Economic Update

Market and Economic overview

Australia

- Economic data continues to paint a mixed picture of the domestic economy. The manufacturing PMI survey – a useful gauge of activity levels in the sector – came in below the 50 level; indicating challenging conditions.
- Job advertisements have also been weak and are running -3.7% below the corresponding period a year ago.
- A closely-watched consumer confidence reading also deteriorated sharply in January. The confidence data does not augur well for discretionary spending, which the Reserve Bank of Australia (RBA) is relying on to help inflation return towards the midpoint of its target range.
- For now, inflation remains below target, coming in at an annual rate of 1.8% in the December quarter.
- Over the long-term, the RBA continues to suggest that Australian inflation will return to the target band of between 2.0% and 3.0%.

United States

- The most important market developments occurred towards the end of the month, when the Federal Reserve signalled that US monetary policy is unlikely to be amended in the first half of 2019, at least.
- Commentary from Federal Reserve Board members suggested they may be willing to be patient in determining whether further interest rate hikes are appropriate.
- The focus on the Federal Reserve diverted attention from economic data that was released. More than 300,000 jobs were created in the US in December and there was further evidence that labour market tightening is resulting in wage pressure. Average earnings growth quickened to an annual pace of 3.2%.

Europe

- Growth in the Eurozone economy moderated in the December quarter, declining to an annual rate of 1.2%. This was the slowest pace of growth for five years.
- In spite of the challenging economic conditions, the employment picture has not deteriorated. The unemployment rate remained unchanged at 7.9%; the lowest level since the GFC.
- In the UK, the Brexit debacle descended into further chaos as Members of Parliament rejected Theresa May's Brexit latest withdrawal proposal. Confidence in the leadership remains fragile, however and lawmakers remain divided over key elements of the UK's proposed withdrawal from the European Union.

New Zealand

- At 1.9% yoy, the pace of inflation was unchanged in the December quarter. For now, there appears to be limited chance of the RBNZ amending policy settings – interest rates remain at 1.75%, where they have been since late 2016.
- Credit and debit card spending plunged in December, adding to concerns that the economy might be cooling.
- Business confidence remains subdued, though has rebounded somewhat from the very low levels seen in the middle of 2018.

Asia

- Chinese authorities injected more than 1 trillion yuan (around A$230 billion) into the financial system ahead of the Chinese New Year holidays. This followed a stream of subdued economic data.
- Chinese exporters continue to be affected trade tariffs – the value of exports in December declined 4.4% from a year earlier.
- Imports were lower too, suggesting consumer demand is tailing off and unable to offset the impact of lower export demand.
- In Japan, inflation eased to a 14-month low of 0.3% yoy; perilously close to moving into negative territory. This is in spite of ongoing stimulus from the Bank of Japan.

Australian dollar

In early January, the Australian dollar fell below the US$0.70 threshold for the first time since early 2016. The currency then made quite a sharp recovery, closing the month at US$0.729 – an appreciation of 3.6% in January as a whole. The 'Aussie' strengthened towards the end of January in particular, following comments from the Federal Reserve that took the wind out of the US dollar's sails.

Commodities

Commodity prices finished mostly higher in January, led by iron ore (+17.4%) and oil (Brent +11.6%). Easing US/China trade tensions supported commodity prices generally, while iron ore prices rose sharply towards the end of the month following a tailings dam collapse at Vale's Feijao mine in Brazil. Oil prices rose on improved demand prospects, as US/China trade talks appeared to progress well, and as OPEC continued to sideline supply. Gold (+2.0%) rallied after Federal Reserve policy guidance pushed back timing expectations of the next US interest rate rise. Industrial metals reversed recent losses, with zinc (+14.3%), lead (+9.3%), copper (+7.5%) and aluminium (+4.1%) all seeing gains.

