Market Watch

January 2016

Read the latest market update from the Economic and Market Research team at Colonial First State Global Asset Management.

Market and economic overview

Australia

- The Reserve Bank of Australia (RBA) left the official cash rate on hold at 2% on 2 February 2016 - where it has remained since May 2015. The next RBA Board meeting is 1 March 2016.
- The statement highlighted the tensions between improving trends in the domestic economy and mounting external shocks "over the period ahead, new information should allow the Board to judge whether the recent improvement in labour market conditions is continuing and whether the recent financial turbulence portends weaker global and domestic demand" while leaving the door open for futures rate cuts if deemed appropriate "continued low inflation may provide scope for easier policy, should that be appropriate to lend support to demand".
- Labour market data continued to surprise on the positive side, although there are some data quality issues. The official seasonally-adjusted data showed 1,000 jobs were lost in December, above the -10,000 the market expected after a revised gain of 74,900 jobs in November. This takes the Q4 total to 128,900 and the total for 2015 to 295,300, the highest since 2007.
- The unemployment rate remained at 5.8% in November, well below its most recent peak of 6.4% in January 2015.
- Q4 2015 headline CPI rose by 0.4% per quarter, slightly above expectations, with the annual rate increasing to 1.7% per year, from 1.5% per year. Headline inflation remains below the RBA's 2% to 3% target range.
- The largest gains in inflation were in Alcohol and Tobacco (+2.7% per quarter) primarily driven by an increase in the federal excise tax on tobacco and the Clothing and Footwear group (+1.6% per quarter), due to gains in accessories prices (+4.5% per quarter). Offsetting the gains were price falls telecommunication equipment and services (-2.4% per quarter) and the Transportation group (-1.4% per quarter) due to a 5.7% per quarter fall in fuel prices.
- Perhaps more importantly, both measures of underlying inflation showed a slight acceleration in the pace of price rises with underlying inflation increasing by 0.55% per quarter, which was the average of the trimmed mean and weighted median measures. This took the annual pace of underlying inflation to 2.0%, down from 2.1%.
- Business conditions and confidence, as measured by NAB remain constructive despite small declines (Confidence -2 to 3 and Conditions -3 to 7). Consumer confidence, as measured by Westpac, remains volatile, falling 3.5% in January after a 0.8% fall in December and 3.9% increase in November.

US

- The US Federal Open Market Committee (FOMC) met on 26 to 27 January 2016 and decided to leave the official Fed Funds target rate at 0.25% to 0.50% as was widely expected.
- The statement highlighted that "labour market conditions improved further even as economic growth slowed late last year" and presented a moderate but mixed view of the economy "household spending and business fixed investment have been increasing at moderate rates in recent months, and the housing sector has improved further; however, net exports have been soft and inventory investment slowed".

- On inflation, the Fed stated that “inflation has continued to run below the Committee's 2% longer-run objective, partly reflecting declines in energy prices and in prices of non-energy imports”.
- In addition the Fed stated that “the Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook.”
- The next meeting will be held on 17 to 18 March 2016.
- The US labour market continued to improve. A total of 292,000 jobs were added in December with November revised up to a gain of 252,000. Despite the strong payrolls data the unemployment rate held steady at 5% due to a 0.1% increase in the participation rate to 62.6%. Average hourly earnings were flat over the month with annual gains increasing to 2.5% per year.
- The first estimate of Q4 2015 GDP was released indicating growth was 0.7% on a seasonally-adjusted-annualised-rate, below expectations and lower than the 2% recorded in Q3 2015. Personal spending rose 2.2%, while net exports and inventories each subtracted 0.5% from GDP. Overall for 2015, the US economy grew by 2.4% for the second straight year.
- The manufacturing sector remains weak, with the ISM Manufacturing Index in contractionary territory at 48.2, while the Manufacturing PMI decreased to 52.4 from 52.7 in December.
- The continued decline in the oil price and the strong US dollar saw inflation fall 0.1% per month, while the base effects increased headline inflation to 0.7% per year in January, up from 0.5% per year in December. The Fed’s preferred measure of inflation; Core Personal Consumption Expenditure Price Index was flat in December, taking annual gains to 1.4%, below the Fed’s longer term goal of inflation at 2%.

