

WEEKLY MARKET UPDATE

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Investment markets and key developments over the past week

While Chinese shares rose 0.2% over the last week, US shares fell 0.1%, Eurozone shares fell 1.1%, Japanese shares lost 1.3% and Australian shares fell 1.2% with a bit of profit taking. Bond yields fell slightly as inflation news remained weak. While gold and copper prices rose slightly, iron ore was flat and the oil price fell slightly. Although the \$US slipped back a bit the \$A fell as weaker than expected wages growth further pushed out expectations for any RBA rate hike.

Uncertainty around US tax reform prospects and rising nervousness in the run up to the December 8 debt ceiling and shutdown deadline may impact markets ahead. However, both are likely to be resolved favourably providing a renewed boost to share markets when they are.

Progress on US tax reform continues, but there is a way to go yet. The past week saw the House pass its tax reform bill, the Senate will then vote on its tax bill after Thanksgiving and, assuming it passes, the Senate and House must then agree a combined bill. I have been assuming this will take into early next year but the risks for the GOP around the Alabama Senate election on December 12 may see it sped up. Either way there is still a long way to go, but our view remains that - thanks to the immense pressure on the Republicans to get either tax reform or simple tax cuts done ahead of the 2018 mid-terms (after which they may not be able to) - there is a 70% chance they will be passed by March next year. While some senators have indicated concerns, these are likely to be resolved as part of the bargaining process. At the very least tax reform or tax cuts will provide a big boost to high tax paying US companies, investors in which look to have given up on tax reform/cuts.

Resolution of the December 8 debt ceiling and shutdown deadline could cause a short delay in progress on tax reform – and several issues remain to be resolved including funding for Trump's wall - but no side of politics wants to see a shutdown or debt default so the issue will be resolved even if its last minute and/or another case of kicking the can down the road.

Should Australia be concerned about a collapse in the Chinese economy as some are warning yet again? China is Australia's number one trading partner so its more vulnerable to the Chinese economy than in the past. But warnings of a

Chinese collapse have been around for years now and I continue to regard it as unlikely. The most common concerns about high and rising debt miss the reality that China's high debt growth reflects its high saving rate which in turn gets largely channeled through the banking system as its capital markets remain underdeveloped. China does not rely on foreign capital (in fact its the opposite) and to slow its debt growth its needs to save less and spend more! Similarly concerns about its property market and commodity demand are misplaced. The "ghost cities" stories of a few years were literally just scary stories and much of China continues to have a housing shortage at the same time that many of the apartments built twenty years ago are now substandard and need to be replaced. Similarly, much of China remains under developed in terms of infrastructure, so peak raw material demand from China is a long way off. Yes, Chinese growth could slow towards 6% over the next few years but I doubt a hard landing any time soon. Certainly there was no sign of any hard landing in China when I visited it again in the last week - things were just as frantic as ever!

Its been another tumultuous week on the citizenship front for Australian politicians with more resigning and increasing concerns about the Government's majority and the risk of an early election. This is a mess...

...but at least we are making progress on getting one issue resolved with the Yes vote winning in the same sex marriage survey. Of course it's about much much more than just material economics, but once its passed into law marriage equality in Australia will likely provide a boost over time to the economy. I must admit it's very hard to estimate the magnitude of any such boost and its unlikely to be enough to prompt me to revise up my short term growth or interest rate forecasts. But the economic impact over a few years is far more likely to be positive than negative and easily exceed the \$122 million cost of the ABS same sex marriage survey. An obvious beneficiary will be the marriage industry (as same sex couples marry here rather than overseas) and maybe the tourist industry from a possible increase in inbound tourism from LGBT people. More fundamentally though, just like earlier moves to extend the right to vote to women in 1902 and the 1967 referendum on citizenship for first Australians, extending the same marriage rights to all citizens will contribute to a more inclusive society in which all feel equally accepted and amongst other things able and motivated to contribute their best. Along with the productivity benefits of greater workplace diversity this provides, one outcome is likely to be stronger economic conditions over time than would otherwise be the case. If anyone thinks I have

just gone flakey sprouting “luvvie economics” (as someone accused me of on Twitter) please see <http://williamsinstitute.law.ucla.edu/wp-content/uploads/lgbt-inclusion-and-development-november-2014.pdf> which looks at “The Relationship Between LGBT Inclusion and Economic Development”.

