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Investment markets and key developments over the past week

Share markets rose over the last week as while volatility remained high, not helped by worries about a missile strike on Syria and the FBI raiding Trump's lawyer's office, trade war risks receded. US shares rose 2%, Eurozone shares rose 1.2%, Japanese shares gained 1%, Chinese shares rose 0.4% and Australian shares rose 0.7%. The risk on mood saw bond yields, commodity prices and the Australian dollar rise.

Good news on the trade front as China continues down the path of opening its economy despite US tariff threats, and Trump responds favourably. But there is still a long way to go. President Xi's Boao forum address was extremely positive in reiterating that China will lower tariffs on certain products, ease access for foreign investors and strengthen protections for intellectual property. Yes China is playing good cop (President Xi and Premier Li)/bad cop (with various underlings like Commerce Ministry spokesman Goa Feng talking of Chinese retaliation if the US further escalates trade tensions) in this so far "phoney trade war". It has to do this if its to achieve a fair outcome for China. But overall China is taking the high ground here in acknowledging its surplus with the US is unsustainable, continuing down a path of opening its economy and implicitly acknowledging the need to protect intellectual property. And President Xi's comment that cold war, zero sum mentalities are "out of place" and that dialogue is the way to resolve disputes clearly indicates its open to negotiation with the US on trade. This issue has a long way to go yet and there may still be lots of sniping in public. But so far Trump has praised President Xi's speech and said the tariffs may not be levied. However, the ball is now in his court to get the negotiations going formally.

Of course, the worry list for investors remains long with the possibility of another military strike on Syria after yet another chemical attack looming large and the Mueller inquiry getting even closer to Trump. In terms of Syria, yes the risk is significant – but stuff in the middle east has been flaring up and down for years without much lasting impact on global financial markets. The Mueller inquiry is more of a slow burn reminiscent of Watergate, but the story hasn't changed. Unless Trump is shown to have done something really bad he won't be impeached/removed from office and if he is it will be rough for markets along the way but US economic policy won't change much under VP Pence. Some might say it would be more peaceful – with no twitter grenades from the President!

The last few weeks have seen lots of market gyrations driven by President Trump's comments. A week ago he said he was considering tariffs on another $US100bn of imports from China, now he says that the tariffs may not be levied and he considering re-joining the TPP. A few days ago he declared that missiles "will be coming" to Syria and then a few days later they are still being considered. All these gyrations are just classic bargaining/Art of the Deal stuff that creates lots of volatility for traders. But for most investors it's a case of turn down the noise and stick to a well thought out long term investment strategy.

While the volatility could go on for a while some things are worth noting regarding the direction setting US share market: the lows reached in February have held after the retest of the last few weeks; the forward PE has fallen to a reasonable 16 times, corporates are accelerating buybacks and M&A and investor sentiment has become very negative and profit growth is very strong, all suggesting scope for a bounce back if the news flow becomes a bit less negative. This would flow through to global shares including the Australian share market.

In Australia, tightening lending standards around tougher checks of borrower income and expense levels are upon us. At least one of the major banks have announced formal changes in their standards on this front and for the last week I have heard multiple anecdotes of the extra hoops borrowers now have to jump through to get a loan. The economic impact is likely to be a slowing in housing related credit growth and since the tightening will more likely hit marginal borrowers in Sydney and Melbourne given higher home price to income ratios it reinforces the downside to home prices in these cities and the uncertainty around consumer spending. It's also a de facto monetary tightening and with the pressure from rising short term funding costs on mortgage rates will likely mean a lower outlook for the RBA's cash rate. We are looking for a rate hike around February next year, but the risk is that this will be delayed into 2020 and another cut in rates cannot be ruled out.

Major global economic events and implications

US inflation pressures continuing to rise, with the Fed on track for more hikes than the market is allowing for. Core producer price inflation rose 2.7% year on year in the March quarter and core consumer price inflation rose to 2.1% (from 1.8%) as the "Verizon unlimited data plan effect" from a year ago is dropping out. Over the last six months core inflation has been running at a 2.6% annual pace. The Fed's preferred core consumption deflator is running below the core CPI inflation rate, but it will be heading up too as last year's mini bout of deflation drops out and capacity utilisation continues to tighten in the US. With the US jobs market remaining ultra-tight and small business optimism remaining very strong we remain of the view that the Fed will hike four times this year. Market expectations for three hikes this year remain too dovish.

