell by 0.7 per cent (falling on three of five days) and the Nasdaq lost 2.3 per cent. The US White House placed Chinese telecom equipment maker Huawei on a trade blacklist. China and the US continued the war of words on trade. On 24 May the UK Prime Minister Theresa May said she would resign on 7 June but stay on as caretaker until a new leader is appointed. UK shares rose 0.7 per cent.

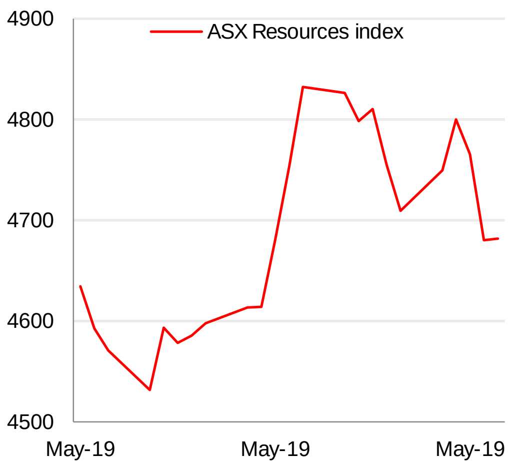
In the fifth week of May (27-31 May) US shares continued to fall. The US President said he wasn't ready to make a trade deal with China. Recession fears re-emerged in the US as the yield curve inverted (short-term yields exceeded long-term yields). And shares slumped on 31 May after the US President threatened to impose tariffs on Mexico unless the Mexican government stopped the flow of illegal migrants into the US. The US Dow Jones fell 3 per cent over the week although the ASX 200 fell by only 0.9 per cent.

Over May, major sharemarkets were lower. The US Dow Jones lost 6.7 per cent, the S&P 500 fell by 5.5 per cent and Nasdaq lost 6.8 per cent. In Europe, the German Dax fell by 4.1 per cent and UK FTSE eased by 3.1 per cent. In Asia, Japan's Nikkei lost 5.6 per cent. But in Australia the ASX 200 lifted by 1.1 per cent.

In Australia over May, major resource stocks responded to a higher iron ore price and the market more broadly responded to the Federal Election result. Overall 12 of 22 industry sub-sectors rose. Media rose 8.0 per cent, Telecom rose 7.1 per cent, Healthcare rose 3.4 per cent with Pharmaceutical & Biotech up 3.2 per cent. The Materials and Banks sectors each rose by 3.1 per cent. But the Consumer Durables & Apparel sector lost 12.3 per cent, dragged down by shares in Breville. Capital goods fell 10.9 per cent and Food, beverages & tobacco lost 9.1 per cent.

Big companies rose the most in May with the ASX 50 up 1.9 per cent and ASX 100 up 1.5 per cent. But, the Small Ordinaries fell by 1.3 per cent and MidCap50 lost 0.8 per cent.

Chart 3 - ASX Resources index



Source: IRESS, CommSec

Australian Dollar

AUD/USD trended lower by two US cents in the first half of May, before consolidating in the second half of May. The swap market materially increased pricing for rate cuts by the Reserve Bank of Australia (RBA). The increased pricing for rate cuts weighed on AUD. The Australian economic data generally disappointed expectations in May. Retail volumes decreased by 0.1% in Q1 2019 (consensus: 0.3%). Most important for RBA watchers, Australia's unemployment rate increased to 5.2% in April compared to 4.9% as recent as February 2019.

Lower commodity prices also weighed on AUD in May. Most mining commodity prices that are important to Australia decreased in May. Iron ore was the exception. AUD traded near the low point for the month after RBA Governor Lowe delivered a speech on 21 May titled "The Economic Outlook and Monetary Policy". Lowe moved to a clear easing bias and indicated that the RBA was considering cutting interest rates at its next meeting on 5 June.

Table 1 – Australian dollar April performance

AUSTRALIAN DOLLAR			
	End Apr 30-Apr-19	End May 31-May-19	M/M % Change
AUD-USD	0.7048	0.6938	-1.6
AUD-JPY	78.55	75.12	-4.4
AUD-EUR	0.6286	0.6211	-1.2
AUD-GBP	0.5409	0.5493	1.6
AUD-CHF	0.7186	0.6942	-3.4
AUD-CAD	0.9436	0.9377	-0.6
AUD-NZD	1.0560	1.0625	0.6
TWI	60.5	60.0	-0.8
Month High		0.7061	1-May-19
Month Low		0.6865	17-May-19

Source: Bloomberg, CBA

Commodities

Commodity prices were mostly lower in May, led by oil. Iron ore and gold were the notable exceptions. The main negative driver across the commodity space was an escalating US-China trade war. Chinese data got worse last month, indicating weaker commodity demand in China. The weakness in China's commodity intensive sectors comes despite increased infrastructure spending and tax cuts. However, the weakness in the Chinese data is also raising hopes of even more stimulus.

Iron ore prices tracked higher through most of May on supply concerns and demand hopes. China's iron ore port stockpiles fell sharply in May, continuing a trend that began in early April. China's port stocks are an important indicator of surplus and deficit concerns in iron ore markets. That is mostly due to China's enormous influence on seaborne markets, where they account for ~70% of the world's seaborne imports. Port stockpiles in China currently sit at 125 Metric tonnes (Mt). Broadly speaking, ~120Mt is considered a "safe" level for port stockpiles, while ~100Mt is considered a level that would lead to significant price volatility.

The decline in China's iron ore port stockpiles primarily reflects the supply disruptions that have roiled iron ore markets this year. Headlining those disruptions was the fatal dam disaster at Vale's Feijao mine in Brazil in late January. Vale has curtailed nearly 6% of seaborne iron ore supply since the dam collapse in order to ensure the safety of its operations. In fact, the decline in China's iron ore port stockpiles since early April can be linked to the time to ship ore from Brazil to China following the dam disaster.

