AMP CAPITAL

WEEKLY MARKET UPDATE

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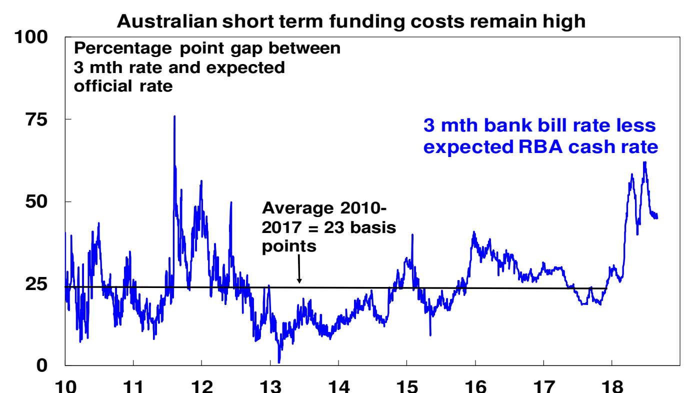
Investment markets and key developments over the past week

The past week saw most share markets rise with US shares pushing further into record territory, but gains were capped by ongoing turmoil in the emerging world (notably Argentina and Turkey as their currencies plunged anew) and nervousness around trade, particularly ahead of the next round of US tariffs on imports from China. US shares rose 0.9%, Japanese shares gained 1.2% and Chinese shares rose 0.3%, but Eurozone shares fell 0.6% on trade worries. Australian shares rebounded 1.2% after being hit by the previous week's political turmoil. Bond yields rose in the US but were flat in Japan and fell slightly in Germany and Australia. Oil prices were flat but metal and iron ore prices fell. The $US was flat for the week, but the $A fell 1% thanks to trade fears, soft data and the likelihood that out of cycle bank mortgage rate increases will keep the RBA on hold for longer.

Good news regarding US trade with Mexico and maybe Canada (with negotiations set to resume Wednesday), but the global trade threat from the US remains high and looks like ramping up further with more tariffs on China coming soon. News that the US and Mexico have reached agreement on a revised trade agreement and that Canada may join too leading to a revamped and renamed NAFTA is a good sign and coming on the back of the US/Korean trade deal and the start of negotiations with Europe signals that Trump is not anti trade per se but just wants what he regards as fairer trade for the US. But it's clear that with Trump still threatening to pull out of the World Trade Organisation, saying that the EU offer to remove auto tariffs "is not good enough" and with indications that the threatened next bigger round of tariffs on China will soon be implemented its clear that the trade war risk is continuing to rise. The public comment period on threatened tariffs of up to 25% on $US200bn of US imports from China ends on Thursday and its likely they will start to be implemented soon thereafter, possibly in instalments. If fully implemented it will mean that around half of imports from China will be affected, albeit its only 10% of total US imports – so we are still a long way from 1930. Negotiations between the US and China are unlikely until after the mid-terms and a possible Trump/Xi summit in November, so trade will be a continuing source of market volatility for a while yet. A lack of progress in US/North Korean negotiations are also adding to US tensions with China again.

Australian mortgage rates on the rise with Westpac and some smaller banks moving and other big banks likely to follow. This was no real surprise given the rise in money market borrowing rates this year which has seen the gap between bank bill rates and the RBA's cash rate blow out well beyond normal levels - see the next chart. While bank bill rates have fallen back a bit in the last month or so the gap remains over 20 basis points higher than it has averaged over the last decade or so. Since banks get around 35% of their funding from this or related sources it cuts into their margins unless they pass it on in the form of higher lending rates. Small banks had already moved and now it looks like the big banks are starting to follow – having delayed moving in the hope that the money market will settle down which it hasn't (and probably won't given slowing growth in bank deposits meaning more competition for money market funds). While the rise in mortgage rates on average is small at around 15 basis points, it's still another dampener on consumer spending and home buyer demand, particularly given many borrowers will fear that more rate hikes will follow. **It will hit the home buyer market particularly in Sydney and Melbourne at a time when it's already down**. As such it's a de-facto monetary tightening and is yet another reason for the RBA to remain on hold for longer.



