Month in Review

Index returns at end October 2018 (%)

Australian Equities	1 mth	3 mth	6 mth	1 yr	3 yr	5 yr	10 yr
S&P/ASX 200 Accumulation Index	-6.05	-5.92	-0.42	2.94	8.25	6.02	8.53
S&P/ASX Small Ordinaries Accumulation Index	-9.60	-7.67	-4.22	2.59	10.54	6.00	6.73
Global Equities							
MSCI World TR Index (AUD)	-5.38	-0.95	4.48	10.03	8.76	13.81	9.86
S&P 500 TG Index (AUD)	-4.89	1.48	10.12	16.13	11.77	17.98	12.43
FTSE 100 TR Index (AUD)	-4.82	-4.87	-4.22	3.19	1.71	6.39	5.77
MSCI Emerging Markets NR Index (AUD)	-6.80	-7.33	-11.10	-5.36	6.76	6.80	7.07
Real Estate Investment Trusts (REITs)							
S&P/ASX 300 A-REIT Accumulation Index	-3.12	-2.13	4.06	7.31	7.43	11.30	9.27
FTSE EPRA/NAREIT Dev. NR Index (AUD Hgd)	-3.18	-3.78	1.30	2.10	4.02	7.23	11.01
Fixed Interest							
Bloomberg Ausbond Composite 0+ Yr Index	0.48	0.87	2.21	3.09	2.92	4.39	5.44
Bloomberg Ausbond Bank Bill Index	0.17	0.49	1.01	1.89	1.93	2.18	3.14
Barclays Global Aggregate TR Index (AUD Hgd)	-0.23	-0.32	0.24	0.19	2.91	4.36	6.74

Data source: Bloomberg & Financial Express. Returns greater than one year are annualised.
Commentary regarding equity indices below references performance without including the effects of currency (unless specifically stated).

Australian equities

The S&P/ASX 200 Index returned -6.1% through October as local markets reacted to selling on Wall Street and growth shares came under pressure. Sectors that have enjoyed a relatively robust earnings trajectory in recent months, such as Health Care (-7.0%) and Information Technology (-11.2%), were hit hard as investors backed away from elevated valuations. Returns for 'bond proxy' sectors such as Utilities (-4.0%) and A-REITs (-3.1%) were the least negative during the month but continue to be buffeted by moves in the US bond market, which has seen yields push higher as investors raise their inflation expectations in response to the strength and duration of the current US economic cycle.

Some of Australia's own growth darlings came under pressure, including fintech player Afterpay Touch (-30.4%) and global logistics software provider WiseTech (-27.3%), but both were still trading at around 50x FY20 earnings by month-end. Within the Energy sector (-10.5%), Worley Parsons (-24.7%) saw the biggest drop, with investors cautious about the price paid for its $4.6 billion acquisition of Texas-based Jacobs Engineering's energy, chemicals and resources business.

Global equities

In the US, the market rally gave way to a rolling bear market in October, with debate raging about whether the selloff was predominately technical or driven by fundamentals. Global shares, measured by the MSCI World Ex Australia Index, returned -5.2% in Australian dollar terms, while small cap shares fared even worse, returning -8.0%. While systematic flows may have exacerbated the drawdown, there are signs of slowing earnings momentum in the US and companies missing EBIT margin estimates for 2019, while liquidity and Fed tightening remain overarching concerns.

The S&P 500 Index returned -6.8% in US dollar terms, and in price terms the index surrendered all of its year-to-date gains in just three weeks. Losses were concentrated in the areas of the market where fund managers have relatively higher levels of exposure, including IT (-8.1%), Consumer Discretionary (-11.3%), Energy (-11.3%) and Industrials (-10.9%). The STOXX Europe 600 Index lost 5.3% in October with the largest falls coming from Industrial Goods and Services (-9.3%), Technology (-8.7%), and Banks (-9.3%). Chinese equities and the yuan remained under pressure over the past month as investors fretted over the ongoing slowdown in growth and the potential negative impact from the escalating trade war with the US.

