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Investment markets and key developments over the past week

Despite a bit of volatility around the US tariff issue and the Italian election, share markets bounced back over the last week as it all turned out less bad, North Korea's Kim Jong Un and President Trump agreed to meet and goldilocks returned to the US jobs market with February payrolls showing stronger than expected jobs growth and weaker than expected wages growth. Over the week US shares rose 3.5%, Eurozone shares gained 3.2%, Japanese shares rose 1.4%, Chinese shares gained 2.3% and Australian shares rose 0.6%, although the last three are yet to react to Friday's goldilocks US jobs report. Bond yields rose a bit in the US, UK, Italy, Spain and Australia but fell a bit in the Germany and Japan. Oil and copper prices rose, but iron ore fell 6.7%. While the $US was little changed, the $A rose.

So what a difference five weeks makes! The January US payroll report released in early February showing an acceleration in wages kicked off rising Fed fears, surging bond yields and a sharp correction in share markets and then we have seen fears of a global trade war and Gary Cohn resigning. Now the US is back to goldilocks (at least for now), the tariffs are less severe, and Kim and Trump are to meet. We still expect more volatility this year as many of these issues have further go run, but the broad trend in shares likely remains up.

The noise and fear around the global economy and financial markets initially ramped up another notch early in the past week with initial negative market reactions to a messy election outcome in Italy and news that Trump's rational chief economic adviser Gary Cohn was resigning adding to fears of a trade war. However, to borrow a great quote from Joe Granville it was another case of "if it's obvious, it's obviously wrong", as things turned out to be much brighter by the end of the week.

First, the risks around a full-blown trade war kicked off by Trump's tariffs on aluminium and steel imports have receded a bit. Yes, they have been confirmed at 10% and 25% respectively and Gary Cohn will be missed, but there is reason for optimism that a global trade war will not occur.

- The tariffs will cover less than 2% of US imports. It's a far cry from the over 20,000 imported goods hit by an average 19% tariff hike under the Smoot-Hawley Act of 1930.
- Canada and Mexico are exempted conditional on reaching a new NAFTA agreement with scope for other allies to be exempted too on the basis of national security, which has the potential to reduce the risk of retaliation.
- The potential exemptions indicate Trump has listened to criticism of his initial plan. So another case of Trump's bark being worse than his bite. There is also a bit of The Art of the Deal here – go in hard, then back down to something that sounds more reasonable or acceptable.
- Trump won't want to go too far on tariffs as the resultant price increases won't go down well with his supporters.
- Other countries are likely to be cautious in retaliating and China may want to come across as the "good guy" on trade.
- It's also worth repeating that the direct impact on Australia in relation to steel and aluminium exports to the US is trivial as less than 0.02% of GDP is directly affected, so exemptions aside the real risk will come if there is a full-blown trade war affecting markets for our raw materials in China and Asia. But as noted there is reason to see this as unlikely.

Of course, this is not the end of the matter as Trump has warned of more tariffs coming. China looks like being a key focus of this given a US review of China's alleged theft of US intellectual property and a request that China cut its trade surplus with the US by $US100bn (revised up from $1USbn in a tweet by Trump who must have been channelling Dr Evil only to realise $1USbn is not much). So, while there may not be a full on trade war, there may be no peace on the trade front either.

Second, the messy Italian election outcome is not great for Italy, but its unlikely to threaten the Euro. Basically, there are now three major blocs in the Italian lower house: the right wing coalition dominated by the far right Northern League; the Five Star Movement (5SM); and the centre left dominated by the Democratic Party (PD). None of these blocs are near a majority and after parliament first sits on March 23 it could take months to resolve and may require a new election (not that most parties want that). Barring a worst-case coalition between 5SM and the Northern League, which given their huge political differences is unlikely, it will be the Democratic Party that will decide who forms government and given its pro-Euro and left of centre bias its more likely to lean in the direction of 5SM but only if it remains supportive of Italy remaining in the Euro. So, while the final outcome may not be great for Italy in terms of keeping the budget under control and reforming the economy, there is unlikely to be a short-term threat to the Euro. 5SM is no longer advocating an exit from the Euro and the Northern League has backed away from it too (which given 57% of

Italians support the Euro is why they and 5SM were able to do well in the first place). It's unlikely a new election will change this. This and the German Social Democrat Party's solid support for a coalition with Angela Merkel leaves Germany on track to work with France on strengthening the Eurozone.

