MARKET OUTLOOK

29 August 2016

Economic and Market Round-Up

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Investment Markets and Key Developments over the Past Week

While Eurozone shares rose 1.2% over the last week, US shares fell 0.7%, Australian shares lost 0.2%, Japanese shares fell 1.1% and Chinese shares fell 1.7%. A ramping up of expectations of a Fed rate hike, reinforced by comments from Fed Chair Janet Yellen and Vice Chair Stanley Fischer, and downwards pressure on defensive shares, weighed on the US share market. Concerns about regulatory controls of interbank lending and property weighed on the Chinese share market. In a broader sense some sort of share market consolidation/correction seemed likely after the strong gains seen over the last six months. Meanwhile the Australian dollar and commodity prices were a bit softer as the US$ rose. Bond yields rose in the US but were flat to lower elsewhere.

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Janet Yellen's Jackson Hole speech reinforced the message that the Fed is getting more confident about resuming rate hikes. In a more upbeat assessment of the US economy she bluntly noted that the case for a rate increase "has strengthened in recent months" but she continued to refer to "gradual" hikes and noted that monetary policy is not on a pre-set course. While her comments are consistent with a possible September hike – as subsequently emphasised by Vice Chair Fischer – there was no clear guidance as to timing and we remain of the view that a hike in December is more likely (unless of course Friday's August payroll data shows an ultra-strong gain of 250,000 or so). Yellen's comments are consistent with those from the Fed's Dudley, Williams and Fischer over the last two weeks but coming from her they naturally take on more significance. As a result US money market-implied probabilities of a September and December rate hike have now moved to levels that look reasonable at 42% and 65% respectively, after being ridiculously low just two weeks ago.

However, while the move towards another Fed rate hike will likely cause bouts of consternation in investment markets I don't see the same degree of uncertainty that we saw around last year's Fed rate hike. This is because it's clear from the Fed's actions this year that it is aware of global risks, the impact of its own actions on those risks and any potential blow back to the US economy and of the impact of a rising US$ in doing some of its tightening work for it and so acting as a limitation on how much it can hike. In short, expect the Fed to remain cautious and gradual.

In terms of the Fed's monetary policy toolkit, the basic message from Janet Yellen was that it was appropriate and adequate. While she noted that the Fed "is not actively considering…additional tools and policy frameworks" she did highlight the need for more effective fiscal policy, an assessment that is becoming increasingly obvious given that there is only so much monetary policy can do.