REITs

The S&P/ASX 200 A-REIT Index returned -1.8% in September as rising yields brought the sector under pressure. Shopping centres tracked downwards, with Vicinity Centres (-5.4%) sliding through the month before announcing the selloff of 11 centres for $631 million, and Scentre Group (-3.4%) feeling the pinch as department stores battle falling revenue. Over the past year, the ASX 200 A-REIT Index has delivered broadly in line with the ASX 200 Index, and has outperformed Australian shares over five and seven years. While rising long-term bond yields are generally negative for

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REITs, especially those with higher leverage, the sector is proving relatively robust, indicating that investors are still looking for exposure to sustainable income and high-quality property. Labour's plan to eliminate most cash refunds for excess franking credits may also result in a shift away from high-dividend paying and franked shares in preference of REITs and infrastructure. Globally, developed market property returned -1.8% on a hedged basis in September. US REITs hit a roadblock in September, with the Bloomberg US REIT Index down 3.1%, with falls in Health Care (-4.8%), Office (-4.3%) and Malls (-3.2%).

Fixed income

Global bonds, measured by the Barclays Global Aggregate Index, returned 1.0% in October in AUD terms and -0.2% in AUD hedged terms. October was dominated by the sharp rise in US bond yields and the accompanying downturn in global equity markets, with the US 10-year yield pushing to a high of 3.26%, while the S&P 500 suffered a 9.9% drop from its record high in September to its October low. Ongoing strength in the US economy and a readjustment in inflation expectations was the obvious culprit, although loose guidance from the US Fed may also have been a contributing factor.

The market lifted its expectation for the Fed funds rate, factoring in a December move and two further hikes in 2019 to 2.875% but with a low probability of further action. Yields eased through the end of October and early November as the market came under pressure from record volumes of longer-dated US government debt supply, which saw the 10-year yield slip to 3.18%, while the US Dollar index fell below 96. Australian bonds returned 0.5% in October and it was rocky ride for the Australian 10-year yield as well, which hit a high of 2.78% in October before falling to low of 2.57% late in the month, only to shoot back above 2.75% by the second week of November.

ASX 200 share movements

S&P/ASX 200 share performance for the month to October

Best performers		Worst performers	
Saracen Mineral Holdings	31.37%	Corporate Travel Management	-34.33%
Lynas Corp	30.41%	Syrah Resources	-30.43%
St Barbara	19.20%	Afterpay Touch Group	-30.42%
MYOB Group	13.73%	Bellamy's Australia	-29.32%
Regis Resources	13.44%	Domain Holdings Australia	-29.14%

S&P/ASX 200 share performance for the year to October

Best performers		Worst performers	
Bravura Solutions	151.26%	Syrah Resources	-52.52%
Afterpay Touch Group	140.19%	G8 Education	-52.33%
Appen	98.10%	AMP	-47.42%
Altium	84.65%	Automotive Holdings Group	-41.09%
Beach Energy	82.91%	Bellamy's Australia	-39.95%

Economic News

Australia

Despite the risk of a material slowdown in the Chinese economy, evidence of a decline in house prices, and global trade concerns, business conditions remain relatively robust while labour market conditions continue to show signs of underlying strength. At its November meeting the RBA lifted its forecast for economic growth in 2018 and 2019 slightly to 3.5%, with growth then set to slow in 2020 due to reduced exports of raw materials. Minutes from the September RBA meeting signalled a heightened risk in the housing market, raising the possibility that banks could tighten lending conditions further in light of the Royal Commission into Financial Services report.

Employment continued to grow through September, with 20,300 full-time jobs added, offset by a fall in part-time jobs of 14,700. Recent seasonally adjusted figures have indicated a possible slowing in momentum, but trend employment growth shows the labour market continues to tighten. The **unemployment rate** fell 0.3 points to 5.0%—the lowest level since April 2012—helped by a fall in the participation rate of 0.2 points to 65.4%. The underemployment rate remained steady at 8.3% while monthly hours worked in all jobs rose by 6.2 million to 1,757.5 million hours.

