Market Wrap

JULY 2017

The Reserve Bank of Australia (RBA) Board met on 1 August and left the official cash rate on hold at 1.5%, as widely expected. There has been no change in the official cash rate since August 2016.

After making significant gains in June, the Australian dollar was stronger over the month, supported partly by rising commodity prices.

The S&P/ASX 200 Index finished the month flat, despite some volatility. In a repeat of last month, there was considerable divergence in the performance between industry sectors.

Meanwhile, global shares recorded another positive month, and various market volatility measures continued to fall to record lows.

In the US, the target Fed Funds rate range remains unchanged, while the Fed waits to see a little more data before continuing on the path of normalising US monetary policy.

Australia

The RBA's July interest rate decision was complicated by the recent strength of the Australian dollar, largely driven by a weaker US currency. The RBA noted that:

> *"the higher exchange rate is expected to contribute to subdued price pressures in the economy. It is also weighing on the outlook for output and employment. An appreciating exchange rate would be expected to result in a slower pick-up in economic activity and inflation than currently forecast".*

The RBA continues to balance three key risks in the economy for their monetary policy deliberations:

- the outlook for inflation,
- the strength or otherwise of the labour market, and
- household financial stability.

In other news, Q2 CPI data came in at a softer 0.2% per quarter, reducing the annual growth rate to just 1.9% per annum, a drop of 0.2 percentage points. As a result, inflation is now just below the RBA's 2–3% target band.

The average of the two underlying measures, the trimmed-mean and weighted-median, was 0.5% per quarter, in line with expectations, with the annual figure rising to 1.8%, a slight increase on the 1.75% reading in Q1.

The most significant price rises over the quarter were in medical and hospital services (+4.1%), new dwelling purchases by owner-occupiers (+0.9%), tobacco (+1.0%) and beer (+1.0%). The biggest offsetting price falls included domestic holiday travel and accommodation (-3.2%), automotive fuel (-2.5%) and fruit (-4.4%). Weakness continued in clothing, with price discounting and competition in the segment. The price increase expected in fresh fruit and vegetables as a result of Cyclone Debbie was largely offset by price declines in seasonally available fruit such as apples, bananas and mandarins.

The NAB business survey for June showed business confidence strengthening, up one point to +9. Overall business conditions rose to multi-year highs with a reading of +15, up from +11 in May on the back of stronger trading conditions and profitability.

The June labour market report saw job gains continue, although there was a return to a more normal monthly gain of +14,000. The unemployment rate held steady at 5.6%.

CoreLogic capital city dwelling prices regained momentum in July, rising 1.5% over the month to bring the annual growth rate to 10.5%. Prices in Sydney and Melbourne remain elevated, rising 12.4% per annum and 15.9% per annum respectively. The monthly price moves by capital city were: Melbourne (+3.1%), Sydney (+1.4%), Adelaide (+1.1%), Brisbane (-0.6%) and Perth (-1.3%). Strength in the housing market remains, despite signs of a slowdown in investment lending following tighter macro-prudential measures put in place in March.

US

The US Federal Reserve Open Market Committee (FOMC) met on 25–26 July and, as was widely expected, left the Fed Funds rate range unchanged at 1.0% to 1.25%. This decision is consistent with the Fed waiting to see a little more data before continuing on the path to normalise US monetary policy.

The Fed noted that:

> *"The labour market has continued to strengthen and… economic activity has been rising moderately so far this year. Job gains have been*

solid, on average, since the beginning of the year, and the unemployment rate has declined. Household spending and business fixed investment have continued to expand."

The Fed also noted that:

"near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely."

Significantly, the Fed signalled that balance sheet adjustment will start shortly, reinforcing the general expectation that this will get under way at the next FOMC meeting on 20 September, provided the economy evolves broadly as the FOMC anticipates.

In other US economic news, newly released Q2 GDP data indicated a healthy rebound from weak growth in the first quarter. Real GDP rose by 2.6% on a seasonally adjusted, annualised basis, up from 1.2% in Q1. The improvement was underpinned by a 2.8% lift in consumer spending and a 5.2% increase in non-residential fixed investment.

