# Australian Monthly Wrap

September Economic Wrap

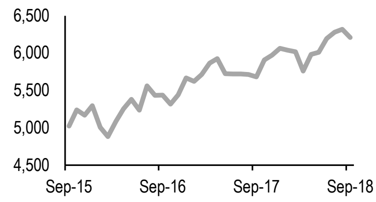
**Summary -** In a nutshell, both leading and hard economic data point to resilience in the global economy led by the US. This resilience continues to be tested however with investor sentiment being weighed down by ongoing trade concerns that saw additional tariffs be implemented between the US and China during the quarter with more anticipated to come unless the two nations can reach a compromise. Business sentiment has been weighed down by the uncertainty on tariffs and trade policy with it being cited as a persistent concern across both developed and emerging markets. Australia continues to track in a mixed fashion, on the one hand GDP surprised on the upside driven in part by solid export growth and also Australia's strong population growth (more people → more demand for goods and services → stronger growth) but conversely wage inflation remains weak at 2.1% per annum, in line with inflation.

**Markets** - The September quarter was marked by a rising US Dollar (USD) with the Australian dollar (AUD) falling on the back of disappointing economic data, relative to the United States and a growing interest rate differential with Australian rates now 0.75% below US rates reducing the attractiveness of holding AUD vs USD. US leading economic indicators and hard data are holding up, offering support for the Federal Reserve's ("The Fed's") decision to raise interest rates in September. Emerging market underperformance has continued since the start of the year driven by trade war concerns with China comprising a sizeable component of the index (see chart 4). The ASX underperformed global markets (see chart 2) with growth stocks in aggregate maintaining their outperformance for the quarter (see chart 3) as market darlings such as Afterpay and Appen were traded up following their positive FY18 results.

**Key economic news** – The Reserve Bank of Australia left the cash rate on hold at 1.50% as expected. September marked the twelfth consecutive month of contracting home prices in Australia with a fall of 1.5% over the quarter according to the latest CoreLogic data. The weakness was driven by declines in Sydney and Melbourne dropping 1.5% and 2.4% over the quarter. In the US, the Fed increased interest rates again this quarter with a 0.25% hike to leave its target rate at 2.25%, a 0.75% premium to Australian rates, adding pressure to the AUD.

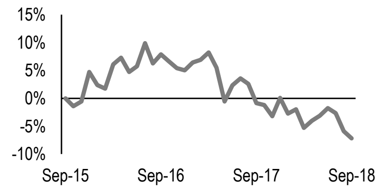
**Key company news –** TPG Telecom (ASX: TPM) rose strongly in the quarter following an announced merger with mobile rival Vodafone as well as earnings that exceeded consensus forecasts and guidance. Leading tech companies Afterpay Touch Group (ASX: APT) and Wisetech Global (ASX: WTC) delivered strong growth that saw their valuation multiples re-rate with substantial share price appreciation as a result. By contrast Speedcast International (ASX: SDA) was on the other side of the ledger with a downgrade to FY18 guidance driven by declining revenues from the Energy sector seeing its share price correct substantially. Other points of weakness such as Estia Health (ASX: EHE) and Lynas Corp (ASX: LYC) saw themselves fall afoul of prospective government intervention in Australia and Malaysia respectively.

**1. S&P/ASX 200 Price Index**



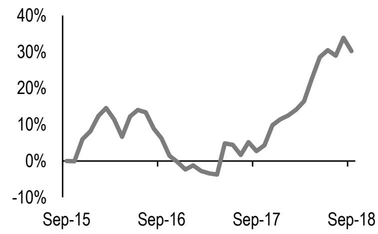

Source: Bloomberg, IOOF

**2. ASX200 vs All-World, US$ terms**



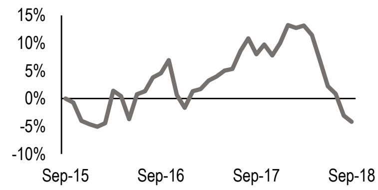

Source: Bloomberg, IOOF

**3. MSCI Australia Growth relative to MSCI Australia Value**




Source: Bloomberg, IOOF

**4. Emerging markets vs Developed Markets, US$ terms**




Source: Bloomberg, IOOF

## Sector and stock returns

| | ASX/S&P 200 Sectors (GICS) | | | | Best and Worst S&P/ASX 200 Performers | | | |
|---|---|---|---|---|---|---|---|---|
| | Monthly | %Δ | Quarterly | %Δ | Top five stocks | | Bottom five stocks | |
| ▼ | Consumer Discretionary | -4.66 | Consumer Discretionary | 0.02 | Monthly | | | |
| ▼ | Consumer Staples | -3.30 | Consumer Staples | -2.17 | Northern Star Res Ltd | +19.3% | Lynas Corp Ltd | -27.2% |
| ▲ | Energy | 4.02 | Energy | 2.73 | Vocus Group Ltd | +15.1% | Estia Health Ltd | -22.3% |
| ▼ | Financials ex Property | -2.37 | Financials ex Property | -1.44 | South32 Ltd | +12.6% | Blackmores Ltd | -19.4% |
| ▼ | Financials | -2.37 | Financials | -1.44 | Monadelphous Group Ltd | +12.1% | Resolute Mining Ltd | -14.2% |
| ▼ | Health Care | -8.36 | Health Care | 3.44 | Pilbara Minerals Ltd | +11.8% | Aveo Group | -14.0% |
| ▼ | Industrials | -2.84 | Industrials | 3.44 | Quarterly | | | |
| ▼ | IT | -1.01 | IT | 9.85 | Afterpay Touch Group Ltd | +92.0% | Speedcast Internat. Ltd | -35.0% |
| ▲ | Materials | 2.67 | Materials | -2.83 | TPG Telecom Ltd | +65.2% | Bellamy's Australia Ltd | -34.2% |
| ▼ | Property Trusts | -1.80 | Property Trusts | 1.28 | Mayne Pharma Group Ltd | +49.4% | Lynas Corp Ltd | -31.8% |
| ▲ | Telecommunications | 2.44 | Telecommunications | 22.56 | Vocus Group Ltd | +42.0% | Pact Group Holdings Ltd | -29.4% |
| ▼ | Utilities | -3.65 | Utilities | -5.66 | Wisetech Global Ltd | +41.1% | Estia Health Ltd | -28.0% |