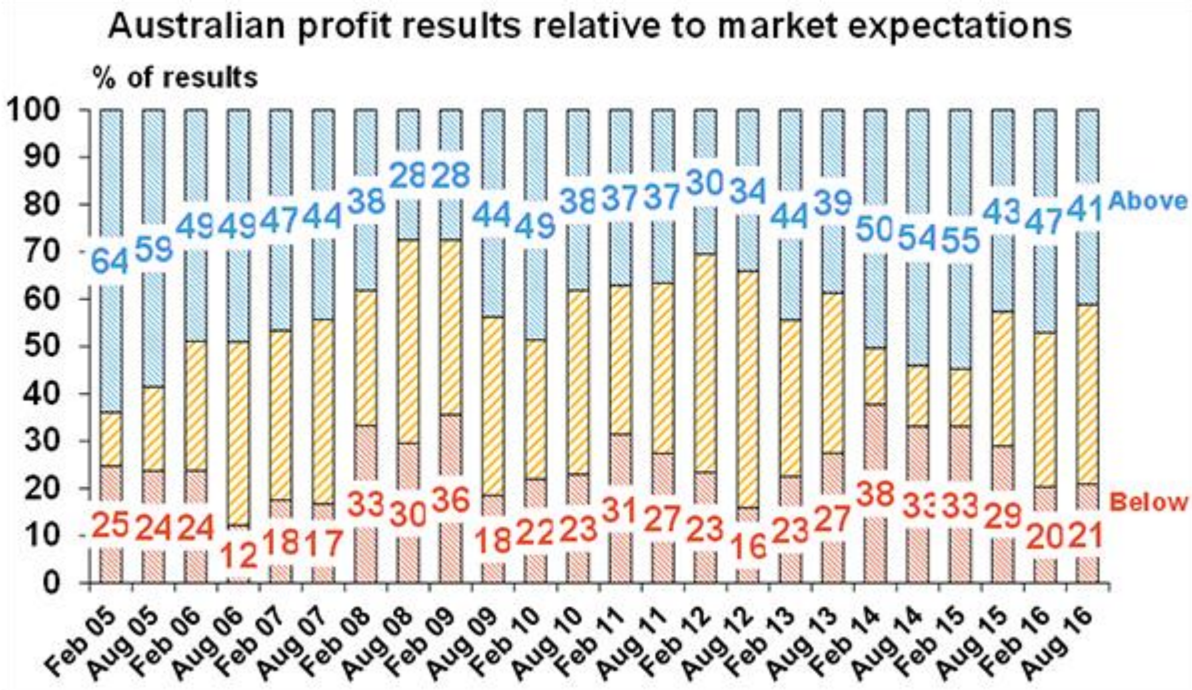
The next few months will see a bit of a renewed ramp up of political risk in Europe with the main events being the Italian Senate referendum and Austrian presidential election re-run in October, both of which have the potential to see a return of worries about a break-up of the eurozone (which I continue to think ultimately won't happen). But in the week ahead the focus will be on Spain. In an effort to break a political deadlock Spanish PM Rajoy has called a confidence vote to be held on Tuesday or Wednesday, with a potential follow up on Friday, to help resolve the political impasse Spain has been in since the December election. While the June election saw his centre right People's Party attract more support (and the far left eurosceptic Podemos attract less) and he has the support of the Citizen's party, he still lacks an outright Parliamentary majority. The vote will put more pressure on the centre left Socialist party to at least abstain or risk having another election later this year. Our base case is that a minority centre right Government will ultimately be formed, but there is still some risk around that and some way to go before it is confirmed.

Ukraine tensions on the rise. After falling out of the headlines following a peace deal, the Ukrainian conflict may be hotting up again with increasing violence in the Donbass region of eastern Ukraine and tensions around Crimea. A further escalation could threaten the peace deal and potentially cause nervousness in investment markets. However, while this may occur we doubt it will become a major problem for the same reasons we couldn't see it escalating two years ago - the US regards Ukraine as part of Russia's "sphere of influence" and Europe has little interest in getting directly involved. And of course both the US and Europe are a bit distracted at present anyway (which may partly explain what Putin is up to). In any case the lifting of sanctions on Russia next year is starting to look less likely.

