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Investment markets and key developments over the past week

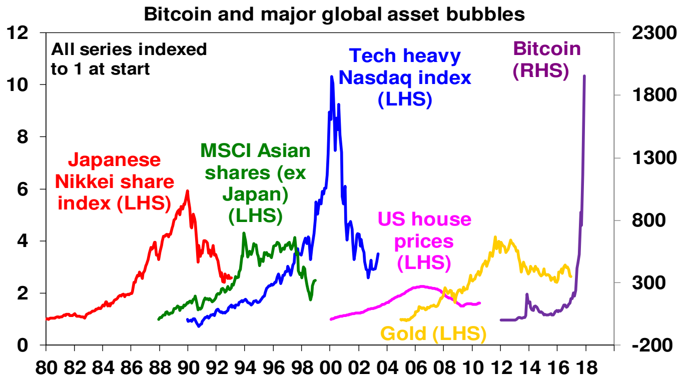
US shares rose 1.5% over the last week to new record highs helped by progress on tax reform and Jerome Powell confirming that he would opt for less onerous financial regulation at the Fed. Japanese shares also rose 1.2%, and Australian shares rose 0.1% but Eurozone shares fell 1.1% and Chinese shares lost 2.6%. Oil prices fell 1.1% in a case of “buy on the rumour and sell on the fact” as OPEC extended production cuts to the end of next year, but the iron ore price rose 3.2%. The $A was little changed at around $US0.76.

US Senate passes tax reform 51-49, with a good chance it will now be in place by year end. With the Senate passing its tax bill it now moves to a House-Senate conference to resolve differences between the House and Senate tax bills – for example the House bill sees the corporate tax cut to 20% commence in 2018 whereas the Senate bill delays it to 2019 – ahead of a final vote in both houses. Having gotten so far tax reform is now more than 90% likely in the US and the GOP is likely to want to wrap it up by year end to avoid the risk that its final passage through the Senate may be adversely affected by the outcome of the special Senate election in Alabama (where the new Senator will sit from January).

At a big picture level, tax reform in the US will mean a boost (maybe 0.5%) to 2018 GDP growth, a likely additional Fed rate hike (four hikes in 2018 rather than three) and more upwards pressure on US bond yields and the $US. For Australia, US tax reform will mean a lower than otherwise $A, more flexibility for the RBA and more pressure to lower our 30% corporate tax rate for large companies (given the risk some companies may choose to relocate their headquarters to the US).

News that former US National Security Adviser Mike Flynn has pleaded guilty (to lying about his Russian contacts) and will cooperate with the Mueller inquiry into the links between the Trump campaign provides a reminder of the cloud hanging over the Trump administration and the potential for Trump’s resignation or impeachment. This could cause bouts of volatility (as we saw briefly on Friday with US shares down 1.5% on the Flynn news before largely recovering) next year and just adds to the likelihood that the GOP will lose control of the House in the November 2018 mid-term elections. However, we remain of the view that it does not change prospects for tax reform (it’s already nearly there) and in fact just highlights the pressure on Congress to get it done. We also remain of the view that unless there is clear evidence of wrong doing Republicans will not impeach Trump. The Democrats may try post the mid-terms but they are unlikely to get the necessary votes in the Senate again unless there is clear wrong doing. In any case even if Mike Pence replaces Trump it’s doubtful the administration’s economic policy direction will change much (less tweets though!). The main risk is that if the pressure on Trump mounts he may lash out with more populist policies (like protectionism) to shore up his support base.

Bitcoin to infinity and beyond with a surge through $US10,000 in the last week! Crypto currencies and block chain technology could revolutionise currency and payment systems. But bitcoin’s price surge increasingly looks to have more to do with speculative investor demand as rapid price gains and stories of millions being made on it with headlines like “Bitcoin mania sweeps into Manhattan” and “Bitcoin leaves sceptics behind” attract more attention to it. Which in turn draws in more investors - as evident in a spike in “how to buy bitcoin?” Google searches - fuelling more exponential price gains as it becomes self-perpetuating. As such it has all the elements of a classic bubble but there is no way to reliably value it as it produces no income so it’s impossible to tell how far it could go up before the music stops. But what goes up rapidly can come down just as rapidly and the volatility seen over the last week (where bitcoin rose to just below $11,500 only to fall back to near $9000 before rebounding again) provides a reminder that it’s not great at providing a reliable store of value which is a key characteristic of a currency. My views on it are unchanged from those expressed here.



Source: Thomson Reuters, AMP Capital

North Korea's latest missile test keeps the risk of military conflict alive but has not increased it. The US knows that a military response will result in thousands of deaths in South Korea and the North Korean regime does not want to push so far that it threatens its survival. Military conflict with North Korea is best regarded as a tail risk – worth keeping an eye on (including looking for appropriate portfolio protection where it's cheap) but not enough to change our base case which is positive on the global outlook.

