Monthly market update

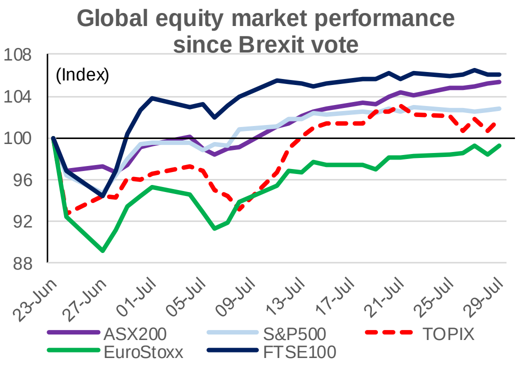
July 2016

Share markets had a remarkably strong month, with the ASX 200 up 6% as investors anticipated a major global policy response to address risks from Brexit. Australian shares are now 5% higher for the year, broadly in line with most other developed markets.

Jumping at shadows

And what an entertaining year it has been. Investors have spent 2016 jumping at shadows. At various times, they have fretted about Chinese financial risks, higher US rates and a credit crisis from falling commodity prices. The latest shadow has been Brexit (see Chart 1). None has proved enduring - in fact, it appears the global economy has improved through the year.

Chart 1:



Source: Datastream

Unfortunately, there are further shadows ahead. Investors may now be underestimating Brexit, as they are assuming aggressive central bank action will swamp the economic hit. But there is a feedback loop - better investor sentiment and stronger share markets make a policy response less necessary. Share markets could now recede as the policy outlook is reassessed.

Will the cavalry arrive?

Policy support has already been aggressive this year and more could follow. 29 central banks have cut interest rates this year, including the Reserve Bank of Australia (RBA), and the European Central Bank (ECB) has significantly stepped up its Quantitative Easing program, while the US Federal Reserve (Fed) has paused its tightening cycle.

Central banks will remain in focus over the next month as they finalise their post-Brexit strategies. The Bank of England (BOE) will announce its plan in August and the ECB is reassessing its economic forecasts ahead of potentially more measures at its September meeting. The Fed has delayed its planned interest rate tightening, probably until next year. The RBA is also likely to be cutting rates further as inflation remains below its target range.

Japan is now a major focus. The victory by Prime Minister Abe in the July upper house elections provided a mandate for a major fiscal package. Much attention will be focused on how this spending will be financed. This could be the first Monetary Financed Fiscal Program by a major country in the modern era. Instead of raising funds from debt markets or the public, the funds would come directly from money printing from the Bank of Japan (BOJ).

Markets are ahead of themselves for now

We recommended three opportunities from the Brexit turmoil that have generally played out.

1. European shares have bounced
2. The yen has fallen
3. Australian bond spreads have contracted

Unfortunately opportunities are now harder to find. The ASX 200 is trading above our year-end target of 5,400. Further gains from here will require an improvement in the earnings outlook, which could become apparent in the full year reporting season in August.

The Australian dollar is also above our year-end forecast of US73c. Further rate cuts will hold down the currency unless commodity prices stage another bounce. The direction of commodity prices will, as ever, depend on China. While the Chinese economy has improved this year, it might not be enough for a sustained rise in prices, given the surge in mine capacity over the past decade.

For now, we are most comfortable with share markets in Europe and Japan. These have the best combination of relatively cheap valuations and aggressive policy support. Policy has already driven some improvement in the European economy, and Japan has the most potential for a bounce next year if the Prime Minister is able to deliver an effective fiscal package. In debt markets, government bonds are looking very expensive with corporates the best opportunity given support from central bank buying.

