AMP CAPITAL

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

Investment markets and key developments over the past week

US shares rose 4.8% over the last week, their strongest week December since 2011, helped by increasing signs from the Fed that it is open to pausing or slowing its interest rate increases. This helped push Eurozone shares 1.1% higher and Japanese shares 3.3% higher. Chinese shares rose 0.9% but Australian shares fell 0.9%. Weakness in resources, consumer, utility and real estate shares weighed heavily on the Australian share market over the last week offsetting gains in financials, industrials and telcos. Reflecting a more dovish Fed and generally low inflation readings bond yields fell. Commodity prices were mixed with metals and oil up a bit, but iron ore down. The Australian dollar rose.

The past week and most notably events around the weekend G20 summit in Buenos Aires saw some positive developments for shares and risk assets that provide more confidence that shares will see a rally into year end and that we won't go into a major ("grizzly") bear market. First, comments from Fed Chair Powell and Vice-Chair Clarida along with the minutes from the last Fed meeting have added confidence to the prospect of a pause in rate hikes next year. The key message from the Fed is that it remains upbeat on the US economy – consistent with another hike in December, but that rates are now "just below…neutral" and it needs to be aware of potential headwinds to growth including the lagged response in the economy to past monetary tightening and that there are no major excesses to deal with, which is all consistent with the Fed being open to a pause and slower pace of rate hikes next year. Following a hike in December the Fed is likely to lower its "dot plot" of rate hikes for 2019 and replace the reference to "further gradual [rate] increases" in its post meeting statement with a reference to being more data dependent. A pause on rates in the first half of next year is now highly likely particularly if core inflation continues to remain benign. A slower more cautious Fed would be positive for markets as it would reduce fears of a US downturn and take some pressure off the $US which would provide some relief for emerging markets and commodity prices.

Second, the meeting at the G20 summit between President Donald Trump and President Xi Jinping has gone well with both describing it has "highly successful." Basically, the US and China have agreed to halt the imposition of new tariffs (including the scheduled January 1 increase from 10% to 25% on $US200bn of US imports from China) for 90 days as the two countries negotiate a lasting agreement to solve their differences around trade and other issues. This is a short-term positive for markets as its more than most appear to have been expecting from the meeting. Of course, it makes March 1 next year a bit of a drop-dead date (yet another one!) and it could still end in failure like the other attempts at negotiation so far this year. However, there are some big positives this time around pointing to a more successful end to these negotiations which would be positive for investment markets next year: China has indicated a preparedness to negotiate on issues like forced technology transfer, intellectual property protection and cyber intrusions that it hasn't before; negotiations have been kicked off by a Chinese commitment to purchase a "substantial" amount of US products, designate Fentanyl a controlled substance, reconsider the Qualcomm/NXP deal and work with the US to make North Korea nuclear free; the direct involvement of both Xi and Trump suggests greater commitment this time around than back in May; and the costs of the trade war are now getting higher for both countries given the threat to growth. **I remain of view that Trump will want to resolve this issue sometime in the next six months** before the tax/tariff hikes wipe out all of the remaining fiscal stimulus next year and start to act as a drag on US economic growth pushing up prices at Walmart and pushing up unemployment threatening his re-election in 2020.

Thirdly, the fact that the G20 leaders' summit at least agreed on a communique unlike the G7 and APEC summits is a good sign that compromise can be found around the trade issue that results in a stronger trading system as opposed to a descent into trade wars.

Finally, while the 30% or so slump in the oil price will provide a boost to consumer spending power and hence growth, confirmation from Saudi Arabia and Russia at the G20 summit that they plan to extend their agreement into next year to manage the world oil market is consistent with an agreement to cut back oil production (which is likely to be confirmed at this Thursday's OPEC meeting) which will provide confidence that a re-run of the 2014-16 75% oil price crash won't be repeated which should provide some relief for energy stocks and support for energy related investment.

