5 JANUARY 2018

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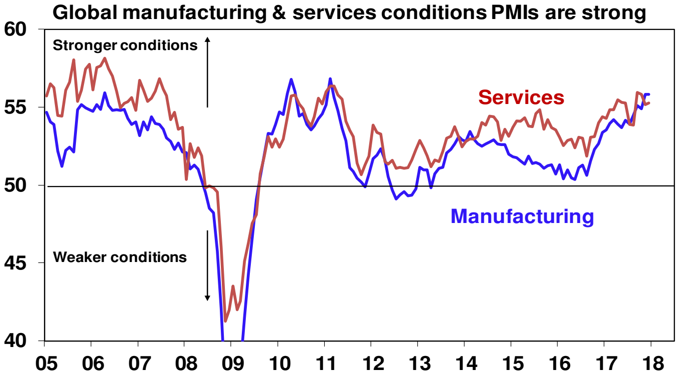
Investment markets and key developments over the past week

While share markets saw a softish last few days of 2017, they have started 2018 on a solid note with strong gains in all major markets over the last week helped by favourable economic data and as seasonal cheer kicked in again. US shares rose 2.6% to a new record high, Eurozone shares rose 3%, Japanese shares rose 4.2%, Chinese shares rose 2.7% and the Australian ASX 200 rose 0.9% taking it above 6100 for the first time in ten years. Bond yields have also pushed slightly higher over the last week as have prices for oil, gold and iron ore. The combination of further weakness in the $US and rising commodity prices has seen the Australian dollar push higher.

Are global economic conditions so good that they are bad? We are continuing to see record or near record highs in various business and consumer confidence readings globally. A concern is that historically it doesn't get much better than this and we saw how similar readings around 1999-2000 & 2006-2007 ended badly. The big difference this time compared to those periods of similar highs in confidence readings is that at those peaks inflation was becoming more of an issue and global monetary policy was tight and bearing down on growth, whereas now inflation is still low and monetary policy remains easy. In other words, we are still in the "sweet spot" in the investment cycle which augurs well for further gains in growth assets albeit share market volatility is likely to rise and returns are likely to be more constrained this year as inflation starts to rise in the US and geopolitical risks become a focus again.

Global manufacturing & services conditions PMIs are strong



Source: Bloomberg, AMP Capital

Geopolitical risks likely to figure more highly in 2018. Geopolitics was a focus in 2017 but it mostly turned out okay as President Trump focussed on business friendly policies, there was no trade war with China and European elections saw support for centrist pro-Euro parties. 2018 may not be quite so smooth though as the risks around US politics rise (as the mid-term elections and the Mueller inquiry ramp up the risk of more populist policies from Trump), the risk of US tensions with China rises as a result and as Italy heads to the polls on March 4. In terms of the latter the Five Star Movement has a good chance of "winning" the prospects of which may cause some investor nervousness but it won't get a parliamentary majority and is unlikely to be able to form government. In any case it has relaxed its anti-Euro stance lately.

The world oil price has started 2018 on a strong note with West Texas Intermediate pushing decisively through $US60/barrel. Unrest in Iran is no doubt an additional factor – but it's likely to either fade out or be suppressed so a disruption to Iranian oil production is unlikely. Rather strong demand for oil on the back of stronger global growth and OPEC supply discipline are likely the main drivers. The oil price is likely to be capped by a pickup in shale oil production, but it could go a bit higher yet in the interim. So Australian motorists could see petrol prices pushed 2-3 cents a litre higher in the weeks ahead.

Major global economic events and implications

US data over the last two weeks has remained strong with robust readings for business conditions including the ISM business conditions indexes, construction activity, labour market indicators, pending home sales and home prices. Consumer confidence fell in December but to a level that is still high. While payroll growth in December of 148,000 was less than expected, it has averaged 176,000 over the last six months which is well above the 100,000 necessary for a stable unemployment rate. A wider than expected trade deficit indicates that trade will likely be a constraint on December quarter GDP growth though. Meanwhile, the minutes from the Fed's December meeting indicate that it's not too concerned about currently low inflation and the flatter yield curve and remains upbeat on growth helped by tax cuts which is all consistent with ongoing gradual monetary tightening this year. While wages growth remained softish at 2.5% year on year in December, **we remain of the view that the Fed will hike rates four times this year as growth is strong and eventually inflation lifts with the first move in March**, in contrast to market expectations for just two hikes. This should eventually turn the $US higher and put further upwards pressure on bond yields.

Eurozone inflation remained low in December with core inflation stuck at 0.9% year on year, which is consistent with the ECB continuing to slow stimulus very gradually despite good growth.

