Colonial First State

Market Watch

May 2015

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) cut the official cash rate from 2.25% to 2.00% on 5 May; this was largely expected by financial markets. The RBA subsequently left the official cash rate on hold on 2 June.
- The RBA noted that "the global economy is expanding at a moderate pace" but commodity prices have declined over the past year, generally reflecting increased supply.
- On Australia, the RBA noted "the available information suggests improved trends in household demand over the past six months and stronger growth in employment".
- The key drag on growth will be weakness in business capital expenditure in both mining and non-mining sectors and subdued public spending.
- On the Australian dollar (AUD), the RBA noted "further depreciation seems both likely and necessary, particularly given the significant declines in key commodity prices" and "the inflation outlook provided the opportunity for monetary policy to be eased further, so as to reinforce recent encouraging trends in household demand".
- The RBA also released its quarterly Statement on Monetary Policy and downgraded its GDP growth forecasts. For June 2015, growth was downgraded to 2%, for December 2015 to 2.5% and as at December 2016 to 2.75%-3.75%.
- This indicates the Australian economy will remain below trend for longer than had been anticipated in February 2015 when forecasts were last published. Downgrades were largely driven by a later pickup in non-mining business investment and will eventually be helped by a lower currency and above average consumption growth.
- Inflation forecasts were also revised a little lower due to weaker product and labour markets, the unemployment rate is now forecast to peak around 6.5%.
- The 2015/16 Commonwealth Budget was handed down, with a deficit estimate of A$35.1bn, 2.1% of GDP. This compares with a deficit of A$41.1bn, 2.6% of GDP, in 2014/15. The Budget deficit will slowly improve to A$6.9bn in 2018/19, before a return to surplus currently expected in 2019/20.
- Net debt to GDP will peak at 18% in 2016/17. Australia, however, remains only one of nine countries with a AAA rating from all three major ratings agencies.
- The unemployment rate edged up to 6.2% in April, with 2,900 jobs lost. This compares to 41,300 jobs added in March. Annual employment growth is now 1.5% - a reasonable result given below-trend economic growth.
- Private capital expenditure intentions data was released in late May. For 2014/15 the sixth estimate is A$150bn, down from A$153bn, while for 2015/16 the second estimate fell to A$104bn from A$110bn. The big disappointment has been the lack of improvement in non-mining investment - current estimates have this falling 28% in 2015/16.
- In positive news, the Westpac / Melbourne Institute Consumer Confidence Index rose 6.4% in the month, the largest gain post Budget since 2007, taking consumer

confidence to the highest level in 16 months. The RBA rate cut also helped the rebound.

United States

- The US Federal Open Market Committee (FOMC) did not meet in May, with its next meeting scheduled for 16-17 June 2015. Attention is on the first interest rate hike, currently expected in September 2015.
- In May, the Federal Reserve System (the Fed) Chair Janet Yellen delivered a speech titled 'The outlook for the economy' and noted "one sign of a stronger labor market is that the number of job openings has risen impressively, and another is that more workers are quitting their jobs, signalling greater confidence in their ability to find a new job. I say 'approaching' because, in my judgment, we are not there yet".
- Yellen also noted: "if the economy continues to improve as I expect, I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate target and begin the process of normalizing monetary policy" and "to support taking this step, however, I will need to see continued improvement in labor market conditions, and I will need to be reasonably confident that inflation will move back to 2 percent over the medium term".
- On employment, there were further positive signs in the month with the unemployment rate falling to 5.4% in April with 223,000 jobs added. This is the lowest unemployment rate since May 2008 and coincides with a 15 year low in initial jobless claims and a 14-year high in job openings.
- However, inflation remains weak. Headline inflation fell to -0.2% per year in April, from -0.1% per year, largely driven by lower gasoline prices and a stronger US dollar. Core CPI is 1.8% while the Fed's preferred measure of underlying inflation, the Core Personal Consumption Expenditure, fell to 1.2% per year in April, down from 1.3% per year.
- The second estimate of Q1 2015 GDP was released, with growth downgraded from 0.2% on a seasonally-adjusted-annualised-rate to -0.7%. A sharper fall in net exports and a lower positive contribution from inventories drove the downgrade.
- The sharper than anticipated fall in Q1 2015 GDP has led to expectations of stronger April and May data. This has largely been delivered, with the ISM Manufacturing Index rising to 52.8 from 51.5 in May. Construction spending rose 2.2% per month in April and core durable goods (ex transportation) rose 0.5% per month and housing starts bounced 20.2% per month to 1.135mn. At this stage GDP forecasts for Q2 2015 and Q3 2015 GDP in the US remain around 2.5% to 3%.