Despite the better growth results, the ISM Manufacturing Index retreated, falling from 57.8 in June to 56.3 in July. New orders and employment fell, although they remain well above the long-term average.

US inflation was flat in June and once again weaker than expected, with the annual rate falling to 1.6% per annum, down from a peak of 2.7% per annum in February. Core inflation rose 0.1% per month and 1.7% per annum. Headline inflation remained suppressed, with weakness in energy prices, wireless phone services, and new and used cars. The Fed's preferred measure of inflation, the Core Personal Consumption Expenditure Index, rose 0.1% per month and 1.5% per annum for June.

The labour market continues to perform well, with 222,000 jobs added in June, compared to 152,000 in May. Nonetheless, the unemployment rate rose to 4.4%, driven by a rise in the participation rate to 62.8%. Average Hourly Earnings also rose to 2.5% per annum, from a revised 2.4% per annum the month before.

Europe

The European Central Bank (ECB) met on 20 July and made no changes to policy. After the Bank moved to a more neutral view of growth risks and removed its asymmetric forward guidance on policy rates in June, there was some expectation that it may commit to a timetable for tapering its asset purchase program. But the ECB made no such commitment, instead deferring the decision to the northern hemisphere autumn and the next staff forecasts due in September.

Eurozone Q2 GDP data showed above trend growth of 0.6% for the quarter and 2.1% per annum, up from 1.9% per annum in Q1. But while this pick-up in growth has been reflected in better Euro area manufacturing PMI and services PMI data over recent months, The Markit Eurozone Manufacturing PMI retreated slightly in July, down from 56.8 to 56.6.

In better news, the Eurozone unemployment rate fell to new cyclical lows, falling to 9.1% in June, down from 9.2% in May. Headline inflation was also steady at 1.3% per annum for July, while core inflation rose to 1.2% per annum, up from 1.1%.

Greece returned to bond markets in July for the first time in three years, raising €3bn and issuing a 5-year bond that was twice oversubscribed with the yield set at 4.62%. While the credit rating for the newly issued bonds remains below investment grade, Standard & Poor's raised its outlook for Greece from "stable" to "positive", given recent cost cutting reforms and an expected return to economic growth.

UK

The Bank of England (BoE) did not meet in July, with the last decision on 15 June, where no policy changes were announced.

The BoE Board had a robust debate over the month on the future course of interest rates. The debate centred on the timing of moves to lift rates, while acknowledging that the economy doesn't need as much stimulus as is currently being provided. Weak wages growth and uncertainty due to Brexit negotiations are likely to see the BoE hold off on rate rises in the near term.

UK headline inflation edged lower in June, with the annual rate down to 2.6% per annum from 2.9% per annum in May. Core CPI also retreated, falling to 2.4% per annum from 2.6% the month before.

The unemployment rate fell to a 42-year low at just 4.5% for the three months to May 2017, down from 4.6% in the previous three-month period. Unemployment fell 64,000 while employment climbed 175,000 as participation increased. Nonetheless regular earnings rose just 2% per annum.

NZ

The Reserve Bank of New Zealand did not meet in July. The cash rate has been on hold at 1.75% since 10 November 2016, when a 25-basis point rate cut was announced.

Q2 CPI was weaker than expected, staying flat over the quarter to bring the annual rate to 1.7% per annum, down from 2.2%. The lower-than-expected figure was driven by falling fuel, accommodation and transport prices. However, price pressures remain for construction costs and rents.

Canada

The Bank of Canada (BoC) announced on 12 July that it would raise its target for the overnight rate to 0.75%, as was widely expected. This was the first move in interest rates since the emergency rate cut to 0.5% in July 2015.

In raising the rate, the BoC noted that:

> *"recent data [has] bolstered the Bank's confidence in its outlook for above-potential growth and the absorption of excess capacity in the economy".*

Although the BoC acknowledged that inflation has stayed soft, a lag between monetary policy actions and future inflation drove the decision to lift rates.

