Australian Quarterly Wrap

December 2018 Economic Wrap

Actionable insights

Outlook for 2019

Australia

- **Economic growth** to moderate with the drag of weaker equity and house prices contributing to a negative "wealth effect"
- **Business confidence** to also moderate on the same impulse and weaker Chinese economic growth.
- **Interest rates** to remain on hold with a rate cut possible if the labour market deteriorates. Latest business surveys point towards solid job creation so this is unlikely in near future although political uncertainty may weigh on hiring to start this year.
- **Property prices** to continue decline in line with weaker lending growth. Fundamentals had become decoupled in the boom to September 2017 with greater jobs and wage growth needed to bring property values closer to intrinsic levels.

Global

- **US economic growth** to continue to hold up but at a weaker pace as the effect of fiscal stimulus wanes.
- **US interest rates** to increase but in a more conscientious and less automatic fashion i.e. if economic data is deteriorating the Fed will pull back.
- **US black swan event** in Trump impeachment or resignation depending on the severity of the final Mueller report. We note that this inquiry has progressed throughout 2018 with more people closer to the President being implicated for involvement with Russian operatives. Impeachment and the process around it is not unprecedented, last occurring in the late 90s with President Clinton and may contribute to market volatility should it occur.
- **Europe economic momentum to slow** with key member states such as Germany potentially experiencing technical recession.
- **Brexit "no deal" risk** may emerge and contribute to market volatility but much of this has already been priced into the weakness of European equities with UK companies trading at historic discounts relative to the global peer group.

Implications

- The downside of holding **sovereign bonds and strong corporate credits** in inflation risk is capped by weak inflation levels globally. Given the more uncertain economic backdrop and geopolitical risk in Europe for example, consider adding some exposure to sovereign bonds for portfolio protection over defensive alternatives.
- Consider reducing **exposure to Australian consumer and property** given the weaker outlook for the year ahead.
- Consider introducing **growth alternative** managers to diversify equity risk exposure for clients with higher risk tolerances.

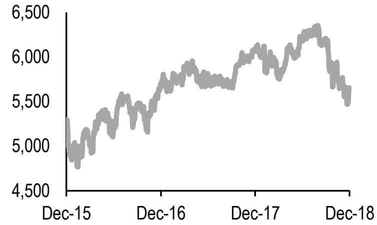
Summary - Both leading and hard economic data point to resilience in the US economy with solid growth relative to the rest of the developed world. Global economic momentum continued to slow in 2018, led by weakness in Europe with China also weaker but showing some potential stimulus gains later in the year. We will likely see slower growth in the US in 2019 as the effects of the fiscal stimulus wear off and the economy adjusts to tighter financial conditions with some signs of this in weaker housing starts (the US works off 30-year fixed mortgages so higher interest rates can have a large long-term impact). Business sentiment has been weighed down by the uncertainty surrounding 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 export surpluses continue to be recorded with November marking an eleventh straight month while the unemployment rate remains low at 5.1%. Wage inflation ticked up, backed up by the tighter labour market while housing price weakness continues on the back of more robust lending standards.

Markets - The December quarter was marked by a retreat to safe haven assets with defensive equity sectors (REITs, Utilities etc.), bonds and the US Dollar all beneficiaries of this trend. US leading economic indicators and hard data held up on balance, offering support for the Federal Reserve's ("The Fed's") decision to raise interest rates in December. However, signs of weakness in both housing and car sales figures point towards more caution for future hikes. Emerging market equities staged a bounce back over the quarter (see page 11) clawing back some relative underperformance this year (see chart 4). The ASX outperformed global markets (see chart 2) with value outperforming growth on a relative basis over the quarter (see chart 3) as the ASX benefitted from its lack of technology companies which were a key target in this quarter's selloff along with cyclical sectors such as Energy.

Key economic news – The Reserve Bank of Australia left the cash rate on hold at 1.50% as expected. December marked further contraction in house prices in Australia with a fall of 2.3% over the quarter according to the latest CoreLogic data. The weakness remained focused in Sydney and Melbourne, down 3.9% and 3.2% respectively over the month. US inflation remains contained with core PCE (The Fed's preferred target inflation rate), slightly below target (2%) at 1.9% for November.

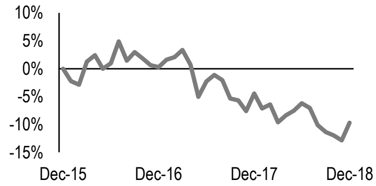
Key company news – The broader macro backdrop was a key driver for the top-performing stocks of the quarter with gold miners comprising the majority of the top ten. Stock-specific news items were notable with companies hosting their AGMs and providing trading updates during the quarter that saw G8 Education (ASX: GEM) benefit from positive news flow after seeing an uptick in usage rates for their childcare centres nationally. CYBG (ASX: CYB) shares fell after it highlighted planning for Brexit uncertainty in its FY19 outlook and disappointing margins in its recent acquisition while Emeco Holdings (ASX: EHL) struggled over the quarter as investors downgraded expectations for the earthmoving equipment provider in line with weaker commodity prices.