Europe

- The European Central Bank (ECB) did not meet in May, with the next meeting scheduled for 3 June 2015.
- The ECB did announce it bought public and private assets worth €63bn in May under its expanded asset purchase programme. This takes the total of the public sector purchase programme holdings to €146.7bn at the end of May.
- Negotiations were ongoing with Greece over the month to disburse bailout funds under its current program. No progress has been made after five months of negotiations.
- Greece has €1.7bn of payments to the International Monetary Fund due in June, with a deal required at some point over the month to disburse funds required for this repayment. The main sticking points for a deal remain pension and labour market reform and budget surplus targets.
- Economic data released included flash estimates of Q1 15 GDP, with overall growth in Europe recorded at 0.4% per quarter and 1.0% per year.
- Spain, France, Germany and Italy all grew, while Greece contracted by 0.2% per quarter with the economy recording growth of just 0.3% per year.

United Kingdom

- The Bank of England (BoE) left policy unchanged at its 11 May 2015 meeting, as expected. The Bank Rate was unchanged at 0.5% and the stock of asset purchases remained at £375bn.
- The UK General Election was held on 7 May 2015 and in somewhat of a surprise David Cameron and his Conservative government

was re-elected with a majority. The final results were The Conservatives (330 seats), Labour (232), the Scottish National Party (56), the Liberal Democrats (8) and the United Kingdom Independence Party (1).

- One outcome from the election was the commitment to hold a referendum on European Union membership in the next two years.
- Inflation remains weak, -0.1% per year in April after a monthly gain of +0.2%. Core inflation is 0.8% per year to April, down from 1.0% per year. The unemployment rate fell to 5.5% from 5.6% with 202,000 jobs added in the three months to March.

New Zealand

- The Reserve Bank of New Zealand (RBNZ) did not meet in May, with the next meeting scheduled for 11 June 2015.
- Over the month financial markets and economists begun to price in expectations for a rate cut by the RBNZ given low inflation and regulatory changes to curb the Auckland housing market.
- The RBNZ has taken additional action to tighten lending restrictions on residential investment loans, particularly in the Auckland Council Region.
- Auckland investor loans will effectively need to have a Loan to Value Ratio (LVR) of no more than 70%; Auckland owner-occupied houses retain the 80% LVR 'speed limit' of 10% of new bank loans; housing loans outside of Auckland will have a higher 15% 'speed limit' (from 10%) for 80% LVR loans. The changes are intended to take place from 1 October. The RBNZ also intends to require banks to hold more capital for investment loans.
- The 2015 Budget was released with a deficit this year of 0.2% of GDP with a return to surplus in 2016.

Canada

- The Bank of Canada (BoC) left the overnight lending rate on hold at 0.75% at its meeting on 27 May 2015. The BoC surprised markets by cutting the cash rate to 0.75% from 1.00% in January 2015.
- Of note this month were comments that inflation and consumption were holding up in line with forecasts, despite persistently low inflation. The BoC also noted the weakness in the US economy in Q1 2015 and a recovery in the US should help rotate demand in the Canadian economy toward more consumption and business investment.
- Canadian GDP contracted -0.6% on an annualised basis in Q1 2015, down from 2.2% in Q4 2014, the sharpest fall since 2009. Business investment fell 9.7% in Q1 2015 on an annualised basis, the most since the recession in 2009.

