

Economic Update



Market and Economic overview

Australia

- The Reserve Bank of Australia (RBA) again left interest rates on hold at 1.50% in July, extending the record period where policy has been unchanged.
- The chances of official borrowing costs being amended in the foreseeable future remain low, particularly with inflation only approaching the bottom of the RBA's 2-3% target band. Annual Core CPI was reported as 1.9% in the June quarter, although higher petrol prices helped lift headline inflation to 2.1%.
- Employment trends remain encouraging, with more than 50,000 jobs created in June. The official unemployment rate remained steady at 5.4%, however, and there is currently insufficient wage pressure to concern policy makers.

United States

- Preliminary US GDP statistics for the June quarter were released and showed that the economy grew at an annual pace of 4.1% in the three months ending 30 June 2018.
- This encouraging statistic followed a slightly weaker reading in the March quarter. Viewed together the two releases confirm the economy performed well in the first half of 2018, growing at a pace that was broadly in line with consensus expectations.
- The improved performance in the June quarter was supported by solid consumer spending and higher soybean exports. Business spending slowed during the period.
- The value of exports rose 9.3% from a year earlier, compared with a 3.6% increase in the previous quarter. Imports moderated over the same period, resulting in a strong influence from trade overall. In fact, the contribution of trade to GDP growth in the June quarter was the highest since 2013.
- Headline CPI again edged higher, to 2.9%. Ongoing pricing pressures in the economy are supporting the case for official interest rates moving back towards neutral.
- Housing starts data released in mid-month was particularly weak, with June starts 12.3% below the May level. The residential construction market may be starting to feel the impacts of higher interest rates.
- US interest rates were left unchanged at 2.00% in July, although further hikes are anticipated before the end of 2018.

Europe

- Economic activity in the June quarter did not rebound as many economists had anticipated.
- In fact, GDP growth in the Euro area was just 0.3% in the period. This was below consensus expectations and dragged the annual pace of growth down to 2.1%, from 2.5% previously.
- In spite of subdued economic conditions, some inflationary pressures appear to be emerging; the latest estimates suggest headline CPI in Europe has risen above 2.0%.
- UK inflation data for June came in below expectations, which arguably should reduce the likelihood of an increase in official interest rates by the Bank of England (BoE).
- However, previously hawkish comments from BoE officials have seen the market retain a 91% chance of a hike in early August.
- No meaningful progress has been made recently in the prolonged 'Brexit' process and the UK's proposed withdrawal from the European Union.

New Zealand

- Inflation picked up to 1.5% yoy in the June quarter, driven by higher food and transport prices. The increase was slightly short of consensus expectations, however, and is unlikely to be a concern for policy makers. Interest rates remain at 1.75%.
- In spite of loose monetary policy, business confidence fell to a 10-year low in July. Inflationary forces could lose momentum if subdued confidence levels result in investment plans being delayed or cancelled.

Asia

- The Chinese economy grew by 1.8% in the June quarter, compared to a 1.4% expansion in the first three months of the year. The economy advanced 6.7% in annual terms, which was in line with market expectations.
- For 2018 as a whole, the Chinese government is targeting economic growth of around 6.5%.
- During the month officials announced that China is taking steps to contain debt and leverage levels in the economy in order to reduce financial risks. Rising defaults among Chinese corporate bond issuers earlier in 2018 had become a concern for investors. This news was well received by investors – the stock market stabilised in July, having lost more than 20% of its value between mid-January and the end of June.
- Elsewhere in Asia, the Bank of Japan lowered inflation forecasts out to 2020, suggesting monetary policy settings will not be tightened and that bond yields will remain anchored at low levels.
- With inflation running at just 0.7% yoy, Japanese interest rates remain at zero and a Quantitative Easing program is still in place.
- GDP data for the June quarter is due on 9 August. A contraction would see the economy enter into a technical recession, following a negative growth reading in the March quarter.

Australian dollar

At the end of July, the Australian dollar bought 0.742 US dollars; an exchange rate that was almost unchanged from the end of June.

Commodities

Most commodity prices finished the July lower as the US announced a new set of tariffs on Chinese goods. China is expected to reciprocate by imposing further tariffs of its own on goods imported from the US. Concerns also mounted over the outlook for global growth, which has been driving demand for commodities in recent months.

Oil (-6.5%) took a breather after posting strong gains in recent months and reaching multi-year highs. Thermal coal (-11.3%) also retreated as deficit concerns subsided. Precious metals were mostly lower, with gold (-2.3%), silver (3.6%), palladium (-2.6%), and platinum (-2.4%) all finishing in negative territory.

