# Weekly market & economic update

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WEEK ENDING FRIDAY, 29 JULY 2011

## Headline developments of the past week

- **The US has been the centre of attention over the last week as its failure to resolve its debt ceiling impasse has generated increasing investor nervousness**. There are two issues at stake. The first is to agree an increase in its debt ceiling by August 2nd, much beyond which the US will have to cut government spending by around 40% in order to bring spending into line with revenue. This could involve a default on interest payments but with the US Treasury likely to prioritise interest payments its more likely to involve a big cut in spending on things like welfare and public servants pay, which could potentially throw the US economy back into recession with a flow on right around the world. The second is to agree to budget savings that will put the US public finances on to a more sustainable path such that Standard and Poors doesn't downgrade America's AAA sovereign credit rating to AA. At present there are roughly two competing proposals but both fall short of the $US4 trillion in savings over ten years necessary to stabilise public debt and there is much wrangling over the mix of tax increases and spending cuts and the size of the debt limit increase.
- **While the risk has increased significantly, the most likely outcome is still that a deal is reached just in time to avoid a default and/or big forced cuts to spending**, hence avoiding the Armageddon scenario many fear. However, its likely that any deal won't entail budget savings anywhere near the $4 trillion needed to avoid a credit rating downgrade by S&P. A ratings downgrade would probably have a bigger impact on share markets and the $US than on US bond yields. The impact on US borrowing costs is likely to be limited as AA is still regarded as investment grade, the uncertainty involved would likely see continued safe haven buying of bonds and if bond yields do back up too much its likely the Fed will start buying them again (via QE3) for fear that higher bond yields will slow the economy. Despite all the talk of a default or downgrading in the US, US bond yields have been little changed over the last two weeks at 2.9 to 3%. Note also that Japan's sovereign rating is AA and its 10 year bond yields are just 1.1% and other countries that have been downgraded from AAA to AA in the past have only seen very limited upwards pressure on their bond yields.. A US downgrade may however, further spur demand for Australia's AAA rated Government bonds, pushing down their yields, with the capital inflows adding to the upwards pressure on the Australian dollar.
- **The Australian dollar rose to its highest level since early 1982** on the back of its perceived safe haven status in view of debt worries in the US and Europe and as stronger than expected inflation in the June quarter increased the chance of a rate hike. The $A looks like it's on its way to around $US1.20-$US1.30.
- **A worse than expected increase in inflation in the June quarter in Australia and somewhat positive comments from RBA Governor Glenn Stevens regarding the outlook for consumer spending, have boosted expectations for an increase in the cash rate**. However, with uncertainties in the US and Europe looming large, much of the rise in inflation due to bananas and petrol, Australian households remaining very cautious, house prices still sliding and the $A remaining very strong, an interest rate hike any time soon would be very dangerous and would risk tipping consumer spending and the housing market right over the edge.

## Major global economic releases and implications

- **US economic data was mixed to soft**. Consumer confidence and pending home sales both rose, unemployment claims fell and house prices were virtually flat in May. But against this new home sales were weaker than expected, weekly mortgage applications fell and durable goods orders were worse than expected. What's more the Fed's Beige Book of anecdotal evidence confirmed the slowdown in the economy with comments that the pace of growth has slowed in many districts. The news on June quarter company earnings remained strong though with profit growth now expected to have come in at 19% over the year to the June quarter up from an initial expectation a few weeks ago of around 13 to 15%.
- **In the Euro-zone, business and consumer sentiment deteriorated**, and political squabbling returned with Germany pouring cold water on plans for the European Financial Stability Facility to buy government bonds which put more pressure on bond yields in troubled countries. The Euro-zone debt crisis continues.
- **Monetary tightening in Asia continued with the Reserve Bank of India jacking up its key lending rate by 0.5%** as part of an ongoing effort to rein in inflation. This is a much nicer problem to have than the debt problems of advanced countries though.