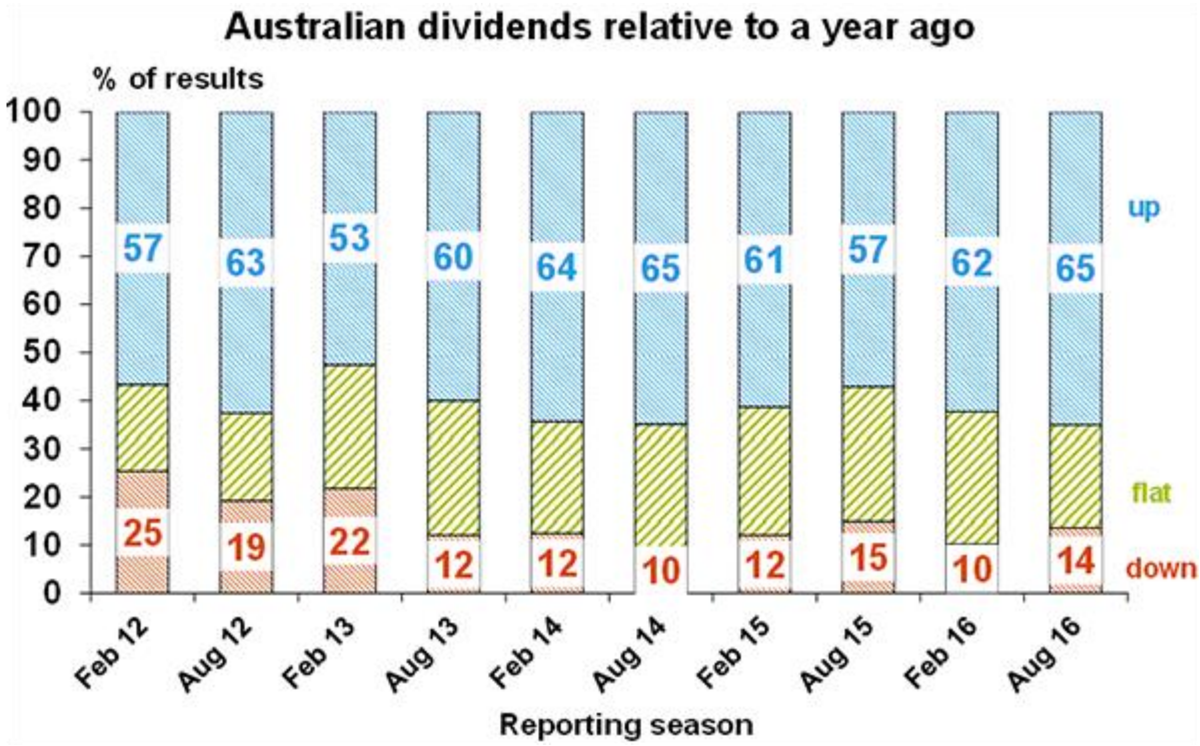
2015-16 was a bad year for listed company profit growth in Australia, but the worst may be behind us. As is often the case with profit reporting season, the quality of results deteriorates towards the end and we have seen that over the last week. With nearly 95% of results having been released the past week has seen the total number of companies exceeding expectations fall back to 41%, which is below the norm of around 45%.

The key themes have been pretty much as expected, with a horrible year for resources stocks (that suffered a 48% profit plunge). However improving conditions lie ahead on the back of improving commodity prices, cost controls and supply side discipline. Constrained revenue growth for industrials, ongoing cost cutting, continuing headwinds for the banks and an ongoing focus on dividends - with 86% of companies raising or maintaining their dividends – will offer further support.

While overall Australian listed company profits have fallen by around 8.5% in 2015-16 thanks largely to the resources slump, it is notable that 62% of companies have actually seen their profits rise on a year ago and the median company has seen profit growth of around 4%. 54% have seen their share price outperform the market the day results were released, which adds to the view that results haven't been worse than expected. Overall profits are on track to return to growth in 2016-17 as the slump in resources profits reverses and non-resource stocks see growth. 2016-17 earnings growth is expected to be around 8%, with mining companies now seeing the fastest rate of upgrades.



Source: AMP Capital



Source: AMP Capital

Major Global Economic Events and Implications

US data was a bit mixed. Manufacturing and services conditions PMIs fell slightly in August but against this, durable goods orders including for capital spending were stronger than expected in July. Existing home sales fell in July but this followed several months of gains and new home sales surged higher pointing to a sharp rise in housing starts; permits and home prices continue to rise moderately. Meanwhile unemployment claims remain very low and the goods trade deficit fell in July. June quarter GDP growth was revised down but only slightly to 1.1% annualised (from 1.2%) and this was mainly due to lower inventories.

Eurozone business conditions PMIs continue to point to resilience with the composite PMI for August rising slightly to a solid 53.3, a level which is consistent with ongoing moderate growth.

The Japanese manufacturing conditions' PMI improved slightly in August, but remains weak at 49.6 indicating continued weak growth in Japan. Meanwhile the CPI remained in deflation at -0.4% year-on-year and core inflation slipped back further to just 0.3% year-on-year. The benefits from Abenomics – at least in terms of breaking the deflation mentality in Japan – look to be fading. Ultimately I think the Bank of Japan and the Japanese Government will jump in with more aggressive policies – but that may still be a way off.

