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Investment markets and key developments over the past week

Share markets had another volatile week – starting down as the US announced details of proposed 25% tariff hikes on $US50bn of imports from China and as China announced its own plans for same sized tariffs, rebounding as investors came to the view that some sort of negotiated solution was most likely only to come under renewed pressure again when Trump threatened tariffs on an extra $US100bn of Chinese exports to the US. This saw US shares fall 1.4% through the week, but other markets still managed a modest rise with Eurozone shares up 1.1% and Japanese and Australian shares up 0.5%. Chinese shares fell 1.1%. Bond yields had a calmer roller coaster ride but mostly rose, commodity prices were mixed with oil and iron ore down but metals up. The $A fell on trade war fears and as the $US rose.

While the details around the proposed product list totalling $US50bn of imports from China to be subject to a 25% tariff hike and China's announcement of a planned same size retaliation were not surprising, Trump's ordering the US Trade Representative to "consider" tariffs on an additional $US100bn of imports to the US in counter retaliation ratchets up the risk of a serious trade war between the two countries if negotiations fail. While tariffs on $US50bn of imports would have very little impact (amounting to around a 0.4% tariff increase averaged across all US imports which would impact growth and inflation by less than 0.1%) a ratcheting up in the products subject to tariffs will mean a greater economic impact. The additional $US100bn response if it is adopted by the US Trade Representative will likely also be followed at some point by China announcing another matching tariff hike on imports from the US running the risk that Trump ups the ante yet again.

However, all of these tariff hikes are still just proposals and the latest $US100bn will have to go through the same 60 day public comment period as the initial $US50bn is going though. The US tariffs and matching Chinese tariffs will only go into effect if negotiations fail. Both China and the US have indicated their support for negotiations. While America stands to lose less from a trade war than China (because it is less trade exposed and it has a trade surplus) it will still lose. China's proposed tariffs on US soybeans, aircraft, whiskey, wheat etc will hit Trump's supporter base. And he would prefer to see the share market going up, not down, particularly the closer we get to the mid-term elections. So, while Trump is upping the stakes and the threat to the global economy if negotiations with China fail our view remains that a negotiated solution is most likely and so the tariffs ultimately won't be implemented or will be much milder if they are. However, negotiations could take months. In the meantime, there will be ongoing noise around the issue – with China and the US potentially announcing a further escalation in their proposed tariffs, the US Trade Representative to hold public hearings on the initially proposed tariffs in mid-May and the US Treasury likely to announce its recommended investment restrictions on China in late May which will lead to more tensions. So, it will likely remain a case of no full-blown trade war, but no trade peace either. Against this backdrop share market volatility will likely remain high but global growth should remain solid and so the rising trend in shares will likely resume once the trade worries start to settle down (which is likely to be the case ahead of the US mid term elections later this year).

What would be the impact of a full-blown trade war? This is always a bit hard to model reliably - Chinese and US goods flowing to each other could just be swapped for goods coming from countries not subject to tariffs reducing any impact. But modelling by Citigoup of a 10% tariff hike by the US, China and Europe (and bear in mind we are nowhere near that at present) showed a 2% hit to global GDP after one year with Australia seeing a 0.5% hit to GDP reflecting its lower trade exposure compared to many other countries.

The US dollar looking interesting. Earlier this year talk that the Bank of Japan and the ECB may be getting closer to an exit from easy money put more downwards pressure on the US dollar. The problem is that the rise in the Euro and Yen against the $US has adversely affected growth indicators like PMIs in Japan and Europe relative to the US and the BoJ and ECB are just following their earlier announced plans regarding easy money with no sign of an early exit. So the $US fell too far into February and looks like it's built a base for a rally. This in turn is also likely to weigh on the $A as US rates rise further relative to Australian rates.

