Market watch

Investment market review

As at August 2013

Economics overview:

- **Australia**: As widely expected, the Reserve Bank of Australia (RBA) eased monetary policy by a further 25bp in August. The cash rate is now 2.5%, the lowest since the establishment of the RBA in 1958/59.

  - The Board Minutes cited below-trend economic growth and well-contained inflation as reasons for the move. The Board concluded that it “should neither close-off the possibility of reducing rates further, nor signal an imminent intention to reduce rates further.” That is, the RBA’s next move is data-dependent with a modest easing bias retained.

  - Economic data released in August was mixed. Employment decreased by 10.2k in July. However, the unemployment rate remained steady at 5.7% as less people looked for work. The participation rate fell by 0.2% to 65.1% over the month.

  - The Westpac consumer confidence index rose by 3.5%/mth in August, pushing this series a fraction above its long-term average levels to 105.7. The survey was conducted over the week when the RBA cut its policy rate and Prime Minister Kevin Rudd confirmed a 7 September 2013 Federal election.

  - The July NAB business survey was weak. Business conditions remained at a well-below-average level of -7, while business confidence slipped from 0 to -3.

  - Retail sales were flat in June (consensus: +0.4%/mth), up by a very modest 1.1% over the past year.

  - ABS housing data was a little brighter, with capital city house prices rising by 2.4%/qtr to 5.1%/yr in the June quarter.

  - Private capital expenditure rose by 4.0%/qtr in the June quarter, as stronger mining spending outweighed a decline in manufacturing. However, investment intentions weakened.

  - **US**: The Federal Open Market Committee’s (FOMC) July Minutes released on 22 August reiterated that “almost all participants confirmed that they were broadly comfortable with the contingent outlook for asset purchases that were presented in the June post-meeting press conference.” This implied that the slowing pace of asset purchases could occur as early as the US Federal Reserve’s meeting in mid-September.

  - Chairman Ben Bernanke is also expected to announce his intention to step down when his term comes to an end on 31 January 2014.

  - The two most likely candidates to take over Bernanke’s job at present are the Fed vice-chair Janet Yellen and Larry Summers, a former Treasury secretary who is one of Obama’s closest economic advisers.

  - US economic data was mixed. June quarter 2013 GDP expanded at an annualised pace of 2.5%, supported by surging housing investment (+13.4%/yr).

  - The July US employment report was weaker-than-expected. Non-farm payrolls rose by 162k, below consensus estimates for 185k. This was the weakest outcome since March. However, the unemployment rate fell to 7.4% from 7.6% in the prior month.

  - The headline Consumer Price Index (CPI) rose by 0.2%/mth to 2.0%/yr in July – a third consecutive monthly increase.

  - The University of Michigan consumer confidence index fell to a four-month low of 80.0 (preliminary) in August before rebounding in its final release to 82.1 at month-end.

  - The ISM manufacturing purchasing managers index (PMI) jumped to 55.4 in July from 50.9 in June. The non-manufacturing composite rose to its highest reading since February at 56.0 from a revised 52.8 in June.

  - Core retail sales (ex-autos, gas & building materials) increased by 0.5%/mth in July – its largest gain in seven months.

  - **Europe**: The European Central Bank (ECB) kept its benchmark interest rate at 0.5% at its August meeting.

  - The Eurozone finally emerged from its six quarter recession. GDP grew by 0.3%/qtr in the June quarter (-0.7%/yr). Output growth was driven predominantly by
Germany (+0.7%/qtr) and France (+0.5%/qtr), partially offset by declines in Italy (-0.2%/qtr) and Spain (-0.1%/qtr).

The Markit flash composite PMI for the Eurozone reached a two-year high of 51.7 (consensus: 50.9) in August, as economic activity in the region showed further signs of a gradual recovery.

**UK**: Bank of England (BoE) Governor Mark Carney announced forward interest rate guidance at his press conference following the release of the August Inflation Report. The BoE Bank Rate is unlikely to increase from its current level of 0.5% until the unemployment rate reaches 7.0% (currently at 7.8%).

**Japan**: Bank of Japan Governor Haruhiko Kuroda stated that the central bank’s policy measures were having their desired positive effect at the annual global banking summit in Jackson Hole.

Japan’s GDP growth decelerated in the June quarter to 2.6%/yr (+0.6%/qtr) from a revised 0.9%/qtr and 3.8%/yr in the previous quarter. The decline was largely attributable to a fall in business investment, which was down 0.4%/yr.

**China**: People’s Bank of China Governor Zhou Xiaochuan ruled out the possibility of easing monetary policy, stating that adjustments would only be made if needed for ‘fine-tuning’ purposes only.

The official China August PMI increased to 51.0 in August from 50.3 in July – its fastest pace in 16 months – as overseas demand and new orders jumped. Recent economic data releases have signalled more solid growth momentum in China.

