Colonial First State

Market View – June 2016

By Carlos Cacho, Analyst, Economic and Market Research

Summary

The Reserve Bank of Australia left the official cash rate on hold at 1.75% at both its June and July meetings, as was widely anticipated by financial markets. The US Federal Open Market Committee (FOMC) met on 14 and 15 June and left rates unchanged. The European Central Bank (ECB) met on 2 June and as expected no policy changes were announced. Against the run of the opinion polls and the betting markets in the final few days before the vote, the people of UK voted to leave the EU on 23 June 2016. The Bank of Japan's (BoJ) policy board met on 16 June and left policy unchanged.

Australia

The Reserve Bank of Australia (RBA) left the official cash rate on hold at 1.75% at both its June and July meetings, as was widely anticipated by financial markets. The RBA statement included a slight easing bias: "Over the period ahead, further information should allow the Board to refine its assessment of the outlook for growth and inflation and to make any adjustment to the stance of policy that may be appropriate."

On the Brexit, the RBA noted that "Financial markets have been volatile recently as investors have re-priced assets after the UK referendum. But most markets have continued to function effectively… Any effects of the referendum outcome on global economic activity remain to be seen and, outside the effects on the UK economy itself, may be hard to discern."

On inflation, the RBA noted that "Inflation has been quite low. Given very subdued growth in labour costs and very low cost pressures elsewhere in the world, this is expected to remain the case for some time."

A 'double dissolution' Federal election was held in Australia on Saturday 2 July. This election was for the House of Representatives (150 seats) and the full Senate (76 seats).

Australia's trade deficit decreased by more than expected to AUD1.6 billion in April. Exports increased by AUD$171 million; driven by increases in agricultural goods and services exports. Imports declined by AUD$221 million due to a decline in capital goods imports.

The unemployment rate remained unchanged at 5.7% for the third straight month. The number of people employed increased by 17,900, slightly above the 15,000 expected. The increase was entirely driven by part-time employment. The participation rate remained unchanged at 64.8%.

The Westpac / Melbourne Institute Consumer Confidence Index also declined, by 1% in the month, reversing some of the 8.5% gain it made in May. The results showed that whilst consumers had confidence that family finances would rise they were concerned about deteriorating economic conditions.

Credit growth increased by 0.4% per month in May lowering the annualised rate to 6.5% per year (from 6.7% per year). This was driven by a more gradual increase in investor housing, rising 0.4% per month taking annual growth to 6.0% per year.

Australian house prices rose 1.6% in June according to Core Logic RPData, increasing annual house price growth to 10.0% per year. On a capital city basis Melbourne (+1.6%), Sydney (+3.1%), Brisbane (+0.1%) and Adelaide (+0.1%) all rose while Perth (-2.6%) fell.

US

The US Federal Open Market Committee (FOMC) met on 14 and 15 June and left rates unchanged. This was largely expected after May's surprisingly weak payrolls report.

On the labour market the FOMC noted "the pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up." They continued to reiterate that they expect "gradual" rate hikes that will be dependent on "incoming data.

The FOMC revised down their forecast for 2017 and 2018 growth and expect the unemployment rate to remain at 4.7% for the remainder of the year.

As alluded to above, employment was weaker than expected in May increasing 38,000 (160,000 expected). Whilst a strike by Verizon workers accounts for 35,000 jobs, there was unexpected weakness in all sectors except education, health and government.

Despite this, the unemployment rate fell by 0.3% to 4.7%. This was driven by a significant decrease in the labour force (-458,000).

Inflation remains subdued. Headline inflation fell 0.1% to 1.0% per year in May whilst core CPI increased 0.1% to 2.2% per year. Gas prices (+2.3%) and apparel prices (+0.8%) increased whilst food price (-0.2%) and used vehicle prices (-1.3%) dropped.

The Fed's preferred measure of underlying inflation, the Core Personal Consumption Expenditure, remained at 1.6% per year in May.

The housing market saw a slight improvement with the NAHB Housing Market Index, a measure of home builders confidence rising from 58 to 60. Building permits rose 0.7% in the month, existing home sales were up 1.8% whilst new home sales declined by 6.0%.

Europe

The European Central Bank (ECB) met on 2 June 2016 and as expected no policy changes were announced.

The ECB remained focused on implementing the remaining parts of its latest policy package with corporate bond purchases and new TLTROs commencing over the month.

Overall the policy statement was largely unchanged with the ECB repeating that rates will stay at the current or lower levels for an "extended period" and past the horizon of the QE program.

News over the month was dominated by the United Kingdom's (UK's) referendum on European Union (EU) membership which occurred on 23 June. In the lead up to the vote, several prominent EU figures spoke out in favour of "Remain" and warned against the consequences of leaving.

After the vote to Leave, EU leaders called on the UK to activate Article 50 (which begins the formal two year leave process) without delay, refusing to negotiate until then.

UK

Against the run of the opinion polls and the betting markets in the final few days before the vote, the people of UK voted to leave the EU on 23 June 2016.