Source: Bloomberg, AMP Capital

Major global economic events and implications

US data remains mostly solid. While the past week saw pending home sales fall continuing the run of softer housing conditions, home prices continue to rise, consumer confidence is at a new 18-year high, personal spending is rising strongly with strong income growth keeping the savings rate high, jobless claims remain ultra-low and the goods trade deficit widened in July as imports picked up. Meanwhile core inflation

rose back to the Fed's 2% inflation target. All of which is consistent with ongoing but gradual Fed rate hikes.

Eurozone economic sentiment fell a bit further in August but the German IFO business conditions index rose strongly, growth in bank lending is continuing to trend higher and unemployment has now fallen to 8.2% which is still high but down from a peak of just over 12% in 2013. Meanwhile, core inflation fell back to 1% year on year in August which will keep the ECB relatively dovish.

Japanese data was mixed with a continuing very tight labour market (helped by a falling population) but another slight fall in industrial production. Core inflation rose in Tokyo to 0.6% year on year but this was due to higher hotel rates which are volatile.

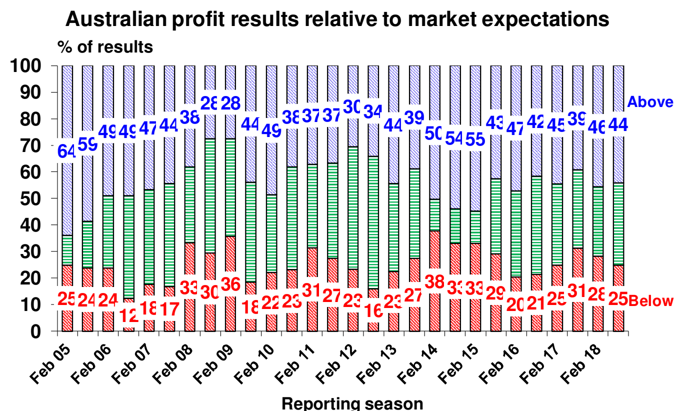
Just when it seemed Chinese growth is slowing, its PMIs surprisingly rose in August. Not a lot but they remain at levels consistent with good growth and suggest that the deleveraging campaign and trade war fears are not having a huge negative impact.

Meanwhile growth in India accelerated further to 8.2% year on year on the June quarter, as it continues to push ahead of China in the growth stakes.

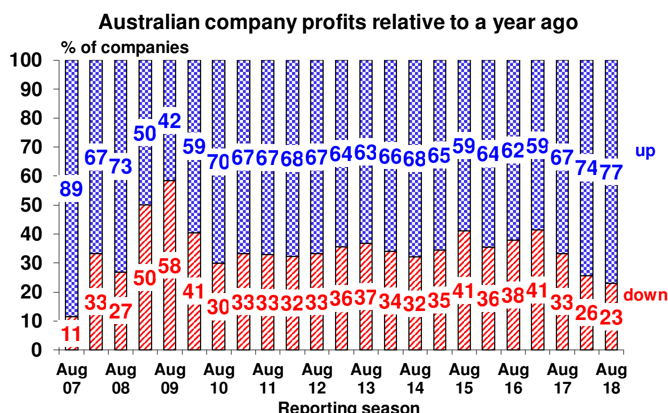
Australian economic events and implications

Soft capex, soft building approvals and soft credit. June quarter business investment was disappointing with an unexpected decline in the June quarter and investment plans for the current financial year still pointing to falling mining investment and soft growth in non-mining investment. At least the big drag on growth from slumping mining investment is largely behind us. Meanwhile, soft building approvals add to evidence the housing construction cycle has peaked and credit growth remains soft as investor lending continues to fade and personal and business credit remain weak. Notwithstanding solid economic growth in the first half of the year our view remains that growth going forward will be weaker than the RBA is expecting.

The June half Australian earnings reporting season is now wrapped up and results have been solid, but not spectacular. 44% of results have surprised on the upside which is in line with the long term norm, the breadth of profit increases was impressive with 77% reporting higher profits than a year ago which is the strongest since before the GFC and compares to a norm of 66%, 86% have increased their dividends or held them constant and 62% of companies have seen their share price outperform the market on the day results were released. 2017-18 earnings growth have come in around expectations at about 8%, with resources earnings up 25% thanks to solid commodity prices and rising volumes and the rest of the market seeing profit growth of around 5% with bank profits seeing a 2% fall but strong profit gains for insurers, health care, gaming and utility stocks. It's not the 28% earnings growth being seen in the US but its still solid. Key themes have been continuing strong dividend payments, some pressure from higher raw material costs, outperformance by high quality offshore exposed companies and softer than expected guidance. Profit growth this financial year is expected to slow to around 5% as the growth in resource profits slows further.



