

WEEKLY MARKET UPDATE

16 SEPTEMBER 2016



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

Investment markets and key developments over the past week

While the US share market recovered some of its loss from the previous week as fears of an imminent Fed rate hike declined, other major share markets fell over the last week as bond yields generally rose further and they saw a catch up to the earlier fall in US shares. Commodity prices were mixed with oil down on supply concerns but metal prices up. While the \$A bounced around with fluctuating Fed rate hike expectations it ended the week just fractionally lower.

The soap opera regarding the Fed swung back to dovishness over the last week with Fed Governor Brainard remaining dovish and urging "prudence" in raising rates and soft economic data seeing the US money market's assessment of the probability of a September rate hike fall below 20%.

Have central banks run out of bullets? Is fiscal policy now about to take over? The back-up in bond yields (just a flick in a big picture context) and volatility in share markets over the last week or so in part has its origins in concerns that some central banks have hit the bottom of the monetary policy barrel and that the focus will now shift to fiscal stimulus. This seems to be now the standard narrative in financial markets, but when everyone starts saying the same thing I must admit to get a bit concerned. While I think we will see a shift in focus from monetary policy to fiscal policy (see this <http://bit.ly/2bKcLts>) I doubt that we are seeing an abrupt turn. First, government's should do more to help boost growth both via structural reforms and fiscal stimulus (where they can) - but a shift in this direction is likely to unfold slowly. Second, central banks would all like more help from their governments but they also have inflation mandates and when inflation is well below target they still have to act. Third, the situation varies dramatically between the major central banks so it's impossible to generalise and say they have all run out of bullets:

> the debate (or rather soap opera) in the US is not whether the Fed has run out of bullets but about the continuing process of removing monetary stimulus because it has been successful;

> while the ECB did not seem to be in a hurry to do more stimulus at its last meeting it wasn't expected to anyway, it currently sees no reason to rush into doing more and the debate has only been about whether it will extend its current

quantitative easing program but it still has plenty of time (and scope) to do that because it doesn't expire till March next year; > the situation facing the Bank of Japan is more problematic because of all major countries Japan is the one where deflation expectations are more entrenched. While the BoJ initially had some success in 2013 and 2014, this has now failed for a variety of reasons. To get a more assured result Japan is one country where "helicopter money" (ie the direct financing of fiscal stimulus by the central bank) should be considered;

None of this is directly an issue for the RBA - it has lots of bullets (150 points of rate cuts & hasn't even done QE) and with growth remaining good is unlikely to run out of them anyway.

The bottom line is that a shift in reliance away from monetary policy towards fiscal policy and structural reforms is desirable but it's likely to be a gradual process and vary from country to country. It's unlikely to justify a rapid back up in bond yields (more like a choppy bottoming) or sharp fall in share markets.

In Australia, there was some good news on the budget with the Government and Opposition agreeing on \$6.3bn in savings over the next four years highlighting that sensible bi-partisan agreement is possible. A compromise on the "retrospective" aspect of the proposed superannuation savings suggests they are likely to be passed as well. That said this just helps keep the budget projections on track as such savings had already been largely factored into projections and there is still another \$40bn or so in savings that have yet to be legislated so the risk to the AAA rating remains.

Major global economic events and implications

US economic data was soft with weaker than expected retail sales and industrial production, a slight fall in small business confidence and weak producer price inflation. While the New York and Philadelphia regional manufacturing surveys showed improvement the components were soft. Although jobless claims remain low and retail sales tend to understate consumer spending the weak run of data lately doesn't support the case for an imminent Fed rate hike.

The Bank of England left monetary policy on hold following last month's easing & seemed a bit more upbeat on the outlook.

Eurozone industrial production fell in July, but business conditions PMIs point to a reasonable bounce back in August.

Chinese economic data was better than expected in August adding to confidence growth has stabilised around 6.5-7%. Industrial production, power consumption, retail sales, investment and growth in credit all picked up pace.

Australian economic events and implications

Australia saw good news on business and consumer confidence but mixed jobs data. While the NAB business survey showed a slight fall in business conditions it is still above average and business confidence actually rose. Meanwhile consumer confidence edged up slightly on the Westpac/Melbourne Institute measure and remains around average, but rose to be well above average according to the ANZ/Roy Morgan measure. The bottom line is that confidence is okay in Australia. August jobs figures were a bit messy but jobs growth is still solid at 1.5% year on year and unemployment is trending down but weak growth in full time jobs is going hand in hand with high underemployment meaning that there remains plenty of spare capacity in the Australian labour market. In other words the economy can still run faster until it is used up.

