# Market Highlights – December 2014

## Drop in oil prices continues to dominate market news

In December markets continued to be dominated by the ongoing sharp decline in oil prices. Dated Brent crude oil prices fell by 18% in the month, with prices plunging by almost 50% since the end of June.

The fall in oil prices reflects the combination of weaker demand due to the continued lacklustre recovery in global activity and increased supply, including shale oil from the US. The lack of production cuts by the Organisation for Petroleum Exporting Countries (OPEC), which accounts for around a third of global oil production, has also contributed to the drop in prices.

## Falling oil prices supported fixed income

Plunging oil prices helped drive further gains from fixed income in December. As in November, the fall in oil prices helped drive a decline in government bond yields (prices rose) as it solidified the prospect that inflation and with it, central bank cash rates, would remain low for a long time. This encouraged a return of the search for yield, though this was more focused in relatively higher quality assets than was the case earlier in the year.

The Australian fixed income market performed particularly strongly, returning 1.7%, as falling commodity prices saw markets increase expectations for rate cuts by the Reserve Bank of Australia (RBA) in 2015. Combined with a return of the search for yield, this saw both 3-year and 10-year bond yields drop by more than 25 basis points (bps), with 3-year yields falling to 2.19%, more than 30bps below the current cash rate.

The international fixed interest market returned 0.8% in December. This return was aided by a strong broad-based decline in euro zone bond yields as markets viewed it as being increasingly likely that the European Central Bank (ECB) would soon announce it will purchase euro zone government bonds. By contrast, US 10-year yields were broadly flat as the latest meeting of the US Federal Reserve (Fed) was seen as leaving the way open for the start of rate rises some time in 2015.

## Oil prices weighed on growth assets

In contrast to November, the drop in oil prices weighed on many growth asset markets in December. This reflected concerns that the fall in prices was symptomatic of weaker global growth.

There were also some concerns that the abrupt decline in oil prices may lead to defaults in the energy sector which could create a systemic shock in financial markets.

The high yield debt sector was especially hard hit given that the energy sector comprises 15-20% of total issuance in the US. Despite dropping late in the month, spreads for the high yield energy sector over government bond rates widened by 139bps in December to 727bps, roughly double their mid-year level, as market implied default rates for the sector jumped to as high as 40%. This saw the high yield sector post a negative return of 2.1% in the month on a hedged Australian dollar (AUD) basis.

Emerging market shares also performed poorly, posting a negative return of almost 5% in US dollars (USD) in the month. Russian shares dropped sharply as the combination of Western sanctions and the sharp decline in energy prices saw a significant outflow of capital from this economy. The resulting plunge in the Ruble exchange rate prompted the Russian central bank to raise rates by 650bps to 17.0% just days after raising rates by 100bps in an effort to stabilise the currency. Brazilian shares also fell sharply given the drop in commodity prices.

Developed market shares posted a negative return of 0.7% on a hedged AUD basis. The fall in share markets was most noticeable in Europe, where markets declined on average by more than 2% on a local currency basis, partially reflecting concerns about the Russian economy. By contrast, US and Japanese share markets held up relatively well as their economies are seen to benefit the most from falling oil prices. Meanwhile, the New Zealand market performed positively, posting a return of 2.6%, as investors were attracted to its relatively higher yield and more defensive characteristics.

The Australian share market also performed well in the month, posting a total return of 2.0% following the weakness recorded in November. This was despite weaker commodity prices continuing to weigh on the resources sector which fell 2.6% in the month. Investors were attracted by the higher yield of the market, especially of the financial sector and property trusts, while the broader market was also supported by rising expectations for rate cuts by the Reserve Bank of Australia (RBA).

The drop in oil prices and continued strength in the US economy relative to the rest of the developed world saw a further strengthening in the USD, with the USD index rising 2.2% in December. The AUD fell almost 4% to finish the month at US81.8c as weaker commodity prices and increased expectations for rate cuts by the RBA saw the AUD decline against most other major

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currencies. The weakness in the AUD helped support returns for unhedged global shares. On an unhedged basis, global shares rose 2.6% in December with global small company shares posting a rise of nearly 5% after weakness earlier in the year.

