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Investment markets and key developments over the past week

The last week saw US shares hit a new record high but end the week down 0.4%, Eurozone shares fell 0.5% with a bit of profit taking after the French election but Australian shares were flat and Chinese shares rose 0.1% and Japanese shares gained 2.3%. Bond yields generally fell slightly in major countries despite good economic data and commodity prices were mixed with oil up (on lower US stockpiles) but copper and iron ore were down. The latter and a rise in the $US weighed on the Australian dollar.

The French presidential election panned out even a bit better than the polls indicated with Macron winning 66% of the vote. Coming on the back of the Spanish, Austrian and Dutch elections it is clear that Eurozone countries continue to reject the nationalism and populism evident in the Brexit and US elections. France under Macron is likely to move down a path of economic reform, openness and working with Germany to strengthen the Eurozone. This is good for France, Europe and the Euro but because the French outcome had largely been factored in after the first round vote there was a bit of "selling on the fact" in the last week. The focus now turns to the June 11 and 18 parliamentary elections in France which are likely to see an outcome where Macron's La Republique En Marche party takes the most or maybe even a majority of seats and a centrist reformist government is supported and then the German election in September where Merkel is looking stronger and support for the nationalist AFD is trivial. So political risk in Europe has declined. It will ramp up ahead of the Italian election next year though - but even there it's doubtful Italy will leave the Euro. Despite the diminished political risk in Europe for now, the absence of higher underlying inflation pressures means the ECB is unlikely to back away from current supportive monetary policy settings any time soon. As ECB President Mario Draghi has pointed out its "too early to declare success" in lifting inflation. This is all good for Eurozone shares which should benefit from attractive relative valuations, rising economic growth and profits and a stimulatory ECB. Even Greece is looking good by the way.

In the US the political risk around the Trump Administration rose a notch with the firing of FBI director James Comey in the midst of the FBI's investigation into the links between Russia and the Trump presidential campaign. At this stage this is just a political and not an economic/financial issue. But to the extent that it adds to the risks around the GOP losing the House and Senate after next year's mid-terms and the risk of a Trump impeachment thereafter, if anything it actually increases the pressure on the Republicans to pass healthcare and tax reform quickly. However, while these measures are not planned to require any Democrat support in the Senate, measures that do require Democrat support (eg, Dodd Frank regulatory changes, ramped up infrastructure related spending) are looking less and less likely to pass.

In Australia, the Federal Budget signalled a further shift from austerity to populism. The big positives include new spending measures being funded, retention of the target to return to surplus by 2020-21, a further ramp up in needed infrastructure spending and a more comprehensive than expected housing affordability package which may not make much short term difference but could have a big impact on a 3 to 5 year time frame if the plan to reward states for meeting housing supply targets is implemented. The negatives though include a 12 year run of budget deficits that swamp anything seen in the past (and I worry that increasingly no one seems to really care), very optimistic revenue assumptions which point to another delay in reaching the surplus target, a risk that some of the infrastructure projects will see "good debt" become "bad", a big element of tax and spend and a populist tax on big banks which some say begs the question of which sector might be next?

The danger is that the focus on levy/tax hikes has opened the door to further tax increases as part of a compromise to pass the Budget through the Senate with the Opposition proposing that the 2% budget repair levy be continued for high income earners on top of a 0.5% increase in the Medicare levy taking the top tax rate to 49.5%. The danger is that the Australian personal tax system is already highly progressive with the top 3% of taxpayers already contributing around 30% of the income tax revenue raised by Canberra. A top rate of 49.5% would be at the high end of comparable countries and compares to just 33% in New Zealand, 22% in Singapore and 15% in Hong Kong. Not great for incentive.

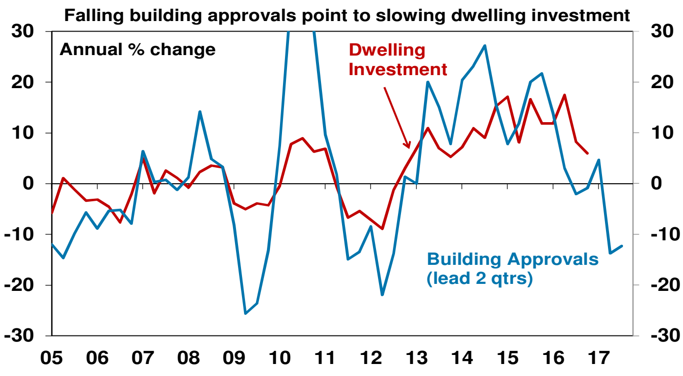
Major global economic events and implications

US data remains consistent with strong economic conditions with: a solid April retail sales report; continued strength in consumer sentiment; job openings, hiring and people quitting for other jobs remaining high; jobless claims remaining ultra-low; and small business optimism remaining about as strong as it's ever been. Meanwhile, underlying consumer price inflation was weaker than expected in April and fell to 1.9% year on year after being as high as 2.3% in January. Solid economic data keeps the Fed on track to hike rates again in June and September, but soft inflation means that it will remain gradual.