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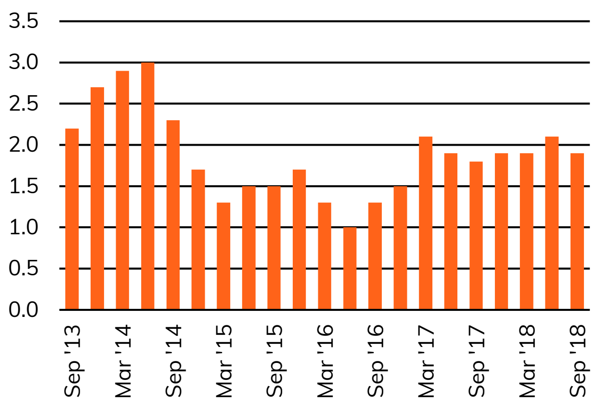
The **AIG Manufacturing Index** fell 0.7 points to 58.3 in October, reflecting continued overall strength in manufacturing activity. Respondents in the large machinery and equipment sector noted rising input costs due to the lower Australian dollar and lower sales in drought-affected areas. For the third month in row all seven activity indices were in expansion, although Employment (-5.4 points to 52.6), New Orders (-3.8 points to 58.8) and Exports (-3.8 points to 55.1) slowed. Production (+2.9 points to 61.6) expanded at a quicker pace in October, partly reflecting high activity levels in mining, infrastructure and construction.

Australian CPI (% change year-on-year)



Source: ABS

October saw a small silver lining appear for consumers, even as market conditions deteriorated. The Westpac Melbourne Institute **Index of Consumer Sentiment** rose from 100.5 to 101.5 on September, but still reduced from July's most recent high of 106.1. Negative sentiment resulting from mortgage rate increases, falling home prices and rising petrol prices appears to be washing through, while labour market conditions continue to be favourable. The 'finances, next 12 months' sub-index only edged up 0.6% and is 4.1% below its high following the announcement of tax cuts in the May Budget.

Retail turnover rose 0.2% in September, below the expected 0.3% growth as consumers held back on discretionary spending. Clothing was the biggest group hit, falling 1.2% through the month, while department stores and household goods retailing were flat. The major food retailing group rose 0.4%, rescuing the retail sector from a flat or even negative month. Overall, retail sales grew only 0.2% over the September quarter and will likely contribute very little to Q3 GDP.

Australia's **balance on goods and services** grew from a surplus of $2,342 million in August to $3,017 million in September. The value of non-rural goods exports rose $678 million, including a $551 million rise in metal ores and minerals. The results included a significant upward revision to August's trade balance figure, which was $1,413 million higher than the original $1,604 million figure. Imports fell by 1.1%, led lower by a pull-back in capital goods and higher prices associated with the lower Australian dollar.

Global

US **September quarter GDP** grew by an annualised 3.5% according to October's advance estimate, beating expectations for growth of 3.4% and boosted by consumer spending growth of 4.0%—the fastest rate since the December quarter of 2014. While growth moderated from the 4.2% recorded in the June quarter, the continuing strength of the consumer is promising, although concerns remain about the sustainability of recent growth, with fixed investment falling slightly during the quarter despite the implementation of the Trump administration's tax cuts earlier in the year.

October's **non-farm payrolls** showed 250,000 jobs were added over the month, breezing past the consensus 190,000 figure. The unemployment rate was steady at 3.7% and remains the lowest since December 1969. Average hourly earnings rose by 5 cents to $27.30 and have risen 3.1% over the past 12 months, representing the fastest pace since 2009.

The past month has been dominated by the sharp rise in US bond yields and the accompanying downturn in global equity markets. On face value one might assume that it was ongoing strength in the US economy that was to blame for the most recent surge in bond yields, but there was not a lot of 'new news' to move expectations. While President Trump's loose comments that the Fed had "gone crazy" and was "out of control" certainly did not help, but the primary catalyst for the sharp rise in yields was the increasing uncertainty regarding the so-called 'neutral' Fed funds rate.

Despite some warranted scepticism of political polling, the baseline consensus for the mid-term elections proved correct, with the Democrats winning control of the House and Republicans holding the Senate. The result lowers the chances of a large fiscal stimulus, while Trump will also need the blessing of House Democrats for any new trade deals.