Japan

- The Bank of Japan's (BoJ) policy board convened on 22 May 2015 and left its qualitative and quantitative easing (QQE) program at an annual increase of Y80trillion to its monetary base. BoJ Governor Kuroda sees inflation reaching 2% in H1 2016, but won't hesitate adjusting policy if needed.
- The preliminary Q1 2015 GDP data rose 0.6% per quarter, annualising at 2.4%, compared to 1.5% in Q1 2014.
- CPI data showed the effects of the consumption take hike dropping out, with inflation falling to 0.6% per year in April, from 2.3% per year in March.

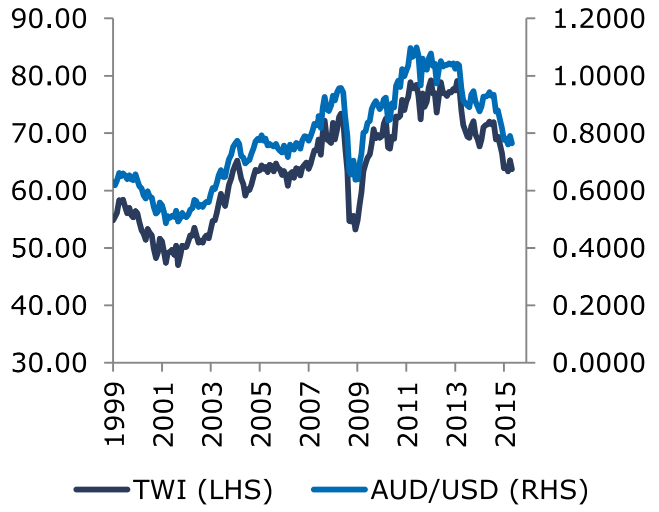
China

- The Peoples Bank of China (PBOC) cut the 1-year lending rate to 5.1% from 5.35% on 10 May 2015. This is the third rate cut since November 2014.
- The PBOC also raised the ceiling for deposit rates to 1.5 times that of the benchmark deposit rate, from 1.3 times, in an effort to continue down the interest rate liberalisation path.
- M2 growth continues to slow, and was recorded at 10.1% per year in April, down from 11.6% per year in March.
- Official Manufacturing PMI data record a slight gain, up to 50.2 from 50.1, whole Non-Manufacturing PMI data weakened to 53.2 from 53.4.

Australian dollar

- The AUD was mixed in May, recording falls against the US dollar (USD), sterling and euro. The AUD fell 3.3% to US$0.7644 in May, assisted by the RBA rate cut, weaker economic data and renewed strength in the USD. The falls came after gains recorded in April.
- The AUD also fell against the sterling and the euro but rose against the Japanese yen.