Most industrial metals lost ground on concerns around global economic growth, including lead (11.0%), zinc (7.9%), copper (-5.2%) and aluminium (-4.3%). Iron ore (+0.7%) edged higher as the drawdown of Chinese steel inventory continued, given stable demand and supply disruptions from China's environmental crackdown.

Australian equities

After some volatility, the S&P/ASX 200 Index finished July up 1.4%. Investors focused on improving domestic economic data, as well as the upcoming 'earnings season'.

Telecoms stocks made a noteworthy comeback in July, rising 7.9% reflecting strong recoveries in TPG Telecom and Telstra. Technology stocks struggled following poor results from US-listed Facebook. Utilities also underperformed after the ACCC proposed wholesale and retail electricity price reforms.

Small caps underperformed, with the S&P/ASX Small Ordinaries Accumulation Index declining -1.0%. Toilet tissue and hygiene products supplier, Asaleo Care lost nearly half of its value after releasing disappointing preliminary half year results and lowering full year earnings guidance.

Listed property

The S&P/ASX 200 A-REIT Index returned 1.0% in July. Diversified A-REITs (3.4%) was the best performing sub-sector, while Industrial A-REITs (0.1%) was the weakest.

M&A activity remained a key driver, with Blackstone's \$3.1 billion takeover bid for Investa Office Fund being labelled unfair but reasonable by independent expert KPMG. Elsewhere, Hometown lodged a bid for Gateway Lifestyle, with Brookfield reported to have walked away from its proposed transaction.

The strongest performers were Mirvac (5.1%), Stockland (4.5%), and National Storage REIT (4.0%). Mirvac benefited from securing Suncorp as a major tenant at its proposed office development in Brisbane.

Underperformers included Scentre Group (-3.2%), Charter Hall Long WALE REIT (-3.2%), and Shopping Centres Australasia (-2.0%). Scentre shares fell following earnings downgrades from multiple brokers, despite expectations that FY18 earnings guidance would be reaffirmed following the Group's recent 50% acquisition of Eastgardens, a shopping centre in Sydney.

Globally, major property market returns underperformed broader equity markets. The FTSE EPRA/NAREIT Developed Index returned 2.5% in USD terms. In local currency terms, Hong Kong (2.8%) was the best performing market, while the UK (-0.6%) was the worst.

Global equities

Stock markets fared well in July, with positive economic news and a bright start to the US earnings season supporting sentiment. All major markets registered positive returns. US technology earnings unsettled investors in the final days of the month, however, dampening returns from the MSCI World Index to 2.5% in Australian dollar terms.

The German DAX finished the month up 4.1%, as the US and EU appeared to reach a trade truce towards month-end. Having been hit hard over the potential US trade war, rebounds in carmakers Volkswagen and BMW helped the German bourse to outperform other major equity markets worldwide. The Japanese Nikkei rose 1.4% in local currency terms, but was the worst performer among major markets. A number of large listed technology stocks were caught in the Facebook-inspired global sector downturn.

Emerging markets added 1.8% in local currency terms, supported by a sharp rebound in Brazilian stocks. The MSCI Brazil jumped 9.2% in local currency terms, partly reflecting easing trade tensions.

Global and Australian Fixed Interest

News flow affecting global bond markets moderated in July, with few major themes influencing market sentiment. Volatility was reasonably low, certainly when compared to the heightened level of yield fluctuation we've seen in recent months.

The rise in yields in the second half of July was mostly related to increased attention on the Bank of Japan (BoJ) after officials indicated they were considering a change in policy settings. If Japanese Government Bond yields were to rise, local investors invested in overseas bond markets might liquidate some of those investments and reallocate the proceeds into JGBs.

US Treasury yields are expected to continue to test their recent highs as the Federal Funds rate is increased. This is likely to support higher yields in other regions, particularly those where monetary policy is also being tightened. Negative investor sentiment associated with the withdrawal of liquidity from central banks remains a key risk to this scenario playing out as expected.

Global credit

Credit performed well in July, providing some long-awaited good news for investors. Investment Grade spreads narrowed 12 bps, closing at 1.13%. This followed five months of persistent weakness, where spreads had widened by around 40 bps.

Another solid set of quarterly earnings announcements from listed US companies supported sentiment towards issuers in most regions and industry sectors. Disappointing earnings in the tech sector did not have a significant influence on the market as a whole, as credit issuance is limited in this area of the market.

There was particular respite for Asian issuers, which have underperformed recently due to trade concerns. Chinese authorities appear to be easing back on measures that had been implemented to contain credit growth.

The general optimism and healthy appetite for risk extended into the High Yield market too, with yields closing 24 bps lower, at 2.95%. Following the pull-back in July, yields in the High Yield sector are close to their average level over the past 12 months.

Source: Colonial First State.