AMP CAPITAL

WEEKLY MARKET UPDATE

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SHANE OLIVER
Head of Investment Strategy and Chief Economist, AMP Capital

Investment markets and key developments over the past week

Global share markets rose over the last week helped by another Goldilocks combination of good economic data, strong profits and benign US inflation. This was despite the US withdrawal from the Iran nuclear deal which pushed up oil prices. For the week, US shares rose 2.4%, Eurozone shares gained 0.7%, Japanese shares rose 1.3% and Chinese shares rose 4%. The positive global lead pushed Australian shares up by 0.9% despite weak retail sales and little short-term stimulus from the Budget. Bond yields were little changed, except in Italy where they rose as populist parties are close to forming a government. Metal prices and the iron ore price rose. The US dollar was pretty much unchanged as was the Australian dollar despite a mid week fall below $US0.75.

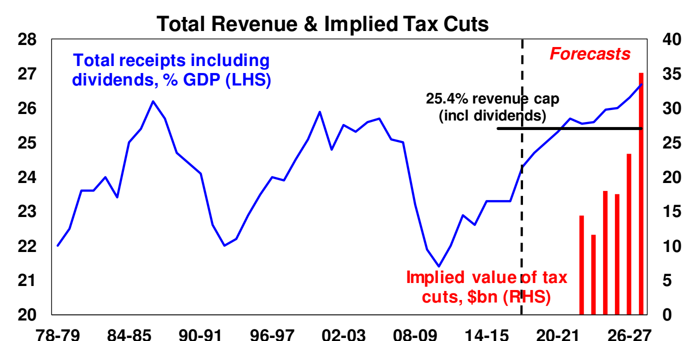
Geopolitics: the good, the bad (but possibly okay) and the ugly. The good is of course North Korea which continues to move in a positive direction with President Trump to meet North Korea's Kim on June 12 in Singapore. The bad is the US/China trade skirmish but the noise around it is okay with President Trump and President Xi having a phone call and a trip to the US by Vice Premier Liu He soon to continue the negotiations on trade. Don't expect a quick resolution but they are still talking and the incentives remain strong to find a negotiated solution. The ugly is Trump's confirmation that the US will withdraw from the Iran nuclear accord and reinstate sanctions. It's ugly because it threatens around 0.7 million barrels a day of Iranian oil exports at a time when the global oil market has tightened, it may see Iran cause more trouble in the Middle East and develop nuclear weapons and it threatens the relationship between the US and its allies notably France and Germany that may stick to the accord (and possibly compensate any of their companies that are adversely affected by US sanctions). The oil price has already moved up so the risks may be factored in. And of course, there is a way to go yet. The US sanctions on Iran and companies that deal with it won't kick in until after a 90-180 day wind down period. And Trump's approach as with many things looks like a negotiating ploy to get a better deal. So the Iran nuclear deal is not necessarily over yet.

Meanwhile, over in Italy the populist leftist Five Star Movement and populist far right Northern League look to close to forming government. This was the worst possible scenario after the inconclusive March election given both parties background of Euro scepticism and support for irrational economic policies. While its marginally negative for the Euro its not an immediate threat, but it will slow a Macron led move to a more integrated Eurozone. And for Italy it risks a renewed deterioration in the budget deficit and an undoing of structural reforms which is negative for Italian shares and bonds. That said, the more extreme 5SM and League policies are likely to be softened down a bit in government and in any case politics is often a mess in Italy so what's new.

Mahathir returns as PM in Malaysia – now that's something! The uncertainty could negatively impact Malaysia's growth in the short term and hence its share market but it's a long term positive for the country. The 61-year rule of PM Najib's coalition (which was led by Mahathir between 1981 and 2003) is over and Malaysia looks like its going back to what should have happened 20 years ago with Anwar to succeed Mahathir. Will have to look up what recalcitrant means again!