1. S&P/ASX 200 Price Index



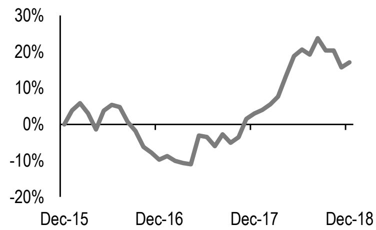
Source: Bloomberg, IOOF

2. ASX200 vs All-World, US$ terms



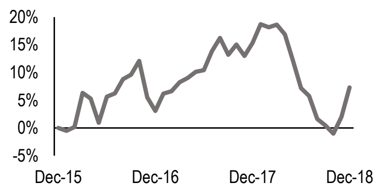
Source: Bloomberg, IOOF

3. MSCI Australia Growth relative to MSCI Australia Value



Source: Bloomberg, IOOF

4. Emerging markets vs Developed Markets, US$ terms



Sector and stock returns

ASX/S&P 200 Sectors (GICS)

	Monthly	%∆	Quarterly	%∆
▼	Consumer Discretionary	-1.88	Consumer Discretionary	-14.49
▲	Consumer Staples	1.43	Consumer Staples	-6.46
▼	Energy	-2.02	Energy	-21.34
▼	Financials ex Property	-3.10	Financials ex Property	-9.19
▼	Financials	-3.10	Financials	-9.19
▲	Health Care	2.92	Health Care	-8.15
▼	Industrials	-1.17	Industrials	-6.76
▼	IT	-3.97	IT	-14.01
▲	Materials	5.29	Materials	-5.03
▼	Property Trusts	-0.11	Property Trusts	-3.65
▼	Telecommunications	-5.05	Telecommunications	-14.75
▲	Utilities	2.03	Utilities	-4.14

Best and Worst S&P/ASX 200 Performers

Top five stocks		Bottom five stocks	
Monthly			
Graincorp Ltd-A	+25.6%	Pilbara Minerals Ltd	-25.6%
Resolute Mining Ltd	+21.6%	Orocobre Ltd	-25.2%
Saracen Mineral Hldgs Ltd	+18.6%	IOOF Holdings Ltd	-25.1%
Evolution Mining Ltd	+17.5%	Lynas Corp Ltd	-24.5%
Sigma Healthcare Ltd	+16.3%	Emeco Holdings Ltd	-21.6%
Quarterly			
Saracen Mineral Hldgs Ltd	+57.1%	Seven West Media Ltd	-45.0%
G8 Education Ltd	+41.5%	CYBG Plc - CDI	-44.0%
Evolution Mining Ltd	+39.2%	Emeco Holdings Ltd	-41.2%
St Barbara Ltd	+34.7%	Worleyparsons Ltd	-41.1%
Regis Resources Ltd	+29.8%	Bingo Industries Ltd	-40.9%

Source: Bloomberg, IOOF

Equity review

Major Market Performance, December 2018

	Australian Indices	Dec-18 Price	1M return (%)	Sep-18 Price	3M return (%)
▼	S&P/ASX 200	5646	-0.37	6208	-9.04
▼	All Ordinaries	5709	-0.69	6326	-9.74
▼	Small Ordinaries	2458	-4.50	2863	-14.15
	US Indices				
▼	S&P 500	2507	-9.18	2914	-13.97
▼	Dow Jones	23327	-8.66	26458	-11.83
▼	Nasdaq	6635	-9.48	8046	-17.54
	Asia Pacific Indices				
▼	Hang Seng	25846	-2.49	27789	-6.99
▼	Nikkei 225	20015	-10.45	24120	-17.02
	UK & Europe Indices				
▼	FTSE 100	6728	-3.61	7510	-10.41
▼	CAC40	4731	-5.46	5493	-13.89
▼	DAX Index	10559	-6.20	12247	-13.78

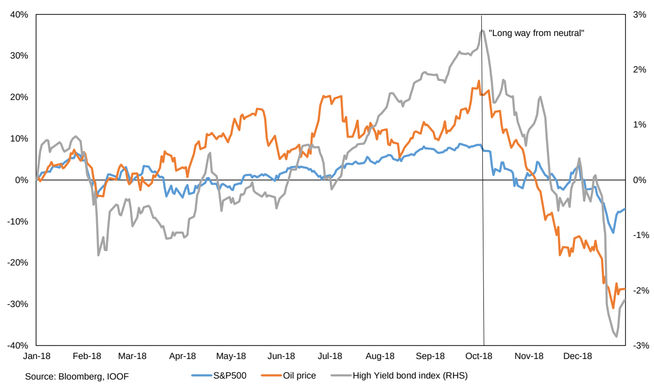
Source: Bloomberg, IOOF

US equity market

The S&P 500 index finished the quarter down 14% while the tech-heavy NASDAQ fared comparatively worse, down 17.5%. The market performance was negative across most sectors with Utilities (up 0.5%) the sole exception. One trigger for the selloff were remarks in early October by Fed Chairman Powell noting that interest rates were "a long way from neutral". This is a reference to the "neutral rate of interest", a long-term theoretical target of monetary policymakers at which inflation is stable and trend GDP growth is achieved with the implication being that more interest rate hikes would be necessary to reach this target rate.

As we discussed in our December webinar and show below in chart 5, this saw sell offs across risk assets with oil (in orange), US stocks (in blue) and high yield bond prices (in grey) all falling from their year-to-date highs.

5. "We're a long way from neutral" moment, 3 October 2018



While Chairman Powell walked back from these remarks in November—contributing to a brief recovery in that month—further selling ensued in December with a mix of yield curve inversion, a still hawkish Fed stance following Chairman Powell's press conference as they raised US rates by 0.25% and scepticism on a positive trade outcome all weighed on market sentiment.

