Market View

July 2014

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) held the cash rate steady at 2.5% at its 1 July 2014 meeting. There was no change to the Board's neutral policy 'guidance' and signal that there is likely to be "a period of stability in interest rates".
- The RBA continues to see moderate growth in consumer demand and strong expansion in housing construction. On the flip side, resources sector investment spending is starting to decline significantly while investment intentions in some other sectors are emerging. These conflicting forces will lead "growth to be a little below trend over the year ahead".

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- The RBA has acknowledged that given the Australian dollar remains high by historical standards this is offering less assistance in achieving balanced growth.
- In a subsequent speech on 3 July 2014[1], Glenn Stevens stated "the exchange rate remains high by historical standards" and by "most measurements would say it is overvalued, and not by just a few cents". Despite the strength of the Australian dollar, Glenn Stevens did think "investors are underestimating the likelihood of a significant fall in the Australian dollar at some point".
- Australia's headline inflation rate increased by 0.5% per quarter in Q2 2014, taking the annual rate to 3.0% per year, up from 2.9% per year previously. This puts inflation right at the top of the RBA's 2% to 3% target range.
- The underlying rate of inflation rose by an average of 0.7% per quarter, taking the annual pace from 2.65% to 2.8% per year.
- The largest price rises were in medical, housing and tobacco costs. These were partly offset by price declines in domestic holidays, fuels and telecommunications.

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[1] Economic Update - The Econometric Society Australasian Meeting and the Australian Conference of Economists, Hobart, 3 July 2014

- This quarter's inflation print is unlikely to change the RBA's inflation expectations and should see interest rates remain on hold in the near-term.
- The unemployment rate rose for the month of June (data released in July), from 5.9% to 6.0%. Overall 15,900 jobs were created in June, however this was not enough to offset the rise in the participation rate (rising from 64.6% to 64.7%), leading to the increase in the unemployment rate.
- Credit growth for June rose a strong 0.7% and the annual rate rose to 5.1%, the strongest growth in over five years. The strength was driven by business credit growth, which rose 1.0% per month, the strongest gain since the GFC in October 2008. Personal lending also rose the strongest (+0.6% per month) since 2009.

United States

- As widely expected, the Federal Open Market Committee (FOMC) of the US Federal Reserve announced a further $US10bn 'tapering' in the QE3 bond purchase program at its 29 to 30 June 2014 meeting. This takes monthly purchases down to just $US25bn.
- After an expected further $US10bn reduction at the 16 to 17 September FOMC meeting, the Fed's QE3 bond purchase program is set to end on 28 to 29 October with a final taper of $US15bn.
- The Fed noted in its release that "growth in economic activity rebounded in the second quarter" and that "labour market conditions improved, with the unemployment rate declining further". In addition, "household spending appears to be rising moderately and business fixed investment is advancing".
- However, the Fed clearly remains cautious on the outlook and gave no further hints on the likely timing of interest rate hikes.
- The Fed stated that "a range of labor market indicators suggest that there remains significant underutilization of labour resources". This is the case even while "inflation has moved somewhat closer to the Committee's longer-run objective.
- Consistent with their ongoing rhetoric, the Fed also continued to signal that "it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends". The general consensus is the Fed will begin to normalise rates in mid-2015.
- The first estimate of Q2 2014 GDP growth was released in the month and showed a stronger-than-expected rise of 4.0% on a seasonally adjusted annualised rate basis. This compares to a revised fall of -2.1% in Q1 2014 (was -2.9%).
- The main source of growth in Q2 2014 was final sales, up 2.3% after a decline of -1.0% in Q1 2014. This was attributable to the consumer, with spending up 2.5% in Q2 2014. Consumer spending on goods rose a solid 6.2%, led higher by vehicle sales.
- Other data released over the month was mixed. Employment growth was strong rising 288,000 in June and the unemployment rate fell to 6.1%, the lowest since September 2008.

Europe

- The European Central Bank (ECB) left all three of its key interest rates on hold at its 3 July 2014 after easing policy in June. The ECB stated "key ECB interest rates will remain at present levels for an extended period of time in view of the current outlook for inflation".
- The ECB also confirmed more details for its targeted long-term refinancing operations (TLTRO), with the aim of this program to enhance the functioning of the monetary policy transmission by supporting lending to the real economy. At this stage this program could be expected to reach a maximum of €1 trillion. The ECB also has intensified preparatory work related to outright purchases in the ABS market to enhance the functioning of the monetary policy transmission mechanism.
- Inflation data for June continued to show minimal pricing pressures. CPI rose 0.1% in June with the annual rate just 0.5%. Greece (-1.5% per year) and Portugal (-0.2% per year) are already in deflation while Spain

(flat), Italy (+0.2% per year) and France (+0.6% per year) are close.

