AMP CAPITAL

16 June 2017

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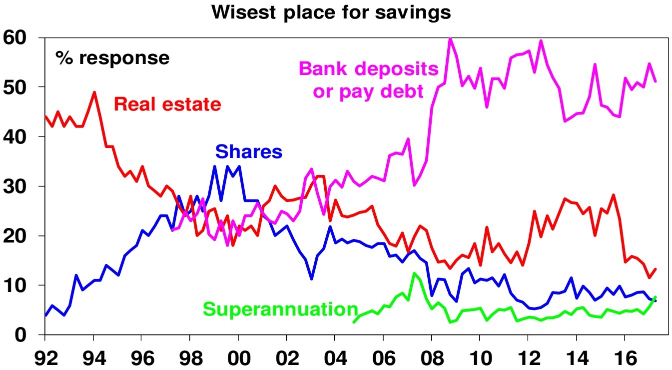
Investment markets and key developments over the past week

Global share markets were soft over the last week with US shares up just 0.1% as tech stocks continued to correct, Eurozone shares down 0.8%, Japanese shares down 0.4% and Chinese shares down 1.6%. Australian shares managed a decent 1.7% rebound, as they were due a bounce after having fallen 5% from early May highs and fund flows into superannuation ahead of a June 30 deadline for some members are likely providing a strong source of demand which is likely to intensify into month end. Bond yields fell in the US on low US inflation data but were little changed elsewhere. Prices for oil, gold and copper fell but iron ore managed a gain. The $A also had a bounce thanks to stronger Australian jobs data.

On the superannuation boost to Australian shares this month, it's interesting to note that while Australian consumers remain sceptical about shares as the "wisest place for their savings" their interest in superannuation has picked up (albeit from a low base) presumably in response to recent super reforms which allow for large one-off contributions prior to June 30. Something similar was seen in mid-2007. It's also noteworthy how sceptical Australian's remain of real estate (relative to the historical norm) according to the survey. But this has been the case for more than a year now and it didn't stop further gains in Sydney and Melbourne property prices.



Source: Westpac/Melbourne Institute, AMP Capital

The Federal Reserve provided no surprises with its fourth rate hike this cycle, no change to the so-called dot plot path for expected future interest rate hikes, some details around how it will slow reinvesting in bonds as they mature to allow its balance sheet to start returning to normal and the usual assurances that the removal of easy money will be gradual and conditional on the economy behaving as expected. Our view is that the Fed will hike rates once more this year in September and commence balance sheet reduction in the December quarter. However, ongoing benign inflation is likely to see a slower path of rate hikes in 2018 and 2019 than the dot plot is implying. The absence of significant upside inflation pressures mean the Fed will remain benign and unlikely to pose a threat to US or global growth and hence share markets.

In some ways the situation in the US resembles the bond conundrum that Fed Chair Alan Greenspan observed in 2005. Tightening monetary policy and yet falling or low bond yields at the same time as a strong share market. While this might seem contradictory then as now it reflects reasonable growth but low inflation. Of course back then bond yields did eventually rise but it morphed into what was commonly called "goldilocks", "pleasantville" or "the great moderation". Ultimately it came to an end after excessive risk taking but it lasted for longer than many expected.

The noise around President Trump and Russia links continues with talk that Trump was thinking of sacking Special Counsel Bob Mueller who is investigating the links and then news that Mueller was looking into a possible obstruction of justice by Trump the leak of which may have been motivated to get Trump to back off. All of which saw an amusing tweet from Trump: "They made up a phony collusion with the Russians story, found zero proof, so now they go for obstruction of justice on the phony story. Nice." Mueller's probe will probably find something somewhere even if it is not related to the Russia link. Reminds me a bit of the twists that the investigation into President Clinton took from Whitewater to Monica Lewinsky. Our view remains that while the Democrats may find something to impeach Trump on when they get control of the House of Representatives after the November 2018 mid-terms, in the meantime the Republicans are unlikely to impeach Trump. Rather anticipation of the likely loss of control of Congress after November next year will see Republicans pull together to pass their pro-business agenda including around healthcare and tax reforms. The shooting of Republican Congressional members only adds to this.