Stronger Australian budget position likely to see the Government announce tax cuts ahead of next year's Federal election. PM Morrison's announcement that next year's budget will be brought forward to April 2 is clearly designed to clear the way for an election in May (on either May 11 or May 18). Meanwhile, the Mid Year Economic and Fiscal Outlook report to be delivered on December 17 is likely to show that Federal budget is running around $9bn per annum better than expected – thanks to higher than expected commodity prices and employment driving stronger tax revenue only partly offset by fiscal easing measures. This suggests this year's budget deficit projection is likely to fall to around -$6bn (from a projection of -$14.5bn in the May Budget) and the 2019-20 surplus on unchanged policies will be projected to be around +$11bn (up from $2.2bn in May) with future surpluses looking even stronger. This is likely to enable the Government to announce $9bn in income tax cuts and other pre-election goodies starting in July 2019 and still maintain a surplus projection for 2019-20. The big risk of course is that the revenue windfall is not sustained as slower Chinese growth weighs on commodity prices, jobs growth slows and wages growth remains weak. The upside of bigger and earlier income tax cuts is that it will inject a bit of spending power into household budgets providing a partial offset to what looks like being an intensifying negative wealth effect from falling house prices on consumer spending next year. So, while we see pretty constrained consumer spending growth next year its not all doom and gloom.

Major global economic events and implications

US data releases over the last week were mixed. On the weak side home prices rose only slightly in September, home sales fell in October, the goods trade deficit deteriorated again in October and jobless claims rose again (although they remain very low). But against this, growth in consumer spending and income was solid in October, consumer confidence fell slight in November but remains around an 18-year high and Black Friday retail sales look to have been strong. Meanwhile, core inflation fell back to 1.8% year on year in October suggesting inflation may have peaked and providing plenty of scope for a Fed rate pause at some point next year.

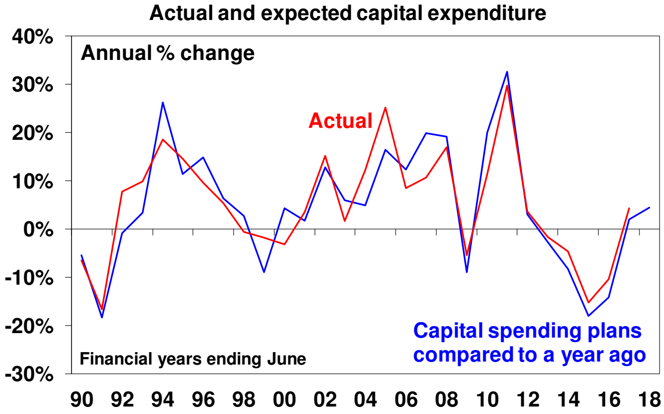
Eurozone sentiment slipped for the 11th month in a row in November, unemployment was unchanged at 8.1% in October, bank lending slowed and core inflation surprisingly fell back to just 1%yoy in November all of which will keep the ECB cautious.

Japanese jobs data slowed a bit in October but remains strong, industrial production rebounded after weather disruptions and core inflation measures in Tokyo tracked sideways at a low level. Ultra-easy Bank of Japan monetary policy will continue.

Chinese official PMIs softened further in November and momentum in industrial profits continued to slow in October which is all consistent with a further gradual slowing in growth and points to a more vigorous ramp up in policy stimulus.

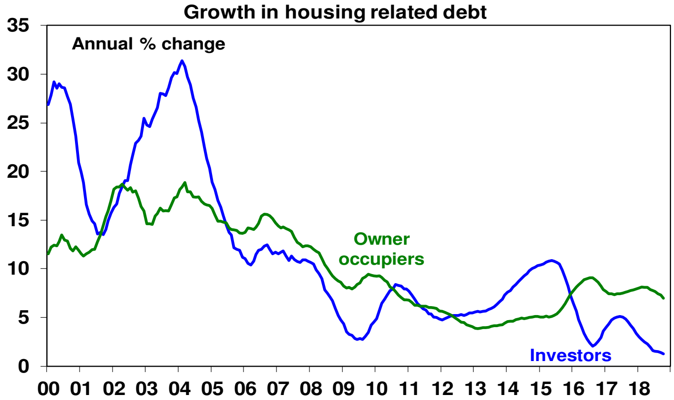
Australian economic events and implications

