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Market Review – August 2019

Australian Economy

The ongoing rally in Australian government bond yields received a further boost following an escalation in US-China trade tensions and forward guidance from the Reserve Bank of Australia (RBA) that an extended period of low interest rates was required for it to meet its employment and inflation objectives. Sentiment shifted from 'risk-on' to 'risk-off', with equity markets weaker and credit spreads widening.

Australian economic readings continued to provide mixed signals and partial indicators point to another quarter of sub-trend growth in the upcoming release of the June quarter national accounts. While retail sales rose by a better than expected 0.4% in the month of June, volume growth over the quarter was up by only 0.2% and points to sluggish consumption growth.

Construction work completed data for the June quarter was softer than expected, falling 3.8%. Total residential spending fell 5.1% and points to dwelling investment being a drag on economic growth over the June quarter. Business investment remains sluggish, with private capital expenditure falling 0.5% over the June quarter.

On the stronger side was Australia's trade balance, which moved from a $6.1bn surplus to an $8bn surplus in June. Net exports are poised to add to economic growth over the June quarter.

Against this backdrop, the RBA released its updated economic forecasts. Their central case view is for economic growth to lift from 2.5% in 2019, to 2.75% in 2020 and 3% in 2021. Given the amount of slack that still has to be absorbed, the RBA have inflation lifting at a slower rate, with core inflation only reaching 2% in the second half of 2021.

In light of offshore and domestic developments, many commentators have built in a further two cuts in the cash rate, with a move to a 0.75% cash rate in November and a move to a 0.50% cash rate in February 2020. This stimulus will build on the pro-cyclical pulse the economy is receiving from earlier cuts to the cash rate, the first tranche of tax relief worth around 0.5% of GDP, a relaxation in macro-prudential policies, a lower exchange and stabilisation in house prices. Thereafter, it is expected that the cash rate will remain at 0.50% for an extended period.

Investors sought "safe-haven" assets in August and, as a result, the AUD depreciated against other major currencies. The Aussie finished 1.6% lower against the US dollar at US$0.6737, 0.8% lower against the euro and 3.9% lower against the yen. However, it gained 1.9% against yuan as the Chinese currency was allowed to devalue against the greenback.

Global Economy

August saw global stock markets decline while perceived safe-haven assets such as bonds outperformed amid escalating worries over trade and growth. A closely watched US bond market indicator suggested rising recession risk.

In the US, shares fell amid growth worries. The Treasury yield curve inverted for the first time since 2007, magnifying concerns that the economy may be heading into recession. Government bond yields declined significantly (meaning prices rose) amid the various geopolitical concerns. The US 10-year government bond yield fell 35 basis points, closing the month at 1.50%, a three-year low, while the two-year yield also ended at 1.50%.

UK: Figures from the Office for National Statistics revealed GDP fell 0.2% in Q2, following 0.5% growth in Q1. The biggest drag on growth in the quarter was a reduction in inventories in the run up to the initial 31 March Brexit deadline.

US: US equities declined in August, although the falls were less pronounced than in other major markets. The Federal Reserve (Fed) cut interest rates, as expected, at the end of July. The Fed's comments indicated that the move was an adjustment rather than the start of an easing cycle, which seemed to disappoint investors concerned about an economic slowdown.

The yield on two-year US Treasuries briefly rose above those on the 10-year bond. This represents an inversion of the yield curve, which is regarded as an indicator of a forthcoming recession.

China: China posted a negative return but marginally outperformed. The US announced 10% tariffs on $300 billion of Chinese goods with effect from 1 September, albeit around half of these were later delayed to 15 December. The renminbi subsequently depreciated beyond the symbolic 7-per-US-dollar threshold, and in response the US Treasury labelled the country a currency manipulator. The Chinese authorities retaliated to trade actions with tariffs on $75 billion of imports from the US, and also suspended new US agricultural product purchases. Meanwhile, fresh policy support was announced in response to domestic economic weakness.

Europe: Eurozone shares ended lower in August with the MSCI EMU (Economic and Monetary Union) index returning -1.2%. Weak economic data from Germany weighed on stock markets while Brexit uncertainty remains another key concern for markets.