Major global economic events and implications

US data remains strong with a 17 year high in consumer confidence, another strong ISM manufacturing conditions reading, solid growth in construction activity, strong gains in home sales, rising house prices and an upward revision to September quarter GDP to 3.3%. While the Fed's Beige Book see economic growth, wages growth and inflation as all being "modest to moderate" it did note widespread labour market tightness and skill shortages and Fed Chair Yellen noted broad based growth and that gradual rate hikes remain appropriate as did Powell. With inflation in the core private consumption deflator rising to 1.4% year on year (or 1.447% to be precise), the Fed remains on track to hike again this month and three (or four) more times next year. Market expectations for the Fed remain too dovish.

Eurozone economic confidence rose to a 16 year high in November and unemployment fell again in October but core inflation remained low at 0.9% year on year keeping the ECB cautious.

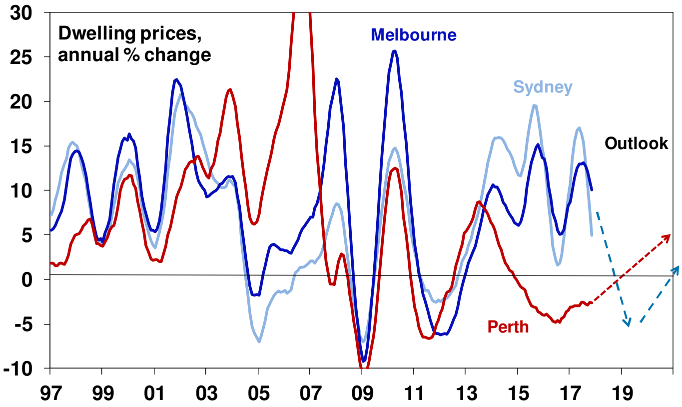
Good Japanese activity data but ongoing low inflation. Industrial production bounced back in October (with solid business conditions PMIs pointing to continued strong growth), the labour market remains very tight and household spending was stronger than expected. However, with core inflation remaining weak at just 0.2% year on year the Bank of Japan will remain stimulatory for a long while yet.

Chinese data was solid with industrial profit growth remaining strong and business conditions PMIs remaining reasonable on average in November (with the Caixin PMI down slightly but the official PMIs up) suggesting that growth has remained solid into year-end. Measures aimed at reducing financial risk point to some softening in growth into next year though.

Australian economic events and implications

The Sydney and Melbourne property boom is continuing to fade, but Perth looks like it's bottoming out. CoreLogic data for November showed a 0.1% decline in capital city property prices resulting in annual price growth dropping to 5.5%. Sydney prices are continuing to fall (down another 0.7%) and Melbourne prices are continuing to slow but prices in Perth look to be bottoming as the slump in mining related employment bottoms out.

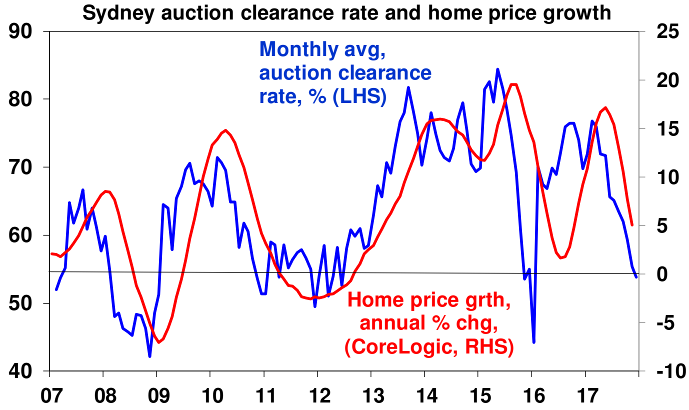
Home prices: Sydney falling, Melbourne following, Perth bottoming



Source: CoreLogic, AMP Capital

The Sydney and Melbourne property boom is fading thanks to APRA's tightening measures (higher rates for investors and interest only borrowers, etc), rising supply and weakening expectations. Sydney auction clearance rates have already fallen into the mid-50s a level that points to price declines on an annual basis on the back of the experience in 2008 and 2012. (This didn't happen in 2016 because the auction slowdown then was too brief.)