The Australian 2018-19 Federal Budget proved surprisingly responsible for a pre-election budget with stronger revenue used to drive budget repair in the short term. If the Treasurer was playing Santa he was a bit stingy. Tax cuts and even more infrastructure projects were the main goodies but the immediate tax cuts are just $10 a week for low to middle earners and won't be accessed until after June next year and the overall fiscal stimulus in the year ahead is basically zero, which is another reason why the RBA will remain on hold. (While Opposition leader Bill shorten indicated that a Labor Government would increase this to around $18 a week if Labor wins it still won't be accessed until after June next year.) Rather the big hoped for gains come next decade when the budget is projected to generate larger surpluses and the Government is promising to hand some of this back as tax cuts to stop revenue as a share of GDP rising above historical norms. Based on current projections this will allow tax cuts starting at around $10bn a year in four or five years time – see the next chart. Of course, this all assumes that the Government is re-elected and that revenue grows by around 5.5% pa over the next four years, which are big ifs! A key risk here is the Government's assumption that wage growth will rise back to 3.5%, which looks a bit optimistic. Nevertheless it does make sense that tax revenue will be capped as a share of GDP around previous high levels and bracket creep returned to tax payers. The Budget also highlights the starker than normal choice faced by Australians running into the next election between a higher

taxing/bigger government offered by Labor and a lower taxing/smaller government offered by the Coalition.



Source: Australian Treasury, AMP Capital

Major global economic events and implications

US data remains strong with small business confidence and job vacancies remaining very strong, but inflation is only moving higher gradually. Consumer price inflation rose 0.2% month on month or 2.5% year on year in April, but despite a 3% rise in gasoline prices this was less than expected as core inflation was weaker than expected and unchanged at 2.1% year on year. Core producer price inflation remains in an uptrend but edged down a notch in April. So while inflation is continuing to trend up its only happening slowly. Goldilocks continues. Strong growth and continuing labour market tightness with jobless claims continuing to fall will keep the Fed normalising, but for now it can remain gradual, with the next hike still on track for June. The US March quarter earnings reporting season is now 90% done, with 76% beating on profits, 73% beating on sales and and earnings up 24% on a year ago. Strength has been broad based but the strongest sectors for earnings growth have been energy, technology, financials and materials.

The Bank of England left rates on hold as expected, but despite recent softer data still sees a case to raise rate again this year.

Chinese trade data remains consistent with continuing solid growth with export growth rebounding to 12.9% year on year in April and import growth rising to 21.5%. Credit growth came in a bit stronger than expected in April with annual credit growth around 12% and again consistent with solid economic growth. Meanwhile, CPI inflation fell to 1.8%yoy from 2.1% but with core inflation running along at 2%. So nothing to get excited about here.

Australian economic events and implications

Australian data was mixed with very strong readings for business conditions and to a lesser degree business confidence according to the April NAB business survey but weaker than expected March retail sales highlighting the ongoing divergence between the business and household sectors as low wages growth is good for the former (at least for a while) but bad for the latter. Retail sales were flat in March and March quarter volume growth slowed to just 0.2%. Strong net exports should make up for the implied softness in consumer spending in terms of March quarter GDP growth, but the downside risks to consumer spending remain with weak wages growth, high underemployment and now falling home prices in Sydney and Melbourne and the Budget not providing much short-term support to households. Meanwhile, housing finance commitments were weak in March, particularly for investors.

With the impact of tighter bank lending standards yet to really hit our view remains that there will be more downside in Sydney and Melbourne home prices and that given the flow on to consumer spending and the broader economy the RBA will be on hold at least out to 2020 and the next move in rates being a cut cannot be ruled out.

What to watch over the next week?

In the US, expect April retail sales growth (Tuesday) to remain strong, the NAHB home builder's conditions index (also Tuesday) to rise slightly to a strong reading of 70, housing starts to be flat but industrial production to rise solidly (both Thursday) and the New York and Philadelphia regional manufacturing conditions indexes to be solid.

Japanese March quarter GDP (Wednesday) is expected to decline 0.1% quarter on quarter, reflecting soft consumer spending and core inflation for April (Friday) is expected to remain weak and well below target at 0.5% year on year.

Chinese April activity data is expected to show a rise in industrial production to 6.3% year on year, retail sales growth remaining around 10% and fixed asset investment remaining around 7.5%.

In Australia, the minutes from the last RBA Board meeting (Tuesday) are expected to repeat the message that the Bank is comfortably on hold, wages growth (Wednesday) is expected to remain unchanged at 2.1% year on year, consumer confidence (also Wednesday) will be watched closely for a post Budget bounce and April employment (Thursday) is likely to show a 10,000 gain but with unemployment remaining unchanged at 5.5%.

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 (trade, Mueller inquiry, etc) 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, and with the ASX 200 now at 6120 it now looks a lot more believable.

Low yields and capital losses from rising bond yields are likely to drive low returns from bonds. Australian bonds are likely to outperform global bonds helped by the relatively dovish RBA.

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 prices are expected to slow 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 likely has more downside to around $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.

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