In Germany, the "composite purchasing managers' index (PMI) came in at 51.4, indicating the economy is expanding. However, the manufacturing PMI came in at 43.6, well below the 50 mark that separates growth from contraction. The weak data raised suggestions that Germany's government could increase spending in order to try and fend off a recession.

Political uncertainty was the theme of the month in Italy after the break-up of the governing coalition of the right-wing League and populist Five Star.

Emerging Markets: Emerging market equities lost value with further strengthening of the US dollar exacerbating wider risk aversion. The MSCI Emerging Markets Index decreased in value and underperformed the MSCI World. Amid rising uncertainty, those markets most sensitive to US dollar strength came under pressure. These included Turkey and South Africa, but also Argentina where surprise primary election results triggered a major sell off in equities and the currency.

In conclusion: Markets continue to be supported by liquidity. There were further dovish comments from both the US Federal Reserve (Fed) and the European Central Bank (ECB) over the month, with both central banks focused on pre-empting further economic weakness and suppressing the potential appreciation of their respective currencies. The challenge for markets is that global trade data remains soft. There are also some concerns about the Fed's ability to ease aggressively when confronted with the strength of the US labour market.

Table 1: Market Performance – Periods to 31 August 2019

Sector	1 Month %	3 Months %	1 Year %	3 Years % pa	5 Years % pa
Australian Shares	-2.4	4.2	9.0	11.4	7.9
Australian Shares Small Cap	-3.9	1.4	0.9	8.4	7.8
International Shares Ex-Aus (Unhedged)	0.3	8.0	7.6	13.7	13.5
International Shares Ex-Aus (Hedged)	-1.9	5.1	1.1	10.0	7.6
Emerging Markets (Hedged)	-2.5	1.0	-2.8	7.3	4.3
Emerging Markets (Unhedged)	-2.7	2.7	2.7	9.7	7.2
Australian Listed Property	1.2	8.2	19.4	8.6	13.0
International Listed Property ($A)	4.5	7.0	16.9	9.4	13.1
Australian Direct Property	0.1	2.0	7.9	11.1	11.7
Australian Fixed Interest	1.5	3.5	11.2	4.7	5.3
International Fixed Interest (Hedged)	2.3	4.2	10.0	3.9	5.1
Cash (BAUBIL)	0.1	0.3	1.8	1.8	2.0
		Change over the month			
Australian Govt. 10 yr Bond Yield	0.95%	-36 bps			
AUD/USD	$0.67	-$0.01			

*as at 30 June 2019

Australian Shares (S&P/ASX 200 Accumulation Index)

The S&P/ASX 200 Accumulation Index took its first monthly loss for the year in August, falling -2.4%. Trade war fatigue hit global equity markets in August after another bout of Trump tariff escalation. This was amplified by deterioration in industrial production indicators in China and Germany.

Powerful macro themes flowed into local sector returns. Defensive sectors, cushioned by falling bond yields, continued to post solid gains: Staples returned +0.0%, Healthcare +3.6%, Real Estate +1.2% while cyclical underperformance continued; the Energy sector lost -5.6%, Metals and Mining -8.0% and Materials (ex-mining) -7.5%. Exceptions to this general trend were Consumer Discretionary (which rose +0.2%) and Communications Services (which fell -4.5%). Discretionary was stronger following continuing recovery in auction clearance rates and anecdotal evidence of improving consumer activity. Earnings downgrades to Telstra (-4%) held back the communication services sector.

The index finished trading at a P/BV of 2.1x and a P/E Ratio of 17.8x and equity yield (dividend) of 4.0%.

The VIX was at 14.1.0 (the average since 01.10.2010 is 16.4) indicating below average level of market volatility.

Australian Shares Small Cap (S&P/ASX Small Ordinaries Index)

The Small Ords Accumulation index gave back most of its July gains in August with a drop of -3.9%. Reporting season is often a volatile period and this reporting season was also interesting. On a net basis, profits were a little lower than expectations (revisions of <5%) though not as poor as feared.

Companies such as Super Retail Group, Baby Bunting Group, Bapcor and Nick Scali all had solid jumps after posting their profit results.

Trailing P/E Ratio was at 198x at the end of the month, P/BV is at 2.1x and equity yield (dividend) of 3.1%.

