Economic update – November 2017

Australia

- CPI data for the September quarter showed prices rising 1.8% from a year ago. This was below expectations of a 2.0% increase. Recent increases in utility prices had a more modest impact on the inflation data than anticipated.
- Housing and transport costs also continue to rise for most Australians, but weaker food prices dragged down the overall inflation reading.
- Inflation has undershot the Reserve Bank of Australia's 2% to 3% CPI target for almost two full years, suggesting domestic interest rates might remain low for an extended period.
- There was some good news on the employment front, with nearly 20,000 jobs added in September. This pushed the unemployment rate down to 5.5%, from 5.6%. Some economists suggested this could result in upward pressure on wages and, in turn, inflation in 2018.

US

- Despite hurricanes Harvey and Irma, which dampened activity, the US economy expanded 3.0% you in the September quarter; pleasingly similar to the 3.1% for the June quarter.
- The latest payrolls data disappointed, again likely affected by the recent storms. New job vacancies remain robust, however, suggesting employment could improve before year-end.
- The latest Federal Reserve Board meeting was held on 31 October and 1 November. Official interest rates were left unchanged at this meeting, but an increase in December remains likely. This decision continues to be the key focus for investors globally and is affecting sentiment towards markets.
- In the statement that followed the latest meeting, the 'Fed' amended its previous description of current US economic growth to 'solid' from 'advancing moderately'. Observers took this as a further signal that rates will be increased for the third time this year at the mid-December meeting.

Europe

- Preliminary estimates suggested inflation in the euro area declined to 1.4% you in October, reflecting moderating energy and services costs.
- As anticipated, the European Central bank held its benchmark refinancing rate at 0% at its latest meeting, but did announce a reduction in the scale of its quantitative easing program.
- From January 2018, the Bank will reduce its bond repurchases to €30 billion per month (from €60 billion per month currently). It has, however, extended the scheme by nine months, suggesting persistently low inflation requires ongoing stimulus.
- Whilst still high by Australian standards, the unemployment rate in Europe continues to trend lower. The jobless rate fell to 8.9% in September, the lowest rate since January 2009 and well below the average of the past 20 years.
- According to the latest data, economic growth in the Euro area continues to outpace that in the UK. Eurostat has estimated that GDP in the 19 euro member states rose 2.5% in the year ending 30 September; well above the UK's 1.5% growth rate.
- 'Brexit' talks – regarding the UK's planned withdrawal from the EU – are continuing, albeit at a slow pace.

New Zealand

- Business confidence sank in October, reflecting political uncertainty. During October, the Labour Party formed a coalition government with the populist New Zealand First Party, breaking the nine-year rule of the National Party.
- The new government is believed to be considering ways of reducing immigration and restricting foreign ownership of property.
- There has also been speculation that the new government could amend the mandate of the Reserve Bank of New Zealand, to include employment as well as inflation targets.
- For now, interest rates remain on hold at 1.75%. Markets are not currently anticipating an increase until 2019, which is contributing to currency weakness.

Asia

- Data showed China's economy expanded 6.8% in the year to 30 September, slightly below the pace in the March and June quarters, but in line with consensus expectations.
- The tone of other Chinese economic data remained reasonably encouraging. Manufacturing data moderated slightly, but remained close to recent highs. Fixed asset investment and manufacturing activity also both slowed slightly in October.
- The 19th assembly of the Communist Party also attracted investors' attention.
- There were no announcements about specific economic growth targets, but President Xi affirmed that China would deepen economic and financial reforms and seek to further open its markets to foreign investors. The Communist Party has an agenda to migrate the economy towards high-quality rather than high-speed growth.

Australian dollar

The Australian dollar performed poorly against most major peers in October, losing around 2% against a trade-weighted basket of currencies. Against the US dollar, the Australian dollar is now trading at its lowest levels since early July 2017.

The weakness in October was primarily driven by the subdued inflation reading, which suggested local interest rates are unlikely to be raised any time soon. This is in contrast to the US, where a rate hike is widely anticipated in December.

Commodities

Commodities were mixed during October. Lower iron ore and coking coal prices were offset by gains in other commodities, particularly industrial metals.

Nickel prices (+12.0%) surged on hopes that increasing use of lithium-ion batteries will increase demand for the metal. Other metals continue to benefit from ongoing supply concerns.

Copper (+4.9%) remains well supported, for example, reflecting the possibility of supply disruptions. Meanwhile, China's crackdown on illegal aluminium production and impending winter cuts have helped support aluminium prices (+1.4%).

Iron ore fell 5.7%. The price is under pressure amid concerns of steel production cuts in China. Coking coal prices drifted 6.8% lower, for similar reasons.

Oil prices rose (WTI Crude +5.2%). Russia and Saudi Arabia have both hinted they are willing to extend a deal among oil producers to limit supply for a further nine months.

Gold fell 1.1%, to US$1,267/oz. The stronger US dollar and imminent interest rate increases in the US appeared to affect demand for most precious metals (but not all – palladium prices continued to rise – see our Chart of the Month).

