Economic Update

Market and Economic overview

Australia

- The Reserve Bank of Australia lowered interest rates in June by 25 basis points to 1.25 per cent, and again in July by a further 25 basis points - moving the official cash rate to 1.00%.
- In a July speech, the Governor of the Reserve Bank suggested it would be imprudent to lower Australia's inflation target (2% to 3%/yr) and affirmed that policy makers are willing to ease policy settings further, if required.
- Australia's Composite PMI – a reasonable barometer of activity levels in the manufacturing and services sectors – deteriorated slightly in July, but remained in 'expansionary' territory.
- Unemployment was unchanged at 5.2%. While new job adverts increased markedly in June, it is too early to suggest this is indicative of a meaningful improvement in the labour market.
- The residential property market appeared to stabilise. National home prices rose 0.1% in July; only a modest gain, but significant in that it followed 20 consecutive months of declines.

United States

- At the end of July, the Federal Reserve lowered US interest rates by 0.25 percentage points.
- Consensus expectations suggest US interest rates could be lowered further in the months ahead. Markets have already factored in a 60% probability of another cut after the Federal Reserve Board's next meeting in September.
- Economic growth in the US slowed in the June quarter, to an annual pace of 2.1%. Whilst below the 3.1%/yr rate seen in the March quarter, the reading was ahead of forecasts. A marked improvement in consumer spending supported growth; rising employment and a reasonable level of wage growth appear to have contributed to buoyant discretionary expenditure.

Europe

- The Eurozone economy expanded just 0.2% in the June quarter, down from 0.4% growth in the first three months of the year.
- There was no growth at all over the quarter in Italy, while the pace of growth decelerated in both France and Spain.
- These releases increased the probability that the European Central Bank will announce a new phase of Quantitative Easing; most likely in September.
- Core inflation dipped back below 1%/yr in July, which is likely to be another concern for policy makers.
- In the UK, Boris Johnson won the Conservative Party leadership contest and has been sworn in as the new Prime Minister.
- Johnson has talked openly about his willingness to pursue a 'no deal' Brexit in October if terms cannot be agreed with European officials. The increased probability of this potentially destabilising event resulted in sterling weakness and a sharp move lower in UK government bond yields following his election.

New Zealand

- Business confidence deteriorated in July, to its lowest level in a year. This does not augur well for growth.
- Inflation remained below target in the June quarter, but picked up to an annual pace of 1.7%. Some suggested this might result in the Reserve Bank of New Zealand leaving monetary policy settings unchanged when it meets on 6 August.
- That said, markets continue to suggest one or two rate cuts remain likely before the end of 2019.

Asia

- Economic growth in China fell to a 30-year low of 6.2%/yr in the June quarter. The slowdown appeared primarily due to trade tensions with the US, which are reducing export demand and affecting the manufacturing sector.
- A slowdown in Chinese imports is a separate concern, indicating weakness in the domestic economy.
- Export demand has also tailed off in Japan. June data indicated exports were 6.7% lower than the corresponding period a year ago.
- Consumer confidence levels in Japan have deteriorated to their lowest levels in more than five years. With demand weak, Core inflation remained anchored at 0.7%/yr, well below the Bank of Japan's 2.0%/yr target.

❖ Australian dollar

The release of mixed economic indicators in Australia and stronger-than-expected GDP data in the US saw the 'Aussie' dollar depreciate against the US dollar. By the end of July, the Australian dollar had fallen back below the US$0.70 level, closing below US$0.69.

❖ Commodities

Iron ore prices closed the month of July at around US$115 per tonne. There was a notable increase in stockpiles at Chinese ports, indicating demand could tail off in the near term.

Continued weakness in China's manufacturing activity saw a sharp decline in premium coking coal prices during the month. Oil prices weakened for much of the month and closed July around -2.0% lower. The demand outlook in a slowing global growth environment offset potential supply concerns as geopolitical tensions between the US, UK and Iran intensified. Disruptions in the Persian Gulf could affect a significant proportion of global oil supply.

