

## Consumers Check Out



### Introduction

In the aftermath of the Federal Budget market chatter lamented the lack of demand within the Australian economy, and the increasingly cautious consumer.

Household consumption represents the lion share of the Australian economy at around 60%, and therefore a major driver of economic growth. Household, or disposable, incomes are being squeezed by record low wages growth and persistent levels of underemployment. Hence, retail sales posted the first back to back quarterly decline since mid-2011.

The retail sector has been flashing warning signals for some months now, with over a dozen retailers filing for voluntary administration over the last year. Low levels of consumer price inflation and intense competition have largely prevented retailers from passing on higher prices, thereby resulting in razor thin profit margins.

Previously, sharply rising house price growth (notably Sydney and Melbourne) generated consumption growth from the positive wealth effect. Now, however, negative home prices (-1.1%) in May (according to CoreLogic data) are weighing on household confidence and spending.

**The 'Wealth Effect'** – Rising home prices in Australia have been a significant driver of economic activity and household wealth. Typically, rising markets support confidence and spending amongst households, and hiring and investment in businesses. Australia's housing market is slowing under the weight of higher interest rates and restrictions to credit. Also a looming unit supply glut threatens to weigh on home prices, and thereby become a negative driver for wealth, confidence and prompt saving in preference to spending.

Household budgets are being squeezed from both ends, as a result of the following factors:

1. Record levels of household debt;
2. Low wages growth;
3. Rising part-time work and underemployment;
4. Higher finance costs;
5. Rising utility costs (i.e. gas and electricity);
6. Higher petrol prices;
7. Rising health insurance premiums.

### Interest Rates

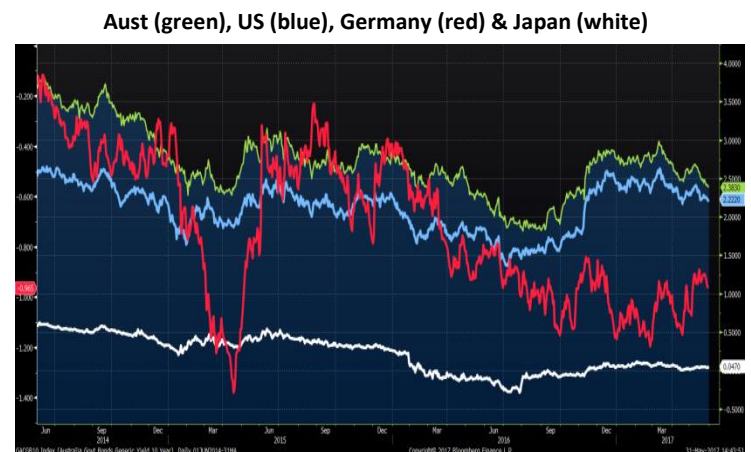
The maligned Trump *trade* came into question again during May, such that the turn of phrase became the Trump *fade*. As a consequence, bond yields fell sharply in several key countries.

Central bank activity picked up a little, with ten rate adjustments, but they were mostly limited to the less developed economies (there were four rate hikes and six rate cuts).

The RBA left the cash rate unchanged for an eighth consecutive meeting, and the minutes revealed the RBA was buoyed by firmer global growth and inflation.

Aussie ten-year bond yields rose in the early part of the month to a high of 2.68% before falling sharply to below 2.40% for the first time since Trump's election. The spread to equivalent US bonds came in for closer scrutiny as margins contracted to 16bps for a sixteen year low.

The Aussie three year bond yield also fell sharply in May to 1.63% from 1.80% for the previous month. The spread between the three year bond and the RBA cash rate contracted to 13bps, suggesting the chances for a rate hike are highly remote.



Australia's bond rally outpaces peers (Bloomberg)

Chinese bond markets continued to defy global trends with a further rise in bond yields in May. The ten-year bond climbed 17bps to 3.62%. China's thinly traded five-year bond was even more dramatic with a 26bps climb to 3.60%.