Thirdly, there was also good news regarding North Korea, with Trump to meet Kim Jong Un before May. Whether it comes to anything remains to be seen false thaws in NKs relationship with SK and the US several times over the decades. Or maybe its development of nuclear weapons was all just a negotiating ploy, and this is really a very big deal. At least it will be "quiet" on this front for a while yet.

And finally, this is all occurring against a global backdrop of strong economic and profit growth and still relatively easy monetary conditions. In fact, on this front the US jobs report showed a return to goldilocks with stronger than expected jobs growth of 313,000 but wages growth falling back to 2.6% year on year and previous months revised down. So while the issues around US inflation and the Fed, Trump, trade and Italy, etc, will likely continue to contribute to volatility this year the broad backdrop for share markets remains positive.

Major global economic events and implications

US economic data remains strong – both in terms of non-manufacturing conditions and jobs data. The tight US labour market will likely continue to result in upwards pressure on US wages and we remain of the view that the Fed will hike later this month and for a total of four times this year, but the softness in wages growth evident in February makes it easy for the Fed to retain a reference to "gradual" rate hikes and likely means the "dot plot" will remain at three hikes for this year for now.

The ECB made no changes to monetary policy, but it did relax its easing bias by removing its commitment to increase quantitative easing if needed, but made no other changes leaving QE on track to continue at €30bn a month out to September (after which its likely to be phased down to end in December) and a reiteration that rate hikes are only expected to come "well past" the end of QE which probably means around mid-next year. So no real surprises here.

As expected the Bank of Japan left monetary policy on hold and with inflation running well below target Governor Kuroda has indicated that "powerful monetary easing" is going to continue for a while yet.

China softens growth target (a bit). Chinese Premier Le Keqiang's Report to the National Peoples' Congress set the growth target at "around 6.5%" and the inflation target at 3%. Both are the same as last year, but the growth target omitted last year's reference to "higher if possible" suggesting a greater focus on reducing pollution and financial risks. There was no sign of slower growth in trade and credit data. CPI inflation bounced, but looks due to bad weather and holiday distortions.

Australian economic events and implications

In Australia, the RBA provided no surprises leaving rates on hold for the 19th month a row, and is likely to remain on hold for a while yet. The global economy looks good, business conditions are strong, non-mining business investment and infrastructure spending are increasing, further export growth is expected, jobs growth is strong and the RBA still expects to see stronger economic growth and inflation. But against this, uncertainty around consumer spending remains high, wages growth remains low, inflation remains low, the $A is arguably too high, and the cooling Sydney and Melbourne property markets have provided a bit more flexibility for the RBA. All of this supports the case to leave rates on hold.

And last week's data don't do anything to move the dial on rates. Building approvals bounced 17% in January but this was after a 20% fall the previous month. Exports bounced back relative to imports in January but against this March quarter retail sales are off to a very weak start. The economy is on track to keep growing but is likely to come in below the RBA's expectation for 3.25% growth. As a result we have pushed our expectation for the first rate hike into early next year.

What to watch over the next week?

In the US, the key focus will be on February CPI inflation data (Tuesday) and retail sales (Wednesday), particularly after the January data showed a stagflationary combination of stronger inflation and weaker retail sales. February data is likely to be more positive though with a fall back in core CPI inflation to 0.2%mom leaving it at 1.8% year on year and underlying retail sales growth bouncing back to 0.4% month on month. Meanwhile, expect small business optimism (Tuesday), the New York and Philadelphia manufacturing indicators and home builder conditions (all Thursday) to remain strong, industrial production (Friday) to rise solidly, but housing starts (also Friday) to have fallen back a bit after a bounce in January.

Chinese activity data for January/February to be released Wednesday will provide a firmer handle on how Chinese growth is running. We expect to see a slowing in retail sales growth to 9.9% yoy and in industrial production to 6.3%.

In Australia, expect the NAB business survey (Tuesday) to show continued strength in business conditions, housing finance (also Tuesday) to show a 1% or so bounce and consumer confidence (Wednesday) to show a slight improvement. Speeches by RBA officials will be watched for clues on the outlook for rates.

Outlook for markets

Volatility in share markets is likely to remain high, with investors yet to fully digest the outlook for higher inflation and interest rates in the US and as issues around President Trump and trade continue to impact, but the broad trend in share markets is likely to remain up as global recession is unlikely and earnings growth remains strong globally and solid in Australia. We continue to expect the ASX 200 to reach 6300 by end 2018.

Low yields and capital losses from rising bond yields are likely to drive 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 remain 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%.

The $A is likely to fall as the gap between the RBA's cash rate and the US Fed Funds rate goes negative this month. Solid commodity prices will provide a floor for the $A though.