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Investment Strategy & Economics

Weekly market & economic update

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Investment markets and key developments over the past week

> **The past week saw more messy and volatile trading in share markets** with dovish comments by US and European central bankers along with mostly good profit news providing support but worries about tech stocks and uncertainty about Ukraine continuing to drag. While European shares rose slightly, US and Asian shares fell. Australian shares were little changed with budget fears continuing to drag on consumer stocks. Bond yields were mixed, but with yields continuing to fall in formerly troubled Eurozone countries. The $A gained in response to stronger than expected jobs growth while talk of ECB easing weighed on the euro.

> **Ukraine risks have receded a bit with Russian President Putin sounding more constructive**. However, there has been no real progress in terms of resolving the crisis and so Ukraine still has the potential to cause volatility in investment markets.

> **In Australia, it's likely the Budget will contain income tax hikes but only applying to those earning more than $180,000 so as not hit those earning between $100,000 and $150,000 with a double whammy as welfare is cut back too**. That makes sense and helps minimise the short term blow to spending. But taking nearly 50% of extra income away from high income earners is a backward step in terms of incentive and the need to address poor productivity. A supposed temporary income tax hike along with a hike in fuel excise also does nothing to deal with what is really a structural spending problem.

> **Our concern is that the Government has exaggerated the budget problem – it's a problem, but far from an emergency - and that this combined with the political cycle which argues in favour of getting the budget pain over with early will result in the Government going too hard in terms of the fiscal austerity**. The OECD has rightly warned Australia that "heavy front loading of fiscal consolidation should be avoided". Right now the economy is still a bit fragile with only tentative signs of improvement in the non-mining economy. But this could be snuffed out if the budget is too tough. The key is to put policies in place that bring long term spending growth under control, as opposed to adopting too much austerity in the short term. Hopefully this will be the case.

> **The clear message from the RBA's quarterly Statement on Monetary Policy is that interest rates will likely remain on hold for a while yet**. The RBA only made minor changes to its economic forecasts – seeing growth this year and next of 2.75%, before rising to 3.25% in 2016/16, with near term uncertainties remaining around the decline in mining investment and the pick-up in the non-mining economy. While the RBA is allowing for weak public demand it would probably be loath to have to respond to excessive fiscal austerity by cutting interest rates again for fear of over stimulating the housing market.

Major global economic events and implications

> **US data was relatively light but provided a mixed picture**. The trade deficit narrowed in March but along with data for construction and inventories points to a revision to March quarter GDP growth into negative territory. That said June quarter GDP growth looks like being a strong 4% annualised or so and gains in the ISM and Markit services PMIs for April were consistent with this. A survey of bank lenders pointed to easier conditions for business loans but weaker housing loan demand. Chair Yellen's overall message remained dovish saying there is no timetable for when interest rate hikes will occur.

> **US March quarter earnings have continued to impress**. 449 S&P 500 companies have reported and while bad weather depressed annual sales growth to 2.5%, 76% have exceeded earnings expectations which looks like coming in at 5.5% year on year. This is good compared to expectations for a 1% fall a month ago.

> **The ECB left monetary conditions unchanged as generally expected, but President Draghi signalled a clear willingness to ease in June to combat the problem of low inflation and the strong euro**. It's not sure though whether the ECB is ready for quantitative easing though and so any easing may take the form of fractional cuts to interest rates. Meanwhile Eurozone data was mostly okay with a decent rise in the business conditions PMI confirmed for April and stronger than expected March retail sales.

- **Chinese export and import data both unexpectedly rose slightly in April**, which is a big improvement on previous months. Meanwhile inflation continued to subside in April to 1.8% year on year and producer prices continuing to fall, suggesting along with the slowing housing market plenty of scope for monetary easing.