Europe

- The European Central Bank (ECB) met on 21 January 2016 with no changes to monetary policy announced. The ECB last made changes in December 2015 when the interest rate on the deposit facility was cut by 10 basis points to -0.30% and the asset purchase program (APP) was extended until the end of March 2017 with the ECB noting at the January meeting that the “decisions were fully appropriate. They will result in a significant addition of liquidity to the banking system and will strengthen our forward guidance on interest rates”.
- However ECB President Mario Draghi also acknowledged that “downside risks have increased again amid heightened uncertainty about emerging market economies’ growth prospects, volatility in financial and commodity markets, and geopolitical risks.”
- Consequently there are renewed concerns about downside risks to inflation and as a result “it will be necessary to review and possibly reconsider our monetary policy stance at our next meeting in early March”.
- Preliminary market expectations are for interest rates to move further into negative territory and an expansion in the size of the asset purchase program at some point over 2016, possibly as early as March.
- The estimate for CPI inflation in January was 0.4% per year for headline and 1.0% per year for core inflation, both up marginally from December.

UK

- As expected, The Bank of England (BoE) left policy unchanged when it announced its decision on 14 January 2016. The Bank Rate was unchanged at 0.5% and the stock of asset purchases remained at £375bn. There was one dissent on the nine member board, the sixth meeting in a row.
- The BoE emphasised recent volatility in financial markets, downside risks to global growth and how recent falls in the oil price will act to depress global inflation in the near term.
- In a speech following the BoE meeting, Governor Mark Carney noted; “now is not yet the time to raise interest rates…the world is weaker and UK growth has slowed. Due to the oil-price collapse, inflation has fallen further and will likely remain very low for longer”.

- The advance estimate for Q4 2014 GDP was 0.5% per quarter and 1.9% per year, down from 2.1% per year with growth driven all by the services sector.

NZ

- The Reserve Bank of New Zealand (RBNZ) met on 28 January 2016 and left the official cash rate on hold at 2.5%. The cash rate was last reduced in December 2015.
- The RBNZ conceded that further easing may be needed over the coming year and that further NZD depreciation would be appropriate.
- This followed weaker than expected Q4 2015 CPI at -0.5% per quarter and 0.1% per year. This was down from 0.4% per year in Q3 2015 and below expectations and the weakest since 1999.

Canada

- The Bank of Canada (BoC) met on 20 January 2016 where the overnight rate was left on hold at 0.5%.
- The BoC noted that the “Canadian economy appears to have stalled in the fourth quarter” with the main issue being slower exports to the US and maintains a bias toward further monetary easing, although this will also depend on the prospects for further fiscal easing.

Japan

- The Bank of Japan's (BoJ) policy board convened on 29 January 2016 and added a new dimension to their policy armoury by lowering by 20bps one of its new three-tiered policy rates to -0.1%. The BoJ has labelled the policy action “Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate.”
- The BoJ, led by Governor Kuroda, was likely prompted into action in response to the weaker inflation data, with headline inflation of just 0.2% per year recorded for December, well below its 2% inflation target. Recent Yen strength would also have been a concern for the BoJ, (signalling their unwillingness to tolerate JPY/USD below 120), as well as also wanting to break recent deflationary trends ahead of the upcoming wage negotiations.

