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

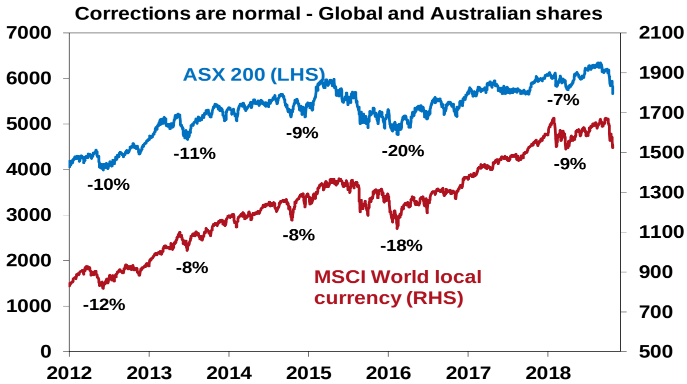
Investment markets and key developments over the past week

Most major share markets fell over the past week as worries about the global growth outlook continue. US shares fell 3.9%, Eurozone shares fell 2.6%, Japanese shares lost 6% and Australian shares fell 4.6%. Chinese shares rose 1.2% though thanks to stimulus measures. Bond yields fell on safe haven demand as is usually the case through significant share market falls and while iron ore prices rose, oil and metals fell. The $US rose and this weighed on the $A.

The share market correction continues and, as is often the case in significant falls, is morphing into broader concerns about global growth. From their recent highs to recent lows global shares have fallen about 9% and Australian shares around 11%. It's still too early to say we have bottomed but we remain of the view that it's not a major bear market. The worry list of rising US interest rates, the US/China conflict, a correction in tech stocks, problems in the emerging world, the US midterm elections, the Italian budget and signs of a peak in global economic and profit growth is continuing to drive shares down and as we have seen in the past this is morphing into another global growth scare with investors latching onto companies that had negative profit news in the US and declining Eurozone PMIs. Shares are technically oversold again and so may see a bounce, but a circa 20% top to bottom fall in share markets as occurred through the 2015-16 global growth scare is possible and this would likely require some sort of global policy reaction to turnaround, eg the Fed hitting the pause button and the ECB extending QE. Of course, China is already easing.

But the following key points are worth bearing in mind:

1. Corrections are normal – global and Australian shares saw multiple pullbacks ranging from 7% to 20% since 2012. See the next chart.



Source: Bloomberg, AMP Capital

2. The main driver of whether we see a correction or even a mild bear market (say a 20% fall) as opposed a major bear market like the GFC is whether we see recession in the US and right now this still looks unlikely even though the growth rate may have peaked as we haven't seen the sort of build-up in excess that precedes a US recession. Don't forget that share markets often overreact to risks as highlighted by the old Paul Samuelson saying that "share markets predicted 9 of the last 5 recessions".
3. Selling shares after a big fall just turns a paper loss into a real loss.
4. When shares fall in value they become cheaper and offer better return prospects so in this sense pull backs are good.
5. While the value of shares has fallen dividends haven't and so if its income you are after it hasn't changed if you have a well diversified portfolio. In fact, the grossed up dividend yield on Australian shares is now around 6%.
6. Shares bottom when everyone is in a panic. I don't know when that will be but the trick is too look out for when the crowd gets very negative.
7. Finally, to be a successful investor you need to keep your head and that gets hard it times like the present when negative news reaches fever pitch. So it's best to turn down the noise and chill out a bit.

These points are covered in more detail here.

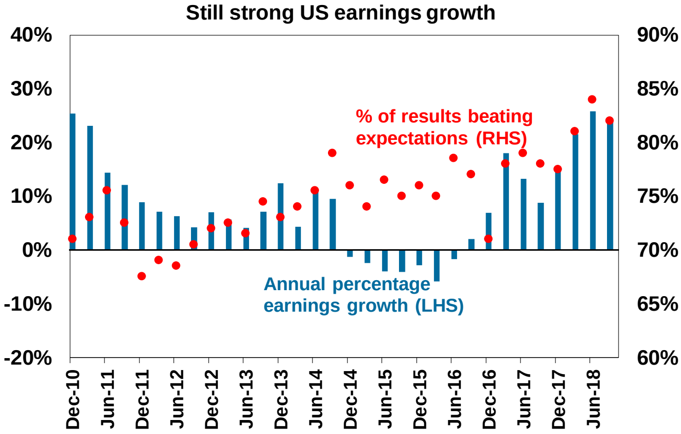
There is just one other thing worth mentioning. October is known for share market volatility. Sometimes it's referred to as a bear killer given that in the US it often sees a share fall and then a rebound. But the point is that the share market traditionally strengthens through November and December in the US (and December in Australia). This is particularly the case in years of US midterm election (which is the second year of the US presidential term) particularly once the election uncertainty is out of the way. In fact, the US share market hasn't declined in the 12 months after a midterm election.

Is this week's The Economist cover – headed "Aussie rules" and showing a kangaroo bouncing through the clouds – the kiss of death for Australia? They do great covers, but it reminded me of their 2009 cover showing Brazil/Christ the Redeemer blasting off only to fizzle back into the mountain in a 2013 cover. Worth checking the Magazine cover indicator.