A likely parliamentary majority for President Macron's Republic on the Move party at Sunday's final round French parliamentary election is probably already factored in by markets. Nevertheless, it will be a momentous occasion with the French about to head down a market oriented reform path starting with labour market reforms, and clearing the way for France to work with Germany to strengthen the Eurozone. The French elections coming on the back of pro-Euro outcomes in Spain, Austria and the Netherlands and almost certainly in Germany highlight diminishing political risk in the Eurozone. While Italy remains a risk, the waning of populist support across Europe may have a spill over in Italy, the Eurosceptic Five Star Movement is unlikely to be able to form government and in any case the risk of a domino like flow on from Italy to the rest of the Eurozone looks to be in retreat. Similarly, while Catalonia in Spain is aiming to have another independence referendum in October it should be noted that polls of Catalonians show that most favour more autonomy within Spain, not independence. All of which along with attractive valuations and a supportive ECB is positive for Eurozone shares.

Major global economic events and implications

US data was a bit messy but consistent with reasonable growth and continuing low inflation. May retail sales were soft but already solid April sales were revised up and in any case regional manufacturing conditions surveys were strong in June, small business optimism remains very high, home builder conditions remain strong and unemployment claims remain around their lowest since the early 1970s. May housing starts were weak but are likely to bounce back given strength in other housing related indicators. Meanwhile, core CPI inflation was weaker than expected in May at 1.7% year on year. The US economy continues to look good but the lack of inflation pressure means the Fed can afford to remain gradual.

The Bank of England left rates on hold but it was more hawkish than expected. The risk of a rate hike has gone up, but Brexit uncertainty will keep the BoE on hold for a while yet.

The Bank of Japan remained on autopilot as expected as it has committed to continuing quantitative easing and targeting a zero 10-year bond yield until inflation exceeds 2%.

Chinese activity data and credit growth for May points to growth holding up. While fixed asset investment slowed a touch growth in retail sales and industrial production was unchanged. Credit growth edged up slightly to 14.7% yoy.

India saw a nice combination of stronger than expected industrial production in April and weaker than expected inflation. It remains a bright spot in the emerging world.

Australian economic events and implications

Australian data was a bit more upbeat over the last week. While consumer confidence fell further below its long term average highlighting the negative impact of poor wages growth, high underemployment, rising electricity prices, etc on households, business conditions and confidence remained solid and jobs data surprised on the upside for the third month in a row taking the unemployment rate down to its lowest since early 2013. While the boom in jobs over the last three months should be treated with some caution, it is consistent with forward looking labour market indicators and the jobs data along with solid business conditions provide a bit of an offset to other recent more negative data. The jobs data and the NAB survey support the RBA in leaving interest rates on hold for now. But given softer data for growth, consumer spending, housing construction, non-mining investment and wages growth, our view remains that there is more risk of another rate cut than a rate hike in the next 12 months or so.

For a decade or more political dysfunction has played havoc with Australia's energy supply – as the uncertainty has led to underinvestment in new capacity by both clean and dirty sources of energy - and we are now paying the price. Not only in terms of getting our emissions down but also in terms of surging energy prices weighing on households and businesses. This is set to continue with price rises of up to 20% this year. The problem is widely recognised but unless we can put politics aside and get agreement around energy policy – with the Finkel review providing a way forward - then the problem will only worsen and we will lose businesses and jobs to countries who have got their act together on this front.

What to watch over the next week?

In the US, Markit business conditions PMIs (Friday) are likely to remain solid at around 53-54. Meanwhile, both existing home sales (Wednesday) and new home sales (Friday) are expected to rise after weakness in April and home prices are expected to show continuing strength.

Eurozone business conditions PMIs for June to be released Friday are expected to remain strong at around 56-57.

Japan's manufacturing PMI will also be released Friday.

In Australia, a speech by RBA Governor Lowe (Monday) will be watched for any clues on interest rates, albeit I don't expect any. The minutes from the RBA's last board meeting (Tuesday) will also be released with most interest likely to centre around how it sees the housing market given recent signs of a cooling in Sydney and Melbourne. March quarter ABS house price data (Tuesday) will likely show growth of around 3% quarter on quarter consistent with private surveys, but this data will be very dated given APRA's latest tightening measures came at the end of March and since then CoreLogic data has shown a distinct softening in home prices since.

Outlook for markets

Shares are still vulnerable to a short term setback as we are going through a weaker seasonal period for shares with risks around Trump, North Korea, Chinese growth, the Fed and the Australian economy all providing potential triggers. However, valuations remain okay – particularly outside of the US, global monetary conditions remain easy & profits are improving on the back of stronger global growth, so 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.