Source: Bloomberg, IOOF

## Equity review

### Major Market Performance, September 2018

| | Australian Indices | Sep-18 Price | 1M return (%) | Jun-18 Price | 3M return (%) |
|---|---|---|---|---|---|
| ▼ | S&P/ASX 200 | 6208 | -1.77 | 6195 | 0.21 |
| ▼ | All Ordinaries | 6326 | -1.59 | 6290 | 0.57 |
| ▼ | Small Ordinaries | 2863 | -0.93 | 2859 | 0.15 |
| | **US Indices** | | | | |
| ▲ | S&P 500 | 2914 | 0.43 | 2718 | 7.20 |
| ▲ | Dow Jones | 26458 | 1.90 | 24271 | 9.01 |
| ▼ | Nasdaq | 8046 | -0.78 | 7510 | 7.14 |
| | **Asia Pacific Indices** | | | | |
| ▼ | Hang Seng | 27789 | -0.36 | 28955 | -4.03 |
| ▲ | Nikkei 225 | 24120 | 5.49 | 22305 | 8.14 |
| | **UK & Europe Indices** | | | | |
| ▲ | FTSE 100 | 7510 | 1.05 | 7637 | -1.66 |
| ▲ | CAC40 | 5493 | 1.60 | 5324 | 3.19 |
| ▼ | DAX Index | 12247 | -0.95 | 12306 | -0.48 |

Source: Bloomberg, IOOF

**US equity market**

The S&P 500 index finished the quarter up 7.2%. The market performance was strong across most sectors with nine of the twelve in positive territory for the quarter. The best performers were technology (up 8.5%), industrials (up 9.5%) and health care stocks (up 14%). Energy and Materials stocks were points of weakness (both down 0.1%) with real estate stocks likewise struggling to participate in the overall market rise (flat at 0%). Markets took the expectation of a Federal Reserve rate hike of 0.25% in their stride with the focus instead on the strong US economy and positive earnings results across most sectors.

**Australian equity market**

The S&P/ASX 200 index was flat over the quarter finishing up 0.2%. On a sector level, the best performers were telecommunications (up 22.6%) and technology stocks (up 9.9%). The telecommunications space rallied on the back of the proposed merger between Vodafone and TPG Telecom. TPG had been seen as a major competitive threat in the mobile phone market with this proposal reducing the market from four players to three once again. The expected reduction in competition for consumers saw Telstra shares also rally in sympathy.  The worst-performing sectors were in the Materials (down 2.8%), Utilities (down 5.7%) and Financials sectors (down 1.4%) with the major banks and other financial institutions struggling against negative sentiment over a tougher regulatory environment post-Royal Commission. In addition, Utility stocks struggled in the face of a possible Royal Commission curbing pricing power in that space while Materials stocks declined in line with general commodity weakness over the quarter.

## Fixed Income

| | Fixed Income | Sep-18 yield | 1M mvt (bps) | Jun-18 yield | 3M mvt (bps) |
|---|---|---|---|---|---|
| | Aussie Cash rate | 1.50 | -- | 1.50 | -- |
| ▲ | 10-year Bond Rate | 2.67 | 0.15 | 2.63 | 0.04 |
| ▲ | 3-year Bond Rate | 2.05 | 0.07 | 2.06 | -0.01 |
| ▼ | 90 Day Bank Accepted Bills SFE-Day | 1.93 | -0.02 | 2.1 | -0.17 |
| ▲ | US 10-year Bond Rate | 3.06 | 0.20 | 2.86 | 0.20 |
| ▲ | US 3-year Bond Rate | 2.88 | 0.19 | 2.62 | 0.26 |

Source: Bloomberg, IOOF

During the September quarter, the Australian yield curve steepened slightly with longer term rates rising and short term rates falling. The Australian 3-year bond yield fell 1bp and the 10-year bond yield rose 4bps. The U.S. yield curve rose and flattened slightly with the 3-year yield increasing by 26bps and the 10-year yield, 20bps.

Australian bond yields were weighed down by a mix of concerns. Domestically the Westpac interest rate hike weighed on interest rate expectations, sending yields lower as did the low inflation and wage growth figures of 2.1% for the June quarter (reported in the September quarter). These are all factors that weigh on growth expectations with real wage growth of 0% (2.1% - 2.1%) implying that household buying power on average has not increased over the past year. To these we can add the concern on global trade wars with the tariff saga continuing between the US and China which weighed on growth expectations for China (Australia's largest trading partner) and consequently on Australian growth expectations (i.e. if trade partner growth is lower then, markets anticipate Australian growth is lower) seeing yields fall over the month. A way to think about this last point is to consider bonds as a prediction on where interest rates will be in the future i.e. in 3 years' time the cash rate will be 1.98% (about two interest rate hikes within the next 3 years). Now if growth is lower going forward then inflation is, all else being equal, likely to be lower as well in which case rates are more likely to remain low, leading investors to buy bonds and push bond yields lower (by bidding up the price). The upward movement in the 10-year reflects a rise in sympathy with higher US yields with Australian long-duration bonds being sold off (increasing the yield) given the greater attractiveness of US bonds following the 0.25% increase in US interest rates that drove US yields higher along with positive economic data which supports the case for further rate hikes in December and in 2019.

