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Investment markets and key developments over the past week

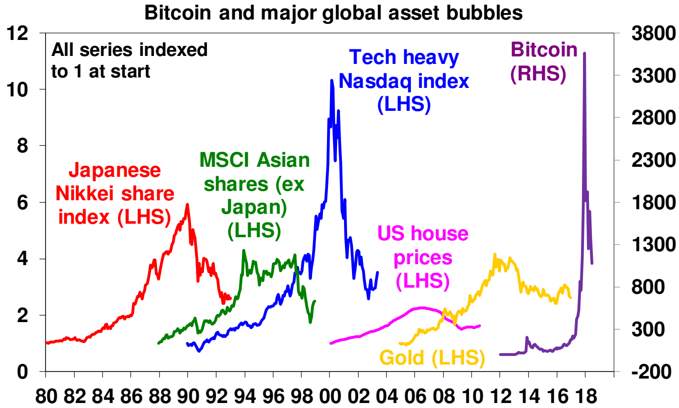
Trade war fears continued to impact investment markets over the last week, but it turned out to be a classic case of "sell on the rumour, buy on the fact" as markets bounced just before and after the initial US/China tariffs went into effect on Friday. These tariffs have been talked about since March and so were largely factored into markets and now investors appear to be hoping for a resolution. However, despite a late rally Chinese shares still fell 4.2% over the week and Japanese shares lost 2.3%, but US shares rose 1.5% and Eurozone shares gained 1.3% with good US jobs data also helping. Australian shares also rose 1.3% helped by a rebound in Telstra. Bond yields generally fell, excepting in Italy. Iron ore and metal prices fell, as did the oil price due to a rise in oil stockpiles and President Trump's pressure on Saudi Arabia to get prices down (he is clearly focussed on the mid-term elections and sees Saudi Arabia owing him a favour given the return of US sanctions on Iran). The US dollar fell back a bit, and this saw the $A push back above $US0.74.

Trade skirmish escalating, and it will likely get worse before it gets better, but still expect a negotiated solution before it gets too bad. The scheduled July 6 25% tariff on $US34bn of imports from China and Chinese same sized retaliation on US goods have started up. Of course, this along with the tariffs on steel and aluminium still only amounts to tariffs on less than 3% of total US imports that have actually started up – which is a long way from the 20% Smoot Hawley tariff on all imports in 1930s. That said it's not over yet with much more still threatened - including US tariffs on another $US16bn of imports from China proposed to be implemented soon and two additional $US200bn tranches on Chinese goods and Trump even threatening to put a tariff of more than all of Chinese imports if China keeps retaliating along with a 20% tariff on auto imports from the EU.

However, much of this still looks like a negotiating stance – otherwise all the tariffs would already have started up by now. And Trump knows that the costs to US workers (from soybean farmers to Harley Davidson workers) and consumers will escalate as more and more tariffs are imposed and this could become a problem for him if it's not resolved by the mid-term elections. There are also some signs that Europe (or at least Merkel) may be open to negotiating by cutting current EU tariffs on auto imports. So **our base case remains that some form of negotiated solution will be reached, but things are likely to get worse before they get better**. So far, the Australian share market has proved quite resilient in the face of trade war fears – partly because Australia is not directly affected, but it will become vulnerable should trade wars pose a threat to global growth as that would reduce demand for our exports.

Bitcoin bubble bath. Remember the obsession with bitcoin and the other cryptos late last year? Whatever happened to it? Well as with many such manias, the Bitcoin price peaked last December at $US19,500 just when everyone including my dog was asking about it and lots jumped on board (my dog tried but I cut off her financing!). Since then its seen a 70% plunge almost rivalling the tech wreck and providing another classic reminder to be wary of the crowd. Sure, blockchain technology has a bright future but how its priced into Bitcoin and other crypto currencies was always a separate issue.

Bitcoin and major global asset bubbles



Source: Bloomberg, AMP Capital

I have tended to ignore the ongoing Brexit related negotiations because it's a bit of a soap opera and it doesn't have much impact on global markets. It's really just a UK issue. PM May and the UK Government looks to have finally arrived at a plan for a soft Brexit - proposing a free market with the EU in goods, but not in services (which means for example that UK financial services will lose access to the EU) and people. However, so far the UK has just been arguing with itself and it's not clear the EU will support breaking up its "four freedoms" – in terms of the free movement of goods, capital, services and people. So there is a long way to go yet and the Irish border issue also remains a big one. It's too early to say the British pound is out of the woods.

