GODFREY PEMBROKE

market update

APRIL 2018

- The global economy is maintaining momentum and inflation is gradually moving higher in line with central bank targets.
- Growth in US average hourly earnings is still not showing conclusive evidence of a sustained pickup in wages.
- The threat of a trade war between the US and China is creating significant uncertainty for markets.
- Euro area inflation was 1.4% in March, up from 1.1% in February but still well below the ECB's target.
- The Australian economy continues to improve, but the RBA is wary of the impact of interest rate rises on the household sector.

March market performance

Equity Markets – Price Indices	Index	At Close 31/03/2018	% Change 1 Month	% Change 12 Months
Australia	All Ordinaries	5868.91	-4.1%	-0.6%
Japan	Nikkei	21454.30	-2.8%	13.5%
Hong Kong	Hang Seng	30093.38	-2.4%	24.8%
UK	FTSE 100	7056.61	-2.4%	-3.6%
Germany	DAX	12096.73	-2.7%	-1.8%
US	Dow Jones	24103.11	-3.7%	16.6%
EMU*	Euro 100	2798.01	-2.3%	-5.2%
World**	MSCI – Ex Aus (Gross) (Hedged)	1601.58	-2.3%	11.0%

Property – Price Index	Index	At Close 31/03/2018	% Change 1 Month	% Change 12 Months
Listed Trusts	S&P/ASX 300 A-REITS	1291.17	0.0%	-5.0%

Interest Rates	At Close 31/03/2018	At Close 28/02/2018	At Close 31/03/2017
Aust 90 day Bank Bills	1.93%	1.77%	1.79%
Australian 10 year Bonds	2.72%	2.86%	2.81%
US 90 day T Bill	1.73%	1.66%	0.76%
US 10 year Bonds	2.74%	2.87%	2.40%

Currency***		At Close 31/03/2018	% Change 1 Month	% Change 12 Months
US dollar	A$/US$	0.77	-1.22%	0.89%
British pound	A$/STG	0.55	-3.00%	-9.81%
Euro	A$/euro	0.62	-2.29%	-12.92%
Japanese yen	A$/yen	81.61	-1.86%	-3.96%
Trade-weighted Index		62.3	-2.04%	-5.89%

* Top 100 European stocks trading on the FTSE
** Price Index (Source: msci.com)
*** All foreign exchange rates rounded to two decimal places (Source: FactSet)
Past performance is not a reliable indicator of future performance.

Global economies

While underlying economic data is broadly positive, markets remain concerned about the prospect of inflation as well as the potential for a trade war between the US and China. Shares continued to sell off in March as investors favoured bonds, property and defensive sectors. The US economy is maintaining momentum and measures of underlying price inflation are gradually moving higher, but signs of imminent wage inflation have not yet materialised.

US

The prospect of a trade war has been the cause of some consternation for markets over the past month, with China announcing a retaliatory 25% levy on a range of US products, including soybeans, cars and whiskey. While US steel and aluminium hardly represent the new economy, it is the response from US trade partners that poses the greatest uncertainty. The revised figure for Q4 GDP growth was 2.9%, up on the previous 2.5% estimate, and reassuring markets that economic momentum is being maintained.

US (continued)

The ISM manufacturing PMI fell modestly in March from 60.8 to 59.3, but remains firmly in expansion. With the PMI above 55 for the past ten months, the US manufacturing economy still appears healthy. Manufacturers reported concerns about the impact of tariffs across the supply chain, but so far demand appears to be holding firm. Non-farm payrolls edged up by 103,000 in March, versus the expected 193,000, leaving the unemployment rate unchanged at 4.1%. While a significant miss, the labour market is already tight, with unemployment at a 17-year low. Growth in average hourly earnings, while slightly higher at an annualised 2.7%, is still not conclusive evidence of a sustained pickup in wages.

Europe

Despite stronger than expected growth throughout the eurozone, the ECB kept its key interest rates on hold in March, although notably dropping its usual commitment to increase the size of quantitative easing if the situation deteriorates. Euro area inflation recorded 1.4% in March, up from 1.1% in February but still well below the ECB's target. Core inflation (excluding energy, food, alcohol and tobacco) was estimated to be flat at 1.0% and has refused to budge over the last six months. Unemployment in the eurozone fell to 8.5% in February, down from 8.6% in January and reaching the lowest rate recorded since September 2008. The IHS Markit Eurozone Composite PMI saw eurozone economic activity expand at the weakest pace since the start of 2017, as growth moderated in both the manufacturing and service sectors. Bad weather was again cited for the slower pace, along with supply chain constraints from recent growth. In her Mansion House speech in early March, Prime Minister May sketched out the form of a Brexit agreement, stating Britain would stick close to EU standards, mirror Brussels' state-aid and competition rules, embrace some EU agencies, and accept that European Court rulings would still affect the UK.