On the growth front RBA Assistant Governor Kent made a point that is very important for Australia and this is that we are heading towards “the abatement of two substantial headwinds” being the falls in the terms of trade and mining investment. Just as the housing construction cycle starts to turn down in 2018 the big growth drag from these two will likely have come to an end enabling reasonable growth to continue.

What to watch over the next week?

The week ahead is a big one with the long awaited Fed rates decision and the outcome of the Bank of Japan’s “comprehensive review” both due on Wednesday.

Our assessment is that the Fed will remain on hold. Recent economic activity data has been mixed – with strong jobs data but weak ISM business surveys, industrial production and retail sales – pointing to growth averaging below the Fed’s own expectations and a long way from any overheating. So with wages growth remaining subdued and its preferred inflation measure stuck at just 1.6% yoy the Fed can afford to wait. This is particularly the case with global growth remaining subdued and the risk that a Fed rate hike could lead to a renewed surge in the \$US which will weigh on US growth and create problems in currency markets and the emerging world including China. A September hike can’t be ruled out but with the US money market only attaching an 18% probability to it, a surprise hike would unleash market ructions that the Fed would probably prefer to avoid. So **our base case is that the Fed will be on hold but it may send a signal that it anticipates economic conditions to justify a hike in December (with the “dot plot” dropping to just one hike for this year from two) but indicate that this remains data dependent (as it should be).**

On the data front in the US, expect the home builder conditions index (Monday) to remain strong, housing starts to fall slightly but permits to rise (Tuesday), existing home sales to rise (Thursday) and the Markit manufacturing conditions PMI (Friday) to remain around the okay 52 level.

In the Eurozone the composite business conditions PMI (Friday) is expected to remain solid at around 52.9.

Expectations are low for the Bank of Japan’s meeting on Wednesday and it’s likely that only modest measures will be announced. While its adoption of a 2% inflation target and massive monetary expansion initially had some success this has flagged in the last 18 months thanks to the GST tax hike which knocked Japan back into recession, the slump in oil

prices which knocked inflation back down and global growth worries and share market weakness since mid-last year that have pushed the Yen higher. It now appears to be positioning the 2% inflation target as a longer term objective. The BoJ appears to be reluctant to add to its purchases of Japanese Government Bonds (it already owns more than 40% of them) and various reports suggest that it is looking to try and encourage a steeper yield curve by buying shorter dated bonds and possibly even lowering its negative interest rate. Logically the next step for Japan is “helicopter money” ie direct BoJ financing of fiscal stimulus so as to achieve a more guaranteed impact than just bond buying but without ramping up Japan’s already high public debt. But while the BoJ may stress close cooperation with fiscal policy, it’s doubtful it’s ready to announce helicopter money just yet.

In Australia, it will be a quiet week. Expect ABS home price data for the June quarter (Tuesday) to show a 3% rise, based on CoreLogic data (which rose 3.3%) which is now the source for ABS home price data. Skilled vacancy data and March quarter population figures will also be released.

Outlook for markets

Shares may get a short term boost if as expected the Fed leaves rates on hold in the week ahead. But after a period of strong gains from February lows they remain vulnerable to a further correction in the next few months. September and October are often rough months seasonally and various event risks loom in the months ahead including ongoing debate around the Fed, the Austrian presidential election, Italian banks, the Italian Senate referendum, the US election and global growth generally. **However, after a short term correction, we anticipate shares to trend higher over the next 12 months** helped by okay valuations, continuing easy global monetary conditions and continuing moderate global economic growth.

Ultra-low bond yields point to a soft medium term return potential from them, but it’s hard to get too bearish in a world of fragile growth, spare capacity, low inflation and ongoing shocks. That said the bond rally this year had taken yields to pathetic levels leaving them at risk of a snapback, which we are now seeing.

Commercial property and infrastructure are likely to continue benefitting from the ongoing search for yield by investors.

Dwelling price gains are expected to slow to around 3% over the year ahead, as the heat comes out of Sydney and Melbourne thanks to poor affordability, tougher lending standards and as apartment prices get hit by oversupply.

Cash and bank deposits offer poor returns.

There is a high risk that the \$A will re-test its April high of \$US0.78 if the Fed continues to delay, presenting challenges for the RBA. Beyond the short term though we see the longer term downtrend in the \$A ultimately resuming as the interest rate differential in favour of Australia narrows as the RBA continues cutting and the Fed eventually resumes hiking, commodity prices remain low and the \$A sees its usual undershoot of fair value.