- **The Reserve Bank of New Zealand made it pretty clear, that with the recovery in growth and inflation remaining high, the 0.5% cash rate cut which took it to 2.5% following the Christchurch earthquake won't remain in place much longer**. We expect a rate hike in September.

## Australian economic releases and implications

- **Australian economic data was somewhat disappointing**. Inflation rose more than expected in the June quarter although its worth noting that half of the increase in the Consumer Price Index was due to fruit and petrol prices. However, I don't think the inflation problem is anywhere near as acute as many make out. Strip out fruit, petrol and a range of government related prices (in the areas of health, child care, local government rates, utilities, etc) and inflation is pretty benign running around 2.5%.
- Meanwhile house prices continued to fall in the June quarter according to APM and in June according to RP Data-Rismark and private sector credit actually declined in June. Deleveraging looks like its accelerating!

## Major market moves

- **Global shares fell** on the back of increasing worries about a US default or credit downgrade or both, ongoing European debt worries and disappointing economic data. They have now fallen for 3 months in a row.
- **Following the global lead, Australian shares fell sharply** not helped by renewed talk of another interest rate hike and further gains in the Australian dollar. Australian shares are now down 4 months in a row.
- **While commodity prices were mixed, the $A benefitted from safe haven flows** on the back of US debt worries and renewed talk of higher interest rates in Australia. Safe haven flows also helped Australian bond yields which fell whereas US bond yields were essentially flat. Bond yields backed up again in Italy and Spain.

## What to watch in the week ahead?

- **In the US the focus will no doubt be on the debt ceiling negotiations**. On the data front, expect the ISM manufacturing conditions index for July due Monday to fall slightly, but July payroll employment data due Friday to show a 100,000 gain leaving unemployment at 9.2%. In Europe, the ECB and Bank of England are expected to leave interest rates on hold on Thursday and the same will go for the BoJ on Friday.
- **In Australia, we think the Reserve Bank should leave interest rates on hold yet again**. While the worse than expected June quarter inflation rate means that the risk of rate hike is high, we expect the RBA to balance this out against the increased level of uncertainty globally, the fragile nature of household demand in Australia and the ever strengthening Australian dollar which is doing part of the Bank's work for it. While the RBA will no doubt signal that it retains an inclination to raise rates at some point, the most likely scenario is that rates will remain on hold for an extended period, ie well into next year. The RBA's Statement on Monetary Policy due Friday will likely see an upwards revision to the Bank's near term inflation forecasts and a downwards revision to its growth forecasts, and will be watched closely for clues on the direction of interest rates.
- Meanwhile in Australia, expect June building approvals to show a slight bounce on Tuesday, June quarter house price data to be weak (also due Tuesday) and June retail sales to record a slight rise (Wednesday).
- **The June half profit reporting season is starting to get underway and it's expected to be a tough one** with softening household demand, rising unit labour costs and the strong Australian dollar all expected to have constrained overall earnings growth to around 13% over the last financial year, driven by the resources sector. These factors and global uncertainties are also likely to weigh on outlook statements.

## Outlook for markets

- **While attractive valuations, easy global money and solid profit growth are positive for shares on a six to 12 month horizon,** the worry list remains significant and so further volatility and weakness is likely in the months ahead. European debt problems are unlikely to go away, US debt problems are looming ever larger, the soft patch in the US is still in place and uncertainty remains as to whether China will have a hard or soft landing. Added to all that, the September quarter is normally the weakest time of the year for shares.
- **Australian shares are likely to continue underperforming global markets** thanks to relatively high interest rates, the strong Australian dollar and uncertainty regarding the carbon tax. A less aggressive RBA would help.
- **The $A is likely to remain strong** on the back of high commodity prices, high interest rates in Australia, possible safe haven demand and maybe another round of US monetary easing. Expect a rough ride though.
- **Government bonds in major global countries, including Australia have performed well in recent months** on the back of soft economic data and safe haven demand. However, as yields are low and as the global economic recovery continues, government bonds are likely to deliver only modest returns in the medium-term. Given their new found safe haven status Australian bonds may be a better bet than global bonds.