WEEKLY MARKET UPDATE

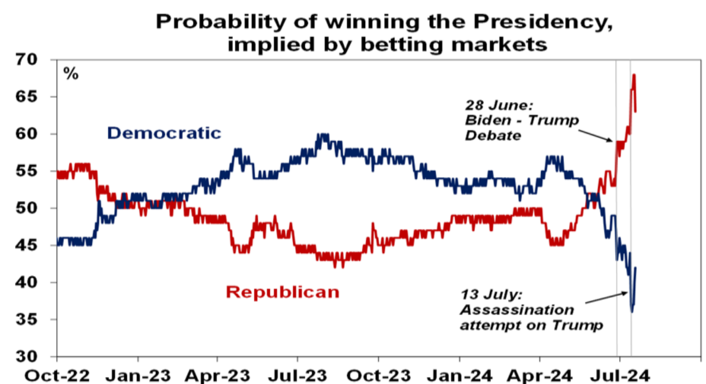
19 JULY 2024

Investment markets and key developments

Global share markets mostly fell over the last week with tech stocks remaining under pressure, US political uncertainty starting to creep in, a lack of new stimulus from the Third Plenum in China and profit taking after markets reached record highs. For the week US shares fell 2%, Eurozone shares fell 3.4% and Japanese shares lost 5.1%, but despite the disappointment around the Third Plenum, Chinese shares managed to rise 1.9%. While the Australian share market surged through the 8000 level earlier in the week, the poor global lead saw it give up most of its gains to rise just 0.2% with sharp falls in IT and resources shares but solid gains in property, consumer, health, industrial and financial shares. Bond yields rose in the US but mostly fell elsewhere on prospects for central bank rate cuts. Oil, metal and iron ore prices fell as did the $A as the $US rose.

Good and bad news for investment markets. The good news is that US June quarter earnings reports are likely to be strong, inflation globally is still falling, and more central banks are heading towards rate cuts and this should lead to improved valuations and shares anticipating stronger growth in 2025. The bad news is that valuations are stretched, recession risks remain high, geopolitical uncertainty particularly around the US election is high and we are coming into seasonally weak months for shares. So while we see more upside in shares on a 6-12 month view the risk of a significant correction as we come into the seasonally weaker period from August is high.

