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Investment markets and key developments over the past week

Share markets had another rough week as the worries around rising inflation and bond yields and a more aggressive Fed continued to impact. While US shares had a good bounce on Friday for the week they fell 5.2%, Eurozone shares fell 5.1%, Japanese shares lost 8.1%, Chinese shares fell 10.1% and the Australian share market lost 4.6%. Bond yields were little changed over the week though as safe haven buying kicked in limiting their upside. Commodity prices generally fell, apart from the iron ore price, and a resurgent $US along with the RBA indicating that it is not in a hurry to raise rates saw the $A fall back to around $US0.78.

While inflation, Fed and bond yield worries were the trigger for the share fall its rapidity owes much to the unwinding of a huge build up in so-called short volatility positions through exchange traded vehicles like XIV that collapsed circa 90% in value (and is now being closed) as volatility measured by the VIX index surged. Quite why some thought already record low volatility would go even lower beats me and it all looks like another case of financial engineering gone wrong, but as Warren Buffett has said "when the tide goes out you get to see who was swimming naked".

From their recent highs to the lows share markets have fallen 11% in Japan (made worse by a rise in the Yen), 10% in the US, 9% in Europe, 13% in China and 5% in Australia. The severity of the falls globally with markets having got oversold and the VIX volatility index pushing up to levels often associated with market bottoms suggest we may have already seen the worst but with bond yields likely to back up further and uncertainty around how much the unwinding of short volatility positions has to go, further weakness cannot be ruled out in the short term and volatility is likely to remain high. **However, our view remains that in the absence of a US or global recession – which are unlikely - the pullback is just another correction**. It may feel worse because we haven't had a decent one for a while.

So why has the Australian share market been more resilient through the sell off, when it normally comes down by more than the US does? The Australian market's high yield status left it vulnerable, but bond yields were actually little changed over the last week. I suspect that its relative resilience owes to its significant underperformance on the way up, the fall in the $A providing a bit of support as it makes Australia more competitive and the unwinding of short volatility bets not being much of a factor in the Australian market.

Some things worth bearing in mind though around the pullback are that: corrections are normal; they usually don't turn into deep bear markets unless there is a recession; selling after share market falls only locks in a loss; pullbacks provide an opportunity because shares are now cheaper; and while share prices may have fallen dividends have not so the income yield from shares is actually up.

Another US Government shutdown begins, but ends within a few hours. Soon after the shutdown started (and before it could have any impact because it was night time) US Congress approved and President Trump signed a bill that that will boost Federal government spending by $US300bn over two years (including on infrastructure), suspend the debt ceiling until March next year and fund the government out to March 23. The funding extension to March 23 as Congress needs time to fill in the details around spending raises the possibility of another shutdown with the Dreamers/border control issue yet to be resolved. But again, if there is another one its likely to be brief. With a resurgence in support for Republicans cutting the Democrats lead in Congressional polling (such that they may now fail to get enough seats to take control of the House in the mid-terms) the Democrats have realised that taking the blame for a shutdown is not smart politically. The economic issue in this is that the new budget deal will add more stimulus into the US economy in the short term and further boost the US budget deficit, all of which adds to the upwards pressure on US bond yields.

More Europe on the way if a Merkel/Social Democrat agreement to form Government is approved. Angela Merkel and the SPD have reached an agreement to form government with the very pro Europe SPD taking the finance ministry. If this is approved by the SPD membership (which will be close but likely) it will clear the way for Merkel to work with French President Macron to build an even stronger Europe. Which would ultimately be very positive for Eurozone assets.

Major global economic events and implications

US economic data remains strong with a rise in the non-manufacturing conditions ISM index to a very strong 59.9, continued strength in job openings and hiring, the lowest level of jobless claims since 1973 and a strong rise in imports driving a worse than expected trade deficit.

Consistent with the strong US economy, the December quarter US earnings reporting season has continued to impress. Of the 341 S&P 500 companies to have reported so far 81% have beaten earnings expectations and 79% have beaten on sales. Earnings growth for the quarter is tracking up 14.5% year on year and revenue is up 8% yoy.

German factory orders rose very strongly in December highlighting the strength in the Eurozone economy.