**India**: Annual GDP growth slowed to 4.4%/yr in the June quarter, down from 4.8%/yr in the March quarter, led lower by the construction, manufacturing, and trade-related services sectors.

**The Australian dollar and commodities:**

- The Australian dollar (AUD) depreciated by 0.7%/mth to $USD0.8901 against the US dollar (USD) in August.
- The AUD was supported by positive Chinese economic data flow, despite another RBA rate cut and continued anticipation of US Federal Reserve ‘tapering’ of asset purchases.
- Commodities performed well in August, led by Iron Ore (+6.0%) as Chinese steel output remained robust with port inventories at low levels. The iron ore price climbed to $US142.80/tonne on 14 August 2013. Oil (+2.5%) benefitted from rising tensions in Syria, while Gold (+5.3%) continued its recovery, bolstered by less Exchange Traded Fund (ETFs) selling, which slowed to its lowest level since December due to risk aversion.

**Australian equities:**

- The Australian equities market was a stand-out performer amongst its global peers in August.
- The release of companies’ earnings for the period ending 30 June 2013 was the key focus for Australian equity market investors in August. Almost all companies with a 30 June or 31 December year end updated the market with their latest results.
- The ‘reporting season’ held few significant surprises. On the whole, earnings came in broadly in-line with consensus forecasts. Companies appear to maintain a preference to return cash to shareholders rather than invest for growth – nearly half of all companies increased their dividend payments and several reported a lower level of capital expenditure.
- Investors appeared to be reassured by the results – the S&P/ASX 200 Accumulation Index rose 2.5% during the month.
- Another interest rate cut appeared to support stocks in the Consumer Discretionary (+5.5%) sector. Materials (+3.9%) stocks also maintained their recent form, supported by buoyant iron ore prices. Energy (+5.4%) stocks were supported by the oil price, which edged higher reflecting escalating geo-political tensions in Syria.
- On the domestic front, the imminent Federal election dominated attention. Following the election, we will be looking for signs of improvement in business confidence, which is likely to be a prerequisite for any significant improvement in capital expenditure.

**Listed property:**

- Australian listed property securities (S&P/ASX200 A-REIT Accumulation Index) dipped by 0.2% in August, underperforming the broader market by 2.7%. This was despite the 25bp interest rate reduction by the RBA.
- Property securities announced their 2012/13 financial year results during the month. Numbers were broadly in-line with expectations, and management teams’ guidance for the financial year ahead was generally positive.
- At a stock-specific level, Stockland Group (+4.2%) and Westfield Group (+1.0%) performed strongly. Diversified A-REIT Stockland, whose assets include a series of residential property developments, announced results in-line with expectations, and a confident earnings outlook. Westfield Group’s results were also in-line with forecasts. Its portfolio of retail property assets in the US and the UK could help to boost earnings in the event of Australian dollar weakness.
- Charter Hall Group (-9.6%) was the month’s worst performing A-REIT. Investors took profits ahead of its 2012/13 results announcement. The company has
First State Investments

performed strongly over the past 12 months due to the successful execution of its capital-partnering strategy.

- Listed property markets offshore fell during August. Overall, the UBS Global Property Investors index (local currency) decreased by 5.2%. Japan (+0.2%) was the strongest-performing region, followed by Australia (-0.2%). The US and Canada (-6.8%) underperformed, as the US 10-year Treasury bond yield continued to climb.

Global developed market equities:

- Global equity markets were weighed down by concerns over speculation that the US Federal Reserve will begin moderating its $US85bn per month bond purchase program (QE3) from mid-September.

- The MSCI World Developed Markets Index decreased by 2.3% in USD terms and 1.7% in AUD terms during August.

- In the US, the S&P500 Index fell by 3.1% in August as ‘tapering’ worries, some disappointing earnings results and the prospect of US military strikes in Syria heightened investor caution. The Utilities (-5.5%) and Banks (-5.0%) were the top performing sectors. Materials (-0.2%) was the top performer, boosted by improving China economic data and rising commodity prices.

- News that the Eurozone had emerged from recession for the first time since the September quarter of 2011 failed to buoy European equity market participants.

- Political tensions in Italy re-emerged after former Prime Minister Silvio Berlusconi’s conviction of tax fraud threatened to bring down the Letta government. The Euro Stoxx 50 Index ended the month down by 1.7%.

- In Japan, the Nikkei 225 and Topix Indices fell by 2.0% and 2.3%, respectively, in August. Markets were left exposed to global ‘risk-off’ momentum on the back of relatively sparse domestic news flow. The Topix lost 3.1% in the final week of the month as fears over the Syrian conflict escalated. Utilities (-7.9%) fell sharply as evidence emerged of new radiation leaks from the stricken Fukushima nuclear power station.