Source: AMP Capital



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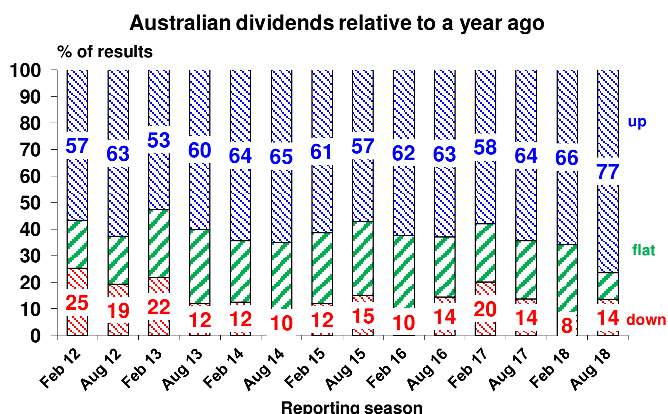

Source: AMP Capital

What to watch over the next week?

The next round of US tariffs on China will likely be the big focus for the week ahead. On the data front in the US, August jobs data (Friday) will be watched closely for continued strength and the long-awaited pick up in wages growth. Market expectations are for payrolls to rise 190,000 – although its worth noting that August is known for initially seeing a soft result which is subsequently revised up, a fall in unemployment to 3.8% and a rise in wages growth to 2.8% year on year from 2.7%, which will just leave wages at the top of their range for this year. Meanwhile, the ISM manufacturing and non-manufacturing indexes for August (due Tuesday and Thursday) are likely to remain strong at around 57 and the trade deficit (Thursday) is expected to worsen.

In China, the Caixin PMIs will be released starting Monday.

In Australia, the Reserve Bank is expected to yet again leave rates on hold when it meets on Tuesday which will

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bring it to a record 25 months in a row with no change. If growth and inflation picks up as the RBA expects then a rate hike is likely at some point down the track but with downside risks around consumer spending, the housing cycle turning down in terms of construction and prices in Sydney and Melbourne and wages growth and inflation likely to remain lower for longer we don't see a rate hike until 2020 at the earliest and still can't rule out the next move being a cut particularly as falling home prices impact. A speech by RBA Governor Lowe (also on Tuesday) is unlikely to signal any changes in the RBA's views on monetary policy.

On the data front in Australia, expect June quarter GDP data (Wednesday) to show solid growth of around 0.7% quarter on quarter or 2.8% year on year helped by a rebound in consumer spending and growth in housing construction and public spending, but soft business investment, only a small contribution from net exports and a slight detraction from inventories. In other data expect CoreLogic to show another slight fall in home prices for August and July retail sales to show a gain of 0.2% month on month (both due Monday), the July trade surplus (Thursday) to fall back slightly to around $1.4bn and housing finance data (Friday) to show continuing softness in lending to investors. Data for business indicators, public demand and the current account will also be released.

Outlook for markets

We continue to see share markets being higher by year end as global growth remains solid helping drive good earnings growth and monetary policy remains easy. However, we are now into a seasonally weak period of the year for share markets and rising threats around trade and emerging market contagion at a time of ongoing Fed rate hikes, the Mueller inquiry in the US, the US mid-term elections and Italian budget negotiations point to a period of increased volatility and potential weakness ahead. Property price weakness and election uncertainty add to the risks in relation to the Australian share market.

Low yields are likely to drive low returns from bonds. Australian bonds are likely to outperform global bonds helped by the relatively dovish RBA.

Unlisted commercial property and infrastructure are still likely to benefit from the search for yield, but it is waning.

National capital city residential property prices are expected to slow further with Sydney and Melbourne property prices likely to fall another 10% or so, but Perth and Darwin property prices bottoming out, and Adelaide, Canberra and Brisbane seeing moderate gains.

Cash and bank deposits are likely to continue to provide poor returns, with term deposit rates running around 2.2%.

We continue to see the $A trending down to around $US0.70 as the gap between the RBA's cash rate and the US Fed Funds rate pushes further into negative territory as the US economy booms relative to Australia. Solid bulk commodity prices should provide a floor for the $A though in the high $US0.60s. Being short the $A remains a good hedge against things going wrong in the global economy – eg around trade and emerging markets.

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