Other demand side factors have also played an important role in helping iron ore prices higher. Steel mill margins, while declining recently, have held up remarkably well this year despite rising iron ore prices. Steel margins directly reflect the ability of steel mills to absorb higher iron ore prices. Demand hopes are also translating through to higher steel volumes. China's crude steel output rose to a record high in April, consistent with the trend of rising steel operating rates this year. Weaker demand-side indicators though, like lower steel margins, weighed on prices towards the end of May.

Oil prices weakened in May as demand worries outweighed supply disruption risks. Demand concerns were mostly prompted by the escalating US-China trade war, but gained more traction as US oil stockpiles continued to increase. US oil stockpiles currently sit at the highest level above the five-year average in 2019. The final day of May saw oil prices slump as demand worries grew in response to the imminent US tariffs on Mexico.

Demand concerns trumped a number of supply disruptions in oil markets last month. These disruptions included dwindling Iranian oil exports and falling Venezuelan production. Iran's oil exports have declined in response to US sanctions, while Venezuela's production has collapsed on the back of a leadership and economic crisis, as well as sanctions. Russian oil production also took a hit in May after contaminated oil was found in pipelines connecting Russia to Europe. Future disruptions also loom on the horizon with the fighting currently underway in Libya. The country accounts for ~1.2% of global oil supply. Libya's oil supply has been supported in recent years by the precarious alliance between the two currently warring factions.

Australian Residential Property Market

The fall in national dwelling prices continued in May. Prices were down a further 0.4% in the eight capital cities, taking the annual fall to 8.4% and peak-to-trough fall to 10.1%. The pace of falls continues to reduce each month. The fall of 0.4% was the smallest since April 2018.

Prices fell in all capital cities but one. Adelaide posted a gain of 0.2%. While all other capital cities posted falls, there has been a significant moderation in the falls in Sydney and Melbourne. Auction clearance rates have lifted, buyer sentiment has improved after the Federal Election and the expectation of interest rate cuts have also helped. Changes to the interest rate used to test serviceability of home loans could also help at the margin. CBA data has also shown a lift in home buyer applications in recent weeks. We expect overall house prices to stabilise in the second half of 2019.

In May Sydney prices fell by 0.5%, the smallest fall since March 2018. The falls were across units and houses with unit prices down 0.6% for the month. There are some concerns over the lift in supply of apartments in Sydney. Rental growth is softening and vacancy rates have also lifted. Over the past 12 months houses have recorded a steeper decline as more expensive properties have been worst hit. Overall prices are down 14.9% since the peak in July 2017.

In Melbourne prices fell by 0.3%, this was the smallest fall since April 2018. House prices were down by 0.6% over May while apartment prices recorded a small gain. Lower priced properties have performed better in Melbourne over the course of the downturn. There appears stronger demand for this type of property and the recent lift in supply is being absorbed without too many issues. Incentives for first-home buyers could also boost demand for lower priced properties.

Perth prices continue to fall. They were down another 1% in the month, taking the total peak to trough fall to 19%. Falls continue despite very little increase in supply, falling vacancy rates and an improved outlook for the mining sector including a pickup in investment intentions. It is a similar story in Darwin with prices falling a further 1.6%. Weak if not negative population growth is weighing on prices.

In Brisbane prices fell by 0.5% and are down 2.4% from peak to trough. More expensive properties are driving the falls. In Hobart prices fell for a second month, down 0.4% after robust growth over the past 18 months.

Chart 4 –Dwelling price moves

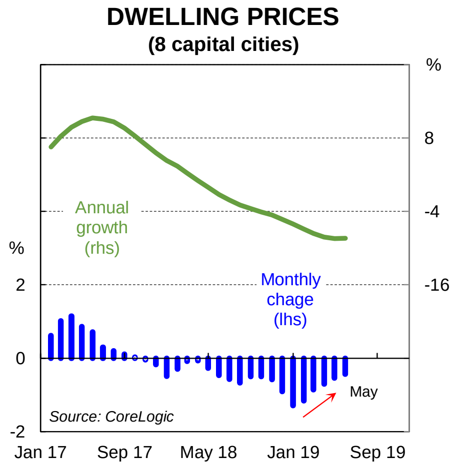


Chart 5 – Dwelling price annual moves by capital city

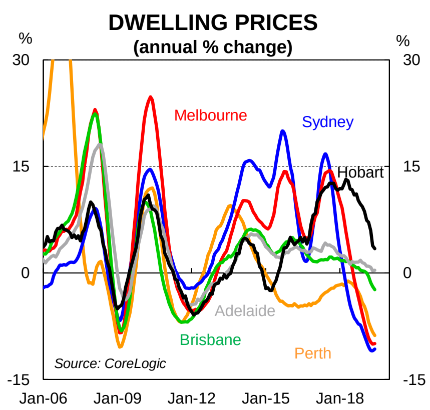


Table 2: CoreLogic Median Dwelling (Houses and Apartments) Prices – May 2019

	Sydney	Melbourne	Brisbane	Adelaide	Perth	Hobart	Darwin	Canberra	Capital cities
%chg mth	-0.5	-0.3	-0.5	0.2	-1.0	-0.4	-1.6	-0.2	-0.4
% ann chg	-10.7	-9.9	-2.3	0.4	-8.8	3.4	-8.6	2.4	-8.4
% chg from peak (peak)	-14.9 (July 17)	-11.1 (Nov 17)	-2.4 (Apr 18)	-0.5 (Feb 19)	-19.2 (June 14)	-1.3 (Mar 19)	-29.5 (May 14)	na	-10.1 (Sept 17)

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