Major global economic events and implications

US data remains strong with solid retail sales growth pointing to strong December quarter consumer spending, a big (partly hurricane related) jump in housing starts and permits, a very strong rise in industrial production in October, strong readings for small business confidence and regional manufacturing indexes and continuing very low unemployment claims. While a continued pick up in producer price inflation points to rising inflationary pressure this is yet to show up in CPI inflation where core inflation rose to just 1.8% year on year in October. Sure core inflation surprised on the upside in October but only if you go to the second decimal place – it was 0.22% month on month as opposed to market expectations for 0.2%!

Japanese September quarter GDP growth was a bit weaker than expected at 0.3% quarter on quarter or 1.7% year on year with a strong contribution from trade but weaker than expected consumer spending and business investment. Various confidence surveys and business conditions PMIs point to continuing good growth though.

Chinese economic data for October was a little bit softer consistent with a moderation in economic growth to around 6.5%. Growth in retail sales, industrial production, investment, money supply and credit all slowed compared to September suggesting that growth has moderated a bit after the slight acceleration seen over the last year, particularly as the property sector has slowed again. However, the softening in activity indicators was only modest, it may have been affected by the Party Congress, retail sales may have been affected by “Singles Day” in November and credit growth remains very strong at over 14% year on year. So don’t get too excited.

Australian economic events and implications

Australian data was the usual mixed bag providing something for the optimists and pessimists alike. On the upside, according to the NAB business survey business conditions rose to an (unbelievable) record high and business confidence remains strong and while jobs growth slowed to a crawl in October full time jobs growth remains strong and unemployment fell further to 5.4%. On the downside though wages rose a less than expected 0.5% in the September quarter or 2% year on year which when adjusted for the bigger increase in the minimum wage this year means that underlying wages growth slowed to a record low of 1.8% year on year. The weakness in wages growth goes a long way to explaining why consumer confidence (which fell again in November) is so low relative to business confidence and together with still high underemployment and rising energy costs will act as an ongoing drag on consumer spending. We seem to be locked in the opposite of the 1970s upwards wage-price spiral where now low wages growth and low inflation are feeding on each other. The continued strength in jobs growth and falling unemployment holds out the prospect that sooner or later wages will accelerate and the downwards spiral will be broken. But for now we are still waiting and given the downside risks to

consumer spending and inflation from weak wages growth it all means that the RBA will have to keep interest rates on hold at a record low for longer – probably into 2019 – and that the risk of another rate cut remains significant.

What to watch over the next week?

In the US, expect the minutes from the Fed’s last meeting (Thursday) to confirm that the Fed remains on track to raise interest rates by another 0.25% at its mid-December meeting. On the data front existing home sales (Tuesday) are likely to see a modest rise, the trend in durable goods orders (Wednesday) is likely to remain up pointing to ongoing strength in business investment and the Markit business conditions PMIs (Friday) are likely to remain solid.

Eurozone business conditions PMIs (Thursday) are expected to remain strong consistent with ongoing strong economic growth.

In Australia, speeches by RBA Governor Lowe (Tuesday) and officials Kearns and Kohler (Monday) along with the minutes from the last RBA board meeting (Tuesday) will be watched for clues regarding the interest rate outlook. September quarter construction data (Wednesday) is expected to show a decline after a strong rise in the June quarter, but should show some evidence of improvement in non-mining investment and will provide input to September quarter GDP forecasts. Skilled vacancy data (Wednesday) will also be released.

Outlook for markets

The risk of a further short term correction or volatility in share markets is high given recent strong gains and risks around US tax reform and the December 8 debt ceiling and government shutdown deadlines. US shares have not had a decent correction since a near 5% pull back into the US election last year. **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 more and the Fed on track to hike in December with another three or more hikes next year the interest rate differential will continue to move against Australia which should result in further weakness in the \$A.