In July, we highlighted how the 3-month bank bill rate had declined slightly to alleviate some of the pressure on bank funding costs. A notable move over the quarter was the decision by the major banks in August to raise rates with Westpac announcing a 14bps hike in its variable interest mortgage offerings to offset a larger than expected decline in net interest margins (the gap between the rate it lends to customers at and the cost of those funds). Regional bank Suncorp followed suit as did CBA and ANZ in early September even with the negative public sentiment towards the sector in the wake of the Royal Commission into Financial Services and its revealing coverage. This will potentially delay the case for rising interest rates in Australia as higher mortgage rates achieve the same tightening of credit conditions as an interest rate hike would. This is because mortgage repayments constitute a sizeable portion of total household borrowing repayments in Australia and given the major banks retain a dominant market share, higher mortgage rates will crimp spending elsewhere by consumers.

## Currencies

| | Currencies | Sep-18 Price | 1M return (%) | Jun-18 Price | 3M return (%) |
|---|---|---|---|---|---|
| ▲ | $A vs $US | 72.24 | 0.49 | 74.05 | -2.44 |
| ▼ | $A vs GBP | 55.44 | -0.08 | 56.07 | -1.12 |
| ▲ | $A vs YEN | 82.13 | 2.89 | 82.01 | 0.15 |
| ▲ | $A vs EUR | 62.24 | 0.44 | 63.37 | -1.78 |
| ▲ | $A vs $NZ | 109.10 | 0.39 | 109.30 | -0.18 |
| ▼ | $US vs EUR | 86.17 | -0.03 | 85.58 | 0.69 |
| ▼ | $US vs GBP | 76.76 | -0.52 | 75.72 | 1.37 |
| ▲ | $US vs CHF | 98.17 | 1.32 | 99.06 | -0.90 |

Source: Bloomberg, IOOF

The Australian dollar (AUD) depreciated against major global currencies over the quarter dropping to USD 0.7224 on the back of political turmoil in Canberra as well as the Westpac mortgage rate hike which delayed the case for a RBA rate hike further into the future. In addition, US Dollar (USD) strength continued over the quarter benefitting from safe haven demand as global trade tensions continued to roll on with China and the US levying heavier tariffs on each other leading investors to flee emerging markets (which are affected as part of global supply chains) while also showing stronger relative strength compared with other markets with growth ahead of the EU for example.

## Commodities

| | Commodities | Sep-18 Price | 1M return (%) | Jun-18 Price | 3M return (%) |
|---|---|---|---|---|---|
| ▼ | Aluminium | 2056 | -2.94 | 2135 | -3.70 |
| ▲ | Copper | 281 | 5.02 | 299 | -6.12 |
| ▼ | Nickel | 12525 | -1.77 | 14918 | -16.04 |
| ▼ | Gold | 1196 | -0.87 | 1266 | -5.54 |
| ▲ | Silver | 15 | 1.06 | 16 | -9.83 |
| ▲ | Crude Oil - Brent | 83 | 6.85 | 79 | 4.13 |
| ▼ | Lead | 2026 | -2.33 | 2409 | -15.91 |
| ▲ | Zinc | 2650 | 7.64 | 2849 | -7.00 |
| ▲ | Iron Ore | 68.73 | 2.34 | 64.80 | 6.06 |

Source: Bloomberg, IOOF

Commodity prices continued to experience weakness over the September quarter with nickel, copper and precious metals as points of weakness. On precious metals, it is important to note that given a backdrop of rising US interest rates, gold's value as a safe haven is weaker because it is not an income-producing asset versus US Treasury bonds that are offering investors both safety and yield. In addition, gold can "catch a bid"—i.e. increase in value—at moments where the financial system appears on the verge of collapse such as the freezing of credit markets during the global financial crisis, such an extreme lack of confidence in the system remains absent. Nickel and copper suffered from trade war concerns continue to weigh on investor sentiment on the back of fears of falling global trade which is expected to be the fall out of the tariffs being deployed between the US and China. In addition, in the case of nickel the relaxation of export quotas by the United States added to supply, contributing to price weakness. Lastly, we should note that given commodities are priced in US Dollar terms, all things being equal, a rising US Dollar makes them more expensive to end users resulting in lower demand and consequently lower prices.

International oil prices rose with a pivotal moment being the OPEC decision along with Russia to not increase production in response to rising oil prices but instead keep their quotas on target. This withdrawal of expected supply saw oil prices bid up further as did the tightening of US sanctions against Iran with a major importer in India signalling its cutting back on demand for Iranian oil. That demand needs to still be filled helping to bid prices further such that the overall mix of tighter supply and steady demand saw oil prices rise. Iron ore benefitted from speculation that production limits on Chinese steelmakers, implemented to combat pollution would continue going forward.

## Australia

Rates on hold with low wage and headline inflation (CPI) continuing the “lower for longer” theme. Economic growth surprised at 3.4% for the year to June 2018 but was driven by strong consumer spending we do not expect to persist without further income growth. Weaker retail trade numbers in July and August slightly offset by continued trade surpluses to paint a mixed picture for Sep-18 economic growth. The outlook for residential construction poses an additional headwind to growth with dwelling approvals declining over July and August.

The RBA held interest rates steady at 1.5% (consensus: 1.5%) over the quarter as expected marking over 2 years now since the last change in interest rates in August 2016. Signs from the RBA statement following its meetings over the quarter were notable for several factors. First trade figured prominently as a source of uncertainty in its global economic outlook highlighting the trade tariff battle between the US and China. Second was the downgrade in its inflation forecasts to 1.75%, below target for 2018, as well as the highlighting of increased mortgage interest rates. Both of these factors point towards a continuation of low interests for a longer period with the earliest implied market forecasts pointing towards late 2019 or early 2020 for the next interest rate hike.