United Kingdom

- The Bank of England (BoE) left policy unchanged at its 10 July 2014 meeting, as expected. The Bank Rate was unchanged at 0.5% and the stock of asset purchases remained at £375bn. The expectation remains that the first interest rate hike could be as early as late 2014.
- The advance estimate of Q2 2014 GDP was released, rising 0.8% per quarter, taking the annual rate to 3.1%, the fastest annual pace since Q4 2007. This result pushed total output above its previous peak recorded prior to the GFC in Q1 2008. The result was driven by growth in the services sector, particularly finance, hotels and restaurants.
- Inflation data over June showed a gain of 0.2%, taking the annual rate to 1.9%, just shy of the BoE's 2% target.

Japan

- The Bank of Japan's (BoJ) policy board convened on 15 July and decided by unanimous vote to leave current monetary policy settings unchanged, as expected. The BoJ will continue to carry out money market operations so that the monetary base increases by around ¥60 to 70trn a year.
- The quarterly Tankan survey was released in July, with the Tankan Large Manufacturing Index falling to 12, from 17. This largely was driven by the changes to consumption tax on 1 April 2014 with the Outlook index rising from 8 to 15.
- Retail sales continue to recover post the consumption tax hike, rising 0.4% per month, although remains 0.6% lower over 12 months.

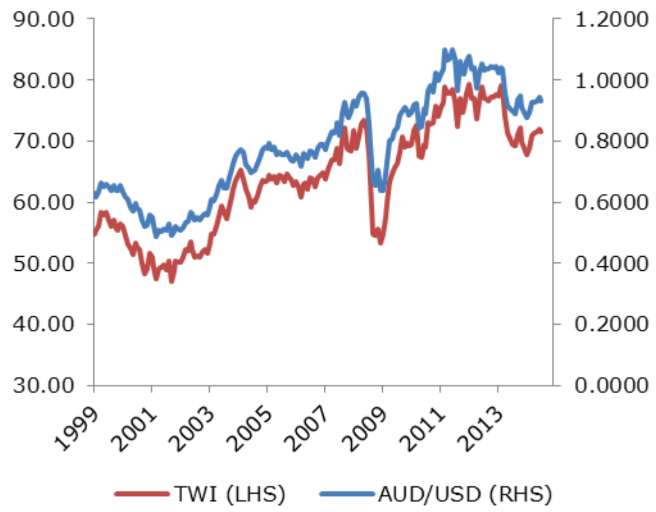
China

- Q2 GDP data was released showing 2% growth over the quarter, compared to 1.5% in Q1 2014. This took the annual growth rate to 7.5%, up from 7.4% for the 12 months to March 2014. The expansion from earlier in the year was assisted by the government's mini-stimulus measures that were introduced over the quarter. These included bringing forward railway spending, reducing reserve requirement ratios for some lenders and fine tuning tax policies.
- There are however continued signs the property market is cooling. Prices rose in only eight cities, versus 15 cities the month before and fell in 55 cities compared to 35 the month before and only eight cities in April.

Australian dollar

- The Australian dollar (AUD) fell by 1.5% per month to finish July at $US0.9296. Falls came later in the month on stronger US economic data and growing expectations that the Federal Reserve was getting closer to normalising monetary policy.

THE AUSTRALIA DOLLAR FALLS ON BETTER US ECONOMIC DATA



Source: Bloomberg as at 31 July 2014. Past performance is not an indication of future performance.

