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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 were mixed over the last week with US shares down 0.2% not helped by tax reform uncertainty and Eurozone shares down 2.3%, Japanese shares getting hit by profit taking but still managing a 0.6% rise and Chinese up 3% and Australian shares up 1.2%. Bond yields rose except in Japan. Oil, gold and iron ore prices rose but copper prices fell. The US dollar fell back a bit but the $A was little changed.

Uncertainty around US tax reform ramped up over the last week and will remain for a while yet, but the pressure on Republicans to get it or simple tax cuts done is intensifying. With the Senate releasing its version of tax reform with several differences versus the House version - notably around mortgage interest and state and local tax deductions and the start date for reducing the corporate tax rate - it's clear that there is a long way to go yet before its agreed with the House (by which time the Senate's proposed one-year delay to the corporate tax rate cut probably won't survive because the House and Trump won't support it). But this was always going to be the case, particularly given the need to constrain the cost to $US1.5 trillion over ten years. Going by the relative performance of US high tax paying companies, the US share market is now factoring in little prospect of tax reform or tax cuts. However, our view remains that it's on track.

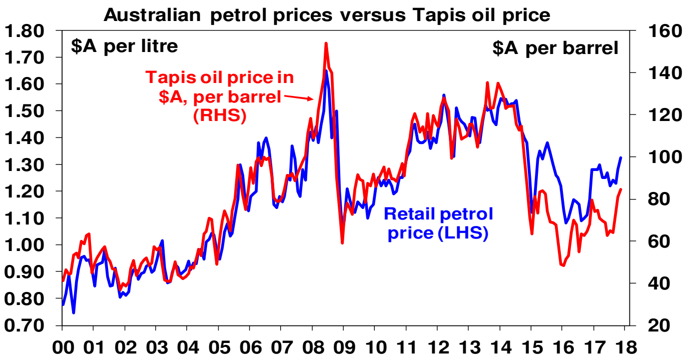
- First, unlike Obamacare reform, lower tax rates are core to Republican belief. It's what they do – think Reagan & Bush.
- Second, political pressure to get it done has intensified. Strong Democrat support in the Virginian elections and President Trump's low popularity indicate the GOP is on track to lose control of the House in the November 2018 mid-term elections. So the pressure on Republican's to get tax reform (or cuts) done to boost their chances in the mid-terms and make sure it's out of the way before they can't do it anyway – is immense.
- Third, if reform of deductions proves too hard politically the GOP can always revert to just delivering tax cuts, albeit the headline rates won't be able to come down as much.
- Finally, some Democrat senators may support it (12 did with GW Bush's first tax cuts and 3 did with the second round). (And this may be necessary if the GOP loses the December 12 Alabama Senate election where their candidate is now embroiled in a scandal.)

As such, we remain of the view that the chance of US tax reform or simple tax cuts by March 2018 is 70%. The next step is for the House to vote on their plan probably in the week ahead, then for the Senate to vote possibly before Thanksgiving (Nov 23) but this could slip until after the December 8 debt ceiling and government shutdown issues are resolved. By the time the House and Senate are able to resolve all their issues it will be early next year.

More fundamentally, while there is much interest in US tax reform, there is a danger in overemphasising its importance to the US economy in the short term. At most it might add 0.1% to US GDP growth a year over ten years, maybe a bit more in initially. So some might argue its much ado over nothing much.

It's too early to expect a negative impact on growth from rising oil prices, but they will likely put some renewed upwards pressure on headline inflation. Recent gains reflect a combination of stronger global growth driving stronger oil demand, constrained supply and worries that tension between Sunni Saudi Arabia and Shia Iran is intensifying again. However, the Saudi Arabia/Iran issue has flared up several times in recent years only to settle back down again. Our assessment remains that direct confrontation cannot be ruled out but ongoing proxy wars are more likely. But whatever, it all supports oil prices which could have more short term upside as global growth continues to improve, before supply starts to ramp up again (including from shale oil) to put a cap on prices. At this stage the rise in oil prices is not enough to threaten global growth - historically its only when the oil price rises 80% or more over a year that it causes major problems whereas at present its up only 15% year on year. But it may start to push inflation rates up again. And it's good for energy related shares.

Australia is a net oil importer but net energy exporter so it will benefit from higher energy prices (as oil prices flow through to gas prices). It's not so good for Australian consumers though. Petrol prices may have another 2-3 cents a litre upside as recent oil price increases flow through and this combined with any further upside in gas prices will be another constraint on consumer spending. (Note in the next chart that for the last three years Australian petrol prices have been running around 10 cents a litre higher than their normal relationship with oil prices would suggest – this appears to reflect higher refining margins.)



Source: Bloomberg, AMP Capital

In Australia, the citizenship issue may become an increasing drag on confidence. While it was hoped that the High Court decision would resolve the issue this has not been the case with questions about new politicians continuing to be raised, with the possibility of more by-elections adding to the risk regarding the Government's majority. The sense of malaise in Canberra that's been the norm since 2010 continues.

Just as we saw the All Ords push through the 6000 level, the ASX 200 has now followed suit. Correction risks aside our view remains that the share market has more upside ahead thanks to rising profits and benign monetary policy. The headline effect of the share market making it back through the 6000 level may also help boost interest in shares amongst ordinary Australian investors where share market scepticism has been running high. However, while the Australian share market has finally made it back above the 6000 level it has significantly underperformed global shares since 2009, this remains the case this year (with Australian shares up 6% or so but global shares up 14%%) and is likely to remain the case for some time as global earnings growth is now running around 15-20% compared to underlying earnings growth in Australia of around 5-6%.