Echoing that downgrade on inflation forecasts by the RBA, overall wage growth of 0.6% was recorded for the June quarter in line with market expectations (consensus: 0.6%). Annual wage inflation remained flat at 2.1% for the year (Mar-18: 2.1%). Private sector wages grew 2.0% while public sector wages grew 2.4% for the year slightly above the annual rate for public sector wages recorded in March which was in line with the 2016 record low of 2.3%. A different wage series, average weekly earnings, was also released which showcased continued weakness. If we contrast wage growth against the inflation print of 2.1% we see real wage growth (the difference between inflation and wage growth) of 0% for the year to June 2018.

The unemployment rate fell to 5.3% (consensus: 5.3%) in August (the latest figure reported) from 5.4% in June. In August, employment growth surprised with total employed persons rising by 44k (consensus: +18k) continuing its up-down trend in recent times shifting between growing and falling total job numbers. The bulk of this increase came in full-time jobs with 33.7k growth supported by a further 10.2k part-time roles being created. This continued the overall recovery in full-time jobs growth which had declined in the March quarter but has since recovered to be up 1.23% in the year to August though still dwarfed by part-time jobs growth of 1.78% over the same period. A key driver of the steady unemployment rate was the increase in people seeking work with the participation rate rising from 65.6% in July to 65.7% in August. If this was flat over the two months, the unemployment rate would have fallen in line with stronger jobs growth to 5.1% but instead stayed constant as more people seeking work were added to the sample. This re-entry into the workforce is a positive sign and reflects the strong demand for labour with ABS job vacancy data highlighting a continued increase in the amount of job vacancies relative to the overall workforce which should support jobs growth and eventually, as the RBA has highlighted repeatedly this year, wage growth.

The Australian economy grew strongly at 0.9% for the Jun-18 quarter (consensus: 0.7%) and 3.4% for the year ended June 2018. Key drivers of the move were domestic demand with house consumption rising 0.7% in the quarter with spending across both discretionary and non-discretionary goods and services, reflective of the improvement in retail trade we observed in the months of April to June. Net exports added 0.1% of the 0.9% growth with the positive contribution we noted was expected in the July Monthly, reflecting the growth in production output by Australian resource companies. One concern that has been called out is the continued decline of the household savings rate which made a new post-GFC low of 1% reflecting the increased consumption funded out of savings and not increased wages. The fear is that such a situation cannot persist forever without consumers taking on more debt.

Retail trade was flat in July (consensus: 0.3%) which was below expectations and led by declines in clothing and footwear (down 2%), household goods (down 1.2%) and department stores (down 1.9%). These declines were offset by gains in Food retailing (up 0.3%) and eating out (up 0.6%). Retail trade grew 0.3% in August (consensus: 0.2%) which was slightly above expectations. The growth was led by café and restaurant spending (up 0.7%) while the clothing and footwear space rose 0.8% and department stores bounced with a 0.9% rise for the month following weaker performance earlier in the year. Taken together these figures imply weaker growth in consumer spending for the September quarter that is likely to weigh on overall economic growth (reported in December). The Australian trade balance for August (exports less imports) came in at a surprise $1,604m (consensus: $1,450m) with exports the primary driver rising 0.5% on the May figure while imports rose 0.4% on July values. This together with the July surplus (revised down from $1,551m to $1,548m) points to net exports being a neutral to slight contributor to economic growth for the September quarter (reported in December).

The decline in housing markets in recent months did not draw additional attention although September marked the 12th straight month of housing price declines with national prices falling 2.7% since September last year according to CoreLogic data. Sydney has been the worst performer over the year with a decline of 6.1% followed by Darwin (-3.7%), Melbourne (-3.4%) and Perth (-2.8%). Other capitals saw gains in line with or below inflation (i.e. up 2.1% or less) with Hobart a notable exception (up 9.2%). The tightening in financing seen as part of the Royal Commission fallout has been singled out as a major contributor. Dwelling approvals for August fell 9.4% compared to July (consensus: +1%) with an 18.4% drop in unit approvals that was centred on the Sydney and Melbourne markets. This points to a potential softening in residential construction activity going forward given a weaker pipeline of future projects (it contributed 0.3% to GDP growth for the first half of 2018).

## United States

Strong domestic economy continues to justify case for interest rate hikes widening gap to Australian rates with a 0.25% rise in September. Business confidence hurt by ongoing uncertainty surrounding global trade with tariff war against China partly offset by resolution on the domestic front with both Mexico and Canada signing up to a reconfigured free-trade agreement ending months of uncertainty.

Trade talks figured prominently this quarter with a revised version of NAFTA (a trade agreement between the US, Mexico and Canada) being finalised between the US, Mexico and Canada. This ended several months of uncertainty on the future of trade relations between these close partners following the implementation of steel and aluminium tariffs by the US. In addition, strong rhetoric on China continued to translate into hard action over the quarter with the implementation of further tariffs against one another in both July and September with no clear resolution obvious at present.

As widely expected by markets, the US Federal Reserve raised interest rates by 0.25% to a range of 2-2.25% at the end of the quarter. Support amongst Committee members for another rate hike this year—expected for December—also strengthened from 8 to 12 members implying we could end the year with US rates at an upper range of 2.5%. To date, trade concerns have not knocked the US economy off course with ongoing strength still being observed in economic growth and consumer confidence helped by the Trump Administration tax reforms. This sets the stage for a further three rate hikes next year (the current Committee member forecast) to end 2019 with rates at 3.25%. Soft data in the form of business surveys points to some slowdown in growth which may weigh on rate decisions in coming quarters if this translates into weaker inflationary pressures and weaker growth.