AUSTRALIAN DOLLAR WEAKER

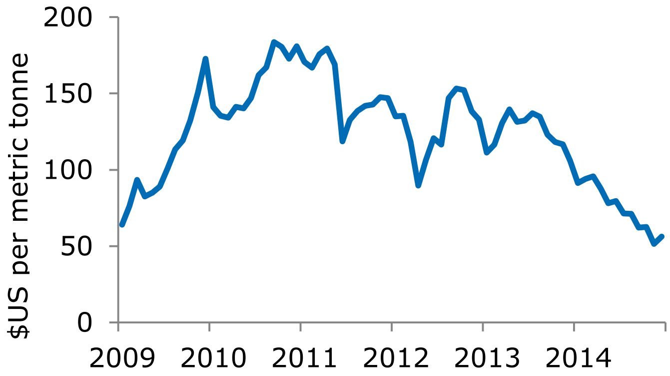


Source: Bloomberg as at 31 May 2015

Commodities

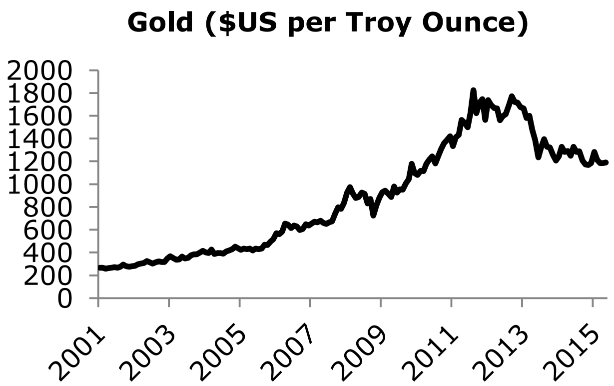
- Commodity prices were mixed in May, with recovery in oil, gold and iron ore and weakness in metal prices.
- The iron ore price, as measured by the benchmark price of iron ore delivered to Qingdao China – 62% Ferrous Content, rose 10.2% in the month to US$61.9/metric ton, on further easing measures in China, and some signs of production cuts. The recovery from low in early April is now over 30%.
- The oil price also rose in May, following sharp gains in April, with the price of West Texas Crude rising 1.1% in the month to US$60.3 a barrel. Brent fell 1.8% in the month to US$65.6.
- Metal prices also were weaker after good gains in April. Aluminium, nickel, lead, copper and zinc all fell.
- The gold price rose just 0.5% in May to US$1190.55 an ounce. The gold price has been relatively stable since mid-January.

IRON ORE PRICE REBOUNDS BUT STILL WELL OFF ITS HIGHS



Source: Bloomberg as at 31 May 2015

GOLD DIRECTIONLESS



Source: Bloomberg as at 31 May 2015

Australian equities

- Australian shares were little changed in May, with the S&P/ASX 200 Accumulation Index adding just 0.4%. With one month of the financial year to go, Australian shares have added 11.6% in FY15.
- There was strength in several areas of the market in May. Stocks in the Industrials, Health Care and Materials sectors, for example, tended to perform well. Weakness in the heavyweight Financials sector prevented the Index from making further progress.
- Three of the 'big four' banks reported semi-annual earnings early in the month. The actual results were overshadowed by ongoing concerns over capital requirements in the

sector. Regulator APRA is rumoured to be considering an increase in minimum capital levels, which has focused investor attention on balance sheets in the sector. In anticipation of such a move, National Australia Bank completed a A$5.5bn equity raising during the month, some of the proceeds of which will be used to shore up the company's capital position.

- Elsewhere, BHP Billiton completed the demerger of diversified mining company South 32. The stock made its debut on the ASX in mid-month and performed reasonably well after listing.
- Corporate activity also remained in the news, with Flight Centre, GUD Holdings, Independence Group and TPG Telecom all looking to make acquisitions.

Listed property

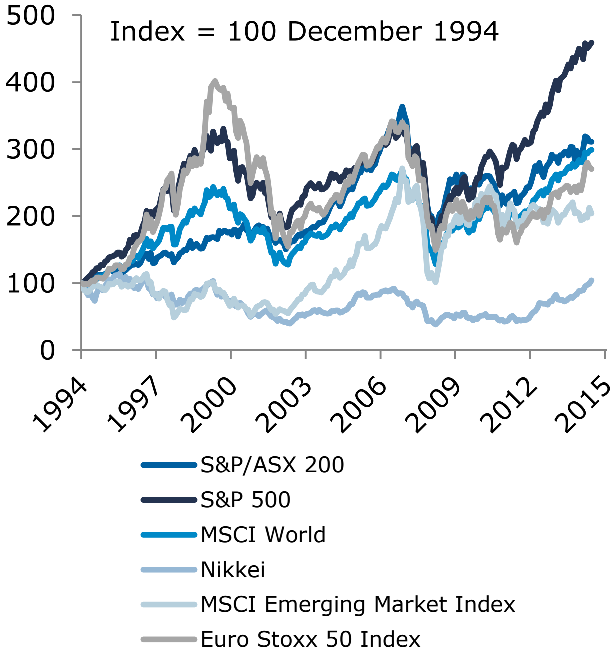
- The S&P/ASX 200 Property Accumulation Index returned 2.9% in May, 2.4% ahead of the broader Australian share market. The interest rate cut by the RBA on May 5th proved supportive of this income-generative sector.
- Office A-REIT Dexus Group (+8.5%) rallied after announcing well-received leasing numbers for its office and industrial property assets. The company also raised $A400m through a placement; and reaffirmed 2015 financial year earnings and dividend guidance. Peer Investa Office Fund (+6.7%) also gained during the month.
- Underperforming stocks included diversified A-REITs Charter Hall Group (-6.6%) and Stockland (-2.3%). Charter Hall Group fell after raising A$225m via an institutional placement at a 2.8% discount to its previous closing price. Stockland underperformed despite tightening its earnings guidance and announcing it had secured its highest number of residential deposits since 2011.