The **ISM manufacturing PMI** fell 2.1 points to 57.7 in October, reflecting robust but softening demand and consumption. New Orders (-4.4 points to 57.4) slowed noticeably, falling below the 60-point mark for the first time since April 2017, but remains firmly in expansion. Production (-4.0 points to 59.9) and Employment (-2.0 point to 56.8) were both down. Input price pressures continue, with the Prices index (+4.7 points to 71.6) showing a higher rate of expansion in October with price rises across all sectors, due in part to higher oil prices, while respondents continue to be concerned about the impact of tariffs and potential delays in material from China.

US consumer prices for all items rose by an annualised 2.3% in September, lower than the 2.7% recorded in the previous month. Core CPI, which excludes food and

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energy, was steady at 2.2%. The core PCE index—the Fed's preferred measure—was steady at 2.0% year-on-year, consistent with the previous two months. While inflation appears to be holding at target, the main impetus for further Fed rate hikes is continued labour market tightening and the expectation for higher wage growth in the near future.

Euro area GDP grew 0.2% in the September quarter according to October's initial estimate, missing against the expected 0.4% growth. Markets did not appear too fazed by the result, with temporary factors, including disruptions in car production from new car emissions testing procedures, impacting growth, while lower oil prices through October are seen as positive for consumers going forward.

Of concern, however, is the data for Italy, which showed the national economy stagnating in the September quarter, while the PMI points to negative growth early in the December quarter. The Italian government intends to stick to its election promises, including its controversial basic income policy and tax cuts. The government is aiming for a budget deficit of 2.4% of GDP, which would represent a significant fiscal expansion from the previous government's 1.6% target, risking a confrontation with the European Commission and unnerving financial markets.

Chinese GDP grew by 6.5% year-on-year in the September quarter, below the expected 6.6% and down from the June quarter's growth of 6.7%. The official manufacturing PMI dropped from 50.8 to 50.2 while the Caixin PMI was for all intents and purposes flat, rising from 50.0 to 50.1. The People's Bank of China has cut reserve requirements for lenders four times this year—a total reduction of 2.50%—with the latest cut taking effect on 15 October, injecting more liquidity to stimulate bank lending. Shibor rates have declined and the 6.0%-plus decline in the yuan may also absorb some of the downside pressure.

The impact of tariffs on growth is difficult to determine but the IMF recently downgraded its projection for Chinese GDP growth in 2019 from 6.4% to 6.2%, citing trade as a key issue. Indeed, trade data for September showed higher than expected growth in Chinese exports, up 14.5% year-on-year as producers frontloaded exports ahead of the tariffs. Scenario analysis by the IMF indicates that a full-blown trade war between the US and China, including an extension of tariffs to automobiles and commensurate retaliatory measures, would knock 1.6 percentage points off China's GDP growth.

Commodities

Commodities were mixed through October, with Copper (+0.3%), Tin (+0.6%) and Zinc (+1.8%) holding firm while Nickel (-10.2%), Lead (-7.4%) and Aluminium (-5.2%) suffering falls. Gold rose 1.1% to end the month at US $1213.34/oz, down from its April high of $1358.31. Oil prices slid in October, with Brent crude falling 9.5% from US $82.72 per barrel to $74.84 and WTI falling from $73.16 to $65.31.

Currencies

The Australian dollar fell 2.1% in October to US $0.7072 and is down 7.7% over the past 12 months. The currency is close to levels reached during the 2015-16 Chinese deflation scare, although somewhat at odds with the more sombre forecasts, bulk commodity prices have remained relatively steady this year. Emerging market currencies staged a recovery in October, with the Brazilian real up 9.4% against the US dollar and the Turkish lira rising 8.8%.

The Australian dollar was down 0.5% in trade-weighted terms through October, falling against the USD (-2.1% to 0.71), EUR (-0.5% to 0.63), JPY (-2.7% to 79.95) and flat against the GBP (0.55). Over the three months to the end of October, the Australian dollar has depreciated 4.9% against the US dollar, falling from a high of 0.7459 in August to a low of 07053 in October. On a trade-weighted basis, the Australian dollar has depreciated 2.5% over the past three months, losing value against the EUR (-1.5%), GBP (-2.1%), JPY (-3.8%) and NZD (-0.6%).

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