We have also seen remarks by Chairman Powell in early January be positively received in the expectation that the Fed would not "over-tighten" interest rates. This reflects a retreat from his remarks at the poorly-received press conference in late December where the Chairman noted that quantitative tightening (the sell down of the Fed's balance sheet) was "on autopilot". Instead markets have responded positively to the prospect of a more sensitive Fed policy with high yield spreads contracting and the S&P500 up notably since the start of the year. This received further confirmation in the minutes from the Fed's December meeting which highlighted concern with the backdrop of financial market volatility and the weaker economic picture outside of the US. The disconnect between that meeting and the press conference held by the Chairman immediately after is potentially concerning as it weakens Fed credibility and, for markets, predictability that may point to further volatility from communication missteps in the future.

Australian equity market

The S&P/ASX 200 index finished the quarter down 9% with the bulk of losses coming during the October sell-off (down 7.9%) followed by further weakness in November (down 2.8%) and December (down 0.4%). All sectors fell over the quarter with Utilities (down 4.1%), materials (down 5%) and consumer staples (down 6.5%) holding up best while Energy stocks were the worst performer (down 21.3%) on the back of oil price weakness. The consumer outlook was also a point of concern during the quarter given the weakness of consumer spending in Sep-18 GDP data which was reflected in weaker trading updates by consumer discretionary stocks during the November AGM period that saw the sector fall 14.5% over the quarter.

Fixed Income

	Fixed Income	Dec-18 yield	1M mvt (bps)	Sep-18 yield	3M mvt (bps)
	Aussie Cash rate	1.50	--	1.50	--
▼	10-year Bond Rate	2.32	-0.27	2.67	-0.35
▼	3-year Bond Rate	1.85	-0.16	2.05	-0.20
▲	90 Day Bank Accepted Bills SFE-Day	2.09	0.14	1.93	0.16
▼	US 10-year Bond Rate	2.68	-0.30	3.06	-0.38
▼	US 3-year Bond Rate	2.46	-0.34	2.88	-0.43

Source: Bloomberg, IOOF

During the December quarter, the Australian yield curve flattened with long term rates declining more than short term rates. The Australian 3-year bond yield fell 20bps and the 10-year bond yield fell 35bps. The U.S. yield curve inverted at certain points of maturity (short-term bonds yielding more than long-term bonds) as bond market participants became increasingly concerned over the outlook for the US economy and sceptical on the pace of future rate hikes. This scepticism was not unfounded with the Federal Reserve walking back on its September interest rate projections to estimate 2 rate hikes for 2019 instead of the previously-forecast 3 hikes.

In Australia, bond yields were weighed down by a mix of concerns. The broader selloff in equity markets saw investors bid up safe haven assets, seeing longer-term yields fall over the quarter. In addition, the miss on consensus for Sep-18 GDP numbers in Australia weakened the forward outlook for interest rates to the extent that the market is pricing in a possible interest rate cut. This environment makes existing bonds a more attractive investment because cash is a less competitive alternative. It is another reason helping to explain the drop in bond yields.

Closing US yields continue to track in a volatile fashion with an intra-month high of 3.23% reached during October for the 10-year yield that now sits at 2.32%. Triggers for the 10-year movement include safe haven demand with the continued volatility in equities attracting investors. In addition, sentiment towards future growth appears to be tracking lower with the US yield curve flattening over the month and inverting for certain durations in December. Yield curve inversion has been a useful indicator of recessions in the past with bond markets pricing in lower growth than equity markets but one with uneven application with it indicating a recession between 12 to 24 months ahead of its occurrence depending on the particular spread being discussed. The most reliable past indicator has been the spread between the 3-month Treasury Bill and the 10-year Treasury Bond which remains positive at 29bps. Concerns over the tightness of monetary policy have been reflected in comments by Federal Reserve Chairman Jerome Powell who noted rates were much closer to neutral in a November speech, walking back from remarks that had contributed to the October sell off that rates were “far from neutral”. The logic of this last point is that the Federal Reserve targets a neutral rate of interest with its interest rate changes. If that neutral rate was much higher than current levels it implies more rate hikes are necessary which led investors to price this possibility into bond markets and contributed to rising bond yields during October (as bonds are sold their yields rise). Subsequent to the quarter-end Chairman Powell has given remarks pointing towards greater data dependency and sensitivity to financial conditions that have helped calm concerns over the Federal Reserve “over-tightening” by continuing to hike interest rates. As with the Australian case, if interest rates are not expected to rise in the near future this makes longer-term bonds more attractive and should be a force driving their prices higher (and yields lower).

Finally, we close with a comment on the 3-month bank bill rate which rose 16bps over the quarter. The bulk of this move occurred in line with broader equity market volatility in December. We have also observed a rising cost of insurance (measured by CDS spreads) for Australian bank debt over this period. If these rates remain elevated it does raise the prospect of another out-of-cycle interest rate hike by Australian banks should their funding costs remain elevated. We note that this last occurred mid-way through 2018 with regional banks who are more reliant on lending markets for funding being the first to hike before being followed by the majors between September and November. On 9 January Bank of Queensland announced hikes of 0.11%-0.18% citing rising international borrowing costs which may see other lenders follow suit if they persist.

