Count

Market Wrap

JUNE 2017

The Reserve Bank of Australia (RBA) Board met on 4 July and left the official cash rate on hold at 1.5%, as widely expected. There has been no change in the official cash rate since August 2016.

After weakness in May, the Australian dollar was stronger over the month, supported by gains in bulk commodity prices, particularly iron ore and coal.

The S&P/ASX 200 Accumulation Index finished June broadly flat with a rise of 0.2%, despite some volatility during the month.

Meanwhile, global shares recorded another positive month, although the magnitude of the gain was smaller than in recent months and there were more mixed performances across the board.

In the US, the Fed announced plans to reduce its balance sheet by decreasing reinvestments in maturing securities.

Australia

In announcing its June interest rate decision, the RBA acknowledged that the "broad-based pick-up in the global economy is continuing", although core inflation and wages growth remain subdued in most countries.

Contrary to some expectations, the RBA didn't join the growing chorus of more hawkish global central banks.

The RBA continues to balance three key risks for the economy in their monetary policy deliberations: the outlook for inflation, the strength or otherwise of the labour market and household financial stability.

In other news, Q1 GDP data was released in June, coming in at a soft 0.3% per quarter, taking the annual growth rate down to just 1.7% per annum. This is the lowest annual growth rate since the 2009 GFC-inspired slowdown, when growth troughed at 1.2% per annum.

Growth was driven by a 0.5% quarterly increase in household final consumption, with spending on insurance, financial services, electricity, gas and other fuels strong. However, there was some weakness in spending on clothing and footwear and alcoholic beverages.

Net exports detracted 0.7% from growth, while dwelling investment was also weak, with a 4.4% decline over the quarter.

Nonetheless, with GDP growth at 1.7% per annum, real gross domestic income surged higher, rising 6.5%. A 6.6% quarterly gain in the Terms of Trade played a key part in driving income growth, although that growth continues to flow strongly into company profits, rather than labour. The profit share of the economy rose to 27.5% in June, while the wages share fell to 51.5%.

With wages growth at record lows, the savings rate has now declined to 4.7%, from a post-GFC high of around 11%.

The NAB business survey for May showed a softening in business confidence, down from +13 to +7. However, overall business conditions remain at elevated levels, with a reading of +12 in May, down slightly from +14 in April.

This month also saw a convergence between employment findings from the NAB survey and the Australian Bureau of Statistics (ABS), with the ABS data showing a strong gain of 42,000, for a total gain of 141,000 over the last three months. As a result, the unemployment rate has fallen to 5.5%, the lowest since early 2013.

With interest rates low and employment rising, CoreLogic capital city dwelling prices rebounded in June, rising 1.8%. Annual growth was 9.6% per annum, roughly the average pace over the past 12 months. Price gains in the month were concentrated in Sydney (+2.2%), Melbourne (+2.7%) and Perth (+1.4%), while there were falls in Brisbane (-0.8%) and Adelaide (-1.7%).

US

The US Federal Reserve Open Market Committee (FOMC) met on 13–14 June and, as was widely expected, raised the Fed Funds target by a further 25bp to a range of 1.0%–1.25%. This was the fourth rate rise since December 2015. There was one dissenter at the meeting, Neel Kashkari, who voted to hold monetary policy steady.

The Fed made several changes to its policy statement, but its policy outlook remains unchanged. It noted that "the labour market has continued to strengthen and… economic activity has been rising moderately so far this year… household spending has picked up in recent months, and business fixed investment has continued to expand."

On inflation, the Fed acknowledged the recent lower CPI readings, but said that inflation is expected to stabilise around the Committee's 2% objective over the medium term, commenting that "near term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely."

The Fed made minimal changes to its 'dot plot', with a further interest rate hike expected in 2017. The dot plot continues to point to three more rate hikes in 2018.

The Fed also released an "Addendum to the Policy Normalisation Principles and Plans", highlighting its intention to reduce its balance sheet by decreasing reinvestments in maturing securities. This reduction is expected to be in the order of $US6bn per month initially for Treasury securities, increasing in $US6bn steps at three month internals over 12 months until it reaches $US30bn per month. For agency debt and mortgage-backed securities, the cap will initially be $US4bn per month, increase in $US4bn steps at three month intervals over 12 months until it reaches $US20bn per month. This process could start as early as September 2017, although the target range for the federal funds rates will remain the primary means of adjusting the stance on monetary policy.

