AMP CAPITAL

WEEKLY MARKET UPDATE

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Investment markets and key developments over the past week

Share markets bounced back over the past week helped by good US earnings results and a lessening of trade war fears following a phone call between President Trump and President Xi Jinping. US shares rose 2.4%, Eurozone shares gained 3%, Japanese shares rose 5%, Chinese shares rose 3.7% and Australian shares gained 3.2%. Reflecting the risk on tone and a strong US jobs report for October bond yields rose. While the copper price rose, the iron ore price was flat and oil fell 6.6%. Although the $US was little changed the risk on tone along with a larger than expected trade surplus saw the $A rise to around $US0.72.

A poor October but have we seen the bottom in the share market rout? October was a bad month for share markets with global shares losing 6.8% in local currency terms which was their worst month since August 2011 and Australian shares losing 6.1% which was their worst month since August 2015. The good news though is that markets have had a good bounce from their lows of around 3%. Shares had become technically oversold and were due for a bounce. It's possible that following top to bottom falls of 10% for global shares, 11% for Australian shares and 21% in emerging markets we have now seen the low but with risks remaining around US interest rates, the US/China conflict, tech stocks, emerging countries, the Italian budget and the US midterm elections in the week ahead its impossible to be definitive so there could still be another leg down.

However, while it's impossible to say for sure whether we have seen the bottom in share markets there are reasons to be optimistic beyond the near-term uncertainty.

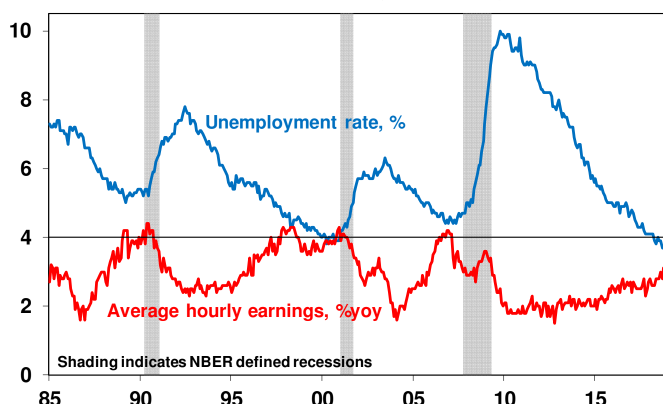
- First, investor sentiment has hit very bearish extremes which is positive from a contrarian view.
- Second valuations have improved with many markets now in cheap territory, including Australian shares which have seen their forward PE fall from around 16 times to 14 times.
- Third, US shares tend to rally once the midterm elections (to be held Tuesday) are out of the way and global shares would follow.
- Finally, we remain of the view that what we have seen (or may still see) is a correction or a mild bear market at worst (like 2015-16's circa 20% fall that was quickly reversed) rather than a deep bear market like the GFC as the conditions for a US recession that invariably drive major bear markets are not in place: US monetary policy is not tight and the sort of excesses that normally precede recessions in terms of inflation, spending and debt are not present.

If we are right, then cyclical shares (like autos and energy) trading on very low PEs of 10 times or less are offering good investment opportunities.

The US and China getting closer to a trade deal according to President Trump? At last Trump and Xi are talking, Trump says he thinks "we'll make a deal with China" and that "a lot of progress has been made" and the US is reportedly drafting a deal for Trump and Xi to consider signing at the G20 meeting in late November. This is all very positive and sooner or later I think a deal will be made before the economic pain gets too great. But we have seen several episodes of false hope on this front before only to see the conflict worsen again, both sides are still a long way apart, we have not heard comments from China matching Trumps and Trump's comments may be aimed at boosting support for his party ahead of the midterms. So, it's premature to get too excited.