The vote was extremely close with the Leave camp receiving 51.9% of the total with very high voter turnout, 72% compared to the 66% seen in the 2015 General Election.

The morning following the vote, PM and Conservative leader David Cameron announced his resignation stating that "the British people have voted to leave the EU and their will must be respected. I do not think I can be the captain to take the country to its next destination."

The Conservative party will decide on a new leader by 2 September 2016. The front runners to take over as PM are MP Theresa May (Home Secretary) and MP Andrea Leadsom after the former Mayor of London and favourite, Boris Johnson, unexpectedly left the race.

The Bank of England (BoE) left policy unchanged when it announced its decision on 16 June 2016.

Japan

The Bank of Japan's (BoJ) policy board met on the 16 June 2016 and left policy unchanged with the BoJ continuing to view the economy as being on a "moderate expanding trend".

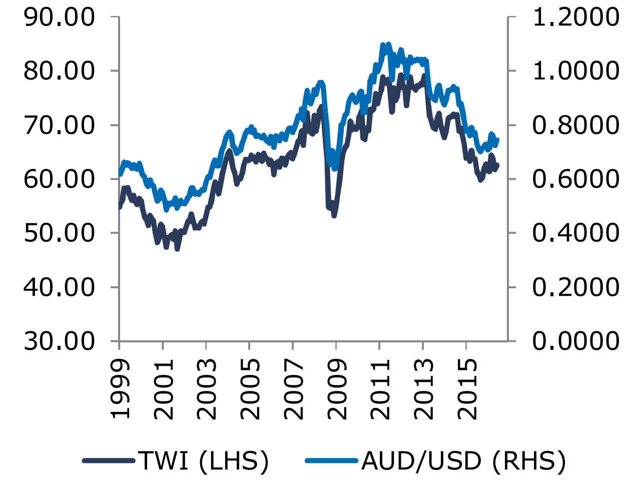
Headline CPI decreased further from -0.3% per year to -0.4% per year over May while the core measure excluding food and energy fell to 0.6% per year from 0.7% per year in April, both well below the BoJ's 2% target.

Australian dollar

The Australian dollar strengthened against most of the major currencies in June. The AUD finished up 2.94% against the USD to $US0.7447. This was largely driven by USD weakness on lower Fed hike expectations.

The Australian dollar rose against the euro (+3.54%), the sterling (+12.63%) but fell against the yen (-4.02%) and NZ dollar (-2.29%) over the month of June.

AUSTRALIAN DOLLAR STRONGER ON SLOWER EXPECTED PACE OF FED HIKES AND GLOBAL UNCERTAINTY



Source: Bloomberg as at 30 June 2016

Commodities

Commodity prices were mostly stronger in June driven by views that policy makers will step in and support markets from any Brexit related downturn.

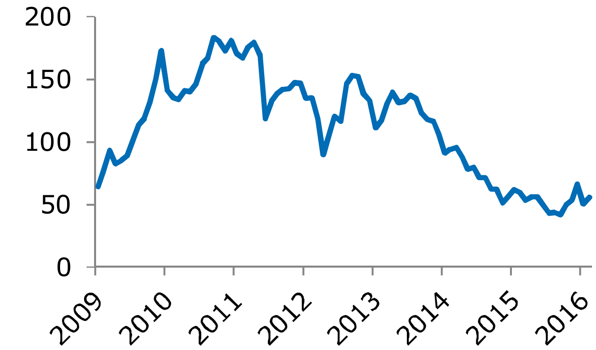
The price of West Texas Intermediate Crude finished the month at $US48.3/bbl, down 1.6%, while the price of Brent was down 1.2% to $US49.71/bbl. Supply balance appears to be returning to global energy markets with strong demand growth, particularly in US and India, and falling inventory levels in the US, despite larger than expected increases in Iranian supply.

Gas prices remained volatile with the US Henry Hub spot price up 38.6% to $US2.899/MMBtu while the UK natural gas price was up 4.4% over June.

Iron ore prices were higher in June, up 11.0% to $55.66/metric tonne, as measured by the benchmark price of iron ore delivered to Qingdao China.

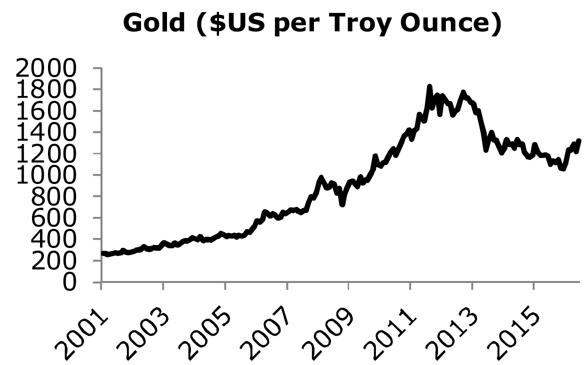
Gold (+8.3), Zinc (+9.4%), Copper (+3.7%) Nickel (+12.0%), Aluminium (+6.0%) and Lead (+5.2%) all rose over June.