In other US news, the ISM Manufacturing Index gained momentum, rising from 54.9 in May to 57.8 in June, its highest level since August 2014. New orders, production and employment components all performed well. This reading suggests US economic growth is tracking around 3.5% pa – a decent recovery on the 1.4% seasonally adjusted annualised rate recorded for Q1 2017.

US inflation fell 0.1% in May, a weaker result than expected, with the annual rate falling to 1.9%, down from 2.2% per annum. Core inflation rose 0.1% a month and 1.7% per annum. Weakness in energy prices as well as apparel, airfares, communication and medical-care services all led to the lower-than-expected result. The Fed will be watching for signs that the weakness in inflation is not just temporary, as this could delay future rate rises until December 2017.

Europe

The European Central Bank (ECB) met on 8 June and made no changes to policy. The one major change was a shift to a balanced perception of growth risks and the removal of the asymmetric forward guidance on policy rates. This was the first step towards an eventual normalisation in policy, with the next step a tapering of its asset purchases, most likely to begin post December 2017. Later in the month, ECB President Mario Draghi reiterated his more positive view on the broad-based economic recovery and removal of deflation risks. An improvement in the political environment could also prove a tailwind, however risks remains and monetary policy still needs to be persistent and accommodative.

June also saw further improvements in manufacturing PMI, with a reading of 57.4 for the Euro area (up from 57.3), including strong data for Germany (60.9), France, Italy and Spain (all around 56), suggesting a continued cyclical upswing in economic growth.

Eurozone finance ministers also agreed to lend Greece €8.5bn under its long-delayed bailout program, although debt relief is not expected until 2018. The IMF was included in the deal, although no money was provided. The deal should allow Greece to meet debt payments due in July.

UK

The Bank of England met on 15 June, voting by a majority of 5–3 to maintain the Bank Rate at 0.25%, and deciding unanimously to maintain its stock of corporate bond and government bond purchases. The five members voting to leave the Bank Rate on hold believed that the UK economy is set to operate with a small degree of spare capacity for most of the three-year forecast period, and that current conditions justify tolerating some degree of above-target inflation.

After the meeting, a debate opened among Board Members on the possibility of upward moves in the Bank Rate. Previously dovish on the outlook for rates, Governor Carney noted late in the month that "some removal of monetary stimulus is likely to become necessary", although this is predicated on the possibility of unexpectedly high growth or inflation. This slight hawkish tilt follows growing dissent within the Bank of England Board on the need for higher rates, despite countervailing factors such as political uncertainty, weak wages growth and nervousness around Brexit. However, there is general agreement that any policy tightening would be limited in scope and pace.

The 8 June election provided a shock result, with Conservative Prime Minister Theresa May losing her parliamentary majority. Instead, a coalition government has been formed with the Democratic Unionist Party from Northern Ireland. This is likely to lead to a softer Brexit stance, with negotiations officially commencing on 19 June 2017.

NZ

The Reserve Bank of New Zealand (RBNZ) met on 22 June and left the official cash rate on hold at 1.75%.

The RBNZ focused on recent moves in the trade-weighted exchange rate, which rose 3% in May. The Bank sees a lower New Zealand dollar as desirable to help rebalance growth towards the tradeables sector.

Q1 GDP was slightly weaker than expected, at 0.5% per quarter and 2.5% per annum. Weaker export volumes and residential construction were partially offset by stronger consumption. Positives for the growth outlook include recent Budget changes, stronger population growth, better terms of trade and low interest rates.

Canada

Although the Bank of Canada did not meet in June, expectations rose for an upcoming change in monetary policy. Governor Poloz noted that interest rates have been "extraordinarily low" since a 50 basis point cut in the overnight rate target to 0.50% in July 2015. He added that "it does look as though those cuts have done their job", with excess capacity now being used up. Financial markets reacted by pricing in a rate hike before year end. As a result, the Canadian Dollar rose 4.2% against the US dollar over the month, while the Canadian 10-year bond yield rose 35 basis points to 1.76%.

