CPG Research & Advisory Pty Ltd

ECONOMIC & MARKET COMMENTARY
SEPTEMBER 2018

Monetary Policy

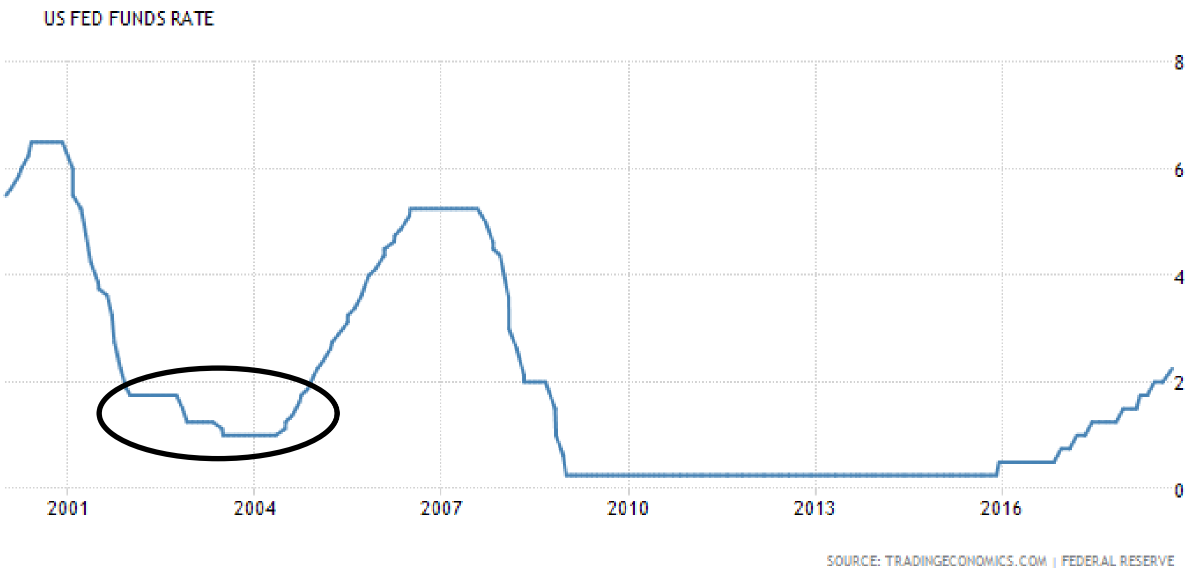
All of the central banks face major challenges. Too high, too low, avoiding inversion – and in the case of the Bank of Japan, how to conduct policy at all.

US Federal Reserve

Since 4Q16, the Fed has just held one meeting without a rate increase – skipping only Sept 2017. Their challenges are numerous.

Being too slow: The slow and steady approach to interest rates after the 2000 Tech Bubble burst set the scenes for a disastrous second-round asset and credit boom through the 2000s. **That ended in poor lending practices and the assumption of Fed support that ended in the GFC.**

This cycle is much longer still, and alongside a much stronger stockmarket return:



Overtightening: The Fed has to manage not just interest rates, but other monetary tightening. The end of Quantitative Easing (QE: Bond purchases to inject cash), and its replacement with quantitative tightening. **QT will remove cash from the economy, and has never been tried before**.