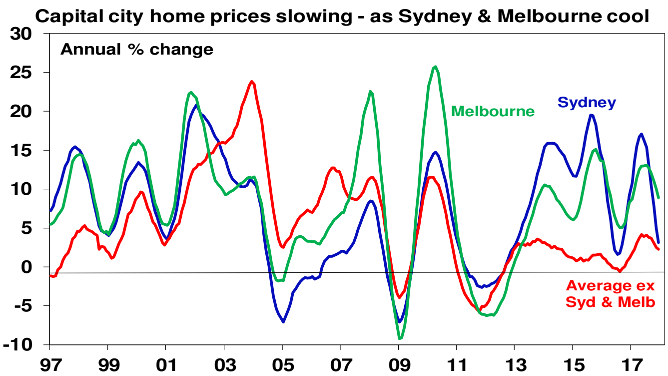
Japanese data points to continued reasonable growth in Japan with solid business conditions PMIs, gains in industrial production and household spending and a continuing tight labour market. Even core CPI inflation rose in November, but only to 0.3% year on year so it's still premature for the Bank of Japan to start thinking about exiting ultra-easy monetary policy.

Chinese business conditions PMIs were mixed for December but on average were solid, whereas industrial profits slowed in November. The overall impression is that growth may have slowed a bit in the December quarter from 6.8% year on year in the September quarter, but not by much.

India's December manufacturing PMI climbed to its highest in over five years and its services PMI improved pointing to strengthening growth, after the hits from demonetization and the GST start up.

Australian economic events and implications

In Australia, home prices softened further in December as the Sydney and Melbourne property boom continues to deflate. Tighter lending standards, rising levels of unit supply, slower Chinese demand and reduced investor enthusiasm for property are all impacting and are likely to lead to further declines in Sydney and Melbourne property prices this year of around 5% - maybe a bit more in Sydney and a bit less in Melbourne. The cooling in the Sydney and Melbourne markets is good news for APRA and the RBA and helps provide the necessary flexibility to leave interest rates low until the broad economy is ready for a hike (which we don't expect to be the case until late this year). It also provides a bit more room for first home buyers. However, other cities are running to their own cycles with Hobart likely to continue strengthening, Perth and Darwin close to the bottom and moderate growth in Adelaide, Brisbane and Canberra.



Source: CoreLogic, AMP Capital

Meanwhile, manufacturing conditions PMIs remained solid in December and services conditions PMIs improved consistent with reasonable economic growth. On the downside though the trade balance is now back in deficit for October and November with trade being a possible drag on December quarter GDP growth. However, stronger imports are a sign of stronger domestic demand and exports should pick up with the iron ore price and higher LNG export volumes.

What to watch over the next week?

In the US, the main focus will likely be on December retail sales (due Friday) which is likely to show another solid gain buoyed by strong jobs growth and consumer confidence. Job openings and small business confidence (both Tuesday) are also likely to remain strong. Meanwhile, core CPI inflation for December (Friday) is likely to remain below target at around 1.7% year on year.

Eurozone economic confidence data for December (Monday) is likely to remain very strong and the unemployment rate (Tuesday) is likely to show a further fall to 8.7%.

Chinese trade data (Friday) for December is likely to show continuing strength, but export growth slowing slightly to around 11% year on year and imports slowing to around 14% year on year.

In Australia, expect November building approvals (Tuesday) to show a 1% fall, ANZ job ads (also Tuesday) and ABS job vacancies data (Wednesday) to remain strong and November retail sales data (Thursday) to show a 0.1% gain.

Outlook for markets

For 2018, continuing strong economic and earnings growth and still easy monetary policy should keep overall investment returns favourable but stirring US inflation, the drip feed of Fed rate hikes and a possible increase in political risk are likely to constrain returns and increase volatility after the relative calm of 2017.

Apart from the likelihood of more volatility through the year, global shares are likely to trend higher through 2018 and we favour Europe (which remains very cheap) and Japan over the US, which is likely to be constrained by tighter monetary policy and eventually a rising US dollar. Favour global banks and industrials over tech stocks that have had a huge run.

Emerging markets are likely to underperform if the $US rises as we expect.

Australian shares are likely to do okay but with returns constrained to around 8% with moderate earnings growth. Expect the ASX 200 to reach 6300 by end 2018.

Commodity prices are likely to push higher in response to strong global growth.

Low yields and capital losses from a gradual rise in bond yields are likely to see low returns from bonds.

Commercial property and infrastructure are likely to continue benefitting from the ongoing search for yield by investors.

National capital city residential property price gains are expected to slow to around zero as the air comes out of the Sydney and Melbourne property boom and prices fall by around 5%, but Perth and Darwin bottom out, Adelaide and Brisbane see moderate gains and Hobart booms.

Cash and bank deposits are likely to continue to provide poor returns, with term deposit rates running around 2.2%.

After a short term further bounce higher, the $A is likely to fall to around $US0.70, but with little change against the Yen and the Euro, as the gap between the Fed Funds rate and the RBA's cash rate goes negative. Solid commodity prices will provide a floor for the $A though.