The Markit Services PMI for September was 53.5 falling by 3 points from its June reading of 56.5. This slowing of momentum marked the weakest growth since January driven by problems with capacity constraints and a build-up in backlogs of work that sees input prices rising at a sizeable rate with cost pressures continuing to be a running theme. The impact of tariffs was cited as an explanation for greater input price inflation, as was higher wage costs, that was being partially passed on to end-consumers and partially absorbed in business profit margins. The higher wages costs were also reflected in the latest wage data that saw US hourly earnings consolidate around 2.8% year-on-year growth in August, with hiring strength observed in both construction and professional services industries.

Manufacturing conditions improved slightly with the Markit Manufacturing PMI rising from its June reading of 55.4 to 55.6, a four-month high that remains above the long-run series average. That movement belies the volatility in the series during the quarter with August marking a nine-month low point of 54.7. The main drivers of the improvement consisted of strength in both production and new orders domestically albeit partly offset by slower growth in export orders and rising input cost inflation. Manufacturer confidence on expected growth remains positive but the degree of confidence has been tempered by worries over and the impact of tariffs alongside higher input cost pricing. One potential headwind for future quarters lies in the build-up of raw material inventories as firms worry about the prospect of future tariffs and stockpile materials now. It will take time to erode these stockpiles with new production thereby lowering future growth for suppliers.

## China

Economic momentum is slowing, weighed down by negative sentiment on the trade front that has prompted additional stimulus to help businesses and consumers. Tariff measures continue to impact business confidence and have seen China lower import tariffs against other trading partners to alleviate the consumer and business impact and reduce its vulnerability to further US measures.

On the trade war side, China responded to the implementation of US tariffs in late September with its own 10% levy against US goods totalling $16bn including scrap metal imports from the US. It countered the 10% tariff on $200bn of Chinese exports with its own 10% levy on $60bn of US exports (the smaller amount reflects the lop-sided trade balance with the US importing more from China than vice-versa). The limited ability for China to match tariffs dollar for dollar may see the Chinese government rely on other means such as using regulatory power to shut off businesses operating within China. There is past history on this front with China retaliating against the South Korean installation of a missile defence system by closing Korean company Lotte's retail operations within China and encouraging consumer boycotts against Korean products. This possibility has not yet eventuated with China instead preferring to reduce its tariffs vis-à-vis other trading partners such as Europe to mitigate the damage of the US measures. There is scope for further changes on this front with China imposing an average tariff rate of 9.8% on foreign imports compared to the US rate of 3.4%.

Chinese industrial production expanded by 6.1% year-on-year in August (consensus: 6.1%) in line with market expectations while conversely, fixed-asset investment growth continued to slow 5.3% per annum (consensus: 5.6%) also below expectations. Retail sales grew faster than expected at 9% per annum (consensus: 8.8%) highlighting a mixed response to stimulus in the Chinese economy (beating on retail but disappointing on the business side) potentially setting the scene for easier policy particularly if the US continues to employ more tariffs on Chinese products.

The Markit manufacturing PMI gradually declined over the quarter from 51 in June to 50 in September. This is on the verge of contractionary territory by the manufacturing sector (a reading of below 50 signals shrinking business activity) but given the further stimulatory economic measures implemented by Chinese policymakers some recovery may arise. Services activity added to the weakness falling from 53.9 in June to 53.1 in September picking up from the three-month low in August of 51.5. The composite level data highlighted the downward economic trajectory (dropping from 53 in June to 52.1 in September) driven by trade concerns as well as more restrictive environmental policies while price inflation continued even as demand weakened, crimping corporate profit margins further.

## Europe

Trade concerns and Brexit remain prominent in business thinking on the future with both weighing on sentiment. Green shoots however can be found in stronger growth in both the UK and the EU with some investors cautiously optimistic that a Brexit deal can be reached in time.

The European Central Bank (ECB) left interest rates unchanged over the quarter in line with previous guidance that rate hikes would be deferred until at least July 2019. Market observers are looking to see if it will downgrade its economic forecasts with economic growth slowing relative to last year but still expanding 0.4% in the June quarter (consensus: 0.3%) supportive of the planned tapering of ECB bond purchases for October. This equates to annual growth of 2.1% and even with the weakness in economic activity unemployment across the European Union continues to tick lower with the unemployment rate falling over the year from 7.2% last December to 6.8% in August.

The Bank of England increased interest rates by 0.25% during the quarter but is expected to remain on hold in the near future with concerns continuing to persist of the prospect of a British exit from the European Union without a deal that addresses myriad issues including immigration and trade. In addition, the UK grew faster than expected in the June quarter with quarterly growth of 0.6% at the top of the range of market forecasts supporting the Bank of England decision to raise interest rates with the focus now on an expected 0.4% growth rate for the September quarter.

The Markit Eurozone Composite PMI declined slightly over the quarter, down to 54.1 from its reading of 54.9 in June. This was driven only slightly by services which fell from 54.9 to 54.7 with the bulk attributable to a slowdown in manufacturing activity with the manufacturing PMI sliding from 55.2 to 53.2 over the quarter. The decline in the manufacturing sector print was driven by concerns over the business outlook weighing on business sentiment with tariffs and Brexit cited as factors of concern. The slowdown amongst services was partly attributable to weaker business confidence and input cost pressures both in wages and fuel. On the positive side, jobs growth remains strong which should allow EU member states to continue to erode their still-sizeable unemployment rates which sees France and Italy still at 9.1% and 10.7% respectively. While business activity growth has slowed from its strong pace in the December 2017 quarter putting current results in context still points to solid growth of 0.5% for the September quarter according to IHS Markit economists.

## Emerging Markets

Weakness continues thanks to the rising US dollar and, trade wars and institutional problems prompting investors to flee the space. Valuation discount to developed markets continues to widen.

