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

Investment markets and key developments over the past week

Despite uncertainty about who will chair the Fed and tax reform in the US, 59 shot dead and over 500 injured in another terrible US mass shooting in Las Vegas, a political crisis in Spain and the ongoing issue around North Korea, global share markets continued to climb the classic wall of worry over the last week. Why? Put simply the global economy is looking stronger and stronger and this is driving profits all at a time when inflation and central banks remain relatively benign. US shares rose 1.2% over the last week with gains being pared on Friday after North Korean tensions flared up again, Eurozone shares rose 0.2% and Japanese shares gained 1.6%. Australian shares rose 0.5% but remain big underperformers year to date reflecting a relatively less positive growth and profit outlook. Bond yields were mixed: up in the US, flat in Japan and Germany but up in Spain and Italy after the Catalan mess and down in Australia. While metal and iron ore prices rose, oil and gold prices fell. The $A also fell back below $US0.78 as the $US continued to recover.

US jobs data for September was messy thanks to the hurricanes and the Fed will look through it. Payrolls fell by 33,000 but this was entirely due to hurricanes. Expect a rebound this month: the household employment survey (which is less affected by the weather) remained very strong and showed a fall in unemployment to 4.2%; jobless claims are falling again in Texas and Florida; and the ISM business surveys point to continued strong employment growth. Meanwhile, although average wages were likely also boosted in September by the hurricanes (with a loss of low paying services jobs) the underlying trend in wages growth has picked up. As a result of all these considerations the Fed remains on track to hike rates again in December.

Expect increasing focus on who will be the next Fed Chair as President Trump will reportedly make an announcement on his choice in the next couple of weeks. But it's doubtful it will make much difference to what the Fed does in the next year or so. The list of people reportedly being considered for chair includes some monetary policy hawks (John Taylor who advocates a rules based approach for the Fed and Kevin Warsh who was a relative hawkish Fed Governor over 2006 to 2011) and some who are likely to be neutral/dovish (current chair Janet Yellen, current Fed Governor Jay Powell and Trump economic adviser Gary Cohn). In the interest of having one less source of instability I would argue it's in Trump's interest to reappoint Janet Yellen but her views on financial regulation may work against that. However, with the Fed already on a tightening path (it has already announced a schedule for reducing its balance sheet and is on track for more interest rate hikes) it's doubtful that whoever is appointed will take a significantly different direction for US monetary policy over the next year or two compared to what would occur under Janet Yellen. The real test may come during the next crisis when a hawkish Fed Chair may be slower to react.

The political mess in Spain around Catalonia is likely to go on for a while yet, but is unlikely to be major issue for the Eurozone. The heavy handed attempt by the Spanish Government to stop the referendum has inflamed the situation and Catalonia may make a unilateral declaration of independence even though the referendum – with only a 42% turnout – didn't provide a clear mandate. Quite clearly, it poses political and economic risks for Spain and risks a further increase in Spanish bond yields and downside for its share market. However, it would be wrong to read too much into the Catalan crisis. First, a Catalan declaration of independence won't really mean much as it won't have any legal standing and will receive little international recognition including by the European Union. Second, Catalans are unlikely to rise up and use force to back any declaration of independence as most don't want complete independence. Don't forget the Catalan Government is a coalition of left and right parties unified only by a quest for independence that did not win the popular vote in the 2015 regional election. 55% of Catalans identify more with Spanish as a language rather than Catalan. Third, the damage to the Catalan economy (which accounts for 20% of Spanish output) could be immense as the European Commission has indicated it would be outside the EU cutting off much of its trade were it to become independent. Finally, the issue is not about the survivability of the Euro with Catalonia wishing to remain in it (albeit it would have to apply anew to re-enter if it does become independent). However, to the extent that the conflict threatens growth in the Eurozone's fourth largest economy it may contribute to a delay by the ECB in terms of reducing monetary stimulus. Fortunately, the separatist movement is divided with signs that some separatists want to delay a unilateral declaration of independence and to negotiate. Overall, we remain of the view it will be a long time before this issue is fully settled, but in the meantime while it puts a cloud over Spain it has little to do with the survivability of the Euro.

The upcoming Communist Party Congress in China (starting October 18) is generating much anticipation. President Xi Jinping is almost certain to continue as General Secretary and Premier Li Keqiang will likely continue as well, but leadership will be renewed around them with the popular President Xi seeing his authority enhanced. Post the Congress we may see a refocus on reform but it's doubtful that there will be an abrupt policy change and as we have seen over the first five years of President Xi's leadership there will be a careful balancing of reform and maintaining growth.