Currencies

	Currencies	Dec-18 Price	1M return (%)	Sep-18 Price	3M return (%)
▼	$A vs $US	70.49	-3.52	72.24	-2.42
▼	$A vs GBP	55.26	-3.55	55.44	-0.32
▼	$A vs YEN	77.31	-6.83	82.13	-5.87
▼	$A vs EUR	61.47	-4.80	62.24	-1.24
▼	$A vs $NZ	104.98	-1.30	109.10	-3.78
▼	$US vs EUR	87.22	-1.28	86.17	1.22
▼	$US vs GBP	78.39	-0.05	76.76	2.12
▼	$US vs CHF	98.21	-1.58	98.17	0.04

Source: Bloomberg, IOOF

The Australian dollar (AUD) depreciated against major global currencies to USD 0.7049 on the back of “risk off” sentiment. This followed a bounce back during November on the back of a strong labour force report showing the unemployment rate had remained at 5% as well as wage inflation in line with consensus forecasts and positive trade surpluses with a surprisingly strong September result. The US Dollar (USD) traded weaker against most major currencies on the back of Chairman Powell’s comments in November before appreciating with a mix of general market volatility and a more hawkish than expected Federal Reserve statement to accompany the 0.25% in late December. This rate hike was broadly anticipated but the still hawkish approach of two additional hikes in 2019 projected by the Fed (down from three in Sep-18) also contributed to US Dollar strength over the quarter against major currencies.

Commodities

	Commodities	Dec-18 Price	1M return (%)	Sep-18 Price	3M return (%)
▼	Aluminium	1823	-6.54	2059	-11.45
▼	Copper	263	-5.61	283	-6.87
▼	Nickel	10623	-4.94	12618	-15.81
▲	Gold	1281	4.51	1202	6.61
▲	Silver	16	9.31	15	4.86
▼	Crude Oil - Brent	54	-8.36	83	-34.96
▲	Lead	2016	2.23	2037	-1.04
▼	Zinc	2483	-3.22	2607	-4.78
▼	Iron Ore	69.20	-4.26	68.73	0.68

Source: Bloomberg, IOOF

Commodity prices tracked weaker over the December quarter with precious metals and iron ore the notable exceptions. Oil prices fell on the back of delayed implementation of Iranian oil sanctions, continued strength in US production (which saw the US emerge as a net oil exporter for the first time in decades during December), fears for global growth crimping future demand and delayed implementation of proposed OPEC + Russia production cuts. Precious metals gained on broader market volatility as investors sought safe haven assets with gold still down 2.7% for the calendar year as it has struggled to compete with rising US interest rates (which make bonds more competitive with gold as they offer a risk-free asset with rising income). Iron ore prices bucked the trend of other industrial commodities gaining slightly on Chinese producer restocking ahead of a seasonal pickup in production with some steel mills that had been shut down temporarily for anti-pollution targets now being restarted.

Australia

Rates on hold with weaker than expected economic growth continuing the “lower for longer” theme. On the positive, wage growth and continued trade surpluses are supportive of growth, however, housing prices continue to fall notably in Sydney and Melbourne due to a mix of tighter financing and increased supply weighing on the forward outlook for construction activity and by connection for economic activity.

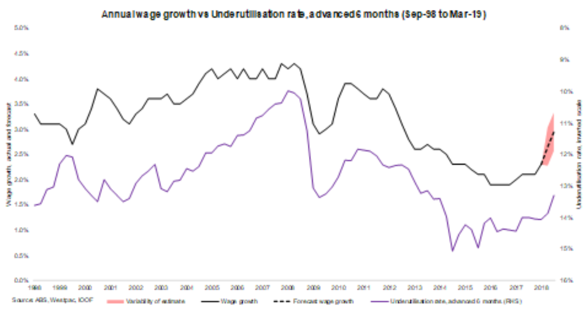
The RBA held interest rates steady at 1.5% (consensus: 1.5%) in its December meeting as expected marking over 2 years since the last change in interest rates in August 2016. Signs from the RBA statement following its December meeting point towards weakening optimism with its expression of concern over a slowdown in global trade and a focus on weaker oil prices implying weaker headline inflation in the near term. By contrast it welcomed the uptick in wage inflation but maintained its belief that any further lift will be gradual. There was also some mention of the weakness in the housing market including the slowdown in lending growth and reduced appetite for mortgage risk amongst lenders. These may see the bank weakening its stance that “the next move in rates will be higher” in coming months as the GDP growth figures released after the meeting point to a likely miss on the RBA’s growth forecast for 2018 of 3.5% growth.

The Australian economy grow 0.3% (consensus: 0.6%) during the September quarter and 2.8% for the year to September. The miss on market expectations was attributable to the weaker consumption growth of 0.3% over the quarter with weak income growth remaining an ongoing theme while the contribution of residential construction looks set to weaken on the back of declining housing approval figures which are good forward indicators for new construction activity. In addition, business investment also detracted due to the completion of major LNG gas projects with this activity no longer being reflected in the national accounts. Public spending remains a growth driver led by infrastructure projects at the state level and may help to offset some of the weakness in construction activity going forward given the pipeline of projects still due to be constructed. In addition, the continued decline in the savings rate to 2.4% in September may pose a headwind to future consumption if the uptick in wage growth discussed below does not eventuate

The unemployment rate rose slightly to 5.1% in November (consensus: 5%), up from 5% in September and October. Employment growth surprised with total employed persons rising by 37k (consensus: +20k) continuing its positive trend in recent months. The bulk of this increase came in part-time jobs with 43.4k growth offset by notable weakness with the loss of 6.4k part-time roles. This highlighted a slight slowdown in the pace of full-time jobs growth which had declined during the March quarter but has since recovered to be up 2% in the year to November while part-time jobs growth recovered strongly to 2.2% over the same period (up from 1% in the year to October). We note that, consistent with our discussion in November, the trend has reversed with part-time job creation outpacing full-time job creation while both measures are above the working age population growth of 1.6% over the same period. A key driver of the uptick in the unemployment rate was the increase in people seeking work with the participation rate rising from 65.5% in October to 65.7% in November. If this had been flat over the two months, the unemployment rate would have fallen in line with the stronger than expected jobs growth to 4.9% but instead rose to 5.1% as more people seeking work were included in the sample.