In the Emerging Markets (EM) space a running theme has been the vulnerability of these economies to a weakening in global demand and their general exposure to the commodities cycle. Turkey continues to be a point of weakness with its currency, the lira, falling further against the US Dollar over the quarter thanks to a mix of investors increasingly lose confidence with President Erdogan's tight control over the economy including monetary policy even with inflation in the double-digits and the imposition of US sanctions. Taken together these see the IMF increasing its inflation forecast to 20% for 2018 and 15.5% for 2019 with unemployment of 11% and 12.3% over the same periods, both negative updates to its April forecasts. Argentina remained a point of weakness hampered by the rise of the US Dollar with the country unveiling new measures to bring its budget into surplus in line with IMF targets set in exchange for emergency loans. These new measures include new exports taxes which have impacted some ASX-listed companies such as Orocobre (**ASX: ORE**) that operate there (down 18.4% over the quarter).

## Actionable insights

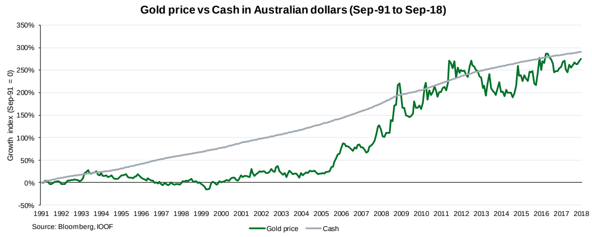
Playing defence by asset class

Gold as an asset class is notable for its popularity in moments of crisis. It compares unfavourably however in terms of both volatility and returns to traditional asset classes making it a difficult holding for investors to stomach. The risk hedge it purportedly offers is not fool-proof either with notable drawdowns present even as equity markets decline.

Given the backdrop of higher equity valuations and low bond yields, a question that naturally arises is where can investors play defence today?

Last month we covered off our options in both the equity and bond universes. This time we will look closely at another popular option, gold. First let us consider the historical returns displayed in Chart 5 below for the 27 years to September 2018.

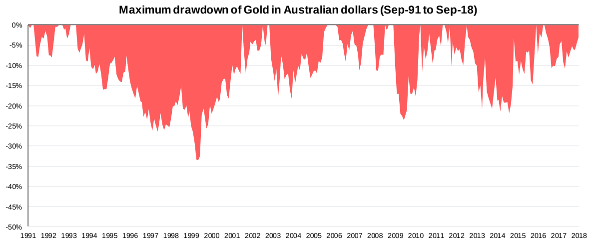
### 5. Gold price performance vs Cash




As we can see it traded in a narrow range until 2005 with the bulk of its positive performance associated with the 2006-2012 period that was marked by the global financial crisis and the European sovereign debt crisis, both events that shook investor confidence in the financial system and saw gold demand rise as an alternative to major currencies. Even allowing for this spike in performance however gold struggled against other asset classes including most notably the weakest traditional asset class, cash with underperformance over this period. If we include equities and bonds over the same time frame the underperformance would be even more stark.

Finally, if we look to Chart 6 we have a snapshot of the maximum drawdowns incurred by an AUD investor in holding gold over this period. This is a measure of the decline from the previous highest price and indicates that investors have required sizeable staying power to handle the frequency of drawdowns with prices on average down 10.4% from the previous high and volatility of 15% over this period. This is not ideal from a behavioural perspective as assets with low returns and high volatility are both difficult to hold and unlikely to deliver the real, risk-adjusted return objectives clients require (5% annual return is equivalent to a CPI +3% objective but with greater volatility than equities).

### 6. Gold maximum drawdown history (Sep-91 to Sep-18)




Source: Bloomberg, IOOF

### Volatility (VIX Index)

Equity market volatility has spiked this week following a sell-off in US markets triggered by a few factors including rising US bond yields. We are actively monitoring this situation and considering positioning the portfolios more defensively to manage risk for clients.

### 7. Volatility index (Oct-14 to Oct-18)

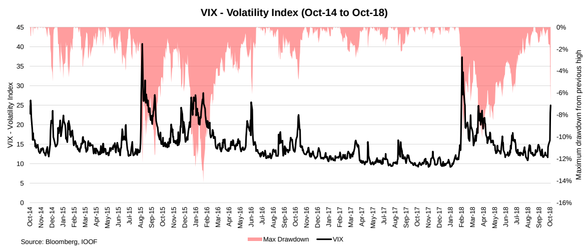



Chart 7 above looks at the VIX index, over the past 4 years. The VIX is a volatility measure that captures how much US equities move around on a given day. When the VIX (the black line) spikes upwards this typically reflect days where stocks have been sold off as you can see by the red areas in the above chart which represent the drop in the market from its previous high. Sustained moves above 20% are associated with market corrections and we have just touched on this territory recently and are monitoring accordingly.

As we can see from the amount of red on the chart it is common for the stock market to fall from previous highs (only to bounce back eventually). We are monitoring this episode of volatility closely in both the equity and model portfolios and will when appropriate take action to manage risk accordingly by using the defensive asset classes and ETFs available to us.

## Company news (best and worst performers over the month of September)

In summary, the September quarter was marked by the FY18 reporting season with the companies listed below typically outperforming (underperforming) market expectations and being rewarded (punished) as a result. Strong growing technology names such as Wisetech (**ASX: WTC**) or Afterpay (**ASX: APT**) was clear examples of the former case while Pact Group fell squarely in the latter camp. In addition to reporting season, certain company-specific factors featured prominently such as the prospect of a government review into Lynas Corporation (**ASX: LYC**) threatening its sole operations in Malaysia and seeing its share price fall.

**Afterpay Touch Group (APT)** rose strongly on the back of an earnings upgrade that saw underlying sales (retail transactions completed using Afterpay) grow 289% on FY18 with estimated FY18 Group revenue and underlying EBITDA at 142m and 33m-34m respectively. In addition, the company reported strong receipt of its offering for its US expansion, ongoing progress towards an additional warehouse receivables funding facility to facilitate further growth and expansion into other retail verticals.