Major global economic events and implications

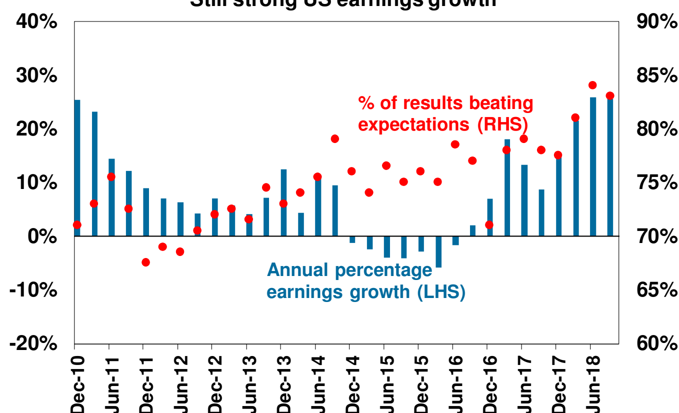
US economic data remains strong with solid growth in September personal spending, an 18 year high in consumer confidence, still strong business conditions surveys (albeit the ISM manufacturing index fell back from its very high September reading) and continuing strong jobs data. The October jobs report was particularly strong with payrolls up by 250,000, unemployment remaining very low at 3.7% as participation rose and wages growth (as measured by average hourly earnings) moving up to 3.1% year on year, its highest since 2009, as a decline in wages last October dropped out of the annual calculation. As can be seen in the next chart though, despite very low unemployment the rise in wages growth remains gradual and we are a long way from the 4% plus growth rate that preceded the last three recessions.



Source: Bloomberg, AMP Capital

Meanwhile, US core inflation remained at 2%yoy in September and growth in employment costs in the September quarter was unchanged at 2.8%yoy and rising productivity growth is helping keep growth in unit labour costs low. All up the Fed remains on track to continue tightening, with the next move to be in December, but in the absence of a significant inflation threat it can continue to do so gradually.

Yet again the US September quarter earnings reporting season is proving to be strong. With roughly 75% of results now in 83% have beaten on earnings, 61% have beaten on revenue and earnings growth expectations for the quarter have now moved up to 26% (up from 20% a month ago). All of which is seeing earnings match their June quarter high. Of course, 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

Eurozone data was a bit disappointing with a further slowing in GDP growth in the September quarter, confidence measures continuing to fall (albeit they remain high) and unemployment unchanged at 8.1%. Core inflation rose to 1.1%yoy but it's still way below the ECB's 2% target. While the ECB is probably on track to end QE next month, it won't start raising rates till 2020, quantitative tightening is years away and it may even do another round of providing cheap funding to banks (LTRO) given the slowing in growth.

The poor performances of the German grand coalition parties at state elections in Bavaria and Hesse do not signal a threat to the Euro. Merkel has confirmed she will step down as Christian Democrat Union party leader and won't seek re-election as Chancellor in 2021. However, several points are worth noting. First, comments by Social Democrat Party leader Nahles indicate that the grand coalition is not under immediate threat. Second, Germany's budget surplus and falling public debt indicate plenty of scope to provide needed fiscal stimulus which would be positive for Germany and the Eurozone and provide an electoral boost for the grand coalition partners. There is also the chance that the CDU will do what John Howard did in response to One Nation and adopt a tough stance on immigration to neuter the Alternative for Deutschland's appeal. Thirdly, German Euroscepticism is not on the rise. In fact, support for the Euro in Germany has risen to 83% and it was support for the pro-Euro Greens that surprised in Bavaria and Hesse, not support for the AfD. Finally, a new election is unlikely as both the CDU and SPD have seen a loss of support, so they aren't going to support an early election.

Japanese data was mixed with strong jobs data (helped by a declining workforce) but weak industrial production. As expected the Bank of Japan remained on hold and monetary tightening remains a long way off.

China PMI's slowed further on balance in October highlighting the downside risks to growth. Consistent with this the past week's Politburo meeting signalled greater urgency in combating the threats to growth and that even more policy stimulus is on the way.

The combination of continuing US economic strength relative to Europe, Japan and China points to ongoing upwards pressure on the $US (notwithstanding the scope for a short-term fall as excessive long positions are unwound) and in US bond yields relative to bond yields in other countries.

Far right Jair Bolsonaro's victory in the Brazilian presidential election is a short-term positive for Brazilian assets and pushed Brazilian shares to a record high, but maybe not in the long term. A right-wing Bolsonaro presidency will boost business confidence and allow pro-business policies like corporate tax cuts and reduced regulation. But as a populist without a landslide victory margin he lacks a mandate to do much about Brazil's high public debt and unsustainable pensions. So, while there may be a short-term boost for Brazil, long term problems will likely remain.

Australian economic events and implications

Australian data released over the last week highlighted the cross currents currently impacting. On the negative side the trend remains down in building approvals, credit growth remains soft, retail sales were weaker than expected in September and rose just 0.2% in real terms in the September quarter and home prices continued to slide in October posing an ongoing threat to consumer spending. Meanwhile underlying inflation as measured by the trimmed mean and weighted median fell to 1.7%yoy in the September quarter and is just 1.3%yoy using a US core inflation measure.