China

Economic data for the early part of 2018 has been mixed, with manufacturing PMIs failing to break out of the low 50s, while exports, industrial production and retail spending data have surprised on the upside. Producer prices continue to outpace consumer prices, although the annual rate has dropped back to 3.7% year-on-year, while the CPI lifted to 2.9% year-on-year in February. The uncertainty around the true state of the economy relates to the timing of the Lunar New Year holiday period, as well as the initial unwinding of the authorities' anti-pollution campaign. Clearly, the strength of the global economy is benefiting China, however the lift in interest rates and the slowdown in credit growth to the shadow banking sector are likely to mean slower growth over coming quarters. In an important political move, the Chinese leadership proposed to remove the line in the constitution stating that the President and Vice-President of the People's Republic of China "shall serve no more than two consecutive terms". Regarded as the most powerful Chinese leader since Mao Zedong, the constitutional change could allow President Xi to serve in that capacity without consecutive term limits.

Asia region

Although headline GDP growth numbers in Japan have been low in absolute terms, by Japanese standards they have been solid, resulting in a narrowing of the output gap. Japan's Q4 GDP growth of 1.6% year-on-year is the 16th quarter of positive growth, but there have been a number of misses along the way. The Nikkei Japan PMIs suggest a moderating rate of output growth, with manufacturing growth softer but still maintaining an expansionary trend in both output and new orders, encouraging firms to raise employment and input buying. After dropping sharply to a multi-decade low of 2.4% in January, Japan's unemployment rate rose slightly to 2.5% in February. The labour market has been tightening since the post-GFC unemployment high of around 5.5%.

Asia region (continued)

The bad news is that annual wage growth has fallen in real terms in each of the past three months, making the Bank of Japan's task of raising inflation even harder.

Australia

Despite leaving the cash rate on hold at its March meeting, the RBA continues to expect labour markets to tighten globally, and for central banks to get on the front foot by withdrawing stimulus. In its statement, the RBA mentioned the market's concerns about US trade policy and its contribution to heightened volatility. The RBA and Treasury both expect GDP growth to be in excess of 3% over the next two years, but monetary policy is still extremely accommodative. The paradox is best explained by ongoing consumer caution, and the concern of policymakers over the impact of any interest rate rise on the household sector, especially given current low wages growth and high levels of household debt. Australia's labour market continues to tighten, with 17,500 seasonally adjusted jobs added in February. The unemployment rate was unchanged at 5.5% and has been steady for the past six months. The AIG Manufacturing Index jumped 5.6 points to a record high of 63.1 in March (the second-highest was 62.1 in May 2002). Australian retail recovered slightly after a very lacklustre start to the year, with retail turnover rising 0.6% in February, soundly beating the consensus 0.3%.

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EQUITY MARKETS

- Australia's S&P/ASX All Ordinaries Index fell 4.1%, dashing hopes of a quick recovery following February's volatility.
- Global developed market shares fell 2.3% and emerging market shares fell 1.9% in local currency terms.
- The US Dow Jones Index fell 3.7% in March and 2.5% since the start of 2018.
- The German DAX Index fell 2.7% and the French CAC 40 Index fell 2.9%.
- The Euro 100 Index fell and the broad STOXX Euro 600 Index both fell 2.3%.
- The Japanese Nikkei 225 Index fell 2.8% and the Chinese CSI 300 Index fell 3.1%.

Australian equities

	Index/Benchmark (% pa)	1 Year	3 Years	5 Years	7 Years
Australian	S&P/ASX 300 Acc.	2.86%	3.92%	7.62%	7.06%
	S&P/ASX 50 Acc.	-0.14%	2.08%	6.81%	7.07%
	S&P/ASX Small Ordinaries Acc.	14.99%	10.67%	6.45%	2.35%

The S&P/ASX 200 Accumulation Index fell 3.8% in March, topping off the worst Q1 performance since the GFC despite a mostly positive earnings season in February. Potential inflation is still a concern for investors, and the market is steeling itself for the next rate hike from the RBA, which, when it finally comes, will be the first increase since November 2010. All sectors aside from property were down over the month, with defensive utilities shares (-0.8%) able to stem losses, and industrials (-0.9%) supported by gains from Brambles (+4.0%). Telecommunications (-6.2%) was the worst performing sector, with Telstra (-6.3%) falling to its lowest price since 2011 and still finding its way in a very different marketplace since the arrival of the NBN. Financials (-5.9%) took a hit through the month, with major lenders coming under pressure as the Financial Services Royal Commission began testimony, while investment managers suffered from further market falls. Materials (-4.2%) continued their slide since the start of 2018, with Fortescue Metals (-14.1%) following the iron ore price down and Rio Tinto (-10.4%) lower despite announcing the sale of its last remaining coal asset.

