Colonial First State

Market View – August 2016

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Summary

As mentioned in the July edition of Market Watch, the Reserve Bank of Australia (RBA) lowered the official cash rate at its 2 August meeting by a further 25bps to 1.5%, a new all-time low. There was no meeting of the US Federal Open Market Committee (FOMC) in August, with the next meeting to be held on 20-21 September. The Chair of the FOMC, Janet Yellen, delivered a key-note speech at the annual Jackson Hole economic symposium in August. This year's symposium was 'Designing Resilient Monetary Policy Frameworks for the Future'. As largely expected, the Bank of England (BoE) cut the benchmark interest rate by 25bps to 0.25% at its meeting on 4 August 2016. The European Central Bank (ECB) and the Bank of Japan (BoJ) also did not meet in August, with their next meetings scheduled for 8 and 21 September.

Australia

As mentioned in the July edition of Market Watch, the Reserve Bank of Australia (RBA) lowered the official cash rate at its 2 August meeting by a further 25bps to 1.5%, a new all-time low.

The Q2 Capex survey released in early September was weaker than expected, -5.4% per quarter compared to the -4% per quarter anticipated. The decline was mostly related to mining and structures. On the positive side, spending on plant and equipment was up 2.8% per quarter, more than expected and a positive for Q2 GDP which is due in September.

Forward looking components of the capex survey were also better than expected. Total capex intentions for 2016/17 were upgraded to AUD$105 billion from AUD$91 billion, implying an annual fall of 19% per year compared to 25% per year previously.

The July labour market report showed the unemployment rate decreased by 0.1% to 5.7% while the participation rate was steady at 64.9%. The number of people employed increased by 26,200, above the 10,000 expected. However the increase was entirely driven by part time employment while full time employment fell over the month.

Quarterly wage data released over the month showed an increase of 0.5% per quarter with the annual rate steady at 2.1% per year, suggesting income growth is likely to remain weak.

Retail sales were unchanged in July, below the +0.3 expected. The weak print was driven by a 6.2% decrease in department store sales while cafes and restaurants (+1.2%) and food (+0.7%), which now represent 55% of retail sales, improved.

Consumer confidence increased over the month with the index up 2% to 101. Gains were seen in almost all sub-indices with the largest improvements in 1 year ahead economic expectations (+3.5%) and 1 year ahead family finances (+4.3%). Confidence has likely been boosted by the second rate cut from the RBA and the continued strength in house prices.

Australian house prices rose by 1.1% in August, taking annual house price growth to 7.0% per year, up from, 6.1% in July. Annually, Sydney (+9.4%) and Melbourne (+9.1%) continue to be the best performers while Perth (-4.2%) and Darwin (-4.2%) continue to lag.

US

There was no meeting of the US Federal Open Market Committee (FOMC) in August, with the next meeting to be held on 20-21 September.

The Chair of the FOMC, Janet Yellen, delivered a key-note speech at the annual Jackson Hole economic symposium in August. The title this year's symposium was 'Designing Resilient Monetary Policy Frameworks for the Future' and Janet Yellen's speech focused on 'The Federal Reserve's Monetary Policy Toolkit: Past, Present and Future.'

While the Fed Chair's presentation was focused more on the medium-to-long term, rather than the current policy, deliberations of the Fed Chair did take some time to discuss the current economic situation and outlook.

Yellen stated that recent developments had been a little more positive. US economic activity "continues to expand, led by solid growth in household spending", although business investment remains "soft" and net exports are "subdued." The Fed Chair highlighted that even though "economic growth has not been rapid, it has been sufficient to generate further improvement in the labour market."

In terms of the outlook, the Fed Chair repeated the standard view that "the FOMC expects moderate growth in real GDP, additional strengthening in the labour market, and inflation rising to 2% over the next few years. Based on this economic outlook, the FOMC continues to anticipate that gradual increases in the federal funds rate will be appropriate over time to achieve sustained employment and inflation near our statutory objectives."