China's January Caixin services PMI rose solidly adding to evidence that Chinese growth has remained strong coming into this year. Similarly, Chinese export growth remained strong in January at 11% year on year and import growth surged to 37% year on year. The surge in imports likely partly relates to a distortion caused by the floating timing of the Lunar New Year holiday but even so is suggestive of strong domestic demand. Meanwhile, producer price inflation and core inflation fell slightly but mainly due to Lunar New Year holiday distortions.

Australian economic events and implications

RBA upbeat but in no hurry to hike. The RBA provided no surprises leaving rates on hold for the 18th month in a row and making no significant changes to its growth and inflation forecasts for a pick-up in growth to a bit above 3% and in headline inflation to a bit above 2%. However, it needs to see further evidence that unemployment is falling and inflation rising to target and as it expects this to be gradual its clearly in no hurry to raise interest rates. Our view remains that the next move in rates will be up but with inflation still below target, wages growth remaining around record lows, uncertainty around the consumer and household debt and the Australian dollar still too high this is unlikely to occur until late this year at the earliest.

Meanwhile, it was another mixed bag on the data front in Australia over the last week. ANZ job ads rose strongly in January, services conditions PMIs remain solid and retail sales volumes rose strongly in the December quarter. But against this, December retail sales fell after two strong months, a worse than expected December trade deficit implies a strong detraction from growth due to trade in in the December quarter and housing finance continued to slide in December particularly for investors. Meanwhile, retail price inflation remains at zero highlighting the ongoing weakness in inflation.

So far so good for the December half reporting season with 56% of results exceeding expectations and 67% boosting profits from a year ago and most continuing to raise dividends. However, its early days yet with only 18 major companies reporting so far and results can tail off a bit as more report.

What to watch over the next week?

In the US the focus will be on January retail sales and inflation data on Wednesday. Expect retail sales to remain solid reflecting high confidence levels, strong employment, rising wages and tax cuts. Core CPI inflation is likely to slip to 1.7% year on year though. Meanwhile, expect continued strength in small business optimism (Tuesday), industrial production and the NAHB home builders index (both Thursday), and a rebound in housing starts (Friday).

Japanese December quarter GDP growth (Wednesday) is expected to show softer GDP growth at around 0.2% quarter on quarter.

In Australia, the focus in the week ahead will be on confidence, jobs and profits. The January NAB business survey (Tuesday) is likely show that business conditions and confidence remains strong, consumer confidence for February (Wednesday) is also likely to have at least held on to recent gains and the January jobs report on Thursday is likely to show a 5,000 gain in jobs after some very strong months with unemployment remaining at 5.5%. RBA Governor Lowe's Parliamentary Testimony on Friday is likely to reinforce the message that while the RBA is upbeat it is in no hurry to raise interest rates.

The Australian December half 2017 earnings reporting season will ramp up in the week ahead with about 58 major companies reporting including Amcor, Cochlear, CSL, IAG, Woodside Petroleum, ASX, Origin, Telstra and South32. This reporting season is expected to see a fall back to single digit earnings growth (after the resource driven surge seen in 2016-17) with overall earnings growth around 7% (compared to around 16% in the last financial year), with resources profit growth slowing to around 14% (from 130% in 2016-17) but still supported by solid commodity prices and production growth, bank earnings growing around 3% and industrials up 5% with strong results for insurers, utilities, healthcare, building materials and consumer discretionary. The main themes will be continued strength in companies exposed to housing construction and the infrastructure spending boom, the impact of the US tax cut on companies exposed to the US and the potential for some special dividends and capital returns.

Outlook for markets

Ongoing strong economic & profit growth and still easy monetary policy should keep investment returns favourable but stirring US inflation, the drip feed of Fed hikes and a possible increase in political risk are likely to keep volatility high after the relative calm of 2017

The share market correction could have further to go, but the worst is likely over and shares are likely to trend higher this year as global recession is unlikely and earnings growth remains strong globally and solid in Australia. We remain of the view that the ASX 200 will reach 6300 by end 2018.

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

Unlisted commercial property and infrastructure are still likely to benefit from the search for yield by investors, but it is waning, and listed variants are vulnerable to rising bond yields.

National capital city residential property price gains are expected to slow to around zero as the air continues to come 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 reaching as high as $US0.8136 which is near the top of the technical channel it's been in since 2015, the $A is on the way back down again against the $US, and this is likely to get a push along as the gap between the Fed Funds rate and the RBA's cash rate goes negative next month. The next stop is likely to be around $US0.76. Solid commodity prices will provide a floor for the $A though.