The Canadian domestic economy was described as "robust, fuelled by household spending" and the BoC noted that "as a result a significant amount of economic slack had been absorbed."

On the outlook for interest rates, the BoC noted:

> *"future adjustments to the target for the overnight rate will be guided by incoming data as they inform the Bank's inflation outlook, keeping in mind continued uncertainty and financial system vulnerabilities."*

Japan

The Bank of Japan (BoJ) met on 20 July and, as expected, made no changes to rates. It continues to maintain its policy balance rate at -0.1%, with a 10-year bond yield target of 0%. The BoJ pushed out the point when 2% inflation will likely be achieved to sometime "around fiscal 2019."

The growth side of the economy is in better shape, with the BoJ upgrading its economic forecasts in July, as did the International Monetary Fund (IMF). They now expect growth of 1.3% in 2017, up from 1.2%.

China

In China, Q2 GDP data showed the economy growing at 1.7% per quarter and 6.9% per annum. While stronger than expected, this is the same annual growth rate as Q1 17. Monthly indicators also suggest stronger growth, with industrial production expanding by 7.6% per annum, up from 6.5%, and retail sales rising 10% per annum in the year to June, up from 9.6%. Healthy property and infrastructure investment, along with an easing in credit conditions, have helped build momentum in the economy.

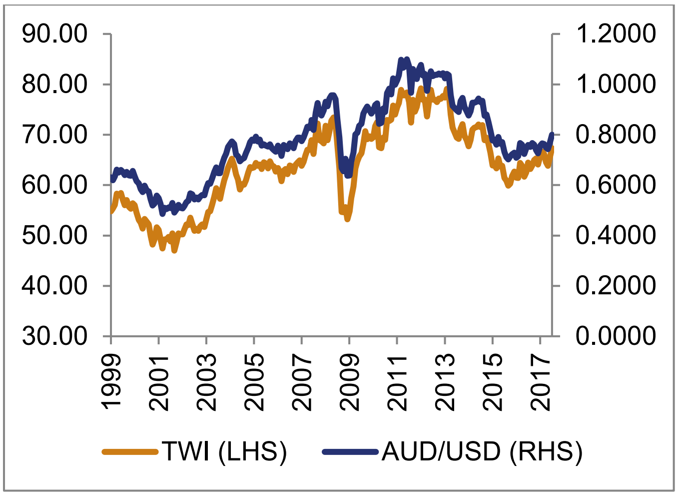
Australian dollar

After gains in June, the Australian dollar was stronger again in July, supported by rising commodity prices and expectations that the RBA could join other central banks in removing monetary policy accommodation, particularly after the Bank of Canada lifted rates. US dollar weakness was also evident as the market reduced the scale of future Federal Reserve rate hike forecasts on the back of weaker inflation data and reduced expectations of tax reform in the US given Congress' failure to pass healthcare reform.

As a result, the Australian dollar rose 4.1% against the US dollar to $US0.8003, its highest level since May 2015.

The AUD also rose against the Sterling (+2.6%), the Euro (+0.4%), Japanese Yen (+2.2%) and NZ dollar (1.5%).

AUD up strongly in July



Source: Bloomberg as at 31 July 2017

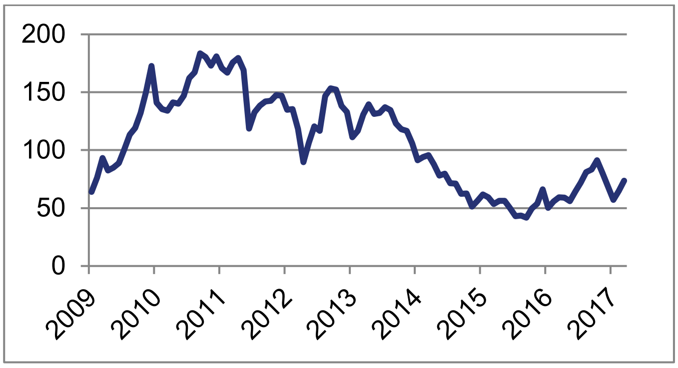
Commodities

Commodity prices were generally higher in July, supported by a lower US dollar and further signs of a synchronised pick-up in global economic growth.