Additionally, however, the Fed Chair was clearer than usual on the policy outlook, stating that "in light of the continued solid performance of the labour market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months."

Employment was stronger than expected in July, increasing by 275,000 before a weaker than expected print in August at 151,000. Despite this, the unemployment rate was stable at 4.9%,

Average hourly earnings data for August was weaker than expected at 0.1%, bringing the annual rate down to 2.4% per year from 2.6% in July.

Inflation remains subdued. Headline CPI was flat over the month and fell to 0.8% per year in July from 1.0% in June. Core CPI increased 0.1% with the annual rate falling 0.1% to 2.2%.

Energy (+1.3%) and transport (+0.6%) increased while apparel (-0.4% per year) and food (-0.1%) declined.

The Fed's preferred measure of underlying inflation, the Core Personal Consumption Expenditure, persisted at 1.6% per year in July, a level which it has remained around for the past 6 months.

Retail sales were flat over the month after increasing by 0.6%/ in June. Sales excluding autos were down 0.3%.

Durable goods orders surprised on the upside in July posting a 4.4% increase driven by a strong rebound in aircraft orders and a recovery in core capex order (+1.6%).

Europe

The European Central Bank (ECB) did not meet over August. The next meeting is on 8 September 2016.

GDP data released for the Euro area was confirmed at 0.3% per quarter, in line with expectations. Annual growth for Q2 2016 fell to 1.6% per year from 1.7% in Q1 2016.

German growth was above expectations, recorded at 0.4% per quarter over Q2. The annual rate fell marginally to 1.8% per year from 1.9% in Q1. Exports and Government spending drove growth as household spending slowed and business investment fell over the quarter.

CPI for the euro area weakened in July printing at -0.6%, dragged down by the fall in oil prices. On an annual basis inflation remains at 0.2% per year, well below the ECB's 2% target

UK

As largely expected, the Bank of England (BoE) cut the benchmark interest rate by 25bps to 0.25% at its meeting on 4 August 2016.

The BoE also announced additional policy easing in the form of GBP60 billion of sovereign QE over the next six months and up to GBP10 billion of corporate bond purchases over the next 18 months. The BoE also introduced a new Term Funding Scheme (TFS) to "reinforce the pass-through of the Bank Rate cut" which provides four-year funding to banks with the explicit intention of facilitating a lower bank rate, conditional on bank lending staying positive.

Along with the changes to monetary policy the BoE also updated its forecasts, with 2017 growth revised down from 2.3% to 0.8% and inflation projected at 2.4% over the next couple of years.

Nationwide House Price data over the month showed a surprising pickup in August, +0.6%, with the annual rate rising to 5.6% per year from 5.2%.

Retail sales were also stronger than expected, up 1.5% in July comparted to the +0.3% the market anticipated. The largest gains were in department store sales (+4.1%) and clothing and footwear (+5.1%), likely aided by the weaker pound and summer tourists. Annually, retail sales are up 5.9% per year.

CPI data showed inflation decreased by 0.1% in July, driven by the volatile transport services component. The annual rate of inflation rose to

0.6% per year from 0.5% while core inflation fell to 1.3% from 1.4%.

Japan

The Bank of Japan (BoJ) did not meet in August. The next meeting is scheduled for 21 September 2016.

GDP was flat over the second quarter, down from 0.5% per quarter in Q1 2016. Growth was dragged down by slowing consumption growth (+0.2% per quarter) and a fall in business spending (-0.4%). The annual rate of growth is now 0.6% per year.

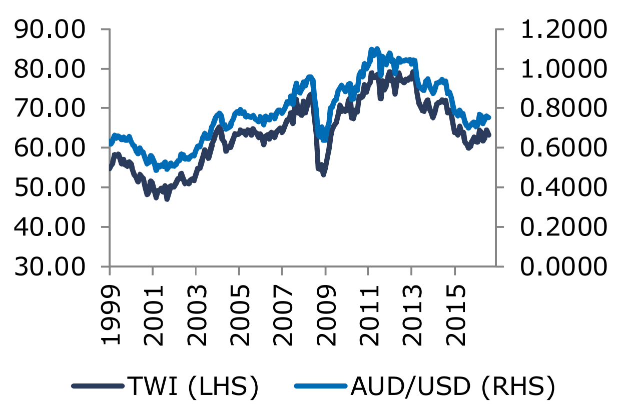
Headline CPI remained low at -0.4% per year over July while the core measure excluding food and energy fell to 0.3% per year from 0.5% per year in June, both well below the BoJ's 2% target.

