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

Investment markets and key developments over the past week

Share markets mostly declined over the last week, with US shares down 0.3%, Eurozone shares down 0.2% and Japanese shares down 0.8%. Australian shares lost 1.9% as worries about the economy weighed particularly on consumer stocks and lower oil prices weighed on energy shares. Chinese shares were an exception and rose 2.6%. Bond yields rose slightly in the US but fell elsewhere. Despite falling prices for oil and iron ore and a rise in the $US, the $A surprisingly rose.

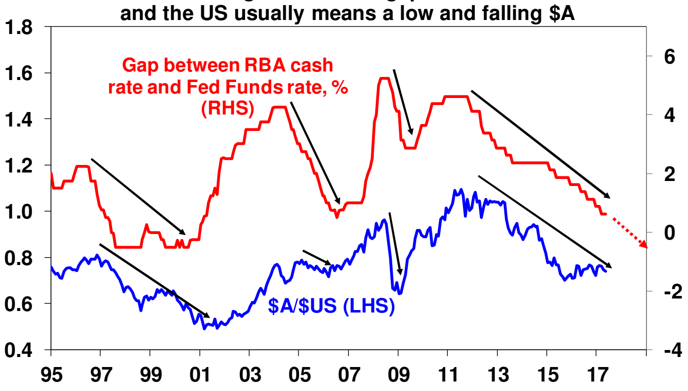
UK election upset – messy for the UK, not much impact globally. Not helped by a bunch of mis-steps and a backlash against austerity and PM May's approach to Brexit (and maybe even Brexit itself), the Tories lost their majority forcing them to form a coalition with Northern Ireland's Democratic Unionist Party in order govern. This puts a cloud over Theresa May and its Brexit negotiations. As with the Brexit vote, the uncertainty is being dealt with by a plunge in the pound, which is again helping the British share market. If anything the election outcome likely increases the probability of a soft Brexit – which may be good for the UK economy (and perceptions across Europe). However, from a big picture perspective the UK is just 2.5% of world GDP and it's hard to see significant implications for global investment markets. Just noise - unless of course you are in the UK or have a big exposure there!

Former FBI head James Comey's congressional testimony hasn't changed the risks around President Trump. It contained nothing really new and no "smoking gun". Democrats may want to see Trump impeached, but it won't have convinced Republicans that he should be and they have comfortable control of the House of Representatives where impeachment would start. As the chance of impeachment is low for now but this may change once the Democrats, as looks likely, get control of the House after the November 2018 midterms. In the meantime, the pressure remains on the Republican's to get the key elements of their agenda - tax reform and tax cuts, deregulation, Obamacare reform - passed before they lose control of Congress and our base case remains that they will.

Upside risks to oil and gas prices from a boycott of Qatar and a new flare up of the Iran (Shia)/Saudi (Sunni) tensions are overstated. Tensions erupted in the Middle East between several Arab countries led by Saudi Arabia imposing a boycott on Qatar over the latter's support for extremists and IS (which is Sunni and seen by some as "aligned" to Saudi Arabia) undertaking a terrorist attack in Iran. Putting aside the debate about who is supporting extremists - some say both sides are - the tensions pose some upside risks to oil and gas prices. Qatar accounts for about 1% of world oil production and much more in relation to gas. But both are shipped via sea as opposed to through Saudi Arabia and are so far unaffected by the boycott. Both Iran and Saudi Arabia are big oil producers but unless their supplies are disrupted due to war (which is most unlikely) it's hard to see much impact from Saudi/Iran tensions. In fact, the oil price fell over the last week, due to rising US oil stockpiles. A diplomatic solution is likely around Qatar and the Sunni/Shia conflict will likely just continue to bubble along but without direct Saudi/Iran conflict, but upside pressure on oil and gas prices may rise if the boycott does start to affect Qatar's energy exports.

Australia saw relief over the last week in that the economy did not contract again in the March quarter, as had been feared, allowing it to rack up 103 quarters without a recession. All good, but it would be wrong to get too excited. Growth was just 0.3% quarter on quarter and annual growth slowed to 1.7% year on year, its lowest since the GFC. Yes, bad weather disrupted housing construction and trade and this will pass. But the weather impact on trade will actually worsen in the current quarter resulting in another quarter of poor growth. More fundamentally consumer spending is heavily constrained by record low wages growth and high levels of underemployment resulting in household disposable income growth of just 1.8% over the last 12 months at a time when the contribution to growth from housing construction and the wealth effects from home price gains are likely to slow. Strong public infrastructure spending, an eventual return to trade contributing to growth and a lessening in the detraction from mining investment should all ensure that Australia will avoid a much predicted recession. However, growth is likely to remain subdued and well below Government and RBA expectations for a return to 3% posing downside risks to the inflation outlook. As a result, we remain of the view that the chance of an interest rate hike any time soon is very low and the probability of another rate cut before year end has pushed up to around 40-50%. Yes, the RBA remains reluctant to cut rates again and showed no signs of an easing bias in its June post meeting Statement, but then again it's been a reluctant rate cutter all the way down since 2011. Ideally given the declining potency of monetary easing this should be a time for tax cuts and growth enhancing structural reforms like de-regulation but it's hard to see this coming out of Canberra. For investors all this highlights the desirability of maintaining a decent exposure to global shares relative to Australian shares and doing so on an unhedged basis as rising rates in the US at a time of flat or falling rates in Australia will maintain downwards pressure on the $A. See the next chart.