China's MNI business sentiment indicator for August fell, but retains most of the gains it has seen since its low earlier this year. Meanwhile, after the rebound in property prices seen over the last year it's no surprise to see Shanghai looking at ways to cool it down again. The People's Bank of China's moves to reduce the supply of overnight money to the interbank lending market also caused some consternation in the last week, although this seems to be offset by an addition of longer term funds (in a sort of "operation twist").

Australian Economic Events and Implications

Australian construction activity fell more than expected in the June quarter, led as usual by another sharp slump in mining related engineering activity which offset gains in residential and non-residential building activity. This points to another weak quarter for business investment and trade is unlikely to contribute much to growth after the March quarter surge, hence June quarter GDP growth could fall back to around 0.3% quarter-on-quarter after the 1.1% quarter-on-quarter surge in the March quarter. That said, it will still be up 3.1% year-on-year.

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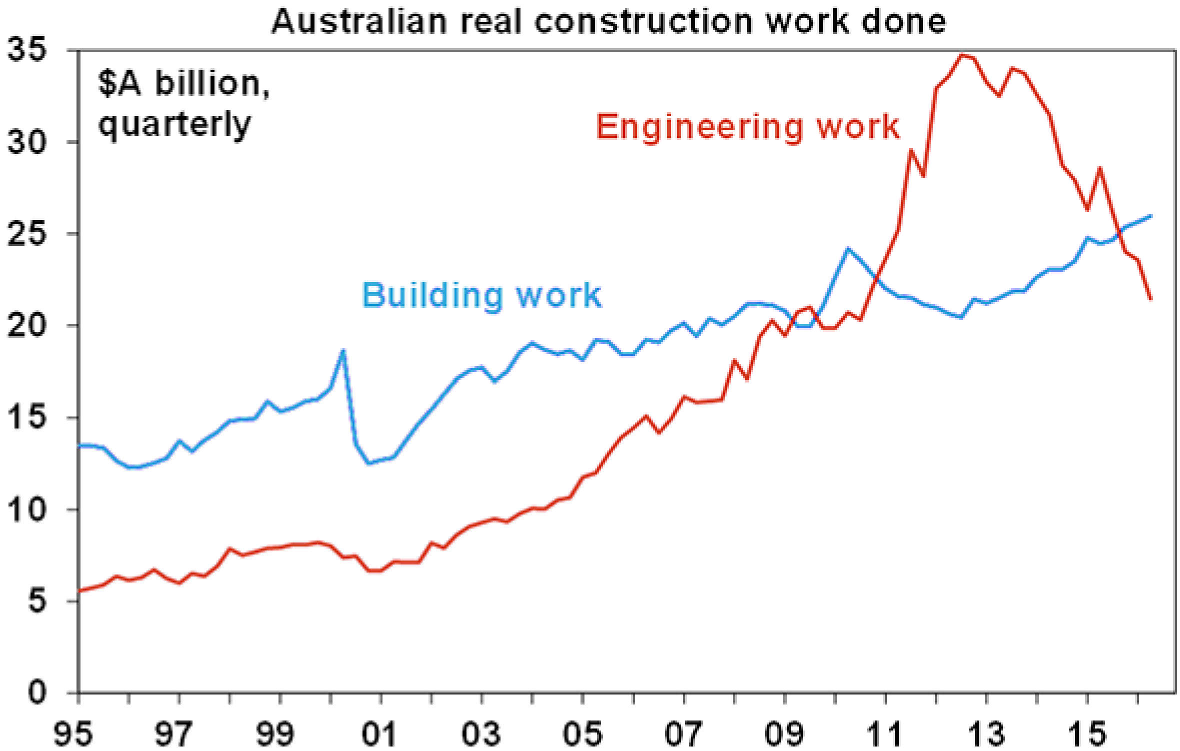
Perhaps more significantly, the volume of engineering construction has now fallen back to near its long term trend indicating that the wind down in the mining investment boom is almost complete and that it will be less of a drag on growth next year. Meanwhile, skilled vacancies slowed again in July consistent with a further slowing in jobs growth after the surge of last year, but the ANZ-Roy Morgan weekly consumer confidence index has hit a three year high which may be good news for consumer spending.