News that my favourite social media – Twitter - has doubled its character limit to 280 has come as a shock. After six years of learning to be concise and precise on Twitter I can now waffle on in my tweets. Even pad them out with the "it could be this or it could be that" stuff so favoured by some economists. A basic axiom of economics is that "more is preferred to less" but this may be another case where more is not best. Well I guess it means less time having to cut characters when I am just over 140!

Major global economic events and implications

US data was a bit light on but job openings, hiring and workers quitting for new jobs all remain very strong and unemployment claims remain ultra low consistent with a tight labour market and rising wage pressures. Meanwhile, the September quarter earnings reporting season is now largely complete with 91% of S&P 500 companies having reported. Companies have continued to surprise on the upside with 77% beating on earnings and 67% beating on sales. Earnings growth for the quarter has come in around 7% year on year, which is up from 4% a month ago and would have been closer to 10% were it not for the hurricanes.

Japanese wages growth picked in September but only to 0.9% year on year and it's just back to where it was 18 months or so ago, so there is a fair way to go to be able to call it a sustained inflation driving pick up. Meanwhile, Tokyo office vacancies fell to an ultra-low 3% in October.

Chinese export and import growth slowed slightly in October but remains consistent with solid growth and foreign exchange data implies that capital outflow remains under control. Chinese consumer and producer price inflation came in a bit stronger than expected but not alarmingly so – core CPI inflation of 2.3% year on year is still low for an emerging country. It's consistent with no PBOC easing though and points to solid nominal growth in China. Meanwhile, the announcement of a significant expansion in foreign access to the Chinese financial sector highlights that reform momentum is ramping up post the Party Congress.

Australian economic events and implications

RBA on hold and revises down its inflation forecasts yet again. While the RBA's Statement on Monetary Policy remains relatively upbeat and still sees 3% plus growth by the end of next year, it slightly downgraded its growth forecasts and revised down its inflation forecasts by 0.25% to 0.5% seeing underlying inflation remaining below target for longer. The downwards revision to the RBA's inflation forecasts reflects the ABS's new CPI weights that correct for "substitution bias" (which sees increasing spending on things that fall in price like computers and reduced spending on items that go up a lot in price like tobacco), but regardless it all means that inflation is expected to take longer to get back to target, which in turn runs the risk that low inflation expectations will just get further entrenched making it even harder to get inflation back up again and increasing the risk of deflation the next time the economy slows down. All of which means low interest rates for longer. Improving global growth and the RBA's own forecasts for stronger growth along with solid business conditions and employment growth continue to argue against rate cuts. But ongoing low inflation and wages growth, uncertainty around consumer spending, signs that the housing cycle is slowing and the still strong $A argue against a rate hike. **We remain of the view that the RBA will leave the cash rate on hold until a probable rate hike late next year. The risk is that rates won't start rising until 2019 though**.

On the data front in Australia, ANZ job ads showed good growth in October suggesting the labour market remains solid, but a further 6% plunge in housing finance commitments to investors in September highlights that APRA tightening measures are continuing to bite. Falling investor housing finance, falling auction clearance rates along with anecdotal evidence are consistent with an ongoing slowing in the Sydney property market and to a lesser extent in Melbourne. Expect more price declines in Sydney and eventually Melbourne ahead. The good news is that there is more room now for first home buyers whose share of housing finance has risen to a five year high.

What to watch over the next week?

In the US expect to see more solid readings for: small business optimism (Tuesday); retail sales (Wednesday); industrial production and the NAHB homebuilders' conditions index (Thursday); and housing starts (Friday). The New York and Philadelphia manufacturing conditions indexes are also likely to have remained strong for November.

Against this though, core CPI inflation (Wednesday) is expected to remain at 1.7% year on year.

Japanese GDP growth for the September quarter is expected to slip back to 0.4% quarter on quarter (from 0.6%), but annual growth is likely to pick up to 1.7% yoy.

Chinese activity data for October (due Tuesday) is expected to show continuing solid growth with retail sales up 10.4% year on year, industrial production slowing to 6.4% and fixed asset investment around 7.5%.

In Australia, the key focus is likely to be wages growth (Wednesday) which should show a bit of an acceleration, to 0.7% quarter on quarter or 2.2% year on year reflecting the 3.3% increase in the minimum wage, but beyond this underlying wages growth is likely to have remained weak. Meanwhile, jobs data (Thursday) is expected to show a 10,000 decline in employment after a long period of strength and unemployment rising to 5.5%. The NAB business conditions survey (Tuesday) and the Westpac consumer sentiment index (Wednesday) will also be released.

Outlook for markets

The risk of a short term share market correction is high given recent strong gains and this may have already started in Europe and Japan. US shares have not had a decent correction since a near 5% pull back into the US election last year. Australian shares are also short term overbought after their recent break higher**. But looking beyond the short term risk of a pause or correction we are now in a favourable part of the year for shares seasonally and 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. Australian shares are likely to continue to participate in the global share rally, but remain a relative laggard thanks to a more constrained earnings outlook.

Bond yields look to be starting to break higher again, led by US bonds. 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 looks 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%.

Expect the Australian dollar to fall to around $US0.70. With the RBA on hold for the next year or so and the Fed on track to hike in December with another three or so hikes next year the interest rate differential will continue to move against Australia which should result in further weakness in the $A.