Developments in the global economy

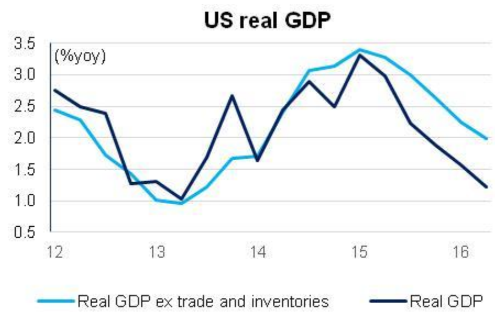
Australia

Available data for the June quarter is consistent with a moderation in GDP growth following the stronger-than-expected March quarter. This is mainly due to a smaller contribution to growth from net exports. But other indicators have softened of late. Retail sales increased only slightly in April and May, while building approvals fell in May although they remain elevated and imply a considerable amount of work yet to be done. The RBA cut rates in August on the back of the subdued June quarter inflation data. Headline inflation fell to 1% - its lowest level in 17 years. Core inflation stayed at 1.5% and therefore is still undershooting the RBA's 2–3% target band.

US

Activity data had suggested the US economy rebounded strongly in June. However, the actual growth numbers were disappointing (see Chart 2). Annualised GDP growth was 1.2%, well short of expectations for 2.5%. While consumption grew at a solid 4.2% annualised pace in the second quarter, investment continued to lag, dropping by 3.2% - its biggest decline in seven years.

Chart 2:



Source: Datastream

On the labour market front, payrolls bounced back in June after disappointing job gains in the previous two months. However, the three month rolling average gain has slowed to ~150k from ~200K over the past year. Against this background, the Fed left policy unchanged at its July meeting, noting near-term risks to the economic outlook have diminished.

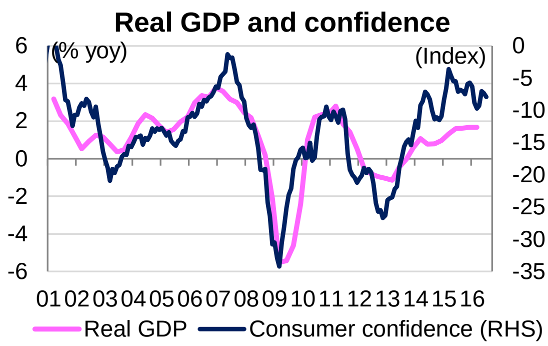
Japan

Upper House elections in early July saw Prime Minister Shinzo Abe win comprehensively. This has given Abe a mandate for more aggressive stimulus, especially in light of the fact that underlying price pressures continue to deteriorate. Despite this, the BOJ disappointed investors at its July meeting, announcing only minor new stimulus, when market expectations were for aggressive easing. The most significant outcome of the meeting was that Governor Kuroda has asked the Board for a comprehensive review of the economic environment and current policy settings for the September meeting.

Eurozone

The Eurozone economy slowed to 0.3%q/q in the second quarter, half the pace of the first quarter. Annualised growth eased to 1.2% - its slowest since the third quarter of 2014. Headline inflation picked up slightly in July to 0.2% from 0.1% in June. Core inflation remained at 0.9% for the third month. Both measures continue to lag the ECB's target of just below 2%. On a positive note, the June quarter bank lending survey showed a further improvement in loan supply conditions for businesses and households, as well as a continued increase in loan demand. The ECB kept policy unchanged following its July meeting, but ECB chief Draghi reiterated the Bank stands ready to act to support growth if needed. In the UK, the BOE decided to leave rates unchanged at its July meeting but acknowledged monetary policy would probably be loosened in August in light of the "yes" vote to Brexit.

Chart 3:



Source: Datastream

China

Data released in June was broadly ahead of expectations, suggesting growth stabilised in the second quarter of 2016. Real GDP increased 6.7% over the year to the June quarter, with the National Bureau of Statistics commenting that consumption contributed 73% to growth in the first half of 2016, up from 60% a year ago. Industrial production and retail sales came in ahead of expectations in June, while fixed asset investment grew more slowly than expected. Meanwhile, credit growth reaccelerated in June after a soft patch in the last two months. Producer price deflation eased for the sixth straight month with the 2.6% decline the smallest since late 2014.

Developments in financial markets

Australian shares

July was a very strong month for Australian shares. The ASX200 was up 6%, outperforming international shares. The best performing sectors were utilities, consumer discretionary and consumer staples. In contrast, energy and IT were the biggest laggards.