Global emerging markets:

- Emerging markets (EM) came under intense pressure in August as ‘tapering’ speculation pushed US bond yields (10-year US Treasury yield +22bp) higher, triggering large capital outflows. EM equities declined with the MSCI World EM Index returning -1.9% in USD terms and -1.3% in AUD terms.

- Investors also focused on the excessive credit growth and current account deficits in a number of key emerging markets.

- Indonesia, Brazil and Turkey were forced to raise official interest rates, as the authorities came under mounting pressure to support their weakening currencies amid rising inflationary pressures.

- The MSCI EM Asia Index declined by 1.4% in USD terms and 0.7% in AUD terms.

- In China, the Shanghai Composite Index surged by 5.2%, making it the strongest performer in Asia. Chinese equities were bolstered by signs of a stabilisation in economic activity alongside the advantage of having a relatively closed capital account.

- The Indonesian (-9.0%) equity market tumbled to a 12-month low during August, driven lower by rising bond yields (10-year government benchmark yield +58bp to 8.42%) and net foreign outflows ($US552m).

- The MSCI India Index fell sharply by 11.4% as investors reacted badly to the Reserve Bank of India’s attempt to defend the Indian Rupee (-22% vs. USD since May) by limiting the amount of liquidity that banks could borrow from it. Yields on both short and long-term Rupee bond yields rose in response. Concerns over Indian growth prospects, rising inflation and the widening current account deficit also weighed heavily on sentiment.

- The MSCI Emerging Markets EMEA Index decreased by 2.2% in USD terms and 1.5% in AUD terms over the month.

- The Czech Republic (+2.8%) and Poland (+4.1%) were the only two rising markets in August, boosted by the release of stronger-than-expected expansionary manufacturing PMIs due to the improvement in export orders.

- Latin American equity markets were lower in August, with the MSCI Emerging Markets LatAm Index falling by 3.3% in USD terms and -2.7% in AUD terms.

- Brazilian (+3.7%) shares were an exception, supported by easing concerns over a slowdown in China, rising commodity prices and speculation that the weakening currency will boost Brazil’s exports. June quarter GDP surprised on the upside given the country’s challenging macro backdrop which saw the Selic policy rate increased by 50bp to 9.0%. Output expanded by 1.5%/qtr (consensus +0.9%/qtr), boosted by agricultural production.

- EM sovereign bond yields sold-off sharply during August as the 10-year US Treasury yield reached a two-year high of 2.89% and foreign capital fled EM bond markets: JPMorgan EMBIG LatAm (+38bp to 7.06%), Middle East (+47bp to 6.73%), Europe (+45bp to 6.27%) and Asia (+66bp to 5.63%).

Asia ex Japan markets:

- Asian equity markets declined in August, with the MSCI Asia ex-Japan Index falling by 1.8%/mth in USD terms.

- Asia ex-Japan equities remained under pressure as investors remained cautious about increasing speculation
that the US Federal Reserve would scale-back its asset purchase program from mid-September.

- Tensions in Syria also contributed to heightened risk aversion towards month-end.
- North-East Asian equity markets outperformed, led by bourses in China, Korea and Hong Kong.
- The Shanghai Composite Index surged by 5.2%, making it the strongest performer in Asia. Chinese equities were bolstered by signs of a stabilisation in Chinese economic activity alongside the advantage of having a relatively closed capital account.
- In Korea, the Kospi increased by 0.6%, as Korea is considered to be relatively well insulated from concerns over the US Federal Reserve scaling-back its asset purchase program. The country has a solid current account surplus, sizeable currency reserves and a lower proportion of short-term foreign exchange borrowings compared to its peers.
- Hong Kong’s Hang Seng Index declined by a moderate 0.7%, supported by the sharp rebound in Mainland China equities. June quarter GDP also picked-up by 0.8%/qtr to 3.3%/yr due to a solid recovery in investment and services exports.
- Countries with widening current account deficits, such as India and Indonesia underperformed significantly.
- The Indonesian (-9.0%) equity market tumbled to a 12-month low during August, driven lower by rising bond yields (10-year government benchmark yield +58bp to 8.42%) and net foreign outflows ($US521m).
- Bank Indonesia increased its policy rate by 50bp to 7.0% on 29 August in an unscheduled meeting as inflation pressures rose, the current account deficit widened and the Rupiah fell sharply.
- The MSCI India Index fell sharply by 11.4% as investors reacted badly to the Reserve Bank of India’s (RBI) attempt to defend the Indian Rupee (-22% vs. USD since May) by limiting the amount of liquidity that banks could borrow from it. Yields on both short and long-term Rupee bond yields rose in response. Concerns over Indian growth prospects, rising inflation and the widening current account deficit also weighed heavily on sentiment.
- Thai equities plunged by 9.1% as foreign investors sold down their holdings in August (net $US1.3bn) after positive buying in July.
- Philippine (-8.5%) equities also gapped down during the month, tumbling at one point to a nine-month low on concerns that the country will not be spared from massive fund outflows seen in other emerging ASEAN markets.

