9 DECEMBER 2016

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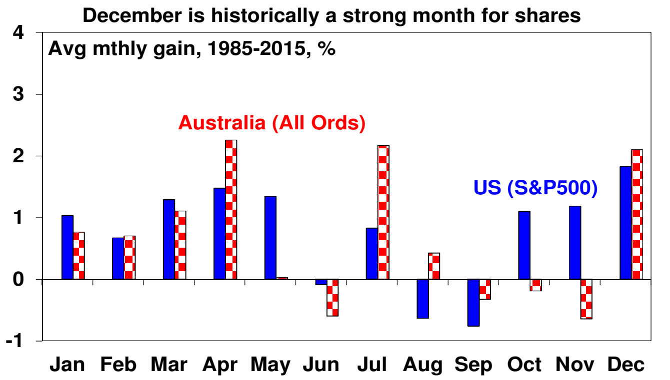
Investment markets and key developments over the past week

The past week saw most major share markets rise with a new record high in US shares, a breakout in Eurozone shares led by banks, Australian shares nearing their August high and Japanese shares continuing to surge. The main drivers have been continued good global economic data, the prospect of help for Italian banks, a dovish ECB and expectations of lower interest rates in Australia. Bond yields were mixed and commodity prices softened a bit. Despite a stronger $US the $A was little changed.

Bad news is good news. It seems that ever since the Brexit hoopla seemingly bad outcomes for share markets have seen a brief dip in markets – often in our time zone – only to be followed by a surge higher. This has been the story with Brexit, Donald Trump's election, the Italian "No" vote and even Australia's recent poor growth news. There are several reasons for this seemingly perverse response.

- First, many share markets had 20% plus falls into earlier this year so bad news was sort of factored in.
- Second, many of these events have seemed less negative than feared once they transpired – Britain and more importantly Europe did not collapse after the Brexit vote, many of Donald Trump's policies are positive for growth and hence share markets and even though Italy voted "No" there is a long way to go to get to an Itexit.
- Third, the macro economic backdrop globally – with rising business conditions PMIs, still easy monetary policy and the end of the earnings recession in several key markets – are positive in contrast to say a year ago.
- Fourthly, each event has held out the prospect of more pro-growth economic stimulus.
- Finally, December is one of the strongest months of the year – see next chart. Normally the Santa rally doesn't come till mid-December but he seems to have arrived early this year!

A lesson in all this is to turn down the noise – the coverage around Brexit, etc, was huge but investors would have been better off doing nothing but sticking to their long turn strategy. Or if you are going to do anything be contrarian & buy the dips.



Source: Bloomberg, AMP Capital

The Italian "No" vote is a case in point. It was no more a sign of increased support for the populist anti-Euro Five Star Movement than a "No" vote to a similar neutering of our Senate in Australia would signal support for One Nation. And in any case a lot will have to occur before Italy leaves the Eurozone, if at all. Meanwhile, Austrians voted against their anti-Euro far right presidential candidate in greater numbers than was the case pre-Brexit. I remain of the view that a break-up of the Eurozone is unlikely and that the various European elections in the year ahead could simply prove to be buying opportunities.

Meanwhile, the ECB provided more support for financial markets. While it cut its quantitative easing program to €60bn a month it extended it to the end of 2017 which was more than expected and President Draghi's comments were dovish.

Major global economic events and implication

US economic data remained solid with the non-manufacturing ISM business conditions index rising to a strong 57.2, job openings and hiring remaining strong and jobless claims remaining low.

Meanwhile, Donald Trump's appointments are continuing to be market friendly with his pick for head of the Environmental Protection Agency consistent with a roll back of EPA regulations and his choice of a China friendly ambassador to China could help soothe relations with China. Meanwhile, although Trump's tweets have created some angst the trick as borrowed from US political commentator Salena Zito is to treat his comments seriously but not literally.

While German industrial production was soft in October, a 4.9% mom surge in factory orders points to a rebound ahead and a broader pick up in German growth.

Japan wages growth remains weak but an economic sentiment rose to levels last seen before the sales tax hike.

In China, export and import growth improved far more than expected and producer price inflation rose further to 3.3% yoy adding to the message of improvement seen in other Chinese economic indicators.

Australian economic events and implications

As feared the Australian economy contracted in the September quarter – with broad based weakness across housing, business investment, public demand, net exports and consumer spending – but here are seven reasons why it's unlikely to signal the start of a recession.