Major global economic events and implications

US data remains strong. September jobs data was hit by the hurricanes but a rebound is likely this month, the ISM business conditions indexes rose to very strong levels in September (no hurricane dip here) with very strong readings on employment plans and auto sales surged in September (although this may reflect hurricane replacement demand). This is all consistent with another Fed rate hike in December with the money market probability of a December move now at 79%.

Japanese data was strong with further gains in the Tankan business conditions indexes, okay readings in business conditions PMIs and a rise in consumer confidence.

Details from the People's Bank of China regarding a cut in bank required reserve ratios for lending to small business, start-ups and agricultural businesses indicate that most banks will benefit. While it should really be seen as a targeted measure to encourage entrepreneurship and innovation as opposed to being a monetary easing, it highlights that the Chinese authorities wish to maintain decent growth.

Australian economic events and implications

As expected, the RBA left interest rates on hold for the 14th month in a row and retained a basically neutral short term bias on rates. Improving global growth, strong business confidence and jobs growth, the RBA's own expectations for a growth pick up and already high levels of household debt argue against a rate cut. But record low wages growth, low underlying inflation, the impending slowdown in housing construction, risks around the consumer and the strong $A argue against a rate hike. The next move in rates is likely to be up, but for now the downside risks are still significant and as such we remain of the view that it's way too early to start raising rates just yet and don't see a rate hike until late next year.

Data releases over the last week are consistent with the RBA remaining on hold. Trade data is pointing to an ongoing contribution to growth from trade volumes and business conditions PMIs fell in September but remain solid. Against this though building approvals and new home sales point to a declining trend in dwelling construction albeit gradual and a sharp fall in August retail sales indicate that the weak consumer has returned. Meanwhile, further evidence of a loss of momentum in home prices for September suggests that this year's tightening in lending standards is working,

What to watch over the next week?

In the US, the minutes from the Fed's last meeting (Wednesday) are unlikely to add much that's new with quantitative tightening underway and the Fed likely on track for another rate hike in December (with a 70% probability according to the US money market). On the data front expect continued strength in small business confidence (Tuesday) and job openings (Wednesday), a rise in September core CPI inflation to 1.8% year on year from 1.7% (Friday) and a 1.2% rebound in retail sales (also Friday) for September after the hurricane depressed fall in August.

It's pretty quiet on the data front in Europe but there may be some noise ahead of Austrian parliamentary elections on October 15 with current polling suggesting the currently governing Social Democrats will lose to conservative People's Party who may form a coalition with the nationalist Freedom Party. Such an outcome would likely add to a tougher line on immigration across Europe and may slow European integration a bit as the German election outcome may but is unlikely to threaten the Euro with the People's Party supportive of the Euro and Freedom Party dropping demands to ditch it.

Chinese trade data for September is likely to show an acceleration in export growth to 10% year on year reflecting the strong global economy and a slight rise in import growth to 15% yoy. Money supply and credit data will also be released.

In Australia, the NAB business survey (Tuesday) will be watched for any slippage in business conditions, consumer confidence (Wednesday) is expected to remain relatively subdued and housing finance (Thursday) is expected to rise 0.5%. The RBA's semi-annual Financial Stability Review will be watched for how the RBA views recent progress in reducing financial stability risks around the property market.

Outlook for markets

This is still a seasonally volatile time of the year for shares, North Korean risks remain high and Wall Street is overdue for a decent 5% or so correction which would affect other share markets. However, **beyond short term uncertainties we remain in a sweet spot in the investment cycle – with okay valuations particularly outside of the US, solid global growth and improving profits but still benign monetary conditions – so we remain of the view that the broad trend in share markets will remain up**. This should eventually drag Australian shares up from their range bound malaise.

Low starting point bond yields and a likely rising trend in yields will likely drive poor 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.

Residential property price growth in Sydney and Melbourne is likely to have peaked with a slowdown likely over the next year or two, but Perth and Darwin are likely close to the bottom, Hobart is likely to remain strong and moderate price gains are expected to continue in Adelaide and Brisbane.

Cash and bank deposits are likely to continue to provide poor returns, with term deposit rates running around 2.25%.

While further short term upside in the $A is possible, our view remains that the downtrend from 2011 will ultimately resume as the Fed continues to tighten and the RBA remains on hold into next year.