For a really cool mix of Elvis doing Burning Love with the Royal Philharmonic Orchestra check here. 1970s Elvis was the best.

Major global economic events and implications

US economic data remains strong with the June ISM manufacturing and non-manufacturing indexes surprisingly rising to very strong levels, construction spending continuing to rise and another "Goldilocks" jobs report. June jobs data saw payroll employment rise a stronger than expected 213,000 and upwards revisions to previous months, but a rise in unemployment to 4% as participation rose and wages growth remaining stuck at 2.7% year on year supports the notion that there is still spare capacity in the labour market and that the so-called NAIRU (or sustainable unemployment rate) is below the Fed's estimate of 4.5%. All of which keeps the Fed on track to hike rates every three months but there is no pressure to get more aggressive. Meanwhile, the minutes from the Fed's last meeting indicate it is clearly keeping a close eye on the threat to global growth from a trade war but at this stage it still sees it as a risk rather than its base case and unlike in 2016 when it delayed rate hikes in the face of global uncertainties, the strength of the US economy today means that the hurdle to slow monetary tightening is much higher now.

German factory orders rose solidly in May after four months of falls providing some confidence that the slowdown in Eurozone growth may be bottoming out.

The Japanese June quarter Tankan survey showed continuing strong business conditions and solid capital spending plans but expectations for inflation remain well below the Bank of Japan's 2% inflation target. Meanwhile household spending remains weak but wages growth spiked higher (although its done this a few times without being sustained).

Like China's official PMIs for June, the Caixin manufacturing PMI fell slightly but the services PMI rose very strongly resulting in a solid gain overall. It's hard to see much of the feared slowdown here, although manufacturing export orders have fallen possibly on trade concerns.

Meanwhile India's manufacturing and services PMIs rose strongly in June pointing to a possible acceleration in growth.

Australian economic events and implications

Australian data was the usual mixed bag with stronger than expected May retail sales and continuing robust business conditions PMI readings, but home prices continuing to slide in June, building approvals falling again in May, a weak reading for ANZ job ads and the trade surplus coming in smaller than expected with the April surplus getting revised down. There are a few points to note here. First, both the fall in building approvals and the rise in retail sales look to have been exaggerated by volatile components. Second, trade looks to be on track for a flat growth contribution this quarter after the March quarter boost but fortunately the consumer looks likely to have perked up in the current quarter which will help keep the economy growing albeit not as strongly as the RBA is expecting. Finally, we continue to see more downside in home prices, particularly in Sydney and Melbourne where we expect 15% or so top to bottom falls spread out to 2020 with a nationwide decline of around 5%.

Meanwhile, the RBA provided no surprises in leaving interest rates on hold for the 23rd month in a row which given the various cross currents affecting the economy - stronger investment, infrastructure and export volumes but weakness in housing, the consumer, inflation and wages and banks tightening lending standards - is where they are likely to remain for a long while yet. **We see no RBA rate hike before 2020 and still can't rule out the next move being a cut**.

What to watch over the next week?

In the US expect to see June CPI inflation (Thursday) push up to 2.9% year on year as higher energy prices impact and core inflation edge higher to 2.3% yoy from 2.2%. Rising inflation pressures are also likely to be evident in a further rise in core producer price inflation (Wednesday) to 2.6% yoy although US dollar strength is likely to keep import price inflation (Friday) down. Small business confidence and labour market hiring and vacancy data will also be released

Chinese June CPI inflation is expected to rise to 1.9% year on year (from 1.8%) and producer price inflation is also expected to rise to 4.3% yoy (both due Tuesday). Export and import growth (Friday) is likely to show a moderation to around 10% year on year and 20% year on year respectively. June money supply and credit data will be watched for an acceleration after slowing in May and as monetary easing starts to impact.

In Australia, the focus is likely to be on confidence readings with the June NAB survey likely to show continuing strength in business conditions, but the Westpac/MI consumer survey for July (Wednesday) showing consumer confidence running around average levels. May housing finance data (also Wednesday) is likely to remain soft with another fall.

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 driven trade skirmish 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. In the very short term there is now a good chance that the Australian ASX 200 index will hit our year-end target of 6300 early.

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 continue to fall, 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%.

After having become oversold the $A is due a short-term bounce, but the trend likely remains down 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.