## Major asset class performance as at 31 December 2014 (%)

| Sector | Index | 1 month | 3 months | 12 months |
|---|---|---|---|---|
| Australian Shares | S&P / ASX300 Accumulation | 2.0 | 2.9 | 5.3 |
| Global Shares (hedged) | MSCI World ex Australia (hedged) | -0.7 | 4.0 | 12.6 |
| Global Shares (unhedged) | MSCI World ex Australia (unhedged) | 2.6 | 8.2 | 15.0 |
| Global Emerging Markets (unhedged) | MSCI Emerging Free Net in AUD (unhedged) | -0.5 | 2.1 | 6.9 |
| Global Small Companies (unhedged) | MSCI World Small Cap ex Australia | 4.9 | 10.1 | 11.7 |
| Global Low Volatility Shares (unhedged) | MSCI World minimum volatility index ex Australia (unhedged) | 3.2 | 8.3 | 17.3 |
| Global Listed Property | UBS Global Investors ex Australia (hedged) | 1.5 | 12.7 | 28.4 |
| Cash | UBS Bank Bill | 0.2 | 0.7 | 2.7 |
| Australian Fixed Interest | UBSA Composite Bond All Maturities | 1.7 | 4.0 | 9.8 |
| Australian Inflation Linked Bonds | UBS Government Inflation Index: All Maturities | 2.0 | 5.6 | 14.2 |
| International Fixed Interest | Barclays Global Aggregate Bond Index (hedged) | 0.8 | 2.9 | 10.4 |

Source: JP Morgan & ANZ Global Wealth

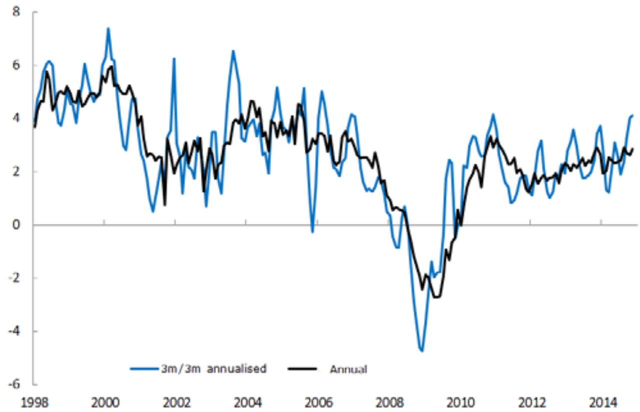
# Economic highlights by region

## US

Economic data released in the US in December continued to point to a robust expansion in the overall economy. This was despite some weakening in business surveys related to the impact of falling oil prices on the energy sector. Growth in the September quarter was revised up to a strong 5.0% annualised rate, led by an upward revision to consumer spending. Meanwhile, falling oil prices and faster income growth from the strengthening labour market has supported a further pickup in the pace of consumer spending growth in the December quarter, with real spending rising strongly in November. Falling mortgage rates also appear to be supporting the housing sector, with price growth re-accelerating following a lull in the middle of the year.

Given this backdrop the Fed continued to pave the way for the start of rate rises in 2015, with changes to its forward guidance pointing to potential rate rises by the middle of the year. Importantly, the Fed sees the impact of falling oil prices on inflation as being temporary given the strengthening labour market. At the same time, the Fed left its forecasts for the future path of rates unchanged, with the median forecast being for the Fed funds rate to rise to 1.00-1.25% by the end of 2015.