A low and falling interest rate gap between Australia and the US usually means a low and falling $A



Source: Bloomberg, AMP Capital

Major global economic events and implications

US data remains solid with the May services conditions ISM index remaining strong and job vacancies rising to record levels and unemployment claims remaining ultra-low telling us that the labour market remains very tight.

As expected, the ECB made no changes to monetary policy. Its risk assessment regarding growth was revised up to balanced but President Draghi remains dovish on the back of underlying inflation remaining well below target. Later this year it may announce a tapering of its quantitative easing program through 2018 but political risk around Italy will make it wary of moving quickly. March quarter Eurozone GDP growth was revised up to 0.6% from 0.5% taking annual growth to 1.9%, reinforcing other indicators pointing to stronger growth.

Services conditions improved in Japan in May according to the Markit PMI adding to confidence regarding Japanese economic growth. While March quarter GDP growth was revised down to 0.3% quarter on quarter from 0.5% this was due to weaker inventories and is positive for future growth.

Chinese exports and imports surprised on the upside in May telling us overall economic growth is solid. Chinese CPI inflation rose in May to 1.5% year on year, but producer price inflation fell to 5.5% from 6.4% as the commodity price surge a year ago drops out. No pressure for PBOC tightening here.

Australian economic events and implications

Apart from news of soft March quarter GDP growth, there was good and bad news on the trade front in Australia. The March quarter current account deficit fell to just 0.7% of GDP its lowest since 1979, but as a collapse in the April trade surplus attests this won't be sustained in the current quarter as coal exports have been hit by Cyclone Debbie and capacity constraints will prevent the disruption being made up for in May and June and more fundamentally iron ore and coal prices are now well off their highs from earlier this year. Meanwhile, ANZ job ads continued to grow in May pointing to continued solid jobs growth for now but housing finance fell in April as bank rate hikes and APRA moves start to impact reinforcing the view that the Sydney and Melbourne property markets have peaked (at least in terms of price growth).

While the Fair Work Commission announced a 3.3% increase in the minimum wage the impact is likely to be minor. Only 2.3 million works are on awards and maybe only a few percent of all workers are on the minimum rate. Australian wages need to accelerate but raising them by decree won't do the job when what's needed is more demand in the economy.

What to watch over the next week?

In the US, the Federal Reserve (Wednesday) is expected to raise interest rates again for the fourth time in this tightening cycle taking the Fed Funds rate to a range of 1.00-1.25%. However, this is widely expected so the focus is likely to be on the tone of the post meeting statement, Fed Chair Yellen's press conference comments and the so-called dot plot of Fed member's interest rate expectations. We expect the Fed to signal that it expects to raise rates once more this year, probably in September, and to start letting its bond holdings decline from late this year by phasing down the rolling over of maturing bonds. However, it is likely to stress that further tightening remains contingent on activity and inflation improving and that the process will remain gradual. In view of recent softer wages and inflation data it may even revise down the dot plot of interest rate expectations. All up the Fed is likely to remain relatively benign for investors.

On the data front in the US, expect May core consumer price inflation (Wednesday) to remain around 1.9% year on year, underlying retail sales growth (also Wednesday) to have remained solid in April, industrial production to be flat and the June home builders' conditions index (both Thursday) to remain strong and housing starts (Friday) to rebound by 4%.

In France the first round of the parliamentary elections (June 11) is likely to see President Macron's La Republique en Marche (The Republic on the Move) party in reach of an absolute majority in the final round election on June 18 or at least being able to govern with moderate Republicans or Socialists. Polls point to LREM winning more than 300 of the 577 lower house seats. Which in turn will enable Macron to implement his market oriented reform agenda starting with labour market reforms, and ultimately paving the way for German/French led moves to strengthen the Eurozone.

The Bank of England also meets Thursday and is unlikely to make any changes to monetary policy and likewise the Bank of Japan (Friday) which is basically on autopilot.

Chinese activity data for May (Wednesday) is expected to show industrial production remaining at 6.5% yoy, but retail sales growth picking up to 10.8% and investment slowing to 8.8%. Chinese credit data is also due for release.

In Australia, the NAB business survey's confidence and conditions readings (Tuesday) will be watched for any slippage from high levels seen in May, consumer confidence (Wednesday) is likely to remain sub-par and May labour force data (Thursday) is likely to show slowing jobs growth.

Outlook for markets

Shares remain vulnerable to a short term setback as we are now in a weaker seasonal period for shares with risks around Trump, North Korea, Chinese growth, the Fed, the Middle East and the Australian economy all providing potential triggers.

However, with valuations remaining okay – particularly outside of the US, global monetary conditions remaining easy & profits improving on the back of stronger global growth, we continue to see the broad 6-12 month trend in shares remaining up.

Low yields point to low returns from sovereign bonds.

Unlisted commercial property and infrastructure are likely to continue benefitting from the ongoing search for yield, but this will wane eventually 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%.

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 or cuts) and commodity prices will also act as a drag (particularly the plunge in the iron ore price). Expect a fall below $US0.70 by year end.