Japan

The Bank of Japan (BoJ) met on 16 June and, as expected, made no changes to rates. It continues to maintain its policy balance rate at -0.1% and a 10-year bond yield target of 0%. There have been growing discussions in the month over the need for the BoJ to have an exit strategy, both from its yield curve policy and its quantitative and qualitative easing program, as the BoJ already owns 40% of Japanese government bonds on issue. No progress was made in June, with BoJ Governor Kuroda stating "it takes time to turn the deflationary mindset".

China

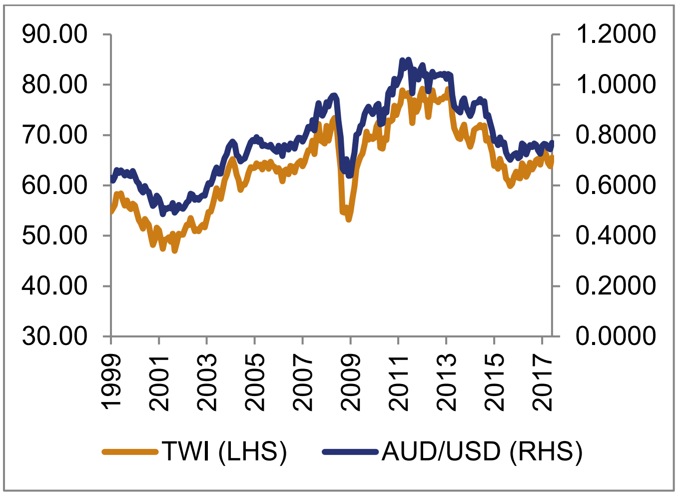
There was little economic news from China in June, with the situation staying stable ahead of key political changes in November 2017. Industrial production was unchanged at 6.5% in May, while retail sales also remained steady at 10.7% per annum. However, Fixed Asset Investment slowed to 8.6% per annum in May, down from 8.9%.

Annual inflation rose to 1.5% in May, up from 1.2%. Yet there were also indications that inflation pressures are easing, with Producer Price Inflation retreating to 5.5% per annum, down from a peak of 7.8% per annum in February, as weaker commodity prices flowed through to factory inputs.

Australian dollar

The Australian dollar was stronger over the month after weakness in May, supported by gains in bulk commodity prices, particularly iron ore and coal.

AUD STRENGTHENS



Source: Bloomberg as at 30 June 2017

Better labour market data also had some market commentators discussing the prospects of an upward move in interest rates by the RBA, especially given the hawkish commentary from some other global central banks – especially, the Bank of Canada, the European Central Bank and the Bank of England. That saw the Australian dollar rise 3.5% against the US dollar to $US0.7687, despite the US Federal Reserve lifting the Fed Funds rate in June.

The AUD also rose against the sterling (+2.4%) and the euro (+1.8%), with even stronger gains against the Japanese yen (+4.9%). However, the AUD was flat against the NZ dollar.

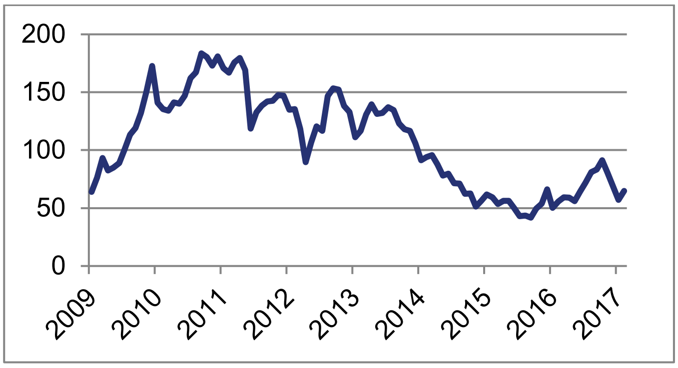
Commodities

Commodity prices were mixed in June, with oil prices lower, bulk commodity prices stronger and base metal prices mixed.