**US - Real Consumption growth (%)**



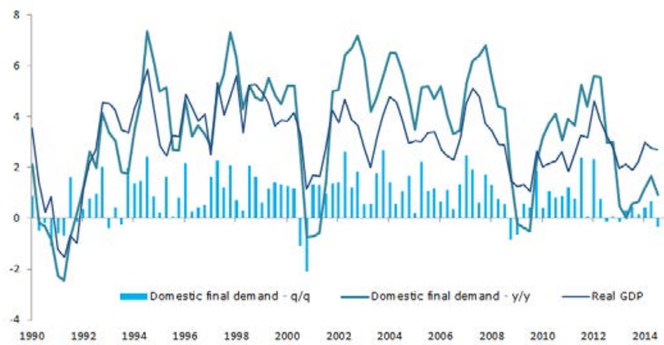

**Source: Thomson Reuters, ANZ Global Wealth**

## Australia

The Australian economy grew at a clearly below trend pace in the September quarter, with the overall economy expanding by 0.3% despite a strong rise in export volumes. Growth was held back by the sharp fall in commodity prices which constrained growth in nominal incomes and with it private demand; on a nominal basis the economy contracted in the quarter as did domestic demand. This was the mirror image of the prior decade where rising commodity prices boosted domestic spending. While the transition towards non-mining growth still appears to be occurring slowly, a 6% fall in consumer confidence and a drop in business confidence increased uncertainty as to whether this transition would continue.

Against this backdrop, the RBA left rates on hold and continued to note that a period of stability in rates remains likely. At the same time in the face of the sharp fall in commodity prices, the RBA Governor noted a lower exchange rate of around US75c would be desirable to aid the economy's transition

**Australia – Real GDP growth & domestic final demand growth (%)**

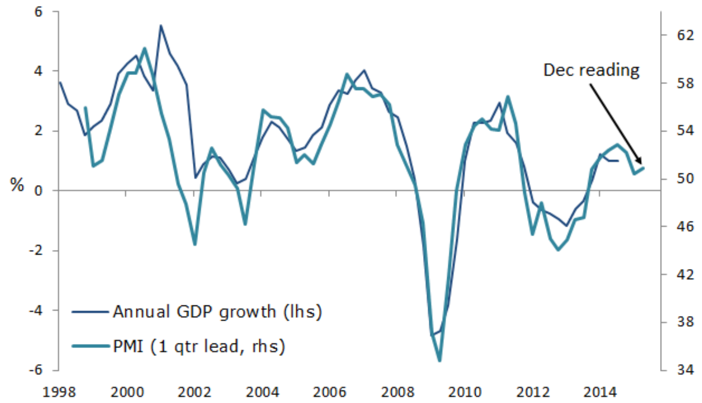



**Source: ABS, ANZ Global Wealth**

# Europe

Data momentum improved in the euro zone in December. Importantly, after falling since June, there were modest signs of improvement in key business surveys with the purchasing manager's index (PMI) rising modestly in December, led by a pickup in new orders. Other surveys also improved, with the German IFO index rising, led by the expectations index which has moved back to an expansionary level. While the signs of improvement are encouraging, at best these surveys are currently only consistent with modest growth in the regional economy. At the same time, increased expectations that the ECB would soon announce a program to buy euro zone government bonds saw investor confidence improve sharply.

**Euro zone – GDP growth & PMI**




**Source: Thomson Reuters & ANZ Global Wealth**

# Asia

Economic data in Japan continued to highlight the problems with Abenomics as it is currently being implemented. The rise in inflation generated by the sharp fall in the yen and the rise in the value added tax rate has only served to constrain real personal disposable income growth. This in turn continues to constrain consumption spending which was a key factor behind the renewed recession recorded in Japan in the September quarter. The extent of that recession was deeper than originally reported, with aggregate activity revised lower in the September quarter. Meanwhile, industrial production surprisingly contracted in November as a range of business surveys continued to point to lacklustre activity.

In China, economic activity indicators continued to slow at the end of 2014 as the transition of the economy away from investment towards consumption continued. To some extent, the weakness in industrial production was overstated by a shutdown of factories in Beijing ahead of the APEC leaders' summit held in November. Nonetheless in December the official manufacturing PMI fell to an 18 month low. Chinese share markets shrugged off this weakness given signs that policymakers are not only able but willing to support activity via increased stimulus should this be required.