Global fixed interest:
- Bond yields in the US, UK and Europe increased sharply during the first half of the month as evidence of a cyclical improvement in the major developed nations gathered pace and expectations firmed that the US Federal Reserve will commence ‘tapering’ of its bond purchase program from mid-September.
- However, concerns over a possible US military strike against Syria contributed to a global ‘risk-off’ move that was supportive of bonds in the last week of the month.
- The 10-year US Treasury bond yield increased by 22bp to 2.80% by month-end, having reached a two-year high of 2.89% on 21 August 2013.
- Ten-year German Bund and UK Gilt yields followed suit, increasing by 19bp to 1.86% and 22 bp to 2.77%, respectively.
- In the Euro-periphery, the 10-year Italian (no change at 4.40%) and Spanish (-12bp to 4.53%) government bond yields reacted positively to news that the Eurozone was finally emerging from its prolonged recession.
- Japanese Prime Minister Shinzo Abe’s decisive victory in the Upper House elections in late July, together with the Bank of Japan’s bond purchase operations capped Japanese government bond (‘JGB’) yields. The 10-year JGB yield finished the month 8bp lower at 0.72%.

Australian fixed interest:
- The UBS Composite Bond Index declined by 0.32% in August.
- Longer-dated Commonwealth Government Security (CGS) bond yields trended higher during August, despite the RBA’s decision to reduce the cash rate to a record low 2.5%.
- The 10-year CGS yield tracked the rise in global bond yields, reaching its highest level since April 2012 at 4.08% on 22 August 2013. The yield eventually finished the month at 3.89%, an aggregate increase of 17bp.
- The RBA’s monetary policy easing bias continues to support the front-end of the CGS yield curve. However, the 3-year CGS yield rose by 16bp to 2.69% in August as market participant’s pared-back expectations of a September rate cut in the lead-up to the 7 September 2013 Federal election.

Asia ex Japan fixed interest:
- Asian bond markets came under pressure from rising US Treasury bond yields (+22bp to 2.80% in August), which increased to year-to-date highs during the month.
- Asian sovereign bond yields sold-off sharply during August as the 10-year US Treasury yield reached a two-year high of 2.89% and foreign capital fled developing Asian bond
markets. The JPMorgan EMBIG Asia sovereign bond yield rose by 66bp to 5.63%.

- Some encouraging data out of China boosted Asian sentiment early in the month, but the gains were erased by the negative news flow from India and Indonesia, which led to further weakening of both countries’ currencies.

- In the second half of the month, the volatility in currency markets pushed Asian corporate bond spreads wider, with Indian and Indonesian credits taking the brunt of the pressure.

- The JPMorgan Asia Credit Index (JACI) returned -1.68% over the month. The average spread of the JACI widened by 20bp to 312bp over the month.

- China was the strongest performing country (-0.04%) of the JACI heavies, bolstered by signs of a stabilisation in economic activity alongside the advantage of having a relatively closed capital account.

- Indonesia was the poorest performer, returning -6.85% during the month.

- Indonesia’s government flagged that it may introduce fiscal stimulus and tax breaks for companies in order to boost investment and economic growth. The government also plans to speed-up a planned revision of limits on foreign investment in certain industries.

- The measures come as Indonesia’s current account deficit widened to a record high in the second quarter and foreign direct investment grew at its slowest pace in three years.

- By JACI sector, non-investment grade corporates (-0.57%) were the strongest performers while investment grade sovereigns (-5.18%) underperformed by the most.

Global credit:

- Global credit spreads moved wider in the first half of the month on stronger than expected US economic data. Spreads widened on the assumption that economic data supportive of ‘tapering’ will push US Treasury yields higher, which will lead to tougher financing conditions for corporate credit markets.

- Credit spreads tracked sideways in the second half of the month in an environment of rising long-dated yields and volatility.

- Overall, the Lucitoss Index of US investment grade spreads widened by 8bp to 122bp over the month. The Markit iTraxx Europe Index followed suit with spreads increasing by 7bp to 107bp.

- Spreads for US high yield (‘HY’) securities also moved wider during the month. This occurred despite rising US Treasury bond yields, as outflows from the high yield sector recommenced. The Markit CDX US HY 5-year spread widened by 35bp to 406bp in August.

- Australian credit spreads tightened over the first half of the month as reporting season revealed generally positive results. However spreads widened sharply in the second half of the month to finish wider overall, as investors sought to reduce duration risk as bonds sold-off globally. The Markit iTraxx Australia finished the month 2bp wider at 125bp.

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