West Texas Intermediate (WTI) crude oil finished the month at $US46.04/bbl, down 4.7%, while natural gas prices also fell. The falls were driven by continued signs of increased US shale production and questions around the effectiveness of OPEC supply cuts. They came despite escalated tensions in the Middle East, as Saudi Arabia, Bahrain, Egypt and the United Arab Emirates severed ties with Qatar over its ties with Iran and support for groups such as the Muslim Brotherhood.

Iron ore prices recovered from recent heavy falls, with the spot iron ore contract (Qingdao 62% Fe fines) up by 13.9% to $US64.95/t in June. There were some signs of sustained demand from steel mills in China, especially for high grade ore. Coal prices also rose in June, up by 10.3%.

IRON ORE TICKS UP



Source: Bloomberg as at 30 June 2017

Base metals were mixed, with the London Metals Exchange (LME) Index rising by 3.4%. Lead rose 8.1% in the month and copper 4.5%. Precious metal prices were weaker, with gold down 2.2% on weaker inflation globally. Silver fell 4%.

Australian equities

The S&P/ASX 200 Accumulation Index finished June broadly flat, returning 0.2% for the month, despite some volatility.

Energy was the worst performing sector, falling 6.9% despite a strong performance from Whitehaven Coal, which was not enough to offset weakness from other companies such as Santos, Woodside Petroleum and Origin Energy.

Bond proxy sectors were weak, as Australian bond yields followed global yields higher. REITs, Utilities and Telcos fell by 4.8%, 2.7% and 1.5% respectively.

Healthcare (+6.1%) was the top performer by a clear margin, as CSL, Cochlear and Sirtex Medical all posted solid gains.

It was also better month for the large banks, lifting the Financials sector (+1.6%) into positive territory.

A late jump in the iron ore price helped the Materials sector recover earlier losses and finish the month 0.6% higher.

Listed property

The S&P ASX 200 A-REIT index fell by -4.8% in June in AUD terms, taking its return over the 12 months to 30 June to -6.3%. The retail A-REIT sub-sector made up ground in relative terms, outperforming the office and industrial sub-sectors over the course of the month.

The best performing A-REIT was self-storage REIT National Storage REIT (+6.9%), which is due to acquire a portfolio of three storage centres in Brisbane's northern suburbs from smaller operator Elite Self Storage for A$28 million.

The worst performers included office A-REIT Dexus (-6.5%) and diversified A-REIT GPT Group (-6.3%). Dexus fell after announcing the acquisition of several substantial Sydney and Melbourne property assets (including a 25% interest in Sydney's MLC Centre), and raising A$500 million of equity to help fund the purchases.

Listed property markets offshore fared better. The FTSE EPRA/NAREIT Developed Index (TR) climbed by +0.9% in USD terms during the month, taking its 12-month return to +1.1%. The United States was the best performing region, with a gain of +2.4%. The worst performing market was Japan, which fell -2.4%.

Global shares

Global developed equity markets recorded another positive month, although the magnitude of the gain was smaller than in recent months and there were more mixed performances across the board.

Global equity markets had to contend with multiple headwinds in June: the shock UK election outcome; weakness in the British pound; a lower oil price; and, later in the month, rising bond yields (as some central banks speeches took on a hawkish flavour).

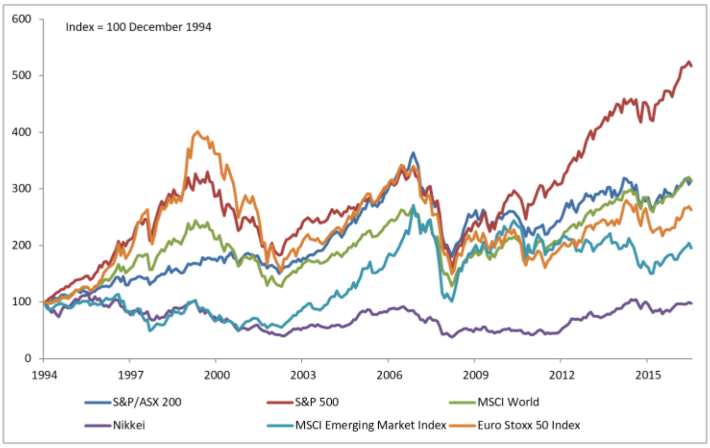
The MSCI World Index was up 0.2% in US dollar terms in the month, but fell 2.9% in Australian dollar terms on the stronger AUD.