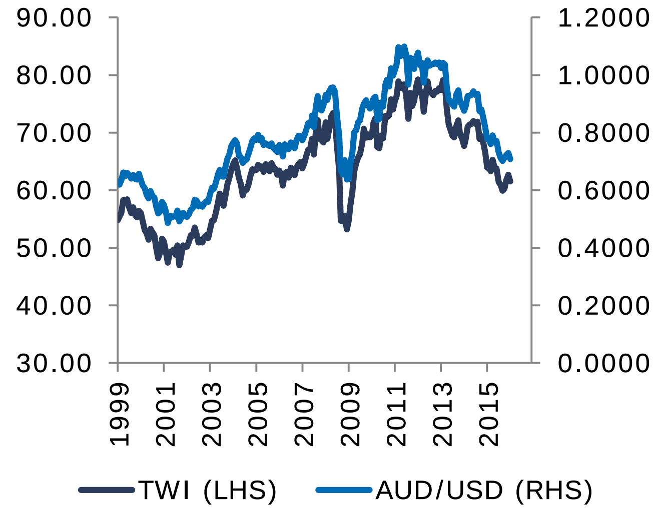
China

- Q4 2015 GDP was released in January, with growth slowing to 6.8% per year, down from 6.9% per year in Q3 2015. For the whole of 2015, growth of 6.9% was recorded, the slowest since 1990. Consumption and services remains the key contributors to growth with a slowdown in real estate investment and manufacturing investment the reason for lower growth. The services sector now makes up 50.5% of the Chinese economy.
- Over the course of 2015, real estate investment slowed to 1% per year compared to 10.5% per year in 2014 and manufacturing investment slowed to 8.1% per year in 2015, down from 13.5% per year in 2014.
- No rate cuts or reserve requirement ratio easings were announced in January, with the focus on further depreciation of the Chinese Yuan. The People’s Bank of China (PBOC) allowed for further depreciation over the month with the Yuan depreciating by 1.3% against the US dollar in January.
- Higher frequency economic data releases continue to point towards slow manufacturing growth but a better performing services sector. In early February the Caixin PMI Manufacturing Index rose to 48.4 from 48.2 while the Caixin PMI Services Index rose to 52.4 from 50.2.

Australian dollar

- The Australian dollar was mostly weaker against the major cross currencies in January. The AUD finished down 2.8% against the USD to $US0.7084. These losses occurred despite reduced expectations of the US Federal Reserve continuing to raise interest rates in 2016.
- The Australian dollar fell against the euro (-2.5%) and yen (-2.1%) and rose against sterling (+0.5%) and NZ dollar (+2.5) over the month of January.