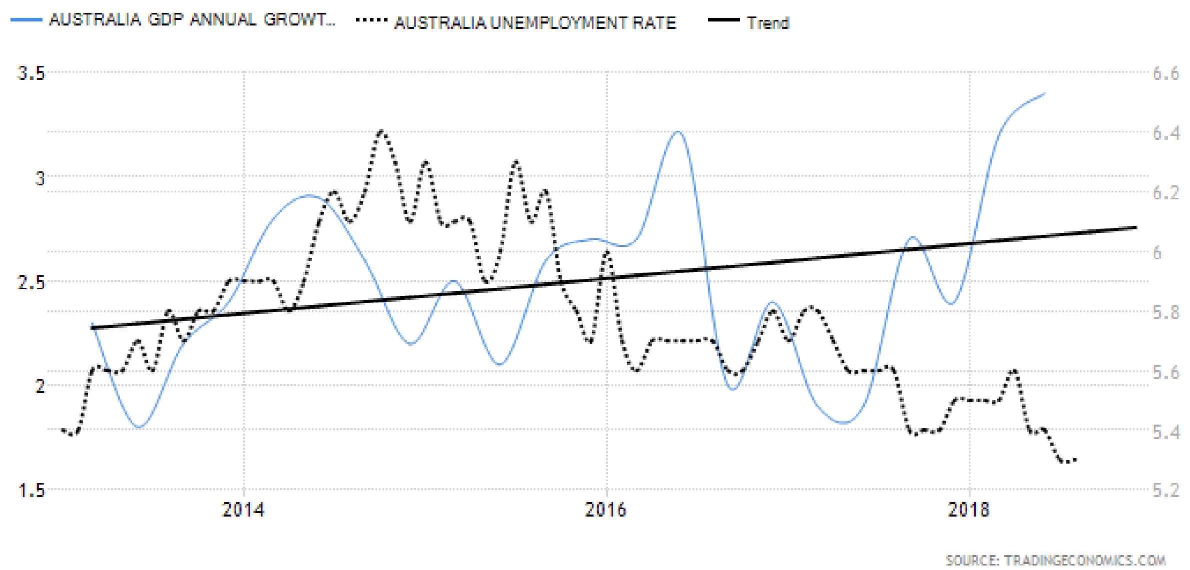
Avoiding Yield Curve Inversion: An inverse yield curve has always foreshadowed a recession. Of course, because recessions occur every few years, everything foreshadows a recession!

However, markets are acutely following this measure. For many years, the Fed wanted low bond yields to stimulate borrowing and investment. Now, the stubborn refusal of bond yields to reflect the new interest rate cycle creates a significant constraint. **On the current path, in a year, either bond yields will be higher or the curve will invert.** It is already very close – shaded areas indicate recessions:

Level 13, 111 Elizabeth Street, Sydney, 2000 | PH 02 8246 8800 | FAX 02 8246 8899
CPG Research & Advisory Pty Ltd | ABN 93 052 348 026 | AFSL NO 243361

Reserve Bank of Australia

The Australian economy is strong – 5 year low unemployment, 5 year high growth, budget around balance.



Last time things were this good was during the mining boom, and the RBA was aggressively tightening to 4.75%. Today it is stuck at 1.5%, and not even talking about any rate increase. This would be very anomalous, except that property prices are falling and the RBA appears terrified of triggering a systemic crisis if this becomes disorderly.

In 2011, it was a mistake to base policy on Sydney residential property – the economy fell into a modest slowdown, and more importantly the $A soared about $US parity.

There is nothing to suggest a single data point approach is any more sensible today.

Bank of Japan

If the other central banks have problems, at least they have instruments that they can use. Japan has been running such aggressive QE that they may at some point run out of bonds to buy. Already, 6 years into the monetary experiment, **the BoJ owns the majority of the 5-10 year government bonds – as well as the majority of ETFs for the Nikkei 225 shares, the property trusts,...** If they do not taper, whether they like it or not, they will buy the last financial asset in Japan – and then the next day an unimaginable monetary policy cliff occurs when they are forced to stop!

Leading Markets

The Dow Jones and S&P500 finished +1.97% and +0.57% respectively. NASDAQ was -0.70% lower. US stocks were the main contributor to +0.78% for the MSCI World ex-AUS.

Emerging Markets stresses showed signs of easing, led by Turkey +20% and Russia +10% (in $US) for the month. China recovered from steep losses mid-month, although India dragged the MSCI EM index into negative territory.

Turkey offered to release a US prisoner / hostage.