# Monthly Market Update

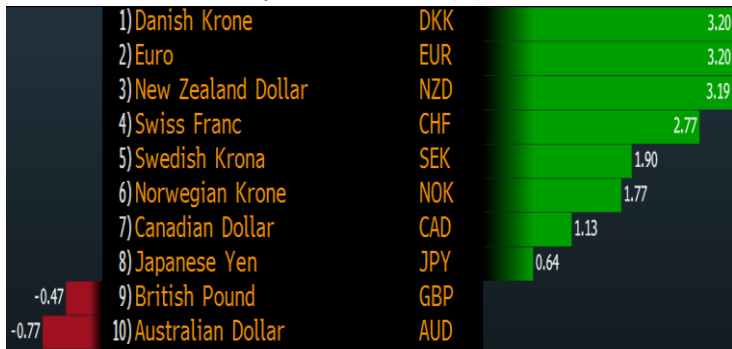
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### Currencies

The US dollar index (Bloomberg dollar spot) declined for a third straight month in May to its lowest level since Trump's election. As a result of the US dollar weakness, the majority of the top ten currencies registered monthly gains for May.

The Eurozone group of currencies performed strongest, with the Danish krone and the Euro dollar just pipping the New Zealand dollar.

Spot Returns v USD (%)



With the exception of the Kiwi dollar and the British pound, the quarterly currency movements look very similar to the monthly movements (per the above table).

The big winner over the month and the quarter were the euro dollar and the Danish krone. The British pound performed strongly over the last quarter, but less so over the month due to rising uncertainty around the upcoming election. The European economy has stabilised and stronger economic growth raised the possibility of the ECB easing back on QE sooner rather than later.

The big mover and shaker over the month was the skyrocketing price of Bitcoin. Bitcoin's price blew past US\$1500, US\$2000 and US\$2500 in a single month. Parabolic rises such as this do not occur without a healthy dose of speculation, and Chinese investors were rumoured to be bypassing Chinese stocks and commodities in favour of Bitcoin.



Source: Zerohedge

Late in the month, Chinese authorities announced changes to the yuan reference rate (i.e. measures to smooth out changes in the daily fixing of the yuan against the US dollar). The inclusion of a 'counter-cyclical adjustment' should reduce the yuan's daily volatility, but also represents a further step back from openness and a free-floating currency. The move was received poorly by currency speculators as it adds an additional layer of uncertainty, and hence extra risk.

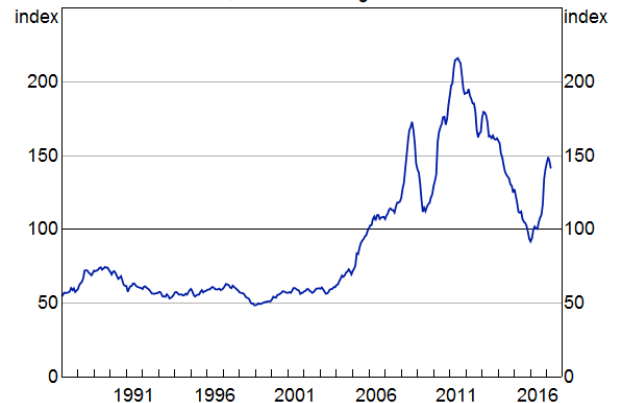
### Commodities

It was another poor month for commodity markets, with only the livestock (+5.5%) and precious metals (+0.5%) managing to register gains in the Bloomberg Commodity Index. The energy (-3.3%) and agricultural (-2.2%) sectors fared the worst in May.

Brent Crude fell 2.75% in May, even though OPEC members agreed to cap production levels for a further nine months. It seems oil producers are facing dramatic shifts from both the supply side and the demand side. Shale oil in the US and Canada and the deepwater oil producers are operating far more efficiently, and can sustain lower prices. Lower demand is a result of companies switching to cleaner energy sources as they reduce carbon emissions (think airlines). Further competition is coming from alternate fuels such as bio-fuels, and the switch to electric cars.

RBA Index of Commodity Prices

SDR, 2015/16 average = 100



Source: RBA

The all-important bulk commodity prices fell sharply in May, such that the Federal Budget's optimistic assumptions took on a positively rose-coloured complexion. Iron ore prices plummeted 28% from the beginning of this year to below US\$58 per tonne. Noting, the budget forecasts suggest US\$66 per tonne for the September and December quarters of 2017.

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Both thermal and metallurgical coal prices continued their price declines. Coking coal prices (compiled by The Steel Index Ltd) collapsed a near US\$100 during the month monthly decline to trade below US\$150 per tonne.

### Equities

Stocks bucked the downward trends witnessed in commodities, currencies and bond yields to reach new record highs in several key markets around the globe. The benchmark, MSCI World Index, climbed 2.2% (including dividends) to touch a fresh record high. Emerging markets (3.0%) outperformed their developed market (1.8%) peers during the month.