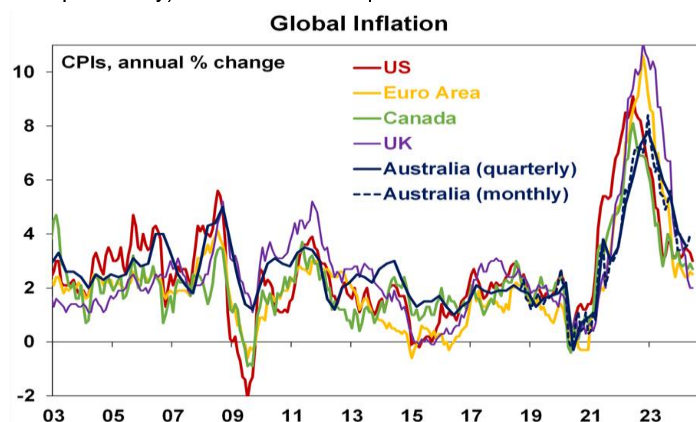
The increasingly dystopian and unfortunate reality of US politics and the spectre of a Trump victory in November are starting to loom large over investment markets. The debate debacle and the failed assassination attempt and associated sympathy boost have seen Trump and the Republicans' probability of winning the election implied by betting markets surge to around 65%. Trump's appointment of Ohio Senator JD Vance as his VP running mate effectively anoints a successor to lead the MAGA movement (15 VPs have gone on to become President in the US), further cements the rejection of the economic rationalist free market policies introduced by the Reagan era in favour of more state driven intervention and will likely strengthen Trump's populist appeal (although it may not boost support from independents). There is also an increasing chance of a Republican clean sweep (with Republican's winning the presidency and control of the House and Senate) which history shows is the worst combination for share market returns. The anticipation of a Trump victory appears to be starting to impact investment markets and his policies could have a huge impact. The obvious positives from a share market perspective are lower taxes and deregulation both of which are positive for profits. And we saw in 2017 that shares surged in response to this mix. But Trump is also proposing a huge increase in tariffs, less immigration and his team have been looking at ways to reduce Fed independence. Taken together Trump's policies point to a further blowout in the US budget deficit and higher inflation. His proposed 60% tariffs on imports from China and 10% on all other imports would boost the average US tariff from 3% to around 17% or near the 20% that applied after the Smoot Hawley tariffs of the 1930s. This would potentially add 2.5% or so to US consumer prices (as importers would seek to pass the tariff on or have to use more expensive suppliers) and take around 0.5% off US GDP. And its hard to see other countries not responding to the US declaration of a trade war with their own tariff hikes which would accentuate the hit to growth as we saw in the 1930s. Higher budget deficits and inflation would be bad for US and hence global bonds. All of which would impact share markets. Australia would be particularly vulnerable - exports to the US are only 4% of our goods exports but roughly 35% of our goods exports go to China the demand for which would be impacted by increased US tariffs on imports from China. Nervousness about trade is already starting to creep in with the share prices of computer chip makers down on fears of tougher restrictions on exports to China in the last week. As we saw in the Trump 1.0 trade war of 2018 shares were hard hit with tariff hikes contributing (along with Fed rate hikes) to a near 20% fall in US shares and a 14% fall in Australian shares. Of course, the boost to Trump's prospects could prove temporary if Democrats replace Biden (which seems likely) with a strong candidate, the boost from the assassination attempt could wear off as it did for President Reagan in 1981 and may already be doing so (see the next chart), there is still four months to go so lots could happen in the interim, Trump's tariff proposals could just be "Art of the Deal" bargaining chips and they will take up to 12 months to implement and in the interim falling inflation & falling interest rates will likely still drive bond yields lower. Even so they need to be taken seriously - particularly if the red line remains way above the blue in the next chart into November.



Source: PredictIt, AMP

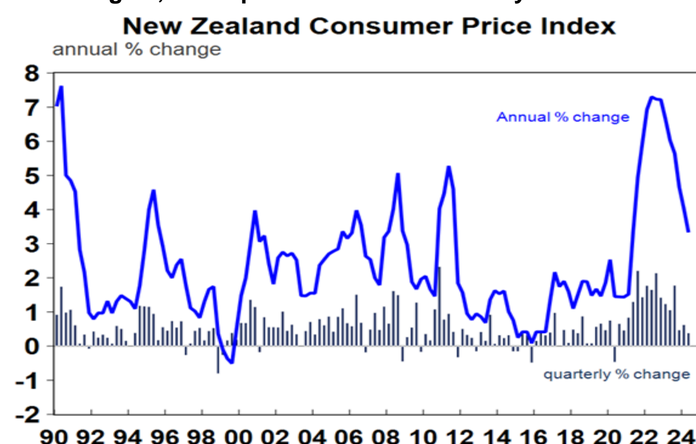
Global IT outage another blow to globalisation? While brief, and unlikely to have had a huge economic impact beyond disruptions that will have to be made up for, the global IT outage on Friday impacting many Microsoft Windows computer systems will likely further fuel the backlash against globally integrated supply chains in favour of state intervention with protectionist measures. Its also a reminder to always carry a bit of cash!

The good news is that global inflation is continuing to fall with a global monetary easing cycle falling into place. The past week saw further falls in inflation in Canada (to 2.7%yoy) and New Zealand (to 3.3%yoy) with UK inflation remaining at 2%yoy. Canada may cut rates again in the next week (with a 76% probability according to money markets) or if not then in September. UK underlying inflation measures are not as good but wages growth is slowing so a cut in August is possible (the money market has a 69% probability) or if not then in September.