Eurozone industrial production fell again in February for the third month in a row, but still strong business conditions PMIs indicate it will bounce back. Meanwhile the minutes from the last ECB meeting came across as somewhat dovish with concerns about the strength of the Euro. There are no signs of an early exit from easy money or a rate hike here.

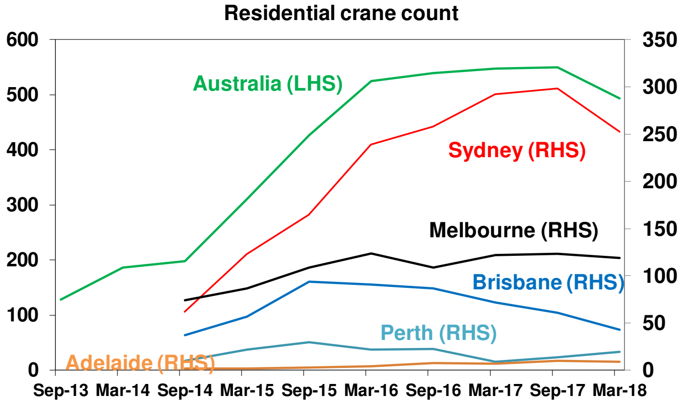
But not everyone is seeing inflation rise - Chinese inflation fell in March providing no impetus for any PBOC tightening. Chinese exports also fell in March, but this mainly reflects distortions caused by the timing of the Lunar New Year with growth being very strong in the March quarter as a whole and the same for imports. Credit and money supply growth in March was weaker than expected,

Australian economic events and implications

Australian data was rather bland over the last week. The NAB business survey showed business conditions and confidence slipping in March but that was down from unbelievably strong levels and they remain solid. Consumer confidence fell slightly and remains below business confidence, which is likely to remain the case until wages growth picks up. Meanwhile, housing finance going to first home buyers has continued to improve but is at risk from the current tightening in lending standards around income and expenses as they tend to have to stretch more to get a mortgage.

The RBA's Financial Stability Review sees the risks around household debt in Australia as having fallen thanks to macro-prudential measures. More broadly, it sees the resilience of Australian banks as improving and is not too fussed by the rise in short term funding costs.

The Rider, Levett, Bucknall count of cranes being used for residential construction has started to fall, mainly driven by Sydney. However, approvals remain high so the crane count is likely to remain high for a while yet. Meanwhile, the reduction in residential cranes has been offset by a rise in cranes being used for office, hotel, retail & education construction.



Source: Rider, Levett, Bucknall Crane Index, AMP Capital

What to watch over the next week?

In the US, expect a solid 0.3% gain in March retail sales (Monday) after several soft months, the NAHB home builders' index (also Monday) to remain strong with housing starts (Tuesday) up solidly and a 0.3% gain in industrial production (also Tuesday). Manufacturing conditions surveys for the New York and Philadelphia regions will also be released along with the Fed's Beige Book of anecdotal evidence. The March quarter earnings reporting season will start to ramp up. Consensus expectations are for a 17% year on year rise in earnings, but this could be too conservative given that tax reform provided a 5-10 percentage point boost which could take profit growth above 20%.

Japanese inflation data (Friday) is likely to show a fall in CPI inflation to 1.1% year on year from 1.5% and core inflation remaining at 0.5% year on year.

Chinese March quarter GDP growth is likely to have remained at 6.8% year on year consistent with reasonably solid business conditions PMI readings so far this year and PBOC Governor Yi Gang indicating growth has been a bit better than expected. Consistent with this March retail sales growth is expected to rise slightly to 9.7% yoy with industrial production rising to 6.5% yoy, but fixed investment growth slowing to 7.7%.

In Australia, March employment growth (Thursday) is likely to be around 10,000 jobs with leading jobs indicators remaining solid but unemployment will likely remain around 5.6%.

Outlook for markets

Volatility in share markets is likely to remain high 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 take a bit longer to get back on the path up to there though.

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 further as the air continues to come out of the Sydney and Melbourne property boom and prices fall by another 5% this year, 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 towards $US0.70 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.