**TPG Telecom (TPG)** rose strongly on the back of two factors, first, its proposed merger with mobile phone operator Vodafone which stands to create a diversified telecommunications company with sizeable market shore both in mobile and broadband. This also benefitted TPG by reducing competition for the combined entity as TPG had only just recently begun to build its position in the mobile phone market as a fourth player in this space, a merger reduces competition and the price pressure it brings by shrinking the number of market players. Second, TPG reported an updated earnings forecast ahead of previous guidance with EBITDA of $840m. This was another positive piece of information building on a month of positive news. The prospect of reduced competition saw other rivals in the mobile phone market such as Telstra rise on speculation of reduced competition. The company traded slightly lower in the month of September as investors took profits following its strong rally over August (up 63% from 16 August to 30 August).

**Mayne Pharma Group (MYX)** share price has several catalysts over the quarter that saw it rise strongly. The first was an earning-accretive acquisition of generic Efudex from Spear Pharmaceuticals at an attractive price point with supply security in place. The second was a turnaround in its results for the second half of FY18 with adjusted EBITDA up 35% on its first-half result driven by a mix of new product launches, cost savings from internalising production and a stabilising market outlook for generics within the US. In addition, one-off items that had detracted from results in the first half such as stock obsolescence normalised to industry-stand levels removing a further drag on earnings from this result.

**Vocus Group (VOC)** benefitted from the rally in TPG with its share price participating in the telecommunications sector rally over the quarter even though the merger had little practical implication for Vocus given its lack of mobile presence (i.e. it is not affected by a reduction in mobile competition because it has no offerings that will benefit. In addition, the company met its guidance for FY18 earnings with underlying EBITDA growth of 7% as well as alleviating investor concerns on its debt burden with reported net debt of $1bn better than its prior guidance.

**Speedcast International Ltd (SDA)** shares sank after it downgraded full-year guidance from an EBITDA figure of $US155m to $US135m - $US145m i.e. a fall of 6.5-13% on forecasts it had only issued in May of this year. The first-half earnings (Speedcast reports on a calendar year basis) also disappointed with a 17% drop in earnings from the energy sector as there were delays in oil projects and fewer offshore oil rigs being deployed. This pointed to a reluctance amongst business to re-activate more expensive offshore oil sites even as oil prices rose over the first half of 2018.

**Bellamy's Australia (BAL)** sank following an analyst note from Goldman Sachs in July highlighting that the company was likely to experience delays in receiving regulatory approval in China for its China-labelled infant formula products and on this basis downgrading earnings expectations. This pointed towards weaker investor sentiment with a broker downgrade from Morgans in late June and a downgrade from Citi in early August weighing on the stock.

**Lynas Corporation (LYC)** sank following speculation of a hostile government review against the company's rare earths processing operations in Malaysia. Multiple reports suggest the newly-elected coalition government has chosen politicians known to be hostile to the firm with its refinery the subject of bitter protests while under construction in 2012. The prospect of the government potentially hamstringing the approval renewal process Lynas requires to continue operating has seen its share price fall sharply on the announcement late in the quarter.

**Pact Group Holdings Ltd (PGH)** shares fell after delivering earnings below consensus estimates with profit contracting from FY17 to $94.7m, 10% below the consensus estimate of $105.6m. The result was heavily impact by rising resin and energy prices with the inflation in input costs only partially absorbed by clients in FY18 with management also guiding a $7m impact to first half FY19 results consequently. Combined the miss on FY18 earnings and the negative guidance for FY19 both sent the stock lower. The company continued to trade down post-results following the resignation of its CEO Malcolm Bundey who had been in charge for the past three years and overseen the Group's expansion into Asia.

Source: ASX company announcements, Bloomberg

## Movers and Shakers for September 2018

| ASX Code | Company Name | Closing price ($) | Month ago, close ($) | Month Δ (%) | Quarter ago close ($) | Quarter Δ ( %) | Year ago, close ($) | Year Δ (%) |
|---|---|---|---|---|---|---|---|---|
| APT | Afterpay Touch Group Ltd | 17.95 | 18.13 | -1.0 | 9.35 | 92.0 | 4.18 | 329.4 |
| TPM | TPG Telecom Ltd | 8.54 | 8.64 | -1.2 | 5.17 | 65.2 | 4.87 | 75.4 |
| MYX | Mayne Pharma Group Ltd | 1.30 | 1.19 | 9.7 | 0.87 | 49.4 | 0.66 | 97.0 |
| VOC | Vocus Group Ltd | 3.28 | 2.85 | 15.1 | 2.31 | 42.0 | 2.39 | 37.2 |
| WTC | Wisetech Global Ltd | 22.09 | 21.36 | 3.4 | 15.66 | 41.1 | 8.70 | 153.9 |
| IPH | IPH Ltd | 6.02 | 5.68 | 6.0 | 4.45 | 35.3 | 4.54 | 32.6 |
| TNE | Technology One Ltd | 5.58 | 5.53 | 0.9 | 4.25 | 31.3 | 5.02 | 11.2 |
| SOL | Washington H. Soul Pattinson | 25.96 | 23.76 | 9.3 | 20.69 | 25.5 | 15.93 | 63.0 |
| CCP | Credit Corp Group Ltd | 22.26 | 23.08 | -3.6 | 18.07 | 23.2 | 19.22 | 15.8 |
| BXB | Brambles Ltd | 10.90 | 10.97 | -0.6 | 8.88 | 22.7 | 9.00 | 21.1 |