Australian equities

Following the slump in the fourth quarter of 2018, the Australian equity market started the year off with renewed optimism as the S&P/ASX 100 Accumulation Index climbed +3.7% higher. Resurgent global markets, rising commodity prices, solid local employment data and a growing belief that domestic interest rates will stay lower for longer helped 'risk assets', such as equities, rally over January. The Energy sector (+11.2%) provided the best return, benefiting from a recovery in oil prices after the near 40% drop in the fourth quarter of 2018.

The 20% climb in oil prices through January helped all constituents to provide positive returns, with WorleyParsons (+21.5%) and Caltex Australia (+5.3%) at the extremes. The Financials sector (-0.2%) not only provided the lowest return, but was the only sector to decline over the month. Small cap stocks outperformed their large cap counterparts, evidenced by the +5.6% rally in the S&P/ASX Small Ordinaries Accumulation Index.

Listed property

The S&P/ASX 200 A-REIT Index returned 6.2% in January. Industrial A-REITs (+9.7%) was the best performing sub-sector, followed by Office A-REITs (+8.0%). Retail A-REITs was the weakest performing sector in January (+2.8%). Major offshore property markets also delivered strong returns, bouncing back from disappointing performance in December. The FTSE EPRA/NAREIT Developed Index returned 10.9% in USD terms and 10.5% in AUD terms, well ahead of broader equity markets. In local currency terms, Hong Kong (+13.3%) was the best performing market, while New Zealand (+4.0%) lagged

Global equities

Global equity markets bounced back solidly in January after a dismal end to 2018, driven by resurgent emerging markets and the US S&P 500 delivering its strongest January return since 1987. The appreciation of the Australian dollar (AUD) over the month dulled returns a little, but the MSCI World Index nonetheless finished up 4.1% in Australian dollar terms.

The S&P 500 rallied just over 8.0% in USD terms on a combination of broadly pleasing earnings results, ongoing progress towards a US/China trade resolution and increasingly dovish commentary from the Federal Reserve. The FTSE 100 in the UK struggled under the continued Brexit debacle, but still returned a respectable 3.6% in sterling terms. Emerging markets brought up their third month of positive returns in style, with the MSCI Emerging Markets Index rallying 5.0% in AUD and outperforming developed markets for the third successive month as well.

MSCI Latin America was again the strongest region, up 11.0% in AUD, whereas MSCI Asia was the weakest, but still up 3.6% even though MSCI India just fell short of a positive result, down -0.1% in Indian rupee. The Brazilian stock market powered the Latin America results, hitting a string of record highs and the MSCI Brazil Index finished the month up 10.7% in local currency terms.

Global and Australian Fixed Interest

Treasury yields drifted lower as investors digested the change in commentary from the Federal Reserve and readjusted their interest rate outlooks for the remainder of 2019 and beyond. Ten-year Treasury yields closed January 5 bps lower, at 2.63%.

The somewhat gloomy economic picture and an expectation that US interest rates are likely to be unchanged for the foreseeable future saw yields in other major bond markets follow Treasury yields lower. Yields declined 9 bps and 6 bps in Germany and the UK respectively, for example, though were almost unchanged at 0.00% in Japan.

Australian government bond yields followed the lead of other major markets and declined during January. The 10-year yield closed the month 8 bps lower, at 2.24%, dragged lower by the subdued inflation reading for the December quarter.

Global credit

Global credit markets were supported by the more optimistic outlook for equity markets, as well as expectations that US interest rates might not be increased as aggressively as previously anticipated.

The yield on the Bloomberg Barclays Global Aggregate Corporate Index fell 19 bps, to 1.36%. The improved sentiment was reflected even more clearly in the high yield sector – the Bank of America Merrill Lynch Global High Yield Index (BB-B) spread narrowed 93 bps, to 3.66% - close to its level from the end of November prior to the December blow-out.

There was a reasonable amount of new supply – less than January 2018, but nonetheless a significant increase from the closing months of last year – and pleasingly there appeared to be no signs of indigestion. New offerings were generally met with reasonable demand and tended to fare well in the secondary market.

Source: Colonial First State.