The VIX Index, a market estimate of future volatility of the S&P500 Index, finished the month at 11.18 after falling as low as 9.75 early in the month. Market volatility remains below average, with commentators citing multiple possible causes, including earnings growth, reassuring central bank guidance and the sheer volume of cash on the sidelines.

US equity markets produced mixed results, with the S&P500 (+0.5%) and Dow Jones (+1.6%) edging up over the month, while the NASDAQ (-0.9%) declined, driven lower by a 5.8% fall in Alphabet (Google's parent company).

At a sector level, the MSCI Telecommunications sector underperformed (-3.6%) while MSCI Financials climbed higher (+4.7%) after positive stress test results allowed some major banks to increase distributions to shareholders.

EQUITY MARKETS MIXED IN JUNE



Source: Bloomberg as at 30 June 2017

Equity markets in Europe were weaker, with Spain (-4.0%), France (-3.1%) and Germany (-2.3%) all falling. Greece rose 6.3% after its next bailout package was finalised, allowing bond repayments in July. In the UK, the FTSE100 was down 2.8% after a surprise election result saw Theresa May's Conservative Party lose its majority.

Asia markets were stronger, with the Japanese Nikkei 225 up 1.9%. Singapore (+0.5%) and Hong Kong (+0.4%) made more modest gains.

Global emerging markets

Emerging market equities had another positive month, assisted by the cyclical improvements in the global economy, led by trade and manufacturing. The MSCI Emerging Market Index was up 0.5% in USD terms but down 2.9% in AUD terms.

MSCI EM Latin America (+0.5%) rose despite the weaker oil price, with the BURCAP Index down 1.9% in Argentina. MSCI EM Asia ex Japan gained 1.1% over the month assisted by a 2.4% gain in the Shanghai Composite Index.

The MSCI EM Europe, Middle East and Africa was weaker over the month, down 2.7%, led lower by Russia (-1.1%) on oil and political uncertainty, while the Prague Stock Exchange was down 2.2%.

Global and Australian developed market fixed interest

Bond markets had a relatively quiet month, trading in a moderately narrow range until commentary from the President of the European Central Bank (ECB) provided a reminder of the future path towards tighter monetary policy. The market reacted accordingly, with a spike in bond yields, despite President Draghi making it clear that any movements would be measured, gradual and dependant on continued economic recovery.

The Federal Reserve lifted the Fed Funds rate as expected, while the Bank of England and the Bank of Canada also turned more hawkish. Against this backdrop, 10-year government bond yields were up 21 basis points (bps) in Australia to 2.60%, up 10 bps to 1.26% in the UK, up 10 bps to 2.30% in the US, and up 16 bps in Europe to 0.47% – with around half of the upside experienced in the last two days of the month. In Japan, yields traded in a narrow band of 7 bps, ultimately ending the month up 4 bps to 0.09%.

Global credit

Global investment grade credit spreads gradually ground a little tighter in the month, but continue to be resilient despite wider market noise impacting government bond yields. Investment grade issuance in the US and Europe remained strong in the month.

The Bloomberg Barclays Global Aggregate Corporate Index average spread moved 5 bps tighter to 1.09%. US credit moved 4 bps tighter, with the Bloomberg Barclays US Aggregate Corporate Index average spread closing at 1.03%. In Europe, the spread on the Bloomberg Barclays European Aggregate Corporate Index was 7 bps narrower to 1.02% on the back of the ECB rhetoric.

US high yield credit spreads traded in an 18 bps range but ended the month close to where they started, with the Bank of America Merrill Lynch Global High Yield index (BB-B) 1 bp wider to 2.97% by month end. The high yield market continues to be impacted by downgrades particularly in the energy and mining sectors.

Australian credit spreads moved little in the month, with the average spread relative to swap on the Bloomberg Australian Corporate Index 1 bp tighter

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