  Listed property markets offshore declined in May. Overall, the UBS Global Property Investors Index fell by 1.3% in USD terms. The UK was the strongest-performing region. Continental Europe lagged, returning -6.6%.

Global developed market equities

- Global developed equity markets were mixed in May, with the US market moving higher, falls in some European markets and mixed markets in Asia. Protracted negotiations on the next phase of the Greek bailout unsettled markets as did timing of the first rate hike in the US. Liquidity through central bank purchases continues to assist equity markets in moving higher, despite stretched valuations, particularly in the US.
- Overall, the MSCI World Index rose 0.1% in USD terms and 3.2% in AUD terms given the fall in the AUD over the month.
- US markets moved higher with some evidence of a recovery in US data in early Q2 2015, and a slowdown in USD appreciation.
- The S&P 500 Index rose 1.0% in the month, the Dow Jones was up 1.0% and the NASDAQ rose 2.6%.
- Equity markets in Europe were mixed, the German DAX fell 0.4% in May, France fell 0.8% and Spain was down 1.5%. In contrast Italy rose 2.0% and the Athens Stock Exchange rose 1.2% despite no resolution on Greek funding. Equity markets appear sanguine about the risks of the Greek default and exit from the Eurozone. Instead currency markets and bond markets were more volatile. The euro fell 2% against the US dollar in May.
- The UK FTSE 100 was up 0.3%, with the re-election of the Conservative government. There are some expectations that this could lead to more aggressive fiscal consolidation, although this would be offset by less monetary policy tightening by the Bank of England.
- The Japanese Nikkei 225 rose 5.3% over the month and is now up 42.9% over 12 months. Aggressive stimulus from the Bank of Japan and a significantly weaker yen continue to support the equity market.
- Hong Kong (-2.5%) and Singapore (-2.7%) both fell.

EQUITY MARKETS MIXED



Source: Bloomberg as at 31 May 2015

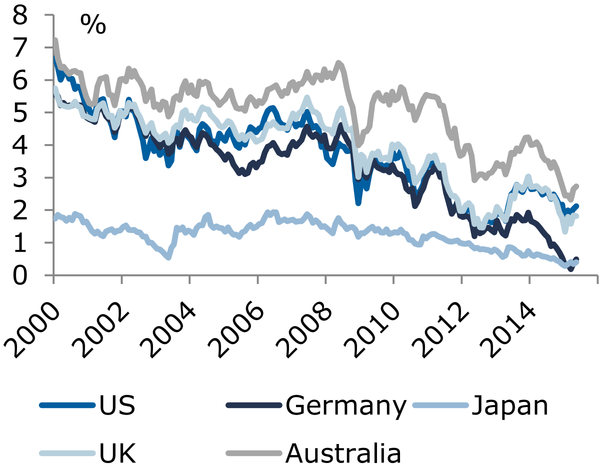
Global emerging markets

- Emerging market (EM) equities fell sharply in May, down 4.2% in US dollar terms (MSCI EM Index) after strong gains in April. The MSCI Emerging Markets Index underperformed the broader developed market index. In AUD terms, the index fell 0.9%.
- The index was not helped by the stronger USD in May, which rose 2.4% over the month. All regions suffered losses, with MSCI Latin America reversing gains in April, falling 7.0% in May, with sharp falls in Argentina and Brazil, while Mexico gained ground. Brazil raised rates again in late April, with the SELIC rate now 13.25%, the highest since 2008.
- Elsewhere, MSCI Europe, Middle East, Africa Index fell 6.4% and MSCI Asia ex-Japan fell 2.61%.
- MSCI India recorded positive gains, rising 3.4% in May, there is rising hope and evidence of an economic recovery in India. Economic growth was recorded at 7.5% per year in Q1 2015.