The gold price climbed a further 1.1%, adding to recent strength. The nickel price rose a further 17.8%, adding to gains earlier in the year. In fact, nickel has been the best performing industrial metal in 2019, benefiting from increased demand for electric cars.

❖ Australian equities

Australian equities followed global equity markets higher as prospects of more stimulatory monetary policies both here and in the US drove Australian shares to all-time highs during the month of July.

Sector performance was dominated by Consumer Staples, which rose an impressive 10.2%. The Health Care sector (+6.2%) also fared well, supported by Resmed (+10.7%). The sleep disorder mask and medical device manufacturer announced a 13% increase in revenue in the June quarter and set an ambitious target for its user base to jump to 250 million by 2025. Materials (+0.4%) lagged in spite of rising iron ore prices.

Australian small caps bounced back from the longer-term underperformance of their large cap counterparts. The S&P/ASX Small Ordinaries Accumulation Index rose 4.5%, driven by small gold stocks.

- **Listed property**

Global listed property posted moderate gains for the month. The FTSE EPRA/NAREIT Developed Index returned 0.4% in USD terms and 2.2% in AUD terms.

Europe (ex UK) was the best performing market (+2.5%), while Hong Kong was the worst performer (-5.1%) amid ongoing civil unrest in the territory.

In Australia, the S&P/ASX 200 A-REIT Index returned 2.6%. Diversified A-REITs was the best performing sub-sector (+4.2%), followed by Retail A-REITs (+4.1%), which bounced back after three consecutive months of negative returns. The worst performing sub-sector was industrial A-REITs, driven by the underperformance of Goodman Group.

- **Global equities**

Global equity markets continued to establish new highs in July. The MSCI World Index edged up only 1.2% in local currency terms, but the weaker AUD helped to bolster returns in AUD terms to 2.3%. While momentum in US markets helped, the UK bourse was the strongest performer, with the FTSE 100 Index up 2.2% in local currency terms. UK stocks were up as much as 3.6% as sterling fell to two-year lows. German stocks struggled, with the Dax falling -1.7% in euro terms.

Emerging markets have now underperformed their developed counterparts for six straight months as the MSCI Emerging Markets Index only rose 0.7% in AUD. MSCI EM Asia was the weakest regional index in AUD terms, rising only 0.3%. Both MSCI India (-5.5%) and MSCI South Korea (-3.9%) fell particularly heavily in local currency terms.

The US/China trade conflict is hitting many Asian companies hard, but there is also an escalating trade disagreement between South Korea and Japan. Indian stocks fell sharply on market unfriendly budget proposals announced earlier in July.

- **Global and Australian Fixed Interest**

Fixed income markets remained dominated by expectations of interest rate cuts and other potential forms of monetary policy easing.

Australian 10-year government bond yields closed the month 14 bps lower, for example, at 1.19% as Reserve Bank of Australia officials indicated that borrowing costs could be lowered further. Investors are speculating that Australian interest rates could fall as low as 0.50% in this cycle, effectively pricing in two further 0.25 percentage point cuts.

Yields plunged even further into negative territory in Europe, with 10-year German bund yields closing July at a new record low of -0.44%. In the UK 10-year gilt yields declined 22 bps, to 0.61%, as markets factored in the prospect of a potentially disorderly withdrawal from the European Union.

Bond markets were little changed in the US and Japan, with 10-year yields up a single basis point in both countries in the month as a whole.

- **Global credit**

Anticipation of interest rate cuts worldwide helped support sentiment towards global credit markets. All else being equal, lower borrowing costs make it easier for companies to service their debt repayment obligations by reducing the cost of new issuance.

Around two thirds of US companies also released their quarterly earnings during July. Collectively, earnings increased by nearly 3.0% during the period, which was well ahead of consensus expectations.

These positive factors saw spreads narrow in both the investment grade and high yield areas of the market in July, resulting in another month of positive returns from global credit portfolios.

Source: Colonial First State.