Major global economic events and implications

US economic data was a bit mixed. Home sales data remained weak consistent with the softness seen in other housing activity indicators lately, but home prices are continuing to rise, durable goods orders were okay, business conditions PMIs rose in October and jobless claims remain ultra-low. September quarter GDP growth came in slightly better than expected at 3.5% annualised. Growth in final demand was a strong 3% annualised driven by very strong consumer spending and public demand but offset by soft investment and housing. Growth is likely to slow a bit further in the current quarter but there is no sign of an impending recession.

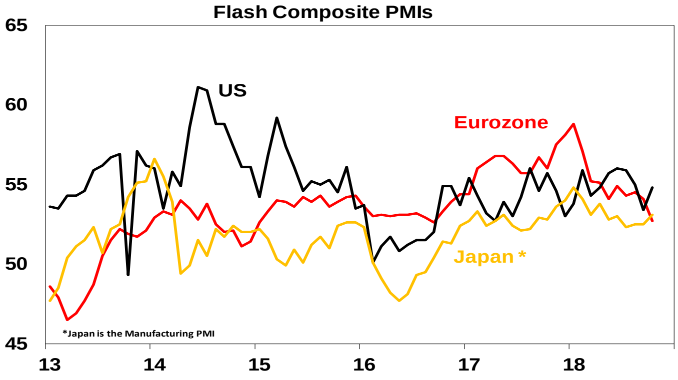
At the half way point of the US September quarter profit reporting season overall results have been good with 82% of results beating on earnings, 58% beating on revenue and earnings growth expectations moving up to 24%yoy. However, the level of earnings are down from the June quarter and the uncertain environment has seen investors latch on to those companies who have disappointed resulting in outsized share price declines relative to those who have exceeded expectations.



Source: Bloomberg, AMP Capital

The ECB made no changes to monetary policy with none expected and appeared to play down recent softer data. It remains on track to end QE in December, but it did refer to the possibility of using another round of cheap bank financing (LTROs if needed) and rate hikes still look to be a long way off. Meanwhile, Eurozone business conditions PMIs fell again in October albeit to a still reasonable 52.7 but adding to concerns that Eurozone growth is continuing to slow.

The PMIs across the G3 are shown below. In short, the US is tracking sideways, Japan is possibly moving up and only Europe is seeing a downtrend. So no sign of a major developed country growth downturn – well at least not yet anyway!



Source: Markit, Bloomberg, AMP Capital

Details of personal tax cuts were announced in China and look like being bigger than expected at 0.5% of GDP.

Australian economic events and implications

It was a quiet week on the data front in Australia, but what was released was soft. The CBA preliminary business conditions PMI fell to 51 for October down from 58 18 months ago and skilled vacancies fell for the sixth month in a row.

What to watch over the next week?

In the US, the focus will be back on jobs with October payroll data to be released Friday expected to show solid jobs growth of 190,000, unemployment remaining at 3.7% and an in wages growth to 3.1% year on year. Meanwhile consumer data (Monday) is expected to show a solid rise in real consumer spending and the core private consumption deflator inflation remaining at 2% year on year, home prices are likely to show further gains and consumer confidence is likely to remain high (both Tuesday), September quarter growth in employment costs (Wednesday) is likely to remain at 2.7% year on year, the October ISM index (Thursday) is likely to remain strong at around 59 and the trade deficit (Friday) is likely to get a bit worse. September quarter earnings reports will continue to flow.

Eurozone September quarter GDP data due Tuesday is expected to show moderate growth of around 0.3% quarter on quarter or 1.% year on year, unemployment is likely to have remained at 8.1% in September and core inflation for October is likely to have edged up to 1% yoy (both due Wednesday).

Japanese jobs data (Tuesday) are likely to remain strong but industrial production (Wednesday) is expected to be soft.

Both the Bank of Japan (Wednesday) and the Bank of England (Thursday) are expected to leave monetary policy on hold.

Chinese PMIs for October (Wednesday & Thursday) will be watched for signs any further slowing in growth.

In Australia the focus will be on September quarter consumer price inflation data (Wednesday) which is expected to show headline inflation of 0.4% quarter on quarter or 1.9% year on year with higher fuel prices and tobacco excise only partly offset by higher childcare rebates and lower electricity and gas prices. Underlying inflation is likely to remain subdued at 0.4%qoq or 1.9%yoy. Meanwhile, expect a 3% bounce back in building approvals (Tuesday) after their plunge in August, continued moderate credit growth (Wednesday), CoreLogic data for October (Thursday) to show a further decline in home prices, the trade surplus (also Thursday) to fall slightly and September retail sales (Friday) to show growth of 0.2%. Business conditions PMIs will also be released Thursday.

Outlook for markets

We continue to see the trend in shares remaining up as global growth remains solid helping drive good earnings growth and monetary policy remains easy. However, the risk of a further short-term pull back is high given the threats around trade, emerging market contagion, ongoing Fed rate hikes and rising bond yields, the Mueller inquiry, the US mid-term elections and Italian budget negotiations. Property price weakness and election uncertainty add to the risks around Australian shares.

Low but rising yields are likely to drive low returns from bonds, with Australian bonds outperforming global bonds.

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 15% or so, but Perth and Darwin property prices at or close to bottoming, 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%.

While the $A is now fallen close to our target of $US0.70 it likely still has more downside into the $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. Being short the $A remains a good hedge against things going wrong in the global economy.