Australian equities

After five months of subdued performance, the ASX 200 jumped 4.0% during October; its best monthly return so far, this year. All industry sectors posted positive returns, with Energy (+6.5%), Consumer Discretionary (+6.2%) and Health Care (+5.5%) among the outperformers.

Energy stocks, including Oil Search, Santos and Woodside Petroleum, continued their rally on the back of a rising oil price.

Materials (+4.5%) also had a strong month. A falling iron ore price was offset by gains in other commodities, particularly industrial metals. A number of larger materials companies also released solid Q3 updates during the month.

Financials (+3.2%) were supported by strongly performing insurance stocks, including QBE, IAG and Suncorp. The large banks were also mostly positive, although ANZ underperformed after disappointing the market with a lacklustre earnings update.

Telcos (+2.4%) were mostly positive, with Telstra finally stemming recent losses and posting a small gain. The ACCC report on the communications sector, looking into NBN charges, saw TPG Telecom bounce sharply into month-end. Vocus Communications rallied further after announcing its intention to sell its New Zealand business.

Listed property

The S&P/ASX 200 A-REIT Index returned 2.2% in October. The Office sector (+2.5%) outperformed both Industrials (+1.5%) and Retail (+1.0%). A series of quarterly updates from retail stocks confirmed further weakness in retail sales growth.

The best performing A-REITs included Charter Hall Group (+8.0%) and Iron Mountain (+5.5%). Charter Hall Group gained after announcing an encouraging increase in funds under management in its first quarter results. Iron Mountain also performed well following its quarterly release, which included a 7% dividend increase for the quarter.

Listed property markets offshore performed less well. The FTSE EPRA/NAREIT Developed Index (TR) fell 0.7% in USD terms.

Singapore rebounded from being the worst performer in September to be the best performer in USD terms (+4.3%) in October. Positive sentiment from the residential sector drove stock prices, with recent government land sales and 'en-bloc' transactions suggesting that local developers have turned bullish on the sector. Furthermore, housing inventory has reduced. This is typically the first indicator of a pending market recovery.

Global equities

Global equity markets continued to reach all-time highs in October. The MSCI World Index added 1.9% in USD terms; the twelfth consecutive monthly increase. The weakness in the Australian dollar boosted the return to 4.3% in AUD terms.

Markets were buoyed by a combination of solid economic data (including the US GDP growth figures) and strong corporate earnings results in the US and Europe.

There was a market-pleasing election result in Japan, which supported the Nikkei 225 Index (+5.6% in JPY terms). The re-election of Prime Minister Shinzo Abe heartened equity markets, given the likelihood of continued monetary stimulus and a supportive fiscal policy.

Growth stocks jumped with the strong earnings releases from US technology stocks and the favourable GDP data. The MSCI World Growth Index added 2.8% in USD terms, outperforming the MSCI World Value Index (+1.0%) for the eighth month this year. In 2017 to date, growth stocks have outperformed value stocks by 10.2%.

Emerging markets stocks also benefited from the increasingly robust outlook for global growth and outperformed their developed counterparts for the ninth month this year, rising 3.5% in USD terms and extending accumulated outperformance to 13.9% since the start of 2017. Asian markets led the way in October, up an impressive 5.3% in USD terms.

Global and Australian Fixed Interest

The release of weaker inflation data in the US in mid-month caused bond yields globally to move lower.

This trend quickly reversed, after comments from the US Federal Reserve suggested a December interest rate hike remains likely.

Towards the end of the month, investors focused on the imminent announcement of a new Chair of the Federal Reserve. The favourite candidate for the role is perceived to be one of the more dovish members on the Board, suggesting the pace of rate rises could be moderate if he is appointed. This outlook saw bond yields globally fall towards month end.

The net impact of these events in October as a whole saw 10-year government bond yields up slightly in the US (+5bps) and down in other major markets.

Australia saw a significant drop in yields in the month (-17 bps), following the softer-than-expected inflation data.

German yields were down 10 bps, UK down 3 bps and Japanese yields closed the month unchanged.

The current low inflation environment appears likely to continue to support historically low yields, limited volatility and, ultimately, lower real rates of return from fixed income investments.

Global credit

Global investment grade credit spreads continued to tighten. Specifically, the Bloomberg Barclays Global Aggregate Corporate Index average spread moved 7 bps tighter, to 0.95%.

US credit moved 5 bps tighter, with the Bloomberg Barclays US Aggregate Corporate Index average spread closing at 0.91%. In Europe, the spread on the Bloomberg Barclays European Aggregate Corporate Index was 9 bps tighter, to 0.87%.

US high yield credit spreads also moved tighter, with the Bank of America Merrill Lynch Global High Yield index (BB-B) in 7 bps, to 2.68% by month end. The high yield market continues to be impacted by downgrades, particularly in the energy and mining sectors.

Source: Colonial First State.