7 SEPTEMBER 2018

SHANE OLIVER
Head of Investment Strategy and Chief Economist,
AMP Capital

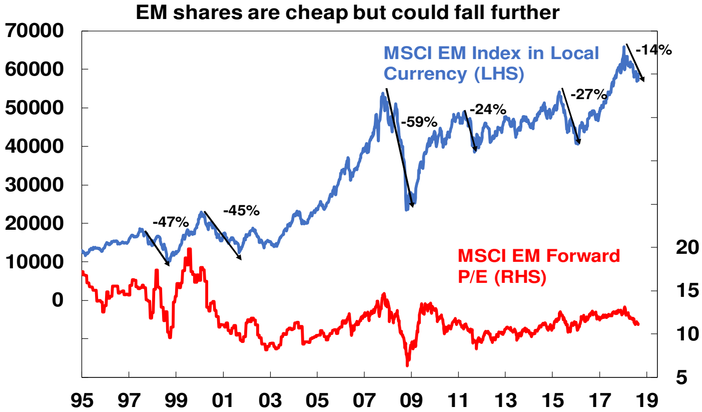
Investment markets and key developments over the past week

The past week saw share markets fall on the back of worries around emerging markets, trade wars and the potential regulation of US social media stocks. US shares fell 1%, Eurozone shares lost 2.6%, Japanese shares fell 2.4% and Chinese shares fell 1.7%. After being resilient to global threats over the last few months Australian shares also got hit and fell 2.8% to their lowest since June. Bond yields generally rose, although they fell in Italy. While the iron ore price rose, oil and metal prices fell. The $A fell to its lowest since early 2016 on the back of strong US jobs data and ongoing trade threats.

This time of year is well known for financial market weakness and volatility and this year looks like it will be no different with risks around the emerging world, global trade and tariffs, Trump and US politics, Chinese growth and tech stocks.

- The emerging market crisis is continuing to ramp up with emerging market (EM) shares in local currency terms down 14% from their January high and emerging market currencies down 16% since their February high as investors fear other blow ups beyond Turkey and Argentina in emerging countries with current account deficits.

EM shares are cheap but could fall further



Source: Bloomberg, AMP Capital

Emerging market shares are cheap trading on a forward PE of around 11 times and are a good buy on a long term view but their decline so far is mild by the standard of past emerging market crises (eg, they fell 27% in 2015-16) and they could easily fall further as long as the US dollar remains in an uptrend (threatening debt servicing problems in the emerging world), Chinese growth continues to slow and the trade threat continues to ramp up. So far, the impact on advanced countries – via banks, etc – has been minimal but as we saw in 1997-98 the deeper the EM crisis goes the bigger the risks.

- The US trade conflict still looks like escalating with no breakthrough so far in US/Canadian negotiations increasing the risk that NAFTA will be terminated, Trump now threatening Japan on trade, Trump repeating his threat to raise tariffs on all Chinese imports (which are just over $US500bn) and the US moving towards implementing the next round of tariffs on China - up to 25% on $US200bn imports from China. 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. But it could still knock up to 0.5% off Chinese growth and maybe 0.1-0.2% off US growth and of course Trump is threatening to do more. Some sort of negotiated solution is likely but not until after the US mid-term elections.
- The risks around Trump are continuing to build – including reports of a “resistance” by White House aides to prevent him doing impulsive things (surely not!) – and investor nervousness is likely to build ahead of the mid-terms given indications the Democrats could get control of the House.
- The breadth of US share market gains has been narrowly focussed on tech stocks, which are at risk of a decent pull back particularly if regulatory pressure builds.

Our base case is that global growth will remain strong and that this along with rising profits and still easy monetary policy will keep the broad trend in share markets up, but these issues suggest a significant risk of a short-term correction in developed country share markets. So far, the US share market and until recently the Australian share market have shown little concern, but the Australian share market has started to come under pressure. And as we saw in the global growth scare of 2015-16 while the US share market remained resilient for a while in the face of falls in other global share markets eventually it too came under pressure. Overall it remains a time for a relatively cautious investment strategy for investors with a short-term investment horizon.

At least one threat seems to have receded a bit and that’s the threat of showdown between the Italian populist Government and the European Commission regarding its 2019 budget with the draft due by 27/9. Indications so far are that the

Italian Government will respect EU budget rules, despite its tax and spending policies implying a budget blow out. Time will tell.

Back in Australia, the ANZ and CBA as widely expected followed Westpac in raising their standard variable mortgage rates all by an average 0.15% to recoup higher money market funding costs. This is a bit more than I would have thought as the rise in funding costs on average looks to be around 0.09%. It's a defacto monetary tightening equal to say a 0.25% RBA hike 15 years ago given the higher debt load. It will add to the weight on home prices and is another reason why the RBA won't be raising rates any time soon and why another RBA rate cut can't be ruled out.