Wage data for the September quarter saw quarterly wage growth of 0.6% (consensus: 0.6%) and annual growth of 2.3% for the year to September. This is a welcome sign, particularly for the annual growth rate, that wage growth may be recovering in line with the RBA forecasts. Over the shorter term, consistent with our previous statements, the gradual decline in the unemployment rate has seen overall labour market capacity tighten further this year which should lead to some improvement in wage growth over the next half year to March 2019. In addition, job vacancies grew 1.7% in the three months to November boosting the demand for labour relative to the supply which should also contribute to wage growth pressure eventually provided broader economic activity holds up.

5. Annual wage growth vs labour market capacity



October and November were marked by further trade surpluses of 2bn (consensus: 3bn) and 1.9bn (consensus: 3bn) respectively making this almost a year of surpluses in 2018. The 2.3bn recorded in October was also revised downwards to 2bn. The surplus narrowed in November following a decline in coal exports coupled with stronger investment imports such as machinery and equipment.

United States

Domestic economy has begun to show some pockets of weakness such as weaker business investment spending and a partial government shutdown but remains solid on balance particularly when compared to other developed countries. Business confidence has been hurt by ongoing uncertainty surrounding global trade which may be alleviated by the "ceasefire" with China going forward.

The US and China reached an interim agreement during November that pushed back the Trump Administration's planned hike into March. Tariffs of 10% on $200bn of Chinese imports into the US had previously been set to increase to 25% on 1 January 2019. This deal provides a stopgap that has also seen China for example reduce tariffs on US auto imports from 40% to 15% as well as buying US agricultural goods such as soy beans which had been subjected to counter-tariffs by China. Initially observers and markets were sceptical about a final resolution to the tensions between both countries. This was due to the confusion surrounding the specifics of this agreement with inconsistent communication by both US and Chinese representatives. Subsequent developments over December and into early January have seen increased optimism on a deal being done with President Trump reportedly pushing for one according to White House Sources while high-level negotiations progress positively between US and Chinese officials.

During the quarter, as anticipated by markets, the Federal Reserve increased rates by a further 0.25% to a range of 2.25-2.5%. A key item was the updated economic projections of the Board which outlined their plans for monetary policy. Previously this had seen three rate hikes for 2019 to end the year at 3.25%. Now there has been a downwards revision to only two rate hikes this year with members flagging threats from a softening world economy while also lowering their long-term forecast of the neutral rate—a theoretical target rate to direct monetary policy to target over the cycle—to 2.75% from 3%.

US core inflation numbers for the month of November showed that the Federal Reserve's preferred measure of underlying inflation, Core PCE, grew 1.9% in the year to November. This rate had in prior months remained at the 2% mark, a level targeted by the Fed, and the dip below the 2% threshold may indicate some underlying slowdown in the pace of US economic growth. Given economic strength across other sectors—specifically the labour market with wage growth at 3.1% year-on-year and solid jobs growth—it remains possible that the Fed will "look through" these measures and feel justified in hiking interest rates at least twice this year on current projections. This remains a point of disconnect with market participants pricing an interest rate cut rather than a cumulative 0.5% hike by year-end. A disconnect is not a new phenomenon with the market underestimating the pace of Federal Reserve hikes but given the signs of weakness in terms of housing investment and an uptick in initial jobless claims (a sign of emerging unemployment) over the quarter we may see the bearish view win out. This latter perspective has gained traction following the disclosure of more dovish Fed minutes discussed earlier in this report and comments by Chairman Powell on Fed policy flexibility when it comes to further rate hikes.

During the quarter a partial Federal government shutdown began and has continued into January. This was due to President Trump making the passage of government funding conditional on funding being given to his promised wall on the Mexican border. This poses a headwind to US growth the longer that this situation persists. March-quarter GDP numbers are usually weaker due to the impact of the US winter and we may see weaker initial growth than anticipated at year-end to start the year. This is corroborated by still positive but weaker PMI numbers compared to December 2017 which implies economic growth but at a slower pace as discussed further below.

Manufacturing conditions declined with the Markit Manufacturing PMI falling from its September reading of 55.6 to 53.8 in December, a fifteen-month low. The main drivers were lower expectations for future output with respondents concerned about the sustainability of new business growth with a weaker overall rise in new orders seeing business confidence fall in December. After rising during the year, the rate of inflation fell to an 11-month low on both input prices and output charges (to end customers) pointing towards limited pressure on overall economic inflation from the manufacturing sector. Inventory destocking was taken as a sign about business caution on spending given the broader macroeconomic backdrop of uncertainty prompted by trade and political concerns discussed above.

The Markit Services PMI for December was 54.4, an improvement on its September reading of 53.5. As in the manufacturing sector concerns on the sustainability of future output growth weighed on the services industry but this was offset by improvement in current activity with solid growth in both new orders and repeat business. New order growth has slowed with the increase in interest rates weakening economic activity and greater uncertainty curbing client demand. Taken together these surveys are consistent with annualised GDP growth of 2.5% in the December quarter according to IHS Markit. While green shoots exist in the pace of current activity which has also seen strong job creation (a plus for US workers) the weaker future outlook may see lower growth eventuate. Possible scenarios to counteract this include resolution on the trade front or a further weakening of the Federal Reserve's tightening bias. On both notes we have seen some positive initial signs in trade talks during January as well as positively received remarks by Fed Chairman Powell on the flexibility of monetary policy going forward with markets taking this as a sign of weaker certainty on the proposed two rate hikes (which would aid economic activity if they did not occur).