Australia data released over the last week was messy with a sharp fall in September quarter construction activity that was broad based across residential and non-residential building and engineering activity, a fall in September quarter private new capital expenditure and continuing softness in credit growth. There was good news though in that business investment plans for the current financial year continue to improve with capital spending plans compared to a year ago growing at their fastest in six years as the slump in mining investment slows but non-mining investment improves. So, business investment should help provide an offset to the downturn in the housing cycle.



Source: ABS, AMP Capital

Credit growth remained soft in October with credit to property investors growing at its slowest on record and owner occupier credit continuing to slow. Fortunately, business credit growth has picked up possibly reflective of stronger investment.



Source: RBA, AMP Capital

What to watch over the next week?

Reaction to the outcome of the meeting between President Trump and Xi Jinping at the G20 summit will be a key driver of markets in the week ahead.

In the US, jobs data to be released Friday will be the focus. Expect to see another solid gain in payrolls of around 200,000, unemployment remaining at 3.7% and wages growth rising to around 3.2% year on year. In other data expect the November ISM manufacturing conditions index (Monday) to edge down to a still strong 57.5, the non-manufacturing conditions ISM index (Wednesday) to edge down to 59.5 and the trade deficit (Thursday) to widen slightly, Congressional testimony by Fed Chair Powell (Wednesday) will likely reinforce the impression that its becoming open to a pause in rate hikes next year and the Fed's Beige Book of anecdotal comments will be released the same day.

There is also another bout of shutdown risk in the US in the week ahead with the need for another "continuing government funding resolution" to avoid another US government shutdown from December 7 - this could create a bit of noise given

Trump's past threats to shut down the government if he doesn't get funding for his wall – but ultimately an extended shutdown in the run up to Christmas is in neither sides interest. And a lot of spending measures have already been approved so the scale of any shutdown will be small with little economic impact.

China's Caixin manufacturing conditions index (Monday) will likely remain soft.

OPEC's meeting on Thursday is likely to agree to production cuts designed to end the rout in oil prices since early October.

In Australia the RBA will leave rates on hold for the 26th meeting in a row. The RBA remains between a rock and a hard place on rates. Strong infrastructure spending, improving non-mining investment, a lessening drag from falling mining investment, strong export earnings and a fall in unemployment to 5% are all good news. But against this the housing cycle has turned down, this will act as a drag on housing construction and consumer spending via a negative wealth effect, credit conditions are tightening, wages growth remains weak, inflation is below target and share market volatility is highlighting risks to the global outlook which is a potential threat to confidence and export earnings. So yet again the RBA will remain on hold. We remain of the view that rates will be on hold out to second half 2020 at least with a rising risk that the next move will be a cut before a hike.

On the data front expect a continuing slide in home prices for November and a 1% decline in building approvals for October (both due Monday), trade data (Tuesday) to show a 0.2 percent contribution from net exports to September quarter GDP growth, September quarter GDP growth (Wednesday) to come in at 0.6% quarter on quarter or 3.3% year on year helped by solid net exports and public demand but soft consumer spending and dwelling investment and weak business investment, October retail sales to rise by 0.3% and the trade surplus to fall back to $2.9bn (both due Thursday).

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 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 (albeit at a slower rate next year).

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 and the Fed moves towards a pause on rate hikes and trade war risks recede. However, beyond a near term bounce the $A likely still has more downside into the $US0.60s as the gap between the RBA's cash rate and the US Fed Funds rate will likely push further into negative territory. Being short the $A remains a good hedge against things going wrong globally.