AUSTRALIAN DOLLAR WEAKER TO START THE YEAR

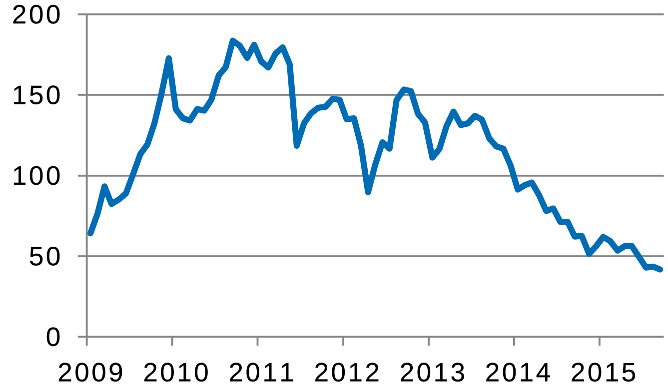


Source: Bloomberg as at 31 January 2016

Commodities

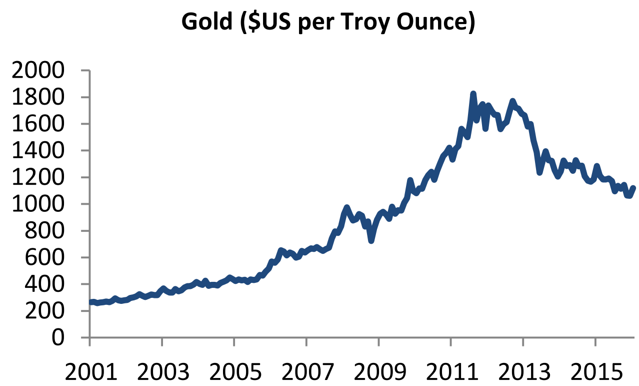
- Commodity prices were weaker in January driven by renewed signs of weakness in China and continued global oversupply.
- The price of West Texas Intermediate Crude finished the month at $US33.6/bbl, down 9.2%, while the price of Brent was down 6.6% to $US36.0/bbl. On 17 January 2016 the UN Nuclear watchdog announced Iran had carried out all measures required under the nuclear deal to enable Implementation Day and the lifting of sanctions. Iran has since announced they plan to restart oil exports and increase production by up to 1 million barrels/day through 2016.
- Gas prices continue to follow lower oil prices, with the US Henry Hub spot price down 2.6% to $US2.31/MMBtu and the UK natural gas price down 13.9% over January.
- Iron ore prices were weaker in January, down 4.2% to $41.7/metric tonne, as measured by the benchmark price of iron ore delivered to Qingdao China – 62% Ferrous Content.
- Copper (-3.1%), lead (-4.2%) and nickel (-2.3%) fell in January, while Gold (+5.2%), Aluminium (+0.8%) and Zinc (+0.9%) made gains.

IRON ORE DOWN SLIGHTLY



Source: Bloomberg as at 31 January 2016

GOLD STRONGER IN JANUARY



Source: Bloomberg as at 31 January 2016

Australian equities

- It was a disappointing start to the new year for Australian equities, with the S&P/ASX 200 Accumulation Index closing January 5.5% lower.
- The Index was led lower by stocks in the Financials sector. ANZ Banking Group declined in value by 13.4%, for example, while the other three ‘big banks’ all closed the month around 8% lower.
- A number of companies in the Energy sector announced production reports for the December quarter. Several saw favourable production reports due to operational efficiency gains, but remained hamstrung by low commodity prices. Oil Search (-3.0%), for example, saw little change in revenue in 2015 from 2014, despite a 52% improvement in production. This highlights the extent of the issue facing LNG producers and other companies exposed to the underlying oil price.

- Most materials stocks announced quarterly updates too. BHP Billiton (-14.1%) announced it will recognise a post-tax impairment charge of ~$7 billion against its onshore US energy assets. Oil and gas prices have been significantly weaker than BHP expected and have affected the company's assessment of asset value.
- Woolworths (-0.9%) announced it intends to exit the home improvement market via a sale or shutdown of its loss-making Masters business. Health care company Resmed (+8.2%) announced interim results that highlighted ongoing market share gains.
- Most other ASX-listed companies will announce their results for the six or 12 months ending 31 December during February.

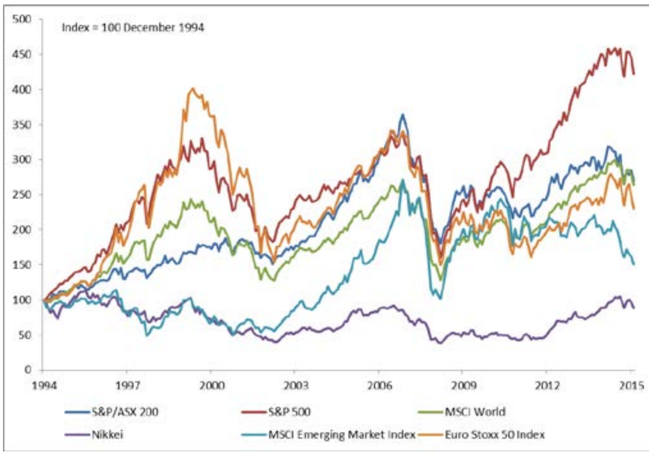
Listed property

- The defensive nature of property securities again enabled the sector to outperform. Despite a >5% decline in the broader Australian sharemarket, the S&P/ASX 200 Property Accumulation Index added 1.1% as investors focused on the relative stability of stocks in the sector.
- Companies in the Retail sub-sector continued to perform relatively well. This area of the market has been supported recently by Australian dollar weakness. Currency movements have reduced the appeal of online shopping from overseas and underpinned sales growth from retail stores in Australia. The lower dollar is also seeing an increase in tourist numbers to Australia, further supporting the domestic retail sector. Stocks including Scentre Group (+3.8%) and Vicinity Centres (+3.9%) have benefited from these themes.
- Global property securities struggled in January, with the FTSE EPRA/NAREIT Global Developed Index declining 4.3% in US Dollar terms. The Hong Kong (-12.5%) market performed particularly poorly, although the UK (-9.3%) also remained weak following disappointing performance in December. In fact Australia generated the best return among major global property regions.