The three main stock exchanges in the US each gained ground, as the S&P500 and the NASDAQ made several record highs throughout the course of the month. It wasn't all plain sailing though, as small cap stocks registered a 2.1% decline. Information Technology (+4.4%), Utilities (+4.2%) and Consumer Staples (+2.9%) topped the list of gainers. Unsurprisingly, a third consecutive monthly decline in the price of crude oil dragged the Energy sector down 3.4%.

Asia's stock markets were standout performers in May, with notable returns in South Korea, India, Hong Kong and Japan. South Korea's Kospi pushed further into record territory with a 6.2% gain on the back of their presidential elections.

The ASX200 stood out like a sore thumb with a negative monthly return of -2.8% (inclusive of dividends) and -3.4% in raw price terms. Each of the three largest sectors within the ASX200 declined, being financials, materials and real estate.

#### ASX200 Returns by sector (incl. dividends)

| S&P/ASX ACCUM. 200 INDEX     | -2.75% |
|------------------------------|--------|
| All Groups                   |        |
| 11) S&P/ASX 200 INDUSTR INDX | 4.71%  |
| 12) S&P/ASX 200 TELECOM INDX | 3.38%  |
| 13) S&P/ASX 200 ENERGYINDEX  | 2.02%  |
| 14) S&P/ASX 200 UTILITIES IX | 1.01%  |
| 15) S&P/ASX 200 CONS DISC IX | 0.14%  |
| 16) S&P/ASX 200 MATERIALS IX | -0.17% |
| 17) S&P/ASX 200 CONS STAP IX | -0.48% |
| 18) S&P/ASX 200 INF TECH IDX | -0.70% |
| 19) S&P/ASX 200 Real Estate  | -0.82% |
| 20) S&P/ASX 200 HEALTHINDEX  | -2.05% |
| 21) S&P/ASX 200 FINANCINDEX  | -7.16% |

The ASX200 underperformed in May (Bloomberg)

Financials are by far the largest sector at 37% of the index, and bank stocks slumped 11.5% after the Federal Budget's 'bank tax' took markets by surprise. In addition, the flatter yield curves, namely in the US, weighed heavily upon financial stocks globally.

### Outlook

The sell in May and go away maxim proved successful for commodity and commodity currency markets, but unsuccessful for equity and bond markets. This was likely a function of the fact that markets offered a long list of good news and an equally long list of bad news for investors to digest.

The European and Japanese economies stabilised further in May, whilst China looked to slow from a self-imposed clamp down in speculative credit. The US economy remained on track with improvements in their labour markets, but wage growth continued to disappoint (in a similar vein to here in Australia).

The Australian economy displayed positive sentiment and profitability within the business sector, but households and consumption spending underwhelmed.

The Federal Budget was initially viewed as neutral for the economy, but upon closer inspection middle-income households are set to bear the burden of budget repair which may further dampen confidence and spending (due to tax hikes and bracket creep).

The budget's infrastructure spending program encouraged markets, but further evidence of a slow down in the larger housing market may ultimately impose a slowdown in broader economic activity.

The brighter global economic outlook will help to sustain positive sentiment within the financial markets. However, markets tentatively await developments from the central banks with respect to the unwinding of approximately US\$4.5 trillion in quantitative easing (bond buying) programs.