Major global economic events and implications

US data remains solid. The March business conditions ISM indexes edged down a bit but remain very strong with continuing strong readings for orders, employment and prices paid. While payrolls rose a less than expected 103,000 in

March, this looks to reflect payback for the stronger than expected gain of 326,000 in February, normal monthly noise and the impact of bad weather. Meanwhile, unemployment remains low, underemployment fell and wages growth edged up a bit further to 2.7% year on year which are all consistent with the jobs market remaining strong. The Atlanta Fed's GDPNow has March quarter GDP growth tracking around 2.3% but note that this is around 3% if seasonal weakness in March is allowed for. All of which is consistent with the Fed continuing along its path of gradual rate hikes as implied by a speech by Fed Chair Powell.

Eurozone unemployment fell further to 8.5% in February – which is well down from its 2012 peak of 12%. But while the economy is continuing to improve core inflation remains stuck at 1% year on year which will keep the ECB cautious in moving towards the exit from ultra-easy monetary policy. While German industrial production fell sharply in February this appears to reflect a high number of workers on flu related sick leave.

Japanese data was mixed. Unemployment rose slightly to 2.5% in February and household spending slowed, but industrial production rose solidly, wages growth looks to be rising and the March quarter Tankan remained solid.

Chinese business conditions PMIs for March were mixed - up for the official surveys but down according to the Caixin surveys. Put an average through them and they are tracking sideways at a level consistent with continued solid growth.

Australian economic events and implications

In Australia, the RBA provided no surprises leaving rates on hold for a record 20 months in a row. The global economy is strong, the RBA does not appear too fussed about recent share market volatility, the risk of a trade war and higher bank funding costs, business conditions and employment growth are strong and the RBA continues to expect a pick-up in growth and inflation. But against this there is uncertainty around the outlook for consumer spending, labour market spare capacity remains high, wages growth remains low (although it may have troughed), inflation remains low and measures by APRA to tighten lending standards have helped cool the Sydney and Melbourne property markets. So, it makes sense to remain on hold.

Australian economic data was mixed with strong business conditions PMI readings and a stronger than expected rise in February retail sales, but a fall back in building approvals and another decline in home prices led by Sydney and Melbourne. The trade surplus slipped in February but only a bit and looks like it could make a contribution to growth in the March quarter.

What to watch over the next week?

No doubt the drama over tit for tat tariff hike plans in the US and China will continue to feature heavily over the week ahead. Key to watch will be progress towards negotiations.

In the US, the minutes from the Fed's last meeting (Wednesday) will no doubt be watched to see what it says about the risk of trade wars but it's like to remain consistent with further gradual monetary tightening. March quarter inflation data is likely to provide support for this with a further rise in core producer price inflation (Tuesday) and core CPI inflation (Wednesday) showing a lift to 2% year on year from 1.8%. The March quarter earnings reporting season will also kick off. Consensus expectations are for a 17% year on year rise in earnings, but this could be too conservative given that earnings were up 15% yoy in the December quarter and tax reform could provide a 5-10 percentage point boost which would potentially take profit growth above 20%.

Chinese data for March will start to flow with producer price inflation expected to slow to 3.2% yoy and consumer price inflation likely to slow to 2.5% yoy (both due Wednesday). Trade data is likely to show a slowing in export growth to 12% yoy after Lunar new year holiday distortions in the previous two months and import growth is likely to rise to 10% yoy. Credit data will also be released.

In Australia expect, the NAB business survey (Tuesday) to show continuing strength in business conditions and confidence, consumer confidence (Wednesday) to remain a bit above its long-term average and housing finance (Thursday) to show a 1% rise. A speech by RBA Governor Lowe (Wednesday) will be watched for any clues on the outlook for interest rates but is likely to remain consistent with rates staying on hold and the RBA's Financial Stability Review (Friday) will likely show the RBA feeling more relaxed around housing related risks.

Outlook for markets

Volatility in share markets is likely to remain high and further weakness is possible as US inflation and interest rates move up and as issues around President Trump and trade continue to impact ahead of the US mid-term elections in November, but the medium-term 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 – it might just take a bit longer to get back on the path up to there.

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 further as the gap between the RBA's cash rate and the US Fed Funds rate pushes further into negative territory. Solid commodity prices should provide a floor for the $A though – in contrast to early last decade when the interest rate gap was negative and the $A fell below $US0.50.