West Texas Intermediate (WTI) crude oil finished the month at $US50.17/bbl, up 9.0%. Gains were driven largely by a late-month fall in the US dollar and Saudi Arabia's pledge to reduce crude exports.

Iron ore prices rose strongly in the month, with the spot iron ore contract (Qingdao 62% Fe fines) up by 13.5% to $US73.7/t. Stronger than expected economic growth figures in China and other industrial indicators helped propel the iron ore price higher.

Iron ore soars in July



Source: Bloomberg as at 31 July 2017

Base metals were generally higher, with the London Metals Exchange (LME) Index rising by 4.4%. Nickel (+8.8%) and copper (+7.3%) rose strongly, helped by stronger Chinese economic data. Tin (+3.4%), lead (+1.8%) and zinc (+1.3%) also rose.

Precious metal prices were stronger, with gold up 2.2% to $US1269.44 an ounce. Silver rose 1.2%.

Australian equities

The S&P/ASX 200 Index finished the month flat (0.0%), despite some volatility. In a repeat of last month, there was considerable divergence in the performance between industry sectors.

With the Australian dollar continuing to rise against other major currencies, the biggest loser was Healthcare (-7.5%), since companies like CSL, Cochlear and ResMed derive a significant proportion of their earnings from overseas. Bond proxy sector Utilities (-5.3%) was impacted by rising bond yields, while Industrials (–2.9%) fell on a combination of a strong Australian dollar and rising bond yields. Telcos (-4.3%) were also dragged lower by sector giant Telstra, which has been under pressure on investor concerns around earnings and dividend risk.

On the positive side, the Materials sector (+3.5%) was strong on the back of rising commodity prices. Financials (+1.2%) were supported by the large banks, which rebounded after the better-than-expected ruling on capital requirements from APRA.

Listed property

The S&P/ASX 200 A-REIT index finished the month largely unchanged (-0.1%), having fallen by as much as -3.6% on global developments.

The industrial A-REIT sub-sector continued its run of longer term outperformance (+1.1%), again outpacing the retail (+0.6%) and office (-0.4%) sub-sectors over the month.

Among the better performing A-REITs in July were Vicinity Centres (+7.0%) and Rural Funds Group (+8.1%), whose investors supported a $78.6m capital-raising to strengthen the balance sheet. Vicinity announced a 5% buyback and asset revaluations, which boosted net tangible assets by 3.3%.

At the other end of the spectrum, Charter Hall Group (-5.6%) and Westfield Corporation (-4.4%) both fell over the month, with the market taking a dim view of Charter Hall entering discussions to purchase Westpac's global infrastructure business, Hastings Management.

Listed property markets were stronger globally, with the FTSE EPRA/NAREIT Developed Index (TR) rising 1.9% in USD terms. Singapore was the top-performing region (+5.2%) and New Zealand the worst in US dollar terms, with the US in the middle of the pack at +1.0%.

Global developed market equities

Global developed equity markets recorded another positive month, as market volatility measures continued to fall to record lows.

The VIX Index, a market estimate of future volatility, reached a new low, falling to 9.36 on 21 July. Stronger global growth, good company earnings, large cash volumes on the sidelines and strong guidance from central banks helped to reduce volatility concerns, despite elevated political uncertainty in the US.

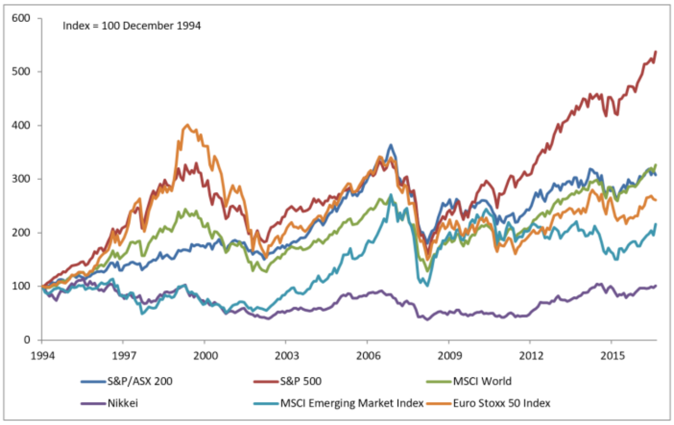
The MSCI World Index was up 2.3% in US dollar terms over the month, but down 1.5% in Australian dollar terms as the currency strengthened. The US dollar was weak in July and was one of the biggest factors impacting country specific returns.

