29 JUNE 2018

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

Investment markets and key developments over the past week

The past week saw geopolitical concerns around trade, and particularly the US-China relationship, continue to dominate investment markets. This saw most share markets fall, with US shares down 1.3% for the week, Eurozone shares down 1.5% despite a Friday rally on the back of an EU immigration deal, Japanese shares down 0.9% and Chinese shares down 2.7%. Australian shares remained relatively resilient falling just 0.5% for the week with higher oil prices boosting energy stocks. Bond yields continued to fall on the back of safe haven demand. Commodity prices were mixed with gold, copper and iron ore prices down but oil continuing to move higher after OPEC's decision to raise production by less than feared – the surge in global oil prices over the last week is likely to add around 5 cents a litre to Australian petrol prices. The $US was virtually flat over the last week but the $A fell slightly.

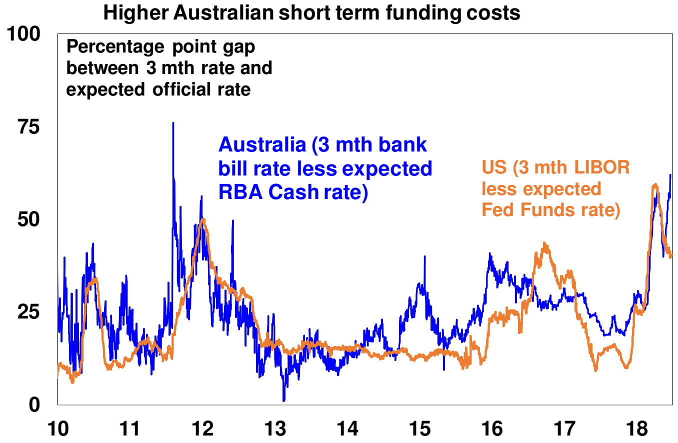
Another strong financial year for investors. While the December half year was strong as global share markets moved to factor in stronger global growth and profits helped by US tax cuts, the last six months have been messy for investors – with US inflation and Fed worries, trade war fears, uncertainty around Italy, renewed China and emerging market worries and falling home prices and the Royal Commission in Australia. Despite this the 2017-18 financial year has seen pretty solid returns for well diversified investors. Global shares look to have returned around 14% in Australian dollar terms, Australian shares returned around 13% (including dividends) and unlisted assets have continued to see double digit returns. While bond and cash returns have been more constrained this still points to balanced growth superannuation returns of around 9% for the financial year which is pretty good given inflation of around 2%. We expect returns to slow a bit over the new financial year but they should still be reasonable as the global and Australian economies are likely to keep growing and this will help profit growth at a time that monetary policy still remains easy. However, global inflation, Fed tightening and trade war fears are the main risks and they will help keep volatility high.

US trade related tensions with China remain high. President Trump's decision to support a strengthening of the Committee on Foreign Investment in the US (CFIUS) process so it can prevent foreign investors from violating US intellectual property rights, rather than declaring an economic emergency in relation to Chinese investments under the International Emergency Economic Powers Act (IEEPA) is less provocative towards China than had been feared. But ultimately the proof will be in the pudding and in the meantime, there is still no sign of the US and China restarting trade negotiations ahead of the July 6 start date for tariffs on $US34bn of Chinese imports. So, it's looking very likely that the first round of tariffs will be implemented. Our base case remains that some form of negotiated solution will be reached but things are likely to get worse before they get better.

The European leaders summit looks to be seeing ongoing plodding towards greater Eurozone economic integration and an agreement on an EU wide "Australian" solution to its migration problem focussed on beefed up external border security (stopping the boats) and holding centres (possibly offshore) to process immigrants. The progress on immigration looks to be enough to keep Italy onside and probably to keep Merkel's coalition government in Germany together for now. All of which is a positive for Eurozone assets, albeit the Italian budget issues remain for the months ahead.

What's up with Chinese shares and the Renminbi? Is it a bad sign for global growth? From its high in January the Chinese share market has fallen around 22% and the Renminbi has fallen around 6% from its April high. These sort of moves are naturally inviting comparisons to the 2015-16 plunge in Chinese shares and the Renminbi. The weakness has been triggered by signs of slowing growth in China, worries that this will be made worse by a trade war with the US and with the shift to Chinese monetary easing weighing on the Renminbi. However, its very different to 2015 when Chinese shares plunged nearly 50% (after previously more than doubling in value to a forward PE of around 19 times) amidst an unwinding of margin positions, government moves to support the market and a shift to a new way to manage the currency that led to capital outflows. This time around the share fall started from low double-digit PEs and the PE is now only around 10.5 times, there has been no panicky unwinding of margin positions, economic data is arguably more stable, there is more confidence in how the currency is managed. In fact, the fall in the Renminbi is a mirror image of the rise in the value of the $US which against a basket of currencies is up nearly 8% since April. For these reasons the fall in Chinese shares and the Renminbi is less worrying for the global and Australian economies than it was in 2015-16, which is why Australian shares have not been falling at the same time.

In Australia, some small banks have raised mortgage rates in response to a blowout in short term funding costs and others may follow. As noted several times in this Weekly Report lately the gap between bank bill rates and the expected RBA cash rate has blown out relative to normal levels (by around 0.35%) in recent months and it was only a matter of time before banks started to pass this on given they get about 20% of their funding from this source (more so for the smaller lenders which have been the only ones to move so far). Initially the blow out was driven by the same thing occurring in the US (which was partly driven by US companies returning cash held overseas in US dollars back to the US) but it has continued in Australia possibly reflecting a desire to lock in funding ahead of the financial year end (after the squeeze into the March quarter end), the Westfield takeover and regulatory reforms including the impact of the Royal Commission.