Sydney auction clearance rate and home price growth

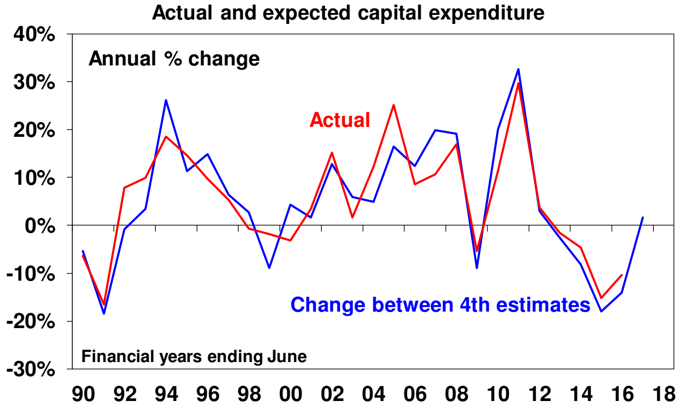


Source: Domain, CoreLogic, AMP Capital

Our view remains that average residential property prices in Sydney and, with a lag, Melbourne will fall 5-10% into 2019. Perth is bottoming and should start to see moderate price gains by 2019, with Darwin following too. Brisbane, Adelaide and Canberra are likely to see continuing moderate gains over the next few years with some acceleration possible and Hobart will remain strong.

However, for those worried about what will keep the economy growing after the Sydney and Melbourne property boom ends there was good news over the last week.

- **First, after years of disappointment the business investment cycle in Australia is finally on the mend**. Not only did investment rise in the September quarter (providing a boost to September quarter GDP growth) but investment plans for the current financial year are up on those made a year ago for the first time since 2012-13 (see the next chart). While business investment intentions point to a further 20% of so fall in mining investment it's now close to where it was as a share of the economy before the mining boom started and its drag on growth has collapsed to around 0.4% from around 1-1.5% a few years ago. More significantly non-mining investment plans point to a gain of around 12% this financial year with even the manufacturing sector looking to boost investment. The diminishing drag from falling mining investment and the improving outlook for non-mining investment (along with ongoing strength in export volumes and public infrastructure spending) has come just in time to offset the downturn in the housing cycle and the weak consumer.



Source: ABS, AMP Capital

- Second, manufacturing conditions PMIs from both the AIG and CBA surveys were strong in November adding to evidence that manufacturing is doing well.
- Finally, while building approvals are down from their 2015-16 highs they remain strong suggesting a slowing in housing construction but not a collapse (at least for now).

What to watch over the next week?

Next week is going to be a busy one in the US with the House and Senate needing to start work on a common tax bill, agreement needed on a spending bill to head off a partial government shutdown on Friday and November payroll data to be released Friday which will be the last big economic release ahead of the Fed's mid-December meeting. On the shutdown risk there remains a number of outstanding issues including funding for Trump's wall and it's doubtful that Congress is ready to agree a long term funding deal just yet so another last minute deal is likely that pushes the issue out another few months. Meanwhile, expect payroll growth to be a solid 200,000 with unemployment unchanged at 4.1% and wages growth edging up (after hurricane related distortions to 2.7%. Meanwhile expect the trade balance (Tuesday) to worsen and the non-manufacturing conditions ISM (also Tuesday) to remain solid at 59.

In China expect November trade data to show export growth remaining around 7% year on year and import growth to slow a bit to 14% year on year.

In Australia, it will be a big week with the RBA meeting (Tuesday) and September quarter GDP data (Wednesday) to provide an update on how the economy is performing. For the RBA we expect more of the same – on hold. While strong business conditions, solid jobs growth, improving global growth and the RBA's own forecasts for a pick-up in growth argue for an eventual rate hike, ongoing low inflation, record low 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 at the earliest.

On the data front in Australia, expect September quarter GDP growth to show a rise of 0.7% quarter on quarter which will take annual growth to 3% as the 0.4% GDP contraction of the September quarter last year drops out. While consumer spending and housing investment are likely to be soft this should be more than offset by business investment, net exports and public spending. Meanwhile expect a solid rise in September quarter public spending and a 0.1% gain in October retail sales (both Tuesday), the October trade surplus (Thursday) to fall to around $1.4bn and housing finance (Friday) to be flat. Data for ANZ job ads, September quarter profits and services and construction sector conditions PMIs will also be released.

Outlook for markets

While the risk of a decent correction in global share markets is high (particularly given the risks of setbacks around US tax reform and the December 8 debt ceiling and government shutdown deadlines), 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. 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 albeit remaining a relative laggard thanks to a more constrained earnings outlook. The uncertainty that will come with a Royal Commission into Australian banks and the financial sector and the possibility of more regulation to follow adds to this assessment – Australian banks will remain great for income thanks to their high dividend yields but banks in Europe and the US are likely to be outperformers as their economies accelerate and particularly with the US heading towards less onerous financial regulation under Trump and Powell at the Fed.

Low starting point government 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.

The Sydney and Melbourne residential property markets are likely to slow further over the next year or two with prices likely to fall by around 5-10%. 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.