Source: Bloomberg, AMP

With NZ inflation coming in lower than the RBNZ expected and underlying measures also looking favourable, the RBNZ may cut in August, but September looks more likely.



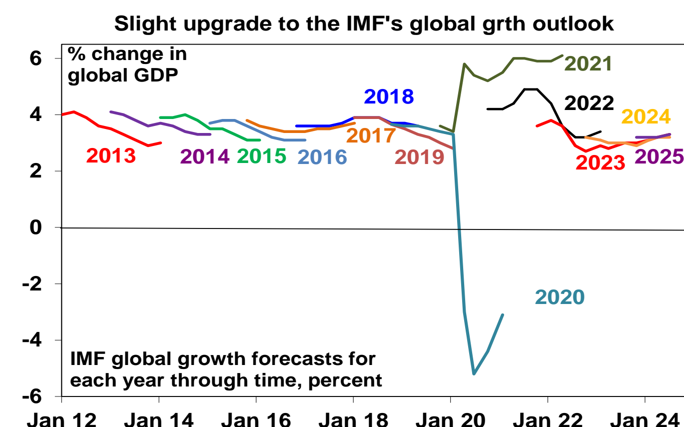
Source: Macrobond, AMP

The ECB left rates on hold as expected and looks on track for an easing in September. While it provided no precommitment its language was mostly dovish with disinflation seen continuing, policy seen as still "restrictive" and President Lagarde saying September is "wide open". It's data dependent but a September cut looks likely and is fully factored in by the money market.

And in the US, Fed Chair Powell reiterated a dovish message noting that "the three [inflation] readings in the second quarter do add to confidence" that inflation is moving sustainably to target. Fed Governor Waller also indicated "we are getting closer to the time when a cut in the policy rate is warranted". The Fed is probably not confident enough to cut this month, so the money market is only attaching a 21% probability, but it still looks on track for a cut in September – with the money market fully pricing a cut in and pricing in nearly three cuts this year.

The easing in inflation globally and moves towards rate cuts in comparable countries is a positive sign for Australia, but strong jobs growth in June keeps the risk of another rate hike here high. On its own the June jobs data is not enough to tip the RBA over into a rate hike as it was in line with RBA forecasts for 4% average unemployment in the June quarter. But if June quarter CPI data comes in on the hot side it won't prevent another hike either. That said, **the cooling in forward looking labour market data indicates that the RBA needs to be very careful here that it doesn't push the labour market into a deep meltdown**. So, while we regard the risk of another rate hike as high, our base case remains that the RBA will hold, unless there is a blow out in the underlying inflation measures in the June quarter (say trimmed mean of 1.1%qoq/ 4.1%yoy or higher). Its seeing a lot of volatility in money market expectations for the cash rate though – a few weeks ago it had priced in a 70% chance of another hike, in the days before the jobs data it had fallen back to around 13% and now it's up around 31%.

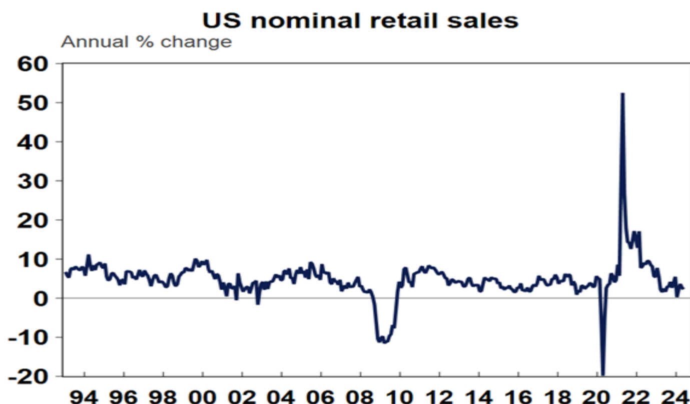
The IMF again revised up slightly its global growth outlook highlighting that at least for now the global growth outlook is okay. Reflecting the unexpected resilience of the global economy, the IMF left its global growth forecast for 2024 unchanged at 3.2% and revised up its 2025 forecast slightly to 3.3%. The 2025 upgrade was mainly due to emerging countries. Growth at this rate is pretty much what was seen in the pre-Covid period. It also revised up its inflation forecasts for advanced countries but only by 0.1% for each year taking 2024 to 2.7% and 2025 to 2.1%.