On the positive side the trade surplus came in far stronger than expected in the September with upwards revisions to previous months. While this was mainly driven by higher prices net exports look like providing a positive contribution to September quarter GDP growth and another rise in the terms of trade in the June quarter will provide a boost to national income. All of which indicates that trade along with an approaching end to the mining investment slump, rising non-

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mining investment and surging infrastructure spending will help offset the drag on growth from the declining housing cycle.

Our view remains that home prices have more downside over the next two years as tightening credit conditions, rising unit supply, lower foreign demand, the prospect of reduced negative gearing and capital gains tax concessions under a Labor government impact and as falling prices impact investors' expectations. We continue to see Sydney and Melbourne prices falling 20% peak to trough and national capital city average prices falling around 10% from peak to trough.

On balance our assessment remains that Australian economic growth will fall back into a 2.5-3% range, inflation will remain lower for longer than the RBA is allowing for and so an RBA rate hike is unlikely until late 2020 at the earliest. In fact, the threat to growth and inflation from falling home prices indicates the next move could in fact turn out to be a rate cut, but that's a second half 2019 story at the earliest because with unemployment at 5% and GDP growth recently surprising on the upside the RBA will need to see broader signs of softness to consider cutting interest rates and that will take time. So, there is no prospect of imminent RBA rate cuts "rescuing" the housing market.

What to watch over the next week?

In the US, the main focus is likely to be on the midterm Congressional elections on Tuesday where polls and betting markets point to the Democrats taking control of the House but Republicans retaining control of the Senate. Such an outcome should already be factored into financial markets, but it may create increased uncertainty about the impeachment of Trump and policy direction. While a Democrat House may attempt to bring impeachment charges against Trump its most unlikely to get the 67 Senate votes required to remove him from office and while a Democrat House will likely prevent another round of Trump tax cuts it won't be able to roll back already legislated tax cuts and won't change Trump's policies around deregulation and tariffs. The Fed (Thursday) is expected to acknowledge various risks to the outlook around trade, emerging markets and recent financial turbulence but indicate confidence in its base case of continuing solid growth and low unemployment and that continuing gradual rate hikes remain appropriate with the next hike on track for December. On the data front the non-manufacturing ISM for October (Monday) is likely to slip back to a still very strong reading of 60, job openings and hiring (Tuesday) are likely to remain strong and core producer price inflation (Friday) is expected to remain at 2.5% year on year.

Chinese October trade data (Thursday) is likely to show a slowing in export growth to 12% year on year (from 14.5%) and import growth to around 10%yoy (from 14.3%) and consumer price inflation (Friday) is expected to remain around 2.5%yoy.

In Australia, the RBA will yet again leave interest rates on hold when it meets Tuesday. While recent news on unemployment coming on the back of news of above trend economic growth is good, the slide in home prices risks accelerating as banks tighten lending standards which in turn threatens consumer spending and wider economic growth, and inflation and wages growth remain low. As a result, it would be dangerous to raise rates and we don't see the RBA hiking until 2020 at the earliest and still can't rule out the next move being a cut. The RBA's Statement on Monetary Policy (Friday) is likely to raise its near-term growth forecasts and lower its unemployment and underlying inflation forecasts a bit but won't signal any imminent move on interest rates. It will be mostly watched for its commentary around risks to house prices & credit growth and inflation & wages. ANZ job ads data will be released Monday and housing finance data (Friday) will likely show continuing weakness in lending, particularly to investors.

Finally, US sanctions on Iran will kick in on Monday potentially seeing a further threat to global oil supply at a time when the global oil market is already quite tight. However, the sanctions should already be reflected in markets as they were announced in May and since then Iranian oil exports have fallen from 2.4 million barrels per day to 1.6 mbd. And reports that the US has agreed to waive sanctions against eight countries – including Japan, India, South Korea and even China – so they can keep buying Iranian oil, highlight that the US does not want to see oil prices driven up. Since its October 3rd high, the oil price has fallen 17%.

Outlook for markets

Shares remain at risk of further short-term weakness, but 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.

Low but rising yields are likely to drive low returns from bonds, with Australian bonds outperforming global bonds as the RBA holds and the Fed continues to hike.

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%.

Having fallen close to our target of $US0.70 the Australian dollar is at risk of a further short-term bounce as excessive short positions are unwound. However, beyond a near term bounce 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.

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