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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 and European share markets got a boost on Friday with another "goldilocks" not too hot, not too cold jobs report in the US. As a result, US shares gained 0.2% over the last week and Eurozone shares were up 1.2%. Thanks to gains earlier in the week Australian shares rose 0.3%, but Japanese shares were flat and Chinese shares lost 0.4%. Global economic and earnings news remains good, but this is partly being offset by the noise around Trump and the risks around US-China trade. Bond yields fell over the week and commodity prices were mixed with oil down but iron ore up. The $US rose helped by the solid US July payroll report and this along with a bit of RBA jawboning saw the $A fall.

Trump led US-China trade risk up another notch. As we noted a few weeks ago while the risk of a trade war between the US and China went into abeyance during the early part of Trump's Presidency its now on the rise again partly in response to tensions around North Korea and reflecting a lack of progress in US-China trade negotiations so far. Initially the focus was on steel but it looks to be moving on to a review of China's perceived violations of US intellectual property which has long been a sore point, which could end in tariffs. Our view remains that cool heads will ultimately prevail but it's a risk worth keeping an eye on, and one that may escalate if Trump's political woes continue to mount – even support for Trump amongst his core Republican base is starting to slip a bit so a ramped up populist "make America great again" campaign around trade could create a useful distraction!

Consistent with its comments over the last few weeks, the RBA has further ramped up its jawboning against the rise in the Australian dollar. It made no significant changes to its growth and inflation forecasts in its latest Statement on Monetary Policy – still seeing a shift to growth a bit above 3% but with the timing pushed out a bit and revising its headline CPI inflation forecasts up a bit on the back of rapid utility price increases but making no changes to its expectation that underlying inflation will be around 2%. However, it has clearly become concerned that the rising $A poses a threat to both its growth and inflation forecasts. We have been of the view that rates are on hold ahead of a rate hike late next year, but if the Australian dollar continues to trend higher (in contrast to our view for a move lower) it will deliver a further de facto monetary tightening and further push out the timing of rate hikes and may even put rate cuts back on the agenda. Of course, continued strength in Sydney and Melbourne property prices would work in the opposite direction but with the RBA constrained in raising rates to deal with this the pressure will simply fall back on APRA to deliver another round of measures to further tighten property lending standards.

A couple of things stand out in the latest HILDA - household income and labour dynamics in Australia - report that has tracked roughly 7000 households since 2001. First, despite all the political noise, income inequality (allowing for taxes and welfare) as measured by the Gini coefficient has changed little since 2001. But the main driver of the building angst in recent years has been a stagnation in real median household income since 2009 – which in part can be traced to record low wages growth. When your own living standard is clearly on the rise as it was for most last decade you don't worry so much about those better off than you are but when you feel like you are stagnating claims about rising inequality start to resonate. Second, homeownership rates for 18-39 year olds have fallen by roughly 10 percentage points from 35.7% in 2002 to 25.2% in 2014. Of course, this partly owes to changed demographic trends where we start everything later in life (leaving home, leaving full time study, starting work, getting married, etc) and millennial scepticism about the benefits of home ownership and having a mortgage. But poor and ever worsening housing affordability is a big factor & must be addressed if we want to avoid rising social tensions – between the "haves" and "have nots" when it comes to owning a patch of the Australian dream. Trouble is that this issue has been brewing since early last decade and it's only this year that governments have started to really take it seriously.

Major global economic events and implications

US data was solid. Business conditions ISM readings slipped in July but along with the Markit PMIs remain solid, pending home sales rose, payroll employment rose by a stronger than expected 209,000 in July and unemployment fell to 4.3%. But inflation pressures remain weak with wages growth remaining stuck at just 2.5% year on year in July and core inflation in June remaining well below target at 1.5% year on year. The strong US labour market leaves the Fed on track to continue tightening monetary policy, but weak wages growth will keep it gradual.

US June quarter earnings results remain strong. Of the 420 S&P 500 companies to have reported 77% have beaten earnings expectations and 68% have beaten on revenue. Earnings look like coming in around 12% yoy, which is almost double the initial expectation.

Eurozone economic growth picked up in the June quarter to 2.1% year on year, its fastest since 2011 and unemployment fell to 9.1% - which is high but down from a high of around 12%. Core inflation rose in July but only to 1.2% yoy.

Chinese business conditions PMIs were mixed in July - down slightly according to the official PMIs but with the Caixin manufacturing PMI up slightly and services PMI down slightly. But the moves are neither here nor there and their levels are consistent with GDP growth remaining around 6.5 to 7%.