In the US, the S&P500 (+1.9%), Dow Jones (+2.5%) and the NASDAQ (+3.4%) produced strong returns. MSCI Materials (+4.6%) outperformed following a rise in commodity prices, while MSCI Healthcare was flat as political uncertainty continued.

Equity markets in Europe were weaker, with falls in France (-0.5%) and Germany (-1.7%) driven by a strong Euro. In the UK, the FTSE100 rose 0.8% on signs the Brexit negotiations were progressing better than some had feared.

Asian markets were mixed, with the Japanese Nikkei 225 down (–0.5%), but Singapore (+3.2%) and Hong Kong (+6.1%) both making strong gains. Hong Kong was propelled higher by some Chinese property companies.

Equity markets driven by US dollar and commodities in July



Source: Bloomberg as at 31 July 2017

Global emerging markets

Emerging market equities had another positive month, assisted by cyclical improvements in the global economy, commodity price gains and the weaker US dollar. The MSCI Emerging Market Index was up 5.5% in USD terms and 1.5% in AUD terms.

MSCI EM Latin America (+8.2%) rose strongly, helped by gains in oil and iron ore prices. MSCI EM Asia ex Japan gained 4.9% over the month, assisted by a 9% gain in MSCI China.

The MSCI EM Europe, Middle East and Africa was up 5.3%, led higher once again by oil prices, with Russia recording positive gains after falls in June.

Fixed interest

July was a relatively stable month for bond markets, with more hawkish central bank themes being offset by continued political and geopolitical headline risks. The relatively low volatility speaks to both the resilience of markets and increasing confidence that global growth is on a healthier trajectory.

Central banks were hawkish, with the Bank of Canada increasing official interest rates for the first time since 2010, plus ongoing tapering discussions from the US Federal Reserve and European Central Bank. Geopolitical tension was driven by continued missile testing in North Korea and the response from other countries, the US in particular. US political uncertainty continued, with no progress on healthcare and ongoing headlines around the US presidency.

European 10-year yields rose 8 bps to 0.54%, but the US and UK were slightly down (1 bp to 2.29% and 3 bps to 1.23% respectively). The equivalent Japanese yields were flat month-on-month at 0.08%.

Australian government bond yields rose 8 bps to 2.68%. The rise was influenced by the release of minutes from the RBA's Monetary Policy Board meeting, which were interpreted as overly hawkish.

Global credit

Global investment grade credit spreads continued to tighten, but remain resilient despite wider market noise. While spreads are now the tightest since 2014, demand shows little sign of slowing down. Investment grade issuance in the US and Europe remained strong over the month.

The Bloomberg Barclays Global Aggregate Corporate Index average spread tightened by 7 bps to 1.02%. US credit also tightened, with the Bloomberg Barclays US Aggregate Corporate Index average spread closing 5 bps tighter at 0.98%. In Europe, the spread on the Bloomberg Barclays European Aggregate Corporate Index was 10 bps narrower at 0.92%, on the back of the ECB rhetoric.

US high yield credit spreads also tightened in July. The Bank of America Merrill Lynch Global High Yield index (BB-B) narrowed 16 bps over the month to 2.81%. The high yield market continues to be impacted by downgrades, particularly in the energy and mining sectors.

Australian credit spreads followed the global trend from recent months and moved tighter, with the average spread relative to swap on the Bloomberg Australian Corporate Index narrowing 5 bps 0.81%.

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If you have any questions, please speak to your Count Financial Adviser.

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