Source: IMF, AMP

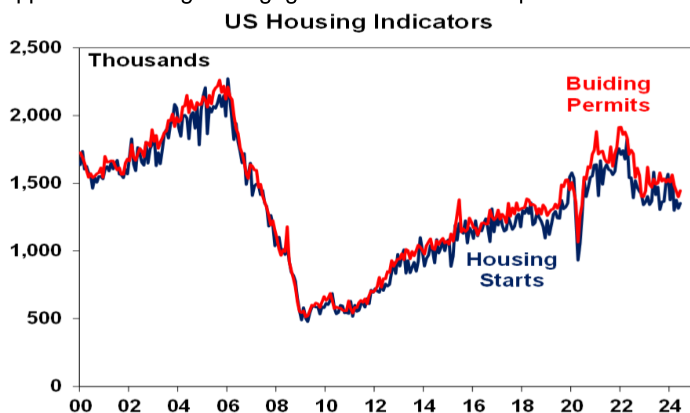
Major global economic events and implications

US economic data over the last week was mixed. The Fed's Beige Book of anecdotal evidence reinforced the message of slowing growth and easing inflation with references to "slight to modest" growth, employment rising at a "slight" pace and slight or modest increases in prices. Retail sales were stronger than expected in June. Industrial production also rose more than expected and manufacturing conditions in the Philadelphia region improved but they weakened in the New York region. Jobless claims rose sharply and look to be getting back on a rising trend after a distortion around the Independence Day holiday.



Source: Macrobond, AMP

Housing starts rose in June but this was due to a bounce in normally volatile multi-dwelling starts with starts overall remaining soft along with home building conditions and mortgage applications as high mortgage rates continue to impact.

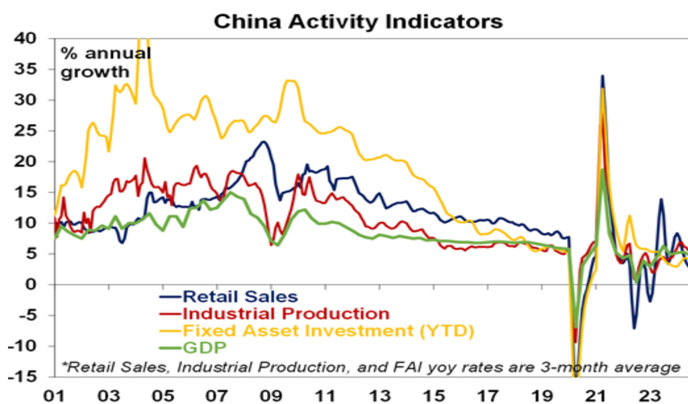


Source: Bloomberg, AMP

Its still early days in the US June quarter reporting season with only 14% of S&P 500 companies having reported so far but 81.4% have beaten expectations against a norm of 76%.

Japanese inflation was flat in June at 2.8%yoy but a rise in core inflation to 1.9%yoy supports the case for gradual BoJ tightening.