A slowing in Chinese export and import growth is consistent with some recent loss of momentum in China (although prior months were too strong to be believed) and slowing producer price inflation as the surge in commodity prices drops out points to slowing nominal growth. Chinese data runs hot and cold and after the heat of late last year and early this year the authorities have tapped the brakes. However, there is little tolerance for much of a slowdown so if things slow too much it won't take much to shift back to the accelerator.

Australian economic events and implications

Risk of another GDP contraction in the March quarter. Australian economic data was a mixed bag with strong readings for business confidence and ANZ job ads but a further leg down in building approvals and very soft retail sales. The peak in building approvals is now well behind us and this will show in slowing growth in dwelling construction activity this year and a contraction next year.



Source: Bloomberg, AMP Capital

More immediately, the weakness in March quarter real retail sales (up just 0.1% quarter on quarter), coming on the back of the previous week's data showing that net exports will likely detract from growth again in the March quarter, points to the risk of a very weak and maybe even negative March quarter GDP outcome. Which in turn highlights downside risks to the Government's growth (and wages) assumptions. More importantly with the Budget providing no net stimulus to the economy (in fact it's a detraction) it still falls to the RBA to do the heavy lifting on the economy and on this front soft recent data and the implications for inflation make it clear that another rate cut in Australia is far more likely than a rate hike this year. With housing set to slow at a time when mining investment is still falling (albeit with a lessening impact), public investment spending and a strong contribution to growth from services exports like tourism and higher education are critically important. The latter points to the ongoing need for a lower $A - which I see falling below $US0.70 by year end.

What to watch over the next week?

In the US expect to see the NAHB home builders' conditions index (Monday) remain strong, April housing starts post a solid rebound after a weather affected decline in March and continued growth in industrial production (both due Tuesday). New York and Philadelphia regional manufacturing conditions surveys will also be released.

Japanese GDP growth for the March quarter (Thursday) is expected to show continued modest growth of 0.4% quarter on quarter or 1.8% year on year.

Chinese economic activity data for April to be released on Monday is expected to show a slight softening after recent strength as tightening policies start to bring growth back into line with target. Expect to see growth in industrial production slow from 7.6% year on year to 7.1%, fixed asset investment slow to 9.1% (from 9.2%) but retail sales growth remain at 10.9%.

In Australia, March housing finance data (Monday) is expected to show a slight gain after falling in February, the minutes from the RBA's last board meeting (Tuesday) are likely to confirm a basically neutral bias on interest rates, March quarter wages growth is expected to be 0.5% leaving annual growth at a record low of 1.9% year on year and consumer confidence will be watched for any boost from the Budget (both Wednesday) and April employment data (Thursday) is expected to show a 5,000 gain after a massive rise in March with unemployment remaining around 5.9%.

Outlook for markets

Shares remain vulnerable to a short term setback as we come into weaker seasonal months (remember the old saving "sell in May and go away and come back on St Leger's Day") with risks around North Korea, the latest softening in Chinese growth and commodity demand and worries ahead of the Fed's next hike next month. However, with valuations remaining okay – particularly outside of the US, global monetary conditions remaining easy and profits improving on the back of stronger global growth, we continue to see any pullback in shares as an opportunity to "buy the dips". Shares are likely to trend higher on a 6-12 month horizon.

Low yields and capital losses from a gradual rise in bond yields are likely to see low returns from bonds. A resumption of the bond bear market looks to be getting underway and this is likely to see a gradual rise in yields.

Unlisted commercial property and infrastructure are likely to continue benefitting from the ongoing search for yield, but this demand will wane as bond yields trend higher.

National residential property price gains are expected to slow, as the heat comes out of Sydney and Melbourne.

Cash and bank deposits are likely to continue to provide poor returns, with term deposit rates running around 2.5%.

For the past year the $A has been range bound between $US0.72 and $US0.78, but our view remains that the downtrend in the $A from 2011 will resume this year. The rebound in the $A from the low early last year of near $0.68 has lacked upside momentum, the interest rate differential in favour of Australia is continuing to narrow and will likely reach zero early next year (as the Fed hikes rates and the RBA holds) and constrained commodity prices will also act as a drag. Expect a fall below $US0.70 by year end.