Global and Australian developed market fixed interest

- Bond yields across most major markets were slightly higher at the end of May, compared with the previous month-end. During the month, markets were volatile and 10-year Government bond yields moved in range of between 25 and 40 bps.
- The German bond market was particularly volatile and at times appeared to lead the other markets. The 10-year German bund yield increased from 0.37% at the end of April to an intra-day high of 0.77% in the first half of the month, before ending May at 0.49%. The sharp intra-month moves appeared to be the result of investors reassessing value with yields so low, rather than due to any specific economic or political events.
- The 10-year US Treasury yield reached an intra-day high of 2.36% during the month, but finished May at 2.12%, an increase of only 9 bps compared with the end of the previous month.
- The yield on the 10-year UK gilt fell by 2 bps to 1.81% over the month.
- In Japan, the 10-year JGB yield rose 5 bps to 0.39%, reversing most of the previous month's fall. There is speculation that the Bank of Japan may expand its qualitative and quantitative program given a lack of inflation pressures and disappointing growth data.
- In Australia, the benchmark 10-year government bond yield increased by 8 bps to 2.73% after reaching a high of 3.04% during the month. The 3-year yield traded as high as 2.19% before closing at 1.88%, 5 bps lower than at the end of April.
- The RBA reduced the official cash rate from 2.25% to 2% early in the month, as was widely expected by the market. However, the absence of an explicit easing bias disappointed some market participants and yields rose following the easing before falling again by month-end. The 10-year bond yield was more affected by global bond markets rather than by domestic monetary policy, hence resulting in a steepening of the yield curve.

BOND YIELDS VOLATILE IN MAY



Source: Bloomberg as at 31 May 2015

Global credit

- Over the month global credit spreads widened by 4 bps with the Barclays Global Corporate Aggregate spread closing at 1.26% and were remarkably stable given the moves in global bond markets. The Barclays European Aggregate Corporate Index closed at 1.00%, widening by 2 bps in May and the Barclays US Aggregate Corporate Index finished the month at 1.27%, widening by 5 bps. US High Yield credit spreads tightened last month with the Bank of America Merrill Lynch Global High Yield index (BB-B) spread closing 8 bps tighter at 3.78%.
- Asian credit markets finished the month little changed, with the JPMorgan Asia Credit Index (JACI Composite) average spread widening by only 1 bps to 2.58%.
- Australian credit spreads were little changed during the month and the average spread of the Bloomberg AusBond Credit Index relative to swap moved between 80 and 83 bps.

Index return

	Index level in base currency	1 month	3 month
S&P/ ASX200 Index	5,777	-0.2%	5.2%
S&P / ASX 200 Accumulation Index	51,325	0.4%	9.9%
MSCI World Net Index (AUD)		3.4%	28.5%
MSCI World Net Index AUD Hedged		1.4%	15.7%
Dow Jones Index	18,011	1.0%	7.7%
UK FTSE 100	6,984	0.3%	2.0%
German DAX Index	11,414	-0.4%	14.8%
France CAC Index	5,008	-0.8%	10.8%
Japan - Nikkei	20,563	5.3%	40.5%
Hong Kong – Hang Seng	27,424	-2.5%	18.8%
MSCI Emerging Markets Net Index (AUD)		-1.1%	21.6%
US 10 year bond yield	2.12%	9bps	-35bps
Australia 10 year bond yield	2.73%	8bps	-93bps
UBS All Maturities Composite Bond Index	8,476	0.0%	7.5%
90 Day Bank Bill Index	2.15%	-10bps	-56bps
Bloomberg AusBond Bank Bill Index	8,260	0.2%	2.6%
S&P / ASX 200 - A-REIT Accumulation Index	38,417	2.9%	29.7%
UBS Global Real Estate Investors Index (Net TR) AUD Hedged	2,146	-0.4%	15.8%
AUD/USD (end of month)	0.7645	-3.3%	-17.9%
Oil price	$US60.3/barrel	1.1%	-41.3%
Gold price	$US1190.55/ounce	0.5%	-4.7%

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