US 10-year bonds closed at 3.05% (+19bp), after another 25bp interest rate hike.

Other Highlights

President Moon and Marshall Kim announced further details of the denuclearisation process after a successful summit in Pyongyang.

The US Federal Reserve raised rates another +25bp, with upgraded economic forecasts accompanying.

Turkey announcing the release of a US detainee immediately saw the currency pare back losses. Lower than forecast tariffs on China implied the Trump Administration opening the door to a deal ahead of crucial mid-term elections.

Canada met a month-end deadline to match Mexico's deal with the US on a NAFTA replacement. Increasingly, China finds itself outnumbered, with countries forced to side with the US.

Despite India now growing above 8%, its market slid -9% in $US.

China appears to be containing the bad debts in the banking system.

US headline CPI eased to 2.7% (-0.2%) in August. Nonfarm payrolls increased by another solid 201,000 month after 49-year low jobless claims. Wages rose +4.6% YoY.

The UK and EU remain gridlocked on the path to Brexit, and a "hard" no-deal outcome remains possible.

The Bank of Japan has recently expanded its target range for bonds; it faces the need to end asset purchases.

Domestic

After the government outperformed its deficit estimate by $10bn, S&P removed Australia from Negative Outlook. The operating deficit was just -$4bn.

The ASX200 fell -1.26%, with Smallcaps finished at -0.35%. Growth leaders such as CSL derated.

Australian 10-year bonds sold off on US leads, with yields rising +15bp to 2.67%, and the gap to US 10Y bonds at -38bp.

The RBA kept the cash rate at 1.5% in September.

Arguments for a rate increase include are booming GDP and employment numbers. GDP hit +3.4% after +0.9% in Q2. The last 5 quarters have been at least +0.7%. Household consumption and net exports dominated. Investment and inventories were flat.

Labour force participation rose +0.2%, keeping the headline unemployment flat at 5.3% as +44,000 jobs were added. Underutilisation was -0.4% to 13.4%. However, youth unemployment rose to 11.7% (+0.6%).

Against a rate increase, the arguments are concentrated around residential property. Prices are already falling (down another -0.7% in Q2), and banks have increased mortgage rates. Retail sales were flat in July.

The trade surplus slid to $1.551bn (-20%).

Commodities and Currency

WTI oil finished higher to $73.56/bbl (+5.39%) while Gold slid below $1,200/oz to $1,182 (-1.57%). Iron Ore rose to $68.11/t (+3.15%).

Base metals were mixed with Aluminium -4.76%, Nickel -4% and Tin -0.53%. Zinc and Copper gained +2.76% and +2.68% respectively. The $A finished at US72.22c (-0.52%).

KEY FINANCIAL MARKET DATA – AS AT 30TH SEPTEMBER 2018 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
AustBond Bank Bill Index	0.16%	0.52%	1.01%	1.87%	1.82%	1.94%	2.19%