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| Interest Rates        | 31-May-17 | 30-Apr-17 | %      | 31-May-16 | %      | 31-May-14 | %      |
|-----------------------|-----------|-----------|--------|-----------|--------|-----------|--------|
| Cash Rate             | 1.50      | 1.50      | 0.0%   | 1.75      | -14.3% | 2.50      | -40.0% |
| Rate Change (%)       | -5%       | -0.02     | 150.0% | -9%       | -44.4% | -4%       | 25.0%  |
| 90 Day Bills          | 1.74      | 1.75      | -0.6%  | 1.99      | -12.7% | 2.71      | -35.9% |
| 3 Year Swap           | 1.84      | 1.99      | -7.8%  | 1.87      | -1.9%  | 2.95      | -37.7% |
| 5 Year Swap           | 2.20      | 2.44      | -9.6%  | 2.14      | 3.0%   | 3.36      | -34.4% |
| 3 Year Govt           | 1.63      | 1.80      | -9.2%  | 1.64      | -0.4%  | 2.74      | -40.4% |
| 10 Year Govt          | 2.39      | 2.58      | -7.2%  | 2.30      | 3.8%   | 3.66      | -34.6% |
| US 2 Year Bond        | 1.28      | 1.26      | 1.6%   | 0.88      | 46.2%  | 0.37      | 243.6% |
| US 10 Year Bond       | 2.20      | 2.28      | -3.4%  | 1.85      | 19.3%  | 2.48      | -11.0% |
| Commodities           | 31-May-17 | 30-Apr-17 | %      | 31-May-16 | %      | 31-May-14 | %      |
| RBA Commodities Index | 133       | 133       | 0.0%   | 101       | 31.3%  | 124       | 6.7%   |
| Beef (MLA - EYCI)     | 6.50      | 6.59      | -1.4%  | 5.77      | 12.7%  | 3.32      | 95.8%  |
| Sugar                 | 14.9      | 16.0      | -7.3%  | 17.5      | -15.0% | 17.4      | -14.4% |
| Cotton                | 77        | 80        | -4.1%  | 64        | 20.4%  | 86        | -10.8% |
| Wheat                 | 430       | 425       | 1.2%   | 447       | -3.9%  | 723       | -40.5% |
| NSW Wheat             | 240       | 228       | 5.2%   | 275       | -12.8% | 335       | -28.3% |
| Iron Ore              | 57        | 69        | -17.1% | 50        | 13.7%  | 91        | -37.6% |
| Coal (Newcastle)      | 73.5      | 83.6      | -12.1% | 54        | 37.3%  | 74        | -0.6%  |
| Natural Gas (US)      | 3.1       | 3.4       | -8.4%  | 2.9       | 4.2%   | 4.3       | -28.7% |
| Gold                  | 1,269     | 1,268     | 0.0%   | 1,215     | 4.4%   | 1,250     | 1.5%   |
| Brent Oil             | 50.3      | 51.7      | -2.7%  | 49.7      | 1.2%   | 109.4     | -54.0% |
| Copper                | 258       | 260       | -0.5%  | 210       | 23.3%  | 312       | -17.3% |
| Nickel                | 8,931     | 9,406     | -5.0%  | 8,399     | 6.3%   | 19,212    | -53.5% |
| Currencies            | 31-May-17 | 30-Apr-17 | %      | 31-May-16 | %      | 31-May-14 | %      |
| TWI                   | 63.8      | 64.5      | -1.1%  | 61.7      | 3.4%   | 71.5      | -10.8% |
| AUD/USD               | 0.7429    | 0.7488    | -0.8%  | 0.7234    | 2.7%   | 0.931     | -20.2% |
| AUD/NZD               | 1.0477    | 1.0905    | -3.9%  | 1.0694    | -2.0%  | 1.0954    | -4.4%  |
| AUD/EUR               | 0.6606    | 0.6873    | -3.9%  | 0.6499    | 1.6%   | 0.6829    | -3.3%  |
| AUD/GBP               | 0.5762    | 0.5783    | -0.4%  | 0.4995    | 15.3%  | 0.55577   | 3.7%   |
| AUD/JPY               | 82.29     | 83.52     | -1.5%  | 80.09     | 2.7%   | 94.75     | -13.2% |
| EUR/USD               | 1.12      | 1.09      | 3.2%   | 1.11      | 1.0%   | 1.36      | -17.5% |
| Equities              | 31-May-17 | 30-Apr-17 | %      | 31-May-16 | %      | 31-May-14 | %      |
| MSCI World Index      | 1,912     | 1,878     | 1.8%   | 1,675     | 14.2%  | 1,715     | 11.5%  |
| S&P 500               | 2,412     | 2,384     | 1.2%   | 2,097     | 15.0%  | 1,924     | 25.4%  |
| VIX                   | 10        | 11        | -3.8%  | 14        | -26.6% | 11        | -8.7%  |
| STOXX600              | 390       | 387       | 0.7%   | 347       | 12.2%  | 344       | 13.3%  |
| FTSE100               | 7,520     | 7,204     | 4.4%   | 6,231     | 20.7%  | 6,845     | 9.9%   |
| Asia APEX50           | 1,133     | 1,079     | 5.0%   | 849       | 33.5%  | 954       | 18.8%  |
| Shanghai              | 3,117     | 3,155     | -1.2%  | 2,917     | 6.9%   | 2,039     | 52.9%  |
| ASX200                | 5,725     | 5,924     | -3.4%  | 5,379     | 6.4%   | 5,493     | 4.2%   |

*"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."*

*~ Warren Buffett*

*"Whoever said money can't buy happiness simply didn't know where to go shopping."*

*~ Bo Derek*

*"People are always going to go shopping. A lot of our effort is just: How do we make the retail experience a great one?"*

*~ Philip Green*