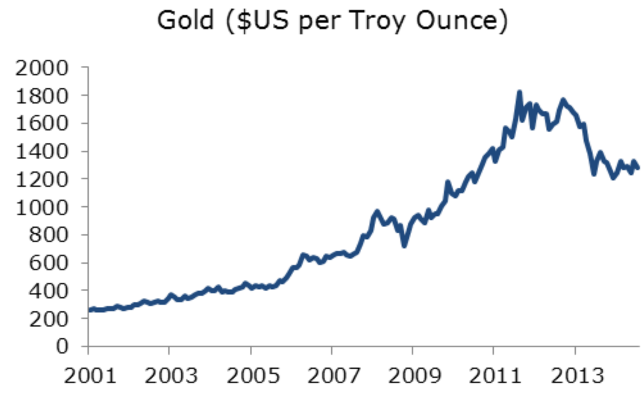
Commodities

- Commodity prices were mixed in July, with soft commodities continuing to experience sharp falls on improving supply outlooks. Both wheat (-6.1%) and corn (-13.7%) fell. Wheat has now fallen 29% from its peak in early May. Good weather conditions in the US are boosting expectations of supply glut next year.
- Energy prices fell in July, with US natural gas prices falling (-15.0%) on good weather in the US restocking inventories after a cold Q1 2014. Oil prices fell 5.6% despite rising political tensions in the Middle East with inventory build-up the likely driver.
- Metals prices were mixed. Gold fell (-3.4%) while zinc continued to make strong gains, rising 6.5% in July on concerns over supply with inventories on the London Metals Exchange falling to their lowest level since 2010. Copper rose 1.4% and lead by 2.4%. Aluminium gained ground, rising 5.1% in July as demand recovers as manufacturers are using it as an alternative to steel and copper.
- The iron ore price rose 1.9% to $US95.6 per dry metric ton on continued signs of stabilisation in the Chinese economy.

IRON ORE PRICE RECOVERS AFTER BETTER CHINA ECONOMIC DATA

Source: Bloomberg as at 31 July 2014

GOLD FALLS IN JULY



Source: Bloomberg as at 30 June 2014. Past performance is not an indication of future performance.

Australian shares

- Australian shares made an extremely strong start to the FY15 year, with the S&P/ASX 200 Accumulation Index adding 4.4%. This pushed the Index to its highest level in more than six years.
- The market was driven higher by stocks in the materials sector. A number of mining stocks released production reports for the three months ending 30 June 2014 – despite lower commodity prices, on the whole these reports were well received by investors. Iron ore exports, for example, are at an all-time record following mine expansions that have been completed by the major producers in Western Australia. Mining stocks also appeared to be buoyed by the release of encouraging economic data in China.
- The ‘reporting season’ will get underway in early August and continue for the remainder of the month. Most ASX-listed companies will formally announce their earnings for the six or 12 months ending 30 June 2014 to the market during this period. Some companies, such as AGL Energy and QBE Insurance Group, have already warned investors that their earnings fell short of consensus expectations.

Listed property

- The Australian listed property sector continued its strong run, increasing by 5.0% in July. Transactions during the month indicated that demand for commercial property assets remains robust, while positive re-valuations from CFS Retail Property Trust and Federation Centres also buoyed the sector.

Global shares

- Global developed equity markets predominantly recorded falls in July after strong gains year to date. Driving these weaker markets was rising geopolitical risks in Russia/Ukraine, Israel/Gaza and the Middle East. Equity markets also begun to contemplate the consequences of an improving US economy for the Fed Funds rate especially post stronger GDP data released towards month end.
- The MSCI World Developed Markets Index fell by 1.7% in USD terms and 0.3% in AUD terms over the month.
- Q2 2014 US earnings season was in full swing over the month. As at month end 76% of companies beat earnings expectations and 65% exceeded sales projections.
- The US S&P500 Index fell by 1.5% in July with the Nasdaq (-0.9%) and the Dow Jones (-1.6%) also falling. There was a large amount of mergers and acquisition activity over the month including 21st Century Fox's $US80bn takeover offer for Time Warner.
- Equity markets in Europe retreated on geopolitical risks with new targeted sanctions announced against Russia for particular industries. This is expected to detract from economic growth across the region. Germany's DAX (-4.3%) and France's CAC Index (-4.0%) suffered the heaviest falls. Spain's IBEX Index (-2.0%) and Italy (-3.3%) also fell.
- The Japanese Nikkei 225 (+3.0%) and Topix (+2.1%) Indices both rose.

Global emerging markets

- Emerging market (EM) equities outperformed their developed market counterparts in July. The MSCI EM Index returned 1.4% in USD terms and 2.8% in AUD terms. Despite rising geopolitical tensions in the Middle East and Russia/Ukraine, emerging market equities rallied, driven largely by Asia.

Need more information?

Please speak with your financial adviser or visit our website at colonialfirststate.com.au. Alternatively, you can call us on 13 13 36.