- First, it looks to be a bit of payback for stronger than expected growth over the year to the June quarter.
- Second, the fall in housing and non-dwelling construction looks to have been partly bad weather related which should reverse with approvals for both pointing up in the short term.
- Third, public capital spending projects point to a rebound in public demand.
- Fourth, the boom in resource export volumes has further to go as various mining and gas projects complete.
- Fifth, recent retail sales data point to a strengthening in consumer spending.
- Sixth, while the drag from unwinding mining investment has further to run its impact is declining as it falls as a share of GDP and it should reach a bottom in the next year or so.
- Finally, it doesn't feel like the start of a recession. The traffic is jammed up, shopping centre's seem full and there is not the sense of foreboding seen in 1989-1990 that went into the last recession (yeah – I was around back then!). Sure it's a recession in WA but that's been the case for a while now and is a direct result of the mining investment slump, but that's not the whole of Australia.

In other data the trade deficit was worse than expected, housing finance fell but continues to bounce back for investors, ANZ job ads remain solid and the AIG's services PMI rose which along with the already reported rise in the manufacturing PMI adds to confidence growth has picked up again.

But while a recession is unlikely, underlying growth looks like its running below the RBA's assumed circa 3% pace which along with chronic low wages growth means inflation is likely to be weaker than it expects too. This is also not a good time for the banks to be raising mortgage rates (as they have started to lately with the high risk standard variable rates will go up too) and the $A remains too high. As such, we remain of the view that the RBA will cut rates again next year. It could come as early as February.

Finally, New Zealand continues to impress. Its latest budget update showed an ongoing surplus despite its latest earthquake whereas our budget updates seem to just go from bad to worse and we seem to go from one silly debate to another – eg whether to levy a back packer tax at 15% or 13% or around in circles over carbon pricing. No wonder NZers are going back!

What to watch over the next week?

In the US, after a full 12 months since its first rate hike the Fed (Wednesday) will finally raise its key interest rate again by another 0.25%. With this fully priced in the main focus will be on whether it's a hawkish hike or dovish hike so the key will be whether Janet Yellen continues to refer to "gradual" rate hikes and how aggressive the dot plot of meeting participants rate hike expectations for 2017 are. Our expectation is that the Fed will stick to the gradual language and the September dot plot of two hikes for next year but indicate that it's waiting to see how significant fiscal stimulus will be under Donald Trump.

On the data front in the US expect continued solid November retail sales growth but a slight fall in industrial production (both Wednesday), a slight rise in core CPI inflation to 2.2% yoy and continued strength in the NAHB home builders' index and manufacturing condition PMI (all Thursday) and some fall in housing starts after October's 25% surge (Friday).

In the Eurozone expect the December business conditions PMIs (Thursday) to remain solid.

In Japan the quarterly Tankan business survey (Wednesday is expected to show an improvement.

Chinese activity data for November (Tuesday) is expected to show unchanged growth in industrial production of 6.1% yoy but a pick-up in retail sales growth to 10.4% yoy.

In Australia, ABS house price data (Tuesday) is expected to show a gain of 2.5% for the September quarter consistent with private sector surveys already released, the NAB survey (also Tuesday) is expected to show business conditions and confidence in November remaining above average but consumer confidence data (Wednesday) may show a dip on the back of the weak September quarter GDP news. Jobs data (Thursday) are expected to show a 25,000 gain in employment and unemployment remaining at 5.6% but the focus is likely to remain on the full time versus part time break up.

Outlook for markets

Shares remain overbought and are vulnerable to the Fed meeting in the week ahead. **However, we continue to anticipate shares to be higher into year-end as seasonal strength continues to kick in and see share markets trending higher over the next 12 months** helped by okay valuations, continuing easy global monetary conditions, fiscal stimulus in the US, moderate economic growth and the shift from falling to rising profits for both the US and Australia.

Sovereign bonds are now very oversold and due for a short term pullback in yield. But still low bond yields point to a poor medium term return potential from them. The abatement of deflationary pressures as commodity prices head up, the gradual using up of spare capacity and a shift in policy focus from monetary to fiscal stimulus indicates that the long term decline in yields since the early 1980s is probably over. Expect the trend in bond yields to be up.

Commercial property and infrastructure are likely to continue benefitting from the ongoing search for yield by investors though as these two asset classes never fully adjusted to the full decline in bond yields.

Dwelling price gains are expected to slow, as the heat comes out of Sydney and Melbourne and as apartment supply ramps up which is expected to drive 15-20% price falls for units in oversupplied areas into 2018.

Cash and bank deposits offer poor returns.

A shift in the interest rate differential in favour of the US as the Fed remains on its path to hike rates should see the long term trend in the $A remain down.