Source: Bloomberg, IOOF

| ASX Code | Company Name | Closing price ($) | Month ago close ($) | Month Δ (%) | Quarter ago close ($) | Quarter Δ ( %) | Year ago close ($) | Year Δ (%) |
|---|---|---|---|---|---|---|---|---|
| SDA | Speedcast International Ltd | 4.01 | 4.24 | -5.4 | 6.17 | -35.0 | 3.98 | 0.8 |
| BAL | Bellamy's Australia Ltd | 10.23 | 10.96 | -6.7 | 15.54 | -34.2 | 7.53 | 35.9 |
| LYC | Lynas Corp Ltd | 1.60 | 2.19 | -27.2 | 2.34 | -31.8 | 1.95 | -18.2 |
| PGH | Pact Group Holdings Ltd | 3.72 | 4.12 | -9.7 | 5.27 | -29.4 | 5.19 | -28.4 |
| EHE | Estia Health Ltd | 2.37 | 3.05 | -22.3 | 3.29 | -28.0 | 3.17 | -25.2 |
| SBM | St Barbara Ltd | 3.49 | 3.94 | -11.4 | 4.83 | -27.7 | 2.63 | 32.7 |
| RRL | Regis Resources Ltd | 3.72 | 4.19 | -11.2 | 5.12 | -27.3 | 3.60 | 3.3 |
| WSA | Western Areas Ltd | 2.66 | 2.63 | 1.1 | 3.56 | -25.3 | 2.60 | 2.3 |
| EVN | Evolution Mining Ltd | 2.65 | 2.65 | 0.0 | 3.51 | -24.5 | 2.21 | 19.9 |
| NUF | Nufarm Ltd | 6.59 | 6.74 | -2.2 | 8.72 | -24.4 | 7.95 | -17.1 |

Source: Bloomberg, IOOF

## Long-term asset class performance to September 2018 (in AUD)

| | Asset | 1-mth | 3-mth | 6-mth | 1-yr (Annualised) | 3-yr (Annualised) | 5-yr (Annualised) | 7-yr (Annualised) | 10-yr (Annualised) | 15-yr (Annualised) | 20-yr (Annualised) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Shares | Australia | -1.3% | 1.5% | 10.1% | 14.0% | 12.1% | 8.2% | 11.3% | 7.7% | 9.3% | 9.1% |
| | World ex Australia | -0.1% | 7.4% | 13.5% | 20.7% | 12.4% | 15.2% | 17.5% | 9.6% | 7.7% | 5.0% |
| | World ex Australia (Hedged) | 0.8% | 5.6% | 9.4% | 12.9% | 14.7% | 12.6% | 16.0% | 10.9% | 10.1% | N/A |
| | Emerging Markets | -0.6% | 1.0% | -3.5% | 7.6% | 11.2% | 9.1% | 9.6% | 6.3% | 9.2% | N/A |
| Property | Australian Property | -1.8% | 1.9% | 12.1% | 13.2% | 10.0% | 12.4% | 15.2% | 6.3% | 6.3% | N/A |
| | Global Property | -3.1% | 2.4% | 11.7% | 11.8% | 5.5% | 12.5% | 14.2% | 6.4% | N/A | N/A |
| Fixed income | Australia government bonds | -0.5% | 0.5% | 1.3% | 3.8% | 2.7% | 4.3% | 4.5% | 5.4% | 5.5% | 5.6% |
| | Australia corporate bonds | -0.1% | 0.9% | 1.6% | 3.9% | 3.8% | 4.6% | 5.4% | 6.4% | 6.0% | 6.0% |
| | Australia floating rate bonds | 0.2% | 0.8% | 1.4% | 2.6% | 3.0% | 3.2% | 3.9% | 4.5% | 4.9% | N/A |
| | Global government bonds (Hedged) | -0.4% | -0.4% | -0.2% | 1.3% | 3.0% | 4.7% | 5.1% | 6.3% | 6.5% | N/A |
| | Global corporate bonds (Hedged) | -0.3% | 0.8% | 0.3% | 0.1% | 4.3% | 5.2% | 6.3% | 8.2% | 6.9% | N/A |
| | Global high yield bonds (Hedged) | 1.4% | 2.1% | 1.0% | 1.0% | 8.5% | 7.1% | 9.9% | 11.5% | 10.1% | N/A |
| | Emerging Market bonds (Hedged) | 1.8% | 2.4% | -1.8% | -2.7% | 6.5% | 6.4% | 7.4% | 9.2% | 9.3% | 11.5% |
| Cash | S&P/ASX Bank Bill Index | 0.2% | 0.5% | 1.0% | 1.9% | 1.9% | 2.2% | 2.6% | 3.2% | N/A | N/A |

**Source:** Bloomberg, IOOF

* AUD total returns as at August 2018 assuming reinvestment of dividends

** Returns reflect index performance excluding any fees; Actual ETF/managed fund performance will vary due to both fees and tracking error.

## Appendix – Index sources

| Asset class | Index |
|---|---|
| Australia | S&P/ASX 200 Accumulation Index |
| World ex Australia | MSCI World ex Australia Net Total Return Index in AUD |
| World ex Australia (Hedged) | MSCI World ex Australia Hedged AUD Net Total Return Index |
| Emerging Markets | MSCI Emerging Markets EM Net Total Return AUD Index |
| Australian Property | S&P/ASX 200 A-REIT Accumulation Index |
| Global Property | MSCI World Real Estate Net Total Return Index in AUD |
| Australia government bonds | Bloomberg AusBond Govt 0+ Yr Index |
| Australia corporate bonds | Bloomberg AusBond Credit 0+ Yr Index |
| Australia floating rate bonds | Bloomberg AusBond Credit FRN 0+ Yr Index |
| Global government bonds (Hedged) | Bloomberg Barclays Global Aggregate Treasuries Total Return Index Hedged AUD |
| Global corporate bonds (Hedged) | Bloomberg Barclays Global Aggregate Corporate Total Return Index Hedged AUD |
| Global high yield bonds (Hedged) | Bloomberg Barclays Global High Yield Total Return Index Hedged AUD |
| Emerging Market bonds (Hedged) | J.P. Morgan EMBI Global Core Hedged Index Level AUD |
| Cash | S&P/ASX Bank Bill Index |

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