Australian dollar

The Australian dollar weakened against most major currencies over August. The AUD finished down 1.0% against the USD to $US0.7521, driven by the August RBA rate cut and rising Fed rate hike expectations.

The Australian dollar fell against the euro (-0.88%), the sterling (-0.32%), and NZ dollar (-1.83%), but rose against the yen (+0.20%) over August.

AUSTRALIAN DOLLAR WEAKER AFTER RBA EASING



Source: Bloomberg as at 31 August 2016

Commodities

Commodity prices were volatile in August with oil stronger and metals mixed.

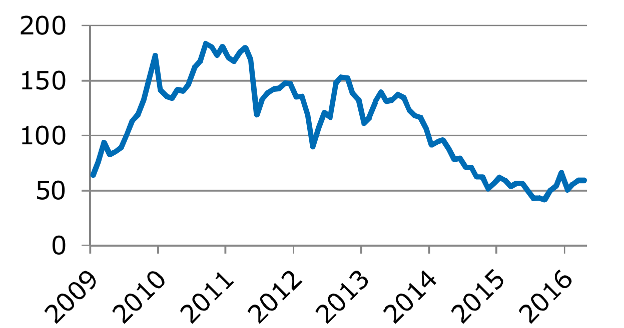
The price of West Texas Intermediate Crude finished the month at $US44.7/bbl, up 7.5%, while the price of Brent was up 6.6% to $US46.89/bbl. Oil prices moved higher on reports of a potential production freeze agreement between OPEC and non-OPEC producers at the September meeting in Algeria. While any deal seems unlikely to materially impact markets given recent increases in production by Saudi Arabia, Iraq and Iran, markets still responded positively to the news.

Gas prices were down with the US Henry Hub spot price down 0.1% to $US2.94/MMBtu while the UK natural gas price was down 30.8% over August.

Iron ore prices were slightly weaker in August, down 0.7% to $58.97/metric tonne, as measured by the benchmark price of iron ore delivered to Qingdao China.

Zinc (+3.0%) and Lead (+4.5%) rose in August while Gold (-2.9%), Copper (-6.3%), Nickel (-8.1%) and Aluminium (-1.8%) were all down over the month.

IRON ORE STABILISES



Source: Bloomberg as at 31 August 2016

Australian shares

The ASX/S&P ASX 200 Accumulation Index returned -1.6% during August. Despite some large swings in the share prices of individual companies, the share market as a whole remained largely flat during the month.

The focus for investors in August has been 'reporting season', where most ASX-listed companies formally announce their financial results for the six or 12 months ending 30 June 2016. In keeping with recent reporting seasons, we have seen big bounces for good results, and 'misses' punished heavily. This was particularly evident in the Health Care sector, with Ansell and Primary Health Care rallying strongly on upbeat results, but CSL selling-off sharply as FY17 guidance disappointed.

Earnings revisions in the Australian equity market as a whole have continued to slide.

Upward revisions to Mining and Materials failed to offset the larger downward revisions to Energy, Insurance, Telco and Healthcare.

With interest rates globally expected to remain low for an extended period, investors continue to favour quality stocks with a relatively high and perceived stable dividend yield. Stocks in the Consumer Staples sectors, for example, continue to perform well.

Listed property

The S&P ASX 200 A-REIT index declined by 2.7% in August. Reporting season saw investors take profits in the sector, following year to date gains of 22.6% over the seven months to the end of July 2016.