Major global economic events and implications

US data remains strong, particularly relative to other major countries which continues to point up for the $US. Construction data for July was weak but jobs data remains strong, the ISM business conditions indicators were very strong and the trade deficit worsened not helped by strong demand growth sucking in imports. August jobs data was particularly robust with payrolls rising by more than expected at 201,000, unemployment remaining very low at 3.9%, the summation of unemployment and underemployment (called U6) falling further to 7.4% (its nearly 14% in Australia!) and wages growth edging up to 2.9% year on year which is its highest since 2009. Wages growth is still low and a long way from the 4% level thats signalled trouble in the past and its rising trend is only gradual - but it is still rising, and it will keep the Fed hiking every three months into next year, unless there is a big hit to US growth from trade wars or emerging markets.

Source: Bloomberg, AMP Capital

German factory orders continued to fall in July, but stronger business conditions readings point to an improvement ahead.

Japanese household spending improved in July, but wages growth fell to 1.5%yoy from a too good to be true 3.3% in June.

The UK and the EU may be heading towards a Brexit fudge, ie the UK initially keeps its trading status with the EU in a transition phase upon Brexit with details to be worked out later. If so this would be positive for the pound.

The Chinese Caixin business conditions PMIs fell slightly in August in contrast to the gains in official PMIs. With the trade threat escalating stimulus measures will continue in China.

Australian economic events and implications

The Australian economy grew strongly over the year to the June quarter, but its likely to slow from here. June quarter GDP growth of 0.9% quarter on quarter or 3.4% year on year (as previous quarters were revised up) was much stronger than expected. Going forward though declining building approvals point to slowing housing investment, falling home prices will weigh on consumer spending at a time when the household saving ratio is just 1% at a ten year low, business investment growth is likely to be modest not helped by political uncertainty and there is also a risk that drought and US trade wars will weigh on growth. So while we don't see a slump in growth we expect it to slow back to around a 2.5-3% pace this financial year. Other data released over the last week was consistent with this with retail sales stalling in July, ANZ job ads losing some momentum, housing finance continuing to trend down and the trade surplus falling back a bit. Business conditions PMIs generally remained solid though.

Inflation remaining low. Various indicators released over the last week indicate that inflation pressures remain very low: average wage and other forms of employee compensation rose just 0.1% in the June quarter or 1.6% year on year, real unit labour costs are falling, the private consumption deflator rose just 0.2% in the June quarter or 1.5% year on year, and the Melbourne Institute's August Inflation Gauge showed headline and underlying inflation struck at 2.1% yoy.

Home prices down for the tenth month in a row in August with more go. According to CoreLogic, capital city prices fell another 0.4% and are down 2.9% from a year ago. Our assessment remains that prices in Sydney and Melbourne will fall another 10% as tighter bank lending standards, rising supply, falling capital growth expectations and fears of changes to negative gearing and the capital gains tax discount impact.

So while economic growth perked up last financial year, the RBA is expected to remain on hold as growth moderates again, wages growth and inflation remain low and given various threats to growth from falling home prices, drought and global trade threats. We remain of the view that the RBA will be on hold out late 2020 at least and still can't rule out a rate cut.

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 and US/Canada trade talks will continue. On the data front in the US, key to watch will be August retail sales (to be released Friday) which is likely to show another strong rise and CPI inflation data (Thursday) which is likely to imply the Fed's preferred core inflation is running around or a bit above 2%. In other data expect to see continued strength in small business optimism and strong labour market hiring and openings (all Tuesday) and a solid rise in industrial production (Friday).

The European Central Bank meeting on Thursday is likely to affirm it will taper its quantitative easing program in the December quarter but that the start of rate hikes is a long way off – we don't see an ECB hike until 2020 at the earliest. The Bank of England also meets Thursday.

Chinese economic data for August will start to flow. Expect to see a fall in producer price inflation to 4% but consumer price unchanged at 2.1% (both due Monday) and activity data on Friday to show retail sales growth unchanged at 8.8%, but growth in industrial production picking up to 6.2% and investment picking up to 5.7%. Credit data will also be released.

In Australia, business confidence in the NAB survey (Tuesday) and consumer confidence (Wednesday) will be watched for the impact of recent political turmoil. Expect both to fall slightly. August labour market data on Thursday is expected to show a 10,000 gain in jobs, but a rise in unemployment back to 5.4% as participation rises slightly.

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 potential correction 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 Hobart, 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%.

The $A is trending down to around $US0.70 and maybe into the high $US0.60s 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.