International Shares (MSCI World ex Australia Index, Net AUD and the MSCI World ex Australia Index, Net LCL)

The MSCI World ex Australia Index (Unhedged) +0.3% for August whilst the MSCI World ex Australia Index (Hedged) returned -1.9%.

US equity market: US equity market losses were led lower by the energy sector with oil prices falling to their lowest levels in a month and a half amid growing concerns that US-China tensions would weaken demand for crude oil. Financial stocks were also impacted by increasing trade tensions which drove the demand for so-called 'safe-haven' assets.

UK and European markets: Also fell sharply at the beginning of the month, spooked by a reignition of US trade war rhetoric and the inversion of the US and UK yield curves. This relatively rare phenomenon was last seen in the UK in 2008 and means that it is cheaper for the government to borrow money, or sell bonds, over ten-years than it is on a shorter basis.

Chinese equities: Underperformed as the re-escalation in trade tensions with the US impacted market performance and further highlighted the difficulty in attempting to predict the outcome of ongoing discussions between the two sides. Domestically, monthly economic indicators were broadly weaker, with industrial production slowing to a more-than-expected 4.8% year-on-year in July while fixed asset investment rose 5.7% over the first seven months of the year.

Growth stocks continue to outperform. For the month of August, the MSCI World ex Australia Growth Index (hedged) returned -0.9% versus the equivalent Value index (Hedged) of -3.0%.

At the country level, US stocks in August were marginally up +0.5% (Hedged) Other major share markets were negative on a hedged basis; Japan (-3.2%), China (-0.4%%) and Europe (-1.7%).

The index finished trading at a P/BV of 2.3x and a P/E Ratio of 17.9x and equity yield (dividend) 2.4%.

Emerging Markets Shares (MSCI Emerging Markets Index, Net AUD)

Emerging equity markets were spooked that the US economy might be headed towards a recession following an inversion of the US yield curve – this is where short-dated US Treasury bonds of two years' maturity pay more than long-term ones of ten years' duration. In a search for perceived 'safe havens', investors opted for government bonds and precious metals, such as gold and silver, over equities during August.

Emerging market shares (Unhedged) fell by -2.7% in August. But returned -2.5% on a hedged basis.

The index ended trading at a forward P/E Ratio of 13.3x and P/BV of 1.3x and equity yield (dividend) 2.9%.

Australian Listed Property (S&P/ASX 200 A-REIT Accumulation Index)

The ASX 200 AREIT index had another strong month, +1.2% in August. The theory of "lower for longer" Interest Rates has flowed through to lower Yields is one that continues to permeate throughout the markets in order to justify a number of Property transactions on all-time low Cap Rates.

At the end of August, the index was trading on a dividend yield of 4.2% with a P/BV 1.2x and a P/E Ratio 14.6x.

International Listed Property (FTSE EPRA/NAREIT Developed ex-Australia Index, AUD)

Globally REITs were marginally positive +4.5% for the month. Hong Kong REITs were negatively impacted due to investor sentiment emanating from the continued protests. US and Continental Europe were also dragged own especially in the regional mall sector. However positive returns came from Data centre and Healthcare sectors.

At the end of August, the index was trading on a dividend yield of 3.8% with a P/B 1.7x and a P/E Ratio 20.7x.

Australian Direct Property (Atchison Consultants Unlisted Property Funds Index)

Australian direct property posted a return of +2.0% over the June 2019 quarter. Capitalisation rates across property sectors continued to trend downwards. Cap rates across office, industrial and retail properties range are 5.2%, 5.8% and 5.2% respectively.

Australian Fixed Interest (Bloomberg AusBond Composite Bond Index)

Australian fixed interest rose by +1.512% over the month. Australian government 10-year bond yields fell by 30bps to 0.89% while 3-year single A corporate credit spreads widened from 0.861% to 0.873%.

International Fixed Interest (Barclays Global Aggregate TR Bond Index, Hedged to AUD)

International fixed interest returned +2.32% over the month (Barclays). The 10-year US government bond yield plummeted by 50bps to 1.51% while the US corporate investment-grade credit spread widened from 1.47% to 1.62%.

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