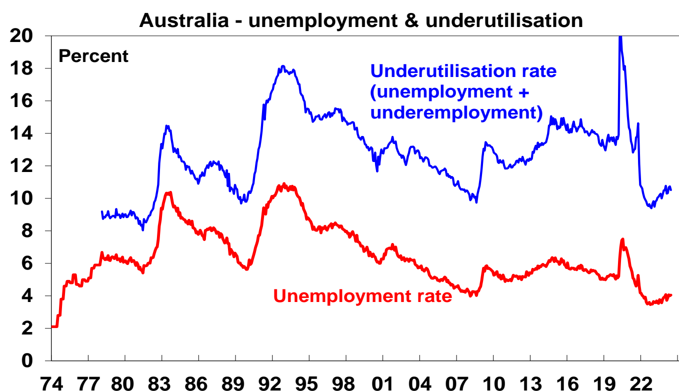
Chinese data for the June quarter points to a further slowing in growth. GDP growth slowed to 4.7%yoy and June monthly data was mixed with industrial production stronger than expected, investment in line with expectations and retail sales much weaker than expected. And property sales, investment and prices keep falling with the property sector remaining a key drag on growth. Growth this year could come in just slightly below the Government's "around 5%" target but it likely requires more stimulus. The Third Plenum laid out reforms for the next five years with a focus on "high quality development" including around innovation, urbanisation, "new-quality productive forces", supply chain security and risk control with details yet to be unveiled. There was no cyclical stimulus but there was a pledge to "unswervingly achieve the full-year growth target" and "pro-actively expand domestic demand" suggesting more policy stimulus ahead. The risk though is that with a focus on "high quality development" any stimulus won't do much to reinvigorate consumer spending where help is really needed.



Source: Bloomberg, AMP

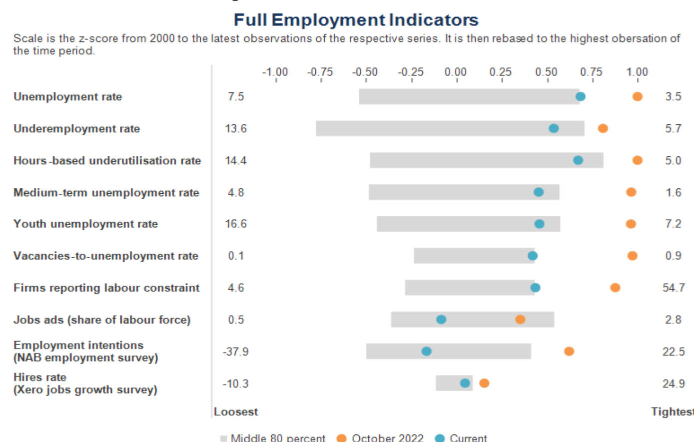
Australian economic events and implications

June jobs data was strong again. Employment rose a strong 50,200, most of the increase was in full time jobs, hours worked rose solidly as less than normal were on annual leave and underemployment fell slightly. However, the labour market is continuing to gradually cool with unemployment rising slightly to 4.1% suggesting the labour demand is not quite keeping up with supply and labour underutilisation at 10.5% is still well up from its November 2022 low of 9.4% despite lots of gyrations.



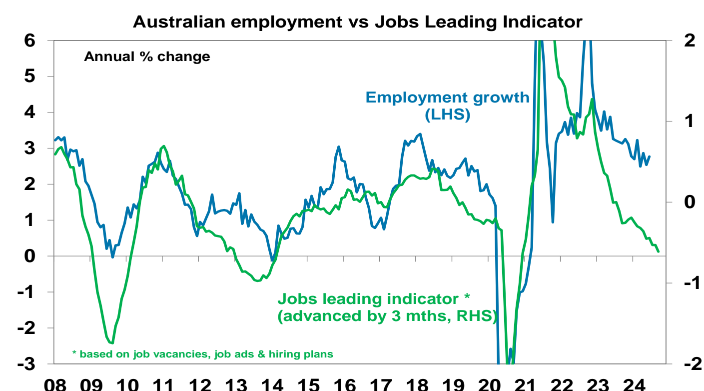
Source: ABS, AMP

The clearly still tight labour market is not enough on its own to bring on another rate hike, but if June quarter CPI data comes in on the hot side it won't prevent one either. But the clear cooling in forward looking labour market data indicates that the RBA needs to be very careful here. The next table provides a detailed set of employment indicators. All show that the labour market is not as tight as it was in 2022 when unemployment bottomed at 3.5%. Most show that it's still historically tight though. But forward-looking indicators like job ads and business hiring plans show that its loosening.