Japanese industrial production rose in July and is up 4.9% year on year, with PMIs pointing to reasonable growth ahead.

The Reserve Bank of India cut its official cash rate by 0.25% to 6%, providing a reminder that major central banks are going in different directions with monetary policy. This is consistent with lower inflation. Indian business conditions PMIs also fell sharply in July, although this likely reflects distortions to the July 1 start-up of the goods & services tax.

Australian economic events and implications

Australian data was a mixed bag. Business conditions PMIs remained solid consistent with other readings of business confidence. Building approvals bounced strongly in June but this was mainly driven by volatile apartment approvals and a fall in new home sales to their lowest since 2013 suggests that the trend will remain down. Retail sales rose more than expected in June and real retail sales rose strongly in the June quarter providing confidence that GDP growth will bounced back from the softness seen in the March quarter. On the flip side though the trade surplus fell back sharply in June and net exports look to be a flattish contributor to June quarter GDP growth. The Melbourne Institute's Inflation Gauge showed low inflation in July, whereas I would have expected a higher rise in headline inflation on the back of higher electricity prices, suggesting that underlying inflationary pressures remain very weak.

Australian home prices continued to bounce back in July after their soft patch in April and May, particularly in Melbourne. While auction clearance rates and investor lending looks to have slowed it's still not clear that the tightening measures announced earlier this year are having a big enough impact so, given the RBA's inability to raise interest rates, further action by APRA may still be necessary.

Finally, it's too early to draw any conclusions from the start of the June half earnings reporting season as only a few companies have reported. But RIO's result has confirmed a huge upswing in 2016-17 earnings on the back of the bounce in iron ore and other commodity prices and announced a large dividend hike. That said it came in a little below expectations, so the good news had already been discounted.

What to watch over the next week?

In the US, expect small business optimism to remain solid and job openings to remain strong (both due Tuesday), headline CPI inflation (Friday) to rise to 1.8% year on year in July from 1.6%, but core inflation to remain unchanged at 1.7%. US June quarter earnings results will also continue to flow.

Chinese growth in exports and imports (Tuesday) are expected to remain strong and inflation data for July (Wednesday) is expected to show a dip in CPI inflation to 1.4% year on year and producer price inflation slipping to 5.3% as the earlier surge in commodity prices continues to drop out.

In Australia, Parliamentary testimony by RBA Governor Lowe (Friday) will be watched for further clues on the interest rate outlook but is unlikely to add much to the just released Statement on Monetary Policy. On the data front, expect the NAB business survey (Tuesday) to show continued solid business conditions and confidence, consumer confidence to remain subdued according to the Westpac consumer confidence survey (Wednesday) and housing finance data (also Wednesday) to show 1% gain for June.

The August profit reporting season will start to ramp up in the week ahead with around 20 major companies reporting including Cochlear, CBA, AMP, Newscorp and AGL. 2016-17 profits for the market as a whole are likely to have increased by around 18%, driven by a huge 135% gain in resources profits on the back of the rebound in commodity prices. Profit growth for the rest of the market is likely to be around 5.5% led by retailers, utilities, healthcare stocks and financials. As always in a low interest rate world dividends will be a key focus, but the key to watch will be on outlook statements as the current financial year won't have a repeat of the huge boost in commodity prices to resources profits.

Outlook for markets

The risk of a short term share market correction has increased: the gains in the US share market are increasingly concentrated in a few stocks; political risks in the US have escalated a bit with the Mueller inquiry intensifying and the need to avoid a government shutdown and raise the debt ceiling next month which will likely see the usual brinkmanship ahead of a solution; the risks around US-China trade seem to be increasing; North Korean risks remain; and we are in the weakest months of the year seasonally for shares. While Australian shares have already had a 5% correction from their May high it would nevertheless be vulnerable to any US/global share market pull back. **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 would see a pullback as just a correction with the broad rising trend in share markets likely to resume** through the December quarter and into 2018.

Low yields point to ongoing low returns from 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%.

The $A has pushed higher on the back of $US weakness, higher commodity prices and technical pressure. While further short term upside is possible, our view remains that the downtrend in the $A from 2011 will ultimately resume as the interest rate differential in favour of Australia is likely to continue to narrow as the Fed hikes rates and the RBA holds. The solid July US jobs report helps take a bit of pressure off the $A and hence the RBA.