Source: Bloomberg, AMP Capital

However, there are a few things to note. First, the increased cost of funding for banks only amounts to less than 0.1% if its fully passed on to all rates so its small. Second, banks so far seem to be focussing the pass through on rates other than traditional owner occupiers on principle and interest loans – given the desire to avoid more adverse publicity - which will reduce the impact on households. Big banks which are yet to move, but likely, will are expected to do the same. Finally, its not a sign that the RBA has suddenly lost control – apart from the small nature of the rise banks have been doing out of cycle moves for a decade now and yet the main driver of the big picture trend in rates remains what the RBA does…and right now they aren't doing anything. So don't expect big changes in traditional mortgage rates. **What the latest mortgage rate hikes do though is provide a reminder to households (if one is needed) that rates can go up and at the margin along with tightening bank lending standards they make it even less likely that the RBA will hike rates anytime soon**.

Major global economic events and implications

US economic data was mostly strong. Regional business surveys mostly rose in June, pending home sales fell but new home sales surged and home prices continue to rise, core capital goods orders slipped in May but were revised to be very strong in April pointing to a strong quarterly gain in capex, jobless claims remain very low, personal spending was softer than expected in May but strong income growth and consumer confidence about as high as it ever gets points to strength going forward. Meanwhile core private consumption deflator inflation rose to 2% year on year on May, right on the Fed's target and consistent with ongoing Fed rate hikes every three months.

Eurozone economic sentiment fell only marginally in June with business sentiment actually stabilising and overall sentiment remaining strong, and money supply and credit growth picked up a bit in May. Against this though June core inflation slipped back to 1% year on year, where its been stuck for more than a year now, which is consistent with our view that the ECB rate hikes are a long way away.

Japanese data was a bit better than expected with the jobs market remaining very strong (helped by a falling population of course), industrial production falling less than expected and core inflation in Tokyo rising to 0.4% year on year in June…albeit that's still way below target so the BoJ will remain pedal to the metal.

China's central bank delivered the foreshadowed further cut to bank required reserve ratios – which looks designed to help bolster the economy as credit from shadow banking slows and given the threat of trade wars. Meanwhile profit growth remained strong in May and business conditions PMIs were little changed in June – up slightly for non-manufacturing and down slightly for manufacturing.

Australian economic events and implications

Australian data was a bit light on over the last week, but job vacancies continued to rise very strongly into May according to the ABS suggesting the labour market remains strong. Meanwhile, credit growth is continuing to slow with lending to investors stalling and the downtrend in new home sales continued in May.

The ABS should forget about a monthly CPI. It says its apparently close – maybe for mid 2020. This would be great for economists, market commentators and economics journalists as it will mean more to talk about. But as we all know monthly data just means more noise - that the ABS always encourages us to look though using its trend estimates. Which is just what the RBA will do so it won't make any difference to what happens to monetary policy. But it will mean more volatility in investment markets and more meaningless chatter about what interest rates should do. The ABS should spend the extra resources required to create a monthly CPI on stats with wider economic and social value.

What to watch over the next week?

Trade will remain a focus in the week ahead with the proposed 25% US tariffs on $US34bn of Chinese imports scheduled to start up on Thursday absent a last minute re-start of US/China trade negotiations which at this stage looks unlikely.

Meanwhile in the US we will get another update on the jobs market with labour market data for June to be released Friday likely to show a 190,000 gain in payrolls, unemployment holding at 3.8% and wages growth ticking up slightly to 2.8% year on year. In other data expect a slight fall in the June manufacturing ISM (Monday) and non-manufacturing ISM (Thursday) but only back to still strong readings of around 58 and the May trade deficit (Friday) is expected to contract slightly. The minutes from the last Fed meeting (Thursday) are likely to just reaffirm that the Fed sees itself as on track for two more rate hikes this year but will be watched to see how concerned the Fed is about the risks to global trade.

Eurozone unemployment data (Monday) for May is likely to show a slight fall to 8.4%.

The Japanese Tankan business conditions index (Monday) is expected to remain reasonably strong but will be watched for trade war worries and household spending data will be released Friday.

Chinese Caixin business conditions surveys will be released Monday and Wednesday,

In Australia, the Reserve Bank (Tuesday) is expected to leave interest rates on hold for the 23rd month in a row (or 21 meeting since they don't meet in Januarys). While a brightening outlook for mining investment, strengthening non-mining investment, booming infrastructure spending and strong growth in export volumes argue against a rate cut, topping dwelling investment, uncertainty around the consumer, continuing weak wages growth and inflation, falling home prices in Sydney and Melbourne, tightening bank lending standards and the threat to global growth from a US driven trade war all argue against a hike. So it makes sense for the RBA to remain on hold. We remain of the view that a rate hike is unlikely before 2020 at the earliest and can't rule out the next move being a cut.

Meanwhile, on the data front in Australia expect CoreLogic data for June (Monday) to show another slight fall home prices, May residential building approvals (Tuesday) to show a small bounce after a fall in April and May retail sales to slow to just 0.2% growth and the trade surplus (both Wednesday) to rise. June business conditions PMIs are likely to have remained solid.

Outlook for markets

While we continue to see share markets as being higher by year end as global growth remains solid helping drive good earnings growth and monetary policy remains easy, we are likely to see more volatility and weakness between now and then as the US trade threat could get worse before it gets better and as worries remain around the Fed, President Trump in the run up to the US mid-term elections, China, emerging markets and property prices in Australia.

Low 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, but it is waning.

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 4% 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 as the US economy booms relative to Australia. Solid commodity prices should provide a floor for the $A though in the high $US0.60s.