Source: ABS, NAB, Jobs & Skills Australia, Xero, Macrobond, AMP

Reflecting the slowdown in forward looking indicators our Jobs Leading Indicator points to slower jobs growth ahead.



Source: ABS, AMP

The delayed slowdown in employment relative to the indicator may partly reflect a combination of longer than normal lags following the pandemic, strong public sector jobs growth, ABS civilian population growth estimates being too high and labour hoarding. The ABS benchmarks employment growth to population estimates which still show growth of 2.9%yoy for the civilian population aged 15 and over but which looks too high given a slowdown in arrivals data suggesting that employment growth may eventually get revised down after March and June quarter population data is released. Labour hoarding is possibly evident in a faster slowdown in hours worked (after smoothing for monthly volatility) than in employment - as businesses caught out by the labour shortages of two years ago don't want to see the same again – and may partly explain the delayed slowdown in employment so far. But it's doubtful that this will be sustainable if consumer demand growth remains weak.

Source: ABS, AMP

Meanwhile, housing starts and completions fell in the March quarter confirming the poor signal from approvals. Yes, there is a big pipeline of approvals yet to be completed but with completions running around 170,000 pa we are well below the 250,000 or so dwellings a year need to keep up with the recent population surge driven housing demand and well below the 240,000 dwellings a year we are supposed to be building under the Housing Accord.

What to watch over the next week?

In the US, June core private final consumption deflator inflation (Friday) is likely to come in around 0.2%mom confirming the slowdown in inflation since March and adding to confidence that inflation is sustainably on track to fall back to the Fed's 2% target. The annual inflation rate will likely be unchanged at 2.6%yoy. Meanwhile, June quarter GDP growth (Thursday) is likely to show growth remaining subdued at around 1.8% annualised reflecting continued soft growth in consumer spending, existing home sales (Tuesday) are likely to fall, underlying durable goods orders (Thursday) are likely to remain soft and July business conditions PMIs (Wednesday) are likely to have slowed slightly from strong levels. The June quarter earnings reporting season will start to ramp up with 126 S&P 500 companies to report in the week ahead including Coca Cola, GE, Tesla & Alphabet. Consensus expectations are for a 7.1%yoy rise in earnings, which is likely to end up being around 10%yoy again. Excluding tech, the consensus expectations are for 1.5%yoy growth.

In Canada its possible that the Bank of Canada (Wednesday) will cut interest rates for a second time reflecting the fall in its inflation rate. The money market has priced in a 72% chance of a cut and one is fully priced in for September.

Eurozone, Japanese and Australian business conditions PMIs for July (Wednesday) are all likely to remain relatively soft.

Outlook for investment markets

Easing inflation pressures, central banks moving to cut rates and prospects for stronger growth in 2025-26 should make for reasonable investment returns over 2024-25. However, with a high risk of recession, possible delays to rate cuts and significant geopolitical risks particularly around the US election, the next 12 months are likely to be more constrained and rougher compared to 2023-24 and there is a high risk of another correction in the next few months.

We have raised our year end forecast for the ASX 200 to 8100. A recession is probably the main threat.

Bonds are likely to provide returns around running yield or a bit more, as inflation slows, and central banks cut rates.

Unlisted commercial property returns are likely to remain negative due to the lagged impact of high bond yields and working from home.

Australian home prices are likely to see more constrained gains over the next 12 months as the supply shortfall remains, but still high interest rates constrain demand and unemployment rises. The delay in rate cuts and talk of rate hikes risks renewed falls in property prices as its likely to cause buyers to hold back and distressed listings to rise.

Cash and bank deposits are expected to provide returns of over 4%, reflecting the back up in interest rates.

A rising trend in the $A is likely taking it to $US0.70 over the next 12 months, due to a fall in the overvalued $US and a narrowing in the interest rate differential between the Fed and the RBA.

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