International shares

Global share markets were up 2% in July in Australian dollar terms, following a strong rally post Brexit. Global central banks voiced that they will continue to act as a backstop. Better-than-forecast economic data and US corporate earnings also helped lift stocks. Japan and emerging markets were the biggest outperformers for the month. At the global sector level, cyclical sectors led the market with IT, materials and consumer discretionary the biggest outperformers. In contrast, energy, consumer staples and utilities were the biggest underperformers.

With global rate expectations coming down and further easing expected, property out-performed the broader index in every market except the UK, where the impact of Brexit on London property in particular remains murky. In Australian dollar hedged terms, global REITs were up 5% in July.

Australian Fixed Interest

In Australia, the RBA cut the cash rate by 0.25% to 1.50% at its August meeting. The accompanying statement noted the prospect of sustainable growth would be improved by easing monetary policy. Australian bond yields fell further in July and the curve flattened. Two-year bond and 10-year bonds yields fell by 7 and 11 basis points to 1.47% and 1.83% respectively.

International Fixed Interest

Brexit continues to drive market expectation to further monetary easing by global central banks, and the share of developed market government bonds with a negative yield continues to grow. The 10-year US Treasury yield fell to its lowest on record during the month, below 1.37%, as we saw all Switzerland's Government Debt trade at a negative yield for the first time in history. However, bond yields strengthened in the second half of the month, leaving global bonds up 1% in Australian dollar terms.

Strong performance of fixed income assets and expectations of ongoing loose monetary policy have supported corporate credit markets. Both US and European investment-grade corporate debt are testing the lows of a three-year range in yield. Asian and emerging market debt also performed strongly in July.

Commodities

After almost doubling from a 12 year low in February, crude oil prices fell almost 15% from the start of July. Traders are currently weighing up the bearish influence of ample stockpiles against the bullish expectations of declining production around the world that could shrink the global glut of crude oil. Further gains in gold and silver in July were inspired by Brexit-inspired talk of additional economic stimulus from some of the world's largest central banks. Meanwhile, metals had a solid month with strong gains for zinc, nickel and iron ore.

Australian shares	**1m**	**3m**	**1 year**
S&P ASX 200	6.3%	5.9%	-2.4%
S&P ASX 200 Industrials	6.3%	6.4%	-1.3%
S&P ASX 200 Resources	6.5%	2.9%	-8.5%
S&P ASX 200 Property Trusts	5.4%	10.4%	18.4%
S&P ASX Small Ordinaries	8.5%	11.1%	18.0%
Global equities	1m	3m	1 year
MSCI World ex Australia A$	2.0%	4.0%	-3.9%
MSCI Emerging Markets A$	4.7%	4.0%	-3.1%
EPRA/NAREIT Developed Index Hedged A$	4.7%	8.7%	9.0%
STOXX Europe 600	3.6%	0.1%	-13.7%
S&P 500	3.6%	5.2%	3.3%
Nikkei 225	6.4%	-0.6%	-19.5%
Fixed interest	1m	3m	1 year
Bloomberg Composite Bond Index +0yrs	0.7%	3.4%	6.4%
Bloomberg Bank Bill Index	0.2%	0.5%	2.2%
Barclays Global Aggregate Hedged A$	0.7%	3.3%	8.8%
Commodities	1m	3m	1 year
Bloomberg Commodity Index	-5.1%	-1.4%	-8.2%
Brent Crude Oil	-13.2%	-10.0%	-26.8%
Copper	1.6%	-2.9%	-5.9%
Gold	2.2%	4.5%	23.3%
Iron Ore	6.7%	-10.4%	11.2%
Currencies	1m	3m	1 year
AUD/USD	2.0%	-0.2%	4.0%
EUR/USD	0.7%	-2.4%	1.7%
USD/JPY	-1.1%	-4.1%	-17.6%
GBP/USD	-0.6%	-9.4%	-15.3%

Source: Datastream

For more information on market activity and investments, please contact your BT relationship manager.