Global developed market equities

- Global financial markets had a volatile start to 2016, with most equity markets recording sharp losses in January. Falls were prompted at the start of this year with weaker manufacturing data in China and the US and political tensions between Saudi Arabia and Iran. These initial reasons for equity market falls were exacerbated by ongoing volatility, indiscriminate selling, sharp falls in the oil price and further Renminbi weakness due to a lack of policy coordination and communication in China.
- On 19 January 2016 the IMF downgraded its assessment of global growth to 3.4% from 3.6% in 2016 and in 2017 to 3.6% from 3.8%.
- With large volatility in equity markets and signs of downside risks to global growth, there was renewed speculation over central bank policy announcements with further easing measures expected. On the last trading day of the month the Bank of Japan surprised markets by introducing negative rates to its already aggressive expansion in monetary base.
- The European Central Bank also expressed the view that they will conduct a full review of policy options ahead of its March meeting while market expectations for further increases in the Fed Funds rate were lowered.
- The MSCI World Index fell by 6.1% in US dollar terms in the month of January, and 3.3% lower in Australian dollar terms.
- In the US, the S&P500 (-5.1%), the Dow Jones (-5.5%) and the NASDAQ (-7.9%) all fell in January. MSCI Materials (-10.2%) and MSCI Financials (-9.9%) were the worst performers while MSCI Utilities (+1.4%) was the best performer.
- Equity markets in Europe were also substantially weaker. The German DAX (8.8%), Italy (-12.9%), Spain (-7.6%) and France (-4.7%) all fell. The UK FTSE 100 was down 2.5%.
- In Asia, the Japanese Nikkei 225 fell 8.0% despite gains on the last day of the month after easing measures by Bank of Japan, while Singapore (-8.8%), Taiwan (-2.3%) and Hong Kong (-10.2%) were mixed.

EQUITY MARKETS SUBSTANTIALLY LOWER IN JANUARY



Source: Bloomberg as at 31 January 2016. Past performance is not an indication of future performance.

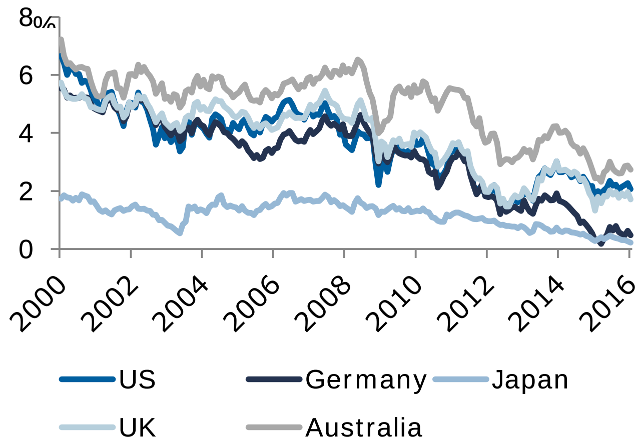
Global emerging markets

- Emerging market equities were weaker in January, with the MSCI Emerging Market Index down 6.5% in US dollars and 3.8% in AUD terms. Concerns around weaker Chinese growth and the continued fall in commodity prices contributed to these losses with all regions recording falls, led by MSCI Asia Ex Japan, down 7.7%. The Shanghai Composite Index fell 22.6% over January. MSCI EM Latin America fell 4.7% while MSCI EM Europe, Middle East and Africa was down 4.2% in US dollar terms.