Source: ABS, AMP Capital

Week Ahead

In the US, the big focus will be on August jobs data (Friday) as the last major data release ahead of the Fed's 26-27 September meeting. Expect an 180,000 gain in payrolls, a fall in unemployment to 4.8% and wages growth remaining around 2.6% year-on-year. This should be enough to keep a rate hike "in play" for the September Fed meeting, but not enough to make it probable. In other data, expect soft July personal spending growth and a fall in the core private consumption expenditure measure of inflation to 1.5% year-on-year (Monday), continued trend gains in home prices and unchanged consumer confidence (Tuesday), a modest rise in pending home sales (Wednesday), the August manufacturing conditions PMI to fall slightly to 52 (Thursday) and a slight improvement in the trade deficit (Friday).

Eurozone economic confidence readings for August will be released Tuesday but are likely to remain around okay levels. The confidence vote in the Spanish parliament for PM Rajoy will also be watched closely.

Expect Japanese data for July to show ongoing labour market strength but weakness in household spending (both Tuesday) and industrial production (Wednesday).

Chinese manufacturing conditions PMIs for August will be watched closely (Wednesday) but both the official and Caixin PMIs are expected to remain around the 50 level consistent with GDP growth around 6.5% or a bit more. The non-manufacturing PMI will also be released.

In Australia, expect July data to show a 2% bounce in building approvals (Tuesday) after two months of falls, continued moderate growth in credit (Wednesday), a 0.3% gain in retail sales and continued softness in June quarter business investment led by mining investment (both Thursday).

Capital spending intensions data will be watched closely for any improvement in the outlook for non-mining investment and Core Logic data on August home prices (also due Thursday) will be watched to see whether recent strength in Sydney and Melbourne property prices has continued.

The Australian June quarter earnings reporting season will wrap up with only 12 major companies left to report in the week ahead including Harvey Norman and Adelaide Brighton.

Outlook for Markets

After a period of strong gains, shares are arguably due for a breather. Weak seasonal market trends over the next couple of months along with risks around Italian banks, the Italian Senate referendum, the Fed and global growth generally could be the drivers for a pause. However, after a 1-2 month correction or consolidation, we anticipate shares to trend higher over the next 12 months helped by okay valuations, very 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. Nonetheless, the recent bond rally has taken yields to pathetic levels leaving them at risk of a snapback.

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.

Recent more hawkish Fed commentary has dampened the A$, but if it delays again then the A$ could resume its push back up to April's high of US$0.78. Beyond the short term though we see the longer term downtrend in the A$ ultimately resuming as the interest rate differential in favour of Australia narrows as the RBA continues cutting and the Fed eventually resumes hiking, the risk of a sovereign ratings downgrade continues to increase, commodity prices remain in a secular downswing and the A$ sees its usual undershoot of fair value.

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‘OUR INVESTMENT PHILOSOPHY’

- Investing requires a long-term approach. Share markets do react, often sharply, to crises. Yet they tend to snap back quickly as investors reassess the real economic impact of these events. So it is important for investors to think long-term when crisis strikes. And there is compelling evidence that panic selling is bad for your wealth in the short term as well.
- Not attempt to time markets or tactically asset allocate across asset sectors.
- In limited circumstances we will trade investments within an asset class in an attempt to increase short term performance. A related mistake is jumping into last year's top performing fund or asset sector. If you invest after a terrific run-up, you may be arriving just in time for a fall.
- Diversifying both within sectors and across the various asset classes, with the aim of achieving the highest 'risk-adjusted' return possible based on the client's individual personal tolerance for risk and volatility.
- We will regularly monitor and when required, rebalance a client's portfolio so as to remain within the appropriate long term asset allocation and objectives.
- Recommending quality investments with high independent research ratings.
- Recommending managers with good defensive capabilities where required.
- Concentration on only buying quality blue chip shares.