A-REIT earnings numbers were generally positive and in line with expectations, helped by a resilient residential property market and a strong office market in Sydney. Diversified A-REIT Mirvac (+5.4%) outperformed after providing robust earnings guidance of between 8% and 11% for the coming financial year.

However Westfield Corp (-2.8%) lagged despite reporting a 5.4% increase in annual net profit, driven by increased spending at its flagship malls and positive property revaluations.

Listed property markets offshore also declined in August. The FTSE EPRA/NAREIT Developed Index (TR) fell by 2.6% in US dollar terms. Hong Kong (+0.3%) was the strongest performing region, followed by the United Kingdom (+0.2%). Property securities in Australian and the US lagged.

Global shares

Global equity markets were relatively quiet over August with all eyes on the Olympics while northern hemisphere summer holidays and the end of reporting season led to limited news.

Those who remained watched closely for any signs of potential Fed tightening and any Brexit related slowdown – which has so far proved elusive.

The MSCI World Index was down 0.1% in US dollar terms in the month of August and up 0.7% in Australian dollar terms.

In the US, the S&P500 (-0.1%) and the Dow Jones (-0.2%) were weaker while the NASDAQ (+1.0%) rose.

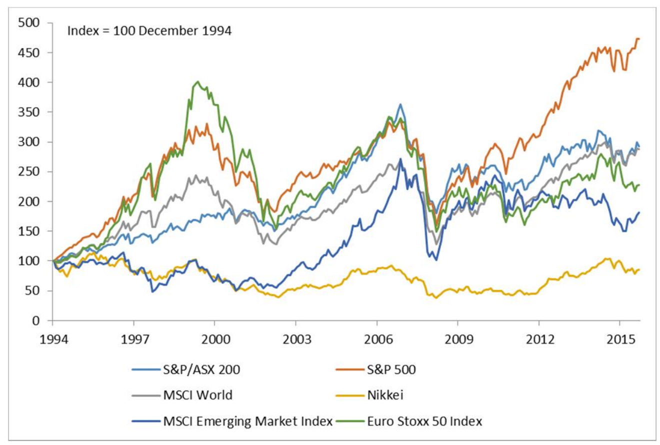
MSCI Financials (+2.91%) was the best performer in August driven by increasing rate hike expectations while the MSCI Utilities (-5.31%) was the worst performer for much the same reason.

Equity markets in Europe continued to take back some of their post-Brexit losses. The German DAX (+2.5%), Italy (+0.6%) and Spain (+1.5%) all rose along with the large cap Stoxx 50 (+1.1%) while France (+0.0%) was flat.

UK equity markets also rose as signs of a Brexit slowdown failed to appear. The internationally focused UK FTSE 100 was up 0.8% while the more domestically focused mid-cap FTSE 250 was up 2.6%.

Asia markets were more mixed with Singapore (-1.7%) down while Taiwan (+0.9%), Honk Kong Hang Seng (5.0%) and the Japanese Nikkei 225 (1.9%) all up.

EQUITY MARKETS RECOVER AFTER BREXIT VOLATILITY



Source: Bloomberg as at 31 August 2016.

Global emerging markets

Emerging market equities were up in August with the MSCI Emerging Market Index up 2.3% in US dollars.

Despite a stronger dollar and increasing odds of a Fed hike global investors continued to look towards emerging markets, particularly Asia, as developed markets struggled to make gains over the month. An investor survey released over the month showed active managers had reduced their short positions and were neutral EM equities for the first time in several years.

Asia was the best performing region with the MSCI EM Asia Index up 3.85% with gains in China and the Shanghai Composite Index (+3.6%) driving the performance. Thailand (+1.6%) and Indonesia (+1.6%) and India

(+1.4%) all rose while the Philippines (-2.5%) was down.

MSCI EM Latin America was up 0.43%, driven by strength in Mexico (+1.9%) and Brazil (+1.0%) while Argentina (-0.4%) fell.

MSCI EM Europe, Middle East and Africa reversed some of last month's gains closing down 2.72% in US dollar terms, led by weakness in Saudi Arabia (-3.5%) and Czech Rupublic (-2.6%).