China

Economic momentum has slowed particularly in the manufacturing sector, weighed down by negative sentiment on the trade front that has prompted additional stimulus to help businesses and consumers. This stimulus may need to be further increased to combat the broader slowdown being observed in business survey data with positive signs in fixed asset investment being offset by weakening consumer spending over the quarter.

Chinese industrial production expanded by 5.4% year-on-year in November (consensus: 5.9%) and fixed-asset investment growth rose to 5.9% per annum (consensus: 5.8%), disappointing and exceeding market expectations respectively. Retail sales weakened to their slowest pace since 2003 growing at 8.1% per annum (consensus: 8.8%). This follows the business numbers beating expectations during October. These on balance highlighted some improvement driven by the government stimulus efforts to date. The prospect of further easing with cuts to bank reserve requirements may help businesses and consumers particularly when paired with the hiatus in trade tariffs until March per the deal with the US.

Chinese export growth weakened from its annual pace of 15.6% in October to 5.4% in November (consensus: 10%). The front running of higher tariffs noted in the November monthly was highlighted as a notable driver with annual growth to all major Chinese trading partners slowing. Given PMI data pointed to export orders being in negative territory for the past nine months, we may see this effect continue to be reflected in the December data release with the impact of the trade war ceasefire with the US likely to be only reflected in January figures onwards. Even then while we acknowledge the positive news on trade negotiations to start 2019 the lack of clear resolution may continue to weigh on demand further though this will be offset in part by the four cuts to reserve ratios for Chinese banks over 2018 to help encourage lending growth.

The Markit manufacturing PMI for December fell to 49.7 from its reading of 50 in September. This move into contractionary territory (a reading of below 50 signals shrinking business activity) follows on from some incremental improvement during the quarter with the weakness occurring predominantly during December driven by weakness in new work orders which saw new export business fall for a ninth month in a row and businesses continue to cut staff at a modest pace with manufacturing employment falling. On a positive note, the outlook for the next year improved over the quarter but remains weak due to a mix of softer client demand and restrictive government policies

Services activity held up well over the quarter by contrast rising from 53.1 in September to 53.9 in December. This offset manufacturing weakness to see the overall China Composite improve from 52.1 in September to 52.2 in December. The strength in services activity was driven by the growth in overall new business including overseas clients with the latter expanding at its quickest pace for six months. Overall business confidence remains subdued with overall new orders falling (the weakness in manufacturing offsetting the growth in services exports) while employment weakened, again reflecting the difficulty of stabilising the manufacturing sector. As discussed for the United States a positive trade resolution would help the manufacturing sector but this may also require further stimulus given the signs of weaker domestic conditions as seen in weakening retail sales growth.

Europe

Trade concerns and Brexit remain prominent in business thinking on the future with both weighing on sentiment. Geopolitical turmoil within France has prompted increased fiscal spending and shocked economic activity while reforms to the automobile industry affected economic performance over the quarter.

France has been beset by so-called “Yellow Vest” protests from thousands of citizens where weak economic growth and still-elevated unemployment crystallised into a protest movement, sparked by a regressive fuel tax from the Macron government. President Macro pledged increased government spending including a higher minimum wage and the removal of the fuel tax in a bid to quell the protests. This move has seen the European Commission also reach a compromise on Italian deficit spending during late December to 2.04% of GDP (down from 2.4%), ending another issue that had driven concerns of EU breakup during the quarter. All else being equal we would expect increased deficit spending to support economic activity with both countries dealing with still elevated unemployment levels pointing towards substantial slack within the labour market. The protests have taken their toll however with the Composite PMI for France sliding into contractionary territory for the first time in over two years as the protests crippled economic activity particularly for the services sector.

Germany auto manufacturers have been caught out by new emissions standards that has seen them forced to withdraw dozens of car models from the market due to certification and retrofitting issues. The auto industry is a key part of the German economy generating 20% of total domestic industrial revenue with this disruption seeing a 1.9% monthly drop in industrial production during November as well as GDP growth in the September quarter of -0.2%. Given the extent of this disruption a ‘technical’ recession (two consecutive quarters of negative growth) remains possible. Given the broader eurozone outlook remains muted, its export-driven economy may struggle in the short-term although its strong government finances could support stimulus spending as in France and Italy should this become necessary.

The Bank of England left interest rates on hold while noting a build-up in inflationary pressures, driven in part by a weaker pound, that had accompanied recent fiscal stimulus in the UK. The prospect of Brexit and the exact form it takes remains a decisive factor to the Bank’s outlook going forward and if particularly disruptive may decide against further interest rate tightening to help stimulate the economy. The prospect of a “no deal” Brexit has strengthened in recent months. While Theresa May’s government reached a deal with the EU in November this has been dogged by opposition both within and outside her ruling coalition. This opposition saw the crucial parliamentary vote to approve the deal in mid-December delayed into 2019 when it is still expected to fail. In early January, a Parliamentary amendment was passed requiring the ruling coalition to propose an alternative option if the vote for the current deal fails within three days. This could see more radical options be considered in addition to a "no deal" scenario such as a general election or second Brexit referendum although it is unclear what will follow. In this context, the Bank of England decision may prove timely depending on how disruptive a sharp exit from existing EU trade arrangements will be for the UK. We continue to watch developments in this space and note that UK exposures to the extent that these are within underlying portfolio funds are limited to being part of a broader portfolio.