Sector	1 Month	3 Months	1 Year
Property	0.1%	-6.2%	-0.1%
Utilities	-0.8%	-6.6%	-7.9%
Industrials	-1.1%	-3.5%	10.7%
Consumer Staples	-1.4%	0.9%	10.1%
Information Technology	-2.2%	1.9%	27.0%
Consumer Discretionary	-2.3%	-3.6%	5.2%
Energy	-2.5%	-6.4%	11.4%
Healthcare	-3.3%	6.6%	17.0%
Materials	-4.2%	-3.4%	16.6%
Financials (ex-Property)	-5.9%	-5.9%	-6.6%
Telecommunications	-6.2%	-11.3%	-26.4%

GODFREYPEMBROKE market update

BIG MOVERS THIS MONTH

Going up

⇑	Property	0.1%

Going down

⇓	Telecommunications	-6.2%
⇓	Financials (ex-Property)	-5.9%
⇓	Materials	-4.2%

Global Equities

	Index/Benchmark (% pa)	1 Year	3 Years	5 Years	7 Years
Global	MSCI World Ex Aus (Gross) in AUD	13.93%	8.58%	17.63%	14.26%
	MSCI World Ex Aus (Gross) in Local Currency	14.60%	7.08%	11.43%	9.70%
	MSCI World Small Cap ($A)	15.27%	9.33%	17.89%	14.04%
Emerging	MSCI Emerging Mkts Free	24.68%	9.06%	12.04%	7.31%
	MSCI AC Far East Free (ex Japan)	27.04%	9.63%	15.13%	10.73%

The MSCI World ex-Australia Index returned -2.3% in both Australian dollar and local currency terms as global equity markets continued to slide through March. The US S&P 500 Index was down 2.7% on the back of February's 3.9% fall, reaching a high of 2787 points to finish the month at 2641. The VIX settled early in the month at 14.6 before jumping higher to 24.9—still elevated compared to the historic lows of 2017. Financials (-4.5%) were hardest hit, followed by materials (-4.5%). In Europe, the STOXX Euro 600 Index fell 2.3%, with banks also suffering, led by the beleaguered Deutsche Bank (-14.2%), which took action to replace CEO John Cryan after reporting its third annual loss in a row. In Asia, the Chinese CSI 300 Index was down 3.1%, Japan's Nikkei 225 Index fell 2.8%, and Hong Kong's Hang Seng dropped 2.4%.

Property

	Index/Benchmark (% pa)	1 Year	3 Years	5 Years	7 Years
Australian	S&P/ASX 300 A-REIT Acc	-0.07%	5.78%	10.79%	12.03%
Global	FTSE EPRA/NAREIT Dv ex AUS TR Hdg AUD	1.43%	1.77%	6.68%	8.93%

The S&P/ASX 300 A-REIT Accumulation Index rose 1.1% in March, with lower yields and a flight to defensive asset classes supporting the sector. A-REITs may also have been positively impacted by Labor's plan to remove franking credit refunds, which will impact high yielding shares like Telstra but not the A-REIT sector, which does not generate franking credits. Global diversified investor Cromwell Property Group (+6.5%) led the gains, with FY18 guidance pointing to a yield of 8.9%. Shopping centres came under pressure, with Vicinity Centres (-2.8%) and Westfield (-2.7%) down amid store closures from struggling retailers. Globally, the EPRA/NAREIT Developed Market Index (AUD hedged) rose 2.4% in March, with US REITs gaining 3.7%, dragged down once again by malls (-2.6%) and boosted by healthcare (+8.8%), data centres (+7.5%) and hotels (+7.0%).

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Fixed Interest

	Index/Benchmark (% pa)	1 Year	3 Years	5 Years	7 Years
Australian	Bloomberg AusBond Composite 0+ Yr	3.28%	2.45%	4.30%	5.49%
	Australian 90 Day Bank Bill	1.75%	1.97%	2.27%	2.82%
Global	BarCap Global Aggregate Index	6.39%	3.00%	7.92%	6.44%
	BarCap Global Agg. Index Hedged	2.89%	3.18%	4.66%	6.23%

Australian bonds returned 0.84% over March, with Australian government bonds returning 0.99% and longer-term government bonds (ten years plus) returning 2.60%. The Australian 10-year yield fell from 2.81% to 2.60% and the spread over 2-year bonds narrowed. Globally, the Bloomberg Barclays Global Aggregate Bond Index (AUD hedged) returned 2.67% as global yields pushed lower. Despite a 25 basis point rate hike from the Federal Reserve, developed market yields contracted as investors rotated into fixed income assets, and credit spreads widened. The US 10-year treasury yield underwent significant contraction, falling from 2.86% to 2.74%. The ICE BofAML US High Yield Option-Adjusted Spread (a measure of the performance of high yield corporate debt) rose from 3.47% to 3.72%. The Japanese 10-year yield fell from 0.05% to 0.04%, still hovering above the Bank of Japan's zero yield target. The German 10-year yield fell from 0.65% to 0.49%, while the 5-year yield fell back into negative territory, falling from 0.02% to -0.11%.

Australian dollar

The Australian dollar fell 1.2% against the US dollar in March and 2.0% on a trade-weighted basis, finishing the month at USD 0.77. Australian rates are now below US rates across the yield curve, and this could be amplified as the Federal Reserve continues to tighten policy, placing downward pressure on the AUD. Commodity prices have also been strong, providing support to the AUD, although the Chinese economy appears to be losing momentum as policy stimulus fades. The US Dollar Index fell slightly by 0.4% in March and has been flat over the past two months, but is still weighed down by the growing 'twin deficits' (budget and current account).