Key Rates	Sep-18	Aug-18	Jul-18
Australian Cash Rate	1.50%	1.50%	1.50%
90 day BBSW	1.94%	1.95%	1.96%
3 Yr Commonwealth Bonds	2.08%	2.00%	2.10%
10 Yr Commonwealth Bonds	2.67%	2.52%	2.65%
CDX North American 5 Yr CDS	60bp	60bp	58bp
iTraxx Europe 5 Yr CDS	68bp	68bp	61bp
iTraxx Australia 5 Yr CDS	75bp	73bp	74bp
US Fed Funds Rate	2.00%-2.25%	1.75%-2.00%	1.50%-1.75%
US 10 Yr Bond Rate	3.05%	2.86%	2.96%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 Acc. Index	-1.26%	1.53%	10.13%	13.97%	11.58%	12.11%	8.19%
S&P/ASX Small Ord Acc. Index	-0.35%	1.10%	8.86%	20.32%	11.31%	16.97%	8.75%
A-REIT 200 Acc. Index	-1.77%	1.86%	12.09%	13.20%	4.92%	9.97%	12.41%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	0.57%	7.71%	11.41%	17.91%	18.26%	17.31%	13.95%
US: NASDAQ ($US)	-0.78%	7.14%	13.90%	23.87%	23.08%	20.31%	16.36%
MSCI World Acc. (Local Currency)	0.73%	5.29%	9.05%	12.30%	15.06%	13.52%	10.85%
MSCI World Acc. (AUD)	0.51%	7.20%	13.22%	20.63%	17.91%	12.42%	15.03%
FTSE (£)	1.05%	-1.66%	6.43%	1.86%	4.33%	7.40%	3.05%
MSCI Emerging Markets ($US)	-0.76%	-2.02%	-10.50%	-3.13%	7.70%	9.78%	1.20%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
BarCap Global Agg Acc. (AUD)	-0.38%	-0.07%	0.08%	0.89%	0.71%	3.15%	4.64%
AusBond Composite Bond Acc.	-0.42%	0.54%	1.36%	3.72%	1.46%	2.85%	4.28%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	Aug	44,000	Jul	-3,900
Unemployment Rate	Aug	5.30%	Jul	5.30%
Participation Rate	Aug	65.70%	Jul	65.50%
Lending Finance				
Housing Finance	Jul	1.30%	Jun	-1.00%
Personal Finance	Jul	-4.80%	Jun	0.80%
Commercial Finance	Jul	0.20%	Jun	7.20%
Lease Finance	Jul	1.90%	Jun	2.40%
Other				
Balance on goods and services	Jul	1551m	Jun	1873m
Retail Sales	Jul	0.00%	Jun	0.40%
Building Approvals	Jul	-5.20%	Jun	6.40%

*All data is seasonally-adjusted.

Median Fund Manager Returns (Morningstar)	1 month	3 month	6 month	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Australian Equity Large Cap	-0.90%	1.23%	10.04%	14.33%	12.15%	12.46%	7.89%
Australian Equity Small Cap	0.31%	2.60%	10.37%	21.70%	12.03%	17.20%	11.48%
Global Equity Large Cap	0.54%	5.87%	11.17%	17.16%	15.89%	11.51%	13.15%
Global Equity Small Cap	-1.49%	4.16%	11.82%	19.37%	18.24%	13.42%	15.38%
Australian Fixed Income	-0.44%	0.49%	1.16%	3.42%	1.32%	2.62%	4.04%
Global Fixed Income	-0.37%	-0.12%	-0.58%	-0.08%	1.21%	3.58%	4.72%
Australian Listed Property	-1.76%	1.44%	11.05%	11.49%	4.72%	9.66%	11.61%
Australian Cash	0.13%	0.44%	0.88%	1.75%	1.77%	1.91%	2.26%
Conservative[1]	-0.13%	0.58%	1.48%	3.10%	2.65%	3.13%	3.85%
Moderate[2]	-0.24%	0.85%	2.66%	4.07%	4.01%	4.48%	4.87%
Balanced[3]	-0.28%	1.77%	4.53%	6.24%	6.91%	7.00%	6.23%
Growth[4]	-0.34%	1.94%	5.79%	9.50%	9.20%	8.56%	7.96%
Aggressive[5]	-0.25%	2.99%	8.32%	12.11%	11.69%	10.82%	9.36%

[1] Growth Assets 0% - 20%
[2] Growth Assets 21% - 40%
[3] Growth Assets 41% - 60%
[4] Growth Assets 61% - 80%
[5] Growth Assets 80%+

For any queries, please contact:

Name	Title	Phone	Email
Andrew Vallner	Managing Director	(02) 8246 8800	andrew.vallner@cpgadvisory.com.au
Vipul Gupta	Advisor – Fixed Interest	(0435) 756 721	vipul.gupta@cpgadvisory.com.au
Rick Lu	Senior Analyst	(0425) 567 022	rick.lu@cpgadvisory.com.au