Moving to Eurozone monetary policy, the ECB ended new quantitative easing purchases in line with prior guidance during December. This will remove an additional source of buying within the European bond markets and may see yields move more in line with market forces and less of the risk mispricing we have observed since QE began there. This must be caveated however by noting that as the Fed also did, the ECB will be reinvesting proceeds from their existing bond holdings into new issues and in that sense, will still be a stabilising source of buying power in bond markets. This week saw bond yields rise on a mix of optimism on trade talk progress as well as increased pricing in of the expected US interest rate increase.

The Markit Eurozone Composite PMI continued its slide over 2018 into the December quarter falling from 54.1 in September to 51.1 in December driven by weakness in Germany and France as highlighted above. A decline in services activity, falling from 54.7 in September to 51.2 in December, added to weakness in the manufacturing industry which fell from 53.2 to 51.4 over the same period. The decline in the manufacturing sector print was led by the major economies with Germany, France, Italy and the Netherlands all marking new lows with the French and Italian manufacturing sectors entering contractionary territory during the quarter. While the PMI remained in expansionary territory for a sixty-fifth consecutive month the 51.4 reading marked its lowest level since February 2016.

The services industry saw its slowest expansion since 2016 with the weakness centred on Germany although on the positive side new business orders continued to grow albeit at the weakest rate in over two years. Input cost pressures remain evident and have led companies to partially pass these on to end customers although competition has weakened the extent of this inflation. Business confidence hit a new six-year low by the end of the quarter with concerns on global trade, geopolitics and tightening financial conditions all adding to pessimism. The contraction in new orders while modest was the greatest in over four years as the auto industry works through the challenges of compliance with new emissions standards

Overall these factors point to weaker economic growth for the quarter and going forward with the prospect of further economic disruption brought on from Brexit remaining a live possibility.

Emerging Markets

An uptick in relative performance for emerging market (EM) equities thanks in part to the weakening US dollar during November. The prospect of trade talk resolution between the US and China bolstered the broader EM market. Valuation discount to developed markets remains notable relative to historical levels and is line with historical averages on a sector-adjusted basis.

Company news (best and worst performers over the December quarter)

"Gold is good" was an overriding theme of the quarter with six of the top 10 stocks in the ASX200 being gold miners ranging from **Saracen Mineral Holdings (SAR)** in first place to **Northern Star Resources (NST)** in tenth. The remaining four were beneficiaries of takeover talks with **G8 Education Ltd (GEM)** the sole exception as discussed further below. AGM updates were characterised by a number of disappointments but in general the company-specific performance was caught up by broader market forces with the sell-off in Australian equities during October in particular dominating performance over the rest of the quarter.

G8 Education Ltd (GEM) saw its share price rise on the back of an increased take-up rate in its childcare centres discussed in its FY18 AGM with occupancy rates ahead of management expectations as it maintained its calendar-year guidance of operating income (earnings before interest and taxes) of $136-139m.

Trade Me Group (TME) shares spiked higher as it received a takeover proposal from private equity firm Apax Partners looking to acquire the company for NZD 6.40, a premium of over 15% on the prevailing market price. Subsequent to the end of November a second, competing bid from Hellman & Friedman at NZD 6.45 was also received prompting speculation of a bidding war between the two.

Graincorp (GNC) shares spiked higher as it received a non-binding indicative takeover proposal from Long-Term Asset Partners at $10.42 a share, a 42.7% premium to the previous day's closing price prior to the announcement. This offer may not proceed with the proposal still in its initial stages as LTAP conducts due diligence. This uncertainty is reflected in the market price trading at a notable 14.3% discount to the proposed offer price while the due diligence is conducted. Such a process could see a revised offer price as occurred with **MYOB** for example with the MYOB Board accepted a revised, lower bid to take over the company from KKR following a due diligence process.

Seven West Media (SWM) shares fell following a disappointing AGM update where the company flagged expectations of a flat TV advertising market and an ability to take increased market share within that dynamic. Given the backdrop of limited advertising spend both **SWM** and **NEC (Channel Nine)** saw a rerating lower over the quarter as a result with the latter also experiencing volatility following its merger with Fairfax.

CYBG (CYB) is a UK-based bank whose CDI is listed on the ASX as a result of an IPO by NAB in early 2017. As such its business is highly exposed to the UK economy with investors punishing the stock over the month for that exposure and its highlighting of efforts to shore up the bank ahead of an undetermined Brexit outcome. The fear here is that any drop off in UK economic growth will flow into weaker credit demand and possibly more bad debts on its existing loan book, crimping both growth and profitability. In addition, CYBG flagged unexpected margin deterioration in its recent acquisition Virgin Money that also weighed on investor sentiment.

Emeco (EHL) weakened on the back of lower commodity prices with the mining equipment provider seeing its share price fall as investors anticipate weaker global demand in the future.

Worleyparsons (WOR) shares fell due to two factors, first its proposed acquisition of US firm, Jacobs Engineering Group's Energy, Chemicals and Resources division and the equity dilution from a capital raising to finance this deal and second, the decline in oil prices leading to weakening earnings expectations for the firm