IRON ORE UP ON EXPECTATION OF FURTHER STIMULUS



Source: Bloomberg as at 30 June 2016

GOLD RISES AS UNCERTIANTY INCREASES



Source: Bloomberg as at 30 June 2016

Australian equities

Brexit concerns weighed on the S&P/ASX 200 Accumulation Index which declined 2.45% over June, wiping out almost all of the gains made earlier in FY16; the Index closed the financial year with a return of just 0.56%.

Unsurprisingly, stocks which generate a significant component of their earnings in Europe were among the hardest hit. Henderson Group (-31.2%) and CYBG (-28.2%), which operates Clydesdale Bank in the UK, were among the worst performers on the ASX.

At the other end of the scale Newcrest Mining (+20.6%) performed well, benefiting from gold's 'safe haven' status during periods of market uncertainty.

There was limited company news released. Most companies are in 'blackout' ahead of the release of their earnings for the six or 12 months ending 30 June 2016. Most of these results will be released during August. As a result, there is unlikely to be a significant amount of company news flow during July.

Listed property

Against the significant uncertainty of the UK referendum the relatively stable, income-producing characteristics of listed property securities once again proved appealing to investors. The S&P/ASX 200 Property Accumulation Index added 3.5% in June, extending gains in the FY16 year as a whole to an impressive 24.6%.

Property stocks in overseas markets also typically outperformed broader global share markets. As a whole, the FTSE EPRA/NAREIT Global Developed Index added 3.7% in US dollar terms. The US was the top performing region in June – was and among the best in the FY16 as a whole with returns above 23%. With a -17.5% return, UK property stocks underperformed those in other global regions as investors began to consider the implications of the UK's 'leave'.

Global developed market equities

It was a volatile month for global financial markets with a downgrade in Fed rate hike expectations and the UK referendum on EU membership.

The UK referendum was the primary driver of markets over the month especially in the two weeks leading up to the vote with markets moving in-line with polls. Global risk markets sold off sharply following the "Leave" vote before recovering some of their losses into the end of the month.

The MSCI World Index fell by 1.3% in US dollar terms in the month of June and 4.1% in Australian dollar terms.

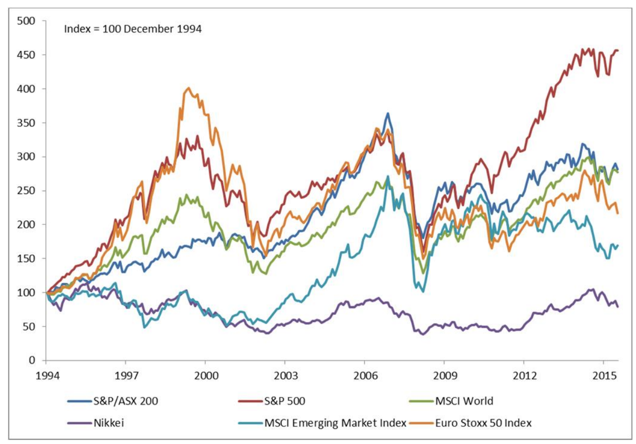
In the US, the S&P500 (+0.1%) and the Dow Jones (+0.8%) rose while the NASDAQ (-2.1%) fell in June. MSCI Utilities (+4.45%) was the best performer in June as investors looked for safe havens amongst global uncertainty. MSCI Financials (-6.09%) was the worst performer over the month as the Brexit vote and the future of financial services in the UK along with the prospect of further monetary policy easing weighed on bank stocks.

Equity markets in Europe, ironically with the exception of the UK, were down. The German DAX (-5.7%), France (-6.0%), Italy (-10.1%) and Spain (-9.6%) all fell along with the large cap Stoxx 50 (-6.5%).

After initial weakness following the vote, the internationally focused UK FTSE 100 recovered into month-end to finish up 4.4%, likely driven by the sharp fall in the Pound. The more domestically focused mid-cap FTSE 250 however finished down 5.3% as uncertainty around the UK's future relationship with the EU weighed on sentiment.

Asia also saw mixed results with Singapore (+1.8%) and Taiwan (+1.5%) up, while Japanese Nikkei 225 (-9.6%) and Honk Kong Hang Seng (-0.1%) declined.

VOLATILE MONTH FOR EQUITIES WITH BREXIT RISKS DRIVING MARKETS



Source: Bloomberg as at 30 June 2016. Past performance is not an indication of future performance.

Global emerging markets

Emerging market equities were up in June with the MSCI Emerging Market Index up 3.3% in US dollars.

Declining Fed rate hike expectations and stronger commodity prices drove markets with the Latin American region recording the best performance. MSCI EM Latin America rose 11.34%, driven by Brazil (+6.3%) and Argentina (+16.1%), the MSCI EM Europe, Middle East and Africa was also up 3.04% in US dollar terms.

MSCI Asia Ex Japan was up 1.89%, driven by the MSCI Indonesia (+9.2%) while the Shanghai Composite Index (+0.4%) was flat.