Global and Australian developed market fixed interest

- Warnings of increased market volatility after the first US Federal Reserve rate hike in December came to fruition, as the new year started off with some significant moves in a seasonably illiquid month.
- However, the main driver of market movements was again the uncertainty surrounding central bank action as we continue to move toward a theme of divergence in global monetary policy. The key central banks made no changes to monetary policy in the month with the exception of Japan where a move toward negative interest rates was announced. Over the month global bond yields fell between 17 and 40 basis points (bps). Japanese yields plummeted to new lows following the surprise change to monetary policy.
- 10 year US Government yields were down 35 bps ending the month at 1.92%, the low end of the range of the past 12 months.
- In Europe, German 10 year bund yields fell 30 bps in the month, to 0.33% on expectations of easing at the next ECB meeting.
- In the UK, the yield on the 10 year gilt fell by 40 bps to 1.56%. Again the Bank of England (BoE) kept rates on hold at 0.5% in the UK at its first meeting of 2016, with an 8 to 1 majority vote.
- In Japan, the 10 year Japanese Government Bond (JGB) yield fell 17 bps in the month to 0.10%. The significant sell off came at the end of the month following an announcement by the Bank of Japan (BoJ) to move interest rates into negative territory.
- In Australia, the 10 year government bond yield followed global yields and fell 25 bps to 2.64%.

BOND YIELDS HIGHER IN DECEMBER EXCEPT JAPAN



Source: Bloomberg as at 31 January 2016

Global credit

- Over the month, global credit spreads traded notably wider however this was more due to the fall in government yields than changes in credit yields. Overall, the Barclays Global Aggregate Corporate Index average spread were 24 bps wider in the month, closing at 1.83%. The Barclays US Aggregate Corporate Index average spread finished the month at 1.81%, widening by 26 bps and the Barclays

European Aggregate Corporate Index widened by 16 bps to 1.50%.

- Volatility continued in the US high yield credit market with weakness from the Energy and Materials sector resulting in a widening of spreads in the month. The Bank of America Merrill Lynch Global High Yield index (BB-B) spread moved 66 bps wider at 6.19%. In Asia, credit markets followed the global widening trend with the JPMorgan Asia Credit Index (JACI Composite) average spread out by 27 bps to 3.31%.
- Australian credit spreads widened in the month. However, activity remained cautious as numerous factors kept investors on the fence including the holiday season, concerns over China's growth outlook amid heightened market volatility, and dollar depreciation. The average spread of the Bloomberg AusBond Credit Index relative to swap increased marginally from 115 bps to 118 bps.

Index return

	Index Level in Base Currency	1 month	12 month
S&P/ ASX200 Index	5,006	-5.5%	-10.4%
S&P / ASX 200 Accumulation Index	45,698	-5.5%	-6.1%
MSCI WORLD (AUD)		-3.3%	4.5%
MSCI World Net Index AUD Hedged		-5.4%	-1.4%
Dow Jones Index	16,466	-5.5%	-4.1%
UK FTSE 100	6,084	-2.5%	-9.9%
German DAX Index	9,798	-8.8%	-8.4%
France CAC Index	4,417	-4.7%	-4.1%
Japan - Nikkei	17,518	-8.0%	-0.9%
Hong Kong – Hang Seng	19,683	-10.2%	-19.7%
MSCI EM (EMERGING MARKETS) (AUD)		-3.8%	-12.9%
US 10 year bond yield	1.92%	-35bps	28bps
Australia 10 year bond yield	2.64%	-25bps	19bps
UBS All Maturities Composite Bond Index	8,666	1.2%	2.2%
90 Day Bank Bill Index	2.29%	-9bps	-28bps
Bloomberg AusBond Bank Bill Index	8,381	0.2%	2.3%
S&P / ASX 200 - A-REIT Accumulation Index	39,866	1.1%	7.3%
AUD/USD (end of month)	0.7084	-2.8%	-8.7%
Oil price	$US33.62/barrel	-9.2%	-30.3%
Gold price	$US1118.17/ounce	5.3%	-12.9%

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