Australian economic events and implications

- **Australian economic data was mostly okay with the highlight being another solid jobs report in April**, which saw unemployment remain off its high at 5.8%. An improvement in forward looking labour market indicators – such as ANZ job ads – also augurs well for the labour market. On top of this, building approvals remained strong in March, retail sales are up for 11 months in a row and the trade balance remains in surplus.
- **However, the recovery still remains tentative with uncertainty remaining about how rapid mining investment is slowing and a potentially tough Budget coming up**. As a result it's no surprise to see the RBA on hold for the eighth meeting in a row. Our assessment remains that they will remain on hold ahead of rate hikes starting around September or October but if Tuesday's Budget proves too tough then rate hikes will be delayed till next year and some may even start talking about rate cuts again. So it's all eyes on the Budget.

What to watch over the next week?

- **In the US, expect a 0.3% gain in April retail sales (Tuesday)**, a rise in the headline inflation rate (Thursday) to 2% year on year as the impact of health care costs a year ago drop out but with core inflation remaining a benign 1.7% year on year and gains in the NAHB home builder's index (Thursday) and housing starts (Friday).
- **Eurozone March quarter GDP growth (Thursday) is expected to pick to around 0.4%** quarter on quarter.
- **Japanese March quarter GDP growth (also Thursday) is likely to be a strong 1% quarter on quarter**, but this will reflect the bring forward effect associated with the April sales tax hike and so will overstate Japanese growth just as June quarter growth will understate it.
- **Chinese April data for industrial production, fixed asset investment and retail sales (Tuesday) are expected to show stabilisation or a mild pick-up in growth**.
- **In Australia, the main focus will be on Tuesday's Budget which is expected to a show steeper decline in the budget deficit than currently projected (in December's MYEFO) with a return to surplus by 2019-20 on the back of spending cuts and tax hikes along with slightly more optimistic growth assumptions**. After a 2013-14 deficit of $46bn, the budget deficit for 2014-15 is likely to be cut to $26bn (from $34bn in MYEFO) and that for 2015-16 to $18bn (from $24bn in MYEFO). Additional fiscal tightening in the budget is likely to be 0.3% of GDP for 2014-15 building to 0.8% of GDP by 2017-18.
- **The main budget savings are likely to be** a phased cut in the income threshold for family benefits from $150,000 to $100,000; tougher means testing for the pension; co-payments for GP visits; a further shrinkage of the public sector; the resumption of fuel excise indexation; a temporary 2% increase in the top marginal tax rate which kicks in at $180,000; moves to increase the cost of higher education; a further increase in the pension age to 70 by 2035; and a possible delay in the start-up of the National Disability Insurance Scheme. Likely sweeteners are using asset sales to fund increased infrastructure spending and a possible cut to the corporate tax rate to offset the increase that will flow from the paid parental leave levy. Whether each these measures pass the Senate will be a key uncertainty.
- The Government's GDP growth assumptions are likely to be edged up a bit to 2.75% for 2014-15, from 2.5%. Note the RBA's growth forecasts are running about 0.25% above the Government's forecasts at present.
- On the data front in Australia, the NAB survey will be released Monday, housing finance (Tuesday) is expected to gain 1% and the March quarter ABS house price index (Wednesday) is expected to show a 2.5% gain.

Outlook for markets

- **While investors should allow for more volatility in share markets, including the likelihood of a significant correction around mid-year, the broad trend in shares is likely to remain up**. Share market fundamentals remain favourable with reasonable valuations, improving earnings on the back of rising economic growth and monetary conditions are set to remain easy for some time. So any dip should be seen as a buying opportunity. For Australian shares much is riding in the short term on how aggressive the coming budget is with respect to austerity for the next financial year. Too much additional austerity would clearly be a headwind for the Australian share market.
- **Bond yields are likely to resume their gradual rising trend and this combined with low yields is likely to mean pretty soft returns from government bonds**. Cash and bank deposits also continue to offer poor returns.
- **With $A short positions now largely unwound, it's likely that the short covering rally in the $A, that saw it rise from a low of $US0.8660 in January, is now over and that the broad downtrend is likely to resume**. Commodity prices remain relatively soft and the $A is likely to revert to levels that offset Australia's relatively high cost base. Aggressive budget austerity if implemented would likely also weigh on the $A. Our medium term view remains that the $A will fall to around $US0.80.