Source: ASX company announcements, Bloomberg

Movers and Shakers for December 2018 Quarter

ASX Code	Company Name	Closing price ($)	Month ago, close ($)	Month Δ (%)	Quarter ago close ($)	Quarter Δ (%)	Year ago, close ($)	Year Δ (%)
SAR	Saracen Mineral Holdings Ltd	2.93	2.47	18.6	1.87	57.1	1.69	73.4
GEM	G8 Education Ltd	2.83	2.80	1.1	2.00	41.5	3.39	-16.5
EVN	Evolution Mining Ltd	3.69	3.14	17.5	2.65	39.2	2.65	39.2
SBM	St Barbara Ltd	4.70	4.44	5.9	3.49	34.7	3.82	23.0
RRL	Regis Resources Ltd	4.83	4.24	13.9	3.72	29.8	4.30	12.3
TME	Trade Me Group Ltd	5.97	5.68	5.1	4.78	24.9	4.41	35.4
GNC	Graincorp Ltd-A	9.17	7.30	25.6	7.90	16.1	8.19	12.0
NVT	Navitas Ltd	5.06	4.97	1.8	4.47	13.2	5.45	-7.2
NCM	Newcrest Mining Ltd	21.80	20.75	5.1	19.41	12.3	22.82	-4.5
NST	Northern Star Resources Ltd	9.24	7.98	15.8	8.30	11.3	6.10	51.5

Source: Bloomberg, IOOF

ASX Code	Company Name	Closing price ($)	Month ago close ($)	Month Δ (%)	Quarter ago close ($)	Quarter Δ (%)	Year ago close ($)	Year Δ (%)
SWM	Seven West Media Ltd	0.55	0.68	-19.1	1.00	-45.0	0.62	-10.6
CYB	CYBG Plc - CDI	3.33	3.62	-8.0	5.95	-44.0	5.79	-42.5
EHL	Emeco Holdings Ltd	2.03	2.59	-21.6	3.45	-41.2	2.47	-17.8
WOR	Worleyparsons Ltd	11.42	13.20	-13.5	19.37	-41.1	13.61	-16.1
BIN	Bingo Industries Ltd	1.86	2.22	-16.4	3.14	-40.9	2.47	-24.9
LLC	Lendlease Group	11.63	12.66	-8.1	19.66	-40.8	16.35	-28.9
MYX	Mayne Pharma Group Ltd	0.78	0.98	-20.9	1.30	-40.4	0.70	11.5
NEC	Nine Entertainment Co Hldg	1.38	1.76	-21.4	2.26	-38.9	1.54	-10.1
SVW	Seven Group Holdings Ltd	14.18	15.92	-10.9	22.63	-37.3	15.31	-7.4
BPT	Beach Energy Ltd	1.35	1.53	-11.8	2.14	-37.1	1.25	8.0

Source: Bloomberg, IOOF

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

					Annualised						
	Asset	**1-mth**	**3-mth**	**6-mth**	**1-yr**	**3-yr**	**5-yr**	**7-yr**	**10-yr**	**15-yr**	**20-yr**
Shares	Australia	-0.1%	-8.2%	-6.8%	-2.8%	6.7%	5.6%	9.6%	9.0%	8.3%	8.2%
	Australia - mid cap	-1.7%	-13.1%	-10.0%	-7.4%	10.0%	10.9%	12.0%	10.1%	9.1%	9.3%
	Australia - small cap	-4.2%	-13.7%	-12.7%	-8.7%	7.5%	5.6%	4.8%	6.9%	5.3%	5.3%
	World ex Australia	-4.4%	-11.1%	-4.5%	1.4%	7.6%	9.8%	15.2%	9.7%	6.6%	3.6%
	World ex Australia (Hedged)	-8.3%	-13.6%	-8.8%	-7.6%	7.0%	7.4%	12.3%	12.2%	8.2%	N/A
	Emerging Markets	1.0%	-4.9%	-4.0%	-5.1%	10.5%	6.6%	8.9%	7.9%	8.4%	N/A
	Global Infrastructure (Hedged)	-3.6%	-2.1%	-1.4%	-1.5%	8.4%	8.7%	11.2%	12.7%	N/A	N/A
Property	Australian Property	1.7%	-1.9%	-0.1%	2.9%	7.2%	12.3%	14.3%	10.4%	5.6%	N/A
	Global Property	-2.7%	-1.9%	0.5%	5.3%	4.0%	11.4%	13.3%	9.8%	N/A	N/A
Fixed income	Australia government bonds	1.7%	2.5%	3.0%	4.8%	3.6%	4.7%	4.5%	5.0%	5.7%	5.6%
	Australia corporate bonds	0.9%	1.5%	2.3%	3.9%	4.3%	4.8%	5.4%	6.0%	6.1%	6.0%
	Australia floating rate bonds	0.1%	0.4%	1.2%	2.3%	2.9%	3.1%	3.8%	4.6%	4.8%	5.0%
	Global government bonds (Hedged)	1.6%	2.3%	1.8%	2.7%	3.6%	5.0%	5.2%	5.9%	6.6%	N/A
	Global corporate bonds (Hedged)	1.2%	0.0%	0.8%	-1.2%	4.1%	4.9%	5.9%	8.1%	6.8%	N/A
	Global high yield bonds (Hedged)	-0.9%	-3.2%	-1.2%	-3.0%	7.3%	5.6%	8.4%	13.8%	9.4%	N/A
	Emerging Market bonds (Hedged)	1.4%	-1.7%	0.6%	-5.5%	5.2%	5.6%	6.3%	10.0%	8.8%	10.8%
Cash	S&P/ASX Bank Bill Index	0.2%	0.5%	1.0%	1.9%	1.9%	2.2%	2.5%	3.1%	N/A	N/A

Source: Bloomberg, IOOF

* AUD total returns as at Dec-18 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
Australia - mid cap	ASX Accumulation Midcap 50 Index
Australia - small cap	ASX Accumulation Small Cap Ordinaries 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
Global infrastructure (Hedged)	FTSE Global Core Infrastructure 50/50 100% Hedged to AUD Net Tax 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

Research Analyst – Cameron Curko

Approved By – Matt Olsen

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